Chapter 1

HOW REAL ESTATE INVESTING GOALS HELP YOU FORMULATE EFFECTIVE FINANCING STRATEGIES

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GOAL OF THIS CHAPTER

The goal of this chapter is to impress on you the importance of establishing worthy and measurable goals to which you can direct your investment efforts. Because real estate is such a versatile method of investing, the most effective method of buying, holding, and later selling differs among investors with different goals, but similar properties. A goal without a method of measurement leaves investors adrift in a sea of doubt as to where they are in respect to the attainment of their goals. A goal is reached by interim steps or interim goals that lead to the desired results.

Most real estate investors struggle through their initial investments. Although this is a common situation, it does not have to be a normal one. It is possible to avoid the difficulties of establishing an effective investment strategy, which is an essential step to your ultimate success in the quest to attain your desired goals. The very mention of the need to obtain effective methods should be etched into your mind as one of the critical keys to achieve success in any task.

TO BE EFFECTIVE, FOCUS ON RESULTS

To be effective, you must know what the results should be in very specific ways so that you can remain focused on those desired results. Effective strategies are not fixed, however, and it is essential that, in real estate investing, likely mistakes are acknowledged, and that corrections in the investment plan be implemented.

The typical investor often uses what I call the "shotgun" method of investing: Their time, energy, and financial resources are spread over a wide range of tasks. This is a system of default, that is, one arrived at because of a lack of knowledge about how to design an effective program. These investors waste resources by learning about the wrong kind of investments for their desired results, often concentrating on investment tactics, and are not productive in maximizing those desired results. This improper use of time and effort diverts the progress toward their goals and can postpone or even halt achievement of those goals.

Have Clear Goals

Much of this book is devoted to helping you achieve your goals, so one of the first steps is to embrace the concept that through a clear understanding of your goals you will have a running start to attain them.

There are eight simple and undeniable factors that will lead you to success in real estate investing. They are:

1. Know what you want to accomplish: Your goal.
2. Ascertain what you need to maximize your abilities and to overcome your deficiencies. Establish your interim goals.
3. Put a timetable on your success in completing an interim goal: to measure where you are in your journey.
4. Find the specific type of real estate that will take you to your goal: Your vehicle.
5. Learn everything you can about that kind of property in the areas you want to own it: Master the vehicle.
6. When you find the property that seems to meet your investment criteria, tie it up: Take action and gain control.
7. When you have entered into a contract that binds the seller to terms you think will work for you, spend time and effort to ascertain if this is truly the property for you to purchase: Conduct due diligence.
8. If you discover anything that suggests the property will not meet your goals, then either withdraw from the transaction, or adjust the price and/or terms to the point where the transaction will meet your original criteria: Final decision time.

While these eight elements may appear to be very basic and overly simplified, they are a specific and important part of real estate financing. These eight elements are so important they should be the essence of every chapter in any book written about real estate investing.

ESSENCE OF ACCOMPLISHMENT

Ultimate success in real estate investing depends on a clear focus of the desired result. As an example, a hotel developer who wishes to own a chain of hotels must first understand what it takes to own and operate such properties. This requires a total commitment to every aspect of hotel operation, starting with what kind of location will best fit the specific type of hotel to be developed. A great location for a convention hotel may not be good at all for a budget "stop-for-the-night" kind of hotel/motel property. However, operational aspects are just a part of the overall picture, and the hotel developer must continually be cautioned to avoid being sidetracked to the green pastures of another category of real estate development. Hotel development requires a very specific and dedicated approach to the economics that make that type of real estate venture work. The same specific knowledge will apply to every category of real estate from rental apartments, shopping centers, mobile home parks, and so on.

Don't Stray from the Right Path

In my more than 30 years as a broker and developer, I can attest to the fact that truly successful investors are those who stay firmly within a narrow focus of interest and knowledge. They are the shopping center giants who do nothing but develop, own, and operate regional malls, or the rental apartment owners who dominate a local or national market. However, size and importance of investment has little to do with this idea. Success is a function of focus that is directed to becoming an expert in the category of real estate desired and to the precise location where the investor wants to own. For the residential rental investor this means knowing what is available, what prices are offered, and how to deal with residential rentals in any given area of the country.

LOCATION, LOCATION, LOCATION IS NOT THE ANSWER

This introduces the critical factor of location. By location, I mean the specific and well-defined area chosen. The less than perceptive investor will quickly discover that to accept the Wall Street definition of real estate as being a universal commodity is a mistake. Wall Street likes to compare every investment to stocks, which can be treated as universal in nature. However, real estate cannot be so easily defined, so what happens in San Francisco will not equally happen in Miami, or New York, or anywhere else. To forget this is a tragic mistake. Although there will be some events that will be similar in the diverse real estate market, real estate is essentially a local commodity that will rise and fall in long-term value based on what goes on in that very local market. Only then will you begin to see opportunity surfacing long before other, less knowledgeable investors recognize a good buy from a relatively poor one.

Real Estate Is Not Universal

The trick is to recognize that real estate is universal in nature, but its value orientation trends, which seemingly follow a similar pattern from area to area, are really very local in nature. This paradox occurs because real estate is not as dependent on national trends as many investors believe. What causes real estate to go up or down in value may be something occurring in or around the location of the real estate and may be created by a much longer process than is apparent. Such events would include elements of financing, taxation, recession or legal impediments, which effect real estate in a national and international way.

What may appear to be a sudden jump in the value of vacant commercial land may really be the long-term effect of continued down-zoning by local building and zoning departments, which have caused a shortage of such zoning. This is an important factor in both the purchases and financing of real estate.

For this reason, it is important that you develop a system or operating procedure that allows you flexibility. With a set program, you can move quickly and decisively when you recognize a property that fits your investment criteria. In addition, be ever vigilant on governmental intervention in land use because simple changes in use ordinances can have a major impact on land values in the future.

