



Objective analysis for tenants in Manhattan's current office market

In this paper, Savills Studley describes the varying perspectives of tenants, landlords, landlord agents and tenant advisors on Manhattan's current office market, reviews the macroeconomic conditions and offers advice to executives operating in the current environment.

We have included an executive summary and the full paper.

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Executive Summary

Varying Perspectives

The Tenant Perspective

Tenants face the challenge of not only managing the complex lease negotiation process, but knowing the best time to strike a deal. They must understand market conditions or depend on a landlord, landlord agent or tenant advisor for advice.

The Landlord Perspective

Landlords have a variety of reasons to see markets perpetually going up. Their lease negotiations, lender underwriting and terminal values all improve in a rising market. Their debt creates leverage that improves returns in a rising market, but penalizes their proforma proportionally when markets fall. Landlords do everything that they can to keep rents up including increasing concessions first when markets begin to decline. This non-public change masks the inflection point that occurs when markets begin to decline.

The Landlord Agent Perspective

Landlords hire agents who will echo and amplify their perspective on the market. Conflicted brokerage firms (firms that represent both landlord and the tenant) have an incentive to adopt the landlord's perspective in their public pronouncements. Many conflicted brokerage firms indicate that they "arrange" transactions between a landlord and a tenant. This implies there is an ideal solution where tenants and landlords both win. However, this is not the case, because real estate transactions are a zero-sum game. Every dollar that rent is reduced or tenant improvement or free rent is increased is a win for the tenant.

The Tenant Advisor Perspective

A firm that only provides tenant advisory services needs to have an objective view of the market. Sometimes the best advice for the tenant is to wait. Missing either inflection point in a market hurts their client – either by hurrying in a downward-trending market or moving too slowly when rents rise. In any market, tenants should be active, organized and prepared to strike when the right opportunity presents itself – this is particularly true at the point of inflection which we believe is happening now.

Current Macroeconomic Conditions

Demand Deficiency – A Structural Change

Manhattan is experiencing a demand shortfall because of a structural shift in how much space companies are dedicating per employee. Space per employee continues to decline as greater efficiency in the use of office space has become standard for Manhattan's banks, law firms and general professional/business services.

Scenario Planning: Slowdown in Jobs

Space utilization has declined as employment has risen. During 2012-2017, payroll growth was 2.5% annually. However, the most recent projections from New York City's Independent Budget Office (IBO) are calling for payroll growth in the 1% range for the period 2017-2021.

Positive Feedback Loop

While the contraction of demand puts a lot of pressure on landlords, it is a positive feedback loop for tenants. As more businesses streamline and densify, it opens up space options for other tenants.

Supply – a Slow but Steady Ascent

The fourth quarter of 2016 brought a preview of the sharper jump in the availability rate that is likely to persist in 2017 and 2018. Availability jumped by 50 basis points in Manhattan in the fourth quarter of 2016. During the first half of 2017, availability was flat. Moderate increases are expected in the second half of the year. The second quarter availability does not yet include 7.1 million square feet of space that tenants have already announced their intention to vacate and 5.6 million square feet of unleased space in buildings under construction. This alone will add 2.8 % generally to the availability rate and 5.5 % generally to the Class A availability rate. Additionally, the amount of space available that companies are seeking to sublet has been rising.

Rent Starting to Decline

Even though demand has been decreasing for the last two years, asking rent has only recently – in the final quarter of 2016 – shown signs of declining. The clearest changes have occurred at the top and the lower-end of the market. Manhattan's most expensive submarket, the Plaza District, registered a decline in asking rent of more than 10% during 2016. Concession packages increased 10.2% to \$167.41 per square foot (a new record) in Class A buildings. Additionally, landlords leasing commodity space in less desirable locations, such as Third Avenue and outdated buildings along Avenue of the Americas, have started to decrease asking rent as well.

