Make Money In The Note Business

by Kevin Clancy

Ask anyone who has been in the note business for several years, "How do you become wealthy in this business?" and they will answer, that one, you don't do it overnight, and that two, you do it by becoming an investor yourself.

A real advantage of this business is that we can use our knowledge of the product to develop net worth. And as we develop expert knowledge we will see investment opportunities in deals that few others will see.

At American Funding Group, we look at every deal to see how we can carve out an equity position, which will grow over time. A straightforward way to do this is to buy a full mortgage and sell a partial to an investor. The note broker keeps a number of payments on the back end of that mortgage. After the investor receives his contracted number of payments, the note broker receives the rest. Or, if the note pays off early, the note broker will receive the present value of the cash flow that he/she kept on the back end of the mortgage. That investment strategy doesn't require the note broker to put up any funds...it's a way to invest with no starting capital.

Let's look at a deal and analyze the option of buying a full mortgage and selling a partial mortgage compared to taking a one time fee by selling the full mortgage. Should we "take the money and run... or let it ride?" Follow this transaction as it unwinds and see how early rejection led to a nice profit opportunity.

In the transaction, our note seller was taking back a note in the sale of his SFR, which would be owner occupied. The seller approached us before the real estate closing. He had authorization to pull the buyers credit. It was excellent.

The house was selling for $250,000 with $25,000 down. The $225,000 first mortgage was amortized over 360 months. The first 18 months were to be at 8% interest, then a $25,000 principal payment was due and the interest rate changed to 9%. If you work out the income stream you'll see that there were to be 17 payments of $1650; the 18th payment was to be $26,650 ($25,000 + $1650); then 342 payments of $1603.05.

The negotiations on the prospective note purchase went on for about a month. The seller was a small custom home builder who didn't need to sell, but could use cash to complete a number of building projects at the same time, instead of just one. We made offers based on our standard yield for new notes.

But the note seller was a good negotiator and pushed hard. And, he wouldn't accept our offers resulting from 10-11% yields. But that apparent problem, led to a discussion of his real needs. He said he needed $50,000 to build a house on property that he owned, but he could use $100,000. We then worked out partial purchase options.

He didn't accept either of the two partial purchase options that we worked out based on 10-11% yields, because in his words "the cost was too high". But the rejection of our offers led to his statement that he would be willing to sell the whole note if he could get $200,000 (a "discount" of 11% from the principal of $225,000). We told him that if we could come close we'd get back to him.

After a few days we told him we couldn't pay $200,000, but we could pay $187,550 and he would keep the first three payments. His total cash in three months would be $192,500; $187,550 cash at closing plus $4,950 (3 months of $1650). Our seller rejected this offer but stated that he'd be willing to take $195,000 for a full purchase ($5,000 less than his last sales offer of $200,000 to us). This $195,000 offer, a discount of 13%, moved the deal from the "undo-able" to the "do-able" category.

We had to get to work to secure this transaction. We had two investors with very aggressive postures. The first would pay $195,000 for 213 payments and the $25,000 principal payment (slightly under a 9% yield). If we bought a full purchase and sold a partial of 213 payments to him,

we would keep 147 payments on the back end for ourselves. Since part of our early negotiation was to get the note seller to agree to pay for a full appraisal and provide a lender's title insurance policy, the "profit" on this transaction would be the back end of 147 payments.

The second investor agreed to buy the entire note at a 9.5% yield for $211,835; an 84.73% ITV (the investment of $211,835 divided by the purchase price of $250,000). Since we were to pay the note seller $195,000, the cash on a full sale, in this scenario where we didn't retain a secondary interest would be $16,835. So the choice was to take $16,835 now "and run" or "let it ride" and wait 214 months to receive $1603.05 monthly. What would you do?

One way to look at this proposition is to analyze the tradeoff of $16,835 cash now, compared to the future income stream that we would receive in 214 months; if we didn't take any cash now. In 214 months, we would begin receive the "back-end" of 147 payments. At that time, our 147 payments would be worth $412,477:

Future income stream:

n -147

i- 9.0%

pmt- 142,477

pv - 1603.05

fv - 0

But we have to wait 214 months for our back end to be worth $142,477. And, we would have to give up the $16,835 in income that we could take if we sold the full mortgage. So the tradeoff between "taking our profits now or letting them ride" would be as if we "invested" a $16,835 fee from a full sale now to receive 147 payments of $1603.05/month beginning in 214 months.

The tradeoff would be:

n- 214

i- 12.04%

pv -16,835

pmt- 0.00

fv - 142,477

So if we let "our money ride", the potential immediate profit of $16,835 would be growing at slightly more than 12% until we started receiving payments on the back end. Are you in a position to "invest" your profits of $16,875? Do you customarily grow your money at a rate greater than 12% ? What would you do? What are the other considerations?

First, even though the payors have great credit, there are no guarantees that we'd receive the backend, since defaults do occur. But if a default occurred in the first month (worse case?), we'd have the opportunity to step into the foreclosure with $40,165 equity ($252,000, actual appraised value, less the invested amount of $211,835 with no prepayment penalty.)

On the other hand, few mortgages go full term. What would the situation be if we had kept the 147 payment back end and the mortgage was paid off in 7 years (close to the average for owner-financed homes)? After 84 months the payor would still have 276 payments left (original 360 payments less the 84 payments made). The investor would still have 129 payments coming to him (the 213 payments he bought less the 84 payments made).

Payor still owes: n i pv pmt fv

276 9.0% $186,560 $1603.05 0

Investor is owed:

n -129

i - 9.0%

pv - $132,218

pmt - $1603.05

fv - 0

The difference between the payor's payoff of $186,560 and the investor's payoff of $132,218, or $54,342, would be ours.

Would be have been "better off" in that scenario by keeping a back end and selling a partial? We could look at that situation as "investing" the $16,835 potential fee (from selling the full mortgage) to keep a back end in the partial sale (of 213 payments)...which resulted in a $54,342 payoff to us after 84 months. In effect, we "invested" the $16,835 potential fee from a full sale for 84 months for a $54,342 payoff. The yield would be:

n - 84

i - 16.86%

pv - $16,835

pmt - 0

fv - $54,342

Now the annual return would be 16.9%...versus the 12% we would receive if we had to wait 214 months before receiving our first $1603.05 payment. Would this knowledge change your mind about taking your profits now (full sale) or letting them ride (partial sale)?

What a business! What fun, using creativity and knowledge to solve customers' problems in ways that really benefit them, and, at the same time creating investments for ourselves requiring little or none of our own capital. Its great being in a business that affords so many opportunities, such as banking $16,835 now or "letting it ride," creating a future annuity of 147 payments of $1603.05 a month.

Not every deal provides this potential but a mindset that looks for the possibility to build equity or modify a deal to make this possible, pays huge dividends. You can buy and sell fulls all day long, but at the end of the day, where do you stand... on flat land or enjoying the view from a rising mountain?

There is real investment opportunity for us in this business. Look for it! Then you'll see how to create equity positions with knowledge gained through experience, vision and focus. Enjoy yourself while diligently working the business! Good luck and God speed!

If you have questions on buying or selling a note, please visit www.National-Note-Buyer.com and contact me.

Thanks for your time,

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