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Property Condition Assessments: A Return to Prudence and Proper Due Diligence Practices

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There was unprecedented erosion of due diligence procedures, especially those related to property condition assessments, during the period of frenetic real estate transactions prior to the last quarter of 2007. With too much money chasing scarce real estate investment opportunities, sellers were able to drastically limit due diligence processes and periods. As a result, buyers, under pressure to invest funds, were forced to take risks that resulted in poor investment decisions and distressed assets. The heady days of hasty transactions and truncated due diligence procedures are over. When the economic recovery begins, the omissions of the past and demands from investors for more risk-averse practices will dictate a return to prudence and proper due diligence procedures. In this context, an exploration of the role of good property condition assessment practices as part of the overall due diligence process and the risks of not following sound practices is considered timely if not overdue.

Purpose and Value of Due Diligence

Due diligence is performed to verify that a decision to purchase an asset is sound, and to ascertain that the asset will meet the purchaser's investment goals. Due diligence is not limited only to revealing and quantifying risk. It also uncovers hidden opportunities that may enhance the value of an asset.

Due Diligence Time and Timing

An obvious fact, often overlooked during the recent period of rushed transactions, is that the entire process must be completed before the decision to acquire the asset is finalized. Discovering problems afterward results in unanticipated costs that affect the performance of the investment. Also, to be thorough, there should be sufficient time to complete the due diligence process. A return to prudence requires that investment managers insist on proper timing and sufficient time for the due diligence process.

An Integrated Approach

While there are no established norms for due diligence, there are certainly essential tasks that form the basis of good practice. These include analysis of the market, tenants, operating costs, acquisition process and physical condition of the property and surroundings. These key tasks are interrelated, and the data gathered in each should be coordinated and integrated before the decision to support or reject the acquisition or to modify the transaction is made. The physical condition of the property is discovered through a physical condition assessment, which informs the analyses of the other key tasks, influences the investment strategy and thereby forms a critical part of the due diligence process. For example, a recommendation to enhance maintenance procedures in order to extend the remaining useful life of a building component will affect the capital repair and replacement costs, the operating costs and will improve the return on investment. Hence, due diligence should be seen as a single process that is integral to the investment strategy, not merely a series of discrete, unrelated tasks to be performed prior to be closing.

Purpose and Methodology of Property Condition Assessments

The property condition assessment sheds light on the condition of the property and the probable costs to address defects, deficiencies, deferred maintenance items, code violations or noncompliance issues and life-safety issues. The assessment also provides costs for ongoing capital repair and replacement of building components and systems as they age and reach the end of useful life. As such, the assessment provides information that shapes the decision to purchase an asset as well as the ongoing management of the asset.

Information about the physical condition of a property is obtained by a variety of methods. The key methods are reviews of construction documents; interviews with users, occupants, property management, property maintenance staff and code officials; and a walk-through survey of the property. These key methods must be written into the agreement for services between the investor and the property condition assessment consultant.

Experience and Expertise Matter

The quality of the property condition assessment is only as good as the competency of the consultant who performs it. Experience and expertise matter. The consultant firm must have established credentials in the property condition assessment arena. In addition, the credentials of each member of the consultant team should be reviewed and recorded in the agreement for services. The agreement should establish that the work will be performed under the responsible control of licensed, experienced professionals. Ideally, there should be a "lead professional" who will coordinate the work of the consultant team, including that of subconsultants such as building envelope specialists and elevator consultants. The lead professional should review all the findings, address conflicts and redundant information, and present an integrated report. The risk of not selecting a reliable and competent consultant team is that key issues, such as balcony replacement, roof replacement or structural distress, may be missed, capital repair and replacement costs may be poorly allocated or inadequate, and established deadlines may not be met.

Some consultants use part-time professionals hired on an "as-needed" basis. In this case, the investment manager should ensure that there are established lines of responsibility and communication, and that a responsible professional who has first-hand knowledge of the project will be available to address concerns and questions during the assessment period and after the asset is acquired.

The property condition assessment should be tailored to suit the unique characteristics of each investment. To this end, the investment manager should ensure that the consultant understands the nature and goals of the investment, and shapes the assessment accordingly. Standardized boiler plate language and vague, evasive statements in the report are not helpful.

Because the property condition assessment informs and shapes the investment strategy, and contains information that will determine how to manage the asset, the consultant should be available for additional follow-up services if required. For example, it makes sense to have the assessment consultant review the scope of work and bids for curtain wall repair or replacement work that was identified in the property condition assessment report.

The American Society for Testing and Materials Standard Guide

The American Society for Testing and Materials has produced a Standard Guide for Property Conditions Assessments, referred to as the "ASTM E 2018-01 Guide," which establishes practices and standards for property condition assessments. Because this is a "baseline" guide, the scope of work must be augmented as necessary to suit the specifics of the project. For example, the level of due diligence for the accessibility survey should be clearly specified depending on the investor's risk tolerance level of accessibility compliance. The guide also describes "out-of-scope issues" such as examining elevator cables, sheaves and motors. If the elevator equipment is old, a prudent investment manager will require that these components be examined, preferably by an expert elevator consultant.

It is time to learn from the errors and omissions of the past. In the coming period of economic recovery, a return to sober due diligence practices will go a long way toward ensuring sound real estate investments.

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