Vacancy Decontrol and Reinvestment in Berkeley Rental Housing

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Rent Stabilization Board

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Vacancy Decontrol and Reinvestment in Berkeley Rental Housing: Executive Summary

Analysis of a random sample of properties with 10 or more units finds that as of 2011 rents have increased by 72% and property values have doubled but no more than 6% of the increased rents from vacancy decontrol are being reinvested in renovations in these buildings.

Findings:

- 79% of the units in the sample have received a vacancy increase since 1999.
- Vacancy decontrol resulted in an average rent increase of 90% over and above what the rent would have been if vacancy control had continued to limit allowable increases. The average increase for an apartment receiving a vacancy increase was $662 a month or $7,944 annually. Averaged across all apartments in the sample this amounts to a 72% overall rent increase, for an average of an additional $6,408 per unit annually.
- During the 13 years of vacancy decontrol from 1999 through 2011, owners averaged $46,912 more per unit over what they would have received under vacancy control.
- During the five years prior to vacancy decontrol (1991 – 1995), properties in the sample took out building permits with an inflation-adjusted value of $91 per unit per year.
- Since full vacancy decontrol (1999 – 2011) permit values have averaged $131 per unit per year, a 44% increase over the 1991 – 1995 period.
- Even assuming that the full value of renovations is triple the reported permit values, the owners of the properties in our sample are reinvesting no more than 6% of current increased rents from vacancy decontrol to renovate or upgrade their buildings.
- The average assessed value of properties in the sample is 52% of the projected market value. Owners of the properties in the sample are saving an average of $647 per unit annually in property taxes because the assessed value is less than their market value.
- Properties that have sold since the beginning of vacancy decontrol are more likely to have invested in seismic retrofits. Excluding seismic retrofits, the year sold made little difference in the value of permits taken out.
- Case studies of two buildings destroyed by recent fires demonstrate that the owners were receiving market rent for most units.
- A case study of a property whose owner claimed inability to carry out needed renovations found that this was due to refinancing to take out equity.

Vacancy Decontrol and Reinvestment in Berkeley Rental Housing: Analysis of a Sample of Berkeley Rent Stabilized Properties with 10 or More Apartments

Section 1: Methodology

Large multi-family rental properties provide the majority of housing units within the City of Berkeley. According to the City of Berkeley Rent Stabilization Board's database 51% of the registered rental units are in properties with 10 or more units. This analysis focuses on these larger properties.

Table #1 shows how rent controlled units in Berkeley are dispersed between larger and smaller rental properties, as of February, 2012.

Table #1: Registered rental units by units on property		
Number of Units	Registered Rental Units	
2-4 units	4,686	25%
5-9 units	4,531	24%
10-19 units	4,135	22%
20 + units	5,554	29%
Total units	18,906	100%

The data for this analysis was gathered from the City of Berkeley Rent Stabilization Board RTS Database, RealQuest, the Bureau of Labor Statistics website, the Rental Housing December 2010 issue, the Rent Stabilization Board 2010 Economic Report, the 2009 Rent Stabilization Board Tenant Survey, and the City of Berkeley FUND$ system Building Permit module.

Sample Selection

The RTS database provided a list of properties with 10 or more units, along with the following: Street Number, Street Name, # of units, Census Tract, Purchase date, Base Rent for each unit, the Current Rent Ceiling for each unit, and the rental status of each unit.

From a total of 215 properties with 20 or more units and 371 properties with 10 to 19 units, a sample was taken of every fifth property from the properties with 20 or more units, and every tenth property from the properties with between 10–19 units. This resulted in a sample of 45 properties with 20 or more units and 40 properties with 10 to 19 units.

After reviewing this sample in greater detail we removed properties that were identified as student housing, fraternities or sororities, boarding or rooming houses, hotels, or new

construction. This removed nine (9) properties from the 20 or more unit sample, and six (6) from the 10 to 19 unit sample, leaving 34 properties with 20 or more units and 34 properties with between 10 to 19 units.

Using the associated census tract the properties in the sample were separated into the following five market areas:

- **North Berkeley (Area 1)**: tract nos. 11, 12, 13, 14, 15, 16, 17, 38
- **Central Berkeley (Area 2)**: tract nos. 18, 19, 22, 23, 30, 31
- **Downtown & Campus Area (Area 3)**: tract nos. 24, 25, 27, 28, 29, 36, 37
- **West Berkeley (Area 4)**: tract nos. 20, 21, 32
- **South Berkeley (Area 5)**: tract nos. 33, 34, 35, 39, 40

Table #2: Units in sample by Market Area compared with all registered units

Market Area	Properties in the sample	Percentage of units in the sample	Percentage of registered units in 10+ unit properties	Percentage of all registered units
Area 1	7	7.3%	4.9%	7.7%
Area 2	9	17.4%	12.7%	17.9%
Area 3	49	72.4%	72.6%	53.8%
Area 4	0	0.0%	2.4%	4.1%
Area 5	3	3.0%	7.4%	16.7%

The vast majority (72.4%) of units in the sample are located in Area 3, the Downtown and Campus Market Area. This is greater than the overall percentage of registered units located in Area 3 (53.8%) but is nearly identical to the percentage of units in properties with 10 or more units (72.6%) located in this area. This reflects that fact that larger apartment buildings are concentrated near the University of California and downtown Berkeley.

