

Steven Roy Management

Cambyes Financial Advisors LLC

Financial Due Diligence Checklist for Property Acquisitions

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Steven Roy Management's Real Estate Services focus on commercial, industrial, investment, and multi-family acquisitions.

For each of those markets, preliminary due diligence is both complex and critical to success. Due diligence considers hundreds of variables that, together, determine your project's feasibility.

It helps to have a roadmap or a guide for the journey.

Steven Roy Management develops (and uses) due diligence analysis checklists to:

- Stimulate ideation and brainstorming to develop project proposals,
- Evaluate property acquisitions or development proposals,
- Provide structure for our due diligence process, and
- Manage property acquisitions or development projects.

Every property you acquire or develop requires you (or your representative) to examine the opportunities and risks that influence the decision. Here is Steven Roy Management's due diligence framework (designed primarily to evaluate acquisitions of mature, seasoned property) – in checklist form:

- Critical Preliminary Questions;
- The Building, The Site, and How You Use It;
- Financial Opportunities and Risks that influence you;
- The Legal, Regulatory, and Administrative influences on your decision;
- The Market, Social, and Political Atmospheres that surround the project.

A word of caution: The checklist is designed for use by someone with intimate knowledge of the issues, processes, and vocabulary of property acquisition and development. Proper execution of many of these procedures requires a great deal of time and effort. Many of these procedures should be delegated to someone with a great deal of experience and/or training. Steven Roy Management will happily assist you with that effort.

Critical Preliminary Questions

Critical Preliminary Questions			
Due Diligence Consideration	Responsible Person	Due Date	Completion Date
Have you answered the “questions every investor should ask about themselves? (See below, to remind yourself or to answer them for the first time).			
Why are you investing in this asset at this time? What do you expect to get from your investment? Are your expectations reasonable? 1. Income or cash flow 2. Investment appreciation 3. Risk diversification			

Critical Preliminary Questions			
Due Diligence Consideration	Responsible Person	Due Date	Completion Date
4. Hedging or store of value 5. Investment control 6. Ego gratification			
How will you use and manage the property? 1. Rental to tenants, Owner-User, or Mixed 2. Professional management, Owner Management			
Do you have sufficient capital of your own to invest in the property? Will you require a lender and/or partners?			
Have you considered the risks inherent in a long term illiquid investment such as this? 1. Are you prepared to tie-up your capital for as long as you own the property? 2. Will you have sufficient savings and other capital to maintain your desired lifestyle after you invest in the property? 3. Will you be able to pay your mortgage if you have no tenants paying rent? 4. Are you aware that your property could decrease, as well as increase, in value?			

Questions Every Investor Should Ask About Themselves

As an Investor, who are you?

You already know that a better understanding of what makes you tick, your:

- Goals and objectives, • Needs and wants,
- Planning horizons,
- Risk Tolerance, and
- Saving and Investment Style

makes you a better investor.

If you are not comfortable talking about these things, use web-based quizzes, guides, and programs to talk through the basics. Once you have identified and assessed your investor persona, talk to an objective financial professional to align what you believe about yourself and what your behavior implies. Then act accordingly.

What is Your Timeframe, Short- and Long-Term Goals?

Now you have identified your investor profile:

- What you expect to achieve,
- What you want to achieve, and
- How you think you can get it

Establish benchmarks for your activities.

Timeframes are the easiest and most measurable benchmarks. To establish timeframe benchmarks, consider how much:

- Time (in years) you have to reach each goal
- Money (in current dollars) you need to achieve that goal,
- Money you can invest (whole dollars, percentage of income) right now, and
- Money (budgeted dollars) you expect to contribute each month.

Balance and prioritize your goals based on reasonable risk and return assumptions.

- Immediate (within six months): You can only accumulate investment funds if current expenses are covered. Budget and analyze both your current spending and your investment plan as part of your current and long-term financial plan.
- Short-term (three years or less): Sometimes, saving is more important than investing. Emergency funds are often kept in three to six month certificates of deposit. To reach short term objectives put your money in a safe place where it will be available when you need it, without loss of principal. For the short run, saving and preserving wealth trumps wealth building.
- Intermediate (four to 10 years): Intermediate benchmarks correlate with major life events: putting one or more kids through college, nearing retirement, or establishing a charitable foundation. You reach these goals by diversifying: balancing safety (mitigating risk to your principal) against return on investment (growth).

