People and Property:

How to Buy an Apartment House

by EMANUEL B. HALPER with WILLIAM SEEVE

Harry invited me to lunch. He promised me something really special.

Harry seldom got so personal. I assumed that all this attention arose because I had been nagging him to bring his account up to date.

On our way to lunch, we sat in the back seat of his Fleetwood Cadillac. As he offered me a drink, I began to broach the subject.

"Harry, there's. . . .

The car stopped. His chauffer opened the door and we entered the Bracciole Hero Shoppe.

Harry remarked that the Bracciole was his favorite source of hero sandwiches in the whole wide world. He ordered a concoction which included meatballs, four different kinds of salami, bologna, provolone cheese, lettuce, tomatoes, peppers, and onions. I stuck to veal and peppers.

We sat down, and I got to the point right away. "Harry, it's really swell of you to take me here. We haven't sat down for lunch for almost a year."

Harry: "Yeah, that's when you bugged me about your bills last."

I: "I'm glad you mentioned that Harry. You know I have to pay rent every month. My secretary insists on getting paid regularly. You know the office has grown. We have a big payroll."

Harry: "Don't you think I know you have troubles. I sympathize. I paid you \$800 this month alone."

I: "But you rolled up new bills of \$3,000 this month alone, and you owe us \$70,000 all told: Some of your bills are a year old. They've shriveled a bit and they're stained with coffee."

Harry: "Look I've been loyal to you. You have to think of my problems too. I have a payroll and rent too. Remember I'm in the construction business. I'm borrowing money all the time. It's expensive to borrow money. You've been wonderfully patient. That's your nicest attribute. Don't worry about it. It's no problem. Old Harry will take care of everything in due course."

I was about to explain to Harry that it was not

fair to me if he saved interest simply by not paying my bills, when my tooth broke on a piece of veal. The result was so painful that it took my mind off my attempt to get Harry to pay up.

Harry: "It's only a tooth. Don't press the panic

As the pain throbbed in my jaw, Harry advised me that he had scheduled an important meeting for tomorrow.

Harry: "For the first time in my career I'm going to buy an apartment house. Isn't that good news. And it's good news for you. You can represent me in the deal."

Harry described the building as a twenty-story modern structure that adjoined the lakefront. There were nineteen three-bedroom apartments, thirty-nine two-bedroom apartments, sixty one-bedroom apartments, and sixty studios. The annual rent roll from all of this was \$400,000.

Harry asked how much he should pay for this package. He knew that the seller wanted \$1 million cash with the buyer assuming the existing mortgage.

I: "Harry you can't figure out how much the purchase price should be from the facts you've given me. Owning an apartment house is similar to operating a manufacturing business. It's not a passive investment like some shopping centers. People live there and demand services. What I need to know is, what is the net return to you after all prospective income is added up and prospective expenses are deducted. Also, I'd like to check the possibilities of depreciation deductions to see to what degree your return on investment will be subject to income tax."

Harry: "Just like a lawyer. I can't get a straight answer to a simple question. We'll have to have a meeting tomorrow with the seller."

I: "Harry, please don't make me go to a meeting tomorrow. I have a terrible toothache. I've got to go to a dentist. I hope I can get a dentist to take me without an appointment."

Harry: "Don't worry, I'll fix it."

I: "You can't fix teeth, Harry."

Harry: "No, no. I mean I'll get you an appointment with my kid brother Gary. He's one helluva terrific guy."

I: "Harry, I'd like to meet your family. We

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haven't really socialized. But I need a dentist—and right away."

Harry: "Gary is one helluva terrific dentist."

The following morning at 8:50 a.m., I arrived for my appointment with Gary. Gary had a beautiful office. The waiting room was compact, but could seat eight people comfortably. All the magazines you ever heard of were staring me in the face. So too were Marsha, Judy, Elaine, and Arlene. They were Gary's staff dressed all pristine in white nylon miniskirts.

