Altus Group

PROPERTY TAX REPORT

Tax as the New Strategic Driver

How better commercial property tax management can mitigate risk and strengthen investment performance

Research Survey Conducted by: IDC *Analyze the Future*

Contents

Introduction

The commercial real estate (CRE) industry is rapidly changing. Now widely considered the fourth asset class in the market, CRE continues to become more institutionalized and is attracting capital at a record level. As a result, there is more competition for available assets, higher asset prices and greater expectations for their performance.

As values have increased, so too have CRE property tax assessments and liabilities. Given the pressure to operate more efficiently, a proactive approach to property tax management presents a significant opportunity for firms looking to derive greater asset value and returns from their portfolios.

Altus Group's Property Tax Report, "Tax as the New Strategic Driver," reveals how firms are currently managing their property taxes and how owners and investors can leverage tax planning more strategically to realize operational and transactional efficiencies and unlock greater asset value.

As the largest single operating expense, property tax is an area often overlooked as an opportunity to drive strategic investment decision-making. In fact, while many CRE firms believe they have adequate property tax planning strategies, recent survey results indicate that few manage their property tax as they might other operational expenses.

This report is based on a quantitative survey of over 200 CRE C-level and senior executives in property tax and finance roles who deal with real estate tax matters at owner operator and owner investor firms in the United States and Canada. All firms that participated had assets under management (AUM) of at least $200 million USD at the time of being surveyed, representing an approximate total AUM of over $350 billion USD. Altus Group commissioned leading international research firm IDC to conduct this survey, which was fielded in spring 2017, and forms the basis of this report.

Report Themes

1. Unlike most operating costs, taxes cannot be shopped around, negotiated or lowered through contracts, but there are established processes to manage them. What does the current approach to property tax management look like?
2. What are the issues surrounding effective management of property tax including assessment reviews, appeals and benchmarking?
3. How is exposure to property tax being incorporated into underwriting and investment strategy?
4. Can firms drive yield and asset value through better real estate tax intelligence?

Key Findings

25%

of firms surveyed incorporate property tax management directly into their investment strategy and decision-making

75%

describe their property tax management as reactive and purely or largely operational and cost reduction oriented

73%

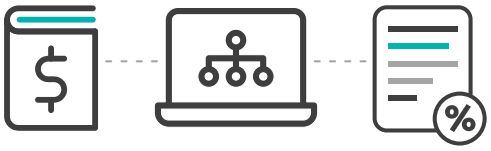
said their firms could make better investment decisions with enhanced property tax planning

32%

said that property tax exposure has very little impact on their underwriting assumptions, and 56% do not incorporate property tax refunds into their ongoing valuations

52%

said they lack the tools to analyze property tax information, and 44% said they lack the expertise and resources to identify property tax data sources

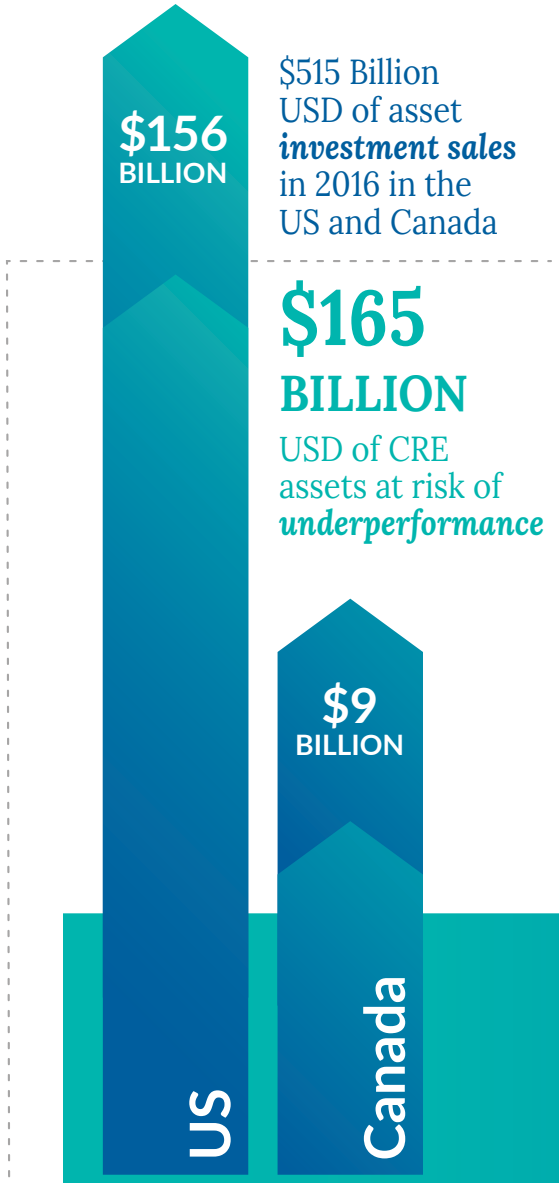


The Current State of Property Tax Analysis

The recent upward cycle in the CRE market has pushed property values to record heights, resulting in property tax disbursement reaching historical highs.

