BBVA | RESEARCH

Real Estate Outlook

Colombia

2012
Economic Analysis

- **The building sector is set to grow by an annual 10.8% in 2012 and an average annual 3.8% in 2013-16.** The slowdown can be explained by less construction of high-value housing, only partially offset by greater commercial activity.
- **Housing sales will remain at record levels, but their rate of growth will slow.** This performance will help limit the increase in housing prices, but it will be offset by strong commercial demand for warehouses, offices and store premises.
- **Public housing policy is aiming to reduce the housing deficit by donating 100,000 homes to the poorest people.** The goal is plausible in the light of the historical levels of social housing construction, but it will lead to challenges in terms of bringing land up to urban standards.

Index

Closing date: November 30, 2012

1. Summary

In 2012 the issue of construction permits slowed to a level close to medium-term equilibrium. So far this year, social housing (VIS) was more sluggish, growing in only 7 departments. In contrast, construction permits for projects other than housing showed better results than in the housing sector. The main contributors to this trend were warehouses and the social-recreational sector.

Public policy is seeking to support the expansion of the sector by boosting social housing. A law was approved recently to allow the construction of 100,000 "free" homes through 2014, targeted at the poorest families and in the departments with the biggest housing deficit. To guarantee the availability of land for these projects, site plans for private housing projects will be obliged to earmark at least 10% of the land for the construction of social housing (VIS), and 25% for housing of priority interest (VIP).

Risk levels in the sector remain under control. Companies in the construction sector have notably reduced their financial leverage. The current supply of housing could be sold in 7 months, below its average construction time. The supply of buildings other than homes has continued to adjust in line with its trend since 2009.

BBVA Research expects investment in buildings to grow above an annual 10.8% in 2012 and an annual average of 3.8% in the period 2013-2016. This performance guarantees more sustainable growth in the sector. In 2015 the sector will begin a new cycle of expansion in response to foreign trade conditions, business performance and increased household consumption.

New housing sales slowed in 2012. The slowdown in new housing sales is healthy, as it restricts any upturn in investment purchases and the subsequent increase in the supply of existing housing.

These is great room for growth in the housing market in Colombia, as more than 50% of households do not own their own home. There is therefore a potential demand, and not only among the lowest-income population. For example, in Bogota, 67% of rental income is from social strata higher than three. Finally, the modern retail channel based on hypermarkets and shopping malls and the recent signing of trade and investment agreements will result in a structural increase in the demand for hypermarkets, warehouses and business offices.

Prices of both new and existing housing picked up recently, despite lower residential demand. However, the current rate of growth is still under the maximum levels of 2007, and represents an early warning of possible mismatches in the residential market.

The indices of capacity and effort measured by BBVA Research reveal improved access by families to the housing market. At the same time, the financial burden of housing loans has remained stable since 2010 at around 2% of annual household income. However, an index comparing the cost of rental with nominal new and existing housing prices shows a falling trend in 2012.

The mortgage portfolio has slowed its growth, but nevertheless its quality indicators are better than that for the loan portfolio as a whole, with a balance of around 2.5% past-due. This has been helped by relatively stable interest rates, at under 14% in recent months. There has also been a positive influence from the use of best practices in the financial sector when granting loans to families.

Interest rate subsidies will help access to finance for families who buy social housing. According to the government this incentive will remain in place until 2014, but it will be associated with quantitative housing deficit targets for the lowest-income population groups. The market for existing homes of medium-high value will benefit from this measure, as it generated a bias in favor of the purchase of new homes.

2. Introduction

The building sector grew by an annual 9.9% between January and June 2012. This performance was in line with the forecasts made by BBVA Research in the previous issue of Real Estate Watch. It also corresponds to the high level of activity suggested by housing permit issues in 2011. From now on we expect a moderation in activity in the sector, which will become more marked at the end of 2012 and early in 2013, according to the recent results of the leading sector indicators. In any event, the levels of both residential and commercial building construction will remain at all-time highs, given that the reduction in construction permits did not mean they returned to the levels of 2009-2010; in fact, they still remained above the historical average.

The contribution of the new housing policy recently approved by Congress will therefore be very important. It includes the project to construct 100,000 housing units for the poorest people in the country. Also decisive will be the commitment of local governments in generating urban land for constructing these homes and guaranteeing private construction activity by planning water and other public utility networks.