Advice to Executives

With a growing number of Manhattan's landlords scrambling to shore up their tenant rosters, now is the time for companies to get organized. In this market, tenants can take time to evaluate and compare a wide array of spaces. Companies can gain leverage and put pressure on their landlord by declaring their needs and objectives to the marketplace.

Hidden opportunities for tenants are already available, even in properties that appear to be fully occupied. Landlords with extensive portfolio vacancy, looming lease expirations or debt obligations coming due are eager to get out in front of market conditions that will continue to slowly give tenants more leverage.

Considering the financial and cultural impact real estate decisions have on organizations, executives cannot afford to surrender their space-use choices to advisors with any form of cognitive bias. Data-driven analysis and fact-based conclusions are needed to avoid pitfalls and missed opportunities, particularly during uncertain times. When the market inflects, opportunity beckons, especially for those with the right advisors.

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Full Paper

Conflicted brokerage firms (firms that represent both landlord and the tenant) have an incentive to adopt the landlord's perspective

Tenants Face a Long List of Challenges

Leasing office space in Manhattan is a daunting endeavor. Executives tasked with securing space may feel as though they are running through a gauntlet. One must secure space that provides the best balance of prestige, comfort and functionality and in a convenient location. All of this must be orchestrated with a minimal amount of disruption, on time and on budget. Finally, in the last few years, new considerations such as workplace strategy and sustainability have been added to many firms' requirements.

However, executives charged with this responsibility can take some comfort – recent trends indicate that real estate market conditions in Manhattan are shifting in their favor. In fact, the supply-demand equation began to lean in tenants' favor for certain individual buildings and landlords in 2015. It spread across more of Midtown's Class A market in 2016 and will be even more favorable in 2017. With the exception of tenants in Midtown South, most occupiers are no longer vying with several other tenants for the same space. Rather, it is the landlords who are increasingly competing with each other to differentiate their space and secure long-term leases.

The Landlord View

Executives about to embark on a space search are faced with two fundamental problems. First how do they know with relative certainty when market conditions shift, second when the market state is unclear, does the market research have "confirmation" bias? Confirmation bias is a term behavioral economists use to describe the disproportionate reliance on facts that support preexisting opinions. In our experience, research in real estate is rife with this bias, as landlord-focused organizations search for any support for rising markets, sometimes in the face of compelling



evidence to the contrary. Distorted representations of market conditions add to the challenges. Executives will not realize opportunities to gain more leverage – particularly if they are represented by a brokerage firm which also has to fulfill the expectations of those landlords their firm also represents. Most owners and their broker representatives will not acknowledge to the occupier-side, or anyone else for that matter, that market fundamentals are in flux until well after the adjustment has already become apparent. Landlords and their brokers have a different set of objectives: secure the highest rent possible, as quickly as possible. This perspective is very often the “street or consensus view” that dominates headlines and market analysis. Demand is always rising. Even when it is falling, it is about to rebound. Rental rate growth is inevitable and this biased view results in biased advice, usually along the lines of “move rapidly to beat the rising market.” This thought process results in boom and bust overbuilding and highly visible bankruptcies and foreclosures in all downturns.

“Cushman has “measured optimism” that the Trump administration, through deregulation, may “stimulate” more employment growth in the financial-services sector, which is a critical sector to New York City.”

Cushman & Wakefield, Chief Economist
(January 2017 – Bloomberg News)

“With the presidential election over, tenants may have more confidence to make moves, and there’s hope that financial services firms will become more active if Donald Trump’s administration eases regulations. If we had some growth, any growth, from the banks, that would be a positive for the market.”

JLL, Director of Research
(January 2017 – Bloomberg News)

“The lesson here is that, despite reports of economic changes and anticipated additional future supply of office space, the future supply in Manhattan is leasing fast. The world is not coming to an end, the economic future is strong.”

