

What impact will the credit crunch have on the nation's premier office market and New York's role as a global city?

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A year of outstanding economic volatility and uncertainty, impacting the nation and the globe, and presenting multiple challenges to the nation's premier office market. The current conditions, however, were not altogether unexpected.

The collapse of Bear Stearns in early 2008 and the turmoil in credit markets that has continued to plague financial markets and caused Lehman Brothers to declare bankruptcy in September 2008 has coincided with the downturn in Manhattan's office market. It is now apparent that Manhattan's office market peaked in late 2007 when the overall vacancy rate stood at a low of 5.7 percent, overall asking rents averaged nearly \$65 per square foot (psf), and top tier class A asking rents exceeding \$100 psf. As of the third quarter 2008 the overall vacancy rate has since increased to almost 7.4 percent and overall asking rents, though higher than year-end 2007, have started to be pressured downwards as landlords offer more concessions to entice potential tenants.

In considering where market conditions are headed over the next few years it is important to examine the relationship between New York City's securities industry¹ and the performance of Manhattan's 395 million square feet office market, the largest CBD in the nation.² While other industries such as legal services, accounting and advertising and information³ are also significant occupiers of office space, the securities industry has historically been the driver of Manhattan's economy. Although securities share of overall employment has been declining with respect to other office using industries, the overall share of income⁴ generated by this sector has grown from 12 percent in 1984 to an estimate of over 30 percent in 2008 and the industry continues to be a leading indicator of the real estate market.

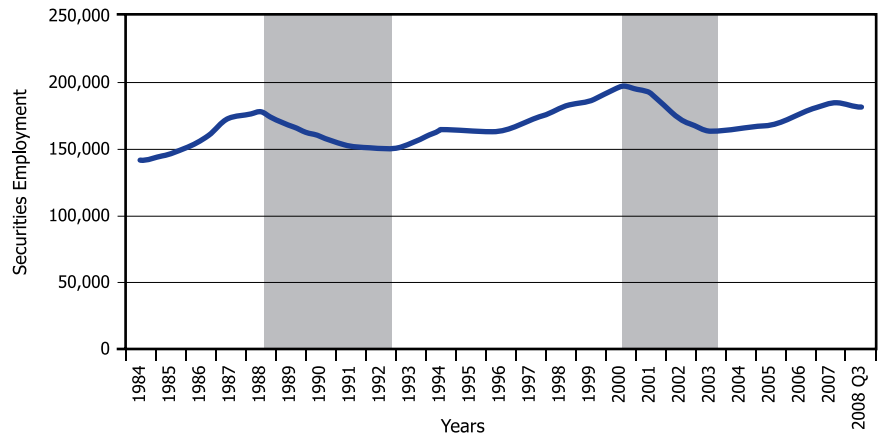
Reflecting upon the three most recent economic and real estate cycles of 1984 - 1992, 1993 - 2001, and 2002 - to the present, reveals a strong correlation between these office-using employment sectors and Manhattan's office market fundamentals.

■ 1984 - 1992 CYCLE

The first of these cycles coincided with the surge in the stock market and employment in the securities industry⁵ that occurred from 1984 to 1987. (Exhibit 1) Securities employment in Manhattan over this time period increased by almost 48,000 jobs or a total of 38 percent, while the S&P 500 Index soared by nearly 50 percent.

Exhibit 1:

Securities Employment: Manhattan 1984 - 2008 Q3



Source: U.S. Bureau of Labor Statistics

Concurrently Manhattan's office market absorbed⁶ over 25 million square feet (msf) although the overall vacancy rate rose slightly as developers rushed to build new space to meet increased demand. In fact, during the expansion years of this cycle, 1984 through 1987, Manhattan's overall office inventory grew by approximately 39 msf or nearly 12 percent, from 320.8 msf in 1984 to approximately 360.7 msf in 1987. (Exhibits 2, 3).

¹ The focus of the analysis is on the securities, commodity contracts, and other financial investments sub-sector of the financial activities industry (abbreviated herein as securities).

² Manhattan is the largest Central Business District (CBD) in the nation followed by Chicago and Washington D.C.

³ Legal, accounting and advertising sectors primarily comprise the professional services industry. Information includes traditional print publishing, as well as internet based companies like Bloomberg and Reuters. Together with financial services these industries comprise the majority of the office-using employment sectors.

