COMMERCIAL REAL ESTATE ADVISORS

"Taking Tenant Representation to the Next Level"

JMS ASSOCIATE NEWS

WHY DUE DILIGENCE IS A CRITICAL STEP BEFORE PURCHASING A COMMERCIAL PROPERTY

Would you say this statement is true?

You love awful surprises that cost you a lot of money during your commercial real estate venture.

No? Who would?

That's why doing your due diligence is vital before purchasing a commercial property. When the dust settles, you want to have a profitable investment on your hands — not a liability that eats up all of your time and money.

The best way to avoid this is to do your due diligence before signing anything or handing over any money.

WHAT IS DUE DILIGENCE IN REAL ESTATE?

It might seem like experienced commercial real estate buyers just pick a property out of thin air and enjoy a successful venture. They have "the magic touch" when it comes to choosing commercial properties.

Nope.

What they have developed over their years of experience are investigational skills and a keen attention to detail.

Before you purchase a piece of property, you want to know about all the potential downsides — and you can't trust the seller to tell you. The seller may try to paint the property with a rosier light than reality and may outright hide undesirable information.

To limit the possibility of this happening to you, it's crucial to do your own investigation. Preferably before signing the purchase contract.

TYPES OF DUE DILIGENCE IN REAL ESTATE

There is a myriad of matters you have to investigate to perform proper due diligence on a commercial property. They all fall loosely into three categories. Let's break it down.

FINANCIAL DUE DILIGENCE

Before you start sinking too much money and time into a property, you want to know the investment potential. How much profit can you feasibly earn from the venture?

Start by finding out how much money the property is currently earning. Be aware that many sellers will present a “pro forma” financial with the listing. This statement usually does not represent the actual financials of the property but rather the “gross potential income.” In other words, the amount of income the property can earn if 100% of the units are rented 100% of the time.

Obviously, this is not always sustainable in the real world.

A more accurate picture is to look at the actual financials for the property going back at least 3 years. You should request the tax returns for the current property owner, current and past years’ rent rolls, and lease information for each of the tenants.

And don’t forget about the expense side of things. Request past property taxes, utility bills, insurance policies, and risk assessment information gathered by the insurance company to get an accurate picture.

PHYSICAL DUE DILIGENCE

If the financials are looking promising, it’s time to dig into the physical structure of the building(s). This part is a little costly as you’ll have to pay experts to inspect every inch of the property.

However, this money is well spent. If the building(s) have major structural issues, pest infestations, or other problems, you could end up in a world of financial hurt after the sale.

Keep in mind that while some unscrupulous sellers might try to hide these problems, others may not even be aware of them.

Also, be aware that even most brand-new buildings will have something wrong with them. The point of the physical inspection is not to find a perfect building, but rather to be aware of any issues and make an informed decision about whether you want to take them on.

LEGAL DUE DILIGENCE

Finally, you’ve got to do your legal due diligence. The title insurance company will help you with this and ultimately issue a title insurance policy to cover you if something is missed.

Keep in mind that there are common exclusions that title policies will not cover. These can include easements, rights-of-way, restrictions, and covenants. Always be aware of what your policy does and does not cover and if any of the aforementioned items apply to your property.

Generally, before the title can be insured, all property taxes must be up to date and any liens on the property must be released. Finally, the deed must be approved, executed, delivered, and filed on record.

NEVER SKIP DUE DILIGENCE

Now that you understand a little more about what due diligence is, you probably also understand why it is so important. You don’t want to get an amazing deal on a “pristine” property only to have the roof cave in a few weeks later. Or you don’t want to be stuck paying a previous owner’s back taxes or being responsible for their debts in the form of liens on the property.

And, most importantly, you want to purchase a property that has the realistic potential to offer a return on your investment.