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# GENERATING CONSISTENT INCOME THROUGH REAL ESTATE NOTES

# THE SEARCH FOR YIELD

Finding investments with strong yields is becoming increasingly difficult. Bond yields have plummeted, and other fixed income investments aren't attractive. In fact, the global interest rate environment has continued to compress for the last several years, even causing negative interest rates in some countries.

The Federal Reserve, and every other central bank as well, have set interest rates low to help stimulate the economy – and they will not reverse course until rising inflation forces them to.  However, consumer price inflation is locked into a strong disinflationary trend (more to come on this in future articles). The bottom line: low rates are here to stay.

This puts the investor in a challenging situation– either you must take more risk to chase higher yields (like junk bonds, for example), or you must look outside of the public markets.

The commercial real estate markets have historically provided strong yields and growth for investors. And there are still many areas where strong yields can be achieved, but as more institutional capital is searching for better yields, many real estate asset classes have been driven up in value, compressing yields to historic lows.

strong but safe yield

It was 8 years ago a friend asked me what he should do to get a strong but safe yield. He had a modest inheritance and wanted to be able to raise his family on the passive income from it.  Knowing the investment landscape, my first thought was "good luck!" But as I thought about it, I knew we could construct an ideal solution – using Real Estate Notes.

# WHAT IS NOTE INVESTING?

When you buy a house, you get a loan and make monthly payments on it. That's a Real Estate Note. What many folks don't realize is that these notes are actively traded behind the scenes.

Have you ever received a letter telling you to send your payment elsewhere? Your loan was simply sold to another lender.

When a loan is sold, all the rights associated with that loan go along with it. Because it is "secured" by the underlying property, the new lower of the loan can foreclose if the loan is not paid. Note investing is generally the purchase of an existing mortgage. And when you purchase a mortgage note, you become the lender. You have all the rights of the lender. You don't own the real estate, but you have a right to take the collateral if the borrower doesn't pay.

The two broadest classes of Real Estate Notes are commercial (e.g., apartments, office space, industrial, etc.) and residential (single family homes). For the purposes of this guide, we will focus on the latter.

# WHAT TYPES OF NOTES ARE THERE?

There are two broad categories of residential real estate notes you can invest in – performing notes and non-performing notes. If you want to break it down further, though it's beyond the scope of this guide, within each category investors can focus on senior or junior lien positions. A further breakdown into these categories is explained below:

## 1 Performing Notes—

these are notes where the borrower is making their scheduled payments. As an investor, the primary focus is on current income.

a. **Loan Modifications—** these notes are usually originated by banks, but have been modified from their original terms (hence, "modification"). Most modifications are initiated at the behest of the borrowers who had a financial setback, like a job loss, medical crisis, or a divorce, but want to stay in their homes. Most might assume these are "bad" notes, budt that is not necessarily the case. For instance, many borrowers recover from their financial setbacks and become faithful payers, grateful to keep their house. In other cases, the property value may more than cover the value of the note. Banks aren't well-equipped to hold these types of mortgages and will sell them at deep discounts to investors, in many cases well below their intrinsic value.

When purchasing an existing note, an investor assumes the role of the bank, with all the same lender protections that the bank has, as well as the right to re-work the terms of the note or foreclose on the property if the borrower ever stops paying.

b. **Private-Finance—** private financing is when an individual (as opposed to a bank) directly lends money to a borrower (usually to purchase a home) who either can't or doesn't want to get a traditional loan from a mortgage lender. The borrowers then typically make a monthly mortgage payment to the individual as they would to a bank.

Most of the time, these deals are born out of personal networks, meaning Joe down the street who wasn't approved for a mortgage from his bank happens to meet Cynthia, an investor friend of Joe's dentist, who he spoke to about his predicament in passing. Cynthia offers to finance Joe's mortgage, and they draft up a promissory note outlining the interest rate and schedule of payments.

c. **Hard Money Loans—**these are often short-term bridge loans made to house rehabbers that need capital to purchase and flip a home. Hard money loans are usually made to an investor who becomes the borrower. The goal is to rehab the property and either sell it or refinance at better terms in a short time period.

