Preparing a CRE Property Budget

The least used budgeting technique is NOI budgeting.

By Joseph J. Ori | February 16, 2024 at 07:35 AM

One of the most important management duties when owning a CRE asset is to prepare annual operating budgets for the property and portfolio. With the depressed volume of transactions in the industry since the Fed began raising interest rates, many CRE owners are focused on their existing properties, with strategies and procedures to increase the cash flow and net operating income (NOI). Most CRE owners and developers begin the budgeting process in September or October of the current year for the next year. There are typically three budgeting methodologies used by most CRE firms. These are baseline budgeting, zero-based budgeting, and NOI budgeting. The most common budgeting technique used in the CRE industry and corporate finance is baseline budgeting.

Baseline budgeting is an accounting method that begins with last year's actual operating statement amounts and makes adjustments to revenue and expenses to arrive at next year's budgeted amounts. This is the most common and easiest-to-use budgeting technique in the CRE industry but is flawed as it assumes that future operations are entirely based on last year's numbers and increase at an inflation rate for the new year. Many CRE firms that own apartment properties just apply an inflation factor to increase revenues and expenses, subject to specific fixed or contractual lease income and expense adjustments, to determine next year's budget amounts. For commercial properties, the tenant leases must be extended and projected with CRE software like Argus and expenses are increased by an inflation factor. Although baseline budgeting is the easiest and the most preferred methodology, it can also be the most inaccurate. It often leads to unrealistic budget numbers and large variances with actual operations.

The second budgeting accounting method used is zero-based budgeting. Under zero-based budgeting, the property income and expenses for the upcoming year are set to zero and a brand-new budget is calculated for the new year. This budgeting method is used by a small percentage of CRE owners due to its complexity and the additional work required, but is the best budgeting method, as it forces management to “start from scratch” and create a more realistic operating statement. If a firm is using baseline budgeting and it finds that the budget versus actual comparison at the end of the year is way off, then it should switch to zero-based budgeting.

The last and least used budgeting technique is NOI budgeting. NOI budgeting is creating a budget by starting with a property’s NOI and working backward up to the gross potential rent to complete the operating statement. This budgeting methodology is also flawed as it requires the budgeting team to meet an NOI target that in most cases may not be attainable unless there are major cuts in expenses and substantial and unrealistic increases in revenue. Many times, senior management of the real estate company forces its management and accounting teams to persuasively try and meet an NOI number that is impractical and unattainable, in a bid to hit an investor return. This is a dodgy technique and can create accounting irregularities and mismanagement.

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