Economic Watch

Mexico

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Economic Analysis

Mexico
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Public housing companies: An early ending?

A review of the current turmoil and its causes

- **The public housing companies turmoil originated some years ago**
- **The model adopted by these companies was successful at the beginning, but it showed little flexibility to adapt to changes in the environment**
- **The decline of these companies is not widespread. Other companies in the sector have not slowed down and show healthy financial credit terms.**

2013 has been a particularly difficult year for housing, due to the change of government and the political vision towards the sector, and also to the accelerated financial unravelling of the public housing companies in the stock market. In the period of six months, the capitalization value of these companies declined around 85%, some had to announce a process of restructuring of liabilities with their various creditors, and their operating scale has been reduced by more than 50% compared to the previous year.

The current turmoil is the result of different factors, although none of them is recent. In essence, the model of the public housing companies that are currently facing difficulties was one of huge volumes at a very low price; and it was very successful in meeting the housing needs of significant segments of the population that were just entering the mortgage market. However, the model turned out to be rather inflexible in adapting to the changes in the environment, that included from the economic to the social aspect, as well as the programs and policies supporting the sector. The signs that pointed to the exhaustion of the model were not interpreted correctly either. In any event, it is important to emphasize that the public companies turmoil is not widespread in the rest of the industry. Among the companies at the next level, there are some that maintain healthy financial credit terms and have not slowed down. In the reconfiguration of the industry that will take place in the medium term, these companies have significant room for growth.

A 2013 chronology

We will start with a review of the events that have defined the development of listed housing development companies throughout the first half of 2013.

At the beginning of the year there was a delay in the operation of housing programs with the change of government. Payment for the homes placed by Infonavit and Fovissste was delayed and the budget for subsidies began to be executed at the end of the first quarter.

The federal government announced the general guidelines of the new housing policy at the beginning of February. Among them, the one to promote a more structured urban growth and to establish a two-year transition period for the housing development companies to adjust to the new model increased the doubts over the value of the land reserves of these companies.

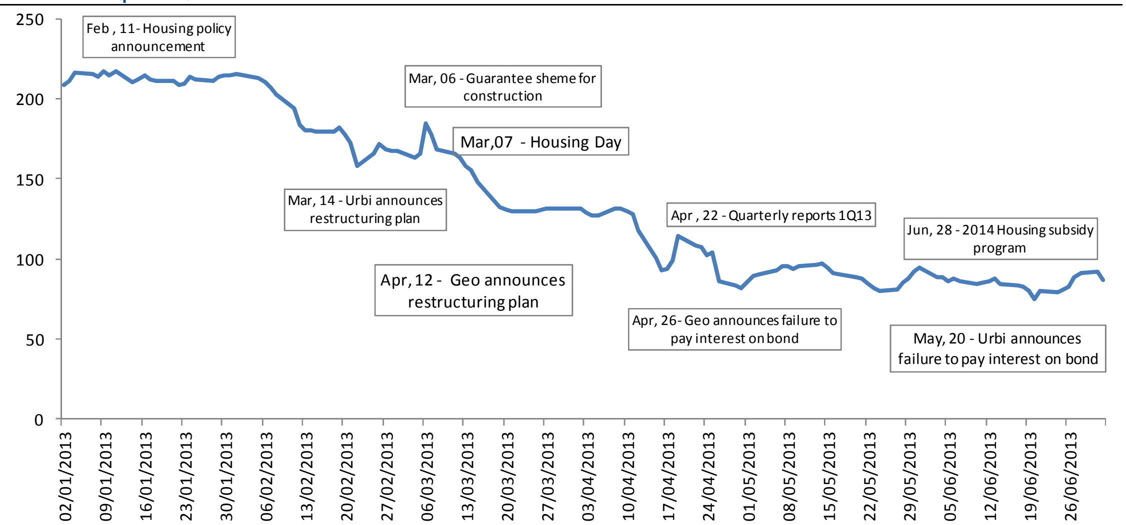
In March, the tenth Mexican Housing Day, an event in New York promoted by the industry to present the housing market's prospects, could not totally dissipate the uncertainty regarding the viability of the companies with the new policy. On that date, the federal government announced through the Federal Mortgage Society (SHF) a guarantee program to support home construction, and there were some doubts regarding its effectiveness, impact and implementation time[1].

In April, the quarterly reports of Geo, Homex and Urbi showed a decline in sales of 38%, 46% and 85% annually, respectively. In addition, liquidity was eroded, making it difficult for them not only to face their liabilities with banks, investors and suppliers, but even to continue in operation.

Around May, Geo and Urbi announced their inability to meet the interest payments for their bonds issued in foreign currency. In that month, Infonavit announced a foreclosure affecting Urbi, Geo and Homex for their failure to meet their payment obligations in the 70-70 program applied in 2012, whereby the institute paid 70% of the value of the homes once 70% of the construction work was completed.

At the end of June, the government announced the operating rules for 2014 for the housing subsidy program, which relaxed the criteria for delimiting urban areas, as well as the minimum conditions to access the subsidy for housing located in the outskirts. In addition, new initiatives to boost finance for construction were announced.

Chart 1
Habita Index* (points)



* Index consisting of the weighted average of the price of stocks of the housing development companies listed on the Mexican Stock Exchange: Ara, Geo, Hogar, Homex, Sare and Urbi.
Source: BBVA Research with BMV data

How have we arrived here?

