Re-positioning of Symphony 10-unit

by Ben Leybovich

Introduction

On January 5th, 2014, I posted an article on my blog at www.JustAskBenWhy.com entitled *How to Build Wealth with Rentals – A Case Study*. I coined this transaction the Symphony Deal, and it was a re-positioning of a 10-unit apartment building. I had purchased Symphony in February of 2013, and I set out to write about this transaction because it is a classic turn-around project, encompassing a lot of the core principles behind making big cash flow and building big wealth through real estate investing, and I thought that my readers would find it interesting and educational.

In *How to Build Wealth with Rentals – A Case Study* I walked you through the underwriting process for this deal, what I saw in terms of value add, and what ended up being my eventual business plan for Symphony. I also provided you with some of the details behind my acquisition plan relative to the creative financing, since I figured you'd be interested in knowing how I was able to finance a $373,500 acquisition with only $5,300 out of pocket.

This eBook is meant to pick up where that article left off. You already know what the plan was, and now you'll find out what actually transpired over the first couple of years of my ownership of Symphony. I'll describe how by 2014 Symphony had put $12,000 of annual cash flow on my income statement and $100,000 of equity on my balance sheet. If you haven't read the article that started it all, please follow the link at the top; I will provide a summary here, but not all of the details.

And with this – let's dig in:

To Review the Facts

At the time I wrote the article on my blog I had been owner of the Symphony 10-unit for about one year. Let us now briefly recap the highlights of what was previously said, specifically as it relates to the numbers in the transaction.

As you remember, the Symphony 10-unit is actually two 5-units sitting next to one another:

The buildings were constructed in 1980. They are, as you can see, 2-story. The units are town-homes, of which 4 units are 2-bedroom 1.5-bath, and 6 units are 2-bedroom, 1-bath. The buildings are all-electric, and both electric and water services are separately metered. The owner is responsible for payment of sewer and trash.

At the time of acquisition I could see a fair amount of deferred maintenance, however, exactly how much did not become clear until later...more on that in a bit.

Financials at Acquisition

The projected Gross Income at the time of acquisition was $5,805/month and the NOI (Net Operating Income) was projected at $3,406/month. It is important to note at this time that there is a big difference between projected and actual financials. Projected numbers are what we refer to in real estate investing as Pro Forma - it is numbers that we anticipate and that we use on paper or excel spreadsheet to build or model for the investments. These projections are not real until they've been proven. However, we have to start somewhere, and having done my research those are the numbers I came up with.

