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Investing in Expensive Renovations For Rental Apartments

Some luxury tenants are giving their apartments makeovers rather than looking for new homes.

By NANCY KEATES



Designer Kendall Wilkinson recently completed an ambitious renovation on a 3,000-square-foot penthouse in San Francisco's Nob Hill. She gutted the apartment, adding a den and putting in leather walls, marble floors, new molding, a high-end kitchen with features by designer Christopher Peacock and Waterworks fixtures. She also designed a closet with custom built-ins, turned a bedroom into a library and made three bedrooms into two bathrooms.

Her clients spent about \$1 million on the upgrade. But when their lease is up, they will be leaving most of these improvements behind.

In competitive real-estate markets, some luxury renters are making a surprising decision: putting tens or even hundreds of thousands of dollars into upgrades on their temporary lodgings. They are investing in redos at a time when rental vacancies nationwide are at their lowest since 2001—currently at 4.3%, according to real-estate research firm Reis. Meanwhile, rents have been rising rapidly, up 3.8% over the past year. The result: More renters are deciding to stay put and put their money into improving their current homes.

“People don't want to live in something that's not up to their standards. They're willing to make big changes even if they'll only be there a couple of years,” says Noble Black, a broker with Corcoran in New York, where the vacancy rate was just 1.9% in the first quarter of 2013, down from 2.1% a year earlier.

“My friends think I'm crazy. But if it's something you're going to live in for the next three years, you don't mind spending the money. It's worth it. It's about lifestyle,” says Daniel de la Vega, who looked for a rental for eight months in Miami and couldn't find exactly what he wanted. He eventually settled on an apartment that had the finishes he liked, but a floor plan that seemed too constricting. He tore down a wall to eliminate one of the bedrooms and make the living room larger.

Mr. de la Vega, a managing partner of One Sotheby's Realty in Miami, received permission from his landlord to make the changes. What he didn't get was any reduction in the rent in exchange for his investment. His lease, which is two years with a one-year renewal option, specifies he must return the apartment to the way it was before he made the changes. But he isn't worried he will have to put back the wall. “I know when I'm done he will love it so much he won't make me,” he says of the landlord.

While the vast majority of redos by renters tend to be superficial—such as a new paint job or carpeting—landlords and building managers across the country report they are also seeing far more expensive and elaborate renovations. They are also getting more requests for structural changes such as knocking down walls, adding new bathrooms and custom built-in closets.

“I’m really amazed at how much people invest even when they’re just renting,” says Isabelle Higson, who owns a portfolio of residential rental buildings in San Francisco with her sister and brother, including the Brocklebank Apartments on Nob Hill. Her renters have installed new malachite sinks in the bathrooms, torn out older kitchens, replaced them with newer models and recovered walls with wood paneling and even leather. Not one of those changes has cost Ms. Higson a dime—they have all been paid for by her tenants.

Jeffrey Weisman, a 53-year-old interior designer who lives in one of Ms. Higson’s buildings, did his first renovation shortly after he moved in 20 years ago, spending about \$100,000 to remodel the master bedroom and kitchen. Five years ago, after his now-husband moved in, they invested about \$200,000 in another extensive remodel: They tore down walls to create a formal dining room, added new molding and wall panels with antique mirrors, covered the ceiling with pewter-leaf tea paper, updated all the lighting and refinished the floors.

For long-term renters such as Mr. Weisman, there is another reason to invest in renovations, rather than moving: Strict regulations on how much landlords can increase their annual rents on some apartments in cities such as San Francisco and New York can make staying put an especially affordable proposition. Mr. Weisman declined to say how much he currently pays in rent, but says it is “substantially less” than the \$6,500 a month that a similar apartment on another floor rents for. Building management says an apartment similar to Mr. Weisman’s is actually going for \$10,000 a month now; rents in his building range from \$2,900 a month for a one bedroom that is been rented by the same owner for decades to \$20,000 for a three-bedroom apartment.

Marsha Monro, a marketing consultant who moved into a one-bedroom apartment at the Brockleback three years ago, began renovating before she moved in. She knocked down a wall between the kitchen and dining room, put in new stainless-steel appliances and Carrera marble counters in the kitchen, installed a new vanity, sink and shower in the bathroom, added new molding to the walls, platinum-leafed the fireplace mantle, put in 9-foot mirrors and refinished the floors, spending about \$20,000 in all. She says she is never leaving: “You’ll see me here 40 years from now.”

