Getting To Know ITV And LTV With Dave Franecki

I've got a repeat guest for this episode. I've known Dave for years now. We saw each other again face-to-face. It's been a while since we've seen each other really face-to-face in person. We were at the Noteworthy Convention and was able to spend a little bit of time with him. He spoke on stage, I spoke on stage and afterward we realized, "There are some other topics people need to talk about." Dave Franecki, welcome.

Kevin, how are you?

I'm doing great. Thanks for taking the time to be on the show again. I know I told you this, but I tell my audience as well. If you get a chance to see Dave at some events, make sure that you do that. He's done a great job putting presentations together. He does a great job explaining the note business or whatever topics he's talking about. I know you have a local meetup group. If you're in Arizona, make sure that you go out and see him there. Dave, we ran into some topics that I figured need covering again. It came up in discussions. I think you've got a lot of Q&A on this as well. That is dealing with the topics of loan-to-value, investment-to-value and also yield and how people look at those. Let me paint this for everybody here real quick. Dave had five case studies that you went through and you had outlined very well. At the end, I noticed that the first thing you looked at on all of these deals was investment-to-value ratio and that was both on performing and non-performing. I totally agree with you on that, but explain to my audience a little bit more about why that number is so important to you.

The economy changes. You've got to have a cushion there. Things do go wrong. If it's an older asset and you're buying it at value, let's say the unpaid balance is $30,000 and you're paying $30,000. If the asset is only worth $35,000 and that thing goes south, you're in trouble. You have no equity spread behind you, you're in major trouble, especially on the older ones. If they've got a greater equity spread, great. That would help with the loan-of-value. The key is you've got to protect yourself. The economy will change. We're not selling on ten-year futures like they used to do in Maine when I was up in there. It's a level of protection. It's security. You've got to have it.

Everybody in my audience should know this but just in case because we get new readers all the time. The investment-to-value ratio is a ratio that compares your investment, how much you're investing in this asset versus the value of the property itself. Remember, we buy notes that are secured by real estate. At the end of the day, if the deal goes bad and the people break their contract with us, which is their obligation to pay, then we fall back on the security agreement, which says that we can go after that asset. We will acquire that property either voluntarily through something like a deed in lieu of foreclosure or involuntarily through a forced sale. At the end of the day, you have to look at that property value and say, "Is it okay if I take that back?" That's the attitude I take on every deal that I look at. You have to be comfortable with that.

You're right, that's what it is. We share a lot of articles, Dave and I and research and those things. I've never seen so much chatter until recently on a possible recession. People were worried about bubbling and you can read other articles. Sometimes it's what you're looking for. You can read other articles that say, "No, property values are starting to stabilize." This concept of investment evaluation becomes even more important when you think, "Are we going to see a deflation of property values?" As you said, it's happened before.

To that point, Kevin, back in the '07, '08 recession, all the hard money lenders that were lending at 85% loan-to-value, investment-to-value, how many of them were around two years later? The properties dropped from let's say $100,000 to, on Phoenix, $50,000 on loans at $80,000. The flippers go leave. A ton of people walked away because there's nothing there. Why do it?

You're talking to one. I had that happen to me with a couple of deals and sometimes that's all it takes. It can wipe out a year's worth of gains on other assets when you have two that go really bad. I did. The market was hyper-inflated and to stay competitive, I lent too much money. Again, lending money is creating your own paper. I don't care if you're a hard money lender versus a note buyer. In the note business, it's the same thing. I did that. I created these short-term loans and a couple of them I couldn't get out fast enough. In Florida, it's the same thing. Our property values dropped in half. I don't think either one of us are saying that we expect property values to drop in half here, but could we see a turndown? Could we see a drop of 10% 20%? Possibly and if that happens and you're into these deals for too much and your borrowers throw up their hands and go, "Forget about it. Why am I paying this anymore?" then you're going to be in trouble.

At the Noteworthy event, I had my discussion on what we talked about, investment-to-value, loan-to-value and yield. There were other presenters up there that were promoting what they have. There was one party that was promoting manufactured housing in a park. They're setting it up so that people that are drunk on yield are chasing that. They were offering a 12% yield. Investment to value was 85%. Really? Yes, they weren't single-wide piece of junk. They were nice double-wide but it doesn't matter. Things change in people's lives and that the vulnerability is there? Why expose yourself to that? You can chase the twelves, you can go for the eights. I'd rather go for the eights and have a strong investment to value of 30%, 40%, 50% and feel secure and be able to sleep at night.

