Discerning Alpha Investments in Downtown Manhattan's Asset Market: The Financial Feasibility of Office-to-Residential Redevelopment and the Planning Implications for Lower Manhattan Economic Development

by

Sung-Min Thomas Suh

B.A., Sociology, 2000
Columbia University

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Signature of Author:____
Center for Real Estate and Department of Urban Studies and Planning
August 6, 2004

Certified by: ____
Langley C. Keyes
Ford Professor, Department of Urban Studies and Planning
Thesis Supervisor

Certified by: ____
Lynn Fisher
Assistant Professor of Real Estate
Thesis Supervisor

Accepted by: ____
David Geltner
Chairman, Interdepartmental Degree Program in Real Estate Development

Accepted by: ____
Dennis Frenchman
Chairman, Master in City Planning Program
Department of Urban Studies and Planning

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Abstract

This thesis examines the financial feasibility of office-to-residential conversions in Downtown Manhattan's asset markets given the policy context shaping redevelopment opportunities. The analysis explores whether such conversion feasibility is desirable in the larger context of Downtown Manhattan's economic development.

Market evidence from Downtown Manhattan's underperforming Class B/C office stock as well as record high performance in residential markets indicate that office-to-residential redevelopment is no longer an option, but a market-based necessity for transitioning Downtown Class B/C stock into more economically viable uses.

Although markets have long identified office-to-residential conversion as the highest and best use of land in Downtown's markets, policymakers have also played an important role in facilitating conversion activity by allowing markets to adjust to economic changes. In the mid-1990's, policymakers used two separate approaches to advance sustainable redevelopment by clearing regulatory barriers for conversion and establishing incentives to encourage redevelopment activity. In comparison to these measures, post-9/11 incentives were designed to hold the market together and address immediate short-term redevelopment needs to stabilize markets in the long-term.

The thesis establishes that even in today's evolving conversion markets, Downtown presents a substantive level of risk for developers. The findings reveal a crucial interdependence between critical mass and private sector investment in services. These issues are compounded by longstanding urban planning issues involving infrastructure, transportation, and access. The market study, institutional analysis, and case-based material support the position that under current market conditions, policy measures must readjust conversion policies to foster reasonably paced residential redevelopment in conjunction with larger economic development plans for Lower Manhattan.

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Title: Ford Professor of City and Regional Planning
Thesis Supervisor: Lynn M. Fisher, PhD
Title: Assistant Professor of Real Estate

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Dr. Henry Pollakowski for having provided much of the initial support and advice in shaping the thesis and the connections with real estate academics as well as MIT alumni involved in local Manhattan-based real estate development. Professor William Wheaton for providing much of the drive and inspiration for examining Downtown's conversion market and for informing much of the fundamental grounding for the thesis.

The informational interviewees, including the industry practitioners, the planning professionals, and real estate academics, all key players shaping redevelopment activities in Downtown Manhattan's real estate markets. These participants were critical to bringing together the findings, connecting market data with tangible project-based information, and discerning key pieces of information on Downtown's evolving office-to-residential markets.

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Table of Contents

Chapter 1: Introduction

1.1 Office-to-Residential Redevelopment in Downtown Manhattan: Feasibility and Desirability

This past Independence Day, New York City celebrated with much fanfare the laying of the cornerstone for the Freedom Tower, as construction ensued on the World Trade Center site. Noted as the world's tallest office structure with a building height of 1,776 feet and 2.6 million square feet of commercial and office space,[1] the tower evokes larger questions of what the highest and best use of land is in Downtown Manhattan's[2] vast real estate market. Despite the World Trade Center's proposed introduction of expansive new Downtown office space, such office development is the anomaly in a market that has identified Downtown as the next major residential corridor in Manhattan.[3]

The purpose of this analysis is to examine the interaction between market and policymaking forces shaping the feasibility of office to residential conversions in Downtown Manhattan. In examining how feasibility results from such dynamics, this research also considers the desirability of such conversions. This thesis goes one step beyond analyzing feasibility and looks at whether such an impact on office-to-residential conversion is desirable from the context of weak Class B/C office fundamentals, a relentlessly growing residential market, and in the larger context of Downtown economic development. For analytical purposes, this thesis defines economic development activity as efforts to improve the built environment, to address the health of weak or unstable real estate markets and urban planning issues, and to shape a livable environment.

In doing so, this thesis studies the context for economic development by organizing two detailed studies. The first is a market overview of how weak Class B/C office fundamentals combined with strong residential market conditions have set the stage for office-to-residential redevelopment (Chapter 2 and 3). The second study analyzes the institutional responses to changing real estate markets and identifies how policymaking has evolved from establishing as-

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[1] Lower Manhattan: Information to Build On. <http://www.lowermanhattan.info/rebuild/new_design_plans/default.asp> (last accessed July 5, 2004).
[2] For the purposes of this thesis, the phrase "Downtown Manhattan" is used synonymously with "Lower Manhattan" and "Downtown."
[3] Real Estate Professional, Informational Interview. July 14, 2004.

of-right zoning to creating post-9/11 economic stimulus legislation (Chapter 4). After the market and policy analyses, the thesis examines three prototypical office-to-residential scenarios – all products of varying degrees of market and policy interactions (Chapter 5). The thesis then concludes by circling back to the examination of how feasible and desirable Downtown office-to-residential conversions have been under various degrees of market and policymaking dynamics (Chapter 6).

In terms of desirability, most stakeholders ranging from policymakers to industry practitioners agree that office-to-residential conversions continue to provide socioeconomic benefits through optimization of economic resources for the community, government, and the industry. The thesis shows that, at a basic level, feasibility has largely been aided by as-of-right zoning, as opposed to recent tax-exempt bond financing and legislation stemming from post-9/11 measures. However, on a deeper level, this T Tthesis determines that post-9/11 incentives such as the Liberty Bond Program were necessary policy tools for immediately addressing market shock and holding together the Downtown real estate markets. Evidence gathered shows why policymakers acted towards jumpstarting the market when the shadow of the 9/11 disaster was inhibiting otherwise valuable investment and redevelopment in Downtown Manhattan.

Given current market conditions and strength in the residential markets, however, the thesis concludes that policymakers should discontinue the Liberty Bond Program while maintaining tax-based incentives enacted during pre-9/11 conditions. These changes ensure that policy measures are readjusted to foster *reasonably paced residential redevelopment without overheating the market* – necessary steps towards establishing viable market conditions in Downtown Manhattan.

1.2 Industry Relevance and Planning Significance: Re-evaluating Assets and Discerning Redevelopment Opportunities

The market study, institutional analysis, and case-based conclusions, are intended to provide industry practitioners and policymakers with evidence about what conditions generate opportunities for office-to-residential redevelopment. The market environment and institutional analyses provide insight into the decision-making process behind conversion of underutilized or underperforming office assets into more economically viable residential uses.

The information, although specific to Downtown Manhattan's market and institutional dynamics, is designed to inform discussion about the economic development benefits of such office-to-residential redevelopment opportunities. Although these conversions may be identified by the market as the highest and best use of land in Downtown's real estate markets, it is clear that a number of stakeholders from both policy and planning aspects also agree that such redevelopment facilitates long-term economic development in central business districts by maximizing economic value for ailing office assets, cross-subsidizing affordable housing product, and promoting mixed-use development vis-à-vis larger urban planning goals associated with current thinking.

45 Wall Street: Downtown's First Large-Scale Conversion. Meltzr Mandl

Of utmost importance in looking at these findings is the critical observation that an informed exchange between industry practitioners and policymakers can produce both an improved built, as well as, a livable environment. Hence policymaking forces can have an important responsibility and role in helping bring about redevelopment of urban space in a matter that balances both socioeconomic considerations with market-based realities. Nowhere is this crucial interaction between market and policymaking forces as carefully examined, and perhaps deservingly so, as those dynamics present in Lower Manhattan's real estate markets. Thus, the primary goal of the thesis is designed to provide examples in which different redevelopment scenarios provide insight into how the decision-making process for office-to-residential conversions is shaped by the interaction between market and policymaking forces.

Chapter 2: Market Conditions Driving Class B/C Conversions: A Pre and Post-9/11 Study

This chapter looks at market evidence based in the Class B/C office market supporting conversion of Downtown office-to-residential space. Demand and supply side analysis, starting with Downtown's last office building boom in the late 1980's and lasting to recent times, both point to one lesson from the market: Downtown Class B/C stock is not economically viable as office space, and has not been for some time. In this respect, the chapter explains why office-to-residential conversion makes sense rather than repositioning Class B/C office space into renovated, re-branded office stock. [4] The reasons for why conversion provides superior economic value over and above repositioning are revealed through the chapter's examination of fundamental weaknesses in the Class B/C Downtown inventory. This chapter builds its market-based position that substantial portions of Downtown Class B/C stock will inevitably convert to residential use by examining three critical Class B/C disadvantages in Downtown Manhattan, covered in the chapter in the following arrangement:

- Chapter 2.2-2.3: Class B/C office market's susceptibility and instability due to cyclical dangers and over-reliance on financial, insurance, and real estate (FIRE) sector for substantive portions of tenant base;
- Chapter 2.4: Substandard physical qualities and aging inventory traits that factor into inability of Class B/C stock to compete with Midtown Manhattan comparables; and
- Chapter 2.5-2.12: Turbulent economic times in the late 1990's and post-9/11 market shock – both events exposing fundamental Class B/C weaknesses that have set permanent, structural reasons for converting uncompetitive Class B/C office stock into other valuable uses.

[4] Repositioning is originally a marketing term that, when applied to real estate development, involves keeping the real estate asset's original use, but re-branding the physical product through substantive renovations and rehabilitation to current competitive market standards. A recent John Hancock Real Estate Investment Group study points out that creating or enhancing value in underperforming real estate assets can be achieved by repositioning or conversion projects. Denise Howard and Jun Han. "Creating Value in a Stable Real Estate Market: Value Creation through Renovation and Repositioning." Real Estate for Pension Professionals, 9 (2004): pp. 45-49.

In looking at the weak Class B/C office fundamentals, this chapter exposes crucial reasons for why industry practitioners and academics are pointing to office-to-residential redevelopment as no longer an option. As well, it has become a market-based necessity for transitioning Downtown Class B/C office stock into other economically viable uses. This chapter demonstrates how office-to-residential redevelopment can correct clear inefficiencies in functionally obsolete and uncompetitive Downtown Class B/C office stock as well as aid socioeconomic goals for supporting more sustainable local economic development.

2.1 Downtown Manhattan Conversion Market Area

For the purpose of establishing a market delineation of Downtown Manhattan, this study defers to both market-based as well as recent policy-based definitions (refer to Appendix A's map of the Liberty Zone) for studying office-to-residential redevelopment activity in New York's Lower Manhattan. As a starting point, because this thesis aims at examining the confluence of both market dynamics and fiscal policymaking, it is especially appropriate to defer to market definitions set in place during recent federal legislation – the H.R. 3090 or the federally mandated Job Creation and Worker Assistance Act of 2002 – which holds key incentives that critically impact redevelopment of office stock into residential product. [5]

As the Liberty Zone is a district designated under federal programming, market-based definitions of Lower Manhattan have traditionally developed various submarket definitions for Downtown Manhattan that encompass areas just north of Canal Street including areas such as Soho/Tribeca, but largely include most of what is designated in the aforementioned Liberty Zone.[6]

Much of the stock suitable for ***large-scale office-to-residential redevelopment*** *is located in submarkets traditionally denoted as Lower Manhattan's insurance districts*, where pre-war Class B/C office product has been identified for transition into residential uses and continues to

[5] The legislation describes a region defined as The "New York Liberty Zone" (The Liberty Zone) which is geographically bound to the North by Canal Street, running into East Broadway and bordered by F.D.R. Drive to the east, Historic Battery Park at the southern tip of Manhattan and Battery Park City next to the Hudson River on the West. Lower Manhattan Development Corporation. Introducing the New York Liberty Bond Program. New York: Lower Manhattan Development Corporation, 2002: p. 1.

[6] Office-to-residential conversion markets are determined by taking office market definitions from C.B. Richard Ellis and Newmark and combining it with residential market definitions supplied by Corcoran and Douglas Elliman.

be the target office stock for redevelopment purposes. *Smaller-scale office-to-residential conversions have occurred in submarkets away from the insurance district into areas just south of Soho/Tribeca.* In order to demonstrate differing submarket considerations as well as economic factors that affect the analysis for converting office space into residential product, a comparison of large-scale versus smaller scale office-to-residential projects will be discussed in Chapter 5's coverage of prototypical conversions, with exploration of market analysis, economic/feasibility issues, and policy implications.

The following page shows a typical delineation of major Downtown office submarkets as divided into the following:

1) Financial/South Ferry;
2) Insurance District;
3) World Trade Center;
4) Old Battery Park;
5) City Hall; and
6) Soho/Tribeca/southern portion of Greenwich Village.

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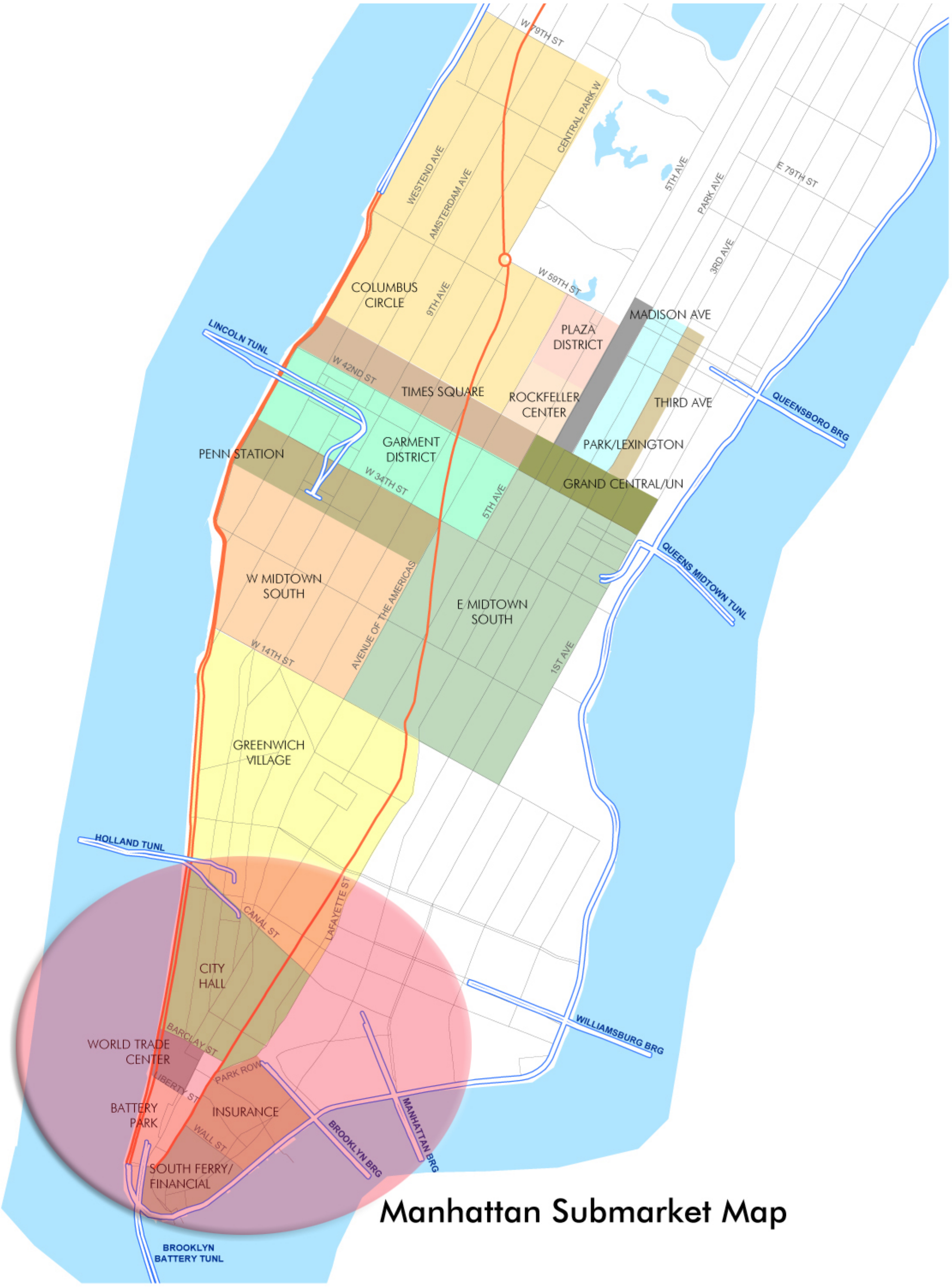
Delineation of Manhattan Commercial Office Submarkets. C.B. Richard Ellis, Manhattan Submarkets Map. Q2 2003 Manhattan Office Market Index Brief. New York: C.B. Richard Ellis, 2003.



2.2 The Commercial Market: Economic and Financial Sector Background

In observing changing market cycles for Downtown Manhattan within the larger context of the commercial office market in Manhattan and surrounding vicinities, it is important to examine what differentiates the prevalent office stock in Downtown Manhattan with other business districts, the economics that lead to underutilization and functional obsolescence of Downtown inventory, and the resulting market-history in the past decade that caused both practitioners and academics to believe that softened Downtown market fundamentals to be part of long-term structural issues for Lower Manhattan.

The past decade is an important period for analysis insofar as there existed apparent developmental cycles of both boom and busts in the office market.[7] More importantly, the past decade showed an emergence of important policy tools demonstrating a market-savvy policymaking designed to deal with correction and management of particularly problematic office inventory and alarmingly weakened market fundamentals in Downtown Manhattan.[8] It is particularly useful to provide a more defined periodic-based analysis in connecting office market dynamics with economic cycles affecting Lower Manhattan. Thus, the discussion of Class B/C positioning the office marketplace is framed around three different contexts, including both pre and post-9/11 periods:

1) Early to mid-1990's -- market conditions following the Stock Market Crash of 1987;
2) 1995 to late 1990's markets following Giuliani-initiated changes and up until the end of the economic boom in the late 1990's;
3) Post-economic boom market fundamentals and post-9/11 conditions.

2.3 The Downtown Office Market from the Early to Mid-1990's: Revelation of Fundamental Weaknesses in Class B/C Office Inventory

As noted by real estate professionals and academics alike, there are significant economic repercussions flowing from the economic base that has long been represented by the financial

[7] Citizens Housing and Planning Council. Report of the Citizens Housing and Planning Council on Housing Development in Downtown Manhattan. Sep. 2002: p. 6-7.
[8] Ibid, 6-10.

cluster of firms in and around Lower Manhattan's Wall Street.[9] The substantive dependence on the economics of the Finance, Insurance, and Real Estate (FIRE) sector has long been studied by economists and real estate practitioners focusing on the direct correlation of the local employment base, demand trends for commercial space, and overall office market fundamentals.[10]

Indicative of the problems inherent in Downtown's heavy dependence on FIRE sector-driven space demand, as well as the need to respond to more fundamental structural problems and changes in Downtown market dynamics, is the stock market crash of October 1987. The crash ushered in a period of substantive retrenchment for New York City's financial service firms, with overall employment in the FIRE sector falling from 615,000 in 1988 to 541,000 in 1996.[11] Even previous to the Crash of 1987, there were substantive shifts in employment nodes specifically from Downtown to Midtown Manhattan. That share fell especially following the Second World War, when Midtown Manhattan emerged as a competitive space for office development in direct response to increasing employment growth in a stronger central business district. Yet following the stock market crash in the late 1980's, employment declines were particularly severe in the city's banking industry, where mergers, relocation, deregulation, and increased market competition within the banking sector reduced employment by almost 30 percent in eight years.[12] Reflecting these employment losses, the vacancy in Downtown office buildings soared, reaching over 20 percent in 1996.[13] According to Jones Lang LaSalle, vacancy was not only high for Class A Downtown stock, *but were particularly acute for the prototypical inventory of pre-war Class B/C office buildings where vacancy rates exceeded 25 percent and climbed up to 30 percent in the mid-1990's.*[14]

Consequently, what was the Downtown building boom during the mid to late-1980's, with over 25 million square feet of modern office space being built in direct response to accommodate FIRE-driven and commercial demand, collapsed in 1987 only to expose key

[9] Ibid, 6. Real Estate professionals and academics, Informational interviews. July 14-15, 2004.
[10] Federal Reserve Bank of New York. "New York City's Economy Before and After September 11." Current Issues in Economics and Finance: Second District Highlights. New York: Federal Reserve Bank of New York, 2003: p. 2-4.
[11] Ibid.
[12] Citizens Housing, 7.
[13] Ibid.
[14] Alliance for Downtown New York, Inc. Downtown New York: A Community Comes of Age. New York: Alliance for Downtown New York, Inc., 2001: p. 11.

underlying weaknesses in Downtown's office fundamentals. Beginning with the prototypical stock found not only around Wall Street, but in other areas around John Street and Broadway, substantive portions of outdated pre-war building space accounting for over 40 million square feet of office inventory were fast being tagged by the market-place as encountering conditions indicative of "empty building syndrome."[15] To understand why underutilization and functional obsolescence characterized much of this Class B/C office space, and why the economics do not exist for repositioning this inventory into newer, more competitive stock, a review of physical qualities and conditions for prototypical inventory in much of the Insurance, Financial District, and secondary low-rise office markets of Soho/Tribeca must follow.

As indicated earlier, significant ground-up development for office space in Downtown Manhattan occurred in mid to late 1980's. However, a substantive portion of the office stock Downtown was unable to compete with Midtown Manhattan for more credit-established commercial tenants such as the Fortune-500 firms that Midtown Manhattan was able to attract. Below shows a table of Downtown vacancy figures for office product dating from the post-1987 market cycle up until 2003.[16]

Office Inventory in Downtown and Periodic Vacancy Trends

Year	Total Office Inventory	Total Occupied Space	Total Vacant Space	Average Vacancy (All Classes A-C)
1989	113,392,000	97,433,040	15,958,960	14.07%
1990	112,999,000	96,122,386	16,876,614	14.94%
1991	112,497,000	93,149,987	19,347,013	17.20%
1992	112,446,000	90,893,190	21,552,810	19.17%
1993	112,446,000	90,861,350	21,584,650	19.20%
1994	112,441,000	93,293,725	19,147,275	17.03%
1995	112,441,000	92,300,208	20,140,792	17.91%
1996	112,441,000	94,949,099	17,491,901	15.56%
1997	112,120,000	100,445,600	11,674,400	10.41%
1998	111,494,000	103,658,180	7,835,820	7.03%
1999	110,693,000	104,650,067	6,042,933	5.46%
2000	109,193,000	100,057,118	9,135,882	8.37%
2001	93,043,390	81,226,879	11,816,511	12.70%
2002	93,043,390	80,482,532	12,560,858	13.50%
2003	93,043,390	80,219,012	12,824,378	13.78%

[15] The term "empty building syndrome" is used in the context of Eric Michale Anton's descriptions of buildings that no longer accommodate the needs of the tenants. Urban Land Institute. "Solving the Empty Building Syndrome in Lower Manhattan." New Uses for Obsolete Buildings. Washington: Urban Land Institute, 1996.
[16] Adapted from Citizens Housing: 10.

