State of the Markets - Real Estate Recession and Creative Financing Opportunities (Part 2) – Eddie Speed: Ep #422

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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, this is David, I'm back with week number two with my good friend, Mr. Eddie Speed. If you missed last week's conversation, go back and be sure to catch that episode because it'll tie together what we're talking about this week.

This week, the loan origination saga, how underwriting in investment deal flow has definitely changed. Are you investing with the promoter or the operator? Big, big difference here, you don't want to miss this part.

And also, what are the opportunities ahead? Why who you know is really more important than what you know. I'll see you on the backside. Take care.

Eddie Speed: 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: And is this playing out in a similar fashion in the commercial mortgage market? There's similar correlations there at this point, likely.

Eddie Speed: One of the things I had my guy do is to pull some data on commercial, and I'm going to pick on multi-family for a minute. It's not exclusively just multi-family, but definitely multi-family because Fannie Mae, Freddie Mac is involved in those loans on multi-family.

So, a year ago, you could borrow the money at 3 to 3.75. That was an institutional lender, that was a bank or a Fannie Freddie. On commercial, the loan to value was 80 to 90%. You could borrow 80 or 90% of the cost of the property.

Today, rates are five and a quarter to five and three quarters, and the loan to value is 75%. So, lenders have shortened their yard stick and how much money they're willing to loan, that's the bank loans.

Now, the non-institutional loans, the rates on that go way up. So, a year ago, they were at, call it mid fives to mid sevens. Today, the bottom is mid-sevens, and the top is 10 or higher.

David Phelps: And on those non-qualifying commercial loans is that for a borrower who has a lesser credit worthiness could apply and get a loan with a lesser down payment? Are those some of the factors that would have someone that would go for that?

Eddie Speed: 100%, and that doesn't make it a bad deal, but it's obviously a riskier loan. By the way, David, do you know what the loan to value is on those non-bank loans?

David Phelps: 65.

Eddie Speed: 65. And they were at 80 and 90.

David Phelps: So, let's translate this for our audience, and my audience are for the most part, are not active buyers of real estate. There are some that have rental houses and probably look at those today.

And there's a few in my group that maybe have looked at or have seen some smaller commercial. But for the most part, we have folks that are investing more passively limited partners in this respect.

What should they be looking at through the eyes of a sponsor? Someone who's out there still bringing deals to the table today. “Hey, I've got this multi-family deal or self-storage facility I'm taking down.”

Just run down some of the criteria through your eyes that you'd say, “Well, that's great Mr. Sponsor,” but what things would you want to look at a little more strongly to make sure that that sponsor is really underwritten well, because you know very well you've been in this game for many decades?

We get in a market cycle like we've had the last number of years where cheap money — and really, I can buy this asset really maybe on marginal cash flow because give it a little bit of time.

Maybe I do a few little things to make it better, but there's going to be someone that will buy it for more 18 months, two years out because rates stay the same, it’s just this over and over. Now, we're in a situation where that's not there.

So, if I'm going to put money with somebody, what do I as an investor need to make sure they are considering in their underwriting to a greater degree today than maybe they had to a year ago?

Eddie Speed: Well, I think the first thing is, are you putting money with a promoter or are you putting money with an operator?

David Phelps: So, two different things. So, you've got people that are capital raisers that will raise money for a sponsor and take a cut, and then they're out. And so, you're not really dealing with the person who's the operator. So, number one, what's your proximity to the actual real deal? Correct?

Eddie Speed: You and I see all these guys on social media all the time, many of which you and I have pretty significant knowledge of their thing, and you and I have been together more than once and smile and say, “He's a promoter,” versus somebody else that we refer to and go, no, “He's an operator.”

Meaning the operator is a guy that has lived through cycles, and he's measured things off, he's doing what you and I are discussing today. And savvy people aren't scared of their decisions. Even if things don't go well, they'll work their way through it, but they probably have calculated more risk than most.

David, a year ago, most every apartment deal out there (and this includes storage too), they were allowing value-add in your numbers. Value-add means you're not doing it yet, but you're going to. You haven't gotten it all rented up yet, but you're going to. You haven't raised the rents, but you're going to.