The current turmoil cannot be explained with one reason only, but rather with a combination of several elements that include the housing model itself, the turmoil in 2009 and its impact on the financial sector, the changes in the policies for the sector and the accounting regulations, the limitations of the companies to adapt to the changes in the environment and the decisions they took to tackle them.

[1] See, for example, the note released by BBVA Research, Mexico Real Estate Flash: The construction guarantee program: is this what is needed? March 7, 2013.

The model that gave rise to the development of the industry encouraged accelerated growth rates.

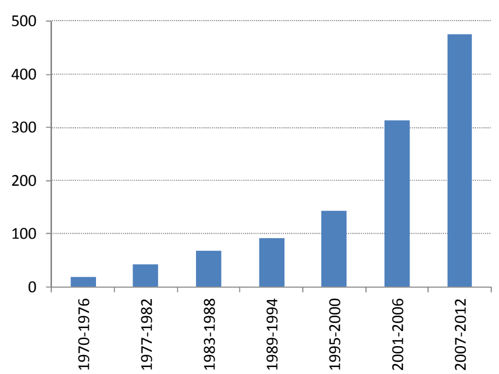
The housing model adopted by public developers that are currently facing difficulties was one of high production volumes and small margins. The vertical integration (from manufacturing of concrete to home construction), the technology (construction based on molds) and the availability of land allowed for the creation of significant economies of scale. With this combination, it was possible to build large housing volumes, at a low cost and in very short periods of time. It must be acknowledged that here, the industry was very efficient and as we documented in the January 2013 edition of Real Estate Watch, it became an international benchmark in this area, even for countries such as China and India.

Among the factors that made the consolidation of this model possible we can mention, first, the wide availability of financing for workers in the formal sector with low wage levels, whose housing needs were just being addressed through mortgage loans. The individual housing accounts, as well as the operational modernization of the financial institutions set up to support the sector, such as Infonavit and Fovissste, gave access to the mortgage market for an important segment of the population whose needs had been neglected until then[2]. The number of loans granted by Fovissste and Infonavit respectively, went from averaging 30 thousand and 124 thousand annually in the 1991-2000 period, to 61 thousand and 376 thousand between 2001 and 2010. In addition, the creation during the mid 1990s of non-banking financial intermediaries, the sofoles, channeled the resources to the market, through bridging loans for housing construction, as well as through mortgage loans[3].

Charts 2 and 3

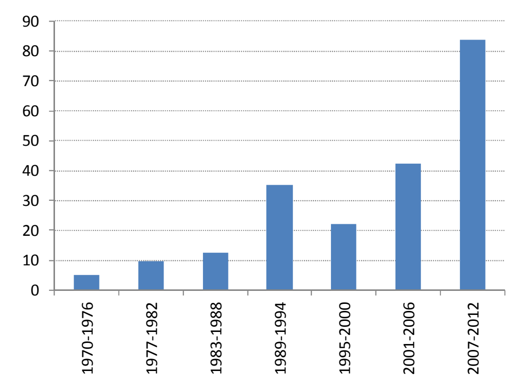
Mortgage loans (number of loans, thousands, annual average)

Infonavit



Source: BBVA Research with Infonavit data

Fovissste



Source: BBVA Research with Fovisste data

The placements of mortgage and bridging loans in the secondary market, or stock market issues, provided an additional boost to financing. From 2003 to 2009, between the sofoles and the banks, these issues amounted to a total of 65 billion pesos. To put it in context, the total amount issued by the sofoles throughout this period, 44 billion pesos, represented nearly half the balance of the total holding that the sofoles averaged in 2008 (89 billion pesos).

Secondly, current regulations generated incentives for growth, through the investment in land as well as in the housing development. On the one hand, taxation allows investments in land to be deducted, so, with the expectation of continued strong activity, incentives to the accumulation of land reserve were generated. On the other hand, from the accounting point of view, until 2010 the companies were allowed to report construction underway as sales, which generated incentives to maintain an accelerated pace in construction. The result was an excess of inventory and land.

[2] Even more if we consider that after the turmoil of 1995, mortgage lending had become limited.
[3] The sofoles financed the construction companies with bridging loans and, in turn, these linked their customers with the same sofoles for the acquisition of housing, all in turn, funded with SHF resources.

Thirdly, the expectations regarding the housing needs and the way the public sector would seek to address them were very high. It was based on the premise of a high housing deficit (at the time it was estimated at around four million homes) and a housing formation that grew by 650 thousand a year. Against this background, the 2007-2012 National Housing Plan set the goal of reaching one million annual financing operations for the acquisition of housing[4]. It was also established that the annual budget for subsidies (measured at 2006 prices) would be in a range of seven thousand to 12 billion pesos[5]. In the end, the budget for subsidies was below that range[6]. Meanwhile, in 2005 Infonavit anticipated that, subject to the availability of resources (not to demand), towards 2010 it could be granting a little over one million loans (Infonavit, 2005). The highest volume of mortgage loans that the institute reached was 494 thousand, in 2008.

