

# It's the End of the World as We Know It

Those are words from the famous REM song but they're more applicable today than ever when it comes to the New York City commercial real estate market. The recently passed new rent regulations are catastrophic for the multifamily real estate market and the tenants that are going to have to live in the apartments of tomorrow.

During the 1977 World Series, the Goodyear blimp panned out and showed fires burning around the stadium. Howard Cosell famously said: "The Bronx is burning."

In those days it was more economically feasible for property owners to burn their buildings down and collect insurance proceeds than to invest in them. Today's politicians will undoubtedly return the market to those days.

The response to the crises of the 1970s was to create incentives for the private sector to invest in the housing stock. The Major Capital Improvement (MCI) and the Individual Apartment Improvement (IAI) mechanisms became an incentive for the private sector to invest in their buildings rather than

destroying them. The results were remarkable. In the mid-1970s, the dilapidation rate in the New York City housing market was experiencing a 14 percent dilapidation rate, meaning 14 percent of housing units were

uninhabitable. The MCI and the IAI went into effect and the private sector plowed hundreds of billions of dollars into the housing stock to improve the quality of their buildings and simultaneously create better living conditions for the tenants. Today, the dilapidation rate is a mere 0.04 percent. I predict the current changes will bring the level back up to double digits.

While not completely eliminated, MCI and IAI programs are marginalized to the point where they will not incentivize private sector investment. The MCI program will scrutinize the items investments are made on, and then, with a smaller basket of items that will qualify, the pass-through has been reduced by 67 percent. With regard to the IAI, the average investment made by owners is about \$60,000 per unit. Today, the IAI limit is a mere \$15,000 over a 15-year period.



Robert Knakal.

For decades, the capitalization rates, or the yields required on multifamily assets, were by far the lowest of any product type in New York. The reason for that is because rent regulation created artificially low rent levels. There were several ways to increase the performance of those buildings which is why property owners were willing to invest tremendously in their properties and over time yields would increase. Today, the new regulations virtually eliminate those ways to create additional value so the renovation dollars that previously were deployed into the housing stock will stop flowing. The housing stock will deteriorate as owners opt for the cheapest fix to their units.

In fact, in the past three days, I have spoken to four clients that have fired a total of 314 laborers who were previously on staff to renovate apartments that became vacant. Seven architects who were on staff are also now out of work. These are just some of the unintended consequences of foolish legislation by officials who don't understand how these markets work. Some owners have told me they will simply put plywood over the doors and windows and wait until more reasonable rules are implemented to put the units back on the

market. With the stroke of a pen, hundreds of billions of equity value has been vaporized.

So what does this mean for property values? If cap rates were low because the upside potential of properties with rent regulated tenants could be extracted, and the ability to extract that upside is eliminated, cap rates have to rise. How much do they have to rise to incentivize investment? Buildings with an overwhelming percentage of rent regulated units will see their net operating incomes drop year over year over year. What is the appropriate cap rate for a consistently declining cash flow? I have asked several clients this question over the past few days and no one could answer. It's like having gold in a vault with no combination to the safe, no key to open it and no current technology to crack the lock. What would someone pay for it? (Answer: Who the hell knows.)

Is this the beginning of the end for New York City? This is bad and there is no light at the end of the tunnel. I love this city and want to see it shine and thrive. There is always a reason why civilizations and cities lose their standing in the world. What will bring us down? Look around, this may be it.