500 Pages of Band-Aids

I. Introduction

The color blue has won the political battle in many cities over the last generation, and ideas that were previously considered on the fringe of American society are now becoming a cornerstone of policy making and electability. The implications are far reaching but are becoming most visible in California and New York. Changes to the current rent regulation regime in New York City are on the horizon as a democrat-controlled state legislature revisits laws that expire on June 15th. Rules and regulations shaping New York City's housing policies run for hundreds of pages, and a law degree feels like the price of admission for making sense of it all. Not surprisingly, the laws are highly nuanced, and the associated impacts vary greatly property by property. A detailed understanding of current rules is necessary to understand the potential impact of any looming changes to landlords.

The following analysis, while not a fun beach read, is an attempt to arm public and private market apartment investors with information to calibrate the political and media narrative that will come out of Albany over the next month. There are a handful of active bills in the committee stage that bear watching. **In aggregate, the risks to asset values and operating fundamentals from draft proposals appear higher for lower-quality apartments, which are disproportionately owned by private landlords**. The apartment REIT portfolios are likely more insulated and may even be net beneficiaries over the near-term. However, apartment landlords of all stripes may share the longer-term consequences of onerous regulation – lower economic growth across the city.

II. NYC Rent Control 101

There are two forms of rent regulation in New York City — rent control and rent stabilization. **Rent control covers a negligible amount of housing stock** (<1%; ~22,000 units), only applying to units occupied by a tenant (or a direct family member) continuously since 1971 in an apartment built prior to 1947. **Rent stabilization is the more common price control in the Big Apple and applies to ~1 million units (~50% of apartment stock).**

Rent stabilization generally covers buildings built between 1947 and 1974, **but *temporary* rent stabilization can also apply to properties built or redeveloped after 1974 that received tax benefits upon construction** (e.g., 421-a or J-51 tax abatement programs). In aggregate, the rent stabilized stock is skewed toward lower rent, non-institutional property. Currently, ~45% of the apartment REITs' New York City portfolios are subject to rent stabilization policies, but the proportion will decline rapidly in the coming years once temporary 421-a tax

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incentives burn off, allowing units to transition to unregulated market rate apartments. In roughly ten years, the rent-stabilized component of REIT portfolios should be negligible under *current* statutes. Detailed provisions of NYC's rent stabilization code include:

- Every rent-stabilized apartment unit carries a maximum legal rent, which is set upon initial occupancy. For non-affordable units, the initial maximum legal rent is typically set near prevailing market rents at the time. The maximum legal rent for affordable-designated units is initially set at a level deemed affordable to specific area-median income (AMI) tiers (e.g. 60% of AMI).

- **Annual increases to the maximum legal rent are determined each June by a nine-person Rent Guidelines Board.** The board is appointed by the Mayor and includes two tenant group representatives, two landlord representatives, and five individuals from the general public. In the last five years, maximum *renewal* rent increases for an annual lease averaged 0.75%, with a low of 0.0% and high of 1.5%.

- Landlords are required to *renew* a tenant's lease for a rent-stabilized unit unless a tenant violates a law. In most cases, renewal rate increases are consistent with the annual increases dictated by the Rent Guidelines Board. Upon change of tenant, landlords can add a vacancy bonus to the prior maximum legal rent ranging from 5% to 20%, depending on the previous length of stay.

- Units with rents in excess of ~$2,775 per month, or that are occupied by an individual earning >$200,000 per year for the last two years, become deregulated and exempt from rent stabilization (known as high-rent vacancy deregulation).

- **High-rent vacancy deregulation does not apply to properties that received tax-incentives through the 421-a program when constructed.** New York's 421-a program is a highly complex system in and of itself. In its simplest form, the program grants developer's relief from property taxes for a defined time period. In return, developers must include an affordable component in new construction. Rent stabilization persists on these buildings until the tax benefits burn off. The vast majority of the apartment REIT portfolios that are subject to rent stabilization fall into this category. Under NYC's old 421-a program, the abatement period runs 10-20 years. Burn off periods under the new 421-a program passed in 2017 are typically ~10 years but can extend to 35 years in certain circumstances.

