Paladin Realty on the 2014 outlook for Latin America

Recently, ***Geoffrey Dobrmann,*** *publisher and editor-in-chief of* The Institutional Real Estate Letter – Americas, *spoke with* ***Fred Gortner*** *and* ***Andrew Cummins*** *of Paladin Realty. The following is an excerpt of that conversation.*

Frederick Gortner (fgortner@paladinrp.com) is a co-founder and Managing Director of Paladin Realty, where he is involved in many aspects of the firm's investment activities, management and operations. Prior to joining the predecessor of Paladin Realty in 1994, he was a partner at two real estate development firms in Los Angeles.

Andrew H. Cummins (acummins@paladinrp.com) is a member of the Investment Committee and Head of Research for Paladin Realty. He has lived, worked and traveled extensively throughout Latin America since 1983. He is the Founder and Managing Partner of Explorador Capital Management, a hedge fund manager focused on investing in the public capital markets in Latin America.

http://www.paladinrp.com

Tell me briefly about your firm and your experience in Latin America.

Fred Gortner: When we founded Paladin Realty in 1995, the firm was initially focused on opportunistic investments in the United States. Early on, we became aware of the exceptional growth potential of Latin America and have since been a leading investor in the region for over 15 years. Latin America is now the singular focus of our institutional investment fund business. To date, we've invested in over $5 billion worth of real estate in seven countries across three funds. Brazil accounts for about 50 percent of our investments in the region, with Mexico and the Andean region — Colombia, Peru and Chile — making up most of the balance. We've also been active in a few smaller but attractive markets, such as Uruguay and Costa Rica. Our strategy focuses primarily on for-sale residential development. In addition, we invest in commercial projects. In all cases, we benefit from the region's attractive demographics, rising prosperity, and growing access to credit. Combined, these factors are creating a large and growing middle class with a need for virtually every type of modern real estate product in the region.

A lot of institutional capital has flowed into Brazilian real estate in recent years and the country's economic growth is slowing. Is this cause for concern?

Gortner: That's right. From 2007 through 2012, many billions of dollars of capital flowed to private funds and public companies focused on real estate in Brazil. A lot of that capital was invested in high-rise office building developments in the two largest cities, São Paulo and Rio de Janeiro. An enormous amount of class A office supply is coming online over the next two to three years in São Paulo, an office market that is already at 15 percent vacancy. So there is understandable reason for caution in the eyes of investors. By contrast, the fundamentals for the housing sector are still quite attractive, even in a slower economic growth environment. Steady demand is being fueled by a tight labor market for semi-skilled workers, strong household formation, 4 million people per year entering the middle class and a large housing deficit.

Andrew Cummins: While lease rates and real estate prices in Brazil have risen sharply in recent years, we do not believe the Brazilian real estate market is in a "bubble." Housing demand in Brazil is driven primarily by owner occupants, rather than investors looking to rent or flip the asset for quick profit. Buyers in the Brazilian market use less debt relative to many developed markets. Even with rising prices, the ratio measuring the relationship between income and housing prices in Brazil has remained relatively balanced over the past decade, with roughly one-third of household income allocated to occupancy costs. The emergence of 30-year mortgages in recent years has extended the affordability of homeownership to millions of new families. This is one of the main reasons we saw housing prices adjust in 2010 and 2011.

What could help unlock Brazil's long-term growth potential?

Cummins: Brazil's economy should be growing at 4 percent to 6 percent, not at current levels in the 2 percent range. Over the past decade, Brazil has made significant strides where tens of millions of people have joined the ranks of the middle class. But the government must embrace significant policy reforms related to infrastructure investment, tax code reform and free trade. There are too many barriers to starting and operating businesses in Brazil today. That was one of the messages of recent street protests against antiquated infrastructure, poor education, corruption and inefficiency. While the 2014 World Cup and 2016 Olympics have served as catalysts for certain infrastructure improvements, much more needs to be done. Brazil is one of the most closed economies in the region in terms of free trade. Opening its borders to trade would improve productivity and strengthen Brazil's growth over time.

Gortner: Brazil still represents the most compelling combination of scale and opportunity in Latin America, even in a slower growth environment.

Mexico has been an active market for institutional investors over the years. What is your outlook for mac-

roeconomic growth and real estate investment in Mexico for 2014?

Gortner: We're bullish on Mexico. The new president's reform agenda is moving forward on energy, education and competitiveness. When enacted, these reforms should drive GDP growth to the 5 percent range starting in 2015. In addition, Mexican manufacturing has regained productivity-adjusted labor competitiveness in dollar terms with Asia in recent years. This is fueling fixed investment by global multinational firms. Violence related to drug cartels has also started to wane. And Mexico is probably the most direct beneficiary of a healing U.S. economy.

