

Unintended Consequences of TARP funding on the New York City commercial office market: Government subsidized, below-market subleases; Value destruction of comparable properties; Unrecognized and unintended real property tax shortfalls.

- Some financial service firms’ subleases are now offered at 79% discount to current market taking rates;
- Job loss data indicates Midtown vacancy may crest at 25% with minimal improvement through 2012; and,
- Real Property Tax (“RPT”) shortfalls for the City budget may reach an additional \$1.8B over the next five years.

Summary

- While it entered this recession more slowly than other cities in America, the City of New York is reeling from continuing job losses which began in the financial sector. According to the New York City Independent Budget Office, New York City job losses will reach 243,000 versus peak employment in the first quarter of 2008, and only 25% of lost finance industry jobs will be replaced by 2012 if at all.¹ Should no new absorption occurs, additional job losses will cause existing Midtown vacancy rates of 12.15% (as of February 27, 2009) to rise to approximately 25%. A vacancy level of this magnitude was last seen in Manhattan in the Downtown market post the tragic events of September 11, 2001.
- Substantial and escalating amounts of prime office space are unused and unneeded, leading to numerous, large subleases offered to the market by financial services companies supported by TARP and its implied guarantee of the Federal government. These financial institutions occupy a large segment of better Manhattan properties and their now government-funded subleases are causing the unprecedented and city-wide collapse of commercial property values. This decline in value, if accurately reflected in Class IV property assessments, could lead to substantial and unexpected City budget shortfalls in excess of the record deficit already projected.

Market Overview²

- The Manhattan office inventory is geographically delineated by three major markets: (i) Midtown (169MM square feet): 42nd Street to 60th Street; River to River; (ii) Midtown South (87 MM square feet: Canal Street to 42nd Street; River to River; and (iii) Downtown (95 MM square feet): Battery to Canal Street; River to River.
- As of February 27, 2009, total available space in Midtown reached 20.5M square feet, which represented a 12.15% vacancy rate. Of the total, 6.2MM square feet was sublease space, which reflected an increase of 3.0 MM square feet of sublease space

¹ “Fiscal Outlook: As Economy Weakens, City’s Budget Gap Swells,” prepared by the New York City Independent Budget Office (“IBO”) in January 2009.

² Per the proprietary database of Manhattan office market data and statistics maintained by www.tenantwise.com

since January 1, 2008. Notably, Class A sublease space represented 80% of the total sublease space available in Midtown with an average published asking rate of \$74.00 per square foot as of February 27, 2009. We expect this trend to continue as more financial services firms dump excess space on the sublease market.

- Asking rates are down across all classes of office space in Midtown. All office spaces, both direct and sublease, are at an average asking rate of \$70.87 per square foot as of February 27, 2009. This rate represents a 17% decline since the peak of \$85.82 per square foot for the year in second quarter 2008 and an 11% decrease since January 1, 2008's average asking rate of \$79.51 per square foot.

Job Loss Impact

- Of the total 243,000 jobs projected to be lost in New York City, approximately 177,000 jobs will be lost in the financial, professional and business services and information sector through the end of 2010. 177,000 jobs lost would equate to 44MM square feet of unneeded office space. Allocating 48% of this square footage to the Midtown office market (as a percentage of inventory) would result in a 21MM square foot increase in available space. Adding the 21MM to the currently available 20.5MM square feet would result in a Midtown vacancy rate of 25%. This increase could well be offset by positive absorption of space. However absorption has been negative since the fourth quarter of 2007. In our estimate, given the anticipated supply, it will take at least 3.5 years for the absorption to turn positive once again.

