How to Make Expensive Renovations Pay Off

With rents plateauing and costs on the rise, owners are ditching bells and whistles in favor of upgrades that protect margins and deliver measurable returns.

Nellie Day

Today's multifamily investment market can feel like a three-ring circus thanks to leveled-off rents, increased costs and more competition in many regions. Performers in this circus are often walking a tightrope.

On one side, there are repairs to be made and renovations that can lead to justified rent increases. On the other side, costs and reality must reign supreme.

"Pre- and post-COVID markets have forced an evolution when it comes to investing in an asset," says Sarah Connolly, vice president of operations at Capital Square Living in Glen Allen, Virginia.

"Owners now have to ask themselves, 'What is actually going to bring a return, and what should be incorporated into programming due to muted rent growth?'"

It's a challenging landscape, to be sure. National rent growth has slowed significantly, with year-over-year increases hovering around 1 percent as of late 2024, according to the fourth-quarter multifamily report from Apartments.com. This is a stark contrast to the double-digit surges posted in 2021 and 2022.

At the same time, construction costs have escalated, with Crescent Insurance Advisers noting the average cost of building a multifamily asset is about $398 per square foot. For context, the national average construction cost for an eight- to 24-story apartment building in 2019 was about $227 per square foot, according to RSMeans data. This represents about a 75 percent increase in the cost to build multifamily product over the past five years.

The unpalatable mixture of slowed rent growth and rising expenses has caused many owners to re-evaluate their renovation strategies going forward.

"The focus has shifted from costly renovations to cost-effective, high-impact improvements and asset preservation to maintain value," continues Connolly.

"Reductions in new-lease rents and increased concessions — even in otherwise stable markets and assets — create uncertainty around achieving the full premium and return projections tied to renovations."

Still, the renovation show must go on at many properties. That is, it must if the owner's goal is to add value, fill vacancies, raise rents or keep up with the competition.

The 52-unit SK Apartments in Kirkland, Wash., was built by MainStreet Property Group in 2009. It is currently being offered for sale, with Dylan Simon of Kidder Mathews describing it as an 'asset with both immediate cash flow and long-term upside.'

Assess the Address

Brennen Degner, co-founder and CEO of Denver-based multifamily investment firm Platte Canyon Capital, knows many investors have worn their pencils down to a nub trying to make the numbers work in today's market.

"The biggest challenge is the compression of margins," explains Degner. "Renovation costs remain elevated, while rents in many markets are flat or declining. That math puts real pressure on underwriting. When evaluating a property for renovation or repositioning today, the process is a blend of art and science and continues to evolve as market conditions shift."

Dylan Simon, executive vice president and co-founder of the Simon | Anderson Multifamily Team at Kidder Mathews in Seattle, is also leading with math when assisting his clients in evaluating a value-add opportunity.

"The first consideration is simply, what can they afford to do?" he says. "From there, we look at how much additional rent revenue they can generate from those upgrades."

Simon believes a renovation is worth carrying out if the investor can garner a 20 to 30 percent return on its money. He notes that a typical full-unit remodel on an older building might cost around $15,000. If the investor can achieve a $250 monthly increase in rent (about $3,000 more per year), that's about a 20 percent return.

"That means you'd recoup your investment in five years," he adds. "So, if someone is spending $15,000 and generating $3,300 in added annual income, that's the basic math we'd look at to determine if it pencils."

Of course, this number can vary, though Degner also prefers to underwrite to a 20 percent return on cost for revenue-generating upgrades.

"Our underwriting breaks down the business plan into its revenue components," explains Degner. "If we believe the market supports a $200 rental increase, we challenge ourselves to attribute each portion of that uplift to specific initiatives, such as flooring, appliances and amenities. This forces discipline and makes the team defend each dollar of spend. While our framework hasn't changed dramatically, what has shifted is the margin for error."

BRENNEN DEGNER
Platte Canyon Capital

Noah Kaufman, director of finance and acquisitions at Los Angeles-based Universe Holdings, has a similar approach — one that is more frequently overheard in an operating room than in an apartment building.

"We've become more surgical," he says. "This process has definitely evolved over the past few years with rising construction costs and more selective capital. Today, our focus is less on 'transformation' for its own sake and more on return on investment (ROI)-driven improvements that align with what the market will actually pay for."

To achieve this goal, Lindsey Romano, senior vice president of asset management at AvalonBay Communities, notes her firm closely analyzes its market position and defines where it wants to land post-renovation, all while ensuring each project meets or exceeds a minimum 10 percent return on cost.

LINDSEY ROMANO
AvalonBay Communities

"We begin by assessing the remaining useful life of existing features, identifying which elements are driving recurring maintenance or redecorating costs and exploring opportunities to enhance layout functionality," she adds.

History and data should play large roles in answering the what, where, why, when and how of a multifamily renovation strategy, emphasizes Zach Dovner, vice president of acquisitions and general counsel at Eastham Capital in Boca Raton, Florida. Fortunately, most of this information isn't hard to obtain.

"Our approach heavily relies on the rent roll as a proof of concept," he says. "If a few previously upgraded units are showing a premium over classic units, we have the confidence to widen the scope. Our process has become more disciplined and data-driven in today's tighter capital environment, so we prioritize improvements that clearly impact rent growth and occupancy."

ZACH DOVNER
Eastham Capital

American Landmark Apartments also utilizes real-time data and cost benchmarks to guide decisions and remain disciplined.

"With rents trending flat over the past two years, we have spent a tremendous amount of time analyzing how much of a rent increase residents are willing to absorb, accompanied with the standard American Landmark upgrades," says Christine DeFilippis, chief investment officer at the Tampa, Florida-based real estate investment firm.

Light-Touch Renovations Prove Successful

Yes, renovation strategies are shifting for many owners, particularly in slower or oversupplied markets. Instead of going all-in on upgrades just to raise rents, more are focusing on keeping their properties in good shape while reducing recurring costs.

Still, the argument can be made for either approach.

Deciding which route to take often comes down to what's more likely to pay off, lowering operating costs through strategic maintenance, or pursuing rent increases through upgrades, even if the payoff is less certain.

Degner knows his answer — at least in this market.

"The broader trend seems to be a shift away from flash and toward function, as residents are prioritizing ease of living over aesthetics," he says.

The 266-unit Equinox Apartments outside Minneapolis was recently purchased by Artisan Capital Group and Eastham Capital. The owners are planning capital improvements such as updated landscaping, a pool deck and playground. (Image credit: Eastham Capital)

Completed in 2023, the 126-unit Heartwood Apartments in Seattle features sustainable design, utilizing hybrid mass timber and steel construction, which helps maintain a 38 percent lower carbon footprint than conventional buildings. The asset is currently under contract for purchase.