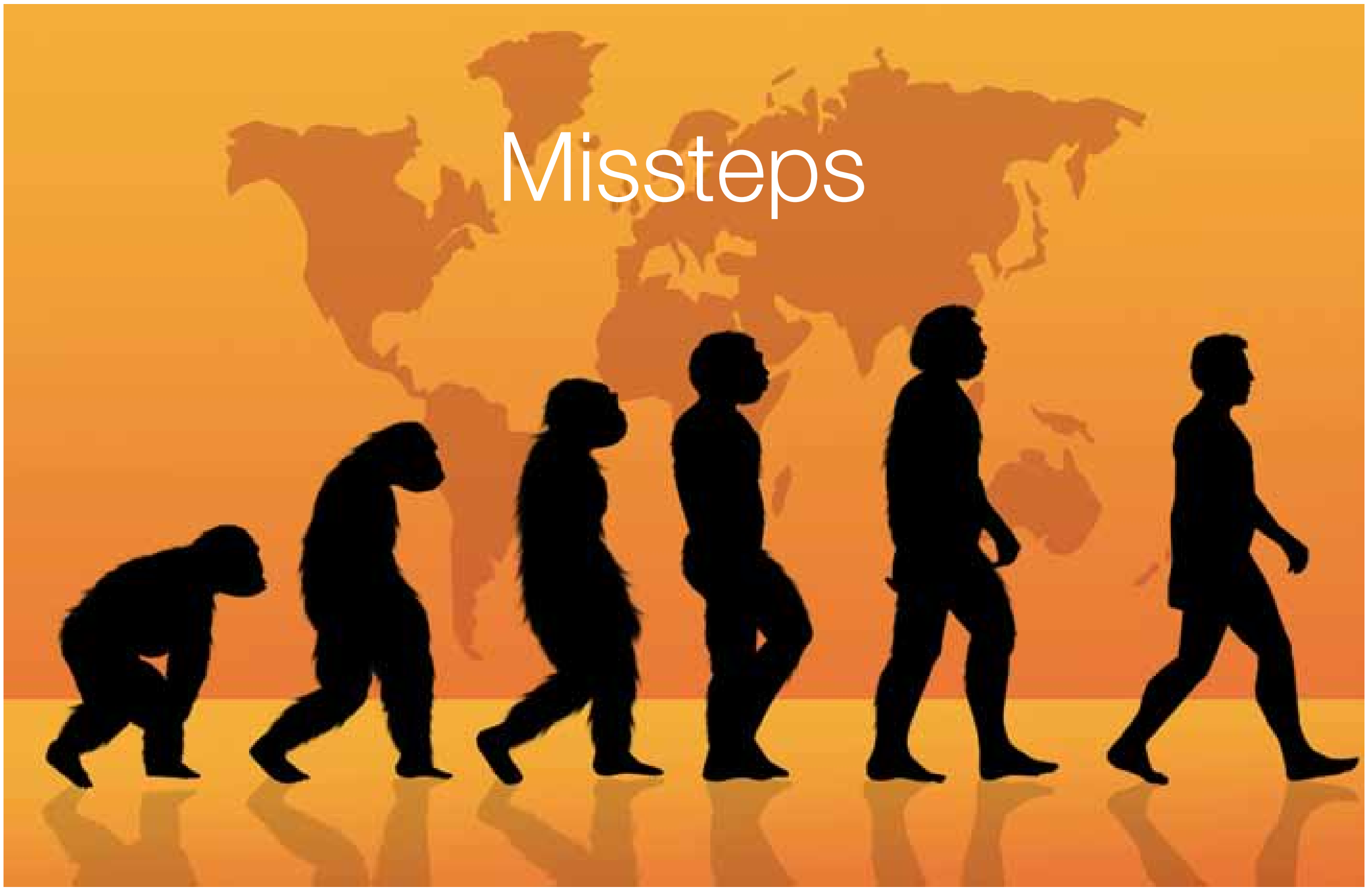


Missteps

Private equity GPs have failed to evolve and are more often wrong than right when predicting real estate trends in Latin America

by James Anderson, David Young and Claudio Freitas

During the past 18 months, private equity real estate GPs in Latin America appear to have missed the mark in the identification and pursuit of opportunities throughout the region. During roadshows and public forums, GPs repeatedly called attention to numerous real estate trends that failed to materialize and grossly underestimated the role of local capital in meeting financing demand.

