THE POWER OF MORTGAGE NOTE INVESTING

PART ONE

A BRIEF INTRO TO NOTE INVESTING

Labrador Lending, LLC

“Although the real estate itself is not your investment, the real estate provides collateral for your investment.”

MORTGAGE **NOTE INVESTING**

Mortgage Note investing is a specialized sub-category of real estate investing. When you invest in notes, instead of investing directly in the property, you are investing in the debt (the loan) that the real estate owner has borrowed in order to buy the property. In essence, you become the bank. Instead of buying the real estate itself, you, as a mortgage note investor, are buying the debt. Although the real estate itself is not your investment, the real estate provides collateral for your investment.

The truth is, while this investing niche is not well known, its basic concepts are not really that complicated. As such, I thought it might be worthwhile to provide a high-level overview of mortgage-note investing.

CHAPTER 1.1
NOTE INVESTING BASICS

What is a Note?

Simply put, a "note" is a written and signed promise to pay. If you have ever taken out a mortgage to buy a house, then you've signed a loan document (a note) promising to pay your lender back over time. This note spells out in detail the terms of your loan. In addition to the note, your promise to pay is "secured" by another document, a mortgage, that says the lender can repossess the house or property in the event you fail to make your loan or note payments. In some states the mortgage is called a "deed of trust." Once the loan documents are signed, the mortgage (but not the note) gets officially "recorded" at the city, township or county recorder's office. This official recording of the mortgage is done to protect the lender's secured interest in the property.

When note investors purchase a "note," they are actually purchasing, from the lender, the right to collect the debt on a property. The investor receives a package which includes all relevant documents including both the note and the mortgage. In essence, the note investor becomes the bank with a secured interest in the property.

Performing vs. Non-performing

There are many types of notes out there, but one easy way to categorize them is to label them either performing or non-performing. A performing note is one that is being paid on-time every month. A non-performing note is typically defined as one where the borrower is behind on their payments by at least 90 days. From an investor's standpoint, non-performing notes typically involve more risk and more work but potentially more reward.

Although pricing has gone up in the last few years, a note investor can often buy a performing note for 70% to 90% of the unpaid principal balance of the existing loan. A non-performing note can be purchased for less, possibly 40% to 70% of the unpaid principal balance. Unpaid principal balance is the amount still owed on the note not including interest, late fees and other charges that may also be owed.

Lien Position

Another way to categorize notes is by lien position. Remember, when a loan is first made, the mortgage is recorded by the county in order to secure the property for the lender in case the borrower fails to pay. Generally speaking, the rule "first in time, first in line" applies here. A mortgage is in "first" position because it was recorded first. If a property has a second mortgage (could be a HELOC or home equity loan), this new (additional) loan is recorded in "second" position. This note is called a "second" because it was recorded after the first. Second mortgages typically have lower balances and higher interest rates than first mortgages.

In addition to first and second (and sometimes third) mortgages, there are many other types of liens (payment obligations) that can be recorded against a property (property taxes, IRS, HOA, mechanic's liens, school fees, etc.). As an investor, this is where attention to detail and proper due diligence are very important. This is also where title companies are vital because a comprehensive title report will reveal all outstanding liens against a property.

Judicial vs. Non-judicial

Yet a third way to classify a note is by the foreclosure laws in the property's home state. Some states are considered "judicial states" and others are considered "non-judicial." The main difference between judicial and non-judicial states is the length of time (and amount of legal fees) it takes to foreclose on a property.

Although foreclosure may not be the preferred strategy for the note investor, he or she sometimes has no other alternative. And foreclosures in judicial states can take years, as opposed to a couple of months as is often the case in non-judicial states.

> **Note investing gives you a path to controlling your investments, as opposed to simply allowing someone else to babysit your money.**

Note-Investing Strategies

One thing I love about note investing is the flexibility it provides relative to both purchasing and exiting the investment. Although note investing is certainly not as liquid as investing in stocks and bonds, it does offer the investor numerous ways to exit the investment and make money.

I will briefly touch on two basic strategies a note investor can deploy, and I'll provide a hypothetical example for each.

STRATEGY #1

BUY AND HOLD PERFORMING NOTES

This strategy is more expensive on the front end than the second strategy, but it is more passive and a little more predictable. When an investor purchases a performing note, he or she is often investing for cash flow.

The investor is expecting the monthly note payments to keep arriving consistently over time.In the event the note becomes non-performing (i.e., the borrower stops making timely payments), there are still several potential exit strategies, but that topic is for another day.

Here's a very basic example:

An investor pays $43k to purchase a performing note with an unpaid principal balance of $50k. The loan carries an interest rate of 9% amortized over 360 months. The borrower pays the investor about $400 per month for the remaining life of the loan.

With each payment, the borrower is paying some interest and some principal. At the beginning of the loan term, most of the monthly payment goes toward interest, and the remainder goes to pay down the principal balance of the loan. As the loan is paid down over time, a greater portion of the monthly payment is applied to principal. The chart below shows the difference in interest/ principal split for a loan that is amortized over 30 years.

Payment#	Date	Beginning Balance	Total Payment	Principal	Interest	Ending Balance
1	6/1/2021	$50,000.00	$400.00	$27.68	$372.33	$49,972.32
2	7/1/2021	$49,972.32	$400.00	$27.88	$372.12	$49,944.44
3	8/1/2021	$49,944.44	$400.00	¢28.09	$371.91	$49,916.34
357	2/1/2051	$1,570.67	$400.00	$388.31	$11.70	$1,182.36
358	3/1/2051	$1,182.36	$400.00	$391.20	$8.80	$791.16
359	4/1/2051	$791.16	$400.00	$394.11	$5.89	$397.05
360	5/1/2051	397.05	$397.05	$394.09	$2.96	$0

STRATEGY #2
FIX AND FLIP NON-PERFORMING NOTES

The strategy of buying non-performing notes is really the bread and butter of discounted note investing. As with the above strategy, the investor has several options when it comes to exiting the investment. One of the most common is to work with the borrower and convert the non-performing loan into a performing loan, thereby increasing its value.

For example:

An investor pays $30k to purchase a non-performing note with an unpaid principal balance of $50k with the same terms as the performing note in Strategy #1 above.

The note is non-performing because the borrower has not paid in 6 months due to a medical issue.

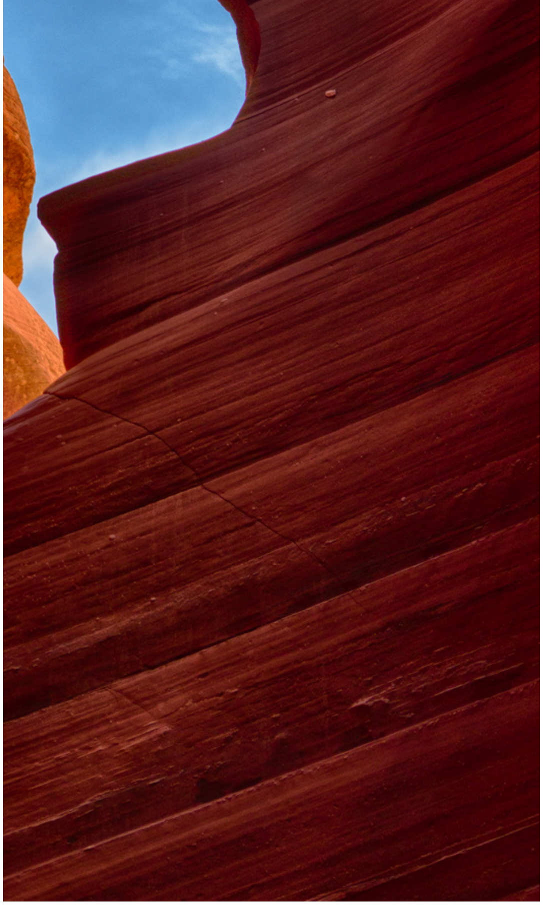
The investor and the borrower work out new terms for the loan, which lowers the monthly payment and gets the borrower back on-track making regular and timely payments.

After 14 months of collecting $300 per month ($4200 to the investor), the investor then sells the now-performing note to another investor for $40k.

The investor received $4200 in principal and interest payments from the borrower plus $40k from his sale of the now performing note to a new investor, a total of $44,200.

This is a triple win, the investor has profited $14,400 in 14 months on his $30k investment, the new investor has purchased a now performing loan at a discount and, finally, the borrower is able stay in his/her home while making lower monthly payments.

In addition, this process is also a win for the community.



BONUS: STRATEGY #3

NOTE FUNDS

For the investor who wants to add note investing to their portfolio but does not want the time and energy commitment of Strategies #1 or #2, a viable alternative is an investment in an established note fund. These note funds typically pool investment capital from accredited investors and buy groups of notes.

The goal of the fund's principals is to manage the notes to produce attractive returns for the investors. In later chapters, there will be a detailed discussion of the pros and cons of active vs. passive note investing, as well as note fund investing.

CHAPTER 1.2

NOTES VS REAL ESTATE INVESTING

Most people are familiar with the concept of investing in real estate. Many of us have rented or purchased housing and some of us have even been landlords. Note investing, on the other hand, can seem a bit more mysterious. When you compare the strategy of investing directly in property (real estate investing) with the strategy of investing in notes, you may wonder which investment approach is better.

Let's review a few key differences between the two strategies and declare a "winner" for each category. For simplicity's sake, we will frame our discussion around renting or lending as it relates to single-family residences.

Property Control vs. Property Ownership

When you invest in a rental property, you own the physical real estate. When you buy a note, you have a secured lien on the physical real estate. In one scenario, you own the asset; in the other, you control the asset.

While determining the winner for this category could be debated endlessly, I am going to give the slight nod here to notes. The main reason: As the note investor, you still have considerable influence over the asset but you incur significantly less of the responsibility and liability that you have when you own the asset. Winner: Notes.

Leverage – Borrowing Money

While it is possible to obtain financing using a note as collateral, traditional financing is much more common in the world of physical real estate. When buying a rental property, you can typically obtain bank financing as long as the collateral (the property that secures the new loan) and your credit position make sense for the lender.

The world of notes, however, can be more cash-intensive. That usually means you are using your own money or that of a joint-venture partner. Borrowing money from a traditional lender to purchase a note is not the norm.
Winner: Real Estate.

Deal Flow

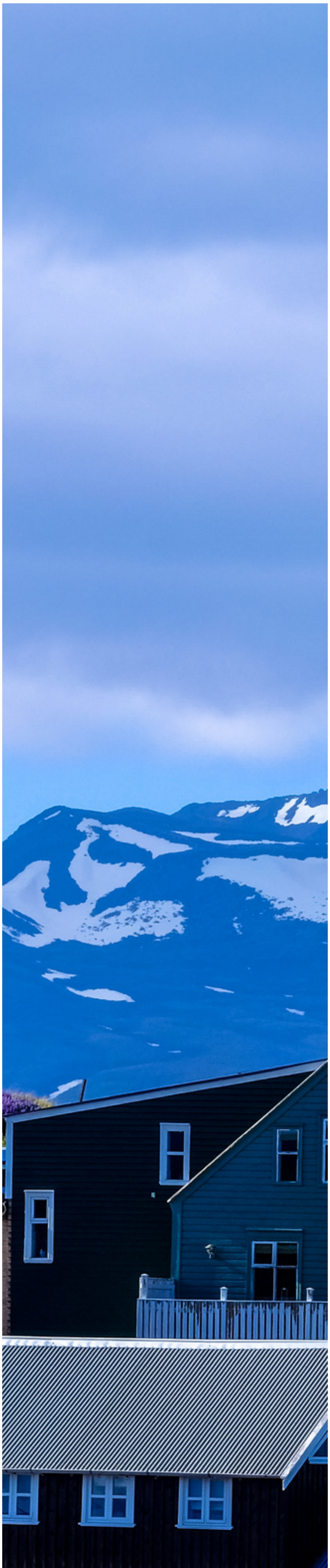
Note investing is very much a niche strategy. Finding notes to purchase is generally not nearly as straightforward or easy as finding real estate.

While online portals that offer notes do exist, you really have to network with banks, brokers, hedge funds, and other note investors to have access to good note deals. Winner: Real Estate.

Effort and Time Required

While neither strategy is truly passive, note investing certainly requires fewer active components to manage. As a note investor, contact with the borrower is typically handled by a third-party servicer. This is especially true with performing note investments. Even investors in non-performing notes can outsource the loan modification process to a servicer.

Managing rentals, from my experience, requires more time and hands-on attention. This is true even if you hire a property manager. Another plus for note investing is that technology now allows you to invest from anywhere as long as you have a laptop with internet access and a phone. Winner: Notes.



Long-Term Value of Asset

Real estate typically appreciates in value over time. Although the value of a note can go up as well, often through forced appreciation like turning a non-performer into a performer (see Strategy #2), that is somewhat atypical and certainly requires patience and work.

What is more common is that, as the investor receives regular payments of principal and interest, the principal balance gets paid down over time, and the value of the note slowly decreases as well. Winner: Real Estate.

Tax Implications

Note: The following is not tax advice:

Owning rental property comes with more tax advantages than owning notes. With real estate, there are often greater expenses that can be written off, such as mortgage interest, maintenance and other expenses. In addition, you can depreciate the value of the property (typically over 27.5 years) for tax purposes. This is one of the main benefits to owning rental property.

When comparing real estate to notes, notes often generate fewer expenses and the profit is mostly due to interest income, which is treated as ordinary income for tax purposes. In addition, unlike real estate investments, note investments don't generate depreciation for tax purposes. Compared to real estate investing, there are simply not as many tax benefits to investing in notes. This is major reason that a lot of note investors prefer to buy notes through tax free or tax deferred entities like a self-directed IRA or self-directed Roth IRA or a Health Savings Account or Educational Savings Account.

These accounts are relatively easy to establish and your tax advisor can help you establish one or more of these entities.) When you invest in notes using one of these tax advantaged entities, your note investment grows, whether tax-free or tax-deferred, the same way more common IRA investments do. Winner: Real Estate.

Versatility

When buying a rental property, the aim is basically to collect rent, pay down the mortgage, and hold the asset for appreciation and long-term wealth-building. With notes, there are several exit strategies at your disposal. If you are forced to foreclose on a note, you might be able to acquire the property and add it to your rental portfolio. In effect, you've converted your note investment into a real estate investment). You can flip the note by selling it to another note investor. You can sell a "partial" (meaning a certain number of the borrower's payments) to another note investor.

Because of these numerous exit strategies, compared with rental property investing, note investing provides more options and versatility for profits. Winner: Notes.

Impact Investing

While providing quality, affordable housing to renters is a socially positive way to invest, helping a borrower who has fallen on hard times to remain the owner of his or her home is even more socially beneficial, especially when considering the effects on the surrounding community. A non-performing borrower is often just a number to a big bank.

But this is not the case with a conscientious note investor. In addition, investing in non-performing notes also adds value by helping the borrower build equity in his or her property and by helping banks and hedge funds clean up their books. Investing in non-performing notes really can be a triple-win scenario. Winner: Notes.

CHAPTER 1.3
WHAT NOTE INVESTING CAN DO FOR YOU

Now that we've covered some of the differences between investing in real estate and investing in notes, it's time to outline some of the key advantages to note investing: Why should you consider investing in notes? I'll give you six reasons to consider, along with a real-life case study that displays the true power of this strategy.

Note investing provides an investment vehicle not tied to Wall Street's ups and downs

Now, I'm not as anti-Wall Street as some are. Being exposed to the traditional markets certainly has its advantages. The stock market has produced average returns of about 10% historically, which is solid. And stocks are extremely liquid. If you need cash for an emergency tomorrow, you can sell your stocks with the press of a button.

