INSTITUTIONAL REAL ESTATE INVESTORS CONFRONT THE FRAYED-COLLAR ECONOMY

by Sol L. Rabin

American real estate is beginning to surrender some of its secrets. Like the shadow on Plato's cave wall, real estate is the physical reflection of the needs and tastes of the American economy. Real estate has served as a lagging social indicator of short term trends, and now coincidentally, it is one of the leading indicators of long term fundamentals.

The thesis of this paper is that American society is undergoing a profound, deep and troubling long term transition from a middle income to a predominately lower income society. This transition erodes the value of some traditional forms of institutional real estate, but it also increases the economic viability of newer forms of real estate. White collar workers decanted into blue collar jobs lead to a "frayed-collar" economy, and institutional investors who now shun some of the newer frayed-collar product will embrace it in coming years.

This fundamental socio-economic shift is having and will continue to have profound impacts on American real estate, some of which today are all too visible to the naked eye. The Schumpaterian process of creative destruction has always been championed by the real estate community as obsolescence creates new profit making opportunities. Change is the only constant and major factor in earning real estate profits.

Income Trends

American households have not been winning the battle to keep median income growth ahead of inflation. Figure 1 shows the long term trend in real median family income measured in thousands of 1992 pretax dollars.[1] Added to the series are two piece-wise linear regression lines which illustrate two distinct periods—the Ozzie and Harriet years after 1947 and the Roseanne years after 1973.[2] From 1974 to 1994 real median family incomes increased at a modest 0.2% per year (despite the sizeable number of women entering the labor force). This slow growth trend, however, has been turbulent and filled with micro-cycle ups and downs. Note that over the ten year period 1985-94, real median family incomes increased and then fell back; that is, median family income in 1994 was about the same as it was in 1985 on a real basis! Without question, a new reality has set in since the early 1970s when competitive global pressures (especially from Japan and emerging Asia) destroyed millions of middle income jobs in automobiles, electronics, textiles, etc.).[3]

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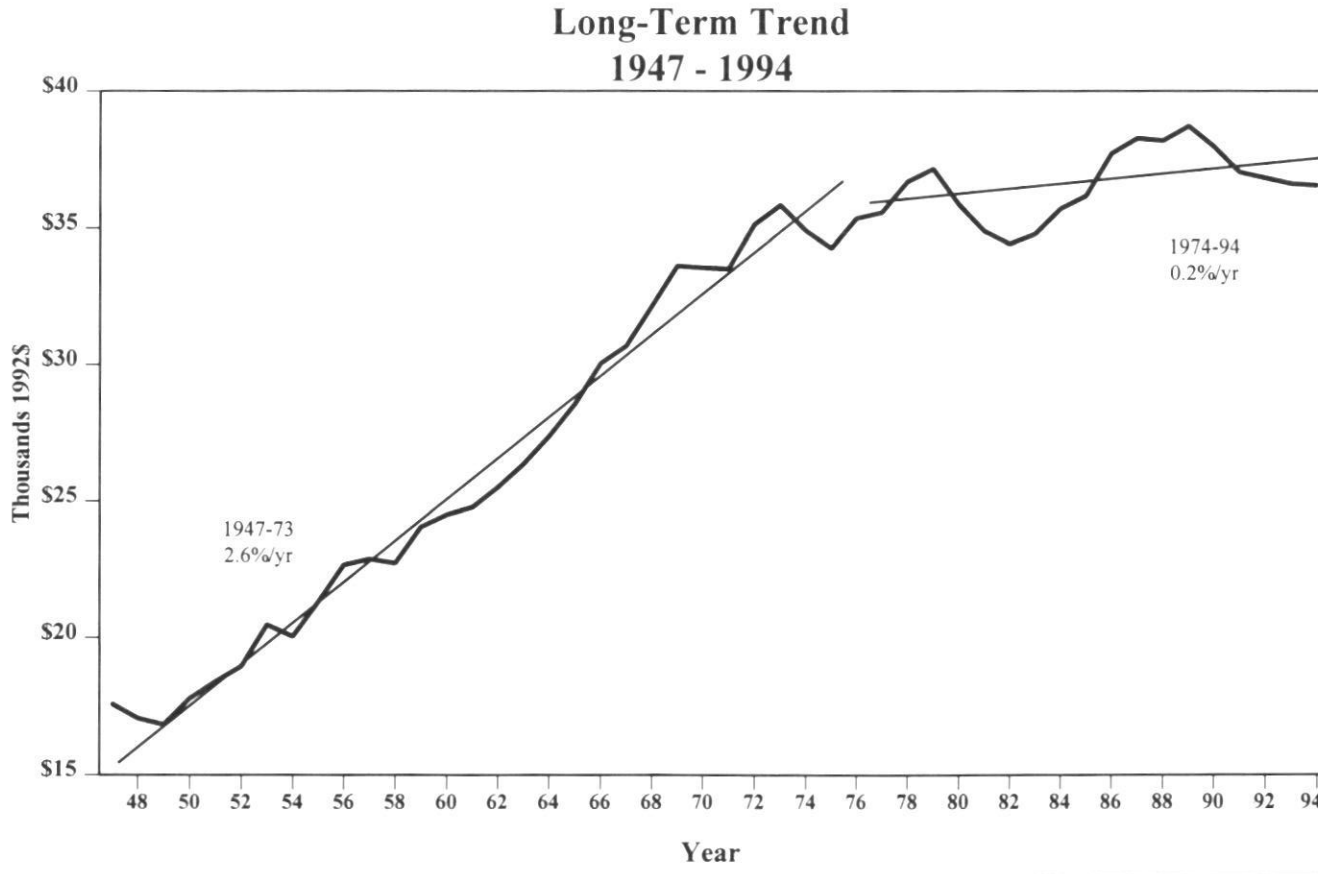
FIGURE 1

