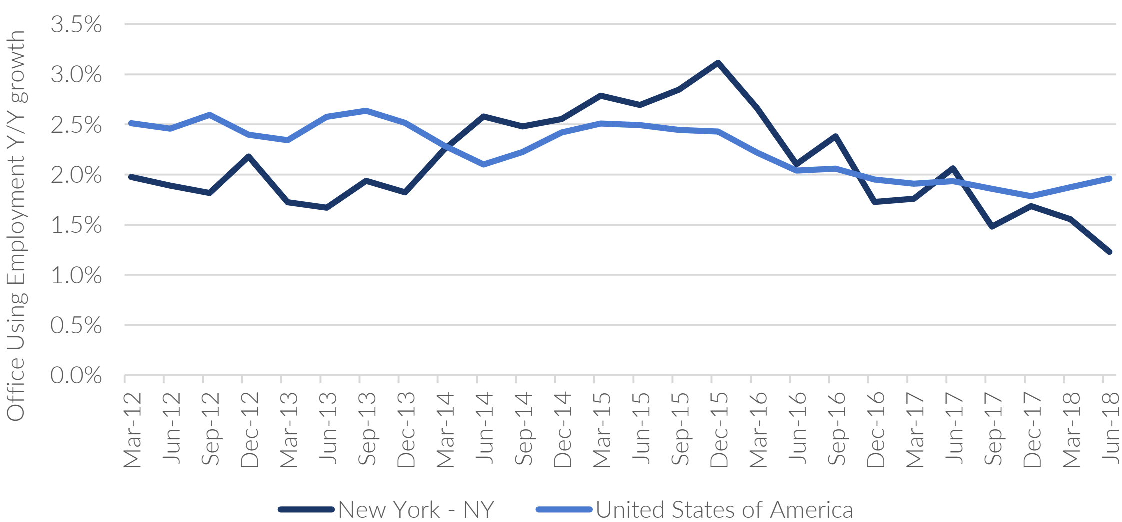
# Stabilized top tier office most exposed to a potential slowdown in Manhattan

- Manhattan and surrounding New York City metro employment is growing and office absorption has been positive – but at a weaker pace than a few years back
- Shifting trends in co-working are reducing office space needed per employee and potentially increasing risk to the market
- Significant supply on the horizon with the addition of Hudson Yards and other projects may exceed demand
- Rents are showing signs of recent declines, and concessions are increasing
- With tight cap rates, and less steady demand, equity investments in stabilized top tier office is exposed to a potential slowdown

## JOB GROWTH REMAINS POSITIVE IN NEW YORK CITY, BUT IS SLOWING

The Manhattan and surrounding New York City metro office market has improved significantly since the depths of the 2009 recession. Demand for office space in New York City has been helped since 2010 by steady job growth (Figure 1). As a result, employment in New York City has fully recovered following the 2008 recession, with the number of jobs in New York City reaching 4.5mn in June 2018, according to the Bureau of Labor Statistics. The number of jobs is now 18% higher than the pre-crisis peak employment in June 2008, and continues to grow at a steady but slowing rate. Most importantly from a commercial real estate (CRE) perspective, office-using employment has shown steady growth, with Y/Y office-using employment posting 2.5% growth in 2014 and 2015, higher than the national average. However, office-using job growth in New York City has slowed since 2015 with Q2 2018 growth of just 1.2% Y/Y, as compared to 2.0% nationally.

