

## California's Tenant Protection Act of 2019

Two words that investors in residential real estate do not want to see in the same sentence are “rent” and “control”. Therefore, it was with more than considerable interest that the CA real estate community monitored the drafting and subsequent formal adoption of Assembly Bill 1482 or the “Tenant Protection Act of 2019”. The law, for all practical purposes, became known in common parlance as California’s new “rent control act.” It took effect January 1, 2020.

A main impetus for enacting AB 1482 is that more than 50% of California’s renter population of 17 million renters are deemed “cost-burdened” – which means their shelter costs exceed 30% of household income. Within that population, more than one-half of the total (or 29% of the total renter population) are deemed “severely cost-burdened” – which means their shelter costs exceed 50% of household income. As you might expect, the “severely cost-burdened” population is comprised disproportionately of low-income households and persons of color.

The major components of the law will be reviewed below. While for sure the RE community would have preferred market-based solutions, it is fair to say that the bill that emerged does **not** represent a punitive assault against RE investors. Governor Gavin Newsom was focused on achieving certain tenant protections but, at the same time, he recognized that the State needed to encourage a strong pipeline of new housing if it wanted to make any headway against its persistent housing shortage. In addition, the California Apartment Association – the nation’s largest statewide group representing landlords – conducted a vigorous lobbying campaign in the effort to educate the legislature about critical provisions that would be needed to support development activity. Consequently, the regulatory framework for **new development** was not subjected to major revisions.

The main components of AB 1482 include:

**1. What annual rent increases are permitted**

Let us look at this provision first because, for obvious reasons, the permitted annual rent increases will largely determine the impact of AB 1482 on CA’s residential real estate - Annual Rent Increases (for rental properties >15 years old) may not exceed 5 percent plus local inflation, but will have a cap of 10%.

As stated above, the new rate can be seen as constructive. The **standard** rent increase that we predominantly use in our pro-forma projections is 5%. And AB

1482 allows a minimum of 5% **plus** inflation. This rate was not adopted to appease the real estate community but was adopted so that returns would be sufficient enough to encourage the development of new housing so urgently sought by the government.

It is also noteworthy that the annual increase metrics are clear and objective: 5% and published local inflation rates. Nothing can be more dysfunctional than having a committee, picked by the politicians, determining “fair” annual increases. That approach always attracts enormous political pressure such that the end results serve political reelection concerns and are rarely, if ever, fair to landlords – a predicament that AB 1482 avoids.

## **2. How long will AB 1482 be in effect**

For ten years. The government initially proposed 3 years. However, the landlord group succeeded to get the term extended for 10 years. They had no appetite to confront contested renewal battles every few years. A longer term would mean a longer period of predictable certainty from the investor’s standpoint.

## **3. New Tenant Protections**

What are the new tenant protections provided by AB 1482, given that the official name of the legislation is the “Tenant Protection Act of 2019”? Landlords **do** retain all their rights to evict tenants for “just cause” such as failure to pay rent, criminal activity, nuisance behavior, etc. But prior to AB 1482, (except for the limited number of apartments covered under older rent control programs) landlords had the sole **arbitrary** rights to: 1) set and amend all the financial terms of the lease such as annual rent, % annual increase, required security deposit, etc. and 2) to allow or deny the tenant the option to extend the lease.

Essentially, most of the landlord’s **arbitrary** rights have been eliminated. Tenants now hold the right to renew the lease and a cap has been established for the rent increase.

## **4. Buildings less than 15-years old are excluded**

Any building that is less than 15-years old is excluded from rent control. This is a rolling 15-year criteria; when a building enters its 16<sup>th</sup> year it automatically falls under the rent control provisions. The exclusion window is intended to support development as it provides an initial 15-year free-market environment for new construction. (The government had initially proposed a 10-year cutoff but

landlords successfully made the case that 15 years were needed to promote development.)

**5. Which buildings are included/are excluded**

The properties (only if they are older than 15 years) that fall under the rent control umbrella will include most apartments under private or for-profit ownership, with no minimum unit-count waiver. The rent controls also apply to single family homes and condos that are owned explicitly for rental purposes by a corporation or a REIT.

Exempted are condos and single-family homes (unless, as noted above, they are owned by a corporation or a REIT). Duplexes will also be exempt provided the owner resides in one of the units.

**6. How AB 1482 will be implemented alongside existing (older) rent control programs in CA cities**

A limited number of CA cities have existing rent control programs but they are largely targeted toward protecting low-income residents in older buildings. Provided the provisions of such existing rent control programs are as strict or stricter than AB 1482 (which is generally the case), these older programs will be permitted to remain in effect alongside AB 1482. Given the limited scope of these existing programs, AB 1482 will now apply to all the other apartment properties in the city subject, of course, to the 15-year old threshold.

