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Diversification efforts in Mexico's real estate sector evident in location, facility offerings

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After years of steady growth, Mexico's real estate sector is preparing for a period of moderately increased uncertainty over interest rates, inflation and trade. Despite some apprehension, sales continue and medium-term market fundamentals remain positive. Some property specialists say worries over inflation and a weaker peso may actually create new investment opportunities and underline the value of property as a secure, long-term holding.

SECTOR BACKGROUND: Mexico's residential housing market continues to grow, but is doing so at a slightly slower pace after a period of turbulence in 2013 when the country's three largest housing developers collapsed. A central problem leading to the collapse was a government focus on subsidising both housing developers and buyers in the affordable housing segment in selected peripheral areas of Mexico City. Although land values were less expensive in those locations, the long commuting times and lack of essential services – including, in some cases, delays in connecting water and electricity – meant many units in a number of developments remained unsold. Policies have now changed with new units being built closer to the urban centre, and greater emphasis is being put on the construction of fully serviced apartment blocks.

The state-owned National Workers' Housing Fund Institute (Instituto del Fondo Nacional de la Vivienda para los Trabajadores, INFONAVIT) is the country's main mortgage provider. Employers make contributions to INFONAVIT on behalf of their employees who can use the funds as a down payment on a new home. With land and housing prices rising after 2013, the government raised maximum INFONAVIT mortgage loans; the agency's share of the total mortgage market rose to 75% in 2014. The Mexican Housing Commission (Comisión Nacional de Vivienda, CONAVI) also runs a subsidised programme known as "Esta es tu Casa" (This is your Home) that helps would-be home buyers pay a deposit on a new residence and also helps existing homeowners carry out repairs. However, in the light of fiscal austerity imposed after 2015, funds for some of these programmes have been cut back.

According to the Ministry for Rural, Territorial and Urban Development (Secretaría de Desarrollo Agrario, Territorial y Urbano, SEDATU), national housing policy aims to ensure decent housing for all Mexicans. The ministry states that the housing deficit has been reduced by 30% during the four years of the current administration, in part by increasing residential density in appropriate areas by constructing high-rise apartment blocks. Prior to 2012, when the current government took office, only 3% of new housing starts were in high-rise blocks, but this proportion has subsequently increased to 35%.

GEOGRAPHICAL INCONSISTENCY: The housing market is broken down into various segments and geographical areas. Mexico City and other urban areas tend to drive the national market. Ricardo Nebrara, director-general of real estate development firm Grupo Arpada, sees the importance of the capital city but highlights opportunities in other urban centres. "There is healthy growth in the Mexican real estate sector, constrained only by a lack of space in the capital. Rapid economic growth in areas such as Querétaro and the Bajío region has shown that there is a noticeable decentralisation of activity towards the country's secondary cities," he told OBG. A higher standard of living and a growing middle class have played a significant role here. According to The National Institute of Statistics and Geography (Instituto Nacional de Estadística y Geografía, INEGI), the national statistics institute, the middle class grew from 37m to 44m between 2001 and 2010.

There is, however, a major north-south divide in the country's housing market. According to Alicia Ziccardi, a specialist at the Universidad Nacional Autónoma de México, one-third of residents in the poorer southern states live in homes with laminate or metal roofing, 10% have dirt floors, and less than half have access to running water and sewage systems, compared to over 75% in the rest of the country. Ziccardi said that small houses – 40 sq metres or less – represent 27% of the total in the south of the country, but just 16% in the north and 10% in central Mexico.

The main trade association for the real estate and property development sector is the Asociación de Desarrolladores Inmobiliarios (ADI), which has over 70 members. ADI says its members are investing a total of approximately $21.5bn in a range of property projects around the country. The association also seeks to

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improve the image of the industry. Recent initiatives include a draft code of anti-corruption practices, designed to commit developers to full observation of legal and planning requirements, and to promote environmental awareness, collaboration with local communities and corporate social responsibility. Another recommends that 30-50% of total real estate investment be earmarked for associated infrastructure improvements including water and electricity supply, street lighting, cycle routes, pedestrian crossings and public amenities such as parks.

SECTOR PERFORMANCE: Real estate activity can be measured in various ways. One of these metrics is the value added of real estate services, as measured by INEGI. During the financial crisis of 2008-09, total Mexican GDP dropped by 4.7% in 2008 and then recovered by 5.2% in 2009. Real estate services over those same two years grew by 1.1% and 2.8%. In the years the sector has remained stable, growing at a marginally slower rate than the economy. Value added grew by 2.1% in 2014 compared to 2.3% for the economy as a whole; by 2.5% in 2015 versus 2.6% for the entire economy; and by 2.1% in 2016 compared to 2.3%. Furthermore, segment growth fluctuated within 1% on a quarterly basis in 2016, with real estate value added growing by 2.4% in quarter one, 2.2% in quarter two, 1.9% in quarter three and 1.8% in quarter four. These figures are comparable to those of prior years.