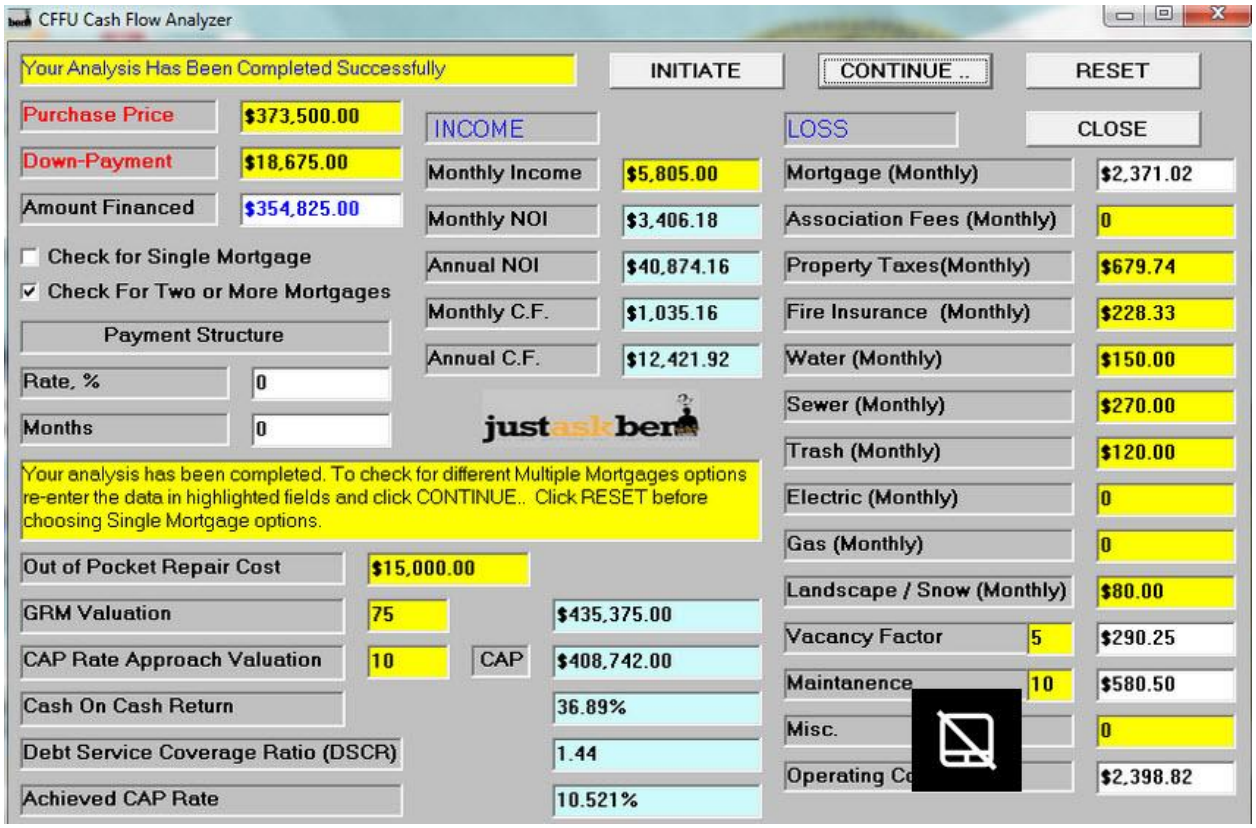
I paid $373,500 for Symphony, and I was able to finance a total of $354,825, which represents 95% LTV. For those who may not know, LTV stands for *Loan to Value* - it's a number which juxtaposes the amount of debt against the value of the asset. Most often, when the financing is for a brand new purchase, the contract purchase price defines the value of the asset.

Thus, in my case, since the purchase price was $373,500, and the total amount financed was $354,825, this relationship is 95%, since $354,825 is 95% of $373,500.

My financing package on Symphony included an institutional portfolio loan for 70% of the acquisition price, and a private 2nd position note in the amount of 25% of the purchase price. Both of these totaled

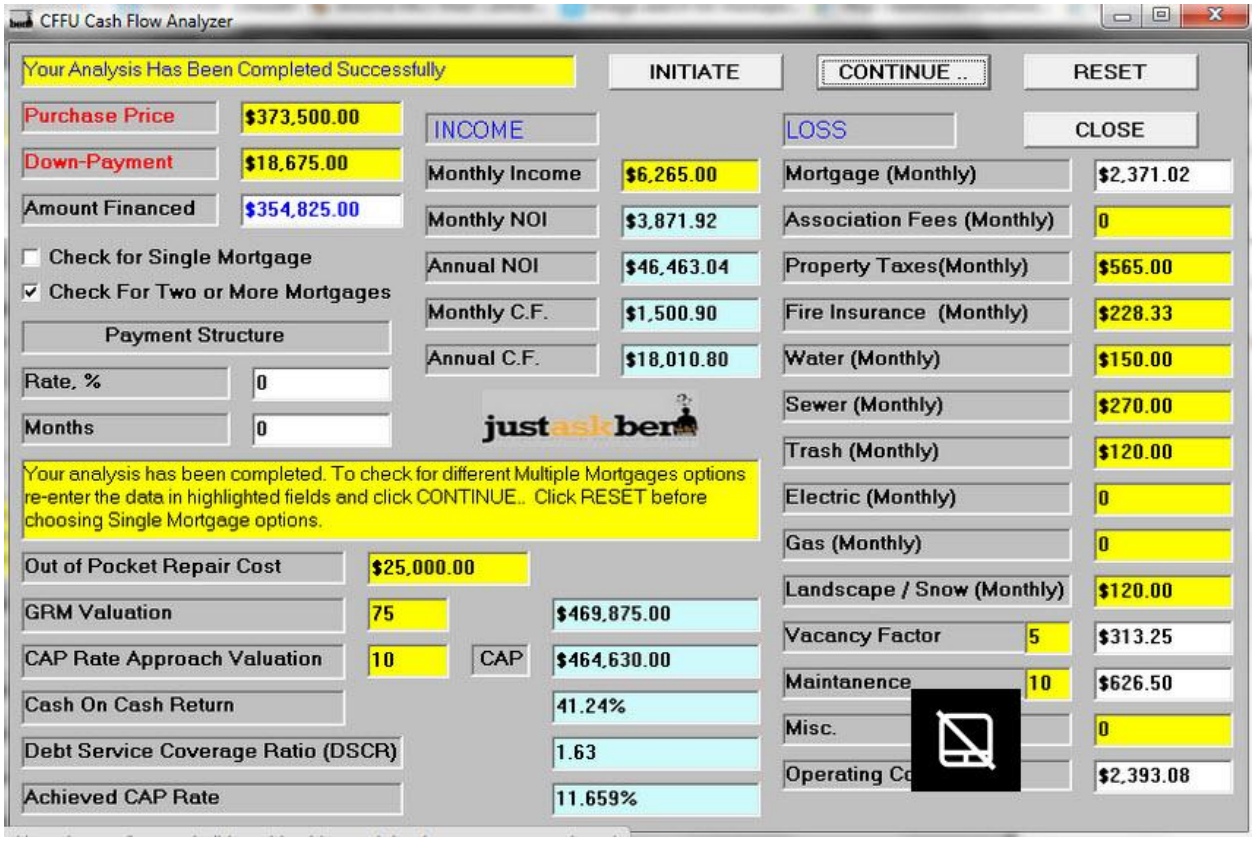
$354,825, which left me with having to come up with the difference of $18,675 – 5% of the purchase. However, after all pro-rations and credits, I came to closing with around $5,300...

