Latin American Market Outlook – First Quarter 2005

Market Perspective

A full year of strong economic showings in Latin America set expectations high for 1Q05. After trudging through three years of insipid economic growth, the region made a shining comeback in 2004. Final GDP results surpassed what were already optimistic growth estimates. An export boom, local consumer demand and foreign capital inflows fueled economic advances of 4.4% in Mexico and 5.2% in Brazil. Chile and Peru registered GDP growth of 6.1% and 5.1%, respectively, while Argentina and Venezuela made up for previous years' contractions with economic expansions of 9.0% and 17.3%, respectively.

Foreign capital flows to the region continue to benefit from the growing cash transfers of foreign nationals living abroad, as well as a recovery in foreign direct investment (FDI). Foreign nationals' cash transfers to Latin America rose 20% in 2004 to $45.8 billion, driven by heavy flows to Mexico, which received a total of $16.6 billion. FDI to Latin America rose 44% on the year to $56.4 billion, with Brazil receiving the lion's share: $18.2 billion was invested, predominantly in the manufacturing and service sectors (mainly telecommunications and electrical utilities). According to the Institute of International Finance, net direct investment flows to Latin America could reach $40 billion this year, up sharply from $26 billion in 2004, through higher FDI and fewer net outflows from commercial banks.

On the external front, it was relatively smooth sailing for Latin American countries in the first quarter, but risks endure. A decline in demand for regional exports (commodities and manufactured goods) or in the appetite for emerging-market risk would curb what have been the region's main engines of growth since last year. During times of relative external stability, internal factors, especially politics and their implications for local economic stability, tend to take the spotlight.

Many Latin American nations will hold presidential elections in the next 18 months. In Mexico, the political focus presently concerns whether or not Mexico City mayor Lopez Obrador will run for president. In Brazil, President Luiz Inacio Lula da Silva is losing popularity, although his chances of re-election in October 2006 remain strong, according to local polls. Chile, which in December 2005 will be the next country in the region to hold

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presidential elections, could elect its first female president, as the front-runner is a woman. Overall, local markets are more preoccupied with disruptions resulting from hotly contested presidential campaigns than with the outcomes of the elections themselves.

Monetary authorities in Mexico and Brazil maintained a firm grip on interest rates in the first quarter. Inflation, which increasingly raised concerns in both countries during most of 2004, showed signs of receding. After peaking at 5.43% in November, 12-month consumer price inflation in Mexico approached 4.00% at the end of March, a level not seen since year-end 2003. In Brazil, inflation reached a 2004 high of 7.60% in December, although this figure was an improvement from annual inflation of 9.30% in 2003. At the end of March, 12-month Brazilian inflation was running at 7.54%, which is high enough to prevent the central bank from starting a much-anticipated easing cycle on interest rates.

Capital Markets

As investor appetite for some Latin American sovereign bonds hit record highs in the first quarter, Argentina concluded the most complex part of its debt-restructuring program. The Argentine government pulled off a record restructuring of over $80 billion in defaulted debt (not including interest payments), which will be exchanged for new bonds at a rate of 35 cents on the dollar. While 76% of the country's bondholders have signed on to the debt deal, the storm still has not passed. Several legal suits remain, and the country is just resuming negotiations with the IMF. Given the complexity of the renegotiation, and, more importantly, the pain that the whole process has caused, Argentina's experience will most likely discourage other highly indebted nations from choosing the default route.

In a sign that contagion among Latin American countries is much more limited than in the past, foreign debt spreads, as measured by JP Morgan's Emerging Markets Bond Index, have reached successive record lows. In Mexico, the spread neared 140 bps, while in Brazil it broke the 400 bps mark during the first quarter. In January, Moody's and S&P upgraded their ratings on Mexico's sovereign debt, citing macroeconomic stability, strong international liquidity and depth of local financial markets. Moody's lifted Mexico's credit rating to Baa1 from Baa2, while S&P raised its rating to BBB from BBB-. Moody's also changed its rating outlook from stable to positive on Brazil and Chile. Markets consider Brazil well on its way to becoming investment grade in as few as two years, provided that current fiscal and monetary policies are maintained and the country's external debt load declines.

