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Observations on the New York City office market: flight to quality, new concepts, repositionings and conversions - by Shimon Shkury

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Investor demand for New York City office buildings rose in the first six months of 2022 with $4.7 billion trading, up 11% from 2H 2021 and up 353% from 1H 2021, Ariel Property Advisors' research shows.

Two transactions in the first half of the year stand out as distinct trends in the office market. These include Google's $2.1 billion purchase of an office development, St. John's Terminal in SoHo, which accounted for 45% of the dollar volume in this asset class, and RFR's purchase of 475 Fifth Ave. in Midtown for $290 million, more than double the $143.9 million Nuveen paid for it in 2011.

Building a Home, Not Just an Office

Google is a trendsetter because the company isn't just creating an office at St. John's Terminal, but a home for its employees. Alphabet and Google CFO Ruth Porat wrote in a blog post that this "groundscraper" will include office space occupied by Google, a public food hall, community space, galleries, the city's largest public rooftop space and educational and environmental programs run by the Hudson River Park Trust.

Knowledge workers, especially in TAMI, are in high demand and a unique, amenitized workspace like Google's horizontal campus is one way to retain them. Therefore, we can expect other companies to build 'day' homes for their employees. Another tech giant, Amazon, is renovating the historic Lord & Taylor Building in a great Midtown location at 424 Fifth Ave., which it acquired from WeWork for $978 million in March 2020 just before Covid-19 shut down.

Rather than buying buildings, other tech firms are leasing office space and leaving it to their landlords to make significant improvements. Meta (Facebook) signed a 730,000 s/f lease in August 2020 for the Farley Post Office building across from Penn Station where owner Vornado is investing $1.03 billion to redevelop. In January 2022, Roku announced it was taking 240,000 s/f on the top eight floors of 5 Times Square, where owners RXR and David Warner have launched a $126 million capital improvement project that will include 50,000 s/f of amenities, and Microsoft leased 150,000 s/f of space in October 2021 at 122 Fifth Ave. in Union Square, where Bromley Companies is undertaking a $100 million upgrade featuring private and communal terraces.

Investor Flight to Quality: Location and Tenancy

A few blocks north of Amazon's building, RFR purchased 475 Fifth Ave. in May 2022. This well located Midtown asset with a great tenancy is an example of quality and it starts with its location a few blocks from Grand Central Terminal and across from the New York Public Library and Bryant Park, which in a way are natural city amenities. This transaction followed RFR's acquisition of 522 Fifth Ave. for $350 million from Morgan Stanley in August 2020.

Recent similar sales with attractive tenants in desirable locations include Commonwealth Partners' $1.033 billion acquisition in December 2021 of Hudson Commons at 441 9th Ave., which is 75% leased and includes tenants Lyft and Peloton; Meadow Partners' $288.23 million purchase in June 2022 of 95 Morton St. in the West Village from RFR, whose tenants include PayPal, Venmo and Fanatics; and Macquarie Asset Management's $130 million acquisition in January 2022 of 375 W Broadway in SoHo, where financial services payments technology firm, Block, leases the top four floors.

Back to Basics with Proactive Management

Despite these high profile transactions, however, no asset class has been more adversely affected by Covid-19 than the office sector. The "Work from Home" culture has reduced office occupancy rates to around 40% of their pre-pandemic level and the existing stock of available office space for lease at a staggering 19.2%, definitely exceeding demand. Therefore, we see a clear division between newer buildings, those with effective managers, attractive amenities and locations and 'tired' side street product.

During our firm's recent, Coffee & Cap Rates event, panelist Andrea Himmel, principal, CIO, and head of acquisitions for long term office owner/operators Himmel + Meringoff Properties, said she believes that New York City remains an attractive investment for office, noting that office buildings in her firm's portfolio have returned to above 90% leased, although the physical occupancy is still lower.

Himmel said her firm is still bullish on the city's office sector and is a buyer for select office buildings near transit in emerging and/or temporarily impaired neighborhoods. "As long term holders, we are patient and can arbitrage time because we don't value assets based on current income," she said.

