J.P.Morgan

Brazilian Homebuilders

The Guide to Dos and Don'ts for the New Wave of IPOs. Why This Time It Should Be Different

LatAm Real Estate / Cement / Construction

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While most sectors in the Brazilian economy are still trying to figure out their operations and markets post COVID-19, Brazilian Homebuilders seem to be one step ahead in the game, as CVM (local SEC) shows that 8 companies have already filed for an IPO and local news media say that another 4 companies are also planning to do so. According to our estimates, the sector could raise over R$13.8bn this year – assuming all filed offers are successful and those already concluded – despite the break caused by the COVID-19 crisis, making 2020 a record year for the sector in terms of issuance. Under this scenario we provide investors with a recap of that went wrong in the past IPO cycle (listings from 2007-08) and why this time things could be (hopefully) different.

- **What went wrong last time?** In the last IPO cycle (2007-08) the sector had 22 listed companies, with only 11 still listed and active today (at least one project launched in 2019). In our view, the main mistakes were: i) Geographic expansion either organically or inorganically; ii) Lack of proper controls and organization; iii) Irrational competition; and iv) Macro headwinds. Even though most of the micro topics are somehow correlated we believe geographical expansion and M&As were the root cause of the sector's issues and companies' failures. Moreover, the Macro front also played against the sector, with Selic hiking from 8.75% at the end of 2009 to 12.5% in 2011.
- **Low interest rate changes everything.** As the Homebuilders sector is heavily dependent on mortgages, which depend on long term interest rates, we cannot stress enough the positive impact generated directly and indirectly by macroeconomic stability and the low interest rate environment. Although at this point banks are still offering mortgages as low as 6.99% per year and the line linked to inflation has not taken off yet, we believe we are on the verge of seeing of new mortgage products for the segment, lowering rates for homebuyers even more. Keep in mind that Brazil's mortgage penetration is at only 10% of GDP, significantly below the level observed in other LatAm countries at 15-20%. Each 1pp expansion in the mortgages to GDP ratio represents an increase of ~R$70bn in the outstanding mortgages market, representing according to our calculation around 3x of the volume launched by listed players in 2019.
- **New comers: dos and don'ts.** Our experience shows that one of the most important factors for the long term success of a homebuilder – although it is not the only one – includes the alignment of minorities and majority shareholders interests, given the sector's complex accounting and long term cycle. Usually family owned companies where most of its wealth is at risk are the most successful names (ex. Eztec, MRV and Cyrela). Additionally, there is no short cut in Homebuilding, any company aiming to grow too much or too fast will likely end up losing control of its operations due to the lack of economies of scale in this business.
- **How to differentiate companies?** Track record and capital discipline talk louder than land bank numbers. In a sector where companies need to reinvent themselves every year, we believe that management track record (a long successful one) and capital discipline (reflected in returns) are key to differentiate companies more than their business niche or land bank levels.

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Table 1: BZ HB Coverage Summary

	Rating	PT 21e	P/BV
TEND	OW	R$ 40.00	2.6x
DIRR	OW	R$ 18.00	2.1x
MRVE	OW	R$ 22.00	2.0x
EVEN	OW	R$ 13.00	1.8x
CYRE	N	R$ 27.00	2.2x
EZTC	N	R$ 46.00	2.4x
Avg.			**2.3x**

Source: Company data, J.P. Morgan estimates.

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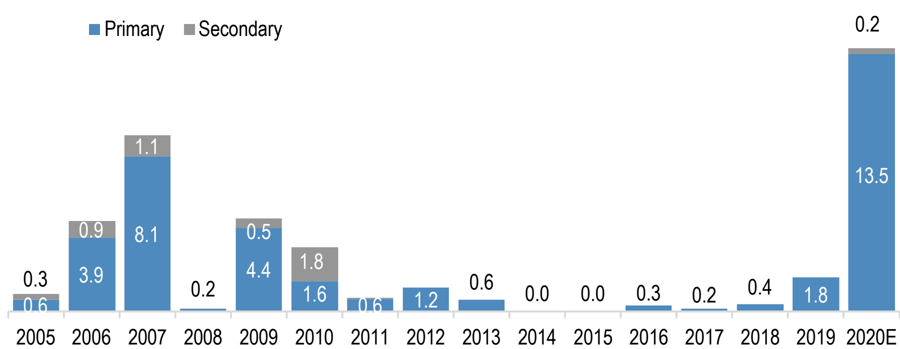
New Comers

