

Getting Started on Predatory Equity Research in Your City

By Tom Waters, Community Service Society

What is predatory equity?

Predatory equity is a tenant advocate's term for the harmful practice of investing equity to buy rental apartment buildings at inflated prices. Predatory equity investors calculate that they can replace poor and working people with new tenants willing to pay much higher rents—thus bringing higher profits in a hurry.

Usually, the predatory equity investor is a partnership between a private equity investment group and a real estate professional, often someone with experience in luxury buildings or office buildings rather than working-class housing. This combination of players is able to raise and borrow enough money to outbid either a responsible landlord or the typical “slumlord” apartment building owner. However, the resulting inflated purchase price means that the predatory investor must borrow much larger amounts of money than normal, and this means monthly interest payments that are much higher than normal.

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Predatory equity investors' plans to displace tenants are bad enough in themselves, but if the higher rents fail to materialize, the interest payments can't be made—which may lead to more bad consequences, such as:

- reduced services,
- building deterioration,
- redoubled efforts to oust tenants, or
- foreclosure.

Given current economic conditions, these bad consequences are almost certain to happen. Buildings in this predicament are often called “overleveraged.”

Why do predatory equity investors think they can dramatically increase rents on a working-class apartment building? There are many possible answers.

- The neighborhood is gentrifying.
- The buyer believes the building can be converted to condos.
- The tenants are benefiting from local rent control laws that could be circumvented.
- The tenants are benefiting from a subsidy program such as federal Section 8 or Section 236 that could be eliminated.
- The buyer believes that there are other possible tenants who would pay an even higher share of income as rent than the current tenants.
- The buyer simply believes that “the housing market always goes up.”

During the hot housing market that stretched from 2003 or so until 2007, buyers believed many of these things about many buildings. Now the market has slowed tremendously due to reduced bank lending and a general economic downturn.

Even though the predatory equity investor party is over for now, tenants are left with the hangover. There are two main concerns.

- Many buildings are already overleveraged and headed for trouble.
- If the economy picks up, the predatory equity investor sharks may return.

What can be done?

Tenants, organizers, and advocates have found ample evidence of the predatory equity crisis in New York City, Los Angeles, San Francisco, and Silicon Valley. Many other large or “hot” cities in the country are also very likely affected. If tenants, organizers, and advocates can begin responding to the crisis in more places, there will be two important benefits.

- We can rescue troubled buildings in our own towns.
- We can unite to win federal government support for rescuing buildings across the country.

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The first step is research

Tenants, organizers, and advocates must document the extent of the predatory equity crisis in our own towns and in as many places as possible. The purpose of this pamphlet is to help you get started doing that.

Every local real estate market is a little bit different. Unfortunately, that means that if you are beginning to research predatory equity locally, you will not be able to simply use the techniques that have worked somewhere else. You will need to develop local sources of information and local knowledge.

The good news is that if you are a tenant, organizer, or advocate, then you already have access to one of the most important sources of information to get started. You know the apartment buildings and tenants who

are affected. You should always be looking to make use of this knowledge. As you begin to develop relationships with people who have access to other sources of information, you will probably find that they don’t know nearly as much about tenants and buildings. This means that you will be bringing something important to the discussion. Make sure the other players respect what you bring to the table, and you will get more out of these relationships.

There are two other key sources of information that you will need:

- the local real estate press and business press, and
- one or more friendly nonprofit affordable housing developers.

We will consider these two sources in order.

Getting to know the real estate press

Your city or region probably has at least one specialized publication or web site that reports on real estate news for an audience of real estate investors and professionals. And your more general local business publications and web sites may contain useful reporting on real estate news as well.

The first thing that you will notice about the real estate press is that it speaks a different language from the one we use when talking about the same buildings as “housing.” The tone of their language gives some insight into the real estate investors’ (or as we would usually say, landlords’) mindset, and it can be confusing. Wikipedia has many articles on real estate investing and related areas, which can be a good tool for getting comfortable with real estate talk.

The real estate press also tends to focus on types of properties other than working-class apartment buildings. Homeowner developments, malls, and office buildings are all seen as more glamorous investments. But if you keep searching, a few apartment building deals will start to appear. These will often be the most “predatory” ones, because unusually high purchase prices make good headlines, and big-shot real estate people and private equity firms are considered more newsworthy than old-fashioned slumlords.

