



Nine Things to Consider When Evaluating Trust Deed Investment Sources for Your Clients

A White Paper for Financial Advisers

Presented by Sterling Pacific Financial (www.sterlpac.com)



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With portfolios battered by the recent stock market decline, investors are eager to pursue quality opportunities outside the public markets. Trust deed investments – i.e., secured private real estate loans – are one option that many financial professionals are evaluating for their clients' portfolios. Backed by real estate collateral and offering impressive yields, trust deeds can provide meaningful portfolio diversification. What's more, their steady income can help rebuild portfolio value relatively quickly. However, the performance and stability that make them so appealing depend greatly upon the company(s) selecting and servicing the loans – and, many advisers have little or no experience evaluating these companies.



To help you make sound trust deed resource recommendations for your clients, here are the nine criteria we believe matter most:

1. Source type

At the low end of service, investors can buy a note directly from an individual; at the high end, licensed trust deed investment companies (TDICs) offer investors both lending and servicing operations. Brokers offering only origination or sales of existing deeds fall somewhere in between.

For most investors, a full-fledged TDIC with loan origination and servicing capabilities is the safest and easiest choice. Specifically licensed for real estate lending and investment sales, these firms handle all aspects of a trust deed investment, including evaluating lending opportunities, securing appraisals, researching title and encumbrances, originating loans, billing and collecting loan payments, distributing investor yields, handling payoff and returning or reinvesting investor principal.

In the event of repayment problems, these firms also handle workouts, help investors understand their foreclosure and refinance options, and act as intermediary between investor and borrower. The most fully integrated firms can handle the sale of foreclosed property and/or manage rental properties on behalf of investors.

2. Licenses

While the sale of trust deeds is governed by laws that vary from state to state, entities or individuals offering trust deed investments are usually required to hold *at least one license* from their state's governing real estate, banking, securities or incorporation authority.

Confirming that these license(s) are in place is a good first due diligence step.

Even if not required, certain licenses can be very useful to a TDIC – and their investor clients. For example, a TDIC with a licensed real estate broker on staff will have the option to foreclose and re-sell relatively quickly and seamlessly on behalf of its investors. In states with usury laws that set a ceiling on interest rates between private individuals, working with a licensed lender or realtor may be the only way to legally earn a market-driven rate.

3. Experience, reputation and track record

Because they're secured by hard real estate assets, trust deed investments can be relatively low-risk – provided the underlying properties are well-selected and accurately appraised. Trust deed companies with a successful track record evaluating the types of properties they lend against are better equipped to identify quality opportunities for your clients.

Experienced managers can also spot loan repayment problems earlier – and, manage them effectively to minimize their impact on investors.

The Internet has made researching a company's management depth and reputation much easier. A TDIC's web site will usually offer team background on its web site. Blemishes on a company's record can often be researched initially on sites representing state real estate or corporate licensing authorities. (For example, in California, TDICs are licensed by the Department of Real Estate and the Department of Corporations.)

Investor comments about specific firms can also often be found on discussion boards. While individual comments can be highly biased, a pattern of consistently positive or negative comments could provide a sense of a firm's reputation.

Any firm or individual broker you're evaluating should also provide its investor retention rate, total portfolio size, length of time in operation – and, of course, investor references.

