CHAPTER 1

How Lease Options and Subject-Tos Work and How They Can Set You Up for Future Financial Freedom (FX3)

What Are Lease Options and Subject-Tos?

Lease options and subject-tos are ways to purchase real estate, usually with very little or no money down, sometimes even with money back in the investor's pocket. Sound too good to be true? Well, it isn't. Can an investor end up with money in his pocket and not have to put 10 to 20 percent down to purchase real estate? Yes. These techniques are used commonly today by successful investors. This book will show you how to find motivated sellers and homes that you can purchase with little or no money down—truly the fastest way to Future Financial Freedom (FX3).

A lease option is a strategy that gives an investor the right to lease a home and also the right to purchase the home during or before the end of the lease period. An *option* is a contract that gives its purchaser the right to exercise a privilege. In the case of real estate investing, it gives the investor the right to purchase property during a contracted period of time. It is a technique that involves gaining control of a property without the added burdens of ownership. All money made in real estate is made by controlling property. Owning property is the most obvious way to control it, but control is possible without ownership—and control is what brings in the money. It was a dying John D. Rockefeller who shared his secret to achieving great wealth: "Control everything, own nothing." All of the most successful real estate developers today utilize options.

A subject-to is a technique by which the investor gains the title to a property but doesn't have to get a mortgage on the property he is about to control. The seller keeps the mortgage in his own name but deeds the property to the investor. It is deeded to a new owner "subject to" the existing mortgage, which stays in place with this technique. The mortgage company isn't usually made aware of the change or asked about the change. The new owner just starts making the payments on the old owner's loan.

It is important to be aware that there are some risks involved with either technique, and I cover these risks later in the book to help you minimize your exposure. The rewards that can come with either of these techniques far outweigh the risks, as long as you keep aware of all the factors involved. Real estate investing is perhaps the quickest and best way to build lasting wealth. Many of the world's wealthiest people acquire much of their wealth through investing in real estate.

While lease options and subject-tos can build you tremendous wealth, they usually shouldn't be considered a short-term investment strategy. I define a short-term strategy as one in which the time between the start of the transaction and its completion (cashing out) is less than one year. A classic example of this would be a rehabbing project (fixing up a home and reselling it). The other end of the spectrum would be a long-term strategy, such as buying a rental property and renting it over many years. I consider lease options and subject-tos to be in the center of that spectrum, usually requiring one to three years for the best payoff. However, you can always immediately sell the deal to another individual or investor for a profit; this is called *wholesaling*. It can be done if you buy the property at a low enough price that you can turn a profit by selling the deal to another investor where there is still enough room for them to profit as well.

Visualize This Scenario

In every seminar I teach, I ask the students, "Who of you would be willing to purchase a home valued at $200,000 for $100,000?" Of course all hands shoot up. Then I continue by asking if they would still be willing to purchase the same home if the price was $150,000. Most of the hands stay up. I proceed upward with the price, increasing the increments by $10,000 each time. I always sit and watch with amazement as the hands slowly but surely drop. At the price of $180,000 almost all hands are down. At $190,000, usually, all hands in the room are down. The point I am trying to make to each of them is that most investors are not willing to pay this close to retail price for a home.

I then re-pose the question to each of them: "How many of you would be willing to pay $200,000 for a $200,000 house with no money down, in a market that is appreciating at 10 percent per year, with a 10-year period to pay the $200,0000 to the seller at $1,000 per month?" Now all their hands go back up. I ask, "Why, now, are you willing to pay more for that house that you refused to pay $180,000 to $190,000 for a few minutes ago?" They respond in unison, saying, "Because you added some attractive terms!" My response is always the same: "You didn't ask the terms before!"

Terms are part of a whole deal, such as price, length of time to pay, monthly payment, and other items negotiated with the seller, which are discussed in more detail in Chapters 5 and 9. Many times even experienced real estate investors don't ask, "When does the seller need his cash?" They say "no" to a price without asking the seller when he needs the money. The previous example illustrates how most investors think: They don't ask all the right questions about the property before they make a decision. They look at the surface but they don't dig deeper for other possibilities.