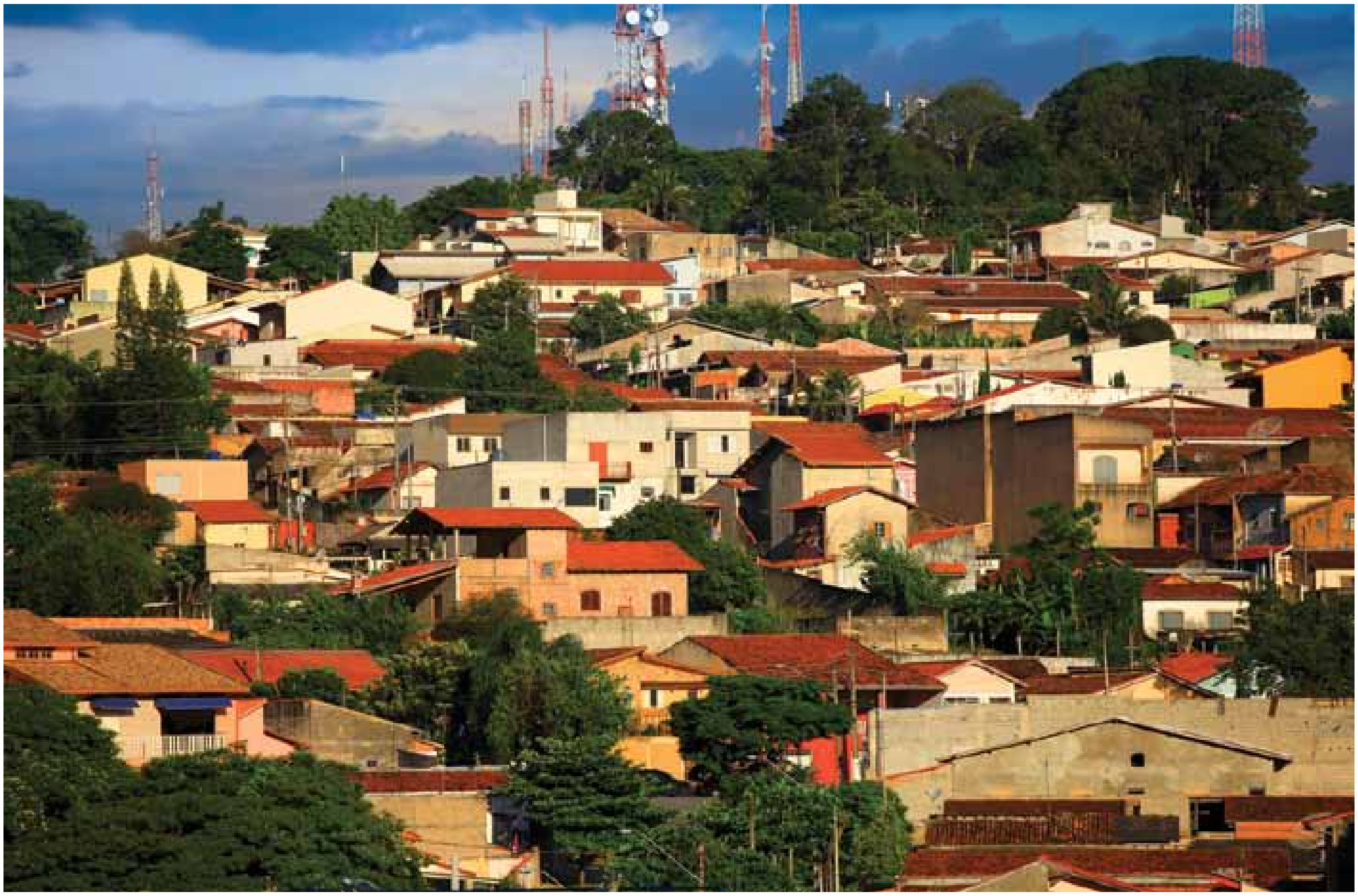
The low rate of new LP commitments suggests that the current real estate private equity model is no longer operating ahead of the curve and, consequently, that existing LP investors may experience chronic underinvestment for the duration of the current cycle and beyond. Worse yet, as GPs feel the pressure to invest, mistakes may be made in terms of the alignment of interests with local partners and capital investment decisions. This scenario is further complicated by the fact that the increasingly active role of local capital serves to make the operating structure of GPs more expensive on a relative basis.

