EPISODE 742

[INTRODUCTION]

[0:00:00.0] ANNOUNCER Welcome to the Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host, Whitney Sewell.

[INTERVIEW]

[0:00:24.4] WS: This is your daily real estate syndication show. I'm your host Whitney Sewell. Today, our guest is Sherman Arnowitz, thanks for being on the show Sherman.

[0:00:32.8] SA: Thank you very much for having me Whitney.

[0:00:35.0] WS: For over 25 years, keyhole financial services, under the leadership of Sherman, has been buying, selling and managing distress second mortgages. He has created numerous private funds managing thousands of distressed second mortgage notes and has continually paid out returns in excess of 20% to private investors, Sherman, pleasure to meet you, pleasure to have you on the show, grateful for your time and just being willing to share. Your 25 years of experience in this business with our listeners, syndicating private mortgages is not something we've talked about many times on the show if ever. Grateful for just your level of experience and being willing to share it today.

Give the listeners a little more about this business and how you got into this and let's maybe back up a little bit to even what having a second mortgage or distressed mortgage, what that is and how you've made a business out of that and why we need to know about it.

[0:01:28.6] SA: Great, well, again, I'm very excited to be here and I'm very excited to share my story with your listeners. I started about 25 years ago and the funny story is, my college roommate who was my best friend, we graduated college and he asked to borrow $5,000 for a real estate deal. He told me I'll pay you back within 30 days and a great interest rate and 30 days came and went and 60 days and six months and nothing. I sadly lost a relationship and lost the $5,000 and 15 years later, I got a certified check in the mail for $5,000 and on the check was my roommate's phone number.

Of course, I called him up and the first thing that I said was okay, where is the interest. We rekindled this relationship and I was kind of on the out, selling one of my companies and he was telling me this story that there are banks out there and you know, there is a first mortgage and then some people take out a second mortgage for a bathroom rehab or kitchen or whatever it is.

The second mortgage space is exploding. Now what happens is that when the borrower can't afford and just stops paying that second mortgage, the banks try, they send out letters, they do whatever they can. They don't really want to foreclose so what they're looking for is investors to buy these distressed second mortgage notes at heavily discounted rates. He said hey, why don't I show you the ropes at the time, he was bringing in about 200, 2nd mortgage notes from a company called Ditech.

He showed me the ropes and I invested money with him, I invested, if I remember right, about a hundred thousand dollars with him and in the back of my mind, I'm thinking, this is probably another one of his scams. I kept thinking, something's going to happen but lo and behold, I invested $100,000 and within about two years, I got my $100,000 back and another year later, I got another $100,000 and it was just mind boggling that there was this opportunity and it was an opportunity with very little people knowing about this opportunity.

Very well-kept secret, maybe when we started, there were about 10 to 15 investors. It really was the Wild West. He started training me on how to do this and after about a year and a half, two years, he said look, I've done all I can for you, it's up to you now. You're going to do it on your own.

I started doing it on my own and the big decision that I had to make was, do I want to do this and just invest my own money, or, do I want to turn this into a business? Fortunately, I decided on the latter and turned it into a business and so, I would go to friends, relatives, business associates and I would do my sales pitch whenever I would come across loans to buy.

These loans I was buying, I was buying them from banks, hedge funds, other investors and so whether it be as small as 25 loans, I would create a fund up to 300 loans, I would create a fund. In the beginning, I would create these smaller funds and I would make my sales pitch, I remember one of the first ones that I did, it was for about 50 loans and I went to my friend who was a lawyer and the conference room, he had some of his other partners and so there was about or six people that I was making the sales pitch to at the very beginning.

As I'm going along, talking about these 50 or 60 loans and the benefit of investing in them and who I was, et cetera. They were all nodding their heads and at the end of the meeting, they were like yeah, I think we're good, we'll each put up $50,000. In the back of my mind, it was funny, it was kind of like, on this side of my shoulder was this guy whispering to me like wanting to say, don't invest with me, I don't know what I'm doing, are you sure you want to invest with me?