The most important things to know about an apartment building deal are the sale price per apartment and the average monthly rent per apartment. You will generally find the first number in the real estate press but not the second.

When you start researching a specific deal, write down:

- the building’s name and address,
- the name of the buyer (both the corporate name and any individual names mentioned),
- the name of the mortgage lender (if it’s in the story),
- the sale price, and
- the number of apartments.

If the real estate press article doesn’t mention the number of apartments, you will have to find that out somehow so that you can determine the sale price per apartment—the only way to really know whether the price is high or low.

Other potentially useful information that you may find in the press includes the amount of the mortgage and other loans, as well as the names of the lenders. Keep track of as much of this information as possible. You never know what will be useful later on.

How can you find out the number of apartments and the average rent? You may be able to obtain some information, such as the number of apartments, from a government agency that deals with property tax. But average rent may be more difficult to find out because it is not public information. You may also find useful information included in marketing material on the building. If you can reach out to someone with access to listings, like a real estate agent, they may be able to look at how the property was marketed to see what the gross rents were.

Another way to get this kind of information may be to ask your friendly nonprofit developer. He or she may know or at least be able to give you a good guess. An even better way is to use your own strong point—go ask the tenants.

Finding a friendly nonprofit developer

Friendly nonprofit developers can be invaluable allies in researching predatory equity, because there is no substitute for their firsthand real estate expertise. But the key word is friendly. Not all nonprofit developers will see themselves as being on the same side as tenants on this issue. And most of those who do see themselves as allies will probably not have the time or inclination to give all the help you are going to need.

So take the time to find the right person or people for this purpose, and take the time to develop a relationship with them. Rest assured that although

you are the one asking for help, your knowledge of the tenants and communities affected by predatory equity means that you are bringing something important to the relationship, too.

Your first question to your friendly nonprofit developer, once you’ve explained who you are and what you are trying to do, might be something like this:

The Fuzzy Arms apartment building just sold for \$5 million. That’s \$50,000 per apartment. The tenants tell me rents average \$500. It sounds to me like the new owner, Velociraptor Equities, paid much more than the usual price. Is that an unusually high price for that kind of building in that neighborhood? The tenants are worried about what it all means.

Hopefully, the developer will tell you that that is a worryingly high price (unless it isn’t) and you can get down to business. More likely, he or she will ask for more information—which could be the beginning of a good working relationship.

In this example, Velociraptor paid \$50,000 for each apartment that produces rents of \$6,000 a year. This means the “rent multiple” was 8.3 (\$50,000 divided by \$6,000). The higher the rent multiplier, the more speculative the deal. An 8.3 multiple for a working-class building in New York City was rare a few years ago, but it is not so unusual anymore—a sign that the market in New York has moved in a predatory direction.

There are other, more sophisticated ways of determining whether the price paid for an apartment building is too high, ways which take into account the cost of operating the building and the terms of the mortgage loan. The rent multiple approach is just the beginning. (Two other approaches are described at the back of this booklet.)

This analysis does suggest some other questions you could ask your friendly nonprofit developer.

- What is considered a normal “rent multiple” in an apartment building sale?
- What was considered normal in 2003 or so?
- Why did it change? Was it just because interest rates changed, or did something else happen?
- Could the building’s finances be causing the changes we are seeing at the building?
- What are typical operating expenses for a building like this one?

- If your organization were bidding on that property, how much would you pay?
- Can you explain to me why it does or doesn't make sense that the building sold at that price?

If you do not already know what bank or other lender made the mortgage loan and possibly other loans to the buyer, you can ask about that as well.

The answers to these questions could be important and useful, plus they help to open a line of communication with the friendly nonprofit developer.

Back to the tenants

You will also want to know what a possibly predatory purchase means for tenants. In addition to finding out what a building's typical rents are, you should also try to learn:

- the rents paid by tenants who moved in most recently,
- whether there has been an increase in tenants moving out, and for what reason,
- the vacancy rate,
- whether services have changed—for example, if building staff have been laid off,
- whether conditions are getting worse,
- whether vacant apartments are being improved in ways not available to existing tenants, and
- whether cosmetic improvements are being made in an attempt to attract higher-paying tenants.

