

Chapter 5

Choosing the Advisor

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Introduction

This chapter explains why it is important for an investor to perform due diligence with respect to real estate investment advisors and also includes a detailed list of due diligence topics.

Assessing advisor operations is time consuming and many investors or wealth managers are not staffed appropriately to perform a thorough review. Therefore, the chapter presents a menu of topics and issues, and investors can prioritize the topics according to their investment goals and determine their own preferences on depth and processes. A summary of the due diligence topics covered and a checklist are presented at the end of the chapter.

Why Perform Advisor Due Diligence

The degree of diligence varies but virtually every investor requires some type of diligence review. Strategy and vehicle selection alone will not ensure successful performance. It is easy to make the choice to spend significant time to assess the risks of a real estate strategy and little time assessing the risk in an advisor's operations. However, spending time assessing advisor operations is the key to successful real estate investment for several reasons. First, because individual property investments have unique issues and status in their submarkets, published market information for an area must be individually augmented with onsite visits to competing properties and calls to brokers for each asset. This means the advisor has to have sufficient qualified staff and processes to assess the issues and market. Second, real estate investment is generally a longer-term investment and does not have an easy exit. Noncore real estate investments need three to five years to achieve cash flow returns and any value enhancement due to contractual increasing rents, or a development/value-add strategy. For such a long-term commitment, it is only logical to do one's homework on the investment advisor before the commitment is made. Investors are heavily reliant on the advisor's decisions and recommendations, but the ramifications of those decisions and recommendations are borne by the investor.

Ample time spent with the advisor during due diligence can help the investor establish a level of trust and respect with the advisor, and gauge the advisor's ethics. In addition, the investor can learn much about the advisor that will assist in managing the future relationship, such as the advisor's understanding of the investor's needs, and the advisor's responsiveness to questions.

Some investors do not focus on advisor due diligence because they think that 1) other prior investors already have done the review and they can rely on that diligence, or 2) the advisor's good track record speaks for itself. Regarding other investors' due diligence, it is not the case that "one size fits all". Investors have similar but not identical expectations regarding advisor responsibilities. For example, it might be that an investor has unique financial or informational reporting requirements. Investors also have different risk tolerance levels. For example, decision making by one individual at an advisor might be acceptable to one investor while another believes decision by consensus is a better process with less risk. Regarding the advisor's good track record, track records must be analyzed thoroughly to provide the complete story and some investors do not do a thorough analysis. As discussed more fully in the track record section, good returns reported on a portfolio as a whole might mask some problems in certain areas.

The goal for advisor due diligence is to determine whether the advisor has a sustainable platform, and the required skills, resources, and processes to successfully implement the strategy. It cannot be stressed enough that the investor should spend serious time up-front on advisor due diligence.

Advisor Evaluation

The investor should look at all aspects of the advisor's operations. In particular, the investor wants to ensure that sufficient processes and qualified staff are in place at all levels so as to maintain or add value according to the investment strategy, and, in the event of a market downturn, to minimize losses.

The review described in the remainder of this chapter assumes the investor is evaluating a US-based advisor for investment in the United States. Advisors located, or investing, outside the US have their own risks to consider that are not covered here.

Process

Advisor due diligence can be divided into three aspects: written material that can be digested both before and after in-person interviews, in-person interviews with key advisor staff, and market reconnaissance, which includes third-party assessments of the advisor's reputation.

1. **Written documentation.** A review of written documentation on the advisor's corporate history, organization, financial health, and certain written procedures can provide significant insight into operations. A sample document request list is at the end of this chapter.
2. **Interviews with advisor staff.** Interviews with advisor personnel are useful to determine company culture and whether processes are indeed performed as written. Interviews can take place either at the advisor's office or at some other location more convenient to the investor. However, despite the inconvenience, far more insight can be gleaned into an advisor, its culture, and its operations by being on-site. Thus, whenever possible, interviews should be held at the advisor's headquarters and, if appropriate, satellite offices, with advisor personnel at all levels. Whenever possible, it is preferable that interviews take place with all levels of personnel from the chief executive officer (CEO) to the financial analyst and accounts payable person. It is important to interview people at different levels in an organization to see whether the "story" told by senior executives is indeed confirmed by the mid- and junior-level personnel who are actually responsible for executing the investment strategy and the advisor's operations. At a minimum, an investor should spend at least most of a day interviewing the CEO, chief financial officer (CFO), head of acquisitions, an acquisitions officer, the head of asset management, an asset manager, the person responsible for the investment vehicle, the accountant responsible for investment accounting, and a financial analyst.
3. **Market reconnaissance.** Market reconnaissance is the attempt to determine the advisor's reputation and includes formal reference checks with investors and suppliers, informal reference checks with general market participants who are similarly situated investors but are not associated with the advisor, and adverse publicity searches.