In addition, housing, store premises and office sales will also moderate. As we show below, the lower level of economic activity and stabilization of the urban unemployment rate at over 10% are the main factors determining this result. However, the reduction in the intervention reference rate and continued structural demand for housing due to the housing deficit will support positive levels of sales in the real estate market. Finally, slowing demand for housing and other constructions will help moderate rising prices.

3. Real-estate supply

The supply of buildings moderates its cycle of expansion to a more sustainable level in the medium term

Construction permits in 2011 were equivalent to 185% of the average for the past 26 years, with a rise of 33.8% on 2010. The surge in permits was focused on permits for high-value housing, which accounted for 57% of the total area. Social housing and commercial constructions contributed 22% of the total number of permits each. In 2012 the rate of construction permits issued has slowed, given that part of the increase in real estate permits in 2011 was the result of regulatory changes relating to seismic resistance. In fact, in the period between January and August this year the square meters registered fell by an annual 19.5% to 161% of the historical average.

This level of construction permits is closer to what we could call a new medium-term equilibrium for the sector, according to some statistical exercises showing that the permit cycle has closed its gap and is no longer falling. There has also been continuous growth in the number of permits since 2000, only interrupted temporarily by the economic slowdown of 2008-2009 (Chart 1).

The issue of housing permits has partly been restrained by political decisions at district level affecting the performance of other municipalities close to the country's capital due to reduced availability of water in the area from Bogota towards the Savanna. As a result, between January and August the total number of permits fell more than the national average in Bogota and Cundinamarca, two regions that account for over 35% of the national permits, with an annual fall of 38.7% in Bogota and 48.3% in Cundinamarca. In the rest of the country, the worst figures so far this year have been in the departments of Valle (an annual fall of 46.0%), Santander (38.9%), Caldas (32.7%) and Quindío (27.2%). Overall, these departments account for 21% of permits in the country.

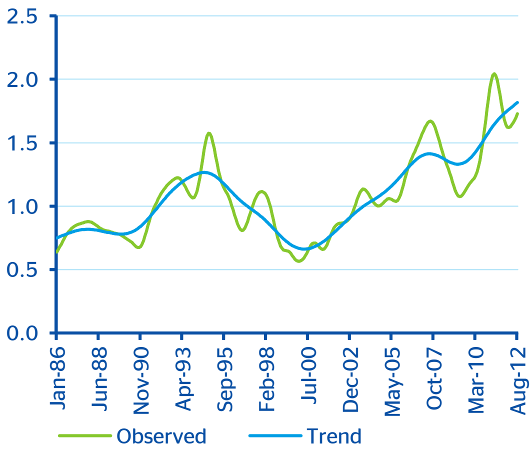
The decline in new construction projects is closely related to sluggish activity in social housing (VIS), which only grew in 7 departments so far this year, compared with the 15 departments that posted increases in the case of high-value housing. In total, while VIS construction permits fell by more than an annual 39%, permits for other types of housing fell by an annual 20%, although the number of permits for other housing is 3.4 times bigger than that for VIS housing.

This decrease has been confirmed by the Camacol indicator housing starts, which was down by an annual 28.6% in the case of social housing and 11.7% in high-value housing. Overall, the indicator was down by an annual 18.9%. The main negative contribution was from Bogota and Soacha, which between them account for 12 percentage points of the fall. However, in recent months there appears to have been a change in the trend, favoring an upturn in social housing, with the numbers of new non-social housing units falling still more.

Construction permits for projects other than housing performed differently from housing, with an annual growth of 0.6% in cumulative figures between January and August 2012 (Chart 2). The main contributors to this trend were warehouses and the social-recreational sector. In contrast, the main sectors with slowing rates were construction permits in the manufacturing sector and offices. The worst performing departments were Atlántico, Antioquia, Santander and Valle.

