

The Advanced Teachings of Mrs. Langerhorn: 26
The Remarkable Mortgage Constant
By Klarise Yahya, Commercial Loan Broker

Dear Mitochondria,

Do you recall our little discussion about how being sited in an archipelago (*it's called that because there are lots of locational "islands" where property investments tend to do better than average*) will more than likely raise a simple little building to franchise status? The key, of course, is the "economic island" location.

The short way to recognize a good location is that it's where values are highest. Usually rents, but always values.

I've always tried to buy my "keeper" buildings in an economic island, but I've never succeeded in buying the "best" available building, although I've sometimes tried. The price was always too high, and they were sold to dentists. I've been satisfied in buying any decent building on the island, and things have worked out reasonably well using only that simple filter. Sometimes, however, during brief and widely spaced periods, a second filter can be profitably employed.

Have you ever reflected on interest leverage? Here's how it works. Assume you can borrow money at 6% and invest it at 10%. Clearly, you'd be making a profit on the borrowed money. At the most basic level, that's all interest leverage is. Now let's turn that concept into something useful to us.

The first adjustment we have to make is to replace the 6% interest rate with something called the "mortgage constant". If you borrowed \$1,000,000 at 6% interest-only (no principal payments), your annual debt service would be \$60,000. If you then reinvested the million dollars at 6.50%, you would be earning \$65,000 and only have to pay out \$60,000. You'd be making "free" money off what you borrowed, and you'd be a happy puppy.

But if you had to pay off some of the principal every year, your debt service would obviously be higher. If you had to pay \$10,000 towards the principal every year, your combined debt service (principal and interest) would be \$70,000 even though you would only be earning, in this example, \$65,000. You'd be reaching in your purse every year to make up that difference. Did you notice your tail stopped wagging?

Right now – and things will surely be different when you read this – reasonably good buildings in economic islands can occasionally be had for a 10% cap rate. You get the cap (short for capitalization) rate by adding all the income the building *actually* generates in a year, then subtracting all the associated costs (*except for debt service*),

including reasonable reserves. Whatever is left you divide by the cost of the property. Basically, the cap rate is the “interest” rate you’d earn if you paid all cash for the building.

*Relationship Key: Net Operating Income (NOI) is the dollars received, while Cap Rate is the NOI expressed as a percentage of purchase price. As an example, that little 7 unit building across the street rents each unit for \$1,000 a month. It brings in \$84,000 a year. But there’s a 5% vacancy factor, and the fixed and variable expenses and an allowance for reserves total 37%, so after paying all the costs associated with ownership, the building nets \$48,000 a year. It’s for sale, and they want \$560,000 for it. Our **NOI** is \$48,000 (the dollars that are available for debt service and cash flow) and the **cap rate** is 09% (\$48,000 divided by \$560,000).*

Returning to our discussion, you don’t deduct for debt service because cap rates are independent of whatever kind of financing the prospective buyer elects. If it were otherwise, than the guy who takes a 60% fixed rate loan would have a different cap rate than the guy who choses a 75% adjustable mortgage and the information communicated by the cap rate would disappear.

Starting with some *hypothetical* examples, let’s assume we have \$1,000,000 to put down on a building. We find something we very much like, at the edge of an economic island, available at a 10% cap rate. They want \$1,000,000 for it, so our down payment could pay for the the whole thing. If we paid all cash for the building, we would have a before-tax cash flow of \$100,000 a year. That’s 10% of the purchase price.

But right next door is a similar building, only bigger. The fellow wants \$4,000,000 for it and it, too, is based on a 10% cap rate. We still only have \$1,000,000, so we’ll have to get a loan. We go see Klarise.

We want a 15 year fixed rate loan. She tells us that they are currently available for 5.75% fixed, fully amortized over 15 years. The monthly payments will be \$8,304, or about \$100,000 annually per million dollars borrowed. Whoa! You mean that if we put our million dollars down and borrowed \$3,000,000, we could buy this building, make the monthly mortgage payments, *and still net the same \$100,000 a year* we’d have if we’d paid cash for the little bitty one next door? Imagine that!

It can get better. Hypothetically, suppose interest rates dropped to 4.50%, and our total payments for the entire \$3,000,000 became \$275,000 a year. Well, from our NOI of \$400,000 we take away principal and interest payments of \$275,000 and our cash flow becomes \$125,000. That’s 25% higher. The lower the mortgage constant is relative to the cap rate, the greater our cash flow *because we’ll be making an “interest spread” on the borrowed money.*

Don’t think of interest rates, here. Interest rates aren’t important in this calculation. Reflect only on the mortgage constant (annual principal and interest payments divided by

the amount borrowed). ***The Rule is: if the mortgage constant is less than or equal to the cap rate, we're in Fat City.*** But remember, such times occur very seldom in any investor's lifetime.

*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.***