POST-ELECTION NEW YORK REAL ESTATE: A VIEW FROM THE MIDDLE

BY STEVE DENARDO

DECEMBER 2016

One might be tempted to jump to the conclusion that having a newly elected president with his name splashed across iconic buildings throughout New York City is unequivocally positive for local real estate. While likely true in a broad sense, the reality will be more nuanced, with winners and losers in different market segments, project sizes and even neighborhoods. Proposals floated during the rhetorically charged campaign have far-reaching implications for global capital flows, domestic fiscal policy and regional socio-economic population dynamics that will likely play out in slow motion over the next four years. As important as these new dynamics may be, New York City had been thriving long before this president-elect won the electoral vote. The underlying trends defining its role in the global asset ecosystem as well as its diverse regional micro-markets are driven by forces far beyond the control of any one administration. The old saying "don't bet against New York" is as true as ever, but where do you place your bets?

GLOBAL AND DOMESTIC POLICY IMPLICATIONS

Among President-Elect Trump's campaign pledges were: lowering taxes; decreasing regulation; and spending on infrastructure.

Lowering Taxes

The prospect of cutting corporate taxes from 35% to 15% in addition to keeping capital gains taxes at 20% could increase real estate operator profits while still allowing them to reinvest into capital expenditures. One concrete example is President-Elect Trump's highlighting the positive attributes to real estate remaining a depreciable asset in addition to the 1031 Like-Kind Exchange. These have significant positive implications for investment and liquidity in real estate markets.

Decreasing Regulation

President-Elect Trump's ambitions for broad financial market regulatory reform, including a repeal of Dodd-Frank and other restrictions considered particularly onerous on banks and financial institutions, has already buoyed stock valuations to record highs. Given the significance of the financial industry to New York's tax base and that industry's impact on demand for residential properties, this is yet another broad positive for the industry generally and the New York region specifically.

Spending on Infrastructure

Increasingly, President-Elect Trump has made clear that he plans to put Americans back to work with a massive national infrastructure plan. His proposals already have broad bi-partisan support. The form and scale have yet to take shape, but they are already being touted as unprecedented since the New Deal, and likely to involve significant tax credits and public-private partnerships. The implications for regional markets are not as clear as for the broader economy, as there may be some displacement of capital, and these developments deserve close watch.

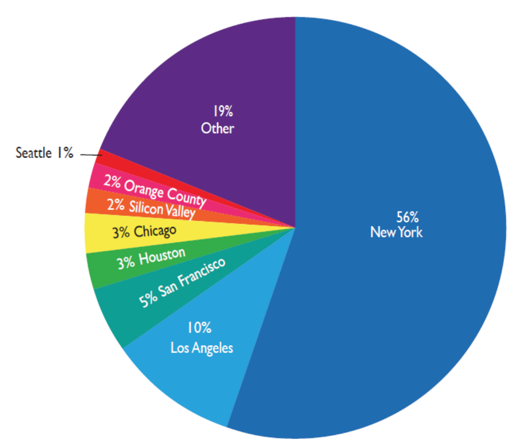
NEW YORK CITY REAL ESTATE

The day after the election, Crain's New York Business ran the headline: "President-elect Trump unlikely to hurt real estate industry that made him." This is likely putting it mildly. As of this writing, it appears that President-Elect Trump's proposed cabinet and broader administration will be flush with names and faces from New York City, including industry friendly politicians, bankers, private equity moguls and real estate magnates. The implications for New York City real estate markets are significant. New York has seen immense growth year over year tracing back to the great recession. 2016 sales volume is already shaping up to be the third best year ever at $59.2 billion after 2015 and 2007's record breaking $77.1 billion and $62.2 billion respectively. Interestingly, while the statistics are still dominated by large-scale projects in Manhattan, growth in the other four boroughs has been more consistent and significant on a percentage basis year over year. President-Elect Trump's primary impacts on New York City real estate will likely manifest themselves through: foreign capital flows; sanctuary city dynamics; and costs of construction.

