

## How to Hurt New York's Commercial Property Stock

### Brought to you by the City Council! First step: Commercial rent regulation

As a New Yorker, some of the actions taken by the City Council really make me scratch my head, particularly when it comes to initiatives that will clearly force unemployment to climb, tax revenue to decrease, and the deterioration of our commercial properties to accelerate. If the Council's initiatives are implemented, New Yorkers will suffer significant job losses and further erosion of our tax base. Our deficits are at historical levels, and a main objective should be job creation, not job destruction.

In fact, we need job creation now more than ever. Our local unemployment rate, at 10.8 percent, is already above the national average. We need jobs to help our local economy, and those very jobs will help our commercial real estate market. Unfortunately, the initiating and endorsing of bills that are anti-stimulative and anti-job creation seems to be a growing trend.

One of these horrendous bills was part of the proposed rent-regulation-reform package passed by the New York State Assembly earlier this year, which had the endorsement of the City Council. Among other things, there was a bill proposing the limitation on the benefits of making major capital improvements (MCIs) and individual apartment improvements (IAIs) to multifamily properties.

In the 1970s, the quality of our housing stock deteriorated significantly. Because of rising costs of ownership, which could not be mitigated due to rent regulation, many buildings were abandoned and burned and entire neighborhoods suffered. The Legislature, in response, created a system of rent regulation in which an owner was rewarded with rent increases for making MCIs in a property and for upgrading the quality of a unit via an IAI.

The legislation motivated the private sector to invest in the city's housing stock. It has been estimated that on an annual basis, these two incentives create approximately \$500 million of private investment. These programs have been an enormous success, and the dollar value of investment in housing that they represent far exceeds state and city investment in affordable housing.

Under Bill A01928, rent surcharges for MCIs would be prohibited after the cost of the improvements have been recovered. Therefore, the primary incentives to upgrade building systems in the older rent-regulated housing stock will be eliminated if the Senate passes this bill. Sixty percent

of New York's stabilized housing stock is at least 80 years old, and old buildings require more maintenance, not less. The proposed law creates incentives for owners to do little more than patch and minimally repair building systems that are antiquated and obsolete, rather than replacing them.

This bill will hurt the construction industry, as all of the renovation and improvement work that would have been done will not be. There will be less need for carpenters, electricians, plumbers, etc. This deterioration in the housing stock will erode property values and ultimately have negative implications for our real estate tax base.

As if this anti-stimulative and job-eliminating bill was not enough, recently the City Council introduced Bill 847-a, which contemplates commercial rent control. If passed, the negative impact on employment, our real estate tax revenue and our stock of commercial properties will be disastrous for our city.

**Similar to the reduction in the quality of the housing stock that pending residential bills will cause, the commercial rent control bill will cause a reduction in the quality of the stock of commercial space within the city, as owners would be unable to upgrade swaths of space the way they normally would. According to Mary Ann Tighe, CEO of the tristate region of CB Richard Ellis, by 2010, 63.4 percent of the stock of commercial properties in New York City will be more than 50 years old.**

The bill seeks to restrict the ability of an owner of a non-residential building to freely decide what they are able to do with commercial space when a tenant's lease is expiring. The bill covers any building or space occupied for non-residential purposes, including, but

not limited to, offices, retail, manufacturing, industrial, professional services, cultural and nonprofit entities that meet four distinct criteria. The criteria: The tenants are residents in the city; they are independently owned and operated; they are not dominant in their field; and they employ 100 or fewer people.

The basic concept of this bill is that tenants falling under the categories above will be entitled to recurring 10-year renewal leases based upon a substantial set of guidelines, with rent levels that can only rise based upon legislated increases. The bill proposes only a short list of cases in which a property owner could avoid renewing a tenant's lease, regardless of the owner's history with that tenant.

The owner would not even have the right, in some cases, to occupy the space for their own purposes upon the expiration of a lease.

This mandatory renewal mechanism opposes the natural forces of the free market system. The commercial sector has been allowed to operate under market conditions, where price mechanisms interact with supply-and-demand characteristics. It is obvious that there is an anti-capitalism movement afoot, but this bill takes things to new heights.

