Global Matters Weekly

22 July 2024

What do replacement costs tell us about the outlook for global listed property?

Richard Stutley, CFA, Portfolio Manager

"Building cost trends continue to show an unprecedented increase in construction cost inflation for the year ending January 2023 with an average increase of 12.90% for the year" - Zurich Resilience Solutions[1]. While cost inflation may be slowing – 1.2% over the 12 months to January 2024, according to insurance giant Zurich – we have still experienced several years of rapid price growth. Yet, counterintuitively, property prices have at times fallen during that same period[2].

Falling property prices and rising construction costs isn't a dynamic that can continue indefinitely. The squeeze on developers' margins makes construction less and less profitable. When prices eventually fall below replacement cost (marginal price < marginal cost), there is clearly no incentive for developers to increase supply. No new supply means growing demand can't be met, and instead a portion of this demand has to be squeezed out by higher prices, a situation that continues until prices exceed replacement cost and supply is turned back on.

The sight of prices below replacement cost is therefore bullish for property from a demand-supply perspective. The opposite is also true: prices above replacement cost incentivise new supply and are therefore a bearish signal, kick-starting a new development cycle. Replacement cost, therefore, is a fundamental force in the property market and one worth paying attention to.

The data is patchy: you are more likely to find a meme stock index[3] than something high quality like 'enterprise value to replacement cost' for the global listed property universe. However, data from Zurich Resilience Solutions[4] shows that construction costs in the United States have risen by an average of 43% since 2020, or 9.3% per annum. Over the same period, global listed property companies, representing a liquid way to buy and sell real estate, have fallen by 3.7%[5].

This divergence looks stark. If it results in less development, then this bodes well for rental growth in the coming years. We would argue, however, that higher rental growth is a necessary condition for one to start constructing a bullish case for property, rather than a nice to have. Our analysis[6] suggests realised growth over the past 20 years hasn't been adequate to compensate investors for risks associated with investing in global listed property: this new environment may help to correct that.

Rising replacement costs and falling prices are certainly relevant, but up to a point. A higher cost of production doesn't always translate into a higher sales price: there are plenty of things that aren't meant to be made, because the process of making them uses up more utility than the finished goods add. If, for example, demand for secondary office space is fundamentally lower today than in the past, then it may take a long time for demand to absorb current capacity, with downward pressure on prices during that period. Development cycles are also long, while spending by occupiers on new space is lumpy, meaning it may take some time before the effects of constrained supply start to show up in higher rents and prices.

Overall, the current trend in replacement costs and prices isn't sufficient to construct a bullish case for global listed property today. It is, however, an important data point and a positive one.

Sources:
[1] "Replacement value cost trends" by Zurich Resilience Solutions, January 2024. [2] The S&P CoreLogic Case-Shiller 20-City Composite City Home Price NSA Index (ticker SPCS20Y% Index) turned negative in 2023. Bloomberg Finance L.P. [3] Bloomberg Finance L.P., Most popular meme stocks (UBXXMEME Index) [4] Refer to [2]above [5]Bloomberg Finance L.P., S&P Global Property USD Total Return Index (SPBMGPTU Index), 31/12/2019-01/01/2024 [6]Bloomberg Finance L.P., global listed property dividend per share growth between March 2005 and May 2023, plotted against variability of 12 month dividend growth and compared against global equities.

Belvest 研富

For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

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