Based on the information in the documents and insights obtained during interviews, the investor should get a good sense of:

1. **The company culture.** The culture includes the degree of commitment by the advisor to being a fiduciary to investors and to treating employees fairly, and the degree to which the advisor's employees have integrity and experience. All these attributes will go a long way in making sure the investor is satisfied with the investment.
2. **The components of the advisor's track record.**
3. **The operational execution capability in terms of processes and procedures for both investment and back-office functions.**

Topics for Review

The remainder of the chapter covers topics to be considered in an advisor review.

Determine the Culture of the Advisor

The “soul” or culture of a real estate investment company lies in the way it treats its investors (does it behave like a fiduciary?) and employees (is the advisor maintaining a firm at which an investor can have confidence that past success can be replicated?), and the quality of the individuals. Underwriting the culture is, perhaps, the most difficult assessment to make and can only be done through interviews with advisor personnel and other independent market participants.

Fiduciary Mindset

Gauging the way an advisor views its investors is best done through discussion with senior management and reference checks with the firm’s other investor clients. Reviewing only a written response to a standard questionnaire on the topic will not provide an adequate picture. The discussions should include examples of situations in which the advisor indeed acted like a fiduciary. It is easy to “talk the talk” but not so easy to “walk the walk” of a fiduciary. During interviews, the investor can determine:

- Client communications. How does the advisor communicate with its clients? Is the information flow “transparent” and timely? “Transparent” information flow means issues are raised early; all sides of issues are discussed even when some aspects are not in the advisor’s best interest, and sufficient detail is provided to explain conclusions.

Does the advisor listen to and act on investor input, even on issues for which it is clear the advisor has discretion? Markets and investor profiles change over time and the advisor has to be willing to listen to the concerns of its investors.

- Conflict of interest policies. Does the advisor have a formal conflict of interest policy? Or an investment rotation policy that determines how investments are allocated to clients or funds with potentially competing mandates? Are these policies acceptable to the investor? For example, rotation policies range from keeping investor priority lists by strategy to “the advisor will allocate investment opportunities in its sole discretion.” It is best when the advisor has written policies for these areas, but the investor must ascertain whether the policies are acceptable and are indeed followed.
- Use of resources. If the advisor has captive resources, does it choose the best resource even though it might be a third party? The most common example of this type of decision is the use of in-house property management. In-house management may not be the best choice when a third-party firm may have more experience in a particular market.

Treatment of Employees

As the employees will actually be executing the strategy, it is important to determine if they are satisfied with their employment and believe they are fairly treated so as to be able to determine if the advisor is maintaining a firm where past successes can be replicated. Gauging the level of the firm’s commitment to employees can only be done through discussions with the employees to determine if they feel fairly compensated, have sufficient resources to do their jobs, and that their voices are heard in the decision making process. In this regard, open-ended questions work best such as: Who do you interact with on a daily basis? Or, what additional resources do you need to do your job better?

Quality of Individuals

It is important to ascertain the quality, experience, and integrity of the staff assigned to the contemplated investment. Once again, this assessment is best done through interviews with advisor personnel, reference checks with current investors and service providers, and general discussions with like-minded investors who have not invested with the advisor about the advisor’s general reputation. In addition, there are numerous Internet resources that can also be used to derive a general sense of an advisor or to determine whether there are any adverse topics, such as a major lawsuit or scandal, that the investor should be aware of.

Evaluate Advisor's Track Record

Thoroughly evaluating an advisor's track record can be a complicated and frustrating experience. Many investors stop after reviewing a realized (sold) portfolio's internal rate of return or simply rely upon an advisor's projection of future, anticipated, returns. Since it is likely the investor does not have the in-house staff or systems to calculate an advisor's performance, the investor will rely on the advisor to do so. Therefore, the investor needs to determine whether an audit of reported performance is necessary.

Objectives

To start a track record review, the investor needs to determine the objective for the evaluation. Is it to compare the advisor's performance:

- against the investor's internal return requirement,
- against peers, or
- against a published index?

It may be the investor has multiple objectives.

Since the 2008-2010 economic downturn, most investors will analyze an advisor's track record based on the vintage year of investment and stop there. This is an important analysis; however, investors should not stop there.

There are other ways to "slice and dice" the returns depending upon the investor's objectives. The most common analyses would be returns by the target geographic markets, stage in the life cycle, property type, and investment size. Other analyses might include returns by the assigned advisor team to the contemplated investment vehicle. If an objective is to generate current income, then "same store" net operating income growth year over year should be reviewed.

