Developers Face Hard Choices As Cities With Tight Housing Supplies Embrace Rent Control

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Los Angeles developer Decron Properties spent most of its 55-year history focused solely on building and buying apartments and other commercial properties in California.

Now, after amassing a portfolio of 9,400 apartment units in the state, the company is pulling back. Its calculus has been changed by a statewide rent control law enacted in 2019, followed by state and local eviction bans passed in the early months of the pandemic that in some cases have been extended until at least mid-2023.

“We're reducing our exposure in the rent-controlled markets of California," CEO David Nagel, son of Decron founder Jack Nagel, said in a statement. "Instead, we're focusing our growth efforts in non-rent-controlled markets that offer substantial population growth and job growth, like Phoenix.”

Decron has plenty of company. Multifamily developers and investors have hit pause or scaled back in markets with strict rent control laws across the country, arguing that caps on rent increases crimp the bottom line too much to warrant investing. At the same time, a severe shortage of affordable housing has led some traditionally conservative states and localities to explore limits on rising rents that have become a major factor in the recent inflation surge that is weighing on the U.S. economy.

Rent inflation projected at almost 7% nationally from now through the end of 2023 "points to significant upside risks to the overall inflation outlook," economists at the Federal Reserve Bank of San Francisco wrote in a February economic forecast.

In both Tampa and Orlando in Florida, one of more than 30 states with laws that prohibit municipalities from adopting rent control, rent growth has exceeded 20%. Such steep increases have led lawmakers and tenant advocacy groups in Florida and several other states, including Colorado, Illinois, Massachusetts and Washington, to weigh measures to allow at least some form of local rent regulation.

If enacted, they would join more than 200 municipalities across the country, including Los Angeles and New York, the nation's two largest cities, that have some form of rent regulation in place. Those limits, which largely took root in the 1970s, are both praised for allowing low-income people to stay in their residences and blamed for the rise of owners who allow their properties to slide into disrepair and lack of multifamily housing construction.

Movement Spreads

Soaring rents that threaten to price tenants out of their homes and worsen homelessness have spurred recent campaigns among tenants and low-income housing advocates to pass rent control ordinances in Minnesota and California's conservative-leaning Orange County and Santa Barbara, localities that once were thought to be unlikely hosts to tenants rights movements.

In St. Paul, voters on Nov. 2 approved one of the region's only rent control ordinances, limiting annual increases to 3%. Unlike most rent regulation measures in the country, the ordinance covers all rental buildings regardless of age as well as all future rental construction.

In neighboring Minneapolis, voters in November approved a change to the city's charter that gives the city council the authority to enact rent control. Minnesota law prohibits any local law to control rents on private residential property unless the ordinance, charter amendment or law that controls rents is approved in a general election.

A rent control ordinance in Santa Ana, California, went into effect in November, limiting annual rent increases on older rental properties to 3%, or 80% of the annual inflation rate, whichever is lower. The law covers apartments built in 1995 or earlier and mobile home parks that opened in 1990 or before.

Santa Ana sits in Orange County, the launchpad of Ronald Reagan's political career and arguably on of the most conservative area in Southern California, if not the state, once upon a time. Now, Santa Ana has mandated one of California's lowest annual caps on rent increases, one that is more restrictive than the cap of 5% plus the rate of inflation set by the state about three years ago.

Tenants rights and affordable housing advocates say regulation is necessary to protect millions of residents at risk of eviction or homelessness amid double-digit rent increases and rising median home prices in California and across the country.

Owners and investors counter that rent regulation causes developers to avoid building or buying sorely needed new housing and leads to such unintended consequences as poorly maintained buildings and neighborhood blight.

Investment Disincentive

Charles Carillo, managing partner of Harborside Partners, a multifamily and commercial real estate investment firm based in North Palm Beach, Florida, argues such rent caps discourage landlords from upgrading their properties when insurance, taxes, utilities, management fees and other costs keep rising while income is capped.

