

**Challenges of Investing in Brazil’s CBDs**

**With Flavio Mantesso of Wise Capital**

**David Snow, Privcap:**

Today, we’re joined by Flavio Mantesso of Wise Capital. Flavio, welcome to Privcap. Thanks for being here.

**Flavio Mantesso, Wise Capital:**

Nice to meet you, David. Thank you.

**Snow:** You invest in the Brazilian office real estate market and I’m fascinated to hear what you have to say about the opportunities in Brazil. Clearly, the economy has been growing. Whenever economies grow, people need offices to build their businesses in, and I’m sure that’s what you’re investing in. Can you talk about the most important dynamics that are driving the office market in Brazil today?

**Mantesso:** The most important dynamics are the demand and supply. As you know, in every business, demand has been decreasing this year, but it’s consistently among the average since the early 1990s, among the deviations, and we expect it to grow in the next years. [With] supply, on the other hand, new construction starts where we measure the initiation of supply had decreased during this year. Expected deliveries for 2015 and 2016 have decreased substantially to 40% of what it was in 2014 and 70% in 2016 related to 2014. So, all the stock that was delivered during this period will be absorbed, and we expect vacancy rates to start to decrease in 2016, with rents coming up since then.

**Snow:** Talk about how the debt markets work in the real estate market in Brazil. How do you finance your deals? How much debt is available and what kinds of groups are supplying debt typically?

**Mantesso:** Financing in Brazil for the commercial properties for office buildings is too expensive. Interest rates in Brazil are high, one of the highest in the world. Financing will cost around 14%, so in the strategies that are aimed to add value in properties, it’s not possible to leverage. In development, you can leverage the construction part of it, but it’s a small part of leverage as development would achieve higher returns like 25%. That’s our target for our next fund actually.

**Snow:** Would you be open to having partners in investing in some of these properties?

**Mantesso:** We could have partners investing along with us. We may maintain the control of the investment as we designed the strategy, we execute the strategy. We keep all the return to the investors since we buy the land and we hire the construction company. We do all things. We don’t enter in third-party projects, but we can receive other investors to invest alongside us in bigger deals.

**Snow:** What are the current drivers of demand or what have been the historic drivers of demand in the Brazilian market? What are people using the office spaces for? What do these companies look like?

**Mantesso:** The demand mostly is driven by employment growth, and we come through this modeling from GDP. We forecast development and employment growth along the years and, from that and other variables, we identify how much space will be needed in the prime office market. We expect, for now ahead, for the demand in employment to grow further.

**Snow:** What are the most important things that international investors, who might have a lot of experience investing in property outside of Brazil, need to understand about what’s unique about doing business and investing in property in Brazil?

**Mantesso:** Investing in property, anywhere in the world—you have to have local expertise. The international investors normally look for a partner or the platform where they can operate, because it’s very local. Location is very important. It can change the vacancy rates you have in your investment, the rents, and the returns; so, every market is different.

**Snow:** Talk about the relationship between the public markets and the kind of investing you do and how it affects your returns. How does it affect the decisions you make?

**Mantesso:** Public and private markets are co-related. The private market has the driving fundamentals that will drive the public markets ahead. Normally, the public markets anticipate what happens in the private market. As an example, this year in Brazil, public markets were priced down very fast because of our increase in interest rates, and this was faster than the effect it has in the private place. Sometimes it is possible to leverage from one side to another. You can exit, as we did in the last fund, two properties we exit in a public market because we saw that they were pricing the properties already ahead in the upper values and the private market hadn’t reached that. On the other hand, it’s possible also to buy from the public market and exit in the private market. So, there is leverage there.

**Snow:** Can you talk about receiving higher-than-market risk-adjusted returns in the Brazilian real estate market? What are some approaches your firm takes to accomplishing this?

**Mantesso:** To accomplish in this, we have three basic, most important things. One is the access to pipeline. We have a big net of brokers, architects, lawyers and people that can have information about deals, and we’re talking about office buildings. With these, we can choose the better ones and not be just focused on what we receive from brokers and we have to decide to invest because there are no others. As we are focused in CBD location, very constrained regions, this is very important to have. The second is strengths that you use to maximize returns—the research part. The research, we have developed along the years; we have been working with these econometric models where we model the end results are what rents are going to reach. Where are they going to go, if decreasing or increasing? On the other side, you have the demand. What’s the demand coming in? Mixing those, you can forecast rents and have a more accurate figure of returns to deliver to the investor and he can know the risk of these returns, too.

**Snow:** Based on your models, were you not surprised that construction of new office buildings slowed down with the most recent economic downturn? Was that a predictable result?

**Mantesso:** It was a predictable result because rents are coming down. If you talk to any developer in Brazil, they will say it’s crazy to develop new buildings now, to start developing. Our new fund targets developing in business exactly because of this. We are contrarian, as we have more information. We have information and specialization in the office market. Our last fund, we exited two years ago in the peak of the market, one year and a half ago. With these rents decreasing and vacancy increasing, it doesn’t make sense for the developers to construct. He initiates construction when he sees the rents coming up again, he sees vacancy decreasing and he says, “Now is the time to construct.” But then, it’s too late.

**Snow:** One final question for you, Flavio. Especially in the São Paulo market, there is a history of financing buildings using a strata method where there are multiple owners who basically own different strata of the building. Do you invest in those kinds of buildings? If not, why not?

**Mantesso:** We invest if we can consolidate, which is very difficult if it’s very spread out, because we like to have control of the building. We like to have at least 100%, or if not, have the power to control 100% of the building. Strata was a historically developing method that the market had in Brazil because of the high price of financing. It’s very difficult to consolidate a business plan with this with many owners; normally, the building keeps not the maximized managed. We try to avoid that, although if we can consolidate and buy and control this, we do.