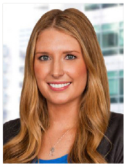
How is New York City positioned to handle the challenges of today's retail market?

CBRE



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EXECUTIVE SUMMARY

New York City is the premier retail market in the U.S. Its tremendous density, restrained retail development and strong demand from its enormous residential, worker and tourist populations put it in a far better position than smaller retail markets to adapt to the structural changes and cyclical hardships impacting the country.

Nationwide, many challenges have led to an increase in store closings and questions about the future of brick-and-mortar retail business. The New York City market is not immune to these challenges—but the unique dynamics of the market point to long-term strength. While local demand fundamentals remain on solid footing, getting back to market stability will require downward rent adjustments along some retail corridors.

- **The scale and depth of New York City's retail market is a buffer against challenging times.** The city's retail sales have grown for seven straight years, with robust demand supporting a large, diverse landscape of retailers. Nearly all demand indicators are poised for future growth.

- **The biggest challenge to the city's retail market is high rent.** Retail asking rents surged during the economic recovery post-Great Recession, a trend that far outpaced growth in retail sales activity. Many retailers now find it unaffordable to continue in the market, resulting in a rise in available storefronts along Manhattan's main retail corridors. Landlords will likely need to continue to sweeten lease terms to stabilize rents in the market.

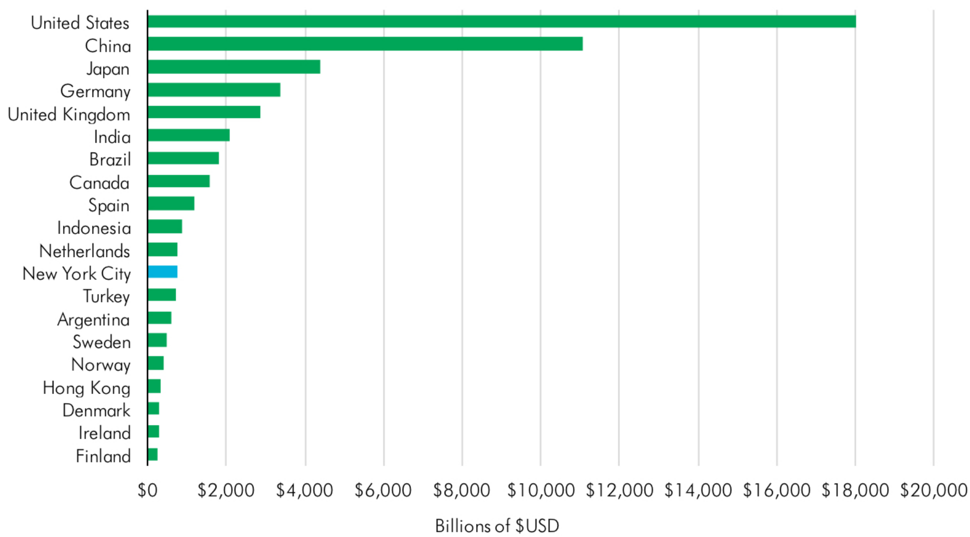
- **As rents recalibrate, New York City's strong demand fundamentals leave it well-positioned to adapt to the changing retail realities.** While some retailers feel the pinch of competition from internet-based retailing, much of this e-commerce business goes to brands with a strong brick-and-mortar presence. This trend demonstrates the power of an omnichannel retailing strategy, which many New York City retailers have begun to embrace. Additionally, while some of the market has fallen victim to overexpansion, growth from food and beverage (F&B) operators, discount retailers and international brands in the city continues. And while increasing pressure on department stores has led to closures across the country, the city's shopping environment is far less dependent on department stores to drive foot traffic—and thus less vulnerable. Added to this, the shift in spending from goods to experiences has driven the growth of experiential retail in the city.

- **While some Manhattan shopping corridors are well-positioned, others face near-term challenges.** Retail corridors best positioned in the current market include SoHo, the Meatpacking District, Times Square, Flatiron and Downtown, while those facing the biggest challenges include Upper Madison Avenue, Fifth Avenue between 42nd to 49th streets and 49th to 59th streets, and Herald Square.

