

## real estate

### How to buy a foreclosure



Someone else's misfortune could be your golden opportunity, but making a profit by flipping foreclosures is a risky business. Here's what you need to know.

By [Bankrate.com](#)



While foreclosures wreak havoc on the finances of their victims, they also can be golden opportunities to buy.

In recent years, foreclosed homes have become popular targets for real-estate investors. Even novices have been lured by the dream of getting rich quick through foreclosure "flips."

How good -- or bad -- an idea is it to buy a foreclosure, given the current housing market?

Let's start with the bad news: Buying foreclosures for profit is now much less feasible and practical for the average Joe or the newbie investor than it was just a few short years ago. Many sources of easy financing are now just a memory, and with home prices dropping, the potential for a big profit in the short term is not as great.

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But with so much inventory to choose from at bargain prices, investors with available capital or ready financing -- combined with the financial wherewithal and patience to wait for housing prices to rise before trying to sell -- might want to consider buying foreclosures.

It boils down to supply and demand.

There's plenty of supply. Would-be investors have their pick of foreclosed homes, often choosing from several different foreclosures on the same block.

The other side of the coin is demand. To make quick profits, the investor has to buy properties cheaply and then flip them quickly at a significant profit. The faster you can flip it -- at a profit over the cost of purchase, repair and updating -- the more money you will make.

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#### What's your home worth?

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Right now, demand is not so good for investors. The same low demand that makes foreclosed houses attractive because of low prices turns right around and bites the investor when the updated house is put back on the market. Buyers are scarce; demand is low. The flip often turns to flop.

Traditionally, investors flipped a lot of homes to first-time buyers, who didn't mind putting some sweat equity into a fixer-upper. They would also sell to people who had gotten approval for questionable subprime loans. In some cases, they would sell to people who wanted the properties as investments and planned to rent them out. Or, the investor might not sell the property and might decide to be a landlord himself.

### Dwindling options

But now, loans are much tougher to get. Landlords now may be struggling to make their mortgage payments on properties they financed several years ago. And then there's the added burden of rising costs related to rental properties, such as soaring fuel prices and rising costs of construction materials needed for repairs.

What's more, the investor may be in a very crowded field. The popularity of TV shows featuring flippers who make nice profits after a few weeks of work has created the notion that anyone can do it. The veteran investor finds himself competing with a bunch of newcomers, all trying to unload rehabilitated foreclosures.

Bottom line: Many investors, caught unawares when the housing bubble burst and the subprime lending market melted down, found themselves holding a bunch of properties they couldn't get rid of -- properties quickly becoming expensive to maintain.

If it still sounds like a good idea for you to buy a foreclosed property, keep reading.

### Three types of foreclosures

First, consider the three options when it comes to investing, which coincide with the three stages of foreclosure:

**1. Pre-foreclosure:** This is when the borrower is in default on the loan, but a formal foreclosure has not yet been filed. To buy a property at this point, you deal directly with the homeowner, possibly while involving the lender, such as in the case of a [short sale](#). If you try to acquire a pre-foreclosure without notifying the lender -- say, by simply taking over the mortgage -- you risk triggering the "due on sale" clause found in most mortgage agreements. This clause in the homeowner's mortgage means the note becomes due and payable in the event of any title transfer of the property.

**2. Auctions and sales:** This is where the property is sold at an auction or sheriff's sale. The good side of this is that there are no negotiations with homeowners, and existing liens and encumbrances typically are wiped out. The downside is that you often cannot inspect the property beforehand, you usually need significant and immediate cash, and you may need to evict the occupant from the home.

**3. Real-estate-owned properties:** At this point, the lender has reclaimed the property, and the homeowners have vacated. The condition of real-estate-owned, or REO, properties can vary widely. Generally, liens and other clouds on the title have either been satisfied or wiped out. You can tour the property before making an offer. You will usually get the property for less than market value, but not drastically lower. Discounts are more likely if the property is in less-than-perfect condition. However, the lender is eager to unload this home and therefore will probably be willing to offer favorable financing terms or throw in other incentives.

