Here’s How Some Apartment Pros May Deal With Higher Interest Rates, Insurance Costs

Multifamily Investors, Bankers Swap Tips, Plot Strategy in San Diego

By Jon Leckie

Among the palm trees and plaster facades of San Diego, apartment brokers, bankers, and builders from across the nation gathered this week to figure out how to navigate what they say are two of the biggest challenges hitting their industry: higher interest rates and insurance costs.

Deals slowed, rent growth fell and the Federal Reserve kept borrowing costs high over the past year, leading industry executives at the National Multifamily Housing Council’s annual strategy meeting to swap laments as they warmed the aches inflicted by that quiet turbulence.

Attendees discussed using alternative financing to regular banks to fight the reduced lending with higher borrowing costs and whether to consider insurance rates in where they choose to buy or build. And the discussion turned to whether building more will reduce high rent costs. But the multifamily professionals generally focused on urging the Fed to start cutting interest rates.

The conference began with speakers saying interest rates led the list of culprits responsible for weaker dealmaking, along with a general uncertainty about the economy, and lack of available credit. Attendees shared often pessimistic outlooks.

“These are tough times,” Eddie Lorin, founder of Strategic Realty Holdings, told CoStar News, reprising a popular sentiment of current market conditions.

These difficulties, along with volatility in the insurance and underwriting market that has been simmering since Hurricane Harvey struck the Gulf Coast in late summer of 2017, are affecting deals, according to industry executives.

Zamir Kazi, CEO of ZMR Capital, citing the high cost of insurance, sat on the sidelines for the entirety of 2023.

“We haven't done much of anything in the last 24 months. I mean, we bought one deal in the last two years,” he told CoStar News. “You know, we've got capital, we've got partners that are willing to deploy just waiting, waiting right now.”

Bankers such as Shlomi Ronen, managing partner at Dekel Capital, are hoping to see interest rates cut in 2024, which is expected to bring back dealmaking.

“What we really need is transactions quite frankly,” he told CoStar News. “Thankfully we've seen an uptick this year so far and it's very early into the year. There's definitely some optimism so long as there's transactions.”

Persistently high rates haven’t just frozen the number of deals, but access to capital as well.

“Today, you've got to be able to have something that comes out of the gate, it's got to be a 5%-plus cash flow. Day one,” Henry Manoucheri, CEO of Universe Holdings, told CoStar News. “You can attract that kind of capital from private investors. But for institutions that are so cash-flow driven, there's more yield. So that's not going to make a difference,” noting that funding from private investors is almost always far lower than capital from institutions.

“I think a lot of them will come back in the market, once the 10-year [Treasury] drops to like three and a half or 3%, if that ever happens,” Manoucheri said. “Until then, I think they're going to sit on the sidelines … and put their money in CDs where they make five and a half, seven.”

Others, however, see opportunities in limited financing from traditional institutions.

“With the banks retreating last year, the real players in the market have been the debt funds on the construction and floating-rate bridge side,” Ronen said, referring to short-term financing. “And the debt funds are still out there very actively lending. Trying to get deals done.”

Higher Insurance Costs

Kazi summed up the state of insurance costs in two words: “It’s bad.”

Largely driven by climate risks — floods in Florida, fires in California, hail in Denver — insurance premiums have taken off over the past year and that has meant more cost volatility and greater uncertainty for apartment investors and developers.

One Denver deal involving DB Capital Management saw insurance premiums rise 250%.

“It was a nightmare last year,” Brennen Degner, DB Capital’s CEO, told CoStar News, citing insurance premiums that went from $80,000 a year to $280,000 a year at renewal. “That's just purely off the bottom line, it's purely a hit to value.”

Kazi said the cost of insurance at one of ZMR Capital’s properties increased 400% over the past year and half. And Manoucheri relayed he’s seen increases up to $2,000 a door, which can equate to between a 300% and 400% increase.

“I've seen deals that come on the market.” Manoucheri said, “and depending on the location ... if it's near a hilly area, or surrounded by mountains with a ton of brush, you can't get any insurance that makes any sense.”

The same dynamic is playing out in Florida with properties near the coast, he said. But nearly any Florida or Gulf Coast deal is threatened by hurricanes if not outright flooding, and as the occurrence of these natural disasters increases, it becomes almost a certainty insurance carriers will face widespread claims and payouts.

“I don’t understand how you make money in insurance in Florida,” said Kazi, who operates out of Tampa.

Lorin called rising insurance the second-biggest problem in multifamily real estate behind interest rates. Whatever the reasons for why rates have gone up, he said, the bottom line is that there’s just not enough people to reinsure as large providers have pulled out.

“When a major carrier exits the market, everyone has the ability to be more competitive at a higher price,” Degner said. “When one of your highest expenses quadruples overnight without adding any value to residents, it has a huge impact on [property] value. And then that feeds into the volatility story of how do you price an asset.”

Affordability Remains an Issue

DeRitis was cautiously optimistic about the state of the U.S. economy.

“Looking forward, consumers are still in good shape,” he said during a panel discussion. But beneath the surface there is at least one danger sign.

While the upper 25% of consumers by income have amassed over a trillion dollars in excess savings, those in the bottom 25% have completely run out of savings, he said. And with the mortgage market constrained by low supply, rents have gone up so fast that housing isn’t affordable for some right now.

“Affordability is a big factor, and I think keeping things affordable is something we’re all going to have to make an effort to do,” Kazi said.

The consensus about how to bring down rents was clear: build.

“The ability to solve the affordable issue is new development,” Degner said. “We're seeing it as we speak in markets like [Austin, Texas]. All these Sun Belt markets that were arguably overbuilt, over the last few years are seeing rents decline. … They're seeing pricing power back in the hands of the consumer. I mean, it works against me right now. But I think ultimately, that's how you keep things functioning.”

But more development isn’t possible everywhere, and markets where it’s difficult are often the markets where rents are the highest.

“In the metros, that's going to continue to be a challenge,” Ronen said, “because there's a lot of constraints to supply. Where in places like Austin and Houston and San Antonio, where we can just build, affordability becomes less of an issue.”

Inflation too has been complicating the issue, he said, driving up the cost of building that necessitates higher rents. It’s one area where Lorin sees the opportunity for regulation to help spur construction.

Affordability “is a big problem. And if you're going to cap your rents, something has to give,” he said. “You need a property tax abatement, you need some financing from the city, you need free land, you need all kinds of things that aren't available now. So it's only going to get worse.

And you got to build, build, build."

Lorin believes rent prices will stabilize in the coming year, with yearly rent growth back to relatively normal rates between 2% and 3%. But that doesn't erase the historic growth over 2021 and 2022.

"You had a run-up almost 20%," he said. "And incomes didn't keep up, right? So [rents] can't do more than we have now. I don't think rents will go down in some markets, maybe a little bit. But they just need to catch up. The incomes need to catch up." Or something else needs to fill the gap, he added, such as federal vouchers that bridge what people can afford and the cost of rental housing.