# COMMENTARY – *Bob Knakal*

OCTOBER 21, 2008

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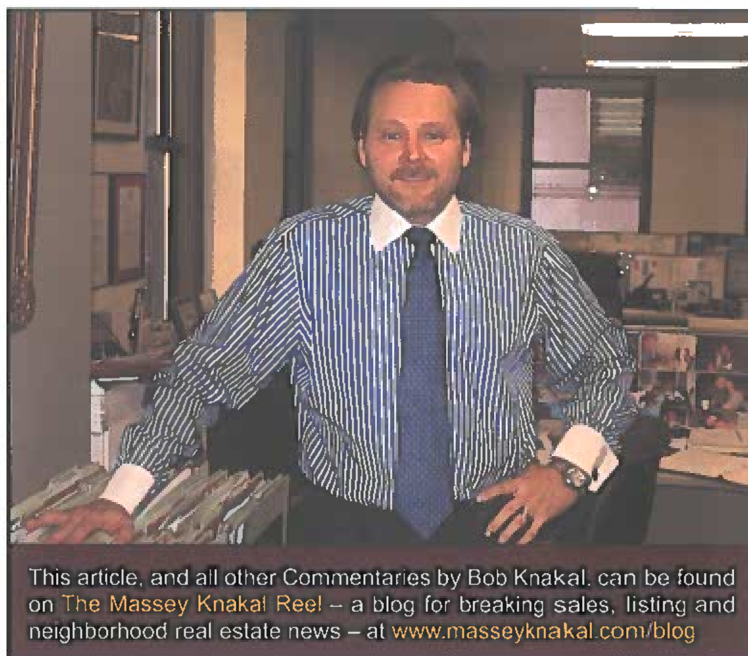
# *New York City Multi-Family Properties Continue to Show Signs of Strength Despite the Credit Crisis*

Yes, I know that things in our real estate market are very challenging and we have a long way to go before any recovery can occur, but there is some encouraging news out there. I am often asked what types of properties are most highly sought after today. After pointing out that income producing properties in under the $50 million market are doing much better than larger institutional quality buildings, we start to look at specific product types. **Clearly, retail properties which are well-leased and parking garages are two product types where we have seen high demand. The third product type which is, by far, in the highest demand remains multi-family apartment buildings.** This product is, and always has been, highly sought after primarily due to the safety of the investment due to the artificially low rent levels that are created by rent regulation. The buildings which have a high percentage of regulated units have, in most cases, been nearly as safe as T-bills with junk bond type yields over the long term. **The higher the percentage of rent regulated units in a building, the more interest is generated from the marketplace.** Rent regulation keeps rents at such low levels that there is little risk of a reduction in gross rent rolls, regardless of economic conditions. This was the case in the recession of the early 1990s when gross rent multiples declined from 12 to 13x (for properties sold for co-op conversion) down to 4 to 5x. While these multiples dropped, the rent rolls in the properties continued to increase given the upside in regulated rents. Therefore, **the downside in multi-family properties is relatively low provided the appropriate level of financing is placed on the property. Over leverage is the Achilles' heel of apartment properties.** These properties also have a characteristic in which tenancy risk is very diversified. In a typical 40,000 square foot apartment building there may be 50-60 units. In a typical 40,000 square foot office building there will be a substantially lower number of tenants. Therefore, the risk of default by the tenants is relatively low in an apartment building.

A downside to multi-family properties is that they are extremely management intensive and only knowledgeable and hard working operators are able to truly maximize the potential that these buildings have. **Rent regulation is a highly complex and continually changing set of rules by which these buildings must be operated. This complexity creates a significant barrier to entry for new buyers and is the main reason why we see such little direct investment from foreign buyers in this market segment.** There has only been one major foreign acquisition that I can think of in the past several years and it appears that transaction is headed for bankruptcy. Not surprisingly, much of the foreign capital that is deployed into the multi-family sector is in the form of equity financing for local operators. While this barrier to entry might intuitively indicate that with less buyers, yields should be high, this is not the case. There are many operators in New York City that understand rent regulation and are able to maximize the performance of their properties through active hands-on management.