Consultancy firm Tinsa Research tracks residential sales in the wider metropolitan area of Mexico City, covering the city itself and urban municipalities in the adjoining states of Estado de México and Hidalgo. In the last quarter of 2016 a total of 7101 residential units were sold in this area, a fall of 6.6% from the third quarter. However, from end-2015 to end-2016, the market was broadly flat, falling 0.7%. Moreover, average home prices were up by 3.6% over the same period, while the cost per sq metre rose 4.5%. In both cases, this actually represented a fall in US dollar terms due to the depreciation of the Mexican peso.

Tinsa Research categorises homes into five brackets beginning with “Popular” at the lower end, “Traditional” and “Mid Market” classes in the middle of the scale, and finally “Residential” and “Residential Plus” at the top end of the market. According to data from the fourth quarter of 2016, the strongest growth rates in terms of units sold were registered by the “Mid Market” and “Residential Plus” categories.

Furthermore, the average price per sq metre of a new house in Mexico City in 2016 was around MXN39,667 ($2390), while the price per sq metre for apartments was MXN39,909 ($2405). The house price index compiled by the Sociedad Hipotecaria Federal, a government mortgage agency, showed that house prices increased by 7.55% nationally during 2016, and by 7.15% in Mexico City.

CONTINUITY IN RESIDENTIAL: Alejandro Ballesteros, director of property developer Grupo Copri, told OBG that the real estate market was at a potential turning point in early 2017. Many are monitoring the prospect of greater protectionism in the US that may suggest a period of uncertainty in the performance of the local economy. Since the 1990s Mexico’s macroeconomic stability has gradually increased the attractiveness of real estate to investors. The financial crisis of 2008-09 was largely seen as an external factor that had little impact on Mexican property values.

For the moment, Grupo Copri is reporting continuity in residential real estate, its most important business segment. A continuing scarcity of housing is driving the market, which is expected to keep fuelling fairly high levels of demand, even though monthly mortgage payments may rise 10-15% as interest rates are tightened. “Half our clients buy homes to live in and the other half buy them as an investment, for rental,” Ballesteros told OBG. While a weaker peso might discourage some buyers due to rising mortgage repayments in national currency, investors operating in dollars or able to take a longer-term view may actually increase their exposure. “Over the long term, people know that Mexican property values have largely kept up with the US dollar exchange rate and are a good way of preserving asset value,” Ballesteros added. Mexican property prices remain attractive from an international perspective. Mexican capitalisation rates – net annual operating income from a property as a proportion of current market value – are competitive compared to those in the US. International institutional investors are increasingly present in Mexican property, a sign that the local market is becoming more widely recognised as stable and profitable. Speaking at a Mexican property conference in February 2017, Lee Menifee, head of Americas investment research at PGIM Real Estate, said that despite current uncertainties, international companies are seeing the country as a long-term investment opportunity. However, Menifee acknowledged some alarm signals, such as a fall in the number of transactions, but said this was a worldwide phenomenon which indicates no more than a period of caution.

MIXED-USE DEVELOPMENTS: A number of areas around Mexico City and other urban centres have seen the rapid development of office, residential and commercial property, and the scarcity of suitable land for these facilities has been a factor encouraging the rise of mixed-use developments. Moving around Mexico City can be complicated, with many public spaces of a relatively low standard and, for practical reasons, inhabitants are forced to circulate in a restricted area of influence within the larger city. For this reason mixed-use developments can provide a wide range of services and activities all together in one convenient and secure area. SANTA FÉ: One of the biggest mixed-development areas has been the Santa Fé business district to the west of Mexico City. In the past the area had been used as a sand mine and as a landfill site where much of the city’s garbage had been dumped. However, after an earthquake in 1985, city officials and developers set about reclaiming the area to build a modern business district, partly modelled on Paris’ La Défense district. One of the first developments was the construction of a new 20-ha campus for the privately owned Universidad Iberoamericana, which was inaugurated in 1988. Over a 20-year period, a large number of corporate headquarters and office blocks were also built, followed by up-market residential apartments and shopping centres. It is now estimated that over 200,000 people work in the Santa Fé district every day. It is also home to Centro Santa Fé, a shopping mall of over 100,000 sq metres and parking space for 5000 vehicles that opened in 1993; it is one of the largest of its kind in Latin America.

