# COMMERCIAL OFFICE BUILDINGS ASSESSMENT AND IMPACT ANALYSIS

## MONTGOMERY COUNTY, MD

Prepared for Empower Montgomery
October 16, 2023

# ABOUT RCLCO

Since 1967, RCLCO has been the "first call" for real estate developers, investors, the public sector, and non-real estate companies and organizations seeking strategic and tactical advice regarding property investment, planning, and development.

RCLCO leverages quantitative analytics and a strategic planning framework to provide end-to-end business planning and implementation solutions at an entity, portfolio, or project level. With the insights and experience gained over 50 years and thousands of projects–touching over $5B of real estate activity each year–RCLCO brings success to all product types across the United States and around the world.

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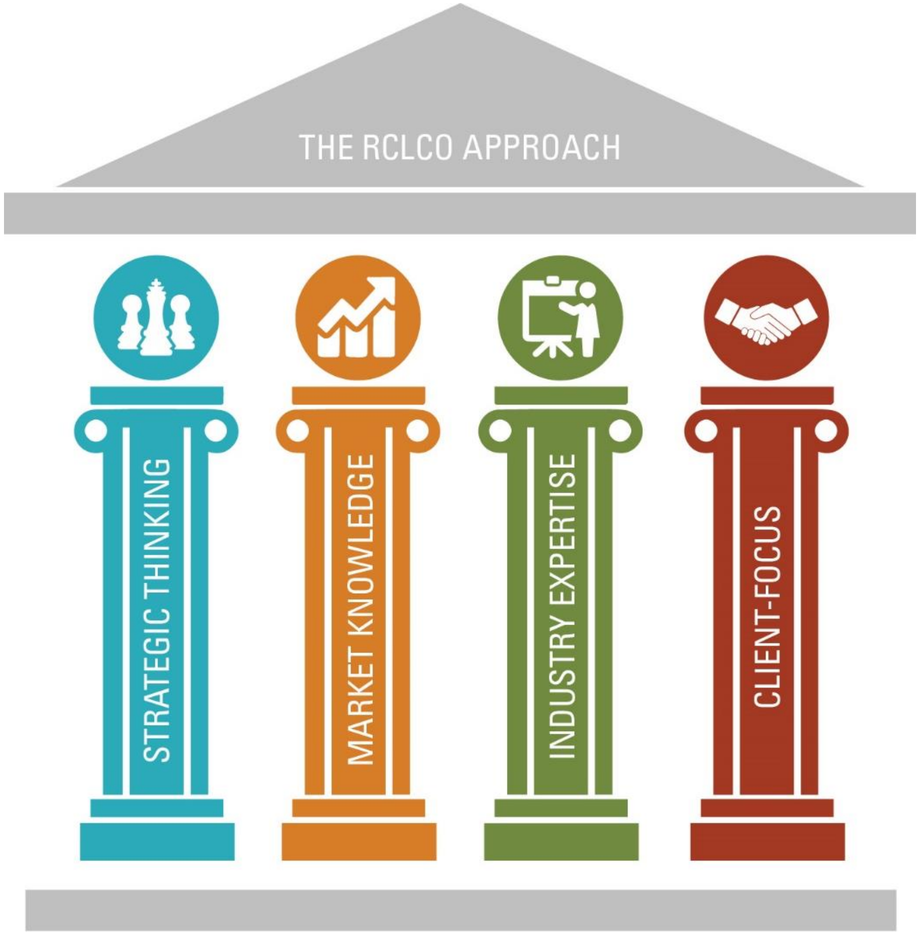


## REPORT AUTHORS

*Project Director:*

Adam Ducker, Chief Executive Officer

- P: (240) 644 0980 | E: ADUCKER@RCLCO.COM

*Project Manager:*

Philip Carney, Vice President

- P: (240) 669-5635 | E: PCARNEY@RCLCO.COM

*Additional Authors:*

Evan Farrar, Associate

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## OBJECTIVES

In light of key policy changes in Montgomery County, Empower Montgomery engaged RCLCO to produce a body of analysis that speaks to the commercial property vulnerabilities in the County, in order to inform the ongoing effort to drive constructive legislative progress in the months and years ahead.

Specifically, it is suspected that Montgomery County's current system of commercial property tax assessment reporting, which broadly includes all types of commercial buildings (including multifamily), masks the potential impact of current and imminent declines in office valuations on county tax receipts. Further, the lag in valuations may also serve to obscure how current office market conditions are likely to pose a serious threat to Montgomery County's fiscal health in the near term.

Against that background, the analysis contained in this report is designed to answer the following questions:

- How has the assessed value of office properties in Montgomery County changed in recent years?
- To what extent are changes in office values impacting county tax receipts?
- How might future declines in office values impact the fiscal health of Montgomery County?

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# KEY FINDINGS

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## ECONOMIC & OFFICE MARKET CONTEXT

- **Office Market Trends**: The Montgomery County office market is experiencing heightened stress due to several structural shifts in office space demand that are still ongoing. The shift to remote and hybrid work has reduced overall demand for space, and evolving technological needs as well as increased availability has fueled a flight to quality that has left older suburban office space at risk of chronic vacancy. As a result, Montgomery County has seen a net loss of 200,000 square feet of occupied space since 2019, and market-wide vacancy has climbed to 17.7%. Poor returns and a slow leasing environment are motivating investors to dispose of their office assets at declining price points, but lending market conditions have suppressed transaction volume.
- **Implications for Office Values**: Office market trends and capital market conditions have created an environment where future declines in office values are highly likely. Transactions are unlikely to pick up until prices fully "reset" and cap rates expand sufficiently to allow palatable risk-adjusted returns for existing assets, or values fall below replacement cost and redevelopment becomes more widely viable.

