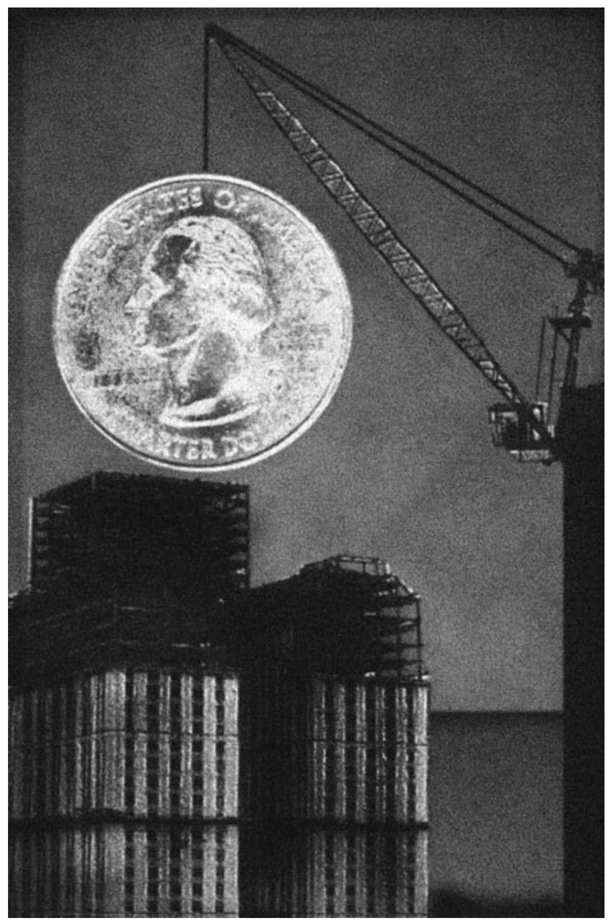
New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION
An incisivemedia publication
Real Estate
BOARD OF NEW YORK
WWW.NYLJ.COM
MONDAY, JANUARY 12, 2009

City Leasing Trends: Recapping and Projecting

Amid the breathtaking drop and looming negativity, surprising activity and opportunity.


NEWSCOM

BY BRADLEY A. KAUFMAN

IF I, AND EVERYONE reading this article, had a nickel for every time in 2008 we heard the phrase, "I have never seen this before in [fill in the blank, number of] years in the business," we all might have enough money to offset the significant losses to our respective financial portfolios resulting from the plunge in the financial markets.

Wow…what happened?! Throughout the second half of 2008, while the stock market plunged, so did Manhattan commercial office and retail rental rates. Deals were scrapped, back-burnered, or restructured at significant discounts. The number of such deals occurred in an unprecedented manner and breadth throughout the real estate community and rents fell at a pace never seen before. By the end of the year, landlords were bloodied and staggering and tenants were unsure of which way to turn.

Why did this happen in 2008 and what is in store for us 2009? Once again, this year I will view leasing activity by sector, while interjecting commentary from well known and well regarded non-legal real estate professionals. I will include in this article their and my prediction of what we can expect for 2009.

The Year 2008

The year 2008 began much in the way predicted in my piece last year, in that rents continued to creep up, though at a slower pace, while landlords continued to hold the line on concessions, etc.

The experts that I polled last year concluded that we were unlikely to see rapidly escalating rents over the near term, and we did not, though rents did in fact increase during the first half of the year. That all changed toward the end of the summer. The stock market began to tumble, the financial services sector fell apart, hedge funds lost fortunes and went out of business and the real estate market began to spiral southward.

I have once again asked a frequent previous contributor to this column, Josh N. Kuriloff, vice chairman and member of the Global Advisory Board of Cushman & Wakefield Inc., for his analysis of the year 2008. As Mr. Kuriloff advises,

"The New York City real estate market felt the full effects of the credit crisis cum recession in 2008, setting the stage for a challenging 2009. The financial crisis, which began in mid-2007, hit the nation with full force in the third and fourth quarter of 2008 as the nation's financial system lurched from one emergency situation to the next and the federal government made unprecedented intervention into the financial system an almost routine weekly event.

"The enormous volatility that was injected into the economy had a major impact on tenant firms in New York. In a year that was already shaping up as one of the weakest since the 2001–03 downturn, leasing activity slowed even further in the fourth quarter of 2008. The recession brought on by the financial crisis worsened dramatically in the September/October time frame, causing firms that were in the market for space to reassess their own business situation and put any real estate decision on the back burner."

