

Seller Financing to the Rescue!

How Investors Can Profit from the Emerging Solution to the Real Estate Crisis

By W. Eddie Speed

As a real estate investor, you know all too well that the mortgage industry is suffering from a major meltdown. Too many institutions have been lending money in a blind, reckless way. Lending institutions are folding, foreclosures are reaching record highs, and subprime lending has caused a catastrophe for property sellers, buyers, and lenders alike.

As a result of today's credit crunch, there's a limited pool of qualified buyers and a shrinking supply of conventional lending sources. In addition, there's a growing number of would-be buyers who can no longer obtain conventional loans—and an abundance of properties on the market at low prices.

Seller financing is coming to the rescue. It's filling the void created by the mortgage crisis, offering an alternative to those hard-to-come-by conventional loans. But seller financing can do more for the real estate investor than just move property. For one, it can sell property more quickly and at higher prices. That's because it offers a much larger pool of potential buyers.

With safe seller financing, you underwrite loans before they are made, and then manage them thereafter. You must learn how to identify and qualify capable buyers who are excluded from traditional mortgages as a result of today's tightened underwriting standards and the diminishing number of conventional lending institutions.

Seller financing is fast emerging as *the* solution to the collapse of many lending institutions, and the shrinking supply of financing available from those that survive. For you, the real estate investor, it could very well be the key to your survival in this business.

Seller Financing Goes Mainstream

After the high-interest rates of the 1980s, seller financing became a specialty niche among real estate transactions. The upheaval in the housing market, however, is now creating an extraordinary demand once again for this alternative funding source.

Consider this: two years ago, seller financing accounted for about 1 in every 400 real estate transactions. Today, it accounts for 1 in every 50 transactions. What's more, some real estate experts predict that seller financing will soon become the financing vehicle for one out of every ten real estate transactions. Not since the 1980s, have I seen the extraordinary increase in, and necessity for, seller financing.

What does this mean to you? Seller financing provides you the opportunity to sell your properties to quality buyers, at the full retail property values and more quickly, for a substantial and steady income stream. The smart real estate investor will become adept at using this method. Indeed, your level of success will likely depend on how well you use seller financing.

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For Quality, Qualify

Qualifying for a conventional mortgage today is much more difficult than it was just a few years ago. As a result, there are many more quality candidates for seller financing than there were in the past. These are people who've been rejected by conventional lending institutions, in part, because less money is available. More

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restrictive underwriting criteria are in effect, which disqualify countless candidates who have both a willingness and the ability to meet the requirements of the loans. In addition, many other would-be buyers have had hardships that they've since overcome.

Together, these factors contribute to a startling fact: As many as 50% of the people who would have qualified for a conventional mortgage just two years ago no longer do. True, there had been much reckless lending to risky borrowers in recent years. But since the shakeout in the lending industry, many good candidates are now being denied the opportunity to borrow money.

Seller financing is the ideal solution for these people and investors alike. To avoid the same pitfalls that brought down many lending institutions, however, the investor must weigh the risk of each loan and proceed only with those that present a high likelihood of success. That means being meticulous about qualifying the buyers and lending only to those of the highest caliber.

From This Day Forward . . .

Most people enter into seller financing contracts with the same enthusiasm with which they enter into marriage. They're as happy at closing as newlyweds at the altar. Everybody's eating the cake and tossing the rice. But if the commitment is based solely on blind faith, the relationship may dissolve faster than ice in the punchbowl.

No investor finances his property for a buyer with the belief that the arrangement will turn sour. At most, it's considered a remote possibility with tolerable consequences. If the buyer defaults on the loan, the investor assumes that he can simply annul the deal, repossess the property, and avoid any loss.

But this assumption is flawed. The buyer has occupied the property for months, perhaps years. What condition is it in now? Have the taxes been paid? Are the

insurance premiums up to date? Has the buyer kept up with the routine maintenance and repairs? Or, as in the case of some foreclosures, has the buyer trashed the place and fled? With falling prices in the housing market, even the equity might be reduced. The seller/lender gets stuck with unpaid bills and costly repairs. The honeymoon is over.

Like fiancés, borrowers are emotionally involved with the transaction and might not view their situation objectively. Even well-meaning buyers might believe they can afford to commit to a long-term loan without realizing all the responsibilities and expenses they will incur, nor their ability to meet those obligations. Equally excited about closing the deal, the seller might be blind to the potential risks in doing business with a particular buyer.

Other investors recognize the risks but believe they can sidestep a foreclosure action by having the buyer pre-sign a deed back to them at closing. That would be an invalid deed because the buyer cannot waive his future rights. But there is no protection for the seller in case the arrangement goes sour. Seller financing doesn't come with a pre-nup.

Clearly, the smart approach is to learn all you can before you're heavily invested in the relationship.

A Safe Bet

How risky is seller financing? Much lower than it used to be. In the past, would-be borrowers paying on seller-finance mortgages were, as a group, much riskier than they are today. That's because it was easy, too easy, to obtain a conventional loan. People who failed to qualify for traditional mortgages were, by definition, the riskiest borrowers.

Lending institutions have since tightened their criteria, making it far more difficult for would-be buyers to borrow money. As a result, more people are now purchasing property with seller financing. Squeezed out of conventional lending, formerly qualified applicants are increasing in number and anxious to buy property. This raises the quality of the typical seller-finance candidate.

Many are "just missed" borrowers who now fall narrowly outside the newly tightened criteria of lending institutions. These are reliable, low-risk prospects who show every intention of meeting the terms of their loans, and they have the ability to do so. They would

have easily qualified for conventional mortgages in the past but no longer “measure up” on paper.