Gráfico 1

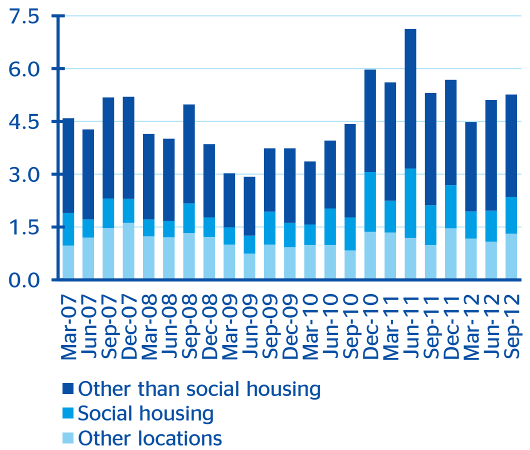
Construction permits gap. Difference relative to its long-term average



Source: BBVA Research

Gráfico 2

Building permits by location. Millions of square meters



Source: DANE and BBVA Research

Public policy is supporting the expansion of the sector by boosting social housing

Management of social housing policy has been focused on two fronts in recent years: first, to ensure the availability of land; and second, to guarantee access to housing for the poorest families in the country. In the case of land, housing policy has been focused on providing more available land and promoting the construction of social housing through the launch of large-scale projects. However, given that available land for this purpose is generally on the outskirts of cities, the costs of building the infrastructure for transport and public utilities increased the financing needs for the project considerably.

A law was approved recently to allow the construction of 100,000 "free" homes through 2014, by a subsidy in kind, targeted at the poorest families. The target, at 50,000 per year, matches the average annual volume of construction of social housing (VIS) between 2003 and 2011. However, they are down on the average figure of 78,000 for 2010 and 2011, when the execution of large-scale projects led to a record in social housing construction. The law also authorizes the extension of payment of notary and registry rights in priority housing (VIP) rental. It exempts rents for ten years from payments derived from housing lease contracts, and extends the tax benefit for the issue of mortgage bonds and securities to 2017.

The departments with the biggest share of the 100,000 homes are Antioquia (13,718), Bogota and Cundinamarca (11,409), Bolivar (8,146), Valle (6,178), Magdalena (5,515), Córdoba (4,930) and Atlántico (4,870). These regions account for 55% of all the housing units to be constructed in the country, which is very close to their share of the total population (60.3%) and the quantitative deficit (63.5%). The significant share of the departments of Atlántico and Córdoba are a positive surprise. They have the second and third biggest housing deficit in the country, respectively, behind Antioquia, despite having a significantly smaller population than the latter.

To guarantee the availability of land for these projects, site plans for private housing projects will be obliged to earmark at least 10% of the land for the construction of social housing (VIS), and 25% for housing of priority interest (VIP). These percentages could be higher (but in no case lower) in the land use plans (POTs) developed by each municipality. Finally, the success of the government plan will depend on the political will of the regional and municipal governments in terms of offering new land that can be put to urban use, with access to public roads and utilities.

The risk levels in the sector remain under control

Companies in the construction sector have notably reduced their financial leverage. Their balance sheets show that their financial obligations as a proportion of assets, liabilities and equity have fallen by 10 percentage points, 12 pp and 28 pp respectively since 1995. At the same time, while in 1999 their debt with the financial sector accounted for 96% of annual operating income, this indicator currently stands at 66%. These figures show the change in the form of financing in the sector, which now makes more use of the greater balance achieved through the system of pre-sales, rather than financing the project by leveraging to dangerously high levels through the financial system or own funds.

Lending to constructors has grown. Loans to developers for the 12 months to July 2012 grew by an annual 29.8%, focused on funds linked to pesos, although they were also boosted by the growing size of loans in units of real value (UVRs), although to a lesser extent. By type of home, loans have increased most for social housing, growing from an annual 20% in July 2011 to the current 39%. At the same time, loans for non-social housing, which accounted for 78% of the total, increased from a rate of 3% to a current 27% (Chart 3).

At present, there are 67,800 housing units on offer, of which 21,000 belong to the social housing segment. This level is 5.4% higher than the housing stock 12 months ago. The increase is focused on zones in Cundinamarca other than Bogota and Soacha, Antioquia and Santander.

In particular, the growth of construction in Antioquia has hit all-time highs, and triggered concerns of possible over-supply. It is true that supply has already begun to stabilize in recent months, according to the negative results for new housing project launches and starts. This coincides with a necessary process of adjustment in supply, which would support a healthy moderation of the sector in this department.

Risk levels in the sector remain in check when measured in terms of stock turnover: the total supply of housing at present could be sold in 7.1 months, which is very close, and even below, the average time for its construction in Colombia. These turnover levels are highest in the case of the most expensive housing (8.2 months), but they are still low. Similarly, the completed and unsold units remain at minimal levels, at 5.3% of the total stock.