- Affordable-designated units within 421-a properties must remain affordable for 35 years after construction. Annual rent increases on these units are the lesser of area-median-income growth and the annual Rent Guideline Board increase.

- Special circumstances allow for annual rent bumps in excess of the Rent Guidelines Board annual increase. These include Major Capital Improvement (MCI) and Individual Apartment Improvement (IAI) rent increases. MCI's allow landlords to pass through building-wide capital expenditures to tenants through a per-room allocation of the annual depreciation expense of big-ticket items. The MCI increase is permanently added to the unit's maximum legal rent for purposes of calculating future rental increases. IAI increases allow landlords to pass through

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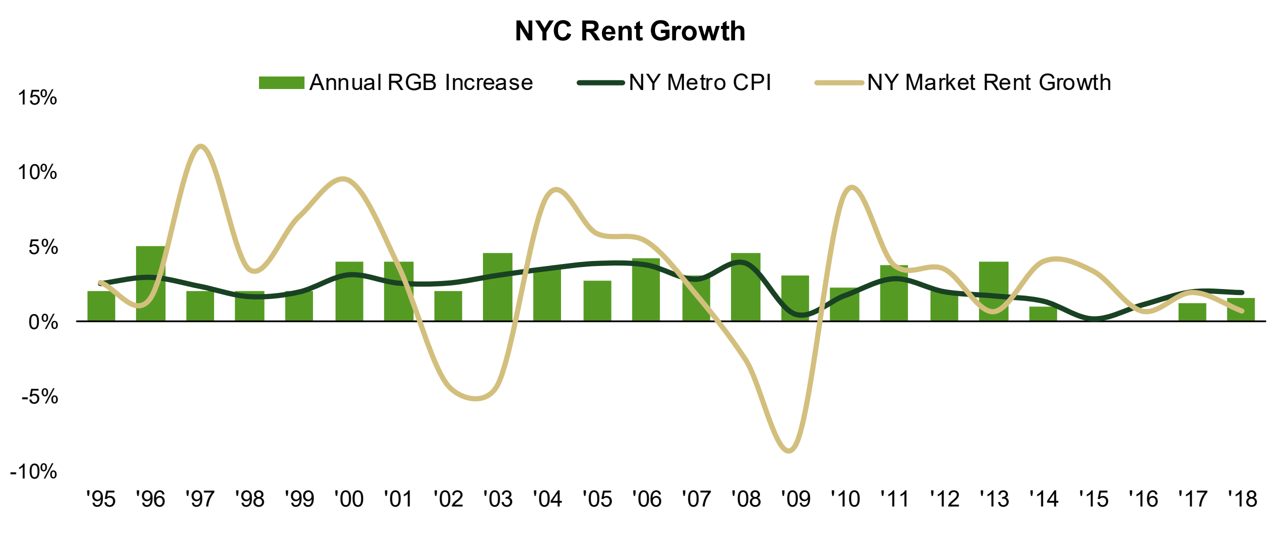
between 1/40th and 1/60th of smaller ticket unit upgrades per month, depending on the building size. Apartment REITs do not actively use the MCI and IAI programs.

- Because the system is not convoluted enough, one additional caveat to the above ordinances is worth noting. **The maximum legal rent may not reflect the actual rental rate charged for the unit.** Landlords can charge a Preferential Rent, which is lower than the legal amount. Upon lease renewals, most Preferential Rents can be repealed at the owners' choosing, increasing the rent to the maximum legal level. Owners often charge a Preferential Rent to boost occupancy if leasing activity is weak. The system ultimately incentivizes landlords to file an above-market initial legal rent to lock in a high-water mark and mitigate the risk of any future rent freezes or rollbacks implemented by the Rent Guidelines Board. The degree of gamesmanship employed while setting initial legal rents ranges from minimal to aggressive. Enforcement of the program is typically weak. While the REITs actively include Preferential Rent Language on most rent-stabilized leases, there is generally not a large mark-to-market benefit in REIT buildings where actual rents are fairly close to prevailing market rents.

