TURNER DRAKE & PARTNERS
Real Estate Counsellors,
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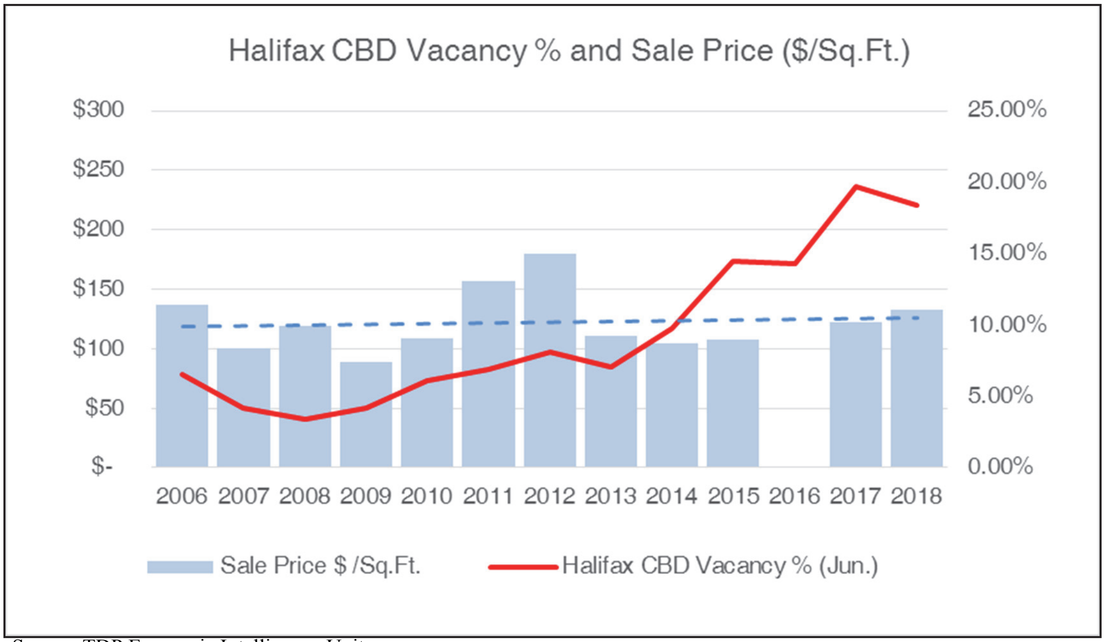
Newsletter

Spring 2018
Vol. 2 No. 112 (ISSN. 1203-1410)

MAXIMISE VALUE: MINIMISE RISK



Source: TDP Economic Intelligence Unit

Property owners can draw on the expertise of a valuation profession in many developed countries, but such a resource has yet to mature in Canada. Instead there are a multiplicity of organisations, each of which focus on *part* of the real estate spectrum: brokerage, appraisal, property tax agency, space measurement, right of way acquisition, planning, economic research, et al. Provincial licencing may further muddy the water because it follows the same fractures: since it obfuscates rather than illuminates, it may forestall due diligence; less knowledgeable purchasers of property advice may be willing to accept licencing as a proxy for professionalism in all matters real estate related. More knowledgeable consumers may cynically attribute the lack of expertise in a particular field as being emblematic of all licensees in other fields too.

The absence of a valuation professional body is echoed in the lack of research at university level. This paucity of research renders property investment in Canada a relatively risky exercise particularly since it leads to municipal and regional government policies which are frequently counterproductive. During the four decades we have been active in Atlantic Canada we have witnessed numerous real estate markets decimated by ill-advised and reckless government programs seemingly driven by whatever the politicians or bureaucrats deemed advisable "at the time", without any research or consideration of the consequences: call centres, conference centres, golf courses, heavy water plants, hotels/motels, hydro plants, industrial parks, industrial buildings, marinas, nuclear plants, oil refineries, shopping centres, steel mills, and most recently the flooded office market in Halifax's Central Business District, have all fallen victim to a rapid expansion in supply fuelled by government grants or policies which favour a specific market segment. The grants and policies are usually motivated by the conviction that they will spur employment; that public participation is necessary to combat private sector inertia. Chasing dreams at all levels (Federal, Provincial, Municipal) is a political preoccupation in the Atlantic Region.

Given that there is no national professional valuation institute, little university research, government action predicated on short term objectives, an appraisal industry mandated to measure value rather than create it: how can you maximise value and minimise risk in the ownership of your real estate?

