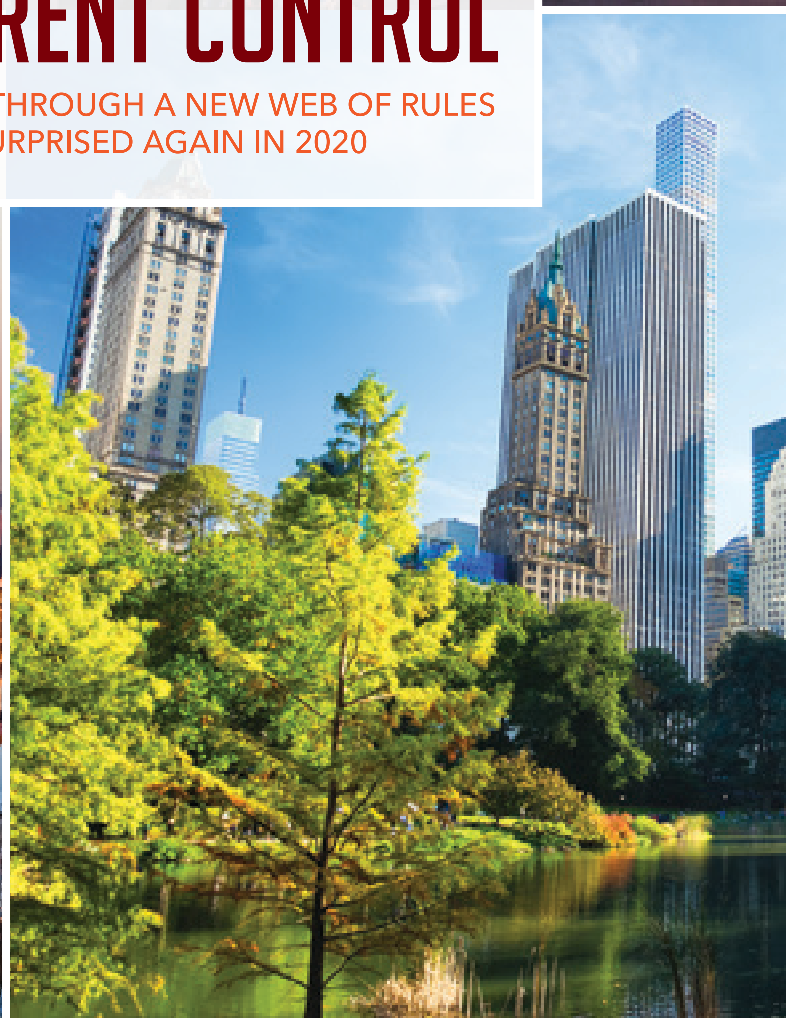
A NEW WAVE OF RESIDENTIAL RENT CONTROL

APARTMENT INVESTORS SORT THROUGH A NEW WEB OF RULES AND PREPARE TO BE SURPRISED AGAIN IN 2020

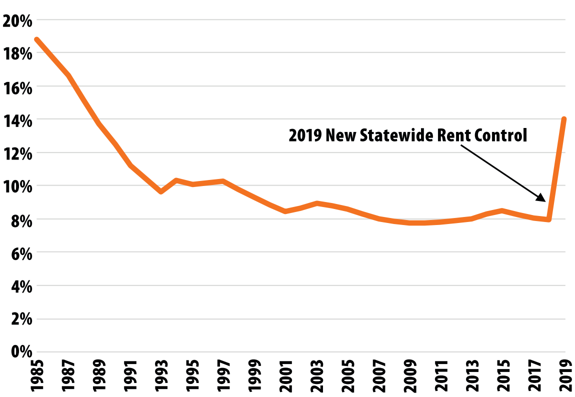


Apartment rent control[1] initiatives surged in 2019 (Exhibit 1) propelled by a combination of falling affordability in the most productive—and expensive—cities and in part by greater polarization in the policy views of legislators and voters. The strength of recent momentum toward stricter rent control policies took many by surprise, especially after California voters had defeated a ballot measure in November 2018 that would have allowed cities there to broaden their rent regulations. The share of US apartments subject to some form of rent control has been trending lower since the 1980s, but three major 2019 laws sharply reversed that pattern.

