City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Condominium Conversion Fee: Economic Impact Report

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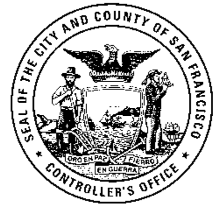

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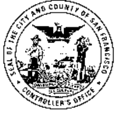

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Main Conclusions

This report analyzes the economic impact of proposed legislation that would modify the way tenancies-in-common may be converted to condominiums in San Francisco. Currently, 200 condominium conversions per year are permitted, and are selected by lottery. Approximately 700 TIC buildings, containing 2,269 housing units, have registered for the 2013 lottery. The proposed legislation would allow property owners of housing units that were registered for the 2012 or 2013 lotteries to bypass the lottery, and convert their buildings to condominiums by paying a fee. The fee was designed after a nexus analysis to offset expected increases in the demand for affordable housing in the city associated with condominium conversion.

Condominium conversion creates clear financial advantages for owners of tenancies-in-common (TIC) buildings. Property owners gain from the fact that financing costs are significantly lower for condominiums than for TIC units (with rates currently at 4.75% for TIC loans vs. 2.25% for comparable condominium mortgages). Under the State Costa-Hawkins Act, condominiums cannot be subject to rent limitations under most circumstances, so owners of condominiums also have the opportunity for greater rental income than owners of TIC units, the vast majority of which are subject to rent control.

The OEA projects that approximately 1,730 participants in the 2013 lottery would elect to utilize the fee option if the legislation were adopted, generating $25 million in one-time fee revenue for the City. The City and other agencies that receive local property tax revenue also stand to receive an additional $1.0 - $1.7 as converted condominiums are sold and reassessed at a higher level. Tenants of these converted properties would likely spend between $0.8 and $1.1 million annually in higher rent.

The City may wish to explore the legalities of strengthening the tenant protections in the legislation. The financial analysis in this report suggests that the bulk of the benefit to property owners is associated with reduced financing costs, and the condominium conversion fee would still be attractive to TIC owners, even if any future rent increase in converted condominiums were limited in exactly the same way, and to the same extent, as rent-controlled apartments are.

INTRODUCTION

Background

Many multi-family residences in San Francisco are legally owned as entire buildings, in which the individual apartment units cannot be bought and sold separately. Condominiums, on the other hand, while often physically part of a larger multi-family residence, may be legally owned by an individual owner, and may be bought and sold separately from the remainder of the building.

For the most part, apartments are occupied by renters, although owners of apartment buildings may occupy units within their buildings. When units in a multi-family residence are occupied by more than one owner, it is referred to as a tenancy-in-common (TIC). Such buildings are often owned by a legal partnership.

TIC owners may buy and sell shares that are equivalent to the ownership of a single unit in the building—for example, a 20% share in a 5-unit building—but this does not make TIC ownership as straightforward as a condominium, as the TIC owner does not actually own his or her unit. Buying, selling, and making investments in a TIC can be significantly more complex, and risky, than it is with a condominium.

Because of this, financing and transaction costs associated with purchasing a TIC share are significantly higher than they are with a condominium, and most investors place a value on the condominium form of ownership. This value appears in the market as a price premium for condominiums over TIC shares.

TIC owners therefore have a clear financial incentive to convert their jointly-owned multi-family property into individually-owned condominiums. The City has a process to allow this conversion. 200 TIC units may be converted to condominiums each year, chosen by lottery.

The Proposed Legislation and Nexus Study

The proposed legislation would create a one-time opportunity for TIC owners to bypass the lottery, and convert their TICs to condominiums by paying a fee to the City.

The legislation would only apply to TICs that were enrolled in the 2012 or the 2013 lottery.

In addition, the legislation would require any tenant remaining in a TIC unit at the time of conversion (a "non-purchasing tenant") to be granted a lifetime lease, with rent increases that are controlled by the Bay Area average rate of inflation in residential rent. The lease could not be modified by any future owner of the condominium.

The legislation establishes a conversion fee of $20,000

per unit, which decreases the longer the TIC has participated in the lottery, according to the schedule in Table 1.

