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Flood and Fire: The Multifamily Sector's Response to Natural Disasters

Last year will rank as one of the most catastrophic in recent memory for Americans who experienced natural disasters. Storms in the Caribbean, Southeast and Gulf Coast—along with wildfires, floods and convective storms across much of the western U.S.—affected millions of lives and will require billions of dollars for recovery. Over the final quarter of 2017, multifamily rents grew materially, occupancy increased, insurance rates rose and policies tightened in many storm-affected areas. The destruction will continue to impact the real estate as well as the insurance industry throughout 2018.

Three hurricanes inflicted some $110 billion in property damage, according to Freddie Mac, and the economic loss from the storms surpassed $300 billion. The storm-affected areas are recovering at different paces, and Puerto Rico, which lost 100% of its power in the wake of Hurricane Maria, is still in need of major infrastructure resources, as roughly half of the island remains in blackout more than three months after the storm. The situation in Puerto Rico continues to be a humanitarian crisis, as residents and local leaders endure a lack of power and potable water, and face costly rebuilding in the years to come.

While Hurricanes Harvey and Irma were also devastating, the two storms that hit the United States mainland impacted areas with stronger infrastructure. For many residents, rebuilding has begun, but will likely take months to complete, if not years.

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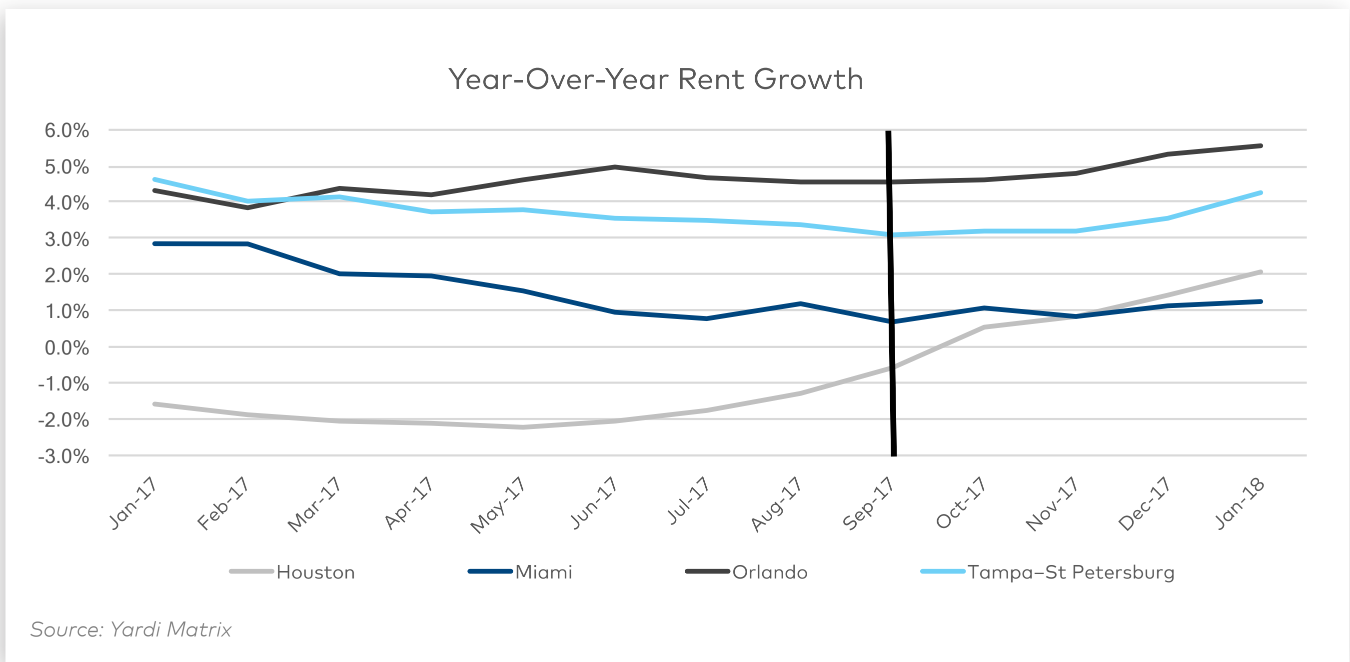
Rising Fundamentals

The counties impacted in Florida and Texas account for about 13% of total U.S. housing permits. In the immediate wake of the hurricanes, the need for housing spiked, and many renters and homeowners had to relocate. As a result, average apartment rents increased quickly. Houston rents, which declined for about 18 months prior to Hurricane Harvey, reversed course and increased 1.6% over the last four months of 2017 alone, according to Yardi Matrix. While many renters will return to their homes upon completion of recovery and renovations, the local multifamily industry appears poised for longer-term growth, as housing oversupply and economic issues that previously dampened real estate fundamentals will reverse.

Rent growth was less pronounced in major metros such as Miami, Tampa and Orlando, as rents increased between 0.3% and 0.9% in the last four months of the year. Demand in Florida may increase, however, as displaced residents leave Puerto Rico. According to a Bloomberg study, nearly a quarter million residents of the U.S. territory traveled through Orlando, Tampa and Miami airports during the fourth quarter of 2017. School enrollment is up in Orlando and Miami, and local districts are planning for additional new students.

While some recent arrivals stayed in hotels approved by the Federal Emergency Management Agency, the long-term need for housing will lead to higher occupancy rates, especially in the Renter-by-Necessity (RBN) segment. As of November, occupancy was already tight for RBN units, sitting at 97.0% in Miami, 96.3% in Orlando and 95.6% in Tampa. Occupancy will likely continue to increase through much of 2018.

