BBVA Research

Colombia

Real Estate Outlook

June 2010

Economic Analysis

- The fall of interest rates and the subsidy policy will boost housing demand in 2010 and 2011, with particular dynamism in low-income housing.
- A positive year-on-year change is expected for the construction sector starting in the second quarter of 2010.
- The adjustment in housing inventories and the recovery of demand will lead to an increase in residential prices, though at a moderate pace.
- Overcoming the challenges of availability of developable land and the informality of housing will be essential to the sustained growth of the sector.

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Closing date: 25 June 2010

In the first half of 2010, the Colombian economy recovered faster than expected, due to a greater dynamism of domestic demand, especially in private consumption and public investment. This was possible insofar as household and company balance sheets were not seriously affected during the last cycle. The monetary stimulus allowed a reduction in the household debt burden, increasing the willingness to borrow and invest.

The BBVA Research Colombia growth forecast for Colombia for 2010 and 2011 stands at 3.0% and 4.4%, respectively. Further increases cannot be ruled out if the recent improvement in activity indicators becomes consolidated. Increases in machinery investment and building permits could hint at a more dramatic increase in private investment than forecasted.

Against this backdrop, the real estate sector has entered into a new phase of expansion following the slowdown experienced in 2008 and 2009. Now, the components that will determine the growth of the construction sector will be different. While in 2009 the sector expanded and was sustained by a year-on-year growth of 33.9% in civil works, and despite a 12.4% fall in private buildings, our forecast for this year suggests a positive variation of construction activity based on a null contribution of civil works and a near 5.0% increase in buildings.

1. Outlook for supply and demand in the real estate market

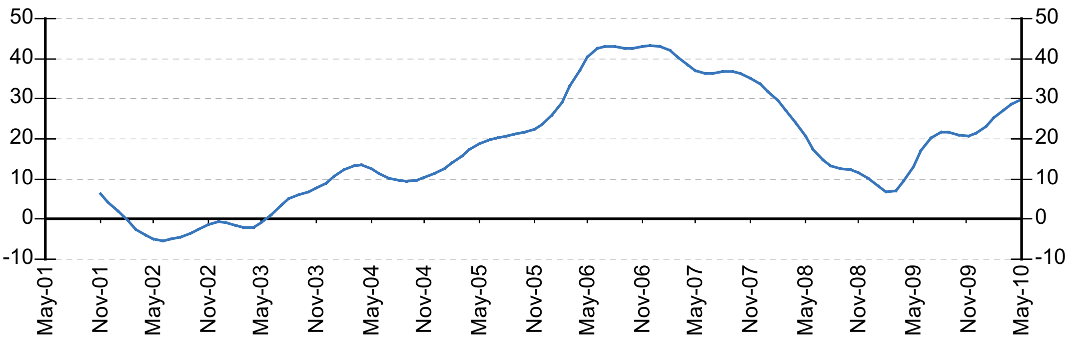
Construction activity started to show signs of recovery in the second half of 2009. Key indicators observed included the decrease of housing stock and the reactivation of mortgage lending. The outlook for 2010 indicates that demand will continue to grow and that real estate prices will maintain an upward trend, though the rate of increase will be moderate. The Government's demand incentives program will continue to boost housing demand in 2010 and 2011, and the historically low interest rates will sustain demand even after the subsidy program has come to an end. Likewise, incentives for the housing supply through the Macroprojects program will continue to drive the construction of public housing.

Demand factors

Short and long-term factors allow for an upward trend in residential demand in Colombia. In the short-term, the acceleration of economic growth, improvement in the housing affordability indicators and the demand subsidies policy will determine an increase in the sale of homes that should last at least until the beginning of 2011. In the long-term, residential demand will be boosted by demographic factors, especially as regards the country's housing deficit and upward trend in the creation of new homes.