In the context of comparing our subject Downtown Class B/C office product with Class A counterparts, there appears to be a vacancy differential in 1993 of at least 1000 basis points lower occupancy for Class B/C stock relative to more modern Class A stock -- the most pronounced period of elevated vacancy rates for this market. Furthermore, although the chart may appear at first glance to suggest declining vacancies occurring in conjunction with the period of economic growth witnessed in the late 1990's, a closer examination of market activity and the response of holders of Class B/C office stock in Downtown Manhattan reveals that it was conversion activity from office-to-residential use that took inventory off the market.[17] With the amount of vacant Class B/C space more than doubling between 1990 and 1995 and reaching nearly 10-12 million square feet, critical momentum built up in the market for converting office to residential use. As noted in a Downtown office market study:

> Although some conversion activity had occurred earlier in the 1990's, the conversion market picked up steam after [1995]…. All told close to 6 million square feet of older Class B/C space was withdrawn from the office inventory since the beginning of the 1990's.[18]

As seen in the previous table, without separating out the effect of office-to-residential conversion activity taking significant portions of Class B/C inventory off-the-market, vacancy rates that lump Downtown office stock becomes misleading. Furthermore, as will be discussed later in the analysis covering the period of economic boom for both Downtown Manhattan and New York City, much of the reported vacancy for Downtown inventory becomes inherently understated, considering the growing use of "phantom occupancy" of relatively large amount of leased, but underutilized Lower Manhattan office spaces designated for either back-office or back-up facilities.

To understand why over 10 million square feet of office inventory in any central business district could be prone to underutilization or identified by the market as functionally unsuitable for prime commercial tenant leasing, it is necessary to account briefly for the office development of Manhattan itself and chronicle the differences in building technology as well as other stock qualities that factor into the economic unfeasibility of holding office inventory in the Downtown market. Thus, aside from changing employment dynamics favoring Midtown Manhattan over

[17] Citizens Housing: 8.
[18] Ibid.

Downtown, the condition of Class B/C stock relative to Midtown Manhattan office inventory further explains a general flight to quality out of Lower Manhattan's office core.

2.4 Prototypical Class B/C Product Qualities and Ramifications on Performance

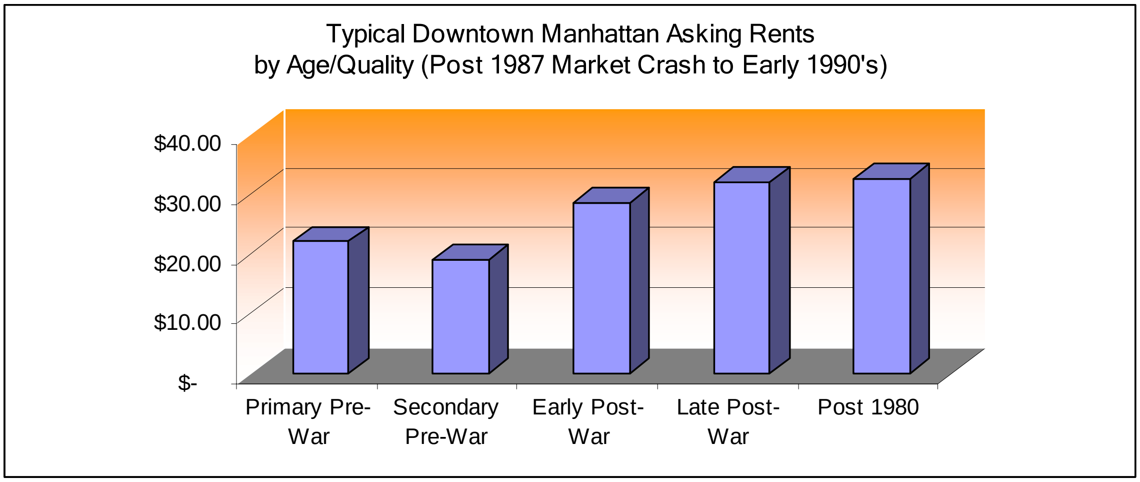
Understanding the age and physical conditions of the office stock itself accounts for some of the market-identified disadvantages and economic difficulties of continued office use for existing Class B/C inventory. Historically, Manhattan office markets developed from Lower Manhattan to Midtown, with Downtown representing earlier clusters of commercial development.[19] Much of the Downtown inventory that is the subject prototypical office stock for economically valuable redevelopment was largely built from 1900 to 1932.[20] Built to suit the needs of insurance firms and businesses with storage needs different from current more technologically intense operations, Downtown Class B/C inventory is not only underutilized as office space but considered by current market and legal building specifications as functionally obsolete. Much of the pre-war and early post-war building stock contains physical and technological limitations that are significant disadvantages for both FIRE-based businesses as well as other major commercial tenants, such as:

- Smaller floor plates, which are inefficient for multi-tenant floor operations typical of banking/trading and other businesses in the FIRE sector.
- Outdated concrete masonry, as opposed to steel construction, making wiring installation of telecom technology along with physical adaptation of office space difficult.
- Need for adapting fenestration, updating elevator and HVAC technologies, and asbestos removal.
- Awkward floor plans designed around outdated building specifications for maximizing light and air with lack of modernized ventilation systems.
- No drop ceilings and lack of accessibility or inability to accommodate wiring and modern telecommunication needs.[21]

Consequently, the chart below demonstrates how Downtown Market witnessed even sharper rent differentials following the Crash of 1987 among its various categories of office

[19] Real estate academic. Informational interview. July 15, 2004.
[20] Ibid.
[21] Urban Land Institute. "Solving the Empty Building Syndrome in Lower Manhattan." New Uses for Obsolete Buildings. Washington: 1996. Real estate professional and planning official. Informational interview. July 14-15, 2004.

stock, with noticeable variances between the aforementioned functionally obsolete Class B/C office stock and more modern or relatively recent ground-up development.[22]



With lower than average asking rents, along with other upfront costs such as tenant improvements/leasing commissions and annual operating/tax-related expenses, proforma-based net rents on 10-year leases for commercial space was nowhere near justification for economic viability of Class B/C office use during this period. From an economic standpoint, even with substantive capital positioning on the part of a Class B/C property owner, leasing space at these conditions continues to be unreasonable.

In terms of pricing, holders of Class B/C buildings who were unable to respond to growing marginalization of their outdated inventory in direct competition with technologically responsive ground-up developments, were routinely trading for $10 to $30 per square foot, as opposed to prices that were trading in excess of $100 to $200 per square foot in the building boom of the mid-1980's.[23] Furthermore, 1990-1995 is characterized by weak growth anticipation and periods of negative net absorption. Further discussion of market trends and leasing statistics will indicate that the market for Class B/C office space is a significant indicator that Downtown Manhattan's office fundamentals witnessed long-standing structural transformation, rather than cyclical movements, in the direction of economically viable product centered on increasingly market-dominated residential uses.

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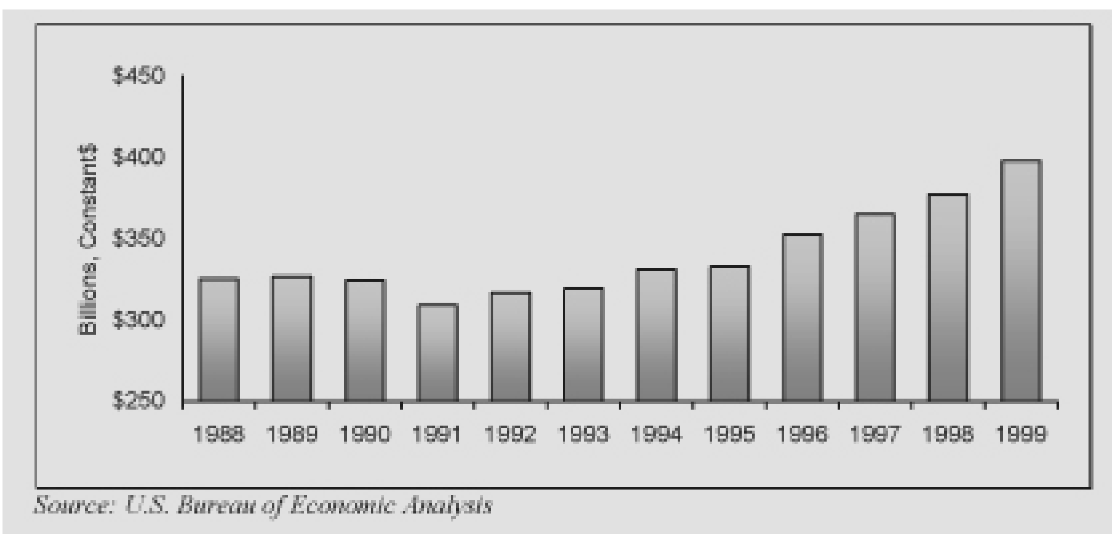
[22] Eric Michael Anton. Empty Building Syndrome: A Case Study of Highest and Best Use in Lower Manhattan. Avery Archives. New York: Columbia Univ., 1995.
[23] Real estate professional and academic, Informational interview. July 14-15, 2004.

2.5 Temporal Class B/C Market Ebullience: Continuous Weak Fundamentals

Before pursuing market analysis of current Downtown office fundamentals and the impact of 9/11 on reinforcing structural transformation of Class B/C market positioning, the second major period of analysis encompassing the late 1990's boom must be explored in order to distinguish structural versus cyclical market changes. During this period, gross metropolitan product for the New York Primary Metropolitan Statistical area (PMSA) surpassed the rate of economic expansion for the nation as a whole. Strong job growth since 1997 returned employment to the levels of the late 1980's.[24] By the middle of 1999, the New York Metro Area regained all of the jobs lost in the recession of the early 1990's.[25]

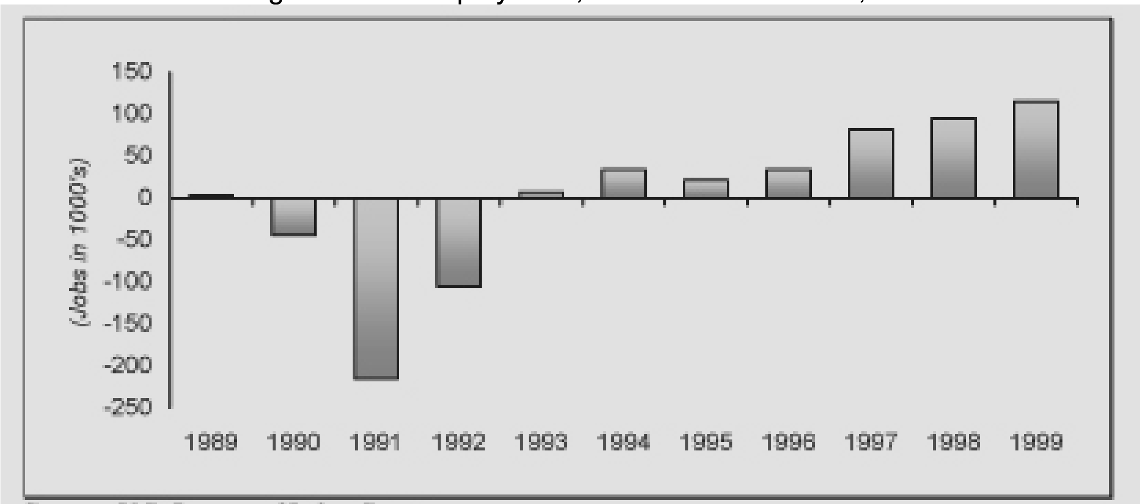
Gross Metropolitan Product, New York NY PMSA, 1988-1999



Even in the late 1990's boom, the FIRE sector continued to be the primary engine driving regional growth. Financial service sector employees earned nearly 20 percent of total wages in the region even though they accounted for only 5 percent of the employment base.[26] With average salaries of approximately $200,000 in 1999, financial sector workers were earning an average of five times the salaries of non-financial sector workers.[27]

[24] Alliance for Downtown New York, Inc.: 13.
[25] Ibid.
[26] Ibid.
[27] Ibid.

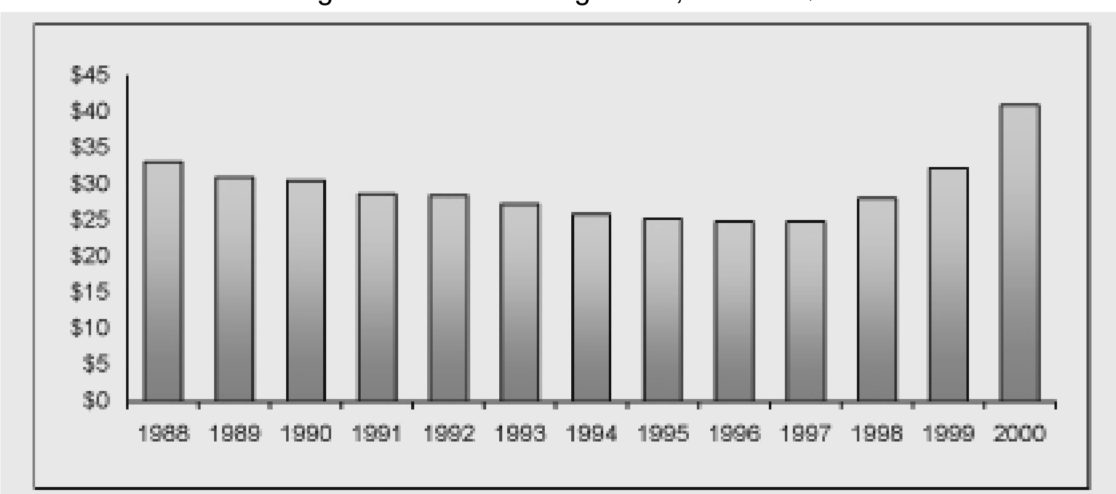
Net Change in Total Employment, New York NY PMSA, 1989-1999



Source: U.S. Bureau of Labor Statistics

Consequently, the Downtown markets made a dramatic, albeit short-term, turnaround beginning in 1996. In the five-year period of economic growth, Downtown's 110 million square foot office market went from the reported high of 23 percent vacancy to a record low of 4 percent as late as the third quarter 2000.[28]

Average Downtown Asking Rents, 1988- 2Q 2000



Source: Cushman & Wakefield

[28] Ibid, 15.

2.6 Troubling Market Signals for Class B/C Office Stock and the New Economy

Yet starting with the fourth quarter of 2000, Downtown vacancy started a sharp upward trend as the market recognized underlying problems in office fundamentals and general uncertainty about long-term prospects across all property types. As pointed in a Downtown Alliance study, almost half of the space demand for office space was driven by "new economy" companies.[29] In looking back at much of the changes in market demand and leasing dynamics, much of the heightened performance in Downtown Class B/C inventory must be considered in the larger context of the economic contraction resulting from both the crash of dot-com industries as well as the related retraction of the financial service sector.[30] Thus, even though vacancy rates in all property classes dipped into the single digits during this period, with unprecedented demand for Class B/C space and unseen lows in available supply of pre-war office stock, these changes are tempered by the fact that escalated rents and tumbling availability was driven by what was seen as the "dot.com revolution" and strong industrial growth in "new media" businesses.

More importantly, the lessons to be gathered in hindsight from the Class B/C office market of the late 1990's is that even a highly unusual period of local economic growth ultimately resulted only in temporary, rather than long-term, sustainability of demand for this specific product type. In fact, even with unprecedented spikes in market demand, new office construction during this period was limited and immaterial because the short-term economics that may have justified ground-up development in certain Downtown submarkets were outweighed by long-term financial uncertainty around speculative building developments and overall questioning of market fundamentals and sustainability of office market demand.

2.7 Overstated Phantom Occupancy and Conversion Pressures

The panning out of market ebullience and the ensuing economic contraction revealed troubled credit bases for new-economy businesses and soft capital commitments. Furthermore, the market identified more long-term, sustainable functional reuse of Downtown Class B/C

[29] Alliance for Downtown New York: 16.
[30] Federal Reserve Bank: 2.

office stock. It became clear that Downtown Class A space was trending toward functioning as what is referred to as “phantom office space,”[31] with more credit-established tenants and Fortune 500 firms locating primary commercial space needs towards Midtown and back-up space or more secondary back-office operations to less commercially attractive Downtown Class A office space. *In this respect, even with Downtown office stock operating within an important space market for Manhattan, Class A was setting itself as secondary office inventory competing with the least attractive of Midtown office stock, while Class B was clearly positioning itself for phasing out of use as office inventory altogether*.

Thus, following the recession, Downtown Class A office space clearly positioned itself in the larger context of Manhattan’s two central business districts as a back-up office marketplace with substantive portions of “phantom occupancy.” This sustained what the market perceived as residually desirable office stock that held secondary positioning with respect to non-core Midtown South office inventory. In this respect, whatever factors directed at redeveloping Downtown Class B/C office stock into highest and best uses for multi-residential purposes were only reinforced and gained increased market momentum. Beyond these growing market forces ushered in by conversion pressures, a discussion of the policy initiatives that set much of the stage for more feasible Downtown redevelopment will be discussed in Chapter 4 of the thesis.

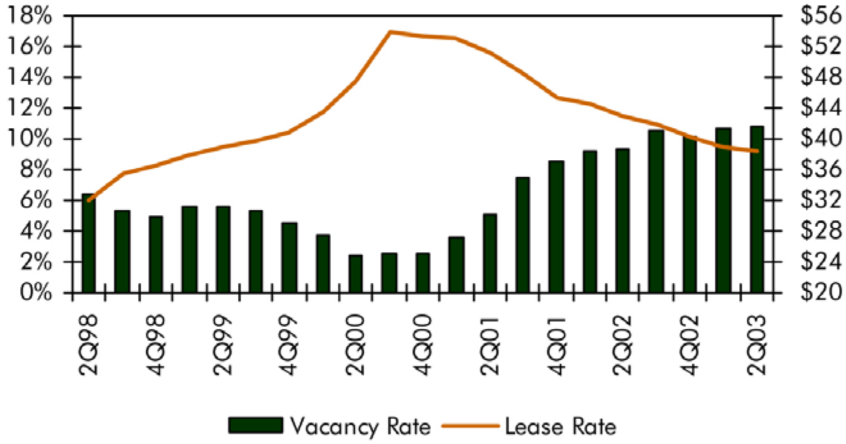
2.8 Market Shock and Recession: September 11 Impact on Commercial Markets, Office-to-Residential Conversion Dynamics and Local Economies

Even without a major event bringing about market recession, there was always an overarching flight to quality as firms pulled out of Lower Manhattan’s older, outdated office core into more favorable market conditions in Midtown Manhattan.[32] Already shaken by the economic slowdown, the real estate industry was experiencing a longer and more protracted contraction. Immediately prior to the events of 9/11, Downtown demonstrated much weaker fundamentals compared to Midtown in an overall soft Manhattan office market, as the

[31] The phrase “phantom occupancy” is defined as space that is being leased but not used. William C. Thompson (Comptroller), 9/11: Two Years Later: An Analysis of Federal Aid. New York: Office of the Comptroller, 2003.
[32] Urban Land Institute: 18.

availability rate was increasing and weighted average asking rents were decreasing beginning in 1Q 2001.

Overall Manhattan Office Market Trends 2Q 1998 – 2Q 2003.
Source: CBRE Manhattan Office Data, 2Q 2003.



What softened office fundamentals combined with overall weak economic conditions meant for office-to-residential redevelopment opportunities is captured in this Citizens Housing and Planning Council of New York statement issued a year after 9/11:

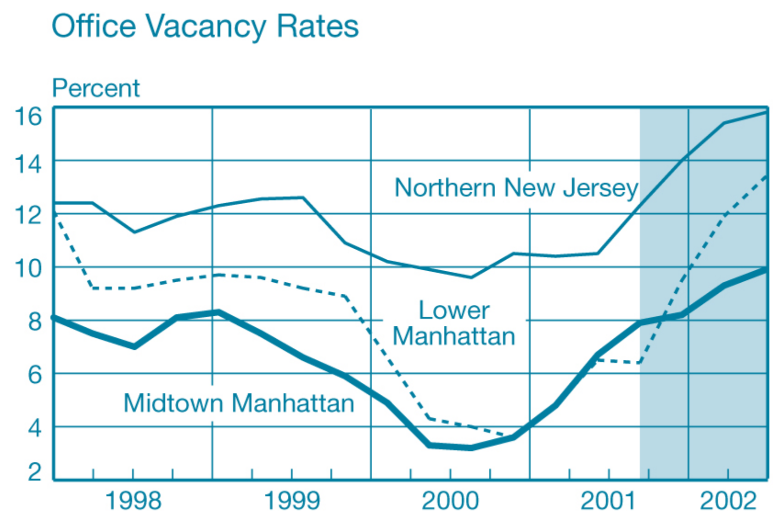
> September 11 changed many things dramatically…it did alter the commercial market equilibrium between Lower Manhattan, Midtown Manhattan, and secondary centers like Long Island City and Jersey City…it is likely that Lower Manhattan's commercial base has been permanently diminished relative to those alternative locations. *A smaller office sector will mean higher vacancies and lower rental prices, especially in older buildings, making some of them* ***more attractive conversion candidates than they were previously****….* With the exception of the World Trade Center site itself, there remains very little vacant land on which to construct new residential or commercial buildings in Lower Manhattan. At the same time, the market's voracious appetite for housing in Manhattan should not be quelled…this combination of new circumstances and old considerations will probably make the climate for residential conversions more favorable than it was during the period of peak office demand during the late 1990's.[33]

[33] Citizens Housing: 4-5 (emphasis added).

In the following section, a brief look at both the market response to 9/11 and the extent of damage to capital stock will be followed by economic background on the impact of market shock on both local economies as well as resulting adjustments in office demand.

2.9 Near-Term 9/11 Consequences on Space and Inventory

One of the most pronounced market-based outcomes of 9/11 was the effect on Downtown's office performance relative to Midtown Manhattan's. Though demand for office space had already been weakening and vacancy rates rising prior to the attack, 9/11 fundamentally changed the dynamics of Downtown vis-à-vis Midtown.



