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DRAFT MEMORANDUM

To:	Honorable Mayor and City Council, City of Beverly Hills
From:	HR&A Advisors, Inc.
Date:	July 26, 2018
Re:	Analysis of Buildings with Four Units or Less in the Beverly Hills Rent Stabilization Context

The City of Beverly Hills (the "City" or "Beverly Hills") retained HR&A Advisors, Inc. ("HR&A") to provide independent research and analysis about seven policy issues related to recently enacted changes to the City's Rent Stabilization Ordinance (the "RSO").[1] This Issue Paper addresses whether, and if so how, the City Council might consider amending the RSO to exempt multifamily buildings with two, three and/or four units per building, which are now regulated by the RSO.

The Issue Paper begins with a general statement about the issue, notes some of the positions about it that have been mentioned in public discussions about the RSO, and summarizes how this issue is addressed by 13 other California cities with multifamily building rent regulation, based on review of their ordinances and regulations and through discussions with city representatives. The Issue Paper then presents data from various sources that have a bearing on the issue, including the relevant numbers of two to four-unit buildings and apartment units in Beverly Hills, other characteristics of these buildings, available data on the households who rent them,[2] and financial data about their operating costs and real estate value. The data used in this Issue Paper are drawn from multiple sources, some of which are specific to Beverly Hills, such as the City's RSO rental registry,[3] data from the Beverly Hills Unified School District ("BHUSD"), and the U.S. Census Bureau, and some of which utilize data for a more general area around the City, because City-specific data are not available.[4] Based on the information and data provided on this topic, the Issue Paper concludes with a set of plausible policy options for City Council, City staff, and public consideration.

[1] Ordinance Number 17-O-2729, adopted in April of 2017 (the "RSO Amendments").

[2] As discussed in HR&A's Draft Beverly Hills RSO Data Brief ('Data Brief"), the relatively small scale of the City means that the U.S. Census Bureau Public Use Microdata Sample ("PUMS"), which makes it possible to cross-tabulate multi-family household characteristics with the number of units per multifamily building, is not available (i.e., the geographic area applicable to PUMS data is generally an area with a population of about 100,000 people). Therefore, data such as household incomes in two to four-unit buildings versus buildings with more units, is not available.

[3] The RSO Registry file provided to HR&A by the City on March 21, 2018 includes three properties containing a total of 17 units that are recorded as having been built after 1995. Because rents for properties built after 1995 cannot legally be controlled pursuant to the Costa-Hawkins Rental Housing Act, HR&A excluded these three properties and 17 units from the analysis contained in this report. The three properties and 17 units that were excluded represent less than a percent of all RSO properties and units, and their exclusion from the analysis is therefore assumed have a *de minimis* impact on the general characteristics of buildings subject to the RSO.

[4] More detail about all data sources can be found in the separate HR&A Data Brief.

Statement of the Issue

The City's RSO currently applies to multifamily apartment buildings with two or more units, which has been the case since rent regulation was first established in the City in 1978, and this coverage universe did not change in the RSO Amendments. During a series of professionally-facilitated dialogue sessions between Beverly Hills housing providers and tenants living in buildings subject to the RSO following adoption of the RSO Amendments, housing providers raised the issue of whether regulated buildings with between two and four units (i.e. duplexes, triplexes, and quadplexes) should be exempt or subject to different regulations than buildings with five or more units.[5] Some housing providers posited that there is a fundamental difference in real estate financial characteristics and tenant profiles for buildings with fewer than five units compared to buildings with five or more units. Additionally, some housing providers argued that duplexes, triplexes, and quadplexes should be exempt from the RSO because they believe the typical management, building operation, and relationships with tenants in these buildings differ materially from large multifamily buildings. Some observed that the operation of these smaller buildings more closely resembles single-family homes or condominiums, which are exempted from the RSO. The Beverly Hills Renters Alliance has expressed the view that all tenants need rent regulation and eviction protections provided by the RSO Amendments, regardless of the number of units in a multifamily building.[6]

Comparison to Other California Cities with Rent Regulation

Besides Beverly Hills, 13 other California cities currently have residential rent regulation programs. As shown in Table 1, four cities (31%) do not exempt buildings by number of units (i.e., the current situation in Beverly Hills), while the other nine cities (69%) exempt multifamily buildings with two, three and/or four units, although the specifics of these exemptions vary. Four cities (31%) exempt duplexes only; three cities (23%) exempt duplexes and triplexes; and two cities (15%) exempt duplexes, triplexes and quadplexes.

