

DUE DILIGENCE CHECK LIST

Through the lens of property management

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After reaching an agreement on terms and conditions to acquire a new property, there are a myriad of due diligence items to inspect and consider before closing. From our vantage point, below are the top ten items to consider, which have the greatest impact on the performance of the asset after closing:

1. Relative Demand

The type of property that appeals to the largest audience is a one story, three bedroom, two bath, single family home with a two car garage, a fenced in yard and located on a quiet street. If the property is located on a noisy street, be careful as it can be very difficult to lease up as there is little demand to live on a busy street. Next, stay away from awkward floor plans, especially a three bedroom home with one bath. Put more emphasis on a location near good schools, larger employers, and area amenities such as restaurants, parks, community pool, grocery stores and entertainment. As gas prices continue to climb, so does demand for homes closer to employment.

Don't be fooled by the purchase price alone.

2. Current Lease Agreements

If the property being acquired is currently occupied, keep in mind there is an ideal time to for a lease to expire. Leases that expire in May, June or July are preferred as this is the peak leasing season and the market will support the highest rates. A majority of people are on the move and looking for a place to live during this time of year. As a result, in most cases, lease concessions are not necessary and the property can be leased up without delay. Granted, there is more inventory on the market during this time of year; however, property moves rapidly in the summer months and if the current resident decides to vacate during this period, it will be much easier to lease. On the contrary, leases that expire in November, December or January, are much more difficult to lease as very few people are looking during this time of year. Be prepared to consider lease concessions or discounts on the terms in order to lease up the property.

Before the option period expires, negotiate for a renewal of the current lease agreement to expire in May, June or July before closing.

3. Lease Renewals

In 2007, we conducted a study of renewal rates for different types of property in our portfolio which consists of assets north to Round Rock, east to Manor, south to San Marcos, and west to Lakeway. Single family homes in general, regardless of price or location, had the highest renewal rate of any other property type available. Keep in mind this includes offering the lease at the same rental rate. Renewal rates on duplexes versus single family homes were 50% less, regardless of price, location and time of year. Renewal rates on multi-plexes were the lowest of any property type. So, while a multiplex may have an attractive rent roll versus price, keep in mind that you will experience higher turnover rates. At the end of the day, the most expensive outcome for landlords is turnover. To hedge against turnover, the safest investment is still a single family home, one story, three bedrooms, two baths, two car garage and a fenced in yard. This layout appeals to the largest audience and offers the best chance to keep residents for a long period of time.

Factor in renewal rates in your budget model.

4. Credits and Resident Statements

The rent roll by itself does not tell the whole story. Be sure to request and review each resident's statement to get an accurate picture of how they are performing. Specifically, review the details to see if a resident received a move in special credit. For example, the resident may receive the last month free or a pro-rated discount over the term of the lease. If so, you'll need to plan accordingly or negotiate from the seller to receive this credit. Check to see if the resident has paid on time. Have they been charged back for any repairs? Also, check the move in date for each resident. If a large majority of residents have moved in within the past three months, it's likely the seller rushed to move them in just to make the property look more attractive. It is very possible the residents were not screened as thoroughly. Long term residents are extremely valuable to landlords.

*How are the residents truly performing?
Are there any credits to consider?*

5. Security Deposits

Security deposits are also an indicator of the predictability of the resident and their future performance. Market conditions in the area typically support 80%-100% of one month's rent for the security deposit. If the resident has less than this amount, chances are they will not take care of the property as they have little motive.

Negotiate with the seller to increase the security deposits so you are covered once the resident decides to leave. After closing, be sure to notify the resident that you have increased their security deposit on record to help encourage them to better care for the home.

Does the resident have an incentive to take care of the property?

