The Rent Guidelines Board

State of the New York City Rental Market, 1998

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Introduction

Summary

The New York City rental market is in high gear and continues to show signs of robust growth in the short-term. Unlike previous periods of accelerated growth and decline, the current rental market is characterized by higher revenue streams resulting from changes in the rent laws and a booming regional economy, slow growth in operating costs, and improved mortgage financing options. These strengths should help minimize the impact of the inevitable downturn in the business cycle. A number of long-term trends, however, may limit the future vitality of the rental market: a general contraction in public-sector investments for affordable housing, growing income inequality, out-migration of middle-class households, and continued reliance on Wall Street as a source of economic growth.

Owners have benefited from a six-year trend of moderate rent increases, declining vacancy and collection losses, a modest "core rate" of operating cost inflation, and low-rate mortgage refinancing. From 1992 to 1995, there was an 18.4% increase in net operating income (NOI), bringing profitability nearly back to pre-recession levels. Although NOI growth slowed down in 1996 due to unexpected expenses and heavy maintenance expenditures, rents have continued rise for two important reasons. First, the resurgence of the regional economy has helped prolong a business cycle that has dramatically driven up demand for housing. Second, the vacancy allowance provisions of the 1997 Rent Regulation Reform Act has provided an opportunity for owners to boost revenue in many rent-stabilized buildings, particularly in parts of Manhattan.

A low rate of increase in operating costs is also an important factor contributing to rising profitability for owners of rental properties. Despite accelerated growth in the overall economy, there has been no notable increase in price inflation in the past two years. With stable prices for materials purchased by landlords and labor costs under control, the expense side of the profitability equation, like the revenue side, is quite favorable. One factor that may change this equation is the possibility of increased real estate taxes for Class Two properties, which includes rental apartment buildings, coops, and condos. Although Class Two properties will most likely take on a larger part of the tax levy, the extent of the increased burden remains unclear due to unresolved political differences between the Mayor and the City Council.

Another positive trend that will continue to bolster the rental market is the revival of the mortgage financing industry. Mortgage costs have dropped to historical lows and many owners have benefited from refinancing at lower rates. In addition, the secondary mortgage market is expanding and competition among lenders appears to be intensifying, resulting in greater flexibility and lower costs. This competition, coupled with favorable loan terms and the renewed participation of Freddie Mac in the market, will be quite positive for owners in the short and intermediate term.

Market Segmentation

While the Citywide trends noted above appear quite positive, they do not always translate uniformly to all boroughs and neighborhoods. As in many large cities, New York's rental market is segmented by a number of variables: income, ethnicity, and proximity to growth industries and major commercial centers. These variables—which often affect the ability of owners to raise rent levels and find low-cost mortgage financing—differentiate revenue streams from one area to another. The most dramatic division is found between "Core Manhattan" (the area south of East 96th and West 110th streets)—which has some of the highest household incomes and rents—and the rest of New York City.

Rent growth in stabilized buildings is uneven across the City, with Core Manhattan rents growing by 18% from 1993 to 1996 (Income & Expense Study, page 41). The rental market in Core Manhattan, more than any other part of the City, has been the prime beneficiary of a booming regional economy and the vacancy allowance provisions of the 1997 Rent Act. A few blocks to the north, in Central Harlem, the rent growth was only 8% during the same period. In the other boroughs, rents also grew at a slower pace than the Core: 10% in Queens and the Bronx, and 11% in Brooklyn. A similar pattern is found with rents paid by recent movers after the passage of the 1997 Rent Act: the RGB Recent Movers Survey (page 64) found that rents for vacant apartments had increased 21% in Core Manhattan neighborhoods, while only increasing by 7% in northern Manhattan.

Age and size of buildings are another important consideration when analyzing differences in rents collected and profitability. Older prewar buildings (built before 1945) tend to have lower overall costs than more modern postwar buildings (Income & Expense Study, page 100). However, smaller prewar buildings (with less than 100 units) also constitute the vast majority of "distressed" buildings, where operating and management costs exceed gross income. A similar pattern emerges when we look at Net Operating Income (income remaining after expenses are paid). According to this year's Income & Expense Study, prewar rent-stabilized apartment units earned $135 less (per month) than those in postwar buildings. Buildings over 100 units also tend to generate substantially higher NOI than smaller buildings, which are mostly located outside of Core Manhattan. It is this distribution of smaller prewar buildings that is another factor in the widening divergence of profitability between Core Manhattan and the rest of the City. Between 1993 and 1996, Manhattan's NOI growth—driven up by districts in the Core—was 13.3% higher than the growth found in other boroughs.

