
Chazen Society Fellow Interest Paper

Equity International's Real Estate Investments in Brazil

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Legendary real estate investor Sam Zell is bullish on Brazil. He and Gary Garrabrant cofounded Equity International in 1999 and have since invested in 17 real estate–related companies in emerging markets across the globe. Four of those investments were in Brazilian companies—homebuilder Gafisa S.A. in 2005, shopping center owner and operator BR Malls Participacoes S.A. in 2006, corporate real estate company Bracor Investimentos Imobiliários in late 2006 and logistics company AGV Logistica in August of 2008. Equity International values these holdings at close to US\$550 million. The aim of this paper is to examine the investment thesis behind Equity International's investments in Brazil.

Underlying Zell and Garrabrant's investments in Brazil is the overall belief that favorable long-term macroeconomic conditions and demographic trends will drive strong demand for real estate. Brazil has a growing population and an expanding middle class with enhanced purchasing power. There is an extraordinary and unmet demand for housing. The availability of consumer credit and mortgage finance is expected to increase. Furthermore, Brazil has “world-class” managers and an extraordinary talent pool compared to other emerging markets, according to Thomas McDonald, chief strategic officer of Equity International. Lastly, the sheer size of Brazil allows for scalability in operating platforms and growth potential that simply cannot be achieved in smaller countries or regions. However, the global economic recession and slower growth prospects in Brazil present new challenges for Equity International's portfolio companies.

Gafisa

Gafisa was founded more than 50 years ago and is a leading homebuilder in Brazil. In 2005, Equity International invested US\$50 million in Gafisa for a 32 percent stake in the company in

order to capitalize on a highly fragmented and rapidly expanding housing market in Brazil. Gafisa was listed on the São Paulo Stock Exchange, Bovespa, in February 2006 and on the New York Stock Exchange a year later.

Two factors driving expansion in the residential sector in Brazil are the unmet demand for home ownership and increased access to mortgage financing. Brazil's housing deficit is estimated at 7.5 million units, or approximately 15 percent of households. Gafisa aims to take advantage of this demand. It has 143 projects under construction and a land bank of more than 2,000 acres across 21 of Brazil's 26 states.

McDonald notes that the affordable-housing sector has traditionally been the least supported in Brazil, whereas in Mexico it has been the most supported. As Equity International takes an active role in guiding the strategy of its portfolio companies, it has encouraged Gafisa to focus on the "affordable entry-level" (AEL) market in order to capitalize on the demand for housing among Brazil's middle class. For example, one of Gafisa's new joint-venture projects is a 2,386-unit development targeted at the AEL market and located in the city of Coita, 45 minutes outside São Paulo. While many developers, including Gafisa, have focused on building in Rio de Janeiro and São Paulo, 60 percent of Gafisa's new launches are now outside those two major cities.

Rapid growth in mortgage financing has also created a new potential set of buyers for homebuilders like Gafisa. The mortgage market in Brazil is nascent, with real estate debt currently accounting for only approximately 2 percent of Brazilian GDP, compared to 11 percent in Mexico. The vast majority of homeowners in Brazil do not have a mortgage on their homes. However, the Brazilian government has committed to expanding the country's mortgage market. Commercial banks are mandated to allocate 65 percent of savings deposits ("Cadernetas de Poupança" accounts) toward the funding of residential mortgages. Fundo de Garantia de Tempo de Serviço (FGTS) deposits are also distributed to support low-income housing. Using resources from FGTS through ABN Amro, buyers of Gafisa's homes can make a 10 percent down payment for a 25-year term mortgage at a competitive interest rate. This type of mortgage product simply did not exist a few years ago.

With any opportunity comes risk. The massive inflow of capital to Brazil is the main risk that Garrabrant cites, since it forces asset prices up and returns down. The number of IPOs on the Brazilian stock market increased markedly between 2005 and 2008, and more than 25 real estate companies listed on the Bovespa. Consolidation in the sector is widely expected as larger, more profitable operators like Gafisa acquire smaller real estate companies that never would have gone

public in a normal market environment. Many of these companies also used proceeds from public offerings to buy development parcels at inflated values, underwriting their purchases using overly optimistic future sales projections.

As part of a massive decline in Brazil's stock market and sell-off of homebuilder stocks in 2008, by mid-October Gafisa's stock price had dropped 50 percent since the beginning of the year. Equity International believes that the stock became an attractive value relative to its price and increased its stake in Gafisa by five percent in October.

