

Understanding Replacement Reserves in View of Storm Season

- The topic of replacement reserves is often confusing for commercial real estate professionals:
- How much should be set aside for replacement reserves?
- Should replacement reserves be included in net operating income?
- How do replacement reserves impact cap rates and value?

What are Replacement Reserves?

Replacement Reserves are funds set aside that provide for the periodic replacement of building components that wear out more rapidly than the building itself and therefore must be replaced during the building's economic life (short lived items).

These components typically include the replacement of the roof, heating, ventilation, and air conditioning (HVAC) systems, parking lot resurfacing, etc. Note that replacement reserves do not include minor repairs and maintenance such as broken doorknobs or lightbulbs. These minor expenses are considered routine operating expenses, not irregular capital expenditures.

Now, with the advent of hurricane season in the South and East, tornadoes in the Midwest and the myriad of natural occurrences everywhere in between, an "anticipatory disaster reserve" can now be justified.

How much should be set aside for replacement reserves? You should start by working with your insurance agent, what is the "risk rating" is for your area and adjust replacements accordingly. A good rule of thumb is to:

- Estimate replacement value along with shipping and labor
- Subtract the insurance coverage
- **Add 30 days Gross Earnings (based off your prior years 1120)**
- **Include 3X marketing expense to recapture lost market share.**

Conclusion

Replacement reserves are an important line item in any commercial real estate proforma. Capital expenditures are necessary for Continuity of Income. Yet, many people gloss over the reserves for replacement line item and often exclude it completely from the NOI calculation. The fact is that, if you include it after Earnings and before Tax it will not affect your capitalized value and show sound management and planning. This is also an excellent time to "put adversity to work for you" and get up to speed with your practice analysis, diversity of income and compliance measures including payment performance programs.