The Advantages Of Having Financial Partners

Another piece of advice that I've heard is not to partner with somebody and split the profits 50/50. Instead, they say that you should offer them 15% or 20% interest. I can't tell you how many times I have heard real estate experts say "never partner with an investor 50/50 because 15 or 20% is better than 50%". I assure you that it is faulty logic. You are not splitting 50% of the value of the loan with the investor; you are splitting 50% of the profits. These are two totally different things. A better piece of advice is to say, there are times when you should partner 50/50 and times when you should give an investor a set interest rate. Let's explore an example.

Assume that you buy a property for $60,000. You borrow $60,000 from a private investor, and an additional $10,000 from the private investor to fix up the property. It takes you 8 months to fix up the property and close the property. After 8 months, you sell the property for $85,000 and you net $82,000 after paying all associated fees. That represents a profit of $12,000 ($82,000 minus a purchase price of $60,000 and $10,000). If you were to borrow money from the private lender at 15% interest, you would owe the investor $7,000. That is 8 months at 15% of $70,000. That represents more than half your profit. You receive $5,000 and the investor receives $7,000. If you split the profit with the investor, you would have only given him or her only $6,000.

Additionally, when you pay a set interest rate, you are taking on all the risk, and the investor gets paid whether or not you make a huge profit. For example, if you made only $6,000 profit, you would still owe the lender $7,000. Thus you would lose $1,000 for all your time invested. Whereas if you had split the profits with the private lender, you would have made $3,000. Hopefully you are not buying properties where you are making such small profits over such extended periods, but this scenario is certainly a possibility. There are a number of things that could cause such a scenario.

On the flip side, if you were to net $88,000 for the property, that would represent a profit of $18,000. Of that $18,000 you would only have to pay the investor $7,000 and you would keep $11,000 – or more than half. In this scenario, you would have been better to offer the investor 15% interest.

I'm not telling you to do one or the other, but I ask you to recognize that there are pros and cons to each. When somebody tells you to only offer an interest rate, and not to consider profit sharing, they are offering incomplete advice. In some cases, they are actually offering a mathematically poor advice. The next time somebody gives you this advice, please explain to them how their advice has the potential to be a mathematical problem.

Is there really any way of knowing which method you should take? It is very difficult to accurately forecast when and for what you will sell the property, however, there is typically less risk when you partner. There is also no reason you should have to partner 50/50. Perhaps it is a win-win situation to offer then investor 25% of the profits or 15% of the profits. It all depends on their goals, motivations, and their relationship to you.

I have found that on average, if I offered a 50/50 split to investors, I would end up paying them more than the interest rate that I give. I generally pay one percentage point higher than prime to private investors. This amount on my deals works out to an average of 20% of the profit per house. If I offered an 80/20 split, the investor would on average end up the same thing as if I offered a percentage rate. The reason that I do not do this is simply that I have not tried. I can see many reasons why I would want to do this. For one, I reduce much of my risk. Secondly, the agreement would probably call for me not to make payments to the lender as they are small partners in the transaction.

Thirdly, this strategy might make the lender motivated to help me find a buyer for the transaction. Whereas, the investor would receive the exact same interest rate for all sales, if I make the investor a partner, they may be in a position to help. However, you may find that they become more of a nuisance under this arrangement because they are constantly calling to see how things are going. If they do become a nuisance, you probably want to abandon that strategy with that particular investor.

Having your investor putting pressure on you will only provide unneeded stress. You may become more likely to make mistakes or to sell to unqualified buyers, or even to take too low an offer. While I have not used the latter of the two strategies, I'm not opposed to doing so. It would just have to be the right person and the right situation. Right now, all my investors are out of my local market and thus would be unable to help locate buyers regardless of their motivation.

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