How Manhattan's Fiscal Problems Have Affected the Office Market

by John Robert White, CRE

THE PRIOR BOOM

The five-year period from 1966 through 1970 witnessed the most intensive, hyperactive office market boom in Manhattan's history. Manhattan's office market was profoundly influenced by the strong national inflation that commenced in the mid-1960s, primarily because of the Johnson administration's unwillingness to finance the Vietnamese War on a more current, conservative basis. In retrospect, the boom was an impressive performance. Absorption of space was at an abnormally high level. Some 28 million square feet were rented between 1966 and 1970, an average of 7.6 million square feet annually, while only 32 million square feet were being completed. Rents rose 50% to the $12-$14 per square foot level. Vacancies were virtually non-existent. Land values in prime locations such as Park Avenue more than doubled from $300 per square foot to $700 a square foot.

Corporate relocations to the suburbs and elsewhere were lightly regarded and frequently dismissed. The Borden Company, for example, moved its corporate headquarters to Columbus, Ohio. Its Manhattan building was then sold to Condé Nast for $100 per square foot, reportedly the highest price ever paid for a 40-year-old office building. What matter that Pepsico, Continental Oil, American Can, Johns Manville, General Telephone & Electronic, and others had left or planned to leave in this same five years? Internal growth was considered to be so strong that Manhattan could not be affected. Indeed, the office market paid little heed to the rather shallow recession of 1969-70 even though industrial and other blue collar and service employment declined sharply at the time, presaging a deterioration in local economic conditions. Planning and construction of new office buildings continued in the face of warning signals.

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RISING CONCERN OVER CITY SPENDING

In retrospect, the widly inflationary boom of the late 1960s masked some disturbing economic and political facts. During this time, New York was sowing the seeds of its own near destruction. Starting with the transit strike on the very first day of the Lindsay administration, the city thereafter appeared to capitulate to strong union demands for wage increases and improved fringe benefits by permitting raises possibly beyond its financial capacity. After all, with assessed valuations in Manhattan increasing $2.4 billion in those five years, why should the city be unduly concerned with its ability to afford these increases?

The city's position was further complicated by the costs associated with the in-migration over many years of culturally and educationally-deprived blacks and hispanics. This forced the essential expansion of programs in welfare, education, and job training. There were also significant related increases in police, fire, sanitation, and other service costs. Taxpayer and business groups became increasingly restless and concerned over what they felt were excessive and poorly-structured debt issues to finance these costs. Debatable accounting practices further undermined the confidence of the business community in the city. If prosperity had continued unabated, it might have been possible to carry this financial burden. Events rapidly proved otherwise. While the office market was seemingly riding out the recession of 1969-70, non-white collar job losses were severe. As it subsequently turned out, New York never fully recovered from the 1969-70 recessionary effects. Coupled with a sharp ensuing retrenchment in office demand and a staggering oversupply, the city moved closer to its own denouement.

A SERIOUS REAL ESTATE DECLINE

The decline in the real estate market in late 1970 and 1971 was in its own way as unforeseen as the prior five-year boom. It was experienced in diverse ways. Corporate relocation planning intensified. Other companies accommodated their office growth needs simply by decentralizing on a regional and divisional basis. Demand for all practical purposes nearly vanished. The burden of ever-increasing taxes of a wide-ranging nature was the principal motivation in the corporate abandonment of Manhattan. It appeared that crime, congestion, educational problems, deficient commuting, and pollution in themselves were not sufficiently strong reasons for commerce to leave New York City in large numbers. These problems were common to all the older major eastern and midwestern cities and were certainly not peculiar to New York. By 1975, only 1,453,000 square feet of new space was rented, a drop of 65.7% from the 1966-70 five-year average. An unfortunate complication that further weakened the market was the 42 million square feet of space completed in the five-year period after 1971.

Real estate market indicators told the classical story of demand retrenchment and oversupply. Rents in prime buildings plummeted from the $12 level to $10 or less. Vacancies reached 33 million square feet in 1974, representing a 14% vacancy rate. Assemblage activity ceased, except to complete assemblages long since previously started. Building plans were shelved. Assembled plots were broken up. Sales activity declined precipitously. Mortgagees quietly re-evaluated their willingness to make mortgage loans on Manhattan property. The once proud, bellwether commercial real estate market of the world was at almost a standstill in 1974-75.

THE FATE OF LAND VALUES

Land values really could only be hypothesized or inferred since there was no direct market evidence in the form of land sales made for the purpose of constructing new office buildings. One factor was clear. It was impossible from 1971 through 1976 to find any signs of land value by using so-called land residual capitalization techniques. Although direct building costs had declined under the pressure of high unemployment in the building trades, indirect or "soft" costs, principally construction loan interest went to new highs.

