With new foreword by Brandon Turner, bestselling author of *The Book on Rental Property Investing*

FINDING & FUNDING GREAT DEALS

THE HANDS-ON GUIDE TO ACQUIRING REAL ESTATE IN ANY MARKET

REVISED EDITION

ANSON YOUNG

BiggerPockets® PUBLISHING

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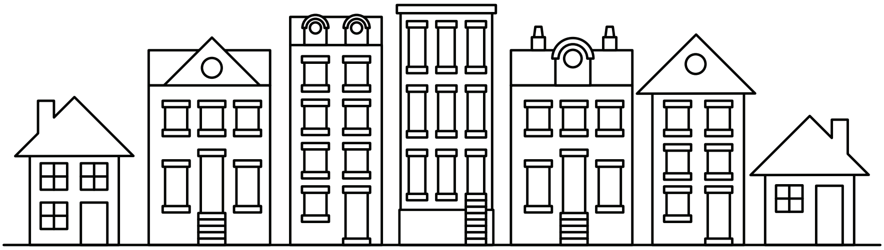
CONTENTS



CHAPTER 3
REACHING YOUR MARKET

> Yoda: *I am wondering, why are you here?*
>
> Luke: *I'm looking for someone.*
>
> Yoda: *Looking? Found someone, you have, I would say, hmmm?*
>
> —STAR WARS: THE EMPIRE STRIKES BACK, 1980

There are many kinds of sellers and many types of properties for sale out there. Just like there are all kinds of people out there, there are all types of sellers who are selling for all kinds of different reasons—from distress to divorce, from hoarding to simply moving out of town. This will be your crash course in all kinds of seller situations—why they might sell and how you can be there to help them.

In this chapter, after I offer a quick definition of different types of sellers, as well as where sellers can be found and how much competition you will have from other investors and agents for sellers, I'll review deal-finding strategies. I also break down potential pros and cons of working with each type of seller and deal. By the end, you should have a good idea of what sort of seller you'd prefer to work with and the methods you'd like to start using in your market to get deals flowing.

ON MARKET

With these properties, the seller has contacted an agent, and the agent has listed the property for sale on the local MLS for other agents and private homeowners to find. (Realtor.com is the national public side of MLS systems; most MLS systems will also post on Realtor.com.)

Competition level: highest. Danger, Will Robinson! Since MLS-listed properties can be seen by every agent in town—and every client the agents have on an automatic email system, and the public via Realtor.com/Zillow.com/Redfin.com—it's safe to say that the most eyeballs possible are on these properties. That's great for sellers. That's exactly why people list their property—to get maximum exposure. That must mean it's a waste of time for wholesalers or investors, right? I say no. The MLS might have the highest level of competition, but that doesn't mean you won't find deals there.

OFF MARKET

In these instances, the sellers haven't yet contacted an agent, and in some cases, they may not have even considered selling. These sellers can range from those offloading highly distressed properties to those who just haven't gotten around to contacting an agent yet and who may want to see what you're offering first.

Competition level: low. Since we, as investors, are actively seeking these people out, it goes without saying that competition is low, but you need to know that "low" is relative, at least compared with the MLS. That does not mean there aren't a ton of other investors who are marketing to off-market leads and trying to do exactly what you're doing. The more specific, creative, and clever you are as an off-market investor, the lower the competition gets. If you go online or talk to local investors and see that seemingly everyone is mailing white postcards to absentee homeowners (landlords, mostly), you will know that there will be a ton of competition in that specific niche. Will you just blindly do the same thing and hope to elbow your way into a landlord's already-full postbox to get their attention? I certainly hope not.

AUCTIONS

For a variety of reasons, some properties may be put up for public auction, in which potential buyers vie to outbid one another to get a deal. Do you like fast-paced action? Do you enjoy split-second, hundred-thousand-dollar decisions? Do you long to associate with the largest players in your market? Do you thrive on drama? Do you crave Count Chocula? (Seriously, when will they keep that on the shelves year-round?) If you answered yes to any of those serious questions, then boy, do I have the place for you! Auctions! Not just any auctions, but a place where they are selling houses, condos, townhomes, commercial property (think strip malls, apartment buildings, office buildings), and land to the highest bidder.

