1 The Beauty of Lease-Options

The Benefits of Lease-Options

There are many benefits to using lease-options as a strategy to manage a portfolio of investment property. As an investor, our emphasis is to improve portfolio performance by increasing returns, reducing volatility, and lowering the overall risk.

The following characteristics make lease-options more favorable than conventional landlording:

- More Upfront Money
- Higher Rents
- Higher Sales Price
- Little or No Maintenance Costs
- Attracts Better Tenants
- Flexible Use
- Less Management Responsibilities

- Quick Tenant Removal When They Default
- Tax Benefits
- Alternative Financing

Most of these benefits come from the tenant mindset that they are “buying” a property where the lease-option becomes a form of intermediate financing for them. With this short-term intermediate financing, the goal is to obtain a refinance loan with another lender to ultimately own the property. Because of the buyer’s mindset, tenants are willing to pay more and do more for the opportunity to buy.

More Upfront Money

There is almost always greater upfront money received from lease-option tenants than is normally collected with a standard rental. The tenants are willing to provide more upfront money because they view the funds they are paying as similar to a down payment in a conventional purchase with a mortgage. Because their intent is to ultimately own the property, they are willing to give extra upfront money to secure the right to purchase the property.

Higher Rents

Because few property investors are willing to sell and provide financing to the type of people we deal with, they are willing to pay a higher monthly premium for the right to buy. As such, we are able to collect higher rent payments than normally allowed through conventional rentals. It is not uncommon to receive monthly payments that are 10%-20% higher than prevailing market rents.

Higher Sales Price

In addition to the willingness to pay higher rents, the tenants are willing to pay a higher price for the property as well. The price is often secondary as long as they can afford the upfront money and the monthly rent payments.

People in this socio-economic group are simply not as discriminating in the price they pay for a property. Most are simply happy to have someone willing to sell a house to them and provide intermediate financing to do so. This sense of gratitude makes them very receptive to paying a higher price.

Little or No Maintenance Costs

When people buy houses, it is unsaid but understood that once someone buys a house, they have to assume the repair and maintenance responsibilities for that house. Because all parties are clear in the arrangement that the tenants are ultimately buying the property, it is expected they will take responsibility for all repairs and maintenance since it will become their house. To real estate investors, this point is one of the major benefits in using lease-options. Short of catastrophic damage to the property, the investor can expect nearly no maintenance or repair costs compared to those with standard rentals.

Attracts Better Tenants

The people who are attracted to lease-options are often those who have already rented for many years. They have attempted to buy a house through conventional means, but for a variety of reasons, they have been unable to do so.

Because they have rented for many years, our tenants are frustrated homebuyers looking for someone to give them an opportunity to buy with easy financing. Because many have tried to qualify for conventional mortgages, they are aware of the need for a down payment. As such, these people often have a good tenant history, are employed, and have accumulated a decent amount of savings to put towards a down payment. In our case, this is upfront money to be used for a lease-option arrangement.

Flexible Use

Typically, in a conventional rental situation, the landlord is expected to provide housing that includes functional appliances, functional environmental systems, reasonably good flooring/carpeting, landscaping, and a good interior condition. Not only are landlords expected to provide tenants this at the time of move-in, but the landlord is also expected to incur the cost of ongoing maintenance and repairs! All this so that he can collect only a small security deposit and first month's rent!

When the tenants enter into a lease-option transaction, they understand that they are "buying" into the property in "as is" condition. It does not mean that we, as investors, don't do some property preparation. However, it also doesn't mean that it is necessary to totally renovate a property before we can "sell" it. Often, you can "sell" the property "as is" with all its imperfections.

Less Management Responsibilities

Once an investment property has been "sold" through a lease-option transaction, there are almost no management responsibilities except to ensure that the monthly payment is received. The repair and maintenance responsibilities have been placed with the tenant. As such, most of the well known "landlord headaches" have been removed.

