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Real Estate Outlook

Argentina

2011
Economic Analysis

- **Construction is no longer leading growth, although it is growing at the average for the economy,** with a greater contribution from urban centers in the interior of the country that have benefited from the boom in the agricultural sector.
- **Although the increase in costs (mainly wages) has reduced the profitability of the construction sector,** the steady rise in the real estate prices continues to provide momentum to construction activity, which should be up 7% in 2011.
- **Demand for real estate shows some signs of weakening due to uncertainty about the election cycle,** but we consider that, once this is over, it will continue to be supported by investors seeking to preserve the value of their savings in an environment offering few financial alternatives.
- **Despite the improved affordability due to increases in real wages,** the restrictions on mortgage financing continue to limit the access to housing for broad sectors of the population.

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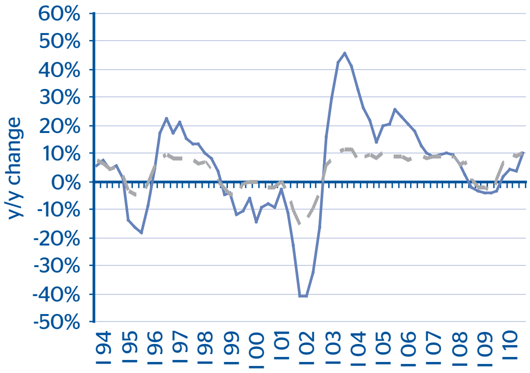
Closing date: June 23, 2011

1. Housing supply no longer shows the same strength

The recovery was slow after the slump in the economy in 2009, but gained strength in the last quarter of 2010

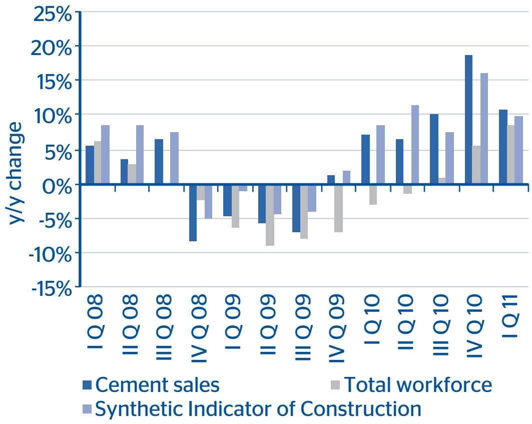
Construction GDP fell in 2009 by 3.8% y/y, while in 2010 there was an improvement of 5.8% y/y, slightly below our forecast growth of 6.0%. As has been the case since 2007, the sector has underperformed average growth (see Chart 1), given the steady increase in construction costs and land prices and the scarce marginal impact of public investment, which remains sluggish at around 0.6% of GDP.

Chart 1
Construction GDP and total GDP



Source: BBVA Francés Research using Indec data and private

Chart 2
Construction activity indicators



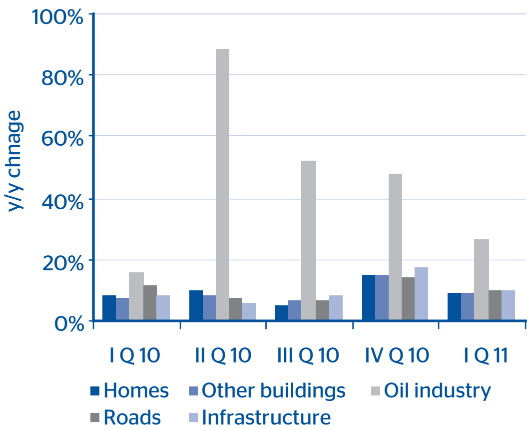
Source: BBVA Francés Research using Indec data and private

The performance of the different sub-sectors in the Synthetic Construction Indicator (ISAC), which measures the activity of the construction sector based on inputs used, did not show any major disparities in 2010 (see Chart 3 and Table 1), as both housing construction (accounting for nearly 60% of the total) and commercial buildings and infrastructure projects grew at rates of around 9-10%. The only outstanding component was oil-industry construction, with growth rates of 49%, but this sector only accounts for 5% of the total.