Despite the concerns regarding the impact of COVID-19 on the Brazilian economy, homebuilders are taking the lead in the capital markets with 8 prospectuses filed at CVM (Brazilian SEC) and another 4 to come according to local media and companies' material facts (link to the news flow). If expectations are confirmed it would be a record year for the sector in terms of issuance with total financial volume – including offers priced on February – reaching at least R$13.8bn according to our calculation, which assumes an average offer of R$1bn per company, representing almost the same volume as 2007-09 combined. In this scenario, investors have raised several questions, including how to differentiate the new comers among themselves and how to prevent the sector facing the same challenges as in the past cycle, when out of the 22 companies in the previous cycle (including the ones that IPO'ed in 2009) only 11 companies are still listed and active (launches in the past 12 months) today. In addition to PDG and Viver under Chapter 11, Rossi, Gafisa and CR2 also had no launches during 2019.

Figure 1: Homebuilders IPOs
R$ in billions



Source: Company reports and J.P. Morgan estimates.

Who are the contenders?

Among the new comers there is a group of companies represented by the spin-off of subsidiaries of existing listed companies in order to accelerate their growth or allow the controlling companies to focus on their core business. The initiative started with the filling of: (i) Cury, Cyrela's low income subsidiary; continued with the filing of (ii) Riva, Direcional's mid income subsidiary; (iii) Lavvi, Cyrela's mid and high income subsidiary to act in SP; (iv) and most recently Melnick Even (link for Even's material fact), which is Even's subsidiary acting in Rio Grande do Sul State. Additionally, Alphaville which used to be a subsidiary of Gafisa is also on the list for a potential IPO.

The list of companies planning their IPOs also includes names run by former executives of the sector like You Inc and One Innovation. While You Inc is run by former Abrão Muszkat who helped to create Even, One Innovation was founded by Milton Goldfarb and Paulo Petrin who helped to found PDG. Other names entering the IPO market include Pacaembu and Canopus. For our detailed reports on some of these names, please check our notes: (i) Riva, (ii) Lavvi and (iii) Cury, Pacaembu. Canopus and You Inc.

Table 1: New Comers Details*

New comers	Equity	Book as of	Comments
Cury	220	1Q20	Cyrela Low income subsidiary
Lavvi	266	2Q20	Cyrela Mid & High income subsidiary
One Innovation	225	2019	Founded by Former PDG
You Inc	280	1Q20	Founded by Former Even
Melnick Even**	558	1Q20	Even subsidiary in RS
Alphaville	33	2019	Former GFSA subsidiary
Riva	163	2019	Direcional Mid & High income subsidiary
Pacaembu	275	2019	
Canopus	613	2019	

Source: Company reports and J.P. Morgan estimates.*Not including names mentioned on news flow. **Not filed prospectus yet, but Even released material facts.

In the table below we summarize what happened to the 22 companies listed in the previous bull market for Homebuilders. Out of the 22 listed company, only 11 are still trading and active (at least one project launched in the past 12 months), indicating a survival rate of 50%. From the initial group, 3 companies were delisted thru tender offers and another 4 companies were acquired, with PDG being the main consolidator of the segment. Moreover, looking at 2019 data, PDG, Viver, Gafisa, Rossi and CR2 had no launches in the period.

Table 2: Summary of companies' status

Company	Current Status
Abyara	Acquired
Agra	Acquired
Brascan	Delisted
Camargo Correa	Delisted
Company	Acquired / Delisted
CR2*	Active (~US$10mn Mkt cap)
Cyrela	**Active**
Direcional	**Active**
Even	**Active**
Eztec	**Active**
Gafisa*	Active
Helbor	**Active**
Viver (Former Inpar)	Under Chapter 11
JHSF	**Active**
Klabin Segall	Acquired
MRV	**Active**
PDG*	Under Chapter 11
RNI (Former Rodobens)	**Active**
Rossi*	Active
Tecnisa	**Active**
Tenda	**Acquired / Re-listed / Active**
Trisul	**Active**
Total Listings (2007-09)	22
Listed and with Launches in 2019	11
% survival	**50%**

Source: J.P. Morgan estimates, Company data. Not including Mitre and Moura Dubeux listed early this year. *Companies with no launches in 2019.