Valuation Data

RealQuest provided data from county property records with the Sale Price (for the most recent market sale), and the Total Taxable Value of the property.

Table #3: Sample Properties/Units by Last Sale Date		
Year Property Last Sold	Number of Properties	Number of Units
1999 to present	18	317
1996-98	11	275
up to 1995	39	863
Total	68	1455

Renovation and Improvement Data

The Building Department FUND$ database provided the following: a count of the number of Building Permits approved since January 1, 1991, and the total dollar amount of the valuation of these permits. We adjusted the permit valuations for inflation by increasing the dollar amount for permits based on the percentage increase in CPI from the year the permit was applied for until 2011. We include permits going back to 1991, prior to the actual beginning of vacancy decontrol, in order to have a baseline for the years prior to vacancy decontrol (1991 to 1995) to compare with the transition period prior to full vacancy decontrol (1996 to 1998) and the period of full vacancy decontrol (1999 to 2011). Data prior to 1991 is not available in the FUND$ database.

This data provides a basis to estimate the total money spent on renovations, upgrades, and improvements to the property. There is also work that does not require permits or whose permits are not based on valuation, and some owners may have had work done without getting the required permits. Most of the work done without valuation permits falls into the category of routine maintenance, however. Landscaping, painting, replacing smoke detectors, and replacing or fixing broken electrical outlets or light fixtures are examples of work that does not require permits. Small jobs such as water heater and toilet replacements or a wall heater installation only require trade permits, which do not provide information on the valuation of the work unless they accompany a building permit, in which case their value is included in the building permit valuation. Such work is often done without permits even though they are legally required. Substantial work, however, such as a foundation, roof or elevator replacement, a plumbing, electrical or seismic upgrade or a bathroom or kitchen remodel is usually done with permits.

From the inception of rent stabilization in 1980 through 2004 the Annual General Adjustment (AGA) in rents was based on an annual cost study, and included an increase to cover the costs of routine maintenance. This means that an estimate of what monthly rents would have been under continued vacancy control will include the costs of ongoing routine maintenance, the kind of work that would not be done under permit. The cost of major renovations and upgrades could be recouped through an Individual Rent Adjustment for capital improvements or, since vacancy decontrol, through the additional rents gained when units are rented at current market rates.

Since vacancy decontrol applications for capital improvements increases have been rare, so a critical question is whether rent increases over and above what would have been allowed under vacancy control have been sufficient to renovate and upgrade Berkeley's rental housing. For purposes of this study we take work done with permits to indicate renovation and upgrading, rather than routine maintenance that should be covered by the Annual General Adjustment.

The Rent Stabilization Board 2009 Tenant Survey showed a modest decrease since the 1998 Tenant Survey in both respondents who reported problems in their building and the average number of problems reported per building since the beginning of vacancy decontrol. This suggests that some landlords have improved maintenance as a result of receiving the additional revenue from vacancy decontrol. The permit data allows us to measure the extent of significant renovations and upgrades.

Vacancy Decontrol Analysis

In order to calculate what monthly rents would be if vacancy decontrol had not been instituted, the 1980 base rent for all units in each property was increased by the percentage increase in the Consumer Price Index (CPI) from 1980 to 2011. This is based on the Rent Stabilization Board 2010 Economic Report findings that the allowable rent ceiling increases from 1982 to 2004, which were based on annual cost studies, were slightly less than the rate of inflation as measured by the percentage increase in the CPI. Therefore, the CPI increase provides an approximation of what allowable rent ceilings would have been under a continuation of strong rent control.

This method gave us a multiplier of "2.90", meaning that the 1980 base rent multiplied by this number gives us the 2011 CPI increased rent. Next, monthly rents were totaled for both the 1980 base rent for all units in each property and the current monthly rent ceiling for all units by property. The monthly rent totals for the 1980 base rent, the CPI increased rent, and the current rent ceiling were then each multiplied by 12 to get the annual total for each for every property. For units that were not rented until after 1980 the CPI increased rent was calculated with a smaller multiplier depending on the base year. For example, the multiplier for a unit with a 1985 base rent is "2.15", for 1995 base rent it is "1.54", and for a 2005 base rent it is "1.15". These multipliers were calculated by dividing the 2011 San Francisco-Oakland-San Jose region CPI for all items by the number in the base year.

In order to estimate the cumulative increase in rental income properties have experienced due to vacancy decontrol we subtracted the annual total of the base year rent ceilings increased by the CPI from the annual total of the current rent ceilings for all units.

