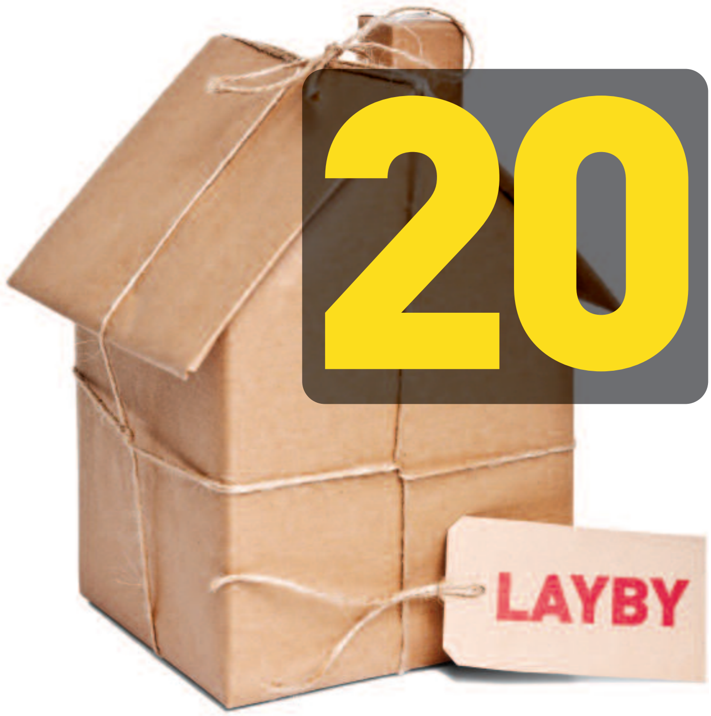

20 DOS AND DON'TS OF PROPERTY OPTIONS

I've been using property options since I started in the real estate game, young and green, more than 10 years ago. It worked out so well the first time that I never stopped. It's a method of investing that can be very profitable, but there are pitfalls you need to be aware of. **NHAN NGUYEN**

These days, getting finance can be one of the most challenging components of a property deal. You might've already maxed out your borrowing power with other projects, committed your savings to a family holiday, or perhaps you're just not keen on using your own money.

That's why options can be a viable way of securing an opportunity, making a healthy profit and moving on – all without having to splash out your own cash.

There are two types of options: call options and put options. For the purpose of this article, I'll only be looking at the first one.

WHAT IS IT AND HOW DOES IT WORK?

Call options give you the right, but not the obligation, to buy something. Think of it as a high-level equivalent of laybying an outfit at a department store. You love it, you want it, but you don't have the cash for it right now.

Instead of going away to save the money and potentially missing out altogether, you put down a small amount to secure your right to purchase the outfit at a nominated price and within a certain period of time. After signing a document of agreement with the seller, you're on your way.

In the case of property, there's generally no maximum timeframe on the exclusive right (but not obligation, remember) to buy. The minimum deposit – or option fee, as it's called – is just $1.

The document you sign is a legal agreement between you (the grantee) and the owner (grantor). The agreement stipulates that the holder of the option – or someone they nominate – obtains the exclusive right to buy the property at a fixed price within an agreed time.

There are various reasons why someone might take an option on a property. The types of deals that involve an option might include townhouse or unit developments, house-and-land packages or rent-to-buy arrangements.

