

The Value of Property Condition Assessments

in Commercial Real Estate Lending

•• **A property condition assessment** can be used in pre-purchase due diligence and for the life of the loan as a reference point and an asset management tool. With the proper scope, it can help the owners stay in compliance with applicable codes and regulations.

BY DEREK EZOVSKI

COMMERCIAL REAL ESTATE lending is a complex job. When deciding whether to extend credit, savvy lenders must act like detectives, weighing multiple factors before rendering a decision. For loans secured by real estate, there are obvious considerations such as the borrower's creditworthiness, the property's loan-to-value ratio, and the presence of environmental risks like lead-based paint or asbestos.

But other, less obvious considerations can also impact a commercial real estate deal. One such issue is building maintenance. Borrowers who allow an asset to deteriorate because they can't—or won't—pay for routine upkeep can cause serious problems for lenders. In today's economy, maintenance considerations take on even greater importance because many borrowers are strapped for cash and the cost of building materials is rising. Fortunately, a tool called a *property condition assessment* (PCA) can help a lender factor these important considerations into lending decisions. Here's what you need to know.

Property Conditions and Commercial Lending Concerns

From elevators and air conditioning to electrical systems and parking lots, building maintenance represents a significant cost of property ownership. If a borrower fails to conduct routine maintenance, it can affect the lender in several ways. First, a property with significant material deficiencies could lead to direct liability for the bank. Second, if the property is not maintained regularly, its value deteriorates—a concern since the property serves as collateral. And third, if borrowers are skimping on routine maintenance, this could indicate that money is tight for them, which could affect their ability to repay the loan.

Owing to the potential exposure an improperly maintained building presents, lenders should include an evaluation of building conditions and deferred maintenance needs into their decision-making process. Because even significant defects aren't always discovered by a layperson during a quick prepurchase property tour, many are



turning to property condition assessments to get valuable information on a property's physical state.

Property Condition Assessments: The Basics

Similar to the way a Phase I environmental site assessment uncovers real or potential contamination at a given site (or on adjacent properties), a property condition assessment benchmarks the physical condition of a property's structures and provides estimates of deferred maintenance and future capital costs. Banks, lending institutions, bondholders, purchasers, equity investors, and sellers routinely rely on PCAs, although they're most commonly conducted for lenders or owners as part of a commercial real estate transaction's due diligence or asset management functions.

Sometimes referred to as an engineering report, a capital needs assessment, or a physical needs assessment, a property condition assessment consists of a site walk-through, document research and review, and interviews with facility managers and others familiar with the property. The results, which are presented to the client in a *property condition report* (PCR), include, among other things, an assessment of the property's general physical condition and deferred maintenance status, an estimation of the remaining useful life of the components, recommendations for repair of items important to the property's current operation, and probable costs to remedy observed or predicted material physical deficiencies.

Cost estimates are typically projected over a set amount of time—usually the term of the loan. “If a building is worth \$1 million and has \$250,000 of deferred maintenance over five to 10 years, the lender should take this into consideration for credit quality,” explained Michael Kulka, P.E., a vice president and principal with PM Environmental.

The industry standard for property condition assessments is *ASTM E2018-08, Standard Guide for Property Condition Assessments: Baseline Property Condition Assessment Process*. E2018-08 provides guidance on the evaluation of a property condition relative to:

- Structure and foundation.
- Electrical systems.
- Heating system components.
- Air conditioning system components.
- Ventilation systems.
- Plumbing systems and fixtures.
- Roof surface, including flashings, drainage, and chimneys.
- Interior components (concentrating on noncosmetic considerations).
- Exterior wall components, including doors, windows, and signage.
- Landscape components, including walkways, driveways (excluding sewers), and retaining walls.

- Review of any outstanding fire, building, water, and/or tax violations.

Property investors, site owners, and lenders have different motives for ordering a PCA. For lenders, the PCA is important for a number of reasons. Lenders commonly use periodic PCAs to revalue assets in real time, such as after a major capital expenditure or rehab, and the report serves as a check of the value they carry on their books.

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For prepurchase due diligence purposes, a PCA benchmarks a property's physical condition and offers estimates on current deficiencies and likely capital needs over the life of the loan—also useful for lenders when structuring deal terms. Lenders can use the information to validate the requested loan amount and even gauge a borrower's creditworthiness. Deferred maintenance may indicate that a borrower's creditworthiness isn't up to par or that cash flow problems exist.

“A property condition assessment is the single best indicator of how borrowers treat their assets,” said Sean Dundon, a principal with Blackstone Consulting. “If the PCA indicates that the borrower or client has a great deal of deferred maintenance, lenders can assume those habits won't change.”

