LESSON SIX: ANALYZING STABILIZED PROPERTIES

1.1 FROM THE OWNER'S PERSPECTIVE

Owners are concerned with several factors when it comes to analyzing stabilized properties. These factors include the NOI, Cash Flow, Net Cash Flow, Rent Roll, Types of Leases, and Operating Statements. Each of these factors are examined below:

1. NOI

The first step in underwriting any stabilized transaction is to understand the project's NOI. The NOI is calculated as follows:

	Revenues
LESS:	(Operating Expenses)
Equals:	**NOI**

2. UNDERSTANDING THE NOI – IS IT STABILIZED?

For the NOI to be stabilized, it must have the following characteristics:

- Building occupancy: needs to be at market, typically 90% leased.
- Building lease: rates need to be at current market rates (not below or above).
- Tenant rollover: the property should not have a significant amount of tenant rollover (expiring leases) in the short term, or at the same time.

3. CASH FLOW

Once the NOI is established, the investor will look at the project's "unleveraged cash flow." The unleveraged cash flow is the money available after the loan principal is paid.

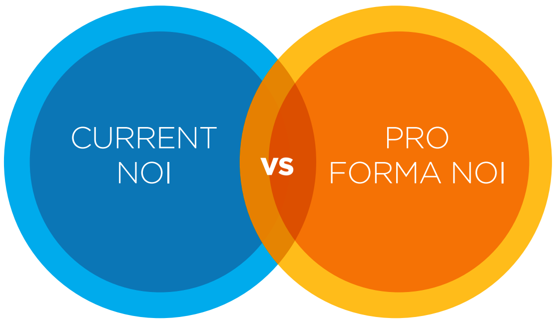
4. NET CASH FLOW

Net cash flow is the real money that can be distributed to the owners. The investor should always understand the project net cash flow.

COMMERCIAL REAL ESTATE TRIAGE FINANCIER

Tips, Tricks and Traps: How To Analyze Any Commercial Deal In Less Than 90 Seconds

1.



Most brokers will do an across the line increase in rents (especially for multi-family) of 10%. In the real world, it's simply not possible to do this, especially during hard economic times.

Look at the **OCCUPANCY.** This is the easy test to tell if the asset will have a chance of even approaching its Pro Forma form a back-of-the-envelope standpoint.

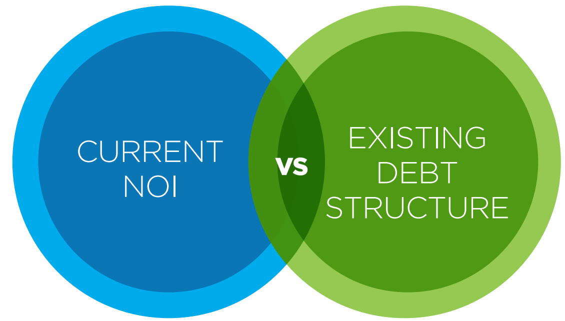
EXAMPLE:
If we look at the example below, even in a perfect world if we could get 100% occupancy, the Pro Forma NOI could never be more than $200,000.

	Occupancy	Current NOI	Pro Forma NOI
STATED BY BROKER	50%	$100,000	$300,000
REAL WORLD SCENARIO	100%	$100,000	**$200,000**

So getting a Pro Forma of $300,000 would be practically impossible to get.

Many investors have bought off of the Pro Forma only and got slaughtered shortly thereafter. Buying or valuing off of the Pro Forma is **overpaying** for the asset.

2.



On any income producing property, it's the income which drives the value of the property. Some sellers or brokers will value the property off of the **Pro Forma**. The reasons for this are not as obvious as they seem at first.

Most of the time, the Pro Forma will be manufactured to mask the fact that the property may be **overleveraged.**

EXAMPLE:
Depending on the market that the asset is located in, a **CAP RATE** will be applied to make an apples-to-apples comparison. In this example, we're going to use a 10% cap rate to apply to the Current and Pro Forma NOIs.

	Cap Rate Used	Value	Asking Price	Existing Debt
CURRENT NOI	10%	$1,000,000	$3,000,000	**$3,000,000**
PRO FORMA NOI	10%	$3,000,000	$3,000,000	$3,000,000

In this example, we see that the asking price by the seller or broker is manufactured by creating a Pro Forma high enough to create a perceived value to justify an asking price with the hope the buyer won't notice that the property is overleveraged and pay the Pro Forma price.

DON'T BE FOOLED! Many sellers are locked into CMBS loans that are assumable. Meaning they must be assumed or they have a nasty prepayment penalty.
Assuming a loan on a property that is overleveraged is the same as overpaying for it and you'll probably be stuck with it.

5. THE RENT ROLL: A KEY BUT OFTEN OVERLOOKED DOCUMENT

Stabilized properties are driven by their rent rolls. All rent rolls are not created equal. The rent roll is the summary of the tenants in the building and their rental terms. This is important, as the rents paid by the tenants drive the cash flow of the property.

- Rent roll analysis will include:
  - Percentage of the building currently leased
  - Rate of lease (monthly payments)
  - Lease terms: how long is the lease
  - Lease expiration date
  - Renewal clauses
    - Extension options
    - Contract rate increases
    - Owner requirements over the lease term (i.e. improvements to space, building, storage, etc.)
  - Credit quality of tenants
    - Credit tenant: “A rated” company by Moody’s or S&P
    - Strong credit: A company with a good balance sheet and income statement
    - Poor credit: A “Mom & Pop” business
  - Roll schedule: The investor/underwriter will spend significant time in order to understand the “project roll schedule” which means knowing which tenants’ leases mature and when.

Lenders and investors seek out properties that have a “balanced” roll schedule. They don’t want the risk of all the tenant’s leases expiring at the same time. See Exhibit b for Rent Roll example.

6. TYPES OF LEASES

There are two basic types of leases: a) full service and b) triple net leases. Most office buildings are full service, while most retail and industrial buildings are leased triple net. Details for each lease type follow:

- Full Service: Landlord pays all expenses, such as maintenance, taxes, and insurance.
- Triple Net: Typical charges in triple net include:
  - Taxes: Paid by tenant
  - Insurance: Paid by tenant
  - Maintenance: Paid by tenant

7. OPERATING STATEMENTS: THE WINDOW TO THE PROPERTY'S PERFORMANCE

Operating statements are the profit and loss statements of the commercial real estate asset (i.e. the building). Operating statements show if the building is operating at a profit or a loss. These statements are the detail behind the cash flow formulas. This is the single most important piece of documentation when analyzing a stabilized real estate investment. Annual operating statements show the following information:

- Historical revenues
- Historical expenses
- Historical net operating income (NOI)