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Real estate markets

Rent control - How big a risk to the apartment industry?

Chief Investment Office GWM | 11 June 2019 07:23 am EDT
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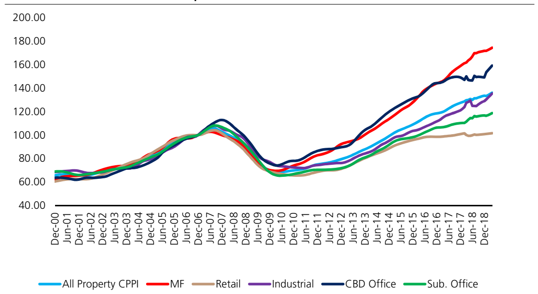
- The apartment sector has been one of the strongest sub-sectors of the commercial real estate industry following the global financial crisis. Apartment rents in many cities have grown significantly, particularly those in more expensive, coastal cities.
- The substantial increase in apartment rents across the nation following the global financial crisis has, among other things, led to numerous rent control conversations, ballot initiatives and legislation (both enacted and proposed) in a number of states across the country.
- Oregon recently enacted statewide rent control. California and New York have a number of bills circulating through their respective legislatures. Based on current proposals we believe New York has the potential to enact the more unfavorable legislation for the apartment sector.
- We continue to believe rent control is an ineffective manner to address housing affordability as it will likely lead to decreased returns for apartment owners and developers and will ultimately lead to a decline in new construction, thus further exacerbating as opposed to ameliorating the affordability equation.
- We believe California and New York-focused REITs should be relatively insulated from rent control initiatives based on their property exposures and the nature proposed legislation, particularly in California.

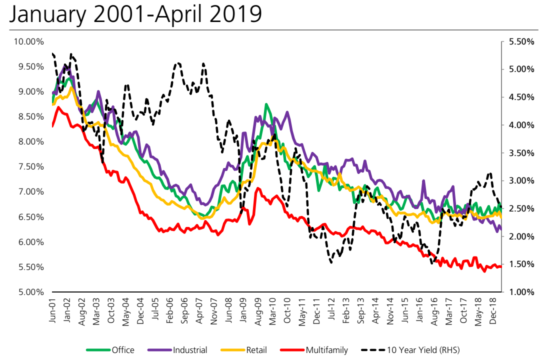
The apartment sector has been one of the strongest sub-sectors of the commercial real estate (CRE) industry following the global financial crisis (GFC). As can be seen in Figures 1 and 2, since 2001 the apartment sector (also known as multifamily) has experienced the greatest increase in asset values among the major CRE asset classes (Figure 1) and the greatest compression in capitalization rates (Figure 2). Contributors to this strong performance include favorable demographics, solid operating fundamentals and strong rent growth, particularly post the GFC.

Figure 1: Moody's Commercial Property Price Index for Major CRE Asset Classes
December 2000-April 2019



Source: Real Capital Analytics

Figure 2: Private Market Transaction Capitalization Rates for Major CRE Asset Classes
January 2001-April 2019



Source: Real Capital Analytics

Rents have experienced strong growth since 2010

Apartment rents in many cities has grown significantly following the GFC, particularly those more expensive, coastal cities. In Figure 3 we highlight the growth in rent for a one bedroom apartment between 2010-2018 for select, high cost coastal cities. In addition Figure 3 details monthly rent as a % of monthly household income. As can be seen the average for these cities exceeds the national average of 24% - with the exception of Portland, OR.

Rent control – a knee- jerk response

The substantial increase in apartment rents across the nation following the GFC has, among other things, led to numerous rent control conversations, ballot initiatives and legislation (both enacted and proposed) in a number of states across the country. Oregon was the first state in the US to enact statewide rent control earlier this year. In addition, despite the failure of Proposition 10 in California in 2018 the California legislature has proposed several rent control measures in 2019. Other states that are considering rent control include Colorado, Illinois, Washington, Massachusetts and New York.