Although the indicators show that in 1Q11 growth was strong at around 10% y/y (8.7% in the case of housing), we consider this rate will slow over the coming quarters due to a) increased relative costs of construction; and b) more uncertainty generated by the election year.

The greater boost expected from public works in what is an election year has not yet materialized. In April 2011 the increase in public-sector capital spending in nominal terms was 17.5% y/y, below the increase in construction costs (21.6% y/y) and the growth of total primary expenditure for the same period (32.1% y/y). Given the implementation time lag, it is unlikely that there will be an upturn in the period remaining before the election in October to allow public road and infrastructure works to expand above the average for the sector.

Chart 3
Construction by component



Source: BBVA Francés Research using Indec data

Table 1
Weightings in the
Syntetic Indicator of Construction (Base year: 2007)

Component	%
Housing	58.36
Other buildings	19.00
Road works	7.18
Other infrastructure works	10.36
Oil-industry construction	5.10
TOTAL	100.00

Source: Indec

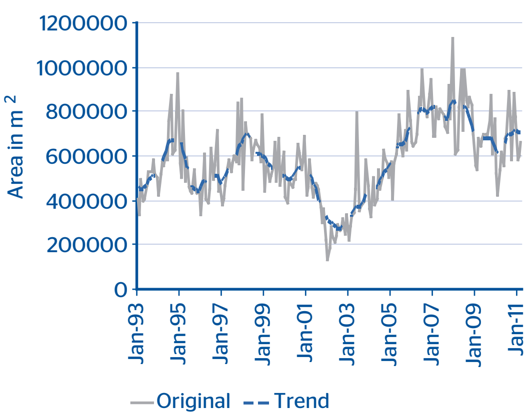
2. Construction permits do not suggest a new boom

The construction boom that characterized the 2003-07 period appears to have run out of steam, as apart from the cyclical recovery of 2010, the number of new construction permits for private buildings (family, commercial and industrial structures) is still substantially below the record levels of 2008.

The number of permits issued in 2010 was 3% down compared to 2009. It is only towards the end of 2010 that positive rates of change emerged (see Chart 4). Although the surface area for which permits are granted showed significant signs of improvement in 1Q11 (up 24.8% y/y), this is mainly the result of the low basis of comparison, as the figure remains on a plateau of around 600,000 m^2 per month.

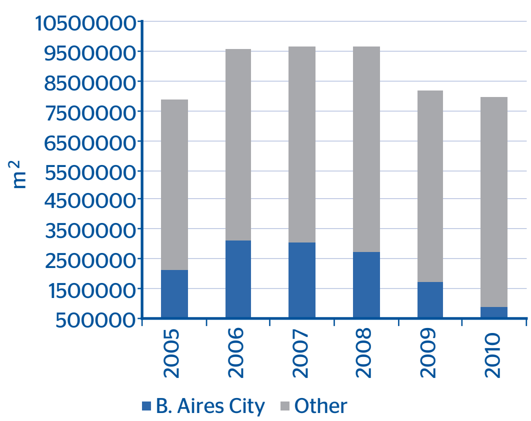
At the same time, the share of the City of Buenos Aires in the total construction permits issued continues its steady decline (see Chart 5) due to reduced availability of area for development in the most popular neighborhoods, which has resulted in rises in land prices. In contrast, cities in farm areas, such as Santa Fe and Cordoba, are increasing their share of total new construction, capturing the profits generated by the agricultural sector in a context of high commodity prices and the low yields of other financial investments.

