NEW YORK CITY COMPTROLLER
BRAD LANDER

Spotlight

New York City's Office Market

May 14, 2024

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Introduction

One year ago, in June 2023, the Comptroller's Monthly Spotlight focused on New York City's office market, presenting a range of potential scenarios that might unfold in the years ahead, their implications for City tax revenue, and the New York City economy more broadly. This month, we take a fresh look at how the market for office space has evolved, and how its various segments have fared.

We first look at the overall market for office space, how it has changed, and where it appears to be headed. We then look at the extent to which a "flight to quality" is differentially affecting various segments of the market and what effect that is likely to have on the city's economy and fiscal situation.

The seismic, pandemic-driven shift toward remote work has substantially pushed down demand for office space, approximately doubled the vacancy rate, and adversely affected rents and market values, presenting a range of serious challenges—especially in Class B and C buildings. However, the potential "doom-loop" scenario we considered a year ago now seems unlikely to unfold. The market for prime, high-end office space seems to be holding up reasonably well, despite the large volume of space that had been added in recent years.

We review commercial buildings that have converted to residential (only 600 completed, but 2,000 more permitted and another 1,000 in the pipeline). In addition, we provide analysis of the NYC Economic Development Corporation's "M-CORE" tax incentive program for renovating office buildings, highlighting two short case studies: one where the Comptroller's office voted in favor, and one where we voted against the subsidies.

Finally, we focus on how the City assesses the value of office buildings for tax purposes, and how trends in those values since the pandemic compare with trends in market values, as revealed by actual sales transactions.

Overview of NYC's Office Market

New York City's five boroughs comprise nearly 730 million square feet of office space, according to CoStar data—far more than in any other North American city (Los Angeles is 2nd with 432M SF). The vast majority (82% or ~600M) is in Manhattan, predominantly in the prime business districts, south of 59th Street. Along with San Francisco and San Jose, it is also the priciest office market, both in terms of rent and sale values.

The inventory of office space varies substantially and is highly segmented in terms of price and quality. As an illustration, the average asking rent for 5-star (i.e. "trophy") office space—mostly in Manhattan—is roughly $100/square foot (SF). This essentially represents the top quintile of Class A space, which, in turn, comprises a majority of office space in Manhattan. In contrast, Class B and C space goes for an average of $54/SF in Manhattan and $40/SF in the outer boroughs.

Table 1 below summarizes the distribution of office space across the city.

Table 1

	Total Square Feet of Office Space			
	NYC	Manhattan	Outer Boroughs	Manhattan Share
Total	728,584,747	594,309,799	134,274,948	81.6%
Class A	393,809,911	361,054,636	32,755,275	91.7%
5 Star	80,285,603	75,619,534	4,666,069	94.2%
4 Star	296,076,132	271,349,692	24,726,440	91.6%
3 Star or less	17,448,176	14,085,410	3,362,766	80.7%
Class B	236,936,969	172,960,516	63,976,453	73.0%
Class C	96,287,994	59,340,112	36,947,882	61.6%
	NYC	Manhattan	Outer Boroughs	
Total	100.0%	100.0%	100.0%	
Class A	54.1%	60.8%	24.4%	
5 Star	11.0%	12.7%	3.5%	
4 Star	40.6%	45.7%	18.4%	
3 Star or less	2.4%	2.4%	2.5%	
Class B	32.5%	29.1%	47.6%	
Class C	13.2%	10.0%	27.5%	

