Brazil: Justified potential in real estate

The recent proactive approach by the Brazilian government to engage with the Middle East should pave the way for some form of financial integration in the future.YAHYA ABDULLA discusses.

As the largest economy in South America and a top three exporter of halal meat, with an abundant supply of natural resources and strong growth forecasts, Brazil shares many potential synergies with Middle Eastern countries.

The Brazilian economy was one of the first to recover from the global financial crisis and continued to expand rapidly in 2010. GDP grew by an estimated 7.5% (with some states including Espiritu Santo growing by more than 12%) over the year on the back of stimulus measures, strong internal demand, export recovery, and improved credit availability.

Salaries and employment levels have continued to rise, translating into strong consumer confidence and a growing middle class.

Despite the limited Muslim population in Brazil, the recent proactive approach by the Brazilian government to engage with the Middle East (including various trade pacts which have recently been or are currently being negotiated) should pave the way for some form of financial integration in the future.

A GDP of about US$1.98 trillion ranks Brazil within the top 10 global economies (in terms of size): more than five times larger than the economies of Saudi Arabia and Malaysia. Combining the size of the economy with a population of about 190 million, it is a country with considerable potential.

This potential has started to translate into actual investment, as has been indicated by property market investment volumes, which almost quadrupled between 2009 and 2010; from EUR1.25 billion (US$1.76 billion) to EUR4.58 billion (US$6.44 billion).

It is worth noting that, as in other BRIC nations, a contractionary monetary policy has been implemented to counter the threat of over-heating, and Brazil's interest rate is therefore among the highest in the world, with a reference rate of 12% per year.

However, the long-term outlook suggests a reduction in interest rates with the long-term reference rate expected to fall to somewhere between 7% and 8%.

Brazil: Facts	
Population	190.7 million
Top cities	
Sao Paulo	
Metropolitan area	19.6 million
Belo Horizonte	
Metropolitan area	11.6 million
Porto Alegre	
Metropolitan Area	3.9 million
2010 estimate	
GDP	US$1.98 trillion
GDP per capita	US$11,250
GDP growth	7.5%
CPI inflation (average)	5.9%
10-year bonds (year end)	5%
Unemployment (average)	5.7%
Politics	
Dilma Rousseff of the Workers Party won the October 2010 presidential run-off election and took office on the 1st January 2011.	

Property market	
2009 Investment volume	EUR1.25 billion (US$1.76 billion)
2010 Investment volume	EUR4.58 billion (US$6.45 billion)
Change from 2009	266.6%
Interest rate (December 10)	10.67%
Currency (December 10)	US$1=BRL 1.66 EUR1=BRL 2.23
Rent measurement	R$/sq.m//mth

Source: Cushman&Wakefield

Trading costs	
Total transaction cost average 6.25% — 7%	
Transfer tax	2%
Notary	0.25% — 0.5%
Legal	1% — 1.5%
Agency	3%
Others	n/a

Source: Cushman&Wakefield

This may be viewed as an opportunity for Islamic financial institutions (IFIs) seeking to provide financing in an already expensive interest rate environment. Real estate investment returns are considerably higher than the traditional IFI foreign stepping stone of the UK, and perhaps more comparable to markets in the GCC and Asia.

Given the shifting dynamic of global economics, it would be wise for IFIs to position themselves to take advantage of the Brazilian opportunity.

As a result of strong investor demand and rising asset values associated with the anticipated reduction in long-term interest rates, yields have fallen sharply (see Figure 1) and currently stand at record lows of 8.5-11%, still with annual inflation adjustments and are expected to remain stable in 2011. However, there are still considerable opportunities across all sectors.

Office market

The Brazilian office market (potential) is characterized by:

- Limited large-scale property ownership and professional real estate platforms (though this is changing);
- Significant (but unintentional) owner-occupied real estate due to a historic lack of third party funding which has forced corporations to own properties (headquarters, warehouses, etc);
- Insufficient asset quality (in most cases) to meet corporate requirements and growth needs.

