Columbia Business School

ChazenInstitute

The Jerome A. Chazen Institute of International Business

Chazen International Study Tour Report

A Snapshot of Brazil's Residential Real Estate Sector

GRETCHEN SKEDSVOLD MBA '08 AND JULIANA MARTINI MBA '07

Sponsored by The Heinz Dürr International Communications Fund

A Note from the Authors

A group of 24 Columbia Business School students traveled to Brazil in March 2007 to study the changing regional real estate market. This report is a result of discussions and meetings with Credit Suisse, Bracor Investimentos Imobiliarios, Tishman Speyer, CBRE Richard Ellis, Lopes—LPS Brasil S.A., Universidade de São Paulo, Maxcap—Real Estate Investment Advisors, Prosperitas and Sherman & Sterling LLP.

Chazen International Study Tours

Designed to enhance the classroom curriculum, Chazen International Study Tours offer students and their faculty adviser an intense, firsthand experience of the business culture of their chosen country or region. Study tours are initiated by students and organized with the help of the Jerome A. Chazen Institute of International Business. During study tours students meet with leading executives and government officials while visiting businesses, factories and cultural sites. Recent destinations include China, France, India, Japan, Russia and Scandinavia.

Brazil's housing market has yet to realize its full potential, despite a housing shortage estimated at 7.2 million in 2004. This is mainly due to a lack of long-term financing. However, improved macroeconomic fundamentals and an enhanced legal framework for the sector are changing the dynamics of real estate finance.

The number of homes built in 2006, though double that of a year earlier, represents less than a quarter of the estimated 600,000 new homes a year needed to meet the shortage of homes in Brazil over the next 20 years. This shortage takes into account homes occupied by more than one family, as well as substandard housing. In tandem with the existing housing shortage, Brazil's growing adult population is driving demand for new homes.

Developers, faced with the lack of financing, have come to rely on presales and land-share deals to finance construction. Working capital, which for homebuilders is indispensable, historically has been generated by presales. Developers have also adapted to the mortgage-scarce environment by providing vendor financing to homebuyers. In many cases, this was a profitable business for developers. But as a series of factors increases the availability of financing in Brazil, residential developers are focusing less on financing customers and more on their core competency of building homes.

A combination of downward-trending interest rates, an improving regulatory framework, government measures to increase financing and homebuilders' access to capital is changing the housing landscape in Brazil. Low interest rates (real rates below 10 percent) are not only a boon to the mortgage industry but also good news for the real estate industry as a whole: returns on real estate investments have become more attractive than those of government paper.

Mortgage penetration—at around 1.7 percent of GDP—is still very low. This figure is set to improve as falling interest rates generate greater demand and measures to increase lending to the sector lift supply. The government has taken measures to increase the allocation of bank deposits to housing and to cap interest rates on mortgages.

At the same time, the government has made the country's regulatory framework more lender-friendly. Foreclosure, for example, now takes between 12 and 18 months, compared to between three and four years in the past. Other notable legislation "alienates" projects from the companies that develop them, thereby creating tax incentives for developers and reducing risk for buyers (and lenders).

On cue, private-sector banks are now moving into the mortgage industry in search of clients. Banks are afraid to repeat the mistake of ignoring anything but high-income clients (like they did in the market for consumer financing) and are being more proactive this time around with the market for mortgages.

Investor interest in the Brazilian stock market—particularly the shares of local developers—has also benefited the housing industry. The capital raised on equity markets has allowed developers to expand outside the core markets of São Paulo and Rio de Janeiro, extend the maturity of payment plans and target lower-income buyers. This newfound access to capital via share offerings has had the side effect of generating a land-grabbing frenzy, in which developers are consequently bidding up the price of land. As conditions improve and more investors buy in, cap rates have started moving down.

The question whether the housing sector runs the risk of too much money chasing too little opportunity can largely be answered by the aforementioned housing shortage and demand. If any such risk exists, it is in the market for properties that target high-income buyers, since this market is already the main focus of homebuilders. But the expanding availability and greater affordability of mortgages, together with the bulk of demand lying among low-income buyers, have already prompted some developers to shift their focus to lower-income segments.

This is not to say that Brazil's housing sector does not face challenges. Low-income housing is tough to finance, market intelligence is hard to obtain and the sector is still susceptible to economic and political risks. There are a number of concerns that affect the industry, including GDP growth rates, the central bank's lack of autonomy, a reverse in downward-trending interest rates and delays in the country's attaining an investment grade rating.