In February 2019, Oregon enacted the country's first statewide apartment rent growth regulations. In June, New York became the second jurisdiction to pass statewide rent regulation. California then enacted new state rent regulations in October. Increased regulation of rent growth has been proposed in half a dozen additional states, from Massachusetts to Washington. And this trend is not isolated to the US: Berlin's state government enacted a five-year rent freeze in June, sending German listed residential company share prices tumbling.

The flurry of activity on rent regulation raises questions for US apartment investors: How concerned should they be about negative impacts to cash flows and values for assets in their portfolios? How do the new laws change the risk-return profile of future apartment investments? And how will the new laws affect local apartment market dynamics?

Exhibit 1: Estimated Share of US Apartment Units Subject to Rent Control



Source: LaSalle calculations based on analysis of the American Housing Survey, NYC Housing and Vacancy Survey, US Census Bureau, Moody's, and CoStar. Estimate is as of December 2019.

The Evolution of US Rent Control

Apartment rent control remains the exception rather than the rule across the US.[2] The rules that exist are set at both the state and the municipal levels, creating a complex and overlapping mix of laws.

The majority of US rent-controlled units have long been in New York City and its metro area—and this remains true today. New York was the only market to retain permanent rent control after the Second World War, and its first-generation controls originally fixed absolute rent levels. After 1969, a second generation of reformed rent controls allowed market forces to determine starting rents and then regulated subsequent rent increases (also known as rent stabilization). Nearly all US rent regulation today takes this approach of regulating maximum annual increases rather than setting absolute rent levels.

In the wake of emergency national price controls amid high inflation in the 1970s, individual cities in Maryland, New Jersey, and California and the District of Columbia enacted their own rent controls, with the share of US units subject to rent control peaking around 1980. A mix of forces then resulted in an ebbing tide of controls during the 1980s and 1990s. These included slower relative inventory growth in rent-controlled markets, the expansion of New York City vacancy decontrol policy, a state referendum victory for a ban on rent control in Massachusetts (1994), and state preemption of new rent control in California's Costa-Hawkins Act (1995).

Affordability Puts Rent Control Back in the Spotlight

Already low rental affordability has fallen in many US markets since 2010, as rental rates have risen faster than incomes. Apartment rents have risen by more

1. We use *rent control* as a useful umbrella term to describe all laws that constrain private owners' ability to raise apartment rents, including "rent stabilization" and "rental brake" policies. Our focus here is on limits to rent change rather than rules governing eviction, transfer taxes, zoning, transaction regulations, or other tenants' rights policies.
2. This is in contrast to many European countries, where much of the residential stock is under a form of rent regulation. The Organisation for Economic Co-operation and Development recently created an affordable housing database that shows that 22 out of 35 countries surveyed have some form of residential rent regulation, with some setting the regulations at the provincial or state level and others at the national or municipal level: http://www.oecd.org/social/affordable-housing-database/.

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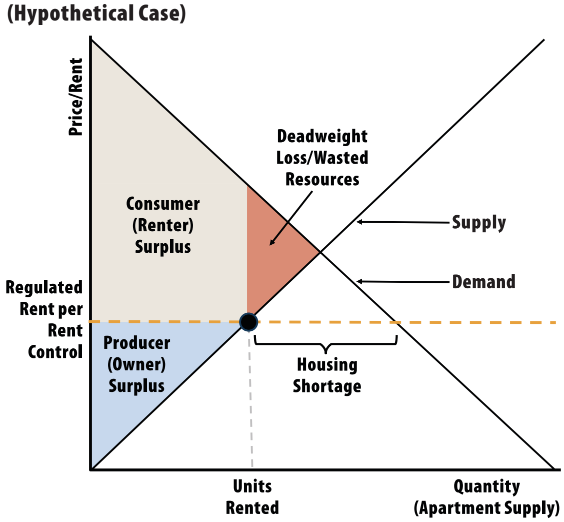
than 45% since 2009 in San Francisco, Los Angeles, Portland, and Seattle, well ahead of income growth for the median household.

