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What You Should Do During Due Diligence Period for Commercial Properties

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After your offer is accepted, your purchase contract will specify that you have somewhere between 15-30 days due diligence period to investigate about the property. Per the results of your research, you will decide either to

- Cancel the purchase and get your full refund of your deposit. It's important to know that during this due diligence period you can cancel the transaction for any reasons and are not required to justify your reason with the seller.
- Continue on with the transaction.

Many consumer laws designed to protect residential buyers do not apply to commercial properties or apartments with more than 4 units. In addition, many sellers are investors like you and do not have ultimate knowledge about the properties as they may not live close by. Therefore, a thorough investigation of the property is essential to avoid significant and/or potential surprises after closing. You should not attempt to buy a commercial property yourself without help from an experienced commercial real estate broker. A little mistake could potentially become a big problem moneywise due to size of the transaction Once the due diligence period expires, you can only cancel the transaction if the loan if not approved. While your real estate broker will assist you with the following tasks, you may want to know the whole process to make sure you understand what is going on.

Book & Records: Normally within 5-10 days the seller will provide you various financial documents. Your goal is to verify that the property generates the net operating income (NOI or income after all expenses paid) shown in the property listings or brochures to justify for the price you paid. If the NOI is less than what you expect, it is a ground to demand a price reduction.

1. Income and expenses: This includes rent, reimbursements from tenants from the last 2-3 years. The documents should be either operating statements from the property manager or schedule E's or equivalence, e.g. form 8825's from the seller.
   - Ideally the income should go up from year to year due to rent increases. If the income fluctuates from year to year, then it's an indication the property is not stable and that you need to understand the reasons.
   - You also want to know if the tenants pay rent on time or not. During the recession, many tenants actually pay less than what is stated in the leases so make sure you get the copies of 12 most-recent rent checks.
   - Regarding expenses, they should include property taxes, insurance, utilities (drinking water & electricity), irrigation (water for the lawn), repairs, parking lot sweeping, garbage, snow removal (if applicable), security camera expenses (if applicable), landscaping and property management fees. If the seller provides the Schedule E's, you should exclude the following expenses: amortization (closing costs), mortgage interest, depreciation, collection expenses, travel expenses, leasing fees as these are not reimbursable by the tenants. Note: in California, property taxes will be automatically re-assessed based on the purchase price. They could be a much higher if the purchase price is much higher than the current assessed value. This is critical on a property

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with gross leases as expenses will likely go up after closing. In many states, e.g. North Carolina, Illinois properties are re-assessed for property taxes purposes every few years and are not necessarily based on the purchase price as in California.

2. Leases: Commercial leases are typically 20-80 pages long. You should go through the lease and find out:
   - Who the tenant is. If the tenant is a private and small corporation, make sure there is a personal guaranty in the lease. Otherwise, you can only go after the corporation, not the owners of the corporation if it defaults the lease. Public companies have different policies about how they handle leases. Fox example Walgreens and Starbucks always put corporate names on the leases and thus the leases are guaranteed by the corporations. Kragen which is owned by O'Reilly Auto Parts is the tenant on the lease. DaVita, on the other hand, puts one of its several dozen subsidiaries on the leases and so technically, the leases are guaranteed by its subsidiaries and not DaVita. CVS puts its name on the leases. However, it created a LLC (Limited Liability Company) for each Eckerds location it acquired. And so the leases for former Eckerds drugstores legally do not have corporate guaranty from CVS. A property with a lease from a public company with S&P rating of A+ does not make it a bullet proof investment. Many leases to Washington Mutual Bank, once with high S&P rating were later voided after it was seized by the FDIC.
   - The base rent, and rent bumps if any. Check to see if the rent in the leases matches with the rent in the marketing brochure. In commercial leases, the rent often goes up 2% annually for 10% every 5 years. Some leases have CPI-based (Consumer Price Index) rent bumps. A lease with annual rent bump means the tenant needs the landlord more than the landlord needs the tenant. And thus it is an indication the property is more desirable.
   - Lease terms: when the lease begins and ends. As a rule of thumb, it is desirable to have lease expiration dates for different leases spread out to different years The cash flow is more stable in such properties.
   - The tenant's deposits as the seller should transfer the deposit to you at close of escrow. Otherwise you may be liable to the tenants for the amount later on.
   - Who pays for property taxes as these are big ticket expenses? For NNN leases, tenants are responsible for property taxes. State of Florida has no state income taxes but has rent taxes. Normally tenants are responsible for rent taxes on the NNN leases. Otherwise you have to deduct these taxes when you calculate NOI.
   - Who pays for property fire insurance? For NNN leases, tenants are responsible for property fire insurance. This insurance is different from business liability insurance which the tenant should be required to carry to cover for liabilities coverage inside the tenant's unit.
   - What expenses the tenant is responsible for. You also want to find out who pays for property management fees and the repairs of the roof (often the trouble spot in commercial properties), external walls (subject to graffiti's in lower income areas) and structure as many leases, e.g. CVS, Family Dollar may not cover some of these expenses . Many leases also have a cap on how much the expenses can go up from one year to the next. If the expenses exceed the cap, the landlord has to pay for the difference. And thus it may lower the NOI.
   - Any unusual provisions buried somewhere in the leases. Leases from local realtor associations tend to be more straight forward with special provisions written in the last paragraph. Unusual provisions are harder to find in custom leases. This author once reviewed an 80-page lease from a single-tenant property with 5 years left on a 20 years term and found several big surprises: a) the tenant owns the building which is not stated even in the listing, b) if the building is damaged in the last few years of the lease, the tenant may collect the insurance proceeds and is not obligated to rebuild the property! The buyers later canceled the transaction because they could not buy insurance for the building which is owned by the tenant.

