LATIN MARKETS

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WHERE ARE INVESTORS AND MANAGERS LOOKING AT REAL ESTATE IN LATIN AMERICA?

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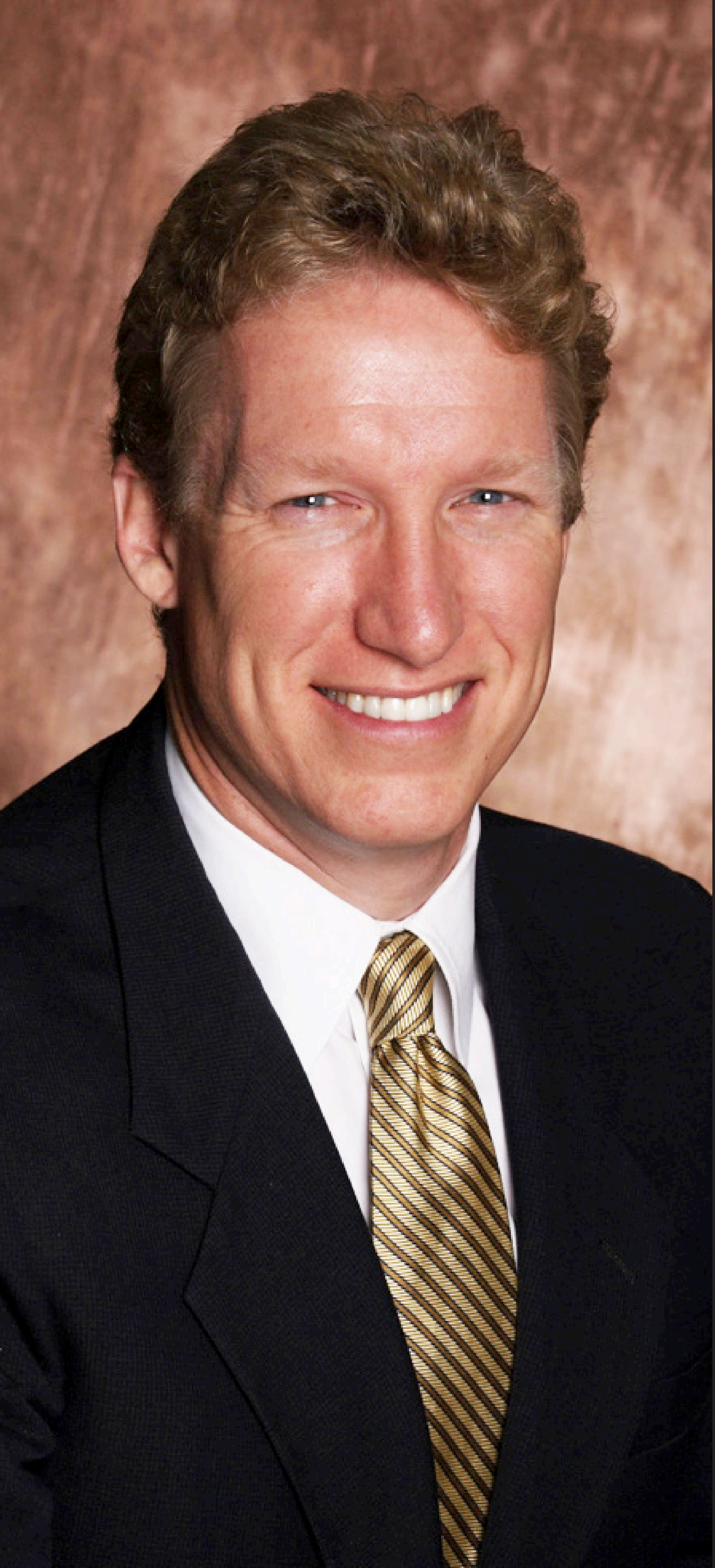

Why Middle-Income Housing is Receiving the Lion's Share from Paladin

LREJ Interviews Fred Gortner, Managing Director at Paladin Realty Partners

1. Give us a brief background of the company and your role at the firm.

FG: I'm a co-founder and the Chief Operating Officer of Paladin Realty Partners. We're nearly a 20-year-old firm and have one of the longest track record of any private equity fund managers in Latin America, now in our 16th year of investing actively throughout the region. Our Latin America funds business is the sole focus of our firm. It takes a deep team to do this business the right way and we have over 30 people dedicated to our Latin America strategy, with four offices located in the region. To date, we've invested in $5 billion of real estate and over 150 assets in seven countries across Latin America. We're currently investing our fourth pan-regional Latam fund.