Which Value?

If you wish to determine the value of your property, establishing "which value" is the essential first step in all assignments. It is a common misconception that every commercial property has a single value. Not so! Yet we are frequently asked by professionals, such as accountants and lawyers, as well as real estate owners, what it will cost to appraise a (specified) property. The International Valuation Standards (IVS), adopted by Canada, and incorporated into the Royal Institution of Chartered Surveyors' Global Valuation Standards, specify *six types of real estate value*

(Continued on page 2)

IN THIS ISSUE
Maximise Value: Minimise Risk................................1
Seniors' Housing 3
Egg Head Awards 5
Mayor Savages Property Tax....................................6

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(Continued from page 1)
(Market, Rental, Equitable, Investment, Synergistic, and Liquidation). Legislation, case law and the purpose of the real estate assignment, result in many variations of these property valuation bases. Any conversation about valuing (or appraising) your property has to start therefore with an understanding of the purpose of the assignment or you can end up with a conclusion which is worthless at best, or seriously misleading at worst. Whilst the common assumption appears wedded to the concept of Market Value *assuming that the property will be utilised for its highest and best use …* this basis is not acceptable for mortgage financing, if for example, the highest and best use is predicated on redeveloping or repositioning the property for an alternate use. Nor may it be relevant if the property's existing use is special-purpose and/or trade related with a limited number of potential purchasers e.g. fish plant, meat packing plant, hotel, service station, etc., even if the existing use is the highest and best use, unless the financing is based on the value of the asset as part of a going concern. Nor is Market Value appropriate if the purpose of the valuation is to determine the price for liquidation (under conditions of forced sale), a sale to an adjoining owner, a land assembly, for an identified investor, or between identified willing parties. Determining the correct ***valuation premise*** and the ***level of real estate reporting*** necessary to satisfy the end user of the valuation and advisory report is a precondition to any valuation (or appraisal) assignment.

Adding Value

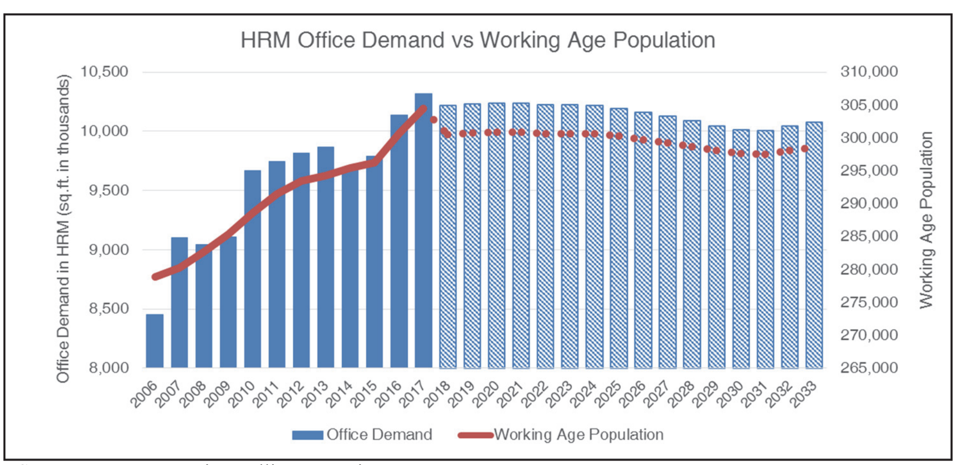
Valuation tasks fall into one of two groups: **adversarial** or **non-adversarial**. Both situations present different opportunities for adding value to the assignment.

Adversarial assignments can rapidly escalate into a costly, time consuming and frustrating legal exercise. Your prime objective therefore should be to seek a solution which avoids litigation and an expensive court action. This can only be achieved by an open, consultative and transparent process involving all parties, thorough research, and a well-documented valuation report with a fully supported, unbiased conclusion, the rationale for which is technically and legally valid but easily understood by a non-technical reader.

