

## **Builders Can't Pencil Apartments**

By Andy Fixmer – 4/18/2005

### **Los Angeles Business Journal Staff**

Soaring real estate and construction costs have made it nearly impossible to build new apartments in many parts of Los Angeles County, a situation that is likely to aggravate the existing shortage of rental units.

There are very few new apartment complexes in the construction pipeline, and developers with approvals to build apartment complexes are selling the entitled projects to for-sale builders before even starting construction.

"It's difficult to pencil apartments out today given construction costs and land prices," said Tyson Sayles, senior vice president of acquisitions at Kor Group Inc., which built the Marlowe apartment building in Hancock Park and has switched to only for-sale housing. "Developers who bought sites intending to build apartments have been forced to switch to condominiums to make it pencil out."

With the price of land tripling and the cost of construction for materials and labor nearly doubling, developers say that rents in Los Angeles no longer justify the building of new apartments.

Last year, the average apartment in Los Angeles County rented for \$1.55 a foot, up from \$1.50 a foot from the prior year, according to the USC Casden Real Estate Forecast.

But to justify current prices and development costs, average apartment rents would have to rise to about \$4 a foot, said Kevin Ratner, senior vice president at Forest City West, a division of Cleveland, Ohio-based developer Forest City Enterprises Inc.

"That's a pretty good ways off," said Rather, whose firm has built hundreds of apartments across Southern California.

While L.A. rents have been going up--faster than the national average, in fact--they're being outpaced by increases in housing prices. "There have been substantial rent increases," said Delores Conway, director of the Casden Forecast. "It's just that rents aren't nearly keeping pace with housing values."

In February, Forest City West purchased the former Getty Oil headquarters at 3800 Wilshire Blvd. from Calabasas-based Upside Investments Inc., which had intended to convert the building into apartments but couldn't make the project pencil out. Forest City intends to finish the project as more than 200 condominiums.

Forest City also recently purchased a vacant office tower outside downtown L.A. at 1100 Wilshire Blvd. that the company is converting into about 260 condominiums.

"Look, I'd love to find a seller who says to me 'the right thing is to sell this for \$100 a foot so you can build apartments,'" Ratner said. "But that's not going to happen. Sellers, rightfully so, want the most for their property and fight now that means condos."

## Selling out

It's no secret why developers have turned their attention to the more lucrative condominium market, where prices are growing at a much faster rate than apartment rents.

While year-over-year prices for condominiums are up by about 25 percent, apartment rents in Los Angeles have increased just 3.3 percent.

Christopher Thornberg, a senior economist at the UCLA Anderson Forecast, has maintained for more than a year that the surge in housing prices, unsupported by a similar move in rental prices, are evidence of a housing bubble.

But until the bubble bursts, limited supplies of new apartment units are worsening the living conditions of the poorest residents of L.A. County, where occupancies are already at 97 percent.

"We have the worst crowded housing situation in California and the entire United States," Thornberg said. "Roughly one out of every five apartments falls under the definition of being overcrowded, which means there's more than one person per room."

Greg Harris, a senior vice president at Marcus & Millichap who specializes in the sale of apartment projects to condo developers, said many such sales are taking place.

Apartment developers realize they can't make their projects work under current market conditions, Harris said, but they are still able to profit by selling the project to someone who can convert the project to for-sale housing.

This month, Harris listed the planned Camino Real apartment project on Ventura Boulevard in Sherman Oaks. In the marketing materials he breaks down the economic advantages of converting the 118 rental units to 90 condos.

"These people started the entitlement process 12 to 24 months ago with the notion to build apartments, but the costs have gone up significantly," he said. "Now their proformas no longer work, and condo development is the only thing that makes sense."

As a result, few apartment projects are under construction without significant public subsidies. And many of those that were in the pipeline are now being sold to condo developers.

In February, CIM Group Inc. warned that it couldn't afford to break ground on a planned development at Ninth and Flower streets that includes a Ralphs grocery store until it received approvals to convert the complex's apartments to condominiums. Even then, the developer said it couldn't make the project break

even unless CIM also added another story of condo units. The city gave CIM its approvals and the project broke ground last month.

"It's just not feasible to do apartments anymore," said John Given, a CIM senior vice president, at the time. "Not at these prices."

Imbalance remains

Conway said it could take years before a significant number of apartments are built again in Los Angeles. As housing prices have risen substantially across Southern California, buyers priced out of single-family homes have resorted to buying condominiums.

The increased demand is fueled by historically low interest rates and other home ownership incentives, such as tax breaks. Conway said apartments won't start getting built until demand for condos wanes.

"This is probably not going to be a permanent situation," she said. "We don't know how long it's going to last but interest rates are moving up and eventually pressure on condos will subside."

However, the market for homeownership could be more resilient than economists have anticipated.

Applications for U.S. home mortgages for the week ended April 8 increased 6.1 percent, despite a quarter-point rise in interest rates on 30-year mortgages, to 6.25 percent, according to the Mortgage Bankers Association.

Ratner believes demand for housing in Southern California is broader and deeper than the rest of the country. He believes that even if mortgage interest rates surpass 7 percent--the point at which some economists believe demand for homeownership will slacken--homes in Los Angeles will continue to sell at a brisk pace.

"L.A. has such a housing crisis that I think there is a lot more room here to handle higher interest rates," he said. "There's only so many places you can live where you don't have to sit in traffic for two hours a day commuting."

Still, the lack of construction of new apartments actually bolsters the Anderson Forecast's prediction of a housing bubble both nationally and locally, Thornberg said.

A home, even if it's owned and occupied, has a rental value. The bubble exists because those values are far below the monthly mortgages new homeowners are paying. "There's a basic imbalance between rents and home prices," Thornberg said. "If there is a bubble right now, and there most definitely is, it's because asset prices are out of whack. And that's exactly why we're not seeing new apartments."