Introduction

Options, lease options, sandwich options and management agreements. You may have heard about these from a friend, a colleague or even me! It is the answer to all your dreams…..well kind of anyway. If used properly you can make money. A lot of it. Especially if we see a boom in prices over the next 5 years or so.

So first I must define what these things are before I go on about how great they are. You will soon see what I am talking about. Iam going to start with options (as opposed to lease option and sandwich options) as this is the most simplest and an excellent place to start.

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Options

An option is exactly that. It is a legal document that gives you the option to buy a property at a set price within a set period of time. That's it. Let me show you an examples.

Address	Option
5 London Road	You can buy this property for £250,000 if you complete by 1st January 2011.
12 Acacia Avenue	You can buy this property for £200,000 if you complete by12th December 2015.
4 Jones St	You can buy this property for £55,000 if you complete by the 30th June 2020.

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These are all examples of options. It is a legal agreement between you and the owner of the property. It specifies:

1. the *price* you have agreed called the exercise price
2. the *period* which can be a date or a period amount of time from the date of signing.

Please note you never have to buy the property. It only gives you the right to buy (but not the obligation) this property within the time period.

So if someone goes on about options to you there should be TWO key parts to the option:

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The PRICE and

The PERIOD

Think of these as the 2Ps of options or think of a 2 pence coin as soon as the word option is mentioned.

The 2Ps are everything when it comes to options. If the Price is good and the Period is good then you have a very valuable option. If the Price is bad and the Period is bad then you have a worthless option.

So what is a good price, bad price, good period and bad period? Well you have to look at the both together as they are correlated to determine whether you have a valuable option.

I want you to have a think about what a valuable option would look like. I am hoping my explanations above will give you a clue to the answers as it

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seems obvious to me. It might explain why you can “buy a house for a £1”!!!!

Valuing Options

A valuable option has a good price and a good period. Now let me make it simple for you. Always remember this:

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A good price is a *cheap* one

A good period is a *long* one

You can remember that can't you?

You want to have the price of the property bought as cheaply as possible (no surprise there!) and you want to be able to do that over the longest period of time. That is where the negotiation comes in.

Look at this example:

A property has a market value today of £100k. You find a seller who will grant you an option to buy this property in 5 years time for £110k.

So the Price is £110k

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And the Period is 5 years.

Now you have to decide whether you think:

The Property's price will rise in excess of £110k over the next 5 years or not.

This is the key question you have to ask yourself. If you say I don't know then this is a good answer! No one knows.

However lets just say you think the property will be worth £150k in 5 years then the option could generate you a profit before fees of:

£150k - £110k = £40k.

So the option can make you a good return if you can keep the exercise price as low as possible and the period for as long as possible.

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So to increase the value of this option of £110k over 5 years you could:

Decrease the exercise price to £108k

Increase the period to 7 years

Or decrease the exercise price AND increase the period to 6 years.

All of these things will increase the value of the option.

The key point to note is the option still may be worthless. The reason being no one knows what the property prices are going to be like next year, the year after or the year after that!

So if after a 5 year period property prices have declined and the property is now worth £90k then the option to buy at £110k is worthless. You would simply offer market value of £90k.

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So I hope you can see that valuing an option is not an easy thing. It largely depends on where you think property prices are going to be. The longer the period you set the more assurity you have that prices are going to rise as property prices rise in the long term.

A typical property cycle lasts around 10-15 years so you have to say if you had an option for 15 years and property prices were currently on the line of the long term average you would be assured the long term average rate (2.9% p.a.) of property price inflation.

So the big question is:

What would you pay for an option to buy a property for £110k within a 5 year period that is currently worth £100k?

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Now let me tell you the owner of the property is going to want something off you. The owner is not going to give you the option for free!

Valuing Options (2)

To value an option properly you have to:

1. come up what you think the minimum price you think this property will be in 5 years
2. Calculate this profit element after all fees
3. discount the profit based on inflation

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4. incorporate a risk multiplier

And then you will get the value of an option! Sounds tough doesn't it? However let me remind you that the options game is very risky. All you own is the option. You do not own the property. Once the period expires and you haven't exercised your option then anything you paid for the option is lost. An option is a bit of paper and it only comes to value when you exercise it (assuming that it is worthwhile).

So bear with me. If you want to get good at this you have to apply those 4 steps above so you can be sure you will make some money.

So lets take the example of an option of £110k in 5 years on a property worth £100k today.

Lets say I think the property will be worth £150k in 5 years. Then the profit is:

£110k - £150k = £40k

Then deduct fees of buying the property and selling the property say £5k.

So the profit is:

£40k - £5k = £35k

Then you have to discount that £35k profit in the future in today's terms. I am going to assume an inflation rate of 3%. To do this you need a scientific calculator to do this (you can get one in my package) and perform the calculation:

$(1-0.03)^5 = 0.85873$

So a £35k profit in 5 years time is actually worth:

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0.85873 x £35k = £30,055

Now you have to apply a risk multiplier to this. As this £30,055 is not money in the bank and in no way guaranteed. So you have to multiply this by a suitable percentage.

