

INVESTMENT APPRAISAL

FRANKIE'S FUNFAIR

The Sell family own and operate a large fairground and funfair in County Durham. The business was started in 1940 by Frankie Sell, and is now managed by his daughter, Carol Sell.

Over the past 5 years, Frankie's Funfair has seen a decline in sales revenue, partly due to increased competition in County Durham. County Durham has recently witnessed large scale investment and regeneration with a £40m development in the city, comprising of a bowling alley, cinema complex, 23 refurbished retail units and 35,000 sq ft of new restaurants.

Three new state-of-the-art leisure centres could also be built under plans to invest £63 million in leisure services across County Durham.

In response, Carol is considering investing in a new children's rollercoaster in order to attract more families, as well as expanding the range of food and drink outlets at the fairground.

The cost of the investment is estimated to be £1m, of which £200,000 would need to come from outside investment. The investment would be expected to achieve an average rate of return of at least 8% and a net present value of £200,000.

Below is some selected financial data relating to the business and the proposed investment:

Sales Revenue

Year	Sales Revenue
2019	£10,800,000
2018	£11,000,000
2017	£11,200,000
2016	£11,500,000
2015	£12,000,000

Extracts from Financial Accounts

	2017-2018	2018-2019
Profit for the Year/ Net Profit Margin	8%	7%
Current Ratio	1.9:1	1.7:1
Gearing	35%	42%

Investment Appraisal Data

Initial Cost: £1m

Year	Cash Inflows	Cash Outflows
1	£300,000	£100,000
2	£420,000	£120,000
3	£540,000	£140,000
4	£660,000	£160,000



5% discount factors: Year 1 0.952 Year 2 0.907 Year 3 0.864 Year 4 0.823

Question: The investment is expected to achieve an average rate of return of at least 8% and a net present value of £200,000. Is this a realistic objective? Use calculations to support your answer.

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TEACHER ANSWERS

Year	Cash Inflows	Cash Outflows	Net Cash Flows	Cumulative Cash Flows	Discount Factor (5%)	Present Value
0	0	(£1,000,000)	(£1,000,000)	(£1,000,000)		
1	£300,000	£100,000	£200,000	(£800,000)	0.952	£190,400
2	£420,000	£120,000	£300,000	(£500,000)	0.907	£272,100
3	£540,000	£140,000	£400,000	(£100,000)	0.864	£345,600
4	£660,000	£160,000	£500,000	£400,000	0.823	£411,500

Average Rate of Return

Total net cash flows = £1,400,000

£1,400,000 - £1,000,000 = £400,000

£400,000 / 4 = £100,000

(£100,000 / £1,000,000) x 100 = 10%

ARR = 10%

Net Present Value

Total net cash flows (present value) = £1,219,600

£1,219,600 - £1,000,000 = £219,600

NPV = £219,600

- Based on the investment appraisal data, the investment achieves a 10% ARR and an NPV of £219,600 therefore in quantitative terms, both objectives are achievable
- Sales revenue has fallen by 10%
- Profit for the year/net profit margin has fallen from 8% to 7%
- Liquidity has fallen from 1.9:1 to 1.7:1
- Gearing has increased from 35% to 42%
- Falling sales revenue and net profit/profit for the year could make it difficult in attracting outside investment as well as affecting the estimated cash inflows
- Gearing has also risen. Although it is still under 50%, this could deter investors
- The proposed £63m investment in leisure facilities may affect the predicted cash flow figures

Based on the investment appraisal data, the objectives are achievable, however, how accurate are the financial forecasts given the 10% decline in sales revenue and the fall in net profit? Qualitative factors such as the economy and the proposed investment in leisure facilities could all have an impact on the accuracy of the predicted cash flows.