**FIGURE 1.** OFFICE-USING EMPLOYMENT GROWTH IN NEW YORK CITY IS SLOWING BUT REMAINS POSITIVE



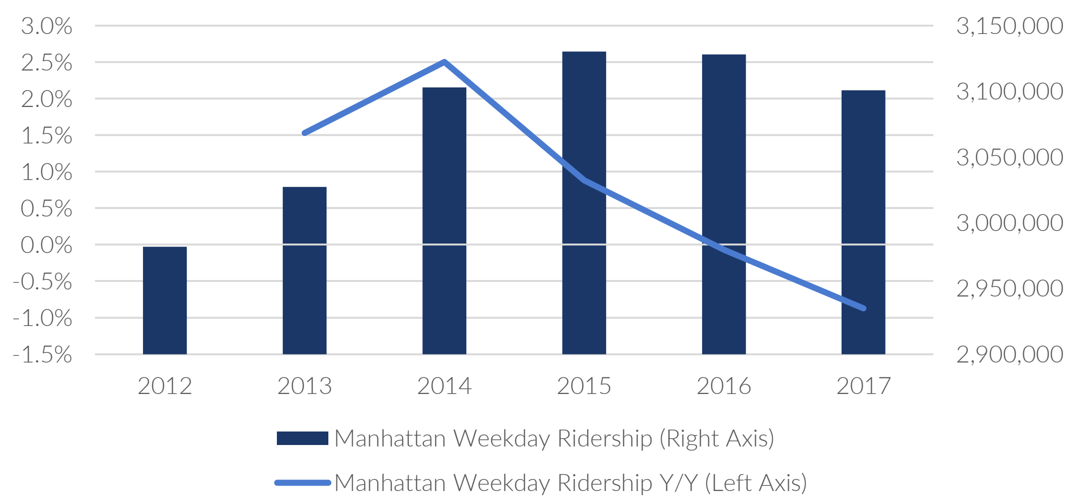

Source: Costar, Moody's Economics, Bureau of Labor Statistics as of Q2 2018

## SUBWAY RIDERSHIP IS DOWN BUT IS LIKELY DUE TO THE RISE OF UBER AND LYFT

One other metric frequently used to see if jobs are translating into office demand in New York City is to analyze subway ridership. Subway ridership has been historically correlated with job growth, since many (if not most) Manhattan office workers depend on the subway to reach their respective offices ("Subway ridership falls as MTA scrambles to improve service," New York Times, November 15, 2017). Subway ridership steadily rose following the recession, peaking in 2015, with 3.13mn per weekday riders in Manhattan (Figure 2). However, despite continued job growth since then, subway ridership declined into 2017, and in Manhattan is down about 1% from the peak to 3.10mn weekday riders. Similar trends exist for the entire metro, with 2017 weekday ridership down 1.3% or 75k rides to 5.58mn.

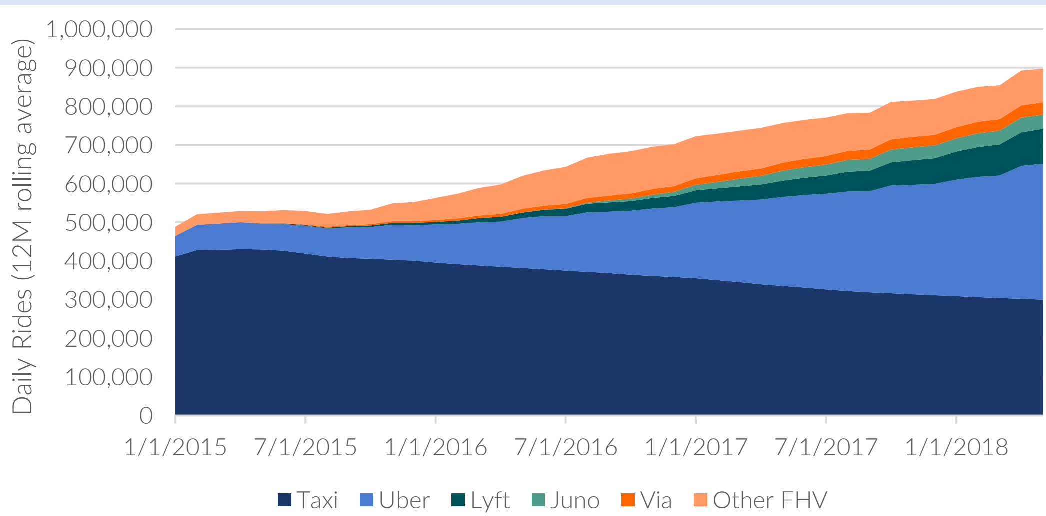
In a vacuum, this could be viewed as a distressing leading sign of job decline, as it could foreshadow job losses that have yet to be picked up by the Bureau of Labor Statistics. However, another trend, the rise of ride-hailing services such as Uber and Lyft may be the explanation for lower subway ridership. For-hire vehicles excluding taxis companies have increased usage from 77k rides per day in January 2015 in New York City to 700k rides per day in May 2018 (Figure 3). Even after taking into account declines in taxi ridership, the use of any taxi or ride hailing service has risen from 500k daily trips in early 2015 to 900k in May 2018 on a 12-month rolling average. It is likely that some of these rides are substitutes for subway ridership and help explain the decline in weekday subway ridership. Lower subway ridership notwithstanding, job growth in New York likely continues to be positive, though possibly at a slower pace.

