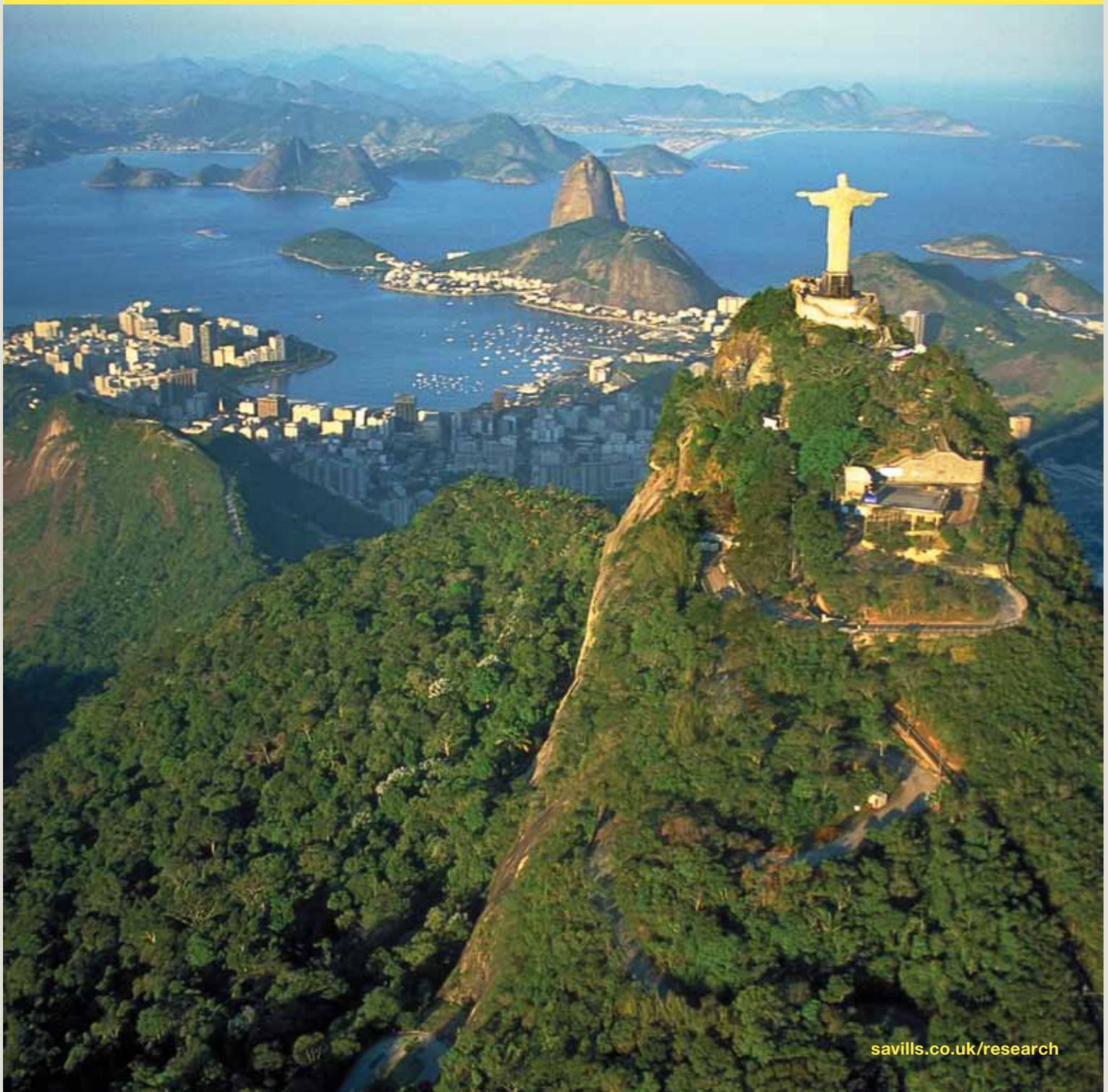


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Savills World Research
Brazil Residential

Spotlight Brazil Residential Property Market

June 2013



Spotlight Brazil Residential Property Market



Strong economic growth and wealth creation has resulted in a booming housing market; but does that make Brazil an investable proposition?

This year, 2013, is a particularly appropriate one in which to focus attention on Brazil's real estate markets. As the football World Cup and the 2016 Olympics in Rio de Janeiro draw attention from over the Atlantic, it is interesting to contrast the state of Brazil's housing market with those of the North Atlantic countries and also the fast-emerging Asian markets.

South America, in general, and Brazil, in particular, have enjoyed the benefits of fast economic growth, but apparently without the attendant excess house price inflation that has become associated with so many of the 'new world' real estate markets of the East.

Although house price growth over the last five years has averaged 23% per annum in Rio and 17% per annum in São Paulo, residential rental yields are on a par with many of the troubled 'old world' economies and house price to income ratios are much lower than many of the Asian 'tiger' economies.

In this Spotlight, we examine the drivers of housing demand in Brazil, comparative indicators of affordability, international comparisons of pricing levels and an assessment of how the residential property markets might behave in future.

Brazilians, alongside other South American nationals, are poised to become more significant players in international residential real estate markets. As the domestic market grows and as investors have prospered at home, so they will become more inclined to invest overseas.

As Brazil's wealthier classes have grown in number and are increasingly looking for avenues for investment, real estate becomes an increasingly attractive store of wealth and investment medium.

