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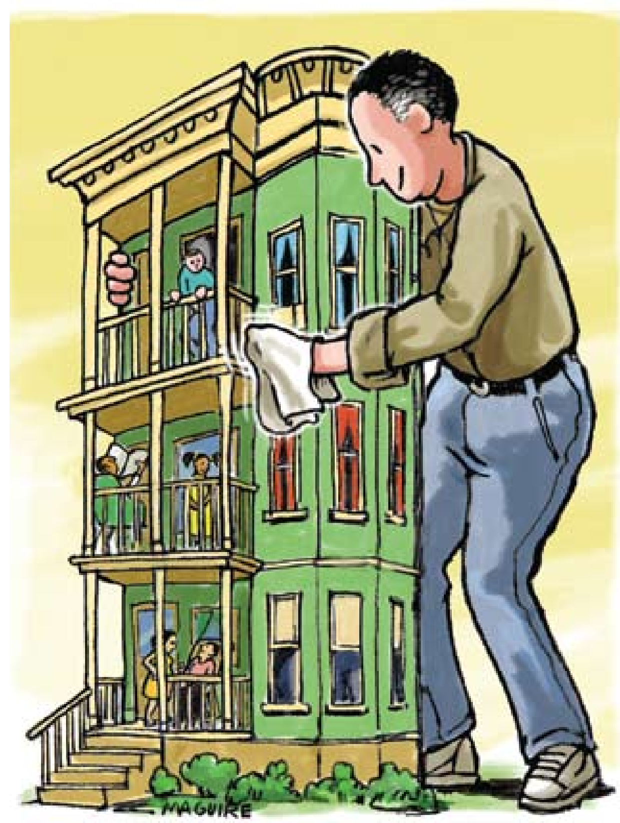
Challenges of the Small Rental Property Sector

by Alan Mallach

Most rental housing in the United States is not large apartment buildings but single-family homes, two- and three-family properties like Boston's famous triple-deckers, and small multifamily buildings tucked into urban and inner-ring suburban neighborhoods. Rental properties with fewer than 10 dwellings (called "small rental properties" in this article) make up the backbone of the privately owned, affordable rental stock in this country. While larger apartment buildings are concentrated at the two ends of the market – subsidized housing or expensive, upscale properties – small rental properties house two out of three renter households and one out of every five American households.[1]

Despite the large volume of small rental properties, the importance of the private sector's role has been largely ignored by public officials and policymakers who are more likely to see it as a problem, rather than as an invaluable and increasingly important source of housing for millions of Americans. As the homeownership rate in the United States drops, more families are becoming dependent on the rental market. The number of renters has increased by over 3 million households for the past four years, whereas even with steady population growth the number of homeowners has remained relatively constant.[2] As foreclosures mount, tough questions are being



raised about national policies that focus too narrowly on homeownership, and new attention is being given to the rental housing sector. Addressing both the quality and quantity of rental housing in our towns and cities has become even more urgent as increasing numbers of investors have moved into the distressed property market, buying bank-owned real estate (REO) properties or

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properties at foreclosure sales and putting them on the rental market.

In this article I will provide an overview of the privately owned small rental housing sector, and explore the important policy issues it raises. I will conclude with suggestions about how the public sector, at all levels of government, can foster both better-quality existing rental stock and greater production of affordably-priced new rental housing. Only by considering both issues can we hope to ensure that affordable and adequate rental housing will continue to be available in our communities.

The Small Rental Property Sector: An Overview

More than one-third of U.S. rentals are single-family homes while another one-third are in small rental properties, defined as buildings containing two to nine units. Although most parts of the country contain far more single-family homes for rent than multifamily rental properties, the proportions are reversed in New England because of the large number of triple-deckers. Seventeen percent of all rental units in the region are single-family homes, and nearly 40 percent are in two- to four-family properties. Another 14 percent are in buildings containing five to nine dwellings.[3] This trend is particularly pronounced in Massachusetts, where only 14 percent of rentals are single-family homes, while 41 percent are in two- to four-family properties.[4]

Larger apartment buildings are often owned by partnerships, real estate investment trusts (REITs), or corporations, yet small rental properties are truly "mom and pop" operations. Nearly 90 percent of one- to four-family properties and three-quarters of five- to nine-family properties are owned by an individual or a couple.[5] In fact, many two- and three-family properties are owner-occupied, with the owners living in one unit and renting out the others. In many communities an immigrant family will buy a triple-decker and rent the other units to members of their extended family or fellow-immigrants, often an important step in sinking roots and building wealth.

