

Cash-in Refinance - 16.5% Cash on Cash Return

Most of the time when you hear about refinancing it is usually along the lines of locking in a lower rate and/or cashing out during the refinance. You don't read or hear much about a cash-in refinance and how the returns could really be worth consideration.

My wife and I currently find ourselves about 10 years into the 5/1 ARM on our investment condo. It didn't start out as an investment. Actually, it is an interesting story on how we even became the owners of the condo. My wife's parents had bought it back in 2005 before the market went off a cliff during the depths of the financial crisis. They paid \$257,500 for it and put about \$50,000 down. They secured a 5/1 ARM at something like 5.65%.

Their thought process was that real estate was going to keep going up and they feared their daughter (Mrs. GYFG) would never be able to afford to buy a place when she finished school in 2008. So, they figured they would buy something now to lock in current prices (just in case). During the time that the Mrs and I were still in college they rented the place out.

The Financial Crisis

Fast forward to 2008 and we are in the middle of one of the worst financial meltdowns in history. Unfortunately my wife's parent's livelihood was/is heavily dependent on real estate performing well. My wife's mom owns an escrow company and her dad is a designer/contractor.

As my future in-laws financial world got rocked, it was assumed (or maybe hoped) that we would move into and take over the mortgage on the condo. It was either we assume the place or they were going to fire sale it. They were panicking and not thinking rationally, especially given that they still had a tenant in the unit. We hadn't necessarily decided we wanted to move back to our home town, but we thought this could turn out okay even though the condo was upside down. At the current mortgage payment of \$1,190 we would had been hard-pressed to find anything we could rent for much cheaper.

We agreed to assume the mortgage and with that ownership of the condo. My wife had graduated in May of 2008 and I in December of 2008 (I actually walked with my class in May but had a few classes to finish up). I had already started working full time as a financial analyst for the oil company I had interned with. My wife actually moved back home and started looking for a job. Once she found a job we gave notice to the tenants. Once the tenants moved out in early 2009 we decided to do a full kitchen remodel and put in new flooring and granite counter tops throughout.

When we officially moved into the condo in 2009, similar units were selling for as low as \$80,000. Oh, and the mortgage we had just assumed was around \$195,000 with an interest rate of 5.65%. Luckily that remodel only cost us material and the labor was free (thank you father in-law). My wife and I laid the slate flooring ourselves.

So, to recap we had just assumed a mortgage on a condo that was **worth about \$125,000 less than what was owed on it** (after you factor in the \$10,000 we had just put into it to make it our own). Our view at the time was that we could help family from losing this thing and with a long enough time horizon we would actually come out ahead. We were going to have to pay rent somewhere anyways, right?

The Benefit of an ARM Mortgage During Times of Economic Instability

Don't be fooled! I know I paint a very calm picture, because that is just how I roll. My wife (girlfriend at the time) on the other hand was freaking out. She felt burdened with this place, but also had mixed emotions, because she was stoked to make it her own. At the bottom of any fall, it is easy to eat what the media feeds you, and at the time everything was going to **ZERO**. Obviously that was a bit of an overreaction.

At the bottom of any steep decline the case that something is going to **ZERO** becomes very compelling, but isn't always **RATIONAL**. By the time we assumed the place, it had already fallen almost 70% from its purchase price. It didn't seem plausible that these would ever be free.

But I would be lying to you if I didn't admit to second guessing our decision over and over...and over again.

Then the ultimate freak out moment came when my wife learned that the mortgage

rate was adjustable and was set to reset in October of 2010. Not really understanding how the interest rate was set at the time, she had nightmares of the rate jumping to some ridiculous number...like 10.65%. She had learned that the rate could increase up to 5% above the current rate (thus the 10.65% number), but what she failed to realize at the time was the following:

1 - The rate could only increase by a maximum of 1% a year with a life time cap of 5%. So, even if it were to increase it would be at least 5 years before we hit the max rate

2 - The rate could adjust UP or Down depending on the state of interest rates.

But more importantly...

3 - The rate was based on a spread over the federal funds rate. The margin is 2.75%.