OPTION ON RAW DEVELOPMENT SITE

Outcome = Get an approval (add value) and sell higher than option price

TYPICAL OPTION TIMELINE (12 MONTHS)		
Look for buyers	Contact buyer	Settlement

TYPICAL RAW SITE DEVELOPMENT APPROVAL TIMELINE (12 MONTHS)			
Townplanning/ plans drafted and submitted	Approval period plans approved/rejected (decision notice given)	Appeal period/ Approval	Development of site can commence (continues after settlement)

OPTION ON HOUSE-AND-LAND DEVELOPMENT

Outcome = Secure option on one or more blocks of land and sell higher via house-and-land package/s

TYPICAL HOUSE-AND-LAND OPTION TIMELINE			
Secure option during development of site* (roads, services, curb and channelling)	Application for and issue of titles 4-6 weeks	Typical option expiry 21-30 days after issue of titles	Settlement 30-60 days after issue of titles
	Option period = Timeframe to find a buyer		

*Not always possible but ideal as it gives maximum time to onsell product

HOW TO MAKE MONEY

You might take an option on a property for one price and sell it on as is for a higher value, pocketing the profit without having actually spent any of your own money. There are obviously difficulties involved with this tactic.

You might opt to sell it on with a house-and-land package attached, making money on the build as well as the land.

If there's already a dwelling on the site, you could renovate it to increase its value and sell it on for more than the agreed option price. Or, if the market allows it, you could negotiate an extended period and ride the capital growth wave.

ISTOCKPHOTO

THE DOS OF OPTIONS

When you're undertaking an options arrangement there are some things you should definitely do.

1] Pay a small options fee, if you're able to – say, $100 or $1000 dollars – to secure the deal. Keep in mind that if you back out, you'll lose this money so make it an amount you're willing to part with if things don't work out.

2] Enlist a good lawyer to help you and make sure they understand how options work and what's involved. All solicitors are not created equally, especially when it comes to property deals. Talk to a few experienced property developers – they'll know who you should engage.

3] Start on a small scale so you can get your head around how options work, their potential and the many ins and outs. When you're comfortable, move on to something more challenging.

4] Have a clear exit strategy if things don't go to plan. Having multiple exit strategies is ideal.

5] Have a buyer type in mind from the outset and look for agents or marketing groups that can sell your property type for you.

6] Do your due diligence on whether the opportunity stacks up. Just because you've got something under option doesn't mean it's a solid deal.

7] Add value to the property where possible.

8] When you're drawing up the paperwork, ensure you've got a right to caveat clause to protect your interests. A caveat is like a padlock on a property and will prevent the owner from selling it to someone else. Some owners, seeing their property's worth increase due to the value you've added or by external market forces, might get greedy and want more than you've previously agreed to.

9] Check the owner is up to date with their mortgage repayments. While you might not be liable for their debt, the options agreement is with them – if they default on their financial commitments and the bank repossesses the property, all bets could be off.

10] Consider making monthly options payments – for example, $500 per month – that are non-refundable. This is often a good approach as it allows you to tie up the property as well as find a buyer. It's also a bit easier on the hip pocket than paying thousands of dollars up front. Do the math – compare it to taking out a loan on the property and paying six or seven per cent interest. On a $1 million deal, paying $6000 over the course of a year in options fees is a much better outcome than $70,000 in interest. From the owner's point of view, they're at least getting some form of payment.

THE DON'TS OF OPTIONS

Like any investment, there are a number of things you should avoid doing. It's easy to make mistakes in any setting but the stakes are different when it comes to options.

1] Avoid cutting corners when it comes to the agreement. Seek expert advice from someone who knows what they're doing.

2] Invest an adequate amount of money in legal fees. Trying to save some cash in this area could cost you big.

3] Don't forget to pay the option fee. Until the owner has received it, the agreement isn't legally binding and the seller could have grounds to pull the pin on the whole arrangement.

4] Don't underestimate the power of working directly with property owners. When you're negotiating directly you can find out what the seller's needs are and work out ways you can deliver a win-win outcome.

5] Don't give any personal guarantees regarding settlement.

6] Research is critical – don't cut any corners. You need to know exactly what you're dealing with, who your target market is and how to get out quickly and painlessly should the need arise.

7] Don't be greedy. If you're making a small amount of money on the deal in a short space of time, and there's no risk for you, be happy with that. Small fish are the sweetest. If you're new to the game, take the money you make and run instead of trying to squeeze a bit more blood from that stone.

