

Finding the Line

Permitted Regulation or Fifth Amendment Taking Under Residential Rent Controls

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Abstract

Rent control is becoming more prevalent as a tool of public policy in the United States. One of the many issues that arise with this topic is the line between permitted regulation of business and the unconstitutional taking of property requiring compensation under the Fifth Amendment. Regulatory takings differ from the physical takings of property that appraisers are most familiar with. For physical takings, the taking of the property is not disputed. To establish that a regulatory taking has or will occur, the property owner must establish that the regulation exceeds constitutional authority by a sufficient magnitude in order to establish a taking. For a rent control law to be constitutional, appellate courts have required that the property owner must be able to request a rent adjustment based on the need to obtain a "just and reasonable return" on their investment. Tools used in the application and review process are rooted in the appraisal body of knowledge and include capitalization theory, yield analysis, rental market research and analysis, and concepts of value. In rent control cases, these theories and tools have been employed most often by persons other than appraisers. Real estate appraisers, with understanding and expertise in the twin disciplines of financial and market analysis necessary to properly advise legislative bodies and the courts, have had limited historic input. Readings of position papers and court decisions reveals confusion and contradictions arising from the application of appraisal theory and techniques by nonappraisers. The intent of this article is to examine the various theories used in the determination of just and reasonable or fair return, to note how the appraisal body of knowledge is applied in these theories, and how misapplication of appraisal theory and analytical tools has distorted the analyses made and results achieved, and to suggest a comprehensive process to provide both legislators and jurists with appropriate assistance in the determination of just and reasonable return in the rent control context.

Introduction

Finding solutions for the perceived lack of affordable housing in the United States has become a major focus of public policy. State and local governments have struggled with implementation of policies to address this problem. Proposed solutions have ranged from "carrots," such as development incentives and allowing higher densities, to "sticks" that include restrictions on the use of residences for short-term rentals, discouragement of the displacement of lower-income tenants by gentrification in urban areas, and the imposition of rent controls.

Rent controls tend to be the most controversial of the public policy choices, as they bear the potential to cross the line from permitted regulation of business to the taking of private property requiring compensation under the Fifth Amendment. For the past 50 years, makers of public pol-

icy and the courts empowered to interpret it have struggled to craft a clear path through this thicket and have not been able to establish clear and credible guidelines.

The theories intended to test these guardrails are rooted in the appraisal body of knowledge and the practice of financial and market analysis employed by appraisers. In published articles and testimony, the presenters of these theories have historically been attorneys, accountants, urban planners, legislative advocates, and others with little or no educational or experiential practice in applying the appraisal body of knowledge or market-based analyses to the problem of defining and quantifying fair return. This inexperience has led to oversimplified applications of complex valuation theories and analysis, and to participants in policy debates and implementation ignoring critical components of valuation theory and practice to a predictable conclusion.

Rent controls have long been the subject of study by various academicians, economists, and public policy wonks. Appraisers should have a place in the process, as the appraisal body of knowledge is well suited to consider impacts of public policy on value and provide a definition of the line between allowed business regulation and compensable confiscatory behavior.

This article will review the predominant theories used in the process, examine the strengths and weaknesses of each, demonstrate internal contradictions that limit credibility, and suggest the tools necessary to provide credible analysis.

History

Modern residential rent controls were implemented in the 1970s in individual cities in several states (California, New Jersey, Massachusetts) to variously address residential unit rents in multi-family housing and homesite rental rates in mobile home parks.¹ Statewide rent regulations have been imposed by Delaware (mobile home parks), Oregon (rental housing and mobile home parks), and California (rental housing).² State laws and local ordinances affecting both mobile home parks and rental housing have been the subject of discussion and legislative proposals in other states, and intervention at the federal level is also being proposed.

The provision of a mechanism for the property owner to seek rent increases to achieve a “just and reasonable return” or a “fair return”³ is an integral part of local laws and ordinances following court direction but is generally missing from

the various state laws. Challenges based on this failure to include an appropriate mechanism for this purpose are reported⁴ and may expand as more states impose rent controls or provide local jurisdictions with the power to enact controls.

Characteristics of the Controls

Rent controls govern the property owner’s ability to negotiate rental rates with tenants under two circumstances in residential housing and under three in mobile home parks:

1. Periodic rent increases to existing tenants are generally limited to annual imposition. Rents may be allowed to rise by the local CPI change, or some percentage of the CPI change, and may have minimum or maximum limits. A few jurisdictions require a statutorily described application process for any proposed increase.
2. Negotiations with an incoming tenant upon the vacating of a rental unit or homesite may be limited under some regimes, unlimited under others. In California, the Costa-Hawkins Rental Housing Act⁵ prohibits local ordinances from placing controls on the initial rent to an incoming tenant in rental housing but does not apply to mobile home parks where local ordinances may directly address vacancy decontrol.
3. Rent negotiation involving the transfer of tenancy that comes with the sale of a mobile home from the outgoing tenant to an incoming tenant may or may not be controlled.⁶

1. The terms *manufactured housing communities* (MHC), *mobile home park* (MHP), and the now-obsolete *trailer park* are used to describe properties in which homesites are under one ownership and are rented to tenants who own homes built off-site and placed on the rented homesites. For the purposes of this article, the term *mobile home park* is used because these properties are named such in legislation, articles, and court decisions. From the standpoint of rent controls, the terms are interchangeable.

2. California does not have statewide rent controls for mobile home parks, but more than 100 individual cities and counties have imposed rent controls on mobile home parks.

3. The terms *just and reasonable return* and *fair return* are used interchangeably in writings and court decisions, and this article will primarily use the latter term for brevity.

4. California AB 978 (2021) placed a state rent control regulation (California Civil Code § 798.30.5) on a single mobile home park in Orange County. An active challenge to the law by the property owner references the failure to include such a mechanism in the state law, among other charges. The Orange County Superior Court has found the law to be unconstitutional due to the lack of a mechanism allowing the owner to seek a fair return. As of this writing, the State of California has appealed the decision to the California Court of Appeals, Fourth Appellate District, where the case is currently pending (*Anaheim Mobile Estates LLC v. State of California*).

5. California Civil Code, § 1954.50 et seq.

6. This is an MHP specific issue. It is argued by some that if the outgoing tenant vacates the rented homesite prior to the time that the incoming tenant moves in, a vacancy has occurred because the tenant has left the property. Others argue that a vacancy only occurs when the mobile or manufactured home is physically removed from the site. Some ordinances specify different treatment for rent adjustment when the homesite is vacated than is required when the tenant sells the home to a successor tenant.