We then calculated the cumulative percentage of rental units that have been rented at market rate from 1999 to 2011. We estimate the percentage of rental units that have been rented at market rate each year using the average between the previous and current year December total. For example, in December 1998 0% of units that have gone to market and by December 1999 there are 19.1% that have gone to market, so the average for 1999 would be 9.6%.

Table #4 shows the percentage of units at market for each year based according to the Rent Board database and the December of the previous year to December of the following year average for each year from 1999 to 2011.

Table #4: Percentage of Units Rented at Market		
Year	% of all units that have gone to market as of December	Average December to December % of All Rental Units Rented at Market Rate
1998	0.0%	N/A
1999	19.1%	9.6%
2000	35.7%	27.4%
2001	43.9%	39.8%
2002	52.8%	48.4%
2003	60.3%	56.6%
2004	65.2%	62.8%
2005	69.5%	67.4%
2006	72.4%	71.0%
2007	75.0%	73.7%
2008	77.2%	76.1%
2009	79.2%	78.2%
2010	80.4%	79.8%
2011	82.0%	81.2%
Total	N/A	771.7%

The cumulative December to December percentage of rental units that have been rented at market rate from 1999 to 2011 is 771.7%. This indicates that the average unit received a market rent for 7.7 years out of the 13 year period of vacancy decontrol from 1999 to 2011. We multiplied 7.7 by the difference between the annual CPI increased rent ceiling for all units and the current rent ceiling for all units in order to estimate the cumulative increase in rental income these properties have experienced due to vacancy decontrol. This method is somewhat conservative because the Annual General Adjustment (AGA) increase in Berkeley has allowed for an increase that has been slightly less than the rate of inflation.

Current Market Value Analysis

To project current market value we utilized the gross rent multiplier (GRM) method because. The first step was to query RealQuest for all multi-family sales (5 or more units) in Berkeley for 2008, 2009, and 2010. We then selected the properties from this query that had rent controlled units and divided the sale price by the annual rent generated (based on the current rent ceiling for each unit). This resulted in an average GRM of 10.48 for 2008, a GRM of 9.73 in 2009, and a GRM of 9.72 in 2010. The average GRM for 2008 to 2010 is 9.98. In order to make a conservative estimate for market value we chose a GRM of 9 for this analysis, and multiplied this by 95% of the annual rent ceiling for each property to take into account the assumed 5% vacancy rate. The actual assessed value of properties sold since 1999 was 102% of our estimated current market value, suggesting that our method is a reasonably accurate means to determine the increase in value resulting from vacancy decontrol.

Property Tax Savings Analysis

The taxable value for each property was then divided by the projected current market value. Since property is taxed at 1% of assessed value, 1% of the taxable value was deducted from 1% of the market value for each property in order to calculate the amount of property taxes the owner is saving and the City of Berkeley and other local governments are losing because properties are not taxed at their market value. (The additional assessment due to general obligation bonds is omitted because it does not change the amount received by the local government, so actual savings to the property owners are somewhat higher.) In order to figure out the total property tax savings over the 13 year vacancy decontrol period we multiplied the per unit property tax savings by 7.7 as we did to calculate the additional rent received through vacancy decontrol, since the property value is based on the rent in this model.

NOI Analysis

We used the capitalization rates reported in *Rental Housing* (published by the East Bay Rental Housing Association) and in the Rent Stabilization Board 2010 Economic Study to estimate Net Operating Income (NOI) as a percentage of rent. The December 2010 issue of *Rental Housing* contains capitalization rates for 10+ unit properties based on data provided by Costar, and the 2010 Economic Report has capitalization rates for 5+ unit properties, also based on data from the Costar Group. With an average annual sales price, cap rate and rent multiplier we can estimate the average NOI as a percent of the rent using the formulas: sales price x cap rate = NOI and sales price / rent multiplier = rent.

Section 2: Rent Increases and Renovations

1). Impact of Vacancy Decontrol on Rents

Vacancy decontrol began in 1999 and has had a dramatic effect on the rents paid for Berkeley's rental housing. Rent Board data shows that as of December 2011 82% of all registered units have a tenancy that began after 1/1/1999 and almost all of these received a vacancy increase. The average monthly rent for these units was $1,405. In our sample 79% of units had received an unrestricted vacancy increase, and these units had an average rent of $1,401. (An additional 2% of apartments in our sample had received 15% increases during the 1996 – 98 transition period. These increases are not counted as part of vacancy decontrol.)

As of December 2011 the average monthly rent ceiling for units that never received a vacancy increase was $766 monthly. In order to simulate what rents would be like today without vacancy decontrol we multiplied the base rent for each unit in our sample by the percentage increase in CPI as of 2011. This results in an estimated average rent per unit without vacancy decontrol of $739 per month or $8,868 per year. Assuming that there is no major difference between the apartments that have and have not received a vacancy increase, vacancy decontrol has increased the rent of the affected apartments by 90%.

