

Think like a Brazilian

Doing business in Brazil in 2010 means «thinking out of the box», says **JOSÉ ERNESTO MARINO NETO**, President and Founder of **BSH INTERNATIONAL** in São Paulo. This is his primer on succeeding there next year.

Brazil is one of the few countries not so much affected by world crises like the major developed nations. The reason which kept Brazil apart from the world's crazy growth during the last few years is the same thing that saved it from the recent crises: It's a closed country to the world. Less than 25 % of Brazil's GDP is generated by international trade. Still, that's more than ten years ago when it was only 16 %.

Economic background and fundamentals

In order to understand the development of the Brazilian economy it's necessary to spend a moment to review its background: Between the 1930s and 1970s, the Brazilian per capita GDP grew 4 % p.a. on average. During this period, Brazil improved from a low-income country, like India, to a medium-income country, like South Korea.

Growth was driven by the process of import substitution, characterized by an economy closed to external trade and strong state intervention, especially in physical economic infrastructure investment (but not in human capital, nor in social cohesion). By the beginning of the 1980s, this model was exhausted. The lack of external competition created severe inefficiencies in several sectors of the economy, and the government's capacity to invest was limited by its high level of indebtedness and the urgent need to invest in social measures aimed at directly fighting poverty and inequalities. So a period of stagnation set in. The most evident symptom was hyperinflation.

In the 1990s inflation was significantly reduced, providing a prerequisite for stronger growth, but the economy continued to be characterized by high current account deficits and consequent vulnerability. The macroeconomic stabilization occurred in the period 2003-2006, with the reduction of inflation to levels close to the average of emerging countries. Growth accelerated above the 2 % per year rate which had been observed between 1981 and 2005.

Since the beginning of the 1990s, important macro reforms were implemented, including:

- Opening the economy to trade and investment;
- Privatizing public entities;
- Approving a Fiscal Responsibility Law;
- Undertaking initiatives for reforming the social security system;
- Restructuring the banking system;
- Making fiscal adjustments; and
- Stabilizing inflation.

The micro reform agenda, aiming to modernize regulations and reduce distortions, also advanced substantially in recent years.

With the collapse of the fixed exchange rate regime, it was necessary to search for a new nominal anchor for the economy. Alternatives were: (i) monetary aggregate control; (ii) a new exchange rate anchor; (iii) dollarization, although this did not seem viable in practice. So a new targeting regime was implemented in June 1999, complementing the transition to a floating exchange rate regime.

This regime means that the Central Bank is committed to act in order to guarantee that the inflation rate remains in line with a pre-established target. As it is more transparent and well understood by society, it also serves as a mechanism to coordinate expectations.

In short, monetary policy targeted inflation; fiscal policy aimed at generating surpluses; and exchange rates became flexible. The result: the world began to perceive Brazil as a good place for new investment.

Price sensitivity and hotel brands

When Brazil was included in the «BRIC» scenario, many investors saw three strengths here:

- a population of over 190 million consumers
- wealth to be distributed (GDP of over US\$ 1.9 trillion in 2009)
- a huge land area to generate more wealth – over 8.5 million square kilometers useful to agriculture.

The big picture is certainly « beautiful » – but potentially misleading. For example, annual GDP per capita is about US\$ 6,000, but the reality is that only 0.7 % of the population has family monthly income in excess of US\$ 7,000. Accordingly, the Brazilian market is extremely price sensitive, and not particularly brand-driven.

A similar misleading idea is the notion of Brazil's « middle class ». I have seen international hotel companies trying to grow in Brazil, pushing international investors to explore the « huge emerging middle class » by building many mid-market hotel products. But in Brazil, middle class is the class in which almost 46 % of Brazilians are concentrated. They have monthly family income ranging from US\$ 500 to US\$ 770. Obviously, at these income levels, purchasing power is completely different from American or European conceptions of « middle class ». To avoid business failure here, it is essential to understand this.

According to BSH Travel Research, there are only 17 luxury hotel properties in Brazil. Fasano, Hyatt, Hilton, Renaissance, JW Marriott, Sofitel, Sheraton and Orient-Express are brands in this group. « Upscale » brands include Radisson, Four Points by Sheraton, Sonesta, Novotel, Blue Tree, Golden Tulip and others. « Midscale » is a market segment explored by Mercure, Quality,

Howard Johnson, Estanzuela and other brands. The « budget » segment is being served by many Brazilian brands like Intercity, Travel Inn, Bristol, Sleep Inn and Ibis among others.

The Brazilian mid-scale hotel product is completely different than American mid-scale hotel product. What kind of brand could be developed? Remember: it's a price-sensitive market, not driven by brands.

If this is true, then why has the Ibis brand been growing like a weed? Accor has won over the heart (and the pocketbook) of Brazilians. Ibis is a Brazilian consumer phenomenon. The brand wasn't known in the country when the product was launched about 15 years ago. But the product matched Brazilian tastes and needs, with reasonable room size, good bed quality, acceptable bathroom facilities, free Internet access, television and phone facilities, good location and – the most important component – affordable room rate.

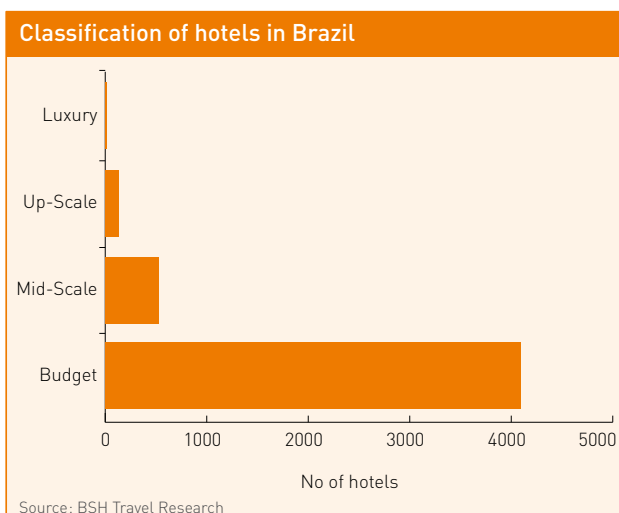
A thumbnail history of the market

Sheraton began activities in Brazil in the 1970s, as did Hilton. Why are they still so small in Brazil?

