Poised for a comeback

Brazil faced its share of turmoil in 2015 and 2016; will 2017 hold something different?

by Denise DeChaine

The year 2016 was definitely one of transition for Brazil, a country once touted along with the other BRIC members as "the next big thing." But emerging markets are not in favor currently, and Brazil has had a tough run for the past two years, according to *Waiting for the other shoe to drop in Sao Paulo: Is 2017 the time to consider real estate investing in Brazil?,* a report by InDev Capital. The numbers speak for themselves:

- GDP contraction of approximately 10 percent in three years; worst economic contraction in Brazil's history
- Unemployment rose from 4.8 percent to 11.8 percent in three years
- Inflation rose from 5.9 percent to 10.7 percent in two years
- Interest rates rose from 7.25 percent in 2013 to 14.25 percent in 2016 (but have since been lowered to 13.00 percent in January 2017)
- Debt as a percentage of gross national product rose from 60 percent in 2013 to 73 percent in 2015
- Loss of institutional-grade credit rating by rating agencies

Aside from economic woes, the country was in the spotlight again in 2016, but for very different reasons. Media coverage focused primarily on Brazil's role as host country for the 2016

Summer Olympics — and the success or failure of that venture — and on the impeachment and removal from office of President Dilma Rousseff.

The Olympics

Brazil was flying high when the International Olympic Committee entrusted the country with the Games, during a period when the nation was hailed as one of the four fastest-growing emerging economies, according to *Rio's Olympic Legacy,* a report by GTIS Partners. Rio de Janeiro outbid Madrid, Tokyo and Chicago, becoming the first South American host city for the Olympics. The city proposed an ambitious $10 billion plan to build an Olympic Park, dramatically improve its transportation infrastructure, and clean up the environmental and health hazards plaguing the region. At the time, 92 percent of Brazilians supported the Games.

But it is no surprise the plan had its share of setbacks in the face of the deepest economic recession since the 1930s, the corruption scandal at state-run oil company Petrobras, presidential impeachment and the Zika outbreak.

"Audiences around the world were treated to pictures of Olympic venues amidst Rio's spectacular scenery, as well as images of pollution and social unrest that continue to plague this city of 12 million people," notes the GTIS report.

Peter Ciganik, a director at GTIS, explains more than R$25 billion ($8 billion) was allocated for the development of new transport infrastructure, including a new Metro line, four Bus Rapid Transit routes, a new 17.4-mile wireless-streetcar line and overhaul of the Galeao International Airport. The airport was enlarged by approximately 1 million square feet and received 26 new air bridges as well as an express BRT connection.

All of these improvements were important, but Ciganik also adds one of the most challenging, but ultimately most impactful, projects was the redevelopment of Porto Maravilha, the old industrial port adjacent to downtown Rio, which received two new museums, a renovated cruise ship terminal, underground expressway, and a new waterfront esplanade called Olympic Boulevard. The port exceeded expectations as a new tourist attraction, with the Santiago Calatrava–

designed museum receiving many more than the projected 500,000 visitors.

"While coming at a high cost, the need for more-efficient infrastructure for the Games broke through [the] previously intractable administrative logjam amongst federal, state and city agencies, and the city should benefit from these upgrades for decades to come," says Ciganik.

Although all of these changes seem positive, some say they are mixed at best.

"A post-mortem arguing officials in charge overpromise and underdeliver can probably be used to describe any of the past Games," says Mike Golubic, principal and portfolio manager at The Townsend Group. "The city will benefit long term from many of the much-needed infrastructure improvements; however, the cost and burden on the public sector of putting on the Games will make future investments in the city that much more challenging."

Any positive impacts from the Games, adds Golubic, will be outlived by the effects of elevated levels of new supply over the past five years — driven more by general optimism than specifically

by the Games — and reduced demand resulting from the recession and further magnified by the decline in the price of oil, as well as the negative impacts of Operation Car Wash, an investigation into money laundering and corruption at Petrobras. Rio has been affected by a confluence of events, the Olympic games merely one, that have contributed to the likelihood of a more prolonged recovery.

Impeachment

Politically, Brazil has experienced a period of turbulence and turmoil. Former President Dilma Rousseff was impeached in May 2016, accused of breaking fiscal laws, and ultimately removed from office in August that same year

Dilma Rousseff

"The political uncertainty around the impeachment was a significant headwind to Brazil's economy in 2015 and the first half of 2016, impacting both business and consumer confidence, all of which hurt real estate demand," says Fred Gortner, COO at Paladin Realty Partners. "On the flip side, this uncertainty also caused a lot of capital to sit on the sidelines, which created some attractive real estate asset values in U.S. dollar terms."