Chart 4
Building permits (42 municipalities)



Source: BBVA Francés Research using Indec data

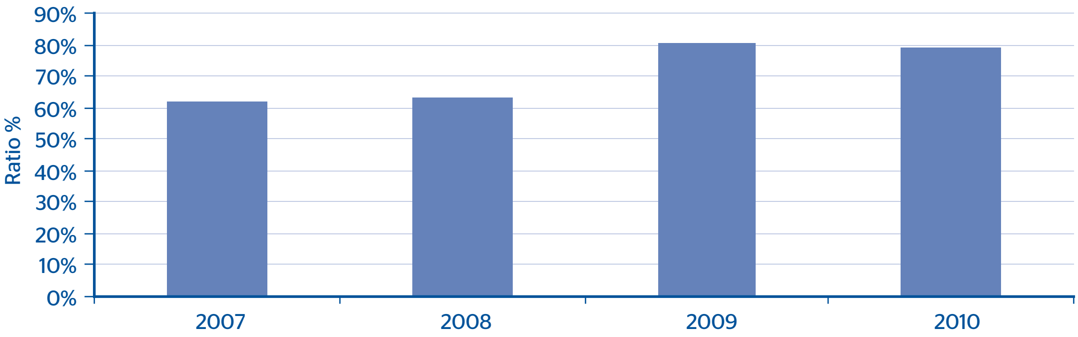
Chart 5
Building permits (42 municipalities)



Source: BBVA Francés Research using Indec data

Greater demand in the interior of the country is also reflected by the fact that prices of real estate are growing faster in cities benefited by the favorable agricultural cycle than in Buenos Aires, so the traditional gap in square-meter prices is narrowing (see Chart 6).

Chart 6
Prices: Cordoba Departament/ Buenos Aires City Departament



Source: BBVA Francés Research using Real Estate Report data

These indicators suggest that the sector will continue to grow, but at a lower rate than in the past, and probably only slightly above the figure for the economy as a whole. We estimate that in 2011 construction of family homes and commercial buildings will grow at 7% y/y, slightly above the figure for 2010.

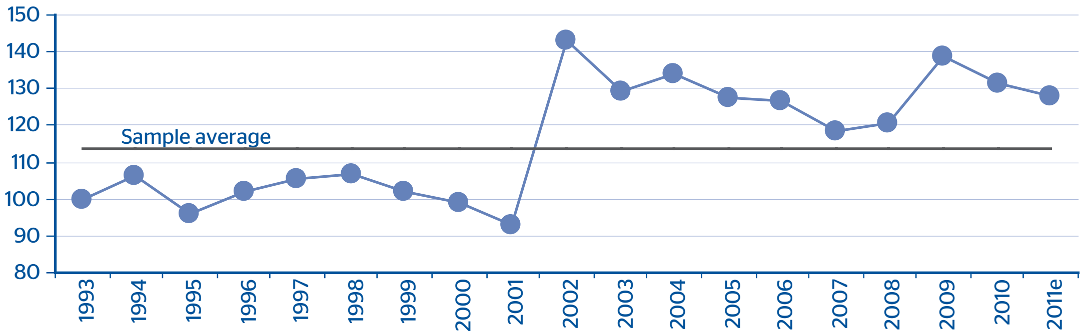
3. Increased costs in dollar terms erode incentives for new building plans

Beyond political uncertainty, the weakness of the construction sector mentioned above is also a reflection of its steadily declining profitability. The price of a square meter in dollars (as it is quoted in Argentina) has continued to increase at an annual average rate of 8% between 2008 and 2010, but profit margins have been falling as costs grew faster. As can be seen by the indicator in Chart 7, relative sale prices and costs are still favorable for the construction sector and remain above the sample average, but profits have tended to moderate, thus reducing incentives to undertake new works.

The biggest factor in the 16.8% y/y increase in construction costs in 2010 was wage hikes, at an average increase of 23.8% y/y. With the peso depreciating by 5% y/y, these increases led to an increase in dollar costs of more than 11%, which compares negatively with the 5.2% increase in the price of a square meter.

In a context of moderate recovery in demand, tempered by the uncertainty generated by the election process, housing prices grew by 7% y/y in dollar terms in the first months of 2011. This growth in the price of a square meter in a context of stable nominal exchange rates, together with the recent 24% y/y wage agreement between workers and employees in the sector, will reduce profitability even more this year, though it remains at attractive levels (see Chart 7).

