SPECIAL REPORT

Marcus & Millichap

RISING INSURANCE COSTS

AUGUST 2023

Rising Cost of Insurance has Wide-Reaching Implications for Commercial Real Estate Investors

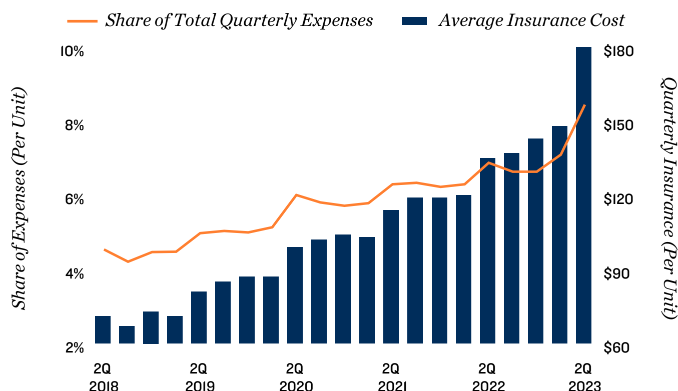
Apartment expenses climbing at twice the pace of rents. Insurance costs are rising at an accelerated rate for commercial real estate, while providers concurrently implement new policy limitations to decrease their exposure. Together, these dynamics are eroding commercial real estate owners' and developers' margins, especially in states with higher environmental risk factors, including Florida, California and Texas. As of June 2023, the average U.S. quarterly apartment premium stood at $180 per unit, translating to a 33 percent year-over-year spike. Following this sizable adjustment, insurance now accounts for more than 8 percent of an owner's quarterly per-unit operating expenses, nearly double the share from five years ago. Factor in rising property taxes and payroll costs, and the expenses associated with apartment ownership rose 9 percent over the past year. At the same time, the national average effective rent rose 4 percent. This disparity and expectations for further operating cost increases and rent growth moderation will broadly influence development proposals, property valuations and investors' acquisition criteria moving forward.

Developers react by paring back project starts. Spiking insurance premiums, along with elevated labor, materials and financing costs, are making it more difficult for developers to underwrite ground-up developments. This dynamic has the potential to facilitate a broad pullback in U.S. project starts, a trend that already appears to be taking shape. Through the first six months of this year, the value of all commercial starts fell 11 percent, while the number of permits issued for new multifamily projects in June represented the lowest level since late 2020. A slowdown in multifamily groundbreakings, however, appears warranted as the delivery of 400,000 units this year will exceed short-term demand, raising the nation's vacancy rate to a 12-year high of 5.7 percent.

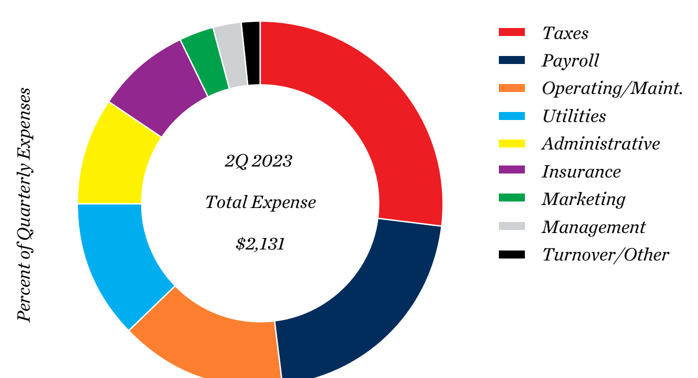
Underwriting and expense concerns favor net-leased assets. The accelerated cost of insurance will alter property valuations, making it more difficult for some investors to underwrite acquisitions moving forward. This dynamic, which could negatively impact localized deal flow, should be most apparent in metros deemed to be at high risk of weather-induced property damage. Heightened insurance costs may also cut into merchant builders' proceeds when selling a newly-built or pre-stabilized property, as current premiums are significantly higher than what developers underwrote when financing these developments several years ago. Considering these market conditions, an ownership model where the tenant pays for all insurance and property maintenance may represent an appealing investment option for more investors, bolstering the outlook for net-leased transaction activity and sale-leaseback velocity.

Home insurance erodes some markets' cost-of-living advantage. The elevated price of coverage also represents a line item that is driving up the cost of single-family ownership. This is positioned to influence migration trends moving forward, specifically in states where national providers have stopped issuing new policies to homeowners or curtailed their coverage. Rising single-family premiums — estimated to be roughly $6,000 on average in Florida, quadruple the U.S. mean — are likely to deter some prospective homeowners from purchasing in specific metros that are renowned for their lower cost-of-living. Other households may opt to rent, a potential boon for multifamily owners during a period of trailing demand. The rising cost to insure apartments, however, may adversely impact these households, as the added expense will require some owners to tap into capital typically allotted for property upgrades, potentially lowering the quality of rental stock.

Insurance Cost Spike Raises Apartment Expenses



Quarterly Expenses Per Unit By Category



Pronounced Increases Apparent Across Florida and California Markets

Multifamily Market	Y-O-Y Increase Per Unit*	Average Quarterly Insurance Cost*	Average Effective Rent*	Y-O-Y Rent Growth**
Orange County, CA	79.1%	$174/unit	$2,738	2.4%
Jacksonville	61.8%	$250/unit	$1,530	0.7%
Tampa-St. Petersburg	52.1%	$293/unit	$1,837	2.5%
Oakland	50.2%	$232/unit	$2,616	0.4%
Fort Lauderdale	48.8%	$305/unit	$2,450	3.8%
San Francisco	44.7%	$282/unit	$2,851	-0.7%
Miami-Dade	38.6%	$310/unit	$2,557	9.1%
Orlando	38.1%	$215/unit	$1,824	3.3%
West Palm Beach	35.8%	$355/unit	$2,445	3.4%
Los Angeles	27.2%	$298/unit	$2,803	3.9%

** As of 2Q 2023*

Providers Reduce Their Exposure in High-Risk States; Insurance Spikes Extend to Texas

Costs likely to go up as insurers exit some areas. Of the 10 major U.S. metros with the highest second quarter multifamily premiums, eight were in Florida or California. This situation is poised to continue for the foreseeable future as the exit of several major providers in each of these high-risk states will impact other insurers' policies and rates moving forward. In Florida, Farmers Insurance's departure will place pressure on the state-run Citizens Property Insurance Corporation, with the company expected to have up to 1.7 million policies by year-end. In June, the provider requested the maximum premium increase allowed, which would raise the average cost to customers by up to 12 percent. In California, State Farm and Allstate's exodus may impact renewals in addition to new policies, a potential concern for owners of older buildings requiring seismic upgrades and assets in wildfire zones.

Providers face less pushback in Lone Star state. Similar to Florida and California markets, Texas metros are dealing with steep insurance price increases. In Houston and Fort Worth, the average cost to insure a unit rose 40-plus percent year-over-year in the second quarter. Here, and in other in-state metros, providers are attempting to recoup losses from winter ice storms that impacted properties over the past two years. However, unlike the aforementioned states, Texas is a file and use territory where providers are less regulated. Under this policy, a company may raise premiums immediately after filing a request with the state's Department of Insurance, rather than being required to wait for approval. Last year, nearly 90 percent of the rate adjustments submitted stood, suggesting insurers are unlikely to leave the state and that additional increases may be awaiting owners and developers.

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; U.S. Census Bureau; U.S. Bureau of Labor Statistics; RealPage; U.S. Department of Commerce; Federal Emergency Management Agency; Texas Department of Insurance; Dodge Construction Network; Insurance Information Institute; Quadrant Information Services

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