3. **Tenant's financial information:** on single-tenant properties, sometimes you may receive tenant's P&L statements (Profit & Loss) which show income and expenses of the business; and Balance Sheet which shows assets, liabilities and net worth. You should have these documents reviewed by a CPA to give you an opinion about current financial strength of the tenant. Here are a few basic things you should know:
   - It's possible that the P&L's may show little profit in a highly profitable business. This is because the profit could be distributed as compensation or salary to the principals. You should also back out any depreciation from the P&L's.
   - If the P&L's show lots of profit in a sale and lease back transaction (tenant sells the real estate to you and signs a long term lease after closing), make sure it's still profitable after paying rent and all the expenses.
   - In the balance sheet, look for the goodwill value which is the value of tenant's business name. Some tenants assign a huge number for its goodwill, e.g. Disney puts $2 Billion for the value of name the killer whale Shamu, and may have negative net worth if this number is taken out from its book.

Site Inspection: This may be the first time you visit the property as it may be located far away from your home. You could either visit by yourself or make an appointment with the current property manager to show you around. In this site visit, you should meet and evaluate potential property managers for the property. It is very common that the seller does not want potential buyers to talk to existing tenants and let them know that the property is for sale. Here are a few things to consider:

- Bring a portable GPS with you or rent a car with a GPS to make sure you don't get lost in your visit.
- Take plenty of pictures of the property for your records to review later on.
- Count the number of parking spaces. As a rule of thumb, commercial properties should have at least 4 parking spaces per 1000 square feet (SF). Ideally, you want to have 6 or more per 1000 SF. If it is a single-tenant fast food restaurant, it needs 10-15 spaces per 1000 SF.
- Check for the visibility of the property from the road. Tenants prefer properties or units that are visible from the road so customers can easily find their businesses.
- Check for ease of ingress and egress. See if it is easy to drive in the property, to make right turn and left turn.
- Stop by the property at different times to see how the tenants are doing.
- Drive around the neighborhood to see if it is clean and well kept. If you see lots of trash flying, and graffiti in the surrounding neighborhoods, chances are that your property will have the same problem.

