State of the New York City Rental Market, '97

Introduction

In last year's State of the Rental Market report we wrote:

> *The economics of the rental housing industry have improved greatly during the last two years. Owners' vacancy and collection losses are down sharply due to an improved economy. A very low "core rate" of operating and maintenance (O&M) cost inflation continues to benefit landlords. Mortgage interest rates remain low and the availability of financing has improved. In sum, these factors have led to the highest level of profitability in apartment buildings since 1989. While predictions are always dangerous, the near term future appears quite positive for owners of rent-stabilized housing.*

In fact, the favorable trends noted last year continue, and in some respects have intensified. Moderate increases in rent, declining vacancy and collection losses, a modest "core rate" of operating cost inflation, and a wave of low-rate refinancing are the factors which benefitted building owners over the past year. The net result was an 8% increase in net operating income (NOI), bringing profitability nearly back to pre-recession levels.

A stronger economy is partly responsible for the improvement in the the rental market. A slow but steady increase in jobs and income has made it easier for owners to collect rent and fill vacancies, especially in the higher rent stock.

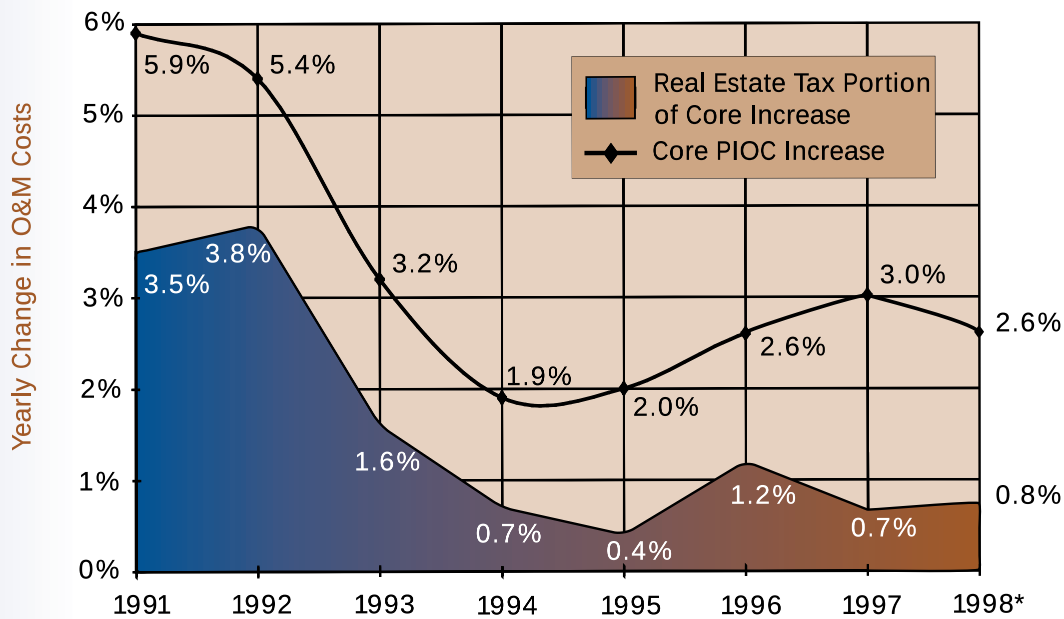
A low rate of increase in operating costs is the other part of the profitability equation. Despite the uptick in the City's economy, there has been no notable increase in price inflation. The prices of materials purchased by landlords are rising slowly, labor costs are under control, and City government appears determined to hold increases in real estate taxes to a minimum. Thus, the expense side of the equation, like the revenue side, is quite favorable.

Trends in mortgage financing activity are also very positive. This year's Rent Guidelines Board Mortgage Survey (p. 51) found that mortgage financing costs were near historical lows. Many owners benefitted from refinancing at lower rates in 1996. In addition, the secondary mortgage market is expanding and competition among lenders appears to be intensifying, resulting in more choice and lower financing costs.

In the short term it appears that rents will continue to rise at least as fast as they have in recent years, and possibly at a greater pace. Operating cost inflation, which one might expect to be on the increase at this stage of the economic cycle, remains dormant. Indeed, the near term outlook is for a small DECREASE in the rate of O&M inflation, due in large part to the recent agreement with Local 32B-32J, which is quite beneficial to owners. If there is a dark cloud on the horizon, it is the possibility of higher interest rates and mortgage expenses as the Federal Reserve Board acts to cool the economy. Nevertheless, on balance the outlook for building owners remains very positive.