## TAX ASSESSMENT ANALYSIS

- **Assessment Trends**: Property taxes have increased, as total assessed value across land uses has steadily grown. However, this headline increase obscures how values have trended by land use. Rental residential (excluding single-family) accounted for 58% of the total increase in commercial assessed value from 2019 to 2023, compared to just 17% for office. The assessed values of Montgomery County's most valuable office buildings are moderating but have yet to fully capture the "market reality" on the ground.

## IMPLICATIONS

- **Impact on Future Tax Receipts**: If office values decline by as much as 30%, Montgomery County would lose $47 million in annual tax revenue. <u>Even a 10% decline, which is likely conservative given already-observed 7% declines in value and far more severe occupancy losses, would cause a loss of $16 million in tax revenue per year</u>. Furthermore, a decline in values for other uses (e.g. rental residential) could compound this loss; while such declines have not yet been observed, a near-term contraction in the assessed values of other property types could occur if the assessment cycle coincides with worsening market conditions.

**Total Assessed Value by Land Use (Properties Built Pre-2019), 2019-2023;**
Montgomery County, MD

| | YEAR | | | | |
|---|---|---|---|---|---|
| LAND USE | 2019 | 2020 | 2021 | 2022 | 2023 |
| Single Family, Land, Other | $146,628,593,670 | $149,651,649,144 | $152,801,593,819 | $156,945,498,371 | $163,607,899,497 |
| **Office** | **$12,208,314,677** | **$12,337,323,157** | **$12,382,944,176** | **$12,027,906,658** | **$12,052,292,462** |
| Rental Residential | $9,202,431,722 | $9,686,826,199 | $9,987,147,213 | $10,171,595,412 | $10,634,155,803 |
| Retail | $8,529,883,503 | $8,900,971,359 | $9,013,663,742 | $8,701,707,748 | $8,802,819,481 |
| Industrial | $3,102,853,807 | $3,220,404,029 | $3,435,627,489 | $3,556,152,651 | $3,827,391,638 |
| Specialty | $1,311,563,235 | $1,327,298,431 | $1,356,411,934 | $1,369,351,667 | $1,419,233,365 |
| Hotel | $1,065,393,268 | $897,661,999 | $1,025,080,033 | $926,263,400 | $893,057,101 |
| Public | $373,967,766 | $385,786,166 | $391,374,467 | $403,879,501 | $428,622,635 |
| **TOTAL** | **$182,423,001,648** | **$186,407,920,484** | **$190,393,842,873** | **$194,102,355,408** | **$201,665,471,982** |
| Total Commercial (Excluding Single Family) | $35,794,407,978 | $36,756,271,340 | $37,592,249,054 | $37,156,857,037 | $38,057,572,485 |

*Source: Montgomery County Assessor's Website; ArcGIS Online; CoStar; Real Capital Analytics; RCLCO*

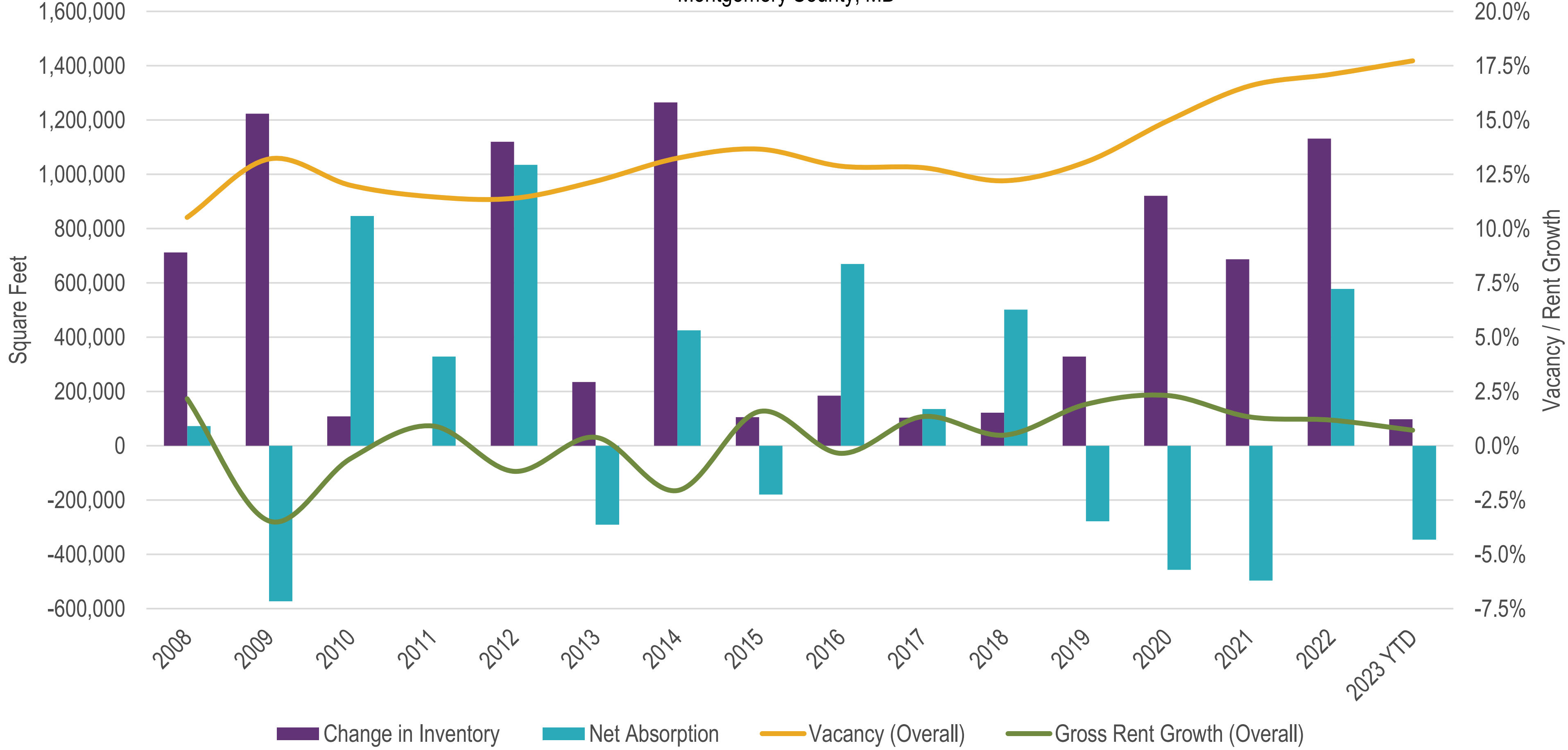
# MONTGOMERY COUNTY OFFICE MARKET PERFORMANCE

