

How NPV and IRR can help to achieve realistic business results



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These two measurements, Net Present Value and Internal Rate of Return (known as NPV and IRR), are highly valued decision makers. But how to understand and apply NPV and IRR in business investment choices, be they JV establishment, M&A potential, new sales channel establishment, or sell/own decisions?



In this sense, IRR is the most straightforward, as it shows the maximum return a project can achieve. Simply put, if the IRR exceeds your expected project return (often referred to as the corporate hurdle rate), the investment is considered worthwhile.

NPV, on the other hand, shows in absolute terms what could be today's value of your business; it does this by discounting future cash flow, less your investment. If NPV is greater than zero, it means that the corresponding positive sum is essentially your potential business profit, which can be realised, for example, if the project is sold.

The important question is how to define an appropriate discount rate within the NPV formula. By definition, the discount rate is an opportunity cost that can be compared to bank deposit rates, government bonds, and alternative business cases; it includes market risk premiums, as well as industry-specific expected returns.

In summary, you can evaluate your investment potential via two key indicators – IRR and NPV:

1. IRR shows the maximum return rate achievable; if it exceeds your expected rate of return, extra profit can be made.
2. Positive NPV indicates your likely profit from future cash flow (less initial investment) in terms of today's money.

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