

DATE: April 2, 2009

TO: Chairman and Members of the Manufactured Home Fair Practices Commission

FROM: Neighborhood Services Department

**SUBJECT: CONSIDERATION OF A SPECIAL ADJUSTMENT FOR CAVALIER MOBILE ESTATES**

**SYNOPSIS**

Staff recommends that the Manufactured Home Fair Practices Commission deny the Special Adjustment request for Cavalier Mobile Estates, because Cavalier is already earning a fair return and therefore does not need a special adjustment increase to allow a fair return.

**BACKGROUND**

The Manufactured Home Fair Practices (MHFP) Ordinance provides for annual permissive rent increases equal to 75% of the increase in the consumer price index (CPI). As an alternative to the annual permissive increase, the Ordinance also provides for a rent increase based on the park's net operating income (NOI). The NOI provisions of Section 16B.9 are designed to allow a park owner to increase rents as required to maintain the park's net operating income at a certain level from year to year. Under the Ordinance it is presumed that the annual permissive increase or an NOI increase provides a fair return. However, a park owner may apply for a special adjustment under Section 16B.10, if the owner believes that the application of the permissive and NOI adjustments do not result in the owner receiving a just and reasonable return on his investment.

**ANALYSIS OF THE APPLICATION**

An application for a Special Adjustment was filed by Cavalier Mobile Estates (Cavalier), a manufactured home park located in the City of Oceanside. Cavalier is one of the oldest parks in the City and is an all age park. It is an average park in average condition and has 346 rental spaces and one space that is currently used by the resident manager.

The applicant claims the Park is not earning a fair return and seeks the following alternative rent increases:

1. An average increase in monthly space rents of \$252.39 to increase space rents to \$600 per month for each of the rent-controlled spaces in the Park and the applicant claims this large rent increase is necessary to provide a fair return. The applicant claims this increase is justified by the “market rents” shown in the rental value appraisal report prepared by MAI appraiser John Neet. (Special Adjustment Application, Attachment H). Neet’s report lists an approximate average rent of \$347.61 (as of December 2007); the difference to total \$600 is \$252.39. Brabant’s report (Summary Appraisal Report, Exhibit C) states that the average rent is currently \$355 per space per month (as of February 2009); thus, the average rent increase proposed is \$245 per space per month. Rents in the park currently range from \$334.76 to \$394.80. If rents are increased, the amount of the increase will be between \$205.20 and \$255.24 per month per space.

2. A \$118.93 increase in the monthly space rents in order to earn a fair return of 8.6% based on the report prepared by the CPA management firm Smith, Linden & Basso (Special Adjustment Application, Attachment G) and the methodology for determining fair return set forth therein.

3. A rent increase of \$68.81 using a modified MNOI methodology; instead of indexing base year income by 40% of the increase in the CPI since the base year as required by the Ordinance, the applicant uses 100% of the increase in the CPI claiming that 40% is insufficient to provide a fair return.

#### History of Rent Adjustments at Cavalier

The ordinance was adopted and became effective in January 1985. At that time, parks had the option of applying for an Initial Permissive Adjustment or an Initial NOI Adjustment; Cavalier elected to apply for an Initial Permissive Adjustment that increased the rent by \$60.96 per space per month. Since then, the park has received annual increases equal to 100% of CPI through 1991 and 75% of the increase in the CPI thereafter, pursuant to the Ordinance. Ongoing Pass Thru Adjustments were granted in the following years and amounts.

1985	\$18.47
1987	\$ 2.31
1988	\$ .35
1990	\$ 1.13
1991	\$ 2.97
2008	\$ 1.19

In 1993, rents were decreased by \$43.39 pursuant to Civil Code Section 798.41 when the applicant began separately billing residents for utilities in addition to the monthly space rent.