Table 1 – Summary of Rent Stabilization Program Exemptions by Number of Units in Multifamily Buildings in Other California Cities

	No Exemptions by Number of Units in Multifamily Buildings	Duplexes	Duplexes and Triplexes	Duplexes, Triplexes, and Quadplexes
Total Number of Cities	4	4	3	2
Percentage of Cities	31%	31%	23%	15%
Cities	West Hollywood San Francisco Richmond Los Angeles	San Jose Mountain View Berkeley Los Gatos	East Palo Alto Oakland Santa Monica	Hayward Palm Springs

Source: HR&A Advisors, Inc. and the individual cities

[5] Based on HR&A communications with City staff, and documented in September 5, 2017 City of Beverly Hills City Council Agenda Report (http://beverlyhills.granicus.com/MetaViewer.php?view_id=49&clip_id=5722&meta_id=341890)

[6] Dialogue #6 Takeaway, Tenants Positions, Beverly Hills Renter Alliance (bhrentersalliance.org2017/08/dialogue-6-my-takeaway/)

Four of the nine cities that exempt two to four-unit buildings do not limit them in any way (i.e., San Jose, Mountain View, Los Gatos and Hayward), but the other five cities qualify their exemptions by conditions of simultaneous building owner occupancy or other building ownership requirements. These stipulations include the following:

- **City of Berkeley**: exempts duplexes only if one unit was owner-occupied in 1979 and is currently owner-occupied.
- **City of East Palo Alto**: exempts duplexes and triplexes only if one of the units is currently occupied as the primary residence of the owner, or relative of the owner, who has occupied the unit for a period of one year or longer.
- **City of Oakland:** exempts duplexes and triplexes only if one unit is occupied by the owner as his or her primary residence.
- **City of Palm Springs**: exempts duplexes, triplexes, and quadplexes only if one unit is occupied by the owner as his or her primary residence.
- **City of Santa Monica:** exempts duplexes and triplexes only if an owner with at least a 50 percent interest in the property, who is a natural person (i.e., not a legal entity), occupies a unit on the property.

Most cities with exemptions for buildings with fewer than five units do not state a specific rationale for the exemptions in their rent regulation ordinances. However, the City of Oakland, which exempts duplexes and triplexes, states a specific rationale for doing so in its ordinance:

> "The City Council believes the relationship between landlords and tenants in smaller owner-occupied rental properties involve special relationships between owners and tenants residing in the same smaller property. Smaller property owners also have a difficult time understanding and complying with rent and eviction regulation. The Just Cause Eviction Ordinance recognizes this special relationship and exempts from its coverage owner-occupied buildings divided into a maximum of three units. For these reasons, the City Council believes owner-occupied rental properties exempt from the Just Cause Eviction Ordinance should similarly be exempt from the Rent Adjustment Program so long as the property is owner-occupied."[7]

Similarly, an administrator in Santa Monica's Rent Control Department summarized in a discussion with HR&A that the intention behind that city's exemption for duplexes and triplexes was that the relationship between tenants and an owner living on site is likely to be more congenial. For example, the owner may be more responsive and sensitive to tenant needs, concerns, as well as unit maintenance. An administrator of the Mountain View ordinance noted in another discussion with HR&A that while their ordinance was drafted by a tenant's coalition, the rationale for the exemption may have been that a housing provider who owns a duplex often lives in one unit and rents out the other unit, and therefore is more likely to have a direct and personal relationship with tenants than is typical for buildings with more units.

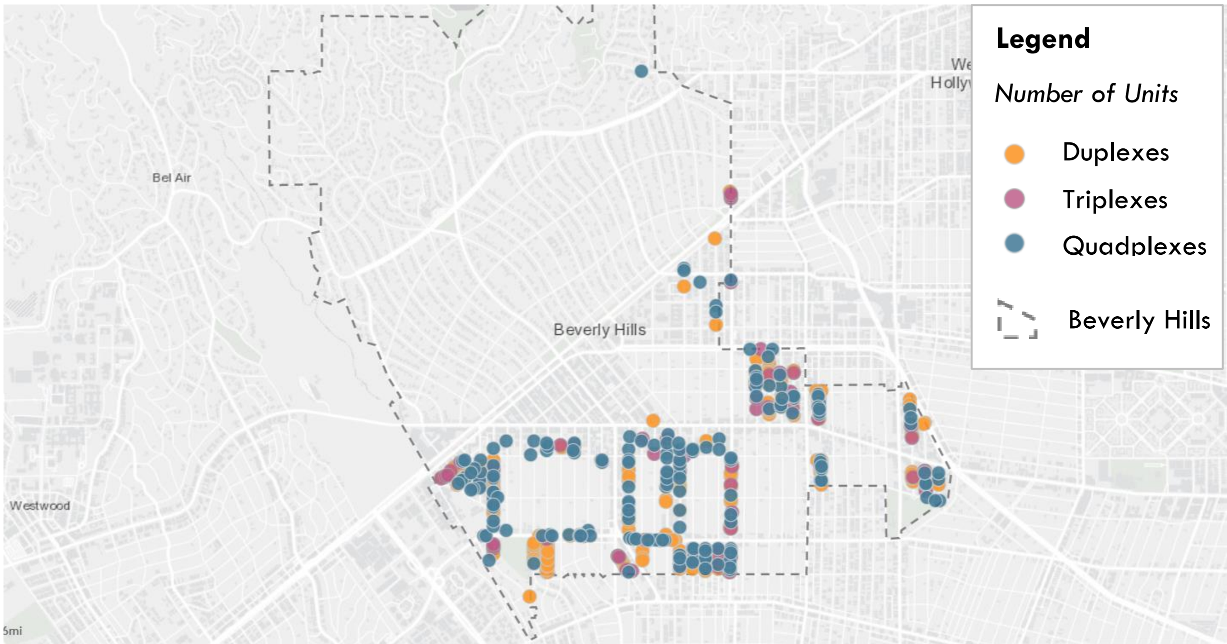
Relatedly, while Los Angeles does not wholly exempt properties from rent stabilization based on the number of units in structures, its rent stabilization provisions allow "mom and pop" property owners, who are defined as owners of no more than four residential units and a single-family house within the City of Los Angeles, to pay reduced relocation fees to their tenants in cases of eviction for owner or relative occupancy and comply with certain additional conditions. One of the conditions for reduced relocation fees is that the building containing the unit subject to eviction must contain four or fewer rental units.

