

Daniil's Very Informal and Incomplete Guide to Financing

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There are typically two main financing requirements in real estate investing: short-term and long-term. There is also mezzanine and bridge financing but that's a topic that's too advanced for what we are covering today and usually only comes up in commercial lending anyway. So:

Short-term financing: Usually needed when your holding term is less than 24 months and when you have an exit planned. This exit can be any number of strategies:

- Fix and Flip
- Buy and Flip (no rehab)
- Buy and condo-convert
- Buy and sell with owner financing, with a short-term balloon on the note (2 years or less)
- Buy, rehab and refinance into long-term financing.
- About a million other strategies

Long-term financing: This is typically for your buy-and-hold investors. Long-term financing can entail anything with a holding period of 5 years or more, though typically it's longer. Residential investment property loans typically have a 30-year amortization. If you go with a commercial loan (for residential or commercial property), amortization is usually 20 years (or 25), and the loans can carry balloons of anywhere from 3 years to 15. That means you have to pay off or refinance the loan at that date. There are also some government backed commercial loans out there with amortizations of 40 years as well (HUD, etc).

These days, if you call yourself a "long-term investor" or "buy and hold investor", your holding term should be, in my opinion, 10 years or longer. It's going to take that long for most markets to really see any significant upside – and some will take much much longer. So if you are getting loans with 3 or 5 year balloons, you obviously need to be planning your "exit" for that loan as well – sell the property (and be ready to face the same market as today) or refinance (and be prepared to deal with potentially much higher rates).

[I] Short-Term Sources of Financing

Cash – Cash is King!

Private Lenders

- Private lenders are usually individuals, not banks
- This can be a great source of short-term money, one I highly recommend.
- Private lenders are easier to deal with than banks, can have flexible terms, can refer you to their friends who also have money, etc etc.
- Private lenders will scrutinize your personal credit, balance sheet, and income A LOT LESS than banks, if at all.

Credit Card Cash Advances

- Be mindful of rates (can be high)
- Watch your overall debt levels – maxing out your cards will lower your credit scores, as well as make it tougher to get other kinds of financing down the line

Tip: Look for the “0% APR on Cash Advances” promotional offers from your credit card providers. When you have a clear exit strategy for a property, this can be a great source of short-term cash! But make sure you pay off the balance before your rates go up!

Home Equity Line of Credit

- Rates will typically be lower than credit cards
- But same as with credit cards, be mindful of your overall debt level and your total CLTV % (Current Loan to Value) on your home.

Tip: Talk to you friends and relatives – if they have untapped home equity lines of credit at low interest rates, see if they’ll tap them for you! My first few private loans were from my cousin and my family friend tapping their lines for \$20-\$25k each. I paid them 6% upfront on the loan and then made their monthly payments, repaying the loan after about 12-18 months. 4% interest rate is hard to beat! Plus they were happy to make a few \$grand for doing nothing!

Wholesaling

If you don’t mind doing a little work, wholesaling residential or even commercial property can be a great way to build up some cash reserves, which you can then take and us to start buying your own deals.

Hard Money Lenders – these guys will eat your lunch. Typical loan scenario will be 6-8% (points) upfront (or on the backend) and 14-16% interest rate. They will usually have a very short-term loan timeline (6-12 months) and you’d better have a very clear, likely exit strategy (sale or refinance), because after the loan balloons, there can be some very severe consequences for not paying off the loan on time (higher interest rates, foreclosure).

Interesting note: I personally know a few hard money lenders who lend money actually hoping they’ll have to foreclose. Why? Because they lend at such low LTVs that they will get the property way under market value if they take it back from the borrower!

Question: So why would you ever use hard money lenders??

Answer:

1. They can close very quickly – I’ve had a hard money loan close in 4 days from when I first called and introduced myself to the lender. And he probably could have done it quicker, just as soon as title-work was finished!
2. Usually (not always), they don’t care about your personal credit, so the paperwork is very minimal.
3. They’ll lend to an LLC

Despite the advantages above, I only recommend using hard money lenders when all other options are unavailable AND when you absolutely know you can get out of this loan quickly (maybe you have a pre-approved end-buyer already lined up and committed or have a definite source of refinancing loans once rehab is done).

Construction Financing – in my experience, this has usually been available from local community banks, typically commercial portfolio lenders. A portfolio lender is a banking institution that lends their capital and holds and services the loans in-house, instead of selling them off into the secondary market. So they can be more flexible in the type of lending they do, though in this economy even these guys are starting to get hammered by the regulators.

A construction loan will usually be a short-term, interest-only loan, which then either balloons after 12, 18 or 24 months or will automatically roll over into a long-term, fully amortizing mortgage. There are usually low upfront origination or discount points (1 or 2) and interest rates are much lower than a typical hard-money loan.

Revolving Lines of Credit – This can be secured or unsecured (though getting an unsecured line higher than 10-20k is getting more and more difficult). It can be in your name or in the name of your business. If it’s secured, it can be secured by a 1st or 2nd line on your primary residence (I mentioned a home equity line above), a 1st or 2nd lien on investment property, or on a pool of investment properties.

I’ve seen a very wide range of rates for these things, so it’s hard to say what’s typical. But the sweet thing about having a line of credit for \$200k, \$500k, even \$1-2million is that you can now have ability to close very quickly on deals with cash – the line of credit is basically just that. But getting them is not easy. I am currently working with a few local portfolio lenders to secure a line backed by 2nd liens on a pool of about 15 properties I own and it’s proving challenging because everybody wants to be in 1st position (lien-wise), not 2nd.

