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Anatomy of a Flip

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No, we are not going to attempt to teach a backflip (or front-flip for that matter). All previous attempts by your author ended decades ago with a bruised head and ego. Rather, we will attempt to illustrate the mechanics of a “fix and flip” transaction, from the perspective of both an equity sponsor and debt provider, with the goal of highlighting best practices for both parties and illustrating how loans (increasingly referred to as Residential Transitional Loans or “RTLs”) backed by such investments can be an attractive component of a real estate debt portfolio.

Background

The fix-and-flip strategy has likely existed for nearly as long as people have owned homes. From the outside looking in, a fix-and-flip appears to involve little more than buying an older home, adding some new paint and appliances, then selling in short order for a tidy profit.

This couldn't be further from the truth. In reality, a successful flip involves marshalling a highly diverse set of skills. These skills range from the obvious, such as practical experience in one or more trades and a deep knowledge of the local real estate market, to the not so obvious, such as knowledge of the arcane databases that local municipalities and banks use to post tax lien and foreclosure sales or a direct marketing strategy to source off-market transactions.

Pre-Investment Considerations

Performing a fix-and-flip transaction should be viewed as a business, in this case, the business of delivering a desirable and up-to-date product to a home buyer. Successful flippers follow a disciplined process and rarely stray from their area of expertise. The foundation of this process is a focused acquisition strategy, one that encompasses not just high-level considerations such as a location, but also equally important items such as:

- Target property type – affordable homes, mid-market homes or luxury properties?
- Target buyers – single professionals, young families, empty nesters or others?
- Sourcing methods – foreclosure sales, tax lien sales or direct marketing strategies?

- Reliable financing – many acquisitions require quick closing. Where will such financing be obtained? Post closing, how quickly can the source of financing release construction draws?
- Contractor relationships – time and delays are the enemy of a successful flip. Does the sponsor have established and reliable relationships with all the trades that will be required?
- Real estate agent relationship – driving repeat business through a real estate agent can not only save money on commissions but can also serve to provide a source of off-market deal flow.



Investment Execution

Despite the effort involved in sourcing and closing on a would-be flip, the work has just begun once papers are signed. Successful flippers will often pre-stage materials and have subcontractors queued in advance ready to start as soon as the transaction closes. Should structural

work be involved, engineers should be briefed pre-closing. Similarly, the sponsor should have a process for applying for any permits required by local municipalities. At a minimum, commencing work without proper permits can result in costly fines. At worst, unpermitted work can cause significant delays or result in some refurbishment having to be torn out and redone, resulting in significant cost overruns.

After setting these foundational measures, the focus shifts to the rapid execution of renovations. It's crucial to maintain a strict timeline that coordinates all subcontractors' work, from electricians to plumbers to carpenters, ensuring that each task is completed in the right sequence to avoid any rework. Regular meetings among all involved parties can help address any issues quickly and keep the project on track.

Sponsors should also have an efficient process for requesting construction draws. This includes facilitating site inspections and collecting lien waivers from contractors. Efficient operators are able to request and process draws seamlessly; inefficient operators can lose weeks or even months of progress due to an inefficient draw requestion process.



Equity Mechanics

It can be tempting for flippers to let their foot off the accelerator as the refurbishment process draws to a close, but seasoned flippers know that a successful flip can be fumbled at the one-yard line. Once renovations are nearing completion, attention turns to the aesthetics of the property, such as final paint, fixtures installation and

staging the property for potential buyers. Effective staging can significantly enhance the property's appeal and lead to quicker sales at higher prices.

Marketing the property also begins at this stage, with listings prepared and open houses scheduled to attract a wide array of potential buyers. As offers begin to come in, it's crucial for flippers to remain engaged, evaluating each proposal carefully and negotiating terms that maximize returns.

Throughout this final phase, maintaining flexibility to adapt marketing tactics and showing schedules can significantly influence the speed and success of the sale. Ultimately, the closing process demands meticulous attention to detail to ensure all legal and financial aspects are handled accurately, ensuring a smooth transition to the new owners and a profitable conclusion for the sponsors.



Debt Mechanics

So, while the above transaction worked out quite well for the sponsor, how did the debt investor fare? As it turns out, not too shabby either. In exchange for a first mortgage and personal guarantee, the loan used to facilitate the above transaction also carried an interest rate of 11.50% and earned a 1.00% origination fee and a 1.00% exit fee. Once paid off upon the sale of the renovated home, the debt investor earned a 26% IRR while taking on substantially less risk than the equity sponsor. All-in-all, the transaction represented a win-win for both the equity and debt investors.

Evolution

Once a cottage industry, fixing and flipping homes has become a mainstream investment strategy. Perhaps nothing symbolizes this more than Wall Street attaching a new acronym to the debt used to finance such transactions – hence the birth of the RTL. The acknowledgement from Wall Street goes far beyond a new name, however. The new moniker also accompanied Wall Street routing capital to the strategy via securitization, a process whereby several hundred million dollars of RTLs (aka fix-and-flip loans) are accumulated and packaged into a CRE CLO, a close cousin to the much larger CMBS market. This has had the effect of lowering the cost of capital for professional flippers who can meet the criteria for their loans to be packaged into securitizations; however, sponsors should be aware that this capital can be quite unstable. When the window for securitization closes, even seasoned flippers can find themselves

without a lender if their existing lender was dependent on selling loans into the securitization market. As such, sophisticated flippers will inquire as to the source of their lender's capital.

Lenders backed by stable private capital will often be able to weather tumultuous markets and continue lending regardless of the state of the securitization market. In contrast, thinly capitalized lenders reliant on selling their loans may be unable to service their repeat borrowers when markets turn rocky.

Regardless of where fix-and-flip loans are ultimately housed – whether in a CRE CLO or a private credit fund – the product's highly attractive economics and risk-reward profile have brought a once obscure mortgage product into the mainstream institutional investment landscape. While operationally intensive to originate and service, RTLs deserve serious consideration as a part of a diversified real estate debt portfolio.

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1. Banks utilize double entry bookkeeping whereby a new loan creates two corresponding entries on its balance sheet. The first is the creation of the loan as an asset on the balance sheet, the second is a corresponding newly created deposit, which is entered as an offsetting liability on the balance sheet. Hence, the creation of a loan actually creates deposits.

2. Source: Trepp