THE BIG APPLE IS A CLASS APART WHEN IT COMES TO RETAIL MARKET FUNDAMENTALS

The scale and depth of the New York City economy offers a set of demand drivers that are the most compelling of any market in the U.S. With a real gross city product of $741.3 billion,[1] a hypothetical country of New York City would rank as the 18th largest nation by GDP, following the Netherlands, and ahead of Turkey.[2] In addition to being the largest city in the U.S., with a population of more than 8.5 million,[3] the city has the biggest, most diverse employment base of any urban market, with one of the highest median annual salaries.[4] New York City is also the top tourist destination in the country, increasing steadily over the past few years to reach 61 million annual visitors in 2016,[5] including some 12 million foreign visitors. Together, these demand drivers resulted in a total of $134.2 billion[6] in annual retail sales in New York City over 2016. The city's great density and tightly integrated geography concentrates all of this economic activity—much of it in Manhattan. With its three dense office markets, major tourist attractions and high concentration of upper-income households, Manhattan is the premier retail market in the country and one of the strongest around the globe.

Figure 1: NYC Gross City Product & Select Countries by GDP



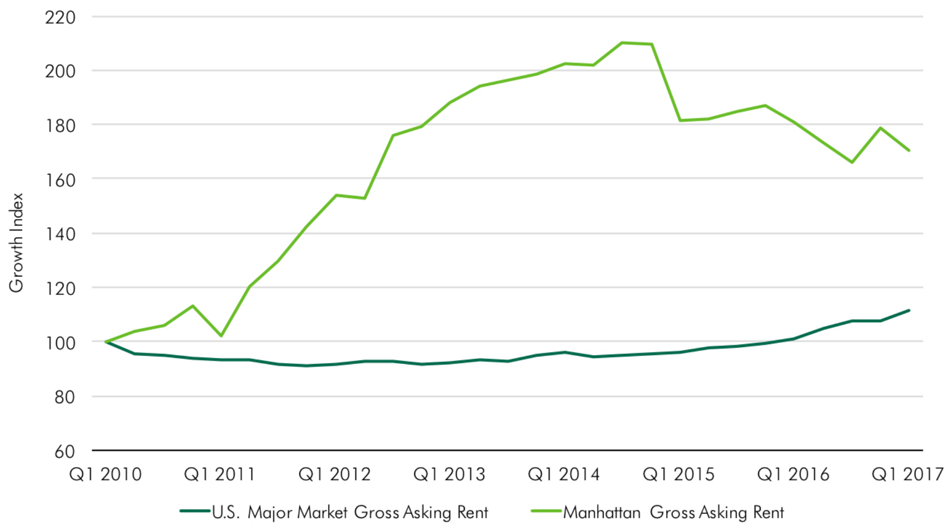
Source: World Bank, New York City Comptroller.

Despite the headwinds facing the retail market, demand drivers in New York remain sound and continue to move in a positive direction. Reaching 4.4 million in March, city employment is at an all-time high[7] while unemployment, at 4.1%,[8] is near a historic low. The output of goods and services is also on the uptick, as the New York City real gross city product grew at an annual rate of 2.1% in Q1 2017.[9] From a consumer perspective, Manhattan's total retail sales continue to grow, albeit at a slowing pace, increasing 2.1% year-over-year in 2016.[10] Looking ahead, New York City's median household income is expected to grow 2.2%, compared to projected growth of 1.9% nationally.[11] The city's population continues to outpace growth projections, and is expected to reach 8.95 million by 2021.[12]

CONTINUING HIGH RENTS ARE NEW YORK CITY'S BIGGEST CHALLENGE

Between 2010 and 2014, average asking rents in Manhattan recorded a more than 100% increase over the 16 retail corridors tracked by CBRE. This growth was well beyond the expansion of retail rent seen at the national level. According to CBRE Econometric Advisors, the average net asking rent across the major U.S. markets was essentially flat, increasing by 1.1% between Q1 2010 and Q1 2017. Although the average asking rent across Manhattan has decreased 21.1% since 2014, current asking rents are still almost 50% higher than in 2010.

