The Resmark Companies

Investing in the West Coast housing market and navigating regulatory trends

Recently, **Geoffrey Dohrmann,** president and CEO of Institutional Real Estate, Inc., spoke with **Ziv Cohen,** chief investment officer of The Resmark Companies (Resmark). The following is an excerpt of that conversation, which took place on March 4, 2020, prior to U.S. shelter-in-place mandates necessitated by the COVID-19 pandemic. It presents the interviewee's opinions reflecting market conditions as of that date. While many of the topics discussed herein concern fundamental industry matters, there are immediate implications of COVID-19 that are not covered in this conversation.

Following up on the article Resmark wrote on the California Rent Control Bill AB 1482 (AB 1482): How, if at all, has the legislation affected Resmark's investment thesis, pipeline and underwriting?

Resmark focuses exclusively on residential real estate development. Since our inception in 1995, California has been a key target market for us. Historically, approximately 50 percent of our portfolio has been invested in California, so we are keenly focused on understanding the nuances of the market. We take a micro-market approach to our research, constantly studying supply-and-demand imbalances and specific trends, such as local employment and the introduction of new mass-transit lines. With boots on the ground, we aim to always maintain a local perspective. The political and regulatory environment is one of many key considerations reviewed and documented during investment underwriting. However, our underwriting for new development projects is not significantly affected by AB 1482, as the legislation applies to buildings that are 15 years or older.

We focus primarily on two segments of the market: urban core-adjacent and urbanized suburban. Urban core-adjacent locations represent the first ring of neighborhoods and residential mixed-use areas that surround the central business district within the gateway cities. Urbanized suburban locations are areas of planned residential and mixed-use growth located in a suburban setting, which incorporate highly desired urban-centric characteristics such as amenity-rich walkability, diverse residential and retail offerings, and readily accessible public transportation. This market focus is important because, even if rent control becomes more prevalent in California, we believe we are well protected.

Why do you believe these locations are protected?

Historically, the more concentrated the lower-income population is, the more likely the municipality is to enact rent control. We have been operating in areas that have typical rents ranging from $2,000 to $3,000 per month, which implies $90,0000-plus of household income. These municipalities are less likely to enact rent-control regulations. This, coupled with the 15-year exemption, provides for some comfort.

It seems that what I am hearing is that the California rent control bill has negative implications for value-add real estate, with only minor disruption to development.

That is correct. Along with potentially lower property values and shrinking margins, the AB 1482 rental cap will limit one's ability to potentially profit from renovations/improvements for class C buildings and, to a lesser extent, class B buildings. In turn, this will affect the project's cash flow and corresponding value. We believe that a significant mismatch exists between the increase in rent allowed by AB 1482 and the cost of an average class C building renovation. This mismatch will likely cause renovations to become less feasible in California and, as a result, incentives for value-add projects may drop to levels that fail to attract new participants.

AB 1482 is one example of California's ever-changing regulatory environment. How has this environment affected the pipeline for residential developers?

Structural, regulatory and bureaucratic constraints within California's various jurisdictions have continued to limit housing starts and perpetuate the statewide and nationwide housing shortage. The entitlement process for new development and AB 1482 are two examples of these current constraints. It is becoming more difficult to process new pipeline in California, which requires exceptional local expertise.

What do you view as the primary regulatory considerations when investing in California real estate?

There are three key considerations. First, is the SB 330 Housing Crisis Act of 2019 (SB 330). SB 330 addresses the statewide housing crisis by restricting local rules that limit housing production, speeding housing project approvals, and preserving existing housing stock. The act declares a statewide housing emergency in effect until Jan. 1, 2025, when several components of the law will expire.

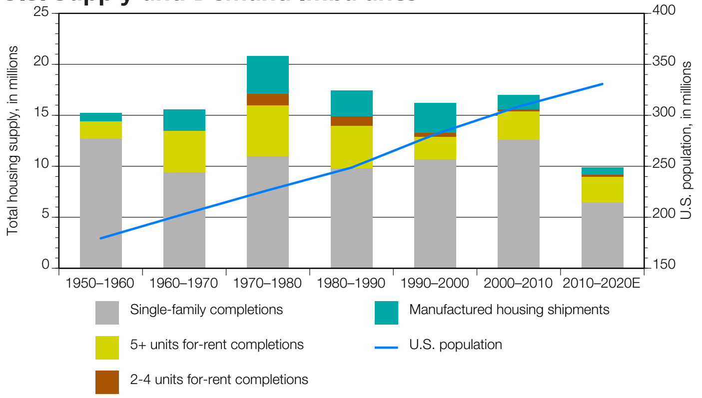
Second, the state government is attempting to alleviate some of the pressure that comes from rent-control advocates, while trying to remain pro-development. By passing AB 1482, which puts a cap on rent growth for buildings that are 15 years or older, they are doing just that. As I mentioned before, I think that AB 1482 actually creates a little bit of turmoil in the renovation business.

