UNDERSTANDING HEADLINE RISK:

OFFICE VALUES AND TAX IMPLICATIONS

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- *Declining office values could lead to an uncertain tax environment for multifamily investors if cities face significant tax revenue shortfalls, which could affect the overall attractiveness of certain markets for residents, investors, and businesses.*
- *Markets with diversified tax revenue streams and newer vintage office stock are best positioned to manage potential challenges ahead.*
- *In many markets, the increase in organic revenue growth from residential real estate tax is expected to be enough to offset the potential losses in commercial real estate tax revenue.*
- *The conversion or repositioning of office buildings into other asset classes like multifamily, hospitality, and medical office could further ease potential challenges to city budgets.*

INTRODUCTION/KEY RISK

Due to the widely accepted remote and hybrid work environment that resulted from the COVID-19 pandemic, urban downtown locations have been slow to recover. Lower demand for office space has led to lower occupancy and rents, which has dramatically decreased the value of office real estate. One result of lower office values is reduced property tax revenue for cities/municipalities. Further, the reduced office utilization has impacted retail and restaurant activity in urban downtown locations, leading to a decrease in sales tax revenue for local governments.

The rightsizing of the U.S. office market poses two key risks for multifamily investors: a potential shift in tax burden from commercial real estate owners to residential owners, and a decrease in the desirability and overall demand for markets with high office vacancies. Both of these risks could materialize via a fiscal revenue spiral, where a material decline in assessed office values impact city budgets, and policy makers are encouraged to look elsewhere for tax revenue to meet future budgets—potentially shifting the tax burden onto residential owners.

While the potential concern of city budget risk has not yet materialized, White Oak is proactively tracking this key risk and evaluating market conditions to factor into our underwriting and due diligence of existing portfolio positions and new acquisition opportunities.

WFH AND POST-PANDEMIC TRENDS

The appetite for remote work coming out of the COVID-19 pandemic has fueled conversation about the necessity for traditional office spaces. The tight labor market is also adversely affecting office values as employers are using a flexible work schedule as bargaining power to recruit and retain employees. This has spurred a flight to quality in the office sector as workspaces with desirable amenities are necessary to convince employees to come back to the office. The COVID-19 pandemic fueled another trend: the outflow of residents from dense urban cores into low-density suburban locations with in-demand lifestyle drivers. Outflows of residents in major urban cores has negatively impacted office performance in many markets.

The combination of residential suburban demand and labor market conditions facilitating "work from anywhere" lifestyles have both contributed to the current state of the U.S. office market, which consists of over 5.5 billion sq. ft. of office space.[1] Net absorption has been negative in every quarter except one since 2020.[2] Vacancy remains the key headline figure and currently stands at 21.0% nationally, up nearly 900-basis points from 2019.[2] As the market adjusts to WFH pressures, there are expectations that the U.S. office market will enter a period of rightsizing, similar to what the retail market experienced in the face of ecommerce.

IMPACT ON OFFICE VALUES AND TAX IMPLICATIONS

The impact of work from home (WFH) trends on the office market has several implications for multifamily investors. Elevated vacancy rates, limited transaction activity, and uncertain market conditions have depressed office assessment values and reduced revenue for impacted markets. Many office owners are appealing valuations to reduce their tax liability, putting further pressure on market dynamics. A material decline in assessed property values could put policy makers in a challenging situation—if revenue does not meet budget expectations they may be forced to look elsewhere to make up for losses. Shifting taxes from office to residential properties poses risk for both multifamily investors and homeowners. Multifamily is classified as residential real estate at the market level, and an increasing or uncertain tax liability can create a challenging underwriting environment.

Another risk for multifamily investors to consider is that a market typically becomes less desirable for residents as property taxes increase. This can create a feedback loop where residents move out and businesses relocate, causing tax revenues to decline even further. An increase in residential taxes could fuel resident migration out of high-tax cities—a trend that has already become apparent, evident by the influx of new residents in low-tax states like Texas and Florida.

