The Condo Comeback?

Strained supply and high rents have condos in demand, though many developers remain hesitant

Mike Ratliff, Senior Associate Editor

It seems that each day brings news of another shining condo development. A new neighborhood of ultra-luxury residential skyscrapers is forming in New York just south of Central Park. Dubbed "Billionaire's Row," the competition between these projects to create the tallest residences in North America is so fierce that city dwellers are already worried about the shadows cast across their beloved park.

On the surface, over-the-top projects like 432 Park in New York and 201 Folsom Street in San Francisco suggest that we are in the midst of a surge in condo development. The reality is an increase in planned condo starts, while construction rates remain at the steady lows seen throughout the recession. Up until recently there was something that resembled a stockpile of condos thanks to the prevalence of condo development leading into the crash.

"At the peak in 2006, condos represented 45 percent of multifamily units built each year," says David Crowe, chief economist at the National Association of Home Builders. "Condo production has been on a gradual decline since then, reaching 9.4 percent in 2012."

The NAHB saw that percentage tick upwards for the first time in the first quarter of 2013 to 9.5 percent, though for the second and third quarters condos only comprised a respective 7 and 8.5 percent of multifamily starts. According to Crowe, the normalized level is roughly 25 percent of multifamily production during a normalized unit delivery rate, which stood at 335,000 units a year from the early 2000s through 2007. Legislation to prevent an unsustainable level of home ownership will help to keep the condo production level far from 45 percent, though Crowe expects the rate to slowly drift back towards its normalized 25 percent rate due to economic and demographic factors.

Pressure from both ends of the age spectrum is pushing for denser living in urban areas. Millennials want to be near employment centers and nightlife, while Baby Boomers are downsizing and settling near cities where they can age in place. Tight underwriting standards also contribute to a condo demand, according to Crowe.

"First time home buyers often look at condos as a less expensive alternative to single-family housing," he says. "Many would-be home buyers have been squeezed out of the single family market because of tight underwriting standards. Finding a less expensive opportunity is one way to counteract the high threshold for getting a mortgage."

When interest rates rise with the tapering of QE3, the demand

Bosa Development Corp.'s Insignia *(left and above)* was the first post-recession condo to break ground in Seattle. The twin 41-story buildings will be built in phases, the first of which is scheduled to deliver in 2015. When complete, the project will be the largest condo in Seattle with 707 residences. The property was designed by Perkins & Company.

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for condos might realize a bump as an additional tier of would-be single family buyers are priced out. But while the demand for condos comes from several socio-economic classes, in many instances, the first condos to hit the market are tailored to a specific kind of money.

A new global currency

“The product that is being built now is much different than the product that was built during the last boom,” says Jonathan Miller, president & CEO of New York real estate appraisal and consulting firm Miller Samuel Inc. “This is less true in New York—which has always had a penchant for luxury—but in other markets, the new product is generally weighted to the upper end of the market.”

A driving factor behind this trend is that land prices have escalated since developers are able to access financing with extremely low interest rates. Higher land prices necessitate a finished product at the higher end of the market, otherwise developers won’t see a profit.

“So we are seeing high-end condo development because the assemblage costs is expensive,” Miller adds. “And coincidentally it works out because we are seeing a phenomena of luxury real estate becoming a new global currency.”

A combination of volatility in equity markets and higher taxes has the global jet-setting class looking to invest in tangible assets. This benefits luxury real estate, and the market is meeting the demand.

“In many metro areas we are building the word’s most expensive bank safety deposit boxes,” Miller says. “Essentially you are building these units that people place their valuables in, and then rarely visit. I am not saying whether this is a bad thing or not. It is what it is. But we are not addressing what is the more significant issue, which is expanding the new development trend across a wider swath of housing stock.”

On the whole, condo inventories across the country are at or near historic lows depending on the market. If you look at New York, the ultra-luxury construction has left the remaining market supply constrained. Year-over-year inventory in New York City is down 3 percent as of October for the top 10 percent of the condo market by price. Inventory for the remaining 90 percent of the market is down 37 percent. There is no coincidence that low inventory on the residential side and rising rents on the apartment side happened in sync. Low condo supply keeps apartments full, and competitive, while renters save up for a down payment and homeownership.

This has created a phenomena that Miller calls “bracket creep.” One bedrooms at Extell Development Co.’s One57, for example, start at $3 million, which is the bottom of the top 10 percent of the market. People who are priced out of Manhattan, but want new product, set their eyes on Brooklyn, where housing prices are actually rising at a quicker rate. Inventory in Brooklyn is also tight, as the development scene caters to the luxury renter, rather than the luxury condo buyer. People priced out of Brooklyn are now beginning to look at Queens. Some skip over Brooklyn all together.

“What is happening in these metro areas is a push outward from the central business district in a search for affordability,” Miller adds.