Chart 1

Home-buying decision (Seasonally adjusted series)

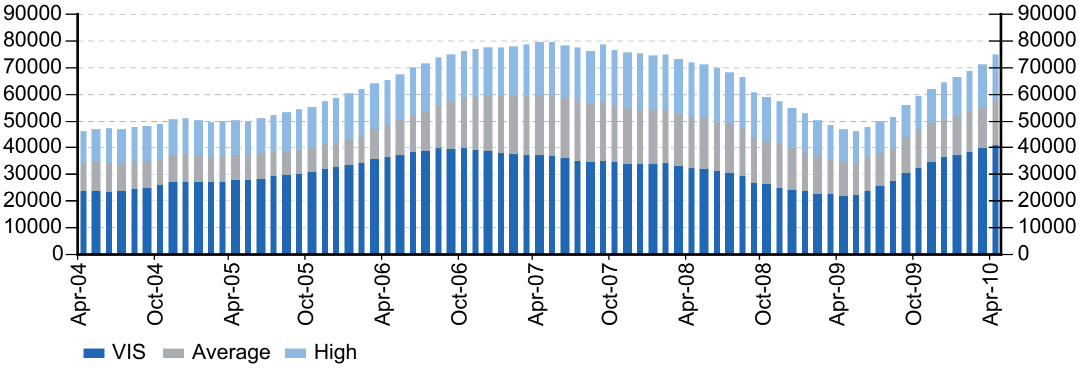


Source: Fedesarrollo and BBVA Research

In terms of the economic outlook, the deterioration of the labor market conditions has begun to revert based on the greater dynamism of economic activity. Over the rest of the year, the unemployment rate will maintain a downward trend which, together with the decrease of the household debt burden, will back the improvement in consumer confidence. Likewise, willingness to purchase a home has been on the rise since April 2009 and stands at the same levels as in 2005, when the real estate boom that consolidated in subsequent years was just appearing (see Chart 1). This has materialized into a 68% increase in housing sales over the last 12 months until May 2010 (see Chart 2), improving the inventory turnaround indicator.

Chart 2

Housing Sales by Price Range (units)



* Data for Bogotá, Medellín and Cali
Source: Real Estate Gallery and BBVA Research

The expansive monetary policy and interest rate subsidy also determined an increase in the housing affordability rates, with a greater impact on the lower income classes. Thus, if both the rates of interest and inflation remain low in the coming quarters, improved earnings conditions will allow this indicator to progress further, which would be a significant boost to short-term demand.

Furthermore, subsidies continue to stimulate growing housing demand, especially in the low income housing segment (VIS). This measure is aimed at promoting the purchase of new homes valued at below 335 current legal minimum salaries, approximately $173 million for 2010. Initially, the program had $500 billion in resources corresponding to 32,000 loans. Due to the success of the initiative, the number of quotas increased to 95,000, confirming $350 billion in additional funds. At the same time, the deadline for the development of projects was extended from June 30, 2010 to December 31, 2011. According to Government figures, 56,104 families benefited between April 2009 and June 2010. Of the quotas approved, 63% were allocated to the acquisition of low income housing (VIS) and Priority Housing (VIP).

As a result, the share of VIS housing in the market total increased significantly. While the VIS segment represented 43% of total home sales in 2007, it now stands at 59% and continues to increase its share in the market as more projects of this kind become available.

In terms of demographic factors, the downward trend in household size and the increased number of households is expected to remain the same over the coming years. According to the Quality of Life Survey, the average number of people per household dropped from 3.9 to 3.7 between 2003 and 2008. This trend is more evident in urban areas. In Bogota, for example, the average number of people per household stands at 3.4. Therefore, we expect that, in the long-term, the national average of people per household will fall even more[1] as the country progresses in its urbanization process.

