GO Committee #2
March 18, 2013
Briefing

MEMORANDUM

March 14, 2013

TO: Government Operations and Fiscal Policy Committee

FROM: Jacob Sesker, Senior Legislative Analyst JS

SUBJECT: Inspector General Report—Review of Montgomery County Commercial Property Tax Assessments

Presentation

The Office of the Inspector General (OIG) presentation is attached to this packet. *See OIG Presentation, ©1-9.* The full report can be viewed on the Montgomery County website at: http://www6.montgomerycountymd.gov/content/Inspectorg/pdf/igactivity/mcdof_sdat_final_report_jan_2013.pdf.

Background

In 2009, the assessed value of the Parklawn Building fell to less than half of its 2007 assessed value. The Inspector General reviewed commercial property tax assessments "to determine (1) whether SDAT has a consistent process for assessing the value of commercial buildings, (2) if so, whether that process was followed in the case of the Parklawn Building, and (3) what the County's process is for challenging inaccurate commercial property assessments."

OIG Recommendations

OIG recommended that the Department of Finance should be more active in meeting the requirement of §20-41A, that the Director of Finance must protect the public interest by acting on behalf of taxpayers and the County to intervene in tax and assessment proceedings, appeal decisions in tax and assessment proceedings, and take any other action permitted by law to review and challenge inaccurate property tax assessments.

OIG recommended the following seven specific changes to Finance practice:

1. *Develop a policy and a method for identifying and analyzing large changes in SDAT's assessed values, to determine if the changes are reasonable.*
2. *Develop a policy and a method for identifying assessed values to review and a method for determining if the values are accurate.*
3. *Examine more assessed values and appeal the assessed values that the Department of Finance believes are inaccurate.*
4. *Make appeals to the Supervisor, to the PTAAB, and to the Maryland Tax Court and beyond, if the County determines it would be cost-effective.*
5. *Track the success of its appeal and participation efforts.*
6. *Participate in taxpayer appeals that may result in large changes that are inaccurate. This participation could range from providing an opinion to intervening in a case.*
7. *Perform a more comprehensive review of commercial property tax assessments similar to the review performed by CountyStat of residential property tax assessments, and take appropriate actions based on the results of that review.*

CAO Tim Firestine wrote a letter to OIG, including responses to each of the audit recommendations. *See Firestine letter, © 10-12.* Most significantly, the letter states that Finance will work to develop a consistent process for tracking and analyzing changes in commercial assessment values, and that a "mid-level research position may be appropriate for performing the necessary research and data compilation to identify material changes in assessment values."

<u>OIG Findings</u>

The OIG report also includes several findings; findings 3(a), 3(b), and 3(c) are most relevant to the recommendations. Finding 3(a) is that Finance does not intervene in or otherwise participate in appeals brought by taxpayers.[1]

Finding 3(b) is that Finance is less involved in assessment appeals than it was in previous years. The report indicates that County participation in assessment appeals declined from 727 in 2003 to 57 in 2011. Furthermore, the staff time dedicated to this effort declined from 1.3 workyears in 1994 to approximately 0.05 workyears today.

Finding 3(c) is that Finance has taken other efforts to improve the fairness and accuracy of tax records. The report specifically cites Finance's efforts to implement the Homestead Property Tax Credit Compliance Program, which has already resulted in revenue collections in excess of program costs.[2]

<u>Staff Analysis</u>

Staff agrees with OIG's recommendations. The homestead property tax credit compliance program illustrates the potential returns from additional expenditures to improve the fairness and accuracy of tax administration. This Committee was recently briefed on the early success of that program, which in its brief existence has already generated sufficient revenues to pay for the cost of the program, and which could generate revenues that are many times greater than the cost of adding one additional workyear. In

[1] According to the report, SDAT notified Finance in April of 2012 that 300 accounts were under appeal, including one with an assessed value of $160 million.

[2] Implementation of OIG's recommendations in this case should improve tax fairness, even though in this case it would not result in additional revenues (assuming that property tax revenues are set at the Charter limit).

the case of property tax assessments, successful appeals and intervention by the County would result in lower tax rates for all taxpayers.

The Parklawn Building's assessed value did drop by half between 2007 and 2009. As such, the building illustrates a type of situation in which Finance should more closely examine SDAT commercial property tax assessments, possibly appealing or intervening as facts warrant.

The report applies a wide range of capitalization rates resulting in a similarly wide range of possible valuations—from $60 million using a 7% capitalization rate to $140 million using a 3% capitalization rate.[3] The actual 2009 assessment, which was reached through a negotiated settlement, was $54.5 million. That assessment indicates a cap rate of 7.7%. Staff notes that this cap rate actually is close to the national average cap rate of 7.9% in the 1st quarter of 2009. *See Co-Star: Rising Cap Rates Add to Real Estate Investors' Worries, © 15-16.* Cap rates for Class A rates for "value add" properties were 8% to 9% for the Suburban DC market in August of 2010. See *CBRE Cap Rate Survey August 2010, © 17.*

Contents:

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[3] A capitalization rate (cap rate) for a specific asset transaction is derived by calculating the net operating income (NOI) of the asset and dividing that NOI by the transaction price for the asset. When valuing an asset using the income approach, the NOI of the property is divided by a cap rate that is selected by the appraiser based on a review of comparables and an assessment of the unique risks associated with a particular property.

Review of Montgomery County Commercial Property Tax Assessments

Presentation of Final Report to the Montgomery County Council
Government Operations & Fiscal Policy Committee

March 18, 2013

Review of Montgomery County Commercial Property Tax Assessments

Parklawn Building and Surrounding Properties in Common Ownership

Parklawn Building

	2007	2009	% Change
Assessments of 10 Properties	$163 million	$90 million	-45%
Parklawn Bldg Assessments	$121.6 million	$54.5 million	-55%
DC area office property prices			-34%

Finding 1: SDAT files for Parklawn Building did not support assessed values

- The final assessed values for the Parklawn Building resulted from a settlement between the property owner and SDAT.
- Regarding the Parklawn settlement, the SDAT Montgomery County Supervisor of Assessments wrote on July 16, 2009 that

  "The adjustment was made utilizing petitioners income and expense information."