If real estate is part of your portfolio, consider how long you will hold the property. Short-term real estate investments are often more risky than long-term investments. Over the long-term real estate usually appreciates. In the short and intermediate term, shifting markets or unscheduled degradation (e.g. replacing a roof before you planned for it) have immediate hard money consequences.

- Long-term (10+ years): The long term generates greater uncertainty but tolerates more portfolio risk. For most of us, our notion of what will happen ten or fifteen years from now is, at best, hazy. At the same

time, when you have a long time to recover from hiccups, you can tolerate more risk and volatility in your portfolio. Since you won't need the cash for a while, long term assets don't need to be as liquid as shorter-term assets. Real estate fits well in a long-term framework, as does entrepreneurial activity. Be prepared to regularly revisit your long-term portfolio as market and economic dynamics change and your needs and goals evolve and mature.

How do you spend your money?

Research and anecdotal evidence indicate that good investors are rational savers. They budget current expenditures, include saving plans in their budget, and keep track of the cost of doing business even for personal activities (e.g., credit card interest, bank administration fees, etc.). Rational savers anticipate their current and long-term cash flow needs, save money, and put that money to work earning more money.

Initially, formal tools, (accounting programs, spreadsheets, budget vs. actual comparisons) are less important than your mindset. Get in the habit of questioning the need for most expenditures. Learn to distinguish need from desire—but reward the desire enough to provide incentives.

Once your internal saver becomes an investor you can readily adopt financial analysis tools that compare cash flow, capital appreciation, risk management, and cross correlation. Alternatively, find competent advisors to do it for you, explain the results and help achieve your objectives.

Do you Know When To Say Yes; When and How To Say No?

Sometimes, you get lucky... yes and no questions prompt clear, identifiable, unequivocal answers. These are the easy ones: Q: "Are you going to jump naked into this flaming brimstone pit?" A: "Uh, that would be a BIG NO!"

Unfortunately, investment decisions are rarely that clear. Often, your answer must consider several objectives (e.g. maximize gain, maximize income, minimize risk, avoid volatility, and serve your social objectives), and balance risk against return. When you first invest in a program or security, that decision must usually be made based on inadequate information.

In short, investment decisions often resemble Bayesian decision trees—but the expected payoff, probabilities, and the outcome are all a bit hazy. When it comes right down to it however, you have only three choices: Do nothing, Take the plunge, or politely refuse the offer.

Doing nothing provides time to breath and take stock of your position. Maybe, with time, some of the haze will clear. Be very cautious if any investment promotor presses you to "Make up your mind, 'cuz this great offer won't last forever." That may be true of cheap jewelry on late-night Shopping Channel. It is rarely true of a legitimate investment. In fact, it is a pretty good diagnostic for a fraudulent offer. (Our reflex response to this pressure tactic: If we must answer now, Then No.)

Saying Yes means you are in: You can still choose how deep you want to go. Like entering a cold pond to swim (or taking a bandage off the back of your head) saying yes commits you to action—it does not determine "how much action." Feel free to go knee deep, then re-evaluate your decision.

Saying no usually does not mean you can't change your mind later. When you say no—do it politely but firmly. Set the relationship so you, not the promoter, decide when the time is right.

Do You Call When You Need Help?

The most successful investors start networking as soon as they begin to build a portfolio. Fairly early in the process, every successful investor builds a team to assist with the things they cannot (or should not) do themselves.

There are always those who swear “I can do it better by myself.” At the risk of sounding too much like Võ Nguyên Giáp, “That is (or may be) absolutely true; But it is also irrelevant.” Before you let words escape, think about competitive advantage: What could you do to improve your business or portfolio if you weren’t fishing little Johnnie’s rubber ducky out of a plugged toilet? If you don’t build a team, your portfolio is forever limited by what you can do, and whether you have time to do it.

If you invest in commercial scale realty: We do not know a single person who can be their own best architect, engineer, carpenter, plumber, electrician, HVAC expert, appraiser and financial analyst.

If you are always reluctant to ask for help; We suggest that a good psychologist might be a great early addition to your team. It often makes all the difference needed in both your business-investment and your private life.

