

Private Mortgage Loans Provide a Short-Term Financing Alternative

by Don Konipol

Private mortgage loans are made by private lenders instead of traditional financing sources such as banks, lending institutions, or government agencies. They usually are short-term (6 months to 3 years) hard money or asset-based loans, and the decision to lend is based on the equity and value of the property being put up as collateral, not on the borrower's credit.

These loans are a source of funding for professional real estate investors who wish to acquire, rehabilitate, or cash out equity of income producing property, and those who otherwise would not qualify for conventional financing. Private mortgages also assist real estate investors who need immediate financing without the financial documentation required by traditional institutional financiers.

Private mortgage loans are very secure because they represent a maximum of 65 percent to 70 percent of the appraised value of income producing property. On non-income producing property, a maximum of 55 percent loan to value is lent. Investors can expect to pay interest rates of 12 percent to 14 percent on first liens and 16 percent to 18 percent on second liens in this current low interest rate environment. Historically, first lien yield of six points over prime has been obtainable.

Why Borrow Private Money?

When interest rates of 14 percent to 18 percent are added to four to eight points, the borrower is paying more than 20 percent annually for a private mortgage loan. This is a good deal for private mortgage lenders, but why would borrowers want to pay these high rates when conventional mortgages range between 7 percent and 10 percent?

Many reasons exist, but all fall into four categories.

Speed of Closing. Conventional mortgages usually take between 45 days and 90 days to fund, since institutional lenders need to obtain an appraisal of the property's value, perform a detailed examination of the borrower's credit history, and thoroughly evaluate the borrower's current financial status. On the other hand, private mortgage lenders usually can complete a transaction within seven to 10 days. Since the property itself is the main criteria used to determine loan eligibility, less information on the borrower is required, resulting in a much quicker approval process. The private mortgage lender is protected by lending at a significantly lower LTV ratio: 65 percent vs. 80 percent to 90 percent for institutional lenders. Further, the private mortgage lender can make a decision within 24 hours of receiving information, whereas institutional mortgage money must be approved by a loan committee that may meet only twice a month.

Easy Application Process. While a borrower's lack of up-to-date personal financial information would negate or at least delay approval for an institutional mortgage, it should have no effect on the ability to obtain a private mortgage loan. Private mortgage lenders generally base their

decisions on the asset used for collateral -- the property. If the property value is high enough and the income being generated from it is sufficient to pay the interest on the debt, the borrower's personal financial situation should not affect the private mortgage lender's decision.

Other Money Resources Are Not Available. A borrower may not qualify for an institutional mortgage loan for reasons ranging from low borrower credit scores or too much borrower debt. Further, the property itself may not support the type of loan the borrower wants: Many institutional lenders will not loan amounts under \$500,000 and will not lend second lien money even if there is significant equity in the property.

In these cases private mortgage lenders may be the only available resource. Institutional lenders are concerned with both the appraised value of the property and borrower and property credit; however, private mortgage lenders are concerned only with the appraised value, as long as it represents a fair market price. Hence, if a property is producing or can produce sufficient income to pay the note and the value of the property will provide sufficient equity, the borrower's credit is not an issue for the private mortgage lender.

More Funds Available. Since private mortgage lenders base loans on the appraised value of the property, the borrower may be able to borrow more and therefore have less of its own capital invested in the property. In these instances, the borrower is not penalized for purchasing a property at a significant discount to market value.

Investment Parameters

The most important parameter private mortgage lenders consider when evaluating a loan request is LTV ratio. They typically will lend up to 50 percent on raw land or undeveloped property; 65 percent on commercial income producing property such as office buildings, shopping centers, and warehouses; and 70 percent on multifamily income property such as apartment complexes. The maximum amount usually will be lent if all criteria are met; lower amounts may be lent if the loan or borrower is considered less than ideal.

The second parameter is the type of properties to lend on, which often is determined by the ease in disposing of the property in case of default. Obviously, a single-use property that would take a year to sell is less desirable than a multi-tenant, income producing office building.

The third investment parameter is the cash flow or income potential of the property put up as collateral. Although many private mortgage lenders are liberal in this area, the monthly interest payments must come from somewhere. If the property is producing a cash flow after all expenses, the property income alone may cover the monthly payments without the borrower having to come out of pocket. This adds a great degree of safety to the note. Cash flow from other income properties also can substitute for cash flow from the property being placed as collateral.

The fourth major investment parameter the lender must consider is exit strategy, or how the borrower plans to repay the loan. Since most private mortgage loans are short-term, private mortgage lenders have a keen interest in analyzing whether a particular exit strategy is viable. For

example, if the exit strategy is to refinance the property, the lender must determine if the credit score of the borrower is high enough to qualify for a long-term mortgage, if the property cash flow is sufficient to cover the debt payments, and if the property will meet the general criteria set up by the mortgage lenders most likely to refinance the property.

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.