Energy Gel Case Questions

The most important financial decision a firm makes is selecting the correct projects. Projects whose expected return exceeds their cost of capital (i.e. projects with a positive net present value) create wealth for the firm's shareholders. One of the most, if not the most important, component of valuation is the correct estimation of future cash flows. We will use this case to discuss how to forecast future cash flows. The case examines investment in a new product line inside a multi-divisional firm. This raises the question of which cash flows are relevant to the decision and how to allocate costs correctly. We will discuss both the science and art of forecasting cash flows and valuing projects using the discounted cash flow method. The following questions should guide your thinking as you read the case and provide the basis of our classroom discussion.

1) Cash flow forecasting.[1] Which cash flows are relevant for HPC's decision of whether to launch the Energy Gel product line. In addition to the standard cash flows, you should consider how to treat the product development expenses, the allocation of over head costs, the possible cannibalization of Energy Bar sales by Energy Gel, and the required investment in manufacturing capacity (mixing machines) required to produce Energy Gel. Many, but not all, of the numbers you need are in Exhibit 5. Construct your cash flow forecasts based on these numbers, but also consider whether you think the numbers are correct.

2) Should HPC pursue the Energy Gel market? To answer this question, you need to consider how a firm should make investment decisions. HPC uses several metrics when choosing which investment projects to pursue. Should strategic concerns (e.g. we need to invest to remain competitive) be relevant to the investment decision?

3) Theory versus practice. Valuation is often taught as a very scientific process. Given the cash flows and the discount rate, all parties should agree on whether the project is a good one. In practice, the cash flow forecasts may be produced as part of a political process. How does this change the way we do valuation in practice, oppose to theory?

[1] I have posted an excel spreadsheet which contains a copy of Exhibit 5 on the course web page. This should speed your preparation as many, but probably not all, of the relevant numbers have been entered for you.