Figure 2: U.S. Gross Asking Rents vs. Manhattan Average Asking Gross Rents Indexed



Source: CBRE Research, CBRE Econometric Advisors.

As rents accelerated, total retail sales for the city increased, but at a slower pace—a discrepancy that created an unsustainable situation for some tenants as rents surpassed what their sales growth could support. Between 2010 and 2014, total Manhattan retail sales increased by 31.9%, much less than the doubling seen in rents. While the average asking rent has come down somewhat since 2014, it remains nearly 50% ahead of where it stood before the run-up, while growth in retail sales has begun to taper off over the past two years. In order for the market to stabilize, rent will likely need to pull back further and allow time for retail sales growth to catch up.

The rapid escalation of asking rent has contributed to Manhattan's rising availability. Along the corridors tracked by CBRE, the number of available storefronts increased from 129 in Q1 2016 to 213 in Q1 2017. In particular, Upper Madison Avenue and parts of SoHo have seen increases in available storefronts as tenants wait for prices to come down. Some of the corridors that have recorded the sharpest escalation in rent are where luxury tenants are clustered. In 2016, the personal luxury goods market contracted by 3.0%, so paying high rents is becoming particularly challenging.

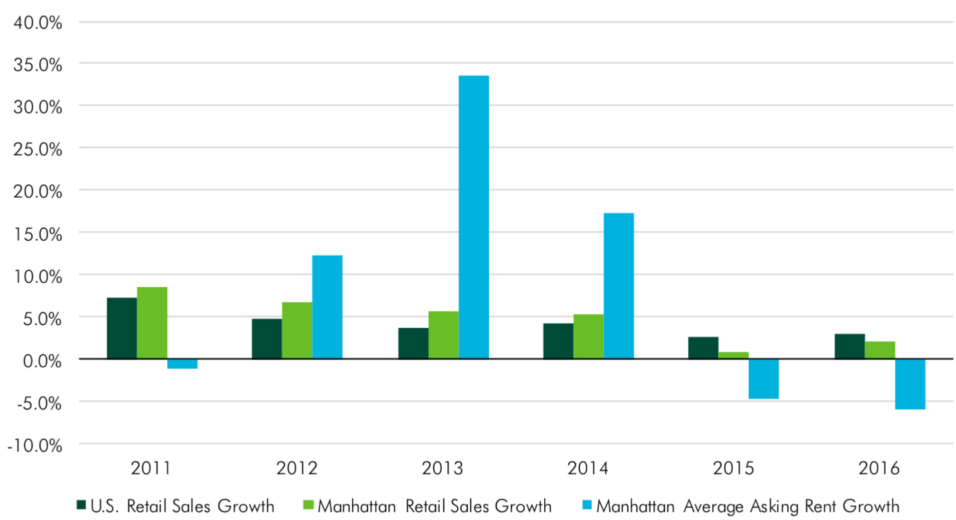
Figure 3: Manhattan Total Retail Sales Volume

Year	Total Retail Sales (Billion $)	Annual Growth (%)	Absolute Increase (Billion $)
2010	49.9	5.6	2.6
2011	54.2	8.6	4.3
2012	57.8	6.7	3.6
2013	61.1	5.7	3.3
2014	64.3	5.3	3.2
2015	64.9	0.9	0.6
2016	66.2	2.1	1.3

Source: U.S. Census Bureau, Moody's Analytics Estimated.

However, asking rents have become "sticky." The investment environment over the previous few years has been competitive, with strong capital markets activity and cap rate compression to between 3.0–4.0%[15] for New York High Street assets. Landlords need to achieve a certain cash flow to meet their income projections, but declining market rent challenges these expectations. In order to keep face rents in line with investment pro forma, landlords are offering additional tenant incentives, allowances and free rent periods. Although asking rents have decreased 2.7% in aggregate across the 16 tracked corridors year-over-year, CBRE estimates that tenants signing leases for similar spaces in 2017 could achieve net effective rents 20-30% below 2014 rents.