CBRE, Vice Chairman
(March 2017 – Bisnow)

Landlord / Landlord Agent View

- No concern over the amount of new construction because it is already pre-leased
- Demand is always rising or about to rebound
- Focus on exceptional deals or top-performing buildings
- Rents will inevitably push higher
- Advice to tenant: time is of the essence, lease before space disappears or rents rise

Tenant Advisor View

- New construction is available plus the space being vacated by the tenants moving to new construction substantially increases availability moving forward
- Recognition of structural changes in demand – “densification”
- Nuanced assessment of micro-market and building-level demand factors
- Effective rent provides better gauge of conditions; don’t buy the hype of face rent
- Advice to tenant: align strategy to reality of current level of demand, competition and landlord – sometimes the right answer is to be well-prepared, but wait

Landlords also claim an “insider” view — an exclusive understanding of the level of activity based on traffic in their buildings.

“Well, with all due respect to the brokers community, they frequently have a point of view that’s either in their research reports that are trailing statistics ... The owners I think are the better source of insight because we have a good visibility as to the deals that are actually getting signed, the term sheets that we’re considering versus other – one deal versus another. And have a broader perspective as to the types of businesses that are coming through our door. Whether they’d be floor activity, proposal activity or actual leases that we’re signing... we’ll see how the year unfolds but we’re still feeling very strong.”

SL Green, EVP/Director of Leasing
(January 25, 2017 – Earnings Conference Call)



Landlords do know their portfolio best, but both in Manhattan and in general, they individually own only a small fraction of the market and do not have a broad perspective. Additionally, even if they do sense that a correction may be imminent, they have incentives not to admit it.

Repeat Performance

It is telling that the nation's largest landlord representative firms portray the market in a way that reads almost like a script – “demand is always rising” or “a rebound is imminent.” We heard it up to the very edge of the 2008 collapse. Even as Lehman Brothers and Bear Stearns were in the midst of collapse, executives from some of these conflicted brokerages expressed their bullishness on the New York real estate market.

“We live in a space starved city. Despite the state of the economy and despite problems in the financial services industry, you’re still seeing space leased in Manhattan at very high prices.”

Cushman & Wakefield, Chief Operating Officer – NYC Metro region
(July 2008 – The Globe & Mail)

“The perception is this market is dead and dying and that’s not true. There are still deals being signed at numbers that will boggle your mind.”

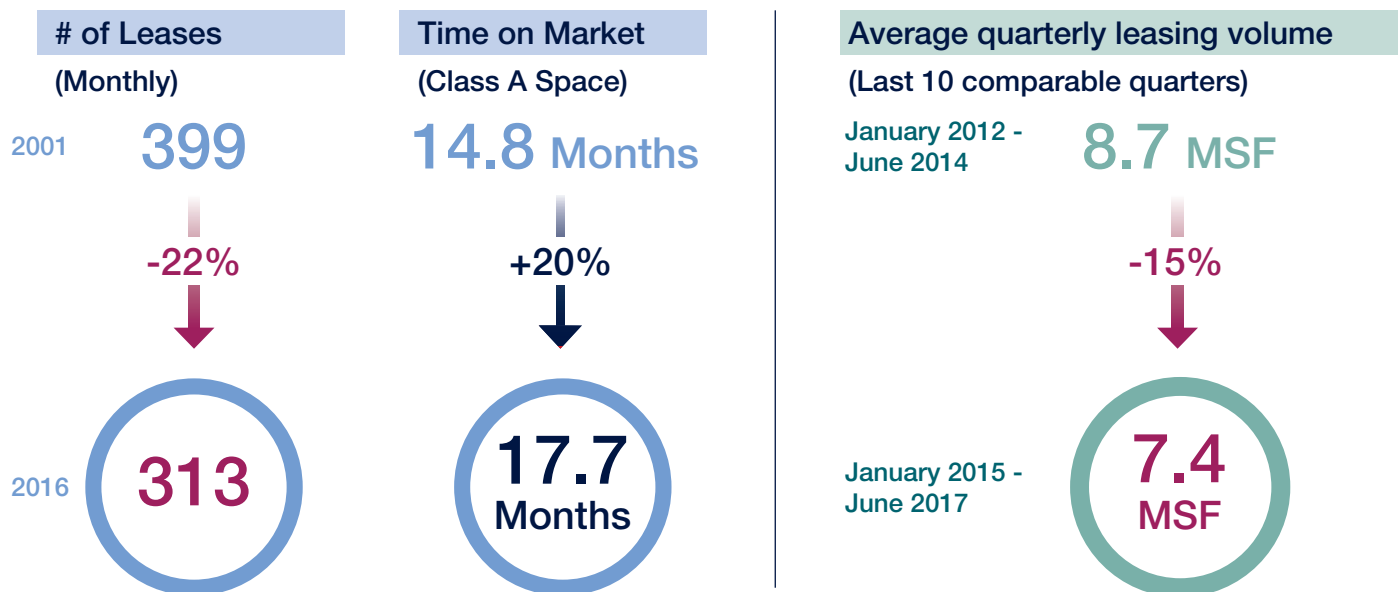
CBRE, Chairman of Global Brokerage
(October 2008 – The New York Observer)