Important tip: There are people out there that will try to sell you what’s called an “aged shell corporation”. This is a C-corp or an LLC that has been created a few years ago and aged. Sometimes it’s also called “shelf corporation” because it was created and then put on the shelf to age. Sometimes it will already have some kind of credit history and a Paydex score, other times it will just be aged. The strategy is that because this corporation has been around for a long time, it will be very easy for you to get unsecured lines of credit in its name. **BE VERY CAREFUL** here. I’ve been approached by people asking me for \$8k to buy a corporation like that and they even went as far as promising me to secure \$200k in credit for the corporation within 2 weeks! The guy claimed to be doing this for dozens of clients each month. But when I repeatedly asked for references – to speak to a few of these clients, there were crickets on the phone – the guy wouldn’t produce. So I walked. Can this strategy work? Potentially. But I personally don’t know anyone that just bought a shell corp and immediately secured large lines of credit for it. I’d guess you’d still have to put in a good amount of work and time to build solid credit for this

corp before getting any significant lines. It can be done though. Do your homework before you fall for any schemes – if it sounds too good to be true, it usually is!

401K/Roth IRA – I know zero about this topic. I do know that you can use your self-directed IRA to buy real estate, but that's as far as my knowledge goes. If this is an option for you, talk to an expert and make sure you do this right, to stay out of trouble with the you-know-who (the tax-man).

Other sources of Short-Term Cash:

- Rob a liquor store – make sure you have a good ski mask
- Hold a bake sale – people love brownies
- Break your kid's piggy bank – the kid might hate you forever
- Donate blood – not a very sustainable strategy
- Moonlight as a stripper/gigolo – make sure you are operating in the right market (Vegas or Miami is better than Lynchburg, Virginia for example)

[II] Long-term sources of Financing

Conventional Mortgages – If you can qualify for a conventional, investment property loan, then this will have the best interest rates and terms. The paperwork is a pain, closing takes a long time, and they currently limit you to 10 investment properties max. Plus about a million other restrictions/requirements. But if you can qualify, I suggest you go for it – locking in a low interest rate for 30 years is not a bad idea at all!

Portfolio/Commercial Mortgages – There can be a million reasons these days why you can't qualify for a conventional mortgage for residential investment property: you have more than 10 mortgaged properties, you want to borrow in an LLC, you want to cash-out refi within 6 months of owning the property, you have a partner on the title who is abroad, etc etc. In this case, you should find what's called a "portfolio lender" in your area. These are usually community banks or thrifts who only lend in your local area. They will typically be institutions who lend their own capital and keep the loans in-house. This allows them a lot more flexibility on who they lend to and what they lend on.

These are the guys that actually understand the business. They don't care that you have 20 properties because they can take a look at your "global balance sheet" and "global cashflow" and see that your portfolio is strong. So why not buy property #21? They will let you buy a property and cash-out refinance after 1 month! (not all of them, but mine do).

These are the guys still shelling out construction loans and then rolling them over into long-term financing! Find these lenders and create relationships with them.

Fannie/HUD Mortgages – These are for multi-family financing. I am not an expert in this field but if you are buying multi-family buildings, find a good broker that's well versed in these mortgages and is on top of all the latest guidelines. He will be a great resource for you.

Private Lenders – Private lenders are more commonly used for short-term financing, but can also be used for long-term scenarios. It all depends on what goals the particular private lender you're dealing with has. Some would love to see their money earning them a steady, long-term return without worrying about getting this money back after 6 months and having to reinvest it. Other private lenders only want to have their money out for a short-time to limit their risk and leave them open to better opportunities down the road. If you can find long-term private lenders at reasonable rates, hold on to them dearly.

Takeaways and Conclusions: The beauty of working with your own cash is that you answer to no-one. The problem with using your own cash is that it's limited or non-existent, so at best, you can do a limited number of deals. The other problem is that, well, you're putting your own cash at risk.

Now, every single "guru" out there will brag to you about having done a gazillion deals and never having used "their own cash or credit", ever! That's fine. Personally, I don't see a problem with using my own cash to do deals, especially using my strategy – where I pull that cash out of a deal within a few months every time. First off, I believe in personal responsibility and taking risks. If I do a deal, it's usually a good one, it's a deal I've spent a lot of time evaluating, and I feel confident I will make money. And if I lose money, I am prepared to accept responsibility and the loss that comes with it.

But if you don't have cash or don't want to put your cash at risk, the best way to go for finding short-term acquisition and renovation funds, in my opinion, is finding private lenders.

For long-term financing, you need to look at your personal situation and what kind of properties you are going after. Who you go to for residential lending will differ from who you go to for commercial loans.

But at the end of the day, more so than ever, getting access to capital is ALL ABOUT RELATIONSHIPS. Whether it's building strong rapport with private lenders or with local community banks, or anyone else, putting time into this aspect of your real estate business will have the highest payoff. Getting money these days is not just about the numbers – it's about your reputation, your professionalism and your ability to get whoever is doling out the money to trust you and believe in you. That's key!

Have something to add to this? Have a story you want to share? Come back to my blog entry and share your thoughts: <http://www.rentalvaluator.com/blog>