Building optimism

The current state of real estate development in New York City

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Where is the New York City real estate market heading in 2018?

Indicators suggest cautious optimism for the coming year, following a more subdued 2017. That was the consensus of insights from a number of prominent real estate professionals who spoke recently at KPMG LLP's conference, "The Current State of Real Estate Development in New York City."

While tenants are tending to leave midtown Manhattan for more southern and western parts of the island, overall construction activity is healthy and rents are trending higher. Developers are finding capital in ample supply and from a number of sources, while labor costs are becoming more competitive.

The city government is helping as well. The current administration has embarked on an ambitious program to develop more affordable housing and is looking for private developers to assist in the effort. In addition, the city has rezoned a number of areas, creating more opportunities for real estate developers.

To further fuel development, an unexpected addition to last year's tax reform legislation pertaining to Qualified Opportunity Zones (QOZs) offers an attractive tax incentive for investors interested in development in low-income areas.

The conference also offered the more than 150 attendees an opportunity to ask questions and have meaningful discussions with KPMG's leaders in real estate.

The following is a recap of the conference's presentations and panel discussions along with some recent market observations.

The Manhattan real estate market

Keynote speaker: Michael Cohen, Colliers International

While leasing volume was down in the first quarter of 2018, there is a more complex story underlying Manhattan's real estate outlook.

Manhattan comprises three main markets: Midtown, Midtown South, and Downtown. And the story that's emerging is that Midtown South has been the most robust performer of the three areas.

These markets are highly competitive, and one's loss is another's gain. Since the recovery, Midtown has seen a migration of tenants leaving its boundaries, and a net loss of 10 million square feet of space.

As to where these tenants have moved, the big winner has been Midtown South and its Hudson Yards development in particular. One reason for the movement to Hudson Yards is the appetite of tenants in Manhattan for brand-new construction.

Downtown has also benefited from this migration, gaining 6 million square feet from both Midtown and Midtown South. The main reason for Downtown's attractiveness is price. Downtown has gained tenants that have been priced out of Midtown South and is emerging as the bargain of the three areas.

Asking rents also reflect the growing desirability of Midtown South. For the first time in the history of Manhattan, the Plaza district has been eclipsed, and now Hudson Yards is the most expensive submarket in the borough. The extraordinary success of new construction, often at the expense of older construction, has been one of the underlying characteristics of this marketplace.

Although there has been rental growth throughout Manhattan, Downtown and Midtown South have fared much better than Midtown. To fully understand this indicator, one needs to consider the simultaneous growth in tenant-concession packages. These packages are rent incentives landlords grant to tenants as inducements to remain in or move to a building and tend to obscure the real picture of rental rate growth. There has been a steady growth in these packages through 2017.

Stripping out these packages provides a net effective rent that best captures the performance of the three markets. Looking at the net effective rate of each area, since 2012, Midtown's rose 8 percent, Downtown gained 23 percent, and Midtown South added 40 percent.[1]

As for new construction, most is planned for Midtown South, including Hudson Yards, because the investment community understands these trends and knows that it is the place to build. However, the pipeline for Midtown is also strong.

What does this mean for investors in Manhattan real estate? Right now, sales volume is up from 2017, which was a hangover year from 2015 and 2016, which were strong years for investment. Foreign capital still continues to flow into the city, both sovereign and independent.

[1] Colliers International, Research Data (based on captured completed office lease transactions recorded in Manhattan between Q4 2012-Q1 2018 with rents and concessions)

Development trends in Manhattan

Panelists: Jason Barnett, RXR Realty; **Norman Sturner,** MHP Real Estate Services; **Ziel Feldman,** HFZ Capital Group; and **Robert Koen,** Mayer Brown

Prospects for real estate development—both new construction and renovation—are strong, with ample supply of capital and more competitive pricing for labor, both union and non-union.

New construction is healthy on Manhattan, with many buildings partially or fully leased even in the early stages of construction. For example, L&L Holding Co. is redeveloping 380 Madison Avenue, which will be renamed 390 Madison Avenue at its reopening, expected this year. The reconfigured building will top out at 32 floors, compared to the original structure's 24.[2] JPMorgan Chase has announced that it would tear down its headquarters at 270 Park Ave. and build a 70-story building on the site for its world headquarters.[3] And Related Companies and Oxford Property Group continue to work on the Hudson Yards megaproject with its towers, high-end apartments, and parkland.[4]

Renovation work also offers opportunities. With the right location and the "right bones," an older property can be turned into a trophy asset that's competitive in price with other buildings.

