

Does It Make Sense to Get Into The Market for Troubled Homes?

In March, [RealtyTrac](#), a leading online market for foreclosure properties, reported that February 2010 foreclosures were actually down 2 percent from the previous month.

Yet, RealtyTrac indicates this break might not last long. Even though the 6 percent year-to-year increase in February foreclosures was “the smallest annual increase” RealtyTrac recorded in 50 straight months, it believes that current foreclosure prevention programs and processing delays are keeping a lid on the numbers. If those programs end and processing glitches lift without an upswing in the economy or job market, or the foreclosure could accelerate.

For individuals with some money to spend and invest, the troubled home market has its attractions. First, there’s the possibility of attractive real estate – albeit some in need of serious repair – at a bargain price. Then there are the sellers, both banks and individuals, who are at best eager, at worst, desperate to get out from under their obligations. But the trail to ownership of properties that are under a cloud can be treacherous and it’s best to know what you’re doing. It’s wise to consult a tax planner and a financial planning professional before making a move into this risky arena. Here are some of the things potential investors should know:

How foreclosure works:

A foreclosure happens when a buyer defaults on their payments and their lender takes legal steps to take back the property. Rules vary by state and local government, but generally, when a lender decides to foreclose on a property it files a notice of default or a *lis pendens* (Latin for “lawsuit pending”). This document is a public record, and for buyers – including other lenders -- it’s the first step in locating a property in foreclosure. A buyer looking for foreclosures can look online (RealtyTrac is a good source) for lists of properties in default, but individuals with contacts inside lenders holding these properties have a particularly good leg up.

Pre-foreclosure sales are attractive, but often tough to close.

With so many homeowners struggling with payments, “pre-foreclosure” or “short sale” transactions are currently common, but fraught with obstacles. Short sales essentially allow a seller to sell their home for less than they owe as long as they get their lender to buy their story about a lost job or other financial hardships. The second obstacle is getting a real estate agent to work to sell the property for a far lower commission than they usually get. Third, many states allow for very tight timeframes between the notice of default – the first news a homeowner is facing foreclosure, if they’re checking their mail – and an actual foreclosure notice. Deals of this variety need to close within days, not months.

How do people invest in foreclosure properties? There are three primary ways this happens. First, you will see buyers coming in at the “pre-foreclosure” stage. Second, you will see buyers going after “REO” (real estate owned) properties – literally foreclosed real estate still on the books of a lender. Third, you’ll see foreclosures auctioned off at the public courthouse or in private auctions, depending on how the lender wants to market such properties to get them off their hands. Each process has its own conventions for inspecting the properties – sometimes prospective buyers get time to inspect what they might buy, other times little or none. It’s best to learn the process as a bystander before putting any skin in the game. The most knowledgeable foreclosure investors also have good intelligence on how heavy the lender’s inventory is with troubled properties – the more headaches they want to get rid of, the faster they’ll get rid of them.

Is it wise to borrow?

Given the current state of the lending industry, such a question might be a moot point even for the most-creditworthy individuals. Buying distressed property is primarily a cash game. It lowers the cost of entry and speeds these kinds of transactions where time is definitely of the essence. Even sophisticated foreclosure investors often discover ugly surprises when buying – property with greater damage than they anticipated, for example – and they may not have the flexibility to borrow to fix those unexpected problems after they borrowed to buy in the first place.