CHAPTER THREE

Do your due diligence

You can't put a price tag on information and preparedness.

"Diligence is the beginning of brilliance."

In December of 2019, we purchased an apartment building. Prior to close, in one of our information gathering sessions with the landlord's realtor, we spoke about the roof. His exact words were, "It's in good condition, don't worry. You have at least seven years before it needs replacement."

We proceeded with our Building Condition Assessment (BCA). It was thorough but given the weather, and in particular the snow buildup, it was impossible for our inspector to go onto the roof for a proper evaluation.

We had two choices:

1) Take the landlord's word for it. The roof was in good condition.
2) Figure out a way to assess the roof accurately.

While we know many an investor who would have easily chosen option 1) without a second thought, that wasn't us. A roof inspection was essential to our due diligence process. So, we hired a drone for $250. And you won't believe what it found.

The roof was completely shot!

7 years?! Try 7 *weeks*.

We still purchased the building, by the way. Except that now we had negotiating power – $25,000 off the purchase price (the cost of a new roof), to be exact.

Think you can cheat on your due diligence? Think again. In this case, if we hadn't taken matters into our own hands to ensure the assessment of the roof, we would have paid at least $25,000 more for the building *and* we would have been in for a rude awakening after closing when we finally realized the actual state of the roof. Not to mention the fact that we'd be out-of-pocket an extra $25,000 to replace it.

Due diligence is a pain in the ass. Absolutely. It's time consuming, expensive, exhausting and can even become overwhelming at times. But it is critical to sound investing.

Why?

1. Information
2. Peace of mind
3. Minimized risk

Proper due diligence provides you with all the information you need to make an intelligent decision. Sometimes, it's what reveals a serious flaw with your potential purchase to give you incredible negotiating power. Other times, it identifies the positive attributes of a property to give you that added confirmation that you're making a good investment.

Due diligence puts in clear view the good, the bad, the minor considerations and the major concerns. In the event of large real estate investment purchases such as the apartment buildings we find ourselves evaluating, proper due diligence gives us deep insight into the lifetime of that building. It's invaluable.

Take warning, however. When it comes time to do it, you may feel tempted to forego the money and effort. Thorough due diligence can run you ten thousand dollars or more, which can be difficult to swallow upfront. But all you need to ask yourself is, "Do I want to do everything in my power to make sure this is a good investment? And if it has issues I am uncomfortable with, don't I want to know this now so I can walk away?" Give yourself that added level of peace of mind – it's worth every penny in the long-run.

Investors, especially those who are already seasoned in the market, often think they know everything on their own. This is a dangerous assumption because you may be a shrewd investor, but that doesn't make you an expert on the construction of a building or the state of the electrical panel. Minimize your risk. Enlist the services of professionals and surround yourself with a reliable team that can give you the structural, internal, external and environmental details you need prior to making a decision on a property.

While most A and B lenders (banks, credit unions) require due diligence in order to approve you for financing, private lenders don't always make it a requirement. In these cases, YOU need to make it a requirement.

Even though our investment model is to buy, renovate, rent and hold on to our properties for the long-term, we walk in to each transaction with a different mindset:

We see every investment as a potential sell.

When we temporarily shift our thinking in this way as we conduct our due diligence, this allows us to view our potential asset as sellable. In the event that we want to liquidate sooner than our master plan dictates, how easy will it be to sell? What are the existing and future issues that may make the sale more difficult?

In the apartment building market in Ontario, we believe the key aspects of a thorough due diligence process are:

Building Condition Assessment ($2,500+)
A building condition assessment is an evaluation of the condition of a building's structural foundation and superstructure, mechanical systems and envelope performance. It's an essential step towards making informed decisions regarding your commercial real estate offer and it's usually this that makes or breaks a deal.

Appraisal ($3,000+)
In a property acquisition process, you definitely want to know the appraised value of the building. In commercial multi-family real estate, this cost can run anywhere from $3,000 and up. One time, because of the type and size of the apartment building, we paid $15,000.

Elevator inspection ($2,000)
This is not required, but we highly recommend it. Take a second to think about this. If you're considering the purchase of a building that is far from new, that means the elevator is also far from new. Imagine you acquire the property and shortly after, the elevator breaks down. Now you're out at least $50,000,

whereas you could have paid about $2,000 to have a proper inspection conducted ahead of time.

Environmental Assessment (Phase One: $3,000+)
An environmental assessment identifies, estimates and evaluates environmental impacts on the building. For example, what are the impacts of a gas station next door? Dry cleaner? Funeral home (the older ones are known to have huge oil tanks under the ground to facilitate their incinerators)? Auto repair shop? Highly industrial factories? In our experience, it is the presence of these types of places that pose a higher environmental risk to your building. This is exactly why we take a close look at the area, neighborhood and street. A Phase One environmental assessment is a visual inspection usually around $3,000, Phase Two is a deeper inspection according to findings in the direct surroundings of the building and costs upwards of $10,000. A piece of advice: if something is found in Phase Two, walk away. It's not worth taking any further.

