nerej

Turning "due" diligence into "do" diligence

November 08, 2012 - Appraisal & Consulting

"So how can we optimize the due diligence process to make sure we are getting the most meaningful results from our efforts? The answer is to tailor a due diligence strategy for each target property that truly considers and incorporates the buyer's investment goals."

"The due diligence process not only allows us to evaluate the current physical condition of the property and its improvements, but if done right, it can allows us to define and quantify where we can take a property in terms of future use and, consequently, return on investment."

The commercial real estate due diligence process can be somewhat overwhelming, cumbersome, and even frantic as the deadline to back out of the deal looms over the horizon. No matter how many written guidelines and standards of practice we develop and follow, in the end, questions can remain: "was anything substantive missed or overlooked regarding the property that can cost us significantly, or preclude us from doing what we intend to do with the property?" This is what investors want to know with the highest degree of certainty. So how can we optimize the due diligence process to make sure we are getting the most meaningful results from our efforts? The answer is to tailor a due diligence strategy for each target property that truly considers and incorporates the buyer's investment goals.

In The Handbook of Real Estate Portfolio Management, institutional real estate due diligence is defined as "...an evaluation of the policies, procedures, and results of an organization's structure and staffing, portfolio construction, and monitoring and selection of specific real estate investments" (Pagliari, Joseph L., Jr. [edited by], Roulac, Stephen E., et al, Ch. 18 Due Diligence in Real Estate Transactions, Richard D. Irwin, Inc., 1995.). The authors go on to explain that the level of due diligence will vary based upon a number of factors. Many investors that I have worked with over the years might simply define the goal as "tell me what I don't know about this property, A.S.A.P.â€"and no surprises!"

No doubt, the real estate due diligence process, when properly implemented, is comprehensive, and can be quite expansive in depth and breadth of scope. It is a process best performed by a team of skilled professionals, working in their various disciplines. There are the "tangibles", the physical attributes of the property that can be seen, touched, or in some way measured: the building's foundation, framing, cladding, unit sizes and layouts, presence of lead paint, etc. Then there are the "intangibles", or the more subjective and abstract attributes of a property: liens, easements, the property's history, age of buildings, code compliance, income potential, and so on. By way of example, let's focus on just the tangibles.

The due diligence process not only allows us to evaluate the current physical condition of the property and its improvements, but if done right, it can allows us to define and quantify where we can take a property in terms of future use and, consequently, return on investment. Due diligence can be used as a non-committal, pre-purchase opportunity to evaluate the feasibility or potential of

adding value to a property in terms of capital improvements and asset optimization.
For example, when we are examining the present physical condition of an existing building, there are three basic "stages" of evaluation that can be performed, depending upon the investor's strategy for the property. These stages are: 1) Evaluation of Conditions for Intended Use; 2) Evaluation of Conditions for Proposed Improvements keeping Intended Use; and 3) Evaluation of Condition for Potential Repurposing.
In Stage 1, the building is simply evaluated in light of any code violations (building code, ADA regulations, occupancy regulations, etc.), necessary repairs, deferred maintenance, and the like, with the investor's goal to make the acquisition and maintain the property's current intended use (e.g., multifamily, office, retail, warehouse). Industry professionals are called in to examine all of the various components of the building and the site (e.g., structural engineer, civil engineer, roofing contractor, HVAC specialist, elevator specialist, electrician, plumber, hazardous materials removal specialists).
In Stage 2, the investor seeks to maintain the current intended use but also intends to improve the property in some way. This may include upgrades and/or capital improvements. Upgrades could include replacement of a building's HVAC system for a more efficient system, thereby reducing operating costs and meeting energy reduction and sustainability goals. Capital improvements could mean adding amenities that have a direct payback in terms of higher projected rent or lease rates. The property and its improvements are highly examined to come up with innovative strategies to improve upon the property, generate increased income, and reduce overall operating costs. Essentially, the same professionals are called upon to offer concepts, advice, cost-estimates, and even cursory plans or schematics. A preliminary construction schedule can also be developed to help predict when occupancy can occur. The information generated is then submitted to the investor (or investment committee) to help evaluate the acquisition decision.
Finally, in Stage 3, the investor seeks to entirely repurpose the property. For example, the investor may decide that a commercial or industrial property will be well suited as a mixed-use property, perhaps involving ground floor retail with a multifamily component on the upper floors. At this point, the entire due diligence process is revised to focus on attributes like the condition of the basic structure(s), the size and type of existing utilities, parking, existing property line set-backs, and things of this nature. The team of professionals is augmented to focus on the more basic, global aspects of the building and the site, in light of what can be done to achieve repurposing. Existing building plans (if available) are examined to look at things like the foundation type, location and type of framing, and construction details. Basic floor plan layouts are drawn and perhaps preliminary load calculations are made for new loading schemes and requirements. Again, the information generated is then submitted to the investor to help evaluate the acquisition decision, this time in light of repurposing.
Obviously, the due diligence functions identified in Stages 1 through 3 need to be performed in a very expeditious and cost-effective manner. In the event that a decision is made not to acquire the subject property, all expenses incurred during due diligence essentially amount to forfeited capital.
The key, therefore, is to build a specific strategy and organize a pre-determined team that knows precisely how to acquire the necessary information, quickly and efficiently, and keep out-of-pocket costs down. Here are some guidelines for selecting the right team: 1) The onsite team players are practitioners in their respective fields. For example, the person assessing the HVAC system is a highly trained, experienced individual who tests, evaluates, repairs and/or replaces HVAC systems

professionally. 2) The more hands-on the professional is during the actual property evaluation the better. For example, a roofer who comes out to look at the roof but doesn't throw up a ladder and actually get up onto the roof to inspect the roofing materials and flashings up close won't be much help, as knowledgeable as that individual may be. 3) The team players are ideally professionals that understand the real estate acquisition process (at least somewhat) and offer their portion of the property and/or building evaluation as part of their core services. Ideally, they have pre-established, cost-effective pricing structures set up and have staff available on short notice.

Personally, I absolutely enjoy participating in pre-acquisition property walk-throughs and assessments. It's always interesting and challenging to evaluate a building's hidden true potential or some aspect of the site that can be capitalized upon. It is also very rewarding to discover not so noticeable attributes and conditions that could cost a buyer dearly and to be able to point those out to an investor beforehand. The key is to have a great team in place such that after completing the due diligence process, the investor can say "I am satisfied that nothing significant has been missed."

Joel Breuer, PE, is managing principal at HG Cornerstone, LLC, Boston, Mass.