Gortner explains the impeachment and removal of Rousseff, with a new, reform-minded, centrist president taking the helm, marked a turning point in the minds of many investors, as evidenced by the BOVESPA — the Brazilian stock exchange based in Sao Paulo — which has rebounded by about 50 percent from the beginning of 2016. This improvement in business and consumer confidence, which became more firmly rooted in second half 2016, bodes well for real estate investment over the medium and long terms.

Without that visibility, though, says Golubic, real estate investors lacked confidence in formulating the fundamental assumptions necessary to achieve returns consistent with the levels of risk.

"The good news is that late 2016 brought some resolutions and clarity to the political situation," says Golubic. "There still remain many outstanding concerns, but with the formal removal of President Rousseff, there is a clearer path politically through to the next election in 2018. Positive momentum on key issues around fiscal policy have advanced through the new government, providing support to an improvement in the economic forecast, which in turn provides better visibility to real estate investors and increased interest."

The investment case for Brazil

Aug. 31, 2016, marked the official inauguration of Michel Temer's presidency. According to *Brazil's Reform Agenda,* a market commentary by GTIS, President Temer's goals for reform are ambitious, and implementing all of them during a shortened two-year term of office will be challenging, but it seems in the long run it will ease investors' minds about investing in Brazil. The agenda includes sweeping reforms along three broad lines: (1) better conditions for investment through market-friendly policies, especially infrastructure investment and

privatization; (2) restoration of fiscal budget balance; and (3) improved competitiveness through tax and labor reform.

Although things still seem risky, some are positive about the future.

"When the government decided to take the bitter pill of reform, the negative aftereffects, of course, would last for a while before realizing long-term benefits," says Josh Pristaw, co-founder and managing director of GTIS. "Despite the progress, the economy remains weak, with unemployment still rising and industrial production stabilizing at low levels. Investing in this environment entails a heightened level of risk and commensurate return expectations on the opportunistic side of the spectrum. Brazil is not out of the woods yet, but the best investment opportunities are often contrarian, as investors abandon out-of-favor markets, dumping assets first and asking questions later. Brazil's macro environment may deteriorate further, but asset values are now near historic lows and represent a compelling opportunity for long-term institutional investors. While volatility may persist in the near term, high-quality assets are now available significantly below replacement cost, implying rates of return not available currently in any other major market."

Sao Paulo skyline

According to Golubic, the investment opportunities in Brazil can be divided into two broad categories:

- **Core-plus/value-add:** acquisition of existing, good-quality, well-located office, retail or industrial assets at high cap rates. "The primary strategy is to make modest capital improvements and maintain or increase occupancy, benefitting from a future recovery in rental rates and decline in cap rates," says Golubic. "This strategy is more suitable to longer-term investors looking for a lower-risk/lower-return strategy to take advantage of valuations that have declined materially from the peak in both local and USD terms, and the eventual improvement in the economy and real estate fundamentals."
- **Opportunistic:** debt, preferred equity and equity strategies seeking to capitalize on distress caused by the years of recession and dislocation in the capital markets. "High market interest rates and reduced lending capacity by banks has impacted capital availability across traditional corporations and real estate owners and developers," says Golubic. "This has created opportunities to provide debt or other structured transactions at opportunistic levels of return as an alternate source of funding. An example is providing gap debt or preferred equity to residential projects that are permitted, have sales and construction in-progress, but the developer lacks the capital to finish the project."

Major markets are likely to have better investment opportunities. "In general, we prefer focusing on the major markets of Sao Paulo and Rio, and to a lesser extent Belo Horizonte and Porto Alegre," says Gortner. "The municipalities and planning departments tend to be better staffed and, as a result, approvals are much more predictable. You also tend to find a larger pool of high-quality local operating partners in these markets, which provide the opportunity to scale up investment platforms through programmatic joint ventures. For now, though, we remain cautious on Rio, as virtually all segments of the real estate markets there are oversupplied in the wake of the Olympics, and the local economy is driven mainly by oil and gas, mining, and government, all of which are struggling sectors."

Residential investments targeting the country's growing workforce and middle-class remain one of the most attractive risk-adjusted strategies to capitalize on the long-term growth opportunity in Brazil, notes Gortner.