8] Don't get distracted with multiple strategies. Focus on one type of option arrangement, whether it's single land lots or development sites. A lack of focus will delay your success indefinitely.

9] Don't aim too high too quickly. The big players out there can smell when there's a lack of experience and will eat you alive. If you're not careful, a cut-throat operator could bypass you on deals or void your options. Don't take the risk by doing big deals early on – learn the ropes first.

10] Don't be a pushover when it comes to sellers who feel remorseful. If they change their mind once all the paperwork is signed, remain firm. Stand your ground, especially if you have a legal leg to stand on. No doubt you'll have put in many hours of research and thousands of dollars in legal fees and due diligence. Don't walk away now!

I've broken down the usual process and timeline of two of the more common options arrangements on the previous page – the house-and-land package option and the raw development site option.

THE BENEFITS OF HAVING OPTIONS

There are a number of reasons for going down the options route and numerous potential benefits for the investor driving the deal.

Here are the top perks of a property option:

1) Interest free for the life of the option: Who wouldn't want to skip out on paying interest? Imagine you need to wait for zoning to change, the real estate cycle to improve and prices to lift, planning approval or new local infrastructure to be completed. If you held a traditional loan on the property, the costs involved would quickly add up. With an option, you can essentially sit back and wait. Similarly, you're not impacted if

Back in 2007, I negotiated an options deal that seemed like an absolute cracker, *writes Nhan Nguyen*. The landowner wanted to offload 20 blocks in Brisbane's bayside with an asking price of $5.4 million, equating to $270,000 per lot.

After much discussion, I was able to get a discount for buying all 20 blocks. The owner agreed to an option – we'd pay a total of $4.7 million, or $235,000 per lot, within two years. It was a dream outcome for my business partner and I.

We began selling the blocks at about an average of $290,000 each. Based on our projections, we expected to make a total profit of $1 million.

For the next 12 months, we had a pretty good run... until disaster struck. The development hit rock, rain and bad management. Ongoing delays and the onslaught of the global financial crisis (GFC) at the end of 2008 saw buyers start to pull out via the sunset clause (the timeframe in which the land had to be registered). We were watching contracts crash every week, with some worth up to $100,000 in profit.

Thankfully, having secured the lots at a low price at the beginning, things were still leaning in our favour. In early 2009, we scrambled to keep the remaining profitable contracts alive and sell the remainder at near cost.

But there was another problem. The seller wanted to renege on our original deal and keep the option fee of $235,000 that we'd paid. On top of that, he also wanted any profits we'd made.

With the help of a very good lawyer and a lot of negotiation, we resolved the dispute and carried on selling the blocks. In the end, we made a total profit of $200,000 – not a bad result in the GFC.

THE FIGURES

Property	Option price	Option fee	Year secured	Timeframe	Initial projected profit	Actual net profit
Alexandra Hills, Qld – 20 blocks of land	$4,700,000	$235,000	2007	2 Years	$1,000,000	$200,000

the Reserve Bank of Australia (RBA) chooses to go over the top with interest rate increases or the banks decide they're not making enough money and jack up their numbers.

2) No job or finance necessary: Getting finance can be a tricky sticking point when it comes to property deals these days. It's not impossible to find, but it's a hassle – especially if you don't fit a lender's mould.

3) Minimum risk, no obligation: Sometimes life happens and circumstances change. You might change your mind about a deal, have trouble finding an investor, find yourself in a rapidly changing market or be subject to a change of rules by the government. All of these things are possible and can make a deal unprofitable. An option gives you, well, options – you've got an out if circumstances arise. That flexibility isn't usually available in a traditional setting.

4) Control the property: An option gives you control of the property and with the owner's written consent you can apply for development approvals or planning permits through council. You might even choose to undertake a quick cosmetic renovation on the property and sell it on at a higher price.