Property Inspection: There are 2 main inspection reports for commercial properties:

1. **Property Inspection Report**: your broker should order a property inspection report from a local property inspection company. This report will assess the condition of the property including the description of the building, site drainage and paving, structural components, roof composition, parking lot and landscaping, cursory inspection of electrical systems, plumbing systems, heat/ventilation/AC systems, fire protection, and compliance to Americans with Disabilities Act (ADA). The report also provides a rough estimate to correct critical deficiencies. You should take time to read this property inspection report, talk to the property inspector if needed and let your advisor know if you want the seller to repair anything, preferably at seller's costs. As a rule of thumb, you would like all deficiencies related to health and safety, e.g. emergency exit light not working or exposed electrical wiring to be taken care of before close of escrow. The language in some of these inspection reports may sound very scary as property inspection companies try to limit their exposure to liabilities for not warning the buyers about some of the deficiencies.
2. **Phase I or Environment Assessment Report**. This report will tell you if the soil is contaminated or not. It also provides a list of contaminated sites within ½ miles from the property. The report could be several hundred pages long. You should at least read the summary which is 1-2 pages long to see if there are any recommendations and anything unusual. Normally there are 2 possibilities:
   - There is no evidence of contamination so there is nothing to worry about;
   - There is evidence of possible soil contamination, e.g. underground tank. The inspection may recommend a more expensive Phase II Report. This involves testing the water and soil to measure the level of contamination if any. If the level exceeds a certain governmental standards, the lender will most likely decline the loan.

Title: By providing a title commitment or title insurance policy, the title company insures that the property has free and clear title. When reviewing this document, please check the following:

- Interest in the land: this should be either "fee", "fee simple" or "fee simple absolute". This is the highest form of interest in the land. If you are buying a property without this kind of interest, e.g. life estate interest, you better know what you are doing. Otherwise, you get much less than you think.
- Title to the property: this is the legal owner. If the name of the seller in the purchase contract does not match the name on the title then you are buying the property from someone who is not the legal owner.

1. **Title Requirements**: the title policy has a set of requirements under Schedule B, Section 1. The following is a list of typical requirements:
   - Payment of the current loans and liens on the property
   - Deed from seller to buyer
   - Deed of trust from the buyer for the benefit of the new lender
   - A current survey of the property
   - Payment of property taxes and assessments

2. **Title Exceptions**: the title insurance also has a set of exceptions under Schedule B, Section 2. Basically, the title company says the title is free and clear except these items. All of these exceptions go with the land. Some of the exceptions are very common to most properties, for example:
   - Easements to power company, water company, phone company, and sewage authority so basic services can be provided to the property.
   - Encroachments, overlaps, boundary line disputes, or other matters which would be disclosed by an accurate survey. This exception can be deleted if an ALTA survey is provided to the title company.
   - Property taxes that are not due and payable.

   Others are unique to the property which you absolutely need to understand and approve these exceptions. Otherwise you will be in for surprises after closing.

- Ingress & egress easement: this is just an easement to allow vehicular access to and from adjacent properties.
- Cross parking easement: this easement allows customers to park anywhere among several lots.
- Mineral deed: when you see this document, it normally means the land does not include mineral, or oil and gas underneath. This is common for new properties in Dallas metro.
- Operation and Easement Agreement: this is normally a thick document that governs the operation of a big commercial development project involved several property owners and buildings. It has details about common area maintenance, parking lot easement, and even restriction about what kind of business can be opened in the center, e.g. no adult book store. Whenever you see this in the exception, you need to clearly understand it.
- Memorandum of lease: this is a summary of the lease for long-term (longer than 3 years) tenants in the center. It's recorded by the tenant to protect its leasehold interest in the property. When the property is transferred or foreclosed, the new landlord and lender have to honor the terms of the lease. It may also contain restrictions, e.g. a memorandum of lease from McDonald may say that it has the exclusive right to sell hamburgers in the center. And so if you own the shopping center, you can only lease it to Pizza Hut, but not Burger King, or Jack in the Box.

Property Survey: the survey shows the lot size, the property boundary, building footprint, layout of all parking spaces, and easement areas. On the corner, it should have the name and the signature of the surveyor. If you don't see the name of the surveyor, then it's probably the site plan drawn by the architect. You should review the notes on the survey see if there is anything unusual, e.g. the roof of the building or the fences may encroach the adjacent property.

Financing: by the end of due diligence period, you should receive a Letters of Intent (LOI) from several commercial lenders stating

- How much loan you can borrow
- Interest rate
- Loan terms
- Loan fees

While the LOI's are not final loan approval, they give you a rough idea if you have enough money to close the transaction and what your cash flow will be. This in turn helps you decide if it makes investment sense to move forward.

Once you complete all the above steps, you should have enough information to make a decision to move forward or cancel the transaction.