The New York Times · October 5, 2003
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For Rental Buildings, A Rising Market

By ALAN S. OSER

PERSPIRING in his shirt sleeves on an August afternoon, Frank Pecora directed the workers completing his new Italian restaurant in a building he bought on First Avenue near 73rd Street. It opened on Labor Day as the new Delizia, next door to the old Delizia, which was in space he had leased in 1983.

But Mr. Pecora, 52, is more than a restaurateur and no novice as a real-estate investor. With a brother and other family members, he owns 23 buildings in Manhattan, most of them purchased since 1990. This year he bought four of them, three in East Harlem.

They put him in the ranks of those who have been active buyers of modest-sized rental buildings lately, a group that includes everything from hands-on owner-managers like himself to nationally oriented real estate investment trusts. Most of the buildings have fewer than 60 apartments, and often they have commercial as well as residential space.

The buying comes at a time of favorable interest rates, if weaker rent levels than owners had grown to expect before the events of Sept. 11. But lower rents have not fazed buyers. They complain about a paucity of offerings. In New York City, sales offerings are abundant mainly in hard times, when owners or their lenders are driven to unload inventory.

Nevertheless, the buyers keep looking. The philosophy that drives them differs, but Mr. Pecora's is a familiar one. "For me, it's always a good time to buy when I have the money," he said. "I buy it and forget about it. In the long run it has no way to go but up."

Interviews with sales brokers and buyers themselves reveal that this underlying faith is common. Since total rents in regulated buildings are usually below market levels, some buyers are willing to forgo any return at all in the early years of their investment, in the conviction that higher rental income will eventually justify the prices they paid. Building improvements and other changes in operations or occupancy may be needed to bring this about.

With certain properties producing incomes far below their potential, some buyers have been willing to pay as much as 12 or 14 times the current rent roll in Manhattan. That is not the norm, however. The more typical range in recent sales in Manhattan is 9 to 12

times the annual rent, brokers and investors say.

To some extent these multiples reflect favorable mortgage-interest rates, about 5 percent in recent years, but 6 percent or a more lately. As interest rates decline, prices typically rise.

The concept of "multiple of the rent roll" is a standard way of speaking of sale prices in rental buildings in New York City. It means, for example, that if the average rent is $1,000 a month in a 60-unit building -- or rent of $720,000 a year, assuming full collection and full occupancy -- the building would sell for $5.76 million at eight times the rent roll. At 10 times the rent roll the same building would sell for $7.2 million.

"It's counterintuitive," said Robert Knackal, a principal in the sales brokerage firm of Massey Knackal Realty Services. In general, he said, "The lower the rents the higher the upside, and the higher the upside the greater the multiple of price to rents."

Another factor in the current market, active buyers say, is that in recent years some wealthy individuals have found real estate more appealing than the stock market as a place to invest. "Equity financing is easy to come by," said Eric S. Margules, principal in Margules Properties, which has bought four Manhattan buildings in the last two years.

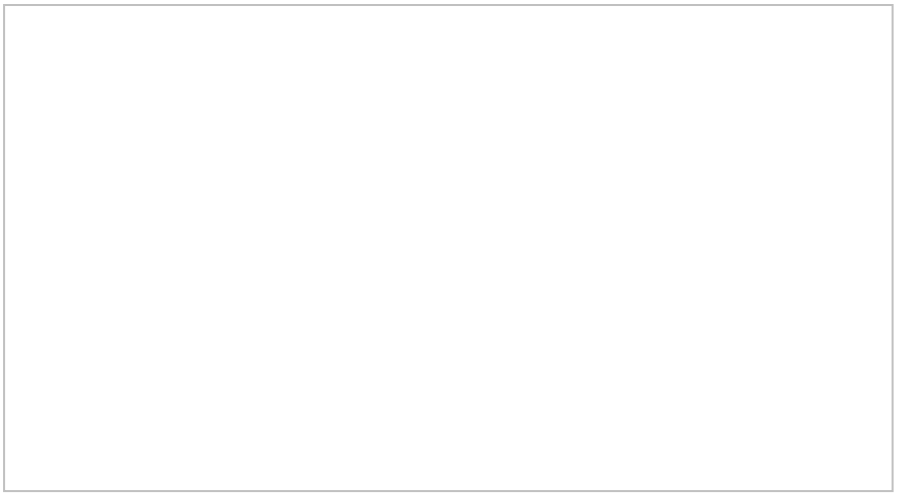
Massey Knackal was the broker in the sale of a portfolio of 12 West Side elevator buildings with 786 apartments this year. They sold for $109 million, or 11.28 times their total rents. These buildings had been held by the same family for 80 years, Mr. Knackal said, and because of long-term occupancies, about 40 percent were renting at less than half of what they would rent for if vacant. The new owner is Acquisition America L.L.C., in which Fred Shalom, president of Empire Management, is a principal.

