Chapter 1

Taking a Crash Course in Real Estate Investment Financing

In This Chapter

- Gaining leverage with other people's money
- Deciphering key terms
- Grasping the difference between a home and investment property
- Discovering vital sources of real estate investment capital
- Getting ready to meet your lender

Are you eager to set out on the road to building wealth through real estate? Although we hate to hold you back, we do discourage you from moving forward without the proper preparation. Our advice doesn't necessarily mean, however, that you need to read the entire book from cover to cover before you purchase your first investment property.

Here, we provide a quick primer on real estate financing along with what you need to do to secure financing for your real estate investments. We also provide a generous supply of references to other chapters in the book where you can find more detailed information on specific topics. So without further ado, let the real estate financing primer begin.

REMEMBER

Don't let negative economic and credit information dampen your desire to invest in real estate. The best time to purchase real estate is when prices are low. You can still find and secure financing; you just may need to look and work a little harder and smarter to get it.

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Pumping Up Your Purchasing Power with Borrowed Money

If you have any reservations about borrowing money to buy real estate, you need to overcome those reservations by developing a better understanding of leverage — using borrowed money to buy more and better properties, thus improving your chances of earning bigger profits.

In the following sections, we show you why the goal of owning a property free and clear isn't such a smart move, reveal the secret of leveraging the power of borrowed money, and explain how you can offer "cash" for properties even when financing the purchase.

Although we encourage investors to borrow money to increase their leverage, keep in mind that borrowing money can carry significant risks. As an investor, you can take action to minimize the risks — by carefully evaluating your real estate market and properties under consideration, overestimating costs, underestimating profits, developing realistic backup plans, and so on; however you can never completely eliminate the risk. You have to decide for yourself what an acceptable level of risk is.

Minimizing your potential by owning property free and clear

For many Americans, paying off their mortgage early and owning their home free and clear is the real American dream. Life would be so much better if they didn't have to deal with a house payment.

For real estate investors, however, owning property free and clear means that valuable equity is locked up in those properties — equity they can use to finance the purchase of other revenue-generating real estate. Don't get caught in the trap of thinking that paying off a mortgage loan is a smart move — it may be a noble goal, but it's rarely a savvy strategy.

Maximizing your potential with other people's money

Other people's money (or *OPM* for short) is money that you borrow from other people to finance your investments. OPM isn't much of a secret. Assuming you own a home, you probably used OPM to buy it. You may have put down 5 to 10 percent of your own money as a down payment and then borrowed the rest.

REMEMBER

Dealing with a major credit crunch

The mortgage meltdown, foreclosure epidemic, and global financial crisis that all came to a head in 2008 led many real estate investors to believe that credit had all but dried up. Banks were failing left and right, and the United States was forced to step in with more than $1 trillion in economic rescue funds to keep cash flowing to individuals and businesses that needed credit. Surely, real estate investors would be the last on the list for cheap and easy credit.

Actually, the credit crunch didn't put real estate investors out of business. In fact, in many cases, it made conditions better for investors:

- When the bubble burst, properties became much more affordable. Investors could buy better properties for less money.
- As millions of people worked through foreclosure, demand for rental properties soared.
- Financial institutions, eager to rid their books of empty, expensive, cash-sucking foreclosures, became more willing to offer great deals. I (Chip) just had a client pay $82,000 for a brand new property with a market value of about $275,000. The bank had taken it back from a builder, was more than glad to just get it off the books, and was willing to finance it with a 15-year loan.

A credit crunch doesn't mean that financing disappears — it just means that you probably need to look for it in some unusual places. Even FHA has investor financing with 25 percent down — and a lot of foreclosures they're willing to deal on. Throughout this book, we show you how to tap into these markets — credit crunch and all.

In most cases, OPM helps you earn a profit. When you calculate in the appreciation of the home, the tax savings it represents, inflation, and other factors, you're likely to earn more money off the home than you pay out in interest over the life of the loan — barring a major housing meltdown.

The same applies to your real estate investments. The more OPM you can put to work for you, the more you stand to earn — as long as your earnings from it exceed the cost of borrowing it. For more info about OPM, check out Chapter 5.

