# Why Commercial Second Mortgages Come First

## Part I

*by Sándor Lau*

*Investing* in residential or commercial "junior" (second lien position) real estate notes can give tremendous advantages to those investors who are willing to understand them and to put in the effort and patience to collect on them. Some of those advantages include:

**Discount**: Notes usually sell for a discount from the full unpaid principal balance. Junior notes usually sell at an even greater discount. Defaulted junior notes sell at some of the greatest discounts.

**Diversification**: Larger discounts and smaller balances than first mortgages mean that the price per note for seconds is typically lower than for firsts. Lower prices give investors the advantage of being able to diversify their portfolios across more assets in more georgraphical markets — thus putting more eggs in many different baskets.

**Appreciation**: My dream residential note is a $50,000 second mortgage on a $500,000 home in an urban or suburban area in a nonjudicial foreclosure state where the borrowers are current on the first mortgage. Assuming uniform appreciation of 5%, that $500,000 house goes up $25,000 a year, while a $50,000 home goes up only $2,500 a year.

**Principal Paydown**: Borrowers paying their first mortgage every month are reducing the principal balance of their note, increasing the equity securing the second note. The longer they pay, the more the note amortizes down and more of their monthly payment goes toward principal.

*Market prices for many residential seconds, even defaulted ones, are now quite high.*

**Property Preservation**: Whether or not borrowers are paying their first mortgage, as long as there is a servicer managing the first note, that servicer is making sure taxes, liens and insurance are being paid. (Servicers require the lienholder to advance the funds.)

**Borrower Motivation**: Borrowers who are paying their first mortgage are also very likely to have a job or income stream. They pay the first mortgage because they enjoy living there (or collecting rent from their tenants). Their payment history as revealed by their credit report is the quickest way to see their level of motivation. If they have income and like living there, they are likely to be more motivated to want to pay their second mortgage.

I began note investing in the residential second mortgage space, but market prices for second notes, even defaulted ones, are now often higher than I'm comfortable paying. No one wins arguing with reality. You can try to change others, but it's much easier to change yourself.

Looking for an additional investing niche, I have started investing in commercial second mortgages. They afford investors most of the same advantages as residential notes — and a few more.

**Commercial Mortgage Advantages**

**No FDCPA**: The Fair Debt Collection Practices Act (FDCPA) governs collection of consumer debt and places severe restrictions and penalties on collectors who break it. I'm not a lawyer, accountant, or pro wrestler. If you want advice in any of those areas, please seek it from a qualified professional, but here's what the NOLO Legal Encyclopedia says: "The FDCPA only applies to consumer debts incurred for personal or household expenses. It does not apply to corporate or other business debts."

**High-Value Properties**: Commercial properties are often more valuable than average homes. If a $5,000,000 apartment complex, shopping center, medical building, office, self-storage facility or mobile home park appreciates 5%, it goes up $250,000.

**Income-Generating Properties**: Most homeowners only consider one option for generating revenue to pay their obligations — employment. Many homeowners are also perfectly

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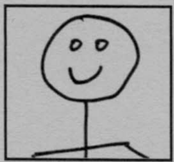

# 5 Non-Performing Note Deals With Exit Strategies

*The author is one of the most experienced investors in non-performing notes and wishes to remain anonymous.*

To give you a feel for how this works, here are some transactions we've done:

**Case Study #1: Memphis, TN (REO Exit)**
Initial investment: $500 for a $32,833 1st mortgage
Net profit after expenses: $5,600
Total hold time: about 150 days

I bought a non-performing note secured by a house in Memphis, Tennessee, for $500... yes, $500! (I really like buying lower-balance notes because I don't risk as much money on a single investment, and the payoffs can be excellent—and for beginners, this is a great way to get started without much cash.)

I soon found out that the son of the borrower was living in the house, and we did a $1,000 "cash-for-deed" deal with him that left the house vacant and in my possession.

I immediately listed the house for sale, and in less than 60 days the house sold for $9,000, netting just over $8,200 in proceeds: A $5,600 profit on a $500 note.

**Case Study #2: Cave City, KY (Re-fi Exit)**
Initial investment: $1,200 for a $12,000 2nd mortgage
Total profit after expenses: $11,200
Total hold time: about 60 days

I purchased this 2nd position note for $1,200 on an owner-occupied house in Cave City, Kentucky. The unpaid balance of the note was $12,000, the balance of the 1st mortgage was about $15,000, and the house was worth about $35,000.

Since it was the holidays, I didn't do anything with this other than than inform the borrower that I was the new investor on the note.

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capable of increasing their income by renting out rooms or space on Airbnb or driving for Uber or Lyft if they want to, but many prefer not to. Investors who own commercial property are already entrepreneurial. That's why they bought the property in the first place, and if they are motivated, they can probably find a way to increase income from the property.

**Bigger Discounts**: Very few investors will touch the most plain vanilla second mortgages — those on single family homes. Even fewer will consider commercial seconds. Thus, commercial seconds sell for less: the law of supply and demand.

**Shorter Terms**: Lending money is inherently risky, because the borrowers get what they want up front, and all at once, in exchange for a promise to consistently make their payment every month in the future. Every month is a new risk in that the borrower may break their promise. You can increase your return by increasing the velocity of your money — buying at a discount and getting a full payoff in the shortest time possible. Most commercial notes amortize on a shorter schedule than residential notes, meaning the proportion of the first mortgage payment going to principal starts higher and increases faster than in most 30-year residential notes.

**Rational Borrowers**: Most people make the majority of their decisions based on their emotions rather than logic. And many homeowners decide whether to pay their debts based on whether it makes them feel good. Business owners are more likely to be more rational and acknowledge their responsibility to pay their debts.

**Next month: The unique challenges of second notes on commercial property.**

*Sándor Lau is the founder of Noted Financial and has been investing in junior notes and speaking at the Paper Source Note Symposium since 2013. His Paper Source presentation videos and many others on how to live richly are all free at* **YouTube.com/Sándorlau**. *He would be happy to quote a price for your junior notes secured by residential or commercial real estate. And he is looking for a bookkeeper.*
**info@notedfinancial.com**
**NotedNoteBuyers.com**