



Understanding net operating income in commercial real estate - by Ron Koenigsberg

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In commercial real estate there are many important terms you must know to become a savvy investor. Property owners and investors must become familiar with terms such as capitalization

rates, debt coverage ratio, net leases, and much more.

In this article, we'll cover one of the most important terms, Net Operating Income (NOI), and its importance to a commercial property.

What is Net Operating Income?

Net Operating Income (NOI) is a calculation used to determine the profitability of commercial real estate investments. It accounts for the cash flow of the property.

NOI is arrived at by subtracting the total operating expense amount from the effective gross income amount of a given property.

There are various expenses that are required to operate commercial real estate. These expenses can include real estate taxes, insurance, utilities, repairs, maintenance, and landscaping. Any other expenses that are imperative to operating a commercial property should also be accounted for.

On the other hand, there are several factors involved in the total gross income of a given property. This gross income can include monthly rental income, parking or storage income, and any tenant contributions towards taxes, insurance, and common area maintenance (C.A.M).

How to Calculate the NOI

As an example, let's imagine the following information are the income and expense financials of a retail building:

Income

Rental Income: \$100,000

Expense Reimbursements: \$10,000

Total Revenue: \$110,000

Expenses

Property Taxes: \$35,000

Insurance: \$5,000

Repairs & Maintenance: \$6,000

Utilities: \$4,000

Total Expense: \$50,000

To arrive at the net operating income in this example, you take the total revenue (\$110,000) and subtract the total expenses (\$50,000), resulting in \$60,000 Net Operating Income.

How to Increase Net Operating Income

There are many ways to improve the NOI of an investment property. One way this can be achieved is by increasing the income of the property. For example, a landlord can raise the rents of the tenants, or have tenants reimburse for expenses, within a new lease agreement.

Additionally, expenses can be reduced by going green with specific utilities such as electricity. Grieving taxes (by undergoing the tax certiorari process), and shopping around for better insurance rates are also ways in which the NOI can be improved.

How is NOI Used in Commercial Real Estate?

Maintaining a healthy net operating income or cash flow is important for many reasons. Positive cash flow can help landlords reinvest in the property, pay towards their real estate loan, and prepare for any future financial threats.

It is also extremely important in determining the worth or value of a property. The higher the NOI of a property, the higher the valuation will be based on a cap rate approach. For example, a 7% cap rate at different net operating incomes can greatly change the property's value.

If the NOI of a property is \$90,000 at a 7% cap rate, the property will be valued at roughly \$1,200,000.

Now, the same property with a higher NOI of \$100,000, also evaluated at a 7% cap rate, would be worth around \$1,430,000.

As you can see, a \$10,000 increase of the NOI can result in a significantly higher evaluation and price.

The net operating income is also useful when calculating the debt coverage ratio (DCR). The DCR explains whether or not a property's revenue sufficiently covers its operating expenses and debt payments. Learn more about debt coverage ratio by visiting us online at aipcommercialrealestate.com/.

Conclusion

The net operating income is an important part of commercial real estate investments, as it determines the profitability of a given property.

If you have any questions, or are looking to buy or sell a commercial property – our team can assist you.

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