Attracting Foreign Real Estate Investors to the Brazilian Hotel Market

Spring 2012

January 2012

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Stockholm 2012
**Abstract:**

The last financial and economic crises have revealed the fragility for developed countries, especially European countries, to resist to a major upheaval. This event has affected for a long time their capacity to spur their economy and their attractiveness. Indeed, trapped in a low GDP and with a high public debt, the last summer has recalled that the situation stay unstable in Europe and U.S.

Nevertheless, following this event, some countries have succeeded to emerge stronger. These emerging countries, especially BRIC countries (Brazil, Russia, India, China), achieve to recover quickly a high GDP rate in spite of the global crisis and are confirming their capacity to reach their economic objectives.

This thesis report focuses on a Real Estate investment recommendation in one of the most attractive emerging countries in the world, Brazil. The country, the last American country entered in recession and the first one exited from it, is becoming more and more attractive. Now, the country is among the ten largest economies in the world and remains very attractive to foreign investors due to its growth potential, large and competitive market and political stability, transforming the country from “a country of the future to a country of the present”. Their ability to master the inflation to a stable value, to reduce the net debt and to pay off international Monetary Fund loans reassured investors.

The new Domestic demands accompanied by an increasing business development and touristic demand are transforming the country, especially in the Real Estate sector, ranking it as one of the best place to invest in the world. Thanks to specific strategic investments in Real Estate, investors can make
interesting returns and diversify their portfolio which is essential to decrease their exposition to specific risks.

My thesis focus on a specific Real Estate sector: the Brazilian Hotel Market, and describe some strategic investments for foreign investors in Brazil.
**Acknowledge:**

This Master Thesis has been conducted at the Division of Building and Real Estate Economics at KTH Royal Institute of Technology, Stockholm.

First, I would like to express my gratitude to all those who helped me to accomplish this thesis with their support and knowledge. Hans Suck Song (PhD, Centre for Banking and Finance), Rosane Hungria-Gunnelin (Research engineer).

Secondly, I would also like to thank my supervisor Professor Hans Lind, Research Leader at Building and Real Estate Economics, for his guidance and valuable comments throughout the writing of this thesis.

Finally, I would like to thank my friends for all their support and feedback.

Many thanks!

Stockholm, 2011-06-01

*Alexis MIGNONAC*
Table of contents

1 Introduction..................................................................................................................7
  1.1 Problem Analysis ..............................................................................................7
  1.2 Purpose and Objectives ....................................................................................7
  1.3 Methodology .....................................................................................................8
  1.4 Limitations .........................................................................................................8
2 Brazil .........................................................................................................................9
  2.1 Political and Economic aspects ........................................................................9
    2.1.1 The Real Plan to control the inflation.......................................................9
    2.1.2 Low Unemployment ..............................................................................10
    2.1.3 Positive Trade Surplus ..........................................................................10
    2.1.4 BRIC countries and GDP’s ....................................................................11
    2.1.5 Direct Foreign Investments ....................................................................13
  2.2 Commodities ...................................................................................................14
    2.2.1 Oil and Gas Industry .............................................................................14
    2.2.2 Other industries ....................................................................................14
    2.2.3 Agricultural Production .........................................................................15
  2.3 Population growth and creation of the Middle Class ......................................15
  2.4 Lack of Transparency .......................................................................................18
3 Sustainable Brazil: World Cup 2014 and RIO Olympic Games 2016 ..................19
  3.1 World Cup 2014 .............................................................................................19
    3.1.1 Principle .................................................................................................19
    3.1.2 Social and economic impacts in Brazil ...................................................19
  3.2 Rio Olympic Games 2016 ................................................................................23
4 Real Estate Investment in Brazil ..............................................................................24
  4.1 Principles .........................................................................................................24
    4.1.1 Asset Allocation ....................................................................................24
    4.1.2 Fundamentals ........................................................................................25
  4.2 Investing by Style ..............................................................................................26
    4.2.1 Core Strategy ........................................................................................27
    4.2.2 Value added Strategy ...........................................................................27
    4.2.3 Opportunistic Strategy ..........................................................................28
  4.3 Investing by Phase ............................................................................................28
    4.3.1 Development ..........................................................................................28
    4.3.2 Stabilization ...........................................................................................28
4.3.3 Repositioning/Redevelopment ................................................................. 29
4.4 Taxation in Real Estate .............................................................................. 29
  4.4.1 Inheritance and Gift Taxes ................................................................. 29
  4.4.2 Tax on the Disposal of Real Estate (ITBI) ......................................... 29
  4.4.3 Tax on Inheritance and Donations (ITCMD) ...................................... 29
  4.4.4 Municipal Property Tax (IPTU) ......................................................... 30
5 Joint Ventures ............................................................................................. 31
  5.1 Principles ............................................................................................... 31
    5.1.1 Joint ventures in General (JV) ......................................................... 31
    5.1.2 International Joint Ventures (IJV) .................................................... 31
    5.1.3 Gtis Partners and Ager Incorporacoes joint Venture Focused on Real Estate in Rio De Janeiro 33
    5.1.4 Wealth Impacts of Real Estate Joint Ventures .................................. 34
  5.2 International Joint Ventures utilization ................................................... 34
6 Hotels in Perspective in Brazil .................................................................... 35
  6.1 Strengths ............................................................................................... 35
    6.1.1 Domestic demand ........................................................................... 35
    6.1.2 Business demand ........................................................................... 35
    6.1.3 Tourist demand .............................................................................. 36
    6.1.4 Performances .................................................................................. 36
  6.2 Weaknesses .......................................................................................... 38
    6.2.1 Management .................................................................................. 38
    6.2.2 Saturation ..................................................................................... 38
    6.2.3 Land price ..................................................................................... 38
  6.3 Outlook .................................................................................................. 39
7 Challenges and Opportunities ................................................................. 41
  7.1 SWOT Analysis .................................................................................... 41
    7.1.1 Presentation .................................................................................. 41
    7.1.2 Analysis ......................................................................................... 41
  7.2 Investment Description ........................................................................ 46
    7.2.1 Investment in Hotel Sector ............................................................. 46
  7.3 Strategic Decision ................................................................................ 47
    7.3.1 Private Equity Real Estate investment ........................................... 47
    7.3.1 Joint Ventures Structure ............................................................... 47
8 Conclusion ................................................................................................. 48
9 References ................................................................................................. 49
1 Introduction

1.1 Problem Analysis

The last financial and economic crises have revealed the fragility for developed countries, especially European countries, to resist to a major upheaval. This event will affect for a long time their capacity to spur their economy and their attractiveness. Indeed, trapped in a low growth and with a high public debt, 2011 has recalled that the situation stay unstable in Europe and U.S.

