



Free-falling office values: challenges - by Margo Tiffen **A catalyst for property tax**

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Certain segments of the U.S. commercial real estate market are facing significant difficulties in recovering from the pandemic, especially office buildings. The news is awash with reports of large office landlords defaulting on loans. Many highly leveraged owners expect significant challenges ahead.

Almost all New York commercial real estate property owners will challenge their assessment, but it's not as simple as completing a form. The velocity of changes in the office market is unprecedented in recent decades. Given this rate, assessments for almost all office buildings are outdated. Income, occupancy, and expenses are all factors assessors evaluate when estimating a property's valuation. Capitalization rates (cap rates), which estimate property value based on income potential, have increased rapidly in the past year, at a pace not seen in over 30 years.

A decade of low-interest rates has led to high valuations, but as interest rates rise, valuations fall. Higher interest rates, combined with record vacancies, increased expenses, and reduced cash flow, are creating a perfect storm for office owners.

These trends are expected to continue. This past February, distressed U.S. commercial real estate debt hit a 14-year high of 5.2%, prompting analysts to caution that developers may default on a substantial portion of the \$3.1 trillion of outstanding loans. Data from the Mortgage Bankers Association indicate that nearly 25% of office building mortgages must be refinanced in 2023.

Banks, as the largest lenders in the sector, hold 46% of all commercial real estate debt. However, banks typically do not devalue the mortgages until borrowers struggle with their debt payments, so potential shockwaves haven't surfaced yet.

High interest rates increase the risk of defaults. Owners with floating-rate mortgages are already making larger debt-service payments, reducing their cash flow. Some owners with fixed-rate mortgages may have difficulty refinancing their loans.

These conditions have begun to show recently in the high-end office market, with several highly visible defaults. Nearly 19% of all high-end office space in Manhattan was available for lease in the fourth quarter of 2022, up from 11.5% pre-pandemic, according to Savills.

Office building prices have dropped by 25% since early 2022, according to Green Street. This has created a challenging environment for landlords. Higher vacancies lower the value of these buildings. Banks are establishing stricter terms for new mortgages, requiring landlords to demonstrate that they have secured long-term leases with creditworthy tenants.

Valuing real estate is a complex and fluid process. With over 25 years of extensive experience in the New York commercial real estate market, Realty Tax Challenge (RTC) is the leading expert in valuation. Our team of highly trained, multidisciplinary staff use the latest data analysis tools and our exclusive proprietary database to determine your real property value.

It has been said that an airline pilot is overpaid for 364 days a year and earns their salary on the 365th day. Similarly, your tax reduction can make a significant difference to your property's survival during this period. During these times when values are in freefall, with many lenders struggling to survive, it is crucial to work with a firm whose core competency is valuation. Don't let your property be overvalued and overtaxed.

Given these conditions, both banks and investors face significant challenges. As banks decrease investments and lending, the office sector will be impacted first, but this will also have implications on other asset classes, affecting their values. Investors, focused on safeguarding their office portfolios and managing mortgage payments, will allocate fewer resources to other sectors. While the impact on non-office asset values may be comparatively lesser, it remains an important consideration.

RTC caters to all commercial property types, including office, retail, industrial, and multifamily. Allow us to put our expertise to work to provide you with the most effective strategies to challenge your assessment and lower your taxes.

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