Companies that signed a \$100+ per square foot rent in 2008 probably wished that they had waited a bit longer.

Jawboning the Market, Creating a Sense of Urgency

The “rush to market” view can be seen even today, despite the fact that leasing that has been running well below its long-term average since year-end 2014. Landlords try to persuade or pressure tenants with their overly optimistic view of the market. They discount the recent reduction of demand and highlight the potential for, say, a post-election jump in activity. They are again counting on the banking industry – hoping that a rebound in this sector will bail the market out of its current demand shortfall.

Demand Dynamics



Source: Savills Studley

The change from a landlord-favorable market to one that is more tenant-favorable has been an unusually gradual process. Deal volume has been below historical average and the time that space is on the market has increased. Deal volume has been running about 15% below its quarterly average since the first quarter of 2015. The number of leases has also dipped – with an average of just over 300 leases per month in the last 12 months, compared to the long-term average of just under 400 leases per month. Success in Midtown South, coupled with leasing momentum in Hudson Yards and Lower Manhattan, has overshadowed the reality that overall leasing in Manhattan is down on multiple counts, despite accounts to the contrary.



Demand Deficiency – A Structural Change

Manhattan is experiencing a demand shortfall because of a structural shift in how much space companies are dedicating per employee. Space per employee continues to decline as greater efficiency in the use of office space has become standard for Manhattan's banks, law firms and general professional/business services. As the relationship between occupied space and office employment continues to change, there is no evidence that all "densification" possible has already taken place.

There is also no reason to expect firms to reverse course and start allocating higher square footage per employee in future cycles. Many banks, law firms, publishing companies and general professional/business services companies have shed as much as 20% of their space, as they restructure their lease or relocate.

Some landlord-focused firms postulate without evidence that space densification as a trend has run its course.

