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Annual Forecast 2008: Slower, But Still Strong

By: Joseph Dobrian
Contributing Editor

WHILE INDUSTRY INSIDERS PREDICT that growth is likely to slow in all areas of commercial real estate this year, the New York metro area will remain strong—and expensive. Debt will be harder to come by, but still available, especially to those who don't need much of it. Portfolio lenders are likely to have a terrific year, while securitized lenders could fall back and regroup. REITs, foreign investors and others that can come in with a big piece of equity, are likely to be the big buyers. Rents might not grow a lot, but they're not going to slide either.

Even if rocky times are ahead for the rest of the country—which is by no means certain—the Manhattan office market is likely to stay pretty solid. Most observers agree that this market can't be lumped in with the rest of the US, because it's a world capital and demand for office space here will always be high.

"Rental rates are firm and the fundamentals are strong enough to support them," asserts David Arena, president of Grubb & Ellis New York. "Vacancy is historically low—less than 1 percent in modern buildings in Midtown. It's expensive to build, land isn't readily available and the permit process is time-consuming. This all leads us to believe that rents will be supported at or around today's levels. However, there will probably be some trimming of the sails in financial services, some reductions in the workforce as the banking crisis continues. Some space might be put back on the market and there will be no accretive employment growth. In all, our outlook is optimistic, but realistic."

Arena points out that in times of financial crisis, the legal profession usually finds growth opportunities, and so does the municipal government sector. The healthcare industry is sure to need more real estate as well, he adds.

"We've seen three major price dislocations here in the past four decades," he recalls. "One was the result of the oil crisis in the 1970s; another followed the stock market crash in the late 1980s; the third followed the dot-com meltdown of 2000. In those first two cases, a large amount of new space had just come onto the market, which made the problem worse. But in the third case there was no supply-side infusion, so the situation worked itself out quickly. This current situation is similar. We've had one big macroeconomic shock in a market where vacancy is tighter than in 1999. Unless there's some other variable that we can't see today, we should weather this storm with no problem."

As for other property types, Frank Zuckerbrot, president of Sholom & Zuckerbrot, says the outlook is uncertain, and perhaps a cause for concern. In the outer boroughs, where S&Z concentrates its efforts, he foresees an upturn in demand for industrial space, largely because much of the supply has been converted to residential and retail.

"We might see a little new industrial development in Maspeth and the Bronx," he suggests. "Also, the city government has come out with 'IBZs'—Industrial Business Zones—that will stop the rezoning of some industrial areas. In residential, the big story resolves around the 421a abatement, the expiry of which might keep new condo development from happening in 2008 and 2009."

The current 421a abatement has been extended to mid-2008, which the development community generally regards as better than nothing. Louis A. Perfetto, managing partner at Cohen & Perfetto LLP, a New York-based real estate law firm, agrees that changes in the 421a guidelines are causing some worry.

"People are trying to get their foundations and footings in prior to June 30," he comments. "Whether they can will be a criterion of whether their projects will succeed. Overall I see moderate growth from a development standpoint. I don't see a huge downturn."

OFFICE: TEMPERED DEMAND

Jeffrey Katz, CEO and principal owner of Sherwood Equities, agrees that the condo market will proceed more cautiously this year. He notes, though, that all property types are suffering from the tightening of debt availability. "Class A office demand has tempered a bit and some development projects have been postponed six to 12 months because of difficulty in getting financing," he says. "The hotel market is still very strong because of all the foreign visitors, but again construction is hard to finance."

As for what neighborhoods are hot, several observers cited the rehabilitation of 200 Fifth Ave. as a huge boost to Midtown South. Craig Panzirer, senior vice president and director of leasing of Monday Properties, says the media giant Omnicom's move to 195 Broadway from Midtown was one of the key events of the year.

"Omnicom is paying an all-time-high rent for that area and will bring lots of small ancillary businesses with it," he declares. "Citywide, we're bullish. This year should see a slight slowdown in velocity, but it'll still be a strong year for leasing activity."

Quite a few buildings will be going into the ground in 2008, although most of them won't open for business for another couple of years. Howard S. Fiddle, vice chairman at CB Richard Ellis, says he's working with Extell Development Co. on a 800,000-sf spec. building on 46th Street between Fifth and Sixth avenues, scheduled for 2010 completion. Another building—a Boston Properties opus—will go up at 250 W. 55th St. if two prospective tenants sign on. (GlobeSt.com, the online division of Real Estate Media, broke the news last month that one of the firms was Proskauer Rose LLP.)