However, the survey revealed that the majority of firms take a reactionary approach to property tax management. Seventy-five percent (75%) of executive respondents describe property tax management at their firms as purely or largely operational and cost reduction oriented.

When asked how their firm is managing property tax exposure within its portfolio:



$515 Billion USD of asset ***investment sales*** in 2016 in the US and Canada

$165 BILLION

USD of CRE assets at risk of ***underperformance***

Source: RCA and CBRE 2016

41%

said they only periodically review assessments to identify appeal opportunities

21%

said they use enhanced real estate tax analysis that includes tax benchmarking to identify exposure of their portfolio compared to the market

32%

said that property tax exposure has very little impact on their underwriting assumptions

When compared to the CRE industry's level of analysis typically applied to the review and control of property management costs the limited attention paid to the tax line item becomes more pronounced.

Historically, the real estate industry has viewed taxes as a fixed expense, driven by market and government assumptions. The lack of analysis of historical or benchmarked tax data has led to an industry standard of applying a static growth rate to the property tax liability for budgeting and underwriting purposes.

Firms appear to apply limited analysis of the variables that impact tax liability calculations.

Typically a growth factor of 3% is applied, but an overall assessment of past industry underwriting and transactions shows that most property tax growth assumptions are inaccurate. This carries with it a significant risk of portfolio underperformance.

Many additional considerations underscore the importance of a deeper understanding of the implication of property tax dynamics. From significant year-over-year assessment value increases and fluctuations, to the complexities of the appeals process, designation of property for current or future development, and variations of purchase prices relative to assessment values, there are a vast array of factors that can directly impact property tax expense.

While the frequency and comprehensiveness of assessment reviews to identify appeal opportunities varies among firms, efforts to understand a portfolio's tax liability versus a competitive or comparable set of properties within the market are less common. In essence, reducing property tax liability is a common and important objective for owner operators and investors — but the appeal pursuit alone does not provide the critical insights on current and future investment performance that can come from benchmarked tax information.

It is important for owners to know where their property stands in comparison to competing properties for leasing and disposition purposes. Remaining competitive and providing a "lower real estate tax cost" to potential tenants or buyers can drive very real and tangible value. Underwriting assumptions typically span 10 years and the ability to predict real estate tax costs throughout an investment time horizon can increase returns through higher net operating income (NOI).

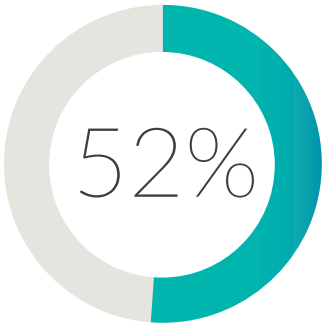
Taking a proactive approach to tax analysis and management can provide firms with a highly strategic benefit to their investment decision-making and directly contribute to what, where, when and how assets are bought, sold and managed. Yet only 25% of respondents said their firm incorporates property tax management directly into their investment strategy and decision-making. The result is an increased risk of portfolio and asset-level underperformance.

Lack of Tools and Resources Impacting Underwriting and Investment Strategy

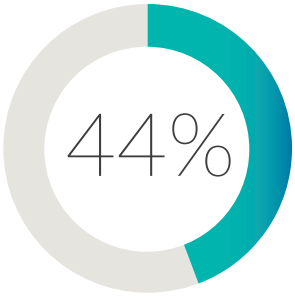
It is clear there is a huge opportunity to better leverage available market and asset-level information:

While a lack of granular or rigorous tax management processes seem to be one of the major issues inhibiting a more strategic approach to the management of property tax, having access to and utilizing the right tax data and analytics is also a critical factor. The vast majority (83%) of respondents think their firms have enough property tax information and/or the right tax metrics necessary to optimize their underwriting decisions and investment strategy. So why aren't they?

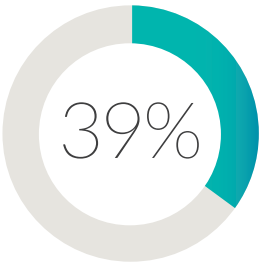
While most said their firms have enough data and metrics, respondents were also asked to identify the main barriers preventing the collection or utilization of property tax data.