Methodologies

Based on the objective(s), there are different methodologies used today to calculate returns, which include the following:

- Internal rate of return (IRR). The IRRs can be compared against other portfolio investments' or advisors' IRRs. This method is the best for real estate as it considers both the amount and timing of cash flows. Individual property cash flows can be grouped by vintage year, location, investment size, property sub-type, or even by investment officer to determine performance.
- Time-weighted return (TWR). An advisor's TWR can be compared against industry benchmarks. Typical benchmarks include the National Council of Real Estate Investment Fiduciaries' Property Index (NPI) or Open End Diversified Core Equity Index (ODCE). These indices vary in terms of the amount of debt and fees included. The NPI is published by property type, property sub-type, geographic region, and sub-region. A review of the intricacies of time-weighted returns is beyond the scope of this chapter. It will suffice to say that time-weighted returns do not consider the timing of the property cash flows.
- Equity multiples. The advisor's equity multiples can also be compared against multiples for other investments or advisors. The equity multiple has multiple definitions but the most useful one is the amount of total cash received divided by the maximum capital outstanding. This metric is a good complement to the internal rate of return. For example, an advisor could have a high internal rate of return but low equity multiple for property investments with very high leverage or short duration.
- Leverage and fees. An analysis of leveraged and unleveraged performance and before and after fee performance can provide valuable insight. In normal economic environments, leverage is generally

accretive to returns. But, due to the economic downturn in 2008-2010, the advisor's leveraged returns might not show the expected premium over unleveraged returns. Performance shown both before fees and after fees can provide insight into how expensive the advisor's fee structure is in relation to other investments.

The investor should request that detailed returns by asset be presented along with the portfolio returns. This detail is important so the investor can determine any anomalies in the portfolio returns. Anomalies might be caused in a portfolio IRR if there are only a few assets in the return grouping. For example, there might be only one or two assets in the West region, which does not make for a robust track record. In addition, maybe one of these assets is a serious over- or under-performer, which skews the overall regional results when using IRR.

If the advisor does not have a track record for the specific investment strategy, there are other ways to determine whether the advisor likely can produce the intended financial results. The advisor could joint venture with a partner that does have the requisite expertise, such as a developer. In this case, a review of the partner's track record would be useful. The investor should also review the performance of other joint ventures managed by the advisor in order to gauge the advisor's ability to underwrite venture partners. For a start-up advisor, the track record of the senior managers while they were at predecessor firms can be analyzed.

Evaluate Operational Execution Capability

This section covers the topics to be reviewed when underwriting advisors for our clients. We do not review every item listed for every client; the scope of the review depends upon client requirements. We do cover a majority of the items in every review. Although not mentioned explicitly in each section below, the investor's goal is to understand the way risks and conflicts are determined and managed or mitigated.

Also, in all the of functions listed, the investor should determine whether the personnel assigned to the investment being considered appear qualified (through interviews and a review of resumes), if the staffing levels are adequate (determined by reviewing organization charts and asking about how work load is assigned), and the percentage of time to be spent on the specific investment being considered (through the information requests and confirmed in interviews).

Corporate Overview

There are numerous aspects to consider in the overall corporate overview.

1. Corporate history. A brief review of the history of the firm can be enlightening. The history can explain why certain people are where they are in the organization and why processes are the way they are, as well as provide insight into the overall company culture.
 - Existing issues. The investor should determine whether the advisor has issues that siphon staff time away from the contemplated investment. These issues might include problem assets in older portfolios that require substantial time to manage, absorbing a recent merger or acquisition, the introduction of new or different investment vehicles, or on-going or pending litigation.
 - Historic growth. A review of the history would include how growth has occurred. Was growth organic or through corporate acquisitions that brought new ideas into the culture? How did the company decide to pursue avenues of growth including new lines of business? This last question provides good insight into the way the firm makes corporate decisions. The pace of growth and organizational changes to accommodate growth are important considerations.
 - Competing mandates. The advisor may have multiple investors or funds with competing mandates with the intended investment. Or the advisor may invest on its own account. Competing mandates present a risk of divided loyalty.

- Investor base. The history review would include a look at the existing investor base. If the advisor is highly dependent on one or a few investors, there is a risk of divided loyalty.
2. Corporate structure and ownership. A review of the corporate structure and ownership provides insight into the way decisions are made and the motivations for those who share in firm profits. The basic structures are private companies, public companies that are not REITs, and REITs. The structure impacts business processes. For example, a publicly traded firm has pressures from Wall Street that do not impact private companies. A public firm is subject to monitoring by the Securities and Exchange Commission and will have numerous written policies and procedures and process checks to ensure the policies are followed. These firms will also have public financial statements for review. Note that a public firm may still have a single shareholder or a small number of shareholders who control decisions.

