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Investing in Private Notes Secured by Real Estate

By Solomon Gorlick

Are you interested in earning between 9 and 13% annualized secured by equity in real estate? To someone uninitiated in investing in Private Trust Deeds, this may sound like the topic of a late night infomercial, but to the thousands of investors here in California and across the country that have been taking advantage of these opportunities for years, they are reality. This article will explore the process, advantages and disadvantages of what is known as Private Trust Deed Investing.

As a class of investments, private trust deeds provide a significant, stable return on invested funds. With savings accounts paying a paltry 0.5-2% and American treasury bonds providing about 4 to 4.5% per year in the current market, Private Trust Deeds returning 9-13% per year have been only growing in popularity in recent years. Unlike the FDIC-insured savings accounts and American Treasuries, private trust deeds are not guaranteed by the Federal Government, so they are not without risk. However, they are secured by a valuable asset, equity in real estate, which does provide significant security as detailed below.

The investor in a Private Trust Deed is acting like a bank by extending money to a borrower, while securing those funds with real estate of greater value. As with a real estate loan from a bank, the borrower signs a *promissory note* promising to repay the principal of the loan in addition to agreed upon monthly payments corresponding to the interest rate and other terms of the loan. Also, as with a real estate loan from a bank, the promissory note is *secured* to the property, usually by a *trust deed* that is publicly recorded. Doing the above effectively secures the investor's interest in the property in the same way that banks secure theirs.

Why would the borrower want or need to borrow money privately instead of borrowing it from a bank? Usually, the borrower's motivation is one or more of: speed, simplified application process, short term/bridge nature of the required funds, small loan size, turned down by the bank. A healthy market exists for these types of funds in "good" markets and in "bad" ones alike.

One of the measures of risk of a real estate loan of any kind is the loan amount relative to the value of the piece of real estate that the loan is secured against. This is

referred to as the loan-to-value or LTV. LTVs vary greatly by lender, property type and other factors, but basically, the more “unusual” a property and/or situation is, the lower the maximum LTV that would likely be offered by an investor or lender. Given the same set of factors as above, a lower LTV implies a more secure investment from the point of view of the investor or bank. Thus a loan of 65% of the value of a single family home is more secure than a loan of 90% on that same property. This is where the private trust deed shines. Typical LTVs on single family homes for private trust deeds would be up to 65% of value, whereas a loan on the same property arranged by a bank might be up to 80 to 100% of value. Measured this way, the loan invested in by the investor would be more secure than the bank’s.

Loans secured by real estate have priority. Typically, a piece of real estate could have a loan in 1st position. In addition, it might also have a loan in 2nd or 3rd position as well. The loan in 1st position is more secure and usually earns a lower interest rate than the 2nd or 3rd lien because there is less risk of loss of interest or principal in the event of foreclosure. Depending on the method of foreclosure, the nature of the loan, the circumstances of origination, and the value of the property, the investor may or may not be able to recover his entire investment. In the event of foreclosure, *senior liens*: e.g. government taxes and 1st liens are paid first. Only after these have been paid, are *junior liens*, e.g. 2nd and 3rd liens, paid. The foreclosure process can be quite complicated and a thorough discussion is outside the scope of this article. Suffice to say that 1st position liens up to 65% LTV on single family homes for example, are common practice in the industry and relatively safe from loss even in the event of foreclosure. Higher LTVs, junior loans, and more risky property types increase the risk of loss to the investor.

For most investors, investing in private trust deeds works as follows: the investor’s broker identifies opportunities suitable for funding by his investor and presents the relevant information to the investor for review. The investor then deposits the required funds (or a portion of such funds) in escrow where they are used to fund the real estate transaction, detailed in a promissory note and secured by a trust deed to the subject piece of real estate. The investor then receives monthly payments based upon the agreed upon interest rate, loan amount and other terms of the note. These payments are often managed by a 3rd party provider that may take care of the foreclosure process if it becomes necessary. After the payoff of the note by the borrower within the defined period, often 1 to 3 years, the investor is free to re-invest the principal in another private trust deed opportunity.

This article is an updated version of an article written by Solomon Gorlick that appeared in the San Francisco Examiner on Friday December 23, 2005. Solomon Gorlick is a licensed Real Estate Broker in the State of California and provides private financing and investments secured by real estate from Red Tower Funding, a division of Tri-Bay Financial Group, Inc. in San Francisco, California. Solomon maintains a newsletter that discusses issues in real estate investment and finance and holds periodic seminars discussing related issues. He can be reached at 415-377-1284 and by email at: Solomon@RedTowerFunding.com. © 2005 by Solomon Gorlick. All rights reserved.