

The Due Diligence Process - Germany

Pär Hakeman, 2011-01-17

Introduction

The term “Due Diligence” is used in many different situations in today’s business and political life. For example when a company intends to buy another company or a government wants to initiate new relations with a foreign government. We use the term when we buy a new property or a property company. The term indicates how an assessment, research or analysis of the purchase object shall be made, hence with *due diligence* or with other words *adequate care*.

The term and the process as such have its origins in the US-Law system, where the buyer is obligated to assess the goods or property with due diligence in order to define their rights in a contract or preserve their rights under the relevant law. Under German law a buyer is not obligated to assess the object (with due diligence) in order to preserve their rights, the seller is by law responsible for errors or defects.

However, it has become common practice that the seller’s responsibilities and obligations are defined in the purchase agreement and that the seller excludes all responsibility for facts, errors or defects which have not been expressly regulated in the purchase agreement. That is one of the reasons for making a due diligence process when buying real estate. Another reason is that we do not want to rely on the sellers guarantees only (the seller may not be able or willing to pay compensation should we have a claim under the purchase agreement), in fact we have to know what we are buying before we sign or close a deal.

The Due Diligence Process in Real Estate Transactions

The main purpose with the due diligence process is to i) gather, ii) analyse, iii) verify and iv) document all the relevant information regarding the purchase object. That means all information that may be relevant for the purchase price, contractual conditions, guarantees and undertakings.

The process starts when we obtain the information that a property is for sale and you could say that it ends when we sign the purchase agreement or inform the seller or broker that we are not interested in buying the property for what ever reason.

Our most important document in the due diligence process is our calculation sheet, which calculate total expected return, initial

yield, total transaction costs and other relevant key figures. It is needless to say that the quality of the output corresponds to the quality of the input. Hence, a high quality due diligence process is essential for the estimation of the total return and low risks in the short as well as in the long run.

The result of the due diligence is presented in a Board application, which in brief contains all the relevant information about the property. The outcome may also be documented in an internal due diligence report. As mentioned above, the outcome of the due diligence is not only relevant for the purchase price but also for payment conditions, guarantees and undertakings in the purchase agreement.

In order to structure the due diligence work itself we have divided the due diligence work into three different areas, financial, technical and legal due diligence.

Essential information

We have identified the information we need in order to assess what we would be willing to pay for a property. These facts and assumptions are summarized in the calculation sheet and in the Board application. The majority of the information is of standard character and will be obtained and assessed in every transaction. However, almost every transaction has its own special issues or problems. It could be an extension of the attic, large extent of deferred maintenance, dispute with tenants or an authority, a building permission application that is pending or an insolvent seller. Below you will find a list of the most important information we shall obtain and analyse as well as the assumptions we have to do in our due diligence process:

Facts:

- 1) Location
- 2) Residential and commercial rental income
- 3) Number of apartments, leasable area
- 4) Apartment standard, balcony, elevator
- 5) Floor plan
- 6) Standard of general areas, deferred maintenance
- 7) Investment needs or possibilities in apartments and in general areas
- 8) Initial vacancy ratio
- 9) Market rent

Assumptions:

- A) Required yield
- B) New lease level
- C) Vacancy ratio
- D) Fluctuation
- E) Condominium potential, price per square meter

The Due Diligence Process Step by Step

Location, Required Yield

The first item we check is the macro and micro location of the property. The location is not only important for the estimated new lease level and the estimated vacancy ratio, but also for the estimation of the required yield. As the main rule, one can say that the better the location, the lower the required yield. The required yield is our estimation for how the market will value the property at a certain point of time and it is an important figure which has to be entered into the calculation sheet. Our required yield benchmarks for A cities are: A location 4.0 percent and B location 4.5 percent. For the time being are we only focusing on A cities in Germany.

New Lease Level and Vacancy Ratio

The new lease level and the vacancy ratio are also two very important figures for the calculation of the purchase price.

The new lease level is set by the market, since Germany applies market rents for apartments. Thus, we have to carefully assess the macro and micro location in terms of inter alia vacancy, existing average market rent for comparable apartments, letting strategies, we are letting without broker fees; however, many owners are letting with broker fees.

The vacancy ratio is almost based on the same criteria as new lease level.

