

Latin American Quarterly

Market Perspective

Executive Summary

- Economic data improved throughout the third quarter in Latin America. Key indicators are improving monthly, in some cases returning to pre-crisis levels.
- Signs of a recovery restored investor confidence in the region, prompting gains in local currencies and stock indices and a surge in new debt and equity issuances.
- Commercial real estate fundamentals are likely to lag the economic recovery. Although retail sales and consumer confidence are rising, it will take many retailers a while to recover from the damage done to sales figures.
- Rents in the office sector are under pressure from the delivery of new space and softer demand. A growing number of industrial firms are starting to search for space, but rents remain low and vacancy levels high. Transaction activity remains stalled.
- Demand for housing is centered on the low-income housing market, which is boosted by ready financing from government-backed mortgage agencies. As a result, homebuilders have shifted resources to the low-income sector.

Overview

Positive economic signs that started at the end of the second quarter in Latin America grew stronger during the third quarter, although the results were not the same across the board in the region. Improved production data served to increase employment while boosting sentiment among businesses and consumers. The restoration of confidence was reflected in the large amount of debt and equity issued by Latin American companies, especially in Brazil and Chile, and the appreciation of local currencies and stock markets. In Mexico, attention is centered on the fiscal reform package and the timing of a U.S. rebound.

Property markets have also started to show some movement. Although industrial market rents are low, vacancy levels have not fallen much to date and some tenants have reactivated their search for space. The retail market continues to suffer from the impact of the recession, although sales figures have been rising in recent months. The low-income housing sector is booming, reflecting the subsidies of government-backed mortgage agencies.

Pramerica Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054
USA

Tel +1 973.683.1745
Fax +1 973.734.1319
Web www.pramericarei.com

Regional Economies

All countries in the region have posted declines in industrial production and retail sales so far this year, leading to higher unemployment rates. Mexico's second-quarter GDP contracted 10.3% from 2Q08, according to government agency INEGI, the sharpest quarterly decline since 1981. Year-over-year contractions were also recorded in Chile (4.5%, according to the Central Bank of Chile) and Brazil (1.2%, according to government agency IBGE). In response to the crisis, policy makers in the region lowered interest rates and passed stimulus packages.

The region has also benefited from the more positive global economic environment. Mexico's monthly economic activity indicator rose 2.45% in July from June, according to INEGI, and posted a lower-than-expected year-on-year decline. The unemployment rate, 6.3% at the end of August according to INEGI, continues to post month-to-month increases, but the increases have been getting smaller. The employment component of a manufacturing index developed by IMEF, Mexico's Institute of Finance Executives, was positive in August for the first time in 11 months, suggesting that manufacturers are confident about new hire plans.

Brazil's second-quarter GDP rose 1.9% from the first quarter, according to IBGE. The government's repeal of the industrial tax on new auto purchases spurred a jump in auto sales. The unemployment rate has dropped to 8.1% in September from 9% in March, as Brazilian employers hired 242,000 new workers in August. After months of decline, a consumer confidence index measured by the Getulio Vargas Foundation rose in July to its September 2008 level, and has held steady since. The announcement that Rio de Janeiro will host the 2016 Summer Olympic Games boosted sentiment in Brazil and should spur investment in coming years.

Chile's recovery has been slow, but stimulus efforts are beginning to show. The federal government's US\$4 billion fiscal stimulus package and very aggressive counter-cyclical monetary policy have helped soften the decline of industrial production and stabilize unemployment rates. In August, Chile's monthly economic activity index, the Imacec, fell by just 0.1% from the year-ago month, a strong improvement from the 2.8% contraction posted in July and 4.1% contraction in June, according to the Central Bank of Chile. The unemployment rate in August stood at 10.8%, which is 260 basis points higher than August 2008, but marked the first time in six months it has not increased, according to government agency INE. A consumer confidence survey by the University of Chile has also begun to rebound, rising more than 25% in July, putting it back near pre-crisis levels. Chile is in the final stretch of a presidential election in December. The ruling party is expected to lose after holding power for nearly 20 years.