Your Secret Weapon Is the Local Building and Zoning Department

Because many local building and zoning departments are often directed by local governmental departments that are antigrowth, it is not uncommon for building regulations and restrictions to continue to change and together with zoning ordinances become more restrictive. These tightening of rules can quickly take away development rights you thought you had purchased a few years earlier. You need to be ever vigilant of what goes on in your local government. This includes all levels of your city, county, and state governing bodies.

BE AT THE RIGHT PLACE AT THE RIGHT TIME

Just about every person has made this comment at one time or other: “Boy, that person sure was lucky to be at the right place at the right time.” Timing is very important to just about every decision you can make, and when it comes to investment decisions, timing is generally the most important aspect of the entire process. However, for timing to work there must be recognition of opportunity. Unless you see a way to reach for your goals, the right time just never seems to come around. As for being at the right place, that is up to you. Your gold mine is likely to be found wherever you want to look for it—that is, if you truly want to take the time and effort to learn everything you can about the kind of property you want to buy in that chosen location.

Without Action, the Best Time and Place Are Lost

To benefit from being at the right place at the right time you must act. You must make a decision to move forward in a decisive way. For a pilot, the act of taking off requires a decision to pull back on the yoke before arrival to the opposite end of the runway. Fortunately, the real estate investor can act without having to make an all-or-nothing decision. But there is a right way and a wrong way to go, and unfortunately, the vast majority of real estate buyers or sellers only think they are acting decisively. In reality, they make decisions by default, or they spend time trying to decide what to do without having control over the situation.

Get the Other Party to Commit First. The key to having control over the situation is to get the other party to commit to deal with you prior to your being locked into the deal. This kind of strategy sounds simple and it is how smart investors function. Only by locking up a deal as early as possible will you have extra time to do due diligence, obtain ideal financing, and decide if that investment truly fits into your investment portfolio prior to that final decision moment.

Who Is More Motivated?

Sellers are generally the more motivated of the two sides of any transaction. They are, after all, fixed to one action: to dispose of that property. The buyer has the luxury to buy that property or to go on to another one. Sellers will commit to a price, terms that seem to work for you, and while they are bound to those terms, buyers are still are not firmly committed to the transaction.

As a buyer, it will be up to you to discover the important facts about the property and to make educated investment decisions accordingly. In real estate terms, you negotiate a contract to purchase the property that gives you time to conduct and approve all the due diligence, elements you believe are necessary. Only when you have completed these inspections and investigations can you be expected to make an informed final decision. That decision may be to move forward to close on the contract, to walk away from the deal, or to seek to modify the agreement by adjustment in price, time, or terms—or all three. The key is to obtain the time that allows you to control the deal until you are comfortable to continue to invest time and money in the deal.

Know What Is Important

Timing plays its most important role in the step that comes just before your gaining control over the situation. For example, suppose you have made a decision that rental apartments are what you want to buy. Your goal is to own enough rental apartments to allow you to hire full-time outside management to professionally and effectively manage and operate the investment. This is your choice because it fits the kind of lifestyle you want for yourself and your family. You have hired a good real estate lawyer and a good tax accountant to advise you on those specific matters. Your lawyer has given you a good purchase agreement that allows for adjustment to different situations, but that covers all the possible due diligence you would want to accomplish. This means full property inspections. These inspections will include all building elements, such as plumbing, electrical, structural, roof, foundation, termites, radon gas, and most important of all, environmental problems.

Carefully Investigate Existing Leases. Added care must be given to a complete review of all existing leases, if any exist, to be sure that the revenue potential has been properly stated by the sellers and that you do not become saddled with a rent roll full of holes. It is not uncommon for sloppy management to fall down on lease control and the tenants you ultimately inherit may have you over an economic barrel.

Buyers Need a City Code Violation Inspection. In addition to these situations, your due diligence provisions should give you the right to request a city code violation inspection. Most cities will send out a code enforcement inspector to decide if there are any building code violations. You will also want to check out all other governmental restrictions such as zoning, environmental issues, and possible limitations due to platting or possible building moratoriums. These situations all require time to check.

Due Diligence Checklists. Remember this simple statement: There is no set or specific list of due diligence items you need to include that will cover you in every category of real estate for every location. Every property and every location has different factors that need to be checked. The list that served you so effectively in Miami may overlook a lot of critical factors you need to check when buying a property in Seattle or Chicago. Time and money are spent in accomplishing these studies, and they should be done only if you have the property locked up; that is, have the seller firmly tied into a deal while you spend the time and money to properly make a decision.

Your private due diligence checklist must be compiled locally to fit your specific category of real estate and your own needs. Local inspection companies, your realtor, your lawyer, and individuals in the construction trade (who know the area and the kind of real estate you want to buy) can be helpful in compiling your specific due diligence checklist.

Once you are armed with the knowledge that allows you to recognize a potential opportunity, you are at the right place and now are the right time. You should act by moving quickly to tie up the property. After all, if the property looked good to you, it may also appeal to other prospective buyers.

Because there may be other possible buyers who are about to come to the same conclusion, you do not want your indecision to cause you to lose the opportunity. You act, and now that the property is in your control, you can spend the time and money to make your thorough inspections before making the final decision. All of this assumes that you are acting with a goal in mind. A clearly seen goal is the destination to all your effort and will allow you, or force you, to stay on the right road as you head toward the goal. Not all investors have the same result in mind, and your own goals are likely to vary over a period of time. Therefore, it is important to recognize that ownership and debt structure may also vary. These changes may allow goal adjustments without having to deviate from the actual type of property chosen in the first instance. Any specific property can help its owner attain different goals, depending on the structure and the terms of that debt. This chapter is designed to help you develop a clear understanding of the relationship between financing and the attainment of your financial goals, as they relate to real estate. The financing tools and techniques described in this book will help you enhance your success in real estate investing.

