May 2008

Latin American Quarterly

Market Perspective

Executive Summary

- Foreign direct investment in Latin America accelerated in 2007. Most investors are targeting growth stories – in particular, investors want to take advantage of the rise of the region's middle class, which has led to increased consumption.
- Latin America's economies are strong in contrast to the slowdown in the global economy. Local businesses are expanding in response to strong consumer demand, which is fueled by income growth and the availability of credit.
- Rapid growth, however, has led to rising inflation, prompting central banks to raise interest rates. The result is higher reference rates in the region in contrast to the U.S. and Europe, where interest rates moved down since last year.
- The U.S. subprime meltdown has had little effect on Latin America's mortgage markets. Mortgage financing and housing sales are growing rapidly in Mexico, the region's most developed housing market, and in Brazil.
- The retail market is drawing a significant share of attention from foreign investors, but other sectors also are strong. Office markets show sound absorption and rent levels. The industrial sector benefits from the need for local and international firms to rearrange logistic channels to be closer to the end consumer in the U.S. or Latin America.

Regional Economies

Latin American economies started the year at a fast pace, in contrast to the slowdown seen elsewhere. GDP growth is fueled by strong internal demand and higher prices for the region's major export commodities. The combination of rising exports and responsible economic policies is helping countries such as Colombia and Peru to maintain a strong expansion of their economies over several quarters (growth of 7.0% and 9.0%, respectively, in 2007). GDP growth was also strong last year in Brazil (5.4%), Chile (5.1%) and Mexico (3.3%).

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

Tel 973.683.1745
Fax 973.734.1319
Web www.prei.com

Credit expansion is a key engine of growth. **While global financial markets were retrenching, the volume of consumer loans increased by 24.5% in Brazil and 19.4% in Mexico.** The availability of credit and stable prices led to a notable increase in personal consumption. Across the region, the growing middle class is purchasing automobiles, houses and other goods.

Governments in Mexico and Brazil are taking measures to prolong the positive momentum by focusing on infrastructure projects intended to ensure long-term growth. The Mexican government recently created the National Infrastructure Fund, through which it expects to channel $25 billion over the next five years to build projects to improve the nation's transportation and environmental infrastructure, and water irrigation and sanitation. Similarly, the Brazilian government is focusing its efforts in an anti-poverty initiative aimed at providing infrastructure and jobs to the poorest regions, with investment of as much as $6.4 billion in 2008.

The ever-increasing price of commodities is a boon to many countries in the region. Commodities such as oil (Mexico and Venezuela), agricultural products (Brazil and Argentina) and minerals (Chile and Peru) are fetching record high prices in international markets. While prices remain strong so far in 2008, locals are watching for how a slowing global economy will affect demand for Latin American goods.

Strong internal demand kept upward pressure on prices in 2007, prompting central banks to raise interest rates. Inflation continued to mount in the first quarter, which makes it likely that some central banks will embark on another round of tightening. In Chile, rates rose by 25 basis points in early January as inflation topped 8%. Although rising inflation scares Latin American central bankers, levels in most countries are relatively low, with exceptions in Argentina and Venezuela. In Argentina, inflation unofficially rose by more than 20% over the last year. Christina Fernandez de Kirchner, the newly appointed president, embarked on an escalating fight with the country's farmers in March when she proposed a plan to increase taxes of agricultural exports.

Capital Markets

Latin America's stock markets mirrored the dismal performance of the U.S. markets in early 2008. Most indices posted losses during the first quarter, as investors' attentions were focused on disappointing news from global financial institutions. The Brazilian Ibovespa index fell 4.6% during the first quarter, compared to a 9.9% loss in the S&P 500. Chilean (-4.9%) and Argentine (-2.2%) markets also suffered losses. However, the Mexican IPC, which has a historical tendency to track the S&P 500, increased by 4.7% in the same period.

Latin American currencies were resilient during the quarter, which is notable since historically they have been prone to gyrations during down markets. The Brazilian real showed little volatility, continuing a trend of several years of appreciation versus the dollar. The Mexican peso also moved within a narrow range as compared to the dollar. Remittances from nationals living abroad, an important source of capital to Mexico, are decreasing. Remittances decreased 5.9% in January versus a year ago, reflecting tighter U.S. government restrictions on migrant labor and the downturn in the U.S. construction industry, which employs many Mexican migrant workers.

