FOCUS ON THE ECONOMY

THE "OLD" ECONOMY, THE "NEW" ECONOMY & THE REAL (ESTATE) ECONOMY

by Hugh F. Kelly, CRE

Serious investors in commercial property need to think clearly about the relationships, both subtle and profound, which link the "new" economy, the "old" economy, and the real (estate) economy. All but the most careful commentators have lapsed into a sloppy pattern of looking at the NASDAQ as the New Economy barometer, regarding it as a convenient index of high technology-oriented companies. They contrast this with the Dow Jones industrial average, which they regard as freighted with corporate dinosaurs.

To quote the teenagers: "As if!" Has anyone recently looked at the composition of the Dow? The 30 business giants whose stock prices constitute the DJIA include some of the most advanced tech firms in the world: AT&T; Boeing; DuPont; GE; Honeywell; Hewlett-Packard; IBM; Johnson & Johnson; 3M; Merck; Microsoft; SBC Communications; United Technologies. What distinguishes them from the high-flying dot.coms? More reasonable price/earnings ratios; real products to sell; real profits to report. These are bad things?

In many ways, those dot.com companies that will succeed are those that will find a ready customer base in the corporations of the so-called "old economy." Up until now, it is business-to-business e-commerce (B2B) that has had the greatest advances in profitability, rather than the e-tailers of B2C, or the business-to-consumer sector. What will success in the B2B world look like? Inevitably it will mean the expansion of the new businesses to significantly larger size. That, after all, is what is anticipated in the stratospheric prices of their stocks. They will be migrating from the stage where the main asset of the business is an idea, into the world of products, business management, marketing, distribution, and customer services. In other words, the winners in the new economy will begin to look a lot like the companies of the old economy. The presence of Hewlett-Packard and Microsoft on the DJIA list give us two good examples of the optimal trajectory.

There will be nothing "virtual" about the real estate needs of the winners. Their employee counts will grow, as will their space needs. Microsoft, for instance, grew from about 5,600 employees in 1990 to more than 31,000 workers by the end of last year. In terms of employees and facilities needs, HP actually dwarfs Microsoft: Hewlett-Packard's payroll counts more than 82,000 workers. As we look at markets around the nation, it is the technology field that consistently is highlighted as the critical source of future demand growth. Amazon.com may already be on the same path. As of year-end 1999, Amazon had 7,600 full-time employees. Just two years earlier, it had 614 on its payroll.

The intense competition for qualified employees in an era of general labor shortage is already having a profound effect on these businesses, and is leading the way into the future for real estate assets. When Ford Motor Company

institutes a policy to provide each of its workers with a computer and Internet access, there is a profound shift in labor-management relations afoot. As workdays have lengthened and technology blurs the distinction between company time and private time, the workplace increasingly features facilities for childcare, health and exercise, shopping, and even personal services. It was Silicon Valley that pioneered many of these trends, now becoming more common across the realm of the Fortune 500. Real estate investors are attuned to such shifts and, as I monitor transaction patterns across the nation, I see ever-increasing interest in flex space or R&D/industrial/office assets, at very aggressive prices. Furthermore, the surge in value in cities with significant technological concentrations has been amply evident. The surprise, to some, may be that such cities include bastions of the "old economy" like New York, Boston, and San Francisco.

During April 2000, the capital markets were particularly tumultuous and we saw the first rumblings of potential investor impatience with the promises-not-performance track record of many "new economy" stocks. More such turbulence is likely in the coming months and years. Investors will be looking more critically at performance expectations, and the "old economy" model may indeed be the image into which the best of the start-ups will morph. In a volatile capital market, there will surely be a cadre of investors who will look to real estate assets as havens of relative stability. After all, buying tangible assets with a first-year income return of 10 percent or so, with cash flow secured by enforceable lease contracts with credit tenants has a certain attractiveness to portfolio managers.

With supply-demand forces in the user markets for commercial property still quite sound, further price appreciation in the commercial property world is still available as well. The year 2000 will provide some interesting benchmarks for comparison between commercial real estate, which enjoys full but not inflated pricing, and stocks, some of which now appear vulnerable to substantial reassessment of their price/earnings relationships.

Meanwhile, real estate companies themselves are using technology in ever more imaginative ways. A cluster of the nation's largest mall owners (Macerich, Rouse, Simon, Taubman, Urban Shopping Centers, and Westfield America) have linked with Cisco Systems, IBM, and Intermedia Communications in a venture called MerchantWired, to provide the retail industry with sophisticated technology infrastructure. The list of property and mortgage-related Web sites seems to grow daily. A company like TrizecHahn is looking to sell $1 billion of real property assets, and to redeploy that capital into real estate-related technology ventures such as the broadband communications service Global Switch.

If, indeed, our economy is undergoing a "change of state" (see the Summer 1998 edition of *Real Estate Issues* for an in-depth treatment of that subject), then some turbulence is to be expected. Even with the nimbleness of so-called "gazelle" companies, there are significant advantages that accrue to size. In many ways, the list of real estate companies in the previous paragraph shows that big firms can best afford to tackle innovative ventures. Location still counts, but in a more complicated way. Big cities — 24-hour cities — tend to do well because they offer economies of agglomeration and because they are exciting places to live and work: exactly what the "wired" generation is seeking.

I have often stressed that real estate is a residual economic product, because it ultimately takes its value from its ability to provide well or poorly for basic economic functions. That is as true in the "new" as in the "old" economy. And, I suspect, real estate will best prepare for the future by anticipating that the "new" economy has fundamentally a lot more in common with the "old" economy than the popular press would have you believe.REI

ABOUT OUR FEATURED COLUMNIST

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