



Due diligence is not enough

Property and Prudence

Most offerings of property for sale contain a disclaimer like the following:

Any prospective purchaser should independently determine, to its satisfaction, whether or not the property is satisfactory. The prospective purchaser should conduct or obtain such market analyses, utility studies, zoning determinations, rental surveys, title examinations or studies or information relevant to purchase analysis as are appropriate for a prudent investor.

Diligence

Black's Law Dictionary defines diligence as: Prudence: vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety.

Undertaking the process of due diligence is about avoiding tactical mistakes. But due diligence is not enough because 1) biases identified in the growing literature in behavioral economics occur frequently in the context of valuation decision making; 2) the state of the market affects the quality of due diligence. In up markets, unrealistic optimism, competition for deals and higher costs lead to lax due diligence practices. In down markets, increased risk aversion and more deliberate approaches lead to overly severe due diligence evaluations; 3) the process usually fails to identify latent defects. A latent defect, by its nature, cannot be discovered by observation or a reasonably careful inspection (*Rupp's Insurance & Risk Management Glossary* 2002). The infinite shades of diligence lead to several critical distinctions. *Black's Law Dictionary* distinguishes the following:

Due diligence

Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.

Extraordinary diligence

That extreme measure of care and caution which persons of prudence and circumspection use for securing and preserving their own property and rights.

Great diligence

Such a measure of care, prudence, and assiduity as persons of unusual prudence and discretion exercise in regard to any and all of their own affairs, or such as persons of ordinary prudence exercise in regard to very important affairs of their own.

Special diligence

The measure of diligence and skill exercised by a good business man in his particular specialty, which must be commensurate with the duty to be performed and the individual circumstances of the case; not merely the diligence of an ordinary person or non-specialist.

For buildings and related improvements, traditional due diligence focuses on the cost side of the asset - physical materials, finishes and systems (structure, mechanical, electrical, safety and movement) - to identify problems or potential defects. Physical elements and systems contribute to but they don't generate an asset's revenue. Ultimately, the generator of revenue is space - its quantity, quality and, especially, its configuration. Problems with spatial configuration (like shape, distance perception, visual obstacles) negatively affect functional utility and constitute latent defects.

Space Analytics' special diligence: cost-benefit

The biggest benefit is its risk-identification value. A serious latent functional defect in a large shopping center means not only lost revenue but also redesign and a major capital expenditure. For example, an attractive three-level regional mall in the Los Angeles area had odd revenue variations with line shops. We showed that vertical circulation systems caused many problems. An elevator core near the a main entrance (before-after graphic) interrupted the mall's overall connectivity and diverted a large proportion of shoppers; escalators pointed shoppers in the wrong direction.

A typical upside benefit is discovering (or confirming) the possibility of potential revenue from redesign. Our analysis showed how changing vertical circulation patterns would likely result in a 30 percent revenue increase in about 15 percent of the stores resulting in net value increase of several million dollars. The overall cost-benefit was 1:7.