Private Money Update

CLEAR SKY FINANCIAL NEWSLETTER

November 2019

Letter from the Editor

Happy Holidays! We hope you had a wonderful Thanksgiving, and wish you all a safe and enjoyable holiday season. Here at Clear Sky Financial, we also have something else special to celebrate…the anniversary of our founding! In October, we celebrated our sixth year in business, which means that some of our investors have had over 70 months of interest payments. Thank you to all of our investors, both those who have been with us from the beginning and those who are more recent!

October was another steady month for loan originations, and our call volume continues to be heavy. We originated seven loans in October, six of which were first trusts and one which was a second trust to a repeat client. Two loans were in Virginia, two were in Maryland, two were in Washington, D.C., and one was in North Carolina. In, November we will originate 10 to 11 loans. We are in the midst of a “mini growth” expansion.

CHUCKLE’S CORNER

Nats Nats Nats!

Food for Thought

In previous issues of this newsletter, we have discussed two funds that we created, a 506(c) fund and a 506(b) fund. We created these funds to ensure that we are compliant with state and federal laws. By the end of the year, we are going to convert current Clear Sky Financial monies into the 506(b) fund. This will not impact your investment(s) with us. We will be sending a letter and new subscription agreements shortly. We will be giving you a final opportunity to invest more monies with us at your current favorable returns. We are in the process of reducing these rates in the future.

Also, we will be funding our 506(c) fund by December 1. You can also invest in this fund if you are an accredited investor. An accredited investor is defined as:
A. One who has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence). Net worth is calculated by adding up all your assets and subtracting your liabilities.
OR
B. One who has earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year.

In This Issue:

clear sky FINANCIAL

www.cskyfinancial.com

Charlie Einsmann
(703) 887-1039
charlie@cskyfinancial.com

Sam Jacknin
(703) 587-2475
sam@cskyfinancial.com

Charlie's Corner

Three Things Lenders Think About That Investors Might Not Anticipate

There are many reasons to use a hard money lender. Compared to traditional lenders, hard money lenders can offer faster funding, flexible construction draws, no prepayment penalties, and a willingness to look beyond a specific borrower's credit blemishes. This might beg the question, "When would a hard money lender turn down a deal?"
Our most common reason for turning down a deal is because we don't believe in the borrower's projection of repair costs or their After Repair Value estimate. If something else seems amiss, we have to spend a lot of time figuring out what is going on with the transaction. Assuming that we have a shared understanding with the borrower of the meaning of draws, plans, and prices – we look further. Here is a short list of our "rules of thumb" for turning down deals and examples of each:

Title Issues: Clouded Titles and Wholesale "Daisy-Chaining"
It is an immediate red flag if a title review by a third party is not permitted. A title company once told us that the title report was not subject to our third-party legal review, and that all titles have problems, which is why they sell insurance. We turned this down right away. What would happen if we had needed to clean up a title problem after a closing? We could make a title claim. However, waiting for a title company to resolve a title issue is difficult. If we wanted to expedite it, we would have had to get our own attorney to drive the process. As lenders, if we needed to take back a property, the title would have to be clear. Therefore, we don't want to start the process with any title issues.
"Daisy chain" wholesale deals are also a red flag for us. A single-wholesale transaction does not represent a problem. However, once two or more wholesalers are involved in a deal, the lender starts to wonder if the seller knows all of the facts around the value of their property. If it looks like the wholesalers are capturing more than a reasonable amount of the property's equity, it is worth exploring the situation further. A lender doesn't want to finance a deal where any of the parties are treated unfairly. In addition to the obvious moral implication of such a situation, the lender does not want to deal with title claim and lawsuits that could arise after closing.

Contractor Knowledge: Plans and Permitting
If a borrower suggests that they can outsmart a municipal inspector, we turn that deal down right away. We have had prospective borrowers insist that they can do their construction without permits and that it is perfectly legal. If they continue to insist on proceeding without proper plans and permits, we won't do the deal. If someone has started the project appropriately, and there are construction draws, we personally review the job site. We collect copies of the borrower's plans and permits. If they aren't in order, the construction draws stop until the issues are resolved. If the borrower's contractors or inspectors are not adequate, we refer in ones with whom we have successfully worked in the past.