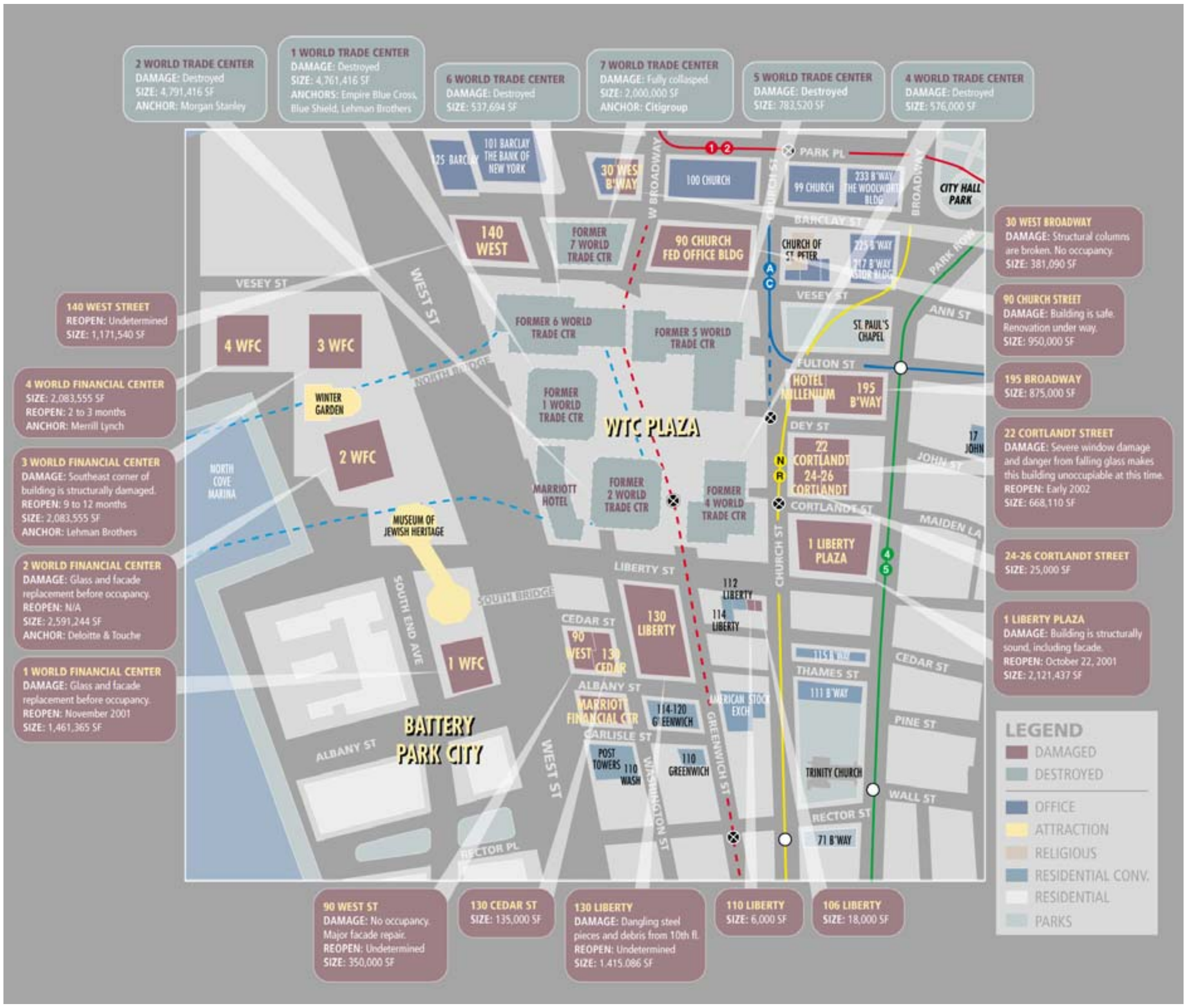
Source: Cushman and Wakefield.
Note: The shading indicates the post-September 11 period.

After 9/11, with an estimated 3 percent of Manhattan's office space destroyed and another 3 percent rendered temporarily unusable,[34] projections by some practitioners and academics were made that a severe space shortage would push down vacancy rates and cause a sharp spike in rents. Yet quite the opposite occurred: vacancy rates rose further and rents declined. This happened because demand weakened more than was anticipated, with firms having maintained "phantom space" in Manhattan and in outer office markets. Much of this phantom space was subleased to displaced firms, and some Manhattan hotels were retrofitted to serve as temporary office space.

Due to the physical capital loss from 9/11, more than 30 million square feet of commercial space, including 22 office buildings in Lower Manhattan, was damaged or

[34] Jason Bram, et al. "Measuring the Effects of the September 11 Attack on New York City." Federal Reserve Bank of New York Economic Policy Review. Nov. 2002: 13.

destroyed.[35] Altogether, 13,450,046 square feet (6 buildings) of office space was destroyed and 16,516,282 square feet damaged (16 perimeter buildings).[36] The 30 million square feet of office space represented a loss of 7.3% of the city's total inventory of office space, and almost a third of Downtown's inventory.[37] The following map illustrates the magnitude of property damage, and a list of affected inventory follows thereafter: [38]



Map of Inventory Damage from Attack on WTC. Source: Newmark Real Estate, 2001.

- Nine Class B and C buildings were damaged severely, including a telecommunications facility for Verizon.

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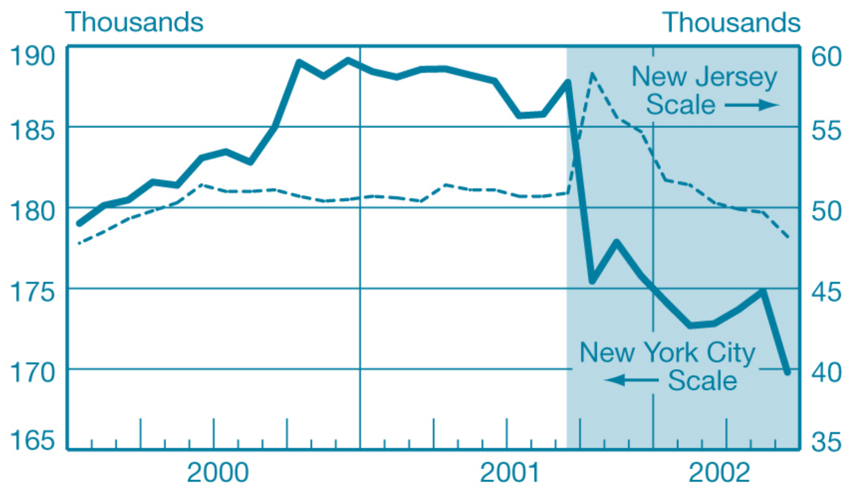
[35] Ibid, 11.
[36] Newmark Real Estate and Financial Services. A City Challenged. Fall/Winter 2001. New York: Newmark, 2001.
[37] Ibid.
[38] Ibid, 2.

- Two buildings, 30 West Broadway and 3 World Financial Center, with 2.6 million square feet sustained the worst damage.
- Six Class A office buildings that made up the World Trade Center complex all collapsed.
- Five other Class A buildings retained their structural integrity and sustained less severe damage, consisting mostly of façade and window damage.[39]

2.10 Post 9/11 Disruptions in Employment and Office Demand

In addition to the capital loss of substantive Downtown office stock, the attack on the World Trade Center had a dramatic effect on employment in New York City. Beyond immediate consequences, there were long-term employment trends and immediate stress placed on local economies, indicated by severe job loss, in critical segments of Downtown office demand.

Financial Services Jobs
in New York City and New Jersey
Seasonally Adjusted Level



Sources: New York State Department of Labor; New Jersey Department of Labor; Federal Reserve Bank of New York.

Note: The shading indicates the post-September 11 period.

In the period beginning in the fourth quarter (Q4) of 2000 to Q4 2002, 66,998 jobs were lost in Lower Manhattan: 57,109 between Q4 2000 and Q4 2001, and an additional 9,889 in the

[39] Ibid.

following year.[40] The job losses from 2000-2001 represent a decline of 11 percent, while the average quarterly salary fell by $2,948, a decline of 14 percent, reflecting the large loss of jobs in the finance and insurance sectors.[41] As a result of 9/11, The World Trade Center lost 26,052 jobs.[42] *The roughly 57,000 jobs lost in Downtown alone represent 37 percent of the total jobs lost in New York City during this period.*[43] The decline in the number of business was approximately 2 percent (refer to cross-tabulation in Appendix B).

According to the New York State Department of Labor, the Finance and Insurance sector sustained the largest job losses (25,087), followed by Professional, Scientific and Technical Services (8,879).[44] This is problematic considering the importance of the FIRE sector in traditionally sustaining core demand for office space in Downtown's submarkets (refer to Appendix C).

For the period from Q4 2001-Q4 2002, the continuing impact of the World Trade Center attack on the Lower Manhattan economy is evidenced by: 1) continuing job losses; 2) wage losses; and, 3) declines in the number of businesses in the year following the attack. Again, during this period, the Finance and Insurance sector suffered the most severe job losses (10,099).[45] Lower Manhattan's job losses remained greater compared to citywide trends. Approximately 18 percent of citywide job losses were concentrated in Lower Manhattan, which had 13.4 percent of the citywide workforce as of the fourth quarter of 2001.[46]

2.11 Commercial Leasing Activity: Event-Induced Flight to Safety and Quality

A total of 652 tenants occupying 28.6 million square feet of space were permanently or temporarily displaced by the destruction, [47] and in the long-term out-migration of firms to Midtown occurred due not only to a fundamental flight to quality, but also because of a near-term flight to safety. The following demonstrates the extent to which office markets outside Downtown experienced increased post-9/11 leasing activity through either permanent or

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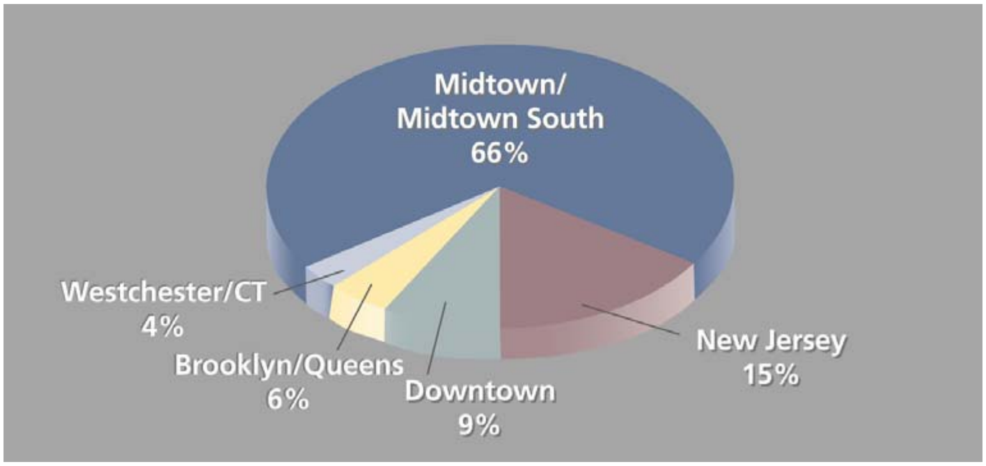
[40] Thompson: 26
[41] Ibid.
[42] Ibid.
[43] Ibid.
[44] Ibid.
[45] Ibid, 28.
[46] Ibid.
[47] Newmark Real Estate: 3.

temporary relocation, and consequently achieved event-induced absorption on the account of Downtown's loss of inventory:

Breakdown of Office Relocations. Source: Newmark, 2003.



The above graph suggests that Midtown Manhattan has benefited most in terms of absorption changes from the 9/11 attacks. At the same time, the graph points to emerging office markets in Jersey and New York City boroughs outside Manhattan that have further eroded Downtown Manhattan's share of commercial office tenants in the wake of 9/11.

2.12 Recent Market Conditions and Office-to-Residential Conversion Activity

As noted by a City of New York Comptroller study, from Q1 2000 to Q1 2004, there has been no significant construction of new commercial office space in Downtown Manhattan.[48] By contrast, there has been construction in Midtown Manhattan for every quarter during that period, reaching as much as 10 million square feet under construction in Q3 2001, and holding as much as 5 million square feet in Q2 2003.[49] In a 2003 office market report, the Comptroller maintains:

> The lack of construction and continued high vacancy rates in Lower Manhattan **reflect *continuing uncertainty* over the timing and final plans for transportation infrastructure and the new office space which will be built to replace what was destroyed by the attack**s.[50]

[48] Thompson, 29.
[49] Ibid.
[50] Ibid (emphasis added).

In comparing market statistics for Downtown Manhattan with competitive submarkets in Midtown Manhattan, Fairfield (Connecticut), Jersey City (New Jersey), and Westchester (New York), vacancy rates on a macro-level for the region have trended upwards since Q4 2000 with vacancy rates in Downtown reaching a peak of 16.3 percent in Q1 2003.[51] What is even more alarming is that a large portion of Downtown occupancy, in comparison to Midtown Manhattan, is driven by "phantom space." With phantom space making up a good portion of Downtown occupancy, vacancy rates for Downtown are acknowledged to be substantially understated.[52]

As recently as May 2004, even with office leasing activity up for Manhattan with first quarter numbers revealing the strongest activity in more than two years (7.7 million square feet),[53] these figures do not capture the continuing problems with office fundamentals in Downtown's office market. In summary, *Downtown office submarkets are clearly demonstrating continued economic vulnerability and instability.* While Midtown posted an availability rate of 12.9 percent at the end of Q1 2004, marking the third straight quarter of positive absorption, *Downtown absorption continues to fluctuate between erratic patterns of positive and negative absorption*.[54] Availability hit 15 percent, or 130 basis points below the peak level of 16.3 percent, but fluctuated to 14.6 percent in March[55]. However, average asking rents slipped further, registering $4.76 less than a year ago and *there was also* ***negative net absorption in Downtown*** *Manhattan of 150,000 square feet.*[56] An important note pointed out by press in past four years as well as real estate professionals in recent media is *the increasing velocity with which conversion activities are occurring.* In fact, in a May 2004 issue of Real Estate New York Magazine/Globe Street, the significant impact of pipeline office-to-residential activity on Downtown markets was highlighted: "***Conversion of office space to residential*** will eventually **remove 31 Downtown office buildings – or 9.8 million square feet –** from the market."[57]

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[51] Ibid.
[52] Ibid, 30.
[53] Kelly Kutchinsky. "New York Metroline." Real Estate New York. May 2004: 8.
[54] Thompson, 30.
[55] Kutchinsky: 8
[56] Ibid.
[57] Ibid (emphasis added).

The chapter closes by providing graphic proof of a market-based "tale of two stories"[58] – the ailing office markets presented in the first two figures starkly contrast with the striking upward trending performance of residential markets depicted in the last two figures. The general office market trends point to Downtown's sharp rise in vacancy rates along with dropping office rent levels. In contrast, for sale residential markets can be used a point of comparison to show record price increases, unprecedented sales velocity, and overall strength in the residential markets.

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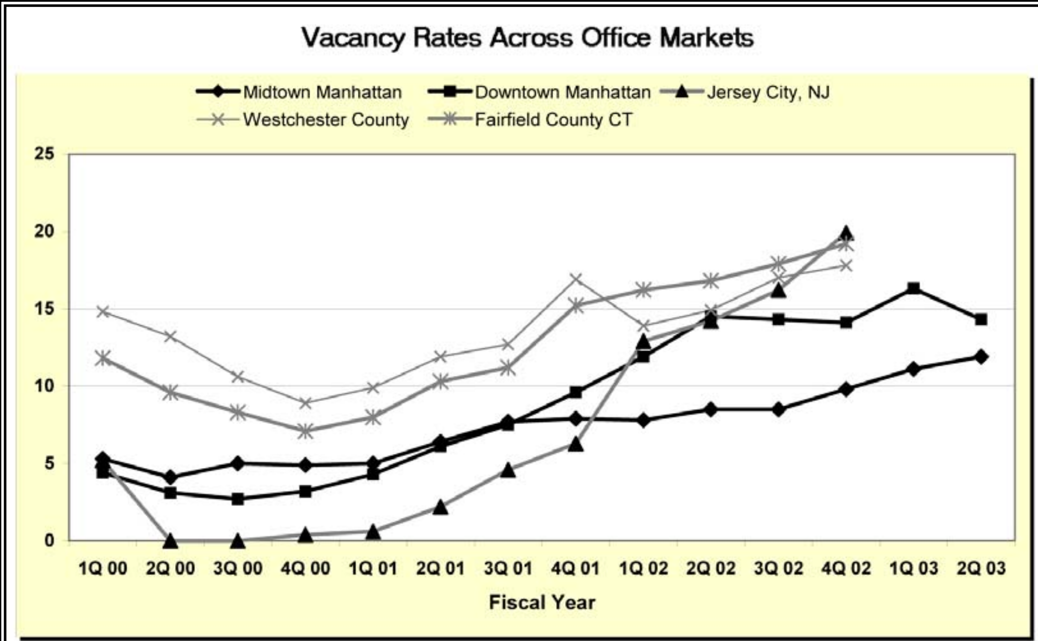
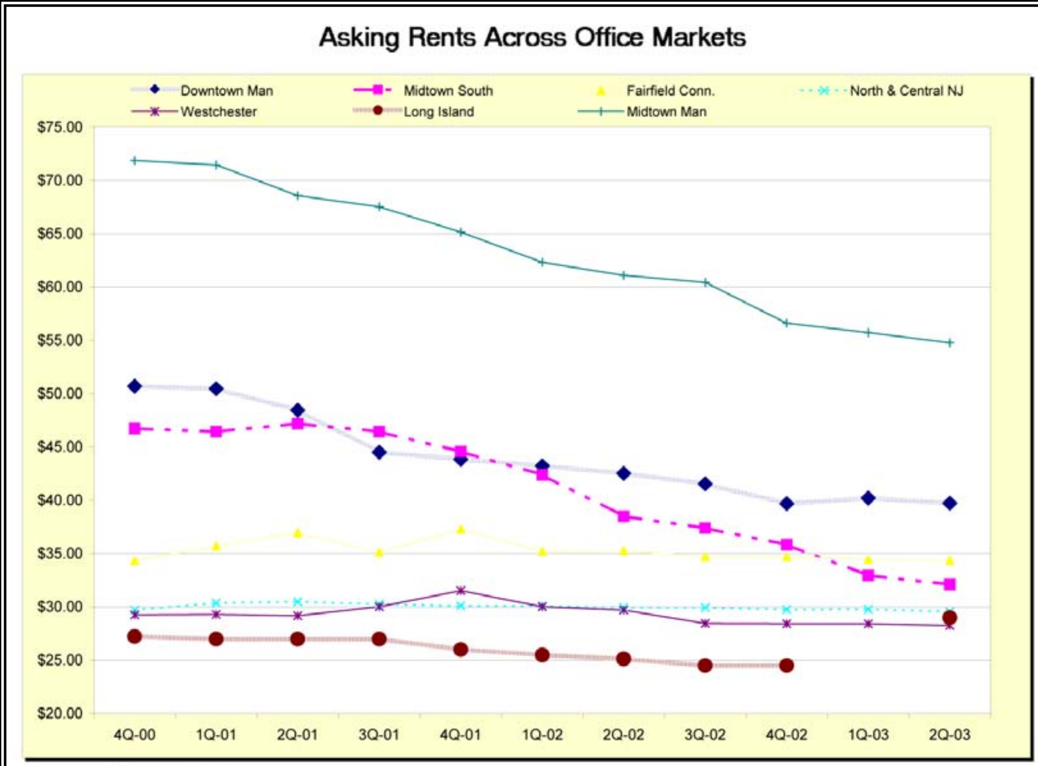
[58] Used by respondent in an information interview to describe the contrast between office and residential performance in Downtown Manhattan's asset markets: July 15, 2004.

Office data indicates problematic Downtown fundamentals and structural changes:

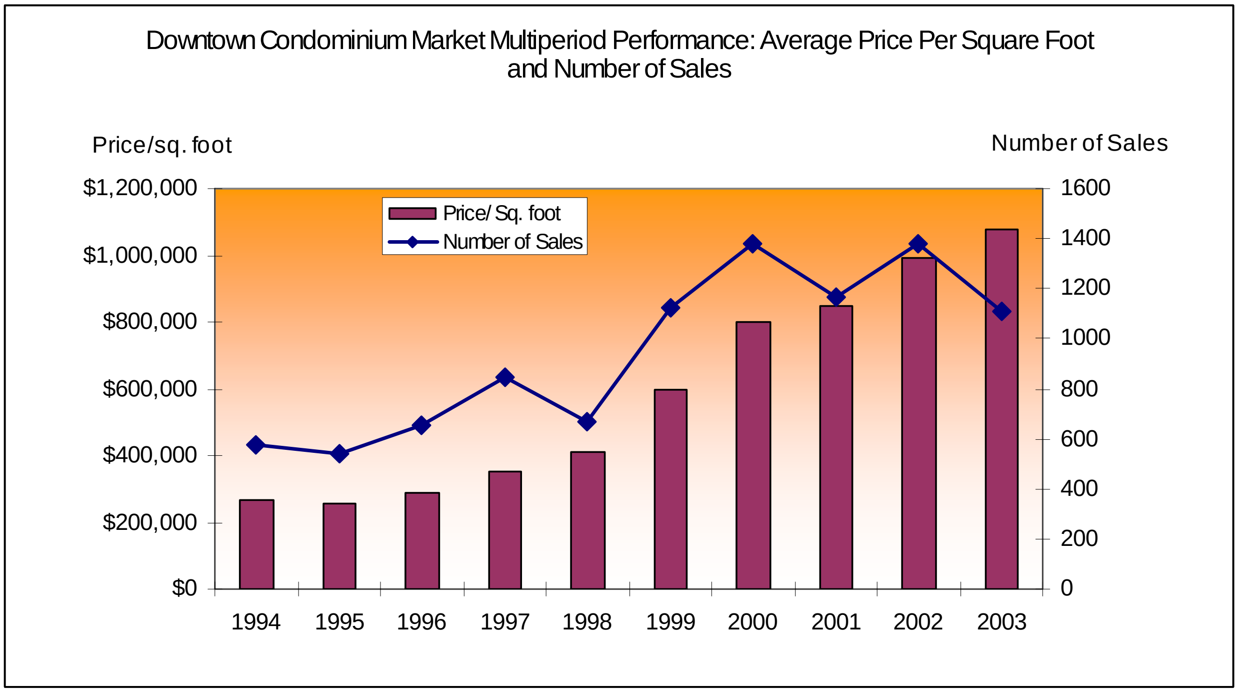


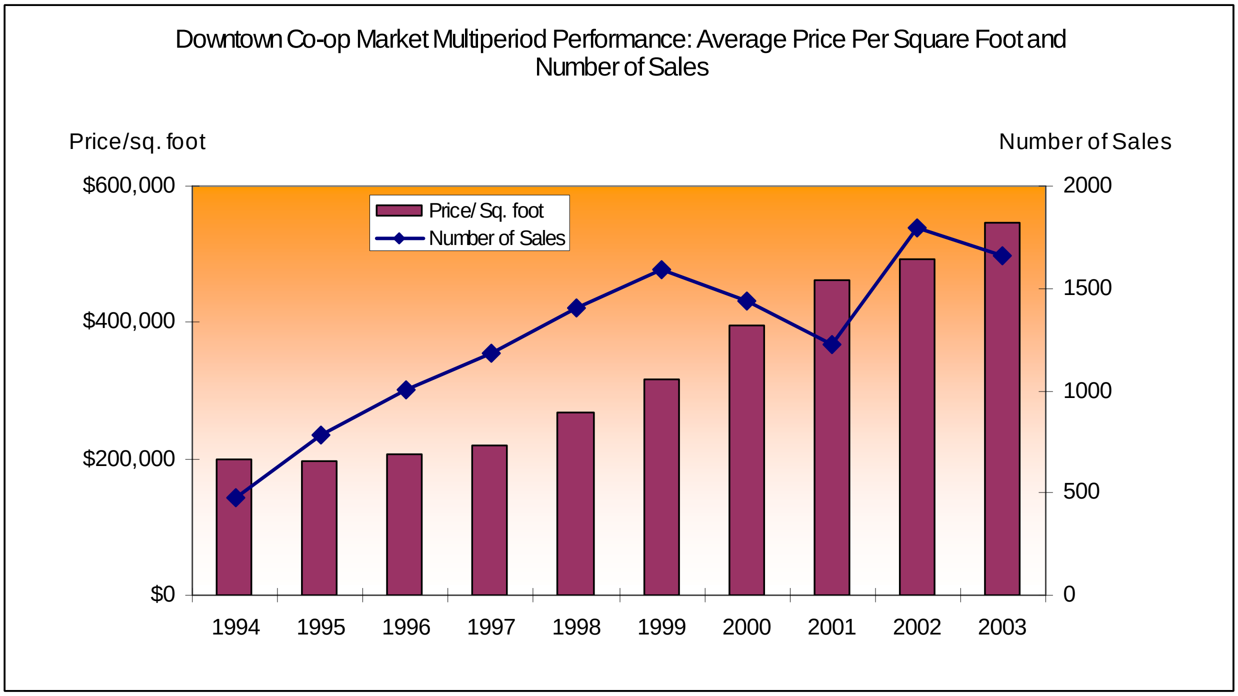
SOURCES: 1. Colliers (1Q 00 to 4Q02). 2. Cushman and Wakefield (1Q03 and 2Q03).



