THE TIMES 100
BUSINESS CASE STUDIES

Investment decision making - Enterprise

Enterprise Rent-A-Car is an internationally recognised **brand**, operating within the United States, Canada, the UK, Ireland and Germany. It is the UK's largest car rental company. The company encourages its branch managers to take responsibility for local operations. This means that each branch is free to focus on the needs of its local customers, while delivering Enterprise's values and high standards of customer service.

When an organisation makes an investment, it is taking a business risk. When a company spends money on opening or moving to a new location, it will hope to see a return on this investment through increased profits. For example, by opening a new branch close to a buoyant or developing market, the business would hope to increase its sales. This in turn should lead to higher profits.

Setting up a new Enterprise branch generates costs: These relate to:

- set-up costs, such as for obtaining planning permission, decorating and fitting out the buildings and installing fire alarms and security
- **fixed costs**, including rent and other overheads such as heating and lighting
- **variable costs**, which will depend on the volume of business. These include staff salaries and the cost of owning and maintaining vehicles.

There are several ways in which Enterprise assesses whether a new branch or relocation will generate sufficient return on the required investment. The starting point for any method of **investment appraisal** is to forecast how much additional revenue the new operation will generate. However, this also needs to be considered against how much that business may take away from other Enterprise locations nearby. This revenue forecast can then be used to obtain a profit forecast.

Projected revenues and profits can be linked back to costs in several ways:

- ***Payback*** measures the length of time it will take to generate sufficient profit to cover the costs of the initial investment. When assessing different project options, companies sometimes choose the project that has the shortest payback period.
- ***Return on capital employed*** expresses the amount of profit generated in a given period (usually a year) as a percentage of the costs of the project. Investors would usually only back projects where this percentage is greater than prevailing bank interest rates. It would make little sense to back a business project if investors could get a greater return by simply keeping their money in a bank account.
- ***Break-even analysis*** is a way of assessing how long it will take (or how many customers are required) for a new business venture to generate a profit. This analysis relates sales revenue to total costs. The break-even point is achieved when the revenue equals the costs incurred to date.

Qualitative factors are also taken into account when making investment decisions. A large multi-national company like Enterprise may sometimes choose a location because it offers a strategic advantage. For example, it may stop a competitor obtaining the location or may be situated in a developing area where the longer term projections are very good.

Questions

1. What is meant by investment appraisal?

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2. Describe the costs involved in setting up a new Enterprise branch?

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3. Explain the benefits that firms like Enterprise hope to experience when making capital investments.

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4. Evaluate the use of quantitative investment appraisal methods, such as payback, when Enterprise is making decisions about the location of new branches.

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Task

Scenario: a firm has forecasted that a project which has an estimated lifespan of five years, will have a positive net cash flow of £60,000 in each of the first three years and £50,000 in years 4 and 5. Calculate Payback, Average Annual Rate of Return and Net Present Value (with discount rate of 10%) for the project. (With a discount rate of 10%, the discount factor will be: 1.0 in year 0, 0.91 in year 1, 0.83 in year 2, 0.75 in year 3, 0.68 in year 4, 0.62 in year 5)+

What have you learned?

Write a paragraph summarising what you have learned today about investment decision making. Include one deliberate mistake in the paragraph. Swap with someone else to see if you can identify each other's 'mistake'.