Investor Ability to Execute and Cross-Collateralization
We talk to prospective borrowers and review projects they have completed to determine if they are similar in scope to the one that is being planned. If their new project is much larger and more complex than any of their former projects, that is a red flag. We look to see what type of team they have assembled to make it a success.
If a borrower has more than one transaction with us, we look to cross-collateralize their projects. Even if the projects are held by separate LLCs, we want to protect our interests by making sure that a default on one of their projects equates to a default on all of the projects they have secured with us. To that end, we don't want the borrower to be cash poor and loaded down with debt obligations. We make sure to discuss the viability of all of the borrower's projects with them before lending on any one individual deal. We might view 20 deals before we find one that we want to lend on. This is usually because the values won't work, but sometimes the deal just presents too many other risks. Understanding what a lender is looking for should help investors seeking to secure their next loan.
There are many reasons to use a hard money lender. Compared with traditional lenders, hard money lenders can offer faster funding, flexible construction draws, no prepayment penalties, and a willingness to look beyond a specific borrower's credit blemishes. This might beg the question, "When would a hard money lender turn down a deal?"

Daisy chain: In real estate, a deal that has been contracted to multiple parties before the end buyer.

"Daisy chain" wholesale deals are a red flag. A single-wholesale transaction does not represent a problem. However, once two or more wholesalers are involved in a deal, we begin to wonder if the seller knows all the facts around the property. These deals are unlikely to close and full of unknowns, so we steer clear.
Our most common reason for turning down a deal is because we don't believe in the borrower's projection of repair costs or their after-repair value (ARV) estimate. If something else seems amiss, we spend a lot of time figuring out what is going on with the transaction. Here is a short list of our "rules of thumb" for turning down deals and examples of each:

Refusal Rationale #1 | Title Issues: Clouded Titles and Wholesale "Daisy-Chaining"
It is an immediate red flag if a title review by a third party is not permitted. A title company once told us that the title report was not subject to our third-party legal review and all titles have problems, which is why they sell insurance. We turned and ran. What would happen if we had needed to clean up a title problem after a closing? Sure, we could make a title claim. However, waiting for a title company to resolve a title issue is difficult and we might have to hire our own attorney to expedite the process. If we must take back a property, the title must be clear. Therefore, we refuse to start a process with title issues.

clear sky FINANCIAL
www.cskyfinancial.com
Charlie Einsmann (703) 887-1039 charlie@cskyfinanical.com
Sam Jacknin (703) 587-2475 sam@cskyfinancial.com

Lesson Learned: Your hard-money lender will always try to avoid uncertainty.

Refusal Rationale #2 | Contractor Knowledge: Plans and Permitting
If a borrower suggests that they can outsmart a municipal inspector, we turn that deal down right away. We have had prospective borrowers insist that they can do their construction without permits and that it is perfectly legal. Possibly so, but we won't do the deal if they insist on proceeding without proper plans and permits. If a borrower is taking over a job that has already begun, then we will need to see copies of plans, permits, construction draws, and inspections. We may loan on a job that has been done with "inadequate" permitting so far, but only if the situation is set to rights before we get involved.

Lesson Learned: Hard money lenders are sticklers for legal minutia because they must be.

Refusal Rationale #3 | Investor Ability to Execute and Cross-Collateralization
If your latest project is much larger and more complex than any you've done before, that's not a deal-breaker automatically but it is a red flag. We talk to prospective borrowers and review projects they have completed to determine if they are similar in scope to the one that is being planned. We look to see what type of team they have assembled to make it a success.
Similarly, we are not comfortable when borrowers take on too many projects at once, so we review everything they're working on with us even if those projects are not under the same "management," so to speak, because they are held in different LLCs. This is a common asset protection technique and not a negative in and of itself. However, we want to make sure that a default on one project just does mean a default on all projects secured with us! If you have so many balls in the air that you are cash-poor and loaded down with debt obligations, we will want to discuss your latest project's viability before making a loan.

