

# Latin American Quarterly

## Market Perspective

### Executive Summary

- Latin America has started to feel the aftershocks of the global economic crisis. Central banks in the region have cut key interest rates in light of lower inflation expectations and decelerating growth, and governments announced stimulus efforts designed to support consumer confidence, extend credit and generate demand.
- Stock indices and local currencies have taken a bumpy ride. The majority of the stock indices in the region managed to finish in positive territory for the quarter, while local currencies remain very volatile.
- Weakening consumer demand, both within Latin America and in its principal export markets, prompted manufacturers in the region to decrease production and make further employment cuts. Industrial tenants are seeking leases with lower rents and shorter terms.
- Office vacancy rates are on the rise as companies look to cut costs and postpone expansion plans. The retail market is also weak. Some small shops are closing, and larger retailers have put expansion plans on hold.
- While home sales targeting higher-income households have suffered, sales targeting lower-income households have remained stable. The sector is set to benefit from government stimulus efforts designed to facilitate access to mortgage financing.

### Overview

Once a foreign event, the global economic crisis is now very local in Latin America. During the first quarter, employment and production deteriorated sharply. In an effort to spur economic activity, central banks cut key interest rates, as inflation was placed on the back burner and is no longer considered the most vital economic concern. Market participants have different views as to when growth could resume in Latin America, generally ranging from late 2009 to late 2010. However, there is a growing consensus that the relatively low levels of debt held by most local governments, businesses and households will allow economies to quickly rebound.

Demand for all types of commercial real estate is declining as a result of the downturn. During the first quarter, several Latin American governments, hoping to counter the effects of the slowdown, implemented programs whose goals include fostering new construction activity. This has caught the interest of investors, particularly for the low-income housing sector, although results will likely take time to materialize.

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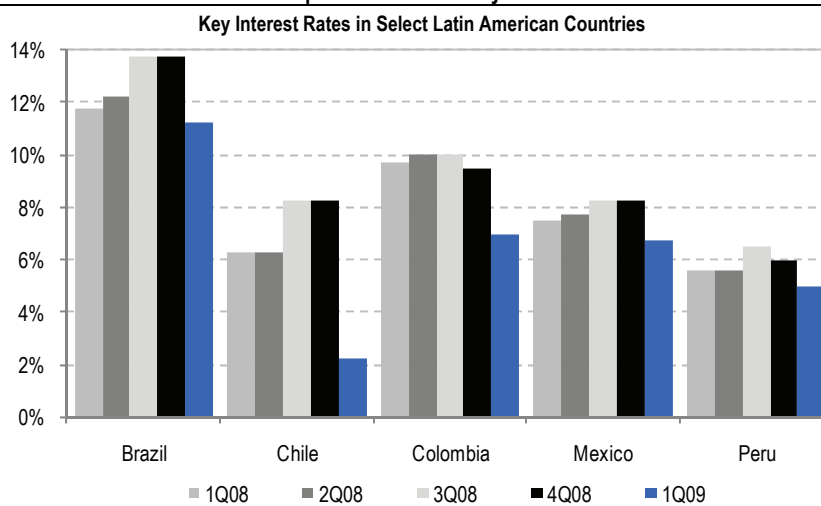
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Meanwhile, transaction activity in the commercial property markets is stalled. Investors are hoarding cash, seeking to identify opportunities to acquire assets from firms that are forced to sell. Such transactions have already started to occur, and should generate some of the most attractive investments going forward.

## Regional Economies

Although the region posted strong growth figures in 2008, the world economic slowdown is certain to take its toll on growth this year. In 2008, GDP growth was 1.3% in Mexico, 5.1% in Brazil and 3.2% in Chile. This year, the Mexican finance ministry has forecast a 2.8% contraction in GDP, while the central bank of Brazil recently adjusted its GDP growth outlook downward to zero. Officials in Chile and Argentina, countries that have been particularly impacted by falling global demand and lower commodity prices, have predicted positive GDP growth for the year, albeit with a bias toward the lower end of the growth range. Many private sector analysts suggest that – despite official government numbers to the contrary – GDP growth actually contracted in Argentina in 2008 and that this year’s outlook remains negative.