It really is the number that measures your risk. At the end of the day, that is the number that measures your risk. If you look too far on the reward side and don't look at that risk, at some point it will catch up to you. There's no question about it. I know we've been talking about this one concept for several minutes now, but it is really that important. If you're a real estate investor, you should be thinking the same way. I've seen people buying at these auctions and I heard people buying these auctions are paying $0.85 on the dollar. When you hear that they're paying $0.85 versus the value of the property, that's their ITV, if you will. That's even before they fix up the property. You might get away with that in certain markets, but when things start to cycle around, you're going to get caught. A smart investor is always going to look at that first because that does assess where you are on the risk meter, if you will.

For those who might be new, the higher your investment-to-value ratio, the more risks that you're taking on. The lower the investment-to-value ratio, the less risk that you're taking on. Because we buy a variety of notes, meaning we buy performing notes, nonperforming notes, reperforming notes and even sub-performing notes. You have to recognize also that in an investment class you have to be lower. We can identify Dave, a typical investment to value ratio on a non-performing asset, which should be below 55%. You absolutely can find them down 30%. You've got to look a little harder and look in the right places. ITVs on performing assets are going to be higher in most cases because you're buying a working product. One of the things you've done very well also is to find performing notes at what I would consider almost non-performing ITVs, right?

Correct. The performing notes that I've been buying, because I'm buying in volume, I'm getting them at 60% investment-to-value at 50%, 40%, 30%. It depends. I'm buying based upon unpaid balance versus even the property value. That end is even stronger. It doesn't change. It's foundational. Everything else is great, but if you don't grasp this and something happens, you're done. I'd beat it to death, but it is what it is.

I do hear people saying, "You can't buy at low ITVs anymore." What do you say to those folks?

I say there are plenty, you just have to look. Don't try to put a square peg in a round hole. You're better off not to do something than to do something and then regret it later. Why go there? Unless you want the practice and then that's called experience, then you won't do it again.

I agree. I do like to encourage new people to get out there and buy a deal. As you said, don't force a deal upon yourself for the sake of getting into a deal. If it takes a little longer to find something that you are comfortable with and at an ITV that you can live with, it makes sense to do that as long as you're realistic within the industry. Please don't expect to go in and say, "I'm not buying based on this. I'm not buying anything unless that's at 20% ITV." You're not going to be buying a whole lot unless you're doing partials or something else like that, which is another way, by the way. Dave, you offer partials from time to time on your website. By the way, Dave's website is Capstone Capital USA. At Capstone Capital USA, you offer some partials on there. That is a way that a beginner investor can come in at a lower ITV simply because they're buying a small portion of that note.

They got the primary note holder behind them in the event if it goes south. You're insulated twice. We're in a market that at par is starting to drop depending upon where you are. If you're in an upward moving market, you could probably take a little bit more risk but not now. We're past that.

Some people do get confused probably going from real estate to real estate notes. They get confused with that loan-to-value because they see that when they borrow money loan-to-values with us, we look at loan-to-value but we look at investment-to-value, which we talked about. Define loan-to-value for everybody real quick and what your thoughts are on that?

When I look at a list of assets, after the investment-to-value, the loan-to-value, I get rid of anything that's over 60% loan-to-value. Some people say I've got a tight filter. I'm fine with that but again, that's my filter that I feel comfortable with. If I'm going over 60%, 65%, there's always redeeming factors. Either way, I'm not going to go there. It's the filter that I use and the folks that I've been working with, they feel the same way. I think I might've learned that from somebody back in the day.

How does the loan relate to the value of the property? It is another number. I agree with you. It's a secondary type of number. It's not as important as the ITV. That is one area that you've got some flexibility as an investor to see what you're comfortable with. You made a good point there to say, "That's where I am at." You certainly didn't say that's what everybody reading should be at. It becomes a level of comfort. For example, if a house is worth $100,000 and somebody owes $50,000 on it and you're able to buy that note at $40,000, your ITV is $40,000. The loan-to-value is 50%. Those are the two different numbers that we're talking about there. Even on investments such as that, if that were a true opportunity, all things being equal, $100,000 house, they owe $50,000 on that. Even if I had to pay $45,000 or even possibly $50,000 for that type of loan, I'm still protected by the value of the asset that's backing it. That's why on these deals, you always have to look and use these measuring sticks to see where your comfort level is.