Golubic points to the potential of the industrial market and believes opportunities exist across each of the property sectors, and investors should maintain a willingness to be flexible and opportunistic.

"Office was overbuilt in each of the two main markets of Sao Paulo and Rio de Janeiro, leading to sharp rental rate declines and high levels of vacancy," says Golubic. "Opportunities to acquire vacant or partially leased buildings will exist, although likely at lower returns due to less leverage and more limited distress. Despite a general oversupply of residential developments and inventory for sale, there still continues to be demand

at certain income levels and in desired locations. Retail malls underwent a significant building boom over the last five years, with many developers focusing on underserved secondary and tertiary cities. The impact of the recession, and markets where too many malls were delivered, is likely to lead to distressed opportunities. Some will present attractive restructuring plays, where others may be a long-term value trap. Hotels and other specialty property types will also likely offer development opportunities as the economy recovers, due to lack of quality existing supply to meet demand."

According to Pristaw, GTIS believes the current opportunity in Brazil is related to a broader distress that is not specific to a particular property type.

"Our focus with distressed investments and credit origination is on the quality of the collateral, levels of subordination, net worth of the borrower, or structural features of the investment that provide enhanced protection, such as cross-collateralization and corporate guarantees," says Pristaw. "GTIS is currently pursuing opportunities in the office, residential, industrial logistics and hospitality sectors. These sectors appear to be bottoming out in terms of fundamental performance of the underlying properties. Because the Brazilian consumer sector remained relatively robust until recently, thanks to government support, retail properties are one area where we expect further deterioration of rents, occupancy and valuations. Credit problems at Brazilian banks and overleveraged consumers may also lead to further deterioration in the middle-income housing sector."

What does the future hold for the land of Order and Progress?

BMI Research's report, *Latin America Monitor: Brazil,* forecasts the Brazilian economy will begin to recover gradually over the coming quarters, as sentiment improves and investment returns to positive growth.

Gortner says the consensus view is Brazil's economy will rebound and return to positive GDP growth in 2017.

"This will come as very welcome news to investors, businesses and consumers after experiencing a two-year recession where the economy shrank by over 7 percent, more than twice the contraction that the U.S. economy endured during the 2008–2009 global financial crisis," says Gortner. "Inflationary pressures should continue to ease, which will allow for a reduction in interest rates. This will bode well for real estate. Office market vacancy in Sao Paulo should peak in 2017, but Rio is likely to continue to see increased vacancy and declining rents as additional supply is delivered and absorption remains weak. The commercial sector is not leveraged, so assets are not trading at distress prices as owners try to ride out the downturn. Low- and middle-income housing, which haven't suffered as much as commercial, should benefit as the unemployment rate begins to fall, mortgages become cheaper and consumer confidence continues to rebound."

GTIS projects the Brazilian economy will stabilize and return to positive growth in 2017, as macroeconomic imbalances begin to correct. Assuming progress on the reform front and relatively benign global macroeconomic conditions (in particular developments in the United States and China), GTIS believes several favorable trends will begin to take hold:

- Improvement in current account deficit, led by a strong trade surplus
- Boost in foreign direct investment, led by the oil and gas sector following market-friendly reforms
- Material reduction in interest rates — return to single digits as inflation subsides
- Favorable movement in real estate cap rates correlated to falling interest rates

"As sellers capitulate to new reality, and begin to dispose of properties forced by loan obligations, or the need to raise capital for half-completed projects, GTIS foresees a strong investment opportunity in Brazil for 2017," says Ciganik.

Golubic explains the consensus view is 2017 will be the inflection point in the Brazilian economy, marking the end of the recession and a return to positive, albeit moderate, growth.

"Within the consensus view, several important areas to note that impact real estate investment decisions include the expectations for, one, declining real interest rates as inflation converges on target, allowing the central bank to reduce benchmark interest rates; two, a GDP recovery led first by investment; and, three, the likelihood of further deterioration in employment, wages and consumer spending before finding a bottom later this year," says Golubic. "Lower real interest rates have the potential to positively impact real estate valuations as cap rates have room to begin to compress. Despite favorable long-term demographics, the expectation for a slow recovery by the consumer will impact the speed and degree of any recovery in the retail and residential sectors. We remain constructive on new opportunities in Brazil but recommend a cautious and conservative approach to underwriting a recovery in fundamentals." ❖

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