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Latin American Quarterly Outlook

JULY 2012

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Executive Summary

Macro Themes

- Latin America's major economies responded in mixed ways to the global uncertainty that punctuated the quarter. Brazil was the most affected due to its links with China, while Chile and Mexico are rolling along despite the weakness outside the region.
- China needs fewer commodities from countries like Brazil as a result of its slowdown. That highlights the need for Brazil to depend more on its local market, which is also struggling due to the lack of global competitiveness.
- Brazilian authorities are using policy measures to try to boost growth and reactivate the internal market. The IMF reduced its 2012 GDP forecast for Brazil, but raised its 2013 forecast.
- Chile's outlook is stable. The Andean country is expected to post GDP growth above 4% both this year and next.
- Mexico's economy is boosted by growing foreign investment and increasing demand from its domestic market. The IMF has twice raised its forecast for Mexican GDP growth in 2012.

Implications and Outlook for Commercial Real Estate

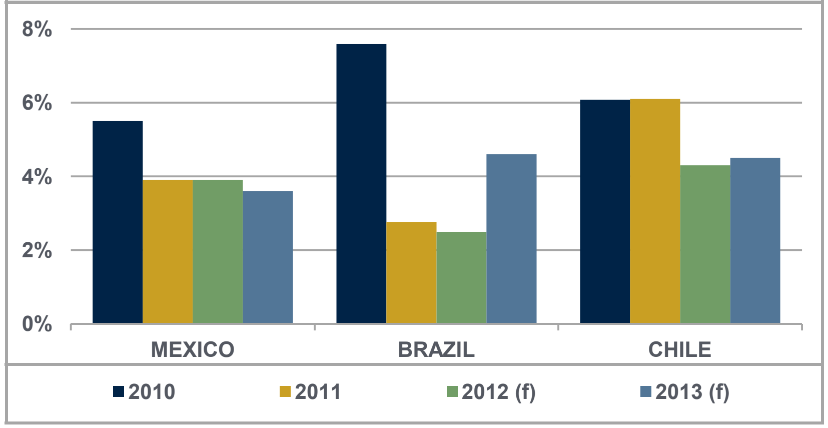
- Although demand for commercial real estate is generally tepid, the lack of high-quality properties in the region supports fundamentals in markets that are suffering the effects of the weak global environment.
- Transaction activity is sluggish due to investors' increased risk aversion toward emerging markets.
- Public real estate offerings have decreased considerably.
- Scarce levels of new supply help to sustain occupancy rates in Brazil, even though demand for prime real estate has moderated as economic activity slows. Transactions are growing in secondary cities, where development is targeting the growing consumer class in previously underserved markets. However, activity could slow if the economy lags.
- Increased demand for office and retail space in Mexico is fueled by improving business and consumer confidence. Mexico's industrial sector has strong fundamentals, and positive news is starting to spread to northern markets. Markets in central and northern Mexico are benefiting from investments by manufacturers.

Economic Trends

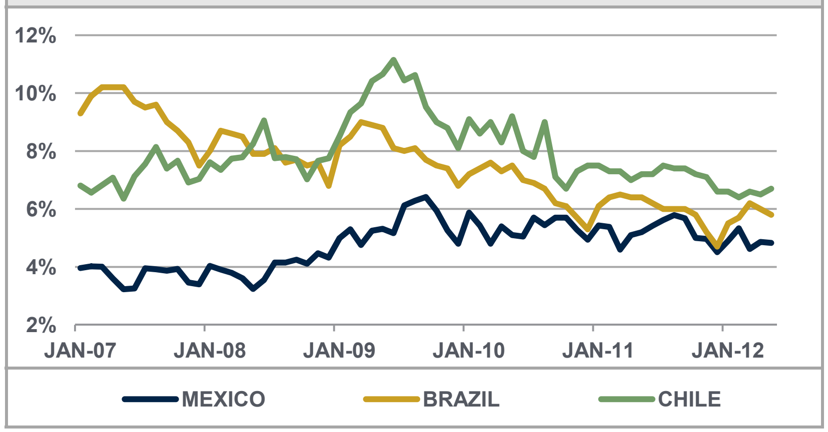
Growth Steady in Mexico and Chile, Brazil Trying to Regain Luster

