THE INVESTOR'S GUIDE TO LEASE OPTIONS

NICHOLAS WALLWORK

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71-75 Shelton Street
Covent Garden
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LEASE OPTIONS: ANOTHER LOW-CAPITAL STRATEGY FOR INVESTORS

Rent-to-rent – whereby you rent a property and sublet it to tenants that you find and manage – is a great strategy for investors with limited startup money, because it gives you the chance to earn a steady income from property that you don't own. But what it doesn't give you is any form of capital growth. You can't sell a property that you don't own, nor will you benefit from any appreciation in the property's value as a result of your hard work.

Could lease options be the solution to this capital growth problem? In my view, absolutely.

A lease option (also known as rent-to-buy) works in much the same way as rent-to-rent, in that you rent a property and then sublet and manage it to earn an income. But in addition to this, you negotiate the option to buy the property in future, and this option is written into your contract with the property owner. In this way, the two strategies combined give you steady income now, plus the potential for capital growth in the future. Talk about win-win.

How do lease options work?

Lease options can get complicated – particularly when it comes to negotiating the contract, which I'll talk about later – but the basic premise is pretty simple. In a nutshell, a lease option is just a rental contract that includes the option to buy the property further down the line.

You'll usually have the option to buy the property at any point during the length of the agreement (meaning you don't have to wait until the end of the contract term), and if you ultimately choose not to buy the property, you don't have to. It's an option, not an obligation. So, if the value of the property goes down or your priorities as an investor change, you can simply walk away at the end of your contract. No strings attached.

But if you do want to buy the property in future, the lease option will have secured you that right, and at a pre-agreed price.

As you can guess from this, pulling off a successful lease option strategy breaks down into two main parts:

- An agreement to rent the property for a set period of time for a set monthly fee. You then sublet the property to tenants that you find and manage (thereby earning a profit in the process). See my separate guidance on rent-to-rent for more on this side of things, including finding tenants and managing the property.
- An option to buy the property in future, at a certain price. This is the part I focus on here.

Why choose a lease option?

For investors, there are many reasons why a lease option might be a great choice:

- You can take control of a property and **start earning money quickly,** without having to buy it. This is a serious advantage for investors who don't have the money to buy a property outright, or the upfront deposit needed to secure a mortgage.

- You earn a **steady monthly income** by managing and subletting the property. For some investors, this income is what helps them purchase the property in future.
- Agreeing the purchase price in advance, at the time you sign the lease option agreement, could net you a great deal, assuming the property goes up in value. To put it another way, when you eventually buy the property, it should already be worth more than you pay for it (i.e. the previously agreed price), giving you **capital growth as well as income**.
- And if you choose not to buy the property after all, **you don't have to buy it**. You've still earned an income and honed your property skills.

Sounds too good to be true? It's not. However, there are some challenges and risks that you'll need to plan for:

- The lease option adds **an extra layer of complexity** on top of the rent-to-rent strategy. For this reason, many people feel lease options aren't suitable for beginners. (Personally, I disagree. The low-capital nature of lease options makes them highly attractive for beginner investors.)
- **Finding lease option opportunities** – particularly owners who are open to you subletting the property and purchasing it in future – can be difficult. And when you do find an open-minded owner, reaching a fair agreement will require some careful negotiation.
- In theory, the owner could **default on their mortgage** and pocket your rent. If the property is repossessed, you lose out on both your monthly income and the chance

to own the property in future. One good way to avoid this is to have it written into your contract that the owner will supply you with regular mortgage statements to prove they're actually paying down the mortgage.

- The owner could also **default on the lease option** and refuse to sell the property to you in future. In my experience, providing you enter into a fair agreement, this scenario is rare. But if it does happen, unless you're prepared to hammer it out in court (which can get very expensive, very quickly), you'll have no choice but to walk away.
- And, of course, **the value of the property may go down**, not up – meaning you've agreed to buy the property for more than it's worth. But there's a risk of market fluctuations with any property investment. At least with a lease option you don't yet own the property and you aren't obligated to buy it.

Why would the property owner agree to a lease option?

It's clear how you as an investor might benefit from a lease option agreement, but what about the property owner? Why on earth would they agree to this arrangement when they can simply sell the property now and pocket the cash?

