

**The Advanced Teachings of Mrs. Langerhorn: 17**

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***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***

First Assets, Then Wealth

Inspection day arrived. Mrs. Mehatabel told us well beforehand that she wouldn't be there, but she promised to give keys to all the units to Ben. He was the fellow who helped look after her, remember?

I guess we were pretty excited, because we got there early and parked under an Elm tree to wait and watch for Ben. My husband can sit for hours and not say a word. He said it was because he learned, as a boy, not to scare the fish. I can't be silent for even ten minutes and I've never given the fish a second thought.

I opened the conversation by asking what he thought about my new shoes. I bought them at PayLess for \$11, and they went really well with my sea-shell beige dress. Well, he was still into not scaring the fish, so I turned the discussion towards what we hoped to gain from buying properties. We were not talking about any specific property, we were talking “concept”. Remember, we'd bought our first six units just as the market plunged. Then we had to deal with owing more than the building was worth until, somehow, the market recovered. Eventually we refinanced and pulled out enough money to make the down payment, we hoped, for Mrs. Mehatabel's units. So it was probably appropriate that we started to think about exactly what we expected to gain from owning rental properties. We'd talked around this issue before, but we never really had a meaningful discussion. I began by pointing out what a pain in the neck tenants were, how we were chained to the units, and how it would be so nice to finally get enough units that we could afford a professional manager.

My husband agreed with everything, and then added, “All that's true enough, but it still doesn't explain what we expect to gain from having units. Remember Cinnamon Roll and Peach Danish? Those real estate guys who come to the bakery every morning and solve the world's problems over their pastries? Well, they've been around the block a time or two, and I've heard them discuss this same issue.” He shifted his position. He had long legs and sometimes got cramped. “Cinnamon Roll is the older one, and he says that – and

I'm going to use his words here – the value of any income property is at the nexus of income and interest rates. The first element, as I said, is net rental income. As your rents go up (everything else being the same), the value of your building goes up, too. So it's best to buy where they're not going to build any competing properties”

I couldn't think of anyplace like that, and I told him so.

He continued, “Remember that place we read about that was running out of water, so they put a moratorium on building? That would probably be one example. Others might be water front properties, or within a particularly excellent school district. Probably the worst place to buy would be outside some Texas prairie town where land is cheap and whenever rents climb a little somebody builds another apartment building and then rents stop going up.”

This was turning into a lecture, not a conversation. So I went back to admiring my shoes. I probably should have bought the red ones, too. He didn't even notice my silence. He probably thought I was thinking about the fish.

“The other reason properties appreciate is a decline in interest rates. Peach Danish brought this one up.” My husband took his calculator out of the glove compartment. “Let's say that an apartment building is fully rented and, after all expenses, nets (before any mortgage payments) \$12,000 a month. The banks only allow a portion of the net income (the NOI) to be used for debt service; normally it's 5/6<sup>th</sup>. So in this case, it would be \$10,000. At 5% interest, that amount would service a loan of \$1,862,000. But if rates were at 7%, the maximum loan would be \$1,503,000. And at 10%, the biggest loan the building would support would be \$1,139,500. So the higher the interest rate, the less loan the building will support and that affects the building's overall value.

“The opposite works, too, I would expect. As interest rates go down, the value of the building's stream of income goes up. That was what we did wrong with our first building. We bought almost exactly at the low point in the interest rate cycle, then, as rates recovered, the value of our property dropped faster than could be offset by increasing our rents.”

He paused and looked out the car window, probably to see if there were any fish left. I was surprised at what he was saying, because I never had a clue he'd been thinking so much about this. He'd never said anything to me before. Anyway, after a moment, he returned to the discussion.

“Sometimes the bells ring, and when you can buy non-rent controlled apartments in areas with little or no likelihood of competitive building for 25% down to a new loan, the bells are ringing. If you're going to buy an apartment building, that's the time to do it.”

He had my interest. We bought our first units at the low point of the interest rate cycle and paid too much, just like I've said. But, although there were some ups and downs, the

longer we held the units the better it seemed to be turning out. Now he was saying that there was more to it just buying blindly. I asked, “What if the building costs more than that? What if we had to put more than 25% down?”

“Well, assuming the rents are at market, the bells aren’t ringing quite as loudly. At some point, they stop ringing entirely. I heard Peach Danish say that sometimes sellers want so much for their properties that it doesn’t make sense to buy. Cinnamon Roll said he’d seen those ‘bubble’ markets too, but then admitted that he never could recognize the tipping point in time to do anything about it. Peach Danish said that, in his experience, the critical point came if the yield on the down payment got to be less than the one year Certificate of Deposit. If it was less, then the tipping point had been reached and values were likely – not certain, but likely – to drop.”

My husband looked at me and said, “It took me a while to puzzle that out, but this is what I think he meant. Let’s go back to that hypothetical building with a NOI of \$12,000 and an allowed debt service of \$10,000. That leaves \$2,000 for monthly cash flow, or \$24,000 a year. If C.D. rates were, say 3%, then dividing \$24,000 by 0.03 indicates a down payment of \$800,000. With the bank loan of \$1,800,000 the total market value of the apartment building would be \$2,600,000 with 31% down. If the property required an even higher down payment (indicating that the yield on the down payment wouldn’t even be equal to a Certificate of Deposit), then the tipping point is approaching.”

I asked, “So what happens if we pay too much, if we just mess up?”

“Well, I didn’t hear Cinnamon Roll and Peach Danish specifically discuss that, but I’d guess that’s why people buy units. Over time, rents trend up. It’s best to buy well, but even if we don’t, even if we mess up, a rising income stream will eventually bail us out. Also, if you buy units you know that even if values never go up, in thirty years the building will be paid for and then we have a good cash flow for the rest of our lives. After a moment, my husband added, “We have no personal control over whether or not our buildings appreciate. Sometimes they will, sometimes they won’t. The really important point is that when we buy a building we put a little money down and then let the tenants pay off the mortgage. Equity build-up is the most secure source of gain. “We began by using savings to buy our first building. Then, when our equity grew sufficiently, we refinanced and used part of our equity in the first building to buy our second. There’s no way we could have saved enough to make the down payment on the second building ... we had to refinance the first so we could buy the second. One day, we’ll refinance the first two to buy a third. It appears to me that that’s how the asset accumulation period works. But one day, we’ll look at each other over breakfast and we’ll know that we have enough buildings. We won’t need to buy any more. Our job then becomes to manage our cash flow so we can pay off all the buildings we own. Our goal will change from accumulating *assets* to accumulating *wealth*.” He looked at me for a moment, then added “There is a difference, you know. Ultimately, our goal will be to finally own all our buildings free and clear.”

We saw Ben approaching. It was time to inspect.

*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.***