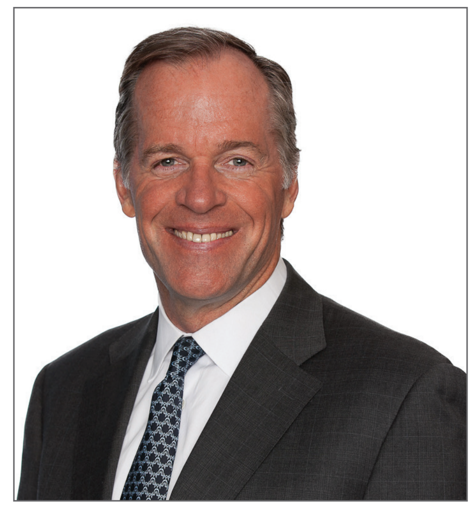
The Outlook for Multifamily Real Estate Development



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Looking skyward in Manhattan, you're likely to see cranes swarming around apartment buildings under construction. Walking along, you're likely to find yourself under one of the sidewalk bridges that seem ubiquitous in four of the five boroughs.

These projects are the welcome signs of a multifamily real estate market that is experiencing lengthy, unprecedented growth.

The dollar volume of all recorded investment sales in the city was up 20% for the first half of this year compared with the first half of last year, after a slight two-year decline, the Real Estate Board of New York found. Citywide, the volume of investment sales hit $21.6 billion, up from $18 billion for the first half of last year.

While dollar volume was up, the number of transactions was down 9%. In the first half of this year, there were 2,200 transactions compared with 2,419 in the first half of last year. Of those, 138 were sales of rental buildings with an elevator for total sales of $4.2 billion, more than double the $1.9 billion sold in the first half of last year, according to the board's figures.

Residential sales in the five boroughs continued its streak of year-over-year declines, dropping by $1 billion in the second quarter of 2018 over the second quarter of 2017, REBNY research shows. That decrease however was half the $2 billion decrease recorded the year before. Total sales of $12.3 billion in the second quarter of 2018 were among the highest recorded since 2006 and the sixth highest of all 49 quarters REBNY has analyzed.

To get an analysis of the market's trends, and where they will lead New York, Crain's Custom spoke to two industry experts.

D. Hara Perkins is a Partner in the New York office of Goulston & Storrs PC, a full service law firm with one of the largest and most highly acclaimed Real Estate practices in the United States.

Perkins co-chairs the firm's Multifamily Housing Industry group and is a nationally recognized authority on housing and economic development. She helped structure some of the more significant neighborhood-transforming real estate transactions in New York City in recent years, including Essex Crossing (on the public side) and Cornell Tech's Roosevelt Island Campus (on the private side). Perkins has also negotiated more than $1 billion worth of affordable-housing tax credit transactions for developers and investors around the country.

Paul Massey is the CEO of B6 Real Estate Advisors, which specializes in middle-market investment sales in the $1 to $200 million range.

Massey launched the firm in June after leaving his post as president, New York investment sales, at commercial brokerage Cushman & Wakefield.

He became part of C&W in 2014, when it acquired Massey Knakal Realty Services, which he founded with partner Robert A. Knakal. Massey Knakal was New York's No.1 investment sales firm for 14 consecutive years. Massey is a member of the Real Estate Board of New York. Last year he ran for New York mayor.

Paul Massey, CEO, B6 Real Estate Advisors

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Crain's: We are living in an age of the Supertalls, the tall skyscraper residences now dotting the cityscape, and high-density development in former industrial areas in the outer boroughs. What is the appeal of high density buildings for developers and for buyers?

Perkins: High density helps satisfy the demand for authentic, urban energy. Take Essex Crossing, for example, a megaproject where we represented the City. It was fully leased as soon as the first market-rate rental building was completed. It includes a new Essex Street Market, parks, local vendors, the Market Line of restaurants. You need this kind of density to support such diversity and spirit.

Massey: These high density buildings are appropriate for areas with transport hubs. There are also view premiums so the ability to build taller comes with an associated uptick in income.

Crain's: Developers are rushing to complete projects to take advantage of record-high rents and sale prices. Are there other potential disadvantages to rushing to a ribbon cutting?

Massey: Certainly. The rush to take advantage of record rents and sale prices which have dropped some takes the focus away from significant problems the city is facing. Housing for everyday people who work and want to live here is becoming more and more scarce. New York City is desperately in need of middle and lower income housing. In terms of the rush to ribbon cutting in general, the best developers are very disciplined and stick to the construction schedule. Cutting corners just to deliver is not a good strategy and is always bad for the long-term livelihood of the building.

Crain's: As the cost of living in a multifamily dwelling rises, so do the expectations of people moving into them. What do residents want in these buildings in the way of amenities and green infrastructure?

Perkins: Trending amenities continue to include the share economy, like Airbnb, Uber pick-up spaces and things like WhyHotel, a pop-up hotel in new multi-family buildings, as well as co-living operators. It's interesting how the sharing economy requires that buildings be more integrated into the system of the city. Smart amenities are trending—in fact, tech is becoming core to design. Health amenities are popular, too, like spa space and outdoor space.

Wellness is being integrated into building design overall, like making stairwells naturally lit and generally more pleasant to increase their use. I first saw this with Jonathan Rose Companies' Via Verde in the Bronx, and now I am seeing outdoor steps designed into the profile becoming key features in many multifamily developments.

