Financial Advisory

The Growth of Rent Control in California

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RENT CONTROL IS SPREADING

In our last election here in California, Proposition 10 proposed the repeal of the Costa-Hawkins Rental Housing Act – a 1995 law that places limits on municipal rent control ordinances. With this law out of the way, California politicians would have much more power to tell landlords what they can charge for their units.

Fortunately, Proposition 10 was soundly defeated. So us landlords can breathe a sigh of relief knowing that our investments are safe, right? Well, not quite. Rent control has, in fact, expanded since the November election. That month, the Los Angeles County Board of Supervisors expanded rent control to unincorporated areas of the county with an annual rent increase cap of 3%. At the same time, the city of Glendale introduced a 5% freeze in rents that expired at the end of February. In late February, Glendale created a law that forces landlords to pay tenant's relocation fees if rents rise over 7% per year. In early March, the city of Inglewood followed by implementing "temporary" rent controls and the city of Pasadena expanded their existing regulations as well.

Could rent control be spreading to more areas in California? Efforts to put rent control measures on the ballots in Santa Ana and in Long Beach have recently failed, but I don't expect those advocates to just give up. Even Huntington Beach flirted with rent control in trailer parks back in 2014 before abandoning the effort.

Please turn to page 15

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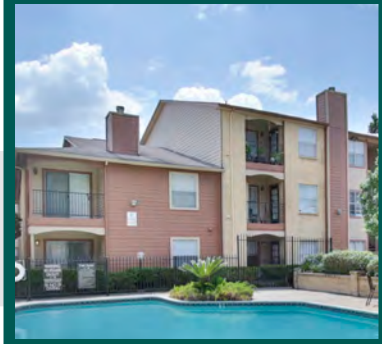


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Continued from page 12

Rent control can be a slippery slope – once it is applied to trailer parks, attaching it to apartments isn't that much of a jump. If Proposition 10 had succeeded, they would have likely come after single family houses, too. I think rent control can be compared to a tax in that, once in place, they never go away, and rarely ease. When is the last time sales taxes went down?

HOW RENT CONTROL HURTS LANDLORDS – AND TENANTS

As an apartment owner, pain caused by rent control is not limited to restriction of your current income. Remember that a rental property is valued based on the income that it generates. You originally bought (and you or your heirs will eventually sell) your apartments based on a multiple of the income they generate. It doesn't matter if you prefer the CAP Rate or the Gross Rent Multiplier valuation; more income equals more value.

Because I prefer to use CAP Rates (because they take expenses into account), that's what we'll use for this example: Let's say that you buy 8 units that are bringing in $1,500 per month each. This gives you $144,000 of revenue every year. I'll pick a number out of the sky and say that 35% of your gross income goes to cover expenses. $144,000 X 35% = $50,400, and $144,000 - $50,400 = a Net Operating Income (NOI) of $93,600. At a Current CAP Rate of 5% (In metro LA or Orange Counties, this would be very cheap in today's market), this gives us a current value of $93,600 / .05 = $1,872,000. Let's say that rents rise 5% annually over the next 10 years. This will give us a gross income of $234,560 in 2029. We'll use that same 35% estimation to come up with an NOI of $152,464. At that same 5% CAP Rate, our property would be worth $3,049,290.

Let's say that, instead, our example property was rent controlled with a 3% limit placed on annual rent increases. This will limit our total rent to $193,524 in 2029 and an NOI, after 35% expenses, of $125,790. At a 5% CAP rate, that gives us a value of $2,515,812 – for a loss of over $500,000 in 10 years from rent control – in equity growth alone. That doesn't even count loss of income over those years.

Note that this example is assuming that all the tenants stayed in place for the entire 10 years. Under the Costa-Hawkins Act, landlords can mark a unit's rent up to market when it becomes vacant. Since at least 1 turnover can be expected, my example can be considered a worst-case scenario. This does expose an interesting feature of rent control: In all of my (non-rent controlled) rentals, I want my tenants to stay as long as possible. In rent-controlled units, this is a recipe for failure. Who will be a better landlord from the tenant's point of view: the one who wants the tenant to stay as long as possible, or the one who wants that tenant gone right away?

Rent control's harm to your property value isn't necessarily limited to future gains, either – it can certainly affect your current value as well. I had a conversation last week with an investor who said he lost millions of dollars in value the day that Inglewood instituted their rent control. He used to be a landlord who wanted his tenants to stay forever – so his rents were below market. (His tenants would need to pay more to move somewhere else.) Rent control is now punishing him for his below-market rents by mandating that he keep them there. Now he'll need to become a landlord that wants his tenants to move out.

Please turn to page 16

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Continued from page 15

ANOTHER REASON TO MOVE SOME INVESTMENTS OUT OF CALIFORNIA?

Over the last decade, we have seen many businesses moving their operations (and all of their employees) away from the heavy regulations in California to more business-friendly environments. Perhaps it is time for us apartment owners to consider a similar move with our businesses. After all; those workers fleeing California will need somewhere to live.

Many investors I speak with are exploring ways to do just that – to sell some of their California-based assets and – through a 1031 Exchange – buy properties out of state while deferring (perhaps forever) their capital gains and accumulated depreciation taxes. I specialize in partial-interest properties that offer a way for investors to do this without worrying about managing a property that is several hours away. If you have any questions, please call my office at (877) 313-1868.

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over three hundred 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998, began working in the partial interest industry in 2001 and has been a broker advising clients since 2003. Call him toll-free at (877) 313 – 1868.

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Christopher Miller is a Managing Director with Specialized Wealth Management in Tustin, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator, and as an advisor helping clients through over two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications, and on television, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313 – 1868.

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= Annual Cash Flow ______________

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= Your Equity Value ______________

Now, divide your Annual Cash Flow by your equity value, and you get your

Cash on Cash Return % _____________ .

Want to increase your properties' income potential? Call Chris Miller at **877-313-1868** today!