The economics of the rental housing industry have improved greatly during the last two years. Owners' vacancy and collection losses are down sharply due to an improved economy. A very low "core rate" of operating and maintenance (O&M) cost inflation continues to benefit landlords. Mortgage interest rates remain low and the availability of financing has improved. In sum, these factors have led to the highest level of profitability in apartment buildings since 1989.

While predictions are always dangerous, the near term future appears quite positive for owners of rent stabilized housing. Assuming that property tax and water/sewer costs do not accelerate, the "core" rate of inflation will remain relatively low. With further reductions in vacancy and collection losses and the higher increases recently passed by the Rent Guidelines Board, it is likely that profitability will improve further in the near term.

On the tenant side of the equation the picture is somewhat murkier. Inflation-adjusted wages seem to be steady or increasing. Employment is up substantially from a year ago and job gains appear to be accelerating. Without data from the 1996 New York City Housing and Vacancy Survey we cannot say for certain whether housing is more or less affordable than two years ago. However, an educated guess is that tenants as a whole are no worse off and may be slightly better off.

Landlords' Operating and Maintenance Expenses

In recent years there has been a remarkable drop in the "core" rate of inflation.[1] In 1991 landlords' core operating and maintenance (O&M) costs were rising by nearly 6% per year. A scant three years later the core rate of inflation had plummeted to 1.9%. Although costs have crept up slightly since 1994, inflation continues to be quite moderate (see chart next page).

1. The "core rate" is defined as the increase in owners' operating costs, assuming that utilities costs (i.e., fuel oil, natural gas, and electricity) remain constant.

The subsidence of inflation in the early 1990's was due in large part to a sharp drop in the rate of increase in real estate taxes. Rising property values and stable or increased tax rates boosted landlords' tax bills throughout the late 1980's and early 1990's, but the severe recession eventually dampened increases in property tax assessments. This falloff in assessments, combined with a new found determination by City government to hold overall property tax rates stable, has accounted for more than half of the decrease in the core inflation rate.

Declining cost pressures in the labor market have also dampened O&M inflation. The relatively severe recession in New York made it very difficult for contractors (e.g. painters, plumbers) and laborers to raise their prices or wage rates. The RGB's Price Index of Operating Costs (PIOC) found that during the recession many contractors were forced to reduce prices in order to attract business. Similarly, the wage demands of labor unions weakened during the recession and have remained very moderate since then, reflecting in part a lower level of general price inflation.

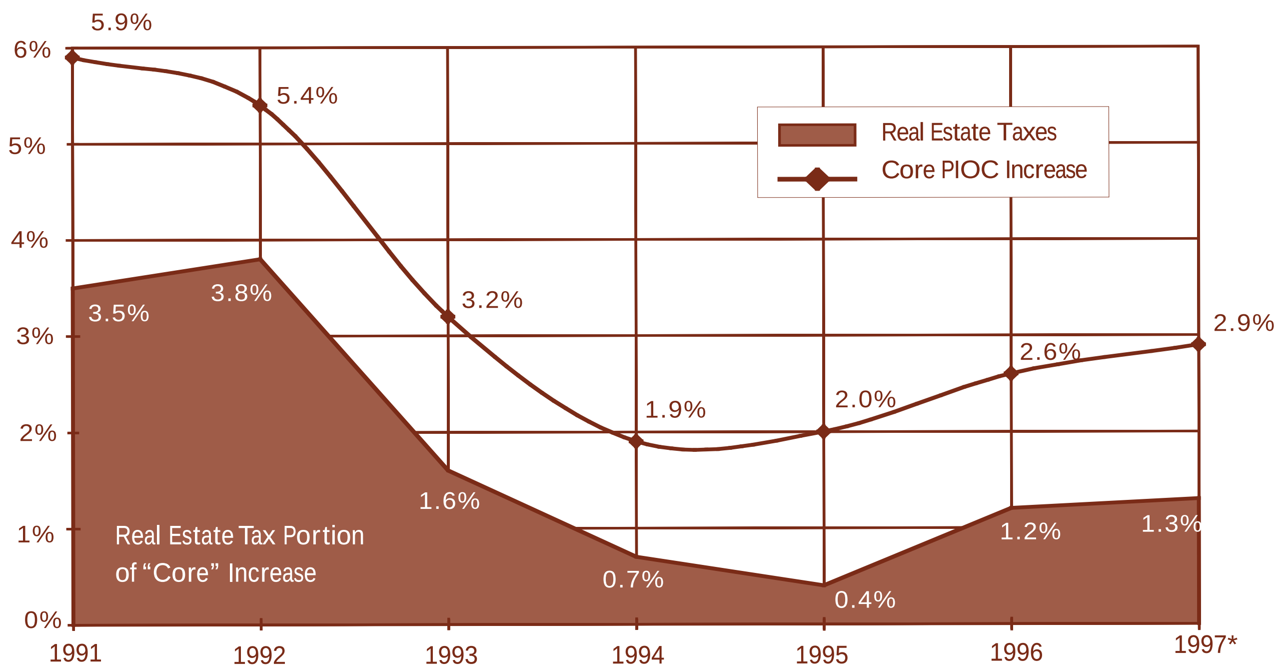
Smaller increases in water/sewer rates also benefitted landlords. Beginning in FY 1994 the Water Board imposed a two year rate moratorium. The Board also extended the voluntary transition program (enabling landlords to remain on frontage billing) and put a cap on maximum bills. The effect of these actions was not as significant as the declining rate of increase in real estate taxes and labor costs, but did shave about one-half percent off the core rate of inflation.

