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Tourism Real Estate Market in Northeast Brazil

Diogo Canteras
Raymond Smith
Cristiano Vasques
Gustavo Moura
Renato Moraes

HVS São Paulo
Av. Brig. Faria Lima, 1912 – Conj. 20J
01452-000 São Paulo – SP, Brasil
+55 11 3093-2743
+55 11 3093-2783 (Fax)

Newmark Knight Frank
Rua George Eastman, 160 – 8º andar
05690-000 São Paulo – SP, Brasil
+55 11 3755-8888

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INTRODUCTION

This article is focused on the Tourism Real Estate in Northeast Brazil, a market that evolved swiftly in the past few years as the result of worldwide cheap capital availability, improved tourism destinations, perceived investment potential, a favorable exchange rate and low Brazilian asset prices.

The information, analyses and conclusions presented herein are the result of an extensive researched carried out by HVS and Newmark Knight Frank on behalf of ADIT –NE (Association for the Development of the Tourism Real Estate Market in Northeast Brazil). The Association's goal is to provide relevant information and analyses to government authorities, investors and developers, in order to assist planning and decision making. The research included vast secondary data collection, field works all over the Northeastern cost and more than 70 interviews with developers, government authorities, brokers, consultant and investors. Its main findings were presented in Nordeste Invest 2008 (an industry meeting). The complete research and findings will be published by ADIT-NE soon.

This article has six sections apart from this introduction. The first two sections present our definition of the tourism real estate market and shows current market data and projections of supply and demand for residential units in tourism real estate developments. The third and fourth sections present the resort market's performance as well as project supply and demand for resort rooms. The fifth and sixth sections discuss the drivers affecting the tourism real estate market in Brazil, draw some conclusion and provide recommendations for industry stakeholders.

THE TOURISM REAL ESTATE MARKET

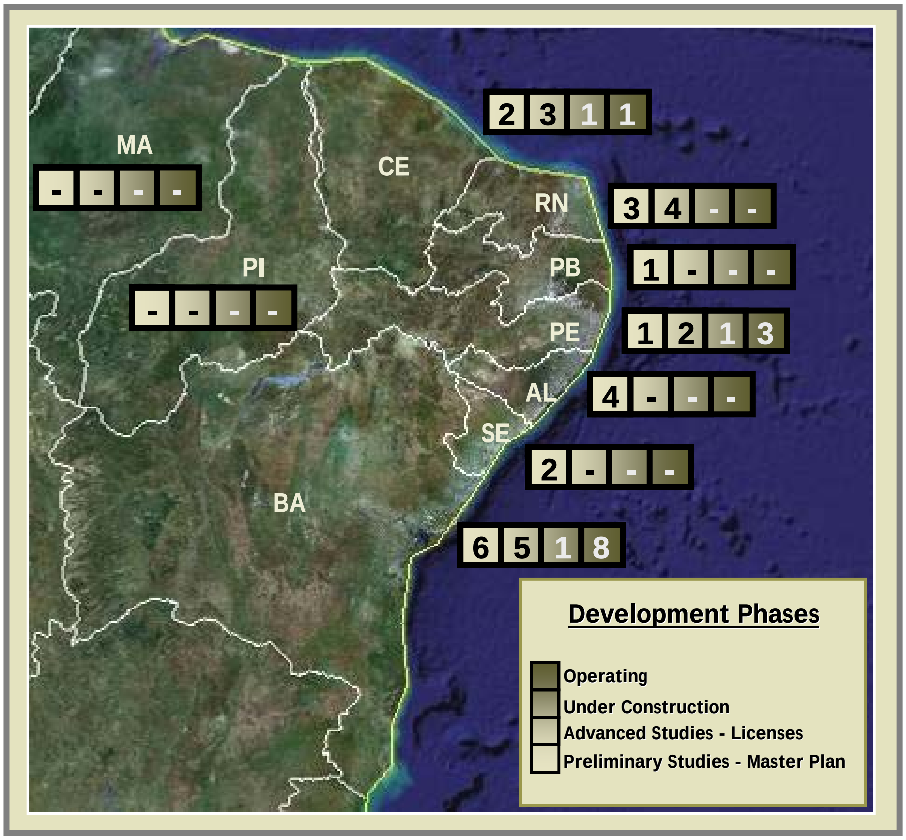
Tourism real estate properties are those located at desired tourist destinations, composed by second-home units and large tourism and leisure facilities such as hotels, parks, marinas, golf courses, etc. These facilities enhance tourist experience, induce tourist flows and provide services to guests and owners. Therefore, they improve desirability and leverage prices and sales speed of residential units. Although the operation of such facilities may be unprofitable, the value they add usually increases the projects' overall value.

