The next wave

Thanks to regulatory changes and market conditions, Latin America's institutional investors are expected to drive an influx of capital into global real estate, with a primary focus on the US. By Evelyn Lee

Last month, regulatory developments in two Latin American countries gave international real estate managers reason to cheer.

Early last month [May], the Colombian Ministry of Finance passed a decree that would allow the country's pension funds to increase their domestic and international allocation limits to alternatives. Partly because of currency volatility in Colombia, pension plans had reached their international allocation limits to alternatives in recent years, but still had room within their domestic allocation limits. Combining the alternatives allocation limits into one would free up more capital for the institutions to invest offshore.

The reforms also called for establishing real estate as a separate investment category. Previously, real estate funds were part of an institution's private equity bucket, but under the newly approved changes, now will be classified as an alternative investment that will compete with other alternatives for a larger 20 percent to 25 percent allocation.

The decree "made it more flexible to invest in real estate private equity funds," said Santiago Montenegro, president of ASOFONDOS (Asociación Colombiana de Administradoras de Fondos de Pensiones y de Cesantía), which represents Colombia's four private pension funds. Moreover, "investments in REITs and other schemes of collective investments in foreign real estate are now a new possibility."

As Montenegro explained: "the recent fall in oil prices and its negative impact on the exchange rate and several Colombian assets created the necessity of searching new ways of profitability and portfolio diversification for Colombian private pension funds."

Under the new regulation, Colombian pension funds can now allocate up to COP$7.2 trillion ($2.35 billion; €2.1 billion) of their total portfolio to real estate which will represent a $163.27 million increase in the near term, according to Montenegro. He added that the allocation to real estate funds could grow depending on the increase in profits that could be generated from the new portfolio diversification.

"We believe that the regulatory change in Colombia is very positive for alternatives in general and for real estate in particular," said Daniel Navajas, the Santiago, Chile-based head of the institutional business at Compass Group, an investment advisory firm focused on Latin America.

Meanwhile, in Chile, a proposal to modify pension fund regulations is being presented in Congress. One of the goals of the proposal is to give Chilean pension funds more flexibility to invest in alternative investments. Current regulations establish limits just for equities and fixed income, but the proposal would include establishing a specific limit for alternative investments.

"International real estate might become more appealing for Chilean and Colombian pension funds, in light of recent changes in local regulation," said Navajas.

And in other proposed regulatory reforms in the region, Peru's Superintendencia de Banco y Seguros is currently considering a change in the way that local pension funds' allocations to alternatives are calculated. Previously, those calculations were based on the amount committed, but now will be based on the current mark-to-market value of the capital deployed, plus a proportion of the unfunded commitment depending on the remaining investment period. This would effectively increase the amount of capital that the pension funds would have available to invest in alternative assets, including real estate.

Talking billions

These regulatory reforms are expected to help unleash a wave of capital out of Latin America and into real estate abroad, and within a matter of months. Alfonso Vargas Rojas, director at FIRSTavenue, a London-based placement agent and investment advisory firm, noted some institutional investors in the region are actively working to commit to US property funds by the end of the year. "In the fourth quarter of this year, you'll really start to see capital flow from Latin American investors to private equity funds in the US," he said.

These initial allocations, expected to occur largely at the end of this year and early next year, would amount to a couple of hundred million dollars in real estate commitments, said Vargas Rojas. "But this will change," he said. "I can tell you that in a couple of years, we will be talking about billions."

Philippe Stiernon, managing partner of ROAM Capital, a Bogotá-based placement agent specializing in alternative investments, agreed. He noted that one pension fund in Latin America with which the firm works closely has earmarked approximately $2 billion for international private equity investments in 2016 and is likely to increase that amount in 2017. "Assuming they deploy at least 10 percent of that into international real estate, mainly in the US, you can easily expect several hundreds of millions this year and well north of $1 billion in 2017," in aggregate from major Latin American pension funds with similar allocation plans.

According to Stiernon: "the ticket size in Latin America

Montenegro: foreign real estate investing is 'a new possibility'

Stiernon: ticket sizes have gone up dramatically

has gone up dramatically in the last five years." Previously, large Latin American pension funds would write checks averaging $40 million to $75 million in size. However, those investors are now committing a minimum of $100 million to a fund, usually designating $125 million to $200 million per investment.

"Latin America represents a great opportunity," he said. "It has excellent demographics driven by a young population and no expectations to be withdrawing assets for a long time. That's why they're able to write such large checks, because the window of liquidity isn't happening anytime soon and they need strong returns to fund the future pensions of retirees."

Other drivers

Recent reforms in the US also have played a significant role in driving more capital out of Latin America, by exempting many foreign pension funds from the Foreign Investment in Real Property Tax Act (FIRPTA), which subjects overseas investors to income tax withholding upon the sale of real estate property in the US.

"In terms of the driver of this new trend, I can say that 60 percent of that was the change in FIRPTA," said Vargas Rojas. During his nearly eight-year tenure as head of alternatives investments at the Colombian pension fund Colfondos, he recalled that the tax law was a major obstacle in investing in US real estate. "If we wanted to invest in the US, the big issue was FIRPTA."

Carlos Fradique-Mendez, partner at Bogotá-based law firm Brigard & Urrutia, had a different perspective on the impact that the regulatory reforms have had on anticipated capital outflows abroad. "The regulations have facilitated things, but they're not necessarily the driver. The driver is market presence," he said. "The pension funds are looking for diversification, including in a different currency. They want exposure to markets other than their local market."

Scale is another issue that has compelled pension funds to look outside of the region. "The domestic markets in Latin America are small, the pension funds can't invest only in their own markets, they're just too big," said Vargas Rojas. "They want to keep continuing to invest in real estate in their own countries, but would like to be 50 percent allocated to their domestic markets, and 50 percent to international markets."