However, you may not want to hitch your entire retirement wagon to the traditional model. Not to mention, the stock market comes with an ever-increasing level of volatility and timing the market has been proven to be an exercise in futility.

Note investing can give you both control and safety

Note investing gives you a path to controlling your investments, as opposed to simply allowing someone else to babysit your money and forcing you to tether your financial future to the whims of the stock market.

Many people are unaware just how easy it is to open a self-directed IRA (or 401(k)). If you have a traditional or Roth IRA, you can easily move some or all of your funds over to a self-directed IRA (traditional or Roth) and take control of your retirement.

Aside from a few restrictions, there is a lot of freedom to this path. You can invest in nearly anything. I recommend investing in something you can understand, and with someone you trust.

And when it comes to safety, just how much collateral does Wall Street offer you for investing in stocks? In other words, if you invest in Apple, and the tech giant's stock takes a nosedive, what is your recourse? The last time I checked, you have none. You may get a tax write-off for your losses but that's not a sound investment strategy, in my opinion. However, when you invest in notes, your investment is secured by your collateral in the property.

As long as there is equity over and above the amount you've invested (and lent to the borrower), if and when the borrower defaults, you can foreclose to take back the property to protect your investment.

Note investing can allow you to help people

When you become the mortgage lender, you can work with the borrower to restructure their loan to help them keep their home. Or you can gracefully help them to face the fact that they may be in over their head and they should relocate or find a better long-term plan than hanging on to a property they cannot afford.

Note investing can prepare you to invest when the next recession hits

Warren Buffet famously said, "Be fearful when others are greedy and greedy when others are fearful." Let's face it, real estate markets are cyclical, and most business economists predict the U.S. will fall into a recession within the next two years. Further, Americans are in more debt now than they were just after the 2008 financial crisis.

I believe that the number of mortgages in default will rise in the coming years. While I don't celebrate this prediction, I do think it prudent to position yourself to help both your own financial situation as well as struggling homeowners.

Note investing can provide you the option of working from anywhere

If you want to turn your note investing into a side hustle or even a full-time business, you can do so from anywhere, provided you have a cell phone and internet access. Let's not pretend note investing does not take work. It does.

But it's not the kind of work that requires you to manage tenants and toilets, and it does not anchor you to a specific location. It really can be done from anywhere.

Note investing can give you bragging rights at parties

In the last decade, investing in real estate has become extremely popular. Thanks to HGTV flipping shows as well as legitimate investors' stories (Okay, there are some legitimate investors on TV), real-estate investing has become quite trendy.

And it's also very popular to be considered an entrepreneur. Becoming a note investor is the perfect way to be both a real estate investor and an entrepreneur!

CHAPTER 1.4
JACKSONVILLE, FL

Would you cash out with a 200% annualized ROI? Or would you try to beat the elusive 2% rule?

Find out what we chose below. Let's take a look at the investment timeline:

April 2019

- We purchased a non-performing note on a property in Jacksonville, FL, in late April, 2019 via Paperstac.com
- The purchase price for the note was $46,500.
- The unpaid principal balance was $93,675, total payoff was approximately $132k.
- The property value was estimated to be $125k at the time.
- Trial payment plan, forbearance agreement: the previous note holder and the borrowers had negotiated a reduced mortgage payment of $400 for 3 years (down from over $1100 per month). This trial payment plan went into effect in April 2017 and was scheduled to end in April 2020. This was a significant reduction to the original monthly payment.
- The last payment made was in February 2019 (with only one payment made in over 2 years), but last contact with borrower was in October 2018.

July 2019

- The borrower (homeowner) claimed they and others were planning to refinance the loan. This would be ideal for all parties involved.

August 2019

- The refinance did not materialize and the borrower ceased communications.
- After attempting to work with the borrower for several months, we hired a Florida-based law firm to prepare for foreclosure.
- Foreclosure in Florida can be expensive and time-consuming for the lender.
- Out of the blue, the borrower's relative contacted our 3rd party note servicer indicating that he had been paying rent to the borrower and was unaware that the mortgage payments were not being made.

September 2019

- Through our law firm, we formally communicated to the borrower our intent to foreclose.
- The borrower contacted our law firm indicating she was willing to deed the property over to Labrador Lending, LLC. We would now own the house and not the mortgage. In effect, our note investment would transition to a real estate investment.
- In this scenario, the borrower would avoid a foreclosure, which would be detrimental to her credit history, and would be forgiven over $20k in debt ($132k owed minus potential sale proceeds of $110k). We would avoid a lengthy and expensive foreclosure process.

October 2019

- The borrower signed deed in lieu of foreclosure. The property now belonged to our company.
- As part of deed-in-lieu agreement, we allowed 2 months (October and November) for the borrower's tenant to relocate. We were also given access to the property so that we could conduct inspections.
- We ordered an interior property inspection and were pleased with the condition of the house.
- We explored our options, including selling the property or renting it out.
- After doing some research about the Jacksonville rental market and underlying economic data, we felt it best not to sell the home; instead, we would rent it out.
- We also researched property managers and settled on a professional firm with a strong track record.

November 2019

- The tenant originally indicated he would not leave unless we evicted him. However, after looking further into his options, he stated he would be purchasing a home of his own by the end of the year.
- Rather than evict the tenant during the holiday season, we decided to allow him free lodging for this transition period.

December 2019

- As of mid-December 2019, we had invested a total of approximately $49,625, including all costs for the note and legal fees.
- The property value was estimated to be $135k at this point.
- If we had sold the property in early December, factoring in closing costs and a conservative sales price, we would have profited $60k on a $50k investment in under 8 months. In other words, this would have been $110k returned to us on a $50k investment, in less than 8 months.
- Annualized, this ROI would have been over 200%.
- Instead, we planned to rent the home for approximately $1100 per month, and we hoped to beat the elusive2% rule for rental properties. This return also factors in $5k for any requisite repairs to the house.

January 2020

Access to the Interior

- In January, 2020, when the occupants of our property had had enough time to purchase a home of their own, we finally had access to the interior of our house. What we found was not pretty. As many real estate investors know, there are often many surprises on the inside of a house. Although we had conducted an interior inspection the prior October, it was cursory. In addition, it turns out I was too optimistic on the required rehab costs. This is a common mistake.
- Although we have managed several rather extensive rehabs for other rental properties in our portfolio, we had never done so from 750 miles away. In fact, to date we have never even been to Jacksonville, let alone to this property.

March 2020

Our Team on the Ground

- Fast-forward a few months, and here we are. We did not realize we'd have to deal with a global pandemic (a mistake not quite as common as under-estimating rehab costs), but our stellar property management team (Suncoast Property Management) and contractors (primarily Mario Brothers Restoration and Turnkey Construction and Maintenance) kept us on track. We were thoroughly impressed with the work of all three companies.

Improvements to the Property

- The house now has a new roof, new flooring, new paint inside and out, and is simply in much better condition than it was a couple months ago. Oh, and it is no longer infested with bed bugs, so there's that.

Here's a link to a gallery of before-and-after pictures, so you can see the improvement for yourself.

April 2020

Renting the Property

- Even in the middle of a global pandemic, the property was advertised for only 2 days before we had a signed 12-month lease for the listed rent amount.

A Look at the Numbers

- At the end of the day, we are doing all of this to make a profit. Although this project has not turned out to be quite the home-run we had hoped, I would still call it at least a double, if not a triple. Here are some of the basic numbers:
    - $563 in cash flow per month, or $6,756 per year (after considering all expenses).
    - 1.43% income-to-expense ratio. We arrive at this figure by dividing the monthly rent amount ($1,075) by the amount we have in the deal ($75,125). This is well under the 2% we had hoped for but is much better than we have done on any other rental of ours.
    - $135,000 in equity we could pull out to invest in another project.

One negative about this project has to do with the time value of money. It took us just under a year from the purchase of the note to get the property rented.

Although there were many legitimate reasons for the delay, there is certainly opportunity cost associated with having an investment tied up for so long without any returns to show for it.

Another thing to note is that this deal could have been even better.
After we were under contract to purchase the note for $46,500, we learned that the seller would have accepted $40,000. Obviously, our returns would have been even better if we could have saved $6,500 on the purchase.

On the bright side, our projections are probably a bit conservative as the expenses associated with repairs and maintenance will likely be lower than we are forecasting considering we just fixed up the property.

If we decide to pull out some of the equity in the property through a cash-out refinance, our cash-on-cash return would be significantly higher (although our cash flow would be a bit lower).

We would then have the ability to purchase another note or another rental property. Rinse and repeat.

Oh, and let's not forget about the inherent advantages of rental properties, like the tax advantage of depreciation and the likely appreciation of the property value.

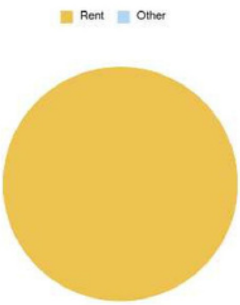
For the number nerds out there, here and below are a deeper dive into how this deal looks.

Monthly Income:	Monthly Expenses:	Monthly Cash Flow:	Pro Forma Cap Rate:
$1,075.00	$512.00	$563.00	5.00%
NOI	**Total Cash Needed**	**Cash on Cash ROI**	**Purchase Cap Rate**
$6,756.00	$75,125.00	8.99%	13.61%

Property Information

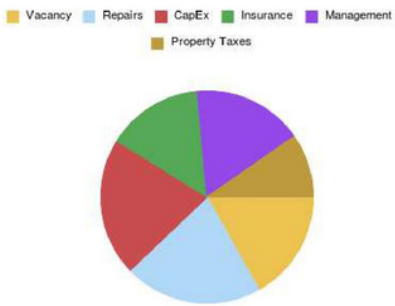
Purchase Price:	$49,625.00
Purchase Closing Costs:	$0.00
Estimated Repair Costs:	$25,500.00
Total Cost of Project:	**$75,125.00**
After Repair Value	$135,000.00
Down Payment:	$49,625.00
Loan Amount:	$0.00
Loan Points:	$0.00
Loan Fees:	
Amortized Over:	0 years
Loan Interest Rate:	0.000%
Monthly P&I:	**$0.00**

Income



Rent	$1,075.00	Other	$0.00
Total	**$1,075.00**		

Expenses



Vacancy	$86.00 (8%)	Repairs	$107.50 (10%)
CapEx	$107.50 (10%)	Insurance	$75.00 (7%)
Management	$86.00 (8%)	Property Taxes	$50.00 (5%)
Total	**$512.00 (48%)**		

Financial Projections

Total Initial Equity:	$135,000.00
Gross Rent Multiplier:	3.85
Income-Expense Ratio (2% Rule):	1.43%
ARV based on Cap Rate:	-

50% Rule Cash Flow Estimates

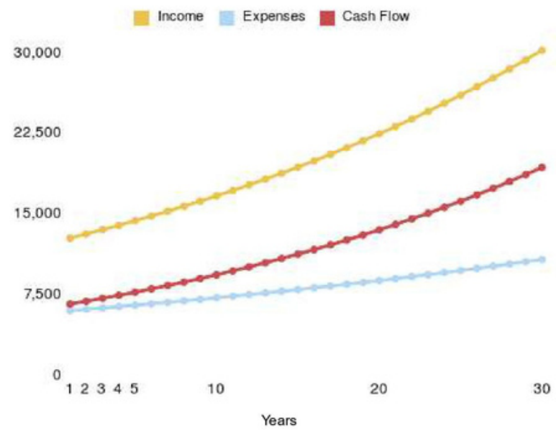
Total Monthly Income:	$1,075.00
x50% for Expenses:	$537.50
Monthly Payment/Interest Payment:	$0.00
Total Monthly Cashflow using 50% Rule:	**$537.50**

Analysis Over Time

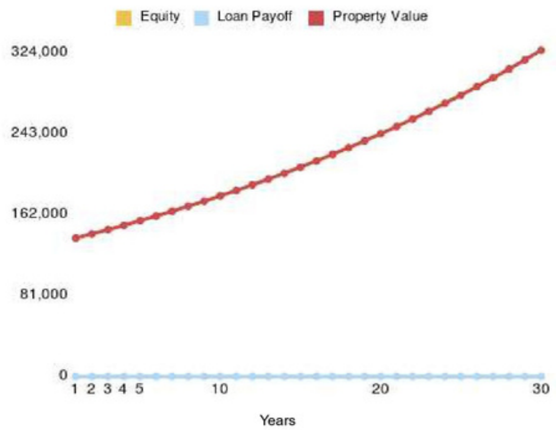
Annual Growth Assumptions	2% Expenses	3% Income	3% Property Value

	Year 1	Year 2	Year 5	Year 10	Year 15	Year 20	Year 30
Total Annual Income	$12,900	$13,287	$14,519	$16,832	$19,512	$22,620	$30,400
Total Annual Expenses	$6,144	$6,267	$6,650	$7,343	$8,107	$8,951	$10,911
Total Annual Cashflow	$6,756	$7,020	$7,869	$9,489	$11,406	$13,670	$19,489
Cash on Cash ROI	8.99%	9.34%	10.47%	12.63%	15.18%	18.20%	25.94%
Property Value	$139,050	$143,222	$156,502	$181,429	$210,326	$243,825	$327,680
Equity	$139,050	$143,222	$156,502	$181,429	$210,326	$243,825	$327,680
Loan Balance	$0	$0	$0	$0	$0	$0	$0
Total Profit if Sold	$58,167	$68,983	$103,806	$170,584	$249,947	$344,101	$587,537
Annualized Total Return	77%	39%	19%	13%	10%	9%	8%

Income, Expenses and Cash Flow (in $)



Loan Balance, Value and Equity (in $)



FINAL THOUGHTS ON JACKSONVILLE - IMPACT INVESTING

A big reason we love investing in notes and real estate is the positive impact we can make on all involved. Here are a few ways that specific parties were positively affected by this project:

- the borrower had many thousands of dollars in debt forgiven (see Case Study Part 1); the previous occupants (the old tenants) are in a better situation now (purchased a home);
- we have provided affordable housing for our new tenants;
- we have supported—and continue to support—the local Jacksonville economy by employing contractors and our property management company;
- at least one house in the neighborhood is in much better condition now; and
- the deal will be profitable for us as real-estate investors.

THREE TAKEAWAYS

Although these returns are not typical, this case study shows how investing in non-performing notes can be highly profitable.

Note investing can be win-win-win. The borrower avoided foreclosure and was forgiven a significant amount of debt. The tenant was provided 3 months of free lodging in order to transition to his own home where he can begin to build equity himself. And a resident of Jacksonville (the new tenant) will be provided affordable housing with quality property management and landlords. Oh, and we will profit significantly, likely for many years to come.

Note investing provides the investor options. There are often several independent exit strategies, something that is not always true with other investment niches.

