July 2010

Latin American Quarterly

Market Perspective

Executive Summary

- Latin American economies rebounded in the first half following their poor 2009 performance, with the recovery highlighting the distinct drivers in each country. In the property markets, improved confidence and recovering demand is evident, although transaction activity remains anemic.
- Increased demand from abroad has led to steep gains in the manufacturing sector, driving the recovery in Mexico. The gains in production have created a need for more industrial space, although new construction activity remains weak.
- Latin America's retail sector is benefiting from lower unemployment, strong domestic demand, expanding access to consumer credit and the improved buying power of the middle class. Retail developers in Mexico are starting to see more demand among smaller tenants in Mexico for the first time since the onset of the global credit crisis. In Brazil, strong domestic demand is supporting the delivery of new shopping centers.
- Mexican and Brazilian homebuilders remain focused on the low-income segment, although a recent expansion in bank credit to housing in Mexico should serve to benefit the mid- to high-income sectors. The rapid expansion in Brazil's residential market has given way to new merger and acquisition opportunities among local homebuilders.

Regional Economies

The GDP numbers from Latin American countries in the first quarter signaled that a recovery is underway in the region. Economic activity increased in Brazil (9%), Peru (6%), Colombia (4.4%), Mexico (4.3%) and Chile (1%), while falling in Venezuela (-5.8%). These numbers are a welcome sign following the weak numbers posted in 2009, when GDP contracted in Mexico (-6.5%) and Chile (-1.5%) and was relatively flat in Brazil, Colombia and Peru.

Mexico's recovery has been largely export-driven, spurred by growth in the manufacturing, commerce and transportation sectors. The industrial sector expanded 5.4% in the first quarter from 1Q09, led by strong performance in manufacturing, according to government institute INEGI. However, job creation remains slow, which has prevented a full rebound in retail sales. Mexico's unemployment rate fell to 5.1% in May from 5.4% in April, but formal employment remains below pre-crisis levels. Domestic demand is showing signs of growth. The International Monetary Fund (IMF) recently raised its 2010 GDP estimate for Mexico by 30 bps, to 4.5%.

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Brazil has grown fast over the past year but that could moderate going forward. The country's 9% first-quarter GDP increase was lifted by a 4.2% rise in industrial activity and strong growth in the service sector, according to government institute IBGE. Total employment has grown over the past year to the benefit of retail sales. Brazil's 7.5% unemployment rate in May was down from 8.8% a year ago. However, Brazil's central bank is raising rates to stem fears of overheating, which could slow growth. The latest central bank survey forecasts 7.2% GDP growth for the year, while the IMF's most-recent GDP estimate is 7.1%.

Chile's first quarter GDP fell 1.5% from 4Q09, according to the Chilean central bank, reflecting the earthquake on Feb. 27. The central bank estimates GDP growth of between 4-5% for the year. The earthquake is not expected to have a large economic impact due to the country's healthy fiscal profile. Moreover, reconstruction efforts are expected to have a positive impact on growth through 2011.

Political events made headlines throughout the region in the second quarter. Brazil's October presidential elections are heating up, with the latest polls indicating a neck-and-neck race between Dilma Rousseff, the chief of staff to President Lula da Silva, and opposition centrist candidate Jose Serra. Columbia's presidential election was won by Juan Manuel Santos, who ran as a successor to President Alvaro Uribe. Santos, who will take office in August, pledged to continue Uribe's security and investment policies, which could attract foreign capital to invest in the country.

Capital Markets

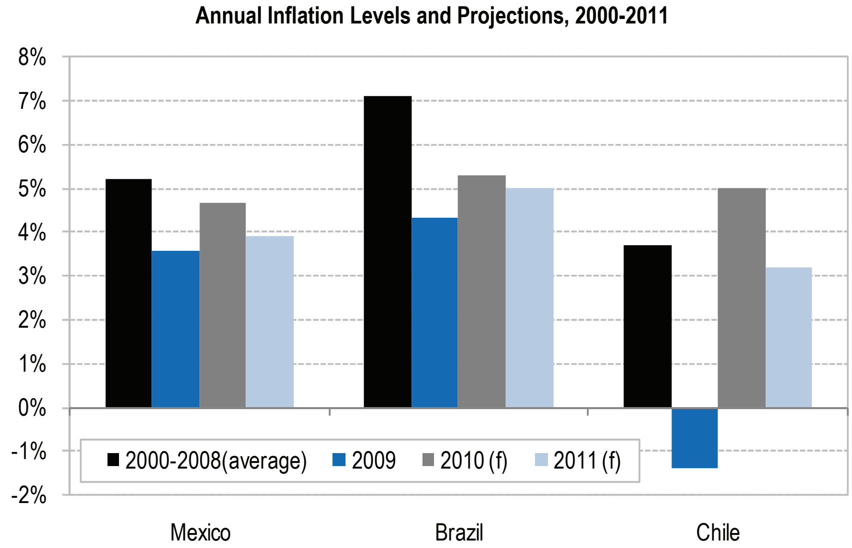
After rallying in 2009, Latin American stock indices have not fared as well this year. Bond index spreads have widened while local currencies have remained fairly stable or shown slight depreciation. Meanwhile, central banks in Brazil, Chile and Peru began to tighten monetary policy amid robust growth. In Mexico, rates remain unchanged because of weak domestic demand and benign inflationary pressures.