Private companies tend to be closely held. A closely held or family-owned firm may have a culture that shies away from nonmandatory regulatory compliance and relatively little documentation of procedures. Family-owned firms can have cultures that engender extreme loyalty from employees, which means they stay in their positions for long periods of time. This tenure bodes well from an operational risk standpoint in that the employees know the procedures, checks, and balances, even if they are not formally documented. But such firms can also lack innovation. In addition, these firms likely will not provide complete financial statements for investors to gauge corporate financial strength and staying power. (A discussion of how to determine corporate financial strength is in a subsequent section.)

If the advisor is part of a larger firm, it is important to understand the level of control by the parent over advisor decisions and resources, and the level of services provided by the parent to the advisor. Also, it may be that there are subsidiaries that would be used in implementing the investment strategy (like a property management company). It is important to determine how the entities interact.

In addition to general firm profits to the owners, it is important to determine the level and manner in which profits are shared with employees. Employee compensation is discussed more fully below.

3. Corporate decision making. “Corporate decision making” refers to management (e.g., personnel compensation, or obtaining new corporate debt) as well as investment decisions. The goal of this review is to determine who really makes the decisions. Collaborative decision making generally provides better decisions as numerous points of view are considered. Advisors may say they have a collaborative, committee decision process, but in reality the founder, CEO, or family head effectively makes the decisions. The only way to ascertain this is through interviews.

The firm will likely have numerous committees that consider issues and may make decisions. These would include an investment committee, a management or executive committee, and certain *ad hoc* committees. The investor should ascertain what decisions the committee makes, who is on the committees, if the members are qualified for the types of decisions being made, and how affirmative votes are obtained (Majority? Unanimous? Does anyone have veto right?)

The management or executive committee would decide non-real-estate investment items generally relating to company resources such as procuring company debt, entering new product lines or markets, personnel promotions and compensation, and systems upgrades. *Ad hoc* committees would be primarily advisory in nature and might relate to the implementation of a major computer system upgrade or the initiation of a new product line.

If the advisor has numerous satellite offices, it is important to determine the degree of autonomy in the outlying offices. If corporate does not have a significant oversight role, it may be that the business processes in the satellite offices are not performed according to the standards stated by corporate.

4. Growth plans. If the advisor is in growth mode, with numerous new lines of business, new funds or client relationships, or new offices, there is a risk that senior management time will be spent managing the growth

and not the investment vehicle. It is important to determine whether the advisor will have sufficient resources to manage the proposed investment vehicle and any planned organizational changes to accommodate growth.

5. Financial status. Obviously, financial strength is a key item to review as the investor wants to be assured that the advisor will remain viable and able to retain key employees through the intended investment period. The best review would be of the two most recent full years' and the current year-to-date financial statements. If the company does not provide statements to investors, then an interview with the CFO would have to suffice.

The major items of interest would be:

- General profitability. Is operating income covering operating expenses? Is it reasonable to assume the revenues will be recurring, such as asset management fees? Some advisors, such as developers, are reliant on nonrecurring revenues, like development fees. Reliance on nonrecurring revenue offers a motivation to provide the services associated with the revenue no matter what the current economic situation. (e.g., pursuing development when the market does not warrant it.)
 - General financial strength. Are there sufficient cash and cash-equivalent reserves? A good "rule of thumb" is that a firm should have sufficient liquidity to cover at least six months of operating expenses. Are debt-to-equity levels reasonable? This should be reviewed especially when the company growth is through acquisitions financed by third-party debt. Also included here is the ability for the company to meet corporate debt covenants. If major initiatives are underway, it is also useful to determine how these will be funded.
 - Material company obligations. Are there any material company obligations that would cause a significant adverse impact on financial health? These obligations might include environmental guarantees, construction completion guarantees, general mortgage loan guarantees, or pending litigation.
 - Related-party transactions. If the advisor does business with related parties, is the compensation to and from such parties market based and transparent? The compensation might be fees paid or overhead allocated. It is important to note the review process to ensure the fees are at market and costs are allocated appropriately.
 - Audit findings. If the advisor provides audited statements, it is helpful to review the most recent and second most recent audit finding and how the company cleared the findings. The findings will provide insight into company operations.
6. Conflict resolution policies. Conflicts can arise in many areas of operations and can be between investors and the advisor, between investors, and between the advisor and related parties. It is important to determine if the advisor is aware of any perceived conflicts and the way they are being managed.
 7. Internal management of operational risk. "Operational risk" is the risk inherent in company operational processes that might lead to bad decisions, fraud, or general waste of company resources. There might be a formal process, such as an internal audit department, or informal process, such as extremely hands-on management, to identify and mitigate or monitor operational risk. The term "operational risk" is not always explicitly recognized by advisors. The key is to determine whether senior management is aware of the concept, no matter what it is called, and pays attention to it. If there is a unit responsible for operational risk management, it should not report to the CFO, since many of the processes to be monitored are financial, but it should be independent and report to an outside board or the CEO.
 8. Personnel policies. There are two important concepts in the review of personnel policies:
 - Retention of key personnel. Retention is important in effective real estate investment management due to the longer-term holding periods. The first item to review is personnel turnover. How many employees