This information will help you understand what is happening to the building, an understanding that you may be able to bring to elected officials, the news media, or other players.

It will also help to ascertain whether the tenants themselves are ready to take action in response to the possible predatory situation.

From research to action

If your research confirms that a speculative purchase by predatory equity investors has placed a building and its tenants in jeopardy, it is time to take action. There are three basic action tasks.

- Create a list of tenant demands.
- Construct the story you want to tell (including a “happy ending,” your proposed solution that benefits the tenants).
- Get your story out.

Tenants should always demand:

- to be informed about anything affecting the financial condition and fate of their building, and
- a seat at the table when options and solutions are discussed.

Tenants will probably want to demand that in return for any government help in resolving a building's situation, there must be protections and benefits for tenants. *Bail out tenants, not banks and landlords!* Depending on the type of threats to the building, these protections and benefits could include:

- needed repairs or capital improvements,
- affordability protections such as limit on rent increases, or
- a guarantee that tenants will not be displaced.

Tenants may also want to demand that the building be sold to a new owner who they choose or approve, such as a nonprofit organization with a mission to provide affordable housing. This is probably the best of all possible outcomes.

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Controlling the story

The key to winning these demands may lie in the decision makers' and public's understanding of the situation, which will be one-sided and incomplete without the tenants' story. So be sure to document the harm to tenants, using verifiable facts and figures where possible and using “human interest” stories about specific tenants whenever you can.

Your story also needs to convey that there can be a solution that benefits tenants—a solution that meets the tenants' demands. But because real estate deals are very complicated, it will often be difficult to provide as much technical detail as you would like about how this can be done. Nevertheless, it is your task to tell the story so that it is clear that a good solution for tenants

is possible, providing as much detail as you can, while challenging elected officials and other players to help come up with the answers.

Your goal is to overcome the attitude that a bad outcome for tenants is fate, and no one can do anything about it. The news media, elected officials, housing agencies, the real estate world—even other nonprofit organizations—all will tend to see this as a story of an owner and a bank with no role for tenants, unless tenants take the initiative to insist on being part of the story. If tenants are the first to raise the alarm, they will have a much better chance of being seen as a key part of the story.

Tenants should also take the initiative to communicate that it was the lender and the owner who created the problem through their own speculative behavior. This didn't just happen to unsuspecting business people. The owner paid too much and the lender lent too much. They knew, or should have known, what they were doing and should accept the consequences. The tenants, on the other hand, are not responsible for the situation. Therefore, the tenants should be protected from the harmful consequences.

If your research confirms that a speculative purchase by predatory equity investors has placed a building and its tenants in jeopardy, it is time to take action.

Once you have your demands and your story, begin telling it. Start with the people you can trust most, whether they are progressive elected officials, sympathetic agency officials, or other organizations. It is important early on to also begin telling your story to people outside your comfort zone, as well as the general public. You can get your story out to the public by calling reporters, holding news conferences, or organizing rallies. A rally targeting a bank could be pretty newsworthy at the present moment.

Remember, you want tenants to be the messengers, and you want to have a variety of story tellers so it doesn't seem like a one-pony show. This means helping tenants prep for publicly telling their personal stories and the story of their building. They will need to have all the facts and figures straight and be able to talk about it comfortably, so all of the usual organizer's tools, such as creating a detailed agenda,

having the whole group vet each story teller's story, and role playing, will be important.

Link up for national action

Once your local campaign gets started, it will be up to your organizing instincts to see it through. But you can also begin connecting with other organizations to help create a national response to the problems created by predatory equity.

The federal bailout of the banking industry has created a context where we may be able to win new protections for tenants from speculative landlords, and where we may be able to win new resources to create and protect affordability.

What's more, organizations in other cities may well be able to help you in your local campaign by sharing their experiences. And the lessons that you learn about your local situation will help people in other cities develop their understanding of the issue.

