

Due Diligence Process - Sweden

Petra Wiklander, 2011-01-17

Due Diligence in property transactions

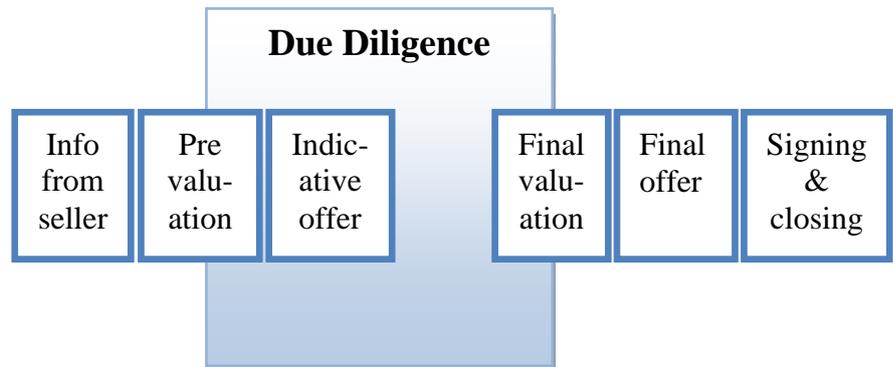
When buying properties all possibilities and risks must be known and assessed in order for us to be able to make assumptions about the future cash flow and what return to expect. A thorough investigation of all aspects of the property is called a Due Diligence process. Within the Due Diligence process we analyze the object, the market and other conditions that may affect the price.

Some parts of the Due Diligence process are made in house at Akelius and other parts are made with the help of consultants. It is the project leader of the transaction that is the coordinator of the Due Diligence and it is he or she who distributes the tasks. The technical state of the property is usually determined by an authorized inspector, whereas the property's rents and other incomes are examined by the project leader. The costs are most often assessed by the city manager or the regional manager. The different areas that are investigated during the Due Diligence are:

1. Technical state
2. Environmental condition
3. Legal, tax and finance
4. Economical features
5. Personnel

One thing that is crucial for the extent of the Due Diligence process is whether it is a deed transaction or a share deal. A deed transaction does not require as much investigation as a share deal.

The transaction process



When the transaction process is initiated we only have the seller's information about the object to base our valuation on. Usually this information includes actual rents and usage bound costs, operational and maintenance costs are usually stereotyped costs estimated by the broker. This information provides us with a picture of the objects net operating income at the moment.

From this we make assumptions about the risks and possibilities for the future cash flow. These assumptions need to be evaluated and secured. That is when we start the due diligence process, we collect as much information as possible about the object before we even make an indicative offer. This is because we want our bid to be as accurate as possible and because it allows us to speed the rest of the process up, which in most cases is an advantage compared to other potential buyers.

In Sweden different authorities provide information about properties, from the land registration system we find information about the property tax value, previous and present owners, mortgage deeds, area. From the municipality we can find out whether or not the property fulfils different statutory requirements.

We can also make a market analysis to find out what the expected future rent increases are and what the condominium market prices are. If the seller approves of our indicative bid we are allowed to perform a full Due Diligence, this means that the seller provides us with all necessary information about the object and we investigate, check the credibility and evaluate this information.

The outcome of the Due Diligence allows us to make more accurate assumptions of the future cash flow and determine the property value through a final valuation. Depending on the outcome, we might change our view on what the property is worth and therefore make a final offer that differs from the indicative offer.

Technical Due Diligence

As mentioned earlier the technical Due Diligence should be made by an authorized inspector. However, it is actually already started when the project leader first learns that the property is for sale and makes the first on sight inspection. Even if you are not an expert you can learn a lot about the condition of a building just by looking at it. Are there cracks in the facades? Is there flaking paint on wooden detailing? Are the toys on the playground broken or worn? We can also look for damage and graffiti on the building and its surroundings, continuous extra cleaning and repair is costly. If you can see defects on the property you can also guess that they will cost money to attend to, money that will affect the net operating income.

We can also make assumptions from which year the house was built and what major refurbishments that have been made since. If the property was built in the fifties and no extensive measures have been made since then, we can assume that the pipe work is in poor condition or that they will be within a few years.

The technical investigation also provides us with information about what possibilities the property has. If the standard in the apartments are low we can renovate them and increase the rent. At Akelius we work with a variety of standard raising measures that our tenants have been shown willing to pay more rent for. The most common are bathroom and kitchen refurbishment, security doors and parquet flooring. The possibilities can also lie within reducing the costs, if the heating system is old and inefficient we can convert to a new and modern system that will consume less energy and therefore cost less.

The point of time when the full technical investigation can be done differs from transaction to transaction. Sometimes the buyer is not even offered a viewing of the property until the seller has accepted the indicative offer. Other times we are aloud to perform the full technical investigation before making the indicative offer.

When the inspector gets access to all facilities he or she evaluates the condition of the building and makes an assessment of what measures need to be done. The assessments lead to a plan for planned maintenance for a period of five or ten years. Below you can see an example of how such a plan might be presented.