This is likely the type of residential real estate note that most investors are familiar with. And while these types of investments can be attractive, they can be risky as they tend to track the highly cyclical construction market, and because the borrowers are investors, not homeowners. More on this in a moment.

## 2 Non-Performing Notes

these are generally sold by banks and other financial institutions and are sold at generally very deep discounts, perhaps between 50-90%. Since the borrower is not making their scheduled payments, the goal as an investor is to either modify the loan in conjunction with the homeowner, reach a lump-sum settlement with the homeowner, or foreclose on the property if needed. Returns can be higher, but often carry more risk.

# ADVANTAGES OF INVESTING IN MORTGAGE NOTES

Intuitively, investors understand that it's good to be the bank. That's one of the reasons why there is a bank on every corner. And in this case, when you invest in notes, you become the bank.

When investing in rental real estate, most investors become a landlord, but it's better to be a "Lien-Lord."

When you invest in real estate notes, you get all the advantages of being the bank, without the headaches of being a landlord. And you have a lien that collateralizes your investment.

As a landlord you are always concerned with the Terrible T's (Tenants, Toilets, and Termites). As a lender, you are less concerned with these, as they are the responsibility of the homeowner. Here are a few of the advantages to investing in notes versus other real estate assets:

**1** **No Property Management—** Many investors have turned to real estate to create cash flow, but managing rental properties can be time-consuming and riddled with problems. Being the lender means you receive the income, while someone else manages the property.

**2** **No Maintenance Issues—** Every homeowner knows what it's like for something to break and be on the hook for the cost to fix it. As a lender, all maintenance is the responsibility of the homeowner.

**3** **No Managing Tenants—** Whereas rental property owners are concerned about vacancies in their rentals, the homeowner must continue paying the mortgage or you can take back the property through foreclosure.

**4** **Lien Secured by Real Estate—** Mortgage notes are secured by the property, meaning if a borrower suddenly stopped paying their mortgage, you have the rights to foreclose and take back the property.

**5** **Mailbox Money—** If you do your underwriting correctly, we haven't found many investments that can provide income that is as passive as mortgage notes.

**6** **Liquid Secondary Market—** An active secondary mortgage market means there is a strong appetite for mortgage notes, allowing investors to sell their notes without incurring the selling costs or opportunity cost of exiting real estate.

**7** **Discount—** Perhaps the greatest advantage of investing in mortgage notes is the discount at which buyers can purchase notes. As mentioned before, banks generally aren't well equipped for these types of notes. Discounts create higher yields, greater profits when paid off, and additional capital protection.

# THE "OWNER-OCCUPIED" MORTGAGE DIFFERENCE

Notes where the borrower is the homeowner, or an "owner-occupied" mortgage, provide significant advantages over notes where the borrower is an investor, like with hard money loans.

**There are two primary reasons this matters:**

- **Emotional Equity—**in a market downturn, a real estate investor is unlikely to keep paying once there is no equity in their project. They will simply give it back to the lender. Imagine as a lender the headache of receiving back a partially constructed home build! In an owner-occupied home, there is more at stake than just the tangible equity. We call this emotional equity – this could be where they grew up, their kids go to school, where they work, etc. For example, if your current home suddenly showed negative equity, would you then walk away? The data clearly show that very few in fact do.
- **Equivalent Rent—**a key metric we evaluate when underwriting performing notes is the market rent in the area where the home is located. Many times, our borrowers' mortgage payment is less than the market rent, which creates further reason for the borrower to keep paying – it's cheaper to pay the mortgage than to leave and pay rent. Additionally, in a foreclosure scenario, you could put renters in the property to create positive cash flow.

Owner-occupied mortgages, as a result, are much less cyclical and much less correlated to the real estate market compared to hard money loans or other real estate asset classes.

# CASE STUDY

This case study is a behind-the-curtain look at an actual mortgage that is owned by one of our funds. This property is located in Glenwood, IL, in the suburbs near Lake Chicago.

This mortgage was originated by a bank and then was modified. The borrower ran into financial challenges many years back and couldn't keep up with the original mortgage payments. Generally, these are caused by temporary issues such as a job loss, medical crisis or divorce. However, like most borrowers, this borrower recovered financially and wanted to stay in their house, so they worked out a loan modification with their lender and started making payments again.