"Within our own portfolio we've signed approximately 1 million s/f of leases in the past year, three or four of which were 100,000 s/f or larger for 15 to 30 years," Himmel said. "We just inked a deal with Mount Sinai for 30 years for 50,000 s/f in our property on 57th St., a life science building, 100,000 s/f to the NYPD, and 70,000 s/f to NYU, amongst others."

Success in today's office market requires active management and a strong proactive approach which Himmel and her team have behind them. In fact, she sees an opportunity to replace owners who are not as engaged in managing and pay them to walk away.

"I do think that landlords who are facing capital calls and then debt refinancings in the next 12 months are going to be stuck," she said. "They're not going to be able to refinance their property because it's now half empty and the LTV is too high. I think we're going to start to see transaction activity in these buildings in which lease-up costs are compounded by CAPEX burdens."

Office Owners Embrace Co-Working

Many New York City landlords are embracing the changing environment by offering flexible office space. Himmel + Meringoff's 1460 Broadway, for example, is fully leased to WeWork and is one of the co-working entity's best performing buildings. Owner Tishman Speyer has expanded the footprint of its co-working brand, Studio, to 350,000 s/f, most recently introducing the concept at 175 Varick St. and 11 West 42nd St. NYC Office Suites is now offering furnished short-term flexible office space in the Chanin Building at 122 East 42nd St., and Industrious is offering co-working spaces in office buildings throughout Manhattan and Brooklyn.

With 45 million Americans working as freelancers and many tenants unsure about the future of their business and space requirements, Himmel said flexible co-working alternatives will remain desirable. In fact, occupancy in well-located WeWork buildings in New York City is 60% to 70%, far above the 40% average citywide, she said.

Office to Residential Conversions

Finally, some policymakers and housing advocates see the lower demand for select office buildings as an opportunity to encourage office to residential conversions. However, this is a tall order. Altering the building structure is in most cases cost-prohibitive, office floor plates are not easily converted into residential use, the locations are not always attractive, and such conversions require zoning changes. Therefore, the city has rarely seen them with a few exceptions.

Macklowe Properties has spent the last eight years converting the former home of Irving Trust and later Bank of New York at One Wall Street in the Financial District into a 566-unit condo building. Sales are underway in the landmarked tower for residences ranging from $990,000 for a studio and $12.75 million for a four-bedroom. The project is expected to be completed by the end of 2022.

In addition, Silverstein Properties and Metro Loft recently agreed to pay $180 million for a 30-story office building at 55 Broad St., also in the Financial District, and convert it into 571 market-rate apartments in the next three or four years.

"Office to residential conversion presents an interesting opportunity given the arbitrage created by a potential near-term oversupply of office and an overheated residential sector," says Himmel, who also noted that it really can only be done in C-zoned buildings with floor plates of at least 15,000 s/f and with a land basis less than $400 per s/f. “You need to account for the lack of loss factor, so for a given office building, you can probably build about 30% less residential square footage.”

Demand Drivers Bring Hope to Office Sector

High availability and low office occupancy rates can be seen as discouraging for New York City’s office stock. But there are some encouraging trends that we should not overlook. First, the growth in office attendance has been substantial and doubled from 2021 to 40% in 2022, according to data from Kastle Systems. Second, bridge and tunnel traffic rose to 948,711 daily vehicles in August, slightly above pre-pandemic levels, MTA figures show. Subway ridership has risen consistently to 60% of the 5.5 million pre-pandemic riders and is estimated to reach 4 million by the end of 2023. And lastly, the Long Island Railroad’s connection with Grand Central at the end of this year is estimated to increase in-city ridership by 160,000 and increase the LIRR’s capacity by 40%. Therefore, these demand drivers are encouraging and coupled with the observations above, the office market in New York City may be headed for a major recovery over the next few years.

Shimon Shkury is the president and founder of Ariel Property Advisors.