Nevertheless, following this event, some countries have succeeded to emerge stronger. These emerging countries, especially BRIC countries (Brazil, Russia, India, China), achieve to recover quickly a high growth rate in spite of the global crisis and are confirming their capacity to reach their economic objectives.

This important evolution has pushed investors to look for new investments, especially in these dynamic places. The main goal is to increase their returns and to decrease their specific risk on more “traditional” market.

1.2 Purpose and Objectives

The main goal of this thesis is to investigate why Brazil is becoming an attractive place for new investment and how to manage it in a specific environment.

Indeed, the country was the last American country that entered in the recession and the first one that exited from it and is becoming more and more attractive. Now, the country is among the ten largest economies in the world and remains very attractive to foreign investors due to its growth potential, large and competitive market and political stability, transforming the country from “a country of the future to a country of the present”. Their ability to master the inflation to a stable value, to reduce the net debt and to pay off international Monetary Fund loans reassured investors.

The new Domestic demands accompanied by an increasing business development and touristic demand are transforming the country, especially in the Real Estate sector, ranking it as one of the best place to invest in the world.

Thanks to specific strategic investments in Real Estate, investors can consider attractive returns in Brazil. Moreover, this investment provides the opportunity for the investors to diversify their port-folio and therefore decrease their exposition to specific risks.
My thesis focuses on a specific Real Estate sector: the Brazilian Hotel Market, and describe some strategic investments for foreign investors in Brazil.

1.3 Methodology

Over my thesis, the reader will have an overall macroeconomic view of this specific market through the historical development in the country, the current situation and the forecast of the near future.

The first stage of the thesis is to provide an overall picture of the current situation in Brazil. This analysis has driven me to describe the political and economic situation and then to describe the actual demographic evolution in the country. The second step gives us an overview how Brazil is going to manage its future. Especially, how the organizations of the World Cup 2014 and the Olympic games in 2016 will foster the economic development in the near future.

The following part provides a specific background in the Real Estate investment, I present the real estate investments in general and then I describe the different strategies between investing by style or by phase in Brazil. As my thesis focus on an investment recommendation in an emerging country, with specific risks, I describe how joint ventures can be used to invest with success in Brazil.

During the following part, I focus on hotels perspective in Brazil and illustrate the strengths and the weaknesses of this sector. I use this part to introduce my investment recommendation for foreign investors in the Brazilian Hotel Market.

1.4 Limitations

The most difficult part of the research was to find solid and reliable aggregated data on the selected real estate market in an emerging country such as Brazil. Indeed, the country has just recently started to publish viable documents concerning their economy.
2 Brazil

2.1 Political and Economic aspects

In recent decades, the government attitude has been very benefic for the country in order to assure a political stability and to enhance the investment in all essential sectors.

2.1.1 The Real Plan to control the inflation

The actual political and economic stability is the consequence of the Real Plan adopted in 1994 to control the high inflation that Brazil has historically suffered.

Above, the figure presents the inflation variation over time in Brazil (GDP deflator). As we can see, the country has achieved to stabilize the inflation to an annual constant value around 6%–7%. This improvement has been essential for its development. Indeed, foreign investors have been reassured by the capacity of the country to keep under control their inflation to a normal value and have started to invest in Brazil’s economy.

1 World bank (2012)
2.1.2 Low Unemployment

In the past 10 years, the unemployment rate is remained at low level over time supported by a high domestic demand and by a constant augmentation of exports. The figure below presents the unemployment percentage evolution. It shows that the unemployment rate decreased from 9% in 1999 to 7% in 2009. This is due to the political and economic stability in the country over the past 10 years.

![Figure 2-2 Unemployment, total (% of total labor force)2](image)

After 2009, due to the global crisis and a decreasing of exports, the unemployment increased by 1% to reach 8%, which is still a low level compared to the rest of the world.

2.1.3 Positive Trade Surplus

As we can observe below, exportations have continuously increased over time, except in 2009 due to the global crisis, from M$ 120,000 in 2005 to M$ 250,000 in 2011.

![Figure 2-3 Trade Balance In Millions of USD ($) 3](image)

---

2 World bank (2012)
Thanks to these high exports and an import rate kept under control, the country maintains a high trade surplus, even during the financial crisis. As the trade surplus is positively correlated with the current money. Thus, since 2003, the increasing trade surplus has appreciated the Brazilian currency against the US dollar.

2.1.4 BRIC countries and GDP’s

The BRIC countries are a group composed by four powerful emerging countries (Brazil, Russia, India, China), with a GDP which is worth 88% of US GDP, that is estimated in US$ 13 317 billion. Brazil is one of the most important exponents with a GDP of US$2 493 billion in 2011 which is the 8th highest in world.4

Moreover, the tight monetary policy has preserved the Brazilian banking system healthy; thus the country has been spared during the financial crisis. Indeed, the country’s central bank had adopted strict monetary policies designed to build and maintain foreign reserves even during the crisis. Since 2000, Brazil has made a lot of improvement creating the foundations for growth, with particular highlighting on achieving macroeconomic stability.

In 2009 Brazil’s GDP declined just by 0.4% during one year, which is low compared to the rest of the world, and became again positive the following year. Thus Brazil was the last American country to enter in recession and the first one to exit from it.

![GDP Growth Chart](image)

**Figure 2-4 GDP Growth (Annual %)**

---

3 World bank (2012)
4 Idem
5 Idem
The country has overtaken to foster further the economy. Thus the government has engaged substantial investments in new airports, roads and supporting structures to keep a high GDP's rate in the future. Brazil is forecast to be among the world’s fastest-growing economies for the next several decades. By 2050, Brazil is predicted to be the world’s fourth largest economy.  

In addition, unlike most other Latin American economies, its debt position has been enhanced. Indeed, the country has changed from the world’s largest emerging market debtor to a net foreign creditor by 2008.

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6 Ernst & Young (2011)
The foreign direct investor, or FDI, is a measure of overseas ownership of domestic productive assets such as organizations, land and factories. FDI includes foreign mergers and acquisitions, investments in joint ventures or strategic alliances with local enterprises. According to the International Monetary Fund (IMF), the FDI value in Brazil reached US$37 billion in 2011, ahead compared to India’s FDI (US$26 billion) and to Mexico’s FDI (US$30 billion).8

The following figure shows the fluctuation of the Direct Foreign Investment between 1975 and 2011, we can observe that the country presents a growing trend.

Indeed, the country meets a combination of capital accumulation, population growth and total factor productivity which probably are going to continue to boost the growth, supported by a growing middle class. In addition, Brazil has adopted a high annual interest policy correlated with a significant tax system modification to transform the country attractive to foreign investors.

Besides, foreign investors that operate through branches or subsidiaries in Brazil can generally also have access to a source of finance.9 In aggregate, the state does not limit foreign ownership of local firms.

