

Real Estate Watch

Colombia

Economic Research Department
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Index

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Executive summary	2
I. The Colombian real estate sector in the face of the adjustment	3
1. Demand factors	3
2. Supply factors	6
II. The Role of the Public Sector in Real Estate Sector Development	8
III. Appraisal and outlook	10

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Executive Summary

The cyclical slowdown process that started in the Colombian real estate sector at the beginning of 2008 intensified in recent months due to the deepening of the international crisis and its effects on the economy.

Demand for housing has also been affected by the deterioration in Colombian consumer expectations who, faced with increased unemployment, have decided to delay their purchase decisions. However, the strong fall in Central Bank benchmark intervention rates and the rates coverage scheme for funding new homes by the National Government have helped to improve real estate investment expectations since May 2009.

In supply terms, construction companies gradually reduced the permit area for buildings over 14 months ago in the face of an exhausted expansive cycle in the real estate sector. This decision was reinforced over recent months in the face of the deterioration in expectations due to the acceleration in the international crisis. The business effects for the sector with lower construction space approved began to be seen more strongly at the end of 2008 due to the decrease in works started and in progress. It should be underlined that this sector's adjustment has been orderly thanks to the highly generalized use of pre-construction schemes for buildings and the financial strength of sector companies.

In turn, bank finance in the real estate sector has kept up well despite deterioration in business supported by the aforementioned passing on of interest rates and the government's rates coverage scheme.

The adjustment process conditions seen over recent months, alongside the present sector strengths, lead us to forecast the same will continue for some months, albeit orderly and without any trauma to the level of real estate prices or non-performing loans levels.

For the future, expectations for the sector continue to be good and we expect that after this cycle stage the sector will follow a positive growth path based on the positive structural conditions for development.

I. The Colombian real estate sector in the face of the adjustment

The real estate sector in developed economies played a major part in the development of the present global economic crisis. A strong hike in housing prices combined with a high level of leverage in the economy with low risk standards in awarding loans led the global economy into its worst recession since the World War II. This time around, Colombia is in a privileged position among the countries least affected by the international crisis and we expect this event will only have a slight effect on the economic growth rate.

When the international scenario was at its worst, Colombia's economy had already been slowing down from its maximum at the end of 2007. This slowdown was the result of a combination of domestic and foreign demand factors as well as impacts on supply.

In this sense, the effect of the external crisis on the Colombian economy will lead to a slight GDP contraction over 2009. BBVA ERD forecasts a fall in investment and exports, and modest growth in final consumption. Thus, the projected growth path forecast for the Colombian economy hit bottom in the second quarter of 2009 to then begin a gradual recovery process. The economy will contract by 0.5% in 2009 and grow below its potential level in 2010 and 2011 at 1.5% and 3.5% respectively.

The construction sector was a main player in the last Colombian economy expansion stage and, in the same way, has suffered the combined effects of an exhausted economic cycle and the major blow to confidence as a consequence of the deepening of the international crisis. In contrast to the crisis at the end of the 1990s, the Colombian real estate sector will only suffer the collateral effect of lower economic growth and will not be the epicenter of it. Supply and demand factors, as well as the performance of real estate funding explain the sector's recent developments.

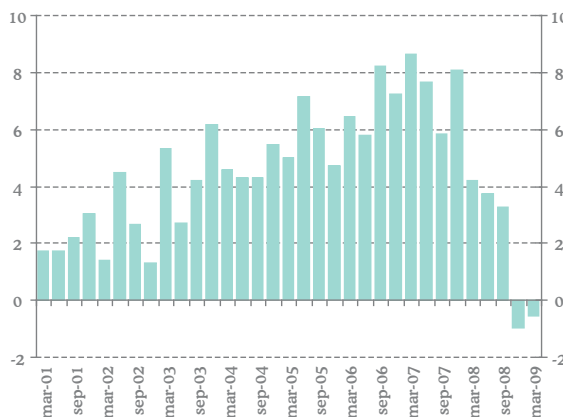
1. Demand factors

Housing demand over the last year experienced two stages with a different trend. The first comprises the period between September 2008 and March 2009, where the fast change in economic conditions had a negative impact on all factors households take into account when purchasing a home.