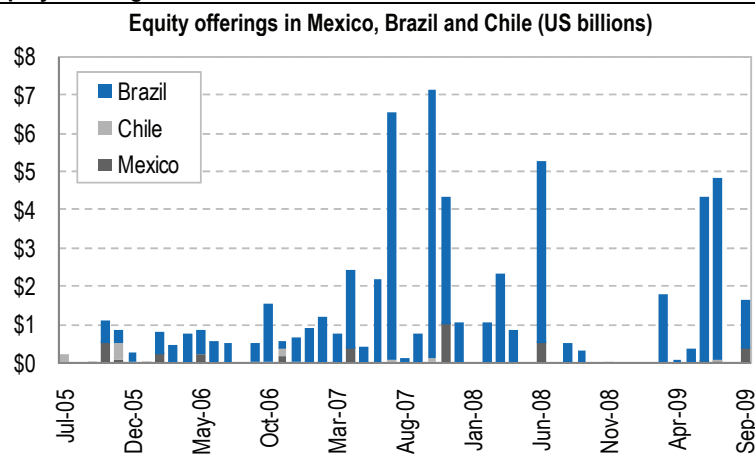
Latin American trade numbers are improving as a result of rising demand, both international and domestic. While trade balances remain down from pre-crisis levels, the declines are growing smaller. Year-over-year declines in Mexico's exports (-24.9%) and imports (-28%) in August were smaller than the declines posted in July, according to INEGI. The Central Bank of Brazil reported that exports in August declined by 27.4% while imports fell 23.9% year-over-year, an improvement from the 40-50% declines posted a few months earlier. Chile's trade balance is also improving, in part due to the rally in international copper prices, although the value of imports continues to fall.

Countries in the southern hemisphere were hit by outbreaks of H1N1 influenza in South America's winter season, which peaks in July. The colder weather facilitated the spread of the H1N1 virus in Brazil, Chile and Argentina. These countries now rank among the most affected by the disease worldwide, and diminished retail activity and school vacation extensions have affected economic performance. Strict health measures and the arrival of warmer weather in the south have shifted the focus of concern to the northern part of the region, notably Mexico.

Capital Markets

Investors began to regain their appetite for Latin American assets in the third quarter. Public companies in the region raised US\$6.5 billion of equity during the quarter, which was the most in any quarter since 2007. Regional stock prices and bond index spreads responded to the signs of recovery. Broad equity market indexes posted strong growth in 3Q09 in Argentina (28.9%), Brazil (19.4%), Mexico (19.2%), Peru (14.4%), Colombia (12.3%) and Chile (8.6%), according to Reuters. Meanwhile, Latin American bond index spreads fell.

Equity Offerings on the Rise in Some Countries



Bloomberg

Some Latin American currencies appreciated during the third quarter as growing trade surpluses eased pressure on exchange rates, although not as much as during the second quarter. The currencies of Brazil (10.7%), Colombia (8.6%) and Peru (4.6%) all appreciated against the U.S. dollar, while the currencies of Mexico (-2%), Chile (-1.3%) and Argentina (-1.2%) depreciated, according to Reuters.

Amid signs of recuperation in global economic activity, central banks in the region stopped lowering interest rates. The Mexican central bank maintained its key rate at 4.5% after a final 25 bps cut in July. The Central Bank of Brazil maintained its rate at 8.75% after a 50-bps cut in July. The Central Bank of Chile stood pat after shaving 25 bps of its key rate in July, bringing this year's total cuts to 775 bps, more than any other country in the region. The consensus is that rates will maintain their current levels until the end of this year, and post small increases in early 2010, as central banks shift their attention from spurring economic activity to heading off inflation.