Lease options provide a creative solution to allow you to negotiate terms that can increase your profits and provide a great investment opportunity. You are able to pay a higher price on a home if you can get reasonable terms, and having this tool at your disposal thus allows you to open up many new possibilities and make money on deals that were before completely ruled out. I am not suggesting that you pay $200,000 for a home worth $200,000, but you can if certain market conditions and terms previously described exist. If your market is flat (not appreciating) and you have only two years to exercise your option to buy the home, then maybe the price you offer should be much less. It's all about terms!

When doing any lease option or subject-to deal, one of my mottos is that everyone must win or we don't do the deal. There are three people involved: the seller, the investor, and the tenant-buyer. It must be a win-win-win; otherwise, walk away.

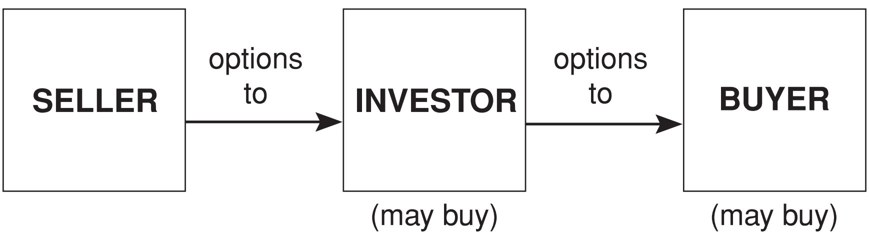
Wendy's Advice about Buying on Lease Option or Subject-To

If it isn't a win-win-win for the seller, the investor, and the tenant-buyer, then walk away from the deal. There are plenty of deals out there where everyone can win.

Standard Lease Option Deals

My typical strategy is to lease option from a seller and then to lease option that home to a buyer.

How Lease Options Work



The above illustration depicts a sandwich lease option. In a sandwich the meat is in the middle—that's the best part. You (the investor) are in the middle of this transaction; your reward is the meat—the difference between what you can pay for the home and what you can then sell it for. There are other ways to make this deal even better and more profitable, which are discussed in Chapters 5 and 9.

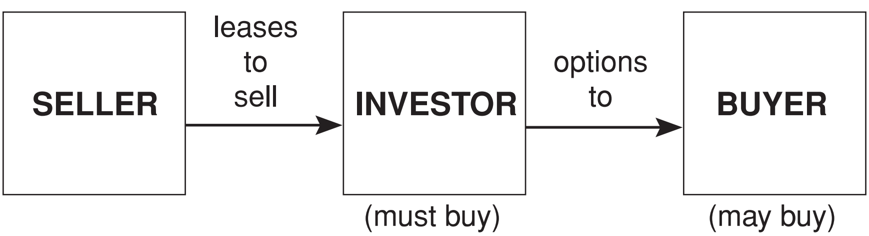
A variation of the sandwich lease is the lease purchase. While a lease option gives the investor the right to purchase real estate, the lease purchase *guarantees* that he or she will purchase the property during a given time period. Under some circumstances I will commit

Wendy's Ethics Rule

Don't do lease options with potential buyers who have no way of ever being able to get a mortgage. That's just being greedy and taking advantage of someone. It is not fair to the buyer. If the buyer messes up, shame on them! If you mess them up, shame on you!

to buying certain homes using this technique—for instance, with specific Realtors, with deals that have a very good potential for profitability, when I have a solid buyer lined up, with high appreciating markets, and with very long-term deals. I do not use lease purchases much when I'm selling, because they are hard to enforce. If your buyer defaults, you have to sue him specifically for nonperformance in order to get him to buy your home. It is costly and very time consuming to do this. If your buyer cannot get a mortgage it is also a waste of time. I would recommend moving on and, in most cases, finding a new buyer. I therefore use lease purchases mostly to buy and rarely to sell.

