

# August 2018 Research in Brief

## ARA Research and Strategy

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## Rent Control Changes in California Posing Significant Uncertainty

California is once again at the forefront of a nationwide attempt to address the shortage of affordable housing. Following Los Angeles voters' 2016 approval of measure JJJ requiring developers to use union labor, a statewide measure to repeal the Costa Hawkins Rental Housing Act "Costa Hawkins" made it onto the 2018 ballot. Costa Hawkins was passed in 1995 and placed limits on municipalities' rent control policies. Its primary provisions are: (a) Ensure landlords' right to raise rents to market levels after a tenant moves out and (b) Restrict rent control policies to buildings built before 1995. While repealing Costa Hawkins would allow cities to pursue more restrictive rent control policies, cities would still need to enact legislation implementing any proposed changes in rent control, something which has not always been successful. Given that existing rent control policies already vary widely across California cities, the potential repeal of Costa Hawkins creates the possibility of even greater divergence in rent control policies from one city to the next, something that could

materially impact how investors view investments across California cities.

### *A brief history of rent control policies in California*

Many of the rent control laws on the books at cities across California were enacted in the late 1970s and early 1980s in response to the same driver as today's concern - a lack of affordable housing units - but most continue to apply to pre-1980 vintage stock today. During the late 1970's, rising real estate values and near-record high interest rates made single family homes in California less affordable. As a result, apartment rents were driven up by increased demand, inflation was high, and wage growth was not keeping pace. This environment helped propel a surge of tenant activism leading to increased rent control regulations - the majority of which are still on the books today. The passage of Costa Hawkins in 1995 was an attempt to blunt the movement towards a more robust rent control model.



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### Expanded Rent Control or Not?

When rent control policies were first enacted, they applied to most of the existing rental stock, with new development not impacted. In the event of a repeal of Costa Hawkins, this could have a significant impact on all stock and this risk should be considered in the analysis and underwriting of potential acquisitions, ongoing developments, and pricing of existing assets. However, a Costa Hawkins repeal does not automatically mean there will be new rent control policies enacted across the state -- recent efforts in Pasadena, Inglewood, and Long Beach to put local rent control measures on ballots all failed to garner enough signatures suggesting mixed support for these regulations. Inglewood and Long Beach are especially instructive as the political compositions of each and, to a lesser degree, percentage of renters fit the profile of cities where rent control would be expected to have a higher probability of being enacted.

So, the jury is still out on what political influences may lay on the horizon. In that context, let's look in more detail at rent control policies currently in place, how much of the market is already affected and the impacts.

### Rent control takes many forms

Most rent control laws have two basic components that determine what a building owner can charge in terms of rent: (1) the Annual General Adjustment (AGA) is the percent by which an owner can increase rent every twelve months, and (2) when a tenant vacates a unit, rent for that unit can be marked up to market rate. The structure of the AGA varies dramatically from city to city. San Francisco, for example, has a very restrictive AGA that allows building owners to increase rents by 60% of CPI every 12 months. Alternatively, rent control in Los Angeles is somewhat more forgiving allowing for the higher of a 3 percent increase or increases tied to CPI up to 8 percent.

### > Existing California Rent Control Policies

City	Rent Cap	Avg. Implied Rent Control Growth Rate (Q1 2000-Q1 2018)	Q1 2000-Q1 2018 Rent Growth (CoStar - All Properties)	Difference
Berkeley	65% of CPI	1.8%	3.3%	-1.6%
Beverly Hills	3 percent or CPI, whichever is higher	2.6%	2.6%	0.0%
East Palo Alto	CPI or 10% whichever is lower	2.7%	2.7%	0.0%
Hayward	5 percent	3.1%	3.1%	0.0%
Los Angeles	3 percent or CPI up to 8% whichever is higher	3.3%	3.5%	-0.2%
Los Gatos	75% of CPI or 5% whichever is lower	2.0%	2.2%	-0.2%
Oakland	CPI or 10% whichever is lower	2.7%	2.9%	-0.2%
Palm Springs	75% of CPI	1.9%	2.9%	-1.0%
San Francisco	60% of CPI	1.6%	3.2%	-1.5%
San Jose	5 %	2.8%	2.8%	0.0%
Santa Monica	75% of CPI	1.9%	2.5%	-0.6%
West Hollywood	75% of CPI	1.9%	3.1%	-1.2%

