WILL THE NEW YEAR BRING NEW ACTIVITY?

By Nancy A. Ruhling
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ALTHOUGH THE MIDTOWN MARKET HAS ALL BUT BEEN SQUEEZED DRY BY A COMBINATION of complex downward-spiraling economic factors and the continuing aftershocks of 9/11, it is slowly starting to show signs of new life. While the overall availability rate currently stands at about 14%, rental rates have come down 40% from their highs in 1999 and 2000, making the area more competitive with Downtown, Midtown South, Long Island City, New Jersey, Westchester and Connecticut—areas where, in the name of diversification, major corporations started setting up satellites in earnest after the terrorist attacks.

"The Midtown market is stable," declares Stephen Sunderland, senior managing director of IGDNYC Inc. "Prices are off their recent lows as landlords start to trim free rent and work concessions. A number of pressures have subsided. The threat of corporate and city and state layoffs have largely ended. And shadow space—the space that has been vacated by major corporations not yet listed for rent because it would require them to recognize the loss in the current year—is being reduced through leasing recapture or withdrawal from the market as corporations are considering expansions."

While there are a handful of lease deals on the negotiating table, it will still take some time for supply/demand fundamentals to improve

Josh N. Kuriloff, EVP of Cushman & Wakefield, adds that the pace of large transactions [those encompassing 100,000 sf or more] has increased. During 2002, there were only nine. By October 2003, there were 14, he says, adding that he expected four or five more to close by year's end.

However, Kevin J. Danehy, senior managing director of CB Richard Ellis, says that although there had been signs of activity over the last couple of months of 2003, he is convinced that availability is at or near its high. "Negative net absorption continues to hover around five million sf for the second year in a row, with asking and taking rents continuing a three-year slide."

With some 241,664,816 sf of rentable space available in Midtown, 11% is vacant, according to CBRE stats. However, when the vacancy rate for sublease space—15%—is factored in, the average moves closer to 13%. Sublease space accounts for about 40% of total availability and even though it continues to decline as corporate downsizing wanes, the sublease supply is above the historical norms of 20% to 25%.

But the sublease factor may be less of a force to reckon with in 2004, says Frank Doyle, managing director in Jones Lang LaSalle's New York office. "Unlike the previous cycle, where sublease space was traded at a steep discount near the bottom of the cycle, much of the sublease space available in the market today is being offered by creditworthy tenants that can offer term. So the discount to direct space is not substantial."

Although rental rates are down, they have not dipped to severely unhealthy depths. Overall, Midtown recorded rents of $43.78 per sf in the 3Q of 2003, a decrease from $48.99 at the end of 2002, Doyle reports. Midtown class A rental rates averaged $46.99 a foot during the third quarter of 2003, down from $52.79 at the same time the previous year. Class B rents were $32.64 a sf, a drop from $35.82 recorded at the end of 2002.

Midtown is stable. Landlords are starting to trim free rent and work concessions.

STEPHEN SUNDERLAND
IGDNYC Inc.

This steady yet slow revival is just what the economists ordered, according to David J. Goldstein, executive managing director of Studley. "The market is healing slowly, which is healthy for the whole," he says. "Rental levels peaked in 1999 through 2000; that's when there were the lowest vacancies and the highest rates, but that wasn't a rational era. If the recovery goes too quickly, it can damage market fundamentals. If we compare this to the last downturn, this time the supply side is being driven by corporate excess. This is a more disciplined environment, no spec buildings are going up, corporate excess is driving it, not unsound business fundamentals."

Recent relocations and stalled projects have indeed slowed Midtown's recovery. The Bank of New York, for instance, has moved its back offices to a 396,000-sf tower at Atlantic Terminal in Downtown Brooklyn and is expected to move 1,400 employees by mid-2004; Morgan Stanley is moving 2,000 employees to the 725,000-sf former Texaco world HQ it bought in Harrison, NY in Westchester County; MetLife is moving 1,700 employees to Long Island City; New York Life Insurance Co. is considering moving 1,000 employees to Westchester; and Goldman Sachs may relocate some support staff to Jersey City. Finally, Wachovia Securities, which acquired Prudential in 2002, put 480,000 sf at 199 Water St. on the sublease market, and by 2005 is planning to sublease half of its 1.3 million feet at 1 New York Plaza.

