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Chicago Investors Face "Fiscal Death Spiral"

By Bob Tivnan, CMI Chicago

The Chicago real estate market has been doing well the past several years as a flood of investment capital has driven property values up. The city's success is evidenced by its attraction of big corporations like McDonald's and ConAgra. However, the trend may be changing according to a new report. Green Street Advisors says investors may pull back and bypass the area as Chicago's growing tax burden leads to an exodus from the city and surrounding metro area.

Green Street is issuing fiscal health scores as part of its ongoing analysis of property markets. It's an attempt to help investors factor in fiscal performance, when it comes to making decisions about where to buy and how much to pay. The research raises serious concerns about the Chicago market, giving it the worst fiscal health score among the top U.S. metropolitan areas.

TAXES KEEP GOING UP

Chicago and the State of Illinois have been forced to raise property taxes to cover budget shortfalls and pension obligations. The cost of worker pensions costs approximately 45 cents of every extra dollar levied by school districts, city halls and other local governments according to the Illinois Policy Institute. Green Street calls the pension and budget challenges "a fiscal death spiral" that could hurt Chicago real estate investors and is likely to drive other potential investors away.

The spiral occurs as rising taxes lead to residents moving out. This reduces demand for apartments, retail, and other commercial space. Investors want to buy where people and businesses are moving in, not out. Chicago's population has already declined 7% since 2000 according to this study.

Most investors are aware of Chicago's poor fiscal condition but it's not easy to model the risks when figuring out how much to pay for a property. It's even more complicated trying to predict migration patterns.

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CAP RATES TOO LOW

Current property values show that investors are not pricing fiscal risk into their purchases. The report says investors are buying apartments in the Chicago area at an average capitalization rate of 5.4%. This is not much higher than the 5.0% national average. The Green Street report argues the rate should be higher to account for the added fiscal risk.

"Fiscal health of states and municipalities is an inescapable threat that doesn't appear to be priced into property market cap rates, likely because there is much uncertainty over timing and outcomes," the report says. "But knowing the train will eventually come off the rails should be enough, and market participants would be wise to incorporate this fact into pricing models today."