[7] Oakland Municipal Code, Chapter 8.22.010: Findings and Purpose, Residential Rent Adjustments and Evictions.

The Beverly Hills Context

As shown in Figure 1, most multifamily buildings with less than five units in the City are quadplexes. Nearly all multifamily buildings with four units or less are located in the southern portion of the City, below Santa Monica Boulevard.

Figure 1 - Map of Multifamily Properties in Beverly Hills, 2017



Source: City of Beverly Hills

Inventory

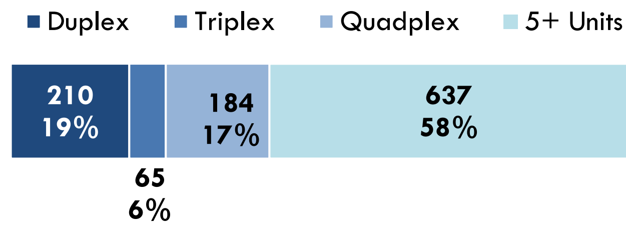
In Beverly Hills, as shown in Figure 2, multifamily buildings subject to the RSO ("RSO Buildings") with four units or less compose more than 40 percent of all RSO Buildings, including 210 duplexes, 65 triplexes, and 184 quadplexes. However, as shown in Figure 3, buildings with four units or less compose less than 20 percent of total inventory of units subject to the RSO ("RSO Units"), including 420 units in duplexes, 192 in triplexes, and 732 in quadplexes.

Building Stock Characteristics

RSO Buildings with four units or less are generally older buildings compared with the rest of the RSO multifamily stock in Beverly Hills. As shown in Figure 5, nearly 98 percent of the RSO buildings with four units or less were built prior to 1960 and more than 80 percent were built before 1940.

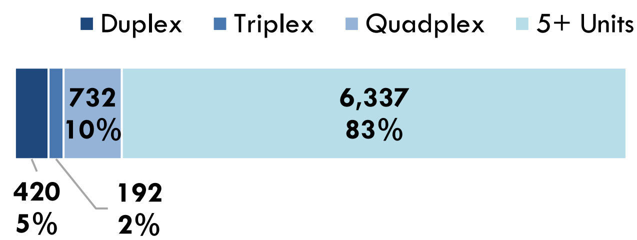
As shown in Figure 4, RSO Buildings with four units or less have more bedrooms per unit than buildings with five or more units. Three-bedroom units make up more than three quarters of units within duplexes, while they account for only four percent of units within buildings with five or more units.

Figure 2 - RSO Buildings by Number of Units in Structure in Beverly Hills, 2017



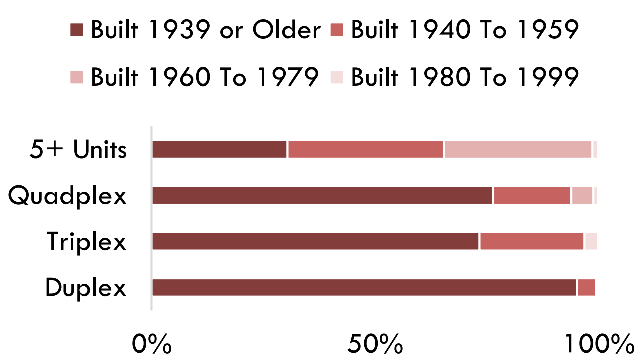
Source: RSO Registry

Figure 3 - RSO Units by Number of Units in Structure in Beverly Hills, 2017



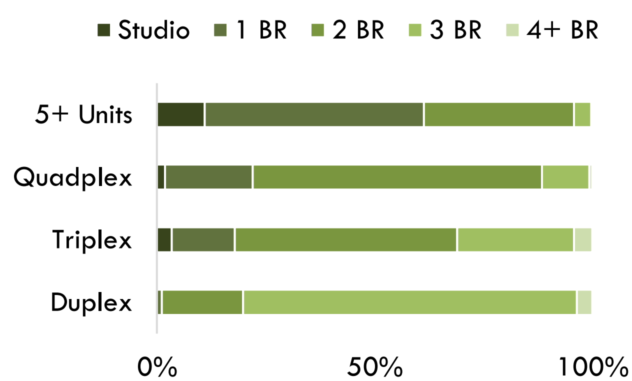
Source: RSO Registry

Figure 5 - RSO Buildings by Number of Units in Structure by Year Built in Beverly Hills, 2017



