

Mitochondria Learns to Invest #12

By Klarise Yahya, Apartment Loan Broker

Continued from last month ...

"How am I going to buy an apartment building?" I shouted. "I rent a house from you!" All the work I'd done to get to where I could start to invest, and now she puts this impossible hurdle in front of me. I felt like I'd been left at the altar.

"You are a bit of a drama queen, aren't you? I think I might have noticed it before". Mrs. Langerhorn did not approve of drama queens.

After a moment, she continued. "Do you recall that there was one investment alternative that was illiquid? It is slow and expensive to sell, but while you own it there is the possibility of both safety and growth. Have you ever given much thought to small rental properties? Duplexes and triplexes and fourplexes? Preferably, of course, fourplexes?"

"You mean two or three or four unit buildings?" Sometimes I mindlessly repeated what the speaker just said. The psychologists called it 'affirmative listening'. I call it 'stupid moments'. "I've never thought of it." I added.

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"Well, let's go over some of the characteristics we might wish to have in a hypothetically 'perfect' investment and see how small units might compare. First, we would want our investment to be financially secure. Do you realize that an owner-occupant can often get 100% financing for up to four units? And that you can get 30 year, fixed rate mortgages? You should know enough by now to understand that if an independent third party – not the seller, not the buyer, but an entity otherwise unrelated to the transaction, a party with institutional memory – will lend the entire purchase price and give you *thirty years* to pay it back, they are saying that in their very extensive experience there is little risk of default. Well, don't you think that should be sufficient evidence of safety for us?"

"After safety, we would want growth. An investment in small units grows in two ways: (a) equity build-up (a kind of forced savings), and (b) cash flow (spendable income).

"Equity build-up happens as the tenants slowly retire our loan. Every time they pay rent, we take a portion and use it to make the loan payment. Most of the payment is interest, but a small bit goes to pay down the principal. As the loan is paid down, our equity increases. Equity is the portion of the buildings value that is really ours. The way you calculate it is: *market value (minus) existing loans = gross equity*.

"Cash flow increases as we raise the rents. Of course, not all of the increase goes directly to your purse because expenses go up as well. But we expect the larger portion of each rental increase will flow right through to the bottom line.

"If your property will support regular rent increases, its value is likely to be appreciating. That is not always true in every market, of course, but it is a good general guideline. Appreciation is when the building's value goes up.

"We do not buy small units specifically because we expect to immediately sell them for a profit. That would smell too much like speculation. We buy small units for their equity buildup and safety of cash flow payments. But as a property's net income increases over time, its market value tends to go up and this automatically increases our equity. So you see, net income and value are joined at the hip.

"Do you recall that I once indicated to you that there were three possible sources of income in investment properties? They were (a) cash flow, (b) equity buildup, and (c) appreciation. Well, there's a fourth source of income. The last stream of income is the tax advantage available in rental properties. We don't invest for the tax ramifications because it seems that almost every time Congress meets they change the tax laws. *Prudent investors don't base long term decisions on what may only be temporary benefits.*

"Small units don't offer liquidity. It takes time and money to buy them, and time and money to sell them. But we can partially offset their lack of liquidity by having a portion of our investment capital in an appropriate stock mutual fund, as we've discussed.

"However, small units do offer safety, cash flow, and the possibility of appreciation. And very importantly, they offer leverage which permits us to buy a building with the 'banks' money. These are all absolutely wonderful things to find in a prospective investment.

"Leverage permits you get higher returns than you could if you paid all cash. Leverage is how you make the 14% or more that we talked about. Here is how it works. Suppose you bought a fourplex (and I'm going to just make up some numbers to illustrate the process) for \$100,000. Annual income is \$10,000. You paid all cash. You bought in an area that was growing in desirability and at the end of the first year, you raise the rents \$1,000 (10%) a year and the building becomes worth \$110,000. Your \$100,000 investment appreciated \$10,000 one year. You made 10% on your un-leveraged investment. For convenience, we're disregarding buy / sell costs.

"But what if you put \$25,000 down and borrowed \$75,000? Everything else stays the same. At the end of the first year, you still make \$10,000 but your investment was only \$25,000. What is your Return on Investment (ROI)? You divide \$10,000 by \$25,000 and you find that you've made 40% on your investment that year. *By using Other People's Money (OPM) and employing leverage, you have benefited mightily.*

"If it was possible to buy that same building with only \$10,000 down, and it appreciated \$10,000 by the end of twelve months, you would have made 100% on your investment.

"If you bought that fourplex with nothing down, as we've noted is often possible using a combination of mortgages, you would be making \$10,000 on an investment of zero. *Your ROI would be infinite.*

"So we put a little money into a liquid account just as a precaution against unforeseen circumstances. Our real money is made in rental properties."

I had to interject. "But, Mrs. Langerhorn, what if it goes down in value? Won't I lose everything?"

"Leverage works both ways. If you paid \$100,000 cash for a building and it went down \$10,000 by the end of the year, you would lose 10% of your investment. If you bought the building with \$25,000 down and the same thing happened, you would lose 40% on your investment. But these are paper losses, and we pay them little mind.

*"Remember that, as investors, all we do is purchase various streams of income! Well, when we buy a building with four units renting for (hypothetically) \$1,000 each, what we are really buying is a stream of income of \$4,000 a month (minus operating expenses). Now it's just a matter of time until the tenants pay off our mortgage. All we have to do is to keep the rents adjusted for inflation, and we know that the building will eventually generate a stream of income of \$4,000 **in constant dollars** (minus expenses) for us.*

"If we accumulate enough of these little fourplexes, our financial future becomes very promising.

"We do not buy properties in the expectation of immediately profiting from a value change. *We buy properties for their net cash flows.* As long as the building is paying for itself and giving us an increasing cash flow each year, what do we care what the market value might be? We bought the property for its income. *We're not planning to sell.*

"If we're not going to sell it, we come to the next step in our program. Do you remember how we penciled out how you could pay off all your debts, including a (hypothetical) mortgage when we first began our teas? Well, once you buy a small building, it becomes your job to pay it off as soon as possible. Once it is free and clear, you become essentially independently wealthy, in that you are no longer dependent on your own labor for your living."

It seemed too good to be true. I asked Mrs. Langerhorn if there were any other common downsides, and she said "Yes, you do have to manage the property, and some people have difficulty with that. For those people, there are local property management companies that will assume the chores."

"But I'm a girl! How am I going to do all the repairs and maintenance?"

She looked at me in that way she had for a moment, then I realized what I said. "Oh, yeah! You're a girl, too! Well, how do you handle that stuff?"

"I joined the local Apartment Owners Association. They normally have a magazine with advertisements for handymen, painters, gardeners, plumbers, roofers, and almost any other useful craft you might wish. Their rates are usually highly competitive, because they know that they are being weighted against the other people advertising in that same magazine.

"The AOA probably has a self-management course, as well. All in all, if you are going to be a landlord, you probably should be a member of your local Association. If there is no Association, get to know other landlords in your area. Swap vendor recommendations."

"But I don't know anything about buying a small building!" I just loved to whine.

Continued next month ...

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.