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Soaring Retail Rents Keep Vacancies High, So Prices Should Come Down—Right? Maybe Not.

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Twenty-three Wall Street in the Financial District has gone over a decade without a suitor.

The last time this address had a tenant was when George W. Bush was president of the United States, the words "cronut," "Tebowing" and "hashtag" were meaningless, and Osama bin Laden was still a wanted man—in this case, the tenant was J.P. Morgan & Co. In fact, it was called the Morgan Building. But that was then.

In 2008, China Sonangol International bought the building for $150 million from Africa Israel. Last year, Sam Pa, who led China Sonangol, was arrested in China on corruption charges, and the Wall Street building continues to sit empty.

And such sights are not so uncommon in Gotham. If you're walking around the city playing Pokémon Go, chances are that you'll notice an increasing number of storefronts that are sitting empty. With a slowdown in global retail growth and surging rents, there have been fewer retail tenants vying for space leading to more vacancies. On the other hand, neighborhood upzoning has attracted high-income buyers in places that often have low foot traffic, which is not suitable for retailers.

Last month, a computer programmer named Justin Levinson released an interactive map (published by *am New York)* that showed a massive amount of vacancies in Manhattan, most notably in Soho and Lower Manhattan, which Levinson attributed to jacked-up rents (he called it "high-rent blight").

Despite this, a lot of landlords are refusing to embrace what is seemingly the easiest solution to this crisis: bringing rents down. Instead, many are waiting for "Mr. Right Retail" tenant, using this desirable tenant as a kind of advertising for their office space above.

"We could rent to a bank but that wouldn't add value to our office space," said Andrew Wiener, the director of leasing at L&L Holding Company.

In such cases—the argument goes—the ideal retail client could bolster the entire commercial corridor, with potential tenants in other office buildings clamoring for space because of proximity to a high-profile retail tenant that L&L has signed at its building. L&L has used this strategy to find food-based tenants at the base of two office buildings, like Eataly at 200 Fifth Avenue in the Flatiron District and Nobu, which will open at 195 Broadway in Wall Street in 2017. But, while in pursuit of this type of tenant, Wiener said he would consider keeping a retail space vacant for up to two years.

Landlords aren't always practical in the search for an ideal tenant. They may hold out hope of leasing to a national chain, but there is a limit to how many national brands can enter a given retail corridor.

“In Hylan Boulevard, Staten Island, big banks came in for stupid money, and everyone wanted a similar deal,” said Scott Plasky, a retail specialist at Marcus & Millichap. “But now there are eight banks on the street and if you’re the guy who has held out, you’ve lost a lot of money because there are only so many banks you can have.”

According to Plasky, landlords who wait for their ideal tenant are generally approached by small businesses but reject them because they want a national chain—like TD Bank, CVS or Starbucks—and a corporate guarantor, which could solve their rent woes. But this leads to a vicious cycle, into which the entire retail corridor is sucked.

“It hurts everyone when spaces are intentionally kept vacant,” Plasky said. “If people can’t walk two blocks for all their needs, they’ll go somewhere else.”

When a retail corridor deteriorates because of its empty spaces, the first tenants to leave because of low foot traffic (and consequently fewer customers) are the mom-and-pop businesses. New York City Department of Small Business Services works to break this pattern.

“We are empowering communities to fill vacant retail space through our grant programs, which provide direct financial support to local organizations that in turn, attract new businesses and stimulate commercial investment,” Gregg Bishop, the commissioner of SBS, said in prepared remarks.

In 2012, Bishop’s organization gave the Grand Street Business Improvement District a $25,000 grant to use a formal market study by Larisa Ortiz Associates to reduce vacancy rates and attract new businesses to Grand Street in East Williamsburg, Brooklyn.

But there is a certain art to matching the right space with the proper tenant on a strip like the one along Grand Street between Union and Bushwick Avenues in East Williamsburg. “We can’t bring an Old Navy to Grand Street because there is no room for it at the moment,” said Artineh Havan, the executive director of the Grand Street BID. “The footprint here is small, and this organically attracts smaller businesses.”

Williamsburg has turned from a depressed, industrial area to a hipster habitat, leading to an influx of retail. The Grand Street corridor has been upzoned, increasing property values as owners can now build taller. Havan said that this has unjustly increased landlords’ rent expectations.

The Grand Street BID presents these landlords with market research to help them come up with more realistic uses for their empty spaces. As a result, a Korean restaurant called Mahji will be opening later this summer at the vacant 617 Grand Street. The grant also resulted in L-Train Cross Fit Gym and Anna’s Spa, both small businesses, signing leases at 667 Grand Street and 644 Grand Street, respectively.

A chichi address, like this one on East 23rd Street between Madison Avenue and Park Avenue South, is no protection; This was occupied by Time Warner Cable and the landlord is now awaiting the right tenant

Of course, not all long-term vacancies are due to a greedy landlord looking to make a big score. In fact, the overall trend suggests that rents are going down. In the Real Estate Board of New York's most recent spring report on the Manhattan retail market, the association found that 10 out of 17 retail corridors had seen decreasing asking rents. (They also predicted that there would be more vacancies in the near term.)

Some of the vacancies create a chain reaction in a desirable neighborhood, which can be lethal when rents get as high as they currently have been. Tony areas of Manhattan such as Fifth Avenue between 49th and 59th Streets, for instance, had average asking rents of $3,398 per square foot on the ground floor as of the spring, according to the REBNY report. The heart of Times Square—Broadway and Seventh Avenue between West 42nd and West 47th Streets—averaged $2,363 per square foot at the street level.

Gaia DiLoreto started By Brooklyn, a business that sold Brooklyn-made products at 261 Smith Street in Carroll Gardens, down the block from a lot that had been vacant for 10 years.