There are 48 tourism real estate complexes operating or under-development in Northeast Brazil (see picture 1). The stock of residential units and land plots in tourism real estate developments locates in Northeast Brazil amount approximately 1,900 units. In the past three years, sales speed ranged from 20 to 100 units annually, per project. Sales were phased in blocks of 100 to 300 units (most frequently from 100 to 150).

Second-home sales prices per square meter of built area ranges from R$ 2.500,00 to R$ 3.500,00 for *midmarket* products or products in less desired locations; from R$ 3.500,00 to R$ 5.000,00 for *upscale* products; and from R$ 5.000,00 to R$ 7.000,00 in *high-end* products. Comparing to other countries, Northeastern-Brazil prices are still low (although in accordance with the national reality) as demonstrated in picture 2. Land sales prices per linear beach-front meters vary significantly, as shown in picture 3. Destination attractiveness and stage of development explain part of the price variations. Some of the most attractive and expensive destinations in Northeast Brazil are Pipa (RN); Porto de Galinhas (PE); Maraú (BA); Itacaré (BA); and Trancoso (BA).

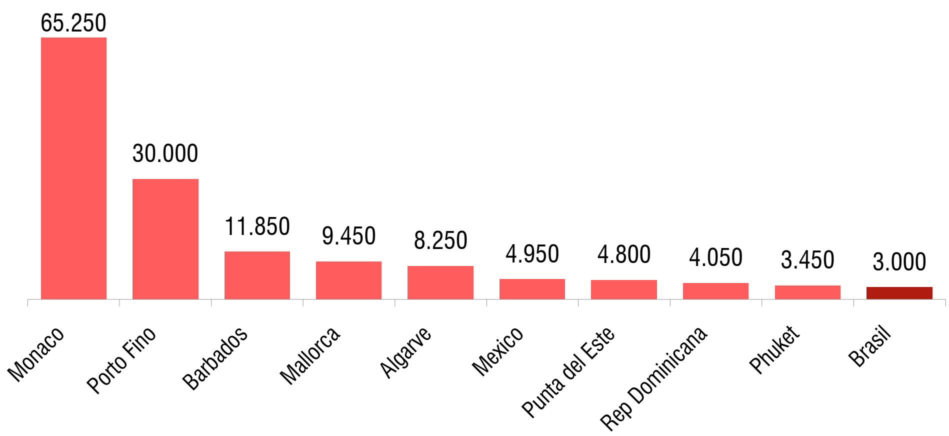
During the past seven years, there has been a great increase in land sales price. Currently the perception is that prices are overvalued, given the expected revenue and sales speed of residential units in tourism real estate projects.

Picture 1 –Tourism Real Estate Projects – Stage of Development – Northeast Brazil



Source: Newmark Knight Frank, HVS, 2008.

Picture 2 – Average Luxury Second Residence Sales Price (US$ / m²)



Source: Knight Frank, 2008

Picture 3 – Land Sales Price – Northeast Brazil (US$ / beach front linear meter)

Source: Newmark Knight Frank, 2008.

SUPPLY AND DEMAND FORECAST

In the first half of 2008, the aggregate announced supply of planned tourism real estate projects totalled over 78 thousand residential units. We estimate, however, that only about 7 thousand units will be built by 2014.