Measurement	Urgent	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6 to 10
Pipework restauration				1 000 000			
Paint windows		300 000	200 000				
Change roofing card board							500 000
New elevator	500 000						
New sand for playground	25 000						
Total	525 000	300 000	200 000	1 000 000	0	0	500 000

Environmental Due Diligence

In Sweden there are some statutory demands regarding properties environmental aspects. There are restrictions about how much PCB and radon a building can contain before the property owner has to decontaminate it. Furthermore all property owners are obliged by law to make sure that the ventilation system is approved by the authorities and they also have to perform a so called energy declaration that shows the property's energy usage. If these demands are not met it will be the next property owner's responsibility and cost.

Legal, Tax and Financial Due Diligence

The legal risks of the transactions are evaluated by the project leader in cooperation with the legal department. All necessary documents should be reviewed and filed. If the property is sold by a deed transaction this part of the Due Diligence is not so extensive. Then we can find all information needed in the Swedish land registration system. But if it is a share deal where the shares in the company owning the property are sold it is more significant.

A newly formed company does not require as thorough an investigation as an existing company. A company that has been active for a while might have commitments and obligations toward other parties. When the company is sold these commitments and obligations come along. It is important to establish that this is thoroughly investigated and that there are no unknown risks when the company is taken over. It is also important to control annual reports, tax declarations, VAT and possible disputes.

Economical Due Diligence

Within the economical Due Diligence we investigate the property's incomes. We control that the rent roll corresponds with the initial information given by the seller. We collect statistics about past rent increases and analyze the potential future rent increases.

The technical investigation tells us what standard raising measures that can be done, now it is time to analyze what rent levels the measures may result in. It is also in this step we make the calculation of the future cash flow. All incomes and costs the future ten years are evaluated so we can accurately calculate the expected return and know whether or not it is a good investment.

When adding the outcome of the technical investigation to the calculation the city manager or the regional manager is involved. If the property is bought it is their task to make sure that the net operating income is generated in line with the

acquisition valuation, it is therefore important that they have a say in cost levels and calculated rent increases.

When the initial valuation was performed we made assumptions regarding the required yield and the condominium market. A part of the economical Due Diligence is to verify these assumptions.

Personnel Due Diligence

If the transaction is made as a share deal, the company might have employees. If so, the salaries and terms of employment need to be evaluated. The human resources department usually performs this part of the Due Diligence.

Result

The result of the Due Diligence is not only the knowledge of the object that we have assimilated. It might also affect the price of the property, especially if it differs from the information given by the seller in the beginning. The final price is negotiated with the background of the findings in the Due Diligence.

If the seller is not willing to lower the price he or she might make guarantees in the sale and purchase agreement instead. An approved ventilation control is a very common thing to guarantee in Sweden.

Documentation

Throughout the complete transaction process documentation is essential. The Due Diligence documents are extra important to save and file since these are the foundation of the guarantees made in the sale and purchase agreement. When we sign the agreement we have to make sure that the information corresponds with the information from the seller during the Due Diligence.

The documentation also serves another important purpose since this is a part of the information given to the asset manager when the property is bought.

Report

When the Due Diligence is completed, the value and return are calculated and the final price is negotiated a Due Diligence report is performed. This report serves both as a conclusion of the Due Diligence process and is also a part of the passing to the asset management. In the report the property's attributes are described and the risks and possibilities are highlighted. The idea is that the asset manager should be able to form an image of the property and understand the business plan for securing the return.

Group Work

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Back ground

Akelius recently bought the property Imröret 11 in Högdalen, south of Stockholm. The thirteen storey block building is divided into two properties, so called 3D-properties. The first floor contains commercial premises and is owned by Boultee. The property we bought, Imröret 11, contains the twelve residential floors on top of the commercial story. The building was erected in 1959 and has a metal façade and cardboard roof. No major refurbishment has been made since the building year. In the building there are two elevators. The property consists only of residential premises and there are no parking spaces included. The average size of the apartments is 61 square meters, which is derived from mostly one room and six room apartments. The standard of the apartments is from the building year and only a few apartments have security doors.

B-location in the Stockholm area

The property is situated in a B-location in the Högdalen centre approximately 11 kilometres south of Stockholm. Högdalen benefits from the strong development of the greater Stockholm area. The public transport communications are excellent and will attract people who commute to for example Stockholm City. The subway train takes twenty minutes to Stockholm city centre. The surrounding area consists mainly of tenant association properties.

SEK 953 per square meter

The current apartment rent is SEK 953 per square meter (approximately 90 Euros per square meter). For the coming years we estimate the rent increase to be 2.5 percent annually. This is in line with what the Swedish property owners association "Fastighetsägarna" recommends its members to demand in the Högdalen area.

Existing company

The seller bought the company that holds the property in January 2010; this is the same company that Akelius bought. The company was formed in 2007 but has been inactive until the property was bought by the company in the beginning of 2010..



The task

Use your different areas of expertise to make a draft for a list of things you think should be reviewed for the Due Diligence process. Consider which risks and possibilities this property might provide.

Also make a draft for a business plan for the first five years of owning the property.