Lease options are often described as a last resort for distressed or desperate sellers. After all, they are agreeing to a sale price potentially years in advance, with a tenant who could, in theory, simply walk away at the end of the tenancy without actually buying the property. Seems like a lose-lose for the owner.

In fact, there are plenty of scenarios in which an owner might be open to a lease option arrangement – and not just because they're in dire financial circumstances. For example, if it's an investment property, then the owner might be very happy to have a comfortable, hassle-free rental income for a few years, with someone else managing the property for them. Or maybe the owner will be working abroad or travelling for a couple of years and doesn't want to have to hang around to sell their property first – in which case, a lease option gives them immediate rental income, with a (pretty much) guaranteed sale when they come back. For me, being a successful property entrepreneur is all about finding win-win scenarios like these, and matching the right strategy to the right circumstances.

But, yes, sometimes you will be dealing with a distressed seller who doesn't have a whole lot of other options. They might be in negative equity. Property prices might have slumped. They might have to move away immediately (for work, for example) and can't wait for the market to recover. A lease option means they don't have to sell now. It gives them a secure rental income. And because you would be subletting and managing the property, they don't have to do any work to earn that rental income.

PRO TIP:

> ***In a strong seller's market, it can be tough to convince property owners to enter into a lease option agreement with you. If that's the case, don't write off lease options altogether. Part of***

being a successful property investor is being able to match the right strategy to the right circumstances, and you never know when the ideal scenario will present itself. Educating yourself on a wide range of different investment strategies is always worthwhile, even if a particular strategy isn't viable right now.

To sum up the benefits for the property owner:

- You're effectively paying their mortgage for them, hassle-free, for the duration of the tenancy.
- They have a sale lined up for the future, and guaranteed rental income in the meantime.
- They don't have to manage a revolving door of tenants because you, with your rent-to-rent strategy, will be finding and managing your own tenants. In other words, the owner deals with you and you alone, which makes their life easier.
- Or, if they've been paying an agent to manage the property and deal with tenants, that's one cost they'll no longer have to pay (because you'll be running the property yourself). That's more profit in their pocket, for no more effort.

Income now, capital growth later: The lease option financial model

Income now, capital growth later: The lease option financial model

Earning income and capital growth

With a lease option, your strategy for earning income is pretty much the same as rent-to-rent, in that your best chance of maximising income is usually to change the use of the property slightly. (If you haven't yet read my guidance on rent-to-rent, now would be a good time.) Changing the use might mean turning a standard residential let, where the whole property is let to one household, into a multi-tenant let, where you sublet individual bedrooms to separate tenants. Or it could mean renting out the property on a nightly basis, through a platform like Airbnb (see also my serviced accommodation guidance).

However you decide to use the property, the basic rent-to-rent financial model is:

- Your tenants pay you rent.
- You pay rent to the owner, plus cover all bills for the property.
- Your monthly income is the profit left over at the end of each month.

Here's a simple example. If you take on a four-bedroom house and then sublet each of the four bedrooms for £500 a month (including bills), that earns you £2,000 a month in rental income. Let's say the rent you pay to the property owner is £1,000 a month, and bills are £550, that leaves you £450 a month profit. Manage several properties and it soon begins to mount up.

The only difference with a lease option is that you also have the option to buy the property, giving you the potential for capital growth. The idea is, when you eventually come to buy the property, it will be worth more than the pre-agreed price.

Let's say the four-bedroom house you're renting is worth £200,000 at the time you sign the lease option. You agree to rent the property for five years, and don't anticipate being able to buy it until the end of the tenancy period, so you secure the option to buy the property for £210,000 (a 5% growth in value over five years).

When the five years are up, let's say the property is actually worth £220,000. You buy it for the pre-agreed price of £210,000, and gain £10,000 in equity immediately. Now, you can sell the property and pocket the £10,000, or you can keep hold of it and continue to earn an income.

What if you don't want to buy the property?

If the property's value has stagnated or even dropped, or if your circumstances have changed, you don't have to buy it. Your main options at this stage are to return the property to the owner, or negotiate to extend the lease option and continue to rent the property.