As capital markets in the region continue to evolve, more innovative investment products will continue to become available. Consequently, LP investors are looking at a broader selection of investment strategies than traditional private equity and actively managed equity strategies.

Discount what I said about discounts

By mid-2012, listed Brazilian home builders began experiencing a sharp drop in market capitalizations. At the same time, private equity GPs predicted that a "great rationalization" had begun in Brazil real estate prices. But the deep discounts never materialized — other than a fairly short-lived, very sharp sell-off in the public home builders that had all but rebounded by the end of 2012. Other property types have simply chugged along with no notable crises, albeit against the global backdrop of steadily declining projected returns.

Speaking last year, one pre-eminent GP boldly predicted, "There will be a need for capital from



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private funding sources. … Whenever there's any kind of increased inefficiency or stress in the real estate capital markets, it's harder to get cheap capital." This turned out to be more of an axiomatic sales pitch, as no such rationalization took place outside the public markets. The misread appears a combination of timing (duration of future opportunities), but equally misplaced was overreliance on past experience as a predictor of future performance. If something is different this time, it must, on some level, be a consequence of the global central bank suppression of yields.

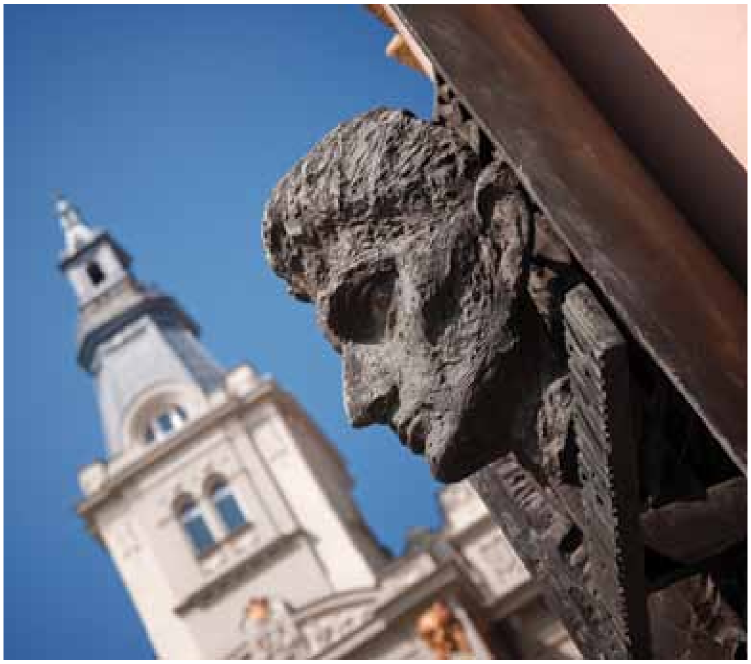
Yet, as evidenced by the strength of the internal capital markets, GPs also miscalculated the situation, as listed Brazilian home builders didn't flock to expensive foreign capital *because they didn't have to*. Interestingly, of all listed home builders in Brazil, this particular GP's investment in Viver stands out as a severe underperformer — based on public filings, the GP's investment may have unrealized losses of approximately 80 percent.