How Lease Purchases Work



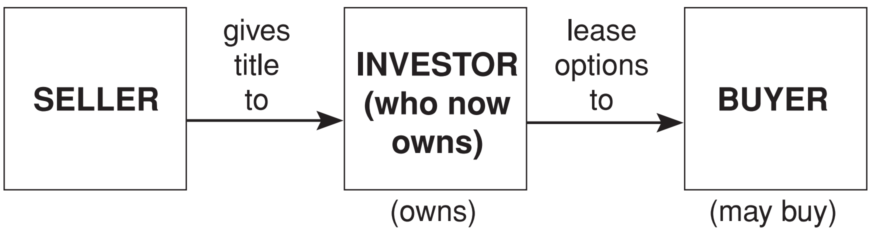
Wendy's Ethics Rule

Don't do lease purchases if you don't intend to follow through on the transaction. Do what you say you will do, when you say you will do it. Help keep real estate investing an honest profession.

Standard Subject-To Deals

If I can't get a lease option or lease purchase from the seller, or if it doesn't make sense from a business perspective, then a subject-to is another way to acquire the property. However, it is important to note that a subject-to is a buying strategy only. Though I may acquire the property subject-to, I would still sell it on an option.

How Subject-Tos Work



A Lease Option Deal

Here's a great real-life example from my files of a lease option deal from start to finish—a true win-win-win:

The Seller: Janet

Janet, a seller, answered an ad I had placed in a newspaper.

> Company looking for 3-4 homes in this area, on long-term lease. Call 123-222-2222.

Janet's home had been listed on the market for $189,000 with a Realtor and the contract had recently expired. She saw my ad and decided to call me. She was exactly the kind of person I was looking for: willing to sell and also willing to do a long-term lease. I still had to determine some other factors to make sure it would be a win-win-win.

Janet's most important area of concern was her price. It was set at $185,000, and she was not going to budge on that portion of the deal. As soon as I knew that Janet was set on this one area of negotiation, I could work with the other areas of the terms for myself (see Chapter 6 on negotiation). I would need to look at the rest of the terms to see if I could still make this a win-win for my side of the deal. These days I do not say no as quickly as I would have years ago; I look at the entire deal now, instead of getting caught up with a traditional style of price-alone deal structuring. Janet had fixed her price, and so I had to look at monthly payments and the time line available. By having all the facts, I was able to analyze the entire deal and thus make sure I would still obtain *my* bottom line of profitability.

At the time of this particular deal, we were in a strong appreciating market—approximately 6 to 7 percent per year. I figured that a 6 percent growth rate on $185,000 would mean approximately $10,000 per year just in appreciation. I had really hoped to get the property for $175,000. Even with the $10,000 in appreciation after the first year, I would still only be where I had originally wanted to be in the first place. I did end up buying the house and putting $4,000 of improvements into the property (basic carpet and paint). I now had $189,000 into the property, including the improvements. Anything above the $189,000 that I could sell it for would be pure profit.

Janet was not in trouble financially but she was motivated to sell. She had a severe shoulder injury that was preventing her from doing the maintenance around the property. She made great money and could have hired someone to do the maintenance, but she decided that with 20-plus surgeries under her belt and more to go, she just wanted some time off from dealing with her large home and yard. She didn't need to pull her money out of the property, but she did ask for $1,000 up front so that she could go rent a lakefront home in the area. The $1,000 I gave her for the option fee, plus the $4,000 for improvements, was a total of $5,000 out of my pocket for this home, which is less than 3 percent down—a small amount for this home.

The Buyer: Roberta

I knew that Janet and I were going to come to terms and do the necessary paperwork on a Sunday, so I ran an ad on that same Sunday, and I got a call from Roberta. I told Roberta that she could drive by the home but that she could not go in or on the property yet, because someone still lived there. Roberta didn't even know I didn't have the deal tied up—I just wanted her to drive by and see if she liked it.

