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Investment Newsletter – December 2010

Even though we are more than two years into the housing downturn, it is likely that we have another three years to go before housing markets get back to normal. This month's newsletter looks at how investors can profit from the banks' mistakes.

Investing in Foreclosures

Based on government reporting for the third quarter, the rate of foreclosures exceeds 850,000 per year. Many of these homes end up in poor condition by the time of the foreclosure auction, and winning bidders at auctions must make immediate cash payment in full. Thus it falls to investors with cash to buy and fix up foreclosure auction homes for resale to end users. Such investors require significant discounts to compensate them for their time, their capital, and the risks of buying foreclosures. As I will show, the average profits on individual houses are very high - but probably best captured by investing in a private fund specializing in foreclosure flipping.

The economics of investing in foreclosures are driven by four key operational variables:

1) Buying at a discount to market value.
2) Doing renovations that add value over their cost and/or speed the sales process.
3) Selling at market value or close to it.
4) Completing the process and repeating it quickly to maximize returns on capital.

We'll use data available from www.foreclosureradar.com, along with some private investment fund data, to illustrate the economics of the business.

Properties sold to investors at foreclosure auctions will generally sell for 20-30% below market value - as estimated by an automated appraisal. (An automated appraisal applies a formula to public information – which may give different results compared to a professional appraisal of the house's actual condition). In Sacramento County California, for example, the average discount in November 2010 was 27.2%. In November, auction notices were filed for 634 houses valued between $100,000 and $200,000 in Sacramento.

Based on these statistics, professional investors can buy a $200,000 house at a 25% discount, paying $150,000 at the auction, and they can do this frequently.

The goal of renovation expenditures is to put the property in move-in condition and to give it an up-to-date look and thereby speed sales. The work may include paint, roof repairs or replacement, basic landscaping, repair of termite damage, repair of other inspection report items, remodels of kitchen and bathroom, new floor coverings, and new interior doors. An investment fund doing this type of investing in volume spends, on average, about 16% of purchase price on renovation. For our example house purchased for $150,000, that would come to $24,000. Such work will take 2 weeks. To keep things simple we assume that this expenditure increases value just enough to cover the costs but that it speeds up resale so that the house sells for renovated value within 60 days of completion of the work.

The above schedule for buying, rehabilitating, and selling, returns the invested capital plus profits every 74 days. According to ForeclosueRadar.com, the average time for an investor to resell a foreclosed property in Sacramento County was 148 days as of November 2010. Thus we are assuming that the renovation work cuts the hold time in half (as opposed to increasing dollar profits). This timeline is in line with past results for funds.

When the property is sold, the proceeds are reduced by a sales commission of 6%, plus closing costs. For our calculations, closing costs include prorated property taxes and insurance, in addition to title insurance and escrow fees. We will use a gross selling price equal to the market value at acquisition plus the renovation costs. In our example this comes to $224,000. The sales commission will be $13,440. The average title and escrow fees in Sacramento are $1,451 according to BankRate.com. Prorating insurance and property tax for 74 days adds another $549. Thus net sales proceeds will be $208,560.

Putting it all together, the investment of $174,000 is outstanding for 74 days and earns a profit of $34,560. This is a 19.9% cash on cash return; which works out to an annualized rate of 98%. Note, however, that we have not accounted for the cost of managing this operation. Still, it's clear that the numbers work if the business is run at sufficient scale to achieve reasonable efficiency.

Now, let's take a look what is involved in operating a foreclosure flipping business. There are five main tasks that must be managed to minimize costs and risks:

1) Performing due diligence – investigating the property.
2) Bidding enough to win but low enough to guarantee a good profit.
3) Moving out current residents quickly and at minimum cost.
4) Performing the profit maximizing amount of rehabilitation work quickly.
5) Selling quickly at a price close to market value.

Due diligence means gathering and evaluating the available facts before the auction. The auction will wipe out a 2nd mortgage or any other lien or encumbrance that was recorded after the recording of the mortgage being foreclosed. It will not eliminate unpaid property taxes. Therefore the most important fact to ascertain is the amount of any liabilities that will come attached to the property. A preliminary title report should show these, but, since no title insurance is available on an auction sale, there will be some chance of surprise liabilities. Public records will also show the number of bedrooms and square footage of the house, as well as the lot size. Most likely the property cannot be entered but someone needs to visit to check the exterior condition and determine if the house is occupied. A visit also helps assess the neighborhood and thus the value of the house and ease of sale.

The starting point for bidding is an analysis of the likely market value of the property in its current condition. The relevant data for this includes comparable sales, current listing prices for similar houses, and days of sales in the listing inventory. Automated appraisals may also be used, but should be adjusted according to the apparent condition of the house. The maximum amount for bidding purposes is derived from the estimated market value by subtracting the attached liabilities, expected selling costs, and the target profit appropriate for the risk of buying at auction.

Since return on capital depends on how long it's tied up in the property, the smart thing to do is to pay the current occupants to leave quickly. Rather than spending 30 days to do a legal eviction, the investor should pay moving expenses of the occupant - conditional on a quick move out. For example, $1,500 could be offered to entice the occupants to leave within 7 days. Helping them find a rental nearby may also speed the process.