Here are the details on the mortgage:

| | |
|---|---|
| **1st Mortgage Balance** | **$95,000** |
| **Home Value** | **$132,000** |
| **Equity in Property** | **$37,000** |
| **Loan to Value** | **72%** |
| **Interest Rate** | **5.375%** |
| **Monthly Payment** | **$649** |

## THE STRATEGY & METRICS

This note was purchased at a significant discount to the unpaid principal balance, or what the borrower owes. In this case the borrower owed $95,000, but we purchased this note for $45,835. As a reminder, when you buy notes, you buy the mortgage, not the property. As such, you become the lender and the borrower sends their monthly mortgage checks to you. The borrower is still responsible to pay property taxes, insurance, and maintenance expenses. Here is how the mortgage worked for us:

| | |
|---|---|
| **Purchase Price of 1st Mortgage** | **$45,835** |
| **Payoff Mortgage Balance** | **$95,000** |
| **Purchase Discount to Payoff** | **52%** |
| **Effective Yield** | **17%** |
| **Investment to Value** | **34.7%** |

This note was purchased at a 52% discount to what the borrower owes ($45,835 versus $95,000).

**This does two things:**

- the effective yield, or cash on cash return, becomes 17%. Even though the interest rate is only 5.375%, the yield is 17% because your cost is much lower than the balance, and
- this provides a large cushion for capital protection.

## CAPITAL PROTECTION

When looking at capital protection, the best metric to use is Investment to Value (ITV), which is the cost basis (versus what the borrower owes) divided by the value of the property ($45,835 / $132,000 = 34.7%). Anything under 65% is great.

In a worst-case scenario where the borrower stops paying their mortgage, because you have a secured lien, you have the ability to foreclose. Since the investment is significantly covered by the equity in the property, you stand to actually make a large profit, even if the borrower doesn't pay.

## COMPARABLE MARKET RENT

Another key metric you should evaluate in underwriting is comparable market rent for the property - i.e. what do similar properties rent for in the area. In this case, the comparable rent estimate for this property was $1,795/mo. You should evaluate this metric for two reasons:

- If it is more than the borrower's mortgage payment, it creates a "stickiness" factor. If the borrower were to stop paying and had to find somewhere else to live, they would have to pay ~$1,795 per month to find a place that is similar to their current house, much more than their current payment of $649 per month. With that kind of savings, they would be foolish to not pay their mortgage.
- If you have to take back the property, you have an idea what you could rent the property for in that market as an alternate way to create cash flow.

# THE CASE FOR A STRONG HOUSING MARKET

After the 2008-09 real estate crisis, many investors are still cautious about the current state of the housing market.

