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The Two Real Estate Dot-Coms

The telecommunications revolution is about to have two quite distinct impacts on the real estate community. First, *how we do things operationally* is about to change significantly; and second, the related increase in income disparity is going to *materially change the demand for space*. Since what we do drives who has the coin, it makes sense to start with anticipated changes in how we do things operationally.

HOW WE DO THINGS — TODAY AND TOMORROW

From real-time architecture to on-line loan searches, today increasingly we are using the Internet. The contractor sees a problem on-site. Using a portable PC, e-mail, and shared design software, he contacts the architect and works out a solution without leaving the site. Likewise, checking loan availability through the ladies at Red Bricks¹ is fast, easy, and even fun. However, this is all about doing what we have always done — just doing it faster or cheaper. There is no longer a need for the architect to drive to the project or for the financial officer to make ten phone calls, but the same people are still performing the same functions.

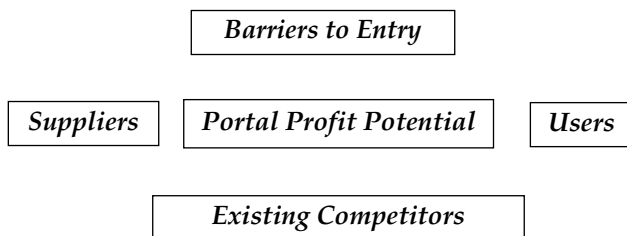
Today the technology makes us more productive, but it hasn't yet materially changed how we do things. Even Simon Property's innovative fastfrog.com and yoursherpa.com are faster and (possibly) more efficient ways to shop, not something new. After all, kids always had lists of what they wanted, and adults could always call in for delivery. The new services make these chores much easier and faster, but that is not a real revolution.

Think back to the dark ages of the computer revolution — the 1970s and 1980s. At first, word processing made secretaries more efficient. The same letter was still typed by the same person, however, it was done faster and cheaper. *Then* we changed how we worked with managers doing their own typing (e-mail) and needing far fewer secretaries. *The second change was the real revolution*. It was more important because it changed who worked where and how much space was needed for certain activities. In the case of the personal computer revolution, the real revolution was also socially productive. Secretaries became administrative assistants performing more involved functions (job enrichment). The real telecommunications revolution may not be as kind.

HOW WILL THE TELECOMMUNICATIONS REVOLUTION CHANGE WHAT WE DO AS REAL ESTATE PEOPLE?

The number of dot-com real estate ventures is staggering. Even the investment bankers and consultants are having trouble keeping their lists up to date.² However, after April's stock market correction, *there is a new focus on which portals can make money*. Vertical, integrated, yada, yada; it comes down to economics. Interestingly, it is the potentially profitable portals that will have the greatest impact on how we do things because they are the ones about to eat someone else's lunch.

In evaluating potential profitability, it is helpful to think of the adjusted Porter model of competitive space presented below. Horizontally, if either suppliers or users have great power, then the industry is less profitable. Likewise, in such a situation, the portal becomes largely a cost-recovery operation, with the powerful (e.g., the Big Three automobile makers) using it to extract an extra pound of flesh from the weak (the large number of smaller auto parts manufacturers). Vertically, existing competition is bad and barriers to entry are good, in terms of portal profit potential.



Many of the new real estate portals make economic sense in that they make life better (cheaper or faster) for somebody. However, only a few of these portals look like big economic winners themselves. The greatest real estate opportunity for big profits appears to be in brokerage (both leasing and sales). In this sector of the real estate dot-com universe, there are a large number of buyers and sellers (lessors and lessees). Yet one is firmly established as an electronic middle person (no existing competition). Finally, the barriers to entry will be high for the second entrant. Buyers and sellers won't want to learn a second system and will have less incentive to help this new player collect data because their back-office need will already have been satisfied.

Commercial real estate has been one of the least transparent, most expensive transactions markets in the U.S. economy. *The net* loves to cut out middlemen and reduce margins. The vast network of commercial real estate transactions is a massive lump of molasses in the sights of an army of geeky flies.

The new technology facilitates a much more efficient transaction process. Consistent, timely, and cheap information is now possible. In addition (and this is a critical factor), two groups of well-endowed people want to make the process cheaper and more transparent. Guy Jacquier³ is representative of one group, and his position is very clear. If the CalPers real estate portfolio stays 1% more occupied, surely it justifies a little venture capital investment to help the on-line brokerage competitors get going. His investment in Property First was made for this reason. It really isn't very important to him who wins the on-line brokerage race (Costar, Loopnet, Property First, the very illusive Goldman Sachs financial venture, the even more secretive Real Pulse, or some other entity). Lots of other big property owners feel the same way.

