A BASIC GUIDE TO

# SELLER FINANCING COLORADO COMMERCIAL REAL ESTATE

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# Why Did We Write This Ebook?

In today's high interest rate environment, it's important that sellers have all the tools in their arsenal to command the highest and best price for their property.  Is seller financing right for everyone? Of course not. But we created this guide to help property owners explore alternative ways of selling their commercial property in Colorado. *When utilized correctly, seller financing can be a fantastic tool to help get a deal done quickly and even help achieve a much higher price for your property*. You may have heard of seller financing so even if you get 1 nugget from this ebook, we'll consider it a success.

# Who Are We?

We are Colorado commercial real estate brokers and have been doing this for over 25 years. We've sold hundreds of properties.  We are also developers, property owners and have a fondness for real estate finance and creative ways to market and sell property.


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# Understanding Seller Financing Basics for Commercial Real Estate in Colorado

Seller Financing basics:

- ➔ Every commercial real estate deal is unique
- ➔ Every Seller has different goals
- ➔ Every Seller has different risk parameters

If we can agree to these 3 points, I think you'll find this guide informative and maybe you'll consider seller financing for one of your properties here in Colorado.

Will this be a super comprehensive guide to seller financing in commercial property in Colorado? No. We respect your time and don't want you to fall asleep reading this. We purposely created a short and concise guide to help highlight another route when selling a property. If you'd like, you can reach out to us directly and we'd love the opportunity to chat with you, learn more about your goals and see if we can help.

**Required disclaimer:** We are not licensed attorneys. We are not CPAs nor any other type of financial/tax advisor. We are writing this from a real estate broker perspective in Colorado who has done numerous seller financing deals where we have represented both buyers and sellers. If you are interested in learning more about what your property may be worth in today's market or certain strategies, we can help. If you have any legal or tax questions, we always suggest you speak with an attorney or financial advisor.

# Introduction

Let's just bust right into an example so we have a framework for how seller financing may be a way to sell your property and command a higher sales price. Seller financing, also known as owner financing or seller carry financing, is a real estate transaction method where the Seller takes on the role of the lender in the sale of a property. Instead of the Buyer securing a mortgage from a bank or traditional lending institution, the seller provides the financing for the purchase.

***Wait, the Seller becomes a lender?***

*Yes - let's explore.*

In this arrangement, the Buyer makes a down payment to the Seller and then makes regular payments, typically with interest, directly to the Seller over an agreed-upon period. The terms, including interest rates, repayment schedule, and other conditions, *are negotiated between the buyer and the seller* and are outlined in a promissory note or financing agreement*. This opens the Seller and Buyer to a myriad of different options.

*This promissory note and financing agreement should be drawn up from an experienced real estate attorney.

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**Seller financing can benefit both parties.**

1. Buyers who might have difficulty qualifying for traditional loans or who want more flexible terms may find it appealing.
2. Sellers can attract a larger pool of potential buyers and potentially sell their property more quickly.

***Let's look at a simple example:***

- Hunter wants to sell his industrial property in Denver for $2,500,000. Tom is interested in buying the property, but because banks are lending at 8.5%, he can't afford the monthly payment at that purchase price.
- Tom needs the building and Hunter wants to sell it.
- Tom's business has a good income, receivables and they have a substantial down payment saved up.

## Seller Financing Agreement:

Instead of going through a bank, Hunter agrees to offer seller financing to Tom with the following terms:

- Purchase Price: $2,500,000
- Down Payment: $425,000 (17% of the purchase price)
- Loan Amount from Hunter: $2,075,000
- Interest Rate: 4% annually
- Term: 4 years
- Amortization period: 30 years
- Monthly Payments: Approximately $9,900

**Loan Agreement:** Hunter's attorney drafts a loan agreement outlining the terms of the loan, including the interest rate, repayment schedule, and any penalties for late payments or default.

**Legal Documentation:** They formalize the agreement with legal documentation, such as a promissory note and deed of trust, outlining the terms and conditions of the loan.

