Chapter 2: Beginning with the End in Mind

While this program is explicitly NOT about exit strategies or how to exercise them, it IS crucial that, before giving a seller an actual offer, you know what your exit strategy or strategies for the property might be.

Why?

Because what you intend to do with the property—and the income or profit, costs, risks, and time frames that are baked in to strategy—will determine a BUNCH of stuff about the offer you make, the specific method you use to control the property, and about what terms make sense for that particular deal.

For instance, **if you intend to rehab and retail** a particular property, the price and terms you'll need to make the deal work are very different than if you were planning on holding that property long term, as a rental:

- You will NOT agree to an overall price higher than the ARV-repair costs-holding and finance costs-sales costs-your desired profit, because *no matter how favorable the financing might be, the entire profit in a retail deal is achieved in the sale*.

- You WILL agree to a reasonable balloon date to completely pay off the financing in one lump sum—unusual in the Transactioneering/creative finance world—because it's your intention to sell the property pretty quickly, anyway.

- You WON'T fight hard for a zero percent interest rate from the seller, because over the course of the 3-6 months you'll hold the property, the difference between 0% and 6 (or 10%, for that matter) just isn't that much in raw dollars.

- You WON'T refuse to buy subject to an adjustable rate loan—again, not the usual rule that Transactioneers follow—because it's unlikely to adjust, or adjust by much, in the few months you'll own the property

- You will NEVER buy in a way that doesn't get you the deed to the property (such as via a lease/option or land contract) for three reasons:

    1. You need the deed in order to secure additional financing for repairs

    2. Without the deed, you're making repairs to someone else's property, and there are too many things that the "someone else" can do that might make it difficult or impossible for you to sell the property (like get an additional loan on it themselves, or get a judgement against them)

3. Unless you have the deed, you could have problems with YOUR buyer's purchase of the property (for instance, the bank might insist that since you're not the title holder, the owner and the buyer must go directly into contract with each other, which could cause issues when your seller finds out you're making $55,000 on the deal)

- If you intend to borrow private money or hard money for the repair costs, you'd probably want to put a "subordination clause" in any seller-held mortgage, because private lenders often want, and hard money lenders always want, to be in first position.

Here's a summary to clarify what I mean when I say that your OFFER strategy changes when your EXIT strategy does:

	Your exit strategy for the property	
Characteristics of the deal	Fix and Sell the Deal in 3-6 months	Hold and rent the it forever
Price	VERY important, as your whole profit depends on the difference between what you have in it and what you can sell it for in a short time frame	Doesn't matter much if terms create lots of cash flow and/or quick paydown
Interest rate	Doesn't matter that much	The lower the better; low rate creates low payment creates more cash flow
Is there a balloon?	Sure, in 9 months-1 year	Ideally not at all; if there must be one, it should be 8-10 years away, minimum
Would you do a lease/option or land contract on the property?	NO, you need the deed	Maybe

For all these reasons and more, it's important that you think through the exit strategy and its implications before you construct whatever offer or offers you make to the seller.

Beginning with the End in Mind: The Story of the Dickerer

Every real estate deal, whether or not it involves "creative financing", has certain terms.[1] And one of the key differences between Transactioneers and regular real estate folks is that Transactioneers think beyond the common "price, payments, amortization" characteristics borrowed from traditional real estate transactions and consider outside-the-box terms that make

[1] In fact, the key difference between a "creative finance" deal and any other type of deal is that, in a creative finance deal, the "terms" extend beyond the closing. In any other deal, the terms are met before or satisfied upon closing

the seller happier and the Transactioneer happier.

For example, I recently watched a self-educated Transactioneer—although apparently, they call them "Dickerers" in the Northeast—in action on a reality T.V. show. He found a seller with a 9-acre plot of densely-timbered land that he wanted to sell; the Transactioneer realized that the land would be far more valuable if it were actually accessible to people who wanted to use it for what it was good for: lumber harvesting.

So the deal he made with the seller was that he—the Transactioneer—would pay the seller $6,500 for the land, but only AFTER putting a driveway on it and finding a buyer.

In other words, the Transactioneer created a term of the deal that was to be fulfilled BEFORE the closing—that he be allowed access to the property and permission to remove some of the trees to clear a driveway—and made the purchase contingent upon successfully finding a buyer. He ultimately sold the improved land for $16,000, "pocketing" $9,500 (because he didn't count his own labor in adding the driveway against his "profit".)