Source: RSO Registry

Figure 4 - RSO Unit Type Distribution by Number of Units in Structure in Beverly Hills, 2017

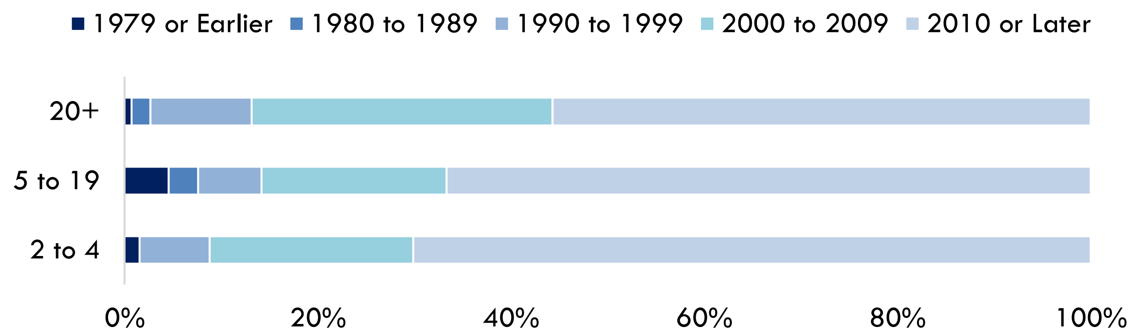


Source: RSO Registry

Tenant Turnover

Tenants in buildings with two to four units have generally moved into their units more recently than those in buildings with five or more units, although the difference is slight. Specifically, 70 percent of tenants in buildings with two to four units moved into their unit in 2010 or later, and 91 percent moved into their unit in 2000 or later. This relatively high rate of tenant turnover has two types of financial implications for housing providers. On the one hand, it increases operating costs to prepare the unit for the next tenant, and to advertise for and screen candidate tenants. But, pursuant to the Costa-Hawkins Rental Housing Act,[8] it also provides an opportunity to raise rents on voluntarily vacated units to market levels, which are then de-controlled under the RSO until the next voluntary vacancy. From a tenant's perspective, this pattern also means that the financial benefits of rent regulation accruing to long-term stayers applies to a small percentage of households in these units (i.e., nine percent moved in prior to 2000).

Figure 6 - Year Renter Householder Moved into Unit by Number of Units in Structure in Beverly Hills, 2016

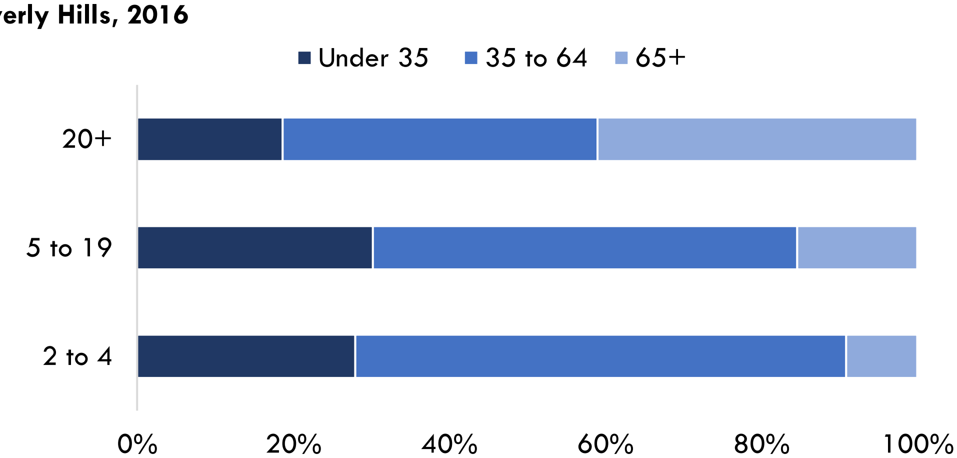


Source: 2012-2016 American Community Survey 5-Year Estimates

Tenant Household Profile

As shown in Figure 7, buildings with two to four units have householders that are predominantly working-age (35 to 64), while seniors tend to locate in buildings with more than 20 units.

Figure 7 - Distribution of Renter Householders by Age of Householder by Number of Units in Structure in Beverly Hills, 2016

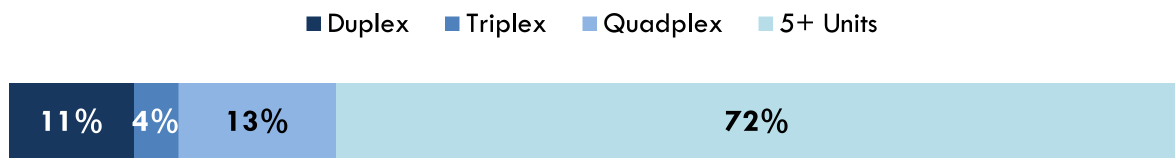


Source: 2012-2016 American Community Survey 5-Year Estimates

[8] California Civil Code Section 1954.50

There are 1,107 RSO households with over 1,700 students attending schools in the BHUSD as of May 2018, according to BHUSD data analyzed by HR&A.[9] The data further indicate that approximately 42 percent of total BHUSD enrollment resides in rent-stabilized housing. Or stated another way, the 1,107 RSO households with children enrolled in the BHUSD make up 14 percent of the total 7,681 RSO units in the City. Among those RSO households with students in the BHUSD, nearly three quarters live in buildings with five or more units, as shown in Figure 8. Thus, any changes to RSO provisions related to buildings with between two to four units would impact slightly more than a quarter of households with a total of 518 children enrolled in the BHUSD.