This affordability crisis primarily affects low- and middle-income renters of Class B and C properties. Class A apartment renters in the US, on average, currently spend a manageable 20% of their gross incomes on rent. Class C apartment renters spend a far higher share of their gross incomes on rent, well over 30% on average, an onerous burden that constrains their ability to afford other key necessities.[3] Matthew Desmond's 2017 Pulitzer Prize–winning book, *Evicted*, highlights the struggles and sacrifices low-income renters have in making rent.[4]

Rising ideological divisions also set the stage for 2019's rent control laws. Currently, 36 US states have "trifecta" governments, with a single party controlling the governorships, lower houses or assemblies, and senates, up from 19 in 1992.[5] The implication of this is that more extreme policies, such as on rent control, are more likely to pass and be enacted.

Improving affordable housing options for low-income tenants is a laudable goal and one that institutional investors can play a part in accomplishing. The overwhelming weight of academic and empirical evidence shows that rent control is among the least effective policies for achieving it.

Exhibit 2: A Rental Market With Rent Control (Hypothetical Case)



Source: LaSalle Investment Management

Evaluating Rent Control

At its most basic, rent control transfers a portion of future cash flows from owners to in-place tenants, creating redistribution winners and losers. A select group of incumbent tenants benefits, whereas property owners see declines in value when rent control is introduced or tightened. New York City apartments in the NCREIF Property Index had negative appreciation of 2% in 3Q2019, their worst quarter in nearly ten years and far below the US average, likely fueled in part by the stricter rent regulation enacted in June.

Yet rent control does not merely distribute the economic pie in a different way; it shrinks that pie in a way predicted by Microeconomics 101. Nobel Prize–winning economist Paul Krugman declared, "The analysis of rent control is among the best-understood issues in all of economics, and—among economists, anyway—one of the least controversial. … Almost every freshman-level textbook contains a case study on rent control, using its known adverse side effects to illustrate the principles of supply and demand."[6]

A simplified model of rent control is shown in Exhibit 2, illustrating how setting a rent level below the market-clearing level gives rise to a deadweight loss and a housing shortage.[7] Real estate markets and rent control policies are of course much more complex than this simple framework.

The market impact of actual rent control policies has attracted rigorous research efforts by academic economists since the early 1970s.[8] Hundreds of papers have investigated how rent control affects affordability, market rents, and housing availability. Notable literature

3. Based on data from Realpage. Also consistent with the findings in *A Primer on U.S. Housing Markets and Housing Policy*, Richard K. Green and Stephen Malpezzi, Washington DC: American Real Estate and Urban Economics Association Monograph Series, Urban Institute Press, 2003.
4. Matthew Desmond, *Evicted: Poverty and Profit in the American City* (New York: Crown Publishers, 2016).
5. "State Government Trifectas," Ballotpedia, https://ballotpedia.org/State_government_trifectas.
6. Paul Krugman, "Reckonings; A Rent Affair," *New York Times*, June 7, 2000.
7. *Deadweight loss* is an economic term for wasted opportunity. It is the cost to society for a market not functioning efficiently.
8. For example, a 1972 article on New York City rent control found that the benefits of controls to tenants were half the cost of those controls to landlords. Edgar O. Olsen, "An Econometric Analysis of Rent Control," *Journal of Political Economy*, Nov.-Dec. 1972, Vol. 80, No. 6, pp. 1081–1100.

reviews on the topic include Arnott (1995), Turner and Malpezzi (2003), and Sturtevant (2018).[9]

This evidence points toward some predictable market impacts from rent control policies. Academic research also highlights how the devil is in the details of individual rent control policies, which are very heterogenous, so it is worth taking a closer look at the details of 2019's major changes.

New Rent Control Laws Take Diverging Approaches

To some degree, the new 2019 statewide rent controls further highlight New York's exceptionalism relative to the rest of the US. New York's new law has had more immediate disruptive effects to real estate strategies, including necessary capital improvements. By contrast, California's and Oregon's rent control laws, as they stand today, set relatively high caps on the rate of rent growth and will have less impact on renovation strategies (Exhibit 3). Since 2001, rent growth in California's and Oregon's major metros has exceeded the newly instituted caps only 16% of the time.

New York's Housing Stability and Protection Act of 2019 (HSTPA) includes a more complex set of changes affecting existing rent control laws in New York City. Rent-stabilized apartments in New York City, which make up 45% of the city's rental housing stock, have had and will continue to have annual rent increases regulated by the city's Rent Guidelines Board (RGB). The renewal rent increase limit for the upcoming year is 1.5%, below recent market rent growth.