"We bought them for the long term," Mr. Shalom said. "In 20 or 30 years down the road, they will be valuable."

Manhattan Sales Trends

Prices Have Risen For a Decade

The Massey Knackal firm keeps statistics on sales of multifamily buildings. One measurement has tracked sales of buildings under 100,000 square feet in Manhattan south of 96th Street, with 27,300 buildings in the survey, since 1989.



Using rolling averages over a 12-month period, the firm found that the average price rose to $465 a square foot in the 12 months that ended on June 30. The rise has been consistent since a low of $115 a square foot in 1993.

Based of sales volume so far, the firm projects sales of 638 buildings this year, or 2.3 percent of the 27,300 buildings. This would be a rise from 510 sales last year.

Prices, too, have risen markedly, although the figures suggest that since the year 2000 the averages have hovered within consistent ranges: for elevator buildings in Manhattan, between 10 and 12 times the rent roll; in Queens, between 8 and 10; and in Brooklyn, between 6 and 8.

Walk-up buildings have lower average multiples -- between 9 and 10 in Manhattan over the last three years, 7 to 9 in Queens and 5 to 7 in Brooklyn. Elevator buildings are more sought after, Mr. Knackal said, since buyers usually perceive a greater upside in them, so they will pay more.

The report has no information on the Bronx. One broker active in northern Manhattan and the Bronx, Robert Chambrй of Chambrй & Company, said multiples had risen to a range of 6 to 7.5 times the rent roll in the Bronx and to 7 to 8 times in Washington Heights.

The New York City Finance Department also has numbers. They show increases in values citywide. For example, in 2000 the average sale price of a residential unit in rental buildings with 4 to 10 apartments in all Manhattan was $217,200; last year the comparable figure was $223,000. In 1995 the figure was $86,000.

In these buildings the buyer is often planning to occupy one or more units, or otherwise alter the property for personal use. Since considerations other than pure investment are involved, the sale prices tend to be higher per unit than they are in larger buildings. Finance Department figures show, for example, that the average sale price per apartment in Manhattan buildings with 11 to 20 units last year was $115,600. In 1995 it was $40,800.

Other boroughs have also experienced increases in sale prices, but not of the magnitude of Manhattan's. In Queens, for example, the average price per apartment rose to $67,300 in 11-to-20-unit buildings last year, from $27,500 in 1995. In Brooklyn the comparable figures were $50,200 last year and $25,100 in 1995.

The buildings that are sold in any given year are only a tiny fraction of the whole inventory. There were only 106 sales last year of 11-to-20-unit buildings in Manhattan out of a total inventory of 5,500 such buildings. Citywide there are 10,000 such buildings; only 250 of them were sold.

None of these figures take commercial space into account in mixed-use buildings, so they somewhat distort true residential values.

Effect of Regulation

Building Owners Rely On Steady Rent Rises

Many sales are of buildings that are fully rent-regulated and are likely to remain so even after vacancies occur. Tenancy turnovers in units rented below their market value may run as low as 2 or 3 percent a year, and in very small buildings owners may wait years for any turnover at all.