TARP Impact

- Many of New York's financial firms have or will likely receive TARP funds to sustain their businesses. As TARP-funded financial firms continue to release unused space onto the sublease market, a disturbing trend is emerging. These banks are offering sublease transactions that are priced well below the existing market at continuing loss levels that no profit making enterprise could sustain. Given that these banks occupy Class A property (i.e. properties that set the standard for the market), these subleases are causing comparable and lesser properties to drop in value as they supplant and/or reset prime lease transactions.
- For example, one TARP-funded bank is currently offering over 600,000 sq ft of Plaza District sublease space at an asking rate of \$60 per square foot with an announced taking rate of \$50 per square foot. In addition the space is offered with a \$50 per square foot cash contribution for work and one year free rent for a ten year lease commitment. However, in an unprecedented move, this bank is offering large tenants an additional \$150 per square foot in tenant construction allowance, for a cash total of \$200 per square foot, nearly four times the market rate. This extra allowance is being made available to large tenants (including typical lesser credits like legal firms) and will have the tenant benefit of completely subsidizing all new office buildouts. Needless to say the existing installations are fully fitted out for bank use and this extra cash may not be needed by the tenant to customize the space. The offer of the additional allowance has the effect of giving the tenant five years of rent free on a commitment of lease period of just ten years. More to

the point, the effective lease rate at these terms is just \$14.93 psf. The average published asking rate for direct and sublease Class A space on Park Avenue as of February 27, 2009 was \$90.81 per square foot. Assuming a 10% discount for the taking rate, a market cash allowance of \$50 per square foot, combined with a market free rent period of six months, yields an effective lease rate at \$70.20 per square foot. Therefore the TARP-backed offer represents a 79% discount to the established current market taking rates.

- Most telling is that current taxes and operating costs in these buildings total approximately \$25 per square foot. So the \$14.93 per square foot lease implies a continuing loss of over \$10 per square foot per annum. Competitive landlords cannot expect to offer \$14 per square foot transaction levels and incur yearly losses at a level of \$10 per square foot. The lowest price or breakeven that any landlord can offer is the combined total of taxes, operating, and debt service. Even if there were a building without a mortgage, which there is not in Midtown, the lowest competitive rate would be in the \$25 per square foot range. While some at the banks may argue that their aggressive pricing will ensure that their bank space is leased first, because there is so much bank space at sublease pricing, it has the potentially apocalyptic consequence of destroying value of comparable properties across all of Manhattan's submarkets. This is the result of the TARP: the banks would not be able to offer such low rates without the Federal capital infusions and support. Since bank occupied Midtown office space represents the top of the office market, this trend bodes very poorly for secondary submarkets and any building that also is in the market to lease space. If \$14 per square foot deals are available for some in Plaza District buildings, why should anyone pay more elsewhere?

Market Forecast

- If TARP programs were not in place, then banks would lease at breakeven or low level loss rates, not the dramatic levels now offered. In fact, some of the large banks would have failed allowing restructurings of equity and debt to course through certain buildings similar to the events of the mid 1990s on the West Side of Manhattan. This would effectively take buildings off the market and reduce inventory. In this current environment, banks are paradoxically the strongest credits given their federal guarantee, and these banks are creating federally subsidized value traps lessening market prices for other landlords seeking to lease direct space.
- As more and more TARP-backed tenants put space on the sublease market, we believe the following will occur:
 - **Value deterioration across all commercial properties:** All landlords competing for tenants will have difficulty because obtaining loans to fund tenant workletters as financing has dried up. Even if landlords are able to fund the higher TARP workletters and accept lower lease rates, the value of their properties will be significantly lessened.

