Rent control and its implications

The road from "the rent is too damn high" to rent control, and implications for investment

by Stewart Rubin and Dakota Firenze

Unprecedented rent increases across the nation have resulted in amplified calls for limiting rent increases. Rent control can result in diminished net operating income (NOI) because rents increase at a lower rate than expenses, which would result in lower value. Rent control also can erode the value of rent itself as caps may be set at a lower growth rate than inflation. Another way rent limitations may adversely impact overall returns is that the pool of investors pursuing rent-controlled apartments is more limited, and those that participate may require higher cap rates. This paper begins by noting the unparalleled rent increases in most U.S. markets, then explores the history of rent control in the United States, the current geography of implementation, as well as recent initiatives to expand its reach.

"The rent is too damn high!" is a rhetorical flourish popularized by Jimmy McMillan, the founder of "The Rent is Too Damn High Party," a New York–based political party that emphasized the need for affordable housing. U.S. apartment rents have risen 15.5 percent since first quarter 2020 (i.e., pre-COVID-19) and 3.7 percent year-over-year as of fourth quarter 2022, coming off the peak of 11.3 percent achieved in first quarter 2022, according to CoStar Group data. Although apartment rent growth has slowed, and even declined in certain markets quarter-over-quarter in fourth quarter, asking rents grew in 78 of the top 80 markets on a year-over-year basis, bolstered by substantial rent increases in previous quarters.

Markets with the highest rent growth over the past year, according to CoStar, include Knoxville, Tenn. (10 percent); Fort Myers, Fla. (9 percent); Charleston, S.C. (9 percent); Savannah, Ga. (8 percent); and Indianapolis (7 percent). Although the national vacancy rate increased again in fourth quarter 2022, up 50 basis points to 6.3 percent, and above the historic low of 4.7 percent achieved in third quarter 2021, it is still below the rate in the first quarter 2020 of 6.7 percent.

Southeast metros in general and Florida metros in particular lead the way in rent growth in the 11-quarter period since the pandemic began, from first quarter 2020 through fourth quarter 2022. Markets with the highest rent growth over this period, according to CoStar, include Fort Myers (40 percent); Sarasota, Fla. (38 percent); Palm Beach, Fla. (35 percent); Tampa, Fla. (32 percent); and Savannah (32 percent). Florida metros took four of the top five spots. Every major U.S. market experienced growth, apart from Phoenix and San Francisco, where rents are 0.5 percent and 1.0 percent lower than pre-pandemic, respectively.

Shortage of multifamily housing drives rent growth

There is a shortage of rental housing in the United States that has been evolving for two decades. The primary reason is inadequate construction, which has been exacerbated by increasingly expensive labor and construction materials. Other causes for the shortage include increased household formation, domestic migration patterns, currently elevated home prices, a dearth of single-family homes for sale, and a doubling of interest rates, which has pushed more potential buyers into the rental market. (For example, the substantial migration to Southeast markets has resulted in elevated demand chasing existing supply, which resulted in some of the highest rent acceleration in the United States. This occurred despite increased new construction.) Construction has not kept up with growth in household forming persons over the past decade.

In a February 2022 interview with *Barron's,* Carly Tripp, CIO and head of investments for Nuveen Real Estate, stated, "There's still a three- to five-million-unit shortage across the U.S. There was a lot of scar tissue from the housing crisis; investors were skittish to invest and home builders were slow to build. We had a whole decade of underbuilding and are playing catch-up now."

Despite multifamily housing starts being at a 36-year high and multifamily housing permits at a 37-year high in 2022, it has not been sufficient to meet the record level of demand accelerated by relocations and remote work.

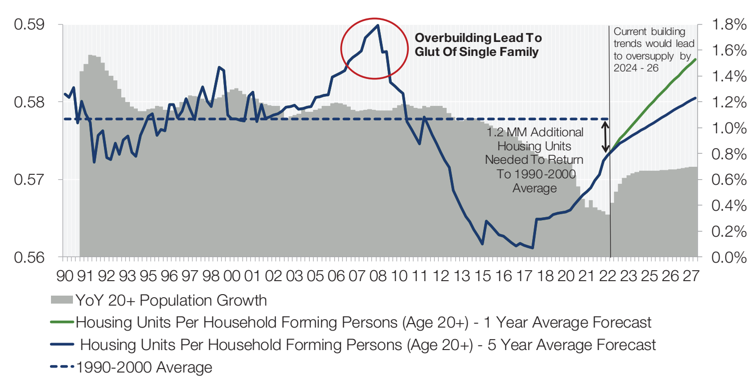
The housing component of the Consumer Price Index (CPI) shows rent costs for consumers have grown more than 8 percent year-over-year as of January 2023.