- The information we reviewed in SDAT files did not clearly reflect how SDAT determined that the settlement amount was reasonable in the case of the Parklawn Building.
- Using available information and the methods required by statute and by the Maryland Assessment Procedures Manual, we calculated assessment numbers for the Parklawn Building that were significantly different from the final assessed values.
- The report does not show our specific calculations, because we used confidential data.

State Department of Assessments & Taxation Letters

In July 2011, a Maryland Assistant Attorney General wrote about the Parklawn Building that:

•*"the federal government did give notice in the latter half of 2008 that it would not renew the lease and that it would vacate the property."*

•*"once notice is given by the tenant and an actual move out seems reasonably foreseeable, that reality must be recognized by the assessment office."*

•the current Supervisor inspected the building and found its condition poor and that it would require major expenditures to be upgraded to a multi-tenant facility.

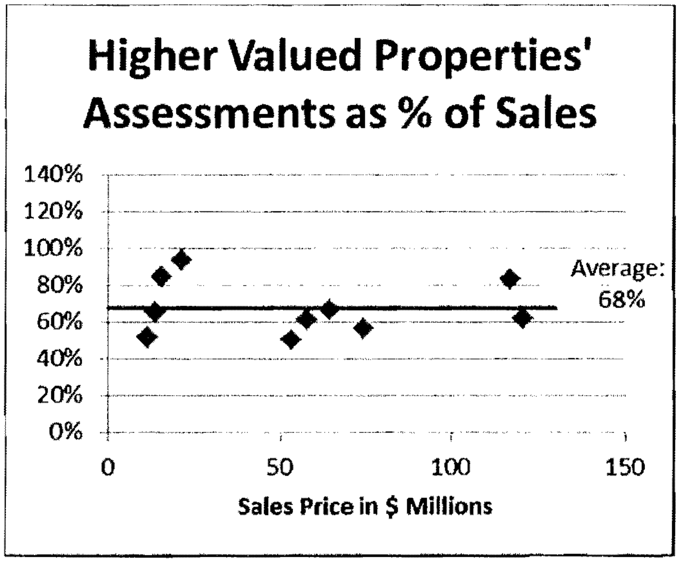
Supervisor's Response to our Draft:

•We provided the Supervisor of Assessments a draft with our formulas; what we understood to be the capitalization rates and expenses; and a discussion of what we found in SDAT files. We requested to be advised of any inaccuracies. We were given no specific corrections.

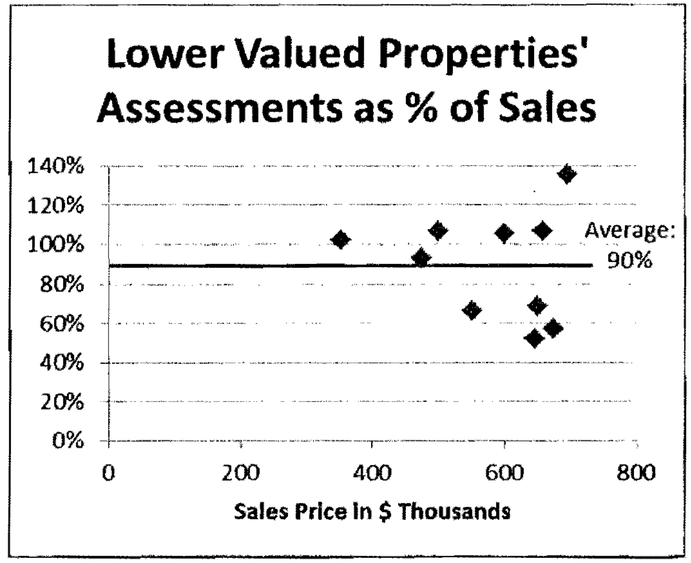
•The Supervisor wrote us that *"While your letter does recognize the income approach as the proper valuation method, it seems to describe it as a fill-in-the-blank methodology. That perspective is incorrect because it overlooks the expertise and experience needed to correctly apply this methodology in the valuation of commercial property, especially the Parklawn Building which was very difficult to value."*

Review of Montgomery County Commercial Property Tax Assessments

Finding 2: In our sample of 20 properties, assessed value was not a good indicator of market value, especially for high value properties



High value properties = sales price > $10 million



Low value properties = sales price < $700,000

- SDAT's 2011 Assessment Ratio Report states, *"We are continually striving for higher quality in assessment uniformity... A measurement of quality is the assessed value/sale price ratio."*
- For the subset of these sales that occurred within one year after assessment, 3 higher valued properties had an assessed value/sale price ratio of 66%, while 2 lower valued properties had an assessed value/sale price ratio of 115%.

Determination of Assessments

1) State Department of Assessments and Taxation – unilateral decision
2) Property Tax Assessment Appeals Board
3) Maryland Tax Court decision, and possible appeals
4) Negotiated settlement

SDAT Response to Final Draft

- The Director of SDAT wrote, *"Your report's emphasis on the Parklawn Building is symptomatic of the fundamental problems with your underlying analysis. The assessment of the Parklawn property and the appeal of that assessment was clearly a difficult assignment and represented an anomaly in the assessment process. That unusual situation should not have been used in any comprehensive review of the normal assessment process for commercial properties in Montgomery County. With all due respect, it is readily apparent to us that your office does not include a licensed appraiser and you did not consult with one on this particular property."*

- He also stated that *"With regards to your sample of the twenty commercial properties, you are making the same fundamental error that County Stats did in its earlier study that does not recognize the significance of the law's January 1 date of finality. One does not compare a recent sales price with a three year old assessment that would have been the product of a data base of sales that are now three to five years old. Similarly, you must take into account for each property whether there has been a reduction in value by the Maryland Tax Court or the Montgomery Property Tax Assessment Appeals Board that the Department legally has to recognize."*

Finding 3: The County Dept. of Finance devotes significantly fewer resources to the implementation of §20-41A of the County Code than it did during the 1990s and early 2000s, and consequently it is significantly less active in carrying out its responsibilities under §20-41A.