Three key changes in the HSTPA law are these:

- **HSTPA sharply reduces the rent increase that can be charged after a renovation of an older property.** Allowable rent increases for major capital improvements to a building are capped at a third or less of their previous allowable pace and increases for an individual apartment unit renovation are cut by a factor of about three for larger buildings. An example provided in "What Lawyers Must Know" in the November 2019 online *New York Bar Association Journal* is for a vacant $2,000 two-bedroom unit. Previously, if the owner spent $15,000 on renovating the unit, the apartment could have been marketed at a new rent of $2,375 (with an increase of 1/40 of the renovation cost). After HSTPA, the owner, if the same renovation were made, would be able to market the apartment at $2,089 (with an increase of 1/168 of the renovation cost), a level offering a sharply lower return on cost that in many cases does not justify the project.[10]
- **HSTPA tightens the limits on renewal rent increases in rent-stabilized units and rent increases upon vacancy,** including in many buildings built between 1971 and 2017 under the 421-a tax exemption program, by removing several channels used to grow rents at the market pace, such as increases of preferential rents if they were below legal rents upon renewal and vacancy bonuses.
- **Municipalities across New York State can now opt in.** Municipalities with a vacancy rate of less than 5% that pass a local law to adopt it can put in place a system of rent stabilization similar to New York City's, with a county Rent Guidelines Board that sets rent increases for properties built before 1974.

Exhibit 3: Comparison of States' New Rent Stabilization Laws

	Maximum Renewal Rent Growth	Applies to	Other Key Provisions
Oregon SB 608	7% + CPI	Buildings more than 15 years old. Single-family rentals included.	Rules around tenant eviction tightened. Rent increases after renovation remain largely unregulated.
New York HSTPA (S6458)	Continues to be set by the Rent Guidelines Board (RGB). Renovation premiums reduced.	All rent-stabilized apartments, as well as a small remaining group of pre-1947 rent-controlled units.	Vacancy decontrol and vacancy allowance eliminated. Preferential rent increases limited to RGB pace.*
California AB 1482	5% + CPI	Buildings more than 15 years old. Single-family rentals owned by REITs included.	Leaves Costa Hawkins ban on new municipal rent control intact.

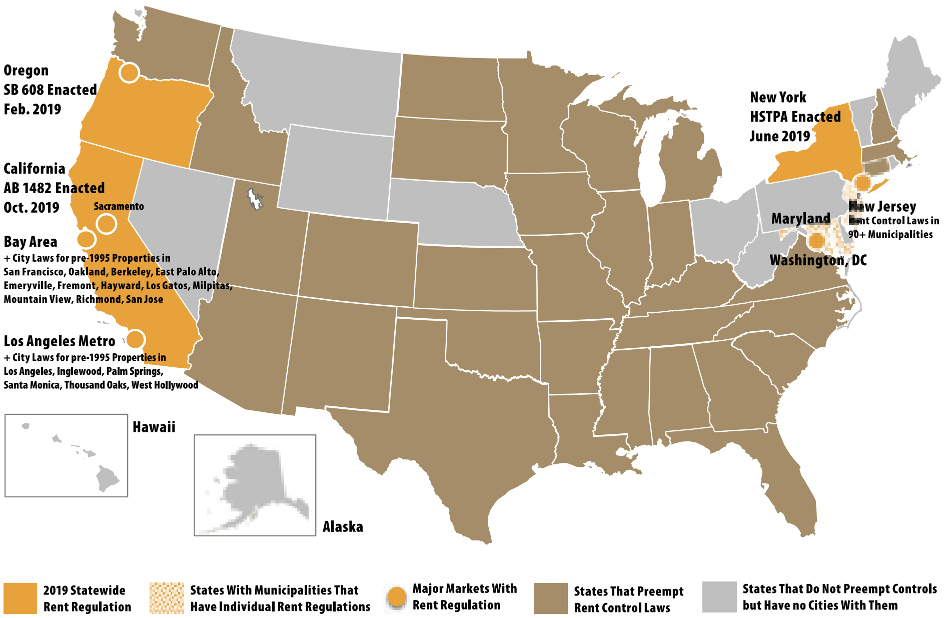
Sources: https://olis.leg.state.or.us/liz/2019R1/Measures/Overview/SB608, https://www.nysenate.gov/legislation/bills/2019/s6458, https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB1482

**Preferential rents* are those where the owner charges a rent set below legal maximum levels. For a tenant with a preferential rent, owners could previously increase rents faster than RGB guidelines on renewals, provided that the rent was still at or below the legal maximum. HSTPA now bars this convergence of preferential with legal rents, and preferential rents, upon renewal, can be increased by not more than the RGB-allowed increase.

