

Cash Flow ... Defeated by Leverage

By Robert M. Locke

As I watch new investors buy houses I see an increasing demand for “positive cash flow along with highly leveraged financing”. New investors want to buy a \$200,000 house with \$8,000 down and have rent cover their monthly expenses. This, and other unrealistic expectations, keeps investors from buying good properties in this expanding and profitable market.

It doesn't take a genius to figure out that Atlanta is just coming out of four years of sliding rental rates. It all started in 2001 when the resale and new home market slowed from it's frantic pace of the 90's. Aggravated by 9/11 and the stock market crunch, slow housing sales resulted in bulging inventories for the rental market. Increasing inventories, and fixed demand, resulted in lower rents for both the apartment industry and single-family homes. In 2004 we leased a \$1,400 home for \$200 less per month than we did in 2000.

The slide hit bottom last year. **Today, applications are the strongest we've seen in five years and rents are inching back up.** Hopefully, we are on our way back to a normal rental market.

So what's the problem? Generally investors do not like putting a lot of cash into each property. Leverage has advantages but in the near term the Atlanta rental rates may not support a 30-year fixed-rate loan, taxes, insurance, management fees and maintenance with 10% down unless you manipulate the financing. We'll get higher rents in the next few years, but today, investors are using other strategies to keep negative cash flow to a minimum. Here are some examples:

1. **Buy houses 20% under market.** Buying foreclosures, or bank owned properties, well below market value can set your payments low enough to give you break even cash flow from day one. Buying this way is hard to do on a consistent basis and cannot be relied on for a regular supply of quality properties.
2. **Manipulating the loan** is another common way to make the short-term cash flow work. Five year ARM's, interest only loans, pay option loans, buy downs and no payment seller

seconds are good ways to keep payments inordinately low for the next three to five years. These are good strategies to get you through the trough in our rental rates. In another 2 to 3 years the rental market will get strong again, rents will be up, and positive cash flows will return.

3. **Lease Purchase the property** with higher than normal rents by giving up some rent credit. Sometimes tenants will pay more than fair market rent if they get the increase credited against the price of the property at closing. This strategy will strengthen the current cash flow for a while but you will feel it at the closing. If you've trapped a good spread in the deal this strategy is more than smoke and mirrors. We use this lease purchase strategy regularly to address the short-term cash flow challenge.
4. **Buying down the interest rate works as well.** Occasionally the seller is motivated enough to pay the lender costs of buying down the loan rate for the first three years. This strategy will lower your payments for two to three years and give the Atlanta rental market time to recover.
5. **Larger down payments are always a sound strategy.** Leverage isn't always the best way to buy good properties. Sometimes it just makes sense to use more capital. Twenty percent down takes more resources but if you can transfer some capital out of the stock market, or leverage the equity in your other properties, this could make sense.

Remember: rental rates are coming back. Now is a great time to buy an investment property in Atlanta because the soft rental market is behind us, prices and interest rates are on the rise, and rising rents will soon turn your properties into good positive cash flow investments.

Robert Locke is owner and Broker of Crown Realty & Management Corporation; "The Real Estate Investor's Choice" ®. Crown helps investors locate, buy, finance, rent, lease purchase, sell and exchange investment houses in the North Atlanta suburbs. Crown has guided investors in the acquisition of over 1,000 houses and 400 lease purchases. See more at www.CrownGeorgia.com