Linking Individual Properties to REITs

Unlike normal companies, real estate investment trusts (REITs) are **collections of individual properties**.

Sure, they have management teams and overhead and other business segments, but most of a REIT's value comes from its property portfolio.

While a REIT has corporate-level expenses such as G&A, Interest, and Depreciation that are not reflected in the financials of individual properties, **most of its revenue and expenses flow in directly from properties.**

REITs grow their businesses by **raising rents on their same-store (existing) properties**, **acquiring new properties**, **developing and renovating properties**, and **disposing of properties**.

REIT Segmented Revenue

Here's what those 4 segments look like in a simplified model that assumes no Rental Income from Acquired Properties or Development/Redevelopment Properties in the previous year:

Equity REIT - Rental Income by Segment, Operating Expenses, and Net Operating Income		
($ in Millions)		
	Last Historical Year	**Next Year**
Rental Income by Segment:		
Same-Store Rent:	$ 520	$ 541
Rent from Development & Redevelopment:	-	10
Rent from Acquired Properties:	-	10
Rent Lost from Dispositions:	(20)	(40)
Total Rental Income:	**500**	**521**

In more complex models (see the case study in this course), you won't see the "Rent Lost from Dispositions" line item because you remove the disposed assets directly from Real Estate Assets in the other categories, thereby reducing the NOI and Rental Income contribution from those segments.

To accurately project revenue over many years, you should track the assets in each different segment above – in this simplified example we are not doing that, but if you look at the case study in the course you'll see an example where we do track the assets in different segments.

Projecting Same-Store Rental Income

This one's straightforward: you assume a simple growth rate for revenue, and then make the operating expenses and property taxes percentages of revenue:

Equity REIT - Same-Store Revenue, Development, and Acquisitions		
($ in Millions)		
	Last Historical Year	Next Year
Same-Store Revenue:	$ 520	$ 541
Rent Escalation %:	4.0%	4.0%
Operating Expenses:	155	161
Property Taxes:	55	57
Same-Store NOI:	310	322
Operating Expenses % Revenue:	29.8%	29.8%
Property Taxes % Revenue:	10.6%	10.6%

You determine the Rental Income growth rate based on company guidance, investor presentations, and equity research; you could also hold it constant or use the historical average growth rate. The margins should be based on historical numbers.

Even in more complex models, **you generally project Same-Store Rental Income the same way**.

Projecting Development/Redevelopment & Acquisition Rental Income

For Developments/Redevelopments and Acquisitions, you assume spending in each segment, a Cap Rate and NOI Margin, and use those to determine Rental Income, NOI, operating expenses, and property taxes.

The thought process is, "If we spend $xx dollars on acquiring or developing properties next year, how much in Net Operating Income and Revenue will that generate?"

You can distribute the total expenses – Revenue minus Net Operating Income – between operating expenses and property taxes based on the historical split.

You determine the proper Cap Rates based on historical Cap Rates in each segment (in the company's filings), company guidance (sometimes in investor presentations), or what equity research analysts are expecting.

Development/Redevelopment usually has a lower Cap Rate than the Acquisitions segment because the buildings are under construction and/or are only partially occupied.

In more complex models, you would also have to take into account the fact that Development/Redevelopment could take a year or more – so the revenue and NOI generated will most likely increase in the future.

Equity REIT - Same-Store Revenue, Development, and Acquisitions		
($ in Millions)		
	Last Historical Year	Next Year
Development & Redevelopment Spending:	100	100
Cap Rate:		5.0%
Net Operating Income:		5
Net Operating Margin:		50.0%
Revenue:		10
Operating Expenses % Expenses:		50.0%
Operating Expenses:		3
Property Taxes:		3
Acquisition Spending:	100	100
Cap Rate:		6.0%
Net Operating Income:		6
Net Operating Margin:		60.0%
Revenue:		10
Operating Expenses % Expenses:		50.0%
Operating Expenses:		2
Property Taxes:		2

More Advanced Additions: There are a few problems with these projections, though – the main one is that **they don't account for cumulative Development/Redevelopment and Acquisitions**.

Let's say that next year we also spend $100 on acquisitions and get $6 in NOI and $10 in revenue from that. For next year's acquisition revenue, we'd have to add **next year's revenue to this year's revenue** to get a total of $20 in revenue and $12 in NOI.

So it's better to **track the assets themselves and assume a Cap Rate and NOI Margin on those**.

For example, let's say we start out with $100 in Acquired Real Estate with a Cap Rate of 6%. In year 2, if we spend $100 to acquire more real estate, we'd add that to the total to get $200 in Acquired Real Estate. A Cap Rate of 6% would produce NOI of $12, so this method handles the cumulative investment without requiring us to add all the previous years' Rental Income and NOI figures.