Stock markets in Mexico and Brazil consistently hit record highs at the start of the first quarter on a surge of foreign inflows, but since then have undergone downward corrections. After climbing 7.4% to a record high of 13,878 points in early March, Mexico's leading IPC stock index ended the quarter down 1.9% in peso terms and 1.6% in US dollar terms. On January 17, Mexican stock markets reached a long-awaited milestone, as local pension funds took advantage of recently passed legislation allowing them to invest up to 15% of their holdings in equity-linked notes traded on several of the world's stock exchanges. Funds will also be able to allocate as much as 20% of their assets in foreign debt and equities. According to Mexico's national retirement savings regulatory agency, the country's pension funds could invest up to MXN65

billion ($5.8 billion) in local and international stocks, which would bring further liquidity to the local stock market.

Brazil's Bovespa index advanced 1.6% in local currency terms and 2.1% in US dollar terms as the real rose to its highest point since 2002. The local currency hit a 32-month high of 2.57 per US dollar in mid-February. A revival in IPO activity that began in mid-2004 continues as private equity investors take public companies as diverse as a rental car agency and an online retailer.

Interest rates in Brazil and Mexico have risen significantly as local monetary authorities work to counter stubborn inflation and react to upward-trending US rates. At the end of March, short-term interest rates in Mexico were 9.45%, up sharply from 6.26% a year earlier. Mexican monetary authorities have maintained a policy of raising interest rates in tandem with increases in the federal funds rate to maintain a constant spread over comparable US debt. In Brazil, interest rates are at an 18-month high of 19.25%, after seven consecutive months of rate hikes by the central bank. This upward trend in the Selic benchmark lending rate, however, is expected to slow in the next quarter and should taper off to about 18.00% by the end of 2005.

Despite higher interest rates, private-sector lending activity across the region continues to advance. In Mexico, bank lending in February rose 22.5% from a year earlier. Consumer credit led the way, gaining 43.3% during the period. Brazil saw bank lending expand an annual 21.2% during February, driven by a 38.7% increase in consumer lending. Seeking to take advantage of this boom in consumer lending, a number of Brazilian banks have sealed credit agreements with local retailers. Mortgage securitizations are also rising in Brazil, after a slow 2003.

According to real estate research consultancy Softec, issues of MBS in Mexico could reach $750 million this year, up threefold from 2004. Government-run mortgage agency Sociedad Hipotecaria Federal (SHF) was the first to issue MBS in 2005, with its January placement of MXN10 million ($890,000). While small, the transaction was significant in that it was SHF's first-ever sale of MBS. The country's leading issuer of MBS, Infonavit, plans to double placements this year to MXN4 billion ($360 million) and again to MXN8 billion ($710 million) in 2006.

In January, Mexico passed legislation creating a REIT-like structure, known as the Fibra, which could bring greater liquidity to the real estate market and give small-scale investors access to real estate assets via publicly traded securities. No Fibras have been launched yet, but commercial and investment banks are interested. As the market moves closer to listing real estate funds on local equities markets, Mexico's only publicly traded diversified real estate developer is set to be taken private by US investors, who acquired a controlling interest in the firm during the first quarter.

Office

Major markets across Latin America continue to recover slowly after years of oversupply. Demand is picking up, but developers are more cautious about resuming construction in oversupplied areas. While construction activity has slowed, the last of several projects begun in recent years are just now being completed. Even so, growth in vacancy rates has stabilized,

mostly due to stronger demand and firms relocating to better-quality new space. Still, this recovery has not yet reached rent values, which remain quite depressed compared with levels seen five years ago.

In Mexico, construction activity in Santa Fe has finally slowed, and central areas have begun to account for a greater share of construction volume. In the city's pricier Lomas and Reforma districts, sizeable projects are going up. The city's downtown avenue, Paseo de la Reforma, is once again a popular location and has attracted the likes of HSBC, which is constructing its new headquarters there. In early April, a German open-end fund announced a $102 million investment in a 30% share of Torre Mayor, Mexico City's tallest office building. With a total of 800,000 square feet of office and retail space, the property is still 40% vacant nearly two years after opening.

In fact, vacancy is still high, at about 20%, for better-quality properties in Mexico City's main submarkets, which is higher than in the overall market. Very high vacancy persists in the newly developed area of Santa Fe, although companies are increasingly taking advantage of the soft market to relocate to high-quality space, with rents as much as 30% less than the cost of similar space in more central locations.