Also impacting the housing recovery is a shortage of construction labor. Nationwide, multifamily development projects are experiencing significant delays, as the average time to complete a property increased by roughly five months from 2013 to 2017, according to Yardi Matrix. The delays can, in part, be attributed to a skilled labor shortage in many construction



Source: Yardi Matrix

trades, as fewer young people enter the industry and its immigrant labor force declines. Many construction laborers will now be tasked with cleaning up and rebuilding rather than expanding inventory. As a result, expect prolonged construction delays nationwide.

Course Change

In the evaluation of the impacts of natural disasters, the insurance market also comes into play. A recent *Houston Chronicle* report explains the complexity behind the National Flood Insurance Program (NFIP), and details multiple attempts to limit development within flood plains. NFIP was created in 1968 to protect homeowners whose private insurance was cancelled as a result of extreme flooding. It offered below-market rates in order to attract customers; however, its premiums were not self-sustaining, and as a result, the NFIP finds itself more than $20 billion in debt. It has also required significant taxpayer bailout funds in order to stay solvent.

Significant objections from lawmakers in the Southeast have prevented numerous attempts to reform the NFIP and limit development and repairs to houses that filed multiple claims within flood plains. The National Association of Home Builders and National Association of Realtors made significant efforts to lobby lawmakers opposing NFIP reform. Fear that reform would limit insurance and thus hurt property values prompted millions of dollars in donations to the campaign funds of legislators that actively support the continuation of the NFIP and its protection of homes in areas at high risk from flooding.

As a result, residents often choose to repair, replace and redevelop their homes, despite the likelihood of future flood damage. Insurance money continues to flow, costing taxpayers millions of dollars, and residents frequently need to supplement the cost of replacement with personal funds, yet the process of rebuilding continues.

Occupancy Rates as of December 2017

	RBN	Lifestyle	Overall
Miami	97.0%	95.4%	96.3%
Orlando	96.2%	95.2%	95.7%
Tampa–St Petersburg	95.4%	94.9%	95.2%
National Average	95.4%	94.6%	95.0%

Source: Yardi Matrix

Regarding the private insurance market, property owners should brace themselves for not only increasing insurance rates but also tightening terms and conditions of their policies. According to Ryan Barber, managing director at Marsh, "The reality is the multifamily sector was already experiencing a challenging year of losses prior to Harvey, Irma and Maria. In the first half of 2017 (much like 2016), the insurance market had already been hit with convective storm losses from tornadoes, hail, etc., in excess of $15 billion, with multifamily being a heavily impacted sector." The early attritional losses combined with the catastrophic losses in the second half of the year left insurance companies with the need to re-assess their pricing.

In addition to rate increases, many of which will be concentrated in high-risk areas, insurers are increasing deductibles for multifamily portfolios, and changing the deductible structure from a dollar value to a percentage of property value. Many deductibles already based on percentages will return to the 5% level after declining to between 1% and 3% over the past few years.

While this trend began taking shape a year ago, Barber expects it to continue. As a result, multifamily owners will likely restructure their policies to retain additional risk, rather than transferring it to insurers. "By introducing a level of retention into their programs, they are able to fund small and expected attritional losses and structure their risk transfer program to respond to larger, more fortuitous-type events," Barber explained.

Spreading the Risk

Looking ahead, insurers will consider last year's catastrophic losses as they reassess their risk models. Insurance companies are well capitalized, and will spread the risk of catastrophic property damage across business units and geographies; however, underwriters will re-evaluate their pricing models. "As pricing decreased over the prolonged soft market, it reached a level where the premium paid for catastrophic losses was being used to pay for attritional losses," said Barber. However, recent losses will force insurers to focus on all risk types when pricing insurance policies.

Despite wildfires that destroyed property from San Diego to Sonoma, no massive rate hikes are expected in California. That is a result of Proposition 103, a 1988 state ballot initiative that tightened regulations on California insurers. The statute limits rate increases to the level approved by the state's insurance commissioner. It also forces insurance companies to raise rates based on long-term models, a provision that would lessen the impact of catastrophic years such as 2017.

The Wildfire Safety and Recovery Act, a bill recently put forth in the California legislature, attempts to establish California as the seventh state to prohibit insurance companies from cancelling policies in the wake of natural disasters. Florida limits insurance companies from cancelling insurance due to natural disasters, but Texas does not, which adds a layer of complexity to the post-Harvey insurance landscape in Houston.

While the social, economic and real estate impacts of 2017's natural disasters should not be overlooked, the calamities raise the question of what the future holds. Some of the most economically destructive storms yet recorded in the U.S.—such as the three 2017 hurricanes as well as Hurricane Katrina and Superstorm Sandy—have occurred in the last dozen years or so. California experienced its largest wildfire as measured by acreage in 2017, and last winter was the state's second-largest season for precipitation since record-keeping began in 1895.

As sea levels rise and weather patterns become more extreme, the potential for property destruction increases. According to the National Oceanic and Atmospheric Administration, roughly 40% of the U.S. population lives in counties touching a shoreline. Whether through legislative or free-market forces, the future of coastal property in many major markets will change. Natural disaster risk should be considered, not only as a basis for insurance pricing but in the investment, management and development decision-making process for the entire commercial real estate industry.

—**Chris Nebenzahl**, *Institutional Research Manager*

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