"These are body blows, but they are not going to put anyone on the canvas," Goldstein says. "The general pace of transactions is increasing. There is more tire kicking. More tenants are getting into the market as a defensive measure because they think rents could rise. Sophisticated tenants are looking for long-term contracts. Large tenants require flexibility—the rights of first offer, the right to grow, the right to terminate or shed space—which is achievable in this market."

In addition, a notable portion of newly constructed space in Midtown has remained empty. At Boston Properties' Times Square Tower, which was left in the lurch when anchor tenant Andersen backed out of its commitment about a year-and-a-half ago, leases have been signed for only 300,000 of its 1.1 million sf. In addition, 700,000 sf at Macklowe Properties' 340 Madison Ave.; 180,000 sf at Vornado Realty Trust's

Pfizer Inc. has driven many Midtown deals. The firm may be striking a deal for Con Edison-owned land on the East Side. It also leases 155,276 feet at 204 East 42nd St. and 664,638 sf at 150 East 42nd St., pictured above.

Bloomberg LP HQ tower at Lexington Avenue and 59th Street; and 140,000 sf at Vornado's 640 Fifth Ave. property are awaiting tenants.

But Kuriloff says that this space will be the first to lease up. "There always are advantages to new construction. In New York, it takes two to three years to build new buildings, so we're not going to see any new buildings for a while."

The downturn is further exacerbated by the fact that some commercial buildings like Trump West Side have been converted to residential use.

"But there is light at the end of the tunnel for Midtown," Sunderland assures. "With corporate downsizing slowing and the majority of firms now profitable, the potential for hiring in Manhattan could cause rental prices to bounce back from their recent historic lows."

Danehy concurs, adding that the most recent figures released by CBRE bear this out. In September 2003, the Midtown leasing of nearly 1.3 million sf of space slightly outpaced the five-year average of 1.2 million sf. And Midtown's cumulative year-to-date leasing total of 8.1 million feet is a 3.9% increase over the 7.8 million for the first nine months of 2002 but still short of the 8.3 million sf leased through the same period of 2001.

Furthermore, Goldstein notes, negotiated concessions have held steady instead of increasing. Tenants in Midtown still can expect to procure nine to 15 months of free rent on a 10- to 15-year lease.

Deutsche Bank recently subleased 380,000 sf to Clifford Chance US LLP, while American Express and Bank of America have announced that they are moving employees who were relocated to New Jersey [after 9/11] back to Lower Manhattan. Also, Pfizer Inc., which owns its 670,962-sf headquarters at 235 East 42nd St. and the adjacent 300,000 sf at 219 East 42nd St. may be close to a deal with Fisher Brothers, Sheldon Solow and Morgan Stanley for a new two-million-sf skyscraper to be built on land they are buying from Con Edison on 42nd Street. Meanwhile, Pfizer leases 155,276 feet next door at 204 East 42nd St., as well as 664,638 sf at 150 East 42nd St.

Major leases recently signed in the Midtown market include the Associated Press' 290,000-sf commitment at 450 West 33rd St., a space vacated by DoubleClick. The AP movedto the Daily News Building from 50 Rockefeller Center. In addition, Time Warner commited to relocate from 75 Rockefeller to the Time Warner Center at 10 Columbus Circle, leaving half of 75 Rockefeller Center up for sublease.

But there is some good news for the Rock Center corridor. A new start-up insurance provider Quanta US Holdings Inc.— a subsidiary of Bermuda-based holding company Quanta Capital Holdings Ltd.— has committed to a 57,000-sf lease at 10 Rockefeller Plaza. CB Richard Ellis' Richard Bernstein and Cushman & Wakefield's Kuriloff collaborated to negotiate the 15-year deal, while Calvin Farley and Blythe Kinsler negotiated on behalf of landlord Tishman Speyer Properties LLP. The deal is being hailed by the brokerage team as a sign of better things to come in Midtown.