Deferred Maintenance, Investments

We visit the property at an early stage to get a good feeling for the location and the standard of the property. We instruct an architect or an engineer to make a technical report regarding the building. The report contains detailed information about deferred maintenance, the quality of the building, heating system, pipes and the roof. The technical report shall contain everything about the building from a technical point of view. Further, the technical consultant shall also assess if all building permissions are in place.

If we identify a possibility to extend the attic, build balconies or make a thermal insulation, this shall also be assessed and a cost estimation shall be provided by the technical consultant.

An important part of the technical due diligence is also to get an overview of the standard of the apartments in order to assess the fluctuation costs. In Germany the deviation of the standard between the apartments in one building can be very large.

Normally we estimate the costs for two alternatives, a complete renovation of the apartment and just smaller jobs like painting and fitting a new floor. Further, we have to estimate how many of the apartments need a complete renovation. Depending on the transaction we strive to look at 10-50 percent of the apartments.

Documents

Tenant List

The tenant list, which is a list over all apartments in the property, shall contain the following: i) actual rent per apartment and total rental income, ii) square meters , iii) moving in date, iv) last rental increase and v) arrears.

The information in the tenant list is essential for several key facts and assumptions which shall be entered into the calculation sheet. For example i) the assessment of the rental income by signing and thus the initial yield, ii) the estimation of the possibility to increase the existing leases, iii) share of residential/commercial rental income iv) estimation of modernisation costs in connection with fluctuation.

The information in the tenant list should be verified by the bank accounts and/or the lease agreements.

Even if the tenant list is guaranteed by the seller it is of great importance to try to verify the varying information in the tenant list compared with other documents, for example the bank accounts and/or the lease agreements, respectively with the inspection of the property.

Technical Report

The content of the technical report is described above. It is important that the liability is not excluded so that we can claim against the technical consultant should they have missed any important findings.

Documents from Authorities

Documents like land register, municipality fees and municipality restrictions are checked by us and our lawyers, and respectively the notary.

Depending on content we may have to adjust the guarantee list or adjust the purchase price.

Internal Processes

The project leader is in charge of the whole due diligence procedure. They are responsible for the calculation and the verification of all information used in the calculation and the Board application. Further, they will decide if we need external support and to which extent.

They will also decide when it is time to make an indicative offer.

The Board application and the due diligence report respectively the documentation list shall be signed by the project leader and Head of Akelius Germany.

The Due Diligence Process - Group Work

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Introduction

We have been informed that a property portfolio in Hamburg is for sale. The location of the four properties is good, all locations are assessed as B+ locations. The potential seller is an Irish Real Estate Fund, and you have heard that the fund has financial problems. We have received a prospectus with information on everything from the property standard to an extensive tenant list. The first meeting with the broker and the seller's lawyer went well. The lawyer is very clear on two issues, the seller wants to sell and they will do anything to support and speed up the due diligence process. They are also willing to give extensive guarantees.

- A. You have the task to support the business development team during the due diligence process and your first task is to visit the property together with the seller's property manager.
 1. Would you take anyone with you?
 2. During the visit you observe that neither the outside area nor the general areas, such as stair cases, the attics and the basements are properly maintained. The walls are full of graffiti, the entrances and the staircases are not cleaned. Your first thought is that it is actually rather good that the entrance and the staircase are so dark. After you have taken some pictures you start to think of how to present this in the DD-Report. What would you highlight?
 3. You have observed that two of the basements are very humid. However, in the prospectus it is said that the cellars are in good condition, the humidity is not mentioned. Which actions would you take? How would you present this information in the DD-report?
 4. The property manager explains that he will only be able to show you one of the 10 apartments you wanted to see (all in all there are 135 apartments). The apartment looks

good, you estimate that you only have to make a face lift to the apartment in connection with fluctuation. This is also in accordance with the prospectus. Which action would you take? How would you present this information in the DD-report?

- B. After the visit you start to assess the tenant list. It indicates a vacancy ratio of almost 8 percent. However, the lease level seems to be slightly lower than the market rent. What are your conclusions? Which actions would you take? How would you present this information?

Three days later it is time to present the due diligence report. Before you start your presentation you receive information that the seller's lawyer has indicated a purchase price around 9 MEUR. The head of business development thinks that the price sounds really good.

Now it is your turn!

How would you present the information above, your conclusions and your recommendations?