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Brazil Real Estate: Having a Ball

Real estate loans in Brazil have nearly quadrupled the past three years. And the sector should continue growing at strong levels.

CHRONICLE SPECIAL

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Mauro Costa no longer lives in a rented apartment on the periphery of Sao Paulo. He is one of the 204,312 Brazilians who, over the last 12 months, realized their dream of purchasing their own house. The debt he acquired for financing the house will have to be paid off over the next 30 years at an annual interest rate of 12 percent. But Mauro is enormously happy nevertheless. A little more than three years ago, before the Brazilian government changed its regulations for real estate financing, he could not even have imagined holding the keys to his own house in his hands.



REGULATIONS SPUR GROWTH

Mauro's story provides an example of the new reality that the Brazilian real estate market has been experiencing ever since the middle of 2005. With continued stability and economic growth, the market has recorded positive growth since 2001, according to Abecip (the Brazilian Association of Real Estate and Savings Institutions). Until recently, however, the market lacked regulations that made conditions for purchasing real estate more flexible. These changes were carried out by the government in 2005. Ever since, loan activity in the sector has shot up. In 2004, 53,787 real estate loans were made in the country, according to Abecip. In 2007, that number reached 195,900.

"The changes revolved around real estate guarantees," says Jose Carlos Oliveira, professor of economics at the Unb (University of Brasilia.) "In past cases of non-compliance, the person responsible for the financing did not recover an adequate amount. Starting with 2005, the government permitted institutions to work with 'fiduciary alienation,' an arrangement where the buyer of the property becomes the owner of the property only after he has just paid it off. Although this option creates a highly risky situation for the borrower, it makes it possible for the person who provides the funds to have an additional motivation" because it permits him to recover the property in case of non-payment.

Once the institutions that granted loans had more security, the government could expand the options for obtaining funding. According to the regulations of the Brazilian central bank, 65% of all the government's savings had to be used to provide housing credits, as specified by conditions set by the SFH (the Housing Financing System, which caps interest rates for acquiring and constructing housing to 12 percent and 13 percent, respectively). The rest of the credits had to be provided at market rates and used for financing residential real estate. "These measures were designed to set up a specific budget from various governmental sources, and they encompass the expansion of credits for the financing of housing and the reduction of taxes on industrial products and a broad range of construction materials," adds Anita Kon, professor at the PUCSP, the Catholic Pontifical University of São Paulo.

LENGTH AND FLEXIBILITY

Adds Kon: "The private financial sector also implemented measures to provide incentives for increased real estate financing. It lengthened the time periods allowed for financing and made the regulations more flexible for verifying the incomes of borrowers." Currently, payment conditions are more stable, and financial institutions have reduced the

requirements when it comes to providing proof of income. Even self-employed workers and small entrepreneurs can get financing based on conditions offered by the SFH, whose funding is subsidized by the government.

Despite this growth scenario and favorable real estate market conditions, Kon believes that this phenomenon still cannot be defined as a boom. However, Antonio Montes, professor at the Instituto de Empresa in Spain, is much more optimistic. In his opinion, the development of the country has made possible the relocation of the rural population to the big cities. This trend is increasing the demand for housing in the large urban centers. "Brazilians who don't have housing are thinking of buying rather than renting. In the past, they could not do that because they didn't have access to credit. This change has produced a democratization of the real estate market," he says.

However, not every Brazilian social class is equally enjoying the larger housing supply. Kon explains that although the government has dedicated specific funds for the lower and middle classes, the biggest beneficiaries of the real estate boom are upper-middle-class and upper-class buyers. "At this level, the housing supply is very high, which leads to strong competition among sellers and makes business opportunities more flexible. On the other hand, even though there are funds specifically aimed at the lower class, a very large part of the Brazilian population is on the fringe and doesn't have the buying power to take on these loans."