The steps under which these controls would be implemented would be cumbersome and expensive. Within 180 days of the expiration of a lease, the landlord must make a proposal to the tenant for a new lease term. The tenant could choose, if the parties are not able to agree on the terms of the renewal, to enter mediation. If the mediation is not successful, the parties would go to "binding" arbitration, although if you read the bill carefully, it becomes clear that it is only binding on the property owner.

The bill includes a list of nearly 20 items that an arbiter would consider in determining the renewal rent for the 10-year extension. The tenant is not obligated to accept the determination of the arbiter. If the tenant elects not to pay the rent set by the arbiter, the tenant would be allowed to remain in possession of the space at a rent no greater than 5 percent above the average rent charged during the final 12 months of the last lease, "until such date on which the tenant shall remove his or her property from the premises."

Furthermore, in the event the owner receives a written "bona fide" offer from a prospective tenant to rent the premises, the owner must first offer the current tenant the option of entering into a lease at the rent and other terms agreed to by the prospective tenant and owner. This gives the tenant a right of first refusal.

How will this mechanism realistically work? It seems obvious that the tenants will never agree to the owner's initially proposed renewal terms. They will go to mediation and then nonbinding arbitration, simply delaying as long as possible, as this delay has no downside for them. The only reason for a tenant to possibly agree would be if they believe the market rent a new tenant would be

willing to pay could be higher than the arbiter's determination. Otherwise, they will only be responsible for paying the small increase over the last lease until a new tenant has been found. They will then likely exercise their first right of refusal and stay in the space.

The implications of commercial rent control are numerous, significant and potentially disastrous for our city. A tremendous amount of economic activity in New York City is created by property owners constantly refurbishing commercial space in the form of tenant improvements for new tenants or building out new space, on a speculative basis, to attract new tenants to their properties. To the extent a significant portion of the tenant base within the city stagnates, by virtue of these perpetual lease renewals, there will be no need for that renovation work. The reduction in this economic activity will significantly impact the construction industry, causing the elimination of thousands of construction jobs.

Similar to the reduction in the quality of the housing stock that pending residential bills will cause, the commercial rent control bill will cause a reduction in the quality of the stock of commercial space within the city, as owners would be unable to upgrade swaths of space the way they normally would. According to Mary Ann Tighe, CEO of the tristate region of CB Richard Ellis, by 2010, 63.4 percent of the stock of commercial properties in New York City will be more than 50 years old. In the rest of the country,

the average is only 28 years. Creating a program that accelerates the deterioration of an already aging stock makes absolutely no sense.

The restraints commercial rent control will place on commercial properties will negatively impact property values. The more cumbersome it becomes to operate a property, the higher the yield has to be to encourage an investor to purchase that property. This reduces value, as do the artificially low rents created by these controls. As value diminishes, so does our all-important real estate tax base. According to the Real Estate Board of New York, the city's fiscal year 2010 budget shows \$16.1 billion of real estate taxes making up 44.6 percent of all tax collections and 26.3 percent of all city revenue. We have estimated that the commercial rent control bill could reduce the real estate tax base by as much as \$1.8 billion annually. The city cannot afford this reduction, particularly at a time when our deficits continue to grow and insolvency is not an impossibility.

Ironically, the commercial rent control bill is actually anti-small business, as owners will not want to rent space to qualifying companies. It will discourage developers from providing retail space in their smaller projects, thereby reducing the supply of retail space. Such reductions would also occur in buildings where retail rents and residential rents are at similar levels. This space would undoubtedly be converted to residential, reducing valuable amenities and services to a neighborhood.

Additionally, passage of this bill will put start-ups at a disadvantage, as owners will not be inclined to accept these tenants. It would favor the very chain stores and large-space users that the bill opposes, as they wouldn't burden owners fearful of being trapped by rent-controlled mom-and-pop tenants.

For so many reasons, this bill would have negative implications for the city. Significant numbers of jobs will be lost and tax revenue will evaporate. It is incomprehensible that, at a time when our fiscal stability is in question, something like this could even be considered.

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