

Letters to Mycroft #43: Being Out of the Market
By Klarise Yahya

To My Dear Nephew, Mycroft,

Dromedary asked, *“Aunt Mitochondria, if I pay full market price for an appreciating asset, and it goes up, I’ll just be making whatever the market appreciation is, won’t I? Isn’t there a way to do a little better?”*

“There may be, my dear. But you have to understand that if your annualized returns, over time, average 10% in stocks and perhaps somewhat more in leveraged income properties, you will die rich ... if you only you live long enough.

“To do better than the market, you have to know how to buy below the *central value* of an asset. The central value is that multiple-of-income about which the value fluctuates.

“For example, if the central value of an apartment building is (hypothetically) 8 x GIM, the market might – through the years – price the building as low as 6 GIM and as high as 10 GIM.

“If you buy at the central value, making a “market” down payment and acquiring a “market” mortgage, you can probably forecast that your returns will be about even with the market. That is not a bad thing. We have seen that you can do quite well just buying at fair market price and holding.

“While income generating assets do tend to have a central value - that does not mean that they spend equal time on both sides of the line. If you visualize the cycles of investment values, you may conclude that while the assets we are interested in may occasionally dip below the line, they generally spend precious little time there.

“You must be aware, Dromedary, that although income producing assets tend to cycle about a central value, the path is not circular (equal time on both sides of the line). It is elliptical (most of the time, their prices are well above central value).

“Auntie”, Dromedary asked, “would that be because everybody knows that as rents go up, so does the building’s value? That means that even if you overpay, eventually the market will probably catch up? And the ‘market’ generally requires buyers to pay for that sort of security?”

“Yes, I think you’re right. Even if you buy at the top of the market, the tenants might eventually bail you out *because increasing rents tend to raise building values.*

“Lets model a building offered at 10 GIM. Pretend we have a 9 unit apartment building generating \$97,200 a year in gross income. It is listed at \$975,000. If you pay listed price, how will the numbers work out?

Gross Scheduled Income (GSI)	\$97,200
...minus vacancy @ 5%	(4,860)
Gross Effective Income (GEI)	92,340
...minus expenses est. @ \$3,500 / unit	(31,500)
Net Operating Income (NOI)	60,840
Divide NOI by 1.20 to determine amount available for debt service	(50,700)
Cash flow	\$10,140

The debt service will support a loan of \$635,000 @ 7% interest. Since the building offered at \$975,000 will only support a 65% loan, the necessary down payment is \$340,000.

If we divide the calculated cash flow (\$10,140) by the down payment (\$340,000), we find the buyer can expect an initial cash-on-cash return of 3%.

"Well, Dromedary, that's our hypothetical purchase at 10 GIM. What happens if you keep the building until it's paid for thirty years from now, raising your rents only 4% per year, then sell it at 8 GIM?

"Excluding cash flow, tax consequences and transaction fees, your down payment will have grown from \$340,000 to over \$2,500,000. That is a compound return of a little under 7% per year in 'forced savings'. Add (increasing) cash flows, and you may very well be making over 10% on your down payment.

"Think about that. You buy high, make modest annual rent increases, and thirty years later sell low. You still make over 10% per year.

"How would the numbers work if you paid the more traditional 25% down? Well, if the down payment will be 25% of the purchase price, then the mortgage has to be 75%.

"Just because you change your down payment, the building's net income doesn't change. And, consequently, the building still supports the same \$635,000 loan.

"Divide the mortgage by 3 to get the (new) down payment and multiply by four to get total purchase price. The new purchase price is \$847,000 (rounded) and the new down payment is \$212,000.

"The \$10,140 cash flow remains the same, so your cash on cash return will be about 4.7% rather than the 3% you would get with the higher down payment. *Your cash flow increases over 50%!*

"Suppose you sell the building thirty years hence at the same \$2,500,000. You will make about 8.5% a year on your down payment (still excluding cash flows and tax consequences). That's an additional 1.5%. Instead of making a little over 10% compounded over 30 years, you'll be making a little over 11.5%.

"The difference between 11.5% and 10% doesn't sound like very much, does it? *But at 11.5%, one thousand dollars will grow to \$26,000 over 30 years.* At 10%, it grows to only about \$17,500. That is almost a 50% difference!

"If you wish to do better than the market, you must buy below an asset's *central value*. But that is very hard to do because assets spend so little time "below the line", and the competition is brutal. If you insist upon all your purchases being below central market value, you will be out of the market much of the time.

"So if I keep my money in a savings account until a \$26,000 chance comes along, I may never take advantage of all the \$17,500 opportunities that are out there, huh?"

"That's right, my dear. In investing, as in life, sometimes the perfect is the enemy of the good."

Colloco, ergo sum.

Aunt Klarise

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**.