Figure 4: U.S. & Manhattan Total Retail Sales Annual Growth vs. Manhattan Average Asking Rent Growth



Source: U.S. Census Bureau ; Moody's Analytics Estimated, CBRE Research.

Figure 5: Manhattan Average Asking Rent Changes

Corridor	Boundaries	Q1 2010 ($)	Peak ($)	Change from 2010 to Peak (%)	Q1 2017 ($)	Change from Peak to Q1 2017 (%)
Upper West Side	Broadway 72nd to 86th Streets	255	408	60	305	(25)
Upper East Side	Third Avenue 60th to 72nd Streets	255	372	46	342	(8)
Upper Madison Avenue	Madison Avenue 57th to 72nd Streets	807	1,771	119	1,406	(21)
Midtown	Fifth Avenue 49th to 59th Streets	1,650	3,850	133	3,432	(11)
Midtown	Fifth Avenue 42nd to 49th Streets	420	1,366	225	1,121	(18)
Times Square	Broadway & Seventh Avenue 42nd to 47th Streets	*1,100	2,413	119	2,187	(9)
Herald Square	34th Street Fifth to Seventh Avenues	446	988	121	665	(33)
Flatiron	Fifth Avenue 14th to 23rd Streets	249	419	68	391	(7)
SoHo	Broadway Houston to Broome Streets	507	871	72	678	(22)
Downtown	Broadway Battery Park to Chambers Street	178	419	136	419	0

*(Q1 2011)

Source: US Census Bureau, Moody's Analytics Estimated, CBRE Research.

HOW IS NEW YORK CITY POSITIONED TO WITHSTAND THE HEADWINDS CONFRONTING THE U.S. RETAIL MARKET?

Let's look at the four biggest trends putting pressure on the business of retail in the U.S. market, and see how New York City is positioned to handle each one:

1. E-COMMERCE AND OMNICHANNEL

The growth of e-commerce has far outpaced that of sales from in-store locations, a trend that has hit some retailers especially hard. Between 2006 and 2016, U.S. internet sales have grown threefold, to reach $394 billion, now accounting for 8.2% of total retail trade,[16] while between 2010 and 2016, online sales grew at an annual average rate of 15.0% and in-store sales grew 4.0%.[17] While e-retailers have eroded the business of some store-based operators, the rise of e-commerce is not the downfall of brick-and-mortar retail proclaimed in recent headlines. In fact, many brick-and-mortar brands see the internet as a complement, and not a competitor, to their in-store locations, as half of all online purchases in 2016 were made from retailers with brick-and-mortar locations.[18] This demonstrates the power of a growing trend known as omnichannel retailing, a strategy that seeks to combine online and in-store shopping into a seamless, integrated experience for customers. The shift seems to be working: a recent study by the *Harvard Business Review* of 46,000 consumers found that 73% used multiple channels while shopping, and these consumers spent more on average than those using only one.[19]

New York City is as susceptible as any market to the impact of e-commerce, and brick-and-mortar retailers operating in the city will have to evolve to meet consumers' embrace of the omnichannel experience. But New York City also has unique assets that help position it well in an omnichannel world. Just as brick-and-mortar brands pivot toward the internet, many pure play e-retailers see the value of brick-and-mortar operations as a way to extend their branding, build customer engagement and grow sales. More online retailers—such as Warby Parker, Bonobos and AYR—are pioneering their omnichannel strategy in Manhattan, drawing on its dense, high-income customer base and high-visibility locales, with other retailers planning to open Manhattan locations in the future.