Source: Costar

Recent Trends in NYC's Office Market

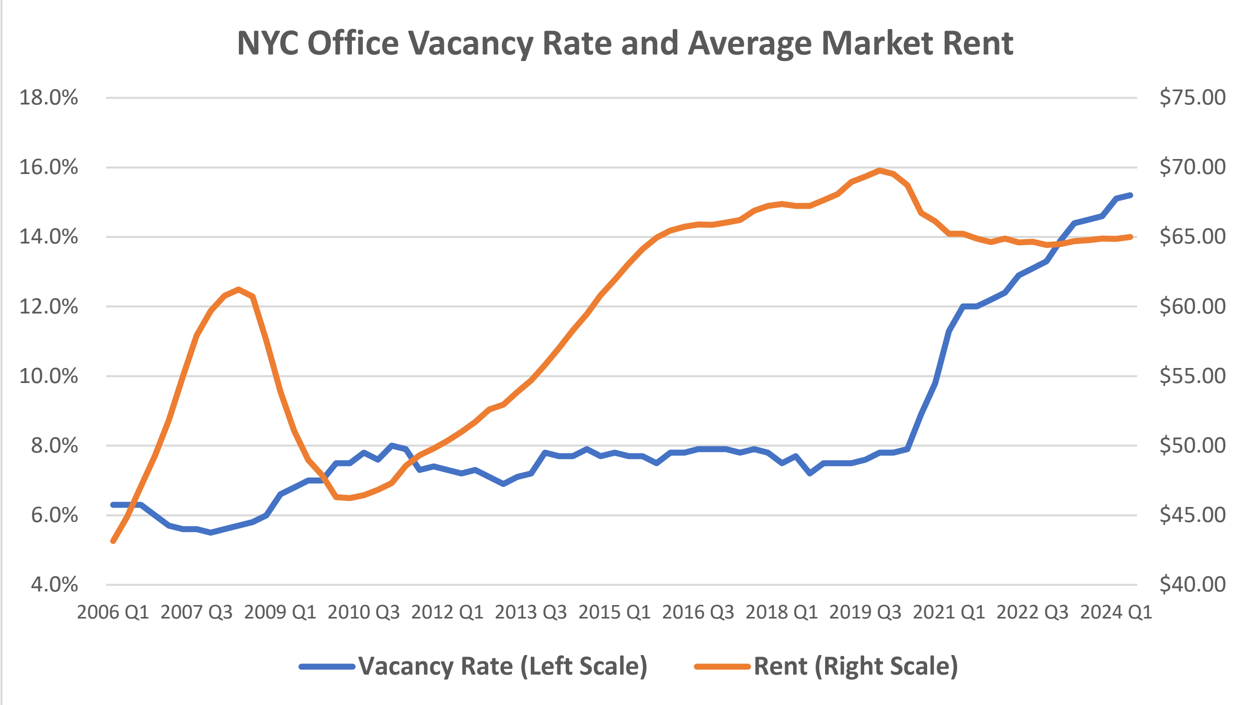
In the aftermath of the pandemic and the seismic shift toward work-from-home, New York City's office market remains slack. Manhattan's[1] office vacancy rate has more than doubled from under 8% at the start of the pandemic to 16% as of April 30th—a level not seen since the early 1990s—and it is unclear if that measure has peaked yet. Meanwhile, asking rents have fallen by 8% since the onset of the pandemic, which is a relatively mild drop versus the 2008-09 recession (-33%),

[1] We refer to Manhattan rather than the city as a whole for comparability with earlier data.

the 2001-03 downturn (-25%), and the 1990s slump (-35%). However, the recent drop is likely understated due to widespread concessions that can distort (overstate) reported rents.

Citywide data (not available for the earliest periods) paint a similar picture: a high and rising vacancy rate, currently just above 15%, along with rents that are roughly 7% off their peaks but appear to have stabilized, as shown in Chart 1 below.

