

Commercial Real Estate Due Diligence

COURSE #5

Course Objectives

1. Explain the due diligence process during negotiations
2. Discuss the cost-cutting tips that can be found during due diligence
3. Explain what mechanical and physical inspections consist of
4. Understand the underwriting process and financial analysis process
5. Explain how to use due diligence to close the deal

Lesson 1 - **Start Here**

Types of Commercial Real Estate Transactions

Stabilized Properties

- Permanent financing
- Fully leased with rents at market rate and current cash flow within the properties
- No more work to be done on the property to “grow or groom” the NOI
- Lenders are betting that nothing “bad” will happen to the project cash flows in the future

Types of Commercial Real Estate Transactions

Unstabilized or Value-Added Properties

- Shorter term or floating rate financing
- Not fully leased, and/or rents are not at market
- Substantial work to be done before the property becomes stabilized
- Something “good” needs to happen to the property cash flow in order to stabilize the property and achieve the business plan objectives

Types of Commercial Real Estate Transactions

Opportunistic Properties

- These properties typically require “specialized” financing.

Lesson 2 - The Initial Stages of Due Diligence

Finding a Commercial Real Estate Attorney

Before you begin any transaction, you should make sure that you have your “team” together.

One key person on your team is an attorney who understands commercial real estate.

This attorney will be an important asset to you and you should feel comfortable in his or her abilities to negotiate and focus on the important issues.

The due diligence process does not just include the transaction itself, but also the people involved in the transaction.

It is also important to remember that you get what you pay for!

Beginning Due Diligence: During the Negotiations

When you begin the negotiations for the deal and start to work on the purchase and sales agreement, one of the first items you want to request is the all of the leases and operating statements (year-to-date and also the past three years).

One of the main reasons for asking for the leases is to determine if there is anything in the leases that would prevent you from moving forward on the acquisition.

When reviewing the leases, here are three areas to review:

1. Look for any outstanding issues that may affect the leases.
2. Confront the outstanding lease issues immediately and try to resolve them so as to not spend unnecessary time on a transaction that has unsolvable problems and issues.
3. Ask to review all tenant files and correspondence.

Beginning Due Diligence: During the Negotiations

During the initial due diligence process, you should also ask for a list of all inventories from the seller.

During the due diligence process, you must verify that any equipment that is used as part of the operation of the property is listed, included and transferred at the close of escrow.

Another key component of the due diligence process at the early stage is to review all mechanical systems.

With mechanical system permits, make sure that all permits required for the operation of the property.

Choosing a Lender

If you have decided to use traditional lenders for your financing, you must conduct due diligence to find the right lender.

Mortgage Brokers: You can choose to work with reputable mortgage brokers who come highly recommended.

Banks/Direct Lenders: You can also choose to go directly to a lending institution of your choice; either a bank, insurance company, credit union or other direct lenders.

Lesson 3 - Due Diligence: Signed Purchase Agreement

Third-Party Reports

Let's discuss the key third-party reports you should be reviewing.

1. The first report is the **Phase I & Phase II Environmental Reports**.
2. The second report is the **Property Condition Assessment Report**. If there is a report available, it will give you an idea of which issues were outstanding when the current owners purchased the property as well as what has been fixed or upgraded since their ownership.
3. The third report is the **Seismic/PML (Probable Maximum Loss) Report**.

There are many other possible reports that could be generated, either as part of a report (such as the Property Condition Assessment Report), or as a totally individual specialized report.

When you have to order any type of third-party report, make sure you bid them out to two or three companies who are approved by the lender (without lender approval you may be forced to have report completed again by another vendor acceptable to lender).

Conducting Tenant Interviews

Much information can come from the reports, but it is also important to talk to the tenants of the properties you are purchasing.

It is best to have a tenant questionnaire sent to the tenants ahead of time to prepare for the interview.

Many tenants will give you a wealth of information if you give them the right questions to respond to. For example:

“Tell me what your likes and dislikes are about this building.”

“Have you had any bad experiences in the building you can share?”

“How is the security in the building and in the surrounding area?”

“Have you had any problems with the HVAC or elevators?”

“Have you experienced any leakage from the windows when it rains?”

Conducting Other Interviews

In addition to interviewing the tenants, you should also take the time to talk to the property manager and the building engineer.

In addition to the property manager and building engineers, you should also interview the current leasing broker.

Finally, you should interview potential leasing brokers.

Be Present at the Property

One of the best ways to find out more about the property, the tenants, and the area is to be present at the property.

Spend time there and actually “self-learn” the investment you are about to make.

There is much to be experienced and found out by spending time in and around the building.

Take time to discover any possible issues that could be occurring in and around the building.

You may be surprised at the different foot traffic that goes through the building.

