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The New York Office Market is Facing an Existential Hurricane

– Land & Buildings sees New York office vacancies reaching 20% and rents declining 15 to 20% –

– Believes Empire State Realty Trust (ESRT) uniquely in the crosshairs, but office landlords across the city likely to suffer –

Stamford, CT (May 6, 2020) – Today Land and Buildings Investment Management LLC (together with its affiliates, "Land & Buildings") issued the following statement regarding its belief that the New York office market is facing an existential hurricane and that Empire State Realty Trust (NYSE: ESRT) is poised to bear the full brunt of this storm.

The New York Office Market Isn't Facing 'Headwinds' – It's Facing an Existential Hurricane

Numerous headwinds have weighed on New York office landlords in recent years as rent growth has stalled and values plateaued. Then a hurricane began to form in 2018, as the $10,000 cap on the state and local tax (SALT) income deduction hurt New York's competitiveness. Things continued to worsen in 2019, as WeWork (NYC's largest office tenant) began its implosion. Now in 2020, this existential hurricane has become a Category 5, as NYC is the epicenter for COVID-19 in the United States – and Empire State Realty Trust is poised to bear the full brunt of this storm.

In the midst of the pandemic, many companies have begun to question the need for physical office space at all, as the necessity of work from home (WFH) provides a real-time and real-life look into a potential future with fewer workers in offices.

NYC Fundamentals were Tepid Before COVID-19 And Could Be Severely Impaired in the Aftermath

New competitive construction, soft demand from financial services tenants and corporate relocations have all weighed on Manhattan office fundamentals over the past several years.

Millions of square feet of new office developments, particularly at Hudson Yards on the west side of Manhattan, have weakened the incumbent landlords in the city. These amenity-filled, Class A assets have primarily pulled tenants out of legacy midtown Manhattan office buildings, pushing up vacancies. Another 25 million square feet of new office product is still planned to be delivered between now and 2024. While some development plans may be on pause for now, this pipeline will likely continue to absorb any incremental demand, especially as user needs adapt to a post-COVID world and require new fit-outs.

In the wake of the Great Financial Crisis, financial services tenants have failed to be the engine of growth that historically has powered the New York City office market. Financial service tenants have increased their footprint in Manhattan by just 0.5% on average annually over the past decade according to data provided by CBRE and may now be poised to shrink.

New York City office vacancy could reach 20% or more. During the last two recessions, the vacancy rate increased by 600-900bps. Considering that the current Manhattan office vacancy rate is 11.3%, a 20% vacancy rate estimate could actually prove conservative. Moody's Analytics forecasts national office vacancy rates rising to 20% by 2021 with rents in New York City plummeting as much as 25%.

According to Cushman & Wakefield, Midtown Manhattan net effective office rents have been roughly flat since 2015, despite the strong growth in the broader economy. With vacancy poised to rise sharply, a 15-20% pull back in rents appears likely.

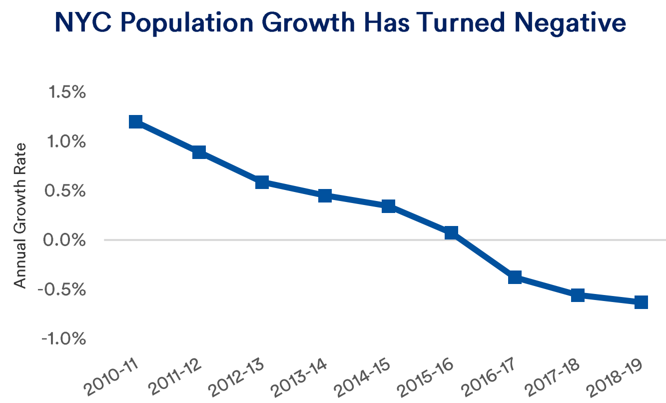
Given the negative outlook cyclically and the cloudy (at best) outlook on secular demand, valuations are likely to come under pressure. Significant capex will be needed to upgrade assets, remain competitive in attracting tenants, and refit office space for a post-COVID world. It would not be a surprise to see cap rates rise from the mid 4% range to 6% over the next several years for Class A New York City offices, while Class B assets could fare far worse.

Additionally, a significant portion of New York City office rents and value is derived from the street retail at the base of these assets. Given the multitude of issues with brick and mortar retail tenants, this real estate is likely to see outsized rent and value deterioration.

