

# Investing in Emerging Markets: China, India and Brazil

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## INTRODUCTION

China, India and Brazil are expected to be among the world's largest economies by the year 2050.<sup>1</sup> These countries encompass a significant percentage of the world's land coverage, 30 percent of the world's population and amount to a combined gross domestic product (purchasing power parity) of US\$16.3 trillion dollars. They are among the biggest and fastest-growing emerging markets with significant long-term growth potential.

Combined, they have an expanding middle class which will double in number within three years and reach 800 million people within a decade. This massive rise in the size of the middle class in these nations will create demand for a wide range of economic goods, including real estate. It is reasonable to assume that a huge increase in demand will not be restricted to basic goods but result in greater demand for all consumer segments. High economic growth combined with the enormous populations of these nations will translate into a large aggregation of wealth, creating ever more attractive world markets.

## INVESTING IN INTERNATIONAL REAL ESTATE

Increasing global economic integration makes the opportunities in international real estate investment more compelling than ever before—especially given slower growth in the domestic real estate markets of most developed economies. While traditional international capital flows were largely directed toward U.S. and Western European opportunities, substantial interest has developed for markets in Asia, and more recently, a growing interest in Latin America.

## About the Authors



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Although most capital currently going into international real estate has an “opportunistic” risk/reward structure, we expect that, over the next few years, “value-added” and “core” strategies will follow as comfort with international real estate grows and reduction in portfolio risk becomes more attainable.

The same logic drives investment in international real estate as in domestic real estate: higher returns, portfolio diversification and the ability to hedge inflation. The international dimension also provides two additional factors: potential to invest in an expanded universe of real estate investments and the need to match international asset holdings to the increased international liability exposure of multinational corporate pension funds.

While real estate investing is not without risk, international investing includes two additional risk factors: political and economic. Political risk is concerned with government structure, policy, leadership and stability, conflicts, tensions and war, political parties, and bureaucracy. Economic risk is concerned with the stability of exchange rates and the performance of the economy. The measurement of economic risk is more quantitative, and insight can be obtained from factors such as output growth, inflation, debt, current account balances and exchange rates.

### CHARACTERIZING EMERGING MARKET REAL ESTATE

Real estate in emerging markets, in general, can be characterized as “embryonic and growth oriented.” China, India and Brazil exhibit such characteristics as accelerating market growth, industry potential that substantially exceeds its current volume, and a rapidly growing number of relatively unsophisticated real estate players. Entry into these markets tends to be easy but exiting the market can be more difficult with a weaker legal structure and fewer market players than developed countries. These are young and growing markets. There has been significant property appreciation, which we expect will continue in the near term. All three markets benefit from large national economies and demand based on solid growth fundamentals. There is ample opportunity to innovate and to build market share. The inherent returns in many strategies can be very high.

### CHINA

China’s growth has been breathtaking, with an average annual real GDP growth rate of more than nine percent from 1978 to 2010, faster than that achieved by any East Asian economy during their fastest-growing periods.

China reported a total population of 1.3 billion and GDP of US\$5.89 trillion in 2010. The country’s per capita GDP reached US\$4,400 that year (nominal term). Per capita GDP is as high as US\$9,000 in first-tier cities: that is, Beijing, Shanghai and Guangzhou. However, Chinese economic development has been uneven among regions. The western regions of the country remain relatively undeveloped while the eastern regions tend to be much more industrialized.

While China has a huge population, it is also one of the fastest-aging populations due to the one-child policy and increasing longevity of the elderly. Despite the slowing labor force growth, there will be an ongoing increase in human capital accumulation. Advances in human capital investment and educational attainment of the general population have boomed.

We believe that one of the keys to sustaining long-term growth will be the gradual shift of the Chinese economy away from exports and towards more domestic, demand-driven growth. To facilitate this, China will gradually let its currency appreciate, thereby making imports more affordable for Chinese consumers. It will also likely develop its consumer market as well as its consumer financial services sector to facilitate a wider range of consumer credit products available to average Chinese households. The expanded use of credit cards would likely spur retail demand and imports, while long-term affordable mortgages will boost housing demand and the concomitant accoutrements associated with home ownership.

China represents a significant opportunity in real estate investment. All of the main drivers of real estate demand are strong—economic growth, demographics, urbanization, rising per capita and household incomes, domestic investment as well as foreign direct investment (FDI). China is moving along a path of (albeit sometimes uneven) economic development, liberalization and privatization. Opportunities abound in both the primary markets and increasingly the secondary markets.

