MAJOR CITIES EXPECTED TO MANAGE COMMERCIAL REAL ESTATE WEAKNESS

The widespread adoption of remote and hybrid work models across the US presents tremendous challenges for the office space market. Over the near term, a combination of soft demand, elevated vacancy rates **(Chart 1)**, and dropping market prices are expected to lower assessed valuations and associated property tax revenues. While most major cities benefit from a diverse sum of income streams, property taxes do represent the primary local source supporting operations at around 44% (per S&P). Despite anticipated weakness in the office segment, we expect revenue losses will be somewhat predictable, incremental, and ultimately modest in impact.

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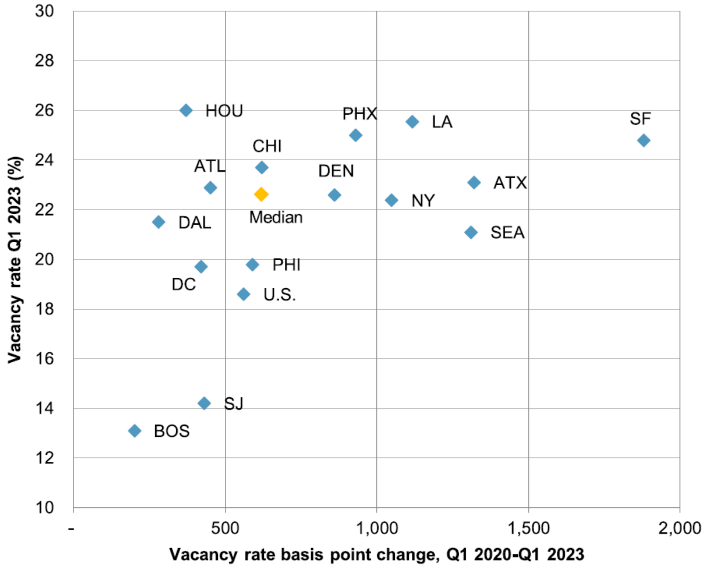
CHART 1

Current Vacancy Rates and Change From 2020



Source: Cushman & Wakefield Office MarketBeat Reports

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Recent commentary from S&P depicts office vacancy rates for a number of major cities across the US. As businesses continue to evaluate their needs, the agency expects vacancies to peak in 2024. Office space is a core subset of the commercial sector, yet S&P points out in a sample of 15 major cities that residential real estate drives tax base valuations and accounts for a median share of 60% of taxable appraisals. Higher vacancy rates do not automatically translate into lower property tax receipts. Assessment practices vary from state to state, and the appraisal process lags market moves. Although vacancies in some regions are running above levels not seen since the early 1990s, the residential market is holding up well and will serve as a stabilizer to offset commercial weakness.

New York City (Aa2/AA/AA-) is the largest local general obligation (GO) holding in our GW&K Municipal Bond Strategy and one of the largest office markets in the world. New York City Comptroller Brad Lander released a report last month addressing concerns surrounding commercial real estate. The Comptroller asserts the office segment represents just over 20% of the City's assessed valuation. Under his "doomsday" scenario analysis, office space assessments are lowered by 40%, resulting in $1.1 billion of lost property tax revenue by fiscal 2027. The projected shortfall represents 3% of the property tax levy, 1.4% of City tax receipts, and only 1% of total revenues that include state and federal grants. In his concluding remarks, the Comptroller states "While not a small amount, it is well within the range in which tax revenues can ordinarily vary."

Moving to the West Coast, taxable valuations in California are dictated by Proposition 13, approved by voters in 1978. The constitutional amendment requires properties to be assessed at market value only at the time of sale and valuation growth to be capped at 2% per annum in the years between transactions. Given consecutive years of rising market values in both the residential and commercial segments leading up to the pandemic, the Proposition 13 rules tend to undervalue properties on the tax rolls. Recent research from Barclay's shows the office sector in San Francisco (Aaa/AAA/AA+) represents about 18% of the city's total assessed value. Absent property sales, appraisal adjustments are made through the appeals process, with the number of disputes by commercial payors reportedly on the rise. According to Barclay's, if all the tax-roll petitions currently pending were granted (historically a highly unlikely outcome), the lower appraisals would result in a revenue loss of $300 million or 13% of property tax receipts, 7% of total tax receipts, and 4.8% of total General Fund revenue in fiscal 2022. It is worth noting that the disputes would be settled over a number of years and the city closed fiscal 2022 with an ending General Fund balance of $2.9 billion, more than 45% of total operating

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revenue. We do not own the city's GO bonds but hold a modest position in the Bay Area Rapid Transit (BART) Authority. The Authority's GO bonds (Aaa/A+/AAA) are secured by an unlimited, voter-approved tax levied on all properties within a three-county area, with proceeds automatically transferred to the bond trustee and restricted for debt service under the state constitution. Both Moody's and Fitch assign a triple-A rating due to these seemingly iron-clad security features.

These two examples on opposite shores capture our expectations regarding the impacts of declining commercial valuations on local government credit. As S&P points out in its recent commentary, "Heading into the current fiscal year, most large cities were at a financial, and in some ways, economic high point, which provides some cushion to manage the near-term budget volatility." Local governments have a long history of navigating economic cycles. We expect no material deterioration in credit quality due to a reset in a subset of the commercial real estate market.

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