Chart 7
Price of Apartments / Cost of Construction

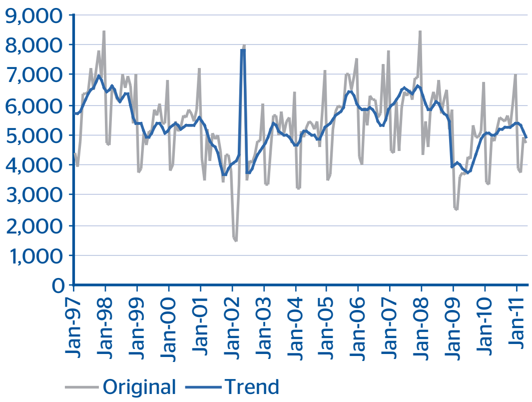


Source: BBVA Francés Research using Real Estate Report data

4. Demand hits a plateau after the recovery in 2010

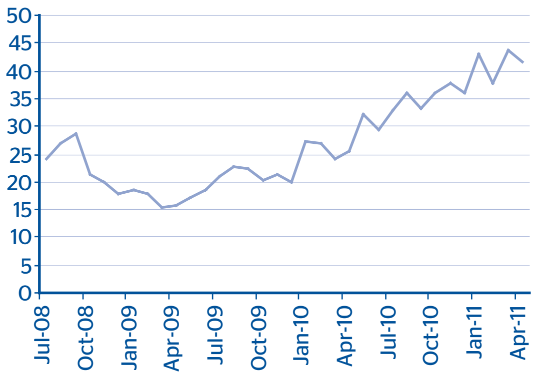
Improved consumer confidence has led to a recovery in the real estate market since the start of 2010 from the very low levels recorded in 2009. The increase in the number of sales operations (deeds registered) in the country's capital was up 34% y/y in the first half of 2010, after which it slowed to 11.8% in the second half of the year.

Chart 8
Deeds in Buenos Aires (nos.)



Source: BBVA Francés Research using data from the Public Association of Notaries of the City of Buenos Aires

Chart 9
Consumer Confidence Index "Cars and Homes"



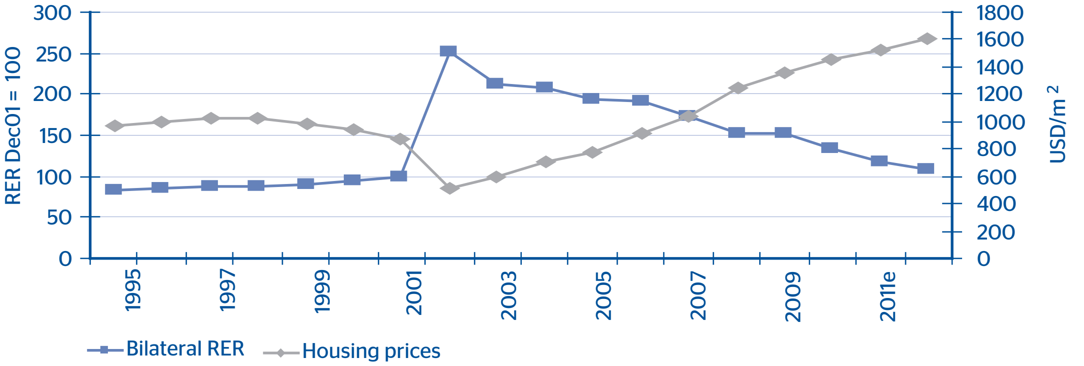
Source: BBVA Francés Research using UTDT data

However, so far in 2011, demand shows signs of weakening at around 4,300 deeds per month, up only 4.5% y/y in the first 4 months of the year. Figures for the last 2 months actually show some moderate year-on-year falls. This reflects the market's greater selectivity in a context of political uncertainty and about the path of the exchange rate after the elections.