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7 Economy Watch (2010)
8 Ernst & Young (2010b)
However, there is a restriction on firms which would like control investments in specific sectors such as the news media and transportations.

2.2  Commodities

The country possesses huge natural resources and is developing its industry in the whole world.

2.2.1  Oil and Gas Industry

Petrobras is the biggest global company in market capitalization in Brazil and the 8th in the world. Compared to the rest of the world, Petrobras is the 3rd biggest company in the world with a oil production close to 1.978 million barrels per day.

Exploitation and production should attract important investments over ten years; exceeding US$250 billion; including infrastructures and transports. Otherwise, some surveys forecast US$1 trillion, as Brazil currently offers the greatest opportunities for the global high seas offshore oil industry.

Moreover, future investments in the deep-water “pre salt” oil reserves, contribute even more to attract the attentions of foreign investors.

2.2.2  Other industries

In addition to its Oil and Gas industry, Brazil is represented by various industries such as aluminum, cement, machinery, paper, plastics, beverage & food and steel, such as:

- Steel: Companhia Siderúrgica Nacional
- Construction and building materials, Real estate: MRV Engenhari
- Engineering and Construction, Oderbrecht
- Homebuilder and real estate company, Cyrela
2.2.3 Agricultural Production

Brazil is one of the most important producers of agricultural products such as bananas, coffee, corn, orange juice concentrate, rice, soybeans, alcohol and sugarcane such as:

- Beverage & food: AmBev

Besides, the increasing interest in biofuels is opening an attractive market for producers as Brazil is one of the world’s leading producers of sugarcane.

2.3 Population growth and creation of the Middle Class

Thanks to the “Demographic Transition Theory” developed by John Caldwell, we can represent the transition from high birth and death rates to low birth and death rates as a country development from a preindustrial to an industrialized one\(^{10}\).

<table>
<thead>
<tr>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
<th>Stage 4</th>
<th>Stage 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Death Rates</td>
<td>High and fluctuating</td>
<td>Falling</td>
<td>Falling</td>
<td>Low</td>
</tr>
<tr>
<td>Birth Rates</td>
<td>High and fluctuating</td>
<td>High</td>
<td>Falling</td>
<td>Low</td>
</tr>
<tr>
<td>Population</td>
<td>Stationary</td>
<td>Large increase</td>
<td>Stable growth</td>
<td>Stable</td>
</tr>
<tr>
<td>Countries</td>
<td>Venezuela, Colombia, Mexico</td>
<td>Brazil, Argentina, Chile, China</td>
<td>USA, UK, France, South Korea</td>
<td>Japan, Germany</td>
</tr>
</tbody>
</table>

\(^{10}\) Credit du Nord (2011)
With a falling death and birth rates, Brazil has a stable population growth corresponding at the stage 3 such as Argentina, Chile and China. The following stage for the country should be the stage 4 with a stable population, the same one than in UK, France and USA.

Below, the figure represents the variation of the population from 2003 to 2030. It appears that the population increased continuously from 2003-2010. In addition several studies forecast that the country will keep the same tendency in the future in order to reach 235 million Brazilian in 2030.

![Graph showing population trends from 2003 to 2030.](image)

**Figure 2-6 Population, Total**

The country is experiencing an important modification of its class repartition. The following table provides an economical classification against wages. We have created 4 different levels, Class AB: the richest, Class C: the Middle Class and Classes E and D the poorest.

<table>
<thead>
<tr>
<th>Class</th>
<th>Lower Limit</th>
<th>Upper Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class E</td>
<td>0</td>
<td>1085</td>
</tr>
<tr>
<td>Class D</td>
<td>1085</td>
<td>1734</td>
</tr>
<tr>
<td>Class C</td>
<td>1734</td>
<td>7475</td>
</tr>
<tr>
<td>Class AB</td>
<td>7475</td>
<td>&gt; 7475</td>
</tr>
</tbody>
</table>

**Table 2-1 Classes and Total Household Income (by per capita terms)**

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11 Ernst & Young (2008)
12 CPS/FGV based on PNAD/IBGE micro data (2008)
As we can observe on the following graphic, the portion of people in Classes E and D has continuously decreased since 2003. Indeed, as Professor Marcelo Neri said “In the past 10 years, the income of the poorest 50 per cent of the population grew 68 per cent in real per capita terms” helped by generous increases in the minimum wage and welfare handouts.\textsuperscript{13}

This tendency is going to last at least until 2014 according to different economies in order to reach respectively 9\% and 16\%.

The following figure provides an overview of the middle and the rich class evolutions. Since 2003, the portion of people in the Class C has continuously increased over time to reach almost 50\% of the total population. In addition, we forecast that the middle class will still increase to reach 60\% in 2014, for the first time. The rich class AB has also increased but in a lesser extent from 8\% to 11\%.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{class_evolution}
\caption{Class E-D Evolution}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{class_ab_c}
\caption{Class AB-C Evolution}
\end{figure}

\textsuperscript{13} Professor Marcelo Neri of the Getulio Vargas Fondation (FVG)
2.4  Lack of Transparency

The country is suffering from an important lack of transparency. Indeed, “this lack of transparency is evidenced by the 2011 Transparency International Corruption Perception Index, where Brazil was ranked 73rd out of the 184 countries rated”\(^\text{14}\).

The higher a country is ranked, the lower the degree of institutional, legal and governmental transparency and there is greater potential for institutionalized corruption. “As a point of comparison Brazil only came marginally ahead of Colombia, which was rated 80\(^{th}\) and well behind the U.S., which was rated 24\(^{th}\). Meanwhile New Zealand was rated as the most transparent and least corrupt while Somalia and North Korea as the most corrupt and opaque.”\(^\text{15}\)

\(^{14}\) The return of Economic Nationalism And Rising Investment Risk In Brazil (2012)

\(^{15}\) Idem
3 Sustainable Brazil: World Cup 2014 and RIO Olympic Games 2016

3.1 World Cup 2014

3.1.1 Principle

Brazil will host the future World Cup in 2014. This international association football tournament which gathers 32 national soccer teams in the country is one of the most important events in the sport world. This event will be retransmitted everywhere in the world and will attract an important number of tourists.

3.1.2 Social and economic impacts in Brazil

3.1.2.1 International Tourist Inflow (ITI)

The World Cup is offering an amazing exposition in the world and will have significant economic and social impacts in Brazil.

Indeed, the World Cup should increase the International Tourist Inflow (ITI) during a long time, putting an end to Brazil’s five-year stagnant foreign tourist inflow. As we can observe on the following Figure, the ITI should increase from 5 million in 2009 to 7.48 million in 2014, during the World Cup, and then continue in order to reach 8.95 million in 2018. If we compare both curves, we can observe how well the World cup impacts the tourist inflow.

![Figure 3-1 International tourist inflow (In thousands)\(^6\)](image)}

\(^6\) Ernst & Young, (2010d)
This important augmentation should affect the airport activity, especially due to the size of Brazil and its localization in Latin America.