BEGIN WITH YOUR GOALS

All success must begin somewhere, and in real estate financing, it begins with the 11 goals of financing. You will find that you can approach any problem using these 11 goals to decide whether financing can provide a solution or direction to attain your specific goals. If, after reviewing each goal and applying it to a given situation to achieve a desired result, no benefit or clear direction can be obtained, you can stop looking to financing as the source of the solution.

To help you decide how to use financing as a purchase or sales tool, review the 11 goals of financing. As you continue through this book and learn the many different financing techniques, you will see how each technique benefits the buyer or seller in different ways, depending on how they are applied. The idea is to gain as much flexibility in moving closer to your desired investment goal or strategy. Financing is more than obtaining a mortgage. Any time you are able to structure a transaction that uses any technique other than 100 percent cash as the payment, you have used a financing technique. You will discover many different financing techniques as you progress through this book. They include steps such as first and second mortgages, deferred payments, split payments, land leases, exchanges, sweat equity transactions, and options just to name a few. By the time you reach the end of this book, you will have a vast tool chest at your disposal as you move on to build your wealth in real estate.

The 11 goals of effective real estate financing are:

1. Enhance the value of a property.
2. Consolidate existing debt into more manageable debt.
3. Attract more buyers to a property for sale.
4. Increase the market potential of a property.
5. Increase the return on cash invested in income properties.
6. Generate immediate cash that is often tax-free.

7. Maximize equity build up of a long-term investment.
8. Help solve tax problems.
9. Create tax-deferred transactions.
10. Open new doors for the investor to expand an investment portfolio.
11. Provide a professional touch to a good marketing plan.

Review each of these goals carefully. It is important to realize that the improper use of any financing tool can negate the positive result needed. It is important to look at all the different techniques that this book provides so that you can select the best approach to solving the problem and to attainment of the desired goal.

Enhance the Value of a Property

When properly used, financing can enhance the value of a property to the owner or buyer. From a buyer's standpoint, financing should provide the best terms that fit the ownership goals. These terms can vary between different owners and buyers, dependent solely on what they expect from that investment. It is possible that for one buyer or owner the best terms may be a high beginning interest rate that declines over the mortgage term. Another investor may find a mortgage with a deferred payment plan where either interest, or interest and principal are reduced during the initial payment term of the mortgage. A third investor may want to incorporate a land lease as part of the financing strategy for reasons that are unique to his or her situation.

Whatever the situation, the amount of principal payments could be the same; the only difference may be the adjustment of when the actual payments are made and what they are called (principal, interest, rent, percent of gross sales, and so on). You should recognize that while the total payments may not vary for one party (either paying or receiving), the benefits or penalties could differ for the other party. Interest and rent may be tax deductible for the payer, but taxable as income for the receiver.

The term *value* is relative to the goal one wants to attain. From the seller's point of view, the financing that attains the seller's most important goal works best and establishes the highest *value* even if the monetary amount is less. If the seller needed to attain the highest possible market price for tax or other reasons, the terms the seller provided to the buyer may soften the economic impact to counterbalance the high price. This could occur by a lower than market interest rate or another condition of the payback. Because the concept of best value is likely to differ between the parties, the method of financing used often helps bring the two parties together to maximize mutual benefits. The compromise aspect of negotiations is enhanced when each party has a wide range of options to view.

The buyer or seller who has only one fixed agenda in drafting a contract will not be as successful in attaining his or her investment goals as the investor who has a strong understanding of the tools of finance. When the market is buyer driven, which is to say, a buyer's market, the most important goals are the buyer's goals. However, when the market is strong and there are more buyers than sellers, then the seller can call the shots. In a seller's market, the seller's goals receive the highest priority.

Usually, the market is rarely oriented exclusively to the buyer or the seller. Savvy investors understand this and, no matter if they are buyers or sellers, they try to make the terms of the deal work for each party. Real insider buyers recognize the value of this well-worn adage: "I'll pay your price, if you'll take my terms." In other words, price can often be a fluctuating factor, solely dependent on the terms of the sale.

It should be clear that a property could be difficult to sell if the seller feels that he or she must receive all cash to agree to the sale. There is, however, a potential market for the property at an all-cash price. Yet, the seller usually does not want to reduce the price to that level. This is a typical situation that often can be solved by a hard look at the seller's most important goals. By doing this, it may be possible that the original plan of action was not the best one to follow. In Chapter 2, you will see more on this aspect of goal orientation and investment strategy achievement.

As a buyer, it is critical to realize that the importance of the cash to the seller may be more critical than the highest possible price. Yet, it is equally critical to recognize that some sellers will find their goals are better attained if they get less cash at closing, and a higher price. It is important for sellers to understand that there are reasons for this disparity in payment schedule and in price determination. Often transactions are lost because none of the parties to the deal—buyer, seller, or brokers—could grasp this truth.

Therefore, using the tools of financing to solve their problems, all parties involved should look at the principal goals more closely. The final aspect of this goal is that the technique used enhances the idea of value that is important to the buyer and seller.

Consolidate Existing Debt into More Manageable Debt

Financing can be used to consolidate existing debt that is overburdening the owner of a property. The goal here is to reduce the total annual (or monthly) payment of the existing debt or the combination of all forms of debt on the property. When this is the desired result, it is necessary to examine the owner or buyer's options. You may discover that by using one or more financing techniques, you can find several potential solutions to the problem.

The simple refinancing of a property can work wonders in a market where interest rates have dropped. In this situation, the owner or buyer may find the opportunity to convert a high-interest loan into a newer, more affordable loan. If there has been an increase in the value of the property, the added value may also provide the opportunity to increase the loan amount, without a reduction of the bottom-line benefits of the property.

