

Why Successful Professional Real Estate Investors Want Private Money

By John F. Ulmer

I'm often asked why I just don't go down to the bank and borrow all the money I want. The answer is that I can, and I have, but I'd rather not. Red-tape, slow response rates, "seasoning" issues, arbitrary caps on the amount one can borrow, inexperienced and fearful bankers are just some of the reasons.

But that's only the beginning of the problem. To more fully answer the question, it might be helpful to look at how the professional real estate investor that needs your cash spends his/her days. Your borrowers are typically going to do about 10 to 50 deals per year. They search for great buys on houses everyday, looking for owners in foreclosure, financial hardship, or houses selling cheaply because they've been abused. They're typically looking to buy houses for pennies on the dollar of their real value.

When these investors buy houses, they already have ideas in mind for how they'll exit the deal and make money. He or she might buy it and quickly flip it for a cash profit of \$5,000 to \$10,000. Or they might buy it, fix it up and sell it to a conventional buyer at a full retail price. The possible combinations of cash-generating "exits" are numerous.

Most sellers of these types of properties need cash and they typically need it quickly. In order for the investor to get the very best price, they need to close the deal quickly (as that is typically part of a negotiated low-ball offer to buy). The investor thus needs to find cash—typically very quickly.

When first in the business, most real estate investors go to banks for financing. They can buy houses at the rate of 2 or 3 per year and get the full cooperation of the banks. But as they get good and ramp up their operations they discover some unpleasant realities about working with banks.

First, banks have a very narrow view of what makes a good loan. For example, all banks require substantial down payments, reasoning correctly that the more money a person has in a home the less likely they are to default on the loan. They figure that the 5%-20% down will give them enough cushion should they need to liquidate the house to recoup their money.

What they fail to take into consideration is that the professional real estate investor you want to lend money to is buying houses as much as 50% (or more) off what we would call the retail price of the home. These houses have substantial equity built into the deal right off the bat, much more in fact than would be needed to cover even a 100% loan on the property. But that's not the way banks figure it.

Always having to come up with 20% down payments drains most investors of cash they need to repair and market their properties. It's a legitimate problem.

Secondly, banks are obsessed with credit reports and credit scores. It's good business for banks to be concerned about whether or not someone pays their bills. It's very bad business to base this solely on "beacon scores", a

number designed to be a quick and dirty means of assessing someone's credit worthiness. This number is based on a number of factors including the total amount of debt someone has (most professional real estate investors have millions of dollars of debt), how many times borrowers have applied for credit in a 24-month period (the more times, the lower the score. If someone buys 25 homes a year, they'll have 25 credit inquiries and their score drops precipitously. In truth, the more successful they are the less is their ability to borrow.)

Third, banks will not write loans with fixed interest rates on investment property. Since the interest floats, an investor can (and have many times) get financially killed by a spike in the interest rate.

Fourth, banks are very hesitant to make loans to entities, even when the borrower is willing to sign personally. This is a huge problem in that astute real estate professionals always own properties in entities (LLC's, corporations, land trusts, etc). The rules of banks are aligned directly against the legal, intelligent and wise protection of ones assets.

Fifth, let's not forget fees! Banks make a killing on fees. Application fees, brokers fees, title fees, and dozens of others. The total loan related fees typically start at \$1500 and go up from there.

Sixth, every lender in the world has a maximum number of loans they'll make to any one individual, no matter how good a customer you are. They also have limits on the amounts of mortgages they'll give to single investors. These limits aren't very high, particularly if you wish to build a vibrant business. Limits of four loans per person, or \$350,000-\$500,000 are common. And the laws are becoming more restrictive over time! Professional real estate investors are coming more and more to rely on private sources of capital to fund their deals.

Lastly, paperwork! Mountains of it! Can you see why private lenders are so much more attractive to professional real estate investors? Even if you charge high rates of return to borrow your money, you're a great option to slow-moving, fee-laden, beacon-score obsessed, paperwork bound banks.