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June 4 (Bloomberg) -- When Richard J. Bailes and his family paid \$4.1 million in March for a four-bedroom apartment in the glass and steel Georgica on Manhattan's Upper East Side, just eight of the building's 58 units were occupied, he said.

Bailes and his family had plenty of places to choose from. About 8,700 new condos sit empty in Manhattan, with 75 percent not even listed for sale yet, said appraiser Miller Samuel Inc. Priced at levels the market no longer supports, they're selling so slowly it would take as long as seven years to find buyers for them all, said Jonathan Miller, president of Miller Samuel.

Miller teamed up with Westwood Capital LLC and developer Gerald Guterman to raise as much as \$1 billion to buy empty condos and manage them as rentals. Guterman made his name in the 1980s doing just the opposite.

"Things are going to run out of steam at pretty predictable times," said Daniel Alpert, managing partner of New York-based Westwood Capital. "In the case of these condos, it's when the reserve funds run out."

Builders can't afford to cut prices because they borrowed too much at the height of the market, according to Miller. He and his partners are betting that lenders will seek to sell their condo units at a loss rather

than foreclose on the building and assume all the developer's liabilities until the units are sold.

Developers taking out construction loans borrow an additional amount for interest reserves, which is intended to cover the monthly payments on the loan while the project is under construction and until sales begin, Miller said. Alpert estimates that reserves on loans made in 2007 and 2008 will dwindle in the second half of 2010 and early 2011.

12 Unit Sales

The Georgica's developer started marketing the apartments there in May 2008, and by the time Bailes bought his, 12 had sold, according to StreetEasy.com, a property listing service.

"On one side of the building at nighttime, ours are the only lights on," Bailes, a director at the Americas division of the architectural firm RMJM who moved to Manhattan with his family from Short Hills, New Jersey, said in April. "You have all the facilities and staff to yourself." The pace of sales at the building has subsequently picked up, with 32 apartments closed and nine more under contract, according to Judy Kekesi, a senior sales associate for Corcoran Sunshine Marketing Group, the firm in charge of marketing the 58-unit Georgica. A call to Ascend Group, the developer of the property, wasn't returned yesterday.

Rent Multiplier

Condominium Recovery LLC, the firm started by Miller, Westwood and Guterman, bases its analysis of the market on Manhattan's "gross rent multiplier" -- the purchase price of an apartment divided by the annual cost of renting a similar one.

The relationship between home prices and rents typically remains steady within a market, Miller said. In Manhattan, the average apartment, adjusted for inflation, cost 8.1 times annual rent from 1991

to 1997, according to Miller Samuel data. That means that in those years, buyers in Manhattan concluded that the long term benefits of owning an apartment -- tax savings and property appreciation -- were worth an initial investment of eight times the cost of renting.

Then in 1998, Manhattan prices began a decade-long climb, with year-over-year values rising by 10 percent or more in most quarters. By the second quarter of 2008 apartment prices peaked at 22.4 times annual rent, according to Miller Samuel data.

Buy Vs. Rent

At that level, buying rather than renting in Manhattan only makes sense if the purchaser expects prices to continue rising at a meteoric clip, with future sales' profits justifying ownership costs that also include property taxes, interest and maintenance fees. New York is the No. 1 city in the U.S. where the overall costs of buying are "significantly more expensive than renting," according to a report released yesterday by property website Trulia.com.

Manhattan's multiple in the first quarter of 2010 was 19 times rent, even as rental prices fell 6.1 percent from a year earlier, according to data from Miller Samuel.

"That suggests a few things," Miller said. "One is that prices are poised to slip further."

The median value of apartments for resale in Manhattan has already fallen 31 percent since 2008, narrowing their spread over rents, Miller said. By comparison, apartments in new developments, which are saddled by debt for construction loans made during the property boom, have fallen by 24 percent -- and much of that drop was due to smaller units being sold rather than significant price reductions by the developer, Miller said.

Pet Spas

New apartments, built with amenities like pet spas and wine vaults,

won't be able to reduce their price tags enough to compete with existing buildings -- and still satisfy their lenders, Miller said.

The hurdle for new developments during the slump stemmed from a lack of financing for would-be buyers. Mortgage-finance company Fannie Mae doesn't back loans made in new buildings where fewer than 51 percent of the units are in contract. That in turn makes mortgage lenders hesitant to make loans at such properties, said Orest Tomaselli, chief executive officer of National Condo Advisors LLC, a White Plains, New York-based consulting firm that helps developments comply with Fannie Mae and Federal Housing Administration lending requirements.

16% of Sales

New development purchases made up 16 percent of all Manhattan sales in the first quarter, compared with 43 percent of all sales in the first three months of 2009. The newly built apartment units that did close in the first quarter were on the market for 385 days, while resale properties spent 103 days on the market, according to Miller.

Bailes, who didn't need financing for his purchase at the Georgica, said he was attracted to the building in part because it hadn't yet secured enough sales to meet Fannie Mae approval. It made the developers more willing to negotiate on price in exchange for a cash offer.