SALT and Population Headwind

The Tax Cuts and Jobs Act of 2018 capped the deduction of State and Local Taxes (SALT) at $10,000, putting New York City at a competitive disadvantage. People have been moving to lower tax states (e.g. Texas and Florida) and businesses large and small have followed.

New York City's population growth turned negative for the first time in 2017, legged down again in 2018 and appears poised for further trouble as housing remains inadequate across the city and the current crisis once again puts New York in the crosshairs.

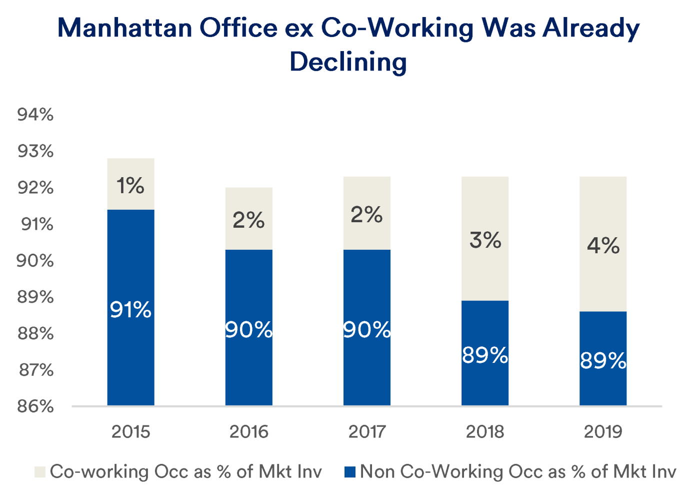


Source: U.S Census Bureau

New York City Comptroller Scott Stringer estimates unemployment may rise to 12% from 3.8%, with 900,000 job loses by the end of June compounded by a decline in tax revenues which creates an $8.7 billion hole in NYC budget.

WeWork and Co-Working's Massive Retrenchment

WeWork and other co-working firms were the largest consumers of office space in New York City during the past several years, in some cases accounting for 100% or more of the positive leasing absorption each year. In total, co-working space accounts for 4% of the office market in New York City, up from less than 0.5% in 2010. WeWork alone occupies 9 million square feet in the city. WeWork's well publicized financial troubles were dire prior to COVID-19. In the current paradigm, the business model appears untenable. The social distancing era is likely to dramatically diminish the popularity of co-working space and the current recession will further reduce demand, potentially substantially. Short-term leases, high rents and poor credit tenants make co-working businesses uniquely vulnerable to near-term stress, which could alone add 3% to the vacancy rate in Manhattan.



Source: CBRE Research, Evercore ISI Research

Work from Home Sealing New York City Office Fate

The accelerant to falling demand for New York City office space may well be the success companies are enjoying with the work-from-home (WFH) approach, which is delivering impressive productivity. The CEOs of bellwether financial firms (and two of New York City's largest office users), Blackrock and Morgan Stanley, have suggested these companies will need significantly less office space in the future.

