The Evolution of Real Estate and the Markets – Eddie Speed: Ep #468

Full Episode Transcript

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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, David here. This week, I'm going to treat you to a special conversation that I had with a really good friend, longtime friend, colleague, hero, mentor in the real estate space, and that is Mr. Eddie Speed. And he began his career way back in 1980, actually the same year I began my real estate investing career.

We didn't know each other back in 1980. But the history of how we both evolved over the years in our respective careers, our respective respect for the marketplace, going through numerous cycles - I think we'll bring in a lot of revelation to each of you as you listen to this conversation today. Eddie is the founder of NoteSchool and Colonial Funding Group, a company that is specialized in the note receivable side of real estate for over four decades and done billions of dollars of business.

We talk about the evolution of the markets and how we've gone through some multiple changes since 1980 when we both began our career, when interest rates were at a high of the upper 'teens, federal funds rate was 20% - and now it's fallen over 40 years to a low in 2020 of 0%, and now it's back on the upswing. What does this mean for any of us who are trying to navigate our finances through the volatility and the changes that are happening so quickly today with so many different variables? I think you'll enjoy this conversation. I'd love to get your comments on the backside. Listen, enjoy, and I'll see you next week.

David Phelps: [I] have the opportunity to spend some time with my good friend, Eddie Speed. Eddie and I have known each other for quite some number of years. We live across the Metroplex, in Dallas Fort Worth, but we have to fly to other cities and states to see each other because that's just the way it works. But going back in time, Eddie, I know we're about the same age.

Our hair is turning the color that it usually does when you have maturity - wisdom is what I like to call it. And what's kind of novel is that we didn't know each other back when we were youngsters, but 1980, I believe, it's the time when we both got kind of our foray into the real estate arena, right?

You have a story, and I don't want to tell the whole thing, but you started on the side of what I call the note side, or you can call it the bond side of real estate, but not like financial bonds on Wall Street. These are notes, notes receivable - owning debts, creating debts, secured by real estate - which is something that through the years, it's something that a lot of people don't understand about real estate. Most people think that real estate, which is how I started, was you buy a property. You buy a rent house, and then people got into the fix and flipping, and there's times when that works out, right?

But there's this other side: stocks, bonds - bonds have a play, and that's been your forte, actually your father-in-law, Mr. Schumaker's, where you've got your time there. And what I love about Eddie is, is there's a lot of people out there that talk the talk and people that came into the arena, maybe in the last 5 or 6 years or whatever, and they found some niche in real estate. But the problem is real estate, like everything, goes through market cycles. And people just forget that. We see it over and over. We've gone through a number of them, right? And you say it's not your first rodeo. Let's talk about that Eddie. What was going on in 1980, and people are complaining a lot about dealing

[with] high interest rates right now and you can't find anything that that cash flows and - gee, I think that's kind of where we started.

Eddie Speed: Well, I don't know that it's relevant, but I'll tell you the quick part of it. I grew up in a cattle auction barn in Jackson, Mississippi. I was a cowboy. I rodeoed and horse showed. I'd lived in Fort Worth and gave kind of riding and roping lessons at a stable out there. And I met an oil guy and he sent me to college at TCU.

I went through the ranch management program. That's a one-year program, but it's like 50 college hours in a year. So it's a lot. It's a pretty well-known program and stuff. And I got hurt - a horse fell on me right after that. So I had to move back home because I've been in college and didn't have any money.

And that's what led me to Hattiesburg, which is about 90 miles, about halfway between Jackson and the Mississippi Gulf coast. And that's where I met, of course, Martha - [and] now we've been married for 41 years. Her dad was a millionaire next-door fireman and had real estate. And then by then, he had gotten into the note-buying business, buying seller finance notes-

David Phelps: People that had property, and they sold it, and carried back terms. Yeah. Great for the financing, right.

Eddie Speed: He had a partner that was an ex-savings and loan guy. So they made a good combination and everything that was established now as a business, nothing was established then. There wasn't any processes. There was no defined marketing. How would you find this deal?

