7-2012

Lodging Market: Overcoming Constraints to Gain First Mover Advantage

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Abstract
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Brazil is a market for investors to consider who are in search of significant growth. A contrast to the underwhelming economic growth in Western Europe and the U.S., Brazil provides a more upbeat picture, with economic growth over the next several years to be twice as high. Active investors in Brazil include private equity and institutional investors from the United States, Europe and Latin America. Investment funds from the Middle East and Asia have Brazil's real estate and hotel markets on their radar as well.

Keywords
Brazil, market economics, Latin America, hospitality, hotels, hospitality investment, BRIC real estate, Jones Lang Lasalle, Cornell, real estate

This article is available in Cornell Real Estate Review: http://scholarship.sha.cornell.edu/crer/vol10/iss1/5
Brazils is among the world’s ten largest economies and is Latin America’s strongest economic force by a wide margin. The country’s long-term growth potential is generating considerable interest among property investors.

Brazil is a market for investors to consider who are in search of significant growth. A contrast to the underwhelming economic growth in Western Europe and the U.S., Brazil provides a more upbeat picture, with economic growth over the next several years to be twice as high. Active investors in Brazil include private equity and institutional investors from the United States, Europe and Latin America. Investment funds from the Middle East and Asia have Brazil’s real estate and hotel markets on their radar as well.

Closer scrutiny of the economic, demographic, political and social factors in Brazil reveals:

• A large and comparatively mature, domestically oriented economy in which growth has largely been purposefully restrained in accordance with austere macroeconomic policies;
• Controlled growth of an increasingly wealthy, westernized population driven by a rapidly growing middle class;
• While still needing improvements, generally a pro-business environment with physical, legal and human resources infrastructure; and
• Substantial pent up demand in virtually all economic sectors, but especially real estate, and in particular hotels.

The real challenge lies in identifying the best opportunities while mitigating risks. Within this context, we believe there has never been a more opportune moment for both institutional and private investors to give serious thought to the Brazilian real estate and hospitality markets.

To that end, we have prepared this overview. This paper seeks to provide insights into some general questions. What is the availability and nature of local finance, and how are these factors changing? Who are the key players, and what are the best entry strategies for a new international investor? In each case, we seek to examine not just the best areas of opportunity, but also shed light on the economic, political and/or demographic factors that might positively or negatively impact the hotel sector.

While Brazil has made significant strides in recent years, having consolidated institutional stability and earned the designation as the most transparent real estate market in Latin America according to Jones Lang LaSalle’s Global Real Estate Transparency Index, doing business in the country remains a complex undertaking. There are still significant
Some of these differences are reasonably apparent, others considerably less so. The country’s classification as investment grade by leading ratings agencies in 2008 was an important milestone, allowing some international institutional investors to now consider attractive opportunities that were previously off limits. Even so, these opportunities must be approached with the caution exercised in all emerging economies, and there is no substitute for solid knowledge of local market conditions and business practices.

Politics: a Stable Democracy

Brazil is a federal republic composed of 26 states and the federal district, where Brasília, the capital, is located. The country has a presidential system with executive, legislative and judicial branches of government. President Luiz Inácio Lula da Silva’s expansion of the solid macroeconomic policies and commitment to structural reforms initiated by Fernando Henrique Cardoso from 1994 to 2002 produced sustained economic growth that improved investor sentiment and strengthened the country’s democratic foundations and governance during the 2000s. Brazil’s current president, Dilma Rousseff, also enjoys strong approval ratings and broad policy continuity is expected under her administration.

Middle Class Growing Strongly

With 197 million inhabitants, Brazil is the world’s fifth most populous country. Forty million residents have joined the middle class during the past five years and they are driving demand for goods and services more than ever before—a considerable success story, although significant inequality remains among the country’s different regions. The rising wealth of the middle class has driven a sea of change in Brazil’s economy and stimulated demand for office space, retail outlets, residential space, hotels and manufacturing facilities.

Foreign Direct Investment Inflows to Remain High

Brazil has attracted a significant amount of foreign direct investment (FDI) throughout the past decade, in particular in the telecommunications, petroleum, chemical manufacturing, engineering, retail and financial services sectors. FDI to Brazil increased greatly during 2008 after Brazil was given an investment grade rating for sovereign debt by Fitch and Standard & Poor’s. The increased credit rating will boost foreign investment in Brazil and open the market to large institutional and private equity investors.