Real Median Family Income
In Thousands of 1992 Pretax Dollars



Source: U.S. Department of Commerce, Bureau of the Census

Household Distribution By Income Class

It is not a new observation that the middle income class is shrinking. But the extent of the change is not fully understood. Figure 2 shows three groups of four vertical bars, each of the three groups representing lower, middle and upper income households as a percent of total households, and each of the four bars representing years 1973, 1985, 1991 and 2000.[4]

Middle income households are on a down escalator shrinking from 53% of total households in 1973 to a projected 39% in 2000.[5] The results have been an increase in lower economic income classes from 39% to 49% over the 28-year period. What is emerging on the American landscape for the first time in half a century is a majority economic household class in the United States that is not the middle income but rather the lower income household.

The upper income group is modestly increasing market share (4%), the middle is losing sizable market share (-14%) and the lower income group is gaining (10%).[6] While income redistribution is an arresting subject, it does appear that the biggest and most important battle is preventing too many middle income households from stepping on the down escalator and not pushing a few upper income households onto it.

Federal Income Tax Shares

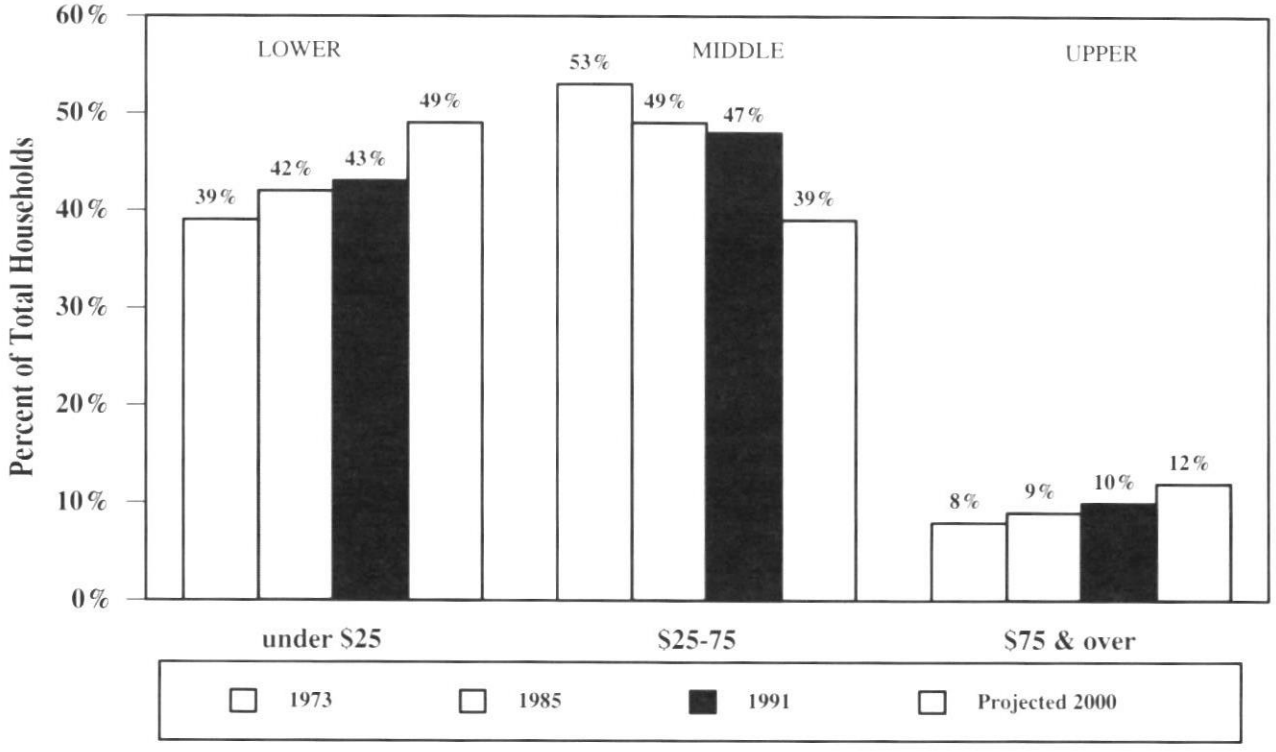
The polarization of incomes is even more dramatically shown in Figure 3 which illustrates for 1991 the percent of federal income tax returns filed by three economic groups (left cluster of bars) and the share of income taxes paid by each group (right cluster of bars).[7] A staggering 58.7% of the households contributed only 9.4% of income tax paid. This is in stark contrast to 6.1% of the households shouldering 46.8% of the tax burden. The middle income class at 35.2% of households contributes 43.8% of the income. This chart reinforces the concept that significant gains in U.S. income tax receipts would be dramatic if both lower and middle economic households were moved up the economic escalator. But it is not the long term trend, and economic miracles are difficult to execute.

