THE STEVEN L. NEWMAN REAL ESTATE INSTITUTE

Going Long on NYC

The Case for Strategic Investments in Downtown's Bedrock Assets

Addendum to Downtown 2020

The Newman Institute's report Downtown 2020 was completed over the summer of 2008 and delivered by the printer in the second week of September. Within a week of the arrival of the printed copies, Lehman Brothers had filed for bankruptcy, the Bank of America had acquired Merrill Lynch, AIG was provided with an $85 billion credit facility by the Federal Reserve in exchange for a 79.9% equity stake, Goldman Sachs and Morgan Stanley converted to bank holding company status, and the White House proposed the $700 billion Troubled Assets Relief Program (TARP). That cataclysmic week marked the culmination of a financial unraveling that had been emerging for more than a year, with roots that extended back perhaps as long as decades.

While the particulars of the financial crisis, its depth, and its extent surprised the authors of the Downtown 2020 report (the Downtown Future Group) – as it obviously surprised the financial community itself, high government officials, and the public at large — our study group had in fact examined long-term cycles and disruptive events as part of our basic work over the preceding two years (as indicated on pages 4, 31, and 65 of the report, and well illustrated by the exhibits on pages 33 and 34). Aware that New York and the nation are subject to volatile economic change, we aimed to gauge the future of Downtown over the middle-range and long-term future, and thus account for the vagaries of the business cycle. The optimism in our report – which has a positive view of Downtown's future even as we address multiple challenges in our analysis, recommendations, and conclusions – is based upon a view of the future in which fundamental forces shaping the New York region and its core persist despite volatility in the short run.

What are those fundamental forces?

• The impact of economic globalization has noticeably benefited New York as the nation's premier global city. Globalization, we believe, is a permanent feature of the 21st century economy.

• Demographically, New York City has not only enjoyed population growth in the past three decades, but with the exception of the 1970's has sustained economic and population growth over a course of centuries. With a growing population and a relatively fixed volume of land, the value of New York's fixed assets experiences powerful upward pressures over time.

• As the nation's foremost 24-hour city, New York is advantageously positioned to realize the economies of agglomeration that make our workplaces the most productive in the nation, measured by output per worker. The mix of people and resources present in New York make it a magnet for the group that various writers have termed "the creative class" (Florida), the "new knowledge workers" (Drucker), and those providing "advanced producer services" (Drennan and many others). At present, such advantages are structurally embedded in the New York economy and keep it at the forefront of economic innovation. Human capital is concentrated and thrives in New York.

• The physical assets of Downtown remain a significant base for our recommendations. Its historical urban structure, centrality to the region, waterfront access, and dense infrastructure are physical capital assets of exceptional value.

• Construction has begun on the massive redevelopment of the World Trade Center site, which has been through an extensive planning process that will yield at least four new office skyscrapers, the memorial, and substantial new retail and museum space. This is all due to be delivered in the early years of our timeframe, and forms the core volume of the amount of new office space envisioned in our report.

• By reason of its density, mass transit configuration, walkability, and ongoing public and private investment, Downtown has emerged as one of the most "sustainable" built environments in the country. Other places are talking about "going green," but Downtown is already well along that path.

While acknowledging these strengths, however, the authors of this report are aware that massive challenges lie ahead as a consequence of the economic dislocation associated with the Panic of 2008. Our projections had anticipated that demand growth would support the redevelopment of the World Trade Center's office buildings and lead, quickly thereafter, to a further requirement for additional office development. We specified that large floor-plate sites targeted to the financial industry's operational needs would be the key to planning for those additional office buildings. That remains our view, but we think that the timing of additional office development has shifted into the latter years of the coming decade. We should still keep this on the planning horizon, but we now see the depth and duration of this cycle as pushing out commercial development activity three to five years later than we anticipated.

It may be helpful to review the economic background that shapes this expectation.