Elaine, the bookkeeper and receptionist, explained, "Doctor is a little late."

The other three led me into a small room, strapped me into a reclining chair, swathed me with an enormous bib, and shined a piercing light in my eye.

Twenty minutes later, two young men entered. Apparently they were Gary and a younger dentist who was greeted as Dr. Kronkite.

Gary introduced himself.

Gary: "I hear you're a real expert on apartment houses. I own quite a few."

I: "I thought you were a dentist."

Gary: "I am, but a guy's got to invest his money in something. I've been talking to my brother about going in with me on a twenty-story job right on the Lake."

1: "Look, the tooth broke back there!"

Gary: "It has nineteen three-bedroom apartments, thirty-nine two-bedroom"

I: "Owwwww. My tooth hurts."

Gary: "And there are sixty one-bedroom apartments."

The front door opened, and I heard four women squeal and fawn upon a male figure which I recognized as Harry. He was accompanied by his faithful companions, Big Irving and Jack. It dawned on me that something was fishy.

Harry told me that since he couldn't bring me to the meeting, he decided to bring the meeting to me. The seller and his lawyer would be here soon.

I got out of the chair.

Big Irving had all kinds of statistics that Gary had given him. We began to sift through the data to see what our bargaining strategy would be. Irving advised that the building employees were a superintendent, two assistants, and two doormen. Jack had been to the tax assessor's office and told us that last year's real estate taxes imposed on the building were \$65,000.

We lined up the income and expenses as best we knew or could guess them:

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Apartment rentals	\$400,000	
Less allowance for vacancies at 3% of rent roll	-\$ 12,000	
	\$388,000	
Washing machine income Parking fees	\$ 3,000 \$ 20,000	
	\$ 23,000	\$ 411,000
EXPENSES		.5411,000
First mortgage at 7% interest (original balance \$2,500,000; present balance \$2,400,000) principal and interest (constant .082%) Real estate taxes Estimated repairs Supplies Insurance Heat Payroll and payroll taxes Management	\$20\$,000 \$ 65,000 \$ 18,000 \$ 8,000 \$ 15,000 \$ 8,000 \$ 17,000 \$ 10,000	
	\$346,000	\$346,000
		\$ 65,000

Harry looked at the numbers. Then he reviewed the numbers. Then he reviewed his review. He glanced at Gary and murmured that there was no way that he would consider investing one-half of a \$1 million purchase price for half of a \$65,000 return. Harry measures his return in cash-flow terms. When computing cash flow, he considers mortgage amortization as an expense but ignores depreciation. In other respects, cash flow is computed like net income

Harry: "Only dentists with bad breath would consider such a stupid investment."

Gary: "Don't be vitriolic, Harry. All I told you was that the seller was asking a million over the mortgage. I wouldn't pay an asking price even if it were a bargain."

Harry: "That's more like it, kid. Now you sound mature. Like a businessman. I'm proud of you. Let's offer the guy \$400,000."

Gary: "Let's offer him \$300,000."

Irving: "Why don't you try \$200,000 and let him bargain you up."

As Harry, Gary, and Irving chattered, the offering price declined still further.

A piercing cry interrupted the strategy meeting. We ran to Dr. Kronkite's room, where a tall, scholarly-looking man was lying helpless on the dentist's reclining chair. Kronkite's knee was pressed firmly against his chest, and the doctor's fingers were in his mouth.

I: "Gary, you know who that is, don't you."

Gary: "I don't give a damn as long as he pays his bills promptly."

I: "Gary, that's Richard Essex, the famous author. Haven't you seen him on TV?"

Gary's face choked with emotion, and he turned on Kronkite.

Gary: "Let him out of that chair now. Do you hear me!"

Gary restrained Kronkite's elbow, while Essex slipped under the drill and freed himself.

Essex: "What kind of an asylum do you run here? I come to sell an apartment house, and five characters descend on me. Suddenly I find myself in a dentist's chair, and someone's drilling and screaming."