So get in touch with other groups early. Here are some organizations that you can reach out to:

- Community Service Society of New York, 105 East 22d Street, New York NY 10010. Contact housing policy analyst Tom Waters at twaters@cssny.org.
- New York State Tenants & Neighbors, 236 West 27th Street, New York NY 10001. Contact director of organizing Pat Coleman at patrick@tandn.org.
- Urban Homesteading Assistance Board, 120 Wall Street, 20th Floor, New York NY 10005. Contact director of organizing Dina Levy at levy@uhab.org.
- National Low Income Housing Coalition, 727 15th Street NW, 6th Floor, Washington DC 20005. Contact outreach director Ed Gramlich at ed@nlihc.org.
- National Alliance of HUD Tenants, 42 Seaverns Avenue, Boston MA 02130. Contact executive director Michael Kane at naht@saveourhomes.org.
- Tenants Together, 995 Market Street, Suite 1202, San Francisco CA 94103. Contact organizer Andy Blue at andy@tenantstogether.org

More advanced research

Lexis/Nexis is a commercial database with information from the news media, courts, and other sources. It has

a powerful search function that you can use to find more buildings that have been purchased by a predatory equity investor that you are interested in. You may also be able to find details on the sales and financing of buildings. The service costs money, so try to find an ally that already has it.

Your local department of finance has a wealth of information on building sales and mortgages. Owners and banks file documents with the department in order to legally establish their claim of ownership of property or the fact that they hold a mortgage on property. The amount of information in these documents varies. Sometimes mortgage rates and loan amounts are included, sometimes not. The ease of access varies, too. If you are lucky, the information will be available online, as it is in New York City.

SEC filings: Many mortgage loans have been securitized. That means that banks or other lenders that made the loan did not keep it, but sold it through an investment bank to a paper corporation that issued securities that are supposed to pay an income stream (similar to dividends from a stock) based on the debt service payments made by the borrower. The investment bank then sells these securities to itself, to other banks, and to the public. Because the securities are offered to the public, the investment banks must file documents with the federal Securities and Exchange Commission. The documents are supposed to identify the risks associated with investing in the securities. In reading them, you may find that the true risks have been artfully hidden for the buildings you are concerned about. But there is still a wealth of useful information to be found in these documents. You can find them on the SEC's web site, www.sec.gov. The site has a search engine but, unfortunately, it is not very powerful, and it will take a lot of trial and error to find the buildings that you are interested in.

The Community Service Society of New York is an informed, independent, and unwavering voice for positive action on behalf of the city's 3.1 million low-income New Yorkers. CSS draws on a 160-year history of excellence in addressing the root causes of economic disparity through research, advocacy, and innovative program models that strengthen and benefit all New Yorkers.

Commercial real estate databases: There are many companies that research, compile, and sell information on real estate deals for the investing public. Trepp tracks the performance of mortgage loans that have been securitized. Real Capital Analytics tracks a wide variety of loans and sales. Marcus and Millichap tracks sales. These services cost money, but if you can find someone who will share one of them with you, you may learn interesting things.

More advanced analysis

As mentioned in Step 3 above, rent multiple is a pretty crude indicator of the financial risk in a real estate deal. Here are two better ways to measure risk.

Capitalization rate: First, determine the net operating income (or NOI) of the building by subtracting annual operating expenses from the annual rent. Then divide the NOI by the price paid to determine the capitalization rate or cap rate. The lower the cap rate the more speculative the deal. For example, if it cost \$300 per apartment per month to operate the Fuzzy Arms, where rents are \$500 per month, that would give a NOI of \$2,400 (\$6,000 annual rent minus \$3,600 annual expenses) and a cap rate of 4.8 percent (\$2,400 divided by \$50,000)—a low cap rate historically, but not unusual in New York lately. Note that you can only do this if you know either the operating expenses or feel confident in an estimate, and that you need the expertise of a friendly nonprofit developer to evaluate whether the cap rate is too low.

Debt service coverage ratio: An even better approach would be to know the actual amount of the annual payment on the building's mortgage and compare that to the NOI. You may not be able to find out the payment amount, but you may be able to come up with a reasonable estimate based on the typical interest rates offered at the time of the sale of the building. In New York City, most predatory equity mortgages are interest-only, so you only need to multiply the amount of the loan by the interest rate to determine the amount due each year. The debt service coverage ratio, or DSCR, is simply the NOI divided by the annual debt service. A DSCR of 1.3 or more would be considered good underwriting. A DSCR of 1.1 means the building is barely scraping by, and anything below 1.0 means that the owner is either using reserve funds to pay the interest or simply not paying.