TALES FROM THE TRENCHES™
BY BARRY C. MCGUIRE

September, 2016

Diligence Time Bombs And Letters Of Intent

After one of my Agreement for Sale (AFS) Focus Workshops, an attendee called me up. He had done some marketing and, guess what? Marketing works!

He got a call from some folks who were trying to live their dream of operating a semi-rural spa and wellness centre. Let's call them the spa folks. They had started building a beautiful house with spa facilities and they ran out of money. They stopped making mortgage payments to TD Bank five months ago and went through the usual round of phone calls and a demand letter from TD collections, which then moved on to TD's foreclosure lawyers. At the time our member got the call, the foreclosure was well in progress.

As is often the case with sellers in trouble, the spa folks just wanted out. They had soured on the spa idea. Realizing they didn't have near enough money, they wanted to exit the situation and start over. They really didn't even want much money. Stopping the foreclosure and getting rid of the stress was the biggest thing for them

My client's original idea was to purchase by way of Agreement for Sale (AFS), but he soon realized that AFS doesn't work very well with a mortgage in foreclosure. The plan was to enter into a Joint Venture Agreement (JVA) with the spa folks and a second joint venture with two other sets of people. Let's call them the 'Finder' and the 'Money Partner' respectively.

The Finder side of the second JVA would be my client as well as the folks who brought him the deal, knew contractors, and would manage the renovation. The Money Partner would come up with enough money to stop the foreclosure ($20,000), complete the home and landscaping [($30,000 plus legal and closing costs ($3500) and miscellaneous cost ($1500)].

The after-repair value minus all input costs and paying out the mortgage showed there was probably equity of about $100,000. The JVA split would be 20% to the spa folks and 80% to my client. That 80% would be shared 50/50 between the Finder and the Money Partner. Already pretty complicated, relationship-wise.

This seemed like a pretty good deal as my client explained it to me in our first conversation. He had worked on a Letter of Intent (LOI), which is an amazing tool in the creative real estate process. I like an LOI on most deals because it makes you reduce the zillions of words to, presumably, a nice clear deal summary in a maximum of a couple of pages. Once you start doing the LOI, if it doesn't just roll off the tongue and really flow along, then there is more work/negotiating/explaining/getting agreement or combinations of all those things, to be done. An LOI is just a real good tool to capture a point in time before all the expense of moving on to diligence, drafting documents, etc., etc.

Now back to our story. I took the LOI and did a little bit of reworking, not much, and our member was away to the races. Time to do some diligence. The biggies were:

1. firm up those contractor prices,
2. get a written statement from the foreclosure lawyer, and;
3. do extensive marketing research.

September, 2016

First up was the foreclosure lawyer, where the estimate of $20,000 turned out to be $30,000 at the point in time when they wrote their letter.

(I have to make another general comment that the actual costs of bringing a mortgage into good standing are always substantially more than what the homeowner/mortgagor thinks. This is a classic foreclosure experience. You are always behind the curve in foreclosures with the homeowner because they never quite know how many payments they are behind. And they have no idea where the foreclosure lawyer is in the process as foreclosure costs mount. You have to get a written statement!)

That extra $10,000 to stop the foreclosure was the start of this project going in the wrong direction.

For further details, let's see what my client wrote to me when the deal collapsed. I asked for his analysis and three reasons why the deal didn't go ahead.

> *Good evening Barry,*
>
> *I absolutely agree with your comment that not going into the potentially bad deal was definitely a good decision and I see it as a learning curve and a success.*
>
> *Honestly there were probably more than 3 reasons why we didn't go ahead.*
>
> 1) ***Risk 1****: the acreage location and it being an acreage – they aren't as easy to "flip" as a house is in Edmonton. I spoke with a realtor in the area who said it had been a decent year but not what it was in previous years.*
>
> 2) ***Risk 2****: if it did not sell that I would have a substantially harder time finding tenants than in Edmonton and there's not much for comparison to find what market rents would be.*
>
> 3) ***Financing/Profit numbers****: the money was just too tight. With the extra $10,000 for the foreclosure, written estimates for construction costs to finish the home at $45,000 not the guestimate of $30,000 and another $10,000 to payout that surprise of a Rural Electrification Lien, our sweet $100,000 was now down to $65,000. Split 20/40/40, our profit was disappearing. And, the more we looked at this deal, the more the costs were going up and would go up. We all know that in renovations you can count on actual costs being higher than even careful written estimates, the project taking longer to finish, it will take longer to sell than you think and always for less then you plan. All of a sudden the money side is looking terrible. $100,000 could easily be turning into $50,000.*
>
> 4) ***Red flag from you****: that technically, with the term of the existing mortgage already expired, we could bring the mortgage into good standing and the bank could have refused to renew the mortgage and then we couldn't do an Agreement for Sale. We would have had to get a new mortgage. That would have eaten up again more money in profits, which would have made the*

spread even smaller than it already was

5) ***3 sets of people splitting profits****: This was my first time working with the finder. Apart from finding the deal, they were supposed to find the contractor and manage finishing construction and landscaping. Their contractor wasn't reliable and I had to bring out my own. Big red flag for me that I would end up running the entire project. Time is money. If I had to supervise, first I didn't have the time and second, my portion of our diminishing profit becomes smaller because I wouldn't get paid for my time.*

6) ***Realtors****: the money partners were insistent on marketing thru a personal acquaintance realtor with no experience in either acreages or this type of property, rather than finding the right realtor for the job. I'm a mortgage broker so I've got loads of realtors I deal with. You need to find the right realtor for the right area with the right tools to get the job done.*

I also ended up chatting with my friend for a second opinion from the outside (also an investor, was a residential realtor, owns a real estate office). I gave her all of the numbers, the home photos and the full scenario and her response was iffy. Exactly how I was feeling about it. Was nice to confirm it wasn't just me seeing the deal was looking shaky.

So, I had the task of giving the spa folks the bad news. I couldn't help them, but, you know, they actually understood what I was saying and thanked me for trying.

That being said I very much appreciate your advice, consultation and the LOI you put together for me. I've got it saved in my files now and will use it as my template for other deals going forward. I've had a lot of response on my website so hopefully something good will come up from all the leads I'm getting!

Thanks again,
Roger.

You know I like to say that the goal of my Focus Workshops is to have attendees do, "One Damned Deal!" If you can do one deal you can do more, so the first one is the hardest and the most important one. But the backdrop is that you don't want your first deal to be a bad deal. In this scenario my client was initially enthusiastic, but analysis and diligence proved that the deal would chew up time and resources with no reasonable expectation of a decent profit. So, that's a bad deal, don't do it. On to the next one.

Lessons Learned:

1. Get started, plunge in, make a conditional offer.
2. Early in the process, clarify the deal with a Letter of Intent.
3. Stopping foreclosures always cost more than you estimate.
4. Any renovation always takes longer, costs more, takes longer to market, and sells for less.
5. Your protection is the gap between after repaired value and estimated costs, BIG is better!
6. Diligence protects you from making bad decisions.
7. Get a second opinion from a trusted mentor or knowledgeable 3rd party.

8. Too many partners means smaller profit, and it's tough to get a consensus.
9. Don't force it. Walk away if it's bad. Use your experience to write another deal.

BUYING OR SELLING REAL ESTATE IN ALBERTA?
EMAIL B.MCGUIRE@RMLO.COM

RMLO Law LLP
Suite 101, 10301-109 ST Edmonton, AB T5J 1N4
Phone: 780.431.1444 Fax: 780.431.1499