Why the disconnect? For one, GPs underestimated the resilience of the local markets and furthermore have misjudged the active role undertaken by both local governments and local private capital in supporting real estate investment. As we have seen in Brazil, many developers were able to foresee the pending mini-crisis and reacted proactively by cutting overheads and new launches, and redoubled their focus on selling existing inventory. In addition, the Brazilian government's CAIXA stepped in to provide more credit, which has led to a fairly robust turnaround for most listed homebuilders. While home builders have not fully recovered, many are up more than 100 percent off their 2012 lows — with no bankruptcies.

Other property types in Brazil witnessed a stabilization and a continuation of the same investment strategies — at lower yields. GPs have simply been unable to find significant opportunities to place capital that is considerably more expensive than either the public markets or local capital.

Kafka dons a sombrero

In Brazil, many GPs missed the mark by being too pessimistic, but for GPs focused on Mexico the opposite appears to be the case. Last year, few foresaw the depth of losses that home builders would experience by Q4 2012



In Kafkaesque fashion, the Mexican government announced that it would not increase available mortgage credits under the INFONAVIT program. The announcement triggered a sell on the entire industry because, after that point, 2013 revenue would effectively be capped for every home builder.

— which has resulted in nothing short of a complete bludgeoning of the industry. To add insult to injury, the recently elected Peña Nieto government has seriously modified the government's homeownership policy by reducing take-out mortgage financing for suburban development and, instead, is seeking to redirect resources to vertical, urban development. This shift is on a par with the Department of Energy in the United States passing an immediate carbon tax on car manufacturers.

The industry is working under a completely new model; the ramifications of this will take time to fully understand, but the old home-building model, as we know it in Mexico, is dead in its tracks. The impacts will not only be on operating companies but also on the value of land across the country. We expect to see a reverberation in related commercial retail development as well, since much of that was premised on a continuation of the suburban residential expansion model. Notably, Kimco Realty exited the last of its commercial retail portfolios as the public markets cannot get enough product to sell to the local pension funds.

And the GPs? Here's what a leading Mexico GP said in July 2012: "Mexico has really responded well over the last 12 months." This particular GP was an early investor in Mexico land banking and subsequently monetized much of its residential portfolio via the CKD mechanism. Notably, only months before the housing crash, the same GP observed that "we're seeing healthy growth, *which is good for real estate*." But the truth was that nobody really knew what lay ahead, given that the country was set to elect a new president.

In Kafkaesque fashion, the Mexican government announced to the market in October 2012 that it would not increase available mortgage credits under the INFONAVIT program. The announcement triggered a sell on the entire industry because, after that point, 2013 revenue would effectively be capped for every home builder. For a business model built on low margins, high volume and working capital financing from pre-sales, not growing the top line equated to a severe reduction in the bottom line.