You and I had a long friend back a few years ago and he used to use a term “future speak.”

David Phelps: Yes.

Eddie Speed: You remember that?

David Phelps: Yeah, and that's exactly what we're talking about here.

Eddie Speed: That's future speak. It hadn't happened, but it's going to.

David Phelps: I'm going to do this and it's going to make the property more valuable, and we'll be able to sell it for this multiple and it's all going to be good.

Eddie Speed: I talk to guys that are commercial lenders or commercial lender brokers, and I'm talking to them a year ago and every deal they do has "value-add," baked in it. And they're borrowing money from the lender and the lender is like, "We know this is going to happen." Well, guess what's happened now, David?

David Phelps: Not now, right?

Eddie Speed: They've cut back on that, and I'm not saying every lender has cut it out completely, but they've drastically cut it back, and there are value buys out there. But let's be fair about it, every promoter in the world says, "This is a value-add, we're going to buy it and make it worth this."

Now, sometimes that's true and sometimes that's the good sales pitch. But the reality is that the commercial side — here's the biggest risk in commercial that's out there, David; their rates have also doubled.

So, the affordability factor for them is really big. I don't know any operator today that when I'm having a private conversation with them, they're admitting they've already slid back in value.

They go to sale, they're having to give concessions for rates. The more the rate goes up, the more your payment goes up, and if your payment goes up, then that means you have more of your income going to debt service. So, you can either lower the price or just make less money, and so, it's fairly easy math when you think about it like that.

And the reality is a lot of these promoters borrowed money where they could get lesser interest rate and a higher loan to value. Not Fannie Freddie, but other loans. And those loans have a feature to them that the lender put in there that was a compromise.

And it was a substantial compromise to loan that higher loan to value and to give a rate that's lower than maybe the normal rate, a starter rate, and that's called an ARM (Adjustable-Rate Mortgage).

So, let me give you a number, in the next 24 months (we verified this last night) 90 billion is going to reset, meaning that the rate is going to be adjusted.

David Phelps: So, what you're saying is that in order to make acquisition in some of these deals that operators are obtaining financing on adjustable rate, which means they can get a lower rate than a fixed rate today and likely get a higher loan to value more money from the bank based on the acquisition price to get into the deal, to make it still easier to get in the deal because the headwinds to get in the deal, now more money and higher and straight, it doesn't work.

So, these operators, some of them that are doing this are betting that they can add enough value and that when the rates adjust, reset, as you said — and you said that's going to happen in the next how many years?

Eddie Speed: Just the next 24 months.

David Phelps: 24 months, 90 billion. So, those that are in this period of time are fingers crossed trying to bet that their reset rate is not going to be significantly higher than what they're floating right now.

Depending upon the deal, they can only tolerate so much of an increase and if it goes beyond that, they blow up. I mean, how long can you carry something that's not producing the cash flow to cover debt service and all the other expenses involved with the property.

So, I think we both see that there's going to be some significant problems as that arises.

Eddie Speed: About this time last year, you and I are in a mastermind together, and I don't think you were necessarily in this room, but I think I told you about it. They break up and then people make their presentations. And a guy was making a presentation, he's a commercial lender.

And he was talking about the market and he's a big operator, he does a lot of deals and does for a lot of money. But anyway, he's talking about the market, and he was talking about these adjustables and stuff and I'm like, "Whoa, whoa, whoa, wait a minute."

And I kind of knew this already, I was just curious what he was going to say. And I said, "What percent of these loans do you think are adjustable?" And he said, "Ooh, at least 25%."

I said, "What happens when they underwrote those loans when rates were 3% and now, the rates are 7 or 6, whatever double call it." I said, "Now, when they rate adjust, and they underwrote the project to an income level that was way lower than what now the cost of money is."

And he said, “Well, they'll just sell the property. If they can't ReFi, they'll sell it.” I said, “What happens if everybody else tries to sell their property at the same time?”

David Phelps: That's right.

