Latin American Quarterly Outlook

JULY 2011
LATIN AMERICA
Real Estate Outlook

**Key Economic Themes**

- Almost three years after the peak of the global crisis, *Latin America has two contrasting stories: Mexico is still recovering, while parts of South America are displaying signs of overheating.*

- China is driving growth in Brazil, Chile, Peru and Colombia through the consumption of commodities and direct investment.

- The recovery of the global economy has fueled demand for goods manufactured in Latin America, which has resulted in high employment and increasing consumption. However, inflation is a concern, especially because access to credit is increasing.

- Latin America’s relatively high interest rates are serving to draw capital from investors from outside the region. If the capital flow is reversed for any reason, local markets would be affected.

- Mexico’s *recovery is slowly gathering momentum*. Growth this year is expected to be spread out across the economy.

**Key Real Estate Themes**

- Transaction volume and prices are on the rise in South America, particularly Brazil and Chile.

- Prices in Mexico remain depressed, with acquisition yields still about 150 bps above pre-crisis levels.

- Banks in the region are returning to finance commercial real estate.

- The evolution of local capital markets provide new sources of funding for real estate – the IPO market is active in Brazil, the first FIBRA was launched in Mexico in 1Q11 and issuance of listed real estate securities is rising in Brazil and Mexico.

- Absorption rates are up across the board. Rents are declining in Mexico and increasing in Brazil and Chile.
Latin American Countries are in Different Stages of Recovery

Growth is determined by different factors in each country:

- **Mexico’s industrial sector is growing.** As US demand for Mexican goods stabilizes, growth in the sector is expected to moderate.

- **Brazil will grow at a more sustainable level this year.** It is not clear whether the end of government stimulus measures and tighter monetary policies are sufficient to avoid a hard landing.

- **High commodity prices continue to be a boon for Chile,** as are the spate of investments that followed the 2010 earthquake.

- Accordingly, labor markets have been strong in Brazil and Chile, but still lack momentum in Mexico.
LATIN AMERICA – ECONOMIC ENVIRONMENT

Robust Growth and High Interest Rates Draws Capital to the Region

• Foreign direct investment in 2011 is forecast to return to the record levels of 2008. International corporations want to take advantage of growth prospects in the region that result from growing consumption levels and high-profile infrastructure investments.

• Latin America is attracting capital from outside the region due to its relatively strong economic growth and high interest rates.

• The influx of capital has led to local currency appreciation, prompting some countries to implement measures to discourage short-term speculative inflows. The currencies of Brazil and Chile should weaken in the long term.

SOURCES: EIU, PRUDENTIAL REAL ESTATE INVESTORS
LATIN AMERICA – REAL ESTATE ENVIRONMENT

Transactions: High in Brazil, Modest Elsewhere

• During the 12 months through March 2011, transaction volume in Latin America totaled US$10.6 billion, an increase of 47% from 2010 and nearing the 2008 level of US$11.2 billion.

• The office sector was the most active, accounting for US$4 billion of transaction volume in the period.

• By country, Brazil dominated activity in the region, accounting for nearly 90% of transactions. Local listed firms and private investors led the parade of buyers.

• Latin American stocks have recovered from their trough in early 2009. Since then, Chilean stocks have posted the best performance, while the gains in Brazil and Mexico have been more moderate.

• Listed real estate firms have produced mixed results. **Investors are increasingly differentiating between companies based on their strategies and efficiencies.**

SOURCES: RCA, PRUDENTIAL REAL ESTATE INVESTORS
Latin America – Real Estate Environment
Growing Capital Markets is New Source of Real Estate Funding

- Real estate companies are among the most active segments in terms of raising equity in public markets in the region.

- Most of the equity is being raised in Brazil. Four Brazilian real estate companies raised public equity in 1Q11.

- Strong investor appetite for real estate has produced a favorable environment for real estate firms to go public.

- Development Capital Certificates were introduced in Mexico in 2008. CKDs, as they are known, enable Mexican pension funds and other institutional investors to invest in real estate, infrastructure, and private equity funds via publicly listed trusts.

- Since 2008, CKDs have raised US$3.4 billion of capital, including US$880 million for real estate. The total represents only 2.8% of Mexican pension fund assets, which indicates there is room for considerable expansion.

Sources: Prudential Real Estate Investors
Market Fundamentals

- **Consumer confidence is positive in Mexico**, although it has not yet translated into a significant improvement in retail activity.
- Leading the recovery is the manufacturing sector, which is sensitive to demand from the US.
- Security issues are serious and create headlines, but their impact on investment activity is limited to a small subset of the country.
- A full recovery in Mexico’s retail sector is dependent on stronger employment and credit growth.
- Bank credit to consumers is starting to expand. Business credit is returning as well.
- Commercial real estate transaction activity remains weak. In contrast, housing sales were less affected by the global economic crisis, and were first to recover.