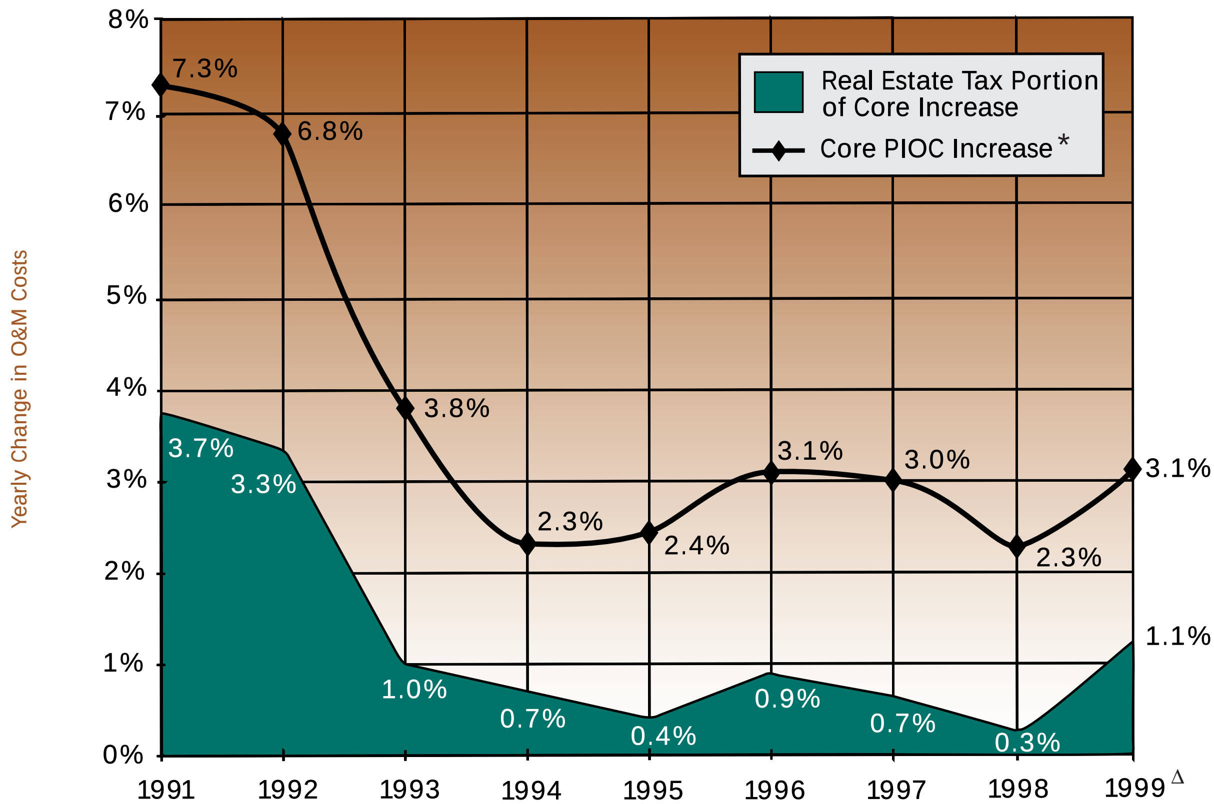
Operating & Maintenance Expenses

Recent History

Operating costs in today's real estate market have been fairly stable, with relatively small increases in the cost of materials and labor. The "core" rate of inflation for maintenance expenses, which measures local trends by factoring out shifts in fuel prices, gas, and electricity rates, has dropped dramatically in recent years. In 1991, landlords' core operating and maintenance (O&M) costs were rising by 7% per year. By 1994, the core rate of inflation had plummeted to 2%. In 1998, operating costs in rent-stabilized buildings were nearly flat, increasing by 0.1%.

