ROBERT ALLEN'S MONEY POWER SYSTEM FOR MAKING YOUR REAL ESTATE FORTUNE

"STRATEGY UNITS"

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THE BIG PICTURE

The Case For Real Estate As A Wealth-Building Vehicle

1. GENERAL CONSIDERATIONS

There are compelling reasons to be active in the real estate investing field today.

For many years, real estate investors have spoken of income property as the "ideal" investment. They have used the word "ideal" as an acronym for the five key factors of real estate investing that have made it attractive over the years as an investment alternative: (1) income generation, (2) depreciation (tax advantages), (3) equity buildup through tenant debt service, (4) appreciation, and (5) leverage.

By now, most people who have been active in this field or who are now in training for it are familiar with this succinct formula:

I = **Income from rents**

D = **Depreciation (tax benefits allowed by Uncle Sam)**

E = **Equity buildup as tenants make their payments**

A = **Appreciation as the value of real estate grows**

L = **Leverage through the use of "other people's money"**

For historical reasons, we have to conclude that this formula is in part true, and in part misleading. It is important to enter the real estate field with a clear picture in mind of its advantages and disadvantages. That is why we begin this course with a little reality therapy.

There have indeed been times during the past quarter century when equal weight could have been placed on all five of these important factors as dimensions of profit potential. For example, during the heyday of speculative real estate investing by throngs of beginners in the mid to late 1970's and early 1980's, even novices with only the most fundamental knowledge of this field stood a good chance to make a profit.

The reason was that all five of the "ideal" factors were at work at the same time. Income from rents were not yet widely under pressure from factors like rent control. The government gave generous preferential treatment to real estate investors through tax write-offs in the real property arena. Equity could build up relatively quickly. Appreciation was advancing with unprecedented vigor in many sectors of the economy, such as California. And leverage was just becoming a household word as a number of celebrated "gurus" were active introducing the secrets of OPM to millions of receptive would-be investors. Such ambitious investors were being enticed out of the side streets of Everywhere, USA, by ambitions to create for themselves a higher quality of life via the American Dream.

But a funny thing happened on the way to the real estate closing.

1.2. UNCLE SAM'S TAX "REFORM"

In 1986, the government "reformed" the tax laws in a major way and, for all intents and purposes, clipped the wings of this kind of investing, except for a few lingering and selective advantages. At the same time, appreciation took a U-turn in many areas of the country. And thousands of new investors who had jumped into the fray with minimal business sense found themselves enrolled in the School of Hard Knocks--without a scholarship.

All of this (believe it or not) was really for the best.

It meant that the "IDEAL" investment had to be spelled a little differently: "I-d-E-a-L," with a small "d" and a small "a." Let's see why.

Today's real estate investors can still enjoy the benefits of income generation through tenant debt-service. They can still enjoy equity build-up (even while they are asleep at night). And leverage is still a vitally important dimension (in many respects *the most important dimension*) of this type of wealth building.

However, the tax benefits of owning income real estate have been seriously reduced when compared with those available in the "good old days," and appreciation is at best regional and unpredictable because of the downward economic trends of the past five years.

The consequence of this historical shift has been to place real estate investing forcefully into the only context where it makes any kind of sense at all, i.e., that of a *business* based on principles of good, professional, *business* practice. In other words, your chances of succeeding in real estate investing are now precisely linked to how professionally you proceed with this kind of enterprise *from a business point of view*. That is the way things should be if they are to have any longevity and profitability.

Fortunately, the real estate bubble of "get rich quick" fantasies with unlimited appreciation and fail-safe but often accidental profits has given way to reality. But the reality has turned out to be nearly as good as the fantasy--if you know what you are doing.

Here is the bottom line: if you have the desire to enter the field of real estate investing today, then enter it with your eyes open, with a commitment to weighing and analyzing all of the factors objectively, making informed decisions based on factors of profitability and predictability, and operating your enterprise in every respect like a legitimate business, with legitimate goals, legitimate controls, and a good measure of creativity to gain advantage in the market place.

1.3. REAL ESTATE--STILL THE GOLDEN OPPORTUNITY

Real estate investing is still one of the most attractive alternatives available to the investor at any level of expertise. Let's count the ways, keeping in mind that the aggregate layering of these benefits makes them all the more appealing.

INCOME POTENTIAL

Where can you find an investment that pays you in predictable and (for the most part) controllable installments, month in and month out? You can, of course, invest in the stock market and speculate on the ability of the blue chips--or the more risky issues--to give you a regular return. But the performance of the stock market over the years is not without its roller-coaster qualities. And with stocks and bonds you relinquish control over your funds totally--except for going in and coming out.

By contrast, when you have a solid piece of income property in place, together with the management controls you need, that income stream, like Ol' Man River, just keeps on flowing. Yes, some mutual funds have done well, and may continue to do well. But in the hierarchy of needs, housing is basic. We all need a place to live. If you want the security of servicing a need that will never decline, then housing has got to be near the top of the list--if you follow certain basic rules outlined in this course of study.

DEPRECIATION (TAX BENEFITS)

Congress changed the tax rules pertaining to real state four times during the 1980's. That decade was not particularly kind to real estate investing. The 1986 reformation was particularly damaging. Moreover, capital gains lost its special treatment and further depressed the real profit potential. And the new passive-loss rules were designed to prevent you from offsetting income from normal sources (salaries or investments in stocks and bonds) by expenses from passive sources such as real estate or limited partnerships. In other words, you could only use "passive losses" to offset "passive income," but not "regular income." To pass the "passive test," you had to "materially" participate in your business and satisfy tough criteria such as:

M You had to work in your business at least 500 hours per year (around ten hours per week).

M If you worked less than the 500 hours a year, you had to be the primary person involved, almost to the exclusion of anyone else.

M If you put in at least 100 hours a year, it had to be more time than anyone else put in, including employees.

This kind of sophistry forced investors to look at real estate through different eyes. The old rules of writing off real estate losses against salaries and wages vanished into thin air.

Was there nothing left of value?

Fortunately, yes.

M Legitimate expenses within your passive activity (such as interest, depreciation, property taxes, insurance premiums, management fees, advertising, legal or accounting fees, repairs, etc.) can still offset income from that passive activity. Uncle Sam only exacts his pound of flesh from the *net* profits.

M Any excess loss from a passive enterprise can be used to shelter income from *other* passive enterprises.

M Any unused loss can be carried forward to *future* years where you will have passive income that needs to be sheltered.

M Your losses from passive enterprises could make it attractive for you to plan to find "passive income generators" (known as "PIGS") in the future--such as the new breed of real estate limited partnerships designed (heaven help us!) to make *profits* rather than generate losses through high debt-levels.

M You still can play the imaginary game of "depreciation" where Uncle Sam pretends that your real estate property loses all of its value in 27.5 years (for residential) or 31.5 years (for commercial), and let's you *write it off* over time as an expense. (For properties placed in service before 1987, the more favorable rules of the "Accelerated Cost Recovery System" applied.)

M If you qualify as an *active participant* in your business activity, you can still use up to $25,000 of losses against other income (such as salary or interest and dividends). However, this $25,000 bonanza is reduced by 50% in stages when your adjusted gross income exceeds $100,000, and evaporates altogether at $150,000 AGI. (Keep in mind that this policy applies only if you own 10% or more of a rental property or limited partnership.)

Thus Uncle Sam still left some valuable crumbs on the table even though the banquet was over--enough to make it still fairly tempting to enter the real estate field from the tax point of view, provided you treated your investment with the care of an astute business person. Tax laws change. Be sure to check current laws and regulations.

EQUITY BUILDUP

When your tenants make their payments, part of the money stream goes to pay interest on the debt, and part goes to retire the principal amount. This unique feature means that every payment causes your equity position in the property to improve. As the debt is serviced, your net worth increases. This simple characteristic makes real estate unique. You make money while you sleep--because someone else is servicing the debt in exchange for the privilege of using your property.

APPRECIATION

In some parts of the country (currently in the mountain states and in the north west, for example), real estate is appreciating at a respectable rate. At the same time, other regions of the country are experiencing flat or declining values. What is the implication of this? It is that you can make real estate work for you--wherever you live--if you structure transactions to emphasize those elements of the I-D-E-A-L formula that will give you the *highest* return in your area. At the same time, if you are fortunate enough to live in areas of the country where property values are rising, then you have that profit "booster" of appreciation to add to the other factors of profitability that pertain to your investment.

Keep in mind that real estate (despite regional fluctuations) is still a "forgiving" undertaking, in that eventually real estate values in most areas of the country will recover from occasional corrections and declines. The reason for this is tied inseparably to the market forces of supply and demand. "They aren't making land anymore" is a phrase that real estate investors are fond of quoting. And it is true. There is indeed only so much land to be developed; that fact, coupled with the fact that housing is a necessity, will cause most real property to rebound after market declines. But you must either have the staying power to wait it out in those cases, or you must use combinations of creative acquisition techniques that make it prudent to invest in those areas despite a lack of appreciation. In any case, the street-smart investor can always target properties that lend themselves to profit-taking on a quick turn-around transaction. More on this later.

LEVERAGE

There is no more exciting or stimulating factor about real estate investing than the concept of "leverage." It means, simply put, that you can control an entire piece of real estate and benefit from its full slate of cash favors, *even if you don't pay for it all at once*. In fact, even with a nothing down transaction where you don't put a dime into a property, you can still reap the harvest of the entire property as if you had paid it off entirely. This, coupled with the principle of using "other people's money" when a down payment is called for in a given transaction, makes real estate leverage so powerful. The yield through leverage can be very high indeed.

By contrast, try buying stocks and bonds with nothing down. Try starting up a franchise with nothing down. Try opening up a retail store with nothing down.

With real estate, you can sit on the throne of profit without having royal blood flowing through your veins. In fact, in many respects, real estate is the "little guy's" only chance to make it big without a fat wallet. And it works.

These five factors of profitability--income generation, depreciation and tax advantages, equity build-up, appreciation, and leverage--make real estate still one of the most attractive opportunities for the average person, provided the action plan for real estate is followed with care.

This course of study outlines in considerable detail what that action plan is, and how you can put it to work profitably.

2. HOW MUCH CAN I MAKE?

It's an age-old question. The answer is: "How much do you need and by when?" The hardest thing for the beginning investor to understand is that he/she is in the driver's seat. When goals are set and commitments made, then you just follow the plan, step-by-step, until you reach your destination, whatever that might be.

A few years ago we were following the case study of a California woman who had made real estate development her primary wealth vehicle. She had it down to a science. For every lot she developed and sold, she made $25,000, more or less. Her goal was very specific--one million dollars a year in earnings. That meant that she had to follow her cycle 40 times a year. That's just about one development lot per week (with some time off for holidays and getaways). She did it like clock work, because she knew the precise steps to follow on a daily basis--and she followed them.

For every such case there are thousands of others where people have lesser goals--but still succeed just as well from the stand point of their own personal needs and circumstances. At one time it was estimated that as many as many as 5% of the adult population of the United States owned and operated at least one income property other than their own home. Such people did not often make a million dollars a year as a real estate investor, but many thousands of them regularly earned hundreds or even thousands of dollars of extra income each month through that rental home or small multi-unit they were conscientiously tending.

Setting goals for earnings in the real estate field is no different than in other fields, except that the formula "IDEAL" gives you greater opportunity for leveraged yield than perhaps any other kind of investment. This is especially true for the tens of thousands of eager and ambitious investors who are willing to put into deals all the money they have--nothing. Where courage, energy, creative enterprise, and sweat equity are the *only* assets to invest, real estate is perhaps the *only* viable alternative to attaining the American Dream.

Whether you are targeting a hundred dollars a month in profits, or a hundred-thousand, there are models in the real estate investing field that you can apply to attain your goals. It is the purpose of this course to provide a comprehensive training experience in such models so that you can exercise the options you want to attain the goals you need.

3. WHAT DOES IT TAKE TO SUCCEED IN REAL ESTATE?

If you were asked to characterize the successful real estate investor, what would that profile be? By and large, those who succeed at this business seem to follow a certain pattern of behavior that includes the following key elements:

M 1. VISION. They cultivate an unwavering vision of what they want to achieve. This vision is not fuzzy or tentative, but specific and tangible. They have in their mind a sensory-rich image of where they want to be, what they want to be doing at the end of their journey, what rewards they want to be enjoying, and with whom they want to be enjoying them--family, friends, loved ones, people they serve.

M 2. GOALS. They translate their vision into specific, tangible, time-conscious goals that can be measured, monitored, and adjusted on a regular basis. Like the woman who needed to make $25,000 per deal, week in and week out, they follow a precise set of goals without wavering.

M 3. ACTION PLAN. They translate their specific goals into a set of behaviors designed to produce specific results. Real estate investing, like any other business activity, must be reduced to daily and weekly actions that are tied to the goals and the vision of the enterprise.

M 4. TEAM WORK. The successful real estate investor, without exception, knows the power of working within the team context. Real estate investing is a networking activity that involves not only buyers and sellers, but bankers, real estate agents, title company officers, attorneys, accountants, insurance agents, appraisers, contractors, partners, and a host of other key people whose services and support are indispensable from time to time. Real estate never works in a vacuum. You must have a "high touch" affinity in order to bring together the various people constituencies into a win/win configuration that gets results.

M 5. CREATIVITY. We will spend a great deal of time diagnosing this mysterious quality and attempting to clarify its meaning and operation. Real estate investing rests on the foundation of creative deal-making and creative financing. This means that the tried and true formula for buying--put down ten or twenty percent in cash, expose all our secrets to intense scrutiny by the loan officers, and use the hard-money lenders to finance the rest of the deal--must be declared old-fashioned (unless you have partners in your back pocket who are flush with capital and willing to put it to work to induce high discounts). In its place you must put an array of interlocking creative techniques designed to solve problems for a very small constituency of property sellers--those who are flexible in price and terms because of high motivation.

This ability to apply creative techniques to the particulars of a given transaction is a key ingredient to successful real estate investing. The "big guys" have been doing this for decades--perhaps from time immemorial. No one in the upper echelons of investing puts their own money on the line. It is always OPM ("other people's money") that makes the macro world of real property enterprise go around. This insight has filtered slowly to the rest of us down on Main Street. It is only in the last quarter century that these insider strategies and techniques have become accessible to the "little guy" in full force. High time! No one need have a monopoly on creativity. These techniques can be learned--and it is this will to learn and apply creative measures that can lift the "little guy" out of the rut of a self-imposed incarceration of negative conditioning and limited vision.

M 6. PROFESSIONALISM. What is required in successful real estate investing is the same thing that is required of any business venture: a profit-and-loss mentality, attention to the bottom line, reading the "small print" in every lease, every document, and every contract involved. If you are willing to keep score, then you can play the game. Records must be kept, taxes paid, the balance sheet maintained. There is no magic wand. It takes keen business sense. And if you don't have it, then learn it, or get someone on your team who knows it inside and out. There is more to fishing than pulling in the big ones. You have to know where to fish and when, what bait to use, what equipment to put to work, and how to clean those slimy critters after you get them on shore. And you have to have a fishing license. It's all a conspiracy by the fateful forces of the capitalistic system--but if you know how to play the game of professionalism, you will win.

M 7. HONEST EFFORT. It has to be honest--win/win in every respect--or you will slip and fall eventually. What goes around, comes around. What comes around, goes around. We are not working in a vacuum. Everyone has to win, or no one wins in the long run. And it has to be effort--lots of effort. Real estate investing is hard work. If you set high goals, you set high work standards. If you set modest goals, you set high work standards. If you set low goals because that is all you need, then you set high work standards.

There is no free lunch (although you can learn to work smarter, rather than harder). We have been following the case of one real estate investor in Milwaukee who never even looked at a piece of real estate before making an offer. He simply knew his town backwards and forwards and sent dozens of offers a week to declared sellers in areas he wanted to buy in. Naturally, his offers were low-ball and based on formulas that assured his success. Naturally, most were rejected out of hand. But a few--one or two a week--would say "yes." And the sellers came to his doorstep, on his terms, hat in hand, ready to do business. Smart. But still hard work--sort of. Get the idea?

4. WHAT IS THE ACTION MODEL FOR REAL ESTATE?

4.1 GENERAL CONSIDERATIONS

Understanding and applying action models is fundamentally important to your success. Therefore, let us take some time to generate a clear picture of how they work.

AN ILLUSTRATION

Picture this: It is a dreary, rain-drenched night. You are riding along the highway with windshield wipers sloshing back and forth rapidly. You are leaning forward and straining to catch a clear view of the slippery roadway before you.

Suddenly a confused scene flashes before your eyes. There has obviously been a serious accident. You slam on your brakes to avoid hitting several cars along the side of the road. Smashed and crumpled vehicles spring into view. There are bodies on the ground.

You pull your car off to the side and step out to help. A number of people are wandering around in a dazed stupor. Your confusion and shock renders you ineffectual. What is to be done? You don't know. No one seems to know.

Suddenly another car screeches to a halt along side the road and the driver bounds out and into the midst of the chaos, shouting firm orders in a forceful manner so that people spring into action.

He points at you and says: "You. Get a flashlight and go down the road to ward off the oncoming traffic." You obey instantly.

He points to another person and shouts: "You. Go immediately over to that farm house and call for an ambulance and the police."

To another person he shouts: "You. Get coats or blankets and cover up the injured people on the ground to keep them warm. Do not move them."

To another person he shouts: "You. Get several others to help you push those cars further off on to the side of the road to avoid further collisions."

To the other onlookers he shouts: "The rest of you move away and get into the background."

Then the man goes immediately to gather up the dazed survivors and render comfort and assistance.

Soon police and paramedics arrive to take charge of the situation. But the leader who preceded them has already done much to alleviate suffering and prevent further injury.

WHAT IS AN ACTION MODEL?

An action model is a sequence of interrelated actions designed to produce a target result. The story illustrates the application of a particular action model to use when you come upon the scene of a traffic accident. In this case, the model is relatively simple:

M Warn or stop oncoming traffic to prevent further collisions

M Get help (police, medical)
M Improve conditions for the injured

M Clear the area for additional safety.

When we examine an action model of this type, our reaction goes typically something like this: "Right. Anyone could and would do precisely these things under those conditions."

Actually, the opposite is true. In times of crisis, it is a *rare* person who can take an action model and apply it in a practical way to the situation at hand. That is why the stranger in our little story is a hero, because he intervened with leadership and power at a time when everyone else was confused and helpless. He applied a simple action model that produced the desired results immediately. In a way, he was like a professional acting among amateurs.

Professionals are trained to apply specific action models to particular situations. Consider these procedures and the chain of actions that must be followed with precision if good results are expected:

- brain surgery
- farming
- training show dogs
- building a house
- fishing

We could outline with precision the exact sequence of steps that must be followed in each of these and many other similar situations. In fact, *virtually any objective we can think of is governed by a particular action model or set of action models. It appears to be a universal truth that results flow from the application of such models*.

The opposite is also true: when we go about targeting results without a clear action model in mind, our success is more a function of accident than design. In fact, much failure in life can be traced back to situations where an incomplete or faulty action chain has been followed.

4.2 SURPRISE: REAL ESTATE HAS AN ACTION MODEL, TOO

Now we can make our point. When it comes to action models, real estate investing is no exception. If it is to be done effectively, it must be done "professionally," i.e., through the application of a particular action model.

Once you have determined the type of real estate you wish to be involved with, the model is virtually always the same. Here are the steps:

- **M** GATHER A PROSPECT BASE
- **M** SELECT THE MOST PROMISING PROSPECTS
- **M** CONTACT THE SELLERS
- **M** NEGOTIATE THE DEAL
- **M** WRITE THE OFFER
- **M** FUND THE PROJECT
- **M** CLOSE THE DEAL
- **M** AUGMENT THE VALUE
- **M** HARVEST THE PROFIT (KEEP OR TURN)

This sequence of nine steps is relatively simple. The logic of it is manifest. It has organic integrity; that is, one step flows naturally into the next to form a completed chain of events.

So what's the big deal?

The big deal is that few people follow the chain with rigor and thoroughness. The temptation is to jump into the action model at whatever point seems congenial to one's personality--and to take off from there without regard to *context*.

SOME AMATEUR EXAMPLES

M Jim fancies himself a real "wheeler-dealer" with a silver tongue. He flourishes in the negotiating arena where he can go after the killer deal. But Jim doesn't like to gather prospects and zero in on those who are most likely to be flexible; he takes on every seller in sight. Therefore, he almost always strikes out. Jim is an amateur who doesn't understand the action model.

M Denise goes down the action chain to the point where writing offers occurs. She is pretty thorough to that point but has a phobia about the written idiom. She doesn't go after the close and get the signature. Therefore, the chain is incomplete and she never gets the results she wants. Denise is an amateur who doesn't understand the action model.

M Fred spends his time spinning wheels with all kinds of contacts and properties. His hang up is creative financing. He can figure the bottom line but never how to get there. His deals lack that innovative, problem-solving core that enables people to jump over walls and around obstacles and put successful deal together. Fred is an amateur who doesn't understand the action model.

M Mary is a whiz with everything except getting out. She is poor at back-end management and tends to get into things without an exit plan in mind. Thus, when harvest time comes around, she comes up short and leaves big bucks on the table. Mary is an amateur who doesn't understand the action model.

M Harvey goes through the whole chain of events in the action model and does pretty well. But for some reason he always forgets how to augment the value of his properties before turning them--often small cosmetic improvements can pay big dividends--and therefore puts up with mediocre returns. He could almost double his results if his action model were complete. But Harvey is an amateur who doesn't understand the action model.

You say: "Well, stupid them!"

Okay. Let's see how smart *you* are. Without looking back at the action model outlined above, write down the exact sequence of actions that make up the investment real estate action model. We'll give you a clue: there are nine steps in this model.

Write them down now:

1.____

2.____

3.____

4.____

5.____

6.____

7.____

8.____

9.____

How did you do? 100% correct? Great--you are well on your way to becoming a pro.

Did you miss some of the steps? Not to worry. Simple things can sometimes be a vexation. But let's give you a mnemonic device to fix this model firmly in your mind.

4.3 PUT ON YOUR THINKING CAP

Let's restate the action model in a slightly different way so that remembering its nine steps will be a "picnic" for you. It might seem a little silly, but suspend judgment for a moment and spell out the words "PICNIC CAP" as follows:

P = PROSPECTS (GATHER A PROSPECT BASE)

I = IDENTIFY THE BEST (SELECT THE MOST PROMISING PROSPECTS)

C = CONTACT THE SELLERS

N = NEGOTIATE THE DEAL

I = IN WRITING (WRITE THE OFFER)

C = CASH (FUND THE PROJECT)

C = CLOSE THE DEAL

A = AUGMENT THE VALUE

P = PROFIT (HARVEST THE PROFIT--KEEP OR TURN)

With this memory trick in mind, put on your "Picnic Cap" and try your hand at recreating the action model once more. See if it flows a little more smoothly this time:

P____

I____

C____

N____

I____

C____

C____

A____

P____

4.4 CHINESE BOXES

It will not surprise you to learn that each one of these nine steps in the action model gives rise, in turn, to another action model consisting of a sequence of steps. That is, each step in our investment real estate action model has its own set of steps leading to a specific targeted result.

For example, if the targeted result in step one is to develop a set of prospects, how do you go about gathering prospects? There is a particular action sequence, or rather a set of action sequences, that will get you the results efficiently and professionally. This set of action sequences is explained in the next unit. In fact, each of the action steps to step one can be broken down further into more detailed steps. There is truly an art and a science to this profession (just as you would expect).

Similarly each of the other eight steps in the action model gives rise to its own action model (of sub steps) that will be elucidated in the units that follow.

It is rather like a set of Chinese boxes, one fitting inside the other, in sequence, until the most fundamental building block is attained.

What you are to learn in this course is how to fit all of these Chinese boxes together into an organic whole that will get you the results you want.

4.5 AN ASSIGNMENT

To get you ready for the units that follow, take a sheet of paper and write down the key words PICNIC CAP in a vertical column. Translate each letter into one of the action steps of the model. Then write down at least five action steps after each letter that you would logically imagine belong to the next layer of action models for each. See how far you can go with this exercise on your own. Don't be afraid to spend an hour or so with it.

You will no doubt come up with some very good answers. Can you accept the probability that your answers will only be *partially* complete? Does this arouse curiosity as to what the complete action models will look like in future units?

If you find that your understanding of some of these nine action steps is skimpy, can you accept the possibility that you will need to become an especially good student of those weaker links in the training experience that is to follow? Everyone has different strengths and weaknesses. You can use the fundamental action model as a training tool to zero in on your own strengths and weaknesses.

And when you are finished with your PICNIC CAP exercise, write down the word IDEAL and identify the five major elements of profitability in real estate investing. Define each and pick out the ones that you feel are the most important for your area and your own personal situation.

How can you stay motivated with this exercise? Think money. The more astute you become at understanding and applying the action models for this profession, the more money you will make. Period. It is a universal truth. Believe it!

4.6 WHAT KINDS OF PROPERTIES ARE IN YOUR "BIG PICTURE"?

Before we jump into the details of the action model for real estate investing, we need to cover a vital point. Real estate is a broad term. It includes raw land, farm land, residential real estate, and commercial real estate. Residential real estate embraces condominiums, single family houses, small multi-unit properties (duplexes, tri-plexes, four-plexes, etc.), and larger apartment buildings and complexes. Commercial real estate includes office and professional buildings, strip malls, and all manner of property used in the manufacturing and service industries.

The principles of locating bargain properties, analyzing their profit potential, using creative finance in the acquisitions process, making offers and closing deals, adding value, and carrying out the management function--all of these factors apply more or less equally to the various kinds of real estate that could be of interest to investors.

However, for the investor who stands at the beginning of his/her career, the most logical place to begin is with the smaller properties--single family homes and small multi-units. If you are in the process of acquiring the skills and expertise associated with the real estate investing field, would it not make sense to cut your "eye teeth" on the simpler transactions where the risk is lower and the arrangement relatively uncomplicated?

The larger residential properties are a step above, where more sophisticated interactions and problem-solving come into play--and where the risk is greater. And the commercial realm brings with it a whole array of challenges related directly to the local, regional, and national economy, and the viability and staying power of various business tenants who are going through the ups and downs of commercial life in ways about which residential tenants in general need not worry. Similarly, real estate development and lot subdivision, while offering the potential of high rewards, also presents a variety of complex challenges not recommended for the untrained investor.

For this reason, we recommend the philosophy that a lot of "little" deals can add up to a great deal of success. Single family houses and small multi-units hold out the potential for considerable profit, if acquired and managed (or sold) appropriately. There will be time enough for the macro-transactions after you have developed a professional modus operandi in the real estate field and learned the ropes that are second nature to the "big guys." That is not to say that the beginner or intermediate investor who comes upon a stellar bargain in the large property arena should shrink from taking a close look at it. After all, if needs be, a partner can be brought into the deal who has the needed qualities and experience. We are saying only that the smaller properties are the logical place to focus at the beginning.

If you have a special interest in the more complicated transactions, we can refer you to the Power Module on Multi-Units later in this course, and also to Unit Nine, where real estate development is discussed.

UNIT TWO

HOW TO LOCATE ULTRA-BARGAINS

UNIT TWO

HOW TO LOCATE ULTRA-BARGAINS

2.1 GENERAL CONSIDERATIONS

Real estate investing, just like any other professional enterprise, is a series of interrelated skills. Finding bargain properties is one of the most important of these skills--in many ways the *most* important. The key to finding bargain properties is the ability to identify sellers who are highly motivated to sell--who *must* sell--as opposed to those for whom it would be desirable and useful to sell. Thus, by and large, real estate investing (especially creative real estate investing) amounts to finding *both* the right kind of seller as well as the right kind of property. In fact, street-wise real estate investors tend to look *first* for the motivated sellers before they go too far in analyzing the properties.

Motivated sellers go by a variety of names: flexible, anxious, "don't wanters," etc. But they all have one thing in common: they want you to solve some major problem for them. It might be that they are being transferred and must therefore hurry and sell. Or they might have personal problems such as a serious illness or a divorce that is forcing them to sell. Alternately, they may be motivated by financial pressures or find income-property ownership not to their liking. Whatever their reason, you can appear to them as a shining knight on a white charger.

Do you find this role comfortable? With whom would you rather deal: (1) someone who spreads rose petals before you as you enter or (2) someone who is a hard-nosed, self-satisfied property owner who could care less if he sells or not? Which type would cause you to experience less fear? Obviously the seller who is motivated, flexible, and willing to talk turkey right away. That is an important reason who the savvy real estate investor will almost always start with the most anxious sellers, because the job is simply easier in that environment.

Think about it. Fear is one of the greatest destroyers of progress. It can keep a perfectly capable person (like you or me!) from even trying something new. As you go through this unit, visualize yourself talking to the flexible sellers we describe. Visualize yourself using the different sources of flexible sellers we talk about. As you become more familiar with the ideas, and as you apply them in a no-risk environment (which you can do with the exercises at the end of this unit), you will find your fears melting away.

2.2 A FEW TERMS YOU SHOULD KNOW

Balloon Payment: A payment that is larger than the normally scheduled payments. This may be for the entire balance of a loan or just a portion of it. For example, a buyer pays $500 per month on a loan, then at the end of two years he must make an additional lump-sum payment of $3,000. Sellers who face an impending balloon are often very anxious. Beware of inheriting problems like this from motivated sellers.

Buyer's Broker Agreement: An agreement between a real estate agent and a potential property buyer. The agreement states that the agent will make efforts to locate property for the potential buyer (both listed and unlisted) and will be paid a commission if the property is purchased. The property may or may not be listed with another real estate agent. Such an arrangement can be a boon to your success in locating flexible sellers.

Contract Sale: An arrangement where the seller agrees to carry the loan (or part of it), thereby eliminating the need for the buyer to get a mortgage from a bank or other financial institution. With a contract sale, the buyer usually gets a lower interest rate--and often there are no credit checks. This method of financing is often used with highly motivated sellers.

Farming: A form of prospecting that is used in real estate listing and sales. The same process can be used in finding don't wanters. In farming, an investor concentrates on and becomes an expert in a particular area.

Flexible Seller: A person who wants to sell his real estate holdings so badly that he will be very flexible in price and/or terms.

MLS: An abbreviation for Multiple Listing Service, a cooperative service that gives member real estate agents access to information on all properties listed. MLS gives maximum exposure to listed properties. If Broker A lists a property, Broker B and all other brokers on the service have the right to market and sell it. The listing agent and selling agent then share in the commission.

Notice of Default: A formal notice legally recorded against a property, thereby beginning the foreclosure process. Reviewing notices of default is one way of finding flexible sellers.

Notice of Sale: A notice, required by law, announcing the date of sale of foreclosed property. Such notices almost always lead you to flexible sellers because their back is against the wall.

Obsolescence: The point at which something has gone out of style or out of date so that it is no longer useful or practical. In real estate, a property can become obsolete when it is outdated, when the economy changes, or when the expectations of property owners change. Owners of such property can often be flexible, especially if they cannot clearly see how future use could be facilitated through conversion.

Realtor: A copyrighted term that applies only to real estate agents who are members of the National Association of Realtors. The broker for a given agency is called a Realtor and agents licensed to him are called Realtor-Associates. Only Realtors and Realtor-Associates have access to the Multiple Listing Service. The National Association of Realtors prefers that a "®" appears after this title as a superscript.

2.3 KEY POINTS ABOUT FINDING FLEXIBLE SELLERS

As you read this unit, keep the following key points in mind. They will guide your thinking and help you to keep the proper perspective on the information you will be assimilating.

M Good deals come from a very small percentage of sellers.

M Finding the right seller is as important as finding the right property.

M The more you know of a flexible seller's true motivation, the better chance you'll have of concluding a good deal with him.

M Seller flexibility can be a communicable disease. Make certain the property you're looking at is immunized before you close the deal. In other words, avoid taking over someone else's problem just to get a good deal.

M Flexible sellers can be found in many places, some easier to discover than others. By prioritizing your efforts, you can save a great deal of time.

M As a real estate investor, you are a problem solver. As you solve a flexible seller's problem, you'll be benefiting both of you.

2.4 TWO KINDS OF FLEXIBLE SELLERS

What Is a Flexible Seller?

A flexible seller is a rare breed. He is the real estate owner who is so anxious to sell that he'll be very flexible with his price or terms--or both. Flexible sellers represent the smallest percentage of the population of sellers. Success in real estate investment depends on finding flexible sellers and helping them with their problems. The person who buys from inflexible sellers ends up paying too much for properties and at too high an interest rate. That's certainly no way to reach financial independence!

Flexible sellers come in two varieties: wholesale and retail. A *wholesale* flexible seller is willing to discount his price substantially in order to sell his property quickly. A *retail* flexible seller may not discount his price, but he is very flexible in the terms he will accept.

Both varieties of flexible seller are good for the investor. But it's important to know which variety you've got on your hands because each requires different techniques and strategies. To complicate things further, some flexible sellers are a combination of the two, being a little flexible on price and a little flexible on terms, but not too extreme in either direction.

Don't worry! The different kinds of flexible seller are easy to distinguish. All you have to do is ask them.

THREE ILLUSTRATIONS

In the meantime, here are some examples to help you. Klaus N. is the proud owner of a duplex--or, at least he *was,* until he got a promotion at work. He was moved from district supervisor of sales to regional director. Now he has to make the rounds through six states, with a significant stopover to work with the salesmen in each major city. It seems like he is gone more than he is home.

As time has gone by, the duplex has become more and more burdensome. He isn't home enough to adequately manage the property, and he feels the tenants are taking advantage of him. His solution: sell the duplex, and do it fast. He is willing to carry a contract with an interest rate that is just a bit less than the going rate. Moreover, he will discount his price by several thousand dollars, simply to move the property quickly. Klaus is a wholesale seller.

Angela T. is in a different situation. She bought a rental home a few years ago, and she has enjoyed watching its value gradually climb. At the same time, she opened a small computer store--and that's the source of her problem. The computer store never did do very well, and Angela kept feeding more and more money into it. Now, forced against the wall, she knows she has to liquidate.

Unfortunately, the business is going to leave a bitter legacy: several thousand dollars worth of debts. Angela knows only one way out. She must sell her rental home.

She doesn't care much about the interest rate she gets from the new buyer, but she is firm about the price. She needs the money so she can pay her debts, and she needs it up front. Angela is a *retail* seller.

Stephen W. is a rare combination of the two. He bought a house two years ago, and its negative cash flow is draining him dry. He is willing to discount the price *and* cut the interest rate on the contract--anything to make a quick sale. But one caution to the excited buyer: will you buy this once-in-a-century deal only to find out a year later that you've become as desperate as Stephen was when he sold?

A good deal is not necessarily always a good deal. Now, before anyone gets too busy contemplating the Zen of that statement, here is a rough translation: Flexible sellers can help us make our fortune--but, only if we buy properties that are right for us.

2.5 WHAT CAUSES SELLERS TO BE FLEXIBLE?

When people buy real estate, they are almost invariably excited about their prospects. The new property, they are convinced, is going to open the door to their financial independence. Then something happens to transform them into very unhappy sellers. It's helpful to understand what *does* happen to them so you can know how to deal with them. We can learn how to be effective problem solvers. And, at the same time, we can discover the secrets of avoiding becoming flexible sellers ourselves.

The reasons people become flexible fit into three broad categories: personal problems, property concerns, and economic concerns. Sometimes a flexible seller will have a combination of reasons.

When we seek to acquire real estate, we must keep one caution always in mind: we want to solve the flexible seller's problem, not buy the problem from him. In other words, the reason he's a flexible seller may transfer with the property. Those problems may be impossible or overwhelmingly expensive to cure and should be avoided like a plague, no matter how inviting the price or terms. Happily, many problems can be solved inexpensively or with your knowledge and creativity.

Here are the three categories of problems that motivate sellers to become flexible:

1. <u>Personal</u>: This includes problems or situations that have to do only with the seller. They will not pass on with the property. These flexible sellers are often real finds.

2. <u>Property</u>: This includes factors that are inherent to the

property. They may be curable or incurable, expensive or inexpensive. Analyze carefully before you buy to see which category applies.

3. Economic: This includes problems with the general economy, problems with the city or the state, or problems with the property's location. This category generally contains factors that are out of control. Beware! You should generally avoid this type of seller--or at least consider all the problems very carefully before you buy. You may end up "don't wanting" the property too.

These three categories break down into specific situations as follows:

WHY OWNERS WANT TO SELL

M PERSONAL

Owner's location
Time/Health
Retirement
Divorce
Management
Financial
Partnerships
Estate Sales
Ignorance/Emotion

M PROPERTY

Management
Financing
Obsolescence

M ECONOMIC

Local Economic Changes

Local Neighborhood Changes
Law Changes
Pending Changes

Now let's look at some examples in each category:

CATEGORY 1 -- PERSONAL CAUSES OF FLEXIBILITY

Owner's location. The location of the property owner can affect the management of the property. For example, Bob S. has recently been transferred to another state. Needing a place to live, he bought a home in his new state--but he still hasn't sold his first home. The result: the "double payment monster" is eating him alive. At the same time, his home is vacant and he is worried sick about vandalism. To say Bob has become a flexible seller is putting it mildly.

Time constraints or sickness. The seller may have become too busy to manage or worry about the property. Or, he may have health problems that interfere with his ability or desire to manage the property.

Retirement. The seller may have just retired. He wants to travel, or take it easy, or simply not have to worry about managing real estate any more. An older couple may also be moving to a different climate or to a smaller home.

Divorce. Ruth and her husband were very active in building a profitable real estate portfolio. But, after a bitter divorce, Ruth had only bad memories about everything her husband had touched. She quickly became a very anxious and flexible seller.

Management Approach. Some investors are frankly such poor managers that perfectly good properties become pains in the neck. Soon they become absolutely fed up with owning real estate. A lack of knowledge of management and general business principles can make a world of difference between a happy landlord and an unsuccessful landlord.

Financial A lot of things fall under this category. It may include a seller's debts, bankruptcy problems, investment capital needs, foreclosure concerns, a tax situation, or a need for status symbols (a seller may be selling his property to buy cars or jewelry or the like). (You'll note that foreclosure is also listed in the property category--but the problem often begins here, with the person.)

Partnerships. A good partnership can be heaven. A bad one can be--well, you get the idea.

When partners no longer see eye-to-eye, they often have no choice but to sell their properties. And, with emotions getting involved the way they do, partners will sometimes go to great lengths to get rid of the property fast so they can be rid of the partnership.

Ernest and Vern are two old friends who started out as partners investing in real estate. They were aggressive and energetic, but they found that they could not see eye-to-eye on management decisions. When things started to slip, each began to blame the other. They finally decided to sell the properties and dissolve the partnership before they would start to hate each other. Ernest and Vern have become truly flexible sellers.

Estate sales. When a property owner dies, he often leaves property his heirs don't want. They would rather make a quick sale and have the money. And sometimes the executor of the estate may need to liquidate assets to pay taxes.

Ignorance, neurotic fears, or emotions. Unfortunately, many sellers make emotional decisions, seeking to sell a good property because of ignorance of economic factors and market conditions. Others have a fear of doomsday or an emotional dislike for a particular property for some reason that is perfectly valid to him, but does not affect the value or desirability of the property itself.

CATEGORY 2 -- PROPERTY CAUSES OF FLEXIBILITY

Management. Management sometimes falls into the personal category, but it can also have much to do with the property itself. Because of neglect or because of the condition of the property, it may now require intensive management. The type of tenants may also affect the management; certain tenants may attract like-minded tenants while deterring the more desirable variety. It is not unheard of for a building to be only 50 percent occupied because of a single undesirable tenant.

Illustration: An attractive office building in a good part of town had two spaces leased to "problem" tenants. Both paid on time and both were legitimate. But one was a government agency frequented by lower class individuals who were a nuisance to visitors of the other offices. And the other space was occupied by a private concern that promoted controversial (though legal) family planning practices. The negative aspect of these two tenants was such that the building remained 50 percent vacant.

Property owners in this kind of situation can quickly become flexible. But problem cases like these can be quickly remedied by getting rid of bad tenants or by changing the looks or "curb appeal" of the property.

Existing Financing. The existing financing on a property can create real problems. Negative cash flows can be extremely discouraging, and they have a way of reasserting themselves every month. Balloon payments and escalating interest rates, due to variable rate loans and adjustable rate loans, can alter a seller's financing situation all too quickly, not to mention his disposition. And, in some cases, the seller secured financing that he never should have agreed to in the first place.

For example, Bruce L. bought a property two years ago that had a two-year balloon. He made no advance plans for the balloon and, due to his personal circumstances, he is unable to obtain additional financing to pay it off. Bruce has now become a definite flexible seller.

Obsolescence. All by itself, obsolescence might not be a problem. But when it begins to affect rent levels, tenant quality, or resale possibilities, it can cause the owner to become seriously flexible. Obsolescence can come in many forms. The style or structure of the property might be out of date. Think of a four- or five-bedroom home that has only one bathroom, for example. Or a four-story building without an elevator. Such obsolescence can lead to overwhelmingly expensive changes.

In some cases, the obsolescence may be imposed suddenly, as in the case of changes in zoning or fire codes. Sometimes this type of change can simply be the last straw for an already harried owner.

CATEGORY 3 - ECONOMIC CAUSES OF FLEXIBILITY

Local Economic Changes. Changes in the local economy can affect the demand for a rental unit or the marketability of a property that is for sale. A major employer in the area may have shut down or laid off a large number of workers, for example, or an entire city may be in decline.

Local Neighborhood Change. Over a period of time, certain neighborhoods become less desirable. Properties become harder to sell and good tenants harder to find. An owner who finds himself in this situation often becomes anxious to sell because management has become too intense.

Illustration: When Clyde A. bought his rental home about twenty years ago, it was a nice, respectable neighborhood. But, in the last few years, the area has become increasingly run down and now Clyde couldn't bring in good tenants if he paid them. The property is becoming more and more run down--since Clyde has lost all desire to effectively manage it--causing it to blend right into the neighborhood Clyde so despises.

Another local change has to do with the competition. The laws of supply and demand may bring deadly competition to a rental unit that previously had little challenge. Perhaps there are more rental units in the area than before--or fewer tenants. Either way the owner may become discouraged and become flexible. You, as new owner, might possibly be able to cure the problem either by upgrading the property or by lowering the rents.

Laws and Government Changes. Local laws can sometimes make a big difference in an owner's success. Perhaps a zoning change affects the neighborhood. Or maybe rent controls have been imposed, and an owner may be in a situation where he can no longer raise his rents or is restricted in how much he can raise them. Either situation can create flexibility--and the new owners could well follow in their footsteps.

Pending Changes. A seller may know of some pending changes that will adversely affect his property, and he may be trying to sell before the changes take effect. For example, he may know that a proposed highway will come near or possibly through his property. Only if you do your homework will you be able to learn the same kinds of things for certain, since the seller may not disclose them to you.

2.6 HOW CURABLE IS THE PROBLEM?

Once you've learned the reason why a seller is flexible, you must ask a hard question:

"What effect will this have on me, as a new buyer?" The reasons that are under Category 1, which are personal to the seller, will not have any effect on the new owner, but reasons under Category 2 may pass on to a new owner. They may be something you can correct--but sometimes making a correction will be too expensive, time consuming, or impractical. Finally, reasons under Category 3 are probably not curable.

You can see why it is vital to know what the seller's motivation is and if it will have any effect on you as a new owner. If it is a problem you will inherit, it is important to know, in advance, whether you can correct it, how to correct it, and how much it will cost.

Remember, some flexible sellers have very good reasons to be that way. In many cases, you may be attracted to the seller's generous terms, but after analysis, you'll learn that you wouldn't want his property even if he gave it to you.

The situation of Jason R. is a good case in point. He started looking for rental homes in the newspaper ads. One ad read:

> "NO DOWN. Assume 9%
> on $65,000 home. 3
> bedrooms, 1-3/4 baths, full
> basement. Excellent condition.
> By owner. Call 555-5555."

Jason had done his homework and he knew a good ad when he saw one. And this buy seemed to be too good to be true. During his lunch hour, he called the seller and had a little chat. Everything was as advertised. There seemed to be no hidden problems. In fact, the seller, Mr. Thomas, was so anxious that Jason got the idea he might be even more flexible than the ad had indicated.

Jason almost made an offer right then. But he decided to take a look at the property, just to be safe. That evening, Jason drove by the home. Suddenly his bubble burst and sailed away. The home was just as Mr. Thomas had said. It was in good condition, with no structural problems, a new exterior paint job, a nice yard. But the neighborhood was a pit. Jason knew that it would attract only the worst of tenants.

He breathed a sigh of relief as he drove away, happy that he had not been hasty. Now he knew why Mr. Thomas was flexible. And, he was glad he had not taken his place.

2.7 NARROW DOWN YOUR SEARCH

Only a small percentage of sellers at any given time will be truly flexible sellers. Many of those, even though they desperately want to sell, either cannot or will not sell their property with the terms or price you need. Many potential buyers waste their time and energy trying to use their creative financing techniques on sellers or properties that just don't work. Such an approach is a short road to discouragement. ("I knew that nothing down approach wouldn't work! Every seller I talk to just laughs when I try to negotiate.") At the same time, other investors are buying millions of dollars worth of real estate because they have focused on sellers that both *can* and *will* sell with good price or terms.

In a research project conducted by the *Real Estate Advisor* during the mid-1980's, over a quarter million ads in the major newspapers of America were surveyed and analyzed for a period of some four years. It was found that less than 16 percent of the ads indicated any flexibility or motivation to sell. Of these, only 2 percent indicated that the seller was highly motivated and very anxious to sell.

The chart on the following page summarizes the findings of this important research project.

It makes little sense to waste time with sellers who are less likely to sell on your terms. The great majority of sellers who will cooperate with you are those who have compelling reasons to sell. So why spend precious time with the others?

2.8 HOW TO FIND THE BARGAINS

Now that you know what flexible sellers are, how do you find them? Sellers don't just show up on your doorstep one morning and say, "Hi, I'm flexible! Let's talk terms!" You'll have to go out looking.

We have divided the sources of flexible sellers into five different categories and have tried to arrange them in an order that reflects the most valuable sources. They are ranked in descending order, with the most productive listed first. But don't be deceived by our ranking--the sources at the bottom are perfectly legitimate and can yield some great flexible sellers. We're simply trying to give you an indication of where you might want to start.

M CATEGORY 1 -- NEWSPAPER ADVERTISING
- Classified ads
- Property buying ads

M CATEGORY 2 -- REALTORS
- Realtors
- MLS book and computer
- Trade and exchange clubs

M CATEGORY 3 -- REFERRALS
- Finder's fees
- Friends and referrals
- Attorneys and accountants

M CATEGORY 4 -- PERSONAL RESEARCH
- Foreclosures
- Repossessions
- Out-of-state owners
- Drive arounds
- Legal papers
- Public notices
- Suits and liens
- Bankruptcies
- Estate sales
- Corporate relocations

M CATEGORY 5 -- OTHER ADVERTISING
- Flyers
- Business cards
- Farming

2.81 CATEGORY 1 -- NEWSPAPER ADVERTISING

To give you some idea about the relative importance of newspaper ads as a source of flexible sellers, we need only refer to the case book *How To Write A Nothing Down Offer So That Everyone Wins* by Dr. Richard J. Allen. This book, which was compiled after a review of thousands of actual transactions based on the Robert Allen methods, discloses the following important summary:

LEAD SOURCES FOR CREATIVE TRANSACTIONS

39% From Classified Ads
31% From Real Estate Agents
13% From the MLS Book
9% From Friends and Colleagues
6% From "For Sale By Owner" Signs
2% From Exchange Brokers

From this summary it is clear that the newspaper is the *single most important source* for finding flexible sellers. The classified ads of nearly every city are filled to the brim with real estate properties for sale. As indicated earlier, some 16% of these ads, on an average, are placed by owners who are at least moderately motivated to sell quickly. Around 2% of the ads are placed by owners who are, in effect, crying for help. These are the intensely motivated sellers who will most likely be willing to deal with you on flexible price and/or terms.

THE IMPORTANCE OF PERSISTENCE

Remember: only 2% of the ads come from sellers who will be truly flexible. Does that suggest the need for patience and persistence?

Here is an illustration. When Steve and Donna B. decided to start investing in real estate, they turned right to the classifieds for leads. Steve got home from work first, and before he did anything else, he scanned the ads. When Donna came home, they took turns calling the sellers who seemed like good prospects.

On the first few nights it seemed they were getting nowhere. They began to believe there was not a single flexible seller in the entire city! But the more they called, the more they were able to refine their approach. Then they realized that they had been asking the wrong questions, or at least, asking questions of the wrong people. Soon they developed more skills at reading the ads like the experts--by going after the clues of flexibility. And Steve discovered that Donna was more effective in the initial contact. Every night thereafter, Donna began making the calls while Steve made supper.

In the second week, things began to pick up. Donna found three sellers who passed her screening. After she finished talking to the third one, she hung up the phone and danced from the study into the kitchen. "I've found some! I've found some!" she shouted. "And we're going to be rich!"

That weekend they went to take a tour of the properties. One was in a horrible part of town, as they learned. They made a note to do better homework. The second house had already been sold. The third was a possibility--but they decided after a failed negotiation with the seller that he wasn't a flexible seller after all.

So they continued their search. In the third week they found more possibilities, and in the fifth week they made their first formal offer. Again, their negotiations broke down.

But they didn't give up. After six months they owned two rental homes, and by the end of the year they owned a duplex as well. All had break-even cash flows (necessary, given Steve's and Donna's financial picture), and all had been bought with little or none of their own money down.

USING BUYING ADS.

Some investors have found a short-cut to success--a lazy man's way to finding truly flexible sellers. Their approach is simple: they place their own ad in the newspaper under the section of Real Estate Wanted. It also helps to use the For Sale sections. Prospective sellers often read other people's ads before placing their own. You might get calls from owners who haven't even put their properties on the market yet.

Three different kinds of ads have been successful: "Fast Cash," "Win/Win," and "Mom & Pop." You should use the kind that works best for you.

M FAST CASH. This ad concentrates on purchasing properties at discounted prices from "wholesale" sellers. It usually says something like this:

FAST CASH. We buy real estate. Call
555-1234. Ask for Jane.

This ad can be very attractive to the seller who finds himself in a pinch. When he calls, you can explain that in exchange for your cash up front, you will need him to discount his price. Some sellers will balk (they are not truly flexible sellers); others will jump at the chance. And where do you get the cash? Find a partner, or use another method discussed in the unit dealing with creative finance techniques.

M WIN/WIN. This ad indicates that the seller will get his price, but that you, the buyer, must be able to name the terms. It goes after the "retail" seller. It reads:

FULL PRICE
I will give you full price for
your home if you will sell to
us on flexible terms. Call
John at 555-4321.

This ad appeals to many people. Large numbers of homeowners are unable to see the correlation between price and terms, and they'll ignore terms to get the full amount they think their home is worth. In essence, they are letting their emotions control their decisions--at a significant savings to you.

M MOM & POP. This ad appeals to many people because of its ring of a "down to earth, home town" type investor instead of a large, inconsiderate company that is out to get them. It reads like this:

Private investor would like to buy real estate. Good price and terms. Call Annette at 555-1111.

These ads can be placed in local papers, "nickel ads," free Real Estate Circulars, and local magazines. Creative individuals have even had success placing such ads in larger papers like the Los Angeles Times and the Wall Street Journal.

Does this approach really work? Absolutely! Some highly successful investors do nothing else. They place their ads, answer the phone, use the Nothing Down techniques to close the deals, and watch their total net worth grow and grow.

2.82 CATEGORY 2 -- REALTORS

We begin this section with an illustration. Zachary F. was a down-and-out factory worker during the latest of a series of discouraging economic downturns. After he lost his job, he found work at a gas station, but he felt there had to be a better way to survive in a tough world. One day, while visiting the library, he picked up a book on real estate. He was impressed by the possibilities, but he didn't have a lot of confidence in his ability to find the right kind of properties.

The next day, before he went to work, he visited a real estate agent whose office was near his home. He explained his situation and said he wanted to get into a rental home for little down. The agent almost laughed in his face. "I've heard of people trying to buy for nothing down," he said. "But you might as well know it doesn't work. If there's one thing I've learned in my fifteen years in this business, it's that money talks when you're dealing in real estate."

Zachary was discouraged, but he didn't quit. He visited another agent, then a third, then a fourth. On his fifth try, he hit the jackpot. The agent talked the language Zachary wanted to hear. "Nothing down?" he said. "Of course. Why spend your own money when there are so many other ways to structure deals."

He asked Zachary what his parameters for buying properties were. Zachary wasn't entirely prepared with an answer, so he went home and did some figuring. Then he went back. "I don't want to look at anything larger than a single-family home," Zachary said. "Let's see if we can find something for little or nothing down, with a reasonable interest rate. Something that doesn't cost more than $70,000."

"Sounds good," the agent replied. "Of course, you know these kinds of properties don't just grow on trees. I'll have to look for a while, and even then I might have to cultivate a deal. But we'll get something to work. Don't worry."

Several weeks later, Zachary closed on his first investment property, using money from a new partner to help with the down payment. Then he sent his agent out looking for another home. He had learned an important principle about buying real estate: the professionals can be your best friends.

Let's look at how real estate agents--and their best tool, the Multiple Listing Service--can help us in our finding efforts.

Real Estate Agents. A great number of the good properties you find will come through working with real estate agents or "Realtors," as agents who are members of the National Association of Realtors are called. But there are good and bad times to work with agents, good and bad ways to work with them, and good and bad techniques and properties to work with them on. Your success will come by knowing the difference. Here are some basic tips:

M Don't be greedy.
M Be realistic.
M Be clear about your goals and follow through.
M Work with more than one agent until you find the right one.
M Use a "Buyer's Broker Agreement."
M Use third-party negotiations to your advantage.

Don't be greedy. Agents have to eat too. Avoid performing "commissiondectomies" on them by trying to take all their money. Be fair with them and let them earn what they deserve. The win/win philosophy needs to apply here too. If your agent is doing a lot of work, pay him back by arranging the kinds of deals that will generate some cash for a commission. Asking an agent to work hard and then expecting him to take his commission on a note sounds good and may work in some instances, but not in most.

On the other hand, if you are doing most of the work in finding the properties and the agent helps only with negotiations and closing, then partial commissions and commissions paid over a period of time may become more acceptable.

Be realistic. If you waste an agent's time searching for properties that are not realistic, then pretty soon they won't give you any more of their time to waste. Know exactly what you are looking for (a little practice will help you here), and don't try to move out of the parameters that work for you.

Be clear about your goals and follow through. It is vital that you give your agent clear instructions on what you are looking for, preferably in writing. For example, you may say, "I want a single-family dwelling with three bedrooms and 1-1/2 baths, in the $55,000 to $60,000 price range. Also, the seller needs to give one or more clues that he is willing to be flexible." When your agent finds a property that fits into those parameters, be ready to act quickly to check it out. If you don't, you'll wind up with a disgruntled agent who soon refuses to work for you. You'll also wind up making no progress on your investment program.

Work with more than one agent. For a variety of reasons, agents do not always follow through on finding you properties. As a safety feature, don't rely on just one agent, but do be loyal to the ones who prove to be helpful. And if you do find an agent who can locate for you as many good properties as you can handle, then by all means work with him or her. But such agents are rare, and the odds are that you might need to work with two or three agents at once until you find the "golden" one.

Use a "Buyer's Broker Agreement." One of an agent's big concerns is that he will bring you a property and you will follow through on your own or with another agent. It is helpful for an agent to know you are working with other agents, but he needs to know that he is protected when he brings you a property. A "Buyer's Broker Agreement" (or "Purchase Agency") will accomplish that goal. In the agreement, you state that you will work with no other agent on a particular property for a set period of time. That protects the agent from competition; with his commission protected, he will work hard to help you make the deal.

One of the biggest advantages of the Buyer's Broker Agreement is that it can help the agent in his negotiations. By most state laws, a selling agent is considered a sub-agent of the listing agent. This means that he legally represents the *seller* and is bound to do the best job for the *seller* that he can. But all this changes with a Buyer's Broker Agreement. Then your agent is responsible to you, the buyer.

To avoid double commissions and the agent relationship with the seller, point out to the listing brokerage that the selling agent is taking his commission from you, the buyer. The listing brokerage should therefore agree to take only half of the normal commission--or the price of the property should be dropped accordingly. This is exactly what the listing brokerage would have received in the first place, since they would have split the commission with the selling brokerage. With a Buyer's Broker Agreement, the same amount of commission is paid to the same people as in a typical transaction, except that half comes from the seller and half comes from the buyer. No one pays more and no one receives less. Yet the selling agent is more free to negotiate in your favor, which will surely be reflected in the terms and price.

<u>Use third party negotiations to your advantage</u>. Having a third party involved in the negotiations can be an important benefit for you. It can provide a wonderful protection: if you are negotiating with the seller personally, he can put you on the spot and ask questions that you would prefer not to answer.

An agent worth his salt can usually save you more money than his commission amounts to. He can take a positive approach with the seller and follow the philosophy of "don't tell me what you *won't* do, tell me what you *will* do." A good agent will try not to leave without a counter offer if the original offer is not accepted.

One way to improve your negotiations is to have an agreement with your agent that provides an increased commission if he can get better terms and a better price than you were hoping for. That way, negotiation is to his advantage. Without such a provision, he knows that the more he discounts the property, the less commission he gets.

<u>MLS book and computer-assisted searches</u>. The Multiple Listing Service provides a cooperative exchange of listing information to subscribing Realtors. All of the properties listed through this service appear in a book that is usually published two to four times per month. Though it is confidential information, many Realtors will still tend to let you look at it. You shouldn't have much trouble getting access to a copy of a current listing book. You don't have to have a copy to keep--just ask your agent if you can look through the book in his presence.

The listing book pulls together a great deal of information about each property. It gives the location of the home, its size, its amenities, and special terms the seller may consider (if any). A picture of the property is even included.

The "remarks" section of each listing will often contain clues about the seller's motivation. You'll often find information about a seller who is in foreclosure, being transferred, "very anxious to sell," or "desperate."

Many agents will have access to the listing files through a computer. The computer can save both agent and investor a lot of time. With its "search" function, you will be able to look for particular types of property or seller conditions by simply punching a few keys on the keyboard.

For example, you can ask the computer to give you every reference to "foreclosure." Type in the request, wait a few minutes, and the computer will give you a printout of every listed property that is in foreclosure.

If you have a home or business computer, you might be able to hook into your Realtor's system. Simply make a deal with the brokerage that you will write your offers through them. The monthly connection fee is sometimes as low as $50.

Here is a sample of some of the clues that can be searched for using the MLS book or computer: *foreclosure, desperate, anxious, flexible, must sell, quick sale, transferred, vacant, trade, exchange, low down, discount, below appraisal, reduced, motivated, fast sale*.

These are just a few of the clues to look for in the "remarks" section of a property's listing. Of course, some clues have a higher priority than others. For example, the term "desperate" shows a lot more motivation than the terms "must sell." But any of these terms can put you on a direct line with a flexible seller.

The computer can also search for other helpful items such as free and clear properties or properties with low loan balances. It can even be very specific, searching for properties, for instance, that are free and clear and that say in the remarks that the seller will take a low down payment and a contract for the balance.

<u>Trade and exchange clubs</u>. Much of the concepts of creative finance originated in the field of "exchanging." All around the country, groups meet on a regular basis to exchange real estate. These agents and sellers are much more creative and flexible than the general public (and most regular agents)--and they are often aware of flexible sellers.

Most clubs do not require you to be a real estate agent before you can attend. If they do, arrange with an agent to attend with him. You can also call the *Creative Real Estate Magazine* in Leucadia, California, and subscribe to their publication, which lists all such exchange groups in the country in each monthly issue (including the names of the group leaders, plus addresses and phone numbers).

2.83 CATEGORY 3--REFERRALS

Once again, let us begin with an illustration. Shirley M. had no time to spend looking for the flexible seller, or so she thought. She was so convinced that the system would work for her, though, that she tried to make time. She analyzed her schedule and decided to get up a half-hour earlier every day. During that "extra" time she had created, she would go through the newspaper and mark ads that seemed promising; then, she could call the seller later in the day.

During the first week, Shirley got up faithfully. She read and marked the paper every morning, making notations beside the properties she felt were red-hot. But she never had time to follow through. She didn't make a single call all week.

At the beginning of the second week, she got a heavy cold. Even though she wasn't sick enough to stay home from work, she really needed all the sleep should could get.

During the third week Shirley was better, but she couldn't get her body off the mattress when the alarm rang in the morning. Yes, it was good to be financially independent--but it was also good to get enough sleep so she could function from day to day.

It was a real dilemma. She was about ready to give it all up when she realized she was going at it all wrong. She didn't have to do all the work. What if she got others to do the looking for her?

She talked to friends and asked them to be on the lookout for good possibilities for her. But even more directly, she asked a college student if he would be willing to help her. She agreed to give the college student a

percentage of the purchase price on every property she was able to buy.

The student went to work, and Shirley slept an extra half-hour every day. When the student finally began to bring possibilities to her, she had to rearrange her schedule to look at them. She was surprised that she was able to do it--a house in the hand seemed to be worth more than two in the ads.

Now Shirley's gross worth is in excess of a million dollars. And the college student has earned enough to put himself through college. (An interesting postscript: the student has become so proficient at finding good properties that he has purchased some himself. And he is thinking of investing full-time after graduation, instead of pursuing his accounting career. Shirley realizes that she soon may have to find another finder!)

Using other people's referrals can sometimes save a lot of time and effort. Here are three ways that have proven successful:

M <u>Finder's Fees</u>. Some investors, like Shirley, are kept running by a good finder. And the finder is able to maintain a moderate earning off the fees he earns.

This idea can be expanded. More than one investor has found that he can multiply his efforts by teaching others how to spot good properties. Then he turns them loose with a promise of a finder's fee on every property he closes on.

Others have been even more specific. They may, for example, teach a finder how to search out foreclosures by looking at records in the County Recorder's office. The finder does all the tedious research work, but when he finds a good buy, he gets rewarded accordingly. And so does the buyer.

If you use this technique, check to make sure paying a finder's fee in your area does not violate any laws.

M <u>Friends and Referrals</u>. Friends are an inconsistent source of help--even a best friend won't go too far out of his or her way to help you find good deals. But if you let friends know what you're looking for, they may remember if they happen across a possibility. If you put the word out, through business cards or any other method, that you are looking for flexible sellers, every once in a while you'll hear in reply, "You ought to call my neighbor. Just the other day he said he would give anything to get rid of a rental he has across town."

M Attorneys and Accountants. Attorneys sometimes know of divorced or divorcing couples who have properties to sell. They also may know of people who are having financial or legal troubles--and a number of those will be flexible property owners.

Accountants are good sources of people with financial or tax problems. They will very likely hesitate giving out names--as will attorneys. But tell them what you are looking for. They may be willing to give your name to their clients. If the client is a truly flexible seller, he will get in touch with you.

2.84 CATEGORY 4--PERSONAL RESEARCH

William Z. was having the worst year of his life. First his wife divorced him. Then he lost the job of his dreams, and the new job brings only boredom. And now he has just received a notice that the bank is foreclosing on his four-plex. If someone would only make him a halfway decent offer, he would quickly unload the property and save his credit rating.

Jenny H. was on top of the world when she bought her three homes. They were perfect rentals--the people paid on time, and when there was trouble she had to drive only a few blocks to deal with it. Then she was transferred out of state, and everything fell apart. She'd love to sell and start over again in her new city. But her homes are just sitting there, along with the thousand others for sale in her old area.

Carlos A. inherited his parents' home after his widowed mother passed away. He was busy with his work and really wasn't interested in managing a rental home. He put the house up for sale, but the market was so saturated that no one even looked at it. Meanwhile, tax time is coming up, and he is going to have to pay property taxes on a home that is vacant and that he doesn't even want.

What do these three people have in common? Yes, they are all flexible sellers. In addition, their situations are such that someone committed to financial independence could easily find out about them. All it would take is a little personal research. This section will tell you how to be successful with this excellent source of flexible sellers.

M FORECLOSURES. Foreclosures almost inevitably create flexibility. Not all foreclosures are good deals, of course. But some can practically be a steal.

There are four different times to work with foreclosure properties. Each requires a totally different procedure and strategy. Let's look at the four opportunities to work with foreclosures:

M 1. Before foreclosure begins. This can be the best point in time to work with a foreclosure property. After the costs and back payments start adding up, the property becomes harder and harder to buy. At the same time, the seller's motivation increases. Another motivator: the tone of the bank's letters sometimes scares the seller to the point where he thinks he is already in foreclosure. The seller's plight is not generally known at this point, and you will have little competition.

Real estate agents are the best source before foreclosure begins. Many times the property will be listed, and the agent knows that it is approaching foreclosure. Perhaps the best way to get the information is to have your agent put the word out to his associates in the city: "I have a client who is particularly looking for properties with pending foreclosures."

Another vital source is the newspaper. Even if the ad says nothing about foreclosure, you can get to the seller's true motivation in a hurry by asking one question: "Are the payments current?"

Another source can be the bank or financial institution that holds the mortgage. Of course, they generally won't give you the names of those who are facing foreclosure, but they may give the property owner your card or phone number.

M 2. <u>During the foreclosure process</u>. Once a foreclosure is started, it becomes a matter of public record. A short trip to the County Recorder's office can tell you which properties in your area are at this stage in the process. A letter and a phone call can let you know, without a good deal of effort, if they are willing to sell. Many owners take a while before they realize that they really need your services, so a follow-up letter and a call in two to three months would be well worth your time.

But walk softly. Once foreclosure has begun, a seller tends to feel very pressured. He will not respond very well if additional pressure comes from you. Do your best to convince the seller that you come as a friend with the creativity to help him solve his problems--not as a shark waiting for his financial boat to sink.

M 3. <u>At the foreclosure sale</u>. Even though some of the best properties are bought before the sale, a number of good properties are still available.

The key to buying properties at a foreclosure sale is to be able to get the essential information you need without spending much time. You need to be familiar with the value and condition of the property. Try to make an inspection; though in some cases, if someone is still living on the premises, you may have to be content with seeing only the outside of the property. The financial institution or individual who is fore-closing will be able to help you to see the property. In addition, it is standard practice for financial institutions to provide a "foreclosure inspection report" and an appraisal at this time.

To buy a property at the sale, you will need cash or some kind of financing. Establish short-term credit with banks or partners so that you can buy the property at the sale, then follow through with some long-term financing later.

M 4. After the sale. That hard-nosed banker you thought was impossible to deal with will sing an entirely different tune when he has to foreclose on a property. Many times bankers become very flexible and anxious when they end up with foreclosed properties. In fact, a bank could even lose its charter if it ended up owning too much real estate. Their R.E.O. (real estate owned) properties are therefore something they like to get rid of quickly. At times, they will discount the price drastically to move the property off their books. Other times, to avoid a loss, they must receive the full amount of their investment. In exchange, they will often agree to very soft terms. Low interest and no interest loans are sometimes made available; some banks will even loan extra money to fix up the property. Even when they require a down payment, they may let you call that down payment "pre-paid interest," and they may defer payments for a year or two so that you can have positive cash flow and money to fix up the property.

The major reservation banks have is that they do not want to take that same property back again. Sometimes they feel so strongly about this that they will not loan against the foreclosed property. In this case, try to find two properties--one with bank A and one with bank B. Then get bank A to loan on bank B's property, and get bank B to loan on bank A's property, all as part of a package deal. Surprisingly, this often works.

REPOSSESSIONS. Banks are not the only institutions that end up with unwanted properties after foreclosure. Others include:

FSLIC--Federal Savings and Loan Insurance Corporation

FDIC--Federal Deposit Insurance Corporation

VA--Veterans' Administration

FHA--Federal Housing Authority

FNMA--Federal National Mortgage Association

IRS Seized Property

Private Sellers

FSLIC. The Federal Savings and Loan Insurance Corporation was set up to insure deposits at savings and loan associations. At times they had to step in and help out a struggling or failing savings and loan. Over time they built up a considerable portfolio of unwanted properties that had to be sold. With the wholesale failure of many S & L's in recent times, the RTC, or Resolution Trust Corporation, was set up to dispose of properties left over in the wake of the S & L crisis.

FDIC. The Federal Deposit Insurance Corporation insures deposits at banks. As with the FSLIC, they may end up with foreclosed properties picked up from struggling or failing banks.

VA. The Veterans' Administration insures certain loans made by banks or mortgage companies. When those loans go bad, they are taken back by the bank--but the VA often gets them in the end.

The VA has local offices and people hired full-time just to advertise and market foreclosure properties. Your real estate agent can get on their mailing list (they work only through agents) and even get a "lock box key" that will open the doors to their properties.

For more information, contact the nearest regional office of the Veterans' Administration.

FHA. The Federal Housing Administration has similar procedures to the VA and will also have a local office. For more information, contact the nearest regional or area office of the U.S. Department of Housing and Urban Development.

FNMA. The Federal National Mortgage Association (nicknamed "Fannie Mae") buys loans from financial institutions like banks and mortgage companies. They foreclose on many properties around the country, then have to resell them.

IRS seized property. The IRS sometimes seizes property due to nonpayment of taxes. For more information, contact the nearest district office of the Internal Revenue Service.

Private sellers. Pay particular attention to loans that have been foreclosed on by a private party rather than a financial institution. While financial institutions are invariably bound by rules and regulations, a private party can do whatever he wants to sell you his unwanted property. He can be creative and flexible. If you catch him before the foreclosure is completed, he might even sell you the loan at a discount. You could then have the right to foreclose and profit.

Note: you can find foreclosures by private sellers by conducting research at the County Recorder's Office. Look for Notices of Default or Notices of Sale posted on public bulletin boards and advertised in the newspapers.

Now let's return to our consideration of other possibilities based on personal research.

Out-of-state owners. Out-of-state owners often have a strong desire to sell their properties. It is truly a hassle managing a property by long distance--even when you have a professional management company doing most of the work for you.

You locate out-of-state owners through the public records at the County Recorder's office or through the Tax Assessor's records. Some investors have built an enviable portfolio strictly through buying from out-of-state owners. They write a simple letter explaining their approach and asking if the owner is interested. Many won't be flexible sellers. But many will.

Drive arounds. Drive through neighborhoods that contain acceptable properties and look for "for sale" signs and "for rent" signs. Stop and speak with the owner. "I notice your home is for sale. I buy properties and wondered if I might ask you a few questions." Then determine if the owner is a flexible seller--and if you can solve each other's problems in a win/win way.

Also, look for properties that are extremely neglected. Neglected or vacant properties sometimes mean a struggling seller who is flexible. You might be able to help.

Legal Papers. Legal notices are published in special legal papers--and a legal notice sometimes means a new seller who is flexible. The legal papers list everything from divorces to lawsuits to foreclosures. Subscriptions to these papers are typically quite expensive, but you can get access to them much more cheaply if you try. See if your local library has a copy of them. Or, see if you can buy used copies from attorneys, title companies, banks, or anyone else who might have a subscription.

Once you've identified some people to contact, send letters asking if they would be interested in selling their real estate. Be careful how you word your letter, taking pains not to be blunt or abrasive. Letters such as "now that you life has crumbled into pieces, are there any chances you would like to sell?" are probably not going to get a favorable response.

Here is a better way:

> "I understand you have recently gone through some difficult changes in your life. If one result is that you now have some unwanted real estate properties, perhaps I can help. I am not a real estate agent, just a private investor trying to buy some real estate. If you are interested in

> talking about the possibilities, please call me at 555-5555. Thank you very much."

Another letter that has proven successful reads as follows:

> "We understand that because of changing circumstances in your life, you may be interested in selling your real estate. We would be more than happy to make an offer. If you are interested, please contact me at 555-5555."

<u>Public Notices</u>. Public notices are usually posted on bulletin boards around the County Recorder's office and other public buildings. When the final stage of foreclosure is approaching, for example, a "notice of sale" must be posted in a public place. This will give you the date and time of the sale.

Public notices also give information on estate sales and tax sales. Another source of public notices is your local newspaper. They are often listed toward the back of the paper, adjacent to the classified ads.

<u>Suits and liens</u>. Still another potential source of flexibility are suits and liens. A person suffering such financial reverses sometimes needs to liquidate his real estate holdings. You can find out about lawsuits and liens that have been filed through public records and legal papers. Approach them with the same kind of letter discussed earlier.

<u>Bankruptcy</u>. Bankruptcy is also a matter of public record, and many times such information includes references to properties that must be sold. In some cases, heavy discounts are available, especially when legal officials are anxious to close the case.

Information about bankruptcies is available in legal papers or at the bankruptcy court. Included in the papers will be the name of the trustee who has been appointed to handle the details of the case. A glance at the papers should tell you if the bankruptcy includes real estate. If they don't, a quick call to the trustee will get you the information.

Some creditors at this point will take extreme discounts if you buy out their position. In some cases, they are happy to get anything at all. Even though the bankruptcy has just been filed and may not have been closed, the court can release the property for sale if it deems it the proper thing to do.

Estate sales. Heirs of an estate often find themselves owners of a property they don't want--or can't afford. Sometimes the property must be sold to pay taxes and debts. Whatever their reasons for selling, heirs can be very anxious to sell quickly. They may be willing to discount the price or accept very flexible terms.

An estate can be viewed as a partnership that has been formed unwillingly. The same type of problems as exist in a bad partnership can sometimes be found among heirs. A creative offer that finds a way to divide up the proceeds might be precisely what is needed.

For example, when five heirs do not get along and would just as soon avoid future dealings with one another, a buyer might suggest a trust deed with five separate promissory notes. This will give each heir his or her own note, and all can go their own way.

Notices of estate sales appear in the papers, as well as in public notices at the County Recorder's office.

Corporate Relocations. When a large corporation relocates an employee, the company sometimes ends up marketing or even buying the home. They can become flexible amazingly fast and may not necessarily need cash.

How do you find these kinds of deals? Mass mail letters to the major employers in your state--the ones that also have offices or factories in other states. (You may need to address the corporate headquarters, which itself may be out of state.) Tell them what you are looking for. If they have nothing at the moment, ask them to keep your letter on file so they can contact you when they do acquire such a property.

2.85 CATEGORY 5--OTHER ADVERTISING

We've included this final category simply by way of information. These approaches to finding flexible sellers *do* work, but they are not nearly as effective as those listed in other categories. Perhaps you would want to use these approaches as supplements to your other, primary finding strategies.

Flyers. Some investors have had success in distributing flyers door to door and in parking lots. Door hangers can also be made and distributed very inexpensively by young kids going door to door.

The flyer need only advertise what you are looking for--flexible sellers--and how interested parties can contact you. The more graphically interesting your flyer is, the greater chance you will have that others will look at it.

Business Cards. This can be one of the cheapest ways to find good properties. A simple card with your name and the statement "I BUY REAL ESTATE," along with your phone number, might bring you some good calls.

Of course, you can't just sit back and wait for someone to ask for your card. Pass out business cards to friends, relatives, and anyone else you meet. Set a goal and pass out a certain number of cards every week. But if you want your investment program to move steadily ahead, use other finding methods at the same time.

Farming. Farming is a sales-prospecting technique whereby you concentrate your efforts in a particular area. As the term implies, it involves planting seeds and waiting for a crop to grow.

To farm, pick a particular area that you would like to buy properties in, then begin to plant. This could include knocking on doors, mailing out flyers, or hand-delivering flyers or business cards. It can even include keeping track of who owns what properties and letting them know that you would be interested in buying if they ever choose to sell.

Farming involves a lot of work and commitment. Other methods can yield more fruit in less time. But farming *does* work (after you've done your work), and some real estate experts swear by it.

2.9 EFFICIENCY FACTORS IN FINDING FLEXIBLE SELLERS.

Which sources of flexible sellers will give the best return for your expenditure of time and money? You can prepared a chart that will help you make the decision. It will help you evaluate sources by five criteria--cost, time, size of city, economic seasonality, and types of flexible seller.

Indicate on your chart by an A-B-C rating how productive a given source is for each of the criteria. An A means the source is most productive, while C is least. These ratings break down as follows:

M Cost Category:

A = Minimal cost or time only
B = Less than $100.00
C = More than $100.00

(Of course, costs vary from city to city and also from person to person. Advertising, for example, can be expensive or inexpensive, depending on where or how you advertise.)

M TIME CATEGORY:

A = High results for time spent
B = Average results for time spent
C = Low results for time spent

M SIZE OF CITY CATEGORY:

A = Good source in all cities of all sizes
B = May not be available in some smaller cities
C = Probably not available in smaller cities

M ECONOMIC SEASONALITY CATEGORY:

A = Good in all seasons
B = Some fluctuation
C = A great deal of fluctuation

M TYPES OF FLEXIBLE SELLER CATEGORY:

1. Owner's location
2. Time constraints or sickness
3. Retirement
4. Divorce
5. Management approach
6. Personal finances
7. Partnerships
8. Estate sales
9. Ignorance or emotion
10. Management-problems with property
11. Existing financing
12. Obsolescence
13. Local economic changes
14. Local neighborhood changes
15. Law changes
16. Pending changes

2.10 A NOTE ABOUT THE WIN/WIN PHILOSOPHY

Some of the foregoing information might appear contrary to the win/win philosophy. Some of the people who are flexible sellers have reached a low ebb in their lives (divorce, bankruptcy, foreclosure, etc.). Isn't it taking advantage of them to try to buy at very favorable price and terms, even for nothing down? Actually, the opposite is true. We are not encouraging you to be hungry wolves, preying upon widows and orphans.

Instead, by taking a win/win attitude, you can truly help the down-and-out flexible seller by solving his problem at a time when he is truly looking for a solution. If you are sensitive to his needs and make sure he goes away satisfied, then he has won; if at the same time you strike a deal where you win, too, then you have a win/win relationship with your seller. Being a problem-solver is a gratifying vocation--especially if you can turn a reasonable profit at the same time!

2.11 HOW WELL HAVE YOU LEARNED?

The better you've learned the information and concepts in this unit, the more you will be able to apply them. Test your learning by answering the following questions. The best way to help the information stay in your head is to reprocess it through your fingertips! If you are uncertain of a particular answer, look back through the unit. The answers to all the questions can be found in the preceding pages.

1. What is a flexible seller?
2. Why is the flexible or "don't wanter" seller so important to a good real estate investment program?
3. What are the three major categories of problems that cause flexibility among sellers?
4. Which category of flexible-seller problems is the least likely to pass on to a new buyer?
5. What should you do if you find a property with a problem that appears to be incurable?
6. What is the difference between a wholesale and a retail flexible seller?
7. How common are flexible sellers? What percentage of all sellers fit into the flexible category?
8. What are the two best sources to use in finding flexible sellers?

