

Sublease Bonanza! Who Can Take It?

by Dana Rubinstein | 7:14 PM January 6, 2009

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This article was published in the January 12, 2009, edition of *The New York Observer*.



Property Shark

Howard Fiddle.

Last year's economic spasms crippled not only New York City office landlords, but also the three major industries that pay those landlords top rent: finance, media and law. That trifecta has in recent months hemorrhaged sublease space back onto the market, as a **CB Richard Ellis** white paper released to *The Observer* shows, dragging down rents and prompting the question, who will take that trifecta's place?

Sublease space—extra space that tenants like Lehman Brothers and *The New York Sun* put back on the market—isn't just a subset of the larger office market. It impacts that overall market, and not in a pretty way.

“As you get a very high level of sublease space, it really begins to put downward pressure on the entire marketplace, because of what it does to pricing,” said **Howard Fiddle**, vice chairman for the tristate region at CB Richard Ellis.

That's because distressed tenants bound by long-term leases are more desperate than landlords to get some rent, any rent, rather than shoulder the burden alone. The

average Manhattan sublease asking rent, at \$62.71 a square foot, is 11 percent less than the average direct asking rent of \$70.23, according to CBRE. (And those are *asking* rents, mind you, which, thanks to the surge in supply, have become increasingly elastic.)

“At times, in real bad economies, sometimes [sublease space] can convert to direct space if a tenant goes out of business,” Mr. Fiddle added. “A lot of these hedge funds, not to name any names right now, are listed for sublease, but they’re teetering and in a few months could be gone.”

And so the sublease pile grows. And grows.

Between July and December of 2008, Manhattan’s sublease availability—sublease space that is either vacant or will be within 12 months—jumped from 7.2 million square feet to 11.2 million, or 28.3 percent of available office space in Manhattan’s 362 million-square-foot marketplace.

Most of that space, unfortunately, is coming from the three pillars of New York’s tenant base. Financial firms, which occupy 25 percent of the supply, coughed up 3.9 million square feet (40 percent of available sublease space). JPMorgan Chase’s acquisition of Bear Stearns alone added 600,000 square feet, and AIG’s troubles, Barclay’s acquisition of Lehman assets and the Bank of America/Merrill Lynch merger could add up to 4 million additional square feet. The advertising/media industry contributed 1.8 million square feet (19 percent); and law firms added 1.3 million square feet (10 percent).

MEANWHILE, CBRE reports that “the number of blocks of contiguous sublease space greater than 100,000 square feet in Manhattan has almost doubled since December of 2007, and the total square footage has increased by 109 percent.” That’s a trend, according to the brokerage, “that will likely increase as corporations continue to reduce their work force [by an estimated 86,000 office jobs through 2009].”

In December 2007, there were nine such blocks, totaling 1.5 million square feet. By December 2008, there were 16. (In 2002, after the dot-com bust, there were 26 blocks of 100,000-plus contiguous feet.)

Thank God 2008 is over. But what of the economy in '09? And in '10? Dare we hope? “In 2010, growth will be lackluster at best,” said **Sam Chandan**, formerly of REIS and now president and chief economist at consultancy **Real Estate Economics**, adding that the national economy’s contraction should slow at the end of this year. New York’s economic recovery will lag the rest of the nation’s, he said, thanks to its unique exposure to the finance industry

The dapper Dr. Chandan (barbershop-striped tie, monogrammed French-cuffed shirt) was speaking to six tables of real estate executives during a Monday afternoon **National Realty Club** luncheon at the Williams Club. The striped curtains behind him opened onto the drab, rust-colored bricks of the neighboring buildings.

Though his near-term prognostications are dire, Dr. Chandan warned against what he calls “headline risk,” which translates roughly into the media overstating the problem and potentially contributing to a “negative price bubble,” in which commercial property values actually fall below their fundamentals.

After all, he said, the New York City market has one distinct advantage: “We haven’t seen a lot of development activity over the last four or five years.”

CB Richard Ellis agrees, pointing out that only four new big office buildings are scheduled for completion over the next four years: “200 West Street (1.9 msf), 11 Times Square (1.1 msf); 250 West 55th Street (800,000 sf), and 510 Madison Avenue (330,000 sf).”

And while the market continues to deteriorate, as of Dec. 1, it had still yet to reach the post-dot-com levels of 2003, when the sublease space totaled 14.8 million square feet.

EVEN SO, the nagging question remains: Who will pick up the slack of Manhattan’s three driving office tenants?

“There is a real conundrum,” said **Robert Freedman**, executive chairman of Williams Real Estate, a First Service Company. “It’s not like there are pat, simplistic answers. This is so fundamental that a lot of people just say we’ll work through it, we’ve done it before, we don’t exactly know how. ... I am more and more convinced it is through what will be a new ... sector of the economy, which is sustainability.”

Others, like Mr. Fiddle of CBRE, believe that the tenant base will remain the same, if in a slightly altered form: “We don’t necessarily think the [financial services] industry will go away. Certainly, companies will go away. But if we fast-forward a few years, a lot of new firms will form.”

Mr. Fiddle pointed out that while financial firms are the biggest contributors to the sublease pool, they’re also sopping up some sublease space. In recent months, financial firms have signed 44 leases for sublease space, in contrast to the second biggest taker, law firms, which have signed 20. But, tellingly, the 44 deals comprised only 9,850 square feet, compared to the law firms’ 24,300 square feet. In other words, the new financial firms appear to be small.

Yet, Cushman & Wakefield executive vice president **Dale Schlather** said that those smaller firms will certainly grow with time.

“I think all these guys getting laid off, they’re plenty smart and they shouldn’t really be laid off, but the world is what is it,” he said. “They’re not going to give up, and with the Goldman Sachs and Morgan Stanleys turning into banks, I think you’ll see a lot more smaller boutique investment advisory companies that will be fee-driven, not equity-driven. They’ll be smaller firms, and then [they] will get bigger.”

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