RETC
PROPERTY TAX CONSULTANTS

The Hidden Value in Pre-Acquisitions Property Tax Consulting

→ This white paper defines the value that property tax consulting delivers to investors when serviced during the acquisitions phase versus the operations phase of commercial real estate investment projects.

→ By seeking property tax consulting early during underwriting and due diligence phases, investors can gain a competitive advantage, increasing their deal success rate.

Executive Summary

➔ Overview

In the commercial real estate investing industry, investment firms that consistently succeed are those that have the ability to identify and uncover value that goes unnoticed by their competitors. Thus, having access to more accurate data and analytics plays a crucial part in this process. Though property taxes account for a large portion of an asset's operating expenses, the majority of times little attention goes into accurately projecting property taxes during the bidding and due-diligence phase.

Both investors and tax consultants generally accept that property tax consulting is a concern primarily reserved for asset managers during operations and not necessarily a point of emphasis for the acquisitions team who work on the front-end of deals.

This white paper addresses this issue and outlines the potential threat facing firms that continue to operate along these lines and, conversely, quantifies the additional value investment firms can obtain from seeking property tax consulting early on in the underwriting process.

Underwriting Challenges

Underwriters working on new deals must calculate a multitude of uncertainties, and in order to mitigate these risks their financial models must include the most accurate assumptions possible. Since property tax is a major expense category, even small margins of error in the forecasted taxes can have large impacts upon the modelled profit estimates.

Below is a sensitivity table showing the change in the Internal Rate of Return when the margin of error of the projected real estate taxes increases by increments of plus or minus 5%.

Tax Projection Accuracy	Internal Rate of Return
85.0%	18.45%
90.0%	17.95%
95.0%	17.45%
100.0%	**16.94%**
105.0%	16.43%
110.0%	15.92%
115.0%	15.40%

The model is based on an asset purchased for $20M, operating margin of 55% for five years, leveraged at 65% LTV, 5% fixed interest rate and an exit cap rate of 7%.

You will notice that for every 5% deviation in the accuracy of the tax projection, there is corresponding change of 50 BPS to the IRR.

Having worked closely with many institutional investors over the years and reviewing many of their property tax forecasts, we have found that it is far too common to see margin of errors in excess of 10-15%.

We feel that that the analytics behind most property tax projections are minimal and oversimplified, thus producing forecast that include high degrees of uncertainty.

Analysts are often using erroneous property tax assumptions in their models that in turn project an IRR that could be more than +/- 100 to 150 BPS off.

Needless to say, in a competitive bidding environment, 150 BPS can mean all the difference when it comes to knowing when to be more aggressive or when to walk away.

In actual RETC client case studies, narrowing the margin of errors and having more accurate tax projections has helped RETC clients to:

- ➔ More aggressively bid on and acquire new assets
- ➔ Obtain the knowledge needed to walk away from certain deals
- ➔ More effectively obtain equity and/or debt financing

➔ Underwriting Summary

Having accurate property tax projections provided early in the acquisitions phase of deals can improve our models and assist us in making better investing decisions. The value of pre-acquisition versus post-acquisition property tax consulting will be compared in the next section.

Post vs. Pre-Acquisitions Tax Consulting

Asset Managers regularly invest their time and energy comparing bids from various property tax consulting firms and typically choose companies that consistently achieve high tax reductions while at the same time, maintaining relatively competitive fee structures. The ultimate goal of this process is to improve and ensure investors' expected returns are met.

With this effort, how much value is actually gained from ending the service contract with an average property tax consultant and switching to an industry best? Below is a chart displaying the difference in performance one might expect from a bottom quartile property tax consulting firm compared to an average and also a top quartile consulting firm.

This uses that same $20MM asset from the above example and assumes that on average, the best property tax consulting firms achieve 20% higher reductions than average firms, and in turn, average firms perform 20% better than those in the bottom quartile.

	Deal Value	Tax Rate	Taxes	Reduction	Tax Savings	Performance to Average
Top Quartile	$20,000,000	1.50%	$300,000	9.00%	$27,000	20.00%
Average	$20,000,000	1.50%	$300,000	7.50%	$22,500	0.00%
Bottom Quartile	$20,000,000	1.50%	$300,000	6.00%	$18,000	-20.00%

Assuming that the asset manager switched from the bottom quartile to the top quartile consulting firm, there would be $45,000 in increased aggregate NOI over a five-year hold period.

Top to Bottom Variance	$9,000
Hold Period (Yrs)	5x
Opportunity Cost	**$45,000**

➔ Pre-Acquisitions

In the underwriting section above, we described the increase or decrease in IRR when the real estate taxes are over or under estimated. Below we use the same deal and place it in the context of a competitive bidding process and calculate the opportunity costs resulting from incrementally increasing the margin of error.

