Pruning Back the Hedge

written by
TERRENCE JONES

Buying real estate has long been thought of as one of the safest hedges against inflation. But one agent wonders if that is actually true in rent controlled San Francisco.

Even though I trained to be an economist at Berkeley, back when the bubble burst in the early 2000s, I was drawn into San Francisco apartment sales and investment. Working in the business seemed to be one of the best pathways to gaining a competitive advantage in ownership. When I first started, one of my early mentors was very successful at investing in apartment buildings. He began by buying a small multifamily building when he was only 30 years old; by the time he was 80, he and his partners owned more than 2,000 units. When I asked him about investing in San Francisco apartments, his advice was firm. He said, “No one should *ever* invest in a rent control market because the business of owning real estate is sensitive to inflation ... and rent control does not allow you to keep pace with inflation.”

Fast forward to today and, ironically, here I am, still helping investors buy and sell rent-controlled apartments in San Francisco. Over the years, I have often been asked by both long-term landlords and real estate neophytes if buying apartment buildings in San Francisco is a good hedge against inflation. We know what my mentor would have said, but before I considered my own answer, I needed to start by looking at the basics of inflation, particularly local inflation here in San Francisco. (To make this a relatively simple discussion, this article only talks about short-term investment hedging and is not a discussion of a long-term total investment hedge that may come from appreciation after the sale of a building.)

Investigating Inflation

The Federal Reserve is the traffic cop that attempts to keep inflation in check and influence interest rates using several measures, such as buying and selling government bonds, setting the interest rate banks pay to borrow from the Federal Reserve, and setting the reserve requirements banks must have on their books. The Federal Reserve explains it simply on its website: "Inflation occurs when the prices of goods and services increase over time. Inflation cannot be measured by an increase in the cost of one product or service, or even several products or services. Rather, inflation is a general increase in the overall price level of the goods and services in the economy."

Nationally, inflation has increased an average of 2% over the past 10 years. Even when we consider the 2008 spike and 2009 dip, that overall average has held steady.

So, is that also the rate of inflation in San Francisco? This question is a bit more complicated. We are living in a unique and very popular micro economy, and we need look at the causes of inflation here more specifically. There are factors here that affect our rate of inflation (our cost of living) in ways that differ from other areas of the U.S. To determine our rate of inflation we need to consider the goods and services available in the Bay Area, which are completely different from Topeka, Kansas or Portland, Maine. Our San Francisco cost of living index might include some items that weigh more heavily on people here then they do in the rest of the country.

There are a few items we might look at in our cost of living index. First and foremost are, not surprisingly, rents. Monthly rents in San Francisco have risen sharply in recent years and are some of the highest in the country. The limited supply has been far outstripped by demand, which has forced the rents higher at a more rapid rate than in other regions. In the past 10 years, we have seen rents rise at a rate that is on average, more than double the regional average of 2% inflation that the San Francisco Rent Board uses to calculate the allowable rent increase. The actual rent increase index for San Francisco is running at close to 5% per year. This means that there is roughly a 3% per year deficit where rents held below market under rent control are not keeping up with overall inflation.

As of June 2013, San Francisco became the number-one most expensive city in the country for parking fines. (We finally beat out New York in something important last year.) Although that increase was only 3% over the previous year, it is still higher than the national CPI of 2% a year. This means that there is roughly a 1% per year deficit between the regional average inflation and the cost of parking fines.

The cost of food is also high and getting higher in San Francisco. As just one example, sushi at my favorite restaurant has doubled in the past five years. (The California roll that was so great at $5 per order is now $10 per order.) Obviously the cost of living index in San Francisco is based on much more than the costs of rents, parking tickets and sushi, but it gives you an idea of how the cost of living in San Francisco is generally higher than almost anywhere else in the country. We can use any combination of goods in our basket for a San Francisco inflation index, but the facts will point back to inflation of the costs of goods and services in San Francisco is indeed a danger to San Franciscans and exceeds the 10-year average of less than 2%.

Hedging Your Bets?

Now that we have a better understanding that we in San Francisco are indeed affected by a higher rate of inflation than in other regions, we need to understand what a "hedge" means in terms of real estate (and no, it's not the row of greenery in front of your building that your neighbor's dog likes way too much).

