The rising real estate market in many U.S. cities is prompting a surge in commercial real estate transactions, with expectations for another two years of substantial growth. 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.

The risk for all investors in commercial real estate, especially now, is to rush into what seems to be a lucrative deal simply because of the robust real estate market, strong property fundamentals, and the broad recovery of the financing sector, evidenced by increased lender competition. 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 bubble. 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

*continued on page 2*
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.

Acquisitive parties should never engage in a commercial real estate transaction without personally visiting, walking through, and inspecting the premises. During the walkthrough, 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 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, 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).

“No investor can risk a costly surprise that rears its head in the aftermath of a transaction’s closure.”

continued on page 3
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.

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.

With regard to undeveloped land, investors must determine whether or not the intended use of the property is permitted. The existence of wetlands must be determined, as must the presence of endangered species that inhabit the area or regularly visit it. In both cases, the land can still be developed, assuming a compliant process is followed.

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.

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 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**

Before venturing into a commercial real estate transaction, the standing, reputation, and track record of sellers 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.

**CONCLUSION**

Current commercial real estate market conditions make this an opportune time for investors to explore the financial value and risks of purchasing property and commercial buildings. The key word is “explore.” A headlong rush into a transaction without comprehensive due diligence will trip up even the most sophisticated investor.

**LEARN MORE**

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

Contact us at (844) 701-2064 (Toll free U.S.) or visit www.ctcorporation.com.

Join the conversation. Follow us on Twitter, LinkedIn, Google+ and Facebook.