After slowing during the global economic downturn in 2009, FDI levels to Brazil rebounded strongly in 2010 and reached all-time highs in 2011. FDI has started out strongly in 2012 and is expected to remain robust in the near term, representing foreigners’ trust in the country. Brazil is expected to remain a leading recipient of FDI among emerging markets.

How to Navigate Brazil’s Debt Markets

Debt financing in Brazil has traditionally been a challenge due to the extremely limited sources of local lending, high interest rates and short amortization schedules. This generally makes debt more expensive than equity. As such, most investments have traditionally been financed by a large equity component, and foreign investors usually source debt internationally.

Most of the local debt for commercial real estate developments currently is originated...
by the federal government’s Brazilian Development Bank (BNDES) and state-run regional
development banks. The BNDES finances only new construction or renovation, and does
not provide acquisition financing for the purchase of existing assets. It is therefore difficult
to obtain local debt for acquisitions.

While public sector development banks currently offer the most attractive source of
local debt financing for commercial real estate developments, as Brazilian interest rates
continue to fall, private banks are expected to gradually start providing more long term
financing to the real estate sector.

The bottom line is that as the availability of private-sector debt gradually starts to
increase, investors will be able to achieve higher returns on their investments and their exit
will have a lower execution risk due to the increased liquidity.

Capitalization rate movements are inversely related to the amount of debt, liquidity,
and perceived risk. As such, cap rates for real estate investments will compress over the
medium term. Over the medium term, investors will see a higher internal rate of return on
deployed capital because leverage will increasingly be used as more debt becomes available.

**Lodging Market Driven by Domestic Demand**

Brazil has a large and growing domestic travel market. In 2011, approximately 90% of
airport arrivals were from domestic flights and the remaining 10% of passenger arrivals
were from flights that originated internationally. Air transport in Brazil remains expensive
by international standards and there is much room for expansion of flights within the
country.

In terms of international arrivals, Argentina represents the largest source market for the
country, accounting for nearly one-fifth of arrivals to Brazil. The U.S. is the second largest
source market, typically accounting for 15% of international arrivals. Western European
countries such as Portugal, Spain and France rank next. Brazil marks a stark contrast from
Mexico where the lion’s share of international arrivals stems from the U.S.

**Brazil’s Operating Fundamentals Making Leaps and Bounds**

Consumers in the growing middle class are aspiring to purchase homes, cars and
electronics and spend more on entertainment and travel. Many residents in the rising
middle class are having access to a large number of products and services for the first
time in their lives. This new middle class is becoming increasingly more sophisticated and
demanding more products and higher quality services, and many Brazilians are travelling
for the first time.

In the hotel market specifically, the country’s revenue per available room (RevPAR)
marked double-digit growth in 2011 and RevPAR is expected to continue to rise at similarly
high levels in 2012 as strong economic growth and healthy inbound tourism levels – all
amid constrained supply – combine to produce solid operating fundamentals.

**The Americas’ next Hotel Development Frontier**

Over the next decade, hotel investors’ focus in Brazil will be on new development,
which is accompanied by large-scale opportunity. Brazil’s development potential is further
solidified by the upcoming FIFA World Cup in 2014 and the Summer Olympic Games in
2016.
Just 15% of room supply in Brazil is affiliated with an international hotel brand and the country still lags with respect to the product differentiation seen in mature lodging markets. This highlights just how much room there is for the establishment of branded hotel supply in Brazil. Later in this paper, we assess how the proportion of branded hotel stock compares to the other ‘BRIC’ countries.

Accor is the most widely represented hotel company in Brazil, with approximately 150 hotels, primarily in the economy and mid-market sectors. Choice Hotels International is the second most represented management company, with over 60 hotels represented by Atlantica Hotels International, a master franchisee. Together, the remainder of the top international hotel chains has a combined presence of just 75 individual hotels in the market, most of which are located in São Paulo or Rio de Janeiro.