Vacancy rates are also high in Sao Paulo, at close to 20%, but are somewhat stable compared with a year ago. The vacant space is concentrated in new buildings along the Marginal and in the Faria Lima and Jardins districts. Not much new space is being delivered, as construction is at a virtual standstill, but some exceptions exist. One is a 650,000-square-foot office building being developed next to the city's Eldorado shopping center.

Residential

The housing sector in Mexico is on the way to meeting the government's goal of financing 750,000 new homes per year by the end of 2006. According to preliminary figures, Mexican lending institutions financed more than 530,000 new homes in 2004. This figure should rise 13% to 600,000 in 2005. Still, a bigger push to finance more affordable homes is needed to drive lending growth of over 20% and to meet the target for 2006.

Government-run housing fund Infonavit outperformed its target for 2004 by placing nearly 306,000 mortgages. At the end of 2004, Infonavit said it would finance 375,000 homes in 2005, a target that had initially been set for 2006. In the first two months of 2005, the fund approved about 66,000 mortgages, or 30% more than its target for the period. This year, Infonavit's total financing to the housing sector should rise 14% to MXN68.4 billion ($6.1 billion).

Infonavit, Mexico's foremost mortgage provider, intends to focus more on lower-income housing, with plans to finance 120,000 affordable homes this year, up from just over 90,000 in 2004. Infonavit also seeks to boost mortgages to the middle-income sector via co-financing programs with local banking institutions. The lender recently announced it would double the amount homebuyers can borrow under these co-financing programs to US$160,000. While Infonavit remains Mexico's largest provider of mortgage financing, with a 60% share of mortgages issued, banks and non-bank mortgage lenders (sofols) are aggressively increasing

their lending to the sector, satisfying demand for upper- and middle-income mortgage financing. Banks last year unseated sofols as the leading private-sector mortgage lenders in dollar volume (US$1.7 billion), but sofols accounted for 80% of units financed by the private sector. This reflects the fact that sofols target a wider mix of middle- and upper-middle-income borrowers, and thus their average loan is smaller than those of banks, which cater almost exclusively to higher-income homebuyers.

Mexican banks expect to issue 50% more mortgages in 2005, according to banking association ABM. Private mortgage lenders have also begun to partner with housing developers to offer mortgages to developers' clients at preferred rates. Hipotecaria Nacional teamed up with Casas Geo in mid-March, while Homex signed a similar agreement with Citigroup unit Banamex. During the first quarter, two new foreign ventures that will invest directly in Mexican housing were initiated. One is backed by $100 million of US institutional money; the second is a Spanish operating company that plans to invest $200 million, mainly in land development.

In Brazil, private-sector financing to the housing sector surged to a 10-year high of BRL3.06 billion ($1.1 billion) in 2004, according to local mortgage and savings association ABECIP. Changes to the regulations governing bank allocations to the housing sector mean that this figure could reach BRL12 billion ($4.4 billion) in 2005. Fearing a credit oversupply and the possibility that underwriting criteria could become more lenient, banks seek a phased implementation of the new allocations. Therefore, total private-sector allocations to housing in 2005 should be about BRL4.5 billion ($1.7 billion). As of February 2005, financing to the housing sector was up 43% from the same month a year earlier, according to ABECIP. Taking into account government-run Caixa Economica Federal's plans to allocate BRL10.5 billion ($3.9 billion) this year, total financing to the sector should reach BRL15 billion ($5.6 billion).

A resurgence in mortgage lending to the middle class has fueled interest in the housing sector on the part of some of the region's major developers. In addition to local developers, international firms have also acquired a taste for the sector, with new projects being planned for this year. Further, a portion of the new construction in Brazil is being financed through dedicated real estate development funds run by local banks and investment managers.

Industrial

Mexico's industrial sector rebounded in 2004 due to a 13.5% expansion in US-Mexico trade and strong internal consumption. Domestic sales of automobiles, for instance, grew by 12.1% in 2004. While total automotive output was down 2% on the year, this was attributed to plants closing operations to re-tool production lines for new models.

Government officials are working with automakers, including VW, Nissan and Hyundai, all of which are considering establishing or expanding their operations in Mexico. Two actual investments include Toyota's recent opening of a truck-bed manufacturing facility near Tijuana and DaimlerChrysler's expansion in the northern city of Ramos Arizpe. These projects reflect a new phase of automotive investment taking place in secondary cities typically located away from the country's largest metropolitan areas. As a sign of the times, a site once occupied by a

Chrysler manufacturing facility in the Mexico City area is now being converted into a housing project.