There are dangers of speculative excess. Additionally, some developers operate largely on a cash basis, declaring little profit for the tax authorities. Another risk is that the legal and institutional framework is vague and seemingly arbitrary in terms of real estate rights, title, and investment regulations. Perhaps the biggest risk currently involves laws governing real estate, particularly real estate FDI. The changes to real estate FDI in July 2006 radically altered the rules of the game for investment by foreigners.

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This was done with virtually no warning. This kind of unforeseen, rapid-fire changing of the rules has the potential to wreak havoc on investment. Working with established in-country partners and trusted consultants is fundamental to helping mitigate these risks.

In the coming years, growth is expected to be driven less by fixed-asset investment and more through consumer spending. Real estate investment is expected to become more dispersed around the country. Urbanization will be a key driver of real estate. Estimates on urban population growth reach 200 million new urban residents by 2015, when 60 percent of the population is predicted to reside in urban areas.<sup>2</sup> This growth would fuel demand for housing, consumer goods and infrastructure. The consumer class is expected to grow prodigiously with higher wages and a declining savings rate.

The lack of sufficient investment-grade properties is one of the main barriers to investing in China. There is the greatest potential in the second-tier cities, but much of this will have to be through development as there are few investment-grade properties to be purchased. The tax regime including lack of predictability, differing tax structures (local, regional, provincial, national), and high capital gains often forces investors to buy out the shares of an existing property holder so as not to affect the transfer of the property itself. This practice exposes the buyer to additional risk and due diligence requirements. Finding a domestic Chinese real estate partner is a key challenge, given potential nonalignment of competencies, interests and reputation. However, Chinese development partners are continually improving in skills and sophistication. This means that much investment will be value-add or new development—moving investment up the risk curve from simply core investment. Repatriation of profits has become easier and less risky over the past years with the implementation of State Administration of Foreign Exchange (SAFE) regulations; however, SAFE registration has slowed the acquisition process, which has made pursuit of prime properties (given shorter acquisition periods) more difficult.

China's real estate sector is highly fragmented—even the largest developer does not command a market share of more than 10 percent in any given city. Most local developers come from non-real estate backgrounds such as manufacturing or heavy industry. This is a result of those companies' accessibility to land and financing. Due to the rapid rate of urbanization, many highly labor-inten-

sive factories and plants are located in prime locations. The closure, relocation and redevelopment of these locations represent one of the major themes in Chinese real estate over the last 10 years.

It is likely that investment capital will continue to flow into the real estate sector unless performance of the equities market dramatically improves. Over the past decade, about 80 percent of all real estate investment in China has been directed into the residential sector. Since 2001, however, commercial and other types of real estate have gained investment share—a trend that is expected to continue. Policies encouraging home ownership and liberal lending enabled investment in the residential sector to increase more than six times from 2000 to 2008, while over that same period investment in commercial real estate increased about four times.

Concerns about overheated real estate markets and speculative bubbles have prompted the Chinese government to take measures since the end of the recession to cool down the real estate markets. The government has increased the interest rate and enabled the renminbi, China's currency, to appreciate against foreign currencies to cool inflation pressures.

### INDIA

Since 2003 India has been one of the fastest-growing major economies in the world, leading to rapid increases in per capita income, increasing demand and integration with the world economy. India has made structural reforms that have led to its growing prowess in certain sectors of the service economy as well. Should the government maintain a growth orientation with respect to economic policy, trade and globalization, India's GDP in dollar terms could surpass that of the United States by 2050, making it the world's second-largest economy.

The increase in service and manufacturing productivity has been a large component of India's surging GDP. The gradual opening up of the economy introduced competition that forced the private sector to restructure, emerging leaner and more competitive. Leading this change have been international trade, financial sector growth, and the spread and adoption of information technology.

The 21st century will likely see a majority of India's population living in urban areas for the first time in history. India has 10 of the 30 fastest-growing cities in the world and is witnessing rapid urbanization. This is

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happening not only in the larger cities, but in small and mid-size cities as well. We believe India's rapid urbanization has implications for demand in housing, urban infrastructure, and location of offices, retail and hotels. The increasing expenditures in infrastructure will likely drive growth in the transportation sector, spur demand for vehicles, contribute to increasing real estate values along road corridors, and boost suburban growth—the natural next phase of urbanization.

The Indian property market differs significantly from many other markets in the world, and investment strategy and decisions must be adjusted accordingly. The Indian market is extremely large, diverse, complex, fragmented, and experiencing rapid growth. It is also rather undeveloped at this time. The economy is growing, and demand for many types of real estate is strong around the country, albeit concentrated in a handful of cities.