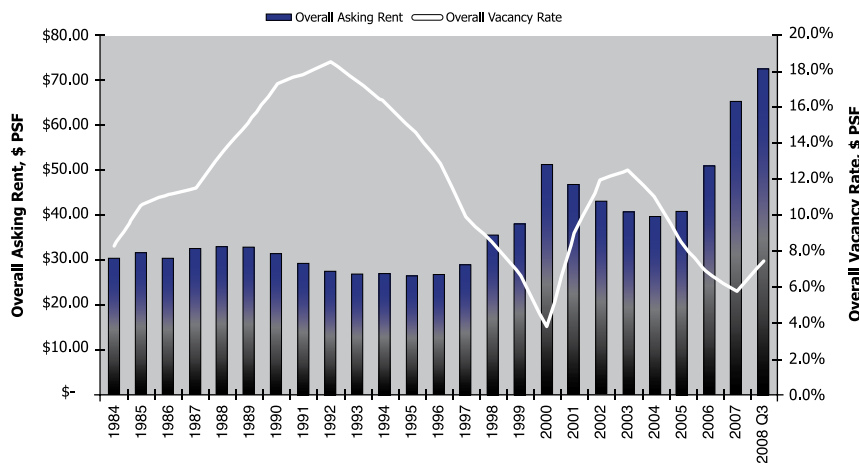
⁴ Refers to wage and salary disbursements as defined by the U.S. Bureau of Economic Analysis; 2008 estimates provided by Moody's Economy.com

⁵ The focus of the analysis is on the securities, commodity contracts, and other financial investments sub-sector of the financial activities industry (abbreviated herein as securities).

⁶ Absorption refers to the change in occupied space.

Exhibit 2:

Manhattan Overall Office Market: 1984 - 2008 Q3



Source: Cushman & Wakefield

The **stock market collapse of 1987** resulted in an acute and immediate pullback in securities industry employment. The sector declined by almost 29,000 jobs from the peak in 1988 to the trough in 1992, with additional losses of approximately 130,000 in other office-using employment (OUE) sectors. The impact on the office market was equally severe. Manhattan's overall vacancy rate rose from below the 10 percent average in 1984 - 1987 to over 18 percent by 1992, while asking rents declined by almost 17 percent from \$32 psf in 1987 to approximately \$27 psf in 1992.

The sharp increase in **vacancies** was also exacerbated by the expanding inventory as developers rushed to construct new buildings without anchor tenants in a speculative boom that proved ill-timed. Even as market conditions deteriorated, construction projects that had been initiated added another 25 msf of inventory between 1988 and 1992 contributing to a growing over supply in the market.

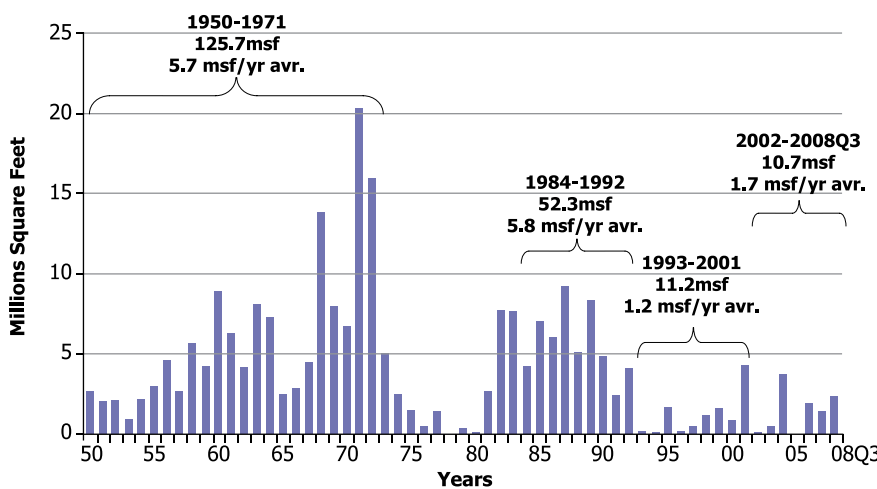
1984 - 1992 CYCLE

Manhattan's economy finally began to stabilize and recover in 1993 as job growth resumed. The recovery stalled in 1995 and 1996 as the Federal Reserve increased interest rates to curb economic growth in order to prevent inflation pressures from spiraling upwards. Following this brief pause employment soared in the latter part of the 1990s as the **dot-com boom fueled Wall Street profits** through lucrative IPOs (initial public offering). From 1993 to 2000, securities employment grew by 49,000 jobs, on par with the gains of the previous cycle.



Exhibit 3:

New Office Construction: 1950 - 2008 Q3



Source: Cushman & Wakefield

⁷ The 3.8 percent vacancy was far below an equilibrium vacancy rate which is generally considered to equate to 7-9 percent and represents balanced supply (availabilities) and demand (occupiers) conditions in Manhattan. The 2000 vacancy rate is also the lowest on record since the early 1980's as tracked by C&W's market surveys.

As demand for office space increased, Manhattan's overall vacancy rate declined from 18.5 percent in 1992 to 12.9 percent by 1996. By the late 1990s, however, availabilities were rapidly declining and tenants looking for space were effectively squeezed out of the market as the **vacancy hit a very low of 3.8 percent⁷** in 2000. Concurrently overall asking rents, after increasing moderately by only 4.8 percent per year between 1992 and 1999, began to spike upwards and in 2000 alone rose by nearly 34 percent from \$38 psf in 1999 to over \$50 psf in 2000.

