Multifamily, Yesterday and Today

Cap rates, GRMs and other metrics since '84—and what they mean for the futur

BY ROBERT KNAKAL

Operating multifamily properties in New York City is a challenging task, given the complexities involved in the city's rent-regulation system. If you are a frequent reader of Concrete Thoughts, you know the many deficiencies that exist within the system. Most people believe that rent regulation is an affordable-housing program, but it is really not—housing is allocated in New York, via rent regulation, based on inertia rather than on economic ability. This creates a significant misallocation of our housing stock, constrains supply, lowers the real estate taxes that regulated properties pay and burdens owners with complex rules and regulations that are sometimes difficult to understand.

Robert Knakal
Columnist

Even those who make the rules and enforce the regulations don't fully understand them, or so the court system would lead you to believe. This was evidenced in the recent Roberts decision in the Stuyvesant Town–Peter Cooper Village lawsuit and also in the recent court decision in which it was held that the Rent Guidelines Board, the entity that decides legal rent increases in regulated units, did not have the authority to implement a low-rent supplement to those paying less than $1,000 per month. In these cases, the courts essentially said that the referees, and even those who make the rules, don't understand the rules.

These occurrences have caused tremendous uncertainty within the multifamily market, and I am often asked my opinion of the market's reaction to these uncertainties. Can capitalization rates return to levels as low as they have been? Can gross rent multiples (GRMs) continue to stay at elevated levels? What directions will these metrics take and how will the horizon change as these rent-regulation laws come up for renewal in 2011?

To provide a clear picture of how multifamily properties have performed in the past, we have compiled data going back to 1984, the year I started brokering multifamily buildings in New York. The four charts on these pages demonstrate the performance of multifamily properties over the past 26 years. We are using the Manhattan market south of 96th Street as the statistical sample on which this data is derived.

GRMs are used in New York City more than in any other location across the country. This is due to owners and operators of multifamily properties knowing, more or less, what operating costs will be, based on the number of units and the square footage of each building. They know insurance costs per square foot or per apartment as well as they know other common operating costs, such as fuel, repairs or maintenance. Therefore, they do not rely on the expenses presented on a broker setup; they merely look at the gross revenue and perform their own underwriting to determine what the property's net income should be.

GRM analysis is common, however, provided that accurate expenses are used; but cap rates are a stronger indicator of the relationship between a property's risk and its cash-flow growth potential. The price of a higher-risk property should be justified by a higher cap rate; a low cap rate can be justified for properties that show greater potential in their cash flow.

By itself, a building's cap rate doesn't mean much. You have to compare that rate with those achievable on other property types and also observe how cap rates have changed over time. To fully understand an investment in a commercial income-producing property and the risk/return trade-off, it is also important to compare cap rates to commercial mortgage rates and 10-year treasury bill rates.

The graphs demonstrate these relationships over time. Graph A shows the performance of cap rates and gross rent multiples for walk-up and elevator buildings. This historical performance is eye-opening, particularly for many brokers who have only been in the business for the past four or five years.