The lower economic growth rate and the increase in unemployment delayed investment decisions by families. Secondly, the major blow to expectations as a consequence to the international credit crunch negatively affected household perceptions of job stability and income. The Fedesarrollo consumer confidence survey shows that the inclination to purchase a home experienced a major decrease in the last months of 2008 and the first months of 2009, even reaching one of the lowest levels ever on this indicator. According to Galería Inmobiliaria, during this period, new house sales in the three main cities plunged 36% in comparison to the same period 12 months earlier.

The second stage began in the second quarter of 2009 and is expected to continue over the rest of the year. In the second stage,

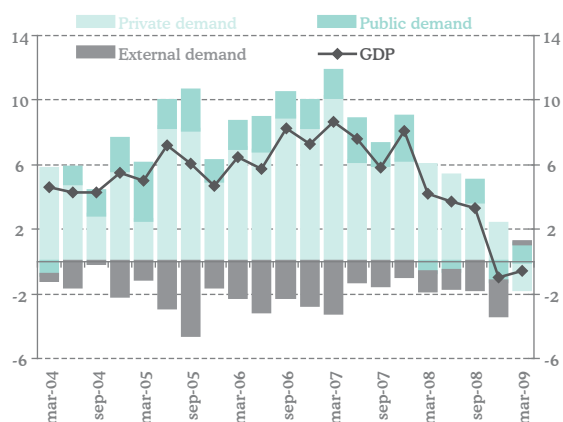
Gross Domestic Product (Year on year variation %)



Source: DANE

BBVA ERD

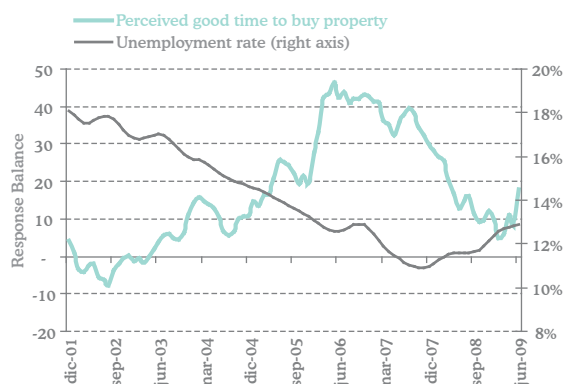
Contribution to economic growth (Year on year variation %)



Source: DANE and BBVA ERD calculations

BBVA ERD

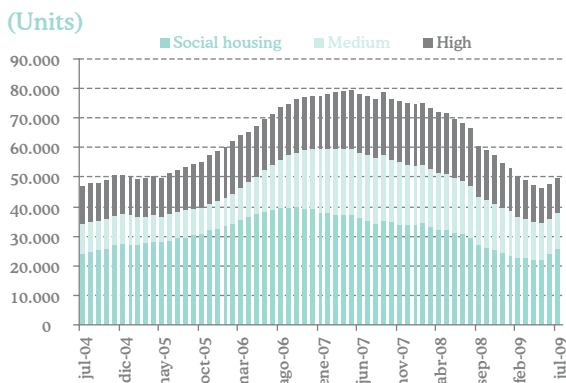
Labor Market and Consumer Confidence for House Buying



Source: DANE - Fedesarrollo

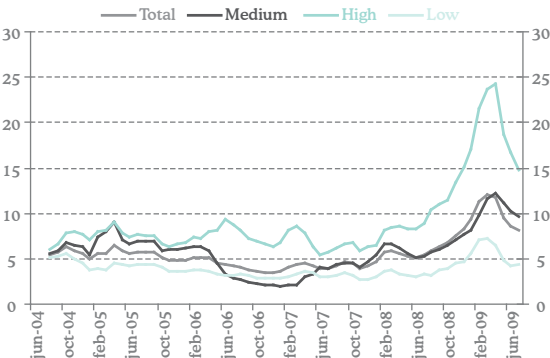
BBVA ERD

Housing Sales by Price Range



Source: La Galería Inmobiliaria
*Data for Bogotá - Medellín - Cali BBVA ERD

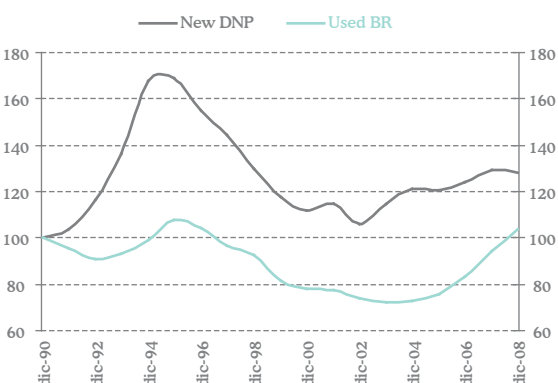
Housing Inventory Turnaround (Months)