This could also affect a city's credit rating, which could stifle their ability to issue bonds and raise funds for future projects including infrastructure maintenance, further driving down the desirability of the market. Between 2002-2008, several Detroit municipal bonds fell into the "junk" rating as the city faced a period of budget deficits. Subsequently, the population declined by 25% in the decade leading up to 2010.[3] While circumstances in Detroit during the Great Financial Crisis were unique, the declining population and lack of trust in city finances for over a decade contributed to the city filing for bankruptcy in 2013.

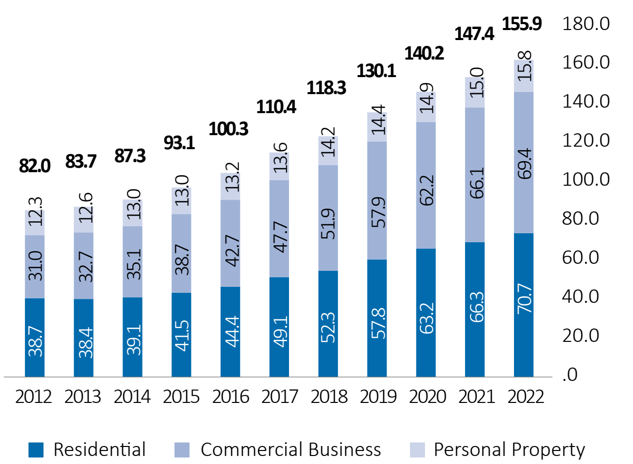
LEVELS OF EXPOSURE

City revenue structures and office market dynamics are nuanced from market-to-market which makes it difficult to make apples-to-apples comparisons. However, there are similar themes to track across markets. The following questions can help highlight the level of exposure a particular multifamily market may have to being subject to a fiscal revenue spiral:

- What percentage of total tax revenue consists of property taxes?
- What percentage of the existing office is Class A?
- What types of industries are prevalent in these markets and what are the WFH trends in those industries?
- Can increases in other revenue sources offset potential losses in office tax revenue?

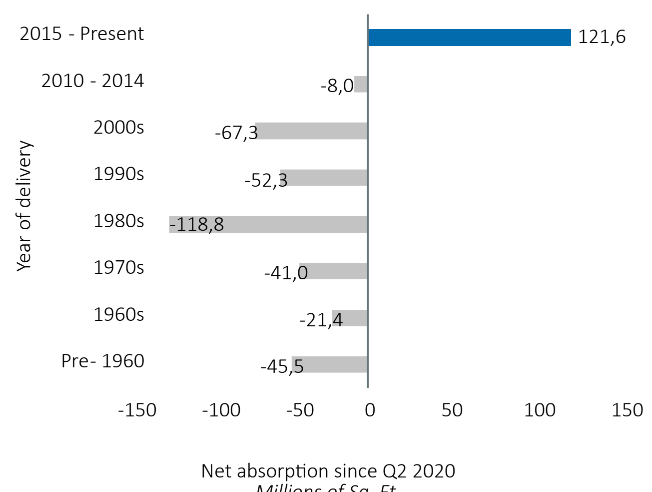
The proportion of property tax revenue the city relies on compared to other revenue streams, like sales tax and income tax, demonstrates its dependency on stable property values and its vulnerability to market fluctuations. Some markets have diverse and growing revenues in other areas to help offset any potential losses in office property taxes. In Dallas, both residential and commercial property taxes have continued to increase throughout 2022 despite high office vacancies, mitigating the risk for the city in dealing with a revenue shortfall

FIGURE 1
Dallas taxable property values (in billions $)



Source: Dallas City Comptroller's Office[4]

FIGURE 2
Net absorption by building vintage



Source: JLL[1]

due to any decline in office real estate taxes (Figure 1). In many cases, increases in organic residential tax growth are expected to offset revenue declines elsewhere, which appears to be true in Dallas.

The make-up or quality of office buildings contributes to the level of resiliency a market may have to a potential decline in office property tax revenue. Convincing employees to return to the office requires amenities that compete with the convenience of working from home. Since 2020, only 10% of office buildings have been responsible for the increase in vacancy rates.[5] The buildings causing this trend are predominantly older vintage assets, built in the 1980s and 1990s (Figure 2). This could be problematic for cities with an older stock of office that are struggling to compete with brand-new Class A properties which could lead to higher vacancies for longer.

