CRAIN'S

www.crainsny.com NEW YORK BUSINESS® MAY 5, 2003

RESIDENTIAL REAL ESTATE

Owners embrace regulated space

Landlords snap up apartment buildings as '97 decontrol provision boosts profits

BY JACQUELINE S. GOLD

While owners of commercial office buildings and the landlords of luxury residential towers fight to find tenants, Robert Nelson polishes the shine on his "no vacancy" sign. As the proprietor of 1,000 apartments located in Brooklyn, Manhattan and the Bronx, he is smack in the middle of one of the hottest segments of the New York real estate market: multifamily, rent-regulated apartment buildings.

"This is a unique time in our industry," says the president of Nelson Management Group Ltd. "Even people who don't understand the market are getting into it."

There are several reasons for the rush into rent-regulated buildings: The stock market is volatile, and commercial real estate is t00 risky for many investors. Financing is cheap. Rent-regulated buildings offer a consistent return.

But the most important reason is legislation enacted six years ago that allows building owners to significantly raise rents for many vacant apartments. The vacancy decontrol provision is boosting owners' profits because it's moving an increasing number of units out of the regulated system. Some even say that if the laws remain unchanged, New York City's rental market will be virtually decontrolled in 20 years.

"There's demand for residential housing in New York in good times and bad," says Mark Teitelbaum, chief operating officer of Argent Ventures, which owns 600 rent-regulated units in Manhattan and the other boroughs. "Decontrol just accelerates your upside."

Estimates vary widely on how many rent-regulated apartments have been decontrolled since the laws went into effect, but the best guess puts the number at 80,000. Since the loosening of the rent laws, units have been moving up to market rates at an ever-accelerating pace. The number of units being decontrolled is approaching 50,000 a year.

Whether the trend will continue depends in part on what happens in Albany over the next few months. The laws regulating rents expire on June 15, and Assembly Speaker Sheldon Silver says his top priority is eliminating vacancy decontrol provisions.

Landlords respond that vacancy decontrol is the sole gift they've been granted under a system that heavily favors tenants. The measure has made it possible for owners to invest in their properties and improve the city's housing stock.

"If you hamstring owners like you did under rent control, it will inevitably lead to the abandonment of housing and the takeover of buildings by the city," says Mitchell Posilkin, general counsel for the Rent Stabilization Association, a landlord group. "That's what happened in the 1960s and 1970s, and it is imperative that it not occur again."

Vacancy decontrol allows landlords to permanently deregulate any empty unit that has reached $2,000 in rent. This relatively recent innovation is tinkering with a system that harks back to the wartime price controls of 1943. A severe housing shortage after World War II led to the extension of rent regulations in 1947.

In 1969, the City Council passed rent-stabilization measures, and 1997 reforms allowed automatic 20% rent hikes for vacant apartments and the deregulating of units occupied by tenants with incomes of $175,000 or higher.

FULL NELSON: Robert Nelson reaps the benefits of owning 1,000 rent-regulated apartments in the city, while other real estate sectors flag.

The rent regulation system allows for an end to limits on rent once the citywide vacancy rate reaches 5%. But that is unlikely to happen anytime soon, since vacancies recently fell to 2.9%, down from a high of 4% in 1996.

About half of the apartments in the city, or 1.1 million, are rent-stabilized, and another 60,000 are rent-controlled.

The fact that the supply of rent-regulated housing is diminishing makes owning such buildings extremely attractive.

Below replacement cost

Mr. Teitelbaum of Argent figures that 400 apartments on the Upper West Side that his company bought in 1999 have since doubled in value. "It's very hard to reproduce stabilized buildings in the five boroughs," he says. "You are buying at a fraction of replacement cost."

While there are several ways to value a multifamily, rent-regulated building, the two most important are capitalization rate (which divides the annual rent roll, minus the landlord's expenses, by the building's price) and gross rent multiple (a building's price divided by the rent roll).

Cap rates for rent-regulated buildings are running between 5% and 7.5%, while gross rent multiples are between 8% and 12%. One company reaping the rewards is Great Neck, L.I.-based Jonis Realty Management Corp., which owns and manages 30 rent-regulated buildings, most of them in Manhattan. In March 1998, Jonis owner Nathan Halegua, along with partners Martin Newman and Ira Fishman, paid $7.7 million for a 64-unit building at Second Avenue and St. Marks Place.

When they bought the property, the cap rate was 7.5%. But since then, six apartments have been decontrolled and rents have gone up substantially due to renovations. Now, the annual rent roll is $1.4 million, the cap rate is 10.5% and net operating income is at least $900,000 annually.

"If you can make that kind of money in these buildings, why do anything else?" Mr. Halegua asks.

Those kinds of returns are attracting larger and more diversified players into the market for rent-regulated buildings.

Denver-based Apartment Investment and Management Co., the nation's biggest real estate investment trust, is scouting for properties in New York. It plans to boost profits by bulk-buying products and services like heating oil, extermination and insurance.

The Praedium Group, another recent investor, now owns buildings with a total of 4,000 rent-regulated units throughout the five boroughs. It started buying five years ago on behalf of pension plans, insurance companies, banks and university foundations.

"Demand in this market is strong, whereas the office market is very, very weak," says Russell Appel, president of Praedium. "Prices of these buildings have been going up," he says. "We thought we saw an opportunity." But life is not all rosy for landlords. They have been squeezed in the short term by spiking fuel costs, rising real estate taxes and skyrocketing insurance premiums.

Double-digit rent hikes

Based on these escalating expenses, landlords expect to win double-digit increases from the city's Rent Guidelines Board this spring. If they are successful, more apartments will become deregulated sooner, since the increases will move more units near the $2,000 threshold.

The rollback of vacancy decontrol is a real possibility, however. Tenant groups are already picketing the offices of downstate Republican state senators in an effort to put pressure on Senate Majority Leader Joseph Bruno.

"We are very well-positioned to get some changes in Albany this year," says Michael McKee, associate director of the New York State Tenants & Neighbors Coalition. "Shelly Silver and the Assembly Democrats have been very forceful and very supportive."

Owners say they are not particularly worried right now because the Legislature is overwhelmed with the state budget process. Landlords trust that lawmakers will have little time or inclination to pass anything but a straight reauthorization of the rent regulations, which would leave the system intact.

"Very few people in Albany are concerned about this right now. The need for changes in the rent laws exists only in the minds of tenants and owners," says Dan Margulies, senior vice president at brokerage Georgia Malone & Co.