This guy was saying, of course they want to invest with you, you're a great investor, you're going to make lots of money for them. It really was an anxious moment that I wanted to do really well; it was one of my first thoughts. That fund, we did really well, even now, after 20, almost 25 years when I do create a fund, you have that little conversation going back and forth but we have managed to take – if you average all of our funds and like I said, it could be a 25 note fund, up to 300 note fund, we've continually averaged between 20 and 30% annualized return on investment for the investors.

We started doing this and creating these funds for our accredited investors and we would create an LLC and all SEC compliant and we would manage the funds and it would be what we call an 80/20, 50/50 split. If you put up $100,000, we would pay out on a quarterly basis. Here is my income, minus expenses that net you get 80%, I get 20% until you get your complete money back.

That would be between three and three and a half years. Once you got your money back, it would be a five-year fund, we would split the profits 50/50 after you got your complete money back. Even with that, we would manage to fall between 20 and over 20% I would say. It's been very good, I've been managing to maintain and increase my pool of investors, when you do right by them, we're probably on fund number 12.

When you do right by them, when you announce, hey, I've got another fund that's going on, a lot of them. Hey, could I bring my golf buddy or can I bring my wife in this and so it's been really well. We have that for the accredited investor under Keyhole Financial. And then we also have a nonaccredited investor fund where you who are not accredited, you're going to buy the notes, it's a $50,000 minimum, you're going to buy the notes, I'm going to find the notes for you, you're going to buy the notes in your name and I'm going to be managing them as a consultant to W2, and we're going to be doing that same split, 80/20, 50/50.

It's been really well about six years ago, I decided to create Keyhole Academy. Keyhole Academy is an online education program, which teaches investors that want to be more than passive, they want to be active investors and so we teach them how to buy and mill the cow all by themselves.

It's an online course, it's 30 chapters, there's text, video, audio, quizzes, final exam, tons of homework and so the student takes the course about three weeks and then at that time, they can either start investing by themselves in the second mortgage space. Or, I put together a private mentorship program and that mentorship program is for those investors who are still a little leery about doing it by themselves.

I came up with, you're going to buy five mortgage notes, they're going to be in your name, we're going to split the profits 50/50 but every step of the way, we're holding your hand.

[0:09:06.8] WS: It's interesting, just the second mortgage business. I feel like it's a lot of times just the way people are introduced to syndication there first, they're like wait a minute, I don't think so. They're very skeptical and that's the way I was too, I think about the second mortgage business, you know, she was the unknown, right? You never been exposed to it and so it's interesting. I wanted to go back, I think your story of this friend is so interesting, he borrowed the 5,000 and it kind of went bad but then wow, that decision ultimately then changed your whole life probably.

But your career path for sure and now, so many other people, so interesting how that happened and then got you into this industry. Now, you've become obviously a major leader in that in helping so many people but you know, starting a second mortgage business, would you say somebody's already doing syndications, would they be better off to do their own second mortgages like you're talking about or should they consider having funds like this so investors can invest on a large scale.

I think 25 to 300, that's kind of overwhelming, right? What do you advise for that person that's looking to get into this business?

[0:10:11.5] SA: That's a great question and yeah, I'm a big believer in the universe and the universe put my college roommate and I together 15 years later and he did teach me and I in turn, created the academy to start teaching other people as well. I kind of geared this up Whitney, to set it up as a menu that if you're the type of person that you know what? I'm so busy doing ABCD, yeah, I'm going to be a passive investor, here you go, here is $100,000, here's $300,000, go for it.

Versus, we have people that want to do it and learn as a supplement to their regular income, their regular job and we some students that are in it, that they want to replace their regular job, they want to turn this into a career. Each option is available depending on where you are in your life and what your expectations are as far as what you want. Whether like I said, it's supplemental or career change or you don't want to be involved and you just want to be a passive, we have the funds and the opportunities for either of those.

[0:11:24.8] WS: What are some of the differences for the passive investor, say investing in a multifamily syndication versus a second mortgage fund?

