CREFC EUROPE DUE DILIGENCE GUIDE

Note: This guide considers due diligence primarily in the context of a loan to be secured on United Kingdom real estate. It may not be appropriate in connection with other types of asset, nor assets situated in other counties.

The guide is designed as an overview only of the main issues the due diligence should address. It is not exhaustive and cannot deal with the specifics of every property or transaction, which may require additional due diligence beyond that contemplated within this document. Further, it does not deal in any depth with tax issues and reference should be made to the CREFC Europe Tax Guide in this respect.

CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A  INTRODUCTION</td>
<td>3</td>
</tr>
<tr>
<td>B   PURPOSE OF DUE DILIGENCE</td>
<td>4</td>
</tr>
<tr>
<td>B.1  What is Due Diligence?</td>
<td>4</td>
</tr>
<tr>
<td>B.2  Why undertake Due Diligence?</td>
<td>4</td>
</tr>
<tr>
<td>B.3  Who should undertake Due Diligence?</td>
<td>5</td>
</tr>
<tr>
<td>B.4  When should Due Diligence be undertaken?</td>
<td>6</td>
</tr>
<tr>
<td>B.5  Co-ordination of Due Diligence</td>
<td>6</td>
</tr>
<tr>
<td>C   TRANSACTION DUE DILIGENCE</td>
<td>7</td>
</tr>
<tr>
<td>C.1  Statutory requirements</td>
<td>7</td>
</tr>
<tr>
<td>C.1.1 Know Your Customer “KYC”</td>
<td>7</td>
</tr>
<tr>
<td>C.1.2 Money Laundering/Source of Funds</td>
<td>8</td>
</tr>
<tr>
<td>C.2  Borrower/Other parties</td>
<td>9</td>
</tr>
<tr>
<td>C.2.1 Legal structure/ownership</td>
<td>9</td>
</tr>
<tr>
<td>C.2.2 Legal power/capacity (legal opinions)</td>
<td>9</td>
</tr>
<tr>
<td>C.2.3 Tax</td>
<td>10</td>
</tr>
<tr>
<td>C.3.  Asset</td>
<td>10</td>
</tr>
<tr>
<td>C.3.1 Inspection</td>
<td>10</td>
</tr>
<tr>
<td>C.3.2 Development/project appraisal</td>
<td>10</td>
</tr>
<tr>
<td>C.3.3 Management/advisory arrangements</td>
<td>11</td>
</tr>
<tr>
<td>C.3.4 Tenant credit analysis</td>
<td>12</td>
</tr>
<tr>
<td>C.3.5 Financial modelling (including funding/debt service)</td>
<td>19</td>
</tr>
</tbody>
</table>
D ASSET DUE DILIGENCE

D.1 Primary reports (to be undertaken in most if not all cases)
D.1.1 Valuation
D.1.2 Legal certificate/report on title/property
D.1.3 Building/site/mechanical & electrical surveys
D.1.4 Measurement survey
D.1.5 Environment/ground survey

D.2 Additional reports (to be undertaken when circumstances require)
D.2.1 Planning (zoning)
D.2.2 Utilities (gas, electricity, telecommunications etc.)
D.2.3 Deleterious materials
D.2.4 Mining (coal, tin, lead, salt/brine, china clay etc.)
D.2.5 Unexploded Ordnance
D.2.6 Flooding
D.2.7 Occupational (health & safety)
D.2.8 Rights of Light
D.2.9 Infrastructure (railway, highway, waterways etc.)
D.2.10 Capital Allowances
D.2.11 Energy efficiency/performance

E INSURANCE ISSUES

E.1 Insurance Due Diligence
E.2 Legal Defects/Environmental Risk Insurance

F SUPPLEMENTARY ISSUES

F.1 Instruction Letters
F.2 Reliance

G DUE DILIGENCE BEST PRACTICE PROTOCOL
A INTRODUCTION

Two years ago CREFC Europe made a key decision. It recognised that one day the shadow of the Credit Crisis would start to dissipate and that it was important to be timely in addressing several fundamental aspects of the real estate lending market. Firstly numerous and important object lessons had been provided as a result of the crisis that should not be lost or forgotten as the property and financial markets improved. Secondly that the providers of debt in the future would not be exactly the same as the past; they would be a wider range of entities than simply banks and would represent a broader and probably more bespoke range of lending strategies. Finally the fall out of human capital meant that educational and training support to the industry may well be generally welcome.

CREFC Europe decided to address these aspects in a number of ways, one of which is building up a volume of thoughtful and rigorous work that offers best practice proposals for the complete value chain of property lending. Key areas of loan structuring, loan documentation, inter-creditor principles and hedging have all been addressed by specific releases. This paper now seeks to address the last key topic, namely due diligence.

In the years leading up to the Credit Crisis our industry did not distinguish itself in the extent and rigour of due diligence undertaken. Indeed the underlying principle of why we undertake such work was lost. Commercial property lending consumes vast amounts of capital and the impact of imprudent lending is usually very material for each individual lender and at the macro prudential level. We can have the most amazing and trusted client relationships but it remains incumbent on all lenders to retain a healthy degree of institutional scepticism on deal facts until they are allayed by professional experienced investigation.

Every transaction has differences but there does remain a core diligence process common to most. CREFC Europe has sought to bring together a wide range of leading experts that will, in summarised form, collate their experience into a single body of work that clearly conveys a cohesive methodology. This paper will provide a starting point for each lender to consider its own individual approach to diligencing loans it wishes to enter into and, we hope, assist in some small way to generally improving the quality of the overall lending business, increasing regulatory trust in the approach we as an industry adopt and assist in the wider training of those that actively participate in that industry.
B PURPOSE OF DUE DILIGENCE

B.1 What is due diligence?

Due diligence is the process of factual and legal investigation, research, analysis and discovery into the relevant borrower, asset, sponsor and other principal parties typically undertaken by a prospective buyer, lender or investor prior to entering into a transaction.

The precise scope of the exercise will vary depending upon the nature and value of the transaction and/or asset, the lender’s existing knowledge of the borrower, timing and cost considerations but, in the context of the acquisition of, investment in or loan secured on, United Kingdom real estate, typically involves:

- an analysis of the buyer’s/borrower’s business plan, cost projections, appraisals and cash-flow forecasts with particular regard to the buyer’s/borrower’s ability to service the debt and repay the loan at maturity;
- a review of the buyer’s/borrower’s, solvency, funding and tax position, principal fiscal issues and other liabilities affecting the property, borrower or buyer;
- enquires into the background, experience and credit record of the buyer/borrower, sponsors and/or other principal parties (for a development property, this could extend to the contractors and professionals engaged and/or any ultimate buyer or tenant);
- a physical inspection of the property;
- a valuation of the property (and/or, in the case of a corporate purchase, the value of the shares in the property owning company);
- an investigation of/report on the title to the property and/or legal restrictions affecting its use, an analysis of any risks associated with owning the relevant property arising from a legal or structural perspective and an assessment of the likely impact of other creditors, tenants or other persons also having interests in or rights over the property;
- where property is let, a review of the stability of the rental income stream, the creditworthiness of the occupational tenants, the terms of the occupational leases and insurance and asset management arrangements;
- a “health check” on the physical condition of the property and any buildings located on it, typically comprising reports on structural, measurement, planning and environmental risks;
- consideration of the principal insurances;
- an assessment of the impact of the transaction upon existing contractual arrangements or permits;
- consideration of the nature of the security to be granted and enforcement issues; and

The purpose of requiring separate reports for different due diligence areas is to ensure that the best quality advice is available. Individual areas can be very specialised and necessitate particular training and expertise – a buyer/lender/investor should therefore always satisfy itself that the professionals or persons responsible for these are competent and experienced in the area concerned. The credentials of any report provider can usually be checked with the report provider’s relevant professional organisation or regulator.

B.2 Why undertake due diligence?

The main purposes of due diligence are:

- to establish whether the relevant asset is sound for the purposes of investment or loan security;
- to verify information given, financial projections and/or assumptions as to the ownership, (value and condition of the property) made in connection with the company, asset or transaction generally;
- to identify any risks inherent in the transaction or asset and mitigate these where possible;
• to comply with applicable statutory or regulatory requirements;

• generally to assist the buyer, lender or investor in analysing the legal and, to the extent possible, factual issues associated with the relevant transaction, and deciding whether to proceed.

Issues arising during due diligence frequently impact upon the viability of a transaction, the price paid for the property or other material terms.

B.3 Who should undertake due diligence?

Seller

This involves identifying material issues which may influence a buyer’s or lender’s decision to invest or offer finance and collating documents and other information which a buyer, lender and/or their advisors are likely to require. Undertaking this at an early stage (even before marketing a property) will:

• assist in identifying specific facts or matters (for example certain defects in title) which the seller may be legally required to disclose;

• help the seller plan how and when to raise these with the buyer and put the seller in a better position to deal with questions raised during negotiations;

• enable the seller to decide what representations and warranties can be given and what qualifications to these are appropriate or necessary; and

• generally ensure that the transaction proceeds quickly and efficiently and reduce the risk of a material unexpected problem arising during the later stages.

Buyer

Any buyer of real estate should undertake due diligence to:

• test the assumptions made about the proposed investment;

• analyse the risks associated with the proposed purchase;

• ascertain whether all necessary information has been provided and, in light of any issues raised during the course of the due diligence process, what further enquiries or due diligence is required;

• verify the accuracy of information provided (on the basis of which the decision to buy/invest is made); and

• determine any outstanding issues which may prevent the acquisition from proceeding, e.g. consents or permits required from statutory bodies or (for leasehold properties) landlords for the buyer to purchase, develop or charge.

Further financial modelling and/or adjustments to the business plan may be required in light of matters arising. Once the process is underway, material points can be raised during the negotiations and appropriate provisions (e.g. warranties) included in the transaction documents. These may help the buyer to shape its business plan, facilitate effective and efficient management of the asset after purchase and planning an exit strategy.

Lender

The two fundamental concerns of a lender are likely to be the ability of the borrower to repay the loan and the value (in both legal and monetary terms) of the security. These will shape the nature and extent of the due diligence - for example if the loan is being underwritten primarily on the basis of a sponsor guarantee, the level of property due diligence may be less than for a transaction where the asset is the only or primary collateral.

For a lender, the primary purpose of due diligence is to assist with the internal underwriting and credit review processes. A lender will often, to save costs and avoid duplication of reports, seek to rely on the due diligence carried out on behalf of the buyer and, whilst in many cases this will be acceptable
where the respective interests coincide, where not so consideration should be given to undertaking an independent review. It is also critical, in such a case, that the lender is able to rely on the reports provided for the borrower (see F.2 on page 41 below). The results should help to ensure that the appropriate provisions are included in the loan documents, the correct security is taken and all relevant conditions are imposed and satisfied.

B.4 When should due diligence be undertaken?

Legal and tax due diligence and financial analysis should start once the parties have settled terms in principle and normally after a term-sheet has been signed. Subsequently more detailed asset and structural enquires and reports should be undertaken, but it should be remembered that many individual reports will take time to prepare and a sufficient period therefore allowed for further investigation or to deal with issues arising.

Individual reports will generally only confirm information and the results to enquires at the time which they are prepared, although due diligence is an ongoing process which should regularly be updated in the light of changes to circumstances (for example lenders usually require periodic revaluations to test the effectiveness of their security and the impact of any lease renewals or expiries - the insurances should also be checked regularly).

B.5 Co-ordination of due diligence.

All parties and their advisors should understand what due diligence is being undertaken and any restrictions on its scope. This may be influenced by:

- the type of property and its planned use;
- the number and location of properties being acquired;
- whether the property or properties are let and the number of occupational tenants;
- the identity of the seller;
- when the seller purchased the property and
- whether finance is required.

The extent of the due diligence should be in keeping with the value and importance of the acquisition to the buyer or investor and any risks identified should be analysed in the context of the transaction of the whole (so the risk profile associated with a portfolio of properties will be different to that of a single asset).

Documents, information and other due diligence materials should be organised into categories and scheduled so that a buyer/lender can more easily determine what is available and whether anything is obviously missing. For larger transactions, or where multiple bidders are expected, setting up a data room should be considered. On-line data-rooms should be secure, allow 24 hour and simultaneous access to different parties and be updated periodically throughout a transaction as and when new information becomes available (with users being notified of all updates). A complete and comprehensive index should be prepared and the content checked to ensure that documents are placed in the correct folders.

It is critical to check that the various reports all cover the same property and that any assumptions made about the property are reasonable and/or accurate. Accordingly copies of all reports should be sent to any due diligence coordinator and all other consultants who may be concerned with its contents (for example the legal report should be sent to the valuers and valuations to legal advisers to check the assumptions made relating to the extent of the property and tenancies, i.e. that the property the subject of the valuation and other reports is materially the same as that over which security is being taken).
C TRANSACTION DUE DILIGENCE

The following enquires, checks and diligence relate to the commercial nature of the transaction and will usually be undertaken at an early stage by or on behalf of the lender. The principal purpose is to verify that there are no material structural flaws in the transaction structure and that the information and appraisals upon which the credit decision to lend is based are accurate and reasonable in the circumstances.