9. Is it a good idea to work with more than one real estate agent at one time? Why or why not?
10. What is the real estate agent's most valuable tool?
11. What can you use with an agent to make certain he represents you, instead of just the seller?
12. What are the key clues a flexible seller might include in a newspaper ad?
13. How many stages does the foreclosure process have, in terms of making a possible purchase? Which stage provides the greatest opportunity for getting a great deal?
14. Out of the many possible sources of flexible sellers, which ones should you concentrate on?
15. How is it possible to deal with a flexible seller on a win/win basis?

2.12 PUTTING IT ALL INTO PRACTICE

In going through the above information, you've learned what you need to know to find flexible sellers. But book learning will take you only so far--then you have to get out and practice to make the information truly workable for you.

How can you learn the details of finding flexible sellers without taking the risk of moving ahead before you know the entire Nothing Down approach? The answer is incredibly simple. Do the following assignments *and do nothing more*. To start with, we are not asking you to find real estate to buy. We are asking you to find real estate just for practice, just to see how the finding process works.

And what if you happen to find that once-in-a-lifetime deal while you're practicing? Don't let it slip between your fingers, ask an experienced person to help you analyze the property. If it really is a hot buy, get an experienced partner to purchase it with you as a joint-venture. Or, you might offer the property to someone else, in exchange for a finder's fee.

In the meantime, go ahead with your assignments. You need not do all the assignments we have listed, particularly if you are a more advanced investor who simply wants to polish skills and make sure you are not neglecting some good sources of flexible sellers. Select the assignments that will be most helpful to you in your circumstances. But don't skimp in your efforts. You'll be hurting only yourself.

1. <u>Get a business card</u>. Have a business card made that you can begin to pass around. If people call you, ask questions about their property. Tell them you're comparison shopping at the moment.

2. <u>Go out to eat</u>. Locate a successful investor to take to lunch and interview. Ask him what made him successful in real estate, and ask what he would do if he were just starting in your area. For the price of a lunch, you will doubtless gain valuable tips and instruction.

3. <u>Check the paper</u>. Buy a local newspaper and see if there are any buying ads. Call the ads and try to establish what type of properties those investors buy and why. Ask how successful the ads are. Be honest. If you are a beginner, tell them this. Some of those with ads will be happy to chat with you and help you out.

4. <u>Place a buyer's ad</u>. A weekend ad should cost only a few dollars, and it will give you a feel for what type of calls you will receive--and how many there will be. Remember, you are just warming up now. When people call, try to determine if they are anxious and just how flexible they will be. But don't worry about buying at this point, unless you feel ready and can't resist. (Even then, proceed with great caution--or you might end up being flexible and anxious yourself.)

5. <u>Find three good real estate agents</u>. Begin talking to agents and telling them that you are in the market to buy properties. Ask them questions to find out how they feel about the type of investing you are doing. Don't be discouraged if some of them have negative opinions. Learn from what they say, if you can, then move on to the next agent. You may have to go through twenty or thirty agents to find three or four who have the attitude and ability to find you good properties. But if you use referrals from one agent to another, you should be able

to find your ideal agent much more quickly.

6. Locate an MLS book. Find an agent who will let you familiarize yourself with your local MLS book. Spend some time with the book (perhaps with the agent present) looking for clues to flexibility.

7. Check into the MLS computer. See if agents use a computer in your area. Find an agent who knows how to use it and have him show you the "search" functions.

8. Learn where your bread and butter is. Determine which areas in your city contain the areas of "bread and butter" homes, as far as your investment purposes go. Use the MLS book (which is divided by area) to find the ten most appealing investment properties in one of those areas. Remember, your first step is to screen the listings for flexible-seller clues.

9. Find the public notices. Locate the area or areas in your city where public notices are posted. Read a couple of the notices and become familiar with them. Particularly look for a notice of sale for real estate. Mark down the date of the sale and the property address. If the address is not on the notice of sale, copy down the legal description and take it to the County Recorder's office and ask for help in finding the address. Now drive by the property and take a look at it. If possible, also take a short tour through the inside.

Next, attend the sale itself. Notice how it is conducted and how much the property sells for. Notice how many people are at the sale. (NOTE: Call the trustee the day before to see if the sale is still going to be held. Sometimes sales are postponed or canceled.)

10. List a Classified Top 10. Complete the exercise called "Match Wits With the Experts," included below. Then search through the classified section of your own paper, reviewing several columns of ads. Using what you know at this time, mark what looks like the top 10 flexible sellers.

11. Call the Top 10. Now call these ten ads and find

out more information. Are they truly flexible sellers? How flexible are they in price and/or terms? What is the property itself like? Ask searching questions. Your job is to screen the properties over the phone so that you spend further time only on the best prospects.

12. Find the legal paper. Track down and look at the legal paper that is used in your area. Your best sources will be the library or an attorney.

13. Drive around. Drive through one of the "bread and butter" areas you identified earlier. Notice what properties are for sale. Take especial note of those that appear to be vacant or neglected.

Look elsewhere as well. Take a different route to work each morning. Look as you go to the store, to the cleaners, or anywhere else you drive. Keep a notebook and pen with you to jot down numbers and addresses. You'll begin to notice the gold that has been right under your nose all the time.

14. Call five banks. Ask if they have any properties they are trying to sell. Find out how you should go about gathering information on them.

15. Assess property curability. When you locate some flexible sellers through the previous exercises, jot down why these sellers are so anxious to sell. Then analyze in each case how "curable" the problem is, should you acquire the property.

2.13 THE TEN MOST ASKED QUESTIONS ABOUT FINDING FLEXIBLE SELLERS

The following are some of the most frequently encountered questions on this subject.

1. "This talk about people becoming flexible sellers scares me. How can I avoid becoming flexible myself?"

The key is making sure you buy the right property in the first place. If you carefully analyze the price, the terms, the location, and property itself, you'll have a good idea whether or not the property will work for you. Buy only if the property passes your most stringent tests. That's a nearly fail-safe insurance policy for staying away from properties that cause flexibility.

2. "Why all this discussion on the reasons a person becomes a flexible seller? Isn't it enough simply to find out that he is one?"

No, that is not enough. Not only do we need to know whether or not a seller is flexible, but we also must know *why*. If we don't get down to the bottom of the matter and find out why, we might inherit a terrible problem without even knowing it. Only those who do their homework are able to avoid making the kinds of mistakes that drive people out of business.

3. "Are all flexible sellers good prospects for the investor?"

Not necessarily, though you'll know only after you ask them the hard questions. A seller might want in the worst way to get rid of his property, but his situation won't allow him to give you the terms you must have. Or, the seller and terms stack up fine, but you find on analysis that the property itself (or location, or underlying financing) makes the problem incurable.

4. "You indicated that the first two categories of sources of flexible sellers--classified ads and real estate agents--are far and away the best. Why should I even bother with the others?"

Those first two sources are indeed the best, partially because that is where the bulk of real estate is made available. And many investors focus only on those two areas and have more to do than they have time for. You may wish to do the same.

But in doing so, realize that other great opportunities are still waiting to be explored. One investor gets every one of his new properties through finder's fees. (The finder goes to the other sources we've listed, especially real estate agents and classifieds--but the investor doesn't. He deals only with his finder.) Others specialize in foreclosures (where almost everyone is a flexible seller), estate sales, or farming.

What should you do? At the beginning, it might be wise for you to experiment. Try a variety of approaches, working with different sources. After you're familiar with a number of the best sources, you'll have the background you need to pick the ones that work best for you and your area.

5. "Do I need to become a real estate agent to find good properties?"

Not at all. The education that you would receive in getting your license might be beneficial, but you can take the course without getting the license. While being a real estate agent gives you first crack at some good deals, that doesn't outweigh one major disadvantage--as a real estate agent, you are obligated by law to represent the seller of the property. Of course, that absolutely weakens your position as buyer.

6. "Don't real estate agents buy all of the good properties themselves?"

Surprisingly, no. Many agents don't recognize a truly good deal, even when they sign the seller up. Others are not sold on the idea of investing for themselves. Besides, most good deals are created out of the needs of both buyer and seller. It takes the specialized knowledge you are now gaining to be able to put the best deals together. Most of what you are learning is not a part of the typical education of real estate agents.

7. "The sellers I have talked to don't seem to be very motivated. What am I doing wrong?"

Most likely you are dealing with the wrong sellers. How many sellers did you screen before you found this one? Are you emotionally involved with the seller or property? Are you trying to use creative financing to make a good deal out of one that's really mediocre? Does the seller fit the description of flexibility given earlier?

If a seller is unwilling to be creative no matter what you suggest, he probably isn't truly a flexible seller. Stop wasting your time with him and keep looking for someone who is willing to talk terms.

8. "Sellers and Realtors don't answer some of the questions I ask. How do I find out what I need to know?"

Sellers and their agents are typically hesitant to give you information you need to know. Try asking the questions in a different way. Be persistent, but still pleasant. If you still don't get answers, you may decide you are not dealing with a flexible seller. Move on to someone else, polishing your skill as you go.

9. "I don't have much time to look for properties. How can I get going on buying real estate for nothing down?"

The key here is to teach others how to find flexible sellers for you. Perhaps a spouse or teenage son or daughter could help. Perhaps you will need to hire someone and pay him or her a finder's fee for properties you buy. And by all means, get a real estate agent looking for you. Commissions and finder's fees can be well worth the cost.

10. "When I find a flexible seller, how do I know a good deal from a bad deal?"

Good question! Unfortunately, analyzing properties (and deals) is beyond the scope of this unit. But don't despair. Subsequent units will tell you everything you need to know.

UNIT THREE

ANALYSIS MADE EASY

UNIT THREE

ANALYSIS MADE EASY

3.1 GENERAL CONSIDERATIONS

Once you have found a property that appears to fall within your range of interest, your next task is to objectify the decision-making process as much as possible. "Do I really want this property?" is a question best taken out of the realm of emotions and coin-tossing and placed within the realm of hard facts and cautious analysis.

This is not a time for guesswork. You must *know* whether this property deserves serious consideration. Such assurance requires that you quickly master a complex web of interconnecting factors in order to come up with a wise and reasoned decision. This process of "street wise" elimination can be daunting to the inexperienced; however, it does not *have* to be so, if one focuses on certain "governing" focal points that get to the heart of the matter.

What are the "governing" focal points of your decision? See if you can pick out the most important ones from this potential list:

- Age of structure
- Location
- Architectural style
- Condition
- Number of bedrooms
- Price
- Flexibility of seller
- Zoning
- Listed or owner sale
- Population of community
- How long it has been for sale
- Time of year
- Property tax assessment
- Financing required

3.2 THE GOVERNING FOCAL POINTS

All of the factors listed above (and many others we could have listed) are important and may have a bearing on your decision.

However, only *five* are truly governing focal points that will render your decision easier and more objective. They are:

- location
- condition
- price
- flexibility
- financing required

If you can quickly zero in on these five factors and make a decision about each of them, then you can put together a fairly objective profile of the target property in the form of an aggregate *score*.

Consider the logic of this approach. If the owner is not flexible with terms or price or both, then you may not be able to swing your deal--no matter what other positive factors come to light. On the other hand, if the owner is ultimately flexible but you are going to wind up with a dog in a decaying area, then you need to stop in your tracks. Similarly, if everything seems to fall into place but you then learn that a very large down payment is required for the financing, then the stock of the property goes down (unless you have a very wealthy partner in your back pocket).

These governing factors then form an interlocking grid of decision points that you can pull together into a final score for a given property. What if you had a decision matrix ready at hand for each property you were considering? And what if the scoring process were relatively simple and fast? Would this not give you the ability to compare scores for various properties you are interested in and thus reach a more objective determination?

3.3 THE PROPERTY SELECTION GRID

The Property Selection Grid included in your "Power Forms" Looseleaf is a powerful way to keep score during your analysis phase. We have assigned a potential of three points for each of the five governing focal points. Thus a perfect score will be fifteen.

Experience has shown that properties scoring nine or less should very likely be *passed over*, while properties scoring 12 or higher should be *seriously looked at* and scrutinized with a more positive eye. Those scoring near perfect will deserve your closest attention.

How does the scoring work? We have summarized the most important points in the grid shown on an adjacent page. Study carefully the logic behind the scoring and become familiar with the main contours of this decision grid. With a little practice, you can begin to make decisions very rapidly--even in your head while you are on the phone or out in the trenches.

Imagine the power you have while facing a prospective seller if you can instantly "size things up" and arrive at a decision with lightning speed. If the score turns out to be marginal but still of interest, there is nothing like "walking away" to stir up the juices of compromise in a seller, especially sellers who need to be taught lessons in flexibility. On the other hand, the decision grid may well protect you from hours of useless negotiating if you can tell from the outset that the prospects are just not worth haggling over.

3.4 FOUR TEST CASES

Below are four fictitious test cases that will help you to get used to the Property Selection Grid. There is enough information given in each of the test cases for you to arrive at a score for each. Your assignment is to score each case and thus identify the most desirable property from this batch. Take a few minutes and complete this exercise before you go on with this unit.

Test Case One

You find a fairly decent house where cosmetic improvements of perhaps $1,000 would help raise the value by perhaps 15%. The owner is retired and does not seem pressed for cash on the balance provided you put 15% or more down. However, the price seems to be around 10% higher than the market place. All amenities are within a comfortable distance from the pleasant suburban neighborhood where the house is located.
Score: ___________

Test Case Two

The owner of this clean-as-a-whistle 3-bedroom rental is moving to a different city and thus is flexible. His price is around

10% below the market for a fast sale. The neighborhood is a working-class area that is okay but somewhat older. The owner wants you to refinance the loan, but he is still willing to carry back a part of the equity.
Score: __________

Test Case Three

The owner of this single-family rental property is getting a divorce and needs to liquidate. There is quite a bit of structural work to do before this one can be rented out. The owner needs cash because of his situation--at least 20% down. However, the price is heavily discounted--perhaps 30% below the market place. The neighborhood is very appealing, with easy access to all amenities.
Score: __________

Test Case Four

Here is a newly renovated rental home that needs no work before renting. Because of a tax problem, the seller is willing to carry all but 5% of the price, which is around 15% below the market place. However, the neighborhood is rather dowdy, a factor somewhat offset by fairly good proximity to schools, churches, and shopping malls.
Score: __________

Well, what is your decision? Which property receives the highest score according the decision grid? Does any property receive a score in the "greater fool" range where you had best back away?

3.5 THE BARGAIN FINDER FORM

To keep you organized and on task, you can keep notes on a sheet called the "Bargain Finder." Each time a property attracts your attention, you reach for the Bargain Finder and follow its logical flow as you collect data and interview the seller or agent. A conversational yet professional tone is best. Fill in the form as you go.

3.6 BARGAIN FINDER CHECKLIST

Here is a checklist of important issues and factors to consider as you fill out each Bargain Finder Form.

Q *Owner or Agent*? Be clear who it is you are speaking with. Your negotiation strategy will vary according to this information.

Q *Address*. Include also the name of the development, subdevelopment, or neighborhood in order to understand the context of the property and aid in gathering more detailed information about number of homes, different models, etc., through title companies or agents.

Q *Square Footage*. The owner will probably have at least the approximate square footage, which can be confirmed through a title company, real estate agency, Multiple Listing Service, etc. Include the square footage of the basement, garage, or other structures as *separate* numbers. The square footage information will help in your comparative shopping, especially if you are using cost per square foot as a benchmark for comparative analysis.

Q *Age*. The age of the property will assist you in looking for the important things. For example, if the structure is more than five years old, you will want to check water heaters, plumbing fixtures, roof, etc. The age can be confirmed through a title company, real estate agency, documents at the county recorder's office, etc.

Q *Bedrooms and Baths*. The most popular "bread and butter" homes will have three bedrooms and two baths. Hence it is important to concentrate on such homes. If a home has only one bath, you may want to consider adding a second bath to increase its value. In that case, you should make sure the property is at least 10% to 20% below the market *after* you factor in the cost of adding the bath. If the property scores a 12 or higher using the Decision Grid, you might consider property-improvement financing, such as FHA Title One Loans and FHA 203K loans. A local mortgage broker in your area can provide more details. Check the current FHA regulations.

Q *Garage or Carport*. One or the other will add considerable value to the property. If there is neither, then indicate whether there is room to add one or the other. Be wary in situations where a garage or carport have been converted to another room (family room or bedroom) as this may in fact *detract* from the value of the property. Also, if you have are interested in a property that has been converted in this way, be sure to obtain copies of all plans and building permits that were used for the conversion. Many lenders will require a copy of them when a borrower is seeking new financing. That could be at the time of purchase or when you sell the property in the future. Be cautious about buying properties with "bootlegged" additions of any kind.

Q *Brick or Frame.* Brick homes may be more valuable in some areas but less valuable in earthquake zones.

Q *Other Features*. Make note of positive features such as: pool, spa, tennis court, built-in sauna, 3-car garage, panoramic view, etc. Negative features might include: master bedroom overlooking busy intersection, property below flight corridor, foul odors near by, etc. All such factors affect the property value.

Q *Asking Price*. When the seller gives you the asking price, respond politely with something like: "With so many different opinions of value in the market place today, how did you arrive at the asking price?" Then be quiet and listen. Don't haggle over price yet; you are just testing the seller's motivation at this time to see how flexible he/she might be. The seller may be using wishful thinking or setting up a comparable price based on what he/she thinks neighboring properties might be worth. Your job will be to determine the true market value, especially using the Comparable Sold Property section of the Bargain Finder.

Q *Why Are You Selling?* This question gets to the heart of the seller's motivation. If there is a compelling reason to sell (moving, divorce, money problems, weary of management, etc.), the motivation will be high and the flexibility will probably increase. You should approach this question from several different angles in order to get to the truth of the matter. Often the seller will need to be asked this question (or variations) several times before you get to the bottom of things.

Q *What if the Property Doesn't Sell?* This is another way of getting at the seller's motivation. Perhaps his contingencies don't include alternative financing techniques such as a contract of sale, seller carry back, or a lease with an option. Perhaps these techniques would solve the seller's problem.

Q *How Long On the Market?* This fact is often a clue to flexibility. If the property has been on the market a long while (6 months or more), the seller may be more amenable to creative solutions. If the property has just come on the market, the seller may be more patient and less flexible. However, if the property has good potential, you may wish to return to it in 30 or 60 days to see if the flexibility has increased.

Q *Any Offers?* Once again, this question will likely generate more clues about the seller's flexibility and tolerance. If you ask why offers have not been accepted, the seller may divulge his price range or other important points that will be useful to you in negotiating.

Q *How Soon Do You Need To Sell?* If the seller needs to sell quickly, then you have a clue about flexibility. Fast sales may require financing techniques such as: contract for sale, lease option, seller carry back, etc. If the seller is not under pressure to sell, then you may need to adjust your approach accordingly, provided the property scores high in the Decision Grid.

Q *Lowest Price?*. This question is about as close as you can come to getting at the truth about the seller's price tolerance. Another way of asking the question would be: "If I gave you all cash today, what would your lowest price be today?" Street-wise sellers will probably hedge with this kind of question, since it is an old adage that the one who divulges the hidden price will lose. Nevertheless, some sellers will come right out and tell you what the bottom line is. It always pays to ask.

Q *How Much Of Your Equity In Cash?* Here is yet another way of getting at the seller's flexibility. This question is a "high touch" question because it shows that you are sensitive to the seller's needs.

Q *Comparable Sold Property.* There is a place on the Bargain Finder form for you to accumulate information about what similar properties have sold for. This information is relatively easy for a real estate agent to obtain. You can also work through a title company or consult county tax records. In some areas of the country, you can also subscribe to data base services where this kind of information can be obtained. A real estate broker can point you in the right direction. Keep in mind that sold "comps" provide a powerful way for you to establish value for the properties you wish to buy. It is your responsibility to gather this data.

Q *Do You Own the Property Free and Clear?* If the seller says "yes," you have a gold mine before you, since flexibility generally increases in proportion to the equity size. If the seller responds that he/she has a mortgage on the property, then you need to get the pertinent facts by asking questions like:

* "What is the remaining balance on the loan?"

* "Is the loan assumable?"

* "Is there a balloon payment coming due?" "When?"

* "Is the note fully amortizing?" "Over what period of time?"

* "What is the interest rate charged on the loan?"

* "Who is the note holder?"

* "What is the monthly payment on this loan?"

All of these questions will help you understand the seller's motivation and help you to prepare financing solutions. For example, if the loan is assumable, you may need to qualify for it (although the assumptions fees may be cheaper than the fees to originate a new loan). If the loan documents state that the loan is not assumable, it may still pay to negotiate with the lender, especially if the current interest rates are lower than the loan interest rate. Also, if there is a balloon payment due soon, you may have a powerful clue to the seller's flexibility.

Q *Secondary Financing*. If the seller has borrowed against the property using a second mortgage (trust deed) or even a third or subsequent loans, you will need to gather these facts as well in order to determine equity.

Q *Equity*. Below the offering price on the right-hand side of the Bargain Finder write in the total of all the loans against the property. By subtracting, you can determine what the seller's equity is. Your whole agenda is to find a way to give the seller his/her equity in a form acceptable to both parties. Often you can trade property (boats, cars), assume indebtedness of equal value, or even exchange other equity in compensation. It does not always require money to make things work.

Q *Proposed Financing*. Having determined the value, offering price, and equity, you are in a position to begin to put together a financing plan. The unit on creative financing will assist you to formulate a workable plan. It is essential to be clear from the outside what end goal you have in mind (controlling temporarily, buying an keeping, or buying and turning).

Q *End Games*. At the bottom of the Bargain Finder is a place for you to establish a preliminary goal for this property (quick cash or long-term wealth building):

> "Assigning contract" -- You tie up the property with an earnest money form (contract to purchase) and then assign the contract to someone else for consideration.
>
> "Sell for cash" -- You buy the property and then quickly turn it for a profit, with or without improvements.

"Sell for paper" -- You buy the property and then quickly turn it on a contract for payments.

"Property Management" -- You buy the property and manage it for profits.

"Partnership" -- You buy the property with the help of partners, manage it, and split the profits. Sometimes the partner is a tenant ("equity participation").

"Trade" -- You buy the property and then trade it for another property that gives you higher advantages.

Q *Rent Amount*. If the seller does not live in the property, record what the current rent arrangement is.

Q *Cash Flow*. Below the rent amount, record the total of all monthly mortgage payments. If the taxes and insurance payments are not included, then write these down on the respective lines. Write also any additional costs (monthly figure to cover ongoing repairs, maintenance, homeowners association fees, property management expenses, etc.). Estimate high. Subtract all the expenses from the rental amount to determine the cash flow for the property (negative or positive).

3.7 QUESTIONS FOR THE SELLER

The next unit is designed to help you strengthen your information-gathering and negotiating skills. Included there is a chart of additional questions to ask the seller, including the "hidden agenda" reasons you are really asking these key questions. As in all business transactions, the "high touch" dimension is important to master.

3.8 ASSIGNMENTS

1. Process a Bargain Finder Form for at least six different properties. Be thorough and complete. Get the feel for the decision-making parameters of this kind of property analysis.

2. Do any of the six test properties hold out potential as profitable and desirable ventures? Do any of them qualify to be taken to the next step of negotiating and making written offers?

In our research over the years, we have found that it takes, on an average, around *ten offers* to wind up with a truly creative and profitable deal. This being the case, how many Bargain Finder Forms do you think you would have to process in order to identify ten properties that qualify to receive written offers? The answer depends, of course, on your own skill at weeding out the less-than-desirable candidates and assembling a target sampling from which to choose the most highly qualified properties.

However, it is not unreasonable to suppose that you would need to analyze *two or three* properties before finding *one* that you felt was worthy of carrying to the next level of negotiating and offer-making. This being the case, your ten offers would follow the analysis of up to thirty different properties that seemed interesting to you. In other words, this (like all business ventures) is really a *numbers game*--but one with carefully worked out rules and screening parameters.

3. Work on your "mind set." Most beginning real estate investors fail to grasp the fact that this kind of business depends on numbers. To wind up with a great investment deal, you will likely have to make at least ten offers (on a variety of properties)--and sometimes multiple offers in sequence on a given property. Therefore, you will have to process several dozen Bargain Finder Forms in order to penetrate to the ten best properties to make offers on. And, regressing even further, to locate those several dozen Bargain Finder type properties, you will need to consider many dozens more as part of your investigation.

Knowing this ahead of time will spare you the trauma of a long sequence of *inevitable* reversals and rejections as you move along the pathway to that one acceptable deal. Each "no" is just another milestone along the way to that "yes" you are looking for.

4. Further Assignment. Let's assume that you could make $250 dollars per month free and clear for every unit of residential real estate (single family home) you purchased and put into service over time. Ignoring appreciation and profit-taking at the point of sale in the future, how many such units of real estate would you need in order to reach your monthly income goal? Write this answer down in the following chart and then calculate the rest of the "numbers" that apply to your particular goal:

M Number of units needed to reach goal:__________________

M Number of offers I need to make in order to acquire this many units (assume that each offer you make is accepted, and that you will need to make ten offers for each unit acquired):___

M Number of Bargain Finder Forms I need to fill out to find this many properties to make offers on (assume you will need to fill out at least three Bargain Finder Forms for each offer you wind up making):_____________________________________

M Number of properties I will need to screen (in classifieds, through real estate agents, through for sale signs, etc.) in order to find enough to analyze in order to meet my goal (assume that you will have to consider at least three properties before finding one that will qualify to do a Bargain Finder Form on):_________

Note: you may have a heart attack when you finish this exercise and find that you will need to screen and consider perhaps *hundreds* of properties in order to wind up with one or two great deals. Do not lose heart! This is a numbers game. Sometimes you will luck into a tremendous deal right off the bat. But in most cases, it takes a considerable amount of screening and analyzing before you can make a purchase. That is the way it should be, since you are a professional who will be going "by the numbers."

With experience, the screening process can go very quickly, and as you internalize the patterns of decision making covered in this unit, you will begin to develop an intuitive sixth sense about the properties you are considering. In the meantime, move carefully and cautiously in order to minimize risk and maximize control over the consequences of your decisions. Best of success!

UNIT FOUR

NEGOTIATING A WIN/WIN DEAL

THE "HIGH TOUCH" OF REAL ESTATE

UNIT FOUR

NEGOTIATING A WIN/WIN DEAL

THE "HIGH TOUCH" OF REAL ESTATE

4.1 GENERAL CONSIDERATIONS

Negotiating to win involves two distinct skills: negotiating and winning. In this unit, you will learn both how to negotiate and how to win.

The acquisition and exchange of real property offers one of the best opportunities for productive negotiation available in our free enterprise system. That opportunity is due in large part to the fact that the value of real estate is uniquely market-determined. What does that mean? To a significant degree, the value of real estate depends on how valuable someone thinks it is--and your ability to negotiate an outstanding deal depends on your ability to influence a seller's thinking. We call it negotiation.

This unit will help you develop the skills that will enable you to build a professional residential and commercial real estate portfolio. It will show:

M What to buy, and why
M How to mesh the seller's true needs with your own carefully established goals
M How to satisfy both buyer and seller at the same time
M How to close without pressure
M How to perfect timing, tone, and preparation

And you won't stop at learning the mechanics of these skills--you'll also learn how to effectively apply them.

You will learn that the negotiating process is not only the most potentially important of the steps in a successful real estate transaction, but that it is the most educational. As your knowledge grows, so will your confidence in your ability to favorably negotiate price, rates, payments, and dates. You will become skilled at questioning, clarifying, isolating needs, and illustrating solutions. You will learn how to eliminate foot-dragging in your negotiating counterpart by inviting him or her to join you in the winner's circle.

This unit will help hone your negotiating vision so that you can identify the opportunities others usually overlook, and it will provide you with the tools you need to become a success at buying prime real estate!

4.2 A FEW TERMS YOU SHOULD KNOW

<u>Blanket mortgage:</u> A legal instrument providing as security not only the property being purchased, but other properties owned by the buyer as well. It can be included in negotiations to persuade a seller who balks at your offer of little or no money down.

<u>Deferred maintenance:</u> Required maintenance that has not been done that you will have to finance after you have acquired the property. Deferred maintenance is a bad situation except when thoroughly researched, and it is used to generate price/terms concessions at least equal to the projected cost of the deferred

maintenance.

<u>Down payment:</u> The initial payment on a property. The down payment is one of the prime negotiating variables, and it can vary markedly in amount, makeup, and time of delivery. it does not have to be in cash. Some sellers need cash to buy another property, but some use it merely to hold the buyer to the transaction--and some don't need it at all.

<u>Escrow:</u> A disinterested third party who prepares and holds appropriate documents and who facilitates the purchase, sale, and exchange of real property. Title research and insurance are often included. The escrow is usually a title company, an attorney, the arm of a financial institution, or some other company established for the purpose and expert in document preparation. The escrow's neutral posture guarantees that all the i's still be dotted and all the t's will be crossed. It's a good idea to employ an escrow agent, even when purchasing property from your brother-in-law.

<u>Flexible seller:</u> A real estate owner who strongly wants to sell his property. The reasons for his desperation vary, and are key factors to successful negotiation. Common reasons are insufficient cash flow, too much time involved in management, and the need to move out of state.

<u>Homework:</u> An activity that must precede any successful real estate transaction. Why? Because most "impulse" acquisitions aren't very successful. Homework helps you avoid disaster because it establishes a link between your investment of time and the probability of profit.

<u>Interview:</u> The fact-finding you conduct during negotiation, just like a newspaper reporter interviews before he writes a story. Your offer will depend on the facts you learn during the interview. Always use a previously determined, well-thought-out list of questions.

<u>Negotiation:</u> A process of discussion with unknown end results. Negotiation implies give and take, the offering and/or acceptance of alternatives, and mutual flexibility. Negotiation is almost always involved in real estate transactions.

Offer: The buyer's suggested price and terms. An offer should always be in writing. Under the contract laws in most states, the offer becomes a contract if signed by both the buyer and the seller. If the seller changes a single word, he makes a "counteroffer" that essentially lets the buyer off the hook. Many verbal offers that are refused would probably be much more seriously considered if they were presented in writing with an earnest money check attached.

Win/win: A negotiating philosophy that allows all parties to secure their original or revised objectives and to complete a transaction that they feel has successfully served their own best interests. It implies different interests on the part of each participant. Win/win is especially successful when negotiations are approached as a set of mutual problems to be mutually resolved.

4.3 KEY POINTS ABOUT NEGOTIATION

As you read this unit, keep the following points in mind:

M Patience is more than a virtue. It is the key to thoroughness, opportunity, and financial reward.

M If you don't like someone, it may be difficult to willingly grant him advantage during negotiations, and he will feel the same way about you. Follow the Golden Rule in your transactions, and the "gold" will begin to follow you.

M Self-interest is selfish interest. Your seller's problems are obstacles in the path toward your goals. Listen. Learn. Help your seller solve his problems, and you'll reach your goals.

M Negotiating is like riding a bicycle: you seldom fall off after you learn the technique, you get a little bit better every time out, and you never forget how.

M A negotiation is a process, not a product. It takes place over time, and begins with your first interest in the property. Take your time. Deadlines can lead to redlines.

M If the seller doesn't want to sell the property at least as badly as you want to buy it, you'll both lose. You will pick up on an extraordinary value only if you are dealing with a truly flexible seller. If your seller isn't flexible, look over his shoulder. There's one just down the road.

M Don't assume anything. Seller motivations can be incredible: high rises have sold for $1 down.

M If you feel your emotions rising, let your interest fall. An ugly black box that produces a cash flow is worth much more than a breathtaking rental that doesn't.

M If you have questions about any of this material, High Touch is only a phone call away.

4.4 HOW TO NEGOTIATE TO WIN

You've honed in on an investment property, and you think you're ready to start negotiating. But hold on to your checkbook. Before you begin any negotiations, you must objectively review the investment requirements you've already established. And you need to emphasize the word objective.

Remember: successful real estate investing is done on a numbers basis. While certain intangibles--such as the pride of ownership--contribute to the overall desirability of real estate as an investment vehicle, the property you're considering must always be viewed simply as a mechanism for obtaining wealth. The real, and realistically projectable, numbers must remain your primary motivation for buying. "Visual appeal" or uptown location aren't important unless those factors have a direct impact on the numbers.

Your desire to purchase, in other words, must be as objective as the figures that originally generated it. One way to guarantee your objectivity is to have more than one property at the negotiating stage simultaneously, each an equally acceptable addition to your real estate portfolio. If you find yourself particularly attracted to a property, your prospects for a win/win negotiation might be dim. Why? Just as successful negotiation requires flexibility on the seller's side, it also requires a realistic "don't carer" on the buyer's side.

The fact that you are entering the negotiations will signal to the seller that you obviously have an interest in his property, buy you must be willing to break off the discussion immediately if the numbers do not meet your previously (and calmly) established goals. If you carry that kind of an attitude to the negotiations, the seller will notice, will quickly lose interest in playing games with you, and will start negotiating on a straightforward, nonemotional basis.

Before starting the actual negotiating discussions, review your motivation for beginning the search, your investment goals, and the specifics of the opportunity under consideration. Does the property fit? Are the figures realistic? Are they verifiable? Is the seller <u>really</u> flexible?

Be careful and realistic. Don't hesitate to discover negative answers to any of these questions, and respond accordingly. Other properties are available! The considerable effort you've invested so far on this property is decidedly not a waste of time if you decide to reject it for any sound reason. The real estate investment market is literally humming with "average" transactions that provide average (which can mean negative) returns. You must avoid that market. By focusing on research, preparation, attitude, and negotiating skills, you will bypass the average in favor of the truly extraordinary opportunities, and you will be prepared to deal with them when you find them.

While the process requires a more highly developed sense of patience than that found in the typical impulse or emotional buyer, you'll find that patience pays off!

When Andrew S. was negotiating with the seller of a single-family home, he found that the house had an existing appraisal of over $65,000. He learned further that the seller was willing to accept a price of only $54,000 if Andrew could relieve him of personal debt obligations of more than $15,000.

How did Andrew know what the seller would accept? Did he have a crystal ball? Of course not! He learned the seller's conditions by following successful negotiation. Let's review those rules and see how effectively they can ensure your success.

THE ONE CLUE YOU CANNOT OVERLOOK

The most critical factor to look for in analyzing the seller and his situation is *flexibility*. If the seller is a flexible don't wanter to begin with, the buyer's task is 90 percent completed. The rest is a matter of win/win problem solving.

In general, there are two broad phases of interaction between the buyer and the seller. The first is the initial "sounding out" contact. The second is the more detailed negotiation related to the formal offer to purchase. During the first, it is absolutely essential that you determine the degree to which the seller will be flexible. Even if you are coming in with cash from partners, you will need to understand the general degree to which the seller is willing to discount. Without the foundation of flexibility established, there really is no reason to proceed to the next phase of detailed negotiation.

4.5 THREE MAJOR OBJECTIVES OF THE INITIAL CONTACT

1. The first objective, then, is to assemble and interpret clues that will indicate flexibility of the seller (a direct function of how much a don't wanter he is).

2. The second objective is to gather significant information about the property and how it might eventually be financed.

3. The third objective is to build up trust with the seller so that he will have confidence in you.

SETTING THE STAGE

Since the buyer-seller interaction is the most important scene in the investment "drama," it is critical that the buyer be clear about his or her role.

The attitudes, assumptions, and objectives of the buer vis-a-vis the seller--i.e., his role--need to be clear prior to the interview.

Naturally each buyer will proceed from a slightly different frame of reference; however, the following five points will begin to outline a pattern that has proven very successful over the years.

1. People First. Your primary objective, of course, is to obtain solid investment properties with little or no money down from your own pocket. However, all interests are best served if yhou remember to approach the seller as a person, rather than as a means to an end. Cultivate a genuine interst in the people you contact; they are, after all, fascinating to interact with. Each seller has his or her own needs, problems, talents, goals, interests, philosophy of life. Not all will be willing to give the price or terms you need. But in nearly all cases, they can be enjoyable klto meet and talk with if appraoched in a spirit of friendship and genuine interest. This makes the work rewarding and fun.

2. Play the Role of Problem Sover. The don't wanter seller always has a problem that can be solved or alleviated through disposing of the property. Problems create willingness on the part of the seller to be flexible in price or terms (or both). In such cases the buyer can enter the scene as a problem sovler. This role is neither self-deception on the buyer's part nor a case of the exploiting wolf in sheep's clothing. In fact, if the deal is structured correctly, the buyer does solve a problem for the seller with the result that all parties win.

To look at it in a somewhat humorous light, the buyer is like a physician who "examines" the patient (seller) for tell-taler clues and symptoms of "don't wanter-itis" and then prescribes certain remedies. Naturally, the poers and resources of the physician are not without limits. He might, therefore, take the followng approach (to carry the comparison a little further):

> "I see that you have certain challenges and needs that must be satisfied. I can help you to the extent of my resources. And I want to help if I can. If it turns out that my resources are not adequate, I sincerely hope things will work out for you soon."

If the seller is not receptive to your "remedies," then you know that he is not a don't wanter. Don't waste your time with him. Keep on looking for someone you can help.

This problenm-solving attitude, if genuine and pervasive throughout the interchange, will infuse your interactions with a sense of humanity and higher purpose. Real estate, after all, is not an end in itself but a means of leading to the solution of people problems. Of course, the attitude of problem solver is largely an innter affair on the part of the bueyur and should not manifest itself in any but the most subtle ways. The p[oint is, you are dealing with a particular group of seller (the don't wanters), and you will find your work more rewarding if you can cultivate a genuine interest in them as people whom you can help while you are helping yourself.

3. Be Penetrating But Polite. In your questioning, you must be thorough. However, thoroughness can be accompanied by good taste, politeness, discretion, and sesitivity to the don't wanter's circumstances. The recent widow or divorcee, for example, should be handled differently from an out-of-the-area seller who simply wants to get rid of a property he does not have time to manage.

4. Pace Your Delivery. Generally speaking, you will want to pace your initial interview with the seller so that it is fairly leisurely and low-key. This will put the seller more at ease and give you the opportunity to build trust. In fact, act somewhat like a "don't wanter buyer." Toss in a line like: "You really should keep t his property." It will surprise you how the seller will open up.

5. Be Persistent. The final element of the buyer's attitude is acceptance of the fact that he will be playing a numbers game. Of 100 sellers you contact, perhaps only a few will be the type of don't wanter you will readily want to deal with. However, it may take only two or three good don't wanters a year to enable you to reach financial independence over time. Stick with it!

SUMMARY: THE FIVE P'S OF INTERACTION

The major points for setting the stage can be summarized as follows:

1. People First
2. Problem Solving
3. Penetrating But Polite
4. Paced Slowly

5. Persistence.

4.6 WHAT QUESTIONS SHOULD I ASK?

The preceding section outlined the tone and underlying philosophy of how to approach the seller in the initial contact. We have included a list of questions to guide you in negotiating and gathering information. The list on the adjacent page includes the basic questions that might be asked, together with the "hidden agenda" reasons for asking these questions. You might want to record these questions on small note cards for quick reference and note taking during the interview.

4.7 FOURTEEN RULES FOR SUCCESSFUL NEGOTIATION

This section contains general information on real estate negotiating that will help you to have more success with the follow-up of your interaction with prospective sellers. You will find many of the questions in the summary chart above will come up as you go through these fourteen rules.

RULE 1: NEGOTIATE IN PERSON

Buildings may be boards and bricks; but real estate is a people business. As obvious as it may seem, the first rule for successful negotiation is that you must be there, in person, to do it.

"I NEED MORE MONEY."

A. I'm real estate conscious: I'm going to buy additional property with my proceeds, so I need cash down.

You respond with ideas such as:

1. I'll raise the purchase price by the amount of your down payment. You can have your asset, the contract, and borrow against it for your investment needs.

2. My credit is good. I'll give you a note against which you can secure a loan for your down payment.

3. I'll make you an equity participant in this property when it is sold.

4. I'll put you in touch with a syndicator who uses investor's trust deeds in place of cash.

5. I'll refinance this property and make advance payments to you in the amount of the down payment.

6. I'll buy back my note and trust deed from you, at a discount.

7. I'll find you a property for no money down.

B. I'm debt conscious.

You respond with ideas such as:

1. I'll assume your debts.

2. I'll guarantee a loan to pay off your debts.

3. I'll lend you money myself.

4. I'll make advance payments.

5. I'll assign collected rents to you in the amount of the debt.

C. I'm security conscious. Why should I sell with nothing down? You could run my property into the ground.

You respond with ideas such as:

1. I'll give you a blanket mortgage on another property.

2. I'll give you a one-year option to rescind in the event of improper maintenance.

3. Let's go see other properties I own (or have owned).

4. I'll permit you to stay in as part-owner. You can oversee maintenance yourself.

5. We can escrow rent payments, and pay a management company of your choice to run the property.

6. I'll pay you to manage this property.

D. I'm investment conscious. I need an income stream. I'm going to invest the down payment and collect interest.

You respond with ideas such as:

1. I'll raise the interest rate, and my payments, to equal what you would receive by investing the down payment.

2. I'll guarantee resale within five years. You'll have your cash balloon to invest by then.

3. I'll pay you to manage this property. That way you can have money coming in.

E. I'm tax conscious. If I sell this property, taxes will eat me alive.

You respond with ideas such as:

1. You're taxed only on money actually received. No down, no tax.

2. I'll send you a CPA who can fully explain the tax ramifications of this sale.

3. We can delay closing until January 1 of next year.

4. I have a copy of the Tax Reform Act right here, and it says....

5. We can set up a trust for your children.

6. We can set up a tax-free exchange for another (smaller or larger) property.

"I NEED MONTHLY PAYMENTS."

A. That's just the way it's done.

You respond with ideas such as:

Most major investments pay quarterly or annually. Stocks are an example. Real estate syndications may take years to pay off.

B. I need the monthly income.

You respond with ideas such as:

1. The less you draw, the more interest accumulation you'll have at balloon time.

2. My payments to you will be a percentage of the property's net income. The better the price to me, the better the payments to you.

3. Part of your need for income was to feed this property. I'll be doing that now. And the time you'll have available by not managing the property can be used to generate an income elsewhere.

4. I can get you a job.

5. I'll hire you to manage this property, and others as well, if you wish.

For years, and for a variety of reasons, otherwise professional investors have found other avenues for this most critical activity: the phone company, the post office, the Realtor, the brother-in-law. Perhaps these intermediaries were meant to "buffer" what was felt to be a difficult or unpleasant task. What they actually accomplished, however, was to confuse, stretch out, and otherwise muddle up what should have been an opportunity for spontaneous, timely, and clear communication between those who really had the most at stake.

People prefer peers. Presidents feel at one with presidents, carpenters with carpenters, real estate principals with real estate principals. Intermediaries are fine for preliminary fact-finding, but the actual negotiation of price and terms--followed by contractual documentation--is hardly preliminary.

Andrew S. could have sent his attorney, agent, or even a friend to meet with the seller of the $65,000 single-family home. Instead he took the time and effort to meet personally with the owner of the property. He knew that one of his important roles was to be a problem solver and the only way to solve a seller's problems is to understand them. Andrew was much more confident of his ability to recognize the potential problems if he could meet personally with the seller. He could read the seller's body language and establish a feeling of trust by meeting with the man one on one.

Agents dealing with agents do perform a service, but they also act as insulation, preventing you from doing some "creative listening" and from discovering the negotiating nuances that can thus be revealed. At the negotiation meeting the functionaries have come and gone. These are summit talks. You hold them face to face. You can't interpret body language over the phone. voice inflections are difficult to assess when the words are typed. The very real benefits of eye contact, a friendly manner, and a firm handshake can't be readily transmitted through walls.

Negotiating is not just another step in the process. It is the culmination of all of the steps that have come before. It is the key to your ultimate success as a real estate investor. Do not send a henchman. Go yourself.

RULE 2: NEGOTIATE PRICE, RATES, PAYMENTS, AND DATES

If Rule 1 involves the who in the process, Rule 2 brings in the what. "Negotiate" implies discussion, give and take, the offering and/or acceptance of alternatives. It is a way for buyer and seller to weigh incentives--and to permit excess air to escape from inflated demands.

There is more than a single "ante" in the game of real estate negotiation. There are five: price, interest rate, down payment, monthly payment, and closing date.

After Andrew S. and the seller were comfortable with each other, Andrew asked the seller what he wanted for his home. He didn't start by asking what the seller would accept, but rather what he wanted.

The seller said he wanted $65,000, with no time contract, all cash, and an immediate closing. In effect the seller said that the price was $65,000; the interest rate did not apply, since he did not want to carry a contract; the down payment was one hundred percent cash; there would be no monthly payment because of the cash price; and the closing date was within seven days.

Andrew's previous research on the property and the seller told him that the seller's initial request was only the starting point. As the negotiation proceeded, Andrew was able to negotiate each of these five areas in a profitable win/win situation.

Relatively few real estate transactions are consummated to precisely the price and terms originally asked. Due to the nature of the marketplace, few sellers anticipate the receipt of a full-price, full-terms offer. They have learned that sophisticated buyers traditionally massage the competitive seller for concessions to "sweeten" the deal--which may, after all, be under simultaneous negotiation with another of perhaps equal merit.

Frequently, those concessions will be built in to the stated price and terms. In other words, there will be some things the seller can automatically give up without sacrificing the financial objectives he established for the ultimate sale. While these concessions are frequently available, they are virtually never granted freely. They must be requested--specifically, skillfully, and persistently.

It is imperative, then, that you enter the negotiations with a completely open mind, not only because of your own mix of requirements, but because of the seller's as well. Particularly, you must drive from your mind any notion that the seller's thought processes operate anything like your own, or that what might appear outrageous to you will automatically be seen in the same light by the seller. Tens and even hundreds of thousands of dollars worth of buyer benefits often go down the drain simply because the buyer was embarrassed to ask! Sure, your request may seem to border on the ludicrous given your particular set of circumstances, but it may fit the seller's circumstances like a glove.

There are two points to remember: one, your seller has a reason for selling, and, two, going in, you don't know what it is. Don't assume! If he has a $5,000 note reaching the end of its second extension tomorrow and you're offering 6 percent down on a $100,000 property, all other terms--save inclusion of immediate family members--may be, in fact, quite acceptable. Don't lie down on the job. Inquire. You snooze, you lose.

Regardless of the seller's motivation, or, in, fact, the logic of his "hot button", you still possess the tools to effect a profitable transaction. When preparing your offer, think of the five negotiating elements from the seller's perspective. By patiently questioning the seller, you find out not only which of the five negotiating elements are the most significant in this case, but, by definition, those that are less so. Focus on the important elements, and you may be pleasantly surprised at the overall benefits available to you.

For some, price is the overriding consideration. Perhaps the seller bought wrong, and is trying to recoup the results of his own lack of sophistication. Perhaps his assessment of the market has led him to a faulty assessment of value--but one he "knows" is right. Perhaps Uncle Louie is looking for his down payment back, with interest, out of profits.

For others, interest rates can be greater determinants than the asking price itself. A seller who is adamant about the price may be flexible enough on rates for you to make up the difference between what you want to pay and what he wants to receive. By having your bank prepare two mortgage amortization tables--at the asking price but with different rates--you can readily determine the out-of-pocket difference at the end of each period, and negotiate from a position of knowledge.

Jay C. had held an eleven-acre wooded hillside in Minnesota for twelve years,
and had settled on a hell-or-high water value of $13,000 for the rural plot. Frank B., a neighboring farmer who was looking for timber and grazing space, had no problem with the price, but thought interest was a communist conspiracy and refused to pay it. After several negotiating sessions, all focused on the single factor of interest, the deal was made on a small down payment, a three-year carryback and balloon, and interest payments that were half the going rate. Jay got his price, and Frank got his timber and grassland, all because interest rates were negotiated.

Another flexible element in the negotiating process is down payment. The down payment is definitely <u>not</u> viewed uniformly by sellers. It may be used to meet emergency cash requirements, to provide the cash for additional investments, or to simply bind an unknown buyer to the sale. If relatively large periodic payments or an early balloon date will satisfy the seller's cash needs, then the down payment requirements may be minimal.

Once again Andrew S. began listening to the seller, he began to understand why he was selling his property. The $65,000 home had a first trust deed of $27,000 at 8 percent interest. The home had a second of $7,000 at 21 percent interest and payments of $568 per month. The seller's wife and two children had recently been in an automobile accident--and they were uninsured. Hospital and doctor bills exceeded $8,000. Other pressing debts added another $7,000.

The seller was not well versed in real estate financing and frankly believed that an all-cash offer was the only way to solve his problems. Andrew asked him if he would forgo the down payment if Andrew could take care of the seller's debt payments for him. The seller said yes.

Major transactions have been completed with as little as one dollar down. The point to remember is that the amount, and even the form, of the down payment is traditionally <u>on the table</u> for discussion as another recognized element in your negotiating arsenal.

Monthly payments are usually computed through the use of amortization tables, based on the length of the financing period. On a private transaction, a "stop" date is usually included, at which time a balloon payment of the remaining monies is due. The length, the stop date, and even the actual monthly outlay are all negotiable. Many transactions are completed with interest-only payments. Some don't even require full interest to be paid, creating a negative amortization that is expected to be offset by income and/or appreciation. Payments can be monthly, quarterly, or annually. Where the down payment is sufficient, there may be <u>no</u> periodic payments at all.

When Andrew S. was negotiating the down payment for the $65,000 home, he found that the seller was very flexible on other items once he learned Andrew could solve the immediate $15,000 problem

. The seller even offered to drop the price of the home as an incentive.

Andrew proposed to refinance the property with a new loan that would pay off the existing first trust deed, the second high interest mortgage, and the $8,000 in medical bills. Because the payments would be higher, Andrew proposed that the seller take back his equity of $12,000 (the difference between the purchase price of $54,000 and all the encumbrances, including medical bills) in the form of a note that was payable over the next 15 years at eleven percent per annum. The payments would be $136.39 per month. The seller agreed.

Finally, the closing date for the transaction may vary substantially, according to the needs of both parties. Bound by a personal note for earnest money, some closing dates are delayed by 90 to 180 days or more to permit the buyer to raise the required funds. Sophisticated investors often automatically extend closing to the maximum limit allowed in order to find buyers and realize extensive profits from a simultaneous closing.

A dramatic example of that philosophy occurred recently in Tucson, Arizona. Twelve thousand acres of prime industrial and residential land owned by the estate of the reclusive billionaire Howard Hughes was purchased by a local savings institution and its British parent company for some $70 million . Less than half the acreage was sold for $50 million within weeks of the original closing.

Is anything sacred in negotiations? No. Not in real estate transactions. If a productive discussion is to be held, virtually every aspect of the transaction must be available for negotiation. If the seller is firm in price, then negotiate terms to your advantage. If the range of terms appears to be non-negotiable, hone in on price. If the seller won't give much on either price or terms, he probably is not truly anxious, and isn't motivated enough to ensure you of a profitable transaction. There is another deal for you--a better one--down the road.

RULE 3: ASK QUESTIONS

By now, you should be realizing the importance of conducting these discussions in person. They are rich with potential, by far the most productive hours you will invest in any particular deal. For that potential to be realized, however, it is necessary for you to be an active participant. But by no means does this imply that you will be doing the majority of the talking.

You would do well, in fact, not to consider these as negotiating sessions at all, but as educational sessions. You are here to find out certain things. If this investigation reveals the quantity and quality of facts you are seeking, you have the option of purchasing the property. If not, conduct another inquiry elsewhere.

As a result, the seller--not you--should do most of the talking.

You must exercise skill as an interviewer and as a creative listener, but your counterpart is the one who should be offering the information.

Let's go back to the example of Andrew's interview with the seller of the $65,000 home. When Andrew sat down with the seller, the first real question he asked was, "Why are you selling?" Then Andrew listened.

Once Andrew understood those reasons, he was able to negotiate a purchase that provided a solution for the seller, at the same time meeting his own objectives. The seller told Andrew what he needed--$15,000 of debt relief, and Andrew was able to provide it. The payments on Andrew's new first loan of $42,000 (over twenty-five years at 11 percent) were $412 per month. Now Andrew was facing a debt service of $548 per month, including the payment to the seller. Andrew was certain that he could rent the house for at least $625 per month, an amount high enough to provide a break-even cash flow.

To be a good interviewer, you must do your homework. This is not a "free-association" interview or a spontaneous exchange. You must determine what it is that you wish to accomplish, and you need to formulate the questions that are most likely to generate the appropriate response. If you want to determine whether the seller is flexible, your questions might revolve around terms, timing, and near-term seller activities.

"Would you consider a lease-purchase arrangement?" may be a conversational inquiry, but a positive response tells you that the seller does not need a substantial amount of cash immediately--and that the value of having someone else take the property now is greater to him than the possibility of some future sale.

"When would you like to close?" is intended to do more than permit you to clear your calendar for the selected afternoon. If you're negotiating in September and the seller says he'd just as soon wait until after the first of the year for tax purposes, you know you have an entirely different set of needs than if he'd responded, "Friday!"

If social chit-chat reveals that your seller has the movers dropping by the first part of the week for his transfer to Atlanta, you know something about his motivation that you wouldn't have known if you hadn't asked.

The point is, <u>do</u> ask--and listen attentively to the response.

Once your seller's flexible status has been established, your questions should be directed to the property itself, with a view toward neutralizing any expectations of high profit the seller may have had in mind. Review current and planned zoning for the area, for example. Upzoning may be potentially profitable over the long run, but the potential of a convenience store being built on the vacant lot down the street could certainly have a negative effect on value today.

Other location-related questions might have a similarly enlightening effect on the seller's mind: "Do those trucks make that much noise at night?" "Isn't that where the break-in occurred?" "My daughter would have to walk a mile to the nearest school?" All are almost insignificant questions individually, but their cumulative effect can set the seller into a much more realistic frame of mind.

Ask about anything you notice that appears to require attention, and some things that don't. "When was the roof last replaced?" might establish a negative, even if it doesn't leak. "How long have you been trying to sell?" can, too. Point out any deferred maintenance, and jot it down on a clipboard or notebook you carry for the purpose. You're an investor, after all, and evidence of your thoroughness and professionalism will be noted and remembered by the seller when--and if--negotiations actually begin. Any odors, stains, or other evidence of past events should be questioned rather than simply commented on. Requiring the seller to provide answers that may not be immediately available, and from which negative implications may be drawn, is a part of the "attention-getting" process that can convert an aloof or unrealistic seller into one more able to observe the sale from your perspective.

Carol T. had purchased her first investment property and was now looking for her second. She had placed an ad in the local newspaper saying she purchased homes as a private investor.

Whenever someone responded to her ad, she immediately took out a form and asked literally fifty questions or more. The truly flexible sellers didn't mind answering the questions; Carol told them she needed the information in order to put together an offer that provided for the needs of all parties.

Martin S. called Carol back and provided the information she needed. After going through her form, she made an appointment to meet with Martin at the property. When they met, Carol brought her questionnaire with her, visibly attached to a large clipboard. Martin knew that Carol was serious and was interested in getting correct information.

As they began their conversation, Carol kept glancing at the clipboard, asking questions. Martin began to look at the property a little differently when Carol asked, "Have the tenants ever moved out without paying the rent?"

"When was the last time you had the sewer pipe flushed to the street?"

"Has the property ever experienced a loss from vandalism?"

Carol didn't really expect a negative answer to any of these questions, but she wanted Martin to start looking at the property as a potential buyer instead of as a seller.

By getting into the habit of examining prospective properties with a fine-toothed comb, involving your seller, you will become adept at "eye-opening" and may well save yourself from buying properties whose deferred maintenance requirements consume the bulk of your anticipated profit.

RULE 4: BE PATIENT

Buying property properly is similar, in some respects, to youthful romance. The eager suitor is often rejected, while the person who plays "hard-to-get" is strangely enticing. It is an undeniable human trait for people, or things, that seem inaccessible to become particularly attractive.

The scenario works in real estate, too. When reviewing the property, take care not to appear too eager, too interested. Remain somewhat aloof, indifferent. Imply, directly or otherwise, that this is but one of several properties you are considering. Using the information from your question session, justify your indifference with summary comments relating to overall suitability, condition, and value.

When Martin S. Heard Carol T. ask questions that imposed a slightly negative atmosphere on the negotiating process, he asked, "Are you serious about this property?"

Carol responded that she was, but it was one of three properties she was seriously considering. Martin knew that Carol was a serious potential buyer, but that she wasn't going to act from emotion alone. The property would have to stand on its own investment potential alone. At no time during the interview process did Carol act overly excited about the property. Martin could tell she was interested, but nothing more.

<u>RULE 5: BUILD TRUST BY BEING SENSITIVE TO THE SELLER'S INTERESTS</u>

Negotiation, of course, is a two-way street. No one needs to tell each person to care for his own interests. The wise negotiator, however, will spend an equal amount of time demonstrating a willingness to protect the interests of the "other side". This is not a misapplication of altruism, but an operating philosophy that will serve you well and profitably over the long run.

It is the seller, not the buyer, who most frequently operates under circumstances of some tension. Buyers, typically, are pursuing an optional course. Acquiring property is a desire for them, but usually not a <u>need</u>. While divesting properties is frequently optional for sellers, it is seldom so for flexible sellers. Whether the reason be money, management headaches, job transfer, or some other factor, the flexible seller typically feels a <u>need</u> to sell, and experiences the full range of pressures (and real or imagined fears) that can accompany it.

When Carol and Martin were negotiating the purchase of the duplex, Carol began to feel a certain amount of reserved tension coming from Martin. As the negotiation interview progressed, she learned that Martin was selling because he had come to hate the management of rental property. During the preceding month, Martin had spent eighteen different evenings at the duplex for one reason or another. (Most of the problems could have been solved if Martin had appointed one of the tenants as resident manager, and then given him a $25 rent allowance for handling small repairs.)

Carol recognized this anxiety and began to focus her negotiation accordingly. She saw that she could help Martin win while winning herself.

The seller's pressure and fears can provide a real opportunity for you. But rather than attempting to take advantage of the cornered seller, and causing a defensive reaction, you must adopt the manner of a counselor. The opportunity is not to get an unfair position, but to help the seller out of a tight spot, while helping yourself.

To make this work, you must come to understand <u>why</u> the seller is selling. You need to find the <u>real</u> reason or reasons. Quite probably, as you probe for problems, you will find the answers to be both candid and revealing. The chances are great that you will be the first to have shown an interest in the seller's needs. Once your legitimate concern is established, and you establish your willingness to work creatively to solve the seller's problems, a bond will have been created that can lead to a mutually beneficial relationship not only for this property, but for others in which the seller may have an interest.

"Where there's a will there's a way" is more than a nice maxim. There really <u>is</u> a way, particularly in the real estate business, with its virtually limitless cache of optional methods of putting transactions together. All that is required is mutual motivation, a little patience, and imagination.

Establishing mutual motivation means not only that the seller feels the incentive to deal, but that he wants to deal with <u>you</u>. The power of the personal relationship is seldom so clearly illustrated as in private-party business transactions. Frequently, terms offered by an overbearing buyer will be rejected, while those same terms will be accepted and even sweetened, when suggested by someone for whom the seller has developed feelings of respect and confidence.

As Carol and Martin continued their negotiations, she told Martin of her success in managing her other rental units. She acted excited about rental property, and Martin began to have confidence in her ability to make the property a viable real estate investment.

This confidence and respect allowed Martin to consider Carol's initial proposal very seriously. Rather than buy the property immediately, Carol proposed to take over the property on a lease option for one year. During that year Carol would sign a master lease on both units at a discounted rent of $275 per month. Martin was presently renting the property for $300 per month per unit. In exchange for the lower rental amount, Carol would assume all management and would pay for all repairs. Martin would have no financial involvement at all. Because the total mortgage payment against the property was only $524 per month, including taxes and insurance, Martin accepted the proposal.

The lease option allowed Carol to make a $50 per month immediate cash flow, and when she was ready to exercise the option to purchase at the end of the twelve months, Martin would credit her with $5,000 towards her total down payment of $7,500. This transaction worked because of the respect and confidence Martin had for Carol's managerial talents.

"Arm's-length" dealings with prospective sellers are fine when it's time for attorneys to review the contracts. But when you're dealing with the person who controls the property and could alter his terms to suit your needs with a single sentence, you'd better be within hand's length--and the hands should be shaking.

Establishing rapport is where the patience comes in. <u>Take your time</u>; don't schedule yourself to see three properties in a single morning. Even if you point out faults, it is essential that you appear <u>interested</u> in the seller's property; act like it is of potential consequence to you, not simply an afterthought worthy of only passing attention. If you are dealing with a truly flexible seller, the property is much on his mind. Let him feel your empathy.

People develop confidence in those who have the interest, skills, and resources necessary to help them meet their needs. Once you've established that you have the interest, the first step in demonstrating the other two qualities is to determine the actual scope of those needs. Here again, your skills as an interviewer will come into play.

Be blunt. You're dealing, hopefully, with a new friend. Treat him as you would an old one. Do so gracefully, but get to the point.

Expecting his prospective buyer to walk through the door with a low offer (if any at all), the seller often comes to the discussion in a wary, if not defensive, frame of mind. By shifting the conversation to <u>his</u> motivations, with nary a mention of dollars, you will relieve some of the pressure. A grateful seller will then be all too happy to begin persuading you that his needs are real and legitimate. Each time he does, you will have an opportunity to demonstrate that you are equipped and willing to meet them.

"Why are you selling this property?" would seem like a logical question to ask when you want to know why a person is selling, but few buyers think to ask it. It <u>is</u> your business. If a motorcycle endurance course is slated for the parking lot next door, that may have some effect on your decision. You are perfectly within your rights to ask.

"What would happen if you didn't sell for six months?" If your question is greeted by the verbal equivalent of a fainting spell, you must let the seller know that you are able to move immediately--to close within forty-eight hours if necessary.

"What are you going to do with the cash proceeds of the sale?" If retiring pressing obligations is the answer, offer to assume them; you may be able to prolong payment of these debts, conserving your precious supply of cash while removing the seller's immediate need for it. If the answer is to develop another piece of property, an opportunity may exist for joint venturing, with the seller's subordinated parcel of land providing the equity essential for development funding.

"What is the real reason you want to sell?" A question to be asked once you feel you've established rapport with the seller (which may be after more than one visit), this direct approach may provide a range of opportunities for you to demonstrate your problem-solving skills.

Consider again the case of Carol's negotiation for the duplex owned by Martin. Before making her lease option proposal, Carol asked Martin very bluntly, "Why are you selling?" It took a little bit of time, but finally Martin responded, in very graphic language, that he didn't like his tenants.

If Carol had not asked Martin why he was selling, she might have spent a tremendous amount of time finding out how much Martin really despised management. In the end she may have missed the real reason for selling, and she could have paid too high a price or possibly not have structured a deal at all.

If day-to-day management is a source of dismay to him, stress your own management skills. If he's moved across town and is bothered by the forty-five minute commute, offer him an equity in a property near his home--and then, if necessary, find one.

"Will you take paper?" "Paper"--or mortgages, deeds of trust, and other real-estate-secured instruments held by private parties--can look very appealing to an individual who spent the last three weekends replumbing his sixteen units and who just received the fourth call this month from Mrs. Pickens, whose bathroom lights "keep flickering". When hours of management time and operating expenses are deducted from gross revenues, the "weekend" investment property owner will often find net profits sufficiently low that a nice, clean, seasoned (with a record of on-time payments) deed of trust offers an attractive alternative. With discounts, these instruments generally provide greater returns than savings accounts, and give a seller an immediate avenue of escape from both people and property problems.

"What is the lowest cash offer you will accept if I give you all of your equity in forty-eight hours?" This question is similar to the one you ask an auto dealer before you mention your trade-in. You may, indeed, not have the cash required for such a transaction, or you may not want to invest it all in this property. The seller's answer, however, will generally reveal the extent of the seller's flexible tendencies and will provide you with knowledge of the true "last-ditch" negotiating base. On the other hand, it may reveal such a favorable opportunity that you decide to tie up the property with an option, low earnest money, or a long-close contract while you locate the necessary funds.

Greg P. owned several rental properties, including three single-family homes located in the same geographical neighborhood. As a result, he was quite familiar with the true market value of rental homes in that area. One day as he was driving to one of his properties he noticed a property for sale by owner. Greg called the number on the sign and conducted his initial interview over the phone, using a question-answer format. He found that the seller was leaving the area to go into the military service. He made an appointment to meet the seller, Brent L., at the property.

When they met at the house, Greg found that Brent was very anxious to sell. When he asked him what was the lowest price he would take for a cash offer, Brent said, "$44,000." Eighteen months earlier, Greg had purchased a house almost identical to the one owned by Brent--for $57,000. There was no doubt that the price was truly a remarkable one.

Greg proposed an option-purchase for all cash, with closing in ninety days. Brent agreed and they closed the option agreement. In less than three weeks, Greg resold the property for $54,000, then simultaneously closed the sale with his purchase from Brent, walking away with $10,000 from the closing.

The list of questions that can open doors with the seller is as endless as the solutions themselves. Particularly if the negotiations involve seller financing, those solutions depend much more on imagination and good faith than on the availability of capital. You supply the imagination. You acquire the good faith by interpreting and relieving the seller's fears.

RULE 6: USE PRE-ESTABLISHED BOUNDARIES OF PRICE/TERMS TOLERANCE

This key to successful real estate investing is perhaps the simplest, yet it is somehow one of the most difficult to consistently apply.

In most instances, the benefits sought by today's investor can be quantified: time, dollar return, number of units, and so on. The trouble is that in many instances, they aren't quantified--or they are done so on the spot during a price/terms negotiation.

This apparent indifference to investment return staggers the mind. In virtually no other endeavor is effort undertaken without the anticipation of a specific, measurable result. A trip to the doctor, a drive to the store, a new business call, or a deposit in a savings account are all undertaken with the expectation of specific return. Spoken or unspoken, that return is usually quantifiable. Yet there are those who will approach a real estate investment opportunity without having established just what mix of benefits would, for them, constitute a "successful" transaction.

For the hobby investor, or one for whom the "thrill of the hunt" is its own reward, this casual approach to prospective gain may be all right. For the serious investor, it is a bad practice--one that could lead to indecisive negotiating and the acquisition of undesirable properties.

For example, Peter and Marsha W. got such a tremendous emotional high when they were negotiating that the sellers knew they wanted the property in the worst way.

One such seller, Victor M., sold a four-unit apartment building to Peter and Marsha. The purchase was negotiated with nothing more than $450 each month, and a balloon payment for over $40,000 was due at the end of nine months. Such a purchase was no way to create wealth and financial independence. It could have been avoided through correct negotiations.

If a preliminary investigation reveals a property worthy of further consideration, the first thing you should do is establish a realistic set of investment objectives for that property. Those objectives can be both tangible and intangible and will reflect tradeoffs from property to property. You may willingly enter into known management "challenges," for example, in return for prospects of a uniquely high short-term return. Before sitting down to discuss a possible purchase, quantify both an acceptable investment of time and a minimum rate of return.

Gross rents, net income, prospects for resale and/or lease-up, price, payments, and interest rate must all be weighed relative to the returns--financial or otherwise--that you expect from the property. If you expect financial returns, your minimum acceptable requirements must be quantified and held to. They are hitching posts, beacons in the often subjective world of real estate negotiation. The problem with a "few dollars more" is that the parameter is not a clear one; "few" may well lead into "many" in the rush of the moment, and you may find yourself obligated to a property you would not, under more rational circumstances, have purchased.

Successful win/win negotiating requires that you establish minimum price and terms, based on realistic financial analysis, before meeting with the seller.

RULE 7: THE FIRST ONE TO MENTION A NUMBER LOSES

Successful real estate buying isn't buying at all. It's selling--and permitting the seller to buy--your interest, your capabilities, your own financial requirements. Successful sales people, regardless of their product, service, or idea, have one trait in common: they know when to stop selling. Picture this scenario, repeated hundreds of times in every city each day:

"...and so, Mr, Buyer, that sums it up. My product will work longer, harder, more effectively, and at less cost than any other available on the market today."

"I'll take it."

"As you can see, it's a very handsome unit. It will fit in well with your office decor, and..."

"Fine. I'll take it."

"If money is a problem, we have a number of financing plans that can help to..."

"That's no problem. I have the ca..."

"We could even delay the first payment until..."

"Um, I guess I don't need your product after all."

Maddening as the exchange may seem, it typifies a common characteristic of buyer/seller meetings: anxiety. In virtually every instance, the seller is the one who jabbers anxiously, and he will usually do so at the earliest opportunity, <u>if given the chance</u>.

You can provide that chance by simply being quiet.

By being quiet, you accomplish two things: you require your negotiating counterpart to fill the silence with talk, and you require yourself to <u>listen</u>. A circumstance in which both actions are simultaneously present creates a uniquely favorable environment for true communication.

Jerry B. applied this idea in his very first negotiation. When he met with the seller, he asked him what he would take for the property if he received cash within thirty days. Immediately the seller asked, "How much will you give me?"

The silence was very uncomfortable, but Jerry just looked at the seller. He knew the seller would have a figure if Jerry would remain silent long enough. It took almost three minutes of continual silence, but finally the seller suggested a price that was 15 percent below market value. This was the seller's starting point. By the end of the negotiation process, Jerry was able to purchase the property for cash at a 20 percent discount from current fair market value.

Don't blow it. The first one to mention a number loses. Look at it from the seller's perspective. You, as the buyer, are interested.

You've already said so. You're qualified, and "real"; in so many words, you've already said so. You can close early. You're a capable manager. You are going to buy, as soon as possible, a property that fills your needs. You know what you want. And you know, as currently presented, that the seller's property does not quite fill the bill.

And there you stand, with your checkbook in your pocket. Silent.

Do you think the seller feels compelled to fill that silence? As a flexible seller, you bet he does. Remember, has a need to sell--and here stands someone who can meet that need.

Faced with such circumstances, most flexible sellers think deeply before trading this bird-in-the hand for those that may--or may not--lie in the bush. Their tendency is to initiate, since you apparently will not, some action that may well solve their property-related problems before the meeting ends.

They do that by talking.

Since they already know what you think of their property, and that your reason for not handing over an earnest-money check is a gap between buyer and seller, their conversation must eventually--if you let it--get around to narrowing that gap. Once again, they have the active role: that of persuading you to accept the new gap they are proposing.

This was exactly the case when Jerry allowed the seller to come up with the starting figure. After the seller named a figure for the property, Jerry looked carefully at his written information on the property, and said that he couldn't even consider anything over a price some $10,000 less than that amount. Then Jerry shut up. He allowed the seller to talk. Eventually the seller knew that he had to narrow the $10,000 gap between his stated "lowest price" and Jerry's proposal.

After thoughtful negotiation, Jerry and the seller agreed to a purchase price that approximated the middle of the gap. Jerry would have been willing to pay a higher price, but through this negotiation process he was able to purchase the property for substantially less.

Your role, once you have established your interest, credibility, timing, and financial requirements, becomes almost that of counselor to the seller: listening to proposals, suggesting modifications, and defining the point at which the proposals will achieve their desired end.

RULE 8: KEEP IT SIMPLE

Human nature guides most of us along the path of least resistance. By definition, that is the path in which the fewest obstacles are placed, the fewest barriers erected.

The optimum for the seller, of course, is the path that satisfies all of his expressed wishes. An offer that fully satisfies price and terms requirements is seldom turned down. (It does happen, though, when buyer eagerness convinces the seller that those requirements were too low in the first place.) But even when those requirements are met, you will fail unless both your position and your purchase proposal are stated in concise, simple terms that are readily understandable to the seller.

John E. wanted to purchase a single-family rental from a recent divorcee who wanted to be rid of the property.

John negotiated with the seller for several days and seemed to be getting nowhere. So he decided to simplify. He sent to the seller and gave her a simple earnest money offer that was typed out very clearly. It stated the price, the down payment, and the contract terms (including interest, time, and amount). Once the seller saw the negotiations put down in simple terms, she accepted John's offer, and both John and the seller had a win/win situation.

Why the emphasis on simplicity? An illustration might help you understand.

Do you regularly file your income tax returns during the first week of January each year? Relatively few Americans do, even those who have refunds coming. The reason is seldom financial. As a people, we have a tendency to put off that which we do not fully understand. Income taxes--and the accompanying myriad of forms, schedules, and interpretations--are an extreme example of the difficult-to-understand, but a clear illustration of the principle. That which is easiest to do is the thing we do first, delaying those tasks that require extensive effort or thought until "later".

Real estate sellers are no different in that respect. Once you have made up your mind, however, the last trait you want in a seller is procrastination. To avoid it, you need to make your purchase proposal one that can be understood, and approved, on the spot. It is decidedly not in your interest to encourage the seller to seek counsel from mate, brother-in-law, bartender, or other nonprofessional adviser, each of whom may feel obliged to wrench their friend from the clutches of a "stranger" who obviously is seeking to purchase property in his own terms.

Professional counsel, in the form of an attorney and/or accountant, will traditionally be sought in a real estate transaction; how it is sought depends on you. If your proposal is complex, your seller-client may approach his adviser with an open-ended "I don't understand this," inviting wholesale rewording. That rewording often includes additional phrasing that may well upend the original intent of your document. If, on the other hand, the counselor is hired to "smooth the rough edges" on an agreement that was satisfactory to both parties, his changes are likely to be of a much more limited nature. The original parameters are likely to remain intact.

Simplicity does not, by definition, mean brevity. It means clarity. If replacing an eight-word sentence with a thirty-three-word paragraph eliminates the possibility of confusion, the change should occur. As an example, "How about a second-mortgage crank on your property?" may be crystal clear to weathered real estate specialists, but it may draw an embarrassed "Huh?" from your prospective seller. It may also raise the flag that brings friends and relatives into the negotiating process.

A longer, but simpler, way of saying the same thing would be: "Would you be willing to take back a second mortgage for a portion of your equity? By refinancing the property, I could give you a down payment of $5,000, and the remainder of your equity in cash." It's also much more understandable.

Avoid "jargon", or real estate-related terms familiar to insiders, in all of your discussions with prospective sellers.   Consistent with the "win/win" philosophy, it is your intent to befriend your seller, not overpower him. The "aw, shucks" approach may not fit in with your image of yourself as a soon-to-be high-powered real estate investor--but, if not, step back a moment and remember who it is that you want to impress with your sophistication. Your creditors and your banker will probably be toward the top of the list, your seller near the bottom.

RULE 9: REMIND THE SELLER OF THE PROBLEMS YOU ARE SAVING HIM FROM

One of the cardinal rules for public speakers is "Tell 'em what you''re going to tell 'em. Tell 'em. And then tell 'em what you told 'em."

An extended, frustrated negotiating session may actually cause him to forget the problems that originally motivated the sale. As a win/win negotiator, you should clarify those problems once again near the conclusion of the negotiations to remind the seller of the negatives that you are offering to remove. The seller can then add to your financial offer the value of being out from under those problems, and he will come up with the true value of the transaction.

Wilma M. was a recently widowed lady in her mid fifties. Her husband had left her with an eight-unit apartment building that was some twenty-five-years old. When her husband was alive, he spent at least ten hours a week at the property doing maintenance and management.

The apartment building was free and clear of all liens and the income was Wilma's sole source of support. She didn't want to give up the income, but she had absolutely no desire to manage the property.

Dan S. wanted to buy the property and add it to his portfolio of investment properties. When he was negotiating the purchase of the property with Wilma, she started to forget her reasons for selling. Dan reminded her of the management problems as well as the memories it might stir up. He offered her a contract payable over the next thirty years that would provide for her support for the rest of her life. She felt good about Dan's solutions to her problems, and allowed him to purchase the property for virtually nothing down.

Once into the "dollars" phase of your discussions, the seller may momentarily forget that he was doing some emergency plumbing at 10:00 last night, or that Mrs. Robbins--out of a job with four mouths to feed--is now three months late with her rent, or that the property taxes, which exceed current net income, are due tomorrow. Since you earlier asked questions to determine his problems, and since you listed the problems in an orderly fashion in your notes, you should now point out the solutions that you are providing to each of these problems. By bringing them back into appropriate focus--perhaps by adding a factor for the time and expense necessary to adequately deal with them--you are sweetening your deal in a way that appeals to the "human factor" as well as to the purse. These few sentences may be the extras that ultimately tip the balance of the negotiations in your favor.

When Dan provided for the emotional and financial needs of Wilma, he was able to structure a completely win/win transaction on the eight-unit apartment building. The approved purchase offer was finally signed because of the appeal to both the "human factor" and the "financial incentive."

<u>RULE 10: EXPLORE "STAB-IN-THE-DARK" OFFERS</u>

At this point, if the seller is still "in the game" but hesitant to commit, there is a technique that can be particularly effective if the seller's expressed value is tied to other than pure market conditions.

An introductory step would be to remind the seller that you are interested in the part of the property that he <u>owns</u>--the equity portion. Once an acceptable range of value for that portion is established, you as buyer might propose a dozen or more "stab-in-the-dark" swaps of property for property, listening carefully to each response in order to narrow down true needs and true valuation.

"Would you take my new Buick as down payment?" does more than assess the seller's affection for Buicks or need for an automobile. If the possibility is admitted, you have just established an acceptable level of down payment--one that may differ from that originally expressed.

If free-and-clear raw land, valued at or in excess of the seller's equity, is of interest, it may signal that absence of management headaches is of greater importance to the seller than cash at this time.

If "Would you take a note as down payment, payable in two years at a third over face value, with this property as security?" sounds like a pretty good deal for your seller, you may have before you a transaction in which the seller will lend you the money to buy his own property, a certain-enough indicator of the degree of flexibility you're dealing with.

In your preparations for the negotiating session, determine what it is about the seller that you wish to find out, and structure your "stab-in-the-dark" questions accordingly. You might determine he doesn't want any management properties at all, because he's been transferred by his company. Traditionally, that places a certain time pressure on him to sell the property he already owns. If no non-cash proposals appeal to him, he may need a specific amount of cash to purchase a family home in another city. Perhaps that specific amount would satisfy his down payment requirements. And so on.

By providing the seller with real, or hypothetical, examples on which to base his value, you are able to assemble a set of facts that he may have been reluctant to provide if asked directly. You can then use those facts to construct your formal offer.

As Dan S. negotiated the purchase of the apartment building with Wilma M., he asked her such questions as, "Would you take an offer that didn't require you to ever visit the property again? Would you accept an offer that provided you with $2,011.56 per month for the next thirty years?"