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**Outcome:**

- Tom becomes the building owner and starts making monthly payments to Hunter instead of a traditional mortgage lender.
- Hunter receives a steady stream of income from Tom's payments
- Tom will either need to pay off Hunter in full in 4 years or refinance the loan.
- Hunter may also enjoy some tax benefits from the installment sale and realization of income over time as opposed to all at once.
- Hunter has likely sold his building at a higher price and shorter time frame than if a Buyer had to obtain a bank loan.

This simple example illustrates how seller financing can benefit both parties: Tom secures a property much easier than by obtaining a bank loan, while Hunter sells his property and earns a consistent income from the sale for, in this case, up to 4 years.

Because the Seller acts a lender, the Seller and the Buyer can agree to many different types of terms and conditions such as but not limited to:

1. **Interest rate**: This can be a set amount each year or it can escalate annually for the length of the term.  The loan may be an interest only loan as well.

2. **Amortization**: In the example above we used 30 years but it could be 2 years, 5 years, 15 years etc.

3. **Down payment:** In the example above we used 17% but you can do as little as 0% or 30% or 75%. It just needs to make sense for the Buyer and the Seller.

    a. Pro Tip: When calculating the down payment, a Seller should take into consideration closing costs. For example, if a Seller has to pay out 6% commission and another 1% in closing costs, the seller would be out of pocket $175,000 on closing day (using the example above). A seller would most likely want at least that amount paid for by the buyer so that they're not out of pocket that amount. Plus, we always suggest to our clients that they have a nice cushion too on closing day. Again, using the example above, 17% as the down payment comes out to $425,000. Subtract closing costs and the seller walks away with $250,000 on closing day.

4. Type of seller financing structure (see more under Types of Seller Financing)

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# Important Considerations With Seller Financing:

1. **Just because you agree to terms initially, doesn't mean that those will be the final terms agreed upon.** The Seller still has the right to review the buyers financials and credit worthiness before signing docs. There are specific provisions in the Colorado Dept of Real Estate ("DORA") contract to buy/sell that allow the seller to review the buyer's financials. Think about it, if the seller finds out the Buyer declared bankruptcy 3 years ago, the seller may want to drastically increase the rate and down payment from the buyer or maybe even not offer financing at all.

2. **No appraisal needed.** If the Buyer and Seller agree on a price and the Seller agrees to finance the property, 99 times out of a 100, you don't need an appraisal. Banks require one because they want to make sure the loan amount is accurate but if the buyer and seller agree on a price - why would you need a 3rd party appraisal? This saves the Buyer money, and saves both the Buyer and Seller time and frustration.

3. **As the lender, you're not the landlord!** Remember that. I like to think about it like this. If you're a Landlord and you're responsible for the pipes in the building, and the pipe starts leaking, the Tenant will ask you to fix it, right? As the lender, that's no longer your responsibility! Think about it…if you own a property and a pipe starts leaking, do you call your bank or do you call your plumber? The plumber!

4. **Make sure you own the property free and clear.** Or make sure the down payment offered by the buyer will be sufficient to pay off the existing debt and closing costs on the property.

    a. Example: You own a property that you're selling for $1M but you have a $209,000 mortgage. In almost all cases, you'll need to pay off that mortgage before you enter into a seller financing agreement. So you may require a 33% down payment which would be $330,000. That's more than enough to pay off the mortgage as well as typical closing costs 5-7% and it will leave you with a few extra dollars at closing.

b. Sometimes a bank will allow a seller to be in, what's known as, 2nd position aka junior position. This is popular with some types of SBA loans. This basically means a Seller can finance part of the deal but they have a junior lien to the bank. There is some risk associated with that and Sellers typically compensate in a number of ways eg; higher interest rate, shorter duration. Best to talk to a financial advisor.

5. **Interest rates**

   a. We're writing this in late 2023 when the WSJ Prime Rate is 8.5%. Because interest rates are relatively higher than they have been for the previous few years, many banks are having a hard time lending and some are not even lending at all. Typically when interest rates go up, property values go down. In 2021, when rates were around 3%, Sellers were seeing property sales at all-time highs as money was basically free and even at the higher price, Buyers could easily afford the monthly payment. Now when rates have almost tripled, monthly payments have gone up dramatically which lessens the affordability of a Buyer which can influence the price of commercial real estate. If you're considering seller financing, you could offer a 3% or 3.5% mortgage rate for a few years and get your desired sales price.