TABLE 1	Condominium Conversion Fee Discount, by Length of Time in the Lottery
0 – 1 years	$20,000
2 Years	$16,000
3 Years	$12,000
4 Years	$8,000
5+ Years	$4,000

The fee is based on a nexus study conducted in 2011 by Keyser Marston Associates (KMA)[1]. The nexus study determined that the conversion of a TIC unit into a condominium would result in a net increase in personal income in San Francisco, through the net replacement of a household able to afford a TIC unit with a household able to afford a condominium. The resulting increase in personal income will lead to higher consumer spending, which is presumed to create employment and population growth. The maximum fee level identified in the nexus study is equal to the amount necessary to offset the housing affordability gap for the new households having income under 120% of the area median.

The nexus study did not consider any potential impacts related to to rent control, or to the effect of conversion on housing construction levels and market rents. It also did not consider the effect of condominium conversion on the assessed value of property in San Francisco, and on property tax revenue.

Based on discussions with brokers, KMA estimated the condominium premium to be 15%, equivalent to a $45,000 to $75,000 gain from conversion (less City conversion fees). The proposed maximum fees identified in the nexus study range from $21,600 to $34,900.

Condominium Conversion Qualification

Each year the City allows qualified TIC buildings with two to six units to convert to condominiums through a lottery system. Two-unit buildings in which separate owners of each unit have occupied the building for at least one year are allowed to by-pass the lottery. Buildings with seven or more units are not permitted to convert to condominiums.

TIC buildings must meet certain owner occupancy requirements in order to enter the lottery and qualify for conversion. Each owner of the TIC must have at least 10% ownership interest. At least one owner must be an occupant of his or her unit for at least three consecutive

[1] *Condominium Conversion Nexus Analysis San Francisco*, Keyser Marston Associates, January 2011

years for buildings with 2-4 units. At least three separate owners must be occupants of their separate units for at least three consecutive years for buildings with 5-6 units.

TIC owners can initially occupy units in the building they own through a variety of ways. Tenants may voluntarily leave, or they may be induced to leave through payments. They can also be evicted through an owner-occupancy eviction or an Ellis Act eviction. An owner-occupancy eviction can occur if the owner owns at least 25% of the property (10% if ownership began before February 21, 1991) and no other unit in the building has been subject to an owner-occupancy eviction. An Ellis Act eviction occurs when the owner withdraws all units in a building from the rental market. However, the City prohibits buildings that have had two or more evictions occurring in separate units after May 1, 2005 from qualifying for conversion for ten years.

TICs that do not win the lottery may remain in it in subsequent years with a higher probability of winning, provided they remain qualified. Based on lottery results from the past several years, conversion has generally been assured by the 7th or 8th year. However, this is not guaranteed by the lottery process, and the actual timing depends on the number of units in the lottery.

Condominium Conversion and Rent Control

Dwelling units constructed before 1980 and offered for rent are subject to rent control under San Francisco's Rent Ordinance. This ordinance allows landlords to establish any initial rent, but limits future increases in rent to 60% of the rate of inflation in the San Francisco Bay Area.

However, the State's Costa-Hawkins Act (1995) prevents local rent control from applying to condominiums in California, in most circumstances. Because of Costa-Hawkins, a conversion of a pre-1980 rental unit to a condominium results in the loss of a rent-controlled unit. Even if the condominium is not owner-occupied, and is instead subsequently rented to a new tenant, that tenancy is not subject by rent control.

The Act does provide for an exception, when a condominium agrees to accept limitations on future rent increases as part of a contract with a public agency, and in exchange for a financial consideration. The proposed legislation utilizes this provision in Costa-Hawkins to require a lifetime lease for non-purchasing tenants; in exchange for this provision, the legislation provides for a fee reduction for affected TIC owners.

ECONOMIC AND FISCAL IMPACTS

Introduction

By changing the process through which apartment units may be converted to condominiums, the proposed legislation will have some near-term, and potentially long-term, impacts on the city's housing market, economy, and tax revenues.

The proposed legislation would not affect the number of units that may be converted under the lottery. The conversion fee, therefore, would result in a net increase in the number of condominiums in the city: from 200 per year under the lottery, to 200 per year under the lottery, plus any that converted in 2013 utilizing the fee option. Assessing the impacts of the fee option therefore involves a comparison a condominium with an equivalent TIC unit.

As stated earlier, condominiums and TIC units differ in two primary respects:

- The financing cost for condominiums is lower than it is for TIC units, because of the greater ease of buying and selling the unit.
- Only TIC units may be subject to rent control.