There was, nevertheless, significant leasing activity, broken down by sector, as follows.

Midtown

Notable Midtown leasing activity included Macquarie Group's 260,000 square foot expansion and renewal at 125 W. 55th St. The Australia-based financial services giant thereby increased its space in the building by 160,000 square feet.

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S.L. Green continued to add tenants at 100 Park Ave. by signing a 120,000 square foot lease with BDO Seidman, as well as full floor deals with Morgan Creek Capital Management, LLC and Adved Management U.S. Inc., two financial services companies. S.L. Green also inked significant deals at 1515 Broadway including, most significantly, renewing Viacom for 1.3 million square feet, the year's largest lease in terms of square footage (though for a relatively short term), and Wurk Environments to a 65,000 square foot, 10 year lease.

Other significant leases in Midtown included Toyota's 10 year deal for 30,000 square feet at Citicorp Center and PR firm Robinson Leira and Montgomery's renewal of 28,500 square feet at 1345 Avenue of the Americas; it should be noted, though, that the Toyota deal, which had been fully negotiated, ultimately signed for 10 percent less than the previously agreed-upon rental rate. The fourth quarter also saw NBC Universal sign a massive 100,000 square foot lease at 75 Rockefeller Plaza.

As Kuriloff notes,

"Perhaps the biggest surprise in 2008 was the number of large leases that were executed. As of early November, there were 30 leases of 100,000 square feet or larger signed during 2008 in Manhattan (including renewals). In the first three quarters of 2007, only 18 such leases were signed.

"Despite the high number of large leases, overall leasing activity for 2008 was weak. Through October a total of 17.1 million square feet of leases were inked in 2008 for all of Manhattan, down 13.8 percent from the level of 2007 and more than 25 percent from the level of two years ago. By the time 2008 [was] over, overall leasing in New York [was] the lowest since 2003."

Downtown

Downtown, Capstone Equities, along with its partner the Carlyle Group, continued to fill up the newly acquired and renovated 14 Wall St. and, as more and more sublets became prevalent, Oberon Media Inc. subleased some 18,000 square feet at World Financial Center from the law firm Richards Kibbe & Orbe (which it in turn had subleased from the bankrupt entity Lehman Brothers).

In December, Larry Silverstein finally crowned off the top of 7 World Trade Center with a 15 year lease to German Bank WestLB for the top three floors of the 52 story building. The deal, reportedly at an "above market rental rate," brought occupancy in the building to above 80 percent.

The fourth quarter of 2008 also saw the first opening of a Palm Restaurant downtown, at 200 Chambers St., the fourth Palm Restaurant in New York City.

Activity in Other Locations

The Hudson Square area has drawn tenants that still could not afford Midtown, but perhaps were not comfortable moving downtown, to an area somewhere in between.

For example, 250 Hudson St., a Jack Resnick and Sons project, saw Lowe & Partners Worldwide Inc., a marketing agency, and the law firm Lieff Cabraser Heimann & Bernstein, take full floor deals in the building in the fourth quarter of 2008.

Pre-Builts: a New Turn on an Old Trick

In order to keep stated rental rates high and satisfy lenders, landlords, more frequently than ever, turned to pre-built units. Such pre-builts (space built out by a landlord, at the landlord's expense, in a "building standard" fashion to permit a tenant to occupy without further substantial construction), previously only somewhat popular and mainly with smaller tenants, have increasingly become a hot commodity in New York City.

> By the end of 2008, in the New York City commercial office and retail leasing markets, landlords didn't know how to price space and tenants were unsure whether or not to conclude transactions at any pricing. For tenants that are prepared to act, however, these conditions have created an opportunity to find rental rates and lease rights that have not been available in years.

Buildings like 55 Broadway, downtown, and 100 Park Ave., 317 Madison Ave., 1350 and 1400 Broadway and even the Empire State and Graybar Buildings, in midtown, have instituted such programs with increasing success. These are only a few of the very many buildings throughout Manhattan offering pre-builts.

In the Retail Sector

While landlords have, particularly recently, chased banks at every opportunity to put them at the ground floor corners of their buildings throughout the city, they are finding that, in some cases, this strategy has become a risky business.

In the fourth quarter of '08, JPMorgan Chase and Co. announced plans to close perhaps as many as 10 percent of the Washington Mutual Bank branches that they had acquired in the takeover of that bank, which would likely result in the closing of more than a dozen New York City locations. One needs only to walk up and down Madison Ave. to see the results of other retail closures as well.