**Latin America Central Banks Attempt to Prime Economy**



Pramerica Real Estate Investors, Reuters

Unemployment rates are rising as companies fight the crisis defensively and eliminate jobs to cut costs and deal with declining demand. In Mexico, the unemployment rate in January rose to 5%, from 4% a year earlier, the highest it has been since April 2000. Unemployment also rose elsewhere in the region, including Brazil, Chile and Colombia.

The rapidly rising unemployment rate in the U.S. has taken a toll on remittance income from Mexican expatriate workers, the country’s second-largest source of foreign currency after oil. Mexicans working in the U.S. sent home \$1.6 billion in January, a 12% drop from the January 2008 total. The job losses and declining trade are also weighing on consumer confidence, which fell sharply in Mexico, Brazil and Argentina in the first quarter.

Mexico posted a \$491 million trade deficit in February due to shrinking demand for manufactured goods from the U.S., Mexico’s primary export market. The U.S. Census Bureau reports that the U.S. imported an average of \$12.4 billion of goods from Mexico in January and February, the lowest average since 2004.

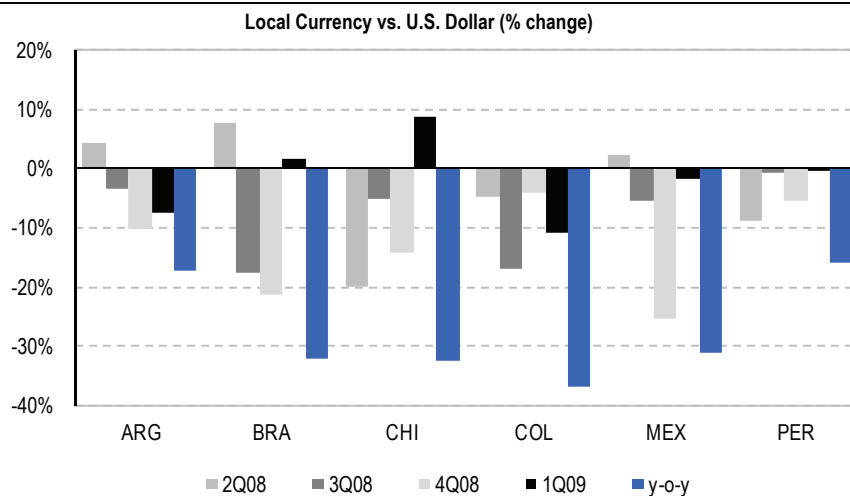
Mexico's trade deficit was not larger because demand for imports fell even more than exports, a result of a weaker peso and the resulting lesser demand for foreign goods. In January, Brazil reported its first monthly trade deficit since 2001, but the surplus (\$1.8 billion) returned in February, due to the slowing economy. As in Mexico, shrinking demand for imports, partly in response to the weaker Brazilian currency, was largely responsible for the improvement in the trade balance as imports contracted at a faster pace than exports. Exports were down 20.9% year-over-year in February, while imports were down 30.9% from the same month last year. Chile's trade surplus posted a \$2.6 billion year-over-year decline in January and February. Argentina's trade surplus declined slightly.

In light of relatively low inflation and decelerating growth, central banks in the region are cutting interest rates. The Bank of Mexico cut its key interest rate three times in the first quarter, to 6.75% from 8.25%, fueling concern that the recent depreciation of the Mexican peso could lead to inflation. After being cut twice, to 11.25% from 13.75%, Brazil's benchmark lending rate now stands at its lowest level since it was introduced in 1996. Chile's central bank slashed the benchmark interest rate to 4.75% from 8.25% in two separate moves in January, the largest reduction since a 175-bps cut in 1998. Peru's key interest rate was also cut twice during the first quarter, to 6% from 6.5%, in a response to a drop in the consumer price index.