Chart 1
Financial indicators for public housing companies

	Public per stocks						Public per debt			
	Ara	Hogar	Geo[2]	Homex	Sare	Urbi[2]	Cadu	Javer	Ruba	Vinte[2]
Sales[1]										
Units (miles)	13.5	1.9	55.5	46.4	0.3	28.2	6.8	8.1	9.5	2.7
Billions of pesos	6.3	0.8	17.4	19.9	1.1	10.5	2.2	2.5	3.3	1.6
Operating profit[1]										
Operating margin (%)	10.2	-2.9	10.7	-242.9	-147.7	-45.0	18.4	11.0	9.2	15.9
Net margin (%)	7.9	-3.8	2.7	-226.1	-134.1	-65.6	14.38	-2.1	7.1	10.4
Ebitda margin (%)	12.4	-3.9	17.0	-1.6	-105.6	18.0	24.19	11.0	10.3	19.1
Financial assets	3.3	-2.3	2.7	-3.0	-25.4	2.5	4.4	-1.4	4.8	8.0
Debt										
Total liabilities / total assests (%)	16.4	15.6	34.1	49.7	44.2	42.2	41.8	434.0	4.6	34.7
Net debt / Stockholders' equity (%)	16.0	46.8	121.3	143.2	138.8	132.8	90.6	197.0	2.1	70.4
Net debt / EBITDA (times)	2.2	35.8	5.1	6.9	9.9	18.6	1.9	4.7	0.6	1.92
Total liabilities (million pesos)	3.2	0.0	25.5	18.4	1.7	22.6	1.2	4.2	0.2	0.6
Banking loans	3.2	0.0	16.0	6.7	1.6	9.7	0.9	---	0.2	0.3
Financial leasing	---	0.0	9.5	11.7	0.1	13.0	0.3	4.2	0.0	0.2
Credit ratings										
Fitch	---	---	Ca	C.mx	Caa1	C.mx	BBB+.mx	B2	A-	Ba1
Moody's	---	---	D	---	mx.A-2	D	BAA2.MX	B+	A-	---

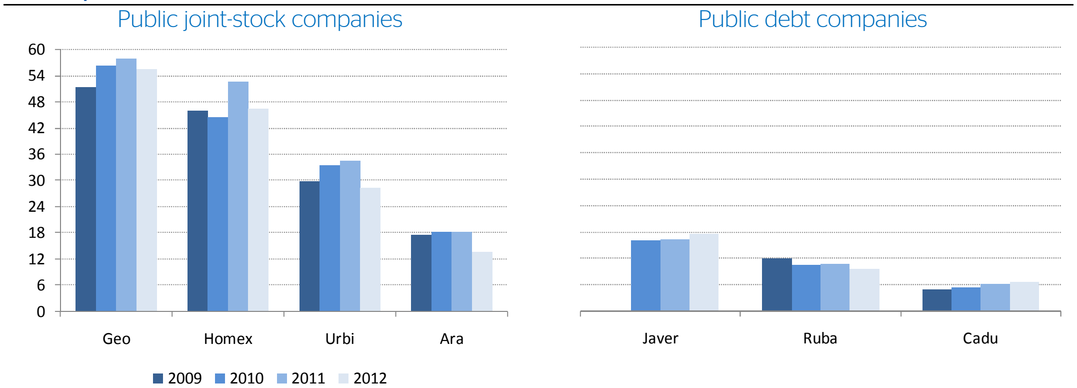
[1] Last 12 months
[2] Figures at 1Q13
Source: BBVA Research with BMV data

It is important to also include under this item the pressure of the market itself. During the years of expansion, in the second half of the last decade, stock market investors contributed significantly to the growth in sales, even more than to the generation of free cash flow. In this regard, it is worth highlighting that not all the companies participating in the low-income market face the same financial situation. Public debt companies have healthier conditions, despite the lower growth in sales.

[4] This was an important failure, as here it should have been announced that, in fact, it is not an effective housing demand. In order to abate it, a specific program is required in any event, funded with subsidies.
[5] This last figure was proposed subject to approval of the structural reforms
[6] Measured at 2006 prices, the annual budget was of 5.2 billion pesos.

Chart 4 and 5

Homes placed (thousands)



Source: BBVA Research with data from the companies

The turmoil in 2009 shook the market

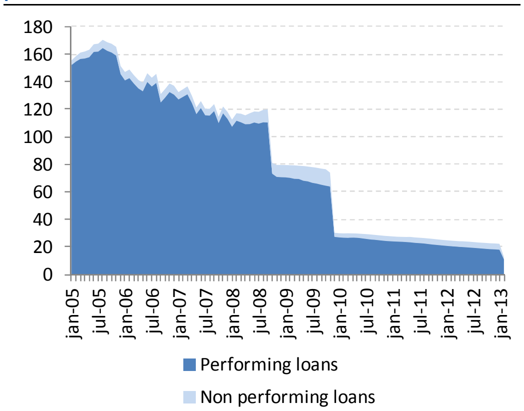
The turmoil in 2009 triggered a significant change in the housing market. On the one hand, demand fell. The financing granted by commercial banks for individual loans dropped by 35% that year, while for Infonavit the decline was 12%, all in real terms. From maintaining an annual average rate of growth of 22% in housing sales of public developers between 2004 and 2008, for 2009 these dropped by 9%.