Roberta had credit problems and seven dogs. Most landlords will not rent to someone with seven dogs, and most mortgage lenders won't do a mortgage for someone who has poor credit. With an inability to get a mortgage, she was also unable to work conventionally with a Realtor, so what was she going to do? No one would rent to her, and no one would give her a mortgage. Many people are in this kind of situation, seeking a solution. These are the people I am trying to help. They want the American dream, yet they are unable to obtain it in the usual way. Lease options give people a second chance to improve their credit while working toward the purchase of the home they desire to own.

If you're a landlord, all you get up front on any of your rentals is the security deposit, and that is just not enough cash to take on the risk of someone with poor credit and seven dogs. You can change this scenario by converting these people from tenants to tenant-buyers; then the risk that once was on you is shifted to the tenant-buyer, which is where you want it. With Roberta putting a lot of money down (option fees are not refundable), she was taking on the risk.

Let's look at how the deal transpired:

My out-of-pocket costs:

Option fee to seller	–$ 1,000
Improvements	–$ 4,000
Option fee from Roberta	+$10,000
Left over in my pocket	+$ 5,000

Without even owning this home I now had $5,000 in my pocket. Roberta was the one risking $10,000 with her option fee, as it was nonrefundable. If she didn't buy, she'd walk away from a lot of money.

Janet asked me for $1,100 per month for rent, and I in turn asked Roberta for $1,450 per month for rent. That way I was able to have cash flow of $350 per month, which would add to my profitability in the deal. In this case Janet had a lot of equity in the home, and I was able to leverage that equity to get her to accept the lower monthly payment of $1,100.

The option sale price I set for Roberta was $225,000. How did I get that figure? I put a 10 percent option premium on top of the retail price (see Chapter 5), plus I added an additional 6 to 7 percent appreciation rate at 18 months, which was approximately another $20,000. I then rounded it up a little to get to $225,000.

What was the property actually worth? Value is always determined by what a buyer is willing to pay. Roberta later had the house appraised at $267,000. Did I lose $42,000? I don't think so. After all, I did make about that much. Was Roberta happy with the appraisal? Of course! Janet was happy because she got the price she wanted, and Roberta was happy because the appraisal gave her an additional $42,000 in equity that she can utilize if she wants. Janet won, Roberta won, and I won. This demonstrates what a classic win-win-win deal is all about.

Here's my profit at closing—not bad for not actually owning the home (except for two hours), but just controlling it!

Front-end cash	$ 5,000
Back-end sale	$31,000
Tax prorations	$ 2,800
$350 cash flow × 14 months	$ 4,900
Total profit	$43,700*

*It is not exactly $43,700. There are transfer fees in most states, title insurance fees, and I give my buyers option credits each month when they pay their rent on time. The extra $2,800 on tax prorations was given as extra profit to me also—a bonus when both the buyer and the seller paid for property taxes at closing. Only one person needed to pay for property taxes; therefore, the extra $2,800 is given to the investor in the middle of the sandwich lease option deal.

A Subject-To Deal

Here's a great real-life example of a subject-to deal from start to finish, another win-win-win.

The Sellers: John and Sally

John and Sally, sellers, answered an ad in a West Palm Beach newspaper, from one of my ads that my student—I'll call him Bob—used. I helped Bob structure the lease option portion of this deal to make the numbers work. Here is the ad:

> Tired of monthly payments? We can help. We will make your payments. Call today. Call 123-222-2222.

The sellers were three months behind on payments of $2,100 each. They saw the ad and called. Their house was worth between $385,000 and $400,000. They owed $268,000 on the first mortgage, which didn't include the three missed payments (one of which was only two days late); a second mortgage of $15,000; and a small assessment fee of $2,000, which could be paid at closing in a year or two. Total owed on the home $285,000 (not including those back payments). These sellers had attempted to sell this home twice in the West Palm Beach market, but both buyers had backed out prior to closing. They had since moved out and rented a place in a better school district for $2,200 per month. They didn't have any savings and could not afford both payments. The home was in pristine condition and needed nothing, unlike many homes in this situation.