[0:11:33.8] SA: I don't know that much about what's entailed in that multifamily. A lot of our students are in the real estate business and their house flippers, their renters and the difference between what they do and what we do is night and day and it's to the betterment of what we're doing. In 20 something years, I've never seen a property.

I buy the second mortgages all across the United States, sometimes when I tell people what I do, they go, that's terrible, you kick people out of their house? I said no, just the opposite. I keep people in their house. When I buy a $30,000 second mortgage and I buy that mortgage for $5,000, I now have the opportunity because I bought at such a heavily discount, hey borrower, you owe me $30,000, your monthly mortgage is 600.

The last time you paid was five years ago, what's going on? How can we work together? Depending on where they are in life, okay, you can't afford $600, what could you afford? $200? Great, they don't know that I paid $5,000. Let's put you on an ACH program, $200 a month, we'll do it for six months, at the end of six months, we'll revisit and maybe we'll turn this into a permanent loan modification.

As long as they're paying, I don't speak to them anymore. The $200 is coming in at the end of six months, we'll do a loan modification, we'll lower the interest, we'll extend out the term of it, maybe we'll forgive a little bit and then now all of a sudden, I have a viable second mortgage that went from nonperforming, it's been five years since they made a payment, to now I have a reperforming note, I have six months history and maybe I'll wait another six months, now I have 12 months paid history.

Now I'll put it out in the marketplace and say hey everybody, are the re-performer with 12 months pay history, okay, give me your bids. Maybe I'll probably get anywhere from nine to $11,000. Well I pay $5,000 for that note.

So, my decision is either keep the note and use it as an annuity or sell it or hold onto it for another year, which I could probably two to two and a half times sell that note now as a performing note. So when you say what's the difference, a lot of people are shocked when they're looking to get into this business. They think, "Oh my god, it is going to take so much of my time. I don't want to, no, it really doesn't take if I buy five notes.

The most I work is when I do the due diligence upfront. If I get a spreadsheet and I am looking at 25 notes and I pair that down to five that I am interested in and I put a bid on those five, let's say I only get two out of those five. All right, I spent two hours on the research. Now I have those two, I probably have to spend another hour getting them ready and filing with the county and blah-blah-blah. Probably another hour of skip tracing and finding them and talking to them.

And depending what they say, I am done with the note. So there is a lot less touching, there is a lot less hands on, you don't have to be there in the same city checking up on anything and the beautiful thing is you need a phone and you need a computer.

[0:14:55.1] WS: What are the tax benefits for passives to invest in a second mortgage?

[0:14:59.2] SA: I don't know. I am not an accountant but what I can tell you is that they are amortized and so each one is amortized and so there is a tax advantage when you are amortizing as well as the ones that don't make it where you lose that $5,000. There are some tax benefits on that as well.

[0:15:17.1] WS: For the passive investor that is looking to invest with someone that's like you mentioned now there are a lot of people that are doing this. When they are looking to invest in a fund like this that's purchasing private mortgages or second mortgages, what are some questions that they need to ask about that operator or about the fund?

[0:15:33.0] SA: Great question. I would say what's your track record, I would then say, what's your philosophy. Some investors as soon as they buy the notes, they start foreclosing on the notes and so it doesn't even matter. In most states the average you're going to spend on a foreclosure is about between six and $8,000. My philosophy is these people that have these problems with the notes, they have kind of been crapped on most of their life in a financial setting.

So why not kind of talk to them, find out what is going on, you will eventually get to a point where we have to decide, "Look, we have done all that we can. Does it make sense to foreclose?" and that space is maybe about three to four months where you are calling them, you are sending letters. You send the door knocker, etcetera, etcetera, we'll get to that time where we will decide whether we want to foreclose or not.

So that is one way that is one question to look at. Well, what is your philosophy when you are dealing with these loans? Another obviously is, what's your track record. Another is and I tell my potential investors all the time, what's the worst that can happen? Well, the worst that can happen is we could buy 20 notes and all 20 notes crap out and you lose everything. Has that happened in 25 years? No, even during the depression of 2008.