It took a while, but I was finally able to explain to her that the adjustable rate was actually going to work to our benefit given the weak economy and historically low rates. The FED had recently just cut the federal funds rate to a range of 0.00% 0.25% (December of 2008), which implied a new rate of 2.75% to 3.0% when the mortgage rate finally reset.

I did the quick math and explained to Mrs. GYFG that our new rate was actually going to go down by about 3% and with that our payment was going to decrease \$290/month (going from \$1,190 to \$897/month).

It has now been 62 months since the rate began its annual reset every October. That first reset took the original rate of 5.65% down to 2.875%, where it stayed for a few years, until recently jumping to....wait for it....3%.

The savings from the adjustable rate mortgage over the past 62 months has amounted to approximately \$17,980.

Values Were Also Reset For Property Tax Purposes

During this time the assessed values that determined your property tax bill were also revised much lower to reflect the true market value. This has saved us thousands of dollars over the past 5 years as well. I haven't actually done the math.

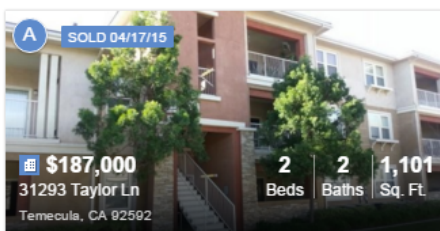
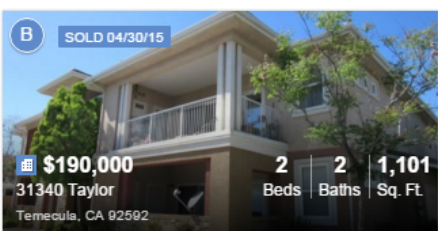
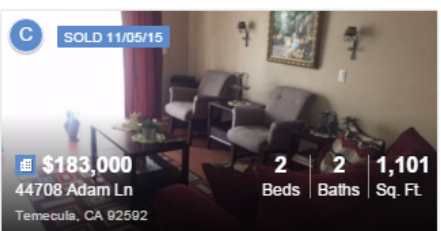
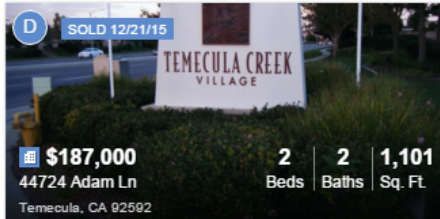
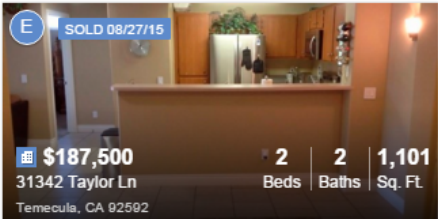
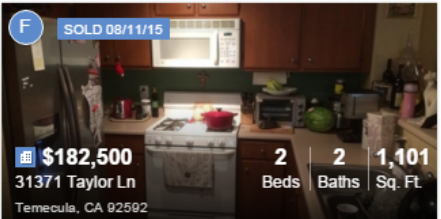
As the market has recovered the assessed value has continued to increase. Sometimes ahead of the market. Luckily my wife has experience in appealing property tax values, which has ensured that our property taxes were a true reflection of the prevailing market price of the condo. Most people don't even realize that you can appeal the value of the property that your tax bill is based on.

Where Are We Now?

Remember towards the beginning of the post when I explained that we assumed a condo that was worth \$80,000 at the time with a \$195,000 mortgage (and the \$10,000 we had just put into it)? So, all told we were **under water by about \$125,000**.

First of all, we lived in the condo for a little over two years before moving and renting it out (in July of 2011). As a rental it has essentially been breakeven (after the Mortgage, HOA, water bill, and Property Taxes). From an income tax perspective it has been slightly better than breakeven due to the ability to depreciate the value over 27.5 years.