In addition to big institutional owners, big venture capital money is supporting new technology in general and its penetration of the real estate industry in particular. Plenty of venture capital is available, big real estate owners are helping facilitate the change, and the result will alter the real estate business materially regardless of which company wins.

Will all real estate leasing and sales be unbrokered Internet transactions in 2005? Very unlikely. Will a smaller number of brokers individually handling a larger number of transactions at a reduced commission cost per transaction be the rule in 2005? Very likely. Brokers have traditionally sold data, insight, and help in "getting the deal done." The telecommunications revolution makes data very easy so that the focus can be on insight and implementation. This allows the better brokers to "add value" on a much larger number of transactions. It also allows a huge number of brokers to seek other employment.⁴

Across the society, not just in real estate, the recent wealth creation from the telecommunications revolution has been overstated. The revolution has destroyed a large amount to human capital as it has produced those big returns on capital in the form of stock market appreciation. Lots of thirty- to forty-five-year-old "managers" who thought they had developed the skills needed for their prime earning years are about to discover a disheartening lack of demand for their skills. It's happening across the economy, and real estate will not be spared.

Moving from the big profit potential of a brokerage portal and the concomitant human disintermediation to other areas of real estate, one sees more of the same — *big-time disintermediation*. This will be true from commercial appraising to the sales of property and casualty insurance. Along with this disintermediation comes new opportunities. Just as with the real personal computer revolution, this is a chance to do things we haven't done before. New things are cost-justified and new business opportunities are being created. Only change is constant, and the rapidity of change is about to increase in the real estate business.

For example, real estate research possibilities expand geometrically with the new, more available, higher-quality data. Real estate research shops should be able to add a lot more value to the investment management process. Similarly, if appraisals get cheap enough, lenders can productively spend a lot more time anticipating delinquencies and acting sooner.

Moving toward the second real estate dot-com, there is an opportunity to provide new kinds of space in new places because the benefits of the telecommunication revolution are not being spread evenly across metro areas or population cohorts. Telehotels at the intersection of major fiber-optic pipes and switching concentrations are already a reality.

The key question in the first real estate dot-com is, "*How much?*" For example, will we have 25% or 75% as many commercial brokers in 2005? The key question in the second real estate dot-com is, *where?*

THE SECOND REAL ESTATE DOT-COM — SPACE IMPLICATIONS OF THE TELECOMMUNICATIONS REVOLUTION

Much has been written about the long-term possibilities of the Internet, from telecommuting to virtual hotels. Likewise, Bill Mitchell has been particularly articulate about the possibilities of the "boxes at the end of the pipes" and what that will mean in terms of new lifestyle opportunities. *Real Estate Finance* has carried several articles on these topics in the last few issues.⁵ These ideas are all very interesting, though quite difficult to forecast in an accurate way. The focus of this article is on the nearer-term implications of money movements. While "following the money" does not provide a crystal-clear path, the implications of dot-com money movements for particular geographies are actually easier to document and extrapolate than on-line shopping or more exotic, remotely operated lifestyle aids.

Silicon Gulch (south of the market area of San Francisco) has already made property owners and developers rich by becoming the focal point for the new telecommunications culture in the Bay Area. Likewise, Austin, Texas, reportedly has more than 2,000 "Dellionaires." This is the tip of the iceberg. High stock prices and a booming IPO market for the last five years of the twentieth century have created the biggest flow of venture capital ever. In the first quarter of 2000, venture capital expenditures in Boston were several multiples of the first quarter of 1999, which was a record at the time. This new money will draw not just people but the smarter and more aggressive people to the few MSAs (and neighborhoods) that are disproportionately benefiting from it. Further, the lifestyle preferences of this newly enfranchised group are different, so different, kinds of space will be demanded in areas receiving the venture capital funding. For example, there will be less demand for midrise, no "walking amenities" office buildings, and more demand for style both around and inside the office.

Fully evaluating this nearer-term, financially driven value shift from the telecommunications revolution is non-trivial for two reasons. First, the money is identified going to a firm's home-office MSA. The firm may plan to invest outside that market. Second, SIC codes for high-technology workers don't readily distinguish between high-level engineers and lower-level technicians handling storage backup on contract for an Old Economy firm. Clearly, the former drives more value change than the latter.