PRO TIP:

> ***Remember, if you decide not to buy the property, it hasn't been a waste of time for either party. In the above example, earning £450 a month profit for five years, you would have banked £27,000 just from subletting the property. Plus, you'll have gained valuable experience on how to manage a***

property and tenants. And the owner has had five years of hassle-free, hands-off rental income.

There is a third option: if you don't want to buy the property or continue managing it, you could sell the option on to another investor for a small fee. This becomes a more viable option as your property experience grows and you come to know more investors like you. You may know someone who would love to purchase the property at the pre-agreed price, who will buy the option from you for a small fee. You still earn a bit of profit. Your investor colleague gets a good deal on a well-managed property (they may even want to encourage the same tenants to stay on). And the owner gets to sell the house at the agreed price.

Planning for your costs

Naturally, there are various initial and ongoing costs involved in a lease option. They are:

- The 'consideration'. This is the upfront fee you pay to the owner in return for securing the exclusive right to buy the property in future. Essentially, for the contract to be legally binding, some money needs to change hands, but this consideration could be as little as £1. It all depends on what you negotiate with the owner. I talk more about negotiating the consideration payment later on.

- Upfront rental costs. As with any rental property, you'll have to pay a security deposit and usually the first month's rent in advance. It's also a good idea to get expert legal help with the lease option agreement, which is another cost to budget for. In addition, you may need to make minor changes to the property, such as fitting locks on bedroom doors.

- Ongoing monthly costs. Naturally, there are costs involved in operating the property, including the monthly rent you pay to the owner, utility bills, insurance, general maintenance and upkeep of the property, and any costs associated with finding and vetting tenants.

PRO TIP:

> ***You can expect to cover the basic costs associated with operating the property during the course of your tenancy, such as giving it the odd lick of paint, or carrying out any basic improvements that are necessary to operate the property in the way you intend. But because you don't own the property (yet), you don't want to be paying for major repairs or upgrades. Make sure your agreement with the owner clearly sets out who is responsible for carrying out and paying for maintenance and repairs.***

Identifying lease option opportunities

Notice this section is titled identifying lease option opportunities, not properties. That's because a good lease option is as much about finding the right owner as it is about finding the right property. You'll therefore need to consider both aspects – property and owner – if you're to find attractive lease option deals.

Pinpointing the right sort of property

Let's start with the property itself. Or, more specifically, the type of rental strategy you want to deploy. Fancy renting out a property by the night on Airbnb and similar platforms? A small flat (or, at a push, a modest house) will generally be a safer bet than a large family home, in that it will appeal to a broader range of travellers. Prefer to sublet individual bedrooms to long-term tenants (for example, young professionals)? Then a larger flat or house, something with multiple bedrooms, will give you the best chance of maximising your profit. Want to target student tenants? Again, something with at least three or four bedrooms is ideal.

Whatever rental strategy you choose, you'll need to be upfront with the owner about how you intend to use the property, and get their express consent (in writing, in the contract) to sublet the property in that way.

Identifying and approaching property owners

Finding the right sort of owner basically means identifying people who are motivated to work with you – people who, for whatever reason, might be open to a lease option at this point in their lives. As I've already mentioned, there are a number of reasons why a lease option might appeal to a property owner.

PRO TIP:

> ***Look for people with a problem you can solve. Can they no longer afford to pay their mortgage? Have they been renting out the property themselves, but now want to be more hands-off?***

Have they been offered a fantastic job elsewhere and need to move right away? Are they getting divorced and can't afford the mortgage on a single salary? Are they retiring abroad but don't want the emotional wrench of selling their family home immediately? These are people for whom you can offer a win-win arrangement.

Over the years, I've used various tactics to find motivated sellers. The most successful methods for me have been:

- Getting to know other local investors who own and operate rental properties. They may be looking to step back and offload the day-to-day management of their property, or be fed up with paying an agent to run it for them. Sometimes, they just aren't running a property well, and experiencing a high turnover of tenants as a result, in which case, the idea of someone else taking on the property could be very attractive.

- Closely monitoring sales listings in my target area to look out for properties that have been on the market for a while, or properties that are obviously overpriced (in which case, they're unlikely to sell). When an owner has no luck selling their property, they may be more open to the idea of someone taking it off their hands and covering their mortgage for several years.

