

# You Don't Have to Win the Lottery to make Money in Preconstruction Real Estate

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Over the last couple of years, preconstruction investing in resort real estate has become the new buzz in real estate investing. Self-proclaimed gurus hawking tapes and books about foreclosures a few years ago have now turned to selling "secrets" about preconstruction investing.

There's no magic and there's no secret to making money in preconstruction investing. It's been done for years. Have you ever had a home built that was worth more when it was finished than what you paid? That was preconstruction investing. The demand for real estate in certain markets' is creating unprecedented appreciation and there's no magic to it. If you buy today, in many areas of the country, you will have significant appreciation in 1 year, sometimes \$100K-\$300K. It doesn't matter if you're investing in resort real estate such as Florida Gulf Coast condos or rehabbing homes 2 blocks from the beach, you'll generally enjoy the same appreciation rate in the same market. The determining factor in which investing strategy to use becomes one of circumstances which best meet your needs. Regarding preconstruction investing:

- you don't make monthly mortgage payments during the appreciation period
- 10-20% of the purchase price is held by the developer's escrow agent during the appreciation period
- you don't get the use of the property during the appreciation period

This article is written to dispel the mystery, the hype and the misconceptions about preconstruction investing and to expose the options to high rise resort investing in which you won't generally realize a profit for 2-3 years.

## Securing the Preconstruction investment

Basically there are 2 stages to a preconstruction purchase prior to closing:

1) **Preconstruction Reservation Stage** - this stage requires a minimal amount, generally \$5,000 to \$20,000. The preconstruction reservation is a non-binding agreement on both the preconstruction investor and the condo developer. In other words, the developer can raise the price and the investor can choose not to purchase the unit and get their deposit back. At this point, the investor has no binding rights to sell and while I have seen zealous real estate agents attempt to market preconstruction reservations, I would never advise my clients to pay someone who holds a preconstruction reservation a profit for this non-binding reservation which may never materialize. Further, I would encourage anyone attempting to sell or assign a reservation to do so only upon the advice of an attorney who has drafted a contract which limits their liability.

**Lotteries:** In recent preconstruction presales of Florida Gulf Coast condos, many developers have chosen to offer a "lottery". This is both a marketing strategy and a way to secure only serious buyers. You send in a reservation for each unit that you want to reserve and generally choose 3 to 6 units which you would accept in the order of preference. On the day of the lottery, one of your unit choices is generally assigned to you. Since numerous buyers may choose the most desirable units, you may not get one of your choices and may be offered what's left, if anything. This is how developers can advertise that they "SOLD OUT IN 2 HRS". Yes they did but they were probably accepting preconstruction reservations for days, maybe months before condos were assigned to the reservation holders.

I've had clients who have literally toasted to winning a preconstruction lottery, only

to have their money tied up for 2 years and the price of their "reserved" unit increased by \$200,000 when it came time for final contract. This is not an isolated case and developer price increases have become more common since preconstruction investing has become so popular.

During the reservation stage, developers hold your reservation deposit while they obtain the financing and required approvals and permits. If this takes a year or two, property values have generally increased significantly over this time and the developer may decide to raise the price of resort real estate to today's market value prior to offering a hard contract. This obviously disappoints reservation holders but one can also understand the developer's position since construction costs may have increased significantly over this time. The bottom line is "don't count your preconstruction profit until it's deposited."

2) **Hard Contract Stage** - Generally, when the developer is ready to begin construction, the investor is required to put down 5%-25% which secures a *bilaterally binding* agreement to purchase the property. The developer can't raise the price and the preconstruction investor has to buy the property.

When purchasing preconstruction from speculative investors or builders, hard contract is the first and only step prior to closing. In other words, if you buy a spec cottage from a builder or another investor, there is often no reservation stage. You enter into a contract to purchase the spec building, put down earnest money and wait for the building to be done. In this scenario, you can often make a significant profit much quicker with a smaller down payment than investing in resort real estate or Florida gulf condos in high rise complexes. Many believe that the trend will be for large scale resort developers to eliminate the reservation stage and also move directly to hard contract.

This is the point that scares many would-be investors - signing their name on the dotted line and "no turning back". Many feel comfortable signing a reservation but not a contract. Unfortunately, until you sign a binding contract, you basically have nothing. Once you sign the preconstruction contract, you have something to resell - your rights established by the contract. In some cases, the developer may allow an assignment of the rights for a fee but in most cases, you'll need to do a simultaneous or back-to-back closing with your buyer.

There's no free lunch. No "big profits" without having to sign a purchase contract. Can you make \$150,000 per year investing in today's real estate market? Absolutely! Can the market change in time? No doubt it will! The question is when and nobody knows for sure. For this reason, I personally prefer preconstruction investments with a shorter return period. Many of you haven't been told about these options and I'm sure you're wondering how this can be done. Again, it's no secret. Obviously a large scale, 23 story condominium complex is going to take longer to build than a 4 story low density condominium building or a single family residence (cottage).

### **Choosing the Right Preconstruction Opportunity for your goals**

Now that you know that there are ways to invest in preconstruction real estate other than large scale resort condos which take 3 years to complete, let's look at your options:

1) You can purchase a preconstruction cottage which can generally be resold for a profit in about 8-12 months with 1% to 20% down. If you are buying a spec cottage from a builder or investor, you can sometimes secure the cottage for earnest money which may be as little as \$5,000. A savvy investor realizes the higher return on such investing.

2) You can purchase a condo in a low rise complex and resell at a profit in also in about 8-12 months with 10-20% down. Upon completion, you can resell with about a year's appreciation and reinvest or hold onto the unit, rent it or use it for personal use.

3) You can purchase a condo in a high rise complex which generally will not realize a profit for 3-5 years with . 10-20% down. This requires parking your money for a longer time and speculating on longer term market stability.

4) You can purchase vacant land in a recently platted subdivision, secure a construction to perm loan, create your own preconstruction and sell it in about 8-12 months at a profit with 10-25% down + interest on borrowed money. This is a little more difficult for out of state investors but many master planned communities will only allow approved builders with approved plans. In reality, the investor can choose materials and conduct a closing walk-through just as in preconstruction condo investing.

Note that with condos and cottages, you generally do not have to make additional payments while you're waiting for completion. In the case of vacant land, you may need to close and make monthly payments on the land and/or interest on construction draws. In some cases, you may find that the land is appreciating so rapidly that you may choose to *flip* the land rather than get the construction loan and build. Since land flipping is not preconstruction investing, it's not addressed in this article.

Obviously, there are methods of real estate investing other than preconstruction that can be quite lucrative. A comparison of these options is outside of the scope of this article. In short, whether or not preconstruction investing is the best choice for your will depend on your particular goals and financial situation. A realtor with knowledge in all types of real estate investment strategies can assist you in determining the best option for your particular situation.

In summary, "big profits" in preconstruction investing are very real but you should know your options. Don't be afraid to ask questions. Do your homework and when you've made your decision, follow through. I've seen so many people put months, even years into researching real estate investments and then they never leave the starting gate. For many years, I was one of them and I can only say that the first time is the hardest but it feels so good when you deposit that check from your first real estate investment.

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