# OFFICE VACANCY AND NET ABSORPTION

## HISTORICALLY, MARKET-WIDE VACANCY HAS HOVERED AROUND 13%, BUT NEGATIVE NET ABSORPTION AMID SIGNIFICANT INVENTORY GROWTH DURING THE PANDEMIC CREATED A GLUT OF NEWLY VACANT SPACE.

- On a net basis, 200,000 more square feet of office space has become vacant than occupied since 2019, amid an uptick in new deliveries and poor performance of older office product. In this environment, owners have struggled to push rents at risk of further endangering occupancy.

**Office Completions, Absorption, Vacancy, and Rent Growth, 2008-2023 YTD;**
Montgomery County, MD

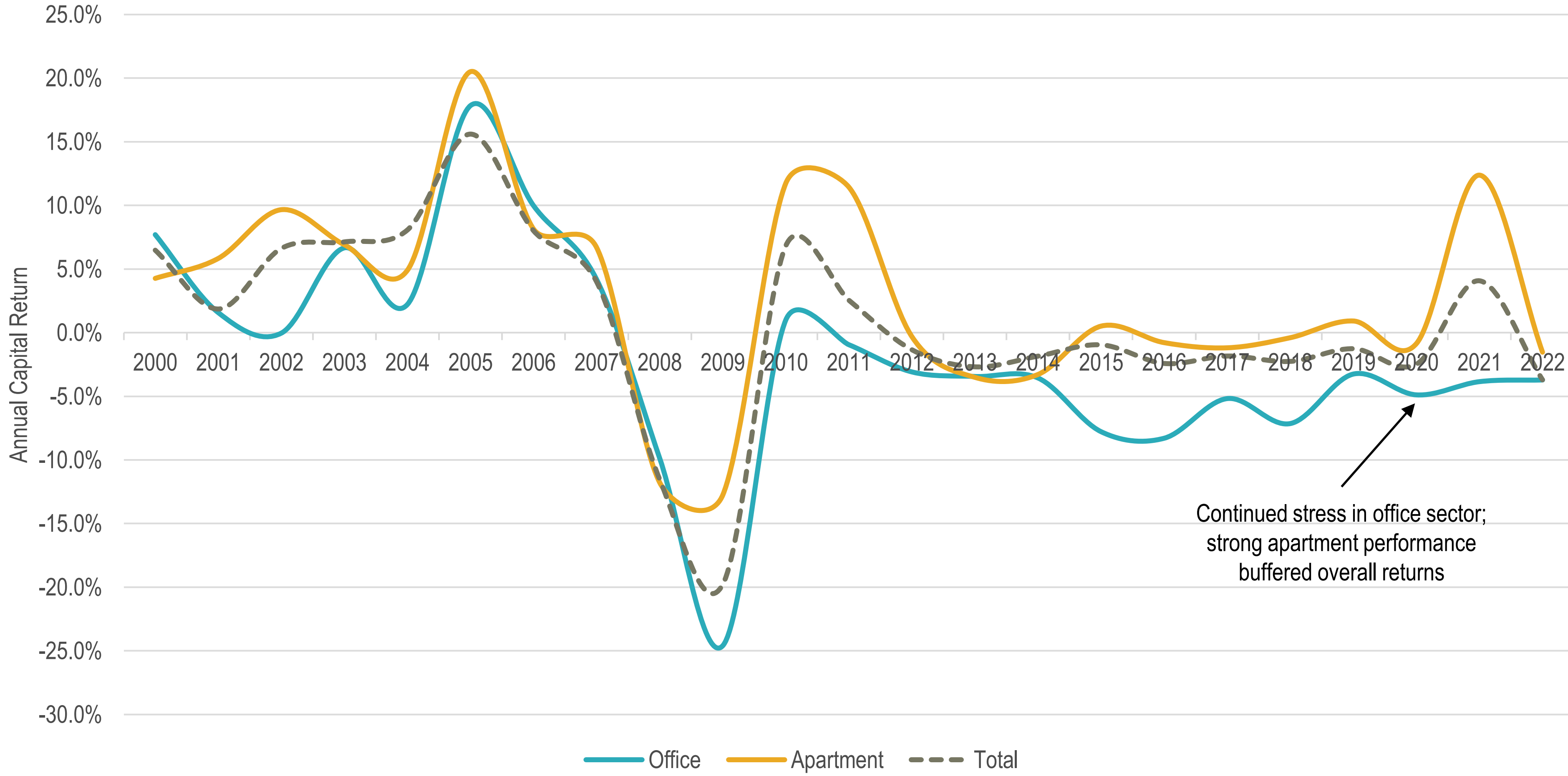



*Source: CoStar; RCLCO*

# OFFICE HAS CONSISTENTLY UNDERPERFORMED OTHER PRODUCT TYPES IN TERMS OF ANNUAL RETURNS, BUT SECTOR PERFORMANCE DIVERGED SIGNIFICANTLY EMERGING FROM THE PANDEMIC.