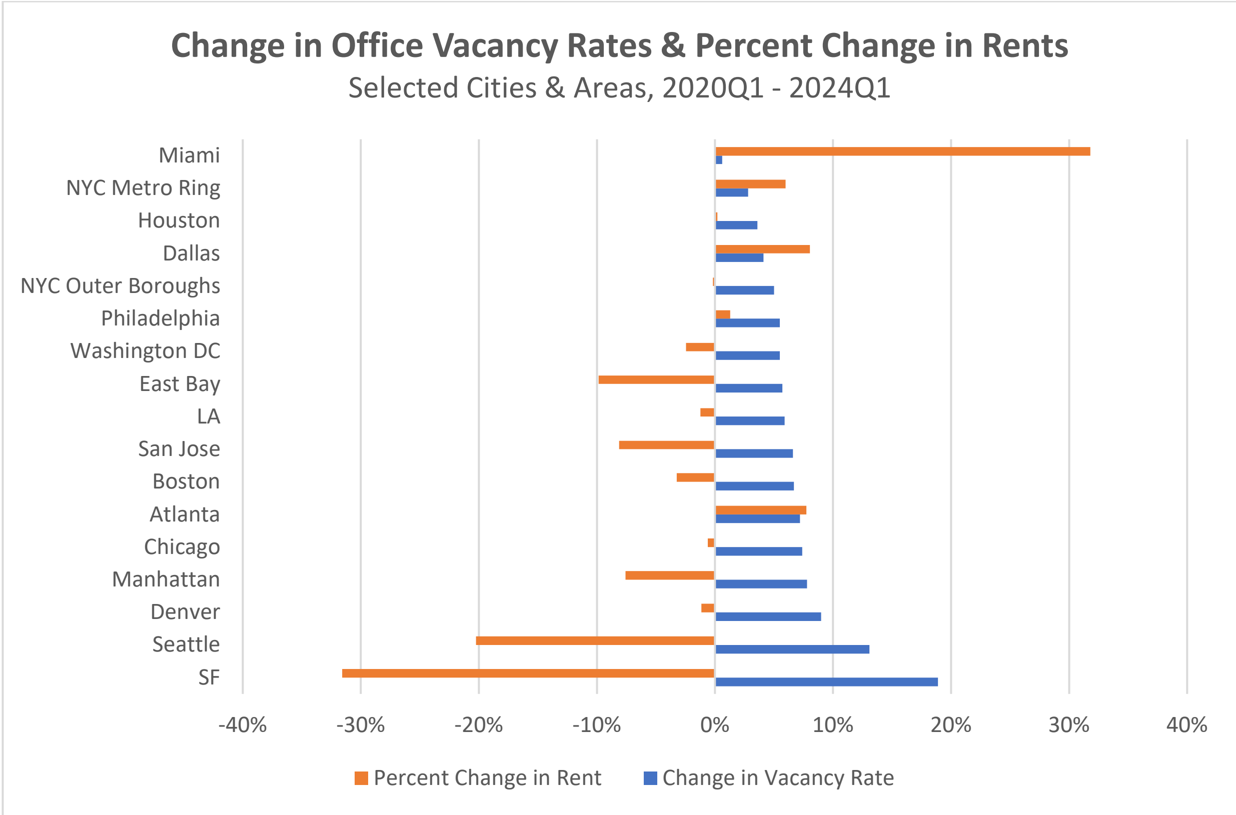
Chart 1



Source: CoStar

It should also be noted that similar trends have prevailed across most other major U.S. cities, but not in areas of the metropolitan region surrounding New York City—nor in a number of “edge cities” in the Bay Area— as shown in Chart 2 below. This is likely due to the general migration of work locations away from urban centers caused by the pandemic, as examined in this 2021 research study.

