Manhattan Office Condominium Market

Michael Rudder
Rudder Property Group
February 17, 2011

Manhattan Office Condominium Market Overview

- 8.2 million SF of NYC office condominiums, or 2% of the 520 million SF office market

- A total of 76 buildings

- Midtown is 57% of the market with 29 buildings

- Midtown South is 31% of the market with 34 buildings

- Downtown is 12% of the market with 9 buildings

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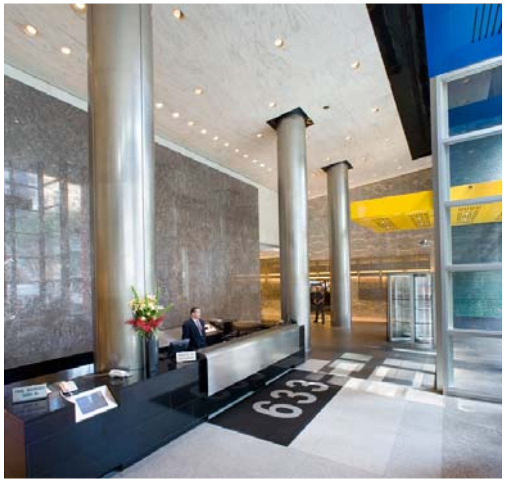
Notable Office Condominiums



633 Third Avenue

1 million SF, Class A

<u>Recent Sale:</u>

3,966 SF for $807/SF

110 East 40th Street

100,000 SF, Class A

<u>Recent Sale:</u>

6,000 SF for sub $500/SF

125 Maiden Lane

340,000 SF, Class B

<u>Recent Sale:</u>

25,622 SF for $350/SF

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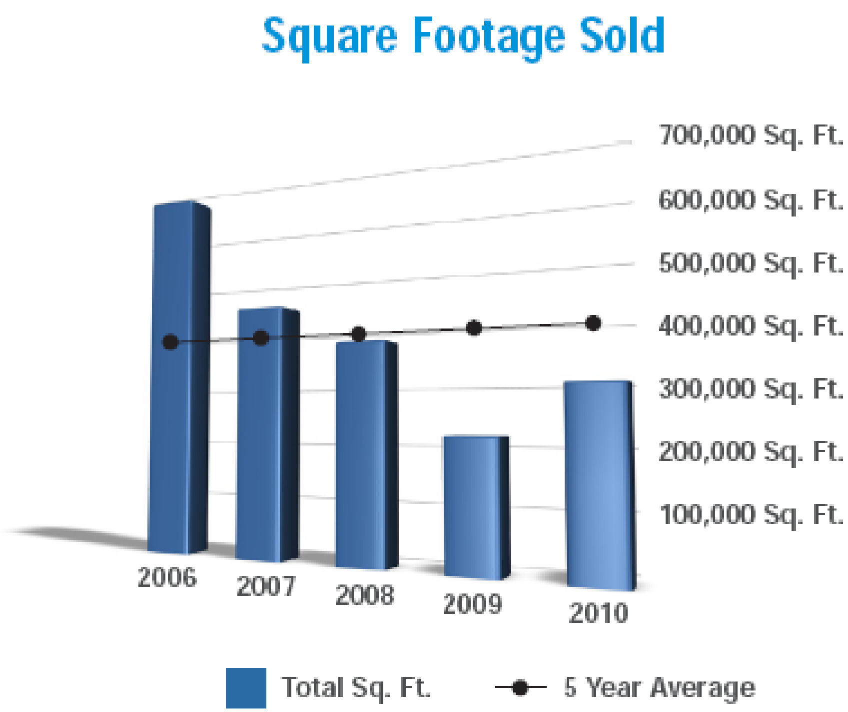
Current Market Conditions

- No activity for 18 months post Lehman collapse
- Pricing down 40%
- Sales at 70 West 36th Street went from \$740/SF to \$450/SF
- RPG closed over \$40 million in sales, 85,000 SF (\$450/SF avg.) in the past six months
- Tremendous buyer interest, severe lack of quality product



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Why Convert to Office Condo?

- Premium pricing
- New better market than Manhattan, no better time than now
- Huge disconnect between demand and availability
- Low conversion cost
- Risk free

Annualized Rental Income

Gross Rent:	$35
CC and RET:	($12)
TI:	($4)
Free Rent:	($1.50)
Avg. Annual Net Income over 10 yrs:	$17.50

5% cap rate = $350

vs.