The drop in international crude oil prices, coupled with lower tax revenues amid the recession, has ballooned Mexico's fiscal deficit. That prompted President Felipe Calderon to propose a series of tax increases and cutbacks in government spending that are aimed at reducing the current year's US\$20 billion fiscal deficit to US\$4.5 billion in 2010 and zero in 2012. The reforms are being fiercely debated in Congress, which must pass a budget by mid-November in order for changes to go into effect next year.

Property Markets

Industrial: The improved global economic landscape has translated into improved production levels in Latin America. With consumers increasing spending, companies in some sectors are beginning to hire again to fulfill new demand. As a result, industrial production in some countries posted smaller year-on-year declines, and even improved slightly on a month-over-month basis.

Amid the market improvements, Mexico's IMEF manufacturing index broke into positive territory in July for the first time since June 2008. The index also registered an improvement in its employment component in August and September, suggesting that job losses in the manufacturing sector will moderate. Mexico's industrial production in July declined 6.5% year-over-year and increased 2.8% from June, according to INEGI. Vehicle sales, which were hard-hit by the recession, posted a monthly increase in Mexico in July for the first time this year. The trend continued in August. During the third quarter, both Volkswagen (US\$1 billion) and General Motors (US\$300 million) announced plans to invest in Mexico.

Landlords are responding to high vacancy rates by lowering rents and shortening the duration of lease contracts. Demand for industrial space remains low. Leasing activity has improved mildly when compared to the same period last year, however, and property tours have become more frequent in recent months. There have also been some new faces in the market, as some American manufacturers are looking to Mexico for the first time as a potential location for their operations. Mexico's low costs, which look even more attractive to U.S. companies with the recent weakening of the Peso, appear to be giving it a competitive edge in luring manufacturing businesses.

In Brazil, industrial production is posting steady month-to-month gains, in part due to government tax breaks on consumer goods. Brazil posted its highest monthly sales volume on record in September due to tax breaks on new auto purchases. People rushed to buy cars before the tax break expired at the end of September. Some new industrial investments were announced during the quarter. In July, GM announced plans to invest US\$1 billion in Brazil to develop two new Chevrolet-brand vehicles exclusively for South America. In September, Brazilian construction firm Odebrecht and Dubai's government-controlled port operator DP World announced a joint venture to purchase a majority stake in the Embraport project, a private port located near Sao Paulo. This project is DP World's first in Brazil.

Office: Office markets in Latin America continue to suffer as companies scale back on expansion plans and need less space. Vacancy levels have been climbing since late 2008. Although several new development projects have been postponed, some new space under construction will become ready for delivery this year, putting downward pressure on lease rates.

In the Mexico City office market, the average vacancy rate stood at 6.7% as of the end of the second quarter as companies are not expanding and new space is going unfilled. Lease rates have decreased only

slightly, but there is expected to be more downward pressure on rents as more space becomes available. This environment will force property owners to be more aggressive to attract new tenants. In Sao Paulo, Brazil's top office market, the demand for space has continued to weaken as a result of soft demand and new deliveries. According to CBRE, however, second-quarter negative absorption improved from the first quarter, when the Sao Paulo market recorded negative absorption for the first time in several years. The combination of soft demand and higher vacancies has placed downward pressure on rental rates.

In Santiago, vacancy rates declined only slightly in the third quarter to 1.7%, buoyed by the fact that no new space is coming onto the market. According to CBRE, companies are vacating existing spaces at a slow rate, so lease rates have decreased only slightly. In Buenos Aires, vacancy rates continue to rise. The delivery of new space creates an increasingly competitive market environment, placing downward pressure on lease rates. According to CBRE, lease rates have declined by almost 20% since the fourth quarter of 2008. As of the end of the second quarter, the average class-A lease rate was US\$28.59/sf.

Very few properties are changing hands in Latin American office markets. Owners feel no pressure to sell while prices are low, opting to wait for a recovery. Buyers remain on the sidelines, looking for opportunities that have yet to materialize to acquire distressed assets.