County Code Section 20-41A:

"The Director of Finance or designee ***must****...protect the public interest by acting on behalf of the taxpayers and the County to:*

(1) intervene in tax and assessment proceedings before administrative agencies and the courts;

(2) appeal decisions in tax and assessment proceedings; and

(3) take any other action permitted by law to review and challenge inaccurate property tax assessments."

Recommendations: The County Department of Finance should be more active in fulfilling the requirements of §20-41A of the County Code

Chief Administrative Officer Response

The CAO agreed to implement the report's recommendations.

- The CAO is identifying an additional, dedicated resource to enhance the Dept. of Finance's ability to track and strategically analyze SDAT's commercial assessments and, in certain cases, determine if an assessment value is consistent with SDAT's procedures and standards.
- The Dept. of Finance will work to develop a consistent process for tracking and analyzing changes in commercial assessment values.
- If the County determines it is cost-effective, the Dept. of Finance will appeal assessments to the Supervisor, the Property Tax Assessment Appeals Board, and the Maryland Tax Court and will participate in taxpayer appeals.
- The Dept. of Finance will track the status of its appeals.
- CountyStat, in collaboration with the Dept. of Finance, will conduct a more comprehensive review of SDAT's commercial property tax assessments, and the CAO will take appropriate action based on that review.

Appendix C(1): Montgomery County Chief Administrative Officer Response

OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

MEMORANDUM

January 7, 2013

TO: Edward Blansitt, Inspector General

FROM: Timothy L. Firestine, Chief Administrative Officer

SUBJECT: Final Draft Report, Review of Montgomery County Commercial Property Tax Assessments

I am in receipt of your memo and final draft report dated December 11, 2012 detailing the audit conducted by your office concerning the property tax assessment of certain commercial properties by the State Department of Assessments and Taxation (SDAT) and the Department of Finance's review of those assessments. Your assessment of this issue has been thorough and fair.

Please find below specific responses to your audit recommendations.

IG Recommendation General:
The Department of Finance should be more active in fulfilling the requirements of §20-41A of the Montgomery County Code, which would require that more resources be dedicated to this function. At a minimum, the Department of Finance should devote sufficient resources to implement the following actions related to commercial property:

IG Recommendation 1:
Develop a policy and a method for identifying and analyzing large changes in SDAT's assessed values, to determine if the changes are reasonable.

CAO Response: We are in the process of identifying an additional, dedicated resource to enhance the Department of Finance's ability to track and strategically analyze SDAT's commercial assessments. While constant in depth analysis would be ideal, we believe, at this point a mid-level research position may be appropriate for performing the necessary research and data compilation to identify material changes in assessment values. In addition, the Department of Finance will work to develop a consistent process for tracking and analyzing changes in commercial assessment values.

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montgomerycountymd.gov/311 MC311 240-773-3556 TTY

Edward Blansitt, Inspector General
January 7, 2013
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IG Recommendation 2:
Develop a policy and a method for identifying assessed values to review and a method for determining if the values are accurate.

CAO Response: As stated above, with an additional resource, the Department of Finance will be able to monitor, track and analyze material changes in commercial assessment values. Also, in certain cases, they can do additional analysis to determine if the assessment value is consistent with SDAT's procedures and standards. However, without a significant increase in resources, County cannot ensure the accuracy of all SDAT commercial assessments nor challenge most of these assessments because of the magnitude and complexity of the workload. We are confident that our proposed strategic monitoring and analysis of SDAT's commercial assessments will improve the current process.

IG Recommendation 3:
Examine more assessed values and appeal the assessed values that the Department of Finance believes are inaccurate.

CAO Response: Please refer to my responses under IG Recommendations 1 and 2. To the extent that the SDAT's values are materially different than our estimate of market value the Department of Finance will be able to appeal these assessments.

IG Recommendation 4:
Make appeals to the Supervisor, to the PTAAB, and to the Maryland Tax Court and beyond, if the County determines it would be cost-effective.

CAO Response: If the County determines it would be cost-effective, the Department of Finance will appeal assessments to the Supervisor, PTAAB, and the Maryland Tax Court. As you are aware, the appeals process can be very time consuming and in many cases quite complex. In particular, the Tax Court appeals require extensive time for expert attorney preparation and the use of outside subject expert consultants to review and analyze the commercial assessment and calculate an alternative market value. The cost of this effort and the tax value of the assessments at issue will be factored into the determination as to whether we will pursue assessment appeals at all levels.

Please note that, as referenced on page 4 of the IG report, in 2002 State law was amended to limit the County's authority to appeal to only when the property is reassessed every three years. This legislative change has also limited the number of appeals that can be performed.

IG Recommendation 5:
Track the success of its appeal and participation efforts.

CAO Response: The Department of Finance will maintain, track and monitor the status of its appeals on a fiscal year effort.

IG Recommendation 6:
Participate in taxpayer appeals that may result in large changes that are inaccurate. This participation could range from providing an opinion to intervening in a case.

CAO Response: If the County determines it would be cost-effective, the Department of Finance will participate as appropriate in taxpayer appeals.

IG Recommendation 7:
Perform a more comprehensive review of commercial property tax assessments similar to the review performed by CountyStat of residential property tax assessments and take appropriate actions based on the results of that review.

CAO Response: CountyStat, in collaboration with the Department of Finance, will conduct a more comprehensive review of SDAT's commercial property tax assessments and we will take appropriate action based on that review.

