

The Secrets of Wholesaling Lease Options

In many parts of the country, lease options haven't worked for years because prices were too high to cover a mortgage payment and many homeowners refinanced and cashed out their equity. So the only properties that made sense were those that were either free and clear of any mortgage or had small enough mortgages that could be covered by a lease payment.

So the premise is an investor approaches a homeowner who has substantial equity but generally wants to sell at full market value ("FMV"). The investor can offer 80% to 90% of FMV on a lease option agreement with a strike price of let's assume 85% of FMV. The seller- homeowner agrees to the strike price and to a lease agreement where the investor pays him \$850 per month for the property for a term of one year, renewable for 3 – 5 years, and for an "option consideration" of \$100.

Next, the investor advertises for a buyer who ideally has challenged credit and currently can't finance a home, has enough income to make a lease payment equal to his future mortgage, a 5% option consideration, and repairable credit. He finds such a potential buyer who does a lease option with the investor for the following terms – 95% of FMV, 5% of the purchase price as an option consideration, and \$1,250 a month lease payment. In real life, the actual strike price of the option to the investor and to the end-buyer/renter would be actual numbers, not percentages of FMV because no one may agree on FMV at the end of the option period.

The major income and potential profit centers are in place including the following:
Investor net income per month = $\$1,250 - \$850 = \$400$; if the end-buyer defaults, the investor can release or default but he will still make \$5,000 (on a \$100,000 property) - \$100 due to homeowner for the option consideration = \$4,900; or if the end-buyer exercises, the investor will also make the spread of the option strike prices = $\$100,000 \times (90\% - 80\%) = \$100,000 \times 10\% = \$10,000$. In this case the \$5,000 option consideration would become part of the investor's total profit. The total income for one year if all went as originally planned would be = $\$400 \times 12 \text{ months} + \$10,000 \text{ spread on sale} = \$14,800$ on an investment of \$10!

There are other nuances with the lease option such as a fee for the buyer to extend it at the end of each year; increasing the strike price each year; make your option contracts and lease agreements assignable without any further liability on your part; and making the end buyer responsible for all repairs under \$2,500, and the homeowner responsible for all repairs over \$2,500. It is critical that the buyer understands that his option consideration is not a security deposit or last month's rent – it is a non-refundable option consideration if he doesn't exercise his option to purchase – period. In addition, if the buyer stops paying his rent, you can evict him much more easily if you have two separate agreements – a lease and an option agreement. Courts seem to favor tenants too often and if you have a single agreement (lease and option), you may find the payments the buyer made are refundable or at least the option consideration will be.

When dealing with the homeowner-seller, make sure you get one contract that is both a lease and an option agreement for the same reasons I just mentioned.

But unless you are doing tons of these deals and have the temperament for landlording, you might want to consider wholesaling the lease-option. This concept isn't new and it allows you to get paid as you go so you have a cash flow. The other benefit to understanding wholesaling lease options is that you may want to be the buyer of existing lease options. Let's look at the three potential income streams that you would be buying or selling. First, the monthly income is nice because it is a monthly cash flow and it keeps you in touch with the tenant and you get a feel for his exercising the option or not. Second, the option consideration that will be forfeited if the tenant doesn't exercise, and finally the profit spread if he does exercise. To add in a mix of greater income potential, the tenant may not exercise the first year at all, he may exercise the second year at a higher price (higher profit) after he pays for an extension to the option contract, or he may forfeit and another tenant and another option consideration comes into play.

As a buyer of the lease option, you would like your tenant NOT to exercise the option contract, forfeit the option consideration and you find another tenant. This process has literally gone on for as much as ten years that I am aware of in flat or rising markets. If your market is declining, your tenant won't exercise but you have two options – get a new strike price from the seller, or default on the purchase (lose \$100). The reality is that you have to be as pessimistic as possible to make this investment work so you have two options – make a ridiculously low offer to the lease option seller, or make him a partner in the transaction.

As a guideline for the buyer of the lease option - first, this transaction should be treated as a buy-sell deal that has to be held for one year. Yes, there is potential for much more upside but you also run the risk of having to evict the tenant and getting sued by the tenant and the homeowner-seller. There are no guarantees in this game. So as a cash offer the "usual" first round would be for you to get the option consideration on signing of the Assignment of Lease and Option Agreements and you pay the seller (original investor) ½ of the monthly NET income for 6 months or about \$600 (\$100 net profit/month) - \$2,000 (maximum). Essentially the seller has worked as a bird dog to find the deal and you are taking it over. The option consideration should have been escrowed but if it wasn't, the seller would have to transfer it to you. You can also offer a percentage of the profit spread if you need to but don't exceed 25% - 30% of the actual net profit. The permutations and combinations are almost limitless for what can be offered and how it is paid out.

As the seller of the lease option, you can make a case for the "huge" upside and the extended stream of income for potentially years if the tenant doesn't exercise at the end of the first year. In addition, if he forfeits, the option consideration plus the rental income is "in the bag" so to speak. You also have an option to make a straight offer to sell the lease and the option, or you can offer to partner for an upfront fee (your immediate cash flow). How you set the value is a function of how motivated you are.

If you are the seller making the offer, you want to split all the income over the life of the contracts – lease and option. In exchange for your giving “so much” up, you are to receive 50% of the expected rental profit spread for the first year at the signing of the partnership agreement. In the above example of a \$100/month (50%) of the profit, you would get \$1,200 immediately and \$2,400 if the net profit was \$200/month. Everything else would be deferred until the ultimate sale was completed. Using this form of an offer, you would continue to get rental income throughout the life of the contracts and participate in the eventual profits. The split does not have to be 50%/50% depending on your and the buyer’s motivations – “everything is negotiable”.

In summary, wholesaling lease options can be a very viable way to be a real estate investor without having any money to buy homes, without credit, and without any risk in the transactions. Just make sure you have the proper contracting, you are able to articulate the seemingly complicated process to a homeowner-seller, the buyer and to another investor to whom you will be selling the deal.

To your limitless success,
Dave Dinkel