Paying cash with borrowed money

In the world of real estate, cash is king. The buyer who shows up with cash is in a significantly stronger position to purchase a property and negotiate an attractive price and terms than a buyer who shows up needing financing.

When we say cash is king, however, we're not advising you to show up with a suitcase full of money. We're telling you to show up with preapproved financing — a financial backer who can deliver the cash on closing day. In other words, although you're financing the purchase as explained throughout this book, you're still placing yourself in a position to offer cash.

Brushing Up on Basic Real Estate Financing Lingo

Throughout this book, we toss around some jargon common in the real estate and mortgage lending industries. To the average consumer, these terms may sound Greek, but we assure you that they're part of the English language. In the following sections, we define the most common and often misunderstood of these terms.

Identifying types of lenders

The moneymen and -women you deal with when securing financing for purchasing investment property play various roles in the process. You need to know whom you're working with:

- **Commercial lenders:** They're financial institutions rather than individuals. They include banks, credit unions, mutual savings banks, savings and loan associations, and stock savings banks. (Chapter 9 discusses commercial lenders in greater detail.)
- **Private lenders:** A private lender is any individual who loans money outside the channels of institutional lending. This person can be a friend or relative, such as your Aunt Mabel, or an investor. Real estate investors often rely on private lenders for access to investment capital when banks and other financial institutions turn them down. (For more about private lenders, check out Chapter 11.)
- **Mortgage banker:** Mortgage bankers are financial institutions that directly fund home loans and either service those loans themselves (arranging and collecting monthly payments and managing any escrow accounts) or sell the mortgages to investors and contract out the servicing of the loans.
- **Servicer:** The servicer is the institution contracted or appointed to collect the monthly payments from the borrower. They have to account for all payments and disbursements and provide yearly statements showing all transactions within a mortgage account to the borrower.

- **Mortgage broker:** Mortgage brokers are licensed by the state to assist borrowers in finding mortgage lenders, comparing loan programs, applying for mortgage loans, and securing financing for purchasing real estate. They act as the eyes and ears for many different mortgage lenders.
- **Loan officer:** Loan officers work for mortgage bankers or brokers to assist clients in securing financing for purchasing real estate. They essentially do the same thing brokers do, but they have to work for a licensed broker or lender.
- **Loan originator:** Another name for a mortgage broker or loan officer.

See Chapter 4 for more on these types of lenders.

Grasping different loan types

Throughout this book, we introduce you to various types of loans for financing the purchase of real estate, including conforming and nonconforming loans, jumbo loans, and hard money loans. In the following list, we define the most common loan types and toss in some additional information that you may find useful.

- **Conforming loan:** A *conforming loan* is one that meets the criteria set forth by Fannie Mae or Freddie Mac — the organizations that purchase the loans and then package them up to sell on Wall Street. In general, to qualify for a conforming loan, the borrower must
    - Show sufficient income to cover monthly payments.
    - Have enough cash for a down payment and reserves.
    - Have a good credit history.

  For additional details about conforming loans and current criteria, visit the Fannie Mae Web site at `www.efanniemae.com`.
- **Nonconforming loans:** These include everything else outside the Fannie/Freddie box. Sometimes referred to in the market as *subprime* or even *exotic* loans, they're bought by other financial companies or investment banks and packaged to be sold to Wall Street investors. When the subprime market suffers, as it did starting in 2008, far fewer of these types of securities make it to market.
- **Conventional loans:** These loans are outside the sphere of the government. In other words, they're not FHA- or VA-secured loans and aren't underwritten by any government agency.

- **Jumbo loans:** As its name suggests, a *jumbo loan* represents a lot of money — specifically, more money than you can borrow under the limits of a conforming loan.
- **Hard money loans:** Also referred to as *bridge loans*, they're typically short-term, high-interest loans that enable investors to get their mitts on some cash in a hurry. You can expect to pay several points upfront (a *point* is equivalent to one percent of the total loan amount) plus up to double the going interest rate. (For more about hard money and strategies for using it to your advantage, check out Chapter 11.)
- **Government loan programs:** The government isn't really in the business of loaning money to homeowners and investors, but it facilitates the process for lenders by insuring the loans — if the borrower defaults on the loan, the government steps in to cover any losses for the lender.