We continue to believe rent control is an ineffective manner to address housing affordability as it will likely lead to decreased returns for apartment owners and developers and will ultimately lead to a decline in new construction, thus further exacerbating as opposed to ameliorating the affordability equation. That said we are mindful that there is a significant political component that must be factored into the calculus, particularly in the coastal states of California, Washington and New York where rents have risen quickly, can represent a substantial percentage of median household income and single party control of government exists.

Although rent control may sound like a panacea to tenants, we believe artificial constraints to rent growth, expense recovery and new development will ultimately lead to decreased investment in existing structures and development as well as reduced transaction volume of existing assets. In Figure 4 we highlight the YOY change in quarterly multifamily transaction volume for a select group of cities in the US between 1Q 2018-1Q 2019. We recognize that many factors impact the flow of investment capital into a given market and asset classes. That said we are intrigued that the markets that have either enacted or are far down the road with various rent control measures (NY, LA, SF, Portland) all witnessed declining transaction volumes over the past several quarters. As we are fond of saying - capital seeks it highest risk adjusted return. It is certainly reasonable to conclude the prospect of rent control has shifted investment capital to more attractive regions.

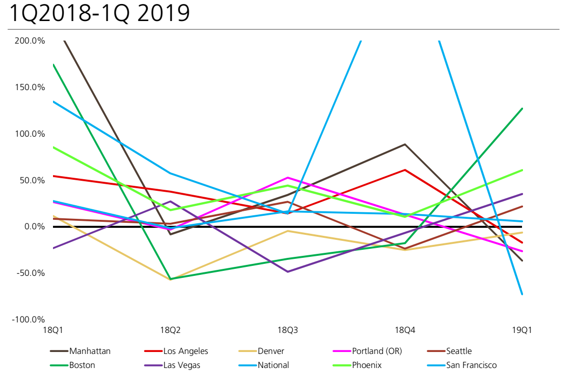
We are particularly concerned about one specific proposal in New York that would limit a landlords ability to recoup the costs of significant building and individual unit improvements - respectively know as MCIs and IAIs. If landlords are not permitted to have rents reflect these costs there is increased risk of declining investment and quality of rent controlled/;rent stabilized units in New York. This could also have a multiplicative effect in that these capital expenditures have historically generated substantial economic activity and job growth in the city.

Figure 3: Apartment Rent Growth for Select Regions
2010-2018

Region	1 Bedroom Apt. Rent Growth 2010-2018	1 Bedroom Apt. As A % of Median Household Income
San Francisco	78.0%	33.2%
Portland	67.2%	19.7%
Los Angeles	49.6%	38.4%
Boston	46.2%	25.2%
NY City	34.6%	29.6%

Source: CBRE, FFEIC

Figure 4: Multifamily Transaction Volume for Select Cities
1Q2018-1Q 2019



Source: Real Capital Analytics

How might the Multifamily REITs be impacted?

In Figure 5, we highlight the exposure for a group of multifamily REITs to markets that have enacted or proposed rent control initiatives. In New York where we believe the greatest potential currently exists for adverse legislation AvalonBay (AVB, Bellwether), Equity Residential (EQR, Bellwether) and UDR Inc. (UDR, Most Preferred) have the most exposure to NYC based on net operating income (NOI) exposure. However, all three companies exposure to potential rent control/stabilization is significantly lower given their lower exposure to tax abatement-benefitted buildings. The aforementioned notwithstanding we believe unfavorable legislation would likely lead to decreased investment activity by these REITs.

In California, Essex Property (ESS, Bellwether) has the greatest exposure at 82% of revenues (NOI figure not available). Other REITs with significant exposure to California include AVB, EQR and UDR. As we discuss below we believe the proposed bills in the California legislature are significantly less onerous than originally feared. Assuming the final outcome is substantially similar to what is currently being proposed we believe the California-focused multifamily REITs should be relatively well positioned.

Rent control – the potential slippery slope

As we discuss below the rent control measure passed in Oregon and the measures being proposed in California are more benign than originally feared. However one concern is that this becomes a slippery slope where the regulations become increasingly more stringent over time, particularly if the affordability situation deteriorates further.