- Office capital returns in the Silver Spring-Frederick-Rockville MD have been negative since 2010, while strengthening apartment values have effectively offset the impact of poor office performance on the broader real estate markets.

**Annual Appreciation Return by Product Type, 2000-2022;**
Silver Spring-Frederick-Rockville, MD Metropolitan Division

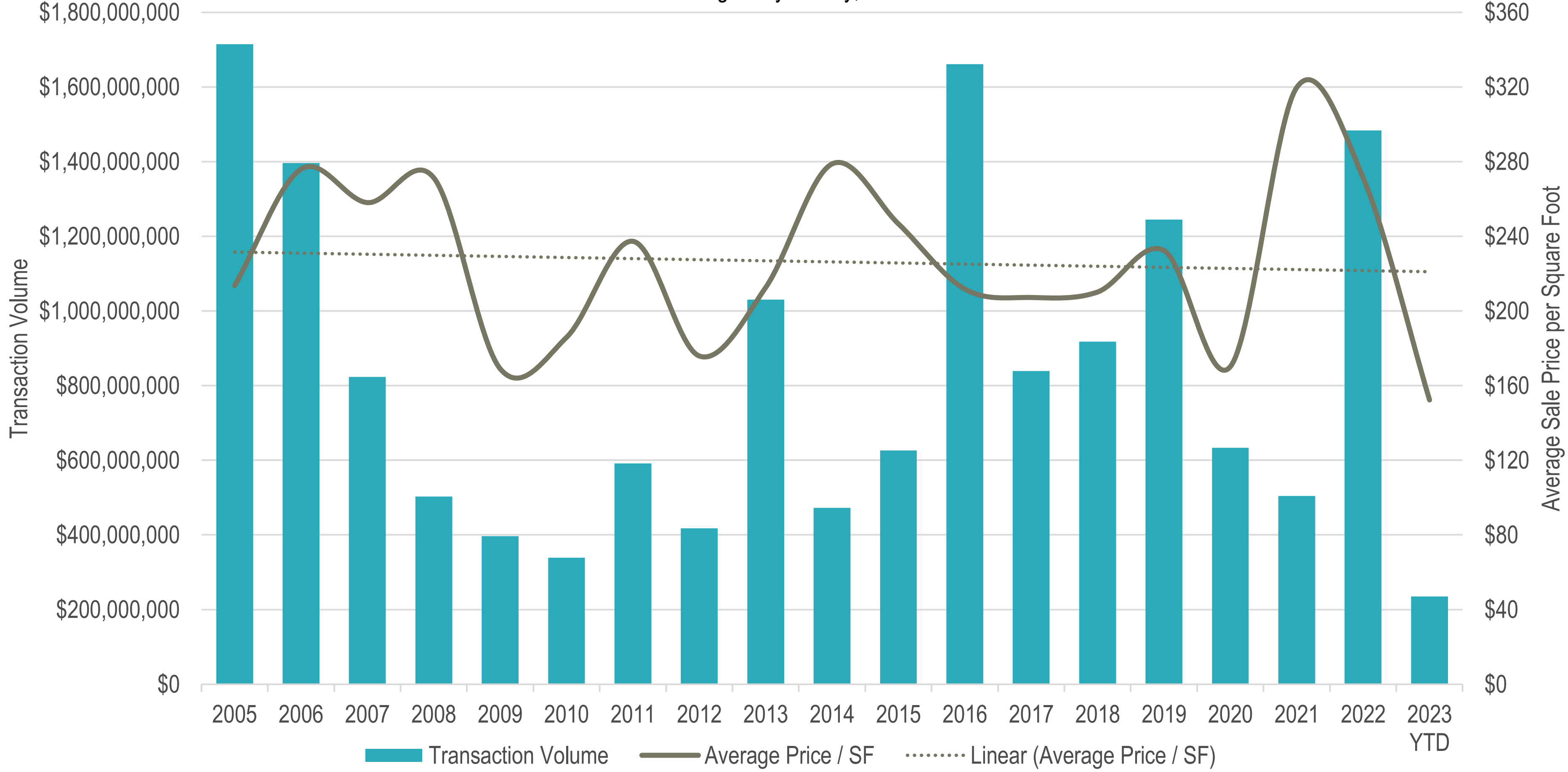



*Source: NCREIF; RCLCO*

## OFFICE TRANSACTION VOLUME HAS DECLINED, DRIVING PRICES DOWN, AS WEAKENED SPACE DEMAND AND BROAD INVESTOR PESSIMISM HINDER THE SECTOR.

- While pricing of office properties in any given year depends on the type and quality of office product being sold, the average size-adjusted price of transacted office properties has declined significantly in 2023 thus far, and has remained below $240 per square foot for most years since 2005. Particularly weak pricing in 2023 YTD is perhaps a sign that distressed sales are accounting for an outsized share of recent transactions.

