

Latin American Quarterly

Market Perspective

Executive Summary

- The global financial crisis continues to dampen growth in Latin America. While certain sectors are starting to recover, unemployment is still on the rise. The added impact of the H1N1 “swine flu” outbreak worsened the situation for some countries, albeit temporarily.
- Soft global and domestic demand has left some manufacturers no choice but to decrease production and cut jobs. In an attempt to keep vacancies in check, some industrial landlords are reducing rents.
- Central banks in the region have slashed interest rates to record lows, and governments have introduced stimulus measures to boost consumer sentiment and economic performance. Stock indices in the region rallied as investors turned their focus to the month-on-month improvements that begin to surface.
- Commercial real estate fundamentals are suffering. Rents in the office sector are under pressure from additional space and lower demand. Depressed retail sales have discouraged contract renewals and prompted tenants to demand lower rents. However, retail sales and consumer confidence are showing signs of improvement.
- Large housing development companies continue to shift their focus to low-income housing, as the sector remains at the center of government stimulus efforts designed to facilitate access to mortgage financing. Limited access to credit has led to consolidation among homebuilders.

Overview

The first quarter of 2009 confirmed that the global economic crisis would not spare Latin America. The region officially went into recession in the second quarter. Softening global demand caused industrial production to plummet, resulting in job losses and depressed levels of consumer confidence. Central banks slashed key interest rates to historical lows as governments made stimulating economic growth a primary concern. In some countries, the weak economy led to discontent with the government, prompting changes in the political landscape. As a result, governments introduced various stimulus measures, with some already starting to produce slightly positive signs that suggest the worst has passed and that economic rebound is on its way.

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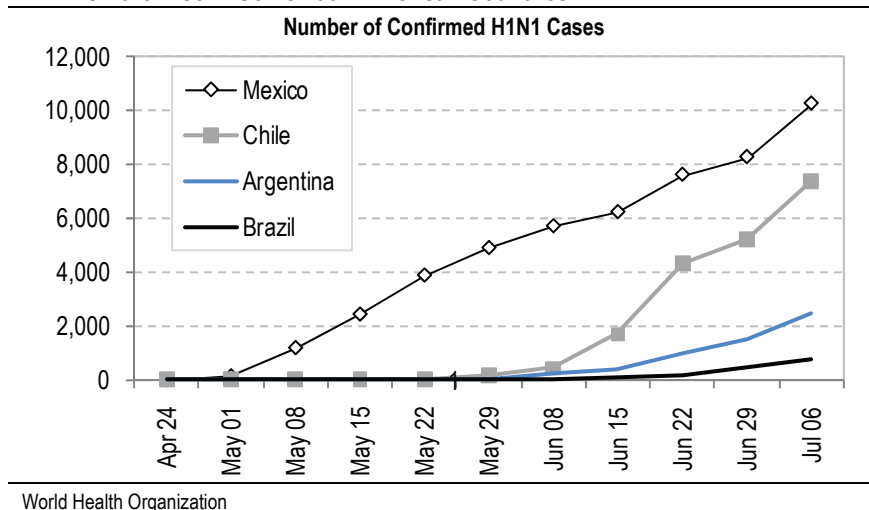
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Real estate markets continue to suffer as credit markets tightened and both companies and individuals remain reluctant to enter into long-term financial commitments. Across the region, companies postponed expansion plans or even scaled back their operations. In some countries, government subsidies to the lower-income market segments led construction companies to shift their focus and concentrate on where demand was highest. Consolidation was seen in some markets as the economic slowdown exposed attractive opportunities for mergers and acquisitions.

Regional Economies

Global economic developments eventually have wide-ranging local consequences. For example, worsening conditions in Argentina brought about largely by the global economic slump triggered the defeat of the ruling party in recent midterm elections. In Mexico, the H1N1 influenza outbreak has been a drag on the economy. The epidemic caused a 13-day business activity stoppage in Mexico City and steep declines in both domestic and international tourism. The result is a total estimated output cost of 0.4% of GDP, according to the Institute of International Finance (IIF).