I remember I had one fund that was about 75 loans and I bought those notes in 2005-2006 and they each had tremendous equity and we got a lot of them performing and then obviously 2008 came along and that equity just disappeared and we were able to probably get back about 80% of everyone's money but the realization in this business is not for the faint hearted because if I buy – whether I buy five notes, 50 notes or 500 notes, there is going to be a certain percentage of those notes that are going to be foreclosed on by the first mortgage.

Remember, we are in the second position not the first position. So if the borrower isn't paying the first then he is not paying me in that scenario the first is going to foreclose. 9.9 times out of 10, there is no surplus of funds. So I am out, I lost my investment. In that same breath, "Hey, I don't want a second mortgage anymore. I want to do a short sale." Okay, you owe me $60,000. I'll tell you what, if you can pay within 60 days I will do it for $50,000.

Okay, here is your check for $50,000. All right, we paid $4,000 for that note. So as much as on one side you are losing and taking risk with those foreclosures because you are in second position, the numbers are in your favor. We're going to virtual Vegas and we are constantly gambling to a certain degree but we want to hedge our bets and when we throw all of these loans into a swimming pool, at the end of the day it is coming out over 20% that's really all I care about.

[0:18:35.6] WS: How do you prepare for a downturn?

[0:18:37.3] SA: In this environment right now, the downturn was what can we expect from our several hundred borrowers and we probably had about 10% that would call up and they would ask for extensions. "Hey, could I take a couple of months off?" and of course, you can take a couple of months off. So that is really the only downturn that we saw. We didn't really see many people saying, “Hey, I can’t pay you anything,” and you know a lot of people will ask me, “Well, what’s going on with the pandemic now? You guys must be crazy busy.”

And the truth is the loans that are going to be defaulted now that these borrowers are in trouble now, we won’t see those loans for another three to five years because the governments put a hold on the banks foreclosing on them now. Once they release that hold, the banks have their own internal processes and then once they decide that they are going to foreclose, they’ll either foreclose or try to sell it to investors like myself but in some states it could take anywhere from one to five years to foreclose. So we won’t see these pandemic loans for another three to five years.

[0:19:50.5] WS: And you said like three to five years, what do you predict over the next say six to 12 months in this industry? Are you ready to buy or is it something you got to wait for numerous years now for this to cycle?

[0:20:01.4] SA: What we are doing now is we are in our time machine and we go backwards and we are buying loans that originated in the early 2000s and there is still trillions of dollars of these loans that they hold. The only thing that is holding those loans from being released are the banks bureaucratic notion that one of the things is that A, the banks created our industry because the banks had the forethought to say, “Well, maybe we could do a loan modification.”

“And maybe we could give this guy an extra six months and maybe we could do this,” they didn’t want to do that. They couldn’t do that so they created our industry and so right now, banks are a little conservative because they don’t want it to come back to haunt them. In one sense, banks only have a certain amount of money to lend and so they want to write these bad loans off their books. So it is kind of to a certain degree they need to get rid of those loans.

And so that is why there is always an influx of these loans. I just purchased 200 loans from a large hedge fund. I will take those 200 loans and half of them are for private fund people and the other half are for my students under the Keyhole Academy umbrella.

[0:21:19.3] WS: Nice. Sherman, what’s a way you’ve recently improved your business that we could apply to our business?

[0:21:24.0] SA: Specially during this pandemic I have learned and it has given me the opportunity to trim the fat. I didn't trim the fat per se because of the COVID-19 but really giving the opportunity to look and re-evaluate my business and see where I am right now and take stock of where I am right now and where I want to be, where should my focus be and where am I doing something that I might like to do it and that is the reason why I am doing it but is that really where I should be putting my energy.

So this time has really given me the opportunity to really re-evaluate what I'm doing, where I am and where my priorities are.

[0:22:05.1] WS: What is your best source for meeting new investors right now?