Already North America, particularly the more cosmopolitan cities of Miami, Los Angeles and New York, is becoming a familiar marketplace for South American buyers – but not yet Europe and Asia.

■ Should Americans, Europeans and Asians also be looking to South America for capital growth and rental returns?

■ When it comes to residential real estate, should Brazil be viewed as a growth stock with fewer dangers than many other emerged markets?

■ Are the fundamentals of strong economic and capital growth but seemingly greater affordability coupled with a young, growing population the perfect ingredients for a housing market boom?

This document attempts to answer some of these questions and, to do so, looks at the fast-growing and economically important locations of São Paulo, Rio de Janeiro and a small, fast growing petroleum economy town of Macaé which is symptomatic of the rapidly developing and fast-growing nation. →

SUMMARY

■ Brazil is an investable proposition which, given continued economic and demographic growth, has the capacity to add value while not becoming as overheated as other real estate markets in some fast-growing 'new world' economies.

■ Economic growth and wealth creation has resulted in a booming housing market, particularly as mortgage availability has increased and credit conditions have eased greatly.

■ Brazil has a relatively high level of owner-occupation in its urban areas – particularly in relation to developed, 'old world' economies such as France, UK, US and Australia. Higher levels of urban owner-occupation are characteristic of many of the new economies and tends to reflect less mature rental investment or subsidised markets.

■ As the Brazilian market develops and more international and domestic investors are attracted to the market, particularly in urban areas like Rio, it may be that rates of owner-occupation will fall as rental alternatives become more numerous.

■ The rate of house price growth in Rio has slowed in the last 18 months, having peaked at an annual rate of 45% in October 2011. According to the FIPE ZAP index, by April 2013 annual growth stood at 13% in Rio, the lowest rate since 2009, but still substantial by world standards and significantly higher than Brazilian consumer price inflation.

■ Affordable housing is a new sector for Brazil, but offers significant investment opportunity, and several private equity funds are already operating in this sector of the market.

“Brazilians, alongside other South American nationals, are poised to become more significant players in international real estate markets” Yolande Barnes, Savills Research

MAP 1

Brazil

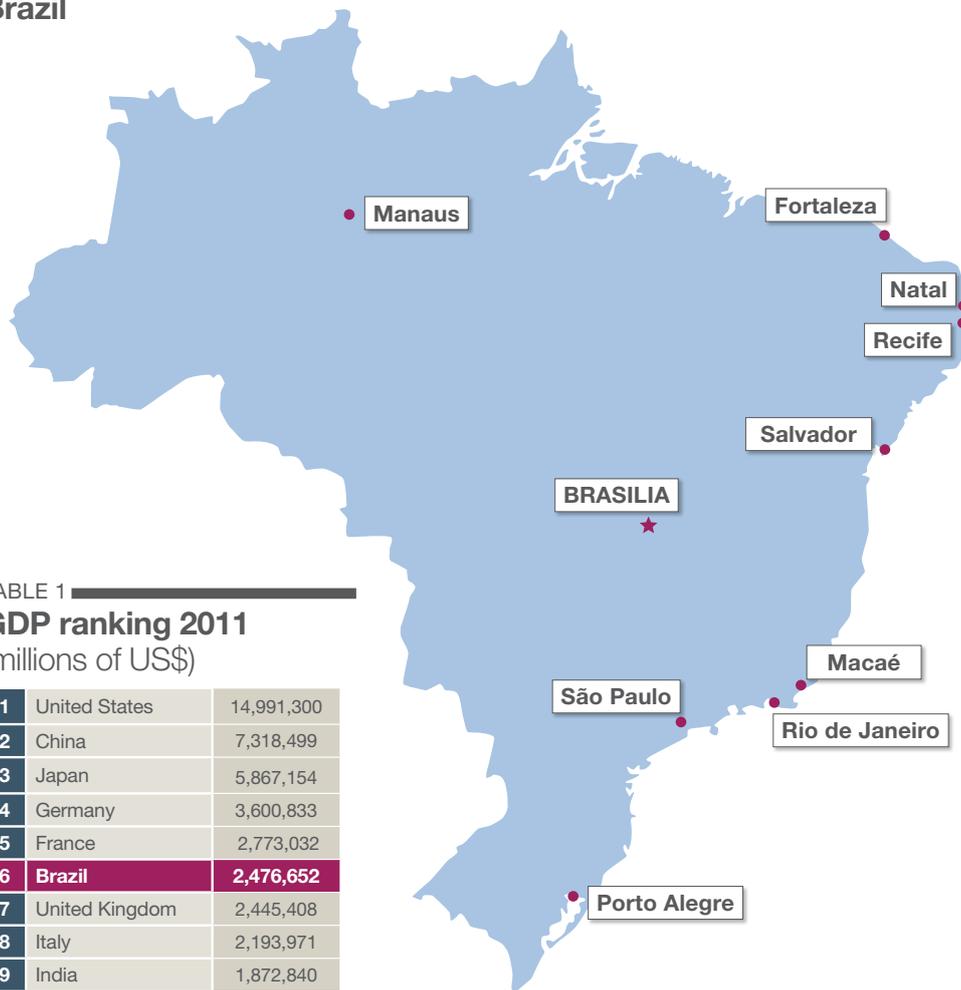


TABLE 1
GDP ranking 2011
(millions of US\$)

1	United States	14,991,300
2	China	7,318,499
3	Japan	5,867,154
4	Germany	3,600,833
5	France	2,773,032
6	Brazil	2,476,652
7	United Kingdom	2,445,408
8	Italy	2,193,971
9	India	1,872,840
10	Russian Federation	1,857,770

Source: World Bank

Population: 196,655,014 in 2011 (World Bank)
Median age: 29.6 years

is centred on Macaé, 180 kilometres east of Rio de Janeiro.