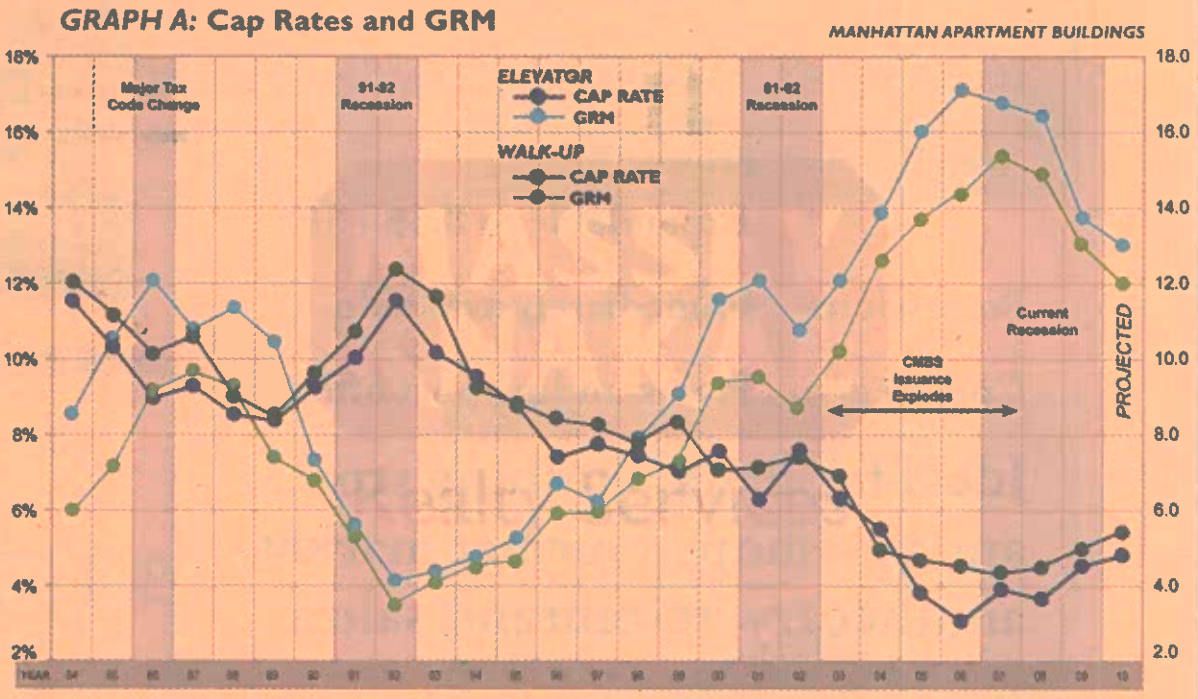
The graphs show that for walk-up buildings, cap rates have been, on average, less than 5 percent from 2004 through the present. In elevator buildings, cap rates have averaged less than 4 percent from 2005 to 2008, and rose to just 4.52 percent in 2009. Interestingly, the average cap rate for walk-up and elevator buildings, over the 26-year history, have been 8.27 percent and 7.56 percent, respectively.

It is evident in the graphs that in the mid-1980s, average cap rates for both walk-up and elevator buildings were in the double digits, and that in the second half of the 2000s, they were significantly lower. This might make you think that investors made a lot more money on apartment-building investments 25 years ago.

