

All You Need to Know About Private Mortgage Lending

Private lending is a strategy that is often missed by investors when it comes to growing or diversifying their portfolios.

In this multipart series, we will cover all aspects relating to private lending and how you as investor can leverage this strategy as part of your investment plans going forward.

What is private Mortgage lending?

Private Mortgage Lending refers to loans that are obtained through non-traditional lenders. Traditional lenders include banks, credit unions, bank-like lenders and trust companies.

Private loans are often offered through private individuals or companies working with private individuals (mortgage syndications) who would like to lend out funds to borrowers that do not qualify / partially qualify for traditional mortgage financing.

Private mortgage loans come in the form of 1st, 2nd, 3rd and even 4th mortgages!

When private lending is required?

With the tightening lending regulations, borrowers these days may resort to private lending for one or more reasons:

1. Buying an unconventional property that traditional lenders would not finance or would partially finance.

An example of this is purchasing a rundown property with the plan to renovate it; where the property has some major deficiencies relating to structure, knob and tubing, asbestos and oil tanks.

2. Having non confirmable income where the borrower cannot qualify under the traditional financing rules.

An example of this is how some business owners report or derive income from their business on an annual basis at the personal level. Business owners often report a gross business income that is quite larger than the net business income (i.e. income after expenses) which is taxable. Moreover, they may pay themselves from their company in the form of salary, dividends, shareholder loan or combinations of.

As the traditional lending rules have tightened for business for self-borrowers, they may have to revert to private lending at times to address shortage in funding.

3. Looking for very fast financing with less hoops to jump to get approved
4. Having bruised credit that does not meet the traditional lenders.

A prime example of this scenario is when a client requires funding after a divorce where their credit got damaged in the way.

Private funding can provide temporary relief to help the borrower address any pressing funding needs while buying them some time to enhance their credit.

5. Wanting to take out equity from an existing property above and beyond what the traditional lenders can offer

Assuming the deal qualifies, the maximum amount of equity you can take out from a property through traditional lenders is 80% of the appraised value. If you were looking to take out above and beyond the 80%, then private lending may be an option.

The Risks

The main risk associated with private lending is the risk of borrower's default (i.e. inability to make their scheduled mortgage payments).

While this is an inherent risk in the lending game, there are several effective ways to manage that risk. The combination of the borrower, property and area where the property is located are key to determining how much a private lender can lend on a particular property and therefore the degree of risk they take.

Let's look at an example.

Assume your mortgage broker advised you of 2 potential private lending opportunities that you can invest in. Both opportunities are for the same borrower who is self-employed with decent credit and owns 2 residential properties (one in Vaughan – Ontario and the other in Wasaga Beach – Ontario). The borrower requires a \$50K second mortgage on each, will pay a 13% annual interest and will cover all closing expenses.

Each of the properties has an existing first mortgage with a traditional lender and your loan will be in second position behind the first lender for a total loan to value (LTV) of 90% on each property.

Which property would you lend against assuming all factors equal?

As a private lender, you really need to think about the worst case situation (i.e. borrower default) and how you will recoup your losses in case that happens.

In case of a default, you can actually initiate foreclosure – similar to what a bank would do - . Any remaining proceeds from the sale of the property after foreclosure expenses will be distributed to the current lenders in priority order. So, if you are in 2nd position, you will get paid only after the 1st lender gets paid.

The length of time it takes to sell the property and the amount of funds left after foreclosure to pay existing lenders -including yourself – in priority order; will determine whether or not you can recoup your principal funds at the end of the process.

With this in mind and knowing that the Real Estate market economics are more favourable to Real Estate values in Vaughan compared to Wasaga Beach, lending in second position in Vaughan at 90% loan to value would be less risky than lending at 90% LTV in Wasaga.

You may choose to lend less on the Wasaga property or charge a higher interest rate.

The Costs

To no one's surprise, private mortgages come with higher fees for closing the transaction and higher interest rates relative to traditional lenders.

Fees include:

1. Lender fees of roughly 1%-2% of the loan amount
2. Broker fees that can range from a fixed fee to a percentage matching to that of the lender's
3. Legal fees of about \$3000 in total for the borrower's lawyer and the lender's lawyer
4. Appraisal fees

The borrower is responsible for covering all fees associated with the transaction; some of which may be rolled into the loan.

In addition to the fees, interest on a private loan can range from 7%-10% on a first mortgage to 11%-16% on a second mortgage and higher on a 3rd or 4th.