It should also be noted that the new law **restricts** municipalities from enacting new rent caps lower than those established by AB 1482.

**7. When can an apartment's rent be reset/increased to market**

The rent can be reset to market whenever a tenant vacates an apartment (which usually will be of their own free will). Two exceptions that allow the landlord to require tenants to vacate are when major capital improvements are needed or a condo conversion program is being initiated; relocation assistance of one month's rent must be paid in both of these instances.

**8. Cap-ex guidelines under AB 1482**

For buildings older than 15 years old, the landlord is required to cover cap-ex costs from existing cashflow. However, as noted above, a landlord can require a tenant to vacate if major cap-ex work is undertaken; relocation assistance of one month's rent must be paid.

## **The Outlook - Now that AB 1482 has Become Law**

While it cannot be expected that a free-market industry would “welcome” regulation, is it unreasonable to acknowledge that CA’s “Tenant Protection Act” stayed in its lane and does not deserve to be called “Tenant Protection – at the Expense of Landlord - Act”? The landlord’s financial rights include: a 15-year waiver for new construction, annual rent increases of 5% plus inflation, right to reinstate market rent when a tenant leaves, retention of “just cause” eviction rights and the right to require, at a modest cost of one month’s rent, that a tenant vacate to enable major capital improvements or a condo conversion to proceed. And AB 1482 also prohibits municipalities from adopting **lower** rent caps through 2020. The combined package of these financial rights creates an acceptable base case for investing in residential real estate.

And what do CA landlords lose? – the ability to arbitrarily raise rents above 5% and to arbitrarily evict tenants for no “just cause”. The vast majority of annual rent increases have always been **below** the AB 1482 cap. And, it is hard to argue the fairness of forgoing an arbitrary eviction right when, for the modest cost of one month’s rent, a landlord has the right to evict a tenant to initiate major cap-ex work or a condo conversion.

Dean Zander, an executive vice president and multifamily specialist at CBRE, noted in a September, 2019 CBRE update:

“CPI plus five percent is causing most people to breathe a sigh of relief, we can live with that. It’s not unfair, it’s not gouging, and I don’t see it affecting sales or values at all . . . There’s no fear of the unknown. We have a super strong market in California and knowing that 1482 passed, we know what to expect and we can underwrite that.”

In popular destination cities, like LA, Portland and Seattle, housing looks to remain in short supply for the foreseeable future. And expanding the supply side is not feasible given the ongoing constraints of zoning and approval controls, shortage of developable sites, and the inability to accommodate higher density (because of inadequate infrastructure and potential traffic congestion).

Basic economics would point out that rent control is not needed in an over-supplied market. As you might expect, rental rates would likely fall and incentives increase in the effort for landlords to compete for the limited market demand.

By contrast, popular destination cities with a shortage of housing experience increasing public demand for rent control - which demand is not likely to abate because the housing shortage is similarly not likely to abate. Also, it is reality to acknowledge that these types of popular destination cities attract numerous millennial move-ins and that, politically, the city will likely evolve toward a left-of-center government. Given the combination of tight supply and left-of-center governance, the pressure to initiate rent control becomes very strong.

There is, however, one **BIG** saving grace . . . We have considerable history that illustrates what happens when rent control becomes excessive and unfairly anti-landlord. We have New York City of the 1970's and 1980's to thank for that. The disinvestment in the housing stock, especially during the 1970's, was massive and fell hardest on the shoulders of the poor. By 1997, NYC had to take legislative action to roll back rent control for much of the housing stock that was occupied by high income residents - as those rent control provisions were effectively perpetuating below-market rent subsidies for a large population of renters.

California, fortunately, appears to have gone to school from these past rent-control debacles and recognized the tipping points where controls can destroy the health of the housing market. California has endeavored to strike a reasonable balance between: eliminating potential major abuses of tenants while, **at the same time**, maintaining appropriate financial rewards that incentivize landlords to continue owning and developing housing. And while ten years is by no means an eternity, CA enjoys a more stable environment compared to almost all popular destination cities thanks to the ten-year term of AB 1482.

Unfortunately, other states and cities have not been respectful of the negative impacts of past rent-control excesses and have recently given into political pressures that resulted in significant anti-landlord provisions. In June 2019, New York State stepped-up its rent control laws with substantial changes that eliminated major landlord protections and swung the pendulum far into the tenant's territory. The Seattle rent controls have likewise ventured into provisions that seek to usurp traditional landlord decision-making prerogatives.

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# VERANDA HOLDINGS

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By comparison, in California we can take heart that new constructive ground-rules for residential real estate have now been set for the next ten years.