The "Core" Rate of Inflation Dropped Sharply in the Early '90's - Lower Real Estate Taxes was the Key

(Change in the Core Rate of the Price Index of Operating Costs for Rent Stabilized Apartment Buildings)



Source: Price Indices of Operating Costs, 1991-1997, PIOC Projection for 1998
*Note: The percent change for 1998 was estimated.

Landlords' Operating and Maintenance Expenses

Recent History

In recent years there has been a remarkable drop in the "core" rate of inflation.[1] In 1991, landlords' core operating and maintenance (O&M) costs were rising by nearly 6% per year. A scant three years later the core rate of inflation had plummeted to 1.9%. Although costs have crept up slightly since 1994, inflation continues to be quite moderate (see above chart).

The subsidence of inflation since the early 1990's was due in large part to a sharp drop in the rate of increase in real estate taxes. Rising property values and stable or higher tax rates resulted in sharp increases in landlords' tax bills throughout the late 1980's and early 1990's. The severe recession eventually dampened increases in property tax assessments. This falloff in assessments, combined with a new determination by City government to hold the overall property tax levy stable without gouging rental properties, has accounted for more than half of the decrease in the core inflation rate.[2]

Declining cost pressures in the labor market have also dampened O&M inflation. The relatively severe recession in New York made it very difficult for contractors (e.g. painters, plumbers) and laborers to raise their prices or demand higher wages. The RGB's Price Index of Operating Costs (PIOC) found that during the recession many contractors were forced to reduce prices in order to attract business. Similarly, the wage demands of labor unions weakened during the recession and have remained very moderate since then, reflecting in part a lower level of general price inflation.

Smaller increases in water/sewer rates also benefitted landlords. Beginning in FY 1994, the Water Board imposed a two year rate moratorium. The Board also extended the voluntary transition program (enabling landlords to remain on frontage billing) and put a cap on maximum bills. The impact of these actions, while not as significant as the declining rate of increase in real estate taxes and labor costs, did shave about one-half of a percent off the core rate of inflation.

It is clear that O&M inflation reached a low point of 1.9% in 1994 and has been inching upwards since then. This year's core rate was 3%, the highest level since 1993. The natural question: Is inflation on the rebound?

Near Term Outlook

At this stage in the economic cycle one would typically expect rising wage pressures for labor, increasing prices for contractor services and administrative costs due to more demand, and substantially higher real estate tax assessments and tax bills due to improving profitability of rental housing. In short, the core rate should be mounting. Although there has been some recent increase in the core (from a low of 1.9% in 1994 to 3% in 1997) we expect the rate to actually DECLINE next year and to remain low in the near future. Labor costs are decreasing, price demands of contractors and administrators remain moderate, and real estate taxes show no sign of significant escalation over current levels.

Real Estate Taxes

Just as the dramatic decrease in the core rate was due in large measure to a decline in real estate taxes, the recent increase can be attributed to rising taxes. The rate of increase in real estate taxes reached a nadir in 1995 (a 1.4% increase), and has been higher since then (3% in 1996 and 2.4% in 1997).

Higher taxes in 1996 and 1997 were not fueled by rising property assessments. In both of these years assessments actually fell slightly. The rise in taxes was due almost entirely to an increase in the tax rate for Class Two properties brought on by falling assessments among commercial properties. As the economy stabilizes, it appears that the disruption in class shares will abate, making it unnecessary to raise the tax rate for Class Two properties. This relative stability in tax rates, combined with slowly increasing assessments (estimated at 2.8% in FY 1998) bode well for the short term. The intermediate term also appears positive, given the determination by the Giuliani Administration and the City Council to hold the line on property tax increases.

Labor Costs

The rate of increase in labor costs, which comprise one-sixth of landlords' expenses, appears to be declining. Although the City's economy is creating jobs, increases in the labor force seem to be outrunning job creation, thus negating any wage pressure and undermining union wage demands. The relative weakness in the real estate market has also encouraged owners to bargain more aggressively with unions and non-union labor.

After rising 4-5% per year in the early 1990's, this year we found that non-union laborers' wages rose a mere 2.9%, an historical low. Given the current weakness in the labor market and the secondary impacts of recent union agreements, non-union labor increases should be similarly low in the next few years.