The other issue with the method above is that over time, Development/Redevelopment Assets and even Acquired Assets may move into the Same-Store category.

To learn how all of this works, please see the advanced case study included in the course – the description above is intended to be an introduction to these concepts.

Projecting Dispositions

Since REITs are constantly selling property, **Dispositions** are crucial to project in operating models. For this segment, you assume a certain amount of Asset Sale Net Proceeds (based on historical averages or company guidance), and then a Gain or Loss on the sale of those assets (based on historical averages).

Then, **Asset Sale Net Proceeds Minus Gain / (Loss) on Sale of Assets = Book Value of Dispositions**. You subtract the Book Value of Dispositions from the Real Estate Assets on the company's balance sheet.

You determine the Rental Income and NOI for Dispositions by assuming a Cap Rate and NOI Margin once again; Depreciation can be a percentage of the Book Value of Dispositions:

Equity REIT - Dispositions		
($ in Millions)		
	Last Historical Year	**Next Year**
Asset Sale Net Proceeds:	$ 100	$ 100
Gain / (Loss) on Sale of Land:	5	10
Gain / (Loss) on Sale of Real Estate Assets:	15	30
Book Value of Dispositions:	80	60
Rental Income:	$ 20	$ 20
Operating Expenses:	(5)	(5)
Property Taxes:	(5)	(5)
Depreciation:	(5)	(5)
Income from Discontinued Operations:	**$ 5**	**$ 5**

In more complex models, you would assume that the Disposed Assets are removed from a category such as Same-Store and you'd link the Cap Rate and NOI Margin to the numbers there.

On the Income Statement, the Income from Discontinued Operations (really the *Net Income* from Discontinued Operations) and the Gain / (Loss) on the Sale of Real Estate Assets would be added together in the Discontinued Operations section, with the Gain / (Loss) on the Sale of Land shown separately.

Putting Everything Together

Once you've projected these 4 different segments, you can add up the revenue, operating expenses, and property taxes from everything to calculate the REIT's Net Operating Income:

Equity REIT - Rental Income by Segment, Operating Expenses, and Net Operating Income		
($ in Millions)		
	Last Historical Year	Next Year
Rental Income by Segment:		
Same-Store Rent:	$ 520	$ 541
Rent from Development & Redevelopment:	-	10
Rent from Acquired Properties:	-	10
Rent Lost from Dispositions:	(20)	(40)
Total Rental Income:	**500**	**521**
Expenses:		
Property-Level Operating Expenses:	150	156
Property Taxes:	50	52
Total Expenses:	**200**	**207**
Net Operating Income:	**$ 300**	**$ 313**

The tricky part is remembering the **cumulative effects** – to project revenue and NOI this way, you need to sum up the Rental Income and expenses from all previous years and the current year for Development/Redevelopment, Acquired Properties, and Dispositions.

You don't need to do that for the Same-Store segment because we're assuming a growth rate and an NOI Margin there, so the cumulative effect is already taken into account.

Linking a REIT's Segments to the Balance Sheet

Once you've projected each segment, you can then link the changes to the REIT's balance sheet:

Equity REIT - Net Additions to Gross Real Estate Operating Assets		
($ in Millions)		
	Last Historical Year	Next Year
Changes to Gross Real Estate Operating Assets:		
Maintenance Capital Expenditures:	$ 30	$ 35
Development / Redevelopment:	100	100
Acquisitions:	100	100
Book Value of Dispositions:	(80)	(60)
Net Change to Gross RE Operating Assets:	**150**	**175**
Gross Real Estate Operating Assets by Segment:		
Land:	1,000	1,033
Buildings and Improvements:	3,800	3,925
Furniture, Fixtures & Equipment:	500	517
Net Changes by Segment:		
Land:		33
Buildings and Improvements:		125
Furniture, Fixtures & Equipment:		17

Maintenance CapEx comes from the Same-Store Properties and you might make it a percentage of the asset value there, or grow it by the Rental Income growth rate. The other numbers flow in from where we estimated investments or dispositions in each segment previously.

Some REITs do not split Real Estate Assets into different categories – if that's the case, the $175 number above would flow in as is and you would add to the single Gross Real Estate Assets number.

But if they do split assets into different categories, you'll have to distribute the net additions we've done above. In this case we allocate them based on the percentage in each category – Land, Buildings & Improvements, and FF&E – in the previous year.

From Properties to REITs

The basic concept is not difficult – the hardest part is properly tracking the assets by category, especially when you assume that Development/Redevelopment assets shift into Same-Store over time, or when the Disposed Assets come out of the other segments here.

For detailed guidance on how to do all that, please see the advanced case study included in this course.