

Due Diligence of New Space

The Ins and Outs of How to Analyze a Potential New Office Relocation

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Due diligence is both a science and a creative art. Whether investigating the acquisition of a house, the purchase of an office building, or the leasing of new space, the real estate due diligence process—or underwriting as some call it—has essentially the same components. Yet there is a certain mystique to the due diligence process...to many it still is unknown what occurs “behind those closed doors.”

In its basic form, due diligence is a broad term describing the concept of investigating the purchase of a company, the loaning of money, the signing of a business contract. Venture capital firms, lending institutions, and commercial real estate buyers all partake in some form of due diligence/underwriting in the course of their usual business transactions. Due diligence is a term originally borrowed from the securities industry: stringently researching that a company, its management, and the securities being issued are all real and bona fide. In more common vernacular, it is a review of all information (some given to you, some acquired on your own) to confirm the accuracy of what is being promised and what is perceived as the “deal” to which your organization is agreeing. Simply put, due diligence is *independently* confirming that *assertions* are *facts*.

For the purposes of this description, we shall concentrate only on real estate due diligence/underwriting. As applied here, real estate due diligence is the method of investigating the underlying details and

conditions associated with a purchase or lease of real estate. It also includes a thorough inspection of the property in question—often by building professionals such as an architect, structural engineer, or fire safety official. For this article, however, we will concentrate singularly on *tenant due diligence* for leasing office space.

Think of your due diligence process as assembling a jigsaw puzzle: you are finding separate pieces which fit together and tell a total story that individually you cannot discern from the separate pieces. People involved in buying, selling, renting, lending, and managing both residential and commercial real estate often are involved in some form of property due diligence. The underwriting process can include gathering voluminous amounts of information and lists of documents about: property characteristics, the financial “numbers,” market conditions, economic situations, financial analysis, rental rates, amenities, environmental issues, zoning and regulatory constraints, and much more. Some of the information needs to be created, some can be found from public sources—but the trick to all of it is knowing where and how to obtain it, how to put it together into a complete story, AND ESPECIALLY, how to interpret that story. It is for these reasons that a professional is often required to conduct an appropriate, adept, and thorough due diligence.

When does due diligence happen? The due diligence process usually falls into the timing of acquiring a property or leasing space sometime *after you have found* the property and *before you have made* the final offer—though your offer may have provisions allowing for review (and approval) of certain conditions, documents and inspections before executing the actual lease.

The due diligence process can be very time consuming. Not only does it involve such things as confirming public records, collecting market information from reputable sources, conducting building inspections, doing lease reviews, projecting lease costs, BUT it also can include numerous meetings, interviews, and repeated document and data requests. Knowing the right questions to ask can become as important as the information you collect. Being well prepared and having determination is required for the success of the due diligence procedure. Some see the underwriting process as stressful and wrought with frustration. Some of us, however, relish in the research and discovery process. Done correctly, due diligence is a disciplined exercise with logical structure and methodical steps.

You might break down due diligence into two phases, dependent upon where your organization is in the process of finding new office space. At first you will identify a number of potential buildings that may fit your needs. At this point you will conduct some preliminary multi-location due diligence. At some stage, however, your organization will decide upon a single building that seems to best fit your requirements. That is when a thorough single building due diligence investigation will occur.

Underwriting a potential property choice involves many subjects, not the least of which is gathering and/or confirming information on the following main topics:

- The Building
- The Space
- The Lease Document
- Comparable Properties/Market

Environmental due diligence, though not usually done as part of a lease underwriting, could also be considered. When purchasing a building, there are the Phase I and Phase II environmental assessments. Phase I due diligence includes an inquiry to determine the environment status of the property from public records, interviews, and a physical inspection. It essentially is an environmental survey and history of the property which concentrates on the presence or potential of hazardous materials. The Phase II is a more detailed follow-up investigation of a property and will involve a more rigorous physical inspection and testing of the site and building. It may include subsurface drilling and soil sampling, radar ground penetration, water table well monitoring, and other sampling. Asbestos, lead paint and mold are issues of particular concern in older buildings. It is advisable, if any of these are suspected, to engage the services of a special consultant to test and report back.

Preliminary space planning also will be part of an office leasing due diligence process. Estimated space requirements need to be conducted prior to searching for new office space—after all, without knowing your organization's space needs, you cannot accurately know what kind and amount of space is appropriate. As the due diligence

process proceeds, the space requirements will get “fitted into” the various possible building space availabilities and tested to see if each space can work for your organization’s needs. As this is done, you may find your space requirements will be adjusted and fine-tuned. This in turn may lead you to look at yet new space possibilities. It can be a very reiterative process.