When the questions were phrased in this manner, Wilma accepted and Dan was able to purchase the eight-unit apartment building for nothing down and a contract for $250,000 over thirty years at nine percent interest.

RULE 11: PERSIST AND PERSIST AGAIN

As a win/win negotiator, you will be constructing formal offers a lot less frequently than will "ordinary" investors. First of all, you will likely be dealing only with truly flexible sellers--a limited population. You will have very carefully assessed your own objectives and the way this property fits into those objectives. You will have spent considerable time locating the correct property, interviewing its owner, and getting background for the pre-offer negotiating session.

You will have, in other words, invested substantially of your time and expertise in coming to the point of offer. In addition to the value of the property, this investment of self must lead you to the conclusion that if at first you fail, you must try and try again. And again, and again. It is not the attempt that separates those who win from those who do not. It is the success. And few, indeed, are those who attain success on the first try.

By their personal nature, and the fact that they may be cancelled with a word from either party, negotiations are always on the verge of collapse. Any single element, or the manner in which it presented, may trigger an emotional response that appears to end the discussions on the spot. Overlooked in such an assessment, however, is the fact

that there are probably dozens of other points on which the parties have already agreed. The point in contention is often merely a burr under the saddle of one of the negotiating parties, with a smooth ride assured once you find a way to remove the burr.

Don't give up! The skills and the attitude that brought you to this point are probably quite sufficient to enable you to "find a way out." After all, that is what you're there to do. If it was to be a cut-and-dried, "rubber stamp" meeting, you could have sent an assistant. It was your tenaciousness and creativity that got you successfully to this point; the same will get you successfully through it.

Examine your offer. Listen to its rejection. What part of it is insufficient? Do the seller's remarks suggest something other than what is being said? Does the seller indicate a willingness to continue discussions? Would concessions in another element of your offer permit you to retain those terms that appear unsatisfactory to the seller? Keep digging. There is a will. You will find a way.

"No" frequently means "I don't understand." Have you made the terms on which you will sign quite clear? Clear to the seller? Often, a verbal review will provide a seller who is reluctant to acknowledge his lack of understanding with an opportunity to "confirm" his perception of your offer.

"Mr. Seller," you might suggest, "I understand that we're apart on some aspects of my offer, but permit me to run through those I've suggested so far. That way we can separate those that there is a question on." Where possible, use terms like it appears", and "I suggest"--terms calculated to provide an opening for the seller when you review an aspect that's bothersome to him. Keep in mind that the creative offer is not the typical offer, and that the concepts you are proposing may be so new to the seller that he almost instinctively reacts defensively. Don't be afraid to illustrate as you go along. A few graphs or columns of figures computed on a note pad can often do wonders to clarify both your intent and the mutual benefit they demonstrate.

Consider again the case of Dan and Wilma negotiating the purchase of the eight-unit apartment building. When Dan asked Wilma if she would accept an offer that paid her $2,011.56 per month, he did something simple, yet original. He made a monthly chart for the next thirty years, with the monthly payment to be received. In this way Wilma was able to visualize the benefits she would receive from the creative offer.

Just as "No" can mean "I don't understand," "It can't be done" can mean "I've never done it" or "I don't know how to do it."

Listen! How many times have you said, "You look wonderful, dear," when what you were really saying--by inflection, or tone, or glance--was something quite different. You are more than an equal participant in these talks. You convened them. You are the host. It is your responsibility to guide both parties successfully through them. If you have ever been accused of "hanging on every word," now is the time to do so without fear of recrimination. Listen. Interpret. Confirm your response. If necessary, illustrate again.

You are a win/win negotiator. You know that what you are proposing is good for both parties. If your counterpart fails to agree, it must be because he doesn't understand. Cause him to understand.

Dan knew that the offer for Wilma's eight-unit apartment building was a win/win situation. It allowed him to own the property with a break-even cash flow right from the start, and yet it would provide Wilma with a regular income for the next thirty years, at an interest rate that was higher than she could get on bank certificates of deposit. When he was able to put the offer in terms that Wilma could understand, she was willing to accept the proposal on a win/win/ basis.

Persistence does not have to mean, or appear to mean, stubbornness. "Stubborn" usually applies to the immovable adoption of a position, and the unwillingness to be swayed from it--regardless of the facts. "Persistence," on the other hand, is stubbornness applied to the result, not the process or position. The persistent person is convinced of the value and the achievability of the goal, but he will try a variety of approaches toward its realization.

Hannibal was persistent about crossing the Alps. That persistence eventually caused him to choose a means of mountain-crossing conveyance never before used. Like many other unconventional, but creative, solutions, it worked perfectly.

True, ingrained persistence cannot be faked. It must be literal, real, internal. It is not an independent attitude, but an offshoot of equally real confidence and optimism.

Unlike higher philosophies, the nothing down, win/win method of real estate investing does not ask that you adopt its principles on faith. Its tenets have been, and continue to be, proven on a daily basis in virtually every major city in the United States (and many smaller ones as well). It <u>has</u> worked, it <u>does</u> work, and it <u>will</u> work for you. Once you <u>know</u> that, the attitude of enlightened persistence necessary to broaden your spectrum of opportunities will automatically be yours. With each success, with each satisfied seller, your confidence, your skills, and your net worth will continue to grow.

<u>RULE 12: TAKE TIME--TIME LESSENS TENSIONS</u>

Do you remember your first date? Your first job interview? Your first meeting with the in-laws? If you're like most of us, they were meetings involving some tension. And the greatest degree of tension probably occurred at the beginning of those meetings.

Once again, we run into a common human characteristic.

Anthropologists judge humans to be a race of gregarious, social animals, forming families, living in bands, seeking out one another's company. What anthropologists usually don't dwell on are the beginnings of those social relationships--often periods of tension, suspicion, and even outright hostility. Wandering tribes of old liked to be able to meet strangers with their backs up against a wall. The handshake has evolved from a practice of showing the palm to demonstrate that no weapons were hidden there.

Historically, the earliest moments of relationships are "on-guard" times, periods of assessment and feeling out. "Hello, Madam, My name is Fred. May I engage in a torrid romance with you in fifteen minutes?" may be the stuff of off-color fiction, but most aspiring Lotharios, anxious to avoid public humiliation, exhibit more restraint in their introductions.

Business relationships, too, begin on a more formal note. The lawyers even have a term for it--"arm's length." Consider the initial buyer/seller meeting in a real estate transaction, if the buyer were to be perfectly candid:

"Mr.Smith, my name is Fred Norman. I realize that you don't know if I am honest, have any money, know anything about real estate, appreciate your property's value, or beat my wife, but I am here to come into ownership of that property without demonstrating any of those things or giving you any of my own money. I'll want to offer you thousands of dollars less than what you think the property is worth, and perhaps ask you to lend me the money to do so. My personal financial statement is none of your affair, and, for all you know, I may want to return your property to you after mismanaging it for several years and draining its bank account. Now, may we chat?"

An exaggeration? Not if you're the seller and you've heard of any of those things happening in the past. Only in court are you held innocent until proven guilty. In real life, economic life, the reverse frequently holds true.

The initial moments of your meeting, then, should be used to establish rapport with the seller--almost exactly the same way you do with anyone else. It should not be a period of tension for you because, as a win/win negotiator--a "believer," as it were--you literally <u>do</u> observe this new acquaintance as a potential friend. You are there not to take advantage or to "hoodwink" him, but to examine his needs and determine whether they might dovetail into yours in a mutually beneficial way.

Do not be rushed in this very important meeting. You never get a second chance to make a good first impression. Arrive a few minutes early. Schedule nothing immediately following. Take the time to do what you're there to do--review his needs. By exhibiting a true interest in finding solutions to those needs, you will be figuratively opening your palm and helping to ease whatever tensions he may have brought to the meeting.

Frank M. was a beginning investor who found a three-unit apartment building that passed his preliminary requirements. He made an appointment to meet the seller at the rental property to inspect the property and to begin serious negotiations.

When Frank met Stewart A., the seller, at the property, he tried to make a favorable first impression. He was prompt, he dressed properly, and he drove up in an immaculate and recently washed car. Frank looked and acted professional. He had factual data about the property and had even gone to the courthouse and purchased a survey plat on the property itself.

Stewart was responsive to this professional approach. He was receptive to Frank's questions and truly believed that Frank was trying to solve Stewart's problem with the property, while still purchasing the property as a good investment for himself.

Remember: you represent a VIT (Very Important Transaction) to the seller, involving his past judgments, his present cash flow, perhaps the very welfare of his family. At the very least, a substantial portion of his ego is involved. Treat it with the patience and respect it deserves, and you will have gone a very long way toward refining "arm's-length negotiations" into thoughtful discussions with a friend.

It's much more pleasant that way. And more productive.

RULE 13: BE FLEXIBLE, BE CREATIVE, BE READY WITH ALTERNATIVES

Several years ago, a young woman, a writer by trade, applied for a position in the public relations department of a major midwestern utility. She successfully passed her first battery of interviews and finally reached the spacious offices of the regional vice-president for her final test.

During the discussions, the executive acknowledged that the job for which she was applying required a great deal of creativity, and expressed admiration for anyone who possessed the trait. "I'm just not creative at all," he said.

"I'm sorry, but I disagree," my friend said. With some feeling, she went on to dispute the notion that creativity was the exclusive domain of writers, artists, and others traditionally tabbed with that label.

She pointed out that there was no "manual" for dealing with the myriad of responsibilities the executive handled each day, but that individual solutions had to be formulated--or created--as situations arose. The fact that the executive had achieved an advanced position with the company, she noted, proved that he had demonstrated abilities as a creative manager, and was able to "build" solutions from a broad, but uncataloged, array of resources.

"In the final analysis, that's all we do," she said.

The interview not only got her the job, but it demonstrated a unique level of perception on her part.

Her well-taken view applies equally to the field of real estate investment. Real estate investing, in fact, provides one of the most fertile fields for the application of personal creativity. It is incredibly broad. While customs relating to the transfer of ownership of its various "products" do exist, they are largely just that--customs. Dealing in real estate is often a largely unstructured process. The variety of solutions to identified problems is almost endless. For example, mathematical science shows that if each of the five elements of negotiation (price, rate, down payment, payments, and dates) had only five alternatives available, there would be more than <u>fourteen thousand</u> offer combinations that could be presented in a single real estate transaction. While such an exhaustive process will certainly never take place, it <u>does</u> prove that the successful, creative negotiator is equally unlikely to run out of alternatives to propose when putting a deal together.

Your task in all of this is two-fold: you must remember that this awesome bank of options is available for "withdrawals" at any time, and you must unloose the reins of your own imagination to determine when, whether, and how to bring them into play.

<u>RULE 14: STEP BACK AND GIVE YOURSELF A CHANCE TO THINK</u>

When you have gathered all of the information you feel you'll need to exercise good business judgment, <u>don't exercise it</u>--not then and there, at least. Take the information, leave the seller, and retire to a place of privacy. Then take as much time as you need to check, and double-check, the information you have received against your own objectives. Be <u>sure</u> that they fit. Play "devil's advocate" with yourself, and try to find flaws in your own arguments.

One effective way of evaluating the deal is to draw a line down the center of a piece of paper. On the left, write all of the advantages of owning this piece of property. Match those advantages against your <u>written</u> list of objectives. Throw out those that do not support one or more of your objectives.

On the right side of your paper, write all of the negatives you can think of--and there are a variety that come with the ownership of <u>any</u> property. Is management going to be a problem? How much deferred maintenance is there? How about zoning, neighbors, vacancy rates, negative cash flows, interest rate?

When you're done, bring your lists to a presumably neutral friend or adviser you respect. Ask <u>him</u> to try to talk you out of your pending deal. If you have done your work, and your friend cannot mount effective arguments against the transaction, you can pretty safely assume that your investment is sound and will help you meet the realistic objectives you require from it.

<u>Now</u> go back to your seller, and present your offer to him. To the extent possible, adopt the public speaker's credo: tell him what you're going to tell him, tell him, then tell him what you told him. Lead him not only into the <u>what</u> of your offer, but the why. Present your case as honestly and thoroughly as you can, using whatever illustrations you may need to highlight your points. If appropriate, inform your seller that you are looking at other properties and that you will conclude whichever transaction meets your financial goals.

While indicating that timeliness is of value to you, leave the offer, if necessary, for the seller's consideration. Remember, as a don't-carer buyer you must not exhibit too much eagerness to tie up the property.

Then, wait. You have accomplished your negotiating tasks.

The seller need only sign to complete the deal. He must take an overt action, returning your earnest money and contract, to reject it. The transaction is now in his hands.

4.8 NEGOTIATING CHECKLIST

As you negotiate the many variables in a real estate purchase transaction, you may find the seller responding to your initial proposals in a negative manner. In order to help you respond to the most common objections to creative financing proposals, we have included this Negotiating Checklist. It doesn't provide a specific response to individual objections, but it does provide many generalized responses that can be adapted to meet most probable seller objections. Review it carefully and visualize yourself conducting face-to-face negotiations with a seller who voices the following objections:

"I NEED MORE MONEY."

A. I'm real estate conscious: I'm going to buy additional property with my proceeds, so I need cash down.

You respond with ideas such as:

1. I'll raise the purchase price by the amount of your down payment. You can have your asset, the contract, and borrow against it for your investment needs.

2. My credit is good. I'll give you a note against which you can secure a loan for your down payment.

3. I'll make you an equity participant in this property when it is sold.

4. I'll put you in touch with a syndicator who uses investor's trust deeds in place of cash.

5. I'll refinance this property and make advance payments to you in the amount of the down payment.

6. I'll buy back my note and trust deed from you, at a discount.

7. I'll find you a property for no money down.

B. I'm debt conscious.

You respond with ideas such as:

1. I'll assume your debts.

2. I'll guarantee a loan to pay off your debts.

3. I'll lend you money myself.

4. I'll make advance payments.

5. I'll assign collected rents to you in the amount of the debt.

C. I'm security conscious. Why should I sell with nothing down? You could run my property into the ground.

You respond with ideas such as:

1. I'll give you a blanket mortgage on another property.

2. I'll give you a one-year option to rescind in the event of improper maintenance.

3. Let's go see other properties I own (or have owned).

4. I'll permit you to stay in as part-owner. You can oversee maintenance yourself.

5. We can escrow rent payments, and pay a management company of your choice to run the property.

6. I'll pay you to manage this property.

D. I'm investment conscious. I need an income stream. I'm going to invest the down payment and collect interest.

You respond with ideas such as:

1. I'll raise the interest rate, and my payments, to equal what you would receive by investing the down payment.

2. I'll guarantee resale within five years. You'll have your cash balloon to invest by then.

3. I'll pay you to manage this property. That way you can have money coming in.

E. I'm tax conscious. If I sell this property, taxes will eat me alive.

You respond with ideas such as:

1. You're taxed only on money actually received. No down, no tax.

2. I'll send you a CPA who can fully explain the tax ramifications of this sale.

3. We can delay closing until January 1 of next year.

4. I have a copy of the Tax Reform Act right here, and it says....

5. We can set up a trust for your children.

6. We can set up a tax-free exchange for another (smaller or larger) property.

"I NEED MONTHLY PAYMENTS."

A. That's just the way it's done.

You respond with ideas such as:

Most major investments pay quarterly or annually. Stocks are an example. Real estate syndications may take years to pay off.

B. I need the monthly income.

You respond with ideas such as:

1. The less you draw, the more interest accumulation you'll have at balloon time.

2. My payments to you will be a percentage of the property's net income. The better the price to me, the better the payments to you.

3. Part of your need for income was to feed this property. I'll be doing that now. And the time you'll have available by not managing the property can be used to generate an income elsewhere.

4. I can get you a job.

5. I'll hire you to manage this property, and others as well, if you wish.

4.9 REASONS FOR FLEXIBILITY: AND HOW TO TURN THEM TO YOUR ADVANTAGE

In addition to the financial reasons outlined above, there may be other clues used by sellers that can give you the upper hand in the negotiations. For example, if the seller complains about property management, jump on this theme by tressing your experitise in management and your tolerance for management detail. If he mentions the fact that his depreciation is used up, show him how you can solve his problem. Offer to help negotiate a tax-free exchange into a newly depreciable property, with your services as down payment. Negotiate with a knowledgeable professional--usually a CCIM (Certified Commercial Investment Member) Realtor--to provide expertise and be compensated over time. With his help, compute the actual financial impact of the loss of depreciation on the owner, and use that knowledge in your discussions.

If the seller appears "cash poor," find the reasons for his problems and offer to step in with solutions; e.g., assuming his debts to relieve pressure, providing him with personal property that he needs (to preclude his having to come up with pocket money), increase monthly payments at first, etc. Keep probing until he is satisfied.

If the seller is in a time bind (divorce settlement is impending, a transfer is in the works, etc.), offer to close quickly. Express a willingness to put yourself into a tight contract where your lack of performance will trigger heavy penalties for you. Build trust.

Then again, if the seller is looking more for an income stream than a heavy down payment, structure your offer to provide the exact benefits wanted, and then present it with confidence and in the context of what the owner wants.

Once again, the value of fact-finding becomes apparent. You are a professional, just like a lawyer, doctor, or accountant. Your own experience with these professionals should confirm that none of them begins interviews by offering solutions! Instead, each follows a carefully structured process of questioning aimed at determining needs, symptoms, and goals. You must not do less. You cannot offer mutually beneficial "cures" unless and until you know <u>all</u> of the facts.

The first one to <u>mention</u> a number may indeed lose, but so will the last one to <u>know</u> that number.

4.10 THREE TACTICS TO TRY WHEN ALL ELSE FAILS

You've done it all. You've researched the market, the property, the individual. You've backed into a corner with your own offer, giving as much as you possibly can. You like the seller. The seller likes, and respects, you. But nothing is happening!

What to do? First, do <u>not</u> do nothing. That may take you to the successful conclusion of a lose/lose transaction. That's not what you're there for! Try these three tactics when all else fails:

THE LAY-THE-CARDS-ON-THE-TABLE APPROACH

This approach appeals to emotions rather than to strict logic; its success depends to a significant degree on your rapport with the seller. It requires not only honesty, which you've exhibited throughout, but full-disclosure honesty--the kind that literally lays on the table any and all negotiating "chips" you may have been withholding for the last moment.

This *is* the last moment.

Say something like, "Mr. Seller, let's face it. I'm sufficiently attracted to your property that I probably *would* come up with your down payment if I had it. I don't. And the cash-flow situation here won't allow me to make payments on both a down payment loan and your contract. Here's what I *can* do." Then proceed to review the problems you will assume, the payments--perhaps slightly larger--you can make, and whatever concessions you may have been saving.

There are endless concessions. Hire him, or a family member, as manager. Move the balloon up a year (but only if you can handle it). Show him a personal statement that illustrates both your substance and your inability to stretch any further. Review the concessions you had made earlier as an indication of your sincere interest in his property, always keeping within the financial framework you had established. Show him your calculations. Ask him if *he* would enter into the transaction if he were in your shoes.

Do not, in other words, hold back at this point. Remember, though, that you are not attempting to persuade him to sell you the property simply for no money down, but within specific financial parameters. Since you've revealed to him what those parameters are, and how they were derived, you can now be perfectly open with him. Knowing that he's reached the breaking point with you, he may indeed be motivated to lay his own negotiating hold-outs on the table.

Tom and Helen P. located a single-family home that was for sale by a truly flexible seller. The seller was disposing of the property in order to raise cash to invest in a fast food franchise.

When Tom and Helen made contact with the seller, they told him that they were interested in making the best investment they could, while at the same time providing the cash necessary to meet the seller's needs. They laid all their cards on the table. Once the seller understood the facts, he was receptive to their offer to buy the property for a substantial discount for cash.

Tom and Helen were able to bring in a partner who loaned them the money to buy the property, and the seller raised the necessary cash to purchase the fast food franchise. The entire negotiation process worked because all the parties were willing to openly discuss their needs and their objectives.

STUDENT-TEACHER APPROACH

"Mr. Seller, you've been in this for longer than I have. I'd like to own your property. I've tried everything I know to accomplish that goal. Nothing has worked. What would <u>you</u> do if you were in my place?"

Frequently, where relative age or experience in property ownership might qualify the seller for a guiding role, simply requesting help can bring forth an almost paternal (or maternal) response.

Vicki H. tried this approach when negotiations broke down on a property she was particularly interested in. The seller didn't especially view herself as an expert, but she was delighted to share what she knew. The seller showed Vicki exactly how to structure a deal that was attractive to both parties--all because Vicki had dared to ask for help! Vicki ended up with a choice property, a new friend, and some invaluable real estate information she otherwise would have been unable to get.

Your seller may also be someone whose expertise is seldom acknowledged. Acknowledge it. <u>Request</u> it. You may be pleasantly surprised at the result.

SHARE-THE-PROBLEM APPROACH

As a win/win negotiator, you have spent a healthy amount of time helping the seller to solve the problems that induced him to sell in the first place. You have asked appropriate questions, and you have listened attentively to the answers. You have charted and reviewed the financial ramifications of the purchase. You have proposed alternative solutions, and then revised those proposals to better suit the needs of the seller.

At this final stage of the negotiations, it is now time for the seller to help solve your problem. Your problem, of course, is the gap in the purchase terms between what makes economic sense for you and what the seller feels makes economic sense for him.

The first step in soliciting the seller's help is to share your problem with him. Identify it as a problem. Show why you cannot exceed the offer you have finally made. Ask for his agreement step-by-step as you review the "number-crunching" process that led to your offer.

"Did I do that right?" "If I understood you correctly, you said such-and-such. Is that right?" "If I extend the monthly negative cash flow over the term of the loan, I'll be out X dollars in cash. Do you see how I got that?" If the seller logically agrees with you on each of the steps that contributed to your final offer, it becomes somewhat indefensible for him to reject the summary of those contributions.

Share your problem. Don't just say "no" to his price and terms. Show him why you must say no, and directly request his personal help in leaping this one final hurdle on the way to a transaction that will permit both parties to place their problems in perspective, as well as in the past.

4.11 APPLYING THE WIN/WIN PHILOSOPHY IN NEGOTIATION

"Win/win" is not simply a catch-phrase or a moral theme; it is a tested and proven operational philosophy for generating extraordinary financial returns from a particular method of real estate investment. In order for those returns to be maximized, it is necessary that both parties do, in fact, come out as winners when the negotiations are concluded.

Win/win transactions appeal to both parties. Hostile feelings and defensiveness are neutralized. The probability of acting hastily--out of emotion--is greatly reduced when the greed-related decision-making of a win/lose transaction is eliminated.

Win/win negotiating is tension-free. It is a process of mutual investigation, not confrontation.

Consider the case of Tom and Helen P. as they were negotiating the purchase of the single-family rental. When the negotiating process took place, all three of the parties sat down at a table and attempted to solve each of the other's problems. As a result, the negotiation process was one of cooperation and not confrontation.

Win/win negotiating does involve preparation, however, and it carries with it the necessity of predetermining what winning and losing mean. It also involves negotiating with a truly flexible seller. "Winning" is a relative term. While it is necessary for both you and your negotiating counterpart to emerge as victors, "victory" for a legitimate flexible seller is usually proportionately less than "victory" for an unmotivated, at-the-market seller.

When you find a property that fits your objectives, and it appears that a win/win transaction is a real possibility, approach the opportunity with purpose and enthusiasm.

"Every man takes care that his neighbor shall not cheat him," said Ralph Waldo Emerson. "But a day comes when he begins to care that he not cheat his neighbor. Then all goes well. He has changed his market-cart into a chariot of the sun."

As you move forward with your win/win strategy, remember these indispensable keys: deal only with a flexible seller, enter the negotiations in the role of problem solver who has the ability to deal with the seller's needs and anxieties, find out exactly what the seller's problems are, and then select those *alternative solutions that will cause both you and the seller to win.*

It's a simply formula, but it can work miracles.

4.12 HOW WELL HAVE YOU LEARNED?

The better you have learned the information and concepts in this unit, the more successfully you will be able to apply them. Test your learning by answering the following questions. <u>Do not skip this step</u>--the best way to help the information stay in your head is to reprocess it through your fingertips!

(NOTE: If you are uncertain of a particular answer, look back through the unit. The answers to all the questions can be found in the preceding pages of the unit.)

1. Whom should you authorize to negotiate in your behalf? Why?
2. Name the five variables in negotiation.
3. What is the key characteristic you must find in a buyer in order to conclude a successful transaction? Why?
4. Who should do most of the talking during negotiation? Why?
5. How do you determine which questions to ask during negotiation?
6. Why is a "don't-carer" buyer as important as a "flexible" seller?
7. Why should you work so hard to protect the seller's interests?
8. Why is it important to establish a powerful personal relationship with the seller?
9. Why do you need to quantify your investment return?
10. What role does silence play in negotiation?
11. Is it wise to use complex terminology in negotiation? Why?
12. At what point(s) in the negotiation process should you remind the seller of his problems (his reasons for selling)? Why?
13. How can it benefit the negotiation process to calculate figures in front of the seller?
14. Name a few non-threatening strategies you can use to help a seller understand your terms.
15. By what method can you clearly evaluate a deal, starting by drawing a line down the center of a piece of paper? Explain the process step by step.

16. List three ways you can negotiate with a real estate-conscious seller.
17. List three ways you can negotiate with a debt-conscious seller.
18. List three ways you can negotiate with a security-conscious seller.
19. List three ways you can negotiate with an investment-conscious seller.
20. List three ways you can negotiate with a tax-conscious seller.
21. How can you respond successfully to a seller who needs monthly income?
22. List five common reasons for seller flexibility, and explain how to turn each to your advantage.
23. What three tactics can you use when all else fails?
24. Why is it said that the most creative part of win/win negotiating occurs after you finish your research on a property or a buyer?
25. Make up a sample list of goals from which to negotiate on an older, single-family residence on a street that's turning commercial in character.

4.13 PUTTING IT ALL INTO PRACTICE

When the book learning is over and all is said and done, the surgeon must still perform his first appendectomy, the barber his first haircut. And you must conduct your first negotiating session. On-the-job training is still the best, and your turn has come.

How can you learn to negotiate without taking the risk of moving ahead before you know the entire creative-financing approach? The answer is incredibly simple. Do the following assignments, <u>and do nothing more.</u> We are not asking you to actually buy real estate. We are asking you to go through a few negotiating sessions, just to see how the process works. Those of you who are already experienced real estate investors can use the opportunity to polish your skills and add to your arsenal of techniques.

What if you happen to find that once-in-a-lifetime deal while you're practicing? Don't let it slip between your fingers--but don't do something you're not ready for! Find a local investment group and get an experienced person to help you analyze the property and the outcome of the negotiations. Better still, call High Touch and speak with an expert about your concerns. If it really is a hot buy, get an experienced partner to purchase it with you as a joint venture. Or, you might offer the property to someone else, in exchange for a finder's fee.

In the meantime, go ahead with your assignments. You need not do all the assignments listed; select those that will be most helpful to you in your own circumstances. But don't skimp on your efforts. You'll only be hurting yourself.

1. <u>Get a copy of your local classified advertisements and find some prospects.</u> With a red felt-tip pen, circle all the single-family homes or small commercial buildings that are for sale by owner, particularly if the ad indicates that the seller is anxious to sell. Watch for "low down," "fix-up special," or "leaving town"; there are many other phrases that should alert you to possible seller flexibility. Virtually every ad that specifies a down payment of $2,000 or less will be a good prospect.

2. <u>Choose the five most promising ads.</u> Eliminate all but five of the properties, based on your own criteria. Maybe you don't want to own a former laundromat, or perhaps the south side of town is not what you have in mind. Made a list of your criteria, and use your own list to eliminate all but five of the ads.

3. <u>Investigate the properties.</u> Begin by driving by the five properties. Are they appealing? What is the neighborhood like? What kind of people live in the neighborhood? What's the current zoning? Does the town have an area plan that may change that zoning in the near future? Would the change be to your advantage? Find out enough about each property to intelligently decide whether you want to keep pursuing it.

4. <u>Narrow your choice to two properties.</u> Keep asking questions, and don't be afraid to get into detail. Interview neighbors, officials at city hall, and area Realtors to uncover everything you can about the properties. Narrow your choice to two of the properties.

5. <u>Arrange for an interview with the owner of each</u>

property. Call the owner of each property and explain that you are interested in talking to him about the property. Set a specific time and date; remember to allow yourself plenty of time for the interview.

6. Do your homework. The day before the scheduled interview, read through this unit again, using a yellow marker to highlight information that's important to you. Then make a checklist of everything you want to find out about the property. Clamp it boldly to a clipboard and approach the interview with confidence. Remember, the seller invited you to come by virtue of his ad in the paper!

7. Conduct the interview. You are a welcome guest, but remember: your seller will probably be a little nervous. Start out by establishing a rapport and putting him at ease. Take your time; there's no hurry. Ask the questions about the property directly from your checklist; if the seller seems impatient, apologize for the time you are taking but point out that each property has unique characteristics, and you want to be certain you make the right choice.

Find out why the seller is selling--and try to get to the real reasons. If you have a truly flexible seller on your hands, he will probably have some very definite problems that he hopes to solve by selling his property. Make note of them in writing at the bottom of your checklist.

Conduct this same interview with the owner of the second property you have selected. Do not make any offers; remember, you are just practicing for now. If the owner seems anxious, tell him you are looking at a number of properties, and are in the process of assessing each for potential purchase.

8. Identify solutions to the sellers' problems. In the privacy of your own home of office, go over the questions you asked and review your assessment of each owner's problems. Using a separate sheet of paper for each property, draw a line down the center of the piece of paper. On the left side, write each problem the seller has. On the right side, list three or four ways you could solve that problem. Use this unit to spark your imagination, and

think of your own creative solutions in addition.

9. Conduct an imaginary negotiation. With your problem/solution sheet in hand, begin an imaginary negotiation session--starring you as your own "devil's advocate!" First, write what you would offer the seller. Next, jot down what you think his objections would be. Then come up with new terms or perspectives that would soothe his objections. Continue this process until you can't think of any more reasons why a seller would balk at your offer. Congratulations--you're on your way!

4.14 THE TEN MOST ASKED QUESTIONS ABOUT NEGOTIATION

The following questions are among those most frequently asked by clients of High Touch. If you have additional questions, don't hesitate to call your mentor.

1. "Thinking about negotiation really makes me nervous. I'm afraid I won't be quick enough to come up with the next line in what must be rapid-fire succession. How can I prepare for negotiation?"

The kind of negotiation that is most successful in real estate is not the kind of rapid-fire exchange that you see between seasoned attorneys in exaggerated television dramas. In fact, it's best to take your time. Why? The seller will come into the negotiation feeling a little nervous and anxious. You'll be miles ahead if you do whatever you can to ease that tension--including establishing some personal rapport. You may find that the best use of your first session is to get acquainted and become friends--and save the negotiation for a later session.

2. "You mention saving the negotiation for 'a later session.' Shouldn't all of the negotiation take place in one session to avoid losing steam?"

Not at all. Unless you're looking at a once-in-a-century deal, you want to take your time and let the seller take his. If you feel it appropriate to propose an offer and then let the seller take some time to consider it, go ahead. No rule says you have to start and finish in the same session.

3. "It's difficult for me to imagine making friends with a prospective seller that I scarcely know. Why is it so important to make friends?"

The success of your negotiation process is going to depend on how well you can solve the seller's problems. He will hesitate to share those problems with you unless he feels that you are his friend. There's another reason why it's important to be friendly: a seller would much rather deal with someone who is genuine, likable, and easy-going than with someone who is abrupt and harsh.

4. "I've tried negotiating before,but the sellers I've worked with don't seem to want to negotiate. What am I doing wrong?"

You may not be taking the time to find truly flexible sellers. A flexible seller is extremely anxious to sell his property, and he is willing to do whatever it takes to get it sold--including going through negotiations. Someone who is <u>not</u> a flexible seller can afford to stay firm on price and terms--and he probably isn't interested in hearing any other offers.

5. "How can I identify a flexible seller so that my negotiation will have the greatest chance at success?"

Start out by asking the obvious: "Why are you selling your property?" Go from there. Probe. A seller who is casually interested in getting rid of his property so he can use the money to invest in another property won't be nearly as motivated as a seller who is facing bankruptcy unless he comes up with some immediate cash. Review the unit on finding properties for complete instructions on identifying flexible sellers.

6. "I'm terrified of the prospect of lengthy silences--I'm afraid I won't be able to keep things moving. How can I prepare in advance so I can avoid those silences?"

Don't! Silences can--and <u>do</u>--work to your advantage in negotiation. By staying silent, you force the seller to keep talking--and the more he talks, the more you learn and the closer you get to concessions.

7. I've always been taught that I should come out ahead in negotiations if I want to be a success. The win/win philosophy seems to be at odds with that. Which is right?"

According to the win/win philosophy, both parties come out ahead. How is that possible? You achieve your goal (you acquire a desirable property), and the seller achieves his (he achieves a fair and effective solution to his problems). Nothing could be more successful than that! It is possible for both parties in negotiation to come out ahead at the same time.

8. "What if I've done everything I can think of and the seller still won't budge? What then?"

There are two different answers to that. There are several tactics you can use as a last resort; to learn more about those tactics, review this unit carefully. But there's something else: you don't have to buy this particular property. It may be appealing to you, and you may be convinced that it will fit perfectly into your portfolio, but if you cannot negotiate a win/win deal, walk away. It's as simple as that. If a seller isn't automatically flexible, no amount of negotiation will turn him into one.

9. "I've found that when I negotiate with sellers who are not experienced in real estate, the negotiation isn't as successful. What am I doing wrong?"

There's probably a very simple answer: the seller probably doesn't understand you. You may be using terms that are foreign to him; you may be proposing solutions he has never heard of before. Take your time. Go slowly. Stop often to ask, "Am I making myself clear? It might be easier if I sketched out an illustration of what I'm proposing, because it can get very confusing." Don't be patronizing--but realize that you need to communicate with great clarity if you are to be successful at negotiating. Take time to teach--but don't talk down.

10. "Why is negotiation so important?"

It is probably the single most important step in buying investment properties. Why? When you approach a seller, there is a wide gap between your desires and his. You want a property at a great price and at great terms, and so does he--only on the opposite end of the spectrum! Negotiation is the process by which you narrow that gap until the two of you meet in a mutually beneficial deal. You get your great price and terms, and the seller gets more than he bargained for--he gets a solution to his problems. Everyone wins!

UNIT FIVE

CREATIVE FINANCE

UNIT FIVE

CREATIVE FINANCE

5.1 GENERAL CONSIDERATIONS

What really separates the sheep from the goats in real estate investing is the skill of putting financial deals together in creative ways. The nickname for this skill is "creative finance."

The term "creative finance" has been used so often in so many different contexts that it has taken on the aura of a cliché. Our purpose here is to attempt to define the term in practical, down-to-earth ways that will demystify what is, after all, a very learnable skill, i.e., putting profitable deals together so that everyone wins.

Ask the man on the street what "creative finance" means and you will get a variety of answers:

- clever ways of coming up with cash

- innovative solutions for bridging the gap in making deals

- "cookie cutter" formulas that can be repeated over and over again in order to buy and sell assets successfully

- sneaky deals à la Donald Trump, etc.

Let us take a very different approach to defining "creative finance," i.e., not as a fixed action or thing, but rather in terms of ranges, or rather a series of points moving along a range of options that relate to certain financing issues.

AN ILLUSTRATION

Let us take one of those issues in order to illustrate what we mean. If we want to purchase an asset or a property using the time-honored approach of "cash on the barrel," then we settle on a price with the seller and reach into our pocket and give him/her the agreed-upon value in the form of currency. That enables us to walk away with the property or asset and call it our own. We are happy, assuming the thing we have purchased is what the owner has represented it to be; and the owner is happy because he has his money.

Creative finance? Not in the least. This is the most ordinary, mainstream, garden-variety financing in the world.

However, what happens if we don't have the money it will take to buy the property or asset, but still really want it? Then we must turn to our creativity in order to consummate the deal. Where will we get the money from? Suppose we have a friend with plenty of money and a willingness to share with us the thing we want to buy. If we now bring our friend to the negotiations and say to the seller:

> "Mr. Seller, I want to purchase your property for the price we have agreed upon, and I have a friend here who will put up the money."

Will the seller object to that? Not if the money is bona fide currency. Thus you and your friend can walk off with the property or asset, share it according to your arrangement, and everyone is happy.

Especially you, because you didn't put up a dime--and still get to use the property. You have just used *creative finance* to close a deal.

The issue here is one of several that go to define "creative finance." In this case we are asking, "Who will put up the finances?" In our example, your partner put up all the financial resources. But it is possible that you could have put up some and he/she could have put up some--a combination of shared investment.

Maybe you put up *half* and your partner puts up *half*. Or maybe you put up a *fourth* and your partner puts up *three-fourths*. Or maybe you put up 37.681 per cent and your partner puts up 62.319 per cent. Whatever! It's a matter of mutual agreement. That kind of arrangement makes it clear that we are talking about a *range* of options all relating the issue of *who puts up the finances to close the deal*.

From your perspective, the range covers all the possibilities from your putting up <u>all</u> the consideration (hardly creative) to your putting up *none* of the consideration (highly creative)--plus every possible combination in between.

Let's look at this range in graphic form:

Issue: "Who puts up the finances?"

YOU..SOMEONE ELSE
(COMBINATIONS)

Think of the answer to the question about the source of financing as a dot that ranges along this line. The further the dot moves along the line, the higher the level of creative finance; the more the dot tends to stay close to the beginning point, the lower the dot falls along this line the lower the level of creative finance.

Thus, in the case of this illustrative issue, we can define "creative finance" as a financing arrangement in which the maximum share of the invested finances comes from *other people* rather than from *yourself*. The more you can induce others to pay, the more creative the deal. The better you are at structuring financial arrangements in which your input is minimized and the use of other people's money is maximized, in the context of everyone winning, the more "creative" you are at financing.

5.2 THE MAJOR FACTORS OF CREATIVE FINANCE

There are at least seven other major factors that figure into the process of creative financing. Here is a listing of these issues, including the issue of OPM (Other People's Money) that we have just discussed. Each of these issues generates a range of options that can serve to define more fully the nature of creative finance from the standpoint of the results it brings:

M 1. AT WHAT PRICE?

Range: from high above the market to high below the market

Commentary: all other things being equal, you are going to be looking for a price as far below the market as possible. It doesn't take a lot of additional creativity in a deal if you can get it at 30% or 40% below the market. That may well be "creative" enough, because you pick up a big chunk of equity as the outset, before anything else happens.

M 2. USING WHOSE FINANCIAL RESOURCES TO BUY?

Range: from our own resources to other people's resources

Commentary: as we have already explained, if there must be money put into a deal, then let it be someone else's money. This is especially true if you don't *have* any money! Sometimes circumstances constrain you to be creative in this sense. A lot of deals are creative because they have to be!

M 3. HOW SOFT OR HARD ARE THE "OTHER PEOPLE" INVOLVED?

Range: from bankers to partners to sellers, i.e., from hard to soft

Commentary: it's one thing to depend on other people's money; it's another to make sure you are dealing with the right kind of "other people." The terms "hard" and "soft" are ways to characterize "other people" by how tough they are with the terms of the deal. Typically bankers and institutional lenders are more conservative and demanding when it comes to the terms of their involvement. They want to check you out and force you to pass through their fine qualifications filter before they will let you have their money. They want to charge you as high an interest rate as possible (especially the "finance institutions" of the type that specialize in second-mortgages), and they watch you like a hawk to make sure that you pay every penny back on time. That's why they are characterized as "hard money" lenders.

Alternately, sellers can be "soft," i.e., they might be willing to play banker for you without any scrutiny, credit checks, or behind-the-scenes detective work.

The more anxious the seller is to sell, the more willing he/she might be to carry back a portion of the equity in the form of a note. That's why sellers are at the high end of the creativity scale. Generally the more creative the investor, the more he/she will push for seller involvement with the financing.

Partners occupy a somewhat intermediate position on this scale. They have to be courted, like the hard-money people, but they may be more flexible and willing to deal by qualifying the deal more than the person. Still, they are not as soft as the seller, because they are going to want their pound of flesh in a timely manner. They are going to watch the pot boil to make sure they get their just dues.

M 4. WITH WHAT SIZE OF DOWN PAYMENT?

Range: from 100% of the value up to 0% of the value

Commentary: with creative finance you throw out the traditional down-payment rules and negotiate what will get the deal done in a win-win fashion. Naturally, you have to do this in the context of the numbers, since "nothing down" deals are a dime a dozen if you are willing to buy into "alligators" with high negative cash flows. The trick is to get away with the minimum input of capital and *still* have positive cash flow.

Some people with unlimited resources or well-heeled partners will argue that the *best* way is to pay all cash and force high front-end discounts. They give up down-payment creativity in favor of discount creativity. You can't argue with them--unless you are broke and have to fall back on low-down deals in order to survive. We'll have more to say about this below.

M 5. WHEN IS THE DOWN PAYMENT DUE?

Range: from way before the deal is closed to way after the deal is closed

Commentary: all other things being equal, you may want to put off the inevitable as long as possible. You may even want to take the down payment and spread it out over the initial period *after* the deal is closed so that it never bites you too hard--assuming the seller will let you get away with it. Creative deals sometimes have to be structured around down-payment flexibility. The trick is to realize that there *can be* flexibility in such cases. Sometimes all you need to do is ask. In the "asking" is the creative energy!

M 6. IN WHAT FORM OF CONSIDERATION?

Range: from cash to property to secured paper to unsecured paper

Commentary: the further away from cash, the more creative. What if your seller is willing to take some personal property in lieu of cash? What if he/she won't take property but will take a note secured by property (such as real estate)? What if the seller doesn't insist on the note being secured, and just takes a piece of paper with your promise on it (i.e., an unsecured note)? All of these possibilities form a sequence from less creative to more creative. If you don't ask, the assumption is "Give me cash." But if you ask creatively, you can sometimes get away with "murder" and still have a win-win deal.

M 7. AT WHAT RATE OF INTEREST ON THE UNPAID BALANCE?

Range: from way above the market to way below the market

Commentary: often this factor is tied in with other creativity factors in the deal. If you don't get your way with one of the other factors, you might insist on forcing the interest rate down (and hence the "creativity" up). Alternately, if you want to force your hand with one of the other factors, you might choose to yield on the interest-rate factor. This may make you seen to be less creative with respect to it, but you will get even on one or more of the others! More of this later.

M 8. FOR WHAT REPAYMENT TERM?

Range: from long-term to short-term

Commentary: all other things being equal, the longer you can postpone the repayment, the better. The reason for this has to do with the time value of money. The longer you have your money in your own clutches, the more you can put it to work for you. The moment you pass it on to the seller, you lose the option of putting it to work for you. Naturally, this has to be counterbalanced against the *cost* of borrowing it from the seller.

In each of these eight ranges, creative finance can be defined as a point along the line defining the range: the further the point moves along the line, the more "creative" the deal you have put together.

5.3 CREATIVE FINANCE SCORE CARD

Let's put our findings in the form of a chart summarizing the eight scales we have used. Let us give our ranges a span of five points for the sake of relative comparison. What we are doing is separating "creative finance" into its constituent parts in order to gain a better understanding in how deals are put together. This is called the *analytical* approach. Later on we will talk about creative finance in terms of a *synthetic* approach where we see how combinations of factors add up to optimum results.

Each deal is a little different, with different sets of demands and needs. We are attempting to set up a way to

"keep score" in the game of creative finance, to measure the degree of creativity needed in order to put deals together.

A HYPOTHETICAL CASE STUDY

Let us suppose, for example, that you want to purchase a valuable painting and are able to structure an arrangement according to the criteria listed above, with the following details. How creative is your deal?

M 1. AT WHAT PRICE?

You are able to negotiate a price that is 50% below the market for the painting in question. Thus, *whatever* financing source you come up with, you are already 50% ahead of the game. Since 50% below the market can be considered a very unusual opportunity, your creativity shoots to the top of the range in this case.

M 2. USING WHOSE FINANCIAL RESOURCES TO BUY?

You are able to set up an arrangement where little or none of your own resources are to be put into the deal, hence your creativity along this scale also rises to a point close to the top.

M 3. HOW HARD OR SOFT ARE THE "OTHER PEOPLE" INVOLVED?

Now, *who* your participating partner is in the deal is very important from the standpoint of creativity. Let us take the position that the most desirable partner is the seller himself; the next most desirable partner would be one or more non-institutional investors or participants within your circle of acquaintance; and the least desirable source would consist of the hard-money lenders. The reasons for this judgment are fairly obvious: sellers who serve as bankers usually don't require involved credit checks or approvals by august high-level committees; non-institutional partners, while usually requiring a good piece of the action are still easier to work with than the hard-money lenders.

Let us suppose in our illustration that you are able to induce the seller himself to finance the purchase of the painting. Thus your "creativity" stock rises upward along the vertical line toward the top, since this kind of financial arrangement is perhaps the least "mainstream" option you have.

M 4. WITH WHAT SIZE OF DOWN PAYMENT?

Let us suppose your seller insists on at least 5% down, despite all of your creative badgering. Your creativity in this regard does not go completely to the top, but at least it approaches maximum.

M 5. WHEN IS THE DOWN PAYMENT DUE?

The good news is that you ask your seller to allow you to delay payment of your 5% down payment for six months--and much to your surprise he agrees! This is not "much later," as indicated on the payment-due scale, but at least it carries you upward toward the top.

M 6. IN WHAT FORM OF CONSIDERATION?

You talk your seller into letting you take care of your payment obligation in the form of an unsecured note that provides for monthly payments. Thus your "creativity" in this regard is high.

M 7. AT WHAT RATE OF INTEREST ON THE UNPAID BALANCE?

You work hard to come to terms on this issue, but find that your seller simply won't go lower than market rate. Your creativity in this regard is only moderate, but at least you got him to come off his initial insistence that you pay him several points above the market due to the fact that you were giving him an unsecured note.

M 8. FOR WHAT REPAYMENT TERM?

When it came to this issue, you were somewhat embarrassed to
ask your seller for ten years to service the note. Much to your amazement, he accepted. Thus your creativity on this scale rises to the top.

Now, if we take our hypothetical example and assign a score for each of these eight ranges of creativity, you can come up with a chart

From your chart it is apparent that your deal was, on the whole, very creative indeed. You bought a valuable asset at 50% below the market (1) without a dime of your own money (2). In fact your "banker" was the seller himself (3), who was satisfied with only a modest down payment (4) delayed for a full six months (5). Your payment was to be in the form of an unsecured note (6) no higher than market rates (7), with a long term for fulfillment (8).

Not bad! If we assigned an actual comparative score to this transaction, then you would have scored 5, 5, 5, 4.5, 4, 5, 3, 5 for a total of 36.5 out of a possible 40 points. This works out to 91.3%--which would give you an "A" in a creative financing course at college.

Compare this with the fellow who might have walked in with a pocket full of money and simply plunked down the equivalent of the full market price for the painting. He would flunk our course outright!

5.4 TRICKS OF THE TRADE

"But," you say, "is there not something missing? Where are the neat little tricks and innovative twists that I often associate with so-called 'creative financing'? Where are the brilliant flashes of intuition that get over the hurdles and around the obstacles?"

Good point. Our little illustration gives only the highlights and doesn't let us in on any of the behind-the-scenes intrigue that we like to imagine as the fabric of creative finance. Okay, have it your way. Let us fantasize a little and hypothesize what might have contributed to the creative facilitation of this deal.

What will surprise you is that you really only need one major "trick" to make creative finance work in your favor, the trick of *tradeoff.* In other words, most of your bargaining power comes from *within* our range in the form of yielding on some issues in order to gain on others that may be more important to you. Your seller is really not fully aware of your tolerance levels with respect to the eight issues included in our lineup. He/she does not know which of the issues is critically important to you on the basis of your circumstances.

For example, what if you are flat broke and therefore you *must* have your way with respect to the second issue (OPM). You simply have no choice but to look to the resources of others to swing the deal. Furthermore, what if you have poor credit and no partners to step in from behind the scenes, and thus the OPM you must turn to is the seller himself. How can you assure yourself that the seller will finance the deal?

Easy. You give up something in one of the other categories of less importance to you than that. For example, you might yield on price, even giving the seller *above*-market consideration for the asset you are purchasing. Or you might give the seller a higher interest rate that you would normally tolerate.

Alternately, you might yield on the form of payment. For example, if the seller demands some form of down payment so that your neck is on the line, but you don't have cash to give him/her, then you might consider property, i.e., personal property instead. You could give up a car, boat, horse, or whatever else you might have that would satisfy the need. Moreover, if you are offering a secured note as the instrument of payment for the obligation, you could *increase* the security on the note in exchange for the OPM/Seller Finance issue.

For example, if it is real estate you are purchasing, you could secure the note not only with the subject property as collateral, but with other properties you might already own. The technical term for this creative technique is "the blanket mortgage," because it covers two or more properties at once and thus increased the collateral of the seller and therefore the trust and tolerance factor.

To use a further example, suppose you have plenty of your own money to use in a deal, or at least access to plenty of money through partners, but you are very keen on price. In that case, you might yield on the second and third categories and focus on what is more important to you: *price*. Your hot button is to acquire the asset at a price that is far below the market so that you will be picking up great amounts of equity right from the start. Here you can yield on some other issue, such as the form of payment, in order to get what you want.

The name of this game is "cash talks." Rather than exerting your creative muscle to pay in the form of non-cash resources, carry-back notes, etc., you simply reach in your pocket (or your partner's pocket) and pull out *cash*. But you insist on lowering the price in exchange for giving up that cash in the deal.

5.5 THE BIG SECRET

By now you know the big secret about creative finance: i.e., *there is no big secret*. It really amounts to mixing and matching your options within the range grid we have outlined. Creative finance means being creative in *how* you mix these options in keeping with your own circumstances.

Your motto is: "You win some battles and you lose some battles, but you *always* win the war." In other words, you are purposely uncreative in some categories in order to be creative over all and bring home the bacon.

Does that make sense?

5.6 CREATIVE FOOTNOTES

Now, having covered that point, we hasten to add that the whole world of creative finance is not covered by our simple chart. There is much room for your own creative thoughts and strategies outside this chart. You will learn how to add other categories and tricks that harmonize with your own style and needs.

For example, what if your interest in *not* to acquire an asset immediately but only to get *control* of it for a time. Then your creativity will suggest to you getting an "option" on the asset. In real estate or business acquisition, it is possible to tie up an asset with an option that gives you a chance either to find another buyer who will give you consideration for your option, or to find the financing to buy the property outright. In any case, the proper instrument in this case is the option instrument, or the lease-option. You don't purchase for the time being, you just control.

Furthermore, you will become very adept at facilitating creative deals by offering things that are out of the ordinary. If security is a big thing with a given seller whom you are approaching on a seller-carry-back basis, then it might occur to you to take out an insurance policy in the name of the seller in order to add security to the deal. If you are short on cash and personal property to put into a deal, then you might use your credit to buy something on time that the seller wants as part of the consideration. Or you might take over an obligation of the seller on another of his assets and shift the credit back to the asset you are interested in buying. If you don't want to refinance a target property as part of a purchase, you can use a "wrap-around" mortgage or contract instrument to purchase it, etc.

Where do such facilitative ideas come from? Your creative brain--encouraged by the circumstances you find yourself in. Often the choice of trade-off is dictated by your circumstances--thus there is no creativity about such choices. You take a certain approach because you *must* take it. The creativity comes in mixing and matching the trade-off parameters.

In fact, virtually all of the so-called "cookie cutter" techniques are rooted in our creative finance grid, sweetened by small creative gestures along the way to grease the skids. In our next section, we'll turn to some of those cookie cutter techniques to show you how they can be used.

5.7 SIX UNIVERSAL CREATIVE FINANCE COOKIE CUTTERS

Let us discuss six of the "classic" creative finance techniques that everyone needs to have in his/her arsenal of strategies. As we discuss these techniques, we will refer to our creative finance chart to see where a given technique fits in.

5.71 THE ULTIMATE PAPER OUT

Every investor has a secret desire to trot into a deal and trot out with a valuable asset *without putting anything down.* Naturally, in the case of an income-producing asset, this desire includes no negative cash flow

Are such deals possible? Yes. All the time. Ask any veteran who has used his benefits to purchase a house for nothing down (here the "negative" cash flow is tolerable because it amounts to rent).

Such deals are even possible for the real estate investor--if he/she is willing to look around to find the ultimately flexible seller.

Let's suppose we can find a flexible seller who is willing to carry back paper on a property in order to facilitate the sale. He is not willing to discount the price, so we cannot be creative in that regard. But he is willing to take on the role of banker.

Why would a seller be flexible in this regard? Perhaps his property has been on the market for a long time and he is weary of the hassle of trying to get it sold. Perhaps he has a large portfolio and needs to reduce a tax burden. Perhaps he is just a philanthropic old gentlemen who wants to help us out! For whatever reason, he is willing to carry back.

If the carry-back is for 100% of the seller's equity, then we have a so-called classic "Ultimate Paper Out." Very likely the seller will demand and get his full price. Possibly he will also insist on a fairly high interest rate. And perhaps he will want a balloon payment in the short term (three to five years).

You may even have to "sweeten" the deal by offering a blanket mortgage to increase the security for a time. Perhaps you will have to purchase an insurance policy on your own life, with the seller as beneficiary, in order to get the deal closed.

All of these inducements and sweeteners don't really matter to you. You do what it takes to close the deal and take advantage of the one creative factor that really matters to you: *nothing down*.

Naturally, you will have done your homework by assembling good evidence that the property will likely hold its value or even appreciate in time to come in and solve the balloon problem. Naturally you will have looked into the bottom line to assure yourself that you will have positive cash flow despite the 100% financing on the property.

On your creativity chart for the Ultimate Paper Out, we will note that the price may be at the market level or even somewhat above (score 3 or lower). Who pays will be OPM (other people's money--score 1). Hard or soft will be the seller (score 1). How much down will be zero (score 1). When due will be a moot point in this case (there is no day of reckoning--score 1)!. Form of pay will be secured note (score 4). The interest rate will probably be at market levels or somewhat higher (score 3). And the term will likely be intermediate and perhaps somewhat shorter (score 3).

5.72 BLANKET MORTGAGE

In the "Ultimate Paper Out" we mentioned the possibility of cementing the deal with a "Blanket Mortgage." Let's go back and analyze what that means in terms of our creativity grid. The Blanket Mortgage is really an inducement technique that falls under the "Form Of Payment" column in our creativity chart. The logic of it is quite simple, especially in a nothing down deal.

The seller in a 100% carry-back situation will say to himself: "Why should I let this investor take over my property with nothing down? If his head is not on the block, then he may not follow through. With nothing invested, he has nothing to lose."

There is a compelling logic to this conclusion. A nothing down investor may really *not* have much to lose in just walking away from a deal that isn't going his way. Hence security becomes an issue for the seller.

How can you increase the seller's security and still take advantage of a nothing down deal? The answer has to do with the nature of a secured
note. A mortgage is really a combination of two interlocking instruments: a promissory note and a collateral agreement. In

essence, the note memorializes your promise to pay a certain sum of money according to agreed-upon terms. The collateral agreement pledges something of value to back up your promise. If you don't perform on the note as

promised, then you allow the holder of the note to take over the property (collateral) you have pledged.

In most real estate transactions, the collateral is in fact the subject property itself that is being purchased. If the seller turns over a property to you then you give back a trust deed note (or mortgage note) plus a security agreement pledging the subject property as collateral.

But what if you pledged *more* than the subject property? What if you secured your note with the subject property *plus* something else of value, such as another property you own? If you offer more security in this way then you are setting up a "Blanket Mortgage" or "Blanket Trust Deed" situation.

Why would you want to do this? To help the seller overcome his security doubts in a nothing-down situation. The Blanket Mortgage is a financing technique that is analogous to a "security blanket" for the seller. You say to him: "I'll give you a security blanket if you give me a nothing down deal."

Naturally you will want to include in your Blanket Mortgage Agreement a provision to release the second property as collateral in the event you perform on your agreement for a specified period of time. Let's say if you make all of your payments for a year in a timely way and keep the property in good condition then the additional collateral can be released. In a year's time, the value of the subject property may well have increased in value anyway, thus increasing the seller's security.

The "Blanket Mortgage" creativity chart will look just like the chart for the "Ultimate Paper Out." The variation is that you will be using an additional property as collateral for the secured note.

5.73 SECOND MORTGAGE CRANK

The term "crank" is an old creative finance term that implies pulling money out of a property at closing, or "cranking" money out of a property in order to close a deal.

In order to crank money in this way, there must be considerable equity in a property. In fact, the "Second Mortgage Crank" can only work well if the financing on a property is 25% or less. Where there is 75% equity in a property, the parties to a transaction can use their creativity to arrange a win-win deal.

How does it work?

What is important to the seller is to get a lot of his equity converted to cash. What is important to the buyer is to get into the deal with little or none of his own money. Thus the buyer will probably have to yield on price and terms in order to get "creative" with the source of the funds to buy the property.

There are two variations:

A. SELLER REFINANCE

In this case, the seller, in order to facilitate the sale, agrees to refinance the property himself with around a 75% - 80% new loan, pay off the existing loan (which should not exceed 25% of the value of the property), and take the balance of the refinance proceeds in the form of cash. The buyer then gives the seller a second trust deed (or second mortgage in some states) for the remaining portion of the equity. Thus the buyer gets in for nothing down.

Again, there may need to be inducements like a "Blanket Mortgage" for the carry back portion of the deal, or an insurance policy with the seller as beneficiary. Or the price of the property or the interest rate on the second may need to be generous for the seller.

The key is for the buyer to creative *where it counts.*

Why would a seller go to the trouble to refinance the property himself and "cranking" out his own proceeds? Perhaps he has had difficulty selling the property and needs to do something special to get rid of it. Perhaps he is tempted by a price that is generous, or perhaps the buyer pays back a bonus when the second is paid off. With some clever negotiating, such deals can be put together.

B. THE "CLASSIC" SECOND MORTGAGE CRANK

With this variation, the buyer takes out a new loan on the property, pays off the existing loan, and gives the proceeds to the seller. The down payment (which is always essential in a new hard-money loan that is part of a purchase) comes in the form of a note that the buyer executes in favor of the seller, using another property as collateral. In other words, there is no second trust deed (or second mortgage) on the subject property; rather, the buyer has paid for the remaining equity in the form of a note--which does indeed have value.

The seller does indeed receive consideration for his remaining equity, but it is not in the form of cash. It is in the form of a note secured by another property. Thus there is no secondary financing on the subject property--just the new first trust deed (or mortgage).

What is the catch? No catch. Just the need to find a lender that will be willing to arrange for such a transaction. What if the lender wants proof that the down payment part of the transaction has really come out of the buyer's pocket. In that case, the lender may require the seller to sign a "verification of deposit" stating that the seller has received consideration for his equity in the form of an exchange. If the lender is aware of the kind of consideration involved, perhaps he will require that the note by appraised in order to demonstrate that the requisite value in there. It stands to reason that lenders will be more amenable to this kind of creative financing in times when capital is plentiful.

In any case, the money needed to complete the deal has been "cranked" out of the property (in the form of the proceeds of the new loan less the payoff for the old loan). Actually, the remaining proceeds to complete the deal have also been "cranked" out of the secondary property in the form of the exchange. It's like a double crank.

This is the classic form of the Second Mortgage Crank because the seller does not need to do anything except agree to a highly creative deal.

Once more, the buyer is likely to yield on the factors of price, interest rates, terms, etc., in order to get the advantage concerning the source of the capital. Thus the creativity is *selective.*

If you do a chart on, the "Second Mortgage Crank" you will note that the price will probably be at market level or higher (score 3). Who pays will be OPM (score 5). Hard or soft is a mixed bag: hard for the bank (score 1) and soft for the seller (score 5). The average will fall in the middle, so score 3 for this factor. How much down will hopefully be zero (score 1). When due--score 1 again because without any down payment, this point is moot. Form of pay is a secured note (mortgage or trust deed--score 4). Interest rate will probably be at market level or higher (score 3). The term will probably be intermediate or longer (score 3).

5.74 WRAP-AROUND MORTGAGE

What happens during tight-money times when the poor old buyer cannot qualify for a loan in order to buy a property?

There is a powerful variation on the seller-carry back that works well when the underlying loan has a relatively low interest rate and when that loan is assumable.

Let's say the seller has a $100,000 property with a $60,000 mortgage at 8%. The seller's equity is therefore

$40,000. You want to buy this property but cannot qualify for a new loan to buy the seller out. What can you do?

You can give the seller a new mortgage that incorporates the old and a large part of the seller's equity. Let's say you can come up with $10,000 down in cash and give the seller a new mortgage for $90,000 at 10% interest. This new mortgage "wraps" around the old underlying mortgage of $50,000. There is a $40,000 portion of the new mortgage that covers the rest of the seller's equity. We refer to this financing instrument as a "Wrap-Around Mortgage" or "All-Inclusive Trust Deed (AITD)."

Why would a seller carry back such a mortgage? One reason is that he is getting 10% interest not only on the $40,000 portion, but also on the underlying $50,000 portion as well. Thus he gets a 2% "spread" on the underlying portion--which he can put into his pocket until that underlying mortgage has been paid off. Alternately, you may perhaps agree to terms that will require you to pay off the new mortgage before the underlying mortgage comes due. In that case, the proceeds you deliver will pay off the new mortgage and old mortgage at the same time.

Thus you have yielded concerning the interest rate, and possibly the time span, but have gained in the area that is important to you: *who comes up with the money*. True, you probably have to come up with a down payment, but the rest of the equity is financed by the seller himself. And perhaps you can negotiate a price that is below the market. These factors make this deal creative.

How do we score this technique on your creativity chart? Hopefully the price can be somewhat below the market (score 4). Who Pays? Essentially the seller carries back for much of the equity, so score 4 for this part. However, you may have to put something down (score 1). The average will be around 2.5 on the chart for his factor. Hard or soft (score 5). How much down (score perhaps 4 since you may have to put some money down on the deal). When due? Probably at close (score 3). Form of pay? This is a blend of cash for the down payment (score 1) and secured carry back (score 4). The average will be around 2.5 for this factor. The interest rate will likely be at the market level (maybe somewhat higher to induce the sale--score at least 3). The term will likely be intermediate (score 3).

5.75 CREATING PAPER

Few people realize that things can be bought with "paper," but it is true. If you start to build up a portfolio of real estate properties with growing equities, you can begin to take advantage of these assets by using them in cash-less deals.

It works like this: if you find a property that you would like to acquire, you can offer the seller a note as down payment, in lieu of cash. The note can be secured by the equity in one of your other properties.

How do you create paper? You sit down at a typewriter and write out a promissory note. Then you back it up with a security agreement that pledges your real estate as collateral. If you prefer, a title company or attorney can whip this kind of instrument up in no time.

Then you take your note over to the seller and say: "I want your property, and here is a note as down payment." Naturally, the terms of the payments on the note will have to be worked out, just as with any note. And you will have to perform on the note, or else the seller is entitled to take over the collateral for the note.

But the beauty of creating and using paper in this way is that it permits you to buy property without cash (or with less cash). And you can put your portfolio to work while your equities are growing. Furthermore, the subject property is not encumbered with any carry-back financing, thus leaving you free, if you choose, to refinance it, and pull out money for other purposes.

Why would a seller accept a note in lieu of cash? Not all sellers will do this. But an anxious seller, or one who is used to creative financing techniques, might be most willing to engage in this kind of deal-making. It is better to pick up a performing note than not to sell the property at all.

Now you may have to be generous with the price and terms in a paper deal. But you will have your way concerning the form of payment. Thus your creativity is *selective* where it counts.

How will you score this technique? Your price will likely be around the market level (score 3). Who pays? In this case *you* do (score 1); however, you are the softest form of revenue (hence score 5 for hard or soft). Score 4 for down payment. When due? At closing, hence score 3. The form of payment is a secured note (score 4). The interest rate will likely be around the market rate or higher (score at best 3). The term will likely be intermediate (score 3).

5.76 LEASE OPTION

A powerful way to have your cake and eat it, too, is to get control of a property through a Lease With An Option To Purchase.

This is using your "creativity" without even purchasing anything except the *right* to purchase. With the Lease Option you can make use of the subject property under the terms specified in the agreement, plus you have the right to buy the property at a certain price within a certain time frame.

Typically you must pay something for the option (anywhere from a few hundred to a few thousand dollars); however, a portion of the monthly rental fee can be applied to the eventual down payment or purchase price. Thus a lease option is almost like a purchase where the down payment is paid over time. Moreover, the prospective buyer will want to lock in a price that will be advantageous at the time the option is due. It is a gamble, of course, but by locking in the price for one, two, or three years (whatever the term of the option is), he might just be able to get the property at a good discount when the time comes. This would be analogous to a "below market" deal when the purchase goes through.

Why would an owner agree to a Lease Option? It could be that he has had trouble selling it and thus wants to attract a larger prospective audience. Certainly a lease option will make his management burden lighter since the tenant will want to treat the property with the respect due to a future acquisition. The seller also retains the tax advantages of ownership until the option is exercised and the title passes to the new owner. Plus the option money is not taxable until the option is exercised.

All in all, the Lease Option can be good for both parties involved.

Naturally the greatest advantage for the prospective buyer is that he can control the property without having to come up with much cash.

5.8 ASSIGNMENTS

1. Define "Creative Finance."

2. What is the "secret" to Creative Finance?

3. Using your own Creative Finance Score Card, chart out the following techniques:

Ultimate Paper Out
Second Mortgage Crank
Wrap Around Mortgage
Creating Paper

3. What is a "Blanket Mortgage" and when is it useful to include

in a deal?

4. In which kinds of situations is the "Second Mortgage Crank" most viable?

5. What are the benefits to the "Lease Option" technique for both buyer and seller?

6. What is the greatest liability with a pure "nothing down" technique?

PRACTICUM

Contact at least ten sellers and negotiate a financing solution for each property being offered. Use the mix and match approach to arrive at a viable solution.

The "Situation Analysis Matrix" Chart included on the next page may assist you to identify the creative finance techniques that relate most to the circumstances at hand.

SITUATION ANALYSIS MATRIX

SIX UNIVERSAL CREATIVE FINANCE COOKIE CUTTERS
AND WHEN TO USE THEM

1. The Ultimate Paper Out
2. Blanket Mortgage
3. The Second Mortgage Crank
4. Wrap-Around Mortgage
5. Creating Paper
6. Lease Option

CATEGORIES	SITUATION AT HAND	Pro	mar				
		per	ket		1		2
BUYER	You have good credit (or access to it) but no cash right now.	ty	©	1		2	
	You have poor credit.	is	Cop	1			
	You wish to avoid credit checks, qualifying, and closing costs.	list	yrig	1			
	You wish to put down little or no money of your own.	ed	ht	1		2	
	You have absolutely no money to put down.	wit	1994	1			
	You have cash or inheritances to invest.	h	Robe				3
	You need more a little more down payment to make it work.	real	rt G.				
	You own property and want to generate cash down payments.	est	Alle			2	
	You have no property but wish to generate down payments.	ate	n	1			3
	You need to solve a negative cash flow problem.	age					3
	You need to buy a home to live in but have no cash.	nt.					
	You have no equity at all.	Pro		1			
	You have a weak financial statement.	per				2	3
	You have dead equities that you want to put to use.	ty				2	3
	You have real estate equities to use in transactions.	is				2	
	You want to use your equities without selling or refinancing.	off					
	You want to pyramid your assets into bigger properties.	ere				2	3
	You want to sell without incurring tax liabilities now.	d					3
	You have an especially keen market sense.	duri					
		ng					3
SELLER	Seller needs cash down at closing.	"lo					
	Seller with low mortgage needs much of equity in cash.	ose					
	Seller mostly interested in monthly payments.	"		1			
	Seller doesn't need a lot of cash but wants more yield.	ma					
	Seller will use second-trust note in transaction.	rke		1			
	Seller is security conscious and suspicious of creative deals.	t.				2	3
	Seller is approaching retirement.	Pro		1			3
	Seller must close quickly.	per		1			
	Seller would like to avoid closing costs.	ty		1			
	Seller would like to avoid immediate tax liability.	is		1			3
		off					
PROPERTY	Property lends itself to fix up.	ere					
	Property is free and clear.	d					
	Property has low mortgage, high equity.	duri					
	Property is assumable (VA, FHA, contracts, etc.).	ng		1			
	Property is under market, discounted	"tig					
	Property rents are below market.	ht"					3

3							
3							
	4	5	6				
3	4						
	4	5	6				
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	4	5	6				
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	4		6				
			6				
	4	5					
			6				
			6				
	4	5					

UNIT SIX

MAKING RISK-FREE OFFERS

UNIT SIX

MAKING RISK-FREE OFFERS

6.1 THE FIVE MAJOR BENEFITS OF THE WRITTEN OFFER

The written offer is the backbone of real estate investing. Most beginners either stand in awe of its "finality" or stand in fear of its complexity. Actually, a little study will completely demystify the offer and reveal it to be a fairly straightforward means of "saving your bacon" if done correctly. In its final version, it is nothing more or less than the crystallization in written form of your best "deal." Through its essential documentation, a written offer gives you five major benefits:

M **PRACTICE**. The process of making offers is to the real estate entrepreneur what the "internship" is to the medical professional. It is the "clinical" part of your training. There is no better way to come to grips with the ins and outs of real estate investing than to make many, many written offers--especially under scrutiny of more experienced associates who can coach you forward.

M **PERSUASIVE POWER**. Used properly, the written offer is one of your most powerful negotiating tools, and (with the proper contingency clauses) should inaugurate rather than terminate your "deal making." The offer begins the serious negotiating process and may go through several generations before both parties put their signatures to the final word.

M **PROTECTION**. The written offer memorializes in a legally binding way what you and the seller have agreed to, and thus serves as the foundation for getting mutually acceptable results. The offer also summarizes for you the wisdom of tens of thousands of deals before you and serves as the accumulation of dozens of significant clauses that have been invented precisely to redress problems in the past and are now included in the "boiler plate" to prevent your going through the misery that other less prudent predecessors have suffered.

M **PERFORMANCE**. Once signed, the written offer serves to open "escrow" and starts the clock ticking inexorably toward the close. Thus it becomes the agenda for getting the deal done--period. If things were left to oral agreements, most deals would never get done.

M **POSSESSION**. A signed offer, correctly structured, is in itself a valuable asset, a possession that can even be brought to market. You are, of course, bound by the terms of the agreement; but in effect it gives you control over valuable property, and this "interest" can itself be sold or traded.

A PREVIEW OF THE UNIT

This unit will give you several valuable keys. It will show:

M What kind of documentation must accompany the offer to purchase.

M How to make the documentation fit the negotiated terms of the agreement.

M Which purchase terms must be documented.

M How to use a documentation checklist.

M How to provide for unexpected contingencies.

M How to use a counteroffer effectively.

M How to use options and lease options.

As you proceed through this unit, imagine yourself negotiating with the owners of investment property. Picture yourself and the owner completing the purchase agreement form according to the methods taught in this unit. As you become more familiar with the ideas, and as you apply them in a risk-free atmosphere (which you can do with the exercises at the end of this unit), you will find that the actual purchase agreements won't frighten you into making investment mistakes.

You can earn significant real estate profits through proper negotiation and documentation. This unit will show you how!

6.2 A FEW TERMS YOU SHOULD KNOW

Acceleration Clause: A clause in a deed of trust or mortgage document that speeds the time when the debt becomes due. It may specify that the entire debt will become due upon the sale or transfer of title to the land, or when the borrower defaults on the payment of either principal or interest. The acceleration clause benefits the seller, not the buyer.

Assumption of Mortgage: The responsibility of the buyer for payment of the original debt. In the event of foreclosure, the buyer assumes responsibility for satisfaction of the entire amount owed.

Bill of Sale: A document that transfers title to all personal property. In a real estate transaction, the personal property should be transferred by a bill of sale.

Breach: Violation of a legal contract. When both the buyer and the seller agree on the terms of sale, and one of them fails to abide by those terms, he is in breach of contract. It is imperative that all terms be documented in the agreement to purchase and, subsequently, in the closing documents.

Closing Statement: The document outlining all costs and credits for both the buyer and the seller of property. The closing statement is drafted according to the terms of the negotiated purchase agreement, so it is crucial that all agreed-upon terms be included in the purchase agreement.

Closing the Loan: The actual execution of the loan agreement. If you purchase an owner-financed property, you will close the loan at the closing settlement. In this case, the terms of the loan must be stated in the purchase agreement.

Collateral: In mortgage lending, the real property or assets pledged to protect the loan. If your negotiated purchase terms include collateral other than the real estate being purchased, you must document that collateral.

Contract: A voluntary agreement between legally competent parties to do or refrain from doing some legal act, supported by legal consideration. When you enter into a purchase agreement, the contract becomes a legally binding document upon the payment of consideration to the seller.

Deed of Reconveyance: The document by which the lien holder releases all lien interest in the real estate. When documenting your purchase agreement, you should provide for the escrow of a deed of reconveyance.

Exculpatory Clause: A clause that limits the borrower's or buyer's personal liability exclusively to the property that is pledged as collateral. If documentation of the clause is done correctly, you won't involve other assets if you default on the loan obligation.

Negotiation Range: The upper and lower purchase limits the buyer should establish before negotiation. Each term that the buyer negotiates with the seller should then fall within the appropriate negotiation range. Fail to keep within range, and it will come back to haunt you!

Subject to Mortgage: A situation in which the buyer purchases a property but does not agree to be responsible for paying the original mortgage debt. He does recognize that the seller must pay the debt, or the property can be lost through foreclosure. In the event of foreclosure, though, the purchaser is not held responsible for the payment of any deficiency. In purchasing real estate subject to mortgage, the borrower should be aware of any accelerated payments that might be required.

"Time is of the Essence": A clause meaning that the contract must be executed within the time limits stated. If this is not done, the party who failed to perform is guilty of a breach of contract.

Valid Contract: An agreement that complies with all the essentials of a contract and is binding and enforceable on both the buyer and the seller of a property.

Valuable Consideration: Consideration upon which a promise may be based. It entitles the promisee (the one receiving the promise) to enforce his claims against an unwilling promisor (the one making the promise). In real estate purchases, valuable consideration may consist of cash, personal property, or promises.

Void Contract: A contract with no legal force or effect because it does not meet essential contract requirements. In real estate, proper documentation must include the essential requirements for any contract.

Voidable Contract: An agreement that seems valid on the surface, but may be rejected or disaffirmed by one of the parties. A minor who executes a contract is usually able to disaffirm within a reasonable period of time after reaching legal age.

Without Personal Recourse: A phrase meaning that the holder of a defaulted note cannot hold the other party personally responsible for payment of the note.

6.3 KEY POINTS ABOUT OFFERS AND DOCUMENTATION

As you read this unit, keep the following key points in mind. They will guide your thinking and will help you keep proper perspective on the information.

M All purchase terms can and must be documented.

M Documentation is as important as negotiation in real estate investments.

M The more you understand about the legal requirements for documentation, the more profitable your real estate investments will be.

M If a purchase term is worth negotiating, it is worth documenting. Make certain that your documentation spells out exactly what you negotiated.

M Problems almost always result from purchase agreements that imply, but do not state, the exact terms of purchase.

M When the seller makes you a counteroffer, it is considered an entirely new offer, and all the terms must be documented if you expect success.

M As a real estate investor, you are a professional. When you negotiate purchase terms, be professional in the way that you document those terms.

6.4 HOW TO DOCUMENT REAL ESTATE OFFERS

Which Steps in the Real Estate Purchase Transactions Require Documentation?

A real estate purchase transaction consists of more than simply signing an agreement and taking possession of the property. As a potential real estate investor, you will need to document your total transaction. As you become familiar with the concepts taught in this unit, you will learn that documentation all relates to one essential document: the earnest money receipt and offer to purchase. (It is also known as the "earnest money agreement," "offer to purchase," "purchase money receipt," or "deposit receipt," "real estate purchase contract and receipt for deposit," and by various other names, depending on the area of the country in which it is used.)

A CASE STUDY

Harold R. was looking for a 2 or 3 unit apartment building. He found a duplex for sale within one and a half miles of his home. When he went to see the property, the owner offered to sell the duplex for $58,500, with a $1,500 down payment and the balance to be paid over a period of twenty years at 10 1/2 percent interest.

Harold asked the owner if the rents were current and if the property needed any repairs. The owner assured Harold that the property was in top condition and that the tenants were always prompt in paying the rent. After reviewing the property, Harold asked to see the operating statement on the property and asked to talk to the tenants. The owner said that he didn't have the financial history with him, and told Harold the tenants had asked not to be disturbed.

The owner then pulled out an earnest money offer and began to fill in the blanks. He wrote in the down payment of $1,500, and told Harold he would need to pay the total amount as earnest money on the property. He put in no contingency clauses, but assured Harold that they wouldn't be necessary since the property was in excellent condition. When he got to the section of the document that referred to closing, he said that his accountant would close the sale the following morning. Harold felt uneasy about the whole transaction, but he believed that the seller was an honest man and that the purchase was a good one.

The following morning Harold closed the sale of the property with the owner, and he regretted it within only a few hours. What did he learn <u>after</u> he closed on the sale?

Q Only one of the two apartment units was rented, and the existing tenant was more than two months behind on the rent.

Q No proration for past rent was included on the closing statement.

Q Harold, as owner, was responsible for the entire utility payment--even though the seller had told Harold that the tenants paid utilities. (The seller later claimed he was referring to the telephone bill.)

Q The water heater in one of the units had been repaired three times in the previous year, and the repair people said that it would need to be replaced if it broke again. It was not working when the property was closed.

Q Harold learned that the seller owed more than $72,500 on the property to a short-term, high-interest loan company, and that he was behind on payments.

Q The taxes on the property were four years delinquent, and the property was scheduled to be sold for back taxes within three months.

Q The accountant who closed the sale was the seller's brother-in-law.

Needless to say, Harold was extremely disillusioned. He tried to get out of the sale, but the seller said Harold was now the owner and was responsible for the payments associated with ownership. Harold asked the seller about his verbal assurances, and the seller simply referred him back to the earnest money agreement. Harold threatened to consult a lawyer, which he did. The lawyer's solemn response? Harold was stuck!

Harold then offered to deed the property back to the seller and forfeit his $1,500 down payment. The seller wouldn't accept the deed, and said the only way he would take the property back would be through foreclosure. Desperate, Harold went through foreclosure and lost the property to the seller. Unfortunately, that wasn't the end of it. The seller had purchased the property back for much less than the loan amount. Harold owed $18,750 in the form of a deficiency judgment.