Through December 2008, New York City posted a year-over-year job loss of 53,600 jobs, or a 1.4% decline. Over the same period, the national job loss was almost 3.0

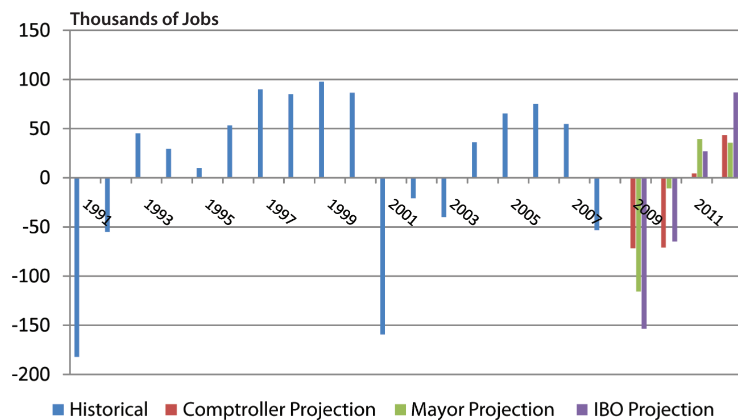
million, or 2.2%. The December unemployment rate for the City was 7.4%, compared with the nation's 7.2%. The New York City Comptroller's year-end "State of the City's Economy" report showed that New York was outperforming the nation in almost all employment categories, with the exception of manufacturing, education and health services, and government jobs. Nevetheless, New York's economic momentum decelerated throughout the year, and the municipal government was girding for substantial private sector layoffs in 2009. Citywide, the Comptroller anticipates job losses of 71,000 in 2009, and a decline of similar magnitude in 2010. The Mayor's estimate of employment decline in 2009 is a more drastic 116,000, but this eases dramatically in 2010 with a projected drop of only 11,000. The Independent Budget Office (IBO) grimly forecasts two full years of massive job declines, 153,900 in 2009 and 65,000 in 2010.

Thereafter, both the Comptroller and the Mayor's office project the return of economic expansion, with job gains anticipated in 2011 and 2012 in both budget projections. The Comptroller expects a marginal employment turnaround in 2011, adding 5,000 jobs, followed by a more robust growth of 44,000 in 2012. The Mayoral outlook plots a more vigorous recovery, beginning with a 40,000-job increase in 2011 and a nearly-as-strong 36,000-job gain in 2012.

The IBO predicts a V-shaped recovery, with the NYC economy adding 27,400 jobs in 2011 and a robust 87,400 in 2012. While none of the projections fully make up the losses of 2008 – 2010, the expectation is that the City's economy will be on the rebound by 2011 and gathering momentum into the coming decade. It would be expected, then, that real estate indicators such as net absorption and occupancy would likewise be posting favorable change early in the next decade. The employment expectations, in historical perspective, may be seen in the chart below.

Exhibit 1:

The New York City Employment Cycle



Source: Historica data, NYS Dept. of Labor CES survey, December to December change; projection as published in NYC Comptroller's State of the City's Economy and Finances, 2008 (12/15/08) and the Independent Budget Office's Fiscal Outlook (January 2009).

A study of the New York securities industry prepared by the New York State Comptroller in late 2008 analyzes the outlook for Wall Street and related jobs in the years ahead. In the past half-century, Wall Street has had six periods of job contraction, with four of them seeing losses in excess of 20 percent of its total. The State Comptroller's office estimates that the City will lose 48,000 financial services jobs in the two years following its October 2007 peak, with aggregate losses in total employment potentially as high as 175,000, given the multiplier factor of financial services in jobs ranging from retail trade and restaurants to advanced producer services functions including law, accounting, and commercial real estate.

Bonus payments on Wall Street have a stimulating effect throughout the city and state economy (especially in the suburbs, where many Wall Street workers reside) in boom times, but retrenchment in incentive compensation creates a retarding effect on growth. Securities industries bonuses peaked at $33.6 billion for 2006, with just a 2% dip to $33.2 billion in 2007. The most recent estimate for bonuses earned in 2008 was off by about 44%, to $18.4 billion (a sum that has been roundly criticized in the light of the financial market implosion). It is highly probable that as long as the financial industry is being supported by injections of capital and liquidity facilities provided by the Treasury and the Federal Reserve, bonus payments in the foreseeable future will be severely constrained.