- Mexico continues to outperform the global environment and other Latin American countries. The International Monetary Fund (IMF) recently raised its 2012 GDP estimate for Mexico by 30 bps, to 3.9% (CHART 1).
- Inflation is steady in Mexico although it slightly increased in June, mainly due to the price increase in agricultural goods.
- Chile's GDP growth is expected to remain between 4-5%, a sign of the stability that the Andean country has achieved in recent years.
- Brazil is affected by the global economic weakness, especially the slowdown in China. Its economy grew at an annual rate of only 0.75% in 1Q12, prompting the IMF to reduce its forecast for the 2012 GDP growth by 60 bps, to 2.5%.
- Inflation has been slowing in Brazil, dropping under 5% from the 7.3% peak in September 2011. That has enabled the Brazilian central bank to reduce the target rate to a historical low of 8% at the beginning of July, down from 12% last year.
- Unemployment rates continue to drop in the region (CHART 2).
- Brazil's unemployment rate returned to its downward trend after an increase early in 2012. Mexico's unemployment rate has been steady and continues to be the lowest among the major economies in the region. Chile's unemployment rate has declined fairly steadily since 2009.
- Price stability in the region has continued to improve due to the efforts of Latin American policymakers. Greater stability reduces the overall level of risk and enables market participants to produce more accurate forecasts and projections. In addition, it has attracted the attention of global investors that are seeking stable markets.

1) ANNUAL GDP GROWTH RATES & FORECASTS



2) ANNUAL UNEMPLOYMENT RATES



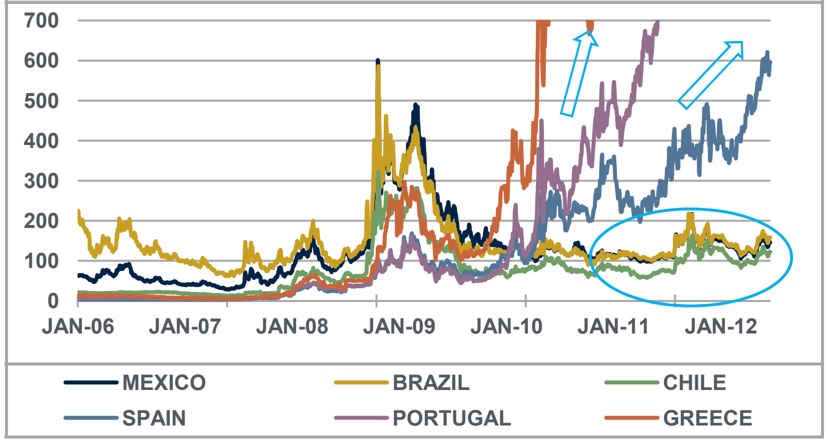
Source: IMF, INEGI, IBGE, INE, Prudential Real Estate Investors

Economic Trends

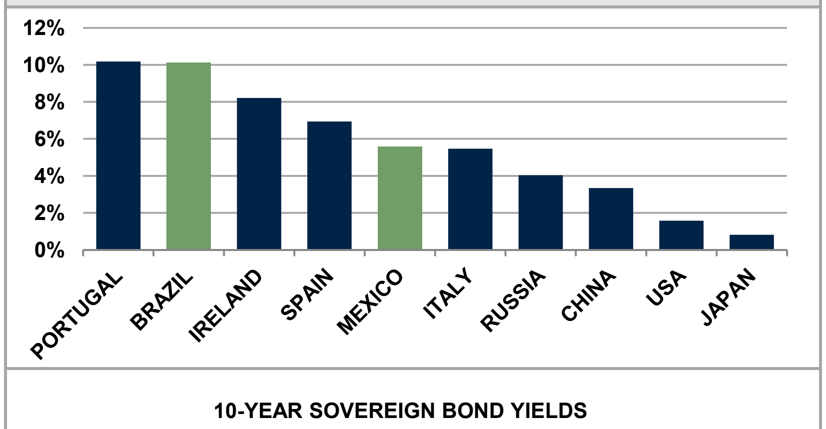
Stable CDS Spreads Demonstrate Favorable Investor Sentiment