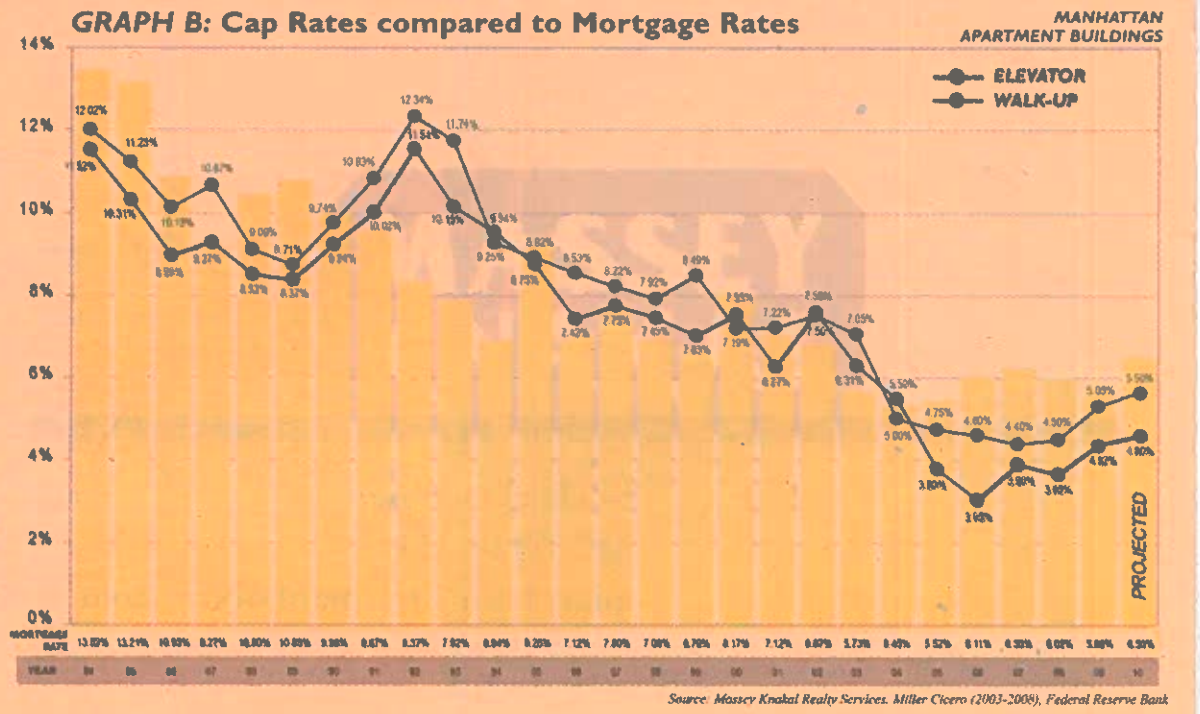
But keep in mind that in 1984 and 1985, commercial mortgage rates were higher than 13 percent, and the 10-year treasury rate, which is considered a risk-free rate on investments, was more than 11.5 percent. When we consider debt service, and yields on alternative investments, it becomes clear that those double-digit cap rates of the mid-1980s were actually aggressively low. Multifamily properties were selling at rates of return below the risk-free rate and below the rates on commercial mortgages.

In the mid-1980s, investors were willing to accept low returns on multifamily properties for several reasons. Owners of apartment buildings received tremendous tax benefits; debt was available in almost limitless supply; and, most importantly, we saw a tremendous wave of conversions of elevator buildings to cooperative ownership. In the mid-1980s, to New York brokers, condominiums

GRAPH A: Cap Rates and GRM



GRAPH B: Cap Rates compared to Mortgage Rates



Source: Massey Knakal Realty Services, Miller Cicero (2003-2008), Federal Reserve Bank

were for retirees in Florida.

As cooperative conversion drove the market during these years, the true value of a property reflected not only the value of its existing cash flow and tax benefits, but a conversion premium. But the good times were interrupted in 1986, when the tax advantages were substantially removed. The higher taxes created cash-flow problems, which resulted in increases in cap rates and reduction in GRMs beginning in 1987.

In October of 1987, the stock market crashed, but the bull market in real estate did not end for another couple of years. Note that in 1988 and 1989, cap rates for elevator buildings were still lower than the 10-year T-bill. In 1989, cap rates for walk-ups were below the risk-free rate as well (see Graph D).

The period from 1984 through 1989 was categorized by high prices, negative leverage and yields below what could have been obtained on a completely risk-free basis. Tax benefits and co-op conversion potential would remain motivators during this period.

However, in the early 1990s, the real estate debt markets evaporated as the savings-and-loan crisis took hold. Leverage wasn't nearly as available as it had been. In fact, many investors had to under-leverage. Easy access to debt had resulted in overbuilding in the 1980s. But in the early 1990s, new construction virtually ceased. As Graph A depicts, in 1990, cap rates began a steady climb, and GRMs began a steady decline.

Graph B represents the difference between cap rates on walk-up and elevator buildings versus commercial mortgage rates. From 1984 through 1990, the market experienced a significant period of negative leverage. Negative leverage means that the cap rate was lower than the cost of borrowing money (mortgage rate).

After the S&L crisis, the market experienced a sustained period (through 2003) of mainly positive leverage. This was due to very conservative underwriting and lending by banks and more conservative investing as participants in the marketplace continued to feel the adverse psychology caused by the S&L crisis.

