The Advanced Teachings of Mrs. Langerhorn: 21 So, Exactly What is a “Good” Location? 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,
As you know, we bought our first little six-unit building at the peak of the market. Values began collapsing just as our signatures were drying on the purchase contract. Eventually the market stabilized and then began to recover. At that point we refinanced, pulled out $10,000, and bought the fixer units from Mrs. Mehatabel that I’ve told you about. It took awhile, but they’ve been renovated and are now generating a nice little cash flow. Thanks for asking.

So my husband and I were talking after dinner last night and tried to make sense of what we’ve experienced so far. I know it’s counterintuitive, but I don’t think we’d buy fixers again. First, no bank is eager to lend on empty, decrepit units. We had to go to a hard-money lender to buy Mrs. Mehatabel’s building and the interest and points we paid were onerous. And renovating the property cost more money – and took longer – than we expected. I guess it always does. Finally, after the fix-up and when all units were rented, we refinanced out of the hard-money loan through a loan broker (she got us a better loan than we could get ourselves) and finally got a good mortgage on the units.

Between the fix up costs and the costs for our hard-money loan and all the other expenses, our out-of-pocket costs were well over the normal 25% down that you’d normally expect to pay. And that’s for a livable, functioning apartment building with an existing stream of income! In retrospect, buying a “fixer” just doesn’t seem worth it.
So that’s why my husband and I were talking after dinner. All those people who tell you that the way to wealth is through “fixers” just don’t buy in our area, I guess.
So how do you make money in apartments? That was the topic of conversation. It turns out that there are only two vital principles: Location and Price.

The first principle is to buy where values will likely trend upwards. There’s a lot more to this idea than first appears. For example, you can’t buy in Texas. There is so much available land in Texas that if rents for existing apartments climb enough to support new construction, it will certainly be built – and probably right down the street from you. The controling element is not land, it’s the cost of construction.

We used Texas as an example, but cheap land is the bane of apartment investors all over the country. After all, the cost of apartment construction divides neatly into land costs and construction costs. If land costs are negligible, then the controlling element is the cost of construction. Apartment values in most areas are based on construction costs, the cost of land being so minimal that it reduces to an non-issue.

Maybe that's where people make money on "fixers". If construction costs are the controlling element, then maybe you could save part of the labor costs if you do your own work. I never thought of that.

Ok, so how can an investor make money in Texas apartments? Well, the property probably won't appreciate very much, but you can still get three of the four benefits of owning income property. Like I said, you won't get much appreciation, but you can still expect cash flow, equity build-up, and any legislated tax advantages. Just buy it, keep it well maintained and the rents up to market, and try to pay it off as soon as you possibly can. Texans have been making money on Texas apartments in this way for many years. The other way to value apartment buildings is based on land costs. California, Manhattan, and a few other areas of the country pretty much have constantly growing populations, especially in high-end areas. Construction costs really aren't an issue. The problem is land. There just isn't enough available land. If you want to build something you pretty much have to buy an existing building, demolish it, and then erect the new construction. The costs of construction are not the key to profitibility. It's how much the land cost you. Assume you air drop into an entirely new area and want to buy property there. How do you determine if the values are based on construction costs or on land values?

It's quite simple, really. Have your broker (or, better yet, hire a certified appraiser to dig up the information) pull up records showing the price the current owner paid for the property you are now considering. The further back you go in the chain of title, the better. Go back five or six owners and you can get a real feel for the matter.

If the last three or four owners all paid about the same price for the property (after adjusting for brokerage costs and costs of sale) as it's being offered to you, then it's pretty clear values haven't gone up very much.

If your appraiser repeats the process with a handful of comparable listings (go back three or four owners and see how much the property value has gone up) and the results are roughly the same, then you have enough data to expect that area values are based on construction costs. Don't even think about appreciation. Buy on cash flow expectations. Let's say, however, that you air drop in, hire an appraiser, and discover that the property you're considering for $3,000,000 was purchased for $2,000,000 five years ago, and for $1,500,000 three years before that, and for $600,000 five years earlier, and for $450,000 when it was built two years before that. So in fifteen years the property has gone from $450,000 to $3,000,000. That's over 13% per year just in appreciation. Construction costs sure haven't gone up that much. If your appraiser researches a handful of comparable sales and discovers a similar pattern, then you are clearly in an area where values are based not on construction costs but on the cost of land. As long as population trends continue a net inflow, land will continue to become ever more valuable and area properties will probably continue to appreciate.

But even for the best located apartments, you mustn't pay too much. We'll discuss that next time.

*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) 414-7830*