For example, a buyer purchases a 10-unit apartment complex for $500,000. There is an existing first mortgage of $250,000 with an annual debt service of $41,240 (principal and interest as would result with a 12-year term at 13 percent interest). The buyer obtains a new loan of $350,000 payable over a 20-year term at 8.75 percent interest. The new annual payment on the new mortgage would be $37,117.50.

Two important things have happened. First, the investor has obtained an additional $100,000 over the previous debt, which could be used to pay off other debt. That other debt might have been the down payment needed to give to the seller. Second, by refinancing at a lower overall payment, additional cash flow has resulted. This additional cash in the pocket of $4,122.50 ($41,240.00 – $37,117.50) may be the single element that makes this transaction work. An important benefit in this transaction is that the additional $100,000 comes to the mortgagor tax-free.

Consolidation of debt extends beyond real estate investing and should be an important part of anyone's personal financial planning. We live in an age of high credit charges. It is not very smart to carry high cost credit card or installment loan interest rates. Such rates can cost in excess of 18 percent. This is not a good idea especially when you have the potential of refinancing your real estate through more modest rates. In the early 1990s, there was a rash of refinancing. It was not uncommon for people to have refinanced their homes several times between 1989 and 2006. The key here was to be tuned into what was going on. Even a small gain obtained through a refinanced loan, such as the reduction of a monthly payment, or amortizing the new loan quicker for less than the old loan, can be smart investing. Those investors who kept putting that off waiting for the rates to drop even more than they had suddenly came up against a hard brick wall. It was called 2007. A bubble in the lending market burst, for many reasons, and I will touch on them as you go through this book. But don't worry, if there is one constant in the real estate market, it is that both good times and tough times come around from time to time. You must look at the overall picture to see if there is any real benefit.

The interest rates are not the only criteria to examine when you are looking into total debt payments. You may owe on several different loans at various repayment terms. The most specific item to note is the combined constant rate of payment of the loans. The term *constant rate of payment* is used within the lending industry, and you should become aware of what it means and how it is used. In Chapter 3, I provide you with details of how to use the constant rate of payment in analyzing mortgage situations.

Consolidation of debt has many different benefits, as you will see when you combine its effects with some different financing tools illustrated in this book. The key to using any of the consolidation techniques is to make sure that you keep your ultimate goal in clear focus. For example, if you simply want to reduce your monthly debt payments that currently satisfy several loans (home, car, credit card company, and so on), you could consider refinancing your home to produce the added cash to retire all outstanding loans. This may look attractive at first, but it is important that you look at other alternatives. One of the most basic forms of reduction of debt payments, often overlooked, is to pay off the overburdening debt. One way to do this is to refinance at a lower constant payment rate. This could be accomplished by obtaining a lower interest rate or a longer amortization term or a combination of both. Other more creative forms of financing, such as an interest-only schedule or deficit payment loan, can provide some debt relief. From a financial point of view, this may be nothing more than sound economic practice. In essence, do not overextend your ability to pay off debt.

Of course, this is often easier said than done, and once you are in the trap of consumer debt (high interest rates), the solution can be hard to come by. The critical point to consider in any form of consolidation is to take a hard look at how the remedy will affect your long-term goals. If a longer payback at lower interest rates benefits you in comparison to paying off debt, then the proper thing to do is to look to consolidation. On the other hand, a very low rate existing loan may be kept in place if the new real estate loan that replaces it produces a greater payback, even if the monthly payments seem lower. For example, you have a total of $20,000 in short-term consumer loans at an interest rate of 18 percent. At the same time, you owe $120,000 on a first mortgage on your home, at 7.5 percent interest per annum. If current new rates on real estate loans were higher than your present 7.5 percent, say 9.5 percent, you may not find any benefit to a refinance and consolidation of the two debts. This would be the situation even though the consumer debt was more than double the interest rate of the potential of your new loan. Review the current payments: Interest on the $20,000 consumer loan is 18 percent of $20,000 or $3,600 per year. Interest payment on the real estate loan is 9.5 percent or $9,000. This gives you a total current interest obligation of $12,600. If you refinanced, with the idea to consolidate your debt, so that you could cover your loan cost, and then pay off the existing consumer loan, you may discover that your new loan balance is $141,500 ($120,000 existing loan, and $20,000 consumer loan, and $1,500 in loan origination cost and out of pocket). If the interest rate on this new loan was 9.5 percent, then your interest cost the first year would be over $13,000. The general result is not favorable. On the other hand, if the $20,000 is due now, or there is some other pressing need for cash, refinancing, even if it increases the previous payment schedule, may be the only solution. If this is the case, you should review all the different possible refinancing tools available to you. You must look at the total picture.

Key Points to Using Consolidation Techniques

1. There is a need to reduce existing debt payments through the refinancing of any or all of the existing debt so that the total future payments will not exceed those payments under the old finance situation.
2. There is an inability to meet current debt payments, and refinancing is the only way to meet the current payments, though the total payments will exceed those of the current debt structure.

3. The property is not readily marketable with the present financing structure. A change in this situation through refinancing may provide a more favorable result in the marketplace.
4. A cash-out situation is needed in which the owner can mortgage above the present financing levels and put cash in his or her pocket. This must be done so that the property will not become overburdened.
5. There is the immediate need to create cash, and no other option is presently viable.
6. There are many ways to consolidate existing financing. Almost any form of financing will lend itself to consolidation of an existing debt. Naturally, some forms of financing will give better results than others.

Attract More Buyers to a Property for Sale

One of the major aspects of financing is the ability to make property more salable. This goal may seem to be the same as Goal 1, but through a careful analysis of the former, you will see some very important, though subtle differences. After all, your initial goal in buying and financing a property may be to maximize either your cash flow or your equity build up of the property. You may not be purchasing for a quick flip or turnover of the property. But then, perhaps that is exactly what you want to do. The flip-artist will look to either temporary or ready to flip type of financing, both of which will not stand in the way of a quick sale. The investor looking for a longer hold time, to either enjoy the investment or to give more time to bring out the full potential of the property for enhanced profit will want to use financing that uses the full benefits of the cash flow or equity build up form of financing selected.

