



Overview Of The Operating Statement

An investment (income) property's operating statement is comprised of two primary categories, income and expenses. The income consists of the potential gross income (PGI), vacancy & collection loss (V&C) and effective gross income (EGI). The operating expenses (OE) consist of those typical items necessary for the landlord to properly operate the property. Once the income and expenses are accurately estimated, a reliable net operating income (NOI) is calculated.

Leases

The expenses included in a property's operating statement is predicated on the terms of each lease agreement. Some leases pass through expenses onto the tenant while other leases include expenses in the rent.

Net leases pass through expenses onto the tenant. The most common net lease is a *triple net lease*. This type of lease is popular for retail and industrial space. In this arrangement, a tenant pays the landlord rent plus reimburses the landlord for all operating expenses, except management and replacement reserves, but including real estate taxes, insurance, common utilities, maintenance & repairs, trash removal, supplies, janitorial, among others. These reimbursements are usually based on the tenant space's proportionate share of the entire building.

Gross leases include most expenses in the rent. These types of leases are common for office space, medical space and apartments. They are much more management intensive than triple net leases and are also less favorable to a landlord since any unexpected and increased expenses are borne by the landlord. Many landlords prefer a modified gross lease where the tenant pays for their utilities (especially if the space is separately metered for electricity and heat) and interior cleaning.

Income

The potential gross income (PGI) is all the income a property generates. It includes the rental income and income such as coin-operated equipment (laundry, vending, etc.) and parking income. From the PGI, vacancy & collection loss (V&C) should be deducted, even if the property is at 100% occupancy. The premise for this is that all properties experience some vacancy (and possibly collection loss) over a holding period due to tenant loss, tenant problems, etc. This is usually estimated as a percentage of PGI and varies depending on the quality of the tenants, economic conditions and local demand and supply for the space.

Once the V&C is estimated, the difference between the PGI and the V&C is the effective gross income (EGI) which is calculated as follows:

$$\text{PGI} - \text{V\&C} = \text{EGI}$$

Operating Expenses (OE)

It is important to know the details of all leases for a property. The lease outlines how the expenses are handled for each tenant. The OE can be either fixed or variable. Fixed expenses do not vary with occupancy. These include real estate taxes and insurance. Variable expenses vary with occupancy and include utilities, maintenance & repairs, replacement reserves and management. Replacement reserves is the pro-rated annual costs of replacing short-lived items such as a roof, carpeting, building mechanical equipment, etc.

Net Operating Income (NOI)

Once the EGI and OE are estimated, the NOI can be calculated as follows:

$$\text{EGI} - \text{OE} = \text{NOI}$$

Not only is the NOI important when analyzing the performance of investment real estate, it is a property's income available to cover annual debt service (ADS).

Operating Statement

Below is a sample operating statement which is based on a property Dean Real Estate sold that was fully occupied with modified gross leases (tenants paid own electricity and heat).

Potential Gross Income	\$150,000
Less Vacancy & Collection Loss (5%)	(\$7,500)
Effective Gross Income	\$142,500
Operating Expenses	
RE Taxes	\$9,000
Insurance	\$3,000
Common Utilities	\$2,000
Maintenance & Repairs	\$7,000
Trash Removal	\$1,200
Miscellaneous	\$1,500
Management (6% EGI)	\$8,550
Replacement Reserves	\$7,000
Total Operating Expenses	(\$39,250)
Net Operating Income	\$103,250

Conclusion

A proper analysis of an investment property's income and expenses is crucial in order to accurately estimate NOI. The NOI is used in investment analysis to calculate the pre-tax cash flow and equity dividend rate (cash on cash rate) and to calculate a property's value.



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