Why Commercial Second Mortgages Come First

Part II: The Pitfalls

by Sándor Lau

My previous article (July, 2018 PAPER SOURCE JOURNAL) highlighted the advantages of investing in commercial second mortgages. All investing carries risk, but as my mentor Gordon Moss likes to say, "there are no bad notes, only bad prices."

By investing in junior commercial notes, you can price according to your risk tolerance by taking into account some of these unique challenges.

Rational Borrowers: Negotiating with a rational person may seem like a great idea if you have any experience dealing with irrational homeowners, but it can be a double-edged sword. A borrower making an unemotional business decision about their debt may decide it is in their best interest to walk away or file bankruptcy. If you were in financial trouble and had to choose between getting your home or your investment property foreclosed on, which mortgage would you stop paying?

Unknown First Mortgage: If the borrower personally signed for the first mortgage, it may be on their credit report. And it may not. Commercial notes are often not reported on traditional credit reports. Without knowing the balance of the first mortgage, how will you know how much equity secures the second? The note seller may not have written authorization or access to information about the first mortgage.

It could be hard to collect rent from a travel agency or video store!

You can ask, but without this information from credit or the seller, your best source of data may be checking title to see what the balance of the first mortgage was at the time of origination and whether the first lender has initiated foreclosure. Also check Public Access to Court Electronic Records (PACER) to see whether the business owner personally, or the business itself, has filed bankruptcy and if the first or second notes were included in that bankruptcy.

Taxes, Insurance, Liens: Commercial first mortgages are less likely to escrow tax and insurance payments along with principal and interest and are more likely to leave that responsibility with the property owner. The first mortgage may or may not actively monitor for other liens against the property.

We bought a note that was two years behind on taxes, and there was nothing on public record showing the first mortgage was doing anything about it. We insisted the seller convince the borrower to bring their taxes current. The borrower brought only one year of taxes current, so we lowered our purchase price in exchange for taking on this problem ourselves.

Difficult Valuation: Even if you can find a commercial property listed on Zillow, their valuation is likely to be very wrong. You can use the tax value, but in many counties the assessor's value differs considerably from market value. Unlike residential properties whose value is primarily determined by the values of comparable nearby properties, commercial property value is determined much more by income. It may be very difficult for you to learn exactly how much rent is coming in. A commercial Broker's Price Opinion (BPO) can take weeks and cost hundreds of dollars. "There are no bad notes, only bad prices."

Changing Value: Since value is determined by property revenue, it is determined in part by tenants paying their leases, which is in part determined by the quality of property management. As a note holder, you have almost no say in who the tenants are or how the property is managed. Tenants could stop paying or the manager could underperform at any time, not only affecting immediate cash flow, but also market value.

Macroeconomic changes can also affect your property value. Small, local retail shops are threatened by online shopping and big box stores. Medical costs continue to increase with no end in sight. These days it could be hard to collect rent from a travel agency or video store!

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"Cardiac" Transactions

by Jeff Armstrong

I could have called this article "why we do not do transactions where the note holder needs to close next week," OR "costly mistakes that could be made in a rush." But this title is catchier!

When you find that "dream note" to purchase you might feel a flush in your face and have an inability to do anything except look at those beautiful numbers (yield, cents on the dollar, ITV, etc). If that sounds like you, then you likely have note fever. When you allow your emotions to drive you and you rush through due diligence to close on a good deal OR when a note seller wants to close quickly (or they won't sell you the note) and rush you because they need the money yesterday, I call these "cardiac transactions." While there is nothing wrong with excitement about your potential note purchase, note fever often comes with the side effect of rushing through your due diligence and potentially overlooking routine steps along the way.

Do you suffer from the potentially financially fatal disease called Note Fever? Here's how to cure it.

In these cases, your dream note can turn into a nightmare after you buy it. Knowing what to consider *before* closing the transaction is crucial in seeing your dream note materialize as you had planned. Some of these note buyer thoughts may seem a bit out there, until, that is, they happen to you. These are some of the worst mistakes people realize they made *after* buying a note:

Skipping A Drive-by Appraisal

Before closing on a note purchase, a buyer is responsible for getting a professional drive-by appraisal to get a current valuation of the secured property. Those who skip an appraisal can find themselves facing issues so major that they would have been deal breakers had they been known. But unfortunately, after closing without an appraisal, those problems become all yours.

"How bad can it be?" you might ask. Problem properties often don't show their issues on the outside. But that doesn't mean they aren't there. In fact, speaking from my note buying experience and horror stories I have heard, some of the worst property issues you can imagine aren't even exposed for your eye to see, including:

Chinese drywall: It looks like normal drywall but it causes health issues and metal corrosion.

Asbestos: This is a highly toxic mineral built into the fabric of many homes. Many homes and apartments built before 1980 often are filled with asbestos.

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You can argue with reality if you like. You can make your best effort to change it. Or you can change yourself, open your mind to new ideas, and build your future by adapting.

Investing in unknowns requires what my first real estate teacher called intestinal fortitude. Success in the notes space is determined by your ability to make the right decisions about calculated risks with limited information in a short time. You're not always going to be right. You just need to be right most of the time and have the patience to see your decisions through.

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.** *Sándor 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.*

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