Gary: "Calm down. I'll give you an analgesic if you like. Then come into my office and we'll get moving on the deal."

We all crowded around Gary's desk and started discussing the purchase price.

Gary spoke up first. In an effort to show Harry just how mature and suave he was, he twisted the facts a bit and claimed that his calculations indicated that the building's cash flow was only \$45,000. As Harry beamed with pride, Richard Essex indicated that he was nobody's fool.

He proved to his own satisfaction that the cash flow was in the neighborhood of \$75,000. Of course, to him \$1 million over the mortgage was an asking price, but he guessed that since the buyer was a dentist, and hence had more money than cunning, he might get \$800,000—all cash.

As Richard Essex's asking price slipped down to \$700,000, Gary's offer crept up to \$500,000. But they could come no closer. The brothers believed that the property yielded \$65,000, and they considered a return of less than 13 percent immoral.

Finally, I made a suggestion which I thought might make them all happy.

Gary and Harry could pay Richard's price of \$700,000 and get a return of almost 12 percent on the cash they invested *if* only \$250,000 would be paid in cash. The payment of the balance of \$450,000 would be deferred, and secured by a second mortgage. The debt service on the deferred amount would be 8 percent of \$450,000 (\$36,000 a year) including 7 percent interest on the unpaid balance as of the time of each payment, with the remainder amortization.

Here is the effect of that offer on the buyer.

When the cash and the deferred payment are

added to the unpaid balance of the existing first mortgage loan, the total price becomes \$3.1 million:

First mortgage	\$2,400,000
Cash	250,000
Second mortgage	450,000
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After giving effect to the \$36,000 second mortgage payment, the cash flow, as estimated by Gary, would be \$29,000 (\$65,000 \$36,000).

This \$29,000 would represent an 11.6 percent return on a \$250,000 cash investment, which is not considered especially handsome for an apartment house deal. But it could be very attractive if the yield proved to be partly or totally sheltered from federal income tax. The tax shelter would result if the tax deductions arising from depreciation of the building they bought exceeded the amortization on the first and second mortgage loans. Since the brothers hoped to be able to deduct around \$70,000 a year for depreciation of the building, and the amortization of the two mortgages would start at \$41,500, almost all of the cash flow would be sheltered for the first few years after the investment was made.

There are tax advantages to the buyer for the total purchase price to be high and the cash paid at closing to be low. Gary was in the highest state and federal tax bracket. So you can guess what kind of a taxable return he'd need to match 11.6 percent tax-free.

The bargain was sealed with a three-way hand-shake.



While Richard Essex exchanged his autograph for a nurse's telephone number, I asked Irving to review some of the figures he collected. There was something that needed checking. There can be some unusual expenses in these transactions which can make the initial cash investment a lot more than originally contemplated. For example, the seller could come to the closing with real estate taxes paid up substantially in advance. In some places, taxes are paid a full year in advance. At the title closing, the buyer is expected to reimburse the seller for those advance taxes in cash. Similarly, the buyer can find insurance premiums paid up to three years in advance.

The buyer is also expected to reimburse the seller for oil in the building's fuel tank, deposits made to utility companies, and prepaid expenses. In addition, some first mortgagees require an escrow fund for taxes and insurance premiums. These escrow funds can build up to substantial amounts for which the buyer will be required to reimburse the seller at closing. Although these items are ordinary operating expenses, they should be considered part of the cash investment. Unless these prepaid items are balanced by adjustments in favor of the buyer, they have the effect of reducing the buyer's yield because they increase his cash outlay at the closing. Other expenses that increase the cash investment and reduce the cash yield included transfer taxes and mortgage recording taxes. There are also title insurance expenses and legal fees.



On the other side of the coin, the cash payment at closing is normally reduced by an adjustment for a portion of the interest portion of the first mortgage payment which comes due next after the closing. But the balance of adjustments and closing expenses normally works against the buyer.