The above regulation, which is controlled by the state legislature, only applies to NYC and select counties in the Southern part of the state. Legislators put much of the above regulatory regime in place back in the 1970's, with heavy revisions and band-aids incorporated along the way. Widespread rent stabilization policies in NYC have generally led to lower market turnover, higher occupancy, poorer aggregate housing quality, and likely less construction over the long run. **Many of these dynamics benefit the unregulated apartment market to a degree, which represents a greater share of apartment REIT portfolios.** Tying government incentives/ support to a unit, incentivizes dramatically longer length of stays, which lowers market vacancy and drives up street rents of nearby properties unencumbered by price controls. Annual

Exhibit 1: NYC Rent Growth

Slow Growth: Over the last 25 years, New York's Rent Guidelines Board (RGB) approved average annual rent increases of 2.7%, 40 bps north of local CPI. More recently however, annual increases have lagged inflation and market rent growth meaningfully as the RGB implemented rent freezes in '15 and '16, a first in its history.



Sources: New York City Rent Guidelines Board, FRED, CBRE, and Green Street Advisors.

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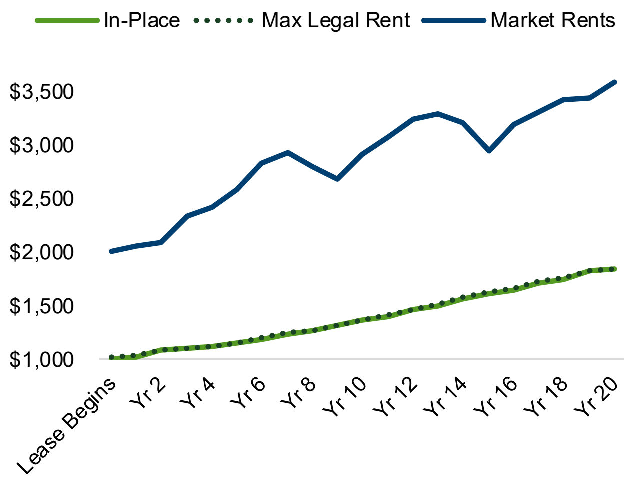
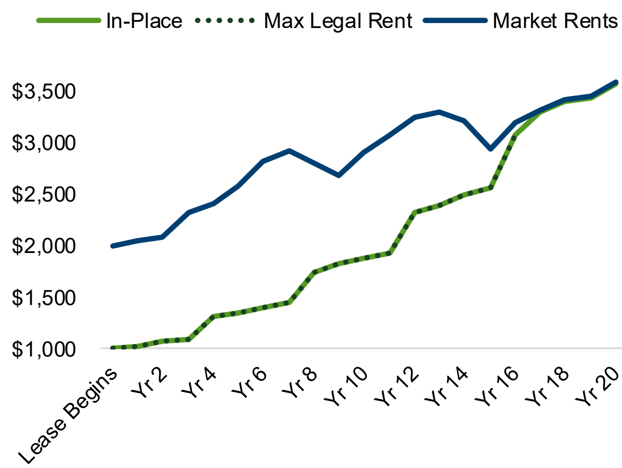
Exhibit 2: The Visible Hand

It Pays to Stay: Property-level economics can vary widely in NYC due to the complex regulations. If a tenant continues to renew a lease, rents will generally grow at the inflation-like increases set by the RGB, and lag market rents for extended periods of time. If a unit becomes vacant, landlords have the opportunity to increase the prior legal rent by up to 20%. Driving tenant turnover in rent-stabilized buildings and increasing rents toward the deregulation threshold (currently $2,775) can often result in highly attractive returns for landlords/investors.

Scenario 1: Older Rent-Stabilized Unit with No Tenant Turnover for 20 years



Scenario 2: Older Rent-Stabilized Unit with Turnover Every 4 years



*Both scenarios assume in-place rents and max legal rents are the same upon initial lease of unit.

