<u>2013 – The Year in Review: Colorado and New Jersey Tax Lien Sale Results and Projections (Part II)</u>

<u>By: Frank Natale, CEO, VADAR Systems, Inc.</u>

Greetings tax lien colleagues! This is the second installment (New Jersey) which follows from Part I (Colorado) last month. Just to recap: at the end of February 2014 I gave a presentation on tax lien sale results at the annual NTLA conference in Miami. We specifically looked at results and projections for 2013 lien sales in both Colorado and New Jersey. I strongly believe that there are some items of interest here for everyone. Whether you are a seasoned “tax lien veteran” or a “tax lien newbie”, this type of industry information can offer value to you.

<u>Colorado Conclusions Summary</u>

As we reviewed last time, we found the following conclusions for Colorado tax lien sales in 2013: Given the impact that the “non-recoverable premiums” have on the portfolios, it is easy to see that “quick pay redemptions” for Colorado produce lower yields and IRR’s while “slower pay redemptions” produce better yields and IRR’s. This makes sense as the accruing interest needs time to “win back” the sunk cost of the premiums required to purchase the liens in the first place. From a pure, dynamic cash flow perspective, we are looking at projected IRR yields probably approaching 5% for both of our Colorado portfolios over time.

<u>New Jersey</u>

This month we will take a look at New Jersey sales results. As you will see, New Jersey is a very different type of lien state with a much different sales process and different portfolio variables than Colorado.

<u>The sale process</u>

Before we dive into some of the numbers and sales results, I think it makes sense to first review the sale process that is specific to New Jersey:

1. New Jersey is an “interest rate bid-down state” where lien sales are performed at the municipal (town) level. Bidders begin bidding at an 18% rate and the lowest interest rate bid wins the lien. This “winning bid interest rate” becomes the annual rate that the lien then accrues interest at for the life of the lien. Please note that tax lien interest is always “simple” interest and not compounding interest.

2. New Jersey, like Colorado, is also an “overbid state” – there are “premiums” that are often paid over and above the face value of the lien itself. Just as in Colorado, these premiums do <u>not</u> accrue interest. However, unlike Colorado, in New Jersey these premiums ARE recoverable. In New Jersey, You DO RECEIVE your premiums back upon redemption of the lien.

3. New Jersey, unlike Colorado, is also a “penalty state.” Upon redemption of the lien, the delinquent taxpayer must also pay a one-time penalty which is a percentage of the face value lien amount. These penalty percentages are pro-rated based upon the original amount of the lien (principal only). The following rules are used to calculate New Jersey penalties: Less than $200 lien amount, no penalty; between $200 and $4,999 lien amount, a 2% penalty; between $5,000 and $9,999 lien amount, a 4% penalty; $10,000 or greater lien amount results in a 6% penalty.

4. There are also two other “nuances” in New Jersey which I would like to mention here. Some towns (but not all towns) will also submit an extra $12 fee back to the purchaser. The buyer of the lien did NOT pay for this $12 fee when the lien was originally purchased. However, some of the towns do collect this $12 fee from the taxpayer at the time of redemption. Many New Jersey investors view this miscellaneous $12 fee almost like a “mini-penalty” which can affect rates of return (depending upon volume). Also important is the fact that all subsequent years’ delinquent taxes (additional lien years belonging to the same parcel) automatically accrue interest at 18% per annum - NOT at the winning bid rate. Furthermore, an investor who owns a tax lien has a “right of first refusal” to purchase the subsequent years’ delinquent taxes on that original tax lien. Put another way – an investor who purchased the original lien at 0% (no interest), does have the ability to buy all of the subsequent years delinquent taxes which will then accrue at 18%. Please note that these last two items – the $12 fee and 18% subsequents – are not included in my analysis as no data for these two “swing variables” was available.

<u>NJ Sale Results</u>

We looked at the combined, summary results for five towns: Bergenfield, Berlin, Clinton, Downe & Frankford.

A combined total of 229 sold liens for these five towns was analyzed. The total lien pool was $667,632. However, in addition, the buyers of these liens had to pay a whopping premium of $1,426,500 (or 213.66%!) to acquire these liens. The total purchase price (cash paid) was therefore $2,094,132 or 313.66% of the lien pool itself.

Further, it is very interesting to note that more than 54% of the total lien pool (in dollars) was bid down to 0% interest! The buyers purchased approximately $362,189 of liens at 0% interest. <u>All</u> of the premiums paid ($1,426,500) were paid against these 0% liens. Of these 0% liens $294,000+ (44%) were residential tax liens and $68,000+ (10%) were commercial. Only $55,496 (8.31%) of the liens were purchased at the original 18% interest rate.

<u>New Jersey Projections</u>

Now that we know the sale results the question becomes: “What does this really tell us?” Put into other words – how would we expect this portfolio to perform given these known parameters?

One very simple way to look at it would be to assume that everything (all liens) redeemed after only one year. We know that this is not how typical lien portfolios “behave”, but we need to start somewhere to get an idea of what type of yields or returns we might expect. Assuming full redemption after only one year, and taking into account the different bid interest rates and penalty calculations, we would receive $48,914 in penalties and interest. This equates to a 2.34% yield on the entire purchase price (lien amounts and premiums). Although the premium amounts are returned to us upon redemption (and are not “lost money”), we are focused here solely on what our entire investment (purchase price including premiums) was able to yield in penalties and interest.

Pushing out our redemption parameters to allow for a two (2) year redemption period, we would receive $68,796 in penalties and interest. This equates to an even lower investment yield of 1.64% (annualized) on the entire purchase price.

New Jersey Conclusions:

Unlike Colorado where faster paying portfolios hurt yields and performance, “quick pays” in New Jersey actually lead to better returns. The very low interest rates of the New Jersey portfolio (where 54% of the dollars are at 0% interest) are offset by the one-time penalties. In New Jersey quicker redemptions equate to higher yields and better returns. Slower redemption patterns in New Jersey decrease the return offsets of the one-time, flat rate penalties. This makes perfect sense since we would receive the same penalty amount regardless of when the lien redeems. The penalties do not help us out as much over longer periods of time with liens which are accruing at such low (or no) interest rates. In short, we find that we have the **opposite** conclusions for our New Jersey portfolio than we had for the Colorado portfolio.

Portfolio Performance Variables

In summary, we have found the following elements to be absolutely critical in determining the performance of different state portfolios:

State-specific processes and rules including: 1. Fixed vs. variable interest rates 2. Premiums vs. no premiums 3. Recoverable premiums vs. non-recoverable premiums 4. Penalties vs. no penalties.

Finally, we must also be very aware of two other very important considerations: 1. Our “Portfolio Complexion” – what we buy at what rate and at what purchase price (premium) and 2. Redemption Patterns – redemption speed and timing. Different state portfolios can and will “behave” in very different ways depending upon all of these dynamic, state-specific variables.

Best of luck to you all and Happy Investing!

About the author: Frank Natale is CEO & Chairman of VADAR Systems, Inc., a national provider of software and consulting services for tax lien portfolios. Mr. Natale and his company have assisted clients for the last 18 years in managing and collecting more than $1 Billion dollars in tax liens across 18 states. Feel free to contact him at frank-natale@vadarsystems.com to learn more about how VADAR can help you!