5) Full right to the upside: If you add value to the property and sell it on at a higher price than you agreed to pay, you've got the right to keep the profit. If the property price falls, you can walk

Case study Quadrupling your investment – fast

Independent property developers would be unlikely to have enough capital behind them to develop and sell an 18-lot project. For Robyn Walker, a bit of creativity, an options arrangement and a relatively small outlay is allowing her to do just that.

The Brisbane-based investor came across the vacant house lots in Gracemere, 10 minutes west of Rockhampton in Queensland, in February. She'd been researching the area and knew it was on the cusp of something exciting.

"This area is taking off," Robyn says. "Being right at the edge of all the mining activity that's happening in Gladstone, people are moving here because the rent is still affordable."

After tracking down the developer of the land, she negotiated an option to buy the lots for $127,000 each and agreed to pay an option fee of $1000 per block.

One of the bonuses of an arrangement like this that includes both the land and a house is you never have to actually own the land to develop it, she says.

You also don't have to physically build anything on the site. You can come to an agreement with a builder to market and sell house-and-land packages in partnership with them. After settlement, the new owner proceeds with the builder.

Local market trends indicated there was strong demand for quality house-and-land packages.

Robyn agreed to include a local builder's product in the sale of land in exchange for a commission.

"Being a developer isn't always easy but it's very rewarding when everything is all said and done."

Based on average sale projections, she stands to make a cool $77,000 profit on the sale of the land lots alone.

Plus, there's big potential profit from the house sales too because Robyn has negotiated a commission structure with the builder in exchange for marketing his designs.

THE FIGURES

Property	Total option fee	Agreed purchase price per block	Projected average sale price per block	Total sale costs	Net profit	Agreed commission per house sale
Gracemere, Qld – 18 blocks of land	$18,000	$127,000	$135,000	$66,000	$77,000	$30,000

away from the arrangement and not lose out. Does it get any better than that? You get to enjoy all the benefits of property investing without the downside responsibilities.

6) Greater certainty: An option allows you to know your exact financial figures for the life of the deal. You're not subject to interest rate or lending cost increases. You haven't technically bought anything and you haven't borrowed a bundle of cash.

7) No holding costs, land tax or rates: Given you haven't really bought anything and the property hasn't been transferred into your name, there's also no financial burden from taxes or council rates. The property owner continues to pay for these. The bonus here is your ongoing costs are kept to a minimum. So many normal deals go pear shaped because of the holding costs involved.

8) Time to decide which entity to put it in: Option agreements usually include a 'nominee provision' that allows you to nominate another entity to exercise the option and buy the property. In some cases this may be a related entity (eg. a company or trust). In the event you're getting investors to fund the deal, forming the appropriate entity is critical and something that shouldn't be rushed.

WHY WOULD SOMEONE DO IT?

I've already outlined the reasons you might take an option on a property… but why would the seller decide to do it? There are a number of possible reasons. Perhaps they need to have a contract on the property to secure another investment. Maybe they're elderly and getting ready to downsize or go into a retirement home.

Tax deferment might be another reason a property owner is willing to agree to an option arrangement. Similarly, ensuring one's Centrelink benefits aren't penalised due to the realisation of an asset could be another motivation.

Some sellers might need a bit of cash right now and the option fee that's paid upfront could be the solution for them. Others might not be able to get their asking price and this arrangement is their way of securing some cash.

Whatever the reason, it doesn't matter – the only thing that should concern you is whether it's a good deal.

USE THE POWER WISELY

There are a number of benefits to using options, but like any tool you need to learn to walk before you can run. You'll make mistakes and learn lessons, and there'll be a bit of trial and error involved.

At the end of the day, I'm a big fan of this method of investing. If you do your homework and approach it properly, options might work for you too. **api**

Nhan Nguyen is the founder of Advanced Property Strategies, an education company that teaches investors how to make money using no money down techniques, property development and options. Nhan is also the co-author of the best selling book *Property Millionaire* www.advancedpropertystrategies.com