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ROI Check-Up

A property condition assessment can protect against deal-killers.

by Joe Derhake, PE

Many investors ignore the return on investment that property condition assessments often can deliver. PCAs yield an ROI in three ways: protecting buyers from bad purchases; providing buyers with information for price negotiations with sellers; and finding opportunities to improve building value post-purchase.

Not all PCAs are the same. The property condition scope outlined in ASTM E2018 is a very flexible standard. The ASTM PCA is a walk-through assessment where a knowledgeable architect, engineer, or building inspector walks through the asset, interviews available personnel, reviews available records, and evaluates the condition of all building systems. For large assets and clients with lower risk tolerance, an engineering assessment firm can upgrade the inspection by bringing in a specialist such as an elevator inspector or an engineer who is trained in mechanical, electrical, structural, or plumbing systems. While this increases the investigation's cost and depth, property owners who regularly order equity PCAs should experience greater ROI.

Dead Deals

Some buyers hire engineers to conduct PCAs to find deal-killer problems. These can include very large capital expenditure items, such as leaking curtain walls, leaky plumbing, faulty elevators, and heating, ventilation, and air-conditioning issues. As a general rule, when the immediate needs and deferred maintenance items add up to 1 percent of the purchase price, they can kill a deal.

Deal-killer findings are not uncommon. For example, during a recently completed PCA for a medical building in Phoenix, the exterior insulation finish system was found to have an undulating surface at specific locations, which triggered a concern about poor installation. An interior inspection in

those areas revealed blistering wall paint, rusting lintels, and stained ceiling tiles, indicating moisture within the exterior wall cavities plus the potential for mold to exist. After being provided with the PCA report that included associated repair recommendations and costs, the buyer decided not to move forward with the acquisition.

In earthquake-prone locations, seismic risk issues also can kill deals. Often a buyer's seismic risk tolerance is determined by its capital sources. Some lenders require a probable maximum loss report and a seismic retrofit or a very expensive seismic insurance policy if the PML report yields a number above a certain threshold. Buildings with high PMLs can cost investors money in financing premiums or higher insurance costs even if the asset never experiences a big earthquake.

Negotiation Tool

Often buyers ask for purchase price reductions to address PCA-reported items. Engineers sometimes find themselves in the middle of these negotiations and their services, expertise, and acumen can yield a very tangible ROI.

For example, during a recently completed PCA for an office building acquisition in the Midwest, the membrane roof system, which was 11 years old, was found to have water intrusion issues due to poor installation. Because of the PCA findings, an infrared detection test for the roof system was completed and pockets of subsurface moisture were discovered within the roof assembly. The buyer was given the PCA report and test results. A full roof replacement would have cost more than \$500,000. As a result, the seller negotiated several options to the buyer such as providing a 10-year full roof warranty and annual maintenance with the existing roof system in place or a significant reduction of costs in the building acquisition.

Adding Value

Energy benchmarking is a useful tool, especially for value-add investors. Energy audits are comprehensive studies of how buildings consume energy, resulting in a list of energy-

Engineers can yield a very tangible ROI.

reducing recommendations with quantified installation cost, cost savings, and payback period. The added value of a building comes from two components: an increase in net operating income due to reduced operating expenses and an increase in building value when applying a capitalization rate to the reduced NOI.

As part of a recent office building energy audit, a lighting system upgrade was recommended. The existing antiquated T12 lamps and magnetic ballasts were replaced with T8 lamps and high-efficiency electronic ballasts along with motion sensors where appropriate. The total cost of the project was approximately \$44,000, which included a rebate from the local utility company totaling 15 percent of the installation cost. The reduction in electric consumption saved

\$14,700 per year, and the payback period was approximately 2.9 years. At an 8 percent cap rate, this higher net income increased the building value by \$183,000, or 4.2 times the installation cost. Over a 10-year period, the internal rate of return of this investment is approximately 34 percent. With typical equity investment yields in real estate falling well below 18 percent, investing in a lighting upgrade certainly proved to be an accretive investment opportunity.

The cost of an equity PCA with a specialty inspector may be more than \$10,000 whereas a standard ASTM E2018-compliant PCA generally costs around \$2,500. Therefore it is important to discuss your needs and what you know about the building with the engineer, as all equity PCAs are custom in scope.

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