Defining the Problem of Fair Return

Two New Jersey cases in the 1970s addressed the line that divides allowed business regulation from regulatory takings that require Fifth Amendment compensation. In *Fort Lee*,⁷ the New Jersey Supreme Court concluded that municipal powers included the right to regulate rents, but noted in *Hutton Park* that “price controls which do not permit an economically efficient operator to obtain a ‘just and reasonable’ return on his investment are deemed confiscatory.”⁸

“Just and reasonable return” is not a defined term in the body of knowledge of any profession normally identified with financial analysis, including appraisal, accounting, actuarial practice, or any similar discipline. The definition of this boundary concept is left in the hands of attorneys, position advocates, and legislative bodies and in appellate court decisions, and all have struggled to set clear and credible definitional parameters. Attempts by courts to define boundaries, and a statement of principles quoted in subsequent appellate decisions,⁹ notably *Birkenfeld*,¹⁰ is found in *Troy Hills*,¹¹ setting the following series of tests to determine constitutional compliance:

1. The income must be sufficient to encourage good management measured as
 - a. Ability to provide adequate maintenance of services
 - b. To allow regulated property owners to profit from efficiency
 - c. To discourage the flight of capital from the rental housing market, and
 - d. To allow owners to maintain and support their credit.
2. The allowed income must provide returns similar to investments of corresponding risks, and

3. The resulting rent should not be so high as to defeat the purposes of rent control, and not so high as to demand more from tenants than the fair value of property and services provided.

The multiple tests cannot be addressed by a single analysis. Test 1 is largely based on financial analysis, while Tests 2 and 3 are based on investment market analysis and rental market analysis, respectively. These are all part of the appraisal body of knowledge. In fact, the ability to provide both financial and market analysis at this level is held by no other profession.

Principles of Fair Return, Operating Theories

Applicable standards can be divided into three categories, with some variations. These are

1. Standards based on analysis of income in a single year,
2. Standards based on analysis of income in multiple years, and
3. Standards based on an unsupported presumption of fair return in a specified base year.

Fair Return Measured on Single-Year Analysis

The analysis of a single year's income is the basis for the most common fair return analyses. Three premises may be presented. These are fair return on value (FROV), fair return on investment (FROI), and fair return on equity (FROE). All three premises use a reciprocal operation of the basic capitalization formula (value = income / rate), restating the formula to solve for income (income = value × rate).

7. *Inganamort v. Borough of Fort Lee*, 62 N.J. 521 (N.J. 1973), 303 A.2d 298.

8. *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. 543 (N.J. 1975), 350 A.2d 1.

9. This case and these principles have been often cited in subsequent cases, not only in New Jersey, but in Massachusetts and California appellate decisions as well. The website www.casetext.com notes 61 subsequent cases that cite this statement from *Troy Hills*.

10. *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129.

11. In *Troy Hills VII. v. Tp. Council Tp. Parsippany-Troy Hills*, 68 N.J. 604, 350 A.2d 34 (N.J. 1975), the court determined that “to be ‘just and reasonable’ a rate of return must be high enough to encourage good management including adequate maintenance of services, to furnish a reward for efficiency, to discourage the flight of capital from the rental housing market, and to enable operators to maintain and support their credit. A just and reasonable return is one which is generally commensurate with returns on investments in other enterprises having corresponding risks. On the other hand, it is also one which is not so high as to defeat the purposes of rent control nor permit landlords to demand of tenants more than the fair value of the property and services which are provided.”

The theory behind each analysis is straightforward in concept but problematic in execution.

- In the fair return on value (FROV) analysis, property value is the basis for determining rent necessary for fair return, using the equation $I = V \times R$. The value (V) and rate (R) variables are subject to significant controversies in application.
- For fair return on investment (FROI) analysis, the “value” component reflects the historic purchase price of the property plus capital investments in the property, with full or partial indexing of inflation applied.
- FROE is equity based, taking into consideration the owners’ equity in the property, based on market value or inflated historic cost, actual loan terms, and financing costs.

Limiting investment analysis to the examination of a single year’s income is problematic for an investment that is intended to be held for multiple years. Failing to consider the impact of rent controls on the income of the property in past and future years, as well as the impact on the eventual sale of the property, is an unworkable theory on its face. However, its widespread use (and its required use under some regulations) necessitates a comprehensive look at the issues presented in a single year’s analysis so that its weaknesses and contradictions are fully understood.

Single-Year Analysis: Fair Return on Value

In solving for value, the most common use of the basic capitalization formula, the valuer generally has strong confidence in the variables. The income component has high reliability, based on actual income reports from the property or market sources. The rate component is established through a variety of sources such as confirmed sales data or market participant surveys. The solution to the equation (the value) can be reasonably tested against records of comparable sales or replacement cost estimates.

Solving for income does not offer a similar level of support for the variables. The value component (V) is the subject of widespread debate with no consensus as to its definition in the rent control context. Using the current market value of a

property that has been subject to price controls will appeal to tenants, while using the market value of the property assuming market rents, reflecting the value in the absence of controls, will appeal to property operators.

Procedural definitions of the value component are varied, and sometimes mix concepts that an appraisal practitioner would quickly see as incompatible. In *San Marcos*, the local ordinance defined the value component, stating “Investment shall include but not limited to the current market value of the mobile home park, [actual capital invested and original purchase price],”¹² incorrectly defining *market value* as the owner’s historic investment in the property. Examples of similar confusion regarding the basic definitions of critical terms is found throughout rent control writings, regulations, and court decisions, and should not be ignored.

One concept that has been emphasized by the courts is what is known as “circularity.” In *Cotati*, the court stated:

The fatal flaw in the return on value standard is that income property most commonly is valued through capitalization of its income. Thus, the process of making individual rent adjustments on the basis of a return on value standard is meaningless because it is inevitably circular: value is determined by rental income, the amount of which is in turn set according to value. Use of a return on value standard would thoroughly undermine rent control, since the use of uncontrolled income potential to determine value would result in the same rents as those which would be charged in the absence of regulation. Value (and hence rents) would increase in a never-ending spiral.¹³

This description is an oversimplification of market forces affecting value. Increases in rental rates will contribute to a higher value only to a point. Income from excess or above-market rental rates is perceived by the market to have higher risk of continuance and result in a lower marginal value increment, as noted in the appraisal body of knowledge.¹⁴ Proponents of the theory have not offered support from market studies, comparing controlled and uncontrolled markets with similar demand levels, or any academic research

12. *San Marcos Mobilehome v. City of San Marcos*, 192 Cal. App.3d 1492 (Cal. Ct. App. 1987), 238 Cal. Rptr. 290.

13. *Cotati Alliance for Better Housing v. City of Cotati*.

14. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed. (Appraisal Institute, 2020), 422–423.

on the theory. The proponents and the courts accept it as an *a priori* fact.

The acceptance by the courts of the unlimited circularity argument further limits the usefulness of the *FROV* concept as it places a rule in the process of analysis that is neither supported nor required to be supported as a basis for its consideration in the context of fair return.

Single-Year Analysis: Fair Return on Investment

The *FROI* concept places the historic cost of the property plus capital expenditures, adjusted by inflation, as the value variable in the equation. This may provide a supportable indication of value in the equation if the property was recently purchased in a market transaction. This concept is more problematic if the property has been long held or obtained through a gift or inheritance or if the owner was the original developer. The primary justification stated for this concept lies in its avoidance of the assumed circularity trap, but has the same real weaknesses associated with *FROV*. In addition, *FROI* would tend to disadvantage owners who were able to negotiate a lower price for the property at the time of purchase or who have added value through upgrades or property repositioning.