David Phelps: There was no platforms, cause there was no internet. I mean, it was all very, very, very disparate, fragmented marketplace, right?

Eddie Speed: Yeah. So the good news is they introduced me to the business - I was dating Martha pretty heavy and I would say probably her dad originally said, “Well, I'm going to see what kind of tenacity this guy had.” And so they sort of threw me out. I first called on realtors. I called on realtors and home builders and real estate investors, just literally door to door.

David Phelps: For relevance, what was the pitch? What were you bringing to realtors at that time during that era of the ‘80s that they needed?

Eddie Speed: Every realtor had clients that had created seller finance notes. Because they had to: interest rates were 18%.

David Phelps: That's my point. We're not at 18%, but we've had the most rapid rise in interest rates in history going from 18 months ago at 0, Fed Funds rate to 5½ now. And mortgage three-year has been correspondingly [high] along with that. So we're in that same era. And so out of necessity - because interest rates were too high, banks wouldn't lend, people couldn't conventionally sell their property like they normally would where a buyer would go to the bank and get a loan - so transactions still have to happen. That's it. That's the point: the transactions still have to happen.

Eddie Speed: Yeah. Of course I was 20 years old. You've heard me jokingly say, I thought a loan was being by myself. Right? I didn't know anything.

David Phelps: I call that an Eddieism. You gotta, make a few more where that came from-

Eddie Speed: But I didn't know anything. But, I was trainable. So I got started. Then I worked in their office for about a year. I really got my hands on paperwork and understood more about the process. Martha and I married in ‘82, and we moved to Dallas Fort Worth. At the time in the note business, you would sort of move to the market. So I moved to Dallas Fort Worth, bought notes.

And then, primarily from mom and pops, like just some individual that sold their property, were forced to seller finance. By the way, David, all the way through the 80s, we bought more seconds than we did first lien. It's like people think, that seconds is a new thing or after, it's definitely not new, right?

But, we did that. I met a guy in, I don't know, probably ‘85 or ‘86, and he and his brother were real estate investors, and they had owner-financed property, and they wanted me to buy some notes, and I did. Their last name was D'Angelo. And John, of course, still advertises on TV in Dallas, Fort Worth - and Paul, the younger brother, is the one you see in the commercials with him. I got to have a lot of responsibility and help teaching Paul this business.

David Phelps: Yeah, the whole was turning to home investors and [helping] the whole home investors franchise figure this out. So people understand: in a marketplace where seller financing is a necessity because the banks aren't lending, the credit markets have contracted, interest rates too high, people sell and they carry back paper. Well, not everybody wants to carry paper. I mean, monthly payments are great. That's cashflow, and there's a place for that. I love to have that in my portfolio, but sometimes people just need to have the cash.

Eddie Speed: They got to recapitalize.

David Phelps: Recapitalize, right. You have to turn the money-

Eddie Speed: That's it.

David Phelps: So you created the source essentially for doing that.

Eddie Speed: Well, you know what I figured out [that] with seller financing is: that real estate investors would show up at my doorstep with seller financing, but it wasn't really done well. It wasn't a recipe.

David Phelps: You're talking about kitchen table?

Eddie Speed: Yeah.

David Phelps: You go to the pickup truck [financing], a little bit of coffee stain, loose deviled eggs, picotti sauce on the paper. That's not the kind of paper that's institutional quality. It still works, but it's not negotiable paper. In other words, you're kind of stuck with that stuff. And if you want to have something you can transfer, which that's what I love about notes is it's fungible.

Eddie Speed: Yeah.

David Phelps: You have liquidity with notes. People don't understand that people say, well, real estate is not liquid. Well, there's parts that are not liquid. There's a whole other part - and that's what we're talking about a little bit, the capital stack, whatever we're moving towards - but there's a part of real estate that is liquid. And there's a time in the market where what you do - and I've learned a lot through you, through the years - is how to have the dance between equities, and the bonds or the notes. I mean, there's the financing part. They tie together, but most people see them as separate or they don't even see both sides, right?

