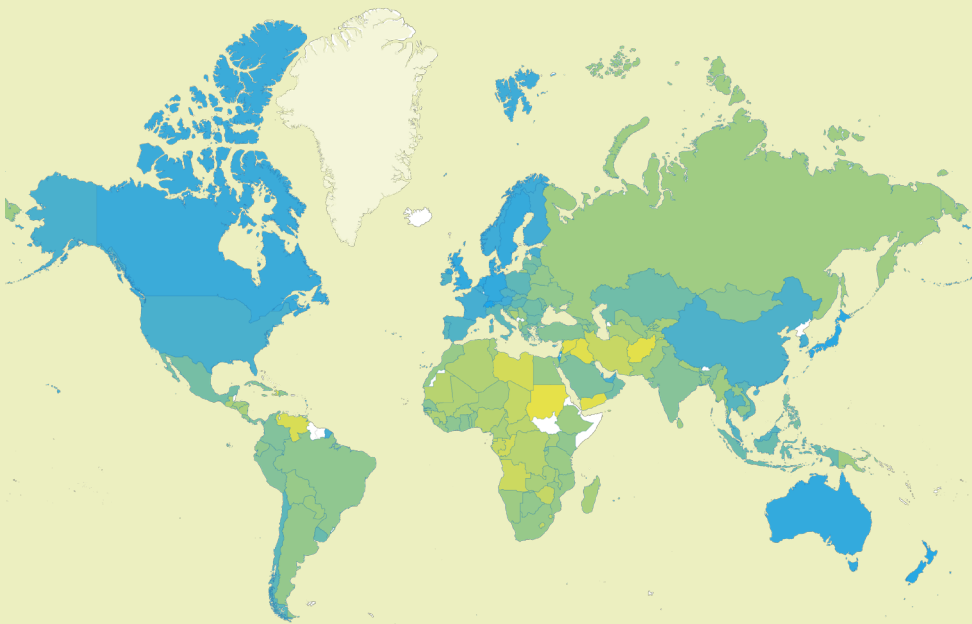ELITE QUALITY INDEX
EQx2023

This PDF includes a contribution from the following book:

ELITE QUALITY
REPORT 2023

Measuring Value Creation in the real estate and construction sectors: Developing two new EQx Indicators

Martin Langen, Swissforecast GmbH

Dr. Marcus Schütz, Swissforecast GmbH

Measuring Value Creation in the real estate and construction sectors: Developing two new EQx Indicators

Real estate is a major industrial activity and contributes to society throughout its entire value chain and by determining the affordability of housing. A well-managed real estate market adds enormous value to a national economy and its citizens. However, Value Extraction can also be observed in countries where, for a number of reasons, the balance between supply and demand breaks down.

The supply and demand of real estate and the upstream construction industry are connected, though there is a time lag. Rising demand for residential buildings reflects increased rental and purchasing prices, triggering additional construction output. However, as real estate is a large asset class with relatively long delivery times, there is likely a temporary gap, conceptualized here as the Construction supply gap (CSG, a new Indicator to be included in the EQx2024). Investors tend to seize opportunities for high project yields during times of undersupply though excessive uniformity in their investment decisions can subsequently lead to an oversupply and falling prices. In extreme cases, we observe 'real estate bubbles'. The bursting of such bubbles is often not contained to the real estate industry but spreads and heavily impacts the overall stability of the financial system.

The CSG Indicator will measure the health of a national real estate sector based on underlying demand and completed dwellings data (see Visual 4.2). Research has shown that a slight undersupply ensures housing affordability, as well as supporting the profitability of the industry and stimulating investment. Large supply gaps or oligopolistic structures are extractive, as is oversupply, as investment levels will eventually be effected causing a downturn in construction output.

On the demand side, the econometric model on which the CSG is based determines the additional number of households, amount of domestic migration, and changes in household sizes. On the supply side, it factors in the net value of new construction and demolition, the number of second homes and tourist real estate. The impact of second homes varies across countries; for example, it is quite significant in France. Second homes count as part of construction output but do not supply additional households with permanent dwellings.

The CSG is scaled to 100, meaning that at this point, 100% of the demand for residential real estate is met. As mentioned before, the optimum is not set as an exact balancing of supply and demand (CSG = 100), but as a slight undersupply which stabilizes the market, maintains real estate values and encourages further investment and protection for the financial sector against waves of non-performing loans.

On the other hand, oversupply with a CSG of over 100 may have devastating effects on real estate owners, the financial sector and on capital availability. Notable examples of oversupply historically include Spain, the US, and Ireland. Construction is a major industry that is closely linked to the financial sector and, if well balanced, creates value by providing affordable living for a country's citizens. Thus, the CSG will be included in the EQx2024 in the Producer Value Pillar (iv.10), as part of the Economic Value Index Area (iv). Its goal is to be an additional analytical instrument to assess the value created or extracted from society at large taking into consideration the construction industry's impact on the national economy and living standards.

A second related Indicator will also be added to the EQx2024: the Housing Affordability Index (HAI, iv.10). The HAI also describes Value Creation and Value Extraction in the housing sector by comparing countries based on the ratio of housing or rental costs to income. The Swissforecast approach to the HAI will consider the ownership ratios for houses and apartments. It is a revealing fact that there are very rich countries such as Switzerland with low ownership rates, while lower income countries such as Romania have higher ownership rates. Particularly interesting is research on countries like Singapore where high house prices have not discouraged high ownership rates, while Hong Kong has very low ownership rates. Together, the CSG and the HAI will extend the Sustainable Value Creation analytical toolset of the EQx into the all-important construction industry and real estate market.

Martin Langen and Dr. Marcus Schütz
Swissforecast GmbH

Visual 4.2: Construction supply gap (GSG) for Switzerland and Germany (2012-2025F)

Switzerland

Underlying Demand (in 1.000 units) — completed dwellings (in 1.000 units)

CH: Construction Supply Gap (CSG)
Optimum = 0

Germany

Underlying Demand (in 1.000 units) — completed dwellings (in 1.000 units)

DE: Construction Supply Gap (CSG)
Optimum = 0