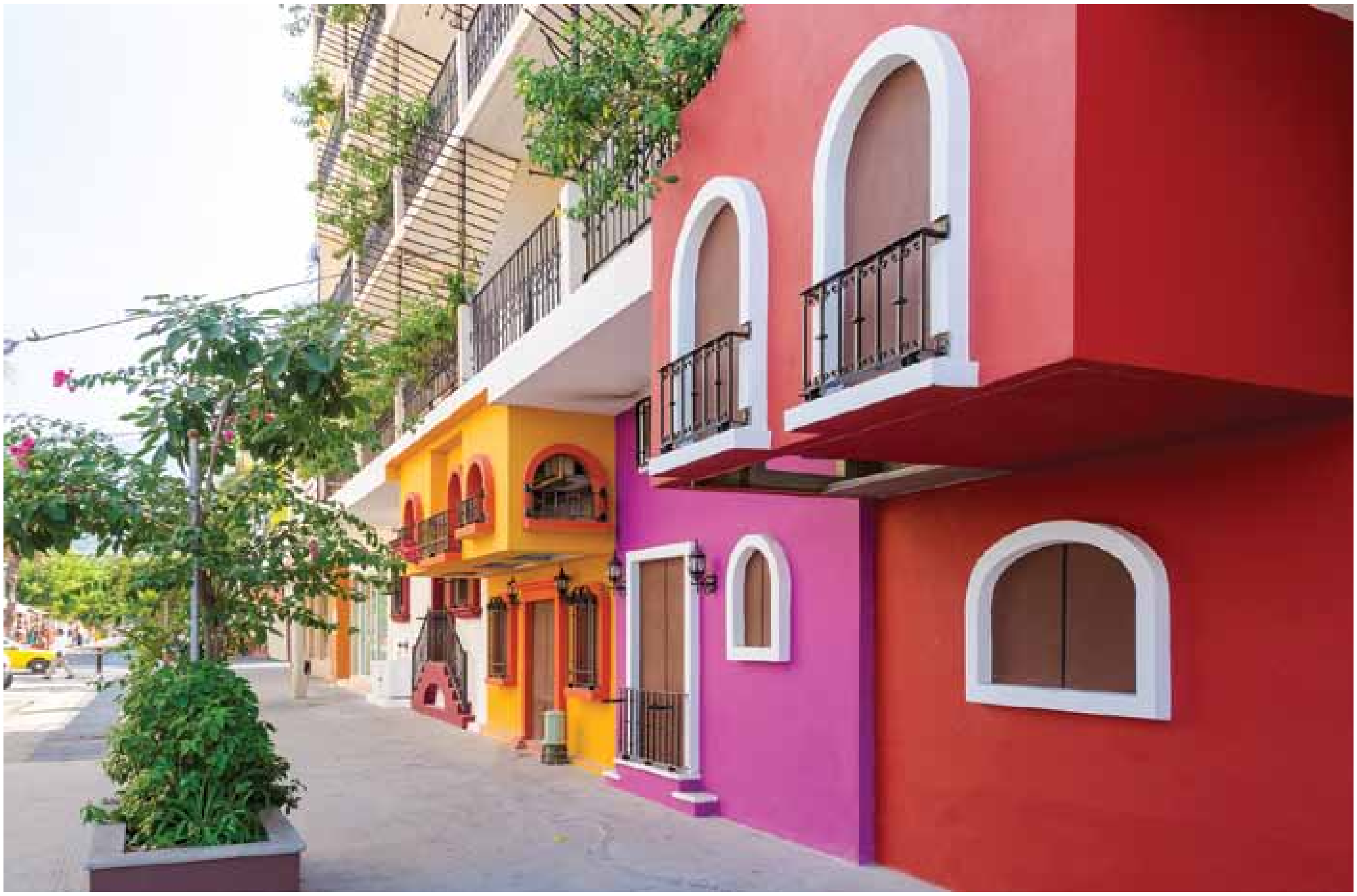
Perhaps more concerning is that GPs with existing investments in Mexico's affordable housing sector remain suspiciously silent. Where is the tactical response to what is surely going to be a massive write-down in land values? Public companies such as URBI, Homex and GEO are not only being sued by lenders and bondholders, but they are actively considering filing for bankruptcy protection. As of June 2013, all three of these builders are in default with lenders and/or bondholders. How this plays out will be very interesting, as there have been no meaningful bankruptcies on the real estate side since the Tequila Crisis in 1994. Homex's bonds, as of June 2013, trade at around 37 cents of face value for a yield to maturity of more than 65 percent.

Similar to what has happened in Brazil, nonresidential property types are experiencing somewhat of a renaissance, as the public markets, driven by local pension fund liquidity, have seen a flood of IPOs, with more to come in late 2013 and 2014. Is there a bubble brewing? Perhaps, but it is a bubble of the same making that we are seeing in sub-5 percent cap rates in New York City office properties, and a 2 percent long bond, and an S&P 500 company trading at 16.5 times earnings. The point is that there does not appear to be anything different about the Latin America real estate markets than what we are seeing in the United States, and one question is at what point do GPs start to overpay for risk?

What just happened?

While most market participants would agree that strong macroeconomic conditions are a necessity for a robust real estate market, the evidence suggests that it is incorrect to extrapolate those benefits into being advantageous for private equity.