Given the fundamental nature of these, and whilst some (especially legal) issues may be the subject of further reports, it would normally be prudent not to proceed to other levels and areas of due diligence until it is established that the results of these initial reports and procedures are, or are reasonably likely to be, satisfactory.

C.1 Statutory requirements (“KYC” and anti money laundering)

These checks and enquires must be made to comply with laws (in particular The Money Laundering Regulations 2007, the Proceeds of Crime Act 2002, the Terrorism Act 2000 and the EU’s Money Laundering Directive) relating to the source of funds and “money laundering” and are intended to reduce the risk of fraud and identify criminal activity. There are two separate limbs:

- the requirement to identify and check all principal persons involved with the buyer or borrower; and
- the duty to report any criminal or suspicious activity or circumstances.

The overall effect is to impose specific obligations upon organisations and professionals (including banks, funds, lawyers, accountants and surveyors) to check identities of individuals with whom they deal and the source of monies they receive.

This due diligence is not optional - any breach of the requirements could lead to criminal prosecution of the individual and/or organisation concerned.

C.1.1 Customer Due Diligence or Know Your Customer “KYC”

A full summary of all the requirements applicable to every particular case is beyond the scope of this guide but generally KYC

- is not only an identity check on the customer/client but also an enquiry into his/her/its ownership and control structure (in particular, identification of the ultimate beneficial owner) and business, scope and location of operations and sources of funds;
- must be applied on a risk-sensitive basis (i.e. background information about the customer/client and its business must be obtained to assess the degree of risk) - the requirements for one person are not necessarily the same as those for another, similar entity;
- is a continuing obligation and should be renewed periodically (for example when a corporate entity changes its shareholders/members); and
- requires a risk assessment - it is not sufficient just to obtain the basic information and further enquires raised or checks undertaken if appropriate.

Most lenders will have their own procedural requirements which should always be followed and, even if a particular lender is exempt from the legislation, the appropriate checks should still be undertaken otherwise it will be difficult if not impossible to transfer any part of the loan to another who is. These requirements should include checks to:

- verify the identity of the customer/client on the basis of documents, data or information obtained from a reliable and independent source (it is not normally sufficient just to rely on uncertified copies supplied by the customer/client);
• identify the beneficial owner(s) (if not the customer/client) and take adequate measures to verify identity (including, in the case of a corporate entity or trust, understanding its ownership and control structure); and

• obtain information on the purpose and nature of the business relationship.

The practical implications for the above vary but usually include (for individuals) reviewing passports and proof of address documents (e.g. bank statements and/or utility bills) and (for corporate entities) reviewing constitutional documents and shareholder lists. Additional investigation may be necessary where an individual is a “politically exposed person”.

C.1.2 Money Laundering/Identification of Criminal Activity

The following are all criminal offences:

• to engage in, assist with or facilitate money laundering;
• to conceal, disguise, convert or transfer criminal property or to remove it from any part of the UK;
• to acquire, possess or use criminal property.
• to be concerned in any arrangement which a person knows or suspects facilitates another person's acquisition, retention, use or control of criminal property.
• not to report to the Serious Organised Crime Agency (SOCA) any knowledge, suspicion or circumstances where there are reasonable grounds for knowledge or suspicion of money laundering (i.e. any one of the above offences).

“Criminal Property” constitutes or represents a direct or indirect benefit from criminal conduct (this could include complicity in arrangements which illegally evade tax or other statutory requirements). There is a defence to the first three offences if timely disclosure of relevant information has been made to SOCA which consented to continuing to be involved.

In addition, those engaged in certain types of business (including banks, financial institutions and law firms) are required to report to the appropriate authority any knowledge or suspicion of money laundering. Failure to do so, or disclosing relevant information to a third party where such is likely to prejudice a money laundering investigation (“tipping-off”) can also be a criminal offence. A company or individual could be liable in this respect even if the customer/client has passed all KYC checks.

There are further criminal offences specifically relating to terrorism as follows:

• inviting another person to provide money or property intending that it should be used (or having reasonable cause to suspect that it may be used) for terrorism;
• receiving, possessing or providing money or property intending that it should be used (or having reasonable cause to suspect that it may be used) for terrorism;
• being involved in an arrangement whereby money or property is made available to another person with knowledge (or reasonable cause for suspicion) that it may be used for terrorism or an arrangement which facilitates another person's retention or control of terrorist property.

The lender must satisfy itself that any funds which the borrower introduces are “clean” and not the proceeds of crime. Consequently a lender should usually investigate the borrower’s business background (and, in the case of a corporate entity, its main shareholders/members). The extent and nature of the enquiries will depend upon the standing and the lender's knowledge and experience of the borrower but warning signs include:

• unusual transactions or an unusual series or pattern of transactions;
• arrangements or structures having elements (e.g. layers of ownership, indirect control, foreign participation) the basis for which is not been satisfactorily explained;
• unusual commercial terms (e.g. a transaction being entered into at a surprisingly high or low price, or at a loss, or a transaction with no apparent purpose);
• payments made by cash or apparently directly between parties but without satisfactory evidence of payment/receipt;
• involvement of jurisdictions without strong money laundering controls; and
• undue secrecy.

C.2 Borrower/Other Party Due Diligence

This comprises basic checks and enquires as to the legal structure and capacity of the buyer/borrower to identify (and if possible resolve) any major legal, financial or other issues. This diligence may also extend to other parties to a transaction, for example if the seller, major tenant, developer or other party is subject to a form of insolvency process and, if any of these is not constituted or resident in the U.K. legal, tax or other advice relating to all other relevant jurisdictions will normally be required.

C.2.1 Legal Structure/Ownership

Generally a single/special purpose vehicle or “SPV” is set up as property owner and/or borrower. Such an entity should have no material assets or business, no creditors or liabilities nor be party to any contracts other than related to the loan and/or property so (theoretically at least) should be “bankruptcy remote” and generally subject to fewer risks as the prospect of any issues unexpectedly arising is less.

In addition, a lender usually wants to know the complete ownership structure and ultimate owners of the property both to satisfy itself that such persons are of a sufficient reputational and financial standing and “KYC” requirements (see C.1, pages [8-10] above) and because financing an SPV is generally non-recourse (i.e. in an enforcement situation, the lender can only resort to the borrower itself and the assets charged as security). Consideration of the ultimate owners is therefore important - having a strong ultimate owner may give a lender comfort that, in a default situation, the owner will give support although, unless a formal guarantee is taken, there is no legally binding obligation to do so.

Most lenders require diligence in all relevant jurisdictions so where, for example, a U.K. property is owned by an entity constituted in another jurisdiction, which entity is owned by a third entity constituted in a different country, a lender will want to ensure that the laws of each relevant jurisdiction are compatible with taking or granting security over U.K. property or shares and that each entity is properly constituted with power and capacity to enter into the transaction. This comfort is usually given in the form of a legal opinion.

C.2.2 Legal Opinions

The form and extent of any legal opinion depends upon the nature of the transaction and the jurisdiction concerned but should specify the documents, assets and/or entities which are the subject of the opinion and generally confirm (from the legal perspective) that:

• all the necessary formalities have been complied with;
• (for corporate entities) the borrower/security provider is duly incorporated and has the necessary capacity and authority;
• the borrower/security provider is not subject to any formal insolvency process;
• the documents and security created are validly executed and legally binding on and enforceable against, all relevant parties; and
• (if the borrower/security provider is a corporate entity not constituted in the United Kingdom) that the choice of English law in the documents is compatible with, and judgements of the English courts are enforceable in, the relevant jurisdiction.

It should also highlight any post completion requirements (e.g. payment of taxes and/or registrations) that need to be addressed to perfect the security and should:

• be provided by a law firm competent to practice in the relevant jurisdiction;
• be addressed to the lender (or if there is a syndicate to the facility agent and/or security trustee on behalf of all lenders);
• allow disclosure on a non-reliance basis to the lender's advisors (e.g. auditors and, in some cases, rating agencies).

It is rarely possible to provide a totally "clean" unqualified opinion and certain assumptions (for example that all parties other than those the subject of the opinion have full power and capacity to enter into the documents/transaction) and qualifications (e.g. as to any provisions of the relevant law which might inhibit or restrict enforcement) will therefore usually be made. The reasonableness and need for these varies according to the matters and entities the opinion covers and the nature of the transaction, but it is important to ensure that all these are appropriate in the circumstances – in particular there should be no exclusions which effectively negate the value of the opinion itself.

C.2.3 Tax

There may be U.K. or other taxes which have to be paid and/or withholding requirements which may in some cases (normally in an insolvency situation) take priority over other creditors (even secured creditors) and/or adversely affect the income flow from an underlying tenant and/or a borrower which could delay, reduce or even stop altogether such income being applied towards servicing the loan. In other cases an election or "clearance" from the U.K. or other relevant tax authorities may be necessary. These issues are especially relevant where the borrower or property owner is tax resident or incorporated outside the U.K., when specific tax advice (which can be included in the legal opinion mentioned above) in respect of any such other jurisdiction may also be needed.

For further information and explanation, please refer to the CREFC Tax Guide.

C.3. Asset

It is important to remember, in real estate lending, that the focus of the transaction is a physical asset and not just numbers in a spreadsheet or valuation. Full due diligence should always therefore be made into the property the subject of and/or security for the purchase or loan, particularly as the lender will quickly become the equity investor if the borrower defaults.

C.3.1 Inspection

A physical inspection of the property being acquired and/or offered as security is very important, principally to check what the property is actually like and the area in which it is located. As well as obtaining a basic "feel" for or impression of the property, other questions or issues which a prospective buyer or funder may wish to check or raise are:

• the conformity of physical outline of the property to any plan available;
• the occupants of the property (if not the legal tenants, they may be unlikely to renew, and an analysis of undertenancies may be appropriate);
• the nature and status of surrounding buildings (other similar or empty buildings nearby may negatively affect value and/or rent reviews);
• the area where the building is located (poor transport and infrastructure links, or other major development works in the vicinity, could deter future buyers and tenants);
• the physical condition of the building (a poor state of repair may be indicative of an owner or tenant in financial difficulties).

C.3.2 Development/project appraisal

Development and project appraisal is an essential addition to the due diligence process. It is important to recognise that most due diligence workstreams are focussed on the condition and status of the asset at the point of loan origination only. The purpose of development and project appraisal differs in that its main purpose is to review how the asset and loan will perform in the future in the context of the borrower's business plan and to determine the potential implications for the lender.
Typically a Valuation will only focus on the ‘spot’ value of an asset at any one pre-determined point of time. It will probably not consider the borrower’s business plan at all. Instead it will usually consider the generic business plan that a typical purchaser in the market might employ (in terms of leasing, development, refurbishment or any other asset management initiatives). Therefore whilst some level of development/project appraisal is always advised, it is particularly important in situations where:

a) the subject property is a development site, or the purchaser is planning significant development or refurbishment expenditure or other major asset management activity;
b) the buyer’s business plan for the asset differs from that of a typical purchaser (this is particularly important where change of use is considered);
c) the borrower or asset manager does not have a proven track record or experience in the relevant markets.

The nature of the development or project appraisal that will be required will vary considerably depending on the type of project making it difficult to be prescriptive. Whilst the appraisal will often be conducted independently of the valuation, there will often be an advantage if the valuer to be involved to ensure a consistency of approach. Where the appraisal is based on information or financial models received from the borrower, this should be always independently verified and tested.

The appraisal should always consider not only the valuation implications of the plan but the risk of the business plan not being delivered as planned. Examples include:

- a review of the borrower’s business plan making comparisons to those allowed for in the valuation;
- a full development appraisal to test project viability and assess future exit values; and
- a sensitivity analysis and scenario testing to determine the range of potential outcomes and risk exposure to test key commercial assumptions such as construction cost levels, market rents, resale levels, timescales and letting assumptions.

**C.3.3 Management/advisory arrangements**

The proper and efficient management of a property is important in preserving and/or enhancing its value, and consequently is likely to prove significant in enabling any borrower to service and repay its debt.

A distinction should be drawn between (i) “property management” services, namely day to day administrative operations including rent collection and service charge management and (ii) “asset advisory” services, which comprise strategic asset planning designed to increase the property’s income and value and include lease negotiations, planning applications, refurbishments and developments. Asset advisory duties are particularly important where the property has significant specific risks such as high vacancy, short leases, weak tenants, refurbishment requirements, structural issues or significant local competition.

Both property manager and asset advisor should have appropriate qualifications. Important considerations in this context are:

- experience and track record of asset managing comparable assets;
- competence of staff and tenure with the company;
- reputation with lenders, tenants and investors;
- systems and procedures for dealing with its duties (especially if these involve handling of rents and service charge funds).

The same person/company can be appointed in both capacities but, more commonly, different parties are engaged in which case there should be a clear separation of roles and, although there is likely to be some degree of overlap, each party should understand what is (and what is not) his/her/its responsibility.
The asset manager, if connected with the borrower/sponsor group, should not also be responsible for rent/service charge collection or expenditure, nor allowed to withdraw fees except in clearly defined and pre-agreed circumstances and should be capable of being replaced without undue penalty or delay if the borrower defaults.

