

Andrew Simon's speech from the Global Market Review seminar

The following is a slightly abridged version of the speech Andrew Simon, Executive Managing Director of NAI Global, New York City office, presented at the Global Market Review seminar on February 5, 2009. At the time of the posting of this speech, the referenced pending sale of 1540 Broadway is rumored to have fallen through.

Andrew Simon. Feb 5, 2009 - During the time period between 2005 and 2007, NYC experienced an unprecedented level of activity and pricing. In 2005, approximately \$22B of investment sales activity occurred in Manhattan, at the time a new record. The next two years saw activity increase to \$30B in 2006 and then, in 2007 to \$47B. In 2008, activity dropped to \$19B, a roughly 60% drop, and the vast majority of these transactions occurred in the first half of the year, or shortly thereafter, after having gone to contract in the first half. Of this amount, a large portion was attributed to the former Equity Office Properties/Macklowe portfolio which was being sold off by Deutsche Bank, the lead lender. These deals were made at a discount of close to 20% from the price paid by Macklowe in the first Q. of 2007, in spite of the fact that Deutsche Bank was offering back financing to prospective buyers. The last two of these Macklowe/Deutsche properties, Worldwide Plaza and 1540 Broadway, were in discussion to be acquired for \$2B as recently as August, and a deal had been agreed to. After the collapse of Lehman Brothers on September 15th, the sale fell apart. The major obstacle to the deal was the fact that a large lease transaction to fill up a 600,000 sq ft vacancy at Worldwide Plaza to NBC fell apart. NBC, like many tenants in the market, decided to put off any long term lease commitments in the rapidly deteriorating economy, opting instead for shorter term sublets to satisfy that particular requirement. Attempts to put the two properties back on the market at an adjusted asking price of \$1.2B failed to get more than \$750M. Today one of the two buildings, 1540 Broadway, is close to being sold for \$415 psf with financing. 18 months ago the price would have been in excess of \$1,000 psf. The other property, Worldwide Plaza, is off the market since there really is no market for a building with a large vacancy today. In 2006 and early 2007, a large vacancy like this would have been valued at a premium. Obviously, there are many factors at work when values drop so dramatically in such a short period of time. But to many people I spoke with over the past several years, the deals that were getting done made no fundamental sense. I remember discussions with colleagues and clients in 2003 when the Sears Tower was sold with 103% leverage. That struck many of us as making absolutely no sense. But that was the beginning of a new era in our industry. Those of us who questioned how these deals were getting done were told there was a new paradigm. That was the answer to everything. 80-90% leverage, no problem. Rent growth projected at 12% for the first two years, 7-8% for the next 2-3 years and 5% thereafter on ad finitum. Again, no problem. The banks had no problem with the underwriting. The sales and leasing agents said we were in a worldwide economy and NYC was a bargain. There was demand for space, not much construction in the pipeline, financial companies had a voracious appetite for space, often leasing much more than they needed, and at rents that were historically off the charts, in order to protect against the projected