- Creating professional flyers and posting them through doors in neighbourhoods with a lot of distressed sellers.

- Running ads in the local paper, or placing ads in coffee shops and other community spaces.

- Paying for Google and Facebook ad campaigns targeting homeowners in my chosen region. You'd be amazed what Google and Facebook know about people!

PRO TIP:

> ***Good advertising is all about focusing on a problem and then offering a clear solution. Keep this in mind when creating ads or flyers. Be sure to highlight the benefits of having their mortgage paid hassle-free, and lining up a successful (stress-free, chain-free) sale for the future.***

When you approach an owner, unless they are a fellow property investor, you'll need to spend time explaining the concept of a lease option, how it works and what's involved. This obviously takes time – and you may still get a firm 'thanks but no thanks' at the end – but it's time well spent. It's really important both parties go into a lease option agreement with a clear grasp of what they're getting into. If someone feels they've had the wool pulled over their eyes, they're far more likely to default on the deal further down the line, after you've spent precious time, effort and money finding and settling in tenants.

Negotiating a lease option and getting the contract right

In many ways, a lease option contract is much the same as a rent-to-rent contract. To avoid what's already been said in my rent-to-rent guidance, here, I focus on the aspects where a lease option contract may differ:

- Agreeing the monthly rent
- Agreeing the term (length) of the agreement
- Agreeing how much you'll pay for the property when you purchase it
- Agreeing the upfront fee (consideration) for securing the right to purchase in future

I'll delve into each of these areas in more detail, but there's a basic rule that applies to each one: you must strike a deal that's attractive for both parties. If you try and screw the owner over – for example, by agreeing a sale price or monthly rent that's too low – all you're doing is increasing the risk of them defaulting on the agreement as soon as they can afford to. If that happens, you and your tenants are left in the lurch with little recourse beyond the threat of (expensive and probably not worth it) legal action. I find it helps to think of a lease option as a fruitful, long-term partnership. And a happy partnership is only possible when both parties benefit.

PRO TIP:

> ***Both you and the owner should take independent legal advice before signing a lease option agreement. I always recommend the owner has a separate solicitor, independent of mine. If the thought of paying for a solicitor puts them off, I may offer to pay their legal expenses, in order to keep negotiations moving. Other areas in which you may need expert advice include: specialist insurance requirements (depending on how***

you intend to use the property), any leasehold implications (if the property is leasehold), and whether the lease option arrangement affects the owner's mortgage on the property.

Agreeing the monthly rent

Offering the going market rent for comparable properties in the same area is the fairest approach for both parties. However, there could be a case for offering slightly more or slightly less than that. Offering slightly more can sweeten the deal and persuade a wavering owner (but you must do your sums carefully and ensure you'll still make enough profit). Alternatively, you could arguably offer slightly less than the market rate, in view of the fact that you're giving them a secure, fuss-free rental income for several years.

The right approach will depend on the owner's circumstances. For example, if they just want to cover their mortgage and costs each month, without having to worry about the property, then the going market rate, or slightly less, seems more than fair. It's therefore worth getting to know the owner, in order to understand their needs, goals and motivations.

Of course, you'll also need to think about your own goals, and make sure the rent you pay leaves enough profit on the table at the end of each month, factoring in how you intend to use the property and how much rent you expect to charge your tenants. It's only fair you earn a decent profit in return for finding and managing tenants, making sure tenants keep the property in good order, and generally running the property on an ongoing basis.

PRO TIP:

> ***Many beginner investors worry that an owner could pocket their monthly rent, without paying off the mortgage – potentially leading to the property being repossessed. This is of particular concern when dealing with distressed sellers who owe other debts. But it's something that can easily be addressed in your contract. For example, you could stipulate that the monthly rent must go towards paying off the mortgage. You could also have it written into your contract that the owner will provide you with quarterly mortgage statements to prove that the mortgage is being paid down. Or, you could even agree to pay the mortgage company direct.***

Agreeing the term (length) of the agreement

You'll essentially be running the property as a business, and this means you really want the stability of a nice, long lease. A longer agreement term also allows more time for the property to go up in value beyond the agreed purchase price, thereby giving you that all-important capital growth. Plus, it gives you more time to accumulate rental income – which may be vital for purchasing the property in future.

