The Advanced Teachings o f Mrs. Langerhorn: 05

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Leverage

When you control a large asset with little of your own money, it's called "financial leverage". An example would be the purchase of a $100,000 condo with 10% ($10,000) down and a loan of $90,000. Because your loans would be 90% of the purchase price, you would be 90% leveraged. Another example might be the purchase of an automobile for $35,000, paying $7,000 down and borrowing $28,000. You would be, in this case, 80% leveraged. As you can see, in a leveraged purchase, loan(s) make up the difference between the price agreed upon and your down payment.

When you borrow money for the purchase, the lender doesn't really care too much what happens afterwards to the value of that purchase. Regardless of what happens, you will still owe the remaining loan balance. In the automotive example, you probably understand that the car will lose substantial value as soon as it's put in your name. It's quite possible, even probable, that its value will drop to less than the underlying loan. In auto finance talk, you will be "upside down", but you still have to pay off the loan.

But even if the value of the car or apartment building drops after your purchase, it does not follow that you, as an investor, should be too concerned because the ***utility*** of the automobile or the apartment building remains the same. You bought the car to get to work, and – regardless of the decreased value – it still performs its function. The utility of an automobile is to get from here to there.

The utility of an apartment building is its net operating income (NOI). It's what you could put in your purse if you had no mortgage payments. As you can see, the utility (NOI) of an apartment building does not automatically change with a fluctuation in its value. Assume you paid cash for a $3,000,000 building with a NOI of $240,000 annually. It's the $240,000 per year that you should focus on, not the fact that the market might value that stream of income at $3,000,000 one year, $2,000,000 the next, and perhaps $4,000,000 the year after that. You are an investor and you bought a stream of income of $240,000 for $3,000,000, earning 8% cash flow regardless of the (future) value of the building. Why would it bother you to have the market value of your apartment building decline when it would not bother you if you spent the same money on a 30 year Treasury bond and the value of the bond went down? After all, as interest rates rise you know the value of long terms bonds will surely drop.

Leverage has no impact on NOI. It does, however, impact return on equity (ROE). Using the condo purchase as an example, leverage can work both ways. It can sting you if the market drops. Should the market decline 10%, your condo would be worth only

On the other hand, if the condo appreciates $3,000 you would have a 30% gain on your investment. ($3,000 divided by $10,000 = .30 = 30%). If the market goes up 10%, you would have a 100% gain. Note that we are ignoring costs of purchase / sale and tax consequences. This simplification permits a clearer illustration of the effects of financial leverage. (Notice that I'm emphasizing "financial" leverage because there ***are*** other kinds).

An aggressive investor would probably seek the greatest leverage possible, perhaps even 100%. Most of the time, however, it's much easier to get loans for less than 100% of the purchase price. In the mind of the bank, the investor's down payment insures the bank

against the first losses in a declining market. A 20% down payment means that the borrower has to lose all of his investment before the bank loses a nickel. If you understand that, you must also accept the fact that when a larger-than-minimum down payment is required, the bank is in effect announcing that in their institutional experience the risk is greater than if they were funding a different type of building requiring a lesser down payment. When I was a young woman, that understanding occasionally caused me to withdraw from marginal purchases. I learned to become grateful for the unwitting advice contained in a lender's loan-to-value (LTV) ratios. Sometimes, a lender will offer to make the loan at a lower down payment if the borrower agrees to a higher interest rate. Functionally, both high down payments and increased interest rates work to alert us that the lender views the prospective purchase as riskier than "normal". We will see, as we move along, that the markets are full of wonderful guidance if only we learn how to read the tea leaves.

Let's assume we purchase a small office park for $100,000. Our down payment is $10,000 and we borrow the balance from the bank. (Obviously, I'm making this up). If, at the end of the year, the value of our office park has appreciated to $110,000, we have made 100% on our investment. The park continues to appreciate at 10% a year, and after five years it's worth $160,000. We still owe $90,000, so our equity is $70,000 ($160,000 minus $90,000). Now, in the sixth year it goes up to $177,000. We made, that year, $17,000 on our equity of $70,000. That is 24% on our equity. Note that when we were leveraged 90%, our investment grew at a 100% rate that first year. But now that the investment has appreciated and our equity has grown, our return on equity (ROE) has slipped to 24%. That's because when we divide our annual appreciation by our accumulated equity, the answer ever-increasingly reduces. After 30 years the loan will be paid off and the property (remember, I'm assuming an unlikely 10% appreciation figure just for illustrative purposes) will be worth $1,750,000. There will be no loan on it, so if the office park appreciates another 10% the next year, you will only make 10% on your investment. *What you should understand is that your ROE is greatest when your leverage is greatest.* As your leverage declines, either through paying off the mortgage or property appreciation, your ROE declines as well.

All is not lost, however. If you are in the stage of your investment career where ROE is important, you have only to refinance and your ROE returns to high levels. For example, if you've paid the loan down to $50,000 and the property value of $200,000 increases 10%, you've only made a ROE of 13% that year ($20,000 divided by $150,000). Assume you refinance and your new loan is $180,000. Your equity is $20,000, and your $200,000 property goes up 10%. You're now back to making 100% ($20,000 appreciation divided by $20,000 equity).

So, is paying off the mortgage on investment property a bad thing? Well, it largely depends on where you are in your investment life cycle. Eventually, if you make more good decisions than bad ones, you will pretty much have all the money you need. (I know it may be hard to believe now, but it's true nonetheless.) At that point, more money will not improve your lifestyle. If you lose assets, however, there is no longer time to make them back. So your focus will change to wealth preservation and owning several diversified properties free and clear is a very comfortable feeling. In the interim, however, you will very likely seek the highest return on equity you can get, and that will require you to always keep your loan balance as high as you can.

Your ROE is potentially maximized when your equity is least. So what's a girl to do? Refinance your investment properties at regular intervals. Pull out as much cash as you can – perhaps you can buy another building or make wise stock investments. Minimize your equity and you maximize your ROE.

Bullets …

- **Leverage permits controlling a large asset with only a little of your own money.**
- **When things go well, leverage can maximize your ROE by refinancing to minimize the money you have in the property.**
- **If you leverage an investment that goes down in value, you can lose your entire investment.**

*Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more – it's probably happened, but not to me or anybody I know – 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.***