

**Letters to Mycroft #46:
Preparing for a Soft Market
By Klarise Yahya**



To My Dear Nephew, Mycroft:

Mitochondria, thus far in her investing career, had purchased numerous buildings and sold most of them. Dromedary knew that her aunt bought two types of buildings. Mitochondria acquired ones that could be quickly fixed up and sold at a profit, and she purchased trophy buildings – in almost any condition – that could be improved and kept forever.

For the last several years Mitochondria had guided Dromedary's investment decisions. At this point Dromedary had roughly 25% of her net worth in a low cost S&P 500 Index Fund. It was there for liquidity and (hopefully!) growth.

The rest of Dromedary's net worth was tied up in a cute fourplex she had purchased a couple of years ago. She lived in one of the units and was trying very hard to pay off the mortgage as quickly as she could. Dromedary knew that once the fourplex was mortgage-free she would become effectively financially independent.

But in the back of her head she kept thinking that *if one is good, two is better*. If owning a fourplex was good, then owning a ten or twelve unit building would be even better. The problem was that Dromedary lacked Mitochondria's passionate interest in apartment buildings.

Mitochondria breathed buildings. She tended to buy only in certain areas, and within those neighborhoods could tell almost at a glance whether a building was a worthwhile purchase. She could just smell potential!

Dromedary, however, had a life outside of real estate. What she needed, if she was going to buy larger properties, was some quick and easy way to tell if a property was a 'buy'.

"Aunt Mitochondria", she said, "I really, really enjoy your lessons. I love it when you get into the mooshy-gooey details of buying and selling properties. And I tell my girlfriends everything you say, but they don't have your abilities. They get bored every time I start discussing cap rates. Isn't there an easy way to tell if something is worth buying or not?"

"Well", Mitochondria said, "people that ignore the detail work miss a lot. Buying a beautiful building with classic architecture and all those period details is worth the trouble. It's become my greatest source of income over the last 25 or 30 years.

"And if a person doesn't take the time to learn what they're doing, they will open themselves to the possibility of serious blunders. But, that said, there is one filter that in most markets usually results in a favorable purchase."

Dromedary waited.

"If your friends can buy structurally sound and cosmetically appealing apartment buildings with a 75% institutional loan and 25% down payment based on current rents, there is a good chance things will turn out quite well. It's not a guarantee, but it's certainly a promising beginning.

"You know there are responsible people who believe that interest rates have begun a long-term uptrend. I think the arguments are compelling. What that means to us is that multipliers will probably trend down even though rents will probably continue trending up. Where is your profit if you buy a \$60,000 annual stream of net income at 12 times gross, raise the rents 5% a year, and seven years later sell the (future) \$84,000 stream of income at 8.5 times gross? You buy it for \$720,000 and sell it for \$720,000."

"That would be terrible!" Dromedary exclaimed.

"It's only terrible if you're not prepared. There is a cycle to all things, and real estate is no exception. That sort of thing has happened before, and foresighted people grew very rich feeding on such a market. You just have to understand how successful people bought in previous downturns."

Let's compare a rapidly appreciating market with a declining one.

Appreciating Market: Apartment values climb 20% a year. Rents go up about 7%.

You buy a 12 unit building for 10 times gross, or \$1,150,000. The bank lends you \$685,000 and you put \$467,000 down. Your down payment is 41% of the purchase price. Your net cash flow is \$912 a month, or 2.3% per year. Three years pass. The value of your 12 unit building

appreciates to \$1,990,000. The rents have grown to \$141,000. Your building is valued at 14 times gross. Pretty good, huh?

But when you try to sell it, you find that the bank will only lend \$839,000. That means that the new buyer will have to put \$1,151,000 down. That's a 58% down payment. And after a new buyer puts over a million dollars down on your little 12 unit building, he will have to be satisfied with a \$1,116 monthly cash flow. That comes to a 1.1% cash on cash.

"Who are you going to get to buy your little building under those terms and conditions?"

"And even if you sell it, you will be facing the same conditions when you try to replace your investment. As a matter of fact, if you pay normal brokerage and closing costs when you sell it, you will walk out of escrow with \$1,146,000. I know that sounds like you died and went to shoe heaven – you only had \$467,000 three years ago – but with all your new money you will just barely able to buy your own building back.

"An appreciating market soon reaches its natural limit, when fewer and fewer people can sell and move up. "Why sell" owners say, "if I can't buy bigger?"

Depreciating Market: Apartment values drop 10% a year. Rents continue to go up 7% a year. You buy a 12 unit building for 10 times gross, or \$1,150,000. The bank lends you \$685,000 and you put \$467,000 down. Your net cash flow is \$912 a month, or 2.3% a year.

You will notice that everything is the same except the day after you close escrow on your 12 units the market begins a long, slow collapse.

"Why would buildings appreciate at 20% but depreciate at only 10%?" Dromedary asked.

"That's easy", Mitochondria replied. "If there is a monthly cash-on-cash return most owners will take the building off the market rather than realize a capital loss. Reduced supply tends to support prices. The key, of course, is obviously that the building continues to provide a monthly cash flow to the owner.

"Three years pass. The value of your 12 unit building dips to \$838,000. The rents, however, have grown to \$141,000. Your building is valued at 6 times gross. You lost big money, didn't you?"

"But that's what I meant!" Dromedary exclaimed. "It would be terrible!"

"It's not if you can see it coming", Mitochondria said. "If you think values will soften, there is nothing to stop you from refinancing your current buildings and pulling out the most cash you possibly can.

"Presume you refinance your 12 unit building at close to the top of the market. You pull out \$200,000 that you put in a safe place. Time goes by and apartment values have dropped to 6 x gross.

"That \$200,000 you have tucked away constitutes the normal minimum 25% down on an \$800,000 purchase. With values down, that may buy you additional 12 units.

"If your first 12 units cost 10 times gross and the second 12 units purchased after the drop costs 6 times gross, you have an average purchase cost of 8 GIM. You have averaged down your portfolio costs.

"So by doing a cash-out refinance at near the top of the market, you have a reasonable expectation of buying a very satisfactory building if the market drops. If the market doesn't drop, you still have a bunch of "free" cash for you to put to use.

"With only a little thought, you can improve yourself in almost any market cycle. We've just discussed a very simple way to make money in a dropping market. You take cash out when values are high so you can purchase when values are low.

"But how does that answer my question? How can a girl tell almost automatically if a building is a good deal?"

"Do you remember when we said that if your friend can buy structurally sound and cosmetically appealing apartments for 25% down based on current rents, there is a good chance she will do quite well? Well, that's the answer to your question.

"And if you wait long enough, the market may very well return to that level.

"A declining market hurts investors when they own buildings and don't prepare for the down portion of the cycle.

"Investors can grow richer in a declining market when:

- 1: They pull out as much money as they can from their existing buildings and patiently wait for favorable purchase conditions.

2: They have no buildings, but continue to save until good buildings can be purchased with 25% down and a 75% institutional loan.”

Cordially,

Aunt Klarise

Klarise Yahya is an Apartment 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**.