If you have any questions, please feel free to contact me or Assistant Chief Administrative Officer Fariba Kassiri, who can be reached at (240) 777-2512 or Fariba.Kassiri@montgomerycountymd.gov.

TLF:fk

cc: Joseph Beach, Director, Department of Finance
Fariba Kassiri, Assistant Chief Administrative Officer
Kathleen Boucher, Assistant Chief Administrative Officer
Robert Hagedoorn, Chief, Division of Treasury, Department of Finance
James Babb, Tax Operations Manager, Division of Treasury, Department of Finance
David Gottesman, CountyStat Manager, Office of the County Executive
Larry Dyckman, Internal Audit Manager, Office of the County Executive

Appendix B(1): SDAT Response to Draft

State of Maryland

DEPARTMENT OF ASSESSMENTS AND TAXATION

Montgomery County Office

MARTIN O'MALLEY
Governor

ROBERT E. YOUNG
Director

B. MARIE GREEN
Supervisor of Assessments

September 20, 2012

Dear Mr. Blansitt,

Thank you for your letter of September 14, 2012 and the opportunity to respond to your draft report. While your letter does recognize the income approach as the proper valuation method, it seems to describe it as a fill-in-the-blank methodology. That perspective is incorrect because it overlooks the expertise and experience needed to correctly apply this methodology in the valuation of commercial property, especially the Parklawn Building which was very difficult to value.

At the time of the assessment which you are reviewing, the Parklawn Building was a very large building that was designed for one tenant, the federal government. An interior inspection of the property revealed that it was in poor condition and in need of major renovations. The owner had been complaining to the assessor for multiple assessment cycles that the federal government was threatening to vacate the property, but because the remaining lease term continued for several more years, the assessor gave little adjustment for that potential circumstance. However, when the employees from one portion of the tenant moved out, vacating 400,000 square feet, that potential could no longer be dismissed. There were also reliable indicators that the remaining federal employees might also move out. Such an event would have caused a drastic decrease in value because it would have been extremely speculative to predict any future use or income stream for such a large property designed for one tenant and in its state of poor maintenance and repair. That was the situation when the case was settled.

A basic principle of valuation is important with this property: A buyer buys future income streams, not historic ones. While the valuation of property does use past income and expenses, it uses those historic actuals to predict future income. However, for this property, the historic financials were not a good indicator of the future income stream because a large portion of the property was vacated. Therefore the legitimate concern was that the entire building would be vacated, because the expense percentage could be significantly impacted by occupancy levels since not all expenses change in step with the occupancy level. There would be a large amount of capital expenses incurred to repair the building before reletting to the federal government or there would be an even larger amount of expenses incurred if the building would have to be refitted for smaller new tenants. Also there would be significant rent loss over a lengthy absorption period to bring the vacancy level back to market norms. Accordingly, while you have recognized that the valuation formula requires the gross income potential be reduced by a vacancy allowance and then reduced by expenses, I am not comfortable that your report has recognized that those figures for this building were extremely difficult to predict.

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MRS (Maryland Relay Service) 1-800-735-2258 (TT/VOICE)

Secondly, the capitalization factor applied to the net operating income (NOI) to achieve an indicated value is not simply an interest rate. Rather this rate must reflect an appropriate rate of return over a holding period (usually 10 years) for the amount of risk involved with the subject property. A market cap rate would not have been appropriate for this property based on the above discussion because it would not have recognized the greater risk involved with the fluctuating situation that existed when this property was valued for the assessment being reviewed.

It is also important to understand that when an assessor initially values property, he/she is not doing it as an individual valuation task. Rather, the income method is used as part of a mass appraisal process that produces an individual value for many properties. It is not a tool that an average person can use. It takes a lot of education and training to gather and decipher a large amount of information to develop cap rates, expenses, etc.

Finally, the initial assessment is subject to further review through a three level appeal process:

Supervisor level: A meeting with the Assessor and Property Owner/Representatives

Property Tax Assessment Appeals Board: Three judges appointed by the Governor determine a value after presentations by the Assessor and Property Owner/Representatives

Maryland Tax Court: One or more Judges appointed by the Governor determine a value after presentations by the Assessor or an Assistant Attorney General and the Property Owner/Representative

During each appeal level, the assessor receives more information that has to be analyzed to determine what, if any, effect it has on the value. In the Parklawn appeal, the property was more thoroughly inspected and the owner shared, considerable more information about the ongoing situation with the federal government and its pending decision to vacate or release the property, however they did not leave this information with the assessor. Accordingly, rents, vacancy and expenses were derived as stabilized and not simply based on past actuals. The capitalization rate was defined through market analysis and national reports with consideration given to the unusual circumstances of this building. Ultimately, all of these factors were taken into consideration when the final settlement was reached. However, that final assessment was also the result of a long appeal process over a period of three years that ended with a negotiated settlement. None of that was mentioned in your report.

Once the settlement was reached, the agreed upon value was entered into the Department's records. However, it did not seem to be a necessary or worthwhile use of the assessor's time to redo the worksheet to arithmetically reach the new value through the income approach. Therefore, only the value was entered. Unfortunately, that prevents your office from being able to verify the exact factors used. But in truth, the final settlement was the result of negotiations in the context of range of value estimates that attempted to capture all the moving parts in the Parklawn situation.

I hope this letter helps explain the final assessment and how our process worked to achieve the final assessment for this property. If you have any other questions, please feel free to contact me.

Sincerely,

B. Marie Green

B. Marie Green
Supervisor of Assessments
Montgomery County

Appendix C(2): State Department of Assessments and Taxation Response

State of Maryland

DEPARTMENT OF ASSESSMENTS AND TAXATION

Office of the Director

MARTIN O'MALLEY
Governor

ROBERT E. YOUNG
Director

January 8, 2013

TO: Edward Blansitt
Inspector General for Montgomery County

FROM: Robert E. Young Robert E. Young
Director, State Department of Assessments and Taxation

RE: Final Draft Report, Review of Montgomery County Commercial Property Tax Assessments

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The purpose of this memorandum is to provide the Department's response to your Final Draft Report regarding Montgomery County Commercial Property Tax Assessments and the Parklawn Building in particular. Your Draft Report was forwarded to me by our Supervisor of Assessments for Montgomery County, B. Marie Green.