This entire episode could have been avoided if Harold had insisted on proper documentation, beginning with his earnest money offer to purchase.

In any real estate transaction, you should follow these steps to make sure that the documentation protects your interests:

6.5 STEPS FOR REAL ESTATE DOCUMENTATION

M 1. Purchaser makes offer to purchase.

Documentation: Deposit receipt or earnest money offer, including reference to all terms and contingencies.

M 2. Purchaser and seller sign offer to purchase or counteroffer.

Documentation: Earnest money offer or counteroffer containing all signatures and negotiated terms.

M 3. Purchaser and seller authorize independent party to handle closing of sale.

Documentation: Escrow instructions that relate to signed offer to purchase.

M 4. Purchaser obtains funds through lender or seller.

Documentation: Notes, deeds of trust, and/or owner-financing agreements.

M 5. Seller proves ownership of property to be conveyed.

Documentation: Title abstract and title insurance policies.

6. Purchaser becomes owner of property subject to purchase money liens.

Documentation: Deed and closing statement.

7. Purchaser becomes owner of property free and clear of purchase money liens.

Documentation: Deed of reconveyance.

6.6 SEVEN COMMON MISTAKES OFTEN MADE BY BEGINNING INVESTORS

As you review the above steps, you can easily see the mistakes Harold made in his first real estate purchase. Each of these common mistakes could have been avoided with the proper documentation:

Q Offer to purchase was drafted by the seller, not the buyer.

Q Earnest money receipt or offer did not contain reference to all negotiated terms.

Q Qualified, independent party did not handle the closing.

Q Financing agreements did not contain non-recourse or exculpatory clauses.

Q Closing of the sale took place without a proper title search and title insurance policy.

Q Closing statements did not properly reflect proration of all negotiated items.

Q Deed of reconveyance was not placed in escrow.

Mistake #1:

Offer to purchase was drafted by the seller, not the buyer. When you are purchasing any real estate property, you, as the buyer, should be making the offer to the seller, not the other way around. When Harold was purchasing the duplex, the seller drafted the earnest money offer to himself and had Harold sign it. This process eliminates the negotiating ranges that are essential to your success (negotiating ranges will be discussed later in this unit).

If the seller drafts the earnest money offer, he certainly is not going to include reference to any item that is not expressly in his best interest. Harold's first mistake was to allow the seller to draft the earnest money offer. Most of his other mistakes occurred because of this first error.

Mistake #2:

Earnest money receipt or offer did not contain reference to all negotiated terms. Harold signed the earnest money offer without including reference to the expenses and rents the owner represented as fact. But that's not all. Harold failed to negotiate most of the terms of the sale: a proper closing date, the payment of proration items, title insurance, an independent escrow closing agent, and contingency and exculpatory clauses.

As you begin investing in real estate properties, you will find that a proper earnest money form that you fill out will insure that you include all necessary documentation.

Mistake #3:

Qualified independent party did not handle the closing. Note two important words: "qualified" and "independent." If you allow a real estate closing to take place without either of these two necessary ingredients, you are teetering on a tightrope over an investment disaster. When Harold allowed the owner's accountant and brother-in-law to close the sale, he immediately violated the requirement for an independent relationship. When he used an accountant rather than a professional escrow service or legal attorney, he forfeited the qualified nature of a closing.

Obviously, an accountant is a professional, but an accountant is not usually a qualified real estate closing agent.

Mistake #4:

Financing agreements did not contain non-recourse or exculpatory clauses. These clauses limit your loss through foreclosure to the property or asset pledged as security (your collateral). It may not be possible to get this kind of an agreement when negotiating a loan with a bank or lending institution, but it should be a part of any agreement that specifies owner financing.

When Harold agreed to pay the owner $57,000 over twenty years, he should have spelled that out in the earnest money offer. His failure to do so allowed the owner to foreclose on the property and require Harold to pay $18,750 in the form of a deficiency judgment.

Mistake #5:

Closing of the sale took place without a proper title search and title insurance policy. We strongly recommend that you delay the closing of sale until you have reviewed all necessary property information, including all expense and income information and the actual title and encumbrances of the property.

When Harold closed on the purchase of the duplex the morning following the offer, he didn't have time to review the necessary information. Harold later learned that a short-term note was due on the property for more than its actual purchase price. Never buy a property when the encumbrances total more than you are financing!

When the title company does a title search on the property, you will discover the total amount of encumbrances against the property, including back taxes. In many states, the property can be sold through a tax sale when the property taxes become five years in arrears. (Remember that the taxes were more than four years delinquent on Harold's duplex.)

Mistake #6:

Closing statements did not properly reflect proration of all negotiated items. Once again, Harold's initial problem was the earnest money offer to purchase--it was filled out by the seller, and no reference was made to the proration of taxes, rents, and so on. Harold should never have closed on a purchase without proper proration. An independent and qualified closing would have specified the proration.

It is possible to prorate an item according to terms agreed to by both the buyer and the seller. If you wish to prorate the items in a separate manner, make sure that such a reference is included in the purchase agreement.

Mistake #7:

Deed of reconveyance was not placed in escrow. Harold never got to the point of receiving a deed of reconveyance because he lost the property through foreclosure. If he had paid the original $57,000 in full, then he would have received a deed of reconveyance from the seller that would have released all lien interest in the property. Because the financing agreement extends for a long period of time, you should have the seller sign a deed of reconveyance and place it in escrow; then, when you finally pay off the property, you can immediately receive free and clear title to it.

When dealing with commercial lending institutions, a deed of reconveyance does not need to be placed in escrow.

As you prepare any earnest money offer to purchase, make sure that you follow the steps for real estate documentation and avoid the common documentation mistakes. Knowing what to include in your offer is a major part of the investment process.

6.7 NEGOTIATING THE RANGES

In the previous section of this unit you learned the importance of documenting every term that is agreed upon by you (the buyer) and the seller. It stands to reason, then, that you also need to negotiate each and every term. Before negotiation occurs, you need to establish upper and lower limits for each of these items; the area between the two extremes is called the "negotiation range." Your success in real estate investing will be tied directly to your ability to keep all--or the majority-- of your purchase terms within respective negotiation ranges.

Once you have established your range, you can begin to make the offer. The first and most important thing to learn is that "cash" is an extremely valuable commodity and should be conserved if at all possible. When making an offer to purchase, remember: cash conserved is the key to increased investment opportunities! If you consistently conserve your cash on real estate purchases, you will have the resources to make additional purchases.

A CASE STUDY

> Dean E. Began investing in small rental properties that he could purchase with little or nothing down. He made offers only on properties that were excellent buys, could be financed using "nothing down" techniques, and would appreciate in value through inexpensive cosmetic repairs and the raising of rents.

His program was based on pre-established negotiation ranges, and he always began his negotiation process with the rule of cash conservation as a priority. If the property required an excessive amount of cash from his own resources, he refused it, even if the return was excellent. Why? If he used the majority --or all--of his available cash to buy the property, he would limit his ability to meet unexpected cash needs and to continue his investment program.

It is crucial to your success in the art of negotiation to include "non-price" items as part of your negotiation. Used correctly, they will allow you some room for give and take and will make your "cash/price" items easier to obtain. Some of the possibilities under this category include the following:

M The seller agrees to defer the date of settlement and closing without changing the price.

M The seller agrees to let the buyer do property improvements prior to closing, and to notify tenants that the rental rates will be increased immediately following the completion of those improvements.

M The seller agrees to finance all or part of the debt at terms better than the buyer could obtain through commercial sources.

M The seller provides warranties that may be better than what the buyer could ordinarily expect.

M The seller accepts an exculpatory clause that minimizes the buyer's risk.

M The seller agrees to accept more than a prorated share of the transaction costs and fees.

M The seller agrees to improve the property to the buyer's specifications.

1. <u>The seller agrees to defer the date of settlement and closing without changing the price</u>. If you can get the seller to

agree to defer closing for an extended period, you are actually getting the seller to absorb part of the interest costs and other cash outlays. This tactic is extremely important if you are going to do cosmetic repairs and raise the rents: you can't raise the rents while the repair work is underway, and you may want to do the repair work before you assume ownership. If you elect this tactic, check with a legal professional as to the validity of your contract before you make any improvements on the property.

A CASE STUDY

Dean E. wanted to invest in a four-plex apartment that was being rented at below market rates. The price of the property was directly related to the rental income, and Dean was able to buy the property at a very fair price. He also knew that if he could raise the rents, he could increase the value of the property.

When Dean first located the apartment building, the units were all being rented for $225 per month. Why were the rents so low? The building needed painting, new carpets, and improved landscaping. When Dean negotiated with the owner, he asked for a closing date of 120 days after acceptance of the offer by all parties. The owner did not agree to 120 days, but did accept a 90-day closing. (Dean had set a negotiation range on closing of 30 to 120 days: he knew that he could do most of the necessary renovation within 30 days, but he wanted to give himself plenty of breathing room. When he got 90 days from the seller, he knew he could do the necessary cosmetic repairs easily during this time frame.)

There were other items that Dean negotiated in the purchase, but the ninety-day closing meant that he did not have to absorb a negative cash flow during the fix-up period. It allowed him to complete cosmetic repairs that resulted in a rental increase from $225 to $295 per month immediately after closing. (As a matter of interest, only two of the tenants moved out, and their units were rented at the full rate within seven days after the closing of the sale.)

2. <u>The seller agrees to let the buyer do property improvements prior to closing and to notify tenants that the rental rates will be increased immediately following the completion of those improvements</u>.

When Dean negotiated this item with the owner of the apartment building, he pointed out that he would do the improvement work at his own expense and that there would be no risk for the owner. The owner realized that the cosmetic repairs would increase the value of the property, boosting his own security in the property. The range Dean had established prior to negotiation was that the seller would allow the improvements but would not allow the notification of rental increase. When he negotiated, however, Dean got both--so it definitely fell within his negotiation range.

3. <u>The seller agrees to finance all or part of the debt at terms better than the buyer could obtain through commercial sources</u>. It is important to contact local lenders in your area to determine what financing is available, what the interest rates are, and what loan-to-value ratio they will loan. Once you know this, you are prepared to negotiate these terms with the seller. If you can get the seller to finance you at a higher loan-to-value ratio and a lower interest rate, you will improve your investment in the property.

Dean set his negotiation range for financing as 100 percent financing at 3 percent below the interest the banks were charging; his lower negotiating limit was the commercial rate obtainable from local lending sources. When he negotiated the purchase of the property, the owner agreed to 97 percent financing at 10 percent interest. The banks would loan only 80 percent at 12 1/2 percent interest. The seller agreed to a loan term of twenty-five years, which is what the banks would have agreed to. The owner financed $81,500, at a payment of $740.59 per month. If he had used bank financing, he would have been able to borrow only $67,200, with a payment of $732.72 at 12 1/2 percent interest. In other words, he was able to borrow an additional $14,300 from the seller for only $7.87 per month.

4. The seller provides warranties that may be better than what the buyer could ordinarily expect. It is important to get as many warranties from the seller as possible. If the seller tells you that the expenses run only 28 percent of gross, then try to get him to warranty this fact by accepting less on his financing payment if expenses increase beyond the 28 percent figure. This may not be possible, but it is worth a try. Other warranties that you should ask for include a warranty or guarantee on the appliances for a period of 90 to 180 days. This insures that you will be able to detect make-shift repair work done to sell the property.

When Dean made his offer to purchase the four-unit apartment building, he had seen verified expense information and did not request an expense warranty. He did, however, request the owner to warranty all appliances, furnaces, water heaters, and swamp coolers for one year. The owner agreed to warranty those items for a period of 120 days after closing. This fell within the negotiation range that Dean had established. The owner later had to pay for the repair of one furnace at a cost of $158. If Dean had not negotiated the warranty information, he would have had to pay this expense himself.

5. The seller accepts an exculpatory clause that minimizes the buyer's liability. No one expects that a property will be lost to foreclosure, but it should be provided for.

Dean knew that none of the banks in his area used a clause that limited risk to the property pledged as loan collateral, but he was unwilling to accept any owner financing agreement that did not include such an exculpatory clause. His negotiating was very inflexible in this matter. When he was negotiating with the owner, he emphasized that if the property was worth the asking price, the owner had plenty of security, particularly with the improvements that Dean was making at his own expense. The owner agreed to this clause, which Dean hoped he would never need. But Dean protected his other assets from attachment or loss regardless of what happened to the property.

6. The seller agrees to accept more than a prorated share of the transaction costs and fees.

Dean was willing to prorate the costs of the transaction, but he tried to get the seller to pay a higher portion of those costs if possible. He asked the seller to pay all closing costs that normally would be paid by the buyer. The owner agreed, paying for a termite inspection, all escrow fees, and all recording fees of loan and title documents, which saved Dean $325 at closing.

7. The seller agrees to improve the property to the buyer's specifications. Rather than negotiating purely on price, it is sometimes possible to get the seller to pay for certain repairs that you consider essential.

When Dean negotiated with the seller, he told the seller that he was willing to do certain improvements to make the property a better investment, but he wanted the seller to resurface the parking lot. It had weeds coming up through the asphalt and contributed to the low rents that the property generated. The seller did not agree to Dean's demand at first, but before the negotiations were concluded he agreed to complete the resurfacing at his expense prior to closing. The bill for the parking lot come to $785 and was paid by the seller not by Dean.

Obviously, it is important to negotiate within your range for all non-price items, but what about the actual price you are willing to pay for the property? If you pay too much for a piece of property, you will lose money from the first day. Many investors believe that if they get extremely favorable financing, they can afford to pay more for the property. That's true, but only to a certain degree, but it is best to never pay more for the property than it is worth, regardless of the financing. If you receive extremely favorable financing from the owner, then you can afford to pay full market value. If financing is less than favorable, you should pay less than market value.

6.8 ESTABLISHING THE VALUE OF A PROPERTY

How, then, do you establish the negotiation range for the price of a property? When buying income property, you should become familiar with all comparable rental properties sold in your area. There are several other techniques that can help you set the range:

M Use cash-flow analysis to determine value.

M Compare sales price with market.

M Get an official appraisal.

1. Use cash-flow analysis to determine value. You can determine value for a property by dividing the net operating income by the capitalization rate that is common to your area. If you have questions about this, ask your mentor. (Simply stated, to calculate the N.O.I., obtain the total gross revenue for the year, subtract total vacancy losses and operating expenses, and arrive at a net operating income prior to payment of debt service.)

> When Dean was evaluating the purchase of the apartment building, he was buying the property based on the existing operating history. He verified the expense information and called several professional real estate appraisers to find out the accepted capitalization rate in his area. He found that the expenses on the property were $3,200 per year; the gross rental income at $225 per unit was $10,800. This left a net operating income of $7,600 per year. Two professional appraisers in his area told him that an acceptable capitalization rate was 8.75

percent. By dividing the $7,600 by 8.75 percent, he arrived at the upper limit of his negotiation range:

$$\frac{\$7,600}{.0875} = \$86,857$$

By using a cash-flow analysis then, Dean set his upper limit at $86,850 and his starting point at approximately 90 percent of value, or $78,000. The 90 percent figure was an arbitrary figure he felt comfortable with.

2. Compare sales price with market. Another method of setting the price range for negotiation is comparing the property with other properties that have been sold or are listed for sale in the community. This is not an accurate method of determining value, but it is a good yardstick for verifying the negotiation range established through cash-flow analysis.

When Dean was evaluating the four-unit apartment building for possible purchase, he compared it to other rental units of similar size that had recently sold in the area. He found that four-unit apartment buildings in his area were selling for $80,000 to $120,000. The rents varied from $210 to $340 per month per unit. Since the existing rental income of the property was toward the lower end of the scale, he estimated that the value of the property should also be at the lower end of the scale. Using the comparable sales price of other rental property, he estimated his negotiation range to be from $80,000 to $88,000.

3. Get an official appraisal. An official or certified appraisal will give the most valid information for establishing the negotiation range. If you decide to get an appraisal, have it done by an appraiser who is recognized by conservative lending institutions; then you'll be reasonably sure that the estimated value is conservative. The seller probably won't pay for an appraisal and then sell the property for much less than the appraisal, so we recommend that you make your offer subject to an appraisal of the property. In this way, the price is

set before the appraisal of the property, and if the appraisal comes in too low, you will be able to renegotiate with the seller. The cost of a qualified, independent appraiser can save you a possible loss of appreciation if you have made a mistake on your figures. It also gives added reinforcement to the negotiation range that you established.

> When Dean reviewed all the available information, he set his negotiation range for a price between $78,000 and $86,500. He initially offered the seller $78,000, and finally accepted a counteroffer of $84,000 (subject to an appraisal of the property paid for by the buyer). When the offer was completely accepted and signed by all parties, he ordered an appraisal on the property. The official appraisal came in at $85,750 (according to the present condition and rental history of the property).
>
> After Dean completed the improvements, purchased the property, and raised the rents, he paid for another appraisal by the same appraiser. The appraisal was based largely on the added net operating income, so Dean was not surprised when the final appraisal came in at $109,500. This was at the upper end of the value for four-unit apartments in the area, but the added improvements and rental income justified the price.
>
> The cosmetic improvements cost only $4,750, and the property value had jumped by more than $23,000. This substantial increase was largely a result of Dean knowing what his negotiation range was for each separate term in his purchase agreement.

6.6 WHICH ELEMENTS ARE ESSENTIAL TO THE REAL ESTATE OFFER?

Once the buyer and the seller agree on the terms of purchase and sign the earnest money offer or receipt, both parties want to be confident that the document is a legal and binding agreement. Why? That's the only way the parties can rely on the promises and representations made in the agreement. Unfortunately, not all agreements are valid contracts. If the agreement does not contain all the elements required by law, the document may not be a valid contract.

We are not giving you legal or professional advice in this matter, but are only offering general educational material that you can use as a basis for questioning a contract. Once you begin investing in real estate, we urge you to consult competent legal counsel in determining the validity of any legal agreement.

A real estate purchase agreement may be considered either a valid contract, a void contract, or a voidable contract. A void contract is one that has no effect because it does not meet the legal requirements of a contract. A voidable contract is one that may become void if later circumstances negate the agreement or if the parties to the contract are shown to be not competent. When you are purchasing a real estate property, you want the contract to be valid and voidable on the part of the buyer. If your real estate purchase includes contingency items on the part of the buyer, then you as the buyer will be able to void the contract if those contingencies are not met.

The essential elements of a real estate contract will vary from state to state and from time to time. The elements listed below are those generally required in most jurisdictions:

M Competent parties

M Offer and acceptance

M Consideration

M Legality of object

M Agreement in writing and signed

M Description of subject real estate

1. Competent parties. Both the buyer and the seller must be of legal age and must not be suffering from a mental handicap that would make them incompetent. Most states have

lowered the legal voting age for national elections to eighteen years of age, and, as a result, most states accept eighteen as a legal age to enter a contract. If either the buyer or the seller of a real estate property is a corporate officer or agent, he must have express written permission, signed by the proper authority, to act for that corporation.

A CASE STUDY

> Snell O. was interested in purchasing an eight-unit apartment building. He investigated the property and found that it was owned by the Miles Corporation. When he began negotiating for the purchase of the rental property, he requested from the individual a written document giving him permission to negotiate for and on behalf of the Miles Corporation for that piece of property. Dennis W., the agent, said that he was authorized to sell the property for the Miles Corporation but that he didn't have a signed agreement authorizing that action.
>
> Snell's reaction? Snell said he was extremely interested in negotiating the purchase of the eight-unit rental property, but that he wasn't going to begin negotiation until he was convinced that Dennis was in fact, authorized to act for the corporation. Dennis finally received the proper document from the Miles Corporation. Snell then felt confident that he could negotiate in good faith.

If either party is not of legal age, the contract will be considered void--or, at the least, voidable by the minor-aged person. For this reason, it is imperative to make sure that you are dealing with someone of legal age.

Another element you must consider when entering into a real estate purchase agreement is mental illness or intoxication. If one party is considered to be incompetent, the real estate contract could be considered valid, but voidable once incompetency is affirmed.

A CASE STUDY

Mitchell A. was negotiating for the purchase of a single-family rental property. The seller agreed to all of Mitchell's terms at the lower end of his negotiation range. Mitchell was elated, and thought he was on the road to a great investment.

Mitchell's elation was short-lived. After the contract was signed, the seller changed his mind and said he wouldn't go through with the sale as agreed to in the earnest money offer to purchase. Why? On the day the offer was negotiated, he had lost his job, had gone home, and had gotten drunk. Several witnesses attested to the fact that he had been drinking excessively just before Mitchell arrived to negotiate the purchase of the property. Mitchell thought that the seller had acted somewhat peculiar during the negotiation process. Under the circumstances, Mitchell realized that the courts would probably rule the owner incompetent at the time the agreement was signed. Mitchell accepted the refund of his earnest money deposit and began looking for another property.

2. <u>Offer and acceptance</u>. This requirement means that there must be a "meeting of the minds." All the terms of the agreement must be expressed in language that is understood, agreed on, and accepted by both parties. If the terms are not clearly understood by both parties, then there would not be a meeting of the minds.

When Snell was negotiating with the Miles Corporation for the purchase of the eight-unit apartment building, both parties understood the need for complete agreement and acceptance on each term. As the earnest money agreement was completed and filled out, no blank spaces were left; all special contingencies were spelled out in simple language that was easy to understand. Snell negotiated the right to review all the financial information concerning the rental property. A special clause was agreed to and included in the contract, stating:

"Seller grants buyer the right to review and approve all financial information concerning the subject property prior to closing. Such financial information includes management information, tax returns, expense payments, etc. If buyer does not approve the financial information, the contract will become void, and all deposits will be returned to the buyer."

3. Consideration. Consideration is, in effect, what the parties promise to give to each other. The courts have ruled that consideration in a real estate purchase contract may consist of money, property, or promises. The agreement must be based on such good and valuable consideration.

Many real estate investors have used as consideration a note that promises to pay a certain amount at a specified interest rate and term of payment. This promise to pay a certain sum in the future is considered good and valuable consideration.

You can offer many possible consideration alternatives in the earnest money offer. Whatever form of consideration you use must be agreed to by both the buyer and the seller.

If your offer is subject to certain contingencies that must be satisfied before the offer is finalized, try not to use a great deal of cash when making the offer. The amount of consideration will show the seller your earnest intention of making the sale take place, but it will not increase the validity of the contract.

Snell wanted to take the eight-unit apartment building off the market while he finished his investigation. He told Dennis that he would be willing to pay additional consideration when all the contingencies in the offer were satisfied, but would give only $100 earnest money until this happened. The offer was drafted in such a way that an additional $900 earnest money was to be paid to the seller as further consideration once all the contingency clauses were fulfilled. This satisfied both Snell (the buyer) and the Miles Corporation (the seller).

4. Legality of object. The law provides that no agreement will be considered a legally binding contract if the purpose for which the contract is intended is illegal or against public policy. Real estate earnest money agreements are generally considered to have a legal object, and would not be considered void because of this element. If the purpose of the earnest money agreement or sale of the property was intended to defraud someone, then the reverse would be true, and the contract would be considered void.

5. Agreement in writing and signed. Every state has enacted a statute of frauds that requires certain contracts to be in writing. Real estate purchase or sales contracts fall into that category. These statutes require that the following elements be included:

Q The signatures of both the buyer and the seller are required. The contract would not be valid if only one of the parties has given written consent while the other party has verbally agreed to the terms.

Q A spouse's signature is required on the earnest money receipt when partial rights are being released. It is always in the buyer's best interests to get both spouses' signatures on the earnest money offer.

Q An agent may sign for a principal only if the agent has written authority to do so. A power of attorney or corporate resolution authorizing the agent to act for the principal should be attached to the earnest money offer. If the agent is dealing for a corporation, a corporate seal must be attached to the authorization. That's why Snell required Dennis to get written authorization from the Miles Corporation before he would begin negotiations.

6. Description of subject real estate The property covered by the purchase agreement must be adequately described in accordance with a survey or adequate title

evidence. Generally, the legal description is required, and the property is usually also identified by its street address.

> When Snell was writing the offer for the eight-unit apartment building, he included the street address and then wrote the exact legal description as found on the tax assessment notice. In this way, Snell was positive that both parties understood exactly which real estate was covered by the agreement.

6.10 DOCUMENTING THE PURCHASE AGREEMENT TERMS

The earnest money offer to purchase is a legal agreement and must be documented properly. When we talk about documenting the purchase agreement terms, we are expressly talking about the written explanation of the terms that will be agreed to in the earnest money offer. Because of the complexity of the purchase agreement and the need to cover all the terms of sale, we recommend very highly that you use printed forms. These forms will not cover every contingency and purchase term you agree on, but because most real estate transactions are so similar, the forms will serve as a basis for the actual agreement. These forms can usually be purchased in any office supply or stationary store.

The use of forms raises three issues:

M How the blanks should be filled in.

M Which printed matter is not applicable to your portfolio real estate transaction and should be ruled out by drawing lines through the unwanted words.

M Which additional clauses or agreements (commonly called "riders") are to be added.

1. How the blanks should be filled in. It is important to fill in every blank on the contract. If the blank is not large enough to clearly state the negotiated term, write the agreement in the

margin or attach a separate agreement. If the legal description of the property is too long to write in the blank, write "See attached Exhibit A," and then attach the legal description as Exhibit A.

2. Which printed matter is not applicable to your particular real estate transaction and should be ruled out by drawing lines through the unwanted words. Because the printed form is designed for generic real estate transactions, certain phrases or terms will not apply to the negotiated terms of your specific real estate transaction. These items should be lined out and then initialed by both the buyer and the seller.

A CASE STUDY

Mark B. was purchasing a rental property for which the seller agreed to pay all the closing costs, including recording fees and all the escrow fees. The printed form contained the statement:

> "Buyer agrees to pay for recording fees....and one-half of the escrow fees."

Because Mark and the seller had agreed that the seller would pay all the closing costs, this entire sentence was lined out and initialed by both parties.

3. Which additional clauses or agreements (commonly called "riders") are to be added. As you learn to include contingencies and terms that apply to your specific real estate purchase and strategy, you will find that printed forms may not include any reference to that particular item. If this is the case, you must write in the additional clause, and then both you and the seller must initial the change.

When Mark was negotiating the purchase of the rental property with the seller, he got the seller to agree to substitute other collateral as security for the financing. There was no reference to a substitution of collateral on the earnest money form, so Mark wrote in the following:

> "Buyer has the right to substitute collateral of equal or greater value on the trust deed executed in favor of the seller at any time, with the seller having the right of approval, such approval not being unreasonably withheld."

In this way, by adding a "rider" to the earnest money agreement, Mark provided for the eventual substitution of collateral.

All printed earnest money offers to purchase are not necessarily the same. We have included a sample earnest money form that can be adapted for most real estate offers. If you understand how to correctly fill this form out and how to document your negotiated terms, you should be able to adapt it (and most other printed forms) to suit your needs. You will note that the different items are numbered. As we discuss each item on the form, you will understand the necessity of filling the form out completely.

In reviewing the form, you will note that there are no blank lines for contingency clauses. These clauses can be inserted between the paragraphs listed on the document. If there is not enough room to complete the entire rider, attach the rider as an exhibit to the agreement. Remember that the attached exhibits need to be initialed by both parties to the agreement. Finally, if you wish to review dozens of real examples of how to fill out earnest money forms, we recommend the book <u>How To Write A Nothing Down Offer So That Everyone Wins</u> by Dr. Richard J. Allen.

6.11 EARNEST MONEY AGREEMENT

We supply herewith a sample earnest money agreement, also referred to as "Real Estate Purchase Contract and Receipt for Deposit." You may adapt this for your own use, or use one of the many similar forms in circulation in the various states, provided you attend carefully to the language and make sure it reflects accurately the terms and conditions of your transaction.

REAL ESTATE PURCHASE CONTRACT AND RECEIPT FOR DEPOSIT

"This is a legally binding contract. If not understood, seek competent legal advice."

1. **DATE AND LOCATION OF OFFER**:__________, 199____. ______________________

2. **THIS CONTRACT IS MADE BY AND BETWEEN:**______________________________hereafter referred to as "**BUYER**," and ____(list names of all owners) hereafter referred to as "**SELLER**," upon terms, provisions, and conditions set forth herein.

3. **BUYER AGREES TO PURCHASE FROM SELLER AND SELLER AGREES TO CONVEY TO BUYER**, that certain real property located in _____________________, County of ____, State of ________, commonly known by the street address of ____, and further described as __________________ ______________________ (attached legal description and tax parcel number if available), with a complete legal description to follow in escrow; together with the following items, if any: permanently installed heating, air conditioning, electrical, plumbing, security, fire detection, appliances including stove, oven, dishwasher, trash compactor, water heater, water conditioner, garage door opener and controls, landscape and shrubbery, wall-to-wall carpeting, custom window coverings, lighting fixtures, fans, television antennas, and other fixtures permanently attached to property. All of the included items, together with the real property and improvements, shall be referred to hereafter as the "**SUBJECT PROPERTY**."

4. **CONTRACT SALES PRICE AND FINANCING SUMMARY**:

A. EARNEST MONEY DEPOSIT INCLUDED HEREWITH (Payable to: ______________)
in the form of ___ Check ___ Promissory note ___ Other (describe:) ___________________________$ __________

B. ADDITIONAL DOWN PAYMENT DUE ON OR BEFORE CLOSE OF ESCROW:
$ __________

C. SUM OF ALL FINANCING DESCRIBED IN PARAGRAPH FIVE BELOW:
$ __________

D. OTHER (describe:) ____$ __________

E. TOTAL SELLING PRICE CONSIDERATION (A + B + C + D)
$ __________

5. **FINANCING** (Note: The obtaining of BUYER'S financing is a contingency or condition of this agreement.):

A. $ __________ BUYER to qualify for and obtain a new first loan in this approximate amount from a lender of BUYER'S choice, payable at approximately $ __________ per month including interest (___ fixed rate ___ adjustable rate) not to exceed _____ percent per annum, all due and payable ___ years from close of escrow. BUYER to pay a maximum of $ _____ as "points" (discount points in the case of FHA or VA) or origination fees on behalf of BUYER. BUYER'S signature on loan documents will be deemed as BUYER'S having obtained financing.

B. $ ______________BUYER to ___ assume/ ___ take title "subject to" the existing first loan of record on SUBJECT PROPERTY, in the approximate balance of $ __________, in favor of __________, payable at approximately $ __________ per month, including interest and at ___% (___ fixed rate ___adjustable) with all remaining principal and interest due _____, 199___. In the event the loan balance or payment differs substantially from that which is indicated above, this contract may be terminated at BUYER'S option and the earnest money shall be refunded to BUYER without delay. BUYER'S fees to take over the existing loan not to exceed $ ________.

C. $ ______________ BUYER to execute a note secured by a ___ first ___ second ___ third (mortgage or deed of trust) in favor of SELLER, payable ___ monthly ___ quarterly ___ annually at $__________ or more, including ___ principal and interest ___ interest only, the interest being ___% per annum, the remaining balance of principal and interest all due _years from the date of origination. Other terms and conditions: ____ ____

D. $______________ BUYER to ___ assume/ ___ take title "subject to" the existing ___ second, ___ third loan of record on SUBJECT PROPERTY, in the approximate balance of $ __________, in favor of __________, payable at approximately $ __________ per month, including interest and at ___% (___ fixed rate ___adjustable) with all remaining principal and interest due _____, 199___. In the event the loan balance or payment differs substantially from that which is indicated above, this contract may be terminated at BUYER'S option and the earnest money shall be refunded to BUYER without delay. BUYER'S fees to take over the existing loan not to exceed $ ________.

E. $ __________ BUYER to qualify for and obtain a new second loan in this approximate amount from a lender of BUYER'S choice, payable at approximately $ __________ per month including interest (___ fixed rate ___ adjustable rate) not to exceed _____ percent per annum, all due and payable ___ years from close of escrow. BUYER to pay a maximum of $ _____ as "points" (discount points in the case of FHA or VA) or origination fees on behalf of BUYER. BUYER'S signature on loan documents will be deemed as BUYER'S having obtained financing.

F. $ ______________ OTHER (describe:)____ ____

$ ___________ TOTAL FINANCING

6. **TITLE**: SELLER shall furnish BUYER with title that is free and clear of liens, encumbrances, restrictions, rights, and conditions other than property taxes not yet due and restrictive covenants, conditions and restrictions of record, including public utility easements, if any, provided that same do not adversely affect the continued use of the property for the purpose for which it is presently being used. BUYER shall have _____ days to reasonably disapprove a preliminary title report furnished at __________ expense. SELLER shall provide and pay for a standard title policy or an abstract brought current on the SUBJECT PROPERTY.

7. **ESCROW INSTRUCTIONS:**. BUYER and SELLER shall open escrow with __________, the escrow holder, and shall deliver signed instructions to escrow holder within ___ calendar days of the acceptance of this offer, and shall provide for closing within ___ calendar days of this acceptance. Escrow fees to be paid as follows: ________________ ____.

8. **POSSESSION:** Possession and occupancy shall be delivered to BUYER ___ on close of escrow, or _____ not later than ___ days after close of escrow. SELLER shall maintain the property in its present improved condition.

9. **PERSONAL PROPERTY:** The following items of personal property, free of liens and without warranty of condition, are included: ____
____.

10. **EXCEPTIONS WHICH DO NOT REMAIN WITH THE PROPERTY**: BUYER and SELLER hereby agree that the following items are not included with the sale of the property, and may be removed by SELLER: ____________
____
____.

11. **SELLER TRANSFER/DISCLOSURE**: SELLER agrees to provide BUYER with a Transfer/Disclosure statement (and to use the official form as may be required by state law). Said statement shall include the identification of equipment and items contained in the residence and lot and whether such items are operational; any significant defects in structural components of the residence; information regarding the improvement and alterations made to the property including compliance with building codes and issuance of building permits and any items of concern regarding health, safety, regulation, violations, existing or potential lawsuits to the SUBJECT PROPERTY, nuisances or neighborhood problems which may affect the BUYER'S decision to purchase the SUBJECT PROPERTY. Upon receipt of the transfer/disclosure statement, BUYER shall have __ calendar days to review same and to disapprove the property because of the disclosed conditions and defects, and to terminate the agreement by delivery of written notice to the SELLER. Should BUYER not disapprove the property within the prescribed limits of time, the conditions described in the transfer/disclosure shall be deemed to have been approved by BUYER.

12. **TAX-WITHHOLDING (F.I.R.P.T.A.)**: Under the Foreign Investment in Real Property Tax Act (IRC 1445), every buyer of real property must deduct and withhold from SELLER'S proceeds 10% of the gross sales price and to deposit that amount to the Internal Revenue Service upon the close of escrow, unless an exemption applies. The primary exemptions include, and no withholding is required, if any one of the following conditions exist:

__ A) BUYER purchases the property for use as a personal residence and the selling price is $300,000 or less and the BUYER or member of the BUYER'S family has definite plans to reside in the property for at least 50% of the number of days it is in use during each of the first twelve month periods after the transfer.

or __ B) SELLER provides BUYER with an affidavit under penalty of perjury that SELLER is not a "foreign person."

or __ C) SELLER provides BUYER with a "qualifying statement" issued by the Internal Revenue Service that SELLER is exempt from withholding.

13. **SUPPLEMENTS**: The following supplements are incorporated as part of this agreement:

____
______________________________________.

14. **INSPECTIONS**: BUYER shall have the right, at BUYER'S expense, to select a licensed contractor and/or other qualified professional(s) to make "inspections," BUYER shall keep the property free of liens, and indemnify and hold SELLER harmless from all liability, claims, demands, damages, or costs, and repair all damages to the SUBJECT PROPERTY arising from said inspections. All claimed defects concerning condition of SUBJECT PROPERTY which adversely affect the continued use of the property for which it is presently being used shall be in writing,m and delivered to SELLER along with written reports within __ calendar days. If SELLER is unable or unwilling to correct the deficiencies within __calendar days of receiving notice or to agree in writing to escrow sufficient funds to correct them, or BUYER and SELLER fail to stipulate in writing as to what defects are accepted "as is" and/or what adjustment is to be made in the purchase price, then before close of escrow, or before any extension mutually agreed upon by both BUYER and SELLER, BUYER shall have the exclusive right to terminate this agreement. SELLER shall make the SUBJECT PROPERTY available for all inspections upon reasonable notice. BUYER'S failure to notify

SELLER in writing of the defects which are unacceptable to BUYER within the time limit indicated shall be deemed approval.

15. **PEST CONTROL INSPECTION**: SELLER agrees, at SELLER'S expense, to provide within __calendar days a written certificate from a licensed pest control operator that SUBJECT PROPERTY is free of wood-destroying organisms. SELLER shall make necessary repairs as required for certification within ___ calendar days, up to a limit of $500.00. In the event the cost to repair exceeds $500.00, then BUYER has the right to accept the property "as is" and receive credit from SELLER, in escrow, or BUYER and SELLER shall, within said days, mutually stipulate in writing as to what repairs SELLER will perform and pay for and what items BUYER will accept "as is," or the BUYER may terminate this agreement.

16. **OTHER TERMS AND CONDITIONS**:____
____
____
____
_____________.

17. **TIME LIMIT OF OFFER**: The SELLER shall have until _____ (___ am/ ___ pm) on _____, 199___, to accept this offer in its entirety by delivering a signed copy to the BUYER. If the SELLER does not accept the offer as written within the time limit prescribed, then SELLER shall immediately cause BUYER'S deposit to be refunded to BUYER.

18. **BOTH BUYER AND SELLER RESERVE THEIR RIGHTS** to assign their respective interests and agree to cooperate in effecting an Internal Revenue Code 1031 exchange or similar tax-deferred arrangement prior to close of escrow, provided, however, that such arrangement does not adversely affect the basic agreements contained in this contract, and that said arrangement does not incur additional expense on the cooperating party. BUYER'S obligation under this agreement is further contingent upon and subject to BUYER'S first obtaining within ___ calendar days the following approvals: ____
____.

19. **REAL ESTATE COMMISSION**: SELLER shall pay a ___ % real estate commission on the total selling price as follows: $ __________. ______________________________is designated as BUYER'S agent and shall receive __ % of all commissions paid. ____________________________ is designated as SELLER'S agent and shall receive ___ % of all commissions paid.

20. **GENERAL AGREEMENTS**: Upon approval of this offer by the SELLER, this agreement shall become a contract between BUYER and SELLER, and shall inure to the benefit of the heirs, and administrators, executors, successors, personal representatives, and assigns of said parties. Time is of the essence and an essential part of this agreement. This contract constitutes the sole and entire agreement between the parties hereto and no modification of this contract shall be binding unless attached hereto and initialed by all parties to the contract. No representations, promises, or inducements not included in this contract shall be binding on any party hereto.

21. **BUYER'S STATEMENT AND RECEIPT**: "I/We hereby agree to purchase the above SUBJECT PROPERTY in accordance with the terms and conditions stated above, and acknowledge the receipt of a completed copy of this agreement , which I/We have fully read and understand."

Dated _____, 199___ Hour: _____, Social Security No. __________
Address: ______________________, City: __________, State: _____, Zip Code: _______.

BUYER'S signature: ____

22. **SELLER'S STATEMENT AND RECEIPT**: __"I/We approve the above offer, which I/We have fully read and understand, and agree to the above terms and conditions this day and time." Or__ "I/We approve the above offer with the additional provisions and modifications set forth in the attached and signed counter offer."

Dated: _____, 199__ Hour: _____, Social Security No. __________
Address: ______________________, City: _________, State: _____, Zip Code: _______.

SELLER'S signature: ____
23. **BUYER'S RECEIPT FOR SIGNED OFFER**: The BUYER hereby acknowledges receipt of a copy of the above agreement bearing the SELLER'S signature in acceptance of this offer.

Dated: _____, 199__. BUYER'S signature: ____________________________________
SELLER and BUYER acknowledge a receipt of a copy of this agreement, which consists of a total of __ pages.

_____ SELLER'S initials

_____ BUYER'S initials

6.12 DETAILED EXPLANATION OF THE EARNEST MONEY AGREEMENT

Now let us review the agreement clause by clause and provide action commentary for you to follow as needed as you complete this form (or one similar to it) in the future.

REAL ESTATE PURCHASE CONTRACT AND RECEIPT FOR DEPOSIT

"This is a legally binding contract. If not understood, seek competent legal advice."

1. **DATE AND LOCATION OF OFFER**:____________, 199_____. ____________________________

COMMENTARY: To be valid, the agreement must be dated and signed. Use the date you present the offer to the seller. This is the benchmark date from which all timed references in the offer are measured. Write in the city and state where the offer is written (not the location of the subject property); this will be the legal jurisdiction for any future legal action, if needed. Make this city and state convenient for yourself!

2. **THIS CONTRACT IS MADE BY AND BETWEEN:____________________________**
hereafter referred to as "**BUYER**," and ____(list names of all owners) hereafter referred to as "**SELLER**," upon terms, provisions, and conditions set forth herein.

COMMENTARY: Add the phrase, after your name(s), "and/or Assigns." This gives you the right to allow another substitute buyer to step in and complete the purchase without the need of establishing an additional escrow to transact the sale. Thus this earnest money agreement really can be used as a short-term option agreement that gives you control of the subject property during the period of the offer.

3. **BUYER AGREES TO PURCHASE FROM SELLER AND SELLER AGREES TO CONVEY TO BUYER**, that certain real property located in __________________________, County of ___________, State of __________, commonly known by the street address of ____

__________________, and further described as ____ (attached legal description and tax parcel number if available), with a complete legal description to follow in escrow; together with the following items, if any: permanently installed heating, air conditioning, electrical, plumbing, security, fire detection, appliances including stove, oven, dishwasher, trash compactor, water heater, water conditioner, garage door opener and controls, landscape and shrubbery, wall-to-wall carpeting, custom window coverings, lighting fixtures, fans, television antennas, and other fixtures permanently attached to property. All of the included items, together with the real property and improvements, shall be referred to hereafter as the "**SUBJECT PROPERTY**."

COMMENTARY: Since the street address is an inadequate description to use in a legal document, a legal description (recorded lot and block number from a drawn plat map, or technical measurements known as metes and bounds, or by government rectangular survey) must appear here or be provided as part of the escrow in order that there not be future confusion and boundary/easement problems. The description may be obtained from the seller's agent, the county recorder's office, or from a capable title company (or attorney handling the closing).

4. **CONTRACT SALES PRICE AND FINANCING SUMMARY**:

A. EARNEST MONEY DEPOSIT INCLUDED HEREWITH (Payable to: __________________)
in the form of ___ Check ___ Promissory note ___ Other (describe:) ______________$ _____________

COMMENTARY: In order of priority, the holder of the earnest money should be the buyer's agent, next the institution handling the escrow (title company), next the lending institute (if it is the owner of the property). It would be rare that the seller would personally hold the earnest money. If the earnest money is in the form of a check, then it is important to include on the check a note that the holder is not to deposit it until the offer has been signed and accepted, after which time the check may be deposited in the holder's account pending close of escrow. If the seller quits the transaction in violation of the terms of the agreement, the earnest money is returned to the buyer. If the buyer quits the transaction in violation of the terms of the agreement, the earnest money is dispersed to the seller.

The earnest money can be in the form of check, promissory note, personal property, etc. Many seasoned investors prefer to use a personal note as earnest money consideration because this allows them to enter into many offers without actually tying up large amounts of cash as offers are accepted. The note can be activated upon acceptance, or can be displaced in favor of other consideration outlined in the agreement. For example, the note can be set up to mature at closing and cause the buyer to provide the indicated amount of cash as part of the deal.

How much earnest money is required? This is negotiable. The rule of thumb for a buyer is "As little as possible." Typically between $500 and several thousand dollars will suffice. Usually the earnest money will not exceed 3% of the purchase price. Larger deals may require more.

B. ADDITIONAL DOWN PAYMENT DUE ON OR BEFORE CLOSE OF ESCROW:
$ _____________

COMMENTARY: This is a negotiable item, and may be in effect zero.

C. SUM OF ALL FINANCING DESCRIBED IN PARAGRAPH FIVE BELOW:
$ _____________

COMMENTARY: Section five of the agreement will summarize the total financing package, and will include any assumed loans, loans taken "subject to," new loans (firsts, seconds, etc.), seller "carry back" financing, or any other financing that is mutually agreed to under the terms of the contract.

D. OTHER (describe:) ____$ ____________

E. TOTAL SELLING PRICE CONSIDERATION (A + B + C + D)
$ ____________

5. **FINANCING** (Note: The obtaining of BUYER'S financing is a contingency or condition of this agreement.):

A. $ ____________ BUYER to qualify for and obtain a new first loan in this approximate amount from a lender of BUYER'S choice, payable at approximately $ ____________ per month including interest (___ fixed rate ___ adjustable rate) not to exceed ______ percent per annum, all due and payable ___ years from close of escrow. BUYER to pay a maximum of $ ______ as "points" (discount points in the case of FHA or VA) or origination fees on behalf of BUYER. BUYER'S signature on loan documents will be deemed as BUYER'S having obtained financing.

COMMENTARY: Why specify the terms of the new loan? Because this clause will protect the buyer. If the new loan cannot be obtained according to these specifications, then the buyer can back out of the deal and get the earnest money back. As an incentive to sell a property, the seller may agree to pay the points on the loan for the borrower. In some VA transactions, the seller is obligated to pay some points to secure a loan for the borrower. In the event the seller has not agreed to pay any of the borrower's loan points, enter N/A (not applicable) into the appropriate space.

B. $ ________________BUYER to ___ assume/ ___ take title "subject to" the existing first loan of record on SUBJECT PROPERTY, in the approximate balance of $ _____, in favor of _____ _____, payable at approximately $ ____________ per month, including interest and at ___% (___ fixed rate _ _adjustable) with all remaining principal and interest due ______, 199__. In the event the loan balance or payment differs substantially from that which is indicated above, this contract may be terminated at BUYER'S option and the earnest money shall be refunded to BUYER without delay. BUYER'S fees to take over the existing loan not to exceed $ __________.

COMMENTARY: Many loans are "assumable" and the buyer can take them over by applying to do so through the lender and complying with the assumption requirements. Many loans are not assumable, thus forcing the buyer to pay them off (usually by originating a new loan to retire the old). If a property is taken "subject to" the existing loan it means that the buyer does not formally assume the loan through the lender, but simply takes on the responsibility to make the payments for the seller, who retains legal liability for repaying the loan. Taking title "subject to" the existing loan(s) may be risky for the buyer to do, since the lender may consider the action a violation of the loan agreement and thus call the note due. If the seller cannot pay it off, the buyer may have to step in and do so or lose all interest in the property. Competent legal advice is highly recommended in such transactions.

Why is it necessary to state the upper limits of fees to assume the loan? This is a protection for the buyer, who then has the right to back out of the agreement if the assumption fees prove to be higher than the tolerable limits.

C. $ ____________________ BUYER to execute a note secured by a __ first ___ second ___ third (mortgage or deed of trust) in favor of SELLER, payable ___ monthly ___ quarterly ___ annually at $_____________ or more, including ___ principal and interest ___ interest only, the interest being ___% per annum, the remaining balance of principal and interest all due __years from the date of origination. Other terms and conditions: ______________
____
____

COMMENTARY: This clause refers to seller "carry back" financing, one of the major strategies in the buyer's arsenal of creative financing techniques. This note will be a "first" if the property is free and clear of liens. It will be a second if there is already a first lien on the property, and a third if there are already two liens, etc.

The terms of this kind of financing are negotiable. The phrase "or more" allows the buyer to repay the note off without any prepayment penalty. Notice that the interest rate on seller financing is typically lower than the market rate. The buyer should try to extend the pay-back period as long as possible and avoid short-term balloons like the plague. If there must be a balloon payment, then make sure you add an additional condition in the space indicated that permits you to "roll the balloon over" for an additional period of time at buyer's option when the balloon comes due. Often a seller will demand some quid pro quo consideration for this privilege (higher interest rate, for example, on the roll-over).

D. $____________________ BUYER to ___ assume/ ___ take title "subject to" the existing ___ second, ___ third loan of record on SUBJECT PROPERTY, in the approximate balance of $ _____________, in favor of _____________, payable at approximately $ _____________ per month, including interest and at ___% (___ fixed rate ___adjustable) with all remaining principal and interest due _______, 199___. In the event the loan balance or payment differs substantially from that which is indicated above, this contract may be terminated at BUYER'S option and the earnest money shall be refunded to BUYER without delay. BUYER'S fees to take over the existing loan not to exceed $ __________.

E. $ _____________ BUYER to qualify for and obtain a new second loan in this approximate amount from a lender of BUYER'S choice, payable at approximately $ ____________ per month including interest (___ fixed rate ___adjustable rate) not to exceed ______ percent per annum, all due and payable ___ years from close of escrow. BUYER to pay a maximum of $ ______ as "points" (discount points in the case of FHA or VA) or origination fees on behalf of BUYER. BUYER'S signature on loan documents will be deemed as BUYER'S having obtained financing.

F. $ __________________ OTHER (describe:)__________________________________
____
____

COMMENTARY: There is no limit to the variety of creative financing that can be part of a transaction. It is possible that personal property is included in a deal or that real estate paper is made part of the deal. This space can be used to indicate such additional financing aspects.

$ ______________ TOTAL FINANCING

6. **TITLE**: SELLER shall furnish BUYER with title that is free and clear of liens, encumbrances, restrictions, rights, and conditions other than property taxes not yet due and restrictive covenants, conditions and restrictions of record, including public utility easements, if any, provided that same do not adversely affect the continued use of the property for the purpose for which it is presently being used. BUYER shall have ______ days to reasonably disapprove a preliminary title report furnished at ___ _________ expense. SELLER shall provide and pay for a standard title policy or an abstract brought current on the SUBJECT PROPERTY.

COMMENTARY: Never accept a property without first having the seller provide a policy of title insurance or at least an abstract of title brought up to date. The former is preferable, since it will provide insurance to cover damages to the buyer if it is later discovered that the title company (or attorney) failed to discover some real underlying defect in the title that the buyer was not made aware of (e.g. judgments, easement or ownership disputes, etc.).

The time aspect of this clause protects the buyer, who can (within the time period) disapprove the property if there are unacceptable title problems. Typically 10 to 15 days is considered a reasonable time frame. Usually the seller will pay for the title report, although this is a negotiable item.

7. **ESCROW INSTRUCTIONS:**. BUYER and SELLER shall open escrow with ____________, the escrow holder, and shall deliver signed instructions to escrow holder within ___ calendar days of the acceptance of this offer, and shall provide for closing within ___ calendar days of this acceptance. Escrow fees to be paid as follows: ____
.

COMMENTARY: The buyer should try to specify the escrow agent, since the buyer may very well have cultivated a good relationship with certain closing agents and may have discount privileges for obtaining title insurance when it comes to selling properties. Usually

3 to 5 business days is sufficient for delivering escrow instructions. Buyer and seller can split the escrow fees, although this is negotiable.

8. **POSSESSION:** Possession and occupancy shall be delivered to BUYER ___ on close of escrow, or _____ not later than ___ days after close of escrow. SELLER shall maintain the property in its present improved condition.

COMMENTARY. It is customary to allow the seller a reasonable period of time to vacate after closing (usually not longer than three days). If the seller needs more time, then a "Residential Lease Agreement After Sale" should be executed, providing for suitable payment to the new owner.

9. **PERSONAL PROPERTY:** The following items of personal property, free of liens and without warranty of condition, are included: ____.

10. **EXCEPTIONS WHICH DO NOT REMAIN WITH THE PROPERTY**: BUYER and SELLER hereby agree that the following items are not included with the sale of the property, and may be removed by SELLER: ____.

11. **SELLER TRANSFER/DISCLOSURE**: SELLER agrees to provide BUYER with a Transfer/Disclosure statement (and to use the official form as may be required by state law). Said statement shall include the identification of equipment and items contained in the residence and lot and whether such items are operational; any significant defects in structural components of the residence; information regarding the improvement and alterations made to the property including compliance with building codes and issuance of building permits and any items of concern regarding health, safety, regulation, violations, existing or potential lawsuits to the SUBJECT PROPERTY, nuisances or neighborhood problems which may affect the BUYER'S decision to purchase the SUBJECT PROPERTY. Upon receipt of the transfer/disclosure statement, BUYER shall have ___ calendar days to review same and to disapprove the property because of the disclosed conditions and defects, and to terminate the agreement by delivery of written notice to the SELLER. Should BUYER not disapprove the property within the prescribed limits of time, the conditions described in the transfer/disclosure shall be deemed to have been approved by BUYER.

COMMENTARY: This clause is an important protection for the buyer, since the seller must disclose here information that could adversely affect the use of the property after transfer.

12. **TAX-WITHHOLDING (F.I.R.P.T.A.)**: Under the Foreign Investment in Real Property Tax Act (IRC 1445), every buyer of real property must deduct and withhold from SELLER'S proceeds 10% of the gross sales price and to deposit that amount to the Internal Revenue Service upon the close of escrow, unless an exemption applies. Check current rules.The primary exemptions include, and no withholding is required, if any one of the following conditions exist:

___ A) BUYER purchases the property for use as a personal residence and the selling price is $300,000 or less and the BUYER or member of the BUYER'S family has definite plans to reside in the property for at least 50% of the number of days it is in use during each of the first twelve month periods after the transfer.

or ___ B) SELLER provides BUYER with an affidavit under penalty of perjury that SELLER is not a "foreign person."

or ___ C) SELLER provides BUYER with a "qualifying statement" issued by the Internal Revenue Service that SELLER is exempt from withholding.

13. **SUPPLEMENTS**: The following supplements are incorporated as part of this agreement:

____
____.

> COMMENTARY: Supplements could include a partner's approval, an attorney's approval, a statement by an accountant, etc.

14. **INSPECTIONS**: BUYER shall have the right, at BUYER'S expense, to select a licensed contractor and/or other qualified professional(s) to make "inspections," BUYER shall keep the property free of liens, and indemnify and hold SELLER harmless from all liability, claims, demands, damages, or costs, and repair all damages to the SUBJECT PROPERTY arising from said inspections. All claimed defects concerning condition of SUBJECT PROPERTY which adversely affect the continued use of the property for which it is presently being used shall be in writing,m and delivered to SELLER along with written reports within ___ calendar days. If SELLER is unable or unwilling to correct the deficiencies within __ calendar days of receiving notice or to agree in writing to escrow sufficient funds to correct them, or BUYER and SELLER fail to stipulate in writing as to what defects are accepted "as is" and/or what adjustment is to be made in the purchase price, then before close of escrow, or before any extension mutually agreed upon by both BUYER and SELLER, BUYER shall have the exclusive right to terminate this agreement. SELLER shall make the SUBJECT PROPERTY available for all inspections upon reasonable notice. BUYER'S failure to notify SELLER in writing of the defects which are unacceptable to BUYER within the time limit indicated shall be deemed approval.

15. **PEST CONTROL INSPECTION**: SELLER agrees, at SELLER'S expense, to provide within __ calendar days a written certificate from a licensed pest control operator that SUBJECT PROPERTY is free of wood-destroying organisms. SELLER shall make necessary repairs as required for certification within ___ calendar days, up to a limit of $500.00. In the event the cost to repair exceeds $500.00, then BUYER has the right to accept the property "as is" and receive credit from SELLER, in escrow, or BUYER and SELLER shall, within said days, mutually stipulate in writing as to what repairs SELLER will perform and pay for and what items BUYER will accept "as is," or the BUYER may terminate this agreement.

> COMMENTARY: The report is generally provided within fifteen days of acceptance, or when buyer contingencies have been removed.

16. **OTHER TERMS AND CONDITIONS**:____
____
____
____
____
______________________________.

> COMMENTARY: This space can be used to record any contingencies the buyer wishes to make expressly manifest as part of the agreement as a protective element of the agreement, for example:
>
> "Buyer may at any time and without penalty pay in full all amounts owing to the seller under the terms and conditions of this agreement."

"Buyer shall have the right to extend the balloon payment due July 1, 1995, for one additional year, provided buyer pays seller a principal payment of $5,000.00 on or before the original due date of the balloon. If buyer extends the balloon payment, he will continue to make the payment of $442.54 on the first day of each month until the balloon payment is paid in full."

"Seller agrees that the note and trust deed referenced in this agreement will be fully assumable, with no due-on-sale clause."

"Buyer and seller agree that the liability on the part of the buyer to satisfy the terms and conditions of the note and trust deed executed in favor of the seller shall be limited to the property securing said note and trust deed and shall not extend beyond this."

"Seller shall deliver all financial and tax records concerning subject property within three days to the buyer. Buyer shall have seven additional working days to review said documents and approve same. If approval is not given, this contract will become void."

"Both buyer and seller agree that the purchase of this property is subject to the inspection by buyer's business partner within ten working days. Buyer's business partner must approve sale in writing, or contract will become void."

"Seller shall deliver to buyer original lease agreements signed with the existing tenants of the property. Said documents will be delivered to buyer within three working days and must be approved in writing by buyer within an additional seven working days, or this contract will become void."

"Buyer and seller agree that buyer has the right to review and approve the title record and preliminary title report prior to closing. This approval can be given anytime prior to closing, but approval must be in writing. In the event that the buyer does not approve the title record or preliminary report, the buyer has the option of having the seller correct any problems, or buyer can void this contract."

"In the seller carry-back financing, buyer reserves the right to substitute collateral that is equal in value to, or greater in value than, the subject property, provided the seller first approves the substitution."

> [Note, this may be a great advantage to the buyer, who can then "definance" the subject property by wiping off the seller-related liens and thus use the subject property as a free and clear asset, or at least one free of seller financing.]

17. **TIME LIMIT OF OFFER**: The SELLER shall have until ______ (___ am/ ___ pm) on ______, 199___ , to accept this offer in its entirety by delivering a signed copy to the BUYER. If the SELLER does not accept the offer as written within the time limit prescribed, then SELLER shall immediately cause BUYER'S deposit to be refunded to BUYER.

COMMENTARY: The ideal time frame for the buyer is "upon presentation." However, as a courtesy, it is not unusual to allow 24 to 48 hours to respond.

18. **BOTH BUYER AND SELLER RESERVE THEIR RIGHTS** to assign their respective interests and agree to cooperate in effecting an Internal Revenue Code 1031 exchange or similar tax-deferred arrangement prior to close of escrow, provided, however, that such arrangement does not adversely

affect the basic agreements contained in this contract, and that said arrangement does not incur additional expense on the cooperating party. BUYER'S obligation under this agreement is further contingent upon and subject to BUYER'S first obtaining within ___ calendar days the following approvals: ____
____
____.

COMMENTARY: The approvals referred to here might include such language as "Subject to the inspection and approval of the subject property by my partner."

19. **REAL ESTATE COMMISSION**: SELLER shall pay a ___ % real estate commission on the total selling price as follows: $ _____________. ____________________________________is designated as BUYER'S agent and shall receive ___ % of all commissions paid. ______________________________ ___ is designated as SELLER'S agent and shall receive ___ % of all commissions paid.

20. **GENERAL AGREEMENTS**: Upon approval of this offer by the SELLER, this agreement shall become a contract between BUYER and SELLER, and shall inure to the benefit of the heirs, and administrators, executors, successors, personal representatives, and assigns of said parties. Time is of the essence and an essential part of this agreement. This contract constitutes the sole and entire agreement between the parties hereto and no modification of this contract shall be binding unless attached hereto and initialed by all parties to the contract. No representations, promises, or inducements not included in this contract shall be binding on any party hereto.

COMMENTARY: This is essentially legal boiler plate, but it provided added clarity and protection for the parties.

21. **BUYER'S STATEMENT AND RECEIPT**: "I/We hereby agree to purchase the above SUBJECT PROPERTY in accordance with the terms and conditions stated above, and acknowledge the receipt of a completed copy of this agreement , which I/We have fully read and understand."

Dated ______, 199___ Hour: ______, Social Security No. _____________
Address: ____________________________, City: ____________, State: ______, Zip Code: _________.

BUYER'S signature: ____
22. **SELLER'S STATEMENT AND RECEIPT**: ___"I/We approve the above offer, which I/We have fully read and understand, and agree to the above terms and conditions this day and time." Or___ "I/We approve the above offer with the additional provisions and modifications set forth in the attached and signed counter offer."

Dated: ______, 199___ Hour: ______, Social Security No. _____________
Address: ____________________________, City: ____________, State: ______, Zip Code: _________.

SELLER'S signature: ____
23. **BUYER'S RECEIPT FOR SIGNED OFFER**: The BUYER hereby acknowledges receipt of a copy of the above agreement bearing the SELLER'S signature in acceptance of this offer.

Dated: ______, 199___. BUYER'S signature: ______________________________________
SELLER and BUYER acknowledge a receipt of a copy of this agreement, which consists of a total of ___ pages.

______ SELLER'S initials

_______ BUYER'S initials

COMMENTARY: Ideally, each page of the agreement should be initialed by both parties to avoid any claim, later on, that parts of the agreement were missing.

6.12 USING A DOCUMENTATION CHECKLIST

Once you complete the earnest money offer, you should review the document to make sure that all lines are filled in correctly, that all changes are initialed, and that the terms of the agreement spell out exactly what you are offering the seller. Many find it helpful to review an earnest money agreement in the form of a checklist. The following checklist is given as a sample. As you become more experienced in your investment program, you will be able to adapt a checklist that reflects your own personal investment objectives.

EARNEST MONEY CHECKLIST

M 1. Have you conserved your cash by making the minimum acceptable earnest money deposit?

M 2. Have you identified the property on the agreement using both a street address and the legal description?

M 3. Are the price and terms accurately described in the agreement?

M 4. Is the proposed seller financing realistic and advantageous?

M 5. Have you included necessary subject-to clauses to protect you in the event that you need to back out of the sale, either because of problems associated with the property or with you as investor?

M 6. Has the seller agreed to warranty his representations? If the appliances are represented to be in top condition, will the seller warranty the same?

M 7. Does the earnest money offer distinguish personal property from real property? If you are receiving personal property as part of the purchase, will you receive title to same through a bill of sale?

M 8. Have you allowed for a review of the title?

M 9. Are the time, location, and closing agent specified in the agreement?

M 10. Do you fully understand all parts of the agreement that you are signing? Did you consult a professional attorney and/or real estate expert about any parts that you don't understand?

M 11. Have you checked with High Touch concerning any questions you may have about the principles of making offers?

If you learn to use a checklist before submitting the signed offer, you will eliminate many potential problems.

6.13 PROVIDING FOR CONTINGENCIES

In the previous sections of this unit, we have referred to many contingencies that can increase your investment success. It is important to include any necessary contingencies when making the offer to purchase. The seller will want to remove as many of the contingencies as possible, so you must set the contingency clauses within your negotiation range.

What follows is a list of situations that can easily be documented in the earnest money offer by using subject-to clauses:

Q Purchase is subject to buyer obtaining financing acceptable to buyer. (It is wise to include the exact terms of financing that you are looking for.)

Q Purchase is subject to inspection and approval by another party (specify). (This allows you an "out" if you need to back out of the sale.)

Q Purchase is subject to review and approval of all lease and rental agreements by buyer. (If you don't approve of the leases, you can void the contract.)

Q Purchase is subject to inspection and approval of all financial records. (You are making an investment so you can increase your financial freedom. If you fail to review the financial records, you are making an investment mistake.)

Q Purchase is subject to seller providing a survey of the property, which survey is to be approved by buyer. (This allows you to examine the physical size and make sure it corresponds to the legal description.)

Q Purchase is subject to review and approval of clear and marketable title. (If the seller has over financed the property or is not the legal owner, you need to know this in advance.)

Q Purchase is subject to all appliances, heating and air conditioning equipment, and related items being in good working order as of the day of closing.

Q Purchase is subject to walk through inspection and approval by buyer 24 hours prior to closing.

If you use contingency clauses to provide for the unexpected, your chance of investment success will be increased dramatically.

A CASE STUDY

Tim H. made an offer for a single-family rental property that appeared to be a good investment. He included several contingency clauses that would allow him the right to back out of the sale if the property or the investment didn't turn out to be as it seemed. He also wanted to give himself the option to market the property on excellent terms in the future, so he included a few additional clauses, especially a clause stating that the note and trust deed would be assumable by a new buyer. He also limited his liability by using an exculpatory clause (see

"A Few Terms You Should Know," earlier in this unit). In this way Tim knew that he was protecting his investment and increasing his chances of selling at some time in the future.

6.14 HOW TO MAKE THE COUNTER OFFER YOUR TOOL

We mentioned earlier that both the buyer and the seller had to agree on the terms of the contract and sign the agreement in order for the contract to be valid. As you begin your investment program, you will be making offers on many properties and many of your offers will not be accepted by the seller when he reviews the terms of your offer. A seller who doesn't accept your original offer will usually make what is called a "counter offer" and will submit it for your acceptance. If you don't agree to the seller's counter offer, you may submit a counter counter offer. This process can go on without restriction until both the buyer and the seller come to a meeting of the minds on all the terms of the contract.

Don't expect the seller to accept your original offer if you are negotiating all the terms of sale at the lower end of your negotiation range. In most cases, the negotiation process is a give-and-take situation. As the seller agrees to some of your terms, you may have to move up the scale on other terms to make the offer more acceptable to him. This process can become a profitable one if you keep your priorities straight. If your main objective is a low price and excellent financing terms, then you may have to sacrifice slightly on the amount of earnest money deposit, the date of closing, or the proration of escrow fees.

In order to make the counter offer a tool in your investment program, remember three things:

M 1. Don't start from scratch each time.

M 2. Always begin negotiations at the lower end of your negotiation range.

M 3. Don't allow the seller excess time.

1. <u>Don't start from scratch each time</u>. When the seller makes a counter offer, negotiate only those items that are still in question. Those items that have been agreed to should remain as they are. In this way, you will narrow down the number of terms that you are negotiating each time you make a counter offer.

A CASE STUDY

Todd A. made an offer to purchase a six-unit apartment building. The owner was asking $147,000 for the property, and was willing to carry the mortgage at 11 percent for twenty years. Todd had reviewed the property carefully and believed that the price was an excellent one. Since the owner was willing to take only $5,000 down on the property and the rents were very high, Todd thought that he could get the property into a positive cash-flow situation in three to six months.

Todd wanted to make sure that he was allowed to have an exculpatory clause, no prepayment, and the right to substitute collateral, so he made an offer to the seller than included all of these additional clauses. He offered only $139,000, with $4,000 down and the balance at 10 percent for thirty years.

When Todd got the counter offer, he found that the seller had agreed to the three additional clauses, the lower interest rate, the lower down payment, and the extended time of payment. But didn't accept the lower price. Todd made a counter counter offer with all the original terms the same, except he changed the price to $144,000. The seller accepted the offer, and Todd made an excellent purchase. The key to his success was that he didn't add new negotiation items when he got the counter offer.

2. <u>Always begin negotiation at the lower end of your negotiation range</u>. When Todd made the offer on the six-unit apartment building, he started at the lower end of his

negotiation range on each of his terms. By using that approach, he could give on one or more items, if necessary, and still purchase the property according to satisfactory terms and conditions.

3. Don't allow the seller excess time. If you allow the seller a great deal of time to think about your offer, he will usually try to negotiate more items. If you want to make a successful purchase, keep the negotiation process moving along with prompt and rapid offers and counter offers.

If Todd had allowed the seller a week to think about all of his terms, the seller probably would not have agreed to the lower interest rate and other terms.

6.15 A NOTE ON THE NEED FOR MAKING OFFERS

A well-known real estate professional once said that you will never buy a property if you don't make a lot of offers. It's true! If you want to purchase good investment properties, you will need to make many offers. We have found that it is necessary, on an average, to submit eight to ten separate offers in order to get one offer accepted. If you are making those offers according to the principles that you are learning in this manual, you will be able to find those people who want to sell their property with nothing-down techniques.

If you want to be successful, take the time to understand the principles--and then start making offers! As you begin, don't be short-sighted by making offers that are not documented with every term you believe to be important.

6.16 HOW WELL HAVE YOU LEARNED?

The better you've learned the information and concepts in this unit, the more you will be able to apply then. Test your learning by answering the following questions. Do not skip this step--the best way to learn is to reprocess what you've learned in written form.

(NOTE: If you are uncertain of a particular answer, look back through the unit. The answers to all the questions can be found in the preceding pages of the unit.)

1. What is the purchase contract between a buyer and a seller called?

2. Name at least five common documentation mistakes make by real estate investors.

3. Why should the offer to purchase be drafted by the buyer instead of the seller?

4. Why is it important to use a closing (escrow) agent?

5. When should a deed of reconveyance be placed in escrow?

6. What is meant by the rule, "cash conserved is the key to increased investment opportunities?"

7. Name at least six non-price negotiation terms that should be documented in the earnest money offer
to purchase.

8. Why would a buyer of a property agree to make improvements without closing on a piece of property?

9. What is an exculpatory clause, and when would it be used?

10. What is meant by the negotiation range?

11. What are the three techniques used to set the price negotiation range?

12. Name the six essential elements of a legal real estate contract.

13. What is meant by the buyer and the seller having a "meeting of the minds"?

14. When making an offer on a piece of property, how do you describe the subject real estate?

15. What are "riders" in an earnest money offer to purchase?

16. How is personal property transferred in a real estate purchase transaction?

17. What should you do when you can't write the total description of the negotiated terms in the space on the printed earnest money offer form?

18. If the printed earnest money form contains a phrase that doesn't pertain to your purchase agreement, what should you do?

19. Why would the buyer require the right to review and approve any and all lease agreements?

20. When do you use an earnest money checklist?

21. Name at least three contingency situations that can be documented with proper "subject-to" clauses.

22. What are the three things you should remember in order to make the counter offer your tool?

23. Why should you continue to make more and more offers?
[End of Unit 6]

UNIT SEVEN

CLOSING THE REAL ESTATE TRANSACTION

UNIT SEVEN

CLOSING THE REAL ESTATE TRANSACTION

7.1 GENERAL CONSIDERATIONS

You already know many of the basics of making real estate investments, how to set financial goals and use win/win principles, how to find real estate bargains, how to write offers, and how to negotiate.

But the real estate transaction is ultimately made through a process called "the closing." Without a successful closing, the property title does not pass from the seller to the buyer, and your valuable time and energy are lost. So it is vital that you become familiar with the closing process.

In this unit, you will learn all about the closing process, including the many considerations involved before, during, and after the actual closing. You will learn about the documents involved in the transfer of property ownership. And you will learn the language of closing, which will give you confidence in dealing with the professionals who will assist you in the closing process and enable you to take an active role in protecting your interests.

As you study this unit, imagine yourself as a buyer or a seller. Ask yourself how each document or step in the closing process would apply to you. The make your own checklist of items to consider when closing your real estate transactions.

7.2 A FEW TERMS YOU SHOULD KNOW

<u>Abstract</u>: A written history of the title to a property.

<u>Closing costs</u>: The costs that buyer and seller pay at the time of closing.

<u>Closing statement</u>: A settlement sheet that show and accounting of funds to the buyer and the seller at the completion of the transaction.

<u>Deed</u>: A document that transfers ownership of personal property.

<u>Escrow</u>: The deposit of funds and documents with a neutral third party, along with instructions on how to conduct the closing.

Escrow agent: The person in charge of an escrow.

Prorations: The division of income and expenses between buyer and seller.

Settlement meeting: A meeting at which the buyer pays for the property, the seller delivers a deed to the buyer, and all other matters pertaining to the sale are concluded.

Survey: An examination of a property's boundaries and improvements.

Title: The evidence of ownership.

Title closing: The process that begins with signing the contract of sale and ends with conveying and recording the title.

Title insurance: An insurance policy from a title company that protects against losses arising from defects in the title.

Title search: A search of public records and documents to determine current ownership and the condition of the property title.

7.3 KEY POINTS ABOUT CLOSING REAL ESTATE TRANSACTIONS

As you read this unit, remember the following key points. They will help you put the information you will be learning into a correct context.

* The closing process usually involves either a settlement meeting, where all necessary documents are signed and a deed is delivered to the buyer, or an escrow arrangement involving an escrow agent and delivery of the deed and other documents in escrow.

* Most of the documents and details of a real estate transaction are prepared and handled by

professionals, real estate brokers, title company officers, attorneys, escrow agents, loan officers, insurance agents, and so forth.

* Some important considerations before closing include choosing a beneficial closing date, ordering a title search, examining the title report, inspecting the property, and obtaining adequate hazard and liability insurance.

* Important documents used in a closing include affidavits, abstracts or title insurance policies, bills of sale, deeds, insurance policies, mortgages, reports, surveys, and warranties.

* The actual closing usually involves examining and executing the closing documents, accepting the closing statements, paying the purchase price and closing costs and delivering the deed.

* Considerations after the closing include recording the documents, changing utility bills to the buyer's name, verifying the adequacy of insurance, and keeping the closing documents in a safe place.

7.4 CLOSING THE REAL ESTATE TRANSACTION

UNDERSTANDING THE CLOSING PROCESS

Congratulations! You've found the right property, presented an offer, and negotiated a win/win contract. Now you can sit back and wait for the day when you will take title and possession. Right? Wrong! Unless you take care of several vital details now and on the day you receive the title, the most brilliant transaction will fall flat.

For one thing, the title must be examined to verify that the seller really owns the property and to identify any mortgages, liens, or other restrictions on the property. Financing must be arranged, insurance and property taxes must be prorated, and documents must be prepared. Finally, you must pay for the property and receive the deed from the seller. This entire process is referred to as either the closing, settlement, or escrow, depending on your area of the country.

The closing process varies from state to state. In many states it is concluded at a meeting of the parties to the transaction, where a deed is delivered to the buyer. In other states, it is conducted by an escrow agent, with the deed delivered in escrow.

Most details of the closing will be handled by professionals such as lawyers, real estate brokers, title officers, escrow agents, loan officers, insurance agents, and inspectors. But it is very important for you to understand the process of closing, the documentation involved, and the legal considerations that might arise.

7.41 A TYPICAL CLOSING OR SETTLEMENT MEETING

In a typical meeting to close a real estate transaction, the buyer pays the seller for the property and the seller delivers the deed. The real estate agents who brought the buyer and the seller together are usually present, along with the representative of the firm that conducted the title search. If a new loan is being made or an existing one is being paid off, a representative of the lender might be present. The buyer and seller might also choose to have an attorney present to see that everything is properly carried out.

If there are questions or disagreements during the closing, they are usually resolved through negotiation. If agreement cannot be reached during the meeting, the parties may agree to adjourn the closing until a later time. If there are major problems, such as a problem with the title, it may be necessary to cancel the entire transaction.

Consider this example of a typical closing or settlement meeting. Jill M. (the buyer) and Ray S. (the seller) arrive at Integrity Title Company at 10:00 A.M. to close the transaction. The meeting is conducted by the title officer for Integrity Title Company. Jill's attorney is present at the meeting, as is the real estate agent who listed and sold the house. Ray's attorney who reviewed and approved the closing documents prior to the meeting, is not present. In case of future dispute regarding anything that transpires during the meeting, both Jill and Ray make a list of those present.

The documents called for by the contract of sale are exchanged for inspection by the parties involved in the closing. Jill and her attorney inspect the deed, the title report and title policy, the mortgage papers, the bill of sale, and any other documents involved in the transaction. Then Jill and Ray sign their names in the appropriate places.

The title officer gives Jill and Ray settlement statements that summarize the financial aspects of their transaction. The settlement statements are carefully reviewed and checked for accuracy. Then Jill signs the buyer's settlement statement and Ray signs the seller's settlement statement.

After all of the documents have been reviewed and accepted, Jill pays the agreed upon amount to the title officer, who will disperse the funds to Ray, and any other's who are entitled to receive payment. The title officer then hands a completed deed to Jill. (If a lender had been involved, Jill would have signed a mortgage and note, and the lender would have paid Sam.) Finally all of the documents are signed and everyone is paid. The deed and other documents are then recorded and the transaction is complete.

7.42 CLOSING THROUGH ESCROW

Sometimes real estate transactions are closed through a neutral third party called an escrow agent. Instead of delivering the deed to the buyer at a closing meeting, the seller gives the deed to the escrow agent who delivers that deed to the buyer after the promises made in he sales contract. As part of closing, the buyer gives the escrow agent the money for the property, and the agent gives that money to the seller after he has completed all of his promises. The buyer, in turn, receives the deed once his promises are kept.

The escrow arrangement is convenient for both buyer and seller because they do not have to meet during the escrow period or at the closing. The escrow agent accumulated all of the documents, approvals, and funds prior to the closing date, and does the closing alone.

After signing the contract of sale, the buyer and seller select a neutral escrow agent to handle the closing. This agent may be the escrow department of a bank or other lending agency, an escrow company, an attorney, a real estate broker, or a title insurance company.

The escrow agent places the earnest money in a trust account and prepares a set of escrow instructions based on the contract of sale. The instructions explain everything that each party must do before payment is made to the seller and the deed is delivered to the buyer. Usually the escrow agent orders a title search and obtains title insurance. If an existing loan against the property is to be repaid, the escrow agent contacts the lender to determine the amount of money necessary to repay the loan and to ask for a mortgage release. If an existing loan is to be assumed, the escrow agent will ask the lender for the current balance and any documents that the buyer must sign.

When the title search is completed, the escrow agent sends it to the buyer for his approval. A deed is prepared and after it is signed by the seller, it is given to the escrow agent. The escrow agent collects insurance forms, tax papers, leases, and other documents for proration and future delivery to the buyer.

After all of the escrow instructions have been carried out, the closing can take place. The escrow agent usually orders a last-minute check on the title. If no changes have occurred since the preliminary title search, the deed, mortgage, and other documents are recorded. After the recording, the escrow agent pays each party who is to receive funds from the escrow. The recorded documents and any other important papers or information are then mailed to each party.

The following example illustrates a closing through escrow. Rob L. (the buyer) and Elaine D. (the seller) have signed a contract of sale for a duplex. The have agreed to have Earl C. at Effective Escrow Company handle the closing. Earl deposited the earnest money in his company's trust account and prepared a set of escrow instructions based on the provisions set forth in the contract of sale. Earl then ordered a title search and title insurance from Integrity Title Company.

After the title search was completed, Earl sent a title report to Rob for his inspection and approval. Elaine signed a deed for future delivery to Rob. Earl also collected insurance forms, tax papers, leases, and other documents for proration and future delivery. All of the necessary closing documents are signed by Rob and Elaine and held in escrow.