According to Danehy, the Plaza District is holding its own, but still suffers from high availabilities, relative to conditions in the rest of Manhattan.

This time the supply side is being driven by corporate excess.

David J. Goldstein
Studley

Drew O'Malley, principal of Trammell Crow's New York City office, says that the Grand Central submarket, where the availability rate of 15.5% outpaces Manhattan's overall rate by 1.5%, is still struggling. "The particularly high availability rate is attributed to the status of buildings such as 140 East 45th St., 300 Madison Ave. and 340 Madison Ave.," he says. "These buildings, which are seeking commitments from anchor tenants, are marketing blocks of contiguous space in excess of 400,000 rentable sf, respectively."

Midtown leasing activity during the third quarter of 2003 showed that 32% of the tenants agreeing to space were manufacturing companies. Legal firms constituted 14.3% of the activity and financial services made up 11%.

Doyle claims that leasing activity has just recently begun to increase. "While sublease space continues to trickle onto the market, the number of firms exploring renewals and expansions has increased. There has actually been a flurry of activity in the market in the past several months. In particular, we are seeing major commitments from law firms, which have been the most active market participant in commercial leasing in 2003, outpacing financial services firms, typically the most active tenant in New York City."

Goldstein, noting that there are several major law firm deals in the works, is not surprised that companies are returning to Midtown even though the direct rental rates in Lower Manhattan, which are averaging $35 a foot, are less costly. "There aren't too many significant tenants moving Downtown," he says. "Only a select few have done it, because Midtown tenants don't locate via price, and Downtown is converting office space to apartment space."

Sunderland, however, says that Downtown is still a formidable competitor for Midtown tenants. He adds that Midtown West and Long Island City will continue "to offer cheaper and more convenient back offices than New Jersey, Westchester and Connecticut."

NYC's job growth in office-sector industries has outpaced growth at the national level.

Frank Doyle
Jones Lang LaSalle

Developer Edward Minskoff, Sunderland points out, is planning a 15-story, 655,000-sf office building at 30-30 Northern Blvd. in Long Island City, where back office rents effectively would be $17 per sf. "That's less than half the Midtown rate," he notes.

While soft rents are beginning to build more muscle, the sale prices for class A office towers have remained historically high. "Interest rates are low, so buildings are trading slightly above the bond rates and prices of alternate uses such as residential or hotel conversions are high," Sunderland says. "German pension funds have been major

Quanta US Holdings has inked a 57,000-sf lease at 10 Rockefeller Plaza, giving the Rock Center corridor a lift. Pictured above is Rock Center.

At the Times Square Tower, leases have been signed for 300,000 sf of its 1.1 million sf.

recent investors due to their low cost of capital."

Danehy points out that with over $6 billion either sold or under contract throughout Manhattan, and over $3 billion in the pipeline, class A sales through the end of '03 produced an average price per sf that is $100 higher than last year's $340. "The mark is on pace to eclipse 2002's total sales volume of $7.4 billion by nearly 25% and 2001's total sales volume of $7.6 billion by nearly 20%, excluding the World Trade Center lease," he says.

Fully leased properties in Midtown continue to trade at high levels. "Harry Macklowe just bought the GM Building for $1.4 billion, which translates to $800 a sf, a record sale price for a new building," Sunderland says. "The building last sold in 1998 for $878 million. The previous record-setting building sale was Lehman Brothers' purchase of 745 Fifth Ave. for $700 per sf."

Even assets with low occupancy rates are fetching top dollar. As an example, Reckson Associates Realty of Melville, NY recently purchased 1185 Ave. of the Americas for $321 million. Upon closing, Reckson will assume $202 million in mortgage debt and $48 million in mezzanine debt. According to Scott Rechler, Reckson's CEO and president, the 1.1-million-sf building is in a "state of transition" right now, with one of its largest tenants in bankruptcy. The property is also encumbered by a ground lease that has a remaining term of 40 years with rent scheduled to be re-set to market at the end of 2005 and then remain flat for the balance of the term. The REIT plans to begin major infrastructure improvements in the 24-story asset to help boost occupancy levels.

