HOW TO PREPARE A COMMERCIAL OR INDUSTRIAL PRO FORMA

A commercial or industrial pro forma is prepared in a manner very similar to that of an apartment pro forma. The main difference is that in net leases, the tenant is responsible for some of the expenses.

First let us look at a full service lease. You will recall that in a full service lease the lessor (owner) is responsible for all of the operating expenses. Therefore, prepare your pro forma just like you would if the building were an apartment building. Use the current actual rent roll, inserting the market rent of any vacant space and use the actual operating expenses.

Use a Vacancy Allowance that is supportable in the local submarket but in no case will an underwriter use less than 5% for commercial and industrial properties. Most often office buildings use a vacancy allowance from 7-12% depending on the market.

You are reminded to use an Offsite Management expense of 3-5% of Effective Gross Income. Use 5% if the building is a multi-tenant building. You can sometimes get away with 3% if the building is large but there is only one tenant. The logic here is that 3% of a large rental income is enough where a property manager only has to deal with one tenant and no pro-rations are necessary.

In addition to Vacancy and Management, there is one other expense item you should almost always use, the Replacement Reserve.

The Replacement Reserve is used to repaint the exterior of the building, resurface *the* parking lot, and to replace the roof from time to time. Even under "triple net" leases the lessor (owner) is still responsible for these items, as well as for the structural soundness of the building. Therefore you should insert 1-3% of Effective Gross Income into the Replacement Reserve line of all of your commercial and industrial pro formas. Generally you should use 3%, unless the building is less than 3 years old. For these new buildings, you can often get away with 1-2%.

Please refer at this time to the attached "Sample Triple Net Pro Forma Operating Statement." Note that a triple net pro forma is relatively simple to prepare.

When a unit is owner-occupied, ignore any existing lease. Since the owner is both the lessor and the lessee, he is in a position to draw up any lease he wants. Simply ignore any existing lease and base all of your calculations and pro formas based the MARKET RENT of the owner's space or unit. Insert the market rent on both the Schedule of Leases and the Pro Forma and footnote the entry with the words:

> Since this space is owner-occupied, we have used a market rent of $X dollars per square foot for that unit.

Commercial and Industrial Pro Forma

The only time commercial/industrial pro formers are difficult is when some of the units are leased on a net basis, and the others are leased on a full service basis. You cannot merely insert 100% of the operating expenses because some of those expenses are later pro rated to the tenants. When a tenant pays a pro rated portion of the operating expenses, it is known as a "tenant expense contribution." Unfortunately, when most owners prepare their income and expense statements for tax purposes, they generally combine the rents and the tenant expense contributions together making your job particularly difficult.

In cases like this, you have no choice but to analyze each lease to first determine which tenants are responsible for pro rations and the expenses for which they are responsible. Then you must compute, generally based on net rentable square footage, what percentage of each expense is paid by each tenant. Show on your pro forma 100% of the operating expenses, but then recapture some of those expenditures in the Tenants' Expense Contribution line of the income section. See the "Sample Partial Net Pro Forma Operating Statement" for an example.

When a tenant is responsible for increases in an expense item over a certain base year, this is known as an "expense stop." The most common usage is for taxes and insurance. If a tenant were to make an addition to an existing improvement, the owner might be subject to a reassessment by the County. In this case the tenant would be responsible for 100% of the increase in real estate taxes and insurance as a result of the reassessment.

Sample Triple Net
Pro Forma
Operating Statement

INCOME:

Gross Scheduled Income		$ 108,200	(a)
Tenants' Expense Contributions			
Laundry Income			
Other Income:			
	Total Income:	$ 108,200	
Less 5% Vacancy Allowance		5,410	
	Effective Gross Income:	$ 102,790	

EXPENSES:

Advertising		$	
Cleaning			
Electricity			
Elevator Maintenance			
Fees & Licenses			
Gardening			
Gas			
Insurance		Tenants	
Legal & Accounting			
Management-Offsite	5%	$ 5,139.50	
Management-Onsite			
P.G. & E.		Tenants	
Painting & Decorating			
Payroll			
Royroll Taxes			
Pest Control			
Pool Maintenance			
Real Estate Taxes		Tenants	
Repairs & Maintenance		Tenants	
Replacement Reserve	3%	$ 3,083.70	
Sewer		Tenants	
Supplies			
Telephone			
Trash Removal		Tenants	
Utilities			
Water		Tenants	
Miscellaneous			
		Total Expenses:	8,223
		Net Operating Income:	$ 94,567

Notes:

(a) Current actual rent roll plus the market rent of the two vacant units.

SAMPLE PARTIAL NET
PRO FORMA
OPERATING STATEMENT

INCOME:			
Gross Scheduled Income			$ 102,700 (a)
Tenants' Expense Contributions			9,193 (b)
Laundry Income			
Other Income:			
		Total Income:	$ 111,893
Less 5% Vacancy Allowance			5,595
		Effective Gross Income:	$ 106,298
EXPENSES:			
Advertising		$ 1,346	
Cleaning		1,427	
Electricity		See PG&E	
Elevator Maintenance		896	
Fees & Licenses		327	
Gardening		1,220	
Gas		See PG&E	
Insurance		3,225	
Legal & Accounting		727	
Management-Offsite	5%	5,230	
Management-Onsite		5,212 (c)	
P.G. & E.		2,345	
Painting & Decorating		896	
Payroll		See mgmt	
Royroll Taxes		682	
Pool Maintenance		n/a	
Real Estate Taxes		10,280	
Repairs & Maintenance		6,250	
Replacement Reserve	3%	3,189	
Sewer		654	
Supplies		1,244	
Telephone			
Trash Removal		896	
Utilities			
Water		1,786	
Miscellaneous			
		Total Expenses:	47,832 (d)
		Net Operating Income:	$ 58,466

Notes:

(a) Current actual rent roll plus the market rent of the two vacant units.

(b) 58% of the space is leased on a net basis where the tenants pay a pro rated share of taxes, insurance and utilities.

(c) 5% of effective gross income

(d) Actual expenses (annualized)

Reserves For Replacements

Roofs wear out; so do HVAC units, ovens and refrigerators. Parking lots need to be resurfaced every few years as well. Buildings need to be maintained, just like a car.

Every time a landlord receives a dollar in rent, he can't consider 100 cents of that dollar a return on his investment. Some of that dollar has to be put back into the building to keep it maintained and leasable.

Almost every Pro Forma Operating Statement, therefore, will include a line item called "Reserve for Replacements." This is different and separate from "Repairs and Maintenance."

Most banks don't require a reserve for replacements in underwriting the loan unless it is an old property in obvious need of repair. Life Companies and Conduit Lenders typically require reserves regardless of the age of the property.

Multi-Family:

Traditionally replacement reserves are not included when preparing a pro forma operating on a multi-family property. They are considered included in the line item for repairs, typically 6% - 10% of effective gross income.

Conduit lenders, however, normally require a replacement reserve of $250 to $300 per unit per year.

Retail:

Traditional: 3-5% of effective gross income for replacement reserves.

Office

Traditional: 3-5% of effective gross income.

Industrial:

Traditional: 2-4% of effective gross income Conduits: $0.15 per square foot per year.

Self-Storage:

Traditional: 2-4% of effective gross income.

Mobile Home Park:

Traditional: 3-5% of effective gross income.

Healthcare:

Traditional: 3-5% of effective gross income. Conduits: $250 - $300 per bed per year.

Hotel/Motel:

Traditional: 5% of effective gross income (includes FF&E's).