Growing

Booming markets such as Houston are dealing with rising property taxes, finding general contractors and filling equity gaps.
Houston has enjoyed a sustained run as one of the country’s healthiest apartment markets. The nation’s fifth-largest city by population in 2013 continues to add jobs, led by the energy sector, and is witnessing rents push higher.

Good news aside for owners and developers, investors also are dealing with challenges. Spiking tax assessments have been tough to forecast, and filling the resulting equity gaps in new construction deals is causing some hardship, especially for less experienced and smaller development firms.

Even when overcoming those hurdles, these projects are also seeing considerable hikes in labor and material costs, while finding qualified general contractors (and enough of them) can become a puzzle, given the unprecedented demand.

These challenges are not unique to Houston, or even Texas, but exist in most thriving markets.

Grandbridge Real Estate Capital LLC Vice President A. David Schwarz IV, CCIM, is handling such situations on behalf of his clients concerning commercial real estate finance. He shares his perspectives.

Q: Just what is driving Houston’s multifamily housing investment sector today? Where is the boost coming from?

A: Single- and multifamily housing unit values are at all-time highs. Last decade, Houston never experienced housing bubbles like so many other key markets had. As such, housing supply remained relatively constrained, buoying single-family housing prices in the face of the financial crisis. The regional economy has been strong, resulting in net-plus workforce in-migration activity with little corresponding increase in the housing stock.

But that began to shift during the past several years. Current housing demand exceeds supply by a large margin. Net in-migration coupled with changing lifestyle preferences of the 25- to 35-year-old age bracket and home loan qualification challenges for single-family homeownership are driving demand for rental housing.

The key is job growth. It’s all related to population growth, which is driven chiefly by job growth. In Houston, every four jobs will produce demand for one multifamily unit, according to historical data.

With approximately 80,000 new jobs forecasted for Houston, the demand is for approximately 20,000 units. Current projections are for developers to complete 21,000 units in 2014. While that is a relatively large number by recent standards, consider that developers were delivering 30,000 units a year in the late 1970s to early 1980s—a quite significantly higher figure—when Houston was a smaller market than it is today.

We are not the only hot market. Others include Seattle, Denver, San Francisco, San Diego and Boston, all thanks in part to better job growth, but also because of highly restrictive construction ordinances.

The list of weaker markets includes many Midwest cities (e.g., Detroit) where job growth is shrinking or non-existent.
Q: How long do you think that these trends will last?
A: I wish I had the crystal ball. Currently we are in an economic cycle—especially in Houston—where the market is firing on all cylinders. We have tremendous job growth, a shortage of housing and overall very solid commercial real estate fundamentals. It’s hard to say how long the rise in values will last, but what we do know is that throughout history, real estate has provided great return for investors.

There will definitely be another downturn. When? Who knows? But, with any luck, we have a good run as long as job growth continues. Absent a material global economic recession and/or a significant rise in the cost of capital, I would expect values to continue to increase in Houston for the foreseeable future.

Q: If real estate truly is cyclical, what factors might take place in the future (based on consumer, economic or government policy events) that would signal a reversal?
A: One big wild card is the U.S. Government. Another capital markets implosion could reverse all of this. A cutback in capital spending by the energy industry (a sector critical to Houston’s health) would probably result in reduced hiring levels. This, in turn, will affect demand. So would an increase in lot and single-family construction deliveries, although those deliveries are not expected until early 2015. A third factor would be increases in interest rates, which would likely increase cap rates. And, of course, property tax increases.

Q: How are developers assessing the situations/forecasts today for projects they hope to deliver in 2017 or thereabouts?
A: Developers are spending more time today with regard to the cost-side than in previous years. Not just cost to build, which is rising dramatically for materials, labor costs, etc., but also on the operations side for items such as taxes, insurance and onsite labor (maintenance, management staff). Public officials in Houston have signaled that commercial property values will be examined more closely to reflect the market. A lot of single-family residents are suggesting (screaming!) that commercial real estate is under-taxed—saying the CRE is not being assessed properly relative to its value—and that single-family owners are being over-taxed.

Q: What is the developers’ response?
A: Taking all this into account, developers are doing what it takes to get deals done. Those with institutional partners, while pushing the limit, are underwriting their deals based on rents that are currently in place today with trended expenses. Equity investors have looked at trending rents in the past, as well, but, more recently, we have not seen them building rental increases into their models due to the amount of supply coming online.

Depending on whether the equity is private or foreign, the rules change and the deals are subject to what those investors’ motives and return expectations are. Foreign investors can be motivated by many things other than just a return on their investment. A good example is the EB-5 program. This program is an immigration business plan to allow foreign money to get into the United States.

Q: What can developers do to dispute the tax bills they receive if they believe that they are significantly higher than what is fair?
A: In Texas, the law gives property owners the right to protest actions concerning their property tax appraisals. It’s a multi-step process. After filing the protest, the owner meets with a staff appraiser in an informal hearing. If an agreement cannot be reached, the owner can request a formal hearing before the Appraisal Review Board (ARB) at which the staff appraiser and the property owner or his agent present their respective cases. The ARB decision is not negotiable. If not satisfied with the decision made by the county appraisal district, you can appeal by filing a lawsuit in the District Court.
To be successful, developers must have compelling evidence to support their positions because tax jurisdictions are less likely to revise values downward. It helps to hire a reputable and experienced tax consultant to carry this out.

