Capital Rationing

Capital rationing means the allocation of the limited funds available for financing the capital projects in such a manner that the long term returns are maximised.
In other words, capital rationing means the selection of only some of the profitable investment proposals due to limited availability of funds or other considerations, say, the desire of the management to keep the growth of the firm within limit, the preference of the management to safety and control as compared to profit.

Effect of capital rationing :-

The effect of capital rationing are :-

1) When there is capital rationing, a firm will not be able to undertake all the profitable investment proposals. It has to accept only some of the profitable investment proposals and reject

the other profitable investment proposals.

2) When there is capital rationing it will not be possible for

the firm to maximise the wealth of owners and to maximize the market value per share.

Objective of Capital Rationing:- The main objective of capital rationing is to ensure the selection of only those profitable investment proposals that will provide the maximum long term returns. In short, the objective of capital rationing is to maximise the value of the firm.

Steps involved in Capital Rationing

Capital rationing involves two important steps. They are:-

1st :- Ranking of different investment Proposals:- First, the different investment proposals available should be ranked on the basis of their profitability in the descending order i.e on the basis of their NPV, IRR or PI.

2nd:- Selection of some of Profitable investment Proposals:- Then, on the basis of their profitability in the descending

23 WEDNESDAY DAY 054-311

order, the selection of that combination of profitable investment proposals, which would provide the highest profitability should be made subject to the budget constraint for the period.

Risk and uncertainty in projects

Need for risk analysis in capital Budgeting:-

Since there are number of reasons such as technical, economic, political, financial, foreign exchange, taxation etc,

24 THURSDAY DAY 055-310

due to which the actual return from an investment proposals can be different from the estimated returns.

So, there is always uncertainty regarding the future estimation of cash inflows from capital projects. But of course the risk varies from one proposal to another. Some proposals will be less risky and some may be more risky. So it is necessary to take into account the risk factor, while taking the capital budgeting decisions.

Techniques used for incorporation of risk factor in capital budgeting decision:—

There are number of techniques used for the incorporation of the risk factor in capital budgeting decision. The most popular techniques are:-

1) ordinary technique or general technique
2) Quantitative techniques

1) General technique:-

* Risk adjusted discount rate method:— Under this method, the future cash flow from capital projects are discounted at the risk adjusted discounted rate and the decision regarding selection of a project is made on the basis of the NPV of the project computed at the risk discount rate.

This technique is based on the assumption that investors expect a higher rate of return on more risky projects and a lower rate of return on less risky projects,

28 MONDAY DAY 059-306

and so, a higher discount rate is used for discounting the cash flows of more risky projects and the lower discount rate is used for discounting the cash flow of less risky project.

* Certainty equivalent coefficient method:-

It is the method which makes adjustment against risk in the estimates of future cash inflows for a risky capital investment project and the project is selected on the basis of NPV of the project.

01 TUESDAY DAY 060-305

The certainty equivalent coefficient is the ratio of riskless cashflow to risky cashflow. Riskless cashflow means the cash flow which the management expects, when there is no risk in investment proposals. Risky cashflow means the cashflow which mgt expects when there is risk in investment proposal.

$$\text{Certainty equivalent coefficient} = \frac{\text{Riskless Cashflow}}{\text{Risky Cashflow}}$$