Our forecasts are subject to the following assumptions:

- Average annual GDP growth of 4% to 5% and achievement of inflation targets throughout the projection period.
- Resumption of North American and European economic growth in tandem with the end of the financial crisis, starting in the second half of 2009.
- Absence of new domestic or international economic crises.
- Maintenance of Brazil's current tourism development strategy in federal and state level.

Additionally, our forecasts took into consideration the following information:

- Existing supply took 30 years to develop and amount only 1900 units, and sales speed in the past years was somewhat limited (as stated previously), even with very favorable market conditions.
- Although there has been an increase in foreign demand, it has been significantly lower than most expectations, even in a favorable environment. In the short-term, there are factors (such as the international financial crisis) that will hinder foreign

demand. In the mid-term, foreign demand should increase again, but there are no signs that such demand will be much higher than the previously observed or high enough to absorb the announced supply of residential units.

- Traditionally, large developments take several years to build and sell all residential units, as they are usually developed in small phases. If any phase underperforms (sells slowly or at low prices), subsequent phases are suspended until market conditions improve. Thus, the market mechanisms prevent supply growing faster than demand in normal times.

Based on this information and on the individual analysis of all existing projects, we developed a forecast of supply and demand for a seven year period. This time span reflects our estimation of the period required for projects under development to finish at least their first or current phase.

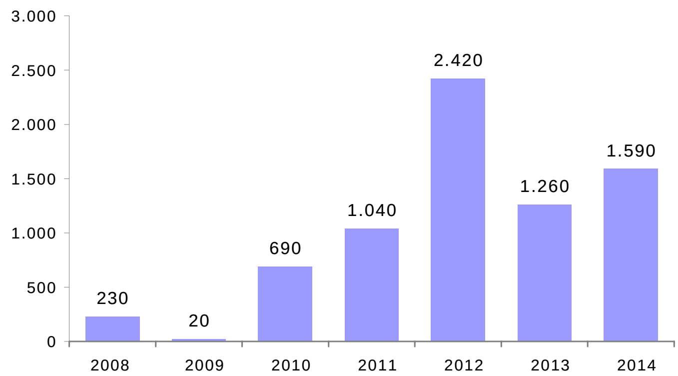
Given the close relationship between supply and demand, we expect future demand for tourism real estate residential units in Northeastern Brazil will be sufficient to absorb the projected supply.

This expectation (base scenario) is represented by the blue line in Picture 5. This Picture also presents demand forecasts for two extreme alternative scenarios. The occurrence of these scenarios is subject to the behavior of the following variables: exchange rates, air-travel accessibility, financing availability, the international promotion of Brazil's tourism industry.

The optimistic scenario assumes the exchange rate will rise and stay at relatively high levels, making the Brazilian product cheaper for international buyers. This increased competitiveness along with investment in infrastructure and marketing will increase attractiveness and air-travel accessibility. Simultaneously, the end of the international financial crisis and resumption of international growth will foster the availability of finance.

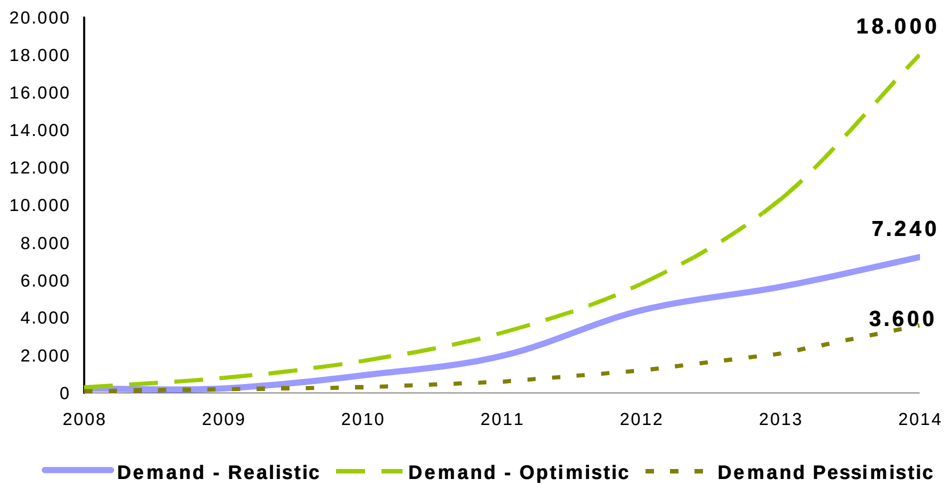
The pessimistic scenario assumes the overvalued local currency, the lack of investment in infrastructure and promotion, and the absence of financing options, will make Brazil unattractive for international buyers. Consequently, the tourism real estate market becomes exclusively dependant on the domestic demand, which would rise as the result of the expected economic growth.