- The cost of protection against sovereign default of the three major Latin American countries remains much lower than the credit default swap rates of troubled European countries such as Spain, Portugal and Greece (CHART 3). That demonstrates that markets see the region as relatively stable, with a low risk of sovereign default.
- The yield of 10-year Mexican bonds have rallied since 2Q11, and funding costs have reached historical lows of about 5.5% (CHART 4). This has produced strong foreign capital inflows to Mexico, enabling the country to fund growth and diversify its currency risk by issuing long-term bonds denominated in both US dollars and samurai.
- Regional currencies have been registering high volatility levels in response to the global economic environment. The Brazilian Real and the Chilean Peso are slightly more appreciated while the Mexican peso is more depreciated than historic averages.
- Solid capital inflows to Latin American economies do come with one major risk: the negative impact if these investments leave the region for a better return or a greater risk aversion.
- Latin American countries register a healthy debt-to-GDP ratio, and most of the major economies in the region have been also accumulating historic high levels of international reserves. This macroeconomic management has positioned the region as a healthy and attractive place for global investors to supply capital.

3) LATIN AMERICA'S STABILITY REFLECTED IN 5-YEAR CDS SPREADS



4) MEXICO'S BOND YIELDS AT HISTORICAL LOW RATE*



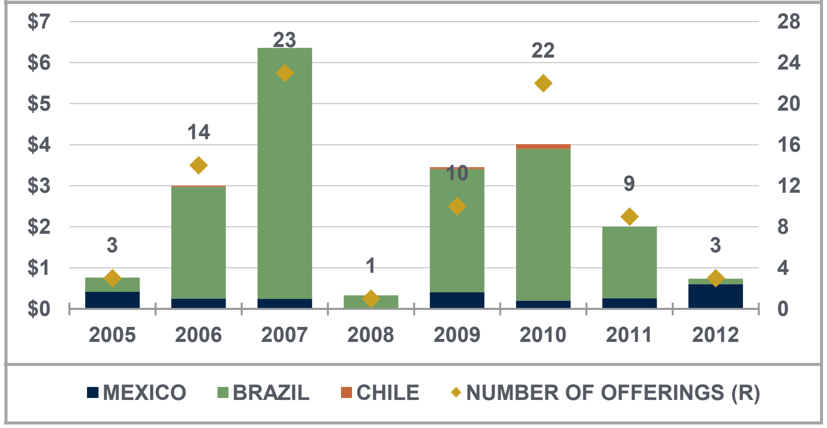
Source: Bloomberg, Prudential Real Estate Investors; *as of 6-29-12

Real Estate Performance

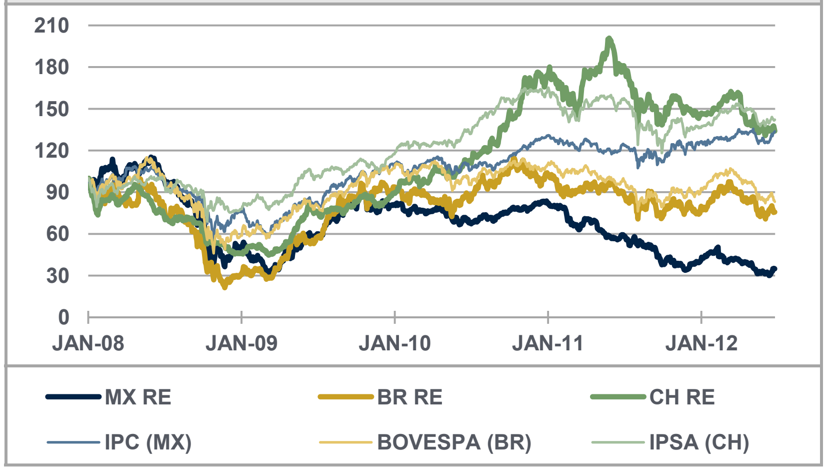
Mixed Performance Between Capital Raising and Stock Performance

- Public equity offerings by real estate companies are being put on hold after a few very active years due to the global economic environment, which has been putting pressure on the economy in the region (CHART 5).
- The number of offerings has decreased each year since 2010 in the three major economies in Latin America. However, the impact is felt the most in Brazil, which has been home to the bulk of the transactions.
- Mexico has led the region in terms of public capital raised for this year. Fibra Uno, the first and only Mexican REIT, conducted its first follow-on and raised more than USD$600 million, a record amount for Mexico.
- Public real estate companies in Brazil and Chile tracked the performance of the general stock markets in those countries. Both reflect global volatility, but the Chilean market has outperformed both the Mexican and Brazilian markets since 2010 (CHART 6).
- The Mexican real estate index has underperformed the general stock index. The index is dominated by homebuilders that have been struggling with high leverage levels and an inability to generate free cash flow in recent quarters.