Single-Year Analysis: Fair Return on Equity

Fair return on equity (*FROE*) directly addresses the financial return to the owner of the specific property. It has been subject to criticism from commentators and the courts due to differing loan terms in controlled properties. In *Helmsley*, the New Jersey court noted that “diverse financial arrangements should not be a factor” in determining allowable rent increases commenting that this “encourages landlords to refinance their mortgages at higher interest rates.”¹⁵ This presumes that a property owner would voluntarily increase the risk of the investment and the cost of leverage with no apparent benefit to obtain a rent increase that would only offset the increased expense. In other cases, courts have allowed consideration of debt as an expense where permitted in the ordinance.¹⁶ *FROE* suffers from the same flaws as the other single-year analyses, and it

would lead to different results for similar properties that were subject to different financing arrangements.

Single-Year Analysis: Determination of Value

Developing an opinion of property value is obviously a task that real estate appraisers are well able to provide, but in the rate-setting context the appropriate valuation assumptions are not well defined. Should the appraisal consider controlled rental rates or market rental rates (leased fee or fee simple) in the projection of income for valuation? The former reflect the value placed by the market on the property as currently restricted, while the latter reflect the market value unimpeded by the rent restrictions. The courts are unclear on this point, except to insert the circularity argument into the mix, as discussed further below.

Single-Year Analysis: Determination of Rate

The lack of consensus on the value component is mirrored by similar controversy regarding the appropriate rate to be used in the equation $I = V \times R$. The goal is to establish something conceptually like an internal rate of return based solely on the income received in a single year, an impossible task given the failure to consider past income or project future events that will affect the rate of return. Rates used include yield rates and overall capitalization rates, neither of which is well suited.

Yield rates—primarily discount rates—are used in “the process of converting future cash flows into a present value.”¹⁷ The use of discount rates is not well supported in the context of a single year’s analysis. While yield rates—primarily the internal rate of return—can be a vital component of the financial analysis utilized in the fair return process, these rates are ill suited for the analysis of a single year’s income.

Attempts to adjust yield rates for use with a single-year income report by estimating the influence on the yield rate caused by the events not encountered in the selected year but expected to influence income and value over time become extraordinarily complex and difficult to explain to

15. *Helmsley v. Borough of Fort Lee*, 78 N.J. 200 (1978), 394 A.2d 65.

16. See *El Dorado Palm Springs Ltd. v. Rent Review Commission*, 230 Cal. App.3d 335, 281 Cal. Rptr. 327 (Cal. Ct. App. 1991) and *Palacio De Anza v. Palm Springs Rent Review Commission*, 209 Cal. App.3d 116, 257 Cal. Rptr. 121 (Cal. Ct. App. 1989).

17. *The Appraisal of Real Estate*, 15th ed., 476.

boards and arbitrators with the clarity and credibility necessary to support use.

Rent control advocates and some courts have adopted the use of an overall capitalization rate (OAR) as an indicator of the fair rate of return. A proponent of OAR use in this context, Kenneth K. Baar, PhD, an urban planner and attorney who frequently assists in the writing of rent control ordinances and serving as an expert witness for cities and tenants,¹⁸ wrote in 2006, “One appropriate measure of a reasonable rate of return is the prevailing capitalization rate for mobile home park purchases, i.e., a measure of actual rates of return currently commanded and received by investors in mobile home parks.”¹⁹ The use of an OAR indication for the rate of return has been sanctioned by the California appellate courts in *Capitola*, *Colony Cove*, and other cases.²⁰

The use of overall capitalization rates present two significant problems in this process. As noted in the appraisal body of knowledge, “the process appears rather simple. The practitioner need only estimate the income and the factor or overall capitalization rate.”²¹ This simplicity is attractive to rule-making authorities and the courts because the significant caveat “that the overall capitalization rate is valid only if it accounts for all the other characteristics of the property”²² is widely ignored in the rent control context as the proponents of its use seek to portray the OAR as a simple and direct solution to the determination of the rate.

The risk of ignoring the complexity has been well documented in appraisal literature:

Appraisers and some courts are attracted to direct capitalization’s apparent simplicity and close representation of market behavior. They understand the basic components and follow the math. Unfortunately, they do not seem to grasp the unavoidable necessity for appraisers to understand just as much about each comparable they are extracting the rate from as they would know

about the market in a discounted cash flow analysis. Information is necessary for all four of the investment criteria not explicit in the model, but that are implied in the capitalization rate: the projection period, the yield rate, the change in income over the projection period, and the property reversion. Without this information, the capitalization rate used in determining the value is no better than a pure guess, and the chance of getting the value right is no more than coincidence.²³

In addition to the problems attendant to the use of unconfirmed overall rate data as cited by Lennhoff, events of the past decade have indicated that overall capitalization rates derived from sales of properties may be significantly influenced by other factors that render use of overall capitalization rates as inappropriate for measuring investment return over time. The historically low interest rates, increases in capital inflows, and high housing demand that were experienced during the post Great Recession and pandemic eras (2017–2022) resulted in reported overall capitalization rates for multifamily and mobile home park properties that were exceptionally low by historic standards. The trend was rapidly reversed in 2023 with the increases in interest rates. Overall capitalization rates have become indicators of market trends that may exist only for limited periods of time and may be heavily influenced by temporary factors from within the property (risk, upside potential) and outside (financing costs, investor demand, competition) that preclude the use of market-derived overall capitalization rates as an indicator of stable investor expectations to be considered in a rent control context no matter how comprehensive the analysis of sales data might be.

If the overall rate is to be used as R in the $I = V \times R$ equation, the complexity of issues noted above are not lessened and take on greater significance in the context of rent controls that limit rental rates and rental rate increases, affect-

18. According to his 2024 CV, Baar has assisted fifteen California cities in the drafting of mobile home park rent legislation and has served as an expert witness for cities and tenant groups in twenty-two fair return cases.

19. Kenneth Baar, “Fair Return Standards Under Mobilehome Park Space Rent Controls: Conceptual and Practical Approaches,” *Real Property Law Reporter* (September 2006): 333.

20. *Los Altos El Granada Investors v. City of Capitola*, 139 Cal. App.4th 629, 43 Cal. Rptr. 3d 434 (Cal. Ct. App. 2006) and *Colony Cove Properties LLC v. City of Carson*, 220 Cal. App.4th 840 (Cal. Ct. App. 2013) • 163 Cal. Rptr. 3d 499.

21. *The Appraisal of Real Estate*, 15th ed., 433.

22. *Ibid.*, 433.

23. David C. Lennhoff, “Direct Capitalization: It Might Be Simple but It Isn’t That Easy,” *The Appraisal Journal* (Winter 2011): 73.

ing the future income and market perceptions that will determine the reversion.

Finally, the claim is made by proponents of use of the overall rate that the OAR incorporates value appreciation, which is presented as inevitable for all properties. Proponents often cite the rise in the sale prices of single-unit residences over time in the locale of the property as evidence for a form of universal value appreciation, reflecting limited understanding of the differences between the investment real estate market and the owner-occupant residential market.

The use of overall capitalization rates as a measure of fair return fails because of insufficient analysis of comparable sales data, the application of an oversimplified analysis that fails to consider the multiple causal components present in the OAR, and the use of the unsupported assumption that any change in the value of investment properties over time is decoupled from the change in income over time.

Single-Year Analysis-Conclusion

The use of a single-year income report in the FROV, FROI, and FROE methodologies presents sufficient challenges in both theory and execution to render the results as not credible. One year's income report does not provide sufficient information regarding the return on investment from a property that is intended to be held for years and is subject to varying influences and events over time.