H1N1 On the Rise in Some Latin American Countries



Mexico's federal government recently announced a US\$2 billion stimulus effort aimed at discouraging layoffs and helping service industries to recuperate from steep declines in sales. Although everyday affairs have returned to normal in Mexico, the onset of the winter season in South America has prompted increased prevention efforts in the region as more cases of the H1N1 virus are confirmed. As of the end of June, fatalities were on the rise in Argentina and Chile.

Unemployment rates are also climbing as employers are forced to scale back on expansion plans and cut costs through layoffs. In Mexico, the unemployment rate in May rose to 5.3%, the highest it has been since 1996 and up from 3.2% from a year ago. Job losses were greatest in the industrial production and trade sectors. Chile's unemployment rate reached 10.2% in May, its highest level since 2005. In response, Chilean President Michelle Bachelet announced a stimulus package aimed at lowering the unemployment rate by 1.5%. The second half of the year will reveal the outcomes of this effort. On the other hand, Brazil's unemployment rate, at 9% in March, declined slightly in May. The country's aggressive countercyclical

monetary policy and industrial tax breaks began to stimulate business sentiment. In May, Brazilian employers hired a net total of 131,557 new workers, up 0.44% from the previous month.

Across the region, trade numbers are declining as both global and domestic demand remains soft. Trade balances at the country level hinge on whether there has been a bigger decline in exports or imports. Mexico posted its third consecutive monthly trade surplus in May. Mexico's recent streak of trade surpluses is actually a positive side-effect of the recession, since it may help ease the potential pressures of the exchange rate with the U.S. dollar that would result from a large current account deficit. Brazil's trade surplus narrowed 28.6% in May from a year ago, as both imports and exports plummeted. Chile's trade balance has been impacted by the drop in international copper prices. The average price per pound declined 45.5% between May 2008 and May 2009, causing copper exports to decline 53.1% this year through the end of May.

Capital Markets

Latin American equity markets were the first to reflect the severity of the downturn in 2008. Accordingly, stock prices responded to the more recent signs of a recovery. Broad market indexes rose in 2Q09 in Argentina (40.0%), Peru (38.8%), Chile (22.8%), Colombia (22.8%), Mexico (22.6%) and Brazil (22.6%).

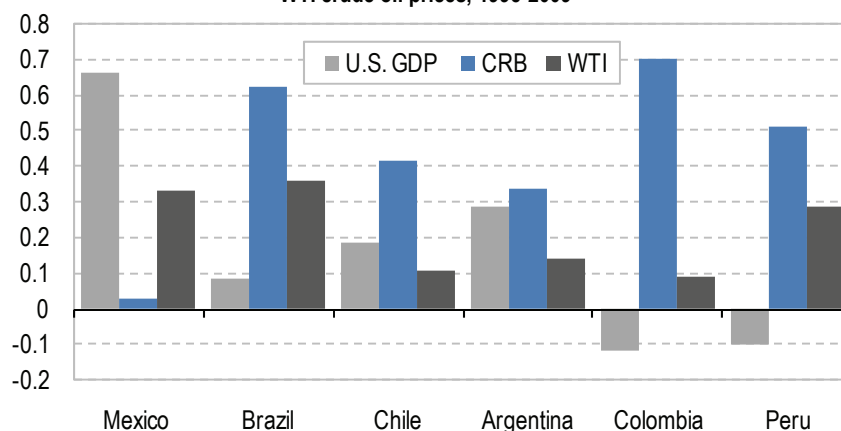
The value of most Latin American currencies appreciated during the second quarter, as soft domestic demand caused imports to plummet at a pace comparable to that of exports, and widening trade surpluses helped to ease pressures on exchange rates. Investors also began to regain their appetite for risk, especially in Brazil and Chile, as demonstrated in the amount of new issuances by companies in those countries. The currencies of Brazil (16.3%), Colombia (16.1%), Chile (8.7%), Mexico (5.4%) and Peru (4.5%) all appreciated against the U.S. dollar, while the Argentine currency (-2.4%) depreciated.