Picture 4 –New Residential Units Built in Tourism Real Estate Properties – Forecast – Northeast Brazil



Source: Newmark Knight Frank, HVS, 2008.

Picture 5 – New Demand for Tourism Real Estate Residential Units – Forecast



Source: Newmark Knight Frank, HVS, 2008.

RESORTS MARKET IN NORTHEAST BRAZIL

The resort hotel is an essential element in tourism real estate properties. Its commercial efforts provide guest flows even during the low season. Resort guests create a pleasant sensation of a living environment (in contrast with a deserted location). Guests are also potential buyers of the residential units. The resort's management structure participates in the management and rental of residential units and provides services such as food & beverage, maintenance and cleaning. The resort's brand, its services and leisure facilities add desirability that can be converted in higher real estate prices and sales speed.

According to Resorts Brazil (Brazilian Association of Resorts), the aggregate performance of resorts in Brazil has been showing a declining trend (see picture 6).

The following factors affected the performance of resorts:

- Local currency appreciation hindered the demand for resorts, as Brazil became more expensive than other international destinations, fostering outbound flows and hampering inbound flows;
- Domestic air-travel crisis which limited access to resorts in the Northeast;
- A significant increase in supply over the past five years resulting in increased competition which put downward pressures on prices;
- The opening of new, more competitive resorts implied market share changes, affecting existing resorts;
- Decreasing cruise prices redirected some of the potential demand for resorts to cruises.

Of the above-mentioned factors, we believe the local currency appreciation is a major driver of the declining performance of resorts.

Picture 7 shows an example of how domestic travel became more expensive than alternative international destinations, such as The Caribbean. In an attempt to maintain competitiveness, resort managers have been lowering average rates. Nevertheless, occupancy rates have continued to fall.

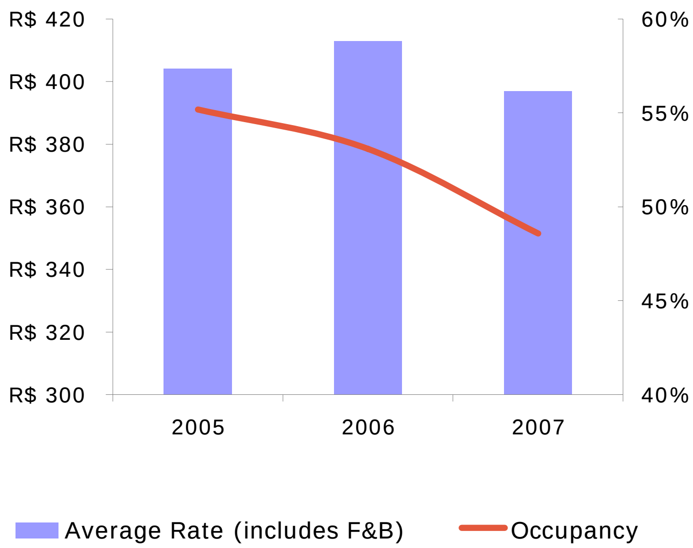
RESORT SUPPLY AND DEMAND FORECAST

Since the presence of resort hotels in tourism real estate projects increases price and sales speed, it makes sense to build them even if they are not profitable on their own. This factor explains why developers continue to include large resort hotels in their projects, despite current market conditions. These developers try to find co-investors willing to assume the resort development risk without sharing the profits of the residential units' sales. Since it is not easy to find such co-investors, it is reasonable to assume the new supply will be significantly smaller than announced by developers. On the other hand, some new, smaller resorts will be developed as they are an important part of the business model.

