DEAL ART: SMALL CHANGES MAKE DRAMATIC DIFFERENCES

GREGORY PINNEO

WWW.REACHRETURNS.COM

Reviewing deals is what I do, for myself and my Power Player students. I am sure there has not been a week stretch in my adult life where I have not pondered the structure of a real estate transaction. Does this structure meet the goals and objectives of the seller? Is it structured in a way that gives me what I need as a real estate entrepreneur? Does it have safe guards and considerations built in that give this deal the best chance to survive the ever changing economic climate? These questions and those like them run through my head constantly.

I have, for a very long time now, had an appreciation for the "negotiable parts" in any real estate transaction. There are as many ways of structuring a real estate deal as there are grains of sand on a beach. Buying real estate in and of itself is not difficult. In fact, it is like falling off a log. With little knowledge or effort you can own real estate. However, buying real estate whereby the deal and its structure allows for maximum safety and profit while still serving the seller…..now this takes knowledge, negotiation, and an extremely proactive approach.

In the spirit of structuring deals that make sound sense there still lies a spectrum within. It is within this spectrum that the scope of this article is intended to emphasize. Although a transaction may be structured well and by all measures be a "good" deal, I want students of mine to dwell on how in any deal, making small changes can dramatically change the entire deal…..often times from a "good" deal to a "great" deal. I want to underscore this by using an example of a real deal that I walked through with a student just recently. His structure was good, but as I looked at it I could not help but see that with a few changes this deal could look dramatically different.

First of all, this was a listed property. By definition, this means it will be difficult to get to the seller face to face. As well, when an agent is involved, "NO" is the answer any agent parrots when they do not understand something. They speak for the seller not out of representation but rather from a self liability perspective covering for their ignorance. When you cannot get to the seller, your chances of hand crafting an offer to meet their objectives go down considerably. I point this out to underscore the reason why I buy so few listed properties. Usually, agents just get in the way, not to mention the inflated price to cover their commission.

Regarding the deal at hand, the sales price, after adjustments for an inspection, was agreed by all parties to be $100,000 for the house. The "after repaired value" was said to be a solid $225,000. Because of limited capital on the part of the buyer, and because the house could not be financed conventionally because of the work required, the structure to purchase was set up to involve a contractor who would partner on the deal. The partners would pay for half of the purchase price and buyers closing costs each at closing. The contractor partner would pay for all repairs to the home as a part of the deal. The property would then be put up for sale on the open market. Each partner would first be repaid their investment and then profits would be split 50 / 50. The duration of the project including rehab, market time, and closing of the sale was scheduled to be six months. Below is a sketch of how the deal was put together from a buyer's perspective following to the bottom line of hopeful profit they would share.

Expense	Partner 1 Contribution		Partner 2 Contribution
House	$50,000.		$50,000.
Buyer Closing costs	$500.		$500.
Rehab costs	$0.00		$60,000.
6 mo's debt service	$3,000.		$5,000.
Selling Closing costs	$11,000.		$11,000.
Total contribution	$64,500.		$126,500.
Combined Total In		$191,000.	
Sales price		$225,000.	
Total profit		$34,000.	
Partner Profit	$17,000.		$17,000.

Assuming that each partner took their $17,000. and put it in the bank at the best offered 10 year rate note, at the end of 10 years the total interest gain would add another $5750. to the deal. The total ten year picture would then yield a before tax gain of $23,750. each. A "good" deal for sure by any measure.

The deal above is in motion. It is on its way to closing, and the structure is in place. When I looked at this deal I could not help but think on what a few significant changes to the structure would have made from both a buyer and seller perspective. Consider the following as an example of an alternate structure, and then we will analyze the merits from both sides of the table.

The purchase price is the same….$100,000. Instead of being cashed out and subjecting themselves to capital gain, the seller agrees to be the beneficiary of a note. A rate of 4.5% is established, and represents a note rate well in excess of what any 10 year note is currently offering. The buyer will put down $10,000. and the seller will be the beneficiary of a note for $90,000. at 4.5%. Payments are interest only or more, but a minimum payment of interest only would be $362.50 per month. This note will be collateralized by a deed of trust on the subject property giving the note collateral backing.