Competition level: medium. There are a few caveats to auctions—there might be fewer bidders present than there would be on an MLS listing, and the barrier to entry for the average investor is quite high. This is because you usually having to pay the full cash amount of the winning bid on the spot or shortly after the auction. Most auctions are publicly advertised, so as with the MLS, there are high amounts of people who know: a) there's an auction going on, and b) the properties that will be for sale. Mix in the grizzled veterans of your market and big players like hedge funds who buy at auction with seemingly limitless amounts of financial backing, and you can see where a run-of-the-mill investor won't even have a ticket to ride the auction train.

Now, as for the various types of properties:

DISTRESSED PROPERTIES

Distressed properties are found on market, off market, and at auction. You'll hear this term often in this business, but what does it actually mean? A distressed property might mean that either the seller is in distress or the property itself is distressed. If you find both at the same time, that usually means the stars have aligned to make a great deal. Either way, it is likely that the property will sell well under market value. That's why we're here, right? To solve problems and negotiate for inexpensive properties.

What kind of seller-distress situations will cause a property to be sold under market value? Good question!

FINANCIAL DISTRESS

People have issues, and when they have money issues, it usually spills into other areas of their lives. When the economy, real estate market, or stock market tanks, you will likely find high levels of financially distressed sellers who are no longer able to afford their homes.

Personal financial distress. This refers to actual money issues of the seller. They can no longer make their mortgage payment due to job loss, mismanagement, gambling, or many other reasons. When a homeowner stops paying their mortgage, they have only a small window of time during which to sell their property before the bank initiates foreclosure proceedings. Foreclosure is a process in which the lender legally takes the property back because the homeowner can no longer make payments. Another cause of distress can occur when a homeowner has an adjustable rate mortgage (ARM), and the loan does just what the acronym implies: It adjusts. This can turn a $1,000 payment into a payment of $1,800 or more, for example, making the mortgage no longer affordable to the homeowner.

Property is underwater. In this case, the amount of the loan is more than the house is worth. If the homeowner is underwater and they try to sell the property, they will have to bring the difference between the loan and the sale price to the closing table. For example, the seller's loan is for $150,000, but the market has gone down and the property is now worth $125,000. If they try to sell, they will have to bring the difference, $25,000, in cash to closing. You can see where this might be a problem, as people generally do not have this kind of money just sitting around. In the 2008 market crash, many homeowners just stopped paying their mortgages, knowing they could never sell their homes.

PERSONAL DISTRESS

Homeowners aren't bound just by financial issues. Usually many factors add up to create the perfect storm. These life circumstances are mostly out of their control but create a ton of stress when an unwanted home is involved:

- Death
- Divorce
- Employment change

- Elderly homeowner making transition
- Investor tired of being a landlord

This is where our mission to help homeowners meets an opportunity to buy properties at a discount.

DISTRESSED PROPERTY CONDITION

Homeownership, while part of the "American dream," is actually pretty darn expensive and can cost you a lot in the long run. Deferred maintenance is like a ninja—if you avert your eyes for a second, he will pummel you with costs that'll add up heavily over time. "Deferred" means "put off until later." Deferred maintenance refers to all the little things that break or need attention through the life of the home. Many homeowners ignore these things until they have gone from a few small things to a huge laundry list of items that have gotten worse over time. Where once the paint was chipped, it will eventually peel, then a few years later the wood is rotted, and after a few more, there's a water leak that's destroying your basement. These things add up, and when an owner won't or can't address these issues, they will eventually drag down the home value to the point where only someone like you or me will come in and buy it for a discount.

