Will Inflation Affect Your Due Diligence?

Depending on the purpose of the report, current inflationary pressures may affect the tables in a Property Condition Assessment—but not always.

By Gary Cohn

With inflation dominating the headlines, and construction costs continuing to escalate, commercial real estate investors may be wondering how these factors affect their Property Condition Assessments (PCA). Does current inflationary pressure impact values in the immediate repairs table (IRT) or the replacement reserve table (RRT)?

In short, the answer is yes and no. Depending on the needs of the entity ordering the report and how the report will be used, the consultant may adjust values in the IRT to reflect current inflation rates—but generally not in the RRT. Read on for an explanation of the variables that affect why and how these adjustments are made.

Different PCA Levels for Different Purposes

PCAs are ordered for numerous purposes. Of course, PCAs are used for acquisitions, and typically required by a lender when a property is financed or refinanced. A baseline PCA performed according to ASTM E2018-15 will satisfy most lender requirements. However, owners and investors who order a PCA are often seeking a deeper understanding of risks associated with a property, along with detailed data to support planning and asset management. Occupiers of commercial real estate, such as corporations and government entities, are also seeking detailed data to facilitate maintenance or repair projects and long-term planning. These users require a richer and more nuanced PCA than required by ASTM E2018. Sophisticated consultants will offer various levels of PCA reports with customized scopes to address the diverse needs of owners, investors, and occupiers. These premium-level PCAs, referred to as "Equity PCAs," are scoped to include specialty assessments, additional research time, and highly qualified assessors whose expertise and perspective add depth to the report.

Consultants are more likely to fine-tune cost data in an Equity PCA—but often only in the IRT.

Replacement Reserves Table

The RRT identifies long-term capital expenses (typically within 5 – 12 years as determined by the term of the PCA) based on the expected useful life of building systems and components. Examples of replacement reserve items include pavement seal coating and striping, exterior painting, or HVAC system replacements. Most consultants use an inflation factor of 3% per year, compounded, in the replacement reserve table. This rate is an industry standard and meant to be a long-term factor, not one that is easily influenced by market volatilities. The standard rate is close to the average annual inflation rate since 1920 (2.75%) and the rate since 2000 (2.5%). Occasionally, some PCA users will ask their consultant to apply a higher inflation factor, which is an acceptable practice. The rate itself is not of critical importance, so long as it is clearly identified in the PCA. This transparency allows all parties to correctly interpret the tables and adjust the inflation factor in their application of the data (i.e. capital plan) if needed.

Immediate Repairs Table

The IRT identifies short-term capital needs (recommended within the next 12 months) such as deferred maintenance, failing or damaged building systems, and life safety issues. It highlights items that require immediate action due to existing or potential unsafe conditions, building code or fire code violations, or conditions that if left uncorrected could result in critical failure or significant increased costs. Examples of immediate repairs include a lack of fire extinguishers, a failing roof system, or structural damage. The IRT also provides an estimate of price to correct all deficiencies identified.

In a standard PCA, consultants use recognized databases such as RS Means to estimate prices in the IRT. Ideally, in an Equity PCA, a consultant will use multiple sources. In addition to RS Means, they may consult subcontractors or vendors to discuss current pricing. They may consult construction cost indexes. And, they should consider trends, such as elevated inflation. Given the current pace of inflation, pricing on significant systems could escalate within the near term. Even the most current databases may lag behind real-time pricing changes, so consultants must compare sources and provide an educated opinion on what that escalation might be. Furthermore, with supply chain issues still at play, some replacement items may not be available, and a more expensive replacement may be necessary. Geography may play a role, too; some items are more easily and affordably replaced in certain geographic locations. This is the kind of industry awareness and expertise that providers of Equity PCA reports should provide, so they can incorporate all relevant factors for accurate pricing.

A Final Thought on Inflation and PCAs

When cap rates drop and margins get tight, the natural instinct is to reduce transaction-related costs as much as possible. However, peak inflation periods and unpredictable economies are not the time to cut spending on due diligence. Though more expensive than a standard PCA, an appropriately scoped Equity PCA will provide the detailed, realistic data and experienced perspective required for informed investment decisions and accurate capital planning. Paying more up front for quality data will help avoid unplanned expenditures that could undermine performance or reduce returns.