  The two most common government loan programs are Federal Housing Authority (FHA) and Veterans Administration (VA) loans. But federal, state, and local governments also provide loan programs to encourage investment in disaster areas and neighborhoods that they're seeking to develop. Within the FHA and VA programs are some great hidden opportunities for investors. (See Chapter 4 for more about specific government loan programs.)

Brushing up on important legal lingo

Even though real estate deals are generally classified as financial, they involve plenty of legalities, especially in relation to who owns the property or has a stake in it. Although real estate–related legal terms can fill an entire dictionary, you should have a working knowledge of the following three:

- **Deed:** A *deed* is a legal document that grants rights to a property. Whenever you purchase a property, whoever is handling the closing must file the deed with the county's register of deeds to make the transfer of ownership official. As the official owner, you have the right to borrow against the property and transfer your rights of ownership.

  WARNING! Be careful signing any deed, especially a *quitclaim deed* (the deed that allows a property's owner to relinquish all rights to the property). Real estate con artists often use the quitclaim deed to hijack property from unwary owners. They may hide a single page quitclaim deed in a stack of papers, fooling the owner into signing the document without knowing what they're signing. Then, they run down to the register of deeds and file the deed, making themselves the new owners, so they can take out bogus loans against the property.

Who gets first dibs?

In the event of a foreclosure, certain liens take *precedence* over others, meaning that when the property is sold at auction, certain lien holders are paid off first:

- **Tax lien:** The proceeds from the foreclosure sale pay off any unpaid property taxes first.
- **First mortgage:** If any money from the proceeds of the sale remain, it pays off the first mortgage or as much of the first mortgage as possible. This is also referred to as a *senior lien.*
- **Second mortgage:** If the homeowner took out a second mortgage, any remaining proceeds from the sale go toward paying it off. Any second (or third or fourth) mortgages are also referred to as *junior liens*.
- **Construction liens:** If money still remains, it goes to the next lien holders in order of precedence.
- **Homeowners:** After all the lien holders receive their cuts, the foreclosed-upon homeowners get the remaining crumbs, which can actually be quite a chunk of change if they had a lot of equity in the property.

- **Lien:** A *lien* is a legal claim that a creditor holds against a property in lieu of payment. Several parties can place a lien on a property, including the lender who holds any first or second mortgage, the county tax assessor (for unpaid taxes), and contractors (if they financed the repairs or renovations).

  As an investor, knowing who (if anyone) has a lien against a property you're purchasing and the monetary value of that lien is important. All lien holders need to be paid in full upon sale of the property. If the property has a lien against it that the seller fails to disclose, you may become liable for paying it when you take ownership of the property.

- **Promissory note:** Whenever you borrow money, you have to sign a promissory note pledging to pay back the loan in full according to terms of the loan, which always specifies a deadline for full payment. Think of a promissory note as an IOU (as in "I owe you" this amount of money).

  The promissory note is your pledge to pay back the loan. The mortgage or deed of trust names the property as collateral in the event that you default on the loan.

Pointing out mortgage concepts

When you take out a loan, the lender requires something of value *(collateral)* to make sure it has something valuable to sell and recoup its investment if you default on the loan. This collateral is officially presented in the form of a mortgage or deed of trust depending on the jurisdiction:

- **Mortgage:** A *mortgage* is a contract between the lender and borrower that gives the lender the right to foreclose on the property in the event that the borrower defaults on the loan.
- **Deed of trust:** A *deed of trust* is a mortgage contract that places control of the deed in the hands of a third party — a trustee. The trustee has the power to foreclose on the property in the event that the borrower defaults on the loan.

The mortgage market is large and complex, but it consists of two main divisions: a *primary* and a *secondary* mortgage market.

- **Primary:** This is the market in which you do business. It consists of financial institutions that lend you money.
- **Secondary:** This is the market where institutional lenders and Wall Street investors converge. The primary lenders who actually loan money to homeowners and investors turn around and sell the mortgages or deeds of trust to investors. This gives the lenders more money to make available to borrowers.

Examining equity

Equity is the amount of money you'd have if you sold the property today and paid off the balance due on the loan. More importantly, as an investor, you can pull equity out of a property by borrowing against it. This power enables you to put that equity to work for you in other investments.

WARNING!