Consequently, when owners convert a TIC building to condominiums, they stand to benefit from lower financing costs, as well as higher rental income, if the condominiums are rented to tenants. While many condominiums are intended to be owner-occupied after conversion, some are rented,[2] and the comparison between TIC units and condominiums is clearest if differences in financing costs and rental income are considered. The lower financing costs and higher potential income of condominiums also raises the value of the property, and ultimately its assessed value and the City's property tax revenue.

Once per-unit estimates of these impacts are made, an estimate of the likely utilization of the fee, and an aggregate economic impact estimate, can be made.

Impact on Unit Financing Costs

A comparison of condominium mortgage and TIC loan offerings that are similar in their payment terms suggests that there is currently about a 2.5% gap in interest rates paid between the two types of products. For a 30 adjustable rate loan, fixed for the first seven years, paying 1.25 points with excellent borrower credit, current TIC loan rates are 4.75%, while current mortgage rates are 2.25%.

[2] According to data from the U.S. Census, the percentage of San Francisco housing units that are renter-occupied increased after the housing market downturn. In 2011, 63.9% of housing units were renter-occupied; in 2006, 60.7% were.

Every property will be different, but the impact of less expensive financing on owner income can be illustrated by reference to two of the "prototype" TIC units referred to in the KMA nexus study. In this illustration, a TIC share costing $300,000, needing to finance 70% of the original TIC purchase price, can potentially save $3,572 in financing costs through conversion, over a thirty-year financing period. Financing costs could potentially be reduced by $5,954 per year for a similar $500,000 TIC unit.

TABLE 2 **Potential Annual Finance Savings from Condominium Conversion: Two Sample TIC units**

TIC Sales Price	Assumed Loan-to-Value	Amount to Finance	TIC rate	Condo Rate	Annual Finance Cost-TIC	Annual Finance Cost-Condo	Annual Finance Savings from Conversion
$300,000	70%	$210,000	4.75%	2.25%	$13,274	$9,702	$3,572
$500,000	70%	$350,000	4.75%	2.25%	$22,123	$16,170	$5,954

Sources: for TIC rates, GordonFriedman.com (retrieved 3/18/13). For condominium mortgage rates, AmericanInterbanc.com (retrieved 3/18/13).

Impact on Future Rental Income

The fact that condominiums cannot be subject to rent control, but most TIC units are, creates the potential for future rent payments to increase in converted condominiums. This increase can be estimated by comparing increases in market-rate rent payments in the past, with allowable rent increases for rent-controlled units over the same time period.

As stated earlier, existing tenants in units converted using the fee may remain in their units, with future rent increases limited by the legislation. However, the index by which rent may increase under the legislation is different than the one used for rent-controlled units. Under the Rent Ordinance, annual increases in rent are limited to 60% of the overall rate of inflation in the Bay Area. For converted condominiums, rent increases are limited by the Bay Area rate of inflation in residential rents, one component of the overall rate of inflation.

This latter index captures the trend in actual rent paid across the Bay Area, and is in fact the best available estimate of future price increases in non-rent-controlled units. This suggests that there will only be a small difference in the increases in rent that current tenants utilizing the lifetime lease provision will face, from those faced by later tenants whose rent increases would be unregulated.

Over the 1980-2012 period, the average annual increase in this residential rent index was 4.9% per year. The

average allowable rent increase over the same period was 2.3%. If this difference extends in the future, then, on average, rental income associated with the property will increase by an average of 2.6% per year (4.9% - 2.3%). As Table 3 below indicates, this would translate into an annual increase in rent of $437 per year for the $300,000 TIC example from the nexus study which rents at $1,400 per month, and $624 for the $500,000 example which rents at $2,000 per month.

TABLE 3 **Potential Annual Rent Increases from Condominium Conversion: Two Sample TIC Units**

TIC Sales Price	Current Rent	Rent increase - TIC	Rent Increase - Condo	Annual Rent Increase
$300,000	$1,400	2.3%	4.9%	$437
$500,000	$2,000	2.3%	4.9%	$624

Source: For current rent, KMA nexus study. TIC and Condo rent increases based on 60% of annual change in the CPI-U inflation index for the San Francisco Bay Area, and annual change in the residential rent component of the Bay Area CPI-U, respectively.