Conclusions

Real median family income has barely increased in over 20 years (4.8% in total during that period). The

FIGURE 2

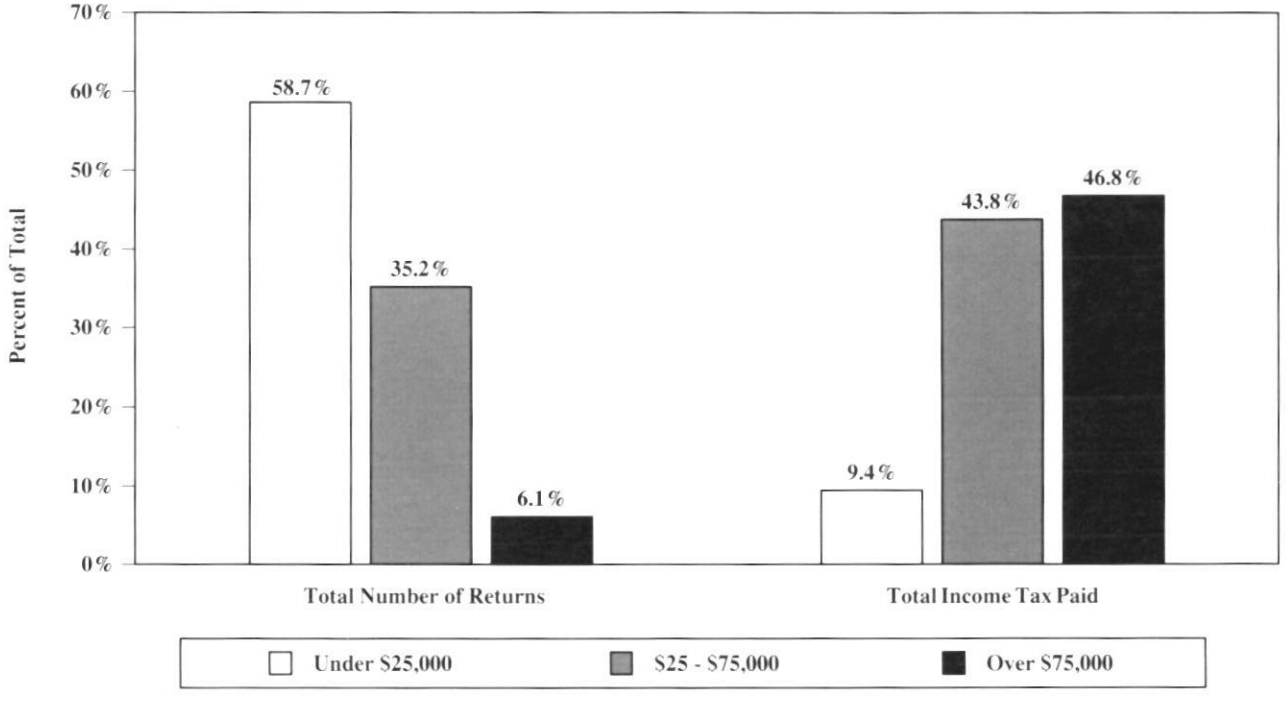
Percent Of Households By Income Class
In Thousands Of 1992 Pretax Dollars