Source: La Galería Inmobiliaria
*Data for Bogotá - Medellín - Cali BBVA ERD

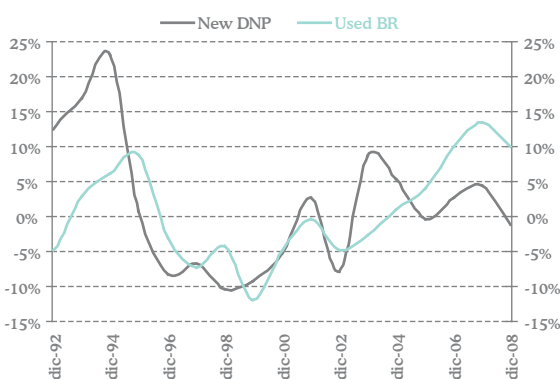
Housing Price Index

Base 100 = 1990



Source: Banco de la República - DNP BBVA ERD

Real House Price Growth



Source: Banco de la República - DNP BBVA ERD

the cut in interest rates and the expectations of better macroeconomic conditions, as well as the rates coverage scheme for financing homes offered by the National Government have helped to boost real estate demand again. The confidence indicator shows a change in conditions for purchasing homes since April 2009 and the July data places availability to purchase a home at levels similar to those in December 2007, a moment when conditions for purchasing a home were favorable. Similarly, home sales have shown a major upturn and the accumulated new home sales between April and July increased by 2% compared with the same period in 2008 and 57% compared with the period running between December 2008 and March 2009.

The two stages can be identified in the performance of home inventory turnaround indicators¹ placed at 7 months in August 2008, increasing to 11.8 months in January 2009 and falling to 5.8 months in July. When comparing the city turnaround indicator, Bogotá, Cali and Medellín come in very near the national average while cities such as Cartagena have indicators surpassing 24 months.

In turn, house prices in 2008 showed slower real growth than in previous years. According to the National Planning New Home Index (IVNPN), in 2008 in real terms house prices fell 1.07%. Further, existing house prices showed real growth at 10% for the same period. Ordered house price growth in the expansion cycle for the construction sector and the recovery of demand over recent months leads to a forecast of no downward pressures appearing in aggregate prices for housing on a national scale.

Demographic Factors

A downward trend in the number of individuals comprising households has been seen in Colombia, leading to a more rapid growth of these households than population. In the country, households grew at an annual rate of 3.4% between 1993 and 2005, while population grew at 2.2%.

Given the estimates for future population composition and the downward trend in household size, the figures show housing needs of around 350,000 new homes per year in the next five years. In addition, according to the last population census in Colombia, there is a housing deficit of 3,828,055, spread between 1,307,757 as a quantitative deficit and 2,520,298 as a qualitative deficit. In turn, permit data from DANE show that between 2005 and 2009 an average of 123 thousand homes were built per year, meaning the deficit enlarged over recent years.

These demographic trends, linked with the existing housing deficit, create positive expectations for housing demand in Colombia in the coming years.

Banking financing for the sector

One of the most important factors allowing the country to face the external crisis is the solidity of the financial system. Credit for home financing and constructing continues to flow and shows year-on-year

¹ Inventory turnaround measures how many months the market takes to empty if sales from the last month are maintained

growth in June 2009 of 10%. The portfolio quality indicator remains at levels near 5%. Similarly, there are some factors allowing us to think that loan performance will continue apace in the coming months despite lower sector activity.

The Banco de la República interest rate cut has been passed on to the other economy rates including mortgage rates. The Central Bank cut its benchmark rate by 550 basis points in a period of 7 months, 250 of which were passed on to mortgage rates up to August 2009. In Colombia, mortgage financing is carried out via fixed or variable loan rates (linked to inflation). The data show that fixed rates came in at an average 17% in August 2008 and in July 2009 at 14.5%; variable rate performance was similar. The interest rate cut reduces the debt burden for households and means credit is a more attractive option for home financing. The BBVA ERD forecasts that the Banco de la República benchmark interest rate will remain at present levels until mid 2010. Mortgage rates are expected to continue their downward trend.

