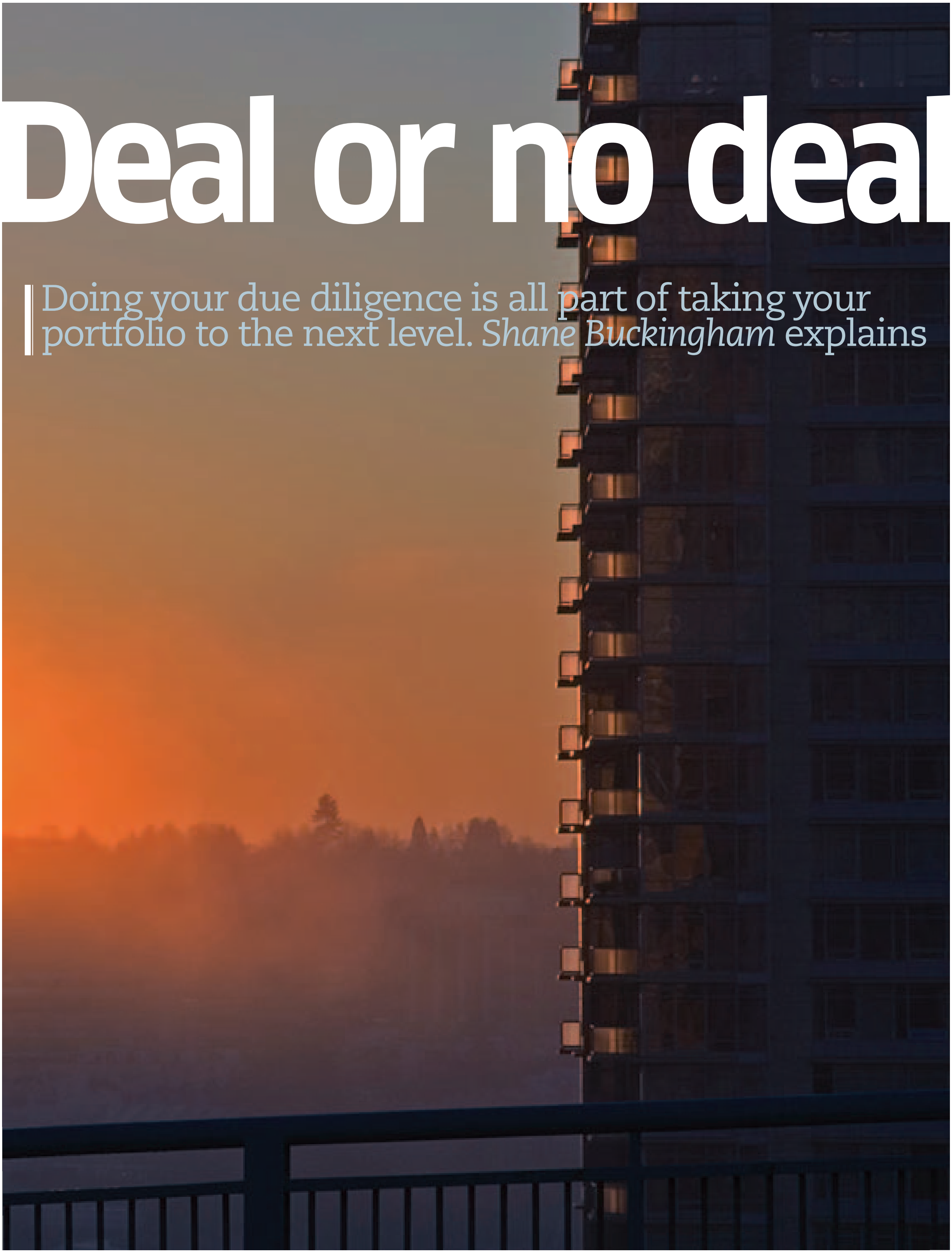

Deal or no deal

Doing your due diligence is all part of taking your portfolio to the next level. *Shane Buckingham* explains

After finding the right apartment building in the right area, it's time to dig beneath the surface-level hype of the listing to uncover what type of investment the building really is.