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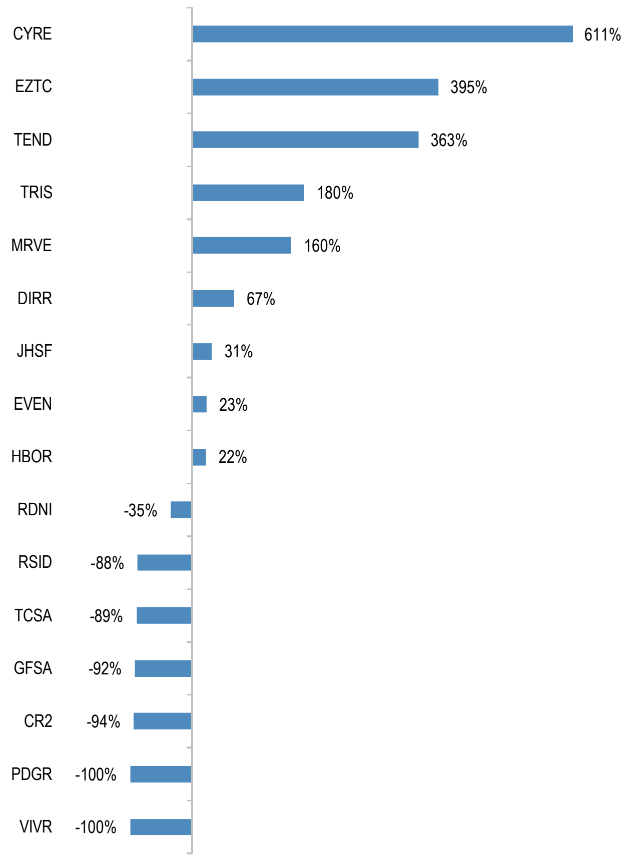
IPO Performance

Despite the low survival rate (listed and active companies in 2019) of the last IPO wave at 50%, it is worth mentioning to investors that the winners in the sector delivered a strong performance with the average return of the companies that are still listed and active today being at 78% (vs IPO price), representing according to our calculation a return of around 17% per year vs 14% from IBOV. The most successful company, i.e. Cyrela, delivered a performance of 611% since its IPO vs 302% from IBOV.

Figure 2: Performance Since IPO (%)



Source: J.P. Morgan estimates, Bloomberg.

What Went Wrong Last Time

In our view there were 4 main points that were somehow common to companies that failed in the past cycle: i) Geographic expansion; ii) Lack of controls and organization; iii) Irrational competition; and iv) Macro headwinds. Below we explain in detail how each one of those impacted companies' performance and profitability.

Geographic expansion

Given the lack of economies of scale in the sector and Brazil's continental size, geographic expansion proved to be a wrong decision for almost every company in the sector, excluding some low income names which given the standardization of their projects, meant they could reach new areas without compromising efficiency. In general, the further the expansion, the higher the losses. Since Real Estate is all about location, companies arriving in new regions – despite their experience or years in the market – will count on local brokers to find the best land plots and to define homebuyers' preferences. As a consequence, there is limited use of their local expertise on a country level. Moreover, there is almost no brand recognition in the sector; therefore, excluding access to capital, there is almost no difference between small and large companies. Although companies might claim to have some bargaining power with suppliers, we believe it is very limited, given the logistics involved in operating in several cities and states and Brazil's well documented infrastructure gap.

Lack of controls and organization

Another major issue, a consequence of the lack of economies of scale, since every project is unique especially in the mid and high income segment, is the difficulty companies have to organize their processes during a high growth phase. Past experience shows that once companies are willing to double or triple their size in a short period of time, they end up selecting riskier projects and adding more complexity to their systems and structures, usually having to hire untrained employees, reducing their overall productivity and profitability. Moreover, the additional building sites, even when closer to a homebuyer's headquarters, forces the top management to reduce the level of supervision on existing projects, leaving room for productivity issues.

Irrational competition

In the race to deliver what was promised to investors, companies with a high growth target usually end up falling for the geographical expansion fallacy or accelerating their launches in its core-market, which in addition to raising questions about demand absorption, also results in an irrational competition for land bank creating a price war among players. This is probably the most difficult item to monitor, since there is no data available regarding land price trends. Companies will usually comment about land price as a percentage of projects sales value (PSV), as a consequence companies could increase selling prices to maintain land cost as a percentage of total within their thresholds limits and within their profitability level. Due to the sector's long cycle – 15-18 months construction – investors will usually see the impact of those practices toward the end of the project when gross margin starts to be impacted by discounts to accelerate sales.