Chart 2



Source: Costar

Flight to Quality and Demand vs Supply

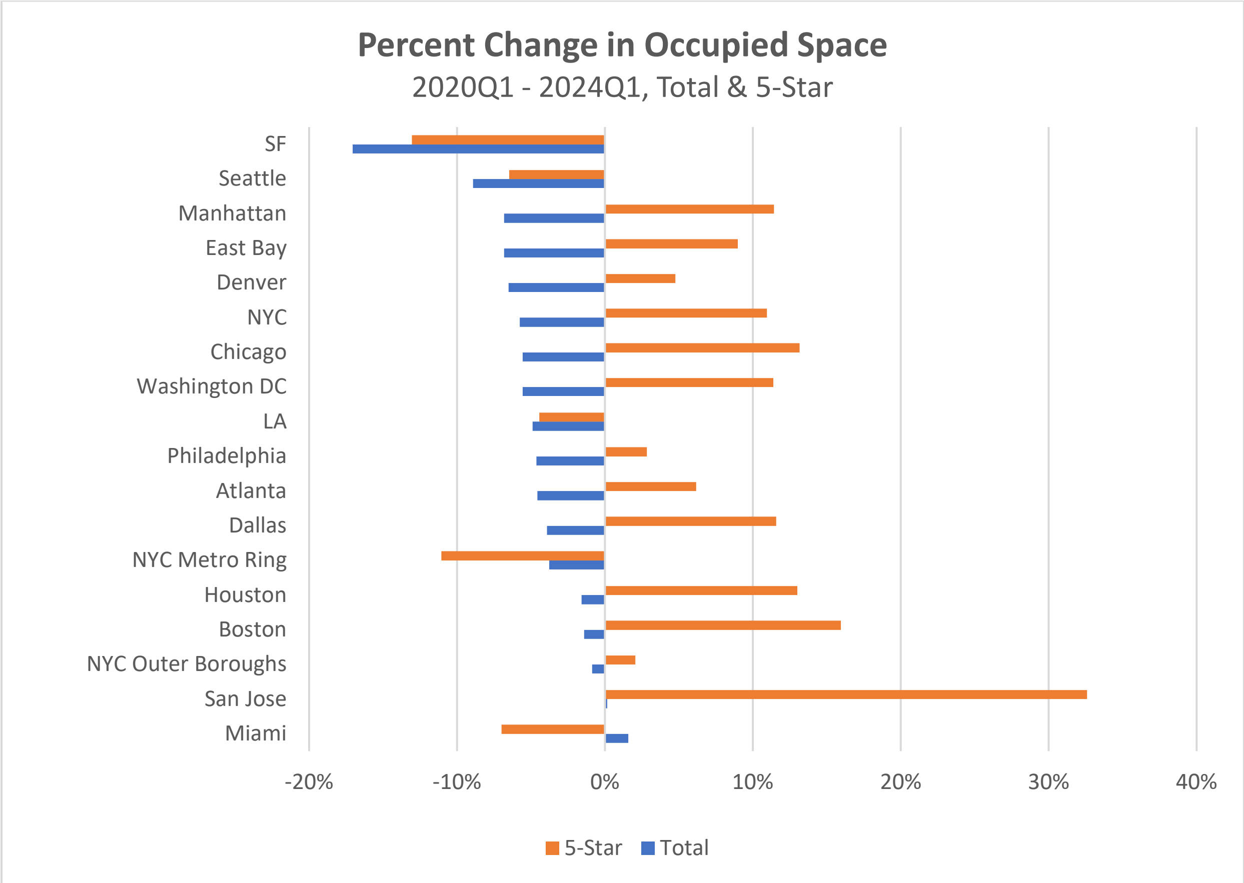
Vacancy rates have roughly doubled across New York City, from 6.4% in early 2020 to 12.8% today; but how much of that reflects reduced demand versus increased supply? It varies in different segments of the market.

At the lower end of the price spectrum, Class B and C properties comprise 46% of office space citywide. The total inventory (supply) of this type of space has declined slightly since early 2020. The rise in vacancy rates among these buildings, from 6.3% to 12.9%, has been driven by a sizable drop in occupied space—specifically 8% or 23M square feet less—showing significantly lower demand in this segment.

At the upper end of the spectrum, 5-Star properties comprise 11% of office space citywide, as shown in Table 1, and the total inventory of this type of space has surged by 13.8 million SF (20%) since early 2020. Here, vacancy rates have also risen substantially—from 9.8% in early 2020 to 17.3% today—which translates into an additional 7.2 million SF of vacant space. But, in stark contrast with the aforementioned drop in occupied Class B & C space, the volume of occupied 5-Star space has actually increased by 6.6M square feet (11%), suggesting higher, or at least resilient demand in this segment.

With rents down across the board, this shift in occupied space toward more upscale properties reflects a significant "flight to quality" among tenants, many of whom are, in effect, "trading up". This phenomenon is not unique to New York City but rather is occurring in most major U.S. cities, as noted in Chart 3 below.

