

## Property-Condition Reports Offer Vital Data

Minimize asset risk by assessing the backgrounds and capabilities of parties involved with property maintenance issues.

By Dean Andrews

The current commercial mortgage crisis has brought about a greater level of scrutiny with respect to new loan underwriting and identifying potential risk. As a lender, you are buying into an asset that carries some level of risk, and any such risk cannot be overlooked.

One area that contains significant risk potential is the physical asset itself, or the building and site systems. Roofing, waterproofing, plumbing, electrical systems and so on are systems that require proper maintenance in order to perform as intended. Without proper maintenance, the asset carries a greater potential for system failure, physical damage and liability to its occupants.

The relationship between property maintenance and financial risk is a strong one, and getting a clear picture of an asset's risk potential requires a current property-condition report (PCR).

The PCR is the industry standard for describing an asset's physical elements, specific site and building systems, and their condition. It offers a budget value for the deferred maintenance, immediate repair and replacement reserve costs for loan underwriting purposes, as well as for discovery.

In essence, the PCR illustrates an asset's risk potential associated with its current physical condition. Additionally, a PCR can tell you more about an asset's risk potential if you focus on its maintenance practices and history.



A typical PCR will describe a physical deficiency and a remedy for immediate repair. In reality, however, a deficiency is often a symptom of a bigger problem, and repairing the symptom does not necessarily cure the problem or remove the potential for future repair costs.

Having performed and reviewed thousands of PCRs over the years, I believe borrowers and lenders too often do nothing more than remove symptoms and move forward with a false sense of security. We need to look beyond the symptoms and seriously consider the causes if we want to truly reduce risk.

Aside from weather-related and human-impact damage, building system and component failures are always the result of poor design, poor workmanship during construction and re-

pairs, deficient materials and inadequate maintenance practices. These conditions, especially the latter, all carry the risk of future building-system failure.

To determine the level of risk associated with an asset, a lender needs to understand the processes involved in the development and maintenance of a commercial asset. It is the intent of this article to offer a better understanding of how commercial assets are developed and how diligent maintenance practices can reduce the potential for system failure. From this, you can better assess the level of risk.

### Cost elements

The health of an asset is directly related to the commitment to and quality of its maintenance. If we know where the risk potential exists, we can make arrangements to eliminate it before it becomes a costly repair or complete failure.

First, a property owner wants to develop his property into an asset that creates a constant positive cashflow. With the help of professionals such as a development consultant, architect, civil engineer, attorney and accountant, a development plan - or pro forma - is created that details the type of proposed development, its development costs, its financing costs, the projected operating costs and its potential income.

The pro forma will illustrate a development generating a monthly income that covers the development costs, financing costs and operating costs - with some money left over for profit.

The amount of profit generated by the asset when it is 100% occupied is its maximum potential profit.

At some point, reducing the occupancy will reduce the income and eventually find the break-even point where no profit exists. The distance between these two numbers is what I like to call the "risk cushion." The larger the risk cushion, the better chance this development has to live a long, successful and healthy life, because there is adequate money for proper maintenance.

Although this is a simplified version of development, it illustrates the basic process. If all cost elements were fixed and remained constant, it would be easy to forecast the amount of profit and risk based on the occupancy rate. In reality, however, all cost elements are not fixed, and this is where the story of risk gets more involved.

From the pro forma, an architect develops a design and engages consulting engineers that may include professionals in landscaping, life-safety, structural, mechanical, electrical, plumbing and civil capacities. With the help of these professionals, the architect develops the design and eventually prepares the plans, specifications, bid documents and contract for construction (i.e., contract documents).

Throughout this process, the daily routine of the architect and consultants is one of a balancing act and constant decision making. The goal is to combine the site and building systems in a compatible and attractive manner within the pro forma budget.

Where and how the budget dollars are allocated requires some thought and knowledge of the various building systems and how they affect one another. For example, the site ground must be prepared to support the building structure and site elements. The building structure must be capable of supporting the roof, walls and all building components.

The roofing and exterior façade finishes must be capable of protecting the building components from water and the outside elements. Each building system serves a specific need, but they all work together to create a single environment.

In all my years as an architect, I have never heard a client say, "Money is no object." Money is always an object and should be spent in the most prudent manner possible. Site and building aesthetics serve a crucial role in attracting tenants and occupants, thus making the development competitive within its market.