Few private owners of small rental properties are full-time landlords. The majority hold other jobs, from which they make most of their living. Indeed, fewer than half of the owners of two- to four-family properties made an operating profit from their buildings, compared with nearly three-quarters of the owners of apartment buildings with 50 or more units.[6] Small rental properties typically have narrow margins because the properties are often burdened by heavy debt loads and high property taxes, and the low incomes of tenants in many of the neighborhoods where these rentals are located make it impossible for owners to charge rents that might generate a healthier cash flow.

Most owners of small rental properties have historically been long-term owners, holding their properties for retirement income, long-term capital gains, or to pass on to their children. The 1995 Census Bureau Property Owners and Managers Survey (POMS) found that nearly two-thirds of the owners of five- to nine-family buildings had owned their building for more than 10 years. The recent housing bubble, however, likely brought a wave of short-term speculators into the rental housing market. Just as many of the bubble speculators were looking for quick profits, some of the current speculators may also be looking for short-term gains. This may even be the case in some weak markets such as Detroit or Cleveland.[7] Regardless of the reason, the increase in investor-buyers during the past year has significant implications which are explored further below.

New England housing tends to be older than housing in most other regions, and New England's small multifamily properties older still. In 2000, the median two- to four-family rental property was nearly 60 years old, while the median five- to 19-unit building was 40 years old.[8] More significantly, this stock is not being replaced. Replacement of five- to 19-unit buildings has been going down since the 1970s. Between 1990 and 2000, New England lost 42,000 pre-1990 rental apartments in five- to 19-unit buildings, or ten percent of the stock, but added only 23,000 new apartments.[9]

Why does this matter? Small rental properties provide most of the options for low- and moderate-income renters. Over 70 percent of all lower-income households live in one- to four-family properties.[10] Small rental properties are an integral part of the fabric of New England's older communities, not only large cities like Providence or Boston, but the region's innumerable smaller cities, inner-ring suburbs, and old mill towns. If this housing is lost or deteriorates through poor maintenance, inadequate cash flow, or other reasons, the vitality of the communities' vitality and their low-income families' ability to find decent and affordable housing is put at risk.

Focusing on the health of the privately-owned, small rental property sector matters for another

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reason. Millions of American households own these properties, from owner-occupants of triple-deckers to investors who buy a small apartment building, such as the so-called "perfect six" of Hartford.[11] The owners put their own capital into these buildings; in most cases, they also put their own time and effort into maintaining their buildings, replacing fixtures, and making repairs. While there are bad actors that may be milking their properties for short-term gain, and failing to adequately maintain them, properly screen potential lessors, or take action against problem tenants, the majority are responsible owners.

Many owners often provide decent if not luxurious housing, while charging operating costs on their books that are a fraction of those of non-profit projects built with federal funds or tax credits. This reflects the extent to which owners treat their time as a form of "sweat equity" rather than a billable cost.[12] It is hard to imagine a way for a more centralized system controlled by either private or non-profit entities to replace or replicate the scale of investment of so much in-kind time and money by millions of individual owners. Even if it could, it would be at almost inconceivable expense to the public, and the outcome is unlikely to be better. It is not just the buildings that need to be preserved, but the system through which they are financed and operated as well.

Government and the Small Rental Property Sector

Privately-owned small rental properties fall between the housing policy cracks. Federal housing programs for the most part ignore them, focusing on homeownership or on programs like the Low Income Housing Tax Credit (LIHTC) and HOPE VI, which help sophisticated developers or non-profit corporations develop large-scale rental projects. When owners of small rental properties find themselves dealing with a public agency at any level, it is usually because of a problem or conflict between them and the government, rather than as part of an effort to work together.

This cuts both ways. Many local governments see small rental properties as little more than a nuisance that places undue demands on police and code enforcement, and do not appreciate the valuable resource they represent to the community. Neighborhood and community development organizations rarely see private landlords as potential partners in their efforts to improve their communities, typically regarding them as a problem or as irrelevant to their efforts. Code enforcement is often administered in a punitive fashion – focusing on minor or even trivial violations – with little attention given to ways local institutions or government could help small land-

lords to maintain and improve their properties, and to build their skills as responsible property owners and managers. This is particularly true in the large number of communities where code enforcement is handled on a complaint basis rather than a systematic basis. Complaint-driven code enforcement, which is the rule in many older cities, offers the worst of both worlds; individual property owners see the system as unfair and see themselves being singled out for undue attention, while advocates do not believe that code enforcement efforts lead to any overall improvement in their neighborhood's housing conditions.

