Avoid Money Pits Before Sinking into a Property

By Jack Garson

November 2004 – As seen in the Washington Business Journal

For the buyer of a commercial property, the due diligence phase is the time when many prospective buyers make the most expensive mistake of their lives.

Failure to dig into the background of a site, examine tenant leases, and explore environmental issues can add up to financial trouble. Investing in the due diligence process enables you to minimize your risk and assess the true value of a commercial property.

Money maker or money pit?

One unfortunate purchaser bought a building in an unfamiliar market, anticipating a 10 percent return plus appreciation, based on current tenants rents. The purchaser was unaware, however, that the seller had bought the tenants by offering them large concession packages of free rent, cash bonuses and tenant improvements in exchange for the tenants promises to pay above-market rents.

When the initial five-year leases expired after the purchaser had bought the property the original tenants left for cheaper digs, went out of business or demanded rent reductions. The uninformed buyer was left with a property yielding markedly lower returns, barely enough to support the mortgage, turning a money maker into a money-pit.

To purchase or not?

Whether you are an experienced buyer or a first-time investor, the due diligence phase cannot be overlooked. Due diligence when purchasing commercial real estate begins with a physical examination of the property and a review of property records. Obtaining representations and warranties from the seller also is a critical element.

Effective due diligence involves interaction with various third parties, such as tenants of the property, government officials, and various experts to determine and verify information about the property.

Physical examinations of a property are largely intended to minimize risk. You should test the property for the presence of hazardous substances. Such environmental testing typically starts with a Phase I environmental assessment, a historical review of the property for past uses that might have involved hazardous substances.

Hazardous spills and drinking wells.

The purchaser of a shopping center should be especially on the lookout for dry-cleaner and automotive uses, where perchloroethylene and gasoline spills might have occurred. Once alerted to uses that may have involved hazardous substances, you may need to sample soil and groundwater.

Related inquiries may involve testing buildings for asbestos and determining whether nearby property owners consume water from wells or could be sources of hazardous substances.

Other important physical examinations include structural analysis, subsurface examinations and testing for legal compliance.

A structural engineer can review the integrity of building structures and report on the remaining useful life and replacement cost of property elements.

Dead but not forgotten.

One buyer discovered Native American graves that halted construction for months while appropriate procedures were followed to relocate the remains. Sensitive community and political issues can appear without warning and inhibit progress important reasons for leaving no stone unturned.

Testing for legal compliance varies with each property. It can focus on limits concerning the size and location of various structures on the property, compliance with the accessibility requirements of the Americans with Disability Act and adherence to storm-water management, green space and parking requirements.

The bucks not in the bricks.

Effective due diligence also requires a review of records and documents pertaining to the property. For occupied properties, review and analysis of tenant leases is critical. Savvy owners understand that the value of a building is not in the bricks but in the leases that represent the owners right to a stream of tenant payments. If the leases are short term, or tenants can easily terminate their leases or the landlord is obligated to incur substantial costs that should have been passed on to the tenants, then that stream of payments is jeopardized.

Burned by bad leases.

In one notable case in suburban Washington, the buyer of a large office building discovered that virtually all the tenants could terminate their leases if there was a building fire and the damage was not repaired within 60 days. The tenants were paying above-market rents and were happy to extricate themselves from their expensive leases when the owner couldn’t restore their premises in the unusually short period required by their leases. Ultimately, the owner repaired the building and replaced the tenants, but the new tenants paid far less and the value of the building was substantially reduced.

Follow the paper trail.

Prospective buyers should examine land records, insurance policies, past claims, assessments, code violations, tenants financial statements, subdivision plans, variances, special exceptions, covenants and easements.

Depending on your bargaining power, you should obtain representations and warranties from the seller. These should include the seller's promises regarding the condition of the property, promises regarding the rents and operating costs, and promises that no other obligations affect the property.

Due diligence involves third parties.

The buyer should verify, directly with the tenants, the terms of all significant leases. Where available, obtain official confirmation of compliance with building codes. Get expert advice from a zoning attorney regarding the permitted uses of the property or an engineer's report on the availability of utilities.

Confirm your convictions.

Effective due diligence enhances your knowledge and often your bargaining power. Knowledge of defects may demonstrate the need for a price reduction or seller guarantees. In some cases, you may want to restructure the transaction. In extreme instances, your due diligence may lead you to terminate the deal.

Or your resolve to buy the property may be strengthened by due diligence that confirms there are no significant problems.

Regardless of the outcome, the benefits of comprehensive due diligence minimizing risk and assessing value almost always outweigh the costs.

Jack Garson is the founding member of the law firm Garson Law LLC in Bethesda, MD, and head of the firms GC Commercial Realty Advisors.

Jack Garson
Garson Law LLC
(301) 280-2700
jgarson@garsonlaw.com