Don DeRosa's

Real Estate Investing for The Real World

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Expanding Your Market with Owner Financing

If the wind will not serve, take to the oars. Latin proverb

Hallelujah! You've finished that rehab project and it's time to sell. Thanks to your flawless management of the renovations, you finished on time and under budget. You've even got a contract! You hold your breath as closing day arrives and… and… the whole deal goes bust because the buyer can't get financing. You mentally add the next mortgage payment into your holding costs and start marketing again.

By now we all know that subprime mortgages – the loans made to people who are financially on the edge – are rising almost exponentially. That means banks are going to tighten up on lending, and it will be even harder to sell a house than before. Right?

Maybe not. While many investors are wondering whether to bail out of real estate for good, some of us are doing a happy dance. Well, mentally, anyway.

You see, changes in economic conditions – any changes – create chaos. And as I often tell my students, chaos means opportunity. It's just a matter of figuring out how to put it to use. In a market where bank money is tight, you can set yourself apart from the competition by financing all or part of the purchase price of the house.

Using owner financing expands the universe of possible buyers to everybody who's looking – those with great credit and those whose ratings aren't so good. And it's extremely flexible. You don't have to finance the whole purchase, and you don't have to do it for 30 years. You can structure the deal any way you want. You can allow interest-only-payments as an incentive. You can make it a five-year loan while you work with a good mortgage broker to repair the buyer's credit. You can require a sizeable down payment, or no down payment at all. That flexibility can make a sale.

Still, owner financing isn't perfect, and it's not for everyone. Here's some basic information to help you decide whether owner financing is for you.

The Basic Idea

The basic idea of owner financing can be stated in just four words: *You Become The Bank*. In other words, you lend the buyer money to purchase the house.

Owner financing might look a lot like renting, but it differs from a lease or lease-purchase agreement in two fundamental ways. First, with owner financing the buyer gets a deed to the house, whereas if he's renting, you keep the deed.

Second, in a lease purchase you and the renter have a landlord-tenant relationship, but if you're financing, you're the mortgagor and he's the mortgagee. This difference is important, because there are distinct tax and legal consequences for each. For example, if the buyer doesn't pay, foreclosure is usually harder than eviction.

There are loads of owner-financing variations. Let's take a look at two.

Wraparound mortgage

Wraparound mortgages are pretty simple. In this type of transaction, you actually issue the deed to somebody else, and you act as their lender. Then you "wrap" the financing around the underlying loan. What on earth does that mean? It means you loan the buyer the entire purchase price of the house, plus interest. You calculate the monthly payment based on the total price of the house, and the buyer makes those monthly payments to you. Meanwhile, you keep making your mortgage payments, and you get to pocket the difference.

Sounds good, right? But there are some sizeable risks with this approach. Even if the buyer doesn't make his payments, you still have to make yours. Although you'll have a promissory note and a security instrument, foreclosure can take months.

The best way to minimize the risk is to require a great big down payment – say, 20%. Even then, there are no guarantees, but at least you'll have already realized most of your profit up front.

Now, how about if you have an adjustable mortgage? You can still do a wraparound. In that case, you'll do what's called a "mirror wrap." You'll have the buyer's contract do whatever yours does. You'll need an attorney to write this agreement. Don't attempt to do this one yourself!

Taking back a second

In another variation, the buyer gets two loans – one from the bank and one from you. Why would you loan money to someone who can get a bank loan? Because the buyer may not be able to get all the financing he needs. If he's got a marginal credit score, maybe he can get 90% or 80% of the purchase price, but what if he doesn't have cash for the difference? In that case, you can loan him that 10% or 20%. Each month, the buyer will make two loan payments: one to the lender on the 80% loan, and the other payment to you for that 20% loan. That means you'll get some residual payment each month.

Still, there are risks. The biggest, of course, is that the buyer may not pay you. If that happens, and you want to foreclose, you are in a junior lien position. For that reason, you'll want to charge a double-digit interest rate.

Conclusion

Should you take on owner financing? The answer depends on your specific circumstances and how badly you want to be rid of the house. Owner financing keeps you in the transaction, and you may not want that. But if you have a house to sell and a buyer with some money to put down, you can get the profit you need up front and get moving on your next project.

After all, it never hurts to put one more tool in the toolbox.

> ***Don DeRosa*** *was recognized as one of the nation's top 21 real estate investors in the New York Times bestseller* The Millionaire Real Estate Investor. *Don, who is a full-time investor, trainer, and mentor, offers a complete system to build and run a thriving real estate business. For more information on Building Wealth with Real Estate, visit* www.donderosa.com.

Synopsis: With many new loan foreclosures, you might think this is the time to get out of real estate for good. However, where there is change and chaos, there is opportunity. You can increase your pool of potential buyers significantly by financing properties yourself. Typical methods include wrap-around mortgages and "carrying a second." There are risks involved, so you'll want a good down payment and the help of a lawyer. But in the end, you can offer one way to sell a house that's not shared by most of your competitors.

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