This article, and all other Commentaries by Bob Knakal, can be found on The Massey Knakal Reel – a blog for breaking sales, listing and neighborhood real estate news – at www.masseyknakal.com/blog

Notwithstanding the current credit crisis, the value of apartment buildings in the first half of 2008 versus the first half of 2007 (which will be viewed as the top of the bell curve for the last cycle) shows that prices were down, on average, only 5%. Since July 1st of this year, prices may have gotten softer by another 5% but, notwithstanding this additional drop, we are still within 10% of the top of the market. It is easy to conclude that this segment of the market has performed much better than others. The average capitalization rate for multi-family properties has inched up from an average of 5.5% in the first half of 2007 to 5.8% today, still

During Mr. Knakal's almost 25-year career, he has sold over 1,000 buildings having an aggregate market value of over $5.8 billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial (now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. In 1990, he was awarded Crain's New York Business "40 Under 40" awarded annually to 40 business people under forty years of age for outstanding achievement in the New York business community. In 2001, Mr. Knakal was named one of "The Top Dealmakers" by Real Estate New York Magazine. He has twice been the recipient of the Robert T. Lawrence Award in the Real Estate Board of New York's Most Ingenious Deal of the Year Contest. First in 2002, for the assemblage of the easterly blockfront of Second Avenue between 54th and 55th Streets. Then again in 2004 for the sale of the historic Gotham Book Mart at 41 West 47th Street.

*Please give a call if you have questions about your property or the market in general.*

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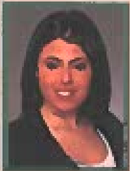


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well below the cost of debt. At our regular Monday morning sales meeting, I asked our brokers if they had any multi-family transactions at a capitalization rate of 6% or better. There was only one hand raised and that was due to the fact that the building consisted of nearly 100% free market apartments. This is indicative of the sector's strength.

**Portfolio lenders have also been a main contributor to the health of this sector.** Multi-family not only is the most highly sought after product type by investors, but is the most highly sought after asset class for portfolio lenders. Loan to value ratios have certainly slipped from 75-85% in the first half of 2007 to 60-65% today. Clearly, there is substantial equity that is required to purchase multi-family buildings but the rates on 5-year fixed money today fluctuate in the mid-6s which is relatively low by historical standards. We have also seen a shift from the very common utilization of gross rent multiples to more of a focus on capitalization rates. **The spike in oil prices earlier this year impacted multi-family properties by almost a full multiple.** Increased cost of operations have also led investors to look more closely at cash flow and capitalization rate as opposed to gross rent multiple.

**Perhaps the biggest trend change that we have seen in this market segment is the shift away from aggregating multi-family properties into portfolios which, up until about a year and a half ago, was the way to attract institutional capital because the bigger the transaction was, the better.** Today the sum of the parts exceeds the value of the whole. Many portfolios that are being offered to the marketplace are now being broken up with properties being sold individually. This is a 180 degree change from the height of this cycle. The individual property sales also require less aggregate dollars making them within reach of a larger pool of investors. We believe that we will see a constant (albeit low) flow of product into the market as the de-leveraging effect of the credit crisis takes hold. We are seeing some larger properties that were over leveraged come to market in the form of note sales or direct sales from lenders who have taken properties back. **Due to the reduction in loan to value ratios, it may become difficult for some owners to refinance an existing loan without injecting additional capital into the property.** If this additional capital is not available to them and they choose not to bring in a preferred equity partner, a sale of the property may be their only alternative. **We believe this de-leveraging process will take place over a period of years as loans mature and interest reserves burn off.**

Perhaps the biggest question on the minds of owners of multi-family buildings today is what will happen legislatively if the majority in the New York Senate shifts from Republican to Democrat? What will be the fate of The Rent Guidelines Board? What will happen to the $2,000 luxury decontrol threshold? These are questions that will only be answered in time and investors who remain the most bullish continue to aggressively seek opportunities in this market segment. A confluence of factors have kept the multi-family building sector in New York City resilient as long time owners continue to grow their portfolios.

Have a great week,

Bob