On the other hand, the financial support of developer companies, the sofoles, disappeared when they began to face difficulties to fund their operations. With the reduction in demand, high levels of overdue portfolio in bridging and mortgage loans, as well as a strong unravelling in the performance of the securitized portfolio, the sofoles dramatically reduced their capacity to grant financing. From its highest level at the end of 2007, at close of 2009 their bridging loan portfolio went from 15.2 billion pesos to 4.5 billion (a 67% reduction measured in real terms), and for 2011 it was just 2.4 billion.

The turmoil affected all the industry. The past due portfolio of the housing construction companies in general (not only public) has presented in recent years higher levels of unravelling than the rest of the construction industry.

Chart 6

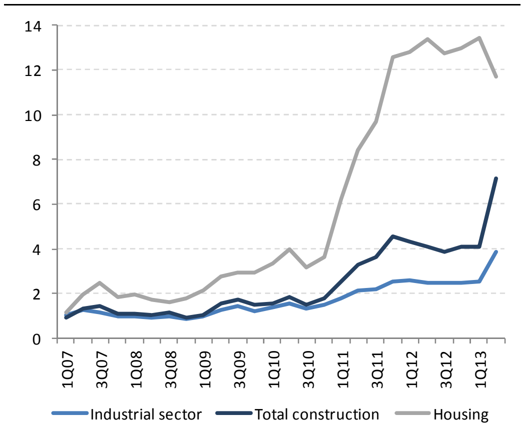
Financing to developers: sofoles (mmp, 2013 prices)



Source: BBVA Research with RUV data

Chart 7

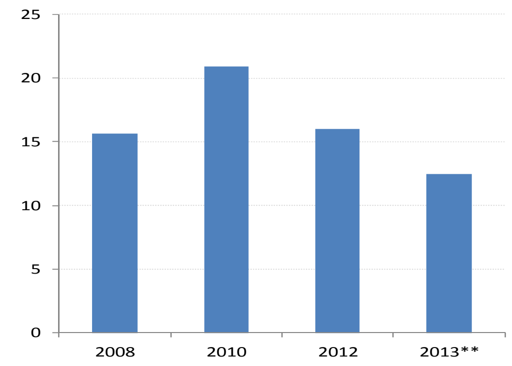
Default rates*: housing construction companies vs. industrial sector (%)



* Loans from commercial banks
Source: BBVA Research with Banxico data

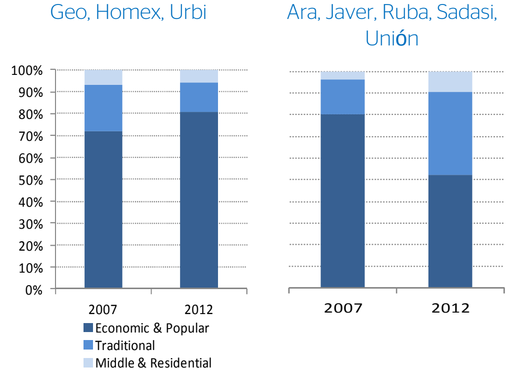
Public companies changed their strategy, focusing more on the low-value, subsidized housing market, expecting it to be the one showing more stability. Thus, on the one hand, their share in the number of loans granted by Infonavit rose from 16% to 21% between 2008 and 2010. Likewise, their new loans were more focused on housing for the low-income segment, particularly subsidized housing. Public companies which are currently in a critical situation increased their new loans for this type of housing from 70% to 80% between 2007 and 2012; in contrast, other large companies opted for greater diversification, so that the share of subsidized or lower value housing in the total number of new loans went from 80% to 52% in the same period.

Chart 8
Public companies share* in Infonavit (%)



*Ara, Geo, Homex, Urbi
** Figures as of June
Source: BBVA Research with Infonavit data

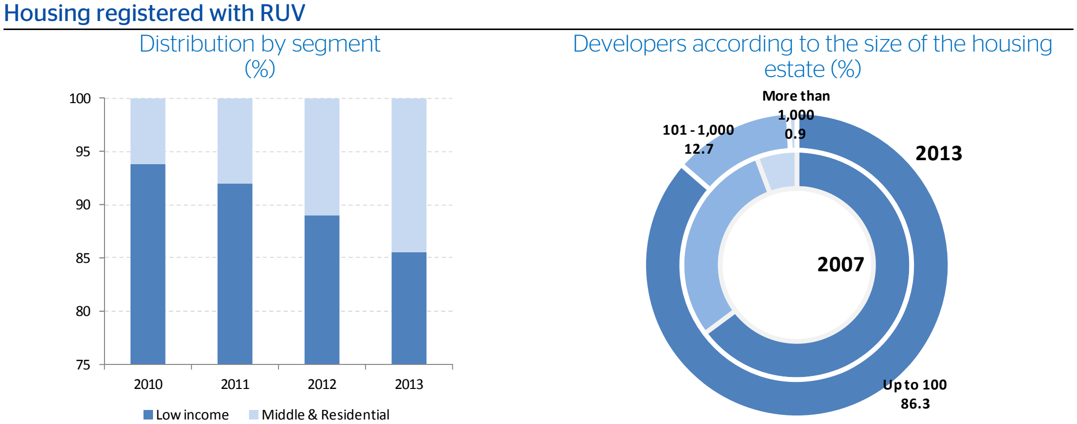
Chart 9
New loan mix (% distribution)



Source: BBVA Research with RUV data

Regarding this point, it is also worth mentioning that in the total of RUV records, the share of the medium and residential segments has achieved growing importance. Although its weight continues to be significantly lower than that of social housing or for the low-income population, the relevant aspect is that this change has not received the attention of public developers; or simply, their business model, based on very large housing estates, did not match the needs of these segments. It is also important to mention the change in the type of housing that is being built. The estates have become more compact, or with a lower number of homes per estate, and this is also an important difference with respect to the public companies.

