An Economic Analysis of Non-Coastal Residential Short-term Rentals for Measure M in Pacific Grove

Proponents of Measure M believe in the Pacific Grove (PG) tradition that residential neighborhoods are for neighbors. The City Charter states that "Pacific Grove is primarily a city of homes and that business and industry shall be compatible with its residential character." When many of us purchased our homes here, we had to acknowledge at close of escrow**(1)** that we understood that short-term rentals (STR) were strictly limited to hotels, motels and B&B inns and we viewed this as a covenant with PG to protect the residential character of our new neighborhood. As an apparent accommodation to a few home owners, PG began to allow limited STRs for a few residential properties. However, as often happens, capitalism crept in and the practice accelerated and attracted new participants and investors interested in exploiting the situation. The PG Council decided to embrace the opportunity and, without voter approval, adopted the practice as a way to generate new revenue. In doing so they broke covenant with many residential home owners and let the commercial hotel business creep into our neighborhoods. The opponents of Measure M are primarily STR owners and a majority of the PG Council who apparently see only economic benefit from the practice. This paper will explore the economics of STRs in PG and conclude that PG's financial health will be better served by the adoption of Measure M.

I remember early arguments by Airbnb and the like that STRs would not have an impact on housing prices. Economics is all about supply and demand. The additional demand cannot help but contribute to rising prices. Further, the STRs garner much higher rents than long-term rentals (LTR), so they very likely contribute proportionately more to price increases. While studies supporting STR economics abound, they are almost always conducted by consultants hired by STR proponents and have a clear bias. One of the first extensive and unbiased academic studies of the economic effects of STRs was led by an economics professor, Dr. Edward Kung, from UCLA and looked at home prices in the 100 largest metro areas in the US between 2012 and 2016**(2)**. Among the researchers' conclusions was that STRs "reduce the supply of long-term rental units and increase the price for residents looking for long-term housing." Further, "home prices rise with rents" and STRs "enable homeowners to generate income from their property, making their homes even more valuable." This is great news for STR owners but not so good for folks looking for affordable housing. When asked how STRs should be regulated, the researcher said: "policies should try to stop conversion of properties from long-term rentals to short-term rental units. But regulators should not restrict home sharing for people who would not have made their homes available to long-term renters anyway, such as owner-occupiers." This recommendation is consistent with Measure M.

PG has a unique dynamic in that the supply of homes is constrained while demand, for many reasons in addition to STR ownership, continues to be strong. Prices will undoubtedly continue to rise, as they always have, unless there is another major economic downturn. Housing on the Central Coast, with its natural beauty and close proximity to one of the greatest economic engines in the world, Silicon Valley, will always be in high demand. The presence of STRs only exacerbates the result.

In order to look at the economics of STR ownership in PG at a simplified level I extracted data from publicly available sources last November. The data was then formulated in terms of average monthly rental income per square foot of property. While there are a range of property types in PG I still found using averages, as realtors often do to value properties, to be instructive. The average rental rates per square foot per month were as follows: long-term residential rental (LTR) $2.95 and short-term residential rental (STR) $3.50. The 10% Transient Occupancy Tax (TOT) was netted out of the STRs for consistency and a 70% occupancy rate assumed. A more recent look at the data confirmed that the LTR rate is still around $2.95, but the STR rate has risen to above $4.00. As you can see, if all zoning rules were equal, an owner wishing to rent their property would elect STRs to maximize income.

In the interest of understanding the expense side of owning rental property, I split owners into three broad categories and estimated their "out of pocket" cash expenses related to ownership for rental purposes, which means the data includes fees for marketing, management, and maintenance in addition to normal ownership expenses. The data is formulated in terms of average expense per square foot of property so as to be a comparable measure to the above rental rates. Expenses are on an "out of pocket" cash flow basis, leaving out depreciation and the impact of income taxes. It further assumes mortgages at market rates, including refinancing when rates dropped significantly, and a 20% down payment. The average expenses per square foot per month are as follows: New owner/Investor $3.60; long-term owners (~10+ years) $2.40; and very long-term owner/inheritors (~20+ years) $1.00. Those who have inherited their residential property are in the best shape as their expenses are likely around $0.50 per square foot per month and they have the benefit of stepped up values for depreciation and income tax purposes. Based on this data, it should be clear that most STR owners can generate very positive cash flow. When you factor in the tax benefits of (non-cash) depreciation and ever increasing property values, it's no wonder why investors have jumped into the market and STR owners in general want to protect this market.