Little government help is available for small rental properties. The federal government has not had a program targeted at small rental properties since the end of the Housing and Urban Development (HUD) Rental Rehabilitation program in 1990.[13] While some cities use the Community Development Block Grant (CDBG) program or HOME money to provide loans or grants to help small landlords upgrade their properties, it is a modest fraction of the funds spent to assist homeowners generally. Few cities feel any sense of responsibility to help maintain or replace their stock of modest, affordable rental properties as they age. The upfront cost of entry, particularly when spread over a small number of units, makes it almost impossible for owners of small properties to access LIHTCs or tax-exempt bond financing. In communities which already have a surplus of rental housing, particularly in the depressed rustbelt, new LIHTC projects crowd out the existing private market housing and contribute to further abandonment of small rental properties.

At the same time, property owners see government more as an adversary than a source of assistance and are often reluctant to approach it for help. The often antagonistic relationship between government and landlords reflects the reality that contact tends to occur under negative conditions. These may be visits by housing inspectors or meetings with unsympathetic city hall bureaucrats arising from attempts to seek regulatory relief or financial assistance. As one immigrant property owner told the author, "They don't conduct business like people who are trying to make a profit. They're slow, and lax about paperwork. They're in total control. They know you need them and they don't need you."[14]

The single-family rental housing stock is constantly replenished, as new single-family homes, townhouses, and condos are constructed and existing ones fluctuate back and forth between owner-occupancy and rental tenure. The same is not true of small multifamily properties, whether triple-deckers or small apartment buildings. With rare exceptions, they can be replenished only through new construction. As older units are lost, they are often not replaced, for both regulatory and financial reasons. In most parts of New England, as well as the rest of the United States, local zoning ordinances do not permit multifamily construction, or if they do, permit it only under conditions that rule out modestly priced small buildings. Even if the zoning were available, affordable financing – particularly under today's stringent conditions – may be all but impossible to obtain. Owners need low-cost financing because rental cash flows are often not enough to carry the cost of building new small multifamily buildings.

These issues have been brought into sharp relief by the growing wave of investors buying distressed single family and small multifamily properties. As house prices have plunged in regions as far-flung as Detroit, Phoenix and Miami, investors have filled a vacuum left by the collapse of the homebuyer market, buying up an increasing number of properties, bidding at foreclosure sales, and buying from lenders' REO inventories. In the words of one Phoenix real estate consultant, "Foreclosure investing is the real estate buzzword now. Huge investment companies and individuals are looking to pick up properties cheap."[15]

Investor purchases account for a large part of the recent increase in existing house sales in the four Sunbelt states hit hardest by foreclosures – Arizona, California, Florida and Nevada.[16] According to the real estate research firm MDA DataQuick, in April 2009 investors accounted for nearly two out of every five home sales in the Phoenix and Las Vegas metro areas.[17] Investors have also become the most powerful drivers of sales in many older urban and inner-ring neighborhoods that are heavily impacted by recent foreclosures and severe price declines. That includes the Northside neighborhood of Minneapolis as well as Roxbury and Mattapan in Boston.

While many local officials and advocates are suspicious of the increased investor activity and believe that investor purchases are crowding out potential homeowners, others see investors as a preferable alternative to foreclosed houses remaining vacant or being abandoned. This is a particularly sensitive issue with respect to the Massachusetts triple-deckers, which are being foreclosed at far higher rates than single-family homes.[18] "The proof will be in the pudding," as Harvard's William Apgar (now at HUD) says. "Are they maintaining them well or are they letting them slip? Time will tell."[19] How will public officials, housing advocates, and community leaders respond to the rising tide of investors?

Looking Forward: Changing Public Policies

To preserve and maintain a decent level of quality and affordability in small rental properties, the public sector needs to become more engaged and accept a share of responsibility for its future health and vitality. Public policy should be designed to multiply the presence of "good actors," while discouraging the presence of "bad actors." To ensure adequate future stock, public agencies should encourage the construction of new triple-deckers and small apartment buildings as older buildings become obsolete or are recycled to other uses.

To succeed, a combination of carrots and sticks – thoughtful regulation and carefully-designed financial incentives – are likely to be necessary. It is often easier for public officials to think of sticks instead of carrots, which may carry a price tag. But without incentives for good behavior, regulatory sanctions and penalties are likely to be ineffective. Landlords who preserve the quality and affordability of their properties and contribute to the stability of their communities need to be encouraged to do so. To be successful, public policy could provide carrots to ensure that "good actors" can maintain their properties at adequate levels of quality, while those who refuse or are unable to should face strong, swift sanctions. Without strong public policies to reward good behavior and effective sanctions to control bad behavior, irresponsible property owners can easily come to dominate a community's rental market.

