State of the Markets - Real Estate Recession and Creative Financing Opportunities (Part 1) - Eddie Speed: Ep #421

Full Episode Transcript

With Your Host

Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

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Welcome to the Dentist Freedom Blueprint, a podcast about freedom—freedom from expectations of society and the traditional path to success that has been ingrained in us from our early years, I'm joined by mavericks, renegades, and non-conformers to discuss an anti-traditional path to financial freedom, freedom of time, relationships, health, and ultimately freedom of purpose. My name is Dr. David Phelps. Let's get started.

David Phelps: Hi everyone, David here. This week I've broken up a conversation I had with my good friend, Mr. Eddie Speed, the Founder and CEO of Colonial Funding Group and also NoteSchool.

Eddie and I go back over 40 years, but we started in real estate investing at about the same time in 1980, and we have coursed together through these decades.

The conversation we had was where are we in the market today? What's going on with the mortgage industry, applications, housing, overall real estate. Eddie's got a multitude of areas that he can bring expertise to the table, and he gives us a lot of relevant data so we can make decisions going forward.

This week, you'll hear the first part of the conversation, next week, we'll pick it up with the second part where we'll start with the loan origination saga, how the underwriting for deal flow and investments has changed. Who are you investing with? The promoter or the operator? That's a big one.

We'll talk about warning signs and also opportunities ahead, and the fact that who you know is very important. Enjoy week one with Mr. Eddie Speed, focusing on the cash flow.

Good day everyone, this is Dr. David Phelps of the Freedom Founders Mastermind community and the Dentist Freedom Blueprint Podcast.

Hey, today, I'm going to have a fun conversation and probably very, very relevant to where we are in the market cycle with my good friend Mr. Eddie Speed. Eddie, how are you doing today?

Eddie Speed: I'm good, Dr. Phelps, how are you?

David Phelps: It's always great to see you. Eddie, you often say to people that you converse with, and we'll get into a little bit more of your background and what you do, but you are an educator, if not a boots on the ground, fingers in the pulse of the real estate market, we're going to get into the depth of that today.

But you often say to people, "Not my first rodeo." And that's a cliche that a lot of people say, but you actually were in the rodeo. I could say that, but I was never in the rodeo. My rodeo is not a real rodeo, my rodeo's different than yours.

So, let me give a little bit of background and this will help people get where we're going. Eddie, actually, grew up around horses but in 1980, he learned that there's more wealth to be built with a pencil than a rope.

That's when his father-in-law, a pioneer and seller finance notes taught Eddie the ropes of the note business (we'll get into what that is, we'll define that). Eddie has been perfecting his craft

ever since introducing creative innovations that have changed the way note investing is done.

He's the nation's most experienced note buyer, he has closed over 50,000 note deals. He launched NoteSchool in 2000, where anyone can learn the art of creative financing for performing and non-performing discounted mortgage notes.

He's the Owner and President of Colonial Funding Group, which acquires and brokers discounted real estate secured notes, and he's the principal in a family of private equity funds that acquire bulk note portfolios.

We'll put the links to where people can contact you, Eddie, but you're on Facebook with the NoteSchool and your website, noteschool.com. We'll put all that in the notes for folks.

But let's go back a little bit, 1988, when we reflected back, when you and I have talked before, that was when I bought my first rental investment property. Now, I bought a property and that's what we call equity ownership.

And that's usually the way most people think about investing in real estate. Particularly the people who want to go out and do it themselves. You buy rental properties, that's tried and true and like everything in life, there’s pros and cons to that.

If you get into it, if you get systematized, if you can find good management or you do it yourself, there's a pathway to get there.

But you are one that fortunately early on in my career of investing and building my wealth outside of Wall Street on Main Street, which is what we're talking about here today, you turned

me onto the art of financing and how important and a whole other world of investing and creating wealth and cash flow, which is what really this is all about. It’s all about the cash flow.

We talk about growth and that's great but the cash flow that we're looking for and you taught me along with, again, thousands of others, the art of creative financing, and that's the route you took on.

You've never been so much of a person who really wanted to be a landlord. I guess you never had the thrill of riding and trying to rope tenants. I guess that wasn't part of your skillset there.

But there's a convergence or a complimentary action between equity and debt financing. In this case, we're talking about owning the debt.