Now what happens if Measure M passes? STR owners in non-coastal residential zones can still generate positive cash flows with an LTR rental rate of $2.95 and approximately $.50 lower cost per square foot for an LTR versus an STR. When depreciation is added to the calculation, just about every STR owner should still enjoy favorable annual net profits as well as accumulating significant long-term value as their properties appreciate. The recent lottery conducted by the Council reduced the number of non-coastal residential STRs from 169 to 143 (the Matrix study assumed they would go back up by 16 to 159). These 143 licenses would be eliminated by Measure M and the properties could potentially become available for the LTR market pool. Not only would this return these homes back to the neighborhoods as comprehended in the PG Charter, it could add a significant number of more affordable homes back to the residential market while owners still enjoy profits. Notwithstanding claims that these STRs would remain vacant, a current profile of STRs suggests that investors, including some of the most vocal opponents of Measure M, have purchased multiple STR properties and are not likely to leave them vacant.

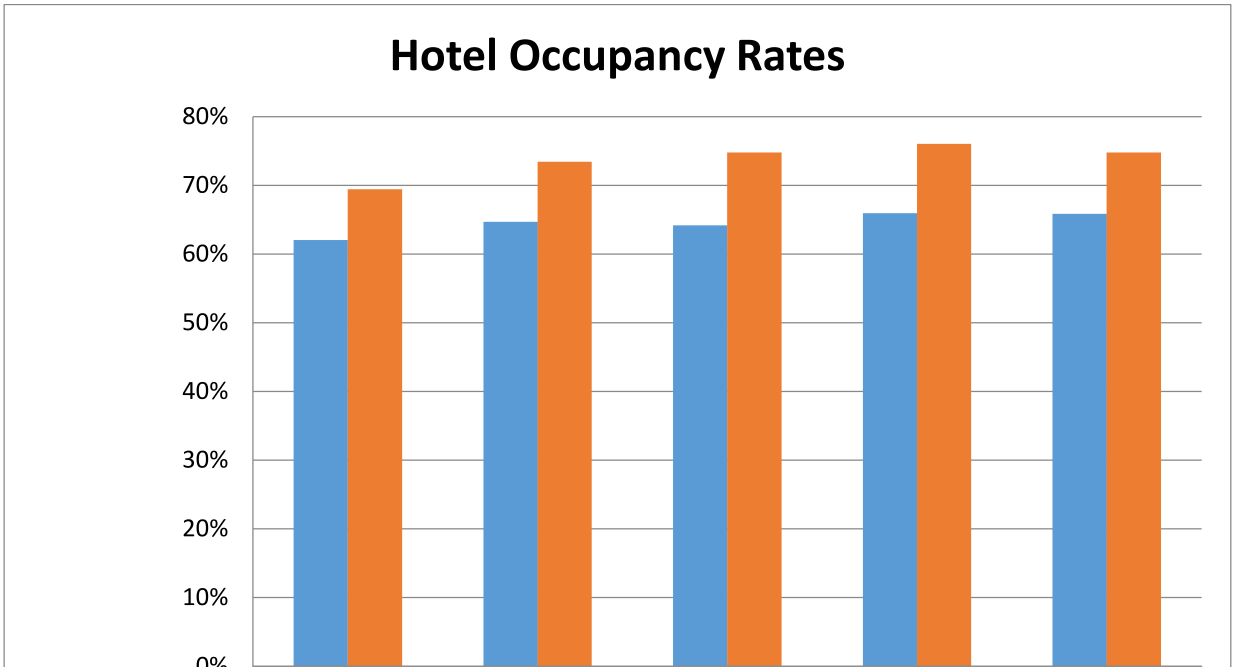
In order to assess the potential economic impact of an initiative to increase the transient occupancy tax (TOT) revenue for the City of PG's, as well as that of Measure M, the Council had a study done by the Matrix Consulting Group. While the study looked at three scenarios, only two were viable: 1) "business as usual" with the current 10% TOT rate; and 2) increasing the TOT rate payable by STRs and commercial hotels from 10% to 12%. In fact, the Council had already decided to place the second option, raising the TOTs, on the November ballot as Measure U alongside Measure M. It is reasonably expected that Measure U will pass. With this in mind the study estimates a loss of $1,288,756 in TOTs from non-coastal STRs, with $192,286**(3)** due to lottery reductions and $1,096,470**(3/4)** due to Measure M. This would be mostly be offset by an increase in TOTs of $1,023,574**(5)** by Measure U, resulting in a net loss of $265,182, $192,286 due to the lottery and $72,896**(3)** due to Measures U and M, if both pass. Measure M does not eliminate all STRs, only those in non-coastal residential zones over a transitional ("sunset") period. They are retained in the coastal and commercial zones as previously permitted by City rules. The law of supply and demand would suggest that the value and rental rates and possibly the number of permitted STRs there will increase and provide additional TOT taxes and higher property taxes as related properties turn over.

