Due diligence is incredibly critical, and you must understand the property, people and paperwork along with how your position in the deal is 100% secured with a note and mortgage/deed of trust.

This is true for many types of investing including:

1. Private Money Lending
2. Joint Ventures
3. Partnerships/LLCs

Going after big returns comes with increased risk and your ability to manage the risk is very critical to achieving the large ROI you are seeking. ***You should avoid deals that require lightning fast funding and do extra levels of due diligence if the deal seems too good to be true.*** If someone pitches you a deal over a dinner, drinks or a ride to the airport always tell them you need to think about it after they supply all the information you need to make an informed decision.

The purpose of this document is not to provide a 100% comprehensive due diligence checklist, but to create thought patterns and understand what you may not know and need help doing. Anytime you are not sure on the deal, consider asking for help, slowing down, sleeping on it before doing the deal.

Trust but verify is a good plan when doing deals. Ask for information and follow up if not received. Once you have it, verify it. Due diligence includes property, people and paperwork and your ability to completely understand them all is crucial.

1. Property – The property is your collateral. If the deal goes bad and you do not get your capital returned, you will receive the property. You need to understand the value, repairs needed and what it is truly worth.

1.1 Value: The ARV is After Repair Value. This is the value of the property once all value-add renovations are completed. This needs to be verified with either an appraisal or real comps or nearby property, with roughly the same square footage and beds/bathrooms. The comps used should be less than 6 months old, close to the target property and similar housing configurations. Investors can be overly optimistic on their ARV value and that can lead to false hope of how good the deal really is.

1.2 Repairs – What is the scope of work needed to take the property from fixer upper to the top comps used in the calculation of the After Repair Value (ARV). The repairs should be itemized and include the following as a minimum:

Demo (and haul away with dumpsters)
Trades – HVAC, electrical, plumbing
Exteriors – Siding, windows, roof, foundation/crawl space, masonry, etc.
Interiors – Framing, drywall, trim, kitchens, baths, paint, lighting, flooring, etc.
Environmental – Is there asbestos, underground oil tanks, mold, etc. that need to be remediated
Permits – What permits need to be filed?
Zoning – Confirm the end use of the property will be zoned correctly and if there is any need for updated certificate of occupancy.

How are the repairs going to be funded? Experienced investors like to be funded at closing for all the repairs, but it is safer for the lender to fund them on draws where repairs are funded as the work progresses and is verified preferably in person. You can have an independent person verify repairs for you or rely on facetime, photos and video.

<u>Equity and Cash Flow:</u>

The equity is your safety net. You should have 20 – 40% of equity as calculated below

ARV * .8 – Repairs = 20% equity
ARV * .7 – Repairs = 30% equity

If your plan is to rent it and joint venture, what is the market rent, how much are taxes and insurance? What will be your net monthly income that leads to your ROI on the net cash flow?

2. People – The people you choose to invest with are critical. How do you really measure their character? How well do they communicate? Sometimes investors will communicate well when all is going well and go dark when things hit the fan. The people component needs to be validated multiple times. When we rent to new tenants, we screen extensively to fully understand who is renting from us. When you are investing you should have a similar approach and take every precaution possible to protect yourself.

3.1 **Credit check** - Ask them for a copy of their current credit report. Review it carefully.

3.2 **Experience** – How long have they been investing? Ask for a copy of their settlement statements from recent investments they have made. Review them carefully to see when they bought them, ask for a copy of the leases if they rented and for the sales settlement statement if they flipped them.

3.3 **Cash reserves** – Ask them about their cash reserves.

All of this is done not to invade privacy, but to help prevent issues later, and create a successful investment.

2.4. **Social media check** - How do they appear online? Do they post about the houses they are working on? Are they constantly on exotic trips (this could be a red-flag).

2.5. **Contracting team** – Is the investor subcontracting everything or is there a general contractor. Are the contractors licensed and insured? How long have they been working together and how do you know the contractors are getting paid by the investor? You may want to use a lien release waiver to be 100% sure.

2.6. **Legal team** – Who is their attorney/title company and ask them for a reference. How long have they working together? When you do the deal be sure you always wire funds to the lawyer/title company and not direct to the investor.

2.7 **Partnerships and LLC's** - If you are creating a partnership LLC be sure to have your own personal lawyer review everything for you including who the members are, the registered agent, address on file and the extreme details of the entire operating agreement.

2.8 **Payments** – How is the investor going to pay you, how often and how will you be 100% sure

3. **Paperwork** – The documentation for your investment is crucial. It needs to be properly created and carefully reviewed.

3.1. **What -** What documents are needed to keep the deal safe? Typically it is combination of promissory note, deed of trust/mortgage, title insurance and home owners insurance.

You should avoid making loans and investments “unsecured” and always know where the money is being sent. Avoid sending it directly to an investors checking account. It should wire to a settlement agent, title company or Lawyer and they will disburse it for you. The best position to be in is 1st position, if you lend in 2nd position your risk goes up if the 1st position mortgage needs to foreclose. Never lend in 3rd position and avoid unsecured loans in all cases. Your position should be secured at the courthouse with a mortgage or deed of trust. You should be named as additional insured on the home owners insurance polity and you should consider receiving a lenders title policy when making private money loans.

3.2. **Who** – Who prepared the documents? They should be prepared by a Lawyer and carefully reviewed for interest rates or equity terms, terms, who is involved (individual, LLC or trust), joint venture agreement, title insurance, etc. Do you have a working understanding of the documents and which ones get recorded at the courthouse to protect your interest? Does the documentation match your agreement on how you will you be paid your interest and when your capital will be returned?

3.3. **Where** - Where is the investment closing? What is the wiring for the settlement agent?

Closing thoughts – You should be able to easily explain your investment to your spouse or a friend. Can you summarize who you are investing with, the property and what is being done to it, how you manage the risk and keep it safe, and how your capital will be returned?

Never do a deal that has to be funded before you have time to complete your due diligence and keep it safe.

Communicate at a level you are very comfortable with. Ask for status updates, photos, videos as the investment is happening. If communication breaks down it is a big red-flag. If a payment does not arrive it is a big red-flag. If both occur, you need to be ready to take action fast. Do not wait but get help early in the process and take the steps necessary to get your investment back!

Watch for the red flags and be certain you can describe the deal to your spouse or an investor friend. If you don't understand it, be sure to ask more questions until you are comfortable with how you will create a great return and are fully secured at the same time.

Due diligence is important, and you should not short-cut it to get a deal done fast. You should create a process that can be followed that includes asking for key information and verifying everything once received. If you want to create great return on investment (ROI) you have to be certain to cover your return of cap (ROC). Due diligence will allow you to sleep at night and feel good about the deal you are doing.

Jim Ingersoll
jim@renovatedhousing.com

DEAL Maker