Picture 8 shows our estimated construction pipeline for resort rooms in tourism real estate properties from 2008 to 2014. Some 4,200 new rooms are expected, representing a 55% increase over the current supply of 7,650 rooms in the northeast region.

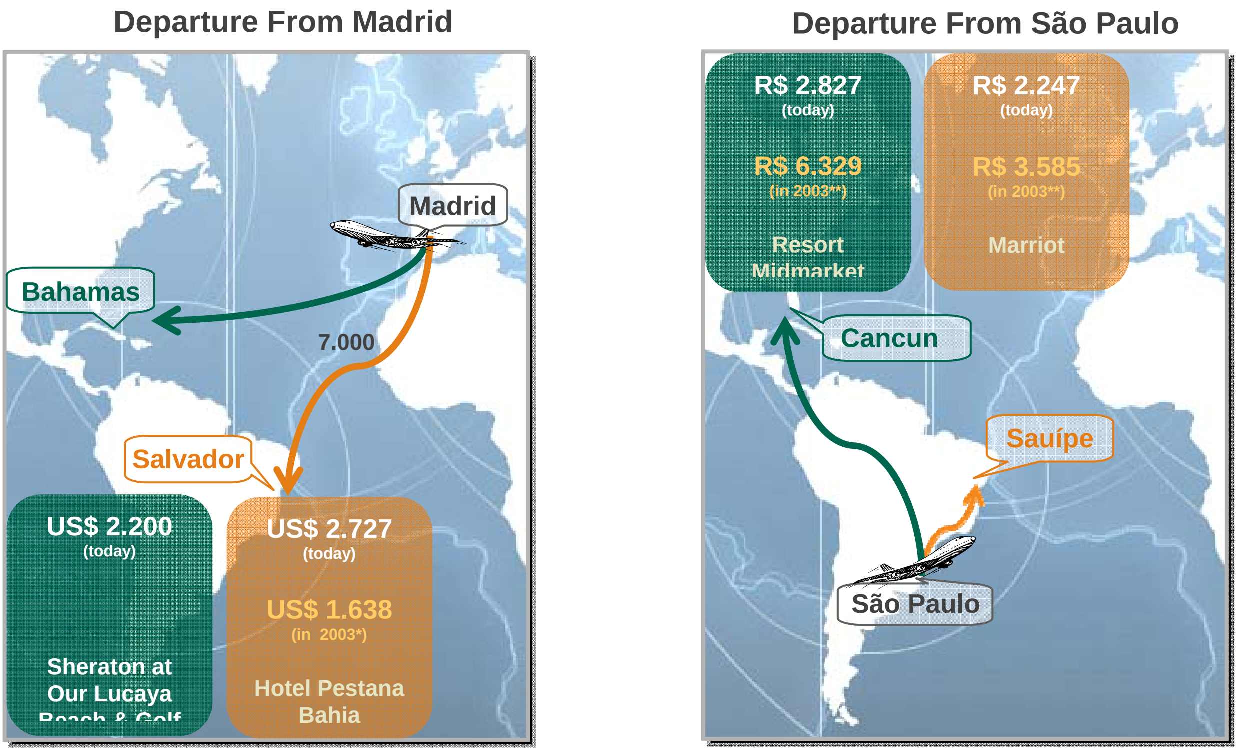
According to the previously described base scenario and to our supply and demand forecasts, if macroeconomic conditions remain the same, the midscale and upscale resort markets are unlikely to recover significantly during the next few years.

Picture 6 – Resort Market Performance – Brazil – 2005 a 2007



Source: Resorts Brasil.