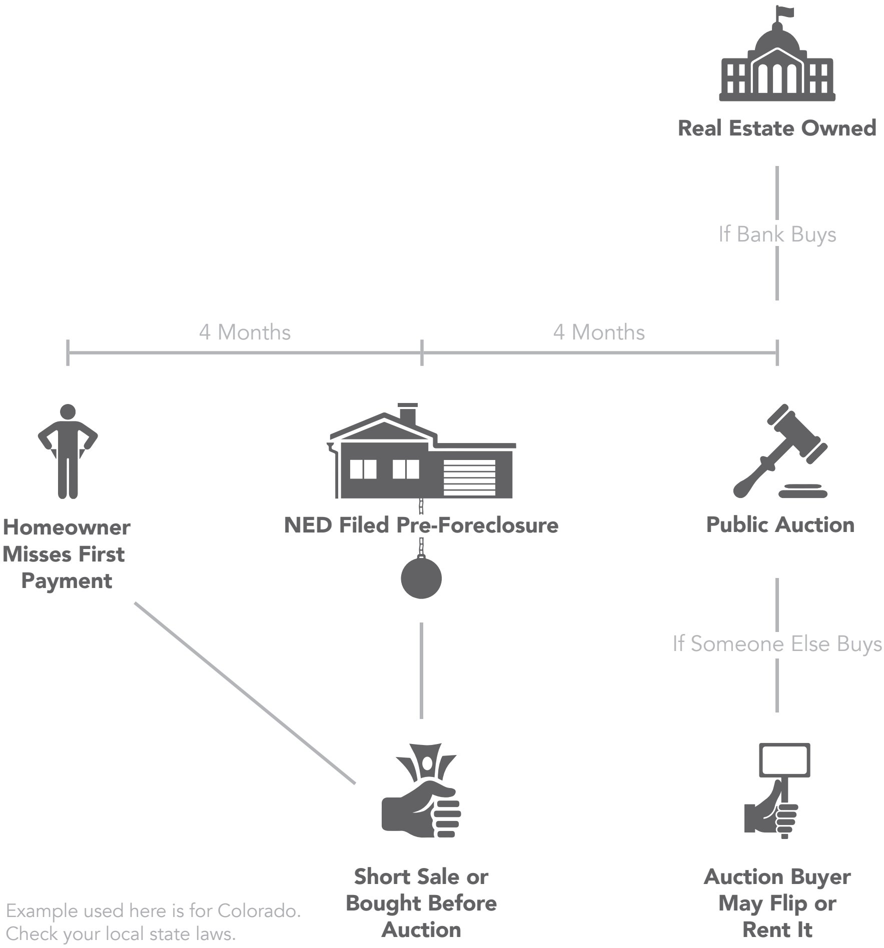
Retail buyers who buy houses don't want to deal with a ton of big, medium, or even small problems. They want a house that's move-in ready— and so does the bank that's lending that buyer the money. Many times, depending on the loan type, a house can be in such bad condition that a new buyer may not even be able to get a loan on the property. With our friend Deferred Maintenance comes his cousin, No-Updating. A badly out-of-date house is not only unsightly and undesirable, but it can be dangerous. It costs a ton of money, time, and energy to keep the cosmetics up to date with new design trends, bathrooms, kitchens, flooring, paint, etc. It's even more costly to keep up the electrical, plumbing, and heating systems. An old electrical system in a home can be deadly, and there are certain electrical types that cannot be insured. In these instances, a bank wouldn't loan on the home.

FORECLOSURES

There are a ton of misconceptions when it comes to this area of real estate, and most people do not realize that there are three distinct heads to this beast. I wanted to initially file this section under "Financial Distress," but it really deserves its own section. Most of the time the process starts with financial or personal distress—loss of job, reduction in income, death, medical issues, or one of a hundred other reasons. The homeowner can no longer pay their mortgage, which starts this entire process. Once the process starts, there are different levels of motivation to sell the property as it moves along in the three phases of foreclosure.

Let's look at these three phases of the foreclosure process and where buying opportunity exists in each: pre-foreclosure, public auction, and real estate owned. ***Important Note:*** the foreclosure process can vary widely in each state. From here on out, we are going to be using Colorado as an example, but it is important that you understand the rules will be different in other states. Make sure you do your homework and fully understand how the process works in *your* state.

What is a foreclosure, you might be asking? Here is the simple version: Foreclosure is a legal process in which the lender on a property has the right to gain ownership of the property through a lawsuit or other legal action if the borrower stops paying the lender; this is called defaulting on a loan. There is public notification of the default leading up to the sale date (pre-foreclosure). On the sale date, the property is sold at auction (public auction). If the lender is the winning bidder at the auction, it will then try to sell the property on the open market (real estate owned/REO).



PRE-FORECLOSURES

Where they're found: on market, off market

Competition level: high. Think of competition this way—if the information or people are easy to find and publicly advertised, then there will be the highest level of competition. Other investors, real estate agents, the bank, the mortgage insurance company, bankruptcy attorneys, loan modification companies—everyone and their mom will be mailing and calling about pre-foreclosures. The kicker is, most homeowners who are facing foreclosure have their heads in the sand, ignoring calls or disconnecting their phones and throwing their mail away without even opening it.

Homeowners who stop paying their loans usually have a grace period before the bank starts to take legal action against them. As soon as the homeowner has missed four months of payment (this varies by state, but we are using my state of Colorado as an example here), the bank will then make the legal action public. This is called notice of default," involving a public notice that the homeowner is in default, with paperwork filed at the county courthouse and advertised in a newspaper. The homeowner and the public are now notified of the pending foreclosure/sale date. In Colorado, this occurs four months from the notice of default and includes the amount owed by the lender. They are nice enough to tack on a ton of late fees and lawyer/filing fees to that amount owed.