Office Condo Sales Price = $550

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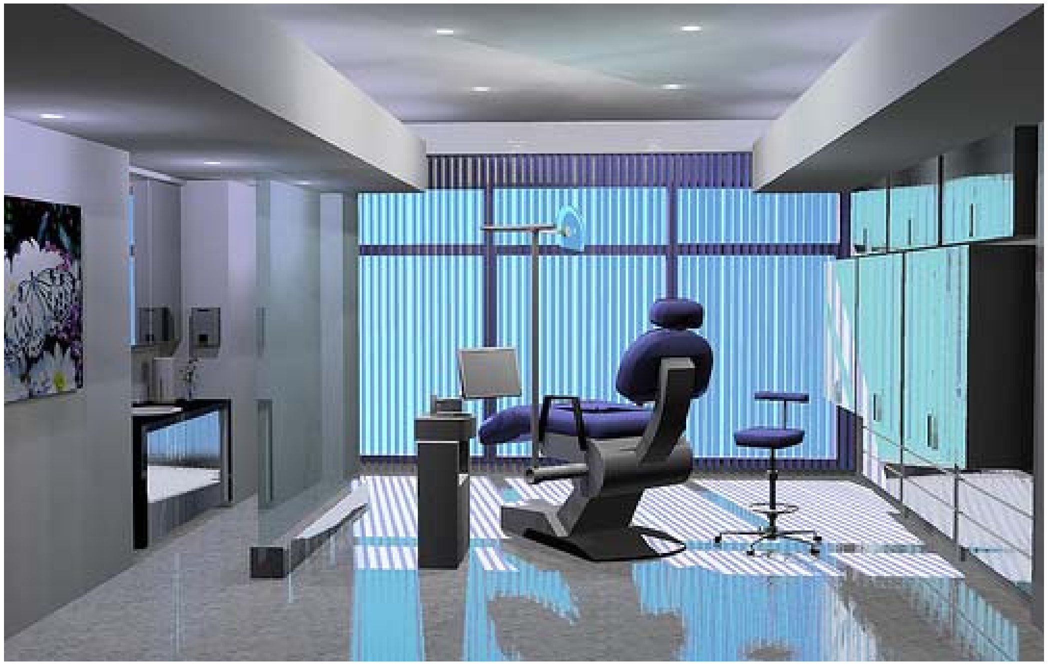
Benefits of Ownership

- Capital appreciation
- Tremendous financing available
- Tax exemption for non-profits
- Long term amortization of construction costs
- Cheaper than renting



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Buyers in the Market

- Non-profits
- Foreign companies
- Schools
- Medical
- UN related
- Businesses
- Unions

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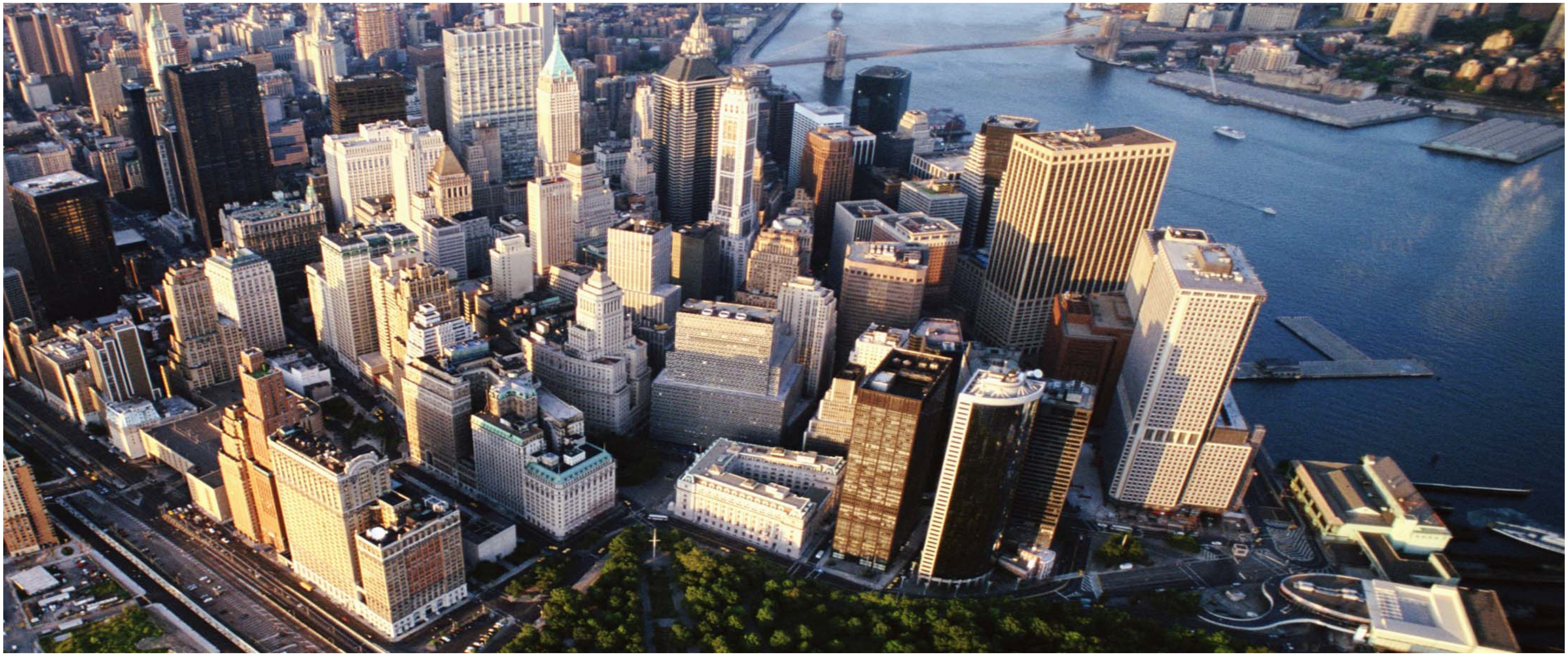