In turn, the National Government launched a new plan to stimulate new home purchases which the BBVA ERD sees as positive and as having a great capacity to make an impact on the sector. The government plan comprises a partial coverage, for seven years, of the interest on loans for purchasing new homes.² The coverage varies depending on the commercial value of the property, being higher for lower cost homes. It could represent up to a 30% reduction in the mortgage monthly instalment. The government initially offered 32 thousand benefits for loans paid out between April 2009 and December 2010. However, it recently extended the number of benefits to 80 thousand and the timeframe until December 2011. The size of the package is significant as, on average, in the last 5 years, 55 thousand homes per year were sold. The plan fulfils two targets set to be beneficial for the country. The first is to help reduce home inventories by favoring access and implementing real interest rates not seen in the recent history of the country.³ The second is to stimulate other sectors that can benefit indirectly from the greater activity in the construction sector such as commerce and national industry.

In turn, access to a benefit is only provided one per person and it is lost if the loan goes into default for over three months. In this way, the government is creating incentives so that people are up-to-date with their payments and does not allow the government support to be used to generate excess demand from investors leading to price increases or inventory excesses to be sold.

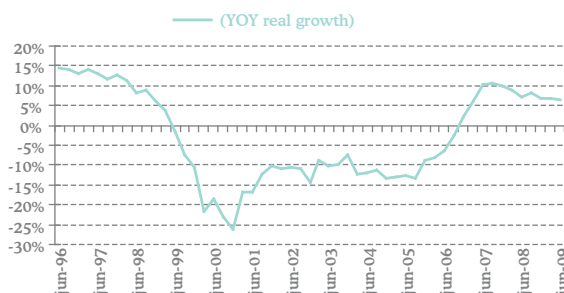
According to data from the Colombian Banking Association, up to August, around 14,000 benefits were awarded and 20,000 pre-approved. This shows acceptance of the government's measure among purchasers.

In turn, the GDP-mortgage ratio, mortgage penetration, remains relatively stable at levels of 3%. The penetration is at low levels when compared with the historical average and other economies such as Mexico and Chile where penetration reaches 10%. The measures taken by the government intend for families to find financing in the

2 If the property value is not above 135 current legal monthly minimum salary (SMMLV) cover is 5%, between 135 and 235 SMMLV 4% and between 235 and 335 SMMLV cover is 3% of loan rate.

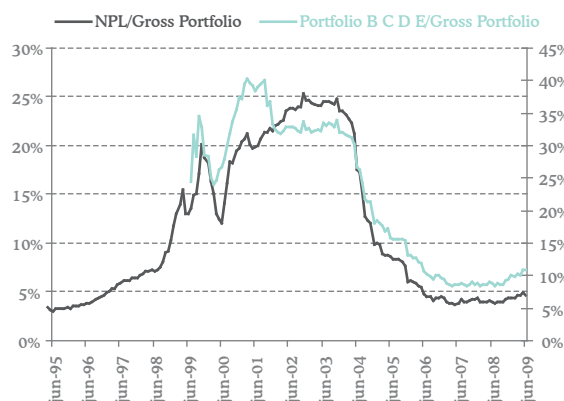
3 In Colombia, the real estate and construction sector contributes 16% of total employment.

Mortgage Lending



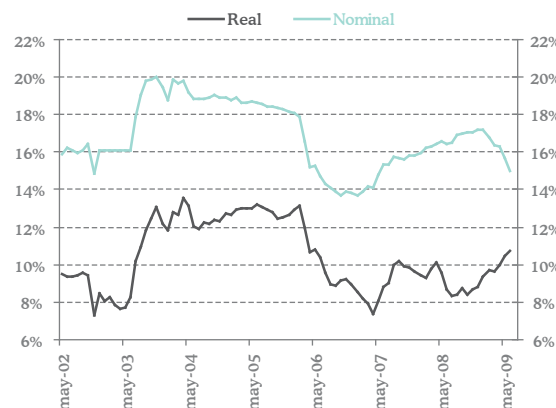
Source: Superintendencia Financiera - Titularizadora Colombiana - DANE BBVA ERD

Mortgage Portfolio Quality



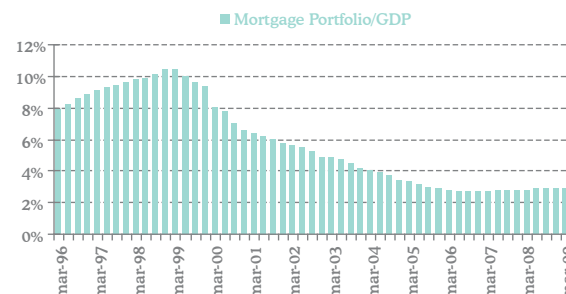
Source: Superintendencia Financiera BBVA ERD

