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Threats and opportunities for multifamily owners in a post rent-reform world - by Victor Sozio and David Baruch

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Victor Sozio

David Baruch

The passage of the Housing Stability and Tenant Protection Act of 2019 (HSTPA) was one of the most consequential developments to ever emerge in the NYC multifamily property market. While the new laws undoubtedly present a host of challenges, both now and in the future, some investors have begun to adapt to new market conditions and opportunities.

As investors took time out to weigh the implications of the new laws, all three volume metrics for multifamily assets recorded double-digit declines in the third quarter, according to our company's "Multifamily Quarter In Review." To view, click on: http://arielpa.com/report/report-MFQIR-Q3-2019

From July through September, NYC saw 61 multifamily transactions comprised of 88 buildings totaling $1.1 billion in gross consideration. Compared to the same quarter in 2018, transaction volume declined 45%, building volume dropped 57% and dollar volume slid 51%. Compared to the second quarter, transaction and building volume both fell 42%, while dollar volume slipped 38%. Dollar volume was weighed down by fewer institutional caliber deals as there were only two sales in the third quarter that exceeded $75 million, below 2018's third quarter tally of five sales at this price point.

Threats

New and emerging threats to multifamily property owners abound, both based on the recent legislation passed in June, as well as the potential for new legislation going forward. From an operating standpoint and without rehashing all the details, HTSPA severely limits a property owner's potential to increase rents on rent regulated units and increases the amount of exposure for any operating history for legal rent increases that may have been applied incorrectly.

In properties with a high percentage of rent-regulated units, owners face the real possibility of a diminishing net operating income (NOI). With the previous mechanisms to increase rents upon turnover no longer in place, it would not be unreasonable to think that the allowable Rent Guidelines Board (RGB) annual increases will not be enough to keep pace with rising expenses. Compounding this issue is NYC's highly disproportionate property tax system, where a "matured" tax load on most tax class 2 multifamily properties will end close to 25-30% of the adjusted gross income.

Concerns have also been voiced on multifamily loans coming to maturity within the next 4-5 years. The years 2013-2016 saw a prolific amount of transaction volume, with an average of 688 NYC multifamily sales and an average $13.2 billion volume seen in that timespan. Many of these loans pushed the envelope on debt coverage ratios or may not have anticipated increases in operating expenses, taxes, or lost income. With the debt on many of these loans close to the value of the asset, operators will face a scenario where new equity could be necessary to refinance and a sale may barely or not cover the balance of the debt. Some investors may perceive that providing additional equity to refinance will not be a sound investment. This may lead to maturity defaults, elements of distress, or pragmatic recapitalizations.

Unfortunately, free market rents are not impervious to the recent changes. While an argument can be made that free market rents will increase over time, due to the pipeline of renovated rent-stabilized units coming to a halt, operators face some real challenges with these assets as well. The new legislation limits rent deposits to one month, as well as the ability to vet a tenant's non-payment eviction history. Coupled with recent chatter for a "good-cause eviction" bill circulating again, the assumption on collections for these rents going forward may have to be more conservative.

The 2020 U.S. presidential and congressional elections may bring more uncertainty to an already fragile market. It could suppress activity should Democrats take greater control of congress and the senate since they might opt to impose tenant-friendly laws on a national level.

Opportunities

So, enough doom and gloom! There are still opportunities that exist. While there will certainly be some distress to work through, quality operators will be able to leverage their platforms, liquidity, and expertise.

With the Federal Reserve recently cutting rates for the 3rd time this year, commercial lending has become a motivating factor for some groups. Long-term, patient capital has become increasingly attracted to securing multifamily opportunities at a going-in yield providing sufficient cash-on-cash returns and making the investment less dependent on the upside of rents that are no longer easily unlocked. When considering the depth and liquidity of the NYC market compared to other parts of the country, these investors are rationalizing the benefits of a 5% or higher cap rate in NYC versus a similar cap rate out of state.

Another opportunity lies in the multifamily property market for smaller properties. Buildings with less than 6 units are typically not subject to rent regulation, thus less impacted by the recent changes. They also benefit from their tax class 2A or 2B status, which limits the amount property taxes can increase year over year. These types of buildings fared well in the third quarter, recording 118 sales totaling $280 million, signifying year-over-year increases of 9% and 14%, respectively.

Many investors use these smaller multifamily assets for diversification purposes as they are perceived to be one of the safest types of commercial assets, with positive cash flow and downside protection during most economic cycles.

Savvy investors have also become acutely more aware of properties that offer the ability for “substantial rehabilitation” or the ability to apply the “first rent” rule. Substantial rehabilitation is a fairly onerous process of replacing almost all of the building’s systems and interior space. Once completed, the property would not be subject to rent-stabilization. The first rent rule can be applied to scenarios where adjacent, vacant rent stabilized units can be combined in some way where the outside perimeter of the apartment is significantly altered. Once completed, the units will still be subject to rent-stabilization, but at the initial rents received.

The shift in value-add driven property evaluation has created an opportunity for mission-driven organizations looking to “preserve” multifamily units, as well as affordable housing operators and developers. With less value being placed on a property’s embedded upside, entering into a long-term affordability agreement and structuring a deal with acceptable cash-flow and downside protection, in the form of tax incentives, has become a more viable option.

Looking ahead, HSTPA has created a new paradigm in NYC real estate, but NYC remains one of the most popular and safest destinations in the world for long-term real estate investment. While sales in corners of the market should continue to slide, NYC investors are savvy and are quickly adjusting to the new environment and the opportunities it has presented.

Victor Sozio is the executive vice president – investment sales, and David Baruch is a senior analyst – investment research, at Ariel Property Advisors, New York, N.Y.