

The Economics of Termite Inspections to Support Real Estate Transactions

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This paper will discuss the economics of termite inspections for the purpose of supporting real estate transactions from the point of view of the structural pest control industry, the building inspector and the consumer purchasing the real estate. As you will see, the structural pest control industry – specifically the termite pest control part of the industry – has a significant economic interest in how inspections are done.

Termites are just one of a class of wood destroying insects. However, it is cumbersome to keep using the phrase “termites and other wood destroying insects.” So throughout this paper we have used the word termites by itself but we are including both termites and other wood destroying insects whenever we do so.

We have chosen to use the phrase “house inspection” when we mean to include all buildings, not just houses.

The basics of termite inspections

The seller or lender has a termite inspection performed to verify that the house does not have a termite infestation, that there is no damage from a previous termite infestations and to identify any conditions that are conducive to a termite infestation.

There are two different entities that can perform termite inspections on houses. There is the house inspector and the termite inspector. In general, the house inspector is not allowed to inspect for termite infestations or conditions conducive to termites, or even say that damage to the structure has been done by termites without a full set of OPM (Office of Pest Management) termite licenses (applicator license, qualifying party license and business license). A company performing termite inspections in Arizona is required to have all three of these licenses.

There are three reasons for performing termite inspections. The first is to determine if there is an active termite infestation. The second is to determine if there is pre-existing damage from termites. The third is to determine if there are conditions conducive to a termite infestation.

From the pest control company's perspective

A termite company is a pest control company with appropriate licenses to perform termite work. The termite company makes money in the termite business by providing termite pretreatments (treatments done during construction to prevent termites), preventative treatments done after construction, treating for active termite infestations, selling annual termite service contracts (sort of like renewable termite insurance), and termite inspections to support real estate transactions. For the purposes of this paper, we are only interested in the inspections done to support real estate transactions and the potential revenue streams that may result from these inspections. You can read the Its-Our-Turn.com white paper "The Economics of Termite Pretreatments and Service Contracts" for additional information about the termite business.

When a house is sold, the termite company holding the termite contract for the house – if any – loses a customer. Assuming the house was under contract, the seller has no interest in continuing the termite contract once the house is sold.

The termite company losing the seller's termite contract has no knowledge of who the buyer is or who the buyer's real estate agent is. The termite company will have little opportunity to influence the selection of the termite company used for the termite inspection. The buyer's real estate agent will heavily influence the selection of both the house inspector and the termite company that will perform the termite inspection.

When a termite company sells termite inspections to support real estate transactions, the termite company has an excellent marketing opportunity to sell additional termite services. If termites are found, the termite company is likely to sell the termite treatment to treat the active infestation – probably to the seller. In any case, the termite company will try to sell the buyer a termite contract for the house, which may necessitate a preventative treatment at the start of the contract.

The chance to sell additional termite services is a huge economic incentive to termite companies. This is the primary reason that termite companies do not want house inspectors performing termite inspections to support real estate transactions – the termite companies want the opportunity to sell additional termite services following the termite inspection. Termite treatments and termite contracts are significant profit centers for any termite company. If a house inspector performs the termite inspection, the termite company has no direct marketing link to the buyer or seller and must compete with all of the other termite companies to make the sale.

How much money does a termite company stand to make on other services after the termite inspection to support a real estate transaction? A typical annual termite service contract will range from \$130 to \$400 per year. A typical complete

treatment will range from \$800 to \$1500. Although the higher priced services tend to be higher quality, price is not always a good indicator of quality. So you can see that there is a lot more money in the other services than in the original inspection.

This strong economic incentive can give rise to a second issue – loss leader marketing. The termite company stands to make significant money on the additional termite services that result from termite inspections to support real estate transactions. Thus, a termite company may decide to sell the termite inspections at a discount in order to bring in more inspections, and with them, the opportunity to sell more termite services.

A proper independent termite inspection done to support a real estate transaction will cost around \$100. The termite inspector must come to the house, takes roughly 30 minutes to inspect the house and then additional time to fill out the WDIR (Wood Destroying Insect Report). The termite company must charge enough to cover the inspector's time, the vehicle, office overhead and company profit.

So how can a termite company sell termite inspections for \$55 and deliver a quality inspection? It is clear the termite company hopes to make up the loss on the termite inspection with profit on the additional termite services. We have to assume the termite company is still delivering a quality inspection for the discounted price – which may or may not be the case.

A termite company that is performing termite inspections to support real estate transactions will be marketing those termite inspection services to the real estate agents. The real estate agents typically recommend a termite company to the seller and the seller typically agrees to use the recommended termite company. So the real estate agent is the termite company's primary marketing focus.

From the house inspector's perspective

A house inspector has been trained to evaluate the physical structure of a house, including the structural integrity of the foundation, floor, walls, ceiling and roof. The inspector also evaluates the electrical system, plumbing system, air conditioning and heating system, ventilation system, doors and windows.

OPM does not allow a house inspector to make a determination relative to termite infestations, conditions conducive to termites or damage without having a separate set of termite pesticide licenses – even though the inspector will never be treating an infestation. Further, OPM requires a special OPM form for reporting termites and termite damage – the WDIR (Wood Destroying Insect Report).