Significantly, unlike the previous cycle, the marketplace was not accompanied by a surge in new construction as banks and developers alike had **curtailed speculative development**. In fact from 1993 to 2000, only 6.0 msf of new inventory was completed. Additionally as a result of conversion to residential uses, inventory actually declined slightly as older Class B and C building were converted to residential uses particularly in Downtown.

The dot-com boom quickly turned bust by March of 2001 as investors began to question the lofty valuations of many dotcoms. As a result of the dot-com bust, the local NYC economy had already begun to show signs of rapidly declining even before the tragic events of September 11th unfolded. From the peak in 2000 to the trough in 2003, 35,000 securities industry jobs were lost in Manhattan⁸ and overall office employment declined by approximately 120,000 jobs. The overall office vacancy rate soared from 3.8 percent in 2000 to 8.9 percent by the end of 2001 reached a high of 12.5 percent at the end of 2003⁹ (essentially matching the nine percentage point overall increase seen from 1987 to 1992). Asking rents declined by roughly 20 percent from \$50 psf to \$40 psf in 2003.

The **Federal Reserve's response** in the aftermath of 9/11 was to immediately drop **interest rates to historic lows** that helped the economy immerge from the recession in a relatively short time frame.

■ 2002 - Present CYCLE

By 2004 employment growth had resumed although at a moderate rate. Securities employment in Manhattan averaged annual growth below 2.0 percent during 2004 and 2005 before finally gaining momentum in 2006 and 2007 when average annual growth accelerated to over 5.0 percent. Similarly the office market began to stabilize with overall vacancy declining from 12.5 percent in 2003 to 8.4 percent in 2005, and subsequently declining to a low of 5.7 percent at year-end 2007. With vacancy rates falling again below equilibrium **overall asking rents spiked** upwards rising by more than 28 percent from 2006 to 2007, reaching a **new overall high of \$60 psf and \$77.66 psf** for class A.

⁸ Some of these job losses were the result of relocations outside the City, like Morgan Stanley's decision to relocate jobs to Westchester County.

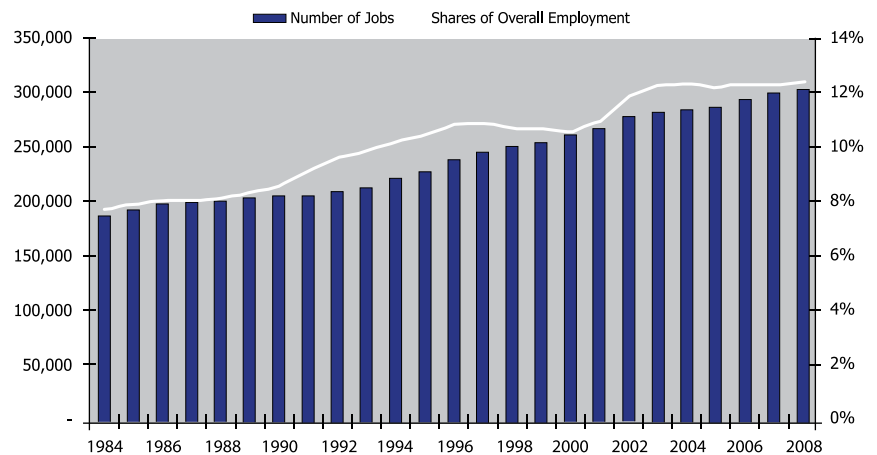
⁹ The overall vacancy rate would have been even higher if the approximately 10-12 msf of the World Trade Center complex and adjacent buildings had not been removed from inventory.

¹⁰ Although in percentage terms this translates to a slightly higher loss of nearly 19 percent as compared to 18 percent in the 2001 downturn.

¹¹ The New York City Comptroller's office as of October 2008 estimates total employment losses, including non-OUE sectors of nearly 165,000 jobs.

Exhibit 4:

Education and Health Services Employment: Manhattan 1984 - 2008 Q3



Source: U.S. Bureau of Labor Statistics

How the current crisis in credit markets will impact the office market will depend on the projected path for Wall Street and the effects that the downturn in securities industry has on other sectors of the economy. **Losses on Wall Street** are expected to be similar to the to the recent 2001 cycle, totaling between 30,000 and 40,000 jobs¹⁰. An additional 70,000 losses are forecast for other OUE sectors, primarily professional and business services and information.