Non-adversarial assignments provide many opportunities to add value to your real estate even when the purpose of the assignment is directed to a single goal, for example establishing Market Value for financing purposes. Our Valuation Team are trained to recognise and identify opportunities to enhance or safeguard the short and long term prospects for your property and can call upon the expertise of our other Divisions (Property Tax, Planning, Lasercad® Space Measurement, Counselling, Economic Intelligence, Brokerage) for advice if such is required. For example, there may be opportunities to reduce the property taxes, to "up zone" or prevent a "down zoning", increase the "BOMA" leasable area, restructure the leases, increase the rents, reduce operating costs, or make cosmetic changes which would enhance marketability and value.

Market Data Drives Property Values. It is fallacious to assume that a real estate professional can provide you with useful advice based purely on experience. The answers lie in the data. The availability of real estate sale prices, property assessments, rents, vacancy rates, operating expenses (common area maintenance & property taxes), building costs, financing, on comparable properties together with the tools to integrate this data, determine and analyse trends on a cross sectional and longitudinal (time series) basis, is the key to uncovering latent value in your property. It allows us to compare operating metrics such as rent, vacancy, operating expenses (property taxes, HVAC, electricity, cleaning, insurance, water, repairs, elevator maintenance, garbage removal, security, landscaping, snow removal, supplies, professional fees, advertising, management) with comparable properties on a unitised basis to determine opportunities for increasing revenue or reducing costs. We can also establish the trend line for each of those items, for your property and its peer group, to determine where you are headed and how your property will be positioned vis à vis its competitors. CompuVal®, our proprietary IT platform, provides a comprehensive picture of property sales and assessments for Atlantic Canada and Ontario. Our Economic Intelligence Team conducts semi-annual market surveys on office and industrial buildings gathering commercial property rental, operating expense, property tax and vacancy data. They also undertake apartment and parking revenue and expense surveys throughout the Region. Our Property Tax Team collects a vast amount of operating data on many property types. The three Maritime Provincial governments now feed raw sales information to our data processing department every month. Because the data is sparse, dirty and defective we have armed CompuVal® with clever algorithms to clean and enhance it. CompuVal® acquires, processes, refines, integrates and analyses all of the sales and operating revenue and expense data. Our data processing staff further enhance the data using our Geographic Information System's high resolution aerial and satellite photography.

The bottom line? On the micro level we can identify areas for increasing revenue or determine if the opportunity exists to reduce any of your operating costs. You probably undertake this exercise every year when formulating your property budgets by reviewing past costs for the same property or comparing it with others in your portfolio. Our Valuation Team does so



Source: TDP Economic Intelligence Unit

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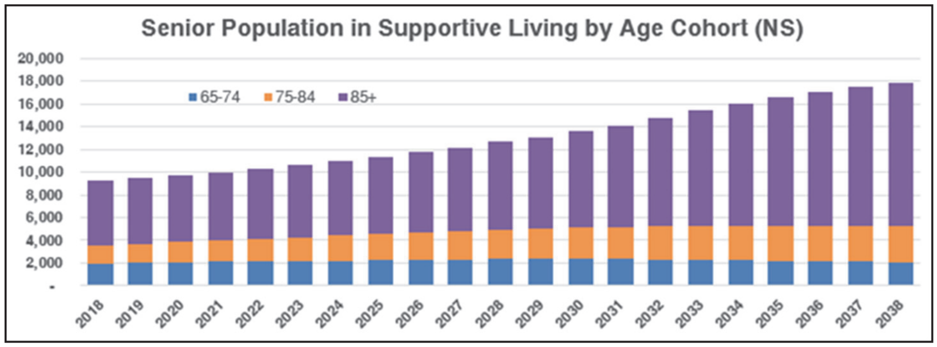
too, but CompuVal® provides them with ready access to detailed revenue and expense data on a universe of comparable properties to assist them identify value adding opportunities for your real estate. At the macro level CompuVal® runs trend line analysis on revenue, operating expenses, capitalisation rates and unitised sale prices to investigate past trends and predict what will happen in the future. We use research generated by our Economic Intelligence Unit to inform our valuation advice.