A house inspector generates a detailed report about the house being inspected. There is no reason why the additional information relative to termites cannot be included in the already detailed inspection report. The only three things the house

inspector cares about in an inspection relative to termites are: 1) is there evidence of damage to the house – structural, superficial or aesthetic, 2) is there evidence of an active infestation and 3) are there conditions that are conducive to termites.

The house inspector has no future economic interest in the house once the inspection has been completed. The cost of the inspection is the sum total of what the house inspector stands to make from the transaction. Unlike termite companies, the home inspector has no additional services that can be sold to the buyer or seller following the inspection.

The house inspector will often spend 4 hours inspecting a house and additional time writing up the report. The long period of time allows the inspector to methodically cover the entire building, top to bottom, inside and out. The house inspector is already providing a full inspection for structural integrity so checking for termite damage does not take the inspector any additional time – it is part of what he already has to do. Looking for termite tubing and other signs of termites is easily done while doing other detailed inspections and adds very little time to the full inspection. Finally, the house inspector can look for conditions that are conducive to termites with very little added time to the inspection.

A termite inspection done by the house inspector is essentially a low cost add-on service. Since the house inspector is already inspecting everything else, the additional time needed to perform the termite inspection tasks is significantly less than for an independent termite inspection of equal quality. Thus, combining the two inspections into one should cost less and be of higher quality.

If the house inspector finds damage, an active infestation or conditions conducive to termites, these items will be noted in the house inspector's report. However, the inspector cannot do anything about the issues found and cannot recommend companies to address the issues found. The inspector will not recommend companies to make electrical, plumbing, roofing, termite or any other repairs to the house. It is up to the buyer and seller to select appropriate companies to address the issues documented in the inspection report before closing. Therefore, the house inspector has no economic interest beyond completing the inspection report.

From the buyer's transaction's perspective

During a real estate transaction, the buyer and lender want to know that the house being purchased is in sound condition. The buyer does not want to purchase a house with unknown defects and the lender does not want to lend money for a house with insufficient value to justify the loan. Thus, in any real estate transaction, a prudent buyer and lender will always have a house inspected prior to concluding the transaction.

In any real estate transaction the inspection report is making a representation

about the condition of the house on a specific date. The inspection report is good for a limited period of time – typically 3 to 6 months. After that, the data is too old to be reliable and so a new inspection must be made. The more time that has passed since the inspection was completed, the more likely conditions are to have changed.

House inspections have historically been split into two separate inspections: the building inspection excluding termites and a separate termite inspection. We have already covered the issues surrounding both of these inspections.

Most people purchasing houses do so rarely. The typical house buyer will not be familiar with who the good house inspectors are or who the good termite companies are. A good real estate agent will process many houses each month and have significant experience with at least a few house inspectors and termite companies. As a result, the real estate agent will make recommendations for house inspectors and termite companies the real estate agent is familiar with and the buyer will go along with the recommendation.

There are other people in the real estate industry that buy and sell property on a regular basis. These people are not agents but rather owners or managers of real estate. As these people transact buys and sells on a regular basis, they will have their own experience with house inspectors and termite companies and generally not seek the recommendations of the real estate agent.

Inspections are a part of the cost of buying and selling real estate. And like any other service, the consumer seeks to keep the cost down. Cost will always be a major factor in selecting an inspector if there are no other criteria available. Other criteria could include availability of the inspector on a particular day and quality of the inspection and inspection report. The consumer does not have any good way to judge the quality of an inspector prior to choosing one because there are no rating services available. All inspectors are licensed by the State and are assumed to be of essentially the same quality.

OPM maintains a Termite Action Report Form (TARF) database that includes a limited amount of historic information on a house. The Its-Our-Turn.com white paper “The Case Against TARFs” discusses why the data can easily give a false sense of security to a buyer and cannot be relied on in a real estate transaction.

Although the buyer’s real estate agent is supposed to look after the interests of the buyer and lender, there are still conditions under which the buyer’s agent may pick an inspector based on the real estate agent’s self interest – even when that interest runs contrary to the buyer’s interest. In general, the real estate agent’s contract protects the agent from a bad inspection and thus the real estate agent can feel confident in getting away with the fraud. OPM has no jurisdiction to actually protect the consumer and will suggest the consumer file a civil case against the agent.

Summary

We have looked at the economics of termite inspections done to support real estate transactions from three different perspectives. We realize it may upset many people in the termite industry but we think this is a complete and unbiased look at all three perspectives.

The termite industry has a huge economic incentive to prevent house inspectors from performing termite inspections. The termite companies stand to lose the lucrative opportunities to sell services beyond the termite inspections to support real estate transactions.

There is nothing to indicate that house inspectors cannot do a good job of termite inspections. When you consider the significantly longer and more detailed inspection performed by a house inspector, the house inspector may be able to do a better termite inspection with minimal additional cost and may be able to reduce the cases of fraud in these inspections.

The real estate industry is mostly looking for the least expensive inspection to keep the buyer's costs down. They do not really care who performs the termite portion of the inspection – only that it is performed cost effectively – or inexpensively.

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