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Investing In Foreclosed Real Estate Properties

Foreclosed homes can be purchased at a considerable discount relative to the market value of the property. Purchasing foreclosed homes means purchasing the mortgage of the underlying property. It is similar to RMBS, CMO, CDO investors. The actual physical property may seem attractive, but as an investor, we need to focus on the financial instruments that will make the purchase possible.

Valuation is 99% of the work required for paper, instrument investments. However, real estate is different. Value can be uncovered with manual repairs done by either the investor, or contractors.

Still, proper valuation can help the investor avoid spending precious time and capital into a property that was not worth the investment from the start. The piece will focus on the foreclosure process and possible investment opportunities.

Critical Points to Know About Foreclosures

1. While skimming through the book, the author makes a point that **purchasing the junior lien is not the same as purchasing the senior mortgage**. In fact, at a foreclosure stage, purchasing the junior lien means a wipeout.

2. Tax liens are unpaid tax bills that the investor needs to pay off when purchasing the property. **Tax liens remain in place after foreclosures**, not junior liens such as HELOCs or contractor financing. Investing in tax liens may be a possible investment.

3. Most investors want to purchase the property and flip it. However, in states with a redemption period, **one needs to be mindful of the taxes and insurance payments that need to be paid during the period. Even the repairs and renovation costs made by the investor are not recouped if the buyer buys back the home during the redemption period.**

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Financing Options

Cash payment is usually required, so need to show up with a cashier's check. So for investors who don't have $200k-$400k lying around, how do they front the purchase? Borrowed money is always best for a purchase. Debt creates leverage, which increases the investor's return, distributes risk, creates a team of concerned investors, and helps investors to focus on cash flow management.

When experts say investors need cash in hand, they mean there is a pre-approved amount. The trustee sales will not wait for the investor to look around for financing after the auction is completed. They want the financing within the day or a few days, max.

Possible options are:

1) Hard money lenders- they base the financing off the future value of the house, so HELOCs, etc. It is the costliest, but as long as the investor is making the expected return, it is a viable option. Watch out for loans with pre-pay penalties.

    a. Bullet loan – pay no interest, but the interest accrues on top of the principal. In theory, it acts similar to a zero coupon bond, which means a higher repayment balance at the loan maturity, but it frees up cash flow during the holding period, which should be a short period of time.

Foreclosure Timeline Summary

Investor can purchase from 1) presale, 2) sale, 3) post-sale

Once a homeowner misses on 2-3 payments, the attorney posts the foreclosure notice to make it public. The homeowner can still reinstate the mortgage. The civil division of the sheriff's office is in charge of the sale. The opening bid is advertised, which is the balance of the mortgage, penalties, unpaid interest, and attorney's fees. The sheriff visits the property to see if it is occupied, which can change the redemption period. The redemption period is the time the borrower has the right to repurchase the property after the sale. The property goes on the auction for sale. The highest bidder purchases the property. If the opening bid made by the lender is the highest, the lender takes control of the property. Once the redemption period expires, the lender can resell it through the Real Estate Owned (REO) department.

Deed in lieu is when they pass the ownership to the lender, foregoing the foreclosure process. Short sale is when an investor purchases the property from the lender less than the full loan amount during the DIL process.

The interesting thing about the redemption period is that the buyer, who might have paid property taxes and insurance, may not recoup the fees if the original homeowner pays off the mortgage and related fees. So investors may have a 50% of retaining the property in areas with a redemption period. Make the minimal investment for repairs since the investor may not be able to recoup the invested amount if the homeowner redeems the house.

The last part is the eviction process, where the borrower has to move out officially by a stated date. The sheriff will forcefully move the tenants out.

Foreclosure Checklist

- Do title research. Priority of mortgage is tax lien, first mortgage, second mortgage. Shows name of the property owners, lien holders and legal judgments on the property. Watch out for title history gaps. Someone else may lay claim to the property. Every city has a property history including building permits.
- Check the property for any damage, foundation problems, toxic materials
- After a purchase, make sure to obtain homeowner's insurance.
- Assemble a team: Real estate agent, attorney, mortgage broker, accountant, title company, home inspector, contractors
- Where to find foreclosure sales: foreclosure notices, bankruptcy notices in local papers, divorce filings, websites, real estate agents, attorneys, lenders

Investing options and Valuation

In order to obtain a 20% return on the total invested capital, one can back into the desired disposition value using simple math on estimated figures.

Final Improved sales price	$150,000.00
Increasing market multiple	1.2
Total	$125,000.00
Unpaid property taxes	($5,000.00)
Repairs and renovations	($15,000.00)
Holding costs	($9,000.00)
Agent commission	($9,000.00)
Closing costs	($1,500.00)
Maximum bid	$85,500.00

Below are some estimates for assumed figures when backing into the sale price.

Loan costs	**2-6%; watch out for loans with pre-payment penalties**
Monthly holding costs	**PITI, utilities multiplied by the number of months investor is holding**
Repair and renovation	**10% of purchase price**
Marketing and selling property	**10% of purchase price**
Closing costs, title ins, appraisal, credit report	**A few hundred to couple thousand**

A prudent method to obtain a controlling interest in the property is through tax liens. They will have to be paid eventually and if not, the tax lien holder will have ownership of the property.

As a senior lien holder, one needs to pay off the tax lien and does not need to pay off the junior lien if the original lien holder doesn't redeem the house before the redemption expiration. However, the junior lien holder could help the homeowner to payoff the loan and obtain a controlling interest on the property. This is especially true for properties where the equity is considerable.

Purchasing the junior lien is very risky, likely to result in a complete wipe out. However, there are investors who purchase junior liens in the hope's the homeowner will redeem the house. The junior lien holder can pursue a short sale by purchasing the junior lien at a discount and then getting the difference on the face value, plus accrued interest. This is such a risky investment, unless one knows for a certainty the owner will repurchase the home, or they get in contact with the homeowner to help them redeem the property.