CRE "By the Numbers": NOI and GRM

Net Operating Income (NOI) relates to the calculation of capitalization rate or 'cap rate.' The cap rate is related to a property's first year of NOI and can help investors and commercial real estate (CRE) professionals determine whether a property is a good potential investment.

Now, let's dive into NOI in a little more depth and touching on another return metric, Gross Rent Multiplier or 'GRM', that provides an additional way to screen potential rental properties.

NOI – Definition and Calculation

According to NAIOP's ever-useful "Industry Terms and Definitions" page, Net Operating Income can be defined as: "The income generated after deducting operating expenses but before deducting taxes and financing expenses."

The equation for determining NOI is:

Net operating income = Gross Operating Income (GOI) – Operating Expenses (OE)

In this calculation, GOI = Potential Rental Income – Vacancy Rates and Operating Expenses includes everything from property tax to insurance, maintenance and any other miscellaneous fees associated with running the property.

As an example:

Consider the case of a small multifamily property with 8 units that charges $1,500 per month in rent for each. The Potential Rental Income is:

(8 units × $1,500) × 12 months = $144,000

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The property also rents parking spaces, however, adding another $10,000 in income for a total Potential Rental Income of $154,000.

In a perfect scenario, all of the apartments are filled and all the parking spaces rented, and this value would also be the GOI. In reality, it’s likely that some of the apartments are not occupied, at least for some of the time, and we subtract that value as Vacancy Rates.

For the sake of simplicity, let’s say the vacancy losses are 10% from the apartments (i.e. $144,000 × 0.1 or $14,400), bringing us to a GOI of $139,600.

If we calculate that the Operating Expenses in this scenario are $40,000, we now have all the information needed for NOI.

NOI = $139,600 – $40,000 = $99,600 annually

With this information, investors and CRE professionals can easily compare the expected profitability of this investment with others in the area. Worth noting is that NOI doesn’t include large one-off expenses (e.g., major upgrades to the property), debt service or depreciation.

Gross Rent Multiplier

Another way investors can compare potential rental properties is by using the Gross Rent Multiplier or GRM. The formula in this case is:

Gross Rent Multiplier = Market Value / Gross Rental Income

In this case, we are leaving out all the information about operating expenses, and simply calculating more of a “ballpark” figure that allows for comparison between properties.

GRM can also be manipulated to find out information like Market Value or Gross Rental Income if you know the average GRM of comparable properties in the area. It should be noted that this is really a “back of the envelope” tool for valuation, as it doesn’t delve into the finer scale details that will affect property valuation and profitability.

A Nuanced Picture

The NOI and GRM calculations serve as a useful basis when comparing properties. As an experienced broker knows, however, coming to grips with the value of a potential investment is never quite that simple! Rather, it’s necessary to compare several return metrics and to factor in the many other subtle market considerations that can influence that value.

What represents a “good” GRM or NOI is also, like cap rate, going to depend heavily on what’s happening in the market and the time horizon and other considerations an investor has in mind.

For the savvy CRE professional, however, these metrics are another tool to help clients get a nuanced and detailed view of what their investment capital can do for them.