The thing that you should find interesting about this deal was that the terms worked for the buyer and the seller, even though they were unusual, and not what the seller could have come up with himself.

The thing you should find bothersome about it was that none of it was in writing. There was no purchase agreement, no protection for the buyer against the seller refusing to sell the property for the agreed-upon price once his land was improved.

In short, the buyer had no legal control over the property that he spent time and money "improving"; he only had a verbal agreement with the seller. And you know what verbal agreements in real estate are worth, right?[2]

In order to be a fully-protected, fully-documented Transactioneering deal, you'd have to find a way to put the terms on paper in such a way that if the seller got sentimental about his timberland and decided not to sell, or got greedy and decided that your effort in putting in the driveway meant HE should get more money, or, God forbid, just died before the sale could consummate, you'd still have no problem making that happen.

A simple, written purchase agreement fully outlining the terms would at least make the contract enforceable in court, though it might take a lawsuit and judgement to enforce it.

A recorded option to buy the land, along with a recorded mortgage to secure that option, would be even better (though perhaps harder to explain to the seller)

A really good solution, assuming that the buyer was quite certain that he'd be able to sell the

[2] They're worth the paper they're written on. In other words, they're completely unenforceable.

land for a profit, and pretty quickly, would be for the seller to go ahead and convey the deed to the buyer along with a no-payments, no-interest mortgage that ballooned in a month or 2.

Yeah, their way was simpler, which has a lot of benefits when there's a high level of trust between you and your seller, but my way is right-er, because control is better than trust.

In any case, the thing that the dickerer did really well was that he understood his exit strategy—to flip the property to an end user—and what would make that land more valuable to the end user. He then structured the deal in such a way that he was able to get what he wanted, and the seller was able to the money he wanted—and he knew what that was before he made the offer, rather than coming back later and saying, "Oh, by the way, we agreed on a cash price of $6,500, but now I need you to agree to let me put a driveway on your property before we close."

Questions to Ask About the Terms You'll Need

Let's assume that you're considering making an offer on a particular property.

If so, you probably already know what your exit strategy for that property will be. And, one assumes, you already know (or can figure out) things like:

- What the property needs, in the way of repairs/upgrades, in order for you to implement that strategy
- What the projected sale price and/or monthly gross income it will generate
- What the expenses of holding the property will be ("holding costs" in a retail deal; monthly including vacancy, maintenance, and reserves in a lease/option or rental deal)
- How long the exit strategy will likely "take"—in other words, how long (worst case scenario) you'll be holding it

With these things in mind, you need to consider the following about every deal, BEFORE you lay out your offer strategy or strategies:

The maximum total price you're willing to pay. This is extremely important if part or all of the profit from your deal comes from selling the property, as would be the case if you plan to wholesale, retail, or lease/option the property. It's less important if you plan to hold the property long-term; if your intention is to rent it, the monthly payment <u>and the makeup of that payment</u> are more important than the price.

The monthly payment that the property can "afford". By "afford", I mean what is the maximum monthly payment you can make to total debt service—the payments to the seller or the seller's lender plus payments on any secondary financing you might have to get to make repairs—given the OTHER expenses of owning the property and your minimum acceptable income.

The probable and worst-case timeframe that your exit strategy will take to fully execute. You'll always ask for LONGER than you think you need to perform on any agreement you make with a seller, particularly if that agreement involves a balloon payment.

Especially in the case of these last 2 items, it's important to not get trapped into "best case thinking" about a deal. This has probably caused more creative deals to "go wrong" than any other mistake Transactioneers make.

Yeah, sure, on paper, we can assume that when we plan to lease/option a property, the tenant/buyer WILL maintain the property as required by their contract, and get financing to buy the property within the 2-year option period we plan to give them. But, statistically, there's a pretty good chance that they'll move out, instead, and that we'll probably then need to paint and carpet the house to make it attractive to the next tenant buyer.

Similarly, we can project that our proposed retail deal will have no unexpected "gotchas" in the rehab process, and get finished on time, and sell within the usual timeframe, with no delays in the buyer's financing.

Or we can use the most aggressive, optimistic rents that we think our future rental might produce when figuring out the cash flow, and also assume that a great house like that in a great area like that will have practically no vacancies, when in fact these things rarely turn out in the practice like they do in our fantasies.

And it's not that these real-world issues are fatal in an of themselves; it's that if you've negotiated terms with the seller that don't take into account the possibility of something going wrong, even when that thing is common enough that it should really be expected.