Source: New York City Rent Guidelines Board and Green Street Advisors.

apartment REIT turnover in NYC currently runs in the 40% range versus 50%+ in less regulated metros. During a period of sluggish job growth and elevated new market-rate supply over the last few years, average REIT occupancy in the city remained north of 96%. The regulatory system benefits in-place tenants paying below-market rates at the cost of new bodies entering the market in search of available (and costlier) housing. It also leads to elevated administrative and judicial costs for landlords to comply with the rent stabilization code year in and out. The REITs hire entire teams to navigate the regulation.

III. Sea Change on the Horizon?

There are nine active rent reform bills in the New York State Assembly that are working through committee. Bill specifics will evolve before potentially reaching the floor for a formal vote. As written, the most impactful bills, ranked in order of highest potential impact to landlords include:

1) **Evictions without Good Cause *(Senate Bill 2892 / Assembly Bill 5030)***

   Description: The bill title is a bit misleading, as the most impactful part relates to price controls and not evictions. The measure would effectively prohibit annual renewal rent increases in excess of 150% of local CPI on units not governed by rent regulation (excludes owner-occupied buildings of less than 4 units). Landlords could still increase rents to market upon turnover.

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Comments: The bill is one of the more worrisome pieces of legislation that, in its current form, would implement wide sweeping rent control on all market rate apartments and manufactured home parks. It would also strengthen eviction rules and increase judicial costs for both landlords and tenants. Industry participants suggest the odds of passing are low, but the bill bears close watching.

2) **Vacancy Decontrol Repeal *(S2591A/A1198)***

Description: Repeals the statute that allows rent-stabilized units to become deregulated once rents exceed ~$2,775 per month. It would cause a greater share of higher-rent properties to remain under rent regulation. The bill would not impact 421-a properties, which are governed by separate statutes.

Comments: As written, the bill would be highly impactful to apartment fundamentals and asset values of properties currently under rent stabilization, as in-place rents could continue to lag market rents for longer periods of time. The impact to apartment REIT portfolios would be minimal, because the majority of the REITs' rent stabilized units will continue to transition to market rate units as 421-a tax abatements burn off. In isolation, this repeal would likely benefit *near-term* fundamentals for the apartment REIT portfolios as it would lead to even lower market turnover and higher occupancy. Less supply would roll from rent-stabilized to market rate each year, resulting in less competitive new supply for REIT properties. Commentary from politicians suggest the odds of passing are high, but the tune may change as real estate lobbyists push back.

3) **Elimination of Vacancy Bonuses (S185/A2351)**

Description: Prohibits landlords from assessing large rent increases upon vacancy, which under current law range from 5% to 20% based on when the unit last became vacant. If passed, rent increases for vacancy would mirror renewal rent increases allowed by the Rent Guidelines Board.

Comments: The bill would have a large immediate impact on cash flows of older rent-stabilized properties, where in-place rents are well below market rate and landlords are no longer able to narrow the gap upon change of tenancy. It would have a modest negative impact on the newer REIT portfolios where in-place rents are slightly below market.

4) **Preferential Rent Amendment (S2845/A4349)**

Description: Prohibits landlords from repealing Preferential Rental rates on lease renewals. Landlords can still increase rents to the maximum legal rate upon vacancy.

Comments: The aggregate impact on newer institutional-quality apartments would likely be modest because there is typically not a large difference between in-place and market rents, and landlords could still bump up rents upon vacancy. Certain older properties with greater loss-to-lease will experience a more pronounced delay of cash flow in the near-term, but long-term economics would be unchanged.