**Q:** What is a reasonable success rate that protestors can expect to achieve when fighting/disputing these tax bills?

**A:** If strong support is presented based on current sales prices, the success rate should be close to 90 percent; if there isn’t, the chances fall to about 5 percent.

In Texas, success rates are relatively high when using strong tax consultants. That said, the current economic cycle—with its rapidly rising values—is not making the job any easier for consultants or developers.

**Q:** What can the industry do to help ensure that their property values are taxed fairly?

**A:** Property taxes vary by state, and while there is no federal property tax, some states tax not only real estate but also personal property used by owners and residents.

Personal property is a type of property that, in its most general definition, can include any asset other than real estate. Personal property is not considered for determining property taxes on multifamily assets. I honestly don’t know how assessors arrive at value for un-stabilized properties except perhaps to estimate cost for newer properties, and maybe sales price per unit on older un-stabilized assets. Apply a discount factor of 80 percent to 90 percent of stabilized value in the early years, and then grow them thereafter by 3 percent per year.

The distinguishing factor between personal property and real estate is that personal property is movable. That is, the asset is not fixed permanently to one location as with real property, such as land or buildings. Examples of personal property include vehicles, furniture, boats or collectibles. Or it typically is equipment (contracting, information technology, machinery). This tends to be a larger issue for operating businesses.

To tax real estate assets properly, taxing authorities need honest and accurate sources of information to determine market values. This is challenging in states such as Texas, which is a non-disclosure state with respect to sales and transfers, but a relatively easy task in states like Florida, which taxes real estate transactions according to their values. Consequently, accurate sales information, and, by extension, valuations, are more difficult to obtain in some states compared to others. Absent this hard data, taxing authorities can only make educated guesses about property values, sometimes resulting in materially higher assessed values.
**Local Tax Rate Trends: Harris County, City of Houston and Houston ISD**

County real estate taxes in most large markets are segmented further, based on school districts and Municipal Utility District (MUD) rates. In Harris County (Houston) for example, there are 21 independent school districts (ISD). The drop in 2007 was the result of state’s margins franchise tax. The uptick in 2012 was specifically tied to the school district tax rate, while the city and county taxes were flat.

<table>
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<th>Tax Year</th>
<th>Combined Tax Rate per $100*</th>
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<td>2006</td>
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<tr>
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<tr>
<td>2014**</td>
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*The above tax rates do not take into account homestead exemption or over 65 exemptions.

**2014 Tax Rate is strictly an estimate and should only be used in that capacity. The 2014 tax rate will not become official until late October.

Source: Marvin F. Poer and Company, Houston

On the other hand, this lack of concrete sales information has generally been advantageous to property owners because assessors must rely on second-hand sources such as third-party commercial real estate databases or publications and have appraisers and brokers confirm sales prices and values.

In summary, mandatory disclosure would probably level the playing field, but it also would intrude on property owners’ right to privacy in connection with a given transaction. Real estate owners must decide whether their interests are best served by mandatory full disclosure.

**Q:** When additional, unexpected equity is required by a developer (midway through the development phase), why do large institutions fare much better in obtaining that extra needed funding compared to ‘mom-and-pop’ firms?

**A:** In today’s development environment you have to pay to play. Although there is plenty of equity available in the market, the ability to get that equity to transact is not as easy as it may appear. With rising development costs, developers face having to put more equity into deals than they had to say... one year ago. There are several reasons for this: Cost increases, supply issues, point in the cycle, land prices, increased operating expenses, etc.

Experienced developers tend to fare better during negotiations, or with coming up with the additional “gap equity” needed compared to smaller developers.

Larger developers tend to have very deep equity relationships, in-house general contractors that help to lower costs, larger pipeline of deals and they buy supplies in bigger bulk to save cost.

**Q:** What advice would you give smaller developers who are seeking to enter these strong, but competitive, markets?

**A:** I advise smaller development shops first to get a few deals done with ‘friends and family’ or ‘country club’ equity. This will help build experience and credibility. It is very important to understand what it takes to graduate to the institutional level—if that is the developer’s intention. When a firm decides to take that step to institutional equity, they often are surprised with the reporting, fees, accounting practices, additional consultants, etc., that are required. These are routine and normal when dealing with institutions, but may provide sticker shock to first-timers. It is beneficial to hire an experienced financing intermediary to assist in finding the right partner and to have them help in negotiations on the client’s behalf. It is imperative that they trust their intermediary and that they work diligently as a team, because everyone’s end goal is the same. The intermediary’s role is to guide the developer on how to build a meaningful relationship and get the deal done, which often can lead to more deals.

**Q:** What factors (other than supply and demand) are leading to rising costs in labor and construction materials?

**A:** I hear from my clients that the permitting and inspection process is lengthening; as the saying goes, “Time is money.” But otherwise, supply and demand drives everything. Costs have been rising consistently since 2012, and seem to have increased at a much more rapid pace during the past 12 months, mainly because of the increased demand, labor shortages, longer lead times for critical components and subcontractor fees. These are some of the main drivers for the cost increases.

There are so many projects under construction in some of the major markets that general contractors and sub-contractors are becoming very selective on the projects they decide to pursue. It helps to get general contractors engaged as early as possible, so that they can assist developers in managing their cost during the process. Some major construction materials such as concrete and lumber have been rising as the supply is becoming more constrained. Generally speaking, the soft costs have remained relatively unchanged.

Also, keep in mind that it is beneficial to get your energy provider scheduled months in advance because they are overwhelmed with this high volume of new development. Not accounting for this demand can push scheduling back for the developer. —Paul R. Bergeron III, NAA

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