BR Malls

BR Malls, formerly known as ECISA, was founded almost 60 years ago and has grown into the largest shopping-center company in Brazil. Equity International invested US\$44.5 million in BR Malls in 2006, acquiring a 14.4 percent ownership stake in the privately held company. In April 2007, BR Malls went public on the Bovespa, and Equity International increased its investment in the company several months later in a follow-on public offering. BR Malls currently has an ownership position in 34 malls. The portfolio is concentrated in São Paulo and Rio de Janeiro, but the company has a nationwide presence that caters to all income classes.

Underlying Equity International's investment decision was the belief that the retail sector in Brazil will experience substantial growth as the middle class expands and has greater access to credit. Despite large disparities of wealth in Brazil—the wealthiest 10 percent of the population controls 48 percent of the wealth—average incomes rose by 7.2 percent in 2006, with considerable gains among lower-income individuals, according to the Brazilian National Statistics Institute (IBGE). The growing middle class is driving consumer spending for retail goods, and other large multinational companies have taken notice. In August of 2008, Wal-Mart announced plans to invest more than US\$1 billion to open 90 new stores in Brazil.

With only 400 shopping centers in a nation of 192 million people, the retail sector is also underpenetrated and fragmented, creating an opportunity for well-capitalized players like BR Malls to expand through acquisitions. Equity International also viewed BR Malls as an attractive investment opportunity because of the company's high-quality portfolio of malls, focus on operational efficiency and professional management team.

While there is concern that an increase in inflation and interest rates in Brazil will dampen consumer spending, BR Malls has not yet seen a significant impact, according to McDonald, who is a director of BR Malls. Same-store sales year to date grew 12.7 percent in the third quarter of

2008, although sales slowed in September compared to the previous two months. In addition, the vast majority of the malls' minimum rent contracts are adjusted annually for inflation. It remains to be seen the extent to which less favorable macroeconomic conditions in Brazil will impact consumer consumption and, specifically, discretionary spending on retail goods.

Bracor and AGV Logistica

In contrast to Gafisa and BR Malls, which were investments in existing businesses, Bracor was cofounded by Equity International with Brazilian businessman Carlos Betancourt. The son of Cuban exiles and a triathlon competitor in his spare time, Betancourt is currently the CEO of Bracor. Equity International committed US\$60 million for a 48 percent ownership position in the company in late 2006.

Brazil's lack of institutional quality industrial space and Class A office buildings presented an attractive investment opportunity for Equity International. Bracor acquires, develops and manages corporate properties, such as single-tenant office buildings and industrial centers. The properties are leased on a long-term basis to high-credit, quality tenants, such as IBM and DHL. In focusing on both build-to-suit deals and sale-leasebacks, Bracor is limiting the downside risk associated with more speculative real estate plays in the corporate-property sector. In January 2008, new investment partners signed on to commit growth equity to Bracor, including the Royal Group, a company owned by the royal family of Abu Dhabi; the Olayan Group of Saudi Arabia; Morgan Stanley Real Estate; and W. R. Berkley Corporation.

AGV Logistica was a tenant in one of Bracor's buildings, and in August 2008 it became Equity International's fourth major investment in Brazil. The US\$100 investment commitment in the privately held logistics company is an extension of Equity International's focus on real estate-related business. AGV Logistica manages materials transportation for a variety of industries (such as animal health, chemicals and cosmetics) and operates 30 dry- and cold-storage facilities across Brazil. Garrabrant believes that the third-party-logistics sector is compelling, and AGV is poised for strong growth given the increasing demand for professional logistics services from multinational and domestic companies in Brazil.

Challenges Ahead

While Brazil's economy grew 5.4 percent in 2007, Fitch Ratings recently cut its forecast of Brazilian GDP growth in 2009 from 5.1 percent to 3.3 percent, citing concerns about the impact

of the global financial crisis. President Lula da Silva of Brazil believes that his country is better prepared to deal with a financial crisis now compared to in the past. Currently, the United States accounts for 15 percent of Brazil's exports, compared to 50 percent in the early part of this decade. In addition, Brazil has in excess of \$200 billion in foreign reserves and a sizable amount of stabilization funds, according to the *New York Times*. The Brazilian government has also authorized state-owned banks to recapitalize real estate developers and construction companies in an effort to bolster the housing sector.

Equity International remains bullish on Brazil and plans to add two or three companies to its portfolio in the future. Given the broad pullback in capital from the emerging markets and opportunities for investing at distressed pricing levels, Garrabrant believes that now "the opportunities are almost *too good*." McDonald adds that Brazil's economy is fundamentally strong, despite the extraneous shocks to the markets. With the prospect of slower economic growth in Brazil, Equity International takes a long-term view and believes that its portfolio companies will weather the storm given their capable management teams, strong balance sheets and ability to access capital.

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