Retail: Stabilizing unemployment rates and rising consumer confidence supported Latin American retail sales during the third quarter. While the small "mom and pop" tenants typical of Latin America continue to struggle, larger, more established retailers have begun to rebound or are even looking to benefit from the crisis. New investment activity is not stalled, and some mall operators have successfully issued securities, anticipating future growth.

In Mexico, mall owners are finding it difficult to find new in-line tenants, as the smaller tenants were most severely affected by the twin impacts of the recession and the H1N1 outbreak. Some small tenants are opting to end lease contracts early this year as they struggle with depressed sales figures. Months of free rent and shorter lease terms remain commonplace in new contracts, as property managers do what they can to keep vacancy levels down. Securing large tenants has not been as difficult, as large discount retailers have fared well through the crisis. However, the problems with in-line tenants make it difficult for property managers to achieve an attractive tenant mix. As a result, there is a new focus on a retail format that is more anchor-reliant.

Mexico's consumer confidence index was on the rise in June and July. National retail sales have begun to post small month-to-month improvements. Wal-Mart Mexico, which posted double-digit percentage increases in its second-quarter sales and profits, increased its expansion plans to encompass 270 new stores in Mexico this year.

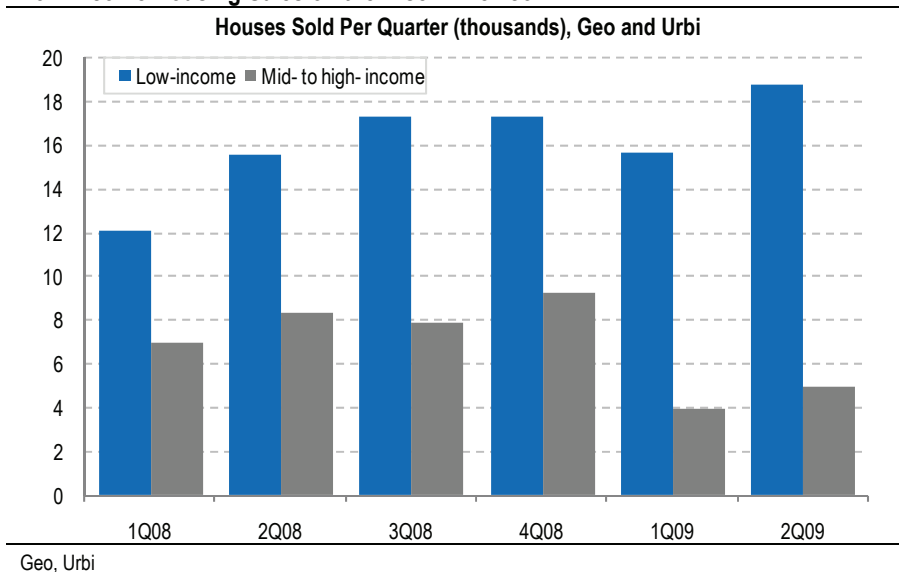
Despite the H1N1 outbreak in South America in July, retail sales in Brazil increased 0.5% from June and 5.9% year-over-year, according to IBGE. Brazil's consumer confidence index nearly reached the September 2008 value, and continues to hover around pre-crisis levels. Brazilian mall owners continue to issue securities to raise capital, indicating plans for expansion. BR Malls issued US\$430 million in a combined primary and secondary share offering, and Multiplan raised US\$438 million of equity in an initial public offering. Brazilian grocery chain CBD acquired the remaining 40% stake in Brazilian wholesale chain Assai, in an effort to accelerate its expansion plans. Commercial real estate developer Cyrela Commercial

Properties announced a sizeable joint venture with foreign institutions, indicative of a renewed interest in Brazilian commercial real estate.

Chile's retail environment reflects aggressive price-cutting, stabilized unemployment and a rebound in consumer confidence. Year-over-year retail sales in Chile increased 8.6% in July and 9.2% in August, according to Chile's National Chamber of Commerce, CNC. Chilean retailer La Polar rejected a proposed merger with Chilean supermarket chain Supermercados del Sur because it wants to focus on expansion plans into Colombia. Chilean retailers are important players in the neighboring markets of Colombia, Peru, and Argentina and, to some extent, Brazil.