Opportunity Cost based on Over / Under Estimating RE Tax *

RE Tax Pro Forma		*Bid*		*Deal*	
Estimate	**Amount (%)**	**Over / Under**	**Amount**	**Won / Lost**	**Opp. Cost**
Over	-15.0%	Underbid	($847,907)	Lost	$8,322,679
Over	-10.0%	Underbid	($565,271)	Lost	$8,322,679
Over	-5.0%	Underbid	($282,636)	Lost	$8,322,679
Accurate	**0.0%**	**Accurate**	**$0**	**Won**	**$0**
Under	5.0%	Overbid	$282,636	Won	$282,636
Under	10.0%	Overbid	$565,271	Won	$565,271
Under	15.0%	Overbid	$847,907	Won	$847,907

** Based on Key Assumption (listed below)*

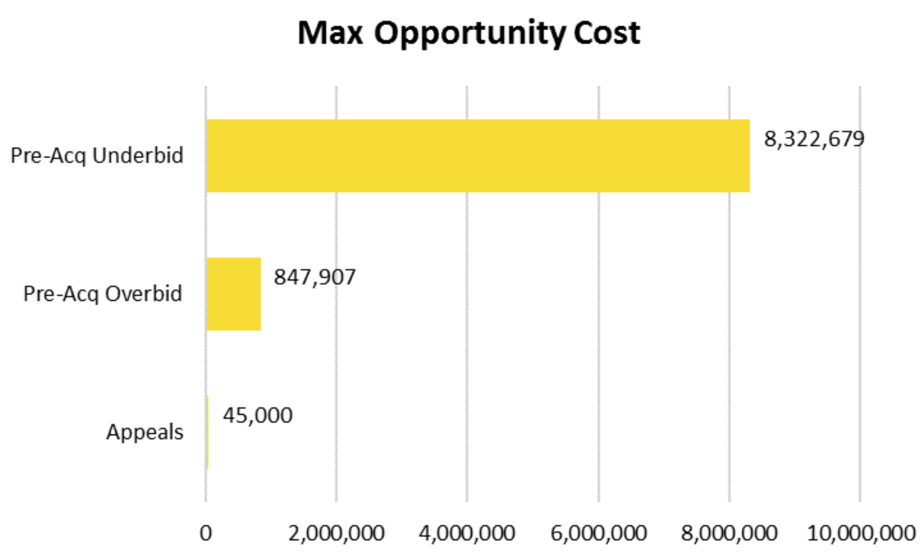
Key Assumptions

Deal Size	$20,000,000
Operating Margin	55.00%
Cap Rate	7.00%
LTV	65.00%
Fixed Rate	5.00%
Hold Period	5.0
Deal IRR	16.9%
Deal Profit	$8,322,679

With increased real estate tax overestimation, the probability that underbidding will also increase. In the event of underbidding, this investor will stand to lose $8,322,679.

If real estate taxes are underestimated, the corresponding bid amount will be higher than necessary. Thus, the investor would have won the deal, but will pay more than originally underwritten in taxes by $282,000 to $848,000.

➔ Post vs. Pre-Acquisitions Summary



RETC Property Tax Projections

RETC makes forecasting a priority in our business because we know true value of accurate property tax projections. Below are sixteen recent property tax projections where appeal work has already been fully completed. The average taxes incurred were only 1.31% higher than RETC's estimate.

Year 1 Estimated Taxes	Year 1 Actual Taxes	Variance ($)	Variance (%)
$1,318,944	$1,356,313	$37,368	2.83%
$762,273	$821,393	$59,120	7.76%
$819,725	$821,689	$1,965	0.24%
$692,301	$638,894	-$53,406	-7.71%
$319,984	$338,367	$18,383	5.74%
$354,371	$338,479	-$15,891	-4.48%
$426,494	$445,778	$19,284	4.52%
$435,971	$455,684	$19,713	4.52%
$699,972	$700,255	$283	0.04%
$801,263	$859,751	$58,488	7.30%
$790,458	$839,845	$49,387	6.25%
$637,185	$667,413	$30,227	4.74%
$1,034,479	$1,036,457	$1,978	0.19%
$884,985	$887,307	$2,322	0.26%
$1,003,969	$998,010	-$5,958	-0.59%
$1,094,570	$1,029,691	-$64,879	-5.93%
$12,076,944	**$12,235,327**	**$158,383**	**1.31%**

Summary

Real estate taxes are one of the largest expense items in an operating statement and even small inaccuracies in projected value can have large impacts on forecasted and actual profits. In this white paper, we've quantified the increase in value that property tax consulting delivers to investors when serviced during the budgeting phase versus the operations phase of commercial real estate investment projects.

By assisting with property tax consulting earlier during underwriting, RETC has helped its' clients to gain a competitive advantage, win more deals and secure investment capital.

RETC has made it our business to provide the most accurate property tax projections in the industry and we look forward to working with you on your next acquisition.

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