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Why Policy Matters—An Examination of the Stamford, Connecticut, Office Market

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Morningstar Perspective

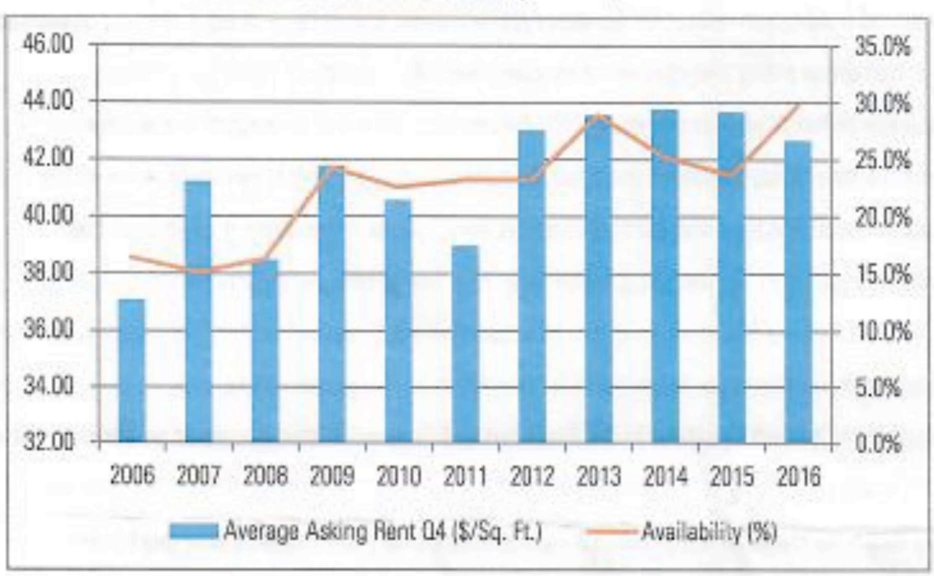
Once a thriving center for corporations and a suburban retreat for business professionals, Connecticut is experiencing an exodus of corporations and residents because of numerous policy changes and a seeming inability to adapt to a changing market environment. Beginning with the implementation of an income tax in 1991, followed by increases in corporate and personal tax rates, as well as a worsening commute, various policy miscues have caused Stamford and the greater Fairfield County office markets to suffer. Stamford, in conjunction with Danbury and Fairfield, had the third-largest concentration of Fortune 500 Companies (behind New York City and Chicago) in 1991, according to the *New York Times*. Now, with General Electric Co.'s departure from Fairfield last year, only three Fortune 500 companies are headquartered in Stamford, which has experienced burgeoning vacancy rates in the office sector. Furthermore, these policies have affected real estate values, and, consequently, over $891.8 million of securitized commercial loans backed by offices in the Stamford and Greenwich markets are at an elevated risk of delinquency or default. Connecticut is facing a daunting projected budget deficit, and with a number of companies considering a move out of state, lawmakers need to take a hard look at the potential consequences of any future policy changes to keep the Stamford office market from falling into further decline.

The State of the Stamford Office Market

Given its proximity to New York City and its historically strong concentration of financial-services and banking companies, Stamford should have a robust office market, especially in its central business district, which is within walking distance of the Metro-North train station. However, as demonstrated in Chart 1, its availability rate has risen since the Great Recession. Although the availability rate dropped in 2014 and 2015 from its peak of 28.9% in 2013, the rate increased significantly in the fourth quarter of 2016, to 29.7%, with a vacancy rate of 26.4%, in part because UBS AG vacated 677 Washington Boulevard, which was once the world's largest trading floor. CBRE Group, Inc. reported that the average asking rent for office space in the Stamford CBD slid 2.3% year-over-year to $42.67 per square foot.

There is some indication, however, that businesses may find downtown Stamford attractive at the current rents. Newmark Grubb Knight Frank reported some positive leasing momentum in 2016 thanks in part to Henkel AG signing a lease for 134,416 square feet (later expanded to 155,000 square feet) at 200 Elm Street in downtown Stamford. Henkel, which is relocating from Arizona after acquiring Sun Products, is benefiting from a state initiative to encourage businesses to expand or relocate to Connecticut. Under the initiative known as the First Five Plus program, Henkel will receive a 10-year $20 million low-interest rate loan and be eligible for $5 million in tax credits.

Chart 1: Stamford CBD Office Rents and Vacancy



Source: CBRE, Fourth-Quarter 2016

Although the Stamford CBD has the highest availability rate of Connecticut's major office areas, the entire Fairfield County office market has an availability rate of 23.1%, according to CBRE. Newmark Grubb Knight Frank places the Fairfield County office market at a slightly higher availability rate of 24.2%, up from last year's fourth-quarter figure of 21.5%. Newmark reports that leasing momentum dropped 15.2% from 2015 for the entire county. The largest decrease in leasing demand occurred in Stamford's non-

CBD area, where GE Capital's 200,000-square-foot space at 201 High Ridge Road and Daymon Worldwide's 90,000-square-foot space at 700 Fairfield Avenue became available.

