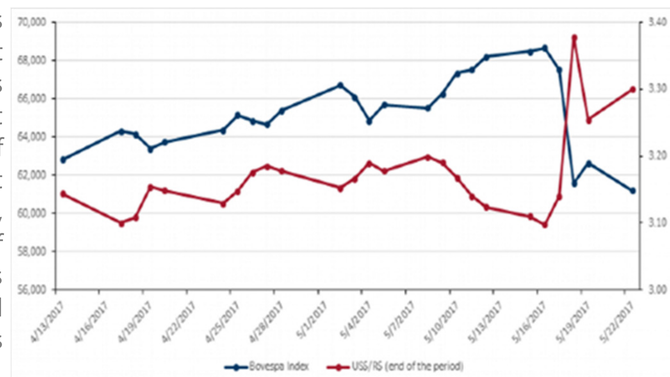
Latin America Research: Brazil Political Risk

June 2017

Summary

A few weeks ago, on May18th, as part of a plea bargain deal in Brazil's on-going *Lava Jato* corruption probe, the head of international food giant JBS released audio tapes in which Brazilian President Temer allegedly condoned the payment of hush money to former speaker of the house, Eduardo Cunha. The tapes would appear to implicate Temer in the far reaching political corruption scandals that have led to the removal and jailing of many high-ranking politicians and businessmen in Brazil. The Bovespa stock exchange dropped 10% the day the audio tapes were released, triggering circuit breakers halting all trading. Brazil's currency also dropped by about 10%.

While this new revelation will likely delay certain of Temer's reform efforts in the short term, the overarching theme is that this continual rooting out of corruption bodes well for Brazil's long-term future, as it becomes increasingly clear to all current and future politicians and business leaders that the days of impunity are gone. The Brazilian economy will be the great beneficiary of a more transparent government going forward, enabling better policy and more efficient allocation of resources; positive for economic growth. Nevertheless, this recent allegation is an unwelcome disruption during a critical period in Brazil's economic recovery, while reforms to Brazil's pension and labor laws are being pushed through congress.



Potential Future Scenarios

There are three potential scenarios to address the current situation: (i) Temer resigns, (ii) Temer is removed from office; or (iii) he survives in a weakened position. Importantly, political will remains to push forward the reforms that Temer has been spearheading, despite his low approval ratings. As such, reforms may continue to advance forward even during this period of uncertainty.

The first scenario, resignation, currently appears to be unlikely. Temer has vehemently denied the authenticity of the tapes and believes it is his duty to get badly needed reforms enacted quickly.

Consensus opinion puts the chances of the second scenario coming to fruition, his removal from office, at about 70-80%, either by impeachment or a ruling of the Superior Electoral Court (TSE). Removal by the TSE, which would happen in June if at all, is a more likely and favorable outcome, as a new president will be elected by Congress, and the reform agenda would likely continue. On the other hand, a long, drawn out impeachment process would reduce chances that any reforms could be passed before a new president is elected in the October 2018 national election and would likely delay and/or dampen somewhat the economic recovery that is now underway.

Interestingly, stabilization of both the equities and currency markets in recent weeks suggests the view that the third scenario may happen, that Temer may survive in weakened form and that certain reforms may still be enacted by Congress. With a dismal 10% approval rating prior to the revelation of the audio tapes, Temer was still considered capable of pushing through his reform agenda, as Brazil's political class would rather have an unpopular President be the public face of such painful measures in the interest of ensuring long-term growth. Thus, the incremental negativity from the tapes may not have enough of an impact to ultimately derail reforms, albeit with delay. The coming weeks and months will be telling.

In any event, Paladin does not expect the current political uncertainty in Brazil to have a material impact on its real estate returns over the short, medium, or long-term. The firm has been investing continuously in Brazil for nearly two decades, navigating and adjusting its investment strategy throughout altering macroeconomic landscapes, including the 2008-09 Global Financial Crisis, the end of the global commodities super cycle, the end of the U.S. Federal Reserve's quantitative easing, the impeachment of former President Dilma, and through several recessions—including Brazil's worst recession on record during 2014-16, a downturn 3x as severe as the Great Recession that the U.S. suffered in the wake of the GFC.

Strategy Implications

A core component of Paladin's strategy in Brazil is focused on low- and middle-income residential investments, a sector where demand far outpaces supply (demographics tailwinds, limited competition, large pent-up demand), and which offers both attractive project-level economics (high profit margins, low leverage) and inherent risk mitigants (substantial pre-sales, inflation-indexed revenue streams). As an indication of the resiliency of this strategy, the five middle-income residential projects that Paladin launched in São Paulo in 2016 were pre-sold by an average of nearly 50% on their opening weekends—well ahead of Paladin's underwriting, despite Brazil being in the midst of a deep political and economic crisis. Indeed, the huge disparity between annual household formation (1.5 million) and new supply (about 200,000 units)—a ratio of approximately 7:1, combined with an existing housing shortage of some 5 million units, provides an analytical framework to understand these positive investment results.

Paladin Realty continues to approach Brazil in constructive, but conservative and highly-selective manner. While much so-called "distress" exists in the real estate sector, many investment opportunities involve significant execution risk with troubled projects and/or operating partners that Paladin has little interest in pursuing. Paladin's preference has always been to invest in high quality assets (not G&A) at attractive values, with experienced local operating partners and strong joint venture terms and controls, and very conservative use of leverage. Paladin Realty's strategy over the past 2-3 years in Brazil has focused primarily on the following types of investments:

- Acquiring control of existing AAA-quality commercial assets on an unleveraged basis at substantial discounts to replacement cost through control investments in select publicly traded property vehicles
- Acquiring prime assets and well-located development sites from distressed sellers who need working capital, at deep discounts to historical values
- Carefully pursuing programmatic residential joint ventures with proven, well-capitalized local partners, targeting strong demand for low and middle-income housing in a much less competitive environment
- Joint venture structures with strong controls and preferential distribution waterfalls (e.g., preferred equity)

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