6. Market Residents vs Section 8 Residents

Section 8 assistance is a government program designed to help needy families with a housing allowance. The applicant applies for aid and if approved, the government guarantees a portion or all of the rent. At first glance, this sounds too good to be true. However, just like there are good market residents and bad ones, there are also good Section 8 residents and bad ones. Some residents may not care for the property since someone else is paying the bill. It's human nature. Do you treat the rental car any differently than you treat the car you own? Taking this one step further, how do you treat the rental car if someone else is paying the bill? Also, there is no guarantee the resident will remain on the Section 8 program for a definite period of time. If the resident is terminated from the program during the lease period, so are the payments leaving the landlord with an eviction or a vacant unit. Lastly, the government does not pay for any damages incurred by the resident.

There is ample risk with the Section 8 program.

7. Inspections

Besides the basic property inspection, be sure to request a plumber to run a camera and inspect all of the lines, especially to and from the sewer, as large beautiful trees also mean large and possibly damaging roots. A basic inspection will not necessarily reveal the condition of the lines. Also, be sure to have the foundation inspected by a certified and licensed company. From Oklahoma to South Texas, red clay is prominent and the soft soil creates a challenge for foundations. Properties that have a sprinkler system in place have a better chance of remaining stable as they are not prone to the extreme weather patterns of central Texas. Additionally, if the property has any age, be sure to contact our office for additional insight as our staff may have managed the property in the past. Finally, in today's market, request the seller to pay for all the inspections, as they may not know it's true condition, and offer to reimburse the seller at closing. Being thorough can be expensive, but not as expensive if you find out the hard way.

The devil is in the details.

8. Home Warranty

Home warranty policies are a good investment to protect against the larger and more expensive items such as appliances, electrical and plumbing. The older the property, the more valuable the home warranty is to protect against the big ticket items. As for smaller repairs, home warranties are not worth the expense as they can be addressed on the spot for about the same price versus filing a claim and waiting for the service men.

Protect yourself against the big hits.

9. Budget

In analyzing the actual performance of properties in our portfolio over the years, the following assumptions will assist to accurately forecast the performance of an asset. Keep in mind some years these figures will be higher and other years they will be lower. The key word is average:

Vacancy: For single family homes, factor in a 5% annual vacancy rate. For duplexes, estimate a 10% vacancy rate as these assets incur more turnover in general. For apartments, the optimal vacancy rate is 5%.

Maintenance: Estimate 5% of the monthly rental amount for maintenance on properties 10 years old or older.

Deferred Maintenance: Earmark 5% of the monthly rental amount for deferred maintenance on items such as appliances, hot water heaters, A/C, furnaces and a roof. Either renew the home warranty policy or budget for the following replacements (parts only):

Appliances / Equipment:

Dishwasher - \$189

Refrigerator - \$399

Stove - \$289 - \$329

Hot Water Heater - \$400 to \$600

Furnace - \$500 to \$800

A/C Condenser - \$700 to \$850 for 2, 2.5 or 3 ton

Budget real numbers and plan accordingly.

10. Risk - Eviction Rates

In 2007 and 2008, we completed an analysis on eviction rates to understand if there was any correlation to rental rates, location or property type. The analysis indicated a direct correlation between eviction rates and rental rates. The lower rental rate the higher the eviction rate. Interestingly, once the rental rate exceeded \$800 per month, there was no longer a correlation between rental rates and eviction rates. Regardless if the rental amount is \$4,000 per month or \$850/mo, there is a 5% chance the resident will be evicted for non-payment of rent. For rental amounts less than \$800, the eviction rates are more than double as the resident lives on a paycheck-to-paycheck basis and are unable to weather the loss of employment or any other unexpected financial event. The possibility of an eviction is the number one reason why clients hire our firm. First, to thoroughly screen the applicant and second to process an eviction should it be necessary.

*There is always risk in predicting the performance of real estate.
Real estate is not about property, it's about people.*

Bottom line, we are here to assist in your acquisition efforts as we see how different types of properties truly perform on a daily basis. **Feel free to contact our office at (512) 282-7393** during your due diligence period as we offer free consultation. We look forward to assisting you in the future.