

PRIVATE MORTGAGE FINANCING - WHEN CONVENTIONAL FINANCING IS UNAVAILABLE OR INAPPROPRIATE

Private mortgage money offers unique advantages for the professional real estate investor. Private mortgage lenders are able to close most loans in 2 weeks or less whereas institutional lenders require 6 weeks or more to close and fund a commercial mortgage loan. Further, private mortgage loans are asset based; the real property itself is the basis of the lending decision. Hence, if a property is producing or can produce sufficient income to pay the interest on the note and the value of the property will fully secure the note and provide sufficient equity, then the borrower's credit is not an issue. Instead of concentrating on minute detail of the borrower's credit history as institutional lenders do, private mortgage lenders concentrate their due diligence efforts on the real estate securing the loan. They provide the professional real estate investor with the ability to borrow on underwriting criteria not available through institutional lenders. No credit check or detailed application forms are required and private mortgage lenders can usually render a decision in 24 hours.

Private or *hard money* lenders loan up to 65% of appraised value with no seasoning requirements and no minimum investment required on the part of the borrower, in other words financing of up to 100% of the purchase price is possible. These loans are typically interest only, paid monthly and due in one year and may be renewable for a second year. Both 1st and 2nd lien financing may be available, with 1st lien interest rates at 14% and 2nd lien rates at 16-18%. Sometimes there is no application fee or other costs up front; fees of 4 - 10 points at closing are common.

Hard Money Loans

Hard Money Lenders specialize in hard to place short-term real estate secured loans including commercial, construction, bridge, land acquisition, development, residential (in selected areas), raw land and other real estate related loans. These Hard Money Lenders are often used when: 'time is essential', 'the project or property does not meet the criteria of conventional lenders', 'bad credit', 'bankruptcies', 'judgments', 'foreclosures' or 'IRS problems'. In order to interest a Hard Money Lender in financing a project the borrower(s) must be willing to adhere to the basics of Hard Money Lending. The term "Hard Money" actually derived from the idea that the Project is hard to finance, not that the Lenders are Hard to work with. Hard Money Lenders often will take higher risks and loan money quicker to Qualified Projects than the Conventional Lenders, at a higher rate, but the project must make financial sense. The most important factor to a Hard Money Lender is risk of their investment and the collateral of the project.

Why real estate investors are willing to pay high rates to borrow private money

When interest rates of 14 to 18% are added to 4 to 8 points, the real estate investor/borrower is paying 20% plus annually for the money borrowed. Its obvious why this is a great deal for the private mortgage investor/lender and the broker, but why should real estate

investors be willing to pay these high rates when conventional mortgage money costs 7 to 10%? There are many reasons, but all fall into four categories.

Speed of Closing The Transaction.

Mortgage money obtained from banking or institutional sources, called conventional mortgage money, usually takes between 45 and 90 days to fund. Institutional lenders need not only obtain appraisal of the value of the property, but also require detailed examination of the borrower's credit history and current financial status, as well as financial statements and tax returns not only for the property securing the loan but for all real property and business interests owned by the borrowing entity and the borrower himself. Private mortgage lenders on the other hand can usually complete a transaction within 7 to 10 days. Since the property value itself is the main criteria to be used in determining loan eligibility, much less information on the borrower and the borrower's other properties are required, resulting in a much quicker approval process. The private mortgage lender is protected by lending at a much lower loan to value ratio, 65% is typical for the private mortgage lender vs. 80% - 90% for the institutional lender. Further, the private mortgage lender can make a decision within 24 hours of receiving information; institutional mortgage money must be approved by a loan committee that may only meet twice a month, and that may send the loan request back to the loan officer for more information, necessitating a further two week delay until the committee meets again.

Real estate investors will often need cash immediately to take advantage of a purchase opportunity below market price. In many cases a seller being foreclosed upon is in denial until the last possible moment. In these cases it may be possible for a real estate investor with cash available to purchase the property at 50-60% of market value - *if* he can produce funds before foreclosure. Conventional or institutional financing takes way too long. The real estate investor wanting to take advantage of this opportunity either needs to have the cash liquid or utilize the services of a private mortgage lender. With so much profit potential in these situations, paying the private mortgage lender's premium interest rates and fees is a small price to pay for being able to complete the transaction. If the real estate investor decides to keep the property, he can refinance with conventional money at his leisure. Further, if the investor in the above example *seasons* his property, that is owns the property for more than a minimum amount of time (6 months- 12 months is usual), then it may become possible for him to refinance based on the appraised value of the property rather than the lower of appraised value or cost. In such a case the real estate investor may be able to pull out some or all of his profit in the form of a new loan in excess of his property purchase price.

Another instance in which opportunity exists for the real estate investor to utilize private mortgage financing is when a property owner is in need of cash quickly - much sooner than possible when borrowing conventionally. I've lent in numerous such situations. One was when a lady who owned two rental houses free and clear needed \$30,000.00 immediately to get her son out of jail in Mexico. In another situation a real estate investor had allowed relatives to live rent free in a duplex he owned asking that they pay the property taxes. He called me on a Thursday needing a loan; foreclosure for taxes due was to occur the following Tuesday. We were able to close by Monday and save a \$130,000.00 property from being lost for \$35,000.00 in back taxes, interests and penalties.