As Gene P. Spiegelman, executive director, retail services, at Cushman & Wakefield, advises,

"As we look to 2009, we anticipate the first half of the year to continue to be the most difficult time for the consumer in decades and this could well continue through the entire year as the other shoe has yet to drop. Rising unemployment, continued depression of housing values and lack of consumer and business credit will make for very difficult business conditions. To date, we have seen record store closings by retailers and we expect this trend to continue into 2009. Taking into account that consumer spending represents two-thirds of gross domestic product, this condition will represent a drag on the overall economy. The stock market does not like a weak consumer and the results are apparent."

However, all was not bleak in the retail sector. It was announced that Forever 21 plans to open nearly a 100,000 square foot megastore at 1540 Broadway in Times Square. High-end jewelry retailer Graff opened a significant retail flagship on Madison Ave., and Abercrombie & Fitch signed a lease for over 23,000 square feet at 666 Fifth Ave. to house a flagship Abercrombie kids store.

The second half of 2008 also saw hot retailer American Apparel sign a lease for a big new SoHo store at 427 Broadway, as did Eastern Mountain Sports, in announcing its new flagship location at 530 Broadway (moving from 591 Broadway to clear space for a newly planned Victoria's Secret store). SoHo continued to be the hottest retail market in the city. Mr. Spiegelman thinks this trend will continue:

"We expect certain Manhattan submarkets, particularly SoHo, Midtown and the core thoroughfares of the Upper East and West Sides, to fare better, as these markets are simply supply constrained markets."

Even the outer boroughs saw some action as H&M opened its first street location in Brooklyn (it already has a sizable store in Vornado's Kings Plaza Mall), a nearly 30,000 foot store on Fulton St., in the fourth quarter of 2008.

However, not all news was positive, particularly outside of New York. The year 2008 saw the closure of numerous Ann Taylor, Eddie Bauer, Cache, Lane Bryant, Gap and Foot

Locker locations throughout the United States, as well as the March filing for bankruptcy protection by the Walt Disney Companies subsidiary the Children's Place.

The Legal Community

The fourth quarter of 2008 saw two major national law firms, each with a significant New York presence, Thelen and Heller Ehrman, collapse and throw large blocks of space back into the marketplace. As the year came to a close, reports of present and anticipated layoffs and rumors of the demise of other firms, both large and small, abounded in the legal community.

However, not all news was negative in our community. Two New York-based mid-sized firms seized opportunity. Fitpatrick, Cella, Harper & Scinto took over 100,000 square feet in Vornado's building at 1290 Avenue of the Americas, and my own law firm, Pryor Cashman, took nearly 100,000 square feet in Boston Properties' Times Square Tower at 7 Times Square. It should be noted that those deals were done at rental rates significantly below what those two firms had contemplated just six months earlier.

The Downtown market also saw law firm activity in the fourth quarter, with Cleary Gottlieb Steen and Hamilton expanding its presence by taking some 35,000 square feet, comprised of two full floors, at 22 Cortlandt St., adjacent to its main offices at Liberty Plaza.

The Outlook for 2009

What then can we expect for 2009? David A. Falk, executive vice president and principal of Newmark Knight Frank, advises as follows:

"2008 [was] a year like none other. Bear Stearns and Lehman Brothers, two venerable financial institutions, are no longer in existence and in the same week in mid-September, AIG gets bailed out by the government and Merrill Lynch is absorbed by Bank of America. Although the Manhattan availability rate had been increasing four consecutive quarters in a row (since the third quarter of 2007), the events that occurred in mid-September have profoundly effected the market, especially in large class A Midtown properties.

"Given that the financial sector accounts for 30 percent of the tenants in class A Midtown properties, there has recently been, and certainly will be, large blocks of space on the market that were built and occupied by major banking firms. The immediate effect of this is that for the first time since the year 2000, the Midtown availability rate is higher than that of overall Manhattan. The concern for 2009 is that there is still a significant amount of space that still has not yet been 'publicly' listed and thus the 10.2 percent availability rate can easily increase 2–3 percentage points once these other expected blocks finally come on the market.

"In addition, these subleases will be competing with blocks of space listed on a direct basis, and as we are already witnessing, sublandlords will be offering discounted economic terms which will, in turn, negatively affect the terms landlords are seeking for their vacant blocks of space. Furthermore, the five million square feet on the market for sublet in Midtown is the highest number since the third quarter 2005. If you add to that the sublease space not yet listed, the amount of sublease availabilities will mirror that of the first quarter 2003 period, which was the period that we experienced the largest Midtown sublease inventory during this entire decade."