First, keep in mind that the apartment's income and expense information from the listing are focused on enhancing the attractiveness of the building in the eyes of the purchasers. This is typically done through demonstrating that the building is generating strong income, running at low expenses and/or has an attractive CAP rate (which is the ratio of the building's net operating income (gross income – expenses) to its purchase price), says Dalia Barsoum, a lending adviser with CENTUM Streetwise Mortgages.

While the listing's information represent a good starting point, as a buyer, you need to ensure the validity and completion of all items that make up the financial statement and also where they stand relative to comparable apartment buildings in the market you are investing.

For example: Is the income based on projected or actual rent charged today? Are there any missing items from the list of expenses? Are the expenses high or low and why? What is the vacancy rate for this property type in the area and has that been factored in? Are the rents charged in line with market rents in the area? Is property management factored in (even if you are going to manage it yourself, lenders factor in 4%-5%)? This adjusted income statement combined with your knowledge of the area's prevailing CAP rate for comparable apartment buildings will help you arrive to a more realistic estimate of value that is aligned to the lender's view of value, Barsoum says.

Lenders are typically more conservative in their valuations as it is reflective of their view of the area's and property risk. The lender's valuation and not what the listing says is what will drive the financing you will be able to obtain at the end.

Reduced expenses

Sellers boost up their building's cap rate not just with potential income, though. They also use reduced expenses to make the numbers look better, says investor Becky McGee, director of business operations at Twello Property Management.

Oftentimes, McGee finds that sellers only list expenses for heating, hydro, water and taxes, leaving out maintenance, lawn care, snow removal, insurance and the vacancy allowance. So when McGee's really serious about making a purchase, she'll ask the selling real estate agent for the owner's expense sheets to see if it lines up with the information included in the listing.

Still, even after you determine what all the expenses are, McGee says prepare to pay more than the previous owner for the same services. For example, to renew lawn care or snow removal contracts, McGee says she typically always pays more even if she goes back to the companies used by the previous owner. "Businesses see opportunities as soon as someone new comes in. That's when they think they should increase their rates," she says. "Once you take over the property, I think you can automatically add 5% or 10% to the bills."

Then think of management expenses. Lenders estimate that property management costs 4% to 5% of the home's purchase price when determining whether the building can carry the costs of the mortgage. So you'll have to account for at least that, if not more depending on whether you'll be using a property management company or a superintendent. So it would pay to figure out right away who'll be managing the building.

You'll also have to plan to pay for utilities' deposits in many cases, which can be fairly expensive. In Ontario, for example, natural gas provides take an average of the most expensive three months of service to arrive at the deposit amount, which isn't cheap, says McGee. In one case, she had to make a $10,000 deposit on a 22-unit building.

Lastly, don't forget the municipality gets a piece of the pie when it reassesses the value of the building after the sale. McGee says the reassessment typically leads to much higher property taxes, usually in the thousands of dollars.

All of these expenses have to be included to get a realistic grasp on not only how much you'll need to set aside for expenses, but also, and more importantly, to see if the building is even a good deal in the first place.

Consider that just after doing these initial checks, McGee has seen the cap rates of the buildings she's about to purchase plunge. In fact, cap rates advertised in New Brunswick at 14% fell to just 6% after she crunched some numbers. For the most part, though, the drops are about 2%, she says. Still, keep in mind lenders may not provide financing for the building if the rate falls far enough.

Do your due diligence

Once you've gotten a decent handle on the net-income situation for the building, make sure there isn't any deferred maintenance.

Overlooking major repairs can leave you broke in a real hurry, McGee says. For instance, if you're about to buy a 50-year-old building in need of a new roof, boiler and windows, the deal may end up costing more than it's worth. But if you do identify deferred maintenance upfront, you can use it as leverage during the sales negotiations to bring down the purchase price.

At this point in the process, however, you won't probably get much more information without an accepted offer. "The seller will initially give you the least amount of information possible to draw you to the building," McGee says. "But for the most part once you submit an offer and it's accepted, you can get the information you need."

