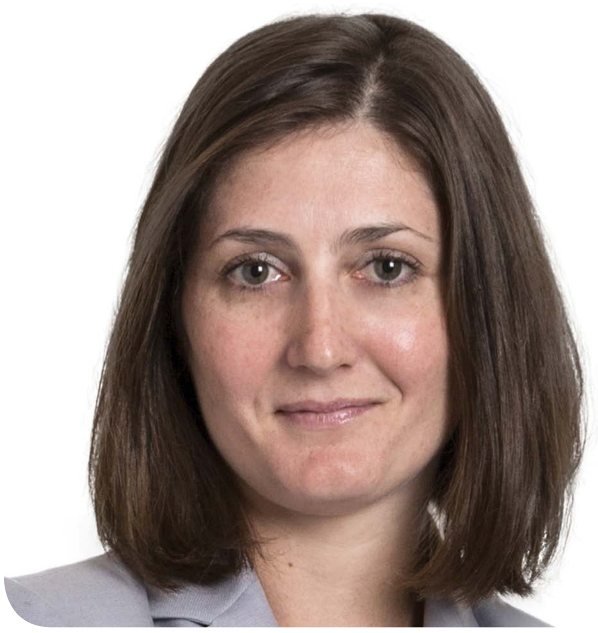
The Future of Multifamily Real Estate in New York



D. Hara Perkins
Real Estate Director and Multifamily Housing Group Co-Chair
Goulston & Storrs

James Nelson
Vice Chairman at Cushman & Wakefield,
Chair of REBNY's Commercial Brokerage Board of Directors

It's been a challenging time for multifamily real estate industry professionals in New York City. For the first half of 2017, investment sales consideration–or the total dollar value of all investment sales–was $18 billion, a 39% decrease from the first half of 2016, according to data from the Real Estate Board of New York (REBNY). The total number of transactions across the city decreased 6% year over year to 2,419. In Manhattan, the slowdown hit especially hard, with a 49% year-over-year decrease in sales consideration and an 8% drop in the number of transactions to 467.

Nonetheless, there was some positive news. Citywide price per square foot across all asset classes increased 7% to an all-time high at $570/per square foot, according to Cushman & Wakefield (C&W) data. Overall pricing increased by 2% in Manhattan to $1,483 per square foot, C&W's finding showed. Though prices for walk-ups were down slightly, by 2% to $1,010, elevator apartments were up 15% to $1,011 per square foot.

To make sense of the current climate for multifamily investors and developers, Crain's Custom spoke with D. Hara Perkins, director and co-chair of the Multifamily Housing Group at law firm Goulston & Storrs PC, and James Nelson, vice chairman, Team Nelson and investment sales at C&W, and chair of REBNY's Commercial Brokerage Board of Directors.

Crain's: Sales activity in New York City's multifamily market picked up in May and June, after a period of softness, according to data from Ariel Property Advisors. Will the Fed's increase in short-term interest rates in June—its fourth increase since 2015—have a significant effect on whether the uptick will continue?

D. Hara Perkins: I would not expect a small move in short-term interest rates to slow overall activity. Maybe it would hit pricing somewhat, more than decrease overall activity.

That said, we can't really speculate about the impact of interest rate increases alone on sales activity without considering the other potential federal legislative and policy changes, like corporate tax rate cuts and the subsequent repatriation of overseas earnings. On Charlie Rose a few months back, Byron Wien of Blackstone made predictions of earnings on the S&P's 500 going from 115 to 130, if we see this administration successfully move forward on deregulation, corporate tax cuts and repatriation of overseas earnings.

Real earnings improvement is significant for the New York City apartment market. We all know a New York City apartment is not purchased from wages alone—or most of our wages—but also investment savings, bonuses (if they still exist), and distributions. Even the half-million-dollar studio apartment is subsidized by mom and dad.

If we see real earnings improvement, I would predict the uptick in sales activity will continue, even with the recent interest rate increases.

James Nelson: The market has been expecting gradual increases in the federal funds rate. I don't think this will come as much of a surprise to investors. We've already seen an uptick in cap rates [the rate of return on real estate investments, based on the income they are projected to generate] to a small degree. The current spread between average cap rates today and the 10-year treasury is 2.3%, the widest point since 2002. What that's really saying is this is an opportunity right now for investors to buy. They can get a much better cash-on-cash return.

There has been a slight upward pressure on cap rates from 4.55% to 4.62% citywide across all asset classes. Typically that means a downward shift in pricing. Interestingly enough on a price per square foot basis, New York City is at an all-time high based on our figures at $1,483 per square foot across all asset classes.

