New rules for investment momentum

HARD MONEY Softens Hard Times

By Scott C. Seckel

Hard-money has always been the real estate investor's best lending source. The term "hard-money" comes from the typically tight terms and higher interest rates, but hard-money lenders unlike banks, make loans in hours, not months. Traditionally, they loan on properties that banks won't touch, like crack houses and other buildings that are distressed or difficult to appraise.

AFTER THE FLOOD

The change of rules in the hard-money business has been evolutionary. Not in the sense that some lenders have learned to walk on land, but in the sense that almost every other competing organism has been wiped out in a cataclysm.

If you've ever worked with a hard-money lender for a bridge loan (and that could've been anyone from a guy in his basement with a pile of money to a national institution), chances are they are not in business, said Gregg Reichman of Active Finance Group, a Phoenix-based lender whose operations cover Arizona, California, Colorado, Nevada, Texas, Utah, and Washington.

"The vendor is not going to be the same vendor, because not many of them are in business anymore," Reichman said. "I can give you a list of people all across the country who have lost between $5 million and $50 million, each." Nearly every former hard-money lender "is on their knees, bleeding," he said.

RISK RISES WHEN VALUES FALL

Until now, it was always considered a low-risk business. Lenders applied conservative loan-to-value ratios. If they had to take the property, they knew they'd sell it to bottom feeders at the trustee sale for the first price to come along, just to get out alive with as little hassle as possible. That was the liquidation platform, and it worked. It was a low-risk business.

That was yesterday. Now hard-money lending is right up there with high-risk careers like deep sea welding and mercenary work in Mogadishu. Borrowers across the country are just not making payments, Reichman said.

That's only part of the problem. The value of the properties received by hard-money lenders in lieu of loan repayment has plummeted.

"The assets they're recovering are worth less than the loan," he said. "Before, our risk would be predictable if the customer stopped paying as the loan was made against a known property value. Almost no one believes that anymore as these LTV ratios, no matter how conservative, have not held up."

He took a breath. "We can make loans all day," he said. "That's easy. It's getting paid back that's the problem."

BRAVE NEW WORLD

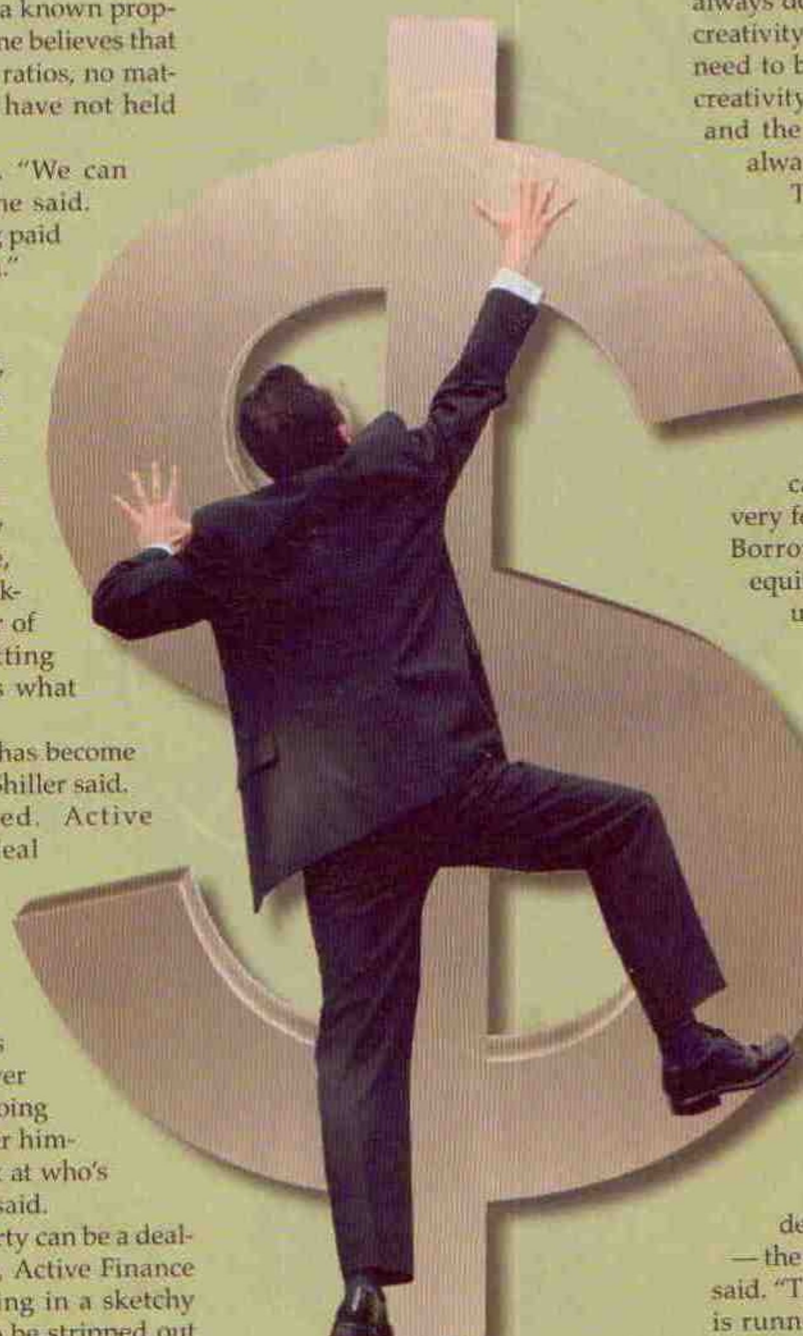
To state the obvious, hard-money lenders have tightened their belts like everyone else. Jeff Shiller, principal with Hard Money Bankers in Baltimore, Maryland, said he's looking at a larger number of deals, but they're getting more complex. Here's what lenders are saying:

"The exit strategy has become difficult for lenders," Shiller said.