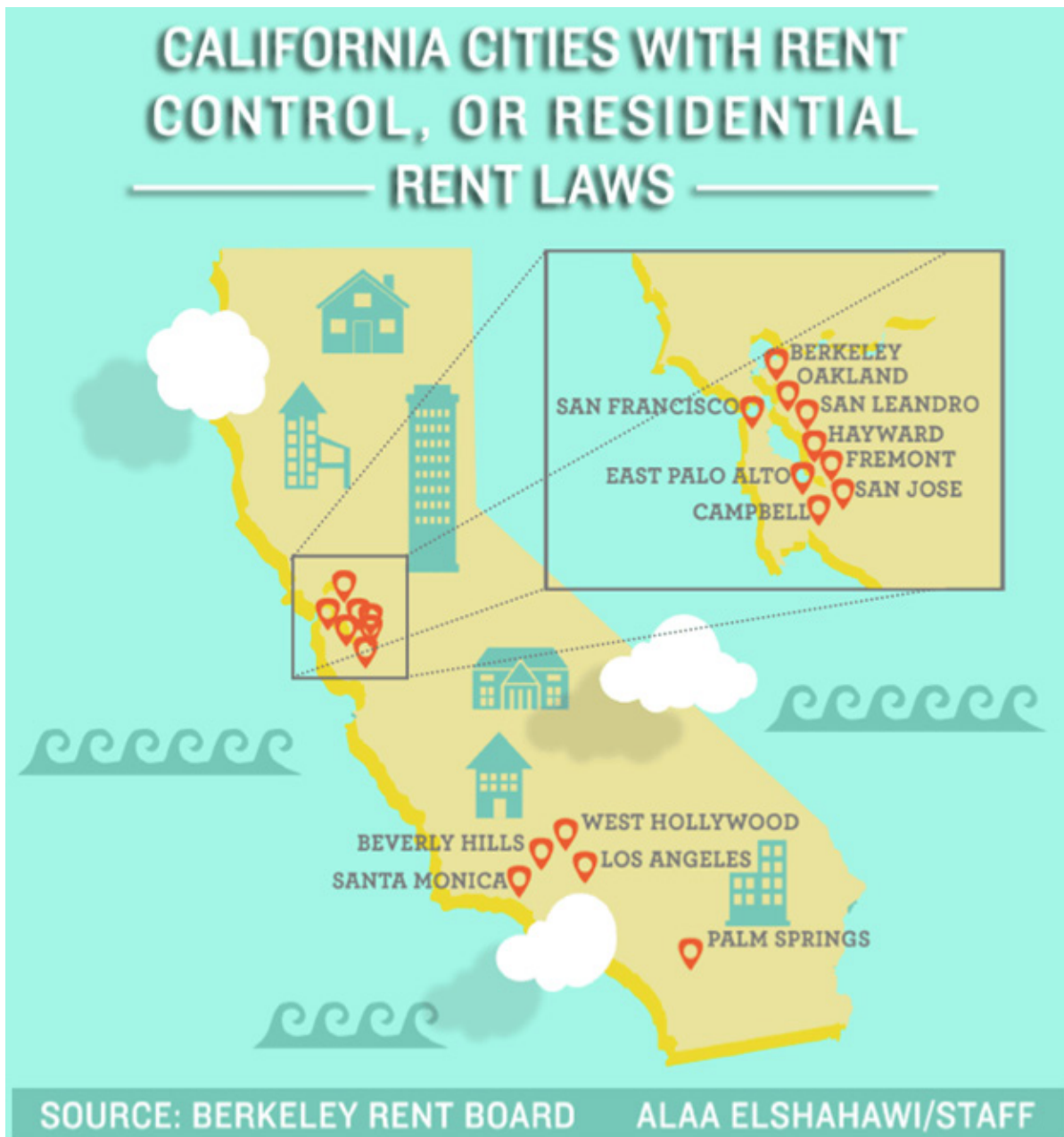
Source: CoStar, California Municipalities, Bureau of Labor Statistics



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The table on page 2 offers a simple hypothetical example for how rent growth under a rent control policy could stack up against longer run rent growth in a market (Q1 2000 - Q1 2018). In markets with lower longer run rent growth and flexible AGAs, such as Beverly Hills or Los Angeles, if an existing asset were to fall under rent-control valuations, it wouldn't necessarily be significantly impaired. The same cannot

be said for Berkeley and San Francisco, where rents in rent-controlled buildings would almost immediately fall behind market rents. If Costa Hawkins is repealed, policies more akin to those in Los Angeles would be much less damaging to current owners than the policies in place in major Bay Area cities.