As of December 2011 the average monthly rent ceiling for all rent stabilized units was $1,297. The average 2011 rent ceiling per unit for properties in our sample is $1,274 monthly or $15,287 annually. Averaged across all apartments, then, vacancy decontrol has resulted in an average additional increase in the rent per unit of $534 monthly or 72%, and an average annual increase of $6,409 per unit.

Looking at the total amount of increased rent received since 1999, properties in the sample have been able to charge an estimated $46,912 per unit in additional rent over the 13 year period since the beginning of vacancy decontrol.

Table #5 shows monthly and annual vacancy decontrol increases units that have had a vacancy increase and averaged across all units.

Table #5: Average Vacancy Control Increases		
Unit Population	Average Vacancy Control Increase	
	Monthly	Annually
Units with Vacancy Increase	$662	$7,944
Averaged Over All Units	$534	$6,408

The data indicates that rental property owners are receiving substantially more rents due to their ability to rent vacated rental units at market prices. How much of this has been reinvested in property renovation?

2.) Building Permits Before and After Vacancy Decontrol

Table #6 compares the number of permits and their inflation adjusted valuation taken out before vacancy decontrol (1991-1995), in the transition period before full vacancy decontrol (1996-1998), and during vacancy decontrol (1999-2011). The average valuation per unit reflect the inflation-adjusted value of all permits taken out divided by all units in the sample, whether a permit was taken out for that unit or not. This provides a measure of relative spending on renovations for each period.

Table #6: Permits and Permit Valuation by Year				
Year	Number of Permits	Permits Per Year	Average Valuation Per Permit	Average Valuation Per Unit
1999-2011	85	6.5	$29,161	$131
1996-1998	25	8.3	$27,224	$156
1991-1995	32	6.4	$20,748	$91

On a per unit basis building permit valuations have increased from $91 per unit to $131 per unit, an increase of $40 per unit. Using 1991 – 1995 as the baseline, permit valuations increased 71% during the 1996 – 1998 transition period, falling back to just 44% between 1999 and 2011 after full vacancy decontrol. During vacancy decontrol the projected permit valuations do not differ greatly between the six year period immediately after vacancy decontrol began (1999-2004) and the subsequent seven year period (2005-2011).

The data shows that there was an increase in renovations immediate prior to full vacancy decontrol, even before rents began to increase substantially. However, this increase has leveled off since full vacancy decontrol, and the percentage of the increased rent going for renovation continues to decrease as more apartments turn over and receive vacancy rent increases.

With an annual permit value of $131 per unit and an average annual increase in rents due to vacancy decontrol of $6,408, an average only 2% of this increased revenue is being reinvested in permits for renovations and building improvements. However, using building valuation to measure the value of building renovations and improvements underestimates the true investment because it does not account for work that requires only trade permits, work that does not require permits, or work that is done without permits. Still, even if we multiply this number by three to

account for work that does not have valuation data, it amounts to a reinvestment of only 6% of annual vacancy decontrol revenues.

3.) Building Permits and Building Sale Date

Properties in the sample have taken out a total of 110 building permits, for an average of 1.6 building permits per property since 1996. These permits had an average total valuation of $2,171 per unit over a fifteen year period when adjusted for inflation. The largest permit valuation in our sample is for one property where the work was valued at $20,744 per unit in 2011 dollars, mostly for a seismic safety upgrade. The next largest valuation represented an investment of $1,200 per unit.

Table #7 breaks down the properties in the sample by the different ranges of per unit building permit valuation.

Table #7: Range of Building Permit Valuations Per Unit for Properties in Sample	
Average Valuation Per Unit	Number of Properties in Sample
$5,000 or greater	4
$2,000 to $4,999	18
$1,000 to $1,999	17
$500 to $1,000	10
$61 to $500	3
$0 (No permits)	16

In Table #8 we look at the number of permits taken out by property by sale date to see if owners who purchased their property in or after 1999 took out more or less permits than owners who purchased their property prior to the passage of vacancy decontrol.

Table #8: Building Permits by Sale Date			
Year Property Last Sold	Number of Properties	Number of Permits	Average Permits Per Property
1999 to present	18	37	2.1
1996-98	11	28	2.5
up to 1995	39	45	1.2
All	68	110	1.6

The average number of permits taken out for properties that were sold recently was slightly higher than for properties that have not sold since 1995.

In Table #9 we compare the average valuation for building permits since 1996 grouped by the last time a property was sold.

Table #9: Building Permit Valuation by Sale Date			
Year Property Last Sold	Valuation by Property	Valuation per unit	Number of Properties
1999 to present	$59,548	$3,381	18
1996-98	$70,959	$2,838	11
up to 1995	$33,509	$1,514	39
Overall Average	$46,460	$2,171	68

It appears that more investment has been made by properties that have been sold recently. However, a closer look at this data reveals that four of the six properties with the highest per unit valuation include valuations for work to complete seismic retrofits. The valuations for seismic work are typically very high and they made up the majority of the permit valuation for five of the ten properties with the highest per unit valuation.