A lender will be especially concerned that any asset advisor or property manager

- is suitably qualified and experienced, and appropriately authorised or regulated;
- has clear and specific duties and responsibilities, which cover all areas likely to be relevant for the transaction and/or property concerned;
- has sufficient resources to enable it properly to carry out its functions (especially if it is will be holding any rent or service charge funds);
- has adequate and continuing professional indemnity insurance that covers all elements of its duties, including the arrangement of insurance on the assets;
- can be replaced upon reasonable notice (or sooner if it is in material default); and
- provides a duty of care undertaking in favour of the principal finance parties whereby (amongst other things) it agrees to pay rents into a specified bank account and acknowledges a duty of care.

A lender will also want to check that there is no material function which is (deliberately or inadvertently) outside either or both property manager’s and asset advisor’s engagement. Consideration should also be given to their fees and expenses – these should be fully disclosed, at market levels and covered in any financial appraisal and the loan documentation should specify when and how these can be paid.

### C.3.4 Tenant credit analysis

The leases, the rental income from which form an important part of the security underlying any commercial property loan, are only as good as the ability of the tenants to meet the obligations outlined in them. It is therefore almost always appropriate to undertake due diligence into the credit quality of tenants and, if relevant, their guarantors. The amount of diligence required is driven principally by the concentration of tenants in the relevant property or portfolio – the Debt Service Cover and Loan to Value (LTV) ratios for a loan which finances a property which is single let or let to a small number of tenants (for example an office block) is far more sensitive to tenant failure than one secured on a multi-let building such as a shopping centre.

There are a number of resources and techniques which can be used to judge tenant credit quality and quantify the risk of tenant default in the short/medium term. The most common are shown below (these are usually most effective when used together to build up a detailed picture of a company’s financial health in the context of the market in which it operates).
Rating agencies

Tenants who issue publically tradable debt securities (e.g. bonds) may have a rating from one or more of Standard & Poor’s (S&P), Moody's or Fitch. Each has a slightly different way of describing credit risk depending on the type of obligation issued. Long term obligations are described by an alphabetic designation system and a summary of this is shown below:

<table>
<thead>
<tr>
<th>S&amp;P</th>
<th>Moody’s</th>
<th>Fitch</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Aaa</td>
<td>AAA</td>
<td>Extremely strong capacity to meet financial commitments (highest rating assigned to a very small number of borrowers).</td>
</tr>
<tr>
<td>AA+, AA, AA-, A+</td>
<td>Aa1, Aa2, Aa3, A1, A2, A3</td>
<td>AA+, AA, AA-, A+</td>
<td>Very strong to strong capacity to meet financial commitments (some large corporates fall into this category).</td>
</tr>
<tr>
<td>BBB+, BBB, BBB-</td>
<td>Baa1, Baa2, Baa3</td>
<td>BBB+, BBB, BBB-</td>
<td>Generally adequate capacity to meet financial commitments, but susceptible to adverse economic conditions (these are the lowest “investment grade” ratings).</td>
</tr>
<tr>
<td>BB+, BB, BB-</td>
<td>Ba1, Ba2, Ba3</td>
<td>BB+, BB, BB-</td>
<td>Speculative borrowers (less vulnerable to near term developments, but face major long term uncertainties).</td>
</tr>
<tr>
<td>B+, B, B-</td>
<td>B1, B2, B3</td>
<td>B+, B, B-</td>
<td>Have a current capacity to meet financial commitments, but long term survival is uncertain.</td>
</tr>
<tr>
<td>CCC, CC, C</td>
<td>Caa, Ca, C</td>
<td>CCC, CC, C</td>
<td>Highly vulnerable to failure</td>
</tr>
<tr>
<td>D</td>
<td>RD, D</td>
<td>Default</td>
<td></td>
</tr>
</tbody>
</table>

If a rating is subject to change, the agency may add a suffix to the current rating grade to indicate whether an upgrade or downgrade is expected (e.g. “Credit watch Negative”). The market standard shorthand for multiple ratings is (i) S&P (ii) Moody’s and (iii) Fitch.

Credit ratings have a number of limitations including the fact that they are

(a) commissioned and paid for by the borrower;
(b) based only on information available to the rating agency;
(c) (notwithstanding the historic default matrix described below) relative measures of risk rather than specific statistical predictors of default; and
(d) not a directly predictive statistical measure of the risk of a default, but an indicator of the probability of a default for any given rating level (seen from cumulative historical default rates published annually by each rating agency).
The S&P global cumulative default table for the period 1981 to 2011 is:

<table>
<thead>
<tr>
<th>TIME HORIZON (YEARS)</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.00%</td>
<td>0.03%</td>
<td>0.14%</td>
<td>0.25%</td>
<td>0.37%</td>
<td>0.49%</td>
<td>0.55%</td>
<td>0.64%</td>
<td>0.71%</td>
<td>0.78%</td>
</tr>
<tr>
<td>AA+</td>
<td>0.00%</td>
<td>0.06%</td>
<td>0.06%</td>
<td>0.12%</td>
<td>0.19%</td>
<td>0.25%</td>
<td>0.32%</td>
<td>0.39%</td>
<td>0.46%</td>
<td>0.53%</td>
</tr>
<tr>
<td>AA</td>
<td>0.02%</td>
<td>0.04%</td>
<td>0.09%</td>
<td>0.25%</td>
<td>0.39%</td>
<td>0.51%</td>
<td>0.64%</td>
<td>0.75%</td>
<td>0.84%</td>
<td>0.94%</td>
</tr>
<tr>
<td>AA-</td>
<td>0.03%</td>
<td>0.11%</td>
<td>0.22%</td>
<td>0.32%</td>
<td>0.42%</td>
<td>0.55%</td>
<td>0.64%</td>
<td>0.72%</td>
<td>0.79%</td>
<td>0.87%</td>
</tr>
<tr>
<td>A+</td>
<td>0.06%</td>
<td>0.12%</td>
<td>0.26%</td>
<td>0.44%</td>
<td>0.58%</td>
<td>0.71%</td>
<td>0.86%</td>
<td>1.03%</td>
<td>1.22%</td>
<td>1.43%</td>
</tr>
<tr>
<td>A</td>
<td>0.08%</td>
<td>0.20%</td>
<td>0.32%</td>
<td>0.47%</td>
<td>0.63%</td>
<td>0.85%</td>
<td>1.07%</td>
<td>1.28%</td>
<td>1.53%</td>
<td>1.82%</td>
</tr>
<tr>
<td>A-</td>
<td>0.08%</td>
<td>0.22%</td>
<td>0.37%</td>
<td>0.53%</td>
<td>0.76%</td>
<td>1.01%</td>
<td>1.37%</td>
<td>1.63%</td>
<td>1.84%</td>
<td>2.01%</td>
</tr>
<tr>
<td>BBB+</td>
<td>0.15%</td>
<td>0.42%</td>
<td>0.74%</td>
<td>1.06%</td>
<td>1.43%</td>
<td>1.84%</td>
<td>2.15%</td>
<td>2.47%</td>
<td>2.84%</td>
<td>3.19%</td>
</tr>
<tr>
<td>BBB</td>
<td>0.21%</td>
<td>0.55%</td>
<td>0.86%</td>
<td>1.33%</td>
<td>1.82%</td>
<td>2.29%</td>
<td>2.73%</td>
<td>3.19%</td>
<td>3.70%</td>
<td>4.20%</td>
</tr>
<tr>
<td>BBB-</td>
<td>0.37%</td>
<td>1.11%</td>
<td>1.98%</td>
<td>3.02%</td>
<td>4.03%</td>
<td>4.94%</td>
<td>5.75%</td>
<td>6.53%</td>
<td>7.15%</td>
<td>7.85%</td>
</tr>
<tr>
<td>BB+</td>
<td>0.51%</td>
<td>1.41%</td>
<td>2.64%</td>
<td>3.87%</td>
<td>5.01%</td>
<td>6.19%</td>
<td>7.23%</td>
<td>7.95%</td>
<td>8.93%</td>
<td>9.87%</td>
</tr>
<tr>
<td>BB</td>
<td>0.76%</td>
<td>2.32%</td>
<td>4.48%</td>
<td>6.43%</td>
<td>8.32%</td>
<td>9.99%</td>
<td>11.43%</td>
<td>12.68%</td>
<td>13.76%</td>
<td>14.72%</td>
</tr>
<tr>
<td>BB-</td>
<td>1.23%</td>
<td>3.74%</td>
<td>6.31%</td>
<td>8.81%</td>
<td>10.96%</td>
<td>13.08%</td>
<td>14.91%</td>
<td>16.74%</td>
<td>18.33%</td>
<td>19.64%</td>
</tr>
<tr>
<td>B+</td>
<td>2.50%</td>
<td>6.75%</td>
<td>10.88%</td>
<td>14.44%</td>
<td>17.14%</td>
<td>19.25%</td>
<td>21.19%</td>
<td>22.93%</td>
<td>24.49%</td>
<td>26.06%</td>
</tr>
<tr>
<td>B</td>
<td>5.46%</td>
<td>11.87%</td>
<td>16.84%</td>
<td>20.29%</td>
<td>22.87%</td>
<td>25.38%</td>
<td>26.81%</td>
<td>27.85%</td>
<td>28.73%</td>
<td>29.57%</td>
</tr>
<tr>
<td>B-</td>
<td>8.64%</td>
<td>16.22%</td>
<td>21.89%</td>
<td>25.86%</td>
<td>28.76%</td>
<td>30.56%</td>
<td>32.29%</td>
<td>33.29%</td>
<td>34.00%</td>
<td>34.52%</td>
</tr>
<tr>
<td>CCC/ C</td>
<td>26.82%</td>
<td>35.84%</td>
<td>41.14%</td>
<td>44.27%</td>
<td>46.72%</td>
<td>47.82%</td>
<td>48.79%</td>
<td>49.66%</td>
<td>50.77%</td>
<td>51.65%</td>
</tr>
</tbody>
</table>

Accordingly, for example, the historic probability of a BBB+ rated company defaulting within 5 years is 1.43%.

Credit ratings are available through Bloomberg, the "CRPR" function and from each rating agency's web site (usually on the "Investor Relations" section of the borrower's web site):

A copy of the rating report from the rating agency, which contains commentary and analysis underlying the determined rating, can also be obtained but there is usually a cost to this. Where a borrower has several types of debt outstanding the most relevant rating is usually the “senior unsecured debt” rating which most closely approximates to the ranking of unpaid lease obligations in case of insolvency.

Credit checking agencies

Credit checking agencies can be a useful source of information where tenants are smaller and have not issued publically tradable debt securities. Two of the largest credit checking agencies are Dun & Bradstreet (D&B) and Experian but, whilst reports from both these contain useful data (especially where underlying properties are leased to large numbers of smaller tenants) it is important to remember that, given these agencies’ high volume and low margin business models, there is a limit on the amount of analysis that each can perform and therefore individual ratings may present a misleading picture.

As a matter of good practice, external valuations should contain these wherever possible.

Experian

Experian have a system known as a “Delphi” score which indicates the risk of failure. The main Delphi score bands are reproduced below:

<table>
<thead>
<tr>
<th>Delphi score band</th>
<th>Proportion of scored companies falling into band</th>
<th>Risk of failure</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>N / A</td>
<td>Serious Adverse Information or Dissolved</td>
</tr>
<tr>
<td>1 – 15</td>
<td>18.94%</td>
<td>Maximum Risk</td>
</tr>
<tr>
<td>16 – 25</td>
<td>9.92%</td>
<td>High Risk</td>
</tr>
<tr>
<td>26 – 50</td>
<td>23.94%</td>
<td>Above Average Risk</td>
</tr>
<tr>
<td>51 – 80</td>
<td>28.52%</td>
<td>Below Average Risk</td>
</tr>
<tr>
<td>81 – 90</td>
<td>14.08%</td>
<td>Low Risk</td>
</tr>
<tr>
<td>91 – 100</td>
<td>4.60%</td>
<td>Very Low Risk</td>
</tr>
</tbody>
</table>

Delphi scores and Experian credit reports may be purchased directly from the Experian web site (https://secure.smebusinesscheck.co.uk/).
Dun & Bradstreet

Dun & Bradstreet operate both a credit scoring system and a rating system. The rating system consists of a financial strength component and a credit risk indicator which is D&B’s view of the likelihood of business failure within the next 12 months. The current financial strength and credit risk indicators are summarised below:

**Financial strength indicators**

<table>
<thead>
<tr>
<th>Based on Net Worth</th>
<th>Based on Capital</th>
<th>Net worth (GBP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5A</td>
<td>5AA</td>
<td>&gt; GBP 35,000,000</td>
</tr>
<tr>
<td>4A</td>
<td>4AA</td>
<td>GBP 15,000,000 – GBP 34,999,999</td>
</tr>
<tr>
<td>3A</td>
<td>3AA</td>
<td>7,000,000 – 14,999,999</td>
</tr>
<tr>
<td>2A</td>
<td>2AA</td>
<td>1,500,000 – 6,999,999</td>
</tr>
<tr>
<td>1A</td>
<td>1AA</td>
<td>700,000 – 1,499,999</td>
</tr>
<tr>
<td>A</td>
<td>AA</td>
<td>350,000 – 699,999</td>
</tr>
<tr>
<td>B</td>
<td>BB</td>
<td>200,000 – 349,999</td>
</tr>
<tr>
<td>C</td>
<td>CC</td>
<td>100,000 – 199,999</td>
</tr>
<tr>
<td>D</td>
<td>DD</td>
<td>70,000 – 99,999</td>
</tr>
<tr>
<td>E</td>
<td>EE</td>
<td>35,000 – 69,999</td>
</tr>
<tr>
<td>F</td>
<td>FF</td>
<td>20,000 – 34,999</td>
</tr>
<tr>
<td>G</td>
<td>GG</td>
<td>8,000 – 19,999</td>
</tr>
<tr>
<td>H</td>
<td>HH</td>
<td>Nil – 7,999</td>
</tr>
</tbody>
</table>