The End Result

What advice could our Valuation Team provide if you own an office building in Halifax's Central Business District (CBD) for example? We would compare your revenue, vacancy, and each operating expense against previous years and also with your building's peers to determine if there are opportunities to increase revenue, reduce vacancy and expenses. The bigger question however is where those metrics are headed. As the Halifax CBD Vacancy graph on Page 1 demonstrates, office vacancy started to climb steeply in 2013 and is now at 18.35% (June 2018), the consequence of oversupply in a market experiencing generally weak occupier demand. Aggregate CBD office demand has now been virtually stagnant for the past twelve years. "Same store" net absolute rents are now starting to decline so we would advise you to lock in your tenants long term. This should be a priority given that the national inflation rate continues to hover around the 2% mark and net absolute rents will continue to fall. Capital values, expressed as a sale price per square foot of office space have been stable over the past 12 years (see Page 1 graph). *During the last market meltdown in 1990, which started when the onset of a recession coincided with a rapid expansion in office supply, office capital values fell by about 55%. The fall in value was not apparent for two or three years because property owners declined to sell, possibly because the amount they could realise on sale left them with no or negative equity after the mortgage was satisfied and/or they were hoping for a turnaround.* As office values fall so should property assessments: you should therefore adopt an aggressive strategy and appeal your property assessment each year. (Realty taxes per square foot have risen by 60% over the past ten years; net absolute rents by just 12%. This is your opportunity to redress that balance). Tenants will move up the value chain to take advantage of the falling rents… Class C to Class B, Class B to Class A. Given that there is a strong demand for rental apartments some Class C and B buildings will be redeveloped or repurposed for residential use and this will ameliorate the vacancy rate. However this will be a slow process because buildings have leases in place, some owners are commercial investors rather than residential developers, and there will be a natural reluctance to "hang on and hope". *How long will it be before supply and demand is in equilibrium and office vacancy returns to a "normal" 5%? It depends how fast buildings are taken out of service… or on the emergence of those offshore financiers coyly closeted in the fog bank at the mouth of the harbour! Our guess is about 20 years: office vacancy took 14 years to fall from its previous high of 16.2% in 1992; it did not reach equilibrium 5.19% until December 2006.* During that period only one small office building was completed and the working age population was growing. Currently Queens Marque is under construction and will add a further 120,000 ft.^{2} of office space to an already flooded market; working age population peaked in 2017 and is now declining. There is a high correlation between office demand and working age population (see HRM Office Demand vs Working Age Population graph on Page 2). Post 2017 therefore, reduction in office vacancy will be a function of diminished supply rather than increased demand. If your office building is a Class B or C and it, or the site, is suitable for residential use you may wish to take advantage of the current strong demand for rental apartments by repurposing the building or redeveloping the land … or by selling the property.

VALUATION DIVISION

Seniors' Housing



Source: TDP Economic Intelligence Unit .

Men and women in Canada have one of the highest average life expectancies in the world. More Canadians are living past the age of 80 than ever before and our aging population is projected to quadruple by 2051. This "longevity wave" is fuelled too by the baby boomer generation as it ages. A direct result of the Second World War, this 10 million strong cohort was born between 1947 and 1966 as the boys returned home and family formation flourished. Unique to Canada, the United States, Australia and New Zealand, the cohort is a disruptive force that moves real estate demand like no other. The leading edge of the wave reached age 65 in 2011 and the last baby boomer will mark this milestone in 2030. Nearly 80% of demand for healthcare related housing comes from the 65 and older age groups according to the 2016 Census, especially those in the eldest range. Seniors' residences, nursing homes and mixed facilities house roughly 5% of the total senior population, but 25% of those aged 85+. Our Economic Intelligence Unit has investigated the impact on one province, Nova Scotia, taking these 2016 proportions as constant and applying Statistics Canada's M1 Medium Growth Projection to create the Senior Population graph above. Demand for supported living facilities

(Continued on page 4)

(Continued from page 3)

will increase significantly over the next two decades, averaging 4.7% per year, to roughly double its current level by 2038.