In the unionized labor sector, the recent 32B-32J labor agreement also bodes well for building owners. The union and the Real Estate Advisory Board estimate that the impact of the contract will be "cost neutral", a euphemism for no increase in costs. 32B-32J labor costs constitute nearly 7% of the typical rent-stabilized building's budget. The settlement will certainly have an impact on next year's local 32E negotiations, and also on the wage demands of non-union labor.

Contractor Services and Administrative Costs

Contractor Services consist mainly of painting and plumbing costs. The same wage pressures which have affected the bargaining positions of janitors and superintendents have also had an impact on painters and plumbers. Price increases for these services have lagged behind the rate of inflation in recent years. Although there has been a slight recent uptick in plumbers' costs, painters report too much competition to raise prices more than one or two percent per year. We expect these market conditions to persist in the short and intermediate term.

Administrative Costs have climbed more rapidly than Contractor Services costs in recent years, presumably because of the higher skill levels of accountants and attorneys. In addition, rising rents have boosted the fees of management companies. Even so, after adjusting for the impact of rents on management fees, administrative costs have been increasing only at the rate of inflation in the 1990's and show no sign of upward movement.

Water/Sewer Costs

After many years of double-digit increases during the late 1980's and early 1990's, the rate of increase in water/sewer fees has slowed significantly. Even so, increases continue to run ahead of other costs. As a result, water/sewer fees now comprise nearly 8% of owners' total operating expenses.

In stark contrast to other operating expenses, which seem to be relatively stable or declining, increases in water/sewer costs are probably on an upward path - it is not likely that future increases in water/sewer fees will dip much below the 6.5% level of fiscal years 1997 and 1998.

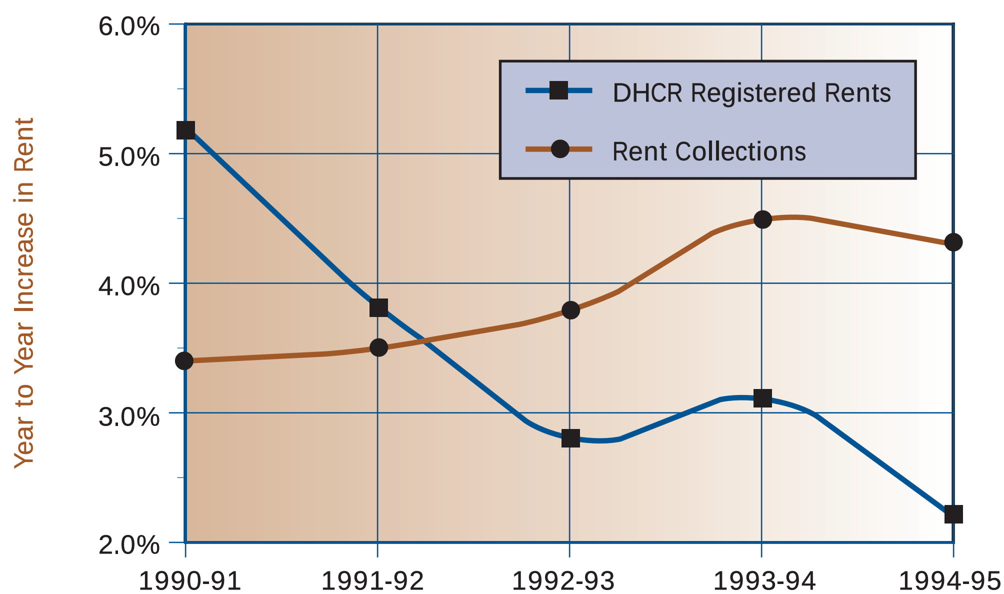
The Water Board's ten year capital improvement program (1996 - 2005) is ambitious and will require floating some $8.6 billion dollars of debt. To pay off the debt incurred by the capital program will require annual increases in fees of at least 6.5% per year. The most recent prospectus of the New York City Municipal Water Finance Authority projects rate increases of 8% in FY 1999 and 8.4% in FY 2000. Water/sewer expense is thus one of the few costs which is not expected to be stable or declining in the short term.