The supply of buildings other than housing has continued its process of adjustment that began in early 2009, although in recent months the launch of new projects for offices in Bogota and Medellín has increased the commercial supply by 25%. This is one of the factors that will lead to positive growth in the building sector in the coming years, despite the lower activity in housing. The reason for this is the greater added value contributed by commercial buildings compared with housing, both in terms of foundations and masonry, according to the methodology for measuring GDP in the construction sector established by the DANE.

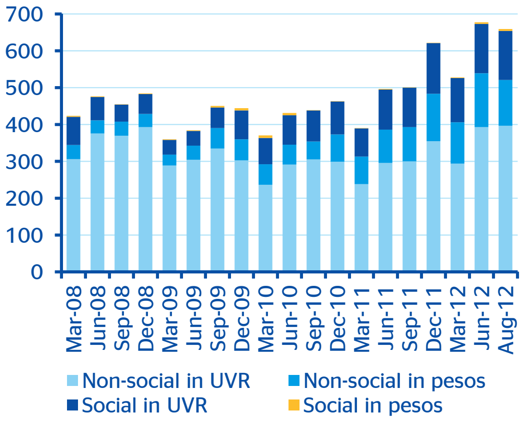
The current stock of offices and commercial premises is significantly below the historical average. This reflects the extensive room for expansion in these kinds of constructions. Indicators for turnover also remain in check at levels below 17 months in the case of offices and 13 months in the case of commercial premises, far below the levels in 2010, when they were over 24 months and 35 months, respectively.

The costs of construction have tended to fall significantly so far this year. This can be explained mainly by the limited increase in the price of machinery and equipment (an annual 1.2%). Labor and material costs, in contrast, continue to grow at above the rate of consumer inflation (an annual 4.3% and 3.4%, respectively).

The outlook for international prices shows a favorable environment for maintaining supply and material costs in check. The global economic slowdown and moderate growth in Asian countries is putting less pressure on iron and steel prices, as well as other non-metal minerals such as cement. However, due to its different market conditions, cement could be subject to domestic pressure as a result of the increased execution of public works. Finally, as Colombia consolidates improvements in its employment situation, wages could increase above the rate of inflation over the next few years.

Gráfico 3

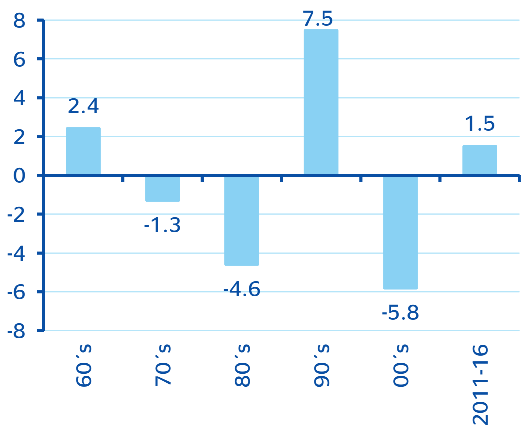
Loans to housing developers*
Millions of current COP, cumulative quarterly



* The August 2012 figure is the cumulative figure for June, July and August
Source: Superfinanciera and BBVA Research

Gráfico 4

GDP housing growth gap
As percentage of potential GDP, annual average



Source: BBVA Research

The building construction cycle will have a smaller positive gap in the coming years

Prospects for the sector are for a continuing expansion cycle, although much more moderate than previously. In fact, while in the 1990s buildings generated a positive gap of more than 7% with respect to potential growth, between 2011 and 2016 the sector will only grow slightly above its long-term level. This performance guarantees more sustainable sector growth as risks of oversupply and costs pressures in the sector fall. The point estimates of BBVA Research for investment in buildings are for annual growth of 10.8% in 2012 and an average annual 3.8% in the period 2013-2016.

The positive gap in the sector increased in 2012 to 4.3% above the structural level, but the decreasing trend will continue in the next two years until the gap closes completely in 2014. In 2015 a new expansion cycle will begin as external trade conditions and business performance and domestic consumption encourage increased demand for warehousing, store premises, offices and housing (Chart 4).