Measuring and Adding Value

Potentially, there are three ways to determine property value (and during that process identify value adding or risk minimising opportunities). Colloquially referred to as the "Three Approaches to Value" they comprise the *Income*, *Cost* and *Direct Sales Comparison* approaches. The mechanics of each Approach are not complex: purpose designed software and spreadsheets have reduced them to a mechanical process. This apparent simplicity encourages anybody with a firm grasp of math to apply the Approach for which they have data and/or professional bias. Accountants and loans officers prefer the *Income (fiscal) Approach* when considering seniors' housing partly because it falls within their comfort zone, but also because the property itself appears to generate the required revenue and expense data… and the Capitalisation Rate necessary to convert the resultant net operating income into the capital (market) value can be selected from the rates freely published by commercial brokers. The other two Approaches are usually sacrificed on the altar of expediency: reliable Cost and Sales information is not accessible without considerable cost and both require a level of expertise in comparative analysis which is only available through specialised education, training and experience. *Unfortunately valuing a commercial property using a single Approach is a method of last resort, and is expressly prohibited by the International Valuation Standards except in extenuating circumstances because it can result in an erroneous conclusion.* The three Approaches are not simply different methods for measuring value, they are interdependent. Rather like a blind man describing an elephant, each Approach considered in isolation misses vital information necessary to (1) arrive at a reliable value and (2) identify value adding opportunities. The belief too that the *Income Approach* fulfills requirements for data integrity because the seniors' housing generates the information necessary to calculate the net operating income, and that an accurate Capitalisation Rate can be chosen from secondary sources such as the commercial brokers, is unrealistic. The revenue and expense data generated by a specific seniors' housing property, as an input to calculating the property value, is meaningful only when validated by benchmarking it against similar properties. Similarly the appropriate Capitalisation Rate is a function of the risk inherent in the property's cash flow and is property specific. The narrow range of capitalisation rates published by the commercial brokers are not representative of a marketplace which encompasses a broad range of properties. At best their mid-point represents an "average". The Capitalisation Rates have to be extracted from the sales of comparable properties and adjusted appropriately for property specific factors influencing cash flow.

Seniors' Housing

Seniors' housing falls along a continuum from independent living accommodation to hospital care. For valuation and data analysis purposes we categorise it into the following four groups recognising that there will be overlap in terms of the level of care provided:

Independent Living – designed for the over 55s with a healthy, active lifestyle this accommodation is similar to conventional accommodation albeit with wider doorways, accessibility hardware, emergency call buttons and grab bars in the bathrooms. Optional services may include housekeeping, meals and laundry and may be arranged and paid direct by the senior without involvement by the complex's management company. This type of housing is usually provided in the form of adult apartments, individual, row or semi-detached housing in active adult communities. Easy access (preferably on foot) to retail shops, hair salons, fitness centres, swimming pools, golf courses, parks and other recreational facilities is required. No government funding is available nor do the provinces licence this type of accommodation.

Assisted Living – designed for seniors who need some assistance with daily tasks it provides supportive housing with services such as housekeeping, meals, laundry, access to basic nursing care, transportation and social activities. This type of housing is usually provided in the form of studio, one-bedroom, two bedroom units and shared suites and is typically smaller than comparable accommodation in Independent Living facilities. The accommodation typically includes a kitchenette for light meals: main meal service is provided in a dining room (no bar yet but they are common in Europe, so we can but hope). Some "in unit" supervision is provided even if the senior is capable of taking medication, bathing, dressing, toileting, walking, and eating without assistance. Corridors and doorways are wide enough to accommodate wheel chair access, corridor lengths are typically shorter than those in Independent Living facilities to assist residents who are less mobile. Bathrooms are designed with larger shower areas and low thresholds for improved access and there are the usual accoutrements of accessibility hardware, emergency call buttons and bathroom grab bars. There is an onsite nurse to dispense medication and visiting professionals such as doctors, physiotherapists, audiologists, hairdressers, etc. Transportation is provided to retail shops and recreational facilities and there is usually a structured program of outings. No government funding is available nor do the provinces licence this type of accommodation.

There is a common perception that Independent and Assisted Living projects both run at full occupancy. However these types of property have to compete with conventional, non-profit or other independent and assisted living accommodation for tenants and we are aware of some facilities that have struggled to achieve a 75% occupancy since opening.

Retirement Home (Residential Care Home) – designed for seniors who need some assistance with daily tasks, they perform a similar function to Assisted

(Continued on page 5)

(Continued from page 4)

Living although the level of care varies by facility and can include dementia care. The care is offered in a residential setting usually in former private residences (Victorian homes are popular) that have been adapted and extended. The group of residents is usually small (15 would be typical) housed in private or semi-private rooms. They may be owned and/or operated by a nurse and offer similar care to a Nursing Home albeit in a more residential environment. "Live in" care providers prepare meals and provide assistance with daily living. Housekeeping, laundry, medication management, social programs, transportation and outings are provided. Government funding is available on an income test basis and the provinces licence the operator and facility. Since the worth of this type of property hinges on its licence, and hence ability to access Provincial funds, the challenge is determining the likelihood of that continuing particularly if the building is old and adapted from a residential use. It may be necessary, or physically impossible, to upgrade rooms, amenity areas and exterior components to remain licenced. The building may no longer be adequate in terms of modern requirements such as corridor widths, accessibility, common areas or physical repair.