To that point too, Kevin, it depends on the asset class too. If it's mobile homes, if it's dirt, if it's commercial, it's all different. If it's a unique property and there's a strong upside, no matter what the economy, everything negotiable. It's all those redeeming factors. I know you have your training too, I'm doing some YouTube videos on this very topic and I expand upon that. It's stuff that I learned from you back in the day.

Investment To Value Ratio: Buying based upon unpaid balance versus the property value is a stronger end.

There are certain yardsticks that aren't going to change. These are what it is. You might adjust them based on experience, based on asset class as you pointed out there. Based on the market and where you think the future is going. One of the things any investor should regardless of what asset class, but in notes specifically, learn the parameters of the business and go with the understanding of you have to operate within the business parameters. You can make your own adjustments within that with the knowledge of the industry is not going to adjust to you if you get too far out from what's normal in the business. You can certainly refine those numbers. If you do that properly a lot of times, the other thing I want to talk to you about is yield takes care of itself.

If a note pays off early, you're going to get a higher yield. If you bought them at a discount, which you should somewhat depending upon where you are in the buying cycle. If you're buying a wholesale to flip it or if you're buying new, you might pay more of a retail price but yield will take care of itself on its own. People do move every seven, eight, nine, ten years. They refinance or whatever it might be. If you've got a note that's already been around for seven or eight years, that is a strong possibility. That's going to pay off the next four or five years. You can wade all that stuff. I looked at a property and in the servicing notes, it mentioned that the house was for sale. It also said the wife was very sick. She was dying of cancer. We took a little bit higher risk, but it was a strong asset because we knew they are going to have to go somewhere. The second one, the people were trying to refinance with Quicken. They got their planning on moving or they're going to get out of the note. You take that into consideration too. There are all of these variables, but you have to weigh it. You don't know. It's like skiing down a slope. You go through the moguls and figure it out as you go with some basic principles.

You've been through enough of my classes and we've had discussions on this. I know sometimes in class I'll go through quick and say, "That's about an 8% yield." Somebody inevitably raises their hand and goes like, "That's actually 8.2%." All yield are projections. You make assumptions when you're doing yields on these instruments. You might be buying 30 years, 20 years, 5 years, and 3 years' worth of payments and what you're really doing mathematically is going out every 30 days and assuming that a payment is coming in. That's what your financial calculator does. It's assuming the payments are paid on time every single month. What if they pay late and then there's a late fee involved? What if they pay some payments early? All those yield projections you see on tapes or trading platforms, those are all projections that assume that the payments will be made on time on a long-term basis, typically on an annual basis because all those yields are going to be annualized. What we were talking about where we said yields would take care of themselves for the most part, there's an assumption in there that you bought with the right investment-to-value ratio on a note.

In the true practice of this business, coming back to your balance analogy there is you look at your ITV. When you're looking to buy a note, the first thing you look at is ITV. If it's a performing note, then you're looking at yield because when you go when on purchase quote with somebody, they start with ITV because you got to protect yourself first. It then becomes a yield situation. That's where we meant that sometimes the yield takes care of itself. You already have a very good yield on something because you protected yourself in that investment. There are times when you buy notes or Dave, when you create notes that enable the investor to be at or below their threshold of ITV. It then becomes a yield-related quote. That's another kind of teeter-totter scale that you look at.

Can I give another example, Kevin? This is so spot on. I used to live in Portland, Maine and this was before the Resolution Trust days, which would have been the late '80s. There was a commercial brokerage firm there. I won't use their names. They were selling apartments based upon the ten-year projection. All the yields are going to be this based upon ten years. What happened right after that? How many people were around after that? Probably about 90% of all the apartment owners went out of business buying on those parameters.