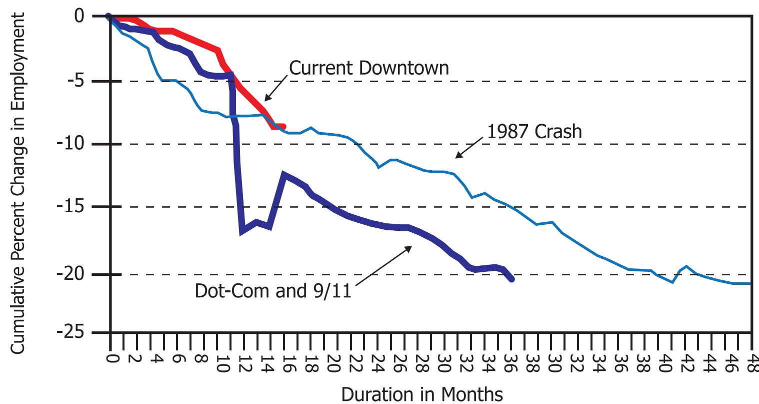
One additional point relates to the new "culture" of the financial industry. This industry has been scaled back. Wall Street is experiencing considerable belt-tightening and increasing layers of oversight, similar to the careful scrutiny of the banking industry in the liquidity and real estate crisis of 1987 – 1993. The impact on the availability of credit, now and in the immediate future, will deter both real estate investment and consumer spending. Without credit, people do not buy residences or spend on big-ticket items in stores. The days when employees of "securities and commodities" or "other financial investment activities" had salaries of four to six times the average of "all industry groups" are over for now. This reality will affect New York City, and particularly Manhattan.

Without question, we are in the midst of a "Great Recession," the longest in many decades. Industries that will be more affected by job losses - and these will dominate - are finance and insurance; professional, scientific, and technical services; and management of companies and enterprises. Those that will be relatively immune - and these will have less impact - are publishing, information services, home health care services, museums and historical sites, colleges and universities, motion picture and video industries, and grocery stores. Thus, while the former group of industries will likely contract significantly during the recession, New York will be partially buoyed up by the latter group.

Beyond the recession, we must concede, the range of potential outcomes for New York in the balance of the decade is wide. There is greater uncertainty now about what a most probable estimate of aggregate employment will be in 2020 than when we undertook our study. From a peak level of 3.82 million jobs in 2008 we may drop to as low as 3.55 million in this cyclical trough. The recovery in the coming decade, in all probability, brings us at least back to the prior peak, with a high-end forecast of growth to as many as 3.96

Exhibit 2:

New York City Securities Industry Employment Downturns



Source: NYS Department of Labor, OSC analysis

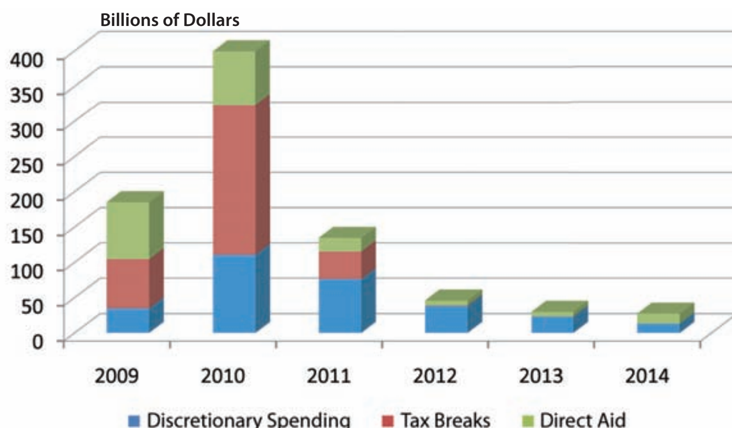
million. There is a risk that 2020 will see us in a weak economic state, though. Full employment recovery cannot be expected with certainty. Here is what it would take. To achieve full job recovery by 2020 would require a very moderate growth rate of 0.76% per year from a trough of 3.55 million in 2010. To have very solid gains at the high-end forecast, New York would need to sustain a 1.1% annual employment growth rate through the decade, roughly consistent with other recoveries from cyclical troughs.

Residential demand is unquestionably linked to employment changes and income levels, with the financial sector as a bellwether. We therefore expect that residential prices and new construction of multifamily housing throughout the New York region and particularly in Downtown will be softer for at least the next two or three years. However, the basic reality of New York City is that it does not develop a sufficient quantity of housing over longer periods of time. The duration of a weaker residential market will be shorter than the trough in commercial properties, due to this inelasticity in supply. We anticipate that Downtown will require the entire volume of new units we project by the year 2020, although the absorption period may be attenuated for several years.

