

The Risks of Leveraging Home Equity

By Nancy Trejos

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Rebecca Malik started an online contemporary furniture store in June, and already she is thinking of expanding it.

"We've been trying to ramp it up and get it going," she said.

Among the changes she is considering: beefing up the marketing budget and the inventory.

But she is wondering how to go about financing it. She and her husband, Raj, an in-house counsel for an information technology company, think that taking a home equity line of credit against their Dupont Circle two-bedroom condo could be a good option.

The couple, who are in their early 30s, bought their condo eight years ago for about \$330,000. Last year, the city assessed it at \$522,000.

But Malik is wondering: In this economy is it a good idea to take equity out of their home? If not, what are their other options? Would applying for a small-business loan be a better route? How difficult are those to get?

First of all, said Mark Avallone, president of Potomac Wealth Advisors in Rockville, Malik should go back to her business plan. "Before leveraging against a residence, we suggest thoroughly vetting the business plan and the outlook for success," he said.

Even so, Avallone and one other expert I contacted were leery of using a home equity line of credit to finance a business venture.

"Borrowing against home equity is risky because a residence is a special place and to put it at risk for a yet unproven business venture could lead to a difficult personal situation," Avallone said. "Even before this credit crunch we urged clients not to over-leverage their home."

Fred Glave, district director for metro Washington at DC Score, a nonprofit counseling service for small-business owners, agreed. "In these uncertain times, one can never tell what the future financial situation will be. Despite the sizable amount of equity in this case, the size of the loan could leave very little headroom, and if the real estate markets were to deteriorate any significant further amount, the borrower could be underwater with two loans on the house."

Avallone and Glave said Malik should consider a bank loan instead. But that still might not keep the house from coming into play. Banks will require some collateral, which in many cases could be the same home that the borrower was trying to avoid risking with a home equity line of credit. They will also require a personal guarantee, which could put the home in the pot of assets backing up the guarantee, depending upon the net worth of the borrower, Glave said.

The other drawback is that bank loans take more time to get, while home equity lines of credit are often granted quickly. "The Maliks need to also consider the time and cost of the bank process versus the relatively fast and easy accessing of home equity," Avallone said. "It is a tradeoff, but one that should be considered against the respective risks and merits."

Even in today's climate, however, banks will offer unsecured loans to people with strong net worth as long as they're borrowing a modest amount, something in the \$25,000 to \$50,000 range, Glave said. For business owners who cannot get funding through regular channels, the Small Business Administration has a microloan program that can provide up to \$35,000 without collateral through nonprofit intermediary institutions, he said.

If inventory is what she is looking to beef up, Avallone said there is one other option. "She may want to contact her vendors, who may allow her to finance from them directly," he said. "This could be a good time to ask for good terms from suppliers."

Contributor's Bio

Mark Avallone is the author of *Countdown To Financial Freedom*, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the *Wall Street Journal* as well as in *Forbes* where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in *USA Today*, *U.S. News & World Report*, *The Washington Post*, and other leading publications. Securities and advisory services offered through Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser. Fixed insurance products and services offered through Potomac Wealth Advisors, LLC or CES Insurance Agency. 15245 Shady Grove Rd, Suite 410, Rockville, MD 20850. (301) 279-2221

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