Financial Due Diligence Checklist

NOI, Revenue, and Operating Expense Questions –Generic Issues

Financial Due Diligence; NOI, Revenue, and Operating Expense–Generic Issues			
Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<i>Define NOI, its components, computation, purpose, and interpretation for this project.</i>			
<i>Identify Revenue Streams for this project (e.g.)</i> <ul style="list-style-type: none"> • Rent (Base and Overage) • CAM and Co-op • Concierge and residential amenities • Parking • Signage and naming rights • Airspace, light, and development, rights • Environmental credits and emissions rights • Concessions • Disposition 			
<i>Identify Expense Sources and Types for this project</i> <ul style="list-style-type: none"> • Syndication • Organization • Acquisition • Operation • Disposition 			
<i>Identify exclusions from NOI that affect cash flow:</i> <ul style="list-style-type: none"> • Mortgage and financing • Reserves • Capital improvements 			

NOI, Revenue, and Operating Expense Questions –Specific Issues

<i>Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues</i>			
Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p><i>Rent Roll and Sustainability Analysis</i></p> <p>Identify all current tenants and their occupancy (size and location within the facility, lease terms)</p> <p>For critical or anchor tenants evaluate</p> <ul style="list-style-type: none"> • Tenant creditworthiness • Tenant payment history • Tenants’ likely future creditworthiness <p>Acquire and review any recent market studies performed by the seller</p> <p>Analyze historical and projected vacancy factor and rationalize any large deviations from both the property’s and the community’s normal pattern.</p> <p>Identify Tenant-Landlord disagreements (resolved and unresolved) and assess their implications</p>			
<p><i>Lease Agreement Analysis Issues (Historical and projected data are needed):</i></p> <ul style="list-style-type: none"> • Speak to existing tenants. – Are they happy with their lease terms and the way the property is managed? • Rental/Lease Rates (compare to local market) • Base year and CAM expense calculation (and escrows) • Security Deposits • Tenant improvements and signage • Maintenance Obligations (Landlord and Tenant) • Duty of Landlord to provide amenities and/or utilities 			

Financial Due Diligence; NOI, Revenue, and Operating Expense-Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<ul style="list-style-type: none">• Lease duration• Renewal options• Expansion options• First refusal or first offer rights• Options to Purchase• Use of the space• Tenant mix/use controls or Tenant exclusives• Sublet and assignment rights• Tenant parking requirements & obligations• Insurance obligations of Landlord & Tenant• Automatic subordination of Lease to future mortgages			
<i>Income and Expense Estimates: Verification</i> General note regarding data sources and their reliability <ul style="list-style-type: none">• Tax returns often include “lifestyle expenditures and costs” (e.g.) Personal vehicle expense and personal meals-travel-entertainment that masquerades as “deductions.” Most tax return misstatements reduce taxable income, which is a proxy or starting point for NOI and valuation.• Internal management reports and external (attested) reports are often more reliable than tax returns or loan applications.• Assume that loan applications reflect best case scenarios. Surprise! The listing broker fudged their NOI and asking price calculation! Two guesses whether their “sins of omission” favor you or their client, the seller. Initially,			

Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>use approximate income and expenses based on the seller's pro-forma – heavily leavened with skepticism. Later, deep review the entire financial pro-forma.</p> <p>Pay attention to:</p> <ul style="list-style-type: none">• Scheduled rents (often optimistic),• Other income (often non-existent),• Vacancy factor (always understated),• Cost of amenities related services,• Insurance Expense (current and post-sale amounts will differ),• Maintenance Expense (deferred maintenance indicated?),• Management Expense, and• Property Tax (current and post-sale amounts will differ).			
<p>Review Scheduled Rents</p> <p>Issue(s): The seller's pro-forma uses "optimistic" estimates of market rent to calculate scheduled rent for the property.</p> <p>Effect: Scheduled rents and NOI are overstated. Asking price is overstated by the amount of the overstatement divided by the Capitalization Rate.</p> <p>Detected by:</p> <ul style="list-style-type: none">• Compare historical financials and/or tax returns for the building and to the seller's pro-forma. Perform a detailed analysis of the rent roll and local market conditions to develop your own scheduled rent. (N.B. If you will repurpose the facility, you will need to develop local market rates for the repurposed facility and estimate adsorption from a-priori assumptions.)• Verify receipts by reviewing bank statements <p>Resolution – use market comparable and discounted cash flow and compare it to historical performance:</p> <ul style="list-style-type: none">• Identify "comparable" properties in your property's market to determine current market rents. (Make phone calls to management			