Before offering

Before sitting down to write out an offer, investor Domenic Mandato, president of InvestPlus Properties Inc., says you should first meet with your mortgage broker to find out what you'll need to finance the building. "If you ask all of the right questions at the beginning of the conversation, and get the answers to the lender without them having to ask you, your trust factor will go through the roof and your ability to get financing will increase significantly." You should also present some cursory research to your lender at this stage including, the age of the building, the gross and net income, the vacancy rate, the cap rate and any deferred maintenance. Part of that research also includes presenting a favourable debt coverage ratio, known in the industry as a DCR. Lenders use DCRs, which are calculated by dividing the build-

For beginners, it's advisable to work with a qualified commercial Realtor or an experienced real estate lawyer when writing and submitting an offer

ing's monthly net operating income by the monthly mortgage payment, to ensure the building will carry its costs. So for a rule of thumb, it's best to ensure that you get a DCR as close to 1.2% (more is better) to ensure that you'll get financing.

"You also need to work with your mortgage broker to adjust the financial statement to drive the DCR up. From a buyer's point of view, they want to make sure they look for properties whose net operating income is high. They should shoot for lower mortgage payments, of course, over the term, so that's why it's good to determine that number right away."

Remember at this stage, too, you want to find a mortgage that will save you money. So it's important to keep in mind, Barsoum says, that multi-residential financing is not all about the interest rate you get. You should really be considering the overall financing costs and loan terms as that will impact your overall return on investment as well as your exit strategy

Financing costs include lender and brokerage fees, which buyers pay for and could be anywhere from .5% - 3% of the loan amount. They also include any fees charged by the insurer for insured mortgages such as premiums and non-refundable administrative fees (CMHC charges a non-refundable $150 per unit with a cap of $50,000 to assess the application).

Next, get to know the seller, and figure out why they have put their building up for sale, Mandato says. "Before I even write the offer, I try to find out who's behind the deal. As you become the expert in that area, you also begin to know what the influences of that seller are, like if they're trying to sell before they lose their money."

Some key questions Mandato tries to answer are:

1. Why are they selling?
2. How long have they owned it?
3. Do they own other properties?
4. What are they going to do with the money?

Knowing the seller's motivation level could give you much more leverage in the negotiation process.

Writing the offer

For beginners, it's advisable to work with a qualified commercial Realtor or an experienced real estate lawyer when writing and submitting an offer, says Barry McGuire, a lawyer with Ritchie Mill Law Office in Edmonton, Alta.

"I have any number of clients who write and submit offers on their own, but they didn't get to be that way on their very first offer," he says. "Typically, the types of buyers who work on their own have bought at least three or four multi-family buildings and even then it takes a particularly detailed-oriented, experienced buyer to write those offers."

Still, the core of a good offer remains the same, he says, and includes three fundamental conditions.

First is a clause stating that the deal is subject to the buyer receiving diligence material provided by the seller and that it must meet the lender's requirements. This typically includes,

- Two years of financial statements,
- The rent roll,
- A building conditions report,
- Environmental assessment,
- Property survey,
- Fire inspection,
- Appraisal,
- And public health report.

Since these items are also required by lenders before they'll issue financing, the more you can get done during the diligence phase, the faster you'll be able to line up financing later in the deal, McGuire says.

Second, add a clause stating that the deal is subject to the buyer receiving satisfactory financing within a 30- to 45-day period after all diligence material has been collected, Mandato says. "That way the owner is in a time crunch as well. And just tell them the quicker they can get that documentation to you, the quicker you can remove conditions," he says. "You want to get that information as quickly as possible, so that you can review it." In this stage, you will likely need to have a new building conditions report and environmental assessment done (See environmental assessment).

Finally, you should include a clause stating that the deal is subject to the buyer's lawyer's approval.

McGuire says that a lot of sellers can get a little fussy about this last condition. To them, it seems like a way out of the deal no matter what. And they're worried they may waste months trying to co-ordinate a deal and provide stacks of documentation for absolutely nothing. Plus, a smart lawyer or a good commercial Realtor usually won't let a buyer or a buyer's real estate agent get away with adding that clause to an offer.