Further, the analytical tools available to determine the value of a rent-controlled property in the context of a rate-setting dilemma and to determine an appropriate rate of return from rates that are developed for other purposes and poorly adapted to this use leads to unsupported results. The willingness of proponents and courts to overlook the need for well-supported analysis and to accept unsupported conclusions further damages any credibility. It is also subject to abuse by rate setters who, according to Baar, "tend to make a

mental determination as to what rent is fair, and then choose a value and rate of return which support their conclusion."²⁴

Fair Return Measured by Multiple-Year Analysis

The analysis of multiple years of income is strongly tied to well-documented and well-supported financial analyses used by investors, lenders, developers, and appraisers in the normal course of analyzing investments. Adapting the tools used for the analysis of multiple years of income reports or projections is a straightforward process and benefits from a wide understanding of the process, limiting reliance on the questionable assumptions that are forced to be made in the analysis of a single year's income.

The use of an analysis that is based on the comparison of the Internal Rate of Return (IRR) with Yield Rates developed from surveys of investors (personal or published), market data analysis, or other sources is easily understood and able to be checked for mathematical correctness and reasonableness.

In a widely quoted 1983 article, Baar used a projected 10-year cash flow to present the return to an investor on a non-rent controlled apartment development²⁵ (Exhibit 1). This IRR analysis was taken from an article appearing in *The Appraisal Journal* written by Harold A. Davidson in 1978.²⁶

The inclusion of the IRR analysis in published articles as early as 1978 and 1983 indicates that the early writings on the topic used an IRR-based analysis to demonstrate investment return in a rent control context.²⁷ Michael St. John, PhD, an economist who has written numerous articles and testified in numerous public hearings and trials as an expert on rent controls, concluded that "the IRR is the only fair return formula which truly accounts for all financial costs and benefits of an investment. The other formulas are easier to apply, but the internal rate of return formula is

24. Kenneth K. Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade," *Rutgers Law Review* 35, no.753 (1983): 800.

25. Baar (1983): 741.

26. Harold A. Davidson, "The Impact of Rent Control on Apartment Investment," *The Appraisal Journal* (October 1978): 570.

27. It should be noted that the Davidson IRR analysis reported in *The Appraisal Journal* used consideration of the tax benefits available at the time, which were later mooted by the Tax Reform Act of 1986. The concluded IRR of 18.5% relied heavily on the pre-1986 benefits. The IRR based solely on the NOI and the purchase and sale prices estimated by Davidson provided an IRR of 8.2%. Davidson's article went on to demonstrate the impact of controlled rents on the IRR, but these illustrations were not included in Baar's *Rutgers Law Review* article.

Exhibit 1 Example of *IRR* Analysis

TABLE 2.2b										
PROJECTION OF NEAR-DOWNTOWN APARTMENT BUILDING RETURNS WITHOUT RENT CONTROL ^{61.2}										
	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Gross rent (increasing at 8% for 2 years, 6% thereafter)	\$243,000	\$262,440	\$283,435	\$300,441	\$318,467	\$337,575	\$357,830	\$379,300	\$402,058	\$426,181
Effective gross rent after 4% vacancy	233,280	251,942	272,097	288,423	305,728	324,072	343,517	364,128	385,975	409,134
Less total expenses (increasing 7% annually)	104,490	11,804	119,631	128,005	136,965	146,553	156,811	167,780	179,533	192,101
Net operating income	128,790	140,148	152,466	160,418	168,763	177,519	186,706	196,348	206,442	217,033
Debt service	121,637	121,637	121,637	121,637	121,637	121,637	121,637	121,637	121,637	121,637
Pretax cash flow	7,153	18,511	30,829	38,781	47,126	55,852	65,069	74,711	84,805	95,396
Depreciation (125% db)	39,548	38,312	37,115	35,955	34,832	33,743	32,689	31,667	30,668	29,719
Interest	114,183	113,443	112,630	111,736	110,753	109,673	108,485	107,180	105,745	104,168
Taxable income (40%)	(24,941)	(11,607)	2,271	12,727	23,178	34,103	45,532	57,501	70,029	83,146
(Tax) Shield	9,976	4,642	(1,088)	(5,091)	(9,271)	(13,641)	(18,213)	(23,000)	(28,012)	(33,258)
After-tax cash flow	17,129	23,153	29,741	33,690	37,855	42,241	46,856	51,711	56,793	62,138
After-tax cash flow return on equity	5.7%	7.7%	9.8%	11.2%	12.6%	14.0%	15.6%	17.2%	18.9%	20.6%
Cash from sale, end of year 10: \$989,463										
Internal rate of return: 18.5%										

1983] GUIDELINES FOR RENT CONTROL LAW 743

Source: Kenneth K. Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade," *Rutgers Law Review* 35, no. 4 (Summer 1983): 743.

The table shown in the Baar article contains a transcription typo. The total expenses reported for 1977 should read 111,804, not 11,804. It is also noted that a math error follows in both the Davidson article and the Baar transcription. The net operating income for 1977 should be \$140,138 and in 1983 the expenses should be corrected to \$167,788. These minor errors (\$10 and \$8, respectively) do not affect the final indication of *IRR*.

capable of providing the most accurate accounting of the profitability of an investment project."²⁸

However, it is rarely presented in fair return cases. This is addressed by St. John, who is an economist, not a financial analyst or appraiser, noting that "the *IRR* computation cannot be made with complete accuracy until the property has been sold. A calculation following sale, however, is too late for purposes of rent regulation."²⁹ This objection, if true or reasonable, would eliminate the use of yield analysis in any context. The

high degree of the use of yield analysis, both in the form of discounted cash flows and internal rate of return analyses across a wide range financial applications, indicates that the objection is not well supported. St. John does suggest that "one solution to this dilemma would be to estimate the value on sale and costs of sale and make an imputed *IRR* calculation. This could be done with the assistance of experts in appraisal."³⁰ An *IRR* analysis for a multifamily property or a mobile home park is not a difficult undertaking

28. Michael St. John, *Fair Return and the California Courts* (St. John & Associates, 1993), 67.

29. *Ibid.*, 67.

30. *Ibid.*, 67.

from a technical or evidentiary perspective. The limitations on income growth imposed by rent controls can be easily projected with a high degree of reliability.

In the following examples, an IRR analysis is shown for illustrative purposes.³¹ These illustrations are simplified for this demonstration, as discussed below. The initial value input can be different based on circumstances, and it may be advisable to consider different value inputs in the analysis based on the circumstances present at the time of the analysis. Appropriate choices include the market value based on rent control restricted income, market value based on market (unrestricted) rental income, or a recent purchase price adjusted for inflation and capital investment.

In the following cash flows, the initial value, with one exception, and initial-year income are set at the same levels for simplicity of illustration. The exit OAR is set at a constant 6% for the illustrations, but the appraiser should consider the impact of the terms of the regulation on future income as one of the considerations in selecting the appropriate exit OAR.

