

Teach Yourself: Economic Evaluation:

Evaluating the Business/Project **2b: Steps 1 & 2**

The purpose of this module is to ...

Level 3: Decision making

**quickly explore Steps 1 & 2
in the evaluation of a
business/project**



Level 2: Evaluating the business/project

Level 1: Hands-on economic modelling

Spend only a few seconds on most slides.

Level 2: Evaluating the business/project

Step 1: Find out what is required

Step 2: Create the hands-on model

Step 3: Compute the basket of powerful economic measures: NPV, IRR, Payback, four cash streams, key drivers, break-evens, uncertainty, risk, optionality

Step 4: Assess alternatives, flexibility, options, risks, the business, the industry

Step 5: Communicate your message

Generally the evaluation will require you to ...

Step 1: Find out what is required

Step 2: Create the hands-on model

Step 3: Compute powerful metrics
NPV, IRR, cash-flow, risk, uncertainty, risk

Step 4: Assess alternatives
the business, the market, the industry

Step 5: Communicate your message

Most of you will think you can skip this step because it is obvious.

But it is not always!
Read on!

Step 1: Find out what is required

- a) Big companies usually have an electronic manual or a checklist that clearly defines what is required by the economic evaluation.
There could be one document for minor capital expenditure, another for major capital expenditure, others for concept studies, prefeasibility studies, final feasibility studies, M&A transactions, and execution of a project. Each is tailored to purpose with increasing activities and accuracy.
They usually are easy to follow and are a clear foundation for the audit team.
- b) Many smaller companies have copies of these or have written their own derived version.
- c) Then there are large companies, small companies and due diligence teams that have no documentation and which use collective experience as the guide.

Comprehensive documentation

Having all the requirements comprehensively documented, that includes checking by an audit team, is very good discipline and very healthy.

- ▶ It should mean that a proper evaluation is completed and one that is fit for purpose (with its detail tailored to the decision to be made.)
- ▶ The audit will make everyone do appropriate levels of work to support conclusions and keep orderly records.
- ▶ It should help stop biased managers from bulldozing their pet projects through the approval process. These comprehensive documents are good to control self-interested managers and project managers on an ego-trip or chasing a monetary bonus. Sadly there seem to be too many M&A's where the motive was self-interest.
- ▶ It should bring efficiency and effectiveness to the evaluation work by giving you as evaluation specialist a clear set of objectives. And by specifying to your colleagues exactly is needed from them for you to complete your role.

Comprehensive documentation

The biggest negatives are likely to be: –

1. **Who wrote the documents?** → I have seen a few written by experienced project engineers. They know the words but really do not properly understand economic evaluation. Being engineers they focus on NPV and other metrics to write in boxes, not understanding these are just a start, and that economic evaluation is far more comprehensive and challenging.
2. **Pedants:** Some managers and some evaluation specialists will become slaves to documents, do exactly as specified but do not think in a business sense and do not see the big picture.

You should take the initiative. You should think the decision through as your work evolves and seek permission to adapt/change your evaluation output to better match the particular business/project. I always think of what I would want done if I owned the business/project.

When there is no documentation

If there are no documents available inside your company then you may need to ask amongst your colleagues for non-confidential versions.

When the evaluation starts it would be wise to discuss the outputs from the economic evaluation amongst your managers and colleagues.

- ▶ If your Team Leader is open-minded and business-like then you have a golden opportunity of quickly earning your place as a key member by hard work and lots of constructive interaction.
- ▶ If you find your Team Leader is an autocratic project manager, who thinks it is only about writing the NPV on a box, then you should use your judgement about talking of a more meaningful role. It may be best to work away and progressively broaden your role within the team by interacting and gaining respect. Eventually you may be able to flourish.
- ▶ Whether you are experienced or not, always find out from key people what each expects from your valuation work. By taking time to discuss and outline your thoughts you can start winning a powerful position in the team.

Economic evaluation can be the best role in the Team.

Some other items ...

Inside that the formal documentation will be a section on the business decision which may be called “Investment Evaluation”, “Economic Evaluation” or similar.

- Hopefully it is not called “Financial Analysis”, “Financial Evaluation” or “Financial Modelling” because those headings apply to either funding with debt/equity or analysing the accounts.
- Worse still are those who call it “Cost Modelling” because that is about synthesising the capital and operating costs. Something done by specialist estimators and operations
- The evaluation work required should increase as the project moves toward execution and always be fit-for-purpose.

The company document should follow the five steps of Level 2 in this series.

- This would be comprehensive, productive and encourage a more mature understanding of the business.
- You may need to extend the evaluation beyond what is specified so everyone understands the business decision from an industry perspective. Much more than evaluation metrics. See Step 4
- I always think of what I would want assessed and recommended if I owned this business.

Presentation of your work

- Readers of the economic evaluation section need the conclusions and recommendations up front so they can either take them at face value, or choose to keep reading through the supporting detail below.
- Avoid the boring sequence of “introduction”, “method” “results”
- I have seen several documents, even in leading companies, where the economic evaluation section is jumbled, inferior and unsatisfactory. These should have been rewritten by a seasoned evaluation specialist.
- In general, the most important evaluation information should be presented first
- Take the lead and present your conclusions and results as you would want if you owned the business

Next is Step 2 ...

Step 1: Find out what is required

Step 2: Create the hands-on model

Step 3: Compute net
NPV, IRR
uncertainty

**This is covered in the modules
for Level 1: Hands-on economic
modelling. Nothing will be
added here.**

Step 4: Assess alternatives, flexibility, options, risks,
the business, the industry

Step 5: Communicate your message

End