HARD MONEY LOANS

Pros and Cons for Real Estate Investment

SCOTTSDALE PRIVATE LENDING LLC
REAL ESTATE INVESTMENT FUNDING

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Introduction

This paper focuses on the role of hard money loans within the real estate investment industry. We will explore the realities and key issues within the industry followed by what defines a hard money loan. Finally, we will examine the pros and cons of hard money loans within real estate investment.

The Real Estate Investment Industry

Without delving too far into the obvious, the real estate investment industry is comprised of many players, an assortment of strategies, property types, time horizons, objectives and sizes. It is the ultimate equalizer of industries in that anyone, regardless of education, age, race, color, creed, sex, or national origin can partake in it in a myriad of ways.

In the aftermath of Arizona's economic downturn and subsequent real estate bust, there are many real estate borrowers that have been left in a challenging situation. Their credit worthiness is not what it once was and they bare the battle scars of foreclosure, short sale, bankruptcy, decreased liquidity and depressed credit scores that in some cases, were a direct result of the economic downturn and not directly the fault of the borrower. Many accomplished borrowers have decreased balance sheets, income statements and overall portfolio shrinkage. They have found themselves in the position of rebuilding their businesses or, in many cases, completely starting over.

It is widely known that, to complicate matters, the availability of institutional credit is not yet what it once was. Stated income loans have not yet returned, underwriting standards are still very high, and an entirely new set of restrictive rules are in place regarding how to obtain financing and who is able to obtain financing. Today's underwriting standards are based far less on a "make sense" basis than they used to be. Perhaps that will change as the market returns to a healthier outlook, however, we're not there yet. Many institutions are still wary of construction and only the most solid of transactions are considered. When coupled with a decreased ability to inject equity capital that evaporated in years past, it represents a challenging environment.

The risk preferences of banking institutions are still very much on the cautious and conservative side. There are few opportunities to finance a transaction within the banking community whose parameters do not allow many viable transactions to fit into today's "banking box".

There is, however, a tremendous hunger for yield on investment and the opportunities to deploy capital in pursuit of yield are steadily returning within Arizona. Construction, fix and flips, residential and commercial rental property and development all represent opportunities to generate a profit to the willing investor and to the parties that provide the debt and equity to facilitate the process.

Due to the demand for yield by the investor, the lender and the equity, there is a significant capital base chasing transactions within this environment. The speed and certainty of execution when closing a real estate transaction is paramount. It can make the difference between obtaining the yield and losing the opportunity. It is fair to say that, in many cases, the speed and execution of the banking community cannot yet be counted on when it comes to getting a transaction closed. If you are reading this, you probably already agree with this sentiment.

Hard Money Loans

There are many myths surrounding hard money loans that I will attempt to dispel. At first blush, a hard money loan is traditionally categorized as an expensive loan on real estate. Expensive is a relative term and needs to be taken into context. When one cannot or desires not to borrow from a banking institution and is not fortunate enough to have a relative willing to provide “friends and family” capital at artificially low prices, one must choose to take on an equity partner or debt or a combination of both. If one chooses to go that route, they could forego what could otherwise be a profitable opportunity.

Although almost always more expensive when compared to traditional bank financing but that should not be the only deciding factor in the overall success of a transaction. An “all-equity” partner is likely to be the most expensive option one has at their disposal and that is if you can find the right party in which to partner with. Debt is the primary method with which to capitalize and other than all cash, is the most economical. A hard money loan is primarily focused on two criteria. They are the depth and experience of the borrower and the valuation and cost of the overall project or property. The degree of leverage is traditionally based on the “quick sale” value, meaning the price at which the subject property would trade in an efficient and expedited fashion. The hard money lender wants to know that, in the event of the worst case scenario default, that at least the principal balance of the loan in addition to the default interest and all associated costs would be recouped in the event of a trustee sale without a shortfall.

