The Troubling Trend Behind Multifamily Investment Woes

While top-line revenue growth increases, net operation incomes slow

The face of multifamily investing in New York may be changing. Given recent trends, it might well be that we are seeing the start of a fundamental shift in the way purchasing apartment properties is structured for a large slice of the buying population.

While there are families and high-net-worth individuals who are very prominent and invest their own funds, many purchasers, particularly in the multifamily arena, rely on institutional equity partners to fuel their acquisitions. A typical structure for these partnerships is that the operator puts in a relatively small amount of equity, with the equity partner providing the balance. After the equity partner receives a preferred return on his investment, the excess cash flow or profit derived from a capital event is shared disproportionately in favor of the operator. This disproportionate allocation to the operator is typically referred to as a "promote."

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When times are good, cash flows are rising and property values are appreciating, this structure is highly advantageous to both the operator and the equity investor. The equity investor gets a satisfactory return plus a portion of the upside while the operator receives substantial compensation in the form of sweat equity.

Within just the past month, however, four operators have complained to me about current dynamics within the multifamily marketplace that have, lately, been causing rifts within this traditional partnership structure and putting its viability moving forward in doubt.

Indeed, while top-line revenue growth has increased by 13 to 20 percent over the past few years, corresponding net operation incomes have increased by only 1 to 4 percent. Top-line revenue growth usually flows to the bottom line in apartment buildings, but lately it has not translated as consistently to higher net operating income because operating costs, particularly real estate taxes, are increasing at a reckless pace. Today, real estate taxes as a percentage of gross revenue are approaching 30 percent, the highest they've ever been.

We've seen real property value in this city drop by 38 percent on a price-per-square-foot basis from the peak of the market, in 2007, to the trough of the market in 2010. During this period, corresponding real estate tax assessments continued to increase year after year, causing real estate tax bills to escalate. This condition is eroding much of the gain that has been observed in top-line revenue.

Due to this dynamic, the operators are having a difficult time paying the preferred return to the equity partner out of annual cash flow. This is particularly true because capitalization rates on multifamily properties have been so low recently. The average walk-up cap rate in Manhattan last year was about 5.5 percent while the average cap rate for an elevator building was about 4.5 percent.

Given these low initial cap rates, operators depend on revenue growth to pay the preferred return to the equity partner and create additional value that can be accretive to the amount they receive as their promote, making it a very challenging business model for these operators.

To the extent operating dynamics don't change significantly in the operations of these buildings, this could significantly change the landscape of multifamily investments moving forward. Relatively passive equity investors may decide to bring operating capabilities in-house. Alternatively, we may see a dominant resurgence of high-net-worth investors and family offices, similar to the huge market share REITs have attained in the office building sector given their extraordinary access to public capital. Or, perhaps, we will see a change in the traditional model in which operators will be required to have more skin in the game than they are accustomed to.

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