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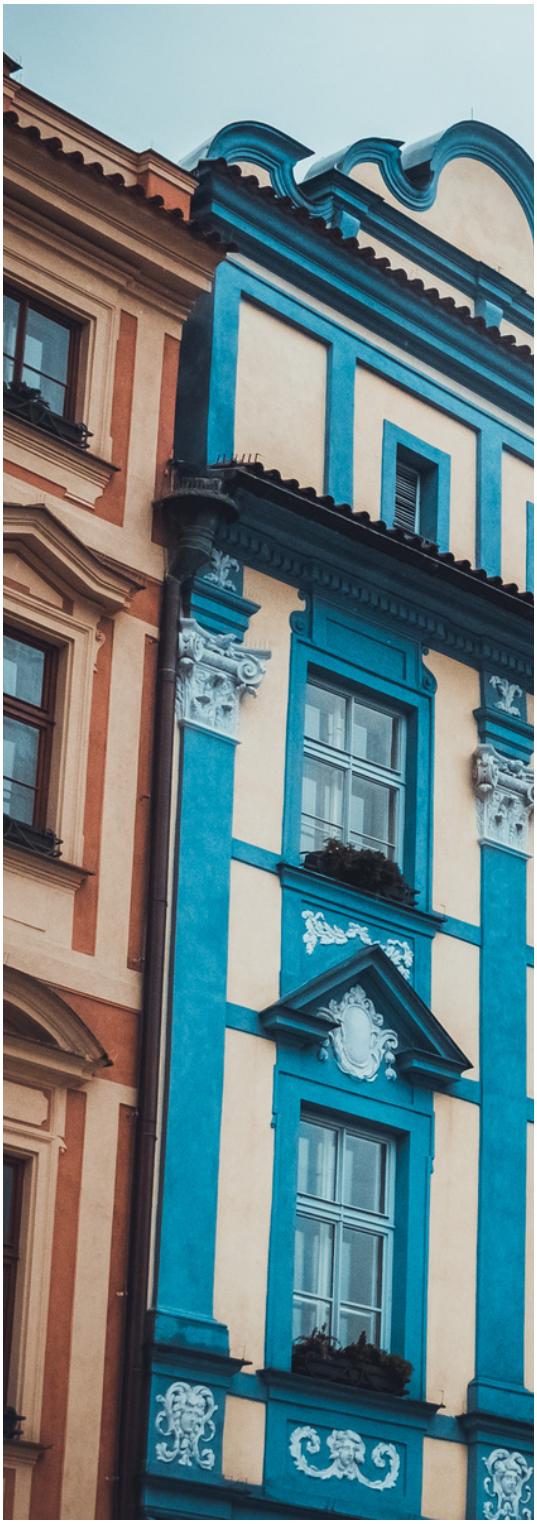
THE POWER OF MORTGAGE NOTE INVESTING

PART TWO
ACTIVE VS. PASSIVE

Labrador Lending, LLC

As we covered in the first E-book, there are many different ways to invest in notes.

Part Two of the E-book dives into the details of investing strategies to flush out the differences between being a passive investor, and investing actively as a note investing business.



CHAPTER 2.1
FROM PASSIVE TO ACTIVE – THE SPECTRUM OF NOTE INVESTING

"It's much more passive than traditional real estate investing" is a phrase you might see or hear when starting your research into the world of note investing. I mean, after all, you don't have to deal with tenants, toilets, and trash. However, just as real estate investing ranges from Very Passive (investing in REITs) to Very Active (rehabbing, flipping, wholesaling), note investing also has a broad spectrum from active to passive that can be tailored to all types of investors.

One key caveat: Clearly understand your personal goals. Are you someone who is heavily invested in the stock market and simply wants to diversify with an asset class backed by a hard asset like real estate? Or perhaps you're someone who wants to pursue notes as a side business? Or maybe you're a seasoned real estate investor looking to switch from raising capital for apartment buildings to starting a fund that purchases hundreds or thousands of notes.

Regardless of your current situation, you need to understand and clarify your goals before deciding on an initial note investing strategy. Before we dive into the details, it is worth noting that the definition of "passive" for the purpose of this article is the amount of time an investor will spend in managing their investment or business.
Let's take a look at some examples of different note investing strategies along the spectrum of passive to active:

Very Passive
Investing in Note Fund

Somewhat Passive
Option 1: Hypothecation
Option 2: Purchasing Partials
Option 3: Partnering with an Experienced Investor on a JV

Somewhat Active
Purchasing Performing Notes

Active
Option 1: Purchasing Non-or Sub-performing Notes
Option 2: Creating Notes

Very Active
Managing a JV on a Non-Performing Note
Managing a Note Fund

STAGE 1:
VERY PASSIVE

Investing in a Note Fund

The first strategy is investing in a note fund. This is probably the most passive way that an individual can invest in notes. The fund structure can vary, but typically the investor is providing capital for an equity stake in an LLC that will purchase many individual notes. Although the JOBS Act of 2012 allowed for increased access to fund investing for those who may not have qualified previously, this approach is often open only to "accredited" or sophisticated investors and can require a substantial minimum investment.

The individual investors in a note fund are not managing any of the day-to-day operations of the fund. Also, because the day-to-day operations are the responsibility of the fund manager, the investor doesn't need to have expertise in the note investing business to realize strong returns. If you're an accredited or sophisticated investor looking to diversify your portfolio outside of Wall Street and don't have the time or desire to learn the ins and outs of note investing, consider researching note funds.

STAGE 2:
SOMEWHAT PASSIVE

Option 1: Hypothecation

Hypothecation is the use of an existing note as collateral for a new loan. For example, if a seasoned note investor has a consistently performing note, they can use that performing note as collateral to obtain a loan from you. You would loan capital to the seasoned note investor at an agreed upon rate and you would receive a lien on the investor's performing note as collateral. This is more active than investing in a note fund for a few reasons. First, you need to know individuals that are in the note industry that have performing notes that they want to use as collateral. Second, even though you don't initially own any notes, there is the potential to obtain ownership of the note if the terms of the loan contract aren't honored.

In this scenario it's possible that you could end up with the property itself through foreclosure or other means if the note becomes non-performing. That's why it is critical that–before you participate in a hypothecation deal–you research and understand: 1) the details of the asset that is serving as the collateral for the note, 2) the experience level and reputation of the investor to whom you are loaning money, and 3) the language in the contract between the two of you. If everything goes well, you'll simply receive monthly payments from the investor managing the note and won't have to worry about much else. However, every situation is unique, so always do your research and understand your exit options and strategies in case the terms of your investment are not honored.

Option 2: Purchasing Partials

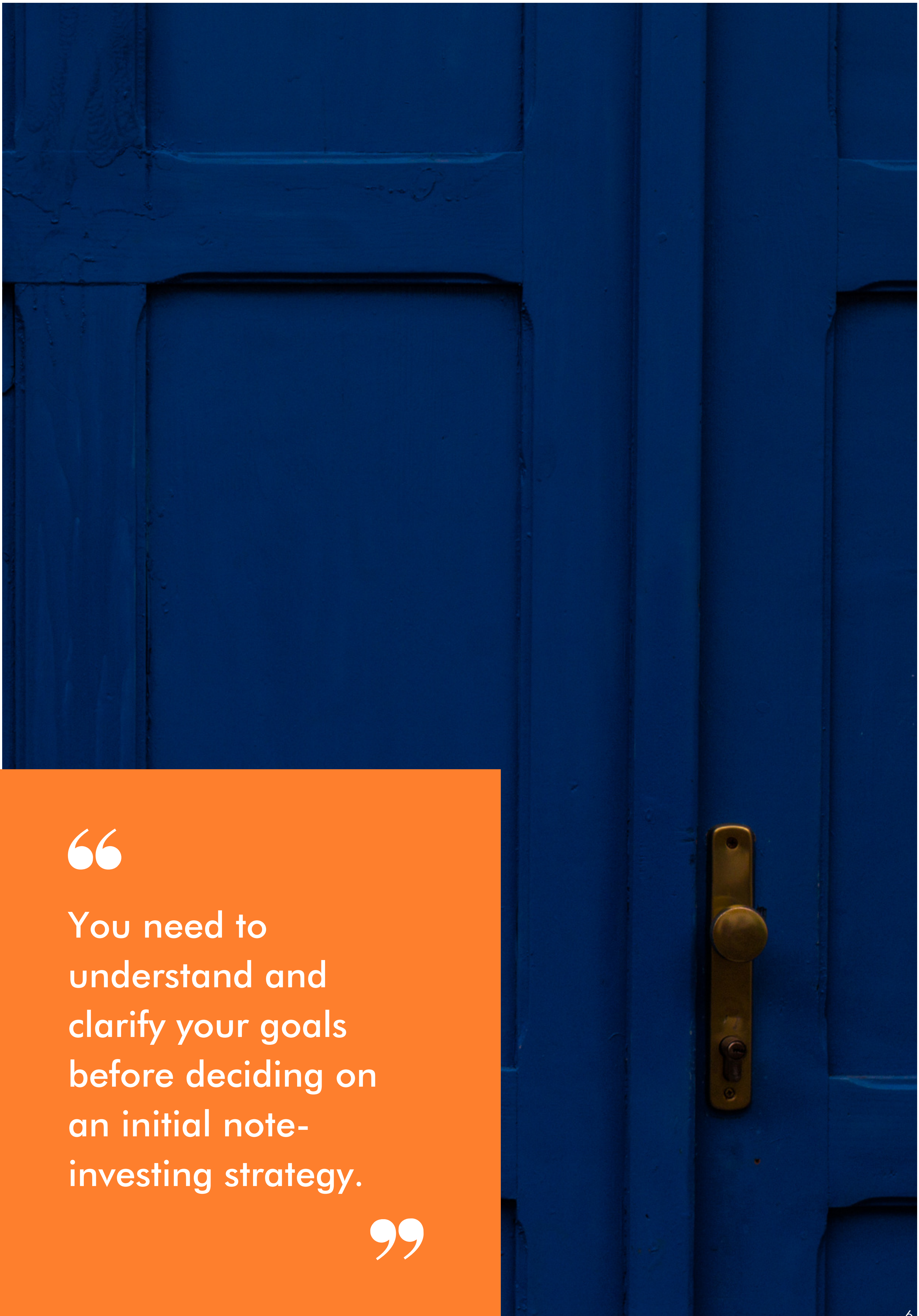
A "partial" note is exactly what it sounds like: part of a whole note. Hence, the sale of a note partial is when one note investor sells a portion of payments to another investor. In our case, this Somewhat Passive strategy is the purchase of part an already existing performing note. It differs from hypothecation in that you are likely taking legal ownership of the part of the note you purchase. The partial buyer may even manage the day-to-day oversight of the note for the time period in which they are receiving payments.

Partial agreements can be structured in many different ways, but in general the risk profile and passiveness level associated with buying partials are very similar to those of participating in a hypothecation.

Option 3: Partnering with an Experienced Investor through a Joint Venture

A third Somewhat Passive strategy is partnering with an experienced note investor on a non-performing loan (NPL) through a Joint Venture (JV) deal. This can be a great option for someone who is interested in getting their feet wet before buying their own notes. As always, it is critical to know and trust anyone to whom you send money. Often, the non-experienced partner is the "money" partner and will supply most or all of the funds to purchase the asset and is also involved in making major decisions regarding the asset.

However, the money partner is not typically involved with managing the NPL on a daily basis. This Somewhat Passive strategy usually involves more upside potential than hypothecation or partials, but can also come with increased risk. As stated previously, it is also a valuable learning opportunity as the non-experienced partner can work closely with an experienced investor to "rehabilitate" a note from "non-performing to "performing." If you see yourself investing in NPLs in the future, consider starting off by becoming a money partner on a properly structured JV deal with an expert note investor you trust.



> You need to understand and clarify your goals before deciding on an initial note-investing strategy.

STAGE 3: SOMEWHAT ACTIVE

Purchasing Performing Notes

Stage 3 is the first of the strategies that differentiate the truly passive note investors from the individuals that see note investing as an opportunity for a side or full-time business. Stages 1 and 2 relied on other note investors to actually purchase and manage the assets. In this stage, however, you are the sole owner of the asset.

The process for purchasing performing notes is quite different from Stages 1 and 2. First, you need to find a source for performing notes. These sources include, but aren't limited to: note brokers, hedge funds, other note investors, and online exchanges, (paperstac.com for example).

Next, you need some sort of purchasing criteria. For example, you'll want to define your target states, lien position (senior or junior), a range for the unpaid principal balance of the loan, notes or CFDs (Contracts for Deeds – a specialized type of owner financing), target yield, etc. In order to calculate your target yields you'll want to have a calculator that takes into account the future cash flow and expenses of the notes. After you get an accepted offer on a note, you'll need to complete extensive due diligence on the paper asset, the borrower, as well as the physical property. Once the due diligence is completed without any show-stoppers, it is time to close on the deal.

At this stage it is likely you'll want to start building a support team that includes, but is not limited to: attorneys, servicing companies, title companies, and maybe even a bookkeeper. Investors often create LLCs or other entities that are used to purchase notes to decrease potential personal liability from these assets.

Another thing that's critical at this stage is understanding your exit strategies. Will you just collect the monthly payments if the note continues to perform, or would you consider selling partial payments to another investor like we discussed in Stage 2? If the note becomes non-performing, what approach will you take to get the borrower back on track? If you end up taking back the physical property, is your plan to rehab and sell at full retail, sell it off as soon as possible to another investor, or hold it as a rental property?

These are all important questions to ask yourself during your pre-purchase analysis as you want to be confident that you can make a profit with your worst-case exit strategy.

STAGE 4:
ACTIVE

Option 1: Purchasing Non-Performing or Sub-Performing Notes

A non-performing note is defined as a loan where the borrower is 90 days behind or more on their payments. A sub-performing note is defined as a loan where the borrower is actively making payments, but they are behind a bit or have missed payments in the recent past. If the borrower is not making payments when the note is purchased, there is obviously no initial cash flow from the asset. Non-performing notes are purchased at higher discounts than performing notes, typically between 30-60% of UPB (unpaid principal balance) compared to 75-95% for performing notes.

The due diligence for non-performing notes is very similar to performing notes, except each step may be more involved and it is critical to properly evaluate the property value as there's a higher chance that the investor could end up with the property.

The main reason why non-performing notes are in Stage 4 (Active) instead of Stage 3 (Somewhat Active) like performing notes is the investor may have to work with the borrower to get the note reperforming (including possibly renegotiating the terms of the note), or work with a servicer and/or attorney to initiate foreclosure or otherwise take back the property.

It is much more important to understand your different exit strategies when evaluating a non-performing note for purchase. Some investors target vacant houses in hopes of foreclosing, while others focus on working with the borrower in order to get the loan back to current status and turn it into a performing note.

Since performing notes are worth more to other investors, turning non-performers into performers is a common way that note investors generate profit and scale their businesses. Another reason non-performing note investing is considered Stage 4 (Active) is that the asset management is much more involved than it is with performing notes. Asset management in this case refers to monitoring your 3rd party vendors, working with your legal team, paying property taxes, etc. You may need to be creative here.

All-in-all, buying and managing non-performing notes is quite a bit more active than buying and managing performing notes.

Option 2: Creating Notes

The second Active strategy is creating your own notes, which is typically done via seller financing. An example might be purchasing a home with cash for a discount, rehabbing it, and then selling the property to a home buyer with seller financing. Instead of the buyer making monthly payments to a bank, they would make the payments to you. You now have the choice to continue to receive monthly payments from the borrower, or sell the performing note to another note investor.

There are a few reasons why we consider this as an Active strategy. First, you need to find a property and most likely purchase with cash. A rehab of this property is often required before selling the property.
After the renovation you'll need to find a buyer for the property, and most of the time, buyers interested in seller financing won't be able to qualify for traditional financing. This may be due to their employment situation, credit history, or the fact that the loan amount may be smaller than that of a typical bank mortgage. Therefore, careful and detailed buyer/borrower screening becomes an important step with seller financing.

You also need to properly underwrite the new loan to be sure it is legally compliant with all new regulations (Dodd Frank/CFPB/SAFE Act). Both federal and state regulations may apply to the creation of a new loan.

You may want to involve a licensed loan originator (RMLO), underwriter, and/or attorney. After the loan is created you have the choice of receiving monthly payments or selling the note for a profit to another investor. Many investors choose to sell these newly originated notes in order to generate capital to buy more properties and create more notes. As you can see, there are many moving parts with this strategy. Hence, we deemed it Active.

STAGE 5:
VERY ACTIVE

Option 1: Managing a Joint Venture on a Non-Performing Loan

The first strategy for Stage 5 (Very Active) is managing a joint venture (JV) on a non-performing note. This involves all of the complexities of purchasing a non-performing note as discussed in Stage 4, and now the investor is also working with and reporting to a JV partner.

