PALADIN U.S. RESEARCH:
Primer on California Residential Rental Regulations

September 2020

Introduction

Regulations affecting residential rental properties in California are varied and complex. Several current and proposed statewide and local ordinances will affect Paladin's apartment investments in Southern California and, like the regulations themselves, the results will be varied and complex. On the one hand, Paladin believes these regulatory requirements and risks create additional stress on smaller "mom and pop" owners of apartments who may be ill-prepared to deal with these rules. As a result, many of these owners may decide to exit the market, providing investment opportunities for sophisticated investors who have more expertise underwriting and navigating such regulatory complexities. On the other hand, such regulations may reduce the potential returns from existing investments. Paladin believes that careful underwriting of the risks, along with the solid execution of value-added business plans to mitigate the effects, will continue to generate attractive risk-adjusted returns for our investors. Additionally, asset pricing will eventually adjust to reflect the realities and limitations of any such regulations.

Below is a brief primer on the most relevant rental housing ordinances and how they may affect Paladin's strategy.

Current Laws

1995 Costa Hawkins Rental Housing Act

- Statewide rent control law enacted in 1995
- No limit on annual rent increases, unless already subject to an existing local rent control ordinance
- Allows units to be re-leased at market rates upon a vacancy (aka "vacancy decontrol")
- Prohibits any limitation on rent increases to market upon a vacancy (aka "vacancy control")
- Exempts from any rent control: (1) single family homes and condominiums, and (2) all rental properties built after February 1995, or earlier if a prior local rent control law was in effect (e.g., 1978 RSO for City of Los Angeles)
- Consistent with Paladin's strategy of encouraging vacancies through voluntary buyouts

Tenant Protection Act of 2019 (AB 1482)

- Statewide rent control law took effect in January 2020 with a 10-year sunset clause
- Applies to all buildings 15+ years old on a rolling basis
- Annual rent increases limited to 5% + CPI, not to exceed 10%
- Allows units to be re-leased at market rates upon a vacancy
- No allowances for pass-thru of renovation costs, unless provided for in a local ordinance
- Can evict for renovations if a unit is uninhabitable for 30+ days and re-lease that unit at market rents
- Relocation compensation to tenants for renovation-related evictions is one-month's rent
- Must have "just cause" for evictions (e.g., non-payment of rent, nuisance or criminal activity, renovation, family owner moving into a unit)
- Does not override more stringent local rent controls (e.g., City of L.A. RSO)
- Consistent with Paladin's strategy of encouraging vacancies through voluntary buyouts

1978 City of Los Angeles Rent Stabilization Ordinance (RSO)

- Applies to properties built in the City of Los Angeles before October 1978
- Annual rent increases established by RSO board (historically 3-4%)
- Allows units to be re-leased at market rates upon a vacancy
- Establishes rules and limits for pass-thru of certain major renovation costs and operating expenses

- Disclosure notice required for voluntary buyouts; while there is no set minimum compensation, mandatory relocation assistance ($8k-22k) for renovation evictions provides a reference for negotiations
- Consistent with Paladin's strategy of encouraging vacancies through voluntary buyouts (buyouts for City of L.A. RSO-controlled properties are typically more costly than under AB 1482, which is reflected in asset pricing and underwriting)

Tenant, Homeowner and Small Landlord Relief and Stabilization Act of 2020 (AB 3088)

- Temporary statewide COVID-19 eviction restriction law signed 8/31/20
- Tenants who pay 25% of rent from 9/1/20 to 1/31/21 protected from eviction
- Landlords can sue to for deferred portion of rent in March 2021
- Voluntary buyout agreements are unrestricted
- Temporary impediment to Paladin's strategy

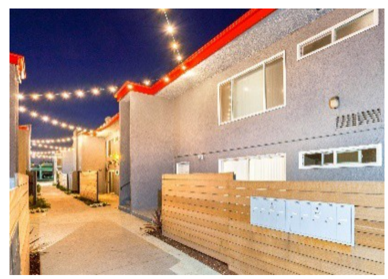
2020 CDC National Temporary Eviction Moratorium

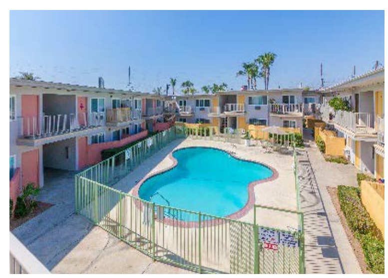
- Temporary nationwide eviction moratorium signed 9/1/20; expires 12/31/20
- Protects tenants earning under $99k; must demonstrate COVID hardship
- Landlords can sue for deferred portion of rent
- Voluntary buyout agreements are unrestricted
- Temporary impediment to Paladin's strategy