Essex was prepared for all contingencies. He whipped out a contract prepared for him by his lawyer, carefully crossed out the figures in the purchase price section, and filled in the newly agreed-upon numbers. Essex, who considered himself a match for any lawyer, figured he could keep his legal fees down by doing his own negotiating.

He demanded a \$75,000 contract deposit with which he intended to pay last month's American Express bill and a bit of alimony (including some arrears on both). This deposit, he averred, should

total 10 percent of the price over the first mortgage. Gary agreed that 10 percent was customary, but insisted that the down payment should be 10 percent of the cash portion only, or \$25,000. Since it's always possible that the deal might not be consummated even after a contract was signed, we convinced Richard that the down payment should be held in escrow by his lawyer until the closing and that the liability of the buyer should be limited to the down payment.

DEFERRED PAYMENT

Although the arrangement to defer part of the purchase price for ten years allowed us to settle the dispute over purchase price, it posed a question we had yet to confront: When would the buyer be required to make the deferred-payment second mortgage debt?

Richard Essex tried to convince us that this should be in five years. Gary pointed out that he intended to glean the funds needed to pay the second mortgage debt by refinancing the first mortgage debt. Could this be done in the near future?

The first mortgage on the property would not be fully amortized for another seventeen years. While the owner of the property had the right to prepay the mortgage, this privilege could not be exercised for the next eight years, and prepayment would have to be accompanied by an additional payment which the mortgagees call a "premium." Since Essex understood that it was unrealistic to expect payment of the second mortgage debt before the first mortgage was refinanced, it was not too difficult to convince him that he should wait a ten-year period for his deferred payment.

Gary then insisted that the buyers might have an opportunity to convince the existing first mortgagee to increase the mortgage debt. Since this would involve the execution of a new mortgage, he asked Essex to agree to subordinate the lien of the second mortgage in this event, so that the first mortgagee could retain his priority. Essex went along with the idea on condition that four-fifths of any new funds loaned by the first mortgagee be used to reduce the unpaid balance of the second mortgage debt.

AMORTIZATION BEFORE THE CLOSING

After a contract to purchase is signed, there's usually a couple of months to wait before the closing. During this interval, the seller must meet his mortgage payments. When he does, he's usually paying part interest and part principal. A seller

argues that since part of the debt secured by the first mortgage has been paid, the cash portion of the purchase price should be increased by these principal payments. There's some sense to this suggestion, because the purchase price may be composed of three elements:

- Unpaid portion of first mortgage debt:
- Cash:
- Deferred-payment second purchase-money mortgage.

If the total purchase price has been agreed upon, it is logical to increase one element (perhaps the cash) when another (the unpaid part of the first mortgage debt) is decreased. In effect, the buyer's equity is increased because he takes title subject to a lower mortgage. On the other hand, the buyer argues that under cash-flow accounting, which is the usual approach to a real estate investment, amortization is an expense and should be adjusted like other expenses.

Of course, Richard Essex asked for the amortization payments to be added to the cash. And, of course. Gary refused to pay it because the crux of the agreement was that the cash part of the purchase price would be \$250,000. One possible compromise is to add the amortized part of the first mortgage debt to the deferred payment.

THE OCCUPANCY LEASES

The income stream from an apartment house and the source of its value is derived from the rent paid by the building's occupants. The occupants are tied to their apartments and their rent by leases. Therefore, these leases become the central focus when an apartment house property is sold.

It is not unusual to examine seventy apartment leases in an hour or two. You don't normally have to read much because the leases are usually printed forms. After reading one carefuly, you limit yourself to the typewritten material on the rest. Abstract the lease to find out the rent, the term, any personal property leased to the tenant, and whether the tenant is entitled to any rent concessions, free utilities, special equipment or facilities, such as an air conditioner, parking space, or the right to use appurtenant parking facilities.

Of course, the rent in all the leases should be totaled to make sure the seller hasn't fibbed a bit about the rent roll.