Picture 7 – Travel Package Comparisons



Source: Cheapticket

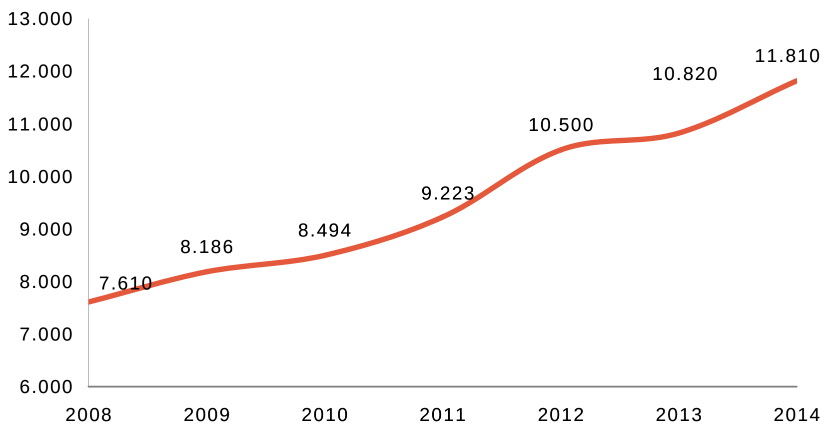
Source: Revista Viagem, mai/08 and dec/02

* Nominal Value

** Value Updated to 2008 Currency (valor real)

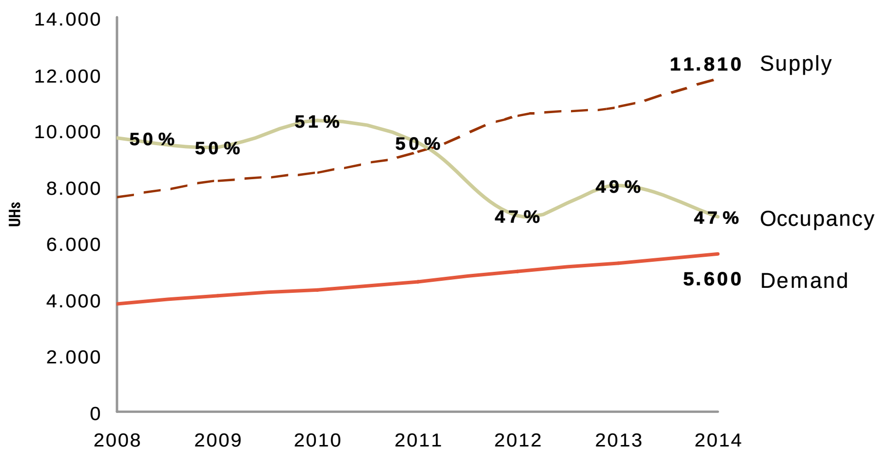
Source: HVS, 2008.

Picture 8 – Resort Rooms Supply Forecasts – Northeast Brazil – 2008 to 2014



Source: Newmark Knight Frank, HVS, 2008.

Picture 9 – Resort Demand and Occupancy Forecasts – Northeast Brazil – 2008 to 2014



Source: HVS, 2008.

MARKET DRIVERS

The following drivers play an important role in determining the tourism real estate market's size and characteristics: demography, cultural behavior, economic development, exchange rates, the state of the financial markets, the legal framework, and the development of tourist destinations. Each of these drivers has positive or negative effects, resulting in a favorable, neutral or adverse situation.

