

The Advanced Teachings of Mrs. Langerhorn: 33
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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.

Dear Mitochondria,

Last month we discussed:

- (a) what an investment is and
- (b) why an investor buys it.

I know that we're reviewing things we've talked about before, but sometimes it's good to have a central repository of key points. So to continue our discussion – and still in no particular order – these are some other items an investor should keep in mind

What to Buy:

Income real estate comes in multiple forms. People usually start with small (two to four unit) apartment buildings, and for good reasons. Small units, compared to SFR's, provide a type of diversification-in-kind. Additionally, they are easier to finance and can be had with a smaller down payment than retail or commercial buildings.

There is a firewall at the 4 ½ unit level. Up to four units the property is considered by the lender as a single family residence. Thirty year fixed rate loans are available, and owner occupied properties may qualify for low down payment mortgages. Five units and above require commercial loans which nearly always carry a variable interest rate – even if the first few years are fixed – and minimum 25% down payment.

There is little wrong with an investor acquiring a portfolio of fourplexes. Many skillful investors focus almost exclusively on small unit buildings. In addition to relaxed lending standards another underappreciated advantage is that if you need a bunch of money you can sell or refinance only one fourplex and leave the rest of your holdings untouched.

If you have one fourplex for each child, purchased at the time of their birth, it would seem that their future would be bright. One small building could be sold to pay for Cost Center #1's college and graduate degrees. Another building could perhaps provide the down payment for Cost Center #2's McDonald's franchise. If you have more buildings than Cost Centers, you and your Beloved could simply collect the rents to augment your retirement.

Commodity Buildings

Notwithstanding the benefits of collecting fourplexes, some good people will progress to apartment buildings of five (+) units ... and the rules change. Please note that

sophisticated investors, when they buy owner-occupied fourplexes, often use the same purchase format they use for larger buildings of 5 or more units. In that way, they are a little more confident of getting a positive cash flow even on small buildings.

The first consideration is the mortgage payment (i.e., “debt service”). The bank will only loan as much money as can be serviced by a portion (say, 80%) of the net operating income (NOI). Let’s get out our calculator we’ll review how it works. Everything starts with the Gross Scheduled Income (GSI), which is what the building is supposed to bring in but never quite seems to. Building values and operating costs vary widely (did I say widely?) throughout the country, so we’ll use only hypothetical figures that will certainly be different than in your area. Let’s start with a building having a hypothetical GSI of \$100,000 and see how much we borrow on to purchase the building.

Gross Scheduled Income (GSI)	\$100,000
minus vacancy and credit losses @ 10%	-10,000
Effective Gross Income (EGI)	\$90,000
minus fixed and variable expenses @ 40%	-36,000
(TUMMI: Real estate T axes, U tilities, M anagement, M aintenance, M iscellaneous, and I nsurance)	
Net Operating Income (NOI)	\$54,000
(This is the most important number in the analytical process. The NOI is what you could theoretically put in you pocket if you’d paid all cash for the building.)	
divided by the bank’s Debt Service Ratio (DCR) estimated in this example @ 1.25	\$43,200
Cash Flow	\$10,800

We can use the above to determine (a) how much of a loan the building will support and (b) what we would be willing to pay for the building.

This is how we determine how much of a mortgage we can get. Remember, we need to keep the principal and interest mortgage payments (in this example) equal to or less than \$43,200 a year. Well that’s \$3,600 monthly, and at 8% interest you could borrow about \$490,000. Your financial calculator will perform the mathematics for you.

Ok, so we know how to figure the maximum loan. Now, how would we use that number to compute an appropriate purchase price?

The purchase price is composed of two items: the mortgage and the down payment. Usually, the bank requires the buyer to put a minimum 25% down. That means the mortgage would be 75% of the purchase price, so to find the minimum down payment

just divide the estimated loan amount by “3” (75% divided by 3 equals 25%). In this case, if the loan was \$490,000 and the down payment was \$164,000, then the total value of the building would be \$654,000.

Thirty years on, when the building you paid 6.5 GIM for is paid off, assume it is still worth the same 6.5 times gross, but the gross (presuming 5% annual net rental increases) has increased to \$432,000 and your building is worth \$2,800,000. Your 25% down payment has increased about 9.9% per year for three decades (plus any cash flows).