Eddie Speed: And he goes, “Well, I mean, there's just such a demand for it.” And I'm like, “A demand today?” Yeah.

So, this is looking over the horizon. Now, by the way, David, I know this sounds, pessimistic or whatever. Anybody that's deeply involved in commercial lending, there's nothing I'm saying that's a surprise. David and Eddie are not the only guys that know this.

This is a highly regarded standard and people are looking over the horizon going, there's a black cloud coming here in this space that has been really good for a really long time.

Now, that doesn't say you should never invest. What that says is you should invest with operators that also know these variables, and also have made calculations that says, “We've done a risk analysis here and we've acknowledged this risk, and this deal overrides that risk.”

David Phelps: Exactly.

Eddie Speed: That's an operator that does that. And so, I think more than ever right now … but the fact that you've made money with a promoter in the past has nothing to do with it, because to be honest with you, you could be a big dummy and do this for about five years, you couldn't go wrong.

David Phelps: You couldn't miss. Well, I'm glad you said that this is exactly what I'm seeing in the marketplace. We have our community of Freedom Founders and we educate to these levels so that our members can ask the right questions, and the education to become a sophisticated investor, it takes education.

That's what you do at NoteSchool, is you educate. So, when we go through these market changes, sophisticated investors can understand the movement and where we're going and how to underwrite whatever they're investing in, whether it's equity or debt, owning the notes.

This is the key, and so many people, Eddie, to your point, have ridden this last, call it 13 years and felt like there's no end to it. There's always going to be demand, there's always another buyer who will take me out of this deal.

But things are changing, the dynamics are changing and people are going to get hurt who don't understand what questions to ask, this is the big problem.

Let's talk about the opportunities, and this is where you and I both also go into a mini cycles, we understand the opportunities. The problem that most people have, whether you're a passive investor or you're an active operator, those don't have the experience of a full market cycle, is they don't know how to pivot or adjust their model.

You've gone through multiple model changes, you've seen the cycle, you've learned how to ride them just like you learned how to ride those bucking broncs back in the day, you had to learn how to ride them.

Well, same thing here, it's a cycle and specifically what you do, because we talked at the top of our discussion, the fact that you invest and you help your investors invest in debt, in note payments, receivables, both performing and non-performing.

Maybe touch a little bit on that because there's people that I think could definitely benefit from the education that you teach. Again, whether you're active investor or passive, understanding how all these dynamics work together will make you a more prudent investor.

So, give us a little bit of take on the opportunities and maybe more so in the debt side.

Eddie Speed: Well, this is my sixth real estate cycle since I've been doing it. It started in 1980 and if you count them out, this is now number six. If you want to call this a recycle or real estate recession or whatever. I've made far more money in the recessionary times than I ever had in the best of times.

Now, I've been lucky like everybody else, and just owned a piece of property in the last couple years, and it just went up in value. And you and I are seasoned enough just to laugh and know there's luck and there's skill.

And most people that property just went out of sight, it was pure luck, not like they could have forecasted that. And probably was a good time to take some money off the table and sell something, like the Wall Street world.

When the stock's that high and that high and whatever, it's like, well is it that hockey stick going to keep the same position going up or is it going to go the other direction?

So, I'm a note guy, so I buy performing notes, and so where would I find a performing note? We're in the space, is what we've been doing for years, the guy that runs our operation has done well over $3 billion in buying notes. So, he's done a lot of business, big institutions, he's been with us now a dozen years, so we're connected.

David Phelps: That's the big thing I want people to understand is you don't just go out into the market, you don't call your local realtor, you don't go to your local bank and say, “Hey, could I buy some loans? Could I buy some carryback?”

This is a relationship business, that's the key. And that's where you and your team for all the years you've been in the business, you have those relationships, you have the access point. So, I just want to make sure that's clear.

Eddie Speed: I bought a couple of thousand portfolios of notes — not a couple thousand notes, a couple of thousand portfolios.

So, the loans that we see today are going to be seller financing. You're seeing a big gigantic increase in the amount of seller financing because of rates. And then a lot of loans that are called scratch and dent, kind of like scratch and dent appliances.