The share of renter households that have become severely burdened (defined as spending more than 50 percent of income for rent and utilities) was 24 percent in 2019, according to *America's Rental Housing 2022,* published by the Joint Center for Housing Studies of Harvard University. The share of households that are moderately burdened (defined as spending more than 30 percent of income for rent and utilities, including those severely burdened) has increased from 40 percent in 2001 to 46 percent in 2019, after peaking at 51 percent in 2011, according to the JCHS. In the wake of accelerated inflation during the past year, rent affordability likely worsened as inflation grew faster than wage growth. According to data from the Bureau of Labor Statistics, average hourly earnings have increased 4.4 percent in January 2023, from a year earlier on a nominal basis. When adjusted for inflation, however, real wages are down 2.0 percent over this period. This has amplified the calls for rent control in many jurisdictions across the United States.

Rent control in the U.S.

The first municipality to adopt rent control was New York City, which instituted rent control in 1943

Units of U.S. housing stock/age 20+ population



Sources: U.S. Census Bureau; Oxford Economics; CoStar Advisory Services, as of Q3 2022

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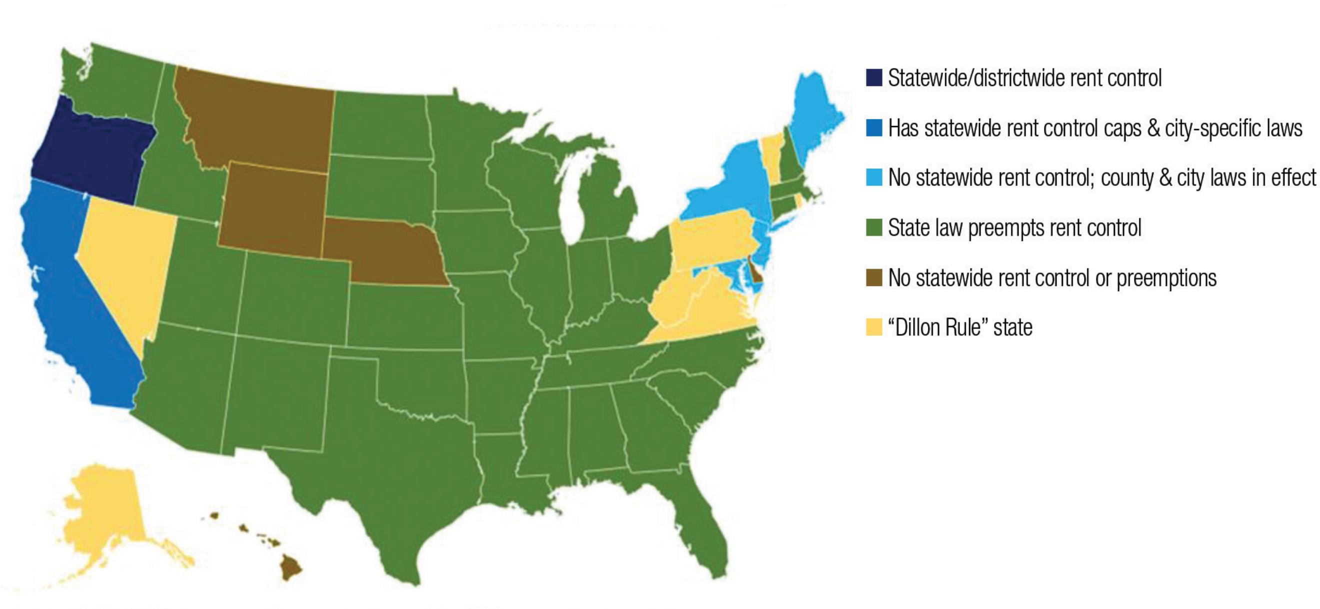
Rental control laws by state



Source: Map created by New York Life Real Estate Investors Strategy & Research Group; as of November 2022

and expanded it to more apartments with rent stabilization in 1969. In addition to New York, Massachusetts (instituted in 1969), New Jersey (1971), California (1972), Maryland (1973), Florida (1973), Maine (1973) and Washington, D.C. (1974) were the only states or jurisdictions with any form of rent control prior to 2019. In the 1980s and 1990s, in excess of 30 states passed laws pre-empting rent control by proscribing the legal ability to do so in its associated population centers.