said they lack the tools to assist with property tax data capture and analysis



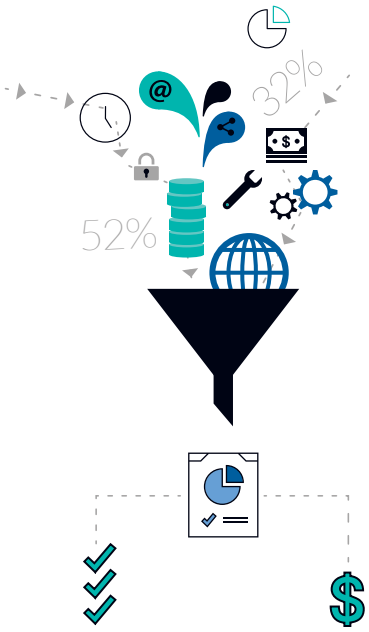
said they lack internal expertise or resources to identify property tax data sources



said that a lack of normalized formats inhibit them from utilizing property tax data

“ Property tax is one of the biggest ticket items in both operations and investments. Proactive management of taxes is critical to add value to the investment. Benchmarking helps us understand where we are in comparison to our competitors and gives us the insight to strategize.”

AANANDAN THIYAGARAJAH
Vice President, Finance, Eastern Region at Bentall Kennedy (Canada) LP



Tax data needs to be collected from a variety of sources. Assessed values and tax rates are received from taxing authorities, capitalization rates are pulled from research reports and market data subscriptions, and valuation variables are obtained from consultants and industry peers. Typically this information is fragmented and incomplete, or arrives as raw data. For it to be useful, the data must be properly aggregated, vetted and analyzed to derive trends and growth factors that can assist decision makers in budgeting real estate tax expenses across their portfolios.

A lack of skilled and innovative tax professionals is not the problem in and of itself. Every single firm responded that they have in-house expertise and/or external advisers managing property tax. However, over half said they lack the tools to properly capture and analyze pertinent data, almost half acknowledge that their tax managers struggle to identify data sources, and nearly 40% find it challenging to use the data they have due to inconsistencies in formats and reporting.

Creating Value with Improved Tax Analytics

Although the industry is rapidly accelerating its investment in technology and embracing the benefits of data, there are still gaps in understanding and leveraging this data for strategic use. With real estate taxes being the single largest operating expense, tangible value can be created through better property tax intelligence.

Despite indicating better tax intelligence may create material value in the underwriting process, many firms have not yet invested in the tools and resources to produce accurate forecasting at the transactional or operational level.

Given the volume of real estate tax data available and with the proper technology-related tools, CRE firms can drive greater value by accurately pinpointing year-over-year trends as related to specific deals, properties and markets. Using variables such as property size, asset type and/or taxing jurisdiction to create the right predictive analytics, owner and investor firms can achieve substantial operational savings, but more importantly, preserve yield across entire portfolios.

"Property tax planning is critical and the dollars involved are significant. Approaching tax management strategically is crucial to proactively managing risk and aggressively driving shareholder value. One of the biggest impacts of having good tax intelligence when we underwrite new opportunities is the strength it brings to our negotiating position."

ANTHONY CHANG
Vice President,
Asset Management
at Washington REIT

Recommendations

The findings of the survey indicate four necessary and immediate steps for firms.

IMPLEMENT PROACTIVE FORECASTING

As property values continue to rise, so too do tax assessments, which means that even a small percentage change in the tax bill equals big dollars. If firms continue to respond only reactively to rising or even stable tax assessments with periodic reviews and appeals, limited to high profile or heavily impacted properties, the missed savings opportunities will grow, potentially leaving portfolios at risk of underperformance. This is true regardless of asset type, ownership structure or life cycle stage.

REVIEW ALL ASSESSMENTS FOR APPEAL OPPORTUNITIES

Ultimately, property tax assessments are determined by a number of known and uncertain factors. Maintain an annual review of all new property assessments, or those mid-cycle assessments that can be appealed. Each assessed value must be reviewed for accuracy of facts, assumptions and equalization.

ADOPT STANDARD REPORTING ACROSS ASSET TYPES

As the survey indicates, the disparate data sets required to create tax forecasting models are a critical barrier to the data's usefulness. Although firms often have no initial control over the information received, adopting standard models for underwriting and budgeting internally will aide in the verification of the data.

BEGIN BENCHMARKING

Implement a process for benchmarking a property against itself and similar assets in the portfolio. A simple chart of a property's assessed value over time compared to the appraised value and market conditions will allow for trends and outliers to be spotted more easily. Furthermore, documenting how assessments changed prior and subsequent to acquisitions, construction milestones, certificates of occupancy, or significant renovations will assist in the under-writing of similar projects in the same market.

Conclusion

The report's findings clearly indicate a growing recognition and need for better real estate tax intelligence and the critical role property tax should play in asset performance and portfolio strategy. In fact, 73% of respondents firmly acknowledged that improvements to their tax planning analysis would help with better decision-making. While the collective majority of executives affirm its significance, enhanced real estate tax management and analytics at both the operational and transactional level are still underutilized. With the right investments in process and technology to provide better visibility into tax growth, risk and savings, the opportunity for property tax to play a more strategic role in investment decision-making is significant.

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