were hired (by title and year) and how many left the firm (by title, year, and reason for departure) for each of the last three years and current year to date?

The investor should review general compensation practices and whether senior management ensures that compensation is at market by participating in compensation surveys. An important aspect of real estate compensation is employee participation in the promoted interest. The “promoted interest” is the disproportionate percentage, in relation to the advisor’s co-investment, if any, of profits distributed to the advisor after certain investor return hurdles are met (e.g., profits after a 9 percent return to the investor are split 20 percent to the advisor and 80 percent to the investor.). How willing are the owners and senior management to spread this promoted interest around? What is the vesting policy? Also, the investor should determine whether there are other policies in place, in addition to compensation, to retain key personnel. This might include the growth of the advisor, which creates positions for employees to move up in the organization.

- Succession planning. Succession planning is important for both short-term and long-term continuity and does not always receive adequate attention. This is a concern due to the short-term risk of investment management issues should key individuals become unable to perform their functions.
9. Legal and compliance. Real estate investment and management involves numerous legal agreements: purchase and sale, leases, loan documents, construction contracts, and service agreements. It is important to determine who is responsible for legal oversight. In general, the investor should determine which corporate and investment functions are performed internally and which are performed externally by third-party law firms. Advisors may have a central legal department that oversees outside attorneys, or may allow the investment personnel, such as an acquisitions officer, to manage outside attorneys. As law is a specialized expertise, legal processes are best managed by an in-house legal team.

A second function generally performed by the legal department is the monitoring of compliance with regulations. This can be a major effort for a publicly traded firm that has to adhere to Security and Exchange Commission standards. The nature of real estate itself involves some compliance as, at a minimum, buildings need to be built or maintained to local building codes. The investor should ask who is responsible for monitoring compliance and what systems the firm uses to perform the monitoring.

10. Reputational risk. The investor should determine whether there is any issue raised in the above reviews that would put the advisor’s future operations at risk. Examples include 1) a scandal that impedes future fundraising ability and therefore the future fee revenue, 2) significant corporate debt incurred due to a corporate acquisition without an identified source of repayment in addition to the presumed increase in corporate value due to the acquisition, and 3) the same maturity dates for all senior management stock options for a newly public firm, which creates the risk that multiple senior managers may exit the firm at the same time. Such issues are important to consider for a longer-term investment horizon.

Investment Functions

Real estate investment requires an organization that can manage investment vehicles and acquire, manage, and ultimately sell properties. Areas for review include the following:

1. Fund or joint venture management. It is important to determine who within the advisor’s organization will be responsible for managing the contemplated investment vehicle, whether that person appears capable, and what are the resources and systems that are available to assist the management effort. The investor should determine whether there is a person within the advisor who represents the investor’s interests over the company’s. This generally would be the fund or relationship manager but it might be an independent member on the investment committee.
2. Acquisitions. The acquisitions process deals with sourcing the investments, underwriting them, and closing the transaction.

- **Sourcing.** An important element to real estate investment is the ability to source transactions. The investor should determine the sourcing capability of the advisor by reviewing a pipeline list or a deal log list. In addition, investments that are widely marketed tend to have multiple bidders and sell for higher prices. So, a key criterion for sourcing capabilities is the percentage of investments sourced “off market.”
- **Speed and quality of lead review.** Another issue in sourcing is the ability to quickly evaluate leads to both be responsive to the lead provider but also to not waste staff time pursuing leads with a lower probability of closing. The investor should review the initial screening process to make sure it is done in an adequate and timely manner. The investor should also review the level of senior management participation in the decision process to pass the deal to underwriting. Senior management participation might be informal, such as verbal approval before a letter of intent is issued, or formal as made by a decision of the investment committee. Early senior management participation implies a higher probability of closing the transaction.
- **Underwriting.** Real estate investment requires a significant amount of detailed underwriting and due diligence. Underwriting involves market research and physical inspections to ascertain the viability of the investment assumptions, risks and the cost to mitigate them, and ultimately the estimated return.