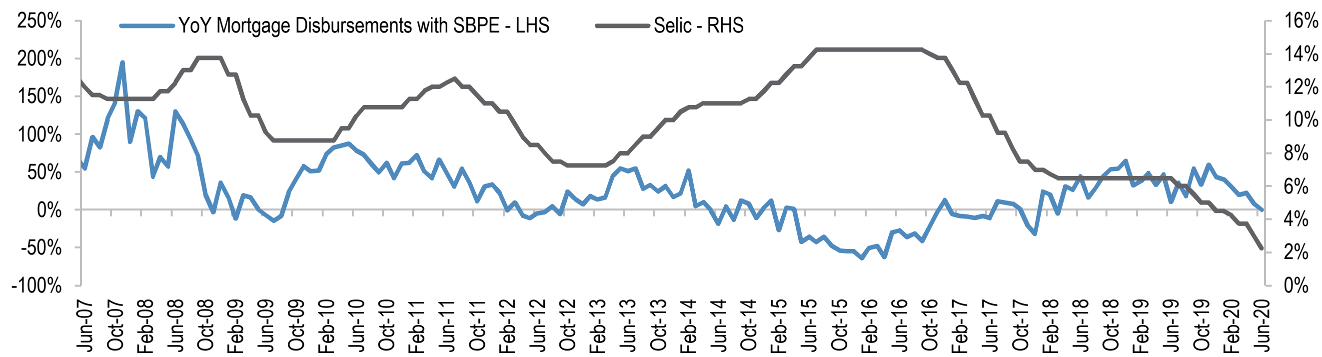
Macro headwinds

Although there is little companies can do to offset the negative impacts of Macro headwinds, such as a decline in consumer confidence impacting sales speed or higher interest rates reducing affordability, these were key during the last cycle, impacting the performance of companies. In our view the best way to counterbalance the potential negative impacts from an economic downturn are: i) Low leverage, especially at the holding level; and ii) Low level of inventories, especially concluded units which have a negative carry. According to our calculation, concluded units can cost up to 4% of their sales value per year in taxes and maintenance.

Low Interest Rate – It Is a New World

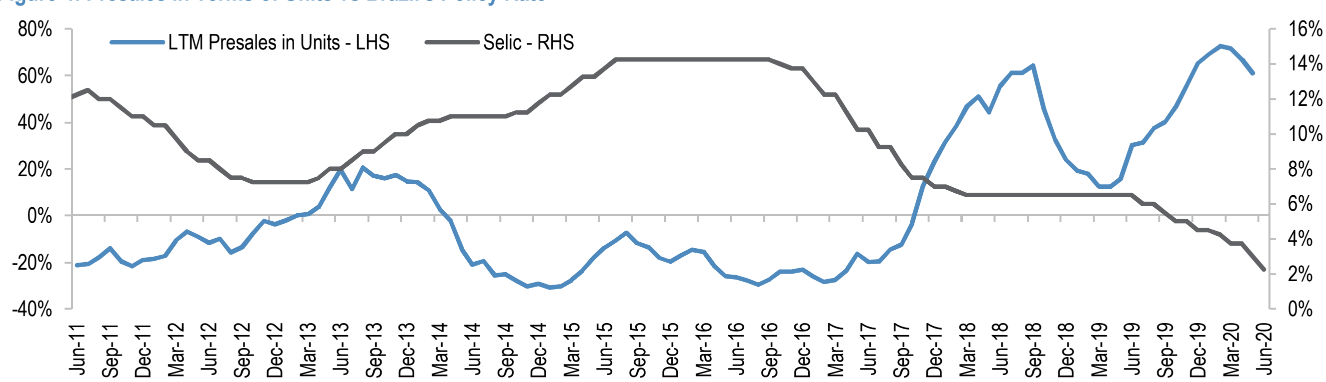
As interest rate in Brazil reached a record low at 2.25% with the possibility of contracting another 25bps by year end reaching 2.0% soon, we expect to see transformational changes in the mortgage market in the country. Currently the most affordable mortgage has a cost of 6.99% per year and 35 years duration. In our view the preservation of interest rates at a low level for the foreseeable future will be an important driver for the creation of new mortgage instruments, likely including variable rates. Remember that last year CEF launched mortgage rates linked to inflation and currently average rate per BCB is at roughly 7% per year.

