The New York Times
Real Estate Q&A
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OCTOBER 23, 2008, 5:00 PM

Expert Q&A: A Downturn for New York Real Estate?

By THE NEW YORK TIMES

Vicki Been, director of the Furman Center for Real Estate and Urban Policy at New York University, and Jonathan J. Miller, the president of Miller Samuel Inc., an appraisal company, will be answering reader's questions on how history might be a guide to the current real estate market in New York City.

Mr. Miller is a co-founder and President/CEO of Miller Samuel Inc. He is a certified general real estate appraiser in the state of New York and has been appraising residential and commercial properties for more than 20 years. Miller Samuel provided Manhattan property valuations of more than $5,000,000,000 in the past year. He is also a co-founder and managing principal of Miller Cicero, LLC, which provides commercial real estate valuation services in Manhattan, Brooklyn, Queens and The Bronx.

Professor Been, the Elihu Root Professor of Law at NYU School of Law, is at the cutting edge of legal scholarship at the intersection of land use, urban policy and environmental law. Been has been on faculty at NYU Law School since 1990, is the Faculty Director of the Root-Tilden-Kern Scholarship Program and Director of the Furman Center for Real Estate and Urban Policy.

Historically what neighborhoods have been more prone to downturns and what factors makes them susceptible? Is there any neighborhoods now showing particular weakness?

Vicki Been: In the past 30 years, New York City has experienced two broad periods of housing price decline, the first in the 1970s and the second at the end of the 1980s and in the first half of the 1990s. These downturns both had impact citywide, though the there was variation in length and extent of the declines across neighborhoods. In the most recent downturn (between approximately 1988-1996), Staten Island experienced the longest slide, lasting about nine years, for example, while the Bronx and Brooklyn experienced the shortest downturns, lasting about five years each.

It may seem obvious, but poorer, more heavily minority communities where housing prices were already relatively low experienced less severe downturns. More affluent neighborhoods with a consistently high percentage of white residents, where prices had been going up for some time, tended to be harder hit in the downturns.

The neighborhoods that gained the most ground in the 1980s upturn were not necessarily the same neighborhoods that saw the greatest price appreciation in the most recent upturn. So it is difficult to predict how neighborhoods will fare based on what has happened in previous cycles.

As for this downturn, it is too early to tell, but we do know that prices appear to have peaked earlier in Staten Island than in the other boroughs. In Staten Island, the prices of single family homes peaked in 2005, and have been falling since then. In contrast, single family homes in Queens and the Bronx did not peak until 2006, and prices for single family homes in Brooklyn continued to rise throughout 2007.

Jonathan J. Miller: Going into the housing boom circa 2003, there was significant new development activity in emerging Manhattan neighborhoods (aka gentrification) that allowed buyers to obtain newly constructed units at significant discounts relative to prices in more established residential neighborhoods. As time passed, the discount between prices in emerging and established neighborhoods reduced and price per square foot as a benchmark became somewhat homogenized across different markets and neighborhoods. In many ways, I think there is no particular Manhattan neighborhood that stands out as more-risk exposed than others right now. In the late 1980s, that question was much easier to answer: Lower East Side, East Village, Harlem, Clinton, and the Financial District.

I believe, to a certain degree, the difference in price between neighborhoods is correlated to the risk of a downturn. It has been my experience in the past few cycles, demand for real estate has expanded to emerging markets on the upswing, only to “return to center” when the market weakens. However, the protracted growth of sales and prices in this real estate cycle has allowed more time for residential support services to become established, reducing the risk of the “return to center” phenomenon for many neighborhoods.

What upward pressures or even stabilizing effects on Manhattan prices can you possibly imagine in the next 2 years?

Richard Johnston

Jonathan J. Miller: I am having a hard time coming up with any rationale suggesting that some external market force would cause Manhattan housing prices to rise over the next two years ... and this assumes that liquidity in the mortgage market is restored. We are faced with rising unemployment and lower compensation in the financial services sector, a national recession, potentially higher mortgage rates caused by the bailout funding and a return to a pre-housing boom mortgage underwriting mindset. If liquidity improves significantly over the next year and mortgages are cheaper and easier to come by, then Manhattan, and perhaps many housing markets, would see significant improvement in activity, providing stabilization. However, if we see a prolonged credit crunch, it will simply serve to push inventory higher in most housing markets, while bailout and other related situations are sorted out in Washington. That excess inventory would need to be worked off before stabilization was to occur.

Vicki Been: Manhattan remains a unique and desirable real estate market in the U.S. and the world. Demand for Manhattan’s housing stock has become increasingly insulated from larger housing market trends because of Manhattan’s continued status as a trophy location. If crime stays low and the general quality of life remains high, we would expect Manhattan’s market to continue to defy national trends to some degree. That said, no one knows the extent of the looming economic downturn or how effective the Federal Government’s interventions will be. Until we see that unfold, we cannot predict how Manhattan’s prices will fare.