The investor should determine who performs the market research. It might be performed by an in-house research department or the acquisitions team. Generally, research performed by an in-house research department is superior as there are minimal conflicts versus research by an investment team that is motivated to close the deal. However, smaller advisors may not have sufficient scale to justify substantial in-house research teams and may be more reliant on third-party research.

Regarding physical inspections, it is generally the case that the advisor will use third party firms with specialized expertise, such as environmental or structural.

In addition, it is important to note what other departments are involved in the due diligence process, including asset or property management and accounting. Involving more departments early in the process means a “second set of eyes” in addition to the acquisitions team reviews and formulates the assumptions (always a good idea) and generally a smooth transition to asset management when the asset is acquired.

Lastly, it is important to determine whether and how the underwriting team is held accountable for the underwriting assumptions. Is a portion of the individual team member’s compensation contingent on the property’s actual financial performance against *pro forma* projections?

- **Debt.** For investment vehicles that allow leverage, part of the acquisition process involves securing mortgage debt. Because debt requires specialized expertise and lender relationships, the best practice is to have a separate capital markets group to secure and monitor the debt. The main thing to determine is whether the advisor has long-term lender relationships so as to receive competitive loan pricing and sufficient lender attention if issues arise.
 - **Closing.** An advisor’s closing process also deserves careful scrutiny. Real estate investments are complicated with many important details (such as clearing title exceptions, reviewing leases, procuring and managing third-party evaluators, and the formation of the owning or borrowing entity) that must be checked. It is important to determine whether the advisor has a standard closing checklist that must be completed and that an experienced individual is responsible for each property closing. (This does not have to be the same person for every property.) This person might be the acquisitions officer, but could also be part of the legal team or asset management.
3. **Research.** Research is important for real estate investments in order to gauge the market risk associated with a particular asset. This market risk includes an assessment of whether the projected rents, occupancy, and operating expenses can be achieved.

It is better to have a research department that is separate from the acquisitions or asset management departments. Real estate research is a specialized skill. Research as a separate department eliminates any

potential conflicts of interest created by having the investment personnel responsible for creating projections when they are motivated to close the transaction.

4. Asset and property management. Asset management for real estate involves managing the overall strategic plan for the asset, including setting leasing parameters, deciding upon and overseeing capital improvements, creating annual budgets, reviewing actual performance against budget, performing periodic hold/sell analyses, perhaps overseeing the sale, and preparing quarterly and annual asset reports. Property management is the hands-on oversight of the property including rent collection, bill payment, maintenance, initial budget preparation, and property accounting.

The investor should review the transition process from acquisitions to asset management. A lot of information is learned during due diligence that would be useful for asset management. Ideally, asset and property management personnel are involved in the acquisition process so the transition from acquisitions would be almost seamless. However, sometimes asset or property management is not involved and the transition has to be more formal. In this case, some kind of formal transition binder should be prepared by acquisitions with a description of the issues raised during due diligence.

Some advisors have a “cradle to grave” philosophy that holds the acquisitions team responsible for asset management until the asset is sold. This certainly assists in the transition. This structure also is useful in making acquisitions personnel accountable for their projections as they have to live with the outcome. However, this structure generally works best for smaller firms in which there is a lot of internal communication and senior management involvement. For larger firms, a more formal division of responsibilities (acquisitions versus asset management) is more in order to allow for specialized skills to be applied.

For asset management, the investor should review the way property operating issues are discovered and analyzed, who makes decisions, and who implements the decisions. The investor should determine what information is available for analyzing issues and how timely the information is provided.

5. Development. Advisors with a ground-up development strategy generally have a separate development department due to the specialized skill set required. The development department performs some similar functions as acquisitions in that it will source, underwrite, and close development sites. However, there are the additional elements of design, detailed and complex cost estimation, and cost tracking in the process. It is important for the investor to determine whether the advisor has done the homework to create the right plan for the site, has secured a reasonable price for construction from a reputable contractor, and has the systems in place to closely monitor actual expenses to budget in detail. One way to determine this is to review a few completed development projects with the development staff. The discussion should be on how the concept was determined, management of the entitlement effort, the selection process for consultants and contractors, and general management processes.

Securing a construction loan also requires a specialized expertise in terms of sourcing, but also in creating monthly draw requests. The draw requests require significant time to prepare, in part due to the backup documentation required. The investor should determine the advisor’s draw request preparation processes.