Basically, there are four months of missed payments and a notice of default is given. Then there are four months until the auction/sale date. That means a minimum of eight months of no payments, though I have heard of cases where this process was delayed two years or more. During this time, the homeowner still owns the property, and they can sell it at any time leading up to the sale date—and most of the time they are very motivated. If they sell the property before the sale date, there is no foreclosure proceeding, and therefore no record of a foreclosure on their credit report. Whether you can make a pre-foreclosure deal work will depend on whether the homeowner has any equity and whether you have enough time before the sale date to make a deal work. I've been contacted a few days before the foreclosure date, but be wary of these deals. While possible, it takes experience to pull off a sale in just a few days.

Pre-foreclosure with equity. Let's say that when Mary contacts Joe that Joe falls into this category. Joe still has a mortgage and owes $50,000 but can no longer afford his mortgage payment. When Mary contacts him, he's in pre-foreclosure and motivated to sell. He wants to avoid a foreclosure on his credit report. Since Mary ends up buying the property from Joe for $70,000, the difference between what Joe owed his lender and the purchase price is $20,000. That is the amount of equity that Joe had in the property. He'll walk away from the closing table with roughly $20,000 and avoid foreclosure ($70,000 purchase price – $50,000 lender payoff = $20,000 equity).

Pre-foreclosure with no equity. Back to our Mary/Joe example, let's pretend that Joe owes his bank $100,000. This would make that last equation look more like this: $70,000 purchase price – $100,000 lender payoff = –$30,000 equity. That is a negative number, and Joe cannot make up the $30,000 difference by pulling money out of his bank account. You might say, "Well, that's the end of the road. There is nothing that we can do for No-Equity Joe." I say, "Wrong! Ever heard of a short sale?"

SHORT SALES

Let's work with the version of Joe the seller who owes more than his house is worth. He owes $100,000, and Mary can buy the house for $70,000, like in the example above. What they can do is start the short sale process with Joe's lender. It is still common in many areas for homeowners to be underwater on their homes because they bought at the height of the real estate market before prices plummeted. This caught many homeowners upside down, unable to sell now that their homes were worth less than they owed their lenders. With a short sale, the homeowner still has the rights to sell the property, but the lender now gets to say, "I'm going to reduce the amount that Joe owes us, but I get to approve the shorted payoff [short sale]." Here are a few quick tips to know about the short sale process:

- The seller needs to be in default for a bank to move forward with the short sale process. Joe has missed four payments so far, so this is a good candidate for Mary to pursue.
- The seller must have a documentable hardship or reason why they are missing payments and need a reduced payoff to sell the house. Look under "Financial Distress" above—it could be any of those reasons. The bank also needs reasonable proof of the event or situation, so they proceed to dig into the seller's private information. I always aim to be up-front with a homeowner about this.
- The bank likes to see a real estate agent involved. Many banks will not consider a short sale without the property being listed. In this case, Mary has networked with a local agent whom she trusts to bring into the transaction to help with buying Joe's house.

Short sales have serious tax and possible legal consequences for the homeowner. I'm not a lawyer, and most likely neither are you.

Therefore, you shouldn't directly advise the homeowner on any tax issues, but you should still be aware of them. Usually, the bank has a form the homeowner signs that lays out any tax or legal consequences.

- **Deficiency judgment**. One piece of that huge stack of paperwork Joe signed when buying his home was the bank's right to sue or recoup any losses the bank takes if Joe were to accept a short-sale payoff. It used to be that the bank would try to get Joe to sign a note or a judgment before closing stating that Joe owes the bank the difference between the sale price and the amount left on his loan—in this case, $30,000 ($70,000 purchase price – $100,000 lender payoff = –$30,000 equity). I've had only one or two banks try this, and we fought back on it. But just because it's not common these days doesn't mean that the bank doesn't have the legal right to enforce this.
- **Tax filing**. Who loves the IRS? Not homeowners kicked while they're down by having to do a short sale, then owing taxes because the lender filed paperwork with the IRS showing the balance owed ($30,000 in Joe's case) as forgiven debt. What does this mean in tax-speak? It means the $30,000 is now shown as income to Joe for the year he completed the short sale. This can have some pretty serious tax consequences, as now Joe, on paper, made $30,000 more that year and did not pay taxes on the increase. This can make Joe go from getting a return to owing several thousand dollars in taxes. Surprise! But thanks to the Mortgage Forgiveness Debt Relief Act of 2007, if the owner lives in the home when the short sale closes, the IRS waives this tax. The bill was extended in 2014 but is no longer in effect as of 2016. However, it is a good idea to be aware of and actively look for programs like this.
- **Credit report**. While Joe dodged the bullet of a foreclosure haunting him for seven years, he will still take a big hit on his credit report. This is due to the combination of missing payments and the bank possibly reporting the debt as being paid off, but not in full when the short sale closes. While not nearly as bad as a foreclosure or bankruptcy, the short sale will cause Joe's credit to suffer.