Figure 8: Distribution of RSO Households with Children Enrolled in the BHUSD by Number of Units in Structure, 2018

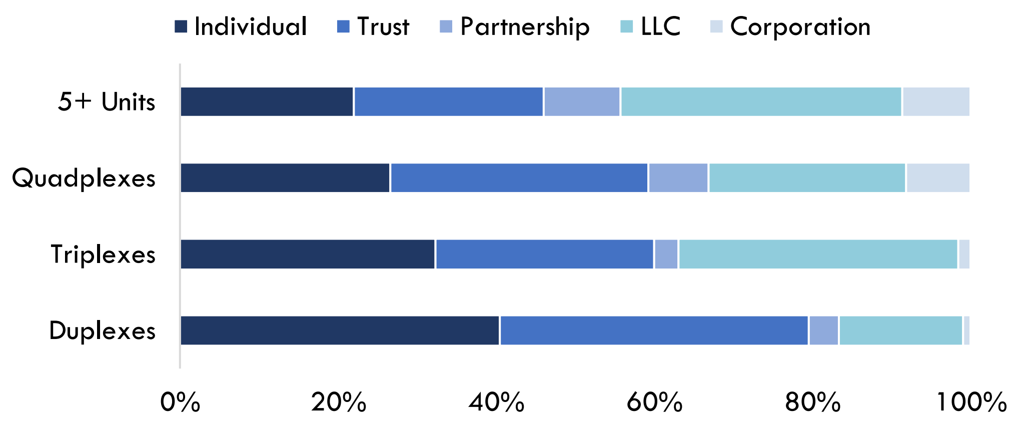


Source: RSO Registry; BHUSD

Ownership Profile

As shown in Figure 9, RSO Buildings with four or less units represent a larger share of regulated apartment buildings owned by individuals and trusts, as opposed to other more corporate ownership entities (i.e., partnerships, LLCs and corporations), than buildings with five or more units. This may be attributable to broader real estate investment dynamics: real estate companies and corporate investors tend to have greater access to investment capital allowing them to acquire larger apartment buildings, which are generally more valuable properties than smaller buildings in the same market. Conversely, individuals and trusts (assuming these are family trusts) generally have more limited access to investment capital, and may seek to acquire smaller, less expensive rental buildings.[10]

Figure 9 - RSO Building Ownership by Type of Entity by Number of Units in Structure in Beverly Hills, 2017



Source: RSO Registry

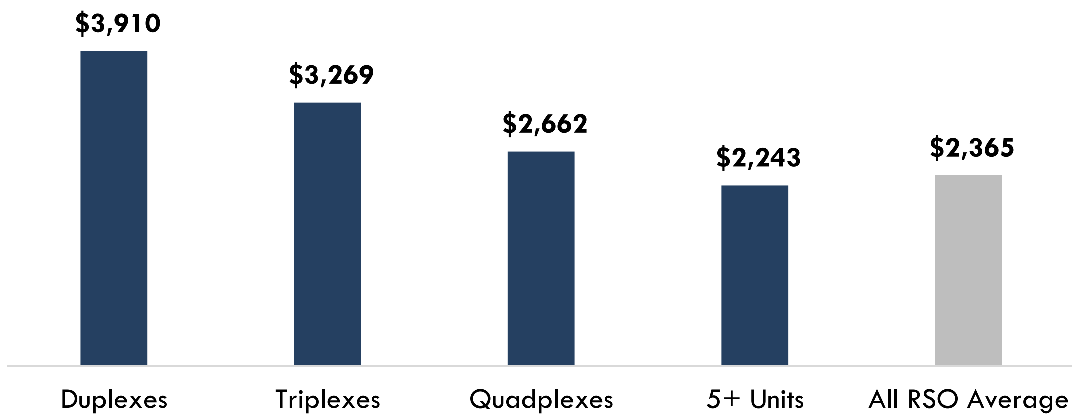
[9] HR&A analysis of enrolled student data provided by BHUSD and RSO Registry data.

[10] This is a generalization, of course, since individuals can form Limited Liability Companies (LLC) and corporations, too.

Characteristics of Building Operations and Financials

As shown in Figure 10, RSO Buildings with four units or less achieve higher average monthly rents per unit than those with five or more units. Average monthly rents for all RSO Units are $2,365 per unit, and rents inversely correlate with the number of units in a building; duplexes achieve the highest average rents of $3,910 per unit per month, while RSO buildings with five or more units achieve average rents of $2,243 per unit per month. This pattern reflects the fact that units with more bedrooms have higher average rents (as documented in HR&A's separate Data Brief) and two to four-unit buildings tend to have more of these larger units, as noted above in Figure 4.

