Real Estate Purchase and Financing Tips

by: Olen Soifer, 6-10-2009

Anyone who successfully buys and finances a real estate property should probably receive a framed certificate of proficiency, because the process is challenging, at best, and often very confusing. There is a lot to know if you are going to do it well, but the information you need to know and the professionals to advise you are readily available. If you are a real estate novice, don't try to "wing it" all by yourself. And, avoid the advice of people who know no more than you do, but profess to know everything. Take advantage of it all <u>legitimate</u> information sources and listen to what your advisory professionals have to say to you.

The following tips are just the basics of what you should know in order to buy and finance real estate. But, they are a start toward minimizing the chances of future regrets after you have closed on your real estate transaction. These tips are primarily directed toward residential buyers, but there are some commercial real estate purchase and financing suggestions scattered herein.

<u>Disclaimer: This information is not knowingly incorrect or obsolete, but your real estate transaction, and its consequences, is your sole responsibility. These tips are not meant to be, or to replace, professional legal or accounting counsel/advice, which is strongly suggested.</u>

I. Do your own homework when estimating real estate values.

A. <u>Take the values that you hear from a real estate broker "with a grain of salt"</u>. Compare them with the values you can find on websites such as Homegain, Realestate, realestateabc, Eppraisal, Cyberhomes, Trulia, Domania, houseamerica, propertyshark, Zillow, Loopnet (follow each site by DOT COM). Most of these are free, but one or two have expanded services available for a fee. This list of value estimators is long because we don't want you to take any individual "authority" as "gospel". Get your own feeling from ***all*** available sources. You will find that some give a range of values, some are liberal and some are conservative. Few have the ability to base their values on variations in interior condition.

   Theoretically, sales prices vary, at least partially, because of that condition at the time of the sale. But these services have little way of matching the condition of a subject property with those of the "comps", at the time you request the estimate of value. Actually, even an appraiser will tell you that value is always both an objective and a subjective opinion. Any bunch of appraisers would be close in estimating the value of a particular property, but it would be rare for any two to come up with the exact same estimate of value.

B. <u>Don't be fooled by taking the cost to replace the subject property as its value</u>: As often happens, it could be "overbuilt" for the neighborhood. Residential real estate values are based on what other similar homes have recently sold for, with neither the seller nor the buyer having been under an duress to buy or sell, and with the property having been adequately marketed. Commercial real estate values are based on a percentage of the net income they generate, when properly managed and marketed. DO keep in mind that, while the cost to rebuild a property is not an important indicator of value; the costs that must be spent to rehab a property do come into play in reducing value!

C. When you do get a feel for the value, <u>don't be afraid to ask for a price reduction or a seller concession</u> (see below). But, if you like a property and it is priced fairly, don't be ashamed to pay fair market value. While you may get a price break if the seller is under some sort of duress, there is no sin to pay value for value. There is no reason to be upset with a seller who originally listed a property for fair market value and then refuses to budge on the asking price.

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D. In terms of residential real estate, declining neighborhoods are actually fairly rare and general declines are even more rare. We are probably at or nearing the "bottom" of the market, now. But, even though these are not exactly normal times, you can usually you can bet that, over the "long haul", the average piece of real estate will be worth more tomorrow than it is worth today. Home purchases are usually a long-term investments. Don't lose your mind over short-term drops in value.
   i. Will Rogers said, "Buy land. God isn't making any more of the stuff." You can quote me too, "In real estate, the vast majority of mistakes arising from paying the wrong price will be erased…if you hold the property long enough."
   ii. If you are looking for a home to actually occupy, don't be afraid to buy a "starter home". Virtually any home that you own will put you in a better financial position that remaining as a renter. Even in today's real estate climate, and other than the closing costs, IF you keep your wits about you, it is rare to lose money on the purchase and sale of a primary residence."

E. Commercial real estate is another matter entirely: While homes are usually financed with long-term, fixed-rate loans, commercial real estate often has payments based on a long term, but the loans often "balloon" in 3-7 years. That is, the unpaid balance is due after that time and there is no obligation for the lender to extend the payments for another term. Then, if the income has dropped, or the general lending guidelines have tightened, the property owner may not be able to refinance the property. Be prepared for a significant drop in commercial real estate values as nearly 2 TRILLION dollars worth of real estate mortgages come due for recasting from 2011 through 2013.

F. Take the time to learn about Capitalization Rates, Loan-to-Value, Debt Service Coverage Ratios and other methods that are used to value, price and finance commercial real estate. This is definitely a case where the more knowledge is a big help in getting value in the properties in which you invest.