This year the PIOC rose 6%, the greatest increase since 1991 (see page 25). Although most of the increase was due to a spike in fuel costs during the winter of '95 - '96, rather than to a change in the core inflation rate, it is clear that the core rate reached a low point of 1.9% in 1994 and has been inching upwards since then. The natural question: Is inflation on the rebound?

Most labor-based costs, which comprise nearly half of landlords' expenses, appear to be well under control. Labor unions have agreed to multi-year contracts with small wage and benefit increases.

The "Core" Rate of Inflation Dropped Sharply in the Early 90's - Lower Real Estate Taxes were the Key

(Change in the "Core" Rate of the Price Index of Operating Costs for Rent Stabilized Apartment Buildings)



* Note: The percent change for 1997 was estimated.
Source: Price Indices of Operating Costs, 1991-1996, PIOC projection for 1997.

Competition among contractors also continues to be strong, resulting in sub-par price increases. Although administrative costs are rising faster than contractor costs, there is no evidence of mounting inflationary pressure. In short, labor-based costs are NOT responsible for the uptick in the core rate.

Just as the dramatic decrease in the core rate was due to a decline in real estate taxes, the recent moderate increase in the core rate can be attributed largely to the same cause.[2] Although increases in taxes continue to be modest - 3% in FY '96 and a projected 3% in FY '97, they are higher than in the previous two years.

Has the core inflation rate stabilized at a somewhat higher level or will it continue to climb? In the short term (i.e. one to two years) there appears to be little reason to expect much increase in the core rate. While moderate increases in water/sewer bills and strengthening property valuations make it unlikely that the core rate will FALL, market pressures are yet too weak to put much upward pressure on costs.

A view of the intermediate term is less sanguine. In the mid- and late-eighties the administration and City Council were quite content to fill City coffers with additional real estate tax revenue created by a surge in property values. In recent years the Council has held the line on tax rates. However, strengthening property values and expiring abatements and exemptions will add to owners' tax bills absent a firm resolve by the City Council to limit the amount of revenue from property taxes.

Rents

Rent growth in the nineties has been surprisingly strong given the severe local recession and some of the lowest guidelines in the history of rent stabilization.

2. Since 1992 the non-real estate contribution to the core rate has been remarkably constant, ranging from 1.2% to 1.6% (as the core fluctuated between 1.9% and 5.4%). Thus, most of the *variation* in the core rate has been due to changes in the rate of increase in real estate taxes.

Although the recession did slow rent increases from 1990-1992, rents accelerated significantly from 1992 to 1994, fueled by the recovery of the local economy and the dearth of new housing construction. We believe the pace of rent growth will continue to accelerate in the next year or two, pushed by higher rent guidelines, a falling rental housing vacancy rate, lower rent collection losses, and greater opportunities for vacant apartment improvements and Major Capital Improvements.

The chart on this page contrasts increases in rents registered with the New York State Division of Housing and Community Renewal (DHCR) with the amount of rent actually collected by landlords. Looking at the beginning of the decade (1990 - 1991), we see that registered rents rose 5.2% while rent revenue actually collected by landlords was up only 3.4%. The difference clearly reflects the impact of the recession.