9. Richard Arnott, "Time for Revisionism on Rent Control?" *Journal of Economic Perspectives*, 1995, Vol. 9, No. 1, pp. 99–120. Bengt Turner and Stephen Malpezzi, "A Review of Empirical Evidence on the Costs and Benefits of Rent Control," *Swedish Economic Policy Review*, 2003, No. 10, pp. 11–56. Lisa Sturtevant, "The Impacts of Rent Control: A Research Review and Synthesis," National Multifamily Housing Council, May 2, 2018, https://www.nmhc.org/research-insight/research-report/the-impacts-of-rent-control-a-research-review-and-synthesis/.

10. Gerald Lebovits, John S. Lansden, and Damon P. Howard, "NY's Housing Stability and Rent Protection Act of 2019—Part II: What Lawyers Must Know," *New York State Bar Association Journal*, https://www.nysba.org/Journal/2019/Nov/New_York%E2%80%99s_Housing_Stability_And_Tenant_Protection_Act_of_2019/.

Exhibit 4: Apartment Rent Control in the US



Source: National Multifamily Housing Council (NMHC). Updated September 2019 and available at https://www.nmhc.org/research-insight/analysis-and-guidance/rent-control-laws-by-state/.

The sharpest impact from HSTPA is on renovation strategies, many of which were halted when HSTPA reduced the rental premiums that could be charged after renovating vacant units and upgrading buildings. New York apartment investment volume has trended moderately lower since the law was enacted in June 2019.

Looking Ahead

Rent control policy changes are now firmly on the radar of real estate investors as a potential risk for 2020 and beyond. As discussed above, rent regulations distort apartment markets and are generally not a long-term solution, even as they appear to offer a quick-fix solution in markets with high housing costs and significant income inequality. But the sky is not falling for institutional apartment investors, and context is important. Besides Oregon, New York, and California, the only US jurisdictions with rent control are Maryland, New Jersey, and the District of Columbia; 32 states ban any rent regulations in municipalities in their states (Exhibit 4).

Most efforts to introduce rent controls over the past three years have not been successful. Legislators in Massachusetts, Nevada, Colorado, Hawaii, Illinois, Washington, Connecticut, and Florida have considered removing prohibitions on rent control, yet they have not changed these rules. Consistent with this pattern, California's November 2018 ballot measure that would have repealed the Costa-Hawkins Act banning rent regulation on buildings built after 1995 failed by a decisive 59% to 41% margin, leaving the local regulation ban intact.

A Predictable Set of Unintended Consequences

Setting aside rent control's policy effectiveness and its immediate impact on building value, the academic literature lays out several likely consequences for apartment market dynamics when rent controls are introduced or tightened:

- **Tenants stay longer.** Studies of New York and San Francisco rent-stabilized apartments show that tenant tenure is longer in rent-stabilized apartments thanks to the incentive of below-market rent, which reduces turnover costs for landlords and leads to very high average occupancy rates in rent-stabilized buildings.[11] It also means that newcomers to rental markets have a more limited set of options.
- **Supply is reduced.** A major prediction of the Microeconomics 101 price ceiling framework is that rent controls will reduce the supply of apartments that would otherwise have been available. Policymakers have tried to address this issue by nearly always exempting new construction apartments from existing rent control, which does mitigate the negative impact of rent control on supply. Academic literature shows that the impact of rent control on new construction is mixed.[12]

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11. Joseph Gyourko and Peter Linneman, "Equity and Efficiency Aspects of Rent Control: An Empirical Study of New York City," *Journal of Urban Economics*, July 1989, Vol. 26, pp. 54–74. Carol Rapaport, "Rent Regulation and Housing-Market Dynamics," *The American Economic Review*, 1992, Vol. 82, No. 2, pp. 446–451. Richard Ault, John Jackson, and Richard Saba, "The Effect of Long-Term Rent Control on Tenant Mobility," *Journal of Urban Economics*, 1994, Vol. 35, No. 2, pp. 140–158.
12. Edward L. Glaeser, "Does Rent Control Reduce Segregation?" Harvard Institute of Economic Research, 2002, Discussion Paper No. 1985.