In 2015 there have been a number of units that have sold in the \$183,000 to \$190,000 range:

| | | |
|---|--|---|
|  <p>A SOLD 04/17/15 \$187,000 31293 Taylor Ln Temecula, CA 92592 2 Beds 2 Baths 1,101 Sq. Ft.</p> |  <p>B SOLD 04/30/15 \$190,000 31340 Taylor Temecula, CA 92592 2 Beds 2 Baths 1,101 Sq. Ft.</p> |  <p>C SOLD 11/05/15 \$183,000 44708 Adam Ln Temecula, CA 92592 2 Beds 2 Baths 1,101 Sq. Ft.</p> |
|  <p>D SOLD 12/21/15 \$187,000 44724 Adam Ln Temecula, CA 92592 2 Beds 2 Baths 1,101 Sq. Ft.</p> |  <p>E SOLD 08/27/15 \$187,500 31342 Taylor Ln Temecula, CA 92592 2 Beds 2 Baths 1,101 Sq. Ft.</p> |  <p>F SOLD 08/11/15 \$182,500 31371 Taylor Ln Temecula, CA 92592 2 Beds 2 Baths 1,101 Sq. Ft.</p> |

Redfin is currently estimating the value of our condo at \$187,500:

| | | | | |
|--|-------------------------------------|------------------|-------------------|---|
| \$187,466 Redfin Estimate | \$257,500 Last Sold Price | 2 Beds | 2 Baths | 1,101 Sq. Ft. \$170 / Sq. Ft. |
| Sold Aug 31, 2005: \$257,500 Built: 2005 | | | | |

At this point in time we owe \$159,845. So, we are no longer underwater when comparing what we owe to the value of the property. However, the property is still \$70,000 off its original purchase price of \$257,500.

This currently puts our LTV (loan to value) at about 85%, leaving us with about 15% equity in the property.

We plan to hold this for the long term, but would like to improve the cash flow of this property. We are currently charging \$1,350/month in rent, which is about \$100 below the market, but we have a solid tenant in there. We don't have plans to raise the rent on the current tenant in the near future, so the other option we are evaluating is a refinance.

A Cash-in Refinance [by the numbers]

Since this is an investment condo the only way we will be able to refinance would be to bring enough money in to move our equity in the property to 25%. Based on comparable sales and the upgrades we have made to the place we estimate the value to be between \$190,000 and \$200,000.

Let's assume it is worth \$195,000 for this exercise.

With that value the max loan on the property could be \$146,250. This means in order to refinance we would need to bring \$13,595 to the table to increase our equity stake to 25%. Because my wife works in the industry we won't have much in the way of closing costs. The refinance we did on our primary residence 2 years ago cost us about \$1,000 (basically appraisal and title, no origination fee or escrow fee).

Since we believe that rates will continue to remain at historic lows for much longer than anyone suspects (hello Japan) and due to the fact we don't plan to keep the mortgage for a full 30 year term, we are interested in refinancing into a new 5/1 ARM.

Giving a quick look on the Internet I see that the rates are as low as 2.50%, and since this is an investment condo I will assume a 75 basis point premium at 3.25%.

The interest rate would be slightly higher than our current 3% rate, but by resetting the amortization schedule our new payment would be \$696/month (at least for the first 5 years). This would represent a savings of \$201/month or \$2,412/year.

\$2,412 is a 17.7% Cash on Cash Return on \$13,595

After you factor in the \$1,000 for closing costs, then we are looking at **16.5% Cash on Cash Returns**.

If rates continue to fall or we are able to get a slightly more favorable valuation (meaning less money we have to bring in) then this cash on cash return could only get better. As I write this on 2/7/16, we are currently sitting on about \$86,000 in cash and building. We don't have anywhere else we could deploy cash and earn this kind of return.


So, over the next 60-90 days we will be moving forward to refinance the condo.

Have you ever considered a cash-in refinance? Did you think about it from this perspective?

-Gen Y Finance Guy

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| 2.89% APR | 15 Year Fixed | 2.75% | 2.80% APR | ➔ | |
| 5/1 ARM | 5/1 ARM | 2.75% | 2.89% APR | ➔ | |

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Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own [financial stats](#). I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! [Read More](#)