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Special Report

California Proposition 21

Fourth Quarter 2020

California Proposition 21 Could Place Significant Restrictions on Apartments; Thousands of Additional Units May Face Rent Control for First Time

California initiative set to upend rent control. Proposition 21, which is on the November ballot, introduces a new law surrounding rent control and amends existing legislation. The largest proposed change alters how rents are adjusted during tenant turnover. Under the two existing laws that dictate rent control in the state, operators are free to lift the monthly rent back to the market rate upon a vacancy, often called vacancy decontrol. However, Proposition 21 would restrict owners to a 15 percent rise in rents when a new tenant moves in, creating vacancy control. That gain can be realized over three years in any manner that owner chooses, along with any locally permitted increase. After that, rent increases will be dictated by the local rental board.

Unintended consequences in legislation. Properties older than 15 years old could fall under new rent control policies enacted at the local level. Without a path to bring rent back to the market rate upon vacancy, the impetus for owners to reinvest capital in these older properties will be eroded over time, particularly as controlled rent falls below those for new properties. Renters will also feel the impact of vacancy control. As operators manage costs without the ability to recoup investment, fewer and lower-quality upgrades will be available. Furthermore, developers will also shy away from cities with vacancy control, elevating the housing shortage in California. Areas where several small municipalities exist side-by-side could see disparate construction and reinvestment.

Health crisis compounds challenges with vacancy control. Lockdowns, particularly those in densely populated areas, have caused significant disruptions in several local apartment markets. San Francisco, for example, recorded a rent decline of 4 percent in the second quarter and another 6 percent decrease in the third quarter. Further erosion is expected through the end of the year and potentially into 2021 depending on the damage done to the local economy, fiscal stimulus and the extent of dispersed working. A resolution to the health crisis could reignite one of the strongest local economies and quickly return apartment demand. Without the ability to reset apartment rents to pre-pandemic conditions, valuations could decline considerably.

Potential Changes Under Proposition 21

- Enables local governments to enact new rent control measures.
- Controls rent during tenant turnover rather than allowing market rent to reset upon vacancy.
- Limits rent increases to 15 percent plus local allowance when a new renter moves in.
- Opens door for nearly all rentals with a certificate of occupancy more than 15 years ago to be rent controlled.
- No path to achieving market rents, reducing likelihood of reinvestment potential.

Potential for thousands of additional units to fall under rent control. The existing legislation that local municipalities must follow, Costa-Hawkins, froze rent control eligibility. In many cities, that date was in the late 1970s. Proposition 21, meanwhile, will allow rent control to be applied to any asset with a certificate of occupancy received more than 15 years ago and continue on a rolling basis. Several local city councils have signaled a willingness to broaden controlled inventory.

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