

## HOW TO PREPARE AN APARTMENT PRO FORMA

The term "Pro Forma" is short for Pro Forma Operating Statement. A pro forma is an annual operating budget for an income property and is probably the most important single document in an income property loan package. An experienced processor will always assemble the package with the pro forma as one of the very first items that the lender sees.

Because you have been provided a form entitled "Pro Forma Operating Statement" the actual preparation of a pro forma is merely a matter of filling in the blanks. The numbers you choose to insert, however, must be supportable and well documented. The stakes are high. If a lender does not accept your pro forma, he will not take the time to prepare one of his own. He will merely select a very conservative operating expense ratio such as 40-45%. Operating expenses of 40-45% will kill most deals. Remember, the loan size rather than the interest rate or points is usually the sticking point in income property negotiations.

First let us discuss Gross Scheduled Rents. You should usually use the current actual rent roll. Insert in your rent roll the market of any vacant units. The only time a lender will accept projected rents is if the rent increase letters have already been sent. It is helpful, but not mandatory, to include a few samples of the rent increase letters that have been mailed. However, be careful not to scare your client away by asking for copies. If the increase letters have been mailed, footnote the Gross Scheduled Income as follows:

Based on an announced rent increase effective date.

The new rent level should be no further off than 90 days. Then if the lender objects, the Placement Officer can suggest that the file be put aside for a few weeks until the rent increase is in effect. Invariably the lender ends up accepting the projected rents now. Another time you can get away with projected rents is if the apartment building is located in a city with rent control, and the annual increases are scheduled to take effect within 90 days.

Most all lenders regardless of the actual vacancy factor in the given market will use 5%.

## **Apartment Pro Forma**

Borrowers will often protest with claims of actual vacancy rates of 2% to 3%. In these cases, remind your borrower that a Vacancy Allowance is really a shorten version of Vacancy and Collection Loss Allowance.

Inserting the actual operating expenses is greatly simplified if a well done appraisal arrives with the package. In this case, simply insert the expenses as listed *in the* appraisal, and foot-note them as follows:

Based on the MAI appraiser's estimate.

However, you usually should not order an appraisal, or a lender will not accept it. Wait until the lender has reviewed the package and the borrower has accepted in writing the lender's proposal, then the Lender will order the appraisal. Therefore you must be prepared to estimate the expenses yourself, and you should document them well.

Ideally you would like to insert the borrower's actual operating expenses for the last 12 months and footnote them as follows:

Actual operating expenses for the last 12 months.

Few borrowers, however, keep records that current, and you must be careful not to scare the borrower away by demanding that he spend hours pouring over his records.

More frequently you will have his actual operating expenses for the last calendar year. In this case, simply insert the figures directly from his tax return and make a footnote.

On other occasions, you will be supplied the year-to-date expenses for the first half or first three quarters of the year. In this case, simply annualize the expenses and make a footnote.

Be careful not to double-count the insurance premium or real estate taxes by annualizing them. Remember that these expenses are just paid once or twice a year. The best source for the annual real estate taxes is the preliminary report. You might find the annual insurance premium in the previous year's tax return, or you might simply have to ask the borrower or the borrower's insurance agent.

## Apartment Pro Forma

Here are a couple of useful rules of thumb. To calculate estimated real estate taxes, take 1.25% of the original purchase price. To compute an estimate of a insurance premium, use \$5.50 per thousand dollars of coverage. Therefore if the sum of the existing 1st mortgage and your new 2nd mortgage is \$787,000; you can take 787 times \$5.50 to arrive at a very rough estimate of the new insurance premium.

There will be times where the borrower simply has only a few months operating history. Examples include properties taken back in foreclosure and recent purchases. In cases like this, ask the borrower to prepare for you a Utility Statement. A Utility Statement is a breakdown of the building's various monthly utility expenses for the last 12 months or less. You can annualize these numbers for your pro forma.

The real estate taxes can *be* obtained from a prelim and the insurance premium from the borrower.

To estimate Repairs and Maintenance use between 6-10% of Effective Gross Income, depending on the age of the property and the quality of the tenants.

In the absence of specific offsite management numbers, you should use 5% of Effective Gross Income. This is what most professional property management firms charge. Onsite management should be handled as follows. Show the full market rent of the resident manager's unit on your rent roll and on your Gross Scheduled Rents. Then list as an expense under Management-Onsite the difference between the market rent of the unit and what the resident manager actually pays. This difference is known as a rent credit and is fully-taxable under the IRS codes. If the resident manager receives a small salary in addition to a rent credit on his unit, be sure to include this as well. Many small units do not have resident managers, and lenders will accept this. However, even if a building is owner-managed, you should include an Off-site Management expense of 5% of Effective Gross Income. The reason why is because in the event of a foreclosure, the lender will have to hire a professional property management firm to manage the property.

**SAMPLE APARTMENT  
PRO FORMA  
OPERATING STATEMENT**

INCOME:

Gross Scheduled Income	\$	<u>102,700</u>	(a)
Tenants' Expense Contributions		<u>1,196</u>	
Laundry Income		<u>2,400</u>	
Other Income: <u>Parking</u>		<u>2,400</u>	
<u>Total Income:</u>	\$	<u>106,296</u>	
Less <u>2% Vacancy Allowance</u>		<u>2,054</u>	
 <u>Effective Gross Income:</u>	\$	<u>104,242</u>	

EXPENSES:

Advertising	\$	<u>1,346</u>	
Cleaning		<u>1,427</u>	
Electricity		<u>See PG&amp;E</u>	
Elevator Maintenance		<u>896</u>	
Fees & Licenses		<u>327</u>	
Gardening		<u>1,220</u>	
Gas		<u>See PG&amp;E</u>	
Insurance		<u>3,225</u>	(b)
Legal & Accounting		<u>727</u>	
Management-Offsite		<u>5,230</u>	
Management-Onsite		<u>5,212</u>	(c)
P.G. & E.		<u>2,345</u>	
Painting & Decorating		<u>896</u>	
Payroll		<u>See mgmt</u>	
Royroll Taxes		<u>682</u>	
Pest Control			
Pool Maintenance		<u>n/a</u>	
Real Estate Taxes		<u>10,280</u>	
Repairs & Maintenance		<u>6,250</u>	
Replacement Reserve            3%			
Sewer		<u>654</u>	
Supplies		<u>1,244</u>	
Telephone			
Trash Removal		<u>896</u>	
Utilities			
Water		<u>1,786</u>	
Miscellaneous			
 <u>Total Expenses:</u>		<u>44,643</u>	(d)
<u>Net Operating Income:</u>	\$	<u>59,599</u>	

Notes:

- (a) Current actual rent roll.
- (b) Actual annual premium.
- (c) 5% of effective gross income