A Moderate Increase in Real Estate Taxes May Push Up the Core Price Index Next Year

(Change in Rate of the Core Price Index of Operating Costs, 1991-1999)



∆The percent change for 1999 was estimated.
*The Core PIOC has been revised for years 1991-96 due to improved methodology.
Source: RGB Price Index of Operating Costs, 1991-1999

Short-Term Outlook

The overall outlook for New York City's rental market is positive, with moderate increases in most operating and maintenance expenses. The Price Index of Operating Costs (PIOC) for rental properties is expected to grow by 3.5% from 1998 to 1999 due to moderate increases in utility fees, administrative costs, and contractor services. The core PIOC, which factors out fuel and utility costs, should rise by 3.1%, a slower rate than the overall PIOC. Despite this optimistic outlook, potentially high increases in oil prices and real estate taxes may push up overall expenses and have a large impact on the rental market. The extent of such increases will depend on the outcomes of future political and economic events mentioned below.

Real Estate Taxes

Political considerations weigh heavily on any contemporary discussion of real estate taxes, which comprise about a quarter of all expenses for rental properties. In recent years, the Mayor and the City Council have been able to agree on stemming the increasing tax burden on Class Two properties, which include rent-stabilized buildings, co-ops and condominiums. This year, political differences between the Mayor and the City Council have complicated this situation and it is difficult to provide an accurate projection of real estate tax rates for next year and assess their possible impact on the rental market. This, of course, has not affected assessments, which continue to increase—especially in light of the improved economy and hot real estate market. Almost inevitably, higher assessments will mean higher tax bills.

Although the total tax levy for all properties has not significantly increased for several years,[1] the distribution of the levy has shifted and Class Two properties have taken on a larger tax burden. In the past the Mayor and the City Council have agreed on real estate tax changes and even intervened to lower the increase in the tax rate for Class Two properties to 2.4% in FY 1996 and 2.3% in FY 1997.

This year, the two branches of municipal government were unable to find common ground on tax policy. Based on last year's preliminary tax roll projections, the Finance Department should have instituted a 4.9% increase in billable assessments for rental buildings and a 5.3% increase for 4-10 family buildings in 1998. Unable to agree on projections for non-property tax revenue, the Mayor and the Council have each presented budgets with different effects on the property tax levy. The City Council's budget bill would have decreased Class Two tax rates by 2.8%. The Mayor, on the other hand, has instructed the Department of Finance to produce tax bills for FY 1998 that use the same rates as the previous fiscal year. Although these issues are not resolved, it is very likely that new billings will go out in December 1998 increasing the tax burden for Class Two property owners.

Labor Costs

Owners of rental properties have benefited from labor costs that have remained fairly stable in the past two years. Overall, growth in laborer's wages and benefits only rose by 2.7% this year, which is the second lowest rate observed since 1976. Much of this stability results from a decline in inflation-adjusted wages in the construction, trade, and service sectors. With an unemployment rate that is well above the national average, New York City has a large pool of unemployed labor that continues to drive down wages in many of the services needed by owners. The relative weakness of unions has also contributed to this decline. Although last year's contractual agreement between the Real Estate Advisory Board and Local 32B-32J has not yet had a major impact on labor costs, this new contract will effectively create a dual-wage system in which new hires and part-time workers will be paid less than those currently employed.

The new 32B-32J contract should begin to have a larger effect as more owners hire new and part-time building superintendents, doormen, and other unionized laborers. In the short-term, the trends noted above should continue to hold down increases in labor costs next year. Along with growth in non-union wages of 4% and modest growth in benefits, labor costs should rise by only about 3% next year. Stable labor costs are a positive development for the rental market in general, and especially for those owners in small and medium-sized pre-war building that have trouble receiving enough rent to meet operating expenses.

Contractor Services and Administrative Costs

Contractor services, which consist mainly of painting and plumbing costs, also face the same wage pressures affecting janitors and superintendents. Overall contractor service costs increased by 2.7%—the first time in recent years they have accelerated faster than inflation. Repainting costs, which is a major portion of contractor services, continued a trend of low increases observed in recent years and rose by 2.1%. However, plumbers' fees rose 3.1% and elevator maintenance costs jumped 4.4%. It appears that the increase in the latter was due to a new union contract. Although contractor service costs vary widely year-to-year, overall costs should increase by 2.6% in 1998/1999.