G. Don't be rushed, or rush yourself, into making a decision. When it comes to homes, don't kid yourself that this is the last one you will ever buy. Americans change homes on the average of once every 6-8 years. When it comes to investment properties, it is more likely that you will make less money than you calculated, than more money. Don't ever "fall in love" with a property to the extent that you convince yourself that "this is a once-in-a-lifetime deal". Such deals are rare. The norm is that, the moment you obligate yourself to a deal that "won't come around again", a better deal comes up.

II. **Single Family Home, PUD, Condo?** In that order will these 3 types of property drop in worth, on average, for the same living area, because of the decreasing ownership rights.

A. With a single-family home, you have the most ownership rights, and must only follow common laws regarding your ownership. Maintenance is, of course, solely your responsibility to accomplish and pay for.

B. With a PUD, you own your home, or your part of the building, you own some land around it, outright, but you also some share of other property (could be the pool, clubhouse, the streets, etc) in common with the other owners. You will have to follow various rules of an HOA (homeowners association) in addition to common law, and you will have to pay a periodic fee to the association..

C. With a condominium, you usually only own the interior of your unit. The frame and exterior of all of the building(s) are owned in common with all of the other owners. There are certainly advantages to PUD's and condos, such as maintenance issues that are taken off of your shoulders. But, there can be issues with dealing with an HOA that you may not like, and the "condo fee" will be larger than with a PUD because the association has a larger responsibility for maintaining the community. Be sure you will be happy with "community living" before you chose these options over a single-family home

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III. **Commercial (Office & Retail) and Multi-Family Property Values:** As hinted at above, commercial property values have probably not reached their lows in the current financial crisis, and may not do so for years. That should not keep you from buying a property that is making a profit and can be financed. Multi-family properties have become more desirable than office and retail space because vacancies in the latter have increased. But, income and profit is always the key. A mostly occupied office building, at adequate rents, could still be a better value that a mostly vacant apartment building. There is a danger of being swayed by general trends when a profitable opportunity is staring you in the face. The trick is to become "proficient with the numbers" (income analysis, that is) or have an honest, proficient expert to help you make sure "the numbers work" in comparison to the available price and terms.

IV. **Interest Rates:** Potential borrowers constantly ask lenders, "What's the rate today?" But, there is no such thing as a standard interest rate, for a particular type of mortgage, except from retail banks.

A. <u>Usually, you can set your own rate</u>, over a range, by paying more or less "points", more or less down or by applying for a loan with more or less required documentation. (See below). Your own income, credit rating, available cash and the mortgage documentation will determine what rate and points charges are appropriate for you. This is especially the case when you work with a broker, rather than a traditional bank, which tends to be more inflexible.

B. Whenever anyone quotes a rate to you, you should <u>always ask, "What are the points</u> and what is the application fee for that particular rate?" Only with that complete information can you compare "apples to apples".

C. For residential mortgages, one way to get a feel for the current interest rate, as they go up and down is <u>to keep an eye on the 10-year US treasury bond yield</u>. This moves in the opposite direction of the bond price and the stock market, but in the same general direction as conventional and government interest rates..

D. A rule of thumb is that a 30-year conventional, fixed-rate mortgage interest rate, will be between 2 and 2.5% higher than that bond's yield, if no points are paid. Unfortunately, if you are searching for the best mortgage interest rate and you have IRA, 401(k), bond or stock market investments, interest rates go down when the stock market does. Sad, but true.

E. <u>Commercial mortgage interest rates are similar to auto loan or credit card rates</u> in that they are often priced at so many points above the prime rate.

F. <u>Alternative funding rates are "all across the board"</u>. They are a case of being based on "what the market will bear". These days, they are 5-10% higher than residential conventional rates, but that is just the way it is now. There is no correlation between those different rates.

V. **Points:** A common question borrowers ask is, "How much is one point?" Again, there is no set dollar amount, because <u>a point is simply one percent of the mortgage amount</u>. Thus, a point on a $200,000 mortgage is $2,000.

A. The points that you might be charged will usually range from none to three, and the more points you pay, the lower will be your interest rate. An unwritten rule used to be that each point you pay will reduce the interest rate by ½ percent. Unfortunately, paying points "buys down" the rate less now. And, each subsequent point that you pay will buy down the rate less than the first point.