Other multinationals, such as Sony, Siemens, Bridgestone-Firestone and Kyocera, also announced investments in the quarter. With an eye on growing demand for manufacturing and distribution space, foreign investors are placing bets on Mexico's industrial real estate. In February, US REIT AMB and Singapore's GIC Real Estate unveiled a $250 million joint venture to develop industrial properties in the country.

In Brazil, real estate investment funds are not yet active in the industrial sector, which remains mostly owner-occupied. However, in light of Brazil's current economic expansion, companies such as Nestle and General Motors are building or improving existing facilities. Vehicle production in Brazil rose 20.7% in 2004 to reach an all-time high of 2.2 million units. Export growth of 52% drove the expansion, although internal vehicle sales increased a robust 10%.

Retail

Strong consumer demand and more widely available consumer financing are helping to drive growth in Latin America's retail sector. In Mexico, retail sales have consistently trended up since the start of 2003, although, as of January 2005, annual growth had slowed to 6.2% after peaking at 8.2% in September 2004.

French retailer Carrefour's long-rumored exit from Mexico finally occurred in March, with a surprise ending. With an estimated bid of $550 million, regional grocery store Chedraui won the 31 Carrefour stores that had been hotly pursued by other leading Mexican retailers. Although these other retailers came away empty handed from the Carrefour auction, at least two of them are planning significant expansions in 2005. Comerci intends to open 22 new stores with an investment of $240 million. Soriana has announced that it will spend $350 million on a 38-store expansion that seeks to undercut the market share of Wal-Mart's Mexican unit Walmex. At the same time, Walmex has announced investments of more than $700 million to open 70 new stores over a 12-month period and has said it is considering 200 small and mid-sized towns across Mexico where it could locate new stores.

Non-supermarket retailers are also undertaking substantial expansions in 2005. Home appliances and electronics chain Elektra is planning to invest $200 million over the next two years on a regional expansion, while department store operator Liverpool has announced that it has set aside $300 million to open three stores and modernize two distribution centers and existing stores. Home Depot has not announced any plans to open new stores, but it is targeting sales of $1 billion in Mexico by 2006. Finally, two local convenience store chains will embark on expansions in a move to counter 7-Eleven's plan to open 500 stores in Mexico by 2009.

To grow their consumer credit operations, Mexican retailers are also setting up and/or expanding banking operations. Local department store chain Coppel has said it has applied for a banking license, while competitor Elektra announced plans to expand its Banco Azteca unit into Central and South America.

Brazil is also experiencing a consumer credit push, with banks and retailers forging consumer financing agreements. The country's largest private bank recently announced an agreement with a low-cost retailer, while the number-two commercial bank signed a consumer financing deal with one of Brazil's largest non-grocery retailers.

Studies by local shopping center association ABRASCE and consultancy A/C Nielsen reveal that Brazilian shopping centers, emboldened by a rally in consumer spending and sales growth of 15.87% in 2004 (9.52% in real terms), plan to invest over $1.6 billion in 21 new projects and expansions by 2006. In Sao Paulo, at least four shopping centers have expansions underway. In Rio de Janeiro, at least five major shopping centers plan to expand during the next two years. Portugal's Sonae announced it will invest as much as $30 million to open two new shopping centers. On the other hand, certain pension funds are exiting their investments in Brazilian shopping centers because of lower-than-expected returns.

Conclusion

After an impressive showing in 2004, Latin America will likely post strong but slightly lower growth this year. Much depends on export demand, inflation and interest rates, and local governments' willingness to pursue reforms that will permit sustained economic growth. The increase in lending activity is helping local firms and internal consumption, but there is still much ground to be gained, as debt financing in the region remains costly and limited.

Regarding real estate markets, the increased demand for space largely reflects the improved economic environment. Homebuilders in Mexico are benefiting from a boom in mortgage lending, which began the year with regained strength. Even in Brazil, where housing developers have suffered from at least three slow years, the sector is expected to recover soon, on the heels of increased mortgage financing.

Improved demand has provided some relief for office landlords in the region, but oversupply is still keeping vacancies high. Demand for retail space, on the other hand, has responded more quickly to consumption growth; developers are expanding and building shopping centers in both Brazil and Mexico.

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