**Credit risk indicators**

<table>
<thead>
<tr>
<th>Risk indicator</th>
<th>Probability of failure</th>
<th>Guide to interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Minimal risk</td>
<td>Good covenant</td>
</tr>
<tr>
<td>2</td>
<td>Low risk</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Slightly greater than average risk</td>
<td>Satisfactory covenant but needs monitoring</td>
</tr>
<tr>
<td>4</td>
<td>Significant risk</td>
<td>Unsatisfactory covenant – may well default</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– confirm quantum of rental deposit</td>
</tr>
<tr>
<td>--</td>
<td>Insufficient information</td>
<td></td>
</tr>
</tbody>
</table>

So, a large company that is in difficulties may have a high financial strength indicator but a poor credit risk indicator (for example “4A3”) while an unquestioned covenant would have both a high net worth and a strong risk indicator (for example “5A1”).
The Dun & Bradstreet commercial credit scoring system is designed to predict the likelihood that a company will pay its bills in a severely delinquent manner (90 days or more past terms), obtain legal relief from creditors or cease operations without paying all creditors in full over the next 12 months. It assigns a commercial credit score class and a commercial credit score to each tenant. The current classes and scores are reproduced below:

<table>
<thead>
<tr>
<th>Credit Score Class</th>
<th>% of Businesses within this Credit Score Class</th>
<th>Credit Score Percentile</th>
<th>Commercial Credit Score</th>
<th>Guide to interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10%</td>
<td>91-100</td>
<td>482-670</td>
<td>Low risk of severe delinquency</td>
</tr>
<tr>
<td>2</td>
<td>20%</td>
<td>71-90</td>
<td>451-481</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>40%</td>
<td>31-70</td>
<td>404-450</td>
<td>Moderate risk of severe delinquency</td>
</tr>
<tr>
<td>4</td>
<td>20%</td>
<td>11-30</td>
<td>351-403</td>
<td>High risk of severe delinquency</td>
</tr>
<tr>
<td>5</td>
<td>10%</td>
<td>1-10</td>
<td>101-350</td>
<td></td>
</tr>
</tbody>
</table>

Dun & Bradstreet ratings and credit scores can be downloaded from their website (https://mycredit.dnb.com/get-business-reports/).

Altman’s Z-Score Model

A well known model for predicting financial distress is Altman’s Z Score model. This uses variables which have been shown to be effective indicators and predictors of corporate distress and attempts to predict the probability that a firm will enter bankruptcy proceedings by applying weightings to a number of key financial ratios as follows:

### Public company

<table>
<thead>
<tr>
<th>Inputs</th>
<th>Model</th>
<th>Outputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$X_1 = \frac{(\text{Current Assets} - \text{Current Liabilities})}{\text{Total Assets}}$</td>
<td>$Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 1.0X_5$</td>
<td>$Z &gt; 2.99$ – low risk of failure</td>
</tr>
<tr>
<td>$X_2 = \frac{\text{Retained Earnings}}{\text{Total Assets}}$</td>
<td></td>
<td>$1.81 &lt; Z &lt; 2.99$ – elevated risk of failure</td>
</tr>
<tr>
<td>$X_3 = \frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}}$</td>
<td></td>
<td>$Z &lt; 1.81$ – corporate distress</td>
</tr>
<tr>
<td>$X_4 = \frac{\text{Market Value of Equity}}{\text{Book Value of Total Liabilities}}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$X_5 = \frac{\text{Sales}}{\text{Total Assets}}$</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Private company

<table>
<thead>
<tr>
<th>Inputs</th>
<th>Model</th>
<th>Outputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$X_1 = \frac{(\text{Current Assets} - \text{Current Liabilities})}{\text{Total Assets}}$</td>
<td>$Z' = 0.717X_1 + 0.847X_2 + 3.107X_3 + 0.420X_4 + 0.998X_5$</td>
<td>$Z &gt; 2.9$ – low risk of failure</td>
</tr>
<tr>
<td>$X_2 = \frac{\text{Retained Earnings}}{\text{Total Assets}}$</td>
<td></td>
<td>$1.23 &lt; Z &lt; 2.9$ – elevated risk of failure</td>
</tr>
<tr>
<td>$X_3 = \frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}}$</td>
<td></td>
<td>$Z &lt; 1.23$ – corporate distress</td>
</tr>
<tr>
<td>$X_4 = \frac{\text{Book Value of Equity}}{\text{Book Value of Total Liabilities}}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$X_5 = \frac{\text{Sales}}{\text{Total Assets}}$</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The model appears to be accurate in the short run, with an estimated 80%+ of firms with a Z score indicating corporate distress filing for bankruptcy within one financial statement period of the test being run but it is not recommended for use in analysing financial companies.
Credit default swap spreads

Credit default swaps (CDS) are a form of insurance entered into between a lender seeking protection from a credit risk and a counterparty who insures that risk. They are classed as swaps or contracts for differences as, when the relevant credit event occurs, the lender exchanges its loan for an agreed amount (usually the principal amount of the loan) with the counterparty. The premium charged by counterparty is known as the CDS spread and, the higher this is, the higher the perceived market risk of a credit event occurring to the borrower.

CDS spreads can be a leading indicator of corporate distress in the public debt markets, in contrast to credit ratings which tend to be lagging indicators, but are generally only available for very large borrowers for whose debt there is a high volume of CDS trading. They can be downloaded from Bloomberg and, whilst are not always directly comparable between all borrowers, a good rule of thumb is that CDS spreads of less than 250 basis points (“bps”) are indicative of lower risk and spreads in excess of 500bps a good indicator of current or near term corporate distress.

Financial statement analysis

Accounts for all UK listed companies can, for a small fee, be obtained from Companies House (http://www.companieshouse.gov.uk/toolsToHelp/WCInfo.shtml). Financial statement analysis is the most effective way of judging credit quality of smaller tenants although is also time consuming and may therefore not be suitable for large multi-let properties.

There are a number of standard analytical techniques that may be applicable to a business which, if used properly, can give a good insight into the creditworthiness of a tenant. In order to calculate these it is necessary first to extract a number of data points from the financial accounts. These include:

<table>
<thead>
<tr>
<th><strong>Net debt</strong></th>
<th>The net amount of financial indebtedness that a company is carrying. It can be calculated as follows:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EBITDA</strong></td>
<td>Earnings Before Interest, Tax, Depreciation and Amortisation. It is calculated by reversing all interest, tax, depreciation and amortisation out of net income (if the depreciation and amortisation expense is not shown on the face of the income statement then it can usually be found in the notes to the accounts).</td>
</tr>
<tr>
<td><strong>EBTDAR</strong></td>
<td>As EBITDA, but interest is not stripped out and rent payments are.</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>The net interest expense of the company</td>
</tr>
</tbody>
</table>

Having extracted these figures, the following financial ratios can be calculated:

**Leverage ratio (Net debt/EBITDA)** – This shows how relatively indebted the tenant is by relating its net debt as a multiple of one year’s EBITDA (the higher the ratio, the more indebted the company and hence the greater the risk of financial distress). A normal operating company that does not operate in a sector where high debt levels are normal (e.g. the property industry) with a ratio of less than 3x is generally considered to be conservatively geared. Ratios of between 3x and 6x are generally considered an indicator of a higher risk of default and ratios in excess of 6x (typical in leveraged buy-out structures) are generally considered dangerous to the viability of a firm.

**Interest Coverage Ratio (EBITDA/Net interest expense)** – This shows how many times net interest expenses are covered by EBITDA (the lower the ratio, the greater the risk that the tenant will be unable to pay interest and may subsequently fail). A normal operating company that does not operate in a sector where high debt levels are normal would be considered conservatively geared if this ratio were in excess of 4x. Ratios of below 2x are generally a sign of over-gearing and an indicator of likely upcoming financial distress.
Rent cover ratio (EBTDAR/Rent) – This shows the headroom between the rent the tenant is paying and earnings available to meet that rent. It is typically used in sale and leaseback and OpCo/PropCo transactions, where the property is let to a single tenant, as a method of increasing the amount of debt that is available. A ratio of any less than 2x leaves the tenant vulnerable to not meeting its rental obligations as a result of a trading slowdown.

Apart from the ratio analysis outlined above, it is also worthwhile checking:

(a) audited accounts should state that the business is a going concern and the audit opinion should be unqualified (a qualified, disclaimer or adverse audit opinion is a sign of financial irregularities which may threaten solvency); and

(b) the firm should have an adequate liquidity profile - indications of this include having a reasonable amount of cash on hand, the presence of overdraft facilities and a staggered debt maturity profile (in the absence of these, even a firm with large profits and a high tangible net worth may be unable to pay its rent).

C.3.5 Financial modelling

Overview

The primary purpose of financial modelling in the context of commercial real estate financing transactions is to identify cash flow and value risks which may manifest themselves during the term of a facility and enable these to be managed and mitigated via loan structuring. It is almost always advisable to model future cash flows as purely valuation driven lending may expose the lender to a number of risks, not least of which is the ability of the borrower and/or underlying security to service the loan and comply with loan covenants.

Commercial real estate debt modelling is complex and requires a disciplined approach to model creation. A good model will allow a user to take a large volume of non-transparent data (tenancy and property schedule) and will synthesize this into a clear, easy to understand projection. This can be used to gain an informative “at a glance” picture of the underlying property/properties and enable the loan to be structured in a way so as to manage the cash flow and value risks of the transaction.

Given the “bespoke” nature of most real estate leases and transactions, a lender will usually prefer to create its own model but, if this is not practicable (and/or to check the lender’s own model and analysis) an external party should be engaged to assist.

Model design

Any form of financial model should consist of three main elements:

<table>
<thead>
<tr>
<th>Inputs</th>
<th>The drivers of the outputs and need to be clearly identified as such - either statements of fact (e.g. the length of an in place lease) or assumptions about the future (e.g. the length of time it will take to re-let).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculations</td>
<td>Formulae that should not contain any hard numbers - calculations process the inputs to build up the model so that it can produce clear and useable outputs.</td>
</tr>
<tr>
<td>Outputs</td>
<td>Selected key calculations reproduced to give an indication as to how a transaction may perform and identify the key risks which may manifest themselves during the loan term.</td>
</tr>
</tbody>
</table>

Excel spreadsheets can be used in financial modelling but are extremely prone to error, as there is no built-in data integrity checking and no internal process for determining whether the formulae are logically or commercially correct. It is best practice to create separate sheets for inputs, calculations and outputs.
Type of model

Generally, commercial real estate financing models fall into one of two categories

(a) **Deterministic** - the predominant type of underwriting model which employs defined and fixed inputs reflecting current reality or future assumptions and generates a discrete set of cash flows driven by these and shows one particular (usually conservative) scenario:

(b) **Stochastic** - these replace certain key inputs with random variables, e.g. the “Monte Carlo” simulation, a modelling method run using multiple iterations of key inputs sampled from underlying probability distributions and a statistical analysis of the results (such as probability of default and loss given default) to provide a more holistic interpretation of the underlying risks. When designing or using such a model it is vital to determine whether the underlying probability distributions:

(i) are correct (historically stochastic models have used distributions that take a too narrow view of the range of potential outcomes); and

(ii) have been correctly correlated or correlated at all (this has tended to be ignored in the past resulting in a too narrow view of potential outcomes – i.e. lending transactions thought to be lower risk than they actually were).