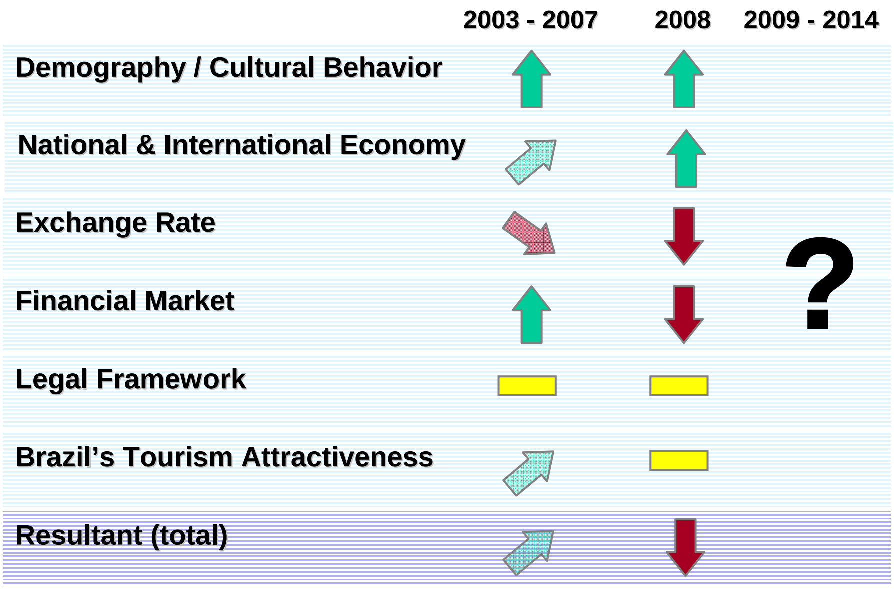
From 2003 to 2007, the market driver's overall effect was positive, despite the declining exchange rate and the troubles faced with licensing authorities. In this period, there has been strong and continuous worldwide economic growth and high capital availability, coinciding with the improved quality and management of Brazil's tourist destinations. In that environment, most of the tourism real estate projects currently under development or planning were started.

After 2008, however, market drivers' behaviors have become uncertain. The length and intensity of the negative effects caused by the credit crunch on the global economy are still unknown. Brazil's ability to maintain positive economic trends despite global turmoil is also unsure, and there are no agreed views on the exchange rate path. On the other hand, there are mid-term and long-term demographic and economic trends that indicate strong demand growth potential in the future.

Our expectations are of reduced market activity for the next few years, followed by a recovery of the world economy and global financial markets which will create much better conditions overall for the sales of second homes , and eventually for an increase in Brazil's market share.

As the market factors evolve in the future, they may or may not confirm the outlook and projections presented in this article. For that reason it is vital to closely track the behavior of the drivers we have identified in order to understand the market's future trends and to adjust development strategy if new scenarios arise.

Picture 10 – Tourism Real Estate Market Drivers



Source: Newmark Knight Frank, HVS, 2008.

CONCLUSIONS AND RECOMMENDATIONS

The study undertaken by HVS and Newmark Knight Frank indicates that the tourism real estate market in Northeast Brazil is still incipient. Although the current low supply and demand levels observed might change in the future, it is evident that expectations which existed until recently were excessively optimistic.

The economic and financial scenarios that emerged after the housing bubble burst interrupted the cycle in which Brazil was increasing its penetration in the world's tourism real estate market. Nevertheless, a new cycle is likely to emerge in the mid-term, possibly resulting in a better structured and more promising development process.

In the short-term, domestic demand maintains its predominant position with positive perspectives, given Brazil's current economic situation.

The market will consolidate with the disappearance of speculators and poorly structured projects, to be replaced by well planned, adequately financed projects, developed by experienced groups. Demand for land is likely to diminish as is the number of projects being submitted to the licensing authorities.

This environment provides an excellent opportunity for the tourism real estate market to grow in a more orderly fashion, avoiding repeated mistakes. If market players take proper advantage of the market's retraction period, exacerbated expectations and counter-productive practices and will be less likely in future development cycles. In that context, ADIT's important role is to foster industry integration, by promoting meetings, conducting studies and encouraging the adoption of best-practices.

Our recommendations to improve market practices for this sector are as follows:

Developers and Investors

Constantly and consistently monitor market drives in order to identify opportunities and develop adequate strategies.

Use long-term, low-cost capital for the acquisition of land. The implementation of tourism real estate properties may take several years to be completed. Only during the construction phase, can the use of shorter-term and higher-cost capital be considered.