FIGURE 2. MANHATTAN SUBWAY RIDERSHIP HAS FALLEN SINCE PEAKING IN 2015




Source: MTA, Amherst Capital Management as of August 2018

FIGURE 3. THE RISE IN RIDE-HAILING APPS HAS OUTPACED DECLINES IN SUBWAY AND TAXI RIDERSHIP



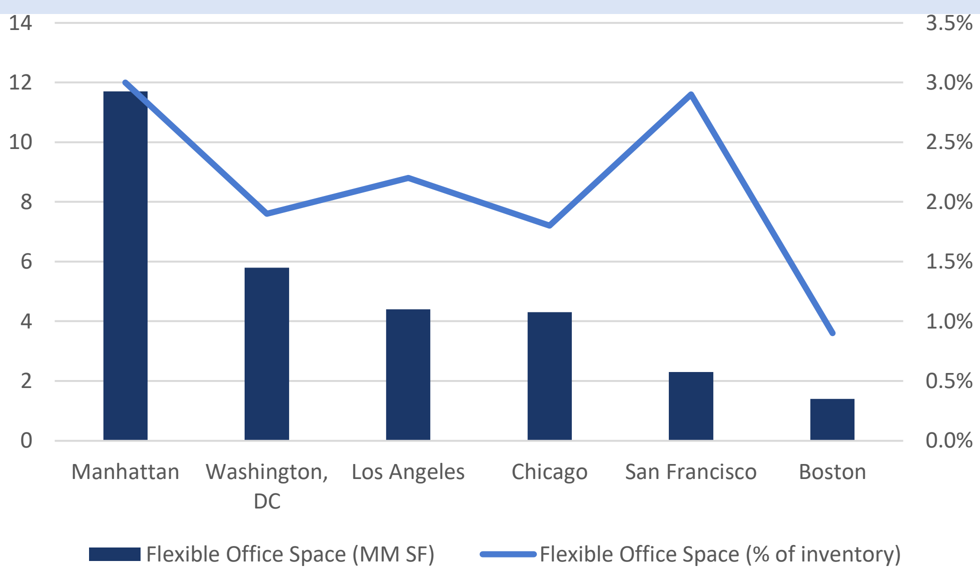

Source: Taxi and Limousine Commission, Amherst Capital Management as of August 2018

## IT'S NOT ENOUGH TO ANALYZE TRENDS IN "OFFICE GOING" WORKFORCE ALONE – PER WORKER OFFICE DEMAND HAS BEEN DECLINING STEADILY

While the job market has helped support steady demand, another factor impacting office demand in New York City is the rise of co-working spaces. Co-working companies such as market-leader WeWork provide shared space for multiple companies, with shared amenities and potentially without assigned space. The arrangement allows companies to have flexible workspace that can accommodate more workers than a typical office. Additionally, leases are short term, increasing flexibility for end-users of the space. According to Cushman Wakefield and Costar as of August 2018, 11mn sf of office space in Manhattan and 12mn sf in New York City is leased to co-working companies (Figure 4). Co-working companies remain a small portion of the market size at 2-3%, but account for 10.5% of all leases signed in H1 2018 and represent 260% of the cumulative net absorption since 2013, according to Cushman Wakefield and Costar data. Highlighting the growth in the sector, WeWork claims to now be the largest private tenant in Manhattan with 5.3mm square feet, surpassing JPM, as of September 2018. Additionally, some larger companies are mimicking co-working spaces by allowing flexible working arrangements that permit operating with less office space per employee ("Out of the Office: More People Are Working Remotely, Survey Finds", New York Times, Feb 15, 2017).

