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REgional Impact:

NEW YORK CITY

Real estate insights from top investment professionals

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New York, New Markets

New York City is the biggest collection of villages in the world, but investors are increasingly turning to the outer boroughs of Brooklyn, Queens, the Bronx—and even northern New Jersey.

New York City itself is one of the largest investable commercial real estate markets in the world, yet there are many opportunities to be found in outer boroughs.

"Places such as Williamsburg are no longer just about price and affordability, they are about lifestyle," says Marc Warren, principal of the capital advisory firm Ackman-Ziff.

With an office market alone valued at $107 billion and measuring 450msf in size, Manhattan will, of course, always capture a significant portion of the global institutional equity targeting the metropolitan area of New York.

What has changed in the wake of the financial crisis, however, is the growth of New York's four other boroughs. With local economies that would each rank as the U.S.' fourth-largest city if judged individually, Brooklyn and Queens have become increasingly competitive as private equity real estate managers and investors target the growth in these two submarkets, Warren says.

"The new joke is that kids are still living with their parents on the Upper East Side in order to save money for Brooklyn," Warren says, highlighting increased migration to areas such as Williamsburg, Park Slope, Cobble Hill, Astoria, and Long Island City, and increased prices as a result.

"A recent luxury multifamily project we financed in Brooklyn is achieving rents competitive with Class A Manhattan rents," adds Warren.

It's a sentiment shared by Brodie Ruland, senior vice president and Northeast region head of investments for ASB Real Estate Investments, who says the shift to New York's outer boroughs is not just a trend for the multifamily sector, but across all property types as corporations follow the customer.

Between 2014 and 2016, ASB, in partnership with L3 Capital, paid $104 million to acquire 15 buildings and four land parcels mostly fronting Williamsburg's North Sixth Street on behalf of its $7 billion core Allegiance Fund. In 2017, the firm invested another $30 million to acquire three buildings in the neighborhood from its $174.5 value-add Meridian Fund II. Since closing, ASB has invested more than $45 million to redevelop the properties, including one that was fully leased to Estée Lauder's Le Labo brand as its U.S. headquarters and NYC flagship store.

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Peripheries in Focus

Insights from RSM's Michael Mastruzzo

As millennials leave urban cores in search of space and value, is "suburbia" being redefined?

Across the U.S., urban areas are experiencing rapid growth as people increasingly choose downtown over suburbia. But it's not just the urban core that's witnessing growth; so too are submarkets on the periphery of urban downtowns.

These urban-lite areas are heavily transit-oriented and mimic much of the urban core in terms of housing, retail, and commercial opportunities—but without the price tag.

In New York City, it's not just headline areas such as Williamsburg, Brooklyn, or Queens that are experiencing dramatic levels of construction and investment, but New Jersey towns such as Edgewater, Englewood and Fort Lee.

RSM senior manager Michael Mastruzzo says that while pricing can sometimes be "commensurate" with downtown valuations, these areas are becoming more "desirable for young people and newer families looking to settle down because of their proximity to the city and the need for more space."

"From a retail perspective, Williamsburg is very exciting, and it's not about an affordability issue. Retailers are being driven there by a need to serve their customers or because they see it as the coolest location," says Ruland.

The same is true in the office sector.

"Corporations need to attract and retain the best talent that's out there, and depending on the company, that may take them to neighborhoods such as Williamsburg and Long Island City," says Ruland.

All About Location

That's certainly been the case for Long Wharf Capital Partners, which leased 77,000sf of office space to WeWork in 2015 at its 195 Montague Street property, the co-working firm's first location in downtown Brooklyn.

"I was a developer at the very beginning of my career, and it was all about the classic question, 'Where is it located?'" says Long Wharf founding partner Michael Elizondo.

> **"Places such as Williamsburg are no longer just about price and affordability, they are about lifestyle."**
>
> —Marc Warren, Ackman-Ziff

"If you've got a great location today, that location should be great in 10 years' time. You may not know who's occupying it, particularly when it comes to retail, but you're always looking at location and the quality of the asset," he says.

Staying Put

While residents may have initially moved out to Brooklyn, Queens, and the Bronx in search of affordability, price is not the primary reason they are staying in the neighborhood, says RSM partner Michael Mastruzzo. Lifestyle is just as important.

Regional Highlights

$1.65T
NYC has the largest economy in the U.S., with nominal GDP of $1.65 trillion, $600 billion more than second place L.A.
Source: Bureau of Economic Analysis[1]

64%
Technology and information service jobs have grown rapidly since 2008, while financial and legal services have remained static or retrenched.
Source: JLL

38.8%
More than a third of average NYC household budgets go to housing, compared to 32.9 percent nationally.
Source: Bureau of Labor Statistics

$22.5B
Value of property transactions in H1 2018, up 34 percent YOY.
Sources: Cushman & Wakefield, Bloomberg

15.4msf
Manhattan leasing activity in H1 2018 increased 12 percent YOY and was the third-highest half-year total since 2009.
Source: CBRE

Footnote

1: BLS and BEA analysis covers the New York, Newark, and Jersey City metropolitan area.