There are a variety of rent control statutes across the United States, according to data collected by the National Multifamily Housing Council (NMHC). The District of Columbia and the state of Oregon have district-wide or statewide rent control. California has statewide rent control and local ordinances in effect. Maine, Maryland, New Jersey and New York have no statewide rent control, but have county and city ordinances in effect. Delaware, Hawaii, Montana, Nebraska and Wyoming have no rent control but no pre-emption either. Alaska, Nevada, Pennsylvania, Rhode Island, Vermont, Virginia and West Virginia are states that have "Dillon Rules" — i.e., a framework where local governments can only legislate what the state government has decreed. If local governments wish to exercise authority outside what has been delegated, they may approach the state and make their case. The remaining 32 states pre-empt (proscribe) rent control.

Recent legislation

In 2019, legislation started going in another direction. Oregon passed legislation limiting annual rent increases to 7 percent plus CPI. This was followed by statutes in larger states including California and New York.

New York state. The Emergency Tenant Protection Act of 1974 allowed for rent stabilization downstate in pre-1974 buildings with more than six units (it applies in New York City as well as certain localities in Nassau, Westchester, Rockland, and Ulster counties). The Housing Stability and Tenant Protection Act of 2019 provided the option for all municipalities to implement rent control. Kingston, N.Y., took advantage of this provision and adopted rent control in July 2022; the policy extends to buildings with six or more units built prior to 1974, which covers about 1,200 units, according to local reporting. Meanwhile, the groundwork for possible rent control in Albany, Buffalo, Newburgh, Syracuse and Rochester has begun but, so far, no legislation has been enacted or voted on. The Housing Stability and Tenant Protection Act of 2019 also included significant tenant-friendly changes regarding preferential rent, major capital improvements, individual apartment improvements, rent control, rent overcharge protection, owner occupancy provisions, high-rent/high-income decontrol, and many other areas.

In 2019, New York City enacted still more tenant-friendly provisions including barring owners from denying a lease based on eviction history. In a possible reaction to these new laws, the number of empty regulated apartments nearly doubled between 2020 and 2021; more than 60,000 rent-stabilized apartments are now vacant, according to a report in *The City*. There are further proposals to ban leasing decisions based on credit history and to stop background checks. This may cause apartment property owners to incur higher insurance costs, and make real estate financing more difficult, resulting in higher mortgage rates. Rent-stabilized apartments represent nearly half of all rental housing in New York City and are among the most affordable places to live in New York, notes *The City*.

California. In 2019, the California 2019 Protection Act was passed, which included a cap on annual rent increases at CPI plus 5 percent, but no more than 10 percent. This act also included "just cause" limitations and extended the rent cap (on rent increases but not initial base rents) and eviction controls to anywhere in the state, even where rent control didn't already exist. When the law took effect on Jan. 1, 2020, about 47 cities and counties already had strict rent control and eviction protections — many with more safeguards than the new state law. Those pre-existing local laws remain unaffected by the Protection Act, and wherever one applies, the landlord must follow the rule that best protects the tenant, according to the NMHC.

Several other California jurisdictions have moved forward with new initiatives. In August 2022, Pomona voted to cap increases to 4 percent. On Nov. 8, 2022, voters in Richmond (in Northern California's East Bay) approved Measure P, which limits rent increases to 3 percent of a tenant's existing rent or 60 percent of CPI, whichever is lower — the measure will supersede state law that says rents cannot go up more than 10 percent, or no more than 5 percent plus the inflation rate, whichever is lower. Considering CPI was 7.7 percent as of October 2022, the landlords would effectively be experiencing real rent declines in Pomona and Richmond.

Santa Monica voters also have approved a reduced rent increase cap of 3 percent (was 6 percent). Pasadena voters approved a change to the Pasadena city charter to create a board to limit rent increases to 75 percent of the CPI annually and limit evictions to those that fall under "just cause."

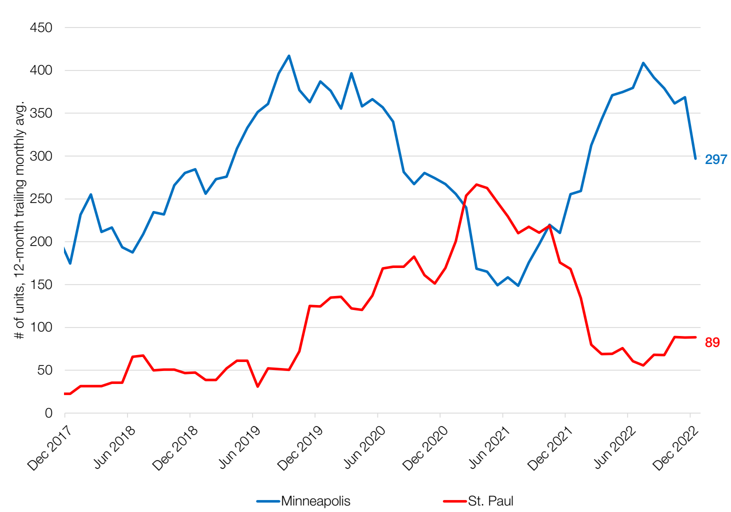
Minnesota. A pair of ballot initiatives in both Minneapolis and St. Paul seeking to authorize the city councils to enact rent control both passed in November 2021. The Minneapolis ballot measure did not specify parameters and left it to local officials to formulate its strictures.

