11 - Risk Analysis - ch. 13

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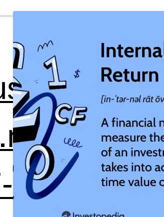
▼ Supplemental

▼ IRR

Internal Rate of Return (IRR) Rule: Definition and Example

The internal rate of return (IRR) is a metric used in capital budgeting to estimate the return of potential investments.

https://www.investopedia.com/terms/i/irr.asp



KEY TAKEAWAYS

- The internal rate of return (IRR) is the annual rate of growth that an investment is expected to generate.
- IRR is calculated using the same concept as net present value (NPV), except it sets the NPV equal to zero.
- The ultimate goal of IRR is to identify the rate of discount, which makes the present value of the sum of annual nominal cash inflows equal to the initial net cash outlay for the investment.
- IRR is ideal for analyzing capital budgeting projects to understand and compare potential rates of annual return over time.
- In addition to being used by companies to determine which capital projects to use, IRR can help investors determine the investment return of various assets.

Resources

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▼ Lecture

- ▼ risk
  - ▼ higher the variability of expected returns → greater rik of an investment
- ▼ risk averse
  - ▼ investors generally require higher expected rturn for mor risk
- ▼ risk vs return
  - ▼ key investmnt consideration
  - ▼ IRR or projected NPV should be viewed w.r.t. risks associated
- ▼ investment risks
  - ▼ economic risk (all geo scales)
  - ▼ bussinesss risk, financial risk, internal rate risk, liquidity rik, inflation risk, managemnt risk
  - ▼ environmental risk, legislaativ risk, pandmic risk, etc.
- ▼ due diligence
  - ▼ process of identifying various risk and potential returns by evaluating all relevant information to determing if returns are worth the risk
  - ▼ market study, rent roll, major leasess, physical inpection, design and engineering, title and

survey, zoning and code compliance, taxes, insurance, litigation

- ▼ senitivity analysis
  - ▼ modifying key asumptions of future invetment performance (rent levels, CPI, occupancy, exit cap rate, sale timing) to check impact on IRR and equity multiple
  - ▼ usually done in combination (two at a time)
  - ▼ shows how ensitive expected reuturn is to changes in assunmptions
- ▼ paritioning IRR
  - ▼ determining portion of investment return that comes from annual cah flow and portion from sale or residual value

▼ Discussion

📌 **SUMMARY**