Investor Education Series | No. 01
Durable Growth Begins with Strong Foundations

ORINOVA
CAPITAL

Cash Flow vs. IRR: What Actually Matters

A Practical Framework for Evaluating Projected Returns in Real Estate Investing.

EXECUTIVE SUMMARY

When evaluating a real estate investment, projected returns are often summarized using a single metric — most commonly, IRR.

While useful, IRR is also frequently misunderstood. It can obscure the underlying drivers of performance, particularly when the assumptions behind it are not closely examined.

A more practical approach is to look beyond the headline return and ask:

How much of the return is supported by current cash flow, and how much depends on future assumptions?

KEY INSIGHT

How a return is generated is often more important than the return itself.

Two investments can produce similar projected returns while carrying very different levels of risk. Understanding how much of a return is supported by current cash flow versus future assumptions provides a clearer picture of an investment's durability.

WHAT IRR MEASURES

IRR estimates the annualized return of an investment by incorporating both the timing and magnitude of expected cash flows.

It includes:

- Cash distributions during the hold period
- The projected sale value
- The timing of those cash flows

Because IRR is sensitive to timing, relatively small changes — particularly around exit — can materially impact the reported return without improving the underlying economics.

It also relies on forward-looking assumptions such as rent growth, operating improvements, and exit

WHAT IRR MEASURES (cont.)

can materially impact the reported return without improving the underlying economics.

It also relies on forward-looking assumptions such as rent growth, operating improvements, and exit pricing — variables that introduce uncertainty and are often outside of direct control.

As a result, two investments with similar IRRs can carry very different risk profiles depending on how those returns are constructed.

WHAT CASH FLOW REPRESENTS

Cash flow reflects the income generated by a property and distributed to investors over time.

Unlike IRR, it is grounded in current operations and less dependent on future outcomes.

It is primarily driven by:

- In-place rents
- Occupancy
- Operating performance
- Financing structure

Because of this, it provides a more immediate measure of performance.

For many investors, consistent cash flow also provides stability, particularly when market conditions or valuations become more volatile.

WHERE RETURN PROFILES CAN BE MISLEADING

Projected returns can appear attractive when driven by favorable assumptions, particularly around exit value and timing.

Common examples include:

- **Exit-dependent returns** — a meaningful portion of the return is realized only upon sale
- **Aggressive growth assumptions** — projections not supported by current fundamentals
- **Compressed timelines** — shorter holds that increase IRR without improving total profit
- **Execution-heavy business plans** — outcomes that depend on multiple variables aligning

In each case, the return may be technically accurate, but less durable in practice.

HOW WE EVALUATE OPPORTUNITIES

When reviewing an investment, one of the first considerations is how the return is generated.

We focus on opportunities where:

- Cash flow is already in place or achievable in the near term
- The underlying asset and market fundamentals are stable
- The business plan enhances existing performance rather than relying on future outcomes

This reflects a preference for investments where performance is driven by what is known and controllable.

From that foundation, we look to create additional value through execution — rather than underwriting that upside at the outset. Our Investment process follows three principles:

1. **Start with what exists:** current cash flow and operating fundamentals
2. **Evaluate what is controllable:** operations, financing, execution
3. **Treat upside as upside:** don't rely on future assumptions to justify the investment.

Our evaluation begins by understanding the durability of a property's in-place cash flow and the market fundamentals supporting today's performance. As a vertically integrated owner and operator, we then assess how our property management, asset management, construction, and operational expertise can enhance value through disciplined execution. Only after establishing those foundations do we evaluate additional opportunities—including operational efficiencies, strategic capital improvements, new income streams, and long-term market growth. While these opportunities influence our investment decisions, we seek to **manage toward upside rather than underwrite to it**, allowing the investment thesis to remain compelling even if every opportunity does not materialize.

THE ORINOVA PERSPECTIVE

While IRR remains one of the industry's most widely referenced performance metrics, we believe investors benefit from understanding how a return is generated before focusing on how large it appears.

At Orinova, we begin by evaluating the quality and durability of a property's cash flow and the underlying fundamentals supporting that income. Only then do we consider projected appreciation, exit assumptions, and other sources of potential upside.

We also place significant emphasis on metrics such as **Return on Cost**, which measures the value created through operational improvements relative to the capital invested. Unlike IRR, Return on Cost focuses on the effectiveness of execution rather than future market assumptions. We'll explore that concept in a future Investor Education guide.