Following are some of the main issues that need to be researched when doing a lease due diligence (*note: this is not an exclusive list*):

Building Characteristics

- Location
- Legal description
- Owner of record
- Ownership stability
- Management company
- Building age
- Size / floors
- Construction type
- Tenant profile
- Image
- Amenities
- Parking
- Hours
- Security
- Life safety systems
- Landscaping
- Zoning, building code, and special assessment compliance
- Adjacent properties
- Stability of area
- Transit proximity
- ADA accessibility
- Community conveniences nearby
- Building insurance
- Taxes
- Litigation history

- Building systems (HVAC, electrical, plumbing, room, elevator, windows, roof, etc.) – type, age, maintenance record, etc.

Potential Space Components

- Availability date
- Location in the building
- Condition
- Access to elevator, restrooms, and exits
- Alarms
- Amenities: conference room, kitchen, closets, storage, etc.
- Any included equipment
- Configuration (if not changing it)
- Preliminary space planning fit
- Construction permits
- Utilities
- Computer / phone / IT systems and connections
- Water / roof leaks
- Radon testing
- Historic preservation issues

Lease Document / Legal Issues

- Rental rate
- Escalations
- Lease term (i.e., number of years)
- Security deposit
- Utility pro-rations
- Other pro-rations
- Tenant improvement allowance
- Signage allowed
- Insurance requirements
- Capacity / use restrictions
- Parking

Comparable Rental Market

- Rates in other buildings (including escalations, pro-rations, terms, deposits, etc.)
- Competing space quality, age, size, availability, etc.
- Amenities
- Tenant improvement allowances
- Utility costs
- Parking

Some general rules of doing due diligence:

- If not confident in your organization's own abilities to conduct a thorough due diligence process, hire an expert—the money you expend will buy you the peace of mind you need to proceed with your desired lease and relocation.
- Whether conducting your investigation in-house or hiring an outside expert, have one person responsible for the process. A single point of coordination is very important—so information does not get lost, so requests can be followed up upon, so suppliers of data and documents know to whom to send them. Further, having one person conduct all meetings, interviews and other interfacing keeps a consistent message and consistent information requests.
- Inform the due diligence person with your goals, expectations, and desired outcomes. Do not withhold information: be honest and truthful, especially if you have reservations or concerns about a particular property. Without full information, the due diligence person cannot do the “digging” and fact-finding that

ultimately is needed to put your organization at ease.

- Either confirm all information yourself, or have your expert confirm information—especially all data from the building owner or property management company. It is not a question of not trusting those who are supplying you information, but frankly no one is perfect: bad or unintentionally misleading information happens. The rule of due diligence is check, confirm, and verify!
- A due diligence person should be an objective expert. For this reason it would be inappropriate for your leasing broker to conduct your due diligence. Your broker, no matter how objective they want to be, has a vested interest in you approving a potential lease. Nor should a management company for a potential property conduct your due diligence. They can supply information—and often times will be a major source of data—however, they too have an interest in steering your decision-making. Always be aware of conflicts of interest during the due diligence process.
- Attorneys are integral to the leasing of office space. They usually draft the formal lease, and advise on its terms and responsibilities. Yet most attorneys—even good real estate lawyers—are not real estate professionals in the sense of knowing the “bricks and mortar” and “the numbers” of a building. Other experts in these areas—other than attorneys—should be sought to

conduct the due diligence process for your organization.

- Beware of outdated information. Part of a proper due diligence is not just getting information, but acquiring current information
- A due diligence expert should be compensated on a flat fee or hourly rate, not on a commission basis. There should be no unintentional incentives to guide your organization to one building over another. Again, objectivity is the name of the game.

Due diligence can take from as little as a few weeks to 60 days or more, depending on the complexity of the transaction and availability of information. Once the tenant is comfortable with the due diligence investigation, final lease execution, space planning, tenant build-out, and other requirements of an office relocation can proceed.

Due diligence is not something to be taken lightly. Just as you would not buy a house without investigating the surrounding area, school districts, construction type, utility costs, and all the rest—you should not pick a new office building without researching important characteristics outlined within this article. Due diligence is intended to confirm facts...and put your organization at ease that you are making the correct decision.