Chart 3



Source: Costar

Conversions to Residential & Renovations to Higher Quality Office Space

Given the weak demand for lower-tier office space and the strong demand and short supply of housing, the pace of office-to-residential conversions has picked up somewhat lately. There are two main challenges in these conversions. The first is loss of rentable area: in general terms, office tenants pay rent on common areas while residential tenants do not. This implies that residential rents or the vacancy rate need to be sufficiently high to compensate for the loss of rentable space and any additional amount of space dedicated to amenities. The second is that conversions are technically complex and expensive to execute, with construction hard and soft

costs in excess $400 per square foot. This implies that acquisition costs (office market values) need to be sufficiently low to justify conversions.

As shown in Table 2, most of the residential conversions permitted in New York City in the past few years are located in the Financial District.

Table 2: Permit Filings of Large Residential Conversions as of 2023Q4 Data

Address	Date filed	Date permitted	Status	Units
160 Water St. (Pearl House)	16-Nov-21	24-Aug-22	Completed	592
90 John Street	21-Oct-22	6-Mar-23	Permitted	114
55 Broad St.	28-Oct-22	2-Nov-23	Permitted	586
17 Battery Pl.	2-Nov-22	13-Jun-23	Permitted	184
25 Water St.	3-Nov-22	10-Apr-23	Permitted	1,163
650 1st Ave.	3-Nov-22	18-May-23	Permitted	111
Total				**2,750**

Source: NYC DCP, Office of the NYC Comptroller. The table includes all projects with at least 100 additional units, with permits filed after 2019, permitted for construction, classified as alterations, and that are not being converted to hotel, other Class B multiple dwelling, or homeless shelters. The permits data are published by the NYC Department of City Planning (DCP) and are derived from Department of Buildings (DOB) filings. The version currently available includes permits filed up to the second quarter of 2023. Since the switchover to DOB NOW in early 2020, permits data from the Census Bureau Building Permits Survey (which can be queried here) has significantly undercounted the number of permitted units in NYC.

Additional conversions are being planned for 222 Broadway (600-800 rental units), 750 3rd Avenue (540 rental units), and the Flatiron Building (40 luxury condominiums). A recently traded building at 80 Pine Street (previously occupied by AIG and renovated as recently as 2021) is also rumored to be a target for conversion.

The City is seeking to facilitate conversions through proposed zoning text amendments included in City of Yes Housing Opportunity application by the Department of City Planning. Furthermore, the Education, Labor and Family Assistance (ELFA) State budget bill (S8306-C/A8806-C, part R) created the Affordable Housing from Commercial Conversions (AHCC) tax exemption for mixed-income rental conversions. Eligible projects need to reserve 25% of the units to renters with income up to 80% of Area Median Income (AMI), on average. The program exempts taxes fully during construction (up to three years) and, afterward, up to 90% of property taxes for buildings in Manhattan South of 96th Street and up to 65% elsewhere in the City. Benefits last 35 years for conversions receiving a permit between 12/31/2022 and 6/30/2026. Subsequently, tax benefits

are shortened to 30 and 25 years for permits issued up to 6/30/2028 and 60/30/2031, respectively.

The AHCC exemption should expand conversions to submarkets where property values have not dropped as they have in the Financial District (note, however, that this likely means that the tax exemption is likely over-subsidizing income-restricted units in the Financial District). Based on their permit date, it appears that most of the projects in Table 2 may be able to apply for AHCC tax benefits.

The City has also taken efforts to incentivize the upgrading of existing lower value office space to better align the mix of supply to the mix of demand. These efforts are described in the text box below:

Manhattan Commercial Revitalization Program (M-CORE)

The Governor's and Mayor's 2022 Making New York Work for Everyone action plan set a target of reducing the vacancy rate in Manhattan office buildings to 10 percent by 2025. One component of the plan has been the creation of a discretionary tax incentive for the renovation and improvement of office buildings, which the New York City Industrial Development Authority (NYCIDA) announced in May 2023. The "Manhattan Commercial Revitalization Program" (M-CORE) is designed to help building owners attract "world class tenant companies" by subsidizing the renovation of obsolete and underperforming office space with more generous tax breaks than available as-of-right through the Industrial and Commercial Abatement Program (ICAP). This, in turn, is meant to promote economic development and growth of the City's income tax base.

