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Putting Recent Headlines in Perspective

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Over the past two decades, the thesis for Latin America real estate investment has undergone a dramatic transformation. When Paladin Realty first began investing throughout the region in the late 1990s, many markets were plagued by weak construction standards, poor infrastructure and corruption. Institutional-quality local operating partners were hard to come by, as was reliable market data. Further, while the region's scale and attractive demographics offered the promise of superior economic gains, the structural reforms needed to unlock the region's long-term growth potential were still in the early stages of being realized. In short, investing in Latin America in the early days required vision, patience, courage and conviction of strategy, combined with intense supervision.

Fast-forward nearly 20 years later, Latin America has experienced two decades of growth that has lifted tens of millions of people out of poverty and into the middle-class, fueling demand for all types of modern real estate along with other goods and services. Improved monetary and fiscal policy, combined with reforms and public investment in the areas of energy, trade, telecommunications, infrastructure and labor, have all contributed in varying degrees to this economic expansion. Each of the region's leading economies earned investment grade ratings (including Brazil, which was subsequently downgraded in late 2015 due to its deep recession), attracting billions of dollars of foreign investment and providing greater access to credit. Modern institutional-quality office, retail, industrial and hotel developments have changed the face of the region's major metropolitan areas, while new housing projects have been developed in an attempt to solve the region's large housing deficit. Along the way, small family-owned development companies have grown up to become large, sophisticated local real estate players in an industry that has become much more professional in all respects.

Why Latin America?

The long-term investment thesis for the region is relatively straight-forward. The five countries that are most suitable for global institutional investors – Brazil, Mexico, Colombia, Peru and Chile – represent a market of considerable scale, comprising over 420 million people, a larger market than the United States. Demographically, Latin America today resembles the United States of the late 1960s and 1970s, as the post-war baby boomer generation entered the workforce, fueling decades of economic growth and wealth creation. Demographic tailwinds in these five countries, combined with decades of prudent fiscal and monetary policies (including an acute focus on managing inflation), have resulted in a burgeoning middle-class population supporting the demand for real estate development, especially affordable housing.

Most importantly, because of the region's under-developed capital markets and relatively low penetration of private equity capital, Latin America offers some of the most attractive project-level economics for real estate investments in the world today – profit margins for real estate investments in Latin America are typically much higher than comparable investments in the United States, Europe or Asia. For example, Paladin Realty has historically targeted 15-25% profit margins on its for-sale housing investments and 250-500 basis points of development profit for commercial properties. Higher profit margins enable the region's investors to target opportunistic returns with a fraction of the debt utilized by the typical opportunity fund in more developed economies. Commercial properties are usually developed on an all-equity basis, while housing projects utilize low leverage, typically 0-40% depending on the country. Importantly, mortgage financing is readily available in each of these markets for home buyers.

With many global institutional investors seeking "defensive" investment positions today, we believe the prospect of a high return, low leverage strategy with solid underlying demand fundamentals offered by Latin America is compelling.

Is Now the Right Time to Invest?

Given its attractive demographics and increasingly better policy decisions, Latin America clearly represents a long-term growth opportunity. Nonetheless, a key question regarding any new investment is timing. Is now the right time for institutional investors to enter the Latin America real estate market?

Anyone who has read the numerous newspaper headlines with respect to Brazil and the region over the past two years may be justifiably cautious. Local currencies declined by as much as 50-70% in 2014-15 due to a combination of external shocks (e.g., declining prices of oil and other commodities as China's economy cooled, and the growing likelihood of rising U.S. interest rates) and internal political issues (e.g., Brazil's worst recession in decades and Presidential impeachment proceedings). Venezuela continues to be on the verge of economic collapse caused by market unfriendly policies. Ominous predictions that the Rio Olympic Games would be a bust and fears relating to potential widespread health threats posed by a mosquito didn't help matters.

A natural reaction by many investors in the wake of such negative headlines would be to retreat from the market by assuming that the trends of the recent past will continue long into the future, paying little or no attention to the market fundamentals that have improved. In doing so, such investors would be committing a classic investment error – looking at the road ahead through the rearview mirror at precisely the wrong time. Newspaper headlines are rarely as positive or negative as the reality on the ground.

When one looks instead at the fundamentals, there are several indications that Brazil, Mexico and the Andean region are poised for sustainable growth in 2017 and beyond. Indeed, the recent challenges facing the region have helped create a more attractive entry point in terms of asset pricing and currency levels. In short, the next few years should prove to be an optimal time to deploy investment capital in the region, particularly for U.S dollar-based investors.

