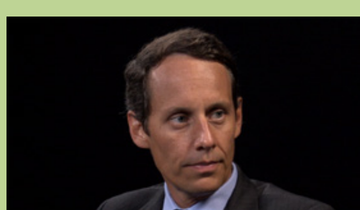
Where Smart RE Investors Are Putting Capital in Latin America

An executive summary of the Privcap video series
"Real Estate Investing in Latin America"



Alfonso Munk
PGIM Real Estate

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Key Findings

1. *Headline risk can be separated from genuine opportunity*
2. *Brazil does offer rewards, for the right real estate investor*
3. *The housing market in Mexico is a prime area for investment*
4. *There are obstacles for rental properties in Latin America*
5. *Domestic investors are increasing their appetite for real estate*

The Panelists

Alfonso Munk
Americas Chief Investment Officer,
PGIM Real Estate

Kenneth Munkacy
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Playing to Win

Alfonso Munk
PGIM Real Estate

When asked the secret to his success, legendary hockey player Wayne Gretzky replied: "I skate to where the puck is going to be, not where it has been." Munk takes that advice to heart. But since he invests in Latin America, he thinks in soccer terms, always anticipating where the ball is going next.

"Where is the game going over the next three to five years?" he says. "Where should you actually focus your activities?" The answer for his firm is Mexico.

"Mexico is our largest market right now. We have very positive yield on Mexico because of the emerging middle class and the young, well-educated population," Munk says. "Also, because it's a manufacturing-driven country that has become very competitive with China." He notes that Mexico has taken a clear lead over China in exports to the U.S., with 80 percent of exports now going to Mexico's northern neighbor. "We think this is a very positive trend," he says.

In fact, multinationals around the world are starting to take a close look at Mexico, inspired largely by the number of international free-trade agreements Mexico now has, including NAFTA. This dynamic is creating new opportunities in industrial real estate.

"Our most important sector in Mexico is industrial," says Munk. "Over half our assets are in industrial. We like this sector because a lot of multinationals are coming to the country to export. We still see a tremendous amount of growth in Mexico."

1 HEADLINE RISK CAN BE SEPARATED FROM GENUINE OPPORTUNITY

The headlines on Latin America are stridently negative: economies in recession, falling commodity prices, stalling exports, inflation, corruption, the Zika virus. But opportunities in the region do exist—particularly in real estate—and those investors who look beyond the headlines are finding returns.

"You have to separate the static from the signal," says Kenneth Munkacy, senior vice president of GID International. "The fundamentals are what you have to look to—young populations, new household formation, aspirational societies across the board."

You also have to unwind Latin America, separate the larger region into its constituent countries and assess opportunities on a national basis. "Look at the two largest economies, for instance, Brazil and Mexico. They're very different from each other," says Alfonso Munk, managing director and Americas Chief Investment Officer at PGIM Real Estate. "They're very different from both a macroeconomic and real estate cycle perspective."

In Mexico, 50 percent of the population is under the age of 35. The country creates 600,000 new households a year, while the U.S., with three times the population, creates about 1.2 million new households. "Mexico had 15 percent year-on-year college graduation rates in the last decade. That's phenomenal," Munkacy says. "And that supports the industrial sector, it supports the retailing, it supports the residential. It's a domino effect because of the demographics."

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2 BRAZIL DOES OFFER REWARDS, FOR THE RIGHT REAL ESTATE INVESTOR

When it comes to headline static, the noise from Brazil is resounding. And the situation on the ground is treacherous indeed. It's politically unstable and macroeconomically volatile on many fronts—inflation, interest rate, currency. Investors cannot even be sure if their capital is protected. Is the rule of law there to safeguard investors? The jury is still out on that question.

But, as anywhere, there is opportunity in volatility. "A lot of investors are walking away from Brazil," Munk says. "It's been the darling of Latin America over the last seven to eight years and investors have gotten a little bit burned. This is opening a lot of opportunities, in our view."

"Savings rates are down, there's a lack of credit, foreign investor money has dried up—and that's a good thing, on one level, for real estate investors," Munkacy says. Although, he continues, Brazil is not a market for the faint of heart, given the valuation risk. "The opportunity now for Brazil, because of the lack of liquidity, is in structured debt products. That's the real bet. When is it going to come and how much will it be?"

Munk says his firm, PGIM Real Estate, is actively lending in Brazil, given the shortage of liquidity in the market. "Banks are not financing, and there is a lack of credit providers. Developers need to finish fully sold or residential product and they have no capital to do so," he says. "So we can provide that rescue capital at 18 to 20 percent rates nominally. We think you're protecting yourself from valuation risk, even if your debt is at leverage levels of 50 to 70 percent, and you have a really good risk-adjusted investment."

What Volatility?

Kenneth Munkacy
GID International

Investing in emerging markets is a risky proposition. And Latin America is no exception.