As the downturn deepened across Latin America, leading to decreased production levels and deteriorating business sentiment, central banks in the region made countercyclical monetary policy a priority and began to slash key interest rates to record low levels. Helping to ease monetary policy even further was the fact that governments retained lower inflation expectations, especially as declining consumer spending placed downward pressure on consumer price index (CPI) growth. During the second quarter, Mexico cut its key rate by a total of 200 bps, to 4.75%, amid falling industrial production and export figures and the added impact of the H1N1 outbreak. Brazil also cut its key rate by 200 bps to 9.25%, the first drop below 10% since 1999. Chile shaved an additional 200 bps off its key rate, bringing this year's total cuts to 750 bps, more than any other country in the region. The rate now stands at 0.75%, its lowest level in history. Chile's central bank announced that it estimates this rate will remain in place "for longer than is implicit in the prices of financial assets."

Although all of the largest Latin American economies are suffering the effects of the crisis, there are also marked differences among them. The graph below shows local economies' correlations to three key external drivers: the U.S. economy, commodity prices and oil prices. The widely different results give hints of how the current crisis is expected to continue to unfold across the region. Mexico's recovery is very dependent on a U.S. recovery, while a recovery in countries such as Brazil and Peru is more dependent on a rise in prices for commodities and crude.

Latin America Economic Recoveries Will Depend on Different Variables

Correlation of GDP growth with U.S. GDP, CRB Price Index and WTI crude oil prices, 1995-2009



Bloomberg; Barclays

In April, Standard & Poor's affirmed Brazil's sovereign rating at "BBB-" and its "stable" credit rating outlook, citing the country's "prudent macroeconomic policies." In May, Standard & Poors affirmed Mexico's foreign debt rating at "BBB+" but downgraded its credit rating outlook to "negative," stating that "Mexico's fiscal and external positions have deteriorated." The country's budget deficit has risen as a result of declining tax revenue and increased government spending. Mexico posted a 12-month budget deficit of US\$11.2 billion as of March, compared with the US\$248.3 million surplus reported in the same period a year ago.

Property Markets

Industrial: Softening global demand had an adverse effect on industrial production in the region and brought double-digit contractions from 2008 peaks. Manufacturing production, especially auto production, was the hardest hit sub-sector. Some automakers announced shorter work weeks or temporary production stoppages. The large cuts made to key interest rates across the region and the stimulus packages introduced in some countries helped to encourage consumer spending with the goal of improving production levels.

Mexico was especially affected by its direct exposure to weaker U.S. demand, particularly in the auto industry. Mexico's first-quarter industrial production declined 9.9% from 1Q08. April's numbers were additionally impacted by the business activity stoppage caused by the H1N1 outbreak, resulting in a 13.2% drop in industrial production and an 18% drop in manufacturing activity. April's industrial production figure did register a 1% increase from March, however, bringing hope of a rebound in business sentiment and global demand. In May, auto production declined 39% from May 2008, although Mexico's auto industry trade association hopes that recent improvements in U.S. consumer confidence levels will contribute to healthier figures for the industry in the second half of this year.

Despite the difficulties the industrial sector experienced during the second quarter, the environment is becoming more encouraging in Mexico. The costs of manufacturing in Mexico are now comparable to those of China, as a result of the peso's depreciation against the U.S. dollar, relatively low transportation costs and free-trade status with the U.S. Investments in Mexico's transportation systems and infrastructure have

also surfaced with the objective of facilitating the flow of people and goods and reducing logistics costs. Mexico's government announced a US\$151 million investment in the national port system and a US\$1.3 billion investment in the construction of new roads and airports in central Mexico.

Still, transaction activity in the industrial market remains low, although it seems that prospective tenants have at least resumed searching for new space. Landlords are responding to a rise in vacancies by lowering rents and shortening the duration of lease contracts. Unusually high inventory levels from 2008 have carried over and complicated the current situation, resulting in further discounted lease rates for all property classes.