The Matrix study only looked at the results to the City, but did not consider the additional cost burden on the hotel industry of Measure U taxes. It also did not consider the benefit to the hotel industry and the City resulting from Measure M by reducing competition from STRs and thereby creating potential for significantly improved hotel occupancy that could produce added revenue and associated TOTs.

Consider first if it is fair and reasonable to impose a 20% tax increase on commercial hotels with no additional benefit to them through Measure U after the Council has allowed residential STRs to grow in recent years and compete with local hotels that have otherwise played by the rules and supported the local economy for years. For this reason the PG Chamber of Commerce opposes Measure U and the additional taxes. At the same time the Chamber supports Measure M as it will relieve commercial competition that now comes from our residential neighborhoods and has to some extent cannibalized the PG hotel industry in recent years.

The facts show that occupancy rates at PG hotels have been flat for several years averaging just below 65% (Exhibit 1) while STRs were on the rise. By comparison, the City of Monterey, which does not allow STRs and has four times as many hotel rooms as PG, has been averaging almost 74% occupancy over this same period, more than 9% higher than PG. Further, the TOTs collected from PG's commercial hotels have been flat at about $4M (Exhibit 2) over the same period implying that not only has occupancy been unfavorably impacted but hotels have not been able to raise room rates as well. This STR experiment appears to have been more like a shell game of moving the hotel industry into the neighborhoods in hopes of creating more TOTs, only to see them go flat from the commercial hotels. Consider that the 256 STRs still licensed at the end of fiscal year 2018 represent approximately 640 to 768 rooms, assuming between 2.5 to 3.0 bedrooms each, fully equal to 62-75% of the 1,027 rooms available at PG's commercial hotels (down from 1,044 due to the failure one B&B) and making for some very serious commercial competition. Measure M would remove the 159 non-coastal STRs used in the Matrix study and eliminate between 400 to 475 rooms, or 40-45% of this competitive inventory. If removing such competition would allow PG hotels to increase occupancy from 65% up to 74%, as enjoyed by Monterey hotels, they could generate almost $5 million in additional revenue and better afford the additional the $931,651 in TOTs estimated to result from Measure U as well as add another $500,000 in TOTs from increased business. So it seems not only fair to the hotels but economically reasonable to all to pass both measures and restore both our neighborhoods and our hotel industry back to their traditional roles.

Exhibit 1.



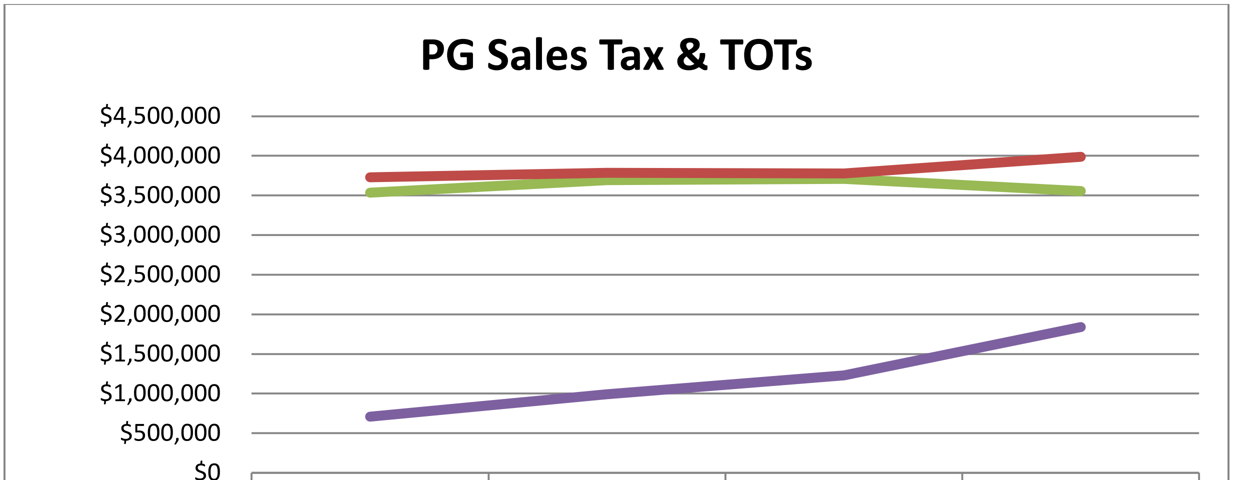
	FY14	FY15	FY16	FY17	FY18
Pacific Grove %	62%	65%	64%	66%	66%
Monterey %	69%	73%	75%	76%	75%