[0:22:07.4] SA: I'm talking to him. I am on Facebook and I do Facebook ads and social media and stuff like that but there is nothing better than a podcast with an honorable accredited interviewee who's got a great – we were talking before about trust, who's got a great audience and that's by far the number one.

[0:22:26.2] WS: What's the number one thing that's contributed to your success?

[0:22:28.7] SA: Being a good listener as well as being fair and honest and building a good reputation.

[0:22:35.6] WS: I believe that to be successful in business you have to be self-disciplined and I know especially in real estate business or almost any business but what about yourself, how have you worked on self-discipline or are there a couple of habits or things that you do say on a daily basis that the listener could do today or improve on to improve their self-discipline and be disciplined about something so they move their business further ahead?

[0:22:59.9] SA: I've always been in my other businesses as well. There is a part of me that has defined how I want to live my life and the lifestyle that I have and with that, I am not going to be working 20 hours a day. I've built my business as well as other businesses so that 20 years ago or whatever, I could come home and be with my children and I could go to their ball games and I could do these things and part of the reason why I created Keyhole Financial Services is that it's a computer and it's a phone.

So I could be anywhere in the world so that I could benefit from that type of lifestyle and I think there's always been – I remember having a challenge within myself of, "Well, how do I know when I work hard? What measure do I do?" and I remember going out to lunch with this guy and he said, "Man, I have been working like a dog" and I turned to him and said, "Help me out here, what does that mean?" because I wanted to compare that against myself.

And he said, "Well last week, I probably put in about 45 hours," and in his mind that was working like a dog and so we all have to kind of come to terms with what our values are, are lifestyle values, what our work ethic and work values are and how they meet. I used to feel so guilty if I would take the afternoon off and then I've come to terms with that to say, "I have the ability that I can take the afternoon off." So make it a great afternoon.

[0:24:31.6] WS: I like that, you got to know how to spend your time and if you can take the time off make it a great afternoon. I love that and how do you like to give back?

[0:24:39.4] SA: I went to three astrologists once and they said, "You're a performer and you're a giver-teacher," and A, I am a musician and I love to write music and I love to perform but also I love giving back of my time to students even the borrowers that I can have a conversation and I could have a relationship with the borrowers listening to them, giving suggestions to them, helping them out. So I really enjoy doing that.

[0:25:11.4] WS: Sherman, it's been a pleasure to get to know you and have you on the show. I am just grateful for you being willing to share your knowledge and experience in the second mortgage business and even syndicating 300 at a time. It is hard for me to imagine but I am grateful for your time and grateful that there is an option for investors to be able to do this with people like yourself as well but tell the listeners how they can get in touch with you and learn more about you?

[0:25:33.7] SA: Please check out our website, it is a great state. It's keyholefinancial.com, it is a great start to look there. We've got lots of information on there. I have YouTubes, I am on

YouTube with lots of videos there but that is a great start and of course, feel free to give me a call. I love to speak to everybody.

[END OF INTERVIEW]

[0:25:51.4] WS: Don't go yet, thank you for listening to today's episode. I would love it if you would go to iTunes right now and leave a rating and written review. I want to hear your feedback. It makes a big difference in getting the podcast out there. You can also go to the Real Estate Syndication Show on Facebook so you can connect with me and we can also receive feedback and your questions there that you want me to answer on the show.

Subscribe too so you can get the latest episodes. Lastly, I want to keep you updated so head over to LifeBridgeCapital.com and sign up for the newsletter. If you are interested in partnering with me, sign up on the contact us page so you can talk to me directly. Have a blessed day and I will talk to you tomorrow.

[OUTRO]

[0:26:32.1] ANNOUNCER: Thank you for listening to the Real Estate Syndication Show, brought to you by Life Bridge Capital. Life Bridge Capital works with investors nationwide to invest in real estate while also donating 50% of its profits to assist parents who are committing to adoption. Life Bridge Capital, making a difference one investor and one child at a time. Connect online at www.LifeBridgeCapital.com for free material and videos to further your success.

[END]