Over half of Brazil's GDP is generated in the south east of the country. The cities of São Paulo and Rio de Janeiro account for 25% of GDP creation but contain just 10% of the country's population. This means that the pressures of urbanisation, and the strength of housing markets, are greatest in this region.

Brazil's economy is growing at a much faster rate than the established economies of the US and Eurozone. Brazil is exceptional among many expanding economies in having natural resources to support this growth, including fresh water supplies. It is forecast to outperform the rest of Latin America, although it still falls short of China (Graph 1).

Socio-economics

Around 30 million Brazilians joined the middle class between 2000 and 2011, resulting in a boom in domestic consumption. Household expenditure increased by 200% in the decade to 2011, fuelled by a rapid growth in consumer and mortgage debt.

A poverty reduction program has led to real average incomes rising by 9% from 2002 to 2012, according to the Instituto Brasileiro de Geografia e Estatística (IBGE).

In 2011, 54% of Brazilians were middle class, up from 34% in 2004, according to Cetelem BGN and Ipsos Social Research Institute – a total of 103 million middle class Brazilians, who account for 46% of the country's purchasing power. It is predicted that around 60% of Brazilians will be middle class by 2018. As a consequence, some residential property developers are shifting from the luxury sector to the mid-market in anticipation of this trend.

The rapidly expanding Brazilian middle class is replacing wealthy international buyers who used to dominate the market in major cities like São Paulo and Rio de Janeiro. Those international buyers that are present are typically Europeans or those from elsewhere in the Americas.

Housing market impacts

It is hardly surprising that economic growth and wealth creation has

Economy: Key drivers

Investment in infrastructure. Brazil is experiencing huge investment ahead of the 2014 World Cup and 2016 Olympics. The Government has initiated an accelerated public spending programme, accounting for US \$526 billion for period from 2011 to 2014.

Large population and an expanding middle class. This is fuelling appetite for property investment, seen as an inflation hedge and alternative to bank savings.

Natural resources in abundance. Brazil is rich in ethanol, timber, and oil. It is also a major producer of coffee, sugar cane, soy, livestock and renewable energy.

Large manufacturing industry. Manufacturing in the aviation and car industries is strong in Brazil.

Increasing availability & diminishing cost of credit. The improved availability and lower cost of credit is now a key driver of domestic demand.

➔ As the foremost of the 'BRIC' economies, Brazil enjoys all the hallmarks of success; a fast growing domestic economy, vast natural resource and a stable, democratic government. It is the world's fifth most populous country, with a youthful population – the average age just 30 – and a growing middle class.

Economic growth

GDP growth in Brazil has been very strong but slowed from 7.5% in 2010 to 2.7% in 2011 and just 0.9% in 2012, partly the result of its reliance on shrinking North American markets.

Oxford Economics forecast a return to strong growth, 2.9% in 2013 and 4.4% in 2014, fuelled by strong consumer spending and infrastructure investment as well as the contribution of the petro-economy, part of which

resulted in a booming housing market, particularly as mortgage availability has increased and credit conditions have eased greatly.

Long-term lending in Brazil was traditionally very scarce due to the very high inflation rates prevailing until quite recently. Mortgage lending used to be restricted to the housing finance loans granted by the Housing Finance System (SFH).

The economic stabilisation process implemented with the Plano Real, in July 1994, enabled the development of new sources of financing for the real estate sector, as well as the implementation of a secondary mortgage market in Brazil. This increased mortgage availability and reduced its cost.

Brazil has also historically had very high mortgage rates. As short a time ago as 2002, base interest rates were well over 20% and so mortgaged owner-occupation used to remain rare and housing market gearing has only increased relatively slowly.

Successful economic reforms over the past several years have now pushed Brazil's central bank benchmark rate (Selic), from a recent high of 26% in 2003 to just over 7% today. Private mortgage rates have followed suit and currently stand at around 10 to 12% (interest rates on government mortgages are nearer 8%), which may be considered high by international standards but is low by Brazilian historic standards.

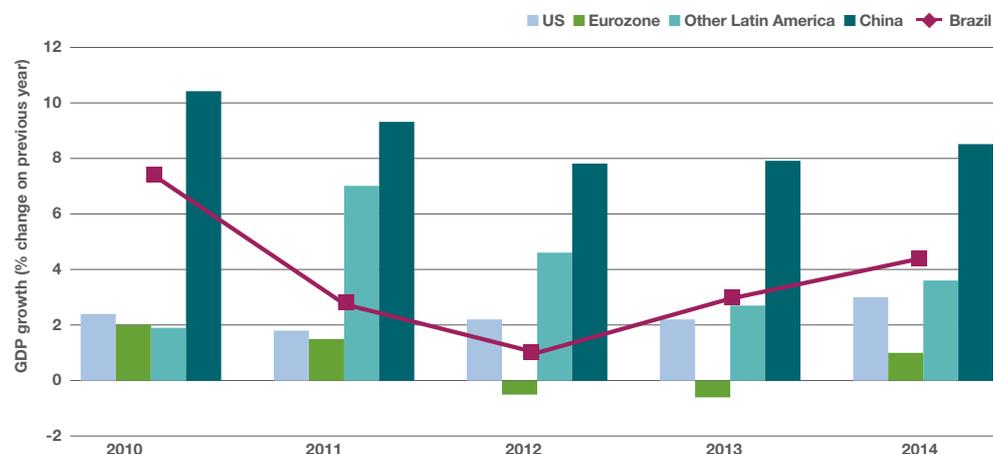
This is a major factor influencing the appetite for geared real estate purchase as previously finance rates were higher than the rental return or opportunity cost of housing.