5) REAL ESTATE PUBLIC OFFERINGS (USD BIL, L)



6) COUNTRIES GENERAL AND REAL ESTATE INDICES



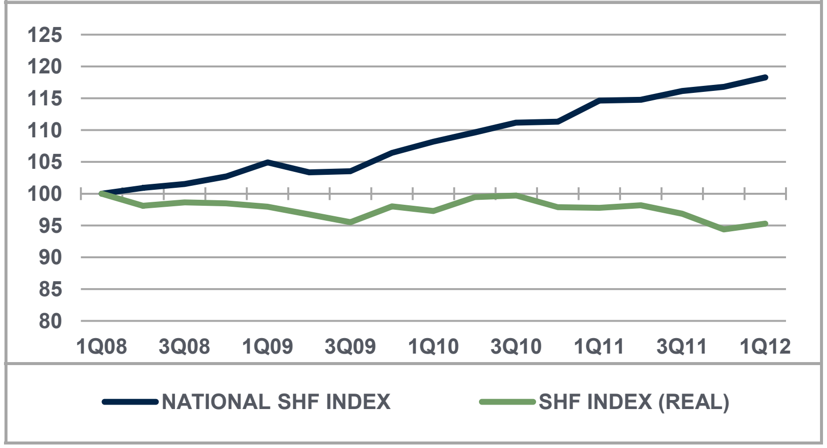
Source: Bloomberg, Prudential Real Estate Investors

Property Markets

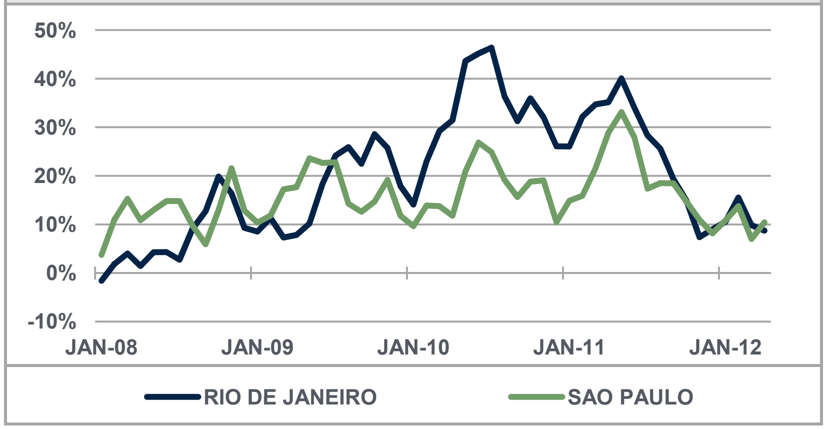
Low-Income Housing Continues Positive Trend

- Demand for low-income housing in Mexico and Brazil continues to be supported by steady population growth, a relatively young population and a large housing deficit. These positive demographics, combined with support from government programs, should sustain demand in the coming years.
- Demand for low-income housing in Mexico has been boosted by new programs and regulations approved by Mexican authorities late last year.
- INFONAVIT, Mexico's largest mortgage originator, issued 276,856 credits as of 2Q12, or 57% of its original goal (490,000 credits) for the year. The institute has historically granted more credits in the second half, so it is expected to surpass its goal for a second consecutive year.
- Housing prices in Mexico have been increasing, mainly due to inflation. Despite the sector's good performance, there are no concerns regarding a bubble within this industry (CHART 7).
- Growth in bank credit to housing in Brazil remains high, which continues to support the growing middle-income housing sector. Brazilian housing prices have grown rapidly in recent years, but recently the growth rates have dropped to more sustainable levels of about 10% (CHART 8).
- In Mexico and Chile, bank credit is growing at more sustainable levels, although the sector would benefit from increased access to credit in both countries.