In the real-life approach to the sale of real estate, creative financing may be the only way to take a property that is difficult to sell into the marketplace. The actual contract of sale may contain more than one form of financing to bring the buyer and seller together. For example, consider a sale then leaseback. Here the seller holds secondary financing (with or without additional security for the lease). This reduces the buyer's risk and is an example of multiple techniques that can be used to simplify the sale. In this and every other situation, the goals of both the buyer and the seller are weighed, then balanced on which is the most critical to solve.

Even great properties are difficult to sell because of high interest rates in the finance market or low buyer demand. In these circumstances, the seller must find techniques to make his or her property stand out as a property that is both attractive and affordable. For example, to get the buyer in the door of a model apartment or home, it is not unusual for a builder to offer mortgage financing at well below the marketplace interest rate and at attractive principal payback for the first several years of the mortgage. Once the buyer has been attracted to the property, the buyers may discover (or be led down the path by the seller) that if they can pay more cash up front they can get a better price (use of the first goal).

We are all accustomed to the leader ad that brings us to the store. Financing terms attract buyers to cars, computers, and homes. The importance, when it comes to real estate, is that you recognize that when the seller offers great terms, that this is a seller who understands the concept of good marketing. This is the right kind of seller to be, and to deal with, if you are a buyer.

In commercial real estate, there are many different techniques that can be offered that look more attractive than they actually are. If you keep your own goal firmly in focus you can be more likely to stick to the techniques that take you closer to your goal rather than farther away. The key to this is to keep your goal clearly in your mind and not to deviate from any technique that will lead you away from the ideal. While you may give in or compromise in the end, it is best to leave that concession to the final moment. You should attempt to visualize the entire deal before you need to learn exactly where to make compromises.

Increase the Market Potential of a Property

This is another seller-oriented financing benefit. Here, the idea is to expand the market potential of the property, which is more than just making the property more salable. It is possible, of course, that by doing one you will also do the other. Review the following case study.

Mr. Wallace wanted to sell his 25-unit apartment house for a price of $500,000. He had an opportunity to buy another property in another town and needed the cash for that purpose. The price he was asking was within the market range with a net operating income (NOI is gross rents less operating expenses, which does not include any debt service) of $53,000 out of a gross rent roll of $76,000.

However, the city was about to launch a major road and sewer project right in front of the apartment house, and it was likely that the apartment complex would lose all of its tenants for part of the year. Once the work was finished, there would be a newly planted median with wide sidewalks where none had previously existed. This kind of improvement could cause the value of the apartment complex to quickly recover as well as substantially increase.

For Mr. Wallace, the approach to his first goal (to sell his existing property) was to find a solution to the pending problem of the loss of tenants. A simple answer was for Mr. Wallace to indemnify a potential buyer for any possible loss of revenue during the construction period. This was accomplished by establishing a format for a sale and leaseback for one year. Wallace became the master tenant, with the existing tenants his subtenants. By assuming the risk for the year during which the roadwork was to take place, the seller was taking no greater risk than if he put the building up for sale and was unable to sell it during the same time period. As the specific need of the seller was to sell the building, holding onto the building was a hardship that he could not afford to take because he was sure to lose the opportunity to buy the other property. By offering an indemnity, a buyer would not suffer from any loss of tenants, and Wallace would only be liable for any lost rent. Wallace calculated that the maximum rent he would have to make up would be around $40,000. He calculated this amount based on the idea that if he cut the monthly rent to the tenants, some of them would tough out the construction mess.

Thus far, the goal served was to help make the property salable. Now the task was to increase the market potential for the property.

To this end, Mr. Wallace could have taken a number of directions. Keep in mind that one form of increasing the market potential of a property is to make it available to more ready, willing, and able buyers. As seller of the apartment building, Mr. Wallace could have turned the building into a condominium or a cooperative apartment building, seeking 25 different buyers at much reduced prices. In some market areas, this has been the direction that many sellers have taken, producing a greater sales price than would have been realized had the building been sold to a single investor.

Another way to increase market potential is to be more flexible in the terms he is willing to accept in the sale of the property. This flexibility is difficult for many sellers to attain because they have not properly established their own investment goals. If you have clear goals and know exactly where you want to be at any given time in the relatively near future, and you constantly review those goals, you will begin to realize that it is the attainment of the goals that is important, not the attainment of any specific terms of a sale.

Let's go back to our apartment building seller, Mr. Wallace. If part of his long-term goal was to retire to the mountains of North Carolina with a nice cabin and 10 acres of apple trees, he might look for an exchange that would take him directly to that goal. It is possible that somewhere in the North Carolina mountains there is a property owner who would like to own the Wallace apartment complex. Of course, Mr. Wallace may not like the cabin offered, if indeed any were offered. However, by offering the apartment complex for exchange, he might be offered something other than a cabin in North Carolina. Something that he would be willing to take as a small part of the overall transaction, for example, a nice vacant lot overlooking Grandfather Mountain.

No matter what Mr. Wallace's long-term goal is, by viewing it clearly, he will begin to see that there are additional ways to help him entice more buyers to his apartment building. At the same time, these ways or avenues of approach would accomplish the critical task of "getting rid of the apartment building" while moving Mr. Wallace closer to his long-term goals.

Meet the Tax-Free Exchange

By utilizing Internal Revenue Code (IRC) Section 1031 (also called the *tax-free exchange provision*), a buyer or seller may enter into an agreement that will have more specific benefits than a more conventional transaction because of the reduced tax liability to one or more of the parties. This option is open to you only if you know how it works and how it fits into your goals. Chapter 12 illustrates the strategic moves you can make as a buyer or seller (or broker) to use IRC 1031 tax treatment to obtain marvelous benefits.