The central bank has recently increased the benchmark interest rate slightly as inflation in the country was running at 6.59%, which is above the ceiling of the country's 2.5% to 6.5% inflation target range. Despite this, the high inflation rate means that real (inflation adjusted) mortgage interest rates are now lower than they have ever been in Brazil's recent history, making mortgage borrowing a more attractive proposition.

The lack of tradition for owner-occupation and real estate

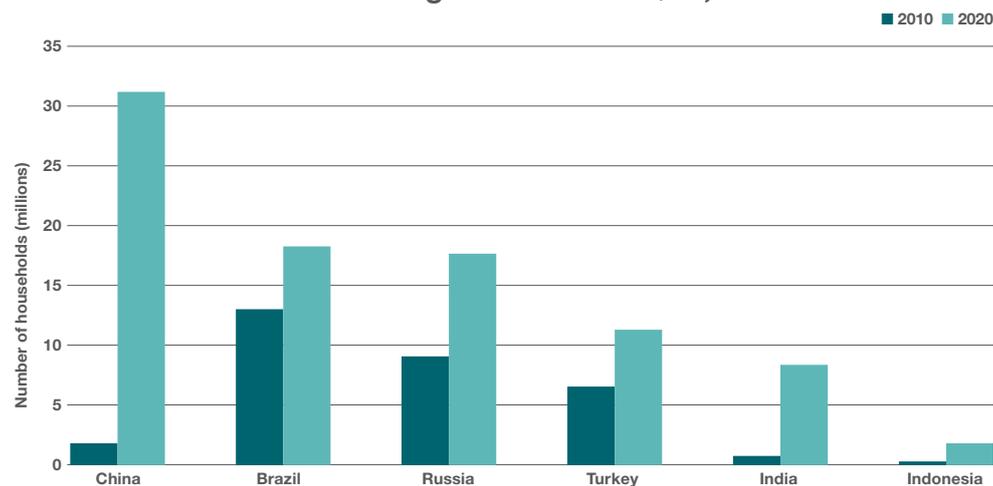


GRAPH 1
GDP Growth and Forecasts



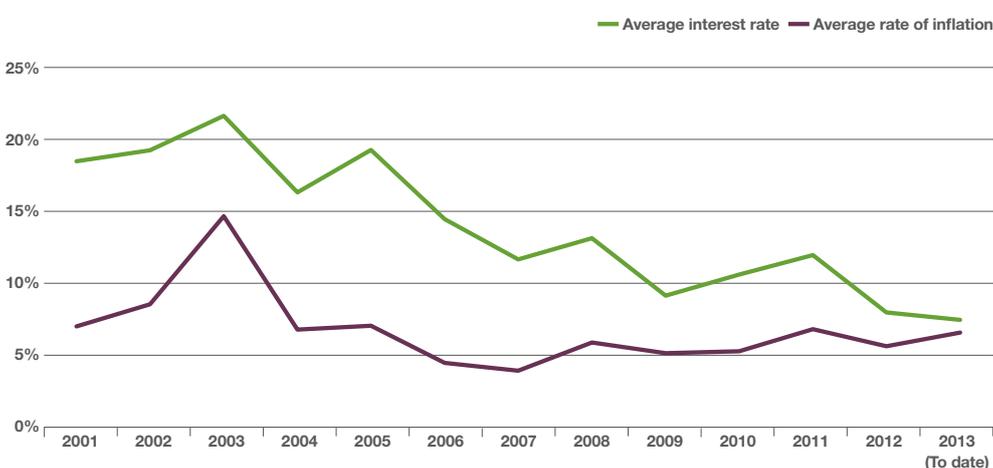
Source: Oxford Economics

GRAPH 2
Households with an income greater than US\$30,000



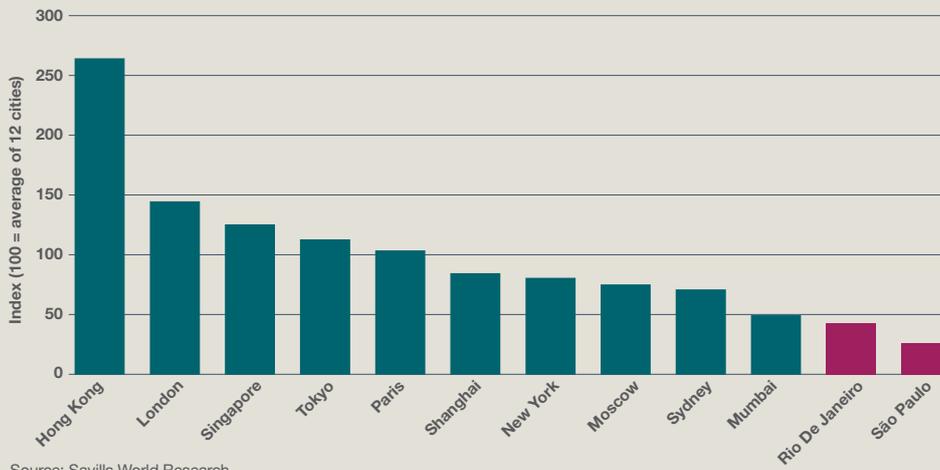
Source: Oxford Economics

GRAPH 3
Interest rates and inflation



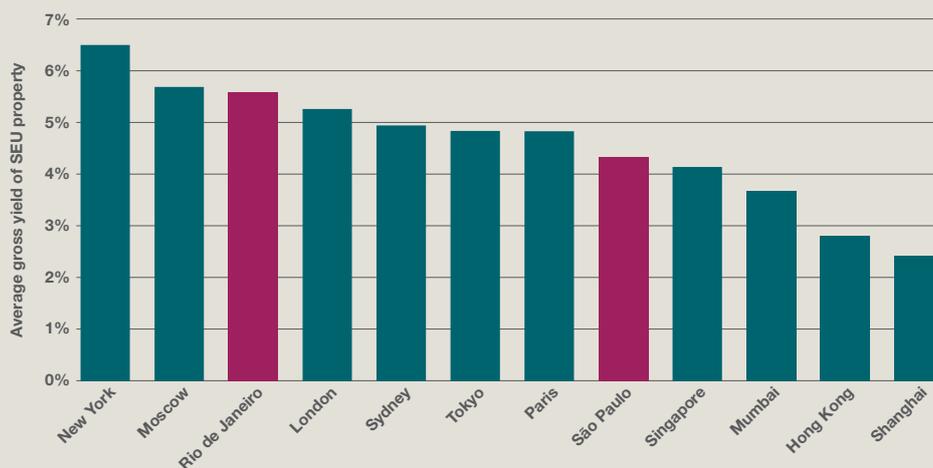
Source: Savills World Research

GRAPH 4 **Relative cost of residential property, Savills Executive Unit (SEU)**



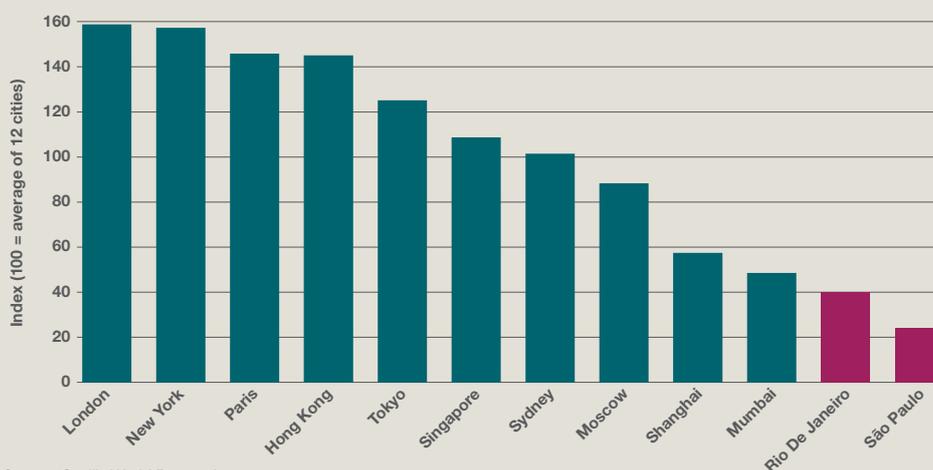
Source: Savills World Research

GRAPH 5 **Yields for SEU in world cities**



Source: Savills World Research

GRAPH 6 **Relative rent of residential property, Savills Executive Unit (SEU)**



Source: Savills World Research

→ investment generally has had repercussions on housing purchases. It is only recently that many Brazilians, in common with other South Americans, have sought to invest in real estate and especially to venture into overseas real estate markets.

It is, broadly, North American cities like Miami, New York and Los Angeles that have seen any significant activity from this region in their real estate markets. For example, wealthy Brazilians were the second biggest investors in Florida residential real estate behind Canadians in 2012.

Global comparisons

Despite some spectacular price growth in the last five years, Brazilian residential property appears good value when compared to the top tier of world cities (Graph 4).

A like-for-like comparison of the capital and rental costs of residential real estate for seven different households (the ‘Savills Executive Unit’ – see box opposite) in each world city is shown in Graph 6. It shows that, despite having nearly three times the GDP per head of India, Brazil’s premier cities still have cheaper real estate than Mumbai.

Brazil’s economy is a similar size to France and Britain’s and far bigger than Australia’s, Hong Kong’s and Singapore’s yet the wealth generated by it does not seem to have been channelled into the real estate of its major cities in the same way as has occurred in those economies.

Another significant indicator of affordability in Brazil is the relationship of rental levels to capital values. We consider annual yields are a useful sign of how overheated capital values are in relation to underlying occupier demand.

Where the annual rent, expressed as a percentage of capital value, is near or below the rates of return available from bonds and other mainstream investments in a given country, we see this as an indication either that rents are low in relation to demand for housing or that capital values are high in relation to underlying demand for accommodation.

In cities where large quantities of investment capital have been

pressing on real estate markets, these yields are often very low by global standards.