South Florida goes international

This era of luxury condo development is not limited to New York. Miller also tracks the market in South Florida, as many Manhattanites are picking up vacation homes in Miami, Palm Beach or Ft. Lauderdale. After all, the plane ride takes about the same amount of time as it does to drive out to the Hamptons.

“In the last two to three years Miami has rebranded itself from the poster child of distressed real estate to a luxury brand,” Miller says.

In spite of this perception, it is important to realize that one-third of the sales are still distressed. The ratio has inverted from three years ago when two-thirds of transactions were either foreclosures or short sales. In addition to New York vacation homes, the rebound in Miami has been driven by the international market, which in many ways bailed the city out.

Melo Group broke ground on Bay House *(spread and above)* in Miami’s Edgewater East neighborhood this November. Featuring 164 luxury condos, the 38-story tower should see completion in late 2014. The development caters to cash buyers and will have prices averaging $380 per square foot. Renderings Courtesy Melo Group.

“All that has happened here in Miami in the last 10 years is amazing,” says Carlos Melo, who co-founded Melo Group with his brother and father. “We came here 12 years ago from Argentina and in that time have seen the city transform.”

The family-owned company is considered one of the pioneers in the redevelopment and repositioning of the city’s East Edgewater neighborhood, which has shed its blighted past for an air of hipness due in part to its close proximity to both downtown and the beach. Since 2001, Melo Group has built 10 rental and condo projects in the area that total in excess of 1,700 units. By amassing entire city blocks, the company is poised to build close to 2,500 units in the future. The firm also holds the distinction of building the first post-recession condo in Miami without any conventional financing. That project, 23 Biscayne Bay, delivered in 2011 and sold-out its 96 units in a 10-month period. In November, they broke ground on BayHouse, a 165-unit condo that was already 70 percent sold prior to shovels hitting dirt.

“When we built the first condo after the crash people said we were crazy,” Melo says. “They asked us who was going to buy our units. Well, the deal was that all the buyers were from other countries. They were trying to buy foreclosures, but realized that it is a complicated process that takes time. We provided these buyers with a new, clean building with no issues at the price they need, that they can pay for with their own money and no financing.”

Melo is able to achieve competitive pricing as a vertically integrated developer with in-house construction and management arms. Price-per-square-foot at their next luxury condo, BayHouse, will be close to $400. The asset features the whole gamut of luxury amenities one would expect, including private elevator access, waterfront views, a gym, social room, spa, fireplace, teenage room and children’s playroom. While the culture and nightlife in Miami are the prime draw for its international condo clientele, the price point compared to other global destinations helps seal the deal. Melo brings up a conversation he had with a French broker. For the price of a nice studio and a Renault sedan in Toulouse, France, one could buy a waterfront two-bedroom condo in Miami with a Mustang convertible in the garage.

“Like an Italian friend of mine says: ‘We make Ferraris, but they are made to use in Miami,’” Melo adds. “People come here to do the things they can’t in their own countries. Not because they don’t have the money, but because they can show it off here. They buy their toys and leave them here, and use them one month each year.”

The trend has its positive and negative effects. Foreign condo owners are supporting real estate and paying taxes. At the same time, rental rates and the cost of living has increased while local salaries and job growth remains stagnant. The ultimate result is the same bracket effect described by Miller where local residents are slowly pushed out from the city center.

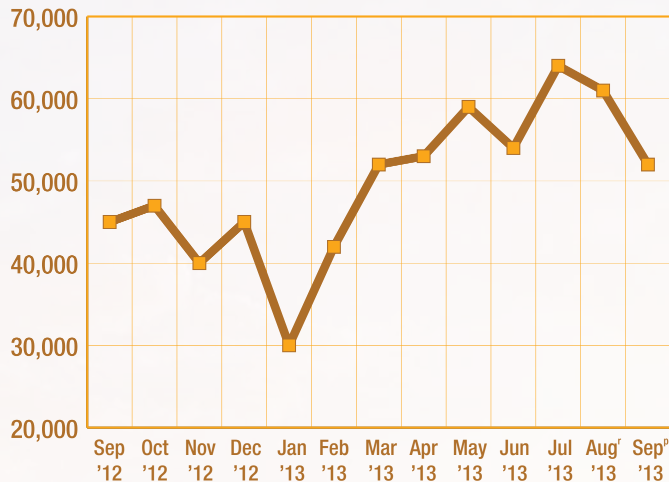
The new west

While foreign investment from Asia does play a role in the demand for condos on the West Coast, a bigger driving factor comes from a Gen Y armed with a down payment from their parents. Dramatic rent increases in San Francisco have led the younger generation to scramble towards ownership, says Alan Mark, CEO of The Mark Co., a San Francisco-based condo sales and marketing firm.

“I have been doing this for 25 years, and this is the first time I have seen the numbers work for even considering the rent vs. buy equation,” Mark says, adding that rents are typically between $4 and $5 per-square-foot, though $6 is not unheard of.