Mortgage Interest Rate in pesos



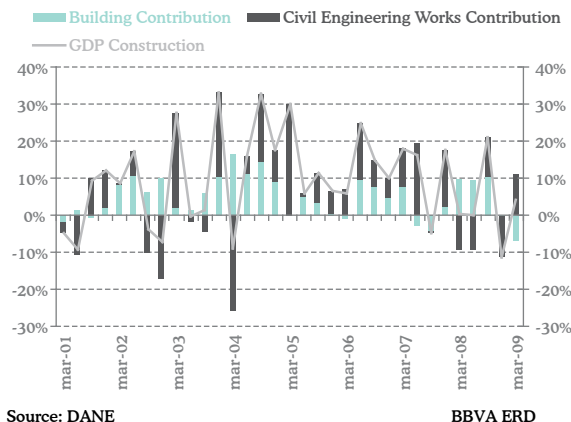
Source: Superintendencia Financiera BBVA ERD

Mortgage Lending

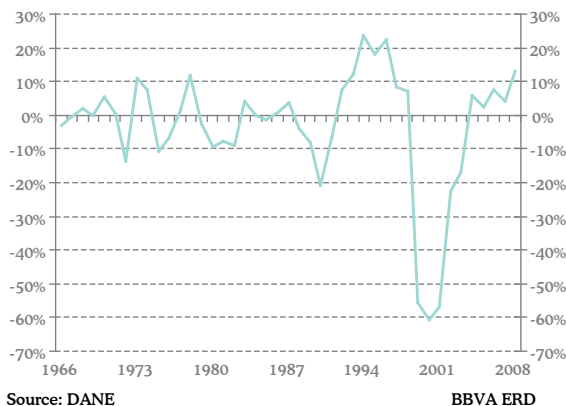


Source: Superintendencia Financiera - Titularizadora Colombiana - DANE BBVA ERD

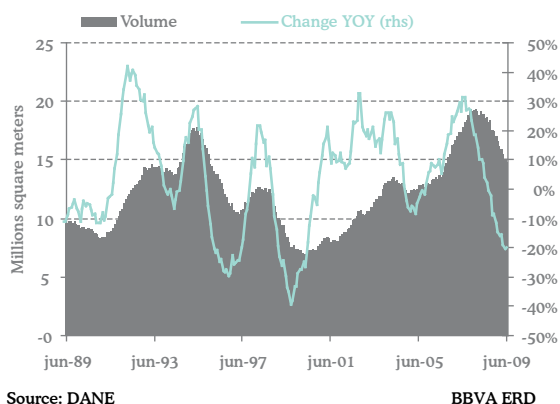
GDP Construction base 2000 (Change YOY)



GFCF Cycle in Buildings (Deviation over Trend)



Building Permits (Accumulated: 12 months)



financial system. This is desirable for sector sustainability as a large percentage of the population with low and middle incomes could not purchase a home without the possibility of financing.

2. Supply factors

Construction business, both for buildings and civil engineering works, experienced an average 12.1% annual growth between 2002 and 2007, being one of the main engines of the economy during this period. This growth is mainly explained by major sector growth in buildings, near 15% annually. However, the economic slowdown had a direct impact on construction and between the first quarter of 2008 and first quarter of 2009, the construction sector only grew at an annual average of 2.4%. In the period after the deepening of the international credit crunch, 4Q08 and 1Q09, construction showed an annual contraction of 3%, mainly explained by a 7.5% annual fall in the buildings side.

The factors behind the buildings supply movement and its short- and medium-term perspectives are analyzed below.

Buildings cycle

During the second and third quarter of 2008, the construction sector experienced a positive performance as a consequence of the finalization of projects begun in the last stage of the growth cycle. However, as advanced indicators showed, in the last quarter of 2008 and first quarter 2009 the effects of the economic slowdown and the impact of the deepened external crisis began to be felt. The finalization of works showed a slowdown in 1Q09 and it is likely that this adjustment will continue throughout 2009. In turn, the start of works shows a major fall for the last three quarters and the advanced indicator data allows us to think that this trend will continue for the coming quarters.