"You might have to add a more specific clause in place of the lawyer's approval one, but I've talked to a number of investors and Realtors and they say a lot of the time people don't even question that clause," he says, adding that it really depends on the deal.

If the vendor does question the lawyer condition, just explain that you would, at least, like to have your lawyer review all of the diligence material. Or suggest that you could make the clause more specific saying that the deal is subject to the approval of the buyer's lawyer's approval of all diligence material.

Going over the diligence material

Once you and the seller have agreed on price for the building, as well as the terms and conditions of the offer, you'll be required to provide a deposit, which could be refundable or non-refundable depending on the agreement. As soon as the deal is signed and the deposit is handed over, you're in the diligence phase, which can be the trickiest and the most time-consuming, says McGuire.

Start by carefully going over the seller's financial statements to really understand the potential viability of the investment, says McGuire. "What two years of financials will say is how the building has performed month to month, year over year. It really gives you an idea if there is steady income in the building," he says.

And by looking at the expenses you can get a good idea about any issues the building has. For instance, if the plumber is coming out to the building every other month, there may be a problem with the pipes, McGee says. "You really want to get an idea of the maintenance costs by going back at least one or two years to figure out what it's actually costing to keep the building running," she adds.

If the seller doesn't have any financial records or tells you they've been recording their expenses on scrap pieces of paper floating around the office that should probably give you pause for concern. "A lot of people don't want to give these records and a lot of people don't even have the records to give, or don't even have any idea of how much they're spending on maintenance," McGee says. Still, the majority of building owners do have this information in an accessible format, such as a spreadsheet, and can get it to you quickly.

Next you want to look at the rent roll, a spreadsheet showing rent due and the total

HOW DOES AN ENVIRONMENTAL SITE ASSESSMENT IMPACT MY PROPERTY?

The Environmental Site Assessment (ESA) is a standard condition on all multi-family purchases and finance agreements, but many owners and even some real professionals do not know what they are.

An ESA is the primary due diligence tool for assessing the environmental condition of a property, and thereby protecting the parties in a transaction against environmental liability. ESAs are preformed to guidelines set by both the provincial Ministry of Environment and/or CSA Standards Z768-01 & Z769-00

The ESA seeks to answer two questions:

1. What is the "likelihood" of contamination on, in, or under the property?
2. If contamination is likely, can the "location and concentration" be verified?

To answer these questions different types of ESAs are used. The "Phase 1" ESA answers the first question (is contamination "likely"?), while the "Phase 2" ESA answers the second (where is the suspected contamination and if it exists, what is the concentration?).

You can think of an Environmental Site Assessment as being like a crime scene investigation (CSI), but instead of examining a body, the ESA examines a property. And instead of looking for evidence of a crime, an ESA looks for evidence of environmental contamination.

A Phase 1 ESA reports involves:

1. **Reviewing records** (surveys, deeds, aerial photos, reports of spills)
2. **Conducting interviews** (owners, neighbours and employees)
3. **A site reconnaissance** (look for physical evidence of contamination)

The evidence is then evaluated by a "Qualified Person" (QP), who typically has an engineering or geoscientific background. If contamination is "suspected," then the Phase 1 ESA will recommend a Phase 2 ESA to test the soil, groundwater and even the indoor air at a property. If contamination is then found and it is above the legal provincial standards, then the Phase 2 report will recommend performing a Phase 3 ESA, or "Site Remediation" to clean up the property.

In Ontario new environmental legislation regarding ESAs became law on July 1, 2011. The new legislation is designed to both strengthen and streamline the ESA process, and will undoubtedly result in more Phase 2 investigations and more Phase 3 site cleanups.

While the new legislation is technically geared only to commercial properties that are being redeveloped, virtually all financial institutions have incorporated the new standards into their Ontario underwriting guidelines for multi-family properties.

Final thoughts: Although rare, environmental issues can seriously impact a property sale or refinance. Therefore it strongly recommended that you use only a licensed, lender-approved environmental engineering firm that has experience in preparing ESAs.