These people wanted to work out a deal so that they would be able to get some of their equity out and not lose it all. They wanted to get their equity when their current one-year lease expired so that they could buy a home in the new school district, but they didn't need the equity out immediately. These people were also in a bad situation: They couldn't refinance the property, even with their equity, because with the missed payments they no longer qualified financially for a mortgage; they had no one they could borrow from. These people were in a difficult situation, which required a solution.

An ad like ours will attract some lease option sellers but also subject-to sellers; this particular couple was a subject-to seller. They were behind on payments. They were willing to take much less than the current value of the house, and to take it at a later date. They did not need their equity immediately. What they needed was a solution.

Bob offered to give the sellers $40,000 on their home, but not until he sold the property. There would be no interest on the $40,000. This would bring his total investment in the home to $331,000 (acquisition cost of $291,000 + $40,000). He also offered to make the three late payments that would bring their mortgage current—a total of approximately $6,300. From this point forward, he agreed to continue making their mortgage payments. This would prevent them from going into foreclosure. Their credit score would improve as he continued to make their house payments on time. While the late payments of 60 days on the mortgage were a negative indicator, they could be explained by the couple's move and the two previous deals falling through.

Bob could have either made their payments until we refinanced the home into a lower rate or until he lease optioned it out. He had several choices. The biggest issue on this particular deal was the payment amount; it was a bit high for a rental, which many times can be a problem for subject-to deals. If the mortgage payment you are taking over is too high, you need to refinance the property at a lower rate or work out a better deal with the seller. On this particular home he lease optioned it out.

The Buyer: Frank

Bob found a tenant-buyer, Frank, with an ad for a lease option for the market rental rate of $1,600. The problem was that this rate left Bob $500 negative per month! He now had two choices: (1) See if Frank could pay more, or (2) do the refinance.

Bob and I came up with an offer that Frank couldn't refuse: He offered Frank 50 percent on his investment (better than most investments). Frank was a high-tech type of guy who had credit issues from the year before when he had suddenly lost his job. Since then he had become reemployed and was making very good money. He could easily afford the payment and more. Bob offered to give him an extra $500 credit plus an additional $250 credit if he paid $2,100 instead of $1,600 per month. He jumped at it. The most it would cost Bob is $750 per month for the 12 months Frank was in the home, if he bought it. If he didn't buy, it would make Bob the $500 per month cash flow, which he could keep, and because he would not have to refinance he avoided the costs related to that. Frank also had $8,000 to put down as his option fee. He would have liked to put more down, but that was all he had saved since he had been so recently out of work.

Let's examine expenses so far:

Investor's out-of-pocket costs:	
Three months of payments	–$6,300
Improvements	–$0
Option fee from Frank	+$8,000
Left over in our pocket	+$1,700

Bob didn't even own this home but already he had $1,700 in his pocket. Frank was the one risking the $8,000 option fee because it's nonrefundable. If he didn't buy, he'd walk away from a lot of money.

The option sale price we set for Frank was $425,900. How did we get that figure? Bob put a 5 percent option premium on top of the retail price (he started at $385,000 on this one, but it could have been higher—see Chapter 5 about determining the profitability of deals), plus an additional 5 percent appreciation rate at 12 months, which was approximately another $20,000. This was a very conservative appreciation rate for that market. I think he should have gone higher on the appreciation calculation. The appreciation rate at the time he sold the home was 10 to 15 percent in his area. This deal was very good on that account; I just did not like the monthly payment left from the owners' mortgage.

Here is the profit at closing—not bad for not getting a mortgage on a deal and putting only $2,500 down! I wish all of my deals could be so profitable!

Front-end cash	$1,700	
Back-end sale ($425,900 – $8,000)	417,900	(less $8,000 Frank put down)
Option fee credits given away ($750/month × 12 months)	–9,000	
Cash flow (break-even)	0	

What Bob owed owner/lender ($331,000–$6,400 paid)	324,600
Total profit	$86,000*

The sellers in this example were thrilled that their credit rating was improved and restored, so they could once again buy a home. The purchaser was also thrilled that he could buy a home in a beautiful town and restore his credit. This is another classic example of a win-win-win.