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6. **Buyer defaults**

   a. What if the buyer defaults on the mortgage? Well, the short answer is, the Seller can get the property back, keep all the payments they've made and any down payment. The Seller can then take the property back (preferably without a long judicial foreclosure process) and resell the property again. An attorney should specifically have experience in drafting the proper default language in the loan agreement.

# Types of Seller Financing

Seller financing offers various methods for structuring the agreement between the buyer and seller. Understanding these types can help both parties choose the most suitable option based on their needs and circumstances.

1. Land Contracts or Contracts for Deed:

- In this arrangement, the Seller retains the legal title to the property (while the Buyer holds equitable title) until the Buyer fulfills the payment terms. The Buyer occupies/owns the property while making installment payments to the Seller, often including interest.

2. Lease Options:

- A lease option allows the Buyer to lease the property with the option to buy it at a predetermined price within a specified period. A portion of the rent payments may be credited toward the purchase.

3. Wraparound Mortgages:

- This method involves the Buyer making payments to the Seller, who, in turn, continues to pay the existing mortgage on the property. The Seller essentially acts as a secondary lender.

4. Equity Sharing:

- This approach involves the Seller retaining a partial ownership interest in the property even after selling it. The Seller shares in the property's appreciation and may receive a percentage of the future sale proceeds.

5. Seller Second Mortgage:

- Here, the Seller provides a second mortgage to the buyer, supplementing the primary mortgage obtained from a traditional lender. This can help the Buyer meet a higher purchase price without a substantial down payment.

6. All-Inclusive Trust Deeds (AITDs):

- AITDs involve the seller financing the entire purchase price, taking responsibility for an existing mortgage and creating a new mortgage with the buyer for the remaining amount. *(this may not be possible with many existing mortgages)*

Each type of seller financing has its advantages and potential risks, and choosing the appropriate method depends on factors such as the buyer's financial situation, the Seller's goals, and the property's specifics.

Understanding these variations empowers both Buyers and Sellers to negotiate terms that best suit their respective needs and preferences. To understand which one is right for you, you should talk with a knowledgeable commercial real estate professional, lawyer and financial advisor.

# Risks, Challenges and How to Mitigate Them

- Potential risks associated with seller financing - it's not all rainbows and unicorns…check out some risks below of seller financing:
    - **Buyer Default:** Buyers might default on payments, leading to complications such as requiring the Seller to pursue foreclosure or legal actions.
    - **Uncertain Future Payments:** If the Buyer isn't creditworthy, a Seller could face uncertainties regarding future payments, impacting their financial planning and potential income.
    - **Interest Rate Risks**: If the agreement involves an adjustable interest rate, fluctuations in rates can affect both parties differently.
- These strategies may be able to help mitigate the risks associated with seller financing:
    - **Thorough Background Checks:** Conduct extensive background checks on the buyer, including their credit history, financial stability, and past real estate transactions to gauge their reliability.

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- **Clear and Detailed Documentation:** Draft comprehensive and legally binding agreements outlining all terms, conditions, and responsibilities of both parties. Engage legal professionals to ensure clarity and compliance with local regulations.

- **Adequate Down Payment:** Request a substantial down payment from the Buyer. This not only reduces the loan amount but also demonstrates the Buyer's commitment and financial capability.

- **Interest Rate Protection:** Consider fixed-rate financing to avoid fluctuations in interest rates, providing stability for both parties.

- **Continual Communication:** Maintain open communication throughout the agreement. Address any issues promptly, and establish a rapport that encourages the buyer to communicate financial difficulties early on.

- **Confession of Judgement:** If a buyer defaults, going through a judicial foreclosure process could take months and tens of thousands of dollars. This could eliminate that burden.

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Is seller financing right for you? The answer is a definitive “Maybe”.

No one can tell if it is or isn’t. That’s for you to decide. This guide was simply created to get the juices flowing in your mind about some creative ways to sell (or buy) a commercial property.

Should you want to speak about your specific property or have general questions, feel free to reach out to us directly.

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