Over the medium term, Brazil will attract a higher level of brand differentiation to serve different demographic groups, in particular the emerging middle class. Entering Brazil as a master developer and building up to a critical mass of 25 to 30 hotels in the branded mid-market and limited service sectors is a substantial investment opportunity.

In addition, the country’s large cities, such as São Paulo, Rio de Janeiro, Belo Horizonte, Salvador, Porto Alegre and other cities with over one million residents are generally underserved in the upper-tier segments and such hotel projects can represent viable development opportunities in these cities as well.

Yet amid all this opportunity, the market is not facing an explosion of new supply—a contrast to other emerging markets such as China. The pipeline for Brazil remains moderate: The number of rooms under construction and in advanced stages of planning for the next three years represents a moderate increase of approximately 7% of total existing rooms in the country.

A recent study prepared by Jones Lang LaSalle Hotels found that there are approximately 200 hotel projects in construction or in an advanced stage of planning that will be affiliated with the main hotel chains present in Brazil. These development projects encompass 30,500 rooms and are largely concentrated in the economy and mid-scale segments.

**Entry Barriers, Development Constraints and Challenges for Investors**

Barriers such as high land costs, the dearth of financing and a relative lack of experienced independent management companies undermine the hotel development pipeline, but at the same time are leading to a compelling opportunity for a strong first mover. This section of our analysis examines a number of these constraints, and suggests how they can be overcome.

**Limited financing for hotel projects**

As discussed earlier, there is limited financing available for hotel developments in Brazil. Investors are typically not able to obtain debt from a bank. Due to this constraint, numerous hotels have been developed under the local condo hotel structure, whereby dozens of individual investors pool capital to finance a project. Condo hotels make up a large percentage of urban hotel supply in Brazil.

Development of hotels under this model took off in the late 1990s, leading to an oversupply in some markets. As investors’ returns shrunk, so did the number of new projects. But the condo hotel structure will again gain prevalence as recent operating performance has once again generated attractive returns.

Additionally, the spate of existing condo hotels now presents a number of branding or re-branding opportunities for hotel management companies—a method for growing brands to enter the market by assuming management of an existing property.
**Competition for development sites**

Hotel developers also face the challenge of securing superior development sites in cities due to the competition with office and retail developers. In some of the largest cities in the countries, development parcels are often fragmented and constrained in size, meaning that it can take years for a developer to assemble several parcels to have a sufficiently large site on which to build a hotel. Foreign investors can mitigate this constraint by working with an experienced local advisor.

In gateway cities such as São Paulo and Rio de Janeiro there are a number of developers who have succeeded in cobbling together prime sites and are in the process of deciding on the programming of the hotel development. These developers have the potential of being hugely successful once they establish an upscale hotel in these prime locations.

**Lack of local hotel management companies**

Compared to the U.S. but even other emerging markets such as Russia, India and China, there is a smaller number of professional hotel management companies with a local infrastructure in Brazil. While a number of smaller groups have been formed recently, Atlantica Hotel International and Brazil Hospitality Group remain the two principal professional management companies that represent international brands.

Due to some of the development constraints outlined in this paper, only few hotel companies have achieved a critical mass in the country in terms of hotel distribution and operating infrastructure. As such, a foreign hotel company seeking to introduce one of their branded hotels in Brazil does not have a strong bench of experienced operators to select from when seeking to establish a franchise agreement. This makes it more difficult for global hotel brands to enter the market. Since they often cannot tap into the services of an established operator, they must operate the hotel on their own, which can be more costly on a per-property basis until they establish a larger network.

While this represents a challenge for investors seeking to establish several one-off internationally branded hotels in the country, the relatively open playing field represents a significant opportunity for foreign investors who do make an investment of scale in the country and establish both a network of branded hotels along with a local management and operating infrastructure. This opportunity has been talked about for years, but a foreign investor is yet to fully establish a network of 20-25 new branded mid-market hotels in urban and suburban locations across the country like Accor has. The first mover advantage has the potential of being tremendous.

**Tax laws**

For foreign investors in particular, Brazil’s often inefficient and complex tax structure and bureaucracy can undermine competitiveness. The country’s tax rates are high compared to international standards. Among its ‘BRIC’ peers, Brazil’s tax environment receives low marks in the World Bank Group’s Ease of Doing Business rankings. Foreign investors are advised to consult a tax professional to understand the withholding taxes levied on their properties.

