Virus Effects on Apartments and Real Estate

by Joseph W. DeCarlo, MBA, CPM, CCIM, CRE

We are now in unchartered and difficult waters with the COVID-19 virus epidemic. The rules, customs and ways of doing business are changing and still unknown. The Social Distancing will alter how people buy, sell and lease apartments after the COVID-19 crisis has ended. We must be flexible, adaptable and changeable in the future.

DEMOGRAPHICS

The buzz word that liberals in California and other states, prior to COVID-19 was "higher density". Build more high-rise apartments in urban centers (cities) and near rapid transit lines. The highest death rates and infections have come from New York City and other high-density areas. In the future, will apartment tenants, condo owners, choose to live in closely packed urban areas 24-7 with crowded buses and subways?

Suburban areas have fared better as well as semi-rural areas just outside the suburbs with more room to spread out and observe the safe distancing (6 feet). Even when they find a cure for COVID-19, viruses will reoccur in the future and the fear will linger and people may not want to live in cities.

DEMAND FOR APARTMENTS

The demand for apartments in Southern California will continue to grow. The jobless rate has soared and those that remain employed fear losing their jobs or having their job eliminated. The single-family housing market will decline in price as employment will determine qualifying for a mortgage loan. Many younger people have moved back with their parents during this lockdown period. Will they now want to move into their own apartment again? Will they want roommates? Will they want a smaller less expensive unit? Since many employees have worked remotely from their homes during this lockdown, will they want to continue to do so and not have a daily commute to work? Maybe they will go in one day a week. Having good Wi-Fi is a necessity for apartments in the future.

The real demand is for the homeless and people who cannot afford to pay market rent. Our Governor never mentions the State providing rent subsidies, like HUD Section 8, to the potential tenants who cannot afford rent. Rent control caps what landlords can charge, thereby effectively reducing the dollar amount State and Local housing programs pay in Affordable Housing subsidies.

SUPPLY OF APARTMENTS

The pipeline has lots of new apartment projects, however most of these are Class A, high end and high rent apartments. Due to high land costs and using union labor, it is not feasible to build working class "C" apartments in Orange County and Los Angeles. The potential of even more stringent rent control measure on the November ballot is also a deterrent to construction of new apartment buildings which are only exempt for 15 years.

I see additional housing supply coming from underutilized hotels and office buildings in the future. Due to the fear that COVID-19 carries, less people will travel and or want to commute to work in a large office building. The value of these properties will drop an adaptive reuse would be to retrofit them into lower rent apartments in the future. If this happens, supply will exceed demand and the rent and price (cap rates) for existing apartments will decrease.

GOVERNEMENT CONTROLS FOR APARTMENTS

The State and Local governments are increasing putting more restrictions and rules on landlords. Evictions are more difficult and the time for landlords to regain possession has been lengthened. There are curbs and caps on rental increases and landlords still must provide the same habitability on aging apartment buildings. Where will landlords get the funds to make the improvements for new electrical and plumbing on these 50-year-old apartment buildings with strict rent control.

The purchase cost of existing apartments at todays high prices do not pencil out. Let us take property taxes for instance. Even under Prop 13, most cities have added water, sewer, school, utility bonds to property taxes. Some cities have even added paramedic services to tax bills. For example, an existing 20-unit apartment building sold for $6 million and the tax rate is approximately 1.4% and not 1% which is the basic tax levy. The tax bill is $84,000 per year or $7,000 per month or $350.00 per month/per unit. If the rent is $1,600 per month, that equates to 21.9% of the rent goes towards property taxes. You also must figure 5% for vacancy and eviction along with a manager's salary, water, utilities, trash and maintenance expenses. Operating Expenses come to 61.9% + NOI of $162,864. The new owner still must pay a mortgage payment before any cash flow. Real cap rate is only 2.7%

20 Unit Apartment Building Sale at $6,000,000.00 (rounded off expenses)

INCOME			**MONTHLY**	**ANNUALLY**
	Rents 20 x 1,600		$32,000.00	$384,000.00
	Vacancy - 5%		($1,750.00)	($21,000.00)
	Collected Rents		$30,250.00	$363,000.00
OPERATING EXPENSES				
	Taxes	29.9%	$7,000.00	$84,000.00
	Trash	3.0%	$907.00	$10,884.00
	Water	4.0%	$1,210.00	$14,520.00
	Maintenance	10.0%	$3,025.00	$36,300.00
	Gas & Electric	3.0%	$907.00	$10,884.00
	Insurance	2.0%	$605.00	$7,260.00
	Manager Salary	5.0%	$1,512.00	$18,144.00
	Workers Comp.	1.0%	$302.00	$3,624.00
	Misc.	4.0%	$1,210.00	$14,520.00
		61.9%	($16,678.00)	($200,136.00)
		Net Operating Income	$13,577.00	$162,864.00

US ECONOMY

We are likely to have a severe recession when the Federal government subsidies are stopped. The current unemployment benefits of $400.00 per week from the State and $600.00 from Federal, which adds up to $4,300 per month. Most tenants can pay rent but what does the future hold for them if they work in hotels, restaurants or the travel industry? State taxes and fees will increase as California cannot print money like the Feds. Apartments will fare as a better real estate investment than retail or office buildings, however prices and rents will drop to a realistic level after COVID-19 will be place us in a different new normal, not the old normal.

Joseph W. DeCarlo, MBA, CPM, CCIM, CRE
joe@jdproperty.com

Joe is President of JD Property Management, Inc. located in Costa Mesa, which manages both Apartments and Commercial properties.