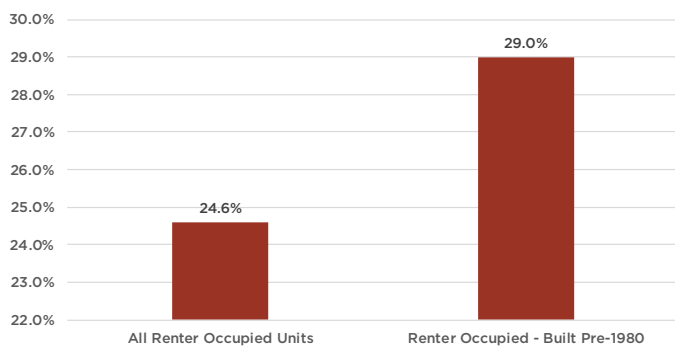
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*Few cities have rent control, but they are some of the bigger ones*

Just over a dozen cities in the state of California have rent control laws that include limiting how much owners of those properties can increase their rent in a given year. However, these include a number of the largest cities in the state (Los Angeles, San Jose, San Francisco, Oakland). As a result, a substantial amount of the state’s renter occupied housing stock is affected.

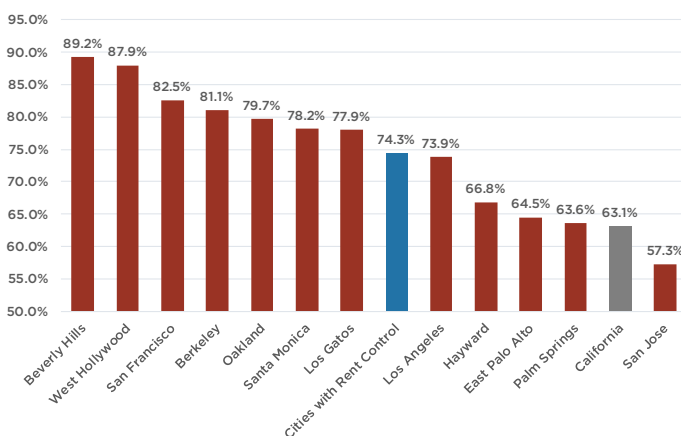
*“If Costa Hawkins is repealed, policies more akin to those in Los Angeles would be much less damaging to current owners than the policies in place in major Bay Area cities.”*

### > % of Renter Occupied Units in CA Located in Cities with Rent Control



Source: Census Bureau

### > % of Renter Occupied Stock Built Pre-1980



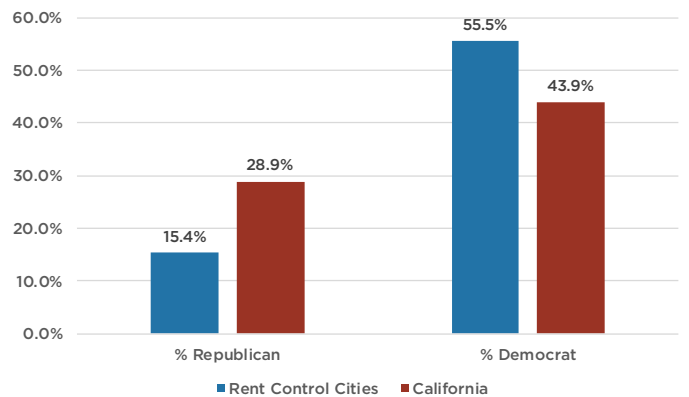
Source: Census Bureau

Most of the rent-control laws in California cities apply to properties built before 1980 which accounts for roughly three-quarters of the renter-occupied stock in these cities. Despite this apparent constraint, investors have been able to earn respectable returns. Thanks to the scale of these markets, there were still more than 370,000 investable market rate units as of 2016, a reminder that even if we end up in a future with broader controls, there will still be compelling investment multi-family opportunities, and every major California city with rent control has had index-beating returns on average since 2000.