Table 1: Fairfield County Rents and Vacancy

Market	Rentable Area (SF)	Availability Rate (%)	Average Asking Rent ($)
Stamford CBD	9,742,804	29.70	42.67
Stamford Non-CBD	6,493,536	25.40	33.18
Greenwich	4,438,261	17.20	60.89
Fairfield County	42,176,338	23.10	34.50

Source: CBRE-Fairfield County Office, Fourth-Quarter 2016

Taxes, Business Climate, Deteriorating Infrastructure Drive Decline

Commercial real estate values in Stamford have been plagued by a number of statewide issues, including tax changes, a pervasive antibusiness environment, a high rate of out-migration by its residents, a worsening commute, and uncertainty around the state's future. As Joe McGee, the vice president of public policy for the Business Council of Fairfield County, told the *Stamford Advocate* "companies don't want to be in an unpredictable or volatile environment. They need stability. These budget deficits indicate this is not a stable fiscal climate." This is epitomized by GE, which had been headquartered in Fairfield County for over 40 years, leaving in 2016 because of changes in state tax policies and its belief that Boston could provide a better business environment and enable the company to attract young talent.

High Taxes: Connecticut implemented a flat 4.5% income tax in 1991 in an effort to solve its budget problems. However, from 1991 until 2014, state government spending "grew 71% faster than the rate of inflation, while population only grew by 9%," Patrick Gleason, director of state affairs at the advocacy group Americans for Tax Reform, wrote in 2016 in an article in *Forbes*. *The Wall Street Journal* reported that the state faces a budget deficit of approximately $1.7 billion for the fiscal year that begins in July. In addition to having one of the highest income-tax rates in the country, the state is ranked the second-worst in personal property taxes, is tied for the fifth-highest state corporate tax rate with a 9% flat tax, and was ranked 43rd in the 2017 State Business Tax Climate Index, published by the Tax Foundation, a Washington, D.C.-based research group. In 25 years, Connecticut transformed itself from one of the most tax-friendly states to 49th on Forbes' list of "Best and Worst States for Taxes in 2016."

Antibusiness Environment: In the *2016 Survey of Connecticut Businesses*, published by the Connecticut Business and Industry Association, 60% of respondents agreed that "state regulations are complex and vague, and making the effort to understand them costs time and money," and 34% said those regulations hurt their businesses. When asked which of the following they think will hamper the ability to grow their businesses in Connecticut, 79% of respondents noted costs from government regulations and mandates, 74% said taxes, 71% cited uncertainty about legislative decision-making, and 69% said the cost of living expenses. Given these responses, it is no surprise that 26% of respondents said that they were considering moving or shifting production to another state within the next five years, citing the cost of doing business in Connecticut as the primary reason. In addition, the 2016 ALEC-Laffer State Economic Competitiveness Index, which assesses whether policy choices made by states have been conducive to economic competitiveness, ranks Connecticut 47th in economic outlook.

Exodus of People: Unfortunately, it's not only corporations that are leaving the state. A 2015 Gallup poll revealed that 46% of Connecticut residents said that they "would like to leave their state if they had the opportunity." Between 2011 and 2013, more than 27,000 individuals left Connecticut, according to the Yankee Institute for Public Policy, which translates into "38 people and $5.2 million in income leaving the state every day for two years." Furthermore, looking at tax data from the Internal Revenue Service, between 2014 and 2015, Connecticut experienced a net loss in population of about 12,800, and the state lost an estimated $1.29 billion in adjusted gross income. The outflow of individuals, especially high earners, is worrisome because a significant portion of the state's revenue is derived from personal income taxes; income-tax receipts for the year that ended in June 2016 were $650 million below budget, according to the *CT Mirror*. Barry Sternlicht, the chairman and CEO of Starwood Capital Group, in an article published in September 2016 by *Bloomberg News* blamed Connecticut's high taxes for making Fairfield County a "terrible" place to live and noted that this is reflected in falling home prices. Equally worrisome for corporations is that Connecticut can no longer attract or keep young talent. According to a study by McKinsey & Company, Connecticut is ranked 38th out of 50 states in percentage of 20 to 24-year olds.

Transportation Woes: Worsening commuting options have also hurt the Stamford office market. Metro-North, the state's rail system, has had a plethora of problems from train crashes to frequent delays over the past several years. According to the *Darien Times*, in the 1950s, the commute from Stamford to the Grand Central Terminal via the New Haven Railroad took 47 minutes. A Metro-North online January 2017 schedule indicates that the current scheduled commute time ranges from 48 minutes to 71 minutes for trains arriving in New York City before 8:00 am. Meanwhile, rail fares have increased 16% over the past four years. In addition, following a 2016 study, lawmakers are considering implementing a mileage tax on state drivers. While only a pilot program is in the works, politicians have already voiced their concerns that this additional tax could drive residents and businesses from the state.