Rents

Recent History

Rent growth in the nineties has been surprisingly strong given a severe local recession and some of the lowest guidelines granted in the history of rent stabilization. Although the recession did slow rent increases from 1990-1992, rents accelerated significantly from 1992 to 1995, fueled by the recovery of the local economy and the dearth of new housing construction. We believe the pace of rent growth will continue to be strong in the next year or two, pushed by last year's higher rent guidelines, a low rental housing vacancy rate, declining rent collection losses, and greater opportunities for vacant apartment and Major Capital Improvements (MCI)[4].

Rent Collections are Rising Faster than Registered Rents



Source: NYC Department of Finance, RPIE Filings and NY State Division of Housing and Community Renewal. See note 3 for additional details.

The chart on previous page contrasts increases in rents registered with the New York State Division of Housing and Community Renewal (DHCR) with the amount of rent actually collected by landlords. Looking at the beginning of the decade (1990 - 1991), we see that registered rents rose 5.2% while rent revenue actually collected by landlords was up only 3.4%. The difference clearly reflects the impact of the recession.

In 1991 the City lost nearly 200,000 jobs. Many landlords found it impossible to raise rents given the sudden deterioration in tenant employment and income. In more desirable buildings and neighborhoods landlords offered "preferential" rents to avoid vacancies. In poorer neighborhoods vacancy and collection losses soared and an increasing number of landlords fell into real estate tax arrears.

Rent increases in 1992 and 1993 were surprisingly strong, given that the City lost 100,000 additional jobs and the unemployment rate leaped to more than 10%. While rents collected by landlords lagged registered rents slightly in 1992, collected rents surged in 1993, rising a full percentage point more than DHCR levels. At the time, it appeared the real estate market was mired in a deep recession; looking at this data in retrospect, 1993 marked the first stirrings of a recovery.

The relative strength of New York's rental market even during times of deep recession is not easy to explain. The resilience of rent levels may be due in part to the relative affordability of the housing stock. In last year's Income and Affordability Study we showed that New York's housing stock is somewhat more affordable than other cities'.[5] To the extent that rent regulation depresses rents below "market" levels and maintains affordability, it may be easier for landlords to raise rents during a recession.

A near collapse of new housing supply is undoubtedly another important factor contributing to the tighter rental market. The Savings and Loan crisis of the early 1990's combined with the recession "squashed" new housing construction. While permits for new construction averaged 11,500 units per year during the eighties, in the nineties new housing permits slowed to 5,000 units per year. Over a six-year period (1990 - 1995) this difference in new housing construction amounts to nearly 40,000 units. Even in a market as large as New York's, such a deficit will put pressure on rent levels.

Future Outlook

In the near future there is little reason to doubt that rental income will continue to grow, most likely at a quicker pace. As the economy improves, vacancy and collection losses will continue to shrink. The sharply higher guidelines enacted by the RGB last year will boost contract rents in 1996 and 1997. Disappearing "preferential" rents, additional vacant apartment and Major Capital Improvement increases, and luxury decontrol will also contribute to higher rent growth in the short run.

This year's RGB Income and Expense Study found that collected rent rose 4.3% in 1995, spurred to a large extent by further reductions in collection losses, and a moderate increase in contract rents. Given that the City gained some 35,000 jobs in 1996, the largest gain since 1987, it seems likely that collection losses continued to fall in 1996.

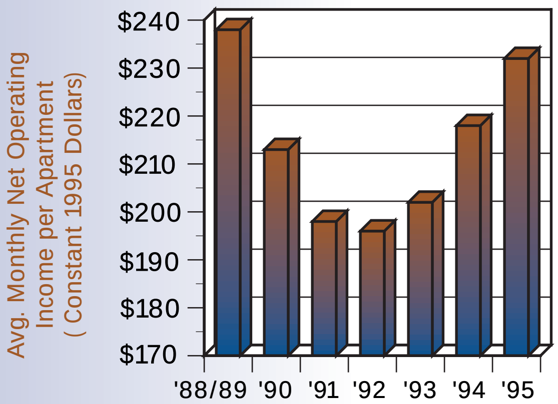
Lower collection losses have been a boon to owners of older, pre-war buildings. Since losses in these buildings typically run much higher than in the post-war stock, it is not surprising to learn that collected rents in the pre-war stock grew 13.3% from 1992 to 1995, versus 11.6% in the post-war stock. Lower collection losses have helped many of these older buildings shed their real estate tax arrears. In last year's Tax Arrears Study we found that nearly 500 buildings repaid their arrears in 1995.[6]

Although landlords' gains from lower vacancy and collection losses will eventually begin to moderate, other factors will certainly boost rents five to six percent per year in the near future. Last year the RGB passed a guideline allowing a 5% increase for a one year lease, a 7% increase for a two year lease and a vacancy allowance of 9%. RGB staff estimates the net effect of the guideline will be to raise rents by 5.7%, the greatest increase allowed since 1989. Most of this increase will be reflected in landlords' 1996 and 1997 bottom lines.