Know the land's true potential before buying to ensure that the envisaged development is feasible. Obtain "purchase options" before studying land and market potential. Buy the land only after doing these studies.

Do not take risks when designing the master plan. The project's feasibility must not depend on critical elements which may be difficult to approve.

Seek strategic partnerships which add to your own capabilities. Consider participating in other projects instead of developing alone. There are many opportunities for this at present.

Choose an attractive destination, with good perspectives, and invest in local amenities as well as in the project itself. Less attractive or less well structured destinations demand longer development periods and require greater investment in promotion and infrastructure.

Be cautious when choosing leisure facilities. Know your target-segment and use adequate facilities. Size the resorts knowing the markets perspectives.

Government Authorities

Understand the role of tourism real estate projects in the state's tourism development strategy, and foster the completion of such projects, allowing them to be implemented under strict regulation but without unnecessary delays.

Perform ecological and economical land zoning for the state's coast, and define regions which are adequate for the development of tourism real estate properties and where these properties are permitted and encouraged.

Demand investment initiatives from developers, in order to enhance local communities' life quality of and visitors' leisure experience.

Licensing Authorities

Create conditions for developers willing to fully adhere to best practices and regulation to approve projects more swiftly.

Make clear the main practices and principles inherent to the licensing process, through technical manuals and industry consultations.

Prepare public environmental agents and private consultants so that they are able to disseminate best practices and provide services which are in accordance with the views of the licensing authorities.

ABOUT HVS

Founded in 1980, HVS is the world's leading specialist hotel and hospitality consultancy. With more than 20 offices globally, HVS offers unparalleled international hotel and hospitality market expertise. Worldwide, the firm has acted on over 15,000 assignments in over 60 countries, providing up-to-date knowledge of all of the world's key markets. HVS literally wrote the book on how to appraise a hotel, available through the American Appraisal Institute. Numerous articles and surveys written by our consultants are published each year, both on a regional and a global basis.

HVS São Paulo has been performing feasibility analysis, market studies, business plans, and appraisals reports for hotels in Latin America and Africa since 1998. It has also been assisting the implementation of tourism-real estate projects in Northeast Brazil since 2002. It has also been responsible for the elaboration of tourism development strategic plans for the States of Bahia and Maranhão and for the Itacaré-BA region.

HVS São Paulo is also the co-creator and the investment manager of Hotel Maxinvest Real Estate Investment Fund.

ABOUT NEWMARK KNIGHT FRANK

Newmark Knight Frank is one of the largest independent real estate service firms in the world. It provides comprehensive real estate solutions to many of the most prominent corporations, property owners, investors and developers across the globe. New York-based Newmark Knight Frank and London-headquartered partner Knight Frank operate over 165 offices in established and emerging property markets on six continents. With a staff of 5,300 employees, it has created an effective global platform from which to serve the property needs of our growing list of clients. Additionally, Newmark Knight Frank serves as leasing agent and/or property manager for 100 million square feet of commercial space in the United States and other countries.

Newmark Knight Frank expanded its operation into Latin American in April of 2006 and offers complete coverage of the entire South American continent as well as Mexico. Headquartered in São Paulo, Brazil, the firm has additional Brazilian offices in Rio de Janeiro, Brasília, Belo Horizonte and Curitiba; as well as offices across the continent in key major markets including Buenos Aires, Argentina; Lima, Peru; and Santiago, Chile

The company has along-term reputation in the development and brokerage of luxury second residences all over the world. Its services in this specific area include consulting, product conceptualization and sales.

AUTHORS

HVS

Diogo Canteras
Managing Director

Cristiano Vasques
Sênior Consultant

Gustavo Moura
Consultant

Renato Moraes
Consultant

Newmark Knight Frank

Raymond Smith
Director

For additional information, please contact us:
Diogo Canteras: dcanteras@hvs.com
Or visit our website: www.hvs.com

Raymond Smith: rhwsmith@uol.com.br