

## **Mitochondria Learns to Invest #13**

By Klarise Yahya, Apartment Loan Broker

### ***Continued from last month ...***

Mrs. Langerhorn ignored me and continued the lesson. "Let's look at your situation and see if it's reasonable for you to proceed. Didn't you say that you had \$25,000 in the bank?"

"Yes. But you said I should keep some of that liquid, didn't you?"

"I did. So how much will you be keeping in the bank?" she asked.

"How much do you keep liquid?" I quickly responded.

"Like I said, I try to keep 25% of my investable assets (excluding my own home) in stocks. Seventy-five percent is in income properties. Whenever I refinance a building, I rebalance my portfolio to return to that 25% / 75% ratio".

"Ok, so I'll put \$6,250 into a low cost S & P Index fund. That will leave me \$18,750 for purchase costs. Will that be enough, do you think?"

Mrs. Langerhorn replied, "Well, let's see if we can find out. What I would like you to do is to call a couple of local loan brokers and discuss matters with them. Ask them if 100% financing is available for 2 - 4 unit properties. Ask them for a Good Faith Estimate of what your closing costs might be. These may include title insurance, inspections, appraisal, your share of escrow costs, and so on. Then report back to me. Will you do that?"

"Why would I talk to a loan broker? Why not just call my bank?"

She said, "Well, call your bank, too, if you wish. Remember, a bank will be very happy to tell you the bank's programs, but what they have to offer might not be the best for you. A loan broker has access to dozens of loan programs from many different lenders. I think one of your calls should certainly be to a reputable loan broker because she might be more likely to get the loan best for you."

I promised I would do as she suggested. It turned out that I had the information by the next afternoon. This was so exciting! I was finally going to be an investor!

One week later, Mrs. Langerhorn sat at her accustomed seat and sipped her tea. She peered at me over the top of her glasses. She could tell I was just bursting. "So?" she said.

"Mrs. Langerhorn, I think I can do it! I talked to several loan brokers and found one that seemed really helpful. I can buy up to four units with nothing down! Briefly, here is an outline of what he told me." I looked at my notes and began reading.

"Four units are not an apartment building. Apartment buildings start at five units and go up from there. Loans on five units or more require a minimum of 25% down, and they are almost always adjustable rate mortgages. You might get the first few years at a fixed rate, if you pay for the privilege, but after that the loan becomes adjustable.

"But anything under five units, like a condo or single family house or a duplex / triplex / fourplex is financed like a regular house. And, if you have reasonable credit, and will live in it, loans up to 100% of purchase price are available.

"You have to be able to make the mortgage payments, of course. But the banks will usually allow up to 75% of the rental income to go towards the mortgage plus some portion of my personal income". I was talking fast, I knew, but I couldn't help myself. This was so exciting! Maybe I wouldn't have to wind up like my parents! But then I thought of something.

"If I buy my own property and move out, what's going to happen to this house?"

You are so good to me, and here I go and treat you like this!" I said to Mrs. Langerhorn. I really didn't care. She looked like she could take care of herself. But I wanted her to think I cared.

She smiled at me, in a soft kind of way. "When you move, I'll sell the house. You see, this property was a dedicated purchase. I bought it twenty-five years ago and paid it off early. You remember how you paid off your debts? Well, I put enough down to give me a break-even property right from the beginning. Then I just put the entire net cash flow towards paying off the mortgage. It's been free and clear for a long time. And after it was paid off, I began putting the net income into a separate S & P Index Fund.

She took a sip of tea. "I bought the house because I promised I'd pay for my sister's grandson's college expenses. I thought that if I bought a house when he was born, and paid it off by the time

he was ready for college, then I could sell the house and fully fund his education. So this house was a dedicated purchase. It was bought as a vehicle to reach a specific goal.

"But the cash in the fund has grown over the years and that, plus the rent you've been paying me, paid for his schooling. He's got his doctorate now, and my obligation is over. It's time to sell the house".

"Sell it to me!" I cried, but was thinking he's a doctor? And now she's telling me? Is he single? How am I going to get her to introduce me? I think I was starting to sweat.

