

Capital Allocation

Capital allocation (sometimes known as capital budgeting) concerns how to allocate the capital a firm has available on different projects or investments to increase profitability and enhance its economic value.

Of the three main decisions a firm makes (i.e. operating decisions, financing decisions, capital allocation decisions), the capital allocation decision is arguably the most important and the one that is the most difficult to undo.

The capital allocation decision usually involves calculating a weighted average cost of capital (WACC) and a marginal cost of capital, and using these to calculate the net present value (NPV) of various projects under consideration. On occasion, firms will simply compare these rates to the rates of return expected from various projects to decide how to allocate their capital.