# STRIPPING THE CASHFLOW FROM THE DEAL

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One of the main themes in commercial real estate over the last decade has been the migration of population and jobs – and investment capital – to the Sunbelt. Gone are the days when large institutions concentrated investment dollars in the nation's top 10 largest markets. Capital is increasingly flowing to the fastest growing markets, places such as Nashville, Charlotte, Austin, and Orlando, where households and companies are migrating for lower costs.

Yet expenses, particularly insurance, recently have soared in many of these low-cost markets. Yardi Matrix found that total multifamily expenses increased by double-digit percentages year-over-year on trailing-12 basis through mid-year 2023 in markets including Tampa (16.2%), Orlando (15.1%) Austin (11.1%) and Charlotte (10.9%). Insurance is rising even faster in states with large numbers of weather-related payouts. Some of the largest property insurance increases on the metro level during that period were in Orlando (34.5%), Houston (31.6%), Tampa (28.8%), San Antonio (27.7%) and Dallas (24.3%), per Matrix.

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The idea is not that far out of left field as it seems at first blush. In fact, the Dallas Federal Reserve warned in a recent publication that rising temperatures correlate to reduced GDP growth. For every 1-degree increase in average summer temperature, Texas annual nominal GDP growth slows 0.4 percentage points, the report said. Leisure and hospitality was most impacted, but transportation, manufacturing and retail also slowed.

The Dallas Fed's report said 2023's heat wave reduced Texas GDP by $10 billion to $24 billion, and the problem will only intensify if projected temperatures rise in coming decades. "As climate change's effects intensify over the next decade, heat waves will become more commonplace and severe, and Texans will need to adapt," the report said.

Population and commercial property inventory is migrating the most to many places where climate change is getting tangibly worse, noted Ryan Severino, chief economist xxxxxx BGO. As more people and businesses continue to move to those places, coupled with climate change, environmental challenges are going to persist and likely worsen, he said. "The data is still largely anecdotal at this point because it is difficult to disentangle that specific effect from the broader slowdown after the pandemic boom. But at the margin it is starting to have an impact on demographic changes," Severino said.

The most obvious impact for commercial properties is rising insurance premiums due to the growing number of weather-related payouts. Not only are premiums increasing, but policies offer less coverage with higher deductibles. South Florida multifamily property insurance now costs thousands of dollars per door, noted Chris Conlon, director of risk management at Mahaffey Apartment Company in St. Petersburg, Fla. "Insurance is not a singular factor, but the insurance line item is part of the consideration of where and what to build. Affordable housing is getting killed," he said.

To be sure, it's far too soon to confidently predict how weather and expenses will play out in commercial real estate. Temperature forecasts might not turn out as expected. Growth in expenses such as insurance trend could reverse as inflation decelerates. And it will take many years to erode the advantage of low-cost areas. Still, it is a risk that investors should underwrite and not assume will go away. Rapidly rising expenses could limit development and reduce profitability in areas that now carry a pricing advantage.

"The increase in insurance costs in high growth markets such as Florida and Texas is stripping the cashflow out of real estate deals," said Danielle Lombardo, chair of Lockton Global Real Estate Practice. "If deals don't pencil as a result of insurance and there is expected continued volatility, real estate owners and developers will look elsewhere."

### ABOUT THE AUTHOR