New York City Economic Development Corporation

City Programs to Support Office Condominium Development in Lower Manhattan and Beyond

February 17, 2011

NYCEDC
New York City Economic Development Corporation

Who We Are

The **New York City Economic Development Corporation** (EDC) is the City's primary engine for economic growth, job creation and improving quality of life across the City.

Our main activities include:

- Spearheading Redevelopment
- Disposition of Assets
- Business Attraction
- Providing Tax Incentives
- Navigating Government

Over **450** real estate transactions closed since 2002, spurring **$12.5B** in private investment.

What Can We Do For You?

Real Estate Transaction Services offers businesses a one stop shop for corporate real estate planning and structuring assistance:

- Location Advisory Services
- Incentives and Benefits Education and Assistance
- Discretionary Incentives Structuring

Lower Manhattan As-of-Right Incentives for Owners

- **Industrial and Commercial Abatement Program (ICAP)**
  - Provides real estate tax abatements to qualified renovated properties and new construction
- **Lower Manhattan Relocation and Employment Abatement Program**
  - Business tax credit for companies relocating employees to Lower Manhattan
- **Lower Manhattan Sales Tax Exemption**
  - Exemption on City and State sales tax on buildings and materials used in renovation
- **Lower Manhattan Energy Program (LMEP)**
  - 12 year energy discount for qualified buildings; savings passed through to tenants

Discretionary Incentives

- **NYS Excelsior Program**
  - Provides job creation and investment incentives in targeted industries such as new media and biotechnology
  - Job, investment and R&D targeted tax credits over 5 years which are fully refundable.
- **NYC IDA Commercial Incentives Program**
  - Sales Tax Waiver based on job growth
  - MRT Deferral
- **Job Creation and Retention Program (JCRP)**
  - Lower Manhattan benefit for large employers
- **Business Incentive Rate (BIR)**
  - Reduction up to 35% on regulated energy cost

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DISCLAIMER: All descriptions of benefits are subject to change without notice, and all benefit restrictions and requirements are not included. Only summaries of benefits are provided. Other incentive programs may be available.

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From Insight to Results

The Asian Tenant and Commercial Office Condominiums in New York

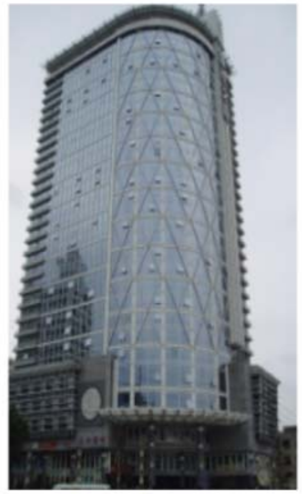
February 17, 2011

The Asian Business at Home

- Commercial condominiums or strata properties/title offices have had success in many Asian markets
- In some areas, strata properties account for vast majority of office space
- Growing trend in Tier One markets toward leasing space in a single owner building from sophisticated local and international firms who demand higher quality occupancies
- Much of the existing inventory is aging and new development is unusual, except in secondary markets
- Some investment by large property funds such as CapitaLand (SG) who see the aging as an opportunity to refurbish and increase net yields