shortage of space. On the leasing side, the vacancy rate for Manhattan was around 5.5% for all space. Top of the market rents, which in 2005 were at \$70 had escalated to \$170/180, and even above \$200 in some extreme cases. The hedge funds made so much money they were bidding up prices in the better Plaza District buildings and building \$300 psf offices. The average asking rent in the Plaza District topped \$90 psf less than a year ago. That was 25-30% higher than the top rent in the city just 4 years earlier. I need to repeat that statement: The average asking rent in the Plaza District topped \$90 psf less than a year ago. That was 25-30% higher than the top rent in the city just 4 years earlier. When some of us had trouble justifying these deals to our clients, we were told it was a new paradigm, the fundamentals are sound, we are in a global economy. It was as though these buzz words were enough to justify an unprecedented level of activity and commitment in our market. The rents, by increasing like this, made the rent growth assumptions on the investment side appear conservative. Rents were actually outperforming the crazy assumptions people were using when they purchased buildings. And everyone was getting into the act. Debt from the banks was abundant, cheap and easy to obtain. Packaging loans to sell into the CMBS markets was commonplace. Rating agencies went along with the program. Everything was so easy. But we have seen this play out before. The mid-late 70's. The late 80's-early 90's. Those were also very difficult times for the real estate market. But when markets correct and ultimately improve, new players emerge who either don't have the experience of having lived through the tough times, or they choose to ignore the down times for the quick profit. One thing that is constant in real estate and always will be, is that it is a cyclical business. And now let's see where we have gone in such a short time, really less than six months.. Asking rents dropped overall in Manhattan by \$5 psf in the 4th Q. \$6.50 psf in Midtown alone. Vacancy rates for Manhattan are up to over 7%, and the availability rate, when you include not only sublease space, but also the shadow space that has not and may never hit the market, is up by some accounts to as high as 12-13%, and there are projections of 15-17% before we are done. Buildings that were asking \$90-100 a year ago, and even last summer in some cases, are doing deals in the \$50-60 range. Concession packages are way up also. So much has been turned upside down in the market today. Traditionally Midtown Manhattan was the submarket most immune to the swings of a single industry. That was reserved to Downtown with its dependence on three main industries; financial, insurance and shipping. But over time, as technology allowed firms to do what they needed to do from virtually anywhere, many of the larger Wall Street firms and Law firms that considered them clients, had migrated to midtown, with its better proximity to the major commuter hubs, hotels, restaurants, etc. Downtown was forced to reinvent itself and did so by converting old obsolete office buildings into residential buildings, resulting into what is now emerging as a thriving 24/7 community. Given the magnitude of the problems today, every industry is affected. So Midtown's traditional immunity to the swings of the market that are rooted in a particular industry, due to its tenant diversity, has not helped it. Also of note, the top of the market has been the most affected due to the problems within the financial industry and the fact that the hedge funds, private equity firms and investment banks had driven that segment of the market to new heights that were not sustainable. So, where do we go from here and what do we think timing wise. First, rents will need to establish a bottom. If the average asking rent in all of Manhattan was \$68 a year ago, it will be back to under \$50 in a year. If the top rents were \$170-180, they will be under \$100, with some rare exceptions possible. Construction costs will need to come down. Over the three year run up, construction costs were rising between 1-1.5% per month. That needs to correct and it will. It is already starting, in fact. Owners that bought over the past three years with high leverage, and short term rates that will be adjusting, are going to have a tough time. The good news for them is that the banks will probably need to work with them to restructure the debt since they don't want the properties back. Owners who have owned their properties for a long time should aggressively front run this market and lower their rents to appropriate levels. We have seen in the past when owners who are slow to react chase the market down. We believe they would be better off setting an aggressive floor and leasing space today.

Income lost today will not be recaptured. The investment sales market is going to need time. Once rents hit their floor, that will be the first step. Investors and brokers will then have a clue on how to value vacancy properly and not at a premium, probably until the next cycle, if ever. Leverage will need to return to traditional levels and I am sure there will be some very creative types to come up with a new CMBS vehicle. I am not a big believer in that, and I think the smartest investors will look at real estate again as a long term investment, with a traditional lender, maybe one they even have a relationship with. They will invest in their buildings, provide excellent service to their tenants and be successful. It will be a more competitive environment and they will be forced to make a commitment to the properties and their clients, the tenants, if they are to succeed. On the brokerage side, what is the positive to take out of this mess? The brokers who are in this for the quick buck, who were essentially space showers offering no real value to their clients will either commit to being more professional or drop out of the business altogether, the latter scenario more likely. Those that remain will be those that really understand the business, take it seriously as a profession, are strategic in their thinking and provide true value to their clients. It seems like we may now be heading in a direction which I would like to suggest we call an "Old Paradigm". I was not all that long ago that cap rates on Class A office properties in Manhattan were trading at an 8 cap, based on income in place and conservative rental growth assumptions. Suburban would have traded at 10% caps then. Are we going back to that? Maybe. If not quite 8% caps in Manhattan we are certainly headed in that direction. Some may say that is pretty far fetched, considering where we have just been. But what is more far-fetched, saying today that we may see cap rates in Manhattan approach 8% in the next 12-18 months, or claiming five years ago that Manhattan rents would see \$180 and even \$200 levels in the foreseeable future? In Conclusion, we believe that overall there are going to be real opportunities in the NY real estate market over the next couple of years, both on the leasing and investment sales side. There are investors out there today gearing up to take advantage of this old paradigm. Those that understand the physical aspects of the real estate and are in it for the long term will make a lot of money over the next cycle. And tenants who are able to look long term and make commitments will find themselves in a position to not only secure attractive rental rates but will also find owners more flexible in other important areas of the lease negotiation, whether those are subleasing rights, options to expand or extend, or even contraction rights. I learned a long time ago from senior people in the industry that the best deals are those where each side comes away feeling they had to give something up and also received something. A one sided deal is not a healthy deal. The same is true for the market; a one sided market is not a healthy one. Just because there were some owners who were able to make enormous amounts of money in the over-heated market, whether on rapidly increasing rental rates or on cap rate compression and access to easy capital, that doesn't mean it was a healthy market. We now are in the early stages of correcting that and trying to find the proper balance. We believe by year end there will be a general sense that we are at or near the bottom, and better days will be approaching.

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