The figure above presents the current situation and the perspectives in 2014. As we can observe, there are 114.6 million passengers per year currently; this number should reach 167 million in 2014.

![Figure 3-2 Higher airport activity (Million Passengers per year)](image)

This high flow in Brazil will generate important revenue over time and spur the Brazilian economy. Indeed, as we can see on the following figure the Revenue Generated by visitor’s spending should increase from a current income of 6.58 US$ billion to 8.73 US$ billion in 2014 and then 10.65 billion in 2018. This impressive augmentation is a real windfall for potential investors.

![Figure 3-3 Revenue generated US$ billion](image)

Thus, the World Cup 2014 would generate 3.63 million jobs/year and R$63.48 billion income for the population over the period 2010-2014, moreover an additional R$18.13 billion in tax collections.19

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17 Ernst & Young (2010d)
18 Idem
19 Idem
3.1.2.2 Investments

To organize the World Cup, the state and investors (local or foreigners) have work together in order to manage the investment in several sectors.

The figure above presents the investment repartition for the World Cup in 2014.

![Figure 3-4 World Cup Investments In millions of BRL (R$)]

- **Expansion and adequacy of the hotel complex:**

  The World Cup will attract an important number of tourists in the country during the event. A lot of investments have to be made to improve the lodge capacity either by the state or by investors (local or foreigners). “Nevertheless, of all the host cities, only Rio de Janeiro, São Paulo and Curitiba are better prepared to meet this demand. In the other cities, the expected number of tourists exceeds their current hosting capacity, resulting in a total projected deficit of 62,397 Hotel rooms”. 21

  Note that different types of accommodation will be likely used, such as seasonal rental of properties, accommodation in neighboring towns, or even the use of idling cruise ships, as 2004 Olympic Games in Athens.

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20 Ernst & Young (2010d)
21 Idem
• **Building and renovation of sports stadiums**

Globally, the various host cities do not have stadiums capable of holding international competition matches. Especially due to theirs capacities to meet all accessibility, safety, comfort, lighting, structure and services requirements defined by Fifa.

• **Investments in media and Advertising**

As we have already observed during previous Cups, the 2014 World Cup will result in a large appreciation of media space (including television, radio, internet, physical space and others).

• **Investments in information Technology**

The high traffic generated by the World Cup will demand the implementation and operation of an extensive IT infrastructure.

• **Public investments in transport Infrastructure**

The long distance between Brazilian cities and the expected increase in tourist inflow will force the public sector to invest in the expansion of airport capacity and in the maintenance or renovation of highways.

• **Reorganization of cities**

As in previous competitions, the 2014 World Cup will represent an opportunity to revitalize the tourist areas of the host cities.

*3.1.2.3 Visitors Spending*

Apart the investment aspect, one of the other most important sources of demand for goods and services will come from the visitor’s spending. Indeed, this event will produce an increasing demand for hotels in host cities (Following figure), not only due to the event itself, but also to the growth in tourist inflow generated by the country’s increased international exposure as a tourist destination.
In addition to the lodging sector, we are expected important returns on several sectors, such as communications, culture and leisure, transport, purchase... The global amount of direct or indirect visitor’s spending in the country would reach almost 6 billion of BRL.

3.2 Rio Olympic Games 2016

The Olympic Games will lead to an investment estimated at R$28.8 billion, with R$23.2 billion of that sum coming for infrastructure projects from the three levels of Brazilian government and the remaining R$5.6 billion coming from the International Olympic Committee.

This event will have an economic impact concentrated on Rio and its sub. As the World Cup, The Olympic Games offers also an amazing exposition for the country to the rest of the world and will participate further to the tourist attractiveness and thus to the economic activity. Nevertheless, as Rio concentrates already a lot of hotel, I decided to not develop this aspect in my thesis.

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22 Ernst & Young (2010d)
4 Real Estate Investment in Brazil

4.1 Principles

4.1.1 Asset Allocation

According to Modern Portfolio Theory, the insertion of low or negatively correlated assets in a diversified portfolio can reduce the general portfolio risk. Real estate as an asset class presents low to negative correlations with equities and bonds. A portion between 10% and 20% of real estate assets into diverse asset portfolios can potentially boost investment returns and decrease portfolio risks over a long term investment horizon.

Real Estate has typically been underweighted in varied asset portfolios. There are a few reasons for this: first of all, real estate is perceived as risky and secondly many investors feel that Real Estate is relatively illiquid and inaccessible to small investors. This has been changing with the proliferation of real estate investment options.

As a final point, it’s important to note that the real estate provides a natural hedge against inflation.

On the whole, investing in international real estate facilitates the potential for:

- Higher returns
- Increased diversification
- Inflation hedging

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23 Kingsley Associates and Institutional Real Estate, Inc
4.1.2 Fundamentals

Generally speaking, real estate investment opportunities can be divided into four categories based on whether the investment structures are equity or debt.

<table>
<thead>
<tr>
<th>Equity</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private</td>
<td>Debt</td>
</tr>
<tr>
<td>Direct Investment in Real Estate</td>
<td>Direct Investment in Real Estate</td>
</tr>
<tr>
<td></td>
<td>Mortgages</td>
</tr>
<tr>
<td>Public</td>
<td>Debt</td>
</tr>
<tr>
<td>Real Estate Investment Trusts (REITs)</td>
<td>Commercial Mortgage Backed Securities</td>
</tr>
<tr>
<td>Real Estate Operating Companies (REOcs)</td>
<td>(CMBS)</td>
</tr>
</tbody>
</table>

Figure 4-1 Four Quadrants of Real Estate Investment

In each strategy, the essential revenue source results from leases paid by tenants who occupy the real estate properties. This income revenue is potentially increased by capital appreciation of the assets realized when the property is sold.

- **Private equity** investment means the purchase and the management of commercial buildings, as well as hotels. This investment may be made through direct property, closed-ended or open-ended funds. Most Real Estate investments in emerging markets are within the private equity quadrant.

- **Public equity** investment involves the purchase of shares in real estate investment trusts (REITs), providing investors with exposure to real estate via publicly traded securities.

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24 Emerging Market Real Estate Investment: Investing in China, India, and Brazil (2011)
25 Idem
- **Private debt** investment includes the organization and acquisition of senior debt (whole mortgages) on commercial properties.

- **Public debt** market includes the creation and trading of commercial mortgage-backed securities (CMBS).

The four sectors can be differentiated by their relative risk and liquidity profiles.26

- Debt assets provide a senior claim on future rents at a specified rate and over specified period. These investments sacrifice some potential return in favor of predictability.

- Equity investments are higher risky because the claim on future rents is linked to the debt position: the benefit of the equity position is in an enhanced ability to control the property through active management and to benefit from the growth of future rents and property appreciation.