Third is the California Local Rent Control Initiative, which has qualified for ballot in November 2020. This initiative is spearheaded by a coalition that failed to pass Proposition 10. This ballot measure would replace the Costa-Hawkins Rental Housing Act that was passed in 1995 and gives municipalities the power to regulate rent control, which could have significant impact on our entire industry.

West Coast markets, California in particular, with limited supply and very high housing costs, make multifamily living attractive, and yet these policies that are designed to help seem to be limiting the delivery of more supply. Why is this happening?

After the Global Financial Crisis, for-sale housing new starts came to a complete halt. For-sale home supply is still

U.S. Supply and Demand Imbalance



Sources: U.S. Census Bureau, Zelman & Associates analysis, 1940 to 2010 Decennial Censuses, 2008 National Population Projection

undersupplied by a significant margin to its historical norms. Meanwhile, population continues to grow and household formation since 2010 is positive. In fact, over the past 30 years, the United States has added 1.2 million households every year, on average. With growth in population and households, the substantially restricted supply of houses, and the inability of many households to afford a down payment or a mortgage, the propensity to rent increases. This demand caused substantial growth in rents, which, in turn, strengthened the voices against market-rate rent growth and for rent control. Such voices always give pause to the potential new investment and, in turn, more supply. In addition, regulation and the administrative costs of development are prohibiting the development of privately financed workforce housing — which is a segment of the market that is not properly fulfilled. In my opinion, these measures are trying to solve a societal issue of income inequality with a real estate solution, which is not the only solution. There are additional measures that need to be considered other than the restriction of rental rates.

Given the demand for multifamily for-rent properties, is the asset class getting oversaturated?

Since 2010, both the for-sale and for-rent housing market in the United States has been vastly underserved, which has created a national housing shortage that has perpetuated the demand for new development. That said, not all markets are created equal, so it is critical for investment managers to understand demand drivers at a micro-market level. At Resmark, we conduct diligence down to the cross-street, not only to ascertain demand drivers, but also to inform our strategy to sell or hold the property. While there is a healthy demand for multifamily new development, we do believe that capital for value-add and renovation investments appears to be oversaturated, which, in turn, drives value-add returns to below their desired risk/return targets.

Given the aforementioned regulatory considerations, not just in California, but other coastal markets such as Oregon, why should an investor continue to invest in these markets and not seek alpha elsewhere?

This is something that we at Resmark think about all the time, and we always come back to the data. Let's consider California, specifically, although this thesis is also relevant to Seattle and Portland, Ore. Almost 40 million people live in California. It is a technology, aviation, aerospace and entertainment hub, and, not surprisingly, it has one of the largest agricultural bases in the world, providing food to half the world. Given this strong economic backdrop, it is difficult to argue that California is not the right place to invest. From an asset-pricing perspective, California and the West Coast still present attractive risk-reward opportunities for investors.

Given the complexities and ever-changing nature of regulatory matters, what are the key considerations an investor should weigh when selecting a manager to deploy a residential real estate strategy?

We believe that there are two qualities that differentiate a manager — the ability to assess and proactively manage risk, and focus/specialization. The ability to accurately identify, assess and manage risk during each phase of the market cycle is critical, which comes from having a long-term history within the asset class and target markets that you operate in. And, secondly, it is important that the manager is a specialist or "sharp-shooter." At Resmark, we pride ourselves in having a seasoned management team with an average of 26 years of multi-cycle tested, residential real estate experience. We believe that this specialization has allowed us to remain disciplined in our investments and also remain nimble in our decision-making process.

What is your vision of how the multifamily sector will perform in the face of a downturn?

While the aforementioned national housing shortage will continue to be a reality, it is difficult to predict how this sector will perform in a downturn. At Resmark, we have remained mindful of cycle maturity. As capital providers in the multifamily development space, we are able to remain nimble as an organization and act decisively in light of a downturn. For us, when we see indicators, we take our foot off the gas — it is as simple as that. We believe that having excess dry powder during a downturn allows us to take advantage of unique investment opportunities that result from market turmoil.

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CORPORATE OVERVIEW

Founded in 1995, **Resmark** is a residential real estate investment manager that finances, develops and manages real estate in California, the western United States, Texas, the Washington, D.C./Mid-Atlantic region, and other select major metropolitan markets nationwide. To date, Resmark has participated in more than 230 real estate projects encompassing over 35,000 single-family lots and homes and multifamily residential units. Celebrating its 25th anniversary in 2020, Resmark is headquartered in Los Angeles and also maintains offices in San Diego and Irvine, Calif.; Austin; and Washington, D.C. For additional information, please visit Resmark.com.