SOURCES: INEGI; PRUDENTIAL REAL ESTATE INVESTORS
**Market Fundamentals**

- Two years of steady job creation has resulted in record low unemployment, which is boosting demand for real estate.
- Construction costs are rising due to the increasing cost of raw materials and higher overall inflation.
- **The strong demand, combined with higher construction costs, has pushed housing prices higher**, especially in large cities such as Rio de Janeiro and Sao Paulo.
- To meet demand, many listed housing developers raced to expand nationally, which in some cases led to serious losses in efficiency. Overall, companies are now retrenching by focusing on core markets.
- Credit is relatively abundant for homebuyers, but still scarce for commercial real estate.
- Commercial real estate players are increasingly turning to new sources of funding, including private funds and bonds.

**FipeZap Housing Price Index, Accumulated Appreciation**

Sources: FipeZap; Prudential Real Estate Investors
LATIN AMERICA – HOUSING

Housing in Latin America is Growing, But Potential to Expand Remains

• Credit to housing has expanded in Mexico, Brazil and Chile since 2009.

• The high pace of growth in Brazil is testing the capacity of homebuilders and financing providers.

• The largest homebuilders in Brazil are facing execution issues as they seek to expand into new markets.

• Despite the expansion in credit available for housing, mortgage debt in Latin American countries remains low as a share of GDP compared to other parts of the world.

• This indicates that there is further room for growth in mortgage originations in countries such as Mexico, Brazil and Chile.

SOURCES: JPMORGAN, CENTRAL BANKS OF MEXICO, BRAZIL & CHILE, PRUDENTIAL REAL ESTATE INVESTORS
LATIN AMERICA - RETAIL

Consumers Fill Shopping Centers in Brazil and Chile, Less So in Mexico

• Retail sales are growing in Latin America, fueled by expansion in employment and credit.

• Chilean retailers are posting double-digit gains after a dip in 2008 and 2009, while in Brazil growth has been more steady.

• Retail sales are growing again in Mexico, but have yet to stage a full recovery from the trough level of 2009.

• Brazil’s shopping center sales amounted to R$87 billion in 2010, equal to 24% of GDP. Shopping center sales are forecast to increase 12% this year.

• Development of new retail space in Brazil has expanded to secondary cities. The main Brazilian developers are all publicly listed.

• New developments and property sales are still stalled in Mexico, and are not likely to resume until next year.

SOURCES: INEGI, IBGE, INE, DANE, ABRASCE, PRUDENTIAL REAL ESTATE INVESTORS.
LATIN AMERICA - OFFICE

Diverging Dynamics in Office Markets

• Office markets reflect the differing economic climate of each country.

• Office vacancies in Sao Paulo and Santiago have declined steadily for the past four quarters.

• Rent levels have increased markedly in Sao Paulo over the past year. Demand is coming from fast growing local firms that cater to the domestic market, as well as foreign firms just entering Brazil.

• Rents in Santiago have also increased. New buildings are benefiting from a flight to quality in wake of last year’s earthquake.

• The vacancy level in Mexico City has been slower to recover, and remains at 10%. The increase in vacancy over the last two years has been due in part to the completion of new office buildings in the city. The combination of new supply and little demand for space has left landlords unable to raise rent levels.

SOURCES: CBRE, PRUDENTIAL REAL ESTATE INVESTORS
LATIN AMERICA - INDUSTRIAL

Industrial Vacancies are Down in Mexico and Brazil

• Industrial vacancies in Mexico have been falling since hitting peak levels in 2009. Class-A vacancy rates fell to 7.1% in Mexico City and 8.8% in Monterrey in 1Q11.

• Part of the reason for the rise in occupancy is that tenants are attracted to low rent levels. Until the rebound in manufacturing activity is more visible, rents will remain under pressure.

• The vacancy rate in Brazil’s main industrial markets of Sao Paulo and Campinas have been falling since 2009, reaching a record low of 5.7% in the 1Q11.

• In Sao Paulo and Campinas, lower vacancies are due to strong demand in a supply-constrained market. Rents have posted solid increases as a result.

SOURCES: CBRE, PRUDENTIAL REAL ESTATE INVESTORS
# Latin America

## Key Investment Themes

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| Residential Development| • Mexico – Housing sales are supported by well-established mortgage programs and favorable demographics, which creates an opportunity to invest with large local homebuilders.  
                           • Brazil – Government programs have expanded access to credit over the past five years, fueling growth of the housing market. National expansion is attractive, albeit with execution risks.  
                           • Chile – The housing market developed on the back of a well-functioning mortgage system, and is expected to show stable growth, especially in the capital city of Santiago. |
| Retail Development     | • Mexico – Shopping centers’ share of retail sales remains low. Retail growth is concentrated in mid-sized cities. The consolidation of national operating platforms has yet to occur. |
| Logistics Development  | • Mexico – Mexico’s prime location and competitive pricing have strengthened its position in production and distribution in wake of the financial crisis.  
                           • Brazil – The expansion of local and international companies in Brazil is generating demand for new logistics space. The quality of existing stock is poor, which presents opportunities for new development. |
| Office Development     | • Mexico – A good entry point due to low pricing, and the quality of tenants is strong. Leverage is available from local banks.  
                           • Chile – Expanding companies are seeking new office space despite the recent delivery of large buildings. The 2010 earthquake encouraged tenants to migrate to newly-constructed buildings. |

Sources: Prudential Real Estate Investors
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Reference #: PFIA-8K5MC8