Loan Negotiations

While you are busy looking through all of the reports, you also need to make sure that your loan approval process is moving forward. Once you have received the initial approval, they will send you a term sheet outlining the terms and conditions on which they will lend.

Always take the approach that they are not the only lender out there and you would like to establish a business relationship with them to do more business, but not at any cost.

There are many other terms and conditions of the loan that must be carefully negotiated.

Be sure to have the attorney (and the mortgage broker, if one is involved) review the loan agreement and promissory note and compare it against the fully executed term sheet to make absolutely sure that the terms and conditions are the same and no changes or additional stipulations have been added that can come back to haunt you later on.

Always try to negotiate a one-time assumption at no cost to the new buyer especially if the loan has favorable terms.

Lesson 4 - Due Diligence: Other Critical Issues

Document all Communication

In this business, there is nothing more important than having written documentation!

It is very important to note and imperative that any and all questions regarding ownership and the building be put in writing and documented.

Building and Fire Code Violations

Another important area to consider is the building and fire code violations.

There may be outstanding violations on the building that have yet to be rectified that the current owners are not disclosing.

It is necessary to go to the local municipal Building & Safety Department and check to see, if in fact, there are any violations currently on the property.

Make sure you also check to see if building permits and a certificate of occupancy (C of O) have been issued for the built out suites.

Building Measurement Verification

Another area to focus your due diligence on is the actual building measurements.

There are many times a building may not have current as-built architectural drawings or space plans, which helps to determine an accurate accounting of the actual square footage.

Often a building's measurement numbers will be over or under estimated, depending upon who has owned the property and for how long.

Insurance Quotes

One often overlooked, but potentially pricey area of the due diligence process is insurance!

You must have insurance, so now is a great time to obtain a few quotes.

If you do not already have a good insurance agent, see if you can get a good recommendation for one from someone you know and trust.

When it comes to insurance claims the trend seems to be for the insurance companies to find all the ways they can mitigate the payout to their insured.

Cost-Saving Tips

Not all of your due diligence will be about the “now” of the property, but also about the future. There are several cost-savings tips that you should consider.

The main cost you can look to reduce is electricity!

- Parking Structure Lighting
- Tenant “bill backs” for Usage
- Evaluation of HVAC Efficiencies
- Eddy Current Test: Pneumatics

Lesson 5 - Due Diligence: Property Inspection & Inspection of the Property's Books and Records

Property Inspections

At this stage of the buying process, you are ready for the property inspector experts to come in and evaluate the building. The first is domestic water pumps.

The second area is an emergency generator.

The third area is the elevators.

The fourth area is the roof.

The fifth area is the curtain wall.

The sixth area is the window system.

The seventh area is the water heater.

The eighth area is the fire life/safety panel.

The ninth area is the fiber optics.

Review of Property's Books and Records

In addition to inspecting the building itself, it is important to review the books and records for the property.

You need to find out as much information as possible about the past and current status of the property.

The value of having the building “as-built” building plans cannot be underestimated to the prospective buyer.

Review the Property's Financial Statements

You want to get at least the last two to three years' operating expenses history/reports on the building, as well as year to date.

This will not only show you what and how the expenses are, but also any trends that may be occurring.

This will also indicate where you can implement cost cutting measures which go straight to the "bottom line."

You should obtain the Aging Report.

Other Considerations

There are also several other considerations that you should review.

The first is warranties.

The second consideration is parking.

The third consideration is ground leases.

The fourth consideration is the operating budget.

The final consideration is the property tax appeals.

Lesson 6 - Due Diligence: Underwriting and Financial Analysis

Key Questions to Consider

There are several questions to consider.

Each property is unique in some way as well as each geographic location. There are some locales that have expenses to the property that are unique to that particular region, such as snow and ice removal, sinkhole problems, seismic concerns, and retrofits on equipment.

You need to continually be on guard as to what information is being given to you and its validity because the end result is once you own the property, so it is your problem to deal with.

Make sure you are verifying information and are comfortable with your findings. Underwriting is an ongoing process during your due diligence and beyond, until closing.

Even then, you will be looking back to see how accurate your analysis was during the time you own the property.

The Final Steps

The first final step is the estoppel certificates.

The second final step is the Subordination and Non-Disturbance Agreement form.

The third final step is the appraisal.

Finally, you need to be concerned with the closing statement.

Final Thoughts

Due diligence, if performed properly and thoroughly, will prevent you from experiencing major setbacks and expenses or keep you from making an investment that you should not. It should never be taken lightly or for granted.

Whoever may be conducting it, due diligence is an ongoing learning experience and you want to constantly hone your skills.

Constantly strive to the best at it.

Remember, a successful due diligence leads to greater buyer peace of mind and less (or hopefully no) post-closing surprises.

Done properly, it will also save you a ton of money and ensure the proper investment decision is made, to buy or not to buy.