As announced in June, the stock exchanges of Chile, Colombia and Peru will merge in November, making the combined exchange the largest in Latin America in terms of number of listed companies (564) and the second largest in market capitalization after Brazil. This move is part of a plan by the countries to improve regional economic integration.

News that Mexico will be the first Latin American government to join Citigroup's World Government Bond Index (WGBI) in October has served to increase inflows to Mexico's debt market. The Institute for International Finance estimates Mexico will receive an additional US$16 billion of fixed-income inflows in 2010-2011 as a result of its inclusion in the WGBI, which should serve to strengthen the Mexican peso.

Strong consumer demand is creating inflationary pressures in Brazil. The 12-month inflation rate through June was 4.8%, above the government's target rate, and the latest full-year forecast among central bank analysts was for 5.3%. The central bank increased the benchmark interest rate by a total of 150 bps in April and May, bringing the rate to 10.25%. Chile followed suit in June with a 50 bps increase, bringing its rate to 1%. The Chilean central bank acted prospectively, since inflation is under control at 1.7% through June, but key indicators point to strong growth. Inflation in Mexico was 3.7% in May, but internal demand indicators remain weak, prompting the central bank to hold off any rate increases.

Inflation Expected to Remain Steady in Latin America



EIU (2008 data), local central banks (2009-2011)

Moody's in June upgraded Chile's long-term foreign currency rating to Aa3 from A1, citing the country's resilience to both the global credit crisis and the earthquake. It was particularly encouraging coming shortly after the announcement that the Chilean government will issue $1 billion in U.S.-dollar denominated bonds and US$500 million in local currency bonds this year to help fund the post-earthquake reconstruction plan. The offering will be Chile's first local currency debt issue ever and first international debt issue since 2004.

Property Markets

Industrial: Industrial production in Mexico rose 8.1% year-over-year in May, according to INEGI, fueled by strong growth in manufacturing. The positive numbers were helped by rising demand from the U.S., which is Mexico's main trading partner. Auto production rose 102% in June over the same month a year ago, while auto exports rose 109%, according to Mexican auto industry association AMIA. The recovery has started to reflect in employment figures: Mexico's manufacturing employment index rose 3.4% in June, the third consecutive rise following 25 months of decline.

The positive environment is translating into improved demand for industrial space, particularly in central Mexico. Rents, however, remain at a fraction of the market's peak two years ago, and construction activity is much lower. Developers are avoiding speculative development, due to weak demand and the lack of available financing. New deliveries of industrial space in Mexico's top six markets fell from a quarterly average of about 4 million square feet in early 2009, to well below 500,000 square feet. Current industrial developments are largely in build-to-suits.

Fueled by strong domestic demand, Brazil's industrial production reached a record level in March. The resulting upward pressure on prices prompted an end of government stimulus measures amid fears of a surge in inflation. Industrial real estate activity is concentrated in the south and southeast regions of Brazil, on the heels of the expansions of manufacturing facilities. Logistics operators have increased their searches for new warehouse space as a direct result of booming demand from local consumers. Global companies are expanding operations in Brazil. Some recent examples include: Bayer will invest US$102 million to construct new laboratories, while General Motors (US$385 million) and Ford (US$2.4 billion over the next five years) will expand facilities to increase capacity and develop new models.

Chile's industrial production rose 1.7% in May from April, reflecting the gradual recovery in the country's production capacity following the earthquake, according to government institute INE. Chile's construction activity was positive in March for the first time since December 2008, and the trend continued in April with a 5.3% increase over the prior year, according to the Chilean Chamber of Construction (CChC). National auto industry association Anac reported that first-half auto sales rose 89% from the year-ago period, a sign that consumption is recovering and domestic demand is driving industrial growth.

Office: The recovery in Latin American office markets continues to be uneven, and should remain that way for the rest of this year. In some markets, increased confidence among developers has led to the delivery of new space, causing vacancy levels to rise.