In order for renovations to proceed promptly, the investor must move quickly to inspect and schedule only the work that will be compensated for at sale. This requires ongoing relationships with local contractors and accurate estimation of costs and values of improvements. A high volume business motivates contractors to prioritize investors' projects.

Likewise, ongoing relationships with local realtors are important. Concentrating listings with a few brokers will encourage them to prioritize an investor's sales and keeps local market information flowing. Given the value of speed in turning over properties bought without debt, the sales price should be set low enough to generate offers in the first two weeks (i.e. slightly below value).

Given that the increased foreclosure activity has been going on for quite a long time and most investors are aware of the opportunities, it would seem that competition for deals would drive down the returns. According to comments from the funds competing in this business, it has gotten much more competitive but they are still maintaining pricing discipline. The volume of houses being foreclosed is still large relative to the amount of expertise available in local markets to execute transactions. In California alone, 39,423 houses were purchased at auction by third parties over the last twelve months at an average price of $265,000. That comes to over $10 billion of total purchases – enough to soak up at least $2 billion in investment capital (assuming five turn-arounds per year).

The business involves a lot of hands-on expertise and labor. It also requires that the decision makers have very strong incentives to earn profits on every deal. This is not well suited to institutional investment, but is ideal for local entrepreneurial investors. However, players in this market need to do significant volume to achieve cost economies and to diversify purchases enough to withstand the risks of buying losing deals. Although there is plenty of demand and lots of foreclosures available, the right sized operators are very limited in their capacity; that should keep profits relatively high. The foreclosure funds that have raised enough capital to keep their people busy are working efficiently and are able to outbid local individuals for the deals they want. The managers of these funds can generate substantial returns and, since it is their expertise rather than capital that is in short supply, they tend to take a substantial amount of the profits for themselves in the form of fees and return sharing.

Despite the high fees of the foreclosure funds, investing via these vehicles makes sense for individual investors with enough capital to be able to risk $200,000 on a single fund. There are a wide variety of funds and investors need to carefully evaluate risks, potential returns, and the legal structure of the funds. The economics presented above showed that the annual rate of return on a single deal in isolation would be 98% before taking into account any management costs or fund fees. Another factor that will drag down returns is the fact that a fund will always have some idle cash sitting around while it’s searching for new deals. Taking all this into account I estimated net returns at 28% on one particular fund whose prospectus I reviewed. This is based on a continuation of the current pricing environment but an extra 4 weeks between investments. Of course there are risks.

The risks of investing in a foreclosure fund are many but the main categories are investment execution risk and what I’ll call legal structure risk. There are also some tax risks which I’ll touch on briefly later.

Investment execution risk refers to the possibility that the fund managers may bid too high or spend too much on renovation and thereby incur a loss at sale. Since the time for turnaround plays a large part in returns for investors, delays in completing renovations or sales also constitute significant execution risks. To evaluate such risks we must look at the market, the past record of the manager and the financial incentives of the fund. Currently my assessment is that market conditions are very favorable for this type of investment and may even get better as banks work through their backlog of foreclosures. Each fund is different but generally they have all started out using their own capital and can show a good record on past deals. If managers are paid a significant percentage of profits, it is likely they will put in the effort to repeat their past successes. Investors should also consider the size of the fund. Ideally you want a fund that has enough capital to buy 5 houses per week so as to have enough volume to keep costs down and to diversify the risk of bad bids. This implies that the fund will need at least $10 million in capital.

The most important risk to assess for funds relates to their legal structure. The questions that must be answered are:

1) When will the money come back to the investor?
2) What controls are in place to protect against diversion of funds?
3) Are the fund managers' incentives aligned with shareholders?
4) What protections exist against conflicts of interest and related party transactions?
5) What are shareholders' rights with regard to replacing managers?
6) How much leverage can the fund employ and at what cost?
7) What other classes of securities will the fund issue if any and what are the legal restrictions on changes to the rights of security holders?

These questions will be answered by a thorough review of the fund's offering prospectus, its operating agreement, and other governing legal documents. Investors will need to spend some money for reviews by legal counsel as well as their financial advisor to ensure that risks are understood.

The tax risk mentioned earlier relates to whether the fund is subject to income tax. Such investment funds will be legally incorporated as limited liability companies (LLC) electing partnership taxation. This means that each investor will report their share of the income of the fund whether it is distributed or not. Thus, an investor could end up with tax liabilities not covered by cash payments from the fund and thus be forced to commit more funds than originally intended. Conversely, another tax risk is the possibility that the Internal Revenue Service could rule that the LLC constitutes a publicly traded partnership (PTP) and therefore subject to tax as a corporation. Such a ruling would drastically alter the economics of a fund. Although this is unlikely, the fund should specify how it will mitigate such risk.

Ultimately an investor must evaluate the expertise, character and track records of the individuals who are sponsoring and managing the fund. Regardless of legalities, the right kind of people will do the right thing where others may not. For any who are interested in evaluating investments in foreclosure funds, Berkeley Investment Advisors would like to help you do your homework to pick the best way to invest in this lucrative corner of the real estate market.

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