While PCAs can be conducted on any type of property—residential, commercial, or industrial—they are typically performed on properties involved in commercial real estate transactions. These commonly include hospitals, affordable and market-rate multifamily and senior housing, car dealerships, vacant or abandoned buildings, chain restaurants, banks and bank branches, food stores, office buildings, hotels, self-storage sites, warehouse/distribution facilities, shopping centers, and parking structures. Typically, the assets subjected to a PCA are valued at \$2 million or more.

Cost and Turnaround

Prices for PCAs can vary widely, depending on 1) the size and type of property to be assessed; 2) the turnaround time; 3) the scope of work; 4) the age, type, and size of the buildings and land associated with the facility; and 5) whether or not specialty subconsultants must be brought in to help with the evaluation. For example, the cost of a PCA for a small commercial building, an apartment community of 100 units, and a large hotel might run around \$1,500, \$3,000, and \$25,000-50,000, respectively.

Lenders can expect to pay around \$2,200 for a PCA prepared for mortgage financing purposes with a standard 15-day turnaround. Like price, turnaround varies with the size and complexity of the asset. Fifteen to 20 business

days is average, although rush jobs can be completed in as few as five to 10 days.

NonScope Considerations

When ordering a property condition assessment, lenders should consider adding items to the inquiry that are outside the scope of ASTM's standard, just as they might add a lead-

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based paint assessment or asbestos evaluation to a Phase I ESA.

Robert Occhiogrossi, a registered architect and a vice president of IVI Due Diligence Services, said most of his clients follow

or exceed the minimum requirements of ASTM E2018—especially the ones who have been burned. “Usually, a client who has had a problem on a previous loan will incorporate that problem into their scope of work. For example, polybutylene piping is not mentioned in the ASTM standard, but it has a history of failing at pipe joints and fittings and is therefore seen as a critical item in existing building condition assessments.”

“ASTM's standard is a bare minimum,” agreed Dundon. “Just like Phase I ESAs, there are many nonscope considerations that fall outside the standard, such as compliance with the Fair Housing Act amendments. Many clients have their own scopes of work and require, for example, things like building code compliance, determinations of zoning conformance, and confirmation of bulk data requirements such as height restrictions, setbacks, and parking space counts.”

Other typical nonscope requests include modified capital replacement reserves; insurable/replacement value calculations; mold assessments; reviews of specialty items such as façades; seismic zones and seismic loss assessments; flood plain information or FEMA wind zone information; assessments of furnishings, fixtures, and equipment; or an opinion of building replacement costs. Clients also sometimes request specialists, such as roofing and elevator consultants or life safety engineers, to perform more extensive evaluations. A discussion with the PCA provider can determine which add-ons might be useful.

Hiring a PCA Provider

Property condition reports contain information that is collected and filtered from multiple sources. The provider must figure out how a building is constructed and how the property operates, determine the history of additions, renovations, and capital investments, and estimate costs. As such, the report is only as good as the skill of the person conducting it. Accordingly, lenders should be careful to hire only experienced providers with registered

architects or professional engineers on staff to review the project, inspect the asset, or both.

While the ASTM standard does not outline specific requirements for the PCA field observer (defined as the person who conducts the PCA and prepares the report), it recommends that the PCR reviewer be an individual “who possesses a professional designation in architecture or engineering, or appropriate experience and/or certifications in the construction field. The PCR reviewer should have experience commensurate with the subject property type and scope (size, complexity, etc.) and experience in the preparation of PCRs....”

PCAs performed for lenders typically have much narrower scopes than those performed for equity investors or owners. (Rather than use the lenders' generalist approach, prospective purchasers often require a team of licensed professionals to perform the site assessments.) Therefore, a PCA performed on behalf of a borrower may not be applicable for lenders' underwriting purposes.

Economic Considerations

While PCAs provide important information for any commercial real estate transaction, they are especially useful in tough economic times. “PCAs provide an unbiased assessment of the level of deferred maintenance at a property. That data can be very helpful during a weak economy, where short-term considerations may play a role in the delay of system maintenance or replacement,” said Eric Westergaard, P.E., a director of PCA Services for ATC Associates. This affects not only the property's current value, but its value over the term of the loan, he adds.

Bottom Line

Lenders who aren't using property condition assessments should consider doing so. A PCA is a valuable tool that, depending on the scope of work and team qualifications, can be used in prepurchase due diligence and for the life of the loan as a reference point and asset management tool.

A property condition report shows whether the asset is being maintained regularly and whether the site has any inherent design defects or flaws that will make the asset difficult to maintain, manage, or perhaps even sell—valuable information for lenders. A good PCA with the proper scope will also help the owners stay in compliance with applicable codes and regulations.

“Just as one would not buy a home without a home inspection, an investor or lender should not spend millions without knowing what they're getting,” said Dundon. ❖



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