2. What has been the focus of this last pan-regional fund?

FG: The current Latam IV fund will likely have a similar geographic footprint as our prior Latam III fund. Latam III had its initial closing in 2008 and ultimately raised $554 million, including a $100 million Brazil-only side car and a $454 million pan-regional fund. The pan-regional fund was about 50 percent invested in Brazil and most of the other half was invested in Mexico, Colombia and Peru. We've been active in the past in Chile, as well as two smaller countries, Costa Rica (which was the first Latin America country we invested in back in 1998) and in Uruguay (a country we also have a lot of familiarity with – our head of South America ex-Brazil is from there). In Costa Rica and Uruguay, we are one of the largest low/middle income homebuilders in the capital cities.

In terms of product type, about two-thirds of the investments we've made to date have been focused on low- and middle-income for-sale housing, primarily executed through programmatic joint ventures with experienced local operating partners. We've also done a handful of entity-level investments and have invested about 20 percent of our portfolio in the commercial sector. Our approach to commercial has been selective and opportunistic, different than some of the other Brazil managers in recent years. We never were really enamored with high-rise office development in recent years and that's a market in Brazil that's going to struggle over the next few years. Over 7 million square feet is coming online in an already 15 percent vacant market in Sao Paulo. Instead of high-rise development, we've focused on office condominiums and retrofits of existing buildings. Attractive retrofit opportunities are very difficult to find in these markets due to the substandard condition of many existing buildings and stratified title, but when you find them, you can redevelop, stabilize and exit the investment relatively quickly, and oftentimes position the asset as an attractive, competitively-priced alternative to high-rise developments. This provides some downside protection if the market softens.

3. How did you begin your first investment in the region?

FG: Our first investment in Latin America 16 years ago was actually a reaction to an investment opportunity that was brought to us, a large master planned resort development in Costa Rica. It was not an easy investment to get approved. At the time, former U.S. Treasury Secretary William E. Simon owned half our firm and was on our investment committee. He had some cautious views about Latin America left over from his Treasury Secretary days in the 1970's, when hyperinflation and economic instability characterized much of the region. Nonetheless, we were able to convince him on the merits of this investment and it really opened our eyes up to opportunities in the region. In short, the combination of resilient demand drivers, high profit margins, and a lack of private equity capital chasing opportunities meant less competition for deals and, as a result, more attractive risk-adjusted returns than we were finding on comparable investments in the U.S. at the time. So, we spent time studying the markets and opportunities in the region, through a combination of top-down research on the major markets and product types, and a lot of time spent on the ground in the markets, touring projects, meeting with potential partners, and so forth.

We use five metrics as a guide towards evaluating whether a new market is attractive for institutional capital. First and foremost is rule of law. We only want to invest in an environment where contracts are respected, where you can get clean title to property, and where you can exercise control provisions in joint venture documents if needed, which has always been a central component of our strategy. The second metric in evaluating these markets was stable money, namely having inflation under control. For the past two decades, this has been the case in all of Paladin's target markets and has been an important factor in all of these countries achieving an investment grade status. The third metric is sound fiscal spending and a stable sovereign balance sheet. Again, all of Paladin's primary target markets – Brazil, Mexico and the Andean region – have scored relatively well on this front for the past 15-20 years. Fourth is an embrace of free trade, which all of our target markets score well on, with the exception of Brazil, which could stand a lot of improvement. Intra-regional trade agreements such as the Pacific Alliance are boosting economic growth in Colombia, Peru, Mexico and Chile, and should serve a signal to Brazil of the potential benefits of opening up its borders. Lastly, we look at the level of regulation in these countries. Namely, how easy it is to do business, how easy is it to hire and fire people, to establish businesses, to create joint ventures and so forth.

On all of five of these metrics, Paladin's main target markets of Brazil, Mexico and the Andean region have scored very well.

4. As far as lower GDP growth in Brazil right now, how much are you taking that into account for your current investments?

FG: The housing strategy we pursue in Brazil performs well even in a 2 percent growth environment. The demand-side fundamentals for housing in Brazil are resilient and strong, fueled by demographic tailwinds, rising prosperity and growing access to long-term mortgages. Approximately 1.5 million households are being created per year in Brazil and four million people are entering the middle class each year. These factors are stimulating demand for modern housing beyond the capacity of the availability of capital to finance new development to meet this incremental demand, let alone dip into the pent-up demand that exists. Brazil has a housing deficit of anywhere from 5 to 7 million units, depending on who is doing the calculation. Similar housing deficits exist in Mexico, Peru and Colombia. And year, a little over 30,000 units were built last year in Brazil's largest market, Sao Paulo, so you're not coming anywhere close to meeting incremental demand, let alone pent up demand.