Your Report's emphasis on the Parklawn Building is symptomatic of the fundamental problems with your underlying analysis. The assessment of the Parklawn Property and the appeal of that assessment was clearly a difficult assignment and represented an anomaly in the assessment process. That unusual situation should not have been be used in any comprehensive review of the normal assessment process for commercial properties in Montgomery County. With all due respect, it is readily apparent to us that your office does not include a licensed appraiser and you did not consult with one on this particular property. Ms. Green also advises me that your office did not share with her the data you relied upon in making your comments on the Parklawn Building.

With regards to your sample of the twenty commercial properties, you are making the same fundamental error that County Stats did in its earlier study that does not recognize the significance of the law's January 1 date of finality. One does not compare a recent sales price with a three year old assessment that would have been the product of a data base of sales that are now three to five years old. Similarly, you must take into account for each property whether there has been a reduction in value by the Maryland Tax Court or the Montgomery Property Tax Assessment Appeals Board that the Department legally has to recognize.

If you would like to withhold the release of your Report until you have a licensed appraiser review the Parklawn Building and also have your employees review a random sample of properties that recognizes the date of finality and appeal reductions, then I would very much like to see that data so that the Department could specifically respond on each and every property.

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Phone: (410) 767-4881 – FAX: (410) 333-5873 TTY users call Maryland Relay 1-800-735-2258
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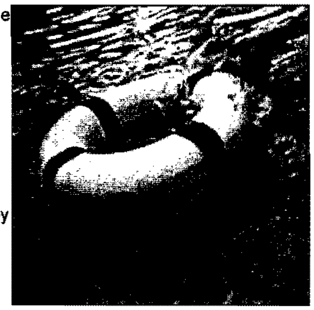
CoStar GROUP

SURVIVAL MODE: Rising Cap Rates Add to Real Estate Investors' Worries

With Tenants in the Driver's Seat, Landlord Find Themselves in Survival Mode As Property Values Fall and Revenue Shrinks

By **Randyl Drummer**
March 18, 2009



The steady rise in capitalization rates from the sale of commercial property shows little sign of abating, adding to the anxiety of real estate investors who don't expect any of the major property sectors to rebound until well into next year.

When cap rates rise, asset values fall, and as investment risk has increased, actual cap rates have risen nationally over the last five quarters -- and continue to rise across most markets and property types, according to a preview analysis of CoStar COMPs data gathered so far in 2009. The continued cap rate expansion also dovetails with the results of the first-quarter Korpacz Real Estate Investor Survey, a widely watched report issued by PricewaterhouseCoopers this week.

More than 100 institutional and private investors surveyed for the Korpacz report predicted that cap rates will rise by an average of nearly 50 basis points over the next six months across virtually all property categories and most metro markets. The largest projected gainers are power centers (74.4 bp) suburban office (65.6 bp) and regional malls (65 bp), with their generally lower barriers to market entry. Although cap rates appear to have dropped in the Houston and Washington, D.C. office markets in the first quarter, Korpacz respondents expect them to rise a whopping 118 points and 25 points, respectively, over the next six months.

"The ongoing problems tied to both the U.S. economic recession and the financial crisis are making it very difficult for investors to sidestep value losses across all property types," said Susan Smith, director in the PricewaterhouseCoopers real estate sector services group and editor of the survey. "It's clear that many investors are more in survival mode than in acquisition mode, even though buying opportunities are expected to increase in the coming months."

The 100-page survey provides a window into the thought processes of the investors in REITs, pension funds, private equity firms and insurance and mortgage companies on the economy, property valuation, cap rates and property-level performance of national and local markets.

Survey authors said with few financing options and receding tenant demand, investors and real estate companies have shifted into a mode of managing and protecting their existing assets, with landlords cutting costs and rushing to sign or renew tenants – in many cases offering sweet incentives and concessions such as free rent. The result is lower revenue and higher overall cap rates reported for the few investment sales that are being completed.

"Tenants are in the driver's seat, and landlords are in survival mode, trying to preserve revenue streams in one of the harshest ownership environments ever encountered," said Tim Conlon, partner and U.S. real estate sector leader for PricewaterhouseCoopers. "It will be survival of the fittest going forward, with owners who are able to remain financially strong being better positioned to capitalize on the buying opportunities that are to come."

Although sales have been weak, survey respondents expect buying opportunities to pick up in coming months as distressed assets from commercial loan defaults hit the market in larger numbers. Both private equity and institutional investors are preparing by disposing of certain assets, revving up potential joint partnerships, retiring debt and scrubbing their balance sheets, according to survey feedback.

However, a huge impediment is that, with the capital markets in disarray and few comparable transactions upon which to build a foundation, buyers and sellers can't agree on pricing.

In fact, one widely watched transaction-based index published at the MIT Center for Real Estate couldn't even produce a retail index for the fourth quarter due to the dearth of transactions. The overall sample size for various other property markets was "scarily low," acknowledged David Geltner, director of research at the MIT Center for Real Estate.

Of the data collected for other commercial property sectors, overall prices of property sold by major institutional investors fell by a record 10.6% in the fourth quarter of 2008 and 15% for the year, in line with similar analyses by CoStar Group, Inc. and other data providers.

The market uncertainty is perhaps best reflected in the confusion over cap rates. Most analysts agree there are just too few transactions to draw many conclusions.

