Rent To Own; Own To Rent

by Robert Stammers,CFA (Contact Author | Biography)

Real estate purchase options are a form of financing that allows buyers to purchase homes without initially taking title of the property. Although they are used in both strong and weak real estate markets, they tend to be most used when sellers are having difficulty renting or selling, or when purchasers are having difficulty qualifying for mortgages. Many real estate investors have used lease purchase options to amass an inventory of assets without the need for a significant capital investment. Lease options can be beneficial for both buyers and sellers, but they do carry some specific investment and legal risk, and are subject to abuse. Investors thinking of using these options to buy or sell properties should understand these risks before entering into a real estate option agreement.

What are Real Estate Options?

Residential real estate options are a financing method where the purchaser initially purchases an option to purchase a property at a later date. The future price of the property is usually set at the time of the agreement, and title is transferred after certain contract obligations are met. As with stock options, the purchaser is just buying an option to later buy the property itself. The strike price is the eventual purchase price of the property and the contract length is negotiated at the time the contract is made. Often, the purchaser rents the property and pays a higher-than-market rent, with the additional money becoming a down payment toward the future purchase. (Read our related article, *Can't Sell Your Home? Rent It*.)

These options are commonly used in buyer's markets where supply (houses for sale) far outweighs demand, or in markets where borrowers cannot find the capital for a down payment or are having difficulty qualifying for a mortgage loan. They are also frequently used by real estate investors following a "no money down" strategy, since the option allows an investor to build equity over time.

For people who can't qualify for a mortgage, using a lease purchase option can demonstrate their ability to pay the higher rental (which can approximate the monthly mortgage outlay), and the creation of the down payment amount can help mortgage underwriters to approve their future mortgage application. The options can also be used by investors to tie up for a nominal price a property they expect to rise in value, and then sell that property in the future to another buyer, capturing future appreciation without a significant capital outlay. The differences between the basic option, the lease option and the lease purchase option should be understood by anyone contemplating using them as a financing or investment vehicle. (Make sure you know what you're getting into, check out *The Hidden Costs Of Home Ownership*.)

Option Basics

Although much about real estate options is subject to negotiation, all options have similar components. First, the purchaser pays the seller some amount for the right to buy the asset at a later date. The strike price may be current market value or a negotiated future value, but most buyers will wish to lock in the price at the execution of the option contract. Nobody else can buy the property during the option period and if the buyer does not purchase the property at the end of the option, the option expires and any option money is kept by the seller. The buyer can sell the option to somebody else if allowed by the contract. This allows real estate investors to hold interest in a property without holding title.

A *lease option* does not obligate the buyer to purchase the property, but it allows them to use the property as a tenant with an option to buy. Lease options are designed for potential purchasers who cannot qualify for a mortgage or do not have the adequate savings for a down payment. In this option, the buyer rents the property in the hopes of purchasing it in the future. Rents are usually greater than market, with some portion of that rent going toward a down payment, and in theory making it easier for the purchaser to qualify for a loan in the future. No other purchaser can buy the property while it is being rented, and if the purchase option is not executed, all rent money is kept by the seller. Depending on negotiations, the purchase price can be market or some estimated future value.

In a *lease purchase option,* the buyer rents the property but is required to purchase the property within the negotiated contract period. In this option, the purchaser rents the property, but incurs all expenses and responsibilities as if they were the titled owner. In this case, rents are usually at market rates. Sellers usually negotiate a purchase price that is higher than current market value. Buyers will usually have to pay a premium for the option that is not considered part of the down payment and is not refundable if the buyer defaults on the contract. The buyer is obligated to apply for financing before the purchase date, and during the rental period no other buyer may purchase the property unless the purchaser cannot get financing and defaults on the contract.

Benefit and Risk
The greatest benefit to homebuyers is the ability to control a property with a limited capital investment. It is particularly useful in a rising market where the buyer eventually purchases a more valuable property, or flips the property to another (in what is known as a double escrow closing) and pockets the difference between the option price and the sales price. This is not an uncommon situation, since options are commonly used in down markets where sellers are not able to sell property using traditional methods.

The benefits for sellers can be significant. An owner selling a purchase option is equivalent to selling a covered call option. It should be done when sellers are not expecting considerable value growth in the property and are benefited by the eventual sale, or by the option premium if the option is not exercised. Many sellers are able to negotiate rents that will cover their mortgage expenses, allowing them to qualify for additional loans during the rental period. (Thinking of getting into real estate? Check out *A Career In Real Estate Portfolio Management* to see if it's right for you.)

Naysayers who discourage the use of these options for buying real estate point to the high percentage of options that go unexercised. Although this can lead to high profits for the savvy real estate investor, it is also a risk for sellers whose ultimate goal is to sell their property. Others point to the fact that these options are never in the money, and if they were, sellers would just sell the property using traditional means. Often these options target young, first-time buyers that do not have the financial capacity to buy the property or qualify for the required mortgage. These financial difficulties are often not rectified during the up-to-three-year option period, and they can be worsened in the face of higher-than-average monthly rental payments.

Another sad fact is that these option contracts are not regulated like stock options, which makes them partial to would-be scammers or predators on the naive. Unless the buyer is informed enough to negotiate favorable terms or an ironclad agreement with legal and monetary repercussions, many sellers can wiggle out of their contracts and renege on their obligation if the option does end up in the money. (For more details on potential lease option pitfalls, see *Get Your Foot In The Door With Rent-To-Own*.)

Summary

Sellers using these options should understand that there is a good chance that the option may not be exercised. This may not be an issue for sellers with the financial backing to hold property and manage rental income. For real estate investors who have located and analyzed struggling markets that they expect to ameliorate significantly, these options can be a method for creating significant wealth, investment returns and a real estate portfolio, with a relatively small amount of capital compared to what would be needed to purchase these properties outright. Many real estate brokers will use these options to give prospective sellers confidence in selling their homes, by contracting to buy them at some amount if the broker fails to sell them within some period on the open market.

Whether one decides to be on the long or short end of these options, it's important to remember that all contracts should be entered into fully informed. This means understanding the financial and investment goals of the other party in the transaction and the risks being borne by both parties. Anyone considering these financing options should get the advice of a real estate attorney, and use them in developing the agreements to mitigate as many of the risks as possible. (For more on how attorneys can help, read *The Benefits Of Using A Real Estate Attorney*.)

by Robert Stammers (Contact Author | Biography)

Robert Stammers, CFA, uncovers and analyzes stock and option trading opportunities as a senior equity analyst at stock market education company BetterTrades. Previously, he was portfolio manager for a $1 billion enhanced real estate fund, a public timber fund and multiple pension fund separate accounts, while acting as a senior executive for several institutional fund managers. Mr. Stammers holds The CFA Institute's Chartered Financial Analyst designation, a Bachelor of Arts in economics from Connecticut College, and a Master of Business Administration with honors from Emory University. Visit Bettertrades.com to learn more timely strategies and tactics for creating cash flow with stocks and options.