With my financing in place, the Pro Forma Cash Flow after debt service stood at about $1,035/month - basically $100 per door. Below is the screenshot of my Cash Flow Analyzer software showing all of the numbers in my Pro Forma underwriting:



Value-Add

I discussed the specifics of how I was planning on doing this in the blog article, but the bottom line was that I thought that by raising rents and lowering costs I'd be able to push the cash flow to around $1,500/month ($18,000), at which point the numbers will have looked like this:



This was my plan in 2013; this was how things looked on paper, so to speak. Let us discuss in real terms now how to make money in real estate investing...not on paper, not the projections, but real stuff!

Cash Flow After 11 months of Ownership – The Reality…

I bought Symphony in February of 2013, which meant that I had the building in my portfolio for 11 months in 2013. Would you like to know how much real cash flow I made on Symphony in 2013? Hold onto your knickers – having done my P & L as part of my tax reporting, it became painfully clear that in the first 11 months of ownership I managed to earn a whopping **$3,000** on Symphony.

That's right, not $18,000, as I'd hoped, and not even $12,000, as I projected; miserable $3,000 was all I got for my efforts in that first year.

In addition to normal unit turn-over, I had to deal with more evictions than I anticipated or could have imagined, the first of which took place in the very first month. These evictions were accompanied by more repairs and more months without rental income than I ever thought possible. I had CapEx expenses to rectify deferred maintenance issues in the tens of thousands of dollars, a lot of which had to be deployed much faster than I'd planned. I knew when I bought Symphony that I'd need to spend money to rectify delayed maintenance issues, but I planned to do it over a couple of years by recycling my cash flow. This wasn't how it turned out – I had to borrow from my floats!

I essentially broke even in 2013, but only barely. Think of it this way – I failed in that this investment did not produce anywhere near the desired ROI; however, I succeeded in that the building paid me back everything I had spent on it that year, plus put $3,000 in my pocket.

But, as they say, while I can put lipstick on this pig all I want, the facts are what they are. $3,000 of cash flow was not why I bought Symphony. Indeed, I bought Symphony for $12,000 with hopes of valu-add to $18,000…not $3,000. I remember thinking – did I mess up…?

That first year with Symphony really shook me. While I absolutely did anticipate significant head-winds, what actually transpired was a whole lot more painful than anything I'd imagined beforehand.

Perhaps you can extrapolate value from this for your own benefit...