She shut her business down this April, after operating for five years, largely because she said the empty lot was unkempt and discouraged people from walking down the street.

With declining foot traffic and peaking rents, mom-and-pop stores were priced out, which led to more vacant spaces that proved to be dismal for the retail corridor and her business.

"People live in this city for the diversity, and when mom-and-pop shops are gone, you lose the diversity—it looks like suburbia with those big malls," she said. "A good tenant may pay less but will be there for longer compared to more high-end stores."

Often, taking lower rent to accommodate smaller stores is not an option for landlords. The value of a property is directly reflected in its cash flow and certain landlords have lenders to which they are answerable since banks lend on certain assumptions. If a particular dollar value is listed in the landlord's mortgage document, not renting to reach that value could potentially lead to legal challenges. But if the space is kept empty, the lender can be approached for negotiation, according to James Famularo, the senior director of retail leasing of Eastern Consolidated.

"No landlord wants to keep their retail space vacant," he said. "They'd like to monetize it."

But charging lower rent reduces the value of the net operating income. This is an important figure to an investor as he calculates the returns. So, in such cases, rejecting clients that offer lesser rent might be more a market pressure than a personal choice.

Just like landlords have certain obligations to their lenders, retailers have certain obligations to their customer base and its changing needs. They realize that retail, especially in prime spots, is risky and expensive and are now looking for smaller spaces or shorter leases. Shorter leases can help both landlords and retail tenants break out of their holding pattern, especially since "pop-up shops" have become such a sweeping trend.

Landlords with vacant spaces can earn income on a short-term basis and be locked into a flexible deal that doesn't stop them from recapturing the space if they have a long-term tenant. At the same time, tenants can test the waters and use that period to scout more economically viable, long-term alternatives.

Lumas, a high-end photographic gallery at 875 Washington Street in the Meatpacking District, signed a lease for six months in late 2015. A short-term lease helped it gauge customer response to its service and helped it understand its area of operation better, according to Robin Abrams, a principal of the Lansco Corporation. After its lease ended, the gallery extended it for nine more months—another shorter, flexible lease.

The alternative to not having a tenant is taking a loss on federal taxes. This is a perverse incentive but one that reduces the tax burden for the landlord. This will not make an immediate difference, but if the landlord has a tenant in the space the next year, it only has to pay taxes for the difference between the net income and the loss, according to Daniel Shapiro, the co-chair of the tax department at Berdon. But if the landlord has another profitable property that has rent-paying tenants, he can offset the loss from the income and pay tax on the difference, which is a benefit.

It's not ideal. "A wise colleague told me that until effective income tax rates reach 100 percent, a dollar of income is worth more than a dollar of deduction," Shapiro said. But it becomes a lot more optimal if a landlord knows that the market is going up.

Suppose a landlord owns a property that costs $10,000 a year to maintain and he can charge $12,000 in rent. But let's say he knows that he can charge $20,000 in two years; he might not want to be locked into a 10-year lease this year and thus not get that higher rent later.

So in one scenario, he might decide to take the loss for the first few years—all the while knowing he'll start to make the money back by say the third or fourth year of a lease. This only makes sense, however, if the landlord knows that the rents are going to rise. There's no benefit to taking the tax loss if the rents are going to stay flat.

But sometimes spaces stay vacant because retailers are changing their footprints. Some are shrinking their square footage because of online sales; others are doing the opposite to cater to customers used to the suburban mall sprawl. In these cases, it might be taking a while for landlords to get creative and catch up.

Larisa Ortiz, the founder of Larisa Ortiz Associates, a consulting firm specializing in commercial revitalization, pointed to Steinway Street in Astoria, Queens, as a place where it took some out-of-the-box thinking to create win-win situations to fill retail vacancies.

Steinway Street is a regional shopping destination with big apparel brands like sister companies Gap and Old Navy, as well as Express. But the buildings there are small and the retailers were slowly outgrowing their 1,000- to 2,500-square-foot spaces. Faced by the threats of these brands moving out, the local business improvement district worked with different landlords to combine their spaces to accommodate their retail tenants. For this to work, some landlords had kept their spaces vacant until the leases in other landlords' spaces expired so that they could combine sites, Ortiz said.

But the opposite seems to be true, generally, for retailers in the borough. Rising rent is forcing retailers to shrink the amount of square footage in which they operate. As a rule of thumb, up to 10 percent of the revenue a retailer makes goes to rent, according to Ortiz. When the rent increases and the revenue stays the same, tenants start to feel the squeeze.

"People are unrealistic about what their property is worth," said Colby Swartz, a managing director at Suzuki Capital. "But landlords are slowly starting to get more realistic."

According to Swartz, given the number of retail vacancies in New York City retail tenants have good leverage. Landlords are realizing that some spaces are more difficult to rent than others, so if legally possible, landlords are increasingly opting to break down their 4,000-square-feet (or larger) spaces to create 1,500- to 2,500-square-foot spaces.

"Smaller spaces are harder to find because there isn't an inventory for them out there," Swartz said.

Ironically, though, because smaller spaces are rare, the landlord can demand a 15 to 20 percent premium per square foot, depending on the location. But because tenant-landlord dynamics are changing, landlords are also throwing in more incentives like rent concessions, or flexibility in terms of leasing (or a gift card or even a Porsche to brokers sometimes instead of cutting rents).

Filling a vacancy is a delicate dance between the landlord and the retail tenant—with lenders and consumers orchestrating it. The "ideal tenant" or "the perfect landlord" is a myth, and while both parties are getting creative to reach a sweet compromise, they often end up waiting for Godot.

With additional reporting provided by Terence Cullen (https://commercialobserver.com/author/terrence-cullen/).