Nursing Homes – designed for seniors who need assistance with everyday tasks such as medication, bathing, dressing, toileting, walking and perhaps eating. They provide 24 hour nursing care in addition to shelter, dietary, housekeeping, laundry and social needs. Nursing Homes provide a higher level of nursing care than Retirement Homes but less care than a hospital and can include clients suffering from dementia, stroke, Alzheimer's or other debilitating conditions. Housekeeping, laundry, medication management, social programs, transportation and outings are provided and the Nursing Homes are generally in landscaped grounds to give clients the opportunity to enjoy the outdoors "on site". Exercise and physical therapy programs, together with social activities, are available to stimulate the patients' cognitive faculties. Pain management and hospice care are available. Three nutritious daily meals, housekeeping, laundry service and medication management are provided. The foregoing dictates that the facilities be much larger than Retirement Homes and they typically fall within the 50 to 200 bed range. The residents are housed in private or semi-private rooms. Government funding is available on an income test basis and the provinces licence the operator and facility. Since the worth of this type of property hinges on its licence, and hence ability to access Provincial funds, the challenge is determining the likelihood of that continuing particularly if the building was constructed more than 20 years' ago. It may be necessary, or physically impossible, to upgrade rooms, amenity areas and exterior components to remain licenced. The building may no longer be adequate in terms of modern requirements such as corridor widths, accessibility, common areas or physical repair.

Rick Escott, our Vice President, Ontario, an expert on the valuation of Extended Care Homes, is a swinger. He took the plunge with a party of Kiwis a couple of years ago. It was his first experience but he jumped right in, recording every playful moment for our Facebook page. Check it out at www.turnerdrake.com > Facebook icon > This month's Featured Consultant.

James Stephens B.Sc. (Hons). Adv. Dip. GIS DULE

Gregory Kerry B. Comm, BBRE, DULE

Ashley Urquhart, B.B.A., DULE

Egg Head Award #1

James Stephens joined Turner Drake in 2013. A winner of this quarter's Egg Head award, he achieved the top marks countrywide in the University of British Columbia's Property Development II course. James graduated with a B.Sc.(Hons) in Environmental Sciences from the University of Guelph, Ontario, saw the light and emigrated to Nova Scotia to attend the Centre of Geographic Sciences campus in Lawrencetown and thence to graduate with an Advanced Diploma in Geographic Information Systems (GIS) for Business. Much of James' grey matter grew here, nourished by bracing ocean breezes and craft beer. James was granted a Diploma in Urban Land Economics by the UBC in 2013 and is currently enrolled in their Bachelor of Business in Real Estate degree. Keen on all things woody, wet and smelly James is also pursuing a Professional Agrologist (P.Ag.) designation through the Nova Scotia Institute. He splits his time between our Economic Intelligence Unit where he is part of their Geographic Information Systems team, and our Valuation Division's Farm Unit.

Egg Head Award #2

Greg Kerry joined Turner Drake in 2011 directly upon graduation with Bachelor of Commerce degree, including three minors, from Mount Allison University, Sackville, New Brunswick. He holds a Diploma in Urban Land Economics (DULE) from the University of British Columbia and has just completed their Bachelor of Business in Real Estate (BBRE) degree as part of our seven year mentored training program. Greg hit the top mark countrywide in a class of 50 in UBC's "Directed Studies in Real Estate" course with an A+ (Class average was 65% ….Greg 92%). He carries a full work load as a Manager in our Property Tax Division, hits home runs on our softball team and is definitely the most dapper member of our staff.

Egg Head Award #3

Ashley Urquhart, the third winner of this quarter's Egg Head award, achieved top marks countrywide in the

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University of British Columbia's Property Development I course, echoing James' achievement last year. A Bluenose by birth, she joined us in 2009 and is now Senior Manager of our Brokerage Division and a Managing Associate Real Estate Broker licenced to trade in Nova Scotia and Prince Edward Island. She holds a Bachelor of Business Administration degree from Mount Saint Vincent University in Halifax, a Diploma in Urban Land Economics (DULE) from the University of British Columbia, and is currently completing UBC's Bachelor of Business in Real Estate degree.