In summary, this brief discussion of development constraints and entry barriers that hoteliers face in Brazil highlights some of the reason why vast areas of the market are yet to be exploited. The timing remains an unknown, but we expect to see several foreign investors entering the market in a large-scale manner, engaging a development strategy focused on building or strengthening the domestic organization and strategically deploying capital to increase their share of rooms in the country. These will be the players that will shape the market for decades to come.
Market Entry Options for Foreign Investors

For new hotel developments, it is common for foreign investors to set up a joint venture with a local investor. Joint ventures are structured through the establishment of a company, in form of a limited company (Sociedade por Quotas de Responsabilidade Limitada, or more simply a ‘Limitada’) or a privately held corporation (Sociedade Anônima - SA) and ownership stakes vary. The underlying joint venture vehicle is a Brazilian company, subject to Brazilian law. Benefits of this structure include the ability to leverage the regional expertise of the local partner.

Foreign investors are allowed to own 100% of a hotel asset in Brazil but investors taking this route must also establish a Brazilian subsidiary, both for land purchases and hotel developments. This entry option is prevalent in Bahia and other resort destinations in the Northeast, where Portuguese and Spanish investors have entered the market without local partners. The benefit of this structure is that the foreign investor has full control over ownership activities and exit strategy.

Snapshot: Brazil’s Other Commercial Real Estate Sectors

Like in other nations, Brazil’s hotel real estate sector is among the smaller commercial real estate sectors in the country. Hotel developers face competition from office and retail developers in urban areas due to the scarcity of suitable development sites. As such, an understanding of other commercial real estate sectors is crucial for hotel investors. Below is a snapshot of the country’s other primary real estate sectors.

Office Market

The Brazilian office market is relatively small in relation to the size of the country and economy. The total office stock in Brazil’s large cities and main commercial corridors is estimated at 25 million square meters. Of this total stock, 60% is located in São Paulo and Rio de Janeiro. These two cities account for an even greater proportion of the country’s high-end properties: 60% of Brazil’s high-end office properties are located in São Paulo and 20% in Rio de Janeiro. The other main office real estate markets are in Belo Horizonte, Curitiba and Brasilia. The country’s urban landscapes are dotted with cranes constructing modern office buildings – a refreshing change from the U.S. where large-scale construction is mostly at a stand-still.

Industrial Market

An estimated 65% of industrial warehouses, factories and production facilities in Brazil are built-to-suit, owner-occupied space. The remaining 35% of industrial warehouses was developed for leasing and consists primarily of distribution and logistics centers, representing the main investment target for foreign investors due to limited supply and strong demand. The country’s older industrial warehouses are generally of poor quality but over the past 20 years, a new stock of higher quality buildings was constructed with more modern specifications. Industrial centers are concentrated in the South and Southeast regions, in particular São Paulo, Rio de Janeiro and Curitiba where vast populations and thus high consumption are centered.

Retail Market

Approximately four-fifths of Brazil’s population lives in urban areas. Shopping center development is resultantly booming. Just over half of Brazil’s population is under 30 years old, a favorable trait given that young people generally spend a notable percentage of their income on clothing, personal electronics and so on. Moreover, consumption by lower income individuals will continue to increase as a result of rising salary levels, lower inflation and the steadily growing population. Retailing in Brazil has gone through a substantial evolution in recent decades, in particular with explosive growth of shopping malls, hypermarkets and big-box chains, many of them under international brand names. As malls grow in popularity and wealth spreads from traditional major cities to prosperous new urban centers in the Northeast, North and Center-West, there will be a plethora of opportunity to develop malls and shopping centers in these regions.
Brazil and its ‘BRIC’ Peers

As one of the ‘BRIC’ countries, Brazil is often compared to Russia, India and China as markets with high economic growth, strongly emerging middle classes and significant long-term real estate development potential. These comparisons often only cover the broader real estate segment, leading hotel investors to wonder how the countries’ dynamics affect the hotel sector specifically. We therefore aim to provide a useful analysis of hotel market dynamics in each of these four economic powerhouses and draw comparisons and conclusions using statistical parameters.