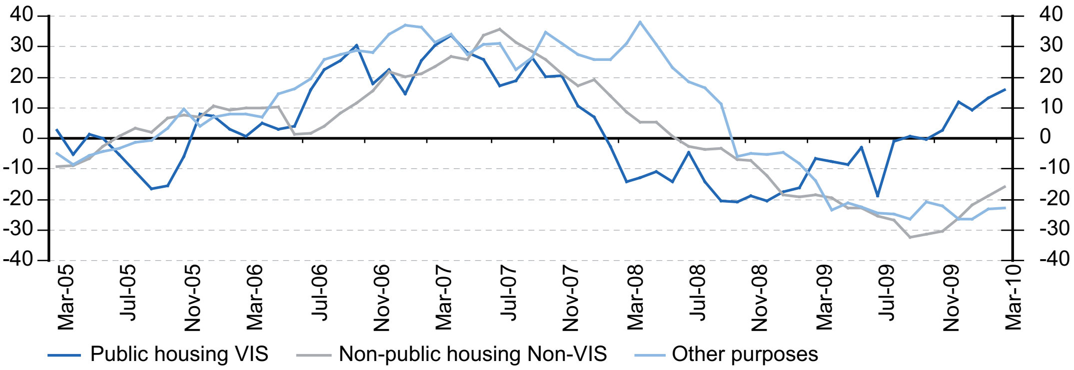
Against this backdrop, the need for new homes for coming years is estimated at 350 thousand units per year[2]. Moreover, the annual number of permits between 2005 and 2010 stood at 118 thousand. This, together with the country's current housing deficit, estimated at 3.8 million homes in 2005, simply corroborates the huge gap in Colombia's demand that will continue into the medium-term.

1: According to DANE calculations, 77% of the population will be located in the urban area by 2020.
2: Calculations made in Real Estate Watch 2009.

Supply factors

The increased home sales since April 2009, which played a fundamental role in the decrease of the housing stock, will have a major effect on the construction projects in the second half of 2010. This result corresponds with the increase in building permits over the last 12 months and their acceleration in the first quarter of 2010 (see Chart 3). This indicator anticipates the development of construction projects with a lead between six and nine months.

Chart 3
Building permits by location (Accumulated 12 months, yoy%)



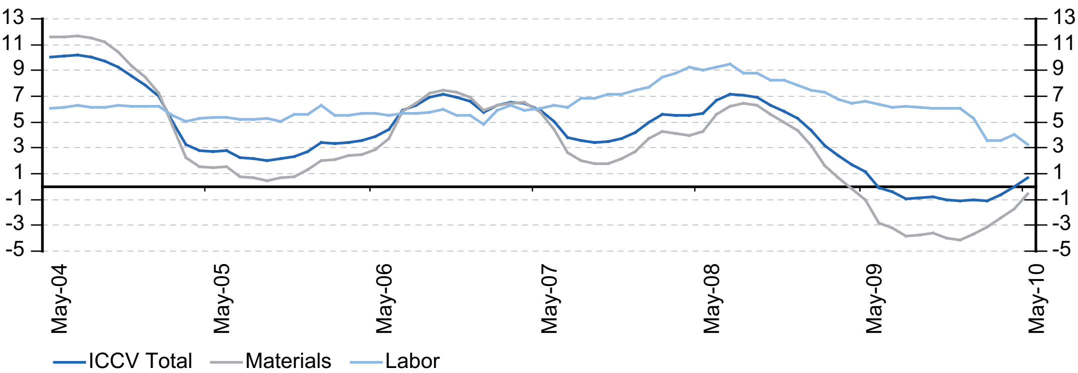
Source: DANE and BBVA Research

However, the sector's performance will differ by type of construction. Specifically, there is greater dynamism in permits for homes, especially as regards VIS projects. Likewise, commercial buildings will continue to adjust downwards due to the huge supply accumulated in previous years and the current reduction in demand. In particular, it is possible that the construction of offices, restaurants and commercial premises continue to experience additional quarters with year-on-year falls to the extent that the economic recovery process will take time to materialize into the expansion of infrastructure for current businesses.