Financial Due Diligence; NOI, Revenue, and Operating Expense-Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>companies to request current availability and rates for a hypothetical “average tenant” or purchase data from a local data supplier.)</p> <ul style="list-style-type: none"> • (Guess) Estimate future rent trends or project trends using available market research (See <i>our</i> Market Analysis Checklist). • Adjust market estimates to account for any value-added services that are unique to your proposal. • Pro-forma Scheduled Rent from existing tenants using rent roll information and assuming current tenants will fulfill the terms of their leases and exercise any below market rate extension options. • Assume that when space becomes available it will be leased at the then prevailing market rate. • Adjust offer price to reflect the altered revenue (altered NOI). 			
Other Income, Part I, Amenities Income:			
<p>Issue(s):</p> <ul style="list-style-type: none"> • The seller’s pro-forma assumes you will continue to offer the same amenities mix the current owner offers. • The seller’s pro-forma assumes you will not change pricing for these amenities. • The seller’s pro-forma assumes tenants will continue to use the available amenities at roughly the same rate they have in the past. <p>Effect: Other Income and NOI are:</p> <ul style="list-style-type: none"> • Overstated to the extent you discontinue existing amenities, • Understated to the extent you increase the price of existing amenities, • Overstated to the extent tenants react to price changes by reducing their use of existing amenities, and • Understated to the extent you offer additional amenities <p>Effect: Asking price is overstated (understated) by the sum of the effects divided by the Capitalization Rate</p>			

Financial Due Diligence; NOI, Revenue, and Operating Expense-Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>Resolution:</p> <ul style="list-style-type: none">Existing Amenities, Option 1: Adjust the seller's pro-forma to account for changes to the amenity package and/or prices. Utilization factors are difficult to estimate with precision, but make an "educated guess" based on historical data for the property. Adjust offer price to reflect the reduced revenue (reduced NOI).Existing Amenities, Option 2: Use "Zero Base Budgeting" to re-estimate amenities income from a-priori assumptions. Replace the seller's pro-forma estimate with your own. Adjust offer price to reflect the reduced revenue (reduced NOI).New amenities: a SWAG estimate of both pricing and utilization factors may have to suffice. Adjust offer price to reflect the reduced revenue (reduced NOI). <p>Notes:</p> <ul style="list-style-type: none">We usually exclude new amenities from offer price calculations but include them in project valuation scenarios. If the current owners are not offering these amenities they should not receive the value of them as part of your offer price. If a bidding war develops, the value of the new amenities can be used to establish an upper bound for your offer price.Amenities income and pricing is often a major factor for commercial smart buildings, wired buildings, and shared staff office operations. It also is significant for concierge-menu residential facilities that offer (e.g.) massage services, workout coaches, dry cleaning, auto detailing, shopping services or other high value amenities. For less refined (snooty?) residential facilities, amenities income is usually comprised of coin-operated laundry facilities and similar productsFor owner-operated facilities offering cash-on-the-table amenities such as coin-operated laundry, amenities income is frequently understated. Somehow, those quarters get collected but never make it to the bank, financial statements, or tax			

Financial Due Diligence; NOI, Revenue, and Operating Expense-Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
returns.			
<i>Other Income, Part II: CAM</i> Issue(s): Effect: Detected By: Resolution: Note: Procedure: Evaluate adjusted, actual CAM rates vs. lease CAM clauses. <i>Other Income Part III: Overages (effect of tenant mix)</i> Issue(s): Effect: Detected By: Resolution: Note: <i>Other Income Part IV: Parking Structures</i> Issue(s): <ul style="list-style-type: none">• Revenue• Cost• Management Control Effect: Detected By: Resolution: Note:			
<i>Vacancy Factor:</i> Issue(s): The seller's pro-forma underestimates vacancy factor. Elements include both frequency and duration of vacancies. Effect: Vacancy losses are understated, Effective Gross Income and Net Operating Income are overstated. Asking price is overstated by the amount of the NOI overstatement divided by the Capitalization Rate.			

Financial Due Diligence; NOI, Revenue, and Operating Expense-Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>Effect: Tenant Improvement reserve requirements are underestimated. Distributable Cash is overestimated. Liquidity and reserves may be insufficient to handle anticipated tenant improvement costs. Typically, no direct effect on asking price, but may result in poor management decisions and frequent resort to credit line or re-finance facilities.</p> <p>Detected by: Compare sellers pro-forma to data from:</p> <ul style="list-style-type: none">• Historical financial statements or tax returns. Reconstruct scheduled gross income from the rent roll and lease terms. Subtract reported rent income from scheduled gross income to reconstruct vacancy factor.• Similar properties in your project's geographic area. Numerous published sources are available, but comparability is always an issue. <p>Resolution: Evaluate any factors that contribute to differences between the historically observed or market derived vacancy estimates and the seller's pro-forma. If you believe those factors are either endemic to the property or likely to be replicated in the future, adjust vacancy to reflect that conclusion. Adjust offer price to reflect the additional expense (reduced NOI).</p> <p>Notes: Often, high vacancy rates are the result of poor marketing, poor management, or both. If simple corrective actions will cure the problem and there are several competing bidders for the property it may be appropriate to use the marketing-management adjusted vacancy rate to insure a competitive bid.</p>			
<p><i>Cost of amenities related services,</i></p> <p>Issue(s): Seller's pro-forma assigns no cost to the value of owner provided amenities. (e.g.) Owner of a high amenities apartment complex performs personal services such as massage therapy or personal training. Outsourcing these services will add expenses that are not accounted for in the seller's pro-forma.</p>			

Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>Effect: Amenities costs are understated. NOI is overstated. Asking price is overstated by the amount of the NOI overstatement divided by the Cap Rate.</p> <p>Detected by: Personal observation and inquiry or detailed analysis of expense accounting for amenities. (Talk to existing tenants as well as the seller.)</p> <p>Resolution: Research the cost of comparable services and adjust pro-forma to reflect unrecognized amenities expense. Adjust offer price to reflect the additional expense (reduced NOI).</p> <p>Notes: For owner-operated facilities offering cash-on-the-table amenities such as personal training and massage services, amenities income is frequently understated. This omission is difficult to identify unless you have access to the owner’s personal financial information, or the building has particularly gabby tenants.</p>			
<p>Insurance Expense</p> <p>Issue(s): Seller’s pro-forma reflects current coverage and limits. Specifically:</p> <ul style="list-style-type: none">• P&C coverage reflects owner’s operational decisions regarding replacement costs and may not correspond to your preferred limits.• General liability coverage reflects owner’s exposure and may not correspond to your exposure.• Worker’s compensation coverage may exclude principals and/or owner provided services. <p>Effect: To the extent your exposures or preferences exceed (are less than) those of the owner, Insurance expense is understated (overstated). NOI is, correspondingly overstated (understated). Asking price is overstated (understated) by the amount of the NOI overstatement (understatement) divided by the Capitalization Rate.</p> <p>Detected by: Review of coverage terms, conditions, and limits. Or use “Zero Base Budgeting” to estimate</p>			

Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>coverage requirements, limits, and premiums from a-priori assumptions.</p> <p>Resolution:</p> <ul style="list-style-type: none">• Obtain copies of Insurance policies (including all riders, risk assessments, and disclosure affidavit from carrier) and claim history• Analyze continuing exposure due to prior events• Estimate exposure due to future claims and events• Optimize coverage to protect your interests• Adjust pro-forma to acknowledge changes in premium and coverage assumptions. Adjust offer price to reflect the additional expense (reduced NOI). <p>Note: Many of these analyses and determinations are best performed by risk-management professionals. Extrapolation from the cost of existing coverage is fraught with disaster potential.</p>			
<p>Maintenance Expense</p> <p>Issue(s):</p> <ul style="list-style-type: none">• Seller’s pro-forma does not reflect the cost of uncompensated owner provided services. Outsourcing these services will add expenses that are not accounted for in the seller’s pro-forma.• (Reduced) cost reported in seller’s pro-forma may reflect deferred maintenance or outright neglect of the facility.• Seller’s pro-forma does not reflect reserves required for scheduled and unscheduled replacement of key property components. <p>Effect: (by issue)</p> <ul style="list-style-type: none">• Maintenance expense is understated. NOI is overstated. Asking price is overstated by the amount of the NOI overstatement divided by the Capitalization Rate.• Maintenance expense is understated. NOI is overstated. Asking price is overstated by the amount of the NOI overstatement divided by the Capitalization Rate. Liquidity and reserves may			

Financial Due Diligence; NOI, Revenue, and Operating Expense-Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>be insufficient to handle scheduled maintenance anticipated deferred under the previous management.</p> <ul style="list-style-type: none">• Liquidity and reserves may be insufficient to handle anticipated maintenance costs. Typically, no direct effect on asking price, but may result in poor management decisions and frequent resort to credit line or re-finance facilities. <p>Detected By: (by issue)</p> <ul style="list-style-type: none">• Personal observation and inquiry or detailed analysis of expense accounting for maintenance expense. (Talk to existing tenants as well as the seller.)• Review service and maintenance agreements and maintenance logs for all major property components. Discuss service history and obtain professional opinion from each service provider regarding the quality or nature of the service and determine whether there is a history of deferred maintenance. Inter-period comparisons of financial statements and detailed analysis of account balances may reveal “scalping” if the deferred maintenance has not gone on for a protracted period. Compare maintenance expense to “industry norms” as compiled by (e.g.) BOMA.• Review scheduled maintenance and inspect all major property components to estimate anticipated life. Discuss service history and obtain professional opinion from each of the service providers.• Service and Maintenance Contracts: review issues<ol style="list-style-type: none">a. Frequency and extent of maintenance problemsb. Duration, extent and coverage of existing agreementsc. Equipment warrantiesd. Certificates of occupancye. Inspectionsf. Engineering studies performed by seller			

Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>Resolution: (By Issue)</p> <ul style="list-style-type: none">• Research the cost of comparable services and adjust pro-forma to reflect unrecognized maintenance expense. Adjust offer price to reflect the additional expense (reduced NOI).• Rely on your professionals’ opinions and cross correlate them with local area statistics to arrive at a “normal” maintenance rate for the property. (Alternatively, prepare a component life analysis to identify items that will require your attention and set a maintenance schedule for dealing with them. From this, develop a discounted cash flow analysis to determine the amount you will need to set aside to amortize the deferred maintenance. Adjust offer price to reflect the additional expense (reduced NOI).• We discuss reserve policy in more detail below. <p>Note: Deferred maintenance is common for distressed or marginal properties (or properties under marginal management). Seller fails to perform required maintenance, causing successor owner to incur the expense. This is not problematic if the successor owner does not pay for the privilege by accepting the seller’s historical maintenance expense as the “norm” for the property – thus over paying to purchase the property. A more sinister scenario occurs when seller deliberately defers maintenance to establish a higher NOI and consequent sale price. Unless the seller has engaged in this practice for a long time, this manipulation will be apparent by comparing several years of operating statements side-by-side.</p>			
<p>Management Expense</p> <p>Issue(s): The seller’s pro-forma does not reflect the cost of uncompensated owner provided services. Outsourcing these services will add expenses that are not accounted for in the seller’s pro-forma.</p> <p>Effect: Management expense is understated. NOI is overstated. Asking price is overstated by the amount of</p>			

Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<p>the NOI overstatement divided by the Capitalization Rate.</p> <p>Detected By: Obtain and review copies of all management contracts, including those for on-site managers (often compensated by rent relief), outside firms, and management/marketing consultants. Supplement your analysis using personal observation and inquiry. (Talk to existing tenants as well as the seller.) If the seller lives on premises, it is almost certain that management costs are understated.</p> <p>Resolution: Research the cost of comparable services and adjust pro-forma to reflect unrecognized amenities expense. Adjust offer price to reflect the additional expense (reduced NOI).</p> <p>Note:</p>			
<p>Property Tax</p> <p>Issue(s): Seller's pro-forma reflects historical property tax. Most jurisdictions reassess property tax on transfer to new ownership.</p> <p>Effect: Property tax expense is understated. NOI is overstated. Asking price is overstated by the amount of the NOI overstatement divided by the Capitalization Rate.</p> <p>Detected By: Comparison of pro-forma to historical financial information (the same number in both places indicates that historical information was used in the seller's pro-forma). Request a detailed analysis of the property tax exposure from your title company (most title companies now have this capability). For Placemat Pro-forma, get a copy of the current owner's tax bill and extrapolate from it based on your offer price (this procedure is usually accurate enough for initial feasibility studies, and is occasionally very close to the correct figure).</p> <p>Resolution: Adjust the seller's pro-forma to account for the increase in assessed valuation and property tax</p>			

Financial Due Diligence; NOI, Revenue, and Operating Expense–Specific Issues

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
expense. Adjust offer price to reflect the increased expense (reduced NOI). Note:			

Reserve and Working Capital Questions**Financial Due Diligence; Reserve and Working Capital Questions**

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<i>Estimate Reserve Requirements</i> <ul style="list-style-type: none">• Bank mandated reserves• Interest reserves• Repair and maintenance reserves• Real estate tax reserves• Insurance reserves• Environmental remediation reserves• Other reserves?			
<i>Business transition expense estimate (current to new owner)</i> <ul style="list-style-type: none">• Transfer of security account balance and data• Condition of Building. Specify that the building will be "broom clean" at closing. That way, you won't have to haul a truckload of debris to the city dump.			
<i>Ownership Transition Expense Estimates</i> <ul style="list-style-type: none">• Who pays for what?<ul style="list-style-type: none">a. survey (at the seller's expense)b. contractor's inspection (at buyer expense)c. Title (at the seller's expense)d. Appraisal (at buyer expense)e. Escrow Services (shared expense?)• Fixtures – removed or staying• Management transition<ul style="list-style-type: none">a. Management office and staff on premises?			

