

Letters to Mycroft #42- Buying High
By Klarise Yahya

To My Dear Nephew, Mycroft:

Dromedary was having tea with Aunt Mitochondria. She opened the conversation with, *"I was talking to one of my friends, and she said her father thought prices for apartment buildings were too high right now"*.

"Well, in raw dollars they seem to be higher than they've ever been, don't they? But why do you think they are *too* high? I'm not saying they are, and I'm not saying they're not. I just want to know why you think as you do." Mitochondria asked.

Dromedary loved it when she was offered the opportunity to talk. *"I'm seeing units selling for 12 – 18 GIM! That's just crazy!"*

Mitochondria looked at her, regretting that Dromedary was permitted to have opinions before she was taught to think.

"Consider a 15 unit building occupied by old people on small pensions. The building is owned by a sympathetic landlord. It shows a lot of deferred maintenance, as you would probably expect. Even though the building is in a non-rent control area, the owner has kept the rents at \$35 a unit since 1952.

"The landlord dies and his heirs place the building for sale. After fully adjusting for the accumulated deferred maintenance, the listing price was established at \$1,000,000. That's a little over 158 times Gross. Is this a sellable listing? Market rents are \$1,000 a month.

Dromedary pulled her calculator from her purse. She punched some numbers and looked up with a surprised expression, *"That's less than 6 GIM on market rents! Of course someone would buy it!"*

Mitochondria sipped her tea. "Have we established, then, that Gross multipliers by themselves seldom tell us very much? In fact, they are most useful when adjusted to reflect market rents. Of course, you must understand the area well enough to know what rent levels are. You certainly can't take someone else's word for it."

"It's important for you to understand", Mitochondria continued, "that the most money in investing seems to be made when assets are purchased at full market value. I know that seems counter-intuitive, but I believe it to be the case."

Dromedary looked at her aunt as though Mitochondria had forgotten her medicine. *"That doesn't make sense"*, she said. *"I thought the best investments were always bought under market."*

"I think we've talked about that, dear. There is just too much competition out there for an asset, in an efficient market, to sell for more -- or less -- than the actual market price. If, for example, apartments are selling for \$100,000 per unit and a building is offered for sale in the marketplace for \$60,000 per unit, don't you think that multiple bidders will auction the price up to approximately full market value?

"Alternatively, if a building is listed at \$150,000 per unit, and similar buildings are selling for only \$100,000 per unit, do you think that listing is likely to sell for more than a buyer could acquire an equally desirable substitute?

"In an efficient market, it may not really matter what a seller prices his units at. As long as the property is fully exposed to the marketplace, under-listed units will be bid up and over-listed units will be bid down."

"Does that mean that you can never get a deal? I've heard of people who have!" Mitochondria still wasn't convinced.

"Deals are sometimes available when the building is not exposed to an efficient market. If you arranged matters directly with a naive seller, perhaps you *could* get a bargain. But that seems very unlikely, and a dreadful amount of trouble.

"In an efficient market", Mitochondria continued, "you always buy at full price. The reason you can buy *that* building, or *that* share of stock, is that there is nobody who will pay more *at that moment in time*. In a sense, all economic activity occurs on the margin."

Dromedary interrupted, "So you think I should be ok with paying top price for a building?" She was being snotty.

"I didn't say 'top price'. I said *market price*. That's the only way you will acquire an investment, dear. Put yourself in the seller's position: why would he sell it to you for less than he could get elsewhere? It's ok to pay full price for either a share of stock or an income property because *they tend to continue going up in value even after you buy them*. You can get very rich paying full market prices for investments that continue to appreciate!" Mitochondria said.

Dromedary was curious, "But doesn't the market itself sometimes get out of whack? Like when all apartment buildings are selling for way too much money? Or the opposite, when the market crashes and you couldn't give an apartment building away?"

"That's why you have collars on your purchase price. No matter what the market is doing, whether it's in a bubble or down in the mud, if you decline to make more than a 25% down payment – and require a decent cash flow on your down payment – you should do well over time."

"I've never really understood what it is that makes buildings go up," Dromedary said.

"There are two things. The first is that the value of an investment tends to rise as its net operating income increases. That's net income before mortgage payments. Obviously, if you paid cash for a building that gave you \$12,000 a year in net operating income, managed it well, and eventually caused the rents to increase enough to allow a new buyer to put \$24,000 a year in his pocket (again, in NOI), the value of the building will have appreciated. You will be able to sell the building for a lot more than you paid for it, everything else being equal."

"What's this 'everything else being equal'? What does that mean?" Dromedary asked.

"The two things that determine value are (a) how much net operating income there is, and (b) how the market capitalizes it. The NOI should be worth some multiple of earnings. If the market says that an income of \$1,000 a year is worth a 10% cap rate, then the value of that stream of income is \$10,000. But if the market says that \$1,000 a year is only worth a 20% cap rate, then its value is only \$5,000.

"If, however, the market capitalizes \$1,000 a year at 5%, then that stream of income is worth \$20,000. (\$1,000 divided by 5%)

"As a general rule, when income properties are 'hot', the market capitalizes their income at a low rate. The \$1,000 of net operating income may become valued on the market at \$20,000.

"When income properties cool down, the market capitalizes their income at a higher rate. The \$1,000 in NOI may become worth only \$5,000. (\$1,000 divided by 20%)

"If you buy at the peak of the market – and somebody always does – you have to live with whatever cash flow you can develop. It will be a long time before you can sell it for a profit.

"But, alternatively, if you buy at the bottom – and somebody always does – your cash flow becomes more valuable. You can cash-out your investment very quickly.

"The way to maximize your net worth, Dromedary, is to refinance when values are high and just park the funds in a safe spot. When values go down, you will have the money to buy at a more favorable price. Real estate is a cyclical business, although most people tend to forget that. If you have a good building, you don't have to sell it. You refinance it and use the cash to eventually buy another building.

"But whenever you buy" Mitochondria concluded, "you will be doing so at the highest price the market will support *at that moment in time*. In effect, you will always be buying 'high'. You let the market, over time, carry you to wealth.

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**.