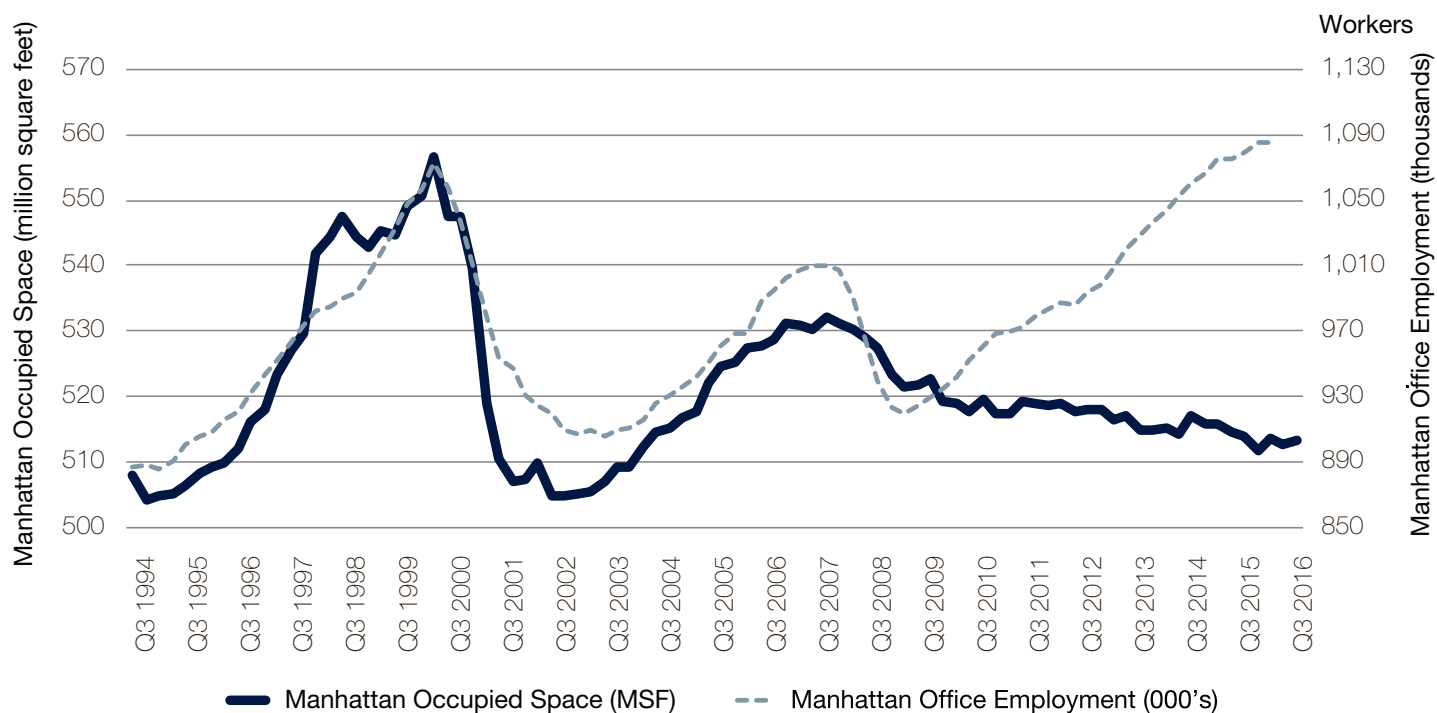
"Well, corporations are always hesitant during periods of uncertainty, but our sense is that people are fairly optimistic and they're beginning to spend more money. Last couple of years, a lot of companies have looked to extract savings through compression and densification and consolidation. A lot of that has been done. And a lot of companies are looking to grow and expand in areas that they might have thought about before."

Newmark, CEO

(February 2017 – Q4 Earnings Call)

Looking at the chart below, the contraction in demand is obvious. In periods prior to 2009, jobs and occupied office space have remained highly correlated. Since 2009, New York City has gained more than 150,000 office-using jobs, but the amount of space occupied in the same period has actually decreased by approximately 8 million square feet (msf).

