



Investment project valuation based on a fuzzy binomial approach

Shu-Hsien Liao^a, Shiu-Hwei Ho^{a,b,*}

^a Graduate Institute of Management Sciences, Tamkang University, 151 Ying-chuan Road, Tamsui 25137, Taipei County, Taiwan

^b Department of Business Administration, Technology and Science Institute of Northern Taiwan, No. 2 Xueyuan Rd., Peitou 112, Taipei, Taiwan

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ABSTRACT

The typical approaches to project valuation are based on discounted cash flows (DCF) analysis which provides measures like net present value (NPV) and internal rate of return (IRR). DCF-based approaches exhibit two major pitfalls. One is that DCF parameters such as cash flows cannot be estimated precisely in an uncertain decision making environment. The other one is that the values of managerial flexibilities in investment projects cannot be exactly revealed through DCF analysis. Both of them would have significant influence on strategic investment projects valuation. This paper proposes a fuzzy binomial approach that can be used in project valuation under uncertainty. The proposed approach also reveals the value of flexibilities embedded in the project. Furthermore, this paper provides a method to compute the mean value of a project's fuzzy NPV. The project's fuzzy NPV is characterized with right-skewed possibilistic distribution because these flexibilities retain the upside potential of profit but limit the downside risk of loss. Finally, this paper discusses the value of multiple options in a project.

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1. Introduction

DCF-based approaches to project valuation implicitly assume that a project will be undertaken immediately and operated continuously until the end of its expected useful life, even though the future is uncertain. For example, in the NPV approach we make implicit assumptions concerning a certain “expected scenario” of cash flows. By treating projects as independent investment opportunities, decisions are made to accept projects with positive computed NPVs. Since DCF-based approaches ignore the upside potentials of added value that could be brought to projects through managerial flexibilities and innovations, they usually underestimate the upside value of projects [4,11,17,26,30].

For high-risk investment projects, the traditional NPV method may adopt higher discount rates to discount project cash flows for trade-off or compensation. However, higher discount rates may result in the underestimation of project value and the rejection of a potential project. Investments such as new drug development or crude oil exploitation may carry high risk, but may also bring higher returns. In particular, as market conditions change in the future, investment project may include flexibilities by which project value can be raised. Such flexibilities are called real options or strategic options.

Real options analysis, as a strategic decision making tool, borrows ideas from financial options because it explicitly accounts for future flexibility value. Real options analysis is based on the assumption that there is an underlying source of uncertainty, such as the price of a commodity or the outcome of a research project. Over time, the outcome of the underlying uncertainty is revealed, and managers can adjust their strategy accordingly.

* Corresponding author. Address: Department of Business Administration, Technology and Science Institute of Northern, Taiwan, No. 2 Xueyuan Rd., Peitou 112, Taipei, Taiwan. Tel.: +886 922268090.

E-mail addresses: Michael@mail.tku.edu.tw (S.-H. Liao), succ04.dba@msa.hinet.net (S.-H. Ho).

In DCF, parameters such as cash flows and discount rates are difficult to estimate [6]. In particular, innovative investment projects may count on the subjective judgments of decision makers due to lack of past data for reference. These parameters are essentially estimated under uncertainty. With respect to uncertainty, probability is one way to depict whereas possibility is another. Fuzzy set theory provides a basis for the theory of possibility [32]. Fuzzy logic may be viewed as an attempt at formalization of two remarkable human capabilities. One is the capability to converse, reason and make rational decisions in an environment of imprecision, uncertainty and incompleteness of information and the other one is to perform a wide variety of physical and mental tasks without any measurements and computations [34]. The outstanding feature of fuzzy logic is that in fuzzy logic everything is—or is allowed to be—a matter of degree. In the generalized theory of uncertainty, uncertainty is linked to information through the concept of granular structure—a concept that plays a key role in human interaction with the real world [33]. Thus, these parameters can be characterized with possibilistic distributions instead of probabilistic distributions, and can be estimated by making use of fuzzy numbers.