**Office Transaction Volume and Price per Square Foot, 2005-2023 YTD;**
Montgomery County, MD




*Source: Real Capital Analytics*

# TAX ASSESSMENTS ANALYSIS

# HEADLINE ASSESSED VALUE TRENDS

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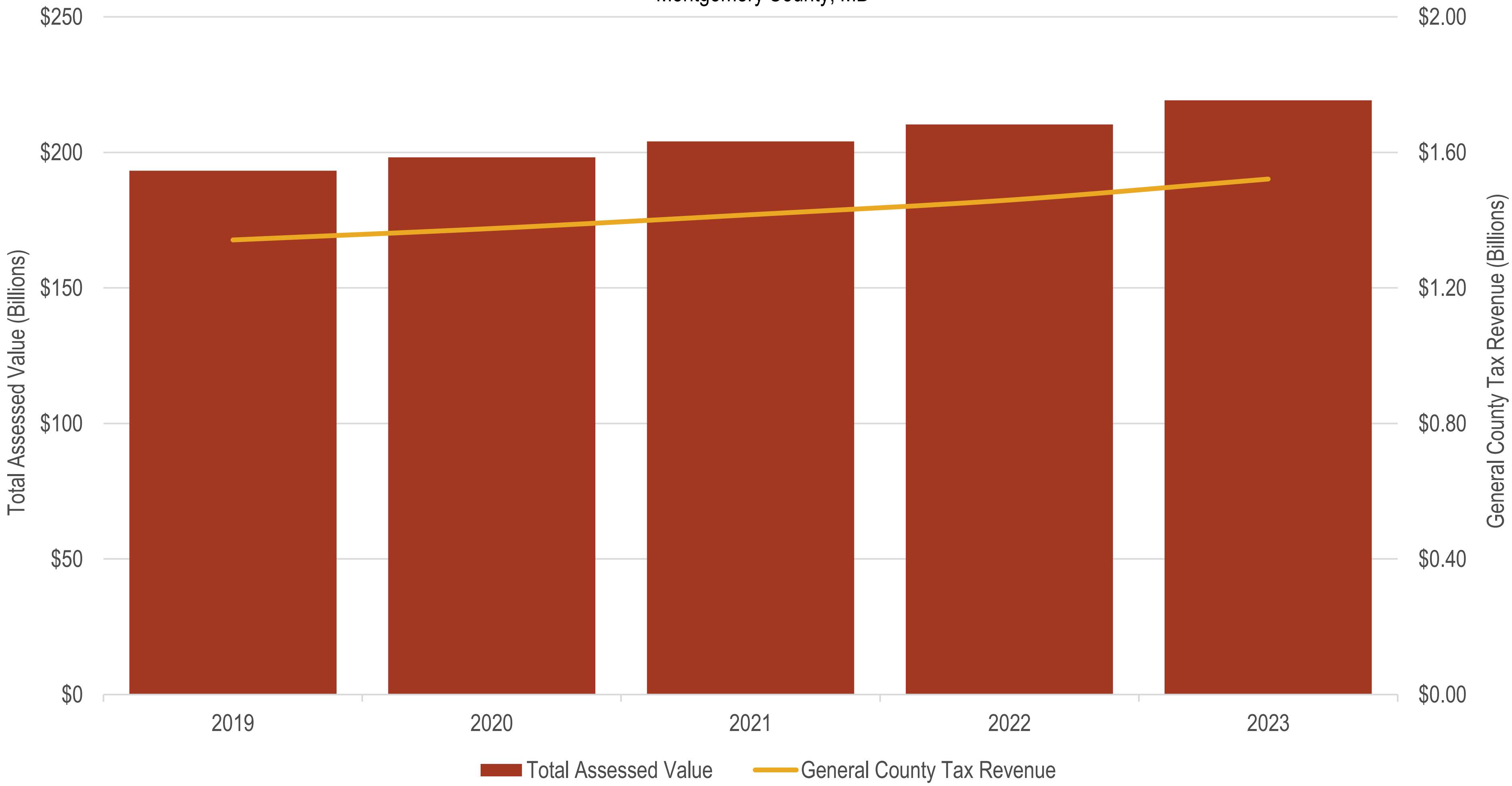
## STRONG RECENT COUNTY-WIDE GROWTH IN ASSESSED VALUES HAS BUFFERED THE TAX BASE.

- General county real property tax revenue has steadily increased, from $1.34 billion in 2019 to $1.52 billion in 2023, and the total assessed value of all Montgomery County properties has increased by $6.49 billion per year on average over the last four years.

