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March 13, 2006

Hon. Scott M. Stringer
Manhattan Borough President
1 Centre Street
New York, NY 10007

Dear Borough President Stringer:

A few weeks ago, you asked IBO to examine critical issues underlying the planned rebuilding at the World Trade Center site. Given the brief time available before Governor Pataki's March 14th deadline for an agreement between Silverstein Properties, Inc. and the Port Authority, IBO has focused on an economic issue often overlooked in the debate over the competing financial analyses. With roughly 10 million square feet of office space planned for the site, IBO has reviewed whether there will be sufficient demand to fill the space at a time when the city is sponsoring other major office development initiatives elsewhere in the city.

To examine this question, IBO has updated the findings of a report we released in August 2004 that projected the need for office space through 2035 and reviewed the amount of commercial space expected to be built over the next 30 years at Hudson Yards, in midtown Manhattan, in downtown Brooklyn, at Atlantic Yards, and other sites across the city, including the World Trade Center. We have updated our projections for office employment using the revised data issued by the state Department of Labor just this past week. Our new estimates of office space to be built account for the changes in development plans at Atlantic Yards and other locations. Among our key findings:

- Despite the long-term secular trends that have fueled the movement of office space to midtown, given the current differences in rents and generous subsidies being offered there is some reason for optimism for the future of lower Manhattan as a location for new office development; the pace of construction at the World Trade Center site and development in Hudson Yards will greatly influence the outcome.
- The potential for a mismatch between the supply of office space and the demand for it citywide may be less than when we examined this issue in 2004.
- Current asking rents downtown in modern class A office buildings are about $34/square foot, considerably below the estimates Silverstein Properties ($50/square foot) and the Economic Development Corporation ($45/square foot) used in their financial analyses of the trade center project. Those estimates both include newly available rent subsidies of $5/square foot that flow to the landlord for buildings at the trade center site.

The following discussion expands and explains the reasoning behind these findings.

Update on Office Employment Trends

In 2004, IBO published a report on very long-term trends in office employment in New York City and the implications of those trends on the future demand for office space in the city. At the time, we found that our mid-range estimate for the growth in office employment yielded an estimated need for 49.8 million square feet of new office space between 2010 and 2035. At the time, city plans and related zoning changes for the World Trade Center site, downtown Brooklyn and Hudson Yards would have allowed for the construction of 42.5 million square foot of office space. One's sanguinity regarding these results depended on assumptions about what other development is likely to occur elsewhere in the city.

New data. Per your request, we have reviewed new data and information that became available after the 2004 report was released. In updating the employment data we have incorporated the latest New York State Department of Labor data which were released last week. The new data, which reflects the annual benchmarking of sample data with administrative data, significantly revised previous estimates for employment changes during 2004 and 2005.

Between 2000 and 2003, New York City lost 128,600 office jobs—10.2 percent of its peak of 1,262,600 office jobs and 67.2 percent of the total job loss between 2000 and 2003. The new employment data show that between 2003 and 2005, the city regained 29,200 office jobs—20 percent of the office jobs lost between 2000 and 2003 and 43 percent of the total job gain during the period. Overall, office employment in 2005 was at 92.1 percent of its 2000 peak level.

The financial activities sector, which accounts for much of downtown office employment, gained 12,700 jobs between 2003 and 2005—23 percent of the financial activities jobs lost between 2000 and 2003 and 40 percent of the net 29,200 office jobs gained between 2003 and 2005. The securities industry, which is part of the financial activities sector, gained 9,500 jobs—28 percent of the jobs lost between 2000 and 2003. Securities employment at the end of 2005 was at 87.4 percent of its 2000 peak level.

Professional and business services gained 17,500 jobs—35.1 percent of the jobs lost from this category and 60 percent of the net office jobs gained between 2003 and 2005. Gains were spread over several industries, including accounting (4,800 jobs), architecture and engineering (2,500 jobs), computer system design (2,900 jobs), management consulting (2,700) and advertising (2,900). While accounting rose significantly above its 2000 peak, computer system design and advertising remained far below their 2000 peak job levels. Other industries in the professional and business services sector, such as employment services—which includes temporary workers—showed little gain from 2003 to 2005.

While the financial activities and professional and business services sectors gained jobs from 2003 to 2005, other industries that are part of the office jobs category lost employment over the same period. Overall, information was down 1,000 jobs; within this sector telecommunications lost 2,300 jobs and publishing 200 jobs.

