

## Mitochondria Learns to Invest #17

by Klarise Yahya, Apartment Loan Broker

*Continued from last month ...*

“What do you mean,” I asked, “when you say that the income can tell us what we can pay for a building? How do you do that?”

“Remember, we’re not talking about five units and above. Five units and over are considered apartment buildings, and are subject to the terms of commercial loans. I’m putting some notes together for you on buying larger apartment buildings, because one day you’ll be able to do that and you should have some guidelines even if I’m not here.”

She coughed into her handkerchief again.

“Right now we are only discussing owner-occupied two, three, or four unit buildings. If you live in the building, as we’ve noted, you can frequently buy it with little or nothing down as long as the bank thinks you’ll be able to make the payments.

“A bank will permit mortgage payments on this sort of property – *owner occupied small units* – to come from two sources. You can contribute a portion of your income towards the mortgage, and a portion of the rental income can be applied to the mortgage.

“As we’ve mentioned, the general rule is that lenders will allow up to 75% of the rental income to be applied towards the payments. That means that if a unit rents for \$1,000 a month, then \$750 of that can be applied to the mortgage payment. How do you determine how much loan that \$750 will support? The simplest way is just to call the mortgage broker you’ve decided to work with and ask her.

“But we can also create a grid that will give us a pretty good idea of whether or not a building is affordable to us. Let’s assume we’re going to apply for a 30 year loan amortized in 360 level monthly payments. We’ll make a chart – I always find that grids make things so much easier to visualize – to estimate how much we can borrow for each \$100 of rental income. (*Remember, the banks only permit \$75 of each \$100 of rental income to be applied towards mortgage payments!*)

Interest Rate	7.0%	8.0%	9.0%	10.0%
\$100 of income	\$11,272	\$10,221	\$9,321	\$8,546

“Now, going back to our rental grid for Saradama Hill, we have established that typical rents are \$1 per square foot of living area. And we’ve seen that most of the one-bedroom units are around 750 square feet and the two-bedrooms are around 900 square feet. Do you agree?”

I nodded.

“That being the case, can we conclude that one-bedrooms rent (roughly) for \$750 a month and that 75% of that is \$562? Looking at our mortgage chart, we see that if we can get an 8% loan, that \$562 will support \$57,000 of mortgage ( $\$10,221 \times 5.62$ ).

“If two-bedroom units rent for \$900 then the bank will allow \$675 to go towards mortgage payments. At 8% interest, the typical 02-bedroom unit will pay for \$69,000 of mortgage ( $\$10,221 \times 6.75$ ).

“Under these conditions, if you were to buy an owner-occupied four unit building with little or nothing down, you could pay \$57,000 for each one-bedroom unit and

\$69,000 for each two-bedroom unit *plus* whatever contribution you could make from your personal income. For the moment, however, we'll disregard your income.

"Using just the building's income, for example, assume you found several four unit buildings in Saradama Hill that you liked. You were going to live in one of the units and wished to buy with nothing down. How much could you pay for a building with all two-bedroom units? Well, clearly, you could pay four times \$69,000 or \$276,000.

"By doing your size and rental survey in the area, you know what the typical values are in Saradama Hill. If you make a chart showing how much debt a typical unit will service, as we did, you can quickly determine the maximum you can pay for any given property."

"But what if I could afford to make a down payment? How would I figure the purchase price if I could put, say, 20% down?" I asked.

"How much of the purchase price would be represented by the loan?" Mrs. Langerhorn answered. "Clearly, if you put 20% (1/5<sup>th</sup>) down then the loan would constitute 80% (4/5<sup>th</sup>) of the purchase price.

"Compute the maximum loan your respective units will debt service. If you have four 02-bedrooms renting at \$900 each and interest rates are 8%, then the grid shows that their rents will support a \$276,000 loan. That's pretty clear, isn't it?

"If we want the loan amount to be 4/5<sup>th</sup> of our purchase price, then we simply divide \$276,000 by 4 (\$69,000) and then multiply by 5 (\$345,000). We can make an offer of \$345,000 and if we put \$69,000 down, the property will still probably pay for itself."

I asked, "Why are you so rigid about getting a building that pays for itself? Most of the brokers I've talked to say that small units are almost always cash flow negative. That means that the rents won't cover the mortgage and expenses and I'll have to pay part of the mortgage every month from my paycheck."

"I try very hard not to buy a hobby ...."she started.

I interrupted, "What do you mean, *hobby*?"

"*An investment pays you. A hobby is something you have to pay for.* Like I said, I try very hard never to buy a building I have to feed. But sometimes, especially when you are just starting out and have no money for a down payment, you have to make small adjustments", Mrs. Langerhorn explained.

"If you paid all cash for a little four unit building", Mrs. Langerhorn began, "you would naturally expect that the rents would generate some money that you could put in your purse even after you paid all the expenses of ownership.

"If you paid 50% down and got a loan for the balance, you would still expect to have some positive cash flow each month. It wouldn't be as much as it would have been if you'd paid all cash, because you would have to make the mortgage payments, but it would at least be something.