We view the near-term investment outlook for the region as strongly positive for the following reasons:

- **The macro outlook in Brazil has improved dramatically over the course of the past year**. Consumer and business confidence is up with the impeachment of Dilma Rousseff complete and a reform-minded President now in command. The Brazilian Real (currently about R$3.30 per US$1.00) is less than half of its 2011 peak and has stabilized in real terms. Easing monetary policy in the near future will further support asset prices, with nearly 6% disinflation in a two-year span (from 10.7% in 2015 to an estimated 4.8% by end of 2017), providing Brazil's central bankers with the capacity to cut interest rates, which have recently been as high as 14.25%.
- **Mexico and the Andean region are poised for sustainable growth**, with their economies increasingly driven by domestic consumption and the negative effects of external shocks on commodities exports already largely priced in with respect to currencies. For example, the Mexican Peso has already depreciated 11.2% against the dollar this year, while the Chilean peso, at 668 per dollar, has corrected to nearly a standard deviation below the 22-year historical average of its real effective exchange rate.
- **Reduced inflationary pressures should allow central banks to lower interest rates**, further stimulating growth.
- **Local currencies have stabilized near decades' lows in real terms**, which should stimulate trade and investment, and which represent an attractive entry point for U.S. dollar-measured investors.
- **Real estate assets in certain markets are trading below replacement cost** due to a combination of slower growth and oversupply.
- **Long-term growth trends remain intact**, including attractive demographics, a growing middle-class, greater access to credit, and huge housing deficits, which should continue to fuel demand for housing and other real estate.

Regional Outlook: Poised for Growth with Near-Term Pricing Dislocations

Compared to other regions of the world, Latin America was relatively resilient during the 2008-09 global financial crisis due to well-capitalized banking systems, ample foreign exchange reserves, flexible exchange rates and prudent fiscal policies. While regional GDP growth has moderated since then, Mexico and the Andean countries of Colombia, Peru and Chile are expected to show sustainable growth in the 2-4% range for the next several years. Brazil, the region's largest market with over 200 million people, is recovering from one of its longest and deepest recessions in over a century. We continue to forecast that Brazil's recession will continue through 2016, with a modest resumption of growth in 2017 as inflationary pressures ease and interest rates come down.

While painful, Brazil's recession is helping to bring needed adjustment and reforms to that country's economy. First, political uncertainty has improved dramatically this year with the impeachment of an unpopular President and new leadership pursuing necessary near-term reforms. Despite negative headlines surrounding the process, the independence of Brazil's federal police and judiciary has demonstrated that independent institutions and rule of law do exist with appropriate checks and balances. President Temer is aggressively pursuing fiscal reforms and the capital markets are responding positively: Brazil's equity markets are up over 60% year-to-date (in U.S. dollar terms) and the Real has been one of the best performing currencies globally, up 18% on the year. Brazilian five-year credit default swaps have fallen from 490 basis points to 264 this year.

The recession in Brazil has also created an abundance of distress opportunities in both the commercial and residential real estate sectors, with capital becoming increasingly scarce. The pricing and terms for new residential development sites have improved significantly, with little competition from companies in the public homebuilding sector. More favorable joint venture structures with local partners (e.g., preferred equity) are increasingly common. Even with high unemployment (nearly 12% today), there remain plenty of employed workers needing homes and supply is down dramatically from prior years. In addition, demographic tailwinds continue to fuel annual household formation that is well in excess – 5x or more – of new additions to supply. As a result, new housing projects today are still selling at an attractive sales pace to support new development. Finally, certain institutional-quality commercial assets are trading at below replacement cost, particularly in U.S. dollar terms, a rarity in the region.

Mexico remains attractive. While the decline in oil prices has hurt the overall economy, sweeping reforms enacted a few years ago in telecommunications and other sectors are expected to have a positive effect on long-term GDP growth. Demand for middle-income housing remains steady, fueled by formal sector employment growth of nearly 650,000 jobs annually over the past three years. Annual housing demand in Mexico City estimated at 60,000 units is not being adequately met, with annual new supply estimated at just 20,000 units. The country's mortgage market has also grown steadily year-over-year, further supporting the housing market. Credit penetration in Mexico offers attractive growth prospects, with mortgage loans as a percentage of GDP just 10% and bank loans to consumers just 4% of GDP. Total household leverage in Mexico is among the lowest levels globally, with a ratio of just 19% of disposable income versus 110% of disposable income in the United States. Mexico City has the largest office market in Latin America, and although absorption remains strong, excessive additions to supply have pushed vacancy rates to 13%, the highest level since 2004.

In Chile, Colombia and Peru, chronic housing deficits remain stubbornly high, totaling over 4 million units. Steady demand for middle-income housing in these countries, combined with growing access to long-term mortgages, leads to an abundance of attractive development opportunities. The office markets of Santiago, Bogota and Lima are currently oversupplied, which may provide some interesting distress opportunities as vacancy rates continue to rise.