Table #10 shows the average permit valuation for building permits since 1996 grouped by sale date, not including permits for seismic retrofits.

Table #10: Building Permit Valuation by Sale Date (Seismic Retrofits removed)			
Year Property Last Sold	Valuation by Property	Valuation per unit	Number of Properties
1999 to present	$26,185	$1,487	18
1996-98	$37,127	$1,485	11
up to 1995	$31,074	$1,404	39
Overall Average	$30,759	$1,438	68

Without the seismic retrofit valuations there is hardly any difference between the valuation of work for properties that have sold recently and those that have not sold since 1995.

Table #11 shows the average permit valuation for building permits for seismic retrofits since 1996 grouped by sale date.

Table #11: Building Permit Valuation for Seismic Retrofits by Sale Date			
Year Property Last Sold	Valuation by Property	Valuation per unit	Number of Properties
1999 to present	$33,363	$1,894	18
1996-98	$33,831	$1,353	11
up to 1995	$2,434	$110	39
Overall Average	$15,700	$734	68

This data indicates that the owners of properties that have been sold since vacancy decontrol have invested far more money in seismic retrofits than long-term property owners.

Table #12 shows the status of the 15 properties in the sample that are on the soft story inventory:

Table #12: Soft Story Inventory Status			
Out of Compliance	Report approved	Report in review	Retrofitted
1	5	3	6

Four of the properties that completed soft story retrofits took out permits for soft-story retrofits between January 1, 1996 and 2011. These permits had a valuation of $2,791 per unit after being adjusted for inflation, not substantially different from the $2,684 per unit valuation for seismic retrofits for properties in the sample that are not on the soft story inventory.

Table #13 compares per unit building permit valuation (including seismic work) since 1996 with the additional revenue from vacancy decontrol by the last sale date. Unlike the analysis in the previous section, this examines total permit value per unit in these buildings from 1996 - 2011 rather than the average annual value per unit and compares it with the total vacancy decontrol revenue from 1999 – 2011.

Table #13: Building permit valuation by increased rents by last sale date			
Year Property Last Sold	Building Permit Valuation per Unit	Vacancy Decontrol Revenue Per Unit	% of Revenue Reinvested
1999 to present	$3,381	$45,901	7.37%
1996-98	$2,838	$54,324	5.22%
since 1995	$1,514	$44,922	3.37%
Overall Average	$2,171	$46,912	4.63%

The percentage of vacancy decontrol revenue reinvested in building renovations over the entire period is higher than the ongoing percentage currently being reinvested because vacancy decontrol revenue was much lower in the first few years after the legislature passed the Costa Hawkins Act in 1995. As we saw earlier, the rate of building renovation increased immediately after passage of vacancy decontrol and has not increased as revenue has increased.

For properties that have turned over since 1999, 51% of the permits were taken out before sale; these permits represented 56% of the total valuation of all the permits taken out by these properties (the permits with the highest and lowest valuations were removed to prevent the data from being skewed). While the data did not show that significantly more investment was made in a building either before or after the sale date, permits were often taken out around the sales date.

Table #14 compares per unit building permit valuation since 1996 with vacancy decontrol revenue grouped by sale date excluding valuations for seismic retrofits.

Table #14: Building permit valuations by increased rents by last sale date (seismic retrofits removed)			
Year Property Last Sold	Building Permit Valuation per Unit	Vacancy Decontrol Revenue Per Unit	% of Revenue Reinvested
1999 to present	$1,487	$45,901	3.24%
1996-98	$1,485	$54,324	2.73%
since 1995	$1,404	$44,922	3.13%
Overall Average	$1,438	$46,912	3.06%

Aside from seismic retrofits, whether or not a property was sold recently has had little impact on the percentage vacancy decontrol revenue invested.

Properties in the sample also took out 76 trade permits between 1996 and 2011, in addition to the 110 building permits. Trade permits include mechanical, electrical and plumbing permits. When these permits are taken out in combination with a building permit the valuation for the trade permit work is included in the building permit valuation, otherwise no valuation data is required. More substantial work will generally require taking out a building permit, and about half of the 80 permits were taken out near a building permit. Given the lack of valuation data for half of the trade permits, and the likelihood that some work has been done to these properties without permits, building permit valuation modestly underestimates the amount of money invested into upgrading and renovating these properties. In the unlikely case that the 37 trade permits that were not taken out near a building permit involved work with a valuation equivalent to the average building permit in our sample, excluding seismic work, they would increase the average valuation of non-seismic work done per unit from $1,438 to $1,999. (Of the 110 building permits

in our sample 15 were for seismic work. Removing these permits leaves a total of 95 building permits with an average valuation of $1,438 per unit. The 37 trade permits represent approximately 39% of this total. Increasing the average valuation per unit by 39% gives us an average valuation of $1,999 per unit.)