Residential: Homebuilders' stock prices have made big gains this year, and companies that focus on the low-income housing sector have performed the best. The shares of Mexican homebuilders Urbi (84.6%) and Homex (86.2%) nearly doubled this year through September, while the broader Mexican IPC Index rose 49.4%. Likewise, the shares of Brazilian homebuilders Cyrela (147.8%) and MRV (214.8%) rose this year through September, compared to 56.5% for Brazil's Bovespa Index, according to Bloomberg.

Low-income Housing Sales on the Rise in Mexico



In Mexico, private lending conditions remain tight, limiting the supply of mortgage and construction financing. Sofoles, Mexican mortgage banks which historically are funded via the capital markets, continue to struggle. In contrast, government-backed mortgage agencies are providing a steady supply of financing in the low-income housing sector. This has led homebuilders in the mid- to high-income sectors to shift their focus to the construction of low-income housing. Infonavit, the government's largest mortgage originator, said it has originated 309,000 mortgage credits so far this year, and may meet its annual goal of 500,000. The agency has increased its lending pace in recent months. Infonavit said it funded US\$511 million in mortgages in the third quarter, after only US\$152 million in the first half. Fovissste, the government's housing fund for public employees, said that it funded US\$302 million in mortgages during the third quarter, after funding only US\$258 million during the first half. Both agencies issued MBS during the second and third quarters.

The shift of focus to the low-income housing sector was reflected in second-quarter housing sales figures. Among Mexico's largest homebuilders, there is a clear shift to low-income housing from mid- to high-income housing. For example, homebuilder Geo sold a total of 14,357 houses in the second quarter, 93% of which were financed with Infonavit or Fovissste low-income credits, up from 86.2% in the year-ago quarter. Conversely, sales of higher-priced products, such as vacation homes, have not seen improvements. Several vacation-home projects remain on hold, while developers offer discounts to entice the few buyers in the market.

A similar trend prevails in Brazil. Government program Minha Casa Minha Vida, which was designed to provide low-cost mortgages, has stimulated the low-income housing sector, prompting homebuilders to shift focus to where demand is highest. The need for economies of scale in a low-margin end of the market is leading to some consolidation. In September, homebuilders Agra, Abyara and Kablin Segall agreed to merge, creating one of the largest Brazilian real estate companies.

Homebuilders have become more active in capital markets. Mexican homebuilders Geo (US\$250 million) and Javier (US\$180 million) have issued debt to restructure liabilities and for working capital. Several Brazilian homebuilders also raised funds during the third quarter for expansion to meet demand. PDG Realty (US\$592 million), Rossi Residential (US\$525 million) and MRV (US\$364 million) issued equity, while Cyrela floated a US\$187 million debt offering.

Closing Thoughts

Economic data continue to confirm that the recovery process in Latin America is well underway. Market fundamentals are improving, which has created a healthier economic landscape with improved business and consumer sentiment. Capital markets have rallied behind these improvements, reflecting restored investor confidence in the region. Several retail and residential development companies, particularly in Brazil and Chile, have taken advantage of the recovery and placed equity and debt issues to raise funds for future investment plans. Property markets continue to experience high vacancies and low rents, although tenant demand is starting to pick up, and sectors such as low-income residential housing are benefiting from a shift in focus amid the recession.

Investors, both local and foreign, are eyeing opportunities to buy commercial real estate in the region, despite the lack of debt financing. Domestic pension funds, for instance, are returning to the sector for a variety of reasons, including regulatory changes and the potential for risk-adjusted returns in a low interest rate environment. Transactions remain slow, however, as owners wait for values to rise on the heels of the recovery that is underway.

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Pramerica Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054
USA

Tel +1 973.683.1745
Fax +1 973.734.1319
Web www.pramericarei.com
E-mail research.reports@pramerica.com

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