The rise of co-working and flexible working is an unmistakable trend but not necessarily a positive one for office CRE. While these companies have increased office demand and made it possible for some otherwise small tenants to lease for limited time in places like Manhattan, it may be increasing risk to the office sector. One, the overall use of office space per employee comes down in these arrangements typically. Two, co-working end-users usually make short term commitments and demand for co-working space could drop quickly in a recession. Many of the co-working companies are new and have not experienced a recession, and have long-term liability in their leases to office owners. This liability mismatch could lead to a faster increase in supply and exacerbate weakness in stressed office market conditions.

FIGURE 4. MANHATTAN IS THE LARGEST CO-WORKING SPACE BY SIZE AND % OF MARKET

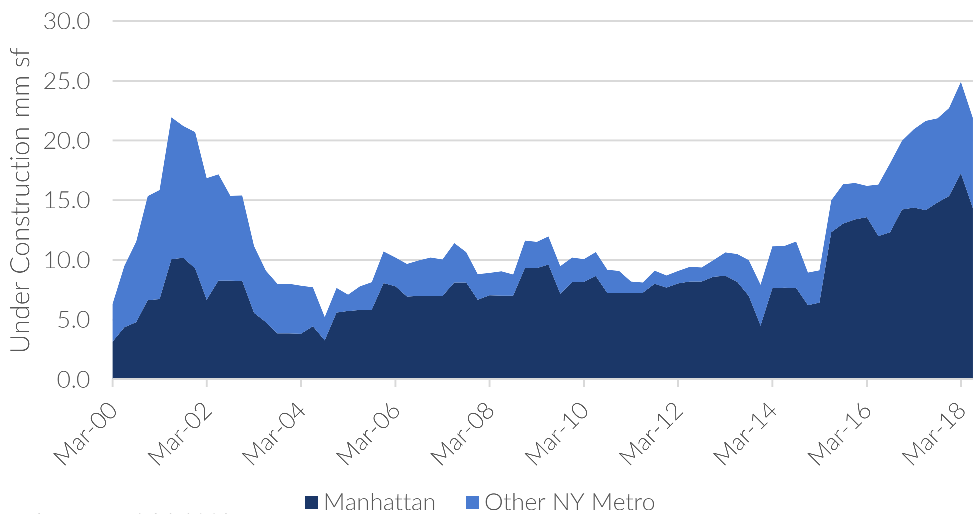



Source: Cushman Wakefield, Costar as of August 2018

## SUBSTANTIAL NEW SUPPLY COMING TO THE MARKET, BUT UNCLEAR IF DEMAND FOR NEW SPACE WILL LEAVE VACANCIES IN OTHER AREAS OF MANHATTAN

While demand remains steady, albeit slowing, there are signs that supply is picking up in the New York City metro. Costar data as of Q2 2018 indicate that there are 22mn sf of office space under construction in New York City, including 14mn sf in Manhattan (Figure 5). Much of the new construction is driven by large construction projects such as Hudson Yards, which including neighboring projects includes of 19mn sf of office space, some of which has already been completed. The new supply totals about 3.5-5% of the total market size, but represents about 650% of the cumulative three-year absorption, based on Costar data. Not only is this construction square footage much higher than historical averages, the amount in Manhattan is above the peak supply in the previous economic cycle from 2001 to 2008.