SOURCE: Grubb and Ellis.

In contrast, residential markets vis-à-vis for sale activity, demonstrate increasing resilience and strength:





Chapter 3: The Downtown Residential Market: Analysis of For-Sale Product Trends in Pre and Post-9/11 Market Conditions

Any examination of Downtown office-to-residential feasibility would be incomplete without understanding why conversion into residential product dominates over redevelopment scenarios such as non-residential products ranging from hotel to biotech/lab space. The conditions for strong residential markets must therefore exist; and this chapter delves into such residential market analysis and rounds out the market-based explanation for why feasibility of office-to-residential conversions makes sense given the context of strong residential markets. This chapter takes the previous office-based context and adds undeniably strong market forces and economic reasons for pushing conversion of underperforming office space into well-positioned residential products. These market-based observations further Chapter 2's argument, making concrete the argument that both Downtown office and residential market fundamentals make conversions an economic inevitability.

The chapter is divided into analysis of for-sale residential and rental markets, but devotes most of the evaluation to the for-sale residential market because the market for this product type is less certain than for rental product.[59] The chapter begins in Section 3.1 by briefly comparing pre and post-9/11 dynamics in the for-sale residential market, and ultimately comes to the conclusion in Section 3.2 that what matters in for-sale market behavior is the upper-end price-insensitive luxury consumer segment. Sections 3.3 and 3.4 examine how recent trends in favorable demand and supply conditions facilitate the record price levels, pricing behavior that is led by this price-inelastic target group. Section 3.5 gives preliminary coverage of the rental market by providing market-based observations on unprecedented pipeline developments along with indicators that post-9/11 spikes in rental production may be triggered by forces outside of pure market-based dynamics. In this respect, Section 3.5 sets the analytical framework for Chapter 5's position that regulatory

[59] Housing shortage and a long-run average 3 percent vacancy rate are preliminary reasons for why rental product development is particularly less-risky redevelopment options and remain economically attractive redevelopment scenarios. Citizens Housing and Planning Council. Out of Balance: The Housing Crisis from a Regional Perspective. April, 2004.

incentives have influenced substantive new rental development in post-9/11 markets. Chapter 3 thus ends by asserting that analysis of conversion activity must also be followed up with the ability to discern the varying degrees by which interaction between market and policy forces manifests itself in such redevelopments.

3.1 Examination of Changes and Continuities in the For-Sale Residential Markets

In many respects, the economics of producing converted office-to-residential stock is based on the corresponding option to take advantage of contrasting fundamentals in the for-sale condominium/co-op/loft or multi-residential rental markets. Past market conditions, particularly following the period of recession in the late 1980's, were not conducive towards strong fundamentals in the for-sale market. In contrast, the demand for rental product for Downtown submarkets has largely remained steady due to New York City's housing crisis and the shortage of multi-residential rental inventory targeted towards housing Downtown's core rental consumers – entry-level FIRE sector employees who were not in the market for condominium and other for-sale products with higher pricing points. In fact, real estate industry practitioners confirm that New York City housing vacancy has remained fixed at 3 percent following the inception of rent stabilization.[60]

As a thematic element post-September 11, where there was a significant downward trend for Class B/C office positioning, there was also simultaneous strong, aggressive activity centered on residential product, specifically on Downtown's increasingly stronger for-sale condominium/co-op/loft market.

In general, much of the pricing movement in the residential for-sale markets is set by upper-end pricing behavior – pricing structuring driven by product for high-income target segments. *Although Downtown Manhattan's residential for-sale market in past pre-9/11 market conditions traditionally positioned itself competitively based on price, with lower price points tagged on comparable for-sale product amenities found in more demand-heavy markets found in Midtown Manhattan,* ***in post-9/11 conditions the for-sale market repositioned itself. Much of this competitive positioning around price gradually started to change as increased sales***

[60] Real estate professionals, Informational interview. July 14, 2004.

activity in the past two years and favorable macrolevel economic conditions produced strong results for performance of Downtown Manhattan's for-sale markets.

What is generally acknowledged by real estate professionals is that, in recent years, the for-sale market has remained one of the most stable sectors in New York's real estate industry, as well as in the economy itself and has continued to benefit from a lower mortgage rate environment, with mortgage rates falling to record 40-year lows.[61] In fact, mortgage origination for Downtown Manhattan residential product set all-time records as sales volume showed strong signs of upward trending. Thus, even after the recession in 2001, vigorous housing price increases continued its five-year trend of unceasing aggressive for-sale activity in both Downtown Manhattan and the city as a whole with unprecedented surges in sales volume.[62]

3.2 Upward Price Behavior Starting the Mid-1990's and the Price-Inelastic For-Sale Consumer

It is important to bring attention to the performance of for-sale residential product targeted for the high-end, luxury consumer segment. Because of pricing and affordability, demand behavior from the upper-end target consumer has spurred much of the for-sale product in the market along with pipeline residential production resulting from conversion activities.[63] As indicated by market data for both Lower Manhattan as well as Manhattan's overall for-sale market, the average price per square foot along with the number of sales figure has moved upwards, beginning in the mid-1990's.[64]

Although on the surface recent market conditions spurred by a favorable interest rate environment may appear to explain this strong performance, in reality a deeper more fundamental reason for such strong for-sale market dynamics has been attributed to the demand driven by a relatively price-inelastic high-end consumer. The core segment for Downtown condominium/loft/co-op product, with demand behavior revolving around largely upper-end luxury products, is essentially price-insensitive. Hence, even with sharp increases in median

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[61] Douglas Elliman. Manhattan Market Report 1994-2003: 10-Year Sales Trend Analysis. New York: Miller Samuel Inc. and Douglas Elliman, 2004: p. 4.
[62] Douglas Elliman. Manhattan Market Report 1993-2002: 10-Year Sales Trend Analysis. New York: Miller Samuel Inc. and Douglas Elliman, 2003: p. 4.
[63] Real Estate professional. Informational interview. July 14, 2004.
[64] Douglas Elliman (2004).

sales prices for Downtown for-sale product, sales velocity, rather than pricing itself, is affected during economic down-cycles.[65] In addition, because of favorable demand and supply conditions, Downtown Manhattan's inventory of converted office-to-residential product is becoming an important market factor in driving sales activity. *Hence, what is apparent from observing market data for the past decade is that* ***velocity or number of sales adjusts during periods of economic uncertainty*** *while much of the* ***pricing for this target high-end segment remains largely unchanged despite economic contraction and increases during growth periods.***

3.3 Favorable Demand and Supply Conditions

Another key factor contributing to rising prices and favorable conditions in the for-sale market has been the lack of residential inventory. According to real estate professionals, market rate and luxury for-sale housing production reached a peak in 1985 with the commencement of twenty-five major for-sale projects in Manhattan submarkets.[66] This spike in new development was spurred by changing policies which enabled developers to take advantage of tax abatement programs. Yet, overall the housing production in the eighties was quite low when compared with any of the previous four decades, with an average new inventory of 3,500 units in Manhattan per year. Overall, new inventory levels peaked during the mid-1980's and then tailed off, falling dramatically beginning with the early 1990's.

In looking at more recent supply conditions post-9/11, since the end of the first quarter of 2003, the number of available for-sale inventory declined nearly every month up until the end of 2003. The 4,843 condominiums/co-ops available for sale represented a 19% decline in inventory from the 5,977 units seen at the end of 2002.[67] This supply shortage placed upward pressure on price levels as demand levels were stimulated by an improving economy and low mortgage rates. The contraction of inventory continues well into 2004, and there appears to be no short-term changes in the mismatch between demand and supply conditions, as there are land constraints in both Downtown's residential submarkets as well as in Manhattan. These conditions not only cap

[65] Real estate professional. Informational Interview. July 14, 2004.
[66] Real estate professional. Informational interview. July 19, 2004.
[67] Douglas Elliman (2004).

the number of ground-up condominium/co-op developments, **but also sets the stage for providing favorable market-related factors driving conversion activity and production of for-sale redeveloped residential product.**

3.4 Recent Price Data: Record Levels in Downtown For-Sale Residential Markets

As demonstrated by recent price behavior and 2003 market data, the importance of these strong demand characteristics coupled with limited supply conditions cannot be understated in producing favorable upward price pressures and fostering opportunities in office-to-residential redevelopment. For example, the average price per square foot of for-sale product (condominium/co-op/loft) showed double-digit gains in four out of five size categorizes in conducted by real estate consultants in 2003.[68]

This pattern illustrates the continued strength of what is referred to as smaller-sized "entry-level" categories in the for-sale markets (i.e. studio, 1-bedroom) as well as renewed interested in the upper-size categories. The average price per square foot of for-sale studios, 1-bedrooms, and 2-bedrooms increased by 14.3 percent, 16.8 percent, and 11.9 percent respectively over the prior year to $555, $610, and $734 per square foot.[69] These size categorizes also reached level highs based on average sales price and median sales price. The overall average sales price per square foot in 2003 was $686 – more than double the average price per square foot of $314 seen in 1997, which marked the onset of the recent industry recovery.[70]

The following market overview of two main Downtown for-sale product types provides insight into the record-setting performance of the Downtown residential market.

Downtown Manhattan Condominium Market Matrix					
Market Indicators	Current Year	Prior Year	% Change from Prior Year	Prior Decade	% Change from Prior Decade
Average Sales Price	$1,076,767	$991,985	8.5%	$265,107	306.2%
Average Price (psf)	$722	$635	13.7%	$264	173.5%
Median Sales Price	$807,000	$785,000	2.8%	$221,000	265.2%
Number of Sales	1106	1380	-19.9%	575	92.3%

[68] Ibid, 4.
[69] Ibid.
[70] Ibid.

Downtown Manhattan Co-op Market Matrix					
Market Indicators	Current Year	Prior Year	% Change from Prior Year	Prior Decade	% Change from Prior Decade
Average Sales Price	$545,854	$491,958	11.0%	$198,876	174.5%
Average Price (psf)	$603	$531	13.6%	$188	220.7%
Median Sales Price	$422,000	$363,000	16.3%	$140,000	201.4%
Number of Sales	1663	1794	-7.3%	479	247.2%

As indicated in the above cross tabulations of condominium and co-op performance, there is a clear indication that various price indicators, including average sales price per unit, and price per square foot, are reaching new thresholds. Record prices and contracting inventory began limiting the number of sales in Downtown residential submarkets, evidenced by record downward percentage changes in both condominium and co-op products. Some highlights of recent market data in Q1 and Q2 2004 reinforce the aforementioned positive market statistics:

- Average for-sale prices among the major categories of for-sale product (condominium, co-op, loft, and luxury apartment) jumped to record figures exceeded the $1,000,000 average sales price per unit threshold.
- Listing inventory of for-sale product, which exhibited continued contraction in Q1 2004, bottomed out in Q2 2004. At the onset of the second quarter, inventory levels were at their lowest in more than two years.
- Condominium Market: During Q2 2004, similar to performance in Q1 2004, average sales prices and price per square foot indicators for all size categorizes of condominium product, with the exception of the 4-bedroom category, set record highs.
- Co-op Market: Records were set in all price indicators for co-op product, as the average sales price of a co-op exceeded $900,000 for the first time.
- Loft Market: A rising market with smaller average loft size indicated increased sales activity with a spike in average price per square foot.
- Luxury For-Sale Apartment Market: Two important indicators reached new level highs, with the average sales price of a luxury unit increasing by 2.8 percent to a threshold $3,787,873 from $3,649,014 in the prior quarter. Average price per square foot exceeded $1,300 for the first time, a 7.2 percent increase above the prior quarter.[71]

[71] Douglas Elliman. Manhattan Market Overview: 2Q 2004. New York: Miller Samuel Inc. and Douglas Elliman, 2004.

3.5 Strong For-Sale Supply Movement and the Comparable Boom in Rental Conversions

By 2005, 12,000 for-sale units are expected to be added to the current market-reported total of 30,000 in Downtown Manhattan.[72] There will be more luxury-related, built-in amenities including indoor swimming pools and basketball courts, as compared to other competing markets in Manhattan. A Downtown developer recently proclaimed: "I see Wall Street, the Financial District, and Downtown in general as the next major residential corridor in Manhattan."[73] Many new condominium conversions are catering to families, who are drawn not only by prices 15 to 20 percent less than Tribeca but also because of tax abatements on converted property.[74] As Shaun Osher, executive vice president at Douglas Elliman explains: "There are a number of projects in the early stages. And in the next five years, you're going to see a lot more coming to market. There's going to be a nice cross mix of small loft buildings, with little or no services, and the high-end projects."[75]

Both large-scale and smaller "boutique" office-to-for-sale conversions are saturating the residential market. An example of a large-scale office-to-for-sale conversion projects is Boymelgreen's redevelopment of the former site for J.P. Morgan's operations.[76] The commercial space will be redeveloped into 250 luxury condominiums that will include basketball courts, a swimming pool, and a bowling alley. Boutique for-sale conversions are also affecting market activity. According to a local Downtown developer:

> As far as small-scale conversions, 25 Ann Street is a good example where they redeveloped a mall building with only 2,500 square feet per floor. And if you look back four years ago, there were one of only a handful of boutique condo conversions like 25 Ann Street. Now there are so many of office-to-condo redevelopments of this scale. Those little boutique buildings are becoming great choices for people to benefit from compared to some of the larger ones that will be coming in because of the character and historical uniqueness of some of the physical product. [77]

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[72] The Real Deal: Condo's Converting Lower Manhattan to 24/7. <http://www.therealdeal.net/issues/April_2004/1081961130.php> (last accessed July 22, 2004).
[73] Real estate professional. Informational interview. July 19, 2004.
[74] Planning official. Informational Interview. July 15, 2004.
[75] The Real Deal.
[76] The Real Deal.
[77] Real estate professional. Informational Interview. July 19, 2004.

Yet, what is also noted by local real estate professionals and industry practitioners involved in office-to-residential redevelopment is that, outside of the strong supply side characterizing the for-sale residential conversion market, there is a simultaneous boom in rental conversions.[78] Although demand for housing in general has always been particularly strong in Manhattan due to a housing shortage, deeper questions naturally arise as to what may influence the economics and tip conversion activity in the direction of an office-to-rental project as opposed to a for-sale development. *To understand what fundamentally lies at the source of triggering such noticeable office-to-rental redevelopment even while the economics of condominium/co-op/loft development remain particularly strong, one must pursue a comprehensive analysis of the larger policy-based context affecting Downtown Manhattan and the recent fiscal programs that may make such rental conversions feasible*.

The following chapter shows why, real estate practitioners and academics have both agreed that much of this unprecedented supply in converted office-to-rental product is attributable to the recent post-9/11 emergence of an "800-pound gorilla in federal financing – The Liberty Bond Program." Chapter 4 examines the larger socioeconomic conditions affecting Downtown's real estate markets, the issues facing Downtown's built environment, and the combined interaction between policymaking and market forces that actuate a central economic development role for office-to-residential conversions.

[78] Colliers ABR. Residential Boom in Transforming Downtown. New York: Colliers ABR New York, 2002.

Chapter 4: Institutional Overview: Policy Tools Impacting the Conversion Market and Policymaking Goals for Downtown Economic Development

The Downtown office and residential markets show why developers are acting rationally in seeking conversion as a way to maximize individual asset value. However, these rational decisions do not take into account the positive externalities and larger economic benefits that can result from Downtown redevelopment. This chapter completes our analysis of the economic development impact of Downtown conversion activity by examining: 1) how policymakers have allowed markets to adjust to economic changes; 2) what measures they have put in place to jumpstart the market; and, 3) what they must do to adapt to new market conditions as Downtown conversion activity evolves.

The chapter begins with a literary review, providing an introduction into the planning-related context under which policymakers were motivated to first monitor Downtown conversion activity (Chapter 4.1). Chapter 4.1 then articulates the position that policymakers have positively influenced market activity in two major periods of Downtown redevelopment by allowing markets to adjust to different economic conditions.

To support this position, analysis is devoted to understanding how policymakers have removed negative policy measures impeding Downtown redevelopment and put in place positive measures for fostering conversion activity, in the following arrangement: [79]

- Chapter 4.2-4.4: The Giuliani Administration's 1994 Plan and its use of different policy tools to clear away regulatory barriers for the conversion market and set up incentives for driving Downtown redevelopment.
- Chapter 4.5-4.10: The Post-9/11 Incentives and the Liberty Bond financing designed to immediately address market shock and utilize short-term incentives to ultimately achieve long-term market viability.

[79] Negative and positive policymaking is used by Lawrence Friedman to explain housing policy and the impact of policymakers on public programs for housing. Negative policy operates under efforts to control and restrict housing, and specific examples cited by Friedman are housing code and tenement house laws. Positive policy allows policymakers to stimulate and incentivize private sector activity. Lawrence Friedman. Government and Slum Housing: A Century of Frustration. Chicago: Rand McNally, 1968.

- Chapter 4.11-4.12: Evidence from residential redevelopment activity indicating that the Downtown residential markets have been jumpstarted, requiring policymakers to reassess Liberty Bond financing under these emerging market conditions.
- Chapter 4.13: Despite substantive residential redevelopment and residential market outcomes, the continuing problem of Downtown disinvestment remains as long as policymakers do not readjust redevelopment incentives and carry through with Downtown planning efforts based on infrastructure, transportation, and overall livability issues.

The chapter ultimately arrives at the position that post-9/11 incentives such as the Liberty Bond Program must be informed by constantly evolving Downtown markets, rather than working under static market-based assumptions. Hence, this chapter supports the conclusion that Liberty Bond financing is no longer necessary given today's market conditions and that policymakers must reevaluate conversion policies to reflect changing real estate markets in Downtown Manhattan.

4.1 Preliminary Institutional Monitoring and Response to Downtown Redevelopment Activity: Building on Euclidean Principles

New York City has been noted by real estate industry practitioners and academics alike as a model for urban planning.[80] In exploring New York's institutional identification of redevelopment and office-to-residential conversion activities, it becomes apparent why and when policymakers began forming ways to deal with what was seen as important policy-related issues. Much of the initial base of inclusionary zoning in New York City emerged from the city's first Zoning Resolution in 1916, which regulated the separation of uses along with building heights and bulk. Incentive zoning, in contrast, was set much later beginning in the 1960's with density bonuses established to promote positive externalities and social goods through development activity.[81]

What explains much of the early history of a strong institutional response and an ensuing regulatory role in adaptive reuse of obsolete commercial stock is drawn from the reaction of city planners and policymakers in the 1960's and 1970's to the extensive pattern of residential re-use

[80] Real estate academic. Informational interview. July 15, 2004.
[81] Ibid.

of obsolete, industrial space in residential submarkets of Downtown Manhattan, including the Soho and Tribeca areas. Such adaptive reuse of industrial buildings and the subsequent conversion into large open residential space became so common in these submarkets that much of this area became known as the "loft district."[82] In observing the basis for what was planning-related interest in the phenomenon of conversions, one can point to early institutional attention and city planning efforts to understand and deal with issues stemming from such adaptive reuse.

The 1977 Department of City Planning memorandum and the accompanying study titled, "Residential Re-Use of Non-Residential Buildings in Manhattan" offer insights into some of the early motivation and policymaking impulse behind what was being observed as "recycling [of] older buildings to new uses" which was observed as becoming market-based realities:

> In recent years, for a variety of reasons – high construction and labor costs, tight money and changes in traditional land use patterns – more and more developers and municipalities have begun to consider and encourage the re-use of inner city buildings as an economic development activity. In New York City and in Manhattan in particular, non-residential buildings are being converted to residential uses at an increasingly rapid rate.[83]

And the significance of such redevelopment for the marketplace, in placing outdated commercial space and providing much needed residential product is explained along with the beginnings of formulating specific regulatory and zoning changes:

> As industrial activity in the City has declined and use patterns have shifted, underutilized space has provided an opportunity for residential conversion. Over time, with changes of city policy in zoning and tax programs, building conversion has become a major form of housing development. The current high demand for housing in converted buildings has *reinforced the need for careful consideration of the impact of these conversions*…. Over the past six years, the City Planning Commission has undertaken several important zoning changes. The first, in the SoHo industrial area in 1971, was made in response to the needs of artists for large, inexpensive space, then available in underutilized buildings. Subsequently, other zoning changes were made in SoHo in 1976 and in Lower Manhattan (Tribeca) in 1976. These industrial zones

[82] Real estate professional. Informational Interview. July 14, 2004.
[83] City of New York Department of City Planning. December 1977 Memorandum: Residential Re-Use of Non-Residential Buildings in Manhattan. New York: Department of City Planning, 1977.

