

The Advanced Teachings of Mrs. Langerhorn: 08
by Klarise Yahya, Commercial Loan Broker

Note to the Reader ... They are not the notes of our conversations that were earlier published under the title "Mitochondria Learns to Invest". These are the papers Mrs. Langerhorn left me after she passed away. They are her advanced teachings and they, naturally, overlap and reinforce her earlier principles. I hope you gain as much from her advanced teachings as I did.

Commodity Buildings

Commodities are items that are functionally indistinguishable from each other. Examples might be sheets of 8 ½ x 11 white typewriter paper, or comparably equipped Ford Explorers, or even low end apartment buildings, wherein the individual units have the same utility as all the other individual units in the area. Everything else being equal, where do you buy typewriter paper? From the cheapest source. Where do you buy your car? From the cheapest source. Why would a blue collar worker rent an apartment from you rather than the fellow down the street? That's right. Your rent is cheaper. The distinguishing feature of a commodity building is that it competes only on price. Transactions are driven by the seller's race to the price bottom. Remembering that value is a function of net income, do you really want to be in the business of competing with other owners to minimize your income? Is that the sort of investment you want to be in?

As a matter of fact, yes, it sometimes is. It is important in the purchase of commodities (whether paper, automobiles, or buildings) to recognize that you make your profit at time of purchase, not when you sell.

That's counterintuitive, I understand. Most of the time you can buy a stock or a building at full market price and as the income goes up over time you can expect your investment to appreciate. Commodity buildings are different. Because they rent only on price, there is great incentive for the owner to keep rents low and the building occupied. That limits upside potential, and, for us, generates our profit point.

You see, the owner of a commodity building eventually recognizes that he made a mistake. Actually, his wife normally sees it first. She'll mention that he's putting all his free time into maintaining the building but they're not getting any more cash flow than they got the first year they owned it. And its value hasn't gone up like they hoped. The investment, in her mind, has gone nowhere. She pressures him to sell, but upon reflection they both realize that they would minimize their losses by doing the least possible maintenance – let the new owner deal with it – until the sale. They list the building at a hopeful price and wait. And wait. And wait, as the building continues to decline. They re-list at a lesser price with another broker and wait some more. Eventually, and nobody knows exactly when, they become "don't wanters". The property is still listed, but they don't go there except to collect rent. The place looks badly, even compared with its neighbors. They know it does, but they don't have the reserves to return it to even average condition and, at this point, they just want out. This is when we make our money.

The market doesn't announce who became a "don't wanter" last night. You can't even tell by driving areas looking for fixer buildings. So you just have to make a lot of offers, confident that if you bid on enough properties you will find someone that will agree to your price and terms.

Isn't it true that you're buying a stream of income, and if the income is the same then a fixer is worth as much as a building in average condition? Well, no. Fixers are not worth as much as buildings in average condition even if the scheduled net income is exactly the same because – disregarding the obvious fact that eventually the deferred maintenance will have to be resolved – you don't get the same class of tenant. It's a "quality of income" issue. Commodity buildings in average condition can expect to draw average tenants. Commodity buildings in low condition attract marginal personalities who may initially agree to pay full rent, but (a) every month it's increasingly difficult to claw it from their pockets, and (b) they are commonly very rough on the building. The "don't wanter" is happy to fill his units with this sort of human debris in the short sighted hope that he will be able to maximize his income between now and the sale. That being said, how can we structure the purchase so we can have at least moderate confidence that a profit might be available?

First, you'll need to drive various neighborhoods and note the really run down apartment buildings. When you see one, stop the car. Get out and walk around the building. Look at the deferred maintenance. One of the fat, hairy men sitting on the bumper of an engine-less car might briefly interrupt his stare-down long enough to ask you what you think you're doing. Tell him the truth. Tell him that the owner called your boss and asked about renovating the units, but then your boss lost the note. You are there to see what needs to be done in case the owner ever calls back. If you handle this with even a little delicacy, the tenant may very well show you his unit and announce in intimate detail everything wrong with his home and explain how he is unused to being required to live like this. It offends – *offends!* – his sensibilities. You observe that it is certainly unfair, but remind him that you don't have any way to contact the owner. At this point, you will have the data to estimate exterior repairs and individual unit repairs (its probably reasonable to assume that all units are similar to your host's). You will also be told the owner's name and contact number.

You will probably wish to continue driving the area looking for additional fixers where you will apply the same approach. You might even see a brokerage "For Sale" sign. If you do, you will have an agent who can give you some details on recent sales in the area.

Hypothetically, assume that the area is full of 10 unit apartment buildings of similar appeal. All units are two bedroom, one and a half bath. Comparable buildings have recently sold for \$100,000 per unit. (I'm just making all this up). Well, now you know the maximum you will be able to get *after renovating* any units you may buy in that area.

You realize that your miscellaneous *purchase* costs will probably be about 2%, your miscellaneous *costs of sale* another 2%, and you will probably be paying 6% brokerage commission. Right away, ten percent comes off the top. Your \$100,000 has been reduced to \$90,000 (Yes, I know the 2% purchase costs will be off a lower figure, but we would all very much appreciate it if you would stop nit picking.). You compute a

per-unit cost for exterior renovation – say, \$5,000 – and add it to your estimate of interior costs – say, another \$7,000 per unit – and now you’re down to \$78,000 a unit. Additionally, you will have costs for eviction and loss of rent, say \$4,000 per unit. You are now down to \$74,000 per unit and you haven’t even adjusted for your profit.

I am not greedy. I generally figured that if I could make twice my costs, it is profit enough. So if we’re looking at \$16,000 costs (\$90,000 minus \$74,000), then I would typically make an offer of \$58,000 per unit (\$74,000 minus \$16,000 potential profit). Did I get every one I wrote an offer on? Of course not. When it did happen, it was almost always purchased from somebody who bought the property years ago. He would at least get his money back at my offer price. Some years I got maybe 1 or 2 buildings, and I made many, many offers. Some years, I got none. But the important thing to remember is that the commodity nature of the building means that I won’t be able to sell the property for more than the local market, currently \$100,000 per unit. With our upside capped, we need to carve our profit out of the purchase price.

And as soon as the building is renovated and filled with the best tenants we can get, it’s probably time to sell it. Commodity buildings are sources of capital gains, not cash flow.

Bullets ...

- **Commodity buildings compete only on price**
- **When you buy commodity buildings, you must make your profit at purchase.**
- **Sell commodity buildings when they are freshly renovated and most appealing.**

*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.*