The buyers plan "A" is still to fix up and sell. However, when it comes time to sell, the plan will be to offer the home for sale where-by the seller will participate in the financing, wrapping the underlying note. Because the seller is offering financing as part of the "for sale" offering, the terms that are being offered open the door to many people who could never buy such a home, separating this offering from many other homes on the market where the buyer needs to get new financing to cash out the seller. In a flooded market, separating yourself in this way gives the seller a much better chance of selling their home. As well, because part of the attraction for the home are the terms being offered, the home itself needs less of an extensive remodel to be competitive in the market place.

Establishing the terms of purchase above sets up the ability to offer the terms of the sale. It also allows the original buyer to do the deal themselves, not needing a partner to help pay for the home and the rehab costs. Eliminating the need for a partner at acquisition automatically increases potential profit, and this combined with the sale of the home on a wrap note make for an impacting one-two punch. Lets run the numbers on this structure and play it out for ten years and see what the end gain looks like.

Expense	Buyer Contribution
Buyers Down Payment	$10,000.
Buying Closing Costs	$1,000.
Rehab costs (less due to term offer)	$30,000.
Debt service on above capital	$1,500.
Debt service on 90K note 6 / months	$2250.
Selling costs (no agent:+/- 3% of 225K)	$6750.
Total Capital Invested	-$51,500.
Sales price of $225K 20% down	+45,000.
Cash shortfall after sale	- 6,500.
Income from note 180K @6.95% (interest only income / no principle)	+$1042.50
Payment on underlying 90K note	-$362.50
Difference monthly on “wrap” spread	+$680.00
Spread gain over 120 months (680.x 120)	+$81,600.
Principle difference year 10 cash-out	+$90,000.
Sub-total of gain over 10 years	+$171,600.
Subtract Cash short fall above	-$6,500.
Total gain over ten years from transaction	+$165,100.

The benefits of this structure are obvious when you compare the bottom line gain, however looking deeper reveals several other benefits on the part of the seller and the buyer. Tell me if you agree with the following benefits.

The original seller: Same seller, same listing, different offer accepted

-Deferral of capital gain for 10 years.
-An interest income far in excess of competitive ten year investments
-Known collateral for their investment
-The ability to name remainder beneficiaries on note
-Receiving interest income on deferred capital gain funds

Same Buyer: Different structure allows for:

-The ability to do the deal without a partner
-Less of an overall remodel necessary to compete because of term offering
-The ability to rent for a positive cash flow and keep if sell plan fails
-The ability to make money on margin, not just on equity
-Offering terms to new buyer increases chance of sale
-A potential profit seven times the other structure
-Because of "owner will finance" term offering, no need for expensive listing / marketing representation.

Admittedly the "upgrade" structure calls on knowledge and expertise that the original structure does not. It begs several questions to be sure.

-Can you negotiate a note and deed of trust structure with the seller?
-Can you educate the seller on an installment sale as it relates to the deferral of capital gain?
-Can you negotiate a 4.5% ten year note without a due on sale clause and underscore its investment benefits to the seller?
-Can you competently draft such an agreement to pass attorney review and escrow?
-On the sale side, do you know how to draft an all inclusive trust deed complete with all the safeguards from both a buyer and seller perspective?

I think what has kept me interested in the entrepreneurial sport of real estate acquisition for nearly 35 years has been the high ceiling of knowledge and expertise it offers and requires. As I stated earlier in this article, the spectrum of "good" to "great" is expansive, and therein lies the challenge to be the best of the best. Our commitment at Reach Returns is to offer a seasoned perspective, and to motivate people to seek high achievement in every area of endeavor. I hope you have found this article challenging, motivating, and in concert with this commitment to excellence. If we can be of help with your journey, please contact us at gregandshauna@reachreturns.com or visit our website at www.reachreturns.com.

Living Deliberately,

Greg Pinneo