

Letters to Mycroft #54: Life Management of Apartments by Klarise Yahya

To My Dear Nephew Mycroft,

I know you've seen those ads for apartment buildings in Texas offered at five times annual gross income. Do you know why the broker is advertising them in Southern California? Because he's been all over Texas and nobody there wants to buy 'em.

There is an unfortunate tendency to think that properties in Texas are exactly the same as in Southern California. Only the prices are less. That's not true.

There may be sensible reasons to buy out of town, but being seduced by cheaper prices isn't one of them. There are always reasons prices are cheaper, ranging from much higher vacancy rates to heavier taxes and utility costs.

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Beyond lower occupancy rates and higher operating costs, you must also consider that it is reasonable to conclude that Texas properties have appreciated due a long down trend in interest rates, just as properties in California have.

As you know, when we buy income property, we are purchasing a stream of income, called the Net Operating Income (NOI). If interest rates are low, the NOI will service a higher loan amount (\$10,000 of monthly NOI pay for a \$1,552,000 mortgage at 5% interest). With minimum 25% down payment requirements, this building will probably sell for at least \$2,069,000.

Conversely, if rates are high, the same NOI will only support a smaller mortgage (\$10,000 of monthly NOI will pay for a \$1,035,000 mortgage at 9% interest). Assuming the same 25% down, at this interest rate the building is worth only \$1,380,000.

Everything else being equal, when interest rates trend down the value of almost any stream of income will trend up. It's a teeter-totter effect: *Interest rates down / Values up*. Alternatively, *Interest rates up / Values down*. This happens in a similar manner nationwide.

Interest rates are near 40 year lows, and prices for apartment buildings have never been higher. We suspect that, as rates trend up, local building values will soften and we want to move our money out of the local market before that happens. We look for investments elsewhere; say in Harris County, Texas. We notice that pleasing apartment units are advertised there at (I'm making this up) 5 to 6 times gross.

Why would we think that the low interest rates that increased values in Los Angeles did not do the same in Harris County? And if we are worried that higher interest rates might reduce local prices by perhaps one-third, why would we not consider the possibility that the same rising rates may also similarly deflate (remember the teeter totter: rates go up / values go down) Harris County buildings?

While we have no power over the rise or fall of national interest rates, we can improve our portfolio whether rates go up or down. (This is not specific to apartment buildings. Stock investors buy "long" when they think prices will go up, but sell "short" when they think prices will go down).

It's important to recognize that income properties are best thought of as alternatives to the bond portion of our portfolio. Just as with bonds, we buy buildings carefully with the intention of benefiting from their income as we pay them off. Along the way, when we can refinance at a lower rate, we do so.

If we can, we pull out as much money as possible when we refinance and park the extra funds somewhere safe. Thus when rates eventually increase and property values decline, we have the funds immediately available to buy another building.

Here is how we might benefit from rising rates / lowering values. What we're going to do is "average down".

Assume that, this year, we buy a 10 unit building at \$200,000 a unit. Each unit rents for \$1,500. We get a 5% mortgage. As soon as escrow closes, rates start trending upwards and continue for the next 25 years. Values consequently decline.

Time goes by and rates trend upwards. As rates go up, values trend down. Eight years after we bought our first unit, we buy a sister building at \$150,000 a unit. Then another eight years pass, rates continue to increase, and we buy a third identical building for \$100,000 a unit. The third eight year period passes, rates continue their upward march, and values still decline. We buy yet a fourth identical building, but now we only pay \$72,000 per unit. We've managed to buy ever-cheaper units because interest rates have been going up, and now they are at about the same levels they were in 1980.

Why are we buying when values are obviously declining? Isn't that kind of wrong-headed? Well, ignoring the cash flow benefits, after twenty-four years we have 40 units at an average cost of \$130,500 per unit. That's a lot better than where we started, with 10 units at \$200,000 CPU!

Interest rates peak the very next year at 15% and start sliding back down to 5% levels. Rents and expenses have both increased since we started buying, but on average your net income has gone up 3% per year. Rents are now \$3,000 a month for each unit. At 5% interest rates, rent of \$3,000 will support a mortgage (per unit) of about \$275,000. This establishes a reasonable market value (at 25% down) of \$365,000 per unit.

Let's review what has happened. You bought at the top of the market, when interest rates were lowest. As interest rates climbed, you continued refinance and use the proceeds to buy similar properties at decreasing prices. Eventually you had 40 units that you kept as interest rates reversed themselves and began to slide. Values began to climb back up. You did not buy more units as rates dropped, you just refinanced for lower mortgage payments, using the increased cash flow to pay off the loans. When rates completed their cycle (low to high, then back to low) you found that the value of your properties had grown from \$5,220,000 to \$14,600,000. They are, by now, free and clear. Your income, after all expenses, is a comfortable \$70,000 per month.

You have used climbing rates and lowering values to enhance your wealth. Others will be doing this, and so can you.

RECAP: Buy property. As interest rates climb, do cash-out refinances and buy more properties at ever cheaper prices. Continue until interest rates start to cycle back down. At that point, serially refinance for lower mortgage payments and use the cash flow to pay off the mortgage. Eventually you own many units free and clear. That's life-management of the income property portion of your portfolio. It's a good life!

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 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.