There are many considerations when deciding to take on a JV partner. First, there is a legal contract between the JV partners that outlines the relationship between the parties.

This requires consultation with an expert attorney familiar with these arrangements. Often, there is a "money" partner, who supplies all or most of the funds to purchase the note (as discussed above), and an "operating" or "managing" partner, who manages the sourcing, due diligence, purchase and day-to-day management of the note. Larger decisions typically need input from both parties. The managing partner now must keep track of the bookkeeping, payments to the JV partner, as well as regular reporting (often quarterly or monthly).

Another challenge to a JV partnership is that typically the money and the deal have to coincide. In other words, you don't want to bid on an asset if you don't have a funding partner lined up, but you don't want to take someone's funds without an asset to put them toward.

Which comes first? As you can see, just the phases of structuring the JV and sourcing and purchasing the non-performing note(s) could be considered Very Active. In contrast, if you're an investor selling partials, normally the note is already purchased and the money is found later.

Option 2: Managing a Note Fund

The last strategy, and the second for Stage 5 (Very Active) involves creating and managing a note fund. Now you are raising capital for large scale purchasing of many assets. For example, a typical note fund could be targeting between $1 million and $10 million of raised capital. A fund isn't cheap to launch – often start-up costs can be between $5k and $10, and this is just to open the fund. Funds also open the door to a variety of different regulations. This can vary between funds, but some examples are Regulation D 506(b) and506(c), and Regulation A. Managing a fund also comes with the responsibility of reporting to all of the investors in the fund. Interestingly enough, depending on the relative size of the fund, reporting to fund investors can be less work than reporting to many individual JV partners. As such, managing 100 assets (whether performing or not) in a fund is likely less work than managing 100 JV deals. Regardless, managing a note fund is certainly on the Very Active end of the Passive to Active spectrum.

Before you decide on your preferred investing strategy and start looking for notes to purchase, first, let's cover some key decisions you need to thoughtfully consider.

CHAPTER 2.2

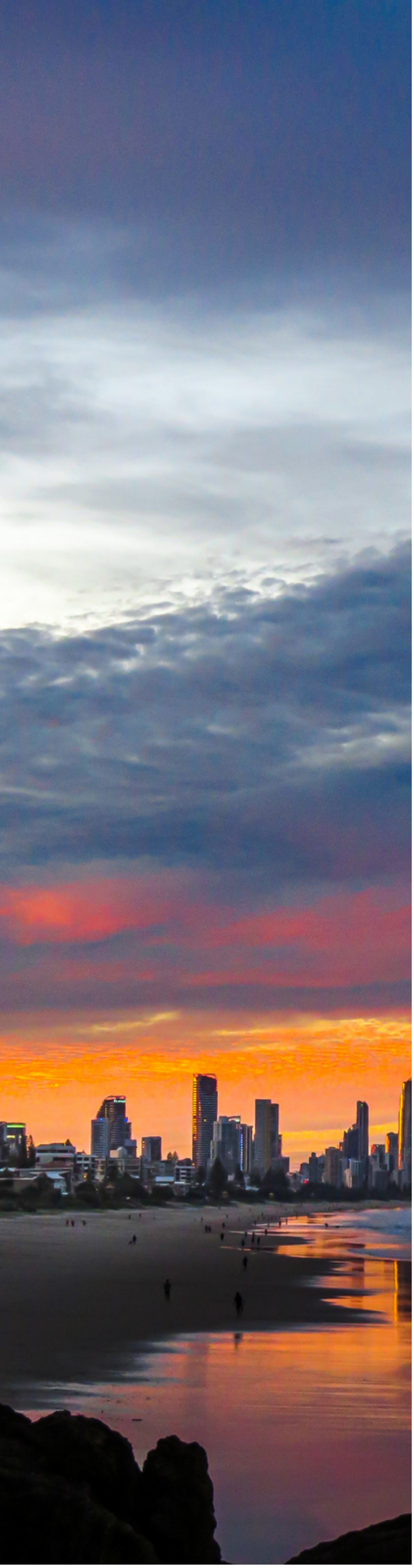
FIVE KEY DECISIONS FOR NEW NOTE INVESTORS

Your first Key Decision is where you want to be on the spectrum of passive to active. As we saw in the previous section, the amount of time, energy and focus varies substantially depending on the investing strategy you choose.Before you start, carefully think-through which of the investing strategies best fits your goals and lifestyle. At the "Active" and "Very Active" end of the investing spectrum, there is a significant learning curve and significant ongoing time, energy and financial commitment. Excellent organizational, time-management and financial management skills are essential.

Your second Key Decision is whether to focus on investing in First Mortgage Notes or Second Mortgage Notes. Advantages to first position notes are inventory – there are substantially more first position notes available for sale. Also, first position notes give you more protection than second position notes. When you are in first position you are closer to acquiring the property in the event you are forced to foreclose. Your due diligence focus as a first mortgage investor is focused more on the property than on the borrower. In contrast, your due diligence focus as a second mortgage investor is focused on both the property and the borrower.

Although there are fewer second mortgages available for sale, and the second mortgage is behind the first mortgage in a foreclosure, there are some distinct advantages to investing in seconds. Second mortgages are typically less expensive than firsts. When investing in a second, you can typically control a more valuable property with less invested than is the case with investing in firsts – and occasionally, you will find that your second mortgage investment has become a first position note because the existing first mortgage has paid-off. There is less competition for seconds. As the holder of a second mortgage, you can still foreclose and either get paid-off (by a foreclosure property buyer) or end up acquiring the property yourself (subject, of course, to the debt on the first mortgage).

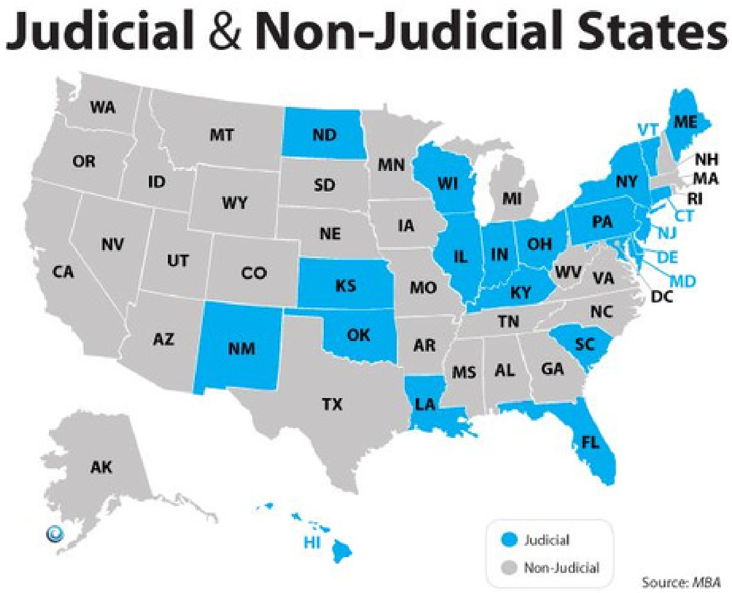
Your third Key Decision is deciding where to invest. In which States will you buy notes? You must understand and think through the issues of judicial vs. non-judicial (see image below), foreclosure time-lines and expenses, licensing requirements, local resources, etc.



I typically recommend new note investors choose three to five states in which they're willing to buy. Don't try to focus on just one state because you are not going to see enough in the way of inventory to run due diligence and make bids. At the same time, don't choose fifteen states in which you are willing to buy. Why, because you're going to be overwhelmed with the differences and nuances of the different

Also, consider states where you may already know people or vendors or have family members willing to help out. If so, you could choose to focus on those states first – assuming they meet the other criteria above.

Map of U.S. showing judicial vs. non-judicial foreclosure states



Your fourth Key Decision is your willingness to buy Contract for Deeds (CFDs). We haven't yet discussed this hybrid real estate/note investment. A Contract for Deed (also sometimes called a Land Contract) is a form of legal lease where the tenet acquires 100% ownership in the property at the end of the lease term – assuming all lease payments have been made in accordance with the lease. There are major differences between a CFD and a typical mortgage and note. Some note investors specialize in CFDs, other investors won't go near them. We're not going to go into the details now, however, here's a link to a blog post on our website with more information:

There are some key advantages and disadvantages to investing in CFDs. If you own a CFD and you are forced to “re-possess” the property because the lessee has stopped paying, often you can accomplish a forfeiture which is faster and less expensive than a traditional foreclosure. Another advantage to CFD investments is they're normally less expensive than a traditional note and mortgage. You are often dealing with lower-end properties and people that can't qualify for a traditional mortgage – accordingly, by investing in CFDs, you may be able to get into the note investing space with less money than you would need for a conventional note investment. For example, if you don’t have $100,000 to work with immediately, you can buy a performing CFD $15,000 to $20,000 and maybe that's a worthwhile alternative to get started.

One downside of CFDs is that you are “on title” so you are responsible for the property taxes (regardless of what the land contract says). As the county or city is concerned you or your company owns that property, you're responsible for the taxes and any nuisance or liability issues.

Contract for Deeds are a viable “niche” within the world of note investing.They can be very profitable.However, be sure and do your homework and understand the pros and cons of CFDs thoroughly before investing.

Your fifth Key Decision is investing in preforming vs. non-performing notes. Even if you want to eventually focus on non-performing notes, I recommend you first buy – at a minimum - one or two performing notes. In buying and managing these performing loans, you will start to understand the mechanics of how to purchase a note, how to board it with a servicer, how to build your team and your systems (software, attorneys, bookkeeping, title companies, etc.). It’s critical to establish this foundation for a successful long-term note investment business.

However, keep in mind that performing notes are more expensive than non-performing notes. One way to think about the difference is to view performing notes like a buy and hold rental property and non-performing notes like a fix and flip property. Like a buy and hold rental property, you purchase a performing note for cash flow and like a fix and flip, you purchase a non-performing note to rehab, add value and sell (or choose to keep for cash flow).

We buy both performing and non-performing notes. We buy performing notes for cash flow to keep the business running and put a little in our in our pocket each month and we also buy non-performing notes that require “active” or “very active” management.

BONUS

Your sixth Key Decision

I know I only promised five, but here is a bonus sixth Key Decision you'll make as a new note investor: Will you use other people's money?

If you are planning to scale, unless you are Bill Gates or Elon Musk, you will probably run out of your own capital. There are numerous strategies for raising outside capital to scale your note investing business: Hypothecation, partials, joint-ventures, note funds have all been discussed previously. Think about this sixth decision and, when the time comes, what strategy or strategies make the most sense to you to add capital and growth to your note investing business.

CHAPTER 2.3

USING YOUR SELF-DIRECTED RETIREMENT ACCOUNTS TO INVEST IN NOTES AND NOTE FUNDS

One way to access capital to invest in notes is by using money you already have in retirement accounts – your IRA or 401K. You start by converting some or all of your existing retirement accounts to an approved, legal, government regulated "Self-Directed" Retirement Account.

Although there are both self-directed IRA's and self-directed 401K's and also self-directed health savings and other legal retirement accounts available, we'll just use the term self-directed IRA in the section below. Consult your CPA or tax advisor for help properly setting-up one or more of these accounts.

What is a self-directed IRA?

A self-directed individual retirement account (SDIRA) is a type of IRA that can hold a variety of alternative investments, like rental real estate or notes. Although the account is administered by a custodian or trustee, it is directly managed or "self-directed" by the account holder. Available as either a traditional IRA (tax-deductible contributions, tax-deferred growth) or a Roth IRA (after-tax contributions, tax-free distributions) (or even a SEP IRA for those who are self-employed), self-directed IRAs are best suited for investors who already understand alternative asset classes and who want to diversify using a tax-advantaged account.

Some sources indicate that there are over $7 billion in IRAs across the United States. However, only an estimated 1 to 2% of those IRAs are SDIRAs.

What self-directed IRA investments are restricted by law?

There are a few asset classes and arrangements that are off limits for SDIRAs:

- collectibles (art, etc.),
- S-corporation stock,
- life insurance, and
- prohibited transactions – self, spouse, parents, children.

In general, however, many people are surprised to learn just how many asset classes are allowed.

Why is note investing a great fit for a SDIRA?

One of the downsides to investing in notes is that notes provide very few tax advantages, if any. You are typically taxed at your ordinary income rate, or at the appropriate capital gains rate (long-term or short-term). So, investing in notes outside of a tax-advantaged account can come with a high tax bill.

This is why marrying the power of both the upside potential and safety of note investing with the tax-reducing advantages of an IRA can be a potent way to grow your retirement funds.

How can I get started?

It is easier to set up a self-directed IRA than many people realize. If you have a 401k from a previous job, you can very easily convert some or all of that 401k to an SDIRA. You do not have to roll it over into your current employer's 401k. Or, maybe you already have an IRA and would like to diversify away from what has been widely viewed as the traditional way to invest: stocks and bonds.

What if I don't have experience with note investing?

A common way to get started with note investing is to partner with someone more experienced. Often, a passive, "money" partner will combine forces with an active, "managing" partner. Another option is investing in a Note Fund run by experienced note investors. As you gain experience as a note investor, you can choose to "move-up" on the "spectrum" from passive to active as detailed earlier in this document.

OK, you've done your homework, you've decided on how passively or actively you want to invest, and you've identified sources of capital you will use to begin your note investing journey. If you've decided on a "Somewhat Active" or "Active" strategy, now is the time to locate some notes to buy!

CHAPTER 2.4

WHERE TO FIND MORTGAGE NOTES

A successful note business consists of primarily three elements: deal flow (access to notes to purchase), capital flow (access to money with which to purchase notes), and the often-overlooked element of asset management (communicating with your vendors and overseeing the notes you already own).

The number one question asked by new mortgage-note investors is, "Where do I find notes to purchase?" It is not as easy as buying stocks or bonds and not as easy as buying physical real estate. There is not exactly a New York Stock Exchange (NYSE) for notes, or even a note Multiple Listing Service (MLS). In a sense, all note purchases can be considered "off-market deals."

The secondary note market is only partially regulated and not very efficient. This inefficiency creates opportunity, but it also means that finding notes takes work. Even for seasoned note investors deal flow can be an ongoing challenge.

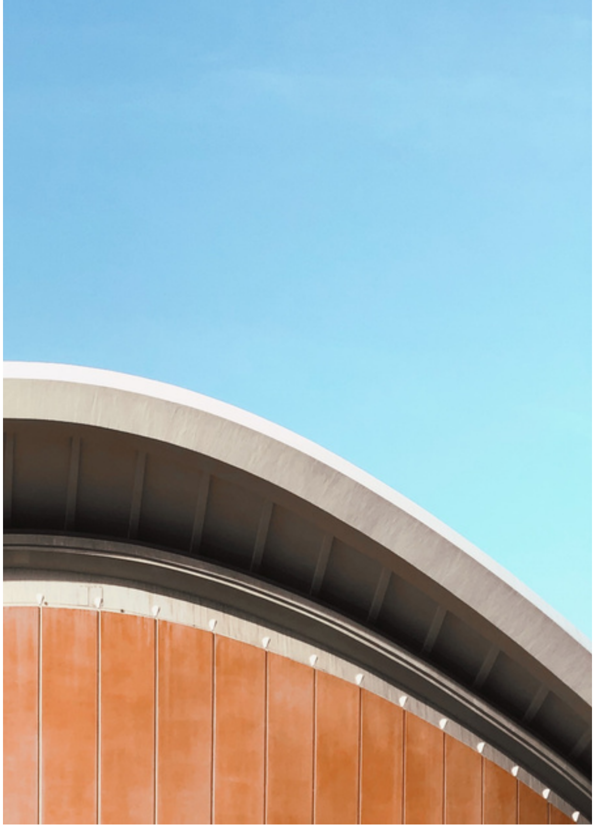
While not an exhaustive list, below are some potential sources of notes.

