

The Advanced Teachings of Mrs. Langerhorn: 22
Land Driven? Pay More. Construction Driven? Pay Less
by Klarise Yahya, Commercial Loan Broker

Note to the Reader ... These are not the notes of our conversations that were published earlier 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 as such they overlap and reinforce her earlier principles. I hope you gain from them as much as I did. The earlier lessons are incorporated in the book "Stairway to Wealth" available at LuLu.com.

Dear Mitochondria,

Last month we talked about how good locations were places where property prices were driven by land costs, do you remember? And then we discussed how inferior locations were driven by construction costs. Now that that's out of the way, the obvious remaining issue is how much to pay.

So how much do you pay? "As little as possible" is not the answer we're looking for. As you know, there's a cycle in real estate prices. In areas of "construction costs" the relative stability of land costs tends to flatline the real estate cycle. In these areas, you build in your profit when you buy the property. Think "commodity" buildings. I'm guessing that probably the best one can do when purchasing a medium or large apartment building in an area where values are driven by construction costs is 25% down, a 1.25 or higher debt coverage ratio, and a 15 year fixed rate loan. This is one way a prospective "Texas" (or any other commodity / construction cost) property could work out:

Purchase price:\$800,000
Down payment:\$200,000
15 year fixed loan:\$600,000
Loan payments @ 7%:\$64,716
Annual cash flow:\$16,178
Return on down pmt:08%

With flat values, at the end of year 15 you will have paid off the mortgage and turned your \$200,000 into \$800,000. Everything else being the same, your cash flow will jump to about \$81,000 annually (\$16,178 plus \$64,716).

That's not bad. You're getting an immediate \$16,000 a year in cash flow and when the mortgage is paid off you get a big raise. And this assumes you never increase your rents (and, of course, that expenses similarly never go up).

Ok, when you get back to Laguna Beach you see another property. The numbers are exactly the same, but the appraiser you hired shows you that values have increased an average of 10% a year since the beginning of time. If this continues, by the time you pay

off your 15 year mortgage, increasing land values should force the value of this building up to \$3,341,798. In this case, you've turned \$200,000 into \$3,300,000. This may be a little better deal, huh?

The problem is that there'll be a lot of competition to buy that Laguna Beach property. There's almost always more competition for "franchise" properties, so you probably won't be able to buy it for the very favorable price and terms we hypothesized for the commodity building. So, how much can you pay?

Money is liquid. It flows between countries, between states, between individuals, between investments. The return offered by a "riskless" investment (Treasury obligations; insured Certificates of Deposits, etc.) establishes the return for a risky investment after adjusting for perceived risk. Simply put, if you can get a guaranteed 5% return in a C.D., what yield should you require before you invest in something where there's a 50% possibility of loss? Clearly, you'll need at least a 10% return. After adjusting for risk, your expected gain is exactly the same as in the "riskless" investment. In this manner, the yield offered by a "riskless" investment establishes the minimum yield for a "risky" investment.

Going back to our hypothetical \$800,000 building, we've forecast that at 25% down you can expect an 8% yield on your down payment. Now, in the short term the maximum loan the building will support doesn't change. But if you were willing to accept less than an 8% return you could afford to make more of a down payment. The higher down payment means that you could possibly pay more and perhaps acquire that very desirable piece of appreciating real estate.

The bank will almost never fund a five or more unit income property loan if the borrower will be putting less than 25% down, so this is just a hypothetical example. What if you were willing to accept a 4% return on your down payment? Then you could double your down payment to \$400,000 and that brings the purchase price to \$1,000,000. If you accepted a 2% yield on your down payment, you could put \$800,000 down and, with the \$600,000 mortgage, pay \$1,400,000 for the property that projects to be worth over \$3,000,000 in fifteen years.

It's important that we both understand how varying our down payment (the maximum bank loan remains the same) affects purchase price.

Now, what would be the maximum down payment (i.e., lowest yield on your down payment) it would make sense for you to make? This is where that discussion relative to "riskless" and "risky" investments comes in. Income properties are generally considered a materially riskless investment. If riskless C.D.'s are paying 1.78% per year, then you could capitalize the expected cash flow at 0.0178 (\$16,178 divided by 0.0178) and find that the most you can reasonably pay for that building in Laguna Beach is a little over \$1,500,000 (the \$600,000 bank loan plus about \$900,000 down payment). If C.D.'s were

paying 6%, than the most you could offer would be (\$16,178 divided by 0.06) \$270,000 down payment plus the new mortgage.

Refer back to the \$1,500,000 example. If you paid that much, does it mean that you could expect the building to be worth over \$6,000,000 (\$1.5 million compounded at 10%) in 15 years? Only if, when you expected to sell the building, “riskless” rates were the same as they were when you made the purchase. In this manner, ownership of franchise income properties is fundamentally a land bank play on future interest rates. That’s not a game most of us are willing to play; consequently, income property investors normally avoid these complications by working around them:

(01) Commodity buildings are bought, renovated, and resold quickly enough that we’re working in an essentially unchanged interest rate environment. I can’t remember more than a handful of commodity buildings that took more than a year to turn.

(02) Our franchise buildings were purchased with the intent to pay them off and then hold forever. If you never intend to sell, future interest rate environments are of little interest.

*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**.*