Source: A. Gary Shilling & Co., Inc.; Westmark Realty Advisors

FIGURE 3

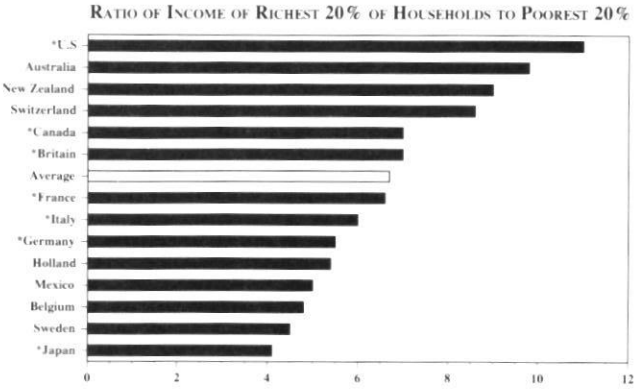
Share Of Income Taxes Paid By Adjusted Gross Income Level—1991



Source: U.S. Internal Revenue Service; Westmark Realty Advisors

FIGURE 4

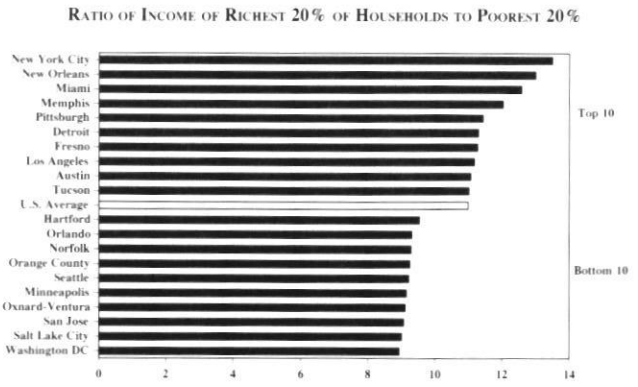
Income Inequality By Country



*G7 Countries
Source: The Economist, November 5th, 1994

FIGURE 5

Income Inequality By City



Source: CACI Marketing Services; Westmark Realty Advisors

middle income household class is shrinking and will not be a majority or dominate class in the future. There is substantial income polarization. These are very deep and long term trends which define the frayed-collar economy. Such trends make institutional investors nervous.

International And Domestic Polarization Comparisons

The previous section illustrated the dynamics of U.S. income polarization. Turning to cross-sectional data will allow comparisons between countries and metropolitan areas. A convenient method for showing income disparity is to compare the income earned by the top 20% of the households to the income earned by the bottom 20%: the higher the number, the greater the income polarization. The income inequality indices of 14 countries for 1994 are shown in Figure 4.[8]

A major surprise is that the U.S. has the highest income polarization of any of the countries shown, including the G7. Of little surprise is that Japan has the lowest income polarization. Reasons for the high level of income polarization in the U.S. can be attributed, in large measure, to our national economic policy which staunchly protects the U.S. consumer at the expense of the U.S. manufacturing base.

The U.S. Antitrust Division has taken action to vigorously prevent the formation of monopolistic firms in the United States in order to keep consumer costs low. A recent example is the blocking of the acquisition of Intuit by Microsoft due to fear of monopoly pricing power. The cost for preserving low price levels for U.S. consumers comes at the expense of losing U.S. jobs. The general free trade policy[9] in the United States is to advocate free trade (e.g. GATT, NAFTA), and few economists voice concern about the loss of jobs to overseas locations if those losses mean that products imported into the U.S. are provided to the consumer at a lower cost (and theoretically lead to increases in real incomes). Even the Federal Reserve Board has, as its primary focus, the stabilization of prices by keeping a firm grip on inflation.[10] Almost the reverse philosophy is followed in Japan by the Ministry of Finance. The ministry has not been concerned about the level of consumer prices but has been adamantly worried about the preservation of jobs.[11]

Frayed-Collar Cities

Figure 5 shows the respective levels of income polarization for the top ten and the bottom ten of 55 U.S. cities.[12] New York City has the highest income inequality and Washington, D.C. the lowest among 55 MSAs (metropolitan statistical areas).[13] Income polarization in New York is well chronicled. Less chronicled is that Washington, D.C., the center of the federal government, is by definition a middle income white collar economy.