Banks, Credit Unions

Many of you reading this have a mortgage and have experienced that mortgage being transferred from one bank or lender to another. This is your personal real-world example of the fact that banks sell notes. Banks and similar institutions like credit unions sell both performing and non-performing notes. Banks sell notes to generate cash that the bank can use for other investments and banks also sell notes that have become non-performing. Banks and lending institutions are not typically interested in running a past-due collection or loan modification operation. Also, banks do not like to foreclose or take over (repossess) the property that was collateralized for the loan. Banks and other large lending institutions are in the lending business, NOT the collection, loan modification, property-management, real estate sales or rental business.

Hedge Funds

Hedge funds are financial partnerships that use pooled funds, normally from high net-worth investors only, and employ different strategies to earn returns for these investors. They often attempt to provide a "hedge" against stock-market downturns by investing in alternative investments like mortgage notes. Hedge Funds are run by professional money managers and investment advisors. Typically, they have access to many millions of dollars and purchase assets directly from banks and other lending institutions. Hedge funds frequently sell off mortgage notes to brokers and investors in the secondary market, frequently in bulk.



Holders of Seller-Financed Notes

In addition to loans generated by banks and other traditional lending institutions, there is also a significant number of loans generated by private parties. Typically, these notes are created when the seller of a property originates a loan to the buyer of the property. In other words, the owner helps finance the purchase of the property by becoming the lender for the buyer. This niche is likely going to grow more and more in the future, especially as bank financing becomes harder to obtain for many people.

Similar to fellow note investors, owners of seller financed notes can be an excellent source of deals. Some note investors intentionally target holders of seller-financed notes. The current note holder, who may have been a landlord for many years and then a lender for a period of time, may simply want or need cash now based on market conditions or changes to their personal circumstances. Seller-financed note holders can be a viable source of deals for note investors.

Other Note Investors

An often-overlooked source of notes is other note investors. We have found this source to be one of the most fruitful. There are several advantages to dealing directly with other note investors. Here are a few:

Level of trust: When buying directly from other investors, you can be selective about those from whom you buy. Networking is key in this business. There is a good chance you may have met the note seller in-person or online and you feel comfortable with the individual or company.

No broker fees: When you purchase directly from another note investor there is no middle man and no fee paid to a middle man.

Less competition: If the seller has not published their deal(s) anywhere, you–as the potential note buyer–may be competing with only a handful of other note investors or none at all.

Online Platforms

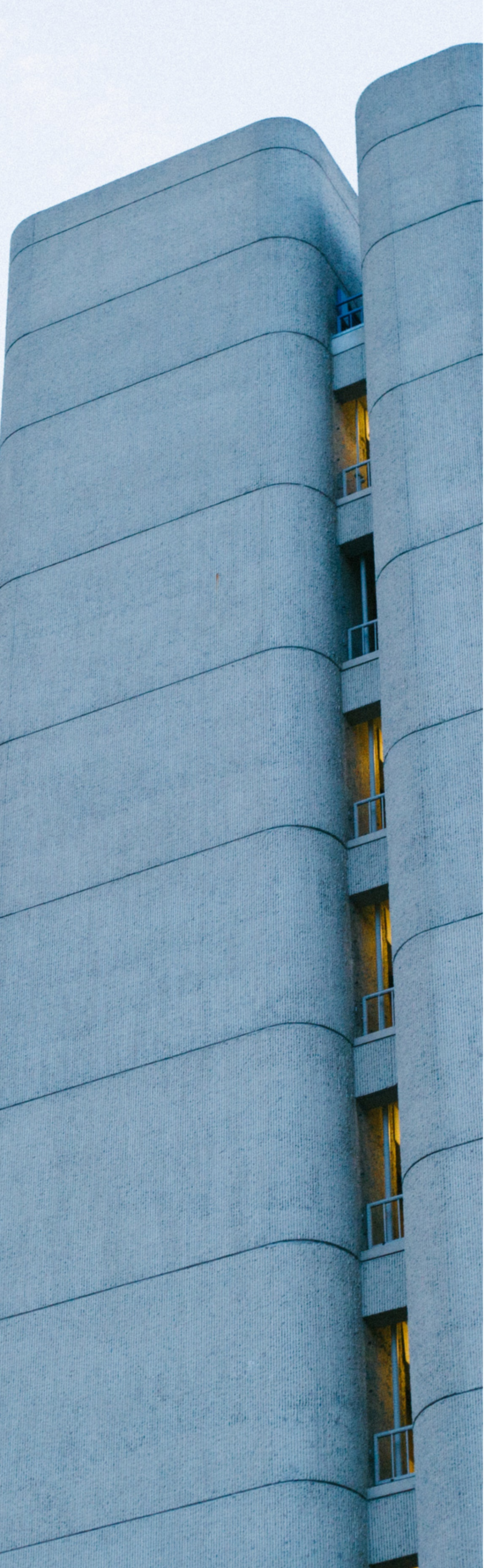
Online platforms are probably the closest thing to the New York Stock Exchange or NMLS for mortgage notes. The platform that currently shows the most promise, in my opinion, is Paperstac.com. Paperstac offers a user-friendly interface that allows a note buyer to sort the assets available by numerous criteria, set-up ongoing notifications, and follow a streamlined process for both negotiating and purchasing a note.

I have purchased several notes via Paperstac and recommend this platform without hesitation. Another, similar exchange is NotesDirect.com. While I have not purchased via this platform, I have spent some time there. Although similar to Paperstac, NotesDirect does not allow for negotiation; the price is what it is. With that said, I have found it to be a user-friendly platform that is a good place to tweak your due-diligence practices and refine your pricing expectations. I believe most, if not all, of the notes available on NotesDirect are of the seller-financed variety.

Note Brokers

Similar to a real-estate agent or a mortgage broker, a note broker matches a buyer and a seller. Often a note broker will send out what is referred to as a "tape" of assets. This tape is typically a spreadsheet with data on specific loans for sale. There could be two notes for sale, or hundreds. Although brokers have various procedures, usually, the note buyer has a specific period of time to submit bids on those notes in which they are interested. Many note buyers will work through the tape, filtering by location, principal balance, term, etc., to narrow down the list to a manageable number of assets on which to bid. A note broker typically charges a fee, to be paid by the buyer, seller, or both. This typically ranges from 1% to 3% of the purchase price, so be sure to build this fee into your pricing models.

Also, be wary of the "joker broker". These are brokers that will try to sell low quality assets or assets in which they're purchasing from another broker. We do not recommend purchasing assets in which there are multiple brokers involved in a "daisy chain". So please do your due diligence on who you are purchasing from.



Attorneys, CPAs, Insurance Agents, Other Financial-Services Personnel

Those who work in the financial sector may not think of themselves as a source of mortgage notes, but they certainly have access to information and contacts that can lead you, the note investor, to the acquisition of good note deals. Some note investors market directly to these professionals, but even if you choose not to, you can mention to them that you are always looking for quality "paper."

Note-Servicing Companies

Another potential source of notes is note servicers. There are many out there, including: Madison Management, Allied Servicing Corporation, National Asset Mortgage, Security National Servicing Corporation, Lake City Servicing, FCI Lender Services, etc. Some servicers will publish loans for sale and some will not. Regardless, servicers certainly have a good deal of information about borrowers, investors, markets, regulations, and the industry as a whole. Note servicers can be a solid source of deal flow.

Creating Your Own Notes

One way to acquire notes is to create them. Maybe you are a real-estate investor, real-estate agent, property owner, wholesaler, or simply have access to inexpensive real estate. Although the majority of mortgage notes for sale today are institutional notes, underwritten and originated by a bank, credit union, or other professional lending establishment, many are not. Many loans are simply held by the seller of the collateralized real estate.

For a more detailed look at some of the sources we've used to locate notes, please click on this link to watch our video which includes a discussion of twelve different note buying sources.

CHAPTER 2.5 HOW TO RESEARCH AND CHOOSE A NOTE FUND

1. Competent and experienced manager. It could be multiple managers, whoever is operating the fund. The manager who's responsible for day–to–day operation of the fund is the most critical piece of the puzzle.

2. Transparency and communication. Look for a fund with a track record of regular, consistent, and detailed communication with their investors.

3. Economic Conditions: Look for funds that are investing in assets that are supportable over the term of that fund. Questions to ask: "In what specific type of assets will the fund invest and why? Is this asset class likely to be viable over the term of the fund? What is the lock-up period (the time period your capital is tied-up)? How do market conditions factor in with a note fund vs. an investment in another asset class?"

4. Upside Potential: Make sure you understand how the payouts are structured. Interest only? Preferred return? Interest/preferred return plus a split of profits? Make sure the fund's payout structure fits your criteria and time frame for your capital.

5. Management Fee: Make sure you research not only the amount of the management fee (1%, 2%, 3%?) but also how it is structured. Is it charged before or after the preferred return? Is it based on the capital invested or the principal balance of the assets? Make sure the management fee structure is fair to both you–the investor–and fund the managers.

Finally, if you are interested in researching our note fund, we have information at Labrador Lending and Integrity Note Fund.

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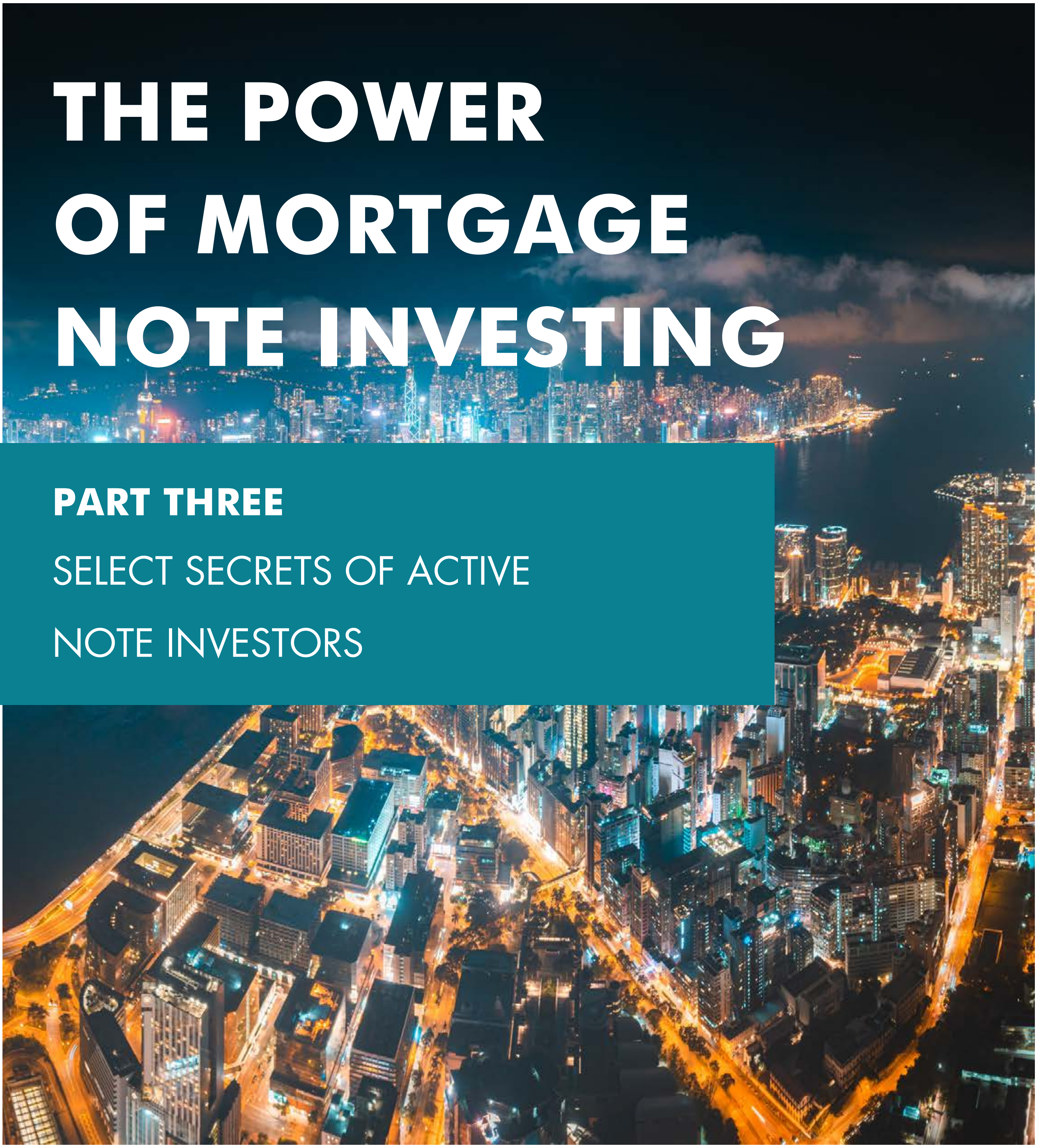


THE POWER OF MORTGAGE NOTE INVESTING

PART THREE

SELECT SECRETS OF ACTIVE NOTE INVESTORS

Labrador Lending, LLC

So far in Part One and Part Two of the E-book, we've introduced the concept of investing in notes, covered some of the different categories of notes, compared note investing to real estate investing, detailed the case study of our Jacksonville investment, discussed the spectrum of passive to active note investing, outlined key decisions for new investors, discussed the concept of using self-directed retirement accounts for note investing and detailed where to source note investments.

In Part Three, we'll share some selected secrets of successful note investors.

CHAPTER 3.1

10 REASONS TO INVEST IN MORTGAGE NOTES

Discounted pricing

Both performing and non-performing notes are almost always sold at a discount. What does that mean? It means that if the current unpaid principal balance of the note is $100k, you may be able to purchase the note between $40k and $90k. Why is that? There are many factors here, but the primary reason for the discount is risk.

A note is simply a promise to pay, and the fact is, sometimes promises are broken. Because of this inherent risk, you can typically purchase a note for less than the amount the borrower owes.

When you purchase the note at a discount, you are able to make a higher rate of return than the interest rate specified on the note. For an example, Strategy #1 from Part 1, Chapter 1.

Collateral

How does the note buyer mitigate the risk of buying performing and non-performing notes? For first-position mortgage notes, this is done primarily through using the property as collateral. If you purchase a first-position note for $50k, and the home is worth $150k, your investment should be well protected by the equity in the home. Moreover, the borrower is typically more motivated to keep paying if they have built up equity in the property.

Contrast this with investing in stocks which, the last time I checked, have no collateral.

Diversification

How many of us simply sign up for our employer's 401(k) plan, invest in stocks and bonds that we don't know much about, and hope for appreciation? Make no mistake, Wall Street has had a great run for the last decade-plus, but history shows this cannot last.

Careful investments in performing and/or non-performing notes can be a great strategy to diversify your investment portfolio beyond conventional stocks and bonds.

Control

When was the last time you attended the board-of-directors meetings at Apple and had influence over the company's operations? Right. Well, with mortgage notes, you can thoroughly evaluate the asset before you buy and then you can decide the prudent steps you want to take to manage it. Yes, this can be more work than investing in stocks, but everything has a trade-off. Note investors like having some control over the management of their investments.

Numerous Strategies

Like real-estate investing, in general, there are many angles from which one can approach note investing.

You can decide to invest through: seller financing transactions, land contracts, institutional notes, firsts, seconds, performers, non-performers, commercial notes, hard-money loans, and note funds, just to name a few.