## Capital Markets

Equity markets took a bumpy ride during the first quarter, but managed to finish in positive territory. Broad market indexes rose in Brazil (9%), Chile (4.3%), Argentina (4.3%), Colombia (6.1%), Peru (31.1%) and Venezuela (22.2%). Mexico's index, which tracks the U.S. market more closely, posted a loss of 12.3%.

Latin America Currencies Decline in 1Q09



Pramerica Real Estate Investors, Reuters

The value of some Latin American currencies dropped during the first quarter, as heightened risk aversion prompted foreign investors to pull capital out of the region while the supply of U.S. dollars in the region declined as a result of lower export revenues. During the quarter, the currencies of Mexico (1.7%), Argentina (6.9%), Colombia (9.9%) and Peru (0.3%) all depreciated against the U.S. dollar, while the currencies of Brazil (1.8%) and Chile (9.6%) appreciated.

Total 2008 foreign direct investment (FDI) in Mexico fell 31.6% from a year earlier, to \$18.6 billion, as investors became concerned with the correlation between Mexico and the U.S. Brazil's FDI fell to \$1.9 billion in January and \$2 billion in February, down 60% year-over-year and a sharp drop from the \$8.1 billion recorded in December 2008. Chile's total 2008 FDI rose 254% on the year to \$10.5 billion, reflecting Wal-Mart's entrance and the diversification of investors into sectors other than mining. FDI data for this year has yet to be released, but Chile's foreign direct investment committee has stated that the year-to-date FDI is steady.

The region's fortunes were boosted in March, when the International Monetary Fund announced its new Flexible Credit Line (FCL), which is available to countries with healthy policy and public finances. This sent a positive message to investors regarding the political stability and future outlook of countries such as Mexico, Brazil, and Colombia, which would potentially qualify for the program. Mexico's government in March announced that it will likely draw down between \$30 billion and \$40 billion on the FCL in order to increase the central bank's reserves. The FCL line comes with a \$30 billion reciprocal currency arrangement option from the U.S. Federal Reserve. The two facilities combined could provide Mexico with a cushion of up to \$70 billion in the event the economic crisis worsens.

Also in March, Moody's upgraded Chile's sovereign credit rating to "A1," from "A2." The agency cited the country's "strong resilience to adverse external shocks related to both the government's robust foreign asset position and a solid balance sheet that reflects the Chilean government's status as a net creditor." The upgrade reflects positively on Chile's fiscal management at a time when other countries' sovereign debt ratings have been downgraded. It also sends a positive message to investors, further establishing Chile's status as a stable destination for foreign capital.

## **Property Markets**

*Industrial.* The adverse effects from the slowdown in the global economy on industrial production in the region led to a decline in investment and consumption in 1Q09. For example, automakers in Latin America decreased production as a result of declining demand from the U.S.

Mexico's industrial output was down 11.1% in January year-over-year, its steepest decline since 1995, due to a slump in the auto, mining and construction sectors. Even so, important investments were announced in several industries, including logistics and aerospace. Hutchison Ports Holding announced plans to invest \$200 million in the construction of a dry port in the state of Hidalgo that could generate 10,000 new jobs. In March, U.S.-based aerospace-industry supplier Triumph announced plans to invest \$20 million in the construction of a manufacturing facility in central Mexico. Industrial tenants, unsure of the future, are seeking lower rents and shorter lease terms. For tenants located near the U.S.-Mexico border, efforts to reduce costs have prompted some to try to convert the denomination of their leases from dollars to pesos.

In Brazil, the government has implemented a stimulus program to jumpstart falling levels of industrial production. As a result, production rose 1.2% in February after falling 17.2% year-over-year in January. One part of the package extends tax breaks on new auto purchases in an effort to stimulate production in the sector. In January, Michelin announced plans to invest \$200 million to build a factory in the state of Rio de Janeiro, the company's fourth factory in that state. Yamaha Motors plants to invest \$15 million to expand

a facility that will double its production capacity. Industrial firm Wirex will also invest \$15 million to build a facility that will produce equipment for the auto industry. And Jurong will invest \$225 million to build a new shipyard in southeastern Brazil.