Although these deals are getting bigger and costs are rising, there is ample capital available from numerous sources.

Compared with tighter credit in previous years, construction loans for new apartment properties are now somewhat easier to obtain, although the amounts remain relatively small compared to the total cost to develop a project.[5]

Smaller deals are looking to "friends and family" capital investments at the very start of the project, where initial costs, such as due diligence and feasibility studies, can be high. These investments can be the riskiest, and investors need to be in it for the long haul. But they do get a seat at the table early. Developers can also pursue a bridge loan to see them through the development stages and until a construction lender can be brought on board. There's also a growing awareness and use of private equity debt funds, which are providing mezzanine financing to fill in the gaps.

Although Manhattan real estate sales and prices fell in the last quarter of 2017,[6] these trends offer developers hope for a more positive 2018.

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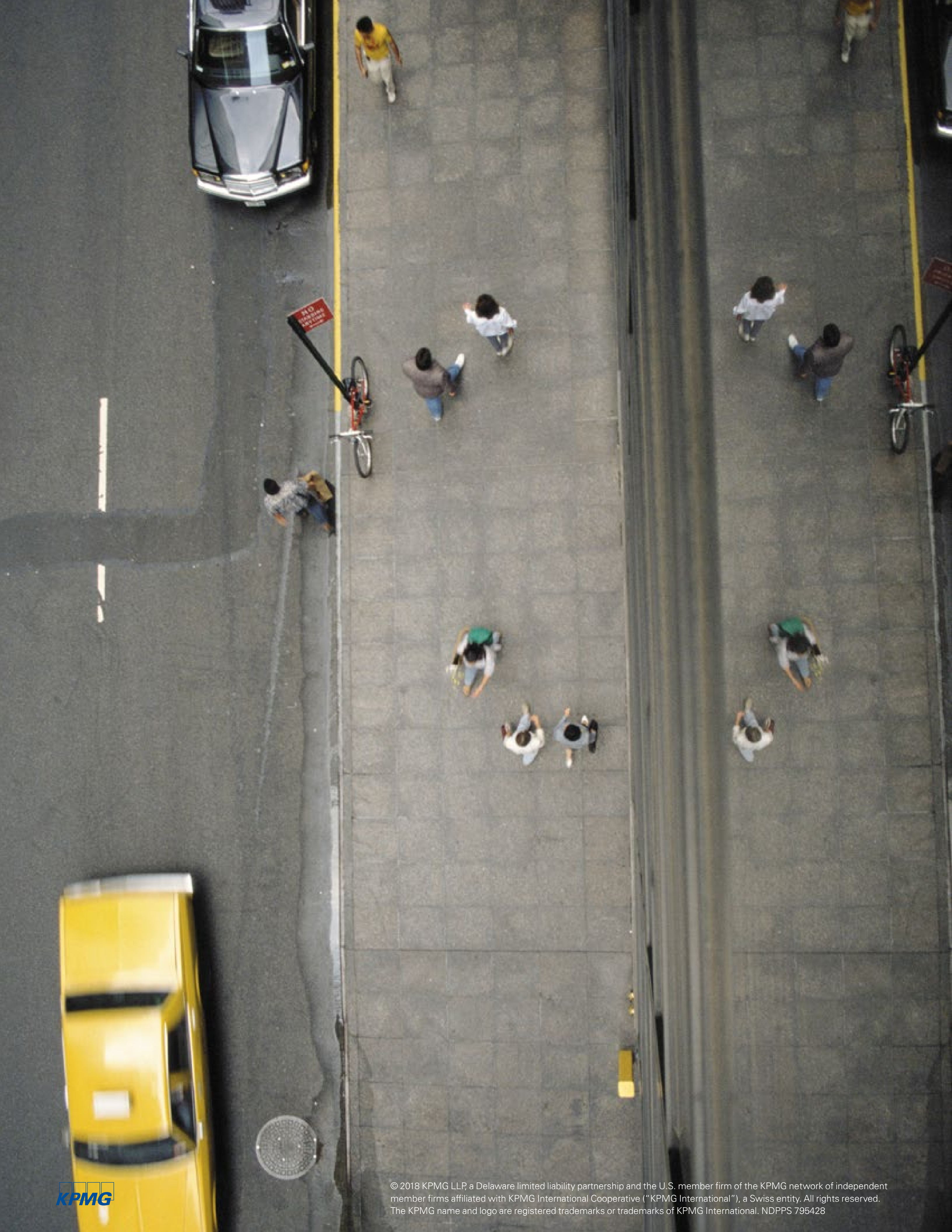
[2] "L&L's 32-Story Redevelopment of 390 Madison Avenue Tops Out, Midtown East," New York YIMBY, October 19, 2017.