In the US, the hotel investment industry is driven by demand and by hotel companies. In Brazil, due to the history of high interest rates, it is driven by real estate developers who can raise capital. But who is the investor for a business that generates an IRR less than the market interest rate? The answer to this question lies in how the Brazilian hotel industry was built:

Until 1980, government fiscal and financial benefits supported the development of many hotel properties. The Brazilian social pyramid was very hostile and almost only deluxe hotels were built, designed to meet foreign demand which paid in US dollars owing to the high inflation rate locally.

From 1980 to 1994, fiscal and financial government benefits were ended. Lack of financial support unbalanced the market, where demand grew and supply was flat. Real estate developers took the idea of the hotel residence (created in ►



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cont.

the 1970s to offer some hotel services in regular apartments), twisting it and launching the Apart-Hotel.

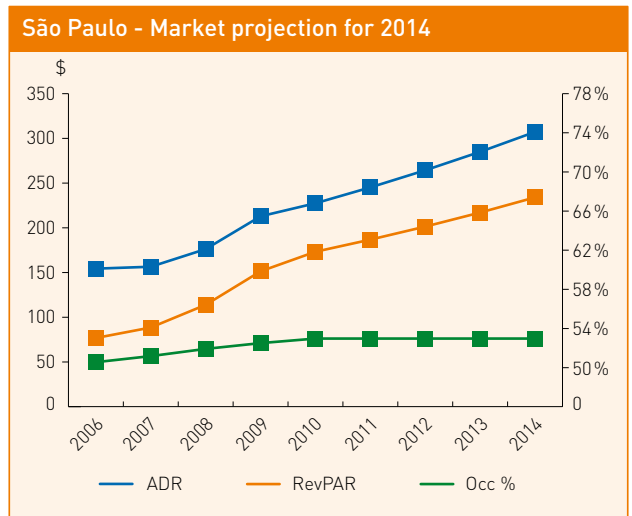
From 1994 to 2000, when the Real Economic Plan was launched, Brazilian «A» and «B» classes decided to invest in real estate products, and once the hotel market was still unbalanced with unaccommodated demand, the hotel management companies and real estate developers created «flat service», a typical hotel room developed as a condo and organized in rental programs. Many markets such as São Paulo, Belo Horizonte, Brasília, Curitiba, Porto Alegre, Recife and Fortaleza were over supplied.

From 2000 to today, almost no new hotels were developed in city centers. Resort properties were developed by Europeans (mainly Portuguese and Spanish companies) as a consequence of easy real estate credit in Europe.

The main financier of this industry has been the small investors who buy condo units in condo hotels because it's a small real estate investment; it pays a monthly income; it grows in value; and there is a very big, well developed secondary market bringing liquidity to the investment.

Therefore, understanding how to work with small investors, like Accor, SuperClubs, Sol Melia and other hotel management companies did, opens a window to do business in Brazil. Why? There are two sides to the answer. First, the condo hotel is not a product in Brazil, but a *financial vehicle*. Second, the Brazilian hospitality industry has not seen any new hotel developments during the last 9 years. The over-supplied market situation is changing into an unbalanced market.

Hotels in São Paulo are working with high occupancy and the trend is to see RevPAR growing sharply (in reais).



Trends for 2010

Many investors ask us about opportunities in Brazilian luxury hotel market and we continue to answer the same way: there are only 120 thousand millionaires in Brazil and this market is very small. There are less than 300 rooms in São Paulo hotels charging more than US\$ 400 a night, and this market segment has decreased a little after the crisis of September 2008.

The Brazilian economy is expected to grow in 2010. GDP probably will increase about 6.5%. Hotel demand will continue being pushed in the business segment, with high concentration in mid market and upscale segment.

ADRs will grow. My colleagues and I expect to see RevPAR in São Paulo reaching US\$ 109. In Rio de Janeiro ADR will be about US\$ 150 and occupancy will be very high in the other main big cities like Brasília, Belo Horizonte, Curitiba and Porto Alegre. Demand tends to grow from 7% to 12% in big cities in 2010.

According to «Brazilian Luxury Hotel Market: Rio de Janeiro and São Paulo,» published by BSH Travel Research, the statistics point to a RevPAR of US\$ 160 in the 5-star hotels in Rio and US\$ 145 in the 5-star hotels in São Paulo.



Demand in São Paulo will grow about 9.5 % and will probably be steady in Rio de Janeiro (due to lack of new hotel supply).

Although some State capitals could be considered secondary cities, like Vitória in Espírito Santo State, we could see demand growth in 2010 thanks to the oil and gas industries. Espírito Santo State GDP has been growing about 11 % since 2002. New oil reserves are been discovered, and the secondary cities of both Rio de Janeiro State and São Paulo State will benefit hugely from this.

The interior of São Paulo State is ready to receive a limited services hotel chain to bring suitable accommodation to meet existing demand. The interior of São Paulo State is the second largest Brazilian consumer market.

The resort market was impacted by the world financial crisis, with decreased demand from Europe. But it will grow again in 2010 due to domestic economic expansion. My colleagues believe resort demand will grow from 5 % to 7 % in 2010. Lastly... The market here is open to new players. The new ones can make profits if they are able to think out of the box. ■