REAL ESTATE EXPLAINED

INTERNAL RATE OF RETURN (IRR)

SHOPOFF | REALTY INVESTMENTS

WHAT IS INTERNAL RATE OF RETURN?

The annual rate used to estimate an investment's performance over time. It is one metric used to evaluate projected performance relative to their required return or cost of capital. It's the discount rate at which the total present value of future cash flows equals the initial investment, meaning the investment breaks even at that rate.

IRR cannot be solved directly with basic algebra when there are multiple cash flows. The IRR must be found through trial and error, testing different discount rates until the net present value equals zero.

Here's an example*

Imagine two real estate investments that each require an initial $1 million investment and are held for five years.

PROPERTY A

IRR: 8%

Property A produces $75,000 in cash flow every year for five years and is sold for $1.1 million at the end of year five. An investor received cash flow throughout and more than their original capital back.

PROPERTY B

IRR: -4%

Property B produces limited cash flow and is sold for $850,000 at the end of year five. In this example, the investor receives less than their original capital investment, resulting in a negative IRR and a loss of principal.

A higher IRR does not necessarily mean an investment generated greater total profit and may involve greater risk. IRR can be influenced significantly by the timing of distributions, leverage assumptions, and projected exit values, and may not reflect total dollars earned. IRR does not measure volatility, liquidity risk, or the probability of achieving projected results. It should be considered alongside other metrics.

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