Figure 3: Mortgages Disbursements* (SBPE) vs Brazil's Policy Rate



Source: Abecip, Bloomberg.* In terms of amount financed.

Figure 4: Presales in Terms of Units vs Brazil's Policy Rate



Source: Secovi-SP, Bloomberg.

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Moreover, we expect a low level of interest rate and new mortgage instruments to allow the housing market to reach new highs in terms of volumes given the increase in homebuyers' affordability. According to ABRAINC (Brazilian Homebuilders Association) each 100bps reduction in mortgage rates represents the addition of 800k families (20%) in the potential demand for the sector, considering a unit of R$300k. Looking at units in the economic segment (R$150k) each 100bps reduction has the potential to add up to 2mn families to the market (please click here to see the study).

Table 3: Eligible families for mortgages of 300k

			Today*		
Mortgage rate per year	5%	6%	7%	8%	9%
Eligible families (mn)	7.2	6.0	5.3	4.4	3.9

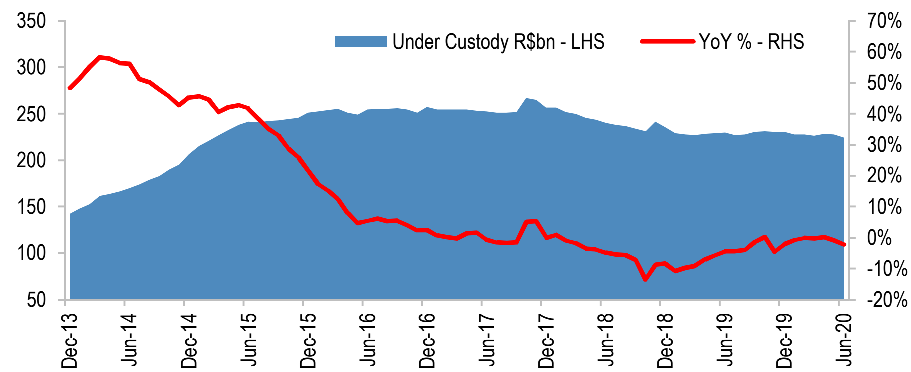
Source: Abrainc, Central Bank. *Closest to market rate per BCB data.

Table 4: Eligible families for mortgages of 150k

			Today*		
Mortgage rate per year	5%	6%	7%	8%	9%
Eligible families (mn)	19.1	17.0	15.1	13.0	11.7

Source: Abrainc, Central Bank. *Closest to market rate per BCB data.

Figure 5: Alternative Sources of Funding – LIG, LCI and CRI



Source: Cetip.

What Else Is Different?

We would like to flag three Macro factors that impacted the sector's profitability in the past cycle and that currently don't represent a threat: i) Unemployment level; ii) Construction inflation and / or bottlenecks in the supply chain; and iii) Cancellations regulation.

Unemployment (unfortunately) is increasing

During the past crisis, sector profitability was impacted by significant constraints on the labor market, since Brazil was operating close to full employment – unemployment rate was close to the all-time low at ~7% – creating pressure on wages and increasing the turnover on companies' building sites. Remember that construction activity in Brazil's main capitals was high due to preparations for the World Cup and Olympic Games, as well as the correspondent investments in infrastructure. It was common to hear from companies that the head engineer of a major project had recently graduated and that construction workers had abandoned the building site as a competitor offered higher remuneration. Since the