In each of the IRR calculations shown below, the following facts are used:

Initial value	\$2,000,000
Initial OAR	5.5%
CPI growth	3.5%
Rent growth	Varies
Initial expense ratio	45%
Expense growth	3.5%
Exit OAR	6.00%

Following the typical protocol in cash flow projections made for yield analysis, the exit value is based on the application of the overall capitalization rate to the 11th year income,³² the year fol-

lowing the sale, based on the principal of anticipation, the “perception that value is created by the expectation of benefits to be derived in the future.”³³

In the first IRR analysis shown (Exhibit 2), market rental rates are seen as increasing at a slightly faster rate than inflation, which has been projected at 3.5% per year based on CPI trends in the market.³⁴ For demonstration, a rent inflation factor of 4.0% per year is used to demonstrate the growth in income if the rental growth rate was decontrolled and allowed to increase at market growth rates. The numbers shown in the calculations are $\times 1000$ in all examples. This results in an indicated IRR of 9.19%.

In the next analysis (Exhibit 3), a mild rent control ordinance that reduces allowed annual adjustments of rental rates equal to 100% of the CPI change is shown. This results in a decline in the IRR of 89 basis points (bps) to 8.30%.

The third model (Exhibit 4) evaluates the effects of a commonly seen rent control ordinance indexing clause that allows rent increases equal to 75% of the CPI change, or 2.625% based on 3.5% CPI growth. This reduces the indicated IRR in this analysis to 6.68%, a drop of 162 basis points, demonstrating the increasing significance of restricting growth at less than 100% of the CPI. The analysis also shows that the value of the property has only increased by less than 1% (0.9731%) per year, not keeping pace with inflation, demonstrating the inherent weakness noted in the earlier discussion on use of the overall capitalization rate as a rate of return in a single-year analysis.

Finally, some of the more recent rent control ordinances have imposed a ceiling of 50% of the CPI change. This is illustrated in Exhibit 5. This reduces the IRR further to 4.94%, a decline of 174 basis points from the 75% of CPI growth allowed in Exhibit 4 and a 425-bp decline from the market growth model (Exhibit 2). In addition, the reduced rental rate growth in this example is

31. The format of the cash flow analysis (DCF/IRR) is based on *The Appraisal of Real Estate*, 15th ed., 496–497.

32. *The Appraisal of Real Estate*, 15th ed., 509–510.

33. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed. (Appraisal Institute, 2022), 8.

34. It is common for rent control ordinances to base inflation measures on the CPI: All Items for the selected locale or metropolitan area, but some ordinances will specify other indexes instead. Historically, housing costs in urban areas of the United States have increased more rapidly than typical measures of inflation. According to the US Census Bureau, CPI: All Items (CUUS0000SA0) increased by 202.67% from 1984 to 2024, and during the same time period CPI: Shelter Costs Index (CUUS0000SAH1) increased by 286.10%. The appraiser may want to consider local measures of inflation as available.

Exhibit 2 Market Rents Increasing Slightly Faster than Inflation

Year	0	1	2	3	4	5	6	7	8	9	10	11
In/out (\$)	-2,000										2,818	
Rental income (\$) (4.0% growth)		200	208	216	225	234	243	253	263	274	285	296
Less: Expenses (\$) (3.5% growth)		90	93	96	100	103	107	111	115	119	123	127
<i>NOI</i> (\$)		110	115	120	125	131	136	142	149	155	162	169
Income (\$)	-2,000	110	115	120	125	131	136	142	149	155	2,980	169
<i>IRR</i> (%)		9.19										

Exhibit 3 Rent Control Ordinance Reduces Allowed Annual Adjustment to 100% of CPI Change

Year	0	1	2	3	4	5	6	7	8	9	10	11
In/out (\$)	-2,000										2,586	
Rental income (\$) (3.5% growth)		200	207	214	222	230	238	246	254	263	273	282
Less: Expenses (\$) (3.5% growth)		90	93	96	100	103	107	111	115	119	123	127
<i>NOI</i> (\$)		110	114	118	122	126	131	135	140	145	150	155
Income (\$)	-2,000	110	114	118	122	126	131	135	140	145	2,736	155
<i>IRR</i> (%)		8.30										

Exhibit 4 Rent Control Ordinance Reduces Allowed Annual Adjustment to 75% of CPI Change

Year	0	1	2	3	4	5	6	7	8	9	10	11
In/out (\$)	-2,000										2,203	
Rental income (\$) (2.625% growth)		200	205	211	216	222	228	234	240	246	253	259
Less: Expenses (\$) (3.5% growth)		90	93	96	100	103	107	111	115	119	123	127
<i>NOI</i> (\$)		110	112	114	116	119	121	123	125	128	130	132
Income (\$)	-2,000	110	112	114	116	119	121	123	125	128	2,333	132
<i>IRR</i> (%)		6.68										

Exhibit 5 Rent Control Ordinance Reduces Allowed Annual Adjustment to 50% of CPI Change

Year	0	1	2	3	4	5	6	7	8	9	10	11
In/out (\$)	-2,000										1,849	
Rental income (\$) (1.175% growth)		200	204	207	211	214	218	222	226	230	234	238
Less: Expenses (\$) (3.5% growth)		90	93	96	100	103	107	111	115	119	123	127
<i>NOI</i> (\$)		110	110	111	111	111	111	111	111	111	111	111
Income (\$)	-2,000	110	110	111	111	111	111	111	111	111	1,960	111
<i>IRR</i> (%)		4.94										

resulting in a frozen NOI trend as well as a decline in the value of the property in nominal terms.

The presentation of this analysis to rent control boards, elected officials, administrators, mediators, and judges needs to be sufficiently understandable to persons who are not experienced financial analysts. In the case of an actual presentation, the data inputs would be supported by market data and information from the subject property and the market, as well as analysis supporting the data inputs.

This methodology allows enhancements to the analysis to provide greater reliability. Some rent control ordinances allow rental rates to be adjusted to market levels upon change of tenant, as permitted by the previously cited Costa-Hawkins Rental Housing Act in California.³⁵ The appraiser could review unit turnover data from the subject property or the market and adjust the income projections accordingly. Similarly, expenses that are expected to grow faster or slower than general inflation could be considered in the cash flow as appropriately supported.

The property values at the beginning and end of the 10-year cycle should be supported by market data and analysis. Earlier, the work of Lennhoff was referenced regarding the diligence and analysis required to properly verify and understand the overall capitalization rates derived from comparable sales. That level of diligence is required, as the market may view properties that are subject to rent controls in a different light than properties more lightly or not regulated.

The entry value used in the previous examples was based on the market value of the property using current, controlled rental rates. Alternatively, the use of market rental rates in the initial investment can be shown to indicate the market value of the property absent rent regulation as the base year value. In Exhibit 6, the appraiser has concluded that the application of market rental rates would indicate an initial value or price increased by 15% over the value indicated by use of restricted rental rates.

To avoid replicating all four IRR indicators on

the previous pages, only the IRR projection of Exhibit 4, allowing for annual increases of 75% of the CPI change, is shown in this example. This demonstrates the impact that past limitations on income growth has had on both the current market value of the property and the income return, declining in this example from 6.68% (Exhibit 4) to 4.83% (Exhibit 6). The analysis could also be based on the inflated purchase price of the property like the FROI concept.

