

Step-by-Step Foreclosure Analysis

Doing a quick analysis of your potential deals is a critical part of your investment program. Follow this simple 5-step analysis to determine, before you purchase the property, whether it is a good deal and how much profit you can make. This step will prevent you from missing out on good deals and, more importantly, losing or tying up your money on bad deals. Don't labor for hours over complicated formulas. Get over the "analysis paralysis" by following this easy-to-use method.

The basic principle behind this foreclosure analysis is being able to buy properties at discount prices. As an owner-occupant (home buyer), you may be satisfied with a discount of 10% to 30%. However, as an investor, you need a discount of at least 30%. You will need the extra equity if you plan to flip the property for quick cash, or if you plan to rent the property for a positive cash flow. You would therefore buy such properties for no more than 70% of market value. You may need an even bigger margin if you project a slow market, a longer sale cycle, or relatively high expenses. A general rule is to overestimate your expenses and underestimate your profits.

Step 1. Determine the Market Value

There are 3 primary sources to determine the current market value of a property: a recent appraisal, current listings, or tax records. The approach used most often by appraisers and realtors is to get listings of at least three comparable (similar) properties that have sold within the last 6 months. The value will depend on the property's location, how it compares to similar properties in the neighborhood, and how quickly those properties are selling. Fast selling properties in great neighborhoods will have higher values than slow selling properties in fair neighborhoods.

Line 1: Enter the fair market value from appraisals, listings, or tax assessments.

Line 2: Determine YOUR VALUE based on the fair market value entries (line 1).

Step 2. Determine the Total Debt

The debt on the property includes mortgages or deeds of trusts (depending on the local jurisdiction), liens, judgments, back payments (arrears), taxes, legal fees, and advertising costs.

Line 3: Enter the balance for each of the trusts or mortgages on the property.

Line 4: Add the amount of each trust and enter the TOTAL BALANCE.

Line 5: Enter the monthly payment amount with late fee for each trust and multiply by the number of months in arrears.

Line 6: Add the arrears for each trust and enter the TOTAL ARREARS.

Line 7: Enter the estimated attorney's foreclosure costs.

Line 8: Enter the settlement costs associated with purchasing the property.

Line 9: Add TOTAL BALANCE (line 4), TOTAL ARREARS (line 6), foreclosure costs (line 7), and purchase settlement costs (line 8).

Step 3. Calculate the Profit Margin

Calculate the debt to value ratio to see if the property fits the 70% or less rule. Also, calculate the maximum you can offer for the property, based on your percentage rule. Finally, calculate your profit margin.

Line 10: Divide TOTAL OWED (line 9) by YOUR VALUE (line 2) and multiply result by 100 to get the Debt to Value ratio.

If the ratio is more than 70% or your chosen % rule -- STOP! This is probably not a good deal.

If the ratio is less than or equal to 70% or your chosen % rule -- PROCEED! This deal may be worth pursuing.

Line 11: Multiply your chosen % by YOUR VALUE (line 2) to calculate the MAXIMUM OFFER you could make for the property.

Line 12: Subtract MAXIMUM OFFER (line 11) from YOUR VALUE (line 2) to calculate your MARGIN (gross profit).

Step 4. Determine the Expenses

Line 13: Enter Expected Repair Costs. Get an estimate from a reliable general contractor.

Line 14: Enter Loan Amount for any new financing you might place on the property (line 14a). Leave it blank if you plan to assume the existing debt. Calculate the dollar amount of the points as a percentage of the new Loan Amount (line 14b). Calculate the total payments for the new or existing financing by multiplying the monthly payment by the number of months (line 14c).

Line 15: Add the Points (line 14b) to the Payments (line 14c) and enter the total CARRYING COSTS.

Line 16: Determine the cost of your marketing approach from newspaper ads (line 16a), referral fee (line 16b), or a realtor fee (line 16c).

Line 17: Enter the MARKETING COSTS from either line 16a, 16b, or 16c.

Line 18: Enter Settlement Costs, including taxes, insurance, property transfer costs, inspection fees, etc., for the property sale..

Line 19: Add the cost of Repairs (line 13), Carrying (line 15), Marketing (line 17), and Settlement (line 18) to get TOTAL EXPENSES.