In Brazil, industrial production fell in yearly terms but posted steady month-to-month gains as government tax breaks on new auto purchases and other products were extended until the end of October. First-quarter industrial production declined 14.7% from 1Q08, but has increased since then. In June, GM Brazil posted its highest monthly sales volume in the company's 84-year history in the country. Accordingly, the auto industry continues to lead the way in terms of investment volume. In April, GM and Ford announced they would continue with their investment plans in Brazil. Between now and 2012, GM plans to invest US\$1 billion in Brazil, while Ford plans to invest US\$1.6 billion in its automotive facilities in both Brazil and Argentina. Chinese automaker Cherry announced plans to invest US\$700 million in the construction of a factory in Brazil with a production capacity of up to 150,000 new vehicles per year. Demand for build-to-suit and speculative industrial space is very low. However, a more positive business environment is starting to reflect in an increased number of inquiries by potential space-users.

Office: In office markets across Latin America, unfavorable market conditions have given tenants the upper hand. Although several new construction projects have been postponed, there is still new space actively under construction that will become ready for delivery this year. As demand remains subdued, vacancy is trending up.

In the Mexico City office market, vacancy is up yet average lease rates remain somewhat stable. But there is expected to be downward pressure on lease rates as more space comes available this year and in future years. In Sao Paulo, Brazil's top office market, the demand for space has started to weaken, and, according to CB Richard Ellis, the market has begun to record negative absorption for the first time in several years. As construction projects are completed and more space becomes available, average lease rates are expected to decrease. In Santiago, activity is starting to slow following a lengthy period of strong growth. Construction projects are being postponed in order to avoid a sharp drop in lease rates. In Buenos Aires, vacancy rates are on the rise. There, the uncertain economic situation, added to construction projects about to be delivered, give tenants room to negotiate more favorable lease terms.

Transaction activity is very low in Latin American office markets. With notable exceptions, properties are mostly free of debt. Owners, therefore, feel less pressured to sell than in more-leveraged markets. The gap in price expectations between potential sellers and buyers remains high. Moreover, as signs of economic improvement emerge in markets such as Brazil, owners will be less likely to adjust their price expectations as they await a recovery from the current slowdown.

Retail. Rising unemployment and declining consumer confidence continued to burden Latin American retail markets during the second quarter. Depressed sales figures have placed downward pressure on rents, and

lower net operating incomes have caused a slowdown in new construction activity. Vacancy rates have increased as tenants, unable to pay rent, are either forced to vacate the properties or opt to not renew leases. Positive signs of recovery are emerging, however, in consumer confidence levels and mild sales growth, particularly among low-end and name-brand retailers.

In Mexico, mall owners are finding it difficult to secure new tenants, especially struggling anchors and small “mom and pop” tenants, as most retailers continue to post stagnant or declining growth figures. The business activity stoppage that came as a result of the H1N1 influenza outbreak was particularly disruptive to the retail sector. Wholesalers were the most severely affected by the outbreak and lost an estimated US\$400 million in sales, as hotels and restaurants lost customers and cut back on the inventory they ordered. Small tenants continued to struggle with declining sales volume and inability to meet rent obligations, but strong name-brand retailers performed well during the second quarter. Mexican retail association Antad reported sales growth among its member retailers during the quarter. In May, Mexico’s consumer confidence index fell to a record low of 78.3 as the H1N1 outbreak fostered fear of a possible worsening of the crisis. In June, the index rose to 81.0, indicating that consumers were somewhat more optimistic about the direction the economy would take in the next few months.

In Brazil, retail sales held steady as retailers maintained deep discounts to entice customer traffic and encourage spending. Recently, Brazil’s consumer confidence index has posted gains. In June, the index rose to pre-crisis levels. Wal-Mart announced plans to invest US\$800 million in Brazil during the second half of the year in light of expectations that the local economy will recover and experience growth. The investment plans include opening 90 new stores, focusing mainly on chain stores that cater to lower-income market segments. Brazilian mall owners have issued securities to raise capital, indicating plans for future growth and consolidation. For example, Multiplan issued US\$51 million of debentures. Also, mall operator BR Malls announced plans to place primary and secondary share offerings worth up to nearly US\$520 million. Mergers and acquisitions activity also continued. Brazilian grocery chain CBD acquired a 70% stake in Globex Utilidades, the majority owner of Brazilian retailer Ponto Frio, for US\$420 million, making CBD Brazil’s largest retailer.