> exhibited similar patterns of industrial use and residential opportunity. [84]

More importantly, the institutional motivation and basis for such policy-based scrutiny of residential reuse of obsolete commercial space is revealed in the following:

> At present, conversion activities are largely unregulated, taking place outside the City's established policy and enforcement framework. Of the nearly 1,000 buildings have three or more occupied housing units identified by the Study, only 87, less than 10%, have valid Certificates of Occupancy for residential use…*Residential re-use of non-residential buildings has created important policy concerns* [including]:
> 1) The impact of a strong residential demand on space occupied at present by business uses, and the continued business use of such space.
> 2) The adequacy, with respect to health and safety, of housing being created by an ad hoc, unregulated conversion process, and its potential hazard and liability to the public, individuals, and property.
> 3) Adequate protection for tenants, cooperators and property owners in an unregulated new form of housing development.[85]

Hence, much of what is observed with respect to the initial basis for regulation of adaptive reuse of converted commercial space stems from basic policy concerns over the health, safety, and protection of the users of redeveloped product – the residential tenants. In this respect, much of the early policymaking impulse is informed by planning principles vis-à-vis regulatory elements that motivate Euclidean principles of protection. Also important to point out from this 1977 planning study is *the clear indication that city planners and policymakers recognized market-based realities*.

Much of the proposed zoning changes was working with such market-based knowledge and was consequently informed by the policy-based recognition that conversion activities was not only an important market phenomenon, but also a significant factor in promoting Downtown economic development:

> Residential re-use of industrial and commercial buildings is taking place at a significant level. This activity is a result of some major changes in the city's economic base. Reduced demand for

[84] Ibid (emphasis added).
[85] Ibid, 2 (emphasis added).

> industrial and secondary office space in Downtown Manhattan has created high vacancy rates in older business properties…At the same time; there is an increasing market demand for this space for residential use. **The residential re-use usually requires substantial investment** and **thus is an important new form of economic development.**[86]

4.2 Removal of Negative Controls and Creation of Positive Market Incentives: The 1994 Plan

The 1994 Revitalization Plan for Lower Manhattan allows us to *distinguish between two different policy tools affecting conversion activity*: ***negative and positive policy measures***.[87] It is important to separate these policy tools and examine what removal of negative regulations can accomplish differently from establishing positive policy measures incentivizing redevelopment. Literature review of city planning commission reports show that policymakers sought to remove negative regulatory barriers to Downtown conversion activity and foster office-to-residential redevelopment through a series of positive policy measures such as tax incentives.[88] The reports also provide evidence that policymakers were grappling with the fundamental interdependence between critical residential mass and Downtown services/retail support.[89] The 1994 Plan also represents one of the first policy efforts to connect market-based conversion activities with policy-related goals of economic development, and to *a larger picture of socioeconomic desirability*. In this respect, the Plan reveals one of the first times that conversions were recognized by policymakers as a way to introduce the critical residential mass needed for "revitalizing and attracting" other services needed for a functional, livable Downtown Manhattan.[90] At the same time, the 1994 Plan shows that **policymakers recognized infrastructure, access, and urban design issues as obstacles for the conversion market as well as for long-term Downtown economic development,** and were grappling with Downtown residential and commercial development in the context of such key urban planning issues.

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[86] Ibid (emphasis added).
[87] Negative and positive policy is used in the context of Friedman's housing policy discussion.
[88] Negative regulation is used in the context of Friedman's concept on policy barriers that control and impede housing activity.
[89] New York City Planning Commission. Special Lower Manhattan District: City Planning Commission Report. July 20, 1998: 1-6.
[90] Ibid.

For developers and real estate academics, Mayor Rudolph Giuliani's 1994 Plan for the Revitalization of Lower Manhattan often represents one of the first institutional examples in establishing "business-responsive" measures that actively worked towards understanding market conditions by using effective market-savvy changes in zoning and building code to engage office-to-residential conversion activities as city planning tools. In fact, many real estate professionals point to the policy measures of Giuliani's 1994 Plan as providing the necessary as-of-right conditions for developing and turning around socioeconomically depressed submarkets in Downtown Manhattan.

On a basic policy level, the 1994 zoning changes simplified and consolidated regulations into one set of comprehensive control mechanisms updated to meet current market-based and legal building standards for Lower Manhattan. On a deeper level, the 1994 Plan demonstrates how policymakers can adjust to allow markets to proceed with redevelopment efforts through eliminating zoning impediments and fostering mixed use through specific incentives. Policymakers stated their position on negative policies affecting conversion along with their policy goals for positive measures in the following excerpt from a city planning commission report:

> The objectives of the zoning amendment [s] are to:
>
> - *Foster the reuse of existing underused commercial buildings;*
> - Allow a wider range of commercial uses that *better support an increasing residential population;*
> - Assure development that is more consistent with the historic fabric, including the existing scale and density of the area;
> - ***Remove*** *obsolete zoning controls that do not respond to present-day needs***.**[91]

Policymakers supported current market-based mechanisms for enhancing economic development by essentially clearing away regulatory barriers for the conversion market. In place of regulatory obstacles, policymakers set up base support systems for this market. As pointed out in a New York City Planning Commission Special Lower Manhattan District Report, the zoning changes supported the continuing efforts to revitalize Downtown Manhattan submarkets by allowing a wider range of uses, eliminating outdated controls, and providing

[91] Ibid.

simplified height and setback regulations that were “more consistent with the character of existing development.”[92]

Using both short and long-term incentives, the 1994 Plan outlined strategies for improving Lower Manhattan’s building stock, decreasing vacancy rates, and improving access to the area. An important part of the policy was the Industrial and Commercial Incentive Program (ICIP) which provided real property tax benefits to “eligible commercial buildings that are constructed, expanded, modernized, rehabilitated or otherwise physically improved.”[93] ICIP benefits essentially enacted “as-of-right” provisions to projects within Downtown Manhattan in the form of commercial as well as residential conversion tax benefits, including:

1. Long-Term Residential Conversion Tax Benefits:
   - A 12 year tax exemption for conversion activity; with 100 percent tax exemption of the increased value due to conversion for the first 8 years; phased out to 20 percent in years 9 through 12.
   - A 14 year tax abatement of the existing tax base at 100 percent for 10 years and phased out at 20 percent in years 11 through 14.
2. Short and Long-Term Commercial Tax Benefits:
   - 5-year real estate tax abatement program at 50 percent of the property tax in the first 3 years (limited to $2.50 psf); phased out to 33.3 percent in year 4 and 16.6 percent in year 5.
   - 5-year commercial rent tax (CRT) exemption to abate 100% of the CRT for the first 3 years; phased out to 66.6 percent in year 4 and 33.3 percent in year 5.
   - Under the Industrial and Commercial Incentive Program (ICIP), a 12-year tax exemption for the new construction of “smart buildings” equal to 100 percent of the increased assessed value added in the first 5 years, 12.5 percent in years 6 through 12.
   - Under the Energy Cost Savings Program, a 12-year energy cost subsidy with phasing out of the subsidy after 8 years.[94]

[92] Ibid.
[93] Ibid, 6-7.
[94] Ibid.

4.3 Downtown Disinvestment and Urban Planning Issues: Context for 1994 Plan's Conversion Policy

The understand how policymakers came to a point of actively revising building codes and zoning in order to facilitate the office-to-residential conversion market, one needs to trace historical urban design and socioeconomic planning issues that contribute to: 1) the lack of critical residential mass; 2) the corresponding lack of private-sector established services; and, 3) Downtown Manhattan's consequent position as an underutilized economic resource.

Evaluating some of the key urban planning issues facing Downtown Manhattan, Jane Jacobs in her 1961 publication of The Death and Life of Great American Cities, argued that an important part of developing the urban environment entailed fostering a mix of economic uses, rather than economic over-specialization.[95] This discussion has led many city planners and policymakers to reconsider the economic value of mixed-use developments within the context of central business districts such as Downtown Manhattan. In many ways, the discussion of Lower Manhattan's socioeconomic issues has not changed. Although the area experienced a great deal of new physical development during the 1970's and '80's, Downtown Manhattan's key economic development issues persist around the following: infrastructure, residential services, and accessibility.

In citing these economic development problems, policymakers also focused on the interdependence between critical residential mass in Downtown Manhattan and private sector investment in Downtown services.[96] A 1998 planning report describes the cyclical condition of disinvestment as follows: *critical residential mass in Downtown is not present to attract private sector investment in services, while services are not in place to attract residents*.[97] These are all areas that point to both outdated and problematic urban planning. To a large extent, *the cyclical condition is a result of the economic development issues limiting Downtown Manhattan* as a specialized and underutilized central business district.

In identifying key urban design issues that contribute to cyclical disinvestment in Downtown Manhattan, city planners, academics, and real estate professionals continue to point

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[95] Biography. <http://www.people.virginia.edu/~plan303/bio.html> (last accessed July 19, 2004).
[96] City Planning Commission: 1-7.
[97] Ibid.

to three fundamental weaknesses: 1) the awkward street network; 2) transportation and inaccessibility; 3) housing issues and lack of services.[98]

Problematic Transportation Corridors and Street Network

Lower Manhattan has traditionally suffered from a fragmented and disconnected street network that contains significant barriers and discontinuities. Important transportation corridors and streets are extremely narrow and creating *congested pedestrian environments*. This also *makes it difficult for retail, services, and other businesses,* resulting in restricted interaction among the various parts of Downtown. In turn, property values are undermined and redevelopment opportunities are limited. Various street grids are non-complimentary and clashing in their layout to the extent that nearly all connections running east-to-west in Lower Manhattan are blocked.

Housing and Lack of Supportive Services

As far as residential development, a study conducted by the Battery Park City Authority and the Port Authority of New York and New Jersey stresses that there are too few housing units in Lower Manhattan within walking distance of the business core for activation of the street. And without a substantive residential base, *it will be particularly difficult to foster the retail presence and services needed to generate a 24/7 livable environment*.[99] Furthermore, many parks and green spaces outside of Battery Park City do not function as public amenities, but as inhospitable incoherent identities that do not benefit the properties surrounding them.

Infrastructure and Inaccessibility

Finally, Lower Manhattan continues to suffer from inadequate commuter access. The absence of direct commuter connections particularly from the suburbs of Long Island, Westchester County, and Connecticut make it less attractive as a location for business and office development. Furthermore, east-to-west connections along Downtown are difficult for vehicles

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[98] Battery Park City Authority, et al. Lower Manhattan Urban Design Plan. New York: Battery Park Authority, 1995.
[99] Ibid.

and pedestrians, or are almost non-existent. As a consequence there is little interaction between developments along Water Street and that found near the World Financial Center area.

4.4 The 1994 Zoning/Building Code Amendments: Easing of Downtown Regulations Impeding Valuable Transitioning of Uses

It was in the context of these urban design issues and the larger socioeconomic climate of the early 1990's when Downtown Manhattan experienced growing job losses, decreasing assessed valuations, and increasing office vacancy rates, that the Giuliani administration convened a task force to develop the 1994 Plan for Revitalization of Lower Manhattan.

The 1994 Plan identified a number of key socioeconomic and real estate development issues:

1) The "structural socioeconomic problems of Lower Manhattan": its reliance on a few industry sectors, aging building stock, and lack of direct commuter rail access that exemplify permanent problems that will only worsen as the economy for the rest of the city improves;
2) The decline by over 29 percent of the assessed value of buildings in Downtown Manhattan between 1991 and 1994;
3) The decline in city tax revenues of $115 million from 1991 to 1994;
4) The high vacancy rate of over 20 million square feet of the building stock;
5) The loss of 10,000 jobs per year to the surrounding suburban areas.[100]

If anything, the most concrete legacy of the 1994 Plan was not so much urban design propositions, ***but the zoning changes aimed at facilitating conversion of obsolete buildings to residential use.*** Much of the outdated building codes were formulated around pre-war office product without proper ventilation systems and designed for maximizing access to light and air through creation of corners and alcoves – inefficient design standards for current commercial needs. Prior to the 1994 plan, excessive size and parking requirements as well as restrictive live-

[100] City Planning Commission, 1-6.

work requirements and home occupancy regulations prevented many office-to-residential conversions.[101]

Yet, with the 1994 zoning changes, size requirements for apartments were reduced from an average size of 1,800 square feet specified in buildings exceeding 10 FAR to a size of 900 square feet regardless of the building's bulk.[102] The plan also allowed for greater wall to window distances, a physical characteristic of converted office stock. The zoning amendments not only reduced the minimum average size of dwelling units in converted building, but also permitted off-street parking in converted buildings and allowed the conversion of non-residential buildings for residential use for commercial stock built between 1961 and 1977 (which reflected the more flexible regulations available for conversion of buildings constructed prior to 1961).[103] Special bulk controls were adjusted to provide for more residential open space, while the controls on distance between buildings, tower setback requirements and limits on floor area were loosened for conversion developments. Appendix D and E illustrate the impact of such zoning changes on conversion market feasibility by illustrating the massive redevelopment efforts occurring in Downtown Manhattan following the 1994 Plan.

4.5 Post-9/11 Institutional Responses to Market Dynamics

The 1994 Plan cleared away negative policy measures limiting the conversion market and set up preliminary tax incentives and other positive policy programs for encouraging Downtown redevelopment.[104] While the 1994 Plan facilitated market activity through a set of negative and positive policy tools addressing long-term structural changes, the post-9/11 driven Liberty Bond Program responded to immediate, short-term market needs. With the events of September 11, policymakers responded to impending market depression, fears of residential evacuation and extensive physical asset damage by establishing short-term measures to jumpstart the market. To a large extent, the **policymakers were responding to market shock** and subsequently **adjusted their role in the marketplace to go beyond the negative policy removals of the**

[101] Planning Official. Informational interview. July 15, 2004.
[102] City Planning Commission, 5-7.
[103] Ibid.
[104] Negative and positive policies are used in the context of Friedman's housing policy discussion.

mid-1990's into establishing immediate fiscal relief -- positive measures that would hold the market together and prevent market shock. [105]

The gravity of market shock and the impending market recession weighed heavily on the agendas at the various levels of government, ranging from local planners to policymaking decisions on the federal level. As stated by a planning official in an informational interview:

> **We did not wait to see whether the real estate markets would recover or stabilize. We wanted to make it stabilize**. Battery Park City was shut down for six months. You could not walk past the barricades that blocked everything south of Houston Street. There were asbestos concerns, health and safety concerns – overall livability concerns.[106]

As indicated above, there were pressing market needs and overarching social benefits that made jumpstarting the residential markets an imperative. To understand how the office-to-residential conversion market has gradually become an integral part of Downtown Manhattan policymaking as well as an important part of short-term as well as long-term policy tools for achieving institutional priorities currently set for Downtown Manhattan, analysis is dedicated in the following section to understanding a significant piece of 9/11-driven legislation -- the H.R. 3090's Liberty Bond Program.

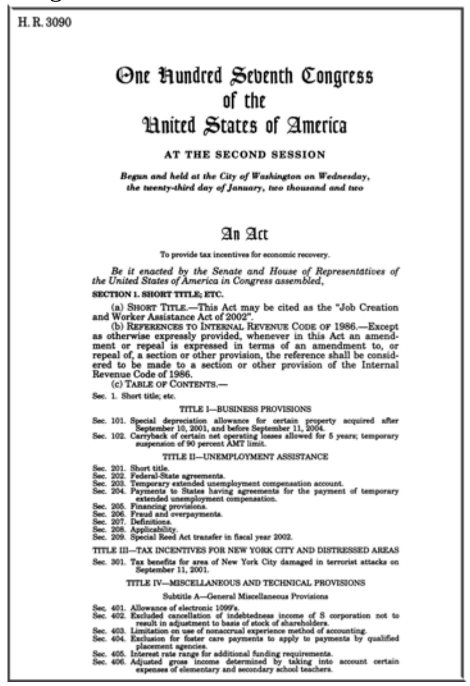
By examining the Liberty Bond Program, the rest of the chapter explains why such a temporary policy tool was *necessary to address immediate short-term market shock*, and why under current market conditions such **incentives must be readjusted or phased out to prevent overheating** the Downtown real estate markets. At the same time, the analysis of current residential market conditions connects to why it is critical for policymakers to reassess current policy measures for Downtown residential redevelopment while continuing to work on ways to improve and drive more momentum around post-9/11 planning efforts to address Downtown's infrastructure, transportation, and access issues.

Policymakers, thus, are at a critical point in Downtown conversion and economic development policy. Policy measures must be pursued to help ensure a viable Downtown real estate market by reassessing current incentives and fostering those positive policy programs that are conducive towards reasonable levels of residential redevelopment as well as following

[105] This is determined from various points raised during separate informational interviews with a planning official and a real estate academic.
[106] Policy Official. Informational interview. July 15, 2004.

through with proposals to improve Downtown's infrastructure, transportation, and access -- critical planning elements needed to develop supporting services and sustainable residential mass in Downtown Manhattan.

Image Source: H.R. 3090 Document: 2002



H. R. 3090

One Hundred Seventh Congress
of the
United States of America

AT THE SECOND SESSION

Begun and held at the City of Washington on Wednesday, the twenty-third day of January, two thousand and two

An Act

To provide tax incentives for economic recovery.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the "Job Creation and Worker Assistance Act of 2002".

(b) REFERENCES TO INTERNAL REVENUE CODE OF 1986.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

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4.6 The Liberty Bond Program and the Federal Pledge

To understand the extent to which Downtown conversion market activity has drawn the attention of policymakers, there needs to be an exploration of the differentiation in recent forms of governmental aid and trends in policy-related involvement starting with post-9/11 legislative actions.

In the wake of the attacks on the World Trade Center, President George W. Bush pledged $21.4 billion to assist New York City with clean-up, recovery, and rebuilding efforts. The package provided in the H.R. 3090 legislation included funding for the reimbursement of emergency service costs, as well as housing, business, and transportation initiatives. The aid included a range of tax incentives for the areas designated as part of the Liberty Zone in Lower Manhattan. The federal assistance package to New York City contains four distinct elements: Federal Emergency Management Agency (FEMA) assistance, Community Development Block Grants (CDBG), federal support for transportation projects, and the Liberty Economic Stimulus Package.[107]

4.7 The Liberty Zone Economic Stimulus Package and Tax Exempt Financing

The New York Liberty Zone Program, originally authorized in March 2002, consists primarily of a package of tax benefits to Downtown Manhattan area businesses. More importantly, it includes a granting of authority to the City and the State for the issuance of tax-

[107] Thompson, 1.

exempt bonds.[108] As shown in the below table, the Federal government projected that the package would provide tax benefits totaling $5 billion over an eleven-year period, beginning in 2002. Approximately 95 percent of the benefits were forecasted as being realized over the first six years (Appendix F).

The tax benefits contained in the Liberty Zone package may be grouped into four broad categories: 1) tax-exempt bond financing tax credits; 2) tax credits; 3) depreciation allowances; and, 4) tax deferrals. Altogether, tax benefits in these four categories were projected to total about $5.3 billion, offset by an increase of $285 million in tax liabilities as a result of the interaction of these tax programs with other business provisions in H.R. 3090's Job Creation and Worker Assistance Act of 2002. [109]

In a New York City Comptroller Report, the budgeted commitment represented by the Liberty Bond component of the post-9/11 economic stimulus package is explained as follows:

> The Federal government is prepared to forgo estimated revenues totaling approximately $2.2 billion over an eleven-year period by allowing the State and City to issue tax-exempt private activity bonds…and to undertake a second advance refinancing of certain municipal bonds.[110]

The New York Liberty Bond Program allows a total of $8 billion in low-cost, tax exempt private activity bonds to be issued to support construction and renovation projects in New York City, with a preference for projects in the Liberty Zone (refer to cross-tabulation in Appendix G for project allocation as of September 2003).

As the bonds must be issued by December 31, 2004, it is particularly relevant to examine the initial purpose of setting up the Liberty Bond Program and whether these short-term policy goals are relevant in today's conversion market. To pursue such analysis, there needs to be a thorough examination of the following points:

- priorities stated in the Liberty Bond program;
- the allocation process and program implementation;
- criteria set up for project selection and program terms;
- program results and the industry's response; and
- policy and community-based responses to the program.

[108] Housing Development Corporation. Notes on H.R. 3090 and "New York Liberty Zone Provisions. 2003.
[109] Thompson, 11.
[110] Comptroller: 14.

4.8 Stated Program Principles: Specific Fiscal Incentivizing of Rental Development

In information provided during a 2003 Bond Market Association and Municipal Form, there are clearly stated program goals that focus on *prioritizing support for development projects with significant permanent physical and economic impact that "fulfill the vision of Downtown as a 24/7, mixed-use, diversified community."*[111] It is apparent that increased institutional awareness of the role of the conversion market and the economic value placed in office-to-residential redevelopment is held as a priority for policymakers, as stated in the program's guiding principles:

- Repair and replace damaged and destroyed commercial space and improve lower quality commercial space;
- *Create additional multifamily residential* **rental** *and complementary retail development in Lower Manhattan*;
- Provide modern office space for displaced and decentralizing businesses and emerging firms through facilitation of investment in the central business district;
- Attract new residents and employers to Downtown Manhattan and New York City.[112]

4.9 Program Implementation of Discretionary Funding: The Institutional Stakeholders

With allocation of federal monies to lower levels of government, New York State and New York City are held jointly responsible for implementing the Liberty Bond Financing Program. The State and City, thus, have responsibility over allocation of $4 billion each. The New York Liberty Development Corporation, a local development entity formed under the direction of the Empire State Development Corporation, along with the New York City Industrial Development Agency, are the designated authorities for approving commercial and utility projects. For residential projects, the state issuer is the New York State Housing Finance Agency and the municipal issuer is the New York City Housing Development Corporation (HDC).[113]

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[111] Bond Market Association and Municipal Forum of New York. New York Liberty Bond Program: Lower Manhattan Rebuilding Seminar. March, 2003.
[112] Lower Manhattan Development Corporation.
[113] Ibid.

In terms of administrating the Liberty Bond monies, both State and City policymakers, in consultation with bond issuers and the Lower Manhattan Development Corporation, partake in the: 1) joint formulation of program goals; 2) project approval criteria; and, 3) program implementation. Once selected, projects are approved by the board of either the State or the City bond issuer, and receive formal designation from either the Governor or the Mayor.[114]

There are two key points to take away from the allocation process. First of all, what is significant about this program is that, unlike previous institutional efforts, the Liberty Bond Program represents a decisive contemporary effort on the part of the federal government, rather than a local/state entity, to effect change in Downtown Manhattan's conversion market.[115] This is indicative of the depth to which the office-to-residential conversion market is understood by policymakers as having consequences that go beyond simply locally-focused economic development. On a more important level, the tax-exempt bond financing, unlike previous positive policy measures,[116] is a **temporary discretionary fiscal tool provided to a limited number of projects and set up during a conditions of market shock**. Hence, unlike the as-of-right zoning changes that were designed to respond to long-term structural market changes, the Liberty Bond program is more of a short-term remedy created to restore market stability.