While everyone would agree that adequate quality should be maintained, not everyone agrees on what that represents. In lower-income communities, there is an inherent tension between maximizing housing quality and maintaining an affordable housing stock without public subsidy. This is an issue that needs attention. Given the narrow margins affecting small rental properties, particularly in low-income areas, if these units are to remain available at affordable rents, it may not be realistic to hold them to the standards of our existing housing codes. However, legitimately distinguishing between necessary and discretionary code standards could prove challenging, both in substance and in terms of the political implications of making such distinctions.

Two authors have proposed what they call a "multitiered" code that (1) gives priority to serious structural and safety conditions while allowing a realistic amount of time to get funding and do well-planned work; and (2) allows existing, older housing to be 'grandfathered' and kept 'as is' as long as feasible, as long as it does not pose health and safety risks to the tenants.[20] The authors further suggest that property owners – rather than just licensed contractors – be permitted to do many repairs, and that technical assistance be provided to owners "emphasizing long-term building maintenance over cosmetics, preservation rather than gut rehab." While these ideas are potentially controversial, new ideas that consider the reality of small property rental ownership deserve further exploration.

Public policy should be designed to multiply "good actors," while discouraging "bad actors."

In addition to giving owners code flexibility to make essential improvements in a cost-effective manner, financial assistance with repairs and maintenance could help owners maintain low rents without impairing their financial viability. Policies that encourage regulatory flexibility and provide financial assistance could also be linked to affordability provisions, training, and technical assistance. For example, the Community Investment Corporation, a Chicago-based non-profit rental lender, offers its borrowers and other landlords some useful property management training covering subjects such as marketing, fair housing requirements, tax issues, maintenance, and budgeting.[21] Additionally, New

York City's Owner Services Program offers training, technical assistance to small groups, or one-on-one mentoring to landlords of multifamily buildings.

One way to encourage "good actors" has been pursued by the city of Rochdale, a small industrial city in northwestern England. Rochdale set up a Landlords' Accreditation Scheme, under which landlords sign on to a code of standards in exchange for preferential access to services from the municipality, including a program under which the municipality guarantees security deposits for tenants who lack the means.[22] The city's goal is to build a cooperative relationship between the municipality and its landlords, and leave behind the more traditional adversarial one.

Investors should be seen as potential contributors to the health and stability of their communities.

Another example of promoting good owner behavior is found in Ogden, Utah. Ogden imposes a stiff licensing fee on rental properties while creating a parallel Good Landlord Program. Participants of the program take an eight-hour training course and agree to carefully screen tenants and maintain their properties free of criminal activity or code violations in exchange for a significant fee discount. Tax incentives, like changing depreciation schedules or providing capital gains to reward long-term holding could also be considered, as should ways of restructuring the Section 8 voucher program to foster greater long-term stability in the affordable housing stock.[23] Given landlords' tight financial margins, even small financial incentives may have a significant effect on an owner's bottom line, and may be enough to motivate the desired behavior.

However compelling the carrots may be, behind them there must be sticks. When federal government agencies or municipalities sell properties to private owners, they should ensure that only responsible bidders participate and are held to clear standards for subsequent repair and reuse of these properties. HUD's disposition practices may have contributed to, rather than ameliorated, the problem of substandard housing in many American cities. While government has no direct control over who buys property on the private market or how long the property is held, it has powerful tools to influence private decisions. Antispeculation measures, disclosure requirements, strict enforcement of habitability codes at the point of sale, and targeted code enforcement and nuisance abatement can all be effective measures. While code enforcement must be used carefully, combining it with programs that help landlords keep their buildings in use and in proper repair is critical. Where landlords are focused on short-term gains and fail to maintain their properties, codes should be rigorously enforced and penalties levied.

For a city facing large numbers of foreclosures, having an effective, well-organized code enforcement agency is critical. The same seriousness that is applied to enforcing laws and fire codes should characterize government's attitude to investors buying REO properties or properties at foreclosure sale. Investors should be seen as potential contributors to the health and stability of the communities where they buy, and should be encouraged with both moral and financial incentives by governments and neighborhood-based organizations to play that role. At the same time, local government should draw a clear line: if investors fail to follow required standards for tenant selection or property maintenance, or if they flip substandard or uninhabitable properties, they need to know that they will face severe sanctions.

