The Resmark Companies

California Assembly Bill 1482: Rent cap/eviction — A stakeholder's perspective

The record-breaking U.S. economic expansion continued in the fourth quarter of 2019, notably in California, with the gross state product reaching an estimated $3.1 trillion.[1] California accounts for approximately 14 percent of the U.S. economy and, if it were its own nation, it would be ranked fifth in the world.[1] Furthermore, California is the most diverse and populous state (projected to surpass 40 million residents in 2019[2]), which helps explain why it benefited from one of the most-improved labor markets in the nation[1]; California's unemployment rate declined to historic lows at 3.9 percent in November 2019, from 12.3 percent, when it peaked in November 2010.[3]

We believe that multifamily development projects will be limitedly affected by AB 1482 from both a property-value and free-cashflow standpoint, specifically in the context of a merchant-build strategy.

Strong economic growth, combined with the prolonged low-interest-rate environment, should have resulted in a robust housing production environment and record residential construction. However, structural, regulatory and bureaucratic constraints within the state's various jurisdictions have continued to limit housing starts and perpetuate the housing shortage. Multifamily housing starts peaked in 2015, with peak deliveries expected at the end of 2019 through 2020.[4]

In light of these market dynamics, we believe that a supply shortage exists in California, thus presenting opportunities for experienced and skilled multifamily developers to execute their growth plans by filling in the supply gap, despite the recently passed rent-control legislation, discussed in detail below.

California Assembly Bill 1482 — Rent cap/eviction[5]

In October 2019, as part of the California Tenant Protection Act of 2019, the California Assembly Bill 1482 (AB 1482) was passed into legislation. This bill limits apartment rent growth in California by placing an upper limit on annual rent increases and restricts tenant eviction.

Specifically:

1. AB 1482 limits apartment rent growth in California to 5 percent plus regional CPI or 10 percent (whichever is lower).
2. AB 1482 requires a landlord have and state a just cause for eviction of tenants who have occupied the premises for a year.

Properties affected are:

- Apartments older than 15 years (built prior to 2005).
- Properties that contain at least two rental units (non–owner occupied rental units).

Properties exempt are:

- Apartments less than 15 years old (rolling 15-year lookback starting with 2005).
- Properties regulated by local rent-control laws under the Costa-Hawkins Rental Housing Act.
- Single-family homes, including condos, townhomes (anything separately alienable), unless owned by a REIT, corporation, or limited liability corporation in which at least one member is a corporation.
- A duplex or a house with a granny unit, if the owner occupies one of the units.
- Housing that is subject to an agreement that provides subsidies for persons and families of very low, low, or moderate income.

AB 1482 took effect on Jan. 1, 2020, and sunsets on Jan. 1, 2030; however, it is retroactive to March 15, 2019.

Expected impact of AB 1482 on new development

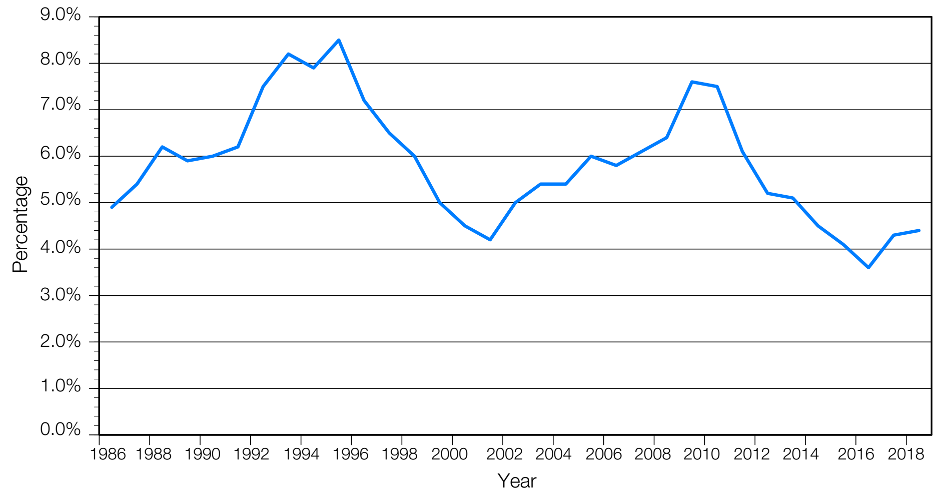
We believe that multifamily development projects will be limitedly affected by AB 1482 from both a property-value and free-cashflow standpoint, specifically in the context of a merchant-build strategy. As long as California continues to generate economic growth and creates jobs in dynamic industries that require utilization of educated and skilled employees, it will continue to attract massive inflows of core capital. The institutional core buyer pool for new development is not likely to underwrite negative value impact due to the 15-year horizon or the rent cap of 5 percent plus regional CPI that AB 1482 prescribes. Institutional core buyers, given the more expensive nature of class A rents, commonly use rental growth assumptions that are correlated with inflation (2 percent to 3 percent) — this growth underwriting parameter is unaffected by the new standards. Given the physical attributes of a newly developed product, and the expected quality and durability of the new systems and components involved with new construction, it is less likely that a comprehensive repositioning will be required in the near-to-medium term.

