Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

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Anatomy of a deal (Part I): Getting into Contract

For many potential investors the idea of investing in real estate is appealing, but the process is complex and mysterious. Once you find a property that looks like it could be a good investment, you must come to terms with the seller and execute a contract to purchase the property. For highly desirable properties there will usually be competition; thus, time is of the essence. Understanding the process in advance will give you the confidence to make decisions quickly and get that good deal under contract before the other guy gets it. My goal this month is to explain the key negotiating terms, and how the purchase contract provisions implement them. By demystifying the process I hope to show you what you need to focus on in competing with experienced investors for deals.

The first step is negotiating terms with the seller. Often the buyer (or his representative) will not even be allowed to visit the property until a purchase price has been agreed. This can be handled by a formal purchase offer, or, in some cases, a non-binding Letter Of Intent (LOI). The LOI outlines the agreement in basic terms before a formal contract is drawn up. The advantage of the LOI is that we can determine whether the economics of the deal work before diving into the details. An LOI tells the seller you are serious and provides an incentive for the seller to provide information and negotiate the other contract terms. Alternatively, if the seller's broker can provide sufficient information about what terms the seller is looking for, the buyer can skip the LOI and go straight to the formal purchase offer.

A purchase offer becomes a legally binding contract when accepted by the seller. The contract, along with the deposit, is submitted to an escrow/title company to open an escrow account for the transaction. The escrow company is a neutral third party that holds the funds and ensures that the terms of the escrow (contract requirements) are satisfied before they settle the transaction. When you have a contract and an escrow account, you are "in contract" or "in escrow".

Price and financing terms determine the economics for both the seller and the buyer. Properties that are priced attractively are likely to draw multiple bidders and sell for their asking price or very close to it. In a competitive situation, a bid too far below the asking price may knock you out of the game. In such a situation it's a good idea to bid close to the asking price (say within 3%) and try to boost your returns with favorable financing terms. For example you could pay full price but ask the seller to provide financing for 10-15% of the price – on top of financing 75% of the purchase through a bank. You can structure this financing so the loan payments are based on a 30-year loan but the balance gets paid off in 5 years. This keeps your equity requirement low, but the seller gets his money relatively soon. Sometimes the seller is unwilling to provide financing because they need the cash for reinvestment (i.e. a tax-free exchange). You can still pay a high price and boost your returns by increasing the upfront costs borne by the seller. For example have the seller pay some of the costs for your loan.[1] By using a financial model you can determine the trade offs among the various terms so that you can structure an offer that meets the seller's demands while preserving your expected returns on equity.

Timing is a key aspect of any offer. An offer should have a short life – an expiration 3 business days from the offer date will allow time to evaluate its value while limiting its use in soliciting higher bids. Most likely, a seller will not accept an initial offer. Instead, the seller submits a counter-offer that modifies key terms (price, financing) to try to improve the deal. The counter-offer may be preceded by verbal negotiations to probe the buyer's flexibility and priorities. If the changes are unacceptable, the buyer can submit a new offer. Whenever a new offer is put forth, it immediately extinguishes the right to accept the other party's previous offer and opens up the possibility that a third party may take the deal away. Therefore, it is wise to accept a deal that meets your goals rather than trying to push the seller to the limit.

Timing provisions of the contract are also important. In particular the time allowed in the contract for resolving contingencies and the date of the agreed closing will position your offer as weak or strong. If times are too long, the seller may conclude that you are trying to tie up the property without a true commitment to purchase it on the agreed terms. Some sellers may insist on a show of commitment by imposing deadlines with financial

[1] . It may even make sense to bid higher than asking price to get the seller to pay some of your loan costs.

penalties. For example, there may be a cost per day for every day the contract is extended past the original closing date. Alternatively, the seller may ask that the buyer's deposit money (or a portion of it) be unconditionally released to the seller early in the escrow period[2] – at the end of the inspection contingency period for example. If this is a large amount, it will effectively commit the buyer to buying the property regardless of the financing terms he must accept. Without such a provision, a favorable 3rd-party financing contingency (i.e. the buyer can back out if the loan rate is over 7%) provides a way out for the buyer all the way until the closing. As a buyer, you will want to avoid the risk of losing a deposit if your bank drops the ball. If the seller is very concerned about the level of commitment then other provisions should be substituted to address this concern without taking on this risk.