St. Paul voted for the Residential Rent Stabilization Ordinance to cap rent increases to 3 percent with no exceptions for new construction. This was unique and has no parallel nationwide, as virtually all rent control measures exclude buildings under 15 years of age in order to encourage new supply. As a consequence of St. Paul's exceptional legislation, multifamily building permits plummeted nearly 82 percent for the three-month period from November 2021 through January 2022, compared with the same period a year prior, according to data from the U.S. Department of Housing and Urban Development, and are 52 percent below the average of the three years prior. According to CoStar, the Minneapolis multifamily market is about 78 percent larger than that of St. Paul, with 61,700 units versus 34,700 units, respectively. Nevertheless, as a result of the ordinance, Minneapolis recorded 4.2 times more permits than St. Paul in the three months following the passage of the new law.

When underwriting multifamily properties, consideration of existing rent control or the potential for future rent control is an important factor in investment decisions and cash flow projections.

On Sept. 21, 2022, the St. Paul City Council passed Ordinance 22-37, which rolls back certain components of the Residential Rent Stabilization Ordinance and became law on Jan. 1, 2023. Modifications include allowing landlords to raise rents on rent-controlled apartments after a tenant moves out (landlords will have the ability to increase rents

Multifamily building permits in Minneapolis and St. Paul, by number of units



Source: Department of Housing and Urban Development; as of December 2022 by 8 percent plus CPI when units are vacated) and, most importantly, it exempts units built in the past 20 years from the rent control law. The decision to modify key provisions of the 2021 rent stabilization ordinance came after several developments were put on hold and some developers threatened to pull out of the local market, according to media reports in the *Star Tribune* and *Twin Cities Pioneer Press.*

As a result of the November 2022 elections, Democrats now have control of the governor's office and both state legislative houses, which makes future statewide rent control laws more possible.

Ohio. In 2022, there was an attempt to legislate rent control in Columbus, Ohio. In response, state legislation was passed and signed by Gov. DeWine blocking Ohio cities from imposing rent control.

Unprecedented rent growth has amplified calls for rent control across many U.S. jurisdictions. Although well meaning, rent caps can result in housing scarcity, buildings with deferred maintenance, and higher rents on noncontrolled units.

Maine. Portland, Maine, approved a rent control ordinance based on local CPI that went into effect on Jan. 1, 2021. On Nov. 8, 2022, Portland voters approved a measure that limits rent increases to 70 percent of local CPI. In June 2022, South Portland, Maine, approved rent control limiting annual increases to 10 percent. The proposal also dictates a host of other tenant protections, such as limiting security deposits to one month's rent and requiring 90 days' notice for a rent increase or lease termination.

New Jersey. The Montclair, N.J., Township Council passed a new rent control ordinance that went into effect May 9, 2022. Annual rent increases are capped at 4 percent for rental properties, defined as properties that include two or three units in which an owner does not reside, as well as for units in buildings containing four units or more. Rents can be raised up to 6 percent one time if rent was not increased. Rent increases are limited to 2.5 percent for senior citizens.

On Oct. 12, 2022, the Perth Amboy City Council unanimously voted to reform the rent control ordinance to reduce rent increases that can occur at lease end. The council passed the reform proposed by the Rent Leveling Board that reduces the current lease increase from 5 percent at the end of a lease, to 3 percent if the rent includes a charge for water and 2.5 percent if the rent does not cover water. The reform applies to rental properties of more than four units.

Future possible rent control laws

There are 44 million U.S. households that rent a home or apartment in the United States, according to the JCHS. Many of these renters were either moderately burdened or severely burdened before the pandemic and are now suffering from the unprecedented rent increases since the pandemic began. Activists within the renter community are now pushing for change; and initiatives are not limited to Democratic Party–leaning states. During the past year, 16 states have introduced legislation to expand rent control. In addition, certain cities are exploring ways to control rent increases. Rent control initiatives continue to appear in various jurisdictions in the nation. The November 2022 election resulted in Democrats gaining control of the governorship and both houses of the state legislature in four new states: Massachusetts, Minnesota, Maryland and Michigan. With unified Democratic control, rent control laws in these states are more possible.