After all of the documents were signed and Rob deposited the money to buy the property, Earl reviewed the escrow instructions to make sure that all of the requirements and conditions of the contract of sale had been met. Earl then ordered a last-minute check on the title to make sure that no changes had occurred since the preliminary title search.

After everything was completed, Earl recorded the deed, mortgage, and other necessary documents. After the documents were recorded, Earl paid Elaine and everyone else who was to receive funds from the escrow. The recorded documents and other important papers were then mailed to Rob and Elaine.

7.5. HELP FROM PROFESSIONALS

You have already learned that most of the details of a real estate closing are handled by experienced professionals.

These experts work as a team to help you accomplish your investment objectives. Your team might include professionals like the following:

Real estate agent or broker. Real estate agents and brokers can be very helpful in arranging and performing different aspects of the closing process. In some areas a real estate broker actually conducts the closing.

Title company officer. The title company officer is one of the most important professionals available to you. He serves as a neutral third party and often prepares the legal paperwork for the closing. The title company usually issues a policy of title insurance.

Attorney. A good real estate attorney can advise you on all the legal aspects of the real estate transaction. In some areas closings are conducted by attorneys.

Escrow agent. If the transaction will be closed through an escrow arrangement, an escrow agent will hold documents and funds for you according to the escrow instructions.

Loan officer. When the transaction involves institutional financing, a good loan officer can be of great assistance.

Appraiser. An appraiser can provide useful information about the value of the property involved in the transaction.

Insurance agent. Every real estate transaction involves questions about property insurance. A good insurance agent can answer those questions and help you get the best coverage for the lowest price.

Other professionals. Other professionals that might be involved in a real estate closing are:

Accountants. Real estate transactions often involve complex financial information and tax considerations; accountants can provide needed expertise in these areas.

Architects. Larger properties may involve architectural considerations that require the assistance of an architect.

Building inspectors. Many transactions require inspection and approval of the property by an authorized building inspector.

Engineers and surveyors. These professionals can provide a survey of the property if one is required.

Property managers. Property managers often have important information about specific properties, tenants, lease agreements, deposits, and service contracts.

Public officials. Certain public officials (such as those in planning and zoning departments) may also become involved in real estate transactions.

Your team of real estate professionals could be compared to the members of a professional football team. Each member of the team has been recruited and trained to perform specific tasks. You are the coach. You design the strategies and call the plays, and the professionals execute their part of the game plan.

Many real estate investors try to save money by doing everything themselves, but professional assistance is usually well worth the expense. Consider the case of Brad K. who signed a contract to buy a large fixer-upper house with the intention of converting it into a duplex. He had noticed several nice duplexes just two blocks away form the house and assumed that he could concert his house without any problems.

After the transaction was closed, Brad discovered that his new property was in an area zoned for single-family dwellings only. Even though the dividing line between the two zones was only a block away, Brad could not legally convert his house to a duplex. A good attorney or other real estate professional would have advised Brad regarding zoning restrictions. The cost of obtaining professional assistance in this case would have been small compared to the expense of not knowing the zoning restrictions beforehand.

7.6 CONSIDERATIONS BEFORE CLOSING

Before closing, you will need to consider a number of routine matters that can nevertheless have a significant effect on the outcome of the transaction.

The story of John Y. illustrates some of the problems that may arise when these important considerations are neglected. John signed a contract of sale to buy a three-bedroom house. Although he ordered a title search, he did not examine the tile report very carefully. As a result, he failed to notify the seller of a defect in the title and did not receive a clear title to the property.

John agreed to assume the existing property insurance policy without reviewing the coverage. He later found that much of the premium went to cover personal property and that there was no liability coverage. Since he planned to offer the house for rent without furnishings, he would have been much better off to obtain new insurance coverage.

John also failed to make a careful inspection of the property. He later learned that the plumbing and electrical systems were in poor condition and that the house was infested with termites!

7.7 CHECKLIST OF KEY ACTION ITEMS IN THE CLOSING PROCESS

Be sure to consider the following matters before the closing takes place. Not all will be needed with all properties; review this information when you have a specific property in mind.

1. Choosing the closing date.
2. Choosing a closing agent.

3. Ordering the title search.
4. Examining the title report.
5. Notifying the seller of title defects.
6. Accepting or rejecting the title.
7. Obtaining a survey.
8. Inspecting the property.
9. Obtaining a chattel lien search.
10. Examining existing leases.
11. Making bulk sales affidavits and notices.
12. Obtaining property insurance.
13. Checking on property maintenance

1. Choosing the Closing Date

The closing date is usually stated in the contract of sale. If not, it is presumed that the transaction will be closed within a reasonable time. The closing date is generally determined by the time required to secure title insurance, the time needed to arrange for financing, the time needed to draft the necessary documents, and the convenience of the parties.

Since the date of closing affects the proration of interest, taxes, insurance, and other expenses, as well as the amount of depreciation and interest income, you should choose a closing date that will be most advantageous to you.

For example, if Kirk, the buyer, assumes an existing loan from Betty, the seller, an interest proration will be necessary. Interest is normally paid in arrears. So if the loan payments are due the first of each month, Kirk can save closing costs by closing near the end of the month. Property taxes are levied annually, and the buyer and seller each pay their proportionate shares. Insurance policies are paid for in advance. If Kirk assumes Betty's policy, he must reimburse her for the value of the remaining coverage on a prorated basis. Kirk can calculate depreciation from the month that the property is placed in service, even if the closing date is near the end of that month.

In some cases, the seller will specify a certain closing date to be sure that his holding period has been long enough to have his profit from the sale treated as a capital gain rather than ordinary income.

If the title search is not yet completed or if the lending institution has not yet processed the loan, the closing may be adjourned for a reasonable period of time. Whichever party is not prepared on the date set for closing may request an adjournment.

The other party in turn may specify that the prorations be computed as of the original date or the adjourned date, whichever is more favorable to him.

For example, if Betty requests the adjournment, and the income form the property is greater than the carrying charges, it is to Kirk's advantage to have the prorating computed as of the original date. Kirk would receive the rents from the date originally fixed for closing, and Betty would be entitled to interest on the unpaid balance of the purchase price from the original closing date.

If the contract fixes a closing date and provides that "time is of the essence," then the party who is ready to close on the fixed date does not need to grant the request of the other party for adjournment.

2. <u>Choosing a Closing Agent</u>

Closing practices vary in different sections of the country and even within the same state. In various areas, closings may be conducted by title insurance companies, escrow companies, lending institutions, real estate brokers, or attorneys. Find out what type of closing agent is commonly used in your area, and develop a good working relationship with that closing agent.

3. <u>Ordering a Title Search</u>

After the contract of sale has been entered into, the buyer should arrange to have a title search made to determine whether the seller holds clear title. If the contract requires the seller to furnish evidence of title, he should do so within the time allowed by the contract. Most buyers are not qualified to do a comprehensive search of the public records. Also, each state has different laws and recording procedures. For this reason, it is wise to have a title company, professional abstractor, or an attorney perform the title search.

The abstract, or title history, is a summary of every recorded document affecting the title to the property. It begins with a description of the land and lists all deeds, mortgages, wills, judgments, mechanic's liens, foreclosure proceedings, tax sales, and other matters affecting the title to the property.

After an abstract has been prepared, it is often examined by an attorney who then issues a certificate of title. This certificate is the attorney's opinion of title, based on his examination of the public record.

You cannot rely completely on the abstract or certificate of title to guarantee a clean title, however. The abstract or certificate of title will not disclose all debts in title; forgery, fraud, or lack of delivery, for example. Suppose that you own a house and someone forges your signature on a deed purporting to deed the house to him or even to some innocent person. Or suppose that a recorded deed was never properly delivered. These defective deeds do not pass title.

Because of these risks, most buyers buy a title insurance policy. Title insurance guarantees the title to the property. The insurance company agrees to defend at its own expense against any lawsuit based on a title defect covered by the policy.

Once the buyer obtains a title insurance policy, it remains in force, without further payment, until the property is sold again. At that time the title is examined to cover the period of time since the issuance of the policy, and a new policy is issued to the new buyer.

4. <u>Examining the Title Report</u>

When you, as a buyer, receive the title report you or your attorney must review it for defects. Since most investors do not have enough legal experience to discover all the defects, professional assistance is crucial.

5. <u>Notifying the Seller of Title Defects</u>

As soon as you or your attorney receive the abstract or title report, notify the seller or the seller's attorney promptly so that any title defects mentioned in the report can be corrected. Almost every title examination will reveal some defects or encumbrances.

6. <u>Accepting or Rejecting the Title</u>

The seller agrees to furnish you with good and marketable title to the property, subject to any encumbrances or exceptions mentioned in the contract of sale. After examining the title report, you or your attorney may decide that the title is defective. If the seller cannot or will not overcome the objections, you can refuse to close the transaction.

If the seller believes that the rejection is unwarranted, he may bring a lawsuit for damages or specific performance. Then the court will decide whether or not the title to the property should have been accepted. When the contract of sale does not specify the kind or quality of title to be delivered, it is implied that the seller must give a good and marketable title, or one free from any reasonable doubt.

7. <u>Obtaining a Survey</u>

In many states, lending institutions require a survey before lending money on a particular property. A survey shows any encroachments on the property; for example, bay windows or eaves that extend over the lot lines, or such subsurface encroachments as footings of a building that extend into adjoining property. The survey may also show a zoning violation. If, for example, a zoning ordinance states that no building shall be built less than fifteen feet from the property line, a survey would show whether the buildings on the property conform to that ordinance.

8. <u>Inspecting the Property</u>

Before making the offer, you should have carefully inspected the property. Now, before closing, you should once again thoroughly inspect the property for problems in structure, sanitation facilities, drainage and mechanical systems. This examination should also disclose whether there are any unrecorded easements.

Sometimes you will want certain professional to check for violations of zoning or building ordinances and for recent construction or repairs that might be subject to a mechanic's lien. It might also be wise to have an inspection for termites or other pests. If income property is involved, you should also determine what furniture and appliances are owned by the tenants.

Howard B. was buying a small furnished apartment building. By checking with the tenants, he learned that they owned most of the furniture. Not knowing this could have caused serious problems when the tenants later moved out and took their furniture with them.

9. <u>Obtaining a Chattel Lien Search</u>

If valuable chattels (fixtures, personal property, etc.) are included in the sale, a search should be made for any financing statements affecting them. Furniture, stoves, refrigerators, and other appliances found in homes are often included in the contract of sale. You will need to find out whether such fixtures or personal property included in the contract of sale are actually owned free and clear by the seller.

10. <u>Examining Existing Leases</u>

If you are buying an income property with existing leases, you or your attorney should examine those leases carefully before closing. Find out the terms of the leases -- including the amount of rent received from each tenant and the amount of deposits. It is also a good idea to have the seller provide an affidavit stating that no rent has been paid in advance by the tenants.

11. <u>Making Bulk Sales Affidavits and Notices</u>

If you are buying a retail establishment that includes a stock of merchandise, comply with any state laws requiring you to give notice of the pending sale to the creditors of the business so that their rights may be protected.

12. Obtaining Property Insurance

Review the coverage of the existing insurance policy to determine whether you will assume that policy or obtain new insurance. An insurance agent can tell you about different kinds of policies available so that you can make an informed decision. If you choose to assume the existing policy, obtain consent from the insurance company before closing. If you choose to obtain new insurance, get an insurance binder before closing.

13. Checking on Property Maintenance

The seller is responsible to maintain the property in a reasonable manner from the date of the contract to the date of closing. If the seller allows the property to deteriorate before the title passes, the buyer may sue him for damages.

7.8 IMPORTANT DOCUMENTS

The actual closing process involves the execution and exchange of various documents. It is somewhat like the process of graduating from school. The student prepares and completes various papers and projects and quizzes and exams. The teachers complete various evaluations and progress reports. These could all be considered preliminary documents. Then when all of the requirements for graduation have been met, the student is given a diploma. This could be compared with the delivery of the deed and bill of sale in a real estate transaction.

Although most of these documents are prepared by professionals, you need to have a basic understanding of the documents form and purpose. The parties often exchange copies of certain of these documents before the actual closing so that any problems can be ironed out in advance.

We will be considering the following documents in this section:

1. Affidavits

2. Bill of sale for personal property
3. Certificates of compliance
4. The deed
5. Indemnity agreement
6. Insurance policies
7. Satisfaction of liens
8. Mortgages
9. Pest control report
10. Power of attorney
11. Tax receipts
12. The survey
13. Warranties
14. Water and other utility bills
15. Leases
16. Service contracts
17. Abstract of title or title insurance policy
18. Escrow agreement
19. Minutes of closing

1. <u>Affidavits</u>

Often the seller must furnish certain affidavits at closing. For example, he often provides an affidavit of title certifying that, during the period between the completion of the title search and the date of closing, there have been no judgments against him, no unrecorded deeds or encumbrances against the property, and nothing else that would cause a defect in his title. The seller might also provide an affidavit stating that all personal property included in the sale has been fully paid for and that the seller is unaware of any zoning or building code violations affecting the property.

The following is a sample affidavit from the seller:

<u>AFFIDAVIT</u>

State of _______
County of _______

_________________ (hereinafter referred to as "Seller") being first duly sworn states:

1. Seller is selling the property located at _______ and describe as follows:

2. The above describe property is being sold to ______________ (hereinafter referred to as "Buyer").

3. The above-described property has been in Seller's peaceable and undisturbed possession since _____and Seller's title and possessory rights have never been disputed, questioned, or rejected.

4. No court of this state, or any other state, or of the United States has rendered a judgment against Seller that remains unsatisfied as of the making of this affidavit, nor are there any court proceedings pending against Seller affecting the above-described premises.

5. The Seller has no knowledge of termites or rodent infestation of the buildings.

6. Present use of the property is no in violation of law.

7. Seller has given no deed, grant, contract, or encumbrance that is not reflected in the public records.

8. Seller has no knowledge of any violation of building or zoning

ordinances affecting the property.

9. All personal property included in the sale has been fully paid for.

This affidavit is given to induce Buyer to accept a deed to the above described premises and to pay the consideration therefor, and it is Seller's intention that Buyer rely upon this affidavit.

____

__

Seller

Subscribed and Sworn
before me this ___ day of ___, 19__.

____
Notary Public

2. <u>Bill of Sale for Personal Property</u>

The bill of sale transfers ownership of that property. The more precisely the personal property is identified in the bill of sale, the better. The bill of sale should also represent that the seller has the full right to sell the property and that the property is fully paid for and free of all liens and encumbrances.

If any personal property is included with a property you are buying, be sure to take an inventory of the premises shortly before the closing and to make a spot-check on the day of closing to make sure you are getting the personal property you have bargained for. But problems may still arise unless the personal property to be transferred is specifically identified both in the contract and in a bill of sale.

Steve N. purchased a house with a new stove and a new 22 cubic-foot Amana refrigerator. Steve inspected the house prior to closing and found all the appliances in working order. After the closing, Steve entered his new house and found that he no longer had a new 22-cubic-foot Amana refrigerator. In its place was an old Kelvinator refrigerator only half as large and in poor condition. Steve's contract and bill of sale contained the word <u>refrigerator</u>, but they did not specify what kind of refrigerator.

To avoid this type of problem, the contract and bill of sale should list and specifically describe all the personal property to be transferred. Appliances should be described by make, model, and serial number. For example, "One 22-cubic-foot Amana refrigerator, model number 110, serial number 1234567."

The following is a sample bill of sale:

<u>BILL OF SALE</u>

Know all men by these presents that Kurt Jensen, the Seller, for and in consideration of the sum included in the purchase price, the receipt whereof is hereby acknowledged, has bargained, sold, assigned and transferred unto Steve Nelson, the Buyer, that certain personal property now at 35000 North Canyon Road, Provo, Utah, particularly described as follows:

1. One 22-cubic-foot Amana refrigerator, model number 110, serial number 1234567.

And the Seller upon the consideration recited above warrants ownership of and good title to said property, the right to sell the same and that there are no liens, encumbrances or charges thereon or against the same and to defend the title and possession transferred to the Buyer against all lawful claims.

In witness whereof, I have hereunto set my hand this ___ day of ______, 19__.

____

__

Kurt Jensen

Subscribe and Sworn
before me this ___ day of ___, 19__.

____

Notary Public

3. Certificates of Compliance

When you are buying commercial or income property, you need to know that the property is in compliance with the various laws and ordinances relating to its use, occupancy, and condition. If you are buying a new building, the seller will give you a certificate showing that plumbing, heating, electrical, and other building standards have been met. Local authorities will often conduct and inspection of the property, and then issue a certificate of compliance stating that no violations of building codes, zoning regulations, or other ordinances exist.

The following is a sample of a letter certifying compliance:

July 29, 1985

City of Provo
P.O. Box 1849
Provo, Utah 84603

To Whom It May Concern:

On July 19, 1985, I made a special inspection at 35000 North Canyon Road in Provo. It appears that everything has been done according to the present code, and there are no violations of any code requirements.

If I can be of further service to you, please let me know.

Sincerely yours,

Albert Alsop
Provo City Building
Inspector

4. The Deed

The deed is probably the most important document in the entire transaction. The provisions in the deed must agree with those in the contract of sale. For example, if the contract of sale requires a warranty deed with certain provisions, then that warranty deed must be produced at closing. The deed sets out the names of the parties, the amount of consideration, the words of conveyance, and a description of the property.

There are many different kinds of deeds which convey title to real estate. Some of the more common types of deeds are listed below:

a. A bargain and sale deed conveys the property but does not include any warranties of title.

b. A quitclaim deed conveys only the grantor's (the seller's) present interest in the land. It contains no covenants, warranties, or implications of the grantor's ownership.

c. In some states, a sheriff's deed is issued following a foreclosure sale. It usually gives the grantee (the buyer) all of the rights, title, and interest except those which were senior to the foreclosed lien.

d. A special warranty deed contains only one covenant. The grantor covenants that he has not encumbered the property except as stated in the deed.

e. A tax deed is issued in some states when property is purchased at a tax sale.

f. A warranty deed contains certain covenants and warranties by the grantor that the deed conveys a good and unencumbered title. Some states such as California, Idaho, and North Dakota use a grant deed instead of a warranty deed.

5. Indemnity Agreement

The seller is often required to provide an agreement to indemnify you form any unpaid or unsatisfied claims due anyone prior to the closing.

6. Insurance Policies

It is important for the buyer to obtain adequate insurance protection. If the existing insurance policy is assigned to you, the seller is entitled to a refund for the amount of the premium that applies to your ownership. If you acquire your own insurance, the seller's insurance is canceled, and the seller obtains a refund.

7. Satisfaction of Liens

If any liens have been imposed on the property, the seller should furnish certificates showing that these liens have been discharged.

8. Mortgages

In almost every real estate transaction, you will be either obtaining or releasing some type of mortgage. Many offers are made subject to the buyer's ability to obtain suitable financing. Review all mortgage documents carefully. If there is an existing mortgage on a property, you are buying and you do not intend to assume the mortgage, the seller should furnish a satisfaction of mortgage certificate. This certificate shows that the mortgage obligation has been discharged.

A mortgage is a pledge of property to secure the payment of a debt. A standard mortgage loan usually involves a promissory note along with the mortgage itself. The promissory note names the lender and the borrower, the amount of the debt, the interest rate, and the terms of repayment.

A trust deed, or deed of trust, is a financing instrument similar to a mortgage. A regular mortgage involves only two parties, the lender and the borrower. With a trust deed, the borrower conveys the property to a third party known as a trustee. The trustee holds title to the property until the debt is paid in full, keeping it in trust for the benefit of the lender or holder of the note.

An installment contract; also known as a conditional sales contract, a contract for deed, or a land contract; is used when the seller does not wish to convey title to the property until the purchase price has been paid by the buyer. The seller would usually receive a down payment plus monthly payments until the property is paid for. The seller can either deliver a deed to the buyer at closing and have the buyer pledge the property as collateral for the balance owed, or the seller can wait to deliver the title after the buyer has paid the debt in full.

Most states have printed forms for mortgages, trust deeds, and installment contracts.

9. Pest Control

In some states the seller is required to furnish a certificate showing the property to be free of termites and other pests. The contract of sale usually allows time for the report to be obtained and often allows time for the seller to correct any problems.

10. Power of Attorney

Occasionally a party is not able to attend the closing or participate in the execution of the documents. When this happens, the documents may be signed by someone who holds a power of attorney conveying authority to act in behalf of the actual buyer or seller.

The following is an example of a general power of attorney:

POWER OF ATTORNEY

STATE OF UTAH)
) ss.
COUNTY OF WEBER)

KNOW ALL MEN BY THESE PRESENTS, that I, JACK H. HOLMAN, the undersigned, of Lyman, Wyoming, hereby make, constitute and appoint CAROL W. HOLMAN, of Lyman, Wyoming, my lawful attorney in fact for me and in my name, place and stead, giving unto said attorney in fact full power to do and perform all and every act that I may legally do through an attorney in fact, and every proper power necessary to carry out the purposes for which this power is granted, with full power of substitution and revocation, hereby ratifying and affirming that which said attorney in fact or her substitute shall lawfully do or cause to be done by herself or her substitute lawfully designated by virtue of the power herein conferred upon her.

This power of attorney shall not be affected by my becoming disabled, incapacitated or incompetent, but shall be terminated by my death.

IN WITNESS WHEREOF, I have signed the Power of Attorney at Ogden, Utah, this ___ day of ____ , 1985.

____
Jack H. Holman

On this ___ day of _____, 1985, personally appeared before me Jack H. Holman, the signer of this Power of Attorney, who duly acknowledged to met that he executed the same.

____
Notary Public
Residing at ____, Utah

My Commission Expires:___________

11. Tax Receipts

The seller usually brings the most recent tax receipts to the closing. If the seller has paid the taxes in advance, these receipts are used to calculate the proration of the taxes. If special assessments have been imposed on the property, the seller should also furnish receipts for their payment.

12. The Survey

Some contracts of sale require the seller to provide the buyer with a survey of the property. This survey will show if the actual dimensions of the property conform to the legal description. The survey will also show whether there are any encroachments on the property, whether the structures on the property encroach on adjacent properties, and whether the setback and side line restrictions are met.

13. Warranties

The seller conveys any existing warranties (for plumbing, furnace, refrigerator, etc.) to the buyer at closing.

14. Water and Other Utility Bills

As buyer, you should receive evidence of payment of water and other utility bills. If these bills have not been paid, water and utility service may be cut off.

15. Leases

If the property is rented, the seller should furnish you with copies of all leases, including any modifications and amendments. The leases are usually assigned to you at the closing. The seller should also write a letter instruction the tenants to pay rent to the new buyer. The seller should deliver any deposits which he holds, and you should furnish a receipt. The seller should also provide you with an affidavit stating that no rents have been paid in advance.

16. Service Contracts

The seller should provide copies of any service contracts that relate to the property, such as contracts for cleaning or maintenance. The seller should either cancel these contracts or assign them to you.

17. Abstract of Title or Title Insurance Policy

The abstract of title or the title insurance policy is another important closing document. As already discussed, an abstract is a written history of the title to a particular property. A title insurance policy usually shows the name of the party insured and the character of his title, along with a description of the property. The policy lists mortgages, easements, liens, or restrictions affecting the property and also contains printed conditions and stipulations.

18. Escrow Agreement

Many real estate transactions involve an escrow agreement that is prepared prior to the closing and executed by both parties to the transaction.

The following is a sample escrow agreement:

ESCROW AGREEMENT

Whereas_______________ of _________hereinafter referred to as seller(s), have sold to _________________ of ___________hereinafter referred to as Buyer(s), the following described property, to wit:

pursuant to that certain _________________entered into by the parties on the ____ day of ____, 19__ and annexed hereto and incorporated by reference and subject to the covenants and conditions therein, it is agreed that Seller(s) will execute and deliver into escrow a full and sufficient ________________, on even date, which shall be securely held in escrow by _____________ ___ of _______________ until the purchase price shall have been fully paid to Seller(s). Upon completion of payment in full to the Seller(s), Seller(s) will furnish to Buyer(s) an affidavit stating that the purchase price has been paid in full and directing the escrow holder to release any and all documents held in escrow and to deliver same to Buyer(s).

It is further agreed that in the event that Buyer(s) shall default in payment f the full purchase price, the documents herein referred to shall be returned to Seller(s) and the property described herein shall revert to Seller(s) as if no agreement of sale had ever been made, and any and all sums paid by Buyer(s) up to the time of default shall be forfeited to Seller(s) as liquidated damages for the breach of this agreement. And it is agreed that in the event Seller(s) do not perform the duties herein agreed to, and Buyer(s) have fully performed any and all duties herein agreed to, then the documents held by the escrow holder, and the property herein referred to, shall be forfeited to Buyer(s) as liquidated damages for the breach of this agreement.

It is agreed that performance of the conditions herein above stated shall be completed on or before the ____ day of __________, 19__.

All charges and expenses incurred in connection with this escrow are to be shared equally by the Seller(s) and the Buyer(s).

Dated at _______, State, this _____ day of _________, 19__.

____
(Buyer)

____
(Seller)

Accepted by escrow holder this ____ day of _____, 19__.

____
(Escrow holder)

19. Minutes of Closing

It is often wise to keep a record of the events that occurred at the closing. The minutes should also list the full names, addresses, and telephone numbers of the parties present. Anyone present at the closing can prepare the minutes, which the parties to the transaction should review and sign. These minutes can be useful if legal disputes arise later.

7.9 MAKING THE CLOSING GO SMOOTHLY

If all of the parties to the transaction have prepared will for the closing, it will usually go quite smoothly. For example, Miriam B. agreed to buy a lovely home in a good neighborhood for $90,000. During the weeks before closing, Miriam carefully reviewed and completed all the important matters that need to be considered before closing. The closing meeting was scheduled for 3:00 P.M. at the local title company.

When Miriam arrived at the meeting, she spent a few minutes examining the documents to make sure that they were in proper form and that they complied with the terms of the contract of sale. Next, she carefully reviewed the closing statement to make sure that the prorations had been calculated accurately. She also reviewed her closing costs to verify that they were correct.

After she was satisfied that everything was in order, Miriam signed the necessary documents and presented a certified check to the title company for the amount specified in her closing statement. The seller delivered the deed to the property and gave Miriam the keys.

Here, then are the essential components of the meeting:

1. Examining the documents
2. Receiving the closing statement
3. Paying closing debts
4. Paying the purchase price and delivering the deed
5. Closing a mortgage loan

1. Examining the Documents

All parties check the documents to be exchanged at closing to see that they are in proper form and comply with the contract of sale. A final check should be made to make sure the title is clear.

2. Receiving the Closing Statement

The closing statement or settlement sheet is one of the primary documents of the real estate closing. It sets forth the amount of money the buyer must pay at the closing and the amount the seller will receive at the closing. It also sets forth the division of items to be prorated between the buyer and seller when property ownership changes hands. These items include property insurance premiums, property taxes, accrued interest, utility bills, rents, and operating expenses.

The buyer receives credit for the earnest money, existing mortgages that are assumed, interest accrued and unpaid on existing mortgages, unearned rents that have already been collected, and deposits from tenants.

The seller usually receives a credit for the full purchase price. The seller is also entitled to credits for unearned insurance premiums, fuel on hand, and any items paid in advance by the seller, such as taxes and service contracts.

Some charges are allocated to either the buyer or the seller, depending upon local custom and the terms of the contract of sale.

Examples of closing statements for both the buyer and seller are included on the adjacent page.

3. Paying Closing Costs

Both buyer and seller must pay certain costs at closing. The buyer typically pays for the following items: the loan application fee, the title insurance policy for the mortgage, the premium for hazard insurance, the credit report, the appraisal, the recording fees for the deed and mortgage, and his attorney's fee.

The seller typically pays for the following items: the affidavit of title, costs of removing clouds on the title, recording fees for quit claim deeds, the owner's title insurance policy, the real estate broker's commission, and the attorney's fee.

Escrow fees are often divided between the buyer and seller. Certain transactions might also involve additional closing costs.

4. Paying the Purchase Price and Delivering the Deed

After all of the closing documents have been reviewed and accepted, the buyer pays the seller the balance of the purchase price as shown on the closing statement. Payment is usually in the form of cash or a cashier's check. The seller then delivers the deed and other necessary documents to the buyer. The buyer also receives the keys and the right to take possession of the property.

5. Closing a Mortgage Loan

Closing procedures and the allocation of closing costs vary according to the type of closing. For example, if new mortgage financing is required, there will be an actual closing of the loan.

A mortgage loan is closed by delivery of the loan documents to the lender and disbursement of the funds to the borrower. Mortgage loan closing expenses are usually paid by the borrower. The expenses include the loan origination fee, costs for title examination and title insurance, the credit report, the mortgage recording fee, the appraisal, and other processing fees.

As an investor, you should be aware of the Real Estate Settlement Procedures Act (RESPA), which became effective throughout the United States in 1975. The RESPA requires that buyers and sellers be given advanced disclosure of settlement costs. This disclosure eliminates kickbacks and fees for services not performed during the closing process. The RESPA covers almost every owner-occupied residential loan, conventional as well as FHA and VA. Lenders must comply with RESPA regulations.

7.10 CONSIDERATIONS AFTER CLOSING

After closing, the buyer should immediately record his deed, along with any other necessary documents. The seller should record any purchase money mortgage (a mortgage used as part of the purchase consideration). The task of recording is usually carried out by the closing agent. If title insurance is involved, a policy should be issued in the name of the buyer as soon as possible. The buyer should have water, gas, and electric bills changed to his name. Any tenants should be notified of the change in ownership. The buyer should also verify that the property is adequately insured.

Usually the buyer's right to possess the property begins at the point at which the deed is delivered to him. The seller should turn over the keys to the buyer and give him any necessary information, papers, and so forth. Any existing leases should also be turned over to the buyer at the time of closing.

In some areas, after the transaction has been closed, the buyer's attorney writes a closing letter to the buyer. The letter encloses and describes the various closing documents. The letter also reminds the buyer of any matters that still need to be taken care of.

The buyer should keep the closing statement for income tax records, and put the deed, title policy, and other important documents in a safe place.

7.11 A TITLE CLOSING CHECKLIST

The following sample checklist is not meant to be comprehensive, and since the closing procedure varies from state to state, many of the items on the sample checklist are not necessary for certain transactions. It is also comforting to remember that most of the details of closing are carried out be experienced professionals. Still, this checklist can help you prepare for closing.

1. <u>Considerations Before Closing</u>:

Execute contract of sale.
Obtain legal description of the property.
Deposit earnest money.
Obtain abstract of title or title insurance policy.
Review unrecorded instruments that may affect the title.
Obtain certificates showing satisfaction of mechanic's liens, chattel liens, judgments, or mortgages.
Obtain seller's affidavit of title.
Obtain survey.
Inspect the property.
Obtain evidence of compliance with fire, health, building and zoning laws, ordinances, and restrictive covenants.
Obtain pest control report.
Obtain soil test report.
Obtain certificate of occupancy.
Review plans and specifications.

Complete chattel lien search.
Obtain indemnity agreement.
Obtain insurance policy assignment, cancellation, or binder.
Obtain corporate resolutions if seller is a corporation.
Obtain partnership agreement if seller is a partnership.
Obtain trust agreement if seller is a trustee.
Prepare power of attorney.
Obtain bulk sales affidavit.
Review tenant roster, rent roll, outstanding leases, and assignment of leases.
Obtain list of operating costs.
Obtain inventory of supplies.
Obtain evidence of fuel on hand.
Obtain service contracts.
Obtain latest water, gas, and electric meter readings.
Obtain most recent tax bill.
Obtain recorded of any unpaid assessments.
Obtain receipt for broker's commission.
Obtain payoff statements on encumbrances to be paid at closing.
Obtain any subordination agreements.
Obtain credit approval.
Obtain appraisal.

2. <u>Considerations at Closing</u>

Execute escrow instructions.
Examine closing documents.
Make final title check.
Execute note.
Execute mortgage or trust deed.
Execute warranty deed.
Execute bill of sale for personal property.
Sign closing statements.
Pay purchase price.
Pay escrow fees, closing costs, commissions, and attorney's fees.
Obtain keys.
Obtain deposits from tenants.
Obtain existing warranties (on roof, plumbing, appliances, etc.)
Prepare minutes of the closing meeting.

3. Considerations after Closing

Record all necessary documents.
Change utility bills to buyer's name.
Notify tenants of change in ownership.
Verify adequacy of insurance.
Keep important documents in a safe place.

7.12 HOW WELL HAVE YOU LEARNED?

Test your learning by answering the following questions. If you do not remember the answer to a specific question, you can look back through the lesson to find it. Feel free to write your answers in the space provided, or use a separate piece of paper. Do not skip this step! You will retain the information learned from this lesson much longer if you write your answers down.

1. Why does a real estate investor need to understand the process of closing?

2. What is the difference between a settlement meeting and closing through escrow?

3. Who are some of the professionals that handle the details of a real estate closing?

4. How is the closing date determined?

5. Why is a title search necessary?

6. What is the benefit of having title insurance?

7. Name five important considerations before closing.

8. Name five important documents involved in a closing.

9. What is a bill of sale? When is it used?

10. What information is set forth in the closing statement?

11. Which closing costs are paid by the buyer, and which are paid by the seller?

12. What are some important considerations after the closing?

7.13 PUTTING IT ALL INTO PRACTICE

The information contained in this unit will be more meaningful if you take immediate action to apply it to your investment program. The following assignments will help you understand and expand upon the things you have learned. Completing these assignments will increase your confidence and move you closer to your investment objectives. It may not be necessary for you to do all of these assignments -- but skimping on your efforts will limit your growth. The more aggressive you are in expanding your understandings, the more successful you will be.

1. Get the facts. Call a real estate broker or other real estate professional and get information about the most common closing procedures in your areas. Are settlement meetings common, or are closings usually conducted through escrows? Is the closing agent more commonly a title company officer, an escrow agent, a loan officer, a real estate broker, an attorney, or some other person? What are the names of several good closing agents who could give you additional information?

2. Ask the experts. Contact several reputable closing agents. Get to know them. Have them explain the process for closing a typical real estate transaction. Ask questions about anything you do not understand. Find out how closing costs are calculated. Obtain sample forms that would be used in a typical closing. Choose a closing agent that you like and trust and develop a good working relationship with him.

3. Visit the recorder's office. Go the place in your area where all of the documents affecting title to property are recorded. The information recorded there is of public record. Ask to see the books where the documents are recorded. Have someone explain how to search the records to find the

history of a specific property title. You might use your home as an example.

4. Visit a title company. Talk to someone who prepares title reports to learn how it is done. Have a title officer or other employee explain the use of title insurance. Ask for any free literature that will help you learn more about the role of a title company and the process of closing.

5. Contact a lending institution. Talk to a loan officer about real estate closings that involve institutional financing. Ask about the allocation of closing costs. Obtain any free literature available.

6. Contact public officials. Call the public department in your area that is responsible for compliance with building codes, zoning regulations, and other ordinances. Make a list of public officials who might need to make inspections or issue permits when you buy or sell a property.

7. Build a team. Contact other professionals who might be of assistance in closing a real estate transaction. Make a list of reliable closing agents, real estate brokers, title company officers, attorneys, escrow agents, loan officers, appraisers, insurance agents, and public officials. Develop a good working relationship with the ones you like and build a team of qualified professionals who can help you accomplish your investment objectives.

8. Develop a checklist. Develop your own checklist of important considerations and documents that relate to a typical closing process in your particular area.

9. Collect sample forms. Gather sample forms and documents that would be used in a typical closing. Become familiar with the different documents that you will sign at closing. Be sure to ask questions about anything you do not understand.

10. Attend a closing. Ask a closing agent to let you observe a closing or settlement meeting. After the meeting, ask questions about anything you did not understand.

7.14 THE TEN MOST ASKED QUESTIONS ABOUT CLOSINGS

1. "When does legal title to a property pass from the seller to the buyer?"

The title conveys the right to possession, ownership, and control of property. In most cases the buyer has no right to take possession of property he has contracted to purchase until he secures legal title to the property. In a typical closing, the title to the property passes when the deed is delivered and recorded. If the closing involves an escrow, the title passes to the buyer when all the conditions set forth in the escrow instructions have been met.

2. "How can I choose the most beneficial closing date?"

The closing date which is usually set forth in the contract of sale is negotiable. You will need to allow enough time between the execution of the contract of sale and the closing to obtain title insurance, arrange for financing, and draft the necessary documents. Prorations are usually made as of the date of closing, although the parties can mutually agree to a different proration date if they wish. Closing costs can often be reduced by choosing a particular day or time of the month to close the transaction. For example, a closing date near the end of the month will usually reduce closing costs for the buyer. Consult with your closing agent to find the specific date that will be most beneficial to you.

3. "When is a survey of the property necessary?"

Some contracts of sale require the seller to provide a survey to the buyer. Many lending institutions also require a survey before they will lend money on a particular property. A survey is most useful in large-scale transactions, but it is also becoming quite common in residential transactions. Generally, a buyer should request a survey whenever there is a question concerning boundaries, encroachment, or zoning violations.

4. "Does a title insurance policy provide any benefits that are not available from an abstract of title?"

An abstract of title is a history of transactions affecting property, as reflected in the public records. Title insurance provides protection against potential title defects which the public records do not disclose. Examples of hidden defects not shown in the public records include forgery of documents, documents that were never delivered to the public depository, incapacity of a party, fraud, unprobated or lost wills, undisclosed or missing heirs, mistakes in recording, deeds by minors, irregularity of tax sales, lack of service in legal proceedings, and defects in powers of attorney. An owner's title insurance policy protects the owner against losses if any claims from these hidden defects are made against his property.

5. "When should I seek the assistance of an attorney?"

In many states, real estate closings are conducted by attorneys. In other areas, attorneys are used to draft and review documents and to provide counsel on a variety of legal issues. Most real estate transactions involve legal issues relating to one or more of the following: proper execution of the contract of sale; examination of the tile; evaluation of any title defects; possible refusal by one party or the other to comply with the contract; various income, estate, and gift tax problems; zoning regulations; legal documents; closing statements; and proper delivery and recording. Although many real estate transactions can be conducted without legal counsel, you may need the assistance of an attorney to protect your interests.

6. "How can I reduce the amount of closing costs?"

If you are a skillful negotiator, you can often reduce the amount of closing costs by having the other party pay certain costs as a condition of closing the transaction. Since the professionals involved in the closing process often charge for their services at different rates, you can also reduce your closing costs by "shopping around." Finally, you can reduce your closing costs by selecting the most beneficial closing date.

7. "Is it better to assume the existing hazard insurance policy or to obtain a new policy?"

In some cases the buyer will want to assume the existing insurance policy. The seller will usually agree to such an arrangement if the buyer reimburses him for a prorated amount of the premium. If the buyer chooses to assume an existing policy, the seller should assign the policy to the buyer and obtain confirmation from the insurance company that it accepts this assignment.

Many insurance policies are tailored to meet individual needs. A buyer might desire insurance that covers personal property or protects against liability. In this case, an assignment of existing coverage may not be satisfactory and the buyer might need to have his own insurance agent prepare a new policy.

8. "What documents will I sign at closing?"

Each real estate transaction is unique and requires different closing documents. The buyer will usually sign some type of mortgage or note. The seller will usually sign a bill of sale for personal property and some type of deed. Both parties will sign a closing statement and any other documents that are pertinent to the transaction. Either party should feel free to ask questions about anything that he does not understand. In some cases it is wise to have an attorney review the documents before they are executed at closing.

9. "Who is liable for any damage to the property until the time that title passes to buyer?"

The seller is responsible to maintain the property in a reasonable condition between the date of the contract of sale and the date of closing. He has an obligation to prevent decay, not allow voluntary waste, and prevent damage to the premises. If the seller allows the property to deteriorate, the buyer may sue for damages.

10. "What additional precautions are necessary if the property I am buying is currently rented or leased to someone else?"

If you are buying a property rented to someone else, the seller should bring the leases to the closing and assign them to you. The seller should also send a letter to the tenants naming you as the new lessor, and giving instructions regarding the payment of rent and other contractual matters. The seller should deliver any deposits to you and you should issue appropriate receipts. The seller should also give you an affidavit stating that no rents have been paid in advance and no special concessions have been granted to any of the tenants. You should inspect the property to verify that the tenants' occupancies are consistent with the terms and conditions of their leases, and to find out whether the furniture and appliances belong to the tenants or go with the property.

We wish you the best of success as you master the art and science of surviving the closing process!

UNIT EIGHT

CREATIVE MANAGEMENT

PART A

UNIT EIGHT

CREATIVE MANAGEMENT

PART A

8.1 GENERAL CONSIDERATIONS

For the investor who chooses to "turn" properties rather than to keep them for ongoing profits, this unit may be a distraction. But sooner or later, every real estate investor bumps into the inevitable task of learning property management skills.

Good property management is the heart of a successful real estate investment program. Landlords who don't understand this principle frequently find that they have more problems than they want to handle. Their properties lose money, drain their energy, and turn the unskilled manager into a flexible seller who is eager to sell at any price simply to get away from the consequences of his poor business judgment.

Fortunately, good management is easy to learn and simple to practice. It begins with preparation and forethought and continues with firm adherence to a sound plan for controlling your time and your tenants. This unit covers the best ways to attract and rent to the best tenants for your investment program and discusses how to deal with those tenants once they move into your property. They will teach you how to be truly successful as a landlord or landlady.

The agenda for Part A of this unit is to concentrate on learning how to prepare a property for tenants, set rental policies, advertise, and pre-screen prospective tenants.

A FEW TERMS YOU SHOULD KNOW

Tenant turnover: When one tenant moves out and another moves in.

Tenant turnover rate: The frequency with which tenants move in and out. For the type of houses discussed in this unit, an average tenant turnover rate is about once every two years. A low tenant turnover rate would be once in four or five years, while a high turnover tenant rate would be more than once a year.

Vacancy loss: The amount of loss experienced by a landlord while a rental stands empty. This is the sum of lost rent, cost of refurbishing and repairs, salaries for any workers hired to help prepare the property for new tenants, advertising, utilities paid by the landlord during the vacancy, costs for checking out new applicants (including telephone expense), and any other expenses involved in placing new tenants in the property.

Vacancy period: The time during which a property is unrented.

8.2 VITAL POINTS ABOUT MANAGING REAL ESTATE

As you read through this unit, keep the following key points clearly in mind; they will guide your thinking and help you to have a proper perspective on the material.

M Learning the skills of good property management is as important to real estate success as learning the skills of finding bargains and negotiating favorable terms.

M Buying property in a good location will help bring good tenants to the property.

M Keeping your property in good condition will help bring good tenants to the property.

M People with a good, solid work background usually make more reliable tenants.

M It is vital to set your rental policies *before* you rent the house. Decide in advance whether you will allow children or pets, for example, and make your policy clear to the potential tenant.

M Whenever possible, collect both the first and the last month's rent in advance, plus a deposit. Do not confuse the deposit with the last month's rent.

M Use a variety of ways of advertising your rental to increase your chances of finding tenants quickly.

M Before you show the rental to a prospective tenant, screen him or her over the telephone.

M Remember that renting homes to tenants is a business. It is your approach to eventual financial independence. Approach all challenges in the business as a wise businessperson would.

8.3 KEYS FOR MANAGING REAL ESTATE

If you've thoroughly read and understood all the units up to now, you've built a strong foundation of knowledge about investment real estate. Now you're ready to enter that wonderful dream castle of wealth and power that all this study supports. But before you can enter your castle, you'll need a key; in fact, you'll need several keys to ascend into higher and higher levels of your real estate dream future.

"Keys," you say? "Where do I get them?"

The keys you need to unlock your future are already in your hand--the contents of this unit on real estate management. Unfortunately, although management is probably the single biggest factor in the success or failure of an investment real estate program, most people actually pay it the least attention.

In a way, this is understandable. Learning to recognize a good buy, hunting for desirable properties, and learning how to negotiate the best price and terms are exciting. Most people also have a basic economic interest in learning the guidelines that will make them knowledgeable buyers and good bargainers. When it comes to the offers and documentation you need to close a sale, you're motivated by the need to understand all the legal technicalities you have to hurdle before you can reach your goal of property ownership.

Then, once the first flush of excitement wears off, when the property is yours and you can truly call yourself an investor at last, comes the moment of truth. Now that you own this property, what will you do with it?

Unfortunately, large numbers of investors neglect to inform themselves about this step until it's too late. Caught up in the thrill of potential success, they overlook (until it's unavoidable) the day-to-day effort required to get them there. A surprising number of people simply rush out and buy a house, a condo, or an apartment building without ever considering what will happen after the closing.

Granted, a landlord's job looks fairly simple from the outside: He leases the unit to a good tenant who will pay the rent every month. He then takes the rent money, pays the mortgage, pockets anything that's left over, and sits back until next rent collection day.

But appearances can be deceiving. The truth is that properties bought to keep bring a profit only when they are carefully and consistently managed.

From experience, both our own and that of others, we know that the best way to avoid becoming an anxious seller/landlord is to know what it takes to become a successful property manager. For every wrong move the failed property owner makes, there is a right move we can choose instead, a way to increase our profits instead of our problems. These moves are the keys to successful management that you'll be studying in this unit. To help manage your property and attract tenants you will want to use the following five keys:

M 1. Prepare the property
M 2. Set your rental policies
M 3. Advertise
M 4. Show the property
M 5. Pre-screen your applicants

8.4 KEY 1: PREPARE THE PROPERTY

AN ILLUSTRATION

Heidi I. bought a three-bedroom home in an older subdivision just outside a Midwestern town. The house needed much attention both inside and out--the paint inside was so old Heidi wasn't positive what its original color had been, and the outside paint was cracking and peeling. One of the toilets ran continually, and the kitchen faucet emitted a constant stream of water. The carpets were so filthy Heidi wondered if they had *ever* been cleaned.

Heidi's cash flow was tight, and she needed to get a tenant into the home immediately. But she knew it would be a waste of time to show the property to prospective tenants. If anyone was interested in such a mess, it wouldn't be the kind of tenant Heidi wanted, and they certainly wouldn't pay the $495 per month she needed.

Her first order of business, she knew, was to get the property prepared to show. She took three days off work to do some basic cleaning and inside painting. At the same time, she hired a young man who lived next door--and who was temporarily out of work--to correct the plumbing problems and to do the outside painting.

At the end of three long and tiring days their work was done, and the house was ready to show. Less than a week later the rental was occupied by a young family who were thrilled to have a home that smelled so new and fresh. Heidi's work paid off even more as the months passed and her tenants took pains to keep the home as nice as it was when they entered it.

The first step in becoming a good manager is preparing your property to appeal to the tenants you want to attract. Even before you take possession, plan what you will do to make your rental attractive to the type of people you want to rent it to. To do this, of course, you have to know who your potential tenants are.

The best property for residential rental is the basic bread-and-butter home which will appeal to the broad spectrum of renting families. You'll find the most success investing in a two or three bedroom house with one or two bathrooms, a yard, and a garage or carport. The best property for residential rental will be in a quiet neighborhood of similar homes that are mostly owner-occupied, near schools and shopping, and convenient to transportation. It probably won't be the nicest house on the street; in fact, it may be the most run-down.

Now, who will live in this house? A lot of people will want to, especially after you've done whatever it takes to put it into good shape. But the people you want to rent it to will be as close as possible to the ideal tenants.

Many of today's good tenants are people who would have been buying their own homes a few years ago. But today, high prices and high interest rates have delayed their entry into the housing market. (They don't understand that they could buy a nice property for "nothing down," if they would only learn how.) Meanwhile, they've started a family and want some stability. They want to live in a neighborhood of people like themselves, send their children to the local schools with their young friends from down the block, and put down some roots.

Tenants like these usually aren't professional, career-oriented, college graduates. You won't find many "yuppies" looking for a rental house in the suburbs, and the few who do are simply looking for a temporary shelter until they move on to better things. Don't get the mistaken idea that your ideal tenant is a highly-paid, ambitious attorney, doctor, or executive who can afford to pay the highest rent.

8.41 BEWARE OF YUPPIES

Yuppies are more apt to rent a luxury townhouse with a pool, tennis courts, sauna, reception room, and a 24-hour maintenance service. They are the most demanding tenants you'll ever see. The instant any small problem comes up--the kitchen faucet drips, there are ants in the garage, the neighbor's dog barks at night--they expect you or your handyman to come right out, whether it's the middle of the night or your mother-in-law's birthday, and solve the problem immediately.

Some of these high-achiever tenants also make a hobby of renter's rights. If they don't receive the sort of service they've decided they deserve, they're apt to organize a rent strike or take their landlord to court. They're not so much concerned with settling into a stable life-style as they are about getting everything they feel is coming to them, plus as much more as they can maneuver you into giving them.

That's not to say that no one should ever rent to anyone with a college degree. But if you're concentrating on bread-and-butter rentals, your unit is not what upwardly mobile professionals want. You'll be doing both them and yourself a favor if you avoid renting to them.

8.42 LOOK FOR STABLE WORKERS

Of course, you don't want to rent to people at the other end of the scale--the chronically unemployed or people whose credit history includes poor payment records or skipping out on debts and other obligations.

What you do want to look for in a tenant is good, solid, working-class stability. By and large, you find this in blue-collar and lower-middle-class families. These people want to maintain a decent life-style for their families and improve it if possible, but they don't expect anyone, including their landlord, to give them a free ride through life. They know they have to work for everything they want, and they're willing to do it.

People in this category often work in factories, on assembly lines, or as mechanics. They may have a technical job in a hospital or production plant. They may be enlisted members of one of the armed forces, or they may even be immigrants from a foreign country who are overjoyed at the opportunity to live and work in America.

Manual labor doesn't scare people from these backgrounds because they were raised on it. In fact, they take pride in a job well done. These people are most apt to take over the maintenance chores for your property. They easily assume that since it's their home, they're responsible for it, and they take pride in keeping their home clean and attractive. There are ways, too, that you can foster that attitude, which we'll go into more thoroughly later in this unit.

8.43 HOW TO FIND OUT WHAT TENANTS WANT AND ARE WILLING TO PAY

Now that you know who your ideal tenants are, you need to decide what will attract them to your rental. In some areas, where housing is very tight, you may not have to think about this at all. If your unit is located near a thriving industrial center where vacancies are hard to come by, simply letting people know you have an empty house may bring a flood of excellent applicants.

Most rental property isn't quite that well located, however. Usually a landlord has to expect to put in a few days getting a house (or apartment) ready to rent to new tenants. The simple secret to success here is to keep that time as short as possible and the amount of money you spend to a minimum. Remember, every day the house stands vacant is a day you don't receive rent, while mortgage and insurance payments continue. You have to keep your vacancy loss down in order to manage real estate profitably.

When you are buying rental property, try to convince the sellers to give you possession of the property before the closing. That way, you can have the house ready to rent the day you sign the mortgage papers. If the sellers have been living there and are selling because of a move, this may not be difficult. Or, if the house is rented to tenants who will have to move, they may be persuaded to leave a few days early--perhaps by paying a small bonus or offering to supply a truck or trailer if they move by a certain date.

Analyze the market now. What work has to be done to put your rental in competition with others on the market? The best way to answer that question is to analyze the competition. You can get a lot of information, of course, by talking to other investors. Ask them which of their houses rents most quickly and has the shortest vacancy periods. Ask them if tenants give any particular reasons for liking those rentals better than others. Ask if prospective tenants mention points they're looking for in a home.

Information from other investors will give you some secondhand ideas of what tenants like, but there is no substitute for personal experience. In order to thoroughly understand the rental market, you're going to have to become personally acquainted with it. You must understand the rental market if you intend to profit from it.

This is where you put yourself into your future tenants' shoes. In effect, you're going to play a real-life game of "Let's Pretend." For one weekend, become the kind of person you will eventually rent to.

On your first day off, imagine that you're an average working-class parent looking for a home for your family. Suppose that your family income is about what a typical two-earner couple earns in your area, and you can afford to spend between a quarter and a third of your income on rent. (If you have no idea what this amount might be, ask around. By now you should know several investors who can estimate what their average tenant earns, or perhaps you can ask your banker.

Your first step will be to read the "Homes for Rent" section of your paper. Choose at least six houses that sound similar to yours and that are as close as possible to the rent you've decided you can "afford." (If no rent amounts are listed, you'll simply have to look at the houses whose descriptions sound closest to the one you will be offering for rent.) Make appointments to see them, pretending that you're a prospective tenant. If most homes in your area seem to be rented through rental services, visit one of these and purchase the current listings. It will be a small investment for the amount of knowledge you will gain.

Next, visit the homes you have chosen. Although you are pretending that you might be living there, remember that you really won't. Just as you do when you choose houses to make offers on, keep in mind that you are not looking for a place for yourself. You are looking for the points that make a good or bad rental property.

As you inspect each of these houses, try to learn something about its "tenant appeal." Ask the person in charge of renting it about the previous tenants. How long did they stay? Why did they leave? Find out how long the house has been vacant, or when it will be available for a new occupant.

Make your own observations as well. Is the house clean and attractive? Is the yard well kept? Is the neighborhood convenient and desirable? How does it compare to the other rentals you've seen?

Find out how firm the landlord is about the rent and deposit. You might hint that you've seen another house you like just as well that rents for $25 or $50 less per month or that you'd be able to move in if only you could pay the security deposit at a later date.

If you find one or two landlords who are flexible about rents or deposits, you may have run into some careless individuals who are too anxious to fill a vacancy. However, if all the landlords you contact are willing to bargain over the amount of rent they will accept or how soon you must pay deposits, you can be pretty sure that the rental market is currently soft in the area. Either there are a lot of vacancies in proportion to the number of tenants in the market, or rents are just beginning to rise but haven't been firmly established at a higher level yet.

By the end of your tour, you will have a good idea of what the available rentals look like and what market rents are. Now you'll be ready to decide what to do to make your unit competitive--assuming, of course, that your rental doesn't need extensive fix-up work.

Were all the houses you looked at sparkling clean and neat? Then yours had better be, too. Were all the rooms in every house freshly painted? If so, you had better plan on painting. Was every yard neat and well-trimmed? Remember that the yard is the first thing people see when they drive up, and if it's not well cared for, it will make a poor impression before they even see the inside of the house. In fact, an unattractive yard will motivate some people to drive right on by without even looking inside.

8.44 HOW TO OUTDO THE COMPETITION

You'll find that some landlords aren't too particular about how an empty house looks. The way the previous tenants left it is the way the new tenants will receive it. More professional landlords may slap on a coat of paint and clean the carpets and perhaps the stove. It doesn't take much to compete with these rentals, and if the vacancy rate is fairly low, about all you will have to do to keep up with the competition is to get your unit into as good shape as the best of the others.

Where tenants have more choice, you will have to be more imaginative. Find ways to make your house the most attractive one on the market. For instance, you might set your rent at the low end of the local range. You could plant some attractive bushes in the yard or arrange a few houseplants inside. You might install a nice shower curtain and matching window curtains in the bathroom. If your house is short on storage space, add a couple of standing cupboards in the bedrooms, put up some shelves in the garage, or install a metal storage shed in the backyard. You don't have to add a lot of expensive amenities, but think up some little touches that add "home appeal" to your rental and make it stand out from the competition.

Make a simple checklist to go over as you finalize your property prior to putting it on the market. List each of the areas of the house and itemize the elements you need to look for. For example: *front hall*: walls and floor; *living room, dining area, family room*: walls, carpet/flooring, drapes; *kitchen*: walls, floor, curtains, stove, oven, sink, cabinets, disposer; *bathroom*: walls, floor, curtains, tub, toilet, sink; *bedrooms*: walls, carpet/flooring, curtains, closets; *garage/basement*: walls, floor, shelving; *other items*: fireplace, mirrors, windows; *outside*: grass, shrubbery/trees.

This checklist, which you can call your "Move-In Ready Checklist," will help you decide whether your house is ready to put on the rental market. Remember, you may not have to do all these things to be competitive in your individual market, but the more of them you do, the better chance you have of renting your house quickly and at a fair rent.

A word of warning: do *not* advertise your house for rent until it's as ready as you can make it, unless your rental market is so tight that people are lining up to move in before the previous occupant has started packing. The first impression a house makes is the most lasting one, and most people have very little imagination. If they see a filthy carpet, marred walls, and a pile of rubbish in the driveway, they simply will not be able to visualize how the place will look when you're through cleaning it. You can tell them about the beautiful shrubs, fresh carpet, and tasteful color scheme the house will have by next week, but their judgment of the house will be that it's too dirty and neglected.

Sometimes, though, even your best efforts will be inadequate for some tenant. Robert J. recently advertised a single-family home for rent in a fairly new housing tract. A prospective tenant phoned and asked detailed questions about the yard. Robert replied, truthfully, that the house had been purchased unlandscaped; grass and several young trees had since been planted, but the trees were still small. When the tenant inspected the house, she paid absolutely no attention to the sparkling clean attractive interior of the house. Gazing wistfully out the patio door, she sighed, "I guess not. Those little trees just won't give any shade at all!"

As a practical matter, you should usually expect to repair holes in plaster, paint any rooms that need it, clean the carpet and the stove, mow the lawn, remove any weeds and rubbish from the premises, and remove or replace any dying shrubs. When you're doing these things, remember that you are not doing this to make the sort of attractive home you want for yourself. You want to appeal to the largest possible number of prospective tenants, and their tastes are likely to vary widely. That's why, if you plant anything, you should stick to low-maintenance, hardy shrubs. Don't plant your favorite flowering shrub, the one that requires constant feeding and pruning, because the blossoms are so pretty for two weeks every spring. Your tenants may have no interest in or time for gardening.

DON'T GO TOO FAR, HOWEVER!

Don't get carried away with extravagant plans for redecorating the interior of your rental. There's no telling what color your tenants may like or think goes well with their furniture. If you have the kind of flair that makes a purple wall and orange carpet blend with scarlet drapes, the best place to display it is in your own home. For a rental, off-white walls work well with everything. In fact, a shade called Navaho White will actually reflect a slight tone of whatever dominant color is in the room with it.

Carpets, too, should be toned down if you have to replace them. An unpatterned combination of dark gold and brown looks good with practically anything and doesn't show dirt and spills easily. If you supply drapes, white or gold go best with this carpet and the off-white walls and make your rooms look light and bright.

8.45 H0W TO GET OUT OF DOING THE WORK

We've been saying that "you" will do all these things, but of course you may choose to hire a handyman to do your painting, yardwork, and repairs. This decision depends on the answers to two questions. First, are you capable of doing the work? Second, can you afford to hire someone else to do it?

If it's at all possible, the first couple of times you prepare a house (or apartment) for rent do everything yourself, or at least as much of it as you reasonably can. Naturally, it will save you money, but doing this job yourself has another advantage. It gives you hands-on experience with the work that needs to be done--how difficult it is (not very) and how long it takes. You can't get the experience any other way. Then in the future, when you have other people do the work for you, it will be easy for you to tell when one of your workers isn't doing the job the way it should be done, or better yet, when someone is doing an outstanding job for you.

In time, of course, you will probably hire someone else to prepare your houses for rent. When that time comes, there are a few simple guidelines that will make hiring the right person easier. First of all, look for someone who can do a variety of things. Professional painters and plumbers may do terrific work, but they're specialists, and they charge accordingly. All you need is someone who can do the job about as well as you can, or a little better, and who won't charge a small fortune. This person should be able to paint, do simple carpentry, yardwork, and clean.

Second, get references. Talk to at least three other people who have employed this person recently, and ask detailed questions. What sort of work did they have done? Was the work done neatly, to their specifications, and on schedule? Did they have any complaints or problems after the work was finished? Would they hire this person again? If you can, try to visit these people and look at the jobs your applicant did for them.

Most importantly, look for someone who will be available on reasonably short notice. Ideally, of course, you should have a month's notice before any tenants leave and your house is on the rental market again. But life isn't always ideal. There may be times when emergencies force tenants to leave on short notice, or someone might just disappear and you won't know they're gone until you try to contact them to ask why rent is overdue. At those times you need a handyman who can make time for you with little or no notice, not someone whose schedule is filled up three months in advance.

Once your house is in ideal shape to show, you want to keep it that way until your new tenants have moved in. Someone should water the grass and plants regularly, pull weeds, and mow the lawn. This would be a good job for a teenager. If you don't have one of your own, see if you can find one in the neighborhood of your rental. This would be a good security measure as well, since you could pay the youngster a few dollars a week to keep an eye on your house and pick up litter as well as keep the yard fresh. If there aren't any local teenagers, ask if one of the adult neighbors would agree to keep an eye on your property when you aren't around.

8.5 KEY 2: SETTING YOUR RENTAL POLICIES

When you have your house ready to show, you'll naturally want to let people know about it. Your thoughts will turn to advertising. But before you take out any ads, you'd better make some decisions about your rental policies. This will make your ads easier to write and will cut down on the time you might otherwise waste showing the property to people you wouldn't accept as tenants.

Lee and Nelda P. have been in the real estate investment business for a long time, and they have learned from sad experience the importance of setting rental policies before they even try to attract tenants.

One of their first tenants was a nice older lady who had three cats. Lee and Nelda had never set a policy on pets, and they said nothing as the cats slowly began to multiply. She always paid her rent on time and never caused any trouble. In fact, she seemed almost like the perfect tenant.

After three years of renting form Lee and Nelda, however, she had a stroke and had to be placed in a nursing home. Lee and Nelda were appalled to discover that the lady had a grand total of eighteen cats in the apartment. Cat hair was all over the place; the draperies had been torn; and the whole place had a disgusting smell.

It took considerable effort--all unreimbursed--for Lee and Nelda to clean the place up. They could have saved themselves a lot of trouble if they had a policy on pets, on regular inspections of the apartment, and on a cleaning deposit.

8.51 Pets

One of the first major decisions you will have to make is whether or not you will accept tenants with pets. Many landlords simply refuse to consider renting to anyone who keeps an animal of any kind, and they have good reasons for this. Animals, especially cats and dogs, can damage carpets and drapes, mess up yards, annoy neighbors, and often leave unpleasant odors behind them.

You will be well within your rights to adopt and enforce a strict "no pets" policy. On the other hand, will that policy be competitive where you rent? Do other landlords allow their tenants to have animals? If they do, and you don't, you may be letting yourself in for longer vacancy periods. Remember, the bread-and-butter house appeals to families, and most of the children in these families are interested in keeping a family pet. Many of them already have a well-loved cat or faithful dog and won't consider moving somewhere where Rover or Fluffy isn't welcome. Think carefully before you cut yourself from a large pool of good potential tenants.

Another factor to consider is that if most landlords in your area refuse to rent to pet owners, you could cut your vacancy time considerably by allowing pets. An ad that says "cat or dog ok" will draw all those people who have or want an animal and can't rent from the other landlords.

Of course, if you allow pets, you'll have to take some measures to protect yourself. In the first place, you should always demand an extra deposit, and perhaps higher rent to cover any damage the animals might do. The range of pet deposits is usually between $100 and $200, although some investors insist on an entire extra month's rent. You may also be able to ask for $50 to $100 more on the monthly rent for each pet.

Even with the extra income, it is wise to limit the size and number of animals you'll accept. You could limit your tenants to two cats or one dog, and the dog shouldn't be more than two feet high at the shoulder or weigh more than forty pounds.

When you get into larger dogs, such as Great Danes and Saint Bernards, there's really no way to limit the amount of damage they can do to your property, especially the yard. Animals like these need large areas to run in and can destroy an average-sized yard in a week or two.

Finally, insist on seeing the animal or animals yourself. Write the pet's name and description right into the rental agreement and also include a clause that says something like this: "The above-described animal(s) is/are the only animal(s) allowed to reside on the above premises under the terms of this agreement. No other animal(s) will be added to tenant's household or substituted for any of the above-described animal(s), even temporarily, without written permission from landlord."

This may seem a little stringent to those with no experience as landlords, but consider this. Bonnie C. wrote an agreement that simply allowed the tenants to keep a dog because they owned a miniature dachshund when they moved in. But one month later she learned that the dachshund has been replaced with a huge Doberman! The tenant was eager to explain: "The kids were just heartbroken when Schatzie got run over, so we let them pick out a new pet, and they fell in love with Bruno." Bonnie wanted to contest it, but she really didn't have any say. Their agreement allowed them one dog, and they had one dog. So, specify which animal, how many, and the size of each, and then make it plain that your permission must be obtained before any substitutions or additions are made to the menagerie.

8.52 Children

As we've said many times in this unit, we prefer bread-and-butter homes because they appeal to families with children. These are the tenants who are most stable and most prepared to settle down in a house and stay on for years.

But perhaps your situation is different. You may be buying houses somewhere like St. Petersburg, Florida, and have property in an area where all the residents are elderly retired people. You don't want to rent to someone whose noisy brood will upset everyone on the street. Or perhaps you have an apartment building, and you know no one likes to live downstairs from the thudding of little feet.

You'll have to be careful, and be sure to check with your attorney. Because of the housing shortage, many communities and whole states now have legislation or court decisions that make it difficult to refuse to rent to families with children. You may have no choice but to accept children, whether you approve of them or not.

Children needn't be a problem in your rental, though. Most children don't cause that much damage. As long as you have a strong rental agreement and a sizable deposit, the children's parents will be responsible for any damage that exceeds reasonable wear and tear.

8.53 Number of Occupants

This is one area in which you can keep some control over whom you rent to. It's best to allow no more than two tenants for each bedroom in the house, and insist that they must be in some sort of familial relationship to one another. This allows a normal family to occupy your house and, at the same time, prevents them from renting out a room to someone you don't even know.

The limit of two tenants per bedroom is not an arbitrary guideline picked out of a hat. If you allow more than this, you'll find that they will put more wear and tear on your property than it can sustain. The appliances, carpet, doors, and yard get heavier wear than they were designed to withstand when large numbers of people are using them.

About three years ago, John L. noticed that a house next to one of his properties was beginning to deteriorate much more rapidly than any other house on the street. When John asked his tenants if there was a problem next door to them, they explained that the house had recently been rented to a family with twelve children, ranging in age from about one to eighteen years.

The tenants said they believed the house had four bedrooms and two bathrooms, and while the people living there were nice, quiet and hardworking, they just didn't seem to able to keep any grass growing with so many children and their friends running across the yard. In addition, teenage boys were constantly working on cars in the driveway and side yards. There were never fewer than five cars on the property, and often more, since the parents, the oldest daughter, and two or three of the boys each had one.

Recently, John's tenants informed him that the large family had moved out of the house next door to them, and the house was going to be put up for sale. Thinking he might be able to get a good price on it, John went over to take a look at it.

What he saw immediately changed his mind about any possibility of buying the house. A crew of four men was already working there, and they estimated that it would take them about a month to put the house in salable condition. Ceilings and walls had to be replastered, floors had to be recarpeted and retiled, and the kitchen cabinets had to be replaced. So much use, and an occasional accident multiplied by fourteen people, had practically worn out everything in the house.

In addition, the entire structure had to be painted inside and out and new shrubs and grass had to be installed. The main bathroom had to be entirely gutted and rebuilt. So many showers had been taken in it that it never had a chance to dry out. The cabinets had warped, the linoleum had peeled off the floor, and the wallboard and ceiling were disintegrating from the moisture. The flush mechanism on the toilet was worn out, and the bathtub caulking was gone.

With the price of repairs and new landscaping, the owner of that house would have had to sell it for top market price in order to break even. Even when all the work had been done, though, it still looked rough around the edges, and the owner wasn't able to get his money out of it. Unfortunately, he had been an amateur landlord whose rental agreement did not require the tenants to maintain or repair the property. Even more effective would have been to limit the number of people he allowed to live in the house in the first place.

8.54 Utilities

The next thing you must decide is who will pay the utility bills. It's always best to make your tenants responsible for these since they will be the ones using the water, gas, and electricity. Require that they subscribe to a garbage service, too, if this is not included in property taxes or other bills.

As always, there are exceptions to the rule that tenants pay for their own utilities. If you're dealing with a large vacancy factor, it may be worth it to you to pay utilities in order to fill your rental. Also, if you have a multi-unit property with only one gas or water meter for the whole building, it is more difficult to allocate these expenses against the various units. If you find yourself in a situation where you must supply utilities when you rent, look for a trade-off later on. For instance, you could tell the tenants at the end of their first year with you that you won't raise their rent if they will take over their own utility bills.

8.55 Discrimination

This has been said many times before, but it bears repeating here. You *cannot* legally refuse to rent to anyone on the basis of their sex, marital status, race, color, ethnic descent, or religion. In addition, various parts of the country prohibit discriminating on the basis of age, sexual preference, and political activities. (This last is the result of a lawsuit brought by a renter who was refused an apartment because he was a leading activist in a tenants' drive to force rent control on local apartment owners.)

You may refuse to rent to someone because he or she:

M 1. Does not have an income that meets the minimum standards you have established. A safe standard is that the prospective tenant's income must be at least three to four times the amount of your rent.

M 2. Has a poor credit record. This includes being late with rent payments at a previous residence.

M 3. Has a history of eviction from other rentals.

M 4. Does not have the money to pay the full deposit.

M 5. Appears unable to control children.

M 6. Lies when filling out the application.

M 7. Has a hobby or occupation that could be annoying or dangerous to your property or the neighborhood at large. For example, a rock musician who practices at home with full amplifiers would normally be considered annoying to the neighborhood. A heavy-equipment driver who owns his own caterpillar and parks it at home could damage the pavement or yard, while a house painter who stores paint and remover in the garage could create a fire hazard.

M 8. Did not keep previous residence neat and clean.

M 9. Is personally unappealing to you. If you simply don't like an individual, you can refuse to rent to that person as long as your dislike doesn't extend to every member of a particular minority group to which that person belongs. For example, you can turn away a white male Anglo-Saxon Protestant if he rubs you the wrong way, as long as you would rent to most other white male Protestant Anglo-Saxons and your reason for refusing him is not based in any way on his being a man, white Anglo-Saxon, or Protestant. Check current laws.

M 10. Has not held a job steadily enough or for a long enough time. How steadily or how long needs to be up to you, as long as you establish a fair standard that is applied to every applicant. It would be unreasonable, as well as foolish, to insist that every tenant you accept must have worked at the same job for the last ten years. But it is entirely acceptable to require tenants to be able to show an unbroken employment record for three years, unless they are just out of school. That doesn't mean that it must be the same job, but simply that the person has been working somewhere, without any long unexplained gaps, during the past three years. You could also put some sort of limit on the number of jobs, such as no more than three employers in the last three years.

Once you have established all your rental policies, write them down. Then show your list to your attorney to be sure you haven't accidentally violated any local landlord-tenant regulations. Make several copies of your policy list, and keep them in a file folder because you will be using them later on when you check out your applicants for your rental.

8.56 Set Your Rent

You're almost ready to advertise your rental now, but first you must do one final and very important task. You must decide how much rent to charge.

The survey you took of the competition should have given you the most vital piece of information you need for this: the amount for which similar properties are renting. Unless your house is exceptional, or there is an acute housing shortage in your area, you'll have a very hard time getting anyone to pay more rent for your house than they would for other comparable rentals.

Even if there is a housing shortage and you believe you can easily charge $50 to $100 more per month than other landlords are getting, proceed with caution. Tenants may rent from you as a last resort after they have checked out every other possibility, which means you will have a longer vacancy period. Also, when they do rent from you they may resent your higher rent so much that they become bad tenants. Finally, the tenants who rent from you as a last resort will probably be looking for a cheaper place to live from the moment they move in. A high tenant turnover rate coupled with longer vacancies can easily wipe out any profit you expect from the higher rent, while adding to the amount of time and work you have to put into your property.

Houses in one Indiana town rent for $500 a month. Since there are very few vacancies, Gus R. decided to charge $600 a month for his rental. Prospective tenants typically looked at every other house in town, considered renting an apartment or staying with friends or relatives a while longer, and even discussed moving to another town where rents are lower or salaries higher, before some of them became desperate enough to accept Gus's terms. As soon as a family did move in, they put their name on waiting lists with Frank Z. and Sally D., who both charge $500 rent for the properties they own.

At the same time, the tenants started thinking that if they had to pay such a high rent, they'd really be better off buying a house, and they started exploring their chances for borrowing a down payment from Grandpa. They began talking to everyone they knew about their desire to buy a home so they could get away from their rent-gouging landlord. They also bought a copy of *Nothing Down* to find out how to buy real estate without cash.

At the end of the year, each of Frank's and Sally's houses had brought in $6,000. Each of them lost only one tenant, both because of job transfers, and the vacancies were filled immediately from the waiting lists, which meant no advertising costs. The new tenants were so happy to find affordable housing that they didn't mind cleaning up after the previous tenants themselves.

In the same year, Gus had three families of tenants move out, one into their own home and two to houses that rented for $500. His rental stood empty for a total of six weeks. Each time it was vacant, Gus experienced a longer vacancy period caused by his higher rents. He also had to thoroughly clean the house each time, shampooing carpets and reseeding the lawn, to make his house look attractive enough to be worth the higher rent. Once he had to hire someone to do all the cleaning and yard work because he was too busy to do it himself.

Gus took in $6,300 for his house that year because of his higher rents. But his advertising costs and his cleaning and maintenance costs came to $400. On top of that, Gus had to spend time showing the house, doing some of the cleaning himself, and interviewing and checking out tenants. Conservatively, he put in fifty to sixty hours on these chores during the year. That's a lot of work to do when you're losing money. Gus could probably have found and purchased at least one more rental in those hours. If he had used that time to buy a $60,000 house at 10% below market value, he would have increased his net worth by $6,000 in the hours he used to lose $400.

8.57 AN ASIDE: CONSIDER THE LEASE OPTION

If you want to increase the amount of income you receive from your rental property, a better way to do it is to offer the house on a lease option. Briefly, here's how it works: tenants lease a house with an option to buy it under specified terms. They pay a higher rent, with all or most of the excess being credited toward their down payment. For instance, if market rents are $500, your tenants might pay $700, and $200 a month is credited toward their down payment. At the end of the option period, the tenants have three choices. They can renew the option; they can pay a lump sum to make up the rest of their down payment, thereby buying the house from you; or they can move out so that you can put new lease-option tenants into the house. Whichever choice they make, the extra $200 a month they paid in rent belongs to you, and you do not have to give it up.

There are many other ins and outs of lease options, and you should study the principles carefully and discuss them with your own attorney before you rent property on these terms. But it is not a difficult subject to understand or to explain to tenants, and many investors rely on this techniques to bring them higher rents. Oddly enough, very few tenants ever actually exercise their options and buy the houses they lease on these terms. That's unfortunate for them, since it is such a simple and relatively inexpensive means of buying a first home. However, that shouldn't stop you from offering them the opportunity, and you will receive a better return on your investment property by doing so.

8.58 <u>Don't Forget the Deposits</u>

Whether or not you use a lease option, you still have to decide how much rent to charge. If your property is in good shape and there isn't a large local vacancy problem, there's no reason why you can't set your rent at or near the top of the range for similar houses. You should also plan on charging a deposit that's at least equal to an additional month's rent. That means before people can move in they have to pay you an amount equal to two months' rent.

The deposit is commonly called "first and last months' rent in advance," but it isn't. The second monthly rental amount is a security deposit to protect you against loss and damages to your property. Think of it as a damage deposit, and refer to it that way. If you and your tenants get into the habit of calling the deposit the last month's rent, your tenants will assume they don't have to pay rent for their last month in your house. You may think the same way. Then when they do move out, you'll end up paying for any damages out of your own pocket and trying to collect from people who feel no further obligation toward you or your property. Also, in some parts of the country, if a deposit is called "last month's rent" or a rent deposit, that's all it can be used for.

Recently, in order to avoid this sort of confusion, a number of investors have started charging two deposits. One, equal to a month's rent, is the rent deposit and may be used to make the tenant's final payment. A second, separate damage deposit is charged to cover any damages caused by tenants or excessive cleaning needed after they leave. This usually ranges from one-half to one month's rent.

In addition, you will have to decide how much extra you want to charge for pet rent and deposits if any. This is usually between one-tenth and one-fifth extra on the monthly rent and anywhere from $100 to a full month's rent for the damage deposit. Deciding what figure to set this at will depend to a large extent on what practices are common in your rental market. If very few landlords rent to pet owners, you can go for the higher figures. But if most rental houses accept animals, you may have to settle for a lower amount from your renters, or nothing extra at all.

8.6 KEY 3: ADVERTISING

Wallace O. bought a nice duplex in a growing area of town. The real estate agent was extremely enthusiastic about the property. "You'll be able to rent this place out immediately," the agent said. "People will be knocking down your door to get a chance to live here."

Wallace took the agent's word for it. He placed a small "For Rent" sign in the window of each side of the duplex and sat back and waited. Nothing happened. A week went by, then two, then three. Wallace got worried, then almost sick.

Finally, in the fourth week, Wallace got a call. He was ecstatic. "I'm calling about the duplex you have for rent," a voice said on the phone. "Would you be willing to let my family of thirteen live in both sides for the price of one side?"

Wallace was almost tempted. After all, he hadn't received any better offers. But he knew such an arrangement would ruin him and probably ruin the duplex. Instead, he did what he should have done from the beginning: He began to aggressively advertise.

Once you decide on your rental policies and your rental amount you can confidently advertise your property. Investors who own rental property in tight rental markets may not need a great deal of help in attracting tenants, but advertising techniques are helpful to know, since real estate markets do change. And who wants to get caught in the trap Wallace was in? The following approaches have proven effective at keeping vacancies filled.

8.61 <u>Newspaper</u>

Probably the most obvious place to advertise is in the classified section of the local daily paper. It's simple. All you have to do is call a phone number that's normally listed right at the beginning of the section, and a helpful clerk will guide you in wording your ad and deciding how many days it should run.

Most people try to keep their ad as short as possible and run it the minimum number of days in order to hold down costs. If you share that concern, simply list the main features of the house and your rental policies: "3 bdrm., 1-1/2 ba., fence, gar., nr. sch., shop, sm. pet ok, $500 + dep., 555-0000 after 6 p.m." The best days to advertise are Fridays, Saturdays, and Sundays, since most families look for homes during the weekends.

However, doing what everyone else does could be a false economy. Prospective tenants quickly learn that traipsing from one rental to another looking for a place to live can be pretty tiring. If your ad is one of a long list of similar notices, many prospects will give up before they even see it. You want people to be motivated to see your house first and get a deposit down before someone else can snatch it up. To attract attention, consider running a more creative ad, and let it run all week so that you can pick up those people who have days off in the middle of the week.

