Funds From Operations (FFO): A Way to Measure REIT Performance

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What Is Funds From Operations (FFO)?

The term funds from operations (FFO) refers to the figure used by real operating performance. FFO is calculated by adding depreciation, amortization, and losses on sales of assets to earnings and then subtracting any gains on sales of assets and any interest income. It is sometimes quoted on a per-share basis. The FFO-per-share ratio should be used in lieu of earnings per share (EPS) when evaluating REITs and other similar investment trusts.

KEY TAKEAWAYS

- Funds from operations is the figure used by real estate investment trusts (REITs) to define the cash flow from their operations.
- Real estate companies use FFO as a measurement of operating performance.
- FFO excludes one-time cash inflows such as income from the sale of an asset; instead, it only includes income from business activities.
- A REIT's adjusted funds from operations subtracts any recurring expenses capitalized and then amortized in addition to any straight-lining of rents.
- REITs disclose their FFO in the footnotes of their income statements.

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Formula and Calculation of Funds From Operations (FFO)

The formula for FFO is:

$$\text{FFO} = (\text{NI} + \text{D} + \text{A} + \text{PSL}) - \text{PSG} - \text{II}$$

$$\textbf{where:}$$

$$\text{FFO} = \text{Funds from operations}$$

$$\text{NI} = \text{Net income}$$

$$\text{D} = \text{Depreciation}$$

$$\text{PSL} = \text{Property Sales Losses}$$
$$\text{PSG} = \text{Property Sales Gains}$$
$$\text{II} = \text{Interest Income}$$

All components of the FFO calculation are listed on a REIT's income statement. Here are the steps to take to calculate it:

1. Obtain the figure for net income, which is the company's profit and is located at the bottom of the income statement.
2. Depreciation and amortization are the expensed portions of a company's tangible (physical) and intangible assets for the period. Depreciation and amortization are merely accounting measures to help companies spread out the costs of their assets. The expensed amounts ultimately reduce net income for the accounting period. As a result, depreciation and amortization are added back to net income to determine the actual incoming cash or revenue from the REIT's operations.
3. Add any losses on the sales of business property, if any. This generally includes long-term assets such as property, plant, and equipment (PP&E). These losses are considered one-time and non-recurring, and are therefore not part of normal operations and should not be included in the FFO calculation.
4. Subtract any gains or revenue earned from the sale of property from the total figure of net income, depreciation, and amortization to obtain

3. Subtract any interest income the business earned. Interest income is generally not a regular part of a business's normal operations, and therefore it should not be included in the FFO calculation.

If, for example, a REIT had depreciation of $20,000, gains on sales of property of $40,000, and net profit of $100,000, its FFO would be $80,000.

Tip: In most situations, you won't need to calculate a REIT's FFO because all REITs are required to show their FFO calculations on their public financial statements. The FFO figure is typically disclosed in the footnotes for the income statement.

What FFO Can Tell You

FFO is a measure of the cash generated by a REIT. Real estate companies use FFO as an operating performance benchmark. The National Association of Real Estate Investment Trusts (NAREIT) originally pioneered this figure, which is a non-GAAP measure.

The funds from operations measure the net amount of cash and equivalents that flows into a firm from regular, ongoing business activities. FFO should not be seen as an alternative to cash flow or as a measure of liquidity.

For example, a typical company's cash flow would be influenced by the company received loan proceeds from a bank. However, FFO does not include such cash inflows. Instead, it is only a measure of the income from business activities.

Important: Don't confuse a REIT's funds from operations with other metrics, such as the cash flow from operations. This figure is reported on the statement of cash flows (CFS) and represents money that a company earns from its normal core operations. A company's earnings before interest, taxes, depreciation, and amortization (EBITDA) is also different. This metric measures the corporation's profitability to net income by factoring out depreciation and amortization expenses, along with taxes and liability costs.

Why FFO Is a Good Measure of REIT Performance

FFO compensates for cost-accounting methods that may inaccurately communicate a REIT's true performance. Generally accepted accounting principles (GAAP) require that all REITs depreciate their investment properties over time using one of the standard depreciation methods. However, many investment properties actually increase in value over time, making depreciation inaccurate in describing the value of a REIT. Depreciation and amortization must be added back to net income to reconcile this issue.

sales are considered to be nonrecurring. REITs must pay out 90% of all taxable income in the form of dividends, which are cash payments to investors. Gains on sales of property do not add to a REIT's taxable income and should therefore not be included in the measurement of value and performance.

As mentioned, FFO per share is sometimes provided by firms as a supplement to their EPS. Earnings per share is a company's net income divided by the outstanding equity shares. EPS and FFO per share provide a measure of how much income is being generated on a per-share basis.

These measures also help investors determine whether the money is being used effectively by management. Also, many analysts and investors assess a REIT's price-FFO ratio as a supplement to the price-to-earnings (P/E) ratio, which is the stock price divided by EPS. In the case of a REIT, the market price of the REIT would be divided by its FFO per share.

Funds From Operations (FFO) vs. Adjusted Funds From Operations (AFFO)

Real estate analysts are also increasingly calculating a REIT's adjusted funds from operations (AFFO). This calculation takes a REIT's FFO and subtracts any recurring expenditure that is capitalized and then amortized, as well as any straight-lining of rents. These recurring capital expenditures may include such maintenance expenses as painting

The AFFO measure was developed to provide a better measure of a REIT's cash-generated or dividend-paying capacity. In addition to AFFO, this alternate measure is sometimes referred to as funds available for distribution or cash available for distribution.

Example of How to Use FFO

Simon Property Group is a popular mall REIT. It reported funds from operations on its 2017 income statement of $4 billion, up 6% from 2016. The firm's net income, meanwhile, totaled $2.2 billion.

To arrive at FFO, the firm added back depreciation and amortization of about $1.8 billion, and further adjusted for other smaller figures—including a reduction of $5.3 million for payment of preferred distributions and dividends, and a noncontrolling interests portion of depreciation and amortization that resulted in an additional $17.1 million reduction.

Simon also reported a diluted FFO-per-share figure of $11.21, compared to a diluted EPS figure of $6.24.

What Do a Company's Funds From Operations Tell You?

Funds from operations measure how much cash a real estate investment operating performance. Keep in mind that FFO doesn't include the gains a REIT makes on the sale of its property(s). That's because this doesn't count as an ongoing or recurring activity.

Where Do You Find a REIT's Funds From Operations?

REITs are required to disclose their funds from operations to the general public. You can easily find this figure on a REITs public financial statements. Search for the income statement and look for this figure within the footnotes. You can also calculate the FFO by adding together the REIT's net income, depreciation, amortization, and losses on property sales. Then subtract that figure from any gains on property sales and any interest income.

What's the Difference Between Funds From Operations and the Cash Flow From Operations?

It may be easy to confuse a REIT's funds from operations and the cash flow from operations. But the two are different from one another. The FFO represents the operating performance and takes net income, depreciation, amortization, and losses on property sales into account while factoring out any interest income and gains from property sales.

The cash flow from operations, on the other hand, is reported on the cash flow statement. It's the total amount of cash that a company earns during the course of its operations. This includes working capital, revenue, and