Below we provide an overview of the recently enacted Oregon law as well as highlights of the proposals in California and New York. The New York rent control/rent stabilization laws in particular are very complex, running hundreds of pages. As such our overview is likely not all encompassing as the NY legislature is grappling with a number of proposals from various constituencies and an imminent expiration date of existing regulations - 15 June 2019.

California and Oregon – It could have been worse

On 28 February 2019, Governor Brown signed Senate Bill 608 making **Oregon** the first state in the US to enact statewide rent control. All in all we believe the bill struck a reasonable balance for tenants and owners/developers. Significant aspects of the bill include the following.

- Annual rent increases are generally limited to 7% + CPI. There is an exemption for some smaller and newer buildings.
- Landlords are prohibited from terminating month-month leases without cause after 12 months of occupancy. In addition rent increases are limited to once per year.
- Rent increases are uncapped if renters vacate voluntarily;
- Rentals built after 28 February 2004 are not subject to rent increase limitations;

Figure 5: REIT Net Operating Income Exposure to Markets Implementing or Debating Rent Control Measures

	NY	CA	CO	FL	OR	IL
AVB (a,c)	7.8%	42.0%	0.0%	0.0%	0.0%	0.0%
EQR (b,c)	9.7%	47.0%	1.0%	0.0%	0.0%	0.0%
UDR' (c)	9.8%	35.6%	1.1%	7.5%	0.7%	0.0%
AIV	4.1%	37.1%	4.0%	6.8%	0.0%	4.9%
CPT	0.0%	12.8%	5.8%	17.8%	0.0%	0.0%
ESS	0.0%	82.1%	0.0%	0.0%	0.0%	0.0%

a) Total NY area exposure for AVB is 22.2%. NYC represents 7.8% of NOI.
b) Total NY area exposure for AVB is 15.3%. NYC represents 9.7% of NOI.
c) AVB, EQR and UDR estimate their NYC NOI exposed to rent control is 1.8%, 4.8% and 2.0% respectively

Source: Company Documents, UBS

Note: The data for ESS are a % of Revenue

- Landlords may evict tenants for non-payment of rent or lease agreement violations. In addition, the bill allows landlords to evict tenants in the case of significant upgrades or planned demolition;
- Landlords who evict a tenant for no fault must pay the relocation fee;
- Landlords who own four or less rental units are not required to pay the relocation fee if the landlord wishes to move into, sell or significantly upgrade the property;
- Landlords who violate the regulations may be liable to tenants for up to three months rent and damages.

California has several bills pending in the legislature addressing rent control and creating incentives for additional development. Although nothing is firm yet it appears that what is being proposed would be more benign for landlords than what was contemplated under the failed 2018 Proposition 10 ballot initiative.

- Assembly Bill 1482 would impose a statewide cap on annual rent increases of 7% +CPI (with a hard cap of 10%). These caps would not apply to affordable units, apartments less than 10 years old, single-family rents (assuming the owner owns 10 or less units) and college dormitories. In addition the bill would expire in three years.

- Assembly Bill 1279 would ease the permitting process for low-density unit construction in what are known as high resource areas. The bill's goal is to ease the permitting and development process for affordable units (affordability to be defined) allowing up to four units to be built in areas zoned for single-family residences. In addition buildings with as many as 40 units may be built in areas zoned for any residential use. Further, as many as 100 units may be built in areas zoned for either residential or commercial use. The quid pro quo for developers would be the requirement to either include an affordable component or contribute to an affordable housing fund (presumably set up by the state).

- Assembly Bill 1486 would require counties to maintain a database of surplus, or unused public land that could be available for public bid starting in 2021. In addition to expanding the definition of public land, the proposed bill would eliminate the current bidding priority for developers of low-income, disabled and senior housing. The proposed bill alters the bidding process by removing the previously mentioned priorities and opens the bidding for low and moderate income housing development. In addition land that was previously zoned for commercial use would be eligible for residential development provided the entire development meets the requirements of affordable.