Congratulations! You have just worked out the *Income Approach* to value. The other two approaches are *Market Approach* which is based on what other competing buildings have recently sold for, and the *Cost Approach* which estimates construction costs, deducts accumulated depreciation, then adds land value. Most (but not all) investors heavily weight the income approach. That seems reasonable because, after all, we’re buying a stream of income.

Franchise Buildings

It’s probably not a good idea to buy income property outside your immediate area, but within almost any reasonably sized geographic area there are *Commodity Areas* and *Archepeigos*.

Commodity buildings are most common and found almost everywhere. The rule of thumb is that if it’s not in a clearly recognized archepeigo, it’s a commodity building.

Commodity buildings, as we’ve discussed, compete on price alone. Think of those simple, box-like apartment buildings you pass every day, the ones with the aging “For Rent” signs. Why would a prospective tenant chose to rent in Fred’s building vs. Ethel’s? Only because Fred’s building is cheaper. Owners of commodity buildings race each other to the bottom of the rent pool. Counterintuitively, however, that does not always mean that commodity buildings are unwise purchases.

Commodity buildings can make money in two ways. You could buy a “fixer” and renovate it, putting it on the market just as the last coat of paint is drying. Naïve buyers may fall in love with new paint and little red flowers and be eager to buy at top dollar.

The second way is more secure, but longer term. Just keep the building until the tenants pay it off. There’s nothing wrong with that. As the buildings around you sell and resell, you still have the same building for which you assumedly paid less than any of your neighbors. You can consequently rent for a little less and keep your building full. You’re using the nature of commodity buildings for your benefit. When it’s paid off, you have a nice little retirement income.

Franchise buildings, to repeat, rent for reasons other than price. Scattered throughout America are little islands where people pay more just to live there. These islands, as a whole, constitute the archepeigo where franchise buildings are found. Extreme

examples: you own waterfront units and find you can rent much higher than exactly the same building seven miles inland, the one surrounded on three sides by the toxic waste dump. Or your units are within the highest rated school district in the State. In both of these cases, tenants rent for the amenities shared by only a limited number of nearby buildings.

Franchise properties almost always cost more than commodity buildings, and that is only partially due to their (usually) higher rents. Their selling price is often beyond the maximum loan their net income will support. A big down payment is required to make up the difference. Thankfully not very often, but there have been times and places where 65% down payments have been (usually briefly) common. Typically, however, down payments for franchise buildings are more than 25% but less than 50% of purchase price. Greater down payments (meaning reduced leverage) have a significant adverse effect on the growth of your invested principal.

Why would a reasonable investor be willing to pay so much for a franchise building that the benefits of leverage area are reduced? Depending on the leverage, a franchise building is not necessarily a better investment. For example, say a well located property is purchased at 12 times gross income and sold 30 years later at the same 12 GIM.

Hypothetically, lets say you buy a 10 unit building with rents of \$2,500 / month per unit (\$300,000 annual income), paying \$3,600,000 while only supporting a loan (at the same 8% interest we used for our commodity building, above) of about \$1,600,000. You would be putting about \$2,000,000 (56%) down.

Thirty years later the loan would be paid off. Income (at the same 5% annual increase as we hypothesized for the Commodity building) would have increased to roughly \$1,300,000 and, at 12 GIM, the building would be worth \$15,600,000. Disregarding friction costs, your \$2,000,000 down payment grew to \$15,600,000 in 30 years. You made 7.09% per year (compounded) on your down payment (plus any cash flows).

At 9.90% (Commodity Building), each \$100 investment after 30 years turns into \$1,698.

At 7.09% (Franchise Building), each \$100 investment after 30 years turns into \$781. In this example, the Commodity Building earned 117% more over the life of the loan.

Considering return on down payment only, the general rule is that it's probably best to limit your downpayment to 25% of the purchase price. The more one exceeds that number, the less the return.

*Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more, **Klarise Yahya** can help. **Find out how much you can borrow!** For a complimentary mortgage analysis, please call her at **(818) 500-9966**.*