PROPERTY TAX DIVISION

Mayor Savages Property Tax

Photo Credit: iStock

In May, Halifax hosted the Federation of Canadian Municipalities' conference. Mr. Savage, the Mayor of Halifax Regional Municipality (HRM), took to the stage advocating an additional tax on Canadians to supplement the revenue municipalities raise through property taxes. Flanked by the mayors for Gatineau and Edmonton, Mr. Savage was quoted by the CBC as saying that expansion within the knowledge and innovation industry does not always mean the construction of new buildings, "In fact, our commercial assessments are flat, you've got 40 or 50 high-tech employees in the space where there used to be three of four offices, or they work from home". As a consequence, he argued, relying mainly on property taxes means cities can miss out on the benefits of economic growth from the high-tech sector. The CBC report then quoted the Mayor as advocating that a "portion of the sales tax" be used to supplement the property tax revenue. Don Iveson, Edmonton's mayor and Chair of the Big City Mayor's Caucus was quoted as saying that there has to be some flexibility and "There's no single answer yet. We're going to continue to do some research on that, but the principle is predictable and sustainable and grows with the economy."

Is this a red herring? Another cash grab by municipalities unable to contain their own costs in an era of a declining work force population and low inflation? It is true that office space utilisation per employee has steadily declined since the 1990 recession, falling from 250 ft.^{2} to 110 ft.^{2} or lower but this is not unique to the high-tech sector. Office layouts now favour an open plan concept with work stations and less emphasis on individual offices to promote better personal interaction and creativity. However buildings are more expensive to construct with more advanced HVAC systems and communications and this too drives efficiency in space utilisation. And the good mayors are a little out of touch with current trends. A decade ago some companies encouraged their employees to work from home; it reduced the firm's overhead. However the private sector has since realised the benefits of collaborative work spaces; they spark creativity. This is particularly true of the high-tech sector: they seek open plan offices to encourage employee interaction, preferably "funky" space to get the creative juices flowing … slaving away in a home office isolated from colleagues no longer cuts it; this trend has been reversed.

Property taxes per square foot in Halifax's Central Business District (CBD) have risen by 60% over the past ten years; net rents out of which property owners have to pay their mortgages have increased by just 12%. It is true that commercial assessments in the Halifax Regional Municipality are flat … indeed in the Central Business District they are about to fall and will continue doing so for at least a decade. However this is largely the result of the actions of the Halifax Regional Municipality and has little to do with the impact of the high-tech sector's diminishing space requirements per employee. Since its creation in 1996 the municipality has neglected Halifax's Central Business District favouring office development in HRM owned business parks instead. Desperate for a major downtown project, it promoted a new Conference Centre, the venue ironically for Mr. Savage's pitch for an additional sales tax. Convinced that the only thing preventing Halifax from assuming the role of "New York North" was a major office complex, the municipality insisted that the developer of the Conference Centre also include 270,000 ft.^{2} of office space; this in a market that was already struggling. The Conference Centre was built without substantive research or cost benefit analysis (the Provincial Auditor General reported that the research lacked analysis and rigor and recommended an independent review; a suggestion that was promptly ignored by the then NDP government)… opponents such as "Save the View" were ridiculed as geriatric do-gooders bent on preserving the view from Citadel Hill (the city's defining landmark fortress) and thus anchoring the municipality in the past. HRM even devised a unique way of disguising the Conference Centre's anticipated losses by dedicating property tax revenue from the entire Nova Centre (Convention Centre, office towers, hotel, carpark) to fund the shortfall in their share of the Convention Centre rent and operations. The Nova Centre complex would, HRM assumed, be the catalyst for downtown revival. Unfortunately adding that much office space to a market already flooded with surplus supply simply increased the vacancy rate to a staggering 18.35%, drove down rents and values … and thence assessments including that of the Nova Centre. The CBD now faces its worst nightmare, competition from cheaper office space in the City's business parks, tepid demand, gross over supply, a declining working age population (it peaked in 2017), and a situation that can only be resolved by repurposing or demolishing existing office stock … a process that will take about 20 years. Blaming the high-tech sector for lack of property assessment growth is dissimulation: calling for an additional sales tax to fix a problem politicians have, in large part created, is outrageous. A more appropriate solution would be to reduce the municipality's operating expenses to meet their revenue, rather than require business and consumers to fund their foolishness.

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