- Senate Bill 330 seeks to spur additional development by limiting each municipality's ability to restrict/delay permitting and new developments. Highlights of the proposed bill would prevent municipalities from a number of items including:

- Lowering maximum density rules;
- Capping the total number of housing permits issued;
- Enacting moratoriums on new residential development;
- Allowing commercial development on land previously zoned for residential use;
- Establishing minimum-parking ratios in densely populated urban areas that are within one quarter of a mile from a train station. For areas not considered dense urban settings municipalities could not require minimum parking/unit requirements greater than 0.5 spaces/unit.

New York City – A tangled web of laws with a short expiration date

New York City (NYC) has some of the most complex rent control and rent regulation laws in the US. Among the complexities in NYC is the differentiation between rent controlled and rent stabilized units. We estimate that a relatively small percentage of the apartment units are rent controlled (approximately 1% of the 1.97 million units in NYC). Rent control only applies to building built prior to 1947 and have been continuously occupied by a tenant or tenant's family member since 1971.

However we estimate that more than 45% of the units in NYC are subject to rent stabilization, something that is overseen by the Rent Guidelines Board (RGB). The RGB is appointed by the Mayor of NYC and consists nine people: two landlords, two tenant representatives and five other individuals. In general rent stabilization guidelines apply to building constructed between 1947 and 1974. However, newer buildings that were constructed under tax abatement programs are also subject to rent stabilization guidelines during the period of the tax abatement. Once the tax abatement period expires the previous stabilized units may become market rate units.

Historically the process of approving percentage increases allowed under rent stabilization has been contentious given the competing dynamics of landlords and tenants. The current process is further complicated by two additional factors: 1) the current guidelines expire on 15 June 2019 and 2) the political climate in New York State and NYC has shifted significantly to the left. The Democrats control the Governor's and Mayor's mansion, the Senate and Assembly in NY State and the NYC Council. Tenants have brought significant political pressure on the various entities to significantly limit any increases and eliminate some landlord protections. Below we discuss some of the proposals being debated in the New York legislature. In all we believe there are nine separate proposals being debated by the Senate and Assembly on the topic.

- AB-A5030A/SB-2892A – The proposals would prohibit annual rent increases on renewals greater than 150% of the local CPI on units not currently under the aegis of rent regulation. This proposal would not apply to buildings with less than 4 units that are also owner-occupied. Under this proposal landlords would be permitted to increase rents to current market rates pursuant to tenant turnover.

- AB-2351/SB-185 – The proposals would prohibit landlords from significantly increasing rents on vacant units. The current laws allow for as much as a 20% increase on vacant units. The proposals would allow rent increases on vacant unit to be in line with those increases authorized by the RGB.

- AB-1198/SB-2591A - The proposals would eliminate a landlord's ability to deregulate a unit once the unit's rent exceeded USD 2,774.76/month or if the tenant annual income exceeded USD 200,000/year. We do not believe this provision would apply to units governed by tax abatement programs.

- AB-4348/SB-2845 – The proposals would prohibit landlords from adjusting the amount of preferential rent, rent charged and paid by the tenant which is less than the legal regulated rent for the housing accommodation, upon the renewal of a lease. In addition landlords would only be allowed to make such adjustments upon a vacancy, which is not the result of the failure of the owner to maintain a habitable residence.

- AB-6322/SB-4312 – The proposals would require a regulatory framework for the approval of rent increases to rent regulated property as a result of major capital improvements (MCIs). Currently, the expenses for MCIs are recovered over seven years. This bill codifies the MCI as a surcharge to the legal regulated rent, which is separately designated and billed as such, and mandates that the surcharge for authorized MCIs ceases after the cost of the improvement is recouped. Finally, this bill prevents landlords from receiving a financial windfall by charging MCIs to tenants, if the New York State Energy and Development Authority funds an MCI. In addition the proposals would govern rent increases allowed for individual apartment improvements (IAIs). Currently landlords are permitted to increase the monthly rent of a unit by a small percentage of the improvements. The percentage varies by building size.

Appendix

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