2. OVEREXPANSION OF RETAIL LOCATIONS

The consequences of overexpansion have come home to roost. Many brands went too far, oversaturating competitive markets and opening stores in secondary and tertiary areas with less and less buying power. This has overburdened many retailers, which now cannot sustain these locations, especially as the rate of consumer spending growth has begun to decline. In addition, retailers are confronting a tight labor market and increasing wages.

The decline of many national brands has had an impact on the New York market, as tenants including Radio Shack, Payless, Aerosoles and Ralph Lauren have announced plans to close stores. This has contributed to growing availability in the city in recent years; in the past six months, the number of available storefronts on Manhattan's main shopping corridors has grown by 31%.

However, New York City is still the biggest, densest and most vibrant retail market in the U.S., and those strong and relatively stable demand drivers are a powerful draw to retailers of all types. Some of the tenants leaving the market may in fact find their brand diminished without a Manhattan presence. Meanwhile, as some brands leave, many continue to expand, such as UNTUCKit, Whole Foods and Soul Cycle. Additionally, 17 international brands opened their first locations in Manhattan in 2016, including Balmain, Canada Goose, Stone Island and Aquazzura.

3. THE DECLINE OF THE DEPARTMENT STORE BUSINESS AND EROSION OF THE ANCHOR TENANT

Rising wages, competition from discount chains and changing consumer demands have put increasing pressure on many department stores, leading to closures across the country. For decades, many malls and shopping centers have relied on department stores as anchor tenants to drive foot traffic to inline shops—and as some of these anchors struggle and close, they can drag other tenants down with them.

While many of the biggest department stores have their roots in New York City and are an iconic and cherished part of the local shopping landscape, the market's High Street shopping environment is far less dependent on department stores to drive foot traffic. Certainly, new leases signed by Marshall's, Nordstrom Rack and Target in Q1 2017 show the continuing growth of discount retailers, adding greater competition for some department store brands in the local market. Yet New York City's powerful demand drivers ensure that many department stores will maintain a significant local presence, especially in Manhattan. The best-positioned department stores likely will be the ones that offer a unique experience in terms of merchandise, ambiance and customer service—and fully embrace the omnichannel strategy.

4. SPENDING SHIFTS FROM "STUFF" TO "EXPERIENCE"

For more than a decade, American consumers have been shifting their spending away from goods in favor of experiences—especially dining out. Spending at food services and drinking establishments has grown twice as quickly as total retail sales over the past ten years.[20] The shift is often credited to the rise of millennials, who tend to go out twice as often as their older counterparts, but dining out has a broad appeal across all age demographics. The rise of food and beverage (F&B) has come at the expense of spending in other categories, most notably apparel, which has seen the most dramatic decline in share of total retail spending. This is particularly a challenge for brick-and-mortar retail: as apparel is now the largest e-commerce category, many stores find themselves earning a smaller share of a shrinking pie.

The shift away from apparel toward F&B spending plays to the strengths of the Manhattan market. With a huge, dense population of workers, residents and tourists, there is a massive audience for F&B operators in the market. With less competition for space from other retailers, F&B operators are finding new opportunities to expand throughout the city. In Q1 2017 alone, F&B tenants accounted for 34.2% of new leases.

The spending shift from merchandise to experience has also prompted the growth of experiential retail. Tenants are finding new ways to promote their brand and bring foot traffic into their stores. In New York City, retailers have introduced compelling new concepts to entice consumers. Some examples of these include dining options, such as Intersect by Lexus in the Meatpacking District, which will feature a restaurant by Danny Meyer; fitness classes, such as yoga at Lululemon; art galleries and performances at Samsung 837, also in the Meatpacking District; and the virtual reality collaboration between Cirque du Soleil and the NFL in Times Square.

HOW DO DIFFERENT NEIGHOBORHOODS STACK UP IN THE CURRENT MARKET?

Areas of Manhattan expected to perform well include:

- **SoHo**
  - Although SoHo is facing high asking rents and availability, it is positioned for long-term strength.
  - Omnichannel retailers are using SoHo almost as an incubator, taking advantage of the high availability to open pop-ups—testing the viability of brick-and-mortar stores to transition into permanent locations within the neighborhood.
  - Examples include Everlane, Birchbox, the RealReal, Saje, Sonos, Outdoor Voices, Aerie and AYR.