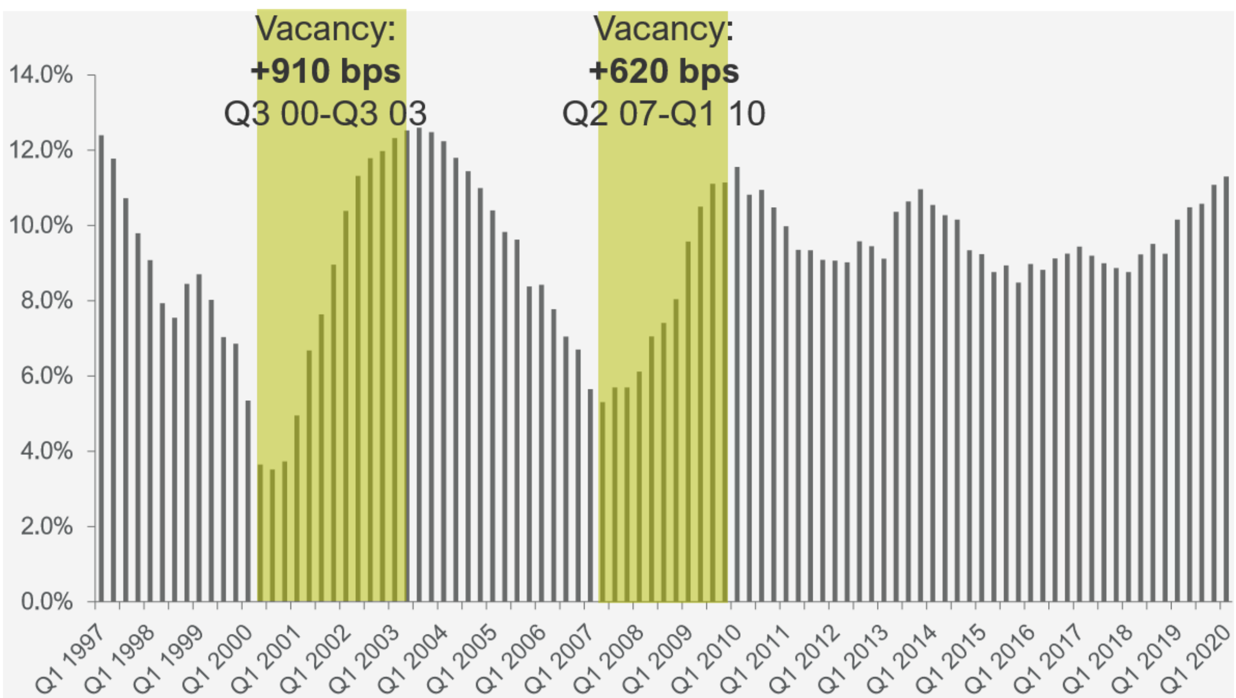
First, in mid-April, James Gorman, CEO of Morgan Stanley, stated that he expects his 90,000-person workforce to require "much less real estate" going forward as "we've proven we can operate with no footprint." He envisions a future with many Morgan Stanley employees working from home, at least part of the time.

Then Larry Fink, CEO of Blackrock, made a similar comment about the world needing less commercial office space, stating, "I don't think any company's going to go back to 100% of the workforce in the office."

And, in early May, Bank of Montreal (BMO) echoed these comments, indicating that 80% of employees may switch to blended home-office work. BMO's Chief Human Resources Officer said, "It allows us to look for new talent in locations where maybe we haven't before and tap into talent pools across the country." The reduction of the need to be in New York City to tap into the local talent pool is a major potential headwind.

As firms reduce headcount and cut costs to weather the recession, office real estate will be at the top of the list to shed, and the pandemic concerns will be a convenient scapegoat.

Manhattan Office Vacancy Already Elevated and Prior Crises Led to Substantial Occupancy Losses



Source: Citi, Cushman & Wakefield

<u>Empire State Realty Trust (NYSE: ESRT) at the Center of the Storm</u>

Empire State Realty Trust, the owner of the iconic Empire State Building, is getting hit from all sides.

- The Empire State Building observation deck, which generated nearly $100 million in 2019 or 25% of the company's net operating income, currently has essentially no revenue and will likely see listless demand until a vaccine is found. However, even then demand may be challenged as international travel/tourism will likely be among the slowest to rebound from the recession and new competition opens. Just a few blocks away at One Vanderbilt, a new state of the art observation deck from SL Green (NYSE: SLG), will surely pull out all the stops to ensure a successful launch.

- The company’s retail tenants are smoldering with stores closed and rent collections of just 46% in April and likely to get worse in May. To the extent the company’s retail tenants survive and re-open, sales volumes will likely be a shadow of their former self for an extended period of time, suggesting meaningful rent impairment today or as the leases expire.
- Then there are the office spaces themselves. ESRT office buildings are much older than public REIT peers and cater to fashion and apparel tenants in particular given the garment district location. Top tenants include Global Brands (i.e. Calvin Klein, Jones New York etc.), PVH Corp. (i.e. Tommy Hilfiger etc.), and Macy’s. Just 73% of the office tenants paid April rent, which compares to 90 – 95% for most other office companies which have reported. Occupancy losses and rent declines are likely to be particularly acute for ESRT.

Empire State’s shares face meaningful cyclical and secular headwinds and could move substantially lower as the COVID-19 pandemic bares its full fury. L&B has a position in ESRT.

– Jonathan Litt, Founder & Chief Investment Officer

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