Inputs required and responsibility for their provision

When underwriting a loan, the lender should list information requirements early to give all parties the ability to secure this on a timely basis. Most of this information will also be required on an ongoing basis whenever covenants are tested (usually quarterly). Two broad categories of information are required:

Transaction level information

This includes information on the proposed facility such as facility amount, cost of the financing and the debt repayment profile:

<table>
<thead>
<tr>
<th>Data point</th>
<th>Responsibility for provision</th>
<th>Data point</th>
<th>Responsibility for provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan term</td>
<td>Borrower &amp; Lender</td>
<td>Swap / cap rate (if hedged)</td>
<td>Lender (use quarterly month actual / 365 rate from Bloomberg) to determine mid-market rate, credit spread by agreement between Borrower &amp; Lender</td>
</tr>
<tr>
<td>Purchase price</td>
<td>Borrower</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan amount</td>
<td>Borrower &amp; Lender</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Margin</td>
<td>Borrower &amp; Lender</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arrangement fee</td>
<td>Borrower &amp; Lender</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commitment fee</td>
<td>Borrower &amp; Lender</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monitoring fee</td>
<td>Borrower &amp; Lender</td>
<td>ISCR covenant</td>
<td>Borrower &amp; Lender</td>
</tr>
<tr>
<td>Drawdown profile</td>
<td>Borrower &amp; Lender</td>
<td>DSCR covenant **</td>
<td>Borrower &amp; Lender</td>
</tr>
<tr>
<td>Amortisation profile</td>
<td>Borrower &amp; Lender</td>
<td>LTV covenant</td>
<td>Borrower &amp; Lender</td>
</tr>
<tr>
<td>Allocated loan amounts*</td>
<td>Borrower &amp; Lender</td>
<td>Yield on Debt covenant **</td>
<td>Borrower &amp; Lender</td>
</tr>
<tr>
<td>Release pricing multiple*</td>
<td>Borrower &amp; Lender</td>
<td>Tax rate</td>
<td>Borrower</td>
</tr>
</tbody>
</table>

* Portfolio transactions only  ** Optional
Property level information

This includes information on the terms of the leases, the valuation of the properties and assumptions as to re-letting:

<table>
<thead>
<tr>
<th>Data point</th>
<th>Responsibility for provision</th>
<th>Data point</th>
<th>Responsibility for provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenant name</td>
<td>Borrower</td>
<td>Lease end date</td>
<td>Borrower</td>
</tr>
<tr>
<td>Tenant guarantor*</td>
<td>Borrower</td>
<td>Lease break option dates*</td>
<td>Borrower</td>
</tr>
<tr>
<td>Type of space (office / retail . etc.)</td>
<td>Borrower</td>
<td>Lease extension dates*</td>
<td>Borrower</td>
</tr>
<tr>
<td>Tenant rating*</td>
<td>Borrower</td>
<td>Lease break penalty payments*</td>
<td>Borrower</td>
</tr>
<tr>
<td>Guarantor rating*</td>
<td>Borrower</td>
<td>Lease extension or non exercise of break option incentives*</td>
<td>Borrower</td>
</tr>
<tr>
<td>Lease type (fixed term or rolling)</td>
<td>Borrower</td>
<td>Anticipated void period</td>
<td>Valuer</td>
</tr>
<tr>
<td>Property associated with lease</td>
<td>Borrower</td>
<td>Anticipated void rate</td>
<td>Valuer or Lender (via the Valuation Office Agency web site (<a href="http://www.voa.gov.uk">www.voa.gov.uk</a>)</td>
</tr>
<tr>
<td>Net lettable area</td>
<td>Borrower</td>
<td>Void rates transitional relief</td>
<td></td>
</tr>
<tr>
<td>Parking spaces*</td>
<td>Borrower</td>
<td>Anticipated service charge and insurance expense</td>
<td>Borrower</td>
</tr>
<tr>
<td>Current gross rental income</td>
<td>Borrower</td>
<td>Anticipated rent free letting incentive</td>
<td>Valuer</td>
</tr>
<tr>
<td>ERV at reletting</td>
<td>Valuer</td>
<td>Anticipated letting fees</td>
<td>Valuer</td>
</tr>
<tr>
<td>Indexation provisions*</td>
<td>Borrower</td>
<td>Anticipated new lease length to first break</td>
<td>Valuer</td>
</tr>
<tr>
<td>Lease start date</td>
<td>Borrower</td>
<td>Anticipated re-letting capex, net of dilapidations</td>
<td>Valuer</td>
</tr>
<tr>
<td>Lease income start date</td>
<td>Borrower</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Not always applicable


**Creating the calculations**

The model should be prepared in the following manner:

- calculations should be built up logically and step by step (if too many are done in a particular cell at once, these are difficult to check or later modify);
- the model should be quarterly and calculations should be, at least, quarter accurate (although day count accurate calculations are strongly preferable, particularly where a property or portfolio is leased to a small number of tenants);
- income calculations should be done on a lease-by-lease level (a summary total of the lease by lease calculations should then be brought into a separate sheet or section where the transaction level cash flows can be calculated);
- property disposals during the term should be catered for and the anticipated excess deleveraging from release pricing as a result of such disposals;
- apart from generating a projected cash flow, the model should include a stratification of the underlying property/portfolio (the calculations for this should be done separately);
- for a lender’s basic underwriting cash flow, the model should generally be run to the earlier of first break or lease end – no extensions or lease renewals should be assumed;
- a premium should be built into the swap rate to allow for adverse interest rate movements between the underwriting date and the actual funding date;
- the model should be sufficiently flexible so as to add leases if appropriate
- the model should include basic data integrity and error checks – for example if a lease is input as ending before the model start date, this should be flagged as a potential error;
- cash flows should be assessed using certain assumptions, for example relating to re-letting (the market convention for projected income calculations, and hence covenant testing, is to ignore these so that, if space is vacant, it is assumed not to re-let - a model should therefore only be used for covenant testing if it can assume a full run off of all leases and any other relevant provisions of projected rental income calculations).
Modelling conventions

There are several modelling conventions specific to the U.K. commercial real estate market:

- leases are assumed to be fully repairing and insuring (i.e. while a property or part of a property is let, the tenant is assumed to pay the rent and all outgoings);
- where there is a lease rent free period, it is assumed the tenant pays for all service charge, insurance, rates and other outgoings);
- generally, there is a short grace period (this may be longer for recently constructed properties) from the termination of a lease before “empty” business rates are charged;
- rent payments are due on calendar quarter end dates (usually 25 March, 24 June, 29 September and 25 December); and
- interest payment days are 2 to 3 weeks after rent payment days, i.e. between the 15th and 25th of the month following (usually April, July, October and January).

Outputs

The outputs of the model need to clearly and accurately identify and summarise the key transaction risks. They should neither be too detailed, nor so high level, that risks are hidden and the following is a basic set suitable for most transactions:

- a granular annual operating cash flow identifying gross rental income, break penalties, void costs, letting fees, headlease payments and other non-recoverables to result in a net cash flow figure, less net capital expenditure (re-letting capital expenditure less anticipated dilapidations payments) and lastly, the amount of cash that is paid to the borrower (or needs to be injected) after financing costs and tax;
- a summary quarterly cash flow which starts with consolidated net rental income and deducts net capital expenditure, interest, tax and amortisation;
- key loan metrics on a quarterly basis (Interest Cover Ratio (ICR), Debt Service Cover Ratio (DSCR), yield on debt, Loan to Value (LTV) and debt per sq. ft.);
- a list of top 10 or top 20 tenants along with key data on their leases (term to first break, term to maturity, total rent paid, ERV, sq. ft. occupied, rent per sq. ft.);
- summary property details (income, Estimated Rental Value (ERV), area and vacancy);
- an annual breakdown of terminating leases by income for a ten or fifteen year projection period (i.e. 10% of income breaks in year 1, 5% in year 2, etc.);
- the weighted unexpired lease term and the weighted unexpired lease term to first break;
- the portfolio vacancy;
- a breakdown of the properties by income and space type (office, retail, logistics, etc.).
D. ASSET DUE DILIGENCE

D.1 Primary Reports

These reports will be appropriate, and should generally be undertaken, in connection with all relevant transactions and types of property.

D.1.1 Valuation

Why undertake a valuation?

Valuation reports are part of the standard package of due diligence for investment in, or lending secured on, property. A valuation

- underpins the investment or lending criteria;
- mitigates the potential for this to be based on over-priced assets;
- offers a summary of the salient findings of other reports; and
- crystallises the issues into an impact upon value.

All investors and lenders should therefore ensure that they can justify actions through professional valuations from firms with a coverage and skill-set appropriate to the breadth of the portfolio or property in question.

Valuations are advised for all loans (whether senior or junior or for investment or development purposes) secured against real estate (whether commercial or residential) to support new lending, to monitor existing loans (in terms of adherence to financial loan covenants and to assist in providing consents to asset management processes, such as the grant or surrender of leases) and to underpin enforcement. In some cases, for example securitisations, different stakeholders may wish to commission their own valuation report, as reports will typically be drafted to be relied upon by a single client.

What is a valuation?

A valuation

- is an opinion of the price that would be achieved for the sale of an asset (free if any corporate holding structure and encumbrances) at any given time assuming an adequate marketing period had elapsed; and

- a snapshot as of the valuation date - it does not provide any indication of the future performance of the asset (although opinions on this can be expressed through report commentary or additional requested valuation bases).

The most relevant standards for the valuation of property assets globally are set out in the manual Valuation – Professional Standards incorporating the International Valuation Standards (March 2012), produced by the Royal Institution of Chartered Surveyors (RICS) commonly known as the “Red Book”. The incorporation of the International Valuation Standards (IVS) into this means that, although individual countries (for example Germany) may have their own standards, property valuations can be more easily carried out to a uniform standard. All formal valuations should prescribe that the valuation should be in accordance with the above standards and any departure from these should be specifically mentioned in the valuation.

The minimum requirements of a valuation report (which should be reflected in a valuer’s instructions) suitable for finance purposes are found in section 6.1 of the Red Book and are:

- identification of the client and other intended users (addressees);

- the purpose of the valuation;
• the subject of the valuation and interest to be valued;
• the type of asset or liability and how it is used, or classified, by the client;
• the basis, or bases, of value and a statement of the valuation approach and reasoning;
• disclosure of any material involvement, or a statement that there has been no previous material involvement (this should be clarified and agreed prior to instruction);
• the identity of the valuer responsible and (if required) statements of the status of the valuer and that the valuer has the knowledge, skills and understanding to undertake the valuation competently;
• any assumptions, special assumptions, reservations, special instructions or departures;
• the extent of the valuer’s investigations and the nature and source of information relied on by the valuer;
• any limits or exclusion of liability to parties other than the client and any consent to, or restrictions on, publication;
• confirmation that the valuation accords with these standards and also complies with the International Valuation Standards, where appropriate; and
• the opinion of value and valuation date.

Certain information should be provided in a valuation report beyond that required by RICS, namely details of any comparables, calculations, Argus files, cash flow forecasts and property details. The valuation will incorporate basic factual data, and it is the role of the valuer to interpret this information, amongst other factors, to form a conclusion of value.

A valuer will usually accept information provided by others in good faith, although he should apply professional common sense in this respect (for example if the information indicates a single tenanted property and inspection reveals a multi-let building, further investigation should be undertaken). A valuer should also review and consider other due diligence reports relating to the relevant asset where appropriate and be satisfied as to the area of the property valued (and require a separate full measurement survey if necessary).

The report will not always contain:
• an allowance for anomalies in title documentation (the property will be assumed to be free of encumbrances and restrictions of use if no title documentation is provided);
• an allowance for any contamination if there is no evidence after preliminary enquiries;
• an allowance for any environmental survey and impacts upon value (for example the habitation of protected species on land);
• an allowance for archaeological findings (except for a Residual Valuation where a developer would make an allowance for dealing with such works - for example a valuation of a development site in an historic town centre should contain a contingency figure for archaeology and a former industrial site suited to development a contingency for contamination) although the precise effect of these will not be appraised unless there is a professional report commissioned for that specific purpose;
• flooding (a report will detail the result of basic flood checks, however the assumption is made that full flood insurance is in place);
• a guarantee that the indicated boundaries are correct;
• a future valuation date (Market Value, according to the RICS definition, cannot be projected unless the valuation is for new build residential mortgage purposes;
• any unrealistic assumption (although a special assumption, for example of vacant
possession), can be incorporated upon instruction); or

- where leases are not provided, an assumption other than that the leases are in a standard modern form (i.e. have no onerous terms and there is no privity of contract after the Landlord & Tenant Covenants Act 1995).

Many factors influence valuations and historic assumptions are not always appropriate to apply to a future date (i.e. it should not be assumed that a property will maintain its value throughout the period of the loan or investment). A valuation will be impacted by:

- the liquidity and speed of sale of the asset (a higher or lower price may be achievable over an extended marketing period);

- the level of demand for the particular real estate product within the market (lower demand decreases competitive pressure and can truncate the distribution of bids);

- market volatility and risk - it is fundamental to investment valuation that risk impacts upon value (explicitly or implicitly - investors require a higher rate of return to compensate them for increased risk and some real estate opportunities, for example development sites, are naturally high-risk); and

- lease events - a valuation with no special assumptions will assume that the current leases are in place (as these leases approach expiry there will be an impact upon valuation, for instance in a bull occupational market the impact may be positive as a higher rent can be achieved on expiry but in a stagnant or declining market with little occupational demand, the value is likely to fall and an investor is often faced with a negative cash flow due to taxes).

Lenders may also ask the valuer to express an opinion as to the property's suitability as security for lending. In such a case the valuer is being asked to help the lender assess risk rather than actually assess risk himself (the final decision on this should always be made by the lender) and should refer to the loan term (if known) or indicate an assumed norm if this is not. The valuer may also comment on issues such as location, tenant quality, prospects for lease renewal and/or rent increase, lease length, capital expenditure requirements and the condition and specification of the property.