Thanks to the credit crisis in 2008 and 2009, the equity requirements to obtain financing are growing. Lenders are taking a closer look at market values, especially in what they call *declining areas* — areas showing a pattern of recently declining housing values. As an investor, you should be doing the same thing. Be cautious when calculating equity positions and profit margins.

REMEMBER

Although we encourage investors to tap the power of equity, keeping some equity in a property (especially the home you own) is a good idea. Having equity to borrow against in the event of a financial setback may save you from foreclosure and bankruptcy.

Looking at loan-to-value (LTV)

The *loan-to-value* (LTV) is the ratio of the total loan amount to the value of the property. If you're buying a $200,000 home with $40,000 down and applying for a $160,000 loan, the LTV would be

$160,000 ÷ $200,000 = 80 percent

Generally speaking, lenders want to see lower LTVs for investment properties than for homes because a lower LTV provides more of a buffer to cover the increased risks inherent in investment properties. Check out Chapter 3 for more about calculating the LTV and how lenders use this number to evaluate risk.

Distinguishing Investment and Home Financing

Your first real estate investment should be your own home. In fact, if you don't own your home, we advise you to put down this book and pick up a copy of *Home Buying For Dummies* by Eric Tyson and Ray Brown (Wiley) first. Owning your own home carries the least risk and the most potential tax benefits while bringing you up to speed on the basics of real estate investing and ownership.

After you've purchased a home, you should have a fairly good understanding of the mortgage loan application and approval process. (We provide a refresher course in Chapter 7.) However, real estate financing differs quite a bit when you take on the role of investor rather than homeowner. You and the lender take on more risk. As a result, you can expect to pay more for the privilege of borrowing money. In addition, your borrowing strategy is likely to change. In the following sections, we cover these differences in greater detail, so you know what to expect before diving in.

Paying a premium for riskier investment loans

When you invest in your own home, you literally have a vested interest in making payments — if you don't, you lose the roof over your head. On the flip side, if you lose an investment property, it may be painful, but it's never *that* serious, and lenders are well aware of the difference. For them, investment loans are riskier propositions. To mitigate the risk, they generally

- Require a larger down payment.
- Demand a larger loan-to-value ratio. (See "Looking at loan to value (LTV)" earlier in this chapter.)
- Charge more interest upfront in the form of points.
- Charge a higher interest rate.
- Require proof that you have *reserves* or liquid assets available in case things don't go as planned.

The actions that lenders take to mitigate the risks and the interest rates and fees they charge vary greatly depending on the borrower and the deal that's on the table. Just make sure you have all the documentation and figures ready when you meet with your lender for the first time, as explained in Chapter 3.

Using quick cash to snag bargain prices

When you're shopping for a mortgage to buy a home for your family, you're usually looking for a low-interest package, no or very few points, and attractive terms. With investment properties, *cash flow* trumps interest rate. In other words, access to cash is often more important than the cost of the loan. To find out more about the relative importance of cash flow and how to shop for loans with the lowest interest rates and fees, see Chapter 6.

TIP

If the numbers work, what you pay in interest doesn't matter. Interest is just another expense. If you subtract all your expenses and can still earn the profit you want, paying thousands of dollars in interest over a relatively short period is acceptable.

Accounting for taxes on your capital gains (or losses)

When buying and selling a primary residence, you don't have to think too much about the tax ramifications of the transactions. In the United States, a huge chunk of any profit you earn from the sale is usually tax exempt — up to $250,000 if you own the home yourself or double that if you and your spouse sell the home.

However, when you're selling investment real estate, any profits are subject to capital gains taxes. During the writing of this book, profits from real estate investments were taxed as follows:

- **Long-term capital gains:** 15 percent if you hold the property for at least a year and a day.
- **Short-term capital gains:** 35 percent if you sell the property in fewer than 12 months from the date you purchased it.
- **Income tax:** If profits from investing in real estate are your sole income, the IRS may consider it your job and tax your profits as income, complete with an additional 15 percent in self-employment tax.

WARNING!

We're not tax experts. Consult a CPA who has experience dealing with real estate investors for details on how the government is going to tax your profits and for suggestions on how to reduce your tax burden. Your measure of success isn't how much you gross but how much you net. By reducing your tax bill, you can significantly increase your net gain.