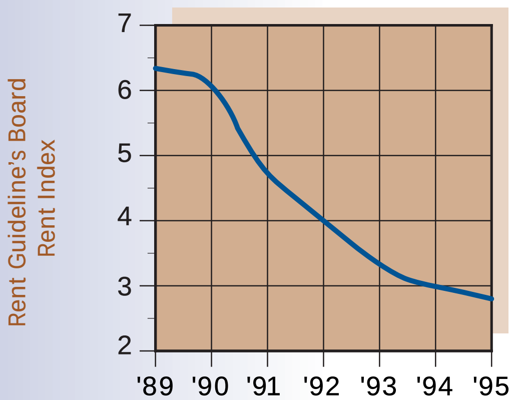
Another factor which will surely have an impact on rents is the growing level of MCI applications. After bottoming out in FY 1994 at 1,168 applications, MCIs began to creep up in the next few years, rising to 1,338 applications in FY 1997.

Despite recent revisions of the rent-stabilization law enacted by the City Council, which will slow the pace of luxury decontrol,[7] this process will continue to spur increases in rental income for higher rent buildings. To date, the State Division of Housing and Community Renewal has issued approximately 1,400 luxury decontrol orders for occupied apartments and an additional 2,150 vacant apartments have left stabilization via vacancy decontrol. Another 1,175 applications were pending with DHCR in March of 1997.

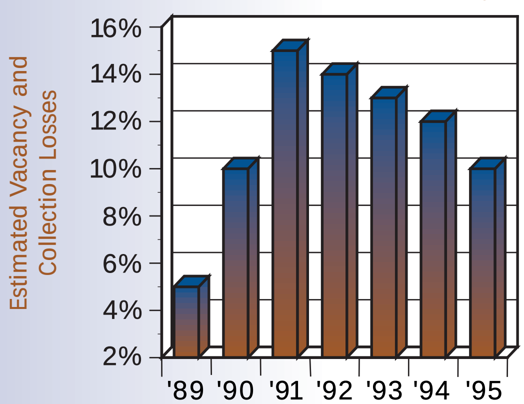
After Inflation, NOI is Approaching Levels Last Seen in the Late 1980's...



Even though Allowable Rent Increases Have Declined Sharply...



Decreased Vacancy and Collection Losses have been the Key.



Sources: RGB Income and Expense Studies, 1990-1997; Rent Guideline Explanatory Statements, 1989-1995. See note 8 for additional details.

One final factor which will spur future rent growth is the disappearance of "preferential" rents. During the recession many owners found they could not charge the registered rent, which was actually above market levels. In 1991 rents in post-war buildings fell due to increasing vacancy and collection losses and preferential rents. As the economy continues to improve and tenants move, many landlords will presumably charge registered rents, providing an additional boost to rental income.

Net Operating Income

The Rent Guidelines Board has never been able to directly measure the profitability of rental housing. The data requirements for such a project would be immense, and inevitably there would be much argument about how to define "profit." Even so, the RGB has obtained data from income and expense statements filed with the Department of Finance for several years, and this data is a reasonably good surrogate for changes in profitability.

The amount of income remaining after maintenance expenses are paid is typically referred to as "Net Operating Income" (NOI). While debt service and income taxes then determine the ultimate profitability of a property, NOI is a good indicator of its basic financial condition. The chart on this page shows changes in the level of Net Operating Income since 1989 in constant (i.e. inflation-adjusted) dollars.

Net Operating Income declined sharply between 1989 and 1992. A substantial decrease in NOI actually preceded the full brunt of the recession. Sharp increases in real estate taxes, water and sewer fees, and fuel costs cut constant dollar monthly NOI (per dwelling unit) from $238 in 1988/1989 to $213 in 1990. From 1990 to 1992 the profitability of rent-stabilized housing declined even further, primarily due to the impact of the recession and declining rent collections.