This would raise the estimated valuation of non-seismic work from 3.1% of additional vacancy decontrol revenue to 4.3%, and would increase the maximum valuation of all permitted work including seismic retrofits from 4.6% to 5.8%. This should be considered a high estimate, since trade permits that can be carried out without an accompanying building permit are typically smaller jobs. However, it is also likely that valuations given to the City are understated by the applicants in order to reduce permit costs, which are normally based on the valuation.

Section 3: Assessed Value versus Market Value

The average projected market value of the properties in our sample based on a conservatively estimated gross rent multiplier was $130,707 per unit, while the average assessed value was $70,759. In other words the average assessed value is 54% of the projected market value. The assessed value as a percentage of the projected value varied greatly depending on how recently a property was sold.

Table #15 shows the percentage of projected value of properties in the sample grouped by when they last turned over.

Table #15: % of projected value by sale date		
Year Property Last Sold	Assessed value as a % of projected value	Number of Properties
1999 to present	102%	18
1996 to 1998	51%	11
1995 or before	38%	39
All Properties	54%	68

More than half (57%) of properties in the sample have not been sold since 1995 and the assessed value of these properties is only 38% of their projected market value. This generates substantial property tax savings for the owners.

Section 4: Property Taxes

In 1978 Proposition 13 was enacted to amend the Constitution of California and decrease property taxes by limiting them to 1% of assessed value, resetting them to their 1976 assessed value and limiting the annual increases in the assessed value to a factor of an inflation not to exceed 2% per year until the property is sold, at which time the sales price becomes the new assessed value. This means that owners who hold properties for long periods of time gain substantial tax savings compared with owners whose property is assessed at close to current value. Since vacancy decontrol increased the value of all of the rental properties in our sample, we can estimate the tax savings that result because the property is not reassessed to its new, higher value.

Property owners that have held ownership since before 1999 saved an average of $17,350 per property, or $762 per unit, of potential 2011 property taxes because properties are not being taxed at their true current value. During vacancy decontrol period between 1999 and 2011 these property owners have saved an average of $5,867 in property taxes per unit.

Table #16 shows the lost property taxes grouped by the last sale date.

Table #16: Property Tax Savings by Last Sale Date

Year Property Last Sold	Tax Savings per Property	Tax Savings per Unit	Total 1999-2011 Property Tax Savings Per unit	Number of Properties
1999 to present	Not Applicable	Not Applicable	Not Applicable	18
1996-98	$16,767	$671	$5,164	11
1995 or before	$17,514	$791	$6,091	39
1998 or before	$17,350	$762	$5,867	50

The Rent Board 2010 Economic Report calculates that just over 70% of properties are still under the same ownership as in 1998. Projecting these savings out to the approximately 21,000 units that are subject to rent stabilization or temporarily exempt indicates Berkeley rental property owners who have held ownership since the beginning of vacancy decontrol are currently saving a total of more than 11 million dollars a year due to the undervaluation of their properties.

Section 5: Net Operating Income

The rent multipliers for sales in recent years, combined with data on capitalization rates for sales in those years allows us to estimate the average Net Operating Income (NOI).

Table #17 estimates the NOI percentage from 2008 to 2010 using two different sources for the capitalization rates.

Table #17: Estimated Average NOI Capitalization Rates from *Rental Housing* (10 + unit sales)			
Year	Rent multiplier	Cap Rate	NOI
2010	9.7	7.1%	68.5%
2009	9.7	6.4%	62.3%
2008	10.5	5.8%	60.8%
Capitalization Rates from Economic Report (5+ unit sales)			
Year	Rent multiplier	Cap Rate	NOI
2010	9.7	no data	no data
2009	9.7	6.6%	64.2%
2008	10.5	5.1%	53.4%

With an estimated NOI ranging from 53% to 68% in recently sold properties, it is clear that in general Berkeley rental properties have very healthy incomes. The Institute of Real Estate Management 2011 report, *Income/Expense Analysis Conventional Apartments* provides data for major U.S. cities that can serve as the basis for comparison. It reports a median NOI for the Oakland area of 59% and NOI of 56% to 63% for the San Francisco area depending on the type of building. For the U.S. as a whole, it reported a median NOI of 42% for low-rise buildings with 12 – 24 units and 47% for elevator buildings.

Section 6: Conclusions

Multi-family residential property owners with properties of 10 or more units have experienced a substantial increase in rents due to vacancy decontrol. Allowable rents increased by an average of 72% and these properties are bringing in an average of an additional $6,400 per unit per year. More than half of these properties have not only received the benefit of vacancy decontrol but are experiencing significant property tax savings, since properties are reassessed only on sale.

However, despite the increase in rents and the savings in property taxes, the data from the sample clearly indicates that these properties have only invested a small portion of these savings in permitted work for their properties. At the present rate of renovation, even assuming actual expenditures are triple the permit values due to under-reporting and work done without permits, owners are reinvesting no more than 6% of increased rents in building renovations. These findings indicate that rent stabilization as it exists today has little effect on the average property owners' ability to invest in renovation and upgrading of their buildings. The increased rents since vacancy decontrol have provided an ample source of funding for the renovation of the properties and the minimal level of such reinvestment is a cause for concern.