Unlike laborers in the service and trade industries, most management companies and professionals have been able to take advantage of the increased demand for their services in the rebounding economy. Administrative costs, which consist of fees paid to management companies, accountants, and attorneys, rose by 3.3%. Management company fees, which comprise two-thirds of administrative costs, have risen from 3.5% to 4.5% in recent years primarily due to the fact that they are tied to apartment rental income. Accountants raised prices by 1.1%, while attorneys' fees rose 4.3%. The strong rental market should continue to boost administrative costs in the near term, with a projected increase of 3.6% for next year.

Water/Sewer Costs

The water and sewer cost situation has begun to improve for many owners of rental properties. Although water and sewer costs have been a significant burden for owners of rental properties in the past decade, recent rate increases established by the New York City Water Board have been substantially lower than projected. The Board's proposed FY 1999 rate increase of 4% is far lower than the 16% average annual increases experienced between FY 1986 and FY 1993.[2] Lower increases should help stabilize rental apartment water costs, which currently comprise 8% of owners' total expenses.

Coming after 5% and 6.5% rate increases, next year's 4% increase appears to reflect a slight downward trend in water and sewage rate hikes. This decline has been achieved despite the fact that the underlying cost factors driving water and sewer rate increases have not changed. The Water Board's ten year capital improvement program (1996–2005) is ambitious and will require floating some $8.6 billion dollars of debt. The high rate increases needed to pay off this debt have largely been offset by increased operating efficiencies. Better management and billing practices, along with a much-improved regional economy, have led to higher collection rates and stronger revenue performance. This trend in turn has decreased the pressure to institute higher rates. The most recent prospectus of the New York City Municipal Water Finance Authority, for instance, projects rate increases of 5.4% in both FY 2000 and FY 2001, considerably lower than in the previous prospectus.

Fuel Costs

The biggest change in this year's cost for owners of rent-stabilized buildings was the deep cut in fuel oil costs. Overall, fuel costs plunged 15% in 1997 (5% due an unusually mild winter and 10% due to price cuts). This decline in fuel costs—further exacerbated by the worsening Asian economic crisis—is an encouraging sign for owners who suffered in 1996, when fuel costs shot up almost 30% due to an abnormally harsh winter and low worldwide oil inventories.

Energy prices, which depend heavily on volatile weather patterns as well as unpredictable political and economic events, may rise again in 1998 if "normal" weather patterns return to the NYC metropolitan area. However, our initial projection of a 6.9% increase in fuel oil costs next year (see Price Index of Operating Costs, page 32) was developed before the widening economic crisis in Asia and Russia, where a declining demand for petroleum has sent prices plunging worldwide. According to the federal Energy Information Administration, excess global petroleum supplies have caused average monthly spot prices for crude oil to fall to nine-year lows beginning spring 1998. In reaction, major world oil suppliers pledged significant cuts in production for the second time in three months.

Reasonably complete implementation of the cuts pledged to date by producers should keep prices above recent lows for the rest of the year. However, oil prices in 1998 are expected to fall to $12.57 per barrel, which is $6 below 1997 levels. Asian oil demand has continued to weaken and U.S. demand growth has been below expectations despite continued solid economic growth. Uncertainties exist about the economic situation in Japan and the former Soviet Union. Unless oil production cutbacks exceed expectations, world petroleum stock levels could remain high (and prices low) throughout the rest of 1998 and into 1999, a favorable development for owners of rent-stabilized property.