Latin American Markets Outperformed U.S. Market in 1Q08

Reuters

Despite the mixed performance in stocks, and tighter credit conditions worldwide, international investors continue to look at Latin America as a compelling investment destination. The region attracted strong inflows of foreign direct investment in 2007, with Mexico and Brazil being the main recipients. Mexico's FDI rose 20.8%, to $23.2 billion, last year, while Brazil posted a record $34.6 billion, up 84.3% from 2006. Investors are lured by the growth in internal consumption in high-population countries such as Brazil and Mexico. Companies are increasingly seeking local wealth, which was triggered by rising exports but made possible by stable economic environments in these countries.

Investors are also capitalizing on trends such as Brazil's future role in the energy market. The nation is the world's largest producer of ethanol, and is home to recently discovered oilfields that should propel production within a decade. Also, the popularity of investing in "BRIC countries" or "frontier economies" has put the region on the radar screen as investors scan the globe for investments that are de-linked from the slowdown they see at home. **As cross-border capital flows into the region increase, the presence of global investors in the region should boost growth.**

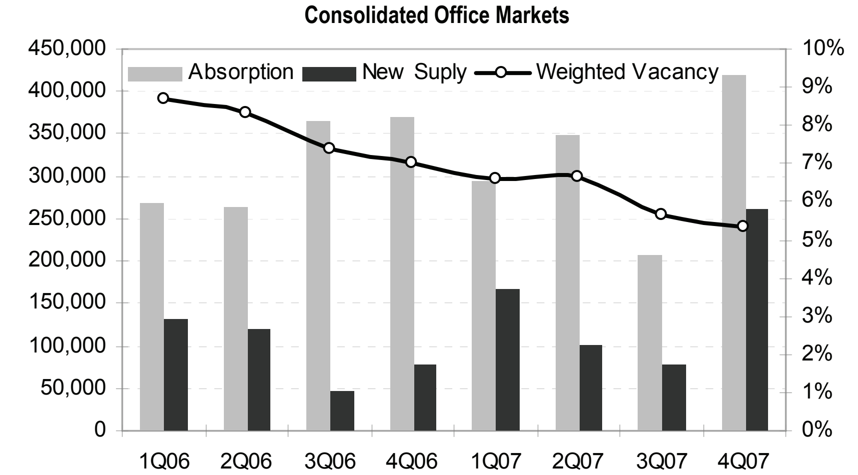
Property Markets

Office

Latin America's office markets remained strong in 1Q07, despite the bearish winds from the financial world. **Office vacancy rates in all major markets have been declining over the past few quarters, reflecting the expansion of businesses across the region.** Absorption continues to outpace new supply by a wide margin, leading to a steady decrease in vacancy rates since 2006. Not surprisingly, the combination of low vacancy and rising rents is prompting developers to engage in new construction in all markets.

Prudential

Office Market Fundamentals Continue to Strengthen



Note: Data for Mexico City, Santiago, Sao Paulo and Buenos Aires

CBRE, PREI®

In Mexico City, vacancy rates for class-A offices are less than 5%. Vacancies in the submarkets of Polanco and Santa Fe are even lower, in sharp contrast to the slow market three years ago. Strong demand has had a predictable effect on lease rates, which increased for all building classes in all submarkets. The positive fundamentals have caught the eye of institutional investors. Over the past 18 months, they have snapped up stabilized assets at increasing prices. However, since opportunities to buy existing core assets are rare, institutions are also providing the funding for developers to build new class A space in different parts of the city. Construction activity is mostly concentrated at the Reforma Avenue area, in addition to large projects in Polanco, Bosque de las Lomas and Santa Fe.

Brazil's Sao Paulo office market is at a similar stage in the cycle. Increased demand has driven vacancy down to below 9% – a remarkable improvement after a period of overbuilding. Meanwhile, rents for class-A space climbed more than 20% last year. For the first time in years, companies that require large floorplates are entering into preleasing agreements. Urban development sites are being bid up by developers looking to build residential and retail projects.

Buenos Aires, Argentina's capital and main office market, continues to experience steep rent increases, though at a slower pace than in previous quarters. The situation is an outgrowth of the country's financial crisis of 2001. At the time, the slowdown halted most new office construction, and leases were signed at low rates. Now many of those leases are expiring at a time when supply is constrained, giving property owners leverage to negotiate higher rents. New development is getting underway in the central Puerto Madero market, as well as in more suburban areas north of the metropolitan area, along the Panamericana highway.

