PART I

HOW YOU CAN MAKE MONEY IN REAL ESTATE TODAY WITHOUT EVER BUYING ANY PROPERTY

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CHAPTER 1

Why Real Estate Options Are Less Risky, More Profitable, and Easier to Use Than Most Property-Flipping Strategies Being Taught Today

The problem with 99 percent of all the property-flipping strategies being taught today is that they require would-be real estate mavens to go out on buying binges and scarf up properties like they are going out of style and thus become financially responsible for monthly loan payments and property repairs. But for many people who want to profit from real estate, outright property ownership is too expensive, too time consuming, and far too risky. They crave a low-cost, low-risk way to make money in real estate, without ever having to buy any property. And this is exactly where little known and seldom used real estate options come into play. Options provide the ideal strategy for people who want to be part-time investors because they do not have a lot of money or time to spend on real estate. Plus, options are an excellent way for savvy investors to create leverage, reduce risk, and conserve capital, while holding the controlling interest in a piece of undervalued property. Real estate options also act to level the playing field by providing individual investors with a low-cost way to gain the controlling interest in large properties that they would not be able to buy outright. Over the years, high-profile investors such as Donald Trump, Walt Disney, and Trammell Crow have successfully used real estate options to assemble large tracts of land for future development. In this chapter, I give you the inside scoop on exactly why most of the property-flipping strategies being taught today are way too expensive and hard to implement and why it makes much more financial sense to flip a real estate option instead of a property.

The Definition of Property Flipping

Before I go any further, you first need to know what the term *property flipping* means. Property flipping is generally defined within the real estate investment industry as: "the process of buying a property and quickly reselling it for a profit."

Today, thanks in large part to news reports by the media, the term property flipping has pretty much become synonymous with fraud. But contrary to what many uninformed members of the media would want the American public to believe, there is absolutely nothing illegal, immoral, or unethical about making an honest profit from legitimately flipping a piece of property. It is called *capitalism* and is what our economic system is based on. And I happen to be an unabashed capitalist and damn proud of it!

The HUD Rule Prohibiting Predatory Property Flipping with FHA Loans

The U.S. Department of Housing and Urban Renewal (HUD) defines *predatory property flipping* as: "the practice whereby a property recently acquired is resold for a considerable profit with an artificially inflated value, often abetted by a lender's collusion with the appraiser." And on June 2, 2003, HUD imposed a rule that places time restrictions on the resale of properties financed by Federal Housing Authority (FHA) loans. This was done in an effort to try to curb predatory lenders and dishonest real estate investors from ripping off unsuspecting homebuyers by reselling or flipping properties at artificially inflated sale prices. However, as far as I am concerned, the only thing that this rule has accomplished is to stop honest investors from using FHA loans. I suspect that crooked investors, appraisers, and lenders are still using FHA loans to perpetrate fraud; they are just using more sophisticated scams, which HUD has not caught on to yet! For a detailed explanation of HUD's rule against predatory property flipping, log on to the following web site: www.florida.ctic.com/bulletins/2003/2003-03.pdf

Why Most Property-Flipping Transactions Are under Intense Scrutiny

Nowadays, because of the media and the hullabaloo surrounding the action taken by HUD, just about every property-flipping transaction is put under the microscope by lenders and title and escrow agents before they will agree to finance and close the deal. The reason for this intense scrutiny is that lenders and title and escrow agents are constantly on the lookout for fraudulent property-flipping schemes, which cost them millions of dollars annually. Most of the property-flipping shenanigans involve collusive relationships among investors, property appraisers, and mortgage brokers. In a typical property-flipping scam, a dishonest investor:

1. Buys a low-cost run-down property in a low-income neighborhood.
2. Buys an inflated property appraisal report from an unscrupulous property appraiser.
3. Steers an unsophisticated buyer to a crooked mortgage broker, who prepares a fraudulent loan application to obtain a mortgage or deed of trust loan from an unsuspecting lender to finance the purchase of a grossly overpriced property.

This type of fraudulent property-flipping transaction usually ends up in foreclosure because the new owner cannot afford to make the loan payments and pay for needed property repairs, too. And in most cases, the American taxpayer winds up getting stuck paying off the government-backed loan that was used to finance the scam.

Five Obstacles That Investors Must Overcome When Flipping Properties

To read most of the property-flipping books, you would think that flipping a piece of property is as easy as changing clothes. I hate to be a spoil sport, but in reality nothing could be further from the truth. The fact of the matter is that most authors fail to point out the potential deal-killing obstacles that investors must overcome when using conventional property-flipping strategies. And they never bother to mention anything about:

1. Title seasoning.
2. Loan seasoning.
3. Property appraisals.
4. Overzealous scrutiny from lenders and title and escrow agents for possible fraud.
5. Stringent financial tests, which investors must pass in order to qualify for a mortgage or deed of trust loan on a non-owner-occupied property.

I can tell you from firsthand observations that most of the investors who try their hand at flipping properties usually end up spinning their wheels. While I was writing this chapter, I received a telephone call from an investor here in Tampa who wanted to know if I was interested in buying a small commercial property that he had under contract to purchase. As I found out, this guy was unable to finance the purchase of the property, and his purchase agreement was due to expire in five days. He was in a panic mode, frantically trying to find someone to buy his agreement before he lost his earnest money deposit and the seller filed a lawsuit against him for failing to purchase the property as agreed. I passed on the deal but took down the property's street address for future reference. Who knows, if the property fits my needs, I may contact the owner later on and try to negotiate an option to purchase.