The approved square meters for the last months show a major correction with regard to 2008 levels. June 2009 data are far from the 19 million square meters reached over the first months of 2008 and the present level, around 15 million square meters, show a sustained slowdown in the sector for the coming months. The fall is more pronounced in house building rather than in other building types (Warehouses, Shops and Offices); on average, approved permits for housing have fallen 18% per year while for other construction types the annual average is 14%. Total permits decreased at an annual average of 17%.⁴ Within the housing segment, Public Housing (VIS)⁴ construction permits fell 9% while those for non-VIS housing show a 23% decrease.

The five main regions in construction permit approvals represent 63% of all meters approved across the country. The performance is differentiated by regions and while Bogotá, Antioquia and Valle show a permit approval decrease above the national average, with annual falls of 25%, 43% and 35% respectively, in Cundinamarca approval shows a fall of 10%, below the national average. In turn, Santander shows a permit approval increase of 16%.

July data for construction permits show a slower deceleration rate. According to BBVA ERD calculations, permits anticipate the

⁴ Public Housing (VIS) is that housing aimed at those on low incomes and its value is below 135 SMMLV

performance of the construction sector by around 3 quarters and, therefore, if the trend change in this indicator is confirmed in the coming months, construction sector results can be expected to come in favorable for 2010.

Further, house building costs performed positively over the last year as a consequence of the fall in international raw material prices. The construction costs indicator calculated by DANE shows that up to July 2009, costs associated to raw materials such as iron and metals, of which prices are set internationally, experienced a dramatic decrease that more than compensated for the increase in labor, cement costs and machinery and equipment.

Construction companies

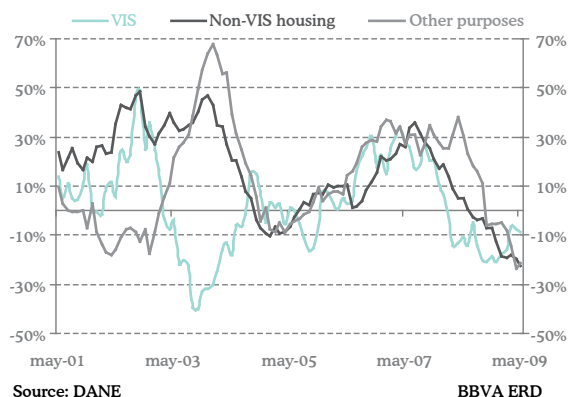
Residential construction companies continue to maintain a solid financial situation despite the sector slowdown. On the one hand, the profitability rates saw major increases and in 2008 indicators such as return on assets reached 2.8% while return on equity came in at 9.3% in 2008, compared with a 1.9% ROA and 6.3% ROE in 2007. On the other hand, companies controlling 75% of assets have positive returns while losses are concentrated in companies representing 25% of total assets.

Construction sector solidity is linked in part to the pre-construction model consolidation through real estate trusts in the country's main cities. Under this scheme, companies only start construction if the project reaches tipping point, i.e., the necessary resources are attained to finish the project. The pre-construction scheme has the advantage of reducing financial risks for construction companies and avoids situations such as that seen in Colombia at the end of the 1990s, where sector companies took on large debts to start a project without guaranteeing the necessary cash flow allowing them to comply with their acquired obligations. In some cities such as Cartagena, the pre-construction model has not been possible as in the other major cities due to idiosyncratic conditions in the type of buildings in these cities. The height and size of projects make it difficult for the tipping points to be reached and, therefore, projects are started without guaranteed financing. This situation is shown in the construction companies' financial statements since Cartagena is one of the few cities in the country where companies saw negative returns in 2008.

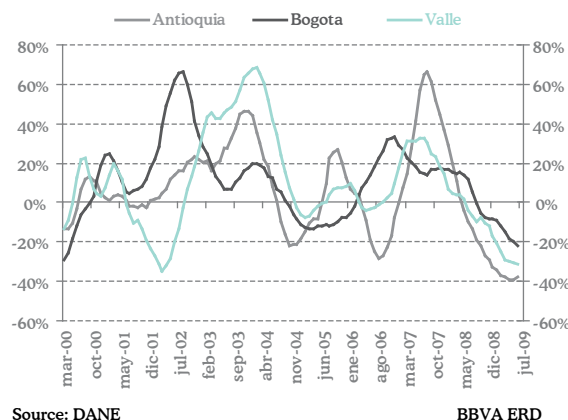
Non-residential real estate

Over the last year, the offices, warehouses and commercial premises segment felt the adjustment in the economic cycle with major differences between cities. In Bogotá, the available area for office sales saw a 34% increase in the last year and the number of units sold and leased reduced by 42%. Similarly, at present large office projects are being finished which will continue to put pressure on supply. In this way, a drop in sales and lease prices can be expected for offices in Bogotá in the coming months. In turn, Medellín is seeing a different evolution with a 26% reduction in available sales area over the same period and a 23% reduction in office sales and leases. With this performance, no downward pressure on office sale and lease prices is being seen in Medellín.