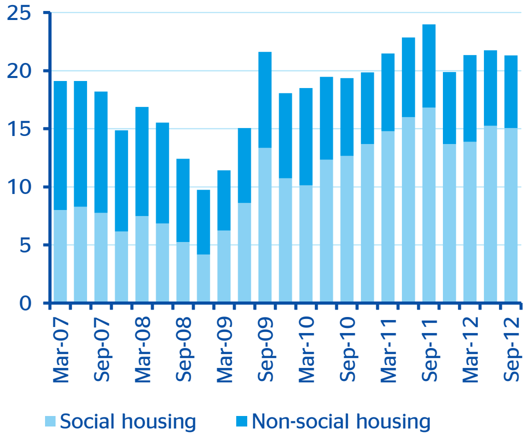
4. Real-estate demand

Housing sales weaken

The slowdown in housing sales so far in 2012 is mainly associated with uncertainty regarding the renewal of some economic policy incentives and fewer investment purchasers entering the market. Housing dropped from a growth of 12.7% in 2011 to a fall of 2.9% so far this year to September (Chart 5). The less positive figures could be seen most clearly in Bogota (annual fall of 22.2% in sales through September 2012), Cartagena (annual fall of 20.2%) and in the non-urban areas close to Bogota (annual fall of 16.2%). At the same time, there were increased sales in Santa Marta (up an annual 41.8%), Barranquilla (up an annual 39.6%) and the municipalities close to Bogota (annual increase of 21.1%).

Gráfico 5

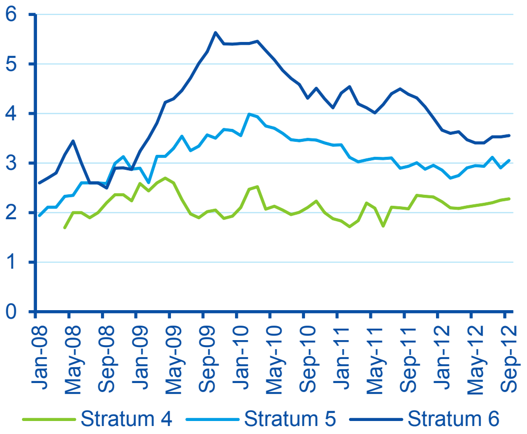
Housing sales by type. Thousands of units



Source: La Galería Inmobiliaria and BBVA Research

Gráfico 6

Indicators of vacancies in existing housing. Percentage of total supply of existing housing



* In Colombia the population is divided into 6 strata by income. This chart shows the 3 upper strata: 4 (average), 5 (average-high) and 6 (high).
Source: La Galería Inmobiliaria and BBVA Research

This performance has halted the convergence in high-value housing sales in the three biggest cities (Bogota, Medellín and Cali) towards the generation of middle-high income households. Even so, in a medium-term context, over the eight years between 2004 and 2012 there are signs of an equilibrium in the housing market for families of this income range, although it could be broken if the falling trend in sales continues for a number of quarters more.

The slowdown in new housing sales is healthy, as it restricts any upturn in investment purchases and the subsequent increase in the supply of existing housing. In fact, real-estate transactions in the first half of 2012 fell by an annual 0.8%, in part explained by fewer transactions in existing housing, which account for more than 80% of the Colombian real-estate market. At the same time, the average time needed to rent an existing home in stratum 6 in Bogota fell from 137 days in December 2011 to 116 days in September 2012, while the time needed to sell a home of this type fell from 189 days to 157 days over the same period. At the same time, the number of vacant existing homes for sale and/or rent fell from 4.1% in December 2011 to 3.5% now (Chart 6).

Home ownership in Colombia is focused on the middle strata with purchasing power

In Colombia Article 102 of Law 142 of 1994 created seven socio-economic strata to classify residential buildings. The strata take into account aspects such as the poverty level of the owners, the availability of public utilities, location (urban, rural), and indigenous settlements. Each local mayor has to determine the stratification of the residential buildings in his municipality or district. The lowest stratum is 0 (no home) and the highest is 6.

According to the electrical power service registers in Colombia, 69% of homes in the country are in strata 2 and 3; however, there are signs of a change in trend over the last 5 years in favor of homes belonging to stratum 4. These homes today account for 12.8% of the total, while 5 years ago they accounted for fewer than 10%. By cities, Pereira and Bucaramanga have the biggest proportion of high-stratum housing, with over 35% in strata four, five and six, while Montería and Barranquilla have nearly 80% of their housing in strata one and two.

