STRUCTURING AN INTELLIGENT OFFER IN A STUPID ECONOMY

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What do I mean by a "stupid" economy?

A "stupid" economy is one where by the momentum is moving so fast it is really tough to know where things are at any particular point of time. Where are values at with single family homes? Can you tell me with any degree of certainty? I can't. A stupid economy is one where REO properties are coming back into the market and re-setting the "value" comparable baseline. The more foreclosures, the more "stupid" the market gets.

When loans are available for every heart beat, or when they are not available at 60% LTV for an 800 credit score client……this also makes for a "stupid" market. In the lending world, illogical motivations also come into play. Loss share agreements between the FDIC and banks taking over a failed institution also make the market hard to read. The lender who has taken over the failed institution has incentive to not touch or modify a defaulting loan because of the terms of the loss share agreement they have with the Feds. When common sense does not apply, the market gets crazy until some form of predictability and order returns. Let me give you an example. If a bank takes over a failed institutions loans with a 95% loss share agreement with the FDIC, the general guidelines of this agreement work like this. Let's say that the loan was for 100,000. and when the new bank took over the loan it was in a default status. The first thing they know is this: the loss share agreement will be nullified if they attempt to modify the loan and it ultimately goes still into default. The new bank has incentive not to touch the defaulting loan in any way, because if they do, the 95% loss share agreement will not apply to the deficiency. Now that the new bank will not modify, the loan is foreclosed on and the new bank owns the property. Now they can sell the property. Let's say they sell it for $70,000. There would be a $30,000. deficiency of which 95% would be reimbursed by the FDIC. The bank gets back 70K from the sale, and 28.5K from the FDIC recovering a total of 98.5K out of the 100K loan. They still have the right to sue the borrower for the deficient balance. What if the lender sells the property not for 70K, but rather for 30K. The deficiency would be 70K and the 95% loss share would cover $66,500. They would recover 96.5 K out of the 100K, but at a sale price of 30K, this property would be off their books immediately. Most lenders take this route so that carrying costs and liability are minimized. Now the sold comp in the neighborhood is 30K, de-valuing all of the surrounding properties. This is a long way of saying that when banks are going under, and aggressive loss share agreements are being drafted by the FDIC, the result of this craziness is a "stupid" unpredictable market. The property owner across the street says to himself, " that house just sold for 30K, and I am currently paying on a 140K mortgage on a similar house! Am I stupid! I think I will give this house back to the bank and go buy one for 30K!" This starts round two of the stupidity!

So when everything is going crazy and nothing is making sense, how do you structure an offer to buy real estate that will be profitable amidst the stupidity? The following is a list of guidelines and suggestions that will help you come out of the craziness a winner. Some are practical and tangible and some are subjective, but all are important when managing a storm of moving parts and confusion.

Storm tip number One:

Know rent comps cold. Rent comps are easier to get a handle on than values. When we know rent comps well, we can calculate what we are able to pay in the way of principle and interest. A very simple tool is to take 60% of the gross rent and tell yourself that this is your negotiation target in terms of your principle and interest payment. If a building has a gross rent of $10,000.00 per month, in your head shoot for a monthly payment of principle and interest not to exceed $6000.00 per month. Working an offer backwards from the rents gives you a way to hold the line indefinitely, which is the key to survival in “stupid” economic conditions.

Storm tip number Two:

No short term financing. All negotiations need to put financing in place for a period that allows the storm to pass. For me, ten years is a minimum time frame for a cash out when you are setting up a purchase in “stupid” economic times.

Storm tip number Three:

Factor return on a down payment as if you were borrowing the down payment with hard money. With enough down, everything cash flows, but does that mean we should be putting huge amounts of money down in these crazy economic times? No is the resounding answer! Set your limit at 10 – 15% down, and pay a return to yourself of at least three times the going CD rate for your own use of your own money. For example, if you used $10,000.00 of your own money as a down payment on a rental house, be sure to pay yourself three times the going CD rate for the use of your own money. In a 3% CD market, you would pay yourself $75.00 / month. Make sure that the cash flow of the acquisition is sufficient to not only pay on the promissory note or notes, but pay a return on you down payment as well. Hoping for appreciation to pay an eventual return in a "stupid" market is bad business. Make sure the offer is structured so that a return on down payment is calculated into the overall Performa.

<u>Storm tip number Four:</u>

Look for properties that are not utilizing all avenues of potential cash flow that the building and location have to offer. A classic example would be to buy an infill urban multiplex whereby the parking is included in the rent. Separating the rent from parking usually creates additional overall cash flow. Be on the look out for additional income producing opportunities that the previous owner had not employed.

<u>Storm tip number Five:</u>

In low interest climates great opportunity exists to set up long term, low interest, cost of funds. A frequent objection to a low interest rate over a long period is peoples thought that interest rates will go up. How do we acknowledge this, and yet negotiate the best overall rate for our note? One tool is to set up the interest rate as one that will adjust as time goes on in an upward direction. On its face, this does not seem like a good idea, however, structured carefully it can be a great negotiation tool. For example, let's say that the note amount is $500,000. I might negotiate the first 7 years at 3%, the next 7 years at 4%, and the remaining 16 years at 7%. My payments will always be interest only or more. What I might do would be to self amortize the note and pay it off over 14 years, thus never seeing the higher step up in interest rate. My average rate over 14 years would be 3.5%. Come prepared with long term CD rates and any supporting comparables to help negotiate interest rate.

Storm tip number Six:

Lease options are a tremendous tool when values are unknown, especially if they come as a "free" addition if you execute the lease. Be sure to have sub-lease provisions in your lease contract, and be sure to record the option portion to put a cloud on title. It is also possible to have the lease payment become a credit to the eventual purchase price, or down payment if the ultimate deal was pre-structured with seller financing. Having an option to buy the building does not mean you have to buy the building….but you can if you want to. The key here is this….longer is better. Give the property time to grow in value and with equity over and above your option price, you have several choices…..all good…..when it comes to your option exercise window. I like to structure options for 7 to 10 years when ever possible.

Storm tip number Seven:

Stay calm. In any storm, staying calm is the first rule. It is easy to get caught up in the overall public uncertainty and panic. Stay calm. Work the situation. There is great opportunity when you use the power of the storm in your favor. Allow the strength of public opinion to work for you as you structure your deals. Don't assume that what would work for you no seller would do….simply ask the question of proposition. You will be shocked at the results you will get during these "stupid" economic times.