One significant factor in this scenario – and the key difference between Brazilian conditions and those in the U.S. – is that the Brazilian system is growing stronger. The Brazilian middle class is going through a prosperous period, with growing indexes of income and employment. One sign of that is in recent data from the Caixa Economica Federal (CAIXA), a government bank, showing that those people who are younger than 30 accounted for 36 percent of the real estate financing deals provided by that institution in 2007. "What happened in the U.S. will not occur in Brazil, at least not now," says Oliveira. "In the first place, that's because the lower and middle-lower classes are not active in this market. And interest rates aren't so low that they've reached the point of stimulating people who don't have the potential to buy and sell."

FOREIGN INVESTMENT

Domestic buyers are not the only players in this ongoing festival. Foreign investors, notes Montes, "have become aware that they can continue to expand in countries like Brazil. That's because of the real estate crisis in the U.S., stagnation in Spain and the general slowdown in all of Europe." One of those investors is José Antonio Sánchez Santamaría, a Spanish entrepreneur who has begun to construct a 2,000-hectar tourism complex in Natal in the Brazilian state of Rio Grande do Norte. Known as Grand Natal Golf, the complex's public faces are Antonio Banderas, the Spanish actor, and Ronaldo, the Brazilian football player.

Santamaría launched his project after building 40 promotional housing units that tested demand from foreign investors. So far, his company has put on sale 90 percent of the area of the Natal tourism complex, where up to 30,000 residential units will be constructed along with five golf courses, various athletic centers and eight hotels. All of this will be managed by an unnamed partner that is a "Brazilian industrial company," the president of the Sánchez Group told the media at the end of last year.

As Montes explains, "There is a growing demand from people who want to have their second homes in Brazil because it is such an attractive country. It is economically and politically stable, and it is developing important infrastructure projects in its ports, airports, highways and railroads. This fact, along with the current level of international confidence in the country, is attracting a lot of foreign investors." Every year, an estimated 70 million tourists visit Brazil. About five percent of them want to have a second residence there. In the Northeastern region alone, 80,000 houses and apartments will be built over the next eight years, expressly for foreigners.

VALUE DOUBLED

In that region, notes Montes, property values have more than doubled over the last year. "Add to that, Lula's 2006 plan that contemplates using up to 32 percent of fiscal surplus

for real estate investments. Also, taxes have been reduced on construction materials. Labor is cheap, and interest rates have dropped a great deal, from 25 percent to 12 percent, and they continue to drop. Prospects are very positive.”

Regarding accelerating sales growth in various regions, “This was initially more intense in the region of São Paulo, which is the center of Brazilian development, as well as in Rio de Janeiro,” notes Kon. “Nevertheless, other parts of the center and the Northeastern part of the country are preparing themselves for accelerated real estate sales.” The strong bureaucracy, along with the centralization of decision-making in the Southeast and Southern regions of the country, Kon adds, “have made it more difficult to stimulate the rest of the regions.”

On the other hand, Juan Ignacio Sanz, a professor at ESADE, believes that we can indeed talk about a real estate boom in Brazil. Compared with other alternative investments aimed at Spanish private investors in recent months, such as in Morocco, investing in Brazil is much more attractive because it is typically tropical tourism yet it benefits from the improvements in low-cost communications, he says. From a cultural viewpoint, he adds, “there is greater proximity to Latin America than with African countries, particularly those that are Islamic, which favors longer-term investments in Brazil in contrast to shorter visits in northern African countries.”

CONSOLIDATION PROCESS

According to Montes, prices in the residential and commercial real estate markets are going to shoot up over the next year, “if they continue to reduce interest rates, contain inflation and the growth rate continues to be stable. I think that there can be a significant surge in prices. So you have to take advantage of the investment opportunities now. There are a lot of international real estate funds that have their eye on Brazil. They are anticipating that Brazil will be granted ‘investment grade’ status by risk assessment specialists. That is something that is very likely to happen within a few months.”