Proposed Laws

Rental Affordability Act (RAA, Prop 21)

- Main pending rent control initiative that could have potentially negative long-term consequences for Paladin's strategy, although near-term impact should be neutral
- November 2020 ballot initiative (Prop 21) that would replace 1995 Costa-Hawkins
- If passed, Prop 21 (RAA) would:
  - Allow, but not require, local governments to establish new rent control ordinances on residential properties over 15 years old
  - Allow local limits on annual rent increases to differ from AB 1482 limits
  - Allow local governments to enact new vacancy control regulations that can limit new rents upon a vacancy to no greater than 15% over the first three years of the new lease term (above any increases allowed by local ordinances)
- Similar ballot initiatives in the past have been rejected by wide margins
- If passed, RAA will likely be challenged in court and create pricing distortions while the market adjusts to the new reality and legal uncertainty
- Near-term impact should be neutral; could be negative to Paladin's strategy over the longer term if local vacancy control ordinances gain traction, although acquisition pricing will likely become more favorable reflecting the limitations on rent increases





Tax on Commercial and Industrial Properties for Education and Local Government Funding Initiative (Prop 15)

- November 2020 ballot initiative would modify California's Prop 13 by creating a "split roll" for commercial properties whose owners have property holdings of more than $3 million
- Property taxes are currently limited under Prop 13 to 1% of the purchase price, increasing annually by 2% or less thereafter
- Prop 15 would base property taxes for commercial assets at market value, to be phased in over 2022-2023
- If passed, Prop 15 will likely place additional cash flow pressure on existing owners with low property tax basis
- Likely to have little effect on Paladin's strategy, although it will put additional pressure on some long-time owners to sell

Strategy Implications

Paladin's primary strategy in dealing with rent control regulations has been to encourage vacancies during building renovations through voluntary tenant buyouts. With the exception of Prop 21 (whose long-term effects are most uncertain and will largely depend on whether future vacancy control ordinances are enacted in any of Paladin's local markets), Paladin believes that the other existing and proposed regulations described above create a neutral to positive near-term environment for the execution of its value-added apartment strategy in Southern California.

While the near-term effects of Prop 21 should be limited, if passed it could potentially have negative implications for Paladin's strategy over the longer term if momentum grows in Southern California for local vacancy control regulations in the future. While such local vacancy control regulations have historically been quite limited in scope (e.g., Santa Monica and West Hollywood were the only Southern California municipalities with vacancy control prior to 1995), there is a risk that California's chronic affordable housing crisis might provide future political support for such local regulations going forward, which warrants further monitoring. In addition, such regulations will likely result in owners allowing their properties to deteriorate and eventually be removed from the rental housing stock (which is what happened in Santa Monica and West Hollywood prior to 1995), only exacerbating the shortage of affordable housing – the opposite of what is intended by most of these rent control regulations.

As mentioned above, Paladin has considerable experience navigating the complexities of California's various ordinances affecting residential rental properties, which Paladin believes provides it with a competitive advantage in a highly fragmented market dominated by less sophisticated "mom and pop" owners and investors.

About Paladin Realty

Founded in 1995, Paladin Realty Partners, LLC is a boutique private equity investor, developer-operator and fund manager focused on institutional-quality real estate investments in the U.S. and select markets in Latin America. To date, the firm has invested in nearly 200 properties across the U.S. totaling over US$2 billion of total cost, including more than 15,400 rental apartment units totaling nearly $800 million in total cost, hotels, office, industrial, and land developments. In addition, Paladin Realty has over a 20-year track record investing in Brazil, Mexico and the Andean region across more than $4 billion of real estate (over 200 assets) comprising over 37,000 for-sale residential and commercial condominiums, income-producing commercial properties and land developments. The firm is a U.S. SEC-registered investment adviser headquartered in Los Angeles, California, with regional offices located in Brazil, Mexico, Peru, Colombia and Costa Rica. www.paladinrealty.com

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For questions or comments regarding this report, please contact:

George Pappas
Managing Director
gpappas@paladinrp.com

Frederick Gortner
Co-Founder & COO
fgortner@paladinrp.com

Evan Pickering, CFA
Vice President
epickering@paladinrp.com

Published September 18, 2019