The overall **OUE job losses of approximately 105,000** are slightly lower than the losses experienced during the 2001-2003 downturn, but considerably lower than the 153,000 OUE jobs lost during the early 1990s recession. Parts of these losses are expected to be counterbalanced by growth in such sectors as health and education. (Exhibit 4)¹¹

The bulk of these job losses are expected to occur over the course of the current year 2008¹² and into the first half of 2009. **OUE employment is expected to trough in 2010 before a gradual recovery resumes in 2011.** This is relatively shorter than the early 1990s recession when job losses extended for five years, but not as immediate as during 2001 when losses occurred almost immediately following the destruction of the World Trade Center.

While the demise of two major firms like Bear Stearns and Lehman Brothers is unprecedented in recent history¹³ and the subsequent merger of Merrill Lynch with Bank of America also suggests further job losses due to consolidations, two positive long term factors differentiate the current downturn from the previous¹⁴.

The first is the **increase role of globalization** in the world economy with large financial centers like New York and London having a dominant position. Growth in the world economy, particularly in Asia and South America, is leading to the emergence of new financial centers, such as Shanghai. This is expected to increase overall demand for financial services as firms will need to transact across borders and wealth spreads. In turn, this will likely increase opportunities for existing global centers like New York. Barclay's acquisition of Lehman is an indication of the increased global nature and demand for New York City's financial services. In the immediate vicinity of the former Lehman headquarter building (Rockefeller Center/Sixth Avenue), are Credit Lyonnaise, Union Bank of Switzerland and Macquarie Investment.



The other favorable factor is that **unlike the early 1990s when many job losses** in Manhattan's securities industry resulted from **relocations of back office** operations primarily to New Jersey where market rents were considerably cheaper, these have largely occurred already leaving core strategic operations concentrated in Manhattan.

Turning to supply, **inventory growth** during the most recent 2002-2008 cycle was **extremely constrained** with only 10.7 msf of new space or approximately 1.7 msf on average per year, far less than the 5.8 msf averaged during 1984-1992 though slightly higher than the 1.2 msf built from 1993 to 2001. The most recent completions in 2006 - 07 include the 1.5 msf New York Times Building in Times Square and 7 World Trade Center in Downtown. An additional 5.5 msf is in the pipeline and is expected to be completed over the next two years from 2008 to 2009¹⁵.

The only other project currently under construction is 11 Times Square which will likely have a greater impact on the market given that construction occurred without commitments from anchor tenants. One important **differentiating factor**, however, is the **residential conversion trend that was so dominant** from the mid 1990's through 2007 is likely to moderate, given both the current housing slowdown and the fact that many of the better suited buildings have been converted.

Looking to the next few years, bearing in mind these recent cycles and their causes and recovery, the forecast for office demand is based on OUE projections and supply factors. The vacancy rate is expected to increase from 5.7 percent in 2007 to 8.7 percent by year-end 2008 and continue to deteriorate until 2010 when vacancies reach 12.3 percent, an increase of over six percentage points. (Exhibit 5) As noted the fact that this is lower than the previous two downturns when vacancies jumped by more than nine percentage points, is a reflection of both the **mitigating factors that globalization and economic diversification** is expected to have on overall job losses, as well as the relatively **scarce supply of new inventory** that is projected going forward. ■

Exhibit 5:

Manhattan Overall Office Market Forecast: 2009 - 2011

	2007	2008	2009	2010	2011	Total Change
Securities Employment	185,536	168,230	155,760	148,003	150,432	
Change from previous year	8,677	(17,306)	(12,470)	(7,757)	2,429	37,533
Office Using Employment	966,609	931,997	907,057	891,543	896,401	
Change from previous year	24,987	(34,612)	(24,940)	(15,514)	4,858	(70,208)
Occupied Space	368,423,914	360,463,057	354,726,857	351,158,637	352,275,977	
Change in Occupied Space (1)		(7,960,857)	(5,736,200)	(3,568,220)	1,117,340	(16,147,937)
Total Inventory	390,668,420	394,986,148	397,386,148	400,486,148	400,486,148	
Vacancy Rate	5.7%	8.7%	10.7%	12.3%	12.0%	-6.3%

Source: U.S. Bureau of Labor Statistics, NYC Comptroller, NYC Office of Management and Budget, Cu. Wakefield
 (1) Assumes that an average square foot usage of 230 per office-using employee

¹² So far through September 2008, the securities industry has shed 13,000 jobs based on the latest available data, per US Bureau of Labor Statistics.

¹³ The most recent precedent was the collapse of Drexel Burnham Lambert in the early 1990s.

¹⁴ One downside is that unlike 2001, when the Fed's lowering of interest rates had a stabilizing effect on the housing market and the economy, the Fed's intervention has been far less effective given the current housing market bust and credit crunch.

¹⁵ This includes the 2.0 msf Bank of America Tower (1 Bryant Park), a smaller boutique building at 520 Madison, and the 2.0 msf new headquarter building for Goldman Sachs in Battery Park City.

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