As with New York, high rents and high purchase prices are feed-

The Alexico Group and Hines are currently building 56 Leonard *(above)* in Manhattan’s trendy Tribeca neighborhood. Designed by Herzog & de Meuron, over 70 percent of the building’s 145 condos were sold as of May 2013. Uptown on the corner of Park Ave. and 56th Street you can spot CIM Group and Macklowe Properties’ 432 Park *(far right)* going vertical. When complete in 2015, the Rafael Viñoly Architects-designed tower will be the tallest building in New York and the tallest residential tower in the Western Hemisphere. One-third of its units were under contract as of March 2013. Keep heading north to Boston to check out The Fallon Co.’s Twenty Two Liberty *(right)*, a 118-unit asset designed by CBT Architects that is the first luxury water-view condo to break ground in the city since 2009.



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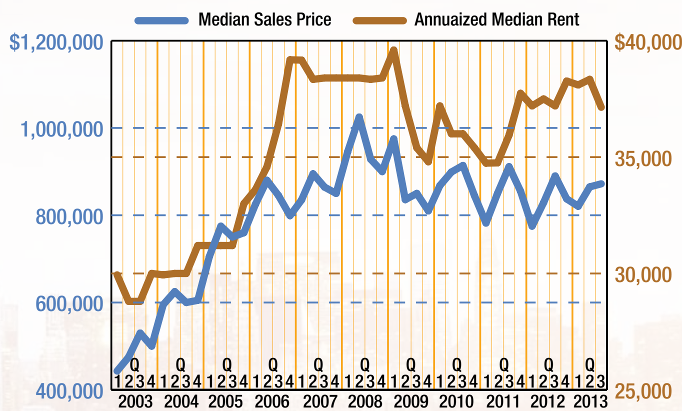

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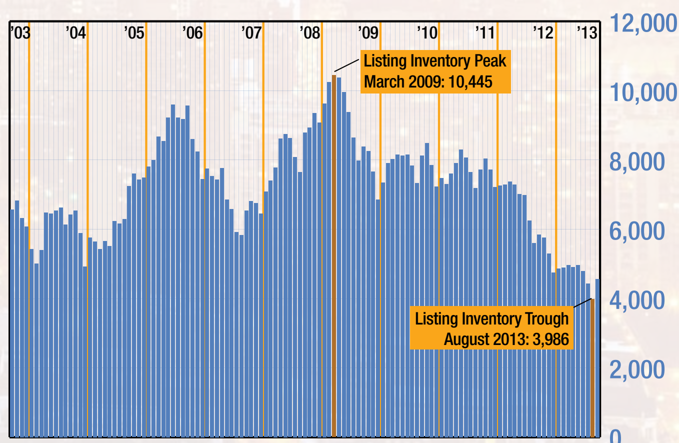

Source: Miller Samuel Inc

ing off each other in a market with limited product. There were 3,000 new condo units on the market in San Francisco pre-crash. Today there are roughly 180 available. According to Mark, the new rock-bottom price for new condo product is $1,000 per square foot. Though the figure is more affordable than New York, high prices are changing the way people are buying.

"Everyone who buys a home with us fills out a two-page questionnaire. We have been doing this since 1997. The big thing we are seeing now is parents coming in. One out of two first-time buyers will actually have their parents with them on the tour. One out of every three first-time buyers will have their parents help with the down payment. One out of every five will actually have their parents on the loan application."

The buyer surveys have also pointed out a clear trend in purchases from the tech sector. Traditionally, 20 percent of buyers came from careers in financial services while 20 percent came from tech. The two industries flip-flopped for first and second place year-to-year, while real estate and healthcare battled out for the third and fourth place spots. Today things are different.

"For the first time since we have been keeping track we are seeing 40 percent of the buyers coming from the tech sector, and it cuts across all age groups," Mark says. "Not only that, but there is no more clear second place industry—the composition has dropped to about 13 percent from law, and 13 percent from finance."

San Francisco is not the only market with a lack of new condo development when you consider the supply constraints. Mark points out that while 4,200 rental units are under construction in Los Angeles, there is virtually no new condo product. In Denver, where his company is marketing a 500-unit condo called Spire, there is also a visible lack of condos while plenty of cranes adorn active rental developments. He speaks of a similar situation in Seattle, where Nat Bosa is building Insignia. The 41-story asset is the first condo to break ground in the city since the recession. Mark adds that despite the supply and demand disparity, economic factors and demographics all suggest that now is the time to break ground on condos, even if the development complex remains hesitant. Just like the stock market, people seem to jump in when the market is hot and get out when things are cooling off.

"I can't believe I heard this, but a potential lender recently asked me why I want to finance a deal on anything for condos when there is no condo construction in L.A.," Mark says. "Many developers still have wounds that aren't fully healed from the recession. They are afraid to put a 300-unit building on the market with units to sell. They are all waiting for someone else to do it first. It just goes to show you the convoluted nature of the business. It takes one-and-one-half, to two-and-one-half years to build a building. You need to get going when all the positive signs may not be totally visible." MHN

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