### *Politics matter*

Rent control is not a purely economic issue. It is also a legal, cultural, and political one. The voter base in cities with existing rent control policies leans considerably more Democrat and less Republican, even when compared to the over-all blue-tint to California politics as a whole.

### > Voter Registration - Cities with Rent Control



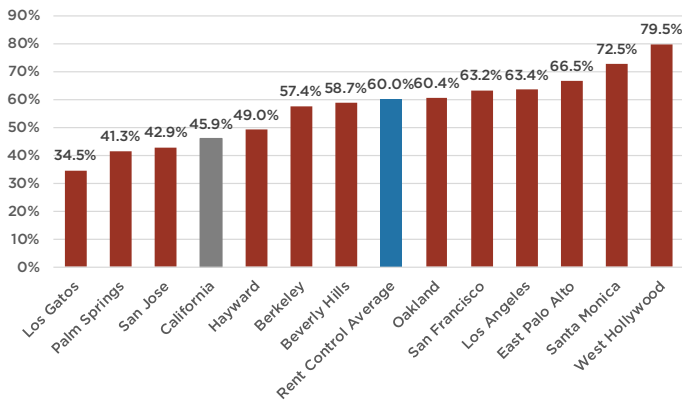
Source: California Secretary of State Report of Registration

The percentage of voters who are registered either Democrat or Republican has been a significant predictor of ensuing rent control policy. Center-to-right leaning regions of California are much less likely to have these controls in place. In addition, the number and percentage of residents in a city who are renters has a potential impact. In Municipalities with higher percentages of renters, the passage of tenant friendly legislation would be expected.



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### > Renter Occupied Units (%)



Source: Census Bureau

### “Go South Young Man” Orange County and San Diego

Relative to Los Angeles and the Bay Area, other So Cal metros have traditionally had a more moderate-to-conservative leaning voter mix and higher rates of home ownership. As a result, these metros may benefit in a Costa Hawkins repeal scenario as they would be expected to be less exposed on average to the risks present in Los Angeles and the Bay Area. Additionally, these markets have historically performed well and are positioned for strong performance moving forward, thanks to desirable geographic locations, good weather, higher density, regulations that limit excess supply growth, and competitive industry clusters, such as biotech in San Diego and high-end business services in Orange County.

County	Democrat %	Republican %	Home-owner %	% NPI Beat 2000-2017
Orange	31.7%	41.8%	56.6%	78.0%
San Diego	35.3%	33.9%	52.1%	72.0%
San Jose	45.6%	21.7%	56.4%	73.0%
Los Angeles	51.1%	21.6%	44.6%	61.0%
San Francisco	55.6%	8.6%	37.9%	72.0%

Source: California Secretary of State Report of Registration, Census Bureau, NCREIF

### Focus on development and newer properties

If cities elect to increase rent control, it is less likely local leaders would include all vintages of stock under the ordinance -- after all, new development means more jobs and taxes. In Los Angeles, a more measured scenario being proposed would have rent control ordinances extended to cover all properties built before a certain vintage (pre-2005 as an example). Under this scenario newer properties and new construction will remain exempt, allowing investors to continue to make investments in core assets, development, and even value-add opportunities with this additional consideration.

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### Investment Conclusions

San Francisco has much more restrictive rent control policies than Los Angeles. Annual rent increases are capped at 60% of CPI for the former and can range from 3-8% for the latter. Under the different existing rent control scenarios, should a property fall under rent control in San Francisco, the likely negative impact to total return potential would be greater than in the Southland. In Los Angeles, with elevated supply levels and currently moderating returns, investors face less risk from stricter rent control policies even if current restrictions were extended.

In the end, while one can bracket the potential rent control outcomes if Costa Hawkins were to be repealed, the range of potential outcomes is wide and highly uncertain. In this type of environment, investors would be wise to first familiarize themselves with the current status of rent controls in each local market as well as weigh the likelihood and risks of outcomes from potential changes and then decide how big a commitment they want to make.



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