To be eligible, a building must be located below 59th Street in Manhattan,[2] have at least 250,000 gross square feet, and have been built before 2000. In addition, the renovation costs need to meet a minimum threshold. The program grants building and land tax abatements for up to 20 years, a sales tax exemption on construction materials, and a mortgage recording tax exemption. The program provides a 100% tax abatement on changes in assessed value for the first 2.5 million square feet entering the program. The percentage is reduced by 10% for each additional 2.5 million square feet entering the program. The program is capped at 10 million square feet.

Comptroller's Office Analysis: Two Case Studies

The New York City Comptroller has an appointment to the board of the NYC Industrial Development Agency, which votes on applications for subsidy through the M-CORE program.

Our office set two parameters that would serve as prerequisites for voting for approval of potential M-CORE projects: 1) the building is not otherwise suitable for conversion to housing and, 2) the investment would not likely take place without M-CORE's tax benefits added onto ICAP (the "but for" criterion).

This approach is grounded in the recognition that while demand for high-quality office space is clearly higher than for lower-tier space, it does not appear to exceed supply, which (as noted earlier) has expanded substantially in recent years. That is, there is not a shortage of high-quality office space. Thus,

[2] Each project is presented to the NYCIDA board for approval as a deviation from NYCIDA's Uniform Tax Exemption Policy (UTEP, Article V). Buildings in the Hudson Yards Financing Area and Penn Station General Project Plan Area are not eligible.

while M-CORE is understood by our office as a way to accelerate renovations and quicken the absorption of obsolete office space, its economic impact is most likely modest and temporary.

A total of 11 projects submitted applications during the first round of applications (a second round of applications that included buildings larger than 100,000 gross square feet closed in April of this year). Three of the projects were either owner-occupied or proposed non-substantial renovations. The office and retail gross square footage submitted by the remaining eight projects was 5.2 million, according to City records. Among the eight projects, some had already planned or started substantial renovations before the announcement of M-CORE, suggesting that the subsidies would not meet the "but for" criterion.

In January 2024, NYCIDA brought two projects (175 Water Street and 850 Third Avenue) to the board for a vote, with a third (522 Fifth Avenue) initially noticed for public hearing but ultimately delayed. Our office voted against 175 Water Street and in favor of 850 Third Avenue. Both were ultimately approved.

175 Water Street (now known as 161 Water Street): built in 1982, 580,000 square feet, 97 percent vacant, $5.5 million property tax, $150 million investment. The Water Street corridor and this building in particular are suitable for conversion to residential use.[3] Furthermore, when development firm 99c purchased the building in October 2022—long before the M-CORE program was announced—for $252 million its co-founder stated that the company was "tremendously excited to deliver a comprehensive reuse plan" for their building. 99c's own website states their company's mandate is "to invest in adaptive reuse projects including office assets."

True to the statement, the renovated building is being hyper-amenitized to appeal to fashion, arts, creative, and technology firms, the developer's sectors of expertise. These factors led our office to doubt the investment would not have occurred but for M-CORE, and ultimately to vote against awarding discretionary tax benefits. A recent New York Magazine article describing the newly renovated building as the "most appealing office building in the city," one which is "turning prospective tenants away," appears to validate our assessment that the developers were not in need of tax subsidies.

850 Third Avenue: built in 1959, renovated in 2008, 575,000 square feet, 67 percent vacant (expected 87 percent by 2027), $6.4 million property tax, $63 million investment. The Third Avenue corridor is one of the most challenged in Midtown and has not seen conversion activity, with only one planned at 750 Third Avenue and only after the passage of a new as-of-right property tax incentive in April of this year. The building was acquired by the lender in 2023 for $266 million. With high and growing vacancy rates, lack of prospects for adaptive reuse, and without a strong economic justification for renovation without additional incentives, this project met our office's requirements. We voted in favor of M-CORE subsidies.

