A Tale of Two Years

Following the boom of early 2007, activity slowed by year's end.

BY BRADLEY A. KAUFMAN

THE YEAR 2007 was another great year to be an owner of commercial real estate in New York City—at least during the first half of the year! Throughout the first half of 2007, owners continued to see rental rates escalate to record rates, though not at quite the pace of 2006. In 2007, concession packages basically leveled off by mid-year at the rates they were at by the end of 2006, and work letters were at relatively the same levels as well. By year's end, however, more big blocks of space were available than at the end of 2006, and leasing activity was down against the same levels in the prior year. It was almost a "tale of two years": clearly, the first half of 2007 was much better than the second half!

What is in store for us in 2008? Once again, this year I will view leasing activity by sector, as in past articles, analyzing the Midtown and Downtown office markets as well as retail leasing transactions throughout the city and again 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 2008.

The Year 2007

I've asked a frequent previous contributor to this column, Josh N. Kuriloff, vice chairman and member of the Global Advisory Board of real estate powerhouse Cushman & Wakefield, Inc. for his analysis of the year 2007. Mr. Kuriloff advises that, 2007 "started out with tremendous momentum as vacancy rates were falling throughout Manhattan and rents were soaring to record levels. But conditions changed abruptly during the summer as the magnitude of the credit crisis became known and its potential impact on the New York City economy and real estate market were understood.

"At the end of 2007, leasing activity is down about 14 percent for Manhattan as a whole, with activity in class A buildings (which account for 62 percent of all Manhattan buildings) down nearly 30 percent. Clearly, the environment has changed. Instead of rushing to renew their leases, tenants are waiting to see if they can get a better deal in the future. Rents are still rising, but the rate of increase has slowed dramatically. Participants in the New York real estate market are holding their collective breath to see if the financial services sector, the main engine of growth in this market, continues to expand, pauses, or reduces employment."

However, it has been reported that overall rental rate increases since 1990 really have only gone up an aggregate of about 50-55 percent or about 3 percent per annum and, were it not for the artificial restraint of rental rates due to the events of Sept. 11, 2001, there would likely be a consistent rental growth since 1990 of about 3 percent. So really, rental rates, while they seem completely out of line, are really in keeping with historical trends.

Success on Sixth Avenue

In my article last year, I wrote about one owner's success on Sixth Avenue, describing Equity Office Properties Trust's acquisition and development of 1095 Sixth Avenue. Interestingly enough, Equity Office Properties Trust no longer exists today, having been bought by Blackstone and having its portfolio broken up and sold to various players such as S.L. Green Realty Corp. This year I note another owner's success on Sixth Avenue, but coming from a completely different prospective.

Bruce A. Spiegel, senior managing director of Rose Associates, Inc., a prominent and prestigious New York City and Northeastern United States landlord, notes that, "Retail typically follows the demographics of area residential and commercial buildings, reflecting the density and makeup of the community. A good example of this is the maturation of the retail north of West 23rd Street along the Avenue of the Americas as well as the adjoining side streets.

"Traditionally, the area's notable retail resided below 23rd Street with such major destination tenants as Bed Bath & Beyond, West Elm, The Container Store, Barnes & Noble, and Best Buy along with a host of casual and white tablecloth restaurants dotting the side streets.

"A significant leap across the West 23rd Street 'border' was recently made by Gracious Home, the upscale home products retailer, with whom an affiliate of Rose Associates recently concluded a 20-year lease at Chelsea Landmark on 6th Avenue, between 25th and 26th streets. This transaction demonstrates how the evolving residential neighborhood along the Avenue of the Americas became an ideal location for a brand like Gracious Home."

This migration noted by Mr. Spiegel is not only one which depicts retailers expanding or "rolling out" stores, including national and international chains seeking new markets for their goods, but also includes those one-off, "mom and pop" type operations which are being forced out of various neighborhoods throughout the city and required to "think outside the box" in coming up with new neighborhoods to move into.

Outlook '08

What can we expect in 2008? Lewis Miller, vice chairman of real estate giant CBRE, advises that, "While current market statistics for asking rent are at an all time high and availability rates are low, the magnitude of the problem in the credit markets has created major uncertainty regarding the economy, and this underlying fundamental is more relevant than the current statistics. This economic uncertainty has caused firms to begin reconsidering growth estimates and in turn, we're seeing some tenants sitting on the sidelines waiting to see the effects, if any, on the real estate markets before making long term commitments.

"We believe the dramatic rent run-up in Midtown is essentially over and that rents will be relatively flat during the next 12 to 18 months with leasing activity down approximately 10-15 percent. Leasing activity has already slowed, with leasing velocity through the first 10 months of the year at its lowest level since 2003. Nevertheless, quality blocks of space will continue to be in short supply and will command a premium. The market for second-tier spaces, marginal locations and space on lower floors, however, will be significantly softer as these locations benefited from the unprecedented increase in rents over the past 24 months."