Implications. In the 2004 IBO paper, we forecasted that office employment would regain the peak it had reached in 2000 by 2010. It appeared that currently vacant space, as well as space expected to come on line during the 2005-2010 period (i.e. Time Warner Center, 1 Bryant Park, the New York Times building, and the Bloomberg building) would be sufficient capacity to accommodate the new workers even while the trade center buildings remained under construction.

Based on the revised employment data, IBO's 2004 forecast that office employment would regain its previous peak in 2010 still seems reasonable. Since there was virtually no growth in office employment in 2004 however, the average rate of growth for the next few years will have to exceed the average 1.55 percent annual growth used in IBO's original study. The revised employment data indicate that after showing little growth in 2004, office employment grew by 2.3 percent in 2005. If that pace were to continue, office employment would regain its 2000 peak level by 2009. A somewhat lower growth rate of 1.66 percent per year would be sufficient for office employment to regain its 2000 peak level by 2010. Nevertheless, it seems plausible that the 2000 peak could be regained by 2010. As a result there is no need to adjust our estimates of likely office-using employment gains after 2010 and the amount of space needed by 2035.

Meeting the Demand for Office Space by 2035. In our 2004 report, IBO's estimate of the very long term demand for office space was only modestly greater than the new supply to be provided by three major office initiatives backed by the city. IBO's mid-range estimate of the amount of new office space needed by 2035 to accommodate the expected office-using employment is 49.8 million square feet. In 2004, we assumed that three big initiatives backed by the city—Hudson Yards (with 28 million square feet), the World Trade Center (10 million square feet), and downtown Brooklyn (4.5 million square feet)—could supply 42.5 million of the square footage needed. These are not the only office projects likely to be developed, however. Development elsewhere in the city, including replacement of existing obsolete buildings and new business districts in Queens and the Bronx, is also likely. If demand for office space falls short of the nearly 50 million square feet that IBO projects, then some of this potential new space will probably not get built.

In the last two years some assumptions about expected sources of new office space have changed, making it more likely that the long run supply will be commensurate with demand. There has been little activity in the already rezoned downtown Brooklyn area. Moreover, the plans for 2 million square feet of office space as part of the Atlantic Yards project, which was not initially part of the downtown Brooklyn rezoning, has scaled back to about 500,000 square feet. Current plans for Hudson Yards now include 24 million square feet of office space, down from 28 million square feet. Some of the other sites identified as potential office space in real estate listings in 2004 now appear more likely to be developed for residential use, although market conditions could shift again in the coming decades. In short, IBO's conclusion in 2004 that demand might not be sufficient to fill all of the space planned for development in the three big projects may have been too cautious. If historic trends in office employment are replicated in the coming decades, it now appears more likely that the demand could line up reasonably well with the expected supply, assuming projects, including office construction at the trade center site, are built out at close to their current plans.

It should be noted that the plan suggested by EDC for mixed use development of tower 4 at the trade center site would amount to a relatively modest 7 percent reduction in the total amount of office space that would be delivered by the first four towers in the project, which would not appreciably alter our conclusions.

While long-run demand may be sufficient to utilize all of the potential new supply contemplated in the city's plans, timing of individual projects will be critical to their success or failure. Current plans call for the Freedom Tower and a building on the northeast corner of the site (Tower 2) to begin construction shortly. Silverstein properties anticipate starting towers 3 and 4, to be built along Church Street, shortly after the Port Authority finishes site preparation in mid-2008. On this schedule, much of the trade center office space would become available within 10 years. In contrast, the latest available publicly released plans for Hudson Yards anticipate that much of the new office development planned for Hudson Yards will come after 2014. Assuming that the current schedules are maintained, competition between these two projects for tenants may prove to be less significant than some anticipate.

Downtown Market

The downtown Manhattan office market has been experiencing a long-term secular decline relative to the midtown market since at least 1960. Although the differences in the trends for the two markets have narrowed at times during swings in the local business cycle, there has been an ongoing shift in the share of employment, office inventory, and new office construction favoring midtown. The likely explanations for this shift include the easier access to midtown from the northern and Long Island suburbs, easier access to Manhattan's premier residential neighborhoods east and west of Central Park, and the later start (relative to downtown) of office development in midtown, which left more land available for construction of modern class A office buildings. The original World Trade Center was the product of an earlier attempt to reverse this trend using government rather than private resources.

Early in 2001, prior to the 9/11 attack, the class A vacancy rate in downtown had fallen to about 4 percent, while the asking rent had reached about $47.00 per square foot. (Source: Cushman and Wakefield. Note that office market data is not officially compiled by a government agency; because the various private suppliers use different measures and definitions of office neighborhood markets, inventory, and building classification, estimates of market statistics can vary from firm to firm.)