In Chile, industrial output was down 11.5% in January and 8.9% in February year-over-year due to weak performance in the metals and food and beverage industries.

*Office.* Office markets in Latin America are at a standstill. Markets across the region reached low vacancy levels by mid-2008, but absorption of office space is down since then. Landlords have become more open to lease renegotiations and lower rents in new contracts, with the objective of minimizing vacancy during the down period in order to cover fixed maintenance expenses. Several large projects have been put on hold since the end of last year. Until there is more clarity in terms of economic recovery, and financial markets reopen for office property developers, new construction will remain subdued.

The Mexico City office market has been slowly weakening for about a year, although vacancy is low by historical standards. More space is coming available for sublease, rents are declining and there is little enthusiasm for new projects.

Vacancies in Sao Paulo, Brazil's top office market, rose moderately during the first quarter. According to CB Richard Ellis, vacancy rates approached 7% by the end of 1Q09, up 100 bps from year-end 2008. Meanwhile, vacancy rates in Rio de Janeiro remain at much lower levels, although rents in that market have stabilized, an indication that the market is weakening.

In Santiago, vacancy rates remain at very low levels. The few properties that were completed in the second half of 2008 have been slow to fill, however. Due to the small size of the market, the new space was enough to push vacancy rates from a negligible level to nearly 2%. The city's largest project has been stopped due to a lack of financing and the anticipated lack of demand.

In Buenos Aires, vacancy has remained persistently low for the last four years, as a lack of financing has kept construction activity down. Buenos Aires is a local office market, with little foreign investment. Landlords have managed to keep rents on the rise during this period, even in U.S. dollar terms. The global crisis and the particularly harsh effects anticipated for Argentina, a notable commodity exporter, will translate into weak demand for office space in Buenos Aires in the near future. It remains to be seen how sale prices will evolve. In the past decade, local investors have consistently sought direct property ownership as an alternative to the weakened financial system, thus setting a floor for falling property prices.

*Retail.* Rising inflation, higher unemployment and declining consumer confidence levels are affecting the retail market throughout Latin America. With sales growth falling, tenants are seeking to renegotiate leases to reduce rents, shorten terms and increase landlord contributions to expenses. "Mom and pop" stores typical of Latin America have begun to default on rent and utility payments, forcing some shop owners to close altogether. With vacancy rates drifting higher, many property managers have placed expansion plans on the backburner and are focusing mainly on cutting operating expenses and maintaining occupancy levels.

Despite the negative developments in recent quarters, a few bright spots remain in the region, where investments in new shopping centers and store expansions are going forward. Although rising unemployment has diminished Mexican consumers' spending power, sales of stores that belong to retailer trade association ANTAD rose 8.6% in January year-over-year and were up 5.4% in February. One big winner among retailers in Mexico is Wal-Mart, whose sales increased in January (9.2%) and February (8.4%), as consumers turned to discount shopping. Wal-Mart Mexico plans to continue its expansion into the region. In February, the company announced that it would spend \$808 million to open 252 new stores and expand into new cities.

Home Depot Mexico also announced plans to open more stores and invest \$60 million in two multi-channel distribution centers, which will improve distribution for its more than 80 stores across the country. Mexican retailer Grupo Gigante, which plans to invest \$98 million this year to open 108 new Office Depot stores, announced a five-year plan to increase sales by 140% and double its workforce. Not all the news is about growth, however. After defaulting on its debt in October, Comercial Mexicana, the third largest grocery chain in the country, has received an extension on its agreement with foreign creditors.