A hedge is a financial offset against the danger of inflation. The best description I have found comes from TIAA-CREF. Its website describes a real estate hedge as the following:

> Commercial real estate investments have specific characteristics that can help them keep pace with inflation. Most important is the structure of leases. Rent is usually renegotiated when a lease is up for renewal. The rent on a shorter-term lease is likely to catch up to inflation more quickly than the rent on a longer-term lease, though longer-term leases often include step-ups in rent, sometimes explicitly tied to the inflation rate. The assignment of expenses can provide further insulation from inflation. For example, some leases allow property owners to pass through all expenses to their tenants.

In short, a hedge in real estate is where your yearly return on investment is protected against inflation by allowing income and expenses to adjust on a yearly basis. At times when goods and services rise in cost, you want to be sure that your income is allowed to increase and your expenses are allowed to be passed along to your tenants at the same rate, therefore protecting your investment in inflationary market conditions.

How does that apply to San Francisco? Let's look at income and expenses under rent control. The San Francisco Rent Board derives its annual allowable increase in rents not from the national level or the San Francisco index discussed above, but from the CPI for the region, which is set by the U.S. Department of Labor. Here is what the rent board says in its rules and regulations: "The annual allowable increase determined by the Board shall become effective each March 1, and shall be no more than 60% of the increase in the Consumer Price Index (CPI) for All Urban Consumers in the San Francisco-Oakland-San Jose region as published by the U.S. Department of Labor for the 12-month period ending October 31."

The consumer price index for the region is based on a variety of goods and services and it does not take into account the significant increases that have occurred in rents in San Francisco. In other words, for existing tenants protected under rent control, there is only a 60% increase of this CPI allowed; so the longer a tenant resides in a San Francisco building, the bigger disparity between the rent they pay and the actual rental rate in the market.

Let's look at an example of a rent starting 10 years ago, with all allowable legal increases and compare it to the actual increase in market rents over this period. Let's say someone rented a one-bedroom apartment for $1,425 a month in 2004 and their rent increased per the rent board rules. They would now be paying $1,706 a month. However, that same one-bedroom apartment would rent to a new renter today for about $2,125. We see the disparity grows to over $400 per month or cumulatively $22,981 over 10 years.

On the expense side, most rent controlled buildings are not set up for direct billing for items like water, sewer, and garbage service, so they are included as part of the monthly rent. (Though it is common for some older apartment buildings to be separately metered for gas and electric service and the tenant pays those expenses directly to the provider.) We are seeing expenses like these increasing at an alarming rate in San Francisco. Garbage rates alone have increased by 50% this past year and it is expected that the water and sewer rates will double and triple over the next 5 to 10 years with the advent of new infrastructure projects scheduled for completion in San Francisco.

The rent board has a process for building owners to apply for a "passthrough" for these expenses so they can pass on some of the increasing costs to their tenants. Unfortunately, the process is currently so complicated that it dissuades some property owners from filing the paperwork to recoup some of those expenses, which would help those who are using their investment as a true hedge. Even those who do make a claim can have their petitions to the rent board denied because their tenants are not able to afford the increase. (Imagine the political uproar if owners whose petitions were denied due to tenant hardship went back to the SFPUC, Sunset Scavenger, or the City of San Francisco Vector Control and told them they needed their money back because the tenants cannot afford to pay for using their products and neither can the owners.) Unfortunately, the landlord is

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obligated to pay the increased expenses, whether or not they are able to recover any of the costs through increased rents.

Rents and expense passthroughs do not move very quickly under San Francisco rent control rules. Rents can only be increased at a rate less than inflation in San Francisco, or increase to market only as tenants vacate the units. Though operating expenses are allowed to be passed through to tenants, the process is slow and complicated.

Therefore, after much deliberation, it appears I agree with my mentor. If you are looking for a true hedge against inflation in San Francisco, owning rent-controlled apartment buildings in the city of San Francisco may not the best strategy on a yearly basis. An alternative within the real-estate arena would be to invest in non-rent control buildings, such as commercial buildings in San Francisco, or apartments outside of San Francisco in non-rent controlled markets.

Judging by how fast and furious the San Francisco apartment market is moving, this argument may not be enough to dissuade many hopeful investors. So, if you do decide to invest here in San Francisco apartments, be sure to learn the ins and outs of the rent control board rules so you can maximize your investment.

Terrence Jones is a senior broker associate with TRI Commercial and specializes in the marketing and sale of investment properties. His business specialty is San Francisco rent controlled apartments. He has extensive experience in properties with special circumstances. He can be contacted at 415-786-2216 or by email at tjones@tricommercial.com.