For a short course in creative ad writing, study the "Homes for Sale" section of the classifieds, and see what real estate brokers do to attract buyers to their offices. Some of those ads sound like everyone's dream home, and Realtors wouldn't spend time writing them and money running them if they didn't work. You probably won't want to compose anything as elaborate and flowery as some of those ads get, but reading them will give you an idea of what appeals to people in a home.

When you sit down to write your own advertisement, focus on the desirable points of your property. Is your suburb near a large city and your house close to public transportation? "Easy commute" might attract tenants. Are there schools, recreational facilities, and various children's activities within walking distance? "No more carpools" could appeal to harried parents. A house out on the edge of town could offer "a breath of country living," one set back from the road behind trees features "peace and privacy," and one in the middle of a bustling development might be in "friendly neighborhood surroundings.
"

Don't make misleading statements. They'll be disproved as soon as anyone sees your rental anyway. But there's certainly no harm in wording your ad so that it stands out from the crowd and entices people to come to you before they end their search.

8.62 Signs

Many landlords like to put a "Home for Rent" sign right on the property so that people driving through the neighborhood will see it. This may or may not attract renters and could cause trouble. If the house is empty, such a sign can be an open invitation to vandals and transients in some communities.

Besides, people looking for a home are not very likely to cruise the streets trying to spot a house with a sign on it. You may attract an occasional family checking out a neighborhood to see if they would like to live there, but that doesn't happen very often. However, a small sign costs very little, so if your rental is in an extremely low-crime area, you may want to try it. You might just be lucky and find a very good tenant that way.

Signs work better for apartment houses, especially those with resident managers. Very often apartment hunters will go from building to building looking for vacancies.

8.63 Word of Mouth

More effective than a sign is telling the people who live on the street that you're looking for a new tenant. They may have friends, relatives, or co-workers who would like to live nearby.

DeeAnn J. hired a neighbor's teenager to mow the lawn or shovel the walks and keep an eye on the place while her rental was vacant. This gave her a natural opening to speak to several of the neighbors. She simply knocked on the doors and said, "Hello, my name is DeeAnn Johnson, and I own the house at 1234 Sunny Lane. The Smith's son Bobby is looking after the place for me until I find new tenants. I'd appreciate it, if you notice anything wrong over there, if you'd tell Bobby about it. Or you could call me; here's my card. Incidentally, if you know someone who might like to rent a home on this street, be sure and have them get in touch with me."

Investors who like this technique but are too busy to walk up and down talking to the neighbors every time they have a vacancy use a form letter or postcard to accomplish the same ends. You can get directories that list everyone's name by their address from the telephone company. Or consult directories in the library, copy out the information you want, and make up mailing lists for the streets your houses are on. If you're too busy even for that and don't have anyone to help you, simply address your notes to "Resident," and begin them with a general salutation such as "Dear Neighbor." Then simply repeat much the same information as above, altering the form slightly. Your letter might look like this:

Dear Neighbor:

My name is DeeAnn Johnson and I own the house near you at 1234 Sunny Lane. This letter is to inform you that my property is vacant and being cared for by Bobby Smith at 1236 Sunny Lane until I find new tenants. If you notice anything wrong with my empty property, I would appreciate it if you would either tell Bobby or contact me directly. My telephone number is on the enclosed card, and you may reach me at any time between 9 a.m. and 10 p.m. If you know of anyone who would be interested in renting this property from me, please don't hesitate to give them my number. Thank you for your time and attention.

Sincerely,

DeeAnn Johnson

Of course, some investors don't want the people who live near their rentals to know who owns the property. These people don't want angry neighbors calling them about their tenant's barking dogs, loud parties, or unruly children. If you feel this way, don't use this technique.

However, the landlord who cares about his property and his reputation in the community should be in touch with the people who live near his rentals. These people can be valuable links in your information network. Those who own their own homes, especially, have an interest in keeping their neighborhood attractive, and so should you, since this directly affects the desirability and value of your own property. Such people will usually let you know if your tenants are neglecting the lawn, letting their dog tunnel under the fence, or keeping a motorcycle in the living room. You may have to fend off a few calls from the local busybody who complains every time a child's ball lands in her prize tulips; on the other hand, if you treat people like this calmly and courteously, they are also the first to let you know about tenants who load all their belongings into a truck and disappear in the middle of the night.

Whether or not you choose to include the people who live near your rental in your information network, don't hesitate to inform the rest of the members of the network when you're looking for new tenants. Tell everyone you meet in the course of the day. You never know when your supermarket checker or florist's assistant is looking for a house or knows someone else who is. Don't forget, too, to tell the tenants of your other properties that you have a vacancy. If you're the kind of fair landlord most tenants appreciate, they won't hesitate to tell their own contacts when their nice landlord has another of his or her neat little properties available.

8.64 Property Rental Firms

In most large urban areas, and some smaller cities, many people now look for rental homes through property rental firms. These usually have names like "Homefinders" or "Rental Assistance Agency" and are listed in the Yellow Pages of the telephone book under "Real Estate Rental Services."

These companies generally make their money by a subscription fee they charge to prospective tenants who use their services. People can go into their offices and buy a list of all the available properties handled by the service. The cost ranges from $5 or $10 for a week's listings to $25 or $50 for a three-month subscription. These rates and terms vary from one part of the country to another and can go even higher in some places like New York City, where finding a decent rental can be extremely difficult and expensive. However, the bottom line to you, the investor, is that it costs you nothing, or at most a very minimal fee, to have your property listed with these services.

When you advertise through a property rental firm you simply supply them with the information on your vacancy, much as you do when running a classified ad in the newspaper. Since it costs nothing to place the listing, however, you can give a much more complete description of your property.

You may have to go back to your studies of creative ad composition to write a description that stands out, but this shouldn't be too difficult. Most of your competition will merely state facts about their properties, without trying to appeal to the applicants' imaginations. Where they go into details about their all-electric kitchen with built-in microwave or state that there is shop space in the garage, you simply supply a more colorful description, such as "Labor-saving kitchen is working mother's dream" or "Handyman's delight hobby space." Rather than merely listing physical facts, such phrases appeal to emotional needs which is what all good advertising does.

8.65 Bulletin Boards

Most communities have bulletin boards where people can post public notices. If you've never noticed any, check around in supermarkets, laundromats, bowling alleys, or almost any place where people go regularly to spend some time. Use your imagination.

For instance, most senior citizens' centers have notice boards. You might think your house is too big for one or two retired people, but you could be wrong. A lot of older people today are joining in groups to share housing so that they can save money, and three widows or widowers who are having trouble meeting the rent for three separate apartments could turn out to be your best tenants. Also, remember this: Even if none of the senior citizens want to rent your property, some of them may have children, grandchildren, nieces, nephews, or friends who could become your tenants.

When you advertise on bulletin boards, some places will restrict you to one card about the size of a 3" x 5" file card. On that you can state as much information as your card will hold. Remember, though, that people often browse the bulletin board in a hurry, especially if they're in the middle of their weekly grocery shopping. Rather than fill your card with small writing or typing that describes your property in detail, use something more eye-catching, particularly if the board is crowded with cards and messages. You might try printing the words "House for Rent" in large letters with a colored marking pen. (Red is usually a good attention-getting color, unless half the cards on the board are written in red. If they are, try purple, orange, or some other bright color that stands out.) Under that, you might put a minimum of information in much smaller letters, such as, "Spacious 3 bdrm., beautiful yard, $500, Gorham School District."

A technique that makes bulletin board cards much more effective enables people to simply tear off your phone number. Make a series of cuts up from the bottom of the card, or paste on a strip of paper that has been cut in this way. Then write your phone number between each of the cuts. This way, if someone is interested but has no pen handy, he or she can still take your number. It also decreases the chance that someone will take the whole card which would prevent others from seeing it.

8.66 Chamber of Commerce

Many people check with the chamber of commerce as soon as they move into town, or even before. See if you can't leave a notice of your rental there. If you own several properties, ask to have your business cards or a small flyer included in the information packet distributed to people who inquire for information about your town.

8.67 Military Housing Offices

If you live near a military installation of any size, you can list your vacancy with the base housing referral officer. You'll find the number for the base in the U. S. government section of your phone book, listed alphabetically by branch or service, and there may be a separate listing for housing. If not, simply call the main base number and ask for the housing office.

When you reach the housing referral office, explain that you are a landlord with a vacant house you would like to rent. Someone will take your name and address and explain the procedures they use. Then the information on your rental will be given to all service members and civilian base personnel who ask for information about rentals in the community.

When you list your rental with military housing offices, they have no jurisdiction over the amount of rent you charge or any other normal tenant policies you establish. They do require you to sign a statement of nondiscrimination, and failure to comply with this policy will mean that your rentals will no longer be listed with that office.

The military also requires its personnel to be able to leave housing on two weeks' notice in the event of a military transfer. This doesn't have to be a drawback. After all, it's better to have a tenant who can leave with two weeks' notice than it is to have a vacant rental property.

8.68 Real Estate Offices

Some real estate offices handle both sale and rental property. If your agent works in an office that does this, you may be able to have his office list your property and show it to prospective tenants. However, they will probably charge you a management fee, or at least a one-time commission, of up to 10% of a month's rent for this service.

Most real estate offices, remember, are in business to sell property, not to encourage house hunters to rent. When they do handle rental property, they usually do so only as a favor to large clients or as a service to buyers who need a temporary home while they are looking for a house to buy and waiting for the sale to close. Many of the rentals they do handle belong to the broker who owns the office.

If you're exploring every possible way to rent out your property, though, it never hurts to ask real estate offices to help you. Be prepared, however, for the agent who tries to talk you into putting the property up for sale instead of renting it out. This agent may simply be looking for a listing or may be in the market for a piece of investment for himself. You should also be aware that when prospective tenants walk into a real estate office looking for a rental, some agents will try to convince them to buy a house rather than renting yours. The result can be that three months after your tenants settle in, they inform you that the nice agent who rented them the house has now found them a place they can afford to buy.

8.7 KEY 4: SHOWING THE PROPERTY

Once you've settled on the ways to advertise, you have to be prepared to show your property to prospective tenants. The first time you do this you're likely to be a little anxious. Your first worry will probably be wondering if anyone will respond to your advertising, and your second one is apt to be how many times you'll have to show the house before you find a tenant and can start collecting some rent.

Don't let these worries get out of hand. If you've followed our advice and bought, prepared, and advertised your rental correctly, you will get results. The most important factor now is not to get too impatient.

Juan R. was the proud new owner of a three-bedroom investment home in a large city in the Northwest. He did some minor cosmetic repairs, set his rental policies, and advertised in the weekend edition of the paper for tenants. His telephone started ringing almost immediately. "Tell me more about your rental home. When can I come see it?"

Juan set up appointment after appointment. He was disappointed when some of the people didn't come, but he gave his best sales pitch when he was able to take people through. "Take a look at this living room! It's much larger than normal--plenty of room to entertain guests in here. And the kitchen--look at all the counter space; and the appliances are nearly new. Here in the first bedroom..."

He went on and on, pointing out all the best features of the home. But the people's response was always the same: "We'll get back to you," or "I'll tell you what--we'll take it if you drop the price by $100." Juan knew he was asking a fair price. After showing the house to eight people in two days, Juan began to get discouraged.

Then a more experienced friend took him aside and gave him some tips. "Maybe you should play a little more hard to get," the friend said. "Don't follow them around selling the house to them. Let the house sell itself."

That sounded like good advice. But the friend wasn't through. "One other thing: You're a busy man. You're going to wear yourself out running back and forth to

your rental. Just set a two-hour block of time and have all the prospects meet you then."

Juan took his friend's advice. He was still friendly and courteous, but he didn't push the home so much. He encouraged all his prospective tenants to meet him in the same evening. He found that was a much better use of his time--and it created a little competition among the prospects. With his new approach, he had the home rented out in less than a week.

Impatient rental property owners like Juan are apt to make mistakes. They push the house so eagerly that renters looking it over begin to wonder if something is wrong with the house. Or worse yet, prospects decide that if the landlord is so anxious to get tenants, they can manipulate the situation to their own advantage.

8.71 Take Control from the Beginning

This is where your own ambition can be your worst enemy. Of course you want to start that rental income flowing, and naturally you want to finish working on this house so you can concentrate on buying the next one. But this is the time to remain cool, calm, and patient. Your first contact with future tenants will set the tone for your entire relationship with them. You must get off to the right start if you want to avoid unpleasant, and possibly costly, developments in the future.

This is not to say that you should be rude, overbearing, or nasty. Nothing is gained by alienating people before they even move in, no matter how tight the rental market is. But you do want to establish from the beginning that you are a businesslike person and that you manage your rentals as a business. The best way to do this is to maintain a professional image for yourself and your rental business from the very beginning. You want your tenants to realize during their initial contact with you that you are fair but firm in all ways.

One way to establish this is to make it plain that you, not your tenants, control your time. When you compose your advertisement, don't include your home or office address or the address of the property. Instead, give your telephone number so that people will have to make an appointment to look at your house.

When you give your telephone number, that doesn't mean that you have to sit by the phone twenty-four hours a day. Instead, you can either state the hours during which calls will be taken when you write your ad, or you can use an answering machine. Many investors get excellent results with a tape that says something like this: "Hello, this is Paul Stimpson. If you're calling about the house for rent, please leave your name and a number where I can reach you after five o'clock. I will answer your questions and set up an appointment if you wish to see it."

If you do answer the calls yourself, you should still set up appointments. Even if you have nothing else to do all day, it's best to give the impression that you are busy and have to schedule your time carefully. This keeps your tenants from expecting you to be on call at all times. If they think you're a very busy person who handles many more important things than one rental house, they may think twice about calling you for minor problems that they can take care of themselves.

Another approach is to schedule a time when you will be at the property and will show it to everyone who comes. This technique was first popularized by author and investor Dave Glubetich, who calls it a "rental open house." In this case, your answering machine message could say something like: "Hello, this is Sally Stringham. If you're interested in the house I have for rent, I will show it to anyone who arrives between 2 and 5 p.m. on Saturday, March 3rd. The house is located at 905 Homewood Drive, which is six blocks east of the stoplight at Third Street and Midtown Avenue. Please leave your name and the time of your call if you plan to stop by."

This method usually works best when there is a fair amount of competition for rentals. Asking people to give their names is simply a way to weed out the less serious prospects. Those who leave a message at least intend to look at your house at the time they make the call, and the number of names will let you know about how many applicants to expect. If no one leaves a name, you will know not to waste your time sitting at the property all afternoon.

8.72 Let Prospects Show Themselves Your House

If you can't get away but want people to be able to see your house at their own convenience, you could allow them to pick up a key at your office. When you do this, make sure the people leave a cash deposit of at least $25. This deposit will be refunded to them if they return the key within one hour. It's not safe to allow strangers to handle your keys for any longer than that.

People who do pay the deposit and go through the house on their own must also give you their present address, driver's license number, and car license. Verify their identification and license number, and keep this information in the record file for that house for at least two years or until the locks are changed.

If you don't have an office, or if you work someplace where visitors can't come and go easily such as in a factory or a classified area, do business from a booth in your favorite restaurant. Tell applicants, "I'll be at Perry's Cafe from 1 to 2, and you can pick up the key from me then if you can have it back to me before I leave. Just ask the hostess; she'll know where I am." Then, of course, be sure the hostess knows who you are and that you expect someone to ask for you. If your prospective tenants can't make it back before your lunch hour is up, have them leave the key with the restaurant hostess or manager who can hold it for you until the next day. (Naturally, the person who does favors like this for you should be paid accordingly, in tips, with an occasional gift, or with increased business from you and your friends, whichever is appropriate.)

Another approach that is sometimes used by investors without an office is to name an important, well-known building in the area. "Do you know where the Metropolitan Bank Building is?" you might ask. "I'll meet you in the lobby at 3 o'clock." It is then your choice whether you want to follow the applicants in your own car and show the house personally or give them the key and wait around the office building until they return.

8.73 Enlist a Helpful Hand

Finally, you can ask a neighbor who lives near your rental to show the property for you. Naturally, you would want to screen people yourself before telling them where the key is, in order to avoid wasting your helpful neighbor's time. This neighbor might be paid $50 or so when the house is rented, depending on how much time he or she spends and how many people look at the house before it is finally rented. It would be better to pay this way than by the hour so that the person is motivated to help you rent out your property and receive payment as soon as possible.

8.8 KEY 5: PRE-SCREENING YOUR APPLICANTS

As a novice investor, Tracy C. was delighted to show her vacant rental to anyone who seemed to be the least bit interested. She learned all too quickly that that approach can eat up a lot of time without bringing many positive results--but she wasn't sure what she could do instead.

Then she learned about pre-screening applicants over the telephone. Instead of showing her rental home to anyone who asked, she found out first if they were even qualified to rent it.

To help her, she developed a list of questions that enabled her to eliminate a number of prospective tenants without even meeting them. For instance, her rental had only two bedrooms, and she wasn't interested in renting to a family with more than four people. So she asked, right up front, "How many people are in your family?" If the answer was more than four, she said, "I'm sorry, but the house is so small that as a matter of policy I simply can't allow more than four people to live in it."

As she went down her list, she gradually eliminated a number of prospects, thus saving her the time and trouble of showing the house to people who didn't qualify anyway.

All landlords can learn from Tracy's example: When you talk to prospects on the telephone, do some pre-screening so that you don't waste your time, and theirs, showing your property to people who aren't really interested. Ask them the following questions:

M 1. How many people are in your family?

M 2. Do you have any pets?

M 3. How many cars or other vehicles do you have?

(If there isn't enough parking for all their vehicles, you must discuss this with them. Some tenants will park their recreational vehicles on your lawn if there's no driveway curb space, and some cities prohibit large RVs from parking in the street. They may be able to store their RV in a special rental lot, but these arrangements must be made and understood before they move in.)

M 4. When do you want to move?

M 5. Where are you living now?

M 6. Why do you want to move from there?

M 7. How much are you currently paying for housing?

Write down these questions, plus any others you might want to ask. Leave space beside each question and a space at the bottom for your own notes. Then make several copies. Keep these sheets, plus a pen or pencil, near your telephone so that you can jot down people's answers and any thoughts you have during your initial conversation with them. These are you pre-screening notes and will be a useful record later on.

The answers to these questions will give you some idea of the kind of people you're talking to. They will probably have some questions of their own, also, such as:

1. What schools are near the house?
2. How large are the rooms?
3. How big is the yard? Is it fenced?
4. What color are the walls, drapes, and carpets?
5. Is the house air-conditioned?
6. How far is it from the nearest shopping center?
7. How close is it to various large employers in the area, major highways, or certain recreation facilities?
8. Is there much traffic on the street?
9. How much is the deposit?
10. Could we pay you part of the rent now and the rest later?

The answer to the last question, of course, must be no, unless you have some very particular reason for changing your policy. We'll cover this later on.

Once you've concluded this initial interview, you will know whether you want these people to examine the house (or apartment). Write down the results of your conversation on your page of pre-screening notes and keep it for later reference, whether or not you make an appointment to show them the house. If one or the other of you has already decided not to rent the house, note why and file the sheet alphabetically in a folder for turndowns.

This may sound like a lot of trouble to go to for someone you may never see again, but there are two major reasons to keep these notes.

First, the people may have revealed some information to you that means you will *never* want to rent to them, such as they are being evicted from their current home for nonpayment of rent and excessive damage. Two years later they may apply to rent from you again, and by that time you probably won't remember their name. But when you double-check your turndown file, there they are.

Second, keep your notes for your own protection. Perhaps these people tell you that they have six children, and you are renting a two-bedroom house for which you've set a limit of four people. You simply write down, "Size of family exceeds limit for this house," clip it to a copy of your rental policies, and put it away.

Three months later, when these people assume they can't find a home because they're being racially discriminated against and they sue every landlord they've talked to, you are called into court. When it's your turn to testify, you have your written notes to support your story that you never saw these people in person and had no way to be sure of their race. Your evidence shows that your decision not to rent to them was guided by your written policy on the number of people your rental can reasonably house.

8.9 CONTROLLING THE APPOINTMENT

If the pre-screening conversation leads to an appointment to see the property, ask that everyone who will be living there come along. Most people do this anyway, but in some cases you may spend an hour showing the house to a husband or wife, for instance, and then be told, "Well, I like it, but I can't sign anything until my spouse looks at it. Can we come back tomorrow night?"

To avoid this, explain at the beginning that you have to schedule your time, so you would prefer that the whole family see the house together at once. You don't want to entrust your property to anyone you can't meet beforehand, anyway, and it's a good idea to see how the entire family interacts when they're together.

When you set appointments to show your property, you know that some of the people you'll be meeting in the next few days are going to become very important to you. Somewhere among them is the family that will become your tenants, live in your house, and pay the rent that will cover your mortgage payments. You hope that this relationship will be smooth, friendly, and profitable for all of you and that it will last for several years. By doing your best to prepare clean, reasonably priced living quarters for these people, you have already started doing your part to meet this goal. The ways you can continue to do your part and encourage them to do theirs, so that all of you will enjoy your new association, will be covered in the next sections.

8.10 HOW WELL HAVE YOU LEARNED FROM PART A?

How well have you learned the information in Part A of this unit? Test yourself by answering the following questions. Do not skip this step--the best way to make sure you remember these concepts is to repeat them in writing. If you are uncertain of a particular answer, look back through this unit until you find it.

1. Why is property management important to your real estate investment program?

2. From the following list choose the best tenant for your property.

a. A young assistant manager in an international corporation,

married to a recently-graduated pediatrician, with no children.
b. A divorced landscape designer who has worked for seven different firms in the last two years, was previously unemployed for eighteen months, and is living with a rock singer. They have four children, one of their own and three from previous marriages.
c. An auto mechanic married to a nurse. He was discharged from the army and moved to your town eight months ago. They have three children and a cocker spaniel.

3. What makes yuppies problem tenants in the standard bread-and-butter home?

4. Your house needs interior paint and new drapes. There is avocado carpeting throughout and oak paneling on some of the walls. What colors will you choose for paint and drapes? Explain your answer.
a. Different colors for every room.
b. Off-white paint in all the rooms, beige drapes in the living room, and beige window shades for the rest of the house.
c. Tell the tenants they can choose their own paint and window coverings, and you will pay for it.

5. Your house is vacant, but you have to work overtime at your regular job. How can you get the house ready to be rented out?

6. Is it a good idea to allow tenants to have pets? If you do, what should you do to protect yourself financially?

7. Can you refuse to rent your property out to someone you disapprove of? On what grounds?

8. Rents for houses similar to yours range from $450 a month to $625. You decide your house should bring in at least $600 a month. What do you do to make your house attractive at that rent?

9. You decide that the top rent in your area is still not enough. How can you bring in $150 a month more for your property?

10. When is a lease option a good idea?

11. Why are deposits so important?

12. Your house is attractive inside, but the front yard is nothing but patchy grass with brown spots and bare places. Should you plant a few shrubs and new grass seed or leave it as it is? Why?

13. You have been camping out in your rental for three days, patching plaster and painting. The kitchen is full of sandwich wrappers and empty soda cans, there are flakes of old plaster all over the dirty carpets, the bathrooms are filthy, and all the drapes are at the cleaners. Your sister comes by and says she has some friends who would just love to see the house today. Do you agree to show it to them? Why, or why not?

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14. There are over two dozen newspaper ads for houses similar to yours at about the same rent. What advertising approaches can you use to increase your chances of attracting the best tenants?

15. How can you show your property to prospective tenants when you don't have time to do it personally?

16. Your neighbor thinks he knows someone who might want to rent your house. Do you wait for him to bring you the applicant or continue with your own efforts to find a tenant? Explain your answer.

17. The first people who look at your property offer you cash for the full rent and deposit and want to move in right away. It is eight o'clock Friday night. Do you let them move in over the weekend? Why, or why not?

18. People have been calling about your rental all week, you are tired, and it's your daughter's birthday. What should you do to take a rest and still get the place rented out?

19. A man calls and wants to see your house. While you are talking to him on the phone, you learn that he has eight children and his wife has left him. While he is at work, his older children are in charge of the younger ones. What do you do?

20. What are some good questions to ask in pre-screening your applicants?

21. Someone picks up the key to look at your house and leaves you a $25 deposit. Three hours later they call and say their wallet was stolen with your key in it. Do you refund their deposit, or use the money to have the lock changed? Explain your answer.

8.11 PUTTING PART A INTO PRACTICE

Now that you have studied the first part of this unit, do the following assignments. They will help you put into practice the concepts you have learned. You need not do all of these assignments--but the more you practice in this setting, the better you will be able to perform when it really matters with your own property.

If you are already a seasoned property manager, you may wish to use this material to polish your skills or add a few new tricks of the trade.

1. <u>Ask an expert</u>. Talk to someone who used to own rental property but sold it. Ask this person why he or she got out of real estate investing. After your conversation, make notes for yourself on how these problems could have been avoided by better management techniques.

2. <u>Scout the competition</u>. Spend a weekend visiting houses for rent as though you were looking for a place to live. After each house you visit, jot down notes on the condition of the house, things you liked and didn't like about it, and ways you think you could make that house more attractive without spending a lot of money. Include the amount of the rent and deposits, whether pets are accepted, why the previous tenants moved, why you would or would not want to rent this house, and whether you think the person who owns it is a good landlord and why.

3. <u>Create your own textbook</u>. Clip advertisements from the "Homes for Rent" and "Homes for Sale" classified sections of

your newspaper every day for a week. Separate these into ads that appeal to you and ads that leave you cold. Then sit down and study them. What do the good ads have in common? What's wrong with the poor ads? Practice writing an ad that you think would appeal to a large number of renters.

4. Look for bargains. Visit local paint and hardware stores. Ask to speak to the managers, and explain that you are a real estate investor who will regularly need paint, tools, and fixtures for your rental properties. Find out if any of the stores will arrange a special discount for you. Next, check with local dry cleaners to see if they have a "landlord's discount" policy for drape cleaning. While you're there, ask if they ever have unclaimed drapes that they might sell cheaply.

5. Compare buying to renting. Survey firms that rent steam cleaners for carpets, plumber's snakes, and any other large tools you think you might need occasionally. Learn what the charges are for these items, and find out what it would cost you to buy the same equipment. Remember, some of these things you will need only once every year or two in the beginning, but be aware that at some point it may become more economical to own them. Don't buy *anything* until you really need it.

6. Set policy. Write down the policies you will use for deciding whether to accept or reject tenants. Be specific. For example, don't say, "Avoid too many people," but rather, "No more than two family members per bedroom."

7. File it. Create files for copies of your Move-in Ready Checklist and Pre-screening Notes. Add any questions you may want to ask to the Pre-screening Notes and find a place for these near your telephone.

8. Make calls. Contact several rental services in your area. Find out their requirement and success rates. Ask how much time passes before the average home is rented out--and ask how many rentals are pulled from the service without being rented at all. Make notes of your findings and save them in your file.

UNIT EIGHT

CREATIVE MANAGEMENT

PART B

UNIT EIGHT

CREATIVE MANAGEMENT

PART B

A QUICK REVIEW

How important is effective property management?

You got some clues in Part A, but in case you haven't captured the entire vision yet, let use restate that *managing your property effectively is one of the most critical things you can do to reach your financial goals.*

Why?

You can go out and exercise all the creative financing in the world, and you can purchase a portfolio stuffed with the most prime properties in town. But if you don't have excellent tenants in those properties, writing out a check to you each month, your efforts won't mean much.

Think about why you are interested in investing in real estate. You want to make money, right? Will your prime properties bring you money? Only if you have excellent tenants in each one.

There is a real art--a real business--to selecting good tenants. Being a landlord involves much more than simply thrusting a set of keys upon the first person who comes along expressing a interest in renting your property. Being an effective manager means taking the time to require each prospective tenant to fill out an application form--and it means taking the time to verify the information. It means making an intelligent decision about which person you are going to trust with your hard-won investment property. We will tell you how to do all that.

Being an effective manager means setting up a good system for keeping track of your tenants and properties. You won't make money if you shove your receipts and notes about your properties into a shoe box that only sees the light of day when your accountant arrives to do the taxes. Being an effective manager means setting up an effective record-keeping system that enables you to keep track of each property with ease. We will show you how.

Being an effective manager means knowing how to conduct your relationship with your tenants. You might be surprised by the fact that you shouldn't be pals with your tenants: keep your relationship on a business level. You must be fair, but firm. Unit B tells you how.

And, as carefully as you choose tenants, the day will certainly arrive when your tenants need to leave--either because *they* have chosen to move on, or because *you* need to get rid of some bad apples. It's not easy, and it's certainly not pleasant but we give you the keys to a systematic, smooth departure.

So stick with us. What you'll learn in the next few pages will mean the difference between your unmeasured success and dismal failure!

A FEW MORE TERMS YOU SHOULD KNOW

Deposit: A sum of money that you require from tenants when they move in as a type of "insurance policy" on your property. When tenants move out, you can use their deposit to make necessary repairs on the property. You can also require special deposits, such as a pet deposit, to take care of necessary cleaning, or a key deposit to pay for changing the locks on your property if the tenants fail to return your keys.

Eviction: The legal process by which you force undesirable tenants to leave.

Inspection The process of visiting each property on a regular basis to check on the condition of the property and to find out how the tenants are maintaining the property. Many landlords inspect the property once each month when they collect rent from the tenants, others inspect once each year when they deliver a notice of rent increase.

Key Deposit: A deposit you collect from tenants when they move in to guarantee that they will return all keys to you when they vacate the property; the key deposit should be enough to cover the cost of changing all locks on the property.

Move-In Ready Checklist: A checklist that the landlord and tenants use when the tenants are ready to move in to record the exact condition of the property at the time the tenants take possession. The Move-In Ready Checklist should record any flaw or damage to any part of the property, inside or out, and should be used when tenants move out to verify any damage that has occurred during tenancy.

Rental Agreement: The legal document that the tenants sign when the agree to rent the property.

Rental Application: An application form filled out by prospective tenants; the Rental Application asks for credit information, employment information, and information on past residences. Each prospective tenant should complete a Rental Application, and the landlord should use the completed Rental Applications to verify information on prospective tenants and to make a selection among the prospective tenants.

Rental Policy Checklist: A list of criteria the landlord insists on meeting in any tenant; tenants who do not meet the criteria on the Rental Policy Checklist are not considered for tenancy.

Tenant Policies: A list of rules provided by the landlord that govern the tenant's behavior while renting the property.

Verification Permission Forms: Forms a landlord uses to get written information that verifies a prospective tenant's employment and banking status.

MORE VITAL POINTS ABOUT MANAGING PROPERTIES

As you read this unit, keep the following key points in mind as principles to guide your actions in property management.

M There is more to good property management than simply attracting tenants to your rental properties.

M Intelligent landlords know that it is better to allow a house to stand vacant for a few extra days than to rent to the wrong people.

M Finding the right tenants is one of the most important aspects of your investment program.

M The relationship you maintain with your renters throughout their tenancy is as important as the care you exercise in selecting them to begin with.

M The more care you take in setting tenant ground rules in the beginning, the fewer problems you will have later on.

M The more you reduce agreements and understandings to writing, the fewer disagreements and misunderstandings you will have down the road.

M Careful record keeping that enables you to keep track of facts and figures concerning your property and tenants is essential to your success as a landlord.

HOW TO BE AN EFFECTIVE PROPERTY MANAGER

In Part A of Creative Management, you learned how to prepare your house for tenants, how to set rental policies, how to advertise your property, and how to prescreen tenants. The next step? You will need to begin meeting people--and, at this point, you have no idea whi of them will become your tenants and what your relationship with them will be like.

When you think about it, that's a little like telling someone that her blind date is on the way, and leaving her to wonder how it will work out. The thoughts that race through the minds of the person waiting for a blind date and the person waiting to meet prospective tenants are often similar: What will he be like? How will he look? Will I like him? Will he like me? Will this develop into a long, enjoyable relationship? Or will it be a brief, uncomfortable encounter that leads to nothing?

These are all reasonable questions, even though you're looking for someone to enter into a business relationship with, not a prospective mate. You want to know if prospective tenants are stable and dependable, neat and clean, people you will like, and people who will like your house well enough to want to rent from you. You'll be wondering whether the next prospects you meet will be the ones who will move into your rental, pay their rent promptly, and take care of the property as though it were their own.

Worse yet, you'll worry whether these people will *seem* to be all right--but, after moving in, will break your doors and windows, stain your carpets, knock holes in your plaster, ruin your appliances, destroy your yard, refuse to pay their rent on time, and then disappear in the middle of the night with all the draperies and the new hot water heater you installed.

Naturally, you want to protect yourself and your investment from the worst tenants and allow only the best ones a chance to live in your rental. Just like the person who dates a lot of people in search of that perfect match, you'll have to be prepared to go through plenty of applicants, and you'll need to be prepared to turn down all the marginal ones. Remember the T-shirt slogan that was popular a few years ago: "You have to kiss a lot of frogs before you find a handsome prince."

In Part A of Creative Management, we discussed various ways to show your house to prospective renters. You can host an open house, allow people to pick up a key and visit the property alone, or enlist a helpful neighbor to show your rental for you. But one of the best ways is to personally walk through the house with your first few prospects. Why? Their comments and attitudes will teach you a great deal about your individual property and how people react to it. And you'll find out plenty about them during the walk through, too!

Ready to begin? In Part A we gave you five keys to property management:

1. Prepare the property
2. Set your rental policies
3. Advertise
4. Show the property
5. Prescreen your applicants

Throughout this rest of this unit, use the following additional keys as a guide.

8.9 KEY 6: WATCH FOR THE LITTLE THINGS

When you visit the house with prospective tenants, don't push. Be available for answering questions and maintain a friendly, courteous attitude, but don't follow people around chattering constantly. You might point out one or two of the most attractive features of the property, but then drop back. Your main job now is to watch and listen.

You can learn a lot by watching people. Peter H., an investor with a dozen single-family homes, says he can tell a lot about a potential tenant just by watching. "Once in a while I make a mistake and bring in tenants who let me down," he says, "but such mistakes are rare. By carefully watching the people as they go through the home, I can learn much about the stability of the family and about how they will treat the home when I'm not around. I may have turned down some `golden' tenants over the years--I'll never know. But by being careful I can sleep much better knowing I have good tenants."

8.91 Is Anyone in Charge Here?

Are the children well-behaved, and do the parents control them? Do all the members of the family seem at ease and happy with one another, or is there tension and arguing? The way children and parents interact can tell you volumes about how they'll treat your property. Take notes--you may need them later.

Kids who show up looking grubby and ragged, who kick doors, who trample candy into the rugs, and who wipe their noses on dirty sleeves aren't going to turn into spotless angels on moving day. Parents who ignore what the children are doing especially if the children are whining, probably don't pay much attention to what the kids do most of the time. What does this mean to you? It could mean that the kids are free to paint on the carpet and set fire to the drapes while Dad watches football and Mom talks on the phone.

Parents who don't notice what the kids are doing until it's too late and who then make a big scene (complete with yelling or even hitting) are probably putting on a show for your benefit.

Responsible people warn their children ahead of time that they have to behave, and then keep a constant eye on them to keep them from getting seriously out of hand.

8.92 Happy Families Make Stable Tenants

At the same time, parents who fight in front of you, blame each other for the children's behavior, or try to convince you that one or the other spouse is irresponsible or difficult to live with may be signaling that their marriage is in trouble. This isn't always true, of course, but if you're alert for warnings, you could avoid that phone call six months later: "Charley/Charlene walked out and left me with all the bills, and I just can't pay the rent by the first."

By the same token, people who have been married for eleven years and who act like a couple of high-school sweethearts may be on the verge of a separation. New surroundings (including a new house) are frequently part of one last attempt to renew a relationship that has become difficult for one or both partners.

This makes it sound as though you can't take anyone at face value--and unfortunately, that's often true. You can't avoid every bad situation on the strength of a single hour with a family but if you learn to watch for danger signals with practice you will soon be able to tell a surprising amount about people from a brief encounter. With practice, too, you'll find that you develop what almost amounts to an instinct about tenants. It won't be infallible--even the most experienced landlords sometimes misjudge rental applicants--but it will make your job easier as you become accustomed to making these kinds of judgments. That's one more reason to get some experience in handling your properties yourself.

8.10 KEY 7: A GOOD APPLICATION IS A MUST

Jason B.'s rental had been vacant for nearly four weeks, and he was getting increasingly anxious. It seemed as though his every thought was focused on that negative cash flow--and *flow* was the right word for what he expected to happen to his cash if the house remained vacant.

When he finally snagged some good prospects through a newspaper ad, he rushed over to show them the house. They were delighted. "This is just what we've been looking for," they said. "Only one problem. We've already moved out of our other place; our stuff is just sitting in a truck. Could we give you a cash advance and move in tonight?"

Jason should have seen the danger signals, but he was too busy enjoying a different vision in his mind: a negative flow sealed up, with a new positive flow coming in.

"Sure thing," he said. "We'll take care of your rental application after you're all settled."

The family did indeed move in that night. They moved out three months later, when Jason finally forced them out. In the interim they had paid *nothing*.

Needless to say, Jason learned quickly in his personal school of hard knocks.

When you go out to show your property, take the correct forms with you. After looking through the house, examining the yard, and checking out the availability of local schools, some people will say to you, "I'm sorry, it's just not for us," or "There are a couple of other places we'd like to look at before we make a decision."

Others, though, will say "This is exactly what we want. Can we give you our deposit now and move in over the weekend?"

That's music to your ears! Finally--no more phone calls, showing the house, worrying about negative cash flow. But hold on. Not so fast. No matter how long the house has been vacant, *never* let anyone move in until you first take their application and check them out thoroughly.

That's hard to do when someone waves several hundred dollar bills under your nose and says, "See, we have the first and last month's rent and the deposit money. Monday is the first of the month, and we have to be out of our other place over the weekend." But don't be tempted. It may be the last money you see from them!

8.10-1 Don't Be Too Anxious

Experienced landlords confirm that when an unchecked applicant offers you cash to move in immediately, it may be the last money you ever see from that tenant. They also caution you to be suspicious of the applicant who pays on a Friday evening and moves in over the weekend. By the time banks and businesses reopen on Monday morning and you can make a few calls to find out who is in your house, it may be too late. It's much harder to evict people who have moved in that it would have been to refuse to rent to them in the first place. Experienced landlords have a saying: "Checking out the application and turning down the worst applicants is the cheapest eviction you'll ever do."

That's where the forms come in. When a prospective tenant expresses interest in renting property, give him a copy of your Rental Policy Checklist. Tell him that whoever finally rents your property will have to meet the criteria you have listed. Then ask him to fill out a Rental Application. Each adult who will be living in the house needs to provide complete information. If a couple has been married for less than two years, ask for the wife's previous name, address, occupation, and the name of her ex-husband if she has been previously married.

Don't forget to get information about the children. You deserve to know the names and ages of everyone who will be living there. Make a point of asking about children from any previous marriages who live with the other parent most of the year but who spend summers with your tenant. Some landlords ask for additional rent if anyone other than the approved tenants stays in their rental for longer than fourteen days. You can decide whether you want to do this, and your decision should depend at least in part on how many children are involved.

For example, if a couple has two children and then has custody of one more for the summer months, it would probably not be a problem in your three-bedroom house. But if they already have four children living with them and then add five more during the summer, you should receive additional rent (maybe $50 per extra child) for each month they live in your house. Your alternative, of course, is simply to not rent to these people at all and to wait for a tenant whose family situation is more suitable for your property.

While you are getting information on the children, you should also make a point of stating that you must be notified of any changes in family arrangements. After all, your decision that not more than six people can live in your three-bedroom rental was made on the basis of wear and tear on your property. If your male tenant's ex-wife marries a man who doesn't like her five children, you could suddenly find yourself with eleven people living in a house suited only for six.

You *can* say no. You are the one who will eventually have to replace carpets and appliances that receive more wear and tear than they were designed for. If you *do* decide to rent to a larger family, you certainly deserve to receive a larger deposit and higher rent to cover the cost of increased damage to your property. Work out an application form for your prospects. (We have provided a model for your use at the end of this unit.) Have them list, besides names and previous addresses, the names and telephone numbers of their two previous landlords (the last one is not enough, since he might be willing to give a good reference just to get rid of them), the names, addresses, and telephone numbers of current and previous employers and supervising person (within the past three years), and both character and financial references (banks, credit unions, and other credit references, together with account numbers). Have them list also their current income level and the amount of that income available for paying rent. Have them also sign a statement allowing you to access their credit report and to verify bank balances and employment. A sample of separate forms for this kind of verification is given below.

VERIFICATION PERMISSION FORMS

Date ________

I/We hereby instruct _____Name of bank____to release information about my/our account balances and/or payment record to Lanny Lord for purposes of establishing my/our financial position in connection with an application to rent Mr. Lord's property at 123 Hometown Drive.

Checking Account # ________________________________

Date account opened ___________________________

Average balance _____ No. of returned checks ___

____
(Signature)

____
(Signature)

Date ________

I hereby instruct _____Name of Company___to release information about my employment to Linda Lord for purposes of establishing my job stability in connection with an application to rent Ms. Lord's property at 999 Comfy Corners.

Date Hired _____ Current position _____

Present salary ____ Prospects for continued employment ___

____
(Signature)

8.10-2 Don't Take Anything for Granted

When the applicants have completed your application form (plus the verification forms), ask to see some photo identification, such as a driver's license or work badge, for each adult. Check the license plate number of their car against the number they have given you. You want to be sure these people are who they say they are, and that they haven't filled out the papers in the name of a friend or relative who has better credit and references than they do.

Once you have the completed rental application, insist on checking all the information out. If the applicants try to persuade you to allow them to move in first, don't give in. Explain courteously that you are a business person--and that regardless of how much you may trust these people, it would be poor business practice to allow them to take possession of your property before you have verified their credit and references.

Then tell them that there will be a $10 charge to cover the cost of obtaining their credit report. You may want to refund it if they are approved and rent the house. However, this is a small fee to cover the time and expense of checking their application, and if they are the sort of people you want as tenants, they won't object to this minimal expense.

You can get some information by telephone when checking bank references, but you may need proof of your applicants' permission before employers and financial institutions will tell you everything you need to know.

Tell the prospective tenants that you expect to have the results of their application in three to five business days, and that you will be in touch with them *if their application is approved*. This statement is a time-saving technique that relieves you of the responsibility of trying to reach every single applicant, whether approved or not. Most of them will probably call you anyway if they don't hear from you, but you won't be obligated to try to contact half a dozen people who are never home because they're out looking for a new place to live.

8.11 KEY 8: VERIFY THE FACTS

John C. had the Wilson's fill out an application for tenancy in his rental unit, then looked it over after they left. Everything on the application seemed satisfactory. Mr. Wilson had been employed at the same firm for nearly six years. Mrs. Wilson was a nurse at the local hospital. They had three children and no unreasonable debts. They had been stable in their residence, too--four years in the same place. They were moving now, they said, only because they wanted to be closer to their kids' junior high school.

After looking over the application, John decided to let the Wilson's rent his home. It was always a bother to verify the facts on applications, and the Wilson's really did seem like nice people. Besides, he was anxious to get someone into the home immediately. Every day the place was vacant it was taking $18 out of his pocket. He called the Wilson's to tell them they were accepted, but no one was home.

The next day he decided to make one quick check with a friend at a bank, simply to confirm this feeling. The bank officer called back with shocking news: "Avoid those people at all costs!" he said. "Mr. Wilson had a business on the side, and it went belly up not too long ago. They have judgments against them that you wouldn't believe!"

John heaved a sign of relief that he had been unable to contact the Wilson's the night before. And he vowed never again to violate the rule that good businessmen in almost all businesses use: verify the facts of someone's application before giving him credit or trusting him with something particularly valuable.

Verifying the information prospective tenants give you is the single most important thing you can do in renting out your property. In fact, it is one of the most vital steps in your investment success. *Never* skip this step or give it less than your best effort. Your rental house or apartment is an asset worth thousands of dollars, countless hours of time, and substantial amounts of energy. Are you going to hand over something this valuable to the first strangers who come along, and then hope they'll take care of it for you?

Of course you won't. That would be like a banker handing the combination for the main vault to loan applicants.

Remember, your rental is *your* property. In order to receive the profits you deserve from it, you must allow only they best, most hones, most responsible people you can fine to live in it and take care of it for you.

8.11-1 Turn to the Pro's

How? Most towns of any size at all have at least one credit bureau. You can find these listed in the yellow Pages under "Credit Reporting Services." These companies will verify job histories and check credit references for you. However, they do charge for this service. Many require an annual membership, which may cost anywhere from $50 to $500 a year. When you're a member of the credit bureau, you can request credit reports on anyone. There is often an additional fee for each report, usually ranging from $5 to $25, depending on how extensive a report you need and how quickly you need it.

If you'd rather not pay the bureau's required fee, consider joining a local association for landlords or apartment owners. They often hold a membership in a credit bureau and allow members to use it for a small charge per application. You might also ask some of the members of your investment team for help; your accountant, real estate agent, banker, or title officer might be willing to send your applications through their credit bureau if you pay the charge for each report.

If none of these alternatives is available, you'll have to do your own investigation. Most of it can be handled with a few phone calls and a letter or two, and is really fairly simple.

8.11-2 How to Check Out a Tenant

The first step, of course, is to verify income. When you call the employer, however, don't use the phone number supplied by the applicant. Look in the telephone directory and verify that there actually is a business listed with the name and address the applicant has given you. Some people will claim they work at companies that don't exist and will give you a phone number of a friend who has promised to give your applicant a good reference as a highly paid employee.

If the phone number listed is different from the one on your form, your applicant may have given you a department number instead of the central number. Call the central number listed in the directory first; tell whoever answers that you'd like to verify employment on one of their workers.

Some companies will tell you that they give this information only by mail. Sometimes you can get around this by saying, "Oh, that's too bad. He has applied to rent a home from me, and said he'd like to move this weekend. If I tell you what he put on his application, could you just tell me whether the information is correct?" If this tactic doesn't work and you want to avoid the delay of sending for verification, call your applicant at work and ask him to speak to the personnel office. If the company isn't too large, it will often be lenient about its "mail-only" policy if the employee asks it to.

On the application, your prospect listed his or her job title and a supervisor's name. You can call the main telephone number and ask, "Can you connect me with (supervisor's name) in (department)?" This will at least help you find out if the person named as your applicant's supervisor works there. However, you can't be sure that anything the supervisor tells you is the absolute truth. Many people have friendly bosses who will stretch the truth a little--or even a lot--to help the people they work with qualify for homes and credit. Ask your applicant to show you some recent payroll stubs.

Once you've verified the employment of all adult applicants, you may want to check with previous employers if the applicant has not been with his present employer very long. Use the same technique.

Next, talk to the applicant's present landlord. This doesn't have to be a long conversation. Ask whether the applicants pay their rent on time, how long they've lived there, and why they're moving. Also try to find out how well they keep their home, and whether the present landlord has any complaints about them. Be cautious about the response, though, if the landlord has had problems with them or asked them to move he may represent them to you as good tenants so he can get rid of them.

The next place to check is with the previous landlord. Even if this involves an expensive long-distance call, it's worth it. Why? He may tell you what the present landlord won't. Ask the same questions you asked of the present landlord, but dig a little deeper and listen more closely. Since the previous landlord no longer has a personal stake in getting rid of your applicants, he is more likely to level with you.

Finally, of course, you want to check on bank accounts and charge account references. Since records on national charge accounts and credit cards are often kept in central processing bureaus, it will make this job simpler if you can check accounts with local firms. If this isn't possible, however, you can call the local branch of an issuing bank or department store and ask where to call or write for a credit rating.

Perhaps all this checking seems cynical and distrustful. Most people are indeed honest and reliable--but what if that one bad apple seeks to become your tenant? You will be glad when you find out *beforehand* who is likely to be a good tenant and who is not.

8.12 KEY 9: CHOOSING THE RIGHT TENANT

You have only one applicant who comes through your tenant-checking process with high enough marks to be accepted as your renter. But you'll probably find that two, three, or even more look like good prospects. How do you decide which one family will move into your house?

Your Rental Policy Checklist can help you make this decision. When a prospect first fills out your application, you should take one of these checklists and clip or staple it to the application. On the back of the checklist, note anything you may have noticed about the applicant. For instance, you might write, "Children clean, quiet, well-behaved. Parents friendly and reserved. Car old but runs smoothly." Or, your notes might read "Baby had wet diaper, runny nose, dirty face. Other children eating ice cream that dripped on floor. Parents paid no attention, too busy arguing with each other." When the time comes to make a decision, these reminders can help you.

8.12-1 Do All the Facts Add Up?

Look at the prescreening notes you made during your initial telephone conversation with this applicant (as discussed in Part A of Creative Management). Check for any discrepancies. Did he tell you over the telephone that he had two children, and did he arrive with five? Or did applicants ask over the phone about distances or bus service to the junior high, high school, and auto plant--and then put on their application that they have only two grade-school children and that the adults work at the post office and the supermarket? You have a right to be suspicious. They may be planning to rent your house and then share it with someone you don't know.

Few people will deliberately mislead you; most people are just what they appear to be. But for your own protection, you must be alert to those few who regard landlords as fair game for any tricks they can get away with. A few applicants will make honest mistakes that can be easily explained. If you decide to turn down a tenant but have no better applicant in sight, then, you can always discuss your reasons and consider their explanation before making a final decision.

As you check out the actual application, make notes about how well the prospective tenants meet your other requirements. Does their income enable them to afford your rent? Is their credit good? Do they have stable histories with former landlords and on the job? If you find something in someone's background that immediately eliminates them, write it down, put their application aside, and concentrate on the others.

To be fair to your applicants and yourself, don't simply rent your property to the first person who checks out well. Someone else may be better. Remember, too, that your first choice may have put in applications with several landlords and could decide to rent from someone else. Check out everyone whose information meets your criteria and whose references support the information on their application.

8.12-2 Contrast and Compare

Once you have all the information you can get on the best applicants, compare everything you've learned about each of them. Usually one or two will stand out as the people you most want living in your house. But if for some reason this doesn't happen, think carefully about everything you've learned about all of them. Does one appear more stable than the others--has he held the same job for, say, four years, while the others change employers frequently? Does one have a larger income, and would he therefore be more likely to be able to afford the rent? Does one have very few credit cards and money in the bank?

If everything appears to be fairly equal among all your best applicants, then there is one final, very simple way to choose among them. Call the one who contacted you first. Introduce yourself and say something like, "I'm happy to tell you that everything on your application to rent form me has been approved. If you'll meet with me at noon tomorrow we can sign the papers."

As we mentioned earlier, there is always the possibility that your first-choice tenant has applied elsewhere and will decide not to rent from you. If that's the case, simply call the second person who contacted you; if necessary, go on to the third. But never go so far down your list that you end up renting to marginal applicants or those you've previously eliminated for serious problems. It's better to leave your house vacant for a few more days than to end up with bad renters.

8.13 KEY 10: FINALIZING THE RENTAL

When you meet with your new tenants to formally award them your rental, you should bring several things with you. You will need two copies of your Move-In Ready Checklist, two copies of your Tenant Policies, two copies of your Rental Agreement, receipt forms, carbon paper, two pens (in case one gives out on you), a clipboard, and a full set of keys to the house that you can give to the new tenants.

You must also ask the tenants to bring something. If they are planning to move in right away, they should bring cash, a certified check, or a money order for the entire first month's rent and all deposits--for last month's rent, security, cleaning, pets, or whatever you have decided to charge. If they will not be moving in for a few days, you may accept a personal check from them, but don't give them the keys until their check has cleared the bank. As an extra precaution, you can also write on the signed Rental Agreement, "This agreement not in effect until tenant's check # __in the amount of $__, dated ___ , 19_, clears landlord's bank. In the event check does not clear, this agreement is canceled."

8.13-1 <u>Be Sure You Get Everything That's Coming to You</u>

If the tenants plan to move in on some date other than the first of the month (or the beginning of the week, if you charge weekly rent), you will need to make some adjustment so that the tenants don't pay for a period when they don't have access to your rental. This is called a proration and is very easy to do. Simply divide the amount of the rent by the number of days in the rental period (the month or the week) to arrive at a daily rent rate. Then charge rent only for the days the tenant is actually renting the property during that time period.

However, prorations are better done during the second month of tenancy. When people first move in, you should get an entire first month's rent. The you can prorate their second month's rent to cover the amount of time they were actually in possession of your property during the first month. Why? When people first move in, you want to be sure that they are able to afford your rental and deposits. You also want to reinforce the fact that you are in control and that you expect them to abide by your rules. Let them know that you expect to receive full value for the service you are providing and that your policies aren't open to negotiation.

Establish right from the start that all tenants must pay full rent on the first of the month. This simplifies your rent collection and record keeping chores, since you don't have to remember a different due date for every property.

8.13-2 <u>One Reasonable Exception For Deposits</u>

As mentioned in Part A of Creative Management, there may be times when you want to make exceptions to your deposit policy. When you do, it will be because it is *your* choice, and you should make this clear by suggesting it to the tenants yourself.

Don Gibson, an investor and lecturer who owns a great many inner-city rentals, outlines situations where this might come up. Don rents mainly to people who are on welfare and to older people whose income is derived from small pensions and Social Security payments. He finds that these people often make very good tenants, but they simply don't have the resources to pay large deposits in a lump sum. In those cases, he allows tenants to pay their deposits in four monthly installments during the first four months of their tenancy. He makes out a separate agreement and receipt form, which says something like this:

> Deposit in the amount of $ __ for the property at (address) will be paid in four monthly installment, in the amount of $ __each. The first such installment shall be paid on (date the tenant signs the agreement), and each of the three following installments shall be paid on the first day of the three months following this date. Failure to make any such installment payment within ten days of the date it is due shall be considered a breach of the Rental Agreement between tenant and landlord, and shall be grounds for eviction.

Below this include lines where you can record the date and amount of each installment, and spaces for all parties to sign. You and the tenant should each have a copy of this agreement, and you should initial the tenant's copy when each installment is paid. When the full deposit has been paid, mark both copies "Paid in full." Give the tenant one and keep the other in your file for that property.

8.13-3 Before Taking Their Money

Before you collect any rents or deposits, go through these steps with your new renters:

M 1. Establish the condition of the property

Take two blank copies of your Move-In Ready Checklist, put a piece of carbon paper between them, and clip them to your clipboard. Then inspect the property with your applicants. Go through every room and around the outside of the house, marking the condition of everything. Make sure that everyone is in agreement about the state of repair and cleanliness of everything, both inside and out. When you've finished this inspection tour, sign your name at the bottom of the checklist, and have your new renters sign theirs.

M 2. Make your policies clear

Next, give the applicants a copy of your Tenant Policies. Explain to them that these written guidelines make clear the sort of behavior you expect from them as tenants. You'll probably have some ideas of your own on what these should be, but we've included a list of suggestions below to help you get started.

Read through the Tenant Policies with your applicants. Make sure they understand every point, and make sure that they are aware that they may be evicted from your house if they do not abide by your policies. When you are finished, take both copies, put carbon paper between them, and have the tenants sign the acknowledgment statement at the bottom. Keep the original in your files for later reference.

TENANT POLICIES (SAMPLE)

1. All rents must be paid no later than 5 p.m. on the first day of the month in order to qualify for the discount rent program. If rents are not paid by the fifth day of the month, you may be liable for legal action.

2. No guests may stay longer than fourteen days, and no animals may live on the premises without written permission from the owner or owner's representative.

3. If you have permission to keep a pet, no other animals may be added to or substituted for this pet without written permission from the owner or owner's representative.

4. Tenants will not erect permanent or semi-permanent structures on the property or make excavations on the property without written permission from the owner or owner's representative.

5. Any serious structural damage to the property must be reported to the owner or owner's representative within 24 hours of its occurrence. This includes fire, water damage, and plumbing failures.

6. Tenants will subscribe to the city trash removal service.

7. Tenants will keep the premises clean of trash and debris. All trash will be stored in closed metal or plastic containers which are no visible from the street until regularly scheduled trash pickup dates. Trash containers will be removed from the curb and returned to their proper place within 12 hours after scheduled trash pickups.

8. Tenants will not disturb other residents of the area. This includes:

* Guests will not be entertained in the front yard or driveway.
* Abandoned vehicles will not be stored on the property.
* Animals must be kept under control at all times.
* Musical instruments, televisions, stereos, and power tools will not be used at such times or in such manner as to disturb neighbors. No such items should be used where they can be heard outside the walls of your own residence earlier than 8 a.m. or later than 10 p.m.
* Parties or other gatherings must be confined to areas and noise levels which do not intrude on your neighbors' rights to peace and privacy.

9. Vehicles, either your own or your guests', may be parked only in your assigned parking areas. Vehicles may not be parked on the lawn.

10. Children's toys must be removed from the front of the house and stored out of sight at night.

We have read and understand the above policies and agree to abide by them. We understand that failure to follow any or all of the above guidelines may be grounds for eviction.

________________ Date ________
(Signed)

________________ Date ________
(Signed)

M 3. <u>Explain your Rental Agreement</u>

Finally, give the renters a copy of your Rental Agreement. Read through the entire Rental Agreement and explain any clauses your tenant does not understand before signing. You may wish to use the sample we've included, or you can make up one of your own. As you gain experience, you can tailor-make your own basic agreement to suit your specific needs and adapt it from time to time to each new situation.

The sample Rental Agreement we've included here can be used either as a lease or as a short-term agreement. You can adapt it to your needs by writing in the appropriate terms and have all parties to the agreement initial the change. You may prefer to use leases because of the security of having the tenants stay for a set period, especially during times when there are a lot of rentals available. On the other hand, a long-term lease may lock you into an undesirable arrangement; it is more difficult to get rid of bad tenants when they have a lease guaranteeing them the use of the property for a year. The decision is up to you. Consider the local market and your own preferences when you decide whether to give tenants a lease or a month-to-month tenancy.

On the lines for deposits, you'll find room to list all charges the tenants must pay when they rent your house. There is even room for a key deposit, which many landlords recommend. This should be an amount equal to what it would cost to have all the locks on the property changed. Refund the key deposit to the tenants only after they have returned all the keys you give them.

Under the "Rent" portion of the agreement, you will notice a paragraph that describes the discount rent policy. This is a simple technique used to motivate tenants to pay promptly. The amount of the discount is up to you, but it should be enough to mean something to the tenants. If rents for properties like yours are in the range of $250 and $300 a month, a discount of $20 may be generous enough to encourage your tenants to pay you by the first of the month. If, however, you own property in an area where rents run $800 a month or more you'll probably have to reduce the rent by $50 or even more to convince renters that they're getting a real bargain when they pay on time.

Discount rents are used as a form of motivation by many experts. We recommend that you use the discount rent policy to encourage tenants themselves to take care of all minor repairs to your property. A policy like this can save you the aggravation of being called frequently to make simple repairs the tenants ought to be able to handle themselves. Some managers suggest that you insert a sentence under "Maintenance, Repairs or Alterations" that states something like this:

> Tenant agrees to be responsible for all repairs and maintenance for which the cost is less than $50. If Tenant contacts Owner to request such repairs or maintenance be made by Owner, Tenant forfeits discount rent for that month and will pay the full rental amount on the following month's rent payment.

M 4. Get All Signatures

Once your applicants understand your Rental Agreement, have all adults who will be living in the house sign the agreement. You don't want to be left in an undefined situation if only one person signs and then later moves out, leaving in your house a spouse or roommate who never signed your agreement. Make sure everyone understands that all adults living in your property are equally responsible for paying your rent and abiding by your rules. If one leaves, those who are left will have to take care of the rent and maintenance without that person's contribution.

After everyone signs, have the tenants pay you the rent and deposits. Give them a receipt and their signed copies of the Move-In Ready Checklist, Tenant Policies, and Rental Agreement. You keep the originals. If they have paid you in cash, by money order, or by other certified funds, give them their set of keys; if they have given you a check, tell them you will let them pick up the keys after their check has cleared your bank. Be firm about this. Remember, it is easier to keep them from moving in than it would be to get them out again if their check isn't good.

Once you've turned over the keys, pat yourself on the back; you're now an official landlord!

8.14 KEY 11: YOU ARE RUNNING A BUSINESS

Rickie F. had a hard time keeping records. The discipline of record keeping was boring to her. "I got into real estate to become free, not to shackle myself with logs and ledgers," she said. Unfortunately, she didn't realize that the road to financial independence is paved with hard work.

Because of her attitude, when she had income from her rental, she simply put it in her regular checkbook. When she had expenses to pay, she simply wrote a check from that same checkbook. But she failed to note where the income originated; and she didn't indicate what the expenditures were for.

After a scant three months, she could tell that she had a serious negative cash flow problem on her hands--but did it come from the rental property or from her life-style itself? She had no idea. Only when she changed her approach to record keeping (finally) did she get a grasp on where her money was. And only then was she able to make the changes necessary to correct the cash flow problem.

Landlord (or landlady) isn't merely a word used to describe a person who owns a house that someone else lives in. It's also the job title of an independent business person. As the owner of your own business, you have the right to set your own policies and hours, the opportunity to see a small initial investment grow into a large fortune, and the privilege of enjoying your profits in any way you please.

Don't forget, though, that the quickest way to lose your business is to handle it poorly. Mismanagement can set you on the road to the poorhouse faster than you can say, "Incomplete paperwork and poor tenant relations." The following business practices will help you stay on top of things.

8.14-1 <u>Keep Careful Records</u>

Let's tackle the paperwork first. According to the Small Business Administration, 80 percent of business failures are due to poor record keeping. To those lucky people who were born with the souls of accountants, neglecting your paperwork probably sounds like the result of sloppy habits, loose morals, and blind stupidity. But to the rest of us, it's a very real problem, and one that needs a quick solution.

Writing down numbers is fun when you're adding up your profits. But in order to have profits to add up, you must keep careful track of what's going on in every facet of your business. When you own rental homes, you need to know who has paid rent and who hasn't, what payments are due on your property and when, which property is vacant, which tenants have given notice, which tenants are due for a rent raise, whose lease option is about to expire, which house is due for a paint job, and whether you owe money to any workers or suppliers.

That sounds like a lot to keep track of. It is, especially if you own dozens of properties. That's why you must begin at the beginning, when you first start investing, to set up a simple, easily updated record system. Form the habit of recording everything for your first house or apartment; add each new purchase to the record system immediately. That way, you'll always know what's going on in your business.

How Important is this? You may think that if you own only one rental, it will be easy to keep track of everything in your head, or that you can throw all your receipts and notes into a shoe box and let your accountant straighten it out at tax time. That may be true if you rent your property to the first applicant and everything goes smoothly all year.

But what if you rent to someone in November who moves out the following July, and you then show the house to several people, one of whom rents it sometime in August? You'll probably need something to remind you if the house was vacant for two weeks or three, how much paint you bought in July, and what your advertising costs were. Did the handyman's charge for the broken window come out of the previous tenant's deposit, or did you pay if yourself? Did you get your temporary deposit back for the short time you had the electricity in your name so you could show the house at night? How much mileage are you entitled to for trips you made connected with your real estate business?

In addition, as mentioned in Part A of Creative Management, a time may come when you need to prove that you didn't discriminate illegally when you rejected an applicant. Or someone who applied to rent one of your houses may someday apply to you again. Why was it the Joneses didn't move into your house three years ago?

The first time you rent out a house, the situation may be so new to you that you'll think details like this will stay in your mind forever. You'll be surprised, though, at how quickly you'll forget even the names of former tenants, let alone people who just looked at your property buy didn't rent. Worse yet is when you can't recall which property has a long-term note coming due, and you need to decide whether to sell or refinance. If you do know which property it is, do you have the facts and figures that will tell you which course would be more profitable? The more houses you have, the harder it gets to keep all the details straight.

8.14-2 What System Do You Really Need?

There are a lot of good property management systems on the market that will help you keep track of all pertinent facts. You can even find some excellent programs you can use on a computer. It's not necessary in the beginning to invest several hundred dollars in a management system, however. You'll probably experiment and find the system that's most comfortable for you as you gain experience. To start, you can set up a simple but perfectly adequate system using a few file folders, a cardboard box or small filing cabinet, a few ledger sheets, a checkbook, and a pocket-sized notebook. You can pick up most of these things for a few dollars at any office supply store.

You'll need a separate file folder for each property. Put all the paperwork for that property into the folder. You may prefer to keep legal papers, such as the original of the deed and any notes you've signed on that house, in a safety deposit box or at your attorney's office. But you should keep copies of the mortgage and any other notes in your folder. Include the payment book, and receipts for any expenses against that property (such as advertising costs and repair bills), and the papers that relate to the current tenants. No matter what, you *must* put all these papers into their proper files as soon as you receive them.

When you come back from renting your house, you will have your copies of the forms you used during the initial telephone interview, the tenant's application (along with the notes you made while checking it out), the Move-In Ready Checklist signed by the tenants, and your copy of the signed Rental Agreement. Staple them together and put them into the folder for that property.

You will need a separate folder for unused copies of each of the forms you use, a folder for rejected tenants, a folder for tenants who applied and were approved but then decided not to rent the house after all, and, eventually, a file for former tenants. It's also a good idea to start a file for ads you have used and ads written by others that you've seen and liked.

For your first house, you'll probably set up fewer than ten files, and each one will have only a few items in it (or sometimes none at all). All your files can probably be kept in one filing cabinet drawer or a small box. Later on, of course, depending on how much property you buy, you may find that just one set of folders, such as those for each house, takes up an entire drawer in a full-sized filing cabinet.

8.14-3 Ledgers Keep Track of Your Money

The ledger sheets can be loose, individual pages or can be bound into a book, depending on your preference. Some landlords like to keep the ledger sheet in the property folder, while others keep their ledger as a separate book. If you keep the ledgers in a book, set aside a full page for each property.

Head the ledger sheet with the address of the property, and add the unit number if you have an apartment building. (Naturally, if you own apartments, you will have a separate ledger sheet for each unit, as well as one for the entire building.) At the top of the ledger sheet write down any important information, such as "Interest-only note expires 8/12/91" or "Lease-option expires 3/17/91." Use red ink to make sure these notes catch your eye every time you look at the record.

Then use the ledger sheet to record income and expenses for that rental. If you cannot do this every day, do it at least once a month, no later than the third day of the month. You will find that with discipline, it soon becomes habit to record your rental income, mortgage payments, and expenses. Remind yourself that the only way to know how well you're doing, and the only way you can increase your wealth, is to keep track of it every single month.

When you record the first income from a new tenant, don't forget to note down any and all deposits, including any option consideration. Since the deposit is not considered income to you unless you keep it after the tenant moves out, don't record it in the income column. Do record it on your ledger, though, so you don't overlook it when a tenant gives notice or exercises an option.

Your checkbook is also a record. Some investors keep a separate checkbook for each property, but that could become cumbersome; it's much simpler in most cases to have one account for all your properties. Since you are running a business, this account can be in your business name; if you haven't created a separate business name, of course, you can simply open a separate account under your own name. Use your business account to deposit your rents and pay the expenses for all your investment real estate, but do not use it for your personal real estate, such as your home.

If it's necessary to occasionally transfer funds into this account from another account, always make a notation in your deposit record of where the money came from. For instance, you might have a deposit of $20,000 with the notation, "Personal loan from Uncle Stephen Alsop," or a $300 deposit from "personal savings," or $200 from "tenant security deposit, J. Doe, 123 Main."

You'll notice that we mentioned a transfer of funds from a tenant security deposit. Some areas require landlords to hold tenant deposits in a separate savings account until the tenant moves and all charges are settled. In other places, a property owner can simply put that money into a business account and use it for any purpose, as long as all monies due to a tenant are repaid within a specified number of days before deposits must be settled.

Many banks and savings and loans now offer checkbooks that make carbon copies of every check you write. These are very handy if you don't have time to note every expense in the ledger on a daily basis. You can simply write the necessary checks and then transfer them to your ledger when you do your monthly accounts. Make a notation regarding the transaction on the line that says "Memo" (usually at the lower left hand corner of the check), so that you will remember the transaction when you make your permanent record. Three checks to Johnson's Paint in one month may be confusing unless they are identified by the property addresses each order applies to.

As time goes on, of course, you will probably buy such items as paint in large lots and use it on several properties over the course of a year. In the beginning, though, you need to itemize expenses and apply them directly to individual properties. This helps you learn where your money is going and what kind of expenses you incur for each of your rentals. With experience, you will learn to recognize what charges are normal and when your spending is getting out of line.

8.14-4 Use Your Notebook Every Day

The final item you will need is a pocket-sized notebook to help you keep track of daily details such as mileage or auto expenses, chores that need to be done, and appointments to keep. Some investors use one car solely for their investment business, which makes this form of record keeping somewhat simpler. Most of us, though, start out by using the family car or truck for everything. That makes a daily record of business expenses doubly important at tax time.

Every time you use your car to go anywhere related to your real estate investments, note the date, the mileage on your speedometer when you start, any other driving expenses, and the ending mileage. Make a note of why you took the trip and what you did. An example would be, "Oct. 23. Start for home, 52,811. Money S&L 52,817. 999 Maple, 52,822. 111 Oak, 52,827. Post office, 52,830. Bank, 52,831. Home, 52,833." Under that you might note, "Turnpike toll, 75 cents. Malona Bridge toll, 40 cents. Postage, 22 cents. Parking, Money S&L, 35 cents." Your record of the day's business might read, "Money S&L, discussed loan on 555 Parker. Need financial statement. Visited tenants at 999 Maple, inspected property, all in order. Showed 111 Oak to Smiths and Bakers. Mailed payment and deposited rent on 999 Maple."

As you can see, this daily record can also be used to record small expenses for which you might not receive a receipt. If you make copies of a document, pay a parking meter, or buy your real estate agent a cup of coffee from a vending machine, note all these items and use them as deductions on your taxes. It may sound petty, but when tax time rolls around, you'd be surprised how much these small daily expenditures can add up. You simply need some sort of written record to back you up.

Writing down these daily transactions can help you in other ways, too. Periodically sit down and review where you go, what you do, and how much it costs you. Have you been driving to another town to show property, then coming back for a meeting with your broker, going back to show the property again, then using the copy machine at the drug store, driving ten miles in another direction to meet with a loan officer, then going back to your vacancy yet again? Maybe there's a more efficient way to use your time. If you find a steadily increasing need to visit your local copy center, perhaps it's time to invest in your own copy machine. When the time you spend inspecting and cleaning up properties could be better spent finding and negotiating new purchases, you should consider hiring a handyman or an assistant. If you're spending most of your time dealing with tenants, it may be time to turn to a professional property management service. But be careful not to buy nor hire prematurely.

8.15 KEY 12: TENANT RELATIONS

When Troy V. began his investment program, he found it nearly impossible to separate himself from the troubles of his tenants--and troubles were something they had continually. One month the Robey's came to him with a real problem: Mrs. Robey's mother had passed away and had had no insurance. The Robey's had to pay the huge costs of funeral, casket, plot, and burial out of their limited income. Could they miss their rental payment for the month and make it up the following month? Troy said they could--but he never saw the money.

Another month the Mehta family approached him with another problem: Mr. Mehta had been temporarily laid off. Could they be just ten days late with their rent? Troy agreed--but they were twenty-five days late, which threw their finances so out of whack that they were nearly a month late with their rent for four months running.

When the Toccalinos asked for a loan of $100 for a family emergency, Troy was so soft-hearted that he couldn't say no. They are paying it back at the rate of $10 per month, but Troy can ill afford to pretend he's a bank.

When Mrs. Dall's brother lost his job, she asked Troy if her brother and his family could temporarily move in with her and her family. Troy agreed. "But only for a couple of weeks," Troy said. Mrs. Dall was very grateful--but her brother stayed for nine weeks, rent free, putting a lot of unnecessary wear and tear on the rental unit.

Slowly but surely Troy learned his lesson. As he tallied up his income and outgo for that year, he saw that his generosity was quickly putting him into the poorhouse. And he realized that if he didn't start acting like a bona-fide businessman, he would lose everything he had worked so hard for.

Once you've accepted tenants, the papers have been signed, you've received the first month's rent and deposits, and they've moved in, your job isn't over. You've just begun! For better or for worse, you and your tenants have entered into a long-term relationship. Whether it will be better or worse is largely up to you.

In dealing with tenants, the best rule is to be firm but fair. Many first-time landlords are so happy to have real live tenants that they are inclined to go a little overboard. Don't feel bad if your instinct tells you to be lenient with your first tenants. Just remember that this is one time you can't afford to follow your naturally friendly tendencies. On the other hand, a few property owners are apt to be overbearing and suspicious with their first renters. This is also understandable--after all, you've handed over an important asset worth many thousands of dollars to comparative strangers, and you're worried about whether they're going to take good care of your property.

You don't want to be downright nasty to new tenants. This can backfire in a hurry--either by driving people away or by creating an adversary relationship right from the beginning. Regardless of how you treat them, some tenants see any landlord as a natural enemy no matter what. If you make it easy for them to hate you, they may convince themselves that they're justified in taking advantage of you in any way possible.

The secret of to being a successful landlord is similar to the secret of being a good schoolteacher. Establish that you have the upper hand in the beginning; later, you can relax and be more friendly. Never cross over into the area where you're so friendly that your tenants lose respect for you.

8.15-1 Your Tenant Is Not Your Pal

Avoid becoming social friends with your tenants. Regardless of what you've seen on old *I Love Lucy* shows, that sort of relationship rarely works. If you play cards or go bowling with your renters, your tenant friends are apt to expect you to do them favors. Letting the rent slide "just this once" can get to be a regular habit. Requests for extra repairs, unnecessary paint jobs, or special amenities (such as new carpet or drapes) are likely to crop up.

If you say yes to these friendly favors, you can put your business at risk. On the other hand, if you say no, you may alienate your friends. You know the choice you have to make, but it's a lot simpler if you don't put yourself in this position to begin with.

You'll also avoid the unpleasant consequences that can occur when such a friendship goes off the rails, whether for personal or business reason. A dispute over a golf score, a political campaign, or a raised rent can all lead to quarrels, and the more friendly you've been in the past, the more bitter the breakup of your friendship can be. When the person you're arguing with is living in your property, the consequences can be especially unpleasant. Your tenant may decide to get even or "show you" by withholding rent, forcing you to go to court with an eviction procedure, or trashing your house and then disappearing in the middle of the night.

8.15-2 Keep Romance Out Of It

One thing is for sure: love and landlording don't mix. The advice about your social life goes triple for romantic entanglements. It doesn't matter if one of your tenants is the best thing you've ever seen off a movie screen: carrying on with a tenant can be the quickest route to landlord's lament.

If either or both of you are married, you already understand that a romance is off-limits. The moral considerations are up to you, of course, but you have to realize that scandal and divorce are bad for business. If you get an unsavory reputation, some of your tenants will become suspicious of you, especially those who think you might have an eye on their spouses. Unexpected vacancies will crop up. When word gets around, some people won't even apply to rent your property. And your own spouse could initiate a divorce that leaves you wondering how you could have been so foolish as to throw away your whole life so cheaply.

What if both you and your tenant are single? It's still a dangerous game. In the first flush of passion, you may offer the loved one all sorts of valuable gifts, including free rent, unlimited use of your handyman, new appliances, and a free redecorating job. If the romance cools, what does that leave you? A messy financial problem to complicate your emotional upheaval, that's what.

If your ex-love moves out, you have only a vacancy to cope with. It's what may happen before you reach the vacancy stage that can be dangerous. You could find yourself with a tenant who won't pay rent for months and who refuses to move--either in hopes that the romance will revive, or as a way of getting even for a broken heart.

If it was a bitter breakup, your property could be damaged. An angry former sweetheart might very well decide to get back at you by vandalizing your rental. Unhappy lovers have splashed paint on walls, broken mirrors and windows, pulled fixtures from ceilings, slashed drapes, and poured chemicals on carpets. One even burned out an oven.

8.16 KEY 13: THE RESPONSIBILITY FOR PROFITS IS ALL YOURS

Maintaining the proper tenant relationship is more involved than keeping a firm, friendly, but nonsocial attitude. In all your dealings, remember that your primary motive as an investor is to collect current income from your rental while increasing its future potential. This future potential must be in the form of higher rents in years to come and increased market value when you decide to refinance or sell your property.

Obviously, natural market forces will take care of some increase in value. If you have followed investment guidelines and used good judgment, your property will continue to appreciate--but *only* if it is kept in good condition. If you allow your investment to deteriorate, it won't appreciate at the same rate as similar nearby properties--and it could even depreciate.

Morris A. owned a six-plex in a quiet Texas town near Dallas. It gave him a small positive cash flow, which he used to help pay old debts from a business gone sour. But the more he kept abreast of his debt obligations, the more he let the six-plex go. Instead of putting any money back into the property for maintenance and repairs, he milked the six-plex dry to feed his other needs. When a tenant notified him of a building problem, he ignored them or put them off. And he was so busy with other concerns that he almost never inspected the property; he rarely even drove by.

Gradually the quality of the building diminished, then the quality of his tenants went down. And when he finally found himself in a position where he had to sell, he discovered to his horror that the property had depreciated in value, rather than growing. He ended up taking a heartbreaking loss, simply because he had failed to keep the property nice from month to month and year to year.

Repairs and maintenance must be an ongoing priority and will be one of your primary responsibilities for as long as you own the property. You don't have to personally do each and every repair job. But you do have to see to it that someone does required repairs promptly and well; if you don't, minor maintenance chores will mushroom into major rehabilitation projects.

8.16-1 <u>You Can Share Your Responsibility</u>

Here's where your relationship with your tenants becomes important. As stated in your Rental Agreement, tenants are responsible for repairing all damage caused by them, their children, and their guests. If any of these people break a window, pull the towel racks off the bathroom wall or back a car into the garage door and crack it, they must get it fixed or pay to have someone else fix it.

Furthermore, you must require that the work be done within a reasonable length of time and in a professional manner. How can you guarantee that? Make all work subject to your inspection and approval. Another option is to personally hire someone to make repairs, and then bill the cost of repairs to the tenants.

You will also want to take care of normal wear and tear before it gets out of hand. To do this, you must know when problems arise that are your responsibility. It's essential that you set up a good information system. Your tenants will have to be part of this system, and you will need to either take a regular personal role in it or delegate some of your information duties to someone else. Whichever method you choose, you must be the one responsible for seeing that this system exists and that it works.

8.16-2 <u>Be Receptive to All Information</u>

Make it easy for your tenants to notify you when they have a problem. You don't need to be constantly available, but your tenants must be able to leave messages for you. A telephone answering machine can be an invaluable aid in you business; it enables you to screen messages and decide whether a situation is an emergency that demands your immediate attention or whether it can wait until a more convenient time.

