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NPV is a valuable tool for analyzing investment property

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Investment property is worth undertaking if it creates value for the owner. In the most general sense, we create value by identifying an investment worth more in the marketplace than it costs us to acquire. The difference between an investment's market value and its cost is called the net present value (NPV) of the investment. In other words, NPV is a measure of how much value is created or added by undertaking an investment.

Suppose you are considering the purchase of a property for $1 million. The property has a single, high credit-rated tenant; the lease is triple net and there are eight years remaining. The property generates $45,000 net cash per year. If 20% is the down payment and your required discount rate is 14%, what is the NPV on this property?

Since the cash flows are equal each year, we effectively have an eight-year annuity. Using an annuity table, we can determine that the factor for eight years at 14% is 4.6389. If we multiply the annual cash flow by this factor we get $208,750. Subtracting our down payment of $200,000 we end up with $8,750, therefore, this is a good investment. Had the result been negative then the effect on value would have been unfavorable and we would pass on this investment opportunity.

In the above example, the decision to sell the property at some point in the future might also be considered. However, the value of the property is only as good as the tenant that occupies it. If at the end of the lease the tenant decides to renew their lease, then the market value of the property should increase. Conversely, if they decide to relocate, then another credit worthy tenant would have to be secured in order to maintain property value.

Calculating the NPV is fairly straightforward. The task of coming up with accurate cash flows, determining future market value of the property and selecting the correct discount rate is much more challenging. An accurate discount rate is critical for determining whether a project should be undertaken or rejected. The discount rate is unique to each company and must be carefully calculated using historical data and rate of returns that provide shareholder value. Using NPV in conjunction with traditional investment criteria such as cap rate and cash-on-cash return can make investment decisions easier.

For more information on analyzing investment property consult a commercial real estate professional.

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