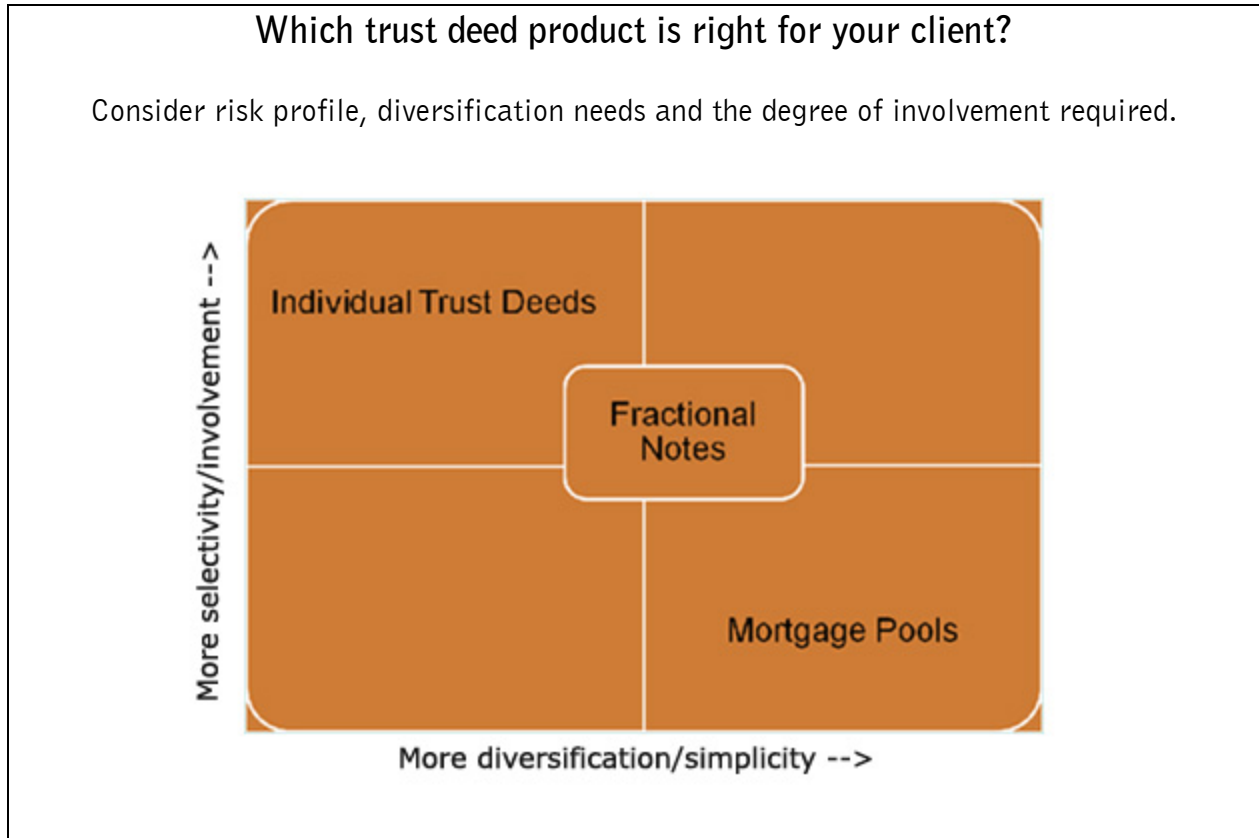
4. Product mix

Choosing a TDIC partner with products matched to your client's risk profile is critical. Trust deed investment opportunities vary significantly in their yields and degree of risk.

Many investors consider trust deeds because they're looking for relative security and predictability. For these clients, TDICs focused on a balance of risk and yield, with an emphasis on first-position loans, are a better choice.

On the other hand, some firms invest to attain the highest possible return – and trade off some added risk to achieve it (usually by lending in a subordinate position, or funding types of properties or projects that are inherently riskier). The interest premium that applies in such cases can be substantial, so these firms can be good choices if maximizing potential yield is the overriding objective.

Some TDICs offer mortgage pools for maximum diversification and simplicity. As with mutual fund investments, mortgage pool investments are spread across a variety of notes – significantly reducing the impact of any single default. They’re designed to be easy for investors: once their money is invested in a pool matching their preferences for risk, yield, and project characteristics, it is continually reinvested in new loans via the pool. Fund managers also take care of distributing yields, managing default workouts, and all financial reporting. Of course, this means that choosing the right pool for your client’s needs is key – especially since it’s usually mandatory to lock funds in the pool for at least a year.



5. Capitalization and management participation

Not all private lenders have capital on hand to invest when they’re approached by borrowers – instead, some firms must look for investors after deciding an opportunity is worth pursuing. This may mean that some of the best opportunities are lost to competitors that can act immediately – i.e., those with capital on hand that they can invest at will.

This cash-on-hand can come from several sources – mortgage pool investments, principal from maturing notes that can be reinvested, and management’s participation in the portfolio. All of these are positive signs of a TDIC’s health and track record.

Financial participation by a TDIC’s management team is especially helpful. When

management invests alongside their investors, it demonstrates confidence in their decision-making. It also means that management's interests will be aligned with its investors' throughout the life of the investment – including in the event of default or foreclosure.