Private equity real estate investors generally anticipate relatively higher returns than public equity, reflecting the lower liquidity and higher risk of the private market, compared to the public equity markets.

### 4.2 Investing by Style

It is an open ended question whether to invest in new buildings as opposed to existing hotels. An assortment of investment styles allows real estate investors to pick a favored level of risk. Each investment style has a specific strategy: there are three main investment styles: core, value-added and opportunistic.

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26 Emerging Market Real Estate Investment: Investing in China, India, and Brazil (2011)
4.2.1 Core Strategy

Core real estate has historically represented for more than half of all real estate commitments. It is usually understood to represent a long term investment with a low risk/low return. This strategy is preferred by investors due to characteristics: its high yield, stable bond, port-folio diversification and inflation hedging benefits.

Placement in core real estate focuses on the purchase of existing, well leased and high quality properties in well-known markets. The hotel segment is frequently not considered to be a core sector, due to its high volatility and the fact that the management is particularly intensive.

4.2.2 Value added Strategy

In its most basic form, value added real estate investment means buying a property, improving it in some way, and selling it at a favorable time for a capital gain. The value added strategy in general uses 40-70% leverage and the objective total return are in the 13-17% interval.

27 Emerging Market Real Estate Investment: Investing in China, India, and Brazil (2011)


4.2.3 Opportunistic Strategy

In the past, most institutional investors had a low exposure to opportunistic placements in their portfolios. Nevertheless, the will for higher returns in recent years fostered growing interest in this particular strategy.

Opportunistic funds focus on distressed assets, development project and emerging markets presenting more risks. Habitually, these investments are more complex and could involve unusual or specialized property types, complex financial reorganization, highly leveraged transactions and international markets. Opportunistic placing, which is by its nature speculative, often uses high leverage (>70%) and target total returns at 20% and above, with a limited income component.

It’s interesting to note that most international real estate placements are usually made as an opportunistic investment strategy, especially in emerging countries.28

4.3 Investing by Phase

Investors can also decide to invest at a specific phase of the property life.

4.3.1 Development

Typically used for an opportunistic strategy in a market with important barriers to integrate. Markets with high barriers are usually characterized by a significant demand (high occupancies and rents) and by a low capitalization rates. This kind of placement is usually justified whether existing properties are regularly sold at a premium to their development cost.

4.3.2 Stabilization

Once the construction phase is ended and the occupancy level targeted is reached, the construction is in the Stabilization phase. Stabilized properties usually are worth a higher price (a lower cap rate) than development or redevelopment properties, due to the lower relative risk.

A typical strategy for stabilized assets is to hold for income returns and sell when the spread between return on investment and the cap rate is the greatest.

28 Emerging Market Real Estate Investment: Investing in China, India, and Brazil (2011)
4.3.3 Repositioning/Redevelopment

Properties badly managed or cash strapped, with a high potential returns constitute the traditional targets in the Repositioning/Redevelopment investments.

4.4 Taxation in Real Estate

4.4.1 Inheritance and Gift Taxes

Transfers of real state are subject to a tax on immovable property (Imposto sobre Transmissão de Bens Imóveis or ITBI), at rates ranging from 2% to 6%, according to municipal law. If the real estate transfer is done through donation or inheritance an inheritance tax applies, (Imposto sobre Transmissão Causa Mortis ou Doação or ITCMD) which is levied at a maximum rate of 8% (in Sao Paulo and Rio de Janeiro, for example, the applicable tax rate is 4%).

4.4.2 Tax on the Disposal of Real Estate (ITBI)

The municipal tax on the disposal of real estate (Imposto sobre Transmissão inter-vivos de Bens Imóveis pr, ITBI) is levied in the case of a burdensome real estate transfer, such as a sale. This tax is also required in specific situations such as for mortgage guarantees. Transfers of real estate resulting from corporate reorganizations or resulting from incorporation may be exempt from ITBI, if the corporate reorganization or incorporation does not characterize a prevalent activity of the acquiring company. As an example, in the Municipality of São Paulo the ITBI tax rate ranges from 0.5% to 2%, to be calculated

4.4.3 Tax on Inheritance and Donations (ITCMD)

ITCMD (Imposto sobre Transmissão Causa Mortis ou Doação) is levied on the complimentary transfer of any assets and equity rights, which means, it applies to donation or inheritance transfers. Each State determines the tax rate applied, up to the maximum percentage established by the Federal Senate, which is currently 8%. In São Paulo, for example, the tax rate is currently 4%, to be applied upon the market value of the transferred real state.
Municipal property tax (Imposto sobre a Propriedade Predial e Territorial Urbana or IPTU) is levied annually on the ownership of real estate in urban areas. The tax is based on the arbitrated value of the land and buildings, adjusted according to formulas prescribed in the legislation. In the Municipality of São Paulo, the applicable rate varies from 1% to 1.5%, depending on the utilization of the real estate.
5 Joint Ventures

5.1 Principles

5.1.1 Joint ventures in General (JV)

A joint venture (JV) is a business agreement in which parties agreed to develop, for a limited time, a new entity or new assets by contributing equity. They exercise the control in the enterprise and consequently share revenues, expenses and assets.29

This strategic structure can be used as a method of corporate expansion in general business, as well as in the real estate area.

Joint ventures may take either form of a corporation or Limited Liability Company (LLC) or the form of a consortium agreement, which is usually adopted for important infrastructure projects in Brazil.

5.1.2 International Joint Ventures (IJV)

International joint ventures (IJV) are those that involve at least one foreign partner. Firms can use this strategic structure to access markets that might not otherwise be accessible; especially in the Real Estate Market or to exploit oligopolistic advantages 30 gained in the domestic market.

I present below a recent International Real Estate Joint Ventures between Inland Real Estate Corporation and PGGM:

- **Inland Real Estate Corporation** is a self-administered and self-managed real estate investment trust (REIT) in U.S. It is one of the Midwest’s largest owners and operators of community, neighborhood, power and lifestyle shopping centers and single-tenant retail properties, with $2 billion in asset acquisition value.31

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29 Control and performance of International Joint Ventures (1989)
30 An oligopoly is a market form in which a market or industry is dominated by a small number of sellers (oligopolists)
31 Inland Group (2012)
- **PGGM** is a leading Dutch pension administrator with its roots in the healthcare and social work sector. PGGM is an organization that works with money, but focuses on people. They currently manage over €121 billion of pension assets of more than 2.3 million Dutch contributors.32

5-1 International Joint Venture between PGGM and IRC

Both companies control the enterprise and consequently share revenues, expenses and assets depending on their equity ownership part.