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Yet infrastructure, particularly transportation linking those communities to New York City, will always be a cause for concern, says Mastruzzo.

In its latest report, the American Society of Civil Engineers gave New Jersey's infrastructure, including bridges, roads, rail, and transit, an average rating of D+. Delays in the planned $20 billion-plus Gateway Project tunnel to connect New Jersey and New York—and effectively the Northeast Corridor—could hamper growth of the peripheries, adds Mastruzzo. "It's a huge challenge for New Jersey and New York. When you have a growing population, you have to make transportation links more efficient, or otherwise undertake some newer projects to reduce some of the volume that's going to be coming in and out of the city."

It's not just employees who need robust infrastructure investment. So too do corporations, as many look outside the urban core to set up operations and be more closely connected to the consumer.

Mastruzzo notes that companies are becoming more strategic in terms of their location. While that has seen mega corporations such as GE move downtown, others are looking for value in peripheral markets.

"Key markets like New York have been through their ups and downs, and these are cities that will adapt over time to what's needed to make their industries successful," says Mastruzzo.

Michael Mastruzzo
Senior Manager,
RSM US LLP

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—Brodie Ruland, ASB Real Estate Investments

Despite the spread between median rent in Manhattan and Brooklyn shrinking 53 percent in the decade to 2018, "people are not moving out of the boroughs and back into Manhattan as they may have traditionally done in the past when the city became cheaper," says Mastruzzo. "People are staying, because these areas in Brooklyn, Queens, and the Bronx have become highly sought after."

The Sixth Borough

For Warren and Mastruzzo, any conversation about New York's boroughs also should include northern New Jersey, particularly Jersey City.

"It's effectively the sixth borough now," says Warren, while Mastruzzo points to the 33,000 residential units that were expected to break ground in Northern New Jersey suburbs in 2018.

Infrastructure, though, is critical to the continued growth of New York and its outer boroughs.

"All the important development that is taking place in New York today [in Manhattan and in the boroughs] is around subway and transit nodes," says Warren.

"They are our biggest asset and sometimes our biggest liability, and it's incumbent on officials to make sure they keep investing in them and try to keep up with other global major city transportation systems if they want to maintain quality growth."

Location Through Cycles

The growth of new submarkets isn't restricted to the outer boroughs, of course. Within Manhattan, new submarkets have emerged to challenge traditional retail and office centers such as Fifth Avenue and Midtown East, and have attracted some of the world's leading brand names as a result.

For ASB, the Midtown South office market is one such submarket, with the bulk of its office portfolio in the neighborhood. In H1 2018, average asking rents in Midtown South rose above $74psf, up 12 percent on the prior year and the first time the rate has been above the overall Manhattan office average.

"Midtown South is still perceived to be the most desirable office location in New York City for a lot of people, particularly companies who need significantly smaller space," says Ruland, adding that rental comps for new Class A product in the area are around $150psf—with anecdotal reports of asking rents hitting $175psf.

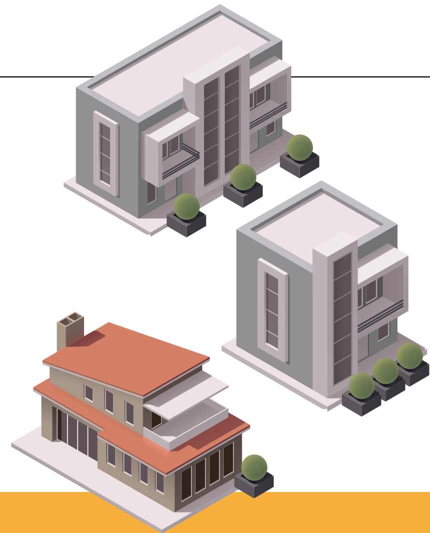
"What's helping bolster rents and keep supply in check is the continued conversion of properties into residential or hotels," Ruland says. "But it's also where employees and employers want to be."

For Ruland, that's the key to navigating commercial real estate markets across the U.S., and not just in New York City—paying close attention to location and to asset quality.

"Over the long term, through up and down cycles, we focus on buying assets in the best locations that have the best physical characteristics and that we believe are always going to be desirable to people. It's about being tenant-centric to ensure you can deliver great long-term net operating income growth. For us, that's about targeting dynamic submarkets across the country." ■

Giving New Life to the Suburbs

In New York and elsewhere, value-add multifamily housing for the middle-market workforce is both an offensive and defensive play, according to Boston Capital Real Estate Partners' Mark Dunne.



Mark Dunne
Managing Director,
Boston Capital
Real Estate Partners

Many developers are targeting major metropolitan areas around the U.S. Why do you focus on the suburbs?

