

**Winning the Deal With Early Due Diligence
With Michael Schwartz of RSM**

Privcap: When it comes to real estate deal due diligence, what's changed since 2008?

Michael Schwartz, RSM:

The change has come in that I don't think people want to see a repeat of what happened in 2008 and 2009. Things were so hot in the early part of last decade through the middle portion and into '07. Deals were coming right and left, be it from the acquisition side, the disposition side or refinancing. Then, of course, we all know what happened in 2008 when things just came to a halt. Everything, if you will, crashed; [it was] the worst real estate depression since The Great Depression. What we're seeing from a change standpoint is more of a focus on...the crux of the deal, the financials, the leases and the income stream and looking at problematic borrowers if they're such a case or questionable issues that we don't want to see a repeat of. Our clients don't want that.

Do you have to be quicker with your due diligence in order to win deals today?

Schwartz: It's becoming a quicker process because...you have many entities chasing the same deals and it's becoming very price-competitive. Cap rates have gone down as a result, especially in the trophy cities, the trophy markets and the trophy properties in those cities. In fact, there was an article this morning about how in Chicago—my hometown—[at] trophy properties, the rents...and the prices are so much higher than non-trophy.

What we're seeing is a lot of acquisition entities out there, folks that are buying and/or lending, are coming to the table—especially on the acquisition side—with a lot of work done, if you will, pre-packaged before they even sign the purchase and sale agreement. Typically, your process is you enter, you put your bid in, you get the purchase and sale agreement and you negotiate. Then, you start your process in terms of (in our

component) the financial due diligence: the lease abstracts, Argus modeling, NOI analysis, CAM reconciliation and whatnot.

What we're seeing now are clients approaching us saying, "Hey, I want all these lease abstracts. I want the Argus models. I want to reconcile all this." And that's before we go hard or, I should say, before we put our bid in because we want to win this property. We're seeing that more and more these days. In fact, I just got a call yesterday from a client and they wanted us to come. It's a medium-sized, fuel-power retail center. They wanted everything done in a week, before they put their bid in, and then negotiate the purchase and sale agreement. So you're seeing a lot of that and it's becoming more and more the norm to get the deal and win it.

How long is the typical due-diligence period now? 45, 30 or 15 days?

Schwartz:

More the latter, and that's a great question because what used to be, say, even for loans—45 days. It was 30. Now, 30 is becoming 21 and 21 is becoming 14. We're seeing some very quick turnarounds. In fact, we had one client recently that came to us with...a suburban office portfolio somewhere between 100 and 150 leases and they basically had 10 days. By the time we actually signed everything up and got the leases, it was seven to eight days. That was very quick and so far, so good, at least from what I'm seeing on their end. So, [it's] becoming much more abbreviated. On the loan side, some of our life insurance companies were 45 days or 30 days. It's now becoming 21. If they want to win it, that's what they're going to have to promise their borrowers. And they're doing it.

What's the impact of shorter due-diligence periods on GP resources?

Schwartz:

It's a definitely and outsourcing, which is where we come in to play and our competitors, too. What we saw leading up to '07 and '08 [was] many firms did have large acquisitions groups, large due-diligence groups, etc. They laid off many of those people in '08 and '09 and they do not want to ramp up where they were back then. So what they do is ramp up a small to medium amount in-house to maintain that control. Then, [they] approach us and/or our competitors in that area. So we're seeing a tremendous amount of outsourcing and using of our services for this to get the deals.

Are we digging deeper into deals when it comes to due diligence?

Schwartz:

That's a great question and that ties to the prior question about in-house versus outsourcing. Because, again, we don't want to see a repeat of what happened several years ago. We are being asked to go deeper than we did back then, too. For example, [for] some of our clients, where before we would just do a cursory approach to the lease analysis or a cursory finance or just...a ticking and tying is used in the term, or a testing of the Argus or financial run. We are going much more in depth.

We're really scrubbing the expenses and looking at the revenue. We're looking at every facet of it. We're taking a look at the general ledgers...at the two- to three-year historical and a rollup. We're digging deeper into management agreements, into administrative fees and things where revenue items to the landlords, where they want to make sure that everything represented by the seller or for our lender clients by the borrower is, in fact, there.

Given increasing competition and valuations, are more people walking away from deals?

Schwartz:

It's funny, but leading up to 2007, I don't think we ever saw anyone walk away from a deal. And we did many of them, both from a loan and from an acquisition standpoint. We have seen more in the last 18 months than I did in, say, the eight years leading from 2000 to 2008, for people actually walking away saying, "You know what? I don't want to make the mistake. I don't want to have to give back the property." Or, in the lenders case, take it via foreclosure.

...If the numbers don't match and if there's a material disconnect or a big variance, they are walking away and we've seen quite a few of those. Both...on the loan and the acquisition side. We're seeing more now than we have. Not to say that—you still want to make the deal work, but we're seeing folks walk away, saying it's just not there.

Does the U.S. commercial real estate industry still have underwriting discipline?

Schwartz:

It's disciplined, yet we're seeing—especially, as I mentioned, these compressed timetables—where they're getting caught up in the moment. I mean, some cap rates in some parts of the

country are really going down. People are chasing the same deals. You hear of a two or three cap in some places and you ask yourself what they are getting out of it. And they're still doing it. In that case, you wonder where the discipline is, but for the most part, we're seeing some regulated discipline on our client's standpoint. Again, both on loans and acquisitions.