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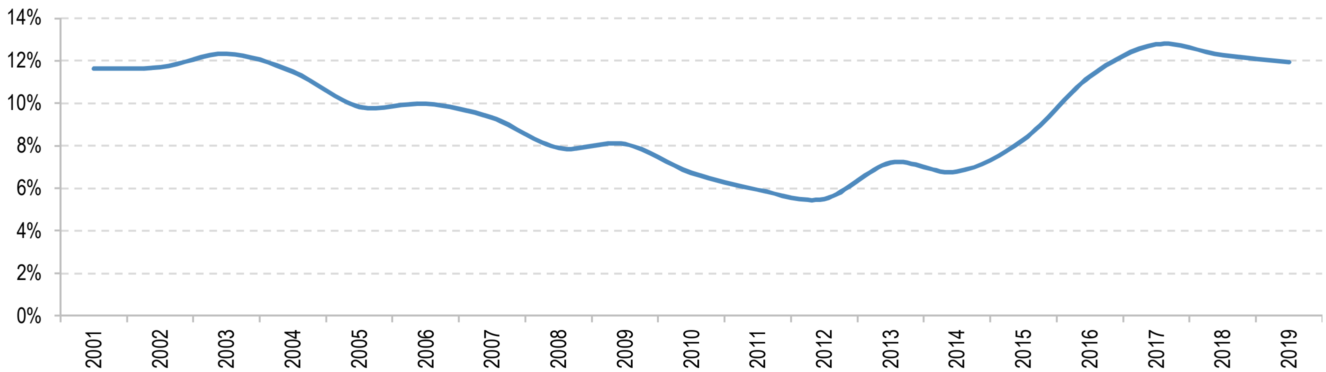
unemployment rate in Brazil is running closer to 13% we don't expect to see short or mid-term pressure on wages for the sector or lack of work force.

Figure 6: Brazil's Unemployment Rate

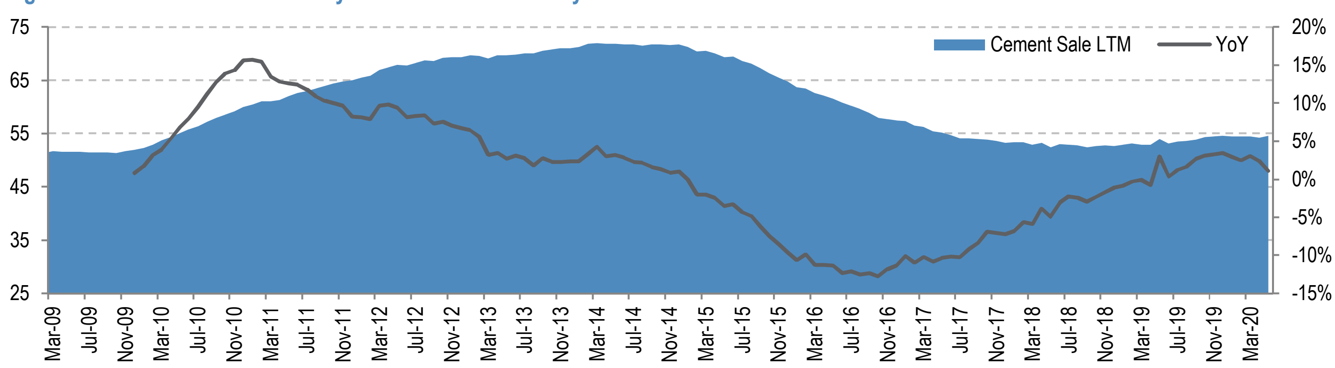


Source: Bloomberg.

No bottlenecks in supply chain

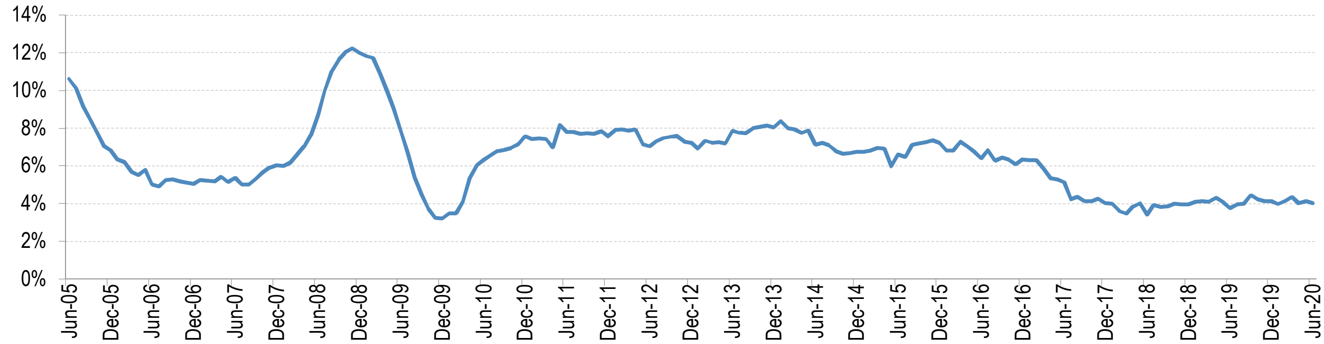
As mentioned above, given the high demand for infrastructure investments related to the World Cup and the Olympic Games during the period of 2010-14, combined with the strong activity in the Real Estate sector – growth in homebuilders launches and properties segment – there was a sharp increase in construction inflation (INCC), reflecting the demand for building materials and labor. Even though homebuyers' monthly payments during the construction phase are adjusted by INCC, the index was not fully reflecting the inflation experienced by companies leading to a mismatch between costs and revenues, pressuring companies' gross margins. Under the current scenario of 2020 GDP expected to contract 6.2% recovering only 2.5% in 2021, we don't expect to see short or mid-term pressures on construction.