Respondents to the Korpacz survey reported that overall cap rates have increased for most major markets and product types over the last during the quarter, a trend bolstered by an analysis of CoStar COMPs transaction data for office, industrial and multifamily sales over the last five quarters:

- In fourth-quarter 2007, 180 closed transactions of Class A office sales of more than $5 million were recorded, trading at an average actual cap rate of 6.1% nationally. By the last three months of 2008, the average cap rate spiked to 7.6% on just 80 transactions, including a jump of more than 100 basis points between the third and fourth quarters. With sales results for the quarter still being collected, CoStar had recorded 42 closed transactions at an average actual cap rate of 7.9% as of March 18.

- Investors closed 279 sales of Class A and B warehouse and distribution property in the fourth quarter of 2007 at an average cap rate of 7.1%. The number of transactions dropped sharply in fourth-quarter 2008, with the cap rate rising 100 bp. First-quarter 2009 is continuing to trend toward a sharp drop in transactions, with the cap rate edging up another 50 bp to a preliminary 8.6% as of March 18.

- In the apartment sector, a look at sales totaling $5 million or more shows that 629 Class A properties exchanged hands in fourth-quarter 2007 at an average actual cap rate of 5.9%. For the same period a year later, 355 transactions sold and the average cap rate rose 90 basis point to 6.8%, thanks to a 50-bp jump between the third and fourth quarters. Though deal volume appears to be again dropping sharply in the first quarter, the cap rate for closed transactions was holding steady at 6.8% in the quarter to date – the only major property category to hold the line on cap rate expansion.

- ***Editor's Note:*** *For news and updates on new development projects, land sales, significant deliveries and trends affecting development and construction,* ***join the distribution list*** *for CoStar's free weekly* ***In The Pipeline*** *column and newsletter.* ***Check out this week's edition.***

Another interesting result in the PricewaterhouseCoopers survey was the average amount of free rent offered by office landlords. Compared to a year ago, the average has increased sharply in several major metro office markets, including Boston, where average free rent increased from 2.15 to 6

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months; Manhattan, where it grew from 4 ½ to six months; and in San Francisco, where it jumped from 3 ½ to six months. Warehouse landlords also have stepped up concessions significantly as tenants have melted away.

In the CBD office market, tenant concessions don't yet appear to be creating a lot of leasing activity, with many survey respondents reporting that deal flow is frozen.

"Tenants have the upper hand, but many of them are afraid to make critical near-term decisions because of the recession," noted one investor surveyed for the Korpacz report.

Subtle signs of weakness emerged in early 2008 as demand for suburban space waned, said an investor. "By the latter part of 2008 tenants were no longer nine deep at the door and calls from prospective tenants began to dwindle."

A suburban office market respondent opined that "fundamentals will remain under pressure as demand weakens and more companies are forced to return space to the market," with the problems lingering for at least two more years.

Office Suburban | Eastern Region

<< | >>

	Class A				Class B				Class C			
	Stabilized	Trend*	Value Add	Trend*	Stabilized	Trend*	Value Add	Trend*	Stabilized	Trend*	Value Add	Trend*
Atlanta	7.75% - 9.00%	↓	9.00% - 10.00%	↓	9.50% - 10.50%	↓	10.00% - 10.75%	↓	11.00% - 12.50%	↓	12.00% - 14.00%	↓
Baltimore	8.00% - 8.75%	↔	9.50% - 10.50%	↔	9.25% - 9.75%	↔	10.50% - 11.50%	↔	12.00% - 13.00%	↔	14.00% - 15.00%	↔
Boston	7.25% - 8.00%	↓	7.75% - 8.50%	↓	8.00% - 9.00%	↓	8.50% - 9.50%	↓	10.00% - 11.50%	↓	11.00% - 14.00%	↑
Charlotte	7.75% - 8.75%	↓	8.75% - 10.00%	↓	9.50% - 10.50%	↓	10.50% - 12.00%	↓	10.00% - 11.00%	↓	11.00% - 12.50%	↓
Jacksonville	9.50% - 10.50%	↑	10.00% - 11.00%	↑	10.00% - 11.00%	↑	11.00% - 13.00%	↑	12.00% - 14.00%	↑	13.00% - 15.00%	↑
Memphis	8.50% - 9.00%	↓	8.50% - 9.00%	↓	9.00% - 10.00%	↓	9.00% - 10.00%	↓	11.00% - 12.00%	↓	11.00% - 12.00%	↓
Miami	7.00% - 8.00%	↓	8.00% - 9.00%	↓	7.50% - 8.50%	↓	8.50% - 9.50%	↓	9.00% - 10.00%	↓	10.00% - 11.00%	↓
Nashville	8.50% - 9.50%	↓	9.00% - 10.00%	↓	9.00% - 10.00%	↓	10.00% - 11.00%	↔	10.00% - 11.00%	↓	11.00% - 12.00%	↔
Orlando	8.00% - 9.00%	↓	9.00% - 10.00%	↓	9.75% - 10.25%	↔	10.00% - 10.50%	↓	10.50% - 11.00%	↓	10.75% - 11.25%	↓
Pittsburgh	7.50% - 8.50%	N/A	9.50% - 10.50%	N/A	8.75% - 9.75%	N/A	9.50% - 11.00%	N/A	N/A	N/A	N/A	N/A
Philadelphia	8.00% - 9.00%	↓	8.50% - 9.50%	↓	9.50% - 10.50%	↓	10.00% - 11.00%	↓	10.50% - 12.00%	↓	11.00% - 12.00%	↓
Raleigh	7.00% - 8.50%	↓	8.50% -9.50%	↓	9.00% - 10.00%	↓	9.50% - 10.50%	↓	10.00% - 11.00%	↓	11.00% - 12.00%	↓
Tampa	7.25% - 8.25%	↓	8.25% - 9.25%	↓	8.25% - 9.25%	↓	9.00% - 10.00%	↓	9.50% - 10.50%	↓	10.00% - 11.25%	↓
Washington DC	7.00% - 8.25%	↓	8.00% - 9.00%	↔	7.50% - 8.75%	↓	8.00% - 10.00%	↓	N/A	N/A	N/A	N/A