David A. Falk, executive vice president and principal of Newmark Knight Frank, adds that, "The second factor negatively affecting these Midtown tenants is the pace in which buildings have been sold over numerous times in recent years. In these properties it is very common for the new owners to establish asking rents that far exceed competing properties. The average asking rent increase for these newly sold buildings was 8.6 percent higher compared with similar properties that had not been sold. Given the rent estimates and projections that these new owners have established with their bankers and investors, they seem very reluctant to quickly change their view of the rental market and as such, will take their time trying to achieve the economics they projected. This, again, would cause frustration for the tenants as they may be facing a situation where the other side has a reluctance to 'meet the market.'"

Quite obviously, Wall Street and the stock market, and more particularly the credit crisis affecting same, will have a likely effect on U.S. and particularly New York real estate. Mitch Roschelle, a partner in the real estate advisory practice group at PricewaterhouseCoopers LLP in New York City, notes that, "The dynamics experienced in the real estate markets since this summer, are not reminiscent of previous cycles. While credit crunches are not at all unfamiliar, they generally are accompanied by other bad news in the macro economy or the fundamentals of real estate. As we enter 2008, the U.S. economy remains stable and growing; the real estate economy is strong as evidenced by rent growth and high occupancy. While debt capital remains scarce, the real estate economy remains buoyed by low interest rates."

Bradley A. Kaufman *is a member of the real estate group at Pryor Cashman, where he heads the firm's commercial leasing practice. He is co-chairman of the New York State Bar Association, Real Property Law Section, Committee on Commercial Leasing.*

The Downtown Marketplace

CBRE's Mr. Miller notes, "Downtown will continue to have some upward pressure on rents as tenants opt to relocate from Midtown to Downtown, taking advantage of the 36 percent disparity in average asking rents between the two markets. Even so, Downtown's leasing activity will likely be down 15 percent next year."

While 2007 saw many service firms exiting Midtown for Downtown due to significantly lower rental rates at the beginning of the year, the gap closed during the course of the year so that many firms in fact were hesitant to give up the easy commuting and access that Midtown offered for not significantly reduced rental rates in the Downtown marketplace. As the gap closes further in 2008, many firms faced with the decision of whether to relocate and move from Midtown for lower, but not significantly lower, rental rates, will be faced with a difficult decision. Do they relocate a work force that previously enjoyed easy commuting and access from Midtown to Downtown just to "save a few bucks." If the disparity in rental rates does not increase, but remains relatively steady and not terribly significant, I would guess that most companies would elect to remain in Midtown.

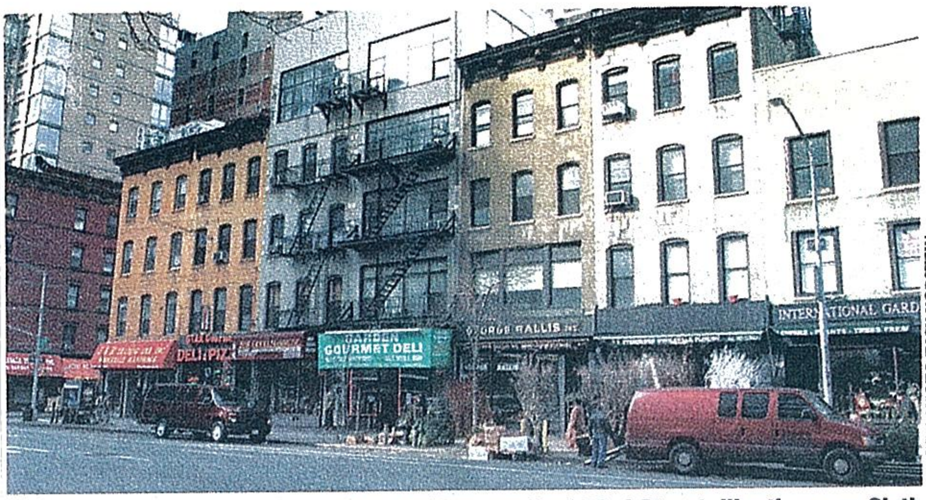
During the fourth quarter of '07, there were also a number of mega deals of note Downtown. Omnicon Group signed a significant lease for more than 180,000 square feet at L&L Holding Company's 195 Broadway. Omnicon will be consolidating its various divisions from spaces throughout Midtown and Midtown South to this Downtown location.

Then in December, law firm Cleary Gottlieb agreed to expand its offices at One Liberty Plaza by over 100,000 square feet, bringing that firm's total square footage in that building to over 500,000 square feet. It is noteworthy that this building is in close proximity to the former World Trade Center site.