Transparency Level of Real Estate Market

Jones Lang LaSalle’s Global Real Estate Transparency Index quantifies real estate market transparency across 81 markets worldwide. Transparency refers in general to the availability market data, the overall legal framework and local law fairness and clarity regarding the transaction process. Categories used to rank the markets include performance management, market fundamentals, number of listed investment vehicles, regulatory and legal environment and transactions process. Scores are assigned from 1 to 5, with 1 representing the highest transparency level.

Brazil’s rank, a measure relevant to lodging development, compares favorably to its ‘BRIC’ peers. Tier I and Tier II cities in Russia are the front runners of the set of countries according to the index, with Brazil following directly thereafter. Brazil ranks ahead of markets in India and China in terms of real estate transparency. Additionally, Brazil has the highest real estate transparency level in Latin America.

Ratio of Existing Hotels to Population

Brazil has the highest number of graded hotel rooms per 1,000 residents of the BRICs, but lags greatly behind the U.S., putting it in perspective just how significant the development potential for hotels will be in Brazil over the next 20 years. Brazil has 1.1 graded hotel room for every 1,000 residents, followed by China, Russia and India. By contrast, there are 15.6 graded rooms for every 1,000 in the U.S. For all of these emerging economies, it is baffling how much headroom there still is for the ratio of hotel rooms to population to reach even one third of the ratio in the U.S.
Brazil Stack Up Overall?

Many an institutional investor will ask themselves how Brazil stacks up against the BRICs overall. This is not an easy comparison, given the vast differences in investment environment in each of the countries. We developed an approach to attempt to capture multiple factors in one matrix. Taking the total number of hotel rooms in each of the countries and multiplying it by the most recent year’s countrywide revenue per available room figure approximates the size of the investable market.

Our methodology also ranks the countries on two axes based on forecasted real gross domestic product growth and the World Bank Group’s most recent Ease of Doing Business rank to capture the level of complexity that international investors face when entering the respective markets.

The sheer size of China’s market is second to none. While accepted terminology continues to refer to the BRICs as a natural grouping of emerging nations, for a variety of reasons, China has moved considerably beyond the other three. Russia, while presenting a number of investment opportunities, is expected to see slower GDP growth than Brazil and as such is positioned below the other BRICs. On the other hand, Russia’s Ease of Doing Business Rank supersedes Brazil’s.

What is remarkable is that Brazil’s market size circle exceeds that of India as there...
are more graded hotel rooms in Brazil, even though India’s population is far larger. The placement of each of the four countries comes with advantages and disadvantages for investors, and investors will target the countries according to their risk appetite, geographic preference, investment hold period and overall strategy.

Source: Jones Lang LaSalle Hotels

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<th>Comparative Hotel Investment Market</th>
<th>Brazil</th>
<th>Russia</th>
<th>India</th>
<th>China</th>
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| **Key Hotel Ownership Groups**    | • Local groups/families with long-term exposure  
• Regional groups with South American focus have begun to emerge  
• A select few U.S.-based investors (i.e. Host Hotels & Resorts) and international equity funds (i.e. Meridia Capital) with focus on gateway cities | • High net worth private capital sources  
• Hotel companies such as Rezidor Hotel Group and the Domina Hotels  
• Developers and property companies | • Hotel owner/operator companies  
• Developers  
• High net worth investors  
• Corporations | • State-owned enterprises, either publicly listed or privately held  
• Hotels are not always core to these businesses |
| **Hotel Transactions Market**     | • The transactions market is in its infancy stages | • The pace of hotel transactions, though far lower than in mature markets, has begun to tick up in recent years | • Investors’ hold period is usually long-term  
• There have only been few reported transactions of operational, institutional grade hotels | • The transactions market in China is in its infancy with the bulk of deals being off-market trades |
| **Reported Hotel Transaction Volume since 2000** | $350 million | $1.7 billion | $1.5 billion | $6.0 billion |

In summary, Brazil has become the most attractive Latin American hotel investment market. Surging domestic demand and seminal international events are dramatically boosting the performance of Brazil’s lodging industry, creating an attractive environment for growth.