Running a smarter building

As office market gets crunched, owners become more efficient

By David Jones

As the credit crunch expands into New York's office market, landlords are starting to manage their buildings smarter to deal with the shrinking margins for error.

Commercial property owners are scrambling to offset declines in rents and combat higher energy and other costs. They are doing everything from outsourcing building management to installing more energy-efficient systems and, in some cases, selling ads on their empty retail storefronts.

From Midtown to Lower Manhattan, companies are slashing jobs and subleasing major blocks of space, eroding the gains in commercial rents that made the city's office market so attractive to investors. A flood of sublease space often undercuts the ability of landlords to maintain price integrity on available space.

There are other signs of a shifting marketplace. Firms like Jones Lang LaSalle are beefing up their property management businesses to offset declines in their brokerage business group.

"There's no reason to beat around the bush: New York City's commercial real estate market will get worse, especially for landlords, before it gets better," said Robert Sammons, managing director of research at Colliers ABR, in a second-quarter report.

That's because some landlords are having trouble filling their buildings, and the situation is expected to get worse. The overall vacancy rate in Manhattan climbed 90 basis points to 8.7 percent in the second quarter. While overall asking rents climbed 2.1 percent to $66.75 a square foot, Class A asking rents fell 28 cents to $87.10 a square foot. And more troubling are projections that the overall vacancy rate will climb to nearly 11 percent by year's end.

In a rival report, Cushman & Wakefield warned that asking rents could fall anywhere from 5 to 10 percent in the second half of 2008, due to financial industry layoffs and newly discounted space entering the market.

The city's top commercial landlords are working proactively to lock up new leases with existing tenants and launching major programs to renovate buildings to make them more attractive to prospective tenants.

Marc Holliday, SL Green Realty Corp.'s chief executive officer, said his company has pre-leased 433,000 square feet of space, which will reduce its overall lease exposure to 421,000 square feet for the balance of 2008 and 1 million square feet in 2009, according to a transcript of the firm's second-quarter conference call.

By renewing existing leases and signing new tenants before a space becomes vacant, SL Green said it is putting itself in a stronger position to negotiate rents with future ten-

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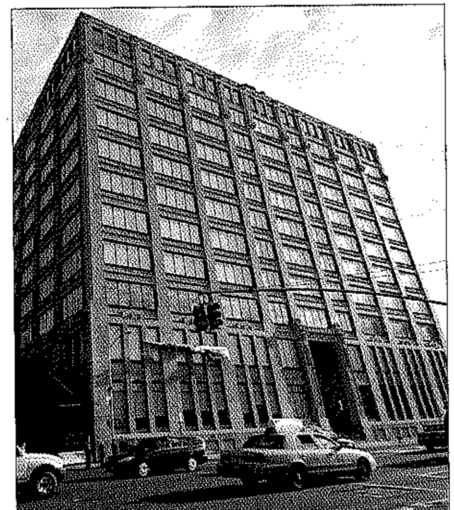

Jones Lang LaSalle is undertaking a gut renovation of the Ogilvy Building at 636 11th Avenue.

The retail space at 1515 Broadway is being updated as part of a major renovation.

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ants. During the first half of 2008, SL Green leased a total of 940,000 square feet, raising rents by 48 percent and raising same-store net operating income by 10 percent, Holliday said during the conference call.

In July, the company signed a 15-year lease with accounting firm BDO Seidman for 121,000 square feet at 100 Park Avenue. SL Green is about to complete a $72 million renovation at the property, which includes adding new elevator cabs, a two-story atrium lobby and also 2,000 new insulated windows.

"We've been very concerned about keeping a close eye on our energy costs," said Larry Thomson, senior vice president and director of operations at SL Green.

The company is seeking silver LEED status in six of its New York office buildings and has also begun the $160 million renovation of 1515 Broadway, which will include upgrading the street-level retail space to bring in higher-end restaurants. The company also plans to raise rents for new tenants.

According to the New York Observer, Greg Hughes, chief financial officer at SL Green, said last month that Viacom is expected to renew its lease at 1515 Broadway, where it pays $50 a square foot in rent. But, sources close to Viacom later told the New York Post that the entertainment company had not committed to doing so. Meanwhile, SL Green has been able to sign two new tenants to $85-a-square-foot leases.

Kevin McCann, managing director of client solutions at Cushman & Wakefield, said the biggest concern of a commercial landlord in this market is how to retain existing tenants, and that it often involves hiring a professional property management firm to create a better environment.

"That doesn't often involve cutting costs, it involves being efficient," said McCann.

Cushman & Wakefield has been asked to help landlords use their space better, even trying to get tenants to cut their space in existing leases to augment sublease possibilities.

"A tenant may have three floors in a building but their layout is inefficient," said McCann. "They say to us, we have 60,000 square feet but I can get 60,000 square feet two years from now for $2 a square foot less. Maybe you don't need one employee for every 300 square feet of space."

With the slowdown in leasing activity, companies like Jones Lang LaSalle see more opportunities in the property management side of the business. It manages 1.2 billion square feet of office space worldwide and about 45 million square feet of office space in New York City.

The firm also has an extensive project management business that helps companies manage relocations, expansions and site build-outs.

"If institutional buyers become more active, that will be a good thing for us," said Lance Carlile, regional manager of Jones Lang LaSalle's property management group.

Jones Lang LaSalle was selected by Ogilvy New York to oversee construction of its new offices in the 11-story Ogilvy Building at 636 11th Avenue, and it is managing the project with an eye to efficiency. The 559,000-square-foot space will include break-out rooms, a full-service kitchen, a media production room, cafeteria, printing facilities and a large gathering space.

Jones Lang is also overseeing a gut renovation of the building, which is owned by the Hakimian Organization, with partner firms Peykar Brothers Realty and Gorjian Properties.

In a slow market, though, many tenants cannot afford large blocks of space.

Robert Bielsky, president of Manhattan Commercial Realty Corp., said landlords are trying to make their buildings more attractive by subdividing large blocks of space, making them easier to lease to small and mid-sized tenants.

"[Rents] are not really coming down that much on small space, because there's still tremendous activity going on," he said.

Landlords are limited in their ability to pass the high cost of energy, labor and building materials onto tenants in the form of higher rent, but they can negotiate escalation clauses into a lease agreement.

For example, if rising winter heating bills are a worry to a landlord, they can negotiate language into the lease that requires the tenant to share those excess costs.

"A tenant now would be responsible for proportionate share in any increase in heating fuel over and above a base price," said Bielsky.

That means landlords are looking to turn a dollar however they can. Inwindow Outdoor, a New York-based advertising firm, helps landlords earn thousands of dollars of incremental monthly revenue. The company launched advertising campaigns for Converse and Red Bull in vacant street-level retail spaces in major office buildings. Inwindow has placed ads in buildings like 675 Third Avenue.

Ray Lee, who manages commercial real estate operations at Inwindow, said: "It offsets expenses from electricity to insurance to taxes." TRD