However, the fall is probably temporary and does not imply a sudden slump in the level of activity in the real estate market, which will continue to be supported by the demand for real estate as a safe haven. The rate of inflation and the lack of financial alternatives make real estate the asset of choice for long-term savings. Low interest rates, significantly negative in real terms (although with marginal upwards corrections since the end of 2010), combined with the good profit margins that will be obtained once more from agricultural operations will continue to be major components of demand for units as a safe haven, particularly in the interior of the country. However, this does not mean there will be a mass surge in demand for housing for new families due to the lack of long-term financing.

In this context, we consider that moderate pressure on dollar prices will continue and they will grow gradually in the coming years in line with the appreciation of the real exchange rate (4.5% annual average). Any significant reduction in the relative price of housing could only occur in the context of a significant real devaluation of the peso (see Chart 10), which is highly improbable in the coming years, as in the current context of a rapidly growing economy, the inflationary pass-through would be higher than in the 2002 experience.

Chart 10
Bilateral RER and Housing Prices

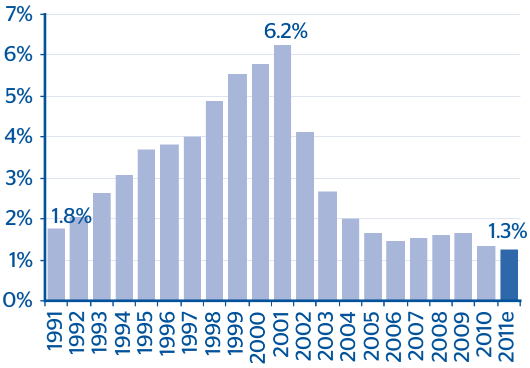


Source: BBVA Francés Research using Real Estate Report data

5. Improved access, but most of the population is still banned from the mortgage market

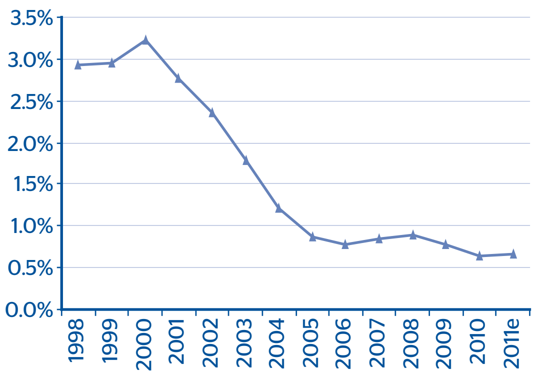
The mortgage loan market remains practically stagnant at barely 1.3% of GDP (see Chart 11), far below the levels of most developed countries. Although the household mortgage burden (see Chart 12) is limited and does not represent a check on greater indebtedness, the factors pointed to in previous reports persist and make a stronger development of the mortgage market difficult.

Chart 11
Mortgage loans as % GDP



Source: BBVA Research using Central Bank and Economy Ministry data

Chart 12
Financial burden of mortgages (capital + interest) over wage bill



Source: BBVA Research using Central Bank and Economy Ministry data

In fact, we estimate that only 5% of the purchase deeds in the city of Buenos Aires were financed with a mortgage loan in 2010, though the level was slightly higher in the first quarter of 2011, at 7.7% (see Table 2).

Table 2

Mortgage Lending

YEAR	Amount of deeds in Buenos Aires	Mortgage loans in Buenos Aires	Deeds/mortgages
2004	6716.7	178.2	2.70%
2005	9659	682.9	7.10%
2006	12214.1	909.8	7.40%
2007	15464.1	2107.9	13.60%
2008	16548.9	2009.5	12.10%
2009	15656.4	723.7	4.60%
2010	23119.2	1212.4	5.20%
2011*	5287	407.3	7.70%
2010*	4238.8	211.5	5.00%

Figures in millions of pesos
* Data to March
Source: BBVA using data from the Central Bank and the Association of Notaries Public.