Quick Tenant Removal When They Default

The lease-option transaction, when structured correctly, often utilizes prevailing Landlord-Tenant laws of eviction to resolve cases of non-payment. With alternative forms of financing, the investor often has to resort to a foreclosure process, which can be both time-consuming and expensive.

The goal of eviction is three-fold. The first is to have the tenants removed from the property. The second is to get legal possession of the property. And the third is to get a judgment so additional collection measures, such as garnishment or levy of personal property, may be pursued.

When the tenant stops paying either voluntarily or involuntarily, having a quick repossession is paramount to getting the investment property performing again. The eviction process is the quickest and most cost-effective way to do this. With legal possession, we can take actions to once again get our investment property performing.

Tax Benefits

Monthly income from investment property under a lease-option agreement is generally considered to be rental income. Rental income generally falls under the category of "passive activity income" within the view of the IRS, which is taxed lower than personal service income (earned income).

Further, some of the upfront money collected such as security deposits can be tax-deferred until the day the landlord claims the money for compensation for damages or losses. Additionally, option money can be tax-deferred until the tenant either leaves the property or exercises the option, whichever comes first.

If the property is sold after 12 months of ownership, it is generally taxed at long-term capital gains rates, which are often much lower than earned income rates. Additionally, if advanced notice is provided, investors need not take the profits. The IRS allows property investors to do a tax-deferred "1031 exchange" so that all the profits are rolled into another property of "like-kind".

Note: As in the case of all taxation matters, you should consult a CPA or other expert financial counsel.

Alternative Financing

Many lenders and investors recognize lease-option transactions as a form of owner-financing. It gives the tenant full use of the property, but also the right to buy. This can be a favorable arrangement for both tenant and landlord. When done correctly, both parties' interests are fulfilled.

Since the lease-option transaction is often recognized as a form of owner-financing, it often facilitates greater ease in getting a new loan for the tenant so he can successfully buy the property and ultimately have title transferred into his name.

Misconceptions of Lease-Options

I often encounter investors who are conventional landlords. It seems no matter how much I try to explain the benefits of lease-option transactions to them, they never quite grasp the benefits. As such, writing this book allows me the opportunity to clarify any misconceptions.

The first step for conventional landlords is to have an open mind when it comes to investing. Never have I said, don't consider conventional landlording; it simply means by understanding lease-options, you will have an additional instrument within your investment repertoire.

Misunderstanding and resistance to lease-option transactions center on the following issues:

- The investors need for ownership "forever"
- Misunderstanding the mindset of lease-option tenants
- Ignorance of multiple profit centers

Buy and Hold Forever

People from a conventional landlording background often "buy and hold" property for life. The underlying motivation for them is to one day fully own the property "free and clear." They are primarily working for the future, and may or may not receive a lot of upfront money or monthly cash flow from their tenants. Their mindset says they are willing to sacrifice some of the money because their tenants will "pay their mortgage" until the day they own it "free and clear." They simply don't want any possibility of "losing" the property.

If the owners do hold the investment for monthly cash flow, conventional "buy and hold" investors fear they will lose the monthly income once it is sold. Along with the fear of loss of monthly income is the fear of not being able to find a replacement property.

What "buy and hold" investors fail to understand is that most people who enter into a lease-option agreement never fully exercise their option to buy. **This is not by our design.** It simply is the nature of the types of tenants that are attracted to owner-financing. They either stop paying or simply move on. If and when the property comes back to us, we can increase the upfront money, the monthly rent, and the option price to better reflect changes in the market.

This is analogous to the homebuyers of today who take on 30-year mortgages. Relatively few such mortgages live out their entire 30-year lifespan. It is commonly known in the lending industry that the average American will move every five to seven years, and when they do, they get a new 30-year loan.

Tenants who agree to lease-option agreements have the *intention* of staying with the property for a long time. However, the very reasons they were unable to buy a house conventionally are often the reasons that eventually compel them to move on. Their track record of personal stability has not been established long enough to allow them to buy conventionally.

