# OAK INVESTMENT MANAGEMENT GROUP

DECEMBER (1) 2012: Due Diligence and Real Estate

*Due diligence is a broad term that is applied to many aspects of real estate investing. Ultimately it is about checking that statements and understandings correspond with the ultimate commercial and legal facts. The best kind of due diligence gets to the heart of the commercial and legal issues at stake whilst giving an early warning of issues ahead and / or issues that could jeopordise the investment as a whole.*

It is useful for the real estate investor to separate out the commercial from the legal due diligence process. Although, commonly they are run together – and legal due diligence looms much larger in most people's minds, there is not much point starting a legal due diligence without a clear indication that the investment will pass the commercial due diligence test. The outcome of any due diligence can be either to highlight risks that have been ignored, red flag issues that can be resolved or ultimately scupper the original basis of an investment decision, halting the deal.

Commercial due diligence can be charecterised as having three filters. First is a 'smell test' of the risk reward profile of the underlying investment. This can be done intuitively and not necessarily with laborious calculations. If passed, it means that the real estate investment has passed the basic commercial parameters required by a capital provider. The second filter is provided by firming up and checking the full and complete figures for the purchase, for the hold period and for the exit. This can be done by checking current / likely purchase costs; current / likely tenant covenants, relations and liabilities; past / likely holding costs and active market trends for the asset itself. The third and final filter in commercial due diligence is in sensitising these assumptions against various scenarios. In this way it is possible to stress test low, medium and high expectations of the most important variables: occupancy, gross / net rent; capitalisation rates on exit; capital expenditure; delinquencies; taxes; inherited (assets and) liabilities of the entity if bought as a going concern; environmental costs of the asset itself etc.

Legal due diligence seeks to check and verify that documents are in order, and as presented by a vendor and / or their management. This can be hampered by lack of competence, continuity or 'ownership' by the vendor team. Sometimes there can be a mixture of all three, especially where there is a dysfunction between the team that is actually selling and the team that is actually managing the asset in question. Legal due diligence will pin down the most important factors in the real estate's title, income derivation and inherent liabilities. Defective asset or mortgage rights over real estate can destroy value post-deal for an investor as well as take a great deal of time to remedy. Due diligence presents the opportunity to force a motivated vendor to remedy any defects (or appropriately markdown the price).

In any due diligence the purchasing entity is trying to overcome the inherent information asymmetry in favour of the vendor as well as vendor's wish to present their asset in as good a light as possible in order to extract as high a price as possible. Beyond this, due diligence must be alert to a vendor acting in bad faith. The Latin injunction still rings true '*Caveat emptor*' – Purchaser beware!

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