Mr. Wallace decided that another available option was to reduce the amount of cash needed to take control of the property. With his accountant, he worked up an attractive package that, when coupled with the sale-leaseback technique, would allow a buyer with little cash to purchase the property. This technique enticed more buyers and produced the desired results of selling the property.

Increase the Return on Cash Invested in Income Properties

This goal is usually the most important goal for owners or potential buyers of income property. Due to its importance to buyers, it also becomes an important criteria of market appeal to sellers. The potential effect of financing on cash flow can be very important to the ultimate success in the sale of a property. For example, consider an office building that is free and clear of any debt. The NOI is $90,000. If the current market for such properties required that the invested capital give the buyer a 9 percent return, then an all-cash purchase price would require the buyer to come up with $1 million in cash. In essence, the return of $90,000 on the cash invested ($1 million) would be 9 percent per annum. Now consider the effect of financing. Assume the buyer could borrow (or the seller arrange for it as a part of the offering package) new financing of $800,000 on the property at a constant rate (the combined rate which is interest and principal repayment) of 8 percent interest per annum over the next 30 years. This kind of financing may be easily found and would ensure that by the end of the 30-year period the debt will have been fully paid off.

Now, during these 30 years of ownership, the investor would have a constant annual debt service of $64,000 (8 percent × $800,000 = $64,000). Deducting this from the present NOI of $90,000 results in a cash flow of $26,000. Remember, the debt service in a mortgage with both principal and interest payments is calculated to include both the principal and interest portion of the mortgage. In this way, although each monthly payment will have a slightly different mix of interest and principal, the total for the year will be $64,000. The resulting $26,000 is the return that the investor would obtain on his or her investment of $200,000 ($1,000,000 less the new debt of $800,000 = $200,000).

A $26,000 return on an investment of $200,000 is a return of 13 percent per annum. This is a substantial increase over the original return of 9 percent. By using financing, the buyer has caused an instant increase of new value (value that is above the amount of debt created in the deal). How did this happen? If the market supports a return of 9 percent, the $26,000 cash flow is a 9 percent return on an investment of $288,888. So, by using this simple financing technique, the buyer is $88,888 richer. There is a longer-term benefit here that should not be overlooked. This debt will eventually be paid off over the next 30 years. If the strategy the investor was striving for was to maximize this investment as a retirement vehicle, look what happens at year 31. Assume a modest 3 percent compounded each year of NOI. This means 3 percent × 30 years × $90,000 will be the actual increase in the cash flow once the debt has been paid off. This means an average of 3 percent of increase each year, until the final cash flow equals the original $90,000 plus an additional 90 percent of that amount (3 percent × 30 years = 90 percent). The grand total is $180,000 per year of cash flow, with no debt to pay.

If cash flow is the desired effect, the investor's goal is to maximize immediate return instead of equity build up or other benefits, then an increase of cash flow will appeal to that investor. All things being equal, a cash-oriented buyer will pay more for a property that produces a greater cash flow, whereas an equity-motivated buyer will adjust financing (on this same deal) to maximize debt pay-off and equity enhancement. The bottom line, which is so important to most investors, is clearly a function of the kind of financing that is placed on the property.

If local or currently available financing is not viable at the best rate or terms, then the ultimate payments would reduce the potential cash flow that the investor could realize. This would indicate that more creative measures might be necessary to sell the property.

Most creative financing tricks learned by real estate investors are designed to soften the overall blow of the property debt. There was a time, not so long ago, when it was deemed that the ideal situation for an investor was when the investor could buy a property without putting up any of his or her own money. This use of other people's money (OPM) would create a deal that was 100 percent financed, or at least 100 percent purchased, without the buyer digging around for cash.

Before you jump to conclusions that such a transaction can be counterproductive to your healthy attitude about buying or selling real estate, let me state that buying real estate without putting up any cash is not difficult to do. The hard part is being able to make money doing it. In any city in the world, there are sellers of real estate who would gladly accept a solid promise of payment as a down payment to a property that they could not sell, or that was grossly overpriced. Let this statement be a warning to you before you rush out and invest in a quick way to fame and riches as promised by some promoters of investment programs who tell you that your only way to success and wealth in real estate is through investing with 100 percent of other people's money. Having just said that, let me also encourage you to learn as many of the techniques that allow you to get the maximum benefit out of the investment capital you have. Remember too that there are many assets at your disposal other than cash. Your ability to create instant value (we just saw $88,888 worth of instant value) which can create investment value to the lender or to the seller in your ability to structure additional financing for the transaction.

As the goal to increase cash flow from marginal properties serves the buyer best, it is essential that you recognize that buying from a seller who is inflexible and who only wants cash over his or her existing mortgage may not give you much room to be creative. In these circumstances, and assuming that you want that property and none other, it may be that the brick wall in the way of the deal is that the seller is ignorant of the benefits of creative financing. As a broker, I have had to educate many sellers to the benefits of using sound economic investment planning that saved them money and time, and produced the desired result: the sale of their property. This is important for every potential seller to review because there are important tax and reinvestment criteria that should be considered. Buyers and/or brokers often must help educate stubborn sellers.

Investors will look for sellers who are flexible and with whom the investor can mix and match one or more of the techniques that will be discussed in detail in this book.

Generate Immediate Cash That Is Tax-Free

Often this goal is overlooked. Since the principal owed in existing mortgages may decline over the years, and the value of the property may increase, generally it is possible to refinance and obtain additional cash after repayment of the old loan. This becomes very attractive when this can be accomplished without affecting the cash flow on a property. For example, the mortgage payment for $150,000 over 15 years at 9.5 percent per annum is $1,554 per month. If a new mortgage can be obtained at 10.5 percent per annum but the term is 25 years, the same payment of $1,554 would allow the owner to get $179,275. This would produce $29,275 (less loan costs) in immediate cash. Naturally, if the interest rate was lower, the benefits for refinancing would be greater. For example, a loan payment of $1,500 per month on a 25-year schedule would allow a mortgage of $194,384 at 8 percent to produce an excess of $44,384 (less loan cost) at a slightly lower mortgage payment schedule than the existing 15-year loan.