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[3] The Vanbarton Group converted 160 and 180 Water Street (directly across the street) to residential use. 175 Water Street—previously owned by Vanbarton— was built in 1982, after the January 1, 1977 deadline for as-of-right conversions set in the Zoning Resolution for the Financial District. However, the City of Yes Housing Opportunity proposed zoning text amendment would, among other provisions, move the threshold to December 31, 1990. Still, the Vanbarton Group decided not to proceed with a residential conversion and instead sold the building in October 2022 to the current owner.

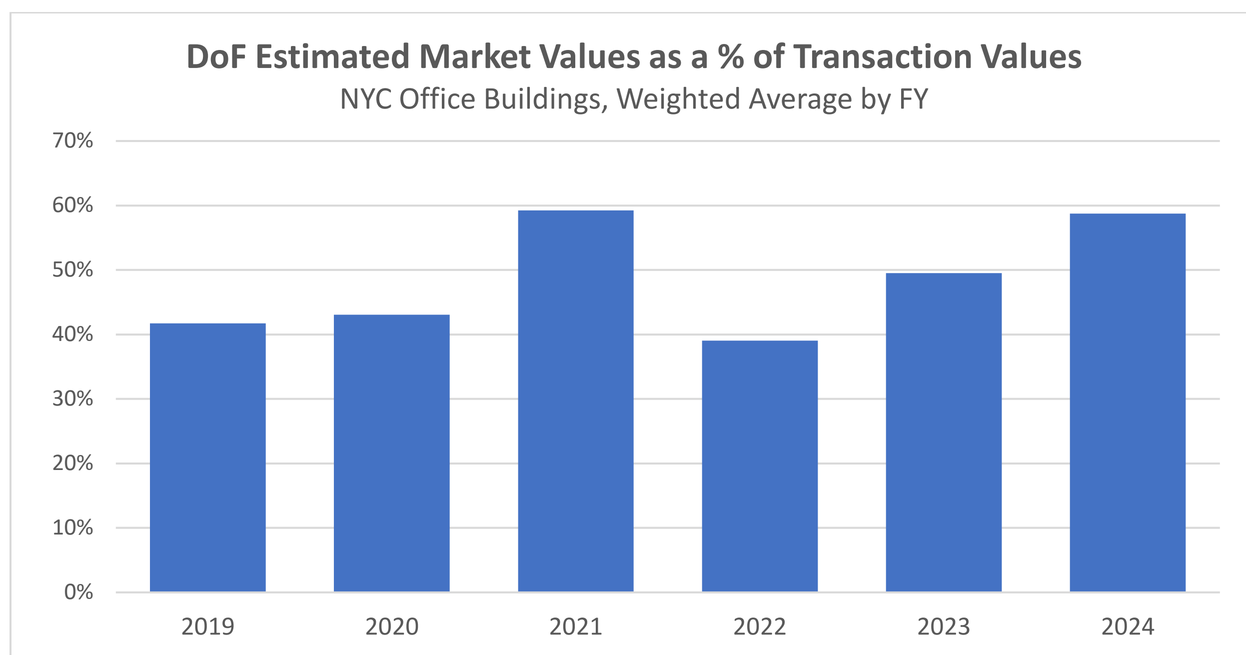
Have Assessed & Actual Market Values Diverged?

The City's Department of Finance uses a complex algorithm to assess valuations of office buildings to determine property taxes. The formula is based on a building's operating expenses in the preceding year, rather than transactions (a comprehensive explanation of this process can be found in this Fiscal Brief by the NYC Independent Budget Office). Due to the methodology, assessed market valuations are typically slow to adjust to changes in actual market values based on transactions—what a building would sell for—and to office market conditions generally. As a result, when there is a sudden and sharp weakening in market conditions, as occurred in 2020, its downward effect on the property tax base and property tax collections tends to lag. Thus, our June 2023 Spotlight, which noted that commercial property tax levies had held up fairly well to date, reflected not only the shift in the increasingly upscale mix of occupied properties noted in the preceding section, but also the lagged adjustment.