Expected impact of AB 1482 on redevelopment/renovation

Per AB 1482, apartment units can be adjusted to market rates when the unit is vacated and rented to a new tenant. Therefore, property values in areas not already affected by rent control could be potentially driven down. With vacancy rates at historical lows, redevelopment/renovation projects will likely face slimmer margins and will be forced to focus on controlling costs and managing long-term, slow-growth revenue streams. Furthermore, AB 1482, from our vantage point, created an unintended disincentive for making major property upgrades.

Along with potentially lower property values and shrinking margins, the AB 1482 rental cap will limit one's ability to potentially profit from renovations/improvements for class C buildings and, to a lesser extent, class B buildings. In turn, this will affect the project's cashflow and corresponding value. Moreover, if a landlord wants to evict a tenant so that a rental property can be "substantially remodeled," the tenant must be paid a relocation fee equal to one month of rent, which further harms the ability to capture remodeling upside.

Rental vacancy rates for California



Source: U.S. Census Bureau

We believe that a significant mismatch exists between the increase in rent allowed by AB 1482 and the cost of an average class C building renovation. This mismatch will likely cause renovations to become less feasible in California and, as a result, incentives for value-add projects may drop to levels that fail to attract new participants.

Conclusion

California is an attractive core market with strong economic fundamentals, cross-generational demographics, and attractive supply/demand characteristics for the multifamily sector. Nonetheless, like AB 1482, new social and political initiatives related to housing in general, and the affordability in the multifamily sector in particular, are expected to continue to be an integral part of California's housing landscape. The ability to skillfully navigate this new terrain is vital to the future economic success of California.

[1] Bloomberg
[2] *Forbes*, December 2019
[3] U.S. Bureau of Labor Statistics
[4] CBRE Research, *Real Estate Market Outlook 2019*
[5] California Legislative Information – AB 1482

CONTRIBUTOR

Ziv Cohen
Chief Investment Officer
The Resmark Companies

CORPORATE CONTACT

Caroline Gibson
Director, U.S. and International Investor Relations
10880 Wilshire Boulevard, Suite 1420
Los Angeles, CA 90024
Tel: 310-862-2254 | cgibson@resmark.com
Resmark.com

CORPORATE OVERVIEW

Founded in 1995, Resmark is a residential real estate investment manager that finances, develops and manages real estate in California, the western United States, Texas, the D.C./Mid-Atlantic region, and other select major metropolitan markets nationwide. To date, Resmark has participated in more than 230 real estate projects encompassing over 35,000 single-family lots and homes and multifamily residential units. Celebrating its 25th anniversary in 2020, Resmark is headquartered in Los Angeles and also maintains offices in San Diego and Irvine, Calif.; Austin; and Washington, D.C. For additional information, please visit Resmark.com.

This article presents the author's present opinions reflecting current market conditions. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product.