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Do-or-Die Due Diligence

Auction.com

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The due diligence process is one of the most important, yet challenging aspects of investing in real estate. Brought to you by [Auction.com](#).

The due diligence process is one of the most important, yet challenging aspects of investing in real estate. If it's not conducted thoroughly with a keen eye, an investor could end up with bad deals and lose millions of dollars, warns Andre Cuadrado, Vice President at Auction.com.

"Due diligence is the process of discovering the real truth about an investment," Cuadrado explains. "The investor must be a sleuth and go through everything with a fine-tooth comb. Every dollar must be accounted for, and every single risk must be identified."

Three forms of due diligence

When it comes to commercial real estate, there are three forms of due diligence: financial, legal, and physical. Smart investors pay careful attention to all three, Cuadrado says. The act of performing due diligence—the process itself—should not be confused with due diligence documentation.

Financial due diligence—Financial due diligence consists of acquiring and reviewing financial documentation such as current and historical financial statements, property tax bills, federal tax returns, utility bills, and other proof of expenses.

"Investors need to verify income and expenses down to the penny by reviewing operating statements and verifying cash flows with source documentation," Cuadrado explains. "Financial documentation allows investors to build their own cash flow analysis and determine whether this is an appropriate investment for them."

Legal due diligence—Legal due diligence consists of acquiring and reviewing all legal documentation related to the property including title and survey. This documentation allows investors to familiarize themselves with anything that might legally impact the property, from liens to encroachments.

Legal due diligence also covers tenant leases. "Leases are legally binding contracts, and the essence of a cash-flowing investment transaction. Special stipulations in the contracts may affect risk, and therefore perceived market value," Cuadrado says.

Physical due diligence—Physical due diligence refers to acquiring and reviewing documentation that shows the physical condition of the property, as well as an on-site physical inspection. The documentation includes a professional site inspection and property condition assessment, known as a PCA. Reviewing site plans and photos (interior, exterior, and aerial) also are part of conducting physical due diligence. Moreover, physical due diligence should also include a schedule of capital improvements, along with work orders, receipts, and warranties which verify if and when the work was actually completed.

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Industry experts advise sellers to keep and maintain robust and accurate documentation for their properties. If they don't, they're jeopardizing the value of their investments at disposition, Cuadrado contends.

"You will never hear anyone complain about too much information," he points out. "It's always the opposite. When a potential buyer has questions during the due diligence period, and those questions can't be answered by the documentation, it can kill the deal. And if it doesn't kill the deal, it's certainly going to impact pricing. The buyer will want to discount the deal because those unanswered questions represent unmitigated risk."

Cuadrado gives this example: a seller wants to sell a shopping center, and a potential buyer wants to know the age of the roof, what kind of maintenance it received, and any existing warranties. Unfortunately, the seller doesn't have any information about the roof.

"In that situation, even with an inspection, a potential buyer is going to factor in the cost of repairing or replacing the roof in the purchase price," Cuadrado says. "That reduces the overall price a buyer is willing to pay."

Cuadrado advises investors to spend the time and resources necessary to conduct due diligence thoroughly. "Some people try to save money on the process," he notes, "but it's expensive to be cheap when conducting due diligence, as your investment may end up not being what you thought it was."

Making documentation accessible and comprehensive

Admittedly, the due diligence process is challenging, even for sophisticated buyers and sellers. It's difficult to compile the information and keep track of it. That's why Auction.com uses an online "vault" where all due diligence documents are stored. Sellers can update the information efficiently, while buyers can easily access the same information after executing a Confidentiality Agreement.

Auction.com is in the process of introducing due diligence standards to ensure that sellers are providing comprehensive documentation. "We have a minimum standard, and we're working on a 'gold' standard, which will indicate sellers have provided a higher level of documentation," Cuadrado says. "Transparency is the key to getting the sell side and the buy side bridge the bid/ask gap to true market pricing."

For buyers, Cuadrado says Auction.com is committed to making sure the buyers who use the platform have ample information to make decisions. "We want to make sure that the buy side has all of the necessary documentation to conduct thorough due diligence on their potential investments, so that they can bid with confidence," he says.

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