We Arrive at Year 2:

Well, in the second full year of ownership (2014) I still did not clear the $18,000 of Cash Flow that I'd hoped for; this is the bad news. However, the good news is that Symphony certainly did a lot better in 2014…a lot! And even better news is that I do think that in year 3 Symphony will indeed have a fighting chance to get most of the way there toward $18,000 of annual cash flow. Let us consider what happened in year 2…

As of December of 2014, according to the T12 P & L my cash flow on Symphony stands at right around $12,500. This means that the cash flow in 2014, the second year of ownership, was at about $1,000/month average, which is what my Pro Forma at the outset of this deal indicated as the bare minimum. I've made my way back to even keel as it relates to my expectations at the outset of this deal. Better late than never, as they say, but it sure wasn't all fun... And, I haven't really made any inroads into any value-add; all I've done is stabilize the asset.

There was Some Good News:

First of all, even if what Symphony did in 2014 (meaning $12,500 of cash flow) is in fact the best that the building is capable of, it's not a terrible thing. Remember, Symphony was financed virtually 100% with only $5,300 out of pocket. I think you would agree that to own a building capable of generating $12,000 of pre-tax cash flow with having only made a down-payment of $5,300 is not too bad of a deal! And it gets better…☺

Status of CapEx

First of all, you need to know that in 2014 I had spent about $7,500 on CapEx items. What is CapEx - it is big-ticket delayed maintenance items, or capital expenses, which have to be rectified if the building is to continue operating as designed; no other way, unless you are going to be a slumlord... These items

include things like roofs, windows, appliances, HVAC, water tanks, flooring, cabinets/counter tops, etc., and I did all of that!

I spent about $15,000 on these CapEx items in 2013, which is why my cash flow was a miserable $3,000; I was essentially re-investing everything I was making. This, in and of itself is OK – that's the nature of the beast with these re-positioning projects. However, because so many of these expenses happened so much quicker than I'd anticipated, I was unable to simply re-invest cash that was coming in. Instead, I had to fund all of these big-ticket items.

Well, I am embraced to admit to it, but I came into this project undercapitalized, and had to borrow from myself and wait to get paid back…not the best way to handle this business, but we do what we must! I learned for the future ☺

In the end, having spent $15,000 in 2013 and $7,500 more in 2014 on CapEx I am obviously on the right trajectory to get control of the delayed maintenance, and I have normal levels of expendatures to look forward to.

And what is normal CapEx for a building like this? Well, normal levels of CapEx for a 1980 building such as Symphony should be in the range of $350 - $500/door/annum, meaning that once the deferred maintenance is caught up, I really shouldn't be spending any more than $5,000 - $6,000 on CapEx per year. Presuming that I am correct, this should add at least $1,500 annually to Symphony's cash flow, bringing it up from the current $12,500 in 2014 to at least $14,000. I do think that this is very achievable in the third year of ownership!

Also, looking at the P & L, I know exactly what the problems were in 2014 - I know which units caused issues and why, and I think that I can make progress on those in 2015. All and all, I think that I can push the total cash flow from Symphony to $15,000.

Obviously, though, even this will still fall short of my projection of stabilized cash flow of $18,000. However, I do still have another trick up my sleeve :)

Financing

Understand something – financing Symphony at 100% came at a price. My payment on the second mortgage runs right around $700/month, which is steep. The good thing is that once that's cashed out, the $700/month ($8,400/year) will stick to me in the form of additional cash flow. That, in and of itself, would get me to $20,000/year CF based on 2014 numbers. The bad thing was that since the 2nd note was a balloon, leaving it in place was not an option. For better or worse I had to do something – I had options…

Two Options

One option was to just pay it off organically. In 2014 I still had 5 years left on the 7-year balloon, and I could do this by throwing some cash at it every month. However, while certainly possible, this was not appealing, because to do this I would have had to allocate about $1,500/month of cash, and while my portfolio can certainly handle it, it didn't appeal to me. Think about it - $1,500 per month for 5 years ($90k in total) in exchange for increased cash flow of $700/month, or so. Not smart; not to mention that all I'd be doing is "buying" cash flow, which I never do. I create cash flow – I don't buy it…

Thus, while this was an option, it was something I'd only do as a last resort.

Another option was to refinance the building with a fully amortized note which was large enough to wrap both existing mortgages together, thereby alleviating the necessity to throw money at it. Doing so, however, is a function of 2 things. One - my portfolio has to qualify relative to cash flow. And two - Symphony must appraise for high enough.