While this may not appear to be dramatic, if cash is essential at that moment, the opportunity to get cash and use cash may be worth the increased term and interest in the debt payment. While the amount paid each month has not increased, the investor has an additional term of years to make those same payments.

When a borrower obtains money through financing, such as getting a loan from the local lender, there may be no income tax liability on that money. In essence, the money was not "earned" but borrowed. The borrower can in many circumstances renew loans from time to time, increasing amounts borrowed as the values of the real estate go up, pulling out capital that is tax-free, at least for the moment. When the borrower ultimately sells the property, an adjustment would be made to determine what amount of the loan still outstanding exceeded the basis (book value) of the property. This excess would be treated as earned income at that time and taxed accordingly. Under present IRS rules, the real estate investor is able to deduct the interest paid on many real estate loans, which makes this technique a very positive approach to real estate investing. For example, if you refinanced a property you had depreciated down to $100,000 but was actually valued by the lender at $500,000, you might be able to borrow $350,000 or more on that property. If the actual loan was $350,000, your loan is $250,000 more than your book value (depreciated basis). If you sold the property for $500,000 any time prior to repayment of the loan to a level below your basis, the IRS will calculate that the excess funds are now taxable. While this may not be a problem, it needs to be considered before you end up selling with a down payment that does not provide sufficient cash to pay your taxes. If you sold for $500,000 and took a $50,000 down payment, and held onto the balance in the form of a wraparound mortgage, you would think you had an installment sale (an IRS-approved method of spreading tax over a period of years—which will be covered in detail in Chapter 13). As an installment sale, there may be little or no initial tax to pay on principal except as the buyer makes payments of principal owed to you. This is a common error that sellers make. Because you borrowed money above your tax basis (book value), and the funds borrowed were tax-free at the time of the loan, it becomes taxable the year you close the sale. Your tax liability on this borrowed money could be over $75,000. This simply stresses the need to examine all potential costs that may diminish what looks like a windfall profit. Pulling out tax-free cash can have a penalty later on, but even that can be part of the overall investment strategy and needs to be considered in your long-range planning.

Your use of financing to produce cash in a transaction will depend on your ultimate goals and what it is that you are trying to accomplish at the time you desire this cash. As you learn more of the creative techniques of financing, you will discover that getting cash in refinancing is not always the most productive or best route to take. For example, also in Chapter 13, you will learn about a technique called *pyramiding*. With it, you will be able to take the cash needed to buy property from the first property you own by giving the seller of the second property a second mortgage on the first property. You will do this, and variations thereon, at interest rates well below those offered by the institutional lenders in your marketplace. Do not jump to conclusions that because I used the word *pyramid* I am suggesting anything illegal. In real estate investing, where real equity that is genuinely creating new value is pledged for future investments, it is not only legal, it can also be a beneficial form of buy and sell for both parties involved. More on that subject in Chapter 13.

Maximize Equity Build Up of a Long-Term Investment

Financing has the ability to maximize equity build up when the investor structures the debt in such a way that there are funds that are continually used to improve and enhance the income of the property. By allowing a steady growth of the NOI of an income property, the long-term value is one of the beneficial results. This usually is done at a sacrifice of the cash flow, so this has to be considered and become a part of the long-term outlook for that investment. I often suggest that investors look to long-term enhancement of value by a well thought out landscape plan for their real estate investments. Twenty years of mature tree growth can turn an apartment complex into an attractive garden that not only provides beauty to the renters who live there, but shade and privacy as well.

Help Solve Tax Problems

This goal serves two masters: the buyer and the seller. When you use a form of financing to solve a tax problem, you often create a problem for the other party to the transaction. The most critical item that comes into play is the motivation of the parties. If the most motivated party is the seller and his or her goals are better met by selling the property, the transaction may be slanted to the buyer in tax benefits and still be able to close. However, if the most motivated party is the buyer, there may be an opportunity for the seller to find additional solutions to his or her tax problems. On some occasions, both parties can gain benefits from careful review of the transaction and the tax laws.

The items to review will vary, depending on the circumstances and needs of the parties. However, there are 10 items that should be part of your checklist when either buying or selling real estate. A review of each item with careful attention to your own goals and circumstances will aid you in determining if there are any tax advantages you need to consider prior to either making the offer or at least prior to closing.

Tax Advantages Checklist

- ✓ What items are to be depreciated within the investment property? Buyers generally want maximum values established; sellers often want lower values set. In exchanges, both parties may want to have the depreciable items considered with different base values.
- ✓ Should you take title to land and building and personal property equally? There are advantages to taking it differently if it fits your circumstances.
- ✓ On what date should you close? This can have a specific advantage to one party or both if the date can be split between two tax years.
- ✓ How should an option payment be established? This can create cash to the seller that is not taxed right away and can be highly effective in nailing down a deal.
- ✓ Review the advantages of the wraparound mortgage because it might apply to the transaction contemplated.
- ✓ In an IRC 1031 exchange, should the replacement property's values be directed against the land, the building, or both?
- ✓ What are the one-time capital gains exclusions available to you under the current tax laws?
- ✓ If the seller is to hold financing, should part of the down payment include the maximum advance interest allowed by the IRS? (The maximum allowed as of this writing is the interest that would be earned during the balance of the year.)
- ✓ Should the buyer buy the property or the personal interest in a corporation or trust that owns the property? This and similar questions about form of ownership can give the investor a lot to think about when he or she buys so as to establish the best form of selling interest.