Conclusions

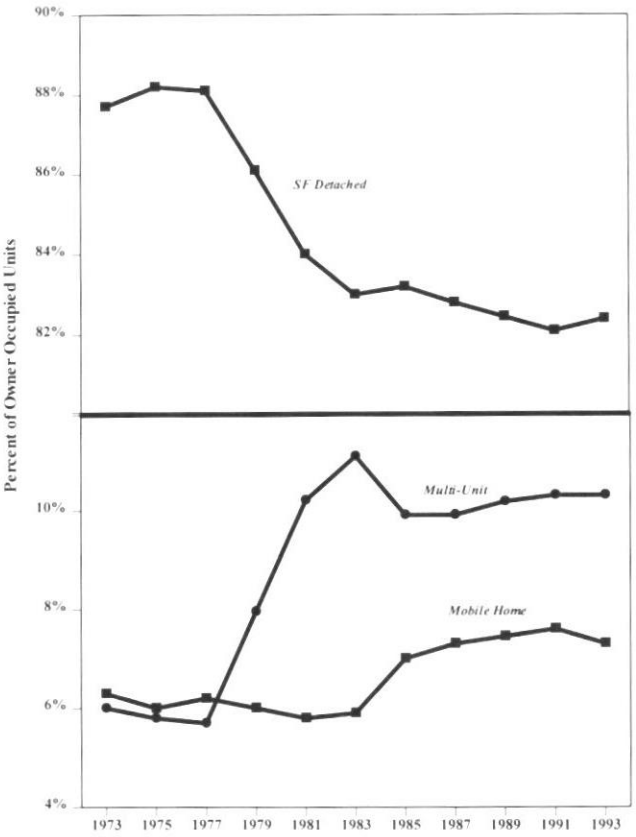
The political and economic philosophies of the U.S. endorses income polarization. The U.S. has the highest income inequality of 14 industrialized countries and the highest among the G7 countries. Income polarization by U.S. cities is substantial with New York City the highest and Washington, D.C. the lowest among 55 metropolitan statistical areas.

Real Estate Implications

Income polarization has had clearly discernable affects on U.S. real estate, and this will become more acute during the next decade. Adjustments will have to be made as institutional investors grasp the new frayed-collar reality.

FIGURE 6

Home Ownership By Type Of Unit–1973-1993



Source: U.S. Bureau of Census, American Housing Survey

Housing

Figure 6 (top) illustrates the decline in single family detached home ownership rates since 1973, and (bottom) the rise in lower priced attached multi-units and mobile homes as housing choices. Further, most new construction today is focused on entry level housing—the bulk of residential activity—for all three sectors. The scenario of course is income-driven: declining or stagnant real incomes burden and decrease the opportunity of home ownership. Less expensive alternatives to traditional single family detached units will be a mainstream growth sector.

Retailing

Figure 7 shows the aggregate annual sales in nominal terms since 1987 for two classes of department store retailers. The first class (solid line) is for the traditional department store, including Nordstroms, May, Federated, Dillards, Mercantile, Sears, etc. The second class (diamond line) is for the discount department store with essentially four retailers: WAL-MART, K Mart, Target, and Caldor.[14] The dramatic increases in the retail sales of discount department stores (10.3% annually) and the less successful increases of traditional department store sales (1.6% annually) almost tell the entire story. These numbers show that consumers are shifting their retailing dollar from fashion to value, the only way to stretch the consumer dollar and keep the family budget under control.[15] Sales figures for traditional department stores have not kept up with inflation and these stores are losing market share.

The implications of frayed-collar retailing are quite deep. Traditional enclosed malls are in retreat. Power-value center malls are running at full gallop. If WAL-MART didn't exist, someone would have to invent it. There is no retreat from this trend (because of the underlying economic income shifts). Therefore, we are seeing a new malling of America, and these malls, unfortunately, will have open air plain Jane architecture of an imminently forgettable variety. But, they will be value oriented and enjoy enormous market acceptance. At the same time, we will see a demalling of America, that is the conversion of attractive fashion oriented enclosed malls to something more in tune with the economic realities of income polarization shifts.

