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New York Rent Control: Paved With Good Intentions

New statewide rent control laws have thrown the New York City apartment market into turmoil, with prices of properties impacted dropping sharply overnight and the possibility that it will lead to the deterioration of housing stock and depress the amount of supply.

The law—the Housing Stability and Tenant Protection Act of 2019—affects 1.1 million rent-stabilized apartments in New York City alone, representing somewhere between one-third and one-half of the apartment stock in the five boroughs. The new controls have many provisions that are troublesome for property owners, but the most critical issues involve eliminating the ability to transfer stabilized units to market rates and limiting the amount owners can increase rents to pay for capital improvements.

Legislators crafted the laws to address the lack of affordable housing in New York, but it could have the opposite affect by incentivizing owners of stabilized properties to take units of out stock. Owners also have less incentive to upgrade older buildings that need renovations.

The law could also hurt investors and lead to an increase in foreclosures. Market players say that the values of properties with stabilized units dropped anywhere between 20-40 percent overnight. Owners with highly leveraged properties or those that are thinly capitalized will feel the most pain, and those that suddenly find themselves underwater might decide to hand over the keys to banks.

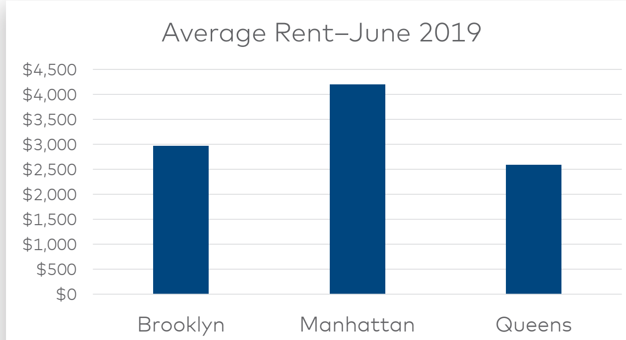
Disincentivizing Improvements

There are many provisions in the act that serve to depress rent growth, but the two biggest changes are the repeal of individual unit deregulation and the limits on Major Capital Improvements (MCI) and Individual Apartment Improvements (IAI).

Unit Deregulation: Owners formerly had the ability to raise rents by 20 percent when stabilized units were vacated, and they were able to deregulate units when rents reached $2,775 and/or the tenants had an income of $200,000 per year for at least two years. Now increases are limited to a percent set by a rent board that is indexed to inflation. In recent years, increases in rent have been set at 1-2 percent annually.

This is a particularly large blow to owners that bought buildings with the expectation of raising rents as tenants change. Because property values account for future rent growth, buildings have lost value that can't be regained unless the law is altered. Some owners likely will walk away rather than continue to operate at a loss.

Transaction activity has ground to a near-halt as the market digests the impact of the new law. The composition of the buyer base is also likely to change, as some owners exit the market while more opportunistic capital sources and those that left when acquisition yields fell to 3-4 percent in recent years will come back looking for bargains or distressed assets.



