Updated Rent Control Decreases Cash Flow

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SAN JOSE—An updated rent control ordinance reduces annual increases to 5%, eliminates the catch-up rent exception and debt pass-through, and places greater restrictions on passing through capital improvement costs, as discussed in this EXCLUSIVE.

Shields says owners may be forced to purchase a property in a city without rent control.

SAN JOSE—The adoption of San Jose's new rent control ordinance is, of course, having an impact on multifamily properties. **Michael Shields**, Managing Director, Silicon Valley Multifamily Group discusses these impacts and other issues surrounding the ordinance in this **exclusive**.

GlobeSt.com: San Jose already had rent control. What makes this new ordinance different?

Michael Shields: San Jose's original Apartment Rent Ordinance (or ARO) limited owners of pre-1979-built multifamily properties to rent increases of no more than 8% each year. However, there were exceptions. If rents had not been raised in the last 24 months, owners could implement a single increase of up to 21%. Owners could also recapture a percentage their property improvement expenses as well as an increased debt load through rents by applying to the housing department for a variance or exception. The updated ordinance, which was effective as of June 17, 2016, reduces annual increases to just 5%, eliminates the catch-up rent exception, eliminates debt pass-through and places much greater restrictions on passing through capital improvement costs. These new rules apply to approximately 44,000 apartments in San Jose–an inventory serving approximately 11% of the city's residents.

GlobeSt.com: What is the biggest short-term impact this revised ordinance will have on San Jose's multifamily inventory?

Shields: Right out of the gate, owners are doing mental math and realizing the unavoidable decrease in cash flow coming their way. Soon, these owners will face tough choices. As repairs arise at their properties, they will have to decide: do I improve my asset (which I can no longer support with rental increases) or do I stay within my means and do only what I can afford? It won't be long before we see the impact of these reality-based capital improvement decisions show up in the decreased curb appeal of our pre-1979-built apartment projects, most of which were built in the 1960s. But even more imminent is a deterioration of investor interest. I already have owners who are chomping at the bit to exchange their San Jose apartment assets for properties in neighboring, non-rent-controlled communities like Sunnyvale, Santa Clara, Campbell or Milpitas. Prospective buyers are doing the same thing, saying "not in San Jose," and investing their money elsewhere. Those who are still interested in San Jose are making offers up to 20% lower than they were before the new ordinance was approved. Before the new ARO, properties could be sold for a premium based on pro-forma numbers, but no longer. Now, investors only care about current rents and paying values accordingly.

GlobeSt.com: What are the biggest long-term impacts?

Shields: Proponents of rent control reason that the regulations ensure a portion of the city's multifamily inventory is protected as affordable housing.

But most multifamily owners and investors (not to mention economists) agree that rent control has long-term consequences that far outweigh the benefits. The **National Multifamily Housing Council** (NMHC) sums these up as: **Deterioration of existing housing:** As cash flow dwindles, so does an owner's ability to improve units. The result is a drop in the quality of existing rental stock. **Inhibition of new construction:** Low returns deter investors, decreasing new unit construction and causing a conversion of no-longer-profitable multifamily assets into other uses. **Reduced property tax revenues:** As property values among rent-controlled buildings drop, so do the taxes that a municipality can assess on those buildings. **High administrative costs:** Creating, monitoring and managing a rent control system is expensive, and can outweigh the short-term benefits envisioned for rent regulation. **Low income residents still lose out:** Rent control is a time-honored shelter for renters who have long surpassed the need for affordable housing, but still cling to their units for the cost savings. This reduces the inventory of available rent control units for the true low-income wage individuals who need them.

GlobeSt.com: What do owners think of the change?

Shields: Affordable housing is a challenge for the industry to tackle, but when it comes to rent control, even the NMHC asks, why should the uniquely public burden of providing subsidized housing be borne solely by providers of rental housing–especially those owners of older, smaller properties? Owners also question whether rent control actually works. An example by urban policy magazine City Journal notes that, even with 1.1 million rent-controlled apartments, New York City's middle-class still struggles with crowded living conditions, a monopoly of rent-controlled units among the wealthy and limited new construction.

Those who oppose rent control generally agree that our solution to high rents and tight inventories involves a return to the basic fundamentals of economic stimulation. Some examples: federal and state programs that provide financial assistance to low-income renters and, in turn, increase their ability to stimulate the economy through buying and renting activity. Also, programs and policies that support easier renovation or new construction of affordable housing units–a move that increases and diversifies San Jose's multifamily inventory rather than narrowing it.

In the current state, San Jose owners are faced with two realities: hold on to properties and face lower profitability or exchange out of San Jose and purchase a property in a nearby city that does not have rent control.