As we move into 2004, we see a sustained period of negative leverage once again. This was created by the condo-conversion era, with effects similar to the co-op conversion movement in the mid-to-late '80s. This condo-conversion craze and the large presence of institutional capital, particularly in the 2005-to-2007 period, led to the highest levels of negative leverage throughout the 26-year period of our study.

Graph D shows a comparison of cap rates to the 10-year T-bill risk-free rate. Remarkably, there have been periods, in the mid-to-late '80s and again in the mid 2000s, when the return on multifamily real estate investments was less than the risk-free rate. This is surprising, as there are significant inherent risks in owning real estate. The fact that cap rates were, at times, lower than the risk-free rate shows what ex-Fed chairman Alan Greenspan would call an "irrational exuberance" during those time periods.

The graphs presented clearly show a significant shift in the marketplace after the S&L crisis. So the question is, now that we are recovering from an even more significant financial crisis, will the market revert back to a sustained period of positive leverage, and will the risk premium associated with real estate show significant premiums in yield versus the 10-year T-bill?

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In 2009, walk-up properties had an average cap rate of 5.05 percent, representing an increase of only 65 basis points from its low point in 2007. Elevator properties had an average cap rate of 4.52 percent, up 142 basis points from the low. The reason that the basis-point increase was higher in the elevator sector was that the condo-conversion craze, which pushed cap rates down during the 2005-to-2007 period, was no longer a motivating factor in the 2009 marketplace.

Walk-up buildings saw an average GRM of 13.04 in 2009, down from a peak of 15.53 in 2007. In the elevator sector, the average GRM was 13.71, down from a high of 17.10 in 2006.

Our current projections for 2010 are that cap rates for walk-up buildings will climb modestly, to 5.50 percent. In the elevator sector, we see cap rates rising to an average of 4.8 percent. These levels should, surprisingly, remain well below the cost of borrowing and well above the 10-year treasury.

If the real estate bears are correct, and we have a significant supply of distressed assets come to market later this year and in 2011, it will increase cap rates. If this occurs, we could see a return to a positive leverage environment once again. From what we have seen thus far in this cycle, it is difficult to imagine this happening. Perhaps history will not repeat itself.