B. Whether or not you should pay points, and how many, depends on your monthly housing budget and how long you plan to have that mortgage. The longer you plan to pay the same mortgage, the less each point must buy down the rate in order for it to be worthwhile. For most people, each point should buy down the rate by about ¼ to 3/8%.

If not, you would be advised to save the points, pay the higher rate and do a "rate and term refinance" when you find that available rates have dropped.

C. **Commercial Points**: As with rates, these range all across the a wide spectrum, but they vary more with the lender and the mortgage type than in association with the interest rate that is chosen. It is less common with commercial mortgages to be able to pay more points, from the same lender, to lower or "buy down" the rate.

VI. **Bank or Mortgage Broker?** The days when dealing with your local bank, as a lender, was an advantage are over, for several reasons:

A. First, your local bank is probably owned by a (multi)national holding company and you are a very tiny cog in a very big, impersonal machine.

B. Second, having reviewed rates and points, keep in mind that banks are much less flexible than mortgage brokers. They will often quote you a rate, and the points on that type of loan, and that is that.

C. Third, the people you deal with at a bank usually get paid whether you settle on the loan or not…so a mortgage broker, whose income is dependent upon you settling, will often work harder for you. Finally, banks have a limited array of loan products. If you don't fit into on of them, you are out of luck. There is much more variety and more options with mortgage brokers who are not tied to one lender.

VII. **Real Estate Touring, Price Negotiations, Seller Concessions and Price Negotiations:**

A. A professional real estate agent will take the time to find out what you want and what you can afford and will only show you those properties. A poor agent will keep showing and showing and showing, for hours and hours, until you stop them and say, "I'll take that one." Don't be upset if an agent insists on taking you to each property, rather than giving you the addresses. It is professional to be at each property with you to answer your questions and lazy/unprofessional to give out addresses to strangers.

B. What if you are being pressured to make a decision quickly and you feel like you are being rushed? You should never be pressured into making a decision. Poor real estate agents will often imply that they have a line of buyers jostling for this particular property. If that were the case, there would be no need to pressure you because they could operate under the "first come, first served" rule. Your best defense should be the same as theirs...you have multiple properties, from multiple agents, that you are considering. You are in the worst negotiating position if you appear "needy" to a real estate agent.

C. Should you try to get the seller to lower their price or pay some or all of your closing costs? The best answer is, of course, BOTH! But, if you must choose, it is generally better to get the seller concession to pay your costs rather than the same amount of price reduction.

   i. Here is the math: On a $200,000 conventional mortgage, the seller is allowed to pay up to 3% of the mortgage toward your closing costs…$6,000. A $6,000 reduction in the sales price and mortgage amount will, at 6%, reduce your monthly payment by about $30. What would you rather have…an extra $6,000 remaining in your pocket after settlement, or $30 smaller mortgage payment each month? The answer should be obvious: Get the maximum seller concession first, and then get a price reduction, as well, if possible. Remind the seller that, from a profit and tax standpoint, it won't matter how they give you a credit…from the price or by paying the same amount of your closing costs.

   ii. A final bonus awaits you if the seller pays your points…you get to take them as a tax deduction even when the seller pays them. In a way, it is a double bonus for you: You pay less for closing costs and for income taxes. You can't beat that. In addition,

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unlike points paid on a refinance…purchase points get deducted in full from your next tax return.

VIII. **Your Agreement, Mortgage Paperwork and Transaction:** While the mortgage paperwork is more or less set in form by the lender and various laws, much of your real estate agreement can be modified by you and your attorney to meet your requirements. Don't be pressured into signing a agreement. This is probably one of the largest "deals" you will ever be involved in. Make sure the terms and the "small print" are acceptable to you.