Most people think about, well, when there's debt or financing I'm borrowing the money to buy a house or borrowing the money to buy a rental property or getting financing to buy business … that's a liability. We’re talking about here to be an investor in the debt.

And then the whole arena of today, what you and I and many others would call creative financing, is something that goes along with market cycles. And we're in a turn of the market cycle now where creative financing is coming back into play in a big time.

And of course, you've been through numerous cycles of this, you've seen it play out (again, not your first rodeo), you've seen it before, you know what's coming, you have a good sense of that.

So, I'm going to back off a little bit and let you give some definitions of what you do and maybe also give us a little bit of lay of the land as what you see in the general overall marketplace, then we'll get down to some specifics, and I know you brought a lot of good data for us today, Eddie. So, let me let you jump in and take it from there.

Eddie Speed: So, David, I started in the business … I was 20-years-old. So, you and I were young in that era when we were stumbling out there doing that, and probably had more willingness to take a chance than we did knowledge of what chance we were taking.

But it turned out okay. I got really lucky. My father-in-law was a true pioneer in the seller finance world, he was an old fireman. So, he was the millionaire next door fireman kind of guy.

And he had learned about seller financing, financing some of his rental properties. And then met up with a guy that became his partner, and they were buying seller finance notes. People were forced to seller finance in 1980 because of interest rates.

David Phelps: Well, let's take people back there. What were interest rates in 1980? I know what they were, you know what they were. But just to give people a sense because people think interest rates are all of a sudden, they're really high right now.

Eddie Speed: They were really about 18%, there may have been a period where they actually got up over 20, but they were really about 17, 18% interest. That's what cost to go get a mortgage at the bank, like a traditional 30-year FHA loan, boom, 18% interest.

And so, people were forced to carry seller financing because that's the only way you could make financing affordable. And so, that was the first use of seller financing where it became so widespread.

Now, seller financing's been around for centuries, it's not like it was just invented, but it became very widespread, and a lot of people did it. And we would then come in and buy those notes. We would let them cash out because people were getting payments over time and maybe they needed a lumpsum of cash.

David Phelps: So, let me back you up and make sure I've got this clear. So, what you were saying is back in that era when you and I got started and interest rates were as high as 18, maybe 20%, the inability of buyers to be able to go to the bank and get that mortgage for 18%, it wasn't viable, it didn't make sense.

So, you still have a marketplace where people want to, they need to sell a property. There's always reasons why people need to sell — job, locations, family issues, whatever they need to sell.

And traditionally, we think about will people go to the bank to get their financing, and then the seller gets cashed out, they get their equity and cash because the bank provides the financing.

So, you're talking about a time period in a market cycle when the affordability factor, the ability for buyers to obtain the financing wasn't viable and so now sellers, in order to get a transaction done to make the move that they want to make, that they would do seller financing, which means they would sell their equity on terms and carry back financing and receive

those payments just like the bank would receive, maybe they wanted cash but they couldn't get the cash.

So, next best thing was, well, we'll be the bank and we'll sell the property and get a down payment like a bank would and then we'll carry back the financing and so, now they're receiving payments like a bank.

But you're saying that you helped make a market for people who will carry that financing back, the sellers so that if they wanted to get a lumpsum of cash, which is what maybe some of them wanted or needed, they could do so, is that correct?

Eddie Speed: That’s it. We basically would buy those future cash flows at a discount and we'd pay cash today. Naturally, you'd buy them at a discount because …

David Phelps: Well, why do you say naturally?

Eddie Speed: Well, because it's present value of future dollars. So, a question might be, David, if I agreed to pay you (we'll use a big enough number that actually makes somebody think) 1,000 bucks.

If I agreed to pay you 1,000 bucks today or $2,000 in 10 years, now that's 50 cents on the dollar, which one would you take? And even you, Dr. Phelps would've to think about that for a minute.

David Phelps: Well, if it's $2,000, it sounds great, but then I'm thinking 10 years, the lost opportunity where I could take that 1,000 a day and probably through some business or some other transactions or just investing it wisely, I could probably in 10

years, do better than just doubling it, so that's what I'm thinking. Is that a correct way to look at it?

