www.REBusinessOnline.com September 2018 · Volume 16, Issue 1

WESTERN REAL ESTATE BUSINESS®
Connecting Real Estate in the West

DUE DILIGENCE IS CRITICAL

Due diligence is of the utmost importance in all real estate transactions. However, it is particularly crucial in the West where taxes, resources and weather can play a role in a landlord's ability to increase (or decrease) their ROI.

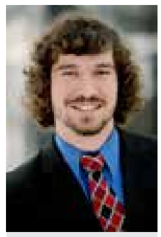
By Max Garbus

Investors are vying to buy assets across the Western U.S., from high-quality properties in affluent areas to value-add plays with potential upside. However, as teams bid on properties, they should keep in mind that an accelerated pace can adversely affect an essential part of any deal: due diligence. Asking tough questions about assets is particularly important in many Western markets where regionally specific concerns can and do come into play.

Buying a property in California, for example, automatically triggers a property tax reassessment under Proposition 13. In cases where the asset hasn't seen its taxes reassessed for years or even decades, the before-and-after picture can be stark. One office building landlord in San Jose was paying $476,000 in property taxes but saw that figure jump to nearly $800,000 upon reassessment of his property. Moreover, because the tenants' leases at this property exempted them from such increases, the buyer recovered only about 1.1 percent of the difference. Tenant leases in California often include such protections, thereby leaving new owners to foot the bill. Indeed, given that most deals are calculated based on forward-in-place NOI, new buyers can easily end up with lower cash flow numbers than those touted by the seller. Prop. 13-related implications should be front and center in due diligence, but some investors fail to adequately consider these dynamics.

In the Western U.S., where solar panels are increasingly common, scrutinizing the utility situation can also be important. Tenants at some properties share in the cost savings yielded by the panels. At others, the solar array is essentially a profit center for the landlord. Utilities conventionally charge a lower rate for electricity as usage at the property increases. However, when solar panels or other renewable sources are part of the picture, utilities often charge a flat rate for whatever energy the property continues to require. Prospective buyers need to know precisely how these costs are being calculated and whether and how they are being passed on to tenants.

Even weather and climate trends can be a factor in due diligence. At the time of this writing, more than a dozen wildfires were sweeping through California, including the largest blaze in the state's history. Of course, real estate in many parts of the country faces higher probability of natural disasters. But in the Western U.S., it is especially important to make sure older leases require tenants to carry insurance against such risks.



Garbus

Certain considerations can be highly specific to local Western markets as well. In and around Hollywood, landlords stand to enjoy an unusual revenue stream — cash pouring in from film and TV production crews shooting on the property. As a result, it is a good idea for tenant leases in these areas to require cooperation with filmmakers and to stipulate that all proceeds from the shoot will go to the landlord.

A good due diligence process will ferret out issues related to financials, vendor contracts, co-tenancy clauses, Common Area Maintenance (CAM) reconciliations and more. The goal should always be to make sure investors avoid unpleasant "surprises" after taking ownership.

All of this high-quality research needs to be conducted within an efficient timeframe, particularly in the competitive real estate markets of the Western U.S. Otherwise, the buyer risks losing out on the opportunity. Imagine a situation where a seller has multiple suitors all offering competitive bids. If one requires 45 days for due diligence while another is content with a 15-day process, the seller will generally engage with the latter offer first.

However, when acquisitions move forward based on a relatively surface-level assessment, bad things can happen. Investors need to feel confident the process has revealed all potential problems — everything from uncollected rents to whitewashed profit-and-loss statements to problematically expensive service contracts set to carry over to the buyer.

Due diligence is not a core competency for investors' acquisitions teams, property managers or accountants. And it shouldn't be. Internal resources are best deployed in chasing deals and courting investors. This is why the most effective firms tap third-party experts who have on-demand resources, adhere to industry best practices, and are adept at quickly sifting through the paperwork to bring risks to the surface and uncover hidden value.

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