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Investment Evaluation Methods and Required Rate of Return in Finnish Publicly Listed Companies

Financial literature advocates the use of the Net Present Value method for the evaluation of investments. Its key parameter is the required rate of return on equity, which is to be calculated using the Capital Asset Pricing Model or a similar model especially if the company is publicly listed. However, there is ample evidence on companies not necessarily utilizing the NPV method or the CAPM in their capital budgeting and investment evaluation processes.

In this study we have surveyed the practice of investment evaluation methods, their use, and the required rate of return in publicly listed Finnish companies. This study updates and to some extent extends earlier studies by Honko and Virtanen (1984), Virtanen (1984), and Keloharju and Puttonen (1995). The results show that even though the finance literature's favored method for evaluating investments, the Net Present Value, is gaining more popularity, the payback method is still used most often as the primary method of choice. Even though 52.1 percent of the companies indicate that they use the NPV either as their primary or secondary investment evaluation method, its use is still far below that in the U.S. according to a recent study (Graham and Harvey, 2001). Interestingly, the largest Swedish companies are also using the NPV as frequently (52.3 percent of respondents) as the Finnish ones.

The capital asset pricing model or multi-beta model is used only in some 40 percent of the companies as the primary or secondary method in setting the cost of equity capital. This is a surprisingly low number, given the fact that all respondents were publicly listed companies. Even more surprising was to find that a quarter of the companies have not even calculated the cost of their equity capital even though it is one of the key parameters in setting the WACC.

The results also indicate that the median required nominal rate of return for the capital on the companies that answered the survey is between 12–14 percent, but that more than 20 percent of the companies have a requirement higher than 20 percent. The tabulated mean WACC is 15.19 percent, indicating an average hurdle of 6.585 years for the payback rule given constant pooled cash flows from investments producing on average cash flows equaling the WACC rate on the original investment.