A. Make sure everything you agree to is in writing and that you get a copy of everything you sign WHEN you sign it.
B. Remember that your agreement is not in force, and your attorney review period doesn't begin, until all parties have signed the agreement and all parties have a fully signed copy in their possession.
C. Make sure you receive a copy of the Settlement Costs booklet required to be given to you by federal law. It contains a wealth of information for you.
D. In the end, you are your own agent:
   i. Remember that, regardless of contract "boilerplate" to the contrary, the real estate agent is usually ethically bound to represent the interests of the seller, more than yours, because the seller is the one paying their commission.
   ii. Also, though the law allows it, when full disclosure is made, keep in mind that it is impossible, practically, to be an effective "disclosed dual agent". Even if there isn't obvious mistrust and hostility between the parties, buyers and sellers are "on opposite sides of the fence". It is implausible to believe that any one person can fully an agent's fiduciary responsibilities to both parties in a transaction. In most cases, this makes as much sense as trusting a fox to watch over your chickens. And, if the dual agent tries to be completely neutral, then they are, effectively useless as agents. Why? Because the interests of the parties do usually conflict and an agent, who remains neutral, is not tending to the interests of either party!
E. Make sure that you have the right to have a home inspection, pest inspection, a survey and title search. You need to know exactly what you are buying and you should rarely trust your own inspections.
F. You may be willing to do some repairs after the settlement, at your expense. But, other repairs (such as problems with the framing and mechanical systems or severe termite infestations) can be very expensive and may be required by the lender before you close.
G. Use caution when buying a property "as is". Make sure that, even if this is an "as is" sale, you still have the right to back out if there are major defects in the structure, roof, systems, etc. It takes a special buyer to successfully purchase a "handyman special" with these types of defects. If ever you do buy such a property, make sure the you can handle the unseen, unknowable problems and costs that WILL arise. The refurb costs will almost always be between 10-30% higher than you initially predict.
H. Don't let the seller or a real estate broker convince you that the way things are traditionally handled is the way they MUST be done. For example, while the buyer usually pays for most closing costs, the parties can agree to have the seller pay for almost everything. Make sure all agreements with the seller (such as personal items to be included in the sale, or repairs to be made) are in writing. This is your purchase and your money. Certain disclosures are required by law, but the bulk of the deal and the written agreement are subject to the negotiated agreement between the parties.
I. Take advantage of your right to have an attorney review the agreement and listen to your attorney's advice. Listen to what your attorney has to say. Your legal counsel is probably more knowledgable about the problems that can arise and they are more objective than most buyers.
J. Some real estate professionals will propose that you sign an agreement allowing them to order the title work, survey, home inspection, pest inspection from "their people", but at

your expense. Usually this is at the very end of a lengthy agreement tiny "boilerplate" language, which has "burnt you out" because you were forced to go through it quickly and under pressure. I recommend that you NOT sign that last page. This is your transaction. Insist on shopping for your own professionals and services.

IX. **Your Mortgage Professional and Financing:**

A. Remember that, as with anyone you deal with, the quality of service, knowledge and ethics can vary.
B. Know what you can afford. Even if you are pre-qualified for a particular monthly housing payment, only you can know whether you are comfortable with that figure. Often, when a real estate person sees that you are qualified for a larger purchase than they anticipated for you, they will start showing you higher priced properties than you want. You can prevent this by asking the mortgage person to give you a pre-qualification that is both legitimate and limited to what you feel comfortable spending.
C. Remember that the credit score used by the lender will be the lowest middle score of all of the proposed borrowers. And make sure that your debt load and income do not change widely between application and settlement. This is not the time to make big purchases!
D. Pre-approvals: A "pre-qual" is only an estimate that is usually based on partial documentation (like a credit report) and verbal information from the proposed borrower. How accurately it reflects a borrower's ability to be approved for, and pay for, a mortgage is a function of the competency of the mortgage professional. Pre-qualifications are rarely foolproof.
E. The alternative is a full pre-approval. In this case, only the actual property to be financed is an unknown. The borrower goes through that full approval process for a particular purchase price and mortgage amount. That gives them 90-120 days to locate an acceptable property at that price or less.
F. When a desirable property is located, it only takes the appraisal, normal inspections and reviews before the purchase can settle. Given 30 days of time, a borrower can feel comfortable signing "cash deals" such as foreclosure sales. It opens many opportunities to buy property for a lower than normal price and makes the borrower much more attractive to negotiating sellers.
G. Ask your mortgage specialist about the possibility of getting a full "property to be determined" pre-approval instead of a "pre-qual".

X. **Professionals and Due Diligence:** Common questions from borrowers include: Should I use an attorney? Should I have a survey? A home inspection? My best response to all of those questions is, "If you asked the question, then the answer is 'Yes'."

A. The most foolish thing you can do is to avoid those services or professionals to save a few dollars. Do not hesitate to try to lower the price.
B. When you find out that you need a lawyer, or that you shouldn't have inspected your own home or that your neighbor's garage is on your property…it is too late.
C. Again, the best advice is to not trust yourself or anyone your own professional that you are paying to perform these services. As the buyer, your proximity to the transaction makes it difficult to be professional or objective. "Don't be penny-wise and dollar-foolish"...and don't skip any of the services or ignore the advice that is readily available to you. You will have to live with the consequences of your purchase for a long time. Use due diligence to make sure you what needs to be done in your own best interest.

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