Mark Dunne, Boston Capital: There is resident demand and investor safety in buying and renovating Class B properties in suburbs with a high concentration of forward-looking businesses in tech and services, where workers have incomes at and above the U.S. median. We're specifically not constructing new luxury apartments in downtown locations dependent on incomes at, say, 200 percent of median. Instead, we typically buy a 1990s-era property and perform significant renovations, including new kitchens and bathrooms, flooring, fixtures, stainless steel appliances, smart technology within units, and renovate the clubhouse and fitness center. We also add sustainable measures such as electric car park stations, water saving, and electric usage efficiencies that reduce impacts and costs to the environment, our residents, and ownership.

We strive to offer an optimal mix of new living and community spaces in a less-dense, mature landscape with more open and green space than new construction. Our residents value the community atmosphere, locations close to employment hubs, good schools, and service amenities, and perhaps most important, a rental price affordable to middle- and upper-middle-income people.

What do you see as the demand drivers for these suburban properties?

Dunne: There's lifestyle advantages as millennials and other cohorts seek more space and lower costs as they plan for families, or simply want to try to build a financial nest egg after spending a high percentage of their incomes living downtown. That is, if they could afford downtown in the first place, which most people can't. It's natural for developing households to look for lower density, more open and green space without sacrificing a modern, fresh look and feel in their apartment homes.

We believe renovated apartment properties that are close to transportation and employment, are well-appointed and new on the inside, and yet have a more suburban feel and lower cost structure are a compelling investment opportunity. The strengths of our properties and locations include lifestyle advantages, convenience, and affordability. We believe it's defensive from an investment risk standpoint to appeal to a very large swath of the income band, but it's also opportunistic in that we're manufacturing value by taking something that's been underimproved and underoptimized, and bringing it up to a standard that a broad spectrum of the renter market demands and can afford.

Are rising interest rates a challenge for the CRE industry going forward?

Dunne: Rising Interest rates of course increase the cost of borrowing, but also typically follow improving economic activity. So far, much of the rate increases have been absorbed in the lender spreads. But that cannot go on forever. With apartments' annual lease structure, you have built-in inflation protection. It's more positive, within reason, than many people might expect on its face. For portfolio properties financed with fixed or capped interest, it can be favorable from a cash flow perspective and overall as well, to the extent that exit cap rates don't track interest rates in lockstep, which historically they have not.

How do you view risk, given the maturity of the CRE cycle?

Dunne: We've invested in apartments throughout every cycle. As we're now seemingly later in the cycle, we believe we're in the best position with our current strategy to weather any storm, and to take advantage of opportunity at the same time. We think the long-term outlook for apartments is very positive, and housing as a normal matter has been undersupplied, particularly at the more affordable end. I have invested during my career in other product types, including office and retail, and decided 18 years ago to focus exclusively on apartments, because I believe it is the best risk-adjusted place to be, whether the sun is shining or a storm is raging. ■

Understanding the Wall of Dry Powder

More than **$278B** of dry powder is sitting on the sidelines of the private equity real estate industry globally, according to Preqin. Experts from across the world offer their insights into the potential impact of the wall of dry powder on commercial real estate transactions and how it will shape investment strategies in the years ahead.

Will The Patience to Deploy End?

"I do not see transaction volumes increasing in traditional sectors in core markets. I sense a real awareness of the risk of overpriced deals. That risk seems to be outweighing the need to deploy for now. To me, the interesting point in time to watch is: What happens when the patience to wait to deploy is exhausted? Could there be appetite to consider viable but non-traditional and less-core markets on the fringes?"

Morag Beers
Director of Real Estate, IMMO Investment Technologies

Focus on Small to Mid-cap Deals

"The levels of transactions as well as prices have already exceeded the pre-crisis period. Driving these record high prices is the demand for quality real estate and the pressure to invest in larger transactions, particularly from the commitments and dry powder of some of the largest institutional investors in the world and the mega funds that have been raised in the last few years. Their focus has and will continue to be on large-cap investments, providing an opportunity to invest in small and mid-cap transactions, where the competition has not driven prices to the levels of pre-crisis. The one thing that still helps me sleep at night is the fact that leverage across the board is much more conservative, and we can see that in the LTV, rate, and covenants."

Asaf Rosenheim
Head of Investments, Profimex

CRE's Relative Value Drives Dry Powder

"We will continue to see an increase in dry powder as long as private equity views commercial real estate as an opportunity to generate higher yield in comparison to other asset classes. While there is concern that too much cash is chasing too few deals, putting pressure on pricing, we are definitely seeing an increase in transaction volume in the multifamily sector as sellers take advantage of the increased competition. Interestingly, we are also seeing larger funds investing their core/core-plus capital into value-add deals where they believe they can receive better returns."

Samuel Landman
Capital Markets/Investor Relations, Universe Holdings