You might ask how do you have cap rates going up as well as prices? When you look at the average rents being achieved, rents are going up. Even though investors are looking for a little bit more yield on their investments, the pricing is increasing as well to an all-time high.

Crain's: Pricing appreciated in the second quarter in the Bronx and Queens. What is driving this trend—and do you expect it to continue?

D. Hara Perkins: I would not have predicted 15 years ago that you would be able to find pain au chocolat in Bedford Stuyvesant before the Grand Concourse. I kept thinking Long Island City and the South Bronx would hit, but for so long they could not compete with the Brooklyn brand. You hear college graduates around the country say they want to move to Brooklyn, not NYC. Now, finally, the Bronx and Queens are trending. Why?

The simplest answer is lower rents, decent housing and not-totally-broken commutes: three stops on the 5 train or one stop on the 7 train to midtown Manhattan.

There has also been significant city investment and support for these areas. I work a fair amount on New York City Economic Development Corporation transactions, helping to reposition underutilized real estate into new hubs of jobs and activity, like Essex Crossing and Cornell Tech on Roosevelt Island, both in Manhattan. EDC also has a number of projects in the Bronx, like Hunts Point Peninsula; and Queens, with Hunter's Point South. The government investment is not merely subsidy, but years of cultivation.

Aside from lower rents, commute times, and government investment, why does a neighborhood attract the demographic it attracts? It's not just the numbers.

Yale professor Robert Shiller uses the term "narrative economics." What's the popular narrative driving the numbers? He asks, what movie am I in? I love that approach. The artists are leaving LIC and heading to the Bronx. Does Gucci's "Soul Scene" campaign help explain Bronx pricing? Does MOMA's PS1's outdoor music series "Warm Up" explain Queens appreciation?

James Nelson: I do expect for it to continue. There has been a lot of interest in the boroughs. I think it's really a result of people looking for more value and opportunity. What investors really look for is the price per square foot. The average multifamily price per square foot in Manhattan is over $1,000 per square foot, in the Bronx it is around $200, in Queens it's about $350, and in Brooklyn it is around $400. In Queens and Brooklyn, you can buy properties three to four times the size you would get in Manhattan for the same investment. Most of the attention is happening in areas that have good transportation. That's why Queens has been so desirable. In Long Island City, Jamaica and Sunnyside, it's really a result of how convenient they are and access to transportation, such as the 7 line.

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— *D. Hara Perkins, Goulston & Storrs*

With the L shut down, Queens is getting a lot of the attention from Brooklyn. If you look at 2016 numbers, Brooklyn was an $8.2 billion market and Queens was a $4.9 billion market. A lot of investors are getting priced out of Queens and Northern Manhattan; that is why there has been so much attention on the Bronx, which was a $2.4 billion market in 2016. The Bronx has that connectivity also, so we've seen a lot of attention. Certainly it has a lot of industrial [areas] as well.

Crain's: The rental market has been an important source of growth for the multifamily market. What do owners of rental properties need to do to stand out in an increasingly competitive market?

D. Hara Perkins: In my practice, the two areas where I see a real competitive edge in the rental market are building amenities and interior design, specifically design for smaller apartments and shared apartments.

We are seeing everything imaginable for new amenities: Uber waiting rooms, movie studios, yoga studios—outdoor yoga studios, outdoor showers, built-in kitchen composters, vegetable gardens, tiers of landscaped roof tops, dog-walking terraces, blowout salons, robot-operated storage rooms. We are seeing the most creative use of common areas. More is more.

Developers are also maximizing each square foot of apartment space in a variety of ways: 250-square-foot micro apartments, shared apartments designed for roommates with occupied/vacant signs on the restroom doors, furniture that can be borrowed if a guest visits, moving walls, expandable tables, collapsible beds. These are all part of the initial design and brand of the building. Less is more.

I have a client who made wide, graceful stairwells a central element of an apartment development in order to encourage exercise among the residents. Another client renovated apartments with elderly tenants and placed treadmills and seated bikes in the hallways of the common areas, rather than hidden away in a gym. The tenants in both of these projects expressed an interest in healthy living, and the developers responded. I love when design succeeds in this manner, changing the way we use space for the better.

James Nelson: The average rents have increased. The one thing you do need to pay attention to is the concession packages. What you are seeing today, certainly for new construction, in many cases, is 1-2 months of free rent and the owner paying the brokerage fee. I would say the rental market is strong, but you do need to look at the concessions and time it takes to rent some of these apartments. The product that's going to move today is going to be the product that's well located. That goes back to transportation and proximity to the subway and in some cases the ferry.