Overall, Latin American pension funds have invested in very little real estate outside of their country to date. In most cases, international real estate commitments have consisted of investments in Latin America-focused funds.

$1bn+

Estimated capital flow from Latin American institutional investors to US real estate in 2017

However, the lack of real estate experience abroad does not mean that the institutions are novice investors. Thomas McDonald, managing partner at Jaguar Growth Partners, a New York-based private equity real estate firm focused on emerging markets investments, said he recently met with investors in Peru and Chile. "We were very impressed with the level of sophistication that these institutional investors had," he said. "They're effectively becoming global investors. Speaking to them, they were naturally conversant in equities, debt, debt funds, secondaries funds, global funds, US funds, as well as European funds."

On the real estate front, "the natural place to start is with the larger established global funds or US funds, then as the investors begin to evolve into diversification mode, they'll look at more specified funds," said McDonald. "The usual suspects in real estate, debt and secondaries have received commitments. Investors want to make sure their first steps out are with global managers."

The Blackstone Group, for example, has raised capital from Latin American institutions through Compass Group for both its core-plus real estate fund, Blackstone Property Partners, and its latest European property fund, Blackstone Real Estate Partners Europe V, according to filings with the US Securities and Exchange Commission.

First port of call

Because the regulatory reforms in Latin America are very recent, many global and US managers are still unaware of the fundraising opportunity in the region. "Right now, you don't have a strong offering of funds" for Latin American institutional investors, said Vargas Rojas, who estimates that only about three or four US property funds are actively engaged in raising money from these institutions, while an additional four to seven firms are trying to develop relationships with the investors.

One firm that has escalated its outreach to Latin American investors is New York-based asset manager BlackRock. "In the last four to six months, there's been a real pickup in the number of our client flights between the US and Latin America, particularly as it relates to real estate," remarked Simon Treacy, global chief investment officer and head of US equity for BlackRock Real Estate. For most Latin American investors, "the first port of call is the US, because it's transparent, has a good legal system and is close to home."

Dominik Rohé, head of BlackRock's institutional and wealth business for the Latin America and Iberia region, noted that the company recently did a road show and received interest from investors in the region, particularly in Peru and Colombia. "They have a mature private equity portfolio, and they see real estate as the next frontier," he said, adding that Latin American pension funds have seen a relative slowdown in their own local real estate markets over the last 12 months to 18 months. "Oftentimes, the first venture into international real estate is core."

However, Rohé noted that there has been a pickup in demand for value-add and opportunistic real estate that can be attributable to a recent tax change in the US, which will remove a 35 percent capital gains tax on foreign investors. Non-core real estate investors previously were more likely to be subject to the capital gains tax than core investors, which derive more of their return from current income.

"There's been a lot of interest from general partners looking to diversify their investor base," especially as traditional sources of capital for funds have dried up due to increased regulations in the developed world, said Stiernon. Fund managers also have been looking to engage with Latin American institutional investors for competitive positioning, to counter rival firms' efforts at making inroads in the region.

The first wave of LatAm capital

Country	Pension fund assets	Allocation limits to alternatives
Chile	$167 billion[1]	None
Colombia	$63.2 billion[2]	Up to 25%
Peru	$22.7 billion[3]	Up to 15%

[1] ***Source:*** *Superintendencia de Pensiones*
[2] ***Source:*** *ASOFONDOS*
[3] ***Source:*** *Asociacion de AFP*

Bogotá: Colombia is the most GP-friendly country in Latin America, says one placement agent

Fund managers also are seeking out Latin American pension funds as a means of leverage when negotiating fee terms and discounts with the firm's existing limited partners in the US and Europe. "It's the number one reason why they're doing this," said Stiernon. "Now you have two significant sources of capital instead of one. If you only have one source of capital, the room for negotiation is much smaller."

He considered Colombia to be the most GP-friendly country in Latin America to raise money, as its pension funds are sophisticated, are known to write the largest checks among institutional investors in the region and have few investment hurdles for fund managers. Indeed, GPs are only required to have at least $1 billion in assets under management, five years of experience and use a local agent to be considered for commitments unless they rely on reverse solicitation, Stiernon said.

Showing a commitment to the region, however, is paramount. Fradique-Mendez noted that fund managers that have set up local offices have fared better in their fundraising efforts. "It really makes a difference to go through the process of building a representative office," he said. "It's time consuming, but worth it. Many, if not all, funds that have done so have received commitments from the local pension plans."

Colombia, Peru and Chile represent only the initial wave of capital coming from Latin America into global real estate. Mexico, for example, encompasses 11 pension plans that managed the equivalent of $159 billion as of June 2015, according to Credit Suisse. The country's pension funds, also known as Afores, have begun investing in real estate domestically over the last few years. Regulatory reform efforts currently are underway to allow Afores to invest in real estate and other alternative asset classes abroad.

An even bigger opportunity, however, is Brazil, the largest country in Latin America, with a 160-strong pension system. "For the first time in several years that I've been going there, Brazilian investors are very interested in investing abroad, mainly due to the political and macroeconomic woes that Brazil is currently experiencing," said Stiernon. "There is really a need to diversify their portfolios and start investing abroad. They're a total blank canvas."

McDonald expected multiple waves of Latin American capital outflows to occur over the next three years to seven years. "We've been traveling and investing in these markets for 20 years and have seen each of the countries evolve," he said. "Several years ago, none of those participants were playing outside of their own playgrounds. Look at Mexico - five years ago, the Afores weren't even investing in real estate. Now they've invested more than $10 billion in real estate. It's the same evolution happening in different countries."

When it comes to Latin American capital, the private equity real estate industry is just starting to see the tip of the iceberg. □