Attachment A: Economic Analysis of Two Buildings Destroyed by Fire

In 2011 and 2012 there were two tragic fires in Berkeley that resulted in the destruction of 49 residential units and the displacement of their tenants. In the wake of these fires the Rent Stabilization Board read claims that Berkeley's rent stabilization system is to blame, arguing that because these property owners were unable to charge market rent they were unable to maintain or upgrade their buildings. In light of these concerns we took a closer look at the impact of rent stabilization on these two properties.

Property #1: Sequoia Building 2441 Haste Street

On November 18, 2011 the Sequoia Building at 2441 Haste Street caught fire and was damaged beyond repair. This building contained 43 residential units, home to 68 tenants, and 3 commercial tenant spaces. The Berkeley Fire Department determined that the cause of the fire was accidental and it was started by either a mechanical malfunction or the improper installation of elevator equipment.

According to the Rent Board database the monthly rent ceiling for all residential units in the building was $43,496 in 2011, and 35 of the 43 residential units at 2441 Haste Street had turned over since 1999, with those rents rising to market, thus eliminating about 80% of the difference between controlled and market rent. As a result, rent ceilings total $521,955 annually, approximately 36% higher than would have been allowed if rents were still regulated on vacancy. Annual rent ceilings are $138,000 a year higher due to vacancy decontrol. Rents for the commercial spaces are not subject to regulation.

County property records as reported by RealQuest indicate that 2441 Haste Street has had the same ownership since passage of Proposition 13 in 1978, with an assessed value of $1,597,323, resulting in a substantial property tax savings in addition to the higher rents.

Over the sixteen years from the passage of vacancy decontrol by the State legislature in 1995 to the time of the 2011 fire, the property owner had taken out one building permit. This permit was taken out in 2003 to replace two (2) 175 gallon water boilers, and had a valuation of $12,500. The property owner had previously made a substantial investment in the property through a 1993 permit valued at $330,000 to complete seismic upgrades to both the residential and commercial portions of the building, which was an unreinforced masonry building covered by the City's URM ordinance. At the time, the property was eligible to petition for a capital improvements increase to help pay for this work. However, there is no record of a capital improvements petition for this property. As the work was completed in 1995, the same year the Costa-Hawkins Act was passed, it is possible that the property owner chose to rely on vacancy decontrol rent increases to help pay for the seismic upgrade.

Property #2: 2229 Dwight Avenue

On March 8, 2012 a 6-unit building at 2229 Dwight Way was made uninhabitable by a two-alarm fire. The building was home to 10 to 12 people. The Berkeley Fire Department deemed the fire accidental, and stated that it originated in a water heater closet.

According to the Rent Board database the rent ceiling for all rental units in the building was $11,894 monthly in 2011, and all residential units at 2229 Dwight Way have turned over since 1999, with all rents rising to market. As a result, the property has rents that are approximately 125% higher than what would have been allowed if rents were still regulated on vacancy. The annual rent ceiling of $142,723 is $79,000 a year higher due to vacancy decontrol. County property records as reported by RealQuest indicate that 2229 Dwight Way has been in the same ownership since passage of Proposition 13 in 1978, with an assessed value of only $275,761, resulting in a substantial property tax savings in addition to the higher rents.

Over the sixteen years from the passage of vacancy decontrol by the State legislature in 1995 up to the time of the 2011 fire, the property owner had taken out four (4) building permits with a total valuation of $7,000.

Both of these properties have had substantial gains in rents due to vacancy decontrol. In addition, both have been owned by one owner since the passage of Proposition 13 in 1978 and therefore are paying property taxes on an assessed value that is significantly less than market value.

Rent stabilization and eviction for good cause provided the tenants of these properties with stability and enabled several long term tenants to remain in their homes, but had at most a modest effect on the owners' revenue. The increased rents since vacancy decontrol clearly provided ample funding for renovation of the properties.

Attachment B: Economic Analysis of a Small Rental Property

The owner of a three-unit rental property approached the Rent Board saying that he had been losing money on the property ever since buying it ten years ago, that the property had excessively low rents and that he needed relief through changes in Rent Board regulations to allow him to charge higher rents so that he would not lose the property to foreclosure and so that he could carry out needed renovations. The Board requested that staff meet with the owner and report back on the details of the situation. Staff met with the owner and he reviewed and approved the following description of his situation. In order to protect his privacy we do not use his name or give the property address and all figures are rounded to the nearest $5 or $10.

The property has three nearly identical one-bedroom apartments of approximately 500 to 550 square feet located in South Berkeley. All three units are subject to the Rent Stabilization and Eviction for Good Cause Ordinance. The owner purchased the property in 2002 for $335,000 to provide long-term retirement income. His real estate agent told him that the property was being sold at a good price to settle an estate. He paid 1/3 of the purchase price, approximately $115,000, as a down-payment and took out a mortgage for 2/3 of the price, approximately $220,000. The owner states that he has never had a positive monthly cash flow from the property. (See the table of current monthly costs and revenue).