We note that, in this period of constrained credit, the major competitive development program, the Far West Side mixed-use district, has immediate troubles relating to financing issues both for the MTA and for the designated developer. The result will be delays for the Far West Side program. This increases the pressures to proceed with excellent planning in Downtown, since that is where most of the economic growth needs of the City will need to be satisfied in the coming decade. From our perspective, the Far West Side proposals need to be seen in the context of previous efforts at Battery Park City, in Times Square, and at Queens West: that is, development will occur, but at time scales of decades, rather than years.

Exhibit 3:

Economic Stimulus Package Massive and Front-Loaded



Source: Hugh Kelly Real Estate Economics analysis of Congressional Budget Office projections (Feb. 13, 2009)

Many of our recommendations, especially in the transportation area, are admittedly costly. Such proposals are compromised by the present fiscal environment: City and State governments, and the MTA as well, are strapped for funds. Some relief, but not sufficient relief, may come as the Federal Government's fiscal stimulus program advances in the 2009 – 2014 timeframe.

It is encouraging that tens of billions of dollars in stimulus are oriented to infrastructure, though there is an unfortunate concentration on highways and far less for mass transit. Here in New York there is no shortage of "shovel-ready" infrastructure programming. As indicated in the map below, New York State is one of the primary targets for infrastructure dollars. The New York portion of the NYC metro area is slated for $210 million in highway funds, and the state has claim to $967 million in transit capital grants. Furthermore, aid to states and localities in the fiscal stimulus package, even if not directed to mass transit, can help by reducing pressures elsewhere in the budget, such as Medicaid, or in block grants apportioned by size of population.

We were careful in our report, moreover, to identify lower-cost improvements, requiring modest capital outlays, "addition by subtraction," and alterations in planning and land use regulation (see the Executive Summary and our Conclusions). There are projects that can and should be undertaken in the short term, where benefits are large and costs modest. In a time of fiscal difficulty, those are the actions to focus on. But we ratify our infrastructure recommendations over the longer term. We are living off investments made 100 years ago and more. There is no excuse for not making major capital investments as soon as credit market conditions regain greater normalcy.

Exhibit 4:

Infrastructure Spending Allocations U.S. Fiscal Stimulus Package

Source: House Committee on Transportation and Infrastructure

Exhibit 5:

Consensus Forecast Sees U.S. Recovery Beginning Third Quarter 2009

Source: Blue Chip Economic Indicators Report, February 10, 2009

Exhibit 6:

Unemployment Forecasts Suggest 8% - 9% Range in Most of 2009-2010

Source: Actual Historical Data from Bureau of Labor Statistics; Forecasts from Blue Chip Economic Indicators, as of February 10, 2009

It must be noted that the outlook for a recovery in the City's economy, and subsequently in its real estate markets, is consonant with the consensus of economic forecasts available in early 2009. The two graphs below reflect the GDP and national unemployment projections published by Blue Chip Economic Indicators. They describe the expectation that the U.S. economy will emerge from recession late in 2009, and achieve real growth in the range of 3% - 3.5% by the end of 2010.

These, then, are our observations on contemporary conditions. But we will affirm the concluding sentences of our formal report:

"Now, as the city faces the challenges of a cyclical downturn, some may cavil at proposals that have as their premise the need to accommodate an even more intensively developed Downtown. For our part, the members of the Downtown Future Group see the improvements we recommend for Downtown by 2020 as merely the springboard for an even more attractive, more energetic Downtown benefiting the whole city and the region further into the present century."

With that, we commend Downtown 2020 to your attention. ■

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Please address inquiries to Jack S. Nyman, Director, at:

THE STEVEN L. NEWMAN REAL ESTATE INSTITUTE

Baruch College, CUNY
137 East 22nd Street
Box C-0120
New York, NY 10010

Tel: 646.660.6950 • Fax: 646.660.6951
www.baruch.cuny.edu/realestate

Kathleen M. Waldron, *President, Baruch College*
William Newman, *Founding Chair*
Richard Pergolis, *Co-Chair*
Jack S. Nyman, *Director*