"It's a rare investor that likes single-family houses", she said quietly. "If you live in it, your costs of ownership will, at least at first, usually be much greater than the rent you're paying simply because your mortgage will be higher. Then you've got all the maintenance and upkeep to think about."

"Is it hot in here?" she asked. "You look a little flushed."

"No", I said, "I'm fine".

Mrs. Langerhorn smiled. She must have guessed what I had been thinking. "He officially received his doctorate on a Friday and got married the following Sunday." It was like she could read my mind. "She's a beautiful young girl. He loves her very much. They were high school sweethearts, you know"

"Getting back to buying a single family home to rent out, unless you put a big amount down you will almost certainly have a negative cash flow. That means that the total costs of ownership will be higher than the rent you receive. You will, in effect, be subsidizing the tenant's living costs. And if the tenant moves out, you will have 100% vacancy factor. You will have to make the payments out of your personal income while at the same time you are renovating the property to make it desirable for the next tenant.

"But if you have a fourplex and somebody moves out, you only have a 25% vacancy ratio. There is the income from the other units to help with the payments. Moreover, when you pay the mortgage off you can retire regardless of how young you might be".

"I could retire? No matter how young I am?" This was getting better and better.

"Most people pay about 25% of their income for housing, don't they? If you live rent-free in a paid-off fourplex, you have the rent from the other three units to support you. You are in the same financial position you are now, except you no longer have to get up in the mornings ... regardless of your age." Mrs. Langerhorn dabbed at her nose. She was coming down with something.

"Ok, let's review what you've discovered. If institutional lenders will permit up to 75% of rental income to be applied towards the mortgage, then let's put some numbers to it and see what we come up with", she said. Mrs. Langerhorn was always interested in the bottom line.

"Please get out your financial calculator and do the math. I'll just make up some numbers so we can develop ratios. If the monthly rent is \$1,000 and \$750 can go towards the mortgage, how much mortgage debt will be supported by each unit? Pretend interest rates are 8%."

I'd read the book that came with the calculator. I knew how to do this. I punched in the data and pressed the last button. I found that at current interest rates each unit would support about a \$100,000 mortgage. I told Mrs. Langerhorn the result.

"Fine", she said. "Then what price range will be affordable to you?"

I must have had a deer-in-the-headlights look, because I had no idea what to say. Mrs. Langerhorn came to my rescue. "You have established that at current interest rates, you can buy a property at no more than 133 times whatever portion of the monthly rental income counts towards the mortgage payment. So if the property rents at \$1,000 a month and \$750 of that is allowable towards the bank debt, then that \$750 will support  $(\$750 \times 133)$  \$100,000 of mortgage and you will have a good chance of the building paying for itself. Under these conditions, if you buy a fourplex capable of generating \$4,000 in monthly rent your price range will be up to \$400,000."

"If you go to a cheaper part of town and find that rents are only \$600 a month, how much could you pay for a fourplex?" I knew she was testing me to see if I understood the process.

"Well", I started, "interest rates won't change just because I want to buy across town, so my multiplier will still be 133. And the percentage of rent allowed towards my mortgage will be the same. So here goes: 75% of \$600 is \$450. And \$450 multiplied by 133 is \$60,000. So I will be able to offer \$240,000 for those four units". I felt kind of cocky.

“Good job. But I want to caution you about something. If you look back over your numbers, you might come to the conclusion that \$1,000 of rent will automatically support \$100,000 of mortgages, and \$600 of rent will automatically support \$60,000 of mortgage. Taking the monthly rent and multiplying it by 1,000 is a shortcut that only works at certain interest rate levels and at certain expense levels. That’s why it is always best to work the data out the long way before actually shopping.

“Also”, she added, “there are expenses associated with operating a building. You will need to make arrangements to pay property taxes, insurance, and maintenance out of your own pocketbook”.

“So am I ready to go shopping for a building?” I asked, trying hard not to be too eager.

“Don’t sign anything until we talk some more. You’re not ready to buy yet. But, yes, it’s time for you to go shopping”. *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.*