We give our tenants the benefit of the doubt that they want to buy, but our experience has shown that most will move on within three years. Like conventional landlording, there is turnover with lease-option transactions. However, the biggest difference between the two, is that we are often financially rewarded when turnover occurs while conventional landlords are not.

Ultimately, we expect most of the houses we have in our portfolio to be paid off by our chain of lease-option tenants over the course of the next 30 years (or sooner). And on the off-chance a tenant successfully exercises his option to buy, through qualifying for a refinance loan, there is nothing difficult in rolling the realized equity forward into an equivalent replacement property.

Misunderstanding the Tenant Mindset

Generally speaking, investors who are accustomed to old-fashioned "buy and hold" often do not understand the mindset of lease-option tenants.

"Buy and hold" investors do not understand that psychologically, the desire for tenants to own a home is extremely high. It is a fundamental dream of most societies. As such, these people are willing to pay more, do more, and assume responsibility unheard of among conventional tenants.

This is the mindset that "buy and hold" investors fail to understand, but ultimately this is what translates into higher returns, better performance and fewer management challenges within our investment portfolio.

When tenants are willing to pay more and do more on all levels, it inevitably translates to better investment performance.

Tenants realize there are mostly "buy and hold" investors in the market. In the lease-options market, we have virtually no direct competition.

In my view, "buy and hold" investors miss the opportunity to capitalize on the fundamental desire of home ownership within most tenants. In many cases, it is unlikely our tenants will have the personal stability to ultimately own the property, and this often works out in our best interest.

Multiple Profit Centers

Closely related to how "buy and hold" investors do not understand the mindset of lease-option tenants, is how they cannot understand there are potentially three profit centers from a lease-option transaction instead of one.

"Buy and hold" investors are mostly focused on the monthly rents. However, in a lease-option agreement, there are potentially three profit centers.

- Upfront money
- Higher monthly payment
- Back-end Option

Typically, in a conventional rental, the upfront money received comes in the form of a security deposit and first month's rent. In the way we do lease-options, our upfront money typically consists of a security deposit, an administrative fee, prorated first month's rent, and option money.

Profit Center 1 - Upfront Money

The greater upfront money we receive from a tenant comes from their willingness to pay the equivalent of a "low down payment". The upfront money typically covers three months worth of vacancy. If we move a property within two months, we actually come out ahead with the tenant turnover.

On top of all of this, we typically do not bring the property to prime condition as we might do with a conventional rental. Later on in the book, I will explain what we do to prepare the property for "resale." I can assure you, however, that they are mostly low-expense items. Our tenants take on the responsibility of repainting, wallpapering, getting appliances, carpeting, flooring, and performing minor repairs.

It is important to note, if we subscribed only to "buy and hold," we would receive relatively little upfront money, AND we would also have to spend far more for selling the property in renovated condition.

Comparison of Lease-Option vs. Conventional Rental

3-bedroom, 1-bath house
Market Rent = $500.00, Monthly P.I.T.I. = $375.00

Lease-Option		***Conventional Rental***	
House cleaning:	$ 50.00	House cleaning:	$ 50.00
Yard care:	$ 50.00	Yard care:	$ 50.00
Carpet cleaning:	$ None	Carpet cleaning:	$ 100.00
Paint:	$ None	Paint:	$ 100.00
Appliances:	$ None	Appliances:	$ 200.00
Total Preparation Expense:	$ 100.00	Total Preparation Expense:	$ 700.00

Lease-Option preparations cost less!

Administrative Fee:	$ 200.00	Application Fee:	$ 20.00
Security Deposit:	$ 250.00	Security Deposit:	$ 350.00
Prorated 1st month:	$ 250.00	1st Month's Rent:	$ 500.00
Option Money:	$ 900.00		
Total Upfront Money:	$1,600.00	Total Upfront Money:	$ 870.00

More upfront money with a Lease-Option!

Profit Center 2 – Higher monthly payment

As I mentioned, because lease-option tenants are willing to make monthly payments that are typically higher than market rents AND are willing to take on the maintenance and repairs responsibility, we do not receive calls for such things. All we do is collect our monthly rent payments. The net effect is that we have higher monthly cash flow and no unexpected maintenance and repair expenses for the property. This is a wonderful thing.