A well-designed property will be easily leased and maintain a high occupancy rate. This is a big part of the balancing act, and care must be exer-

owner and is often approved with little consideration given to future maintenance expenses. In such a case, short-term savings are potentially being traded for long-term maintenance costs. Again, a PCR should identify any such deficiency in material quality.

When all construction is completed, a certificate of occupancy is issued, and the property is ready for tenants and occupants. Up to this point, the health of this asset has been in the hands of the architect, consultants and general contractor.

---

## A typical PCR will describe a physical deficiency and a remedy for immediate repair.

---

cised to avoid compromising building-system and building-material quality for the sake of aesthetics or reducing the cost. If this happens, the future health of the asset will be compromised. A PCR should identify any such deficiency in material quality.

### *Construction to maintenance*

As this process nears an end, the architect obtains all necessary permit approvals, and the contract documents are awarded to a general contractor for construction.

In the construction world, time is money. Everyone is looking for ways to make the best use of time and effort. The sooner the construction work is completed, the sooner the contractor can move to the next job, and the sooner the property owner can start receiving revenue from the development.

To this end, it is natural to seek ways to reduce construction time. Over the years, many building products have been developed for this reason. In many cases, these improved products offer initial cost and time savings at the expense of future maintenance costs and potential failure.

A contractor will often propose a change in materials or installation procedures that will cut cost and time. This action attracts the attention of the

Going forward, the health of the asset is in the hands of the property management entity.

The transition from the development phase to the operation and management phase has an inherent disconnect when it comes to building-system maintenance. Property management was not around during the design and construction, and it is easy to assume that a new building requires minimal maintenance, considering everything is new.

To some degree, this is true, although all systems should be routinely monitored to confirm their smooth operation. If early problems occur, they should be addressed before they become serious.

As tenant space is leased and income starts to flow, property maintenance expenses are allocated as operating costs. Routine maintenance typically consists of trash removal, landscape upkeep, mechanical equipment maintenance, building cleaning and any minor repairs caused by tenant impact.

As building systems start to age, system- and building-component replacements can be anticipated, and associated costs can be forecasted and allocated within the operating costs. A PCR will identify these items in its replacement reserve schedule.

Again, property owners and managers are always looking for ways to increase revenue and reduce operating costs in an effort to increase profit. Unfortunately, doing so can result in the reduction of building-system maintenance and the putting off of necessary repairs.

Unfortunately, it is often not long before a deferred maintenance item becomes a defect and an immediate repair item. These items can have a devastating effect on an asset in cases where deferred maintenance causes water to intrude into the building and site systems, or causes a potential danger to the health and safety of the occupants.

A simple maintenance task, such as cleaning out the roof drains, costs little compared to replacing sections of roofing due to constant water ponding. In some cases, water ponding during heavy rains can cause a roof to collapse - just because nobody cleaned out the roof drains.

At the end of the day, maintenance is everything when it comes to the ongoing health of an asset. Every year, building-system failures cause millions of dollars in damages and repairs that could have been avoided with nothing more than an adequate proactive maintenance plan.

We need to take a more serious look at maintenance policy and procedure if we want a true picture of potential risk. A review of an asset's maintenance history is a great source of information. Where is maintenance money going? If ongoing money is spent on specific repairs, this is an indication of a bigger problem that requires attention.

If no money is spent on specific building systems, this is an indication of neglect and deferred maintenance. A well-written PCR should address this and comment on the adequacy of the asset's maintenance practice. If the PCR is unclear, call the author and ask questions.

The bottom line is to establish whether or not good maintenance pro-

cedures are in place. This will reduce the risk potential. As a lender, you may not be in a position to dictate maintenance policy, but you now know where the risk potential exists.

Every urban area in the world has buildings that are over 100 years old and well occupied because of quality design, quality workmanship and quality maintenance. With these factors in place, an asset's life of profit and good health can go on for many years with minimal risk. **CMI**

---

**Dean Andrews is a California Registered Architect and president of The Andrews Architectural Corp. With 15 years' experience in property-condition assessments and property-condition report review, he has personally performed property-condition assessments on all commercial asset types within the U.S., Canada and Europe. Andrews can be contacted at (530) 887-1879 or dean@andrewsarch.com.**