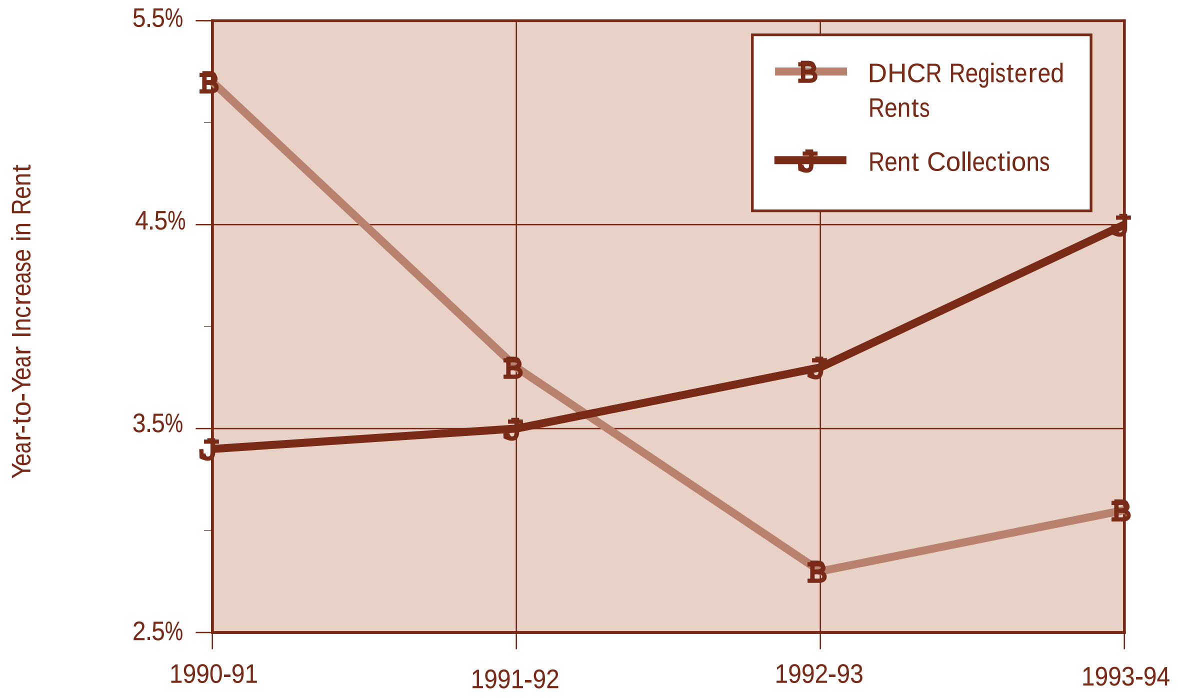
In 1991 the City lost nearly 200,000 jobs. Many landlords found it impossible to raise rents given the sudden deterioration in tenant employment and income. In more desirable buildings and neighborhoods landlords offered "preferential" rents to avoid vacancies. In poorer neighborhoods vacancy and collection losses soared and an increasing number of landlords fell into real estate tax arrears.

Rent increases in 1992 and 1993 were surprisingly strong, given that the City lost 100,000 additional jobs and the unemployment rate leaped to more than 10%. While rents collected by landlords lagged registered rents slightly in 1992, collected rents surged in 1993, rising a full percentage point more than DHCR levels. At the time it appeared that the real estate market was mired in a deep recession. Looking at this data in retrospect, 1993 marked the first stirrings of a recovery.

The relative strength of New York's rental market even during times of deep recession is not easy to explain. The resilience of rent levels may be due in part to the relative affordability of the housing stock. In this year's *Income and Affordability Study* (page 62) we show that New York's housing stock is somewhat more affordable than other cities'. To the extent that rent regulation depresses rents below "market" levels and

Rent Collections are Now Rising Much Faster than Registered Rents

(Annual Percent Increase in Rent)



Source: NYC Department of Finance, 1995 RPIE Filings and NY State Division of Housing and Community Renewal maintains affordability, it may be easier for landlords to raise rents during a recession.