Protecting your personal assets

Just like most things worth doing, real estate investing exposes you to risk. Perhaps the biggest risk is that you're working with borrowed money from lenders who expect you to pay it back. If you make a lousy investment decision or an investment goes belly-up despite your best efforts, lenders are going to do everything legally possible to collect their money.

You also face the ever-present risk of litigation — having a disagreement with a buyer, seller, tenant, contractor, or someone else that eventually leads to a costly lawsuit.

Eliminating risk isn't possible, but you can take several measures to lessen the risk, including operating through an LLC, transferring personal assets to someone else, or having a qualified attorney cover your back. Check out Chapter 2 for more details.

Exploring Common Sources of Investment Capital

You probably picked up this book because you want to start investing in real estate, but you don't know where to dig up the cash to do your first deal. In the following sections, we show you where to start digging.

Tapping your own cash reserves

If you're single, or you and your significant other are on the same page about this real estate investing thing, cracking into your nest egg to finance your investments may be the quickest way to get your fingers on some investment capital.

It's also the riskiest option, because if anything goes wrong — you get laid off or fired, become too ill to work, or encounter unexpected expenses — you have fewer reserves to keep you afloat. In addition, limiting yourself to your own resources also limits your purchase power — you have to buy houses in a lower price range and may not have sufficient cash to properly renovate the property.

A great way to ruin a relationship is to bet the farm on big profits without the knowledge and complete agreement of your spouse or significant other. If your investment doesn't pan out (and even if it does), the other person may take offense at not being consulted.

Even with these caveats, many beginning investors have gotten their start by financing their own ventures — partially or in full. And you want to know about these resources if you need some quick cash in a pinch.

Clearing out your bank accounts

Having a few thousand dollars socked away in a savings account is always a good idea, just in case you run into a cash flow problem. If that house you bought and fixed up is taking a few months longer than expected to sell, your little nest egg can help cover the payments until you find a buyer.

Use your savings as a reserve, not as your main mode of financing. Having some cash to fall back on can save you in a pinch.

Borrowing against the equity in your home

As your home's value rises and you pay down the principal, you build equity. You can often borrow against this equity by taking out a home equity loan or line of credit and then use the money for whatever you want, including purchasing other real estate. The recent credit crisis has made it harder to find these loans, but they're still out there for well-qualified borrowers.

We don't recommend that you cash out all the equity in your home, but if you have a substantial amount of equity, cashing out a portion of it can help you come up with a down payment or cover the cost of repairs and renovations. (For more about home equity loans and lines of credit, skip to Chapter 11.)

Financing investments through a self-directed IRA

More and more investors are choosing to set up *self-directed IRAs* and other types of retirement accounts that enable them to invest in real estate rather than in stocks and bonds. The reasoning: Real estate often provides a better and sometimes even more secure return on your investment.

With a self-directed IRA, you can buy and sell properties out of your retirement account. Setting up a self-directed IRA, however, is no simple matter. Typically, a trust company manages the money and properties in the account, and all profits and losses from your investments must stay in that account. Withdrawing money from the account results in the same IRS penalties you have to pay if you withdraw money from any type of retirement account.

TIP

Consult your financial advisor and accountant for details about using a self-directed IRA to finance your real estate investments. If a self-directed IRA isn't an option, you may be able to borrow money against your retirement account. Keep in mind, however, that borrowing against your retirement savings places those savings at risk, as does any other investment.

Charging expenses on your credit cards

Maxing out your credit cards to purchase a car, clothes, electronics, groceries, and other items that provide no return on your investment is never a good idea. Using your credit cards to purchase investment properties that offer a solid, relatively quick return on your investment, however, can be a savvy (though risky) financial move.

WARNING!

Consider credit cards a last resort to cover the costs of repairs and renovations if financing is tight near the end of a project. With this strategy, your investment activities can directly affect your personal finances, which increases your exposure to risk. For more about this option, check out Chapter 11.

Borrowing from commercial lenders

One of the best ways to finance the purchase of investment properties is to meet with a qualified mortgage broker who can help you find and evaluate various loan programs. These plans are often your best deals — costing the least in upfront fees and interest.