Some 48% of households in Colombia live in their own home, although 5% are still paying for it. In contrast, 32% households rent and 17% have right to usufruct. Thus more than 50% of households do not own their own home. There is therefore a potential demand, and not only among the lowest-income population. For example, in Bogota 10% of the households that rent belong to the strata above 4, while 37% are in strata 3, and have the capacity to pay to access housing of greater value than the income limits for social housing. In addition, 67% of income from rental in Bogota is from strata above 3, at a total of nearly COP 3 billion (0.5% of GDP) per month.

The annual generation of households in Colombia now stands at over 280,000, while only 200,000 homes with permits are constructed per year. The remainder is covered by informal housing construction and sharing by more than one household in a single home, which puts pressure on the qualitative housing deficit. The potential demand for homes, i.e. the housing deficit, comes exclusively from the poorest sectors of the population. This should be partly covered by the national housing policy explained above. The application of this law should increase the current trend in housing production, which is at around 4 homes per year for every 1,000 people, similar to the current level in Chile, which has a lower housing deficit and has reduced this indicator over time.

There is also a great potential for expansion in commercial buildings. There are two determining factors for this: first, the modern retail channel based on hypermarkets and shopping malls has a low level of penetration in the country, which could be reversed in the medium term with the growth of the middle classes; and second, the recent signing of trade and investment agreements will increase structural demand for warehouses and business offices.

Housing prices rise despite lower demand

Housing prices have gathered pace so far this year. In the case of new housing there was a real annual increase of 7.7% in June 2012, compared with the 5.8% annual increase in December 2011. At the same time, prices of existing homes increased in June at a real annual rate of 7.0%, compared with the 6.3% rate in December (Chart 7). This level is still below the highs of 2007 (a real annual increase of between 11% and 13%), but it provides an early warning of the existence of increases above the structural factors in the real-estate market.

The indices of capacity and effort measured by BBVA Research reveal improved access by families to the housing market. While in 2009 households had to spend 4.1 years of their income to buy an average-price home in Colombia, today the rate is 3.6 years. At the same time, while the first payment of a mortgage loan accounted for 33.1% of disposable household income in 2009, currently the figure is 27.9% (Chart 8).

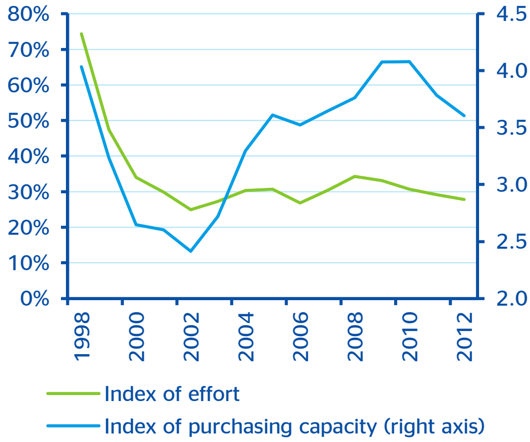
Gráfico 7

Real new and existing housing prices. Dec 06 = 100

Source: DANE, BanRep and BBVA Research

Gráfico 8

Index of purchasing power and index of effort*. As a percentage

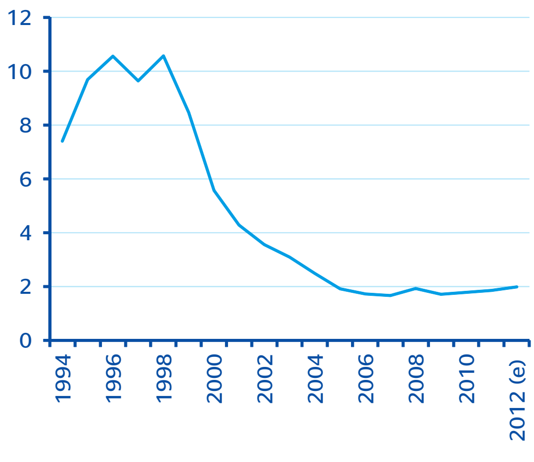


* Index of capacity: the number of years of income needed to buy a home. Index of effort: the proportion of the monthly wage used to pay the first payment of a mortgage loan.
Source: BBVA Research

The financial burden of housing loans has remained stable since 2010 at around 2% of annual household income (Chart 9). This shows that lower interest rates and increased income have maintained the flow of resources used for mortgage lending steady, despite the growth in housing prices. However, an index comparing the cost of rental (taken from the CPI basket) with nominal new and existing housing prices shows a falling trend so far in 2012 (Chart 10). This result could indicate a mismatch of housing prices (the underlying asset) with respect to the price of rentals (the return on the asset at present value) that contravenes the principle of asset price formation, which uses the sum of future returns discounted to present value.

