



What will 2008 hold in store for the due diligence industry?

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What will 2008 hold in store for the due diligence industry? This question is on the minds of consultants across the country. With the credit crunch/crisis or whatever term you want to use, to define the lack of capital gripping the country, how will 3rd party vendors navigate through the downward part of a real estate cycle? It has been approximately 15 years of a robust run for all those that make a living with real estate. With the exception of a few hiccups along the way such as the Russian debacle of 1998 values of real estate throughout the country have risen steadily. This is especially true in the NYC market which has been somewhat insulated but not immune to the current problems many other markets are experiencing. With the current state of affairs, most CMBS lenders are on the sidelines at the moment. In addition, many insurance companies have scaled back on the amount of real estate loans they will do in 2008 and traditional savings and commercial banks are looking at new loans with more scrutiny.

To date most of the problems have been more on the residential side with the sub-prime issues plaguing many people. The predominant question is when will it hit commercial real estate? At a recent luncheon I attended, the featured speaker pointed out that in every down cycle there is opportunity. There will be new players and new sources of financing. We just don't know who they are at the moment. The theme was that real estate is elastic and always comes back stronger.

There are currently several ways in which due diligence is performed on a real estate asset. With the advent of the All Appropriate Inquiry (AAI) rule which became effective in November of 2006 a new era of due diligence was ushered in from an environmental perspective. At that time environmental consultants began adjusting their reports to meet the new standards. These changes were mandated by Congress and issued by the federal Environmental Protection Agency (EPA). The intent was to establish a greater level of due diligence in order for a property owner to qualify under Innocent Land Owner defense should an environmental issue arise after purchasing a property. This may be one of the tools lenders and purchasers use when stressing the need for scrutiny of a potential acquisition.

Property Condition Assessments (PCAs) are another due diligence product typically ordered by the CMBS lenders on all deals to evaluate the condition of the building. These reports usually cover items such as the structural integrity, facades, boiler, elevators, electrical service, etc. to determine the condition and expected useful life. On larger assets such as shopping centers, the roof and parking lots are very important areas to be addressed since they can be large ticket items if upgrades or replacement is required. More lenders may gravitate towards these reports as a way of increasing the due diligence prior to closing on the loan.

During the last collapse in real estate during the late eighties/nineties, banks were left with a lot of residential developments where the builder went bust during the project. At that time, some lenders found out (after the fact) that monies advanced had not gone into the project thereby putting the

lender in an even more precarious position. From that era, the need for site inspections from independent consultants was born. Now on a construction deal, most lenders hire an engineer to review the initial budget and then provide site inspections when the borrower requests an advance of funds. The site inspections help insure that the money requested reflects the work completed. In addition, many banks hold back retainage as well so there is money to finish a project should a problem occur. This process has aided in determining potential completion problems early in the process giving the lender an opportunity to be proactive. All these due diligence tools came from a "how can we do things better" mindset. Perhaps the cautious state of real estate today will lead to undiscovered due diligence tools and new opportunities will emerge to aid lenders and purchaser alike.

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