New Midtown construction projects that were green-lighted during the course of 2003 included: the Hearst Corp.'s 48-story, 856,000-sf tower at 959 Eighth Ave. at 57th Street; Bank of America's 2.1-million-sf headquarters at 42nd Street and Sixth Avenue; The New York Times' 52-story, 1.5-million-sf headquarters at Eighth Avenue in Times Square, across from the Port Authority bus terminal. Yet new construction slated for other markets will take its toll on Midtown. Such new product planned includes InterActive Corp.'s new headquarters in Chelsea and the 1.7-million-sf 7 World Trade Center in Lower Manhattan.

"Demand is starting to pick up, not dramatically but noticeably," Goldstein says of Midtown. "Certain tenants have been warehousing space because they laid off workers, consolidated or merged, but they have been holding the space. Over the next two to three years, they will need the space."

But Kuriloff points out that even though there has been some job growth fueling the Midtown recovery, corporations will not necessarily be looking for more—or even the same amount of space for that matter. "There will be less demand for space as corporations look toward 'densifying' space," he says. "This varies industry-by-industry in terms of space allotted per person. They are trying to get more people into less space, trying to bring down overall space 10% to 20%. They are creating more collaborative spaces instead of big spaces for private offices."

Another key project is one that is still on the drawing boards: the planned rezoning of Midtown West's Hudson Yards, which is bordered by West 28th Street to the south, Eighth Avenue to the east, West 43rd Street to the north and the Hudson River to the west.

"This is one of the most audacious projects to come along in recent years," Sunderland says, adding that the rezoning will open up 30 million to 40 million sf for new hotels, offices, housing, exhibition space and sports complexes in the next two decades.

That rezoning is one of many changes, including affordable housing and quality education that Sunderland sees as imperative to continued vibrancy in the Midtown commercial market.

The high availability is attributed to 140 East 45th St., 300 Madison and 340 Madison.

DREW O'MALLEY
Trammell Crow Co.

Significant changes he advocates include: extending the No. 7 train to the Jacob Javits Convention Center; linking the Grand Central terminal to the Long Island Rail Road at Penn Station; creating incentives to get the car and truck traffic to bypass Manhattan; alleviating weekday truck traffic by offering train and seaway transportation and night and weekend deliveries; encouraging businesses in Midtown and other parts of Manhattan to help support schools via financial aid and mentoring programs to improve the quality of education; rezoning Midtown to increase its housing density to lower housing costs; and building a new stadium.

While Midtown in general has shown signs of improvement, Doyle points to Midtown South as a market where fundamentals have proven to be even stronger, based on statistics. The vacancy rate was 10.7% in the third quarter of 2003, down from 12% the previous quarter and from the 11.5% year-end rate posted in 2002. Nonetheless, rents in that neighboring market have been inching downward. Overall, average rental rate fell from $32.77 per sf at the end of 2002 to $30.10 in the third quarter of 2003.

But, when the big picture is taken into consideration, local brokers say that one thing is certain: Midtown will rise from the ashes, but no one knows for certain exactly when this will occur.

Corporate downsizings and relocation decisions that deflated Midtown were made months ago, Danehy says, and are no indication of where the currently stabilizing market is headed.

The direction in which Midtown will be heading depends largely upon where the rest of the country ends up, says Doyle. "NYC's job growth in office-sector industries has outpaced the growth at the national level in October/November 2003," he says. "A significant number of factors—interest rates, currency rates, business and consumer confidence levels—will dictate whether firms choose to expand here or elsewhere."

When Kuriloff looks into his crystal ball, he sees stabilization in Midtown through 2004, "with some growth in the fourth quarter and much more positive growth through 2005."

But smart players are entering the market now, Goldstein says. "The fundamentals still exist to cut a great deal in Midtown," he says. "Over the next six to nine months, expect to see some significant deals. But the market needs to heal and improve, and there's still a ways to go." —RENY