

Letters to Mycroft #52: Timing Your Refinance by Klarise Yahya

To My Dear Nephew Mycroft,

Dromedary sipped her tea while Mitochondria tried to explain how she timed her refinances.

"I always like to borrow money as cheaply as I can", she said. "But even cheap money isn't enough incentive to refinance if the building isn't ready for it."

Mitochondria waited for Dromedary to ask the obvious question. "So how do you know when your building is ready?"

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"My personal guideline is that if I refinance a building, I need to be able to buy another building at least as big as the one I refinanced. Basically, if I refinance a 12 unit it's to generate enough money to be able to buy another 12 units." Then she added, "Or more, if I can."

Dromedary was curious. "How do you know if you can do that?"

"You have to start with how much refinance money you can pull out of one of your existing buildings. The stream of income from an apartment building can service only a certain amount of debt, depending – of course – on the interest rate. The first thing to do is to find our net operating income (NOI). To do this, we add up all the rental income received over the past year and subtract all the costs incurred in operating the building. This includes property taxes, utilities, management, maintenance, miscellaneous, and insurance (T.U.M.M.I.).

"The net operating income is what you could reasonably put in your pocket if you had no loan on the building. Divide the NOI by five. One of those 'fifths' will be your cash flow after refinancing. The other four 'fifths' goes to debt service. Divide that 4/5ths by 12 so you have an estimate of your new monthly mortgage payment. Then you call a commercial mortgage broker and ask how much you can borrow if your building will support payments of such-n-such. Obviously, the lower the interest rate, the higher the mortgage."

"There are costs to refinancing. There are title, escrow, recording and notary fees, origination fees, and the required bank fees for tax service, appraisal, flood certification, wiring fees, and (possibly) an environmental report.

"My little rule-of-thumb whenever I refinance is that I want the present loan on my property to be no more than half the property's full market value. If, for example, the value of a (hypothetical) 12 unit building is \$1,800,000 then it becomes a candidate for refinancing if the present mortgage is \$900,000 or less.

"For example, at 75% LTV I can refinance my \$1,800,000 building for \$1,350,000. After subtracting the present loan of \$900,000 I can expect to net, after paying off the old loan, about \$450,000 from the refi (less friction costs). That would be approximately enough to buy another 12 units."

Dromedary asked, "Do you wait to refinance until you find a building you want?"

"Oh, no, dear!" Mitochondria exclaimed, "If the new building is desirable the seller surely won't wait for me to refinance. There will be too many competing offers. He'll almost certainly take a bid from some person who can show money in the bank! No, no, I just refi whenever my equity in any building is equal to the underlying loan. Then I park the money somewhere safe until a building I want comes on the market."

"Why don't you just sell one of your buildings to get the money to buy a new one?"

Dromedary inquired.

"If I sell, I have to worry about taxes. I have to either agonize over the time thresholds in a 1031 exchange or I have to just bite the bullet and pay capital gains taxes. But there is no tax on refi's. (A technical boor would focus on a possible mortgage-over-basis problem sometime in the

future, but I have no patience with such nitpicking.) Besides, once I have one of my buildings where I want it, why in the world would I want to sell it?"

Dromedary loved the infrequent times when she could sit with Mitochondria and ask these questions. "Where do you park your refi money?" she said.

"That's a tough one. I agonized over that issue many times, and found there really is no perfect answer. For a while I put it into stocks, but eventually found that I took a big hit if the stocks went down. Going back to our example, if I put \$450,000 in a diversified basket of good quality stocks and the market went down 10% then I would lose \$45,000. And a 10% dip in the market is not unusual.

"Normally, I don't mind dips at all. I use them to buy stock for my equity portfolio. If Pfizer (PFE) slips from \$35 a share to \$25, then I can buy *28% more shares* for the same dollars. I like that very much if I've got time to let the stock recover.

"But if you don't know when you'll need the money – if you could need it tomorrow – it doesn't do to risk your principal.

"So, where do I park my refi money? It just goes into an insured money market account where it is safe and I can get it anytime I want. I know that the interest I'm paying on the additional mortgage is more than the money market is giving me, but I'm willing to accept the small loss in exchange for the ability to perform whenever a building I like comes on the market. Besides, while I have to pay taxes on what I'm making on the money market deposit I can deduct what I'm paying for the new mortgage. So the difference isn't quite as large as it first appears."

Colloco, Ergo Sum

Aunt Klarise

Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more anywhere in the U.S.A., **Klarise Yahya** can help. **Find out how much you can borrow!** For a complimentary mortgage analysis, please call her at **(818) 500-9966**.