

Quiz B for 2:30 Class: 11/26/12

Name _____

Bowl Bound 3 Inc. is considering whether to build a new plant today at a cost of \$50 million. There is a 65% chance that the plant will generate net cash flows of \$10 million per year for 25 years and a 35% chance that the factory will generate net cash flows of \$7 million per year for 8 years. In both cases, net cash flows would begin a year from today. For either level of net cash flow the factory could be shut down and sold a year from today (after net cash flows for the first year are realized) for \$40 million. If net cash flows equal \$10 million per year, the factory could be expanded at a cost of \$15 million one year from today. The expansion would produce additional net cash flows of \$2 million per year for 20 years beginning two years from today. Assume the cost of capital for the project and the expansion equals 8%.

- a. Sketch a decision tree of this capital budgeting decision.
- b. Set up the calculations needed to determine whether the factory should be expanded next year. How would you make a decision?

Wall Street Journal Questions are on the back of this page.