We must determine how many leases expire after the contract is signed but before the closing. Remember that during this period, the seller still owns the place and he can lease the apartments to anyone for any period and for any rent. When you deal with a man as gregarious as Richard Essex, and with his reputation, you seek some assurance that he won't install a former wife, present mother-in-law, or a current acquaintance in a vacant apartment at a low rent. To this end, the buyer rightfully demands the right to approve any lease executed after the contract is signed.



The seller will insist that the buyer agree to approve any new lease if the rent, term, and credit of the tenant meets suitable standards.

By abstracting the leases, the buyer can find out whether the landlord is required to paint some apartments every year. Normally, an apartment landlord expects not to be required to paint more often than once every three years.

The leases can reveal that some of the apartments are rented as furnished. One significant thing an apartment house owner can learn from this is that new furniture must be purchased periodically and that the cash flow will be reduced accordingly. Also, many apartment building operators feel that furnished-apartment tenants are less reliable and more likely to do the kind of things you expect from unstable people.

Gary insisted that a schedule of the occupancy leases, the security deposits of occupants, and some related vital statistics be attached as an exhibit to the lease.

The seller is usually willing to represent that the schedule of leases is accurate. He gives similar assurances as to other sources of income such as that from coin-operated washing and drying machines, parking fees, and swimming pool charges.

If you're buying an apartment project, be sure to insist upon the following representations (and that they are to survive the closing):

• The rents shown on the schedule are really being collected.

- No concession of free- or reduced-rent periods have been granted to tenants except as indicated on the schedule.
- Each tenant pays for his own gas, electric, and other utilities, except as otherwise indicated.
- Each apartment contains the appliances required to be furnished to the tenant, and the seller owns all of the appliances required to be furnished to the tenant.
- The apartments and the appliances in them are in good order and repair.
- All repairs and other work the owner is required to do for his tenants have been done.
- The date each apartment was last painted.
- The rents set forth in the schedule do not exceed any statutory rent-control ceiling in effect.



This is only a partial list; there are many other representations that you may think of. But the important thing is to understand the point—buying an apartment house is a business, and it's a rough one. Always remember that people live there, and underline the word *live*. (Does it make you shudder to think that some people's home lives rest in the shaky hands of an amateur investor with an overstuffed wallet?)

The point about its being a business means that when you enter into a contract to buy an apartment house, you do your best to assure that the seller has represented the facts that will enable you to feel reasonably certain that the return on investment will be what you expect.

Our contract wasn't a pretty one when we signed it at 10 P.M. I saved the day not because of legal acumen, but because of my rare ability to make neat insertions in manuscript. Now, I was reminded of my earlier discomfort. The tooth. Oh, did it hurt.

Harry was proud of Gary, and Gary was proud of Harry. They walked arm in arm toward the elevator. Big Irving, Richard Essex, and Dr. Kronkite followed them. I ran to Gary and begged that he have pity on me and relieve the pain.

I'll say that Gary is a fine dentist. When he played the role of dentist-at-work, he was a different person. Even without his usual complement of four assistants, he worked deftly and thoroughly. At midnight, he was finished. The pain was gone. I tried to thank him.

I: "I don't know how I can thank you."

Gary: "You can express your appreciation perfectly by paying me."

I (a bit startled): "Of course! How much do I owe you?"

Gary: "Well, you'll need three crowns and two inlays. Your right wisdom tooth needs root canal work. There'll be about three more restorations. Finally we'll clean your teeth. Just look at those stains. Disgraceful. You're a bad advertisement for this office."

I: "How much?"

Gary: "All together \$2,325, payable in advance now. Please make the check payable to Kronkite and me jointly."

I: "Look Gary, all you've done tonight is fill one tooth. I'm a little short on cash these days because my collections are slow."

Gary: "That's just the point. I can't afford to carry accounts receivable. We have a big staff here. A big staff means a big payroll, and those women insist on getting paid in advance. You're a lawyer. You must understand just how important it is to have cash in hand."

Believe me, I understood.