In Santiago, the capital and economic engine of Chile, vacancy in class A offices is below 1%. The expansion of local companies and the arrival of multinationals have fueled absorption to a record in 2007. Massive new office projects are underway in the city, around the Las Condes area, which should help bring some breathing space to the market in the next couple of years.

Industrial

The auto industry continued to be the force behind the expansion of the industrial sector in Latin America. In February, motor vehicle output increased by 23.6% in Brazil and 15.5% in Mexico. Sales in Argentina more than doubled in January over the prior year, although the market is small.

Mexico remains an attractive option for global manufacturing firms. Given its proximity to the U.S., stable economic environment and vast availability of resources, Mexico has been the target of large investments in recent years. The first quarter was no exception. AMPIP, the Mexican Association of Industrial Parks, estimates that industrial real estate investments will increase by 75% in 2008. A large share of these investments should support speculative development in the country's main industrial and distribution markets.

Automobile manufacturers are among the main investors in Mexico. Geely Holding Group, the largest Chinese automaker, recently announced a $500 million project to build its first facility in Mexico, through which the firm expects to access the U.S. auto market. In turn, German automaker Volkswagen plans to invest $1 billion over the next three years at its long-running Puebla plant.

Other industries are also making significant forays into Mexico, including steelmakers and producers of consumer goods. ArcelorMittal, the world's largest steelmaker, will invest $400 million in the country, while U.S.-based Worthington plans to construct a new steel mill in the city of Monterrey. Eying Mexico's expanding consumer market, Mexican beverage company Grupo Modelo ($300 million) and Procter & Gamble ($150 million) announced plans to expand capacity. The government is teaming up with private firms on large projects such as ports, airports and railroads that are aimed at solving logistics bottlenecks and improving Mexico's transportation infrastructure.

The auto industry is also expanding in South America. General Motors plans to spend $200 million to build a manufacturing plant in Brazil, while Italian industrial vehicles manufacturer Iveco will invest $48 million to expand its capacity in the country.

Despite rapid growth in the logistics and manufacturing sectors, the industrial market is still in its infancy in Brazil. Most facilities are owned by users or local landlords. However, institutional investors are increasing their participation in the sector. Institutions that started with timid incursions through low-risk build-to-suit projects have moved on to the development of larger-scale industrial and distribution parks in the southeastern states of Sao Paulo and Rio de Janeiro. Local and foreign institutional capital is also behind ambitious infrastructure projects in the country, notably new ports and railroads.

Retail

Part of Latin America's resilience to worsening economic conditions worldwide can be attributed to the growth of its domestic consumer markets. Increased credit availability and real wage growth both play a central role in the expansion.

In Brazil, an emerging middle class was the main force. By some accounts, the middle class last year expanded to 45% of the population, up from roughly 30% in years' past. The surge is the result of falling unemployment and a 6% real wage growth rate in 2007. Middle-class consumers are taking advantage of cheap credit that is not available to low-income families. As a result, retail sales grew more than 10% last year, twice as fast as the country's GDP.

Retailers have been the first to notice – and benefit from – this secular trend. Grocery retailers have for several years been expanding, in many cases offering new sales formats that cater to the new entrants to the consumer market. In the first quarter, retailer Pao de Acucar announced the investment of $570 million in the construction of up to 105 new stores in 2008. Gbarbosa, a Brazilian retailer recently acquired by Chile's Cencosud, unveiled plans to invest $103 million this year, while Cencosud announced plans to invest $3 billion over the next four years in Chile, Brazil, Argentina, Peru and Colombia.

Expansion and consolidation in retail has radically transformed the landscape from a couple of years ago. Large shopping center portfolios have been amassed by just a few firms that were formed through the merger of smaller local mall operators sponsored by institutional capital and private equity funds. Properties traded hands at a rapid pace during 2007, and new development is now ongoing in mid- and large size Brazilian cities.

As with Brazil, a large share of Mexico's economic growth in 2007 can be credited to its consumer market. When the U.S. economy started to decelerate toward the end of last year, some feared the Mexican economy would follow suit. That has not happened so far. While businesses and the government prepared for a slowdown, the economy actually heated up during the first quarter. Mexico's retail association ANTAD, which includes some of Mexico's largest retailers such as Soriana, Wal-Mart and Comercial Mexicana, reported an increase in total sales of nearly 12% in February, or close to three times the rate of output in the overall economy. ANTAD reports that members will invest $3 billion this year, an increase of 17% from last year. Retailers expect to add 11% to their net rentable space in 2008.