Reichman agreed. Active Finance looks at a deal now from the perspective of what they are going to do with it if the borrower tanks. And they're going to look at who's paying off the borrower as closely as they're going to look at the borrower himself. "We need to look at who's taking them out," he said.

The type of property can be a deal-breaker. For example, Active Finance won't loan on anything in a sketchy area. "It's all going to be stripped out the day after we get it," Reichman said. Ten spec houses in the same subdivision? That's a no-go too.

"Now we say, 'Look, we don't want loans on ten properties in the St. Johns subdivision because we don't want to sell ten of them,'" Reichman said.



"'We'll take three of them. Let someone else take the rest of them.'"

Evan Bell is vice president of legal affairs and business development at Kennedy Funding, a Hackensack, New Jersey-based lender. From his perspective, the rules haven't changed dramatically from what Kennedy Funding has always done, but there has to be more creativity to get borrowers where they need to be, Bell said. "In this market creativity and flexibility on our part, and the part of the borrowers, can always get a deal done," he said.

To green light a deal, the most important factor is value in the collateral. "We look to a borrowers' track record on projects they've done before," Bell said. "The land, the collateral, is vital to the process. If there is value there, we can move forward. There are very few deals we can't do."

Borrowers need to have a lot of equity, cash in the bank, and documentable income.

"We're getting borrowers at 680 and above," Shiller said. "You're going to have to qualify for a loan on more stringent guidelines."

Jason Balin is Shiller's partner at HardMoneyBankers in Baltimore. He said the easiest deals to get funded are REOs, pre-foreclosures, as-is, or properties that need light to medium rehabbing.

"Land development deals, larger commercial projects — the stop sign is up on those," Balin said. "They're very guarded. Everyone is running, not walking, to the nearest exit." Most of the loans that Hard Money Bankers are making these days are local and in the median housing prices.

"Our projects can be anywhere from a large construction rehab project to an individual with an investment property they're having a hard time getting bank financing for," Balin said. Hard Money Bankers sticks to lending on projects in Washington, Maryland, the District of Columbia, and northern Virginia. "We know the market trends and we know the area," Balin said. "We really understand the market conditions ... We really want to stay on a localized basis."

THE NEW RULES

From a bird's-eye view, here's what a prospective borrower will face: a risk-conscious approach, an abundance of caution, and a high degree of scrutiny in every area so the likely success of the investment is at the highest possible probability. That's how Reichman characterized his company's new rules of engagement. On the ground, here are the new rules:

• Immediately, investors will see prices go up. "What you're going to see when you get new vendors in – which we aren't yet – they are going to price their products differently because the risk is significantly higher than it was before," Reichman said.

• Collateral will undergo much more intense scrutiny. "Everyone in the business is going to take the approach that they're going to have to collect the entire value of the loan," he said.

• The trustee sale is no longer the exit strategy for hard-money lenders.

"No one wants to do that any more," Reichman said. "They're going to determine a loan amount and assume no borrowers will pay ... (We will loan) what we feel we would highly likely achieve at the trustee sale."

Kennedy wants to see that the borrower has successfully completed similar deals in the past. "There needs to be a broad area of expertise," Bell said. "There has to be trust and a shared goal of getting the job done."

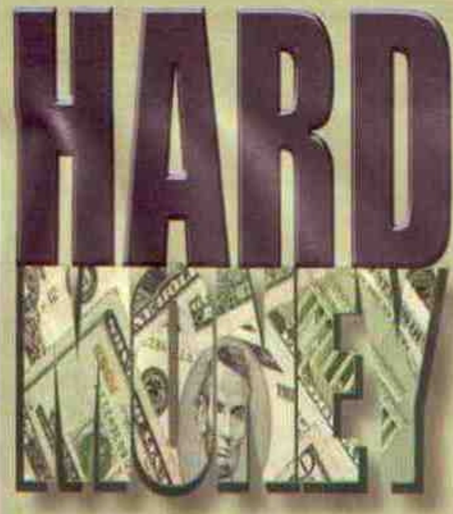
OPPORTUNITIES

Balin predicts continual declines up to 10 percent in some areas of the country, then flat pricing over the next two to three years. He doesn't see the real estate market reviving in any significant form for another couple of years.

"That represents a great market for investors," he said.

Hard-money will likely remain the sole source of vitality flowing through property lending in the foreseeable future. Conventional lending has dramatically scaled back, tightening standards as they regain footing.

"The big picture of this business, I think, is that as the conventional sources of funds have dried and also stiffened their rules, companies like Kennedy funding are filling a vacuum to keep the commercial real estate market moving," Bell said. "We serve a critical role in this market." He paused. "We live in interesting times. What can I tell you?"



However, hard-money lenders have an eye to reaping future rewards, which they are confident in sowing now. Reading crystal balls has just gotten a bit murkier, they say.

"We have to look into the future a little bit to determine what the strategy is going to be at the end of the day," Shiller said.

Balin encouraged borrowers to use him as a resource. "If a hard-money lender won't do the deal, no one is going to do the deal," he said. "Though the market is a challenging one, there are wonderful opportunities, and there are still plenty of deals." ■

RESOURCES

Active Finance Group
www.activefinancegroup.com
602-252-1155

CSI Mortgage
www.csimortgageaz.com
480-860-4028

Hard Money Bankers LLC
www.hardmoneybankers.com
877-991-1500

Kennedy Funding
www.kennedyfunding.com
800-342-8500

Marken Funding
www.markenfunding.com
602-252-0742

Primary Residential Mortgage
www.AZRealEstateLoans.com
602-996-2274