* Compared to 2nd Half 2009

	CAP RATE FORECAST*						INVESTOR INTERESTS**
	Class A		Class B		Class C		
	Stabilized	Value Add	Stabilized	Value Add	Stabilized	Value Add	
Atlanta							↑
Baltimore							↔
Boston							↑
Charlotte							↑
Jacksonville							↓
Memphis							↔
Miami							↑
Nashville							↑
Orlando							↑
Pittsburgh							↑
Philadelphia							↑
Raleigh							↑
Tampa							↑
Washington DC							↑

Increase more than 50 bps | Increase less than 50 bps | Remain flat | Decrease less than 50 bps | Decrease more than 50 bps

* Cap Rate Forecast represents the CBRE professional's opinion of where cap rates are likely to trend in second half 2010 in their local market.
** Investor interests represents the local CBRE professional's opinion on the current level of investor interest as compared to second half 2009 in their local market.

Appendix E(1): Letter from Prince George's County Council Member to the Office of the Maryland Attorney General

THE PRINCE GEORGE'S COUNTY GOVERNMENT

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(301) 952-4436

County Council
WILL CAMPOS
Council Member, 2nd District

June 7, 2011

Maryland Attorney General Douglas F. Gansler
Office of the Attorney General
200 St. Paul Place
Baltimore, MD 21202

Dear Mr. Gansler:

I would like to bring to your attention some disturbing facts that I feel may somehow be related to the Department of Health and Human Services' decision to remain at their current Rockville location. For years, Prince Georges County and the district I represent have been pursuing its first Cabinet level agency to be headquartered here. We thought it was finally our time. If we had lost in a fair and open competition, that is fine. However, the facts I outline below suggest that some serious questions need to be answered or there needs to be some level of investigation by your office.

The basic issue here relates to the Real Estate Tax Assessments for the current location of HHS headquarters in Rockville ("Parklawn"). For illustrative purposes, I have compared the Parklawn building to a building in my district which is the same age, with a very similar lease composition (term, GSA, remaining life on lease at time of assessment, etc). The building I reference within my district is 3700 East West Highway and I will refer to herein as "3700".

All the information below is from publically available sources.

Here is some basic comparative data:

	Parklawn	3700
Year built	1970	1967
Size	1.25 M SF	392K SF
Tenant	GSA	GSA
% Occupied by GSA In 2009	100%	100%
% Occupied by GSA In 2010	64%	100%
Total Revenue in 2009	$16.25M ($13/SF)	$7.5M ($19.13/SF)
Total Revenue in 2010	$27.2M ($$21.76)	$7.5M ($19.13/SF)

County Administration Building – Upper Marlboro, Maryland 20772

Note: Although the leased space decreased by 447,000 SF, the total revenue went up because the rental rate went from $13/SF to $33.98/SF.

Note: According to the State Tax Assessment Office, an impending lease expiration has no impact on assessed value.

	Parklawn	3700
Tax Assessment as of		
7/1/2008	$165M	$52M
7/1/2010	$49.9M	$58.5M
Per SF Assessment as of		
7/1/2008	$118/SF	$132/SF
7/1/2010	$36/SF	$149/SF
Percentage (Decrease)/ Increase in Assessed Value	(70.0%)	12.5%

Note: 3700 was assessed at $66M or $168 per SF. The property owner went through two levels of appeals and was successful in reducing the assessment to $58.5M or $149/SF, a reduction of just under 12%.

I suspect that this drop in assessed value for the Parklawn site is linked directly to the developers' ability to offer a more economically favorable deal to the GSA because it either; creates an opportunity for Montgomery County to offer subsidies based on forthcoming huge increases in real estate tax (which appears to have been totally manufactured); or that this increase, in real estate taxes, will be passed onto the GSA, which would result in Parklawn actually being more expensive, rather than cheaper than the other competing sites.

In the meantime, Montgomery County and the State of Maryland, are short $1.4-$2.0M per year in real estate tax revenue for at least five years (as much as $10M).

Because the state determines tax assessments, it appears that the State (although certainly unwittingly) gave Parklawn and Montgomery County an unfavorable advantage with respect to the HHS lease procurement. For this reason, I wanted to personally contact your office Mr. Gansler and request that you review what I have listed here and provide us some feedback. I am not an expert by any means, however, something is just not adding up correctly on this. If you could shed some light on the matter, I would really appreciate it.

Thank you for your time and please feel free to contact me anytime at 301-952-4436.

Sincerely,

Will Campos
Council Member, District 2

Cc: The Honorable Rushern Baker, Prince George's County Executive
The Honorable Benjamin L. Cardin
The Honorable Donna F. Edwards
The Honorable Steny H. Hoyer
The Honorable Barbara A. Mikulski
The Honorable Paul G. Pinsky
The Honorable Mark Tartaro, City of Hyattsville Mayor
The Honorable Christopher Van Hollen, Jr.

Appendix E(2): Office of the Maryland Attorney General Response to Prince George's County Council Member

DOUGLAS F. GANSLER
Attorney General

KATHERINE WINFREE
Chief Deputy Attorney General

JOHN B. HOWARD, JR.
Deputy Attorney General

STATE OF MARYLAND
OFFICE OF THE ATTORNEY GENERAL
DEPARTMENT OF ASSESSMENTS AND TAXATION

DAVID M. LYON
Assistant Attorney General
Counsel to the Department of Assessments and Taxation

WILLIAM K. HAMMOND
Assistant Attorney General

JEFFREY G. COMEN
Assistant Attorney General

July 13, 2011

Mr. William A. Campos
Council Member, Second District
Prince George's County Government
County Administration Building
14741 Governor Oden Bowie Drive
Upper Marlboro, Maryland 20772

Dear Mr. Campos:

Thank you for your letter of June 7, 2011 to the Honorable Douglas F. Gansler, Attorney General of Maryland. Your letter raised concerns about the reduction in the property tax assessment for a certain property in Montgomery County. Since I am Principal Counsel to the Department of Assessments and Taxation, your letter has been referred to me for purposes of a response.