Office Buildings

Figure 8 graphs the percent of net annual office demand (absorption) occurring in the CBD and suburbs of 55 MSAs.[16] It underscores the flight of office building tenants away from center cities and into the suburbs. This flight is pushed by the proximity to lower income households and perceived social unrest in the CBD but, at the same time, it is also pulled by the economics of suburban locations (lower total costs, including labor). Over the five years 1990-1994, 75% of office demand was experienced in the suburbs and 25% in the CBDs. This suburban market share has not remained stagnate but has continually increased over the past decade and a half.

Warehousing

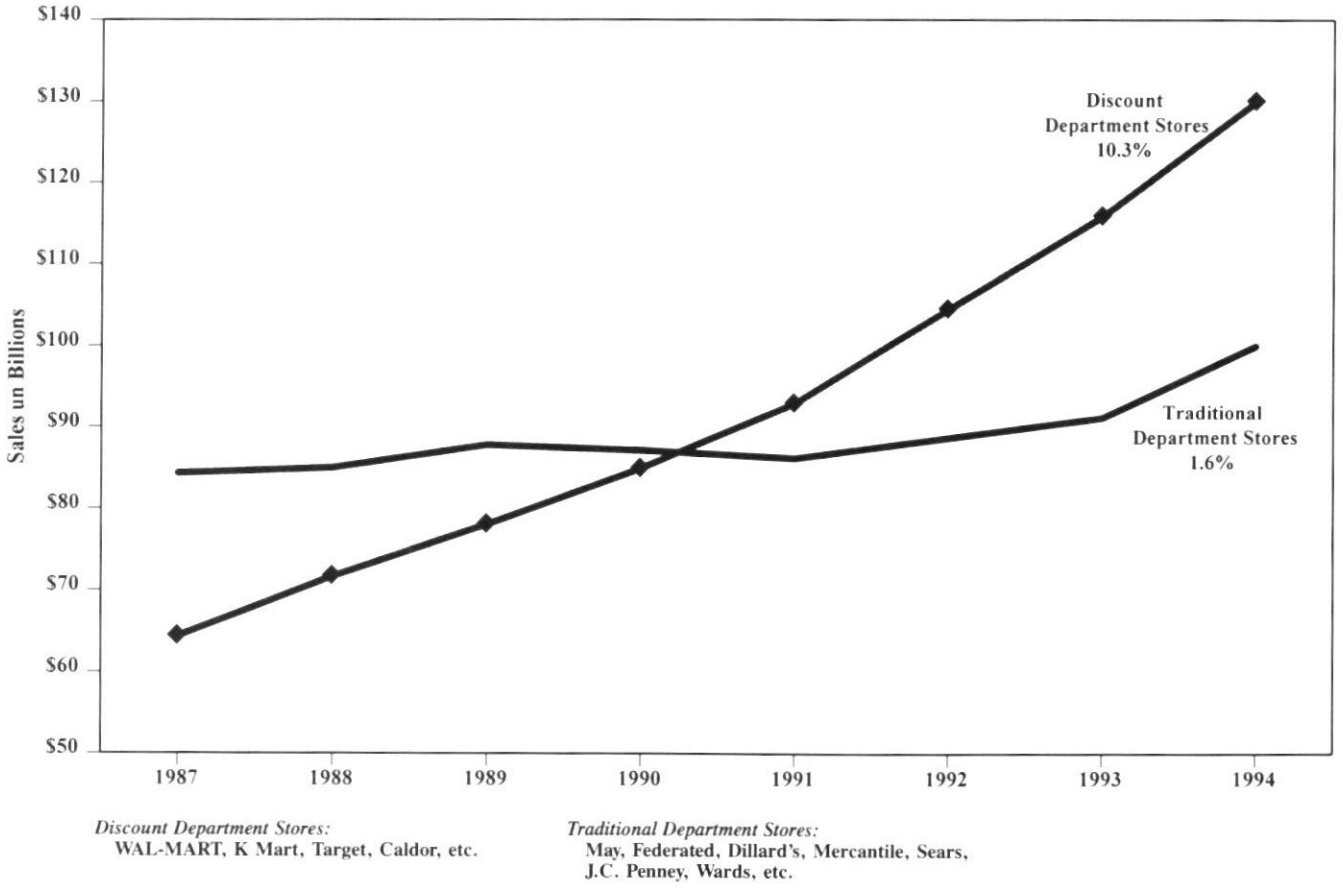
America is being hollowed out of manufacturing. The majority of consumer goods are produced in foreign countries and imported into the U.S for final consumption. Inter-industry warehousing space is being supplemented by finished product (final demand) warehouse space. Hence we are seeing the gradual disappearance of very small warehousing and the emergence of very large buildings required to handle mass shipments of produced goods from major distances. This trend is evidenced by the predominance of wholesale trade establishments (Figure 9) and the predominant construction of larger warehouse buildings (Figure 10).[17]