A combination of high interest, a low level of obtainable rent, high if not excessive building costs, excessive real estate taxes, and inflationary operating expenses theoretically conspired to deprive land of any value whatsoever. Judgment became a major factor. Some degree of eventual recovery had to be anticipated. It was felt that land had fallen between 50 and 60% in the six years of real estate depression that followed the 1966-70 boom. Fortunately, Manhattan land was in such strong hands that there was no complete demoralization or actual collapse of the land market. Owners, mainly institutional or developmental, doggedly stayed with their investments and hoped for a cyclical recovery.

Land of course is a residual product. It invariably suffered the consequences of demand cutbacks, loss of confidence, oversupply of space and erosion of the city's economic base. For example, in early 1974 Landauer Associates, Inc. represented the fee owner in a ground lease arbitration for the land underlying the Chrysler Building. The basis for settlement was a land value of $335 a square foot. In 1977, we again represented the fee owner in a ground lease arbitration for the land under 757 Third Avenue, a tall office tower at East 48th Street. The basis for settlement was $140 a square foot. While this location was not as good as the Chrysler Building site, it was nevertheless a very low land value. By way of comparison, at least four comparable sites within six blocks along Third Avenue had been assembled by 1971 in the $300 to $400 per square foot range.

To return to our narrative, the recession of 1974-75 and the widespread public revelation in 1975 of New York's near bankruptcy dealt a cruel double blow to the office market, to land values, and to the city's fortunes. Job losses continued to mount after 1970 until they reached a high near 600,000 by January, 1977. The city's financial crisis further eroded the confidence of the business community. Passage of emergency legislation insuring greater financial control, debt re-structuring and operating economies, supplemented by state and federal loans, averted the bankruptcy but doubts and fears about the city persisted throughout 1975. It was impossible to see any short-term improvement in our predicament.

TURNING OF THE TIDE

The gradual national recovery from the 1974-75 recession subtly influenced the stirrings of a real estate recovery for Manhattan, beginning in 1976. First, the relocation trend abated sharply; the remaining Fortune 500 companies had compelling reasons to stay in New York. Strong internal growth and mergers were gradually creating newly eligible Fortune 500 companies. The corporate advanced services sector, the wide ranging support services represented by banking, law, accounting, architecture, real estate, public relations, advertising, and other services, was already three times the size of the basic corporate office sector in number of personnel and was growing rapidly in response to national calls for its services. Vacancies in Manhattan by 1976 declined by 10 million to 23 million square feet, or 10% of the total inventory. Rents in prime locations were rising modestly. Suddenly it became apparent that there were no large blocks of space available for very large tenants, except in the historically troubled 1166 Avenue of the Americas building.

Development activity is about to resume as investors react positively to the recovery signs. For example, Harry Helmsley is scheduled to start construction on the Palace Hotel and residential condominium this fall. The Fisher Brothers-Prudential joint venture is seriously examing the start of an office building west of the Racquet and Tennis Club off Park Avenue. Citicorp has been successful in obtaining $16 per square foot rents in their new 50-story office tower on Lexington Avenue. It is evident that six years of recession are over. The upturn has commenced.

WHAT ABOUT THE CITY'S FORTUNES?

New York's fiscal problems are beginning to come under strong control; a break-even budget has become a realistic prospect despite yet-to-be solved questions about substantial overassessment, widespread tax delinquencies, debt restructuring and wage increase pressure. Perhaps the most significant and encouraging event has been the closer alignment of the business community with the city. The skills and competence of business management have been used by the city to reorganize its accounting and computer operations. The city has also recognized the importance of retaining industry and commerce by passing various tax abatement statutes designed to induce industry and people to remain. It has also pledged to reduce or eliminate the notorious stock transfer and tenant occupancy taxes which had become symbols of the city's inability to plan and implement a reasonable fiscal program. The present administration has even promised if elected to refrain from increasing the real estate tax rate for four years!

Employment is stabilizing for the first time in seven years. This has been accomplished in the face of severe declines in government employment necessitated by operating economies. Internal employment expansion is beginning to exceed the loss in jobs arising from the decentralization process. Manhattan's population is also expected to stabilize. Youth particularly welcome the challenges of the city. The major problem of attracting families with children unfortunately remains.

The traditional mix of office tenancy is also changing. For example, five years ago, there were 21 foreign banks licensed in New York. Today there are 117. It is widely recognized that New York is replacing London as the premiere international banking center. The foreign multi-national corporations invariably have offices in New York and are increasing them at a rapid rate. Currently, over 10% of the space in the Pan Am building is leased to foreign tenants. Heretofore little understood is the fact that corporate relocatees to the suburbs or elsewhere continued to depend on New York companies for their banking, legal, real estate, accounting, engineering, advertising and other services, thus minimizing the shock impact of office decentralization.

The biggest factor is and will continue to be the restoration of confidence in the political process by the business community. Strong cities uniformly are characterized by a close and respectful relationship between the business and political leadership—witness Chicago, Atlanta, Houston, and Dallas. There is every reason to believe that a closer bond is being forged; it has been amply evident in the mayor's recent key appointments to high positions, in the willingness of business executives to serve, in the state's more extensive involvement in the city's affairs, and in the achievement of a prudent operating budget.

WHAT ABOUT THE FUTURE FOR LAND?