Massey: Residents paying a premium to live in New York City are expecting more than just a gym nowadays. We're seeing more and more developers incorporate green amenities like composting programs and rooftop gardens. There is also a shift towards amenity programs curated by a third-party service provider or having someone from the development team curate or lead programming in a building's amenity spaces. Outside service providers can also offer services—i.e. personal training or yoga, as well as spa services, massage appointments and activities geared to children.

Amenity developers are also latching onto the addition of co-working spaces in buildings. We're seeing this as more people work from home or have flexible work schedules.

Crain's: What effect are the new tax laws limiting deductions having on investment in multifamily development? Will it turn prospective buyers into renters and invigorate the rental market even more? Where will it be a year from now and five years from now? Can the reduced deductions be offset by energy savings?

Perkins: Tax reform, specifically the cap on deducting new mortgage debt and state and local property taxes, is certainly a factor in the softening New York City multifamily market. That said, this is only one pressure point among a range of macroeconomic trends.

Massey: I can't speak for five years from now, but short-term you're going to see rental developments benefit from people who were thinking of buying but postpone it, or those who are looking to downsize and purchase a smaller apartment or home and rent until they find what they are looking for. A part of that macro shift from home-ownership to renters is the tax change, but that might not be the number one cause. With the inability to deduct all the mortgage tax, we see a few more people renting who would otherwise be buying.

Crain's: Interest rates are creeping up after a long period of record lows. How will this affect the multifamily market in New York? Will the rise help stem the housing glut some are predicting?

Perkins: Rising interest rates will certainly have an impact on the multifamily market. I often think about the reasons for this unprecedented period of growth, and some indicators of a softening commercial real estate market notwithstanding, transaction transparency may be a greater market disruptor than we realize. Perhaps in light of the benefits of transaction transparency we should change our view of market cycles. I know a number of people in the commercial real estate industry are beginning to explore new ways to find efficiency in data transparency.

Massey: Rates continue to increase from the historical lows we have been seeing over the last few years, but the overall cost of capital remains low compared to historical levels. Those low rates continue to produce compelling opportunities to refinance, reposition and/or develop real estate assets.

Zooming in on the New York's multifamily sector, it is important to remember that regardless of any widening in cap rates and a slightly higher cost of capital, the Greater New York City market area still exhibits extremely healthy demand in the residential sector due to strong economic growth.

While residential condominium activity has softened, Greater New York's steady economic growth will continue to generate acquisition and development opportunities—which will always include finding the most favorable sources of capital for each investor.

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Crain's: What factors will influence continued growth in the multifamily housing sector?

Perkins: I anticipate that multifamily will continue to be strong, even if there is a correction. In 2017, we saw the highest level of new supply since the 1980s—about 100,000 new units per quarter or 380,000 overall for 2017. Rising development costs, tighter construction financing and mounting caution levels all help keep the pace of new additions to closer to 335,000 new units in 2018. Steady job creation, healthy demographics and, now, an accelerating pace of household formation all help sustain renter demand.

Massey: Despite the recent boom in residential development, New York City is in a perpetual state of "housing shortage," especially when you consider the lack of affordable housing and with steady population growth none of this is likely to change. Another factor is the increase in urbanization. Older generations moved out of the city earlier to start a family, but we don't see that as often any more. Manhattan is currently priced more per condo than multifamily which results in higher overall land costs. It's challenging to do a rental of scale, it's also challenging to find rental sites in Manhattan. But as land values stabilize and the condo market begins to cool off, the tailwinds are there. The city will keep attracting people for a long time to come.

Crain's: What role will institutional buyers have in shaping the future of the multifamily market? Will they help or hinder investment in fuel efficiency or green programs and costly equipment upgrades?

Perkins: Environmental, social and governance (ESG) issues are increasingly important investment considerations for institutional buyers. We are seeing more REITs and funds track ESG goals and provide public accountability. Our client, AvalonBay, for instance, includes ESG data in their overall financial results.

Massey: Institutional investors will lead the way in these types of investment programs. They often have the capital and resources in place to initiate investment programs aimed at bettering the day-to-day lives of the people who purchase or rent in their developments. I think that because of this, developers like RXR, Brookfield and others will be instrumental in the next, more sustainability-focused phase of residential development. Institutional buyers, meanwhile, are always driven by competition and the need to stay ahead of the curve. They will look to upgrade using more fuel efficient and green programs to do that.

Crain's: What are some of the newer developments coming on board that will reduce fuel costs and fuel consumption in the future? Is it becoming easier to institute energy saving programs as the public becomes better versed in these issues and how much money they can save?

Perkins: Manufactured timber. Multifamily towers more than 30 stories high, built with cross-laminated timber rather than steel. It's pretty amazing. We see this type of construction popping up in Europe and now gaining attention here. Two years ago I was on a panel with the CEO of Urban Villages, a development firm exploring timber high-rise construction who described the energy and cost savings of mass timber. Sadly, I still have not read about a mass timber building breaking ground in the U.S.

Massey: I think the commitment to institute energy-saving and sustainability-focused programs is becoming the norm. Developers continue to seek these opportunities for their tenants' residents and communities in order to enhance sustainability and leave a smaller carbon footprint on the community.

Developers such as Brookfield, Related Companies and Extell Development are spearheading programs geared towards curbing energy consumption. They're incorporating a lot of smart home technology like Nest, where you can control the home environment and temperature from the outside. They make it easier to lower shades or prevent over-heating in the summer. It's all very exciting, and I can see it really taking off in the near future. It will become very efficient—something people will be willing to pay a premium to have in their homes. ■