Because DOF's estimates of market values tend to adjust slowly, when transaction values drop sharply the effective tax rate on property owners increases. In order to gauge how much DOF's market values diverged from transaction values in 2020 (i.e. FY 2021) and how they have trended since, we linked sales records of buildings that transacted in each of the past five years from Costar with NYC Department of Finance records. Typically, during stable times, DOF's estimates of market values are roughly about 40-50% of transaction values. Chart 4 below shows how the ratio of DOF to transaction values has evolved since before the pandemic. The surge in FY2021 reflects the pandemic adversely affecting the denominator (transactions) but not yet the numerator (DOF market values). The drop in FY2022 reflects a subsequent large downward adjustment in DOF values in the first assessment cycle after the start of the pandemic (based on building income data from 2019), which was then largely reversed in FY2023 and FY2024.

As shown in Chart 4, DOF market values used to calculate taxes have yet to converge downward toward actual market values. Because the data in this analysis is for buildings that transacted in the past few years, it may be biased toward more troubled properties. However, the data suggests that, barring an increase in transaction prices in the short term, the risk for property tax on office buildings is skewed to the downside.

Chart 4



Sources: Costar, NYC Department of Finance, NYC Comptroller's Office calculations

Implications for Local Economy & Fiscal Outlook

While risks remain, the fears expressed by some of a "doom loop" scenario—in which property values fall 40%, don't recover, create fiscal shortfalls, leading to draconian budget cuts, and sending the local economy into a downward spiral—appear further from reality than they did a year ago. Occupied space is down approximately 6%, rents are only down about 7% and trending up, and assessed values & tax levies (which were feared to be trending down toward a 40% drop in the "doom loop" scenario) are trending up.

Last June, we simulated three potential scenarios for the commercial property tax base and associated revenues—that is, how such revenues were likely to change in future years. Now that FY2025 tax assessments and associated levies have been established, we can compare the forecasts made in June 2023 to the current estimate. While the property tax on commercial space is tracking somewhat below our forecast, it is still increasing, as shown in Table 3 below. The tax levy is tracking above the pessimistic scenario, and well above the "doomsday" scenario. Moreover, FY 2025 residential assessed values are running well ahead of what we were forecasting last June, and the total property tax levy is expected to exceed the optimistic scenario formulated last June, though it remains well below its pre-pandemic trend.

Table 3

	FY '25 % Chg. In	
Forecasts Made in June 2023 vs. Current Estimate	**Commercial Property Tax Levy**	**Total Property Tax Levy**
Optimistic	+3.2%	+1.1%
Baseline	+3.1%	+1.0%
Pessimistic	-1.3%	+0.6%
"Doomsday"	-6.0%	+0.1%
Current Estimate	+1.7%	+3.5%

Source: NYC Department of Finance; Office of the NYC Comptroller

Conclusion

As New York City's office market struggles to recover from the pandemic and to adjust to seismic changes in work-from-home patterns and policies, the outlook for commercial real estate is one of the primary risks on the horizon. While local office rents have shown signs of stabilizing, vacancy rates have continued to trend up, reaching 30-year highs.

However, only part of the rise in vacancy rates can be attributed to depressed demand. While the volume of vacant space has more than doubled since the start of the pandemic, increasing by roughly 55 million square feet, about a third of that increase reflects increased supply, while two thirds reflects reduced demand (i.e. leasing). However, because a growing share of that occupied space is in higher-quality/value office buildings, the effect on the market is somewhat more muted.

Insofar as the fiscal implications go, commercial property tax collections look to be a bit weaker in FY 2025 than anticipated in our baseline forecast last year, but are still up from the prior year, far exceeding what had been projected in our "doomsday" scenario. Moreover, because residential property tax levies are well ahead of last year's baseline forecast, overall property tax levies for the upcoming fiscal year are actually ahead of plan.

Conversions have begun, both to residential use and to upgraded commercial use, but so far are moving slowly, relative to the volume of vacant space. While the doomsday scenario does not appear likely, there is likely to be a period of protracted pain and long-term transition, especially in Class B and Class C portfolios.

Acknowledgements

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