Charts 10 and 11
Housing registered with RUV



* Low income segments: Economic, popular and traditional
Source: BBVA Research with RUV data

... and from there, deeper changes would come.

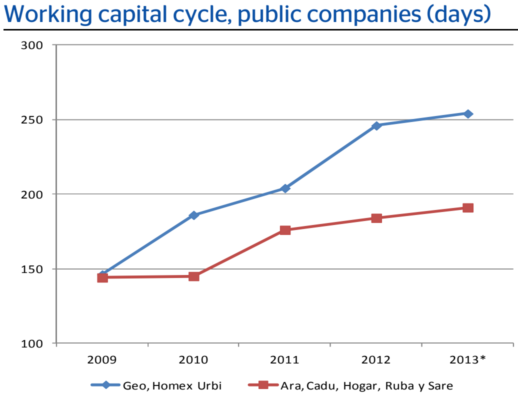
Although the turmoil triggered the adjustment in the industry, it was not the only cause or the most important one. From 2010, the changes in housing policies, as well as the adoption of new accounting regulations, also had a significant impact on the sector.

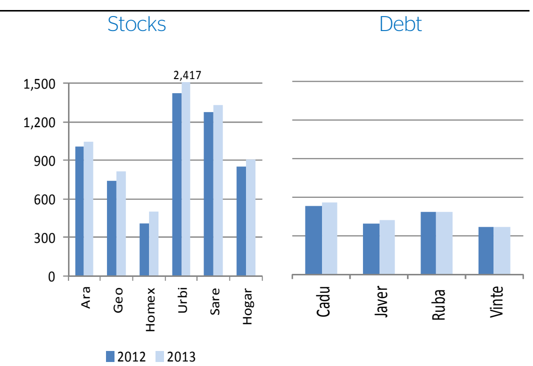
The policies to support the sector gradually began to be modified in order to correct the problems generated by the housing location and, in general terms, to raise the satisfaction level of buyers. Thus, the federal government, through Conavi, as well as the housing institutes Infonavit and Fovissste, began to raise the criteria for measuring the housing quality and the environment of the housing estates. The operating rules of subsidies were modified, first to incorporate elements of environmental and density sustainability, and later to generate incentives for a better location. Meanwhile, the SHF began to measure the satisfaction level of housing buyers through the Residential Satisfaction Index, while Infonavit adopted measurements such as the Borrower Satisfaction Index (ISA) and the Housing and its Environment Opinion Survey (Ecuve).

The adoption of new criteria and standards was one part of the change in policies. The other was to diversify the financing solutions. Infonavit promoted remodeling in 2010 through a pilot project, but it was such a success that by 2012 it already represented one of every four loans granted by the institute. Existing housing went from 17% of the loans awarded by Infonavit in 2007 to 35% at the close of 2012.

The change of policy to promote vertical housing had consequences for the companies, particularly through increasing the working capital cycle. This generates longer times in the movement of units, an accumulation of inventory, as well as an increase in the cost of financing.

Charts 12 and 13
Working capital cycle, public companies (days)





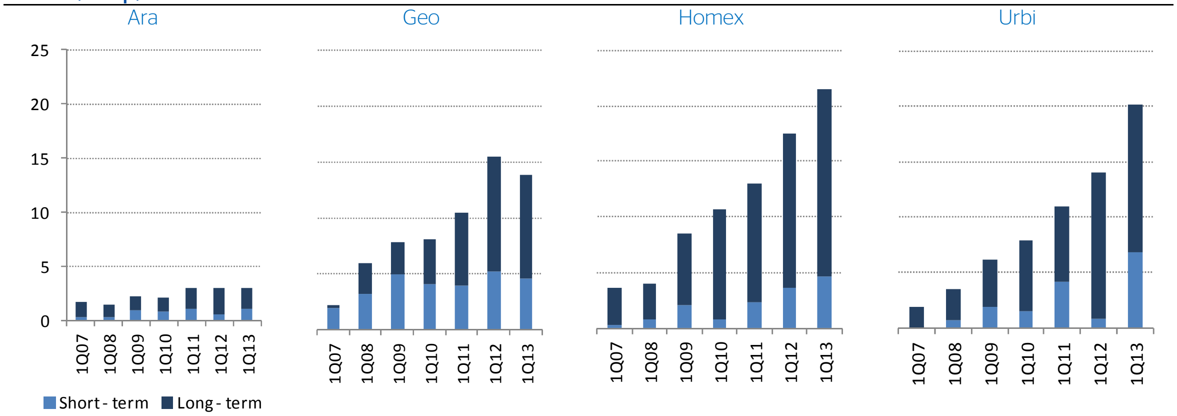
* Figures as of June
Source: BBVA Research with RUV data

Figures as of the first quarter
Source: BBVA Research with Convixión data

The adoption of new accounting regulations involved another important change in the industry. Until 2011, the companies could register housing under construction as sales; however, with the adoption of the International Financial Reporting Standards (IFRS) in 2012, only individual housing is considered as a sale. This, combined with the criteria adopted by the policy regarding location in 2012, generated speculation about the value of the land reserve of housing construction companies and their capacity to maintain their operations.