Cummins: I also would point out that, as in Brazil, the rise of listed investment vehicles and CKDs is expanding the universe of buyers for the type of commercial real estate we develop. Ultimately, this is a positive endorsement of Mexican real estate as an asset class and highlights the gradual maturation of its capital markets.

There's growing intrigue with the Andean countries — Peru, Colombia and Chile. Can you put that opportunity into perspective and give us your 2014 outlook for these countries?

Cummins: The Andean region, as a whole, is comparable in size to Mexico's 100 million-plus population. Peru has a housing deficit of more than 2 million units and a healthy sovereign balance sheet supported by a fiscal surplus. The opportunity in Colombia is driven by its own significant housing shortage, and strong growth supported by a dramatically improved security situation and an aggressive reform and free trade agenda. Free trade pacts, such as the Pacific Alliance, will help fuel growth in Peru and Colombia going forward. Both countries' economies proved very resilient during 2009. Chile is the most advanced economy in the region with a balanced budget, low sovereign debt, low inflation, a robust commitment to free trade, and market-based solutions to social security and healthcare.

Gortner: Peru and Colombia remind us of where Brazil was about 10 years ago, with exceptional investment opportunities and relatively few private equity firms active in the market.

What are the biggest challenges facing institutional investors wanting to invest in Latin American real estate today? How pervasive is corruption and cronyism?

Gortner: Finding a trusted investment manager in these markets with real experience in execution is a challenge. And finding a manager who can execute well and who is also an experienced fiduciary to institutional investors is even rarer. We execute our business model primarily through programmatic joint ventures with local operators, where Paladin underwrites each asset and maintains control. Properly choosing the right partners and projects is a difficult and time-consuming process anywhere in the world. We're currently deploying capital from our fourth Latin America investment fund. The vast majority of investments have been new JVs with longstanding local operating partnerships. Some of these relationships now date back 15 years or more. We also have the capability to do direct transactions.

Cummins: While the underlying real estate fundamentals are similar across Paladin's target markets — Brazil, Mexico, the Andean region — there are myriad differences within each market, including complex legal and tax regimes, local building practices and codes, how projects are financed, and so forth. Navigating local bureaucracies that are overburdened by growth can be a challenge, too. As Fred said, experience and knowledge of these markets is paramount. Despite a few recent well-publicized corruption scandals involving highly respected U.S. companies, we've been able to largely mitigate that risk by focusing on markets where rule of law is respected, avoiding projects with entitlement risk, and implementing a transparent and disciplined investment process with our local partners. The main country risk we face is currency risk. Housing investments provide some natural currency protections, such as inflation-indexed sales contracts. We believe the currencies in Mexico and the Andean region represent an attractive entry point today, and Brazil is much closer to fair value than at any point in the past three years.

What about political risk?

Cummins: Two very different Latin Americas have emerged over the past 15 years. The first is characterized by an embrace of market-friendly policies, steady growth and rising prosperity. The second consists of a handful of countries with populist/socialist regimes that are increasingly being left behind. Much of the institutional capital flowing into the region to date has targeted that first Latin America, in particular Brazil, Mexico, Colombia, Peru and Chile — all investment-grade countries where rule of law is respected, foreign direct investment is welcomed and political risk is relatively low. In general, these countries have followed a decade or more of prudent policies to strengthen their sovereign balance sheets, enact flexible exchange rates, control inflation, enhance security, and promote trade and investment. Social inequality is rapidly being reduced in these countries. Finally, each has had relatively smooth and democratic transitions of power for many election cycles. By contrast, Venezuela, Argentina and other countries with more radical populist leaders should probably not be on the radar screen of most institutional investors until there is meaningful change in their political leadership and direction.

Why should institutional investors consider real estate investments in Latin America?

Gortner: We shifted the focus of our firm toward Latin America more than a decade ago because we were attracted by the real estate economics in the region, where investment returns are driven more by profit margins on the underlying real estate assets, rather than a play on debt or expectations of a market rebound. As a result, you can target opportunistic returns in Latin America with much lower leverage than the typical opportunity fund — an attractive risk-adjusted proposition today.

Cummins: From a macro perspective, Latin America offers valuable diversification for global investors. The region's economies were quite resilient during the 2008–2009 global financial crisis, and many of the countries continue to outpace growth in more developed economies. ❖