RETAIL PROPERTY TAXES WILL RISE

Unless assessors can recognize the challenges facing shopping centers, taxes will increase dramatically.

By Kirk Garza, Krishtian Bazan and Sam Auvermann

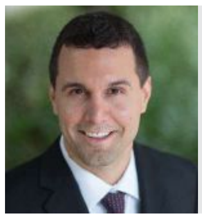
As retailers rise and fall in the age of Amazon, property taxes remain one of retailers' largest operating expenses. That makes it critical to monitor assessments of retail properties and be ready to contest unfairly high taxable valuations.

Assessors — and property owners attempting to educate those assessors — must understand how the changes taking place in the retail sector affect property value. Assessors must adjust their models to reflect new market realities, and property owners or their representatives must be able to explain why previously held valuation assumptions could no longer be valid.

No Going Back

Changing consumer tastes have always required retailers to adapt in order to survive, but traditional retailers are facing a different kind of challenge today. The increasing role of e-commerce in overall sales reflects a fundamental change in consumer behavior that will not reverse course with the whims of fashion. The ability to shop online is resetting consumer expectations, and retailers are struggling to adapt and stay competitive.

This struggle is evident in store closings that in 2019 are outpacing closings from the prior year. In addition to the threat of e-commerce, some economists believe a recession is coming



Kirk Garza
MAI, CCIM,
CMI,
Popp Hutcheson PLLC

Sam Auvermann
Summer Intern,
Popp Hutcheson PLLC

Krishtian Bazan
Summer Intern,
Popp Hutcheson PLLC

in 2020. Falling retail sales, rising assessed property values and changing consumer demographics could combine to accelerate store closings in the years to come.

With millennials and Generation Z mixing into the workforce and increasing the demand for online shopping, retailers and property owners are facing new challenges in catering to consumer expectations unique to these generations. Strategies range from adjusting store buildouts to completely changing the store footprint to fulfill online orders as retailers do what they can to compete with online sellers. In addition to these changes, many property owners are stepping away from traditional big box retailers and are instead looking to restaurants and entertainment venues to anchor shopping centers and drive customer traffic.

Food, Experiential Retail

Across the nation, retail property owners are working to fill vacant spaces with tenants that will offer millennials and Generation Z an exciting and unique shopping experience. In doing so, these owners are attempting to "e-commerce proof" their centers by shifting from big box anchors to an experiential model. Some retailers catering to these two tech-savvy generations are using tenant improvement allowances to build out highly specialized spaces, while others focus on social media. Select retailers even offer discounts to shoppers who share photos of their store or products on platforms such as Instagram.

Retail developments that once contained 40 to 50 percent restaurants are now filling as much as 70 percent of their spaces with restaurant operators in an attempt to drive traffic. A rising threat to this strategy are food delivery services such as Grubhub, Uber Eats and Door Dash, which are collaborating with major restaurants that have previously had no food delivery. Pizza chains and other food-delivery-based retailers losing market share must now rethink their strategies and even partner with these third parties to expand their customer bases.

Home food delivery partnerships continue to evolve as well, with restaurant operators looking into cloud kitchen concepts. These allow restaurant operators to operate from industrial space, avoiding retail rents and the need to pay back above-market tenant improvement allowances. Once the cloud kitchen space is running, the operator can rely on third-party delivery services to get the product to the consumer. This is a growing risk to shopping centers that rely on a restaurant tenant base to draw customers.

Clicks & Bricks

Physical retailers attempting to compete with Amazon's fast delivery have introduced buy online pickup in store (BOPIS). Many sellers have found BOPIS difficult to implement due to expensive software that tracks live inventory and requires staff training. Essentially converting a retail-only property into a retail and warehouse hybrid, the method may require modifications to the real estate. This reclassification should be discussed with assessors, because retail space typically commands higher rental rates than warehouse space.

Grocery anchors have also begun to adopt the BOPIS model, and some are finding the logistics to be a challenge given their existing footprints. As a result, some stores are expanding into smaller, adjacent in-line suites to offer this service. Where this happens, a property owner that was once receiving all in-line rents may now collect reduced rents for these suites, given they are now part of the anchor space. In this scenario, it is important for the valuation to weigh the potential grocer expansion into these in-line suites and adjust as needed.

Assessors must understand the changes rapidly taking place for this product type and their implications for valuation metrics. Given millennials' and Gen Z's familiarity with the internet, e-commerce as a percentage of retail sales is expected to continue to rise.

As property owners increase tenant improvement allowances so retailers can keep up with changing consumer tastes, appraisal districts need to consider how above-market tenant improvement allowances affect the lease rate the tenant is responsible for paying. Assessors must analyze the rental rate to factor in these buildout costs and, if needed, adjust rent over the lease term to reflect the portion that is paying for more costly buildouts. Only then can the assessor conduct a proper rental analysis for the subject property.

Nuanced Classification

In addition to thoroughly analyzing rental rates and vacancy risk, assessors must also consider retail classification. With restaurants stepping into the anchor role in many shopping centers, increased traction by cloud kitchens may pose a threat to these tenants' long-term strength. Struggling retailers attempting to implement BOPIS compound this uncertainty, particularly with a potential recession on the horizon. Assessors must consider these factors before selecting appropriate rental rates, capitalization rates and vacancy and collection loss inputs to calculate taxable value.

Kirk Garza is a director and licensed Texas Property Tax Consultant with the Texas law firm Popp Hutcheson, PLLC, which focuses its practice on property tax disputes and is the Texas member of American Property Tax Counsel, the national affiliation of property tax attorneys. He was assisted by Sam Auvermann and Krishtian Bazan, summer interns with the firm. Kirk can be contacted at *kirk.garza@property-tax.com.*