**Total Assessed Value and General County Real Property Tax Revenue, 2019-2023;**
Montgomery County, MD



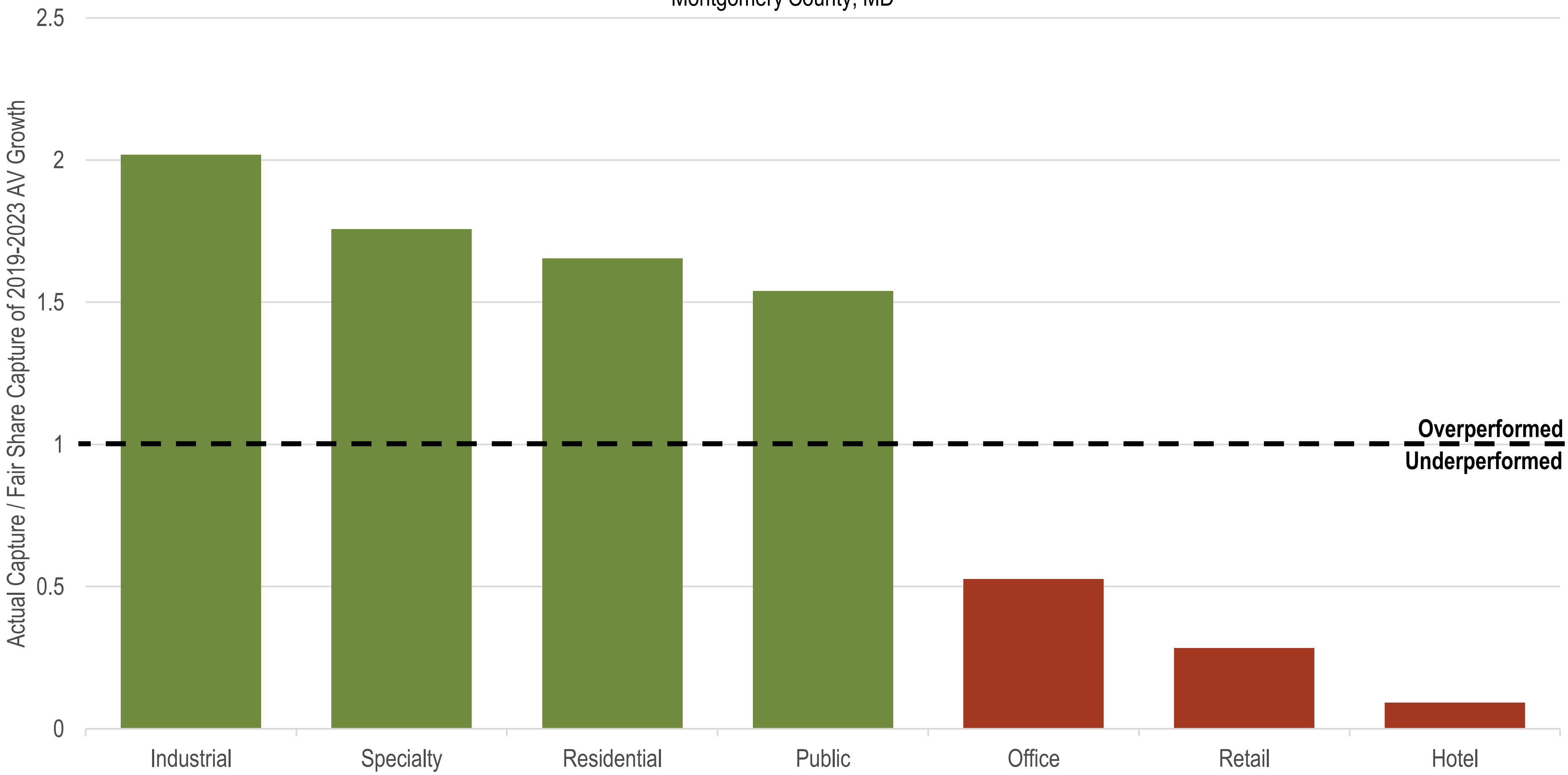

*Source: Montgomery County; RCLCO*

# CHANGE IN ASSESSED VALUE BREAKDOWN

## GROWTH IN RESIDENTIAL VALUES WAS RESPONSIBLE FOR AN OUTSIZED SHARE OF THE OVERALL GROWTH IN TOTAL ASSESSED VALUE DURING AND EMERGING FROM THE PANDEMIC.

- The most high-performing sectors in terms of relative assessment growth were residential and industrial, which office, hotel, and retail underperformed during the pandemic.

**Actual vs. Fair Share Capture of 2019-2023 Tax Assessment Growth by Sector;**
Montgomery County, MD

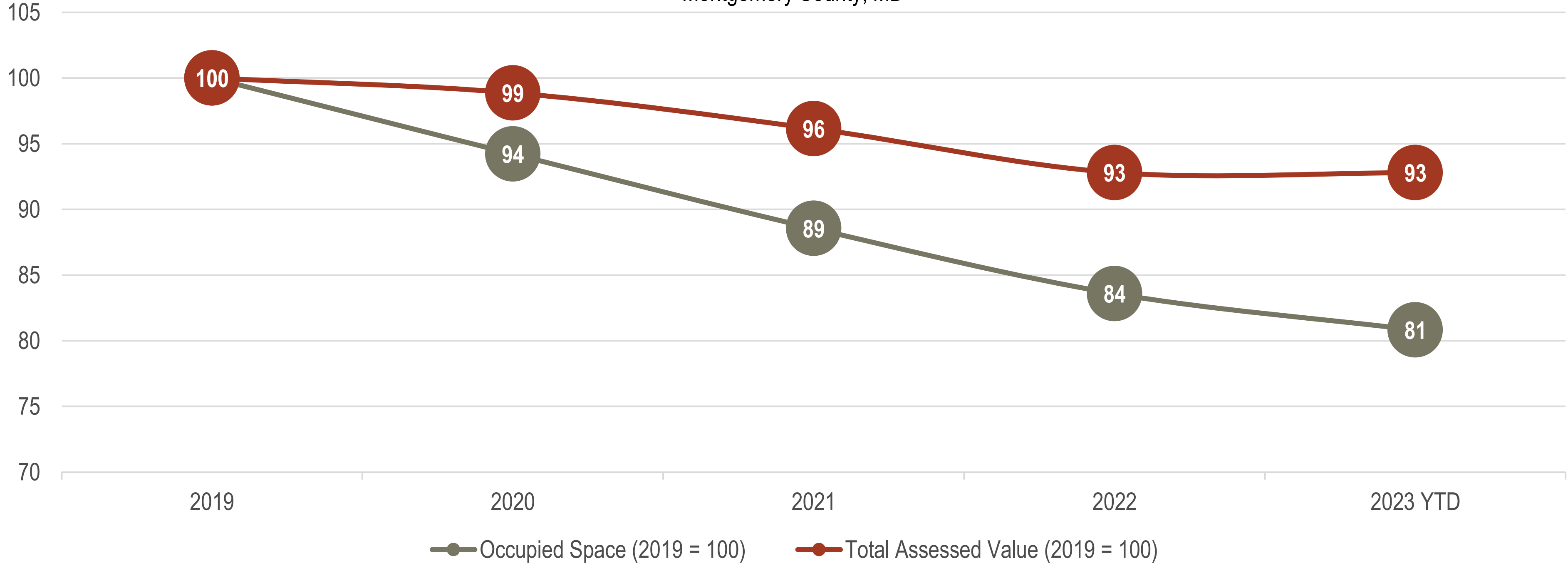



*Source: Montgomery County; Maryland Department of Planning; RCLCO*

## ASSESSED VALUES ARE NOT WHOLLY CAPTURING POOR PERFORMANCE IN MONTGOMERY COUNTY'S OFFICE MARKET.

- While the vacancy rate of the ten most valuable multi-tenant office buildings has increased from 23.9% in 2019 to 38.5% in 2023 YTD, these buildings have lost about 7% of their total assessed value.