Conclusion

Income polarization in the U.S. has dramatically impacted the real estate markets long term. A rise in home ownership levels is doubtful without major changes in national policy. Most Americans are

FIGURE 7

Structural Shift To Value Retailing



Source: Department of Commerce, Annual Report

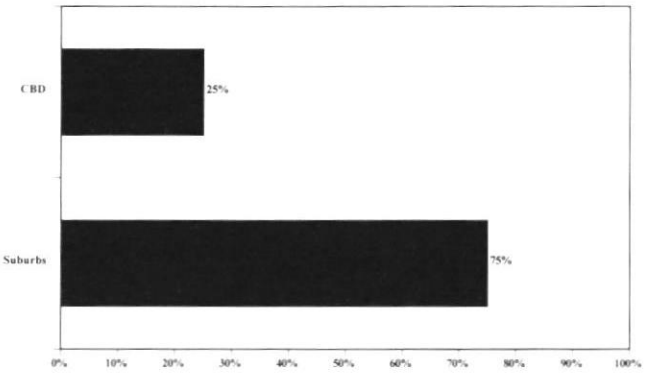
finding it difficult to own a home. In an effort to stretch the budget, American households are flocking to value retailers and abandoning enclosed fashion-oriented malls. With concentrations of lower income households in or near center cities, the office market has relocated to the suburbs. With respect to warehousing, megasize distribution warehouses are emerging as the focus of the distribution system. Virtually all consumer goods are imported from foreign countries as final product—with little need for smaller inter-industry warehousing space to support the manufacturing process.

Observations And Reflections

Income polarization in the United States has produced a frayed-collar economy and will continue to require substantially different real estate products. Much upscale real estate will be destroyed and new real estate will be created to serve a rapidly growing down-scale market. This is the Schumpaterian "gale of creative destruction" in a more concrete manner. Institutional investors cannot invest looking backwards. They must anticipate these far reaching changes. At present, institutional investors are shying away from investing in lower income real estate, such as power retail centers, believing they are just a fad. Eventually investors will understand that this product has solid economic underpinnings.

