

WRAPS Property Trading - the evolution – Part 2

As a starter, this is how the sandwich lease option strategy operates: There are three parties in the mix.

1. A home owner who, more often than not, is looking for debt relief.
2. An investor or trader.
3. An eventual purchaser.

The home owner may be overcommitted, over-leveraged or have a dysfunctional or “hard to sell” house. They may also be just a tired or “out of town” landlord. Despite having to sell their property, they have been unsuccessful and are looking for a quick solution.

Without trivialising the situation, let me term the keen vendors the bottom slice of bread, and name them party A. The property trader (the filling in the sandwich, party B) facilitates the two lease option agreements, and the new third person who intends to eventually purchase the property is the top slice of bread, party C. This sandwich lease option system works best as a private sale deal.

Party B, the trader, may attract party A using advertisements in community papers, signs etc, stating for example “We buy houses”. These two parties will prepare a lease option (note: This lease provides for a rental of the property, and the option enables the tenant the option to purchase).

This written agreement is for a defined maximum period of, say, from two to five years. The agreement will provide for the trader to make a small upfront cash payment (somewhere between \$100 and \$2000) to party A for the option to buy the property sometime before the end of the agreed term, for a predefined figure.

It would also need to be at least what would be owing on the mortgage at the conclusion of the lease period, and it would provide for party B to pay the total outgoings - mortgage payments plus other outgoings such as rates and insurance.

Party B will have a suitably qualified applicant ready to sign a second lease option agreement between party B and party C for the same period covered by the first lease option. Their option consideration should be 2-5% of the registered valuation of the property, which will be more than party B paid out initially as an option consideration to party A. This will give party B an instant upfront profit.

The future sale price would be at fair market valuation, established by a registered valuer. The lease fees would naturally be higher than the regular outgoings to maintain the first lease option with party A. This may give party B a continuing middle profit for the duration of the lease.

Finally, no later than the expiry of both leases, it would be anticipated that party C would exercise their option to purchase from party B. Assuming this occurs, party B will also exercise their option to purchase from the originating party A.

A double (or contemporaneous) settlement takes place, whereby on the same day party B sells to party C and sufficient funds from this sale are used for the purchase between parties B and A.

If party C did not exercise their option to purchase, then their lease would automatically expire. In this event party B could still exercise their option to purchase from party A - if the property had enough potential to carry out another strategy (for example renting, or a standard lease option), and providing finance could be arranged.

Why do it?

What are the reasons for considering these sandwich lease options and what are the outcomes?

The trader has to provide only an extremely small amount of cash as an initial deposit before receiving the higher figure from the second lease option. This enables the sandwich lease option trader to continuously proceed with an unlimited number of transactions, as no mortgage finance is required.

As little cash is involved, no money partners are required. This is quite different from wraps or standard lease options, which create limits because each property normally requires a deposit of 20% (of the lower of cost or market value), with an 80% mortgage raised (which will also carry personal guarantees from the investors). Sooner than later with wraps or lease options, the investor will use up their borrowing ability and will be forced to work in partnership with other "passive" investors.

Another major attraction for the sandwich lease option trader is their ability to derive the three main profit components (there are more) - the upfront profit, the middle spread profit and the back-end profit.

The sandwich lease option is such an attractive low-risk strategy for the young property trader who has plenty of time and energy, but lacks substantial capital, and also for other individuals who want to trade but do not wish to, or cannot, commit substantial investment capital.

This same strategy can also be successfully employed in the higher-priced residential market, and the commercial and industrial sectors. However these sectors would require more capital for deposits and more sophistication by the trader.

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The outcome is in favour of all parties:

Party A (the vendor) obtains a better solution.

Party B (the trader) gets positive cashflow by controlling but not owning the property.

Party C (the purchaser) can create some equity towards their deposit and purchase of the property.

Finally I need to caution over-enthusiastic traders. While the sandwich lease options are conceptually straightforward, the execution can be difficult for the uninitiated. You will need to obtain tried and tested contracts and know the rights and wrongs of doing the business, before becoming involved.