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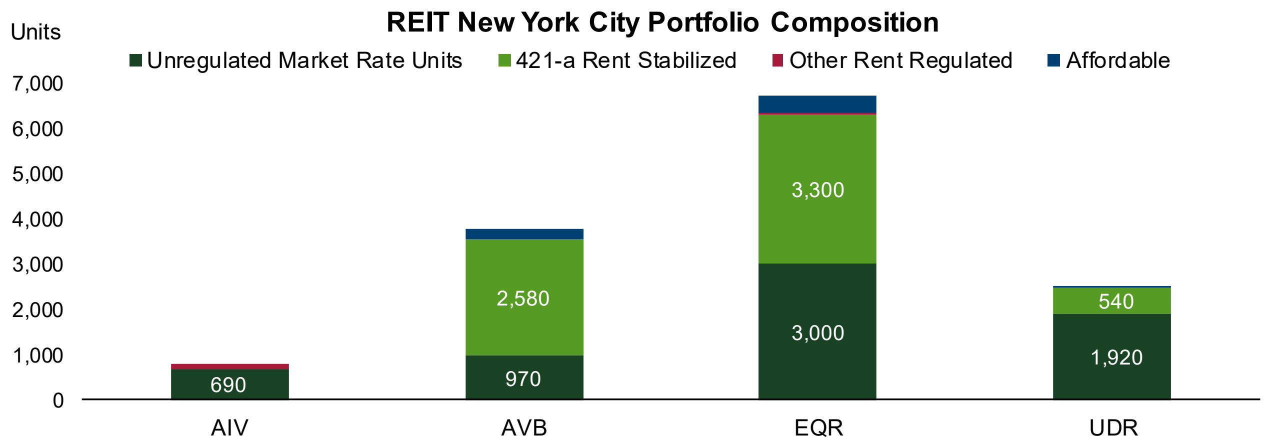
Exhibit 3: Apartment REIT Portfolio Breakdown

Mostly Insulated: Apartment REITs have actively reduced New York City exposure in recent years. Rent-stabilized NYC units represent roughly ~5% of Equity Residential and AvalonBay's total portfolios. Nearly all of the apartment REITs' rent-stabilized units stem from 421-a programs. In ~10 years, the REIT portfolios will be almost entirely unregulated, absent any unforeseen policy changes.

