



## Property Conditions Impacting Real Estate Transactions

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## **Property Conditions Impacting Real Estate Transactions**

Question #1:

“My Firm originates around \$1 billion of loans per year and we have never developed our own in-house policy for environmental due diligence. Instead, we simply require that the consultants follow ASTM standards. Is this an acceptable position from the standpoint of environmental risk? What are the other alternatives?”



## Property Conditions Impacting Real Estate Transactions

- **YES** for both questions, depending on property & loan type
- “All Appropriate Inquiry” (AAI)/ASTM E1527-05
  - » New protocol for Phase I reports
  - » Final rule promulgated November 1, 2005 (effective November 1, 2006)
  - » Provides CERCLA protection if done properly
  - » Spells out requirements for Environmental Professionals



## **Property Conditions Impacting Real Estate Transactions**

- Alternatives to ASTM/Phase I's
  - » Transaction Screens (ASTM 1528)
  - » Desktop Environmental Due Diligence
  - » Environmental Insurance
  - » Environmental Questionnaire Only
  - » Do Nothing
- Why some lenders choose not to do environmental due diligence
  - » Loan value is low/environmental risk assumed to be low
  - » Due diligence process perceived as cumbersome, long, & as expensive
  - » Perception that there is no simple way to capture this information



## Property Conditions Impacting Real Estate Transactions

### Environmental Due Diligence Options

AAI compliant Phase I

Phase I (non-AAI compliant)

Transaction Screen Assessment (TSA)

Desktop Environmental Review

Environmental Questionnaire

No Action

*More comprehensive as you move up*



## **Property Conditions Impacting Real Estate Transactions**

### **Summary of Environmental Due Diligence Alternatives**

- AAI - catalyst for banks to review & revise environmental policies
  - » National banks revising environmental policies today
  - » Federal/state regulatory agencies revisiting environmental policies/guidelines
- Spectrum of due diligence is expanding
  - » Simple, Fast & Cost-Effective due diligence options are sought for all loans, especially small cap loans, to be more competitive.
- Lenders have many options when looking to protect their bank from environmental issues



## **Property Conditions Impacting Real Estate Transactions**

### **Environmental Due Diligence Alternatives - Insurance**

- Lenders have attempted to minimize their environmental risk through various risk management tools such as Phase I's, transaction screens, database reports, environmental questionnaires & requiring financial collateral (indemnities & escrows).
- Problems can be:
  - » Time consuming
  - » Offer no protection to the lender should the environmental assessment fail to detect existing contamination
  - » Doesn't address possible new contamination that could arise during loan term



## **Property Conditions Impacting Real Estate Transactions**

### **Environmental Due Diligence Alternatives - Insurance**

- Environmental insurance is an alternative risk management tool for lenders to utilize as a solution to these problems
  - » On Portfolio basis - lender environmental insurance provides a quick, cost-effective alternative to traditional environmental due diligence.
  - » Provides lender with true risk transfer mechanism for environmental risk.
  - » Policy will pay for covered loss associated with a pollution event rather than simply try to identify it at specific point in time.
  - » Provides collateral value protection through financial compensation to the lender in the event of default and pollution event.
  - » Provides lender with competitive advantage as a result of lower processing fees & faster turnaround on loans.
  - » Provides cash flow management in the event of a claim.



## **Property Conditions Impacting Real Estate Transactions**

Question #2a:

“My bank is negotiating a \$5 million loan on a retail property in Atlanta. The borrower refuses to sign an environmental indemnity. The borrower claims that other banks will make the loan without an environmental indemnity. Should I agree to waive this requirement? Are there other alternatives?”



## **Property Conditions Impacting Real Estate Transactions**

- It depends on your banks environmental policy, property type and loan amount.
- Yes, environmental insurance for lender or borrower can be an alternative to environmental indemnities or escrows.



## **Property Conditions Impacting Real Estate Transactions**

Question #2b:

“If we agree to look at accepting environmental insurance in lieu of an environmental indemnity or escrow, should we require insurance in the name of the borrower or lender? What's the difference in policies and costs? What limits do we require?”