Financial Due Diligence; Reserve and Working Capital Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<ul style="list-style-type: none">b. Use of off-site management, rental agentsc. Existing contract provisions and/or payments due?• Closing cost estimation<ul style="list-style-type: none">a. Tax prorationb. Insurance prorationc. Impound funding			
Existing Tenant Transition Expense Estimates <ul style="list-style-type: none">• TI• Rent Holidays			
Tax Issues <ul style="list-style-type: none">• Consult a qualified tax advisor about the implications of buying, operating or selling property.• Property tax<ul style="list-style-type: none">a. Assessed valueb. Special assessmentsc. Impact feesd. Special abatements• Tax & legal incentives to locate in the area<ul style="list-style-type: none">a. Special Tax Districtsb. Mello-Roos and other bonded indebtednessc. Public/Private Partnershipsd. Incentive Zoninge. Urban Development Action Grant (or similar programs)• Federal or state income tax issues<ul style="list-style-type: none">a. Profit intent under IRC §182b. Dealer vs. Investorc. Tax basis of property and apportionment to land and buildingsd. Depreciation<ul style="list-style-type: none">i. General rule (27 ½ yr or 39 yr straight line)ii. Component depreciatione. Use of Installment Sales Method for disposition propertyf. Use of IRC §1031 exchange			

Financial Due Diligence; Reserve and Working Capital Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<ul style="list-style-type: none">i. Effect on cash flowii. Effect on subsequent depreciationg. Enterprise or Opportunity Zone tax incentives to locate to the areah. Energy and conservation creditsi. Work Opportunity Creditsj. Does the project constitute a Qualified Business Interest under IRC §199?k. Does the project qualify for exemption from, or exception to the Business Interest Deduction Limit under IRC §163(j)			
Non-Tax Local, regional, state or federal assistance <ul style="list-style-type: none">• Employment incentives: rebates or subsidies for<ul style="list-style-type: none">a. Local hiringb. EEOC effortsc. Rent subsidy programsd. Gender based programs			

Valuation and Financing Questions**Financial Due Diligence; Valuation and Financing Questions**

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
Valuation <ul style="list-style-type: none">• Value, seller's asking price, your offer price (your price based on re-evaluation of seller's pro-forma)• Building Price per ft² / m²• Land Price per ft² / m²• Assessed Valuation• Insurance Valuation• Most Recent Sale Price• Cap Rate• LTV and DCR• Comparable Building Rents ft² / m²• Comparable Land Rents ft² / m²			

Financial Due Diligence; Valuation and Financing Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<ul style="list-style-type: none">Yield – Reasonable for risk?			
Debt financing options <ul style="list-style-type: none">Four Fs (Friends, family, fans, and fools)Seller take-backConventional bankHard money lendersConduitInsurance companiesState and local programs available?<ul style="list-style-type: none">Private activity bondsRedevelopment bondsConstruction bondsAD&C (acquisition, development, and construction)<ul style="list-style-type: none">AD&C is temporary financingTake-out commitments“Emergency” lenders<ul style="list-style-type: none">MezzanineGapOfficer, director, principal loans<ul style="list-style-type: none">Subordination usually requiredSignificant restrictions on repayment usually imposedWrap-around, all inclusive note			
Financing Considerations – Debt (General Considerations) <ul style="list-style-type: none">Purchase Money, Refinance, or Seller CarryAmount of the loanInterest rate<ul style="list-style-type: none">RRM ((Renegotiable Rate Mortgage, Rollover Loan, Canadian Rollover)Flexible or fixed rates (If Flexible, Index, spread, adjustment period, caps, floors, maximum initial and subsequent adjustments)Repayment terms<ul style="list-style-type: none">Amortization TermDue inAmount of balloonCollateral			

