Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

Real Estate Investment Newsletter – August 2003

Anatomy of a Deal (Part II): Contract Contingencies

Last month I began my dissection of a deal by explaining the process of entering into a purchase contract. The purchase contract contains clauses called "Contingencies" that allow the buyer to terminate the contract in the event that certain conditions are not satisfied. Typical contingency clauses cover financing, appraisal, title, physical inspections, and operating details. These Contingencies are a key mechanism for the buyer to manage risk and allocate the risks among the parties. This month I will delve deeper into the workings of Contingency clauses and show how these are resolved as the purchase process moves forward to completion.

Assuming you will use a 3rd party mortgage to pay for a portion of the property purchase price, your contract will provide you with an option to terminate the contract if you are unable to obtain the mortgage, on the terms specified, by the closing date of your transaction. The financing contingency is the most important contingency because it ensures that the deal is economically and legally sound before it can go through. This is because a 3rd party lender will do their own due-diligence to make sure the deal is good before they give you the loan. They will require:

- An appraisal to determine market value of the property.
- Assurance as to the physical condition of the property.
- Marketable title.
- Evidence that property cash flows are sufficient to cover loan payments.

Relevant loan terms include the loan to value (LTV) ratio, the maturity of the loan, and the pricing of the loan in terms of fixed or floating rates plus up front fees. You could also include other specific requirements for the loan such as amortization period (period over which payments would pay off the loan), prepayment penalties, etc. Then, if the bank proposes less favorable terms (that reduce your forecast returns on investment), the contingency clause can be used to back out of the deal. Therefore, a Seller should consider an offer weak if it has overly optimistic financing terms in its contingency. Reasonable financing terms depend on the property but generally the maturity and amortization can be 30 years; LTV should be 70-75% unless you are purchasing residential property with fewer than 5 units[1], and the rate should be consistent with current market rates for commercial properties (unless it is residential 1 to 4 units).

In order to obtain financing (and clear the contingency) on a timely basis you must apply to lenders immediately and work with them to meet their underwriting requirements. The seller will want to see that progress is being made to ensure he is not letting you tie up the property without the prospect of the sale actually closing. Accordingly, the contract will set deadlines for the loan application and preliminary approvals. If these are not met, the seller will have the option to terminate the contract.

Note that you have the right to waive any contingency even though the conditions you had specified in the contract were not met. From the buyer's perspective, an unachievable financing contingency provides an option on the property: you can waive the contingency and take less favorable financing, or, you can turn down the deal up to the (financing contingency) deadline. Generally the financing contingency deadline is the closing date - unless a lender is willing to offer an unconditional commitment before the close.

If you are maximizing leverage (i.e. taking a loan at the maximum loan to value ratio allowed by the bank), then an appraisal contingency is redundant because if the appraised value comes in below purchase price, the loan offered will come in below the amount in the financing contingency. Either way you can cancel the contract or renegotiate price. On the other hand, the appraisal contingency (and all the due-diligence contingencies) becomes much more important if you are paying all cash, or if the financing is provided by the seller. Then you do not have a 3rd party vetting the deal for you. In either case you will have to pay for an appraisal up front[2] and schedule it as quickly as possible. In the current environment, appraisers are very busy and lead times can easily be 6 weeks or more. Shopping for a faster appraisal will probably be necessary if the contract has an aggressive timetable for clearing the contingency and closing the deal.

---

[1] Residential property with 1-4 units are underwritten differently by the banks and you can therefore go as high as 90% LTV on these purchases.

[2] This money is <u>not</u> refundable if the deal falls through.

Although every contract contains a title contingency, this is usually the easiest contingency to clear because the title insurance company handles it. Still it's important to order a preliminary title report upon execution of the contract to identify any issues as early as possible. In addition to the title research, the title company may require a survey of the boundaries and dimensions of the property. Title problems can take a long time to resolve; the faster the parties learn about them, the more likely that they can be addressed by the closing deadline.

The due-diligence contingencies (inspections and review of operating details) give you the chance to investigate all the unknown aspects of the property. Because, the buyer has wide latitude to reject the property under these provisions, they effectively give you an option period in which you can buy, or not, depending upon what problems, if any, turn up. In some states this option is made explicit by granting the buyer an option period rather than spelling out the due-diligence contingency provisions.

