The Real Estate Pro-Forma: Calculations, Examples, and Scenarios

Would You Like Some Leasing Commissions with Those Tenant Improvements?

Question That Came in the Other Day…

Just kidding! This tutorial's not an answer to a reader question – it's just important.

https://www.mergersandinquisitions.com/real-estate-pro-forma/

We'll expand on that M&I article here and show you more of the Excel parts.

Plan for This Tutorial

- **Part 1:** Why the Real Estate Pro-Forma?

- **Part 2:** Simple Real Estate Pro-Forma Excel & Calculations

- **Part 3:** How to Build Scenarios into a Pro-Forma (Multifamily Example)

- **Part 4:** Differences for Other Property Types and More Advanced Items

Part 1: Why the Real Estate Pro-Forma?

- **Basic Idea:** Just as companies have financial statements, so too do properties… but do you really need them?

- **ANSWER:** For many modeling tasks, no – you can simplify and project the company’s revenue, expenses and key cash flow line items (we do this all the time in valuation/DCF models)

- With **properties**, you can do the same thing

- **Pro-Forma:** Like a combined and simplified Income Statement + Cash Flow Statement for a property rather than a company

Part 2: Real Estate Pro-Forma Excel & Calculations

- **Structure:** You always start with **Potential Revenue**, if the property were 100% occupied at market rates, and then make deductions

- **Next:** You list operating expenses required to run the property's day-to-day operations

- **Then:** You list the "capital costs" (similar to CapEx and Change in Working Capital for normal companies) that correspond to long-term items that will last for more than 1 year

- **Then:** You show the Debt Service (Interest, Principal Repayments) and the Cash Flow to Equity at the bottom

Part 2: Real Estate Pro-Forma Excel & Calculations

- **Base Rental Income:** Potential Rental Income if property were 100% occupied and all tenants paid proper market rents

- **Deductions and Adjustments:** Absorption & Turnover Vacancy, Concessions & Free Rent, Expense Reimbursements, General Vacancy

- **Absorption & Turnover Vacancy:** Tenant leaves and it takes several months to find a new tenant – not an “expense,” just a loss of potential rental income when there’s no tenant

- **Concessions & Free Rent:** Tenant moves in, and you give a few months of “Free Rent” (e.g., 6 months on a 5-year lease)

Part 2: Real Estate Pro-Forma Excel & Calculations

- **Expense Reimbursements:** Amounts of property taxes, insurance, and maintenance/utilities tenants are responsible for – varies greatly based on lease types

- **General Vacancy:** For spaces that are "permanently vacant," i.e., no current tenants and no move-in plans

- **Effective Gross Income:** Base Rental Income +/- all these adjustments; similar to Net Sales or Net Revenue for a normal company, but on a **cash basis** instead

Part 2: Real Estate Pro-Forma Excel & Calculations

- **Expenses:** Property Management Fees, Operating Expenses, Property Taxes, and Reserves

- **Methods:** Some are % of EGI; some are $ per Sq. Ft. or Sq. M., and some are % of property's value with annual percentage increases

- **Reserves:** Exist to "smooth out" the property's cash flows as large, irregular capital costs come up

- **Idea:** Allocate $200K per year over 5 years → when there are $600K of capital costs in Year 3 and $400K in Year 5, you can use the Reserves to cover them without dipping into cash flows

Part 2: Real Estate Pro-Forma Excel & Calculations

- **Capital Costs:** Capital Expenditures (CapEx), Tenant Improvements (TIs), and Leasing Commissions (LCs)

- **CapEx:** Items that are *not* specific to one tenant (new roof, elevator, AC, heating system, etc.)

- **Tenant Improvements:** Items that *are* specific to a tenant, paid as an incentive to the tenant (additional walls, doors, etc.)

- **Leasing Commissions:** Paid to brokerage companies and agents to *find* new tenants; typically a small % of total lease value

Part 2: Real Estate Pro-Forma Excel & Calculations

- **Net Operating Income (NOI):** Effective Gross Income – Operating Expenses & Property Taxes; *similar* to EBITDA for normal companies and critical in valuations

- **Adjusted NOI:** NOI – Net Capital Costs; *similar* to Unlevered FCF for normal companies since it's core-business cash flow after capital costs, ignoring capital structure

- **Cash Flow to Equity:** Adjusted NOI – Debt Service; tends to be close to the distributions made to the equity investors or "owners" of the property since properties rarely accumulate large Cash balances

Part 3: Scenarios in a Pro-Forma

- **Why:** All investing is probabilistic – need to consider what happens if the deal goes very well, average, or very poorly

- **Multifamily Differences:** Few new items for Parking Income, Bad Debt (tenants just not paying), and “Loss to Lease” (tenants paying below-market rent); expenses shown in more detail

- **Typical Approach:** Base, Upside, and Downside cases with differences in Rent, Vacancy, Bad Debt, Expenses, TIs, and LCs

- **Credit Cases:** Often focus on just the Base, Downside, and “Extreme Downside” cases because upside is extremely limited

Part 3: Scenarios in a Pro-Forma

- **Key Idea:** Everything is connected! If there's a recession, pushing down market rents, then the Vacancy Rate is also likely to increase


- **Plus,** it will be harder and more expensive to find new tenants, which will increase the TIs and LCs


- **This Model:** Idea is that there's an average 7.5% discount to market rents currently, so we're going to spend on CapEx to improve the building and reduce that discount over time

- **But:** Depending on market conditions, all the other numbers will differ

Part 3: Scenarios in a Pro-Forma

- **Base Case:** Steady, uninterrupted growth in Market Rents (3-5%); same 3% Vacancy Rate; same 3% Bad Debt; 2-4% Expense Growth; TIs grow at 2-4%, and LCs remain at 3% of Effective Rent

- **Downside Case:** Mild recession over ~2 years, so Market Rents fall, Vacancy and Bad Debt rise to ~6%, Expenses fall, TIs grow at 10%, and LCs jump to 8% of Effective Rent

- **Extreme Downside Case:** More severe recession over ~2 years, so everything above is even more extreme – these numbers are often based on the most severe recession over the past few decades

Part 3: Scenarios in a Pro-Forma

- **Scenarios:** What's the point?

- **Here:** Determines that proposed financing won't work in the Extreme Downside Case, and that 85% leverage is way too high

- **Credit Goal:** *Avoid losing money* no matter what happens – even in a disastrous recession – and achieve the targeted IRR in other cases

- **Equity Goal:** Typically aim for an IRR like 10%, 15%, 20% (or more) depending on the case, and try to avoid taking a loss in pessimistic cases like the Downside one here

Part 4: More Advanced Items

- **Hotels:** Pro-Forma is quite different – more like normal company

- **Hotel Revenue:** Categories like Rooms and Food & Beverage
- **Hotel Expenses:** Fixed vs. Variable; Sales & Marketing and G&A much bigger; margins tend to be lower than other types

- **Loss to Lease:** Covered here; Market Rents – In-Place Rents

- **Percentage Rent:** Retail tenants pay % of monthly sales in addition to fixed rent

Recap and Summary

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