On the loan supply side, high inflation continues to make it difficult for financial institutions to attract long-term depositors, while the capital market has a very low level of securitization. However, banks still offer mortgage loans, as they want to establish long-term relationships (loyalty) with customers and this is a way to exploit the potential of cross-selling. Up to 80% of the value of the property is financed in the market on average, with a term of around 15 years and nominal interest rates that vary between 13.5% and 22%. Although these interest rates are below inflationary expectations, they are high and make the repayment installments more expensive. In many cases, rates are not fixed for the whole of the loan term, and become variable after the first 5 years.

Table 3

Mortgage Market

	Public banks		Private banks	
Variable	Minimum	Maximum	Minimum	Maximum
Fixed rate	17.50%	19.25%	17.00%	22.00%
Variable rate	13.47%	17.79%	13.73%	19.74%
Term	60 months	360 months	60 months	360 months
LTV	70%	85%	60%	90%
Payment/income ratio	30%	40%	25%	45%

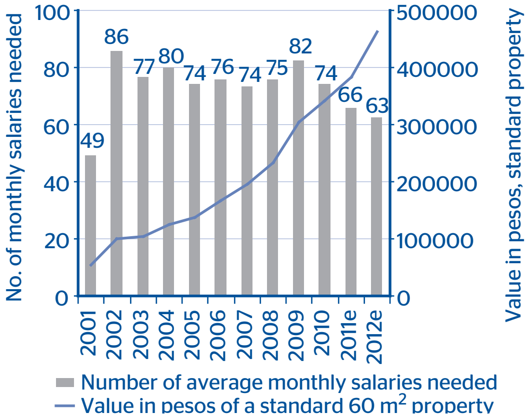
Source: BBVA Francés Research

On the demand side structural factors limit the access of broad sectors of the population to long-term finance. The high rate of informality of the working population (35%) implies that, given information asymmetry, a major percentage of the population does not qualify for bank finance. These sectors of the population are also not beneficiaries of state guarantees or assistance that could allow them to formalize the demand for a home through the mortgage market, as the housing programs in the public sector have been aimed mainly to the supply side, financing the construction of popular housing that is later distributed on a discretionary basis, without subsidizing demand.

Double-digit inflation also discourages demand, as the high nominal interest rates make loans more expensive and generate uncertainty about the future level of repayments required in variable-rate loans. Considering average market conditions, the monthly repayment required to finance 70% of a small 60m^2 apartment in Buenos Aires in the less expensive neighborhoods amounts to around 3,600 pesos, nearly 40% of the total income of a household made up of two formal workers with an average individual income around the mean for the private sector (4,500 pesos per month). In contrast, if interest rates were half what they are now, and more in line with rates in the rest of the region, the monthly repayment would only be 26% of household income, thus making mortgages considerably more attractive.

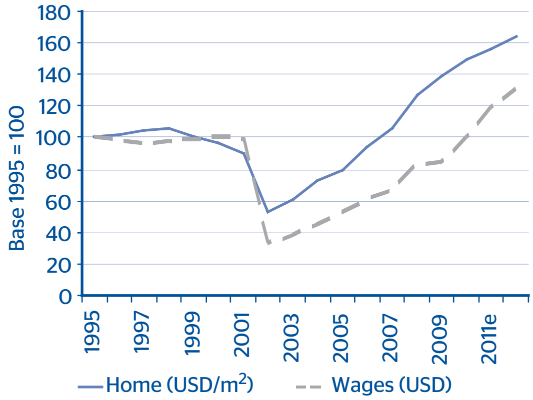
Chart 13 shows that affordability improved in 2010 and will continue to do so over the coming years, as wages will tend to rise more than housing prices. Nevertheless, there will still be a significant gap between wage increases in dollar terms and the m² price of housing (see Chart 14).