So how long a term should you go for? It all depends on your circumstances and goals as an investor, and what the owner is most likely to agree to. I'd plump for three years as an absolute minimum, but ideally five or seven years. In theory, the agreement could be as long as 10, 15 or even 20 years.

PRO TIP:

> ***It's always a good idea to have a break clause written into the contract that allows you to hand the property back if you want to. (If you've chosen your property and strategy well, you shouldn't need to. But it's good to have the option in case your circumstances change.) Preferably, this break clause will be on your side only. If the owner can demand their property back at any point, you lose that must-have stability.***

At the end of the agreement, you'll have the option to buy the property, hand it back to the owner, or possibly negotiate to extend the agreement. If you want the freedom to purchase the property at any point during the agreement, not necessarily at the end, make sure the contract wording provides for that.

Agreeing how much you'll pay for the property when you purchase it

You ideally want to agree a purchase price that's not a million miles from the current market value. This is your best chance of achieving quick capital growth when you come to buy the property. For example, if the property is currently valued at £200,000, and you agree a purchase price of £210,000, you're banking on the fact that the property will go up beyond that figure. Seems reasonable enough. However, if you agree a purchase price of £230,000, you're significantly increasing the risk of not buying it. Of course, you're also banking on the fact that the owner will be happy to accept your price, in return for stable, long-term rental income and a hassle-free sale in future.

Agreeing a realistic and fair purchase price benefits both parties. After all, if the property isn't worth the agreed price by the end of the contract term, you're just going to walk away without buying it. Meanwhile, if the owner feels they've been duped into too low a price, they may be more inclined to default on the sale.

PRO TIP:

> ***There's always a (small) risk that an owner could simply sell the property from under you, as soon as they can afford to. One way around this is to agree what's called a 'restriction on title'. In very basic terms, this means your agreement with the owner is listed on the title deeds for the property. You would then be identified as an interested party (or 'charge' to use the technical term) and informed should the owner attempt to sell without your knowledge.***

Agreeing the upfront fee (consideration) for securing the right to purchase in future

Now we get to potentially the trickiest part of negotiating a lease option: how much should you pay the owner in exchange for the right to purchase the property in future?

Legally, this could be as little as £1. But, unless you're dealing with very distressed sellers, such a small amount probably isn't realistic. As with everything in the contract, it's up for negotiation, and it's up to you to find a solution that meets both parties' needs. Obviously, you want to keep the consideration as low as possible to reduce your risk. After all, the consideration isn't a deposit – it doesn't get taken off the purchase price later on. It's simply a fee you pay in return for the exclusive right to purchase the property during the length of the agreement. If you pay someone an eye-watering £10,000 consideration and then later decide not to buy their property, they get to keep your money. Simple as that.

That said, the consideration should be enough to make it worth the owner's while (assuming they're not in dire circumstances). When reaching this figure, you'll need to carefully assess how much the property is worth now, when you realistically expect to purchase it, and how much you expect the property to be worth at that point. Say the property is currently worth £200,000 and you've agreed a purchase price of £210,000. In reality, you may be expecting the property to be worth £220,000 or more by the time you come to buy it – in which case, paying a £1,000 consideration might be reasonable. It means you'll have spent £211,000 to acquire the property, but still less than its expected worth.

Operating the property on an ongoing basis

The ins and outs of managing the property will vary according to your chosen strategy. Therefore, at this point, I invite you to delve into my guidance on the various rental strategies, including rent-to-rent, serviced accommodation, holiday lets, HMOs, and renting to students and social housing tenants.

In short, though, operating a property successfully is about educating yourself on your chosen strategy, having a clear idea of what your target audience wants, preparing the property so it meets the target audience's needs, and then looking after the property so that your tenants continue to enjoy high-quality accommodation. Happy tenants stay put for longer, which makes your life as their landlord far, far easier…

Final thoughts

At first glance, a lease option seems much more complicated than, say, a standard buy-to-let model, and this often puts beginner investors off. I think that's a shame. If you're relatively new to property investing, with limited capital behind you, then a lease option could offer you a great way into the world of property investing, and provide valuable experience of managing a property and looking after tenants.