Also worth noting is the favorable financial situation enjoyed by construction companies, due, in part to the consolidation of the pre-sale model, which requires projects to reach a break even point before starting the project. Pre-sale projects in Colombia's major cities account for over 70% of the total and less than 5% are completed without being sold. Thus, the financial sustainability of the current and ongoing projects is ensured.

Furthermore, construction activity will continue to benefit from the moderation of the cost of materials, as in the previous year when even negative variations were observed (see Chart 4). The upturn of the price of materials will be contained against a backdrop of low international prices due to the slow recovery of world growth. Likewise, the costs associated with the workforce, machinery and equipment will continue to reflect low pressures in line with the performance of the general price level in the economy.

Chart 4
House building cost index (yoy % variation)

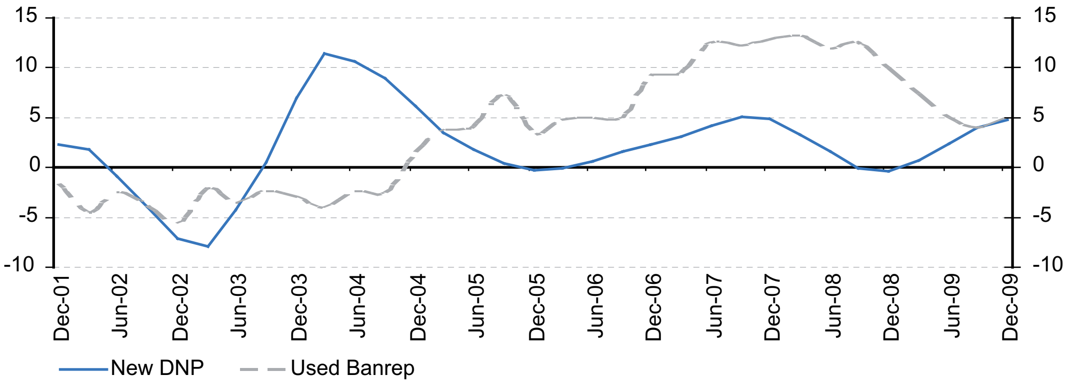


Source: DANE and BBVA Research

The prices of new and used homes showed different trends in 2009. On the one hand, according to the National Planning Department's New Home Index, home prices increased 4.8% in real terms, regaining ground from the 0.4% fall recorded in 2008 (see Chart 5). And on the other hand, prices for used homes slowed with a 5.0% increase in real terms in 2009, as compared to the 10.0% in 2008. For the medium-term, we expect continuity in the upward trend in new and used housing prices due to the decrease of housing stocks and growing demand. Moreover, the rental value as a percentage of the nominal value of the real estate property will become more and more upwardly inflexible due to the greater supply.

Chart 5

Real House Price Growth (yoy %)



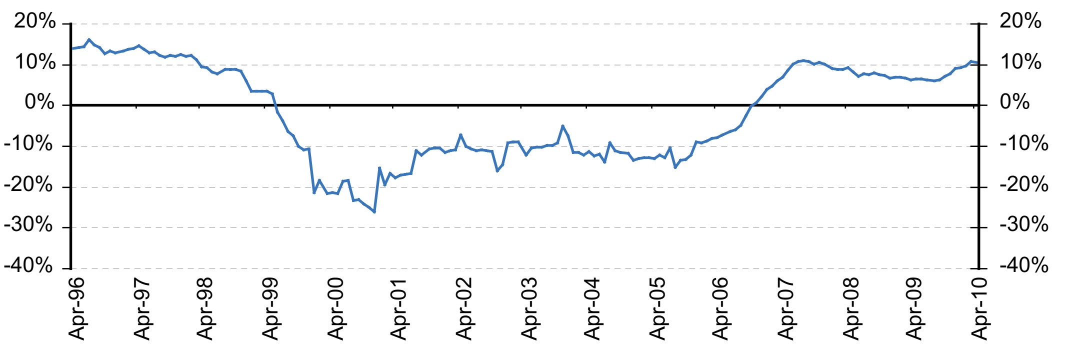
Source: DNP, Banco de la República and BBVA Research

2. Micro-financial conditions and mortgage credit market

The performance of mortgage credit, boosted by the decrease in interest rates and demand incentives granted by the Government will continue to sustain the reactivation of the real estate sector. In recent months, the mortgage portfolio has significantly increased the rate of growth to 10.4% in April, in real terms, from 7.1% recorded six months earlier (see Chart 6).