Eddie Speed: Well, here's the thing about it, David, and you know this very well: it's the investment grade. You can create paper that's different levels of investment grade. Well, Fannie Mae paper is investment-grade paper.

David Phelps: Yeah. That's high level. It's underwritten and it's checked all the boxes, right?

Eddie Speed: So we kind of figured it out. Nobody had ever really done this. So Ken D'Angelo founded Home Vestors - my long friend, great guy, passed away now many years, but just a terrific guy, so creative. And he had a vision. He said, our franchisees really need this, and so we've started out - literally, I'm not exaggerating: we went to Walmart, and bought six easels and six whiteboards.

And every Saturday morning for months, it seemed like, we mapped out one little piece at a time that became the recipe, right? He pulled it out of me and it became the recipe of like, okay, this is how you do it. And so he kind of changed the business. The note-buying business from the institutional investor standpoint was probably what? $50 to $75 million a year business. And within two years, we had taken it to $300 million. So, we taught real estate investors a system and then they could generate a lot more paper than mom-and-pop.

David Phelps: More transactions because that's what they want. The marketplace, again, still has to transact. So the dynamism in putting together what you've termed, filling the void in the marketplace. Filling the void is: people think about conventional, traditional marketplace, retail, banks that lend money, realtors that sell, cash at closing. And that's all fine when that market works. And during cycles that we've had in the past, most recent one coming out 2008, when we got through that turbulence and then interest rates, take it back down to next to zero, and this low cost of capital banks are back fluid again in the last four or five, six, seven, eight years.

Transactions and low cost of capital has caused the equity margins to go up, up, up. I mean, just skyrocket up, right? Federal Reserve comes along and they say, well, we've got to tamp down inflation because, well, the people are getting creamed out there. And right now people are, people cannot make the end of the month, because of the cost of everything. So the Federal Reserve comes in and brings in the interest rate hammer. And we're seeing the lag effect right now, cause that's coming through the marketplace right now. As we speak, it's coming through and people don't understand, people that have been caught up in this exuberant market. They think it's going to keep rolling.

They just haven't seen a full cycle. And that's what we've seen over and over again. And tying these things together, the opportunities really come about when we go through cycle changes because, well, just like a forest fire, it clears out the underbrush, or a flood that takes out a lot of what's been built up. It's not necessarily always good, but you have to have those things. And that's what a market cycle does: it cleans it out, but you've got to get through the gap. You've got a model. You're a realtor, you're an investor, you're a developer. You've got to be able to get through this gap. Most people don't see it coming and they hit right there at the skids and they don't know what to do.

Eddie Speed: David, for me, this is my 6th real estate cycle. And I guess for you, you've been right there with them - like it takes so long sometimes for the cycle to break, then we see it early and we think something's going to happen. And then by the time it actually happens, we kind of almost forget about it again, because it just, well, it didn't happen.

We thought it was going to break or thought it was going to kind of crash. And it didn't, then 2008. By 2005, I said, people have lost their minds. People have flat lost their minds, and they're like, what? This is modern-day lending. Well, it turned out I wasn't wrong on that.

David Phelps: That's right! That's right. Now people say people will often say, well, yeah, but this time it's different. This time is different. The Federal Reserve always comes to the rescue and they try. But it's always too little, too late - and they've done too much on the front end and the cycle is going to roll over. So I think what people understand that you've got to look at the full cycle and understand whatever model you've utilized, whether it's in business or your investments, that's taking you to where you are, that's great.

But understand there's another side of that cycle. And if you don't understand that flip side and how to move with that market. That's where people get caught up and it's going to happen again. I mean, right now we're seeing it, this beginning of starting to happen again, the capital stack. So just for people to understand the capital stack, it's financial structure that's used in all capital markets in terms of how people acquire assets, whether it's businesses or real estate or anything that's tangible. And again, on the top side of the capital stack, we think about equities: that's ownership.