[3] "Out With the Old Building, in With the New for JPMorgan Chase," *New York Times*, February 21, 2018.

[4] "Hudson Yards: A timeline of the megaproject's biggest buildings," Curbed New York Web site, April 4, 2018.

[5] "Banks Get More Generous with Construction Loans for New Apartments," National Real Estate Investor, June 19, 2018.

[6] "New York real estate has its worst quarter in 6 years," CNBC Web site, January 3, 2018.



Housing New York: The city's plan for affordable housing

Speaker: Eric Enderlin, New York City Housing Development Corporation

Ensuring sufficient affordable housing for New York City residents remains a critical challenge for city officials. But recent city efforts are helping to ease the situation, providing more options for New Yorkers to find acceptable housing within their budget. And with the city seeking public-private partnerships for the effort, it's offering an attractive opportunity for developers, as well.

Shortages of affordable housing in New York reflect a larger trend. Nationwide, there isn't a single state where an American earning minimum wage can afford to rent a two-bedroom apartment.[7] In New York City, more than 30 percent of residents spend more than 50 percent of their income on rent—an amount that would classify them as "heavily extremely rent burdened."[8]

To address this problem, the administration of Mayor Bill de Blasio in 2014 launched the Housing New York program, with an original plan to build 200,000 units of affordable housing in 10 years. To date, more than 109,000* homes have been financed.

The program's goals include more than just numbers. The plan also emphasizes creating inclusive neighborhoods, preserving existing housing stock, as well as building new construction.

Housing New York is taking a balanced approach to achieving affordability citywide. While the program is creating affordable housing for a wide spectrum of incomes—from extremely low to middle income—55.5 percent of the housing units created or renovated are aimed at low-income residents, that is, those with an income between 51 and 80 percent of Area Median Income (AMI).[9]

In addition, the plan includes tools like Mandatory Inclusionary Housing (MIH), which requires a share of permanent affordable housing wherever new housing capacity is approved through land use actions. MIH is designed be used in tandem with the 421a tax exemption, which New York City successfully sought reform of last year in order to secure affordability requirements citywide and end tax breaks for luxury condos.

The New York City administration continues to reassess affordable housing needs and based on that data continues to refine and expand its affordable housing program. Key points in the revamped and accelerated plan, Housing New York 2.0, include:

- Create more homes for seniors
- Protect affordability at Mitchell-Lama buildings (City-sponsored housing for moderate- and middle-income households)
- Build a fire wall against displacement
- Unlock potential for vacant lots
- Support homeownership for moderate income New Yorkers
- Enable innovation in new construction.

To achieve these goals, New York City has earmarked $11.9 billion in direct subsidies for its preliminary 2019 fiscal year and is working with developers towards these efforts, recognizing it can't build affordable housing without a public private partnership.

**109,000 reflects the current total units created or preserved as of June 2018.*

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[7] Out of Reach 2017, National Low Income Housing Coaltion: http://nlihc.org/sites/default/files/oor/OOR_2017_0.pdf

[8] 2017 NYC Housing Vacancy Survey (HVS) Initial Findings: https://www1.nyc.gov/assets/hpd/downloads/pdf/about/2017-hvs-initial-findings.pdf

[9] NYC's Housing New York 2.0: https://www1.nyc.gov/assets/hpd/downloads/pdf/about/hny-2.pdf

Navigating your real estate development—Rezoning impact, regulatory considerations

Panelists: Robert LiMandri, Vidaris; **Joseph A. McMillan, Jr.,** DDG; **Michael Shah,** Delshah Capital; and **Roger Pine,** Lettire Construction Corp./Urban Builders Collaborative, LLC

Residential construction has fallen in the five boroughs over the past year, both in terms of spending and number of units. However, that decline is a characteristic of the cyclical nature of the real estate industry, coming off robust periods in 2015 and 2016. In planning new projects, particularly around the city's affordable housing efforts, developers will need to grapple with multiple-dwelling regulations and rezoning, as well as an emphasis on construction best practices and sustainable design by New York City agencies.

