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Due diligence for today's active real estate market

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Major markets across the U.S. have seen significant activity in commercial real estate. There is increased competition and a flood of foreign money chasing the best deals. With the increased pressure it is important to not lose sight of the due diligence process. We are not that far removed from the last economic downturn and cannot afford to make the same mistakes by stretching too far for a deal. Doing the appropriate level of due diligence will help to identify the best properties to pursue.

Which information should be reviewed?

Examine these three categories of information:

1. Financial data. Request at least five years of financial statements, if available. All loan documents, tax returns and bills, and any information on capital improvements should also be requested. Consider how you could operate the property more efficiently, but don't be overly optimistic when estimating economies of scale and synergies with other properties. This will be key in determining an appropriate bid price.

2. Tenants and leases. Obtain a certificate of occupancy for the property, lease agreements and data on tenant mix. Compile rent rolls to assess future rental income and lease terms. For leases nearing expiration, consider whether to renegotiate terms or replace undesirable tenants. This information will give you a solid understanding for future cash flow purposes.

3. Insurance and title policies. Scrutinize policies and riders as well as related risk assessments and claims history. If the policy hasn't been updated to reflect current market values, the property may not be properly insured.

Qualitative factors that should be considered

Qualitative assessments of the property are as important as quantitative data. Always visit the property, focusing on competing properties, traffic patterns and any neighborhood characteristics that could change your assumptions. For example, if a competitor has recently renovated, it might affect market rents or force you to improve your property. This ties back to the requests for capital improvement information during the financial data gathering phase. Incorrect capital improvement assumptions will drastically affect future cash flow and debt needs.

Know the comparables in the area, including current rental rates, selling prices, market saturation and vacancy rates. Outdated or dissimilar comps can lead to poor investing decisions. Use similar properties in size, location, and class within your current portfolios as a guide.

Then inspect individual units. Look for attributes that make a unit hard to lease, such as an unusual layout. Or you might discover that a tenant business is struggling. Can you count on that business to renew its lease or keep up with rent payments and maintenance?

Finally, talk with tenants to find out if they're satisfied with the property and management, or if they have complaints that could affect renewal decisions. This is a good way to help change the direction of the property. If tenants are unhappy and considering leaving then listening to their concerns and implementing changes could result in increased renewals and a bump in reputation.

What else should due diligence cover?

Due diligence should also extend to zoning and land use issues, such as judgments, claims and liens; third-party contractual obligations (such as construction warranties); and environmental issues. More due diligence is required if the property is distressed. Neglected properties risk tenant default and might not comply with building and other codes.

Work with your trusted advisors. Leveraging these advisors can save you time to focus at high levels. Your financial professionals can help in reviewing financial data while you focus on the other aspects of the property.

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