The playing field appears open for a variety of investment and development strategies. There are relatively few major foreign players in the office space, retail (shopping centers/malls), hospitality (hotels/serviced apartments), IT/business parks, and industrial/logistics/warehousing sectors, and limited foreign presence in for-sale residential.

The fundamental growth factors that drive real estate are strong. GDP growth, exports (current account), foreign direct investment, urban growth, population growth, income growth (particularly the middle class), increasing disposable incomes—all portend greater real estate demand and increasing market segmentation. Moreover, the market has been rather artificially constrained because the many regulatory barriers that have been erected for so long greatly limited foreign competition. These have only recently been reduced or removed or are in the process of being scaled back. There is pent-up, unfulfilled demand in several sectors that the domestic real estate market alone has not been able to fulfill.

With the change in FDI regulation, the continuing strength of the Indian economy, and the ongoing improvements to infrastructure, India could be entering a phase of even stronger, deeper and more diversified growth in the real estate industry. In fact the real estate sector is booming, growing at a rate of about 30 percent per year.

The sectors with the greatest opportunity currently seem to be residential, hotel/hospitality and office/R&D. In all

three sectors foreign investors would enjoy advantages in expertise, development standards and capital strength. According to industry players, the housing sector makes up 4.5 percent of GDP, with urban housing accounting for 3.1 percent.

Real estate markets continue to gather momentum in all major areas of the country. Mumbai, Delhi, Bangalore, Chennai, and Hyderabad continue to attract interest from IT and high-tech (domestic and multinational) companies that are either establishing a base in these places or are looking for expansion. Driven by the IT/ITES/BPO<sup>3</sup> demand, the suburban locations are witnessing the most development: the suburban business districts of Mumbai, Delhi, Bangalore and Chennai are all seeing brisk development activity due to easier availability of land, construction of larger floor plates, and offers of build-to-suit facilities.

India lags far behind other developing countries in terms of the contribution from real estate (development and construction) to its GDP. Very low labor productivity in the residential sector reflects low capital investment and a marginalized sector with little international competition. In proportion to the size of its economy, its record of strong economic growth, domestic and international demand, the real estate sector appears to have significant potential for growth. In fact, more than half the FDI inflows into China are in the real estate sector compared to less than one-tenth of one percent for India.

### **BRAZIL**

Brazil is forecast to be among the world's fastest-growing economies for the next several decades. By 2050, Brazil is predicted to be the world's fifth-largest economy. The country possesses vast natural resources, sizable pools of labor, growing productivity and high investment rates. Unlike most other Latin American economies, its debt position has improved, having moved from the world's largest emerging market debtor to a net foreign creditor by 2008. Since the early 2000s, Brazil has made great progress towards putting into place the foundations for growth, with particular emphasis on achieving macroeconomic stability. Brazil's growth rate has lagged behind that of China and of India in part because of the stabilization measures, which have acted as a drag on the economy, but nevertheless should serve as a strong foundation for future growth.

The economy still remains relatively less open to trade compared with other fast-growing emerging market

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countries. Brazil has gradually been opening up its markets and lifted barriers to trade. While still primarily a domestically-focused economy, a boom in the global demand for raw materials and increased openness pushed the share of imports and exports to a quarter of GDP in 2007. Going forward, a combination of capital accumulation, population growth, and total factor productivity should continue to boost growth. In terms of productivity, increased human capital associated with a growing middle class should be a significant driver of economic expansion. We believe this should help move Brazil rapidly up the value chain in terms of its commodity and raw materials sector and further expand its manufacturing base.

Brazil benefits from a large and expanding economy, a growing urban population and youthful demographic profile, expanding real estate market capitalization, lessened levels of systemic market risk, and proven political and financial stability. Furthermore, strong capital appreciation and high rental growth rates were recorded in real estate markets of the country during its economic recovery from 2004 through the middle of 2008. Following Brazil's quick recovery from the global recession, rental growth has returned and we believe that this strong performance will likely continue.

Brazil can be characterized as a growth-oriented market. There is ample opportunity to innovate and to build market share. The inherent returns in many strategies can be very high. The country represents an enormous opportunity; however, there are many risks having to do with market strategy, location and timing. Investment has been largely focused in the primary markets of Rio de Janeiro and São Paulo; however, secondary markets also offer compelling growth dynamics.