A valuer should provide valuations on appropriate bases to match both the asset being considered and the type of finance provided. The most common valuation bases are:

1. **Market Value** – this should be provided in most valuation reports (with only minor exceptions) and is the valuer’s opinion of the price that could be achieved for a sale of the property (ignoring any holding vehicle) on the valuation date assuming that a reasonable marketing period has elapsed;

2. **Market Value on the Special Assumption of Vacant Possession** - this is often requested for commercial properties to assess the downside risk and is the valuer’s opinion of the price that could be achieved if the property were sold on the valuation date with no leases in place (i.e. a “special assumption” as it does not reflect reality - this should nonetheless be reasonable and a valuation report containing such an assumption should comment on this).

3. **Market Rent** – this is the valuer’s opinion of the rent that can be achieved for the property if let on market terms (the report should detail what these terms are and comment on the lease assumptions, for example the lease length and/or whether full repairing and insuring terms or a schedule of condition is appropriate).

4. **Reinstatement Cost Assessment** – whilst not a formal valuation basis this is often requested as part of a finance valuation for checking the level of buildings insurance in place (it is provided on a non reliance basis and should not be used for assessing buildings insurance cover - if reliance is required a formal reinstatement cost assessment should be commissioned from a qualified building surveyor).

Valuation methodology is complex and should be considered by the valuer rather than the instructing client. Formal definitions of the relevant bases used should be included within the report. The various methods are:
1. **Comparable**: this is based on comparable transactions, both occupational and investment, and generally considered reliable in a relatively liquid market;

2. **Investment**: this is typically used where there is a regular income stream, which will be capitalised at an appropriate rate based on the Comparable method (different parts of the income stream may be capitalised at different rates and valuers will use different methods of analysis, for example “term”, “reversion” and “hardcore” methods or discounted cash flow, often used where there is a complex or variable cash flow or where inputs can be easily estimated over a finite holding period;

3. **Residual**: this works backwards from a gross development value and is very sensitive to inputs (so a client should expect a thorough explanation of these and equally the valuer will have high information requirements as small changes in assumptions will result in large changes in the value) and normally used only for development sites or projects - due to this extra risk and sensitivity such valuations are more expensive and should not normally be undertaken in isolation (cross and sensibility checks should be made with market orientated data on land values where possible);

4. **Profits**: this is used for specialist trading properties, for example hotels and public houses, and based on the profits of the tenant’s operations (when commissioning valuation reports for such properties it is especially important to establish the valuer’s experience in the sector);

5. **Depreciated Replacement Cost**: this is used (usually only for financial reporting purposes) for specialised assets that are rarely sold except as part of a sale of the entire business of which they form part (for example chemical plants, port facilities, sewage works, lighthouses, submarine bases and telecommunications structures) and based upon the cost of replacing the asset new, less allowances for physical and functional obsolescence – such valuations should always should be expressed to be subject to the adequate profitability of the business, paying due regard to the value of the total assets employed, and may also be further depreciated for economic obsolescence (although this element is usually addressed by accountants or specialist business valuers).

**Who should undertake a valuation?**

A firm undertaking a valuation should be registered with RICS, and it is important to check that there is sufficient professional indemnity insurance in place for the scale of the property or portfolio involved (valuations will frequently include a liability cap, commonly in the region of 15% to 25% of the value, up to a stated maximum).

A valuer should be an RICS member and Registered Valuer, although is only prima facie evidence of qualification to undertake the engagement and does not necessarily mean that the valuer is suitable to undertake the work. It is therefore very important that a valuer can demonstrate a strong track record in the specific use class and geography concerned because of the heterogeneous nature of real estate as an asset class.

It is usual practice for the signatory to a valuation to be of Director/Partner level or above and have been qualified for at least 5 years. Different valuations will require different methodologies (for example investment valuations against trading valuations) – the valuer should have sufficient expertise and resources taking into account the number and nature or properties concerned.

**D.1.2 Legal certificate/report on title/property**

This comprises a report on the title, and other principal legal issues arising, with regard to the asset financed and/or to be provided as security. It should test, from the legal perspective, the assumptions made and information given concerning the property, and should state that the title is suitable for security purposes should the lender/mortgagee need to enforce. Ownership/title (including principal headlease terms) should be confirmed in all cases.

A “certificate” usually refers to a more formal report/summary of the issues covered in a “standard” form, either stipulated by the relevant lender/mortgagee or a professional body (for example the City of London Solicitors Company). A “report” is usually a less structured document more tailored to the nature of the asset and requirements of the transaction. Both should cover all material and relevant legal and title issues and, in most cases, should be equally acceptable.
Preparation of a certificate of, or report on, title should include the following:

- an analysis of the results of searches of the Land Registry, local authority and any other entity where information on encumbrances and other matters affecting the property may be held;
- a review of the title documents, including subsisting mortgages and documents creating encumbrances to which the property is subject;
- (where the property is subject to, or held under, a lease) a review of the relevant leases;
- an assessment of replies to questions commonly asked of property owners prior to sale/charging;
- consideration of the potential effects of any material relevant legislation or general legal provisions (for example legislation relating to tenant’s security of tenure) which would qualify the specific provisions of any lease or title document).

The report/certificate should include an explanation of any defects/omissions, an assessment of the implications and (where appropriate) recommendations for remedy or mitigation and a general explanation of the potential effects of any material relevant legislation (for example for let properties brief details of the statutes giving tenants security of tenure rights should be included). Subject to this, the nature and extent of the report/certificate may vary (depending on the type and location of the property in question and the party undertaking the review) but should typically include details of:

- property ownership and title, including any existing charges (i.e. that the owner has good and marketable title, and is beneficially entitled, to that property) and, if the transaction is a corporate purchase, ownership of the shares in the property owner;
- (where the property is leasehold) the principal terms of the lease under which the property is held, in particular rent/rent review, tenant’s obligations, insurance provisions, restrictions on transfer, underletting or charging, break clauses and landlord’s forfeiture (termination) rights;
- rights, covenants, obligations and liabilities affecting (benefiting and burdening) the property);
- (where the property is let) leases to which the property is subject, including termination dates, break clauses, rents/rent reviews, transfer or charging restrictions and insurance and repairing obligations (where a property is subject to a large number of underlettings on similar terms, for example a shopping centre, a detailed analysis of a typical or “standard form” lease with a schedule of principal individual letting terms may be substituted);
- any consents required for the purchase or charging of the property, for example from a landlord’s under a lease or a third party under a Land Registry restriction;
- issues arising out of replies to standard enquiries of the owner and/or disclosed by the results to usual searches (e.g. local authority, utility providers and Land Registry);
- existing planning consents and conditions attached (for developments a separate, specialist planning report should consider the merits of further consents required); and
- any material unusual issues arising (for example possible breaches of restrictions binding on the property and any defective title insurance policies).

Where (as is frequently the case) the lender relies on a certificate or report on title prepared on behalf of the borrower, the lender’s solicitors will normally produce an overview report, which will highlight any issues which should be brought to the lender’s attention in the context of financing the purchase of that property. However, such overview report will not amount to a further due diligence exercise and it is therefore critical to ensure that the lender can rely on the underlying certificate/report (see Section E.2, page 48 below)

A legal report on title should always be undertaken by a fully qualified solicitor of firm of solicitors (this can be checked through the Law Society's web site) which has sufficient expertise and experience of the type and nature of the property and transaction in question.
D.1.3 Building/site/mechanical & electrical surveys

This covers the physical quality of each building on a property from a technical, infrastructural, and architectural point of view and identifies potential or known technical deficiencies, compliance issues and risks. It should be used to supplement a valuation and the following principal objectives should be covered:

- the regulatory compliance status of the buildings and surrounding sites;
- an evaluation of the current quality of the buildings and technical installations;
- to develop measures to achieve compliance and to address potential or known liability and repair issues from a technical, infrastructural, and architectural point of view.

This should always comprise:

(a) a “walk-through” site inspection/survey to observe and obtain information on the property’s general physical condition, material systems and components and (to the extent possible) physical deficiencies and unusual features or inadequacies (although not testing, measuring and/or preparing calculations to determine adequacy, capacity, or compliance with any standard of any system or component); and

(b) a document review and interviews to assist understanding and identification of physical deficiencies and/or ongoing efforts and costs of investigating or remediating these (this does not consider the accuracy of such documents although a reasonable attempt to compensate for any mistakes or insufficiencies found should be made).

The precise components of such a report will depend on the nature and use of property but usually include a statutory compliance (including fire protection) review and investigations into the structure, fabric, external areas and mechanical, electrical and other systems of any building located on the property. Optional items such as flexibility in use, pre-assessment according to sustainability schemes (e.g. LEED, BREEAM, DGNB), a spot check measurement of areas, assessment of OPEX costs, completeness of handover documentation and insurance reinstatement cost can also be included. Generally, however, and whilst there is likely to be some overlap with other due diligence reports, such a report will not normally cover environmental and/or valuation issues.

A materiality level (commonly between £5,000 and £25,000) should be agreed to differentiate between material and minor issues and cost implications (often listed in capital expenditure projections) and an estimate of when such are likely to be incurred should be provided (usually short term = 1 year, medium term = 2-5 years and long term = 6-10 years).

Any report should ideally comprise:

- an executive summary;
- an explanation of its purposes and scope;
- a general description of the property and its physical condition (including commentary on the suitability of building materials used and technical installations; and
- photographs.

A risk assessment with cost implications should also be provided for material efficiencies or non-compliance issues identified (although these are sometimes not fully assessable due to insufficient information). The following risk assessments are commonly used:

- high = short term action required and clearance before signing recommended;
- medium = management attention is needed; and
- low = routine procedures.
**D.1.4 Measurement survey**

This is often time consuming and cost intensive. Site areas and lease areas should be cross checked by the commercial and technical due diligence on a document basis but, if significant discrepancies are identified, a full measurement survey should be performed. In practice, two measuring techniques are used:

- **on-site measuring**: this concerns the plotting of an existing building by a professional surveyor, using suitable measuring instruments; and
- **measuring off plan**: this concerns the graphic measuring from "as built" documents and computer files.

Different codes are applicable for the measurement depending upon the nature and location of the property. In addition, building or tenant specific agreements may need to be considered to achieve comparable results to existing rent roles, lease contracts or other documents. Results should not only comprise floor plans but also highlight tenant areas and identify discrepancies in comparison to existing documents in order to facilitate assessment (by other consultants) on issues such as rental income and cash flows.

**D.1.5 Environment/ground survey**

The valuation normally assumes the property is free from contamination, although a valuer would nonetheless be expected to mention any obvious signs of contamination. In such a case a separate environmental due diligence report should be obtained. Environmental due diligence has evolved as a result of increased awareness of potential issues and the passing of more stringent legislation, for example the Environmental Protection Act 1990 and the implications for a lender can be material if/when it has to assume ownership of, and responsibility for, an impaired property from an insolvent borrower.

Environmental due diligence, sometimes referred to as a “Phase I Report” or an “Environmental Site Assessment”, is undertaken to assess the potential liabilities and costs associated with a property (these can be significant and have a materially adverse effect on the property’s value) which may result from contaminative activities previously carried out on the land. The risks posed by such sites vary but, whilst legally the liability associated for contamination “clean up” costs rests primarily with the polluter, in some situations a property owner or lender may be liable (even where this can be passed on to a buyer or developer, the sale price is likely to reduce as a result).

A property can potentially be impacted by environmental issues, but the risks are greater for those that have had an industrial use and fall into several categories:

- **Historic Site Use**: if the site has historically been used for purposes (for example as a landfill site, mining or certain industrial processes such as rendering) that may have left a legacy of contamination;
- **Current site use**: where current activities are causing contamination (this may not be immediately apparent if contamination is “buried”);
- **Surrounding land use**: surrounding properties currently or historically may have the potential to contaminate and/or adversely impact the property; and
- **Deleterious materials and compliance**: a building may contain materials (for example asbestos) which are subject to special control regulations or require careful handling.

The scope of environmental due diligence varies depending on the property and the client’s requirements. A typical Phase I Report will not include any sampling or testing but be based on available data and a site walkover. As a minimum, however, reports should contain:

- a property description and photographic record of areas of interest;
- a review of historic mapping and data for the property (this helps to establish the potential for
• a review of regulatory database information (this assists establishing the site setting and highlights potential local issues);

• a review of the geological and hydro geological setting (including an assessment of underlying geology and its potential to transmit contamination, mining and ground stability issues, and flood potential assessment);

• a visual assessment of all areas of the property and adjoining land, with particular attention paid to higher risk items such as above or below ground tanks, asbestos containing materials, chemical storage, evidence of distressed vegetation, on-site waste disposal and chemical or oil staining;

• an interview with site staff (to determine the current pollution potential and the historic use of the site);

• a review of site documentation (to assess compliance in terms of asbestos surveys and labelling, waste disposal and review of historic site investigation data); and

• conclusions highlighting areas of potential concern and further work requirements.

Intrusive investigation is sometimes required if it is considered environmental contamination may be present in the ground. This can comprise a range of measures including installing boreholes, sampling soils and groundwater or assessing physical site characteristics such as the integrity of any underground storage tanks.

The report should be undertaken by an individual and a senior reviewer with experience of similar projects and, whilst there are no specialised qualifications, typically practitioners will have an engineering or environmental sciences degree. Reports should be factual, conclude with details of potential issues and set out potential further work that could be undertaken to clarify areas of uncertainty, but will not normally include collection and analysis of soil, groundwater or building fabric samples.