A near collapse of new housing supply is undoubtedly another important factor contributing to the tighter rental market. The Savings and Loan crisis of the early 90's and the recession squashed new housing construction. During the eighties permits for new construction averaged 11,500 units per year. Our *Housing Supply Study* (page 74) shows that in the nineties permits for new housing slowed to 5,000 units per year. Over a six year period (1990 - 1995) this difference in new housing construction amounts to nearly 40,000 units. Even in a market as large as New York's such a deficit will put pressure on rent levels.

In the near future there is little reason to doubt that rent increases will continue to accelerate. This year's *Income and Expense Study* (page 39) found that collected rent rose 4.5% in 1994, spurred primarily by decreased collection losses, rather than increases in contract rents. One expects that collection losses fell even further as the employment market continued to improve in 1995 and 1996. Our 1996 *Mortgage Survey* offers partial confirmation - bankers reported a sharp decrease in vacancy and collection losses between 1995 and 1996 (see page 49).

Lower collection losses have been a boon to owners of older pre-war buildings. Since collection losses in these buildings typically run much higher than in the post-war stock, it isn't surprising to learn that collected rents in the pre-war stock grew 5.1% in 1994, vs. 4.5% in the market as a whole. Lower collection losses have also helped many older buildings shed their real estate tax arrears. In this year's *Tax Arrears Study* (page 58) we found that nearly 500 buildings repaid their arrears in 1995. Clearly, conditions are improving even in the distressed portion of the housing stock.

Although landlords' gains from lower vacancy and collection losses will eventually begin to moderate, two other factors will certainly boost rents 5 - 6% per year in the near future - increases allowed by the Rent Guidelines Board and accelerating Major Capital Improvement (MCI) and vacant apartment improvements.

This year the RGB passed a guideline allowing a 5% increase for a one year lease, a 7% increase for a two year lease and a vacancy allowance of 9%. RGB staff estimates the net effect of the guideline will be to raise rents by 5.7%, the greatest increase allowed since 1989. Most of this increase will be reflected in landlords' 1996 and 1997 budgets.

Another factor which will undoubtedly have an impact on rents is the growing level of MCI applications. After bottoming out in 1994, MCIs began to creep up in 1995 and are currently running nearly a third ahead of their low point.

O&M to Income Ratios

The Rent Guidelines Board has never been able to directly measure the profitability of rental housing. The data requirements for such a project would be immense, and inevitably there would be much argument about how to define "profit." Even so, the RGB has obtained data from income and expense statements filed with the Department of Finance for several years, and this data is a reasonably good surrogate for changes in profitability.

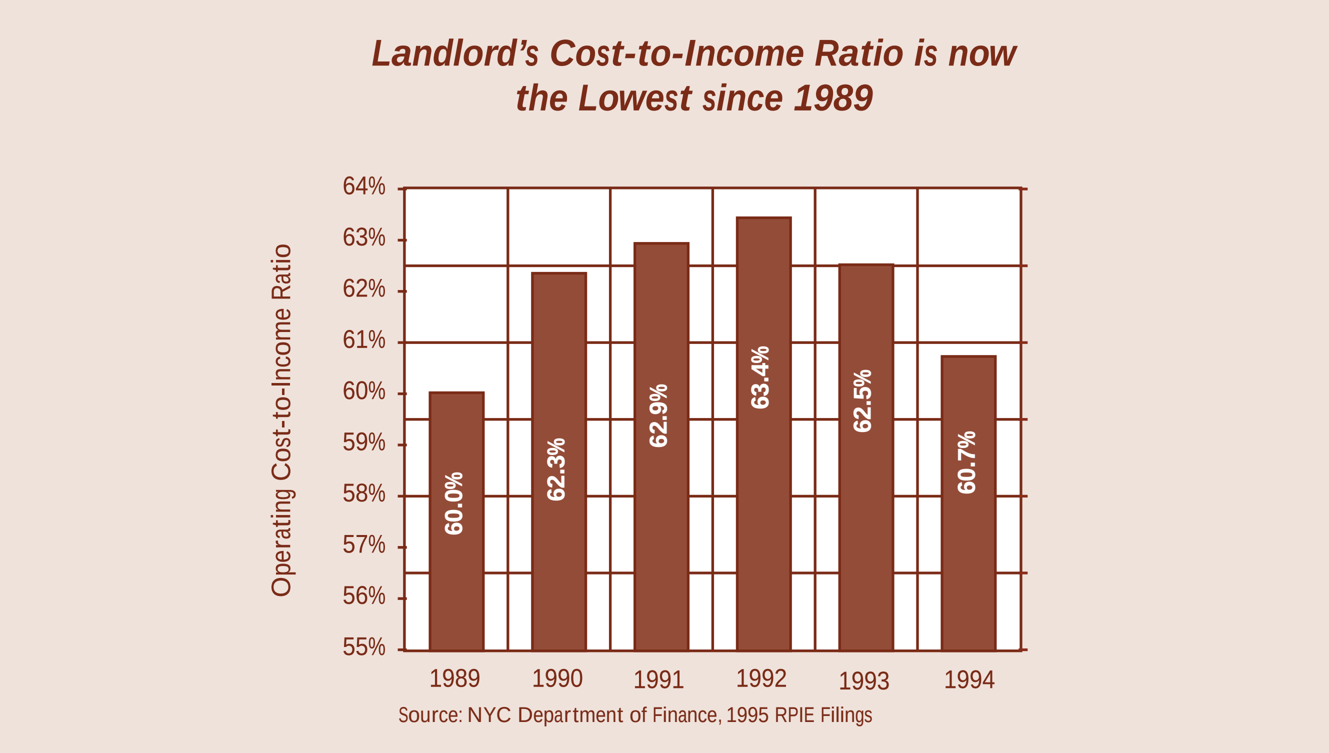
The chart on the next page shows levels of the Operating and Maintenance Cost-to-Income ratio since 1989. Higher ratios indicate less Net Operating Income (i.e. funds available for mortgage payments and profit) and declining profitability.

