

Net Present Value

Net present value is a method to evaluate potential investments. It is calculated by discounting all future cash flows from an investment to the present and summing the present values to come up with a net present value. If the net present value of an investment is greater than 0 (assuming the cost of the investment was included in the cash flows), then the investment is worthwhile and should be funded.

The discount rate used to discount the cash flows should be based on the risk of the cash flows. If the cash flows are speculative and risky, a high discount rate should be used. If they are safe and certain, a low discount rate should be used.

Of the various ways investors try to determine if an investment is worthy of funding (simple rate of return, internal rate of return, profitability index etc.), net present value is usually considered to be the most accurate. Many of the most popular stock models (e.g. the dividend discount model) are really variations on net present value models.