

Letters to Mycroft #48: Commodity Buildings By Klarise Yahya

To My Dear Nephew Mycroft,

Dromedary was curious. "Could you talk a little more about Commodity buildings and who buys them?"

"Sure. But do you know how to recognize a Commodity building? They are usually affordably built, with one unit stacked right above another. They often have stucco exteriors and flat roofs. You usually find several on the same street. Their only observable differences are exterior paint and perhaps a bit of landscaping.

"Since the buildings are so similar, how do the owners compete for tenants? They can only compete on rent. The apartments offered for the least rent get occupied. The other owners are stuck with empty units.

"Suppose a building has a vacant two bedroom unit for which they are asking \$800 (I'm just making that number up). Some of the other buildings on the street also have vacant two-bedroom units, but they are offered at \$775. What is a tenant going to do?

"But maybe the owner fixed up the \$800 unit?" Dromedary objected.

"Are you saying that it never pays to fix up your units?"

"How much do you think it costs to paint and carpet a two-bedroom unit? Say, \$1,200? If that expenditure generates only \$25 more a month, then it would take four years just to get your \$1,200 back. By that time the unit has probably changed tenants twice and is probably ready for another re-do, don't you think? One of the characteristics of Commodity buildings is that you almost never earn back your repair costs.

"Are you saying that it never pays to fix up your units?"

"All landlords have to maintain at least a minimum standard or their units will attract the unwelcome attention of those pesky city officials. But there is little incentive to over improve Commodity buildings because, as we've seen, you'll almost never get your money back.

"Then why should anyone ever buy a Commodity building?" Dromedary asked.

"Well, it really doesn't seem to be very useful for experienced buyers to pay top dollar for a building and then have to compete on a lowest-rent-in-the-area basis just to keep the building full. Consequently, these buildings are usually purchased only by really naive investors.

"Let's take a look at how new investors may buy their first apartment building. They just got a new equity line of credit and have been wondering what to do with it. They hear it's a good idea to own apartments. They get excited and call some real estate office down the street. That weekend, the agent drives them past six or eight or ten buildings, all of which are shockingly expensive and require around 45% down.

"Then the agent drives them past the Commodity building she listed a couple of months ago. The building has recently experienced its first new coat of paint in fifteen years. The driveway and parking area has a fresh coat of oil. There are a couple of flower beds by the front wall with little red blossoms.

"To you and me the building looks like Tammy Faye Baker, but the new investors are excited. And when the agent tells them that they probably won't have to put more than the "normal" 45% down, and it's available for much less than any of those she's shown them earlier, well, you can just see their enthusiasm rise to boiling.

"The agent just played a series of carom shots. She bounced them off the superior buildings and they rebounded right into her listing. Happens all the time.

"Why did the agent tell them that it was normal to put 45% down? And besides, if they overpay won't the bank refuse to give them the loan?"

"The 45% down payment represents the difference between the maximum amount the bank will loan and the asking price. Remember those carom shots? Every time she showed them a building, she mentioned that the down payment was (blank) percent. Usually, the number was

between 40 and 50%. By now, the unsophisticated couple accepts that “normal” down payments for apartment buildings approach half the purchase price.

“Remember that the bank doesn’t care how much you pay for a building. They figure you can give your money to anybody you wish. But they won’t lend more money than the income will support. *The banks are real careful with their own money!*”

“How do you know how much of a loan a building will support?” Dromedary asked.

“Well, most of the time I just call Klarise”, Mitochondria smiled. “It’s much easier that way. But if you insist on puzzling it out yourself, you have realize that in no event will the bank lend more than 75% of the sales price or appraiser value (whichever is less). That’s the first filter. The second filter is that the building’s income must support the loan payments and still give you some cash flow each month. Any loan request must pass both filters.

“The way the banks model the income portion is to start with the total annual income your building should generate if all units were rented. Take away an allowance for vacancies. Then subtract real estate taxes, utilities, management expenses, maintenance, miscellaneous, and insurance (TUMMMI) to get to the Net Operating Income. Divide by 12 to get monthly NOI. Finally, divide monthly NOI by six and multiply by five.

“That last figure you got is the maximum payment a bank will allow for debt service. You get to keep 1/6th of the NOI and the bank takes 5/6th for the mortgage payment. How much of a loan that amount will service depends, obviously, on the interest rate. That’s why I call Klarise. She keeps herself abreast of current interest rates.

