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The Three Faces of Foreclosures

By Andy Heller and Scott Frank

So, you want to invest in residential foreclosures? Not sure quite where to start? It is helpful to understand first that there are three faces to "foreclosures", each with very different characteristics.

The first face of foreclosure investing is the "pre-foreclosure". The pre-foreclosure period begins when a homeowner gets behind on his or her loan, and ends with the foreclosure sale. The pre-foreclosure phase itself is divided into two stages.

The first stage covers the period of time beginning when the homeowner misses their first mortgage payment, and ends in the final month preceding the impending foreclosure sale. During this time if a homeowner is not already marketing their home, it will be up to the investor to reach out to and find these distressed homeowners through ads ("We buy homes fast" and "We have CASH for homes") and networking.

The second stage occurs during the final month leading up to foreclosure. The precise laws differ from state to state, but most states require some form of public notification of a pending foreclosure. Investors can seek out these notifications, and many have ample contact information for the investors to approach the distressed homeowner. Many larger communities have a number of online and subscription services which compile the pending foreclosures in a specific geographic range. You can also network within your local real estate investors association and/or do an internet search (e.g. "foreclosure listings in order to find these publications and services).

The pre-foreclosure face offers wonderful wealth generating potential to investors. They can approach distressed homeowners and give them some quick cash when there is ample equity in the homes. There are also opportunities to work with some of the foreclosing lenders directly (with the distressed homeowner's approval of course), as it is in the lenders interest to avoid costly foreclosures.

Pre-foreclosures may be arguably the most written about method of finding discount property. It is amazing how many distressed homeowners wait to the last minute with their properties, always thinking they would be able to bail themselves out. It is then, with little time left on the clock, that some of these distressed homeowners realize that the only viable remaining option is an investor in a position to move quickly.

On the plus side pre-foreclosures can be lucrative. A typical pre-foreclosure might have an investor paying off a distressed homeowners $220,000 loan, giving the distressed homeowner $25,000 in cash to restart their lives, and taking over a $350,000 property. The primary negative associated with pre-foreclosures is the taxing emotional element associated with constantly dealing with homeowners involved in a downward spiral. Simply put, this will not be feasible for every investor.

Around thirty-four years ago we were one of those investors fresh out of one of those "get rich quick" seminars. Our model was to focus on pre-foreclosures, and we went to one and only one

home. The family we visited was the most likeable family. The husband was a veteran, and both he and his wife lost their jobs within a short time of each other. When visiting the home their little girl took my hand and showed me the "doggie window", the hole in the kitchen door for their family dog to go in and out of the house. I left this visit emotionally drained and with a sour feeling in my stomach. This was the last pre-foreclosure we ever visited.

The second face of foreclosures is the "foreclosure sale". This occurs when the loan on the home is not brought current by the distressed seller or the home is not sold.

Again, the procedures and process have slight differences from state to state, and prospective investors will need to educate themselves as to the foreclosure sale process in their respective state. For many states, the sale of the property takes the form of an old-fashioned auction on the courthouse steps (in many states this occurs sometime during the first week of the month following the foreclosure)..

Like pre-foreclosures, this also can be quite lucrative. However, unlike pre-foreclosures, there is no emotion element other than controlling your adrenalin at the foreclosure sale. The main drawbacks are that often investors are bidding on property they have not been able to access (this makes assessing repairs and improvements quite challenging), an investor may need to assess the title and any liens quickly (this can lead to mistakes and can be costly), and many states require certified funds at sale or within a very short time frame (such as 24 hours). While investors can make money with foreclosure sales, having access to large sums of cash or fast financing limits these to a subset of experienced and well-financed investors. If you're interested in this face, we suggest you go to a foreclosure sale and witness how one works firsthand.

The third face of the foreclosure process is the "post-foreclosure". If the property is not sold in pre-foreclosure and not purchased by an investor at the foreclosure sale, then it goes back to the bank or other lien holder who secured the loan.

With many loans offered today requiring little down payment, record numbers of properties are going through the foreclosure process without attracting investor interest in the pre-foreclosure or foreclosure stage. These properties eventually land on the desk of someone within a financial institution (bank, mortgage company, etc) that has the responsibility of disposing of these properties. Many institutional lenders dispose of so many properties that they have entire departments dedicated to this task. Oftentimes, these departments are referred to as REO (real estate owned) or Post-Foreclosure Departments.

When contacted by investors, institutional sellers will generally fall into one of three categories There are many ways to find these institutional sellers. We teach how to find and approach institutional sellers as well as the agents that many institutional sellers utilize to sell their inventory of properties. (For more information please go to www.regularriches.com).

The first category are institutional sellers that will be happy to work with an investor directly, bypassing listing the property with a real estate agent. The second category are institutional sellers that will at first indicate plans to list their REO property, but can be persuaded by the skillful investor to delay the listing until the investor has a chance to see the property and make an offer. The third category are institutional sellers that will not consider working with an investor directly, but will instead list their properties with selected real estate agents.

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One of the key benefits of purchasing post-foreclosures is that the sellers have no emotional tie to the property. For financial institutions, this is a simple business transaction.

Further, investors seeking post-foreclosures should remind themselves that institutional sellers are in the business of lending money, not managing real estate. At some point, if a bank or lender has too many properties on their books, the number of REO properties will need to be reduced, sometimes quickly, and oftentimes at a discount to investors.

There are always REOs available for purchase, yet there are times when REOs spike, and with those spikes the discounts available to investors are maximized. How can an investor plan for these spikes? By far the best indicator of future spikes in REOs is the mortgage delinquency rate. When there are measurable changes to 90 day mortgage delinquencies, it is highly probably that REOs will spike shortly thereafter. Therefore, long-term strategic investors can look for spikes in 90 day mortgage delinquencies, and when they occur look to position oneself to maximize purchases when the deals are plentiful.

"Foreclosures" is a buzz word that attracts the interest of many new real estate investors. It is helpful to understand from the start that there are actually three very different and unique "faces" to the foreclosure process. Most established investors that buy foreclosures are actually focusing primarily on one of these three "faces". Therefore, for new investors who are just getting started, take a look at the characteristics (time, money, risk, emotion, potential profits) of each of these "faces" of the foreclosure process and select the one that is the best fit for you.

Whichever one you select, implemented properly, the three faces of the foreclosure process all have the potential of putting a smile on the face of the investor. That is the one common denominator of the three very different faces of the foreclosure process.

Andy Heller and Scott Frank are co-authors of the Fortune Magazine recommended book "Buy Low, Rent Smart, Sell High". Combined, they have been investing in residential real estate for over sixty years. Visit them at www.regularriches.com.