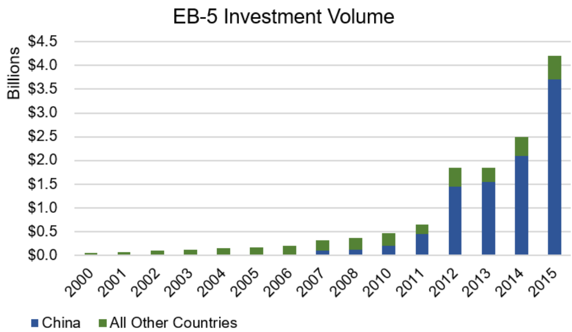
Foreign Capital Flows

Foreign investment into US real estate has been in a long-term rise for decades. Chinese foreign investment has been particularly significant. While some market observers have expressed concerns that the nationalist tendencies voiced during the campaign might somehow be reflected in a slowdown or redirection of investment to other countries, the strength of the US dollar is the best indicator that the US remains the global "safe haven" of choice, particularly for Chinese investors as the Yuan continues to be devalued. Of course, there is also the seemingly friendly relationship that Mr. Trump has with Mr. Putin which may reinvigorate Russian investment in luxury buildings. One interesting indicator of the

Chinese commercial real estate acquisition by metro area ($m)

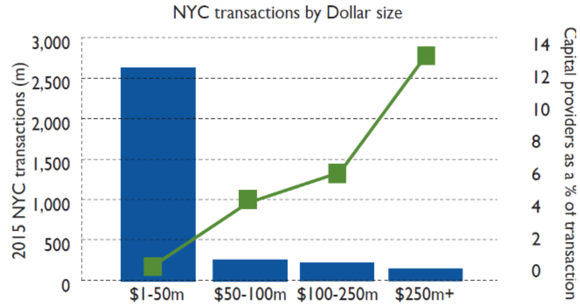


immediate impact will be the flows into the EB-5 program, in which America sells its citizenship for a minimum of a $500,000 investment in the United States. The program is set to expire on December 9, but will most likely experience another short-term extension or total facelift. This would be consistent with President-Elect Trump's less heeded call for an increase in "legal" immigration and support even further foreign investment in US real estate. Clearly, the interest in US citizenship and the related invested inflows have been rising at a remarkable rate. When one considers that the commercial real estate focused portion of investments that get directed into New York have been over half of the national total, the potential for future growth is significant and likely not to abate.



Sanctuary City Dynamics

A battle is brewing over New York's role as a leading "sanctuary" city. Mayor Bill DeBlasio has stated that the city will not turn over its records of documented immigrants living within the confines of the city. Currently New York is slated to receive $7.7 billion of its $82 billion annual budget (approximately 9.4%) in the form of federal grants in fiscal 2017. The implication is that a federal versus city showdown may play a significant role in the allocation of public resources as well as the composition of New York City neighborhoods. An understanding of the dynamics driving the vast majority of transactions in New York is the key to successfully investing in the city's diverse micro-markets. The number of transactions in the $1-50 million range dwarfs larger transactions and an increasing number of these transactions are occurring in the boroughs, or within less well understood micro-markets in Manhattan. As the complexity surrounding immigration and deportation continue to unfold, it is likely that not only will this trend continue, but will even the playing field between Manhattan and the other four boroughs. While we believe small-midmarket real estate transactions will continue to dominate property trades – we are predicting a 100 bps increase in the percentage share of transactions over the next four years. We expect the increase from 92% of all



transactions to 93% to be a function of the boroughs densification and the investors in the opportunistic and value-add space exiting to core.

Costs of Construction

It is likely that the recently agreed 421a legislation will shift the return profile between large-cap and mid-market projects in favor of mid-market. While 421a projects are mandated to use union labor, small to midmarket projects in boroughs of New York rarely use union labor where the immigrant labor force is often helpful at artificially subsidizing the cost of construction. In a city where construction costs are already at all-time highs we will probably see a premium placed on rehabilitation projects over new construction where the cost of labor needed can be up to 50% less.

DON'T BET AGAINST NEW YORK

Times have never been brighter for investment in the greatest city in the world. The United States of America generally and New York City specifically offer investment opportunities that reflect their safe-haven status in a world wracked with turmoil. The US dollar, equities and Treasury bonds have already been outperforming global alternatives, as a reflection of their safe-haven premium as well as underlying superior economics. New York City real estate has long been a vital part of any multi-asset portfolio and is likely to follow, if not outpace, other asset classes while offering significant diversification of risk. As with any other asset class, investors should identify segments of the market with not only the highest potential return but also the best diversification of the risk of other portfolio assets. New York City mid-market real estate, spread across all five boroughs and spanning residential, commercial and multi-use, can play an important role in the generation of superior yields in broadly diversified portfolios.

Steve DeNardo is the CEO and founding partner of RiverOak Investment Corp.