6. LTV requirements and other policies

Qualified TDICs will have carefully determined and clearly stated policies in place to protect invested principal.

The most significant of these is the loan-to-value ratio (LTV), which determines how much protective equity exists in a subject property. Unlike banks, which make lending decisions primarily based on credit rating, private money lending decisions depend more heavily on the value of the property, which provides the lender protection in the event of default. While a bank might lend 80% or even 90% of property's value, reputable private money lenders typically lend no more than 50-75% of appraised value. A lower LTV requirement should always apply for projects that have higher risk or are harder to appraise.

In general, any TDIC you recommend for your investors should regard fair, legal and ethical treatment towards its *borrowers* as its primary fiduciary responsibility. Although this may seem counterintuitive, putting borrower needs first is actually one of the best ways to serve investors, since this ultimately helps prevent defaults and foreclosures.

TDICs should also have income/net worth accreditation standards for their investors (in some cases these are mandated by state law). Ideally, there should also be a cap on the percentage of portfolio your clients are permitted to invest. Even though the planning you do for your clients undoubtedly addresses the need for diversification and risk assessment, choosing a TDIC with a concern for these issues will give you more confidence in their ethical standards and selling practices.

7. Specialization

With laws and licensing varying by state – and huge variation in property values and rents across local real estate markets – geographic specialization is highly desirable in a TDIC.

Similarly, firms with a focus on particular market segments (e.g., mid-size shopping centers, commercial office parks, small industrial complexes, etc.) are more likely to have the historical knowledge needed to effectively assess property risk.



8. Management capabilities and staffing

Investors accustomed to trading only in public securities may have high expectations for service and support, but not all sources of trust deeds are staffed to meet these needs.

To understand what services the TDIC you're evaluating can and can't provide, inquire about the depth and experience of staffing in the following areas:

- * Investment committee (the in-house experts who find and evaluate lending opportunities)
- * Appraisers (the expert(s) who estimate property values)
- * Operations team (the team that manages disbursements, collections and reporting)
- * Real estate brokerage capabilities (to profitably resell REO in event of foreclosure)
- * Property management professionals (to manage rentals of REO in event of foreclosure)
- * Affiliated agencies (to provide any key services not staffed in-house)

9. Auditing and reporting

Whether not required to by state law, reputable TDICs invest in the services of an external auditor with real estate and/or mortgage expertise evaluate their financial reporting and procedures on behalf of their investors.

Clear, detailed and thorough documentation of each investment opportunity is, of course, essential for its evaluation. The company selling the opportunity should be able to answer any question to your (or your client's) satisfaction.

TDICs offering mortgage pools are also required to provide offering documents detailing fund disclosures. Of course, at a minimum, you should be sure that you understand the requirements in your state – and that the fund you're evaluating meets them. Ideally, offering documents should be recently updated, professionally produced, and, most important, contain all the information you and your client need to evaluate the investment (including target fund size, target interest rate, disbursement policy, lock-up period for investments, delinquency/default definitions, late fees and their distribution, mix of loan types and property types, etc.)

For further reading:

The California Department of Real Estate (DRE) has prepared a helpful guidebook for investors considering trust deeds. While some of the legal information may differ for other states, the publication also contains general information that is useful to consider in evaluating any private lending opportunity.

www.dre.ca.gov/pdf_docs/re35.pdf

About Sterling Pacific Financial

Sterling Pacific Financial (www.sterlpac.com) is a leader in trust deed investing – a simple means for individuals and organizations to invest in real estate loans, earning high returns without proportionately high risk. Led by an investment team of experienced real estate and financial professionals, we identify high-quality loan opportunities, underwrite and service the loans, arrange and manage investor participation, and collect and distribute investor payments.

A California-based firm with personnel in the San Francisco Bay Area, Greater Sacramento, the Central Valley and the Central Coast, Sterling Pacific has provided an efficient marketplace for timely financing of select real estate projects for more than a decade. The firm is a licensed real estate lender in California, Oregon, Texas and Washington. The firm's operations center is in Santa Cruz County, California.

To learn more about trust deed investing opportunities we currently offer, please contact Laurie Morgan at laurie.morgan@sterlpac.com or Joshua Fischer at joshua.fischer@sterlpac.com.