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rent received from each tenant, and leases to see what the building's turnover rate is like. If tenants are coming and going every couple of months there's probably a good chance that turnover rate won't change once you own the building. Plus, any lender is going to want to see at leases for every unit. Compare the rate of tenant turnover to the vacancy rate to see just how often you'll be forking out money to cover vacant units and find new tenants. "The last thing you want when you're buying a new property is to have a lot of turnover right away because you're dealing with transition costs," McGee says.

Collecting reports

In most cases, lenders will require you to get a new appraisal, environmental assessment, property survey and public health report before issuing any financing. But, Barsoum says, you should always start by reviewing whatever documentation the seller provides to you to flag any concerns early on and to avoid any unnecessary costs.

For example, if the previous environmental assessment shows that the property was once used for a gas station and is in need of remediation, that may turn most lenders away from the deal nowadays, McGuire says. And if the lender makes remediation a condition of your financing, which could cost hundreds of thousands of dollars, it may be best to back out of that deal – something you can do based on the financing condition. "Every one of those diligence issues should have a facet in them that says if it comes up this way, I'm not buying the property," McGuire says.

"The most important aspect of buying a multi-family building is assessing whether or not you've received all of the requested diligence material from the seller. Second point: if you've received it, is it adequate. Third point: if you didn't get it, do you need to get it."

Getting the inspection

The building conditions report, another requirement of the lender's, is usually taken care of during the building inspection. A good mortgage broker can help you identify which inspection companies lenders use, Barsoum says, so that your lending institution will accept the inspection report. It does cost about $2,000 to $5,000 to get a building conditions report done, but not only do you need it for financing, but just think of the money you'll be saving if the inspector uncovers a structural flaw in the building that could cost hundreds of thousands, if not millions of dollars to fix.

Still, it's not just enough to send an inspector to the building and hope for the best. You, as the potential buyer, should be there with the inspector, asking questions and inspecting every suite personally, McGee says.

As for the appraisal, it's best to rely on the seller's last appraisal first, Barsoum says, and then complete a new appraisal or update the existing appraisal as required by the lender. Lenders have their approved list of appraisers. Speak with your mortgage broker to determine whether or not an update can be done to an existing appraisal report as that could save you thousands.

Show your package to the lender

Next, you'll need to collect and package your diligence material to apply for financing. This should include:

1. Rent roll
2. Environmental report (if available)
3. Appraisal (if available)
4. Two years financial statements
5. Management strategy
6. Building conditions report (if available)
7. Information about the building itself
   a. Unit mix
   b. Age
   c. Unit description
   d. Location
   e. Vacancy rates

"Basically you're giving the lender a comprehensive overview with regard to the condition of the asset they are lending against and its ability to generate sufficient income to cover for the loan" Barsoum said.

Even after you've submitted all of your diligence material, there may be something else that crops up. That's why timing at this stage is critical, McGuire says. "To large extent financing is about timing, I think. You have to give yourself enough time to apply for and be approved for financing and that is a minimum of 30 days and 45 days is better," McGuire says. "It's critical that you get that amount of time because if you don't you then start making bad decisions and removing conditions too soon without having the certainty that you want on the financing side. If you don't have enough time, you start making decisions based on hoping not knowing."

If it does take too long to line up financing, the seller can walk away from the deal or require you, the buyer, to pay a fee or make a portion of your deposit non-refundable.

Closing time

If your lender approves the deals based on the information provided, then it's time to close. Typically, buyers have about 45 days to close the deal. If you exceed the allotted time limit in this phase, the seller can again back out of the deal or require another fee or could make part of the deposit non-refundable.

"In a rocketing market, a property can be up another $10,000 per door in 90 days. So when you ask for more time and let's say it's a 36-suiter, the seller can ask for another $360,000 more than you're paying."

But motivated sellers will usually extend the time limit as long as you provide them with a commitment letter from the lender stating that they will finance the mortgage for the buyer.

If you and your lawyer are satisfied with the deal, it's time to remove conditions and basically play the waiting game as your lawyer and the seller's lawyer exchange documentation until the deal can finally be closed. Typically, your lawyer will just be checking off a list of the lender's diligence requirements to make sure everything lines.

"If the diligence is all good and adequate, the funding and the signing of the documents is relatively straightforward and relatively quick to do." ■