

Altus Group

Five Points An Investor Should Consider When Buying Income Producing Properties

(i.e. shopping centres, office and industrial buildings)

1) Obtain advice from a qualified building inspector and/or an engineer:

Prudent purchasers of commercial properties should generally make their offer to purchase subject to 'Physical and Environmental Due Diligence.'

It is stressed that an appraisal and a building inspection should not be confused as serving the same function. An appraisal is an opinion of a property's market value at a specific point in time. While the physical condition of the property is critical, the appraiser also has to consider subjective issues such as location, design/function, and supply and demand, all of which have a significant influence on marketability and value.

A physical and environmental due diligence is a thorough examination of the physical condition of the structure, its components and/or soils conditions. A building inspector or engineer should at the very least provide an opinion of:

- a) The structural soundness of the improvements and the services to the improvements.
- b) The condition of the roof and electrical/mechanical facilities, including air quality.
- c) The presence of any environmentally hazardous substances (such as asbestos).
- d) The presence of any insect and rodent infestation.
- e) The presence of any soil contamination (examples of this could include seepage from an adjacent gas station or an old dry cleaning operation).
- f) The overall type and condition of the soils, and their overall stability with regard to the existing improvements and any future development.



- g) Any potential of flooding.



The report should provide realistic costs and timelines for repair, replacement, and remediation of any of the above items.

2) Conduct a detailed financial review:

The price paid for most income producing properties is directly related to their current and expected income flow. Verifying the current income flow and estimating the future income flow is a time consuming but important process. Typically, for larger properties, an estimate of cash flow over a 10 year period should be conducted.

Some of the important elements of a 'Financial Due Diligence' include:

- a) A review of all leases to identify not only their financial terms but also any important lease clauses, such as; options to terminate, options to expand or downsize, options to renew the lease at a fixed rent, options to 'go dark', future free rent periods, and any outstanding tenant improvement allowances payable by the landlord.
- b) An analysis of the tenant profile. Personal tenant interviews are a good idea as well as some research into the overall strength of each tenant's covenant. The strength of the covenant of a tenant is determined by its financial stability and general reputation in the business world.
- c) An analysis of the historical operating statements (which should be audited), the year to date performance, and the current budget. Any budgets provided should be reviewed to determine if they are reasonable as well as to identify any possible mistakes.
- d) An analysis of accounts receivable and accounts payable as well as any contractual agreements (such as with cleaning, elevator maintenance, and security companies).
- e) An analysis of recovery revenue. The majority of leases which are typically struck for office and industrial buildings are on a 'net basis', whereby the tenant pays basic minimum rent as stipulated in the lease, as well as its proportionate share of operating costs and taxes. The tenant therefore assumes the risk for potential increases in operating expenses and taxes. A gross lease is a lease in which the landlord receives a stipulated rent and the landlord is obligated to pay all or most of the operating expenses and real estate taxes. For most retail properties, some tenants pay less than the 'full recovery rate'. It is therefore vital that the recovery or 'additional rent' section of the lease agreement for each tenant in a property be

reviewed and fully understood in order to accurately estimate both the current and future income earning potential of a property.

- f) A review of property tax statements in order to determine if there are any arrears in unpaid taxes and utilities.
- g) A review of the property's tax assessment. Is it over or under assessed, properly classified, and will the assessment increase upon the purchase/sale of the property?

3) Analyze the market in which the property is located:

A typical market analysis will include the following:

- a) An Economic Overview: A brief review of the main economic indicators, both historical and projected, is required in order to determine if the future outlook of the local market and surrounding areas is positive or negative.
- b) A Competition and Leasing Market Overview: In order to estimate the future earnings potential of a property, an analysis of any competing properties, including the vacancy and rental rates which are being achieved in these properties, are required. In addition, a review of new and any proposed developments in the area should be conducted.
- c) Investment Market Overview: An analysis of investment demand, investor preferences, and a survey of current valuation parameters will assist in determining not only the price to be paid but will also give an idea of the properties 'liquidity rating.' In other words, 'how difficult will it be to re-sell the property in the future if required to do so.'

4) Undertake a 'legal due diligence':

A typical legal due diligence will include the following;

- a) A title search and a summary of all charges registered on title.
- b) An opinion of any impact on value with respect to the charges which are registered on title.
- c) A review of the heritage site registry. A 'Protected Property' or a property which is on the heritage list could affect the property's future development potential and marketability.
- d) A review of the property's specific zoning and official community plan designation, and any other municipal regulations is required in order to determine if the property conforms to current municipal requirements as well as to assist in identifying the future development potential of the property.
- e) A review of the business licenses to determine if the building operations on the property are in good standing.
- f) A review of the most recent Fire Marshall and Health Department inspections to determine if there are any outstanding orders.

5) Undertake both a site survey and a building survey:

Are the building areas and site areas stated correctly? The only way to determine this is through either reviewing or obtaining a site survey as well as a copy of the building plans and certified floor plans.

For more information please contact:

David Eger, B.Comm, RI, AACI, MRICS
Senior Director & General Manager,
Research, Valuation & Advisory, Altus Group Limited
www.altusgroup.com

D: 778.329.9251
T: 604.683.5591 ext 1651
E: david.eger@altusgroup.com

ABOUT ALTUS GROUP LIMITED Altus Group Limited is a leading provider of independent advisory services, software, and data solutions to the global commercial real estate industry. All of our five core practices – Research, Valuation and Advisory, ARGUS Software, Property Tax Consulting, Cost Consulting and Project Management, and Geomatics – embody and reflect decades of experience, a broad range of expertise, and leading edge technology. Our offerings empower clients to analyze, gain insight and recognize value on their real estate investments. Headquartered in Canada, we have approximately 2,300 employees around the world, with operations in North America, Europe and Asia Pacific. Our clients include some of the world’s largest real estate industry participants, spread across a broad variety of sectors.

We are focused on creating sustainable shareholder value that generates long-term returns by targeting organic and accretive growth while providing quarterly dividend payments of \$0.15 per share. Our securities are traded on the TSX under the symbols AIF and AIF.DB.A.

For more information on Altus Group, please visit: www.altusgroup.com.