Chart 6

Mortgage loans with securities (Real yoy % variation)



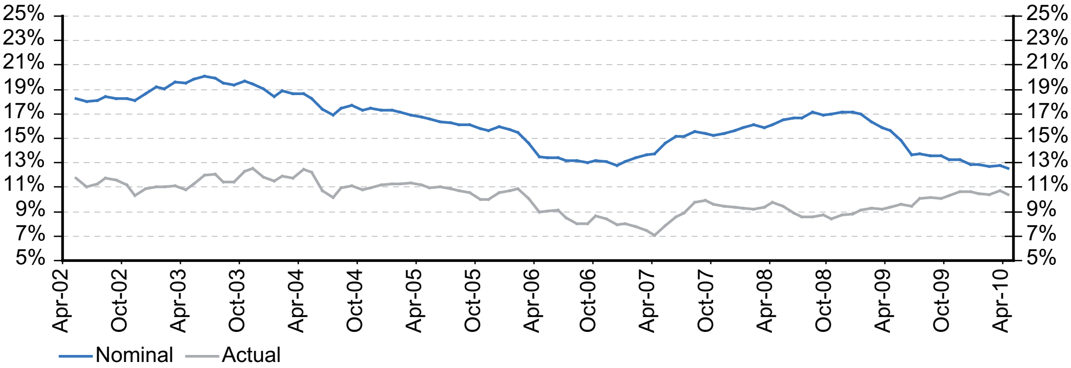
Source: Superintendencia Financiera, Titularizadora Colombiana, DANE and BBVA Research

Likewise, the total value of disbursements for housing has increased since the second half of 2009 for both VIS and Non-VIS housing. According to the figures reported by the Superintendencia Financiera (Finance Superintendence), in the year preceding March 2010, loans valued at $4.9 trillion pesos were granted, implying a real growth of 23.4% as compared to the same period the year before.

Likewise, interest rates are at historic lows and should not begin to increase until late 2010. While real lending rates for the mortgage portfolio have stabilized at 10.4%, the nominal rates are in a downtrend, accumulating a decrease of 458 bps between December 2008 and April 2010 (see Chart 7), due primarily to the flexible monetary policy adopted by Banco de la República. Furthermore, the official interest rate dropped 700 bps in this time period and stands at 3.0% following the last cut in April. We expect for the rest of 2010, against a backdrop of low inflationary pressure, that the interest rate remain at this level, but that the first signs of normalization of the monetary policy stance could appear at the end of the year. This suggests that, even in the scenario in which the program of interest rates subsidies is not renewed, the low rates would guarantee continuity in the credit expansion process.