- **Flatiron District**
  - The Flatiron District avoided much of the large increase in rents seen over the past few years, with

current average asking rents at $380 and $391 per sq. ft. in its Broadway and Fifth Avenue sections, respectively. These two corridors were also the only ones that did not see an increase in available ground-floor space in the past 12 months.
    - The area's tenant base is home furnishings and furniture stores, including ABC Carpet & Home, Restoration Hardware and Safavieh Home Furnishings—tenants that are more resilient to the rise of discount brands and e-commerce.

- **Meatpacking District**
    - New leases from a broad range of tenants—including Hermès of Paris at the Gansevoort Market redevelopment and Dean & DeLuca—illustrate the positive momentum of this neighborhood, which is buoyed by new office developments, hotels and unique attractions.
    - Projects under construction include Restoration Hardware Guesthouse, a 14-key hotel, the first from RH, as well as 40 Tenth Avenue and Gansevoort Market.
    - Tourist attractions such the High Line and the Whitney Museum, as well as the 2.7-acre Pier 55 public park over the Hudson River, will continue to draw foot traffic.
    - A high volume of construction activity is causing temporary disruption; however, the neighborhood is positioned for long-term strength.

- **Downtown**
    - The area has seen a growing daytime population from new office tenants: 4 WTC is now fully leased, and there has been a growing number of relocations from Midtown and Midtown South.
    - Increasing demand from strong tourism and hotel growth, and a robust pipeline of new residential development that includes a sizable number of millennials, has added vitality to the area.
    - Lower Manhattan has blossomed into a retail destination, with significant new additions including Saks Fifth Avenue at Brookfield Place, the shops at Westfield World Trade Center and The Seaport District redevelopment by The Howard Hughes Corporation.

Meanwhile, areas likely to face more challenges in the near term include:

- **Upper Madison Avenue**
    - The slowdown in luxury is hurting the tenant base; in 2016, the luxury market in the Americas contracted by 3.0%.[21]
    - The historically high U.S. dollar has led to decreasing spending by foreign visitors to New York City, which has had a negative impact on luxury retail sales.
    - The average asking rent on Upper Madison Avenue more than doubled from $807 in Q1 2008 to $1,771 per sq. ft. in Q3 2014. Rents have declined only 20.6% since the 2014 peak, to now average $1,406 per sq. ft.

- **Herald Square**
    - Mid-tier department stores like those in Herald Square are being undercut by online retailers and discount department stores such as Target and Nordstrom Rack, which have recently signed leases in Herald Square.
    - Average asking rents in Herald Square increased 121.4% from $446 in Q1 2010 to $988 per sq. ft. in Q1 2015. Since the peak, rents have only receded 32.7%.
    - Given the high ratio of apparel tenants with other locations throughout Manhattan, tenants may choose to reconsider their Herald Square location.

- **Fifth Avenue | Midtown**
  - Both the 42nd–49th street and 49th–59th street corridors recorded unsustainable increases in average asking rents. In 2010, average asking rents in these corridors were $420 and $1,650 per sq. ft., respectively; when rents peaked in late 2015, they stood at $1,366 and $3,850 per sq. ft., respectively.
  - Similar to Upper Madison Avenue, decreasing overseas tourism and spending on luxury purchases continue to affect this corridor.
  - Increased security around Trump Tower has disrupted pedestrian traffic.

CONCLUSION

New York is a city of resilience and reinvention, and these characteristics are evident in today's retail market. As the business of retail continues to evolve, national and local markets will likely confront challenges on the way to stability—but the size, diversity and enduring appeal of the New York marketplace point toward a strong, healthy retail environment.

DEFINITIONS

High Street — The primary walkable retail shopping thoroughfare in the premier location of an urban submarket, serving as a focal point for high-end shops and luxury retailers.

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