Eddie Speed: If $1,000 dollars a day mathematically probably would be better because it's not … to wait 10 years, the return on the waiting, the cost of the money. If you just think in terms of, if you bought a CD today for 1,000 bucks and in 10 years, it matured and it's worth 2,000, the interest rate on that CD would not be that much. Call it maybe 5.5 % interest.

So, mathematically, that's what you and I know how to do, is just calculate that number. But when you think about it, like would somebody really take 50% of the money now in cash versus 100% percent of the money later? And the answer is, well, I bought 50,000 notes fpr people willing to do that.

David Phelps: There's always a need and a motivation. And of course, we couldn't get into it today, but there's a lot of ways to slice and dice that so that you can give them a certain amount of cash now to solve a problem and reduce the amount of the discount and that kind of thing, that's the fun of this.

And again, we can't get it today, but that's what you teach and show. And what I want people to understand from you (which we'll get into a little bit more as we talk today) is how creative financing, whether your buyer or seller can make the transactions possible in a market today where things are being slowed down tremendously. And I think we're going to see more of that.

So, let's pull it back up a little bit for a second, because you're so dialed in. You have to be dialed into what's going on in the marketplace, in real estate, the overall economy.

Let's talk about the overall economy or as it pertains to real estate and give us some data points because everybody wants to know, well, where's this going? Are we going into a recession?

We're seeing the tipping point, where in certain markets, housing equity values, commercial is coming down. We're hearing about rents are softening, again, every market's different. Give us some data points because you're very plugged into this.

Eddie Speed: I think first of all, we like it. My executive team has been deeply involved in — they've worked for big box shops. They've done billions of dollars' worth of business. I've been a smaller operator, I've done hundreds of millions, which is a lot for my business, the most, I think probably around of any independent operator.

But they've done billions because they work for big institutions and so, they're used to studying this stuff and we really like it and have gotten into it. And then I have some friends that work for the big institutions now, I have a very close friend that has about 30 billion under management.

And so, I don't go to Facebook and find out what interest rates are going to do, I try to call my friends that pay millions of dollars for analytics. That may be a better answer.

But the bottom line is, I think we've reached a point, and this is a national story, so David, that may not fit exactly the market that somebody's living in. We've reached a real estate recession, I think is a fair statement.

Now, there's micro markets that may not be true and it may not become true. But if you look at what we call Denver and West, it's definitely been a big truth.

And I think people — you and I are in Dallas-Fort Worth and we're thinking, “Oh, we're insulated” or “We're in Atlanta, we're insulated.” My answer is statistics say that's not true.

So, the bottom line is this: we had a real estate market that was driven by crazy factors. Honestly, David, I don't think it was a real market.

David Phelps: No, I agree not at all. There’s so many factors we've had historically … for thousands of years, historically, low interest rates in the last decade, cheap money where leverage, the ability to go out and leverage it very low interest rates has allowed people to pour money into equities all across the board.

Well, stock market equities, real estate equities, pushing the prices up, so we've had that benefit. And of course, we've had the monetary policy of the Federal Reserve again, coming out 2008 and stimulus there.

And the quantitative easing that they've had in the bond market, well, that just got ramped up on steroids in the last three years going back to when COVID started. And so, now, you've got this flush of money in place, low interest rates and well, what could go wrong there?

Eddie Speed: You had low interest rates and a lack of inventory. People didn't want to sell their house because they didn't want them walking through it or they were scared to do something different. They didn't know what was going to happen next.

Then all of a sudden, house started going up in value and people had nowhere to go. My wife and I, perfect situation, we put our house on the market and then we started really digging around about where we were going to move and then all of a sudden, she said, “Well, I don't want to go live in half the house I'm living in now for two years just because we're ‘in the business’ and we try to make good personal decisions.”

So, we all kind of live in some of that. So, the answer is when rates started going up, then the unaffordability factor started taking a grip, and it was just as simple as rates going up, that's what tripped the switch.

And rates have doubled in a year. We were at about three and now, we're at about six. Now David, that's what you signed the note and it says that's not the effective interest rate. The APR, which is the effective interest rate is more about 7 to 7.5.

So, now, we're at an affordability factor, now seven and a half percent interest, David is about normal over a last 40-year period. So, that's average, that's normal. And there's statistics and all … everything I'm saying, if I've given you a number, I didn't just make it up, we can support it with multiple data sources.