Chart 7

Mortgage interest rates in pesos

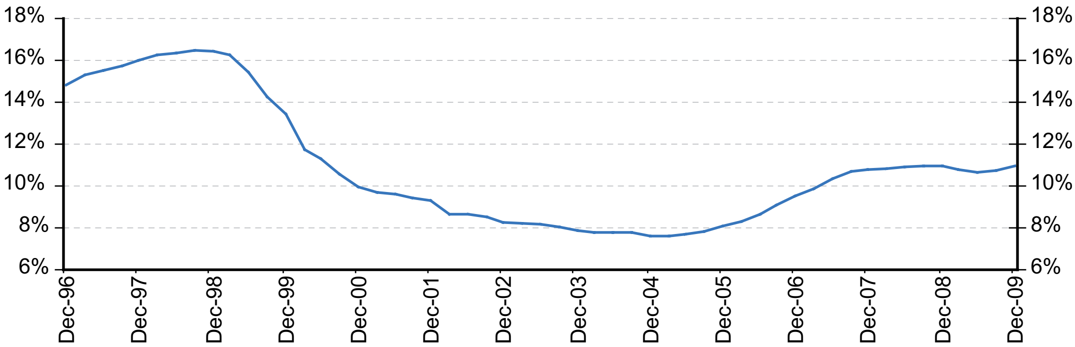


Source: Superintendencia Financiera and BBVA Research

In terms of credit risk, the portfolio quality indicator for the mortgage segment improved from 5.5% in April 2009 to 4.2% in April 2010. This trend should be upheld throughout 2010 to the extent that the improvement of the household financial indicators consolidates. In particular, it is worth noting that the household debt burden has dropped, breaking the upward trend recorded in previous years[3]. This indicator reached a level of 17.9% in December 2009, according to figures from Banco de la República, and should continue to fall as a result of the lower interest rates. Furthermore, household debt, defined as the total mortgage and consumer loans granted by the financial sector as a percentage of GDP, has been increasing and has stabilized at levels near 11.0% in December 2009 (see Chart 8). This level of debt is significantly lower than the historic high of 16.5% reached in mid-1998, when symptoms of a bubble in the credit market were observed.

Chart 8

Level of household debt



Source: Superintendencia Financiera, Titularizadora Colombiana, DANE and BBVA Research

3: The indicator for debt burden is defined as the ratio between the payment of interests and capital amortization associated with the consumer and mortgage portfolios, and the wages earned by workers.

The low financial depth for the mortgage loan category suggests a significant space for the expansion of mortgage credit, taking advantage of the positive outlook for economic growth for coming years. This indicator increased 15 bps, to 3.2%, in the second half of 2009. However, this remains fairly slow as compared to the average for Latin America; significant challenges must be overcome to dynamize the loans for this sector, as explained below.

3. Perspectives for investment in public housing

In order to address the housing deficit in the country and to respond to the strong demand for VIS and VIP housing, the Government has been promoting a large public housing program (Macroproyectos de Interés Social Nacional, MISN). This project seeks to push the development of 16 public-private projects in order to provide nearly 180 thousand housing solutions in the medium-term and to allot the land to construct nearly 50 thousand homes before the end of 2010. On March 4th, the Constitutional Court declared the decree on the macroprojects to be unenforceable as it excludes the municipal and district boards from the process of formulating and adopting these projects, and thereby ignores their role as regulators of land use. In practice, this implies displacing the regulations under the Plan de Ordenamiento Territorial (Land Ordenance Plan) to make way for the MISN.

These macroprojects are fundamental for strengthening the supply of public housing as they streamline the acquisition of land and reduce the administrative steps needed to carry out the projects. In addition to the excessive housing demand, the interest rate subsidies and the decrease of the mortgage loan rates, the macroprojects have allowed the number of construction companies with public housing projects in their portfolio to more than double. These have been able to consolidate a business model mitigating the financial risks and reach a profit margin due to the high volume and the exemption of VAT for some construction materials.

Due to the ruling of the Constitutional Court, six of the 16 macroprojects have been postponed. Those still ongoing seek to prepare the land for 19.5 thousand housing solutions and to construct about five thousand residential units in 2010 (see Table 1). In recognition of the importance of the MISN as an incentive to the VIS supply and in order to overcome the obstacles posed by the Constitutional Court, we expect the Government to issue a decree making MISNs viable before the end of its term.