Manhattan Occupied Office Space and Office-Using Employment

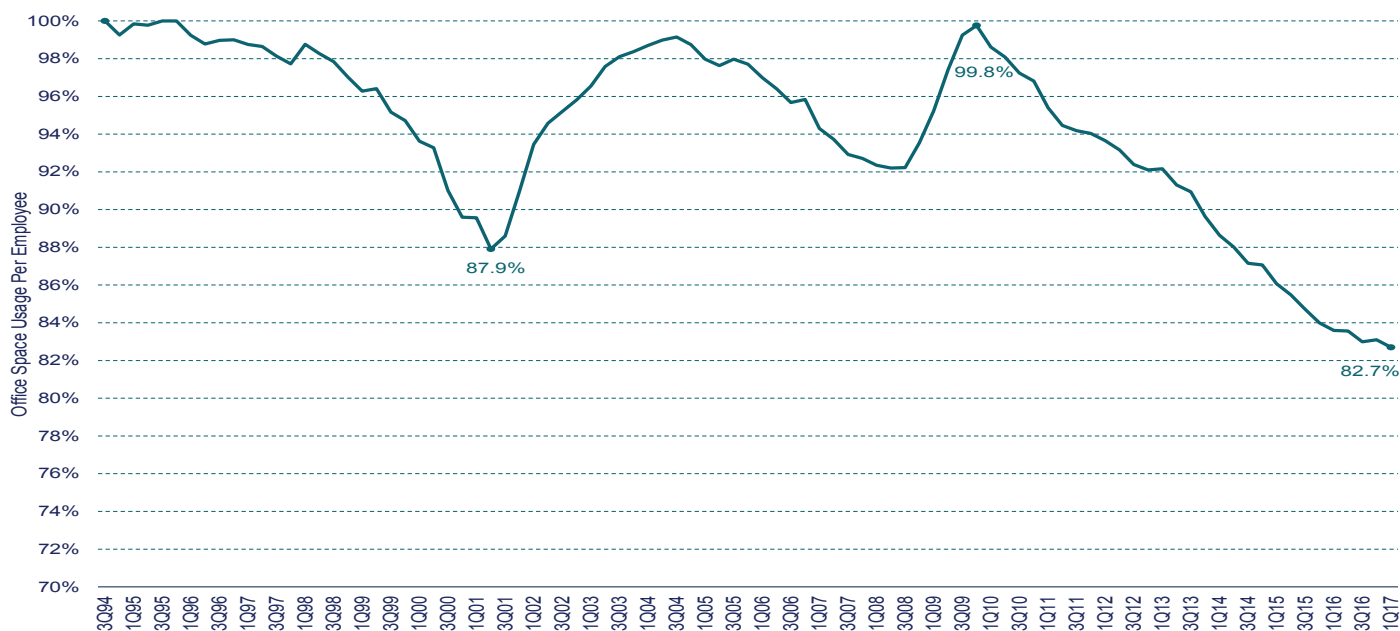


Source: Savills Studley, CoStar and BLS



The figures below indicate that there has been no change in the role of compression that has occurred since 2009.

Office Space Usage Per Employee (3Q94 – 1Q17)



Source: Savills Studley Research

Bullish market analysts are banking on a rebound in the financial sector and an unleashing of demand in the wake of November's election results. We, on the other hand see no material improvement in the below historical average demand. Additionally, any positive impact from a pro-growth Trump agenda is not likely to have a material impact on the market because of space efficiency efforts by tenants, which we see continuing.

Conversely, while the likelihood of a market correction increases in 2018 through 2020, we do not anticipate a contraction anywhere near the scale of the post-Lehman fallout. Timing this market requires diligence as the advantages of waiting will likely not be as great as waiting from 2008 to 2009.

Just as every tenant has a different set of requirements and goals, every market cycle is unique. Excluding Midtown South, this cycle brought slow but steady growth between 2010 and 2014. Manhattan's office market is clearly shifting more in tenant's favor since year-end 2014, but not as sharply as in 2008 or even 2001.

*In all markets,
preparation and
readiness are crucial.
“Fortune favors the
well prepared” and
this is true for tenants*



Tenant Advisor View

A real estate advisory firm focused on fulfilling the needs of tenants should have a more objective perspective on the market – Savills Studley monitors conditions and asks, “What opportunities and challenges do current and expected conditions create for clients?”

In all markets, preparation and readiness are crucial. “Fortune favors the well prepared” and this is true for tenants. Understanding programmatic space needs, having a quantitative view on future needs and having a thoroughly-vetted financial model all make it possible to optimize strategic moves in shifting market conditions.

In tight and challenging locations, there truly is a need for tenants to be nimble and aggressive. When and where conditions are softening, tenants need to be advised how their increased leverage enables them to shift strategies. Experienced tenant advisors can spot when landlords are starting to stretch to get deals done – well before headlines or face rents make market conditions common knowledge within the industry. Sensitivity analysis and scenario planning – common in American industry – needs to be employed by tenants in markets where demand and price are both uncertain.