Residential

Fears that the U.S. mortgage crisis would contaminate Latin American buyers' appetite for new home acquisitions have yet to materialize. Demand remained strong in the first quarter, as mortgage credit sources didn't retreat.

Mexico's main mortgage lender, federal housing fund Infonavit, granted 458,700 home loans in 2007, up 8.8% from 2006, albeit a bit short of its 500,000 target. Infonavit cited lack of housing supply as the reason the fund failed to reach its target, and it is aiming to write between 500,000 and 540,000 mortgages in 2008.

Mexican homebuilders are rushing to expand production. **Mexico's largest homebuilders – Homex, Geo and Urbi – reported double-digit sales growth last year**. Infonavit and commercial banks were successful in tapping securitization markets in the first quarter despite the credit crunch. In February, two well-capitalized institutions tested the markets. Mexico's largest bank, BBVA Bancomer, floated $100 million of bonds in its second mortgage-backed securities offering, while the Mexican arm of Canada's Bank of Nova Scotia made its debut offering of $230 million. The environment appears to be less favorable for mortgage banks that are relying on securitization as an essential part of their business plans. Some smaller mortgage banks reportedly struggled to meet payments on short-term loans that they are warehousing because the securitization markets are unfavorable. Government agency SHF stepped in to guarantee liquidity to these firms.

Despite the larger economy and population, Brazil's mortgage market is still dwarfed by Mexico's, although it has expanded rapidly in recent years. Total volume of mortgages in Brazil rose by 70% in 2007, and may double in the first quarter, according data from the Brazilian System of Savings and Loans, SBPE.

Commercial banks are raising their bets on Brazil's mortgage market. The country's largest bank, state-controlled Banco do Brasil, announced it will start originating mortgages, with a goal to finance up to $570 million in mortgages this year. Brazil's largest private bank, Bradesco, is planning to write $3 billion of home loans this year, while Spain's Santander is targeting $1.7 billion.

The rate of sales growth for the top homebuilders in Brazil all topped 100% in 2007, although it was a turbulent year on the corporate level. More than 20 homebuilders raised nearly $8 billion in public equity between 2005 and 2007. The spigot was shut in mid 2007 after investors became worried that the spate of offerings was too much, too fast. Homebuilders are now looking at alternative methods of raising capital. During the first quarter, developers Cyrela and Inpar raised nearly a combined $550 million by issuing debentures. Companies are also getting direct financing from commercial banks: real estate companies received in excess of $800 million in credit lines from Brazilian banks during 1Q08.

Conclusion

The largest Latin American countries have been able to sail through the first quarter in relative tranquility. Government finances are fairly sound and strong consumer demand has allowed the region to fare much better than in previous global turmoil. Although the economies of countries like Brazil and Mexico showed no signs of slowdown, the global crisis has prompted governments and businesses in the region to take measures to weather more difficult times that may lie ahead. Nevertheless, local stock markets have been able to outperform those in major economies and foreign direct investment inflows remained strong.

The upshot for all major real estate sectors is positive. Consumer demand has greatly helped retailers. Mortgage availability in Mexico and Brazil has fueled housing sales. Infrastructure projects should benefit the industrial sector by improving logistics and transportation. Office markets remained strong in the first quarter, as companies continue to expand while new supply in most cities remains limited.

The next quarters will be crucial for Latin American economies as the credit crisis unfolds. Real estate has been among the segments benefiting most from the prospect of growth that investors identify in these countries. Strong demand from a rising middle-class is one of the main stories that are behind investors' appetite for raising their Latin America exposure. Still, it remains to be seen how much damage a more abrupt slowdown in the global economy will inflict on the internal dynamics of Latin American countries. But given the limited effects thus far, the outlook for the region remains positive.

The Investment Research Department of PREI publishes reports on a range of topics of interest to institutional real estate investors. Individual reports are available free of charge in hard copy, by e-mail or via the Web at www.prei.com. Reports may also be purchased in quantity for use in conferences and classes. To receive our reports, change your contact information or to be removed from our distribution list, please e-mail us at prei.reports@prudential.com, or telephone our New Jersey office at 973.683.1745.

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

Tel 973.683.1745
Fax 973.734.1319
Web www.prei.com
E-mail prei.reports@prudential.com

PREI® is a business unit of Prudential Investment Management, Inc., a registered Investment Adviser and indirect wholly owned subsidiary of Prudential Financial, Inc., Newark, New Jersey.