What the savvy investor must do is differentiate between those deserving buyers and the obviously risky ones. Your success will depend on the thoroughness by which you investigate each prospect and then use sound judgment when deciding whether to offer seller financing.

I Do Diligence

Returning to our marriage analogy, approving your seller-finance candidate is a lot like choosing your life partner.

Few people enter marriage without having first gathered considerable information about their mate. It starts with that first encounter, when your date presents himself or herself in the best possible light. He appears honest; she seems responsible. As you get to know each other, you like what you see and you want this to work. You make plans.

Smart couples approach the altar having already discovered and judged their fiancés’ background, character, values, strengths, and weaknesses. They conduct their own due diligence before their “I do’s.” Many singles even hire a private investigator to do an independent background check on their potential mate before proceeding with the romance. It’s smart with dating; it’s smart with lending.

Likewise, real estate sellers should evaluate their seller-finance candidates with this same level of scrutiny. Yet too often, they fail to conduct due diligence. This careless approach results in countless defaults and creates the impression that seller financing is riskier than it should be.

The savvy investor will ensure good underwriting, not only to achieve a smooth and successful transaction but also to maximize the cash value of the note. Most note holders don’t realize that the number one variable that affects the cash value of their note is the buyer’s credit. So not only does disciplined underwriting mean a more trouble-free loan, you also create a more salable loan in the future, and one that’s worth more.

To help ensure a profitable relationship with your borrower, then, you must perform due diligence. The

With due diligence, good judgment, and some common sense, you can become very successful with seller financing. And the timing couldn’t be better.

independent investigation will assess the accuracy of your buyer’s statements regarding assets, income, employment, debt, and so forth. Due diligence allows you to make sound decisions based on solid facts, not subjective impressions. It allows you to distinguish the quality borrower from the risky one. And you can then create a more valuable loan.

Ronald Reagan said it best with his signature phrase, “Trust but verify.”

You Can Bank on It!

Using another analogy, imagine that you’re considering buying stock in a bank. Despite the bank’s history of solid performance, let’s say it now decides to relax its due diligence procedures. This saves both the time and expense of verifying the loan applicants’ statements and examining other sources of pertinent information. With less stringent requirements, the bank is now able to qualify more borrowers and process more loans. Risky loans. Now here’s the question: Would you want to own stock in that bank?

Unfortunately, many property owners enter into seller-finance contracts with that same, careless approach. They don’t pull a credit report, verify income statements, examine the employment history, or investigate the buyer’s liabilities. It’s like eloping on that first date.

When you seller finance, you’re buying stock in your own bank. Make sure you can bank on your decisions. You can be extremely successful in this business, if you use a methodical approach that calculates the risk and weighs the benefit. (Trust me, I know.) In addition, it’s much more profitable than sitting on an unsold property. But seller financing does require that you understand some fundamental principles—and that leads us to our next analogy.

Playing Your Cards Right

Let's take this concept to Las Vegas. You certainly wouldn't play Blackjack without first understanding the rules of the game. With that knowledge, for example, you wouldn't take a hit if you have 18 and the dealer shows a 4. Otherwise, what stays in Vegas is your money.

Yet a lot of people who offer seller financing are gambling with their own assets. That's because they don't understand the basic principles involved. Rather than analyze the risk and then judge wisely, they unwittingly close deals with high-risk buyers.

Smart seller-financing is profitable. There are plenty of aces in the huge and growing pool of potential buyers. All you need to do is find them.

The Basis Basics

During my 28 years in seller financing, the question I'm most frequently asked by property sellers is this: At what point should you make a very aggressive underwriting decision?

The answer depends entirely on how much you've invested in the asset. If it's worth \$100,000 and you've invested only \$25,000, you have a "low basis." With a low basis in a property, you can better tolerate a default risk.

In a way, you're like a pawn shop owner. You've taken as collateral an item whose value is far greater than the money you've loaned. If the transaction proceeds as planned, your customer repays the loan with interest, and you make a profit on your loan to him. If your customer defaults, you take possession of the collateral. Having invested only a fraction of its retail

value, you can then sell it to someone else for a healthy profit.

That's why the higher the percentage of your investment in the property (your basis), the less risk you can afford to take. Let's say you've invested \$75,000 in that \$100,000 property. You're now at a greater risk of losing more, if delinquency and default occur.

With a low basis you can lower your underwriting standards. I've known and even consulted with real estate investors who maintained a fairly liberal underwriting practice. These transactions succeeded because the investors had a low basis in their properties. With an inordinately low investment in the property, say 20 or 30%, you can tolerate the additional risk. This strategy, however, is riskier and more challenging. It demands greater attention to detail, and requires more time and resources to service the portfolio. But if you have a low basis, you can apply lenient qualifying criteria and still be successful.

Seller Financing: It's a Good Thing

Having purchased more than 30,000 seller-financed notes, I've seen a pattern of success and failures. These aren't just theoretical concepts. They're the result of actual experiences involving a range of variables. With due diligence, good judgment, and some common sense, you can become very successful with seller financing. And the timing couldn't be better.

Today there are plenty of quality people who deserve the opportunity to own their own homes. They can afford to buy your property, and they will make their payments on time. In addition to your own success in this business, you can provide a much-needed service that will help others. Are you ready to say "I do"?



Eddie Speed, Founder of NoteSchool®, has purchased more seller-financed notes than anyone else in the business. With a lifetime volume of seller-financed notes topping half a billion dollars, Eddie has seen just about every scenario. He is also an acclaimed instructor, mentor, and recipient of the industry's most prestigious award.