"You get more of a deal," said Bailes, who purchased the unit at a 17 percent discount off the asking price, according to StreetEasy.com.

"The market is still not back," he said. "But we're in it at least three years. We're not looking to make any money any time soon on where we live."

At One Rector Park, a Battery Park City rental building converted in to 174 condominiums, the sales office has been shuttered. There have been no sales in the building, according to StreetEasy. Melissa

Cohen, sales director at Buttonwood Development LLC didn't return a call for comment. Neither did a spokesman for the project's lender, iStar Financial Inc.

'Shadow Inventory'

The 8,700 unsold new condos in Manhattan exceed all residential sales in the borough in 2009, according to Miller. About 6,500 of those units are "shadow inventory" and have not yet been listed for sale, he said.

"If you flush that all into the market you tank the market," Westwood's Alpert said. "So the only way you can effectively push that into the market is to bleed it out very slowly. Well, the lenders don't really have the option to bleed it out slowly because they can't hold onto it for six years."

Condominium Recovery, formed in 2009, is in the process of securing \$350 million in equity commitments from private equity firms, Alpert said. The partnership plans to approach lenders of stalled condominium projects in Manhattan and Florida, and offer cash in exchange for bulk increments of 50 to 200 units --enough to take control of the homeowners' association, cancel the sales plan, and operate the property as a luxury apartment building, Alpert said. They are making bids on Florida properties, and will turn to New York later this year.

Distressed Investing

There are currently 90 U.S.-based private-equity funds with an aggregate \$37.9 billion dedicated to investing and acquiring distressed real estate, according to London-based research firm Prequin Ltd.

"Most investors would be happy to buy apartments for operation as rentals, but most sellers and their lenders would not," said Susan Hewitt, president of Cheshire Group LLC, a New York real estate

investment and development firm that bought unsold condos in the last property downturn.

“The original developer isn’t interested in any price below the value of his interest and the lender isn’t interested in writing it down until they’re forced to for regulatory reasons,” she said. “That accounts for the paralysis right now.”

So long as regulators don’t force lenders to write down the value of their condo loans, they won’t, said Alexander Goldfarb, an analyst at Sandler O’Neill & Partners LP in New York.

Big Haircut

“Here’s the challenge,” Goldfarb said in an interview. “At the peak, a for-sale condo in New York cost, let’s say \$1,000 a square foot to build. To make it work as a rental -- conceptually you need a pretty big haircut.”

In Washington, Equity Residential, the largest publicly traded apartment company, paid \$167 million for a two-tower, 559-unit building that was developed as a condominium, the company announced in April. The property will become a rental building. Essex Property Trust Inc., another publicly traded apartment rental company, acquired Orange County, California- based Skyline at MacArthur Place condos from a lender for 55 percent of the initial construction costs, according to a March 5 statement. AvalonBay Communities Inc. the second-largest publicly traded apartment owner in the U.S., is in talks with lenders about buying unsuccessful condominium projects in the markets where it operates rentals, Chief Executive Officer Bryce Blair said in an interview last month.

‘Miami ‘08’

“New York is Miami ‘08 right now,” said Peter Zalewski, principal of Condo Vultures LLC., a Bal Harbour, Florida, real estate brokerage and consulting firm specializing in bulk sales.

“If Miami is reflective of what will happen in New York, I would say the only suitable use for those condos that are vacant right now is rental,” Zalewski said.

In downtown Miami, where 23,000 new condo units were built between 2003 and 2010, the paralysis happened in 2006, as new home sales nationally began to decline, Zalewski said. The logjam for investors targeting the oversupply of condos in Miami broke in July 2008, with the bulk purchase of 146 apartments at 50 Biscayne Blvd. by Philadelphia private-equity firm Lubert- Adler Partners LP and the project developer, Related Group of Florida. The firms bought the properties for \$36.4 million, or half the cost of the individually sold units, Zalewski said.

All the units were rented out, and as of March, 50 have been resold to individuals at a price more reflective of the market, according to Zalewski.

Bulk Sales

There have been 44 bulk transactions in Miami since July 2008, covering about 3,600 units, according to Zalewski. In many of the transactions, the developer holds on to the best apartments in the building for sale as condos, while selling the lesser ones in bulk to investors.

In New York, Corcoran Sunshine, the new-development sales unit of New York brokerage Corcoran Group, tried spurring sales at some of its properties in March by holding 12 simultaneous open houses and releasing a list of “Top 10 Reasons to Buy New Development.”

“Brand new everything,” was the No. 2 reason on the list, which also cited “intelligently designed” materials and “immediate occupancy.”

Kelly Mack, president of Corcoran Sunshine, said she doesn’t expect any of her new developments to become rental buildings. With no new projects introduced to the market in the fourth quarter, and the

development pipeline slowing, there will be an eventual shortage of new apartments to buy, she said.

“In today’s environment, buyers have a unique opportunity,” Mack said. “They have a lot to choose from.”

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<http://www.businessweek.com/news/2010-06-04/manhattan-empty-condos-may-become-rentals-as-leases-beat-sales.html>