What the buyers are mainly relying on, they report, is the steady rise in overall rents. Some believe these will average 6 to 7 percent a year over the next few years, taking both vacancies and lease renewals into account. This assumes that most of the apartments are currently renting well below vacancy value.

Buyers and brokers say that the opportunity to deregulate an apartment once it is vacated and the rent that a new tenant can legally be charged reaches $2,000 has little effect on the sales market. However, under a law passed this year, owners can achieve deregulation even if the owner is unable to get a rent that high.

When a regulated tenant moves out or dies, an owner may achieve a legal rent of $2,000 a month via the new-lease guideline increase, a vacancy allowance and the rent increase permitted for apartment improvements. If significant investment is needed to bring this about, it will be made if the owner believes the unit is actually worth that much on the market, or soon will be.

At one time after the enactment of the Rent Regulation and Reform Act by the State Legislature in 1993, regulations of the state Division of Housing and Community Renewal freed the apartment from regulation only if the incoming tenant actually paid $2,000 or more. But the law change allows deregulation even if the tenant pays what the rent-stabilization code calls a "preferential" rent below that amount. Owners are required to inform incoming tenants of the status of apartments that have become deregulated.

Mr. Knackal said that buyers of the buildings he sells in Manhattan often assume their rent rolls will increase by an average of 10 percent a year in the first few years of their ownership. This will come from a combination of guideline increases, lease renewals, vacancy rent increases, major capital improvements, more efficient operations and the new owner's ability to put a stop to illegal occupancy. "A lot depends on how neglectful the prior landlord was in running the property," Mr. Knackal said.

But the range in building values is wide. Robert Shapiro, vice president of Manhattan Property Investor Group L.L.C., said that in 13 deals in the last 16 months in which he was either a buyer or a seller prices ranged from 6 to 10 times the annual rent. The company is a short-term holder of properties, a deal maker whose buyers include Mr. Pecora. "The biggest factor in price is the location of the property," Mr. Shapiro said.

Buyers also have to take into account the weakened rental market of the last three years. Many owners told of a need to reduce vacancy rents from the levels of three years ago. At the higher end of the market in particular, the vacancy rate has risen. It is about 5 percent now in apartments that rented for upward of $1,800 a month three years ago, estimated Nancy Packes, president of Halstead/Feathered Nest Leasing Consultant. It was about 2 percent then, she said.

But, as Martin Newman, a recent buyer on the West Side and East Side, remarked, "The juice in the sales market is the low-rent apartments."

Mr. Newman, who buys property in partnership with Nathan Halegua, owns 33 buildings with 700 apartments and 46 stores in Manhattan, almost all south of 96th Street. He said that over the last 18 months he has profitably resold 11 buildings that he acquired between August 1999 and January 2001. He was able to raise their rental income by an average of 30 to 35 percent through a combination of rerenting vacancies, evicting or making settlements with low-rent or illegal tenants, normal increases in stabilized rents and higher commercial rents.

"There's a limit to how many buildings like this are available," Mr. Newman said. "And there's a limit to how much we would pay. I would not pay more than 10 times the gross rent -- maybe 11 in an elevator building."

Tenant turnover is not necessarily what creates value, he said. At 589-593 First Avenue, at 34th Street, purchased three years ago, there has been little turnover. But the rent roll has risen to $67,100 from $35,000 a month, largely because he was able to cancel three store leases and rewrite them, he said. The tenants stayed.

Another successful recent investment involved a property on the southwest corner of Second Avenue and St. Marks Place in the East Village -- three contiguous six-story walk-up buildings with 64 apartments and 11 stores, three of them little more than kiosks. The

property was purchased for $7.6 million in 1998, when the total rents were $1.07 million. The buyers projected a rent roll of $1.35 million in five years.

After five years, rents have actually reached $1.54 million, Mr. Newman said. The rise in residential rents was the principal reason in this instance. The turnover of 12 apartments, through a combination of deaths, buyouts and eviction, accounted for roughly half the growth in the residential portion of rent roll, which itself accounts for about half of total rental income.

