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General News

Rising expenses strain apartment owners

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Property values are not the only thing on the rise in local apartment communities these days. While apartment owners may be earning more for their properties, they are constantly battling rising operational expenses, some of which may be poised for significant increases over the next year.

According to an apartment expense report produced annually by CB Richard Ellis/Oklahoma, the average annual expense for an Oklahoma City garden-style apartment complex in 2004 was $771,016, which is up from $697,074 in 2003 and up 8.5 percent from 2001's average of $653,512.

"Over the past few years both payroll and utilities have been the two categories that have consistently gone up for apartment owners," said CB Richard Ellis/Oklahoma principal William Forrest.

Payroll costs have risen about 8.2 percent over the past four years while electricity and water/sewer costs have risen more than natural gas. Forrest said an apartment complex he sold in 1995 and again in 2005 had utilities triple over that 10-year period.

With Oklahoma Natural Gas recently announcing that consumers can expect dramatic increases during the upcoming winter months, those apartment communities that pay natural gas costs for their tenants could be in store for a tough winter.

"Any properties that have owner-paid utilities are really having a hard time with their bottom line," said Forrest.

Maintenance and repair costs have also seen substantial increases in costs over the past year. Forrest said that the increases in materials that have plagued commercial and residential builders are also having an effect on apartment communities.

Phil Kennon, owner of Carpet Masters, said that one of the most eye-opening material expenses for apartment owners is carpet costs. Kennon said that over the past 18 months, carpet costs have risen between 25 and 30 percent. He attributed the increases to manufacturers raising their margins in the wake of increases in the cost of raw materials.

"We have had five separate increases up through April of this year and two more since April," he said.

Carpet padding has seen a dramatic increase over the past two months due to the effects of Hurricane Katrina, Kennon said. He explained that two large plants that manufacture the primary chemical used in producing carpet pads received substantial damage resulting in limited availability and price increases of more than 20 percent for carpet retailers.

Kennon, who services several apartment complexes, said that most of his apartment clients have yet to see any significant effect on their bottom lines, but are being forced to select alternatives to standard carpet products.

"We have had to go out and find a substitute at their current budget price, which isn't necessarily an inferior product," said Kennon. "They are budgeted a certain amount of money and if my prices go up I have to go out and find something that will replace it that will do the job. It may not last as long or be as luxurious, but it will get the job done at their current budget price."

One cost that has gone down over the past two years is property insurance. Following the terrorist attacks of September 2001, commercial insurance rates skyrocketed, especially for apartment owners.

The report showed that in 2002 the average annual insurance cost was $52,341; however, over the past two years costs have subsided to an average of $45,661 per year for an apartment complex.

Kelly Miller, president of Professional Insurors Agency LLC, warned that apartment owners should brace for escalating insurance costs over the next year that could come close to rivaling what was seen

following the events of 2001.
"We are telling our clients to budget more next year for increases in property premiums," he said. "To what level we do not know yet, but I am hearing it could be as high as 50 or 100 percent."
Miller explained the expected jumps in property insurance are due largely to the number of hurricanes that have devastated the Gulf states over the past two years. He said that re-insurers, who provide protection to insurance companies, did not adjust their rates in January to reflect the hurricanes of 2004 because they hit so late in the year and damage was still being assessed.
"The feedback that we are getting is that the re-insurers are saying that the four hurricanes last year were worse than they anticipated and then they were hit with Rita and Katrina," said Miller. "As a result, every indication points to their raising rates starting in January of next year."
Already, Miller said that he is starting to see some effects from the expected rate hikes. In the past few weeks, he has noticed that some insurance carriers are already cutting their capacity on the amount insured for commercial properties. He said that some carriers are also coming out with varying deductible options, while mortgage companies are being much more stringent in insurance requirements.
Gary Gregory, senior adviser with Sperry Van Ness, said that despite the increases, most Oklahoma City apartment owners have seen very little negative effect on their bottom lines. That's due to the significantly higher purchase prices that owners have been able to command for their properties from aggressive out-of-state buyers.
"Most owners plan for expense increases to occur and budget accordingly," said Gregory. "At acquisition, it is typical to build in anticipated expense increases when underwriting the deal. The expense increases we have seen are generally within expected levels and are largely offset by income increases in the form of rent growth."
Gregory said apartments are a great inflation hedge for owners because they are able to adjust more quickly than other property types thanks largely to the short-term lease relationships with tenants.
"Other property types such as office or retail respond more slowly to inflation risk, as their leases are usually three years or longer," Gregory said.

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