The reasons behind this appear to be a combination of several themes. First, GPs have been terribly wrong in their short-term predictions



Some GPs quietly suggested that the mass sell-off of Mexican housing would open the door to a new golden era in private investment in home building. We cannot help but ask ourselves if this attitude is not motivated by the fact that GPs who are currently invested in residential are less than keen to discuss the status of these investments.

about opportunities in Brazil and Mexico. Second, the emergence of local investors, mainly pension funds, has proven to be a game changer. There, also, is an implied third theme: GPs have failed to evolve. The basic private equity product costs about the same; is structured and staffed about the same; is focused on about the same strategy; and still seeks to feed at the same trough as it has done for 30 years.

On the first point, few GPs have even discussed the possibility of a broad implosion in the Mexico home building industry. In fact, as Mexican home builders began selling off in force last quarter, the idea that they would not rebound was generally discarded by investors. Some GPs even quietly suggested that the sell-off would open the door to a new golden era in private investment in home building. We cannot help but ask ourselves if this attitude is not motivated by the fact that GPs who are currently invested in residential are less than keen to discuss the status of these investments?

In Brazil, GPs remain busy raising more capital to invest in Brazil's maturing real estate market. Prosperitas's 2012 raise of $800 million was almost two times oversubscribed, as global pension funds continued to throw money at Brazil-based GPs. Smaller raises were seen for strategies focused on Peru and Colombia, but the real sea change was in Mexico.

For the first time, Mexico's pension fund industry began to make its voice heard by funding about $5 billion in quasi-public CKD launches and IPOs of several Mexico-REITs, known as FIBRAs. Most interestingly, foreign buyers represented approximately 50 percent of demand for Mexico's three largest real estate IPOs last year.

So what have we seen in terms of performance from the GPs over the past year? We've seen Brazil go through a fairly quick recovery without the predicted onslaught of distressed opportunities and the emergence of the local investor in Mexico. Meanwhile, GPs have done little to no new net investing.

The broken model

These trends suggest that the traditional GP/LP private equity model in Latin America appears to be out of sync with the broader markets in terms of both strategy and timing. The IPO ship has sailed in Mexico, and the quality investments have been taken public with significant participation from global public investors. In Brazil, the "great rationalization" simply isn't happening, and yet GPs are sitting on substantial dry powder. Of the few meaningful capital raises in Peru and Colombia, the fact is both of those markets will soon be oversaturated with private capital.

The real issue for LPs is that, for them to make money, their GP needs to not only make good investments, but also needs to actually invest their capital well. If a GP can't put the capital out, or worse, if it can't resist putting capital into a bad deal, it is a losing proposition.

Liquid alternatives

Given that local markets are experiencing an IPO renaissance and local private capital is generally more competitive than global private equity, one wonders if LPs should rethink the overall approach.

Quantitative research suggests that by simply investing in a diversified, properly weighted, passive bucket of listed real estate equities, an LP may be able to achieve similar or better risk-adjusted returns than direct investing. One reason for this is simply that this is the trend in Latin America. With the exception of a few notable private investments, almost all activity during the last two years has been in the public markets. *More importantly, a passive approach would offer diversification, transparency, lower cost and liquidity.*

The investable universe of real estate related equities in the region includes more than 60 companies that comprise $65 billion in market capitalization and represent every major property type. Brazil and Mexico account for more than 90 percent of the total. The average daily liquidity of the group has grown at a 26 percent compound annual growth rate during the past five years from $125 million to over $400 million.

Finally, of the major issues faced by LPs is the inability to benchmark even basic total returns. Part of the issue is an obvious lack of public information. Managers simply do not share information and few LPs ever disclose results. Additionally, the industry itself has not invested in creating proxies that use publicly available data in an effort to establish better methods to evaluate past performance.

We wonder how long the global LP investor can continue to overlook the trend in public equities in Latin America. ❖

James Anderson (james.anderson@tierrapartners.com), **David Young** (david.young@tierrapartners.com) and **Claudio Freitas** (claudio.freitas@tierrapartners.com) are principals at **Tierra Capital Partners LLC.**