Regional economics has always cherished the multiplier concept, and it is helpful in analyzing the impact of the new workers. Simply put, the theory says that for every basic industry worker (usually defined as someone producing something that is sold outside the region), there is a need for x number of support workers (from barbers to policemen). Those newly enfranchised by the telecommunications revolution, particularly those at the top of the nerd scale, command a very high multiplier. These are the people who buy neat old homes and spend \$500,000 on renovations. These are the people buying extra toys, paying for elaborate private schools, and (hopefully) supporting the arts. These folks generate a bigger job multiplier because the product they produce and sell outside the region generates a big surplus.

Two sister MSAs demonstrate both the impacts to date and the potential future impact of the telecommunications revolution on locational preference and hence on value change. Consider Austin versus San Antonio and Raleigh-Durham versus Greensboro-Winston Salem.

Over the last three decades (the period of the computer revolution), Austin and Raleigh-Durham have prospered far more than their sister cities. The sister cities are only an hour away by car so the discrepancy isn't caused by climate. The sets of cities are clearly distinguishable on a research/education measure. Over the last thirty years, property appreciation has been greatest in the more education-oriented metropolitan economies.

Now consider the new venture capital money and its *still-to-be-felt influence*. While the two sets of MSAs are of similar size, the new money is going to the leaders by a factor of nearly 10 to 1. This implies yet more separation in the future, as job and income growth continue to diverge. Further, the multiplier on the new jobs is clearly higher in the education-oriented MSAs, accentuating the value impact.

This does not imply that East Austin will see housing prices exceeding Alamo Heights in San Antonio or that downtown Durham will be nicer than the Greensboro Country Club area. The divergent impact is neighborhood-specific as well as MSA-specific. Austin will see a larger part of the MSA benefiting, but it isn't as simple as Austin beats San Antonio by even more in the next few years than the last thirty years.

As in the "how will we do business differently" analysis, in the future existing activities will be not only faster and cheaper, but there will be whole new activities. For example, an increase in data flow generates a need for faster switches and for a new business making optical switches. Who will build the new businesses of the twenty-first century? The best, brightest, and most aggressive may not win every race, but they are probably a good bet, on average.

Where will these people tend to locate? Money doesn't buy happiness, but it does provide opportunities. More of these folks will be in the MSAs/neighborhoods currently winning the venture capital game, and this will stimulate even more rapid growth in these locations. In other words, money today (current growth) moves people, and these are the kind of people who generate faster growth in the future.

SO WHAT DOES IT ALL MEAN?

By separating the telecommunications impacts into "two real estate dot-coms," it is easier to avoid missing the forest fire while dodging the nearest falling tree. Real estate is about to witness a great deal of human capital redundancy. The same changes that destroy some people's human capital create new opportunities literally "to go places where no man has gone before."

This creative destruction/empowerment is playing out across society, setting up the second real estate dot-com. Big money and aggressive people are becoming increasingly concentrated just as their influence in society is accelerating. Even if they fail in their new ventures, the multiplier benefits assure well-above average growth for a considerable period in the preferred MSAs/neighborhoods.⁶ Unfortunately, the flip side is also true. Greater national income and education disparities mean that the non-winning locations will become real losers over the extended business cycle.

ENDNOTES

¹If Prudential completes the acquisition of Red Bricks, this will be not only the same stuff faster, but also the *same* institution faster.

²Bank of America Securities does a nice job of cataloging the players in relevant groups and indicating which players have made progress through the IPO process.

³Guy Jacquier is now working at AMB, but this statement, made when he was the head of real estate at the California Public Employees Pension Plan, is very telling.

⁴This won't happen at the same time in all cities. The new data/information is being assembled in only the top forty to fifty MSAs. It will be a considerable period before the changes are felt in Waco, Texas.

⁵See M. Zandi, "What the New Economy Might Imply for Real Estate Markets." *Real Estate Finance*, (Winter 1999); J. Corgel "Virtual Hotels." (Spring 2000); P., R., and T. Hendershott, "Internet Retailing Possibilities." (Spring 2000); and Mitchell, *The New Urban Infrastructure*, Cambridge, MA: MIT Press, 1999.

⁶Even a material drop in the price of technology stocks will not stop this divergence in growth prospects. The venture capital money is already raised. A sustained drop in prices will shut off new VC fund formation, but there is already enough money in the pipeline to fund the changes discussed in this article.

Mike E. Miles
Editor