### Finding foreclosures

Finding properties in foreclosure isn't hard these days:

- **Drive around.** In many high-foreclosure areas, you can often spot them simply by driving down the streets and look for the "Foreclosure" banners on top of the "For sale" signs.
- **Go online.** Use online foreclosure search services. Many of these sites offer a short, free trial period, but keep in mind you will be charged the subscription fee automatically once that period ends. Be sure you know exactly what fees you will incur; charges can vary widely from one site to another.
- **Pick up a newspaper.** Auction properties are easy to identify, as these sales are usually advertised in the newspaper (and possibly online), often a month or two prior to the sale. Also, search for ads placed by owners or agents that contain buzzwords and phrases that signal distress, such as "owner anxious," "bring all offers" and "priced for quick sale." Many people actually state right in the ad that the home is in foreclosure

or pre-foreclosure. Or use the newspaper in reverse -- you can get distressed owners to come to you by placing newspaper ads or posting signs. Mostly likely you've seen those "I buy homes" ads that seem to be springing up all over. Many other people are posting the same signs, so it can be tough to make yours stand out.

- **Contact a local agent.** Real-estate salespeople can search the multiple listing service for properties that are in distress or have been on the market for a long time. To find REO properties, check with local brokers who specialize in these types of homes. Or go the direct route and simply call the lenders in your area (ask for the resource recovery department).

### How do you pay for it?

The biggest challenge in foreclosure investing is the money issue. Riskier, subprime and "creative financing" loans from most lenders have disappeared. There are some perfectly legal techniques still available, including subject-to deals and lease-option and lease-purchase transfers, but these are risky because of "due-on-sale" clauses in many existing mortgages. Keep in mind that while such clauses are common, they're not universal. Mortgages written before the 1980s, for example, commonly do not contain them.

Financing options include:

- **Conventional financing.** If you have good credit, this may be an option. However, some lenders are hesitant to finance foreclosure purchases.
- **Borrowing against existing equity.** You can get a mortgage (or a second mortgage/home-equity loan) on other property you already own. These are generally a specified amount at a fixed rate. This may be easier than getting a loan for the foreclosed property, but the ongoing credit crisis has caused a great deal of tightening in the home-equity lending market, too, so this isn't as easy as it was just a year ago.
- **Opening a line of credit.** Usually adjustable-rate loans, these, too, are becoming harder to find, because so many homeowners are having trouble meeting their first-mortgage obligations that lenders are reluctant to extend secondary loans. You will need to have high-value collateral, such as property in good condition. The advantage of this route is that you borrow money only when and if you need it, but it is available on short notice, which can come in handy for auction purchases.
- **Enlisting a partner/investor.** This can be a great move, if you can find a partner with deep pockets. There are many investors out there who would like to profit from foreclosures but don't want to do the hands-on work.

For new investors, foreclosures can be risky. There are two major concerns:

**1. Problems with the title.** Perhaps the single most important part of the process is the title search. Have an experienced title-search professional or real-estate lawyer conduct the search for you. This is an extremely worthwhile investment. Buy a property with a cloudy title, and you could be in for big problems. After all, when homeowners can't pay the mortgage and know they're losing their home, they usually stop paying all the other bills too, and so it's likely there's a whole line of lien holders that can make a claim. Also, make sure it is the primary lien holder who is doing the foreclosing. If not, you will probably still be liable for that loan if you buy the property.

**2. Maintenance and structural issues.** Foreclosures are notoriously high-maintenance. Assume you're getting a fixer-upper. If the homeowner couldn't afford the mortgage, it's likely that he couldn't afford upkeep and repairs, either. These homes are often neglected -- and, in some cases, they've been deliberately trashed. It's a good idea to have a home inspector or professional contractor give the home a thorough evaluation.

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- **Be selective.** Skip neighborhoods with lots of foreclosures. It is usually a sign that the neighborhood as a whole will take time to recover from this downturn. Instead, look for a neighborhood with only one foreclosure -- and then scoop it up. Target areas that are doing well (or at least not so bad) overall, and have a good chance of riding out this economic storm fairly well. Places such as Detroit, for example, involve a higher risk because of their unemployment problems and other economic challenges.

- **Don't get cute.** Avoid risky or "creative" financing techniques, at least at first. Until you get a few successful investments under your belt, play it safe. New investors often underestimate the time it will take to fix up and sell a property, which could mean big trouble if you've used a hard-money lender or other time-sensitive means of financing. Interest rates are still pretty low, so if you can qualify for a fixed-rate mortgage at a decent rate, that's probably your best bet.
- **Get a pro.** In order to protect distressed homeowners from scam artists, many states have recently enacted laws involving foreclosures and the transfer of these properties. Your local county clerk's office (or a real-estate attorney) can probably fill you in on the latest legal changes regarding foreclosures. To get some quick info, do an online search using your state and "foreclosure" along with "laws" or "legislation." Unless you consider yourself a real expert in foreclosures, hire an experienced real-estate attorney to oversee the deal from contract through closing. This is no place for amateurs.

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