7) NATIONAL HOUSING PRICE INDEX IN MEXICO



8) HOUSING ANNUAL APPRECIATION IN BRAZIL'S MAIN CITIES



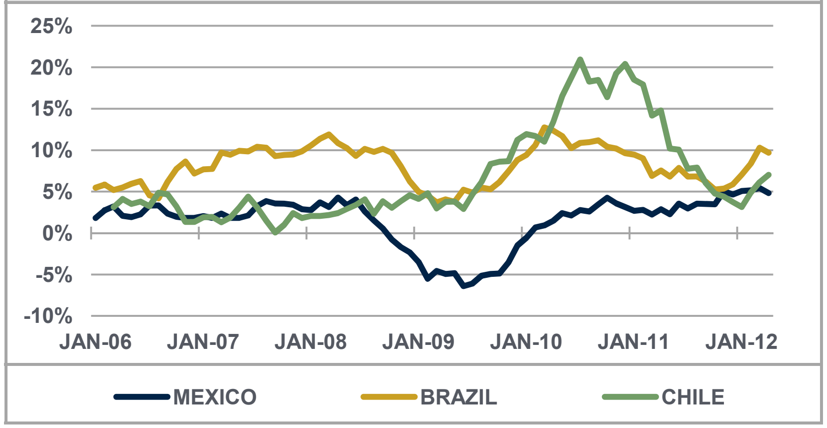
Source: INFONAVIT, Central Banks of Mexico, Brazil, Chile, SHF, FippeZap, Prudential Real Estate Investors

Property Markets

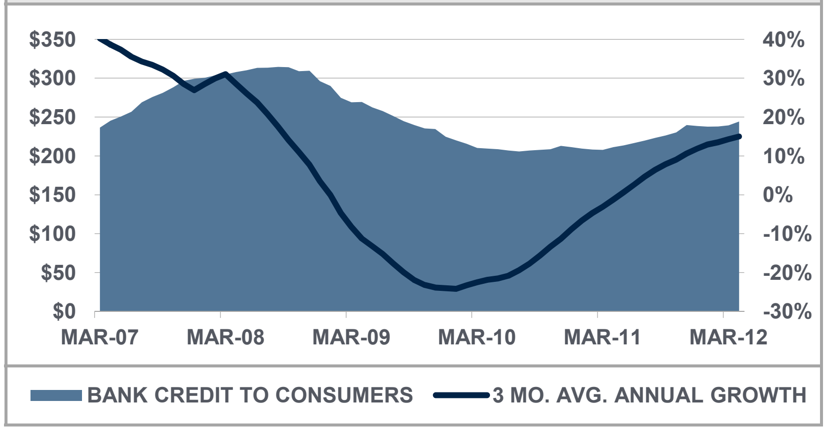
Retail: Outlook Improving Across the Region

- Consumer confidence remains high in Brazil and Chile due to tight labor markets, despite an overall moderation in economic activity. However, confidence is more volatile in both South American countries than in Mexico, where confidence has been steadily and increasingly rising.
- Retail sales in Chile and Brazil have increased during the last year, but the rate of growth has slowed. In Mexico, the upward trend has been consistent since mid-2009 (CHART 9).
- Bank credit to consumers, a driver of the retail sector, is increasing at double-digit pace in Mexico (CHART 10). Sales of clothing and general merchandise are rising as a result of higher confidence levels that allow the population to spend more in discretionary items, according to the ANTAD (Department Stores and Supermarket National Association).
- Investor demand for retail properties in Mexico is mounting. Two local retail developers tapped the Mexican AFOREs earlier this year, raising more than MXN$7 billion to develop shopping centers.
- Shopping center development has continue to spread to secondary cities of Brazil, which are becoming more attractive sources of demand as the Brazilian consumer class expands.

9) ANNUAL RETAIL SALES GROWTH (3-MO. R.A.)