Source: Monterey County Convention & Visitors Bureau.

And, while I don't know all the facts around the Bella Project, the information published about their business plan indicated a big investment and reliance on a high occupancy rate to be viable. Thinking as hotel developer, I would have serious concerns about investing here while PG allows STRs to compete with me. It is clearly in PGs best interest to eliminate this non-coastal residential STR competition if they want to successfully grow the hotel industry as a source of future TOTs.

Proponents of STRs claim that their visitors contribute to the local economy by shopping and dining in town and to the City of PG through the collection of sales tax. The Matrix study mentioned this but only inconclusively. The fact is that sales taxes received by PG have been relatively flat over the past few years at about $3.6M while STR TOT revenue has been increasing steadily (Exhibit 2), thus putting in doubt any claim that STR activity meaningfully contributes to the improvement of local business. One key marketing point for STRs is that you get a full kitchen with your STR, so you can cook at home rather than eat out. Further, STR visitors are likely more comfortable booking and shopping on line, so even if they find something of interest in a local store they are more likely to buy it on line. I suspect that local residents would be more familiar with and likely to shop and dine in PG than STR visitors. Certainly the retail sector has suffered over these years due to lack luster demand.

Exhibit 2.



	FY15	FY16	FY17	FY18
Net Sales Tax	$3,534,495	$3,693,017	$3,708,173	$3,555,000
STR TOTs	$707,468	$992,986	$1,230,429	$1,837,847
Commercial TOTs	$3,730,897	$3,786,439	$3,776,967	$3,989,006

Net Sales Tax STR TOTs Commercial TOTs

Sales tax & timing adjustments as reported by PG through FY17. FY18 estimate from FY19 Proposed Budget (5/10/18)

TOTs as reported by PG through FY18.

Another economic factor to consider is where the revenue from STRs goes. The booking agents in the age of STRs are software programs running on a computer in some remote server farm, so the related fees go elsewhere along with fact that the computer has no personal relationship with the town. Further, as more outside investors participate in STR ownership, most of their income also goes elsewhere and not into the local economy. Currently 82% of STR owners are "out-of-towners."

There has also been increasing anecdotal evidence shared by residents that local driving behavior has been getting worse in recent years and some attribute this to increased STR activity. I looked at the PGPD community reports(6) and found that traffic accidents have been increasing at a rate quite similar to STR growth. There is yet no conclusive evidence to link the two, but it does provide some food for thought and perhaps reason for additional investigation.

Lastly, there has likely been a fairly high opportunity cost to PG over STRs. With so much energy spent by both public officials and private folks on both sides of the STR issue, other priorities must have certainly gone under-attended and precious City funds have been spent on consultants and lawyers to fight the battles.

To summarize, adoption of Measure M will eliminate an estimated 143 non-coastal residential STRs remaining after the recent lottery action and return them back to the neighborhoods, potentially increasing the availability of more affordable housing for long-term residents and returning the commercial visitor business back to the hotels and inns in the way PG's Charter intended. The elimination of these STRs is estimated to reduce TOT revenues by $1,096,470 after adjusting for the loss of $192,276 due to the lottery action. If measure U is adopted at the same time, TOTs are expected to go up by $1,023,574, leaving the City with a net loss of only $72,896. In addition, it can reasonably be expected that hotel occupancy, not to mention rental rates, will go up as a result of significantly reduced competition. Assuming an increase in occupancy from 65% to the 74% that Monterey hotels enjoy, the City of PG would benefit by approximately another $500,000 in additional TOTs. Further, the commercial STRs will also experience less competition and will likely contribute more in TOTs as they can expand within the rules and possibly experience increasing occupancy and rental rates, as well. While owners of eliminated STRs may see a reduction in rental revenue, turning them into long-term rental units will still provide generous profits for most in the short run and attractive profits as their properties appreciate over time and, more importantly, increase the supply of more affordable housing. Finally, a reinvigorated commercial hotel sector should make it more inviting to future developers to invest in PG. I believe these net economic benefits support the passage of both Measures M and U for the financial future of PG.