Rents

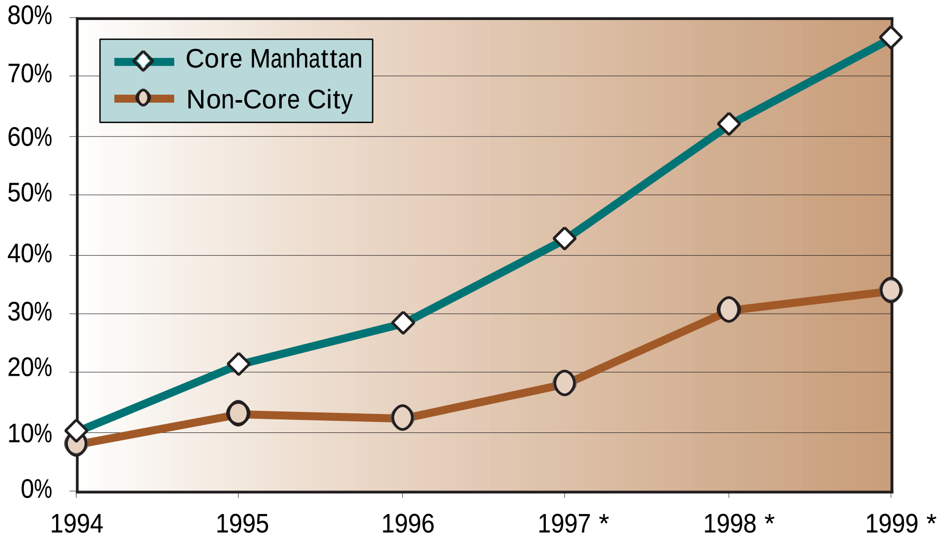
Recent History

Although the City lost nearly 200,000 jobs in the 1990s, the economy has rebounded and created a hot market for rentals in New York City, especially among those whose incomes have pulled up with Wall Street's bull market. In particular, the rental market in Core Manhattan neighborhoods south of 96th Street on the East Side and 110th Street on the West Side has gained the most from the improved health of the regional economy. The RGB's Recent Mover Survey (page 64) shows that stabilized rents went up by 21% in Core Manhattan and 12% Citywide for newly vacant apartments. This disparity is due to many factors such as housing quality, proximity to commercial centers, and neighborhood desirability. The difference in rents is driven primarily by household income. Although many stabilized units in areas outside of the Core can legally rent at higher levels, many owners do not charge the maximum allowed because they cannot find tenants who can afford higher rents.

Along with the rebounding economy, some of the increase in stabilized rents is also attributable to the passage of the Rent Regulation Reform Act of 1997. According to the Recent Movers Survey, the vacancy allowance provision of the 1997 Rent Act, which provides a minimum allowable increase of 18% for newly vacant units, has helped boost rents beyond what would have taken place without the Rent Act.[3] Another provision of the Rent Act—vacancy decontrol—has also contributed to the overall increase in rents. Vacancy decontrol allows owners to deregulate apartment units if the rent is $2,000 or more upon vacancy. The Recent Movers Study estimates that approximately 3% to 4% of stabilized units (about 3,500 to 5,000) were deregulated during the last year. Not surprisingly, most deregulated apartments were in Core Manhattan, where 9% of all vacant stabilized units were deregulated.

Profitability Grows in Core Manhattan, But Lags in Rest of City

(Cumulative Net Operating Income Growth, 1993-1999)



*Projected increases assuming costs go up 2.4% in 1997, 0.1% in 1998, 3.5% in 1999, and income growth is constant (6.0% in Core Manhattan and 3.2% in other parts of the City.)

Source: RGB Income & Expense Study, RGB Price Index of Operating Costs

Short-Term Outlook

As the economy improves and the number of people looking for apartments in New York continues to increase, stabilized rents should show an accelerated increase. Although the trend toward lower vacancy and collection losses stalled last year and RGB guidelines were low, the 1997 Rent Act will be a major contributing factor to rising rents. This jump in rents, along with greater numbers of vacancy decontrolled units and continued use of MCIs and 1/40th increases should help expand rental income.[4]

As noted above, the vacancy decontrol provision of the 1997 Rent Act has made a moderate impact on number of apartment units leaving the rent stabilization system. According to the Recent Movers Survey, about 2,500 to 4,000 more units were destabilized after the 1997 Rent Act than in earlier years. Since the difference between stabilized and "market-rate" non-stabilized units in Core Manhattan is over $500 for vacant apartments, we would expect rental income to increase to a corresponding degree for these recently deregulated units (most of which are located in Core Manhattan). As more units become deregulated, profitability will increase in Core Manhattan as rents keep up with the skyrocketing level of demand for housing.

The level of Major Capital Improvements (MCI), which permanently increase rent as a way to compensate owners for building improvements, has remained relatively stable for the past three years. The most important change has been the elimination of the 2-3 year waiting period most owners endured before their MCI applications were approved by the New York State Division of Housing and Community Renewal (DHCR). Although this waiting period has been reduced to 2-3 weeks, DHCR has not observed an acceleration in MCI application volume. However, if the economy continues to boom, this may change and applications may increase, resulting in a corresponding rise in profitability.