“We love it—as long as they run everything by us first,” says Ms. Higson of her tenants’ remodeling projects.

Not all landlords are thrilled when their tenants make changes, however. Renovations can be expensive to get rid of and make the place less attractive to potential future renters. Josh Weiss found that out after a tenant spent about \$50,000 renovating a 5,000-square-foot triplex in a building he owns in Manhattan’s Greenwich Village. The changes were mostly superficial—window treatments, wallpaper, tiling—but the style was so distinctive

(black and white “Versailles-like” wallpaper, unusual paint colors) that Mr. Weiss asked the tenants to take it all out before they left. He estimates undoing the renovations cost the tenants, who stayed about two years, about \$30,000. With the triplex’s rental price at \$30,000 a month, he says he couldn’t risk keeping the unusual décor and hoping someone with similar taste would come along.

Ms. Higson ran into a similar problem at the Brocklebank when she allowed a tenant to leave without undoing a malachite bathroom with gold fixtures and a kitchen she describes as “tricked out.” Despite a lot of demand for apartments in the building, she had a hard time finding tenants willing to take that unit. “People would see it and say ‘oh dear,’” she says. She eventually rented the apartment to someone from Brazil.

Most rental contracts include a clause that the unit has to be returned to the same condition it was leased—but whether that is enforced is usually decided on a case-by-case basis, says Gary Malin, president of Citi Habitats, a New York real-estate company. He says most landlords let the changes remain if they are neutral enough. “They don’t like improvements specific to one person’s taste. They want it to be universal,” he says.

These rules can mean a tightrope walk for architects and interior designers. “You can’t move too many walls and you can’t touch the heating,” says Ms. Wilkinson, the San Francisco-based designer. Ms. Wilkinson says she does a major rental renovation about every year now in this market: In San Francisco, the rental vacancy fell to 3.2% in the first quarter this year, down from 5% a year earlier, while rents have risen 5.7% over the past year.

Many landlords would rather do the work themselves. They will allow the tenants to pick out the tiles or appliances, but they will hire the contractors and oversee the work, charging the clients for the total project cost. “That gives me control over the quality of what’s installed and the quality of who is installing it,” says Rob Goodman, chief executive of Los Angeles based Resmark Cos., which opened the Avenue in Hollywood, Calif. His company charges about \$125 a foot to replace the standard carpeting with wood floors and about \$1,500 to put in track lighting. The only large-scale renovation that required the tenant to pay for removal was a unit rented by a hip-hop producer who built in expensive shelves for his collection of rare limited-edition sneakers.

Daria Salusbury, who leads luxury residential leasing operations for real-estate firm Related Companies, says the company started combining apartments because of requests from current tenants. A typical case: A couple at the company’s MiMA building in midtown Manhattan wanted to take a two-bedroom, 1,500-square-foot unit and merge it with a 1,000-square-foot, one-bedroom unit next door. The company paid for and oversaw the construction and raised the monthly rent on the combined apartments to more than \$20,000 from \$11,000. “They’re happy, they signed a two-year lease and we’ll be able to rent it to someone else,” says Ms. Salusbury.

When a would-be renter likes an apartment but isn't fully sold on it, knowing they can make changes can make the difference, brokers say. Eric Hantman, CEO and founder of New York brokerage firm Prime NY, always advises landlords to approve any renovations they deem will have lasting value. He recently had a client who wanted all new stainless-steel appliances for the kitchen and new wall coverings; the landlord ended up splitting the cost.

And allowing a tenant to invest in improvements can mean keeping that renter for years to come. Myles Horn spent about \$100,000 several years ago to renovate the aging apartment he has rented for 18 years in a prewar building on Manhattan's Upper West Side. He and his wife put in new bathrooms, installed new kitchen appliances and updated the fixtures and molding. "We're comfortable there. We are used to the space," explains Mr. Horn, a real-estate developer, who says several other tenants in his building also have done extensive renovations.

Mr. Horn, who has a two-year lease and declines to state how much he pays in rent, says every time the lease has been renewed there has been an increase in rent—except the year he did the renovations. He and his wife have no plans to leave.