D.2 Additional Reports

The following additional reports will not be necessary or even desirable in all cases but may be recommended as a result of the findings of one or more of the principal reports and may also be appropriate for particular types of property, transaction and/or for the proposed property use/development.

D.2.1 Planning (zoning)

Statutory approval or “planning permission” is required for all material developments (including initial construction and subsequent alterations works) and/or changes of use affecting a property. In some cases, if a building is “listed” as being of special architectural or historical interest, or is located in an officially designated and specially protected planning area (for example a “Conservation Area”, “Area of Outstanding Natural Beauty” or a National Park), additional consents may be required.

Planning is therefore an important factor influencing the value of a property and, as part of a due diligence exercise, it is important to:

• determine what (and to what extent) planning factors affect the development, redevelopment and/or change of use potential of the property;

• verify that all requisite consents have been obtained and that no changes have occurred which could affect the validity of these and/or require further approvals;

• check that all conditions to which any such consent is granted have been complied with (breach of these could lead to an order to remove any unauthorised works and and/or cease any unauthorised use).

Enquiries in this respect will usually be made of the competent authority (normally the local council, although specific statutory bodies may deal with major specific infrastructure projects) as part of the
legal report on title. A valuer will also normally make basic checks in this respect but these will only identify what permissions are required and/or issued and whether any notice of breach or enforcement action has been served and will not confirm, for example, whether developments have been completed in accordance with approved plans and/or that the actual use complies with the authorised use.

Additional investigations are likely to be needed where a property is being, or is proposed to be, redeveloped. In such a case a report from a specialist planning consultant should be undertaken to ascertain what new permissions are needed, how likely it is these can be obtained and what conditions such are likely to be subject to. A full survey and physical inspection may also be appropriate and, if a major planning application is anticipated, this may advise on the likely issues and objections as well as timing and budget projections. Any such report or survey should consider the following:

- emerging planning policy and guidance and the timescales for public consultation to allow for making representations;
- details of planning applications relevant to the property (whether granted, refused or withdrawn);
- details of planning appeals relevant to the property (whether allowed or dismissed);
- conditions attached to relevant permissions and details of obligations in any legal agreement with any planning or other statutory authority;
- any enforcement action;
- any nearby road or other transport proposals; and
- whether the property is listed, in a Conservation Area or other specially protected planning area, or subject to any Tree Preservation Orders.

It is important, if a major development or change of use for a property is expected, that all consultants preparing due diligence reports are informed when initially instructed as this will have a major impact on the extent and nature of the diligence undertaken.

**D.2.2 Utilities (gas, electricity, telecommunications etc.)**

A new development will need to be connected with all major utilities to be fit for occupation and use and, even where the building is already constructed and/or occupied, additional or new connections may be required to suit the requirements of a new tenant or buyer or simply to keep pace with changes to technology.

Specialist reports may therefore be advisable to check what services are available, whether these have sufficient capacity (taking into account expected additional usage and demand) and what works are required to connect to the mains supply. Planning or construction matters and/or legal issues requiring an easement, licence or wayleave may also arise where the supply crosses other land.

**D.2.3 Deleterious Materials**

There is no definitive list of such materials, but asbestos, high alumina cement, wood wool slabs used as permanent formwork, concrete additives containing calcium chloride, calcium silicate bricks, products or materials containing urea formaldehyde foam and lead based paint are all normally considered “deleterious”. The most common are asbestos and lead based paint.

**Asbestos**

Most buildings should have an asbestos management plan in place, listing materials sampled for asbestos and asbestos containing material, which should be clearly labelled. The different types of asbestos survey are as follows:
(a) Management survey: required during the normal occupation and use of premises - where the premises are simple and straightforward, such a survey can be undertaken to ensure that:

(i) nobody is harmed by the continuing presence of asbestos materials in the premises or equipment;
(ii) any asbestos present remains in good condition; and
(iii) nobody disturbs it accidentally.

The Survey must locate asbestos that could be damaged or disturbed by normal activities, foreseeable maintenance, or by installing new equipment. It involves minor intrusion and asbestos disturbance to make a materials assessment (this shows the ability of asbestos, if disturbed, to release fibres into the air and guides the client, for example in prioritising any remedial work).

(b) Refurbishment/demolition survey: required where premises need upgrading, refurbishment or demolition - normally, a surveyor is needed for this type of survey, which does not need a record of the current condition but aims to ensure that:

(i) nobody will be harmed by work on asbestos containing materials in the premises or equipment; and

(ii) such work will be done by the right contractor in the right way.

The Survey must locate and identify all asbestos materials before any structural work involving destructive inspection and asbestos disturbance begins at a stated location or on stated equipment at the property. The area surveyed must be vacated, and certified as fit for reoccupation after the survey.

Lead

Risks posed by lead are only realised if lead can be ingested, inhaled or absorbed, but can be present if there are lead pipes in buildings or if people are in contact with dust or flaking paint. There are no specific U.K. guidelines for lead paint sampling but a similar approach can be taken to the asbestos surveys, for example sampling and analysis of paint or dust by using a portable XRF metals analyser. The risk posed by lead paint should be assessed using the exposure potential and the lead concentrations of the paint.

D.2.4 Mining (coal, tin, lead, salt/brine, china clay etc.)

Historical mining activity may physically affect a property, causing ground movement as the workings collapse and the ground consolidates. In addition the presence of shafts and adits may form a preferential pathway for the migration of potentially explosive gas.

An initial mining assessment will be undertaken during a standard environmental due diligence process although, if the site is located in a high-risk area, further survey may be required. This can include evaluation of data held by the Coal Authority, such as the depth of mine workings and when they were abandoned, from which it is usually possible to determine if there is a material risk to a project. Occasionally, if there are shallow workings or on site shafts, some exploratory borehole assessment may be needed.

D.2.5 Unexploded Ordnance

Some properties may have been subject to bombing during World War 2. A basic ordnance assessment report can be undertaken as part of an environmental survey, however it is more common to undertake this at development sites where deep excavation or piling may be required. The report will assign a risk level to the site.
D.2.6 Flooding

Basic flood risk assessment is usually covered in an environmental diligence report and takes the form of review of Environment Agency flood risk maps and information gathered from interviews with site staff. The form of such an assessment varies depending on whether it is an existing building (in which case a practitioner would typically look at whether a site has actually flooded) or a new development site (when a full assessment is required).

D.2.7 Occupational Requirements

A valuation report will generally assume a building complies with current regulations but a lender or investor (especially if the property is new, vacant, or to be developed) may wish to obtain a specialist report to verify this since, if a building does not comply, additional works and expense may be required to attract a tenant/user. A building occupier will also wish to be satisfied that such is fit for its intended purpose and use, and to know what alterations may be required in order to comply with any relevant statutory requirements.

The principal responsibility for compliance is usually on the actual user or tenant, but the main areas of interest are:

(i) **Health and Safety:** an owner/user must provide a safe and secure working environment for occupiers and employees – the requirements vary depending upon the type of premises and use but usually a formal assessment of inherent risks should be carried out and steps taken (usually involving additional works) to mitigate these.

(ii) **Disability Discrimination:** a building open to the public or to which the public are generally admitted must be constructed/fitted out so as to accommodate special requirements of disabled users or visitors.

(iii) **Fire Precautions:** there must be adequate means of leaving the premises in case of emergency (this usually requires a second escape route if the main exit is blocked and safe storage facilities for hazardous or inflammable materials).

(iv) **Planning/Building Regulations:** alterations and works must comply with statutory planning and building regulations (see D.2.1, page [37] above).

(v) **Energy Performance:** most buildings now require an Energy Performance Certificate (see D.2.11, page [41] below) offering an assessment of the efficiency of the building in consuming gas, electricity and other energy sources and recommendations for improving this.

(vi) **Utility Supplies:** a user/occupier will want to ensure that power supplies and telecommunications services are adequate, available and installable without having to undertake works and/or obtain easements or licences over neighbouring properties.

D.2.8 Rights of Light

A "right of light" gives a property owner (a "Dominant Owner") the legal right to receive light through defined apertures in buildings on their land. The burdened landowner (a "Servient Owner") cannot substantially interrupt this (for example by erecting a building in a way that blocks the light) without the consent of the Dominant Owner, who is *prima facie* entitled to an injunction to protect its right. The Dominant Owner may have express rights of light (set out in an agreement between the Dominant Owner and the Servient Owner) or, more commonly, undocumented prescriptive rights (acquired by 20 years' enjoyment of light over land owned by the Servient Owner). An interference with a right of light can be acceptable, provided that it does not itself amount to a nuisance.

Rights of light are of particular concern in the case of development land and it is vital to a developer and its funders that due diligence is carried out to identify potential risks since a Dominant Owner with rights of light over the relevant property could prevent construction or, in some circumstances, require demolition of the infringing part of a building. The Court in recent years has been more prepared to grant injunctions restraining development but, even if it does not do so, can award damages (which range from 5% to 50% of development profit) arising from any new development which interferes with the Dominant Owner’s rights. This has led to rights of light being elevated towards the top of a developer's concern, and compensation budgets increasing as Dominant Owners have become more aware of the value of their rights.
A legal title report for the adjoining properties should identify whether there are any express agreements or Light Obstruction Notices (local land charges registered to protect rights in favour of neighbouring undeveloped land), although a specialist survey may be required to identify prescriptive rights. Specialist surveyors can provide advice as to what such rights may subsist and/or whether specific designs will amount to an interference.

D.2.9 Infrastructure (railway, highway, waterways etc.)

Additional, specialised, enquiries should be made where a property is located close to an actual or proposed major national infrastructure development, for example a major waterway, port, power station, new road or railway. Many such projects are subject to special planning (zoning) approval, compulsory purchase (condemnation) and/or compensation schemes, although the final consequences and/or impact on value may not be immediately apparent.

D.2.10 Capital Allowances

Equipment installed on property may be subject to particular tax concessions known as capital allowances although the circumstances where these can apply, be transferred and/or be lost or “clawed back” are subject to special rules which can change frequently. Consequently, where an investor or lender believes that such may have a material impact on the value of a property, a specialist report should be commissioned. This should, to the extent possible, identify any equipment or buildings subject to such allowances, the amount of these and whether these can be passed on to a buyer. In some cases an election can be made for the benefit of these to pass to a buyer or be retained by a seller.

D.2.11 Energy efficiency/performance

All buildings are now subject to energy certification schemes and compulsory inspections for equipment such as of boilers and air-conditioners (new buildings will be required to comply with higher standards in this respect). A consequence of these is that an Energy Performance Certificates must be made available to new tenants and purchasers of property. Generally, these only be issued by competent, licensed, persons and must be commissioned before marketing a property for sale is started.
E INSURANCE ISSUES

E.1 Insurance Due Diligence

The seller/borrower should be asked about any outstanding insurer required risk improvement measures and if there is any reason why the current insurance may not be maintained in the future (if notice of cancellation has already been given by its insurers new cover after completion may be difficult or impossible). All of this should be done, and the adequacy of the cover measured, against the requirements of any purchase, loan or other documents to check that all relevant obligations are met (required insurance can take several weeks to arrange, due to the amount of diligence that will need to be undertaken).

The object of insurance due diligence is to look

• back - on past risk exposures, coverage and claims experience;
• at the present - at insurance in force and compliance with any obligations imposed on the insured, including a comparison with best practice; and
• to the future - to assess if there are any foreseeable factors that might affect the availability or price of insurance which might affect the viability of the transaction.

An analysis of past claims, for both property damage and liability, can identify trends that might influence lending decisions. Further, where an insurance company pays a claim, it has the right of subrogation which enables it step into the insured's shoes and attempt to recover what has paid out from those who have created the loss. Care should be taken not to prejudice this right when entering into agreements with the vendor or other parties.

General Provisions

Copies of the actual policy documents with full schedules, reinstatement valuations, up-to-date endorsements and complete rent schedules should be vetted, as documents prepared by other parties cannot be relied upon (especially where a third party is arranging the cover). Asset or property management agreements should also be checked as these may include a responsibility for arranging or managing insurance (these are regulated activities since the introduction of the Insurance Mediation Directive in 2005 and it is important to ensure that any person responsible for such is registered with the appropriate regulator).

An existing insurance policy may remain in place until (or even after) completion, although this is generally considered unsatisfactory for the following reasons:

• the risk of damage passes to the buyer on exchange of contracts, and, although the buyer's interest can be noted, the seller retains control over the insurance and claims;
• a breach of policy conditions or insurer requirements by the seller or another party (such as a tenant) may prejudice the cover;
• the policy can be avoided if material facts have not been disclosed to the insurer;
• the property may be under-insured and the proceeds insufficient to reinstate the damage or compensate for the loss;

It may therefore be better to arrange separate cover to protect the buyer/funder, even if this results in a duplication of premium. A careful review of the current premium costs should also be undertaken to ascertain:

• outstanding premiums that might have to be paid by the buyer after completion;
• whether the premiums are in line with market rates or if a change of owner and insurer will trigger an increase (causing friction with tenant);
any ‘behind the scenes’ arrangements with the broker or insurers that might cause future problems;

any long term agreements (e.g. obligations to maintain cover with the existing insurers for a minimum period) - these can be beneficial, keeping costs stable but need to be understood as breaking them can be expensive.