David Phelps: That's a normal interest rate or you said average over the four years, I think it was 7.78% was the average. So, we're in that normal period. The problem is there's always a lag effect in the equity market in terms of the time it takes for values to come into some kind of equilibrium with that new normal interest rate.

And so, there's a discrepancy and say, well 7.5, 7% effective rate, that's pretty normal, what's the problem? Well, because

we've had this big boost in asset prices, and they haven't come down. So, the affordability factor is there until something give — either rates go back down some or values come down.

But again, to your point, people can't afford to transact and go to the bank and get mortgages to buy houses that they would've assumed that they wanted to purchase.

Eddie Speed: So, Mortgage Bankers Association and National Association of Realtors and Fannie Mae, Freddie Mac, all these different sources, when you look at their numbers, they're all fairly close to the same.

And mortgage banker says, okay, we have an affordability factor today buying a house because values went up and now rates have gone up, and now what the effective payment is — we have an affordability factor that we haven't had since … since it's been worse, David, it was 1985, that's the truth.

And so, it goes back to this: it goes back to the story in the eighties. Now David, you could either sell your house for this price and carry owner financing. Or you can sell your house for this price and get cash discount, because it all equates to the same thing. I could go borrow money at the bank at 18%, but if you'll loan it to me at 10, I can pay you more money.

David Phelps: Exactly.

Eddie Speed: That's what furniture companies do. It's the world concept and what's caused it is as simple as this. And of course, we see the Fed tapping the breaks on raising rates, but they've not stopped raising rates because of inflation, of course.

And the Fed rate, of course, is the rate that they charge to loan banks the money. It's not exactly tied to 30-year mortgage rates, but there is definitely a correlation. We see these little dips in the market, where mortgage rates will go down a little bit and you and I can't open Facebook, that rates drop for a quarter of a point and everybody acts like it's over, it's all good again …

David Phelps: That's what the market and everybody hopes. I think we see so much of that right now. It's like people are saying, "Well, it is over, the Fed's going to take the foot off the accelerator on the interest rates and it's all going to go back to where it was."

And there's just too many variables out there and I'm never a pessimist, I'm a realist. You and I both know that being a realist means you look at what's out there and you're always hedging, we have to hedge. And I think that's what you're really good at, hedging.

Nobody knows exactly where the market's going to go. We don't know if something could cause really a great liquidity crisis, which again, could change everything. Well, what could that be? It could be anything, globally, it doesn't have to be something here in this country, it just could trigger it to happen. We just don't know.

But there's so many variables, and I think too, the thing we have to look at where things are different today than they were in 1980 is the sovereign debt this country has, we're at 31 trillion plus.

So, these movements of interest rates, people go, "Well, it's only a few interest rate points. You're talking about back in the eighties, you were up at 18, what's the big deal?"

The big deal is the relative increase in rates from a Fed funds rate of essentially zero back in March of last year to now, four and a half, probably going to five, maybe five and a quarter.

Well, that's a 500% increase. Put that against the debt that is being carried not just by our nation, by our government, but by corporations, the zombie companies out there that just have relied on the cheap interest rates to keep rolling their debt over and over on. And consumers, their debts' up.

We've got so many factors at play, and I know you're very good at looking at all those variables. I mean, that's what you and your team do, is you look at all these variables to assess where you sit in the marketplace.

But there's a lot going on here that one has to look at before you can prognosticate where you're going to position yourself in the market for what you do and what you invest in.

Eddie Speed: Mortgage interest rates, and think of just the consumer, the residential mortgage loan, lending people money to buy a house or maybe buy a rental. And we all think in terms of what the most prevalent lender out there are government-backed entities, what we call agency loans; Fannie Mae, Freddie Mac and Ginnie Mae — and Ginnie Mae of course, is FHA/VA.

So, those represent about 70% of all of the loans originated in that market, there are other loans that 30% represent. And typically, those are loans that don't qualify for these standards. in fact, there's a government name for them. It's called non-QM loans (non-qualified mortgages).

So, that's the subprime. But here's the thing, David: mid-January Fed comes along and the Fed being Fannie Mae,

Freddie Mac, the FHA hasn't taken this position yet, but they will. They've said, "You're not pricing loans at a safety level that's good for Fannie Mae and Freddie Mac relative to the market."