Cavalier has not previously been granted a Special Adjustment. The most recent permissive space rent adjustment of 1.73% became effective in July 2008. On September 4, 2008, the Commission approved an ongoing pass thru adjustment in the amount of \$1.19 per space per month. Currently approved space rents range from \$334.76 to \$394.80.

On October 2, 2008, Cavalier submitted an incomplete special adjustment application requesting an increase to \$600 per space per month, an average increase of \$252.39 per space per month. On December 3, 2008 and January 8, 2009, the park owner submitted additional information needed to complete the application. The application included financial information for calendar years 2005-2007; the analysis was based on those years. The application was declared complete on January 13, 2009. Pursuant to the Ordinance, the public hearing was scheduled for March 5, 2009, within 60 days of the application being deemed complete.

Chapter 16B.10(c) expressly provides the presumption that the permissive, NOI and pass-thru adjustments provide the park owner with a reasonable fair return. The law requires that a mobile home park owner be permitted to receive a "just and reasonable" return on investment. The courts have not defined "fair return" and Cities may use any fairly constructed method of determining fair return; no particular formula or methodology is required by the courts. However, at least one court (*Oceanside Mobilehome Parkowner's Association v. City of Oceanside*, 1984) has provided the following guidance "the rent provided must be high enough (1) to encourage good management including adequate maintenance of services, (2) to furnish a reward for efficiency, (3) to discourage flight of capital from the housing market, and (4) 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 a fair return 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 the services which are provided". The courts have further explained that in determining the return being earned by the Park, it is necessary to consider the Park as a whole. It is not appropriate to break up the Park into separate businesses, one for rent-controlled spaces and one for exempt spaces.

The City employed independent expert consultants to analyze Cavalier's application and assist the Commission in making its determinations. One is the economist, James A. Gibson, Ph.D., with NewPoint Group Management Consultants, and the other is appraiser James Brabant, MAI. Dr. Gibson's report

(Exhibit B) addresses the applicant's claim that a rent increase of \$118.93 is required to provide a fair return under the "book assets" approach to determining fair return. Mr. Brabant's report addresses the applicant's claim that rents must be increased by an average of \$252 to bring the rents up to \$600 based on "market rents" for spaces in comparable mobilehome parks.

Dr. Gibson's February 19, 2009 report also discusses each of the 12 factors that the Commission is to consider pursuant to section 16B.15(d)(7) of the Oceanside Municipal Code at a "special adjustment" hearing. Dr. Gibson's report suggests that of the 12 factors, five have greater importance and seven have minor importance. However, under the Ordinance no one factor can be determinative; the factors must be considered together and weighed and balanced by the Commission. Some factors may be more important in one application while others are more important in another application, but the result must allow a fair return to the applicant. Dr. Gibson's report contains an analysis of the return being earned by the Park utilizing the return on book value or return on book assets approach, which has been approved by the courts and is discussed below under Factor No. 11. Dr. Gibson's report shows that the applicant is already earning a fair return.

The applicant submitted a fair return analysis (Smith-Linden report) that uses an alternative methodology to that used by Dr. Gibson. While the applicant claims it is a book assets, or historical cost, approach like that used by Dr. Gibson, it is significantly different than Dr. Gibson's approach in that it increases the park's "book assets" by 100% of the increase in the CPI. For that reason, it cannot properly be called a historical cost approach as claimed by the applicant. Based on that increase in book assets, the Smith-Linden report concludes that a rent increase of \$118.93 to provide a 9.5% return, which Smith-Linden claims is what comparable investments are earning.

Mr. Brabant prepared three reports for the Commission. Two are review appraisals of the reports of appraiser Neet, which were submitted by the applicant; one is Mr. Neet's appraisal of the park's current fair market value and the second is of "market rents" in comparable parks. Mr. Brabant's review of Mr. Neet's appraisal found that Mr. Neet improperly excluded all the lower rents he found, did not include all the comparable parks in the City and considered the rents in parks that are not comparable. Staff finds that Mr. Neet's appraisal is an appraisal of what Mr. Neet believes "market rent," that is the rent in his opinion that could be charged in an unregulated market, would be for Cavalier and does not constitute the comparable rents analysis required by the Ordinance. Mr. Brabant also completed an analysis of rental values in the mobilehome parks he found most comparable to the applicant's Park. That report considers all the rents, including both rent-controlled and non-rent controlled spaces and considered more comparable parks in the City than are considered in Mr. Neet's appraisal.