Lesson Learned: When investors succeed, hard money lenders succeed. We won't loan on projects likely to fail.

The Hard Truth: We might view 20 deals before we find one that we want to lend on. Usually, we refuse loans because the values won't work, but sometimes the deal just presents too many other risks. Understanding what a lender is looking for should help real estate investors seeking to secure their next loan.

Sam's Corner

Lending Trends

In early November, I attended the 10th Annual Conference for the American Association of Private Lenders (AAPL). My purpose was to learn about industry trends, and look for ways to lower our cost of funds. It turned out that our local competitors and colleagues across the country were looking at similar issues.

One of the breakout sessions was entitled "The Year of the Correspondent: Private Lending in 2019". This session really captured what is happening in the private lending space. The days of brokering loans to investors or exclusively using a mortgage fund are gone for many private lenders. The competition has moved to selling, participating and table-funding loans. They have done this in response to the vast amount of hedge fund and institutional money that has entered the private lending space. The private lending business is reverting back to a privately funded (not Fannie Mae/Freddie Mac) securitized model.

Institutional money is being deployed at a low cost for loans that conform to traditional lending standards. For our competition that is chasing this sort of funding, they are having to staff offices with lots of loan officers/processors to keep the deals flowing. These conforming products don't serve new investors and specialty borrowers well so it leaves open the niche we are in. From what I see, there is little reason to compete on loan pricing – we simply need to continue offering more flexibility and higher service/value to our borrowers. As long as we do that, there are plenty of deals with good margins coming our way.

Now that the private lending industry is maturing, there are a lot of software tools available to assist in the lending process. Innovative law firms are introducing state specific document sets that work for private lenders. In order to assemble a complete set of documents, the lender can use an app on the phone and setup the documents in just a few minutes. For lenders that want more control over the construction budget and draw process, there are very friendly estimation and draw management tools available. On the servicing side of the business, new entrants with web-based applications have entered the space as well. I took a look at all of these tools and compared them to our current information systems and practices. There are some areas to explore at the margin of our systems platform that could enhance our operations. Weighing the cost/benefit of the implementation of system changes is part of our regular process.

Lowering our global cost of funds is essential to our business performance. When considering bank financing alternatives there are a lot options. There are wholesale lines, institutions who will buy our loans and service them, and firms that will buy our notes and have us service them. All of these options have a myriad of variables such as whether there is recourse, whether our documents are used, whether the loan products are white labeled (our brand) or branded by others. Beyond the companies that are offering these products are service providers who are trying to connect private lenders with appropriate sources of capital.

Taking care of our existing customers is the very best way to grow our business organically. Working with our existing funding sources and using the latest products is the best way to quickly get to lower cost capital. We will spend some additional time thinking about refinements to optimize our processes. My overall view after going to the conference is that we are on the right track with our business planning.

Charlie Einsmann
(703) 887-1039
charlie@cskyfinancial.com

Sam Jacknin
(703) 587-2475
sam@cskyfinancial.com

Deal of the Month

The Deal of the Month involves a deal that we did on 13706 Autumn Vale Court. We saved a house from foreclosure! The borrower closed the deal and we purchased the loan in less than a week, preventing the house from going to the courthouse steps. We were referred to this borrower from a loan officer friend of ours.

The borrower inherited the house from her father, and the loan was still in her father's name. She got behind on the payments and the bank would not cooperate with her because the loan was not in her name. The loan amount was only $30,000 on a property worth $300,000.

She originated a $70,000 first trust (that gave her some extra cash for breathing room) and we purchased the note. She is expected to refinance out in six months.

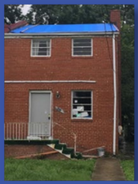
October Deals

1126 Woodland Ave.

4809 Illinois Ave. NW

5329 Pronghorn Lane

6007 Magnolia Ct.



4427 Texas Ave. SE

www.cskyfinancial.com

Charlie Einsmann
(703) 887-1039
charlie@cskyfinancial.com

Sam Jacknin
(703) 587-2475
sam@cskyfinancial.com