Hard money significantly differs from bank funding in the following respects. The hard money lender is far less concerned about specific credit scores and the burden of documentation is less burdensome, as well. Hard money lenders can accomplish in days what banks can do in weeks and months. When banks almost always require appraisals due to FIRREA restrictions, hard money lenders can conduct their own valuations more economically and in a more expedited fashion because they are not depository institutions. The high points for the hard money versus the institutional lender are the ability to repay the loan, a defined exit strategy or a number of defined exit strategies, a realistic time frame to execute the pondered transaction, the character and integrity of the borrower and, most importantly, the valuation and quality of the underlying collateral.

When structuring the pricing of a hard money loan, they are traditionally offered with risk based pricing. This means that the riskiest transactions that represent the highest risk of default and loss carry the highest pricing and the opposite is also true. Lower points of leverage with higher quality assets and more experienced borrower represent the fewest risks and are awarded the most economical pricing, keeping in mind that yields will be higher than institutional bank funding but significantly less expensive than an equity partner requiring a preferred yield and an profit split in some form or fashion.

The services offered by a competent and dedicated hard money lender are many. The most sought after include speed and certainty. The borrower wants to know if the transaction is approved quickly and once that has been established, subject to any funding conditions, it will close. The hard money lender is likely to inspect the property, underwrite, and make an underwriting decision in an expeditious manner so that the borrower knows where they stand at the inception of the transaction rather than 30-60 days later waiting on the bureaucracy of a depository institution subject to documenting every bank statement deposit, credit report item, etc.

Hard Money Loans for Real Estate Investment

When reduced down to a few brief paragraphs, the needs of the real estate investor are simple. The ability to quickly understand what the investor is trying to accomplish and how and when it needs to be done are paramount. Pricing is almost always a factor, as well. If the transaction's profit is too thin and the price of the loan is too high then no one wins and the transaction likely won't occur. The hard money lender's first duty is to that of the investment dollars. That is to say that safeguarding the funds is the highest priority, second to none. The needs of the real estate investor need to be tempered by needs of the trust deed investor, whether the hard money lender is structured as a fund or if specific trust deeds are paired with individual or groups of investors.

The positive aspects of borrowing hard money loans as a tool for real estate investment and development are numerous. When the real estate borrower cannot qualify for bank funding, hard money is an excellent option because it is cheaper than an equity partner, faster and more certain and less restrictive than a bank and, by far, more creative and out of the box than most other alternatives. A working relationship with a hard money lender can create certainty within the borrower's investment strategy, the real estate investor's business, allowing for predictable cash flow and a dependable source of funds that can be relied upon so that the real estate investor can execute with confidence.

The negative attributes of borrowing hard money loans as a tool for real estate investment are easily summarized. Naturally, a hard money loan is not as economical as a bank loan. That's obvious and borrowing hard money is pointless when the transaction is of the plain vanilla sort and the borrower has no issues with equity injection, timing, or qualifying. Generally speaking, the equity injection burden is higher on a private loan than on a bank loan. Borrowers with little equity or liquidity and not partnered with an equity source will have a hard time instilling enough confidence in the hard money lender to fund their deal. The reality is that it is primarily an asset based loan with a trustee sale as the last resort of remedies when the plan is not executed as expected.

If you are reading this, you are either currently looking for a hard money lender, or have previously borrowed from a hard money lender or are at a juncture where this type of financing could make sense for you. It is imperative that you choose a private lender that has character and experience that can be counted on. The character is where the trust is earned and the execution can be counted on and the experience is what allows the lender to confidently determine the underwriting decision and how to structure and close a transaction.

Conclusion

History has shown that hard money is a valuable alternative within the borrower's investment strategy and implementation. It present certainty and execution when needed and allows capitalizing on opportunities that otherwise might be lost. It does require a certain level of planning and sophistication to manage an investment from beginning to end successfully. Pricing and fees fluctuate with supply and demand, market conditions, borrower and transaction risk and asset quality and location. Hard money loans are a viable and even advantageous option for those who are who choose to or those who are required to work outside of today's underwriting standards and those who need service and speed that cannot be obtained within the banking arena.