

The Advanced Teachings of Mrs. Langerhorn: 16
FISBO Negotiation: Determining the Maximum Purchase Price

by Klarise Yahya, Commercial Loan Broker

FISBO Negotiation: Determining the Maximum Purchase Price.

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

We didn't know how long it would take for Mrs. Mehatabel's attorney to finish drafting the plan to take care of her cats after her death. In the interim, we kept in contact and took her to lunch at McDonald's every week. We always went there because it was the site of our first “agreement”, and we tried very hard to be cordial to her. Sometimes it was especially trying simply because she turned out to be such a – crusty – old woman.

While the matter was with her attorney, we did a little demographic survey of the area, finding the modal income – the most frequently occurring income – to be \$8,000 annually. Well, it's easy enough to figure the hourly rate off that. You just divide by “2” and replace the comma with a period. A person that makes \$8,000 a year earns \$4 an hour. It works the other way, too. If someone earns \$5 an hour, they make \$10,000 a year (multiply by “2” and replace the period with a comma). Of course, this is based on the typical 2,000 hour work year.

It's important to know this because it helps you to estimate immediately whether or not a tenant can afford to rent your unit. You probably have had the same experience, but we found that prospective tenants would overestimate the rent they could pay, especially if they really liked the unit. The problem is that tenants who spent more than a certain percentage of their income on rent often ran into financial difficulties. And if tenants couldn't pay their rent we would have trouble paying the mortgage. I know that sounds obvious, but it was something that I continually perseverated upon.

Anyway, later on I figured out that the best way to determine minimum income levels for our tenants was not to reinvent the wheel. All we had to do was to apply the same standards banks employed when a person applied for a mortgage. So I asked Mr. Finley, the bank president and the man who refinanced our six units, about FHA mortgage requirements. He said they occasionally changed, but at the time no more than 28% of a person's gross income could be applied to the mortgage payment (principal, interest, real estate taxes, and fire insurance), and no more than 36% could be applied to all debt

payments (proposed new loan *plus* car, furniture, school debts, etc.). I thought these figures would be good for us because, after all, the tenants would be paying our Principal, Interest, Taxes, and Insurance on the building and we wanted to make sure they could afford it! Mr. Finley asked why I was interested and I said I was just curious.

Right away, my husband and I agreed to apply FHA income standards to any new tenants. We hoped that would minimize missed / late rent payments.

After work at the bakery one afternoon I sat down and ran the numbers. It took awhile because I was still new at it and couldn't do it as easily as I eventually learned to.

Ok, so the modal annual income where Mrs. Mehatabel had her units was \$8,000. Using FHA filters, maximum rent would be 28% of that amount, or \$2,240 which comes to \$185 a month (I rounded down a little, just to be conservative). If we subtracted 5% vacancy and 35% fixed and variable expenses, the Net Operating Income (what we would have available for mortgage payments and cash flow) would be \$114. If that sum were divided by 1.20 (so we could have a cash flow equal to 20% of the loan payment) our maximum mortgage payment would be \$95 per unit and the cash flow would be \$19 (again, per unit).

That \$95 would service an \$8,500 mortgage at the 13.0% interest rates the banks were charging at the time. Since we were talking about four units, the maximum mortgage would be four times that, or \$34,000. If we were required to put 25% down, then I'd have to divide by three (because the loan would be three parts of the purchase price) to get the down payment of \$11,333 (the down payment is the fourth part of the purchase price) and a total purchase price (down payment plus mortgage) of \$45,000.

We would be getting \$19 times four units, or \$76 monthly cash flow. That's \$912 annually, or 8% on our down payment. If the deal happened in this way, we'd have units that would pay for themselves and give us a return of about what we could earn on a passbook savings account. Of course, these numbers reflected the highest purchase price the units would support at our estimated rents. This was important because we didn't have the disposable income to feed a building that wouldn't support itself. If Mrs. Mehatabel didn't accept our maximum offer she could just keep her old units. Do I look like a charity?

Parenthetically, do you remember that we pulled \$10,000 out of our little six unit investment property so we'd have the down payment in the bank whenever another building we wanted came up? This technique, refinancing first – before going shopping – turned out to be a great decision and once we maintained the rest of our investing career. When you're negotiating to buy a desirable property, it makes a huge difference when the guy bidding against you says, "I want to buy your property, Mr. Seller, but I have to refinance mine first" but you say "My down payment is in the bank right now. Wanna see?" This is especially important when you are looking at a great deal. Great deals seem to draw offers like cows attract flies. I can't tell you that over the next forty

years we were investing we always got the buildings we were interested in, even with the down payment money in the bank, but in several cases it turned out to be the difference that made the deal happen. Those often turned out to be some of our best investments.

After figuring the building's theoretical rental income, it was time to check out the area and see if we really could get \$185 a month for two bedroom units and to see what the local vacancy rate might be. I was pretty sure we could get that rent, because it was not much more than one week's average pay in the area, but my husband wanted to make sure.

That weekend, we drove the area and called at every building with a "Vacancy" sign. We asked about the unit – number of bedrooms and size – then arranged to see the inside. There were a couple of units that were being rented without being renovated. They still had the old paint and the carpets hadn't even been cleaned and they smelled bad.

Towards the end of the afternoon my husband observed that most of the "old" units were offered at the same rent schedule as the renovated units, the difference being that the "old" units accepted pets and the fixed up units didn't. It was something we agreed to keep in mind in case we had a long vacancy and became desperate.

We kind of expected to see a few three bedroom units and some singles, but we didn't. All the units we investigated had either one bedroom or two bedrooms. And, yes, the asking rent of the two bedroom units bracketed the \$185 (one went for \$199, but it was bigger and had a two car garage). The lowest rent was \$170, but most of them were around the \$180 level. The highest one bedroom units (there were three offered at this price) were available at \$170. So the most expensive one bedroom's pretty much reached the low end of the two's. I don't know why this surprised me, but it did.

Two weeks later, at our McDonald's lunch, Mrs. Mehatabel announced that her lawyer had finished the Trust and she wanted to go forward.

We arranged to inspect the inside of the property a couple of days later on our day off, which was Thursday that week. We organized for a termite guy and a contractor to inspect with us. And, also, we wanted an appraiser to do his inspection at the same time. It looked like things were going so well!

*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.***