The destruction of the World Trade Center and damage to surrounding buildings removed roughly 30 percent of the downtown class A office inventory. Contrary to expectations, this loss did not result in a spike in rents caused by the precipitous decline in supply. Instead, the spreading impact of employment losses due to the local recession that had started in the spring of 2001 and accelerated after the attack, combined with the existence of leased but unoccupied "shadow space" in midtown and downtown, enabled the real estate market to absorb most of the displaced tenants with little effect on rents. Instead, downtown vacancies grew and rents fell during 2002 before stabilizing somewhat during 2003 and 2004.

At the end of 2005, downtown class A asking rents were about $34.00 per square foot, a discount of more than one-third from midtown rents. Although downtown vacancies have declined somewhat they remain slightly above 10 percent.

Rents downtown will become even more competitive relative to midtown thanks to a package of newly available tax incentives for lower Manhattan. These tax incentives are available to firms taking or renewing leases for downtown space and are most generous at the trade center site. Leases at the World Trade Center site, including 7 WTC, as well as all retail tenants generally south of Murray Street enjoy a permanent full exemption from the commercial rent tax (a savings of 3.9 percent of the annual rent). Elsewhere downtown, there is a five-year exemption from the commercial rent tax for most leases signed by June 30, 2009. There are also substantial exemptions from the sales tax, with the most generous available at the trade center site, including 7 WTC, and at the World Financial Center: a ten-year exemption from the sales tax on purchases of office furniture, equipment and construction materials for tenant improvements. For leases elsewhere downtown that are signed before September 2009, a sales tax exemption is available for purchases related to tenant improvements. Businesses relocating employees to the downtown area or creating new jobs in the downtown area can also qualify for tax credits against their business income tax liability. The credit is worth $3,000 per qualifying employee each year for 12 years.

Moreover, rents at the trade center site will be subsidized by New York State. For the first 750,000 square feet of space rented at the trade center, excluding 7 WTC, the subsidy will equal $5.00 per square foot. At 7 WTC, the subsidy for the first 750,000 square feet to be rented is $3.80 per square foot. With the subsidy, the effective rent received by the landlord is thus higher than the rent charged to the tenant.Both the tax incentives available downtown and the subsidies available at the trade center site make office space in lower Manhattan even more competitive relative to midtown.

In addition to the cost differences, there are other changes underway downtown which should increase its attractiveness to commercial tenants. Transportation improvements already underway (the renovation of the Fulton Street/Broadway Nassau Street station and the new PATH terminal) could address some of the complaints about the difficulty of using mass transit to reach midtown and beyond. The continued evolution of lower Manhattan into a mixed use neighborhood with opportunities for living and working within a short distance and the kinds of amenities that follow residential development can have a positive effect on office demand.

Spurred in large part by the 421g tax exemption program (which expires this year), roughly 10,000 apartments have been created by converting office buildings to residences. According to CB Richard Ellis, since 1997, 6.6 million square feet of downtown office space has been converted to residential use. In most cases these were older, class B and class C buildings that were technologically deficient with small floor plates which were no longer competitive in the office market. By withdrawing these buildings from the downtown office inventory there was presumably some positive impact on the downtown office vacancy rate.

In general there are reasons to be optimistic concerning the downtown office market. With a large price differential from midtown, generous incentives available, and improving neighborhood amenities, it is likely that downtown office buildings will become more competitive with midtown. This is especially the case for newer class A buildings with the necessary large floor plates and technological infrastructure as similar large sites in midtown become increasingly scarce. Conversely, many of the same factors propelling the long-term movement of firms to midtown remain unchanged and the impact of September 11 on the demand for office space at the trade center site remains an open question.

At the current time, however, prevailing rents downtown are considerably lower than the estimated rents used by Silverstein Properties ($50 per square foot) and EDC ($45 per square foot) in their financial analyses. In both of those analyses, the cash flow to the landlord includes a $5 per square foot subsidy in addition to the rent paid by tenants at the trade center site. Whether Silverstein's and EDC's projections prove too optimistic will also depend on changes in market conditions in the next few years and whether the new trade center buildings can command a premium over other competitive downtown buildings.

Your request to IBO noted a number of other critical issues regarding redevelopment of the trade center in addition to the question of the long-term supply and demand of office which you asked us to focus on. These other potentially important issues are beyond the scope of this review.

If you have any further questions regarding this matter, please feel free to call.

Sincerely,

Ronnie Lowenstein
Director