Multiple Exit Strategies

This flexibility also exists for exit strategies. When exiting a stock investment, you have only one option: sell the stock. With rental properties, there still aren't as many exit routes as there can be with notes. With performing notes, you can hold the note for cash flow, sell a "partial" to another investor, or sell the whole note. The borrower may even refinance and pay off your note, providing you with an immediate profit. Non-performing notes also have several exit options – more to come on this in Part Four of the E-book.

This may seem overwhelming at first, but the good news is you don't have to be an expert in all areas. We choose to stay focused on our business model which utilizes a few strategies mentioned above. However, market conditions do change, and it is always good practice to have multiple options.

Capacity to invest from anywhere

Although out-of-town rental-property investing has gotten more popular recently, the investor still needs to be sure they have a quality management and repair team in the area of the property. With note investing, however, you are not managing the property. Although you certainly want to have contacts in place in the event that you need them (attorneys, realtors, inspectors, etc.) generally, the note business is more passive than rental-property investing.

With notes, you can invest anywhere in the country, wherever the numbers make sense. As long as you have phone and internet access, you can invest in notes.

Opportunity on the horizon

While I do not believe we will see a mortgage crisis like we did in 2008, due to the economic effects of the Pandemic, there are some signs of a new correction on the horizon.

When a correction happens, banks and hedge funds will be more inclined to sell off non-performing and sub-performing loans. When supply goes up, prices normally go down. Mortgage notes will become less expensive, and the potential returns will increase.

Ability to scale

You can custom tailor your note investing activity to fit your specific goals. You can buy one or two mortgage notes and leave it at that. You can decide to be a "passive" investor by partnering with a more experienced note investor or participating in a note fund. Or, you can treat note investing like a business. The business of note investing essentially boils down to three things: finding notes (deal flow), finding money (sometimes partners or other investors), and managing your notes and your money.

Once you have systems and vendors in place, there is no reason you can't replicate the process many times over. There can be a lot of moving parts, and it certainly takes hard work and focus. But note investing absolutely lends itself to scaling.

No tenants or toilets

Although I would not consider note investing to be 100% passive (few things are), once the note is acquired and set-up with a loan servicer, a note investment generally requires less hands-on, active work and management than rental property.

While I also believe in the long-term power of rental-property investing, being the lender/note holder comes without the headaches of tenants and toilets.

Think about it, do you own a home with a mortgage? When was the last time you called your lender in the middle of the night?

> “As long as you have phone and internet access, you can invest in notes.”

CHAPTER 3.2

10 REASONS NOT TO INVEST IN MORTGAGE NOTES

No Tax Advantages

There are no ancillary tax advantages to investing in notes when compared to investing in real estate. Interest income from note investments is taxed as ordinary income.

It is Complex

Active note investing involves many different "moving parts." There are a myriad of details that must be managed with each note investment. There is lots of paperwork and legal compliance issues. If you are not ready to commit to dealing with, and staying current with, ongoing complexity, then don't invest in notes.

Value Declines

The value of the note investment decreases over time as the loan is paid down. This is the opposite of most real estate investments which typically appreciate over the long term. In addition, the holding costs on non-performing notes can add up quickly.

Difficult to Leverage

It is difficult to "leverage" note investments.It is much more difficult to borrow against your note investment as compared to real estate.

It's the "Wild West"

The note industry is largely unregulated. There are many unethical players in the industry.

It is critically important to ensure that the people you choose to deal with are trustworthy.

It is Expensive

Note investing can be very expensive.

The ongoing cost of servicing fees, legal fees, licensing requirements and regulatory fees and penalties can add up fast.

You Must Deal with Ongoing Conflict

Note investing is a conflict intensive business.

In order to resolve issues and profit from notes you have to have the personality and willingness to deal with problems and conflict on an on-going basis.

It is Management Intensive

Note investing requires significant management skills. Your profit from each investment is determined by managing that investment correctly.

Correct management is more important than your purchase price in producing your profit.In addition, you are managing remote attorneys, title companies, reality, property management and rehab companies, etc.

Dealing with these remote vendors adds extra challenge to the management of note investments. You must be adept at managing both people and systems and keeping both performing on schedule.

Note Investing Can Be Risky

Typically, you cannot personally inspect the remote properties that are the collateral for the note investment. In addition, in order to determine if the note investment is worthwhile, you must rely on relatively low paid personnel to research and generate the title reports and the property inspection and market value assessments (BPOs or "Broker's Price Opinions") you need to conduct proper due diligence.

Once you acquire the note investment, you must also rely on low paid personnel at your servicing company to conduct your borrower outreach and debt collection.

Training Can Be Problematic

Formal note training programs can be awfully expensive and usually not effective in properly preparing you to be a note investor.You need much more than a few days, or even a few months, to learn the note investing business.

Many of the weekend training programs are designed as "loss leaders" to upsell students into more expensive long-term training and/or mentoring programs.

CHAPTER 3.3
NOTE PARTIALS VS. HYPOTHECATION - WHAT'S THE DIFFERENCE?

Two similar strategies in the note-investing world are often referred to as partials and hypothecation. These techniques can be excellent ways to create a win-win for both parties involved in the transaction.

Selling a note partial or hypothecating a note can each help the note holder to scale their business by providing capital now to reinvest in additional assets for cash flow later. In essence, the note holder can defer profits by using other people's money to expand their note portfolio for the future. This can be quite powerful.

On the flip side, buying a note partial or providing cash for a note hypothecation can allow the buyer/lender to enjoy a relatively passive and lower-risk stream of income for a period of time. It also allows the partial buyer or lender to diversify across several notes since the amount of money needed for the transaction is less than what would be required to purchase a whole note.

What is a note partial?

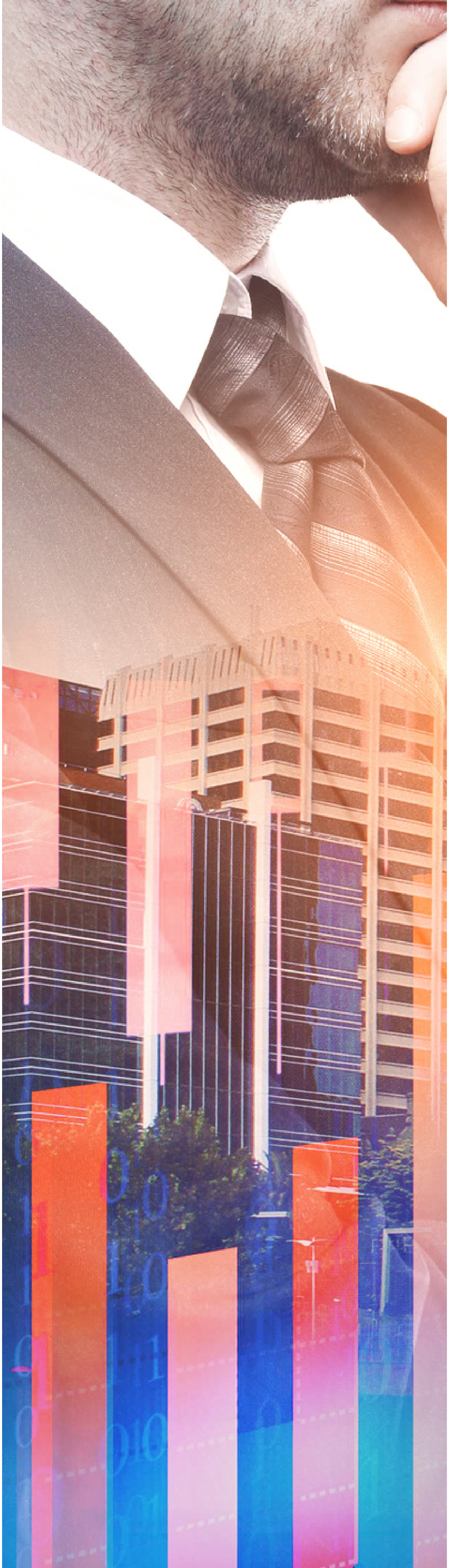
Let's look at a hypothetical example: The note holder has a solid, performing note that originally was $100k at 8% for 30 years with payments of $733. The note holder purchased this note for $85k.

The borrowers have been paying regularly on this note since inception and it now has an unpaid principal balance of $95k and 5 years of seasoning (5 years of consistent payments from the borrower). The note still has 300 monthly payments (25 years) owed to the note holder, but the note holder would like some cash now to buy another note.

So, the note holder agrees to sell the next 4 years of payments to a partial buyer (an investor) for $30k.

The partial buyer then pays a lump sum of $30k to the partial seller (the note holder) and the partial buyer begins to receive about $710 per month (after servicing costs).

The partial buyer now has responsibility to manage the asset for the next four years (the term of the "partial" agreement), although both parties obviously have a vested interest in keeping the note performing. The partial buyer is able to make a relatively safe investment with a solid return.



The partial seller takes the $30k and puts it toward the purchase of another asset for their portfolio. They purchase another solid performing note with 300 months remaining, this new note is paying $350 per month. So, for the next 48 months, the partial seller is receiving $350 per month from both loans combined.

However, after the 48 months of the "partial" agreement have expired, the note holder (partial seller) now has two whole notes from which to receive cash flow: both the original note (from which they sold the 48 month "partial" f to the partial buyer), as well as the new note they purchased with the partial buyer's funds. At this point, the note holder will still have 20+ years of $1,060 per month in payments to look forward to.

Yes, the note holder gave up about $360 per month ($710 - $350) for 4 years, which was over $17k total, but they will make over $50k in interest alone simply by holding the second note for its duration.

What is note hypothecation?

Hypothecation usually means the use of an existing note as collateral to create a new loan. A note holder (investor) will take a performing note and offer it up as collateral to borrow funds from another investor/lender. With a true hypothecation, there is no transfer of ownership of any part of the original note/mortgage.

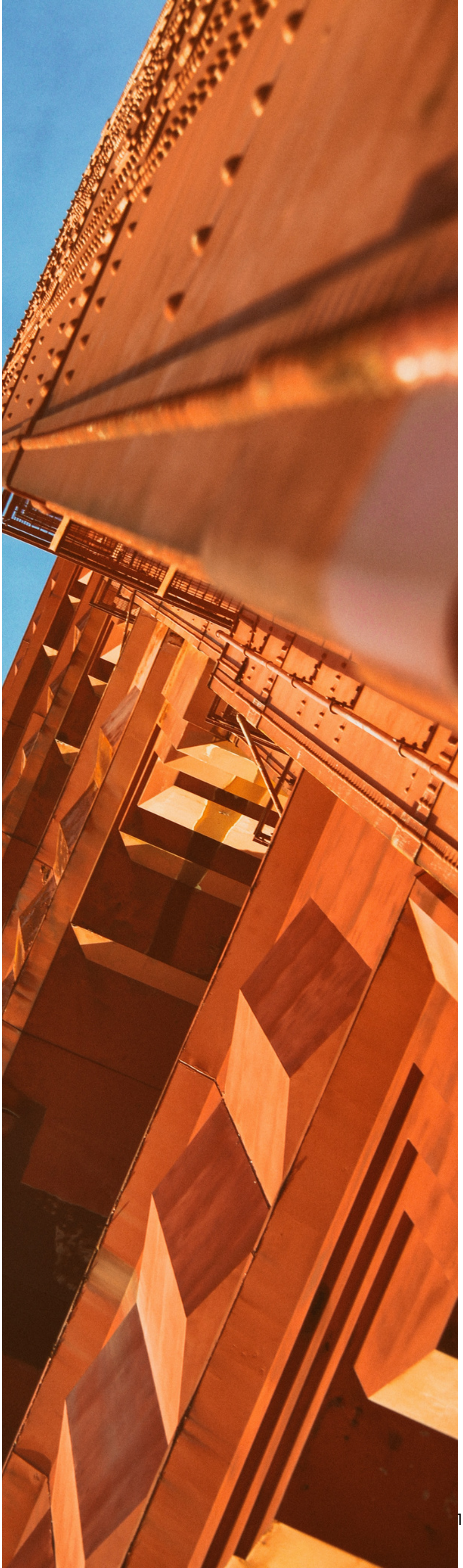
The note holder again has a strong, seasoned asset that he or she would like to use to obtain cash now without selling the entire note. The note holder can—instead of selling part of the note—use the note as collateral to borrow money from a new lender.

Here's an example: As in the previous example, the note holder owns a note with an unpaid principal balance $95k and 300 payments remaining. This time, instead of selling a "partial" (of 48 payments due from the original borrower) to a partial buyer (investor) for $30k, the note holder uses the note as collateral to borrow $30k from an investor. The investor (new lender to the note holder), agrees to use the existing note as collateral for a new loan of $30k to the note holder (payable over 48 months at 8%). The note holder now becomes a borrower and begins paying the investor ("new lender") approximately $730 per month (principal and interest) for 48 months. In this example, there are two borrowers associated with the original note: the original borrower and the note holder borrower.

In this scenario, the note does not get assigned to the new lender. Instead, the note holder retains the responsibility of managing the note as well as paying the new lender monthly payments. Ideally, the monthly payment from the note holder to the new lender mimics that of the payment from the borrower to the note holder.

The note holder takes the $30k from the new lender and puts it toward the purchase of a new note. After the 48 months, the end result is similar for both investors as it was in the partial scenario above. The note holder deferred present cash flow in order to make one or more additional investments to scale their business. The second investor (lender) enjoyed monthly cash flow from the note holder for 4 years through a loan backed by collateral.

Hypothecation, like partials, can result in a positive outcome for both investors.



More Key Differences:

With a hypothecation, there can be a bit more flexibility built into the agreement as far as monthly payments to the second lender, as compared to the monthly payments to a partial buyer. Although the payment amounts are often close, the monthly hypothecation payment from the note holder to the second lender can be greater than, or less than, the monthly payment made on the note by the original borrower.

Further, with a hypothecation, the entire event is between the two investors. The original borrower sees no changes or interruptions. With a partial, however, the borrower has to make changes regarding their new lender and possibly their new servicer. This can cause issues for all parties involved.

Caveats:

None of this constitutes legal or financial advice.

There are many ways to approach and structure both of these techniques.

Further, there could be compliance or tax issues associated with either of these strategies, so be sure to check with your legal and accounting advisors.