Sellers will also try to reduce the risk of a late contract cancellation (via the financing contingency) by requiring a bank "pre-approval" letter within a short time (10 days) after the agreement. These provisions are harmless so long as you make sure your preferred bank can make a decision in the time frame requested. Of course the pre-approval time frame itself must be tied to the timing of disclosures provided by the seller. If the seller cannot provide the information needed by the bank in the allotted time, then the pre-approval letter will be delayed.

Besides the timing provisions the other main things affecting the credibility of the offer are the deposit amount, and the probabilities associated with contingencies. No matter how nice the price, if you put up a small deposit (e.g. 1% of price), your offer will be considered weak. Likewise, if you put in the contract that you don't have to buy the property unless you sell some other property first, the seller will assume that the sale is remote and therefore his sale to you is equally unlikely to close.

Despite the weakness that contingencies connote, they are necessary to manage and allocate risks among the parties. The due-diligence 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. Since no property is absolutely perfect and these provisions allow significant discretion to the buyer, they effectively give you an option period in which to get comfortable with the property or walk away. This is a key point to understand when making a quick offer is necessary to win the deal: you can always change your mind and walk away at the end of the inspection period. Therefore you don't need to know much

[2] Escrow period refers to the time when you have a purchase contract but the transaction has not yet closed.

about the property before making an offer. All you really need to know is: do the economics of the property represented so far make this a compelling investment? If so, it's worth putting in an offer and then doing the homework to verify the representations. (After all, its your broker who should be doing all this investigation work for you).

Before concluding we must delve a bit deeper into the mechanics of the inspection rights provisions to see what happens when needed repairs are identified. For many properties these are relatively minor and the seller may agree to make the necessary repairs prior to, and thus a condition of, closing the deal. Alternatively, a seller may have stated up front that the sale would be on an "as is" basis – meaning he has no intention of repairing the property prior to the sale. Even so, you can still re-negotiate price after the inspection reports reveal the costs of the property's defects. Since the seller will be obligated to disclose the extent of work required to other potential purchasers, he might as well negotiate a deal with you and get it closed. If the repairs are very obvious and extensive, you may want to acknowledge a portion of these in the initial offer by explicitly providing a credit from the seller to cover repairs. This helps increase the odds that you and the seller truly do agree on the sales price of the property and it reassures the seller that you won't ask for full reduction in price for repairs identified by the inspection reports.

Conclusion

Negotiating the terms of a transaction quickly to beat the competition while managing risks through the contingency provisions of the contract will allow you to win the good deals that go quickly. The only catch is that you must be ready to jump in and efficiently perform your due-diligence while in contract to verify that the property will meet your requirements. Berkeley Investment Advisors puts you on an equal footing (or better) with the more experienced investors by providing the expertise you need to negotiate an economic deal, mitigate risks, and efficiently follow through on due-diligence after the deal is locked up. Berkeley Investment Advisors deals with the complexity for you and explains the recommended strategy so you can make intelligent investing decisions quickly and win the deal. Ultimately this edge, means lower risk and higher returns than doing it on your own or using a sales oriented broker.

Featured Investment Opportunities

I recently purchased several 3-bedroom, 2-bath townhouses in Houston that had been foreclosed by banks. The units are being repaired and rented out. I plan to hold 4 of them myself but have one more I can sell for $70,000. This is a good opportunity for someone to purchase property below market with relatively little capital or effort. I expect the buyer to be able to borrow 63,000 for the purchase. After adding closing costs and working capital the required investment is only $9,000. Over a 10-year holding period, I expect annualized return on equity of at least 12% - assuming you exchange for another property at the end year 10. This projection is conservative - it assumes annualized appreciation of only 1.7%. I will provide further details to interested clients.

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