Are there certain yields that you as an individual investor can say, "I will accept that yield or not?" Absolutely, but combine that with the investment to value ratio first because in ITV, it measures your risk. Your return is measured by the yield that you'll get. We're talking on the performing side a little bit more here now because you can't really do a projected yield on a nonperforming note.

The last group I heard about, they bought it at $0.28 which is what we were buying them out at 13% or 14%. It was going to take a year to work those out probably or thereabouts. What's going to be there in a year? We don't know. There's a lot of stuff going on now for lack of another term. Are you willing to take that risk? Could that yield be there then? Nonperforming does pay better than performing but against the risk. It's a risk-reward scenario.

I was going to say you should project out potential returns on nonperforming notes. In fact, we always talk in terms of multiple exit strategies and you absolutely want to do the math on several of those strategies. I encourage you to have at least five that you run the numbers on. With one, you might have to take the property back and see what kind of return you can get. Then it brings us back to that ITV. Project those yields out, whether it's a performing, a mathematical equation where you're buying in an income stream. That's likely to perform rather than unlikely. Then you project your yields on the exit strategies when you're talking about nonperforming notes.

Kevin, I'd like to bring another point into this too. You're looking at an investment to value and you say, "I'm willing to go a little bit more." Some of the redeeming factors might very well be the payment history, which means a lot. The propensity to pay in the future. Are they paying with ACH, meaning automatic checkbook withdrawal? Were there any skips in there? Are they doing a rolling 50 or 30, 60, 90? If they've got rock-solid payment history going back, you can probably push the window a little bit because they're probably a good bet. The other thing I'm finding out is if they've got their own insurance, which can be an anomaly versus force-placed. They're responsible enough. You're looking at that payer. You weigh all that, your box it up, shake it up. What makes sense logically? Where are my barriers? Where am I stopping those dominoes if they're going to start falling?

It's a matter of checks and balances because the perfect note rarely exists out there. If it does, it's probably not going to be a good deal.

Finding a lesser price is a gut reaction, a function of being around this industry for a long time.CLICK TO TWEET

All these notes, especially in the seller finance arena, they have hair on them. There are things there, but I try to mitigate the number of variables and I'm looking for almost investment-grade notes at a hairy price.

What are the numbers? We talked about ITV, a little bit on LTV and yield. Are there any other numbers that you always look at before you push the button?

I checked the values and I'll go to four or five different sites and get an aggregate. It's an intuitive thing that I'm looking at. I look at the property condition, put all that together. It's all those variables, push it back to the foundation, the ITV, LTV and then figure it out. What's the P&I payment, the principal and interest payment? Is it over $300 or $400 a month to compensate for the cost of servicing? These are all those things that you're teaching on your course anyway. This is not new. That's what I do.

I was going for the payment amount. There are times when the payment is low, there's a servicing fee that can be anywhere from $18 to $30 if you're buying a note. It does cut into

your yield. You can calculate yield and then you can do a cumulative yield. Some people do both and look at the yield without expenses. That's the way the industry looks at it. Then you could do a cumulative yield that takes into consideration what the cut for the servicing company is on a monthly basis and calculate that yield. That can drop it down more significantly if the payment amount is lower. There are certainly people like yourself and others that look at these and go, "It's a good-looking note, but the monthly payment is only $200," whatever the number is. When you take consideration servicing and everything else, I'll pass based upon that because your capital could be utilized in better places.

You can always play the discount game too. Find a lesser price and it brings all things all equal. That's what I'm finding. It's a gut reaction. It's a function of being around this industry enough. You get a feeling of what's going to work, what doesn't work, what fits in your box. You may talk to others and see what they do. It's intuitive after a while. That's the best way to say it. It's totally intuitive based upon some foundational principles.

It is an art more than a science at some point in time. It's like a phrasing. At some point in time, it's not always the numbers. It's that feeling that you have and being around it enough because there is no magic formula. Even when I said they're under $200, it was a number. Don't take it like, "Kevin said don't buy notes under $200." I didn't say that. That's why you bought it cheaper or maybe you're brand new to the business and you want to buy a small note that might have a year-and-a-half, two years of payments. I'm seeing a lot of those now. The payments might be lower. There's something to be said about also buying perhaps a note like that with a lower payment where you're not as concerned about making a home run on that deal. You just want to get in the game and it can make a lot of sense to do that too. As I've always said, these deals pay in two ways. They pay you in money and knowledge. It's always that sliding scale. It's not bad sometimes to make less money, gaining a lot of knowledge as long as it's recoverable. Also it goes the other way. Sometimes you can make money and almost fall into this false sense of, "I've got it down now. These things are easy." The problem was you'd hadn't run into any and knowledge on any deals. You bought some easy ones and it can come back and turn on you.