Successful Asian Strata

Grand Millenium
Plaza
Hong Kong



City Tower
Chengdu

Lippo Tower
Chengdu

Chuanxin Mansion
Chengdu

First City Plaza
Chengdu

Drivers for Owning Strata

- Asian culture, land scarcity and high cost at home
- Attraction of real estate as an investment, rather than a cost
- Low up-front cost compared to commitment for a full building
- Expectation of capital return
- Mistrust of owners and their follow-through on services promised
- Ability to control market perception/image of company

Problems with Owning Strata

- Some tenants care only about their space, refuse to contribute funds for management, amenities, landscaping, maintenance, etc.
- New buildings, once given over to buyers by developer, deteriorate quickly due to poor property management and infrequent maintenance
- Fractional ownership results in lack of long-term business plan, slow decision-making and delays in necessary repairs, improvements and changes in vendor services
- High tenant turnovers and low occupancy rates mean decline in value
  - Rates achieved per square meter are 20%-40% lower than in single owner buildings
- System can function like this because in many markets, competition from quality single-owner properties is non-existent
  - Strata owners have nothing to measure their situation against as a comparison

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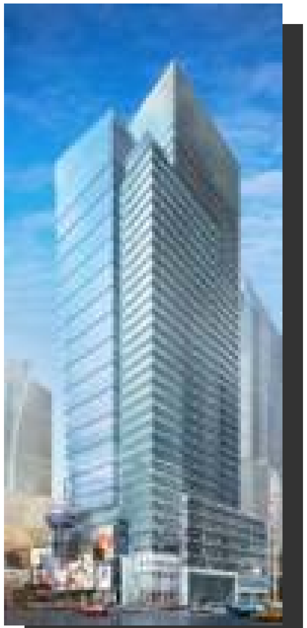
Conclusions

- Asian companies would be highly receptive to more commercial condominiums in New York if they
  - Were in modern buildings
  - Were newly-developed properties
  - Had small floorplates (<15,000 SF)
  - Were in image/trophy properties with prestigious addresses



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Insight from Our Clients

"Chinese for the most part prefer to own their premises. There is both the control factor and the belief that owning is a better financial alternative on a long term basis. If there were good options in midtown for Class A office condominiums, they would in my opinion be a viable alternative for Chinese requiring office space."

Wu Bin, General Manager, ICBC New York

"Whether for personal residence or place of business, the Chinese prefer to own their real estate as they consider it an excellent investment. A New York building dedicated to commercial condominiums would therefore garner great interest from Chinese companies—as long as the quality of both the property and their corporate neighbors was guaranteed consistent for the foreseeable future."

Katherine Farley, Senior Managing Director, Tishman Speyer Properties

FASB Proposed New Standards for Lease Accounting

In (Very) Brief

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What are the Current US GAAP Standards Concerning Real Estate?

- Most space leased in the US today and accounted for under US GAAP is treated as operating lease property
- Under that treatment, a tenant adds up the total lease rents over the term of the lease including renewals that at the inception of the lease are expected, and divides that amount by the term of occupancy to arrive at a straight line rent charge
- Extensive footnote disclosure concerning future payments to be made under the leases is provided currently
- Escalation, CPI charges, percentage rents etc. are treated as contingent items and expensed annually as executory costs
- International accounting standards have for some time not permitted operating lease treatment and have insisted that such arrangements be reflected on the tenant's balance sheet as both an asset and a liability.

Why are New Standards Being Proposed Now?