Chart 13
Housing Affordability



Source: BBVA Francés Research using Real Estate Report and Indec data

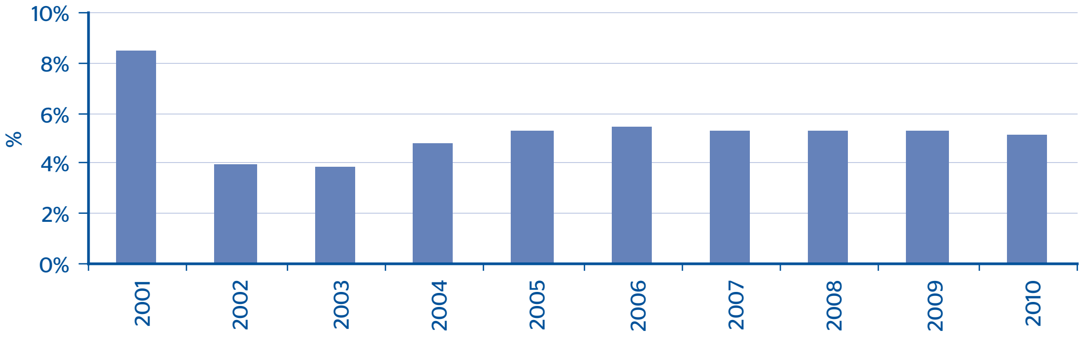
Chart 14
Housing prices and registered wages



Source: BBVA Francés Research using Real Estate Report and Indec data

Because of this, the housing needs of broad sections of medium/low income sectors are channeled through the rental market, where the monthly rent payment is around 50% of the value of a monthly repayment on a mortgage loan for a similar home. In fact, the greater supply of units for rent in recent years has led to an excess supply in this market, which has reduced the relative price of housing rentals (see Chart 15) from the historical 0.66% per month of the price of the housing unit to levels close to 0.4%.

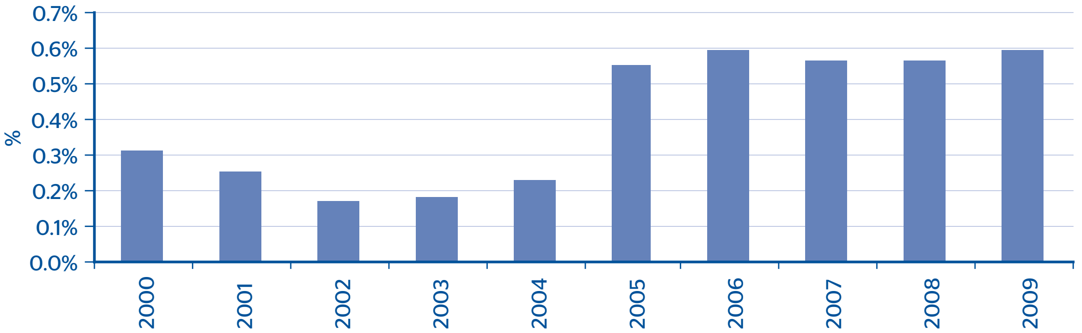
Chart 15
Gross annual income from 3-bedroom apt. (existing 85 m² apartment, Buenos Aires, Norte)



Source: BBVA Francés Research using Real Estate Report data

Following the increase in 2005, public spending on housing has remained at around 0.6% of GDP (see Chart 16). Taking into account the strong growth of nominal GDP between 2003 and 2010, and estimating the average costs of construction, this would allow the delivery of between 50,000 and 75,000 units of social housing per year, compared with a demand that is estimated to grow at around 120,000 units per year. This rate is insufficient to significantly reduce the shortage of homes, which is calculated at around 2 million units for the country as a whole.

Chart 16
Public spending on housing / GDP



Source: BBVA Francés Research using Miplan data

A more lasting solution to the housing problem therefore requires, not only more efficient action from the public sector in channeling resources to provide lower incomes sectors with access to long-term finance, but also a reduction of the inflation rate and interest rates to guarantee access to a larger proportion of the population to bank lending. Over the coming years, despite the expected improvement in real wages, the volatility of inflation and uncertainty regarding economic policy will continue to weigh against a substantial development of the mortgage market.

DISCLAIMER

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