Favorable Demographics + Growth = Rising Affluence

As noted, a central pillar to Latin America's long-term growth outlook is the region's favorable demographics. Latin America's population today resembles the U.S. baby boomers in the post-war decades. These demographic tailwinds, combined with 15-20 years of pro-growth policies and other macroeconomic factors, have resulted in large and growing middle-class populations throughout much of the region.

Personal wealth and incomes generally rise with productivity gains and economic growth. Brazil already has provided the template, with more than 40 million people entering the middle-class in the years since 2003. A similar story is unfolding now in Mexico and the Andean region, with a combined 200 million population that is comparable in size to Brazil.

Increased purchasing power from real wage growth is further amplified by an expanding mortgage industry in each of these markets. When Paladin Realty began investing in the region, long-term mortgages were not readily available, and interest rates were north of 20%. As such, newly built homes were large, catering to multi-generational families who could pool their resources to acquire a condominium unit on an all-cash basis. Today, the increased availability of 30-year mortgages enables newly-formed families to purchase smaller, modern homes with considerably less accumulated savings. This factor has been a powerful demand driver for housing development, particularly for smaller, one- and two-bedroom units located near employment centers, transit corridors, and schools that appeal to younger families.

Lastly, as described above, because of a chronic dearth of capital in the region, there is considerable pent up demand for modern affordable housing, with an estimated 15 million-unit deficit alone in the five countries mentioned in this article. In virtually every market, new supply has not been able to keep pace with new household formation being driven by the region's demographics, let alone make a dent in the housing shortage. For example, new household formation in Brazil alone is about 1.5 million per year and yet only an estimated 200,000 - 300,000 homes have been built annually in recent years, with 2016 on pace to be the lowest increase in new supply on record. Even during the deep recession in Brazil, demand for Paladin Realty's housing projects in São Paulo remained resilient. Indeed, all five middle-income housing projects launched since December 2015 are collectively 55% pre-sold, and the most recent project launched in September was 64% pre-sold in its opening weekend. The low-income market is even stronger, due to the greater overall demand in the market.

Remaining Headwinds are Manageable

Although the region's positive long-term growth drivers remain intact, challenges do remain and progress will vary from country to country.

Currency risk remains, but has been significantly mitigated in recent quarters and is expected to be more of a tailwind in coming years (see *Paladin Latam Research - Currency Risk, Mid-Year 2016*). While the sharp decline in emerging markets currencies over the past 2-3 years has had a significant impact on the U.S. dollar-measured value of investment holdings in Latin America, we believe that current exchange rates also reflect an opportunity, both as an important adjustment mechanism for the real economies in the region, as well as for U.S. dollar-based investors deploying fresh capital in the next few years. Paladin believes that exchange rates are currently 5-15% undervalued in the Andean region on a purchasing power parity basis.

In Colombia, a recent failed referendum on a peace agreement with the FARC generated negative headlines. However, both sides quickly pledged to return to the negotiating table and there is common interest in ending the conflict. That bodes well for a modified peace agreement that will lead to longer and more sustainable peace in the country which, despite the absence of a formal peace agreement, has been largely free of violence over the past several years since Paladin first started investing in Colombia .

Finally, the slowdown in China's economy and resulting decline in the price of oil and other commodities has clearly impacted regional currencies, fiscal balance and investor confidence. However, the effect on all countries in the region is not the same. For example, oil prices have declined by approximately 60% in the last year and a half and remain volatile. This helps Chile, which is a net importer of energy, but hurts the oil exporting countries of Mexico, Colombia and Brazil. Many commodities currently trade below their marginal production cost for higher cost producers. As conditions at the higher end of the cost curve become uneconomic, production shuts down and reduces supply. Despite the difficulty in predicting commodity prices in the near-term, the fundamentals of the commodity cost curve do provide a floor value to prices and suggest a positive medium- to long-term outlook.

Finally, and on a positive note, it is important to understand that, as the middle-class populations in Brazil, Mexico and the Andean region swell, domestic consumption now accounts for about two-thirds of the economic output in these markets. Therefore, even with the decline in commodities prices, other sectors of the regional economy are still viable and attractive, particularly after the countries have taken the currency and fiscal adjustment.

Conclusion

We believe the next several years should prove to be an optimal time for U.S. dollar-measured investors to deploy capital in Latin America through select real estate strategies. The region represents one of the more compelling long-term, large-scale growth opportunities in the world today, with attractive demographics and a population exceeding 420 million in Brazil, Mexico, Colombia, Peru and Chile. Importantly, because of a shortage of attractive debt capital for real estate development in most markets, investment-level economics must be, and are, particularly robust in order to attract the necessary equity investment capital. When compared to similar opportunities in the developed world, either as part of a global diversification or tactical strategy, Latin America can offer institutional investors a relatively conservative formula of targeting opportunistic returns with low leverage while reducing real estate risk and better ensuring preservation of capital.

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