

NEWSLETTER

Due Diligence for Distressed Properties



Clients new to the world of commercial investment real estate may be salivating at the thought of a market filled with undervalued properties that can be had for a song. Distressed properties are called distressed for a reason.

While today's market offers plenty of opportunities in distressed properties, buyers must conduct in-depth due diligence to determine what a property is worth. Below is a checklist of items to consider:

Tenants. Review and confirm the terms of all leases, paying particular attention to co-tenancy clauses, which are common in retail properties.

Require estoppel certificates from each tenant. It also will indicate whether the seller is in default.

Existing Indebtedness. Buyers may be able to assume an existing mortgage or other debt, but they should expect lenders to re-underwrite the terms.

Appraisal. A current property appraisal should be obtained. The appraiser will value the property using comparable recent sales, replacement costs, and capitalization of income methods.

Physical Condition. A licensed engineer's inspection should confirm the property's repair and maintenance needs, both long term and near term, as well as estimates of these costs.

Violations of Laws. To obtain proper assurances that the property is fully compliant with applicable laws, codes, and regulations, including zoning and subdivision ordinances, contact the local governing bodies with jurisdiction over the property.

Environmental. A current phase 1 environmental site assessment is a requisite to a commercial real estate acquisition.

Title and Survey. Does the seller have the financial ability to satisfy all of the liens and judgments that the buyer does not intend to assume?

Obtain estoppel certificates from third parties indicating that there is no default on the seller's part.

Litigation. Does the seller have the ability to settle existing litigation that could delay the closing or result in a new judgment lien filed prior to closing?

Service Contracts. Is the seller current in payment and is each contractor willing to continue providing the agreed to services on the same terms and conditions following closing?

Management. Will the buyer manage the property or hire a third-party management company?

Once the due diligence is completed, the buyer should re-examine the financial model used in deciding on the purchase price.

Now You Own It....

Get rid of poor quality tenants by monitoring tenants' financial condition and keep their monthly rent as current as possible. If they go out of business or file for bankruptcy, it is very difficult to collect past-due rent from pre-bankruptcy lease periods.

Change the property's focus. Purchasing a class C property and redeveloping it into a class A property is an expensive balancing act.

Find novel ways to raise cash. Often a borrower has the ability to sell or pledge up to 49 percent of its equity interest in the owner of the property without the lender's approval. This could be useful in providing security to mezzanine and similar type lenders or collateralizing unsecured debt that may need to be "worked out"

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