5. And that's mainly residential or commercial?

FG: That's residential units. In order to attract development capital to the region, higher profit margins are needed relative to comparable investments in other global markets. For example, we underwrite to gross profit margins – total sales revenues less total development costs – of about 15 to 25 percent depending whether it's low-, middle- or upper-income housing. So, you can target opportunistic returns pursuing this strategy in Latin America with less than half the leverage of a typical opportunity fund. A typical middle-income housing development in Brazil will have leverage in the neighborhood of 35 to 40 percent of the total cost. Higher profit margins combined with low leverage mean that, if something goes awry like a global financial crisis, this strategy can weather the storm relatively well.

Colombia, Peru and Mexico are poised for 4 to 5 percent growth going forward, and those same demand-supply dynamics are in play in those markets – demographic tailwinds, millions of people entering the middle class, and growing access to long-term mortgages. When we started investing in Latin America over 15 years ago, long-term mortgages for homebuyers didn't exist. Less than half of our buyers 15 years ago were getting a mortgage because the average tenor was in the 10 to 15 year range, and interest rates were in the high 20s. Now, interest rates have dropped down to the 10 percent range and 30-year mortgages are more readily available. That has lowered the monthly mortgage payment considerably and, thus, expanded the universe of potential homeownership to millions of people who otherwise couldn't have afforded a home.

Commercial investments are generally more vulnerable to capital flows. For whatever reason, institutional capital tends to gravitate towards Class A office buildings and that's a sector where a lot of capital flowed into Brazil in recent years. As a result there is about 7 million square feet of new Class A office space coming on line right now in Sao Paulo. You're already seeing rental rates come down and vacancy rates go up. I doubt it will result in the "bloodbath" that a few have predicted, because there hasn't been as much leverage in this sector. However, I would expect that many of these investments will struggle to hit the returns projected in their original underwriting.

6. You mentioned some of the sectors that you're looking at as far as high-rises and condominiums. Where do you think are the best opportunities?

FG: We continue to see attractive investment opportunities throughout Brazil, Mexico and the Andean region. Developing middle-income housing, where steady tailwinds of demand exist, remains one of the best risk-adjusted ways to play the growth story in Latin America. Housing ventures will probably continue to account for two-thirds to three-quarters of our investment activity going forward. In the commercial sector, you need to be selective. We prefer for-sale office condominiums, which somewhat mirror the attractive project-level economics of a housing development. We also like retrofits of existing buildings where you can position the asset as at a cost advantage relative to new developments, and where you can develop, stabilize and exit an investment more quickly than with a ground-up high-rise office building development, which can be a five or six year proposition. We're also looking selectively at other opportunities, such as business-oriented hotels, retail, and industrial.

7. What are you hearing from international investors as far as their appetite for investing in Latin America?

FG: Global investors seeking high returns face a myriad of challenges today, particularly in the U.S., Europe and other developed markets. Distress opportunities are harder to find. Assets are priced richly in most regions as an over-abundance of capital chases an increasingly limited number of attractive deals. Underwriting assumptions often assume strong market recoveries, stable interest rates and that exogenous shocks are behind us. High leverage is often required to "make the numbers work."

By contrast, you have a compelling macro story in Latin America compared to other regions in the world with attractive demographics fueling steady economic growth and a growing middle-class, as well as regional stability from a geo-political perspective. Secondly, you have attractive demand-driven real estate investment opportunities in Latin America, particularly in for-sale housing, with highly visible and resilient demand drivers: youthful demographics, rising prosperity and a growing mortgage market. Finally, strong real estate demand fundamentals and a dearth of capital relative to demand translate into attractive project-level economics and superior risk-adjusted returns in Latin America, with profit margins well above what you would find in most developed markets. As I mentioned earlier, profit margins on the typical housing project in Latin America are in the 15 to 25 percent range, compared to single digits in the U.S. and most developed markets. For commercial projects, we typically underwrite to at least 500 basis points of development profit, compared to 100 to 150 basis points in the United States, where significant cap rate risk also exists. As a result, you can target opportunistic returns in Latin America with less than have the leverage of a typical opportunity fund.

Despite the strong investment thesis for Latin America, there is still a general lack of awareness about the region and some confusion exists in making sense of recent newspaper headlines. We spend a lot of time explaining the overall investment thesis for Latin America and putting newspaper headlines in perspective. The reality is that all of Paladin's target markets – Brazil, Mexico, and the Andean region – were well-positioned entering the 2008-09 global financial crisis, and each of these markets emerged strongly from the financial crisis.

8. What advantages do you find attending Latin Markets' events?

FG: Latin Markets events have turned into one of the premier platforms for institutional investors focused on Latin America to meet one another and share information. We've been pleased to be a part of Latin Markets' growth over the years and participate in all of their conferences. We think it's one of the best forums bringing together limited partners and general partners looking for opportunities in the region.

Mr. Gortner spoke on the "Brazilian Real Estate Roundtable" at the Institutional Real Estate Latin America Forum on June 2-3, 2014.