

**ADDITIONAL PROBLEM FOR CHAPTER 12****12-14**
Investment timing option

Oregon Lumber is considering the purchase of a paper company. Purchasing the company would require an initial investment of \$300 million. Oregon estimates that the paper company would provide net cash flows of \$40 million at the end of each of the next 20 years. The cost of capital for the paper company is 13 percent.

- a. Should Oregon purchase the paper company?
- b. While Oregon's best guess is that cash flows will be \$40 million a year, it recognizes that there is a 50 percent chance the cash flows will be \$50 million a year, and a 50 percent chance that the cash flows will be \$30 million a year. One year from now, it will find out whether the cash flows will be \$30 million or \$50 million. In addition, 1 year from now, Oregon also recognizes that if it wanted, it could sell the company in 2 years for \$280 million. Given this additional information, does it make sense to purchase the paper company? Again, assume that all cash flows are discounted at 13 percent.