Connecticut's Response Thus Far Is Not Sufficient

In some cases, policies meant to ameliorate the situation and close the budget deficit are having the opposite effect. In an attempt to retain some companies, the state has provided financial incentive packages to companies who pledge to keep a predetermined number of jobs in the state. Recipients of these incentives include Greenwich-based AQR Capital Management, LLC, Westport-based Bridgewater Associates LP, Bristol-based ESPN, UBS, and Sikorsky Aircraft. The latter, a division of Lockheed Martin Corp., received $220.0 million from the state in exchange for retaining and growing 8,000 jobs in Stratford until 2032. Although such deals are intended to keep jobs in the state, the incentives put pressure on the budget deficit. State lawmakers have congruently proposed policies that would inherently lead to businesses downsizing or leaving the state altogether. According to *The Wall Street Journal*, Democrats proposed legislation that called for a 19% surcharge on investment-management service fees, a tax that would directly affect hedge fund managers, who have historically congregated in Fairfield County. Although Gov. Dannel Malloy ultimately dismissed the effort, *The Wall Street Journal* reported that Malloy's latest proposal to tackle the budget deficit is to shift more than $400 million in annual teacher pension costs to cities and towns, a suggestion, that, if implemented, likely will lead to higher property taxes. This proposal has received pushback from local politicians who believe the rise in property taxes will further incent residents to move out of state.

CMBS Exposure to the Stamford Office Market

As a result of Connecticut's implemented policies and the subsequent loss of businesses, securitized commercial loans backed by Connecticut office properties, specifically collateral in Stamford and Greenwich, are at an elevated risk of delinquency or default. In October 2016, the $146.4 million loan backed by the UBS Center at 677 Washington Boulevard, which was securitized in LBUBS 2004-C1, defaulted when it failed to pay off by its maturity date. The complex, which is leased to UBS through December 2017, is 100% vacant, and UBS started its 14-month free-rent period in October. Now up for sale, the property was appraised in May 2016 for $44.4 million, down 83.1% from an appraised value of $262.0 million in 2003. Morningstar is predicting a $108.1 million loss on the loan.

UBS is not the only company that significantly downsized its footprint in Stamford. Royal Bank of Scotland, which shares space at 600 Washington with UBS, trimmed about 500 positions in the past two years, according to the *Stamford Advocate*. Similarly, since Marriott International, Inc. acquired Starwood Hotels & Resorts Worldwide last year, it announced that approximately 215 employees in its Stamford office will be laid off.

The following table lists securitized office loans in Stamford and Greenwich with debt service coverage ratios below 1.30x, which Morningstar believes raises the risk of default at maturity.

Table 2: Stamford and Greenwich Offices With Low DSCRs

Deal Name	Property Name	City	Current Loan Amount ($)	Square Feet	Status	NCF DSCR (x)	Appraised Value Change Since Securitization (%)	Notes
GSMS 2007-GG10	400 Atlantic Street	Stamford	265,000,000	527,424	Watchlist-7/6/2016 (Current)	0.8	-60.09	Matures 6/2017
MSC 2007-IQ15	First Stamford	Stamford	234,466,416	793,624	Current	1.21		Matures 7/2017
LBUBS 2004-C1	UBS Center - Stamford	Stamford	146,393,655	682,327	Maturity Default (10/2016)	N/A	-83.05	
GSMS 2007-GG10	55 Railroad Avenue	Greenwich	124,000,000	131,634	Current	0.83		Matures 6/2017
JPMCC 2012-CBX	100 West Putnam	Greenwich	74,204,990	155,504	Current	1.22		
SBM7 2001-MMA	Stamford Square	Stamford	19,488,106	298,486	Watchlist-1/11/2012 (Current)	0.18		
COMM 2015-CR26	15 Valley Drive	Greenwich	13,175,182	36,703	Current	1.17		
GCCFC 2007-GG9	300 Main	Stamford	11,500,000	82,676	REO-7/2016	0.29	-41.23	Matures 2/2017
CD 2006-CD3	80 Field Point Road	Greenwich	3,586,434	32,351	Watchlist-12/12/2016 (Current)	1.01		Largest Tenant's (22% GLA) lease expires 11/19/2018
Total/Average			891,814,783	2,740,729		0.84		

Source: Trepp, LLC as of March 2017

The detrimental effects that Connecticut's policies have had on the Stamford office market represent a microcosm of what can happen when policies are implemented without considering potential unintended consequences. Connecticut lawmakers are now faced with the daunting task of trying to find the perfect policy balance that would both close the budget deficit and retain its businesses and residents. Lawmakers across the country, take heed.