After the 1980s bubble, co-ops and condominiums got clobbered to a far greater extent than single-family homes. The average one-family home fell about one-third in value, plus inflation, but many co-ops and condos, particularly outside Manhattan, were unsellable for years (some of our friends had bought them).

I believe the reason is that the whole baby boom was moving out of the singles and couples phase and into the parenting phase, while the smaller Gen X group was moving away from home.

Is it possible that, given the different demographic situation, suburban homes will suffer a greater decline in relative value this time?

Vicki Been: During the 1980s, there was a lot of overbuilding in the condo market nationwide, due in part to tax treatment of investment housing and depreciation. Further, because the price bubble was bigger for condos than single-family homes, we saw a bigger fall when the bubble burst for condos. Today, while there certainly has been a building boom in NYC in the past few years, and many of the new condos have yet to come online, we probably don't have as much excess supply as we did during the 1980s downturn. The single-family housing market in NYC is much more constrained than the condo market (in 2007, for example, only 2% of the City's new building permits were for single family homes), so again we'd expect to see less excess supply, and therefore smaller drops in prices.

Purchasers of single family homes are more likely to be owner-occupants (not investors) than purchasers of condos and may have a longer time-horizon for owning. When prices drop, they are more likely to sit on the property and wait for prices to rebound, whereas investors who own condos may try to sell and minimize their losses. That increases the supply of units for sale and depresses prices further.

The demographic shifts between cities and suburbs over the past few decades are complicated. But in addition to the demographic changes, high gas prices may make homes in the far suburbs and exurbs become less attractive, because they usually require longer commutes. Also high home heating costs may reduce demand for larger houses.

Jonathan J. Miller: One of the reasons co-ops and condos saw a significant decline in values as you described, is because a key driver of demand for these units was speculation. Much of it was tax incentivized so the investment activity was promoted at taxpayer's expense. To make matters worse, many co-op sponsors defaulted because they needed to continue to sell apartments to cover their negative cash flow on rent-regulated apartments (difference between monthly maintenance and rent). Typically, the lender who took back the project from the sponsor, was forced to issue individual mortgages to apartment buyers because outside lenders would not. Although many of the purchases were "all cash."

My favorite story on this situation occurred in the early 1990s. I performed an appraisal of a small studio co-op in a building where the sponsor defaulted. The purchase price was $11,000 and I remember thinking, only for a moment, I could buy that apartment with my credit card, until I pondered the very real possibility that the co-op corporation could collapse. It never did.

During the recent housing boom, a trend toward "new urbanism" gained momentum. Newly constructed residential units were developed within long time commercial business districts. Class C office buildings in commercial districts of many metro markets across the country were converted to residential use along with the creation of retail shopping and other residential support services. Eventually this change may place more stress on suburban housing markets. However, I think I am more concerned about the exurbs, those markets beyond the suburbs, created in response to rapidly rising prices in urban and suburban markets. Their competitive price advantage has been weakened recently by lower pricing near the core.

Can you explain how do the current economic conditions compare to historical market downturns and how deep and long did those last?

Jonathan J. Miller: When I think of historical market downturns, my frame of reference is the '87 stock market crash and subsequent recession in 2000-2001. New York was hit hard and the housing market followed the economy. To the typical characterization, "but this time it'll be different," it may be different, but in both positive and negative ways. The Manhattan housing boom in the 1980s was characterized by a rental to co-op apartment conversion frenzy and a 421a tax abatement incentivized condo construction boom with emphasis on smaller investor apartments. When the music stopped in 1987, marked by the 25% October drop in the Dow, the housing market was left with an absorption rate of about 84 months and 30 year mortgage rates were 12%. Co-ops were deemed the pariah of the housing market with many sponsor defaults, bank foreclosures and speculative insider flips. Condos weren't much better off because of the revisions to federal tax laws in 1986 that reduced the financial incentive for individual investors to purchase the newly constructed condo units that were flooding the market.

This time, New York has been one of the last regions in the country to see weakness in housing. Across the country, housing helped lead the economy into recessionary conditions rather than the other way around. That's largely because the nation actually experienced a "mortgage boom," rather than a "housing boom," which was brought about by a complete lapse of regulatory oversight, historically low mortgage rates and the disconnect by all parties including ratings agencies, commercial banks, investors, Wall Street and borrowers over the relationship between risk and reward. But that's another story. Despite all of this, Manhattan currently has modest inventory levels (a 7.9 month absorption rate) and new development added to the housing stock is largely expected to end next year due to elimination of condo development financing. During the boom, co-ops did a better job vetting buyers than banks did and speculative activity represented less than 5% of all sales (nearly 40% in Miami) and the weak dollar fostered a lot of foreign buyer demand. Ironically, Wall Street, arguably one of the driving forces of mortgage securitization, will impact the New York region with layoffs and lower bonus. Apartment sales activity is already down by 27% year to date compared to 2007 and price trends are leveling off after years of increases. Foreign demand caused by the weak dollar is beginning to slow down as foreign economies are experiencing their own troubles.

