The future of Real Options

There has been considerable debate both in the marketplace and in the pages of JASSA regarding the relative merits of evaluating capital spending decisions using Net Present Value (NPV) or the Real Options method. Vladimir Antikarov, a co-author (with Tom Copeland) of the highly acclaimed “Real Options: A Practitioner’s Guide” was in Australia recently and he spoke with editor John Arbouw.

As part of the team comprising the Boston-based Monitor Group, Vladimir Antikarov’s business is to help companies understand their business and investment strategies.

The tools of his profession include models that allow the tracking and monitoring of investment decisions. One of his favourite tools at the moment is the Real Options method which he believes allows companies to build flexibility into their projects, unlike the approach of Net Present Value (NPV) which works only with average scenarios.

There is little doubt that Real Options is gaining acceptance. A recent survey in the Journal of Financial Economics, 6 (2001) showed that 27 % of US companies have or are using Real Options in assessing investment opportunities.

“There are a lot of average assumptions built into the NPV method that do not reflect the future uncertainties and choices companies face,” says Antikarov. “However, NPV was a significant improvement over the Payback model which didn’t account for no risk in the project and accounted for the future only until recouping the investment.

“What NPV was missing was that it did not really account for the fact that once a project begins it may move in different directions because of circumstances and require continuous monitoring and intervention. NPV was not capturing the reality of actual project management. It is a crude representation of the future actions and analyses only the average (expected) scenarios.”

A criticism of the Real Options method is that it works only if a company is truly prepared to take and execute optimal decisions. For example it requires having the management discipline to pull the plug on an investment when further spending is not justified.

A cursory examination of investment decisions especially in the technology area over the past year easily shows that managers and boards are not always prepared to make the hard decisions.

Antikarov says that if you understand the economics of the project, the uncertainties, the strategic actions available to you and, if you can execute those actions optimally, Real Options analysis will provide you with the total value of the project.

“Real Options is an evolution that has several implications on management decision making and strategy formulation. All our corporate governance decisions are based around average scenario planning. We set targets at the beginning of the year and expect managers and employees to achieve them.

“However, the reality rarely follows the average scenario. No one could have predicted September 11 and its consequences. But if in our project analysis we have an approach that captures a few uncertainties that drive down the project economics, then this is a major improvement. In this sense, Real Options is a valuable risk management tool that helps management plan explicitly for contingencies.

“The first response to an economic slowdown is for companies to cut staff and we are seeing a number of companies adopting this approach. They are also cutting back on projects but this is often done from a short-term economic approach across the board rather than a long-term strategic aim.

“Today, you have to know which projects to keep for that time when the economic upturn happens. Real Option analysis allows companies to know the intrinsic value of projects and the opportunities they provide. This flexibility will become a key competitive advantage.”