They call it long level pricing. So, they make an announcement, and they say, "We are going to adjust loan level pricing and it isn't adjusting down." And so, the truth of the matter is that we've been knowing that had to come, you and I have discussed this offline.

I've got friends that run big shops where they do make mortgages and they sell them into mortgage-backed securities. And they were selling these loans, David, at like 107, 108 cents at this time last year. They were selling them at that much money.

Now, all of a sudden, they're selling them for 100 cents, 101 cents. And so, the mortgage rates that they were writing on the loans, while we thought they were terrible because they were double what they were, truth of the matter is they weren't high enough.

So, when people get all excited because they opened the newspaper or they open Facebook and somebody's got some hot sports opinion about mortgage rates and stuff, the data doesn't take us to the conclusion that rates are going down.

People that make the billion-dollar bets, they're not betting that and that's basically where we are. So, I think Fannie Mae and Freddie Mac stepping in first of 2023 and really making that statement …

And guess when those rates are going to start being that loan level pricing, which they really control what you can originate the loan at. Even though you're the lender, you're going to move it through Fannie Mae, Freddie Mac, they have some control.

David Phelps: You have to follow guidelines if you're going to have any place to put your product.

Eddie Speed: Here's the thing, they're going to implement this — the announcement also said they're going to implement this during the buying season.

David Phelps: So, coming up here, what's that typically March …?

Eddie Speed: March through July or something like that.

David Phelps: So, this announcement will take place and actually hit the marketplace during that spring season coming up. So, do you sense that that's going to be priced in before then? Or is that just the situation where all of a sudden, you're going to see rates tick back up?

Eddie Speed: I think it's a little bit like the Fed cheer when they're like, “It's coming, it's coming.” And I think it's some of that. They know the market reacts seemingly better when they know it's coming.

So, I think they're going to make the adjustments accordingly and of course, underwriting is really tough. People don't realize this. We did a little extra data scraping, we scrape a lot of data every week.

I have a guy that works with us and he in fact used to work for a guy … Mr. Stack and he was kind of the analytics guy for him, and he was really good at analytics.

And this guy now works with us and has for several years and he's really good at this stuff. He's just one of these super smart guys, he gets up and reads mortgage underwriter for an hour every day to get his day started.

Eddie Speed: Now, that wouldn't be me, but he does do that. Seriously, he does. So, one of the things that we started really looking at is not only is there a price and credit, but there's a credit crunch, and we've talked about this on your show before, the mortgage availability index for the viruses at about 185 and that's just a measure they've developed.

Now, it's right about a 100 at end of the year at 103. So, call it — 45% of the people that could get a mortgage before the virus, can't get one now. But David, guess what this number has trended to over the last six months?

The amount of people that make a loan application versus the amount of people that gets accepted, the industry term for that is called the pull-through rate. How many make an application and how many close/50%.

David Phelps: In normal market conditions, that would be?

Eddie Speed: Call it 25, call it 20% of rejection rate.

David Phelps: Rejection rate.

Eddie Speed: Meaning 80%. So, not only is loan production down literally 70%, but now, half the files they work on won't close. Hard to make money on deals you can't close, right David?

David Phelps: Exactly. Go ahead.

Eddie Speed: So, this is all leading up to what we're saying, which is people, their income or the income that is allowed, that they can credit, and many other underwriting factors are causing all these people to do a loan application that finds out they've all wasted their time and it wouldn't close. And this then leads us into the big loan origination saga.

David Phelps: Alright, that concludes the first section of the conversation with Eddie Speed. Next week, we'll go to part two.

We'll talk about the alone origination saga, how underwriting has changed, who are you investing with? A promoter or an operator? And the warning signs ahead, but also the opportunities.

See you next week, enjoy the conversation then.

You've been listening to the Dentist Freedom Blueprint Podcast. If you're tired of trading time for dollars and you want to create more freedom in your life, I encourage you to visit my week blog, freedomfounders.com/blog. I post weekly hard-hitting videos about creating more freedom in your life. Check out my latest book on Amazon, *What's Your Next?: The Blueprint for Creating Your Freedom Lifestyle*, or visit freedomfounders.com to learn more about how we help high income earners create the freedom to buy back their time and create more impact.

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