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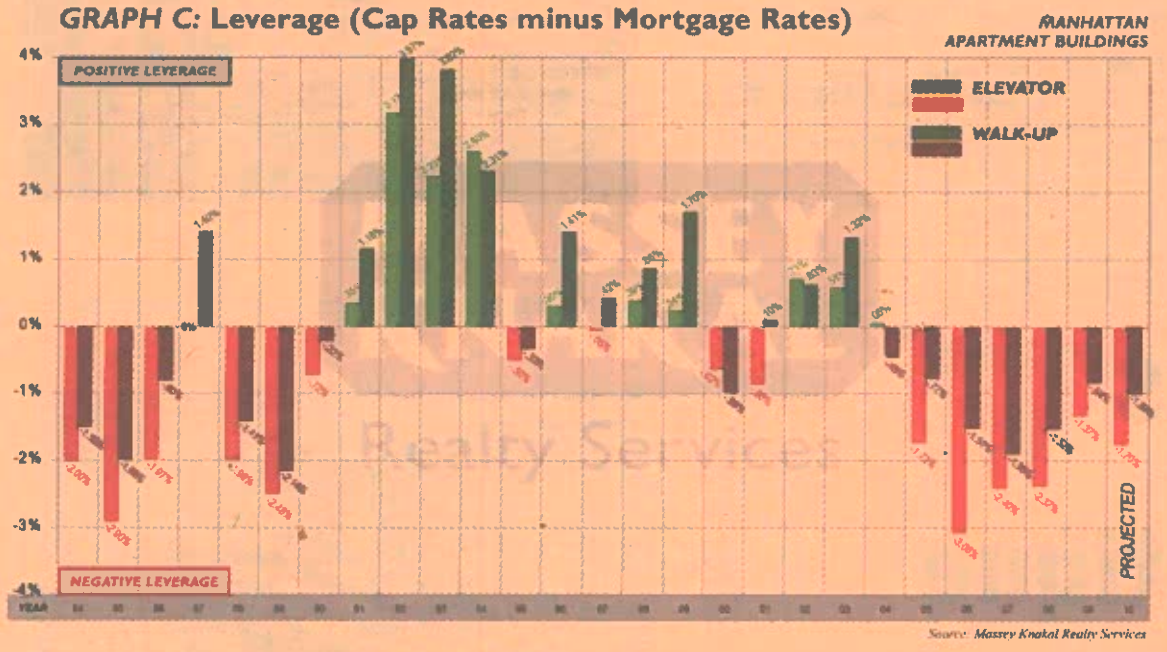
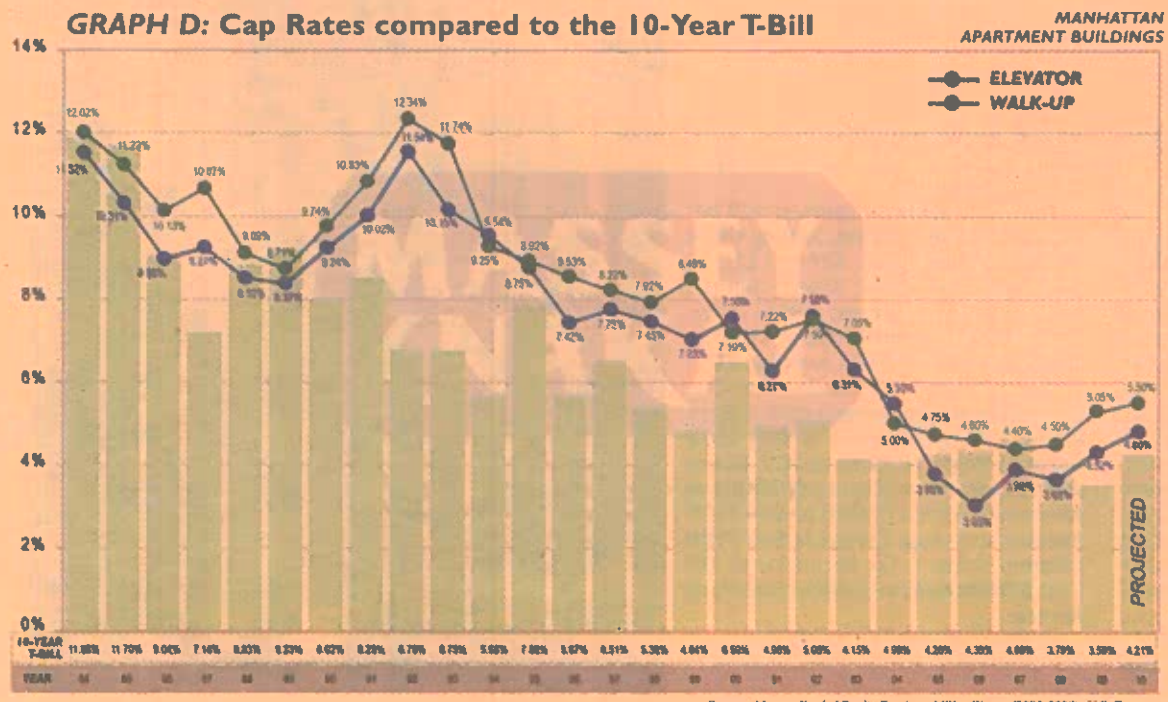
GRAPH C: Leverage (Cap Rates minus Mortgage Rates)



Source: Massey Knakal Realty Services

GRAPH D: Cap Rates compared to the 10-Year T-Bill



Source: Massey Knakal Realty Services, Miller Cicero (2003-2008), U.S. Treasury