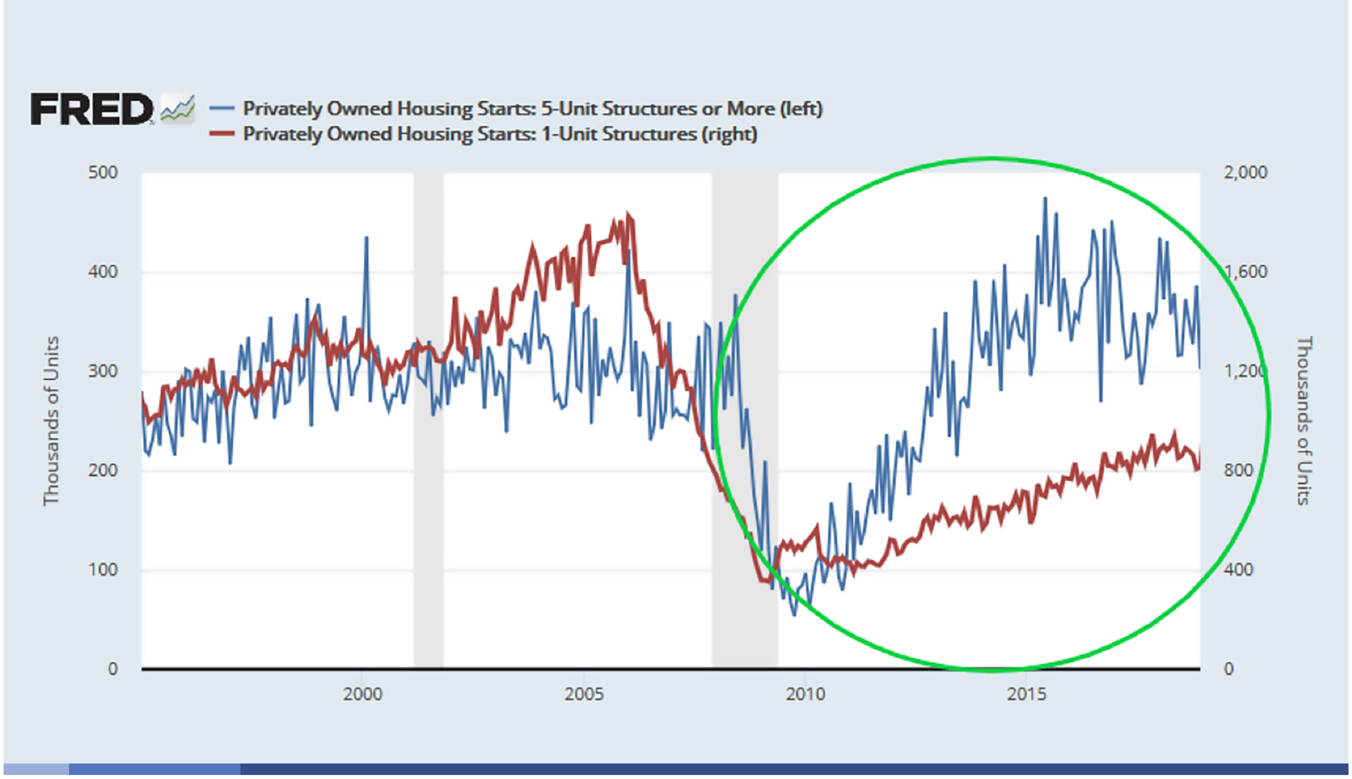
So, many investors are surprised to hear that there has actually been an undersupply of single-family properties built in the last 15 years.

The chart below shows "housing starts", which are new construction projects. The blue line is for multi-family properties, and the red line is single-family properties. After the 2008-09 real estate crash, you can see that both crashed – meaning new construction virtually ceased. However, post-crash, look at the difference – construction of single-family properties has never recovered, while multi-family has accelerated. While multifamily construction quickly exceeded previous levels, single family home construction has never recovered to previous levels.

Why is this good for the residential housing market? Well, very simply, less supply and equal or greater demand, means higher prices. And that price appreciation is exactly what we've been seeing the housing market over the last few years.

This undersupply of new single-family properties being built has been driven by fixed costs of real estate development increasing due to inflation, specifically, lumber costs, labor costs, and land. This has created an especially large gap at the lower end of the market. Higher fixed costs have pushed developers to build at the higher end of the market because there is more opportunity for profit but creating a lack of available housing on the lower end of the market.

This is a long-term trend that will result in the value of single-family homes to continue to rise until the supply/demand imbalance normalizes.



# HOW TO INVEST IN REAL ESTATE NOTES

At this point, you're probably curious about how to invest in this asset class. There are several ways investors can jump into the world of note investing.

**Purchasing Existing Notes—** Both performing and non-performing notes are actively available for sale on the secondary mortgage market. Individual investors can purchase and manage these notes themselves. However, if you choose to go this route, we recommend further education, as there is a large learning curve and due diligence on the front end, involving legal compliance, underwriting, and asset management throughout.

**Investing in a Fund—** Many investors prefer a more passive approach to investing in this asset class and partner with Fund Managers. By doing this you eliminate your need to be involved in the active management of these asset, diversify your risk across many assets and geographies, and leverage the expertise of their team.

## WHY WORK WITH A FUND MANAGER?

- Leverage expertise of experienced managers with a track record and experience in real estate
- Actively managing assets is a lot of work; outsourcing that frees up time & energy
- Deal flow – one of the biggest challenges for active investors is keeping capital deployed
- Liquidity – unlike other RE investments, there is an active secondary market, and one of our Funds allows liquidity after 1-year.

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***Whether you're curious about investing in notes yourself or partnering with a Fund Manager, our team is willing to jump on a quick call to help point you in the right direction.***

**Find more information at our website here:** www.NeuFinance.com

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