In Chile, April retail sales were down 3.2% from the same month a year earlier. Despite slower sales, Chilean retailer Falabella announced plans to move forward with its previously announced US\$390 million investment for the year to expand locally and in Argentina, Peru and Colombia. Several Chilean retail and mall companies have announced plans to issue debt and equity in order to raise capital for operations and expansion. During the quarter, the following companies placed local bond issues: Falabella (US\$287 million); Mall Plaza (US\$188 million), Cencosud (US\$204 million); and Ripley (US\$ 118 million).

Residential. Tighter lending conditions in Latin America since 4Q08 have led to less available mortgage and construction financing, resulting in lower supply and demand. Several real estate development companies, especially in Mexico and Brazil, have shifted their focus to low-income housing, a segment with strong demand that enjoys access to mortgage financing via government incentives. Tough economic times should translate into opportunities for larger, more established development companies to further increase their market share through the acquisition of smaller and weaker competitors.

In Mexico, tighter lending conditions have reduced the supply of both mortgage and construction financing. Commercial banks, which provide mortgages to the middle- and high-income sectors, have imposed stricter

lending conditions. In the past, the other major source of financing for these sectors had been Sofoles, Mexican mortgage banks which historically relied on the capital markets to fund growth, and which now are struggling. Overall, fewer Mexicans are buying homes as unemployment figures rise and consumer confidence levels suffer. In June, Finance Minister Agustin Carstens forecast that demand for housing this year will be 7.1% lower than in 2008. Despite the bleak environment, the lower-income sectors continue to benefit from government subsidies, and government-backed mortgage agencies Infonavit and Fovissste are standing by the goals they set earlier this year for new mortgage originations. Infonavit wrote close to 200,000 new mortgages in the first half, a pace which puts it below its yearly goal of 500,000. Although mortgage financing is available, this gap reflects a lack of construction financing for homebuilders. With fewer houses being built, rates are also lower.

In response to the climbing unemployment rate, Infonavit created a new program in April that is designed to minimize its exposure to credit default risk. Under the new program, Infonavit encourages its affiliate companies to hire unemployed people with Infonavit mortgage credits, offering the companies reimbursement of the total contributions they make to the housing fund on behalf of their new employees. The program, which has generated some 3,000 jobs so far, aims to benefit as many as 50,000 currently unemployed individuals. Fovissste floated US\$265 million of mortgage-backed bonds in June, the first installment in a plan to originate 100,000 new mortgages this year and issue US\$1.5 billion of bonds. Government mortgage financing has boosted demand for new housing among the low-income sector, prompting the largest homebuilders to shift focus to low-income housing as a result. Meanwhile, sales of higher priced homes, including second homes, are slowing in Mexico.

In Brazil, more development companies are also shifting their focus to the low-income sector because of government program Minha Casa Minha Vida, which is targeting the development of one million new homes this year. Limited access to credit has made it difficult for smaller homebuilders to complete existing projects or take on new ones, which has led to some consolidation in the market. In April, Cyrela, Brazil's largest real estate developer, announced it would be acquiring local rival Goldsztein. Cyrela is among the larger firms that have been purchasing land and unfinished developments from smaller, struggling companies. Brazilian homebuilder MRV raised US\$323 million in primary and secondary share offerings in Brazil's only second public share offering of the year.

Closing Thoughts

As with any crisis, the global economic slowdown has unveiled new opportunities for some market participants. Capital is scarce, so companies have to drastically adapt their business plans. Limited access to construction financing has made it difficult for smaller, less established development companies to meet existing obligations, creating an opportunity for larger companies to increase their market share through mergers and acquisitions. Several retail and residential development companies, particularly in Brazil and Chile, have turned to the capital markets to raise funds for their future investment plans, which has caught the eyes of both local and foreign investors. Although demand for space is still very soft, the improving outlook in some sectors should eventually translate into better market fundamentals. In the meantime, market participants must do their best to be well-positioned for the recovery, even as they brace for the difficult times in the near term.

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