A lender should also check whether the security assets are covered by title insurance, either when the loan is originated, or if a subsequent security review is undertaken.

Types of Insurance

As well as standard buildings insurance cover, consideration should be given as to whether cover for specific additional risks is needed, for example:

(a) Public Liability Insurance: protects against third party claims arising out of the ownership and management of the property - often included as a separate section in the buildings insurance policy but a higher level of cover may be needed (this is provided on a claims occurring basis, i.e. the applicable policy is the one in force when the incident happens, not the one in force when such is notified, and it is therefore important to check there is a full insurance history during the period for which the buyer assumes liability.

(b) Environmental risk insurance: covers liability arising from pollution and/or “clean-up” costs (usually excluded from standard public liability insurance).

(c) Professional Indemnity Insurance: any professional (e.g. a valuer, solicitor, or other professional or report provider) engaged in connection with a property should be required to take out insurance (and provide evidence of cover) against future claims (it is important to remember, however, that this is primarily to protect the negligent professional – not to pay claims to the party who has suffered loss).

(d) Latent Defects Insurance: covers damage by unforeseen risks (e.g. rectification of a structural defect) not included in other policies and independent of the establishment of liability (if not already in place, this can sometimes be arranged within two years or so of completion of a development provided there is a satisfactory technical report by the underwriter’s engineers.

(e) Warranty Insurance: a sale agreement often imposes warranties and indemnities upon the seller, but, if these cannot be given or there are concerns about the warrantor’s ability to meet any claim, insurance may give comfort to the buyer and funder.

(f) Defective Title Insurance: insures a defect in the legal title to the property (e.g. an old restrictive covenant prohibiting the current or proposed use) – in some cases this may also be offered in place of the usual legal due diligence reports (see E.2, page [48 ] below).

Lender Requirements

A lender often has specific insurance requirements which necessitate amended or replacement cover. The lender will also want to be satisfied that the insurers are of sufficient financial status to support the credit rating of the loan and may also want a loss payee clause that provides for claims proceeds (usually above a specified amount) to be paid only to it, thus avoiding the risk that a borrower might mis-appropriate these. There is also normally a requirement for the borrower and/or the insurers to notify the lender of any changes and non-payment of premium (allowing the lender to pay this to keep the cover in place).

The loan agreement will normally require insurance of any building against “all risks” in its reinstatement value plus loss of rent (usually for 3 years) if damage renders the property unlettable or triggers rent suspension clauses in leases. The loan documents may also require the lender to be an insured party in its own right (i.e. a composite insured, providing parallel cover unaffected by any act or omission of any insured parties) as anything less, for example interest noted, joint/co-insured or a general interest endorsement, may not be sufficient.
E.2 Legal Defects/Environmental Risk Insurance

An insurance policy can also replace or supplement due diligence reports in particular circumstances and cover, for example, defects with security assets or other inherent transaction risks.

These are usually taken out where time is short, information is incomplete, representations and warranties are not forthcoming or unreliable or the buyer’s budget is limited. The principal risks covered by such insurance are:

- the legal ownership and intended use of the asset;
- planning and compliance with building permits;
- potential contamination of land or failure to properly remediate previously contaminated land;
- matters normally covered by a seller’s representations and warranties, but which the seller cannot (usually because of insolvency) give;
- adverse or nil responses to pre-contract enquiries (e.g. where responses to a search of local authority records cannot be obtained in time);
- policies which support a "sample" due diligence review, where the portfolio is too large for each property to be investigated individually.

These types of insurance cover actual loss arising from a particular peril, are specific to that asset and transaction and last for a set period of time, usually without the need for any renewal or further premium. These policies typically cover depreciation in land value, penalties and third party settlement, loan interest, construction, alteration, demolition and legal costs and either insure the total property value, the loan amount or the "estimated maximum loss" (commonly, the insured risk will not be capable of causing a total loss of value, so it is always worth obtaining alternative quotes).

Such policies, in the U.K., are often called "legal indemnity", "defective title" or "legal contingency" insurances. It is not customary in the U.K. always to take out title insurance (this is normally only done to cover a specifically identified defect) and there are three main types of such policies, which provide different levels of protection:

- **Comprehensive**: insures the borrower’s ownership of, and ability to use, the property for the intended purpose, the loan security (cover against fraud and forgery, unenforceability and priority problems) and costs and expenses incurred protecting the mortgage;
- **Limited Coverage**: insures a specific pre-existing flaw in legal ownership security (e.g. rights of light, lack/breach of planning or building permissions, restrictive covenants, easement issues, adverse possession, and chancel repair) including costs and expenses incurred in protecting the security; and
- **Search Replacement**: used where (when the loan was first advanced) the usual searches and enquiries of the local or other relevant authorities cannot be made, or where the replies to these are oral only for which the relevant authority will not accept responsibility.

It should be checked whether there are any outstanding claims on any existing policy, not only as the benefit of such may need to be assigned but also to ensure that the loan process does not prejudice this. However, where there are uninsured technical ownership and security problems, it may be better for the buyer, not the seller, to put this in place. The policy, or a commitment from an insurer for a policy, should

- be taken out before contracts are signed, or there should be a condition precedent that this is done before closing;
- name the lender and/or borrower as insured (Limited Coverage policies usually also insure successors in title, mortgagees and tenants); and
• Insure the lender for as long as the loan is outstanding (including where the lender is a mortgagee in possession or enforcing its security) and, if a borrower is the insured, should continue for the duration of its ownership or (if longer) for as long as it has any liability for any title warranties given on sale - Search Replacement and Limited Coverage policies can last indefinitely.

Many policies include inflation proofing cover - sometimes linked to an index but more often this will increase, up to a pre-set limit, at a pre-determined rate for each of the specified policy years. These policies, especially Limited Coverage, may also require the existence and content of the policy to be kept confidential and, in such a case, it is very important to comply with this (a seller's undertaking might be appropriate) because any breach could prejudice the ability to claim and/or even allow the insurer to avoid the policy altogether.
F. SUPPLEMENTARY ISSUES

F.1. Instruction Letters

The instruction letter will form the basis of the relationship between the report provider and the recipient beneficiary, and should therefore be as accurate and complete as reasonably possible.

Many providers (for example the “Red Book” sets out basic terms of engagement for valuers) have standard terms of business which should be given to all beneficiaries of the report/survey as early as possible (otherwise the provider may not be able to rely on these).

The scope of engagement may be set out in a formal engagement letter written by the consultant/professional or in an instruction letter prepared by the buyer or lender. Ideally, this should be countersigned by the receiving party to confirm acceptance and is often subject to negotiation. Generally, however, such a letter should expressly set out and list:

- the identity of the party or parties (including, for corporate entities, contact names) for whose benefit the report is being prepared and any other persons to whom the report should be addressed and who are to be able to rely on its contents;
- an outline of the relative transaction (this can often be achieved by attaching a term sheet) and the functions (i.e. buyer, lender, tenant, etc.) of the addressees;
- a description of the relevant property sufficient to enable it to be readily identified (a plan and/or photograph is useful for this);
- confirmation of the type/purpose of report (e.g. credit assessment, valuation, survey, legal) and the form and extent of reporting (i.e. “high level”, “red flag”) required;
- any exclusions and (if relevant) which documents will be reviewed;
- any particular assumptions to be made or disregarded and/or special requirements peculiar to the property, transaction or report beneficiary;
- details of when the report is required and any supplementary work envisaged;
- any due-diligence co-ordinator, parties and others with whom the report provider should liaise, the division of responsibility between advisers, whether advisers will be relying on other advisers’ reports (and, if so, which) and/or to whom copies of the draft and final form report should be sent;
- the person or entity who should be contacted to obtain access or additional information required relating to the property;
- confirmation of any limitation or cap on the liability of or claims against the report provider, plus details of professional indemnity insurance requirements; and
- confirmation of fee basis and disbursements and/or other expenses agreed to be paid.

The absence of an, or an incomplete, instruction letter may delay closing of the transaction or lead to additional expense in making additional surveys or enquiries. It can also cause disputes over fees and inhibit a buyer’s or lender’s ability to claim compensation for material inaccuracy or omission, or oblige the beneficiaries to accept a report the form and content of which is inappropriate.

Occasionally, unforeseen issues arise after an engagement has commenced which necessitate a change to this (for example tenanted premises may become vacant, or a buyer may wish to change development plans). These may necessitate consequential amendments to a due diligence provider’s engagement and, in such a case it is important that these are also clearly documented and agreed.
F.2. Reliance

Most due diligence reports contain restrictions on disclosure to, and reliance by, third parties. Any lender financing the purchase of real estate will, however, want to ensure it can rely on those reports because it or its advisers will have reviewed these and the decision to lend made on the assumption that the information contained in those reports is accurate. The lender will want to be able to claim compensation from the report provider for damages if the report is incorrect and, as a result, it suffers loss.

A party commissioning any due diligence report should normally, before work is started, inform the report providers that their reports should be capable of being relied upon by any lender which finances the purchase and/or development of the property. The lender should either be an addressee of the report or the report provider should provide a separate reliance letter setting out the terms on which the lender may so rely.

A lender will typically expect to be able freely to disclose each report to

- all relevant “finance parties”, including not only the initial lenders and facility and/or security agent but also future syndicate members (who will expect to see and rely on this) - this is important for the lender to be able to sell its interest in the loan although, conversely, the report provider will want to manage its potential risk and not incur liability to a wide group of unidentified parties for an indefinite period;

- its advisers and, for a potential securitisation, rating agencies and other parties such as servicers (in addition banks and institutional lenders especially may need to be able to disclose the report to an affiliate and, in some case, disclosure to a third party may be required by law).

As a result, in practice, disclosure/reliance is often limited in time (e.g. to entities becoming lenders within a year of the date of the report) and to specific groups of future parties (for example any participating lender in a primary syndication or securitisation). Conditions on disclosure/reliance may also be imposed, for example that notice of any future beneficiary is given to the report provider, that the provider shall have no greater liability to any new party than it had to the original parties, that any third party disclosure be on a confidential basis and/or that any liability of the report provider is subject to a cap. A lender, however, should be comfortable that any such limit or condition is appropriate in the context of the value and nature of the transaction and a provider should be satisfied that the extent of reliance is in accordance with the terms of its professional indemnity insurance cover.
G BEST PRACTICE PROTOCOL

Each transaction and property will differ and dictate variable requirements and approaches. However, to avoid last minute problems, to maximise the benefits of the process and increase the understanding of all concerned, for the purpose of a loan secured (and any related asset purchase) on U.K. real estate adoption of the following principles should assist:

- Professional teams should be identified and instructed at an early stage;

- The scope of each consultant’s appointment, especially as to addressees, beneficiaries, further disclosure and special requirements, work to be undertaken and time limits should be clearly specified.

- Report qualifications and disclosure restrictions should be agreed with all beneficiaries and/or clearly specified by report providers before commencing work.

- A working group list should be circulated to ensure that all parties and their advisers remain fully appraised of the progress of the transaction.

- An initial meeting or conference call should be organised for all relevant advisors to discuss the parameters of the diligence process, identify the main risks and issues likely to be encountered and the process/methodology to be adopted and determine individual responsibilities and a timetable.

- For larger (multi property) transactions, regular (at least weekly) update conference calls for all principal report providers should be arranged.

- Lenders should specify which copy reports should be sent to which other parties or advisors and appoint a due diligence coordinator with responsibility for monitoring progress and recording specific requests and feedback.

- Liability caps should be realistic (having regard to provider’s role and insurance cover, and the transaction value) and not quoted as a multiple of fees or a percentage of value.

- Report providers should volunteer details (e.g. summary policy schedule or brokers’ letter) of professional indemnity insurance cover promptly.

- Reports should be self-contained (i.e. not refer to other documents or conditions) and clearly set out their scope and the methodology employed. Plain English should be used and technical terms explained or defined.

- Data rooms should be organised in categories, all documents labelled and subsequent additions clearly identified and notified to all authorised users. The compiler of each data room should ensure that contents are up to date, filed, indexed correctly and checked before opening this to users and electronic rooms should have sufficient capacity to be capable of use by several parties simultaneously and checked for ease of access/downloading before being opened.
List of Contributors

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<td>Clifford Chance</td>
<td>10 Upper Bank Street</td>
<td>Clare Fawcett</td>
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<td>FAF International</td>
<td>76 Shoe Lane</td>
<td>Ian Keith/Phillip Oldcorn</td>
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<td>Helaba (Landesbank Hessen-Thüringen Girozentrale)</td>
<td>3rd Floor 95 Queen Victoria Street</td>
<td>Klaus Betz-Vais</td>
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<td>Nova Consulting Group</td>
<td>Tower 43 25 Old Broad Street</td>
<td>Jim Gott</td>
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<td>REAG GmbH (Real Estate Advisory Group Germany)</td>
<td>Bockenheimer Landstrasse 22 D - 60323 Frankfurt am Main Germany</td>
<td>David Lyon/Thomas Kral/Eric Rieve</td>
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