It is also true that their model limited them to make major changes: they had an extensive land reserve, a business model based on high volumes and a leverage level that forced them to maintain a high pace of activity in order to generate flow and to cover their liabilities. The debt of public housing companies increased three-fold and even four-fold from 2008 to 2012

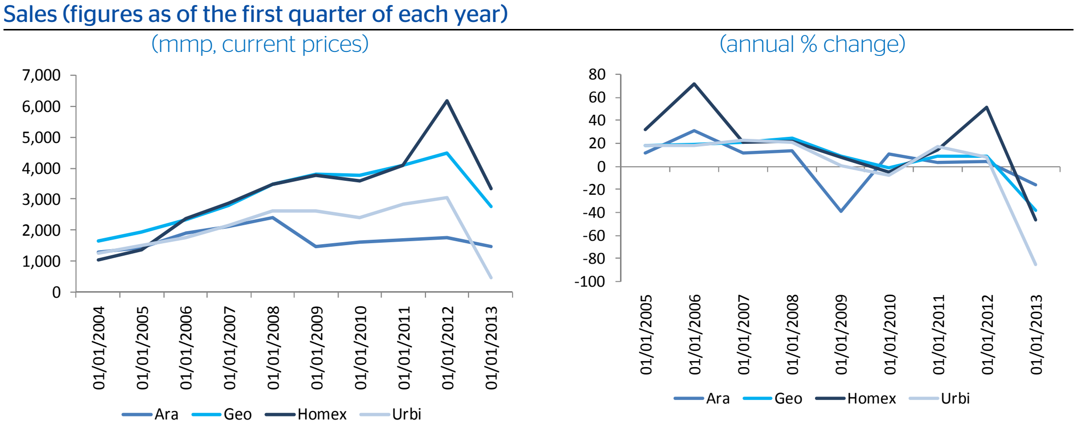
Charts 14, 15, 16 and 17
Debt (mmp)



Source: BBVA Research with Bloomberg data

Thus, despite the changes in the environment, public construction companies in the stock market maintained the activity volumes at high levels. The number of homes placed by these companies maintained the upward trend between 2010 and 2012.

Charts 18 and 19
Sales (figures as of the first quarter of each year)



Source: BBVA Research with Bloomberg data

The warning signs were not fully sized

In recent years there were several signs that showed some deterioration of the housing model adopted by public developers. Starting with the high levels of vacant housing documented in the 2010 census. In the 2011-2015 Financial Plan, Infonavit estimated that one out of four homes placed by the institute from 2006 to 2009 were vacant; in the same way, in more than 90% of the cases, the reason was attributable to location problems (Infonavit, 2010). In this sense, in 2011 Infonavit reported that of the total number of vacant homes identified, 30% corresponded to public companies (including those from the stock market as well as debt).

Even after the results of the census were known, housing continued to be built in the same areas where high rates of vacant housing were registered. The reason was simply because it was where the largest developer companies had their land reserves. This helps to explain to a large extent the negotiation with authorities to relax the criteria to delimit the urban areas and thus continue to benefit from the subsidies.

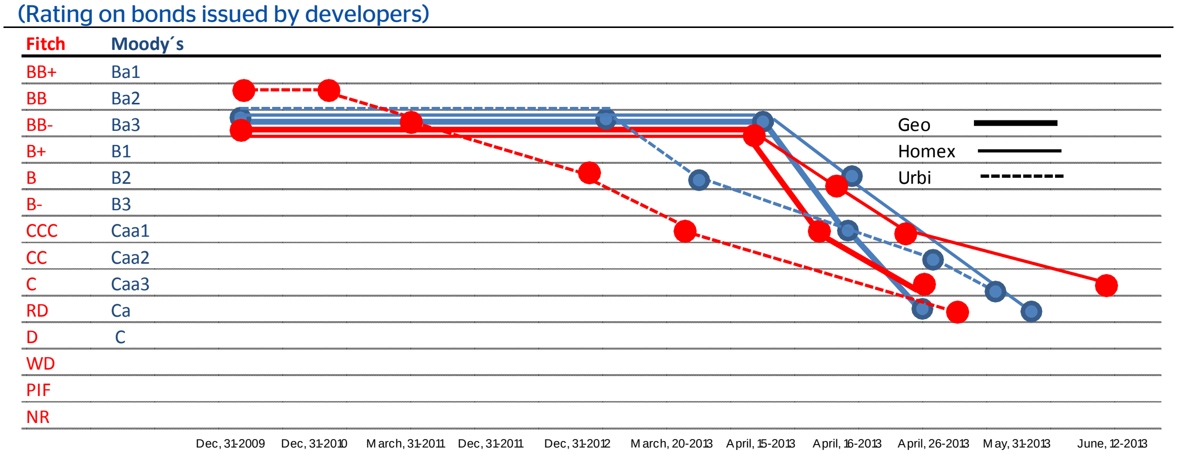
Housing location problems were fully identified. The central topic has been the lack of transport connectivity, rather than the distance. Traveling by public transport from the center of the Federal District to some of the towns in the State of Mexico where more housing has been built can involve a monthly cost that represented more than half the mortgage payment[7].