It's pretty tough to forecast housing trends until the credit markets are at least stabilized. The proverbial "cart before the horse." The scope of the problem is historic, global and complicated. The drive to purchase real estate is still remarkably strong, but that really means little at the moment until the credit situation is stabilized.

Vicki Been: It's impossible to predict just how bad market conditions will get during this downturn based on earlier downturns. But, to put our current situation in context, it's useful to take a look back at overall housing price trends in New York City over the last 30-40 years. Prices for all housing types were mostly flat throughout the 1970s, but saw significant appreciation through most of the 1980s, topping out in 1988. Prices began to fall after 1988, and continued to fall until the mid-1990s, then slowly started to pick up again after 1996. The condo market saw the biggest hit in that downturn, with values dropping by 38% on average between 1988 and 1996 (single family homes fell by 29% and 2-4 family homes fell by 28%). After 1996, initial growth was slow, but the market really took off after 2000, and continued to be strong through 2006. For example, 2-4 family properties increased by 87% on average between 2000 and 2006, and the prices of condos increased by 86% during this time period.

While much of the real estate world didn't begin talking about a downturn in New York until this year, our repeat sales index, which measures inflation-adjusted price changes in the repeated sales of the same properties, shows that prices in the outer boroughs generally peaked in 2006 and have been declining since. Manhattan properties, in contrast, generally continued to appreciate in 2007.

History thus tells us that recent downturns in New York have come on rather slowly and lasted for a number of years. For each downturn, we've witnessed some variability in how different neighborhoods and housing types are impacted, so it's unlikely that this downturn will have a uniform impact.

I own 2 condos in Harlem, one of which I use as a rental property. I intend to hold on to both properties for the next 10 years, so a temporary decrease in housing values is not a big problem for me.

My question is will a decrease in housing value (assuming there is one) have any affect on the rental market? If prices drop, will the potential pool of renters decrease? If property values drop do rental prices follow?

Claudia

Vicki Been: That's a great question with a complicated answer. It's important to remember that in the short run, a relatively small number of households are actively deciding whether to rent or own. The households who are most likely to be affected by a change in prices are new households moving into the region, households within the region who have decided to move within the region because of a change in job or family status, and some smaller segment of households who might be swayed by changes in the cost and availability of financing. In other words, it's unlikely that a drop in value will result in a sudden rush of buyers or renters changing homes.

That said, for those New Yorkers who are looking for housing, the decision to buy or rent depends both on the price of homes and the price of financing. Although homes are now cheaper, it's more difficult to get a mortgage, especially for households with weak credit histories, so it's not clear what the net effect on homeownership rates or on the pool of likely renters will be. Another consideration is that, in the current climate, it also may be harder for developers and landlords to get financing, and if that constrains the supply of new rental housing, rents could increase as a result.

It's also important to remember that the New York City housing market is segmented by tenure (renter versus owner-occupied), geography and quality. A drop in housing prices in Queens and Brooklyn due to foreclosures will not necessarily attract renters from Manhattan to purchase the foreclosed homes in the outer boroughs. Just how rental prices will respond will depend on what else is going on in individual neighborhoods.

Finally, all of this will depend on how New York City's economy performs, which could dampen demand for both rental and for sale properties.

Jonathan J. Miller: This is a great question because conventional wisdom, at least on the surface, does not apply. One would expect to see rental prices trend in the opposite direction of sales activity - a widely perceived zero sum market. "If people are not purchasing apartments, they must be renting." However this is not the case. The rental market is much more responsive to employment conditions than sales activity is. Employment is contracting with many more private sector jobs to be lost over the next year. The number of sales in Manhattan is down sharply from the record period last year and prices are flattening. At the same time, rents are slipping and the level of rental activity is lower than earlier this year. Sales activity tends to lead price trends. In theory, falling prices lead to higher inventory, which leads to more sales listings that become rental listings, leading to declining rents from an increase in supply. In other words, rental price trends could follow sales price trends if the market continues to weaken.

I am looking to buy my first home two to three bedrooms in New Jersey, Queens or Brooklyn, I have saved excellent down payment but need some morgage. Should I wait or buy now if wait how long?

Jonathan J. Miller: In my 22+ years in property appraisal experience, I have yet to meet an individual who was particularly adept at timing the housing market, yet this is a concern of most people that are looking to purchase. I am not a big believer in timing unless you are an investor looking for a quick turnover rather than a longer ownership window of 5-10 years.

You have an advantage over many first time buyers because you have a large down payment. One of the issues that is hurting first time buyers right now is the fact that lending institutions are now requiring larger payments as they had in the past, which generally are 15% to 20% of the purchase price. During the mortgage boom, 5% appeared to be the new norm and first time buyers flooded the market. The down payment was not an obstacle anymore. A better financial position now may give you an advantage over sellers in a market characterized by rising inventory. Sellers are much more aware of the financial characteristics of buyers these days and bank underwriting requirements are much tougher than they were a few years ago. Stronger personal financials may very well yield more leverage in negotiations with your seller.