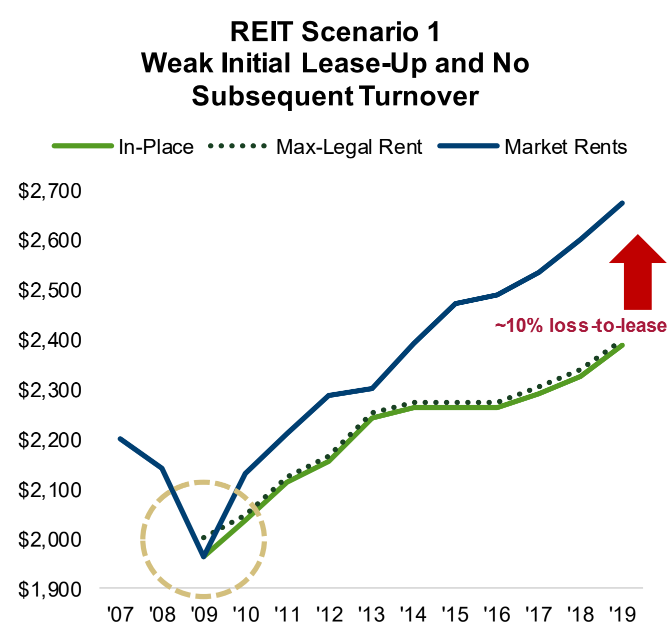


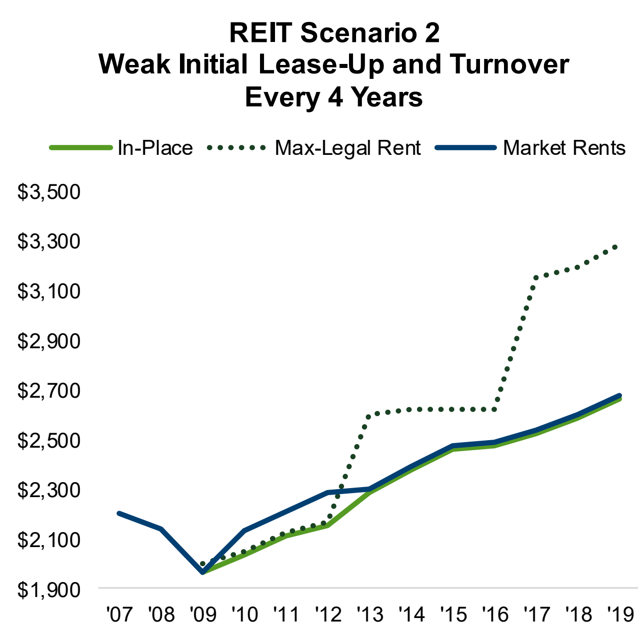
	AIV	AVB	EQR	UDR
NYC as % of REIT NOI	4%	7%	12%	9%
NYC % Regulated Units	11%	68%	50%	22%

Sources: REIT company documents and Green Street Advisors.

Exhibit 4: Rent Stabilization Dynamic at REIT Properties

Timing is Everything: In aggregate, the loss-to-lease embedded in NYC apartment REIT portfolios is modest as most rent-stabilized properties were built in recent years. However, property-level cash flow is not entirely immune to the temporary drag on rents created by lower tenant turnover. Certain buildings that leased up during the recession set low initial legal rents, and for units that didn't subsequently turn, rents are still well below market.





*Both scenarios assume lease-up occurs in '09 and subsequent market rent growth and maximum legal rent growth are based off actual history to today.

Source: New York City Rent Guidelines Board and Green Street Advisors.

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5) Eliminate Major Capital Improvement and Individual Apartment Improvement rent increases (S3693/A6322 and S3770/A6465)

Description: Eliminates MCI rent increases and rolls back rents of units impacted by past MCIs to pre-improvement levels and discontinues IAI's altogether.

Comments: Could result in a large one-time impact for properties that currently use or have used MCI's in the past. Over the long run, it will lead to less investment in properties, resulting in less desirable buildings and neighborhoods. The REITs are not large users of either program. Industry participants suggest the odds that a watered-down version of the current bill passes are high.

6) Statewide Expansion of the Emergency Tenant Protection Act *(S5040 / A7046)*

Description: The regulation outlined in preceding pages only applies to NYC and Nassau, Rockland and Westchester counties. This bill would give municipalities across the rest of the state the right to opt into the same rent regulation.

Comments: The bill has the potential to impact smaller private landlords in upstate New York. The institutional-quality apartment stock outside of the current footprint already governed by rent regulation is modest. Three additional AvalonBay communities in Suffolk County *could* be subject to rent regulation in the future, should municipalities choose to implement rent stabilization.

7) Manufactured Homeowner Protection (S5436/A5247)

Description: Allows for any annual rent increase in excess of CPI at manufactured home parks across the state to be contested in court. ***Comments:*** Impactful for private manufactured housing operators. Equity Lifestyle (ELS) and Sun Communities (SUI) New York manufactured housing exposure is minimal (~2% and 1% of total sites, respectively)

IV. Conclusion

The political landscape has shifted meaningfully over the past two decades and support for populist/socialist legislation is accelerating in many gateway markets. With ~70% of the NYC vote now accruing to Democrats and a super majority in the New York State legislature, the tide of future policy is one of greater regulation and taxation for New York real estate owners broadly, with Apartment landlords fully in the crosshairs. The group of bills now contemplated by the New York State legislature may or may not pass or may become law in a watered-down form. But, the longer-term trend in policy is unmistakable and is likely to result in marginally lower long-term NOI growth rates for New York City. We say marginally lower, because the unintended consequence of many of the proposed bills could widen the moat for institutional owners that know how to navigate the regulatory waters, and the City should still benefit from urbanization trends from high-wage workers despite politicians' best efforts. However, New York City's ability to *continue* to attract high-quality jobs over the long run is directly correlated with the quality and quantity of housing. Should both deteriorate under the expansion of price controls, the next

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generation of renters will increasingly ask, "why move to New York to pay $3,000 per month for a decrepit walk up, when I can move to Austin?"

