The Fallacy of the Maximum Allowable Offer ("MAO")?

Before we look at the subtleties of a traditional real estate method of calculating an offer to a seller, let's preface this overview with where the calculation should be used. In general, there are three types of possible purchases – bank-owned foreclosures (REOs), non-REOs, and income properties. For this exercise and to make it very simplistic, we'll look at non-REOs which are basically purchases from homeowners selling their homes.

I have seen two investors use the same data and come to very different conclusions about what offer they would make to a homeowner. The difference is in how they handle the data, not the data itself. We'll use an industry standard called the Maximum Allowable Offer ("MAO") which is the maximum price an investor would offer a homeowner for his home. Once an investor becomes very familiar with neighborhoods and does a number of deals, he gets enough experience that he seldom needs a formula to calculate his offering price. But for newbies, using this formula is the safe way to start.

The most frequently used MAO equation is very simple and contains the property's After Repaired Value ("ARV"), estimated repairs and a multiplier factor, generally 70% or 0.70. In very bad market conditions the multiplier can be decreased to 50%, or in a hot seller's market, it can be increased to 85% or higher. The entire equation is the MAO = ARV x 0.70 – repairs. An example would be the MAO = $100,000 (ARV) x 0.70 (multiplier) = $70,000 - $20,000 (repairs) = $50,000 Maximum Allowable Offer to the seller.

Where I have seen many newbies go wrong using this equation is first in estimating the ARV of the property. The short course on calculating this value would be to have an appraisal, Broker's Price Opinion ("BPO"), Comparative Market Analysis ("CMA"), or guess at this value. All of these methods rely heavily on comparable past sales or active listings on the MLS®. I believe the REAL ARV has to be a function of what price sellers are willing to take at that moment in time in that specific neighborhood and market conditions.

I am not being facetious about guessing at this value because in unsettled markets, all of the above methods are purely educated guesses. Professional appraisers will take offense to this statement, but when I ask if they would buy a specific property for what they say it is worth, the answer is always "no". Their evaluation is based on comparable (past history) sales in a marketplace not in duress. That should say everything I need to about that.

This REAL ARV is very easily determined by driving the neighborhood and calling each and every seller and doing your best negotiation for a fast-cash closing and see what happens. If you push the sellers for what price they will really take you could be surprised and shocked. These sellers are the real competition for the property you are going to purchase and resell. The average

investor wouldn't take the time to do this work and would miss deals that are not listed on the MLS® and have very motivated sellers. This method of determining ARV is critical to wannabe rehabbers who will have to face the competition when their home is finished and they want to sell to a retail buyer.

Moving forward, the investor has determined his ARV and looks at the multiplier. If he is wholesaling the property his multiplier should be 60% or less so his investor buyer has the margin to buy it and rehab it and make a profit. Rehabbers pay more than other wholesalers because they are essentially an end-buyer until the property is sold at full retail value. The last part of the equation is the repairs and these can be determined in two ways, first carefully using experience or getting a value from someone who is experienced or by using a program that does the work for you such as www.ExcelRESoftware.com

Assuming that all of the above values have been determined accurately, what can go wrong from here? Looking at the equation there are two glaring mistakes that investors make. Improperly using the equation is the first thing that can go wrong – MAO = [ARV – repairs] x 0.70 will give an incorrect answer. Using the numbers from the previous example, the equation would look like this:
MAO = [ARV ($100,000) – repairs ($20,000)] = $80,000 x 0.70 (multiplier) = $56,000 MAO or $6,000 more than the previous example. Is this number incorrect? Not exactly, as the equation is still working, but the investor is leaving $6,000 in the hands of the seller and not in his pockets!

The other issue that hasn't even been addressed is the additional costs not mentioned in this equation, specifically carrying and holding costs. Depending on the financing (even cash) of the purchase and sale of the property, these costs include accrued taxes, double closing costs, utilities, insurance (never forget to put insurance on the property even for a day), transactional funding expenses, hard money costs, and other miscellaneous profit-sucking expenses. These dollars would have been profits to the investor if they hadn't slowly drained away his profits and caused the demise of many a rehabber in a declining market.

In summary, an investor must always remain aware how to calculate the REAL ARV; look for deals at the same time by driving the neighborhood for dollars, be careful calculating the vampire costs to close and carry a property, otherwise the investor will offer too much to the seller, and pay out too much in expenses to make a profit worth his time in the deal. Two options to eliminate the fear of this happening is to use the above software that automatically calculates all the carrying costs and expenses, and to do every possible deal by an Assignment of Contract so he has no closing or carrying costs and no money in the deal aside from a small deposit.

To your limitless success,
Dave Dinkel