Regular Riches

The Fair Lease/Purchase….an investor's perfect Hybrid!

We see them all over the roads today. Growing in popularity, Hybrid vehicles are beginning to offer an enticing option to dependence on foreign oil supplies. Similarly, the Buy Low, Rent Smart, Sell High lease/purchase model offers investors a Hybrid of the "buy and flip" and "buy and hold" investment models.

Most residential investment models resemble and can be grouped into one of two general categories. Each has a major flaw that concerns many investors who consider or invest in each model.

The "buy and flip" model by definition is for the investor who seeks to purchase property at a discount, oftentimes improve the property, then sell the property quickly for immediate gain. This model is ideal for investors who have no interest in landlording, as the "buy and flip" investor does not intend to seek a tenant for the property in advance of sale.

The main problem with the "buy and flip" model is that if a buyer does not come by quickly, then the investor is faced with discounting the property and/or involving a real estate agent in the marketing of the property. Due to this possibility, most "buy and flip" investors need a discount of 25% or more even after adjusting for the necessary repairs and improvement. With such high investor discounts, the pool of properties available with such significant discounts is often small. Simply put, the higher the discount the investor needs to make his or her model work, generally the fewer properties available at such a steep discount.

The "buy and hold" model by definition is for the investor who seeks to hold property for the long term. Many "buy and hold" investors envision funding their retirement years by selling the properties once the notes have been paid off, sometimes thirty years after purchase. A key benefit for these investors is that the need to acquire these properties at a significant investor discount is minimized, as the investors are seeking their primary return many years into the future. Thus, the supply of homes that meet their long term investment model is often plentiful.

There are two main issues with the "buy and hold" model. First, there are no opportunities for "cash windfalls" from the real estate during the "hold period". Without the cash windfalls, funds to expand the portfolio generally must come from the investor's day job, other investments, and sometimes partly from positive cash flow. Because of such "slow growth" characteristics, it is rare to find a pure "buy and hold" landlord with much more than five or six properties.

Second, many "buy and hold" landlords burn so much time, effort, money, and energy taking care of repairs, maintenance, and high vacancies common with pure rental property (some investors delegate this to a management company, and while this may save the investor time, it cuts into the profits as the management company must be paid for their work). The time, effort, money, and energy spent dealing with landlording issues often serves to minimize the investor's ability to grow his or her portfolio to any reasonable size. Worse, troublesome landlording experiences often sour new investors on real estate.

A properly implemented "buy and lease/purchase" model takes the best of the "buy and flip" and "buy and hold" models. It also minimizes each model's most glaring flaws.

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First, most investors who use the lease/purchase model are able to “flip” some of their properties and sell others to their lease/purchase tenants. This allows the investor to generate the “cash windfalls” necessary for portfolio expansion, without the pressure of *having to sell* that is specific to the “buy and flip” model. Additionally, the investor should be able to make purchases work with as little as 10% investor discount (much less than the typical “buy and flip” model), because the pressure and risk associated with *having to sell* fast is no longer present.

Second, on the landlording side, most lease/purchase agreements transfer the repairs and maintenance responsibility to the tenant, as the tenant is not a typical renter but rather a “future homeowner”. The typical lease/purchase agreement can also be signed for significantly longer terms. Both these factors save the landlord much of the time, headache, and cost associated with upkeep and turnover common with most rentals. A final bonus is even when the tenant does not exercise the purchase and vacates either voluntarily or involuntarily, the properties generally are in much better condition than had the tenant been a typical renter.

What do we mean by “fair” lease/purchase as noted in the title?

Sadly, many investors have given lease/purchase a bad reputation by offering restrictive terms designed to minimize the lease/purchasers probability of exercising the purchase option, while “supposedly” maximizing the investor’s return. We have found a correlation between offering attractive and reasonable option terms, and the profits available to the investor, our “win/win” philosophy. People are not stupid, and if the terms are not attractive demand for the investor’s lease/purchases will be minimized. By making the terms especially attractive, there should be higher demand for the lease/purchase, and the investor can be more selective among the available candidates. Carrying this supposition further, higher quality tenants placed in the property mean less money and time spent landlording. That time and money can then be better spent expanding the investor’s portfolio to truly significant levels.

Does this “buy and flip” and “buy and hold” hybrid model work in practice?

Indeed one must allow for variation as no model is implemented exactly the same by any two investors, and markets across North America can be incredibly different. However, implemented correctly and in the right market, we can attest that an investor can manage a large portfolio of properties with minimal management time with the Fair Lease/Purchase Hybrid. We have, and we’ve been able to do this while maintaining full-time day jobs.

If Hybrids are the automotive future of our country, perhaps the Fair Lease/Purchase Hybrid will be the perfect model for investors concerned with the flaws of either the “buy and flip” or “buy and hold” investment models.

Andy Heller is co-author of the Fortune Magazine recommended book “Buy Low, Rent Smart, Sell High” and together with his partner, Scott Frank, have approximately 40 years of combined real estate investing experience and have purchased, rented and sold approximately 100 residential properties.