

What Makes Good Paper?

Often times, when discussing with others the sale of seller-financed notes, I am asked, “What is the going rate for selling notes?” or, “What is the usual discount?” To this, I can answer only with something such as, “It depends on the note.” Many factors are involved that determine the level of discount required by note investors, and this cannot be simplified to a general value or rate. The basic information must be analyzed to determine the level of risk associated with the note.

This article will focus mainly on notes secured by real estate, but most of the principles will similarly apply to other types of cash flows. Let’s begin by discussing the major aspects of the note, then get down to the structure of the note and the original sale in which the note was created.

Security

The security of the note is critical; it is the foundation of the entire deal and will certainly effect the level of risk. The security is what the lien is placed against to ensure the payment of debt. Your basic and most common note will be secured by a single-family residence. These are generally considered the favorite, unless of course you are working with an investor that deals primarily in a “niche” market, such as business or mobile home notes. Also common are multi-family units, vacant land, and commercial properties. Moving away from notes secured by real estate and business, other niches involve cash flows such as structured settlements, annuities, lottery winnings, etc, which are generally considered “unsecured” since there is no tangible asset. Describing the many security types in further detail would be too involved for this article; in fact, I believe it could be the premise for a short book.

Position

Easily explained, position is the “order” in which the liens are placed upon a security. A good example would be to describe the situation of many homeowners, where they have a mortgage or deed of trust with a bank and a smaller lien that may be a home equity line of credit (HELOC). The first lien on the property was the bank lien, so this lien is in first position. The HELOC we mentioned would be in second position, also called a “junior” lien as compared to the first lien in “senior” position. First position is always the best to be in, especially concerning defaulted notes. The senior-most lien-holder has first rights to the property. The junior lien-holder, in the case of Payor default, would be responsible for any senior debts on the property and would have to keep the senior note(s) current while foreclosing on the property, then ultimately have to pay off or assume the first-position lien after acquiring the property. Because of this, junior notes are always discounted significantly, if even saleable at all.

Amortization

When comparing cash flows of the same face value, interest rate, and term, amortized notes will always be more valuable than interest only notes. This is mainly because the monthly payment will be greater on the amortized note, so the Note Holder will be

getting their money back at a faster rate than the interest only note. In addition, the question of whether or not the Payor will be able to pay off the balloon at the end of the term must be considered. Amortized notes with balloons fall into the middle ground. While they can yield higher offers than fully amortized notes, the consideration of defaulting on the balloon payment may offset the attraction of the closer payoff. Some investors will alleviate this by offering to extend or cancel the balloon and continue the amortized payments, so they continue to make money from the interest paid in each payment.

Current/Delinquent Status

Delinquent notes can be severely discounted, for obvious reasons. Not all investors are interested in distressed paper; in fact most are not. Some investors like to purchase these to recast, or change the terms of the instrument to where the Payor can afford to resume payments, which can be a profitable venture. Most investors want to purchase performing notes to collect a steady income stream and do not want to deal with eviction of the Payor and acquisition of the security of the note.

The Payor

Sometimes called the mortgagor or grantor, the Payor is a significant factor in determining the risk of a note. Generally, three items regarding the Payor are evaluated:

- I. Credit history
- II. Payment history
- III. Down payment provided

I. Credit history can be very important, depending on the preferences of the note investor. This is the most common way for the note investor to gage the risk level of a Payor. For an initial estimated offer, most investors will base this factor on a credit score and not require reviewing an entire report. With new notes, credit is especially important since there is little to no payment history on which to base the risk factor of the Payor.

II. The payment history is used to gage how the Payor is expected to submit the monthly payments. If the payment history indicates late payments, particularly if there were payments that were over thirty days late, a greater risk of default is perceived and the discount will be increased. This is related to “seasoning”, which is covered below.

III. The down payment provided by the Payor can affect the perceived risk on a note for a few reasons. Down payment is instant equity, which will reduce the LTV (Loan To Value) and the discount required for an investor to achieve the desired ITV (Investment To Value, see article, [“Investor Requirements”](#)). Payors who provide little to no down payment are considered riskier because these types of Payors tend to default more often than Payors who provide a sizeable down payment.

Seasoning

The seasoning of the note is simply the length of time that has passed since the creation of the note. Most investors consider notes “unseasoned” if less than twelve months of payments have been made. Seasoning is good for multiple reasons. It provides a “history” of the payment performance of the Payor. A good payment history that shows many years of timely monthly payments will help to reduce the risk associated with the Payor, especially if the Payor has less than good credit. On the other hand, a history with late or missing payments will increase the perceived risk of the Payor. Seasoning also improves equity on amortized notes by reducing the principal balance. Lastly, the time passed since the creation of the note should improve the amount of equity in the property by appreciation.

Equity

Equity in a property is considered a safety buffer of sort. If the Payor defaults and the property must be acquired and sold by the investor, it is the amount of equity that will determine if the investor will take a loss on the investment. In addition, another consideration exists regarding owner-occupied notes. When the Payor has significant equity in the property, the level of perceived risk is reduced because it is less likely that the Payor will stop making payments and abandon the property. If there is little to no equity, the Payor can “walk away” without losing much other than the damage done to his or her credit.

Large Monthly Payment

This topic was touched upon previously, but I will focus on it here. A large monthly payment is attractive because the investor will get more of his money back sooner, where he or she can then get that money into another investment to keep his dollars multiplying. Two factors cause a larger monthly payment:

- High interest rate
- Short term

A high interest rate is very good for the resale of notes. A high interest rate will require less of a discount from an investors’ yield requirements (see article, [“Investor Requirements”](#)). A shorter term will get the investor’s money back in his pocket sooner and will cause the monthly payment to be larger on amortized notes. In addition, the discount will be smaller on short-term notes, due to the effect of the “Time Value of Money” (see article, [“Time Value of Money”](#)) on the back end of the payments.

For example, let’s take three notes with the a face value of \$150,000 and an interest rate of 8%, consider all notes new (no seasoning), and change the terms and amortization of each. Note 1 will be fully amortized for 30 years, Note 2 will be amortized for 30 years but have a balloon due in 10 years (30/10), and Note 3 will be fully amortized for 10 years. The offers will be based on an example yield of 10%.

	<u>Face Value</u>	<u>Interest</u>	<u>Investor Yield</u>
ALL Notes:	\$150,000	8%	10%

	<u>Term</u>	<u>Payment</u>	<u>Offer</u>	<u>% of Balance</u>
Note 1:	360 months	\$1,100.65	\$125,419	83.61%
Note 2:	30/10	\$1,100.65	\$131,896	87.93%
Note 3:	120 months	\$1,819.91	\$137,715	91.81%

By these three examples, you can see how the discount is affected by the term and the interest rate, even though all offers were based on the same desired yield.

If someone were to ask me what I feel would be the perfect note, I would likely describe a well-seasoned (at least two to three years, preferably more), first-position note secured by an owner-occupied single family residence. It would have a 10% or higher interest rate, five to ten year term, be fully amortized, have loads of equity (less than 50% LTV), and have a large down payment (20% or more) from a Payor with an excellent credit score (700+ FICO) and never a late payment. If you happen to be holding a note such as this, *please* give us a call.

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