"Money flows where it is less restrictive," Carillo said. "If their returns are capped, investors will invest in another area, thus reducing the inventory of new rental units in markets with rent control."

In markets without rent regulations, landlords have an interest in maintaining their properties to keep tenants as long as possible, Carillo said. Under rent control, landlords want tenants out so they can raise the rent.

"That incentivizes landlords to be slumlords," he added.

Tenant advocates and those who study housing trends reject those arguments, countering that curbing excessive rent hikes and preventing unjust evictions helps slow down gentrification and improves neighborhood safety and stability.

"Without security of tenure, renters aren't as likely to build local relationships or engage in the civic life of a community," said Cea Weaver of Housing Justice for All, a nonprofit advocacy group working to strengthen New York State's rent laws. "Rent regulation should be understood as a tool to promote political participation among working-class and low-income communities, and communities of color."

Milder forms of rent control that apply to older apartments don't appear to discourage developers from building new projects, according to a 2018 study by the University of Southern California's Dornsife Program for Environmental and Regional Equity.

However, stricter rent laws in cities such as San Francisco have been found to spur owners to convert their rentals into condominiums and other owner-occupied dwellings to skirt the regulations, leading to a reduction in the number of available rentals, according to a 2018 research paper by Rebecca Diamond, Tim McQuade and Franklin Qian of the Stanford Graduate School of Business.

'Risk Everywhere'

Centerspace, a Minot, North Dakota-based apartment REIT previously known as Investors Real Estate Trust, owns properties in Colorado, Montana, Nebraska, North Dakota, South Dakota and Minnesota. About a quarter of its 14,400 units across 79 properties are in the Minneapolis-St. Paul area, and the new rent control laws there have the company considering reducing its exposure by investing outside the Twin Cities.

Minnesota is the only state where Centerspace owns property that has rent control, and it is now looking to enter Nashville, Tennessee, a locale without rent limits. Still, said CEO Mark Decker, new regulations could come anywhere if tenants feel the pinch of rising rents and other costs.

"I think it's a risk everywhere," Decker told investors during an earnings call this month. "I know there's lots of states that would never have rent control, but if you have 30%-plus rent bumps in Florida, at some point someone's going to say, 'Hey, we can't do this.'"

Jared Kadry, CoStar's director of market analytics for Orange County, expects an accelerated push this year for more rent control-related measures across California and the country.

“Santa Ana now has one of the strictest rent control laws in the state, so it may give other similarly sized and like-minded municipalities a precedent to push for rent caps lower than 5%,” Kadry said.

About 125 miles north of Santa Ana, the Santa Barbara City Council recently approved even tougher restrictions on rent hikes. By a 4-3 vote, the council in December passed an ordinance that would allow an annual increase of 2% plus the consumer price index. The coastal city has among the highest housing costs in California, the nation's most expensive state.

The authors of the USC Dornsife 2018 study argue in their paper that while rent control appears to help prevent sharp rent hikes and unjust evictions in California's overheated housing market, tenant rights groups must recognize that the state needs broader policies to build more affordable housing targeted to families, middle-class workers and others in need.

"Rent regulation is not a silver bullet and is a somewhat blunt policy tool that generally favors less advantaged populations, but does not always target those who need it most," the report says.

Michael Pollack, principal of Mesa, Arizona-based Pollack Investments, said one of the worst aspects of rent control is that elected officials often create uncertainty by abruptly tightening the regulations.

Pollack said he developed and acquired apartments during the 1980s in a California city, which he declined to name, after being promised by city leaders that newer apartments would be exempt from rent control. The city council later passed an ordinance expanding rent regulation to include his properties.

"One of the reasons I got out of the apartment business was California rent control," said Pollack, who has invested in a range of commercial properties in Arizona, California and Nevada, including 20,000 multifamily units. "Developers, lenders and their partners take a risk when they build or buy apartments and you would hope they have more say in their future instead of having the rules change all of a sudden in the middle of the game."