Letters to Mycroft #50:
Apartments: The New Paradigm
by Klarise Yahya

To My Dear Nephew Mycroft,

Your aging Uncle Gustov came to visit last night, bringing his latest inamorata, Heather. How Gustov loves the internet! After dinner, while we were still at the table, I asked him what he thought was going to happen in the apartment market. Heather was doing her toenails.

Gustov has seen it all, and some of it twice. He'd already made a lot of money back in the days when people, in a triumph of hope over expectation, still thought Jimmy Carter had promise. By the time President Reagan took his proper seat, Gustov was already rich. Since the early 1980's, with interest rates in a long term downtrend, Gustov's wealth has multiplied many fold.

Gustov never ate desert, but he was fond of finishing his meals with an adult beverage. I got a fresh coffee mug out of the cabinet and put a handful of ice cubes in it. Then I filled the balance of the mug with Jack Daniels. I nibbled on some fruit while Gustov sipped his refreshment. Heather pretended not to notice that he was staring at her.

We've been through this before", Gustov said. "You've got to look at apartment buildings as though they were fixed income investments. You know, like bonds.

"If interest rates are 15% and you buy a perpetual bond yielding $15,000 a year in interest, then the bond obviously cost you $100,000 ($15,000 divided by .10). Several years later, you notice that interest rates have dropped to 5%. How much is your bond worth? Well, $15,000 divided by .05 is $300,000. The value of your bond has tripled through no effort of yours." That is basically what has happened to income property since the early 1980's, when mortgage rates were north of 15%. With no real effort on your part, the value of your apartment buildings has exploded simply because interest rates dropped, over the last 25 years, to below 5%. The value of apartment buildings would have tripled even if the net income stayed the same.

"But of course, it hasn't. Expenses have gone up, but rents have gone up more. Net income has probably doubled every ten years. That's a fivefold increase in net income in the last 25 years.

"Now, assume the annual interest on your perpetual bond increased to $75,000 during the period that interest rates dropped to 5%. You may have paid $100,000 for the bond back in the early 1980's, but what is it worth now?"

Talking was thirsty work, and Gustov swallowed the last of his cup. I quickly refilled it. The only time he really talked much was when he was properly lubricated. Heather had finished one foot and was sitting back, admiring her work.

"It's worth $1,500,000 ($75,000 divided by .05)" Gustov announced. "Your $100,000 investment twenty five years ago has multiplied 15 fold simply because (a) its stream of income increased while (b) the yield required by the marketplace trended down. Those were good years." He took an appreciative sip. "Even idiots made money".

"But now it looks like interest rates will be trending up for many years. Apartments are still the best investment available, but the money will no longer be made on the Bigger Fool Theory *('I may be a fool for paying this much for that building, but there's a bigger fool who will buy it from me!')*

"It looks to me like the values of apartment buildings (5 units and up) will soften for a while before they stabilize at a lower cost per unit. Then they may very well go sideways for many years. Their increasing net incomes will hopefully offset rising interest rates, resulting in almost zero appreciation.

"This sort of thing has happened before, and people still made good money. When rising interest rates suck all the appreciation out of the market, there will still be (a) cash flow and (b) equity buildup as reasons to continue investing in apartment buildings.

"Most people will consider the cash flow from their apartment building as spendable income. They will make their mortgage payments, and ten or fifteen years later find that the equity buildup from mortgage reduction just about offsets their costs of sale.

"But that's not the way to do it. Back when this happened before, and I was just getting into apartments, I kept my day job and tried to pay off that little eight unit building I had. I couldn't afford to take money from my salary and apply it towards the apartment mortgage. All I could do was to use every penny of my net cash flow to make principal reduction payments on the loan. It took twelve years to pay it off.

"I've since done the math on several buildings. If you take normal rent and expense increases, you can pay off an average building in about twelve years". Gustov looked at me, and I guess he saw my doubt. "If you don't believe me", he said, "get a calculator and work it out yourself".

"So anyway, now I had this free-and-clear eight unit, but no cash. And I wanted to buy more buildings. So I took out the biggest mortgage on the building I could and used the cash to buy more apartments."

"I used that strategy for many years: let the tenants pay off the mortgage, then re-fi and buy a bigger building.

"I never sold. Just refinanced and bought more. Pretty quickly I realized that I didn't have to wait until a building was paid off to re-fi. I still used all the cash flow to pay off the loans, but I began to refinance whenever I had enough equity to generate the cash-out I needed for the next building.

"Over time I wound up with a lot of units. I found that if I was frugal, I could live off the income and still pay down the mortgages pretty quickly" He looked at Heather, who was just finishing her last foot. "So maybe I'll be able to do something nice for the people around me when I die". Heather showed she was listening by sticking out her chest.

"Now we're in a time of rising long term rates. There will be a ton of money to be made in apartments, but it will not be through skyrocketing appreciation. It will be through using the net cash flow to pay down the mortgage. When the time is right, you will still refinance to pull out sufficient cash to buy your next building. That part will never change. You will always use your current building to buy your next".

Gustov put his empty cup down and turned to Heather, "Let's go home now".

Colloco, Ergo Sum

Aunt Klarise