Comparison of Lease-Option vs. Conventional Rental

3-bedroom, 1-bath house
Market Rent = $500.00, Monthly P.I.T.I. = $375.00

	Lease-Option	Conventional Rental
Tenant Payment:	$ 600.00	$ 500.00
(-) Monthly P.I.T.I.:	$ 375.00	$ 375.00
(-) Repair & Maint:	$ None	$ 40.00
= Net Monthly Cash Flow:	$ 225.00	$ 85.00
Net Annual Cash Flow:	*$2,700.00*	*$1,140.00*

More spendable cash flow with a Lease-Option!

Profit Center 3 – Back-end Option

Finally, we have the option price. The price for which we sell the property is typically 10% to 20% over fair market value. The rationale for this is since we are providing the intermediate financing and bearing the risk for the next few years, we are entitled to capture the appreciation that might come along with it. However, if the tenants make substantial improvements, they receive the benefits of our commitment to cap the price. In effect, they create some "sweat equity."

One of the techniques we use to sell an imperfect or a physically distressed property is by giving a large "repairs and decoration credit." It is far easier for us to give credits on the "back-end", which may or may not be exercised, then to come up with the funds to make repairs to a property ourselves.

Not only do we receive a price higher than market value, but we also leverage this into incentive credits for our tenants to make repairs and improve the property.

As you can see, a lease-option transaction when implemented with some knowledge and creativity, can potentially have three profit centers and provide immense stability within an investor's portfolio. As an investor, the reduction of investment volatility is incredibly important.

Refinance Loan vs. New Purchase Loan

The major difference between a refinance loan and a new purchase loan is: applicants of most new purchase loans require sufficient funds for a cash down payment. (Generally 3%-20% depending on the loan program.) In addition to the cash down payment, the loan applicant must also have sufficient funds to cover "closing costs" which generally includes loan fees, broker fees, attorney fees, title research, taxes, and many other related fees. These fees are broken down in greater detail in a settlement statement and normally run into the thousands of dollars.

In a refinance loan, there are generally no down payments. The reason for this is because the lender recognizes the lease-option contract as the tenant's declaration to purchase the property in the near future. They have demonstrated this by living in the property for at least 12 months, and they have paid upfront money for a purchase option.

In the lender's eyes, as long as the tenant maintains residency and a good payment record, the tenant may be a good refinance candidate. Of course, we would like for this to occur so our tenants will get a loan to ultimately cash us out. But the tenant is still required to be responsible and clean up their personal credit.

Another benefit to our tenants in applying for a refinance loan is that nearly all closing costs are "rolled" into the loan. What this means is that all the aforementioned fees normally paid with cash for a new purchase loan are simply added to the borrowed amount of the loan. So, there is generally no upfront cash required to pay for the loan.

The cash requirement for a down payment plus closing costs often presents a big challenge for a new homebuyer. Additionally, the qualification process for a new purchase loan is generally more stringent than a refinance loan.

Summary

Clearly, I am a proponent of lease-options. They allow my company to create incredible returns for ourselves and out investment partners with minimal overhead. The secret to success of lease-option transactions is not simply the legal instrument, but the tenant's intense desire to buy a home, which allows for fantastic performance within our investment portfolio.

If you're looking for an innovative investment strategy, you should consider lease-options. The first step to successfully implementing lease-options is to not limit yourself to the conventional rental mindset; but keeping an open mind to alternative investment possibilities.

Written Exercise – Part 1

Did I truly understand the main points of this chapter? What do I need to review again?

Which ideas in this chapter can I adapt to my market?

Which ideas in this chapter can I start implementing immediately?

Written Exercise – Part 2

Which tasks do I need to do myself? Which tasks do I need to delegate to others?

What team members do I need to contact to assist me in implementing the ideas within this chapter?

What follow-up questions do I need to ask the Author? What additional information do I need to research?