Scenario Planning: Slowdown in Jobs

Space utilization has declined as employment has risen. What would happen if employment continues on a subpar pace (i.e., less than 20,000 office jobs gained per year) or if employment growth turns negative in 2018 or years after? The most recent projections from New York City’s Independent Budget Office (IBO) are calling for payroll growth in the 1% range for the period 2017-2021.

IBO Estimates of New York City Payroll Growth



Source: NYC IBO and BLS

Positive Feedback Loop

While the contraction of demand puts a lot of pressure on landlords, it is a positive feedback loop for tenants. As more businesses streamline and densify, it opens up space options for other tenants. Additionally, the biggest real estate development pipeline since the 1980s has set the stage for optimal space efficiency. Relocations to more efficiently-configured new buildings have left behind gaping holes in the existing properties, leaving landlords with a daunting challenge of their own – particularly for buildings that have an outdated floor configuration.

The table below details significant relocations over the prior five years. The net result of these moves was a reduction of 1.16 million square feet, or 10%. Also note that Midtown lost almost 9 million square feet from these moves, with Hudson Yards and Downtown each as beneficiaries.

Relocations of 100,000+ RSF from 2013-2017

MOVE TO	DOWNTOWN	MIDTOWN	MIDTOWN SOUTH	HUDSON YARDS	TOTAL
# of Occurrences	12	5	1	14	32
Total Square Footage	3,653,983	852,611	547,996	5,543,426	10,598,016
MOVE FROM	DOWNTOWN	MIDTOWN	MIDTOWN SOUTH	HUDSON YARDS	TOTAL
# of Occurrences	2	22	6	2	32
Total Square Footage	499,354	9,834,248	916,089	512,000	11,761,691
NET TOTAL	DOWNTOWN	MIDTOWN	MIDTOWN SOUTH	HUDSON YARDS	TOTAL
# of Occurrences	10	-17	-5	11	
Total Square Footage	3,051,609	-8,981,637	-368,093	4,900,426	-1,163,675

Supply – a Slow but Steady Ascent

The fourth quarter of 2016 brought a preview of the sharper jump in the availability rate that is likely to persist in 2017 and 2018. Availability jumped by 50 basis points in Manhattan in the fourth quarter of 2016. During the first half of 2017, availability was flat. Moderate increases are expected in the second half of the year. The second quarter availability does not yet include 7.1 million square feet of space that tenants have already announced their intention to vacate and 5.6 million square feet of unleased space in buildings under construction. This alone will add 2.8 % generally to the availability rate and 5.5 % generally to the Class A availability rate.

Additionally, the amount of space available that companies are seeking to sublet has been rising. Available sublet space rose from 8.4 million square feet at the start of 2016 to 10.4 million square feet in December – an increase of more than 25%. Compared to year-end 2009, when sublet space totaled 17.3 million square feet, this current level is still relatively modest.

Rent Starting to Decline

Even though demand has been decreasing for the last two years, asking rent has only recently – in the final quarter of 2016 – shown signs of declining. The clearest changes have occurred at the top and the lower-end of the market. Manhattan's most expensive submarket, the Plaza District, registered a decline in asking rent of more than 10% during 2016. Additionally, landlords leasing commodity space (space on lower floors) in less desirable locations, such as Third Avenue and outdated buildings along Avenue of the Americas, have started to decrease asking rent as well.

The top end of the market includes instances of \$100+ per square foot rents, but in the last few years, these leases have been signed almost exclusively by tenants in “trophy” buildings. Moreover, the number of \$100+ per square foot rents has declined in this cycle as compared to the previous cycle. Tenants have been displaying price sensitivity and pursuing value-plays. Base and mid-rise floors have gone first: at the newest towers at Hudson Yards, in renovated buildings (28 Liberty, Brookfield Place, 1271 Avenue of the Americas) and in big blocks.