At the time of purchase, one apartment was vacant and two were occupied by tenants who had lived there since 1995 or earlier and had not received a full or partial vacancy decontrol increase. The rent ceiling shown in the Rent Board records for unit #1 was $425 in 2002. A vacancy increase reported in June 2005 raised it to $775, and two additional vacancy increases in 2007 and 2009 brought the current rent ceiling to $1,125. The owner currently receives $1,120 for this unit. The 2002 rent ceiling for unit #2 was $505, reflecting a historically low rent increase granted the previous year, and the current rent ceiling is $585. The 2002 rent ceiling for unit 3 was $430. It received a historically low rent increase in 2003, and the current ceiling is now $580. The owner states that one tenant in the lower-rent units is very elderly and the other is younger.

In 2005 the owner refinanced the Berkeley property and added approximately $110,000 to the mortgage, which now amounts to $330,000. He used the additional $110,000 as part of the 25% down-payment for purchase of another rental property in Oakland at a cost of $600,000. He made this purchase with the advice of the same real estate agent who advised him on the Berkeley property. The Oakland property lost money from the beginning of his ownership and he took out a line of credit against his home in order to cover the deficit in the two rental properties. He sold the Oakland property in 2010 in a short sale to avoid foreclosure and lost his entire investment in that building.

The owner is in a difficult financial situation. He is running a monthly deficit on the property, has used up a line of credit of over $100,000 against his home, has taken on $30,000 in credit card debt and is behind on his home mortgage. He works six and sometimes seven days a week and still can't keep up. He is in danger of losing the Berkeley property to foreclosure or a short sale and believes that its current value is less than the mortgage.

July 2012 Financial Picture of 3-Unit Property
(numbers rounded to nearest $5 or $10)

Monthly Costs

$1,420	mortgage		
$110	business license tax	$1,320	annual
$490	property tax	$5,900	annual
$50	registration fees	$600	annual
$125	insurance	$1,500	annual
$125	garbage	$250	semimonthly
$20	gardening, cleaning	$240	annual
$120	repairs & maintenance	$720	six months
$2,460	TOTAL	$29,520	**Annual Cost**

Monthly Income

$1,120	Apt. A		
$590	Apt. B		
$585	Apt. C		
$2,295	TOTAL	$27,540	**Annual Income**

Monthly Deficit

-$165	-$2,000	**Annual Deficit**

Recently the owner has been able to extend his mortgage on the Berkeley property from 20 years to 30 years and to reduce his interest rate from an original 5% or 5.25% to 2.75% by taking out an adjustable rate mortgage. This saves him about $430 monthly over the previous rate.

The owner has invested approximately $20,000 in capital improvements to the property during the period from 2006 to 2011, including $12,000 for a new roof. He has consulted with staff at the Rent Board and learned that he is not eligible for a capital improvements increase because under the current rules he has already received vacancy increases sufficient to cover the allowable increase. He states that he is a very responsive landlord who makes repairs as tenants bring them to his attention.

He states that if he was allowed to raise rents on all three units to market he would be able to cover his expenses, make a modest profit and have the resources necessary to do longer-term repairs, such as to a crack in the foundation. He further suggests that if he is forced to sell the property at a short sale, or if it is taken in foreclosure, that the assessed value will go down substantially and the City of Berkeley will lose property tax revenue.

Staff analysis:
The owner used the Berkeley property as security to borrow approximately $110,000 for his down-payment on the Oakland property. In other words he increased his mortgage so that he could take back almost all of his initial investment in the Berkeley property. If he had not done this, he would now be half-way through the 20 year amortization period for his original Berkeley mortgage loan, the principal owed on that loan would be down to approximately $135,000 and he would have substantial equity in the property. Refinancing a loan amount of $135,000 at today's interest rates would have reduced his current mortgage payments to about half of what they are today and he would be running a positive cash flow from the Berkeley property of several hundred dollars monthly. The property would be secure, and the owner could anticipate substantial future rent increases when the current long-term tenants eventually vacate their apartments. The owner's difficulties are the result of his use of the Berkeley property to invest in the Oakland property.

In response, the owner argues that if he had simply kept his original mortgage, which had a higher interest rate, he would still be losing money today. He also states that he did not understand how rent stabilization with vacancy decontrol worked when he bought the property and that his real estate agent did not explain this to him.

The owner's situation is clearly very difficult and unfortunate but it results from his own investment decisions, apparently based on inadequate information and bad investment advice from his real estate agent, and was not caused by Berkeley's Rent Stabilization Ordinance.

The owner is correct in saying that without rent stabilization he could charge higher rents for his Berkeley property. It is also likely that without rent stabilization the Berkeley property would have had a higher sale price in 2002 because the previous owners would have been charging higher rents at that time.