Gráfico 9

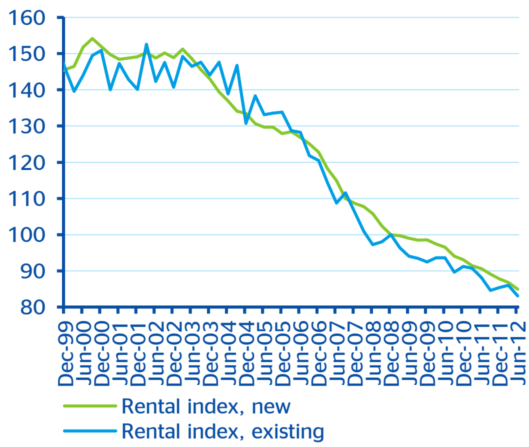
Financial burden of mortgage. As percentage of annual income



Source: BanRep and BBVA Research

Gráfico 10

The indices of rentals and new and existing housing prices



Source: DANE, BanRep, and BBVA Research calculations

A return of price increases to a real level of 10% or above, with GDP growth at close to potential and barely marginal reductions in the unemployment rate would not be sustainable over time. What is more, it would not be offset by growth in disposable income or the stability of interest rates, as is happening at the moment. A return of price increases to a real level of 10% or above, with GDP growth at close to potential and barely marginal reductions in the unemployment rate would not be sustainable over time. What is more, it would not be offset by growth in disposable income or the stability of interest rates, as is happening at the moment.

Lending growth with good portfolio quality

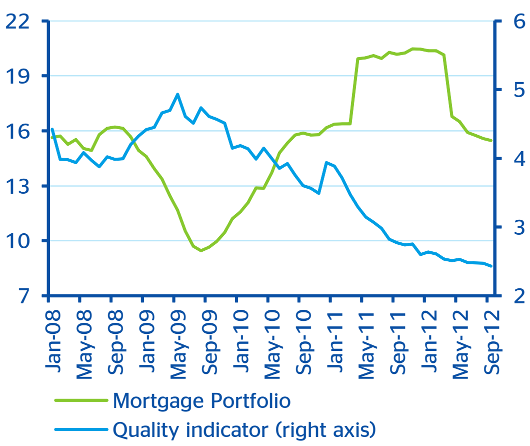
Loans for the purchase of housing slowed from an annual 20.8% in 2011 to 5.5% (Chart 11). This trend is closely related to the large housing stock under construction, which implies high levels of lending to constructers, but a lag in the increase of mortgage lending.

Despite slowing its growth, the mortgage portfolio still has the best quality indicators among the loan portfolios, with around 2.5% of past-due balances, under the historical average of around 10% and the current indicator for the total portfolio of around 3.4%. This has been helped by relatively stable interest rates, at under 14% in recent months. There has also been a positive influence from the use of best practices in the financial sector when granting loans to families.

Our interest rate scenario assumes a return by the Bank of the Republic's intervention rate toward its neutral level of 5.5% at the end of 2013 (Chart 12), which will support low financing costs. After 2014 there will be an increase in the mortgage rate, moderated by low inflation and a lower level of growth in the BanRep rate with respect to its historical highs.

Gráfico 11

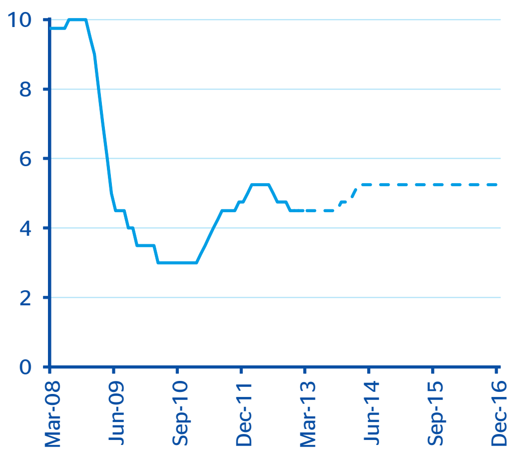
Lending and the quality of the mortgage portfolio As annual change and proportion of the portfolio, %