Munkacy says he realizes that not investing in Latin America means having more money to invest in safer markets like the U.S. "The U.S. has seen outsized returns over the last five years, driven by a wall of capital coming into the market," he concedes. "By contrast, a lot of the Latin America markets haven't had as robust a growth. There have been some regional political issues creating static and investors don't want static at this point in the market cycle."

But that said, Munkacy explains that investors who avoid Latin America are missing a significant opportunity, especially given the region's demographic of young, tech-savvy and aspirational people.

"Those are the things you really have to consider," he points out. "I think volatility is an overused word. There's always been volatility. Good investors look at demographics and market cycles and try to position themselves accordingly."

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For all its difficulties, Brazil is resilient in many areas. It has a strong middle class and high consumption. Commodities, although they have taken a hit overall, are still robust in certain sectors including soy, sugar and ethanol, which means the agricultural regions of Brazil are still doing well.

"As a friend of mine down there likes to say, 'Brazil's not dead, it just smells funny,'" Munkacy jokes. "But, kidding aside, it is transitioning from a consumer-oriented economy, where that was 80 percent of GDP, to hopefully a more investment-oriented economy."

3 THE HOUSING MARKET IN MEXICO IS A PRIME AREA FOR INVESTMENT

When you want to cut to the chase, ask investment professionals where they're investing, not where they recommend investing. So where are PGIM Real Estate and GID placing equity? And where are they seeing their greatest risk-adjusted returns?

"We only look at three markets," Munk says. "The most important is Mexico, where about 96 percent of our current assets under management in Latin America are placed. We have some activity in Brazil and we hope that will increase, given the opportunities we're seeing, and we're active in Chile. The rest of the markets in the region, although very interesting, are not markets that we target."

More than half of PGIM Real Estate's investment in Mexico is in the industrial sector, in the development of industrial assets and the purchase of income-producing assets. The firm's second favorite sector is housing, both for sale and for rent, affordable and upscale. "For-rent housing has been a sector in which we've been a pioneer in Mexico. We've developed a portfolio of seven assets, about 2,500 units, which we developed and recently sold, so we tested the market successfully."

4 THERE ARE OBSTACLES FOR RENTAL PROPERTIES IN LATIN AMERICA

That said, Munk explains that rental housing in Mexico is "still to be proven." It's more profitable, from a return perspective, to invest in housing for sale than for rent, given average rents in Mexico's cities and given the long-term involvement required to operate rental property.

"The rents are not there yet," Munk says. "And the second challenge is that this is a very operationally intensive business. Renting homes and apartments requires expertise on the operational side and in Latin America nobody knew how to do it. So we had to start from scratch and create our own company to operate, to lease, to do credit checks, to deal with the tenants, to deal with turnover."

Also, the product must be adapted to the local culture. Renters in Mexico like different sorts of units and amenities. For instance, they place a far higher value on security. And while a one-year contract is routine in the U.S., it can evoke concern for Mexican renters, who view a one-year contract as an open door to eviction when that year is up. This means renters in Mexico will pay a premium for a longer contract.

"It takes a lot of market research to understand what is uniquely Mexican in the rental requirements," Munkacy said. "What makes a good unit in Mexico City is different from what makes a good unit two hours away in Houston, for example. But it is a long-term, durable asset class, in the same way that all the other food groups have become."

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5 DOMESTIC INVESTORS ARE INCREASING THEIR APPETITE FOR REAL ESTATE

Domestic investors in Latin America are looking for better return on their capital and, as a result, they're increasingly interested in real estate. The growth of domestic inflows will be a game-changer for the region's commercial real estate markets.

"Regulations are easing so we have more money coming into real estate," Munkacy says. "Pension funds are coming alive to the returns of alternatives in general, but [to] real estate in particular, along with infrastructure." There is a very large insurance company conglomerate called Grupo Sura in Medellin, Colombia, he says, that's active in six or seven countries in South America. They have $120B under management—and are ramping up for more and more real estate—but few people outside Latin America have heard of them.

Pension funds are emerging players in the market because more people now are formally employed and are contributing a portion of their salary to a pension fund. "This is transformational for real estate," Munk says. "This is not only providing more capital, it's creating liquidity in the market. It's creating growth in the real estate sector and making it more institutional."

Ten years ago, 100 percent of PGIM Real Estate's capital deployed in the region was from international investors, mainly U.S., and some sovereign wealth funds. Today, more than half of its capital is local and PGIM Real Estate manages vehicles in which more than 50 percent of the capital is from local pension funds.

This trend has implications for international investors who are interested in Latin American real estate. They are now competing with local investors who not only have a growing appetite for real estate but are happy with a more modest serving.

"At some point local investors could crowd out foreign investors because they don't necessarily want the same yield premium," Munkacy says. "They don't have the currency risk, they don't necessarily read the Wall Street Journal. They understand the local scene a lot better and they don't necessarily need over 20 percent returns on a risk-adjusted basis. They can settle for lower- and mid-teens [returns] and have a great investment day." ■

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