Net Operating Income

In recent years, Net Operating Income (NOI)—the amount of income remaining after maintenance expenses—has shown an upward trend, especially for rental properties in Core Manhattan. While debt service and income taxes then determine the ultimate profitability of a property, NOI is a good indicator of the basic financial condition of rental property. Analyzing data from income and expense statements filed with the New York City Department of Finance, we found that the cumulative growth in NOI was over 28% in Core Manhattan and over 12% in the rest of the City between 1993 and 1996. Citywide, except for a brief slowdown in 1996 (due to abnormally high fuel costs), NOI has increased, and will continue to increase in the short-term. As the graph on the previous page shows, future NOI growth will continue to diverge considerably between Core Manhattan and the rest of the City. Cumulative growth of NOI between 1994 and 1999 is projected to surpass 70% in the Core, while only reaching 34% in the rest of the City.

In 1993, lower increases in expenses coupled with accelerating rent collections resulted in an improvement in NOI. From 1994 to 1995, the improvements were even greater, as constant dollar NOI nearly returned to pre-recession levels. In addition to high fuel costs resulting from inclement weather, the slowdown in NOI growth in 1996 suggests that owners used low mortgage rates and cash gained from prior years of robust growth to make repairs and improvements in their buildings. Finally, as reported in the RGB's 1998 Income & Expense Study, NOI growth trends have been uneven across the boroughs, with Manhattan leading the way with a NOI increase of 26% between 1993 and 1996. We estimate, given a 15% increase in Citywide average rents for vacant apartments in 1998 and a 12% vacancy rate, that rental incomes in this market should rise by a factor of almost 2%.

Mortgage Financing

Today, financing is available at more favorable terms than in 1989 and the lending market is far healthier. The easy availability and low cost of mortgage financing in the past two years has been a boon to the real estate market. The average rate for new multifamily loans at the beginning of 1998 was below 8.5%—the lowest observed in the 16-year history of the RGB Mortgage Survey (page 47). Favorable lending terms have provided better opportunities for building owners to refinance existing loans or upgrade their properties with low-interest financing. Lower debt service also increases profitability by allowing owners to keep a greater amount of net operating income.

These recent improvements in mortgage financing industry are in sharp contrast to the 1980s and early 1990s when property owners had difficulty finding affordable financing. Due to the recent economic recovery and a restructured mortgage industry, loan volumes have been inching up for the first time in almost a decade and many lenders have re-entered the multifamily mortgage market. Borrowers in today's mortgage market enjoy relatively low interest rates and also have much more flexibility: fixed and adjustable loans are both available, with loan terms ranging from 5 to 30 years. Apart from the advantageous terms being offered by lending institutions, borrowers have more choices and competition has intensified among institutions trying to gain greater market share. This competition, coupled with favorable loan terms and the renewed participation of Freddie Mac in the market, is quite positive for owners in the short-term.

Endnotes:

(1) "Analysis of New York City's Adopted Budget for 1999," NYC Independent Budget Office: "While the overall tax rate has been frozen, the individual rates for the City's four property tax classes have changed since 1992 and will change again in 1999. This results from the fact that market values have grown faster than average in some classes and slower than average in others, changing the distribution of total assessed value among the four classes. Under state law, these changes trigger adjustments in the shares of the total property tax levy borne by each class, thereby raising property taxes for some classes and lowering them for others."

(2) "Public Information Regarding Water and Wastewater Rates," NYC Water Board, April 1998: "The Board's FY 1999 proposal is to increase water rates by 4.0%. This is the lowest rate increase levied by the Board in its history, with the exception of FY's 1994 and 1995 when no increases were imposed because large surpluses had accumulated as a result of lower than anticipated costs for ending ocean disposal of sewage sludge."

(3) Under the New York State Rent Regulation Reform Act of 1997, the legal rent can be raised 20% upon vacancy if the new lease is for a two-year term. If the new lease is for a one-year term, the legal rent can be raised 20% minus the difference between the RGB's one- and two-year renewals. Since last year's RGB guidelines allowed 2% and 4% renewal increases for one- and two-year leases, this means that the minimum vacancy allowance under state law was 18% last year.

(4) A building owner may raise the rent in a unit 1/40th of the cost of increased services, new equipment, or improvements. This increase is in addition to other allowable increases.