True, it may take more time to find the right property (or, more realistically, the right owner). And when you do identify the right opportunity, hammering out the lease option contract will require some top-notch negotiation skills. But, in my view, the rewards are well worth it. That's why I regularly turn to lease options, and see them as a vital part of my property portfolio.

ABOUT THE AUTHOR: NICHOLAS WALLWORK

Nicholas Wallwork is a multi-millionaire property investor, developer, International ***For Dummies*** book author, property market commentator, entrepreneur and mentor. He also owns the largest international property forum in the world (which is an incredible free resource for property education), **www.propertyforum.com.**

Nicholas fell into property in 2002 when he realised turning his first house into a small HMO (rather than living in it himself) made complete financial sense. HMOs and development were to form the key strategy of his property career. Aged just 24 he had no mortgage or bills to pay and could effectively retire (all be it modestly), teaching him a very early lesson that passive income from property was the way to build long term wealth and a flexible and comfortable lifestyle. Today, Nicholas controls a property portfolio of over £20million and runs and owns a group of successful property businesses including a property investment consultancy, several property development companies, a lettings & management business and not to forget **www.propertyforum.com.**

Any journey through property (or indeed life) is never all plain sailing and Nicholas definitely faced his share of challenges. Surviving the credit crunch was one of the biggest, teaching him many important lessons which he shares with you in his educational on Property Forum. To be successful in any business including property you need to stay at the top of your game. This means continually educating yourself and improving your skills and knowledge to further your business and personal success. This is where forums give such incredible value. Nicholas has big plans to help educate the 65,000+ community members of www.propertyforum.com with helpful ebooks, training, seminars and much more. Property Forum is already the largest international online property community and aims to become the largest and most useful property training and education resource available in the world.

MENTORSHIP HELP FROM NICHOLAS

Nicholas is passionate about helping others success in property, and offers 'bite-sized' 1-2-1 mentorship session to help people fast-track their property investment goals, and make real progress. The sessions are completely tailored to individual circumstances. Nicholas can help you make key decisions, maximise your profits, overcome issues with planning or layout, set up a property business with the correct structure, choose the right investment strategy to enable you to scale up, and get the right finance in place for your next project. He also gives you access to his trusted network of professionals within the property industry. Whatever your individual circumstances, the value that Nicholas can offer will far exceed the cost of a mentorship session. Infact, this is the guarantee that Nicholas offers to all his mentorship clients.

To find out more, you can register for more information on **nicholaswallwork.com/mentorship/** or you can book a FREE 'taster' call to find out exactly how Nicholas can add value to your specific circumstances here.

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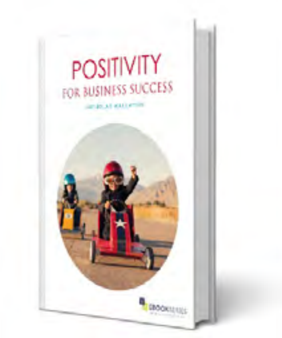

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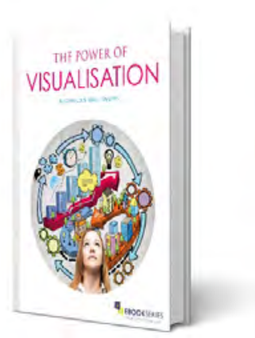

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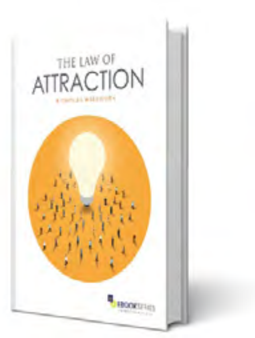

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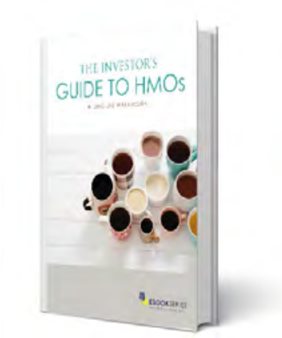

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