"We still have tenants paying $300 a month and a couple are using toilets in the hall," Mr. Newman said. But once vacated and upgraded, a typical one-bedroom apartment will rent for $1,500 to $1,800 a month, he said.

Dealing With Tenants

In Shared Spaces, Owners' Opportunity

In Manhattan buildings, a significant percentage of newly arriving tenants are sharing, and the rents are coming from two, three or four individuals. Many sharers have gone into buildings owned by Baruch Singer and his partners. Mr. Singer, who operates 2,500 apartments in moderate-rent locations, says he has bought 20 buildings in the last three years. More than 40 percent of the new arrivals in his buildings are apartment sharers, he said. Of the rest, half are one-person households.

One recent purchase was the 55-unit building at 894 Riverside Drive, at 160th Street, near Columbia Presbyterian Hospital.

He paid 10 times the rent roll there, he said, because the average rent was much lower than what would normally be expected. He suspected a high degree of illegal activity.

"From my experience, 10 to 15 percent of the tenants are illegally renting out rooms," Mr. Singer said. It is not unusual for the tenant to be collecting $1,200 a month in an apartment in which the landlord is collecting $400, he said. On some occasions the tenant has "sold" the apartment and moved out. The new "tenant" pays the rent with money orders using the name of the tenant on the lease.

Mr. Singer's efforts to evict these tenants keep his lawyers in Housing Court, where he estimates he initiates about 100 actions a year. The outcome is mixed, he said. Some tenants leave, some settle and some are evicted.

But most buyers appear unwilling to pay prices predicated on their ability to gain possession of low-rent, possibly illegally occupied, apartments. There are other ways to add value. Mr. Margules, who owns 43 buildings with 800 apartments owned through various

partnerships, said that there was little illegal occupancy in the buildings he had bought in the last two years, but considerable opportunity for adding value.

In one case he was able to negotiate a settlement of a harassment complaint against the former owner that was impeding rent collections, he said. In another case he was able to change the status of a single-room-occupancy building to a rent-stabilized building.

At 43 Clinton Street, on the Lower East Side, he bought a dilapidated 18-unit building with two stores four years ago. It had six vacancies and a need for $100,000 in structural and apartment improvements. Now he is able to get $1,500 a month for vacant one-bedroom apartments, usually from two sharing tenants, he said.

Many of the new owners know at least some of their tenants personally. But that is not likely to be the case with the executives of the Denver-based Apartment Investment Management Company, a publicly listed real estate investment trust known by the acronym Aimco, a recent buyer of residential property in Manhattan.

Last March Aimco bought 311-313 East 73rd Street, two 1920's walk-ups with 35 apartments, a sale that pointed up the interest of a national real estate company even in a Class B property in the city if it is well located. Aimco's 2002 annual report says that its portfolio includes 1,800 properties with 318,000 housing units.

This year Aimco bought 181-199 Columbus Avenue, a strip of older buildings on the east side of the avenue between 68th and 69th Streets, with 12 stores and 88 walk-up apartments. The price was $37.5 million.

"When rents are down in a lot of cities," said Georgia J. Malone, who represented Aimco in both purchases, "national companies like New York properties, because the rents are stable in regulated buildings even when market rents weaken."

But competition from large buyers does not worry hands-on owners like Frank Pecora, the restaurant owner who buys small buildings in Manhattan. "I have an advantage on them," Mr. Pecora said. "I don't depend on contractors. I don't depend on other people. I depend on myself."

Published: 10 - 05 - 2003 , Late Edition - Final , Section 11 , Column 5 , Page 1

Correction: October 12, 2003, Sunday An article last Sunday about the market for smaller rental buildings misspelled the name of a principal in a sales brokerage firm as well as the firm name, which was also misstated in the credit line of a chart. The executive is Robert Knakal, not Knackal; the firm is Massey Knakal.

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