“The important thing is the ‘*divide by six and multiply by five*’ bit, because that formula provides that you’ll have a positive cash flow equal to one-sixth of the NOI (or one-fifth of the mortgage payment). When the agent makes a big deal about the building having a positive cash flow, remember that it is only because the bank structures the loan specifically for you to have a positive cash flow. If they can’t, then they won’t lend you the money.

“For example, if your monthly Net Operating Income was \$10,000, and you maximized your loan, how much would your cash flow be?

Dromedary didn’t miss a beat. “Wouldn’t my cash flow would be about \$1,700 a month?” she replied. “That’s 1/6th of the NOI”.

“Very good. Now, if you wanted to borrow the most you could on the building, how much would your cash flow be if you put 25% down to the loan? How much if you put 40% down?

Dromedary thought a few moments, then responded, “Assuming a maximum loan, wouldn’t my cash flow be the same dollar amount, no matter how much I put down? After all, my cash flow (in dollars) would be based on the NOI, not on my down payment. If I maximize my loan that means that the bank is going to lend me the most money that the building will support, and that almost always means that 5/6th of the NOI will be consumed by the loan payments, leaving only 1/6th for my cash flow.

“What changes when I pay more for a property is not that my cash flow increases, it’s that the yield on my down payment reduces.”

“That’s exactly right. Bank loans are not based only on the purchase price. Bank loans are based on whatever amount 5/6th of the NOI will debt service. In no event, however, will a bank lend more than the purchase price or appraised value, whichever is less.”

“This being the case, let’s return to our hypothetical Commodity building. We’ve already established that monthly rents for two-bedroom units run about \$775. If vacancy allowance and TUMMMI are 43%, then our NOI will be about \$440 a month. That means that the maximum payment the bank will allow would be \$367 per unit (5/6th of the NOI). At 7% interest (this would be the underwriting guideline rate and may not be your actual rate), that figure will support a loan of \$55,000 per unit, and you will have \$73 a month cash flow from each unit.

“If the building is offered at \$96,000 a unit you will have to make a down payment of \$41,000 (43%) per unit. That will give you a cash flow of \$876 per unit / per year, or about 2.1%. That figure compares favorable with current Certificate of Deposit rates. When the agent points this out, then adds the tax advantages of apartment buildings and their growth potential, well, the new buyers become hungry for the deal.

That bit about Certificate of Deposits didn’t pass Dromedary unnoticed. . “Then if someone is selling their apartment building, and they price it so the buyer gets a cash flow on their down

payment equal to or a little above current C.D. rates, does that mean that the building is sellable?"

"That seems to be the case. And if you believe, as I do, that C.D. rates will be trending up then it means that property values will start to trend down. Remember the teeter-totter we've referenced before? *"As rates go down, values go up. As rates go up, values go down".* We've seen the first part of the teeter-totter over the last several years. Rates are currently at a 40+ year low. Now we'll probably see the second half of the teeter-totter. I think a lot of money is going to be made by investors that refinance and pull as much money as they can out of their buildings now, and park it safely until sometime in the future, maybe three or four or five years from now, when they can buy buildings at a more reasonable price.

"Why not just refinance in four years?" Dromedary asked.

"If interest rates go up and values go down, in four years your building won't be able to support as much of a loan. If you refinance now, with interest rates low and values high, you very well might be able to get a great low interest loan at a higher dollar amount that you could if values go down. Then you take the money you got when values were high and buy when values drop. Even if you refinance now, you will still have a cash flow. The bank will require it.

"But our hypothetical couple does not currently own any investment property. They just got an equity line of credit on their home and want to buy their first apartment.

"Following their agent's advice, our couple makes an acceptable offer and soon become landlords. It doesn't take long before they realize that no matter how much they fix up the units, their income is limited by the owners down the street that bought their units twelve years ago for much less money and get along very well with \$775 rents as long as the tenants don't bother them.

"A year or two goes by and our couple learn that they can't raise rents in any useful way. On the other hand, as long as the rents are low, their building will be filled. Wanting a little more cash flow as the years go by, and unable to meaningfully increase their gross income, they naturally reduce whatever expenses they can. The building deteriorates, and eight or nine years later, well after they have lost all interest in their property, they own a doggy building populated by humans and animals of undetermined pedigree.

"Eventually, our couple just wants out. Some agent tells them that she could sell the building if they fix it up. Not much has to be done, she says. Just paint the outside and oil the asphalt. Maybe put some red flowers in the front.

...And the cycle continues.

Cordially,

Aunt Klarise

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