When your tenants do notify you of problems, don't ignore them. Let them know that you are paying attention to them and to the condition of your property. Depending on the type and extent of the problem, this may mean no more than a phone call the next day to remind tenants that the problem is their responsibility and to suggest a business or workman that might help them. Or it could mean an immediate visit to your rental to personally inspect the damage. The important point is that tenants know you keep control of your business at all times.

When you do respond to tenant complaints, don't lose your temper. It's sometimes difficult to be objective about damage or expensive repairs to your property, but try to remember that most people aren't deliberately destructive. If the damage was the result of accident or carelessness on the part of your tenants, they are responsible for getting it fixed. If it wasn't their fault, there's nothing they could have don't to prevent it. Either way, taking out your anger or disappointment on them won't solve anything. Your priority should be to identify the problem and make arrangements to correct it, not to assign blame or vent your emotions on your tenants. After all, you don't want to make them so afraid of how you'll react that they hesitate to inform you when something else at your property needs to be fixed.

8.16-3 Regular Inspections Are a Must

Your next step in your information system is a program of regular inspection. One easy way to accomplish that is to simply collect the monthly rents in person. Let your tenants know that when you collect the rent, you will also make a brief walk-through inspection of their home. This should motivate them to have the premises in good condition for your visit, and at the same time give you an opportunity to see if anything has come up that demands your attention.

If you see something the tenants should take care of, mention it to them then, and make a note to follow up on it later. Keep this note in the property file for that rental so that you won't forget on your next visit to verify that the problem has been corrected.

Monthly rent collection and inspection is also a good way to encourage your tenants to pay their rent on time. If you have impressed them with the fact that you're a very busy person, but that you make a special point of setting aside the first day of the month to collect rents and inspect your properties, they will make an effort to have the money ready and waiting for you when you arrive. What happens if the tenant doesn't have the rent on the day of your visit? Without losing your temper, explain to the tenants that they have forfeited their discount for that month and that you expect the money to be delivered to you no later than the fifth of the month. Then proceed with your inspection. Some landlords at this point become extremely hard to please. They point out every minor flaw they can find--the tenants' housekeeping, the way the children keep their rooms, or the fact that there are dandelions in the lawn. They may not say anything directly, but they leave the unmistakable impression that when the rent isn't paid on time, they become very hard to deal with. You may not be comfortable with such an approach, but do take care that your tenants don't mistake you for a patsy.

As your business grows and you acquire more properties, you will probably need to hire an assistant to take over this monthly rent collection and inspection. Or you may prefer to have your tenants mail their rent or arrange for an automatic deposit into your bank account.

8.16-4 <u>You Can't Delegate All Your Duties</u>

Even if no one collects the rents personally, someone should still see your property every month. Once you hire a regular handyman, have him visit each property, ask if there is anything that needs to be taken care of, and take an independent look around. He can write any comments about the unit in a daily log book and report them to you later.

Even though you have employees taking care of these details for you, never forget that these are *your* properties and that you are ultimately responsible. You should still make a personal tour of every rental you own at least once each year, in order to be sure that each is being maintained to your standards. If you use a yearly lease, you could visit when the lease is to be renewed. Or you could personally deliver the notices of the annual rent increase and take the opportunity to inspect the property then.

As you initiate this system, you may find that some tenants don't make repairs they're responsible for due to a lack of time, money, or knowledge. If you find that maintenance has been neglected for two consecutive months, ask what the problem is and suggest a solution. If you find--or suspect--that the tenant can't afford the charges for labor or materials, offer to pay these charges and allow the tenant to pay you back in monthly installments that will be added to the rent. Tell him that if the work isn't done by the next monthly inspection, you will hire someone to do the work and bill it to the tenant.

If the problem is a lack of tools, simply rent them some of yours. Many landlords keep a supply of basic tools as well as a couple of extra lawn mowers and vacuum cleaners that they rent out to tenants who need them. You can often pick up inexpensive items like this at yard sales or flea markets--or store your old model instead of getting rid of it when you buy a new one for yourself.

8.17 KEY 14: YOUR TENANTS HAVE RESPONSIBILITIES, TOO

Your basic responsibility is to supply decent, affordable housing and keep it in good repair. Your tenants also have a basic responsibility: to pay the rent on time, with no excuses and no requests for extensions. Don't be shy about reminding them of this. You've worked long and hard for that money, and you deserve it.

After Troy V. discovered how important it was to run his business like a business, he turned his approach around completely. It wasn't easy, but he found that his tenants were generally able to adapt to a landlord who required prompt rent payments. Those who were not able to adapt moved away and were replaced by people who were quickly taught what to expect.

Not that Troy became a grouch, never smiling, never caring. He still cared deeply. But he knew that his bills would come due every month, just as the tenant's bills did, and that if he didn't pay he would lose his properties.

He came to realize that he was performing an important service to let his tenants stay in his rentals. They paid him for that service by giving him the rent every month. But his business could be no different from that of any other: if the payment did not come, the service had to be discontinued.

When a tenant tells a hard-luck story about unexpected expenses, it can be difficult to tell them you won't wait a week or two for the rent. However, you have an agreement with your tenants. You agreed to supply them with a place to live, and they agreed to pay you rent on the first of the month. You don't impose on that agreement by asking them to let your brother-in-law move in with them because he can't find an apartment, do you? Of course not. Why, then, should they impose on your agreement with their personal troubles?

Imagine calling the bank that holds the mortgage on your rental and explaining to a collections officer that your tenants had to spend the rent money on dental surgery. What do you suppose the banker will say? Probably not, "That's all right. We can wait for our payment until your tenants have the money."

When it comes to financial matters, you hold the same position with your tenants regarding their rent that your lender holds with you regarding the mortgage payments. That money is due when the agreement says it is due, and failure to pay as agreed automatically invokes penalties. This is exactly the sort of situation where you would have problems if you were on too friendly terms with your renters. You must impress on them that in the matter of rents, you cannot be swayed by emotional appeals. It is a business matter, and it will be handled in a businesslike manner.

8.17-1 Act Firmly to Head off Problems

First, say no if a tenant asks for an extension. The second step? Refuse to allow the tenant to pay the discount rent if the payment is even one day late; insist on receiving the full rent amount. If the tenant is buying the property from you on a lease-option, cancel the option immediately. If the rent isn't paid by the fifth of the month, serve the tenants with a Three-day Notice to Quit.

A Three-day Notice to Quit informs the tenants that they have three days to either pay the rent in full or move out--that is, to quit the premises. It will either motivate late payers to come up with the rent within three days, or it will be the first step in their eviction. We'll discuss eviction in more detail later in this unit, but for now, know that you should never accept any partial payment of the money owed to you if you think you may go through with an eviction. If you do accept any money, it will negate everything you have done up to that point, and you will have to start the eviction process over again the next time a payment is late.

8.17-2 You Deserve a Raise

In addition to receiving your rent on time, you should also get regular raises. Landlords with negative cash flows are usually keenly aware of this, but no owner should neglect this important aspect of management. After all, financial independence is the whole point of your personal investment program. Increased rents are what bring you profits, to be used either on additional investments or on a more enjoyable standard of living. You should raise your rents regularly, at least once a year.

Don't worry that your tenants will resent this increase. Their own wages increase, all other costs go up, and people expect that their rent will occasionally increase, too. You can make the increase less painful for them, however, if you give them a simple explanation with the increase notice; you might mention that taxes and insurance costs have gone up and that you need to charge a higher rent to cover all the costs of the property.

Many investors recommend that you increase rents in odd increments. If a house rents for $400 a month, for example, don't simply raise the rent by $40--that's obviously a 10 percent increase, and looks completely arbitrary. If you raise the rent by $43, though, the odd amount leaves the impression that you must have added up costs to arrive at such an uneven sum.

If you are carrying a negative cash flow, you'll naturally want to bring your rental income closer to the break-even figure. In deciding how much to increase rents, consider what local market rates are and what your tenants have been paying. Don't hit them with such a big increase that they decide to move out unless you want them to. It's best not to increase rents more that about $10 above what similar properties are being advertised for. If you increase rents more than that, your tenants will begin to think it might pay them to look for a new home.

Once you've chosen a figure, simply compose a letter for each of your tenants. Send or deliver it to them at least thirty days before the increase goes into effect. Your letter might say something like this:

January 25, 19___

Dear John and June Olsen:

Due to rising costs, including property taxes and insurance, I find that I must raise the rent you are paying on 123 Hometown Drive by $43 a month. This will bring your total monthly rent to $443.

This increase will go into effect on March first. If you have any questions or problems about this, please contact me at your earliest convenience.

Sincerely,
Lawrence Marcus

Either deliver these notices personally or send them by Certified Mail. As mentioned earlier, personal delivery gives you a perfect chance to look over the property and see how the tenants have been taking care of it.

Although it seems logical to schedule these rent increases for the tenants' one-year anniversary in your house and to continue to raise their rent every year in that month, that's not always the best idea. That means you have to keep track of when each tenant moved into each house. It's much more efficient for you to raise all the rents during the same month every year.

Which month? Well, there's a certain psychology to that. You want to raise rent during a month when people won't want to move--when they would rather pay a little more rent than pull up stakes. Most families with children prefer to do their moving during school vacations so that the children's education isn't disrupted. Very few people like to move during the worst weather months. Even fewer want to move at Christmas time, of course, but you don't want to be a complete Scrooge about it--"Merry Christmas, your rent is going up!" Many landlords prefer to wait until about the end of January. That gives the tenants the month of February to either decide to move or get used to paying more rent. The children still have about four months of school before the next long vacation, and the weather is usually at its worst point of the year.

Unless your increase is totally beyond the reach of your tenants, they'll usually adjust to the higher rent and decide to stay on. If your increase is reasonable and fair, there's no reason you shouldn't get the higher rent. If your tenants decide they can't afford it, it's time to rent the property to someone who *can* pay you what it's actually worth.

8.17-3 Beware of Rent Controls

If you have the misfortune of living in an area where rent controls prevail, you will need to comply with local regulations concerning raising rents. Well-meaning policy-makers often impose rent controls on property owners in the interest of protecting the well-being of renters in their jurisdictions (or voting districts). Usually just the opposite effect is brought about. Rent controls almost always result in depressing the income real estate market, which in turn lowers the quality of shelter available.

If your area is governed in this way, you will have to make the best of it. Be sure to sharpen your pencil when investing in real estate in such areas.

8.18 KEY 15: DON'T FORGET TO SAY THANK YOU

Oma L. likes people. She likes the tenants in her rental homes. And she especially likes them when they take good care of the rental and pay their rent on time!

Oma has worked out several creative ways to reward good tenants. At Christmas time she will send a basket of fruit or a box of candy with a card attached. "Thank you," the card will say, "for being such a good tenant! Rent on time, every time! Clean house! Attractive yard! Merry Christmas and a prosperous new year to you and your family!"

On every anniversary of the tenant's arrival, Oma does something nice for them. Often the nice gesture will directly improve the house, which upgrades its value and makes the tenants feel good at the same time. One year she will paint the interior. Another year she will buy new carpets, or clean the old ones. She will plant new trees or shrubs. On rare occasions, for long-term tenants, she will even knock off half the rental fee on the anniversary month.

Oma's tenant relations are terrific. And her rentals are looking better year after year!

When your tenants stay with you, pay their rent on time, and do their best to maintain your rental without causing you unnecessary problems, you have ideal renters. You want to keep these people, and they deserve a solid indication of your appreciation.

Like Oma L., many investors give tenants presents every year to mark their "anniversary" months. These can be gifts that please the tenants and that improve the rental at the same time. For instance, one expert gives his best tenants free use of the handyman for an entire day to do any chores or cleaning the tenants choose.

Look around the house and notice little things that need doing, and then use those things as a gift. For instance, you might have all the carpets and drapes cleaned for them, or install a new Formica top on the kitchen counters. One year your present might be a fresh paint job; another year, a new vanity cabinet in the bathroom.

Naturally, you'll have to give the tenants notice when you're going to do something like this to their home. A week or two ahead of time, sent them a little note worded something like this:

> Dear Charles and Rhonda Orvick,
>
> On October first it will be three years since you moved into your home at 999 Comfy Drive. You've been excellent tenants. To thank you for keeping the property up so well and always paying your rent promptly, I'd like to mark our third anniversary together by giving you your choice of a free carpet cleaning or painting your living room and kitchen. Please call me any time between 9 a.m. and 7 p.m. to tell me your choice and to arrange a convenient time for the work to be done.
>
> Sincerely,
> Lawrence Marcus

Giving the tenants a choice, when possible, increases their feeling that your house is truly their home, and that you take their wishes into consideration as much as you can. After all, they won't be too thrilled over having the carpets cleaned if they just spent the entire past weekend struggling with a rental steam cleaner to do the whole house themselves.

You can give tenants a certain amount of choice even when you've made a fairly firm decision on what your house needs and what you can afford. If the bathroom vanity needs replacing, for example, you can go to a local store and choose samples of the models you would be willing to buy within your price range. Then let your tenants go to the same store and pick from those you selected.

8.18-1 You Can Be a Nice Guy--Within Reason

Another way to keep your tenants happy is to be cooperative, as much as possible when they want to make a few changes around your house. Everyone likes to redecorate from time to time, so if your tenants tell you they'd like to repaint their walls, offer to pay for the paint--but let them know that the choice of colors is subject to your approval (you don't want anyone turning the living room into a purple grotto with orange trim).

If they want to landscape the backyard, lend them some garden tools and open a small account for them at a local garden supply store. You might tell them that they can charge $100 or $200 worth of seeds and plants and that you will pay, as long as you can see their plans and approve of the work they want to do. This way you can keep them from trying to turn the yard into a mid-western cactus garden that will die in the first frost, or from training ivy up the back of the house where it will damage the walls.

When your tenants do jobs like this, you get the benefit of their free labor on improvements that enhance the value of your property. There's a psychological benefit, too, when you cooperate with good tenants on projects that they want to do. They begin to feel that your rental is really their home when they can fix it up the way they like it. The more time and energy they invest in your property, and the closer it is to the way they want their home to be, the longer they will stay and the more effort they will put into maintaining it. And if you've helped them, they'll see you as a good, kind landlord who tries to keep the tenants happy.

When they think of you this way, tenants are much less likely to resent the rules you do enforce and the rent raises you ask for. There are two ways tenants react to a rent increase notice. The may say, "Darn that Linda, she can't spend a penny on this place! It's turning into a slum, and now she wants even more money for this dump. Maybe we should look for a better place." Or they may say, "Well, Linda's so nice, and she does a lot for us. I guess she wouldn't ask for more rent if she didn't really need it. Besides, I'd hate to move just when we've got the house so nice." It's up to you. Which reaction would you rather have?

8.19 KEY 16: HELP YOUR TENANTS LEAVE

The day will come when even your most stable tenants give you notice. You can expect an average family of renters to move every two to three years. This average will change where housing is hard to find and in some small towns where there are very few rentals, families often stay in the same house for years. Under normal circumstances, though, you should be prepared for vacancies in about one-third to one-half of your properties every year.

If you hate vacancies and can afford to charge lower-than-market rents, you can tilt the odds more in your favor, of course. When the average house rents for $500 a month and you're asking only $425 you give tenants a powerful incentive to stay with you. But why would you want to do this? If you bring your rents up closer to market level, the extra income will cover the cost of having someone else manage your property and handle the vacancies for you, and give you a better positive cash flow besides.

When tenants do give notice, make sure they do it in the right way. You must have a full month's written notice before they move out, not a casual initial phone call saying they might move out in a few weeks followed by a second call telling you that they're definitely leaving next week. The first time they bring up the subject of moving, remind them that if they are to receive a full deposit refund, they must give you definite notice, in writing, an entire month prior to the exact date they will vacate your house.

The subject of the last month's rent deposit will almost certainly come up at this point. The tenants are almost sure to say, "Well, our deposit included our last month's rent, so, since we're moving at the end of May, we've already paid our May rent."

No. They haven't. They have paid an amount equal to an extra month's rent as a security deposit. That's why so many landlords charge a deposit that's a different amount than a month's rent and why they call it something other than "last month's rent"--cleaning deposit for example.

Explain to the tenants that you expect to receive the regular rent payment for their last month. Tell them that after they have moved out and returned the keys, any money coming to them will be refunded in full, along with a written statement of any changes you deducted from their deposit.

8.19-1 Paperwork Makes Moving Easier

As soon as you receive the formal notice to move, give your tenants a copy of your Move-Out Checklist (a sample found on the next page). This will tell them what you expect them to do and in what condition they must leave the property in order to receive a full refund of all their deposits. Send them the Move-Out Checklist with a letter similar to this one:

> Dear ________:
>
> I have received your notice to vacate (address) by (date). In order to receive a refund of your full deposit, you must leave the property in as good a condition as you found it, aside from normal wear and

tear. The enclosed checklist will show you what is expected. I hope this will help you prepare for your move.

As soon as you return the keys, the house will be inspected. If any further work needs to be done, charges will be computed and deducted form your deposit. An itemized list will be sent to you, along with any refund you have coming, no later than ___ days after all keys have been returned.

You have been good tenants, and I wish you happiness in your new home.

Sincerely,

Lawrence Marcus

Local laws vary; you will have to check with your attorney on how many days you have before you must refund any remaining balance on a deposit. Some areas allow a full month, and others allow as few as seven days; you can usually expect to have at least two weeks.

As soon as your tenants notify you that the house is empty, make an appointment with them to go through the house together. Take your copy of the Move-out Checklist included below, together with the record you mad when the tenants moved in, and inspect to determine the current condition of the property.

MOVE-OUT CHECKLIST

WALLS, CEILINGS, BASEBOARDS, DOORS, AND DOOR FRAMES--To be cleaned of all dirt and other marks. Nails and hooks removed and all holes filled or patched with a material that matches the color of the surface.

Entrance ____ Kitchen ____ Living rm. ____ Dining rm. ____ Family rm. ____ Hall ____ Bdrm. #1 ____ Bdrm. #2 ____ Bdrm. #3 ____ Bath #1 ____ Bath #2 ____ Other ____

CLOSETS, CUPBOARDS, MEDICINE CABINETS--To be completely cleared of all items and wiped clean, including shelves. Sliding door tracks to be cleaned out and any debris remove.

Hall ____ Bdrm #1 ____ Bdrm #2 ____ Bdrm #3 ____ Linen ____

Bath #1 ____ Bath #2 ____ Kitchen ____

Garage ____

Basement ____ Other ____

BATHROOMS--Tubs, shower stalls, toilets, and washbowls to be free of any dirt, scum, or water rings. Shower doors, soap racks, and door tracks to be cleaned and free of debris. Mirrors wiped clean.

BATH #1: Tub or shower ____ Shower door ____ Toilet ____ Sink ____ Mirror_

BATH #2: Tub or shower ____ Shower door ____ Toilet ____ Sink ____ Mirror

KITCHEN--All drawers to be cleared of all items and wiped clean. All appliances to be clean, inside and out, and empty. Counters, work surfaces, and sink to be clean and clear of debris. Cupboard and drawer faces to be wiped clean.

Stove top ____ Stove burners ____ Oven ____

Broiler ____ Refrigerator ____ Dishwasher___ Drawers ____ Counters ____

Work Surfaces ____ Sink ____ Cupboard and drawer faces ____

WINDOWS--All windows, window sills, and window frames to be washed. Windows are to be left closed and locked. Screens or storm window, as appropriate, to be washed and placed on the correct windows.

Front door ____ Back door ____ Side door ____ Kitchen ____ Living rm. ____ Dining rm. ____ Family rm. ____ Bdrm. #1 ___

Bdrm. #2 ____ Bdrm. #3 ____ Bath #1 ____

Bath #2 ____ Garage ____ Basement ____

Other ____

LIGHT FIXTURES--All light fixtures to be clean and in place.

Front porch ____ Back porch ____ Entrance ____

Kitchen ____ Living rm. ____ Dining rm. ____ Family rm. ____ Hall ____ Bdrm. #1 ____ Bdrm. #2 ____

Bdrm. #3 ____ Bath #1____ Bath #2 ____ Garage ____ Basement ____ Other ____

FLOORS--Carpets to be steam cleaned, all spots removed. Linoleum floors to be stripped of wax and cleaned. Cement and wooden floors to be swept clean and hosed down or mopped, as appropriate.

Front porch ____ Back porch ____ Entrance ____ Kitchen ____ Living rm. ____ Dining rm. ____ Family rm. ____ Hall ____ Bdrm. #1 ____ Garage ____ Basement ____ Other ____

GENERAL--The premises, including the yard, must be free of trash, garbage, holes, or pet droppings. You will be charged for the removal of these and of any furniture, clothing, or other items left after you move out.

Be prepared for the fact that the walls will probably need painting, the carpets will most likely show signs of traffic, and the woodwork may be a little scuffed. These are unavoidable facts of life, and shouldn't count against your tenants unless there are obvious signs of negligence. Make notes of any work that you think should be charged to the tenants, and show them why by pointing out the difference between the condition of the house when they moved in and the way it is now. At the end of this inspection they should hand over all keys, including any copies they have had made.

If for some reason your tenants can't accompany you on this inspection, you should still make a written record of any items that need to be replaced or repaired at their cost. When they return the keys to you, give or send them a copy of this list.

When your departing tenants return their keys, be sure they have returned as many keys as you gave them. If they don't, keep their entire key deposit to pay for changing all the locks.

Even if your tenants return as many keys as you gave them, you should still change all the locks and it should be your first order of business. There is no way for you to know how many copies they might have given to friends or relatives. One landlady paying an evening visit to her newly vacated property interrupted an embarrassingly intimate scene: her former tenant's teenager had given a key to a boyfriend, who was now using the empty house to entertain his latest conquest!

8.19-2 Clean Vacant Houses

As soon as the house is empty and you have completed your inspection, take care of any necessary cleaning, painting, or repairs. Remember: the house or apartment is not ready to be shown to prospective tenants until it is ready for occupancy. Every day it stands empty costs you money in lost rents, so it is important to immediately get everything done and be ready to interview new applicants.

When you've taken care of any work that will be charged to the old tenants, immediately itemize the costs, deduct them from the deposits, and refund any balance remaining. If you can't get the work done in the time allowed by local law, make your best estimate and deduct that. Remember to allow a charge for your own labor if you're doing the work yourself. Charge the going rate for general handymen, or whatever you think is fair, but don't cheat yourself. Your time is worth money, and you deserve to be fairly paid for your efforts.

8.20 KEY 17: WHEN YOU INVITE TENANTS TO LEAVE

If you follow the screening procedures and management techniques outlined in both parts of Creative Management and couple them with your good judgment, you'll be able to greatly lower your risk of getting undesirable tenants. But just as the most perfect-looking apple might reveal a rotten spot after you bite into it, the most seemingly desirable tenants might have hidden flaws.

When your shiny apple of a tenant becomes rotten, what do you do? Most people immediately think of eviction, but there may be another solution. After all, eviction is a legal process that may drag out for months and involve costly and time-consuming legal action. Meanwhile, your rotten tenant is living in your property without paying rent, or is causing so much trouble that the neighbors are threatening to sue you for maintaining a public nuisance.

8.20-1 Talk Before You Act

Your first reaction to a tenant gone bad should always be attempt at reasonable problem-solving. Visit the tenant at the property and try to find out what the problem is. Remind the tenant that he signed a legal contract to pay the rent and abide by your rules and regulations, and ask why this isn't being done. Listen to what he says, and see whether you can come to an understanding. Just make sure the "understanding" doesn't involve you losing your rent or allowing the tenants to destroy your house.

When the problem is financial some managers recommend putting the problem right back in the tenant's lap. Look very concerned, express sorrow and sympathy, and then say something like, "Gee, that's terrible." If you don't pay the rent by Friday, I'm not going to be able to pay the bank. If we can't come up with that mortgage payment, they're likely to start a foreclosure action, and then we'll both lose the house. What do you think we ought to do?"

If the tenants can't come up with a solution, the next step is simply to get them out of the house. Serve them with a Three-day Notice to Quit as soon as the rent is five days past due. If they don't seem to be planning to move, try giving them some encouragement before you start formal eviction procedures. Explain that if you have to proceed with the eviction, it will go on their credit record and you won't be able to give them a reference for another rental. Tell them if they'll move right away, however, they can avoid these unpleasant consequences.

If your tenants refuse to move because they can't afford to, it might be cheaper in the long run for you to offer them some assistance. Landlording expert Leigh Robinson suggests you offer them $100 to move. Visit the tenants with a one hundred dollar bill and a pair of scissors. Cut the bill in two right before their eyes, give them half, and tell them they can have the other half when they vacate your property. Less dramatic, but equally effective, measures might include offering to store their possessions for them until they have a place to move to or offering to pay the price of a rental truck or trailer for them on moving day.

8.20-2 Control Your Temper

Whatever you do, don't allow your emotions to rule. It can be exasperating to have tenants who refuse to pay, who are trashing your property, or who are ruining your good relationship with their neighbors. But don't let your temper and frustration get the upper hand the way Sonny U's did.

Sonny, a farmer, inherited his parents' house in town. He divided it into apartments and rented the upper story to a woman who stopped paying rent after her second month in residence. This upper story could be reached only by an outside staircase. After five months of receiving no rent, Sonny drove his tractor into town and parked it in the alley behind the house. He waited until his non-paying tenant went out, and then he drove the tractor into her access stairway, totally destroying it. She couldn't get in and couldn't reach her clothes, food, or, as she later told the court, her checkbook. Sonny ended up paying a judgment for causing his tenant unnecessary inconvenience and mental anguish.

Don't let yourself be drawn into this sort of retaliation against tenants. Removing the doors from the tenants' house or apartment, changing their locks, removing their possessions while they are gone, shutting off their utilities, and threatening or causing bodily harm to them, their guests, or their pets are all illegal activities. Harassment or attacks of any sort from you will only make a bad situation worse. It can also cause the tenants to strike back, either at you or your property, and can lead to major losses.

If your peaceful efforts to remove your tenants don't work and/or drive you close to your breaking point, remove yourself from the situation. You don't have to suffer undue strain. After all, there are other things in your life besides this one unpleasant matter--even though, at the time, it's difficult to think of anything else.

You'll need to work closely with your attorney all through the eviction process, so let your attorney handle the unpleasant details. He or she is more detached and can be more objective than you can in this situation, and will represent you better than you can if you're under an emotional strain. Your attorney will be able to help you with such intimidating tactics as finding a sheriff, marshall or deputy who will serve the necessary papers in full uniform. Many peace officers earn a few extra dollars by performing such chores in their off-duty hours, and your lawyer will know who they are.

Remember, too, that once you start an eviction process, you can't accept any money from the tenants you're trying to get rid of. If they offer you as little as a dollar, and you take it, it can automatically cancel the notice you have already filed and you will have to start again from the beginning.

8.20-3 Prepare Yourself for Court Appearances

Occasionally, really bad tenants will refuse to move out until you take them to court and get a judge's eviction order. The courts are run by people, and regardless of how laws are written, the human factor affects every legal hearing. Unfortunately, some people regard landlords as greedy, heartless monsters who stop at nothing to take advantage of poor, defenseless renters who can't afford to own their own homes. To keep that kind of a perception from influencing your case, you must present yourself and your eviction in the best possible light. Here are four things you should keep in mind to make your case stronger.

M 1. Never lose your temper or become abusive toward your tenants in court. You want to be dignified and business like about this; don't give anyone reason for thinking that you are pursuing the eviction out of any personal grudge or prejudice. Your position must be firm but unemotional: You have a mortgage to pay. Your tenant signed a contract agreeing to pay a certain amount of rent. Your tenant's failure to live up to that agreement leaves you no option but to ask the tenant to leave so that you can rent the property to someone who *will* make regular payments. You simply cannot afford to let the tenant live in your house for free, no matter how personally sympathetic you feel toward him and his situation.

If the reason for the eviction is the tenant's failure to abide by the written rules of the tenancy, your approach must be much the same. The tenant knew the rules, agreed to follow them, and has not done so. The result has been unpleasant for the neighbors, damaging to your property, or a combination of the two. The tenant was warned, failed to change, and has left you no alternative but to ask for eviction.

M 2. Use some subtle courtroom psychology. You don't want to present yourself as a billionaire slum-lord riding roughshod over a pitiful, penniless renter. An eviction hearing is not the place to show up in a custom-tailored silk suit, handmade shoes, and your heaviest gold and diamond jewelry. If you do, you'll look like a stereotypical greedy landlord bleeding your tenants so you can pay for your personal yacht and Jamaican vacation hideaway. On the other hand, you can do yourself just as much damage by going too far in the other direction. Don't show up in court wearing greasy old work clothes and paint-splattered shoes with holes in the soles. Most people have enough respect for the courts to appear at their best when they're called before a judge--and most judges expect it.

Dress nicely, then, but not *too* nicely! You want to present yourself as an average person who is working a little harder than average to try to get ahead in the world--and one to whom a couple of months' lost rent could mean financial disaster.

M 3. Show respect for everyone involved in the hearing. If the tenant has a legal representative, don't be drawn into a heated argument with him. He's just doing his job of making the tenant's case look better--even if he makes outrageous accusations and distorts facts. Remain calm and answer factually, backing up your statements with your written records, and the truth of your position will become apparent.

M 4. The final and most important item to remember is that you must have solid evidence to support your case. Keeping good records will pay off for you if you ever have to take a tenant to court. Whenever you think you might be heading for a problem with a tenant, start collecting evidence in the property file for that rental. Make detailed notes regarding every aspect of your problem, including dates and places of discussions you've had with the tenants or their neighbors, and copies of any warning letters or legal documents you sent the tenant. Keep track of every excuse or promise the tenant gives you, and follow it up with a written confirmation of your understanding. Send the original to the tenant, and keep the copy on file. It doesn't have to be anything elaborate; you might use a note similar to this one:

> Dear Tim and Tina Baxter:
>
> After our conversation this morning, I was left with the understanding that Tim has been temporarily laid off from his job with Smith Machinery, but will be going back to work in two weeks. Meanwhile, you are trying to borrow some money from Tina's parents and expect to have the rent for me by the fifth of this month. I will expect payment no later than that date, and if you cannot make it, notify me immediately.
>
> Sincerely,
>
> Lawrence Marcus

With evidence like this, you will build the strongest possible case for your side. Once you've gone through the eviction hearing and gotten your tenant out, put it behind you. You may be awarded a judgment, but don't make collecting it the crusade of you life. The important thing now is to put your property back into rentable condition and find a good, stable tenant who will make regular payments before you lose any more money.

8.21 KEY 18: STOP MANAGING

Travis N. had twelve rental homes, two duplexes, a four-plex, and two six-plexes. He was a good manager, utilizing the techniques we've talked about in this unit, but the management of all those properties was running him ragged. He still maintained a full-time job, and he was still trying to expand his portfolio. But it seemed he never had time to do more than run in place. Rather than improve his situation--and rather than enjoy his life--he felt he was falling far short of his long-term goals.

A friend suggested that Travis hire a professional management firm to relieve him of some of the hassles, but Travis just did not want to let go. "No one knows these properties the way I do," he said. "No one can do it the way I can."

He may have been right, of course. But he was also right that he was not making any progress toward his broader goals. And he hated to get out of bed in the morning.

Finally he relaxed his hold on the management of his properties. He got several referrals for good management firms, interviewed officers of those firms, talked to a number of their customer, and signed on the one that seemed best.

The result has been exhilarating. "The monkey is off my back," he said. "I don't know how in the world I managed all those properties for so long." Now he has been able to quit his job and focus even more clearly on buying more excellent properties. He is clearly on the road to financial independence.

Odd as it may sound, the final step in managing your rental property successfully is to give up management. By the time you've handled several sets of tenants on your own, you'll be thoroughly familiar with what it takes to go through the entire process. The experience you'll get is an important part of the knowledge you'll use in judging whether someone else is doing a good job of managing your properties for you, and in understanding and helping that person when problems occur. But once you have the experience, doing your own management is simply a waste of time that can be better spent adding to your portfolio. As soon as you have the experience under your own belt, and as soon as your cash flow allows, hire a good management company to take some of the load off your back.

They will charge you for the service, of course--anywhere from 5% to 10% of the gross income. But if you have prepared your bottom line well, it will be a bargain--because it will liberate you from the tasks of management and leave you in a supervisory capacity.

After you've selected a management company, you still need to take care of certain details regarding your properties. Go over the monthly and yearly rental income and expense statements, and question any items you don't understand. Keep track of everything the management company does in your name. And don't forget to make regular inspections of your property, paying particular attention to the kinds of tenants the company is putting into your houses.

Aside from these few chores, you will instead be able to forget about management most of the time, and concentrate instead on your primary goal: finding and negotiating enough good property buys to make you independently wealthy. And that, after all, is why you are involved in rental real estate!

A NOTE ON EFFECTIVE MANAGEMENT

Investing in income real estate is a proven system. It works. It isn't some collection of questionable methods contrived by an intellectual who has never tried to put them to work. Many thousands of people have used investment real estate to realize their dreams of financial freedom.

That's what we want for you. And that's why we've included such comprehensive material on management. Because you'll never reach your financial goals, regardless of how many properties you buy, if you don't know how to manage them properly. Here are some key points to keep in mind:

M You need to do your homework. Find out everything you can about the neighborhood where your property is located. Make acquaintance with the close neighbors. They can become your allies later, and can provide you with important information you might need about your tenants.

M Do your homework, too, when it comes time to choose tenants. No matter how long your house or rental unit has been vacant, don't lunge at the first person who come along expressing interest. No matter how desperate you are to get your house rented, take the time to check the information on the application form your tenants fill out! It's much better to have your house vacant for another week than to rent to tenants who turn out to be a disaster.

M Remember that you are running a business. The methods of effective management might seem a little rough to you, but you're not purchasing and managing properties for the social aspect of it, are you? No. You're purchasing properties to make money. You need to choose tenants who will help you make money, and you need to deal with them in a way that will protect your investment. It's as simple as that.

M At the same time, you can manage in a win/win way. You'll win because tenants will pay you to maintain your real estate investment. The tenants will win because you're providing them with a home they can enjoy for a price they feel comfortable with. But when a tenant seeks to play a win/lose game with you, insist on your right to be a winner, too. If the tenant cannot play the game that way, it's time to deal him out.

8.22 HOW WELL HAVE YOU LEARNED FROM PART B?

The better you've learned the information and concepts in this unit, the more you will be able to apply them. Test your learning by answering the following questions. *Do not skip this step*--the best way to help the information stay in your head is to reprocess it through your fingertips! (NOTE: If you are uncertain of an answer, check back through this unit. Answers can be found in the preceding pages.)

1. Why is selecting good tenants such a crucial element in your investment program?

2. Two men with three children come to look at your rental. They explain that one of the men will rent the house, and that until he goes back to his wife, the second man will stay with the first man. Do you rent the house to the first man under these conditions? Why, or why not?

3. Two women and a child inspect your rental. They are nice, likable people with good jobs, and the child is very well-behaved. The women tell you that they consider themselves married to each other, and they will both sign your lease. Do you have any grounds to refuse them the house if they are your best applicants? Why, or why not?

4. It is the Friday night of Memorial Day weekend. Your house has been standing empty for three weeks, and your family wants to go on a camping trip over the holiday. A family offers you all cash for rent and deposits plus a $100 cash bonus if you will let them move in over the holiday weekend and check their application later. Do you let them move in? Why, or why not?

5. Why is it essential that you verify the information prospective tenants give you on their application forms?

6. You are verifying the information on an application. The renters' present landlady tells you they are excellent people who always pay their rent on time, keep their home beautifully clean, and have outstandingly nice children. Then you speak to their

former landlord, he tells you they were constantly behind on their rent, never cleaned the house, allowed their children to destroy the landscaping, and were finally evicted owing three months' rent. Which one do you believe? Why?

7. You have two families that check out perfectly. One is white, with two children; the husband is a garage mechanic, the wife is a part-time secretary taking night courses in bookkeeping, and both have held their jobs for four years. The other family is black, with one child; the husband is assistant manager at a local bank, and the wife is in her second year of law school. They have been in the area for sixteen months. Which applicants do you favor, and why?

8. In checking over an application, you consult your file of applicants you have turned down in the past. You find that these same people applied to you two years ago and that you rejected them because of poor credit and a weak job history. None of the information on their current application agrees with anything on their previous one. Do you continue checking them out? Why?

9. How can you make certain that new tenants understand exactly what's expected of them?

10. What are the main functions of the Move-In Ready Checklist?

11. What is the discount rent program, and how does it work?

12. Your best tenant phones with the news that he just got a good promotion at work, and he wants you to come to a big party to celebrate. What do you do? Explain you answer.

a. Accept, and ask how to dress.
b. Tell him curtly that you don't have time for such nonsense.
c. Congratulate him genuinely, and politely say that you're sorry, but you have other plans that night.

13. You are a married man; a gorgeous female tenant tells you she doesn't have the rent money, but offers to make it up to you

some other way. Which is the wisest response? Explain you answer.

a. Sit down and ask her what she has in mind.
b. Tell her you don't have time to discuss it now, but you'll come back when your schedule isn't so crowded.
c. Threaten to call the police and charge her with soliciting.
d. Tell her you must receive cash payment by the fifth of the month. Then tell your wife what happened, and ask her to collect from this tenant in the future.

14. How often should you or your representative inspect each of your properties?

15. You go to one of you houses and find the tenants have installed paneling in the living room. It looks good, but they didn't have your permission. What do you tell them? Explain your answer.

a. Nothing.
b. They must tear the paneling down and restore the wall to its original state.
c. Next time they do anything to the house, they must ask you first, and you might even pay for some of the materials.
d. You are going to serve them with an eviction notice for breaking the terms of your Rental Agreement.

16. Every day you accumulate small pieces of paper containing receipts, notes about properties, and lists of appointments. What is the best thing to do with these? Explain your answer.

a. Pile them on the dresser when you empty your pockets at night.
b. Leave them in the bottom of your briefcase or purse until you get around to sorting them out.
c. Sit down at the end of each day and transfer them to the appropriate file folder or ledger sheet.
d. Put them all into a folder labeled "Miscellaneous" and sort them out at the end of the month.

17. You send all your tenants notice of a rent increase, and most of them accept it quietly. However, one calls you and insists that an increase of $37 a month over the $340 she pays now is too much, and she can't afford it. What is your response?

18. How often should you consider making a rent increase?

19. What is a good way to increase the rent amount without making the increase seem arbitrary? When is the best time to raise the rent?

20. A very nice family has lived in one of your rentals for the past five years. In that time they have been late with their rent only twice, and both times paid before the fifth of the month. When you offer them new kitchen countertops to mark their fifth anniversary in your house, they say they would prefer that you install a swing set for their young children this year, and wait until next year for the countertops. Which would be the best solution? Explain your answer.

a. Tell them they must accept the countertops or nothing.
b. Give them the swing set.
c. Present them with a "Good Tenant's Bonus" in cash equal to the amount you would have paid for the countertops, and let them buy what they want.

21. What are some good ways to thank tenants for being good renters?

22. Your excellent tenants of four years move out and you refund all their deposits. Later, while painting the kitchen, your handyman discovers that the dishwasher has been broken for some time, and it looks as though the tenants were at fault. What can you do?

a. Contact the tenants and ask them to pay for fixing the dishwasher.
b. Call your insurance agent to see if your policy covers repairs to the dishwasher.
c. Ask your attorney to file a lawsuit against the former tenants.

d. Rewrite your Move-Out Inspection Checklist to remind you to look inside the appliances when tenants move.

23. Give three reasons why good record keeping is so important.

24. You have to go to court to testify against a tenant who stopped paying rent three months ago. What should you take with you?

25. What is the best way to handle a tenant who falls behind in paying rent?

26. You now own twenty properties and have plans to buy ten more this year. How much time should you put into property management? Explain your answer.

a. Whatever it takes.
b. Five hours a week, and anything you can't get done in that time will have to wait until next week.
c. Two hours a month to check the accounts from a property management firm.
d. None.

8.23 PUTTING PART B INTO PRACTICE

The information in this unit has given you a pretty comprehensive guide to managing properties. But book learning will take you only so far--you have to get out and practice what you've learned if you want to make the information truly work for you.

How can you "practice" the details of landlording if you don't actually own properties you need to manage? The answer is incredibly simple. Do the following assignments, *and do nothing more*. We don't expect you to go out and buy real estate before you are ready just so you'll have something to manage. We *are* asking that you do a few simple exercises just for practice, just to see how some of the techniques associated with good management work.

Of course, if you already own a property or two, you should start practicing the techniques you've learned immediately. You may already have tenants you shouldn't have--tenants you wouldn't have rented to if you had known how to properly screen. Don't waste precious time worrying about what "should have been." Start this minute to practice effective management techniques, and vow to do better the next time!

In the meantime, go ahead with the following assignments. You need not do all of them; select those that will be most helpful to you in your circumstances. But don't skimp in your efforts. You'll be hurting only yourself.

1. Sharpen your eyes. When you are waiting somewhere--a store, an office building, the local shopping mall--watch people around you. What can you tell about them and their relationships with others from their clothes, posture, words, or actions? Make notes of what you see, just for practice.

2. Shop for credit help. Contact local credit bureaus and ask them what their membership and reporting fees are. Get in touch with apartment owner's or landlord associations and ask them if they have a group membership in a credit bureau. Find out how you can use the credit bureau membership. Talk to the professionals on your investment team and see if any of them can help you get credit reports. Look for someone you know who has worked in lending and credit--whether in a bank, a department store, a finance company, or a collection office--and talk to him or her about what is involved in checking credit. Ask for any tips or shortcuts, and examples of the most common problems.

3. Assemble your tools. Go to an office supply store and buy a dozen folders, a receipt book, two or three pens, some carbon paper, and a small notebook. Label your file folders with the names of the forms you will use, and find a suitable container for them. A box works well, as does a single drawer in a filing cabinet.

4. Create more tools. Study the sample forms provided in this management unit, and decide on any changes or additions you would make. Type up your individualized forms, make two dozen copies of each, and file them in their appropriate folders.

5. Learn the laws. Review Parts A and B of this unit and jot down the local laws you will need to know, such as whether a landlord is required to keep tenant deposits in a separate bank account, how long you may keep deposits before refunding them to tenants who have moved, and what the exact deadlines and procedures are for evictions in your state. Then make an appointment to discuss these matters with an attorney or other qualified advisor.

6. Fill out the application form. Get a copy of the Rental Application Form and fill it out, using the situation of a friend or family member to supply the details.

7. Figure proration. Suppose that you are renting out a home for $525 a month and that new tenants are moving in on the ninth of May. Prorate their rent to show what they owe for May's rent. Or, if you are collecting a full month's rent for the first month, prorate what they will owe for June.

8. Adapt tenant policies. Review the Tenant Policies contained in this unit. Adapt them to your own needs and desires.

9. Fill out an agreement. Get a copy of a Lease-Rental Agreement and fill it out. Carefully evaluate each line to make sure you agree with it terms.

10. Fill out a checklist. Get a copy of the Move-In Ready Checklist and fill it out on your own home. Become familiar with the kinds of problems to look for.

11. Make a list. Think of all the ways you can say thank you to good tenants. Put them down in a list, and file it away for future reference.

THE MOST FREQUENTLY ASKED QUESTIONS ABOUT MANAGING PROPERTIES

The following questions are among those most frequently asked concerning property management.

1. "The house I bought has no refrigerator, washer, or dryer. Do I have to supply these appliances for my tenants?"

That depends. Make careful note of what other landlords in your area supply when you do your survey of the competition. You'll buy them. However, if you find out they haven't got something like this they need, you can always offer to rent them one until they can buy their own.

2. "The carpets in my new rental are a little worn in places. Do I have to replace them all?"

That depends on the amount and extent of damage. Again, check the competition. If your carpets are about average compared with others, don't worry about it. However, if they're worn down to the nap or have holes in them, you'll probably have to do something. Don't recarpet the entire house unless it really needs it. Carpet stores and large department stores often have remnants available at bargain prices, and many of these are pieces large enough to do an entire room. Remember, there's nothing wrong with giving the living room a different kind of carpet than that in the bedroom.

3. "Do I have to allow animals in my rentals? I've heard real horror stories from other landlords about this."

That's entirely up to you. The main reason we suggest you do allow them is that it enlarges the pool of potential tenants. If you screen the pet and charge higher rent and an extra pet deposit, and if you include in your rental agreement a clause that makes the tenant responsible for all damage caused by the pet, you should be protected.

4. "Do I have to supply things like vacuum cleaners and lawn mowers for my tenants?"

You shouldn't have to. People who want to live in houses with carpets and yards usually expect to provide these tools for themselves. If they don't own them already, they should be encouraged to buy them. However, if you find out they haven't got something like this they need, you can always offer to rent them one until they can buy their own.

5. "The house I bought came with a set of play equipment in the yard. Should I leave this in place to make it more attractive to families with children?"

No. Children often get hurt on such equipment, and if you supply it, you could be held liable for any injuries. Remove it immediately. The same advice goes for tree houses, swimming pools, and any other potentially harmful "attractions."

6. "There's some kind of plant disease in the shrubs around my rental, and the only way to cure it is to remove all the plants and burn them. Should I do this right away?"

Unless the disease is one that would spread rapidly to every yard on the block, probably not. It would be better to rent the house first, and then replace the shrubs. If you do it while the house is vacant, it will decrease your chances of attracting a tenant until the yard work is done, prolonging your vacancy period.

7. "All the rentals in my area rent for about $500 a month, but I think this is unrealistically low compared to what house payments would be for these people. Why shouldn't I be the first landlord to start a trend toward higher rents?"

There's no reason you can't try this, if you go about it right. If you're successful, most of the landlords in your area will probably follow your lead soon. Remember, though, that you're going against the market trend, and you should proceed carefully. Your house will have to offer more than those that rent for less, whether it's a better location, a better kitchen, or extra amenities, unless housing is very scarce. Start by charging only a little more than the others, perhaps $25 a month, and be prepared to wait longer to find a tenant. Set yourself a cutoff date--a day when, if the house is still vacant, you can drop your rent back down to $500 and wait out the average vacancy period without endangering your financial position. If you can't do this and really need more than the market rent, why not try a lease option?

8. "Why should I rent to people with children? Don't children cause property damage?"

Children don't necessarily cause any more property damage than adults. In fact, children usually do less harm to your property than some classes of older people. The reason we recommend families with children is that these people are more likely to settle down and stay with you for longer periods, causing you fewer vacancy problems. Adults without children are more apt to move on a whim, to split up and go their separate ways, to quit their jobs without finding another position first, to invite other people to move in with them without your knowledge, or to throw wild parties where irresponsible strangers are inclined to cause damage far beyond what most children are capable of. While some adults with children also behave in these ways, it happens less often. The responsibility of taking care of the children and holding down jobs to support them calms most people down considerably.

9. "How can I ensure that my rental will attract only the most stable, solid citizens?"

You can't. While following a solid management program and practicing reasonable care will eliminate most tenant problems, there simply are no guarantees that you will never get a bad renter. Every business has its risks, and this is one of them in real estate investment. The best that you can do is to buy a property carefully, maintain it well, screen applicants to the best of your ability, and be prepared to act if anything goes wrong. This is one of the few opportunities you have in today's economy to exercise so much control over your own financial well-being, and you must be prepared to accept the responsibility as well as the profits.

10. "What if I take an instant dislike to a prospective tenant? Do I still have to rent to him if no one better applies?"

That depends on why you don't like the prospective tenant and on how many other applicants are almost as good. If your dislike is based on a personal prejudice, such as race or religion, you have no legal grounds on which to refuse the applicant. On the other hand, if you object to a tenant whose personality is totally impossible for you to deal with, you may be able to support a refusal on grounds of personal preference.

You should consider this very carefully, though: you will most likely have very little contact with the tenant once the house is rented. Your rental decisions should be based on business considerations, not the sort of personal tastes you would use in choosing a friend.

11. "What should I do if people take a rental application home with them and send it back to me with some of the information missing?"

Call them and find out why they didn't supply all of the information you asked for. Don't start checking them out until you either have all the facts or a reasonable, believable explanation for why the application is incomplete.

12. "I don't know anything about checking credit, and I don't have an interest in learning, but I don't want to join a local credit bureau, either. Is there any other way I can get the credit facts on applicants?"

Not really, unless you can afford to hire someone to do it for you. Consider asking an employment agency that provides temporaries for someone with credit experience in a bank, finance company, or collection agency.

13. "My sister and her husband just separated. He's a good guy, and I have nothing against him. He asked me if he could stay in one of my vacancies until he finds an apartment, and said he would clean up the house and keep an eye on it for me until I find a tenant. Is there any reason I shouldn't do this?"

Unfortunately, there is. You may have nothing against the man, but are you sure he doesn't want to get back at your entire family for his marital problems? People going through separation and divorce often act in irrational ways. Also, once he has moved in, it may be difficult to get him to move out of your rental until he's ready.

If you're sure you can depend on him and really want to help, draft a written agreement that covers exactly what work he intends to do, the quality of work that you will accept, and the amount of notice that you will give him to leave. Also insert a clause that will make him responsible for losses to you if he breaks the agreement or does damage to your property.

14. "I was really impressed with a couple, and I allowed them to move in before I finished checking their application. Now I've completed my investigation, and I discovered some unsettling facts. Although they've been good risks since they moved to my town, they had a lot of financial trouble in another state about two years ago, were evicted, and skipped out on their bills. Is there anything I can do about this now?"

Yes. You have several alternatives. One is to talk to them, tell them you just learned of their former financial problems, and ask for their side of the story. You may find that they had temporary problems that are under control now. Then keep a close eye on them in the future to see that they stay in control. If they made misleading statements on their application in an attempt to hide their former difficulties and you don't want to give them the benefit of the doubt, you may have grounds for eviction. You could also raise their rent by such a large percentage that they will decide on their own to leave.

15. "I rented a house to an elderly couple living on a pension, and the husband has since died. The widow doesn't want to move, but wants to ask her son and daughter-in-law to move in with her. Should I allow this?"

There's no reason you shouldn't. Simply tell her that you'll have to treat it as a new tenancy. Have the son and his wife fill out an application, check it out as carefully as you would any new application, and have all of them sign a new Rental Agreement. If the children don't meet the same requirements you would apply to anyone else, you'll have to ask the widow to continue living alone or to come up with different roommates who meet your requirements.

16. "The people who live next door to one of my rentals call me three or four times a week with complaints about my tenants. I have talked to my tenants, and they claim they behave like every other family on the street. They say the complaining homeowners are overly fussy and nosey. What should I do?"

The first thing you should do is talk to some of your tenants' other neighbors. Explain what's been going on, tell them that you don't want your tenants doing anything they shouldn't, and ask for outside opinions. If you find that your tenants have not really been causing a problem, you will have to tell the unhappy neighbors that your tenants have a right to conduct their lives in privacy. If you find that your tenants are at fault, warn them to change their ways and tell them that continued disturbances may be grounds for eviction.

17. "My state law requires that all tenant deposits must be accounted for and refunds made within seven days after the tenants vacate. My handyman sometimes needs as much as two weeks' notice to schedule a job. I've asked him to estimate the cost of repairs so I can make the refunds, but he doesn't always stay within the estimates he gives me. I've been losing money on almost every vacancy. How do you change a state law?"

Talk to your local state representative or state senator. Join with other landlords and start a political campaign to get the law changed. In the meantime, there are other things you can do. Look for a new handyman, or give your old one more notice. Review your handyman's previous bills for vacancy repairs and maintenance; you may find that you can estimate about how much the overruns average, and you can include that in your estimate. For example, you might find that your handyman's labor charges usually run about 15 percent above the estimate. Add 15 percent when you make out the tenants' statements, and put (est.) next to the charge. If the bill comes to less than your estimate, you can simply forward the difference to your former tenants.

18. "I went to inspect some of my houses the other day, and found that one of the tenants has painted his living room a horrible shade of pink with red trim. it doesn't go with anything, and I'm afraid it will take ten coats of paint to cover that red. How can I get him to change it?"

As long as he lives there, you don't have to. Obviously, he likes it, or he wouldn't have done it. However, write him a strong letter informing him that his paint job is against the terms of his tenancy because he didn't get your permission. Tell him that he must either change it immediately or guarantee in writing that he will pay the expense and assume the responsibility of restoring the premises to their original condition--to your satisfaction--when he moves. End you letter with a strong warning that in the future he must get your written approval for all changes (cosmetic or otherwise) to your property or you will be forced to evict him for violation of your rental policies.

19. "I finally got rid of a family that hasn't paid rent for four months. It burns me up every time I think of the money and time I lost on these people. I'd like to get back at them and give them a little taste of the kind of trouble they caused me, but they've moved out of state. Can I hire a skip tracer to track them down and then garnishee their wages to pay me back?

That depends on whether you can get a legal judgment for damages and loss against them. Consult an attorney. In the meantime, be glad that you've ended an unpleasant situation; concentrate your energies on getting better tenants this time. Even if you find these people, there's no guarantee you will be paid back: many people with bad debts simply move on every time one of their creditors catches up with them. If you continue to pursue them, you may find yourself involved in an endless game of hide and seek, and they have the whole United States to hide in. This kind of game will only cost you more time, money, and energy, with no way to know if you will ever be able to collect the debt. If your initial efforts to collect from them are unsuccessful, write them off as a bad debt and put the whole business out of your mind. There are many more pleasant and profitable ways to spend your time. Rather than trying to get even, use the time and money you would spend pursuing them to find and buy another property. That way you'll be independently wealthy that much sooner, and they'll still be insecure renters hiding from their debts. As you relax on some sunny tropical beach, you can compare your life to theirs and feel smugly triumphant. This is what is meant by the saying, "Living well is the best revenge."

RENTAL APPLICATION

Please fill out all information requested. The application will not be considered unless completely filled out. Date____________

Name___________________________________ Soc. Sec. No.___________

Address_______________________________ Driver's License No.:

(street)

____________________________zip_______ ________________________

(city) (state)

Phone numbers: work___________________ home_____________________

Names of others who will be living on premises (if applicable):

Co-Tenant:___________________________ Soc. Sec. No.____________

License No.:_____________

Name_________________________________ (relationship)____________

Name_________________________________ (relationship)____________

How long have you lived at current address? From______to________

Name of current landlord________________________Phone___________

How long at previous address? From_______to_______.

Name of previous landlord_______________________Phone___________

Car make______Year____model__________license plate no.__________

Occupation Information:

In each case indicate name and nature of employment or business, address and phone number, starting and ending dates, name of immediate supervisor and phone number, and ending monthly gross income:

Current:____

____

Previous:____

____

Co-Tenant:____

____

Credit References:

Banks (list names of banks, address and phone numbers, account numbers):____

____

Credit references (revolving accounts, credit cards--list business and account numbers):________________________________

____

Character References (list at least two persons who can attest to your good character; give relationship and phone numbers):______

____

History:

1. Have you ever filed a petition for bankruptcy? Y___N___
2. Have you ever been evicted from a rental property? Y___N___
3. Have you ever had a prison record? Y___N___
4. Have you ever willfully withheld rent when due? Y___N___

Declarations: I declare that the information given in this application is true, and that any misrepresentations by me will be grounds for terminating any future rental agreement entered into on the basis of this information. I further give permission for the person or persons receiving this application to make contact with persons I have listed as references and verify any information herein provided. I further give permission for a credit check to be made of my file in any credit bureau.

Applicant_____________________ Co-Applicant_____________________
(signed) (signed)
Print names:__________________ _____________________

Date signed:__________________ ___________________

RESIDENTIAL RENTAL AGREEMENT

This Residential Rental Agreement entered into this_______day of ______________19___,
between______________________ hereinafter called Lessor,
and____
of__________________________________County of,_________State of _________, hereinafter called Lessee:

WITNESSETH

Lessor does hereby lease and rent unto Lessee, and Lessee does hereby take as tenant under Lessor, the dwelling accommodations known as____
_________________________________situated at________, County of________, State of____, to be used by Lessee as a lawful private dwelling from the______th day of _____19___, to the____th day of______ , 19___inclusive, a term of three months more or less; thereafter from month to month unless terminated by at least 30 days written notice from either party to the other. Said accommodations are rented for occupancy of____Adults and____Children.

IN CONSIDERATION WHEREOF, and of the covenants hereinafter expressed, it is covenanted and agreed as follows:

1. Lessee agrees to pay to Lessor, or Lessor's agent, in advance, at the office of Lessor or said agent or by mail to Lessor at_____________________________________, on the first day of each month of said term, as rent for said premises, the sum of ________________________Dollars ($_____) per month; the time of payment of each monthly installment is made the essence of this agreement. Lessee may deduct twenty dollars ($20.00) per month discount if rent is paid on time (in no case later than the fifth of the month or with a postmark no later than the fifth of the month).

2. Lessee shall not permit any unlawful and immoral practice to be committed on premises; nor shall he permit them to be used as a boarding or lodging house, for rooming or school purposes, nor for any purpose which will increase the insurance rate; nor shall he permit to be kept or used on the premises inflammable fluids or explosives without the consent of Lessor; nor permit them to be used for any purpose which will injure the reputation of the building or which will disturb the tenants of the building or the inhabitants of the neighborhood.

3. Lessee has examined the premises and is satisfied with the physical condition and his taking possession is conclusive evidence of receipt of them in good order and repair (any exceptions are to be described by Lessee in writing and made part of this agreement), and the Lessee agrees to keep said premises in a clean and satisfactory condition, and, upon termination of this tenancy, will leave said premises, equipment and furnishings in as good condition as when entered upon, except for reasonable

wear and tear or damage by the elements or by fire; and in the event of damage or injury to said premises, except as otherwise provided herein, said Lessee shall pay for all such damages. Note that Lessee will be responsible for each instance of repair or maintenance within the unit that costs less than $20.00. Should any instance of ongoing repairs or maintenance in the unit exceed a cost of $20.00 or more, the Lessor shall pay for same.

4. Lessee agrees to pay all electric power and light, gas and telephone charges; and for dry-cleaning of drapes and professional cleaning of carpets during tenancy, and immediately prior to termination, except as noted after this paragraph. In addition, Lessee agrees that the professional cleaning of the carpets upon termination of the tenancy will be paid for out of the security deposit paid to Lessor by Lessee at the beginning of the tenancy. Lessee also agrees to arrange for cleaning the premises upon termination of the tenancy, including stove, oven, fridge, walls, sinks, toilets, floors, closets, window ledges, etc., and to leave the yard free of debris or clutter of any kind. Should the Lessor determine, upon inspection, that this cleaning has not been accomplished to the satisfaction of the Lessor, then Lessee shall agree to pay for cleaning such premises by professional cleaners at the current reasonable rate per day.

5. Lessee shall not have the right or power to sublet the premises or any part thereof, or to transfer or assign this rental agreement without the written consent of Lessor; nor shall he offer any portion of the premises for a sublease by placing on the same any "to rent," "furnished room," "rooms to let" or similar sign or notice or by advertising the same in any newspaper or place or manner whatsoever without the consent in writing of the Lessor.

6. It is expressly agreed and understood by the Lessor and Lessee that the Lessor shall not be liable for any damage or injury by water or fire or any other cause which may be sustained by the Lessee or other person or for any damage or injury resulting from carelessness, negligence or improper conduct on the part of any other tenant or agents or employees. LESSOR STRONGLY ADVISES LESSEE TO OBTAIN HIS OWN RENTERS POLICY OF INSURANCE TO COVER THE POSSIBILITY OF LOSS OF PERSONAL PROPERTY OR INJURY DURING THE TENANCY. Note that it is expressly agreed by Lessee that no waterbed(s) shall be brought onto the premises without the written consent of the Lessor, which consent shall be given only upon presentation of written evidence that the Lessee has taken out a policy of waterbed insurance covering any eventual damages to the premises.

7. Should the Lessee fail to pay the rent, or any part thereof, as the same becomes due, or violate any other term or condition of this rental agreement, Lessor shall then have the right, at his option, to re-enter the leased premises and terminate the rental agreement; such re-entry shall not bar the right of recovery of rent or damage for breach of covenant, nor shall the receipt of rent after conditions broken be deemed a waiver or forfeiture. Rent unpaid after the fifth of the month shall be considered late and shall cause the Lessee to forfeit the right to the discount for prompt payment of rent. The full rent shall then be immediately due and payable, and if it is not paid by the fifth of the month, Lessor shall issue a three-day notice to pay or quit the premises. Note that rent may be paid by personal check, money

order, cashiers check, or (in the case of payment in person) by cash. In the event rent is paid by personal check and the check is bounced, Lessee shall incur a bad-check charge of $10.00 payable to the Lessor, and Lessee shall forfeit thereafter the right to pay rent with personal check. Note also: in the event of a bounced rent check Lessee shall pay rent immediately by cashier's check, money order, or in the form of cash, and if the date of payment of such rent falls after the fifth of the month in which the rent in due, the Lessee shall forfeit the rental discount for that month.

8. Should the Lessor be compelled to commence or sustain an action at law to collect said rents or part thereof, or for damages, or to dispossess Lessee or to recover possession of said premises, the Lessee shall pay all costs in connection therewith, including reasonable attorney's fees.

9. It is mutually understood and agreed that the Lessor and his agents shall have access to the leased premises at all reasonable times to inspect and protect the same, to show the same to a prospective purchaser, tenant, or mortgagee, and to make repairs. The Lessor agrees to show every courtesy to Lessee in this regard by making every reasonable effort to reach Lessee for the purposes of setting up a convenient appointment.

10. Lessee agrees not to keep or maintain a dog, cat, or any other animal or pet on the leased premises without the written consent of the Lessor.

11. Lessee shall comply with all the reasonable rules and regulations now in force by Lessor, and posted in or about the premises, or otherwise brought to the attention or notice of the Lessee, both in regard to the building as a whole and as the premises herein leased.

12. In the event the leased premises are furnished with furniture of the Lessor an inventory of the furniture shall be included after this paragraph, and it is hereby agreed that all furnishings are received in good condition, unless otherwise expressly stated, and the Lessee agrees to return the same at the expiration hereof in like condition, reasonable wear and tear excepted. Note also that where premises are equipped with a disposer unit, the Lessee shall be responsible to keep said unit in good working order. Where Lessee causes said unit to become clogged or stuck, or where Lessee causes drains in premises to become clogged, it shall be the responsibility of the Lessee to arrange for professional repairs to same at Lessee's expense.13. Lessee agrees, prior to occupancy, to pay Lessor a security deposit of:
____Dollars ($______). Lessor may apply this deposit against any of the following obligations of the Lessee: (1) rent owed and past due; (2) damages done to the premises by Lessee or by persons invited on the property by him, beyond ordinary wear and tear; (3) reasonable costs of cleaning premises following termination of tenancy if not completed to the satisfaction of the Lessor; (4) damages to the Lessor resulting from early termination of this agreement by the Lessee; (5) the cost of having the carpets professionally cleaned. Within 45 days following first written notice of intent to terminate this agreement by the Lessee, the Lessor shall refund to the Lessee the security deposit, less any amount withheld therefrom as permitted herein, together with an itemized

statement of items withheld. NOTE: SECURITY DEPOSIT SHALL NOT BE CONSIDERED BY LESSEE TO BE THE LAST MONTH'S RENT. RENT FOR THE LAST MONTH OF TENANCY MUST BE PAID ACCORDING TO THE PROVISIONS OF THIS AGREEMENT.

14. Lessee agrees to keep flower beds adjacent to premises free of weeds and debris. Note that it is expressly forbidden to keep blocked or unsightly vehicles on premises or to carry out mechanical/overhaul work on premises.

15. It is expressly stipulated that there are no terms of this agreement different from any of the preceding numbered paragraphs or in addition thereto, except the following:

16. All covenants and representations herein are binding and inure to the benefit of the heirs, executors, administrators and assigns of the Lessor and Lessee.

IN WITNESS WHEREOF, the parties hereto have hereunto set their signatures and seals, the day and year first above written.

____________________________ ____________________________

____________________________ ____________________________

(Lessee) (Lessor)

UNIT NINE

PORTFOLIO BALANCE AND CONTROL:

CREATIVE END GAMES

UNIT NINE

PORTFOLIO BALANCE AND CONTROL:

CREATIVE END GAMES

9.1 WHAT YOU WILL LEARN IN THIS UNIT

The real estate investor who seeks true financial independence begins by building a portfolio of real estate properties and then controlling his investments through wise management practices. Unfortunately, many novice investors either buy or sell real estate without any organized plan to balance their portfolio and control its profits. Such investors will likely never achieve their ultimate objective of financial freedom.

The purpose of this unit is to teach you how to build a balanced portfolio and control your properties for maximum profit. It will show:

* What a real estate portfolio is.
* What steps you must take in order to build a portfolio.
* Why diversification of your portfolio will produce optimum profits and minimum risks.
* Which personal and property risks can be controlled.
* How earning excellent profits through your real estate portfolio is related to your ability to control overall cash flow.
* How tax laws and regulations influence the growth of your portfolio equity.
* How to use professional advisers to increase your portfolio profits.
* How to use options and development strategies in real estate investing.

The fear of managing a large investment program can keep an otherwise successful investor from financial independence. In studying this unit, imagine yourself as the purchaser of the properties discussed. As you become more familiar with the ideas, and as you apply them in a risk-free environment (which will be provided for you at the end of this report), you will see your fear of portfolio management quickly evaporating.

Financial independence is as close as the pages you are reading. Study this material well and you will be on your way to financial freedom.

9.2 A FEW TERMS YOU SHOULD KNOW

<u>Capital appreciation</u>: The increased value of a capital

investment such as real estate. Real estate usually increases in value as the inflation rate goes up. It also increases in value if the potential economic profits from that asset improve. You must learn to manage your portfolio in such a way that the value of the individual real estate properties increases, even when the inflation rate is low.

Capital depreciation: In certain economic situations, the value of a real estate property or other capital asset can decrease in value. This depreciation in value is generally associated with a lower investment return on the property, a decline in total neighborhood real estate values, or a change for the worse in the use of that real estate.

Capital gains tax: When you sell a property and realize a gain, you are taxed on that gain as if it is ordinary income, except that taxes from a long-term capital gain (for properties held at least one year) is capped at 28% (which helps only those who are in an income tax bracket higher than that). Check current regulations.

Diversification: The process of including in your real estate portfolio various properties of different size, character, and location. Diversification helps you minimize risk and maximize investment return.

Entrepreneurial profit: The profit earned from selling a short-term investment without waiting for long-term appreciation. You should avoid building a portfolio of real estate properties exclusively upon anticipated entrepreneurial profits.

Feasibility research: The process of determining the profit potential for a specific real estate property or project. You should conduct on all investment properties, regardless of the length of time you expect to hold the asset in your portfolio.

Investment risk: The risk associated with real estate property. If an asset is mismanaged, the profit on that property can diminish rapidly. When building, controlling, and managing a portfolio of properties, you must balance the risk of any one property against your overall investment objectives.

Non-recourse debt: Debt that has recourse only upon the investment equity in the event the investor defaults. When building a real estate portfolio, you must use caution in guaranteeing the payment of investment obligations against personal assets. The best way to insure the safety of the overall portfolio is to use an exculpatory clause which (provides for non-recourse) in as many property financing arrangements as possible.

Portfolio planning: The planning stage in an investment program, in which numerous investment properties are considered. Portfolio planning must be done before you buy or sell a single property.

Portfolio strategy: The decisions made to manage real estate properties in such a way that your financial goals will be realized. Your portfolio strategy must be adjusted on an ongoing basis in response to individual property performance.

Property management: The process of managing the liabilities and asset of a single property in order to achieve your overall portfolio investment objectives. As your real estate portfolio increases in size, you will need to devote more time to portfolio strategy and less time to individual property management. When this change begins to occur, you should seriously consider retaining a professional property management firm.

Refinancing: Taking out a new loan on a property or modifying the existing one on it. Refinancing is used when an existing property loan is mostly paid off, or when the repayment on terms on new financing are more attractive than the existing terms. As a portfolio increases in size and is held for an extended period of time, refinancing may be used to generate further investment capital to control portfolio growth.

Risk: The hazard of investment loss. As your property portfolio increases in size, the risk associated with any one investment property should decrease through diversification.

Tax-free exchanging: Disposing of an individual property by exchanging the property for an investment property of like kind and increased market value. Exchanging properties instead of selling them should always be considered in portfolio strategy whenever possible since it may save you a considerable amount in taxes.

9.3 KEY POINTS ABOUT PORTFOLIO BALANCE AND CONTROL

As you read this unit, keep the following key points clearly in mind. They will guide your thinking and help you to keep a proper perspective on the information you will be assimilating.

* Real estate portfolio consists of a number of properties purchased individually.

* Managing your entire investment program through portfolio control is as important as managing a single rental investment property.

* The more you understand the risk of loss associated with an individual property, the easier it will be for you to control the risk of losing your entire portfolio.

* Cash flow from individual investment properties should be funneled into building your real estate portfolio.

* Diversification can be achieved through the purchase of many small investment properties.

* Outside investment advisers and professionals can provide valuable assistance as you try to maintain portfolio balance and meet your overall investment objectives.

* Your financial independence will be conditioned upon your ability to balance a portfolio of properties and control their growth.

9.4 HOW TO BALANCE YOUR PORTFOLIO AND CONTROL ITS PROFITS

WHAT IS A REAL ESTATE PORTFOLIO?

A portfolio of real estate properties consists of all the real estate investments owned and controlled by an investor. It may include development property, rental property, fix-up properties, and properties held for long-term appreciation. The portfolio with the safest risk is one that contains a well-managed mixture of several different kinds of properties.

The investor who attempts to achieve financial independence without considering the impact of an individual investment upon his total investment program is setting himself up for failure. This is why portfolio planning is so important.

Mark M. attended a short real-estate investment seminar and became excited about the prospect of gaining financial freedom through the purchase of real estate properties. He hoped to control a large number of rental properties and then use the equity in those properties to retire, travel, and generally enjoy life. This was the extent of Mark's portfolio planning.

Being aggressive by nature, Mark had little trouble buying more and more properties using nothing-down techniques. Within nine months Mark owned a portfolio of eight singe-family homes, one duplex, two four-plex apartments, a six-unit rental property, a small office building, two pieces of raw ground suitable for residential development, and a conversion office building. The six-unit rental property generated a positive cash flow of $325 per month, and two of the single-family rentals each showed a positive cash flow of approximately $50 per month. The office building broke even. Unfortunately, all of the other properties showed negative cash flows. Because Mark had not used any system of control to balance the kinds of properties, disaster was waiting in the wings. He had owned the properties too short a time to experience much equity growth through normal appreciation.

Mark had made some cosmetic repairs and earned some equity that way, but his total investment equity was in the early growth stage. His cash flow is summarized on the adjacent page.

By the end of the ninth month, Mark was elated to find that he controlled over $1,000,000 worth of real estate that would appreciate a substantial amount each year. Unfortunately, Mark had a major problem. He could not pay more than $350 to $400 each month to meet the negative cash flow his properties generated. This required dramatic and immediate action.

He decided to sell some of his properties in order to pay the monthly debt he had and to try eliminating some of the negative cash flows. Because he needed cash immediately, Mark found that he had to sell properties at a discount and sell first those properties with the best cash-flow.

It took Mark a little over two months to sell the six-plex apartment property, the office building, and four of his single-family rentals. The paper equity he had in those properties was over $20,000, but due to the discounts he had to offer on the properties he ended up with just under $5,000. He also still had a negative cash flow of approximately $800 each month. He could afford to supplement the cash flow by $400, so it took less than a year to deplete the cash reserve he had. By this time, he had to sell more of his properties, but was able to raise less cash than the time before because he had already sold his best properties.

In just under two years, Mark had lost the entire equity in all of his properties and ended up losing two of the properties through foreclosure. One of these properties remained to haunt him because it had been foreclosed with a deficiency judgment against Mark personally.

None of this would have happened if mark had understood portfolio planning and portfolio management.

Investing in real estate can be a good way to achieve financial freedom and independence, but it must be done wisely. Making a single property purchase will not provide the independence you hope to achieve, but neither will buying a large number of properties, unless you do it in a systematic and controlled way.

Before you buy a single piece of property, you must make some intelligent decisions about the kinds of property you should buy to meet your financial objectives. (This is called portfolio planning.) Then, once you have purchased these properties you must manage them with those objectives in mind. (This is call portfolio strategy.)

Portfolio planning should consider not only your investment objectives, but also your resources. When portfolio planning is done properly, it will eliminate the situation that Mark found himself in. If Mark had carefully planned his portfolio to balance the growth of his investment equity against his investment resources, he would have saved a great deal of money and preserved his portfolio.

Once a portfolio is put together using portfolio strategy, you may change your investment objectives as you make decisions to hold, sell, exchange, or refinance your properties.

Your portfolio strategy may change as the number of properties you own grows and the amount of equity in the properties increases. Later on in this unit, we will discuss techniques that can be used to balance and control portfolio size and profits.

9.5 HOW TO DEFINE YOUR INVESTMENT OBJECTIVES

As you evaluate your investment goals, you should place them in order of priority. As you do so, you will begin to see what kind of goals you need.

Most investors adopt one or more of four objectives for their investment program. They may want:

* Income through property cash flow,
* Tax savings,
* Equity growth through mortgage reduction, and/or
* Capital appreciation.

1. <u>Income through property cash flow</u>. James C. began investing in real estate with the ultimate objective of achieving financial independence. James had regular employment that provided him with the resources to support a small amount of negative cash flow -- no more than $200 a month -- as his portfolio was increasing. This $200 would need to cover all the cash requirements of his portfolio of properties. In the beginning stages of his portfolio growth, James decided to use this $200 to supplement the cash needs of individual properties. He decided, however, that within two years he wanted to begin receiving a monthly cash benefits from his portfolio that could be used for personal consumption without disturbing the equity in his portfolio.

James first purchased a duplex rental property that required a cash input (negative cash flow) of just over $60 each month. He did some cosmetic repairs, and within four months he was able to raise the rent on the two units enough to break even. At the same time, he made another purchase of a single-family rental property that broke even immediately. When he improved the landscaping of the property, he was able to raise the rent by $90. His third purchase was a four-plex apartment property that had a negative cash flow of $140 each month. It took James eleven months to turn the cash flow on this property to a positive income of $205 a month.

Less than two years had elapsed and James had a positive cash flow from his three properties of $405 each month. Following his previous investment decision, he began using $200 for personal consumption and allocated the remaining $205 to help provide for the cash requirements of future property purchases.

Because James based his investment decisions on his resources and on realistic cash income objectives, he was able to balance the growth of his portfolio with his resources and achieve the cash benefit he desired.

2. Tax savings. One characteristic of investment property is that it provides a tax break. When James began purchasing investment properties, he decided to use the tax benefits from property ownership to increase his take-home pay from work. He could then use this tax savings to build a cash reserve to purchase larger investment properties that might require a small down payment. The three properties that James owned at the end of two years showed a total tax loss of $800 each month. Since James was in a tax bracket of 35 percent (combined state and federal), this $800 loss resulted in an actual tax savings of $280 each month. James set aside these funds for future use in his portfolio purchases. Be sure to check current tax rates.

3. Equity growth through mortgage reduction. As an investor pays toward the principal amount of his debt each month, he is creating equity growth in his real estate portfolio. This growth is generally small when the loan required to purchase the property is relatively new. But as more of the debt on the property is paid off, the equity increases.

When James first purchased the first three properties in his real estate portfolio, most of the monthly amount he paid on the loans went toward interest. But some of this payment included a small principal payment. By the end of the second year, James was paying a total principal amount each month of over $125. The equity on his properties thereby built at a rate of $125 a month.

4. Capital appreciation. It used to be that most investors believed that the capital appreciation of the properties in their real estate portfolios would be the major source of long-term profits. Today, most investors look to the current return on investment as the chief factor. Still, in some areas of the country there could be considerable appreciate of real property. Moreover, through careful buying, investors can go into deals with a strong equity gain, almost as if the property

had appreciated instantly. In either case, investors might well have an objective to control a portfolio that increases in value each month through capital appreciation. At some time in the future, they plan to convert this equity appreciation into more and larger properties.

When James purchased his first three properties, he made sure that he bought each at or below market value. He knew that if he paid more than the fair market price for the properties, the appreciation of those properties would first go to recover the excess purchase price. James also used wise management techniques to lower expenses, do cosmetic upgrading, and raise rents. This contributed to an immediate increase in value. James paid $59,000 for the duplex when he purchased it, $38,00 for the single-family rental, and $88,000 for the four-plex apartments. He purchased all three of these properties with no cash of his own invested. By the end of the second year, the capital appreciation of the three properties showed the following:

Property	Purchase Price	Fair Market Value
Duplex	$ 59,000	$ 73,000
Single Rental	$ 38,000	$ 51,000
Four-plex	$ 88,000	$119,000
Total	$185,000	$243,000

As you can see, James was able to realize a capital appreciation profit of $58,000 during the first two years he owned his portfolio. As value of James's portfolio continued to appreciate at approximately 8 to 10 percent per year, his three properties experienced a capital appreciation of approximately $1,620 or more each month after the second year.

9.6 EXPANDED GOALS OF PORTFOLIO OWNERSHIP

After you've looked at the basic investment objectives, you'll want to consider a larger list of goals you hope to achieve through ownership of your portfolio.

What specific goals do you want to achieve by investing in real estate? Do you want a retirement income? How about money for college or charity? Whatever your goals may be, achieving them will depend to a large degree on how you mix your portfolio. One property may best serve as a tax shelter, another as a source of regular cash income, and still another for long-term equity growth. et's discuss some of the benefits a property investment might offer:

* Protection of purchasing power
* Diversification
* Tax shelter
* Regular cash return
* Capital gain
* Retirement income
* Estate building
* Investment for use
* Equity growth
* Entrepreneurial profit

You may have a portfolio plan that includes the selection of one or more properties to realize each of the above benefits. Your major objective may be for long-term estate building and retirement income, with other benefits derived from specific property purchases. As long as these purchases are balanced against your long-term investment objectives and investment resources, you will attain your ultimate goal of financial independence.

9.61. <u>Protection of purchasing power</u>

As you put your portfolio together, make sure you buy only those properties that will appreciate in value at least as much as the inflation rate. This ensures that you will be able to convert the equity in your portfolio into other investments or assets or into personal use without suffering the negative effects of inflation. By using the principle of leverage learned in earlier lessons, you can increase your equity even faster.

Greg and Carol A. decided that they wanted to build a real estate portfolio that would provide for retirement within fifteen years. As the first investment in their portfolio they purchased a three-unit apartment building at slightly below market value with no money down and a total purchase price of $78,000. It was located in a growing area and was one of the lower-priced properties there. They were confident that the property would continue to appreciate at a rate that at least equaled the normal inflation rate, preserving the purchasing power of their investment.