Well, these are scratch and dent loans, and a lot of the loans we're seeing at the moment, David, got delinquent during the virus. They just had something bad happen to them. Like they were a waiter or they were whatever and stuff, and they stopped making their payments and that loan got modified.

And so, now all of a sudden, that loan is not fit into where it was originally boxed up. It was institutional portfolio, and now, all of a sudden because of that, it's gotten moved out and it's gotten put in somewhere else.

And those loans are traded. Now, they're traded in bulk and those loans are traded in the secondary market and they are sold at a discount. And so, those two kinds of loans: seller finance loans and modified loans, what are called reperforming notes. There is a better inventory of this than there's been in many years.

So, there's a supply and now, all of a sudden, a lot of people that would've bought a rental because rental rates are not escalating as they were. In fact, did you know that only 80% of rent is collected every month, meaning that 20% of rent that is supposed to be paid is not paid.

David Phelps: I believe that, I know some operators that have large rental portfolios in a number of cities across the Midwest and Southeast and they're not the properties that maybe I would invest in with my years of experience of being on the ground. But C class properties, they're very difficult, they're less than 80%, I'll tell you that.

Eddie Speed: It's statistically though, it's like 81% is the number today. So, it's a measured number to know that's a truth. So, people say, "Well, I want to just buy a note." Well, that's a pretty good deal, instead of being the landlord, why not be the bank?

And so, I'm going to buy this note, I'm going to have it serviced, and they're going to wire the money to me every month. And you don't have to pay taxes and you don't have to pay insurance, you don't have to pay maintenance, you don't have the tenants calling you, the faucets backed up or the property manager calling you and telling you the sink's backed up and that's why you're not going to get your check.

And so, all of that becomes a lot more of a passive deal. And so, we've taught this for a long time, this is great strategy for like retirement accounts, great strategy for legacy building and stuff.

And so, we've gotten pretty good at it, we've developed all kind of techniques around it, even where you can leverage it and do some cool stuff. So, that's performing notes, good supply right now, way better than it's been. And so, we know how to ride this pony, we've done it quite a lot.

The other side are loans that aren't paying. There's 1.8 million loans that are 30 days or more delinquent today, 1.8 million. But that number, David, has been about the number since the virus started.

There was 8 million loans that weren't paying, then they started paying again, so call it six or eight months into the virus starting, then all of a sudden, we drop down this non-performing loan number and it just hasn't moved. And that's because they got delinquent during the virus or maybe they were delinquent before the virus, and they haven't cured the loan.

So, the problem is, if we're 1.8 million in the normal amount of delinquency, (wouldn't be that bigger deal), that means 3% of every residential mortgage is not paying today. That's a pretty high number.

And so, those loans are going to end up in foreclosure. And so, those loans get sold, the banks end up packaging them up, they sell them to big hedge funds typically.

And we're connected, so we get a piece of what the hedge fund will break off. So, we're buying loans that aren't paying and you buy those loans, it's more like a pawn shop. If the collateral's worth 300 grand and you're buying it for 160 grand.

David Phelps: It's all about pricing, it's about the discount, that's the underwriting, that's what you know how to do. People say, "Well, gosh, why would you buy a loan with a borrower who's iffy or had issues during COVID or we don't know …"

No, you have the ability to go in and look at the different variables and price it according to the risk, that's the whole opportunity here. The reason why banks don't want to do the foreclosing themselves is because it's reputational and it's not what they do.

Maybe years and years ago they might have foreclosed on properties, but today as you said, they just take them and they move them to the hedge funds and then you're connected there, so you're able to pull these off and then source them out, you keep some.

Eddie Speed: So, we think that count David, is going to be over 750,000 loans. Now, it could be a million, but a safe bottom number is 750,000 loans that are in default that are going to get traded as non-performing loans (the industry acronym is NPLs). And if you're in my business, it's been a long time since there was that level of inventory, call it about 10 years.

David Phelps: I was going to say going back to the great financial crisis. So, let me just layer this on, you can agree or not agree, we just have conversations.