The addition of four new buildings in Mexico City pushed the 2Q10 class-A vacancy rate up to 9.2%, a 110 bps jump from the previous quarter, according to CB Richard Ellis (CBRE). Vacancy rates are expected to keep rising as nearly 190,000 square meters of space is scheduled to be delivered by the end of this year. New construction continues to be dominated by high-profile projects, many of which are striving for LEED certification. Sublease space as a percentage of total space fell to 4.3% in 2Q10 from 8% in the first quarter, which has minimized its downward impact on pricing. The average class-A rent rate was stable in the second quarter, at US$23.50, according to CBRE.

The Sao Paulo office market was robust in the first half in wake of Brazil's strong economy and employment climate, which led companies to expand. Net absorption increased by 77,400 sqm in 1Q10, the third consecutive quarterly increase and a 62% jump from 4Q09, according to CBRE. The strong demand lowered the class-A vacancy rate in 1Q10 to 8.2%, from 9.2% in the previous quarter. Average rental rates ticked up 3%, to US$53.40 from US$51.70, CBRE said, although the rise was partly caused by the appreciation of the Brazilian currency against the dollar. The improving market environment in the second quarter spawned a few sales of large office buildings in Rio de Janeiro and Sao Paulo at prices equivalent to 2007 levels. The properties were purchased by local firms.

The vacancy rate of class-A properties in Santiago, Chile, rose to 5.9% in 1Q10 from 3.4% in the 4Q09, mainly due to the addition of 90,000 sqm of new supply, according to CBRE. Among the new buildings is a skyscraper that will be the first in South America to achieve the LEED Gold environmental certification. Net absorption topped 47,000 sqm in 1Q10, nearly double the absorption for the entire year in 2009, according to CBRE. Average rental rates posted a slight increase, although a large amount of new supply in secondary submarkets during the remainder of the year is expected to put pressure on rents. Some recently developed office properties in Santiago's top office submarket of Las Condes have traded this year, in transactions largely backed by foreign capital.

Argentina's weak economy is preventing a rebound in the Buenos Aires office market. The combination of new space and weak demand pushed up the class-A vacancy rate by 320 bps, to 12.2% in 1Q10, according to CBRE. Absorption fell to its lowest level in four years, although it is expected to pick up later in the year.

Retail: Latin America's retail climate continues to benefit from recovering unemployment, strong domestic demand, expanding access to consumer credit and the growing buying power of the middle class. The World Cup soccer tournament also boosted Latin American retail sales, particularly the sale of televisions.

Sentiment continues to improve among both consumers and producers in Mexico. The country's consumer confidence index in June reached its highest level since September 2008, while the producer confidence index reached its highest level since February 2008, according to INEGI. But performance in retail sales remains subdued amid domestic demand that has just started to recover. However, the six-month rolling average of growth in Mexico's total retail sales rose slightly in April, the first positive average in 17 months. Meanwhile, same-store sales of members of retail organization ANTAD rose 6.2% in June, bringing the six-month average to 3.6%.

For the first time since the recession started, Mexican retailers are seeing a rebound among smaller tenants, the segment that suffered the most from depressed sales. Tenant perks are becoming less common as rent levels continue to stabilize. Meanwhile, most shopping center owners are focusing on managing existing portfolios and have put new developments on hold, except for a few developments in the large metropolitan areas of Mexico City and Monterrey. The biggest news in the retail sector came in April, when local discount retailer Chedraui raised US$370 million in Mexico's first IPO since July 2008. The move gives Chedraui more weight in the Mexican retail market, which Wal-Mart has long dominated. Wal-Mart announced in June that it has identified locations to open stores in 300 new cities in Mexico and Central America. The increasing number of large retailers is good news for shopping center owners because it gives them a greater number of tenants who can fill large blocks of space.