Step 5. Calculate Your Net Profit

Line 20: Calculate your NET PROFIT by subtracting TOTAL EXPENSES (line 19) from your MARGIN (line 12).

Now that you have calculated your net profit, you need to decide if it is enough for you to do the deal. You should expect to make a net profit that is at least equal to 10% of the value. So your net profit should be \$12,000 on a \$120,000 property.

Deal Analysis Form

This form shows the completed analysis for an actual deal. The numbers have been rounded off to the nearest \$100 for simplicity. This example shows that the debt to value ratio was really 61%. Using the 70% rule, the maximum offer for this property was \$112,000. The estimated net profit, after expenses, was \$21,400. **The actual net profit was \$20,100** due to some additional settlement costs.

Should you consider a higher ratio such as 75% or 80%? **The answer is NO!** You may be thinking "If I have low repair costs, low carrying costs, and a buyer ready to settle quickly, why shouldn't I buy at 75% of value?" This type of thinking can be dangerous. It may work out on specific deals but will cause you to lose money in the long run.

Review the 5-step analysis along with this sample form until you feel confident with the process. It will become instinctive after you have done it a few times. Don't take any short cuts. Pay attention to the numbers and double-check them to avoid mistakes. Don't sacrifice accuracy for speed. You could end up with an inaccurate and potentially dangerous analysis.

| | | | | | |
|------|---|--------------------|---------------|-----------------------------|-----------------------------|
| 1. | Fair Market Value (Appraisal, Listing, or Assessment) | | | | <u>\$155,000 to 162,000</u> |
| 2. | YOUR VALUE | | | | <u>\$160,000</u> |
| 3a. | 1st Trust/Lien Balance | | | <u>\$48,000</u> | |
| b. | 2nd Trust/Lien Balance | | | <u>\$42,000</u> | |
| c. | 3rd Trust/Lien Balance | | | \$ _____ | |
| 4. | TOTAL BALANCE (3a + b + c) | | | | <u>\$90,000</u> |
| | | <u>Payment+Fee</u> | <u>Months</u> | <u>Arrears</u> | |
| 5a. | 1st Trust/Lien | \$ _____ x _____ = | | \$3,600 | |
| b. | 2nd Trust/Lien | \$ _____ x _____ = | | \$2,400 | |
| c. | 3rd Trust/Lien | \$ _____ x _____ = | | \$ _____ | |
| 6. | TOTAL ARREARS (5a + b + c) | | | | <u>\$6,000</u> |
| 7. | Foreclosure/Attorney Costs | | | | <u>\$1,000</u> |
| 8. | Settlement Costs (Purchase) | | | | <u>\$500</u> |
| 9. | TOTAL OWED (4 + 6 + 7 + 8) | | | | <u>\$97,500</u> |
| 10. | Debt to Value = (TOTAL OWED/YOUR VALUE) x 100 = | | | <u>61</u> % --- GREAT DEAL! | |
| 11. | MAXIMUM OFFER = (Your % Rule) x YOUR VALUE = | | | | <u>\$112,000</u> |
| 12. | MARGIN = YOUR VALUE – MAXIMUM OFFER (2 - 11) | | | | <u>\$48,000</u> |
| 13. | Repair Costs | | | | <u>\$12,000</u> |
| 14a. | Loan Amount | | | \$ _____ | |
| b. | Points = _____% of Loan Amount | | | \$ _____ | |
| c. | Payments = <u>\$600</u> x 3 months | | | <u>\$1,800</u> | |
| 15. | CARRYING COSTS (14b + c) | | | | <u>\$1,800</u> |
| 16a. | Your Ads | | | \$ _____ | |
| b. | Referral = _____% of YOUR VALUE | | | \$ _____ | |
| c. | Realtor Fee = <u>6%</u> of YOUR VALUE | | | <u>\$9,600</u> | |
| 17. | MARKETING COSTS (16a or b or c) | | | | <u>\$9,600</u> |
| 18. | Settlement Costs (Sale) = About 2% x YOUR VALUE | | | | <u>\$3,200</u> |
| 19. | TOTAL EXPENSES (13 + 15 + 17 + 18) | | | | <u>\$26,600</u> |
| 20. | NET PROFIT = MARGIN - TOTAL EXPENSES (12 - 19) | | | | <u>\$21,400</u> |