One positive aspect is that city rezoning efforts—East New York, Jerome Avenue, Greater East Midtown, Bay Street Corridor, East Harlem, Gowanus—have created a number of opportunities for real estate developers, and the city is working with the private sector to figure out the best areas to rezone. At the same time, many developers are assembling large sites and reaching out to the city to initiate rezoning. That gives them the advantage of being first in line to work in the rezoned track, jumping ahead of the competition that occurs once rezoning has passed.

However, one of the biggest challenges facing developments including affordable housing in the city is the Floor Area Ratio (FAR) cap. The size of the lot severely restricts what can be built on it, the city-determined FAR which controls the size of buildings. With some exceptions much of the city's residential FAR is capped at 10.0 for market rate (before bonuses) and 12.0 for affordable (including bonuses). Loosening this floor area limitation would encourage development, particularly around transportation hubs. The challenge is getting city stakeholders to agree to the required legislation that would raise the residential FAR cap.

In addition to FAR, maximum density is another limiting factor in zoning, with the number of dwelling units capped at a building's total floor area divided by a specified factor (the smallest of which is 680 in high-density districts). Building code is different from zoning, but similarly restricts how multiple dwellings are sized and configured, such as with the minimum provision of accessible bathrooms, for example. These regulations force builders to work with their architect to make sure they can build their planned number of units.

Meanwhile, the city has mandated new safety measures and is stepping up its inspection of jobs sites. For their part, builders and developers are making the appropriate investments in training to ensure they are doing all they can to prevent accidents.


THE ART
OF MODERN
2012
MATTERS
OKLAHOMA
WRIGLEY'S
JVC
AT FB.ME/2012MATTERS
CHURCH BLASTS
SEPHORA
SEPHORA
STARBUCKS
COFFEE

Credits and incentives—Qualified opportunity zones

Panelists: Matthew Murphy, NYC Department of Housing Preservation and Development; **Joe Scalio,** KPMG; **Susan Reaman,** KPMG; and **Jay Ross,** KPMG

Last year's tax reform legislation included an unexpected benefit for real estate—a tax incentive designed to encourage investment in low-income communities designated as QOZs. The QOZ program allows taxpayers to defer capital gains by reinvesting gains into a Qualified Opportunity Fund (Q Fund) and to potentially exclude future gains on investments within the zone. A Q Fund, generally, is a partnership or corporation that holds 90 percent of its assets in QOZ property, which can include an interest in QOZ stock, a QOZ partnership, or QOZ business property. Q Funds are self-certified by the taxpayer. A form is included with the tax return stating that the investor has set up a fund, partnership, or corporation that has the purpose of investing in these QOZs. No IRS certification or action is required. The IRS has recently provided more information about investing in Q Funds through a series of questions and answers (FAQs).

The tax benefits under the QOZ program are significant. First, the QOZ program allows for the deferral of certain gains from the sale or exchange of property if those gains are reinvested in a Q Fund within 180 days beginning on the date of the sale or exchange. The gain rolled over into the Q Fund is deferred through December 31, 2026, at which time the gain must be recognized regardless of whether the investor has exited the Q Fund investment. Second, up to 15 percent of the deferred gain may be eliminated if the Q Fund investment is held for 7 years. Finally, gain on the Q Fund investment may be eliminated entirely if the investor holds an interest in the Q Fund for 10 years.

For example, Steve invested $1 million in a successful Internet start-up. In 2018, he sells his Internet stock for $11 million. Under the QOZ program, he may defer his $10 million capital gain until December 31, 2026 by investing in Q Fund Brooklyn, a Q Fund investing in downtown Brooklyn real estate. Because he has held his interest for more than 7 years, he recognized only $8.5 million of capital gain (i.e., he is taxed on only 85 percent of his gain on the Internet stock) on December 31, 2026. In 2029, he sells his investment in the Q Fund for $20 million. Under the program, he pays no federal tax on the sale of Q Fund Brooklyn.

These Q Funds are expected to be popular, but there still remains some questions that will impact the details of the tax benefits. There are many investors with large amounts of capital gains. What's more, mechanics of setting up a Q fund are simple and as is the process of the self-certification. The expectation is that these investments will be a great source of funding for developments in New York as well as throughout the country.

About KPMG's Real Estate practice

KPMG advises owners, managers, developers, lenders, intermediaries, construction and engineering firms, and investors in effectively executing complex transactions ranging from acquisitions and dispositions to securitization of real estate properties and portfolios to entity-level mergers and acquisitions. We believe that our experience and knowledge can help you successfully address today's challenges and help you prepare for tomorrow's opportunities.

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