However, there is clearer evidence that supply is often constrained because of conversions. Studies in San Francisco and Boston (which had rent control until 1995, when it was barred) show that building owners subject to rent control are more likely to convert properties to for-sale condos or other uses, limiting rental supply.[13] Also, while the historical evidence on new construction is mixed, it is plausible that capital market fear about the uncertainty of future changes could constrain new construction in some markets.

- **Unregulated units face higher rents and rent growth.** All else equal, a reduction in housing supply boosts the expected rate of long-term rent growth for nonregulated units. This is often the opposite of the intended policy outcome but is supported by the academic literature.[14] In analyses of a cross section of metros, a number of experts found that those with rent control policies tend to have higher unregulated apartment rents, controlling for other factors.[15]
- **Renovation strategies are less feasible.** Rent control can remove incentives for owners to improve and maintain older buildings to modern standards, in some cases causing older stock to deteriorate in quality. Depending on the specific rules, it can make the execution of core-plus and value-added apartment renovation strategies unworkable.
- **Capital shifts to adjacent jurisdictions.** Municipalities and states where tightening rent controls are perceived to be less likely or less uncertain could see improvement in capital market interest, with higher-uncertainty markets becoming less liquid.
- **Greater bifurcation occurs in cash flow volatility between regulated and unregulated assets.** Rent control can effectively split apartment buildings into parallel markets with two very different cash flow profiles. On the one hand, rent-controlled buildings have a go-forward cash flow profile that is very stable, characterized by high occupancy and relatively low rates of rent growth (in some cases subject to RGB decisions on allowable rent increases that vary in any given year). On the other hand, rent control shifts most market volatility arising from supply and demand fluctuation onto the subset of apartment buildings that is unregulated. Swings in market demand are likely to disproportionately affect this unregulated portion of the apartment market, boosting pricing power in strong years and leading to sharp declines in weak years.

Implications for Investors

Residential real estate is often targeted by policymakers and politicians more than commercial property types, in response to legitimate issues of affordability in the largest US cities. However, the wrong policy "medicine" (such as most forms of rent control) can sometimes be worse than the "disease" (higher proportion of incomes spent on housing). Academic research shows that rent regulations have been found to be counterproductive to the goal of increasing supply to meet rising demand in markets with chronic housing shortages. Investors will need to pay close to attention to these issues across the country in the years ahead. There is a wide gap in the understanding of the housing market from the perspective of politicians and many voters versus what housing policy analysts recommend through decades of research.

The US remains one of the world's least regulated rental markets, and this is unlikely to change, with most apartment assets and markets remaining free of rent controls. Yet real estate investors will likely be navigating more rent control policy changes in the coming years. These changes have the potential to create a wide, and sometimes arbitrary, scattershot of investment winners and losers both across and within markets. ■

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13. David Sims, "Out of Control: What Can We Learn from the End of Massachusetts Rent Control?" *Journal of Urban Economics*, 2007, Vol. 61, No. 1, pp. 129–151. Rebecca Diamond, Tim McQuade, and Franklin Qian, "The Effects of Rent Control Expansion on Tenants, Landlords, and Inequality: Evidence from San Francisco," *American Economic Review*, 2019, Vol. 109, No. 9, pp. 3365–3394.
14. Steven Caudill, "Estimating the Costs of Partial-Coverage Rent Controls: A Stochastic Frontier Approach," *Review of Economics and Statistics*, 1993, Vol. 75, No. 4, pp. 727–731. Dirk Early, "Rent Control, Rental Housing Supply, and the Distribution of Tenant Benefits," *Journal of Urban Economics*, Sept. 2000, Vol. 48, No. 2, pp. 185–204.
15. Stephen Malpezzi, "Housing Prices, Externalities, and Regulation in U.S. Metropolitan Areas," *Journal of Housing Research*, Nov. 1996, Vol. 7, pp. 209–241. Dirk Early and Jon Phelps, "Rent Regulations' Pricing Effect in the Uncontrolled Sector: An Empirical Investigation," *Journal of Housing Research*, 1999, Vol. 10, No. 2, pp. 267–285.