The type of industries in a market plays a key role in understanding how local economies are faring. Markets with a high concentration of industries where work from home is prevalent put more downward pressure on their downtown recoveries and office values. Regional differences in WFH expectations further contribute to the prolonged recovery of downtown areas post-COVID. This is evident in tech-heavy markets such as San Francisco, where workers are more hesitant to return to in-person hybrid schedules.

CASE STUDIES: NEW YORK AND AUSTIN

New York City (NYC) and Austin represent different risk profiles in the office market spectrum. The following studies demonstrate two ways to analyze risks posed to multifamily investors in those markets. NYC is facing a lower floor when it comes to office valuations due to the concentration of "work from anywhere" jobs. On the other hand, the city of Austin has less diversified revenue streams and relies more heavily on property taxes due to a lack of income taxes in Texas. Despite these challenges, both cities appear capable of handling depressed office tax revenue, which poses little risk to multifamily owners.

The NYC Comptroller's Office conducted an internal study of city finances and concluded that even a "doomsday scenario", in which office values decline 40% peak-to-trough, would only result in an average shortfall of 2% of the total tax property levy over the next three years (2025-2027). This is well within what the city is expecting in other revenue increases, greatly reducing the risk posed to multifamily investors. NYC benefits from a diverse revenue base due to its robust income tax structure.[6]

Austin is much more dependent on property taxes due to the absence of income taxes; roughly 50% of Austin's revenue come from property taxes. A study conducted by the Institute on Taxation and Economic Policy projects that even if commercial office buildings shed roughly 13%-25% of their value, total city revenue would decrease by just 2%-4%.[7]

KEY TRENDS TO WATCH

There are several factors to consider when evaluating market risk due to depressed office valuations:

- Conversion of Office to Market Rate Apartments: this could mitigate the risks posed by falling office values by shifting tax revenues into a more stable asset class. While this type of conversion is not widespread due to construction difficulty, this would add to the multifamily supply picture and should be evaluated on a market-by-market basis.
- Corporate Migration: companies migrating into more favorable business tax environments typical of secondary markets located in the Sunbelt bodes well for overall demand in these markets.
- Industry Concentration: some markets will be more sensitive to a recessionary environment due to concentration in cyclical industries, which could disproportionately affect their respective office markets.
- Office New Supply: net inventory has grown by less than half of one percent year-to-date nationally in 2023.[1] The slow pace of new deliveries allows for rightsizing to take place more efficiently.
- Lease Structures: the longer leases that are typical for office spaces ease volatility in assessed values and help mitigate the short-term impact on city revenues.
- Office Utilization vs. Vacancy: many studies tracking future office demand are speculative and do not appropriately consider how companies use office space. Consider a company that utilizes a hybrid schedule with 3-days/week in-person. If you take this at face value, it means they do not use office space 40% of the working week. However, this cannot be equated with a 40% reduction in office space needed—the full space is still needed for the busiest days of the week when the majority of employees are in-person. Research that relies on office utilization as a replacement for vacancy rates may be overestimating the long-term structural vacancy rate.

CONCLUSION

The office market's rightsizing will likely occur over a prolonged period, and office real estate valuations will likely continue to be depressed compared to pre-pandemic levels. The potential decline in city revenue remains a risk; however, markets with diverse revenue streams, newer office buildings, and diversified economies are better positioned to manage potential revenue disruptions. Additionally, organic revenue growth in other areas like sales taxes and residential tax is likely enough to offset a material and rapid decline in office valuations in most markets. Prudent risk management should evaluate city budget risk on a market-by-market basis to gauge the potential impact on multifamily investors.

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[1] *Cushman (pdf)*
[2] *JLL Q3 Office Report (pdf)*
[3] *Timeline: A history of Detroit's fiscal problems | Reuters*
[4] *Annual Comprehensive Financial Report, Dallas City Comptroller's Office*
[5] *Office Buildings Hardest Hit by Pandemic Share Common Characteristics | CBRE*
[6] *Spotlight: What Risks Does the Office Market Pose for the City's Finances? : Office of the New York City Comptroller Brad Lander (nyc.gov)*
[7] *The Impact of Work From Home on Commercial Property Values and the Property Tax in U.S. Cities – ITEP*

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