Not so in Brazil. Gross residential property yields for the SEU in Rio and São Paulo are higher than in many other of the 'new world' cities in recently emerged economies and on a par with London, New York, Sydney, Tokyo and Paris. This would suggest that there are sound fundamental reasons for income-investing in Brazil – especially by investors in regions where interest rates, and hence the opportunity cost of money, are low.

In terms of absolute rent levels, does Brazil look overheated? On the world stage, rents in its two major cities are less than 40% of the world city average and well below the cheapest world cities of Shanghai and Mumbai.

This is despite the fact GDP per head in Brazil is nearly 25% higher than in China and nearly three times as large as India. By this measure, Rio and São Paulo look cheap by comparison to other 'new world' compatriots.

Brazilian housing

Owner Occupation

Brazil has a relatively high level of owner-occupation in its urban areas – particularly in relation to developed, 'old world' economies like France, UK, US and Australia. Higher levels of urban owner-occupation are characteristic of new economies and tends to reflect less mature rental investment or subsidised markets.

As the Brazilian market develops and more international and domestic investors are attracted to the market, particularly in urban areas like Rio, it may be that rates of owner-occupation will fall as rental alternatives become more numerous.

Mortgaged Owner Occupation
Until recently, mortgages were difficult to come by and, as recently as 2007, lending in the residential sector was equivalent to just 1.5% of GDP. The level of mortgage debt in the country has more than tripled in recent years (Graph 7), but still only accounts for 6.2% of GDP, compared with 12% in Mexico, 20% in Chile, 81% in the UK and 73% in the US. This shows it to be a country in the infancy of mortgaged owner-occupation.

What is the Savills Executive Unit?

Comparing the cost of global real residential estate

In order to compare the cost of residential real estate across different global cities, we use the Savills Executive Unit (SEU), which measures the cost of housing an identical group of people in various different countries.

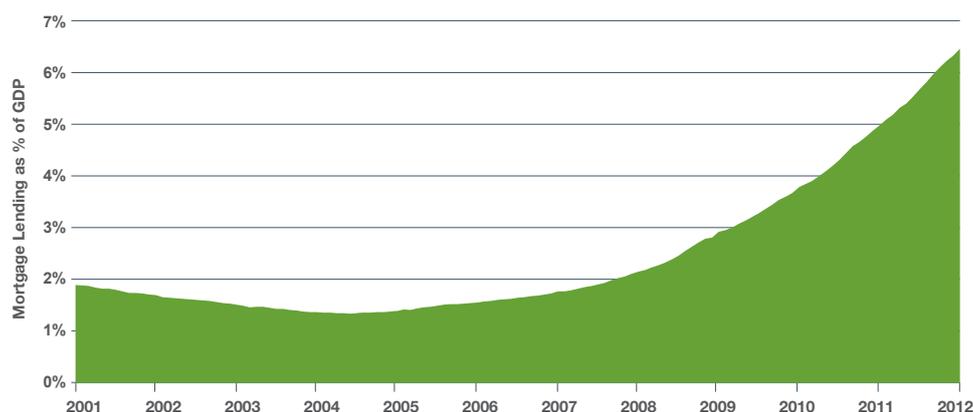
By comparing a group of real people, our cost comparison of residential real estate has a 'real world' relocation story at its heart. We take a typical 'executive unit', a group of people that might start up or expand a global business in any country, and then compare the residential accommodation that they would be likely to inhabit in each of the world cities.

The people who make up our SEU include one middle aged ex-pat CEO, one senior ex-pat director, a locally employed director and four locally-employed administrative staff. They each live in different types of household, some with children, some with partners and some without, and each member of the group chooses different types of locations and different types of property in which to live.

It is by comparing the accommodation costs of these people that we can truly compare the cost of residential real estate across some very different global cities.

GRAPH 7

Outstanding mortgage debt as % of GDP, Brazil



Source: Banco Central do Brasil

What is the rationale for overseas investors?

Brazil's residential markets have been buoyed in recent years by oil discoveries off the coast of Rio, the World Cup and the Olympics, making it appealing to international investors.

Meanwhile, Brazil's biggest cities are being 'cleaned up', government taking a zero tolerance attitude to the crime, which has dogged the country's profile in recent decades. Improved access to credit and a rapidly expanding middle class has enabled increasing numbers of people to buy their own home, and this has put upward pressure on prices.

It is relatively easy for foreigner's to buy real estate in Brazil. Overseas nationals can buy Freehold without restriction – except very large farms and islands/coastal land tracts that could be deemed 'militarily sensitive'. International buyers can purchase freely in Brazil, but do require a tax number from the Government (a CPF).

São Paulo and Rio are two of the cities leading the Brazilian residential property market. Prices in São Paulo have risen by 127%, since the beginning of 2008, and by 189% in Rio de Janeiro. Rental growth is up by 86% in São Paulo and 129% in Rio over the same period. ■ ➔

RIO DE JANEIRO

Rio de Janeiro may have suffered in previous decades by losing its capital city status and the stock exchange, but a new state governor and mayor in 2006 started to reverse the decline. Tougher policing has reduced crime and helped to pacify drug gang-controlled favelas. As a result, adjoining neighbourhoods have experienced rapidly appreciating prices.

Rio has already enjoyed significant infrastructure investment in the run up to the World Cup in 2014 and Olympics in 2016, on top of highly successful Pan American games in 2007. These high-profile events have put Rio on the forefront of a global stage, helping to establish it as, arguably, the premier city in Latin America.