FIGURE 5. UNDER CONSTRUCTION OFFICE SQUARE FEET AT MULTI-DECADE HIGH

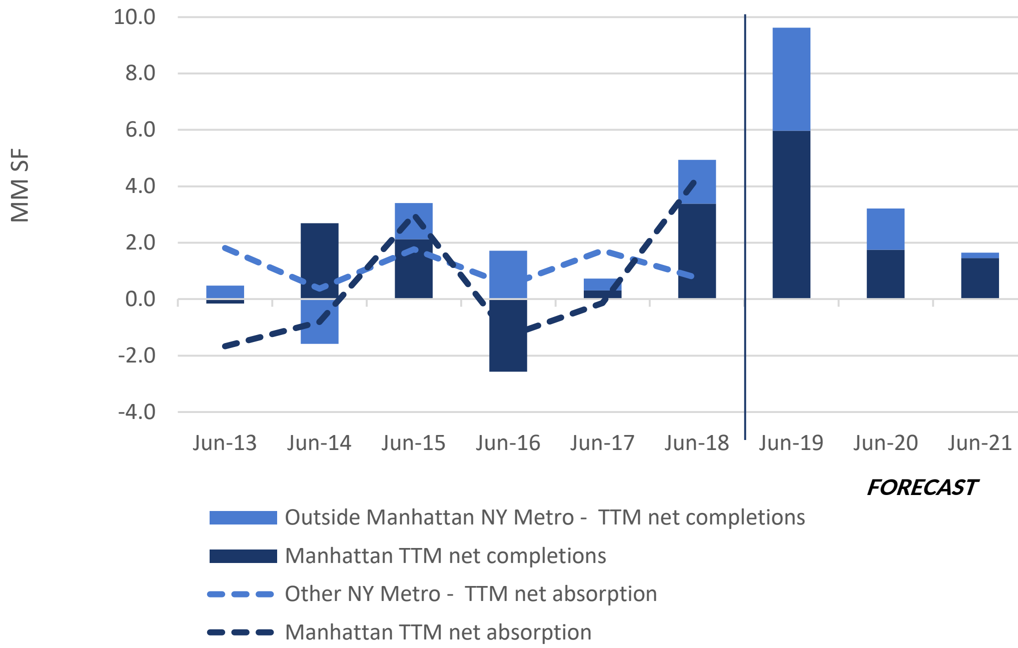



Source: Costar as of Q2 2018

The strong construction pipeline is likely to result in a large pickup in net supply expected over the next three years, particularly compared to the 2015-2018 period. Costar data indicate that net completions in Manhattan were just 1mn sf cumulative for the three year period ending in Q2 2018, but that is expected to rise to 9 million sf over the next three years. Similarly, the rest of the New York City office market is expected to gain 5.3mn sf in the next three years versus 3.7mn in the past three years. (Figure 6). Additionally, the expected supply exceeds historical net absorption which for the past three years has averaged 1.9mn square feet per year in the metro area.

Much of the new construction is being built with tenant demand already lined up via pre-leasing from moves from existing New York City offices such as planned moves by Pfizer, Blackrock, Ernst and Young, Time Warner into the Hudson Yards area. These tenants are drawn to the high-quality new space being built, but is unclear if there is enough demand to backfill aging properties these tenants are vacating. As a result, overall occupancy may decline and rents may be pressured, particularly for older buildings in areas like Midtown Manhattan which need significant capex to compete against new supply.