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32 Strategic management of international joint venture (1994)
GTIS Partners and Ager Incorporacoes Joint Venture Focused on Real Estate in Rio De Janeiro

GTIS PARTNERS, AGER INCORPORACOES ANNOUNCE R$500MM JOINT VENTURE FOCUSED ON REAL ESTATE DEVELOPMENT IN RIO DE JANEIRO, BRAZIL

NEW YORK, NOVEMBER 23, 2010 – GTIS Partners and Ager Incorporacoes announced today that they have committed up to R$500MM of equity in a joint venture to develop real estate projects in Rio de Janeiro, Brazil. The R$500MM equity commitment is anticipated to finance developments representing over R$3.0Bn in total revenues (“VGV”). “The joint venture is the result of a strategic decision to expand our platform in Rio de Janeiro, where we feel geographical supply constraints and significant infrastructure spending ahead of the 2014 World Cup and 2016 Summer Olympics will create a unique and compelling investment opportunity over the next several years,” said Tom Shapiro, President of GTIS Partners.

Shapiro, President of GTIS Partners. “We are extremely pleased and are looking forward to working with GTIS Partners, which brings both financial and real estate expertise to the partnership,” said Antonio Neves, co-CEO of Ager. Added Ernesto Neves, co-CEO of Ager, “This joint venture will allow us to take full advantage of the substantial number of high-quality real estate opportunities we are currently seeing in the market.”

In addition to the upcoming World Cup and Olympic games, large oil finds off the coast of Rio de Janeiro have been a catalyst for real estate demand in recent years and should continue to spur demand going forward. “Having made five investments in Rio to date, we are very familiar with the favorable local dynamics of the real estate market, which in turn has informed our decision to expand our investment efforts there. In Ager, we have found a talented and experienced management team with considerable local expertise to help further these efforts,” said Josh Pristaw, Senior Managing Director of GTIS Partners. “Ager has assembled an impressive pipeline of deals, several of which we are in advanced stages of evaluating. We look forward to working with Ager on these and other opportunities with much anticipation,” added Joao Teixeira, Senior Managing Director and head of GTIS Partners’ Brazil efforts.
5.1.4 Wealth Impacts of Real Estate Joint Ventures

Two recent studies demonstrate that U.S companies can realize significant positive abnormal returns from establishing international joint ventures with either less developed countries or developed countries.

\[ \text{Abnormal Return} = \text{Actual Return} - \text{Expected return} \]

5.2 International Joint Ventures utilization

IJVs are more and more utilized as an alliance for attaining strategic objectives by corporations. Nowadays, a wide variety of control mechanisms have been identified which assure a good management and interesting outcomes.

One of the principle limits of this structure, in the current life, is that managers receive not enough guidance about when and how to use them. As a result, many firms have chosen to avoid the IJV option or have entered ventures ill-prepared. These firms may not only let pass potentially attractive opportunities, they can also, in the end, be eliminated themselves by a contender. This concerns particularly critical sectors such as highly competitive global industries, as well as in the hotel area.

IJVs have an estimated 60 per cent rate of failure. Dr. Shaker and Galal Elhagrasey suggest that "executives can reduce this high failure rate by determining the need for the venture; by carefully selecting compatible IJV partners, by patiently and thoroughly negotiating the purpose, form, scope, duration and administrative structure of the venture; and by managing problems as they occur during the course of the IJV project".

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33 The Wealth Effects of Domestic vs International Joint Ventures: The case of Real Estate (1985)
34 Strategic management of international joint venture (1994)
6 Hotels in Perspective in Brazil

6.1 Strengths

6.1.1 Domestic demand

Changes in economic classes is affecting the domestic demand for hotels, fostering the development in new hotels and the occupancy on the whole.

Indeed as we have seen previously, for the first time the percentage of the middle class has reached 50% of the total population. Consumers are going to have more disposable income to spend on leisure time such as travels. Moreover, this trend concerning the evolution is expected to continue over time. Indeed, in 2014, the Middle Class will represent 60% of the total population.

Otherwise, we are observing in a lesser extent an augmentation of people share earning more than 7475$ by months (Class AB). This rich class, spending more money in leisure time than the middle class, will spur further the demand in luxury hotel, affecting positively the domestic demand in this sector.

6.1.2 Business demand

As we have seen previously, the country possesses huge natural resources to exploit and is developing their industry in the world. The economic development in the country is driving to a significant business demand in the Hotel Market from Brazilian people.

This tendency is reinforced by the important foreign investment in the country. Indeed, Business travels are organized to manage investments in Brazil by firms abroad. Usually, they have to stay in the country during some days to manage the investment, increasing the occupancy in Hotels.
6.1.3 Tourist demand

The organization of the World Cup in 2014 and the organization of the Rio Olympic Games in 2016 are attracting more and more people. Indeed, these events are boosting the exposition of the country abroad and bolstering the attractiveness for many potential visitors.

Moreover, thanks to the improvement in airplanes; capacity and technology; and with the network densification operated by airlines companies, Brazil is actually connected to the rest of the world, especially with the United States and the Europe, offering an interesting destination for holidays. We expect a significant tourism increasing in the country.

These factors will probably stimulate further the hotel sector and is going to drive to an augmentation in the hotel demand.

6.1.4 Performances

6.1.4.1 ADR (Average Daily Rate)

ADR is one of the commonly used financial indicators in hotel industry to measure how well a hotel performs compared to its competitors and itself (year over year).³⁵

ADR = Rooms Revenue/Number of rooms sold

• Rooms Revenue is the revenue generated by rooms sales

Usually, the ADR increases gradually, raising the revenue generated by the hotel. This indicator is not enough to describe the financial health of the hotel because it does not take in consideration the occupancy.

³⁵ STR Global (2012)
RevPar (Revenue per available room)

Revenue per available room is a performance metric in the hotel industry, which is calculated by dividing a hotel's total guestroom revenue by the room count and the number of days in the period being measured.\(^{36}\)

\[
\text{RevPAR} = \frac{\text{Rooms Revenue}}{\text{Rooms Available}}
\]

- Rooms Revenue is the revenue generated by rooms sales
- Rooms Available is the number of rooms available for sale in the time period

Or it may also be calculated by multiplying a hotel's average daily room rate (ADR) by its occupancy rate.

\[
\text{RevPAR(estimated)} = \text{Occupancy rate} \times \text{ADR}
\]

In Brazil, the revenue per available room (RevPAR) growth has continuously increased overtime thanks to the high economic growth in the hotel sector for the second consecutive year. Indeed, in 2010, the country posted the highest RevPAR growth rate on record at 17.3 percent, and hotel performance in 2011 is fitting a similar pace, its value should reach the double-digit mark again this year: “Booming domestic and international travel demand in the country continues to drive up occupancy and average daily rates, or ADR, in markets across Brazil,” said Ricardo Mader, Executive Vice President for Jones Lang LaSalle Hotels in São Paulo. “The rise in ADR has outpaced the country’s GDP growth, highlighting the significant recovery in the sector.”\(^{37}\)

This strong increase in demand correlated to the substantial appreciation of the Real against the US dollar has restored pricing power of hotel, transforming the Brazilian Hotel investment as a really attractive market.