Lewis Miller, vice chairman of real estate firm CBRE, concurs:

"While the Manhattan real estate market had been weakening since last July as a result of the turbulence in the credit markets, the events of the [last] two months [of 2008] greatly accelerated this decline, with the problems in the financial sector spreading to the wider global economy, with major corporate failures occurring or looming and recent and continued government intervention. The effects of these events have been particularly acute in Manhattan and will likely adversely affect real estate market conditions for at least the next 12 to 18 months.

"While some market statistics continue to reflect a 'healthy' market, the reality is that the undercurrent is highly negative, and practical experiences within the market [in the fourth quarter of '08] point to significantly and rapidly weakening real estate market conditions. Leasing activity has slowed dramatically as many firms are standing on the sidelines waiting for the dust to settle since there is no pricing risk associated with waiting. Those few firms that have requirements have been hesitant to act for fear that they will be second guessed as having paid too much six months from now.

"The handful of transactions that have closed have virtually all been repriced at the eleventh hour as a result of competition among landlords for the few tenants leasing space. Landlords have not bothered to adjust asking rents in many instances because it will not increase the low level of demand. Rather, those tenants in the market are being aggressively pursued by landlords, some of whom are discounting their asking rents by as much as 25–30 percent for 'real' prospects."

Conclusion

By the end of 2008, there was significant confusion in, and chaos reigning throughout, the New York City commercial office and retail leasing markets. Landlords didn't know how to price space and tenants were unsure whether or not to move forward and conclude transactions at any pricing. As Lewis Miller notes,

"With little demand for space, pricing space has become almost impossible to establish, as securing tenants is less a function of price at the moment. Once the dust settles and tenants regain confidence, we will see the market statistics reflect lower rents as transactions are completed and landlords move to lower asking rents to attract tenants.

"The above market conditions have created a rare opportunity for those tenants appropriately prepared to act in this environment to identify unique opportunities to significantly upgrade their space at rental rates, and with lease rights, that have not been available in many years. Only those tenants that have undertaken a disciplined methodology in addressing their long-term occupancy requirements will be in a position to recognize and take advantage of these opportunities."

For the last word, I asked Mitch Roschelle, a partner in the real estate advisory practice group at PricewaterhouseCoopers, here in New York City, for his take on things, and here is what he anticipates:

"This year [2009] will by all accounts pose the biggest set of challenges for landlords. It's a perfect storm of, a slowing economy, job loss, weak demand for space, and little to no credit available, and diminished desire by foreign investors to pay top prices for property. While New York City has recovered from many of these individual market conditions before, the ability to bounce back in the wake of so many forces has yet to been seen.

"Hold on tight, this will be a bumpy, long recovery. And it may get a lot worse before the recovery begins. All in all, 2009 will be a down year, for values and rents."

Unfortunately, I see it the same way. Good luck to all of us!

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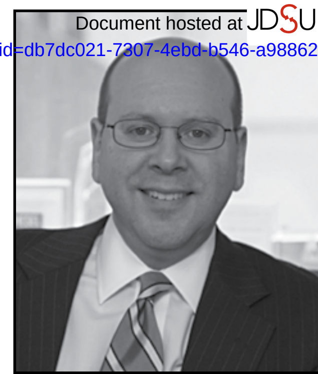

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Mr. Kaufman has been a lecturer at New York Law School on negotiating techniques, has been selected as an expert panelist by the New York Law Journal and Newmark & Company Real Estate, Inc. on negotiating commercial leases, and has been a panel member and faculty chair for International Council of Shopping Centers, the American Corporate Council Association and the Practicing Law Institute symposiums and seminars.

Mr. Kaufman has also authored numerous book and leasing manual chapters, including in the 2003 version of the ALI-ABA Lease Negotiation Handbook, the Retail Leases chapter of the 2004 version of the NYSBA Commercial Leasing Handbook (being updated in 2007/08), and articles in various publications on a wide range of topics in the commercial and retail leasing field, including an annual article in the New York Law Journal on leasing trends in the New York marketplace.

Mr. Kaufman is the co-chair of the New York State Bar Association's Real Property Section, Commercial Leasing Committee, since January 2002.

Mr. Kaufman is AV Peer Review Rated, Martindale Hubbell's highest peer recognition for ethical standards and legal ability.

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