The Ordinance requires the Commission to consider rents in comparable parks and requires the consideration of all relevant evidence and the application form requests that applicants submit a park appraisal. Although the rents in comparable parks and an appraisal of the Park often provide useful information, comparable rents cannot be used to determine whether a park is earning a fair return and fair return cannot be based on current fair market value of a park. Although the courts have repeatedly stated that no particular method of determining fair return must be used, the courts have criticized attempts to use current fair market value as the basis for determining fair return and have approved the historical cost/ return on assets or book value approach used by Dr. Gibson.

The Smith-Linden report submitted by the applicant claims that the Park is entitled to a monthly rental increase of \$68.81 per space to maintain the stated Ordinance presumption of park owners being entitled to maintain their NOI from year to year. This calculation is based on the applicant's assertion that the CPI should be indexed at 100% to provide a fair return. The base year net operating income is \$343,920 and the CPI has increased by 238%. The applicant concludes that after indexing the CPI at 100%, the base NOI for 2007 equals \$1,163,957 ( $\$343,920 \times 2.3844$  CPI factor), which exceeds the NOI reported by the park of \$877,432. The applicant subtracts the 2007 NOI of \$877,432 from the 100% CPI indexed amount of \$1,163,957 to come to a shortfall of \$286,525. Dividing \$286,525 by 12 results in a shortfall per space annually of \$825.72 and \$68.81 monthly.

Under Sections 16.B.9 and 16B.10 of the ordinance, a fair net operating income is defined as base year net operating income indexed by 40% of the percentage increase in the CPI since the base year. According to the financial information submitted by the applicant, from the base year to the current year the net operating income (NOI) of the park increased from \$343,920 to \$877,432, an increase of 155%. During this period, the CPI increased by 238%. The percentage increase in the NOI is equal to 65% of the percentage increase in the CPI ( $155\%/238\%$  equals 65%). Since 65% is greater than 40%, the park is receiving a fair return. If the base NOI for 2007 for Cavalier is \$671,331 or more (and the applicant reports that it is \$877,432), the park is considered to have received a fair return under the NOI standard in the ordinance. If the NOI for 2007 was \$671,331, the increase would be 95.2% ( $(\$671,331 - \$343,920) / \$343,920 = 95.2\%$ ). The percentage increase in the CPI in this example would be 40% ( $95.2\%/238\%$ ).

The Applicant does not contend that it is not obtaining the return that is defined as a fair return under the Ordinance. The applicant contends that indexing at less than 100% of the percentage increase in the CPI under the NOI standard in the ordinance does not provide a fair return as a matter of law and economic principle. However, the courts have held that indexing by 100% of the CPI is not required and the City's Ordinance and others that have been approved by the

courts provide for 40% indexing. In addition, the “leveraged” nature of real estate investments may allow investors to obtain a reasonable return on their investments when rates of indexing are well below 100% of CPI. As a result of the leveraging factor, the return on investment may be a multiple of the rate of increase in the net operating income and in the rate of increase in the value of the property. Park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property’s value or equity over time.

The following is a summary of the evidence pertaining to the factors the Board is required to consider. Each of the factors can be helpful in deciding some applications, but each is not always applicable to a particular application. The factors are intended to assist in determining whether a rent increase is needed to allow the applicant to earn a fair return. Thus, the one factor that is always relevant and of particular importance is the fair return analysis discussed in factor 11 and the expert reports.