That leads us right into our next point: *location, location, location*. Yes, it is important enough to be stated three times! One of the most critical components of proper due diligence is taking the necessary time to ensure that you are finding the ideal location for your investments.

We take this very seriously and conduct a wide range of research in order to determine whether or not we think a location is suitable.

In the commercial multi-family real estate space, at the moment lenders are showing their preference in larger cities that have strong economies supporting them. Cities that are home to many different industries are considered good options. A couple of our current favorites are Ottawa, which has government, manufacturing, tourism, education and healthcare; Brantford in which manufacturing, healthcare, education and trades are prevalent; and Hamilton, a city known for its steel industries, recycling, hospitals, universities, colleges, an airport and shipping. On the flipside, Edmonton, for example, isn't a city where we would consider investing, not because it isn't a fantastic city, but because it is dominated by a single industry: oil. When oil prices plummeted earlier in 2020, the city was immediately impacted and now rental vacancies are a huge problem.

Other city-level traits to look for include infrastructure, hospitals, high immigration and public transit.

"A line I love to use in our investment selection process is:
***Buy the worst building on the best block**."*

- - Jamie Collard

When we say "worst building" we mean the one that's rundown, needs cosmetic repair and whose rents are 50% lower than what they should be because of the state of the building itself. "Best block" refers to the one that has great amenities close by, schools, high walk scores, nearby bus and subway stops, attractive restaurants and stores. As we select our buildings, we're keeping two key audiences in mind: seniors and millennials. What would each of them look for in an apartment?

We love fixing up buildings that need work and raising their property values in the process. We are careful not to get involved in structural repairs and focus on the cosmetic side of the equation. And we look for concrete buildings, not wood-frame. It's a well-known fact that concrete buildings have less sound travel from one unit to the next and experience far fewer structural issues than wood-frame buildings – not to mention the fact that property insurance is significantly cheaper for the former.

To find the best buildings that meet your criteria, you've got to have exceptional commercial realtors on your side. We are very fortunate to have what we consider to be one of the best realtor groups in commercial real estate in our area. A good realtor team plays a key role in your due diligence process because, if they're doing their jobs right, they can supply you with the bulk of the documentation you need including 24 months of bills like utilities, repairs and insurance claims, the site plan, building permits, engineer drawings and so much more.

Let's be honest, especially on a commercial multi-family building, any realtor team is making a shitload of money on that transaction so make sure they're pulling their weight and doing what they're supposed to do. Now we have a great team we can rely on, but in the past we've had realtors who provide nothing in terms of required documentation. When this happens, you have no choice but to reach out to your lawyer, which only drives up your legal costs. For what?

Contrary to what our humble beginnings looked like in real estate investing, we now have thorough and strategic checklists in place that cover everything from tasks to required documentation. And every item on the list is associated with a person's name who is responsible for the fulfillment. By doing this, we have specific checks and balances in place and we decrease the likelihood of something falling through the cracks.

Think you've settled on the ideal building to become your next investment property?

Now it's time to support your idea with data-based evidence.

1. **Crunch the numbers.**

   What is the purchase price of the building? What are the closing costs? How much will renovations be? What is the projected rent increase? What is the building's forecasted value after renovations are complete?

   Use spreadsheets and documents to record every number and make every calculation that will help you determine whether or not this is a money-making opportunity or a money-down-the-toilet poor decision.

   We have a strategy we've now used a few times in which we go on Facebook Marketplace and advertise a unit from one of our previously renovated buildings (our unit renos all look the same: grey walls and flooring, Quartz countertops, shaker cabinets), made to look as though it is a unit at the address of the new building we're interested in purchasing but haven't yet done so. The rent is posted at the rate we anticipate it to be after renovations. Then we wait. Is there any interest? If so, that tells us we're probably on the mark with projected rent to attract tenants to the space. If not, we may be off in our projections. A few times, these "faux listings" have received so many inquiries, that we've had to quickly remove them.

   Create pro forma financial statements. These are designed to facilitate comparisons according to historical data and future projections. For an apartment building investment, the key numbers in your pro forma will include pricing information, renovation costs, closing costs, expenses, carrying costs, utilities and vacancies, to name a few. A pro forma gives you an in-depth look at your investment and shouts out loud and clear whether or not you will come out the other side cash positive, or cash negative.

   On each and every one of our investments, within 12 to 18 months we want a free apartment building (at least!). Let us explain: every dollar we put into the building, we want to be able to pull out once the new appraisal comes in and we refinance the mortgage. And that's our bottom-line goal – if we've made a great investment, we're able to pull out our invested money *and then some*. After a refinance on a successful apartment building investment, it's not impossible to make $1-2 million. We also want to earn $50,000 per month, per building. Here's how we do that: every time we increase the Net Operating Income (NOI) of a property by $1.00, we subsequently increase the value of the building by $20.00. As tenants move out of a building we've acquired, we start renovations. As renovations are completed, rents increase. And this is how we build our net wealth over time.