Brazilians are returning to Rio in large numbers, which is now growing at a faster rate than São Paulo. In part this is due to demand for human resources attracting professionals from other states and overseas. Today, Rio's population stands at 6.4 million.

The rate of house price growth in Rio has slowed in the last 18 months to a 13% annual growth rate in April 2013, having peaked at 45% in October 2011. The rates of growth now seen in Rio are much more in line with world standards and underlying occupier demand, matching rates of growth in rents.

The city enjoys a stunning setting between the mountains and the sea,



but this geography limits space and contributes to a short supply in prime property. The majority of prime residential stock is in condominiums mostly developed in the 1960s and 70s, replacing lower rise villas. Brazilians tend to favour the higher floors which offer better views and security.

Central locations in Rio are generally considered the most desirable neighbourhoods with Rio's prime 'bairros' focused in the south of the city in 'zona sul'. These bairros enjoy excellent views and easy access to beaches and the waterfront with Leblon, Ipanema and Lagoa achieving the highest prices on a R\$psm basis. Copacabana has enjoyed renewed investment and property prices are appreciating there too.

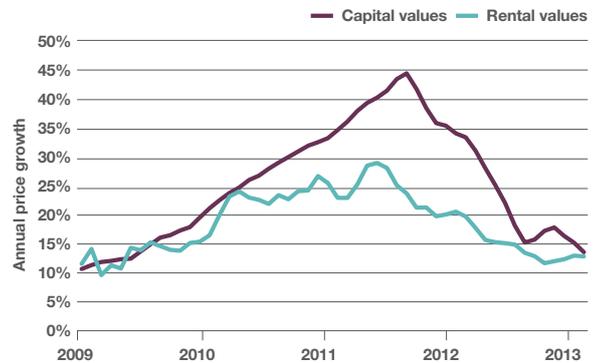
Some favelas also benefit from good views and are changing hands for hundreds of thousands of Real – without title – by developers eyeing long-term development opportunities.

Regeneration and Development

The prospect of the Olympics has fuelled price growth in the city in recent years. Venues for the Games will be focused in Barra da Tijuca, in the west of the city along with Copacabana Beach, Maracanã and Deodoro.

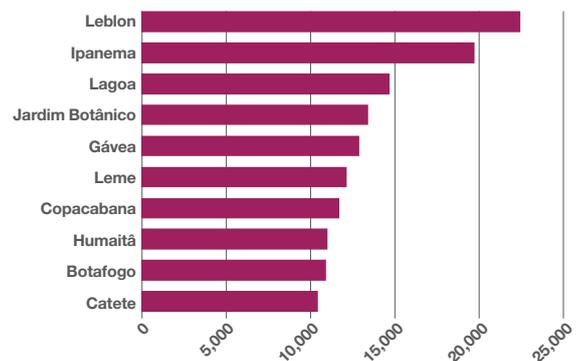
Rio's historical downtown is undergoing a 5-million-square-metre urban waterfront revitalization project 'Porto Maravilha' which aims to increase the city centre's attractiveness and enhance Rio's competitive position in the global economy. ■

GRAPH 8 Rio annual price growth



Source: FIPE ZAP

GRAPH 9 Average asking prices in Rio's prime neighbourhoods March 2013



Source: FIPE ZAP

The rise of Macaé

Since the discovery of enormous oil and gas deposits in the Campos Basin in 1974, the once modest fisherman's village of Macaé has grown by leaps and bounds, with no signs of development slowing. Macaé is the closest port and staging area to the Campos Basin, the source of about three-quarters of Brazil's known oil reserves.

In 30 years, the city's population has increased threefold, jumping from 75,000 to nearly 220,000, and since 1997, its economy expanded by 600%. Macaé's population is expected to increase from 220,000 to 300,000 in the next five years. This means residential units are in high demand and supply will be hard-pressed to keep pace. Residential space is at a premium and likely to remain so.

Surveys conducted show the Internal Gross Product per capita of the city in 2007 is R\$37,667 per year, 200% greater than the national average – and the average salary is 8.2 times the minimum salary, making Macaé the city with the highest wages in the Rio de Janeiro State. We predict that real estate prices and rents will continue to grow rapidly as a result.

SAO PAULO

São Paulo is Brazil's economic capital, and the country's largest city, with a population of 11.4 million. It is host to the city's stock exchange, the BOVESPA; and Latin America's major port, Santos.

The city benefits from a metro, which is clean and efficient, though it is limited in range so São Paulo suffers from traffic congestion. In recent years, São Paulo, or 'Sampa' as it is affectionately known by its residents, has lost some of its appeal to higher-profile Rio, and has seen slower residential price growth.

Like Rio, the rate of annual house price growth in São Paulo slowed in the last 18 months, having peaked at 25% in July, according to the FIPE ZAP index. In April 2013, annual growth stood at 16% in São Paulo, the lowest rates since 2009.

Unlike Rio, São Paulo's capital value growth has been much more in line with underlying occupier demand, shown by rates of rental value growth.

This could reveal something of the extent to which Rio has witnessed excess demand for real estate purchase in the run up to World Cup and Olympics, but also the extent to which São Paulo, as the major

financial city, was already a more sophisticated corporate-rental and investment market.

Given the problems of infrastructure and traffic, central locations are highly prized and achieve the highest prices. São Paulo is an extensive, sprawling city, so those locations close to the CBD are most desirable. Locations achieving the highest prices on a R\$psm basis are Ibirapuera, Jardim Paulistano, and Itaim Bibi.