4.10 Eligibility Criteria for Residential Projects and Reasons for Rental Incentives

As tax-exempt private activity bonds, Liberty Bonds are a form of debt financing available for certain types of capital projects. These bonds are sold to investors, who provide the capital for the project. The bonds are not obligations of the State or City, but are instead obligations of the entities established by the State or City to issue the bonds, secured by pledged project revenues, typically with no recourse to the issuer. Interest on the bonds is not subject to federal, state or city taxes; thus, purchasers of these securities accept lower interest rates and these savings are passed on to the borrower in the form of a below-market interest rate loan.[117] Eligible costs for such financing include: pre-development costs, land acquisition, hard/soft costs

[114] Ibid, 5.
[115] Thompson, 1.
[116] Positive policy is used in the context of Friedman's notion of housing policy and incentives supporting housing activity.
[117] Planning official. Informational interview. July 15, 2004.

of conversion/renovation or new construction, fixed tenant improvements, debt service reserve fund, and certain issuance costs.[118] The interest rate available to a borrower under the New York Liberty Bond Program depends on the individual project's credit standing and financing structure, as well as general market conditions.

An overview of eligibility criteria for residential projects provides a better understanding of the types of residential projects that are encouraged by such below-market rate debt financing. More importantly, the eligibility structure demonstrates the fiscal focus on subsidization of office-to-residential conversions:

1) Multifamily residential rental projects located in the Liberty Zone containing a minimum of twenty residential units;
2) Projects may consist of conversion of an existing commercial facility for residential use, renovation, or new construction of a residential facility;
3) Rehabilitation expenditures of at least 50 percent of the amount of New York Liberty Bonds utilized for acquisition;
4) And while owners of residential rental projects with tax-exempt bonds are typically required to set aside at least 20 percent of the units for low-income households pursuant to Federal Law, the legislation associated with the program waives this requirement. Consequently, HDC and HFA require an additional public benefit/affordability where HDC imposes additional fee of 2.5 basis points to be used to preserve and create affordable housing throughout New York City, while HFA requires that at least 5 percent of the units be affordable to moderate-income families.[119]

In examining these financing provisions, it is important to realize that rental conversion is incentivized over for-sale conversion because of cost and risk factors.[120] There are higher costs associated with implementing a for-sale program due to the multiple ownership interests represented in a for-sale redevelopment. At the same time, there is an increased risk in for-sale projects due to the difficulty in underwriting multiple owners and securitizing such bond financing.[121] Other elements in financing structure options that point to these underwriting and risk management provisions in the tax-exempt bond program are provided in Appendix H.

[118] Bond Market Association, 10-11.
[119] Lower Manhattan Development Corporation, 5.
[120] Policy official. Informational interview. July 15, 2004.
[121] Real estate practitioner. Informational interview. July 19, 2004.

Liberty Bond-financed 63 Wall St. conversion. http://emporis.com

4.11 Liberty Bond Allocation and the Residential Market Response

As of September 2003, as pointed out in a New York City Comptroller study on post-9/11 federal aid**, $634 million of the $1.6 billion earmarked for residential *rental projects* has been approved** and a substantial number of proposed rental projects await evaluation.[122] In contrast, of the $5.6 billion set aside **for *commercial and utility projects* both in and outside the Liberty Zone, a comparatively lower amount of funding has been allocated** in the amount of $556 million in bonds approved.[123] Furthermore, no allocation whatsoever of the $800 million designated for retail development has been approved. Comptroller Thompson's progress report on Liberty financing provides a snapshot on funding devoted to rental projects as of August 2003 (Appendix I).[124]

4.12 Market Evidence of Liberty-Induced Rental Spike: Downtown's Dominance in Rental Pipeline Developments

According to recent market analysis, the response on the supply side for rental product deliveries provides insight into the extent to which the Liberty Bond program has driven momentum in a particular direction in the market. **It is important to note that for 2005 and 2006, *almost half of all new rental units scheduled for production in Manhattan are below Canal Street in Downtown submarkets* as opposed to Midtown West or other traditionally well- performing rental markets with strong supply growth.**[125] In fact, a Halstead Manhattan rental market directly attributes this spike to Liberty Bond financing and points to the federal program as the primary factor for contributing to spikes in Downtown market activity in

[122] Thompson, 14-15.
[123] Ibid.
[124] Ibid.
[125] Halstead Feathered Nest. Manhattan Rental Report: 2003-2004. New York, 2004.

comparison to other Manhattan submarkets.[126] By categorizing pipeline rental developments by submarket area, the below table shows Downtown's focused growth in share of rental product, and the clear dominance of Downtown rental supply over other submarkets.[127]

Pipeline Rental Developments by Manhattan Regional Market - Number of Market-Rate Units in Projects of More than 50 Units -												
	2003			2004			2005			2006		
Regional Market	Market-Rate Units	Projects	% of Total Supply	Market-Rate Units	Projects	% of Total Supply	Market-Rate Units	Projects	% of Total Supply	Market-Rate Units	Projects	% of Total Supply
Below Canal Street (Downtown Manhattan)	1354	4	**27.3%**	726	2	**22.6%**	1864	6	**50.3%**	1929	12	**46.5%**
Canal to 30th West Side	442	2	8.9%	195	2	6.1%	267	1	7.2%	0	0	0.0%
Canal to 30th East Side	51	1	1.0%	278	2	8.7%	0	0	0.0%	240	1	5.8%
31st to 59th West Side	1284	6	25.9%	1272	4	39.6%	917	4	24.8%	1199	6	28.9%
31st to 59th East Side	496	1	10.0%	0	0	0.0%	421	1	11.4%	384	1	9.2%
60th to 96th West Side	565	3	11.4%	232	1	7.2%	0	0	0.0%	0	0	0.0%
60th to 96th East Side	603	3	12.1%	200	1	6.2%	234	1	6.3%	400	1	9.6%
Above 96th West Side	0	0	0.0%	0	0	0.0%	0	0	0.0%	0	0	0.0%
Above 96th East Side	168	1	3.4%	307	2	9.6%	0	0	0.0%	0	0	0.0%
Total	4963	21		3210	14		3703	13		4152	21	

In this respect, a real estate professional explains in a recent industry-based article that, "Liberty Bonds were meant to revitalize Lower Manhattan. [Yet] they are on the verge of transforming it, too."[128] As captured in recent industry press during Q2 2004, office-to-rental conversion activity is, in turn, converting the built environment in Downtown Manhattan:

> **Rental development has been booming,** fueled by the federal government's Liberty Bond Program, which does not apply to condominium development. Developers Nathan Berman and Ronny Bruckner are turning the former Brown Brothers Harriman & Company headquarters at 63 Wall Street into rental units, with leasing [beginning in May 2004]. They also bought 67 Wall Street and 20 Exchange Place and plan to convert those buildings…. Richard Born and Ira Drukier are converting 90 West Street, a 1902 Cass Gilbert office building next to Ground Zero, into a 410-unit rental building. The Ocean at 17 Battery Place is another rental conversion, and Rockrose is completing Liberty-Bond financed 2 Gold Street, with 50 floors and 650 units to be finished in 2005. Finally, 100 Maiden Lane, the 325,000 square foot

[126] Ibid, 2.
[127] Ibid, 11.
[128] David Dunlop, et al. "Liberty Bonds' Yield: A New Downtown." Housing Development Corporation Real Estate Desk Publication. New York: Housing Development Corporation, 2004.

> former headquarters of Cadwalader, Wickersham & Taft is also being turned into a 400-unit rental building.[129]

If anything, the current market and list of pipeline developments clearly supports the position that the Liberty Bond Program has reached its goal of jumpstarting the residential markets. Both demand and supply are at pre-9/11 levels with residency now at 95 percent and Downtown pipeline developments signaling market anticipation of long-term strength and stability in the residential markets.[130] Yet all this points to how the current markets call for a reassessment of conversion-related policies in Downtown Manhattan. If anything, there is a critical need for policymakers to set up the next set of policy measures designed around a **rethinking of conversion incentives** and a **readjusting to current market conditions**. Having jumpstarted the market under immediate post-9/11 conditions, policymakers must look forward and create measures that will allow for sustainable, stable real estate markets in Downtown Manhattan.

The challenge for policymakers, then, is to realize what pieces of the market have picked up, aggressively pursue planning-based changes related to infrastructure/transportation/access, and set up appropriate conversion market incentives based on these planned changes to Downtown's urban environment. Further examination of urban planning recommendations and market incentives is considered in the industry-based recommendations discussed in the final case of Chapter 5.

4.13 The Need for Policymakers to Reassess Conversion Incentives under Current and Anticipated Market Conditions: The Downtown Community and Real Estate Markets

Other than a rapidly changing built environment, there are undoubtedly serious implications from such concentrated Downtown-based residential market activity on the livable environment. According to the New York City Department of Planning, Lower Manhattan, as defined by areas below Canal Street, was the city's fastest growing region prior to 9/11.[131] In

[129] The Real Deal.
[130] Ibid.
[131] Welcome to the Downtown Express Online. <http://www.downtownexpress.com/DE_ 09/downtownsnew.html> (last accessed July 5, 2004).

2002, when the Liberty Bond was established, the residential occupancy rate in Downtown submarkets was at 65 percent.[132] While many residents were displaced in the aftermath of the attack on the World Trade Center, and there was a short-term residential exodus out of Downtown Manhattan, *occupancy has since rebounded.* In stark contrast to immediate post-9/11 conditions, the occupancy rate is now 95 percent according to a recent housing survey conducted by the Alliance for Downtown New York.[133]

Responses from community stakeholders are mixed. In many respects, community-based leaders and residential organizations credit the Liberty Bond Program with reversing the post-9/11 exodus:

> In [some respects] the Liberty Bond Program was government planning at its very best. On the downside, the fact that Liberty Bonds could be applied only to rental buildings skewed the decisions of developers [away] from home-ownership product. That is important because ownership units provide a much greater stake in the community and much less transience – not to say that we do not welcome rental buildings.[134]

Others criticize the allocation of federal monies to what is perceived as "unreasonable" subsidization of luxury housing:

> … [t]he buildings financed by Liberty Bonds unquestionably fall under the luxury rubric. [And] not everyone approves.[135]

A few community-based groups have further pointed to issues of affordability inherent in the program, despite the program's built-in linkage fee that essentially allows policymakers to cross-subsidize affordable housing development either in other affordable housing developments across New York City or directly incorporated into the project itself. However, much of the focused attention around affordability is neither new nor specific to the Liberty Bond Program, and the arguments can be traced back to previous dialogue from community-based stakeholders mindful of the changes associated with neighborhood gentrification. A senior representative from Good Jobs New York, a community group tracking economic development subsidies, and one of the most vocal critics of allocation results from the Liberty Bond program, states:

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[132] Ibid.
[133] The Real Deal.
[134] Dunlap, 1.
[135] Ibid.

> It truly has changed how people are going to live in Lower Manhattan and who is going to live there. What Liberty Bonds are doing for the residential market of Lower Manhattan is…speeding up the gentrification process.[136]

Yet in many respects, **the argument placed by Good Jobs New York is short-sided insofar as there appears to be little consideration of the larger responsibilities and socioeconomic planning that is involved in such fiscal legislation**. On one level, in a post-9/11 policy environment, policymakers were working to effect broad-based changes under the *immediacy of market shock* and potentially *longer-term conditions of market depression*. At the same time, there were other long-term considerations taken into account by policymakers in formulating the Liberty Bond Program – priorities that very much included an analysis of issues pertaining to affordability, the housing shortage, and economic development.[137]

On a more fundamental level, it is important to point out that what informed much of the decision-making process for initiatives such as the Liberty Bond Program was what many stakeholders and academics acknowledge as economic value maximization.[138] In the substantive effort to optimize economic value on several fronts, policymakers shaping the Liberty Bond Program were conscious of how to create valuable affordable housing product in ways that made sense not only for heavily-impacted markets that needed affordable stock the most, but also for markets that would be able to potentially cross-subsidize such product development in the future. Thus, forging much of the economic stimulus provisions apparent in the Liberty Bond Program was the institutional savvy to work with market-based realities, address immediate market shock and depression, and essentially achieve the most affordable housing "bang for the buck." This in turn represents a conscious policymaking effort to best sustain the economic value of Downtown's various assets in conjunction with asset creation in various submarkets outside of Downtown. As a representative from the New York's HDC appropriately points out:

> Our policy was to work towards **effectively creating economic value**, and doing so in a way that made the most sense and **had the most positive impact for that market.** So you create affordable housing where it makes sense and where it will have the most impact. That way, you can create the stock needed in places such

[136] Ibid.
[137] Planning Official. Informational Interview. July 15, 2004.
[138] Real estate academic. Informational interview. July 15, 2004.

> as the Bronx, but by using the knowledge that such valuable creation of good, quality affordable housing can be achieved by addressing sustainable housing needs in Downtown Manhattan.[139]

In fact, local government, under the direction of Mayor Michael Bloomberg has also been advocating various ways to create new sustainable markets for affordable housing. Highlighted as the primary goal in the administration's 2002 "New Housing Marketplace Plan," the mayor specifies use of the Liberty Bond Program as one of many ways policymakers are looking to effect positive economic and community development.[140] In a recent progress report for the Marketplace Plan, three recent Liberty Bond issuances are cited has having specifically generated over $12 million to fund four affordable housing developments in various New York City boroughs including Queens, the Bronx, and portions of upper Manhattan.[141] As cited in a 2003 progress report issued by the City of New York and Mayor Michael Bloomberg in the New Housing Marketplace Plan, Liberty Bond activity is illustrated as one of the many important policy tools used to create and cross-subsidize new sustainable affordable housing stock and maximize affordability for low to middle-income consumer groups.[142]

If anything, **there are larger, more tenable socioeconomic concerns for Downtown Manhattan** stemming largely from aforementioned service-related urban development issues facing Downtown Manhattan. As Madelyn Wils, chairperson of Downtown Manhattan's Community Board 1 elaborates on the externalities of residential growth and the resulting increased need for services:

> The positive side of this [residential] growth is that people recognize it is a great place to live — we must be doing something right. The negative side is we want to keep it a good place to live by making sure that services keep up with the influx.[143]

Insofar as the Liberty Bond financing has accomplished the policy goal of jumpstarting the markets, new policy measures must be set up at this critical juncture in Downtown Manhattan. These measures must not only be informed by careful consideration of the burgeoning strength of Downtown residential markets, but also must work towards enacting

[139] Policy official. Informational Interview. July 15, 2004.
[140] The City of New York. The New Housing Marketplace: 2003 Progress Report on Creating Housing for the Next Generation. New York: City of New York, 2003.
[141] Ibid.
[142] Ibid.
[143] Downtown Express.

some of the planning-related changes that are long due for Downtown's infrastructure, transportation and overall livability. Creation of viable real estate markets in Downtown Manhattan necessitates readjustment of policy measures to reflect the evolving real estate markets and long-term urban planning issues in infrastructure, transportation, and access. Thus, a more comprehensive consideration of the socioeconomic implications of office-to-residential conversion and how to create an improved, more livable environment in Downtown markets has to be discussed in the context of the impending planning efforts for post-9/11 Lower Manhattan. The last case of Chapter 5 takes a look at the prospect for office-to-residential redevelopment opportunities in the context of post-9/11 planning-related changes and proposed improvements for Lower Manhattan. This chapter used prototype office-to-residential conversion cases to support the conclusion that policymakers have facilitated conversion feasibility with different policy tools in pre and post-9/11 environments. Ultimately, the cases point to how policymakers have adjusted to different conversion market conditions and how such policy readjustment must continue in order to maintain sustainable Downtown real estate markets.

Chapter 5: Three Case Studies: Project Feasibility and the Impact of Market and Policy Interaction

These three case studies show how varying degrees of interaction between market and policymaking forces result in different office-to-residential products. The case studies designed to distinguish three different periods of such interaction:[144]

1) Case Study A is an office-to-rental conversion project in mid-to-late 1990's. It is one of the first redevelopments to signal project feasibility under the 1994 as-of-right zoning/building code changes. It is indicative of the developer's ability to recognize, early on, redevelopment opportunities coming from the confluence of strong residential market forces, structural office market weakness, and pro-conversion policies.

2) Case Study B is an office-to-loft conversion project done towards the end of economic growth experienced in the late 1990's. It demonstrates that for smaller-scale projects, as-of-right changes, as opposed to newly enacted discretionary funding incentives have more of an impact on project feasibility.

3) Case Study C is an office-to-rental conversion project occurring in a post-9/11 market recession that directly benefited from the Liberty Bond Program in order to meet financing margins. It shows that such discretionary funding, when applicable, can have a profound effect on project feasibility.

5.1 CASE STUDY A: Mid-to-Late 1990's Office-to-Residential Project

Case A's Take-Away Points

The first case study, Case A, began in 1997 and was completed in 1998. This case is a prototypical office-to-rental conversion project of the mid-1990's involving office stock in the Insurance District. The developer, having extensive experience in local markets with successful results in large-scale residential redevelopment, identifies a number of reasons that office-to-residential redevelopment is preferred to re-branding a Class B building to a B+ office space.

[144] The case material was put together through a series of informational interviews with real estate professionals on July 14 and July 19, 2004. Under terms established by a confidentiality agreement, all responses are kept confidential by excluding individual names, company names, and specific project names.

Case A also illustrates the dynamics leading to office-to-rental conversion rather than redevelopment into for-sale product. The developer for Case A, hereinafter referred to as DA, underscores the importance of mid-1990's regulatory changes that not only helped to set up as-of-right provisions but also provided tax-based incentives that encouraged more office-to-residential conversions.

Conversion versus Repositioning or New Construction

When looking at market trends in office space, rental product, and for-sale residential product, DA looked toward several key market conditions that helped make the decision to convert Class B/C office stock into residential space. Like the findings in Chapter 2's office market study of the early to mid-1990's, DA alluded to the weakness of the Class B/C office market by asserting that there was "no market, and no tenants."[145] Consequently, from an economic point of view, DA did not consider repositioning/rebranding of the office space to Class B/B+ product as a viable option. New construction was also not considered economically justifiable, because the existing structure was overbuilt relative to current FAR allowance for new construction at a 20 to 30 FAR typical of pre-war insurance district office stock.

Office-to-*Rental* versus Office-to-*For Sale* Conversion

What went into the analysis for converting the space from office-to-rental, rather than office-to-for-sale product (i.e. condominium) relates to both the developer's risk preferences as well as the lessons learned from earlier condominium projects during the late 1980's. Even though the project began in 1997, the observation about the for-sale residential market was that it was still particularly weak for parts of Downtown Manhattan below Soho/Tribeca. This made certain office-to-for-sale conversions, such as condominium conversion projects, particularly risky. Lessons from previous for-sale developments along with the tanking of a major condominium development in 1988 were noted as importance factors contributing to the decision to pursue an office-to-rental rather than office-to-for-sale conversion.

[145] Real estate professional. Informational interview. July 14, 2004.

Market Factors Supporting Office-to-Rental Conversion

Further, from the point of view of rental market demand and supply, there was strong evidence supporting rental projects as opposed to for-sale redevelopment. DA points out that a key advantage in 1997, from a supply side point of view, was that there was "no issue of the [Downtown] markets being flooded with rental supply."[146] In identifying competitive office-to-rental developments, a dearth of available land and underdeveloped or vacant sites made pipeline ground-up rental projects inconceivable. In fact, DA establishes that there was net loss of rental stock and that new rental stock is largely negative to the growing population even under today's post-9/11 conditions. DA confirms that Downtown Manhattan was largely seen as a secondary residential market compared to historically stronger areas in the Upper East Side and Midtown; nevertheless, these market conditions along with the economics of conversion allowed for significant savings to be passed down and allowed the developer to take advantage of opportunities to compete on price.

The economics of office-to-rental conversion along with significant cost savings resulting from conversion explain not only the decision to redevelop rather than undergo new residential construction, but also how these cost savings can result in competitive pricing of the rental product. DA offers a relatively straightforward strategy behind competitive positioning of their rental product: "buy it cheap, rent it cheap" and with "lots of jobs" Downtown,[147] strongly position the product with strong demand. DA points out that total development costs for Case Study A were approximately $100 per square foot, consisting of: acquisition costs of $25 and conversion costs of $75. In comparison, a new residential development came out to roughly $150 per square foot, representing a 50 percent cost differential. With $25 in gross rent and $6 in expenses, resulting net operating income (NOI) is approximately $19 per square foot.[148]

Policy Impact on Conversion Capacity and Feasibility

In observing the policymaking impact on development scenarios, DA cannot help but underscore the importance of zoning and building code changes during the mid-1990's, and in particular the policy changes enacted under the Giuliani Administration's 1994 Plan: "With the

[146] Ibid.
[147] Ibid.
[148] Ibid.

office market bottoming in the late 1980's, city government recognized this and they did not want another Detroit. The Lower Manhattan Plan of 1994 changed zoning to allow for conversions."[149]

DA focuses on how these changes allowed residential above commercial, as opposed to the old zoning codes which forbid the mix of uses. A conversion project once required vacating the entire building of commercial tenants. However with the mixed use provisions in the 1994 Plan, developers who wanted to convert office space did not have to offer "outs" to tenants. As to whether government was seen as setting up incentives or impediments towards valuable transitions of use for office space, DA *asserts that these 1994 policy changes were clearly incentives, not impediments.* In fact, he maintains that the administration ***removed impediments and offered incentives by changing zoning and allowing residential development to occur.***[150] For example, DA highlights among the key zoning changes, a new allowance of more than 12 FAR for residential development, along with a loosening of building code.

He also maintains that HPD-related tax incentives clearly facilitated the feasibility of conversion. "The 421-G essentially offers a 10-year tax break" and "with real estate taxes roughly equating to 25 percent of gross rent in New York,"[151] the tax exemption programs enacted during the policy changes of Mayor Giuliani's administration were definitely seen as contributing to the long-run feasibility of these conversion projects. Moreover, the 421-G program and other conversion-facilitating as-of-right regulation changes applied to all developers if the project qualified as occurring within designated Downtown Manhattan markets. In light of these policy incentives, DA emphasizes that an office-to-residential conversion project was all the more feasible, but with the added factor of favorable market conditions for rental product, an office-to-rental conversion became the only redevelopment scenario for optimizing value on this building.[152] In considering to what extent fiscal policy tools such tax incentive programs and zoning changes affected, DA maintains that such conversion of office-to-residential space would have been inevitable, but would occur at a much slower pace if such policy-based mechanisms for facilitating feasibility were not set in place at the time.

[149] Ibid.
[150] Ibid.
[151] Ibid.
[152] Ibid.