Not all subject-to deals or lease option deals are that profitable. It depends on where you start with the seller, how motivated they are, how strong the market is (appreciation), and the price range of the home. If you're looking at a $50,000 home versus a $500,000 one, 10 percent makes a huge difference. The starting number will have a big impact on the total profitability. This is discussed further in Chapter 5.

Financial Freedom—You Can Get There!

These examples show you how lease options and subject-tos can be very profitable. The previous examples are fairly simple versions of the lease option and subject-to techniques, as there are many other creative ideas you can do to make them as profitable and complex as you choose (covered in Chapter 9). Remember, you may need several deals just to lay the groundwork for your Future Financial Freedom (FX3). It doesn't happen with one deal, and it doesn't happen overnight. However, with persistence it will happen!

There are at least three paydays using these techniques:

1. The upfront option fee from your buyer—or anything that your seller pays you to take over a mortgage on a subject-to deal.

*It is not exactly $86,000. There are transfer fees in most states as well as title insurance fees; principal paid on the mortgage during this time period is also kept on a subject-to.

2. The monthly cash flow—the difference between what you pay a seller and what your buyer pays you.
3. The back end—the difference between what you are paying for the home and what you sell it for.

While the option fee is nonrefundable, don't get excited on your first deal by immediately going out and buying that big-screen TV you've always wanted. What if something happens six months down the road? In owning or controlling real estate, things come up that are completely unexpected: broken furnaces, leaking roofs, unpaid rents, and so on. Plan ahead for those things and you will be safe. If you have held the option funds in reserve, you will be able to cover your expenses. That's just good business sense. Yes, the money is yours to keep, but be wise with it because you may need it. You might want to put it aside entirely for an investor's rainy day so that you will be prepared. After the deal closes, you can take another look at the money, because you will have not only that initial option fee but also the back end from the closing.

As you are getting started in this business or any other business, it is important to be conservative with your cash flow and money. I recommend you keep your spending very tight and conservative. Also, you want to be prepared to buy the next property should a good deal be offered to you. Unfortunately, most people in our country do not have good spending habits, and these bad habits allow people to get into financial trouble. It is very important to be on a strict budget for this type of business. If this will be hard for you, then you may want to find some outside help to get you on a system, which can assist you in financial counseling. I cannot stress this enough; it can be a make or break for people!

Let's say you made $30,000 overall on the deal. One positive way to use that money is to reinvest. Reinvestment will continue to bring income, but you will also want to pyramid your income. For example, if your first property made $30,000 overall and you received $5,000 in an up-front option fee, now you're going to want to look for two to three new properties, probably with the same profit ranges. You'll need money up front to pay your option fee to the seller, even though you will reimburse yourself later with the option fees from the buyer. The properties may also need repairs, and that money will have to come out of your pocket up front, so you need to have the funds available from the previous sale. During this time you will probably still keep your day job, just to keep enough cash flowing in while you are building your new business.

Reinvesting doesn't just mean pouring money into new properties. It can also mean purchasing new office equipment, software, or anything else you need to continue to build your business. Maybe it's time you trashed that clunker computer and got one that was made in the twenty-first century. Install a second phone line or buy bookkeeping software. I cannot stress it enough: Be prepared for your future.

At this time, my average profit is $40,000 per lease option deal. Lease options typically turn over every 12 to 24 months. Depending on what part of the country you reside in, the profit range should vary from $20,000 to $150,000 (Midwest to northern California). Subject-to profit ranges should be equal to or greater than lease options, because you are buying from distressed sellers and might be able to negotiate more on the price; however, you might also have to use more cash to purchase them. You decide how much you need to make, and then you will know how many homes you need to lease option or buy subject-to. Not only can lease options and subject-tos set you up to live well today, but they can set you up for Future Financial Freedom (FX3) and retirement. Just sit back and imagine . . . how would it feel to be completely debt free? Real estate is the vehicle that can allow you to achieve just that.