Six Costs That Eat Up Profits When Flipping Properties

The main reason I cannot get excited about the property-flipping strategies that are being taught today is that they are way too expensive. There are six costs involved in flipping a property that eat up profits just like a Florida sinkhole sucks up fill dirt:

1. Acquisition costs.
2. Transaction costs.
3. Closing costs.
4. Repair costs.
5. Holding costs.
6. Sales costs.

The truth of the matter is that investors have no real control over how much a property-flipping transaction will ultimately cost them. The reason for this lack of cost control is that the actual amount of the holding cost is unknown when flipping a property. Holding costs include debt service, insurance, property taxes, maintenance, and security. And the single largest cost of holding on to a piece of property is its debt service or monthly loan payments. The problem with being the proud owner of a piece of investment property is that the mortgage meter is always running, whether the property is occupied or vacant. I learned this lesson the hard way when a property-flipping deal, which I thought was going to be a slam-dunk, turned out to be an air ball instead. When I was young and dumb, I bought a run-down single-family house in South Tampa with the intent of turning it around and reselling it for a fast profit. In those days, the term *flip* was not widely used. I quickly fixed up the house and put it up for sale at a below-market purchase price and waited for the thundering herd of buyers. Well, after six months and $3,800 in mortgage payments, I sold my money pit for a whopping $4,500 profit! This is when I decided there had to be a better way, and I started to learn about real estate options. I came to the realization that it would be much cheaper, easier, and faster to flip a real estate option than a piece of property.

Why the Concurrent Closing Strategy Is Usually Extremely Hard to Implement

Another popular property-flipping strategy that is being taught today is *concurrent closings,* which are better known as *simultaneous closings, double closings,* and *double escrows.* Under a typical concurrent closing scenario, Buyer A signs a purchase agreement to buy a property from Seller B; in the meantime, Buyer A turns around and signs a purchase agreement to sell the property to Buyer C at the same time Buyer A buys the property from Seller B. In theory, this sounds as easy as boiling water, but in reality, it is next to impossible to pull off, especially when there are lenders involved in the transaction, because, nowadays, almost all lenders issue closing instructions to title and escrow agents doing concurrent closings, which require:

1. *The source of title:* The source of title gives the name, date, and recording information of the document that transferred the property's title to the current owner.
2. *The source of funds:* The source of funds provides information on where the money came from to purchase the property. This is done to prevent the end buyer from funding the seller's purchase of the property from the original owner. In other words, each transaction within the concurrent closing must be funded by each buyer.
3. *Full disclosure:* All three parties involved in the two separate transactions must be made aware of one another.
4. *HUD 1 Settlement Statements:* Properly completed HUD 1 Settlement Statements, which accurately document all of the payments made in each transaction and match the actual checks that were disbursed during each closing.

A major flaw in the concurrent closing strategy is that it is illegal to sell any property to which you do not own the title. In legal circles, this is commonly referred to as *grand theft*. For example, in 2002, the Florida Bar Association disciplined an attorney (Florida Supreme Court Case No. SC01-2321) for acting as legal counsel and the closing agent in a real estate transaction involving selling property the attorney's client did not legally own. The attorney and his client were arrested and charged with grand theft, organized fraud, and obtaining a mortgage or promissory note by false representation. The attorney had participated in a so-called double closing, which he later claimed he did not know was illegal, during which his client closed on a contract to sell a property prior to closing on the contract to purchase the same property. Thus, at the time of the closing on the sales contract, the attorney's client did not own the property because the closing with the original, legitimate seller had not yet taken place. In other words, the attorney knowingly participated in a transaction in which his client sold property to a third party, to which the client did not own the title. However, all of these legal problems could have been avoided if the attorney had advised his client to buy a real estate option instead of the property!

Why It Makes More Financial Sense to Flip Options instead of Properties

In the first part of this chapter, I gave you the lowdown on why most of the property-flipping strategies being taught today are too expensive and hard to implement. Now, I tell you why real estate options are less risky, more profitable, and easier to use than 99 percent of all the property-flipping strategies being peddled today. I also tell you why it makes more financial sense to flip real estate options instead of properties. First off, when you buy an option rather than a property, you are not going to be saddled with the financial responsibilities that go along with outright property ownership. And you are not going to get stuck paying any of the costs that are involved in a typical property-flipping transaction. Plus, you will not have to jump through any flaming financial hoops in order to get some lender to give you a mortgage or deed of trust loan. You will never have to worry about being sued by a seller because you failed to close on the purchase of a property. But most importantly, when you flip an option, instead of a property, you do not need to worry about having title or escrow agents looking over your shoulder and checking to see if your deal meets with their approval. As you will learn in Chapter 19, when you flip or sell an option agreement to a third party, all you have to do is complete and sign an assignment of real estate option agreement and collect the assignment fee, and it is a done deal. And then it is off to the bank to cash your check!

I know an investor who specializes in buying options on properties that have been used as methamphetamine labs. His only buying criterion is that the property must be located within a 100-mile radius of Tampa. This guy is a real professional, who can turn a contaminated property around in 15 days or less. And just as soon as a property is cleaned up and certified as being fit for human habitation, he sells his option to another investor, who exercises the option and buys the property. This guy claims to be doing between 12 and 15 deals a year, with an average profit of $8,500 per property.

Savvy Investors Can Use Real Estate Options to Provide Just-in-Time Property

Last, one of the things that I like most about real estate options is that I can use them to provide just-in-time (JIT) property. *Just-in-time inventory management* refers to the practice of ordering an inventory of parts or raw materials on an as-needed basis, versus maintaining a large on-hand inventory. The automotive industry in the United States has used JIT inventory management for over a decade. Today, savvy real estate investors can apply the same JIT inventory management principles when using real estate options. All they need to do is to find a particular type of property that is in demand in their local real estate market and then use a real estate option to gain control of a piece of property that fits the bill. Then they flip the option to an end user or buyer who has a need for the property.