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# There are Four Different NOIs in a CRE Deal. Which One is Best?

In all real estate acquisitions, there are multiple NOIs and using the proper one is vital to making a good deal.

By Joseph J. Ori | March 03, 2023 at 08:31 AM

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The most important metric in valuing a CRE property is the net operating income (NOI). It is used as the basis for CRE valuation whether it is an acquisition, sale, or appraisal. A property's NOI is calculated as follows:

Gross Potential Rent (annual rent for all signed leases plus vacant space at the market rent)

Plus: Other income (tenant reimbursements, parking, percentage rent, etc.)

Less: Vacancy (as a percent of the gross potential rent)

Equals: Effective Gross Income

Less: Operating Expenses (excluding tenant improvements, leasing commissions, capital improvements and debt payments)

Equals: **Net Operating Income**

The NOI is important because it is the cash flow metric used to value a property. For example, if the NOI in an acquisition is \$1,000,000 and the purchase price is \$15,000,000, then the cap rate is 6.67% (\$1M/\$15M). NOI is also important because it represents the initial cash flow from the property in which tenant improvements, leasing commissions, capital improvements and debt service (annual principal and interest on the debt) are paid. Many lenders also use NOI to value a property for loan purposes and a loan yield. The loan yield is the lender's NOI divided by the loan amount. Most lenders seek a loan yield of at least 9.0%. Therefore, calculating and using the appropriate NOI is critical to making smart acquisition decisions. After all, most of the profit made on a CRE deal is when the property is bought, not when it's sold.

In all real estate acquisitions, there are multiple NOI's to review and calculate and using the proper one is vital to making a good deal. There are typically four different NOIs in a CRE acquisition transaction. They are the seller's actual NOI, the seller/broker proforma NOI, the buyer's adjusted actual NOI and the buyer's proforma NOI. Since there are four

NOI's, the question is, which one should be used? It depends if one is on the sell side or buy side of the deal. If on the seller side, the seller/broker NOI that is shown in the sales package is promoted and pushed by the seller/broker team as the most realistic for the property because it is usually an inflated number and used to validate the seller's high asking price. If on the buyer's side, the preferred amount is the buyer's proforma NOI and is almost always much lower than the seller/broker number. The buyer's NOI is usually lower because of more conservative underwriting assumptions, like lower rent adjustments, higher vacancy and increased operating expenses which are typically discovered during the due diligence and underwriting process. The purchaser of a property will operate and manage the property differently than the seller and its NOI and operating metrics will usually reflect this.

An example of a real acquisition transaction to show the contrasting NOI's for a 200-unit apartment complex located in Dallas, TX is shown as follows. The property was placed up for sale earlier this year for \$30 million. The property is a Class B- apartment complex on 12.5 acres and is 95% leased. The sales package received from a national brokerage firm included the 2022 actual NOI and the 2023 proforma NOI of \$1,500,000 and \$1,800,000, respectively. The buy-side analysis of the deal produced two different NOI's as follows, an adjusted actual 2022 NOI of \$1,450,000 and a 2023 proforma NOI of \$1,600,000. The buy-side adjustments included higher vacancy for leases not signed, increased management fees and higher repair and maintenance expenses. These are typical adjustments made by purchasers during the deal underwriting process.

Based upon the above data, what NOI and cap rate should the buyer use? The purchase offer price and deal analysis should be based on the buyer's proforma NOI of \$1,600,000. With a proforma NOI of \$1,600,000, the final price for the property acceptable to the buyer would be at a 6.5% cap rate or a price of \$24,600,000 million versus the asking price of \$30,000,000. Will the seller sell the property for only \$24,600,000, when the asking price was \$30,000,000? Probably not and to make this deal happen, both the buyer and seller will have to meet in the middle and agree on a price around \$26,000,000.

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