- The FASB has for several years been working with its international counterpart- the IASB to “converge” accounting standards
- The goal of the standard setters is to create a global set of “principled” standards, as opposed to the GAAP “rules”

Exposure Draft Process/Progress

- Accordingly, GAAP will virtually eliminate operating lease accounting
- The exposure draft was promulgated in August 2010; Comment period expired 12/15/2010 (Lots of push back as we shall briefly discuss)
- Standard in final form slated for June/July 2011
- Implementation likely to be required by 2013 or 2014 and will be extremely difficult, time consuming and costly

Now we can discuss the WHAT

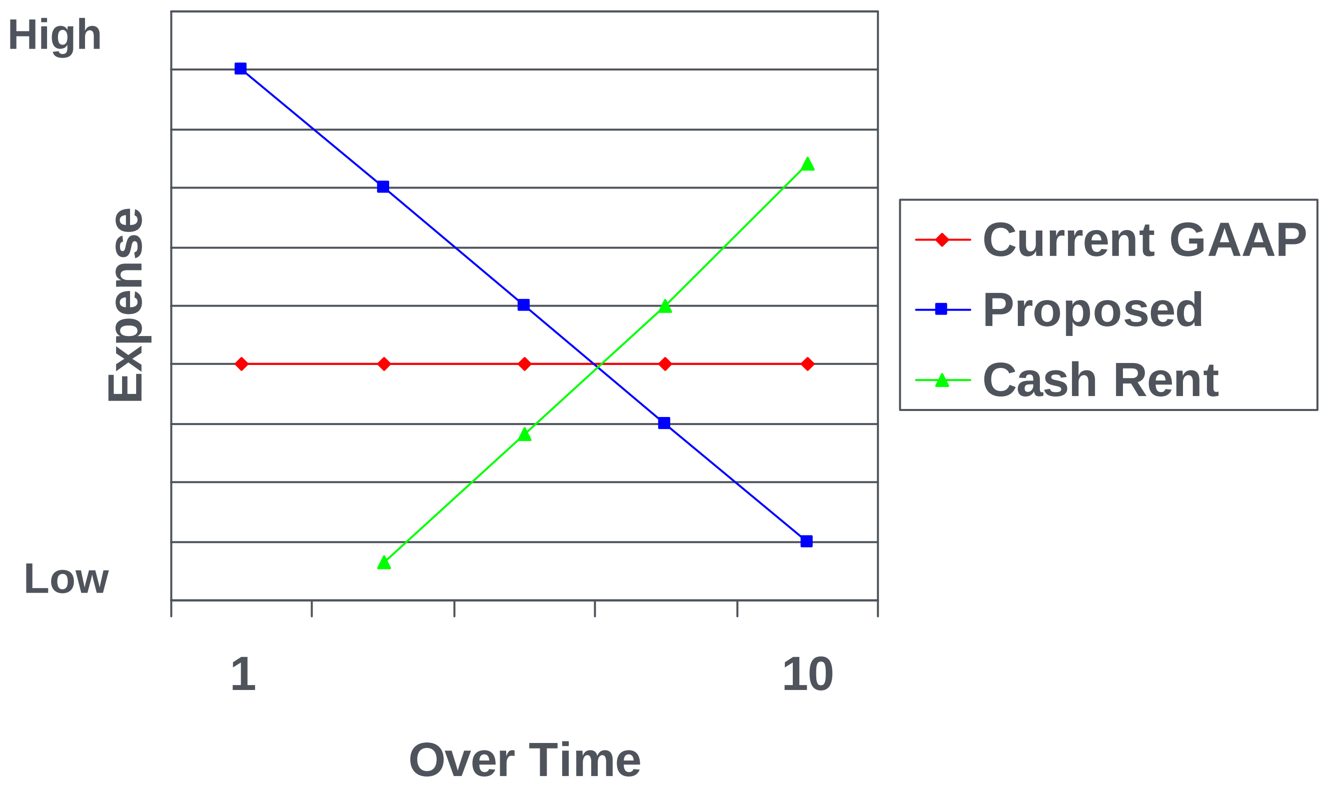
What are the Highlights of the Proposal?

- It will cover substantially all leases of property, plant and equipment (subleases as well) exclusions are very narrow, basically covers arrangements conveying the “right to use” a specified asset for a period of time
- As a conceptual matter, the “right to use” model makes more sense when applied to equipment leases (which indeed are often disguised financings) than it does to real estate leases (which rarely are)
- If services are included- bifurcate and account for each element separately
- Could result in some portion of lease payments being treated as executory arrangements

Basic Concept (Tenant)

- Tenants will record the NPV of future lease payments (including **estimated** contingent payments) over the **estimated** term of the lease using lessees rate (if known) or lessors incremental rate (more likely scenario), plus initial direct and incremental costs
- Tenant will now have a new asset and liability on its books
- So will owner (see later)
- Assets will be depreciated over estimated term of lease
- Liability will be accounted for as pay down of debt
- Income statement
  - No more rent expense
  - Instead: you will have interest expense and depreciation expense
- As compared to prior model- more front loading of expense
- Lots of noise and “true-ups” as estimates change and require remeasurement every year if applicable-- the so-called “true-up footnote” will be in the financial statements

