

The Advanced Teachings of Mrs. Langerhorn: 10

By Klarise Yahya, Commercial Loan Broker

Note to the Reader ... These 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. These are her advanced teachings. They overlap and reinforce her earlier principles. I hope you gain as much from them as I did. If desired, earlier articles are available on-line

Listen For the Bells

As we've discussed, at one level it really doesn't matter what you pay for an investment. Whatever the price, it will be more than any other person is willing to pay for that item at that time and under those terms. That's just how the market works. After all, if someone else bids more, why would the seller agree to your offer? He would only be damaging his own self-interest. We might, of course, pay too much. But as long as we limit our purchases to income producing properties we can expect the market will bail us out over time as net cash flows (and values) increase.

Everything in the above paragraph is true, but I've never found much pleasure in it.

I much prefer buying at favorable points in the market cycle, and I hope, as you grow beyond fourplexes and index funds, that you will share some of my enthusiasm.

The first thing to understand is that the market is sometimes irrational, and we are free to exploit the aberration. There is a famous story about two men who were business partners, Mr. Investor and Mr. Market. Mr. Market was bi-polar. His mood fluctuated between absurd optimism and bottomless depression.

Every morning he would enter the store and offer to buy his partner's share of the business or to sell him his share at some mood induced price. He would state a certain price and a moment later either increase it or lower it or even pretend total disinterest in either buying or selling. At any time Mr. Investor, the calm partner, was free to accept or reject Mr. Market's then-current offer. Mr. Market's price quotes obviously bear little relationship to rational opinions of worth.

The point of this story is that the market is a continuous source of price quotes and sometimes (often?) the quotes don't reflect the true value of the investment. The prudent investor makes his or her own decisions based on their independent judgment of the worth of the investment.

So what makes an investment worthy? Obviously, it's the generated stream of income and its' expected rate of growth.

My initial approach when I screen for apartments or office parks is to recognize that market rents reflect the nexus of all the data available at that point of time. Now, understand that we're talking about market rents here, not necessarily the (non-rent controlled) rents reported by the seller. If your analysis of the area reveals that independently metered two-bedroom units between 800 and 900 sqft rent for an average of \$1.50 per square foot, then all further analysis should be predicated on this rate.

The gross rents, after netting out a reasonable vacancy allowance, fixed and variable expenses, and an appropriate figure for necessary reserves reduces to a figure called the net operating income (NOI). Basically, the NOI is the money you could put in your purse at the end of the year after paying all the costs of ownership if you had no mortgage. Now, the banks won't normally permit all the NOI to be consumed by the loan payment. They want you to have a continuing financial commitment to the property. In their mind, you need to have a monthly cash flow just to maintain your interest. So the banks divide the NOI by some figure, often 1.20, to determine the maximum permitted loan payment. For example, if the monthly net operating income on a hypothetical 10 unit building was \$6,000 then the maximum loan payment at a 1.20 debt coverage ratio (DCR) would be \$5,000 (\$6,000 divided by 1.20). That would mean you would have \$1,000 positive cash flow each month, of course, but it would also mean that since the maximum loan payment is capped at \$5,000, any higher interest rate would (obviously) result in a lower loan amount.

Ok, so what does this mean in real life? It means that ...

- Five-sixths of the net income determines the maximum loan payment the property will support
- One-sixth of the net operating income will be your before tax cash flow
- A higher interest rate results in a lower loan amount, and a lower interest rate results in a higher loan amount

When property values are high – notice I didn't say “overpriced” – the above guidelines result in a very low yield on your down payment. For example, if a property is available at \$2,000,000 but the maximum loan the property will support is only \$1,200,000, then the required down payment will be \$800,000. The one-sixth of NOI that constitutes your cash flow may reflect only a 2% return on your down payment. That may be acceptable if values are skyrocketing and you really believe you will be able to sell the property in a year for \$3,000,000, but it smells very much like rank speculation.

How does all this bear on Listening for Bells? Well, income properties have a built in alarm that sounds when the market says it's time to buy. Assuming well located multi-unit properties in good cosmetic and structural condition, whenever you can buy with 25% down to a fifteen year fixed rate mortgage, and a positive cash flow equal to the 10 year Treasury bill, the Buy alarms are sounding.

This fortunate circumstance happens several times during a person's investing career and should be capitalized upon whenever noticed. Please visualize, in your mind, a sinusoidal graph (you know, the kind that has a succession of waves or curves oscillating above and below an up sloping baseline). The waves won't be equally balanced between that part above the baseline and that part below. The waves will, for the most part, hover above the baseline with only an occasional dip below. Well, such a graph would probably reflect income property values in an active market. You know that part above the baseline? *We don't buy there.* We wait for the dips. When decent properties first become available under the terms noted above, the values are slipping below the baseline. Begin to buy. After a while, often within only a couple of years, values will begin to rise so that

similar properties can no longer be purchased with 25% down. Oh-oh. The “value curve” is crossing the baseline again, but this time it’s going up. Stop buying.

During this brief period you will have purchased at least one and perhaps several architecturally attractive multi-unit buildings in good cosmetic and structural condition located in desirable areas. During the often lengthy period when the value-curve is above the baseline, enjoy your ever-increasing cash flows as the tenants pay off the building over a short fifteen years. Life is good.

Bullets ... several times during an investor’s career the market will permit the purchase of well located, structurally and cosmetically sound multiunit properties with:

- 75% fixed rate 15 year mortgages
- Positive cash flow of 5% (or greater) on your down payment
- During these brief periods it is appropriate to be very greedy.

*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.*