Figure 7: LTM Cement Sales – Proxy for Construction Activity



Source: SNIC.

Figure 8: INCC – YoY

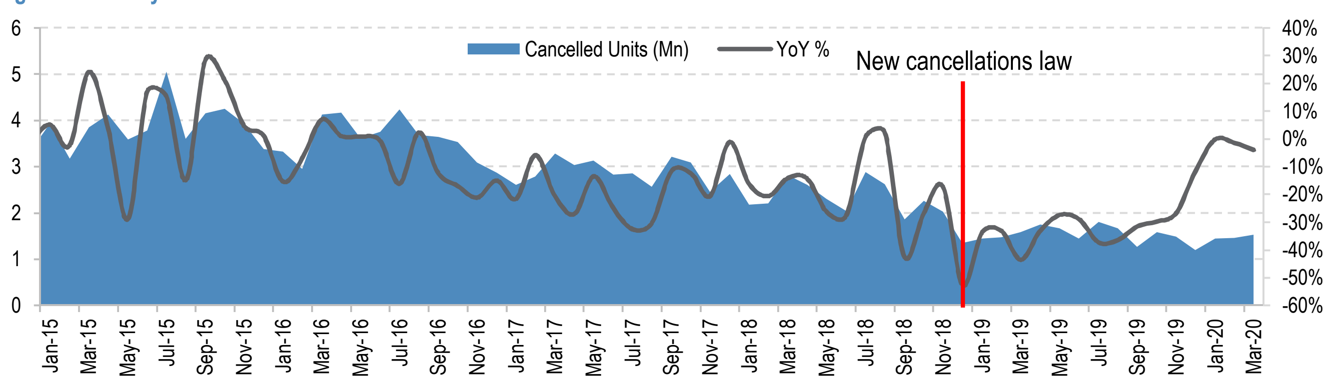


Source: FGV.

Cancelation law – There is no more free lunch

Another important change vs the previous cycle happened on the legal front, given the approval by the end of 2018 of the Cancellation law, which increased the penalty paid by homebuyers in case they give up on the acquisition of a residential unit. The current regulation allows companies to retain up to 50% of consumers' payments in case of cancelation. Previously there was no official rule, meaning the decision would vary case by case, and in general companies were retaining less than 10% of payments. Additionally regulation on cancellations states that the amount to be returned will be net of commissions and taxes. Remember that during construction buyers pay usually 20-30% of the value of the unit, therefore under the old regulation, buyers could cancel their acquisition (if prices were down for example) losing only 2-3% of the value of the units, whereas currently this amount is around 10-15% reducing the moral hazard in Real Estate transactions.

Figure 9: Monthly Units Cancellations



Source: ABRAINC-FIPE.

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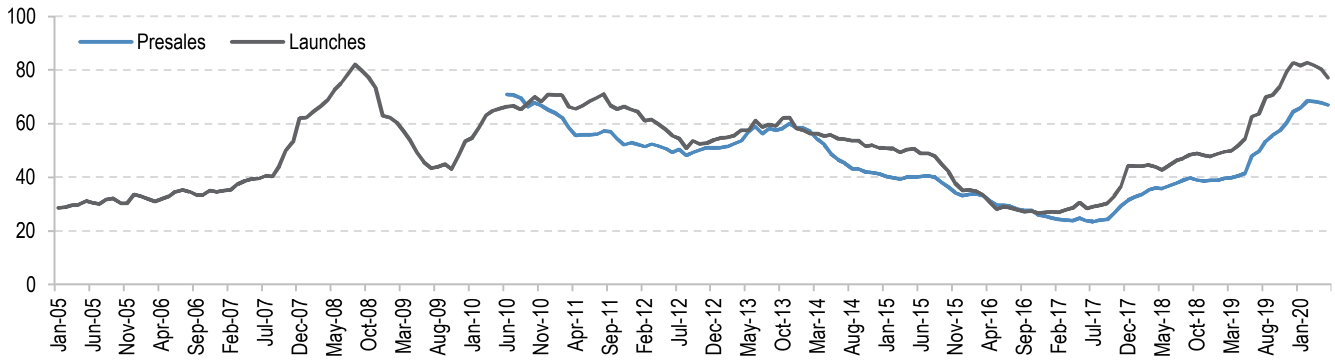
How Many Launches Could the São Paulo Market Have?