**Occupied Space vs. Assessed Value (Top 10 Multi-Tenant Office Buildings by 2019 Value), 2019-2023 YTD;**
Montgomery County, MD




| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Occupied Space | 3,074,268 | 2,896,747 | 2,722,369 | 2,570,004 | 2,484,902 |
| Vacancy | 23.9% | 28.3% | 32.6% | 36.4% | 38.5% |
| Assessed Value | $1,599,809,133 | $1,581,759,734 | $1,538,261,333 | $1,484,813,133 | $1,484,677,967 |

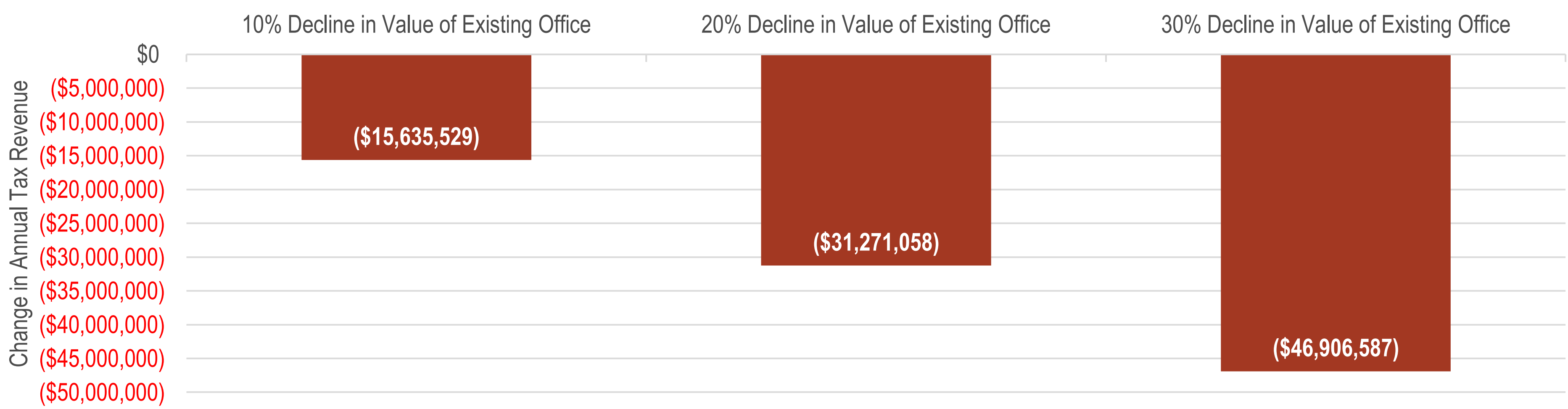
*Source: Montgomery County; Maryland Department of Planning; CoStar; RCLCO*

## FUTURE DECLINES IN THE VALUE OF EXISTING OFFICE COULD CAUSE MONTGOMERY COUNTY TO LOSE UP TO $47 MILLION IN ANNUAL TAX RECEIPTS.

- RCLCO developed three scenarios to evaluate the impact of declines in office values on county property tax receipts, using a range of declines in the values of existing office buildings. While the delivery of new office buildings might offset some of this loss, a significant contraction in office inventory growth is widely anticipated in the near term, as market fundamentals have become increasingly unfavorable.
- This analysis indicates that, if office values decline by as much as 30% over the next ten years, Montgomery County could lose approximately $47 million in total tax revenue per year, solely from declines in the assessed value of office properties that exist today.

**Projected Impact of Decline in Office Values on County Tax Receipts;**
Montgomery County, MD

| SCENARIO | TOTAL DECLINE IN OFFICE VALUES | TOTAL CHANGE IN EXISTING OFFICE AV | TOTAL CHANGE IN ANNUAL COUNTY TAX REVENUE |
|---|---|---|---|
| **Scenario 1** | 10% | ($1,407,929,547) | **($15,635,529)** |
| **Scenario 2** | 20% | ($2,815,859,094) | **($31,271,058)** |
| **Scenario 3** | 30% | ($4,223,788,641) | **($46,906,587)** |



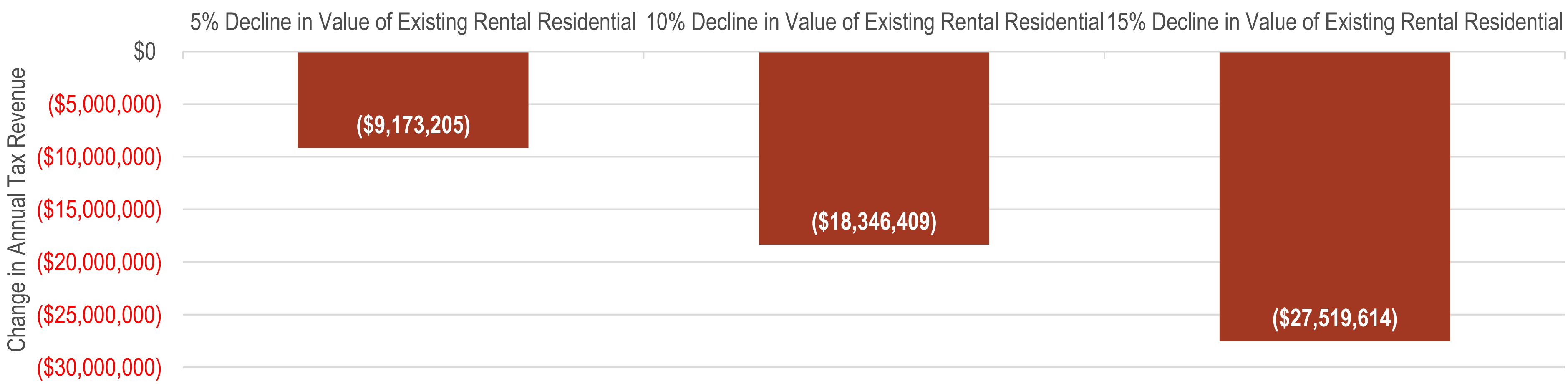

*Source: Montgomery County; Maryland Department of Planning; Maryland Department of Legislative Services; RCLCO*