For more about finding commercial lenders, check out Chapter 4. If you're investing in residential property, Chapter 5 reveals the various residential loan programs to choose from. If you're buying commercial property, turn to Chapter 9 for guidance on choosing the right loan program.

Don't confuse "commercial property" with "commercial lender." A *commercial property* is any property that isn't a one- to four-family residential dwelling. A *commercial lender* is an institution (as opposed to an individual) that loans money. In other words, you can use a commercial lender to finance the purchase of residential investment property.

Obtaining a hard money loan

When banks and other financial institutions turn down your requests for investment capital (or you don't have the time to convince them that a deal is pure gold), consider borrowing money from a hard money lender, as explained in Chapter 11.

One of the main advantages of a hard money lender is that the person is likely to accept the property you're buying as all the collateral needed to secure the loan, so you don't have to place your home at risk.

Financing your purchase through the seller

Property owners who are eager to sell and don't need all the cash at once are often willing to finance the purchase themselves. This tactic enables them to profit in two ways — by selling you the property for more than they paid for it and collecting interest from you. Seller financing take either of the following forms:

- **Land contract:** A *land contract* is like a mortgage, except the seller acts as the bank.
- **Lease option agreement:** A *lease option agreement* is like a rent-to-own deal — you lease the property for a specified period, at the end of which time you have the option to buy it.

For more about seller financing, check out Chapter 12.

Taking on a partner

Whenever you don't have something (like money, skills, time, or talent) to accomplish a particular goal, you can acquire those skills, buy or hire them, or create a partnership with someone who already has what you need. If you have something someone else needs and they have what you need, you have what it takes to form a mutually beneficial relationship. For details on how to partner with someone who has the cash you need, check out Chapter 13.

WARNING!

Choose a partner as carefully as you choose a spouse. Partnerships often end when one person scams the other or disagreements arise over who's putting more into the projects and who's getting more out of them. Have your attorney write up a contract, complete with a prenuptial type agreement stating how all the assets will be divvied up in the event that you part company.

Prepping to Meet with a Lender

Walk into a bank empty-handed and explain to the loan officer that you need a loan to start investing in real estate, and we can almost guarantee that you'll be laughed out the door. Before you even think about meeting with a prospective lender, get all your ducks in a row. Copy all the financial documents lenders are going to ask for and construct a fairly detailed plan on how you're going to profit by investing in real estate. This section gives you an overview of what you need to do before visiting your lender. Chapter 4 provides complete in-depth info.

Gathering paperwork and other info

Before approving your request for a loan, lenders want to know whether you're good for the money — how likely you are to make the monthly payments and pay back the loan in full. For investors, this means two things:

- You're in pretty good financial shape right now and have a fairly clean credit history.
- The property you're planning to buy is more than worth the money you're borrowing to pay for it, and (if you're going to be renting out the property) it will generate sufficient income to more than cover all your expenses along with the monthly payments.

To verify your creditworthiness for yourself and be sure you have all the documents and other information your lender requires, stuff a folder full of a copy of each of the following items:

- Credit reports from all three credit reporting agencies
- A net worth statement (assets – liabilities = net worth)
- A debt ratio statement (ratio of what you owe to what you own)
- Last two months' bank statements
- Last 30 days' pay stubs

- Last two years' federal tax returns and schedules
- Statements of any business income
- Appraisal or comparative market analysis for the property
- Cash flow analysis of the property
- Loan-to-value ratio of the property
- Zoning information for the property's location
- City and county records for the property

Crafting a business plan

Real estate investors often scoff at the idea of creating a *business plan* — a detailed presentation that shows how an investor plans to purchase a specific property and earn a profit from it. Investors often just want to buy and sell and rent out property and make a lot of money — that's the plan. They don't like to think of themselves as pencil-necked pencil pushers. If they feel in their gut that a property is a solid investment, that's good enough for them.

At least that's the false image that many people have of investors. The most successful investors, however, do the math. They crunch the numbers. And if the numbers don't work, they don't do the deal.

Do your homework. Do a comparative market analysis of the property to make sure it's worth what you think it's worth. If you're buying rental property, check the rental history of the property — the owner's tax records showing income and expenses. Craft a business plan showing exactly how this property is going to be a revenue generator.