New developments have tended to be further afield in areas such as Morumbi, to the west, which are a longer car journey away.

Prior to 2007, São Paulo saw major speculative development, but this has now cooled and some schemes may no longer be viable. This is especially the case with those built further from the city centre, some of which are now considered too remote.

As land values have increased in the central areas, blocks built in the 1960s and 70s have given way to taller, modern developments.

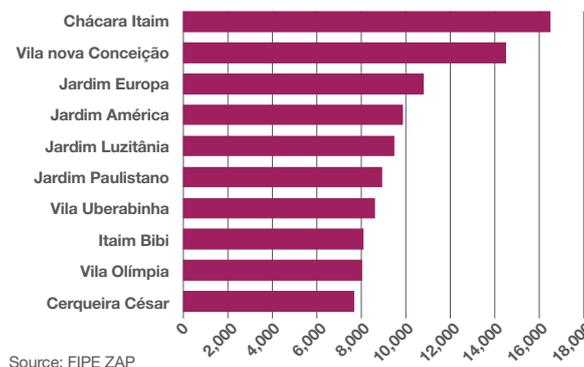
Unlike Rio, the favelas in São Paulo are some distance from the city centre, and therefore have a less direct impact on more established residential neighbourhoods. ■

GRAPH 10 São Paulo annual price growth



Source: FIPE ZAP

GRAPH 11 Average asking prices in São Paulo's prime neighbourhoods March 2013



Source: FIPE ZAP

Minha Casa, Minha Vida: My House, My Life

The Government is making it a priority to re-house the favela population, and in 2009 initiated the 'Minha Casa, Minha Vida', a 20 year programme to deliver 27 million homes to low income families. Households meeting the income criteria can apply for mortgages from the government bank to buy homes from agreed providers. Unemployment benefit and health insurance are pre-packaged with these mortgages. Such is the level of underlying demand, each new development is hugely oversubscribed.

While successful, the scheme is making limited impact on the country's housing deficit, estimated at between 6-8 million homes. Given Brazil's young population and high rate of household formation, this deficit is growing rapidly.

Affordable housing is a new sector for Brazil, but offers significant investment opportunity, and several private equity funds are already operating in this sector of the market. Spiralling land and build costs will need to be offset by innovative technologies and pre-fabrication.



Conclusion & outlook

Brazil has rewards for overseas investors

As in many of the fast-growing, newly emerged 'new world' nations, Brazil's new wealth has been channelled into real estate and has led to high house price growth, especially in the major cities where populations are rising rapidly.

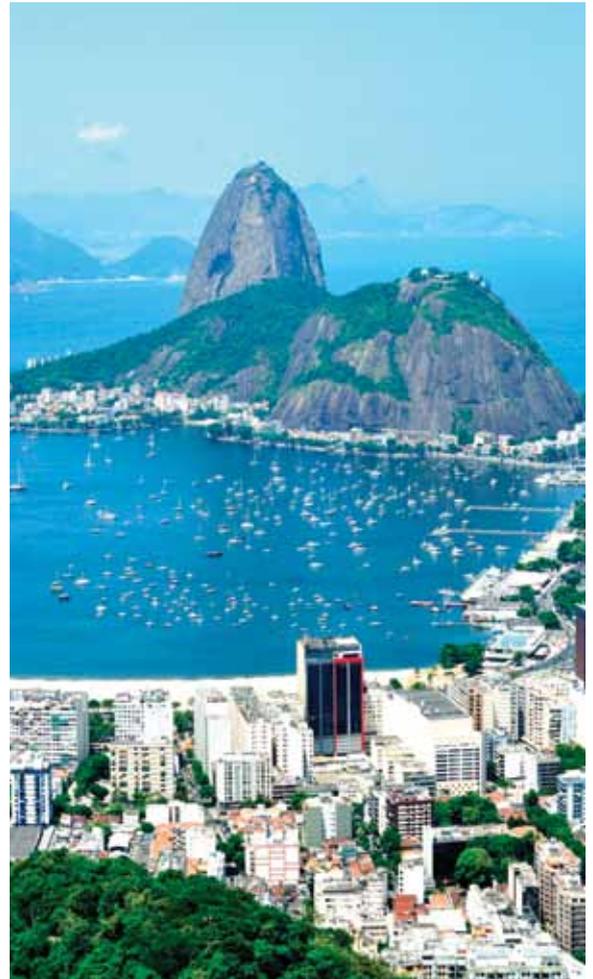
While some 'new world' cities in Asia can look very fully valued by reference to a variety of measures, Brazil's are still in line with less overheated markets. Most notably, yields are high by international standards despite there having been some recent disparity between capital value and rental growth.

We expect the disparity to continue as investment activity increases and more cash drives capital values but we expect this gap between investor behaviour and occupier behaviour to be close significantly.

As a consequence, we expect to see substantial but lower than recent capital value growth and sound income returns. Overseas investors will need to have an eye on exchange rates (the 'strong Real policy' should help here) and beware the prospect of rising interest rates and/or inflation, but may well find Brazil more rewarding than some other 'new world' markets, especially in Asia.

Domestically, rising interest rates may be seen as a threat to the housing market but affordability appears not to be as overstretched as some have suggested.

Credit control is strong and mortgaged indebtedness is relatively low compared to other countries, so prospects for a substantial downward price correction seems relatively remote in the current climate of growing wealth creation. ■



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