- #1. Changes in Consumer Price Index (“CPI”): the park received rent increases equal to 75% from 1992 to 2008 and 100% of the increase in the CPI from 1985 to 1991 through annual permissive adjustments every year since the adoption of the Ordinance. The applicant claims that the costs of operation are at, or higher, than the level of the increase in the CPI, while rent levels increased at a rate below the CPI increase. Contrary to the applicant, Gibson’s report states that Park expenses declined from 2005 to 2006. However, there is no entitlement under the applicable law or the Ordinance that income increase each year in an amount equal to 100% of the increase in the CPI and a park may be earning a fair return even if its income is not increasing in an amount equal to the increase in the CPI. Moreover, this factor like the others cannot by itself be determinative of whether an increase is granted or the amount of any increase that should be granted.
- #2. Rents for comparable mobile home spaces in the City of Oceanside: In Mr. Brabant’s report compared this Park with the nine other parks he found to be the most comparable to Cavalier. He found Cavalier to be an average quality park currently in average condition. Based on his survey, an overall average rental value range of \$380-\$420 for the comparable parks, a point estimate of \$400, per month is indicated for this Park. This translates to an average increase of \$45 per month. The increase would range from \$5.20 to \$55.24 per space per month depending on the current rent for a space. Mr. Brabant’s analysis, which considers the average of the rents in each park considered, including rent for non-rent controlled spaces exempt from the City’s Ordinance, used only parks he found to be comparable. Mr. Neet did not base his report on all the rents in the parks he considered and used only those rental values that in his opinion represented what rents should be in an

unregulated market to arrive at a recommended increase of \$252.39. In other words, Mr. Neet's report sets forth what his opinion of the rent should be when there is no rent control. Staff therefore finds that Mr. Neet's rental value appraisal is not relevant; the Ordinance requires analysis of the actual rents in comparable parks rather than the estimated "market rents" set forth in Mr. Neet's report.

The courts have explained that there is a range of rents that will provide a fair return; the courts refer to this as the "zone of reasonableness". Thus, actual rents in comparable parks as opposed to estimated market rents can be helpful in deciding where in the range of reasonableness a rent increase should fall when a rent increase is required to provide a fair return. However, if no increase is necessary to allow a fair return, the factor is not relevant.

- #3. Length of time since the last rent increase: As set forth above in factor 1, this Park has received a rent increase annually based on 75% of the increase in the CPI. On September 4, 2008, the Commission also approved a continuing pass thru adjustment of \$1.19 per month per space.
- #4. Capital improvements made to the park: for direct capital improvements, no increase is justified under this factor because capital improvements made to the park were included in the assets in Dr. Gibson's book assets analysis, which is discussed under factor 11 and in his report in terms of the return on total book assets analysis.
- #5. Changes in Property Taxes or other assessed taxes to the park: Over the last three years, property taxes have increased \$1,431. Dr. Gibson calculates that based on this factor alone, a \$0.34 cent increase is justifiable. However, rent increases are not determined or calculated based on just one factor.
- #6. Rent Paid by Park Owner for Leased Land: does not apply.
- #7. Changes in utility charges or rates: there were no changes to consider because the residents pay for their own utilities and the applicant did not separate out any utility expenses for the common areas that are not billed to the residents.
- #8. Changes in reasonable operating and maintenance expenses: the Park's adjusted and normalized net income before interest and taxes from the Park increased from \$754,057 in 2005 to \$761,016 in 2007, or a \$6,959 increase, indicating a \$0.00 rent increase. Adjusted and normalized net income before interest and taxes for the Park declined from \$820,403 in 2006 to \$761,016 in 2007, or a \$59,387 decrease.