The use of a value input based on market rents may be appropriate where the property has been subject to a longstanding restrictive ordinance and ownership has not changed, or where rents are not allowed to be negotiated with incoming tenants, such as when a home from a departing tenant in a mobile home park is subject to transfer controls. The ability of a departing mobile home park tenant to pass on rental rates that are below market levels to a buyer who is an incoming tenant results in a leasehold advantage that is transferrable, marketable, and valuable. There have been major published and peer-reviewed studies of this phenomenon, by Hirsch (1988), Quigley and Mason (2007), and Zheng (2006) that have reached this conclusion.³⁶ It may also be apparent in the resale prices reported for mobile and manufactured homes in the local market. Under these circumstances, the value of the mobile home park may have been diminished by the submarket rental rates imposed by the regulation, while at the same time the selling prices of the homes where the rental advantage is monetized have increased. It may be helpful to demonstrate the level of return that would be available absent longstanding regulation. The use of market value based on market rents as the base year value input would provide a credible illustration.

Determining the exit value is an exercise of lesser complexity but must consider the impact of rent controls upon the selling price in the analysis.

One of the most significant benefits of the multiple-year analysis is in its ability to demonstrate the impact of potential allowed increases that may be awarded in the fair return process. By

35. California Civil Code, § 1954.50 et seq.

36. Werner Z. Hirsch; Joel G. Hirsch, "Legal-Economic Analysis of Rent Controls in a Mobile Home Context Placement Values and Vacancy Decontrol," *UCLA Law Review* 35, no. 3 (February 1988): 399–466; C. Mason and J. M. Quigley, "The Curious Institution of Mobile Home Rent Control," *Journal of Housing Economics*, 16 (2007): doi:10.1016/j.jhe.2007.04.002; and Zheng, Deng, Gordon, and Dale-Johnson, "An Examination of the Impact of Rent Control on Mobile Home Prices in California," Working Paper (Lusk Center for Real Estate, University of Southern California, posted 2006).

Exhibit 6 Rent Control Ordinance Reduces Allowed Annual Adjustment to 75% of CPI Change: *IRR* Projection

Year	0	1	2	3	4	5	6	7	8	9	10	11
In/out (\$)	-2,300										2,203	
Rental income (\$) (2.625% growth)		200	205	211	216	222	228	234	240	246	253	259
Less: Expenses (\$) (3.5% growth)		90	93	96	100	103	107	111	115	119	123	127
<i>NOI</i> (\$)		110	112	114	116	119	121	123	125	128	130	132
Income (\$)	-2,300	110	112	114	116	119	121	123	125	128	2,333	132
<i>IRR</i> (%)		4.83										

Exhibit 7 Rent Control Ordinance Reduces Allowed Annual Adjustment to 75% of CPI Change: *IRR* Projection with 10% Rent Increase in Year 3

Year	0	1	2	3	4	5	6	7	8	9	10	11
In/out (\$)	-2,000										2,514	
Rental income (\$) (2.625% growth)		200	205	226	232	238	244	250	257	264	271	278
Less: Expenses (\$) (3.5% growth)		90	93	96	100	103	107	111	115	119	123	127
<i>NOI</i> (\$)		110	112	129	132	135	137	140	142	145	148	151
Income (\$)	-2,000	110	112	129	132	135	137	140	142	145	2,662	151
<i>IRR</i> (%)		8.27		(+10)								

incorporating a projected rent adjustment into the *IRR* calculation, the impact of the adjustment on the *IRR* can be shown.

In the *IRR* analysis shown in Exhibit 7, the projections reported in Exhibit 4 are modified to include a 10% rent increase in Year 3 of the analysis, following an assumed successful discretionary rent increase application that granted a 10% increase to the property owner in Year 3 rather than the allowed 75% of the CPI change under the ordinance terms presented in Exhibit 4. The increase in the income is shown in Year 3, resulting in higher income in the following years, as well as a higher future sales price for the example in Exhibit 7 as compared to the example in Exhibit 4.

Another benefit of the *IRR*-based analysis is that it is also adaptable to historic data analysis if desired. Actual annual income reports, as available, can be incorporated into a historic analysis or a hybrid approach, combining recent history and the actual trends with future projections.

The primary benefits of the multiple-year analysis based on the internal rate of return are in its

simplicity of design and execution allowing for understanding by rental boards, arbitrators, and judges who are not trained as financial analysts, the long history of use in investment analysis and the availability of data to support the calculations, well-understood tools for analysis, and the flexibility allowed in consideration of the particular facts present in each case.

Standards Based on Presumption of Fair Return in a Specified Base Year

The Maintenance of Net Operating Income theory (MNOI) is based on a theory that rent should only be increased to cover increases in operating expenses. The mechanism used is to assume that the property generated an acceptable level of net operating income in a specified base year, which is usually defined as the year prior to the implementation of rent controls. This theory assumes that unrestricted conditions characterized the rental market in the base year. As stated by Baar, "Fair return is defined as the net operating income (income before debt service) yielded by the property as of a specified base period, adjusted by a

portion or all of the CPI increase since the base period.”³⁷ The most important assumption of this theory is that fair return in the base year is assumed, with no requirement that it be demonstrated or supported. This theory has been incorporated into rent control ordinances, most commonly in the ordinances for mobile home parks in California.³⁸

The assumptions supporting the use of the MNOI theory are significant while simultaneously lacking any requirement to support the alleged facts on which the assumptions are based. Attempts to find academic research in support of the use of these assumptions is not fruitful. The assumptions that are necessary to be found true are as follows.

1. Market conditions in the base year reflect a market unaffected by rent controls.³⁹
2. Sufficient information regarding the base year income and expenses for the subject property are available for analysis and a determination of the income in the base year.
3. Operations in the current (comparison) year are sufficiently like those in the base year to rationalize the income and expense statements from each year.

The result is to ensure that all financial benefits from the property beyond the base year net operating income do not flow to the property owner but are instead earmarked for the benefit of the

tenants. Other income-producing real estate investments are not limited in this way, rendering the MNOI theory unable to meet the test of providing returns that are “generally commensurate with returns on investments in other enterprises have corresponding risks.”⁴⁰

MNOI: Base Year Market Conditions

Often, the base year may be 30 to 50 years in the past, and the events surrounding the institution of rent controls in a particular jurisdiction are likely to be lost to history. According to the City of Yucaipa, CA, ordinance, “It shall be presumed in the absence of evidence to the contrary ... the NOI earned by the mobile home park in calendar year 1987 provided a ‘just and reasonable return to the park.’”⁴¹ This was four years prior to the imposition of controls (1991).⁴²

Looking at a more recent (2021) ordinance that governs both residential unit rentals and mobile home parks in Santa Ana, CA, the ordinance states, “The ‘Initial Base Year’ means the 2020 calendar year, which is the full and complete year preceding November 18, 2021.”⁴³ While this was the effective date of the ordinance, staff reports recommending the imposition of rent controls to the city council were issued as early as 2019,⁴⁴ and a COVID-related rent freeze in the city of Santa Ana was instituted on April 7, 2020. A survey of 15 mobile home parks in Santa Ana in August 2020 reported rental rates from \$915 to \$1,690 per month.⁴⁵ Since the passage of a rent

37. Baar (September 2006): 340.

38. One such ordinance in Contra Costa County, CA, states: “For the purposes of determining the special rent increase necessary to provide the park owner with a fair and reasonable return, it shall be presumed that the net operating income, as described below, received by the park owner in the base year, provided the park owner with a fair and reasonable return.” Further, the ordinance states, “It shall be presumed that the base year net operating income adjusted by (1) sixty percent (60%) of the percentage increase in the Consumer Price Index (CPI) between the Base Year and December 31, 2008; and (2) eighty percent (80%) of the percentage increase in the Consumer Price Index from January 1, 2009, to the date the special rent increase application was filed yields a Fair Return.” Code of Ordinances, Contra Costa County, CA, § 14.105.450, “Calculation of fair and reasonable return for special rent increase.”