Remarkably, despite the loss of more than 300,000 jobs between 1989 and 1992 (nearly a tenth of the work force) and the fact that RGB rent increases were declining throughout this period, NOI in pre-war buildings was unchanged from 1990 to 1992. The impact of the recession was felt more strongly in the post-war stock, as NOI declined nearly 25% during the same period.

In 1993 lower increases in expenses coupled with accelerating rent collections resulted in an improvement in NOI. In 1994 and 1995 the improvements were even greater, as constant dollar NOI nearly returned to pre-recession levels. Given recent trends in rents and expenses, it appears likely that NOI improved in 1996 and will make additional gains in 1997.

Mortgage Financing

In evaluating the state of the New York City Rental Market, one final consideration is in order – the availability and cost of mortgage financing. Although NOI may now have returned to pre-recession levels, can we say that owners are as well off as they were in 1989? Is mortgage financing available at favorable terms?

In 1989 the average mortgage interest rate charged by banks was 12%, significantly higher than the previous three years (10.2% to 10.8%) but much lower than in the early 1980's (13% to 16%). Lenders charged 1.5 to 1.6 points for financing in 1989. The average loan term was 5 years. Fixed and adjustable loan terms were equally common.

After the onset of the recession, the market changed radically. Although the decline in interest rates was a positive development, many lending institutions were dissolved by the RTC or left the multifamily mortgage market altogether. Freddie Mac discontinued purchasing mortgages in the secondary market. The disappearance of so many lenders meant that financing was hard to obtain. Even the financial institutions which remained tightened their lending standards.

By 1995 the lending market had been entirely restructured. The rigid lending standards put in place in the early nineties paid off, as defaults stabilized and mortgage delinquency declined. Freddie Mac re-entered the mortgage market, infusing sizable funds into the lending pool. Loan volumes inched up and, for the first time in almost a decade, lenders who had left the market resumed loan originations.

Today, financing is available at more favorable terms than in 1989 and the lending market is far healthier. The RGB's 1997 Mortgage Survey found that the average interest rate charged for new multifamily mortgage financing was 8.8%, virtually unchanged from the previous year. Lenders charged 1.3 points for financing. The average loan term was 11 years with fixed and adjustable terms available.

Apart from the advantageous terms being offered by banks, borrowers also have more choices. It is clear from this year's Mortgage Survey and testimony by bankers that competition among lending institutions has intensified. This competition, coupled with favorable loan terms and the re-entrance of Freddie Mac into the market, is quite positive for owners in the short and intermediate term. ❐

End Notes:

1. The "Core Rate" is defined as the increase in owners' operating costs, assuming that utilities costs (i.e. fuel oil, natural gas and electricity) remain constant.

2. Since 1992 the non-real estate contribution to the core rate has been remarkably constant, ranging from 1.2% to 2.3% (including the projection for 1998). Thus, most of the variation in the core rate has been due to change in the rate of increase in real estate taxes.

. Rent collections are defined as rent received by landlords (i.e. contract rents minus vacancy and collection losses). Income and Expense Statements filed with the New York City Department of Finance are examined each year by the RGB to measure collections. DHCR registered rent is the mean average monthly rent of stabilized apartments registered with the State Division of Housing and Community Renewal.

4. Editor's Note: After this piece was written, the State passed the Rent Regulation Reform Act of 1997 which will certainly boost rents substantially in the near and intermediate term, adding to the other upward pressures on rent identified here.

5. Housing NYC: Rents, Markets and Trends '96, p. 66.

6. Ibid, p. 58.

7. Editor's Note: The luxury decontrol restrictions enacted by the NYC Council were negated by the Rent Regulation Reform Act of 1997.

8. The Rent Guidelines Board's "Rent Index" attempts to measure the effect of the Board's orders on rent levels. While it accounts for the impact of lease renewals, vacancy allowances, and the supplemental allowance, it does not, and can not, incorporate factors outside the Board's jurisdiction, including MCI increases, vacant apartment improvement increases, and other factors. The measure of vacancy and collection losses in this report is the mean rent measured by the RGB's Income and Expense Study, compared to the mean DHCR registered rent. The difference is assumed to be a rough measure of vacancy and collection losses.