nyrej

Commentary on the 2014 Upstate apartment market

October 20, 2014 - Upstate New York

For the last 20 years interest rates, and in tandem capitalization rates, have come down in an almost steady fashion as multifamily activity and prices have risen. Additionally, investment real estate as a whole is also the beneficiary of many preferential tax laws. However in 2014, seeking to find new sources of revenue for the Federal Government, negotiations are underway between both parties to make major changes to the tax code in regards to real estate. Representative Camp, chairmen of the powerful house ways and means committee, proposes eliminating the real estate deduction for home mortgage interest and the federal rehabilitation tax credit. Senate finance committee chairmen Baucus intends to eliminate Section 1031 tax-deferred exchanges, increase the depreciation period for residential investment real estate from 27.5 years to 43 years, and tax depreciation recapture at ordinary income rates versus lower capital gains rates.

Actually, changes to the home mortgage interest deduction may improve apartment occupancy by making home ownership less desirable but changes to the tax treatment of commercial real estate are potentially harmful to the industry, especially to the smaller or newer participant. The worry is that with all the talk and as the various proposals are put into writing some will eventually be enacted. Transaction volume will fall as investors postpone selling properties to avoid the higher taxes on sale and the newer investor entering the business will find fewer opportunities and their ability to grow a portfolio by keeping their capital invested in the business impeded without the 1031 tax-deferred exchange.

The federal rehabilitation tax credit has been utilized in many of the village and city downtowns across New York to convert obsolete buildings into apartments but in real terms the overall addition to the market supply has been small and the loss of the credit won't have a big impact. Some owners aren't happy with the additional subsidized competition anyway. In these secondary and tertiary markets there are plenty of economic and municipal road blocks to new construction, and middle class apartment prices have yet to rise to match the cost of unsubsidized replacement. There is an appreciable lack of new supply in the market. Investor interest and the vast majority of the activity is centered around suburban garden apartment complexes available at well below replacement cost. The middle class and the majority of the job drivers are now in the suburbs. In recent years deals in the major suburbs have been done in the 8% cap-rate range.

The operating climate remains good, absent population and major job growth across New York state's upstate markets, stable tenant generators include the many locations of the state university and college system and the expansion of local medical and healthcare campuses. New QM (qualified mortgages) rules from the new federal Consumer Financial Protection Bureau will limit bank fees, and hence bank profits, making it difficult or impossible to provide small mortgages, a big factor in upstate markets where low priced single family homes for first time home buyers compete directly with apartment rentals. Renters will stay renters for the foreseeable future.

Cap-rates will be pressured as interest rates rise, the Federal Reserve continues to signal that at some point in the future rates will increase, but the overwhelming demand for apartment properties will hold back any rise in cap-rates heading into 2015. Warren Buffett, in a recent interview on the CNBC network, recommended the ownership of apartment houses as a preferred investment to hold over time. The economic advantages of owning an income producing asset with compound annual appreciation makes sense regardless of economic uncertainty or any impending tax law changes.

Brian Heine is a licensed real
estate broker in New York state.