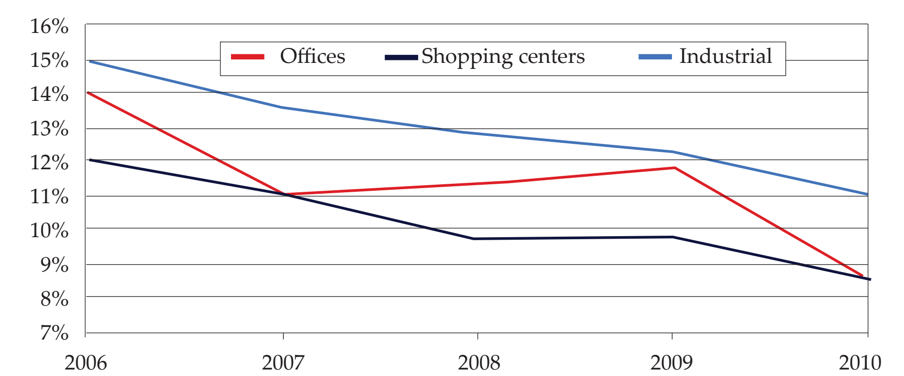
The office market has recently gained depth, with local and international investors being the main agents in the value added and speculative space, joined by pension funds, financial institutions and local capital markets for the core opportunities.

There is considerable under-supply of high quality, modern stock and occupier

Continued

Continued

Figure 1: Headline prime yields



Source: Cushman &Wakefiled

demand remains strong. Rents are rising although expected to peak in the near future, with an increase of high-quality office space expected in 2011-2013 following the completion of a number of class A developments.

Key attractions
• High returns
• Growing investment interest across residential, hospitality and commercial property
• Strong economic growth and emerging middle class
• Possibility of development funding up to 80%

Key drawbacks
• High cost of assets (particularly offices)
• Uncertainty about the strategies of the new presidential administration
• Exchange rates issues (local currency overhauled)
• High interest rates

Industrial market

The industrial market is basic and outdated. Assets have low technical specifications and are designed for a single user (usually the ow ner), and generally do not meet the requirements of tenants and/or investors.

A developing economy coupled with a growing middle class/consumer market is causing substantial changes in the industrial real estate segment.

Major opportunities exist for speculative developments (due to a lack of quality products) and ongoing improvements in infrastructure are likely to create new investment opportunities in the industrial and logistics sectors nationwide.

Retail segment

Brazil has the world's 11th largest shopping mall market based on the number of malls in operation translating to 5 m^2 per 100 people. In comparison to the US (187 m^2 per 100 people), it is clear that the supply of Brazil's shopping center space is below equilibrium. However, it is interesting to note that the rental rates of some Brazilian malls are within the top five for the Americas, comparable to Rodeo Drive in Los Angeles.

There are not many examples of IFIs capitalizing on the Brazilian real estate market. Some IFIs were considering the market prior to the financial crisis and based on recent discussions have only recently dusted off their plans for Brazil.

The most high profile Middle Eastern transaction in the Brazilian real estate space was the acquisition of the Ventura Towers by the Abu Dhabi Investment Authority (ADIA) in 2008.

Value addition through the development phase (it was acquired during the construction phase), market yield compression and favorable currency movements will probably result in extremely positive returns for ADIA.

Given the current state of the global economy, it is probably wise for IFIs to start diversifying a proportion of their currency exposures into emerging markets such as Brazil.

Increased efforts

There will need to be an increased lobbying effort with Brazilian authorities in order to increase awareness of the Islamic financial market and its associated benefits – which could be a protracted affair.

The easiest way for IFIs to create market visibility would be to start building an investment track record. Those institutions which establish platforms to take advantage of the BRIC nations growth will be the future success stories.

Without an intrinsic religious demand for Islamic products, as is the case in Asia or Africa, the key for IFIs interested in tapping Brazilian potential will be to market themselves effectively as an economically justifiable alternative to local finance providers.

The first step would be to collaborate with local players in transactions which would allow IFIs to build a track record and develop regional expertise.

> ***"A GDP of about US$1.98 trillion ranks Brazil within the top 10 global economies (in terms of size)"***

Conclusion

In the medium-term, the run-up to the football World Cup in 2013 and the Olympic Games in 2016 looks set to create further opportunities in the real estate market, particularly in the hospitality and tourism sectors.

With such high profile international events over the next five years, the potential for Brazilian real estate is indeed justified.

Yahya Abdulla is a senior surveyor of EMEA Capital Markets at Cushman & Wakefield. He can be contacted at Yahya.Abdulla@eur.cushwake.com.