\(^{36}\) Idem

\(^{37}\) Jones Lang La Salle hotels (2011)
6.2 Weaknesses

6.2.1 Management

The Commercial Real Estate investment, such as Hotel sectors, need specific managers, knowing how to run an operation of this nature in Brazil. Indeed, the corruption in the country forces investors to find managers who can work in this atmosphere, especially for foreign investors. As said Egil Fujikawa Nes who is a Norwegian entrepreneur working in Brazil “Corruption is often a subject when talking to foreign businessmen that want to do business in Brazil”\(^\text{38}\)

Moreover, the country is confronted to a lack of skilled developers with enough experience and ability to manage this kind of development strategy. This shortage could affect the viability of the operation.

6.2.2 Saturation

One of the other limitations on new hotel development is Brazil’s relatively low ADR level (Average Daily Rate). Even if we have seen previously that this rate is increasing dramatically, with two digits of growth rate, its level remains low compared to other major lodging markets. This rate results partly from the high building pace of condominium hotel projects in the late 1990’s.

6.2.3 Land price

Otherwise, given the high cost of land in urban centers, some hotels do not generate enough returns from the running to meet investors’ expectation. Indeed, developers are facing to a lack of suitable land for a hotel development, increasing the land price.

This situation could evolve whether by an important growth in the occupancy rate or by a continue increasing of the ADR rate which can improve the profitability for Hotel Development.

\(^\text{38}\) The Brazil Business (2011)
In the current situation, only 10% of survey investors perceive current hotel assets to be overvalued and 80% of survey investors in Latin America expect hotel values to increase in the future.

![Value perception of hotels in Brazil](chart)

It’s important to notice that the hotel market is one of the most volatile real estate sectors and usually one of the fastest to retrieve its previous performance after a recession. Traditionally the hotel performance is highly linked to the gross domestic product (GDP).

In Brazil, the actual strong economic frame, the high rate of population growth, the emerging of a large middle class and the important world exposition due to the World Cup and the Olympic game are driving to a wide demand such as domestic, business and tourist demand. Thanks to a strategic investment, investors can expect attractive returns in the hotel sector.

The hotel stock in Brazil is starting to be old; the average age is 30 years and needs to be upgrade. Moreover, there is a lodging shortfall of approximately 62,000 rooms in Brazil for the World Cup in 2014.

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39 Emerging Market Real Estate Investment: Investing in China, India and Brazil (2011)
Investors should focus on two specific investments: On Development or on Repositioning/Redevelopment in the Brazilian Hotel Market.

Nevertheless, as all opportunistic investments, there are specific risks to invest in Brazil and requires specific skills. Furthermore, the city center saturation has affected the land price in principal cities and limited hotel performance in certain situation. These limitations can restrict many investors to make a real estate investment there.
7 Challenges and Opportunities

7.1 SWOT Analysis

7.1.1 Presentation

A SWOT analysis is a strategic planning method used to evaluate the Strengths, Weaknesses/Limitations, Opportunities and Threats involves in a business investment and identifying the internal and external factors that are positive and adverse to reach their objectives.

As my study focus on an investment recommendation in the Hotel Market in Brazil, I decided to make a SWOT analysis to describe precisely the different aspects linked to this investment.

7.1.2 Analysis

7.1.2.1 Strengths

The country concentrates many internal advantages for its future development. We have already listed some of them during the study such as:

- **A positive Trade Surplus:**
  
  Thanks to its high exportation rates and an importation rate kept under control, the country maintains a high trade surplus, even during the financial crisis.

- **A Low Unemployment:**
  
  The unemployment rate in Brazil is remained at low level overtime supported by a high domestic demand and by a constant augmentation of exportations.

- **The population Growth and the creation of a Middle class**
- **Many resources and a strong agricultural industry:**
- **Large Foreign Investments:**
  
  Foreign investments in a state bring in more resources and talent to develop the efficiency and abilities of the country. Investments will stimulate further the economy by generating jobs and by increasing competition that benefits Brazil in general.
• Sound Financial Policies

Brazil has succeeded to resist to the financial crisis and to the recession thanks to a little chance and to a tight financial policy.

After the debt crisis of 1982, Latin America has changed from a protectionist policy to a more liberal one by embracing some capitalist qualities such as:

- Flexible exchange rate
- Independent central banks
- More responsible fiscal policies
- A tight regulation of banks

Through all these measures, Brazilians were the biggest benefactors of these evolutions in policy.

• Hotel Industry:

- **Tourism**: The high Domestic; Business and Tourist demand are encouraging the development of new Hotel projects.
- **Performance**: As we have seen previously, the hotel industry presents attractive performances, especially concerning the evolution of ADR and RevPAR value over time.

Otherwise, it’s important to remark that there are also different program which encouraged indirectly growth in the country, such as:

• **Bolsa Familia Program**:

The Brazilian welfare program named Bolsa Familia pays families to let their children in school and at clinics for regular checkups. If a single child fails to reach the standards set by the Brazilian government, then the whole family loses the payments.

A reduction in poverty and higher education will help Brazil over the long term. Higher education increases a population’s ability to produce high valued goods and services.

• **Brazil has the Highest Human Development Index in BRICs**

The Human Development Index (HDI) has improved in the country overtime. This indicator is a composite index measuring average achievement in three basic dimensions of human development (A long and healthy life; knowledge; a decent standard of living).
7.1.2.2 Weaknesses

Nevertheless, even if the country has strong arguments to attract foreign investments, there are still many problems which can harm to the investment objectives, especially concerning the security in the country

- **Crime and Corruption**

Brazil has a high level of crime which can discourage foreign investments and can have a harmful impact on the cost of business in the country. Indeed, the corruption and the safety of employee weight a lot on profits and then on the final return for the investors.

Otherwise, the high crime in the country affects the tourism rate. Indeed, tourists are usually scared to go to a place with a general image of risk, especially if the risk concerns murders.

  - Brazil is in Top 20 Countries concerning Rate of Murder
  - Crime centered in slums “Favelas”
  - Tourists are the principal targets

- **Infrastructures Investments in Brazil**

Brazil has maintained an underinvestment rate in their infrastructure, especially in the road sector: “Brazil invested just 0.1% of GDP to improve their transportation”\(^{40}\). The World Bank Growth Commission precise that 7% of Brazil’s GDP should go into infrastructure to order to reach their potential economic growth.

- **Inefficient Tax System**

According to the World Bank’s analyze, “Brazil ranks 150th out of 183 countries on how simple it is to pay taxes”. First of all, the tax system is extremely complex and required a deep understanding. Secondly, this taxation amounts to around 70% of the global profit made by the company. A decreasing in the tax rate in the country should increase the growth.