In your letter, you question the appropriateness of the reduction in the assessment of the Parklawn Building located on Fishers Lane in Rockville, Maryland. In support of that concern, you stated that the assessment had decreased from $165 million (M) to $49.9M while the revenue for the building had actually increased from 2009 ($16.25M) to 2010 ($27.2M). That increase in revenue occurred even though the vacancy at the property increased by 447,000 square feet because the rent went up from $13/sq. ft. to $33.98/sq. ft. You additionally made a comparison to the assessment of a building located at 3700 East West Highway, Prince George's County, Maryland, which also houses a government agency.

My investigation into this matter included a review of my office's Maryland Tax Court appeal files for this property and discussions with the attorney assigned to that case. I have discussed the evolution of the situation surrounding this property and the assessments with Marie Green, the Supervisor of Assessments for Montgomery County, and the assessor who was involved in the appeals. Additionally, I have discussed the appeals with Eric Kassoff, the opposing attorney, including the appraisal he had relied upon. Finally, I personally visited the property and met with Edward J. Grau, Jr., Senior Property Manager for The JBG Companies which manages the Parklawn Building.

301 West Preston Street ❖ Baltimore, Maryland 21201
Telephone: 410-767-1280 ❖ Fax: 410-333-5148 ❖ MRS (Maryland Relay Service) 1-800-735-2258

First, the assessment for the Parklawn Building was the result of an income approach valuation which captured the value of the main building plus the value of all other related property owned by the same taxpayer. The original assessment for all that property as of January 1, 2009 was $162M. That value was reduced by the Property Tax Assessment Appeals Board to $150M. After an appeal of that value to the Maryland Tax Court, a settlement was reach that lowered the total property value to $90M. The $49.8M is that portion of the total value that was assigned to the Parklawn Building.

Secondly, this account has been appealed repeatedly by the owner since 2006. In each appeal, the owner claimed that the primary occupants, two federal agencies - Federal Drug Administration (FDA) and U.S. Department of Health and Human Services (HHS), were going to move out at the end of the current lease in 2010 and that the property was in poor condition. The initial response by the Montgomery County Assessment Office was to hold the value because the lease termination date was still several years away and it was generally assumed that the federal government would ultimately renew the lease rather than pay the expense of relocating 1.2 million square feet of workspace and employees. However, as the termination date approached, it was publicly reported that GSA, the federal agency which formally leases real property, was considering vacating the Parklawn Building and relocating the two federal agencies.

Because of these appeals, this property was visited multiple times by the Montgomery County Assessment Office. Marie Green, the current Supervisor, was the chief commercial assessor at that time and she personally inspected the building. She found that the condition was poor and would require major capital expenditures to upgrade the existing facility to a multi-tenant type of facility. Consequently, if the federal government did vacate the Parklawn Building, the landlord would not be able to relet the space very quickly because of its condition and because the interior was designed to serve a large tenant.

Ultimately, the federal government did give notice in the latter half of 2008 that it would not renew the lease and that it would vacate the property. Although this large move was done over a period of time, the FDA did actually vacate 400,000 square feet with the last offices leaving in Spring of 2011. While GSA was going through the procurement process to determine the next site for HHS, a five year lease was signed in August, 2010 that allowed that agency to remain in place at an increased rent until a final decision is made.

Maryland has a triennial assessment system in which property is normally assessed every three years. The law allows the property owner to appeal any new assessment and to file mid-cycle appeals for the intervening years. Because of the successive appeals challenging the assessment of this property and the evolving lease situation, the Supervisor with the assistance of my office reached a settlement that maintained the 2006 assessment at $162M in 2006 but allowed the assessment to step down to $98M in 2008, and to $90M in 2009. That settlement was reached by

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increasing the vacancy allowance and increasing the capitalization rate to reflect the increase in risk associated with this property. However, those values represented the total value of the building and the other accounts which are owned by the same taxpayer and have functioned as one property. The removal of the value of the other accounts from the total $90M brought the separate assessment for the Parklawn Building to the current $49.8M.

While the reduction to $49.8M was certainly significant, the change in the market conditions of this property was extreme - from a fully occupied building with an excellent tenant to a very large building in need of major renovation with 400,000 square feet of vacancy and the last major tenant publicly announcing that it was seeking other alternatives. In light of the August 2010 lease, the assessed value may now seem low, but that information was not available to the assessor when the settlement was reached. Consequently, the assessed value will not reflect that lease until the next assessment under the triennial system which will be as of January 1, 2012.

Your comparison to a Prince George's County building is not helpful in this situation because that site has remained 100% occupied. While the owner may have raised the possible lease termination with the Prince George's County Assessment Office, the assessors would have approached it in the same fashion as the Montgomery County assessors did when that issue was first raised by the owner of the Parklawn Building. However, once notice is given by the tenant and an actual move out seems reasonably foreseeable, that reality must be recognized by the assessment office. That is what happened in Montgomery County and that is why it is different from your example in Prince George's County.

Accordingly, based on the above, I do not find that the Montgomery County Assessment Office did anything other than attempt to reflect market value as the situation at the Parklawn Building evolved from a fully leased building to one where the tenant was threatening to vacate to one where the tenant gave notice of vacating and did actually vacate a significant portion of the building. I have no reason to suspect that the ongoing competition over the relocation site had any impact on the decisions of the Assessment Office because the assessors were responding to the changing situation at the Parklawn Building. The successive assessments simply reflected that evolving situation.

If you have any other questions, please feel free to contact me.

Sincerely,

David M. Lyon
Assistant Attorney General
Counsel to the Department of
Assessments and Taxation

DML:eja
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