



This article brought to you by **Commercial Investment Real Estate**, the magazine of the **CCIM Institute**.

To read the entire issue or find out more about the Institute, go to **www.ciremagazine.com**.



Physical Fitness

Equity investors need a tougher due diligence workout.

by Linda Bryson, LEED-AP

Commercial real estate investors conduct many types of due diligence, such as financial, legal, and physical. Regarding the latter, many investors assume that if they follow the current physical due diligence standard, ASTM guideline E2018-08, *Standard Guide for Property Condition Assessments: Baseline Property Condition Assessment Process*, they will be adequately protected. What you and your clients should understand is that this standard represents the lowest common denominator of physical due diligence and is only appropriate for investors with a high risk tolerance. Investors whose risk tolerance is lower than, for example, that of a commercial mortgage-backed securities issuer, will want to ratchet the investigation up several notches.

Inadequate Observation

At least 90 percent of all CMBS and balance-sheet lenders' due diligence complies with E2018-08, but because the standard was designed as a baseline it is rarely adequate for those taking an equity position. The standard describes a "walk-through" survey of a building's readily observable and easily accessible components and systems. It was never intended to be sufficient for parties with a lower risk tolerance for incurring costs to remedy undisclosed physical deficiencies. ASTM's standard specifically acknowledges these limitations.

An ASTM baseline survey typically is conducted by a field observer, who is described as a "generalist" having knowledge about various building systems. However, due diligence conducted on behalf of equity investors — those in a first-loss position —

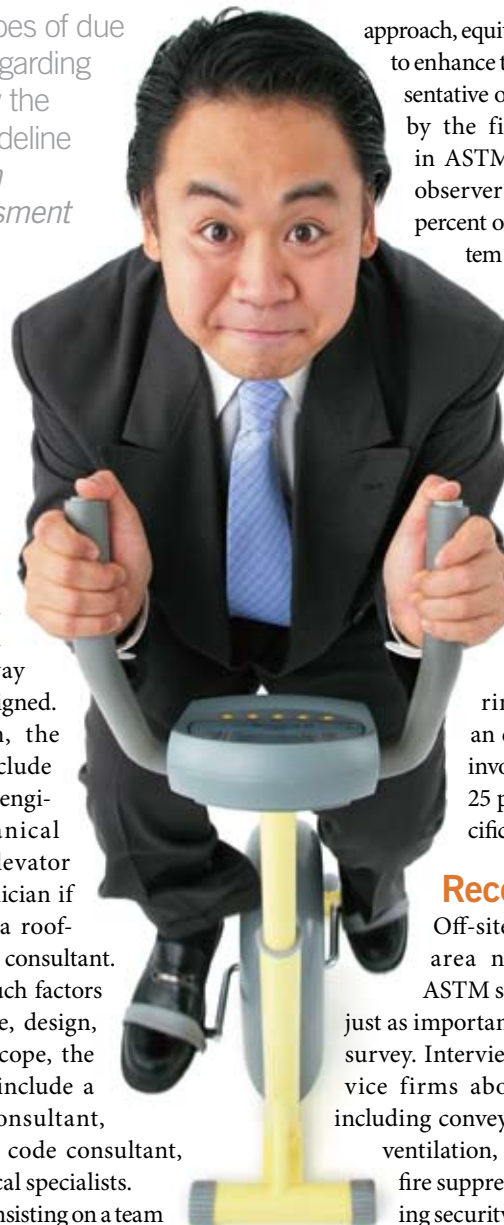
often takes a team approach, much in the same way buildings are designed. At a minimum, the team should include an architectural engineer, a mechanical engineer, an elevator consultant/technician if applicable, and a roofing technician or consultant. Depending on such factors as the asset's age, design, materials, and scope, the team also may include a curtain wall consultant, a fire/life-safety code consultant, and other technical specialists.

In addition to insisting on a team

approach, equity investors should elect to enhance the percentage of representative observations conducted by the field observers, since, in ASTM's standard, the field observer does not survey 100 percent of a given repetitive system or component. ASTM's minimum threshold is 10 percent of repetitive systems such as apartment units, common areas, or retail spaces. Such observations should be carried out to the extent that the field observer can offer a confident opinion as to the general condition of recurring components. For an equity deal, this might involve observing perhaps 25 percent or more of specific areas.

Record Research

Off-site research is another area not required by the ASTM standard, but it is often just as important as the walk-through survey. Interviews with building service firms about various systems, including conveying, roofing, heating, ventilation, and air conditioning, fire suppression/sprinkler, building security, building automation,



SAKIS/Style/Getty Images

cooling towers, water treatment, plumbing, and electrical, provide significant information that would not be discovered during a walk-through. These firms also have access to service records indicating the frequency of certain repairs and costs, chronic call-back problems, pending repairs or replacements, proposals submitted to ownership but never executed, equipment obsolescence (both functional and economic), upgrades necessary to comply with local codes or revised applicable standards, and more. Researchers also should conduct interviews with local building and fire code enforcement officers and look into building department files for open building code violations or mandated improvements to comply with recent or pending code upgrades.

While generalists may be knowledgeable about certain systems due to their educational background or work experience, they may have minimal, if any, knowledge about other building systems or components. Some investors say they will only bring in specialty consultants if the generalist spots something significant or questionable. However, it is very probable that a generalist may not be able to recognize the existence of a significant physical deficiency in certain building systems because many are simply too complex. No architect or engineer is knowledgeable about *all* building codes or systems.

What's Sufficient?

A paradox among balance sheet lenders today is the more conservative the underwriting and the higher the appraised value of the collateral, the less physical due diligence exercised regardless of the asset's physical size. As an example, a lender who recently took a first mortgage position on a 250,000-square-foot Midtown Manhattan office building was emphatic that the physical due diligence budget not exceed \$3,000, even though the asset had an appraised value of about \$100 million. Absent internal guidelines, it is common for lenders to require the same level — and spend the same amount — for physical due diligence on assets as varied as a 30,000-sf strip center and a 20-story hotel.

Not only are lenders conducting minimal due diligence, but so are many opportunistic

buyers in this down market. Most bargain hunters correctly recognize that they are purchasing properties below replacement cost and as is under adverse time constraints. Their emphasis, many times, is simply to secure the asset under contract. Due to the competitiveness of the market in identifying such properties, the Property Condition Report — the product of a Property Condition Assessment — cannot be used to renegotiate the purchase price as a result of discovering physical deficiencies. Therefore, the discovery of physical deficiencies often is moot unless they will materially impact tenancy.

Property Condition Reports prepared on behalf of sellers, also referred to as disclosure reports, have become quite common over the past five years. Sellers use them to present an asset to potential buyers with physical deficiencies disclosed along with the asking price, which takes the deficiencies into consideration. This technique often is used to prevent a potential buyer from using a deficiency discovered during the course of

his own due diligence to renegotiate the purchase price.

However, depending on the exit strategy and length of the intended hold, most sellers will expend minimal monies for conducting their own due diligence, if they conduct any at all. Almost always, the scope of disclosure reports is reduced. For example, it usually is conducted by a single field observer, and it is not unusual for sellers or their agents to forego interviewing on-site building maintenance personnel and off-site building service firms or to keep quiet about known physical deficiencies.

The scope and intensity of due diligence varies with the objectives of the entity retaining the due diligence services. It's a business decision. Due diligence exercised for one party might not be sufficient for another. Make sure your clients know the difference.

Linda Bryson, LEED-AP, is a principal for IVI International and manager of its due diligence group. Contact her at linda.bryson@ivi-intl.com.