Partials vs. Hypothecation - Pros for Each Party

	Partial Buyer/Lender	Partial Seller/Borrower	Borrower
Partials	• More Control, protection • More opportunity to learn • Closer to collateral	• Less work • Not dealing with borrower or servicer • Likely fewer compliance/licensing landmines	• No Pros
Hypothecation	• Less work • Lower costs for transaction • Not dealing with borrower or servicer • More flexibility with payments, terms	• More control • Lower cost for transaction • Closer to collateral • More flexibility with payments, terms	• No changes regarding lender or servicer

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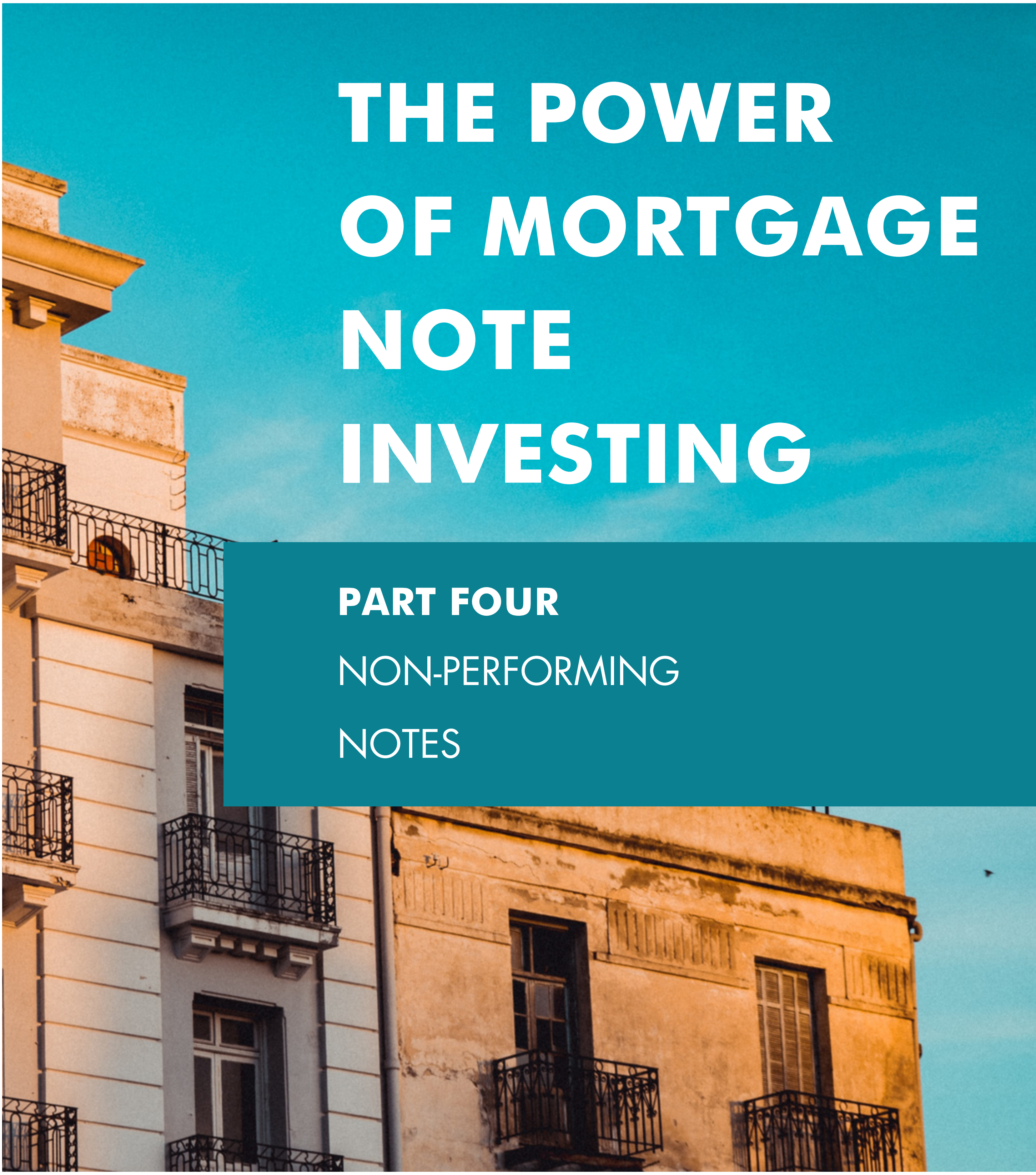


THE POWER OF MORTGAGE NOTE INVESTING

PART FOUR

NON-PERFORMING NOTES

Labrador Lending, LLC

CHAPTER 4.1

HOW TO PROFIT FROM NON-PERFORMING NOTES

Many people who are new to note investing wonder why you would buy a non-performing note? Why would you buy a loan where the borrower has either completely stopped paying or is years behind on bringing their debt current?

There are 5 main ways that investors can profit from non-performing notes:

1 **Borrower Starts Paying Again**

The investor can now either hold this re-performing note for cash flow or sell it to another investor for a profit

2 **Investor & Borrower agree to loan modification**

New terms are often more affordable for the borrower, increasing the odds of the loan re-performing

3 **Borrower Refinances**

The investor makes a profit as the full payoff is more than what the investor paid for the asset

4 **Investor & Borrower Agree to Short Sale**

The property is sold while the borrower still owns it. The borrower has debt forgiven and the investor profits.

5 **Investor Takes Over Property**

This can be done via foreclosure/ forfeiture of a deed in lieu. At this point the investor has options for the property: sell, rent, owner finance.

CHAPTER 4.2
HELPING BORROWERS THROUGH FINANCIAL HARDSHIP

In this section, we explain the differences between five tools a note investor can use when a borrower experiences financial distress: deferment, repayment plan, forbearance, modification, and refinance.

As a result of the COVID-19 pandemic and the subsequent economic shutdown and skyrocketing unemployment, there has been much confusion surrounding options for borrowers who have experienced financial hardship.

Forbearance has been one of the common terms discussed, but what does forbearance mean exactly, and what is the difference between forbearance and deferment? What is a repayment plan? How does a loan modification compare to a refinance? Let's dive in.

Deferment

A deferment is an agreement between a lender and a borrower to temporarily suspend or reduce mortgage payments for a set period of time, often several months. At the end of the deferment period, there are several options with regard to the resulting unpaid interest. It may be added to the payoff amount or it may be waived entirely.

A deferment is often used to supplement another mortgage relief option. For example, if the lender is modifying the loan to a new payment amount, the lender can offer a short deferment period before the modification goes into effect. Other nuances can come into play as well.

Specific parts of the payment obligation may be deferred, for example, interest-only payments defer repayment of the principal portion of the debt during the deferment period.

Repayment Plan

While a deferment agreement suspends or reduces the monthly payment temporarily, a repayment plan increases the monthly payment amount to allow a borrower who has experienced a temporary hardship to gradually bring the loan current. A repayment plan is an agreement to repay the delinquent amount over time, often up to 6 months. The length of a repayment plan will vary depending on both the amount past due and the amount the borrower can afford to pay each month, among other things. Here is how a repayment plan may work:

The lender spreads the overdue amount over a certain number of months. During the repayment period, a portion of the overdue amount is added to each of the regular mortgage payments. At the end of the repayment period, the loan will be current, and the borrower will resume paying the normal monthly payment amount.

Forbearance

A forbearance agreement is an arrangement made between the lender and a delinquent borrower in which the lender agrees not to exercise their legal right to foreclose, and the borrower agrees to a payment plan that will, over a certain time period, bring the loan current. This payment plan often includes a deferment, or a temporary reduction or suspension of payments. The borrower typically must resume the full payment at the end of the forbearance period, plus pay an additional amount to bring the loan current on the missed payments.

Although the terms of forbearance agreements can vary substantially, some options are for the borrower to: pay the amount due in a lump sum; add an extra amount to the regular payments each month until the entire delinquent amount is repaid (repayment plan); or, complete a loan modification in which the lender adds the unpaid amounts to the principal balance of the loan.

A forbearance agreement is not a long-term solution for delinquent borrowers; it is designed for borrowers who have temporary financial problems caused by unforeseen problems. Borrowers with more fundamental, permanent financial challenges–such as unemployment or long-term medical issues–may need a remedy other than a forbearance agreement. In this case, a loan modification could be the appropriate tool.

Modification

While a mortgage forbearance agreement provides short-term relief for borrowers, a loan modification is a long-term tool to address unaffordable monthly payments. With a modification, the lender can work with the borrower to permanently change the terms of the loan. The modification may reduce the interest rate, convert the interest rate from variable to fixed, or extend the loan term by shifting the maturity date. Although the unpaid principal balance may increase, the monthly payment amount normally does not.

Typically, in order to be eligible for a loan modification, the borrower must show that they cannot make the current mortgage payments because of financial hardship, and must also demonstrate that they can afford the new payment amount by completing a trial payment period.

Often, the lender will require that the borrower provide documentation such as a financial statement, proof of income, tax returns, bank statements, and a hardship statement.

Like many of the other tools at the lender's disposal, the terms of loan modifications can vary greatly depending on the situation.

See below for two case studies of profitable loan modifications.

Refinance

While a modification changes the terms of the current loan, a refinance replaces the existing loan with a new one. While a refinance may be more expensive for the borrower initially than a modification, in today's low-interest-rate climate, refinancing may very well be in the borrower's best interest. It can lower the monthly payment or change the term to help the borrower reach their financial goals faster.

A refinance can also be quite profitable for a note investor who purchased the note at a discount. Through a refinance, the investor will normally receive 100% of the unpaid principal balance plus any arrears owed for things like late fees, interest, lender advances for delinquent property taxes, etc. Because of this, some note investors are quite intentional about facilitating a refinance.

CHAPTER 4.3

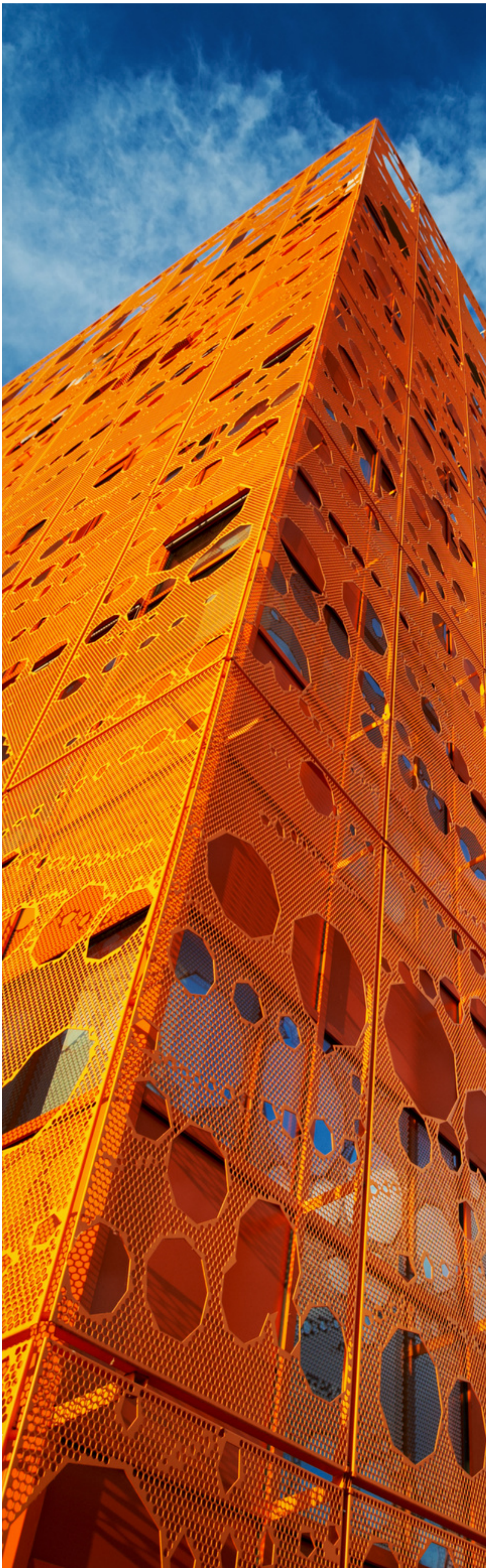
TWO CASE STUDIES:

Profits from Loan Modifications of Non-Performing Loans

I'm going to show you two case studies where the investments in non-performing notes were both profitable. The exit strategy in these two cases was a Loan Modification, option #2 above.

In our first case study we bought a non-performing note in 2020, in the middle of the pandemic. The unpaid principal balance on this loan was approximately $30,000. The interest rate was over 12% and the monthly payment was approximately $320.This was a property in the State of New York.

The borrower was over six years behind on their payments and, as a result, they also owed approximately $26,000 in interest and other arrears fees. In total, the borrower owed approximately $56,000 in order to completely pay off the loan. We bought this loan for $5000. Many people might say: "Well they're six and a half years behind, they weren't paying, why would you pay five thousand dollars for a note that's not being paid?" Other people might say: "Well that that looks like a great deal."



So, let's see how this case turned out: The background: When we were doing the due diligence on this note (trying to decide if we wanted to invest), we sent an inspector out to the property. During the inspector's visit to the property, the borrower told the inspector that he wanted to speak with the lender. So right away, there was positive communication from the borrower. So that's a good thing. That may mean you might be able to exit the deal through the borrower. You can't come to an agreement without communication with the borrower.

This note had bounced around a little bit for several reasons; some people don't like dealing with New York notes; the licensing is an issue for many loan servicers; New York foreclosure can be very time-consuming and expensive, etc. So, this this loan had changed hands a few times and this can also scare off some investors.

We purchased the loan for $5,000 knowing that there was proactive communication and possibly some interest on the borrower's part to talk to the Lender. In talking to the borrower, he said that the loan servicing had transferred several times and he didn't know where to send the payments. Whether or not this accounted for the borrower's 6.5-year delinquency is a valid question.

Attempting to get the borrower back on-track via a loan modification was our strategy and we immediately introduced this option to the borrower through our servicer. We gave the borrower terms to consider with a deadline.

Let's see how it turned out:

We had a total payoff of $56,000, we presented the following proposal to the borrower (with a deadline): The new loan would have a principal balance of $35,000 (we are forgiving $21,000), with interest lowered from over 12% to 9%. There would be a new 30-year term with the borrower's payment lowered from $320 to $282 per month. So, we're offering to lower the borrower's payment by almost forty dollars per month and also forgive over $20,000 in arrears. In addition, we are requiring the borrower to give us a $1900 up-front down payment.

Some investors will structure a trial payment plan; however, we've had success with simply collecting a down payment and going from there. The borrower accepted and executed this agreement.

They sent the down payment and they've made several on-time payments thus far. It obviously remains to be seen how this will turn out but so far, it's looking pretty good.

Right now, we're projecting that, if we hold this loan for another year, we may be able to sell this asset for $25,000 or maybe $20,000.

Even if we sell the note for the lower amount, we will have recouped our entire initial investment (in actuality, at this point, we are into the deal for approximately $6000) plus a substantial additional return of approximately 350%.

Purchase Information

UPB	$30,000
Interest Rate	12.42%
Monthly Payment	$320
Years Late	6.5+
Arrears	$26,000
Total Payoff	$56,000
Purchase Price	**$5,000**

- During the property condition report that was ordered before purchasing, borrower talked with inspector and told him he wanted to talk with the lender
- Borrower said servicing has transferred several times and he did not know where to send the payments, but him and his wife wanted to keep the property
- Strategy: Loan Modification (3 months after initial boarding)

Loan Modification Terms

Principal	$35,000
Interest Rate	9.0%
Monthly Payment	$282
Term	30 years
Down Payment	$1,900

Sale Information (Projected)

# months held	12
# months seasoning	10
Sale Date	11/20/2021
Sale IRR (for buyer)	12%
Sale Price	$25,274

Total Investment	$(5,785)
Total Monthly Interest Payments	$2,618
Total Income from Asset Sale	$25,274
Total Income	$27,893
Total Return (IRR)	387%

Case Study #2, an Alabama loan modification

This is a similar story to Case Study #1 with the difference being that this borrower was actually paying somewhat consistently and had also made very recent payments.

We purchased this note from another note investor who was selling off most of her portfolio. I would categorize this loan in the "sub-performing" category, not truly a non-performer. The borrower was currently making payments, however, she had fallen behind a few years prior. Sometimes bad things happen to good people and I think that's what happened in this case. The borrower was maintaining constant communication, there were recent payments, there were also some checks returned for non-sufficient funds and some missed payments here and there. However, in general, there were a lot of recent payments and a clear motivation to keep the property. These are all good indications that a loan modification can be successful.

When we purchased this note the unpaid principal balance was approximately $53,000 with an interest rate of 11% and monthly payments of $571.

There were interest and penalty arrears of almost $23,000 so the total payoff was over $75,000. We purchased this this asset for $26,000.

For our proposed loan modification, we did not waive nearly as much in arrears as in the previous case study. We did lower the interest rate considerably from 11% down to 8.5%. We lowered her payment about $10 per month and we started a new 30-year term. We also required a down payment of approximately $1150 to secure her commitment.