Figure 10 - Average Monthly Rents per RSO Unit by Number of Units in Structure in Beverly Hills, 2017

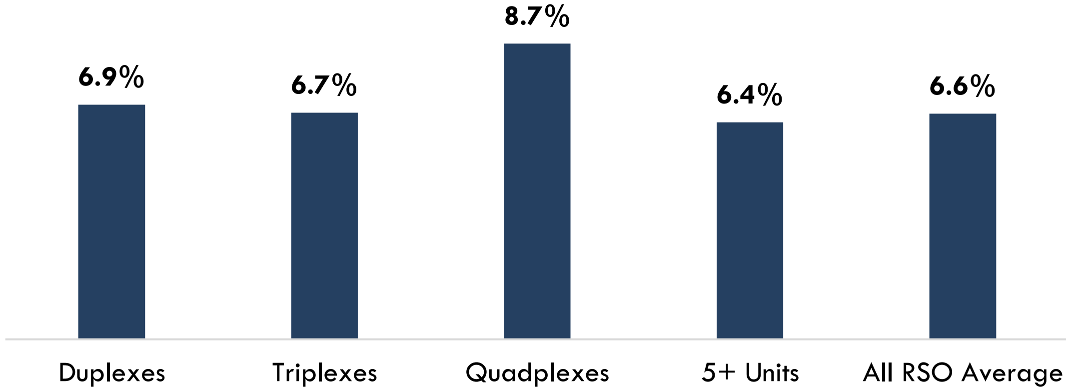


Source: RSO Registry

Although U.S. census data for household incomes by number of units in a multifamily building are not available, it is possible to infer the general scale of household incomes in two to four-unit buildings based on Citywide rent-to-income ratios, which are reported in the Data Brief. Thus, if tenant households in two to four-unit buildings are paying the Citywide median rent-to-income ratio of 30.7 percent, applying this ratio to the average rents shown in Figure 10 implies that average annual household incomes in duplexes are about $153,000, in triplexes, about $128,000, in quadplexes about $104,000, as compared to about $88,000 in buildings with five or more units. Individual household circumstances undoubtedly vary from these general averages.

As shown in Figure 11, RSO Buildings with four units or less also have slightly higher vacancy rates. The vacancy rate for all RSO units is 6.6 percent on average, although buildings with four and fewer units are above this average, while buildings with five or more units are slightly below it. However, this data is for one point in time. Vacancy rates have a different meaning in buildings with fewer units as compared with buildings with more units. For example, a duplex with one vacant unit is 50 percent vacant while a 10-unit building with one vacant unit is 10 percent vacant.

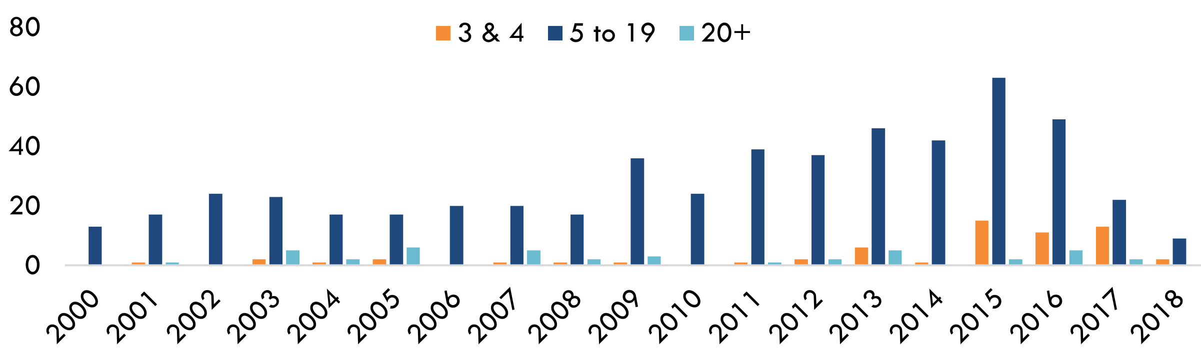
Figure 11 - RSO Vacancy Rate by Number of Units in Structure in Beverly Hills, 2017



Source: RSO Registry

As shown in Figure 12, annual multifamily property sales in the City (and particularly sales of triplexes and quadplexes) remained at very modest levels between 2000 and through the Great Recession (2007-2009), including a real estate market peak just before that recession. The annual pace of multifamily sales increased for all scales of buildings beginning with the end of the recession, peaked in 2015, and has since then tailed off to levels more like the beginning of the decade. This trend also holds for triplexes and quadplexes, but still at much lower volumes than for buildings with more units. More specifically, there have been 535 total sales for buildings with 5 to 19 units since 2000 compared with 60 total sales for three- and four-unit buildings and 41 total sales for 20-plus unit buildings over the same period.[11] Even during the recent peak of sales years (2015-2017) for triplexes and quadplexes, the volumes were only 11 to 15 buildings each year.