### A MODERATE DECLINE IN RENTAL RESIDENTIAL VALUES COULD POSE ADDITIONAL RISKS TO MONTGOMERY COUNTY'S FISCAL HEALTH.

- RCLCO also modeled three scenarios to evaluate the impact of declines in rental residential values on county property tax revenues. RCLCO assumed more modest declines in rental residential values, fueled by softening demand fundamentals and a resulting moderation in rent growth. While these value decline assumptions are more speculative than office value declines (the values of pre-2019 office have already experienced some decline—see Page 13), it is less likely that rental residential properties will continue to drive as much of the growth in overall assessed value as they did from 2019 to 2022, which was a time of outsized growth for the rental apartment market.
- If the value of existing rental residential properties declines by as much as 15%, Montgomery County could lose approximately $28 million in total tax revenue per year, in addition to any revenue loss resulting from declines in office values.

**Projected Impact of Decline in Rental Residential Values on County Tax Receipts;**
Montgomery County, MD

| SCENARIO | TOTAL DECLINE IN RENTAL RESIDENTIAL VALUES | TOTAL CHANGE IN EXISTING RENTAL RESIDENTIAL AV | TOTAL CHANGE IN ANNUAL COUNTY TAX REVENUE |
|---|---|---|---|
| **Scenario 1** | 5% | ($849,903,961) | **($9,173,205)** |
| **Scenario 2** | 10% | ($1,699,807,922) | **($18,346,409)** |
| **Scenario 3** | 15% | ($2,549,711,882) | **($27,519,614)** |




*Source: Montgomery County; Maryland Department of Planning; Maryland Department of Legislative Services; RCLCO*

# DISCLAIMERS

# CRITICAL ASSUMPTIONS

Our conclusions are based on our analysis of the information available from our own sources and from the client as of the date of this report. We assume that the information is correct, complete, and reliable.

We made certain assumptions about the future performance of the global, national, and local economy and real estate market, and on other factors similarly outside either our control or that of the client. We analyzed trends and the information available to us in drawing these conclusions. However, given the fluid and dynamic nature of the economy and real estate markets, as well as the uncertainty surrounding particularly the near-term future, it is critical to monitor the economy and markets continuously and to revisit the aforementioned conclusions periodically to ensure that they are reflective of changing market conditions.

We assume that the economy and real estate markets will experience a period of slower growth in the next 12 to 24 months, and then return to a stable and moderate rate in 2025 and beyond. However, stable and moderate growth patterns are historically not sustainable over extended periods of time, the economy is cyclical, and real estate markets are typically highly sensitive to business cycles. Further, it is very difficult to predict when inflection points in economic and real cycles will occur.

With the above in mind, we assume that the long-term average absorption rates and price changes will be as projected, realizing that most of the time performance will be either above or below said average rates.

Our analysis does not consider the potential impact of future economic shocks on the national and/or local economy, and does not consider the potential benefits from major "booms” that may occur. Similarly, the analysis does not reflect the residual impact on the real estate market and the competitive environment of such a shock or boom. Also, it is important to note that it is difficult to predict changing consumer and market psychology.

As such, we recommend the close monitoring of the economy and the marketplace, and updating this analysis as appropriate.

Further, the project and investment economics should be “stress tested” to ensure that potential fluctuations in revenue and cost assumptions resulting from alternative scenarios regarding the economy and real estate market conditions will not cause failure.

In addition, we assume that the following will occur in accordance with current expectations:

- Economic, employment, and household growth
- Other forecasts of trends and demographic and economic patterns, including consumer confidence levels
- The cost of development and construction
- Tax laws (i.e., property and income tax rates, deductibility of mortgage interest, and so forth)
- Availability and cost of capital and mortgage financing for real estate developers, owners and buyers
- Competitive projects will be developed as planned (active and future) and that a reasonable stream of supply offerings will satisfy real estate demand
- Major public works projects occur and are completed as planned

Should any of the above change, this analysis should be updated, with the conclusions reviewed accordingly (and possibly revised).

# GENERAL LIMITING CONDITIONS

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Reasonable efforts have been made to ensure that the data contained in this study reflect accurate and timely information and are believed to be reliable. This study is based on estimates, assumptions, and other information developed by RCLCO from its independent research effort, general knowledge of the industry, and consultations with the client and its representatives. No responsibility is assumed for inaccuracies in reporting by the client, its agent, and representatives or in any other data source used in preparing or presenting this study. This report is based on information that to our knowledge was current as of the date of this report, and RCLCO has not undertaken any update of its research effort since such date.

Our report may contain prospective financial information, estimates, or opinions that represent our view of reasonable expectations at a particular time, but such information, estimates, or opinions are not offered as predictions or assurances that a particular level of income or profit will be achieved, that particular events will occur, or that a particular price will be offered or accepted. Actual results achieved during the period covered by our prospective financial analysis may vary from those described in our report, and the variations may be material. Therefore, no warranty or representation is made by RCLCO that any of the projected values or results contained in this study will be achieved.

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## AUSTIN

501 Congress Ave, Suite 150
Austin, TX 78701

## LOS ANGELES

11601 Wilshire Boulevard, Suite 1650
Los Angeles, CA 90025

## ORLANDO

964 Lake Baldwin Lane, Suite 100
Orlando, FL 32814

## WASHINGTON, DC

7200 Wisconsin Avenue, Suite 1110
Bethesda, MD 20814