Solutions to Four Major Rehabbers' Problems that Kill Careers

I was at a meeting of a new REIA last week and I was listening to the lamenting of a few rehabbers about the issue of low appraisals. Ever since the banks have their own pool of appraisers, most of the appraisals have been coming in low. Of the five deals I overheard being discussed, four were appraised very low and barely marginal in terms of net profits. Naturally, one rehabber got his appraisal expectation but he seemed to be the exception.

The "pooled appraisers" are getting paid $150 - $175 for the same appraisals that they were paid twice that amount for in the past. It isn't fair and seemingly they are taking their revenge out on investors. Actually, the lenders are most often dictating the parameters of the appraisals and in certain cases looking at distressed property sales, foreclosures and short sales as comparable sales. The logic being that the market is declining and will "meet" the lower values eventually. In addition, the banks do not want to make loans because of their reserve requirements being under constant pressure.

For the majority of rehabbers, it is often a toss-up of what to expect their final sale appraisal price will be. With this in mind, rehabbers must be more careful of how much they pay for a property. In the past, price didn't matter as the rehab of the property generated equity that made the property profitable. Many rehabbers seem to remember the past and get greedy and aggressive about how much they will pay for properties.

I hear all the time, "If you rehab the property correctly, it will always sell at top dollar." This was true in the good old days, now the lenders control the final price through the appraisal. I am guessing that about two-thirds of all rehabbers I talk to, have been stuck with their rehabs. They are now landlords waiting for the market to change. Their rationalization is they are getting a higher than normal return on their money. The problem is they no longer have the control of their money and it's "velocity" or turnover rate is zero. Novice rehabbers tend to over-rehab their houses and learn the hard way what is important to replace and what to be conservative on.

I also see this on REIFAX.com when we are looking at "corporate owner" properties that many of these properties are not foreclosures but rehabbed houses. We can see from the sales price history what price they purchased the property for and guess at how much their rehab cost. Often we see the listing price differential such that we can reasonably calculate that the seller will be making less than $25,000 – if the property sells at the listing price and the appraisal comes in. This profit margin is not enough considering the risk involved in rehabbing in this market – but that's a personal opinion. For us it is easier to do 1.5 to 2 wholesale deals and never take a market risk.

Another issue with rehabs is many lenders have two "unreasonable" requirements that seem to benefit no one except a vindictive banker. The first is the seasoning requirement of 90 days. The mortgage insurers (FNMA, Freddie Mac, HUD, etc.) intermittently drop their seasoning requirements so it is the local and national lenders who stifle investors with these buy and hold restrictions. In a normal or even slightly rising market, this holding requirement is an advantage, but not in a foreclosure saturated market.

The second requirement is the profit limit an investor can make. I think the people who process loans at banks have decided to say enough is enough in terms of profits. So goes the American belief of free enterprise. Generally, what we see is the lenders want to limit the amount of actual profit to 20% over the cost of the property and the actual rehab expenses – forget the cost of money!

In one recent incident, the cost of the property was $102,500 and the materials were $16,200. The lender would not give an allowance for "sweat equity" so the maximum profit acceptable was $102,500 + $16,200 = $118,700 x 1.2 (20% profit) = $142,440 total sales price. This could be disappointing if you are expecting $175,000+ for your rehab or you did all the labor yourself. What is worse is an appraisal for $135,000.

Let's look closer at the answer to doing more deals as rehabbers and making larger profits on a regular basis. The following elements are critical to getting these rehabs done profitably and with a high velocity:

1. Sell your finished rehab in days or weeks not months and sell it yourself (FSBO) to save the 6% realtor© commission that is a net profit out of your pocket! Some people say 5% - 6% isn't a lot to pay for the effort agents do to close the deal. However, if you are working in the $150,000 price range and do10 houses a year, this "not a lot of money" amounts to $90,000 a year of pure profit out of your pocket.

2. Pre-qualify buyers for three factors – credit score, down payment and job stability. Most people will have some sort of issue with one or all of these parameters. If you continuously try to qualify them using conventional lenders, you will be at the mercy of these lenders.

   Credit unions are open to the public by Federal law and do not have the lending constraints national lenders have to contend with. Also, there will be local banks that do what is called "portfolio" lending which means they make the lending decision by committee. In many cases these lenders require a higher initial credit score but can be swayed with larger initial deposits of 20%+.

   The people who have these larger deposits are foreclosure victims who haven't paid mortgage payments in years and foreign nationals who have deposits of 50%+ and, in many cases, 100% and do not need financing. Choose your marketing methods to get larger deposits and foreign nationals who will rent the properties and hold them for appreciation. The disparity in the value of the dollar is an especially good incentive for foreign nationals to invest in American real estate.

3. The best way to overcome all of the lender issues is to find your own private money. If you focus on finding investors who have money in Certificates of Deposit (CDs) that are yielding 2% or less, they are prime candidates for the opportunity to make 8% - 10% for 2 – 3 years. The mortgage these private lenders get at closing should be interest only or 2% less if they want an amortized loan paying principal and interest monthly.

   The huge benefit to private lenders is the substantially increased income and the collateral of a first mortgage on a real property. At the end of the 2 – 3 years of the mortgage the private lender can choose to extend the loan or have the homeowner re-finance him out. In addition, many rehabbers using private money get a 20% down payment so the lender's risk is further decreased. The lenders allow more "worthy" people to buy "ready to move into" homes despite their former inability to get loans. The general thought is that these homeowners will get their credit restored in the coming years, especially with the help of the lender vouching for their paying their mortgage on time.

4. Using private lenders also overcomes the issue of an appraisal coming in too low. While an appraisal must be done for the due-diligence aspect of the lender, there is not the issue of using "pooled" appraisers who seem to be vindictive at times with their appraisals. Now the rehabber can use real comparable sales and not include distressed sales in his pre-estimate of what price he should be able to sell his finished property.

5. Private lenders also instantly overcome two other issues that kill many investor deals. These deal or profit killers are "seasoning" requirements and profit limitations. Many lenders have decided that an investor must hold a property for a specified time period (30, 60, 90 or even 180 days) to be able to resell it. Then these lenders often don't finance these properties if the profit margin exceeds 20% of the purchase price plus the investor's expenses. Neither of these issues for lenders are problems for private lenders – problems solved!

The rehabber is warned not to take advantage of these private lenders by over-valuing the property, not doing the rehab, having straw buyers, or other unscrupulous acts because the civil and criminal penalties can be very severe. A private lender should always receive a lender's title policy from a reputable title company, a written appraisal, a copy of the homeowner's property and casualty insurance policy showing the lender as a co-insured. One final note about private lenders, make certain you do not violate State or Federal laws while you are fund raising which is a whole other Insight by itself.

To your limitless success,

Dave Dinkel