The O&M-to-income ratio increased sharply after 1988. The greatest rise in the ratio actually preceded the full brunt of the recession. Sharp increases in real estate taxes, water and sewer fees, and fuel costs pushed the O&M-to-income ratio from 60% in 1989 to 62.3% in 1991. From 1990 to 1992 the profitability of rent stabilized housing declined further, primarily due to the impact of the recession and declining rent collections.

In 1993 lower increases in expenses coupled with accelerating rent collections resulted in an improvement in the O&M to income ratio. In 1994 the improvement was even greater, as the ratio fell to its lowest level since 1989. Given recent trends in rents and expenses, it appears likely that profitability will further improve throughout 1995 and 1996.

Tenant Income and Housing Affordability

Income levels of rent stabilized households deteriorated rapidly from 1990 to 1992. The loss of hundreds of thousands of jobs boosted the



unemployment rate from 6.8% in 1990 to 10.8% in 1992. The median real income of renter households fell 12%.

The recovery from the recession has been slow. From 1992 to 1995 New York City added approximately 40,000 jobs, a small fraction of the employment lost in previous years. The unemployment rate crept down from 10.8% at its peak to 8.2% in 1995.

Without data from the forthcoming 1996 New York City Housing and Vacancy Survey it is impossible to gauge changes in tenant income and housing affordability with any great precision. Even so, the available evidence does indicate an improvement in household income since 1992. Wages and salaries have been increasing at about the rate of inflation and unemployment has decreased; thus, a comparison of household income in 1992 and 1995 will almost certainly show that tenants are somewhat better off. This improvement in tenants' welfare is consistent with recent Income and Expense studies showing increases in rent collections.

More current data seem to point to accelerating economic growth in the local economy. In this year's *Income and Affordability Study* (page 62) we found that payroll (which accounts for both employment and wage levels) increased by 14% between the first quarter of 1994 and the first quarter of 1995. Comparing the second quarter of these two years shows a smaller (but still robust) 5% increase in compensation.[3]

Employment levels also point to an improvement in economic conditions. The City had 31,000 more jobs in June of 1996 than in June, 1995. The increase in private sector employment was impressive given continued cutbacks of public sector jobs.

How have changes in economic conditions affected housing affordability? One suspects that the 1996 Housing and Vacancy Survey will show no rise in tenants' rent-to-income ratio, given that rents AND wages have been rising about 3% per year since 1992, and that employment has increased. With an unchanged rent-to-income ratio and somewhat higher incomes, tenants are probably slightly better off than in 1993. Unfortunately, for the minority of tenants on the bottom rung of the economic ladder conditions are probably worse. Rising rents and declining assistance to the poor (see the *Income and Affordability Study*, page 69) will mean growing affordability problems. ❐

3. Data received after completion of the Income and Affordability Study confirm accelerating economic growth. The change in total annual payroll in 1995 was 6.2%