But I believe that looking back on what we talked about, going from interest rates as high as 18, 20% in 1980 and having 40 years of falling interest rates down to historic lows and now, tipping back up again to fight the inflation — I believe Eddie, we're in a longer-term secular trend, not just a market cycle, a recession correction that maybe takes 12, 18 months and then we're back to some “new normal.”

I think we're in a period where the secular trend is going to be far different than what we've experienced. Going back to 1980 when this started over four decades ago.

I believe we're going to see more volatility than we've seen in the past. I don't think we're going to have these long run rates, this extended run rate like we've had coming out of 2008, I think that's over.

I think there's going to be a much more volatility, there'll be spikes here, spikes there in financial markets and some spikes here when the Fed does something to try to juice things back up again, you'll see a spike.

I think this is a time period going forward, this decade, probably decades to come where people who want to invest their capital are going to have to be more diligent. This is not a, I'll throw it over here in my 401(k) and give it to a money manager and say, “Joe, take it and have it there for me when I want to retire.”

I think this is a period of time where people are going to have to get into and decide how they want to be the orchestrator of their financial future. Talking to our audience, you've got to figure out where you want to plug in.

Eddie, you and I love real estate because we know where the opportunities are. I love the proximity to either be close to the deal or close to the person who's doing the deal, that's how I run my life today.

I don't think we're going to see the growth overall, these big spikes of growth that we've seen because of what we talked about: low interest rates, federal monetary policy, fiscal policy, Congress throwing money out, helicopter money out — that's not going to happen.

Maybe a juice here, a juice there depending on who's in the administration and Congress, but overall, I think the big growth is going to be tapered off quite a bit. So, what I want to focus on, at least right now, I want the income, I want the income stream.

We always want income, but when there's growth plays, we'll take the growth and say, "I'll take the growth and I'll turn that income later." But I think we're in a dynamic right now where a focus on the income and that's where I like receivables, note receivables, secured receivables by real estate. And as you said, it's great for retirement accounts as well, great place to put those.

So, I think this is again, back to the cycles and back to … this is where what you do really has its heyday and you've done this six-time round, you've got it down, you've got the access points.

I want to just give people that are listening to this the opportunity to connect more with you. As I said, I'll put the links in the show notes here today, but noteschool.com would be a quick easy place to go to the education portal.

That's where people can go and get different levels of education, which will add to their armamentarium whether they want to be active in the business or passive, either one. Understanding what the dynamics is the key, I believe, and I think you do it better than anybody else.

Eddie Speed: Well, I appreciate that. We are experienced and you've pointed this out more than once. You and I have people that we've done business with for 30 plus years, a lot of people, and that is the definition, we talked about difference between a promoter and an operator.

People tend to be your friends more when you've made money with them. I'm sorry but that's just a fact of life. They may love you anyway, but they wouldn't go around and invest more money.

So, I think you're right, I think we've entered a note cycle and for all the reasons, everything you said I agree with, and I'm not just saying it because you said it. I just think all the evidence is there. Every fact that I think I've said today, I've got numerous data sources that support that.

It's not just one headline that we read and it's going to be an opportunity. It's going to be different and the thing is, hopefully, the audience today, has a sense of when we're listening to a deal, we put this deal together and here's what it's going to work, then all of a sudden — if you're parking money with somebody or whoever you're buying a deal from in any way, shape or form, passive or active, they should be able to speak to some risk assessments that they've done relative to the market we've described, and they said, “We've considered this and it's still a good investment.”

David Phelps: 100 % and knowing what those factors are is the key to both that operator and to you, the investor if you're investing with them. Understand you're on the same page, same playing field. So many people don't understand that and that's where they get hurt.

So, Eddie, I really appreciate the time today. We'll come back and get some more market updates because this is going to be a rolling marketplace cycle right now. It's going to be different from quarter to quarter, and you're on the top of it. So, we'll, we'll come back and pick up some more data points as we go through this year.

Eddie Speed: Good to talk to you.

David Phelps: Thanks.

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