Advanced Technique For Purchasing Wraps

by Tom Henderson

With the conventional method of purchasing a wrap note, the note buyer will purchase the entire wrap note and at closing payoff the underlying lien. The wrap note seller will receive the remaining equity**.**

However, there are situations where it would be advantageous to both the wrap note seller and note buyer to leave the underlying lien intact and purchase the entire wrap.

For example, let's assume a property has an underlying note of $70,000 with 180 months remaining, with monthly payments of $553.56 @ 5%. The property sells for $110,000, with $10,000 down with a wrap note of $100,000 for 240 months and payments of $899.73 @ 9%.

If a note buyer purchases the wrap note for $80,000 and pays off the underlying note of $70,000, the wrap seller will receive the difference of $10,000 while the buyer will yield 12.34%.

Is there a way for the note buyer to not only increase his or her yield and at the same time put $20,000 more money in the note seller's pocket? Yes. Why not buy the entire wrap note and leave the underlying in place? In the "old days" prior to due on sale and other issues, leaving the underlying in place was a popular way of purchasing wraps. Let's see what happens.

Compare the two methods: The equity in the wrap note is $30,000 (the difference between $100,000 wrap note and the $70,000 underlying note).

What Is A Wrap? (a.k.a. Wrap-Around Mortgage, AITD [All-Inclusive Trust Deed], or Overriding Mortgage)

A wrap mortgage is a loan transaction in which one party assumes responsibility for an existing mortgage. For example, S, who has a $70,000 mortgage on his home, sells his home to B for $100,000. B pays $5,000 down and borrows $95,000 on a new mortgage. This mortgage "wraps around" the existing $70,000 mortgage because the new lender will make the payments on the old mortgage.

A wrap is attractive to note investors and lenders because they can leverage a lower interest rate on the existing mortgage into a higher yield for themselves. For example, suppose the $70,000 mortgage in the example has a rate of 6% and the new mortgage for $95,000 has a rate of 8%. The lender earns 8% on $25,000, plus the difference between 8% and 6% on $70,000. His total return on the $25,000 is about 13.5%. To do as well with a second mortgage, he would have to charge 13.5%.
— Jack M. Guttentag, Professor of Finance Emeritus at the Wharton Business School www.mtgprofessor.com

The payment on the wrap note is $899.73, from which we must subtract the payment of $553.56 made to the underlying. **The remainder of $346.17 is the cash flow the wrap note holder will receive for 180 months. For the next 60 months, the wrap note holder will receive the entire $899.73,** since the wrap note's term is for 240 months and the underlying note will have been paid in full after 60 months. Now that the groundwork has been made, we can have a little fun, and make it profitable for both the wrap note holder and the note buyer.

Remember, the wrap note holder has $30,000 equity in his/her wrap note; the difference between the $100,000 wrap note and the $70,000 underlying note. What if the note buyer gave the wrap holder his/her entire $30,000 equity? In other words, the note buyer would purchase the entire wrap note for $30,000, leaving the underlying note in place.

Is there any doubt the wrap note seller comes out better by receiving $30,000 instead of $10,000?

What of the note buyer? What is his position in purchasing the entire wrap note and leaving the underlying in place? Since the cash flow the note buyer will receive is irregular in that he will receive note payments of $346.17 for the first 180 months, then for the remaining 60

months receive the full $899.73, we must perform Internal Rate of Return calculations to determine the note buyer's yield. Rather than going into lengthy calculations on a financial calculator, I use TValue software from THE PAPER SOURCE which instantly gives me the answer. **By purchasing the entire wrap note and leaving the underlying in place the note buyer will enjoy a yield of 14.38% rather than 12.34%**.

So far we have a WIN/WIN situation where the wrap note seller receives $20,000 more than the traditional method of purchasing a wrap and the note buyer increases his yield by over 2%.

The benefits to the note buyer continues. Because the underlying note pays off faster than the wrap note, **the note buyer's equity in the wrap note increases for 180 months** until the underlying note is paid off.

Let's examine this phenomenon by illustrating an example of what happens if the property owner sells the property after 84 months and both the underlying note and the wrap note are paid off.

Looking at the TValue amortization schedule of the wrap note, after 84 months we find the balance $82,567.43. Likewise the balance of the underlying note is $43,724.62. After the underlying note is paid off, we subtract the underlying payoff from the wrap note balance. This figure, $38,842.81, is the payoff amount for the wrap note. **Did you notice that the note buyer started with $30,000 equity** in his wrap note, **but after seven years, the equity increased by $8,842.81?**

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So how did the note buyer come out?

N = 84 (Number of months until payoff
I/YR= 16.14
PV = -$30,000 (Amount Paid for Wrap note)
PMT = $346.17 (Cash Flow Received After Making Underlying Payment
FV = $38,842.81

Space is getting short for this article, so I am not able to show the calculations, but the yield on an early payoff purchasing the wrap in the traditional way is 13.77%.

Conclusion: Purchasing a wrap note and leaving the underlying in place has advantages and disadvantages. The first advantage is it can give the note seller more money for his equity. The second advantage is it can benefit the note buyer by producing higher yields. The third advantage is, because the underlying often pays off faster than the wrap note, the note buyer will enjoy an increase in equity until the underlying note matures. In this scenario, when the underlying note matures in 180 months, the wrap note has increased his equity in the wrap note from $30,000 to $43,341.51.

Are there risks involved in purchasing a wrap note and leaving the underlying note in place? Of course, especially if there is an institutional mortgage on the property or in the event of an early default. However, there are also often times when the wrap note has several years of seasoning, as well as the property having a large equity where the risk of default is reduced. Be on the lookout for these opportunities.

Food for Thought: If you were the wrap seller and offered the underlying lien holder an small option to purchase the underlying note at a discount, who would receive the extra money at closing when the wrap note is funded?

The purpose of this article is to point out methods to increase your yield. If you think outside the box, under certain situations, purchasing the wrap and leaving the underlying lien in place is just another arrow for your quiver of note investing techniques. Keep pounding that calculator. You will be surprised at what you discover.

Tom Henderson earned a BBA degree in Finance and Economics. He entered the field of real estate in 1980 during times of turmoil and crisis. Tom mastered the skill of acquiring and disposing of real estate using owner financing and notes, as well as buying and selling notes to achieve astronomical yields. Tom has been called "the best kept secret" of instructors in the nation. Contact him at **www.hpNOTES.com**

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