Now if you are looking to me for this percentage then you would be mistaken! This is your call.

Lets just say you was 100% sure of this profit. Then an asking price of anything less than £30,055 would mean you would profit.

If you were less than 100% sure then you have to decide what you want to pay for it. Whatever you paid for it you would deduct from the £30,055 and this would give you the profit from the option.

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Now if I were getting in to this game I would be extremely pessimistic. Only pay for an option what you are prepared to lose. It is a form of gambling in a strange kind of way unless you get a really long period where the volatility is evened out and the price is within the long term average.

If you paid 10% of the expected profit for an option you could not argue that was an unfair bid. So in the above example a fee of £3,005 (10% of £30,055) for the option would be a fair price if I thought the property would be worth £150k in 5 years time.

The good thing is you can exercise your option anytime within those 5 years. So if there was a mini boom after 1 year you could make around £35k less the price paid for the option. Not bad for shuffling a few bits of paper about.

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However most options in the UK are not just plain options. We have a thing called lease options.

Lease Options

Okay so I have told you what options are and how to value them. What are *lease* options? Well the clue is in the name! It is an option but also you get control of the property by leasing it for the period of the option.

So now you have an added dimension to the standard option. It is the lease element of it. This fast forwards your ownership of the property without really owning it.

Examples of lease options are:

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Address	Lease Option
5 London Road	You can rent the property for £400 per month and you can buy this property for £250,000 if you complete by 1st January 2011.
12 Acacia Avenue	You can rent the property for £500 per month and you can buy this property for £200,000 if you complete by12th December 2015.
4 Jones St	You can rent the property for £100 per month and you can buy this property for £55,000 if you complete by the 30th June 2020.

Now before I spoke about the two Ps in options being:

1. Price
2. Period

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Well I have another P for you:

3. Profit!

Profit is based on the difference between what you can rent the property off the owner for and what you can get on the open market. So look at this example:

A property has a market value today of £100k. You find a seller who will grant you an option to buy this property in 5 years time for £110k.

So the Price is £110k

And the Period is 5 years.

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He will also let you rent the property off him at £300 per month as his mortgage payments are £300 and he just wants rid of the property. You know that the property will rent out no problem for £500. Then the potential profit to be made every month is £500 - £300 = £200.

This profit is possible every month for the next 5 years. So the overall profit would be the total number of months in 5 years multiplied by the monthly profit being:

5 years x 12 months x £200 = £12,000.

So if we were to stand back and look at the deal now the 3Ps would be:

1. Price: £110k
2. Period: 5 years
3. Profit: £12k

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Now in the previous blog I valued the option at around £30,000 potential profit. (see previous blog). Now we can include the potential profit of the renting of the property which is £12k.

If we were to ignore inflation for a minute we would have a lease option with a potential profit of £30k + £12k = £42k.

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Why Lease Options Are So Exciting

The reason why lease options are so exciting is because you can get on with your investing without the need of finance straight away. They fast forward your buying as you can take control of many properties very quickly and literally build massive portfolios in months even weeks.

The reason why I use the word invest is because as long as your options have the correct Ps being:

Price

Period

Profit

Then you will own that property without a doubt. I really want you to understand what I just said there. It is vitally important that you do

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understand that last sentence. You can own the properties which you are controlling by way of lease options.

Now there must be quite a few questions pinging in to your head right now. Trust me, it happened to me. It is a normal reaction! If no questions have arisen in your head then either:

1. you do not understand it
2. it is not for you

If you are in category 1 I suggest you re-read what I have spoken about on options as this is only the theory. It is important to understand the theory before you embark on purchasing options.

If you are in category 2 then this is ok. It is not for everyone. It can seem a lot of faffing about however it is only an invention from necessity. Once the

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mortgage market comes back then we are back to normal however lease options can be a true no money down system without the need for finance.

Sandwich Options

I told you about options and lease options earlier.

Now it is time for sandwich options. The person who gave it this name was not feeling hungry at the time, there is a real justification for the name!

You are the filling of the sandwich. Either side of you is:

1. The property owner

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2. The tenant buyer

I have described earlier how the property owner grants you an option to buy. But now I have introduced a new person to the party:

The tenant buyer

This is person who:

Rents the property off you AND

Buys the property off you at a later date.

In effect the tenant takes a lease option on the property from you.

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Now I hope you can start to see how being the filling to the sandwich can be very lucrative. You simply have two lease options running in parallel with you in the middle collecting profit on every transaction.

Look at this example:

John, the property owner, grants you a lease option to buy his property at:

Price £150k

Period 10 years

Rent £500 per month

You then find a tenant buyer who wants to take a lease option on this property at:

Price £175k

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Period 10 years

Rent £600 per month

Now I hope you can see the profit here. When prices rise beyond £175k the tenant will exercise the option, you will make £25k and you will also would have made £100 per month during the time the tenant buyer was a tenant.

This is the simplest form of a sandwich option. There are many strategies of how options in their many forms can take properties off distressed sellers and create win-win situations.

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PLEASE FORWARD THIS EBOOK TO ANYONE YOU KNOW WHO MIGHT BE INTERESTED!

Ajay

Ajay

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