FIGURE 6. NET OFFICE SUPPLY WILL BE SIGNIFICANT IN MANHATTAN AND THE REST OF THE METRO AREA



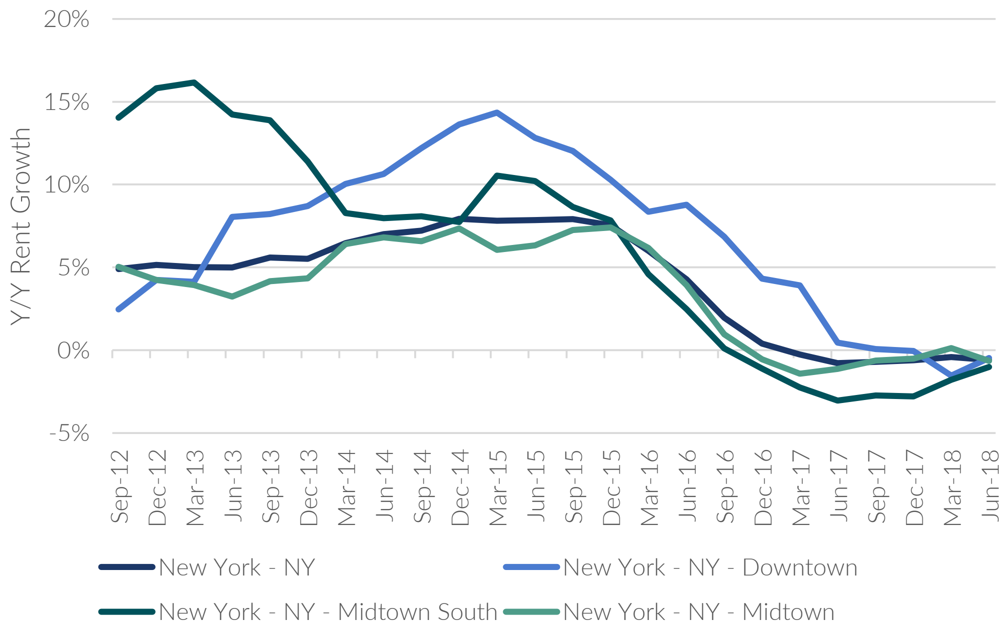

Source: Costar as of Q2 2018

## INCREASING SUPPLY IS ALREADY PUTTING PRESSURE ON RENTS

Even though most of the new supply has yet to arrive on the New York City market, rents are already showing signs of distress. Office rents have declined on a year-over-year basis -0.6% in Q2 2018 in Manhattan, after declining -0.8% in the year ending Q2 2017 (Figure 7). The slowdown was broad based across submarkets of Manhattan, with even the previously hot Midtown South and Downtown neighborhoods showing declining year-over-year rents through Q2 2018 after posting double digit rent growth in 2013-2015.

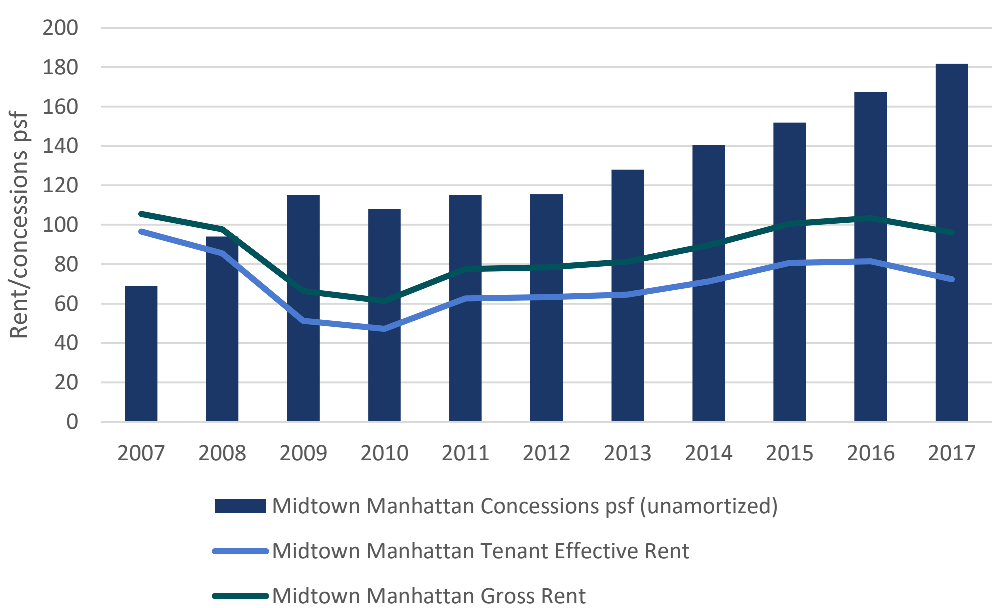
Another sign of rent pressure is the steady increase in concessions needed to sign tenants for new leases. Data from leasing broker Savills Studley indicate that tenant concessions in Midtown Manhattan reached $182 psf in 2017 compared to $152 psf in 2015 and $69 in 2007 (Figure 8). Combined with lower gross rents, increasing concessions indicate more significant declines in effective asking rents. Rent pressure may continue as new supply comes online in the next few years, particularly if demand continues to exhibit slow growth.