Always remember this line (which you've probably heard many times before): *cash is king.* It certainly is. How much cash are you making on your investment? Are you cash flow positive with your rents each month, after you factor in all expenses? To keep your career propelling forward, what you do with your cash is also critical. Let's say we can make $1 million from one of our buildings after a refinance, if we pull it out, we can invest in another building or engage in private lending. Once again, this is fueling our growth and furthering that dream of ours to be able to just pick up and go at the drop of a hat…traveling wherever our hearts desire in that moment.

Numbers are what really matter in the grand scheme of your entire investment plan – not just the property you're currently considering. It always comes back to cash and overall net worth. For us, the latter is the most important. What is the accumulated worth of all our assets? If we sold them all at some point, what kind of cash would we be left with? We're at a point now where we would be able to put that money in a savings account, and live off the interest comfortably, never needing to worry about going back to full time jobs – which feels fucking impossible to us now! We don't want to set our alarm clocks ever again.

"In fact, if there's the odd day when I set my alarm for an appointment, as soon as I hear it my heart jumps and I think in my head, 'Shit! I have to go to work!' After a second I lie back down in my bed relieved that it's not true. I guess that sound has conditioned my brain for good."

- - Leslie Collard

2. **Get pre-approved for a mortgage.**

If your numbers line up, it's time to move on to Step 2. You must determine whether or not you can solidify a mortgage on the property and what the required Loan to Value (LTV) will be. If you cannot get pre-approved, your opportunity is dead in the water and there's no use wasting time and money on the rest of your due diligence tasks. Ideally, you have a pre-existing relationship with a commercial mortgage broker who can give you an answer within a few hours.

3. **Visit the property.**

Pre-approved? Excellent. Now it's time for you to visit the property in person. Do a walk-through. Pay attention to the street, surroundings and local area. Inside the building, look out for any red flags. Get a feel for the place. As you see more and more properties and become a seasoned investor over time, you'll notice that you become quite good at knowing what to look for and figuring out whether or not this is a good investment – just from your walk-through.

Right around this time in any given transaction, we like to find the local tenant Facebook pages and monitor what people are talking about. You'd be surprised what you can find out from people who are just looking for a place to vent. One building turned out to have an obscene number of tenants speaking out about the perpetual infestation of bedbugs and cockroaches for years! It was even in the news. So, our realtors called the owner, thinking we might be able to acquire the building on a steal because of all the bad press. It didn't go through, but this demonstrates the kind of initiative you can take when you have powerful knowledge behind you.

We like to talk to current tenants and ask them questions like, "How do you like living here?", "Do you have any problems with your unit?", "How is your electrical and plumbing?" Some tenants just give simple one-word answers whereas others go on and on about everything they see that's wrong with the building. Are you thinking what we're thinking? Negotiating power!

One time our walk-through of an advertised 4-unit building revealed that it wasn't a 4-unit residence at all, but rather a triplex with an illegal unit in the garage! It smelled horrible, and the poor tenant hadn't had hot water for three years.

4. **Put in an offer.**

   If you like what you see during your walkthrough, and you feel confident and ready, it's time to put in an offer. It helps to have an excellent realtor in your corner at this phase. Determine a fair, yet lucrative, price and away you go. Then come the negotiations, so brace yourself.

   One of our methods is to show up with an offer in-hand during our walk-through. This demonstrates our seriousness in the deal and our confidence in moving forward – as long as the landlord has been honest about what they've disclosed to us thus far. When we put in an offer at this stage, it is always conditional on a thorough due diligence process, which includes assessments and appraisals.

5. **Do your due diligence.**

   If – and only *if* – your walk-through is a success and your offer has been accepted conditionally, do you begin your extensive due diligence process. Here is where you will conduct a building condition assessment, order an appraisal and acquire an environmental assessment.

   For us, we're at the stage where after we've completed our walk-through, we know if we're going to close on the building or not. If we are, we bring in our entire team simultaneously:

   - Building condition assessment engineer
   - Appraiser
   - Project manager
   - Property manager
   - Environmental specialist

   We do this to save time and be as efficient as possible. If at any point, something is found that changes our view on the investment or simply poses too much risk, we walk.

Cheating on your due diligence is cheating yourself out of an intelligent investment. Picture your investment as a carpet atop a floor. The property is the floor. Your due diligence process is the carpet. As you peel back each corner of that carpet, how does the floor look underneath? Polished, solid and intact? Or, carpet in hand, with each backwards step and each new inch revealed, do you find stains, holes, missing boards or something worse?

You want to do everything in your power to ensure that you will be successful. If a property you invest in has detrimental flaws that you didn't make an effort to identify, you just shot yourself in the foot. Instead, use due diligence to close the door of uncertainty and position you and your investment for success.