Notes and References

1. Acknowledgement requiring initialing at close of escrow for purchase of past homes. Copy appended.
2. *How Airbnb Affects Home Prices and Rent* by Lisa Ward. Wall Street Journal October 22, 2017.
3. Source: *Revenue Analysis for Non-Coastal Short Term Rental Results* by Matrix Consulting Group June 2018.

Financial Impact of the Lottery and Measures M & U						
	TOTs per Matrix Report			Difference FY20/21 vs FY18/19		
	Pre-Meas. M/U Pre Lottery 2018/19 10% TOTs	Pre-Meas. M/U Post Lottery-a) 2018/19 10% TOTs	Post-Meas. M/U Scenario 1 2020/21 12% TOTs	Due to Lottery	Due to Meas. M & U	Total
Residential STRs	$1,168,577	$1,096,470	$0	($72,107)	($1,096,470)	($1,168,577)
Coastal/Comm. STRs	$624,030	$503,851	$616,774	($120,179)	$112,923	($7,256)
STRs	$1,792,607	$1,600,321	$616,774	($192,286)	($983,547)	($1,175,833)
Commercial	$4,063,230	$4,063,230	$4,973,881	$0	$910,651	$910,651
Total	$5,855,837	$5,663,551	$5,590,655	($192,286)	($72,896)	($265,182)
STRs	256	229	229			
(a-Derived from Matrix Report methodology.						

4. As exhibited above, data in this analysis was sourced from the Matrix Report, however there were several ways the data was presented: 1) on an annual basis & 2) using a three-year average, including an arbitrary 1% annual increase. This analysis used an annual figure and the City Attorney in his impartial analysis of Measure M used the three-year average. Following is a simple reconciliation of the two methods.

City Attorney's Estimate	**$1,129,731**
1% annual increase assumed in report	($33,261)
Loss due to Measure M in this analysis:	**$1,096,470**

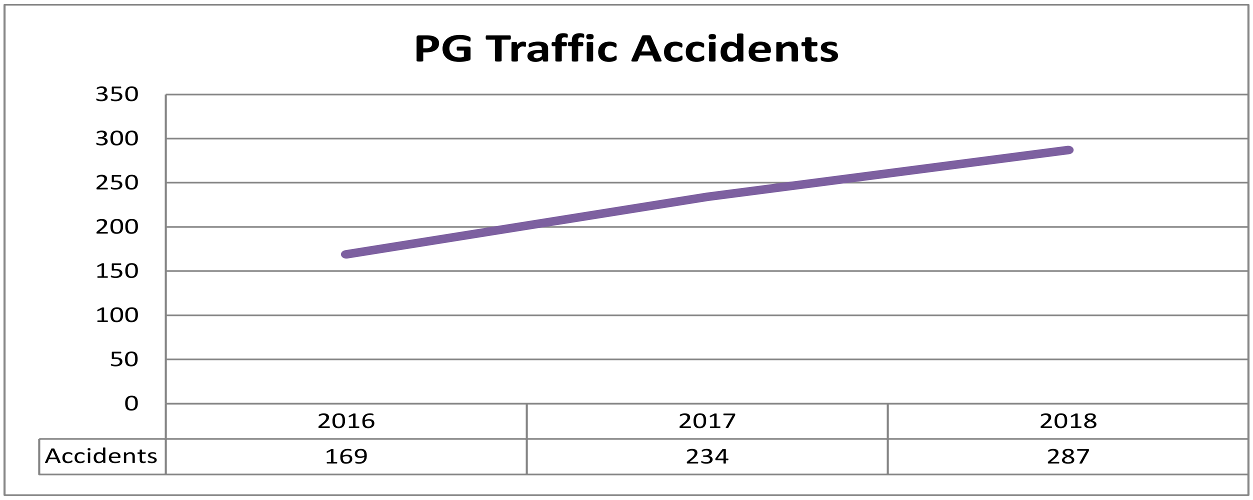
5. As exhibited above, data in this analysis was sourced from the Matrix Report. However, the City Attorney in his impartial analysis of Measure U used an estimate based on the City's revised FY17/18 Budget, which included TOTs from STRs that will be eliminated in the future by the recently completed lottery action. Further, 205 STRs licenses remained active after the lottery. The Matrix Report actually used 229 STRs in their calculations. Following is a reconciliation of the two methods.