Create Tax-Deferred Transactions

Sometimes, the only major benefit from a financing technique might be to pass on the possible tax consequence to some future date. There are, of course, other nonfinancial options available to the investor that may have similar results. The idea is to examine what benefit the investor or the seller may have and at what cost. For example, if the technique used by a buyer was to acquire a property by entering into a long-term lease with an option to buy, the seller would not have a capital gain tax to pay until the sale took place. If part of the rent paid was money that was paid each year or month to the seller to keep the option to buy alive, it may not be taxable until the actual sale closes. As long as that money was to be applied toward the ultimate purchase, it is possible that some or all of the option money would not be taxed as income or as capital gain until the sale actually took place no matter how many years in the future that was.

In the IRC Section 1031 exchange mentioned earlier, it is possible to have a lifetime of investing and still not trigger any capital gains tax; with an installment sale provision you can sell a property and only pay the gains tax on the portion of the actual gain you get, and in the year you get it. Both the exchange and the installment sale allow creative tax planning, and as with any provision that deals with the Internal Revenue Service (IRS) Codes, you must make sure that you have gotten the most recent up-to-date advice possible. All IRS rules and regulations are subject to change and different interpretations to what appear to be similar transactions. While this often intimidates people, you should not let fear of the IRS stand in your way of using totally legal and often creative means to build or keep your wealth.

Keep in mind that many techniques have an effect on the benefits of real estate and change the long-range tax, which may be payable at some time in the future. The more you know about your own tax consequences and your future goals, the better you will be at using the laws and finance tools to your best advantage.

Open New Doors for the Investor to Expand an Investment Portfolio

As a real estate investor, you would learn quickly that profit in real estate is not a function of buying real estate. It depends on use and utility of the property and the final disposition of the property.

This signifies that to be successful in real estate investing, you will benefit the most when the complete plan fits the goal. You will not succeed in investing by buying this and/or that without knowing what to do with the property after you have acquired it. There is no doubt that with sound study of the area and with the development of expertise, you could recognize opportunities that other people would overlook. Soon you will be able to take advantage of those properties. In those cases, the use or utility of the property is simply that of a sound investment spawned out of your unique knowledge in the area and your grasp of the opportunity.

The more you understand about the tools of financing, the better equipped you will become to use them to expand your portfolio. In developing your knowledge, you are reducing your risk in the investment game. Some of the benefits of finance are to assist in the sale or disposition of property. Through your knowledge of these tools, you will move through your portfolio to other properties and investments.

Risk, which will be discussed in greater detail throughout this book, is similar to the term *value*. Both risk and value are relative to the investor's ability and capability. Savvy investors make things look easy because they recognize opportunity, therein reducing or removing the aspect of risk. They create value because they know what they want, and where they are going.

Provide the Professional Touch to a Good Marketing Plan

In selling your most difficult property, the maximum appeal to the marketplace and the maximizing of your goals will be in covering all possible bases. Investors who look after details are generally the most successful investors. Your devotion to the use of the tools of finance will demand that you anticipate your ultimate marketing plan, which should include various financing approaches to suit the probable investors who will buy your property.

When the time comes for you to "need" heavy financing for a large transaction or the development of some upcoming project you have wanted to build, success could well depend on your past history of dealing with lenders.

KNOW THE LIMITATIONS OF THE TOOLS OF FINANCING

The preceding 11 goals are the keys to your use of financing as a problem solver. Yet from time to time, there will be situations that you cannot solve by using any of the financing techniques. In fact, at best you will simply maintain the status quo by using these tools. In the worst case, you can ruin the property and the investment by applying the wrong technique.

The knowledge that you develop of the financing techniques covered in this book cannot be considered absolute. There will be many tips and suggestions to help you expand your knowledge, and you should recognize that there is no single source of knowledge in any field.

In the chapters to come, I show many different investing techniques and list some of the advantages and disadvantages as they are applied to the buyer and seller of any property. In your review of these different points of view, you should ask yourself how you would approach a particular technique in your own circumstances. If you are reviewing this book to brush up on some of these techniques in anticipation of some specific transaction you are trying to nail down, I recommend that you also review the Contents to become aware of other techniques as well.

It is rare for a real estate investor to use any single technique offered, countered, or refined in the final document of sale. One party buys hoping to have made the best investment possible, and another sells with a similar hope in mind. Each party to the transaction may have still held onto a card that he would have thrown into the pot to sweeten the transaction were it necessary. But no more cards were required, so the deal stands as executed.

Some important points to remember when approaching a situation that you feel may be solved with one of the financing techniques covered in this book are discussed next.

Six Tips to Solving Real Estate Financing Needs or Problems

At least one of the 11 goals described in this chapter should be met for financing to have any real benefit to the parties involved. The following six tips will help you relate to the needs of the other parties and attain your own goals while establishing a win/win result:

1. Different points of view will be held by the buyer and the seller in their interpretation of these goals.
2. The results of the form of financing used often will affect these two parties differently.
3. Theories that work on paper are valid only if they work in real life.
4. There often are many parties to a transaction even when only two or three are apparent. The visible ones are the buyer and seller, and often the broker. The not-so-visible ones are the lawyers, wives, boyfriends, bankers, bartenders, and so on; each party has some relationship to the deal.
5. Each party has to be dealt with when he or she impedes the desired results of a transaction.
6. To achieve constant success in real estate investing, stay as close to your long-range goals as possible.

Since so much does depend on this goal-setting ability, I have provided a detailed chapter on goal setting and development of your comfort zone. Each chapter will become a foundation to your future as a real estate investor. If your role in the game of financing is that of a real estate broker, you will have the added burden of acting as fiduciary in the transaction. However, you will also have the advantage in the investment game and will find that all of the techniques covered in this book will become useful tools in helping you buy and sell properties.