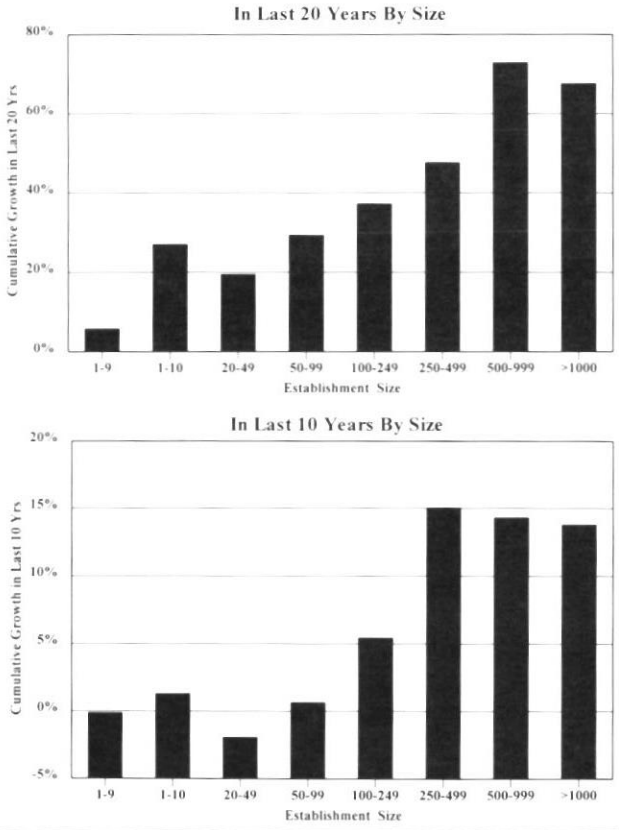
FIGURE 8

Structural Shift To Suburban Office Markets
Share Of Average Absorption



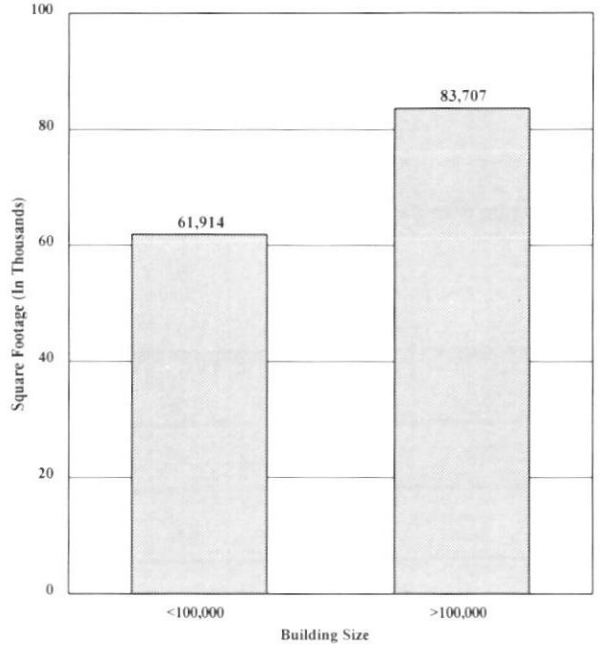
Source: Westmark Realty Advisors, MIDAS IV-XXVL

FIGURE 9
Cumulative Growth Of Wholesale Trade Establishments



Source: County Business Patterns

FIGURE 10
Warehouse Square Footage Built In Last 5 Years In 43 Major Warehouse Markets



Source: Torto Wheaton Reports

Profit opportunities abound in real estate if we can anticipate and capitalize on major trends. A new gale of real estate development and investment is here. Yearning for the past is fruitless. Take the escalator to the basement for that is where real estate investment bargains are found among the frayed-collar merchandise.

NOTES

1. Data is shown as median family income. Note that average income would bias the trend line upward. Income includes wages, salary, rental, interest and dividend income, plus premiums for fringe benefits paid by the employer. The 1993-1994 data are estimates based on CACI Marketing Services data.
2. Generally this graph is interpreted as the end of the American Dream. Irving Kristol of the American Enterprise Institute tends to argue that dreams suggest responsibilities, thereby laying the blame on the American worker. (See footnote 10.)
3. Herbert Stein argues that this is due more to a slowing in the growth rate of productivity. See "A Primer on Pay and Productivity", *Wall Street Journal*, Wednesday, August 23, 1995.
4. A household comprises all persons who occupy a housing unit. A housing unit is a group of rooms or a single room occupied as separate living quarters. Occupants do not live and eat with other persons in the structure. This definition eliminates institutional-type quarters (education, transient, penal).
5. Forecasts from A. Gary Shilling and Co. are forecasts of 1973-1991 data which fundamentally take into consideration the behavior of wages, increases in foreign competition and growth of information technology. The U.S. Department of Commerce median family income series were forecast then broken into quartiles.
6. Obviously social unrest, political instability, trade wars and xenophobia could all emanate from this condition—and are.
7. Adjusted gross income does not entirely equate to median household income. The point of this exhibit however, is to demonstrate income polarization.
8. *The Economist*, November 5th, 1994, for 13 of the countries shown. Information on Mexico is derived from the article "Mexico in Crisis" in the *Los Angeles Times*, April 23, 1995.
9. The aim is to reduce tariffs, quotas, export subsides and other trade-influencing measures.
10. Labor Secretary Robert Reich said that companies have responsibilities to provide decent wages to their employees. A meta-argument can be made that countries have the responsibility to provide economic policies that allow companies to offer decent wages.
11. This opens up a Pandora's box of arguments. Generally, however, analysts on all sides agree that lingering protectionism of APEC (Asian Pacific Economic Community) countries makes the problem worse.
12. This data was derived from *CACI Marketing Services Census Edition*, Volume II, page 74-B by transforming CACI data for income distribution for the bottom 25%–top 25% to bottom 20%–top 20% categories using normalization techniques. For example, for the U.S., the top 25% of households earn above $49,410, while the bottom 25% earn below $15,382; the ratio is 3.21. The ratio from Figure 2 for ratio of income for the richest 20% of households to the poorest 20%, is 11.0. The ratios for the 55 cities were calibrated to this 11.0.
13. This index suggests itself as a valid measure of social tension and unrest.
14. Retail sales for discount department stores (as defined by the Department of Commerce) versus sales for conventional department stores and national chain department stores. Forecasts based on 1987-94 sales increase.
15. Another way of saying this is that consumers are increasing their destination shopping and decreasing their impulse shopping.
16. Share of recent five-year average absorption, *MIDAS Reports*, Westmark Realty Advisors.
17. These establishments have multiple locations so interpretations of firm size over say 20 is ambiguous. Note, however, the smaller and presumably sole location establishment virtually disappeared within the last ten years.