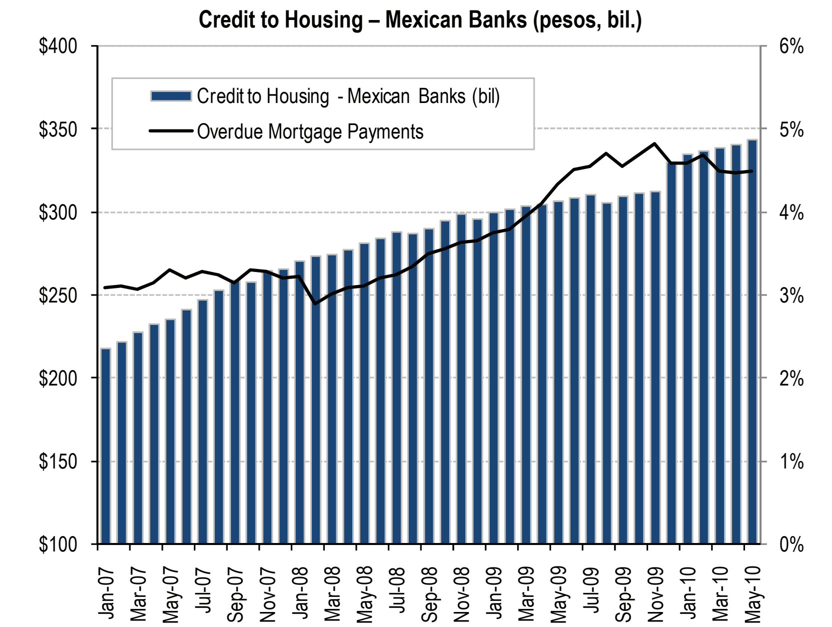
Retail sales in Brazil in May were up 10.2% year-over-year and 1.4% from April, according to IBGE. Strong domestic demand and an improving employment climate have led large companies to seek expansion opportunities in Brazil. According to ABRASCE, a retail trade association, 12 malls with 3.5 million square feet of space are scheduled to open in the second half of the year. Another 29 malls with nearly 10 million sf are scheduled to open next year, according to ABRASCE. Maquina de Vendas, Brazil's second-largest non-food retailer as created by merger in March, acquired electrical appliances chain City Lar in June. The combined company operates 750 stores with combined 2009 sales of roughly US$3.4 billion. Maquina de Venda's goal is to operate 1,000 stores and bring in US$6 billion in revenue by 2014.

Retail sales in Chile grew 19.1% in May year-over-year and 4.3% from April, in part boosted by demand for items needed to carry on post-earthquake reconstruction efforts. Chilean retailer Falabella announced in May plans to invest US$2.6 billion to open 184 new stores over the next four years in Chile, Peru, Colombia and Argentina. Chilean retailers are increasingly expanding into Columbia and Peru. Colombia boasts the second-largest population in South America and business-friendly policies.

Residential: Mexican homebuilders continue to focus on the low-income housing sector, which enjoys ample access to financing from government-backed housing institutions. The low-income segment accounted for 89% of total sales for Mexican homebuilders Urbi, Geo and Homex in the first quarter. Infonavit, the Mexican government's largest mortgage originator, wrote about 220,000 mortgages in the first half, putting it at 42% of its full-year goal. Infonavit (US$335 million) and Fovissste (US$368 million), the government's second-largest mortgage originator, issued mortgage-backed securities during the second quarter.

Home-mortgage lending by Mexican banks is growing at an increasing pace, which should serve to boost mid- to high-income housing construction, a sector that suffered during the crisis as banks adopted stricter lending practices. Credit for housing grew 14.5% in the three-month period ending in May, a rate of increase that is the fastest since 2008, according to Mexico's national banking commission (CNBV). The price of housing and the percentage of overdue mortgage payments have stabilized. Housing prices in Mexico fell 1.8% in real terms during the first quarter, according to government agency SHF.

Bank Credit to Housing is Picking Up in Mexico



CNBV

The focus in Brazil also remains on low-income housing, which accounted for 82% of the combined first-quarter sales of homebuilders Cyrela and MRV, up from 71% in the year-ago quarter. The recovery in Brazil's residential market has given way to new merger and acquisition opportunities among local homebuilders. Brazilian homebuilders Rossi and GMS formed a joint venture in May to operate in the western state of Mato Grosso, while Camargo Correa and Kallas formed a joint venture to develop projects in the southeastern state of Sao Paulo. PDG received shareholder approval to purchase local rival Agre for US$1.4 billion in June, which will create Brazil's second-largest homebuilder by market value.

Closing Thoughts

Latin America's economies are growing, with distinct drivers in each country. Mexico's recovery is being led by a surge in export demand, but domestic demand is starting to pick up as well, as rising consumer confidence is starting to translate into more consumption. The story is different in Brazil, where robust consumer demand has been so strong that it has led to fears of overheating. Chile's recovery has been delayed by the February earthquake, but reconstruction efforts are injecting funds and optimism into the economy.

Just as the economic landscape differs across Latin America, so do real estate markets. The improvements in Mexico's economy are starting to reflect in occupancy rates, a trend that should intensify in the second half of the year. Acquisition yields have stabilized and in some cases may be dropping, although it is difficult to draw firm conclusions since transactions are rare. Banks are slowly becoming less conservative in providing debt, but commercial development remains tepid, except in the low-income housing sector.

Demand for commercial space in Brazil is increasing, resulting in both higher occupancy and prices. Housing developers are achieving new sales records every quarter, while consolidation among homebuilders continues. In the retail sector, development activity is up, and large companies are buying properties at prices that are close to pre-crisis levels. Commercial development activity resumed earlier this year in Chile, despite a large delivery of new office space and upward pressure on vacancy rates.

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