5.2 CASE STUDY B: Late 1990's to Pre-9/11 Office-to-Residential Project

Case B's Take Away Points

Case B, which began in 1998 and was completed in 1999, is an office-to-loft conversion in the Soho/Tribeca submarket – an area on the border of Downtown Manhattan. On one level, Case B demonstrates why a smaller-scale office-to-for-sale conversion would make sense in one Downtown submarket as opposed to an office-to-rental or repositioning project in another. Case B also shows how the prototypical boutique developer is affected differently by post-9/11 policy changes than other large-scale redevelopments such as Case A. The developer for Case B, hereinafter referred to as DB, agrees with DA in establishing the importance of pre-9/11 zoning and building code changes. On the other hand, DB asserts that post-9/11 programs such as Liberty Bond financing may not impact feasibility for smaller-scale conversions. Also, even if economies of scale can be accomplished with larger-scale office-to-residential conversions, DB asserts that there are overriding factors for pursuing smaller-scale conversion projects such as capital constraints.

Conversion versus Repositioning or New Construction

According to DB, land scarcity and constricted supply of underdeveloped sites made new residential construction in the late 1990's extremely difficult. When comparing Case A's market conditions with those experienced by Case B, it is clear that DB's project occurred under improved for-sale product demand on top of the continuing limited supply of for-sale stock. Given such recovery in the for-sale market along with a growing scarcity of convertible Class B/C Downtown stock, increased market focus was directed at smaller-scale conversion opportunities. Also, for more capital-constrained developers such as DB, entrance into the attractive conversion market, began with such boutique office-to-residential redevelopment projects. It must be noted that alongside the recovering for-sale market of the late 1990's there was also unprecedented strong levels of office demand due to the economic growth experienced in both technology-related and FIRE sectors. In this respect, DB provides an interesting example of a developer who held two proposed office-to-residential projects, and continued with conversion in one submarket while flipping the plans for conversion into repositioning under unprecedented office demand in another submarket. DB held the other proposed office-to-residential project in Noho (north of Soho), and decided to change plans for conversion by repositioning and rebranding the Class B space to Class B+ office product. However, after the office market tanked in 2000, DB sold the repositioned office space to a buyer who immediately converted the building into for-sale residential development.

Office-to-For-Sale Residential versus Office-to-Rental Conversion

Although Case A establishes that office-to-rental conversion is less risky for some developers, Case B points to how under different capital constraints, risk preferences, and varying submarket performance of for-sale product, an office-to-for-sale redevelopment can deliver stronger investment results compared to rental conversions for some developers.[153] Even though the recovering for-sale market may have provided, in general, stronger reasons for an office-to-for-sale project during the late-1990's as opposed to the mid-1990's, DB cites several important reasons for office-to-for-sale conversion rather than office-to-rental.

Because he was operating under lower capital commitments, DB focused on acquiring office buildings for smaller-scale conversions. At the same time, shrinking stock of mid-to-smaller scale office buildings in Downtown's core, meant that developers such as DB look towards stock available along the submarkets where light industrial or low-rise office stock predominated, as that found in the Soho/Tribeca submarket of Downtown Manhattan. What went into the analysis of DB's decision to convert in Case B was the traditionally price-insensitive, strong market demand for Soho-based loft product.

Market Factors Supporting Office-to-For-Sale Conversion

DB points to Soho/Tribeca as a Downtown area with particularly strong performance for upscale loft/condominium developments due to the target price-insensitive consumer.[154] Although in the early 1990's, as discussed for Case A, the for-sale market was weak, this impacted turnover rates in various for-sale products differently.[155] DB emphasizes that even in a down-market, buyers of upscale, luxury loft/condominium product are not price sensitive.[156] Thus, turnover rates may be slower, but price is largely unaffected.

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[153] Real estate professional. Informational Interview. July 14, 2004.
[154] Ibid.
[155] Defined by DB as the rate at which inventory is listed as available and is sold. Ibid.
[156] Ibid.

With Soho typically attracting the upper-end luxury loft segment, DB's prototypical *loft conversion targeted price-insensitive for-sale consumers, which contrasts sharply with DA's price-sensitive rental consumers.* Thus, due to a relatively strong base demand for luxury loft/condominium product along with Soho/Tribeca's traditionally strong for-sale market performance, DB's maintains that their Soho office-to-loft conversion project was well justified considering market conditions. Also, in terms of pipeline developments and competitive stock in other parts of Downtown, the Soho conversion project provided competitive advantages because of the smaller-scale office space which came with more architecturally rich qualities than that found in other pre-war buildings. Case B's conversion costs involved approximately $180 per square foot in total development costs as opposed to $225 per square foot for new construction, representing a 25 percent cost advantage in converting the space as opposed to ground-up development.[157]

Pre and Post-9/11 Policy Impact: Differing Effects on Feasibility

What is established that different capital commitments, for-sale market performance, and changing economic contexts can all set in place conditions for a developer to pursue a smaller-scale redevelopment scenario, and an office-to-for-sale rather than an office-to-rental conversion project. Aside from these factors, there is the policy analysis that goes into such an office-to-for-sale development. Although Case B predates pre-9/11, the developer provides us with supporting evidence of the differentiation made by local real estate professionals and industry practitioners on the policy environment and its impact on the conversion market. DB acknowledges that the zoning/building code changes made in the pre-9/11 policy environment of the mid to late-1990's allowed substantial market activity to be driven towards what was already identified by the industry as the highest and best use for various Downtown submarkets.[158] In agreement with earlier observations made by DA, DB makes similar points about Mayor Giuliani's initiation of as-of-right zoning changes that made conversions possible, which were then followed up with tax-based incentives that made office-to-residential redevelopments more feasible.

[157] Ibid.
[158] Ibid.

In contrast, **DB asserts that post-9/11 policy efforts, which may affect large-scale conversion activities, have had "little impact" on developers focusing on *the prototypical small-scale office-to-residential redevelopment.*** [159] In particular, DB sees the Liberty Bond financing as comparable to a "landmark tax credit,"[160] making little difference when considering overall market conditions for prototypical boutique conversions. If anything, DB points to the cost savings as a primary incentive for such conversions, which were 25 to 30 percent in comparison to new construction in 1998, and are still attractive at a 20 to 25 percent difference.[161] He states continuing cost differentials and attractive economics in Downtown Manhattan as overwhelmingly dominating any policymaking forces that may apply to increasing level of boutique office-to-for-sale redevelopment.[162]

5.3 CASE STUDY C: Post-9/11 Office-to-Residential Project under the Liberty Bond Program

Case C's Take Away Points

The final Case Study C, which began in 2002 and was completed in 2003, serves as an example of a Liberty Bond financed office-to-rental conversion in Downtown's South Ferry/Financial District. The developer for Case C, hereinafter referred to as DC, underscores the role of Liberty Bond financing in providing the critical margins that enabled the lender to step forward and underwrite the deal under post-9/11 conditions.[163] DC feels that such policy-based intervention was necessary and that the project would not have been feasible otherwise, considering that the Downtown residential market was still feeling the aftershocks of 9/11.[164] DC agrees with DA's comparison of risk between office-to-rental and office-to-for sale conversions. And consequently, DC maintains that issues of market timing and cyclicality make an office-to-for-sale conversion a riskier redevelopment scenario beyond the risk preference of some developers.[165]

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[159] Ibid.
[160] Ibid.
[161] Ibid.
[162] Ibid.
[163] Real estate professional. Informational Interview. July 19, 2004.
[164] Ibid.
[165] Ibid.

DC also helps us understand how the Liberty Bond works, how it provides incentives for rental redevelopment in the financing structure, and why the Liberty Bond Program should be maintained. His analysis of the Liberty Bond process points to a concrete finance-based for incentivizing office-to-rental rather than office-to-for-sale conversion.[166] He explains that a Liberty Bond project, like other bond-financed projects, is subject to strict underwriting standards and third-party credit enhancements.[167] Because this financing/securitization process is designed to protect investors, underwriting multiple for-sale unit owners becomes far more difficult than underwriting one rental property owner. As an example, office-to-co-op redevelopment is cited as raising issues of credit and consequently making bond financing impossible from an underwriting point of view.

Conversion versus Repositioning or New Construction

The Class C office building involved in this conversion had been 100 percent vacant for in recent years following the economic recession, reinforcing Chapter 2's office market conclusions about the specific vacancy problems experienced by such office stock.[168] Hence, DC points out market-based reasons for why conversion dominates repositioning as a redevelopment option:

> Even if we were to re-brand the Class C to a Class B/B- space, it would only be done on a built-to-suit basis. In this market, Class B/C is still geared towards attracting mom and pop businesses. Today's standards require that Class A space have around 30,000 to 40,000 square feet of open floor plate. B/C space, by pre-war design, offers much less wide open space, and is unmarketable.[169]

At the same time, DC feels that *these Class C qualities of building layout and physical design are exactly why redevelopment of such space* ***takes what is a disadvantage in the office market, and turns it into an architectural/marketing advantage in the residential market****.*[170] Hence, DC did not opt for new construction, considering the competitive qualities the site offered: 1) location in a historical district; 2) unique low-rise building compared to the "canyons

[166] Such finance-based reasoning behind policymaking for Liberty Bond office-to-rental incentives is confirmed in an informational interview with a policy official. July 15, 2004.
[167] Real Estate professional. Informational Interview. July 19, 2004.
[168] Ibid.
[169] Ibid.
[170] Ibid.

of Wall St;"[171] 3) qualities offering a sense of place and quality of life. Furthermore, DC cites total development costs savings typically ranging from 20 to 25 percent from conversion over new construction.[172] In summary, DC feels that conversion was the optimal redevelopment scenario in light of the long-term holding interests in the objective of sustaining long-term marketability.[173]

Office-to-*Rental* versus Office-to-*For Sale* Conversion

Similar to the analysis performed in Case Study A, DC relates risk preference to the decision to convert from office-to-rental, rather than office-to-for-sale product (i.e. condominium). Moreover, he states that: "With the Liberty Bond financing, we can safely do rental conversion projects."[174] Even in the context of today's unprecedented upward shifting for-sale residential prices, DC sees such pricing movement as cyclical and views the condominium/for-sale market in Downtown Manhattan as unreliable. DC acknowledges that with record-level for-sale pricing, developers can achieve far better margins than rental product. Yet because DC carries long-term holding interests and income-focused objectives, an office-to-for-sale conversion does not match his investment goals as well as risk preferences.

Market Factors Supporting Office-to-Rental Conversion

From the point of view of market supply, DC confirms Chapter 4.13's argument that Liberty Bond financing induced unprecedented levels of office-to-rental conversion activity and rental development in Downtown Manhattan. He cites this surge in anticipated rental supply as a cause for concern, as rent prices are driven down and hit by saturation of supply in the market.[175] DC also points to the Liberty Bond Program as the primary factor distinguishing supply conditions in pre and post-9/11 times: with a lack of rental supply prior to 9/11 and an abundance of added supply vis-à-vis unprecedented levels of office-to-rental conversion activity after 9/11.[176]

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[171] Ibid.
[172] Ibid.
[173] Ibid.
[174] Ibid.
[175] Ibid.
[176] Ibid.

Nevertheless, DC maintains that in the long-run, even with near-term supply additions, a net loss of rental space will dominate such introduction of rental stock either via redevelopment or otherwise. DC bases this on the overriding issue of Manhattan's housing shortage as it relates to strong, steady rental demand. As followed up in the next section, Case C demonstrates that how policymaking forces can outweigh market-based reasons for converting office into specific rental versus for-sale products.

Policy Impact of Post 9/11 Programs on Conversions: How the Liberty Bond May or May Not Effect Project Feasibility

While Case A and B show how as-of-right, pre-9/11 zoning changes affect project feasibility, Case C demonstrates the impact of post-9/11 driven discretionary funding. If anything, DC agrees with DA that office-to-residential conversion would have occurred despite any policy incentives for such redevelopment.[177] Yet, DC feels that recent policy changes such as the Liberty Bond definitely affected the decision-making process of whether to pursue office-to-rental as opposed to office-to-for-sale redevelopment.[178] Fiscal incentives such as the Liberty Bond's below margin interest rate along with subsidization of certain critical development costs can substantially affect project feasibility. For DC's conversion project, such tax-exempt bond financing provided the project lender with a certain level of confidence in underwriting standards. This in turn provided the critical gap financing needed to make the project altogether economically viable.

Because the Liberty Bond Program is not an as-of-right incentive, developers such as DC must apply for such tax-exempt bond financing. Industry professionals confer, to this respect, Liberty Bond financing is only relevant for developers who fall under the political radar of policymakers, as it is only approved on a discretionary basis.

At the same time, DC advances the position that Liberty Bond financing is the central cause behind recent surges in rental-focused conversion activity. To explain the economics justifying his position, DC points to how as-of-right regulation benefits accrue differently compared with tax-exempt bond financing.[179] For example, the as-of-right 421-G tax incentive for office conversions ultimately benefits the current owners of the for-sale units, because

[177] Ibid.
[178] Ibid.
[179] Ibid.

operating costs are reduced by the as-of-right changes. In contrast, the discretionary Liberty Bond benefits accrue to the developer, affecting pre-development and construction costs.

On top of showing how benefits accrue differently for various parties, DC points to different ownership structures as the reason behind the Liberty Bond's exclusion of office-to-for-sale incentives.[180] Such exclusion is attributed to the financing requirements for underwriting and securitizing bonds. Underwriting and credit standards make it particularly difficult for meeting these financial/legal requirements considering the multiple ownership interests represented in condominium/co-op/loft product. With for-sale products, owner credit issues are only multiplied, making bond issuance particularly difficult. Credit enhancement is also made more complicated. Hence, Liberty Program's incentivizing of rental program is built around the realities of the bond market -- the logistical requirements of underwriting, bond issuance and subsequent securitization. In this respect, an argument for program structuring occurring in line with notions of rental housing generating a social good ignores the more fundamental financial/underwriting reasons for incentivizing office-to-rental redevelopment.

Developer Recommendations: Keeping Tax-Based Incentives and Conversion Programs

DC staunchly recommends, at the minimum, the tax-based incentives as long as possible in order to fully transfer remaining outdated Downtown office space into more economically viable residential uses.[181] He acknowledges that a key problem persisting with office-to-residential conversions along with other residential development activity in Downtown is the lack of services in this area. Although he feels that redevelopment can directly benefit from Liberty Bond financing, he acknowledges that this type of policy may need to be thoroughly evaluated considering the new concerns among developers about oversupply in the rental markets. He therefore maintains that the Liberty Bond program helped sustain critical residential mass in the immediate post-9/11 environment, but that the program may need to be phased out to prevent Downtown markets from overheating and temporarily glutting the market with residential supply.[182]

DC emphasizes that any services and supporting retail development must be market driven, but also sees policymakers having the critical role of working more aggressively towards

[180] Ibid.
[181] Ibid.
[182] Ibid.

building the appropriate infrastructure needed for attracting private sector investment and commercial/retail development. The following post-9/11 driven planning efforts are looked to by DC as needing further fiscal and policy attention:

- Transportation Improvements such as 2nd Avenue subway and rail links.
- Street and parkland improvements.
- East River waterfront development to define a new mixed use community
- Staten Island Ferry development to activate this public place as destination center.[183]

Thus, in addition to policymaking efforts directed towards improving transportation, infrastructure, and access, DC also underscores the crucial role of policymakers in "weaving in conversion programs into the larger plan for Downtown's redevelopment efforts" and creating opportunities that will attract private investment in Downtown's various real estate markets. [184]

[183] Ibid.
[184] Ibid.

Chapter 6 Conclusion

The thesis investigated Downtown office-to-residential redevelopment in light of the policy measures established during the 1994 Plan and the recent post-9/11 Liberty Bond Program. The conclusion is organized around the following points:

- Chapter 6.1 Policymakers have facilitated conversion feasibility under the premise that markets are best suited for optimizing economic value through redevelopment opportunities. The analysis also shows that the market has identified as highest and best use of land in Downtown's real estate markets produces positive externalities for general economic development, and how policymakers can further foster such externalities by encouraging redevelopment.
- Chapter 6.2 To allow markets to carry through with ways to maximize asset value under changing economic circumstances, policymakers removed regulatory barriers and developed conversion incentives in the mid-1990's.
- Chapter 6.3 More recently, policymakers initiated fiscal measures for holding together market activity under the fear of market shock and post-9/11 instability. With such post-9/11 markets evolving and residential markets showing increased resilience, these initiatives must be reconsidered and readjusted by policymakers to allow Downtown to continue evolving into a more viable real estate market.
- Chapter 6.4 These findings are used to form a series of three recommendations for policymakers to continue adjusting measures and best facilitate sustainable Downtown real estate markets along with livable, built environments.

6.1 Influencing Individual Development Decisions to Achieve Larger Economic Benefits

The thesis supports the position that office-to-residential conversions do indeed maximize economic value for individual developments in Downtown Manhattan. Policymakers must nonetheless continue to monitor the market and adjust policy as redevelopment activity evolves.

For policymakers, conversions are seen as producing valuable re-investment in downtown. For consumers, additional housing in adaptive reuse Downtown buildings can offer the value and amenities offered by comparable Midtown areas at a lower price point.

It is clear that the market is best suited for finding ways to maximize individual asset value through redevelopment.[185] As the case studies point out, developers act rationally and convert uses to maximize economic value. Factors in redevelopment such as capital constraints, submarket demand/supply conditions, and capacity are all considered by developers (as indicated in Appendix J), [186] but what is prioritized above all is the individual project's ability to *maximize economic return considering the risk involved in the conversion*. From the point of view of policymakers, however, such individual economic benefit may not consider the positive externalities from their redevelopment activities and the larger economic consequences for the city. In other words, private developers are viewed as under-investing relative to the socially desirable level of investment.

Along this line, policymakers can facilitate private sector conversion activity through various means. These policy tools allow policymakers to remove negative policy barriers to redevelopment and establish positive policy measures to incentivize conversion activity. Policymakers can, in particular, influence markets via policy measures based on the belief that better coordinated actions across redevelopment projects, businesses and the city will produce a better overall outcome in terms of economic development.

6.2 Facilitating the Market's Adjustment to Economic Change

In the mid-1990's, developers were rational in ceasing office repositioning and new construction of Downtown office space. With lengthy periods of negative absorption, record double-digit vacancy rates, and downshifting rents, the Downtown Class B/C market provided indications of strong, visible structural changes. The economics for transitioning these uses was self-evident to market players, but the zoning needed to change to reflect what the market had already concluded as the highest and best use for such office assets.[187]

[185] Office-to-residential conversions are considered primary examples of how developers can be more attuned to market conditions than government programs. Citizens Housing: 11-12.
[186] Appendix I's provides a blueprint for understanding how certain market and policy-based conditions facilitate conversion activity. The diagram shows how base market conditions combined with as-of-right regulatory changes allow for office-to-residential conversion, and then proceeds to show how other market and policymaking forces drive redevelopment towards two main real estate products: office-to-rental and office-to-for-sale conversion.
[187] Real estate professional. Informational Interview. July 14, 2004.

The 1994 Giuliani Plan changed the regulation to allow the market to adjust to new structural economic realities. For policy to block such transitioning of uses meant increasing disuse and dilapidation of buildings, emptying of valuable Downtown CBD space, shrinking employment bases, and subsequent negative impacts on economic productivity in Downtown. By removing regulatory barriers in zoning and building codes for mixed uses, and adapting commercial space into residential use, these policymakers were coming to terms with market-based realities while working to repair some of the suboptimal economic conditions that outdated zoning had caused within a rapidly weakening Downtown CBD.

6.3 Neutralizing Market Shock and Jumpstarting Market Recovery

The market frontline changed drastically in the wake of 9/11. Market shock and depression took a hold of Downtown's real estate markets, and an exodus of both residents and commercial tenants were foreseen as further plaguing Downtown Manhattan's economic development. Plummeting occupancy in various real estate markets, extensive patterns of negative absorption, and dipping rent levels all pointed to market responses to the economic uncertainty and fear of evacuation in post-9/11 Downtown Manhattan. In the context of such market shock, policymakers set up the Liberty Economic Stimulus Package with the intent of preventing further erosion of Downtown's markets. As a critical component of the Package, the Liberty Bond Program was designed to neutralize some of effects of real estate market depression and the conversion market's response to uncertainty. Policymakers justified discretionary funding that incentivized office-to-residential redevelopment based on the immediate need to stabilize Downtown's residential base and the fear that "no one would live in Downtown Manhattan."[188] The basis for incentivizing office-to-rental redevelopment over for-sale conversions derived from the lower costs and underwriting risks that rental programs offered.

[188] Planning Official. Informational interview. July 15, 2004.

Today, the industry response from Downtown rental markets is clear: rental additions in Downtown dominate over all new Manhattan supply.[189] In terms of demand, occupancy is back to pre-9/11 levels and price is at a record high. Meanwhile, current for-sale residential markets show incredible signs of strong performance. Thus, under these current residential market conditions, the original **short-term goals of the stimulus package are out of context and incentives designed to immediately patch market depression are no longer necessary**.

If discretionary funding for office-to-residential redevelopment continues, the current supply data indicates serious ramifications for the existing service base in Downtown Manhattan. A sharp increase in residents without an accompanying improvement in Downtown services will result in a substantive strain on those services already in place. The public school system, existing retail support, and other services are not in place to respond and meet the needs of such a large increase in residential mass.[190] In this respect, the initial policy-based motivation, while making sense immediately following 9/11, are now out of context when examining market evidence indicating strong momentum in Downtown residential development and record rates of office-to-residential conversion.

The purpose of the Liberty Bond was to *short-term stimulate* in order to *long-term stabilize*, *and this policy was informed by the understanding that long-term market activity would be market-driven, not persistently policy-driven.* Developers would otherwise wait to let some of the uncertainty in the market resolve by itself before starting new redevelopment projects. Policymakers then pursued bond financing as a way to move the development forward in time. As a planning official established in Chapter 4, policymakers did not want to wait to see if markets would stabilize; they wanted to push development ahead as quickly as possible to help the overall recovery efforts post-9/11 as well as overall redevelopment goals.[191] Hence, the Liberty Bond program and economic stimulus package were needed to hold together all the pieces of Downtown market activity immediately following 9/11, but under today's market conditions, the Liberty Bond incentives are **no longer necessary because the market has *already been jumpstarted.***

Sustaining reasonable levels of residential development, however, is important because Downtown Manhattan is still perceived as risky for residential redevelopment efforts, despite

[189] Feathernest Manhattan Apartment Report.
[190] Downtown Express.
[191] Planning official. July 15, 2004.

recovery in residential market fundamentals. As Chapter 4 indicates, risk comes primarily from the lack of services and critical mass. Also, construction costs remain extremely high. And finally, post-9/11 planning efforts for improving transportation, access, and infrastructure are still uncertain. Neutralizing some of the risk and sustaining reasonable levels of residential conversion activity can be achieved by continuing the tax-based incentives that were set in place during the Giuliani administration. Maintaining tax-based programs promotes conversion feasibility in Downtown Manhattan while holding in place policy measures designed to sustain market activity instead of jumpstarting it.