The for-sale residential industry has boomed in recent years and should enjoy healthy fundamentals as demand outstrips supply. Mass housing development in the for-sale category should continue to do well as Brazilians have little propensity to participate in the rental market. We believe that home builders targeting developments in well-located submarkets of first- and second-tier cities should continue to do well in the coming years.<sup>4</sup>

The industrial sector is dominated by owner-occupiers. Build-to-suit and sale-leaseback are potential opportunities, especially when credit-worthy tenants present opportunities to outsource the management of their buildings. New infrastructure—ports, airports and ring roads—is

being developed/planned throughout Brazil on a massive scale. The development of distribution facilities at strategic locations relative to this new infrastructure will likely be necessary. Despite the short-term slump in foreign trade caused by the global economic downturn, exports and imports are expected to continue growing at a very fast pace once the downturn is over. Given the increasing volume of imports expected (partly due to a wealthier population and rising consumption levels), logistics facilities near the main centers of population and located on key infrastructure should respond well to demand. Average asking rents grew by 15.6 percent in 2010 in Rio de Janeiro according to Cushman & Wakefield, and prime A rents in industrial parks in São Paulo increased by nine percent, according to CB Richard Ellis Group (CBRE). Supply will likely increase but robust demand and the scarce international standard supply will likely continue to push rents up and cap rates down.

For the office sector, strong rent growth and capital appreciation characterized the main markets over the period 2006 to 2008. Rents were resilient in both Rio de Janeiro and São Paulo during the downturn. According to Cushman & Wakefield, rents increased by 25 percent in 2010 in both markets. This was led by a jump of more than 40 percent in average rents in Rio de Janeiro. Although the specific figure varies by broker, 2010 was a strong year for office rents in Brazil, especially for Rio de Janeiro, which represents a more local demand and a very constrained market. In the first half of 2011 rents grew by 13.5 percent compared to 1H 2010, ending the quarter at an average R\$68.6/square meter/month (US\$47/square foot/year).<sup>5</sup>

Supply and demand fundamentals vary widely by office submarket and must be considered closely. Currently, vacancy rates are at relatively low levels in Rio de Janeiro and São Paulo. Vacancy rates are traditionally lower in Rio de Janeiro, which is a smaller market and is constricted geographically. The vacancy rate in São Paulo fell to 3.8 percent in 1Q 2011 (CBRE), the lowest on record, and was at three percent in Rio de Janeiro (slightly up from year-end levels due to new deliveries). Prime properties with credit-worthy tenants are likely to perform well in the medium and long terms. Retrofitted buildings, especially in the highly constrained markets with out-of-date supply, may provide good opportunities. The market could be entered through co-development and retrofit strategies. For European or North American multinational tenants (where environmental considera-

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tions may matter in home jurisdictions), there may be a premium to be paid for a “greener” building in Brazil, as there are very few of these currently.

Retail confidence and sales continue to be much more robust in Brazil than in other major markets. Brazil still has an overall shopping center penetration ratio (gross lettable area per capita) that is quite low considering the average purchasing power of its consumers. Those municipalities and states that have low current shopping center penetration relative to their size and wealth have been identified for development through joint venture “JV” with local partners. Additionally, the middle class is growing and becoming wealthier, which will likely expand the consumer base of shopping centers. Smaller malls, anchored with grocery chains or department stores, could do well in smaller, second-tier cities, which are currently underserved. We believe the continued expansion of the middle class and the home-building boom suggests that shopping centers located near areas of high population growth, and with the appropriate tenant mix serving new household formation, might do well. ■

*Editor's Note: This article is based on the book Emerging Market Real Estate Investment: Investing in China, India, and Brazil (John Wiley & Sons, Inc.) written by David J. Lynn, Ph.D., CRE; and Tim Wang, Ph.D.*

## ENDNOTES

1. Goldman Sachs, *Dreaming with the BRICs: The Path to 2050*, Global Economic Paper No. 99. 2003.
2. World Bank, Urban Development and China, <http://go.worldbank.org/LHTNOP9GU0>.
3. IT/ITES/BPO stands for information technology, information technology enabled service, and business process outsourcing.
4. Especially given the very favorable political and financial environments, which are highly supportive of homeownership.
5. Cushman & Wakefield, *MarketBeat* 2Q11, Brazil Offices.

Investors looking for international or emerging markets tend to stick to international funds or ADRs from the so-called BRIC nations of Brazil, Russia, India and China. But not all BRICs are created equal. China and Russia have impressive growth rates, but you have to be more selective in these markets. China is probably too reliant on stimulus money to boost its economy, and there's evidence of a growing Chinese bubble. Russia requires you to put your faith in a corrupt oligarchy. Sooner or later, China and Russia are more likely to suffer from these excesses than their BRIC colleagues, Brazil