"These are two big law firms, household names, that will take up the whole building," Fiddle explains. "Boston's also working on a joint venture with Related at 46th Street and Eight Avenue, and SJP Properties will be ramping up its marketing effort for a development on 42nd Street and Eight Avenue. The holes have been dug for those properties, but no steel has come out of the ground yet."

Fiddle says the big development story for 2008 will be 200 Fifth Ave., which will bring 800,000 sf of virtually new space into play. Grey Advertising has already claimed 370,000 sf at a rent in the high $70s per sf: an historic high for that area.

Leasing may slow down in office product. David J. Goldstein, executive managing director at Studley, suggests that considerable opportunities may arise for his tenant clients as sublease space begins to compete with direct space. Midtown has pretty well been priced out of reach for many tenants, he suggests, and large users are now looking for space Downtown and in Midtown South.

"We're seeing fair amounts of activity in lower Manhattan, on the Far West Side, and in Harlem," he reports. "A handful of companies are looking at Long Island City—and Brooklyn, where you can find interesting envelopes of space at half to a third of what you'd pay for premium space in Midtown."

In the current situation, says Goldstein, it's the mid-size tenant who's having the toughest time. There's been a slow but steady increase in the availability of very large blocks in Midtown, and in any case the mega-user can often afford to build."

"New construction gets snapped up quickly because companies need to upgrade their efficiencies and technology—especially the class A banks, law firms, money management firms," he adds. "They flock to these new environments as a way to retain talent. But that makes it hard for the tenant who only needs 5,000 to 10,000 sf."

This situation will probably lead to continued (if modest) office rent growth in 2008, predicts Fred Posniak, senior vice president of Wien & Malkin. He says his firm had budgeted for a flat first quarter for its nine-building portfolio, but a rush of business at year's end has forced him to reconsider.

"We're looking at rent growth of 3 percent to 5 percent for the year," he reports. "And we foresee a little reduction in landlord contribution. There's a shortage of quality space in prime locations, with lots of stuff coming out of the ground but not much of it ready yet. The 200,000-plus-sf market has been white-hot lately but a lot of those tenants have landed now, and I expect to see more activity this year in the 25,000-sf to 50,000-sf segment. A number of buildings in the Garment District will attract more office users."

Since relatively little new space is slated for imminent availability, many tenants are trying to lock in early lease renewals, sometimes two and three years out, reports Robert Stella, executive vice president and principal at CesaPartners. There will be some layoffs in financial services, Stella predicts, and some retrenchment, with some companies getting hit harder than others by the subprime mortgage crisis.

"Goldman Sachs didn't have any exposure to that market," Stella elaborates, "But Morgan Stanley wrote off $8 billion or $9 billion in subprime losses, and Citibank's total exposure was $65 billion via its different subsidiaries. Thus, some deals have been pulled or delayed. Merrill Lynch was going to move to the site of the Hotel Pennsylvania—but you don't hear about that deal now. Citibank has put 75,000 sf on the market at 666 Fifth Ave., and another big block at 399 Park Ave."

CAPITAL MARKETS: STILL BULLISH

Still, providers of debt and equity are still generally bullish on New York. David A. Cohen, regional director of North America lending at GE Real Estate, admits that subprime exposure and credit issues will raise question marks, "But New York City has so many drivers," he adds. "Limited supply and high demand will continue to drive rents higher, so we'll go on using our balance sheet and taking a value-creation approach. We like buildings with leases signed years ago, where the rollover will create opportunity. We deploy our capital on below-par cash flows. We're especially interested in retail plays, since every luxury retailer wants to establish itself in the key corridors of Manhattan, and in the apartment market where vacancy is still very tight."

REITs and off-shore buyers are most likely to capitalize on current conditions, since they can buy at lower leverage, says Dan Fasulo, managing direct of Real Capital Analytics.