10) BANK CREDIT TO CONSUMERS IN MEXICO (MXN$ TRIL)



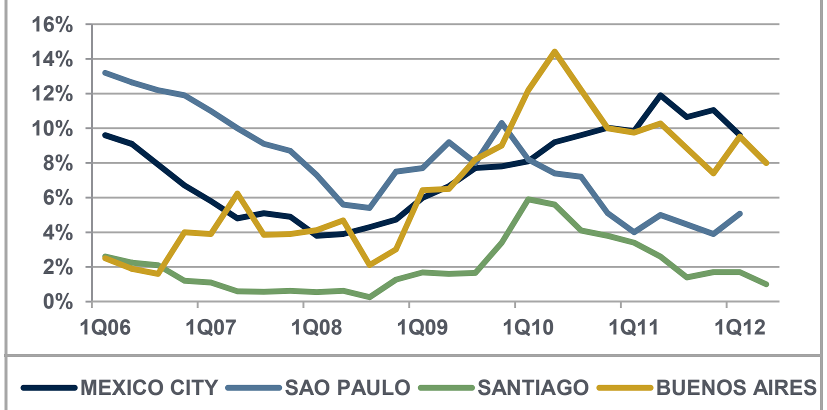
Source: INEGI, IBGE, INE, ABRASCE, ANTAD, Prudential Real Estate Investors

Property Markets

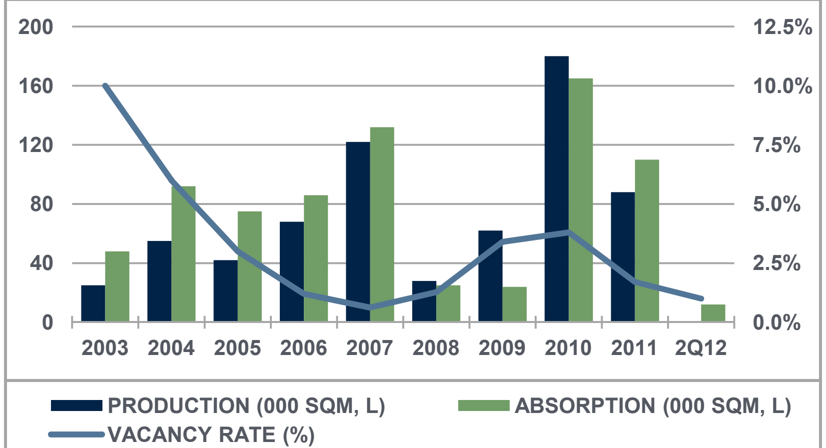
Office: Strong Employment Climate Keeps Demand Robust

- Latin American office markets have fared well despite the uncertain global economic environment. Similar to previous quarters, performance is strong in Sao Paulo and Santiago while Mexico City is slowly but steadily recovering from the 2008 downturn.
- The strong employment climate in Brazil and Chile has been leading both domestic and international companies to expand their workforces.
- Vacancy rates in the main office markets of Sao Paulo and Santiago are at or near historic lows, while Mexico City and Buenos Aires registered a downward trend throughout last year (CHART 11).
- Demand for office space in Sao Paulo has been solid, but a large amount of new supply has produced a slight increase in the city vacancy rate. Rents have remained fairly steady at high levels.
- Deliveries in Sao Paulo have increased this year as companies continue to expand or search for better-quality space. Prime office buildings are scarce, so the majority of new construction activity is focused on this segment.
- The steady delivery of new space has kept vacancy levels high in Mexico City, despite strong absorption, and it is expected to remain the same for the next few quarters. Rents are growing steadily.
- Santiago continues to show solid performance, with low vacancy rates, steady rent levels and strong tenant appetite for better-quality space. There have been no class A deliveries in Santiago this year, thus absorption is low (CHART 12). However, the average lease price has remained stable.

11) LATIN AMERICA CLASS-A OFFICE MARKET VACANCY RATES



12) SANTIAGO CLASS-A OFFICE MARKET



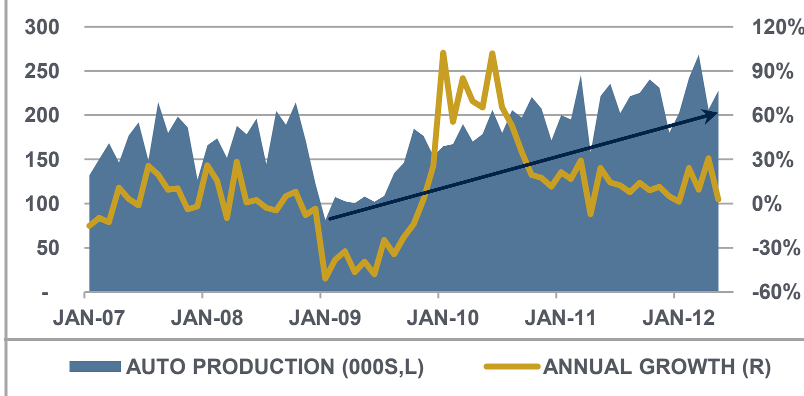
Source: CBRE, Prudential Real Estate Investors