## Property Conditions Impacting Real Estate Transactions

### Environmental Risks in Lending:

- Pollution discovered, collateral depreciates and borrower fails to service the loan.
- Loss of CERCLA secured creditor exemption prior to or following foreclosure
- Following foreclosure (OREO), cleanup requirements may be discovered or third party claims made



## Property Conditions Impacting Real Estate Transactions

### Environmental Insurance:

- The Lender policy provides coverage for the the lender only – lender concerned about protecting collateral value (can be used for single site, portfolio, or securitization deals)
  - » Coverage A – Collateral Value Protection – 2 triggers
  - » Coverage B – First Party Clean-up (OREO properties)
  - » Coverage C – Third Party Liability (i.e. adjacent property)
- The Owner/Borrower policy provides coverage to the owner – lender may require if they are concerned about borrower not being able to service their loan due to environmental issues on-site.
  - » Coverage A – First Party Clean-up
  - » Coverage B – Third Party Liability
  - » Lenders can generally be added as additional insured



## Property Conditions Impacting Real Estate Transactions

### Environmental Insurance:

- Lender policy is generally less expensive than property owner policy.
- Choosing limits is generally done with the assistance of the environmental officer, environmental insurance broker &/or environmental attorney.
  - » Look at property type - what is worst case environmental loss based on environmental exposure
  - » What is loan amount
  - » Which lender policy form is utilized (OLB vs. lesser of)
  - » Capital market deals have specific requirements for limits per rating agencies.



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Question #3:

“What are the three property condition issues that have the most potential to adversely impact a property value?”

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### Numerous "Red Flags"

- » Expansive Clay Soils
- » Structural Issues
- » Deteriorated/Inadequate Balconies
- » Exterior Insulation Finish Systems (EIFS)
- » Termites
- » Tectum Roof Decks
- » Fire Retardant Plywood
- » Star/Omega Sprinkler Heads
- » Phenolic Foam Roof Insulation
- » Galvanized Piping
- » ABS Piping
- » Inadequate Bathroom Ventilation
- » Mold/Moisture Intrusion Issues



## Property Conditions Impacting Real Estate Transactions

### Top 3 "Red Flags"

#### Aluminum Wiring

- » Multi-family buildings constructed between 1965 and 1973
- » Aluminum wire and copper devices differ in expansion
- » Expansion at connections loosen wires
- » Hot spots (bends) causing fires
- » Requires CO/ALR devices or "pigtailed" to remedy



## Property Conditions Impacting Real Estate Transactions

### Top 3 "Red Flags"

#### LP/Masonite Siding

- » Multi-family buildings constructed between 1985 and 1996
- » Known as "Inner-seal" or "Waferwood"
- » Water infiltration problems, causing material de-lamination at joints and mold/fungus growth
- » Requires complete replacement



## Property Conditions Impacting Real Estate Transactions

### Top 3 "Red Flags"

#### Polybutylene Piping

- » Generally multi-family constructed between 1979 and 1995
- » Used as piping between main water supply and fixtures
- » Leaks at joints
- » Requires complete replacement





## Property Conditions Impacting Real Estate Transactions

Question #4:

“My bank is looking to provide a loan on a portfolio of approximately 60 ‘Class B’ multifamily properties located in Florida, Georgia and South Carolina and we have severe time constraints to complete the transaction. Our deal people want to forgo Property Condition Assessments, on the grounds that the strong creditworthiness of the borrower would mitigate any property condition risk. Do you agree with this approach?”

## Property Conditions Impacting Real Estate Transactions

- No. It is a business decision, but some form of due-diligence should be performed on the assets.
- Options:
  - » Complete Property Condition Assessments on all properties
  - » "Screening" visit to all properties, and prepare summary
  - » Review the properties, rate the deficiency risks based upon type, age and location of the asset, and visit those properties that are at the highest risk for deficiencies.





## Property Conditions Impacting Real Estate Transactions

Question #5:

"My bank is in the process of originating a \$150 million loan on a hotel in San Diego that was built in 1978. There are no code violations and the property is in great condition, yet the Probable Maximum Loss (PML) report has come back with a PML value of 24%. This surprised us, as we were assuming it would be pretty low. How do we know this figure is accurate? Is there any 'wiggle room'?"