Borrowers May Not Want or be Able to Provide Personal Financial Information

The borrower may not have all financial information on all his real properties and businesses up to date or complete; he may have filed for an extension on his latest tax return; his accountant may be behind in preparing his financial statements. The institutional lender will want evidence and confirmation of even the smallest detail of the real estate investor's personal and financial life. This is all important to the institutional lender since he is making a loan based upon the credit of the borrower as much or more than on the value of the property. While not being able to provide complete and detailed personal financial information would negate or at least severely delay getting an institutional mortgage, it should have no effect on the borrower's ability to obtain a private mortgage loan.

Many borrowers simply do not want the hassle of filling out pages of applications, providing financial documentation, producing profit and loss statements on bank forms, going through credit checks, explaining minor credit issues, or providing tax returns. Many of our borrowers buy 10 or more properties each year; unless they plan to hold a property for the long term they either use bank pre approved credit lines or private mortgage financing. This saves time and hassle and assures them and the seller that a transaction can be completed in a timely manner.

Sometimes life situations dictate the willingness of a real estate investor to provide details of his financial life for a public record where it can be accessed by just about anybody. More than once we've lent money to real estate investors with perfect credit who could have easily secured much lower cost conventional financing but were either getting ready to go through a divorce or involved in a messy lawsuit and did not want to provide signed financial statements.

The Borrower and/or the Property Does Not Qualify for a Conventional Mortgage Loan.

This can be anything from low borrower credit scores or too much borrower debt, to the borrower's properties not producing a sufficient enough income. Further, the property itself may not support the type of loan the borrower wants. Many institutional lenders will not loan amounts under \$500,000; many will not lend second lien money even if there is significant equity in the property. If major repairs or rehabilitation is necessary, institutional investors will not be interested unless the project is very large and the borrower has an extensive track record. In these cases private mortgage money may be the only resource for the real estate investor/borrower. If a property is producing or can produce sufficient income to pay the note and the value of the property will fully secure the note and provide sufficient equity, then the borrower's credit is not an issue for the private mortgage lender.

Professional real estate investors, those entrepreneurial individuals who buy, lease, manage, restore, build and sell real estate full time, will often reach a point in their career where conventional financing is hard to come by. Somewhere between ownership of four small residential units where qualification is based on personal credit history, and ownership of large office buildings where loan qualification is based on the cash flow of the property, all real estate investors run into a financing problem. They have too many properties to qualify as small investors but their properties are too small to be considered for financing on the properties own strength. Further, the professional investor will not have a steady income from a job or business with verifiable history to strengthen credit scores. It is at this point that the investor must make a

decision; take on partners or pay the high interest and fees for private (hard) mortgage money. Money borrowed is always less expensive than taking on an equity partner.

Every city has areas that are close to downtown and going through significant change. For most of the last half century this change has been downhill; the flight to the suburbs left these neighborhoods abandoned by all but the poor, the aged and the criminal. However the last five years have brought a revitalization to many of these areas. Population growth of these inner city neighborhoods are increasing at a tremendous rate with young professionals willing to pay high rents and empty nest couples willing to pay high prices to purchase and restore these “close in” houses.

This has presented a tremendous opportunity to the real estate investor with access to non conventional financing. Most conventional lenders have been slow to catch on to this trend; while not specifically redlining these neighborhoods they have enacted barriers making borrowing on these properties for investors all but impossible. We have had great success lending to 5 or 6 investors/rehabbers who buy property in these areas, spend \$50,000 plus for improvements and repairs, and then sell them to homeowners. The conventional lender’s refusal to acknowledge property value increases in these areas, unwillingness to lend on property needing repair, and insistence on income verification from the real estate investor/rehabber have allowed us a very profitable niche area for our private mortgage financing.

The Real Estate Investor May Be Able to Borrow More from a Private Lender than from an Institutional Lender

Institutional lenders are concerned with both the appraised value *and* the purchase price of the property. Private mortgage lenders are only concerned with the appraised value, as long as the appraised value represents a low to medium market price. The real estate borrower will often be able to invest less equity in a property by borrowing private money although private mortgage lenders loan to value will be lower than institutional lenders.

The real estate investor may be able to borrow more from the private or lender and therefore have less of his own capital invested in the property. Institutional mortgage lenders lend based on the lower of the cost of the property or appraised value of the property; private mortgage lenders lend based on the appraised value only. Hence the real estate investor utilizing a private or hard money loan is not penalized for purchasing the property at a significant discount to market value. Additionally, most private mortgage lenders do not have onerous seasoning requirements to make the loan.

Don H Konipol is General Partner of Managed Mortgage Investment Fund LP, a private investment fund that provides short term asset based financing for commercial and residential real estate investments in Texas. These loans are used when conventional financing is inappropriate or unavailable. Don can be reached at dkonipol@yahoo.com or 832-577-8838.