Brazil's retail activity increased in the first quarter. Retail sales in Brazil were up 6% in January year-over-year following a three-month decline, as retailers employed deep discounts to increase customer traffic. In January, shopping center administrator Iguatemi obtained a \$25 million credit line from ABN Amro, and General Shopping issued \$35 million of CMBS. Other local developers announced new shopping center projects worth a combined \$108 million. And French retail giant Carrefour announced plans to invest \$870 million to open 70 new stores in Brazil over the next two years.

In Chile, February retail sales were down 3% year-over-year. Chilean retailer Falabella agreed to develop new shopping malls with rival Ripley Corp. in the increasingly competitive Chilean market. In Colombia, January retail sales contracted 4.5% from a year ago.

*Residential.* With consumer confidence down and residents reluctant to enter into long-term financial commitments, housing demand has softened across the region. Although the increasingly strict credit market has also become a concern, some market segments have been more affected than others, and new opportunities have emerged. The continued accessibility of mortgages in Mexico and growing opportunities in Brazil in the affordable, entry-level segment has kept markets in both countries strong.

The Brazilian government's new \$15 billion stimulus program for the housing sector, called Minha Casa Minha Vida, consists of a series of measures to increase the amount of mortgages provided to homebuyers, while slashing financing costs and red tape. The program is targeting the development of 1 million new homes, which will generate 1.5 million jobs and total investments worth 2% of GDP. The bulk of the new houses will be for the lower-income market segments, through direct subsidies and resources to be managed by state-bank Caixa Economica Federal.

In Mexico, sales of houses targeting high- and middle-income households have suffered more than those targeting medium- to low-income households. Despite the crisis, lower-income families continue to buy homes as they have greater access to mortgages through the country's public housing agencies. This has prompted Mexico's largest housing development companies to shift their focus to the low-income sector. Mortgage rates have been held down by strong competition among financial institutions. Infonavit, a

government mortgage provider that lends to employees of private companies, announced a five-year plan to finance 500,000 new mortgages in 2009 and up to 700,000 annually by the year 2013.

Commercial banks, which provide mortgages to the middle- and high-income sectors, are underwriting more conservatively. Still, their portfolios are expected to grow 10% this year. Sofoles, Mexican mortgage banks that have been the other major source of funding for the middle- and high-income sector, historically have relied on debt, equity and MBS to fund growth. With limited access to capital markets, Sofoles will contract in 2009. Despite this, demographics remain favorable. Although population growth has slowed over the past few years, Mexico's current population is very young – some 41% are age 18 or younger – which translates into demand for more than 800,000 new homes per year between now and 2020. Demand for second homes in Mexico has decreased by about two-thirds since the start of the crisis, according to Colliers International, as the economic downturn in the U.S. hampered consumers' ability to purchase large-ticket items.

Tourism is the third largest source of foreign currency inflows to Mexico, and a weaker peso has made tourism to Mexico even more attractive for foreigners, although news of drug cartel violence has caused some apprehension. Some new tourism investment is in the works. Fonatur, Mexico's tourism development fund, expects to generate \$833 million of private investment in tourism projects this year as part of the government's efforts to limit the local impact of the financial crisis.

## Conclusion

The first quarter was difficult for Latin America as the global economic crisis took its toll on economies across the region. Soft demand from within the region and important export markets around the globe caused industrial production to decline, unemployment rates to rise and consumer confidence to plummet. Companies reviewed expansion plans, sending a clear signal to the markets that the downturn still has momentum. Development activity in the property markets fell across the board in anticipation of weaker demand for space.

While equity investors remain on the sidelines and credit availability is limited, there are pockets of liquidity that are poised to step back into the real estate market, including locals and foreigners who expect the Latin American economies to resume their growth mode next year. Price levels continue to restrain transaction volume, as the relatively low usage of debt typical of real estate activity in Latin America has made sellers less inclined to take losses. Nevertheless, the current economic crisis has created certain situations in which companies are (or will be) pressured to sell properties, and for those situations there have been buyers. Going forward, some of the most interesting opportunities in the region will originate from this dynamic, including company and asset transactions.

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