Lastly, among some of the market participants it was known that the subsidies were being diverted from their original purpose of giving access to housing to the population lacking it and without enough income to paying the monthly installment of a mortgage loan. Instead, it became common to offer the subsidy as a discount on the value of the home and not necessarily to live in it, but as an investment, or to enable workers to use the housing sub-account[8]. In this sense, the subsidies encouraged the construction of low-value housing, without strictly meeting the needs of the targeted population. Infonavit's 2013-2017 Financial Plan establishes that, based on a calculation made from the Home Income-Spending Survey (2006), just over half the members of the IMSS (54%) could qualify for a subsidy for having individual incomes lower than three minimum wages[9]; the reality is that just one out of four is in that situation, as the remaining 29% have household incomes above 5 minimum wages (Infonavit, 2012).

... and the problems were bigger than expected.

It is fair to say that although there were doubts about the viability of the business model of the public construction companies with the change of the policies supporting the sector to encourage intra-urban construction, the size of the problems of these companies were far from being known.

Chart 20
Rating Agencies
(Rating on bonds issued by developers)



Source: BBVA Research with Bloomberg data

On the one hand, the portfolio of public companies did not show significant levels of impairment, or not above the rest of the companies in the sector. Meanwhile, the rating agencies did not notice bigger risks affecting these companies when rating their debt issues, which remained unchanged until April 2013, just a few days before the earnings for the first quarter were announced[10]. The same can be

[7] According to figures from the Residential Satisfaction Survey published by the National Mortgage Society, in 2012, for the 139 towns considered in the survey, the average monthly transport expense was 570 pesos, although in some towns this figure doubles or even trebles. Although for the national total there is no direct relationship between transport expenses and vacant housing, in some cases it can be an important factor. For example, in some towns in the state of Hidalgo, where travel expenses can exceed 1,200 pesos, the amount is equivalent to more than 60% of what a subsidized home would pay, around 2 thousand pesos a month if the home's value is between 250 thousand and 300 thousand pesos.

[8] Until 2011, the prevailing idea was that if the loan was not taken, the saving in the housing sub-account was lost. In fact, it could only be recovered through legal action. It was in 2012 when it was stipulated that the refund of that balance should be automatic.

[9] The subsidies are granted to homes with up to 2.5 minimum wages.

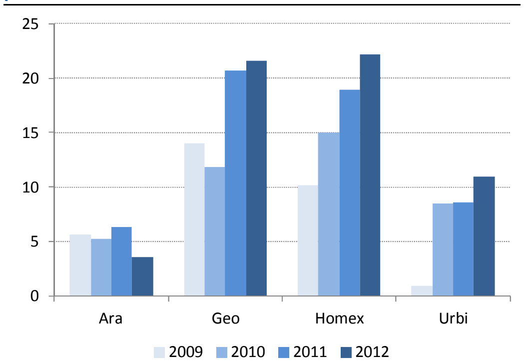
[10] Although it has to be said that Fitch downgraded Urbi's rating from the first quarter of 2011

said of the boards of directors of these companies, that did not detect significant problems either, or did not express them timely.

The housing bodies did not detect a serious problem either. However, Infonavit's 70-70 program did reveal some liquidity problems that the developers were facing, because they took the money but did not finish the homes and these could not be placed. Here there was not a problem of lack of buyers, as the program already linked the home with the customer.

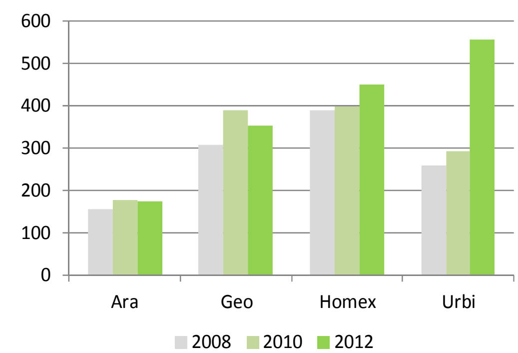
There is evidence that the information presented in the quarterly reports did not fully reveal the financial situation of the companies. For example, it was difficult to precisely measure the level of accumulation of inventories, as a part of them were registered as work in process, when in fact in some cases they were stopped projects. The land reserve, measured in housing units, continued to grow despite the economic environment at the end of the last decade; in any case, it covered more than 10 years of the activity level of the companies. Meanwhile, the companies that used the lease-purchase scheme showed little clarity in the sales done under this model[11].