- **Property tax valuation differentials:** TARP-backed firms are provided with taxpayer funds to continue to pay their office lease obligations, many of which were made at the top of the market. The positive side of the TARP impact is that landlords that have existing leases with TARP-backed financial sector firms may fare the best, at least as long as the TARP funds keep flowing. Therefore, those landlords “lucky” enough to continue to receive TARP-funded rents will not see a diminution of cash flow until the banking firms’ leases expire. However, the landlords who do not have TARP-backed tenants and are experiencing any significant lease rollover during the next two to three years will be in a very difficult position. If these landlords agree to do new transactions at what has effectively become “TARP” offering terms, the cash flow from their buildings will be dramatically reduced. There will be wide divide in income and values between buildings that have significant TARP-backed tenancies versus buildings that do not have TARP tenants and experience significant rollover during the next two to three years.
- **Real Property Tax Shortfalls Result:** We estimated that TARP-backed tenants may skew the price alignment of the overall market.
 - By subsidizing below-market major subleases, TARP will produce a dramatic effect on New York City’s budget. Total City revenue for FY 09 is projected to be \$36.3B of which real property tax revenue (“RPT”) comprises \$13.8B³. Commercial properties (Class IV) have represented approximately 40-47%⁴ of total RPT over the past few years. Assuming Class IV properties are 45% of RPT revenue for FY 09, this means Class IV accounts for \$6.2B in City revenue. If building owners have to compete with TARP-created, below-market terms, the value of these buildings will fall. For example, if a building owner agrees to a 50% discount (in the face of 80% discounts offered by TARP banks) to otherwise market terms then the overall value of the space leased on this basis would fall by 50%. Most Manhattan office buildings have numerous tenants with existing leases and these other older leases will have an ameliorating effect on any newer, cheaper leases.⁵ However, 2010 will be a year with significant lease expirations, more so than the two years preceding it. So, based on projected vacancy rates, nearly a quarter of the entire Midtown market, assuming 3.5 years to reach equilibrium, will be marked down an additional 50%. Net income for buildings will be reduced by lower rents as equilibrium returns, but it will also be reduced by longer downtime periods and greater concessions. In our estimate, the net impact from the

³ “Revenue Note,” November 17, 2008, City Council Finance Division.

⁴ (i) “Pricing the ‘Luxury Product’: New York City Taxes Under Mayor Bloomberg, Civic Report,” No.47 November 2005, Table 3; (ii) “Property Tax Burden Shifts: Where Does the Buck Stop?” IBO News Feature, page 1; June 10, 1999; and (iii) “Perspectives: New York City’s Property Taxes; The Homeowner’s Break on Assessments,” The New York Times, July 2, 1989 on www.nytimes.com.

⁵ The income of buildings with new discounted leases would decline to the extent of the newly leased space (at “TARP rates”) in proportion to the size of the buildings. The overall vacancy rate in Midtown as of June 1, 2007 was just over 9% which indicates that most buildings had been well-leased in the near past. These more recent leases would be at previous market rates. In spite of the downturn, buildings’ cash flow should be somewhat protected by income from leases completed before the downturn.

TARP bank sublets could cause value diminution across the Midtown market in the range of 20-25% on top of the 20-25% lost since the market rental top in rents in July 2008.

- Due to New York City's phase-in of assessments over five years, the reduction in taxes charged to those landlords associated with diminished value will not be lock-step with this drop in lease rates. New York City generally bases tax assessments on the prior calendar year's performance. Additionally, the City phases in assessment increases and decreases over a five-year period. For example, another 25% reduction in assessed values in Midtown, across the board, would result in a gross (i.e. if not phased in) reduction in taxes of \$600M per annum⁶. Phased in over five years, the reduction in revenue would be: (i) \$120MM in year one; (ii) \$240MM in year two; (iii) \$360M in year three; (iv) \$480MM in year four; and (v) \$600MM in year five. Therefore, over five years, the total reduction in tax revenue could be \$1.8B. From the building owner's standpoint, the phase-in of the value of the lower taking terms will have an immediate impact on property cash flow, yet the taxes will not decrease in parallel. Therefore, these building owners will be even harder hit than the City. The City will bear the burden of reduced collections as the commercial office market is reduced in value by the TARP-backed financial firms. Nonetheless, it is ironic at best that TARP funds, which were intended to support the banks and local and national economies, are having the unintended consequence of undercutting the functioning commercial real estate markets and increasing the financial burden on the City of New York.

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⁶ Based on past years, we assumed that Class IV represents \$6.2B or approximately 45% of total RPT for FY 09 of 13.8B. We further assumed that Manhattan's Class IV assessed value is 80% of the entire City's Class IV RPT of \$6.2B, or \$2.4B.