"If you put the 'normal' 20% down on a small building (small units require less down payment than commercial buildings), you may expect to at least break even. Now, at full occupancy you would anticipate that the rents would cover all the building's expenses plus make the mortgage payment."

Mrs. Langerhorn paused and sipped her tea. Then she looked at me as though she was going to tell me a juicy secret. My attention peaked.

“Actually”, she said, “if you understand that the value of income properties fluctuates with interest rates – as rates go up, values trend down, and as rates go down, values trend up – you have a built-in alarm that tells you when to buy properties.

“When you can buy fourplexes in a good part of town and have them generate true cash flows with zero to 20% down for owner occupants or 25% down for absentee owners, the alarm is sounding. The market is telling you it is time to buy. A part of every interest rate cycle results in this fortunate circumstance. Oddly, it is generally when interest rates are near the top and soon will begin a downward trend.

“Now, I don’t want you to interpret what I’ve just said as a commandment to avoid rental properties until interest rates have peaked. You should purchase apartment buildings whenever you can buy them at a price that would generate a real cash flow with 20% down (for owner occupied buildings of up to 4 units) and 25% down for five units or more. Like I said, a portion of every interest rate cycle will provide these opportunities. But, overall, the higher the interest rates at time of purchase, the better for you. If interest rates continue to climb, you have purchased the building on favorable terms. It will make you feel very clever. If interest rates trend down, you can expect to eventually refinance at a lower rate and improve your cash flow. You will then have the best of all worlds: a low purchase price and low payments.

“But if you buy a two to four unit building with little or nothing down, as you often can when you intend to live in one of the units, you will reasonably expect that the higher mortgage will result in a negative cash flow. You will have to feed the building each month out of your paycheck. What you are doing, in effect, is making a deferred down payment. In other words, you’re making your down payment after you buy the building and you’re spreading your down payment out over time. When you’re just starting out, you may have to do this.”

I listened intently. She had so instilled in me the “buy a stream of income” philosophy that the idea of negative cash flow was foreign to everything I thought I had learned about investing. But when she explained that what I was really doing was making the down payment after I bought the building, and I was doing it over time, well, it became more appealing.

“How does one know how much of a negative cash flow the bank will permit?” I asked. It shocked me how I was even getting to talk like her!

“Do you recall when we discussed how the bank will allow the costs of ownership to be paid from two sources? How they will normally allow (and you know that things can change!) 75% of the property income to be applied towards the loan payment plus property taxes and insurance. But they will also permit somewhere around 28% of your salary to be applied towards paying off your loans. If you have no other debts, the entire 28% can be put towards your negative cash flow / deferred down payment.”

Mrs. Langerhorn continued, “So that means that if you want to purchase a four unit building with total monthly income of \$4,000, the bank will allow \$3,000 to be applied towards the costs of ownership. That \$3,000 at 8% interest (remember the chart we did?) will service a \$300,000 loan.

“Additionally, if you make \$4,000 from your job and you have no other debts you can apply about \$1,120 each month towards the building. That will increase your loan amount by approximately \$118,000. So the most you could pay for the building (assuming no cash down payment) would be \$418,000.”

I asked, "How long will I be paying \$1,160 a month?"

"Well, if you raise the rents every year, you will pay less and less out of your own pocket as time goes by. If you increase the rents 5% each year, then you will reach breakeven between the 6<sup>th</sup> and the 7<sup>th</sup> year. Would you like to make a little table showing how your negative cash flow might amortize?"

I said I would and reached for a piece of paper. Then she helped me develop this table:

<b>Year</b>	<b>Rents</b>	<b>5% increase</b>	<b>Mo Cash Flow</b>	<b>Yearly Total</b>
<b>01</b>	\$4,000	N/A	(\$1,160)	(\$13,920)
<b>02</b>	\$4,200	\$210	(\$960)	(\$11,520)
<b>03</b>	\$4,410	\$220	(\$740)	(\$8,880)
<b>04</b>	\$4,630	\$231	(\$509)	(\$6,108)
<b>05</b>	\$4,862	\$243	(\$266)	(\$3,192)
<b>06</b>	\$5,105	\$255	(\$11)	(\$132)
<b>07</b>	\$5,360	\$268	\$257	\$3,084

Mrs. Langerhorn looked at the finished chart then reached into her purse for the financial calculator she carried. "If you add the negative cash flows, dear, you will see that they come to \$43,752. That may seem like quite a lot, but it's spread over six years or so. And you will note that it comes to just a touch over 10% of your purchase price.

"Do you recall that allowing 28% of your paycheck to go towards the negative cash flow on the building allowed you to borrow an additional \$118,000? So you could get a loan for \$418,000? The normal 20% down payment on a \$418,000 building is \$83,600. But by deferring your down payment through negative cash flow, you only had to pay back \$43,752 from your pocket. That's about half of the normal down payment. All the rest came from rental increases from your tenants. It rather reminds me of that old saying, "Wherever you live, you are buying real estate. You are either buying it for yourself, or for your landlord." Continued next month ...

*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.*