Chart 21
Inventories: work in process (mmp, current prices)



Source: BBVA Research with Bloomberg data

Chart 22
Land reserve (thousands of equivalent homes)



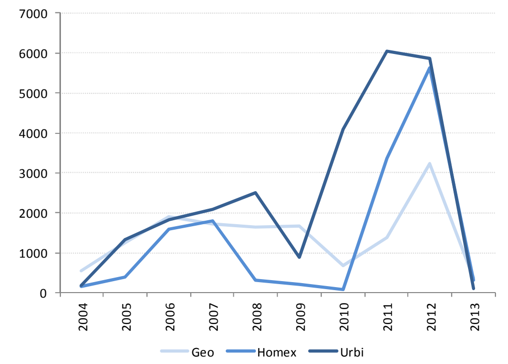
Source: BBVA Research with Bloomberg data

In the same sense, the information relating to the land reserves was insufficient and not too transparent. Aspects such as the geographical distribution, location, extension, the right to use the land and, in general, the potential to develop housing in those reserves have not been clear. The value of the land reserves was adjusted downward, first, by the adoption of the accounting IFRS, that changes the valuation criteria for the value of the home to be sold by the replacement value of the land, and second, because with the incorporation of the location as the main criterion for the granting of subsidies, a part of the reserve did not qualify for them or did so only partially.

Bond issues, especially in 2011 and 2012, gave oxygen to the industry, by providing them with liquidity again, which had declined steadily since 2007, but did not solve their underlying problems. In the end, it forced them to generate more cash flow, something difficult to achieve when new housing sales declined, and when they had problems placing the type of housing they were building.

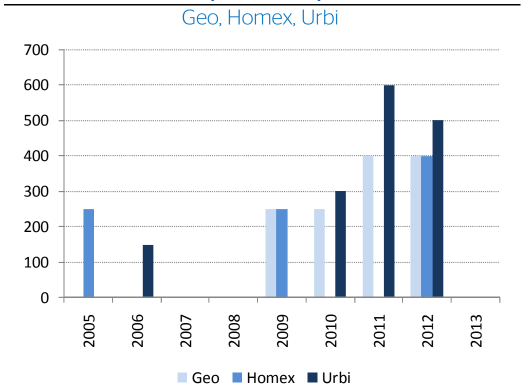
[11] For example, the construction company sells the home to a company (owned by its shareholders) and the latter leases it to the potential buyer for a six-month period, at the end of which the sale is completed. For the construction company this was a house already sold, although pending collection, and for its collection it receives unsecured promissory notes. There was not much clarity regarding the number of buyers who failed to pay the rent during the established period, or the construction company's commitment to the real estate agency in the event of default. However, Urbi's 2011 annual report states that the amount to collect for these sales totaled 11.9 billion pesos (7.5 billion corresponding to 2011 and the remaining 4.4 billion corresponding to 2010).

Chart 23
Liquidity* (mmp, current prices)



*Cash and cash equivalents, as reported on the balance sheet of the companies
Source: BBVA Research with Bloomberg data

Chart 24
Bond issuance (mmp, current prices)



Source: BBVA Research with Bloomberg data

What could be anticipated from now on?

Without a doubt, the situation of the developer companies will herald a new stage for the housing industry. What can be anticipated until now, although in a general manner, is a reconfiguration of the main participants of the housing construction industry in the country, but also in the way housing has been built so far, and even in the role of the public and private sectors regarding urban development.

First, it is clear that the scale of operations of the public companies will have to be moderated. Apart from the arrangements that each one can reach with their creditors, the truth is that their capacity to produce housing at the previous levels has been reduced significantly. It is even possible that some companies could end up in an insolvent situation.

Second, some medium and large non-public companies will have the chance to expand, either by acquiring projects from public companies or strengthening their presence in the areas where the government will give a greater boost to housing construction, and orienting their business model towards the type of housing with greater demand. Here, the key is, on the one hand, the liquidity these companies may have, and on the other hand, the availability of land at affordable prices.

Third, the government could take a more active role in the development of areas in the outskirts of the urban perimeter, but where housing has already been built. These areas on their own could take years to consolidate, but the process could be accelerated with the support of the government in the updating of the development plans, in the contribution of land, as well as in the investment in infrastructures, urban equipment and transport connectivity.

In a scheme comparable to the so-called Certified Developments, the participation of the public and private sectors could be possible, to consolidate, in the medium and long term, the urban centers that are currently half developed. So far, most investments related to urban development in the towns where housing construction has been more significant have been made by the private sector. However, the housing development companies should only focus on this activity; other companies could handle the development of commercial or office areas, while the government, through development banking, could boost the investment in infrastructure and services. The experience with the Comprehensive and Sustainable Urban Developments (DUIS) shows that the institutional coordination in this field can be highly effective.

Conclusions

The business model adopted by the public development companies, based on huge volumes at a low price, although far from urban centers, was successful during the first year of the last decade, when the low-income population gained access to mortgage lending and there was a significant housing lag. However, at the end of the decade, the model already showed some signs of exhaustion. The change in the economic environment after the turmoil of 2009 in the policies to support the sector and in the regulations in the following years, significantly changed the environment in which the companies were operating, while their adjustment capacity was limited by their own structure. It must also be said that although the scale of the developers' financial turmoil was not easy to measure, there were warning signs that appeared in recent years and that were not assessed adequately by the different agents that participate in the housing industry.

Regardless of the final outcome, it must be said that public housing companies have accumulated extensive experience, which will undoubtedly be very important for the future development of the housing market. In fact, some of the areas where housing has been built and which are now facing infrastructure and urban services lags (and where the land reserves of the public developers are located) continue to grow. The important thing will be for this growth to take place in a context of greater planning, coordination between the public and private sectors and with a long-term vision.

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