Source: Yardi Matrix

Conduit

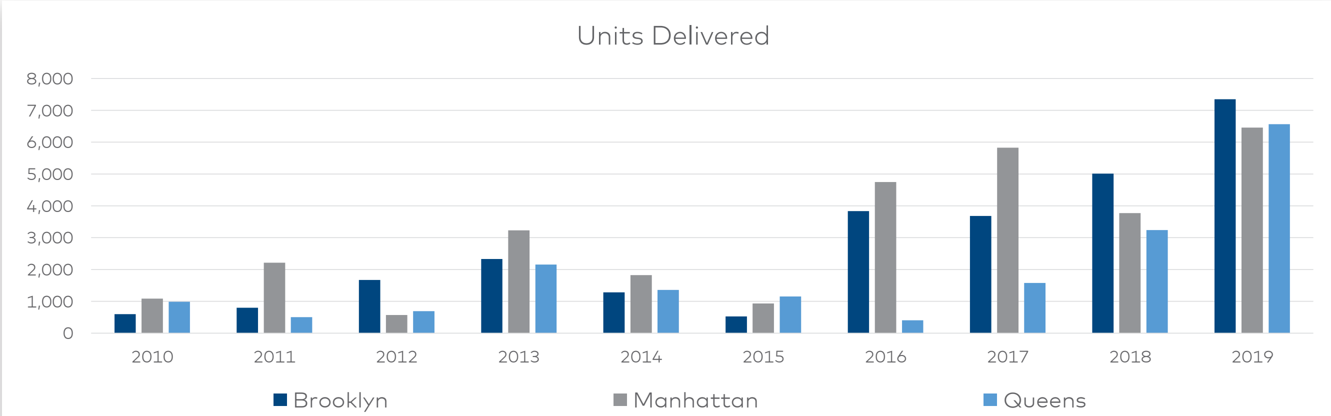
	Under Construction		Planned + Prospective	
Market	Properties	Units	Properties	Units
Brooklyn	46	11,881	85	31,821
Manhattan	43	8,211	91	31,417
Queens	20	7,303	60	29,097

Source: Yardi Matrix. Data as of July 2016

MCI, IAI: Owners formerly could increase rents in conjunction with capital improvements to properties. Now, however, landlords can only get rent increases on $15,000 of improvements over a 15-year period. Anyone who owns housing or lives anywhere near New York knows that $15,000 doesn't buy much in the way of improvements.

To some extent, the capital improvement limits were developed to combat fraud. Some property owners would put in for rent increases without improving the apartments as much as they claimed, and the city did not have the mechanism to enforce violations. That said, the limits on capital improvements are insidious for several reasons.

Most importantly, it will lead to a deterioration of existing stock. If landlords can't recoup capital spent on improvements, they either won't make the improvements or will do it with lesser quality materials. That is to the detriment of renters. It's also particularly critical given that the law applies to older buildings that by definition are the most in need of fixing. New York is filled with pre-World



Source: Yardi Matrix

War II apartment buildings that have—among other issues—old roofs, decaying HVAC systems and inadequate electrical systems.

The law in effect encourages the deterioration of these buildings. Blackstone Group, for example, owner of the 11,000-unit Stuyvesant Town and Peter Cooper Village in Manhattan, has announced that it will curtail all but legally-required improvements. A related impact is that deferring maintenance will lead to less work for tradesmen. Stories abound of contractors laying off workers such as carpenters, plumbers and electricians because of the reduction in demand for those services.

Additionally, in some cases, owners will take units out of circulation when a longstanding tenant moves out. The apartment's rent might be too low to justify the amount of work necessary to bring the unit back to rentable condition. All these scenarios lead to the reduction of the type of stock affordable to middle-income households that legislators are trying to preserve and/or increase.

The law does not apply to new construction, but new apartments in New York City are almost entirely aimed at the luxury segment with market-rate rents averaging more than $4,100 per year in Manhattan, according to Yardi Matrix. The pipeline of new supply may not be severely affected, but it is possible that some developers might decide they don't want to build in New York in the event rent control laws are tightened in the future. Nearly 30,000 multifamily units are under construction in New York City, according to Matrix.

Making Owning a Losing Proposition

The unfortunate upshot is that rent control almost guarantees that the net income of stabilized properties will decline on an annual basis. Owners face a situation in which expenses—utilities, wages, property taxes, capital improvements—almost certainly will rise more than 1-2 percent annual rent increases. That was true before, but until now owners could make up for that with the rent increases from units that had new tenants or were otherwise deregulated. It's hard to imagine how many companies want to own a property with deteriorating net income, unless they can buy it for a distressed price.

Housing affordability is a serious problem affecting most of the renters in New York City, and the legislature is within its duties to address the issue. The specifics of the law, however, will create as many problems as it solves and could will exacerbate the affordability problem by decreasing and/or reducing the quality of apartment stock.

—Paul Fiorilla, Director of Research

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