The objectives of this paper are to develop a fuzzy binomial approach to evaluate a project embedded with real options, to propose a method suitable for computing the mean value of fuzzy NPV, and to explore the value of multiple options existing in projects. The paper is organized as follows. Section 2 provides a literature review of real options analysis. We especially focus on pricing, applications and recent developments of real options analysis. Section 3 presents a fuzzy binomial approach to evaluate a project under vague situations. This section also proposes a method to compute the mean value of fuzzy NPV. Section 4 illustrates a project valuation based on our approach. In the example, the premiums (or values) of the real options are also assessed. Section 5 discusses multiple options and limitations of the study. Finally, conclusions are drawn in Section 6.

2. Literature review

Traditional net present value techniques only focus on current predictable cash flows and ignore future managerial flexibilities, therefore, may undervalue the projects and mislead the decision makers. The real options approach to projects valuation seeks to correct the deficiencies of the traditional valuation methods through recognizing that managerial flexibilities can bring significant values to projects. According to real options theory, an investment is of higher value in a more uncertain or volatile market because of investment decision flexibilities.

Based on real options theory, Chen et al. [8] presented an approach to evaluate IT investments subject to multiple risks. By modeling public risks and private risks into a unified framework, they utilized the binomial model to evaluate an ERP development project. Wu et al. [29] argued that ERP may be best represented by a non-analytical, compound option model. However, most IT studies that employ the options theory only consider a single option, use an analytical model such as the Black and Scholes [1] model, and cannot deal with multi-option situations. Based on the real options theory, Wu et al. employed the binomial tree approach to implement an active ERP management which involves uncertainties over time.

Hahn and Dyer [13] proposed a recombining binomial lattice approach for modeling real options and valuing managerial flexibility to address a common issue in many practical applications—underlying stochastic processes that are mean-reverting. The models were tested by implementing the lattice in binomial decision tree format and applying to a real application by solving for the value of an oil and gas switching option.

Reyck et al. [21] proposed an alternative approach for valuing real options based on the certainty-equivalent version of the NPV formula, which eliminates the need to identify market-priced twin securities. Moreover, Bowe and Lee [3] also utilized the log-transformed binomial lattice approach to evaluate the Taiwan High-Speed Rail (THSR) project.

Basically, if the values of parameters in a valuation model are numeric, they come from the probabilistic expected values of these parameters. However, the values of parameters can also be estimated as fuzzy numbers to characterize the uncertainty in terms of possibility rather than probability.

By modeling the stock price in each state as a fuzzy number, Muzzioli and Torricelli [20] obtained a possibility distribution of the risk-neutral probability in a multi-period binomial model, then computed the option price with a weighted expected value interval, and thus determined a “most likely” option value within the interval. Muzzioli and Reynaerts [19] also addressed that the key input of the multi-period binomial model is the volatility of the underlying asset, but it is an unobservable parameter. The volatility parameter can be estimated either from historical data (historical volatility) or implied from the price of European options (implied volatility). Providing a precise volatility estimate is difficult; therefore, they used a possibility distribution to model volatility uncertainty and to price an American option in a multi-period binomial model.

Carlsson and Fuller [6] mentioned that the imprecision in judging or estimating future cash flows is not stochastic in nature, and that the use of the probability theory leads to a misleading level of precision. Their study introduced a (heuristic) real option rule in a fuzzy setting in which the present values of expected cash flows and expected costs are estimated by trapezoidal fuzzy numbers. They determined the optimal exercise time with the help of possibilistic mean value and variance of fuzzy numbers. The proposed model that incorporates subjective judgments and statistical uncertainties may give investors a better understanding of the problem when making investment decisions. Carlsson et al. [7] also developed a methodology for valuing options on R&D projects, in which future cash flows were estimated by trapezoidal fuzzy numbers. In particular, they presented a fuzzy mixed integer programming model for the R&D optimal portfolio selection problem.

In addition to the binomial model, the Black–Scholes model is another way to evaluate the option's value. Owing to fluctuations in the financial market from time to time, some input parameters in the Black–Scholes formula cannot be expected to always be precise. Wu [28] applied the fuzzy set theory to the Black–Scholes formula. Under the assumptions of fuzzy

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