Finally, policymakers should take a hard look at the barriers to constructing a future generation of affordable triple-deckers and small apartment buildings. Such buildings, by virtue of their small scale and straightforward wood frame construction, offer flexible tenureship, whether homeownership, rental occupancy, or a combination. Promoting this type of stock could be an effective way to replenish affordable private-market housing, and to strengthen the fabric of older urban and suburban neighborhoods. States should take steps to combat local exclusionary zoning practices in ways that open up opportunities for development of small multifamily buildings. State and federal governments should look at both existing and potential financing programs to encourage future small rental property development. Making LIHTC and tax-exempt bond financing programs accessible for small-scale developments would be one important step. Another might be a moderate-income rental program that could combine low-interest financing, partial tax abatement, and a shallow subsidy to make new buildings financially feasible.

Policymakers need to consider two public goods. First, maintaining a healthy, sound stock of small rental properties in dispersed private ownership is a critically important part of providing decent, affordable housing. Second, government has an essential role to play in ensuring that the small rental property sector is financially sound, well-preserved, and replaced over time. As more people move from owning a home to renting, both public policies and government actions need to reflect the importance of good rental opportunities in meeting the nation's housing needs.

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Endnotes

[1]Data from American Community Survey (ACS). 18.7 million renters lived in one- to four-family buildings, with an additional 4.6 million renters living in buildings containing 5 to 9 dwellings. There were a total of 111.6 million households in the United States.

[2]U.S. Bureau of the Census, Housing Vacancy Survey. The number of renter households increased from 33,267,000 in the first quarter of 2005 to 36,426,000 in the first quarter of 2009 while the number of homeowner households increased less than 1%.

[3]Data from ACS.

[4]Data from ACS.

[5]Much of data cited in this article comes from the Property Owners and Managers Survey (POMS) conducted by the United States Bureau of the Census in 1995. Regrettably, it has never been repeated and is the most recent source of detailed data on the operations and management of rental property available.

[6]U.S. Bureau of the Census, 1995 POMS.

[7]Houses in habitable, albeit shabby, condition can be acquired in these rustbelt cities for $10,000 or less. With rents at $600-$750 per month and minimal maintenance expenditures, speculators can double their money in three years and then walk away.

[8]2000 Census of Housing, Summary File 3.

[9]2000 Census of Housing, Summary File 3. This estimate was computed by subtracting buildings constructed after 1990 from the 2000 totals, and comparing that figure with the 1990 totals. This data set is not available separately for 5- to 9-unit properties.

[10]Donovan, 2002, based on data from the *Annual Housing Survey.*

[11]A perfect six is the popular name for a common Hartford, Connecticut, building type, a three-story brick apartment building containing six apartments, two on each floor, off a central stairwell.

[12]This reflects many different factors, including the fact that small property owners often do not charge the value of their time to their buildings. There are, however, genuine economies – reverse economies of scale, as it were – in small-scale, individualized property management.

[13]The HUD Rental Rehabilitation Program, established in 1983, provided modest subsidies (typically $10,000-$15,000 per unit) to rental property owners to make rehabilitation of their buildings economically feasible at market rents. After the rehabilitation, the lower-income tenants in the building received Section 8 certificates (now known as Housing Choice Vouchers) to ensure that they would be able to continue to afford to live there. The program was eliminated in 1990 with enactment of the HOME program.

[14]Quote from Mallach, 2007.

[15]Eric Brown, managing director of real-estate consulting firm Robert Charles Lesser & Co, quoted in Reagor, 2008.

[16]Remarkably, while existing home sales in the first quarter of 2009 dropped in 44 out of 49 states and the District of Columbia reporting compared to the first quarter of 2008, they *increased* in those four states – more than doubling in Nevada, and going up 80 percent in California. Sales increased in those four states by 59 percent, while dropping by 18 percent in the rest of the United States. National Association of Realtors, http://www.realtor.org/research/research/metroprice.

[17]These percentages are determined by checking the address to which the buyer has the property tax bill sent, the assumption being that if the bill is sent to an address other than the property address, the buyer is an absentee buyer. DataQuick provides these data only for selected metro areas, principally in the West.

[18]Goodnough, 2009.

[19]Quote from McKim, 2008.

[20]Schloming, 1999.

[21]The CIC was established in 1974 by a number of lenders as a lending pool for rental housing in Chicago's lower-income neighborhoods. Although it concentrated on one- to four-family properties for its first 10 years of operation, it has redirected its efforts toward multifamily housing since 1984.

[22]Source: Rochdale Metropolitan Borough Council (www.rochdale.gov.uk/Living/Housing.asp?URL=lasscheme)

[23]Apgar, 2004.