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Assessments Often Unsupported by Market Values

COMMENTARY

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Although the economy as a whole has shown signs of life after the Great Recession, the recovery is not being driven by commercial real estate prices and values. It is more accurate to describe the economic recovery as occurring despite the ongoing distress affecting some segments and submarkets of the commercial real estate market.

This distress can be characterized through several structural factors: Sales prices in many markets remain lower in 2016 than they were in 2006, rent growth in some areas is stagnant and below expectations, and the property tax assessment system is failing to take into account the realities of the market. In fact, the property tax assessment system needs to be tweaked.

Modest Recovery

Sales prices for office and industrial properties have modestly recovered since 2011. When the office and industrial markets were severely depressed, many owner-users took advantage of the lower prices to purchase their real estate. They represented 31 percent of office purchases and 46 percent of industrial purchases. But as the commercial real estate market improves, investors often are outbidding each other for net-leased properties, and the rising prices now exclude many users from the market. The result is that owner-users currently represent only 11 percent of office purchases and 28 percent of industrial purchases.

CPI, or Consumer Price Index, which is a measure of inflation, has increased by almost 20 percent from 2006 to 2016. However, the rental growth rate was less than half of the inflation rate over the past decade; office and industrial rental rates mostly are below the 2006 rates, with exceptions for certain submarkets.

This means that property owners need to reduce operating costs to maintain the same level of profitability. **Hoovers** notes that for real estate investment companies, operating expenses are 72 percent of net income. Assuming property taxes represent 10 percent of net income, a reduction in property taxes of 20 percent will increase net income from 5 percent to 7 percent, for a 40 percent increase in profitability.

Struggles in Auto, Retail

Auto dealership properties illustrate the structural issues in the market. Over the past decade, about 10 percent of all dealership property sales were redevelopment projects in which a dealership is being converted to a different use. This is a result of auto dealership compression from reduced consumer spending. The decrease in demand meant that fewer dealerships were needed to meet the needs of consumers. Thus, some auto dealerships closed, which improved the efficiency of the auto dealership market. In 2016, Southern California dealership properties are still not back to 2006 price levels.

U.S. consumer spending on durable goods, an indicator of auto sales, fell 1.5 percent from February 2015 to February 2016. The decline in consumer spending affects not only auto dealership properties, but also retail properties. The recent bankruptcies and closures of grocery stores such as **Fresh & Easy** and **Haggen Food & Pharmacy** as well as retail big-box stores such as **Sports Authority** and **Sport Chalet** exemplify the continued struggles of the retail market.

Annual Assessment Increases

In San Diego County, the assessment roll for nonresidential properties has grown from $65.8 billion in 2005 to $103.5 billion in 2015, which is an annual assessment increase of 5.7 percent. Although some of the assessment increase is due to properties constructed after 2005, the remainder of the assessment increase is unsupported by market values. Auto dealership owners are put in a predicament; their property tax bills are increasing while the value of their properties is down or stagnant.

The property tax assessment system needs tweaking to reflect the current conditions of the commercial real estate market. For starters, instead of a predetermined increase of commercial property taxes across the county, each assessor's office should annually review every commercial property on an individual basis. The current system is unfair to property owners who are struggling to maintain the profitability of their businesses and investments while county governments are making more money than ever. The **National Taxpayers Union** estimates 30 percent to 60 percent of property is over-assessed.

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