6.4 Policy Recommendations: Three Measures Supporting a Viable Downtown Market

The policy recommendations supported by this thesis, thus, focus on three measures for allowing markets to sustain reasonable, viable conversion activity to promote long-term economic development in Manhattan. The first policy recommendation is to discontinue with tax-exempt bond finding and the Liberty Bond Program insofar as the discretionary funding was designed to jumpstart the markets after 9/11 and immediately address market shock. Considering current market conditions, this jumpstarting mechanism is no longer needed and can be considered an inappropriate use of policy measures and funding.

The second recommendation is to maintain pre-9/11 informed tax incentive programs, but to also put in place phasing-out provisions in these tax-based measures. This allows policymakers to promote conversion feasibility until further planning efforts can help neutralize other risky aspects of redevelopment in Downtown. This will allow policymakers to incentivize private sector involvement in bringing about more retail support and services to sustain such residential development. Sustaining reasonable levels of market activity vis-à-vis tax incentives is still in line with creating critical mass in Downtown, and demonstrates that policymakers are willing to share in some of the redevelopment risk. For policymakers, such risk-sharing in residential investment can provide larger public benefits from sustainable markets much sooner than the alternative of relying on the markets for in Downtown investment. In this respect, the tax-based programs will allow policymakers to **continue *fast forwarding* housing redevelopment, *but at a more reasonable pace* than would occur under Liberty Bond.**

The third recommendation, then, is based on what must accompany these residential incentives -- a following-through of plans for improving public infrastructure, transportation and access. Mayor Bloomberg's Vision for Lower Manhattan indicates that current policy measures for aligning residential redevelopment with other public investments in infrastructure and transportation continue to remain largely in their planning stages.[192] **Once those larger public investment proposals gradually come into fruition, policymakers can reassess market conditions and phase out tax-incentives accordingly.** Although the immediate challenge following 9/11 was to hold together market activity, there are new challenges for policymakers to face under current market conditions. Policymakers must revisit plans for public investment in infrastructure, housing, and economic development and rethink the effect of policy measures under Downtown's evolving markets. These challenges can be best approached by continuing to monitor the market and continuing to readjust redevelopment policy for the purpose of creating a viable real estate market, maximizing economic resources in the built environment, and supporting a sustainable living environment in Downtown Manhattan.

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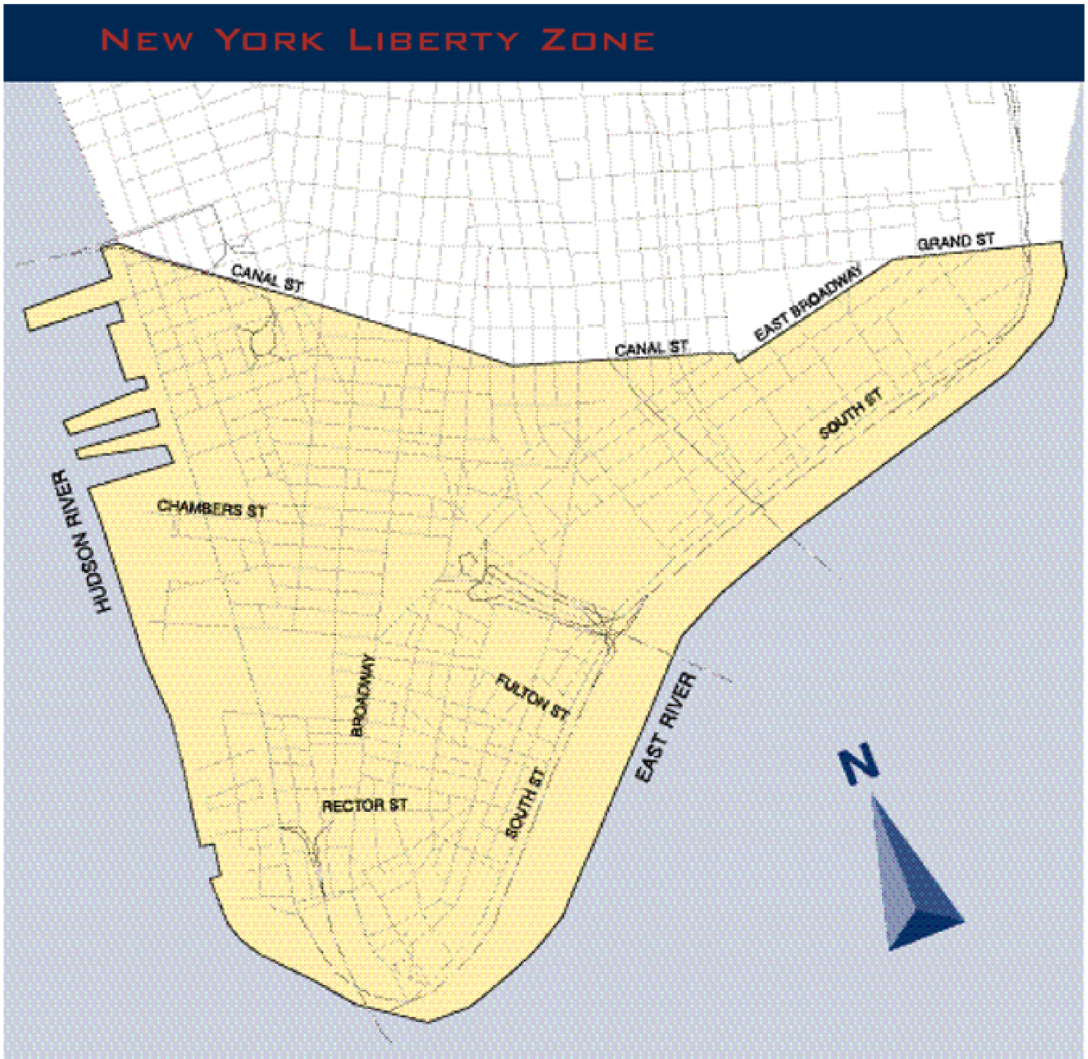
[192] Bloomberg, Michael R. New York City's Vision for Lower Manhattan. New York: Lower Manhattan Development Corporation, Dec. 2002.

Appendices

Appendix A

New York Liberty Zone Map. Source: Lower Manhattan Development Corporation



Appendix B

Year-Over-Year Changes in Jobs, Wages and Businesses: Q4 2000 – Q4 2001

Zip Code	Change in Units	Change in Jobs	Change in Avg. Quarterly Salary	% Change in Units	% Change in Jobs	% Change in Avg. Quarterly Salary
10002	71	137	($82)	4%	1%	(1%)
10004	1	(4,993)	($7,564)	0%	(8%)	(19%)
10005	24	(3,396)	($18,583)	2%	(8%)	(42%)
10006	(31)	(4,210)	($2,574)	(3%)	(20%)	(7%)
10007	(27)	(2,747)	$1,061	(2%	(5%)	9%
10012	10	(4,585)	$139	0%	(14%)	1%
10013	110	(3,263)	$276	2%	(3%)	3%
10014	23	(1,415)	($694)	1%	(5%)	(5%)
10038	(11)	(4,381)	$1,311	(1%)	(5%)	9%
10041	(1)	(809)	$4,793	(3%)	(14%)	21%
10048[a]	**(639)**	**(26,052)**	**($28,688)**	**(100%)**	**(100%)**	**(100%)**
10270	0	(183)	$1,540	0%	(3%)	7%
10271	3	524	$13,455	3%	17%	51%
10278	(1)	23	($194)	(6%)	19%	(2%)
10279	3	184	($4,859)	4%	28%	(12%)
10281	(8)	(1,943)	($9,886)	(7%)	(13%)	(22%)
Total	**(473)**	**(57,109)**	**($2,948)**	**(2%)**	**(11%)**	**(14%)**

SOURCE: New York State Department of Labor and New York City Comptroller's Office.
NOTE: Units equal number of businesses.
[a] World Trade Center

Appendix C

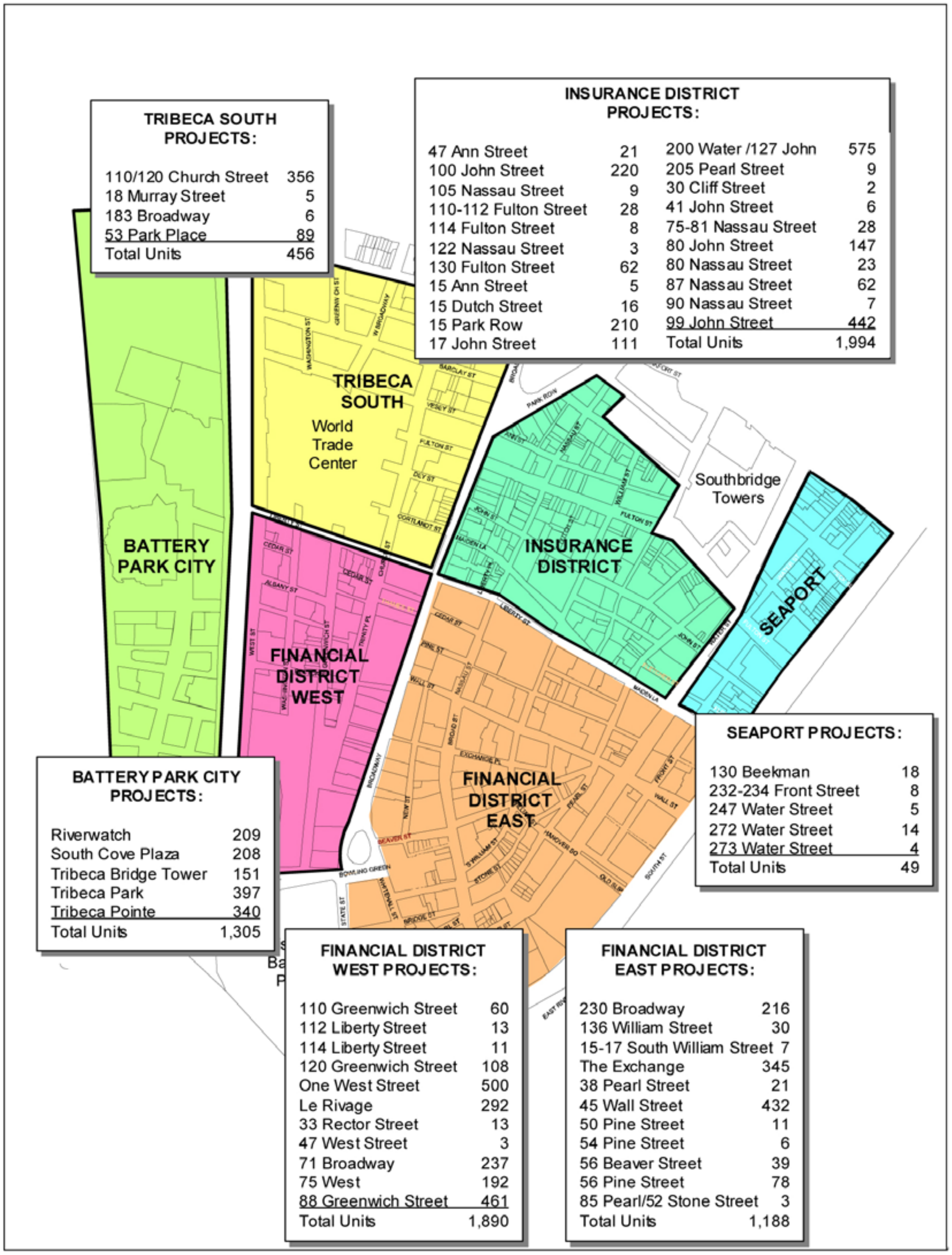
Change in Reported Jobs (Q4 2000 – Q4 2001) Ranked By Industry

Description	Change in Jobs
Finance and Insurance	(25,087)
Professional, Scientific, & Technical Services	(8,879)
Accommodation and Food Services	(5,110)
Manufacturing	(4,130)
Retail Trade	(3,624)
Information	(3,290)
Administrative & Support & Waste Mgmt & Remediation Services	(2,170)
Construction	(1,136)
Public Administration	(1,117)
Transportation and Warehousing	(1,112)
Management of Companies and Enterprises	(1,070)
Wholesale Trade	(844)
Educational Services	(731)
Other Services	(255)
Arts, Entertainment, and Recreation	(239)
Real Estate and Rental and Leasing	(179)
Unclassified	(1)
Health Care and Social Assistance	2,550

SOURCE: New York State Department of Labor and New York City Comptroller's Office.

Appendix D

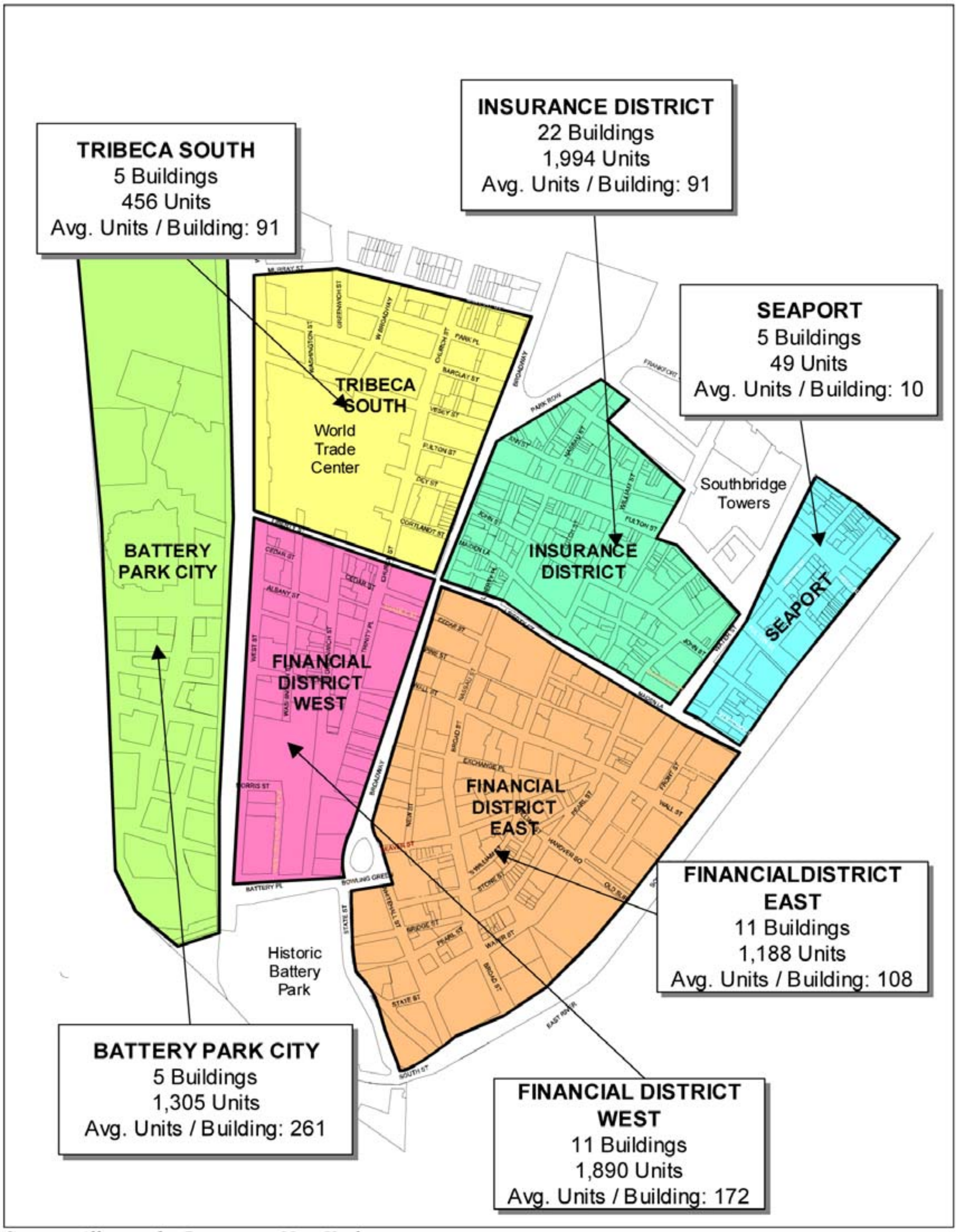
Conversion Projects and New Construction in the Downtown Core by District between 1995-2000



Source: Alliance for Downtown New York

Appendix E

Concentration of Conversion Projects and New Construction by District in Downtown Core between 1995-2000



Source: Alliance for Downtown New York

Appendix F

Post 9/11 Federal Funding Released to New York City			
($ in millions)	Current Estimates	Funding Released	Undistributed Funds
Program			
Liberty Zone Tax Incentives	5029	450	4579
FEMA-Emergency Response and Recovery	6048	3651	2397
Intermodal Transit	2750	0	2750
LMDC and ESDC (CD Block Grants	3483	1002	2481
Transportation Projecgts	2347	182	2165
Other Federal Funding	1159	333	826
Total	20816	5618	15198

Appendix G

Progress of Liberty Bond Program

($ in millions)

Description	Maximum Amount	Proposed Applications	Approved Applications	(Over) / Under-subscribed
Commercial:				
Inside Liberty Zone	$4,400	$442	$442	$3,958
Outside Liberty Zone[a]	2,000	1,214	114	1,886
Residential:				
Inside Liberty Zone	$1,600	$1,872	$634	$966
Outside Liberty Zone	0	0	0	0
Total	**$8,000**	**$3,528**	**$1,190**	**$6,810**

[a] $2 billion for commercial projects outside the Liberty Zone are permitted to be re-programmed inside Liberty Zone.

Appendix H

Liberty Bond Program: Highlighted Terms	
Interest Rates	Fixed and variable offered.
Term (Maturity)	Typically matches the useful life of the asset.
Credit Terms	Credit enhanced or unenhanced; although third-party credit enhancement is required to guaranty timely repayment of bonds issued.
Maximum Bond Amount	As permitted by the credit enhancer.
Placement	Privately placed or publicly offered.
Security Position	Senior, subordinate, and/or deeply subordinated (with recourse).
Real Estate Tax Benefits	Section 421-g for conversion projects; J-51 for rehabilitation projects and 421-a for new construction.

Appendix I

Induced Liberty Bond Projects, Inception-to-August 2003

($ in millions)

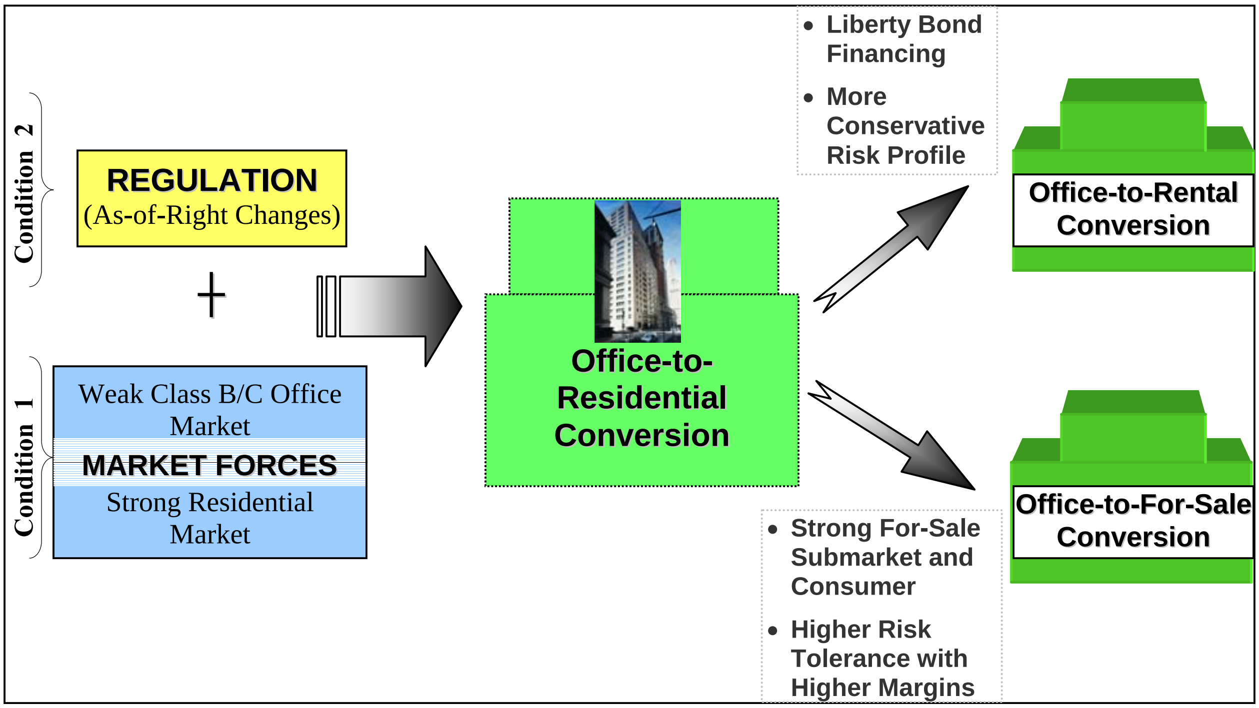
	Amount Induced[a]	Liberty Bonds Issued	Remaining to be Issued[b]	Status
Commercial:				
7 World Trade Center	$400	0	400	Developer has started construction
Atlantic Terminal – Brooklyn	114	0	114	Developer has started construction
Port Convention Center	10	0	10	Developer working to structure project and financing
377 Greenwich Street	32	0	32	Developer working to structure project and financing
Subtotal	**$556**	**$0**	**$556**	
Residential:				
20 River Terrace	$100	$100	0	Bonds Issued
10 Liberty Street	95	95	0	Bonds Issued
Front Street near South Street Seaport	47	46	0	Bonds Issued
90 Washington Street[c]	82	75	0	Bonds Issued
2 Gold Street	200	0	200	Plans to issue in September 2003
Battery Park City – Site # 19 B	110	0	110	Plans to issue in December 2003
Subtotal	**$634**	**$316**	**$310**	
Grand Total	**$1,190**	**$316**	**$866**	

[a] An inducement is an IRS tax code provision under which developers are allowed to include eligible project costs incurred in the first 60 days of a potential project. The inducement stage commits neither the developer nor the responsible government agency pursuing the potential project.

[b] Does not reconcile due to some projects having a taxable debt component to their financing.

[c] Includes $7 million of taxable bonds.

Diagram of What Drives Office-to-Residential Conversions under Current Market and Policymaking Synergies



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Biographical Note

Sung-Min Thomas Suh is a graduate of Columbia University and the Massachusetts Institute of Technology (MIT). Serving as a Public Policy and International Affairs Fellow (PPIA), Thomas graduated with a Master of Science in Real Estate Development and a Master in City Planning from MIT in September 2004. Thomas earned his Bachelor of Arts in Sociology from Columbia University in 2000. Prior to entering MIT, Thomas worked as a Corporate Treasury Analyst for New York Times Capital, Inc., and a Financial Analyst in the Portfolio and Trade Administration teams for Blackrock Financial. Thomas also served as a Field Supervisor for the Literacy Tutoring program with AmeriCorps in Los Angeles, CA.