
DUE DILIGENCE IN COMMERCIAL REAL ESTATE TRANSACTIONS



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The outlook for commercial real estate in 2018 is best summed up in two words: cautious optimism.

That’s the view of [Heidi Learner](#), chief economist at Savills Studley, a leading commercial real estate services firm. Broader market conditions appear favorable, thanks to sustained economic growth and rising employment figures. Additionally, the recent passage of the tax reform bill will likely have a significant impact on all major asset classes, including real estate.

While macroeconomic trends are encouraging, some lingering challenges remain. Tighter enforcement of immigration law—and the prospect of new legislation that significantly reduces the flow of immigrant labor into the U.S.—could create greater labor shortages in the construction industry and dampen renter demand.

New tariffs issued by President Trump have created some uncertainty in the commercial real estate market. Plus, there are concerns about the rising costs of building materials.

Despite these challenges, the overall outlook for commercial real estate is encouraging. [Collier’s International](#), in its 2018 Outlook on U.S. Property Markets, projects continued growth this year following peak numbers in 2017.

DUE DILIGENCE CAN LIMIT POST-TRANSACTION SURPRISES

Investors will be busy searching for new ways to optimize opportunities in a fast-moving and quickly evolving commercial real estate marketplace. Veteran investors in commercial property turn over every stone to limit the possibility of post-transaction surprises. Newcomers should pursue the same approach and resist rushing into a deal, given the breadth of risks at play.

The acquisition of commercial real estate requires intensive due diligence to uncover key information that may not be readily apparent or available in evaluating the value of a property or portfolio. Such hidden details can doom the financial merits of an otherwise profitable deal, turning the transaction into a costly mistake.

There are essentially three types of investors engaged in acquiring commercial real estate. Each is driven to make an acquisition for different objectives:

- ▶ Investment Purposes
- ▶ Real Estate Development
- ▶ Business Operations (where the building will be occupied by the investor’s organization)

These different objectives alter the due diligence process and depth.

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Eager to engage in what appears to be a sure opportunity with little risk, inexperienced investors may jump in where more seasoned buyers fear to tread. Certainly, less than thorough due diligence by all investors may be a ticking time bomb, especially given concerns over a rising real estate market. No investor can risk a costly surprise that rears its head in the aftermath of a transaction's closure.

WHAT IS DUE DILIGENCE FOR REAL ESTATE?

The chief [aims of real estate due diligence](#) are to thoroughly inspect the fundamentals of the property, seller, financing, and compliance obligations to reduce and mitigate financial uncertainties. The effort is not for the fainthearted. Prospective buyers must scrupulously examine zoning restrictions, potential liens, and possible encroachments on the property. Existing structures must be fully inspected to discern needed repairs and their costs. They must determine whether or not they will absorb legacy liabilities from prior owners' [legal and regulatory](#) violations. If the property is largely financed, they need to address their ongoing ability to make required payments to the lender.

Many sophisticated commercial real estate investors consider it a best practice to commence detailed due diligence before the purchase contract is signed. The alternative is to carefully lay out in the contract for sale the items of due diligence that the buyer must undertake and the time this will take. This also serves to compel the seller to deliver required documents on an expeditious basis. Certain findings may adversely affect the acquirer's anticipated financial return, giving buyers a stronger hand in the transaction negotiations to ensure a fair and accurate property valuation, given the risks that have been unearthed.

Given the vast array of documents in a commercial real estate transaction, it is important to prepare a due diligence checklist, marking off each item of concern once it has been addressed. Depending on the investor type and the entity's financial objectives, this checklist can be quite long. Nevertheless, it would be imprudent to close a deal before appreciating and fully evaluating the risks against the rewards.

GETTING THE BASICS DOWN

Due diligence on a commercial real estate opportunity begins with understanding the transaction's objectives. The investment goals in pursuing a commercial real estate transaction serve as the foundation for the due diligence that

follows. For instance, the purchase of an income-producing property like an apartment building will require the investor to verify the existing tenant leases and examine each tenant's rental payment history. Otherwise, the investor cannot ensure the financial stability of the anticipated income stream. On the other hand, the initial focus of a commercial real estate developer is on the intended use of a building and whether or not the property can be permitted to achieve this intent.



“Many jurisdictions have unique laws that affect real estate transactions.”

Acquisitive parties should never engage in a commercial real estate transaction without personally visiting, walking through, and inspecting the premises. During the walk-through, buyers must analyze the property or building in terms of the intended use. Concerns that arise will affect the negotiations. For example, a property that a buyer plans to turn into an office complex with ample parking may be hilly and expensive to grade to accommodate the anticipated volume of vehicles.

Given oft-disparate federal, state, and local environmental regulations, investors also must ensure that a property or building complies with current rules and laws, and planned and potential ones in future. An example of this moving target is environmental sustainability and liability. Investors need to know that a particular regulation will phase in at a later date, in some cases several years away.