Figure 12 - RSO Multifamily Property Sales by Number of Units in Structure in Beverly Hills, 2000-2018



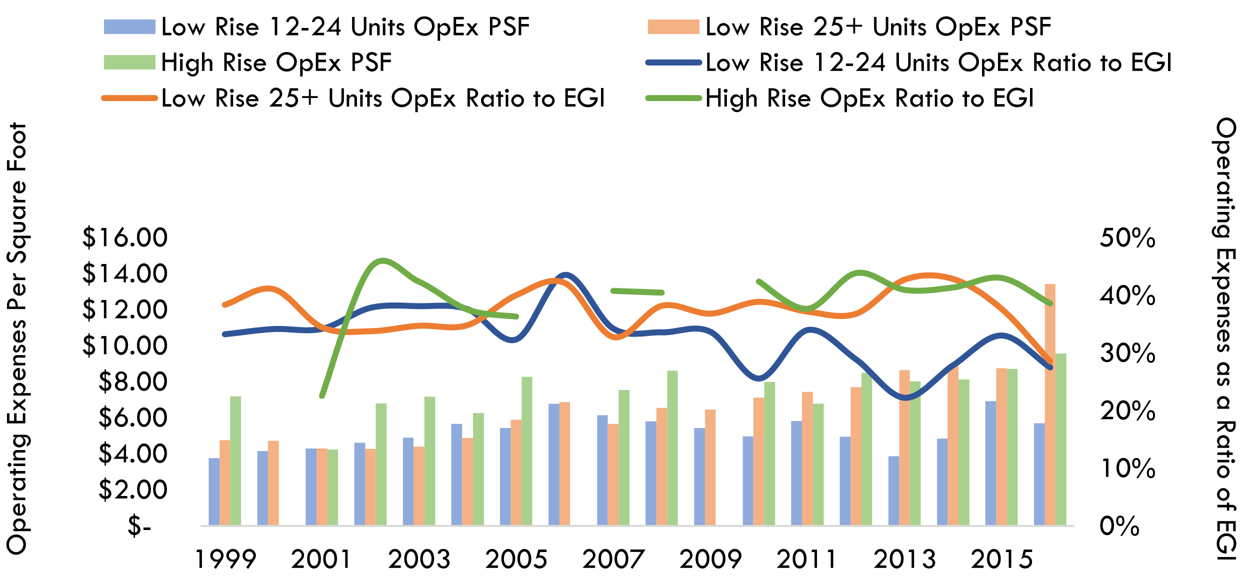
Source: CoStar

[11] Sales data for duplexes are not included in Figure 11 due to Costar data constraints.

There are currently no available independent data for operating expenses specific to apartment buildings in Beverly Hills. HR&A attempted to obtain operating expense data for an analytically robust and representative sample of local housing providers, but HR&A's request to the Apartment Association of Greater Los Angeles for assistance in doing so was declined. In lieu of data specific to Beverly Hills apartment buildings, HR&A analyzed annual data collected by the Institute of Real Estate Management ("IREM") for apartments within the Los Angeles Metropolitan Area as a general indicator of operating expense trends in relatively smaller versus relatively larger apartment buildings. IREM distinguishes apartment properties by size as low-rise (three stories or less) with 12 to 24 units, low-rise with more than 24 units, and high-rise (four or more stories with an elevator). IREM does not collect data for two to four-unit buildings.

As shown in Figure 13, annual operating expenses per square foot for all apartment types in the Los Angeles Metropolitan Area increased between 1999 and 2016, although operating expenses were generally higher for larger buildings over this period. Between 1999 and 2016, operating expenses per square foot averaged approximately $5.20 for low-rise buildings with 12 to 24 units, $6.70 for low-rise buildings with 25 or more units, and $7.60 for high-rise buildings. Over the same period, the ratio of operating expenses to effective gross income ("EGI") varied from year to year, but generally stayed within the range of 30 to 40 percent. On average, low-rise buildings with 12 to 24 units had the lowest operating expense to EGI ratio with 33 percent, while low-rise buildings with 25 or more units had a 37 percent ratio and high-rise buildings had a 40 percent ratio.

Figure 13 - Operating Expenses ("OpEx") Per Square Foot and as a Ratio of Effective Gross Income ("EGI") in the LA Metro Area, 1999-2016



Source: IREM. Data gaps in some years reflect missing survey data.

Policy Options

Based on the foregoing information and data, the case for continuing to regulate rents for buildings with two to four units is supported by the fact that altogether, they represent about 42 percent of RSO buildings (and 17% of RSO units); they house about 24 percent of BHUSD students; they experience higher turnover rates, meaning that rents reset to market rates more frequently; and annual operating expenses for smaller buildings are generally lower than those for larger buildings.