Basic Illustration of Rent VS Depreciation and Interest



Landlord (Lessor Accounting)

- Proposed approach parallels (approximately) the lessee approach
- Landlord will record NPV of future lease payments as a “lease receivable” and a liability representing the “performance obligation”
- The lease receivable is comprised of the probability weighted discounted cash flows and includes fees, commissions, etc (initial direct costs)
- Use “rate implicit in lease” to discount
  - The landlord will have on its books 2 assets and 1 liability as a result

Landlord (Lessor Accounting) (continued)

- If landlord is being relieved of benefits/risk of ownership then there will be a derecognition approach and a profit on sale would be recognized at the outset. As rents are collected the receivable would be amortized, and interest recorded – not expected to be a very common occurrence

Implementation Difficulties for All

Both lessee and lessor have to deal with estimates and moving targets

- Interest rates
- Lease term- “longest term which is most likely”
- Contingent payments- escalations (imagine retailers guessing on % rent)
- Developing estimates and weighing probabilities
- Bifurcation of consideration
- “Truing Up” the estimates at least annually
- Adjusting on the fly will be a new concept in leasing in practice

Problems at Inception Upon Adoption

- Complete “retrospective” presentation to be required of issuers- public companies have 3+ years look back
- Covenant issues galore- banks will do well
- Lots of pencil pushing to develop numbers
- The required data gathering for companies will be an enormous task
  - Information system upgrades may be required
- Certain industries (e.g. retail and banking) will be very hard hit due to the heavy compliance burden

Is this Effort Worth the Presumed Improvement over Existing GAAP?

- Will the purported benefits of adoption of this standard justify the enormous cost/effort?
- Honest folks could debate this question
- Analysts already utilize the cash flow commitment disclosures presently required by GAAP
- Will FASB “water down” final standard in addressing public push back?
- Will these proposed standards, when they come to pass lead to changes in how business is done?
- Will ownership strategies/shorter leases become the norm?
- Will escalation clauses disappear and result in increased base rents?
- Ownership strategies may well become more attractive for some; shorter leases are not likely given the likely pushback from landlords.

STAY TUNED

How will the Accounting/Auditing Profession be Affected?

- Auditors (and preparers) will now have to use a new breed of outside specialist to assist in our work in assessing the reasonableness of all the estimates, moving targets, truing up, etc.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Office Condos: New York Real Estate's Next Big Thing?

February 17, 2011

Douglas Heller

Topics For Discussion

- Find out if there is demand and the conversion is worth doing
- Find out if an offering plan is necessary or use a no-action letter
- For a no-action letter or a plan, try to make the project as flexible as it is necessary

Attorney General's Market Test Policy (CPS #1)

- Historically, a compromise to get projects to market because review process took too long
- Can be effective to actually test the market
  - File as simple affidavit with projected prices and common charges
  - Easy and quick to process

Attorney General’s Market Test Policy (CPS #1) (cont.)

- Can be effective to actually test the market
  - Can be used to obtain lists of potential purchasers
    - Interview and evaluate their interest
  - Isn’t necessary to own tested property
  - Regulated advertising is permitted
  - Test is for 120 days with 60 day extension

No-Action Letters

- For offerings up to four (and maybe more) non-residential units, offering plan may not be necessary
- Sophisticated, qualified purchasers joining in the application can be helpful
- Sale condo-backs
- Upon receipt of no-action letter, the declaration, by-laws and floor plans are filed
- Quick closing
- NYC will honor for a year but it can be easily extended

Offering Plans

- Advantages for commercial conversions
  - Existing commercial tenants have no right to purchase
  - Not subject to lengthy requirements; treated like new construction offering plan
  - No rent regulation

Offering Plans (cont.)

- May be more flexible than for residential plans because sponsor:
  - Is free to sell or lease any particular space and reserve space for expansion
  - Can set up budget based only on estimated usage
  - Can control board of the building indefinitely
  - Can sell leased blocks of space
  - Has the right to create or reconfigure space

Offering Plans (cont.)

- May be more flexible than for residential units because sponsor:
  - Can reserve right to change function of space
  - Can unilaterally amend certificate of occupancy
  - Can control development rights, rights to use roof or right to decorate common areas
  - Can require purchasers to perform work
  - Can control, rent or sell signage

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