

How To Create A Masterful Proforma



by
John MacLeod,
CPA, SIOR

John MacLeod, SIOR, Harry K. Moore Co./Colliers International, Louisville, Kentucky, has been in the commercial real estate business for 10 years. John is an office specialist and has held his SIOR designation for three years.

“A proforma should include two valuation pieces—the present value of the net cash flows and the value of the asset at the end of the projection period.”

If you are looking for a product review of various building proforma software packages, you can go ahead and skip to the next article. Software packages make doing proformas foolproof, right? Just plug in a few assumptions and you're done. A tremendous volume of paperwork, including perfectly formatted schedules, charts, and graphs, can be generated with absolute precision. Perfect presentation, bad proforma.

The Heart of a Proforma

Any proforma must be developed from a grasp of the dynamics of the market influencing the value of the building. While software programs can be great tools, the programs are only as good as the assumptions that go into the program. Garbage in, garbage out.

The Revenue Side of Your Proforma Model

Consider some of the fundamental components involved in a building proforma. The end game of any asset valuation project is to estimate the cash flows of the asset over its useful life and determine at what rate they should be discounted. After putting the existing lease rental streams into the model as a starting point, the model must include assumptions about the future, including: future re-leasing rates, retention percentages, and re-leasing time frames. All are elements that must be estimated to build the revenue side of the proforma model.

Factors that Influence Your Revenue

Assumptions—Each of these assumptions is influenced by supply and demand forces of the market on a macro-level, and by specific tenant profiles and market conditions on a micro-level. Such factors would include: Who are the tenants? What are the credit profiles of the major tenants in the project? The risk profile of the project should also be viewed in the aggregate: What portion of the building does each tenant take? What industries are the tenants in? What are the predominant industry types represented in the building? In the market? Each tenant establishes the risk profile of the building, and the risk profile in turn establishes the appropriate discount rate to be used to value each of the rental streams for the project.

Prevailing Discount Rates Adjustments—

All of the above elements of a particular project under consideration are adjustments to the prevailing discount rate in the market in which the asset competes. Prevailing discount rates in real estate markets are further influenced by:

- the size of the metropolitan area,
- the size of the market for the particular asset type, and
- the building location.

This investigation would extend down all the way into understanding the particular building's submarket.

Figuring the Discount Rate—A quick word about the discount rate. This is not the same thing as the cap rate. A cap rate is the percentage obtained when the net operating income of the building is divided by the price. Or, if you are trying to determine the building value, it is the market-based capitalization rate that divides the net operating income of the building to obtain the building value. For any finance majors, it is analogous to the dividend Discount model to value a stock. Next year's dividend divided by the capitalization rate gives you the price of the stock. But what does this represent, and how does this compare to the discount rate? The discount rate is a market-based rate that is used to discount future cash flows to a present value to estimate value.

This rate theoretically reflects various factors including future inflation, real interest rate returns, and risk. However, unlike the cap rate, the discount rate is discounting to present value future cash flows that have been projected into the future (and implicitly reflect the future growth of cash flows.) This is the difference between cap rates and discount rates. In theory, the discount rate should be the same as the discount rate minus the growth rate of the cash flows.

Rental Stream and Renewals—Another element in projecting the rental stream for a property is the likelihood of renewal. While, in the end, you must assume something about the likelihood of renewal, a few answers about the project might help improve the reasonableness of assumptions made. Some questions to ask: What are the trends of the tenants' industries; does the industry tend to be very cyclical? What are the track records of these companies? What are they doing in other markets? How well does the building fit the tenant's profile? How are the tenants situated in the building? Are they spread out in the building? Is the size of the floor area efficient for the size of the tenants in the project? Is the facility adequately parked for the types of tenants in the project or are they likely to be in the building in the future? How does this project compete against neighboring buildings? Are there a few large employers or are they typically smaller? What are the profiles of tenants in competing properties? What are the vacancy rate and absorption trends in the competing market? What is the availability of new development sites in the area? What are the physical characteristics (i.e., functional obsolescence) of the project versus what is being built or competing in the area (i.e., window line, ceiling heights, amenities, configuration of the building core, bay depths, etc.). All of these factors must be judged to make an educated guess on the likelihood of tenant renewals.

Setting the Building's Market Rate and Future Renewal Rates—Establishing the market rate for the building and the estimated future renewal rates are other components that must be considered to value a project. The existing rental stream of the building does not set the market rate for the building. What sets the market rate are the building's appeal to existing and prospective tenants and the availability and quality of competing product. Existing rents well above or below the market rent for the build-

ing will need to be brought to a market rate upon rollover to set a value for the building. While all of these micro-level components are important and need to be considered, it is also important to understand the macro-level picture. What part of the economic cycle are we in? How do current rents compare to rents required for new construction? If land is available in the competitive area of the project, new construction will act as a natural cap to longer-term rental growth rates.

The Expensive Side of Your Proforma Model

Operating Expenses—On the expense side of the equation, it is important to know the cost structure of the building. The size, age, type of building, and even the location of the building will determine how the building will operate and how much it will cost to run. Complexes of certain sizes will necessitate a specific staffing level for leasing, management, security, maintenance, etc. The cost structure of the building will depend upon the services tenants expect and receive in the competitive market around the building. Comparable data from similar buildings are a great resource to check building operating expense levels. Variances in expense categories can be identified and explained.

Tenant Improvements: Present and Future—Though separate from operating expenses, another cost component to account for involves tenant improvements. Future tenant improvements will depend upon the existing condition of vacant spaces, typical improvement allowances commanded by tenants, and the likelihood of tenant renewals. Based upon an evaluation of the market for the building and the particular tenants in the building, you might, for example, estimate the tenant renewal rate at 67 percent. Each time a tenant's lease rolls over in the future, the tenant improvement allowance in the year of renewal should represent the weighted average cost of renewal and new tenant improvement allowances. To illustrate, if renewal tenants typically receive \$5.00 per square foot for a five-year lease renewal and new tenant improvements are \$10.00 per square foot, then two-thirds of \$5.00 per square foot and one-third of \$10.00 per square foot (or approximately \$6.67 per square foot) should be used in the proforma upon tenant rollover. Capital reserves should also be estimated and accounted for as a cost component.

How to Determine the Number of Years in Your Projection

After deciding upon the discount rate and future cash flows in the proforma, you must decide how many years should be included in the projection. This will depend upon the nature of the leases in the building. Are rents largely above market? Does a single tenant have a disproportionate share of the building? The proforma should

include an adequate number of years to work through any anticipated anomalies that may skew the building valuation (i.e., significantly different renewal rates from existing lease rates or a major tenant departure). Decisions can then be made about the probabilities of different scenarios, and the sensitivity of the valuation to changes in the assumptions can be gauged.

Find the Future Value

To complete the valuation of the building, the reversion value or future building value must be calculated. A proforma should include two valuation pieces. The first is the present value of the net cash flows during the period of projection. The second piece is the value of the asset at the end of that projection period, the so-called reversion value. This value should represent the capitalized value of the normalized net operating income of the building or the projected market revenue for the building less the normalized expenses, including tenant improvements and capital reserves. A capitalization rate can then be applied to calculate the reversion value. This value must

then be discounted to the present value. The present value of the net cash flow piece and the reversion value component can then be added together to obtain the building value.

Your Final Task: Calculate the Cap Rate

Since everybody will always ask you, "What's the cap rate?" the building's net operating income can be divided by the building value to arrive at the building's cap rate. (This calculates a rate that is supported and justified by the particular aspects of the building, instead of just eyeballing the cap rate and seeing how close it is to 10 percent.)