Conversely, the case for exempting some combination of buildings with two to four units is supported by how the majority of other California cities with rent regulation address this issue, as well as the data that suggest that tenants in these buildings are predominantly working age and are better positioned to afford market rate rents than seniors who predominantly live in buildings with more units; tenants in these buildings already pay higher rents and therefore presumably have higher household incomes; these buildings are generally much older and therefore may incur more costly capital improvements not easily accommodated by current rent regulations; and owners of these buildings tend to be individuals or families whose financial situation may be more sensitive to price controls on their assets than professional real estate investors who tend to own buildings with more units.

Considering the foregoing information and data, HR&A suggests that there are at least four plausible policy options that the City Council, City staff, and the public could consider when determining whether, and if so how, to treat duplexes, triplexes, and quadplexes in the RSO:

1) **No Policy Changes:** In this case, the City would continue to regulate all buildings now subject to the RSO, with no exemptions for two to four-unit buildings.
    - **Advantages to housing providers:** Little to no advantages for housing providers overall, although housing providers of buildings with fewer units would continue to enjoy comparatively higher rents and lower operating expenses than those with buildings with more units.
    - **Disadvantages to housing providers:** All RSO housing providers, regardless of the unique physical and operational characteristics of their buildings, would continue to be limited in their ability to increase rents and evict Chapter 5 Tenants, and would pay the same amount of relocation fees for eligible evictions.
    - **Advantages to tenants:** All RSO tenants would maintain rent increase protections and Chapter 5 tenants would maintain eviction protections regardless of the number of units in their building.
    - **Disadvantages to tenants:** Little to no disadvantage to tenants overall.

    Administrative Considerations: This option would not require additional City staff time or resources, or produce any savings, because it would maintain existing conditions.

2) **Exempt Only Duplexes and/or Triplexes with No Limitations:** In this case, the City would exempt only those multifamily buildings with the fewest units per building, and the smallest share of the currently regulated multifamily stock, but without any of the ownership limitations adopted by some other cities with rent regulation.
    - **Advantages to housing providers:** Housing providers with duplexes and/or triplexes would be free to increase rents to market level, would not pay any relocation fees (absent a separate Just-Cause Ordinance or other tenant protection measures) and would have generally greater eviction and administrative flexibility.

- **Disadvantages to housing providers:** Housing providers with buildings of four or more units would continue to be limited in their ability to increase rents and evict Chapter 5 Tenants.
- **Advantages to tenants:** The majority of RSO tenants would still benefit from RSO protections.
- **Disadvantages to tenants:** Tenants of duplexes and/or triplexes would lose the rent limitation, relocation fee and Chapter 5 eviction protections contained in the RSO (absent a separate Just-Cause Ordinance or other tenant protection measures).

Administrative Considerations: This option would incur some limited staff time or other resources to draft and support adoption of the ordinance changes, but would not require additional on-going City staff time or resources, and could result in some cost savings by removing these units from the RSO Registry and associated monitoring and enforcement costs.

3) **Exempt Duplexes, Triplexes and Quadplexes with No Limitations:** In this case, the City would exempt all multifamily buildings with less than five units per building, but without any of the ownership limitations adopted by some other cities in California with rent regulation.
    - **Advantages to housing providers:** Housing providers with buildings with fewer than five units would be free to increase rents as high as the market will bear, and would have generally greater eviction and administrative flexibility.
    - **Disadvantages to housing providers:** Most housing providers (i.e., those with buildings more than four units), would continue to be limited in their ability to increase rents and evict tenants, despite having comparatively higher operating expenses than buildings with fewer units.
    - **Advantages to tenants:** The majority of RSO tenants would still benefit from RSO protections.
    - **Disadvantages to tenants:** Tenants of duplexes, triplexes, and quadplexes would lose the rent limitation, relocation fee and eviction protections contained in the RSO (absent a separate Just-Cause Ordinance or other tenant protection measures).

    Administrative Considerations: This option would require some limited staff time or other resources to draft and support adoption of the ordinance changes, but would not require additional on-going City staff time or resources, and could result in some cost savings by removing these units from the RSO Registry and associated monitoring and enforcement costs.

4) **Exempt or Modify Provisions for All or Some Combination of Duplexes, Triplexes and Quadplexes, But Only with Specified Owner Limitations:** In this case, any exemptions or modified provisions for buildings with less than five units would also include one or more of the onsite owner residency or related requirements discussed above in the rent regulation programs in Berkeley, East Palo Alto, Los Angeles, Oakland, Palm Springs and Santa Monica.
    - **Advantages to housing providers:** Certain housing providers, primarily individuals and families who own multifamily residential real estate, would benefit from a greater ability to increase rents and evict tenants.
    - **Disadvantages to housing providers:** Professional real estate investment entities would continue to have limited capacity to increase rents and evict tenants, and there may be individuals and families who own properties, but do not meet the established exemption criteria and could be comparatively disadvantaged.

- **Advantages to tenants:** The majority of RSO tenants would still benefit from RSO protections.
- **Disadvantages to tenants:** Tenants of exempt properties would lose rent and eviction protections.

Administrative Considerations: This option would require somewhat more staff time or other resources to research, draft and support adoption of the ordinance changes, and additional City staff time or other resources to track property ownership in the City, monitor compliance and conduct enforcement actions.