Although we have been unable to draw any precise mathematical correlation, events of the past seven years conclusively indicated that New York City's fiscal mismanagement contributed heavily to but was by no means the sole reason for the decline in Manhattan real estate land values. Overspending is a pervasive force that finds expression in many ways. Certainly, to the extent that the city lived beyond its means, it has resulted in unnecessarily harsh and regressive taxes, ranging from real estate taxes approaching 30% of gross revenues to city income taxes, occupancy taxes, stock transfer taxes, industrial equipment taxes, franchise taxes, and others. Many in the business community made the judgment that these taxes could no longer be tolerated and that sound alternatives to New York existed where life-styles could be improved while after-tax income could be increased. A mood of despair and disillusionment with the city prevailed from 1970 through 1975. No amount of jaw-boning by the city's Economic Development Administration could deter many companies from leaving. Many decided the deterioration in the city's affairs was irreversible and that relocation was the sensible solution rather than to stand and fight for prudent fiscal policies.

In the forefront was the abandonment of the city by those companies who sought sylvan suburban retreats while still relying heavily if not exclusively on critical business support services available only in the city, and on the city's cultural, educational, and amusement facilities. Problems typical of all major urban cities such as crime, pollution, education deficiencies, congestion, and high living costs also strongly motivated companies and families to move. Employers complained about the difficulty of inducing rising young executives with families to relocate to New York. With increased leisure time the phrase "life-style" caught on to express the desire of many to live in a smaller, less complicated, and less intensively populated environment, remote from the seamy aspects of urban living found in street crime, drugs, poverty, and prostitution.

Purely as an informed judgment and entirely without pretense as a precisely articulated answer, it appears that overspending not only was the root cause of office relocation but probably was more than 50% responsible for the loss of the large executive headquarters companies. It must in all fairness be pointed out that the federal government failed to assume enough of the extraordinary welfare and other costs characteristic of New York. Relocation had been occurring since the early 1950s when General Foods moved to White Plains, New York, and Time and Life and General Electric purchased large tracts in Westchester County in anticipation of doing so. Thus, there were obviously other forces at work to influence decisions to leave New York. Even in earlier times, however, the question of what the business leadership considered to be excessive taxes played some role in shaping corporate relocation decisions. What probably happened is that taxes assumed constantly higher importance as the major reason as the years went by.

At the peak in 1970, assemblage land costs of $400-$500 per square foot were commonplace. Individual key parcels were sold by the Landauer firm for as much as $700 to $1,000 per square foot in order to round out assemblages. It is really difficult to foresee a return to these price levels, at least not for an extended period of time. After all, it took 40 years (from 1930 to 1970) for land prices to begin to recover from the stunning effects of the decade-long depression of the 1930s. Despite increased inflationary pressures, land prices expressed in nominal or so-called inflated dollars will tend to remain lower and lag behind the recovery in rents and occupancy.

This is not to say that nominal land prices will not increase moderately in the next several years. Invariably, they will respond to market forces and an increased level of activity. However, the wild prices paid to obtain possession from tenants with leases and the excessive prices for key parcels will not be quickly seen again. Assuming constant rather than inflated dollars, it is entirely possible that there will be no real increase in land prices within the foreseeable future. In fact, a decline in constant prices is equally likely. Excessive land costs would serve only to drive office space users out of New York because of the higher rents that would have to be charged. In order to continue its progress towards recovery, New York must remain competitive with the suburbs, if not with other sections of the country.

THE FUTURE FOR NEW YORK

New York in the 1980s will have a smaller employment base than the 1969 peak. A significant reduction is foreseen in the total inventory of office space from a high of 230 million square feet down to a low of 200-210 million square feet. Much of this reduction will be accomplished by conversion of marginally located office buildings to residential and other uses or by demolition. An innate stability should characterize the 1980s; internal office growth and in-migration together will be equal to or slightly exceed a sharply diminished but always-occurring office and industrial decentralization.

There is nothing catastrophic about the prospects of continuing decentralization. Modern production technology and distribution requirements compel many manufacturers to relocate to outlying areas. There is no denying that all major cities have lost part of their office dominance as well. Improvements in telecommunications, interstate highways, and other technologies have deprived major cities of a part of their raison d'etre, that is, the need to cluster together for ease of personal communication. Personal interaction and relationships are simply not as important as in the past. The agglomeration phenomenon no longer underpins the major cities.

Yet there is convincing evidence that a good proportion of headquarters companies and, more importantly, the advanced corporate service companies that support them, still prefer to remain in the central city where the advantages of agglomeration still remain, to say nothing of the advantages of and convenience to cultural activities and sports events, private clubs, restaurants, and friends.

Under these mixed circumstances in which there have been expressed significantly different views of the viability of central city areas, land values logically have undergone a recapitalization to significantly lower levels. If wise market heads prevail, city land values will be reconstituted as a smaller component of development costs. This will enable the major cities such as New York to compete more effectively with the suburbs and with smaller cities for the favor of office space users.