Here is a quick short-sale story, so you can understand the process a little more.

Mary and Joe agree to a price for Joe's house. Congratulations!

Mary is going to negotiate this short sale, so she contacts Joe's bank with Joe's permission and gets a list of paperwork that Joe will need to show a financial hardship. Joe gathers all the documents requested—W-2s, tax returns, bank statements, and a hardship letter from Joe to the bank stating why he is in distress. Mary collects these from Joe and submits them to the bank, along with the signed offer and any paperwork needed from the agent. Joe's bank will now review each document and likely kick them back to Mary for anything missing or needing correction.

During this time, Joe's bank will order either an appraisal or a broker price opinion (BPO). The bank is trying to determine whether the market is now supporting Mary's offer of $70,000. Once Joe's paperwork is approved and the valuation comes in at an acceptable price, the bank will either approve the short payoff, decline the short payoff, or counter Mary's offer at a higher price.

If the short sale is accepted, the bank will issue an approval letter. This states the new payoff amount and any terms attached to the acceptance. Terms include the seller having to sign a deficiency judgment to avoid a deed restriction on the property. Deed restrictions restrict what the *next* owner can do with the property, and the favorite one of a few big banks is to say that the new buyer cannot resell the property for ninety days after closing. If you're a wholesaler, this is no good—and I'd fight it. This shouldn't affect other investors such as flippers and landlords as much, if at all. Mary submits the approval letter to the title company, and Joe and Mary head to closing.

You might say, "But isn't the bank taking a huge loss on short sales?" The answer is yes, but they mitigate these risks with the deficiency judgment, creative accounting, and mortgage insurance. Mortgage insurance is mandatory insurance the homeowner must have if they didn't put a big down payment on the loan when they bought the house. It insures the bank against loss if the homeowner defaults on the low-down-payment loan. The bank carefully considers whether it will take a bigger loss with a short sale versus going all the way through to foreclosure auction and reselling the property. Many times, the loss on a short sale is less than all the lawyer fees, repair costs, agent fees, and cost of taking back the property. Banks are not in the house-owning business, and they will try to avoid taking back a home if possible.

There are some serious pros and cons to short sales. I don't mind short sales now that I have eight years of experience with them, but to other people, short sales are a torturous process.

Pros

- **Less competition**. If you see short sales on the MLS, it's highly unlikely that a retail buyer is going to wait out the three-month to two-year process of closing a short sale. Many investors shy away from them for the same reasons. Not many want to wait that long before getting a payday.
- **Great deals**. With a short sale, you are essentially negotiating with a bank for your own profit margin.
- **Patience is your friend**. I will chronicle a deal I did at the end of this chapter, in which I discovered that a short sale is like putting a property in a time capsule. In this case, the bank was still using an appraisal from two years before we actually closed, and the market shot up in the meantime. If you have a good team around you, you can stack up as many short sales as you can handle, and as they get approved or denied, your pipeline stays relatively full and you are moving deals.
- **You are truly helping someone**. This is my favorite part—helping an individual or family avoid foreclosure. They'll steer clear of a stigma on their credit report, and they won't have the bank knocking on their door telling them they have to be out in as little as two weeks.

Cons

- **Patience is not your friend**. As I said above, my longest short sale was over two years. This wasn't passive; there were I was on the phone for hours with the bank. This process is not for the newbie or the faint of heart.
- **A tedious process**. If I had a dollar for everything I've had to resubmit to the bank, let's just say I wouldn't ever need to do a deal again. The banks will lose your paperwork, then lose it again, then lose your number. Then your negotiator at the bank will be transferred or fired, then you will start all over with a new person—on and on it goes.
- **Deed restrictions**. I don't like being told what I can and can't do with something I own, even if I own it for ten minutes. The ninety-to-120-day deed restriction can throw a huge wrench in your machine when it comes to wholesaling or fix-and-flips.