Table 1
Objetives and location of ongoing macroproyects*

Macroprojects	Location	Area (ha)	Housing solutions	
			2010 Obj	Potential
1. Altos de Santa Elena	Cali (Valle)	47	2.000	5.000
2. Ciudadela San Antonio	Buenaventura (Valle)	215	620	4.000
3. Ecociudad Navarro	Cali (Valle)	67	0	6.000
4. Villas de San Pablo	Barranquilla (Atlántico)	297	1.000	14.600
5. Ciudad del Bicentenario	Cartagena (Bolívar)	556	1.650	25.000
6. Nuevo Occidente Viviendas con Corazón hacia Territorios Equitativos	Medellín (Antioquia)	33	4.279	6.822
7. Bosques de San Luis	Neiva (Huila)	36	928	3.500
8. Centro Occidente de Colombia San José	Manizales (Caldas)	111	1.000	3.500
9. Ciudad Verde	Soacha (Cundinamarca)	328	7.000	25.000
10. Ciudadela Gonzalo Vallejo Restrepo	Pereira (Risaralda)	163	1.000	7.500

*Data up to 31 May 2010
Source: Ministry of Housing, Environment and Regional Development and BBVA Reesarch

In the future, we expect the Government to continue backing policies to dynamize the supply of public housing. Juan Manuel Santos, president elect, announced that he will pay special attention to the housing sector, and will create the Ministry of Housing. Of the measures announced, the Government elect estimates an increase of the housing supply of between 200 thousand and 300 thousand homes and the creation of more than 600 thousand direct jobs per year. The proposed reforms include the broadening of the budget allocated to housing subsidies and the simplification of administrative work to process credit, the streamlining of urbanization works, the unification of regulation on land and the clarification of the scope of the national and municipal levels.

4. Risk factors for the real estate market

Although the outlook for the performance of the construction sector in Colombia is quite positive, there are still limiting factors that could hinder its rate of growth. The medium-term factors include the problem of lack of land, the informality of housing and the obstacles to financing homes. Likewise, the continuity of the policy of subsidies and the dynamics of home-buying as an investment will have a bearing on the short-term performance of the sector.

The low availability of developable land is due primarily to the weaknesses of the land regulations in the supply of land and to the private sector's low intervention. In particular, there are difficulties regarding the mechanisms for controlling land prices and financing the transportation and utilities infrastructure to enable its development. This situation has also been reflected in the creation of an informal housing sector, which has been accentuated by the difficult access to financing, which affects the housing sector in general, and especially the low-income segment.

Furthermore, the legal framework governing mortgage credit in Colombia is not clear enough in terms of the rights of debtors and creditors, primarily regarding the issuing of guarantees. Thus, guarantee restitution mechanisms must be developed that are not subject to legal proceedings, as they are a bottleneck to the process. Another obstacle in the executive process is shown through the absence of a standardized manner of settling interest and insurance payments, which prolongs the duration of the legal process. Likewise, the excessive number of steps required to issue the guarantees slows down financing for housing.

Regarding the short-term perspectives of the real estate sector, two key risks can be identified. On the one hand, the interest rate coverage program for housing credits is currently facing greater demand than the subsidies available. In fact, the available quotas for subsidies are at 95 thousand, while applications have reached 106.9 thousand; thus generating an excess demand for 12 thousand subsidies. As some households will have to abandon their investment plans, the time to sell the projects will presumably rise, leaving the constructors with greater financial costs. These results can be altered, however, as the incoming Government has announced a broadening of the resources for financing subsidies for the housing sector.

Another risk factor involves the increased dynamics of housing demand as an investment business. Historically, the purchase of a home as an investment was concentrated in and almost exclusively for the upper class. Recently, however, this practice is on the rise and has become common among the middle-low class housing; it is a growing trend in the traditional segments as well. In fact, while nearly 30% of all home purchases in the last year were done for investment purposes, the average in the past stood at 15%. Therefore, we expect an increase in the placement of homes for sale and lease, which could compete with the residential projects about to be started. This would presumably lead to downward pressure on real estate prices. Likewise, the market's adjustment could also translate into the postponement of new projects moderating the pace of growth of the housing sector.

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