9.62. Diversification

Diversification (which we will discuss in more detail later) decreases the risk of owning anyone property and increases the potential yield or return on it. (Note: Unless you are a very experienced investor, your diversification should be limited to additional purchases of the same type of property.)

Both Greg and Carol understood this principle and established a plan whereby they would diversify their investment holdings among properties of different sizes and in several locations. They felt that they could use this strategy to convert their properties into a retirement income.

Since the three-unit apartment property didn't have a negative cash flow, they immediately began looking for a second property. They selected a single-family rental located in a relatively new neighborhood in a community some five miles away from their first property. Most of the properties in that area were owner-occupied, and Greg and Carol felt the appreciation of the property would be excellent and that their investment was safe. This particular property required a cash down payment of $1,100; the purchase price was $51,000. They were able to rent the property for an amount that left them with a negative cash flow of $65 per month, but they felt they could afford this and believed that the diversification the property provided in their investment program was worth it.

9.63. Tax shelter

One of the real benefits of a real estate portfolio is that the properties often provide a "tax loss" that can be used to shelter other income. Part of the decision Greg and Carol made to purchase the single-family rental with a negative cash flow was based upon the tax savings they would receive from it and their three-unit rental property. The loss attributed to the first two properties in their portfolio was $375 per month. Since Greg and Carol were at the time in a 38 percent tax bracket, the actual cash savings from the shelter benefit of the two properties was calculated as follows: 38% x $375/month = $142.50. That was $77.50 above the $65 negative cash flow. Be sure to check current tax rates.

9.64. <u>Regular cash return</u>

Regular cash return is the normal positive cash flow from rental property. This return is in addition to the tax benefits the real estate provides. Most investors plan to include in their portfolios some properties that will give them a regular cash return. This cash return is then either recycled into additional investments or used for personal financial needs.

Greg and Carol recognized a need for a positive cash flow from their portfolio of $500 per month beginning four years after their investment program began. They were going to need that money to pay the college expenses of their oldest son.

They decided to purchase a third property, and located a small office building in a growing business community. It was leased to substantial clients, and vacancy was rare. They were able to purchase the property for nothing down, and with an increase in rental rates, the property would provide an immediate cash flow of $85 each month. By raising the rental rate each year, they realistically expected that this property would have a cash flow in excess of $500 a month by the time their son entered college.

9.65. Capital gain

Currently you will be taxed on capital gains as if the gains were ordinary income, except that there is a 28% cap on long-term capital gains. Over the years, the capital gains tax rules have changed and varied considerably. Real estate investors must watch these changes closely in order to take advantage of the tax laws where possible (check current tax rates).

Greg and Carol agreed that their investment program was based on selling some of their smaller properties and using the funds both for reinvestment in larger properties and for meeting personal financial obligations. Whenever they got ready to sell any property they looked at their length of ownership and then evaluated the impact of capital gains on the proposed sale.

9.66. Retirement income

Greg and Carol wanted to be able to retire by the time they were 55 or 60. At that time, they wanted to own a home free and clear and have a regular income of at least $7,500 per month to travel and enjoy their life. With the proper growth of their portfolio these goals seemed attainable. They began looking, therefore, to purchase a fourth property. About a year after they had started investing in real estate, Greg and Carol found a twelve-unit rental property owned by an elderly couple. They talked to the owner and found that he wanted to have a house free and clear for the down payment on the property. They were happy to tell him they had a house to trade. When Greg and Carol had purchased the single-family rental property they had included a substitution of collateral clause. This allowed them to transfer the collateral for the loan on the rental house to the twelve-unit apartment building. In this way, they were able to purchase the twelve-plex for no money down, and they exchanged their small equity in the single-family house for the equity in the apartment building.

When the apartment property was added to their portfolio of properties, Greg and Carol had increased the positive cash flow they received by some $375 per month, and they had a property that was appreciating at more than $25,000 per year. They were well on their way to meeting their retirement objectives.

9.67. Estate building

You build an estate in much the same way you build a retirement program. You start by looking for substantial property that will appreciate with time. Greg and Carol wanted to provide an estate that would fund their retirement program and at the same time provide for some of the financial need of their children. Their selection of properties effectively accomplished both goals.

9.68. Investment for use

Most investors want to use a portion of the cash return form their portfolios for personal needs and desires. As long as you make this goal part of your portfolio planning, this is a legitimate use of funds.

When Greg and Carol decided to invest in properties that would provide for the educational needs of their children, their investment decision was based on "investment for use." Later, after Greg and Carol had started their investment program, they wanted to use a portion of the cash flow from their investments to buy a news luxury automobile. They didn't want to disturb any cash flow being developed for other uses (such as education), so they looked at the cash flow from their twelve-unit apartment. They found that they had enough cash flow from the property to buy the vehicle.

9.69. Equity growth

As an investment appreciates in value the equity in the investment also increases, particularly if the investor uses leveraged financing.

Greg and Carol continued their investment program by adding a six-plex rental property that was priced well below market. It required a certain amount of money for repairs and cosmetic upgrading before rents could be raised, but Greg and Carol had the money because they had been leaving a sizable portion of their portfolio cash flow in the bank. They felt the expenditure was worth it because the increased rents generated an immediate equity growth in the property and at the same time turned a slightly negative cash flow property into a positive cash flow situation.

9.6-10. Entrepreneurial profit

Sometimes an investor buys a property with the idea of selling it immediately for a profit. This area of real estate investment carries some risks that must be minimized, but the profits can be substantial. Unless the risks are very low and you know what you are doing, it is best not to jeopardize your portfolio through entrepreneurial profit enterprises that are too risky.

Greg and Carol were not developers, but as they increased their portfolio they gained some valuable experience and knowledge. As they were looking for residential property, they found a piece of property that could be sold for immediate profit if they could get the zoning changed. They obtained an option on the property and completed the pre-development process taught elsewhere in these reports. Within four months, they turned their $2,000 investment into $25,000. They decided to use $20,000 of this money to purchase additional rental properties, and $5,000 for personal enjoyment.

As you can see, building an investment portfolio involves a process of continually defining and redefining your investment objectives, using portfolio planning and strategy to achieve your goals.

9.7 BASIC INVESTMENT CRITERIA

Whatever goals and objectives you may set for a property, you will want to make sure the property meets certain basic investment criteria. These criteria are liquidity, profitability, and safety of principal.

9.71. Liquidity

As an investor, you must have the ability to alter your investment strategy, purchase additional properties or convert a portion of your equity into liquid assets. This is the reason why all the properties in you portfolio must be wise purchases. If it becomes necessary to liquidate any of these properties, you can do it without a loss of equity. At the beginning of this lesson, we reviewed a situation in which an investor -- Mark M. -- acquired properties too quickly and without enough planning, and when liquidity became crucial, he lost a substantial portion of his equity.

Any decision to add a property to a portfolio must consider its liquidity. If Mark had reviewed this investment objective, he immediately would have seen the folly of his investment purchases. When James purchased the duplex, single-family rental, and four-plex, he was aware of the need for liquidity. This was one of the primary reasons why he immediately lowered operating expenses and raise rents. In this way, the property showed a positive cash flow with excellent long-term financing. He knew that if he needed to sell these properties he would be able to do so easily.

9.72. Profitability

Profit in real estate is measured in terms of cash flow, tax savings, equity buildup, and appreciation.

When James purchased his first three properties, he was looking to make a profit in all four ways. As James's portfolio of properties increases, he will undoubtedly change his objectives and place a higher emphasis on one or more of the different types of profit. We remember that James wanted to use at least $200 of the property cash flow for personal consumption. Thus, he began by placing a higher priority on cash flow from the properties.

As you make your own portfolio decisions, you must make those decisions in terms of profitability.

9.73. Safety of principal

Keeping the principal safe involves, first, the preservation of the original equity, and second, the preservation of the equity earned in the property. One of the many mistakes Mark made in purchasing his fifteen properties was failing to consider the safety of his principal. No investor will achieve financial independence who is not concerned with the safety of his principal investment.

James made sure his investment properties provided liquidity, profitability, and safety of principal. He didn't purchase as many properties as Mark, but the total benefit from his investment portfolio was much greater.

9.8 HOW TO BUILD A PORTFOLIO

A real estate portfolio must be build on a solid financial foundation. Consequently, before building a portfolio, you need to ask yourself three vital questions:

- How much regular capital can I contribute to building a portfolio?
- Will personal emergencies endanger my portfolio?
- What effect will my current liabilities have on my portfolio growth?

9.81. How much regular capital can I contribute to building a portfolio?

To invest in real estate, you need capital for down payments, to offset negative cash flow, for cosmetic repairs, and for similar expenses. If you have little or no immediate cash or capital to meet these needs (either your own or a partner's), you can still build a portfolio, but you must do it at a slower pace.

Young portfolios are like babies--they need to be nourished until they can take care of themselves.

Portfolio planning should allow for a period of time when cash must be drawn from other sources to supplement the cash requirements needed by the properties in the portfolio. If this is not possible, you must make certain that each investment will generate a positive cash flow from the day it is purchased.

9.82. Will personal emergencies endanger my portfolio?

Several years ago, an investor by the name of William O. began investing in small rental properties. Since he could not afford to supplement the cash flow of those properties, he used extreme caution in selecting his investments. Shortly after he began investing, however, his three-year old son was diagnosed as having cancer. Luckily the disease was at a treatable stage, and William had health insurance that paid a major portion of the bills. Still, William wisely delayed expanding his portfolio until he was sure of the expenses he would have to pay for his sons's treatment.

The odds against emergencies like this are low, but gambling should be restricted to the casino; make sure you have something to fall back on.

9.83. What effect will a current liability have on my portfolio growth?

If you have a large amount of short-term credit payments, your ability to add properties to your portfolio will be limited. Furthermore, your increased debt will make new loans very difficult to obtain and you will not be able to add any capital to your portfolio. If you currently have a severe cash drain, build your portfolio slowly, using part of the portfolio profits to retire the short-term debt.

You should ask yourself these three questions each time you consider buying a property. Too many real estate investors consider them when starting their investment program, but set the questions aside as their portfolios grow. The result can be disastrous.

There is probably no greater truth in portfolio, balance and control than this:

A REAL ESTATE PORTFOLIO THAT PRODUCES PROFITS IS BUILT BY ADDING ONE PROPERTY AT A TIME.

What you need, then, is a system you can adapt each time you purchase a property. The ideas you have been learning in this course comprise just such a system. If you follow these steps carefully and prudently, your chances for achieving your goals with real estate are greatly enhanced.

9.9 CREATIVE ENDGAMES: STRATEGIES TO INCREASE EARNINGS

We end this course with a number of different strategies that you can use in diversifying your approach to portfolio development. We will consider, in turn, six strategies:

- Split and Double
- Controlling Your Portfolio Growth Through Diversification
- Exercising Risk Control
- Using Teams to Help You Control Your Portfolio
- Using Options
- Developing Real Estate for Profit

9.91. SPLIT AND DOUBLE

In building your portfolio, you might want to try a technique called "split and double." This technique could enable you to convert the equity of a single property into a property of at least double the value.

Here's how the technique works. Dean P. purchased a small duplex for $58,000. Then, using the techniques taught in this course, he increased the value of the property to $67,000 within nine months. At the end of nine months, Dean exchanged his equity of $9,000 for the down-payment on a four-plex valued at more than $120,000. The four-plex was an excellent investment and carried its own weight in his investment portfolio.

Now Dean had the same $9,000 equity in the portfolio, but the assets of the portfolio were valued at over $120,000 instead of $67,000. With an 8 percent appreciation rate, the value of Dean's real estate portfolio was increasing at approximately $800 per month, with the four-plex as the sole asset. (When the duplex was the sole asset, the portfolio was appreciating at only $447 per month.)

Of course, this "split and double" technique should be combined with balance and control in order to avoid the major problems that Mark (the first example in this report) met with his fifteen properties. Each investor must build his portfolio of properties around both short-term and long-term investment goals.

If your short-term goals are equity growth and capital appreciation, the properties you place in your portfolio will generally be highly leveraged, high-appreciation properties with low cash flows. As the portfolio grows in size and matures in age, you will buy properties that have lower financing and better cash flows.

9.92. CONTROLLING YOUR PORTFOLIO GROWTH THROUGH DIVERSIFICATION

One of the best ways to protect yourself as a real estate investor is to place in your portfolio properties of different value, geographical location, and size. Diversifying your portfolio in this way also increases your profits. Exactly how you diversify --which properties you choose and when you buy them--is based on your investment objectives. But remember: specializing is the key to establishing yourself as a successful real estate investor. Diversifying in the sense of buying different kinds or properties (office buildings, shopping centers, etc.) is for experienced investors only.

There are two basic reasons why diversification is in your best interests financially. Diversification (1) decreases the risk and (2) increases the yield.

1. Decreased risk. The more properties you own, the less dependent you are upon the performance of any one property. Thus, the chance that you will lose your entire portfolio because of one bad investment decreases with every profitable new property you buy.

George R. began investing by first drawing up a portfolio plan. Basing his decisions on this plan, he began placing properties in his portfolio that to the best of his knowledge, would break even immediately and within twelve months generate a positive cash flow. George was a knowledgeable investor, but he did make a mistake from time to time. After George had placed six properties in his portfolio, he bought a duplex that he believed he could improve through cosmetic fix-up. However, he wasn't able to rent the duplex until the cosmetic repairs were done, and once he got into the project, he found that the needed repairs were more structural than cosmetic. George had neither the cash nor the desire to do the structural repairs, and so returned the property to the previous owner (which he could do because the exculpatory clause in his purchase agreement allowed him to do that.) Consequently, he lost his original investment of $1,800 and the $1,692 he had paid on the mortgage during the three months he held the property.

If George had only had the one property in his portfolio, the $3,492 he lost might have destroyed his entire investment program. But by the time that George made the investment, the other six properties were generating enough cash to cover the monthly payment deficit. Furthermore, he had saved the $1,800 down payment from earlier cash flows. He still realized a loss of almost $3,500, but thanks to diversification, he only lost that one investment, not his entire portfolio.

In beginning, you should select small properties in different geographical locations. Then as your portfolio grows, you can use the split-and-double technique discussed earlier to consolidate some properties while maintaining a diversified portfolio.

2. Increased yield. Diversifying your portfolio increases your profits in three important ways:

First, if you have purchased your properties using nothing-down or little-down techniques, you could enjoy appreciation on several properties instead of only one.

Second, the portfolio is more liquid. You can sell, exchange, or refinance one or more of the properties while leaving the other investments alone to appreciate or bring in rents. For example, Jerry K. had build a portfolio of seven different investment properties. Five of the properties were single-family homes used as rentals, one was a duplex, and one was an eight-unit apartment building. One day, Jerry found an additional six-unit apartment building that could be bought for less than $5,000 down. He didn't want to disturb the equity in his investments if at all possible, so he decided to refinance one of the first properties he had purchased.

With funds from the refinancing, he was able to purchase the six-unit apartment building, and with the positive cash flow from the rest of the portfolio, he was able to pay for the $5,000 loan. Without his portfolio, Jerry would have had a much more difficult time refinancing such a large property and the refinancing expense would have been much higher because it would have been tied to the total mortgage price of the new loan.

Third, diversification allows you to meet more than one investment objective. Most investors have different objectives to meet at different time. If the investor needs cash for education, he doesn't need to sell or refinance his entire portfolio to get the money.

Darlene S. had built a portfolio of five small properties. As one of her investment goals, she had planned to eventually take out sufficient equity to fund a retirement trip for her parents. Because she was diversified, she was able to sell one of her properties to pay for the trip when the time came. If she had not diversified her portfolio, she would have had to take more dramatic and expensive steps to accomplish the same goal.

9.93. EXERCISING RISK CONTROL

Whether a real estate investment succeeds or fails depends on both the investment and the investor. Both elements are critical, and both have their own forms of risk.

Category 1. Investment Property Risk

The risks associated with the investment property itself include:

* Insurable risk
* Investment (business) risk
* Financial risk

1. Insurable risk. You can lose your investment if fire, flood, or some other natural disaster destroys the property. This risk is low, however, and can be controlled by purchasing an insurance policy against such loss.

2. Investment (business) risk. If an investment property is not managed correctly, expenses associated with owning the property can very rapidly eat up any profits in it. If that happens, the property is not worth the same market value as it was when you bought it. For example, if tenants are not kept happy or if the property is not protected against the wrong kind of tenants, the vacancy rate may increase or rental rates go down. In either case, the property loses value.

This investment risk can be controlled through effective management techniques. Early in your investing career you may need to manage your portfolio personally, but once you can afford professional management, you should do so. Your time can then be used to control and balance your portfolio of properties.

3. Financial risk. Risk increases as the ratio of debt service to net operating income increases. High leverage financing can produce exceptional by high rates of return on the actual cash invested, but it can also increase the risk of investment loss if you cannot meet the debt payments.

The best way to control this risk is to use options when purchasing property you plan to resell immediately, to obtain realistic and reasonable financing terms when purchasing the property, and to include an exculpatory clause if possible.

Category 2. Investor Risk

There are many things an investor can do, foolishly, to increase the possibility his investments will fail. The main risks are in:

* Being too aggressive
* Speculating rather than investing
* Investing with too little capital

1. Being too aggressive. If an investor fails to plan his portfolio and map out his investment strategy, he may purchase too much property too quickly, acting out of emotion rather than reason. Remember Mark, at the beginning of this report? This was his problem, and the reason he lost his entire portfolio. The key to building a successful portfolio is to start small, buying one property at a time, doing so only after a careful review of your financial resources.

2. Speculating rather than investing. Some neophyte investors are tempted to try making their fortune on a single transaction. The potential is certainly there, but the risks are very large.

Still, speculating can be done--if you never commit more than 10 to 15 percent of your real estate investment capital in such projects. Another safeguard is to use options. In this way, you can try making it big all at once with minimal capital investment and risk.

3. Investing with too little capital. One of the major problems for many investors trying to build a real estate portfolio is that they do not have the capital necessary to increase the growth of their portfolio as rapidly as they want. Capital cannot be created simply by imagination. It is possible, however, to expand your portfolio by arranging joint ventures, employing partnership arrangements and using wise nothing-down techniques.

9.94. USING TEAMS TO HELP YOU CONTROL YOUR PORTFOLIO

As your portfolio increases in size and value, you will find it necessary to use outside professional help in reaching your investment objectives. These professionals all charge a fee for their help, but if they provide a margin of safety and increase profits, their advice is worth every dime. The professionals that you will find most helpful are:

- Accountant
- Appraiser
- Architect/engineer
- Broker
- Insurance broker
- Property manager
- Lawyer

9.94-1. Accountant

A professional accountant can audit and analyze your finances, prepare your taxes, draft loan documents and financial reports, and make valuable suggestions for improving the cash flow of the entire portfolio.

When Steven and Sally M. began building their portfolio, they realized that they would need the help of an accountant, but they knew they wouldn't be able to afford one until the portfolio was producing a regular cash income. As soon as this happened (after the purchase of their fifth property), they engaged a professional accountant for an hourly fee. The accountant showed them how to organize their portfolio and prepare their tax records. His fee was more than offset by the tax savings his advice and expertise earned for them.

9.94-2. Appraiser

An appraiser can estimate property values for exchanges, sales, and refinancing. He can also do marketability studies and make feasibility reports for the development of portfolio assets. Most appraisers can be hired on a one-time basis and are paid a fee based on the work performed.

9.94-3. Architect/Engineer

An architect or engineer is most helpful in you have a portfolio that includes some development real estate. In fact, it is dangerous to buy such properties without securing the services of an engineer or architect. They can also provide valuable cost estimates for completing development work.

9.94-4. Broker

Many real estate investors want to sell their properties by themselves. But the portfolio increases in value and size, a real estate broker can be a real asset. He can help market properties. He can watch for properties you might want to purchase. And he can provide valuable information only a broker would have access to. It is important, however, that the broker follow your guidelines. If he is unfamiliar with nothing-down techniques but is willing to learn, give him a try. After a few purchases, the broker may have learned enough about nothing-down techniques to provide a valuable service for your portfolio.

9.94-5. Insurance broker

Insurance brokers are paid by the companies that insure your properties. You will want to decrease your insurable risk by working with a qualified insurance broker who can provide the liability and casualty insurance you need.

9.94-6. Property manager

As you increase the number of rental units in your portfolio, you will want to consider engaging a professional property management firm. Good property managers can increase your rental receipts and lower your overall expense costs. Steven and Sally learned that with a professional property management firm, they were able to dedicate more time to portfolio management and increase their total equity much faster.

9.94-7. Lawyer

A lawyer can assist your accountant in his work and help in estate planning and tax shelter selection. He can also protect you by reviewing legal documents and sales agreements.

When Steven and Sally retained a lawyer, they went to one familiar with real estate transactions. However, before retaining the lawyer, they made sure that he was comfortable with their portfolio strategy and investment objectives. Once they knew they could trust his advice, they never purchased or sold a property without consulting him.

The key to using professionals is finding people you feel comfortable with and who will increase your profits. As long as the value of the services they provide equals or exceed their fees, they can be worthwhile additions to your portfolio management team.

9.95. USING OPTIONS

The astute investor will always have "options" on his/her mind. An option allows you to gain control of a property without having to purchase it until a later date. When you negotiate an option with a seller, you pay a certain sum of money for the right to purchase the property for a designated price within a specified time frame.

For example, let's say that you locate a twelve-unit apartment complex offered for $360,000 and your analysis indicates that the property would be an excellent addition to your portfolio. However, for financial reasons you cannot swing the deal for at least eighteen months. What can you do to hold on to that opportunity? You can offer the seller an option for, say, $3,000, to be exercised within eighteen months at a price of $400,000. The future purchase price is something you guess would be appropriate at that time. If the seller accepts, he might be guessing that his property might not quite appreciate that much in a year-and-a-half, or he might simply be betting that you will actually follow through with the deal and he will have sold his property for an acceptable price. If you do not follow through, then he will be $3,000 ahead of the game and have the use of that money for up to eighteen months without having any tax liability for it until after the option is exercised or expires.

Meanwhile, you have "control" of the property in that no one else can purchase it during the option period unless you decide to let it go. If someone does come along and make a better offer, you could always sell your right to buy the property for a "price," which might be many thousands of dollars. To prepare for this possibility, you should make sure that your option agreement contains wording that allows you the right to sell your option to another party. Also, make sure that you record your option agreement with the county recorder so that the seller cannot option is off or sell it to someone else in the meantime.

During the option period you have no management hassles or concerns with the property, since the owner has not sold it yet. You do not have to worry about taxes, either. It is a good way to have your cake and eat it, too. We have provided a copy of an option agreement at the end of this unit. You can obtain similar forms from your local office supply store.

Here is an example of how an option can work to your advantage in the words of Bob Allen:

"Some time back, I was looking at a 100-acre parcel of ground in a growing area which the seller wanted to sell in one large package for development of housing tracts. He wanted $18,000 an acre, total price of $1,800,000. There were no loans against the property. $1,800,000 is a very large amount of money. And it would probably take from three to five years to be able to develop that 100 acres of ground in this particular community. This would mean that if I purchased that ground now, I'd either have to have $1,800,000 in cash to invest and to tie up for a five-year period of time, or I would have to pay interest on that land as I purchased if from the seller. And that is not palatable either; 10 percent interest on $1,800,000 is well over $180,000 a year in interest alone just to carry the land. I proposed to him that I pay him the cash and have him deliver five acres free-and-clear (5 acres x $18,000 = $90,000). Inherent in the purchase of the initial five acres was an option to be able to purchase 10-acre tracts thereafter each year for the next five years until the entire project would either be developed or the options would be relinquished.

"In other words, I would buy a tract of land with a $90,000 down payment. I could develop it, build houses on it, take my profit and buy another ten-acre tract of land. If I continued to have success, I could roll my option to the next parcel of ground and continue rolling that option from tact to tract to tract until the final 10-acre parcel was completely developed. I would not have to have high interest carrying costs, but the options that I would negotiate with the seller would be at higher and higher prices per acre until at the end of five years the seller would still make the same amount of money but would eliminate the necessity for me to have to carry that in monthly interest payments.

"This form of an option is called the 'rolling option.' I buy one piece of property with the option to buy another piece within a certain period of time and to roll that option to the next piece of ground until the entire parcel is finished. This approach is very common and predominant in the land development business."

There are many variations to this form of agreement. For example, you do not have to offer money for the option amount. You could offer other real estate property or paper or personal property, with the pledged consideration passing to the seller at the end of the option period. You also can use the ordinary Earnest Money Agreement as a short-term option.

9.96. DEVELOPING REAL ESTATE FOR PROFIT

In earlier reports we have walked through the crucial steps of finding and purchasing good real estate investments. By applying the ideas we have discussed, you will be able to gradually establish the financial independence you have dreamed about for so long.

One way is to establish that independence is through developing your own properties. Developing is not without its risks, however, and first time investors enter the development arena with no more chance of success than a bull in a bull fight. They are excited about the possibilities and eager to begin earning large profits. But they fail to realize that the profits can be earned only if they understand the perils and pitfalls.

How can you generate profits in an area of real estate that is known for its tremendous risks and liabilities? This final section will discuss a plan that will show you:

* Which properties hold potential development profits and which ones don't.

* What you must include in your purchase agreement in order to protect your future profits.

* How zoning can make or break your real estate development.

* How to control development property with no risk and no finance charges.

* Why one developer can make a profit when another developer can't - with the same real estate!

Profits through development may be as close as the ground you are standing one. Increase your understanding, practice what you learn, and profit from your real estate developments.

As you read this section, keep the following points clearly in mind. They will help you understand and apply the concepts discussed.

* Good development property may be found in all locations. Developing a property if your site analysis says "no" is an invitation to failure.

* Analyzing the market demand for the completed development is an important as finding a property that can be developed. Profits from real estate development may be eaten up by interest and carrying costs. It is vital, therefore, that you gauge a property's marketability before you begin developing it. Otherwise, you aren't developing--you are speculating!

* Zoning laws were not passed down from heaven. Don't be afraid to try to change them. You won't succeed every time, but when you do, the profits can be immediate and sometimes enormous.

* Developing a property consists of several vital steps. Don't skip any of them. You may regret it all the way to the poorhouse.

9.96-1 HOW TO RECOGNIZE GOOD DEVELOPMENT REAL ESTATE AND TURN IT INTO A PROFIT

So you'd like to make money--a lot of money--by developing real estate? If you know what you're doing, it can certainly be done.

Chuck M. did by predeveloping properties in

Wisconsin. In his first experience, he found seventeen acres of farm land that had gradually been surrounded by a growing city. The owners had purchased the land years before, but had done nothing with it. It was still zoned as farm land, Chuck paid a good price for it as such. He immediately went to the zoning commission, requested and received a zoning change, and immediately resold the property for a $168,000 profit. He was off to a running start toward his first million.

Can others do the same? Absolutely! This section will show how to make it happen.

WHAT IS A GOOD DEVELOPMENT PROPERTY?

Real estate that can be developed for profit is more than just bare ground. It is property that someone else wants--they just don't know it yet!

Success in development depends first and foremost on your ability to locate unimproved real estate that <u>can be quickly developed and marketed</u>. To take the opposite approach--to buy real estate without knowing how you are going to use it, who you are going to sell it to, and how long the entire process will take is a quick road to unproductive debt and the fulfillment of your wildest nightmares!

Development property can be divided into two main categories. First is the type of property that can be immediately resold, once the use is defined, without further development. This type is commonly referred to as "pre development property." The second type of property is called "completion development property"--the developer retains ownership until the development of the property is completed and ready for use. Both types of development can be very profitable.

Let's look at these two major categories and decide what characteristics each possesses.

<u>Pre development property</u>

Highest and best use not established

Zoning may be changed, altered, or varied

May be an infill development

Purchase price set according to existing zoning

Market demand is very high for proposed use

<u>Completion development property</u>

Highest and best use established but not functional

Zoning changes completed

May be infill or growth development

Purchase price set, allowing for profits from construction and marketing

Market demand is very high for completed use

CATEGORY 1 - PRE DEVELOPMENT PROPERTY

<u>Highest and Best Use Not Established</u>

Pre-development has characteristically been used in a way that has not brought the owner the highest return it could. When Mary and Helen F. were growing up on their farm outside of town, for example, their father always told them that the value of the land was in what it produced. Both girls eventually married and later inherited the property from their father. As the years went by, Mary's and Helen's new families moved form the area and leased the farm to a neighbor who continued to grow hay on it. Although the town eventually grew up to and around the farm, Mary and Helen continued to lease the ground out for less than $100 per acre. If the twenty acre farm were developed into building lots, the value of the ground would be as high as $30,000 per acre. In this case, Mary and Helen are not using the property to its highest and best use.

Charles A., on the other hand, turned a vacant lot into a modern office building worth over $300,000. When he graduated from law school, he established his law practice in a large metropolitan city. After looking around for office space, he decided to build an office building he could use and rent out to other attorneys. Within tow weeks he found a piece of vacant ground that was part of a public school parking lot. The school had closed down years earlier, and the buildings and immediate surrounding property had been sold to a private research foundation. However, the property that Charles wanted was still owned by the school and he was able to buy it for $36,000. The rent from the office building he built on the lot more than paid the monthly premiums on the loan he took out to build it.

A good way to begin your development career is to drive through your own city and write down the addresses of all the vacant ground that interests you, listing the existing use and any proposed uses that may seem compatible with the neighborhood. Once you have done this, you can begin looking at zoning.

<u>Zoning May Be Changed, Altered, or Varied</u>

When looking for pre-development property, you need to check the local zoning laws to see if your proposed "highest and best use" of the property would be permitted. If it isn't, the land may be worthless as an investment--you would be able to sell it only for the price determined by its existing, undeveloped use.

Let's return to the discussion of Mary's and Helen's twenty acre farm. They finally decided to sell their farm and to divide the sales proceeds between them. A professional appraiser told them that the property was worth $3,000 per acre as a farm. It had never been annexed as part of the city, and neither Mary nor Helen know how to complete this process. (They hadn't considered annexing it earlier because their taxes would have gone up considerably.) The two sisters received an offer to purchase their property for $4,800 per acre. The offer contained certain contingency clauses and option rights that allowed the new owner to apply for annexation and to request certain city zoning. The sisters accepted the offer, and after about ninety days the closing was completed. The new owner promptly resold the property to a

local builder for $14,800 per acre. His total pre-development profits: $200,000.

As a developer, you always need to look for those properties where the existing zoning may be changed to permit a "higher and better use." Your ability to purchase and market such properties is your ticket to financial wealth.

<u>May Be an Infill Development</u>

As towns grow into cities and cities expand into urban areas, development is not always consistent and uniform. When certain properties surrounded by new developments, the vacant property is said to be an "infill property." Because the property was never developed, chances are that the highest and best use was never established, since the existing zoning on the property have been established many years ago. These properties are prime candidates for healthy profits.

Mark R., for example, owned a chain of convenience stores in the western United States. He operated the business with his sons and wanted to expand into several metropolitan areas. Mark explained his desires to a close friend, and asked him if he knew of any properties in central locations. Mark's friend said that he would look candidly "but I'd like to make a profit on the transactions myself," the friend candidly told him. Mark said that he didn't mind, as long as he got the property at a fair and reasonable price.

The friend, Lou H., began looking for properties that might be good locations for convenience stores. Lou found two properties and he got options to purchase both of them, along with the right to change the zoning if he desired. Both of the properties were infill properties surrounded on all sides by developed commercial and residential developments. When the transactions were completed, Lou had changed the zoning on only one property (the other didn't need it), but he made a profit on both of them. And Mark was very pleased with the new properties he had acquired.

<u>Purchase Price Set According to Existing Zoning</u>

If the owner has established the purchase price of a pre-development property according to the existing permitted uses, and you can improve those uses through zoning changes or variances, then you may be able to make a quick profit by immediately reselling the property.

In the mid 1970s, Gary C. moved to a city in the Midwest. He discovered this characteristic of pre-development property almost be accident. Having read some books and having attended several seminars on real estate, Gary was convinced he could make a profit by having homes built and then selling them in the retail market. He found an oversized lot in a beautiful area of the city and made an offer to purchase it. He included language in his offer that allowed him to apply for a building permit and to request variances to the zoning. After having the property surveyed, he found that the lot he was going to purchase was only fourteen feet short of being wide enough for two lots. He went before the planning commission and requested a variance that would let him build two houses on the property with each house having a lot that was seven feet narrower.

His variance was granted. After the meeting, a neighbor in the area asked him if he would sell one of the lots. Gary said he would and quoted him a price. The price was low enough that the neighbor asked to buy both lots. Because the price was almost double what Gary was going to pay for the lots, he agreed. A simple trip to the Planning Commission had netted Gary a profit of may thousands of dollars even before closing on the purchase of the property.

If you want to make an immediate profit on pre-development property, buy the property at the price set by the existing zoning uses, then use legal means to improve the use of the property and thus increase its price.

Market Demand Is Very High for Proposed Use

Even if the property meets all the characteristics we have just reviewed, you won't be able to make a profit from an immediate resale unless the demand for the best use of the property is very high.

For example, the neighbor who purchased Gary's new loan was confident that there was a demand for new housing in the area. If this had not been the case, he would not have purchased the property.

Let's consider what happens when the demand for a proposed use is not high. A few years ago a young college graduate named Marlyn J. decided to develop real estate residential lots. The property was in a nice area that was experiencing some growth. When Marlyn closed on the property she wasn't sure when she would be able to sell the lots, but she was confident that she could do so. In this she was a little naive. She should have paid attention to the large number of new homes on the market and the fact that very few new houses were being started. There were actually several developments with completed roads and utilities that still many unsold lots.

Marlyn went ahead and marked up the property enough to give her a good profit and still allow a builder a discount for buying all the lots and putting in the utilities. Because lots were not selling, Marlyn ended up holding the property for almost three years before she sold it. Although she sold it for slightly more than she paid for it, she still lost a good amount of money. She had financed almost 90 percent of the purchase price and had paid 16 percent interest for almost three years. When her accountant did her taxes, she had lost almost $11,000 on her development.

This does not have to happen if you gauge the market demand correctly before you close the purchase. If you are wise, you will also further protect you profits by using some of the tips on financing you will learn later in the report.

CATEGORY 2 - COMPLETION DEVELOPMENT PROPERTY

Highest and Best Use Established but not Functional

Sometimes when you establish the highest and best use for a property, you will discover that you can generate higher profits by controlling the property through actual construction of the building or buildings that will occupy the site. Here's an example.

Dan S. was a builder who had constructed several large shopping centers for a hefty profit. He was more than ready, therefore, to purchase two acres from another developer who had gone through the entire predevelopment process. He bought the property as shopping center property and paid a very reasonable price for it. After he finished the shopping center he sold it to a management company and made a profit both on the buildings and on the property.

You, too, can make a profit from "completion development property," but you need the expertise and professional experience to complete the development. The profits you will make are deprived from actually developing the total construction project, not in just preparing the property for construction.

Zoning Changes Completed

As a developer of completion development property, you are not concerned with changing or altering the zoning. The use to which you intend to put the property is already permitted by existing zoning.

Ron R. bought a residential subdivision of twenty-two building lots for $18,000 per acre. It had been filed with the county recorder, which meant that all zoning requirements had been established and met. No work had been done in the subdivision, so he put in all the water, gas, and power lines, as well as the roads, sidewalks, curbs, and gutters. When he finished, Ron sold the twenty-two lots to five different builders. Even though Ron didn't build the houses, the investment was still a completion development property for him, since he completed the utility work necessary to sell the lots.

May Be Infill or Growth Development

Infill property, as we discussed earlier, is property that has been surrounded by other developments. "Growth property" on the other hand, is property that is developed as the city expands into the area. If all the zoning requirements for the best use of such properties have already been met, the developer need not be concerned with whether the property is infill or growth property.

Wally N. owned a development company that built movie theaters and then leased them to major distributors. Wally bought sites for the theaters in urban areas surrounded by other developments and in new shopping malls and strip shopping centers that were part of major residential developments in California. As much as possible, he tried to find infill properties located in the inner cities because the cities would often provide special financing to get these sites developed. Cities generally believe that the completion development of infill properties strengthens the cities and surrounding areas.

Purchase Price Set, Allowing for Profits from Construction and Marketing

The purchase price of a property is largely determined when the zoning is established for the highest and best use of the property. The actual sales price of the property must also take into account the cost of the property's construction and marketing.

Trisha H. built townhouses in small twenty fifty unit developments. Whenever Trisha bought the property for her townhouses, she projected profits from the actual construction of the townhouses and from the sales commissions or marketing fees for the individual units. She was not concerned with making a profit on the ground, only on the actual completed units. Because she sold these units through her own company, she also expected to make a profit from the marketing or sales of the units.

Market Demand is Very High for Completed Use

This is the most important factor to consider when contemplating buying property and building on it. If you build something you can't sell, lease, or exchange, your profits will evaporate very rapidly. You must be able to assess market demand, not only for your type of property, but for your specific property as it will be constructed.

By now you probably have decided that you would feel more comfortable pre-developing a property. And, in fact, we suggest that novice investors concentrate on these kinds of properties. They require the least amount of experience and can still generate substantial profits. But if you feel that you have the skills and interest to specialize in development property, go for it. But first thoroughly assess your ability to follow through on the construction and marketing of a project.

9.96-2 HOW DO YOU ESTIMATE MARKET ACCEPTANCE?

To determine a realistic estimate of the market demand for your property, you must inspect the site. This includes a physical inspection of the property and a perusal of the property's legal description. In doing so, you are trying to assess the property's development possibilities and marketability.

The importance of doing site analysis on every property you consider can't be over-stressed. The experience of Ted G.

illustrates. Ted had sold real estate for just over six months when he decided to go into real estate development. He had been successful in selling a few homes, and thought he could make a profit buying and selling pre-development real estate. While Ted drove around town, he found many potential development sites. He completed a handwritten site analysis on each one. After his sixth site analysis, he was sure that he had found a property that would make an ideal fast-food outlet. He obtained the property through a real estate option that allowed him to do whatever was necessary in order to develop the property. His option was for six months, plus extensions, and during that time Ted changed the zoning and sold the property with a simultaneous closing to a major fast-food franchise. His profit was over $36,000. Ted's homework in preparing a site analysis was a major reason why he was successful in his first development experience.

A good site analysis will consider the property's:

* Legal description
* Physical land characteristics
* Land Parcel Characteristics
* Development possibilities
* Market ability and best use analysis
* Financing
* Construction
* Marketing

As you can see, the data you must collect is lengthy, but it is important. If you are concerned only with pre-development property, you will still need to complicated form for this, just a pad of paper and pen. Or use the form we're providing in this section. (We're including the form here to give you an overview. You'll understand all the parts better once you've studied the entire section.)

SITE ANALYSIS FORM

1. What is the property's legal description?

2. What are the property's physical characteristics?
   a. Soil quality?
   b. Topography?
   c. Subsurface conditions?

3. What are the land parcel characteristics?
   a. Size of property?
   b. Slope?
   c. Access to transportation?
   d. Nature of adjoining property?
   e. Zoning and building codes?

4. What are the development possibilities?
   a.
   b.
   c.
   d.
   e.
   f.

5. What is the best use of the property?

   What is its marketability at that best use?

   a. Economic growth patterns?

   b. Employment trends?

   c. Housing market?

6. What financing can be arranged?

7. What construction is needed?

   Who can best do that construction?

8. What is my marketing plan?

Legal Description

This may sound basic, but you need to make sure that you are investigating the property. If you have the property's address, you can go to the county recorder's office and get a complete legal description. Once you have this information, you can determine if the property is part of a larger piece of property, and if it is <u>the actual property</u> you were looking at. You will also be given the property owner's address.

Studying a property's legal description can often save you a lot of time. Evan I., for example, drove by a piece of property that appeared to be about 200 feet across the front and 600 feet deep. He had a proposed use in mind for it, but he needed to make sure it truly was at least 190 feet wide. When Evan went to the courthouse, he found that the legal description said the property was only 181 feet wide. Without this information, he might have made a foolish decision to invest in a property that wasn't suitable for his needs.

<u>Physical Characteristics</u>

When you are writing down information about the land itself, you will be concerned with the following characteristics, not only of the land you are looking at, but of the surrounding property as well.

1. <u>Soil quality</u>. Note the type of soil. Is it sand, clay, or something else? If you are going to develop residential lots, you need not be too concerned with the ability of the soil to withstand a heavy load. But you definitely would be concerned if you were going to construct a twelve-story office building!

2. <u>Topography</u>. How does the ground lie? Is it level? Would it be best suited to residential, commercial, or some other type of development? This information may be critical when you start to determine where the buildings will eventually go on the property. Dick L. was interested in buying some hillside property that could be subdivided "on paper" into twelve individual lots. But after looking at the actual topography, he found that the terrain would accommodate only

seven lots. As you can see, the topography of a property can make a dramatic difference in the value of the property.

3. Subsurface conditions. How high is the water table in the area? Is there any mining nearby? In the early 1980s, major "sink holes" appeared in several cities in the western part of the country causing millions of dollars in damage. Eventually someone will build some type of building on your development. If the land proves unstable, you could be involved in a law suit.

Land Parcel Characteristics

An examination of the property and of its legal description can provide you with some important information about the land.

1. Size of property. This may be determined form the legal description. If the parcel is part of a larger property, you may want to purchase a survey of the property or at least make your offer subject to that survey. If you don't have a survey, you can use a fifty-foot tape and estimate the size. You will need to know both the dimensions of the property and the total number of square feet.

2. Slope. The slope of the property will indicate whether the development will need to be filled in, cut back, or have other earth-moving work completed.

3. Access to transportation. If you are developing residential or commercial property, you need to know what transportation routes are available. Failure to do so can be costly. Mitchell F., for example, purchased a piece of property for an office complex but did not check on the permitted access from a state road. After closing on the property, he found that he could not enter his new property from the state road. The tenants of the building would have had to take a six-block detour through a run-down section of the city in order to get to the property. Needless to say, Mitchell never developed his property, and to this date has not been able to sell it.

4. Nature of adjoining property. The value of any

completed development will be partially determined by the surrounding area. Beautiful lots in a run-down area will not bring the same prices that they would in a well-cared-for area. An office building's value will be determined by the rental income of that property, and rents will vary according to the tenant's perception of the neighborhood.

5. Zoning and building codes. Once you have located the legal description of a property, you can go to the local planning office and find out what zoning is permitted. Before you do, though, look at all adjoining property and see if that zoning may be more favorable than your present zoning. It is extremely difficult to get a zoning change for one piece of property when the other property in the area is zoned differently.

Development Possibilities

As you complete your site analysis, begin to look at the wide range of development possibilities. The following types of projects have generated profits for developers all across the country:

* Single family homes
* Townhouses
* Apartments
* Condominiums
* Office buildings
* Shopping centers
* Retail stores
* Medical buildings
* Industrial warehouses
* Distribution centers
* Manufacturing plants
* Recreational developments
* Mobile home parks
* Automobile service centers
* Automobile dealerships
* Theaters

Marketability and Best Use

Once you have determined what kinds of developments are possible on the property, narrow your choices down to that use which will raise the value of the property, as high as possible. Make sure, though that there is an above-average demand for your proposed use of the property in the market place. As you complete this analysis, pay special attention to the following:

1. Economic growth patterns. This information will help you determine in which areas the city is growing, where the people are choosing to live and to shop.

Harold S. used this kind of information to escape a serious debt and make a tidy profit. He was completing his first site analysis and had selected several possible uses for the property he was looking at. Almost all of the uses involved selling residential living space. When he checked with the local Board of Realtors, though, he found that fewer homes were sold in the current year than in each of the past three years. With this information he was able to determine that the highest and best use of the property was probably not residential housing. He went back to his list of possibilities and found that he could get a conditional use permit for a medical building. The hospital was directly across the street. No need to say more!

2. Employment trends. The employment rate in your area has a definite influence on the highest and best use of development property. If employment in your area is up, for example, then developing shopping center or retail store would be a logical choice, since more and more people will be spending more and more money. Of course, the overall demand for any development property is tied to the economy. If the economy is doing well and expanding, then development should be good. If the economy is down or stagnant, almost any development could face some major problems.

3. Housing market. This part of your site analysis considers the need for new housing. If growth patterns and employment trends are up, you would naturally think that the demand for housing would also be up. But this isn't necessarily so. If an area has been overbuilt; meaning there is an over

abundance of available housing on the market; the best use for a property may be something other than residential.

Financing

When you are doing a site analysis, review the situation of the seller. Will he be willing to carry the financing on the project while you develop the property? You must also determine if there are potential financing sources for the completed development. If the highest and best use of the property is deemed to be apartments, but there are no lenders who are making income property loans at competitive rates, you will need to look at another use for the property.

If financing seems difficult to arrange, consider seeking a joint venture with the existing property owner. You give him a percentage of the property, and he gives you the equity in the real estate at no interest.

Whatever you choose as the highest and best use under existing or proposed zoning, you need to consider the financing arrangements. Pay special attention to the section later in this report on protecting your profits through proper financing.

Construction

If you are a beginner in real estate development, you may want to consider only pre-development property. But if you want to do the final construction of a project, you must consider your ability to follow through on the construction.

Skip P. had completed a site analysis and decided that there was a terrific demand for a stand-alone movie theater on a piece of infill development property. Skip had the resources to finance the property purchase and building construction, but he had no building or construction experience. So he went to several friends and business acquaintances and asked for references for good builders. When he found that three people recommended the same individual, Skip offered him a percentage of the profits on the project in return for building the theater at cost. The builder agreed, and both Skip and the builder were able to turn Skip's theater idea into reality.

Don't be afraid to use professionals who can do the construction for you. These people may be able to insure that you get a quality development, and some may also even participate in the financing.

<u>Marketing</u>

If you plan to build on a property, never put a dime down unless you have a good plan for marketing the developed property. However good the development concept is, it can turn into a real lemon if you don't have a realistic plan for selling the developed property for the highest amount, in the shortest period of time. This may sound simple, but the lack of marketing foresight has caused more developers to fail than any other reason.

Answering the following questions will help you to develop a workable marketing plan.

1. Have I really identified the highest and best use for this property?

2. What is my competition for that kind of use? Is there is glut of such properties in town? How about in my area of town (meaning the area of the property)?

3. Who are my most likely customers for that use of the property?

4. How can I find those customers who would be willing to locate in my area?

5. What are my best selling points? How can I best convince prospective customers that my development is the one for them?

If you're still uncertain how to market your development, you would be wise to engage the services of an expert. Find a Realtor who specializes in marketing the kind of development you have in mind. Meet with him and pick his brain. Learn all you can from him. Find out what his commission rate is. Then, before you ever sign on the dotted line with the seller of the property, sit with the Realtor and map out the plan you'll use (or he'll use) in marketing your development.

This point is so important we repeat it:

Have your marketing plan in mind before you exercise your option to purchase the property.

9.96-3 WHAT MAKES ZONING THE KEY TO SUCCESS?

Each local government has established zoning regulations and laws to protect the interests of its citizens. As we noted earlier, these regulations did not come down from heaven written on stone tablets. Rather, they were decided upon and voted into existence by local planning officials. Some zoning regulations have been in existence for decades. Your ability to work with these laws and regulations, and to change them when possible, will be your ticket to large profits as a real estate developer.

D&D Development, for example, was a company that built middle income apartments. When two national major employers moved their production and manufacturing facilities to their city, D&D knew that more housing would be needed and that development sites were available. D&D completed a site analysis on a piece of property contiguous to a multiple family area, but found that the property was zone only for single family units. After completing their analysis, they requested a zone change that allowed for eight apartment units on each average sized lot. Permission was granted and D&D increased the value of that property over 400 percent.

When you are considering developing property, the first thing you should do is find out if you can upgrade the zoning.

Here are the basic zones that a city will have.

* Residential single family
* Residential multiple family
* Commercial
* Industrial
* Rural
* Special (e.g. flood plain)
* Mixed use (e.g. PUD)

When you are checking the zoning on a property, look beyond the use put to it by the present owner. It is possible that the zoning laws have changed and the present use would not be permitted if the property were transferred.

One aspect of the zoning laws that can make a profit for the developer concerns "non conforming use." This allows the zoning on a specific property to be changed without changing the zoning of the entire area. If your site analysis and property review have indicated that the highest and best use of the property is for a use not currently permitted, try to apply for a non conforming use permit.

When you are preparing to buy a property with an eye to securing a nonconforming use permit, you may be able to increase the value of the property without major expenses. Make sure that you include contingency clauses in your purchase agreement that allow you to back out if you are denied the nonconforming use. This is essential, since your profit comes from your ability to upgrade the zoning of the property without getting a complete zone change.

How do you go about requesting a zone change or variance? Any request for a variance or zone change must be made at your local planning commission. Be prepared to argue the best case you can for your proposed zone change, because you may face some opposition from neighbors or other interested parties when you go before the hearing board. The best thing to do in such a case is to work with these people, showing them how your application is in the best interest of all concerned.

Here are a few ideas to help you work effectively and successfully with your local zoning authority.

1. Prepare your case to show that you are asking for reasonable relief from a hardship you did not create.

2. Strategically use experts and professional testimony when arguing your case.

3. Go to neighboring property owners, explain what you would like to do, and request their cooperation.

4. Prepare a petition or agreement to be signed by neighboring property owners.

5. Consider negotiating with objectors at the hearing.

Most opposition to zoning changes comes from people who tend to oppose any change. But if you can show them how your change will not have a detrimental effect on their property, most owners will be willing to cooperate.

William O. had found a piece of property bordering a multi-family residential zone. It was currently zoned single-family residential, but after completing his site analysis he decided to apply for a zoning variance to have the property zoned for multi-family residences.

He anticipated some opposition from neighbors, so he went to as many as he could and described the type of development he was contemplating. He explained how the vacant property was presently an eyesore and that the increased traffic would most often use the access through the existing multi-family residential zone. At the hearing, he had a professional appraiser explain how his development would not decrease the value of the adjoining property, and local architect explained how the proposed development would enhance the entire neighborhood. When the opposition stood to object to his request, William was prepared with a list of other property owners who had signed a petition requesting that his zoning request be approved.

When the council voted on William's request, they approved the variance five to two. If he had not, been prepared, the opposition would probably have won, and William would never have made his development profits.

Zoning laws can create the potential for substantial profits in other ways as well. When an area is growing and zoning regulations are put in place, certain parcels of ground are sometimes left undeveloped because they do not meet the size requirements or some other criteria that the new zone required. A typical example would be a property in a commercial zone that did not have the required one hundred feet of frontage and ten thousand square feet in order to qualify for a commercial structure. Such "undersized lots" and "substandard lands" exist primarily in infill development areas and can often be purchased for a song. If you can get a variance approved, you can enjoy some very nice profits on your investment.

Henry M. lived in a metropolitan area in California. He noticed a vacant lot that appeared to be about 75 or 80 feet wide and possibly 100 feet deep. It was an excellent location for a small real estate or insurance office. After conducting a site analysis, he discovered that the lot was 23 feet too narrow and 1800 square feet too small. The property owner also knew this and was offering to sell the property for $2.40 per square foot. Surrounding properties that met size and frontage requirements were going for almost $6.00 per square foot. Henry made an offer to the owner for $2.25 per square foot, but with an option that allowed Henry the right to apply for any variance necessary for the construction of a commercial building.

When Henry went before the planning commission, he explained that the property was "substandard," through no fault of any property owner (but was large enough) to build on. After a well-prepared presentation, he got the variance approved and subsequently sold the property to a national insurance company for $5.60 per square foot. He realized a profit of nearly $27,000 on the transaction.

As you can see, the profit potential in getting zoning changed is substantial. You may not get every variance approved, but when you do, you will instantly reap some large profits.

9.96-4 HOW DO YOU WRITE AN OFFER FOR DEVELOPMENT PROPERTY THAT MAKES SENSE?

When you have done a preliminary site analysis on a property and are satisfied that the property may produce a sizeable profit, you are prepared to negotiate with the owner and make an offer on the property. Your major concern at this point will be to control the property without penalty for non-performance, while still retaining the potential for earning large profits. This can best be done by using either an option or an earnest money agreement. In both cases, you will be concerned with two types of clauses that will protect future profits and limit future liabilities. The first is a contingency clause; the second covers development rights.

Contingency Clauses

The cardinal rule in preparing any offer to purchase is always to make provision for the unknown or unexpected. Contingency clauses like the following are absolutely necessary.

"The buyer has the right to cancel this agreement if buyer is not able to obtain zoning or use permits necessary for buyer's development of the property."

"This sale is contingent upon buyer applying for any variance, zoning change, or necessary use permit and receiving appropriate approval of same. Buyer has sole discretion as to what appropriate variances, zoning uses, and permits will be required."

"This sale is contingent upon buyer obtaining the necessary financing to complete the development of the property according to buyer's development plans."

Never make an offer that does not give you the right to cancel the purchase without penalty if you are unable to develop it to your highest and best use. Robert M. learned that lesson the hard way. He found a piece of infill commercial development property he considered a good buy. But this was Robert's first experience in developing real estate, and he was sure that the property owner would increase the price if he knew what Robert was going to do with it. To keep from revealing his plans, Robert left out a contingency clause in his offer. He wasn't worried, though. He was "positive" there would be no problem in getting the zoning variance he would require.

Unfortunately, the planning commission turned him down, and he was obligated to purchase a property that he had no idea how to develop. He immediately changed from a developer to a "speculator." Eventually he sold the property for exactly what he paid for it, however, his interest and carrying costs were over $7,800.

Don't ever be caught in this situation. It is better to pass up a piece of property than to take a chance on getting burned.

Remember that the property owner probably wants to sell the property as bad as you want to buy it. Use this information to protect your profit from the start.

<u>Development Rights</u>

When you are making an offer to purchase or drawing up an option agreement, be sure to include a clause that allows you the right to represent the present property owner in any zoning change, variance, use permit, or related matter. All of these requests must be applied for in the name of the property owner. If you can assure the owner know that you will perform as promised and pay for all related expenses, the owner will almost always give you these rights. A clause like the following will satisfy both your need and his.

> "Present property owner grants the buyer of the property permission to immediately apply for any zoning change, variance, or use permit that the buyer of the property deems appropriate. Buyer of the property agrees to assume all responsibility for preparation of any documentation or presentation that may be required for said items. Buyer further agrees to pay any and all expenses related to the above items."

When preparing your purchase or option agreement, make sure you allow yourself plenty of time to complete your development process. Remember, you may want to immediately resell the property for a profit. It's always a good idea, therefore, to get the longest closing time or option period possible. If you think that your zoning request will take sixty days, <u>double</u> that amount of time. Then include a provision whereby you can pay an additional sum, which will apply to the purchase, to extend the closing for an additional period of time.

Several years ago two young developers made an offer to purchase a large piece of property surrounding a golf course. They arranged to sell the property for a profit of $300,000, but closings had to take place on the same day. The third party, however could not close that day, and so two developers lost the profit. Worse yet, they lost over $190,000 in non-refundable earnest money. They had placed themselves in a corner by not allowing enough time for closing.

At this point, a word to the wise. Use an option agreement whenever possible. An option is very difficult to break, and it allows the new buyer to openly try to sell the property once the option is signed.

If you can use an option agreement, try to make only a small option deposit. You can explain to the property owner that you will probably not exercise the option if you can't make your development work. For this reason, you don't want to spend a lot of money for an option that may not be used. If the seller balks, negotiate for an extension of your option in return for a larger deposit. And make sure that all sums are applied to the purchase price.

The key to a successful offer on development property is protecting yourself at all times. Never allow yourself to be squeezed into a corner by unforeseen events.

9.96-5 HOW DO YOU ARRANGE FINANCING THAT PROTECTS YOUR PROFITS?

If you are interested in pre-development property, your major concern will be to find interim financing that will hold the property until you can resell the property for a profit. If you are going to complete development of the property, you will also need to arrange financing for the longer term.

Let's discuss first several alternatives that will help you protect your pre-development purchase and maximize your profits.

FINANCING ALTERNATIVES

Owner financing through purchase or option agreement

This is by far the best method of financing any pre-development property. A good purchase or option agreement will allow you sufficient time to complete your development and resell the property. Your purchase agreement should therefore permit one or more extension periods in case you are unable to resell the property right away.

Rena W. found a piece of property she was able to rezone from residential to commercial. She had anticipated selling the property to a grocery store chain, but they were unable to make a firm commitment prior to Rena's closing date.

This was no real problem, however, Rena's option agreement permitted her to extend the option period for three periods of six months each. The $500 she had to pay for each option period was to go toward the purchase price. Although the first grocery chain did not buy the property, a competing grocery chain did buy during the second option period. Her profit on the transaction was over $50,000.

If she had not sold the property by the end of eighteen months, Rena would have been better off to have lost her option money than to finance a $100,000 piece of property at high interest rates, not knowing when she would be able to sell the property. Remember, the cost to Rena of the entire option period was really zero, as all option monies went toward the purchase price of the property.

This same method can be used with earnest money offers to purchase. Many smart developers never use any other source of financing than this method when buying pre-development property.

Owner or third-party financing

If you really want to carry the property yourself, until you can locate another buyer, consider financing the property under a contract of sale with the owner. You may also interest a third party to put up the money for a portion of the profits. But be careful. If you don't sell the property when you expect, your carrying costs may exceed any profits that the property may produce.

Bank or conventional lending sources

As a last resort, you may want to investigate taking out a land loan. Most lending institutions have shied away from this type of loans during the past few years, but there are still a few available. You will probably have to pay a high interest rate and settle for a fairly low loan-to-value ratio. Unless you are absolutely convinced that you will get exceptional profits from the property, stay away from these types of loans. The cost of financing by this method can decrease profits to zero!

PROTECTING YOUR PROFITS IN FINANCING

It is impossible to say what type of financing you may require to finish development. Rather than explain the many types of loans that lenders may or may not have available, let's discuss how you can protect your profits.

Always use your purchase agreement

Allow yourself sufficient time to develop short-term and long-term financing for your project. This can be done with contingency clauses and extension options written into the purchase agreement. If you are going to develop a property through construction and marketing, you should have all financing arranged before closing your property purchase. If you fail to do this, the interest will destroy your profits, and at some time in the future, you may not be able to even arrange financing.

When obtaining financing follow a financing plan

Under no condition close your purchase on a property without having financing in place for all phases of the development. If you need separate long-term financing on your completed project, get a commitment on this financing prior to closing your purchase. Work up a financial plan and stick to it. Your failure to do so may come back to haunt you.

Barrett C. applied both these principles in a purchase he made. He bought some property for a budget motel on a busy interchange. He was confident that the motel would make money and made sure he left himself enough time in the purchase agreement too obtain both construction and long-term financing. Because he used development financing wisely he had all the financing he needed when he closed on the property, and eventually received a sizeable monthly income form the motel.

CONSTRUCTION FOR PROFIT - NOT PENALTY

The construction requirements different for different types of projects, and each requires different construction methods and personnel. There is one requirement all will have, however. They must be constructed for the lowest price that still permits the best quality. You will invariably be penalized in the future for shoddy or poor workmanship. If you are not a general contractor yourself, make sure that you use a contractor who is reliable, reputable, and bondable.

To protect yourself from liability on the project, make sure the contractor is bonded for the entire amount of the development. Then try to get the general contractor to participate as a partner in the project. He will need to forgo his usual construction profit, but the prospect of larger profits later may be too attractive to pass up. If you can get him as a partner, you will have a contractor who is going to make sure your completed development is one that he himself would like to own--because he does.

9.96-6 A NOTE ON THE RISKS AND REWARDS OF DEVELOPING REAL ESTATE

Development of real estate can be a "risky game." You <u>can</u> make a substantial profit from the development of real estate, but only if you undertake projects that you can handle, based on your experience, talents, and resources. For the above reasons, we suggest that you concentrate on predevelopment property. These offer the least risks and the highest immediate rewards for the beginner.

The key is knowing what you're doing. And that's the reason for this section.

If you don't know what you are going to do with the property prior to closing your purchase, you can almost assuredly count on losing money. However, if you follow the plan given in this course, success-and wealth-is within your reach.

9.10 HOW WELL HAVE YOU LEARNED?

The better you've learned the ideas taught in this unit, the more you will be able to apply them. Test how much you've learned by answering the following questions, writing in the space provided or on a separate sheet of paper. Do not skip this step--to retain this valuable information, you need to review it in writing.

If you are uncertain of a particular answer, look back through the lesson. The answers to all the questions can be found in the preceding pages of this lesson.

A. PORTFOLIO DEVELOPMENT

1. What is a real estate portfolio?

2. What two major problems usually arise when portfolio strategy has not been planned in advance?

3. Name the four objectives most investors have in mind when they make investment decisions.

4. What importance do liquidity, profitability, and safety of principal have to portfolio planning?

5. Name at least six benefits you may want from your portfolio. How do your investment goals determine the mix of properties you acquire?

6. What does the term "investment for use" have to do with defining investment objectives?

7. Before building a portfolio, what three questions should you ask you self?

8. What steps should you follow in purchasing any property?

9. What type of properties should you place in your portfolio if you are concentrating on long-term goals?

10. What is portfolio diversification?

11. Why should you not rely upon the purchase of a single real estate property to meet your investment objectives?

12. How can you control financial risk?

13. What are the three main aspects of investor risk?

14. How do you balance portfolio profits against portfolio cash flow?

15. Why must the balance between cash flow and equity appreciation be maintained in the portfolio?

16. What are the current tax rules regarding capital gains?

17. Why would an investor be willing to increase the value of the properties in his portfolio without increasing the equity? What does depreciation have to do with your answer?

18. How can a professional accountant help you manage your portfolio?

19. Name at least four professionals who can assist you in your real estate transactions. Name at least one benefit each can provide.

B. OPTIONS AND REAL ESTATE DEVELOPMENT

1. What is the difference between "infill development" and "growth development"?

2. What is substandard real estate?

3. Which category of development property may generate a profit by a simple zone change?

4. Which type of development property already conforms to zoning ordinances that permit its highest and best use?

5. Why should the novice investor concentrate on making a profit from pre-development property?

6. Where can you find the legal description for a parcel of unimproved property?

7. Why is the nature of the adjoining property essential to the site analysis of a particular property?

8. Why are zoning restrictions placed on real estate development?

9. If employment is up, what type of development property will be in high demand? Why?

10. What is the first thing you should look for in order to create an immediate profit from development property?

11. How can a developer make a profit by applying for "nonconforming use?"

12. What steps should a developer take in order to get a zoning change or variance approved?

13. How can a developer make a profit with undersized lots and substandard lands?

14. What is the cardinal rule in making an offer to purchase development property?

15. What development rights should a purchaser include in any option agreement or offer to purchase?

16. Which type of property rights should a purchaser obtain whenever possible?

17. How can a developer provide for owner financing with zero percent interest when developing a property?

18. Why should you bring in a general contractor as a partner in a completion development property?

19. How does a site analysis increase your chance of generating a profit in real estate development?

20. How can interest and carrying costs eliminate any and all profits from real estate development?

9.11 PUTTING IT ALL INTO PRACTICE

Now that you've learned the basic principles of portfolio planning and the use of creative end-games like options and real estate development, it's time to put your understanding into practice. A safe way to do that is to do the following assignments and <u>nothing more</u>. Do not yet purchase properties for your personal portfolio or put options or development strategies into place.

Simply go through the exercises outlined below, <u>pretending</u> that you own a number of investment properties that must be managed as are investment portfolio. In this way, you will be able to see how balance and control in a real estate portfolio actually works. Similarly, <u>pretend</u> that your portfolio management includes transactions involving options and development.

This exercise should help you feel confident in managing a portfolio of your own right from the start.

Remember to take the investment process one step at a time and to review the success of other investors in managing their portfolios.

In the meantime, go ahead with these assignments. They have been designed so that you can select those tasks that will be of most benefit to you. But don't skimp on the number of assignments that you do; you will be cheating only yourself.

A. PORTFOLIO MANAGEMENT AND CONTROL

1. Read the paper. Look in the classified section of the newspaper and find at least ten properties that are advertised as rentals. Make a list of the phone numbers and any other information given in the ads. These properties will become your practice "real estate portfolio." Diversify your portfolio by selecting properties in different locations and of different sizes.

2. Call the owners. Make an appointment to see each of the properties on the list. Try to determine over the phone why the owner is selling and how flexible he is. For each property, write the address, property description, price, and other investment information on a separate sheet of paper.

3. Visit the properties. Go see each of the properties, looking for obvious reasons why the investor may be selling. Pay attention to the neighborhood, the appearance of the property, and similar factors. If the properties are already rented, look for evidence of proper management.

4. Consider yourself the owner of all the properties. On each sheet of paper list the reasons why the owner of the property is selling. Then determine if the owner's decision is based on remedial action or on long-term portfolio planning. (You will be surprised at the answer.)

5. Define your peroneal investment objectives. Determine why you want to own real estate. List the specific goals that you want to achieve, both short-term and long-term. Then use the principles taught in this lesson concerning cash flow, equity build-up, tax savings, and capital appreciation to

determine how your investments will help you meet those goals.

6. Decide what properties you should purchase in order to achieve your goals. Using the strategy taught in this report on defining objectives and building a portfolio, see if you would have purchased each of the ten properties on the list. What benefits would each of the specific properties provide? If you can't answer that question fully, follow the steps outline in this

report for building a portfolio one step at a time. You may even need to do a cash-flow analysis on some of the properties.

7. Discard the questionable properties. Based upon your decisions made in the previous assignment, discard any of the properties that you wouldn't have purchased to begin with. You will probably be left with three to five good properties for your portfolio.

8. Do some portfolio planning. By focusing on your investment goals, determine how long you would have held each of the remaining good properties if you had been the owner. Would you now be selling, exchanging, or refinancing the properties in question?

9. Compare your decisions with the present owners' reasons for selling. Analyze the situation of the owners of each of the properties left on your list. Describe the reason the existing property owner is selling, and then compare that reason to what you decided in assignment 8.

B. OPTIONS AND REAL ESTATE DEVELOPMENT

By now, you have learned how development profits are made and lost. You have seen the perils, pitfalls, and potential profits that exist in real estate development. But without actually getting involved in a development project, you will really never be able to assess your ability to make a profit.

Since you aren't prepared for the risks involved, make a dry run first. This section of the report will allow you to experience each phase of the development process without risking anything.

If you happen to find a development property that can generate the kind of profit you have read about, leave it alone until you have finished the entire report. If the opportunity still appears too good to pass up, bring in a partner that will help you get started.

Now start the exercises. Depending on your experience, choose those assignments that will be of most help to your total learning experience. Since your efforts in this section of the report will help to eliminate a large percentage of the risk you may face in the future, don't skimp in your efforts. You'll be hurting only yourself.

1. Go to school. Review this report several times until you've convinced you know how to eliminate the risk and liability in development property investments.

2. Make a choice. Now that you understand the difference between pre-development property and completion development property, decide which you want to specialize in. Remember that your best chance of success as a beginner may be with pre-development property.

3. Go shopping. Go to an office supply store and buy a notebook with dividers. Use a divider for each piece of property that you will review. Also purchase several blank "Earnest Money Offer to Purchase" and "Option Agreement" legal forms.

4. Drive around. Drive around your city and locate some vacant properties. Record the addresses and descriptions of the properties on the forms in your notebook.

5. Fill out the site analysis forms. Reproduce a number of the site analysis forms included earlier in the report. Using one form for each property, evaluate each property. If you are unsure of any item on the form, leave it blank. But recognize that you will need all the forms fill out completely before you select the five best properties.

6. Visit three real estate agents. Tell the agents that you are exploring the possibility of investing in development property. Tell the agents that you have several development sites in mind, but that need to have certain information about the properties before considering them further. Give the agents copies of your site analysis form. Tell them that when they have looked at the properties, you will review the information on the forms with them. They may ask if you are interested in

purchasing the properties right away. If they do, say that you are, provided the information is correct and the properties are potentially profitable. (This is true, since you may involve a partner if the property truly is a good deal.)

7. Make a visit. Go to the local planning commission. Request a copy of a zoning map of the entire city along with a copy of the zoning regulations. Find out the time of the next planning commission meeting at which zoning changes or variances will be acted on. Ask what the procedures are to request a zoning change or variance in your city and pick up the appropriate forms.

8. Check the zoning of your potential properties. Using the zoning map and your property addresses add the zoning information to each site analysis form. While completing this assignment, make sure that you note the zoning of adjoining properties. Are they different from that of your subject property? If so, make a note of it.

9. Attend the planning meeting. Attend the next planning commission meeting where zoning changes will be voted on. At the meeting particularly pay attention to how the property owners present their cases. Note the type of objections raised. Some day soon you may be presenting your case.

10. Prepare three application forms. Using the forms you obtained through the planning office, prepare application forms for each of three properties for which you might like to have the zoning changed. Complete the forms just as if you had the property under option agreement.

11. Prepare your presentation. Select one of the three properties and prepare a complete presentation that you would use to present your case before the planning commission. Include imaginary expert witnesses and neighborhood petitions. Once this is completed, present your case to friends or family and get their response.

12. Practice purchasing. Using the earnest money

forms and option agreements that you purchased at the office supply store, practice filling out purchase agreements on the properties you've looked at. Include contingency clauses and rights to develop in order to protect yourself if things don't work out.

13. Make a list of the top five potential properties. Using the information contained on your site analysis forms and those completed by your real estate agents, select the top five properties that seem to offer the best potential profits.

14. Select one property for completion development. Decide on the highest and best use of one property and then determine what type of financing would be required, where it could possibly be obtained, what type of construction would go on it, how the property would be marketed, who the general contractor would be, and what your long-range profits might be. This phase of developing property is more difficult, but you should have some exposure to it.

9.12 THE TEN MOST-ASKED QUESTIONS ABOUT MATERIAL IN THIS UNIT

A. PORTFOLIO BALANCE AND CONTROL

1. "This talk about large portfolios scares me. Is it really necessary for me to own more than one investment property."

The key to financial success lies in suing portfolio planning and strategy. As you define your investment objectives, you will realize that you will need a combination of properties to accomplish your objectives. If managed correctly, this portfolio can increase in value and productivity far more than if you managed only one property--or even a number of properties separately. And you needn't be frightened. If you adhere to the principles and cautions presented throughout this course, you will be able to invest safely and securely, whether in one property or one hundred.

2. "Why all the discussion about portfolio planning? Isn't it

enough to define your investment objectives in general terms?"

The purchase or sale of any investment property that is not based upon a portfolio plan of balance and control will result in a haphazard growth at best. In many cases, your return may become a loss if proper investment planning is not done. By planning your portfolio in advance, you will know when to sell, when to exchange, and when to refinance existing properties. If you have not made a decision in advance as to when these transactions should take place and how to recognize when that time has arrived, you will realize few investment objectives.

3. "Are all properties of equal value in an investment portfolio?"

No. Each property should be purchased to meet specific investment objectives. Since all your objectives are not of equal weight, the properties purchased to meet them are not of equal importance to your portfolio. The long-term benefit of building an estate may be your priority objective, for example, and the properties purchased to provide maximum capital appreciation would be the most important properties you own. If you have also decided to structure a steady cash income as a secondary goal, you will need additional properties. These, however, may be less important to your portfolio than those which are needing your priority objective. Beyond this, though, you should value your portfolio as a whole, using the component properties to maximize your total investment return.

4. "You indicated that the highest profits from a portfolio will come from equity appreciation. Why, then, should I worry about purchasing properties that provide the other types profits?"

Your goal in buying specific investment properties is to obtain properties which will enable you to achieve all of your objectives. These objectives can usually not be realized without the benefits that come from tax shelters and investments for use. There are many investment objectives that can't be achieved unless the portfolio is diversified among a variety of properties purchased specifically for what they can contribute to the portfolio as a whole.

5. "Do I need to study business management in order to properly manage my portfolio?"

No. By now you should have learned the basic principles necessary to manage, control, and balance your portfolio, although your portfolio increases in value, you may want to retain some professional advisers to supplement your efforts. If you establish a proper plan at the beginning of your investment program, your portfolio management will largely become a matter of follow-through. It will help your confidence, however, to associate with other real estate professionals and to continue to enroll in real estate education programs.

6. "Should taxes be the controlling factor in deciding when to dispose of individual properties in my real estate portfolio?"

No. Each property should be sold, exchanged, or refinanced based on your overall investment strategy. Tax planning and strategy can be used to weaken the effect of tax liabilities, but your decision to dispose of a property must be based on your investment objectives. If you have established a positive cash flow to meet personal financial objectives, for example, then exchanging or selling a certain property may not be the best decision for your portfolio. The problem many investors have is that they rely on one or two investment objectives in making all of their portfolio decisions, when their decisions should consider all their investment goals.

7. "Other real estate owners that I have talked to don't seem to understand portfolio balance and control. Is it really necessary for me to develop these management techniques?"

Yes. You must learn to balance and control your portfolio of properties if you want to realize your investment goals with the least amount of risk in the shortest period of time. True, many property owners never structure a total investment program. They invest in a certain property because it seems prudent at the time. And their decision to dispose of that property usually results from the need for cash. This process may produce some property profits, but will usually decrease the value of a total investment portfolio. The need to understand and apply balance and control within a portfolio can't be overemphasized.

8. "Professional advisers and consultants don't seem very interested in associating with me when I tell them I want to start my investment program with a single rental property. What should I do?"

These professionals are usually very busy, and the competent ones don't advertise for additional clients. If you want to develop a team of professional consultants, you need to convince them that, though your portfolio will be small at first, it will increase in value with their help and assistance. You will be pleased to find that most professionals who initially seem uninterested will become excited to help you if they can see future profit in working with you. Naturally, all professional advisers won't be of equal value to you. You need to associate with those who understand nothing-down techniques in combination with portfolio planning and strategy.

9. "I don't think that I will have time to devote to the management of a large portfolio. Is there any other alternative?"

You can always turn your investment program over to a professional investment adviser. The problem with this approach, though, is that the investment adviser will charge a substantial fee for managing your investment program. He will also make the portfolio strategy decisions based upon his perception of your investment goals, even if that perception is incorrect. It is in your interest to find the time to control and balance your own portfolio. If you review the lesson material presented in this course, you will find that making the necessary decisions doesn't take a great deal of time.

10. "When I find a good property, how do I know if I should include it in my portfolio?"

Remember that each property added to your portfolio should be acquired to accomplish a specific investment objective. The units in this course should give you the information you need to define those objectives.

B. OPTIONS AND REAL ESTATE DEVELOPMENT

1. "You have explained how interest and carrying costs may eliminate all development profits. What can I do to secure financing that will leave me profits, not poverty?"

The key is preparing a proper purchase agreement. If you allow yourself sufficient latitude to cover the unexpected and unknown, you are halfway to success already. You must also get the present property owner to agree to extend the closing of the property until you have obtained all necessary zoning changes and use permits. If you can extend the closing far enough, you may even have time to secure a new purchaser for the property or to arrange to develop it to completion. It is usually possible to get an owner to agree to time extensions and contingency clauses when you first make your offer. On the other hand, it is almost impossible to do so after you complete your zoning and development process. Finally, try to get owner financing. If the owner is extending the financing, you are, in effect, borrowing his money at zero percent interest.

2. "Why would a property owner or seller agree to sell me the property subject to my changing the zoning to a higher use, when that change will automatically increase the value of the property--and my purchase will not increase?"

Most owners with property for sale are anxious to sell. They will have already set their price for the property and are satisfied with that price. They will also realize that you will not purchase the property at all if your terms are not met. In this case, it is a "win-win offer"; the seller gets to sell his property for a price he is already happy with, and you get to purchase a property that will be worth more money after your development work is completed.

3. "I thought that a site analysis was performed by a professional. Why should I do my own?"

Professionals such as lending institutions and real estate appraisers perform site analysis for their own needs. Your site analyses, however, will include items they will not consider, such as market demand and alternative uses. Your work is not designed to replace the reports prepared by the professionals; rather, it allows you to <u>estimate the potential market acceptance and profits that might be achieved</u>.

4. "Why should I purchase development property under option rather than under an earnest money offer to purchase?"

Once you have the property under a purchase agreement of any kind, you will begin to perform development tasks that very possibly will increase the value of the property. Unfortunately, earnest money agreements are easier for sellers to breach. An option agreement leaves less latitude for the seller to renege on the purchase terms. The option thus protects you and your development work to a much greater extent.

5. "If it appears that a zoning change or variance will permit an immediate profit by increasing the value of the property, why hasn't the existing owner applied for the necessary change?"

Many times property owners are not aware that pre-development work can increase the value of their property. Or if they do, they don't know how to get a change. As you come to understand and apply property concepts, you become a professional who can visualize higher and better uses for real estate than the average owner. It is this ability that will make you money in real estate development.

6. "Can I find good development property by myself?"

Yes, but it is not possible for you to be aware of <u>all</u> the property that is listed for sale in you area unless you use other professionals, such as real estate brokers. Your best chance of success, in fact, will be to investigate every development opportunity you become aware of--including those formed by other professionals. Yes, these people will earn commissions, but you will still earn a profit, and sometimes that profit can be enormous.

7. "Do I need a lot of money to begin developing property for a profit?"

If you follow the concepts and principles taught in the other units of this course, you will find that you can purchase development property with little or no cash down. Pre-development property is especially accessible to "nothing down" techniques. If you are going to develop completion development property, however, you will need more capital, more credit, and possibly a partner or two.

8. "Real estate development almost seems like a matter of luck. How can I increase my chance of success?"

Succeeding in any area of real estate investing is not so much a matter of luck as it is of education and application. It is true that certain profits can be realized by being in the right place at the right time, but this report--and this entire study course--teaches you to know the "right place" when you see it and when it's "the right time" to buy it. You are in control; you make you own luck.

9. "The unimproved development property that I have found already seems high in price. Can I still make a profit with such real estate?"

Your profits in real estate development come from finding the highest and best use for a certain piece of real estate. If that real estate has not yet been qualified for its highest, best use, there is still room for excellent profits. You must understand, though, how to increase the valued of the property by finding a better permitted use or developing an existing permitted use. If you do, and if you protect yourself through contingency clauses and development rights, you can still make an excellent profit.

10. "If I decide to develop a property through to completion,

why would I want a general contractor as a partner after the project is finished?"

Remember that your profit from completion projects is derived from such things as quality construction at reasonable prices. If you have invited a good general contractor in as a partner, you can expect realistic development costs, quality work, and possibly even help with financing. If the general contractor has helped in these areas, then he has earned his keep--and he should be able to look forward, with you, to long-term profits.