At the moment, most of the companies that compete in this market are Brazilian. Montes notes that the sector is consolidating. “When they began to talk about the growth of the sector, many companies wanted to issue shares on the stock market so they could undertake grand projects. The real estate market shot up after that. Some companies took a wallop but others survived. By the end of 2008, we’ll see what the results of the consolidation are.” Montes predicts that the big companies will survive, along with those firms that specialize in one specific sector.

In the current consolidation process, a large number of small construction companies are also growing, and they are confident that they will continue to make money. A quick walk through Sao Paulo, for example, makes it clear to visitors that many real estate projects will come onto the market during the next few years. “The market continues to show strength because the entire process is still very cheap. Land is very cheap in Brazil. Whoever makes an investment on a certain scale in this country will still make a lot of money,” adds Oliveira.

LATIN AMERICAN CONTEXT

In Latin America, notes Montes, three countries are comparable from the viewpoint of real estate – Chile, Mexico and Brazil. These countries are less risky for investors, for a series of different reasons. In Chile, he explains, “The overall population has become wealthier, which means that everyone can acquire housing thanks to political stability. There isn’t much of a market for tourists or foreign investors.”

Mexico is “very similar to Brazil, but it is a lot more influenced by the fact that it is on the border with the U.S.” Montes notes that there are even people who work in the Southern part of the U.S. and have a residence in Mexico because it is cheaper, Mexican taxes are lower and so forth. Mexico also has important tourism centers and large shopping malls, as does Brazil. In those two countries, Montes adds, there are great concentrations of population and cities where security is an elaborate issue, as you can see from walking down the street and looking at the European-style shops. In both countries, U.S.-style shopping malls are popular. On the other hand, he adds, huge companies, such as Spain’s Fadesa, are buying large office buildings in Brazil “because the investment is

enormously profitable, on a day-by-day basis.”

Montes notes that foreign investors have also shown a great deal of interest in renovating buildings in Rio de Janeiro. “In some abandoned ships in the port area, for example, companies have converted space into deluxe apartments and shopping malls.” However, he warns people that they “must take along a map from the government or the respective municipality, and the security arrangements must favor foreign investors who want to stay there.” In addition, it is important to note the bureaucratic obstacles that can arise at the last minute.

According to Montes, prices will increase at a spectacular rate. “A rental property [that you lease to someone] in Spain provides you with profitability of from 2 percent to 5 percent. In Brazil, you can get three times that much. In addition, according to the Lula plan, the largest airport in Latin America will be built in Natal, which will make that city only six hours from Madrid and five hours from Lisbon. It will have a capacity of about five million passengers.”

THE PROSPECTS

Kon believes that real estate sales in Brazil will continue to grow over the short term, with the country passing through a stage of industrial acceleration, especially when it comes to building materials. This will have a considerable multiplier effect on employment and income.

Nevertheless, Kon notes, “in the medium and long term, this movement is not sustainable since the supply of real estate for the medium and upper classes is growing in a way that exceeds demand.” Over the medium and long term, “there is a major chance that the net assets of the less privileged classes will decline since there is a need to give priority to other basic infrastructure projects and to other social problems, such as education and health projects, that support development.”

Montes is much more optimistic. For him, the major risk revolves around knowing whether the Lula government will continue all the structural reforms that it has initiated and still has in the works, as well as whether it is able to battle against corruption and the shortage of security. Another danger is the energy crisis, which could affect the domestic market.

Oliveira notes that the Brazilian government is working hard to create fewer barriers to investing in the manufacturing sector, and to make it easier for foreigners to enter the Brazilian market. According to Oliveira, these types of investment will make it more attractive for foreign investors to come back to the market, as positive conditions in the country reduce the risk of massive capital flight. “The government is working on regulations that do not restrict foreign investment in liquid assets, but which provide incentives for investing in real assets both in the manufacturing sector as well as civil construction. These regulations should not be extremely rigid, or they will alienate investors. They should help avoid volatility.”

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