I don't want to put too much weight on the subway. In Greenpoint, there are a tremendous number of apartments coming on line. There is a ferry that will take you to 34th Street and the Financial District. Many believe the waterfront will be an important part of revitalizing some of these areas. When you look at the amenity package it goes further than the gym and the rooftop. Some buildings have yoga classes, private wine cellars, movie-viewing spaces, and entire floors that are amenity floors. Now some of these amenity spaces are on the top floor of buildings, making it a major selling point to the building.

Crain's: How is the transportation situation in New York City affecting multifamily development?

D. Hara Perkins: My commute to work from the Upper West Side to 53rd and 3rd went from 20 minutes to an hour in under two years. The 1 and E simply don't work at rush hour. How will we all get to work in a year, in five years? How will this impact multifamily development?

I hope we find the political will to fix the subway. For now, I am keeping my eye on bicycles, ferries, motorcycles, driverless cars.

Bicycles are the most obvious recent development with Citi Bike and bike lanes a reality. Bikes have opened up whole new areas, like the Brooklyn Navy Yard. If your target demographic likes to bike, then new neighborhoods become prime targets for multifamily investment.

The ferries have been so much more successful than anyone anticipated. According to NYCEDC, by next year NYC Ferry's six routes will carry an estimated 4.6 million trips per year. NYC Ferry reached from Astoria to the Rockaways. It's worth looking at a map of the waterfront to see what areas will next open up if the ferries further expand.

Paris began eliminating parking spaces, rather than use congestion pricing to reduce traffic, and was pretty soon overrun with motorcycles and mopeds. Will this happen here as we get more bike lanes, with few garages? Anecdotally, I have heard of three locally designed and built motorcycle companies that lease space in new creative office/industrial design buildings in Williamsburg and the Brooklyn Navy Yard. This would make us even less centralized and subway-dependent.

I cannot yet imagine the impact of driverless cars on our urban centers. Right now I see the Uber/Via/Lyft explosion and the Amazon/Jet last mile delivery takeover and how congested our city streets are becoming. The way we move around our city—and the way our stuff moves around—is going through a major change.

REBNY **James Nelson:** It's a huge driver, and if you look at what's happened on the Upper East Side with 2nd Avenue, especially the apartments on 1st Avenue and York, over the last 5-10 years they have suffered with construction. Now that the 2nd Avenue subway has opened up, it's been a boon for the area. If you look at Hudson Yards, I doubt that would have all been possible if not for the 7 train extension. They are now introducing apartments for sale or lease there. It's becoming a 24/7 type hub, which is really what you need if you are looking for strong residential demand.

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Crain's: What are the key challenges for investors in multifamily real estate in New York City at the moment?

g&s **D. Hara Perkins:** The biggest challenge I see working with multifamily investors is simply the tightening of the market, for a host of reasons: soaring construction costs, the expiration of 421a, and the scarcity of construction financing.

Construction costs are now over $350 per square foot. Commercial and multifamily construction starts in the first half of 2015 were $19.3 billion and now $7.2 billion in the first half of this year. We know 2015 was above average, with 421a abatements set to expire. Still, that is a significant decline.

Also, national and international investors are no longer hot on New York City multifamily. It is on every sale list due to peaking rents and vacancy rates higher than usual for New York City. Also, New York City is not a millennial destination, like Austin, San Diego, Charleston and Fort Lauderdale. Texas, Florida and California all have cities that are stronger on the multifamily investment target lists than New York City.

REBNY **James Nelson:** It's a seller's market. Even in 2015, which had the most trades ever, in Manhattan it barely reached 4% turnover. Historically, turnover in New York City is only about 2.5%. The average owner holds a property about 40 years. The challenge is really finding product to buy. Most investors always complain about there not being enough product on the market. That really pushes up pricing, even though we saw a decline in the number of transactions the first half of the year. A lot of long-term owners are really generational. The rates have been so low and the financing has been so compelling that these long-term owners decide to refinance instead of selling. Lack of supply is always one of the biggest challenges.

Other challenges are pro-tenant legislation and rising real estate taxes. Politicians say the real estate taxes haven't increased. They are right when they mean the tax rates haven't changed significantly, but the assessments have gone up dramatically. In the current administration it's about 9% on average. In some cases, real estate taxes are one-third of gross income. There is a much deeper story in this pro-tenant environment.