The typical, “I'll buy a rental property, I'll buy a short-term rental Airbnb property, but you own the property”, that's equity. And yeah, that's typically where the chutzpah comes from, because you get the growth - whatever growth's there - you can add value, you get the tax write-offs, you get the inflation hedge, you get the increase in cash flow from the work you do, and that's great. In that market side it works great. But on the flip side, which is where we're going, those equities actually are coming down in value now. So people still want to be in that growth phase - well, it's not a growth phase right now. People go, well, what do I do? They're kind of lost. It's like, “Well, I'm used to this phase. And I can't get the same amount of capital and I'm trying to squeeze my margins down.”

And if they only understood that the other side's going to be what you've been bringing to the market every time the cycle turns and it's right where we are. So talk a little bit about this market cycle right now. What are you doing through NoteSchool and Colonial Funding Group to bring the market the solutions to the problems we know are out there in the real estate space today?

Eddie Speed: The one constant I could say, every time, has been the banks. When banks are in trouble, when banks are under pressure, then there's a lot more discounted notes. So if you took the market from, say, 18 months ago to where we are today, I would say comfortably we have 3 or 4 times the note inventory that we had.

Why? Okay, well, people that are seller financing, a year and a half ago or two years ago, probably had some relationship with the bank and they can go recapitalize at the bank or borrow money. Now all of a sudden the bankers are going, no, we're not doing that right now. And so then now they're coming to the marketplace and saying, I need to sell seller finance notes. We had a huge amount of loans that went delinquent during the virus, and then they were modified. And now they've actually modified, they're paying well, and they're called RPLs; re-performing loans. And we actually see a better pile of them in front of us at the moment than even seller financing. So once again, the banks wrote down the loans.

They put them on their books at less than the principal amount. Just like a department store would write down clothing or whatever, right? After it's been on the shelf too long. So it's the same thing. And now that loan is coming to the marketplace and those are performing notes. And then David, there's 2 million residential mortgages that aren't paying.

David Phelps: 2 million?

Eddie Speed: 2 million. And that's according to Black Knight. I mean, they do a report every month and we monitor it closely. So that's about where we are in inventory cycle. And so these loans are coming through the marketplace. There are loans that are typically bought at a discount. And I believe David, generally speaking, we have real estate cycles and note cycles, right? And if you look at the edge of the market, people say, well, what is a note cycle? A note cycle is where notes make more income and a better return than owning traditional rental investment property.

David Phelps: I'm going to say that I've done both, and I started it on the equity side and you started on the note side of the capital stack. There is a convergence where those work very well together. I found that owning real estate, it has a lot of hair on it. People have done it, being a landlord - whether you have a manager or not, there is just a lot of issues to deal with. Now it can be a very good disciplined way because you have to keep paying that debt, a disciplined way to develop equity.

And you could do it over a period of time. But what I found out is, and I sort of inherently knew this, but coming out of 2008, I'm going to your point of there's times when you can make a lot more money owning the note than the real estate - I did a number of financing opportunities for boots on the ground, people that they were able to buy it in good discounts, because we came out 2008. So I knew the values were good. I lent money and I also took an equity position. So I got an interest carry that worked for them because it has to work. Then they got a cashflow, but I also took an equity play. And, we've just - in the last year - some of those have gone to fruition. In other words, that the owner, the equity owner has sold the property. And so now it's time to tabulate what my part was and what their part was. And my friend with whom I did, oh, probably a dozen of these, he's coming to me and say, "It was good for both of us because the market went up, right?"

But he said, "David, you came out a whole lot better than I did." I said, "Well, I wasn't actually [going to] bet you on that." But I said, "I felt like that was going to be the case." And today I'm not going to rush. Well, even when the market turns, I'm not going to rush back into equities.

Now, some people, that's good for them to do. You want to be hands-on that when you're a young person, I mean, go there. But for me, I want to be on the side where I'm set more separated from the liabilities, responsibilities, but I still want to have a piece of the action. And there's so many ways to slice and dice that. So I'm a big fan as you know, of the note side of real estate.