Bills have been introduced in Illinois, Massachusetts and Washington state seeking to revoke statewide pre-emption on rent control, according to the NMHC. States with a higher risk of rent control legislation being enacted include Colorado, Illinois, Massachusetts, Minnesota, Nevada and Washington. States with a high degree of risk of rent control being expanded include California, Maine, New York and Oregon.

Florida. Even jurisdictions within relatively conservative states, such as Florida, are considering rent control. Orange County, Fla., which includes the Orlando area, had a proposal on the November 2022 ballot to limit increases to CPI. This was the first such measure to go on a ballot in Florida's history. The argument for superseding the state's pre-emption law is that the county is suffering a "housing emergency." (Florida's statewide rent control pre-emption law has an exclusion clause if a municipality declares a housing emergency. After such announcement, city council or county commissioners can put forth a rent control provision for a public vote.) Though the ordinance was approved by voters, a court ruling ordered county officials to not certify the results, meaning the Orange County government cannot enforce it. Lake Worth, Fla., recently declared a housing state of emergency as a first step toward potential rent control implementation. Tampa and St. Petersburg city councils both rejected the idea of rent control.

Massachusetts. Boston Mayor Michelle Wu ran on a platform of rent control and is now examining various possibilities for implementation. Mayor Wu formed a Rent Stabilization Advisory Committee to provide recommendations on a policy that would stabilize rents by capping annual rent increases. The committee will meet with the goal of shaping a proposal for the next state legislative session. As a result of the November 2022 elections, Democrats now have control of the governor's office and both state legislative houses, which makes rent control laws more possible. On March 8, 2023, the Boston City Council voted to approve a rent control bill that would cap rent increases at 6 percent plus CPI for the Boston MSA but not to exceed 10 percent per year. Buildings newer than 15 years old are exempt from the new bill, as well as owner-occupied homes with six units or fewer. The bill still requires state legislative approval in order to become law.

Nevada. The Culinary Workers Union Local 226 is pushing for rent control, but the North Las Vegas city clerk has blocked efforts by the union to place a rent control referendum on the ballot. The city council also rebuffed the union's efforts. The union vowed to continue pushing for enactment and an attempt to foster a 2023 statewide initiative is likely.

New Mexico. The city council of Albuquerque is considering a resolution that would ask the state to remove its rent control pre-emptions. Though the resolution is nonbinding, approval by the city council could hint at public sentiment in New Mexico's largest city.

Rent control puts investment at risk

Multifamily has been the second-best performing property type over the past year, behind the industrial sector. In the four quarters ending fourth quarter 2022, the apartment sector produced an unlevered total return of 7.07 percent, according to the NCREIF Property Index, consisting of 3.28 percent appreciation return and 3.79 percent income return.

Rent control can erode multifamily NOI and returns, should expenses grow faster than mandated rent increase caps. When underwriting multifamily properties, consideration of existing rent control or the potential for future rent control is an important factor in investment decisions and cash flow projections. Underwriting should consider rent control's impact on NOI growth, since the potential for cap rate compression as an upside is curtailed. Furthermore, because the investor pool is more limited for rent-controlled apartments, NOI and cap rates should be adjusted accordingly.

Conclusion

Unprecedented rent growth has amplified calls for rent control across many U.S. jurisdictions. Although well meaning, rent caps can result in housing scarcity, buildings with deferred maintenance and higher rents on noncontrolled units. Rent control limits rent growth while expenses may continue to grow at a faster pace.

Although rent control poses challenges to investors, skillful underwriting and portfolio management can uncover multifamily investment opportunities even in markets with these restrictions.

The analysis of potential multifamily investments should include consideration of which states, municipalities and counties have rent control in place and which ones have the potential for more restrictive rent control. Analysis should also include the possibility of such legislation being enacted in the future in states and jurisdictions that currently are not subject to it. States with pre-emption laws or where rent control is unpopular have a lower likelihood of enactment. Bills introduced in states where there is strong opposition to rent control are not likely to make it through legislative committees. Rent control is more likely to be enacted in deep "blue" states in which the Democratic Party has control of the governor's office and both state legislative houses. However, it is still possible in certain "red" states with accelerating rent levels. Some investment managers have decided not to deploy capital in multifamily markets with rent control, which could curtail investment activity and adversely affect liquidity in those markets, according to the NMHC.

Although rent control poses challenges to investors, skillful underwriting and portfolio management can uncover multifamily investment opportunities even in markets with these restrictions. ❖

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