Interest rates and fees are determined on a deal by deal basis once the private lender reviews the deal in details and determines the risks involved.

In our next article , we will discuss in details how to do your due diligence on a private deal.

About the Authors

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All You Need to Know About Private Mortgage Lending – Part 2

In our previous article on private mortgage lending, we discussed what private lending means, when you can leverage that strategy and the risks and costs associated with it.

In this article, we discuss the type of diligence you should conduct as an investor before lending out your funds privately.

Private lending is often perceived as high-risk strategy.

We often hear the following comments:

“If this such a great strategy, why didn’t MY BANK tell me about it”

“Why would someone pay a 12% interest or more through a private loan, if the rates these days are below 3%?”

Like any other strategy, there are always risks involved (unless you keep your money under a mattress or invest in in GIC!). Having said that, risk management is the heart and soul of private lending and it is what distinguishes a good deal from a bad one.

So, how do you manage the risks and reap the rewards of being a private lender?

It all boils down to 4 key variables that we will discuss in details: Property, Borrower, Market and Exist Strategy.



PROPERTY

The property you are lending against is the most important component in the private lending equation. It determines how soon you can recoup your initially invested funds in case the deal goes sour and the borrower defaults on your loan.

Depending on the type of the property and its condition, a property can sit on the market for months before it sells.

It is crucial for you to review the appraisal report that is prepared by an independent 3rd party certified appraiser and check for a couple of things:

1. How long does it take the comparable properties to sell?

2. Property value: this is the most important component of the report in our view as it will give you a 3rd party validation of the value based on market data versus going by the value the borrower has indicated. Value also influences the amount of funds you should lend.

Let us look at an example:

Say a single-family house in Calgary was appraised for \$450,000. The first mortgage on the property is currently \$300,000 and the borrower would like you to lend in second position an amount of \$50,000.

If you agree, then the loan to value (LTV) ratio on this property would be 77.7%:

$$(300000 + 50000) / 450000$$

This means that there is roughly 22% equity cushion in the property to cover foreclosure expenses in case things go south. Keep in mind that if that happens, the bank get their money first, then you are paid any left overs as your funds are secured in second position.

The lower the overall LTV, the better you are protected as an investor. Depending on the calibre of the property, you are lending against and the market it is at (appreciating, depreciating, stable), you may choose to limit or increase the amount of funds and the overall LTV.

MARKET

The area and the location at which the property is located have a great influence over its future value and ability to sell in case of a foreclosure.

You may come across a great property and a good borrower in a depressed market. This does not mean that you should stretch yourself thin and increase the loan to value. Instead, you should keep in mind the impact of the market on the future value of the property as the values may decline. In a market like that, you may choose:

1. not to lend all together or
2. lower your risk by reducing the loan to value and shorting the time period for which you lend the money or
3. increase the returns for the risk you are taking by charging a higher interest or fees

BORROWER

It is important to assess the borrower's ability to pay back the loan and their ability to afford it given all other debts they have and the income they make.

While traditional lenders have clear rules about what the Total and Gross Debt Coverage Ratios should be for each deal, private lending does not have any black or white rules with respect to those ratios.

Every deal is different and the risks private lenders are willing to take also vary significantly.

Our philosophy is to use a common sense approach to private lending, which boils down to understanding:

1. The story behind why a borrower's credit may be shut down or bruised and observing most recent behaviors with respect to how they are paying their bills and obligations
2. How the borrower derives their income, including:
 - a. how much they really make (some clients have a cash component , some report less on their personal taxes compared to what their personal corporations really make)
 - b. The stability of the income
3. The reason the borrower needs a private loan

Working with an experienced mortgage broker is crucial to understanding the credit and income components and to conducting proper diligence.

EXIT STRATEGY

Exit strategy refers to the plan that the borrower has in place for paying you back your principal at maturity.

For example:

- Is the borrower going to sell the property at maturity to pay you back?
- Is he/ she going to get the property refinanced with a traditional lender and pay you back? In addition, will they in fact qualify for a mortgage at the time to do so?
- Is he/ she going to find another private investor to replace your loan at maturity?

You need to understand what the long-term plan is for getting your money back. The harder it is to get your money back or the longer it takes to get it back, the higher your risk.

In summary, when it comes to private lending, do not just get fascinated by the high returns. Understand all variables of the deal that drive your risks and returns, do your diligence and work with an experienced broker. This way, you will enjoy high returns and supplement your portfolio with a solid strategy.

In our next and last part of this series, we will discuss the differences between private lending under a mortgage syndication and individual private lending.

About the Authors

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