- **Informal Business Sector in Brazil**

\(^{40}\) The Economist (2007)
According to a McKinsey\textsuperscript{41} study, “informal businesses in Brazil are about half as productive as their competitors who follow the rule”. This is due to the access limited to capital for informal businesses and because they find more interesting to add more workers than to buy machines, as they do not pay taxes on employing people. Even if these companies are relatively inefficient, they are usually more lucrative than rivals which pay huge taxes. One of the main consequences is that firms are not pushed to grow because bigger firms tract the attention of the taxman.

- **Lack of transparency**

  Transparency represents still a real challenge for the country, especially concerning financial reports.

In the Hotel Market, we can recognize two significant weaknesses:

- **Weak brand recognition of hotel brands**
- **Low marketing initiatives from hotel brands**

### 7.1.2.3 Opportunities

This part develops the external chances which can improve the performance of an investment in the hotel sector and provide greater profits than expected:

- **2014 World Cup and 2016 Olympics Game**

  As we have seen previously, Brazil will organize two main sport events which will procure for the country an amazing exposition to the rest of the world and will participate further to an increasing of tourists coming in the country.

- **High Economic Growth compared to the rest of the world**

  Currently, BRIC countries represent an attractive market as they display strong growth compared to developed countries. Indeed, most of investors expect that the development pace will accelerate overtime in the country.

- **International Joint Venture**

\textsuperscript{41} The McKinsey Quarterly (2007)
The dynamism in the country will encourage many investors to invest in the Brazilian Market, which is going to participate also to its growth.

- **Peak of oil supply**

  According to the IEA\(^2\) “the peak of increasing oil supply will happen around the 2020 to 2030”. This peak in demand will benefit countries with lots of unexploited oil, such as Brazil. The importance of oil will grow over time and will bring a lot of money to the country and participate to the growth in the country.

7.1.2.4 **Threats**

This part develops the external elements which can cause trouble for the business development about a Brazil investment in the Hotel Sector for foreigner investors.

- **Real currency**

  As the country has made a lot of progress during the last 10 years, the exchange rate has changed a lot and now Real is becoming too strong. If it continues in this way, the Real currency will harm Brazilian exports. The exchange rate could have considerable impact on the Business in the country.

- **Export driven economy**

  As exportations have an important impact on the Brazilian economy, if the Global demand decreased, Brazilian economy will slow and affect the growth in the country.

- **Colombian terrorist kidnapping around border**

  Brazil is suffering of important kidnapping waves which affect the development of specific areas around border. Many investors are preoccupied by this tendency and can reject an investment project due to this issue.

- **Increasing competition**

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\(^2\) the International Energy Agency (2007)
The country is experimented an important evolution of its market. Competition in the country has increased and has transformed the country, so that Brazil is a place riskier to conquer than before. Besides, this important competition has participated further to the creation of a potential bubble concerning hotel land price in Brazil.

7.2 Investment Description

7.2.1 Investment in Hotel Sector

As we have seen previously, hotel investment in Brazil requires a deep understanding of the local market and the investors have to be attracted by the risk. The important political and economic stability bolstered by an amazing GDP growth is attracting many foreign investors looking for new placement.

Foreign investors have to be familiar with the opportunistic strategy to manage this kind of investment. Indeed, Brazil is an emerging country with its part of risk but can offer more interesting returns than many other markets. Nevertheless, due to the high cost of financing (Saturation), investors have to be prepared to pay more than in their home markets (30% more equity).

The Brazilian hotel sector owns many advantages for a long term investment for foreign investors looking for a Portfolio diversification abroad. As the Modern Portfolio Theory explained, the insertion of low or negatively assets, such as Real Estate, in a diversified portfolio can reduce in general portfolio risk. Real estate as an asset class presents low to negative correlations with equities and bonds. A portion between 10% and 20% of real estate assets into diverse asset portfolios can potentially boost investment returns and decrease portfolio risks over a long term investment horizon.
7.3 Strategic Decision

The actual economic growth will stimulate the Private Equity and Venture Capital markets in Brazil.

7.3.1 Private Equity Real Estate investment

One of the most usual investment structures in emerging countries is to use Private Equity. Private Equity Real Estate Investments typically involve an active management strategy ranging from moderate reposition or releasing of properties to development or extensive redevelopment.

This kind of investment is usually made via private equity real estate fund. This structure pools capital from different investors. It’s important to note that given the high risk linked to private equity real estate investments, an investor can lose all of its investment if the fund performs badly.

Commercial real estate has been increasingly recognized over the past 15 years because of its high current cash flows, diversification benefits, and has a hedge against inflation.

7.3.1 Joint Ventures Structure

Some investors are trying to hedge their risks by entering into international joint ventures with established local players in the Real Estate Sector who knows the intricacies of the Brazilian Market (60% opts to pursue joint ventures).

“We believe that the most successful structure is a joint venture with a multiyear lockup agreement that allows the Brazilian managers to have skin in the game, and remain motivated to outperform and distribute. However, as long as capacity is an issue for Brazilian equity funds, consolidation will be slow to develop.” Credit Suisse (2011).

Brazil presents intriguing possibilities for retail entry via joint venture but this kind of investment required qualified joint venture partners as the recent IJV between Gtis Partners; a Private Equity Fund; and Ager Incorporacoes a Brazilian Real Estate
8 Conclusion

As we have seen, the Brazil concentrates many interesting advantages for a placement for a foreigner investor, especially in the Real Estate sector. This investment should take especially the form of a long term investment in the hotel sector, an opportunistic investment precisely. Indeed, the health of the hotels and the general actual economic situation in this emerging country and its probable future will generate attractive returns. Even if the placement presents several risks due to its lack of transparency and the necessity of specific skills.

My recommendation for a foreign investors is to manage an International Joint Ventures between a investment fund such as a Private Equity fund and a local construction company as the recent IJV between Gtis Partners; a Private Equity Fund; and Ager Incorporacoes a Brazilian Real Estate. In my opinion, the country will keep an intensive economical pace which is going to stimulate further the placement in this sector.

My study is based on the current situation and probable perspectives; it could evolve overtime against of the economical evolution in the country and in the world.


Ernst & Young, *A world of possibility: Brazil hotel investment opportunities*, 2010a, pp 1-12.

Ernst & Young, *Doing Business in Brazil*, 2010b, pp 1-96.


Ernst & Young, *Sustainable Brazil, Social and Economic Impacts of the 2014 World Cup*, 2010d, pp 1-57.


Prudential Real Estate Investors (PREI), *the case for Commercial Real Estate*, 2011, pp 1-4.


The McKinsey Quarterly, *Five properties for Brazil’s economy*, 2007, pp 1-105