- #9. The need for repairs, etc.: The Applicant does not list the need for repairs caused by circumstances other than ordinary wear and tear as a rent increase factor.
- #10. The amount and quality of services and amenities provided, etc.: Park amenities include two clubhouses, two pools, wading pool, spa, Barbecue Area, playground, carwash and two laundry rooms. Staff is unaware of any increased amenities. Most of the amenities are natural conditions or characteristics of the park, at no additional costs to the Applicant, such as weather conditions, distances to the Oceanside Beach and shopping malls, number of spaces and the average space rent. Residents have submitted more than 170 letters of opposition; some include complaints regarding service and maintenance. Residents have made the following complaints:
- Clubhouse: Sound system and television have been removed; the size of the club house has been reduced by approximately 20 feet to set up a mobilehome sales area.
  - The trash dumpsters have been relocated to the far end of the park. This has been described as a hardship by many residents. Some residents have to walk ½ mile to the nearest dumpster.
  - There is no longer security in the park.
  - The fence along Beechwood Drive is badly in need of repair.
  - The condition of the streets makes it difficult for persons in wheelchairs to access the park.
  - Only one of the pools is available year round. This list does not include all residents concerns from the letters, just the most common items. The letters are attached as ‘Resident Letters of Opposition’. The Applicant does not indicate this factor as a specific basis for rent increase and this factor cannot be a basis for determining fair return. It could be used to determine where in the range of reasonableness a rent increase should fall if one is necessary to allow a fair return.

#11. The Park Owner/Applicant’s Investment, additional investments, appreciation, depreciation, and possible tax benefits: Dr. Gibson’s analysis of the Cavalier book value or assets and the return on those assets shows that when the Park as a whole, all 346 rental spaces, is considered, it earned a return on investment of 39.71% in 2005, 40.45% in 2006 and 36.53% in 2007. If the Park’s adjusted normalized income before taxes is averaged over the three year period, it has been earning 38.9%. Dr. Gibson’s report determined that the benchmark fair return for investments of the size of Cavalier is approximately 9.2%. The Smith-Linden report submitted by the applicant, states that the benchmark fair return for the similar investments in the data base relied on by Smith-Linden is 8.6%, but further stated the opinion that fair return for Cavalier should be increased to 9.5% to arrive at a recommended increase of \$118.93. Mr. Neet’s

appraisal of the current fair market value of the Park shows that the overall rate of return earned by the parks used in his comparable sales analysis ranges from 5% and 6.6%. The return earned by comparable mobilehome parks is a strong indicator of the return being earned by investments with comparable risks and comparable potential for appreciation. Thus the Park is already earning a fair return. Dr. Gibson's analysis also shows that the Park had a positive net income before interest and taxes for each of the three years, 2005-2007. These positive net income before interest and taxes were fairly consistent, and for 2007 were \$761,016. Furthermore, the analysis shows that Cavalier had a positive cash flow in each of the three years, 2005-2007. This cash flow for 2007 of \$590,693 represents a cash flow return of \$1,702 per space, per year and this is the equivalent to a cash flow return of \$142 per space, per month. The Smith-Linden report concludes that a rent increase is necessary despite this data because it claims you must index (increase) the value of the park's book assets by 100% of the increase in the CPI before determining whether it is earning a fair return. If, as is the case in the Smith-Linden report, the analysis of the return being earned is based on a much higher book asset value, the return being earned will necessarily be lower. However, as set forth above, the courts have approved the historical cost approach, which depreciates assets rather than indexing them (increasing them) by 100% of the increase in the CPI. Staff recommends reliance on Dr. Gibson's report.

#12. Any particular hardship circumstances of the park: The Applicant does not list this as a rent increase factor.

Based on consideration of the 12 factors and Dr. Gibson's showing that that the Park is already earning a fair return, staff recommends that the Commission find that the Park is already receiving a fair return.

### **CITY ATTORNEY'S ANALYSIS**

The procedure is in compliance with Chapter 16B of the Oceanside City Code.

### **RECOMMENDATION**

Staff recommends that the Commission deny the special adjustment request for Cavalier Mobile Estates because Cavalier is already earning a fair return and therefore does not need a special adjustment increase to allow a fair return.

**PREPARED BY:**

**SUBMITTED BY:**

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