Financial Due Diligence; Valuation and Financing Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<ul style="list-style-type: none"> a. Commercial real estate only b. Real estate and personal property together • First lien and/or junior lien • Single advance loan, multiple advance loan, construction loan • If it is a multiple advance loan, can the principal be re-borrowed once repaid prior to maturity of the loan; making it, in effect, a revolving line of credit? (Open Ended Mortgage) • Reserve requirements (see list above) • Borrower required to open business operating accounts with the Lender? If so minimum compensating balances? • Is the Borrower required to pledge business accounts as additional collateral? • Early repayment fees or yield maintenance requirements ("pre-payment penalties") • Repayment blackout periods during which Borrower is not permitted to repay the loan? • Loan Commitment fee or "good faith deposit" due upon Borrower's acceptance • Loan funding fee or loan brokerage fee or other loan fee due Lender or a loan broker at closing • Borrower's expense reimbursement obligations to Lender (When due) • Borrower's obligation to pay Lender's expenses if the loan does not close? • Personal guarantees • LTV and DCR maintenance requirements • Debt to Equity requirements • Lender participation in equity <ul style="list-style-type: none"> a. Shared Equity Participation Mortgage b. Shared Appreciation Mortgage 			
<i>Financing Considerations – Debt (Source Specific Considerations)</i> <ul style="list-style-type: none"> • Conduit Loans – Yield Maintenance, Defeasance, Lockouts, Additional Collateral • Blanket mortgage <ul style="list-style-type: none"> a. Release clause (partial release clause) b. Release schedule (% of receipts, or other) • Assumption of existing liabilities 			

Financial Due Diligence; Valuation and Financing Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<ul style="list-style-type: none"> Release of existing guarantors 			
<i>“Near Equity” (Risk Management)</i> <ul style="list-style-type: none"> Option the property Subordination of property seller’s interest to construction and take out lender’s interests Release schedule (used to limit risk exposure) 			
<i>“Near Equity” (Public-Private partnerships and assistance)</i> <ul style="list-style-type: none"> Direct Financial Assistance <ol style="list-style-type: none"> Land assembly Capital improvements Cost sharing agreements Underwriting pre-development or pre-acquisition studies Debt financing <ol style="list-style-type: none"> Direct loans Below market rate loans Guarantee and credit enhancements Indirect Assistance <ol style="list-style-type: none"> Zoning and density bonuses Development rights Air rights Regulatory relief Expedited processing of permits and applications Eminent domain Utility subsidies Dispute arbitration Space rental Financing vehicles <ol style="list-style-type: none"> Grants Local debt financing Off-Budget financing (leases, swaps, and abatements) Earmarked or restricted funds (including Development Entities) General fund revenues 			

Financial Due Diligence; Valuation and Financing Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<i>Equity</i> <ul style="list-style-type: none">• Debt to Equity (Down payment and initial working capital/reserves)• Who will provide (for what interest?)• Passive vs. active investment vehicles (Securities Regulation)• Legal entity desirable? (SPE, Is it Bankruptcy Remote?)• ROE appropriate to risk for all investors?			

Legal and Title Questions***Financial Due Diligence; Legal and Title Questions***

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<i>Title Issues (That affect cost of acquiring or operating the property)</i> <ul style="list-style-type: none">• Quality of title• Deed restrictions• Easements• Liens<ul style="list-style-type: none">a. Financialb. Mechanicsc. Taxesd. Judgementse. Lis Pendens			
<i>Legal and Governmental Compliance Issues (That affect the cost of acquiring or operating the property)</i> <ul style="list-style-type: none">• Litigation History: details of any past or pending litigation (if none, then affidavit from owner)!• Zoning and permitted use• Environmental compliance			

Financial Due Diligence; Legal and Title Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
This portion of the table includes only those legal and compliance issues that directly affect financing. See Our Legal and Site Due Diligence Checklists for additional issues.			

Site, Location, and Market Questions

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
<i>Physical Inspection and Survey (Items that affect the cost of acquiring or operating the property)</i> <ul style="list-style-type: none">• Physical condition of premises• “As Built” plans• ADA compliant?• Boundary lines• Location of buildings, structures, easements, other improvements• Personal property of the seller on premises?			
<i>Market Factors (Items that affect the production, distribution, promotion, and sale of your product or services)</i> <ul style="list-style-type: none">• Competition for Tenants<ul style="list-style-type: none">a. What comparable properties are available?b. Will new comparable properties be built in the area in the near future?• Economic climate (as it affects the use of this building)<ul style="list-style-type: none">a. Localb. Regionalc. National• Market demographics and trends<ul style="list-style-type: none">a. Laborb. Materials and suppliesc. Target market			

Due Diligence Consideration	Responsible Person	Due Date	Completion Date
This portion of the table includes only those site and market issues that directly affect financing. See Our Market and Site Due Diligence Checklists for additional issues.			