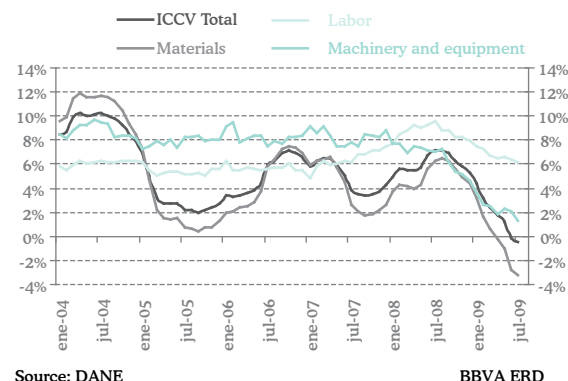
Building Permit Growth by Purpose (Accumulated: 12 months)



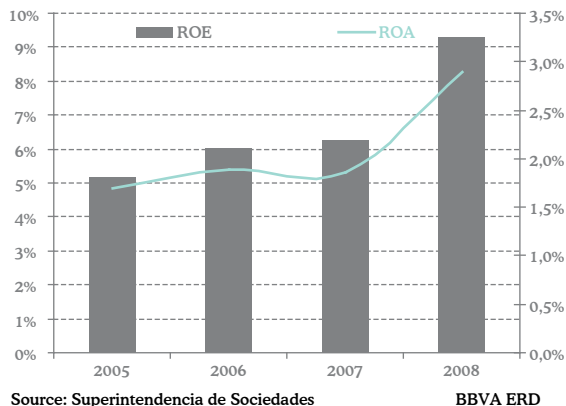
Building Permits in Main Regions (Year-on-year Growth)



House Building Cost Index (Change YOY)



Sector Profitability Index



Source: Superintendencia de Sociedades

BBVA ERD

II. The Role of the Public Sector in Real Estate Sector Development

Supply Incentives

The main housing policy in the second government of President Uribe (2006-2010) has been focused on considerably increasing the supply of Social Housing (VIS). One of these plans is based on building Macro-projects providing housing solutions on a national scale. The Government has promoted the passing of 16 Macro-projects aimed at offering nearly 180 thousand housing solutions in the medium-term. Of these 16 projects, 6 were adopted, i.e., are being built, 7 were announced with the decree regulating them and the studies for construction being presented, and 3 are yet to be announced, being in the initial project stage with no regulatory decree yet existing. In turn, one of the short-term targets for these projects is to condition land to build 50 thousand homes before the end of 2010. One of the solutions the Government has taken into account to achieve this goal is land management through the production of partial plans, including urban renovation, the use of real estate banks and the attainment of developable land.⁵ The conceptual and methodological bases for ordered city growth are meant to be formulated through these programs.

Finally, another of the alternatives to incentivate VIS supply is through regulation.⁶ An example is the National Development Plan for 2006-2010, which sets out a mandatory use of at least 25% of useful land on any development project for building social housing, or 15% to priority housing⁷. These percentages apply for projects built as a consequence to a partial plan or an urban expansion project.

The government's plans are ambitious and may support construction sector growth in the coming years. However, the difficulty in attaining developable land makes the fulfillment of these goals rather questionable.

Supply Incentives

Nationally, the government has a series of subsidies for purchasing housing that include both home purchase and renovation. For 2006-2010, the National Government's target is to finance 828,433 Social Housing solutions through subsidies and loans for new and used home purchases, as well as the construction of own homes or the improvement of current housing.

The Social Housing Family Subsidy intends for households lacking sufficient resources to be able to access a single social housing solution. Total household monthly income can not surpass 4 current legal monthly minimum salaries. Housing subsidy applicants must have at least 10% of the total housing solution value saved. The subsidy amount is progressive, depending on the income level, and can represent between 4% and 42% of the total home value.

In turn, through the National Guarantee Fund (FNG), the government

⁵ Land Banks or Real Estate Banks are establishments whose main business is to intervene in necessary real estate operations to generate available land for public projects.