The public-market impact of the various bills, which will likely play out before a shift in private market fundamentals occurs, is difficult to handicap (including what is already priced in). Of most concern, are the Evictions without Good Cause Bill and the vacancy bonus repeal, to a lesser degree. The passage of these measures would be a clear negative for AvalonBay (AVB), Equity Residential (EQR), and UDR given the REITs' elevated concentration in the city. However, apartment REIT investing is often a relative game and the politics of the Left Coast are no more hospitable to apartment owners.

John Pawlowski, CFA
Alan Peterson
Galen Faurot-Pigeon

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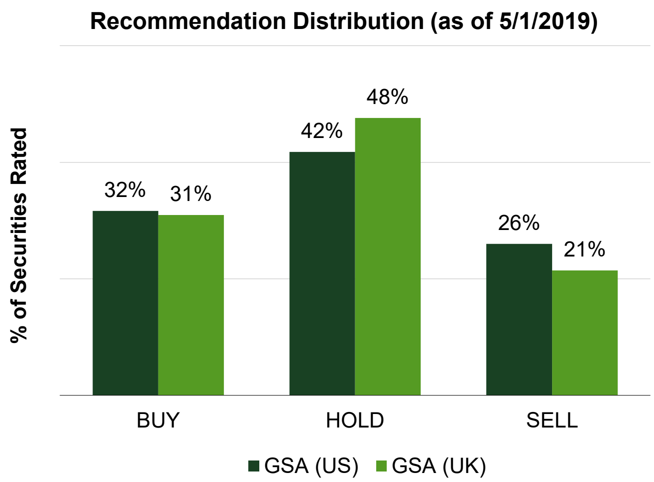

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Year[3]	Buy	Hold	Sell	Universe
2019 YTD	18.5%	14.3%	13.2%	15.3%
2018	-5.1%	-6.6%	-9.2%	-7.0%
2017	6.4%	0.2%	2.1%	2.6%
2016	14.9%	14.7%	13.1%	14.4%
2015	8.3%	0.9%	-1.7%	2.4%
2014	41.6%	31.5%	27.3%	33.3%
2013	4.1%	0.6%	1.7%	2.2%
2012	24.5%	24.7%	18.9%	23.0%
2011	18.9%	7.6%	-4.7%	7.6%
2010	43.3%	32.8%	26.6%	33.8%
2009	59.0%	47.7%	6.0%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
Cumulative Total Return	**19020.2%**	**1257.5%**	**36.4%**	**1498.0%**
Annualized	**22.2%**	**10.4%**	**1.2%**	**11.1%**

The results shown above are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from the hypothetical performance shown above due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the returns above assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, cannot be used to predict future performance. Investing involves risk and possible loss of principal capital.

(1) Results are for recommendations made by Green Street's North American Research Team only (includes securities in the US, Canada, and Australia). Since July 5, 2017, performance is calculated whenever a recommendation is changed using the share price at the most recent market close. Previously, performance was based on recommendations provided in Green Street's "Real Estate Securities Monthly" (RESM) and assumed no change in recommendation between RESM publications. Results from January 28, 1993 through January 4, 2016 were independently verified by an international "Big 4" accounting firm. The accounting firm did not verify the stated results subsequent to January 4, 2016. As of January 4, 2016, the annualized total return of Green Street's recommendations since January 28, 1993 was: Buy +24.0%, Hold +11.1%, Sell +0.6%, Universe +11.7%.

(2) Beginning July 5, 2017, all companies in Green Street's North American coverage universe are included in the performance calculation. Previously, inclusion in the calculation of total return had been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly" and had a rating other than "Not Rated".

(3) From 1993 until July 3, 2017, the returns for each year cover the period following the first RESM issued in the respective year through the first RESM issued in the following year and are not based on a calendar year. Subsequent to July 5, 2017, returns are based on calendar months.

Per NASD rule 2711, "Buy" = Most attractively valued stocks. We recommend overweight position; "Hold" = Fairly valued stocks. We recommend market-weighting; "Sell" = Least attractively valued stocks. We recommend underweight position.