"Almost all REITs are raising capital now because they think they'll finally be able to compete for deals, whereas previously they had not been able, at 50 percent leverage, to compete with those who were using 95 percent leverage," he notes. "We're starting to see REITs winning deals already. SL Green just captured the former Citigroup towers at 388 and 390 Greenwich St., a $1.5-billion deal. That's a bullish sign; those deals don't happen in a slow market. We've seen activity in all the major property types. Some hotels changed hands in the fall, and some major apartment complexes, and Louis Vuitton just bought the property right next to their headquarters on 57th Street. That was on off-market deal where they paid more than $3,000 per sf for 743 Fifth Ave.: a record price for that neighborhood."

Business is booming for life insurance companies and other portfolio lenders, Fasulo adds. These players had been forced to the sidelines in the middle years of the decade, but they're now at a point where they can get better terms for their money than they could when the CMBS market was king.

"Today, if you have the equity you can do business," he concludes. "The CMBS market will come back eventually, because it's such an efficient way to place debt—but it's not clear in what form it will return."

David Rosenberg, managing director of Meridian Capital Group, predicts that we'll see more debt structures of the type that were common in 2003-04, with debt service coverage no longer based on prospective cash flows.

"If you change the rules like that, it changes how you can borrow," he remarks. "If you can only borrow 65 percent or 70 percent, rather than 90 percent, you'd think prices would drift down, but in the core primary markets they're still pretty high."

Spencer Garfield, managing director of Hudson Realty Capital, predicts that property sales will be slow for the first half of 2008 at least, because the bid/ask gap to which Rosenberg alludes will take some time to close.

"The capital markets have seized up and financing is less available," he says, "so buy buyers are adjusting their prices down while sellers are looking for the same prices as previously. Thus there's a tremendous slow-down in the secondary market. A company like SL Green or Vornado that's less reliant on debt can still transact, but those who rely on high leverage low-interest financing will find it's no longer available."

Although Hudson often targets the higher-risk plays, Garfield warns that the current market demands a conservative approach. "So many people are saying the market fundamentals are strong," he says, "but excluding residential, I'm not so sure about that. Retail has been a darling for years, and recently there was a lot of building of retail that was meant to cater to residential developments—which are now not being built. Now more than ever you need to be careful about purchase price, cap rate and how much you can lease for what rent. I'd be very cautious."

RESIDENTIAL: "FULL STEAM AHEAD"

As for residential, the local market is still extremely strong, no matter how dire the conditions in the rest of the country. Diane M. Ramirez, president of Halstead Property, says she's going "full steam ahead" with developments and re-sales in Brooklyn and Queens.

"Strategy-wise, we don't expect to make any changes," she says. "The younger buyers are very strong. We have very little product available in the studio marketplace because lately, so many owners of larger apartments have been buying adjacent studios as additions. Our larger apartment market is extremely strong and the middle market is solid. First-time buyers very much want to be here, and the empty nesters are coming back."

Foreign buyers are also finding good value in the city, due to the weak dollar, Ramirez adds, and these are usually not investors, but people who want to spend time here.

RETAIL: CONTINUED HEALTH

Retail is going to stay perfectly healthy through 2008 as well, predicts Gary Alterman, senior vice president of Robert K. Futterman & Associates, due to steady demand for residential space and ever-increasing foreign tourism.

"Even when you build a million-sf office building, you're only adding one floor of retail, so this market doesn't get flooded with retail space," he explains. "Retail grows through the gentrification and cleanup of neighborhoods, and we're packed with tourists who come here more to shop than to go to museums."

You'll have the local shoppers coming back "when the dollar strengthens again," says Faith Hope Consolo, chair of Prudential Douglas Elliman's retail leasing and sales division. "This has always been the shopping capital and it is still a very healthy shopping market. Space is much sought after in SoHo, in the Meatpacking District and anywhere in Midtown."

Also, Consolo says, "The Lower East Side with all its new residential development will gain more retail. Even if there's a glitch and the stock market misbehaves, this is New York City and we always bounce back strong."

Alterman says he's especially excited about SoHo as an area of retail growth. "A couple years ago, retailers stopped just south of Prince Street," he elaborates. "Now they're working south to Canal Street. Soon SoHo's boundaries as a retail community will match its borders on the map. You'll see a lot of upper-middle to high-end retail: Cole Haan, Banana Republic and Coach, plus the European discount retailers like H&M and Zara that sell high fashion at good price points."

Possibly the best overall assessment of the metro area's real estate outlook comes from CBRE's Fiddle: "If you're in a car going 100 mph and you slow to 60 mph, it feels like you've stopped," he says. "But we haven't. We're still doing 60."