In a big way, they can hurt. One of my first note was a little note in Winter Haven, Florida. It's at $9,000. That's where I was. It was a good place to start and get baptized on. You can place it with a servicer and followed it to see how it works.

Go through some of the motions. People do that in the stock market. They dabble with a little bit of money. Within the stock market, they use fake money and all that stuff too to get the process, get the understanding, see what can happen. Those are some big variables for everybody that you have to think about in this business. If you are looking at what are the main three things on every deal, we talked about them on this show, the investments-to-value, loan-to-value and the yield on these things. You consider your expenses and that stuff is almost a secondary but it is accumulation of all of those things to find out, what works? What does the industry look like? What's the flavor of the business, if you will? You start to personalize where your margins are. There's a lot to be said with sticking with what works for you and not just be drunk on yield, meaning you always think about yield not considering the risk. You've got to get a good balance. If you do that, you're going to have much more longevity in the business and much better time in the industry and much better returns as well.

One last topic, Kevin. There are a lot of re-performing notes out there and there are different filters on those based upon what the new payment history was, what the background was, why the people went south or got slowed down in their payments. If you're looking at that type of asset class, what are you using for numbers? I'll give an example. I brokered a note in Columbus, Ohio. A friend of mine bought it from my meetup. It was a re-performing. Two months afterwards, the lady stopped paying. Luckily the gentleman that bought it used some really tight filters. He said, "I'm okay." The unpaid balance is $20,000 and the house is worth $80,000. "There's no way I can get hurt." He used a totally different filter in case it went south. Nothing is fixed. It's all variable. Plug and play based upon that particular situation.

There's something to be said about experience in the business. If you don't have the experience in the business, there's no better way to learn quicker than from people who do have that experience. If you're in the Arizona area, check out Dave and go to his meetup group. If you're down there in the Phoenix area, it's a nice meetup group. You're growing it like crazy.

Investment To Value Ratio: Nonperforming pay better than performing but against the risk; it's a risk-

The attendance goes up and down depending upon the season if it's hot or Christmas time or the topic.

Did you say if it's hot in Phoenix?

Yeah, it's great now. You spoke once or twice there, Kevin. You brought in 55 or 60 people. It's a phenomenal attendance. It's typically the first Wednesday of every month in Mesa at lunch, 11:30. It's the Note Investors Forum Meetup. Google that. It will pop up, sign up. It's on my website too. There's a place to sign up if you'd like. You do have to buy lunch, but I think for $17 you could probably afford the information and networking. It's a good deal, I would think.

He has some assets listed most all the time. There are some full notes for sales, some partial notes for sale. I recommend this inventory because I know personally and you heard as well, Dave's set some good parameters on what he's looking for. He wants safe investments as well. He's got some deals on there that you can essentially buy the front end of notes that he already owns. It could be a great way for some of you to go and that's on his Capstone Capital USA website. It's CapstoneCapitalUSA.com. You'll find those notes in the Note Vault. As you're looking at his site, look on the top there and go over towards testimonials and free info. It's right in between there. It's called the Note Vault and that's where you're going to see some assets that he has listed. Go back on a regular basis because they do change quickly. Dave's an active investor. Dave, thanks for being on. I do appreciate it. It was great to see you out at the Noteworthy events. I know we've talked about some other things coming up and I'll be following up with you on those as well.

That's a good idea. Thank you, Kevin. One last thing is my promotion for you. If you folks want to get some great information, some great teaching from a pro, check out Kevin's material. I've been told he's selling it too cheap. Get it before it goes up. He didn't tell me to say this. Buy it. It's good stuff. I learned from it. Thanks, Kevin.

I do appreciate that. For the audience, thanks for reading. Do visit the website at KevinShortle.com. Check out the vendor relationships that I have for you there as well. On behalf of Dave and myself, thank you.