Investment Accounting and Reporting

In general, there are two levels of accounting for real estate investment: property and fund. The property accounting generally is done by the property manager and generally does not include accounting for property debt. The fund-level accounting applies property-level debt service and any fund-level allocations to properties, rolls up the properties into a portfolio, applies any fund-level debt or expenses, tracks investor contribution and distributions, and provides the base fund-level cash flows for performance measurement.

Investment accounting is a highly technical area. It is beyond the scope of this chapter to cover it in detail. If the investor requires a rigorous review of this issue, an accounting specialist who is familiar with real estate investment accounting should be retained.

On a general level, the key functions a non-accountant can cover in due diligence interviews include the following:

1. **Data entry and review.** It is important to determine whether the property and fund accounting systems “talk” to each other or if the upload of property information is done manually. If the systems are provided by one vendor, generally they will communicate. However, third-party property management firms sometimes do not use the same accounting software as the advisor so data has to be transferred. The goal is to minimize the amount of manual data entry between systems. In addition, the investor should determine the levels of review by various accounting personnel of data entry. There should be at least two levels of review of data entry in addition to the person responsible for input.
2. **Cash management.** The investor should determine how cash is managed. Is the investor comfortable with the number of signatures or approvals that are required to approve invoices, write checks, or authorize wire transfers? There should be at least three separate functions performed by three separate people: invoice approval, invoice input into the accounting system, and payment approval.
3. **External property audit practices.** If the advisor obtains individual property audits, the investor should see the general scope of work to determine whether it is sufficient. In addition, the investor should review samples of recent audit findings and management’s resolution of the findings. A review of audit findings and resolutions will detect whether there are any anomalies in the property accounting.
4. **Reporting.** Quarterly or annual investor reporting is a time-consuming process. The reports typically contain individual property financial information, a written description of property activities during the period, and fund or investment vehicle financial information, which includes limited partner contributions and distributions, the actual performance of the investment vehicle to date, and the projected performance at the end of the term. The sections are typically prepared by different departments. The investor should review the advisor’s process for compiling the reports and especially the process to review them before they are issued. The investor should also determine the time required to prepare the reports to be assured the reports will be delivered within the investor’s required time frame.

A large part of the reporting is the performance measurement of both actual and projected returns. The two key issues are the calculation integrity of the advisor’s performance measurement models and the amount of manual data entry required. The investor should determine the data flow between the accounting and performance measurement systems and review a sample performance measurement worksheet to make sure the calculations are performing correctly.

Information Technology

As with any twenty-first-century firm, information technology (IT) is very important, particularly if the advisor has satellite offices. In general, IT is a highly specialized area and a discussion of all the nuances is beyond the scope of this chapter. Depending upon the investor’s requirements, an IT specialist might add significant value to the review.

On a general level, the key functions a nonspecialist can cover in interviews include:

1. **Status of IT within the company.** Effective IT is a crucial element to running an advisory company. Some advisors do not give IT enough status within the organization to do a good job. “Status” means the IT department has sufficient resources to do its job and the IT team is an integral part of business operations. A simple way to determine the status of IT is to review a list of current and planned IT projects. If there are multiple projects with sufficient funding allocated, IT likely has sufficient status within the organization.
2. **Level of service provision.** It is difficult for a nonspecialist to determine whether the systems are of sufficient sophistication for the size of the company. One way to do so is to ask the users (other interviewees) if they are satisfied with the firm’s hardware, software, and level of IT support.

3. Data integrity and continuity. Data integrity and continuity of service are also important aspects. The investor should determine where and how data is stored, backup and recovery systems, redundancy in both systems, and connectivity between offices.
4. Change management. IT by itself is a rapidly changing field. In addition, an advisor may find it necessary to upgrade its software programs. If the advisor is upgrading or implementing new hardware or programs, it is important to review the advisor's intended management of the change. Poorly managed IT changes can be quite disruptive to general operations.

Conclusion

This chapter covered the reasons to perform advisor due diligence, outlined how to approach advisor due diligence, and provided a list of corporate, investment, accounting and reporting, and information technology topics to be covered in the review. An outline of the topics covered and an information request list are included at the end of the chapter.

Advisor due diligence is just as important as selecting the investment strategy. The right advisor will go a long way in ensuring the real estate investment performs as planned or at least that losses are minimized.