FIGURE 7. RENTS ARE DECLINING IN MANHATTAN AHEAD OF UPCOMING SUPPLY




Source: Costar as of Q2 2018

FIGURE 8. TENANT CONCESSIONS ARE INCREASING AS WELL, FURTHER REDUCING EFFECTIVE RENTS:

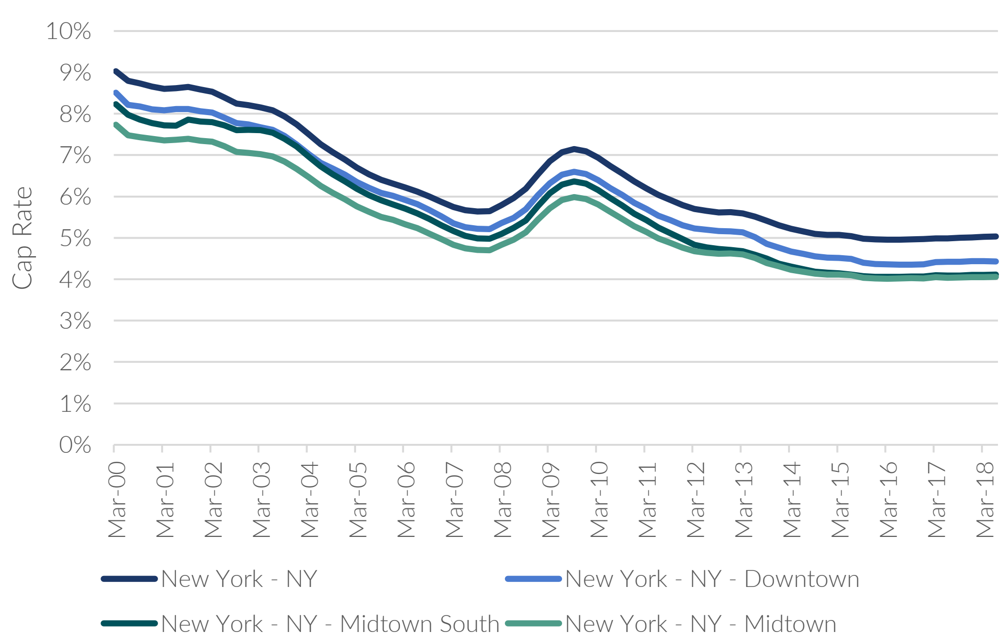



Source: Savills Studley as of April 2018

## NEW INVESTMENT OPPORTUNITIES REMAIN IN NEW YORK CITY, BUT EQUITY INVESTMENTS IN OLDER, STABILIZED NEW YORK OFFICE MAY BE EXPOSED

The fundamental case for the Manhattan and surrounding New York City metro does not call for an exit from the market – it warrants caution. While reports suggest that much of the new developments in the pipeline have significant tenants already lined up, supply is expected to increase considerably in the coming years. Properties owned at lower bases and with necessary capital expenditures may continue to do well. However, for equity investors in stabilized assets, there might be reasons to be more cautious than before. The older stabilized buildings in parts of Midtown and Downtown Manhattan may witness increased pressure from the significant new supply (and leasing activity) in Hudson Yards, in our view. In addition, Manhattan cap rates are at multi-decade lows at close to 4.1% (Figure 9) leaving little margin for error if tenant re-leasing costs and concessions continue to increase and pressure Net Operating Income (NOI). Last but not the least, many new co-working companies are untested through a recession, and their growing presence may result in greater pressure on landlords in a stress scenario. Co-working companies' short-term, flexible tenants are supported by long term liabilities which may be harder to navigate than it seems during economic downturns. For these reasons, we recommend defensive, up in the capital structure strategies that focus on value-add rather than levered positions in stabilized assets facing re-leasing risk.

**FIGURE 9.** MANHATTAN CAP RATES LEAVE STABILIZED EQUITY EXPOSED




Source: Costar as of Q2 2018

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(1) March 31, 2018. AUM includes gross assets managed in the single-family equity and commercial real estate strategies, which includes $272 million and $66 million of leverage, respectively.

(2) Seed capital Investor. It is not known whether the listed client approves or disapproves of the adviser or the advisory services provided.