Although the top of the market has seen recent rent compression, the floor for the market (the lowest rents) has increased in this cycle. Finding \$40 per square foot space is nearly impossible. The dearth of this space has spurred demand for space in Jersey City, Brooklyn and Queens. In addition to new challenges from a flight to quality (to Hudson Yards and Lower Manhattan), landlords of older buildings now face the strong challenges from alternatives in NJ and the boroughs.

Asking rent trends can also send misleading signals to tenants. Less than 20% of the space listed in Manhattan for lease in CoStar (the industry standard for listing office market space) has a published asking rent.

What's Behind the Asking Rent in Trophy Buildings?

Asking rent is just the starting point for negotiations. The final deal terms (the actual taking rent and concessions) provide the true measure of how much landlords are shifting from their original ask. Concession packages include rent abatements (free rent) and tenant improvement allowances – cash the landlord will contribute to building out the tenants' space.

The Savills Studley proprietary database of lease comparables contains data on these negotiated lease terms. An analysis of leases completed in the last year shows that landlords became more aggressive as 2016 progressed, particularly in terms of tenant improvement allowances. Concession packages increased in 2016 to \$167.41 per square foot (a new record) which was 10.2% above the prior year. A Class A tenant's effective rent increased 13.1% and 10.4% in 2014 and 2015 respectively, but only 1.1% in 2016.



\$103.32

Taking First Year
Gross Rent (Midtown)

+2.9% Year-on Year

\$81.45

Tenant Effective Rent

+1.1% Year-on Year

\$167.41

Concessions

+10.2% Year-on Year

So what should a tenant do in Manhattan's current office market?

With a growing number of Manhattan's landlords scrambling to shore up their tenant rosters, now is the time for companies to get organized. In this market, tenants can take time to evaluate and compare a wide array of spaces. Companies can gain leverage and put pressure on their landlord by declaring their needs and objectives to the marketplace. Given current conditions, it will become increasingly possible for tenants to both meet their basic needs (enough space, within budget), and also to accomplish goals like obtaining a prestigious address, finding highly efficient floorplans and acquiring concessions to greatly reduce the cost of relocation.

Have we seen the bottom – no. In this cycle, all submarkets will not react in the same way. While some markets, Midtown South and Hudson Yards, will remain landlord favorable, others like Plaza District and Third Avenue will continue to move in a more tenant-favorable way. Although readiness is important, for many tenants without an immediate lease expiration, the best strategy might be to wait 6, 12 or even 18 months. If a tenant's decision is driven by a lease expiration or an immediate need to expand, here are some thoughts about maximizing leverage.

Hidden opportunities for tenants are already available, even in properties that appear to be fully occupied. Landlords with extensive portfolio vacancy, looming lease expirations or debt obligations coming due are eager to get out in front of market conditions that will continue to slowly give tenants more leverage. Buildings that seem to have ironclad cash flow sometimes have hidden tenant and revenue vulnerability depending on lease rollover. In addition, landlords have hold/sell or debt mandates depending on the property's capital stack. Tenants need to be mindful that in the absence of a market-wide fallout in pricing, (which we do not anticipate happening), rent and concessions will vary dramatically among landlords or among buildings.

While the window of opportunity for generous deals is already open in some buildings, in others it will take a bit more time for space and options to expand. Renewals, early restructures and lease extensions are back on the table. Consequently, this market can provide favorable options even for

firms that do not have a lease rollover for another 18 to 36 months. That said, compared to the last cycle in 2009, this market will be tricky to time. There was value to be gained by delaying signing a lease in 2008, 2009 and 2010.

However, unlike the last cycle, the bottom of this market is not expected to fall out.

Considering the financial and cultural impact real estate decisions have on organizations, executives cannot afford to surrender their space-use choices to advisors with any form of cognitive bias. Data-driven analysis and fact-based conclusions are needed to avoid pitfalls and missed opportunities, particularly during uncertain times. When the market inflects, opportunity beckons, especially for those with the right advisors.