Green Street will furnish upon request available investment information regarding the recommendation

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North American Team

Green Street Advisors

Research

Strategic Research	Mike Kirby, Director of Research Dave Bragg, Managing Director Peter Rothemund, CFA, Managing Director Zane Carmean, Senior Associate	mkirby@greenst.com dbragg@greenst.com prothemund@greenst.com zcarmean@greenst.com
Company and Sector Research	Cedrik Lachance, Director of REIT Research	clachance@greenst.com
Industrial/Towers/Self-Storage	Eric Frankel, CFA, Senior Analyst Ryan Lumb, Senior Associate	efrankel@greenst.com rlumb@greenst.com
Lodging/Data Centers/Health Care	Lukas Hartwich, CFA, Senior Analyst David Guarino, Analyst	lhartwich@greenst.com dguarino@greenst.com
Office	Daniel Ismail, CFA, Analyst Chris Darling, Senior Associate	dismail@greenst.com cdarling@greenst.com
Residential	John Pawlowski, CFA, Senior Analyst	jpawlowski@greenst.com
Retail/Net Lease	Daniel Busch, Managing Director Vince Tibone, CFA, Analyst Spenser Allaway, Analyst	dbusch@greenst.com vtibone@greenst.com sallaway@greenst.com
Research Generalists	Paulina Rojas-Schmidt, Senior Associate John Magee, Senior Associate Nick Fromm, Associate Alan Peterson, Associate Dylan Burzinski, Associate Galen Faurot-Pigeon, Associate	projasschmidt@greenst.com jmagee@greenst.com nfromm@greenst.com apeterson@greenst.com dburzinski@greenst.com gfaurot-pigeon@greenst.com
Real Estate Analytics	Andrew McCulloch, CFA, Managing Director Joi Mar, CFA, Senior Analyst Casey Thormahlen, Analyst Rob Filley, Senior Associate Ryan Miller, Senior Associate Weston Mui, Associate Claire Arora, Associate Alexandra Boyle, Associate Jared Giles, Associate Ashton Stansbury, Associate Michael Stroyeck, Associate	amcculloch@greenst.com jmar@greenst.com cthormahlen@greenst.com rfilley@greenst.com rmiller@greenst.com wmui@greenst.com carora@greenst.com aboyle@greenst.com jgiles@greenst.com astansbury@greenst.com mstroyeck@greenst.com
Quantitative Analytics	Peter Rothemund, CFA, Managing Director Stephen Pazzano, Senior Associate Michael Eynon, CFA, Senior Associate	prothemund@greenst.com spazzano@greenst.com meynon@greenst.com

Executive

Craig Leupold, Chief Executive Officer	cleupold@greenst.com
Jeff Meister, Chief Financial Officer	jmeister@greenst.com

Account Management

Damon Scott, Managing Director	dscott@greenst.com
Seth Laughlin, Managing Director	slaughlin@greenstreettrading.com

Sales

Kris Hoffman, Managing Director	khoffman@greenst.com
Kevin Johnson, Senior Vice President	kjohnson@greenst.com

Green Street Trading*

Michael Vranich, Managing Director	mvranich@greenstreettrading.com

Advisory

Jim Sullivan, President	jsullivan@greenst.com
Dirk Aulabaugh, Managing Director	daulabaugh@greenst.com
Phillip Owens, CFA, Managing Director	powens@greenst.com
Justin Brown, Senior Vice President	jbrown@greenst.com

Marketing & Media Relations

Rosemary Pugh, Senior Vice President	rpugh@greenst.com
Katie Clemons, Vice President	kclemons@greenst.com

Green Street Advisors, LLC
660 Newport Center Drive, Suite 800
Newport Beach, CA 92660
T 949.640.8780

Green Street Trading, LLC
2828 North Harwood Street, Suite 1200
Dallas, TX 75201
T 800.263.1388 (Trading)   214.855.5905 (Sales)

* Brokerage services offered through Green Street Trading

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