Before financing the transaction, lenders are likely to require an environmental suitability assessment. A best practice is to undertake this evaluation anyway, irrespective of financing issues. Recruit a reputable environmental engineering firm to assess past uses of the building or property, in addition to collecting evidence of possible contaminants like mold, lead, and asbestos, and the presence of underground storage tanks. What appears to be perfectly safe and legal in a visual inspection can turn into a litigation minefield in the future, since the investor will inherit these potential liabilities and be required by law to eliminate the discovered problem.

Lastly, although sellers are legally required to provide certain disclosures on a property's physical characteristics, such as easements, encumbrances, and other restrictions,

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it is prudent for the investor to personally review, validate and check off each item. A best practice when acquiring commercial real estate is to never automatically assume the same degree of disclosures from the seller that exists when buying residential property. Key differences exist.

DIVERSE DOCUMENTS

New investors in commercial real estate should consider the value in retaining the assistance of a [specialized commercial real estate attorney](#). Numerous legal documents must be accessed, evaluated, and verified. At a minimum, these documents include the title, leases, zoning regulations, surveys, tax certificates, and the seller's financial records and operating statements. All documents should be listed in the aforementioned checklist and stored initially in a VDR (virtual data room).

Title Searches and Property Descriptions

Once escrow has been opened, the investor should order a preliminary title report. The title will provide information about the property, such as its current and past ownership and the existence of liens, encumbrances, and easements. Once these factors are understood, a best practice is to undertake a [professional survey](#) of the property to corroborate the particulars, as well as to confirm lot size, access roads, boundary lines, surface waters, rights of way, soil condition, and possible property improvements and alterations. To verify the accuracy of the title, it is prudent to contract with a title insurance company, which will commit to absorbing unanticipated financial losses due to possible [title defects](#).

Municipal Lien Searches for Florida Properties

Many jurisdictions have unique laws that affect real estate transactions. Anyone who plans on purchasing property in Florida should make sure to conduct a municipal lien search. In Florida—unlike most other U.S. states—unrecorded liens, fees and permit violations are attached to properties rather than individuals.

Because of this, virtually all real estate transactions occurring within the state of Florida must have a municipal lien search conducted as part of the closing process. Florida property buyers should be aware that a conventional title search will not uncover issues found in a municipal lien search.

Zoning and Property Codes

Investors also must ensure compliance with current zoning rules and property codes. With regard to the former, a

smart tactic is to solicit documentation from the relevant municipality to ensure the current and anticipated use of the property is compliant with existing zoning regulations and land use classifications. For buildings that are relatively new, a review of the certificates of occupancy can indicate compliance with relevant property codes. With regard to the assessed valuation of a property, this information can be obtained through the tax certificates. The latter will also indicate the standing of property tax payments. As a precaution, buyers should consider reaching out to an outside zoning specialist to independently confirm the received information is accurate and up-to-date.

Be Aware of the Time Frame for City Approvals

If problems are uncovered, or if the buyer plans on making any changes to the property, including its use, then additional permits and business licenses may be required. Prospective property buyers need to be cognizant of time frame issues associated with city approvals. Depending on various factors, it can take a month—or even years—before building permits are secured.

This means that it's imperative to arrange meetings with local authorities to determine which approvals are necessary. This includes planning and zoning, site plans, city council and other approvals.

Lease Payment History

For an income-producing property like an office building or apartment complex, a thorough review of the lease payment history will shed light on the orderly and predictable flow of rental income. Another best practice is to scrutinize the seller's financial records and operating statements—assuming these can be obtained—to discern gaps in lease payments.

ADA Compliance

A key item is to determine the compliance of an existing structure with the Americans with Disabilities Act. Each state has its own regulations regarding accessibility and needed modifications to ensure compliance, in addition to the documents pertaining to these issues. The federal government has created a checklist helping investors understand the rules prior to acquiring a building, property or undeveloped land.

All of these many documents are needed to rigorously evaluate the risks of an investment versus its potential return. In each case, once the data in the document has been validated as accurate or inaccurate, mark it off on the checklist and store it in the VDR. Compare the findings to the anticipated returns

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or revenue streams that the transaction will produce. These details become ammunition in the negotiations to close the deal. Once the transaction has closed, transfer and store the documents for compliance purposes to a [highly secure, centralized platform](#) that provides easy accessibility.

KNOW THE SELLER

Due diligence extends beyond matters related to the property being acquired. Before venturing into a commercial real estate transaction, the standing, reputation, and track record of the seller should be fully investigated and vetted. Not only may this indicate a [less-than-scrupulous transacting partner](#), the reputation of the current owner (and even occupants) may have a negative impact on future earnings.

Ask for and examine the seller's tax returns, service contracts, loan documents, past litigation history, and any other items that are related to the entity's financial status, prior use

of property, and integrity. Such insights will be useful in negotiating a fair deal, or making a determination to pass on the prospect.

CONCLUSION

Every real estate transaction is different and requires a unique due diligence plan. Moving too quickly—and failing to perform comprehensive due diligence—can create problems for even the most experienced investors.

LEARN MORE

Learn more about how CT can provide support for every stage of the deal, from [due diligence](#) to closing, to ongoing compliance.

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