Together, the reduction in financing costs and the increase in rent combine to increase annual property income by about $4,000-$6,500 per unit. Table 4 suggests that, given a typical capitalization rate of 7%, this increase in property income would translate into an increase in property value of $57,270 for the $300,000 TIC, and $93,965 for the $500,000 TIC unit. When the condominium is sold, its 1% base annual property tax payment will increase by $573 and $940 respectively.

Although actual financing savings and rent increases will differ from these examples, it appears likely that property owners will benefit far more from the financing savings than from the rent increases. In both examples, finance savings make up 90% of the gain in property income and value.

TABLE 4 **Potential Annual Rent Increases from Condominium Conversion: Two Sample TIC Units**

TIC Sales Price	Annual Finance Savings from Conversion	Annual Rent Increase	Annual Increase in Property Income	Capitalization Rate	Increase in Property Value	1% Annual Property Tax Payment
$300,000	$3,572	$437	$4,009	7%	$57,270	$573
$500,000	$5,954	$624	$6,578	7%	$93,965	$940

Fee Utilization and Revenue

As Table 1 indicated, the fee for TIC buildings in their first or second year in the lottery is $20,000, with the fee declining with

According to the Department of Public Works, 2,269 eligible housing units are in the 2013 lottery. It is unlikely that all of them will elect to use the fee, because properties which have been in the lottery for six, seven, or eight years have a high probability of winning without needing to pay a fee.

Based on past winning probabilities for properties at different stages of the lottery, the OEA estimates that approximately 1,730 housing units would elect to convert using the fee. As it would mainly be more recent lottery entrants that would elect to pay the fee, the per-unit fee paid would be relatively high. The OEA further estimates that fee revenue would approximate $25 million.

Aggregate Economic and Revenue Impacts

Given an estimate of the number of units that might be converted under the fee option, and the per-unit impacts discussed in earlier sections, a range of estimates of the aggregate impact of the proposed legislation on the City's economy and property tax revenue can be developed. Using the estimate of the number of housing units utilizing the fee, and the range of per-unit impacts discussed above

- An aggregate annual reduction of housing finance expenditure of between $6.2 and $11.4 million annually, benefitting the owners of the converted properties.
- An annual increase in rent payments of between $0.8 million and $1.1 million annually, due to the loss of rent-controlled housing units and the expected difference, based on past trends, between annual increases in market rents and allowable increases under the Rent Ordinance.
- A one-time increase in local government revenue of $25 million, from the fee.
- An annual increase in property tax revenue of between $1.0 million and $1.6 million.

CONCLUSIONS AND RECOMMENDATIONS

The analysis in the preceding section suggests that the proposed legislation would create clear advantages for owners of tenancies-in-common. Their costs of financing their units would decline, and they would likely earn higher rental income from them, if they wish to put them up for rent, as many condominium owners do. This is both because condominiums are not subject to rent control, and because the rent index used by the lifetime lease provision of the legislation is equivalent to market-rate rent in the Bay Area.

The City stands to benefit from approximately $25 million in one-time fee revenue, and, over time, approximately $1.0 - $1.7 million in higher property tax revenue, because the condominiums will, upon sale, have a higher assessed value.

At the same time, utilization of the fee option would reduce the number of rent-controlled housing units in the city, leading to higher rent payments from current and future tenants.

Despite the fact that property owners stand to increase their property income and value, while some renters face higher rents, condominium conversion is not a zero-sum game for the city.

Financial analysis of some typical TIC cases suggests that the benefits to property owners do not come primarily from higher rents, and that higher rents account for only about 10% of the gain to property owners. The reduction in financing costs is likely to be a much greater source of property income than higher rents. Fundamentally the financing savings is due to the greater efficiency of condominium ownership, compared with TICs, and those particular savings do not come at the expense of other stakeholders in the city.

This suggests that the legislation could be changed to eliminate the costs to future tenants without substantially reducing the incentive for property owners. Specifically, the City may consider if it is legally acceptable to modify the legislation in two ways:

1. Applying the same allowable rent increases to lifetime leases that apply to rent-controlled units;
2. Applying this level of rent limitation to every post-conversion tenancy, in perpetuity, and not only to tenancies of current non-purchasing tenants. As TIC owners would only be voluntarily accepting this control, in exchange for realizing the other benefits of conversion, it may be deemed to fit under the Costa-Hawkins exception that rent control may

only be applied to condominiums when the owner signs a contract with a public agency. As mentioned earlier, the lifetime lease requirement that is currently in the legislation already utilizes this exception.

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