**Real Estate Investment Advisor
Due Diligence Checklist**

- I. Determine the Culture of the Advisor
 - A. Fiduciary mindset
 - 1. Client communications
 - 2. Fiduciary decision process
 - 3. Conflict of interest policies
 - 4. Use of resources
 - B. Treatment of employees
 - C. Quality of individuals
- II. Evaluate the Advisor's Track Record
 - A. Objectives
 - B. Methodologies
- III. Evaluate Operational Execution Capability
 - A. Corporate overview
 - 1. Corporate history
 - a. Existing issues
 - b. Historic growth
 - c. Competing mandates
 - d. Investor base
 - 2. Corporate structure and ownership
 - 3. Corporate decision making
 - 4. Growth plans
 - 5. Financial status
 - a. General profitability
 - b. General financial strength
 - c. Material company obligations
 - d. Related-party transactions
 - e. Audit findings
 - 6. Conflict resolution policies
 - 7. Internal management of operational risk
 - 8. Personnel policies
 - a. Retention of key personnel
 - b. Succession planning
 - 9. Legal and compliance
 - 10. Reputational risk
 - B. Investment functions
 - 1. Fund or joint venture management
 - 2. Acquisitions
 - a. Off-market sourcing
 - b. Speed and quality of lead review
 - c. Underwriting
 - d. Debt
 - e. Closing
 - 3. Research
 - 4. Asset and property management
 - 5. Development
 - C. Investment accounting and reporting
 - 1. Data entry and review
 - 2. Cash management practices
 - 3. External property audit practices
 - 4. Reporting
 - D. Information technology
 - 1. Status within the company
 - 2. Level of service provided

3. Data integrity and continuity
4. Change management

Real Estate Investment Advisor

Information Request List

Advisors who are experienced in raising money will likely have a generic investor questionnaire that will contain much of the information listed below. The investor's first request should be for such a questionnaire. However, an investor *cannot* determine the "soul" or culture of a company or actual operating processes by simply reviewing written information. On-site advisor interviews and market reconnaissance are also critical elements of advisor due diligence.

Corporate Overview

1. Organization charts.
2. A brief history of the firm and parent entity, including any recent organizational changes.
3. Current ownership, including the five largest shareholders.
4. If the advisor is part of a diversified firm, the percentage of revenue, operating income, and assets under management for the advisor compared to the parent total for the prior two years. Also, the reporting structure of the advisor within the larger firm and any services provided by the parent company.
5. Expansion plans (new funds, new offices, or new lines of business).
6. Investment performance record presented according to the investor's objectives.
7. Members of the investment committee, resumes, a list of actions that need to be approved (acquisitions, annual plans, dispositions, financing) and a description of the way approvals are granted (Unanimous? Majority vote?)
8. Members of the management committee, resumes, a list of actions that need to be approved (compensation, new lines of business) and a description of the way approvals are granted (Unanimous? Majority vote?)
9. Resumes of the key senior management personnel who will be managing the investment vehicle and the estimated percentage of time each will spend on the investment.
10. Advisor employee turnover for the last three years and current year-to-date, including the titles of new hires and year, and the title of departures, year, and reason for departure.
11. Summary of compensation structure, and who is eligible and to what extent to participate in the promoted interest, including vesting periods.
12. List of current litigation that would have a material adverse impact if judgment went against the advisor.
13. Ethics policy.
14. Risk management policy.

15. Investment allocation policy.
16. Projected role of limited partner advisory committee, if there will be one.
17. Advisor financial statements for the prior two years.

Investment Functions

1. Resumes of acquisitions and asset/property management personnel responsible for the investment vehicle and the estimated percentage time each will spend on the investment.
2. Pipeline of potential acquisitions for the investment vehicle.
3. Sample preliminary and final investment committee memos.
4. Sample pro forma model used to evaluate a proposed investment.
5. Sample model used to calculate performance measurement.
6. Sample annual asset plan.
7. Sample property management report.
8. Sample client quarterly report.
9. Valuation procedures including timing, when external appraisers are used, appraiser rotation policy, and valuations of properties under development.

Accounting and Reporting

1. Resumes of accounting and reporting personnel responsible for the investment vehicle and the estimated percentage time each will spend on the investment.
2. Policies relating accounting procedures, including period-end closing procedures.
3. Cash management procedures.
4. Policy regarding allocation of corporate overhead to investment vehicles or assets.
5. Schedule of services provided by or to related parties (if applicable) and pricing of such services.

Information Technology

1. Resume of the head of IT.
2. A diagram and description of the IT infrastructure and how the corporate and asset systems interface. Include connections with regional offices.
3. A description of where and how data is stored.
4. An overview of the IT data security policy.
5. A description of the routine backup procedures, notably:
 - a. What information is backed up?

- b. When are backups performed?
 - c. Where is the backup information stored?
 - d. How frequently and by what method is backup data test restored?
6. A description of the disaster recovery and business continuity procedures.
- a. How often are the procedures fully tested?
 - b. When was the last full test?
 - c. When is the next test?
 - d. How many data centers are there and where are they located?
7. IT improvement projects currently underway and those projected for the next three years.