Eddie Speed: You ever hear the old saying that, "When I'm a real estate investor and I grow up, I want to be a note guy."

David Phelps: That's what's happening to me. I'm on the other side now. I'll take that side a lot because I can get all the benefits I want from that. Really, there's no question: that works well.

Eddie Speed: David, here's the thing about it. We have seen a big significance in lending from the cost of money, the affordability of payments. And that's what's happened to the BURR model: the buy, rehab, rent, refine, all that stuff, right? And we've seen it from consumers trying to buy houses and their payment is double what it used to be.

And all of that, that is a clear image of the cost of money. What is not so obvious to people is the availability of money. Underwriting's gotten progressively tighter. That's even true in the residential space. We're going to drastically see it be true in the commercial space. And so this is where another side of the business is. You referred to it as the void in the market, right? Where is there a void, that's what entrepreneurs really should do, right? Where's there a void in the market and where can I fill it?

David Phelps: Exactly what you have to do. You've got to be able to pivot. You can't just stay in that one model. So let's talk a little bit about what we foresee in the next number of quarters, in the next year. 2024, 2025, no one has a magic crystal ball - but again, we've both been through six major cycles. What do you foresee?

Eddie Speed: I think there's going to be a significant shortage of credit. I think the banks have issues. I think that a lot of commercial lending is going to be drastically affected by this. I think there's going to be a lot more necessity for private financing, for papering a deal, for all of that. And then I really honestly see it being true on the residential side. Residential mortgage lenders went through a real bump during the crisis.

David Phelps: 2008.

Eddie Speed: And then they got well again, and they guaranteed payments to the lenders. So when they started going back to Wall Street and securitizing loans, they did a deal they didn't do before, and that is: they kissed the loans.

They guaranteed the bondholders they would get payments. And that's all was fine and good until the crisis came along, and all of a sudden you had 8 million mortgages not making a payment, and guess what? Those mortgage bankers had to make a payment to the bond holders, even though they weren't getting paid - at a rate, David, of a billion dollars a week.

It wasn't well publicized, but it's a well-known fact in the mortgage banking world, that the sins of that have really put mortgage bankers in a tough spot. And so they've tightened underwriting. Mortgage Bankers Association has an index that basically says this is our level that we loan money. So before the virus, it was about 185. Today, it is 95. So are you saying Eddie, that half of the people that could have gotten a mortgage before the virus can't get one today? And that's exactly what we're saying. So that's where I see a tightening of credit is a much different level of concern than just a cost of credit.

David Phelps: Yep I think they both go hand in hand. Well, it's going to be interesting times ahead. I don't fear them. I think, because we run in circles of people that have a lot of experience. You've got a great team that you've run with for decades that have, again, gone through these cycles. I think the key thing for me, and anytime there's challenges in business - or in this case investments, real estate, which we both love - is you've got to be plugged in with people that actually have their fingers on the pulse of the market.

You can read all the financial news you want to, and that's fine, and economists have their play. But [when] comes right down to it, what's happening on the street is what matters and I think that's where we gain the people that we get to run with, gain a great benefit - because we get to see really what's happening right now and not three, four weeks later when the news media finally starts to report it on the backside.

Eddie Speed: Yeah, it's just the weather forecast. That's all that it is. I mean, if you don't know the storm's coming, then all of a sudden you get surprised. I'm not saying we're always right, but I will say that I think the data is more available than it's ever been. I think you and I’s clarity is better than it's ever been, and so we're better to read things.

And I'm not calling for a 2008 on the resi side - we have such a shortage of inventory, so somebody's arguing, “Well, there's just less houses for sale.” which is an absolute truth. So for that reason, I think there's a insulation factor on the resi side. I don't think on the commercial side. I think it's going to be some - what did the guys at the TREP report say? Significant headwinds ahead, I think, is the wording they used when they came out with the latest TREP report.

David Phelps: Well, I would agree with that. It's going to be interesting to see, but I always appreciate the time with you and the insights that you always bring. Thank you, Ed.

Eddie Speed: See you.

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