Well – as history books (and court records) recorded, I took door number 2. Indeed, once Symphony was verifiably stabilized in 2014, I was able to arrange for a refinance of this project. Symphony appraised at $450,000, which meant that I was able to wrap the balance on the existing 1st mortgage with the 2nd private note into one fully amortized loan.

This refinance lowered my monthly debt service by about $135/month. The new loan is a standard portfolio note with a 20-year amortization. And yet, since the interest on the current loan is so much lower than the private 2nd was, my over-all debt service has gone down. Essentially, this is $1,600 of annual Cash Flow that I won't have to work for, and it'll be there in perpetuity. And with this little bump to the cash flow, I am reasonably certain that $15,000 - $16,000 of annual CF is achievable in year 3.

Finally, and this is just a side-note, my new debt is $351,000, which means that I get to stick $100,000 on my balance sheet. But, that's incidental…

What Is the IRR? The Big Picture.

The internal rate of return is how we should underwrite income-producing deals. The IRR tracks all of the income and expenses while assigning value to time. It also necessitates that we project the exit, since the capital gains on the back end is one of the income streams.

With this in mind, in order to calculate the IRR on any deal, including Symphony, I'd have to anticipate an exit, in terms of when I sell and for how much. This necessaity of projecting the investment plan all the way to the exit is one of the reasons why underwriting to the IRR is so effective; it forces us to be pro-active and precise, and to plan things out!

The issue with projecting an exit on Symphony, however, is that it's not immediately apparent to me how I would invest the proceeds in order to generate comparable returns?! In 5 years Symphony will put as much in my pocket via CF as it would if I sold for capital gains, and considering I have no money in the deal, even if adjusted to NPV (net present value), those cash flows are more than anything I can do with the proceeds from the sale.

But, just for conversation's sake, let's figure out the IRR if I were to sell in 2017, having held the building for 5 years. We will assume a sale price of $425,000, which is $25,000 under the current appraised valuation. Let's also assume cash flows going forward of $12,000/annum, though, as I stated above, I think I can do better. Finally, let's not take into account any principle pay-down, since if we did that, to be fair we'd have to take into account recapture of depression, and that's more than the scope of this eBook intends to outline.

Thus, the distributable capital at the end is sale price less the starting balance, with $12,000 CF for that year added in (assuming I sell in December):

Table 1: 100% Leveraged IRR Calculation		
Exit Price	$	425,000.00
Starting balance on note:	$	351,000.00
Initial Investment	$	(5,300.00)
2013 CF	$	3,000.00
2014 CF	$	12,000.00
2015 CF	$	12,000.00
2016 CF	$	12,000.00
2017 CF + Distribution	$	86,000.00
IRR		146%

The IRR is 146%!

What you need to understand is that the reason the internal rate is so high is mostly due to a very low cash investment at the front door. Just to demonstrate the difference, let us construct an IRR projection on the same property, but with a 25% down-payment. This would mean a much higher initial investment, but also higher cash flows throughout due to the fact that because of the down-payment the debt (and debt service) is much lower, resulting in higher cash flow:

Table 2: 25% Down IRR Calculation	
Exit Price	$ 425,000.00
Purchase Price	$ 373,500.00
Down-Payment (25%)	$ (93,375.00)
Starting balance on note:	$ 280,000.00
Initial Investment	$ (93,375.00)
2013 CF	$ 10,000.00
2014 CF	$ 19,000.00
2015 CF	$ 19,000.00
2016 CF	$ 19,000.00
2017 CF + Distribution	$ 164,000.00
IRR	24%

Conclusion

Guys, I could not have done the Symphony Deal 10 years ago. Intellectual worth is in large part a matter of perspective, and perspective only comes with time and experience. Simply put, I could not have wrapped my brain around all of the moving parts that a deal like Symphony requires. And today, I don't even look at anything under about 100 units…

I touched on a lot of concepts in the eBook. Much more specific discussion of all of this concepts and more importantly their application, can be found in the **Cash Flow Freedom University**. If you are serious about learning the nuts and bolts of this craft please consider CFFU – you won't be disappointed!

Good luck to you in all of your endeavors,

Ben Leybovich