Law Firms as Hot Commodities

In 2007, law firms were very hot commodities, hotter even perhaps than firms in the financial services sector. The year saw significant law firm transactions, including Davis Polk & Wardwell's renewal at 450 Lexington Avenue in a deal for over 650,000 square feet; Cravath, Swaine & Moore's renewing at One Worldwide Plaza (at Eighth Avenue and 50th Street) in a renewal and expansion for over 600,000 square feet; and Goodwin Procter entering into a new lease at the new New York Times building, for space in excess of 215,000 square feet. Each of these deals were at or approached the $100 per square foot per annum benchmark. These are just some of the significant law firm deals concluded during 2007. I view this as a harbinger for a number of law firm deals which will be concluded in 2008.

The question facing many law firms, as was the case with those noted above, is whether to renew in place or seek space elsewhere. While largely financially driven, the issue is not always simply about dollars and cents, but in the case of a law firm, also reflects its client base and identity. Much in the way retail tenants are often branded by location, the same can sometimes be true for law firms.



NYLJ PHOTO/RICK KOPSTEIN

Smaller businesses now populate Chelsea, north of 23rd Street, like these on Sixth Avenue, between 27th and 28th streets.

New York Versus Other Markets

Joseph J. Sitt, president of national real estate developer Thor Equities, suggests that, "We as a national allocator of capital are seeing that New York's real estate market continues to run in a dichotomy to the national averages. The fundamentals are strong—New York's commercial and residential leasing markets continue to show strength and housing prices are holding. All this is running in contrast to the weakness being felt in other parts of the United States."

Retail

As noted by Rose Associates' Mr. Spiegel, retail is finding different neighborhoods and areas of the city to creep into. While banks have largely forced more traditional goods-selling retailers off the "corners" and even off the main avenues, neighborhoods such as Chelsea, the Village and, of course, SoHo have been fertile growth areas for such retailers, particularly European and Asian brands coming to the United States for the first time. Retail rents in these markets rose throughout 2007 and given the scarcity of good retail space, I foresee a continued rise in retail rental rates in 2008.

However, Gene P. Spiegelman, executive director and head of Retail Services at Cushman & Wakefield, Inc., has a different view of things. Mr. Spiegelman notes that, "At the close of 2007, the consumer was under assault from a troubling set of market forces that lend a note of caution as we look forward to 2008. The combination of tightening credit, rising energy prices and volatile equity markets have conspired to dampen consumer confidence. These factors have been reflected in retailers downgrading their sales forecasts for 2008, as they have tempered their outlook. Notwithstanding the gathering storm clouds, the run up to the year end of 2007 proved resilient, as shoppers delivered positive results for retailers on Black Friday.

"As with all U.S. economic cycles, our nation experiences different levels of expansion and contraction based upon geography and demography. Thus, as we forecast retail real estate expectations into 2008, we can expect to see various results for retailer turnover based upon region and demographics. We do not expect to see universal contraction as certain market segments will be less impacted by the credit issues resulting from this year's subprime mortgage debacle. For the most part consumers have been absorbing increasing energy costs, as gas prices exceeding $3 per gallon has become the rule rather than the exception. Also, the luxury market segment continues to show strong sales."

Conclusion

Cushman's Mr. Kuriloff opines that, "The bottom line is the 2008 real estate market will be fundamentally different than what we have experienced over the past several years. Rent increases are likely to be smaller, and may not occur at all. In some cases, landlords may offer greater concessions to entice tenants. While it's unlikely that we will see major declines in rents during 2008—the market is not expected to get that bad—the days of rapidly escalating rents are over in the near term."

I agree. At the end of 2007 we were already seeing a trend in favor of lower asking rentals and, therefore, lower taking rentals, as well as increased concession packages in the form of longer periods of free rent and increased scope of landlord work letters and larger construction allowances to tenants. We also saw a willingness on the part of landlords to spend capital to upgrade building services and amenities in order to attract a higher class of tenants willing to pay rental rates at or about what was reached in 2006 and the first half of 2007.

I think 2008 will continue to see a trend that is toward flatter rental rates, though probably not decreasing in any significant manner, with continued increasing concession packages. However, if the first half of 2008 sees significant layoffs in the financial sector, I think that will translate into large blocks of space becoming available either in the sublease market, or in what is commonly known as the "shadow sublease market," meaning that such spaces are commonly known to be available though not formally listed. These shadow market sublease spaces often go for significantly reduced rental rates and put pressure on asking and taking rental rates from landlords seeking to do direct deals. Again, if we do see significant layoffs, rental rates could visibly decrease in 2008. It should be an interesting year!