39. Baar notes that “a pre-rent control net operating income is seen as reasonable because it was based on the market, rather than regulation.” Baar (September 2006): 340.

40. *Troy Hills Vil. v. Tp. Council Tp. Parsippany-Troy Hills*, 68 N.J. 604, 350 A.2d 34 (N.J. 1975).

41. Yucaipa Municipal Code, § 15.20.100, “Rent increases by application to the hearing officer.”

42. The City of Yucaipa was incorporated as a city in 1989, following an election in 1986. At the time, mobile homes in mobile home parks represented 30% of the housing stock in the community, and the imposition of mobile home park rent controls were a significant part of the reasons cited for incorporation. The first rent control ordinance was enacted in 1991, and under that ordinance site rental rates were rolled back to the site rental rates in effect on 12/31/87. (Source: Yucaipa Municipal Code, Chapter 15.20.010)

43. City of Santa Ana, Rent Stabilization and Just Cause Eviction Ordinance Regulations, Policies, and Procedures, Amended December 13, 2023.

44. City of Santa Ana Staff Report, “Assessment of Existing Conditions and Policy Options” (May 21, 2019).

45. *DataComp JLT Market Report, Orange County California, August 2020*, published by DataComp USA.

control ordinance is a political process, it may be that some owners tried to demonstrate that controls were not needed, while others increased rents while still able to do so. This was not necessarily an unimpeded market.

In some jurisdictions, a base year following the imposition of rent controls is mandated.⁴⁶ Information such as this may indicate that normal market conditions were not present in the defined base year, but determining the state of the market in the base year is more difficult the longer the ordinance has been in effect.

The MNOI theory assumes that fair return can be determined by comparison of income before the period in which rent controls were instituted with the current level. The basis of the argument in favor of this theory is undermined when its primary assumption—that base year income reflected market conditions—is not supported by credible facts.

MNOI: Base Year Income and Expenses, Inflation Adjustment

Without accurate base year operating statements, there is no base year document of income to consider. This is the case often when property has been subject to rent controls for 25 to 40 years or longer. A review of the cities in California (Berkeley, Beverly Hills, East Palo Alto, Hayward, Los Angeles, Los Gatos, Oakland, Palm Springs, San Jose, Santa Monica, and West Hollywood) with residential controls and more than 100 mobile home park rent control ordinances indicates that more than 90% of the ordinances predate the year 2000. The unavailability of property rent rolls and income statements for base year analysis is a significant issue affecting the credibility of the application of the theory.

When base year income information is not available, analysts use the income reported in a later year—often 20 years or more distant from the base year—and adjust the income and expenses downward by the cumulative CPI change and rely on an unsupported assumption

that this fairly represents the base year income. The reliability of the result is assumed, but not questioned nor subjected to requirements of offers of proof.

In many ordinances, the use of partial indexing, or measuring inflation based only on a portion of the percentage change in the selected CPI, is mandated. As justified by Baar:

[The] rationale for indexing at less than 100% of the increase in the CPI has been that investors can earn substantial rates of return on their cash investments with less than 100% indexing due to the leveraging factors associated with real estate investments. In fact, a substantial portion of the typical investment (the mortgage payment) is a fixed cost or, at worst, a cost that varies with interest rates, but generally has a ceiling. In any case, mortgages principle and interest payments are not indexed by the CPI. Because this very substantial portion of costs is fixed, the remaining net operating income (the cash flow) can increase at a much greater rate than the overall rate of growth in the NOI.⁴⁷

This reasoning assumes that, like residential mortgages, commercial loan rates are fixed for 30 years, an assumption that would not be made by anyone familiar with commercial loan terms characterized by variable interest rates, terms shorter than the amortization period, periodic readjustments of rate and terms, and other significant differences between home mortgages and commercial loans.

An additional rationale for partial indexing is that full indexing provides unearned profits to the property owner due to the margin between gross and net income that results in increased equity as well as higher profits over time. The assumptions monetize the benefits of leverage but do not consider the risks associated with borrowed capital or consider that these benefits are available from other real estate investments, failing to consider the requirement that a fair return “is generally commensurate with returns on investments in other enterprises having corresponding risks.”⁴⁸

46. The Rent Control Ordinance in San Jose, CA, mandates use of 1985 as the base year for MNOI calculations, while acknowledging that rent controls were instituted in 1979. In *MHC Operating Limited Partnership v. City of San Jose*, 106 Cal. App.4th 204 (Cal. Ct. App. 2003), the California Appeals Court noted that “it is within the City’s legislative authority to decide what base year to employ in its rent control ordinance.”

47. Baar (September 2006): 342.

48. *Troy Hills Vil. v. Tp. Council Tp. Parsippany-Troy Hills*, 68 N.J. 604, 350 A.2d 34 (N.J. 1975).

MNOI: Comparison of Base Year and Comparison Year

The practicing appraiser with knowledge and experience of the specific property type—residential rental units or mobile home park—can provide insight into the comparison of operating statements between the base year and the comparison year where this information is available and the market conditions prevalent at each time period that affected NOI.

MNOI: To Whom Do the Benefits of Property Ownership and Management Accrue?

The Maintenance of Net Operating Income theory is not based on an investment model that provides a return “which is generally commensurate with returns on investments in other enterprises having corresponding risks.”⁴⁹ It is a theory that property owners should only increase rental rates to cover increases in operating expenses and that all financial benefits beyond that level are transferred to the tenants. Compared to the investor perception of income producing real estate, this theory is not in agreement with the basic motivation of investors as expressed in the appraisal body of knowledge. “The notion that an investor anticipates a complete recovery of invested capital-plus a payment for the use of capital-prevails in the real estate market just as it does in other markets.”⁵⁰ For this reason, the reliance on a theory that holds that all marginal income is transferred to the tenants is difficult to support when exposed to the appraisal body of knowledge and understanding of motivations supporting investments.

MNOI: Conclusion

As an analysis or predictor of fair return, MNOI fails on multiple levels. On an overall basis, the theory makes no attempt to determine the basis of the investment or its value, or the rate of return required to meet the first group of *Troy Hills* tests. An assumption is made with no offer of proof presented or required.

In the test measuring good management, the MNOI theory may not negatively affect the “ade-

quate maintenance of services” because adequate maintenance is mandated by landlord-tenant laws in most states.

It does not “furnish an award for efficiency” because any generated reward is earmarked for the benefit of the tenants.