	FY 17/18 Budget	FY 17/18 Amendment	FY 17/18 Revised Bud.		
STR-Total	$1,151,000				
Commercial	$4,022,000				
TOTAL	$5,173,000	$500,000	$5,673,000		
Measure U TOT rate @12%			$6,807,600		
Current TOT @10%			$5,673,000		
Difference			$1,134,600	or $1,135,000	-a)

(a-Since this estimate is based on the 2018 Budget rather than the Matrix Report, it includes TOTs from STRs eliminated by the lottery.

City Attorney's Estimate		
Post-Lottery STRs	**205**	**$909,000**
Lottery Eliminated STRs	51	$226,000
Total STRs at end of FY18	256	**$1,135,000**
Matrix Report		
Post-Lottery STRs actually used in the report	**229**	$1,014,620
1% annual increase assumed in report		$8,954
Total-Post Lottery Measure U TOTs in this analysis:		**$1,023,574**

6. PG Traffic Accidents:



As reported by the PGPD. 2018 annualized based on 8/17/18 year-to-date report.

7. The author, Charles Alvarez, retired to PG after a 40-year career as a Chief Financial Officer (CFO) in Silicon Valley. He holds a BA and MA in economics. He most recently served for 10 years as volunteer CFO and Chief Gofer for Nancy's Attic, a gift shop in downtown PG which closed this past June. He still reports to Nancy at their PG home which they have owned for nearly 20 years, first as a weekend retreat and finally as their post-retirement home. Their home has never been rented out.

CITY OF PACIFIC GROVE

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INFORMATION FOR THOSE PLANNING TO START A BUSINESS IN PACIFIC GROVE AND FOR OPERATORS OF HOTELS, MOTELS, APARTMENT HOUSES, AND OTHER RENTAL UNITS

Before commencing any business activity in Pacific Grove, you must comply with a number of local regulations. We suggest you take the following steps:

Check On Zoning And Any Special Permit Requirements

Discuss your proposed business with the City's Community Development Department, 648-3190. The Community Development Department will check to make sure that your proposed business is in the proper zone and assist you in applying for any special permits you might need, such as a use permit or a sign permit. Depending on the type of business you plan to operate, the Community Development Department may also refer you to other departments or agencies, such as the Fire Department or the Monterey County Health Department.

Check On Water Management And Sewer District Fees And Regulations

Discuss your proposed business with the Monterey Peninsula Water Management District, 187 Eldorado, Monterey, 649-2500, and the Monterey Peninsula Water Pollution Control Agency, 5 Harris Court, Bldg. D, Monterey, 372-3367. The Water Management and Sewer Districts will advise you of any special water or sewer permit fees you may be required to pay and explain current regulations.

Obtain A Business License

Obtain a business license from City Hall, 300 Forest Avenue, Pacific Grove, 648-3100. The current business license tax rate is one mill (0.001) of your estimated annual gross receipts ($1.00 per $1,000.00 of gross receipts), with a minimum annual tax of $15.00 and a maximum annual tax of $3,000.00

Special Note Regarding Hotels, Motels, Apartments, And Other Rental Units

There are very specific regulations which govern hotels, motels, bed & breakfast inns, apartment units, and other rental units.

- Hotels, motels, and bed & breakfast inns are permitted to have transient occupancies only (guests staying for 30 days or less). Such establishments must obtain both a business license and a Transient Occupancy Registration Certificate from the City and must collect the transient occupancy tax for the City.
- Apartment houses and other rental units are not permitted to have transient occupancies (stays of 30 days or less). Anyone owning or operating more than three residential rental units - whether separate single family dwellings, duplexes, triplexes, or one or more apartment buildings - must have a City business license.

Other Regulations

- You should check with the State Board of Equalization in Salinas, 443-3008, to determine if you will need a resale permit.
- If you plan on doing business under a name other than your own, you should check with the Office of the County Clerk, 647-7730, regarding a fictitious business name statement.
- Certain businesses, trades, and professions require a special license or permit from the State.