The inspection contingency covers a range of possible inspections, including the buyer walk-thru of the property. Usually a purchase offer is required *before* you, or your representative, can visit the property. The buyer's inspection should include a look at any vacant units and, if possible, a few occupied units. The goal is to see a sample of units that fairly represents the property condition. Discuss the units with the current property manager to determine which units to view[3]. Typically, you can reject the deal if you disapprove of anything you find during your personal inspection. Assuming you don't find a deal killer, this step is used to determine what additional follow up is required.

Generally a bank will require a termite inspection and so should you. Correcting termite problems can cost substantial money; ideally you will have the seller fix the problem before the close or provide a credit to cover the cost. Sometimes a thorough inspection by a general contractor can substitute for a termite inspection (if the bank allows it). In any case it is recommended: this can cost a few hundred dollars but it is money well spent. The contractor should be capable of estimating repairs for all the major structural components – especially the roof and the foundation. The result is a detailed list of repair costs that eliminates much uncertainty about the property's condition and this listing may be used to negotiate a compensating price reduction from the seller. Once they know of the defects they will be obligated to disclose them to other potential buyers and therefore they may as well address the problems with you. These most basic

[3] If they want to be retained after the purchase, it is in their interest to be cooperative during the purchase.

inspections should be scheduled as quickly as possible to allow time for follow up inspections within the contingency period.

Other inspections may be necessary depending upon the nature of the property and what you and your contractor find during your inspections. Possible follow up inspections include:

- Tests for the presence of lead based paint or other hazardous substances
- Plumbing systems tests – including well water quality and quantity
- Soil tests
- Compliance with government regulations

While these may not be necessary, you may need to schedule these in advance to insure they can be completed within the contingency period if needed. You can then cancel them if they are not needed.

The buyer can also terminate if a review of operational details causes a reevaluation of the property's past or expected economic performance. Unfortunately sellers' brokers tend to misrepresent property operations when marketing a property; this contingency allows you to adjust your offer to reality if you discover the truth is vastly different from what you expected. The contingency provides for review of the following.

- Books and records detailing the property's income and expenses
- Leases and vendor contracts
- History of insurance claims and insurability of the property
- Government permits, zoning and use restrictions

In doing this portion of the due-diligence, the buyer must rely on the seller to provide all the relevant documents. Therefore, the contract should link the timing of the contingency expiration to the delivery of the documents. Once you receive the documents, review them promptly to allow time for follow up and renegotiation in the contingency period.

In addition to the standard contingencies described above, there are many others that could be used to address the uncertainties of a particular situation. For example, you might make the purchase contingent upon the sale of another property you currently own (because you need the money for the current purchase). Whatever you decide to put in, remember that the more contingencies you put in, the more likely the seller will conclude that the deal will not go through and reject your offer in favor of a stronger offer (i.e. more likely to close) – even if you are offering the higher price.

Conclusion

Despite the weakness that contingencies connote, they are necessary to manage and allocate risks among the parties. The contingencies give you the chance to thoroughly check out all the unknown aspects of the property and cancel the contract if the uncertainties are not resolved to your satisfaction. Even so, including the terms in the contract is not enough; you must work quickly once in contract to resolve the contingencies by the contract deadlines. If your due-diligence does not get done, you lose the benefits of these risk management provisions and take unnecessary risks.

Berkeley Investment Advisors can manage the process for you and make sure you find out the drawbacks of the property in time to adjust the purchase terms or terminate the contract if necessary. We suggest strategies for dealing with issues that arise and we adjust financial forecasts to take into account the new information. Investors working with Berkeley Investment Advisors know how problems will affect future risks and returns and therefore they make informed decisions when resolving contingencies.

Featured Investment Opportunity

This 11-unit apartment building in North Las Vegas is priced at $376,000. The property is in good condition in a quiet neighborhood. The owner has been reluctant to raise rents. As a consequence, current rents are estimated to be more than 20% below market. Raising rents to market over time should produce a capitalization rate of 8%. Long-term returns should easily exceed 20% with cash on cash return of 8%. The owner is an old lady who moved to Utah after her husband passed away - so she is motivated to sell. This looks like an excellent opportunity to purchase a low cost property at an attractive valuation. Roughly $109,000 in cash is required.

Contact Information:

RayMeadows@BerkeleyInvestment.com
Tokyo phone: (080) 3122-9601
San Francisco phone (510) 367-3280