⁶ Ministry of the Environment, Housing and Land Development

⁷ Priority Housing (VIP) is a housing solution whose value is not above 70 SMMLV.

offers guarantees on loans for VIS purchases. The FNG offers direct guarantees to individuals wanting to purchase VIS and also offers products guaranteeing loans to institutional creditors whose purpose is to award loans to micro, small or medium-sized enterprises or to individuals applying for loans for purchasing, improving or building on their own land Social Housing solutions. Finally, the law sets out that the private compensation agencies have the obligation to finance homes to their low-income members charged to the non-fiscal resources they receive.

III. Appraisal and outlook

The construction sector cycle and the economic slowdown seen in the Colombian economy in a setting of greater global uncertainty affected the development of the real estate sector over recent quarters. Both construction permits and real estate sales decreased and, therefore, turnaround levels increased.

However, the BBVA ERD forecasts a recovery in confidence and economic activity over the coming months having a positive impact on the real estate sector. In this sense, the government's mortgage interest rate coverage plan added to the policy of cutting rates by the Banco de la República and lower inflation have the ability to drive demand. This will reduce inventories, improve turnaround indicators in the short-term and boost sector performance. With an outlook for low stable interest rates in the future, low inflation, adequate flow of resources for financing and economic recovery, sector expansion is expected above the average growth in the economy for the coming years.

For the future it is important to underline that sector expectations continue to be favorable due to structural demand factors such as the existing housing deficit, the expected population increase and the higher number of households, among others. These conditions, linked to the strength of the sector and a long path to run in mortgage loan penetration among different population groups, generate positive expectations for the sector's development. The sector's performance will also be favored by the forecasted high evolution of the non-housing building segment, which the country will need when heading into a new economic expansion stage, such as offices, commercial premises and hotels.

Principales indicadores del sector inmobiliario

Indicator	2005	2006	2007	2008	2009*
Population (millions)	41.9	42.4	42.9	43.4	44.2
GDP Growth (YOY %)	5.7	6.9	7.5	2.5	-0.5
Urban Unemployment (%)	12.0	12.8	10.2	10.9	13.0
Construction GDP (% yoy)	6.7	9.9	17.6	-11.3	7.7
Buildings (% yoy)	0.8	11.4	5.8	-0.9	-11.7
Civil Engineering Works (% yoy)	11.4	8.9	26.2	-17.7	25.2
Total construction works (% a/a)	10.2	8.6	22.1	0.6	-9.5
Finished Works (% yoy)	0.3	6.9	-6.4	20.0	21.7
Works in Progress (% yoy)	16.4	11.7	32.1	-4.0	-18.5
Stoppage Works (% yoy)	-4.3	-5.0	1.2	12.2	21.6
Building Permits (millions mt2)	13.0	16.2	19.2	17.0	14.2
Building Permits (% yoy)	6.3	24.9	18.7	-11.7	-24.2
Housing permits (% yoy)	7.1	22.0	15.7	-14.1	-24.0
Non-Housing Permits (% yoy)	3.8	34.0	27.5	-5.3	-24.6
Mortgage Loan Portfolio (trillion pesos)	9.8	10.4	12.1	13.9	14.6
Mortgage Loan Portfolio (% yoy)	-4.5	6.8	16.3	14.9	9.7
Mortgage Loan Portfolio (% GDP)	2.9	2.7	2.8	2.9	2.9
Constructions costs (% yoy)	-65.9	146.8	-36.3	25.1	-
New Home Prices (% yoy real)	-0.4	2.7	4.4	-1.1	-
Existing Home Prices (% yoy real)	4.0	10.0	13.5	10.0	-
Banco de la República Repo Rate	6.0	7.5	9.5	9.5	4.5
Fixed Mortgage Rate (% anual)	18.2	13.8	15.9	17.2	14.7
Variable Mortgage Rate (% anual)	12.1	8.6	10.8	11.5	10.6

Sources: DANE, Superfinanciera, DNP, Banco de la República
 * 2009 data as June

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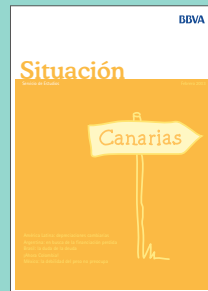
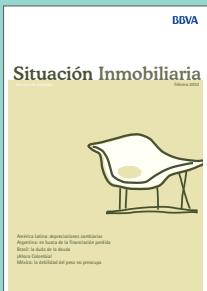
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