Ignoring the possibility of expenses and delay when negotiating the payments and length of the seller financing is a big mistake. And it doesn't just hurt your profits, it hurts your seller. If you can't keep your promise to pay off a balloon in 5 years, or you discover that you can't make the payments you agreed to make because the property has a $500 a month negative cash flow that you can't cover, your seller, in one way or another, suffers.

When you've determined your limits for these three items—the price, the maximum payment, and the minimum amortization and loan term—<u>for the particular deal you're contemplating</u>, you're ready to begin the negotiation with the seller. If he has already has a loan and you're considering buying subject to that loan, you can determine whether the terms of that loan meet your requirements, or whether the seller will need to bring money to closing to sell you the property. If you're negotiating a seller-held loan, you can use the payment and amortization to back into loan terms that make sense.

The Other Big Question: How Much Control Will You Need?

In most negotiations with sellers, the price, payments, and timeframe can be duplicated with any of a number of actual techniques with different control, tax, and risk and responsibility implications.

As a general rule:

- The more of the risks and responsibilities of ownership you want to leave with the seller, the more control you'll have to give up. If you want him to continue to pay for the taxes, insurance, and maintenance, you'll also have to leave him in possession of the title.

- The more money you'll need to invest in the property, the more control you'll want. If a property needs $50,000 in rehab to be placed into service or sold, you probably want to get the deed to that property, so that you're not effectively fixing up someone else's' house for them.

- The less money the deal itself is likely to make, the less control you want of it—you'll want the right to give it back, as it were, if it doesn't turn out to be very profitable, and getting the deed doesn't let you easily do that.

- The more control you leave with the seller, the greater the chance that he can do something to mess up the deal, even post-closing, a topic we'll discuss when we get to the section about control without title.

We'll discuss some of the specific risks of strategies when we discuss the strategies themselves, but in general, the strategies from highest control (and risk and responsibility) are:

Seller-held mortgage
Buying Subject to the existing loan
Land contract/contract for deed
Lease/option
Lease or option alone

It's important to note that part of "beginning with the end in mind" is understanding that **you can't pass on, sandwich or assign to a tenant or buyer more control than you have**.

In other words, if you've 'bought' a property via a lease/option, you can't sell it via a land contract: you don't HAVE equitable title, so you can't GIVE equitable title. If you buy on a land contract, you can't give a lender a mortgage, because you don't have legal title with which

to secure it.

On the next page, there's a chart that compares these strategies in terms of where the control and responsibilities lie. You'll choose which to use based on the details of the deal and your exit strategy

	Seller-held mortgage	Buy subject to the Seller's existing loan	"Wrap around" to seller's existing loan	Contract for deed/land contract	Lease with option to buy
Who holds "title"?	Buyer	Buyer	Buyer	Seller, until final payment is made	Seller, until buyer gets money to exercise the option
What can the seller do to mess up the deal post-closing?	Nothing	Declare bankruptcy	Declare bankruptcy on underlying loan; not make payments to bank if payments are made directly to the seller	Declare bankruptcy if there is an underlying loan; get judgments or liens; not make payments to the bank if there's an underlying loan seller is paying directly; refuse to convey title when final payment is made	Declare bankruptcy if there is an underlying loan; get judgments or liens; not make payments to the bank if there's an underlying loan seller is paying directly; refuse to convey title when final payment is made; borrow additional money against the property
How easily can the seller "repossess" the property?	Foreclosure, unless you've given a deed in escrow or set up a land trust with default protection	He can't, unless you've given a deed in escrow or set up a land trust with default protection	Foreclosure, unless you've given a deed in escrow or set up a land trust with default protection	In some states, Foreclosure, unless you've given a deed in escrow or set up a land trust with default protection. In others, a shorter and less expensive forfeiture process	Eviction
Who is responsible for taxes and insurance?	Buyer	Buyer, often through an escrow with the bank	Buyer, often through an escrow with the bank	Usually the buyer, but negotiable	Seller
Who is legally responsible for repairs and maintance?	Buyer	Buyer	Buyer	Buyer	Seller, though buyer usually agrees to take this on as part of the option agreement
Who gets to claim depreciation?	Buyer	Buyer	Buyer	Buyer	Seller, if he qualifies
Level of control	Very high	High	High	Medium	Low—do not buy this way if you will be investing additional money in renovation