A couple months ago we put this note in Paperstac to sell it and capitalize on the modification. There we multiple offers and we ended up selling the note for $50,250, which was actually a pretty healthy return for the buyer at just over a 13% yield. After the sale our Joint Venture partner realized over a 60% IRR on their investment, and our return was infinite as we didn't have any money in the deal. The graphics on the next page show a nice summary of the deal.

Not every deal works out this well, but if you target the right type of assets and make good buying decisions, returns like this aren't extremely uncommon.

Purchase Information

UPB	$53,000
Interest Rate	10.99%
Monthly Payment	$571
Unpaid Interest	$20,400
Late Fees	$2,200
Total Payoff	$75,600
Purchase Price	**$26,000**

- Purchased with JV partner (50/50) from another note investor who was selling majority of portfolio
- Borrower was paying, but had stopped paying for a period of time, years before
- Showed prior interest in loan modification
- Strategy: Loan Modification (4 months after initial boarding)

Loan Modification Terms

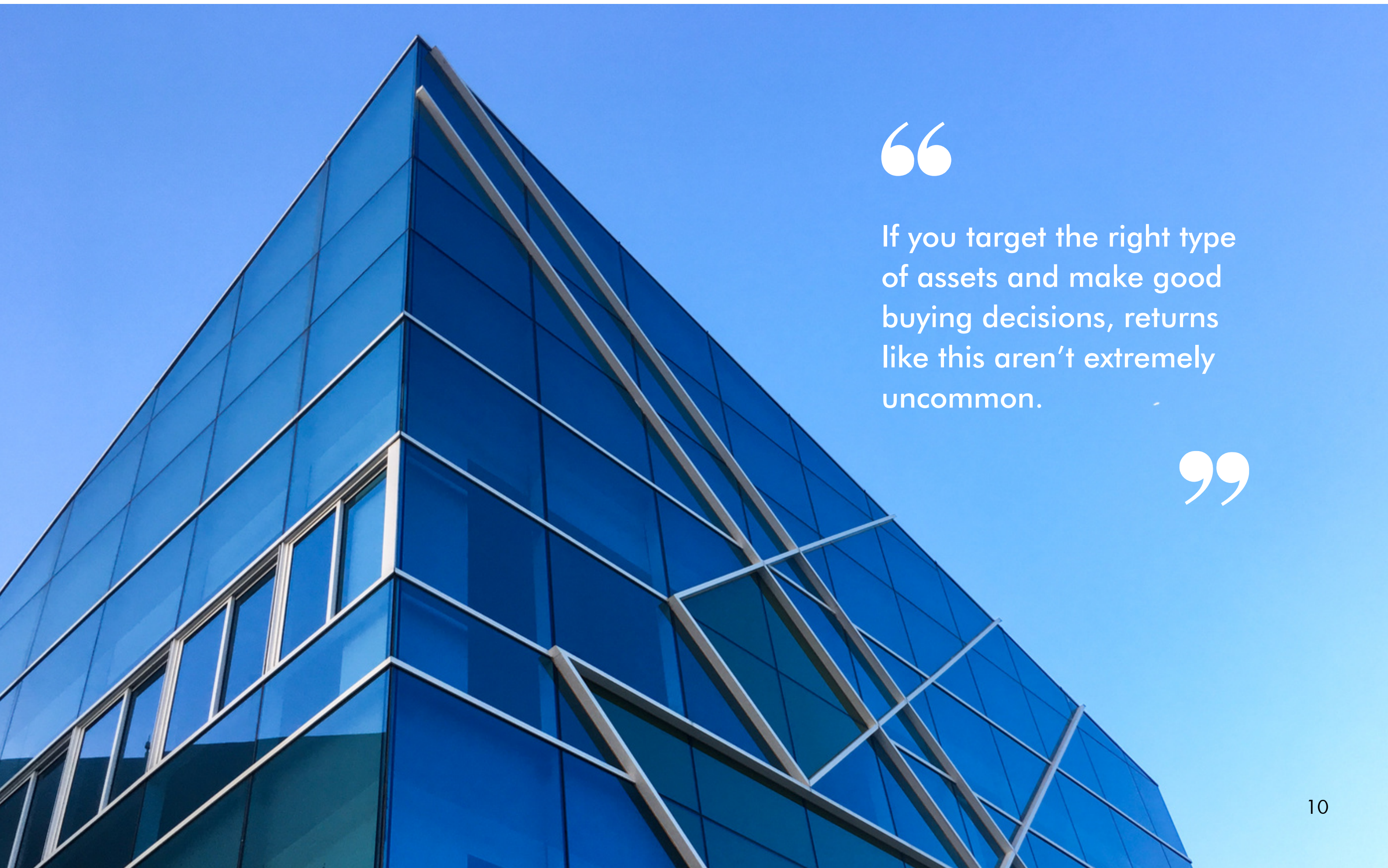
Principal	$73,000
Interest Rate	8.5%
Monthly Payment	$561
Term	30 years
Down Payment	$1,150

Sale Information

# months held	12
# months seasoning	9
Sale Date	05/01/2021
Sale IRR (for buyer)	13.1%
Sale Price	$50,250

	JV Partner	Labrador Lending
Total Monthly Interest Payments	$ 1,801	$ 1,801
Total Income from Asset Sale	$14,249	$9,049
Principal Returned	$ 27,000	-
Total Income	$16,049	$10,849
Total Return (IRR)	60.7%	∞

Now let's look at a little known but powerful strategy to access capital to turbocharge your note investing.



> "If you target the right type of assets and make good buying decisions, returns like this aren't extremely uncommon."

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THE POWER OF MORTGAGE NOTE INVESTING

PART FIVE

BONUS

A HIDDEN STRATEGY OF SUCCESSFUL NOTE INVESTORS

Labrador Lending, LLC

HOW TO USE INFINITE BANKING TO FUND YOUR NOTE BUSINESS

Infinite banking has been a central strategy in our ability to grow our note business in the last couple of years. To find out why and how we do this, and whether this powerful technique could help you as well, read on!

What is Infinite Banking?

The Infinite Banking Concept (IBC) is a philosophy and process developed by the late Nelson Nash where individuals can take control of their own cash flows and essentially become their own banker. Although there are many variables in how this can be applied, the financial vehicle used most commonly with this system happens to be high-cash-value, dividend-paying, whole-life insurance. One critical piece of this—and something many people miss—is that in order for this to work optimally, the policy must be specifically designed with IBC in mind. Many life insurance policies simply would not work well with this strategy.

Once the life insurance policy is established (whether on yourself, your spouse, or someone else), you as the owner of the policy use the cash value of the policy as collateral to borrow money from the life insurance company.

Remarkably, if the policy was properly designed, not only does the cash value in the policy continue to grow, the funds obtained as a loan can be used in any way the policy owner sees fit.

Most of these life insurance companies have been in business and consistently paying dividends for over 100 years. In fact, some are older than the IRS, and much older than the 401(k). There is a reason that banks own $190 billion in life insurance (BOLI).

IBC is by no means a get-rich-quick scheme. But if used properly over the long term, it is a way that responsible, disciplined people can take control of their finances and become less reliant on big banks. It is also a way to quickly get access to capital when you need it with no questions asked. This capital can be used to fund investments, businesses, or college education. It can be used to purchase vehicles or even vacations—all while the policy itself keeps growing in value.
What does this have to do with note investing?

Let's dive in.

The Three Parts of a Note Business

In its simplest form, running a note business boils down to three activities:

- A. finding money to buy notes,
- B. finding notes that fit our investment criteria, and
- C. managing the notes

Finding Money to Buy Notes: When you are first getting started, I recommend using your own money to acquire your first few notes. After successfully investing for a while, you can scale your business using other sources of money. See the section below for an in-depth discussion of this strategy.

Finding Notes that Fit Our Investment Criteria: Obviously, note investors need to have access to notes to buy. If you want to run a business investing in mortgage notes, buying and selling notes is the backbone of your business. The notes themselves are the assets in which you are investing and trading. And lately, given today's market conditions, finding these assets seems to be more and more of a challenge.

Managing the Notes: The central pillar to this business is managing the notes you purchase. This is where working with your servicers, attorneys, vendors, and borrowers, as well as planning your exit strategy for each note, is essential. If you can't manage your systems well enough to receive cash flow from your performing notes and add value in order to profit from your non-performing notes, you won't make it in this business. Profitable asset management is crucial.

Last, but not necessarily least, is the challenge of finding additional capital to grow your note business. It doesn't matter how deep your pockets are, you will eventually run out of your own money if you are trying to scale your note business. Even if you have quality, consistent deal flow and you are a competent asset manager, at some point you'll need to find more capital to acquire more notes. This is where infinite banking can help.

WHERE TO FIND MONEY

Note investing is a capital-intensive undertaking. And it is very unlikely that you, as a small-time note investor, can walk into a bank and ask for a loan to go buy a note. As such, what are your options? Here are three potential sources of money:

Personal funds

This is rather self-explanatory. I strongly recommend you build a track record and a foundation of experience using your own money before putting someone else's capital at risk.

Other people's money

Joint ventures, partials, hypothecation, establishing a note fund are examples of strategies you can deploy to acquire other people's money to grow your note business.

Infinite Banking

In our business, we have used our own funds as well as other people's money through joint ventures and partials, and we have now taken the next step and created a note fund. In addition, a vital contribution to our business growth has been our use of IBC.

This is how we do it:

First, we (personally) borrow money against our life insurance policy. This is done very easily and quickly. The funds we've borrowed from the policy are deposited into a personal account (an IBC flow-through account) we have established only for this use.

Second, we loan the money we've borrowed from our life-insurance policy to our note company. The funds are transferred from our IBC flow-through account into our note company. The loan to our note company is formally documented and structured, so there is a clearly defined payment plan for the note company to repay the loan to our IBC flow-through account.

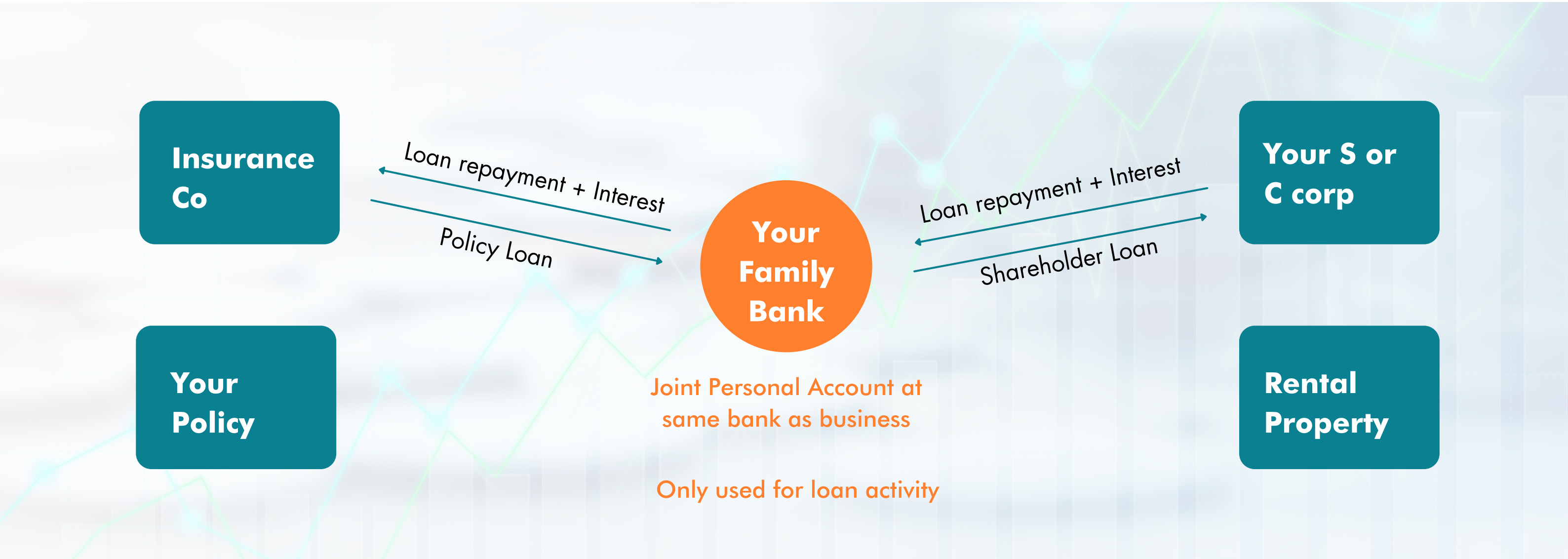
IBC expert Nelson Nash recommended paying back the loan to the insurance company at a higher rate than the rate the insurance company charges you, so that is what we do. However, we structure the loan repayment so that we are earning more interest with this money in our note business than we pay back each month.

For the most part, we have structured our loans to be amortized over 10 years at either 5% or 6%. This is a form of arbitrage. If we could not make more than this 5% or 6% in our note business, this strategy wouldn't make sense.

Automatic payments.

We use the "bill pay" feature at our bank to set-up automatic payments from our IBC flow-through account back to the insurance company to pay down the original loan.

THE PROCESS



*** Credit for this image goes to Anthony Faso of Infinite Wealth Consultants

ADVANTAGES OVER OTHER SOURCES OF MONEY

Here are a few advantages to using an IBC loan rather than using other people's money or a traditional bank loan:

Flexibility and control.

You can not only design the payment schedule when you create the loan, you can also change it later if necessary. Let's say your note business takes a turn for the worse. For example, there is a global pandemic and ensuing foreclosure moratoria that cause your business to be less profitable than you had anticipated. Well, you can halt or lower your loan payments (both from your business back to yourself AND from yourself back to the insurance company).

With an IBC loan you are in control and you have options. If you die with an outstanding loan balance, the insurance company will simply deduct the money you owe them from the death benefit paid out to your beneficiaries.

No reporting.

When you manage a note fund or participate in joint ventures, your investors and JV partners are going to want some level of involvement and reporting to stay informed on their investment. Well, this requires regular ongoing time and effort on your part.

Not so with an IBC loan. There is no reporting to the insurance company about what you did with the money or how their "investment" (the policy loan to you) is performing.

Once the loan and the repayment accounts are set-up, there is not much work at all.

No application.

Unlike applying for a bank loan (for example, a mortgage), there is no application. The insurance company (of which the policy holder is a (mutual) co-owner) is contractually obligated to provide the loan. You tell the insurance company where and when to send you the money, and then you pay them back. The time between loan application and receiving the loan money is typically a matter of days.

Opportunity cost.

When you use your own cash to purchase notes, that cash is not being used elsewhere. It is tied up. In contrast, if you use that same cash to start a properly structured, life-insurance policy, and then you borrow against that policy to purchase notes, most of that initial cash outlay is now earning money for you inside the policy. It can take a few years for the policy growth to really start to pick up momentum, so the earlier you can start the policy, the better.

Here's a link for more detailed information on Infinite Banking:

WRAP-UP

Note investing is a fantastic niche to consider. From the potential for significant profit to the positive social impact, and from the ability to scale from anywhere to the flexibility, collateral, diversification, and control that note investing affords, the benefits are apparent. However, as we have covered, note investing is not without downsides and potential pitfalls.

If you decide to become a note investor, there are numerous approaches you can take. Whether you decide to be an active investor or take a more-passive approach, whether you want to tackle non-performing notes or stick with performers, whether you want to utilize some of the more advanced strategies we have addressed here or not, the key is to be informed before you jump in.

While most people tend to learn best by doing, you should be educated and prepared when the time is right for you to begin to invest. We've found there is a constant tension between pursuing education and study, and jumping in and taking action. You don't want to suffer from analysis paralysis, but you also don't want to be reckless.

We sincerely hope this book has helped you to find the right balance for your situation, and to learn through our experience in running a note-investing business.

Our goal is to aid you to move one step closer to living your best life.

Please do not hesitate to reach out.

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