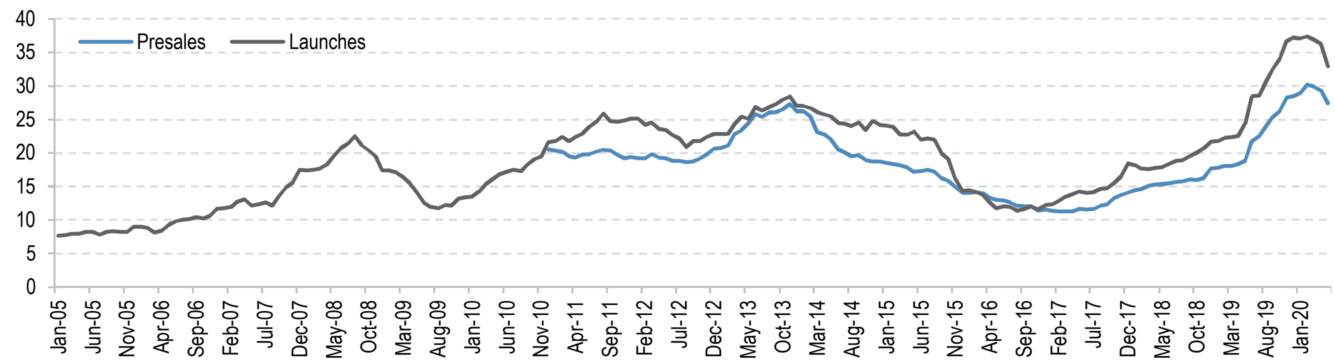
Given that several of the new players as well as existing ones are planning to enter or expand their launches in the São Paulo market we compared the expected launches in the city vs historical levels. According to Secovi-SP data, launches in São Paulo Metropolitan region reached a record high in 2019 with R$37bn in PSV represented by 83k units, representing an average price of R$450k.

Figure 10: São Paulo Metropolitan Region – Launches and Presales – Units
'000 units



Source: Company reports and J.P. Morgan estimates.

Figure 11: São Paulo Metropolitan Region – Launches and Presales – Potential Sales Value
R$ in millions



Source: Company reports and J.P. Morgan estimates.

According to our calculation, existing listed companies had a market share of 32% in 2019 launches, while non listed players including new comers had a share of 68%. Assuming that the 2021 market will be the same size as 2019 at R$37bn, we expect new comers to have a market share of 16% and current listed companies to have a share of 50%. This means that around 34% of the market of São Paulo Metropolitan region or R$12.6bn in launches will still be in the hands of non-listed companies.

Table 5: Market Share by Launches in São Paulo Metropolitan Region

Company	2019	Share	2021	Share
Cyrela	3.6	10%	4.0	11%
Eztec	1.9	5%	2.5	7%
Even	1.5	4%	2.0	5%
Trisul	1.2	3%	2.0	5%
Tenda	0.9	2%	1.5	4%
Mitre	0.7	2%	1.5	4%
MRV	0.7	2%	1.0	3%
Helbor	0.6	2%	1.0	3%
JHSF	0.5	1%	0.5	1%
Direcional	0.4	1%	1.0	3%
Tecnisa	0.1	0%	0.8	2%
Gafisa	0.0	0%	0.5	1%
Rossi	0.0	0%	0.2	1%
PDG	0.0	0%	0.2	1%
CR2	0.0	0%	0.0	0%
Viver	0.0	0%	0.0	0%
RNI	0.0	0%	0.0	0%
New Comers	3.0	8%	6.0	16%
Others	22.2	60%	12.6	34%
Total	**37.2**	**100%**	**37.2**	**100%**

Source: Company reports and J.P. Morgan estimates.

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