Source: Superfinanciera and BBVA Research

Gráfico 12

BanRep intervention reference rate. As a percentage



Source: BanRep and BBVA Research

One element of public policy that will help families who buy social housing access finance will be interest rate subsidies. According to the government this incentive will remain in place until 2014, but it will be associated with quantitative housing deficit targets for the lowest-income population groups. The aim is to reduce demand pressures that could cause excessive price increases in higher-value housing, where there is no quantitative deficit. For this reason the government allocated COP 1.4 billion to finance 136,000 housing units from 2012 through 2014, divided between priority housing (VIP) at 40%, and social housing (VIS) at 60%. Over 10,000 loans were approved with this subsidy from July through September 2012, and a participation of around 65% of VIS housing and 67% in Bogota and Cundinamarca.

The market for existing homes of medium-high value will benefit from the elimination of the interest-rate subsidy, as it generated a bias in favor of the purchase of new homes. In fact, according to the most recent reports on housing finance, new loans are showing a clear increase in the share of the market of existing homes, from 43.5% in the first quarter of 2012 to 48.5% at the close of June. As a result, it is likely that in the future the vacancy rate of the existing housing market will remain low.

The tax reform project proposes not including the AFC savings accounts as a credit in people's IMAN income tax returns. In the future, these funds will be considered as income, and as a result possibly generate less incentive for housing demand. Currently the average balance of savings in AFCs accounts is COP 4 million, with a total of 133,000 accounts open. Even so, the AFC accounts only account for 2.3% of the total mortgage portfolio with securitizations, so any negative effects this measure could have on the purchase of housing will be limited.

5. Conclusions

The construction sector has ample room for growth until the end of 2012, when it will see the completion of most of the homes now in the process of construction, many of them of high value. Activity in the sector is likely to slow in 2013, given the smaller volume of permits issued and new housing starts. Even so, the faster pace of commercial activity, particularly in offices and warehouses in Bogota and Medellín, will maintain the positive rates of growth over the coming years, given that this kind of building has a high share of the GDP in the sector according to DANE statistics.

Expected growth for the next five years will differ from previous periods of expansion in terms of the extent of its gap to the trend level. While in the 1990s the rate of increase was far above the long-term level, the expected gap will this time be moderate, and limit any possible sudden reverse in the construction cycle.

The good performance of building will be supported by the performance of residential and commercial demand. Sale of high-value homes will slow as a result of the elimination of interest subsidies, thus taking away the stimulus for purchase by investors and reducing the supply of existing housing. However, this will be partially offset by the increases in household income levels, stability in mortgage interest rates and subsidies in kind given to low-income families.

In addition, commercial demand will be supported by the positive impact of high foreign investment flows for the purchase of offices, increased warehousing needs in a context of Colombia's greater openness to trade, and the effect of private consumption on the expansion of store premises and other buildings.

Housing prices began to rise faster recently, breaking the moderate trend in place since the end of 2011. However, the slowdown in housing sales and the elimination of interest rate subsidies for non-social housing could lead to prices slowing over the coming quarters. Even so, the improved structural conditions, particularly in terms of urbanization and mobility, will maintain the growth in housing prices at levels above inflation.

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This report has been produced by the Colombia Unit:

Chief Economist for Colombia
Juana Téllez
juana.tellez@bbva.com

Mauricio Hernández
mauricio.hernandez@bbva.com

María Claudia Llanes
maria.llanes@bbva.com

Julio César Suárez
julio.suarezl@bbva.com

Interns:

Paola Andrea Angulo
paolaandrea.angulo@bbva.com

Juan Felipe Duarte
juanfelipe.duarte@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Alejandro Puente
apuente@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macroeconomic Analysis Mexico

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity Global
Ana Munera
ana.munera@grupobbva.com

Global Credit
Javier Serna
Javier.Serna@bbvauk.com

Global Interest Rates, FX
and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Contacts details:

BBVA Research Colombia
Carrera 9 No 72-21 Floor 10
Bogotá, Colombia
Tel: 3471600 ext 11448
E-mail: bbvaresearch_colombia@bbva.com