Property Markets

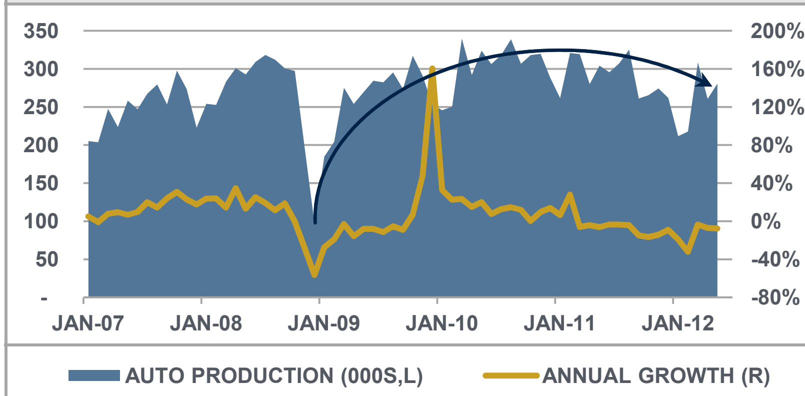
Auto Sales Power Warehouse Demand in Mexico; Brazil Vacancies Tight

- Manufacturing activity in Mexico continues to grow, boosted by robust auto production, which grew 12.5% year-over-year in the first five months of 2012 after a 17% gain in 2011 (CHART 13). Meanwhile, auto exports continue growing at a double-digit pace.
- Although the US remains the main destination for Mexico's auto exports, a growing number of cars are being sold in Latin America, Canada and Africa. This is despite the limits imposed by the Brazilian government on Mexican autos as well as a tax benefit that is no longer being respected by Argentina.
- New investments by automakers continue to increase demand for industrial real estate by parts suppliers. In addition to previously announced investments by Ford, Nissan, Mazda, Honda and VW, Audi has also announced a US$2 billion investment in its first assembly plant in North America, which will be located in Mexico.
- Hyundai also announced the construction of a new plant in Tijuana, northern Mexico, with a USD$131 million investment. Most recent foreign investments have been concentrated in central Mexico, but a few have been in the north.
- Vacancies in Mexico's main industrial markets of Mexico City and Monterrey continue to decline, buoyed by increased leasing activity rather than low rent levels, which fueled absorption in previous quarters. Rents continue to rise due to lower vacancies and slow delivery of new space.
- Strong demand for premium space in 2011 and 1H12 drove the class A vacancy rate to historical lows in Brazil's main industrial markets of Sao Paulo and Campinas. The expansion of both domestic and multinational firms in Brazil has increased demand for better-quality industrial space, which is scarce in the county.

13) STRONG AUTO PRODUCTION IN MEXICO



14) BRAZIL'S AUTO PRODUCTION ON THE RISE



Source: INEGI, AMIA, ANFAVEA, CBRE, Prudential Real Estate Investors

Attractive Risk-Adjusted Investment Opportunities — Latin America

THEME	INVESTMENT IMPLICATIONS
Scarcity of Quality Affordable Housing	• Mexico — Housing sales are supported by well-established mortgage programs and favorable demographics, which creates an opportunity to invest with large local homebuilders. New government initiatives that support low-income housing development confirm the government's interest and position the sector for sustainable growth over the short- and medium-term. • Brazil — Government programs have expanded access to credit over the past five years, fueling growth of the housing market. A large housing deficit, population growth and expansion of the middle class drive new developments and prices. 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.
Expanding Business Generating Demand for Logistics	• Mexico — Mexico's prime location and competitive pricing have strengthened its position in production and distribution of goods bound for the US in wake of the financial crisis. Recent foreign direct investment figures confirm investors' confidence in Mexico's manufacturing sector. • 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, although a large existing stock in certain areas could pose a vacancy risk. The quality of tenants is strong, and credit 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.
Retail Development	• Mexico, Brazil, Chile – A growing consumer class and low retail penetration outside of large cities have created opportunities for retail development in secondary cities.

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