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Latin America Research
Brazil: Is Now the Time to Invest?

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2014-2016: The Perfect Storm

Over the past few years, Brazil has weathered significant social, political and economic shocks, driven by both internal and external factors. The slowing of China's economy and the end of the global commodities "super-cycle" boom in 2012 hit Brazil's terms of trade hard, causing its currency to depreciate by nearly 70% from 2012 through 2015. Lower commodity prices strained the government's finances and exacerbated the budget deficit, leading to the loss of Brazil's investment grade credit rating in 2015 and precipitating the end of Dilma's populist rule. Business and consumer confidence collapsed as the country entered its deepest recession on record, contracting by more than 7% in real terms during the 2014-16 period. Fixed investment slowed. Unemployment increased to over 10%. Inflation hit double-digits, because imported goods were suddenly more expensive in local currency, and because the government rolled back price subsidies. Local interest rates increased even more to 14.25%. International newspapers predicted that the 2016 Olympic Games in Rio would be a bust and that a mosquito-borne virus would wreak havoc on the country. The country's highly unpopular President was impeached. And a landmark investigation into systemic corruption at the highest levels led to large street protests and the arrest of politicians and prominent business leaders who were previously considered to be above the law.

After enduring this storm of negative news, the social, political and macroeconomic outlook for Brazil today has decidedly changed for the better and appears more constructive than at any time in the last five years. That much is evident with: (i) a new centrist President in power pushing forward a sweeping reform agenda; (ii) inflation and interest rates trending down significantly; (iii) business and consumer confidence strengthening; (iv) Brazil's currency and stock markets rallying since the summer of 2016; and (v) a consensus forecast of an economic recovery taking root in 2017.

Is this the time to consider deploying capital in Brazil? We believe it is.

2017 & Beyond: A Compelling Thesis for U.S. Dollar-based Investors

Four factors lead us to conclude that expected returns for U.S. dollar-based real estate investors at this juncture are compelling and substantially outweigh downside risk:

1) ***Demographic tailwinds continue to fuel steady demand for real estate, particularly housing***. Half of Brazil's 204 million people are under the age of 30. The middle-class has doubled in the past decade. With respect to homebuilding, a large, youthful and increasingly wealthy and aspirational population are forming new households on an annual basis at roughly seven times the number of new homes being "launched" for sale, adding to the already large housing deficit estimated at five million units.

2) ***Structural reforms and pragmatic economic policies are being enacted***, catalyzed by the recent upheaval, that will underpin GDP growth and investor returns. Political risk is substantially reduced with the ouster of Dilma's statist and protectionist policies, in favor of orthodox economic management and free trade. Politicians today understand that their survival depends upon delivering on their promises. Already, Congress has passed President Temer's proposed constitutional spending cap that freezes government expenditures in real terms for 20 years. The agenda for 2017 includes reforms in the areas of pensions, labor, campaign finance, and regulation and has a good chance of being enacted into law.

3) ***Asset values will be supported by economic recovery and lower interest rates***, made possible by stable prices. Inflation peaked at 10.5% in 2015 and is expected to decline to about 5% by the end of this year. As a result, the central bank has already reduced interest rates from its high of 14.25% to 12.25% today. The consensus interest rate forecast ranges between 350 and 400 additional

basis points of reduction over the next 24 months. Lower interest rates support higher asset valuations, because a lower cost of capital increases the present value of future cash flows.

4) ***The Brazilian currency has stabilized at attractive levels***. After rallying since last summer, the Brazilian *real* has stabilized today (R$3.10) at nearly half of its 2011 peak (R$1.62), representing an attractive entry point for USD-based investors today. At current levels, the *real* is near fair value on a purchasing power parity basis, the level to which real rates tend to revert over time. Going forward, further currency depreciation should not significantly detract from USD-based returns.

Remaining Headwinds are Manageable

Although Brazil appears to be squarely back on the path to recovery with its long-term growth drivers remaining intact, some challenges remain. There are two main downside risks which we continue monitor. First, Brazil may fail to implement the major structural reforms described above that set the conditions for stable prices, sustainable government spending, free market competition and growth. This year represents a generational opportunity for Brazil's government to implement tough decisions. Under normal circumstances, entrenched interests and complacency might make such changes difficult to achieve. However, the loss of Brazil's investment grade status in 2015, disgust at entrenched corruption, and the memory of hyperinflation have all focused voter resolve – if only for a short period – and that of congress too. As a result, we believe a meaningful reform agenda will be approved. Second, we note rising geopolitical risk globally: rising protectionism in developed markets, unprecedented monetary creation by central banks, and increasingly bellicose militarism. Geopolitical risk has the potential to impact global capital markets and access to credit, create currency volatility, and precipitate a flight to quality assets. To mitigate these risks, Paladin Realty focuses on demand-driven investments, such as low and middle-income housing, which has proven to have resilient demand and can be executed with low leverage to provide a sufficient margin of safety.

Strategy Implications

Paladin Realty continues to approach Brazil with a conservative and highly-selective investment strategy. While much distress exists in the real estate sector, most 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 partners and strong joint venture terms and controls, and very conservative use of leverage. Paladin Realty's strategy to take advantage of the distress in Brazil over the past two years 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 investments in select publicly traded property vehicles ("FIIs")
- 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

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