## **Property Conditions Impacting Real Estate Transactions**

Aspects in Calculating Earthquake Loss Estimates:

- » Ground Motion Hazard Assessment
- » Site Stability
- » Building Stability
- » Building Damageability
- » Building Contents Damageability



## Property Conditions Impacting Real Estate Transactions

### Top Five Variables in Calculating Earthquake Loss Estimates:

#### 1. Ground Motion Hazard

- » Earthquake return period or exposure period with probability of exceedance
  - (examples: 475 year earthquake or the earthquake with a 10% chance of exceedance in 50 yrs)
- » Site specific?
  - Area
    - > Zip codes
    - > Gross project coordinates
    - > Seismic zones
  - Specific coordinates
  - Site conditions
  - Rating agency requirements



## **Property Conditions Impacting Real Estate Transactions**

### **Top Five Variables in Calculating Earthquake Loss Estimates:**

#### 2. Confidence Level on Loss Estimate

- Confidence on damageability, not the hazard
- Typically either a 90% confidence interval or a 50% confidence interval (mean)
- Coincides with Scenario Upper Loss (SUL) and Scenario Expected Loss (SEL)
- Consider lender policy and risk tolerance

## Property Conditions Impacting Real Estate Transactions

### Top Five Variables in Calculating Earthquake Loss Estimates:

#### 3. Site Stability

- Surface fault rupture
- Liquefaction
- Land sliding
- EQ induced inundation
- Settlement

#### 4. Building Stability

- Structural irregularities
- Instabilities
- Configuration
- Type of construction
- Quality
- Condition



## Property Conditions Impacting Real Estate Transactions

### Top Five Variables in Calculating Earthquake Loss Estimates:

#### 5. Building Damageability

- Building code
  - Quality
  - Condition
  - Structural characteristics
  - Lateral system
- Wiggle Room





## Property Conditions Impacting Real Estate Transactions

### Other Concerns – The Dirty Dozen

- Site Vulnerability
  - » Earthquake
  - » Inundation (floods, tsunamis)
  - » Wind (tornadoes, hurricanes, etc.)
  - » Landslide
  - » Subsidence
  - » Snow/Ice Loads
- Conditional Vulnerability
  - » Water infiltration
  - » Settlement and heave
  - » Corrosion (water, salts and debris)
  - » Fire
  - » Excessive deflections
  - » Cracking (vertical and horizontal framing)



## Property Conditions Impacting Real Estate Transactions

Question #6:

“Like most lenders, my bank requires flood insurance for any properties we loan on within a Flood Hazard Area. We require FEMA flood insurance to the lesser of the loan amount or the maximum FEMA provides. However, some of our properties in New Orleans experienced several million dollars in Katrina-related damage, but FEMA will only pay out \$500,000. Is that right?”

## Property Conditions Impacting Real Estate Transactions

The National Flood Insurance Program:

- Managed by the Federal Emergency Management Agency (FEMA).
- Established in 1968 by the National Flood Insurance Act to provide affordable flood insurance to property owners in flood-prone areas ("Flood Hazard Zones").
- In order to enforce participation by at-risk property owners, FEMA requires all federally regulated banks to mandate NFIP coverage for loans on properties in Flood Hazard Zones.





## Property Conditions Impacting Real Estate Transactions

### Typical Casualty Insurance Characteristics

|  | <b>Commercial Earthquake Insurance</b>          | <b>Commercial Hurricane/Windstorm Insurance</b> | <b>FEMA's NFIP Flood Insurance</b>              |
|--|---|---|---|
| <b>Property Damage Coverage</b>  | Available - negotiable limits (PML calculation) | Available - negotiable limits                   | Available - max limit of \$500,000 per building |
| <b>Contents Damage Coverage</b>  | Available - negotiable limits                   | Available - negotiable limits                   | Available - max limit of \$500,000 per building |
| <b>Business Interruption Coverage</b>                                  | Available - negotiable limits                   | Available - negotiable limits                   | Not available                                   |
| <b>Demolition/Increased Cost of Construction (Law &amp; ordinance)</b> | Available - negotiable limits                   | Available - negotiable limits                   | Not available                                   |
| <b>Claim Resiliency</b>  | Per occurrence                                  | Per occurrence                                  | Aggregate only                                  |
| <b>Value Calculation</b>   | Replacement Cost Value                          | Replacement Cost Value                          | Actual Cash Value                               |



**MBA's Commercial Real Estate Finance/  
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Questions?