It is unlikely to “discourage the flight of capital” based on the elimination of rewards for income growth. And because banking relationships are generally based on income growth, the freezing of income negatively affects the ability of the owners to “maintain and support their credit,” especially during times of higher interest rates or more conservative lending policies.

Finally, the concept of simply maintaining (or freezing on a constant-dollar basis) income does not provide for a fair return. As noted in *Cotati*, “If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory.”⁵¹

MNOI use is mandated in many jurisdictions, and, if presented, a well-documented analysis of its weaknesses in both concept and application should accompany the presentation or be used to rebut the MNOI presentation.

Fair Return and the Purposes of Rent Control

Returning to *Troy Hills*, the rent required to meet the tests of fair return cannot be “so high as to defeat the purposes of rent control nor permit landlords to demand of tenants more than the fair value of the property and services which are provided.”⁵² This qualification relates to “excess rent,” which is a well-defined term in the appraisal body of knowledge. “Excess rent is the amount by which contract rent exceeds market rent.”⁵³ This definition is compatible with the *Troy Hills* qualification that it should not “permit landlords to demand of tenants more than the fair value of the property and services which are provided.”

49. *Troy Hills Vil. v. Tp. Council Tp. Parsippany-Troy Hills*, 68 N.J. 604, 350 A.2d 34 (N.J. 1975).

50. *The Appraisal of Real Estate*, 15th ed., 428.

51. *Cotati Alliance for Better Housing v. City of Cotati*, 148 Cal. App.3d 280 (Cal. Ct. App. 1983).

52. *Troy Hills Vil. v. Tp. Council Tp. Parsippany-Troy Hills*, 68 N.J. 604, 350 A.2d 34 (N.J. 1975).

53. *The Appraisal of Real Estate*, 15th ed., 422.

Again, the real estate appraisal body of knowledge is well suited to assist in this determination. Conducting rent surveys and developing opinions of market rent is a regular practice. Market rent is useful in this context because it is based on transactional data that represents the willingness of the tenant to accept and the property owner to charge a certain fee for the property rights exchanged and services provided. Market rental transactions are not coercive. Transactions that report rental rates from terms that are dictated by the ordinance, or are existing rents charged to tenants long in tenure with or without regulation, are not indications of market rent and should not be considered in this analysis. Market rent is the product of open negotiations and meets the qualifications set by *Troy Hills* and is not excess rent. The “fair value of the property and services which are provided” is equal to market rent where market rent is supported by the use of market rental transactions.

Conclusion

The goal of determining what courts have identified as a just and reasonable return is made more credible when full implementation of the body of knowledge of the appraisal profession is incorporated as a substantial part of the process. Over the past 50 years, incomplete and inexperienced application of the appraisal body of knowledge by professionals not schooled or experienced in the use of appraisal theory and practice have led to results that are at best ill advised and unsupported, and at worst, misleading and unworkable, and internal contradictions in the arguments made are ignored.

Compliance with the qualifications established by *Troy Hills* requires a comprehensive set of analyses that may be reconciled to determine compliance with the multiple tests necessary to meet this goal. Investment analysis is necessary to assist the rate-setter to determine whether the allowed income results in a fair return to the property owner. Market analysis is necessary to determine if the results of a fair return analysis place a burden on tenants more than the reasonable value of the rental unit and other services provided.

Both inquiries must be part of the investigation

and analysis. This will require robust financial analysis of the income stream in the subject property past, present, and future. The financial analysis must be accompanied by rental market analysis to demonstrate the rental value of the units offered to the market. A single analysis addressing one of the two considerations will not suffice. No other professional body of knowledge is as well positioned to provide this investigation and analysis than real estate appraisal.

Analysis of a single year's income to determine fair return is an untenable process as it cannot consider past or future events that will impact the return provided by the investment. The use of rates of return and value assumptions that lack consensus further diminishes its usefulness, and reliance on unsupported concepts such as circularity without limits and assumed increases in value in the absence of income growth further renders the analysis of a single year's analysis as not credible.

The assumptions that underly MNOI theory similarly will not provide for a credible analysis in support of fair return. The failure to meet several *Troy Hills* tests are embedded in the basic theory and cannot be overcome in its application. It is apparent that MNOI will not “furnish an award for efficiency” as any increases that are accomplished by the property owner are earmarked for the benefit of the tenants.⁵⁴ It will not “discourage the flight of capital from the rental housing market” because rational investor behavior would focus investments to property types that are not so restricted. MNOI does not provide a return “commensurate with returns on investments having corresponding risks” because investments in other income-producing properties are not subject to restrictions reserving increases in net operating income for the benefit of the tenants. The lack of any requirement for supporting base year income in the absence of actual records, the unsupported assumption that the base year reflected market conditions, and the required indexing of allowed income growth at lower rates than the CPI change limits combine to further restrict the credibility of the MNOI theory. The application of MNOI theory relies on so many layers of unsupported assumptions that it cannot be considered as a credible analysis.

54. According to Baar, “Under the maintenance-of-net-operating-income standard, owners may obtain rent increases which are adequate to cover increase in operating expenses.” Baar (1983): 810.

Of the available tools to consider fair return, only the *IRR* analysis provides the robust support necessary for credibility. The use of yield analysis is widely accepted as an indicator of acceptable return, and the conclusions can be demonstrated and tested. It is the only credible analysis of those presented.

Credible results can be achieved by the application of the *IRR* analysis to determine the rental rate required for a fair return, but the second consideration—whether the rental rates exceed the value of the property rights transferred and the services provided—must also be considered.

With the rapid pace at which communities and states are incorporating rent controls, the need for expert application of well-supported and well-reasoned analyses to determine appropriately supported levels of fair return will increase going forward. The decisions made by boards, arbitrators, and courts tasked with the job of assessing whether a property or its owner is receiving a fair return will benefit from the tools, discipline, and reasoning in the appraisal body of knowledge by those who are best able to supply and interpret the market.

About the Author

John P. Neet, MAI, is a solo practitioner based in Southern California with an appraisal and consulting practice focused on manufactured housing communities, recreational vehicle parks, and regulatory issues involving these property types throughout the West. He has been a practicing real estate appraiser for 47 years, beginning as a residential bank appraiser in the late 1970s, eventually transitioning to an exclusive MHC- and RVP-based practice in 1995. In the past 30 years, he has provided appraisals for a full menu of clients, specializing in complex valuation and analytical work involving these properties including fractional interest valuations, leasehold/leased fee analysis and valuation, conversions, regulatory issues involving rent controls and right-of-first-refusal laws, and resident cooperatives. Neet has been qualified as an expert in state and federal courts on such topics as valuation, fair return under rent controls and other rent control topics, and forensic review. In addition to court testimony, he has appeared before local rent control boards and arbitration hearings as an expert in these topics, providing both market and financial analysis in conjunction with discretionary rent increase applications under the fair return provisions of rent control laws and ordinances. **Contact:** jneet@johnneet.com

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Lum Library Online Catalog [Login required]**
Subject heading: "Rent control"
- **Lum Library Knowledge Base Bibliographies [Login required]**
Rent analysis: rent control
- **Publications**
 - Richard L. Parli, MAI, *The Valuation of Apartment Properties*, Third Edition
 - Robert Scott Saia, *Appraising Manufactured (Mobile) Home Communities and Recreational Vehicle Parks*