Property developers say high land prices and difficulty finding the necessary space mean there are unlikely to be many more shopping malls on the scale of Centro Santa Fé. Current development is more focused on neighbourhood shopping centres, with floor space roughly between 15,000-50,000 sq metres. To be viable, such a centre usually needs to house a small or medium-sized supermarket, a film theatre, a gymnasium, and a range of restaurants and shops. Most developers build and operate, leasing out the retail space to a number of outlets. Many shopping malls are built as part of a combined project with residential apartment blocks. The advantage of this approach is that the developer can structure a mixed financial return consisting of capital from the sale of residential units and revenue from rental income in the shopping centre. The shopping centres usually require refurbishment and updating every 3-5 years. Over the long term, developers also have the option of partially or fully divesting the shopping centre to release capital for new projects.

INVESTING IN HOTELS: The hotels and tourism sector is another important component of real estate demand. In March 2017 US hotel chain Marriott International announced it was building two new units – branded as Courtyard and Fairfield Inn and Suites – in Vallejo. The development is being funded in partnership with Fibra Hotel, a local real estate investment trust listed on the Mexican Stock Exchange. Fibra Hotel currently has an investment stake in 83 hotels located in 26 Mexican states.

In early 2017 Fibra Hotel announced that it was putting some projects for 2018 on hold while it assessed macroeconomic conditions, but other investors remain positive about the hotel sector in the shortterm. Another real estate trust listed on the exchange, FIBRA Uno, said it acquired the 457-room Park Tower Vallarta resort hotel, which would be renamed Grand Fiesta Americana, for MXN1.47bn ($88.6m).

Canadian investors have also been active in the Mexican hotel and resort segment. According to Vancouver-based Re/Max Crest Realty Westside, there has been a property boom in hotels and high-end holiday homes around Cabo San Lucas in Baja California. Other resort areas attracting foreign investment include the Yucatán peninsula on the Caribbean coast. Even though resort property prices tend to be fixed in US dollars, the depreciation of the Mexican peso has sparked added interest, since living costs and property taxes are low.

FUNDING: Mexico has diversified its funding sources for property investment in recent years. One innovation has been the introduction of US-style real estate investment trusts. Their Mexican equivalents are known as *fideicomisos de infraestructura y bienes raíces* (FIBRAs), securities designed to offer stock exchange investors a way of participating in both the real estate and infrastructure sectors.

The first FIBRAs began trading in 2011. FIBRAs pay no corporate taxes if they distribute 95% or more of their income to shareholders as dividends. There are currently 10 FIBRAs trading on the Mexican Stock Exchange. In late 2016 their combined market capitalisation sat at $13.3bn. Due to sustained macroeconomic growth and increasing demand for industrial and warehousing space, offices, retail outlets and homes, FIBRAs have enjoyed double-digit growth rates. An index of eight FIBRAs showed returns of 10.4% in 2013 and 20.8% in 2014. In 2015 there was a 7% drop in the index, but 2016 saw a strong recovery with average prices bouncing back and rising by 26.5%.

According to Marco Medina, equity research analyst at brokers Grupo Financiero Ve por Más, FIBRA trading volume held up in late 2016 despite concerns over US-Mexico relations and the possible withdrawal of multiple automobile assembly operations. However, FIBRAs linked to industrial parks and factories appeared the most vulnerable to worries over the future of the North American Free Trade Agreement.

OUTLOOK: Grupo Corpi's Ballesteros said the sector faced two looming challenges in 2017-18. One is uncertainty over the future of the US-Mexico relationship, triggered by the January 2017 arrival of a new administration in the US. The other is Mexico's own political transition, with presidential elections due in mid-2018. In the least favourable scenario, both factors may lead to a period of exchange rate and interest rate volatility. In early 2017 there was a wide range of attitudes in the market; sentiment varied from cautious to optimistic.

As the year progresses, Ballesteros expects a consolidation process to begin. Some highly leveraged property companies might become targets for acquisition while some diversified conglomerates might divest the property-related assets in their portfolios, selling them to specialists better prepared to navigate more uncertain market conditions. Still, Ballesteros insists that market fundamentals for those willing and able to take a long-term view remained robust and healthy. "There is still demand for well-located residential homes here. There is still demand for well-located offices. And there is still demand for well-located shopping centres," he told OBG.

However, higher inflation and financial volatility might actually increase the attractiveness of investing in property. "In a context in which inflationary expectations are set to rise throughout 2017, investor appetite for residential property is set to increase because these assets are a refuge in times of volatility and exchange rate uncertainty," said Leonardo González Tejeda, an analyst at www.propriedades. com. On the supply side, Jorge Paredes Guerra, president of Realty World Mexico, noted that peso depreciation has contributed to rising construction costs, as many component inputs are imported. General inflation was 3.4% in 2016, but the Cámara Mexicana de la Industria de la Construcción – the Chamber of Commerce for the Mexican Construction Industry – said prices for construction materials rose by a higher 12%. He believes that this, too, may exert upward pressure on house prices in the remainder of 2017.

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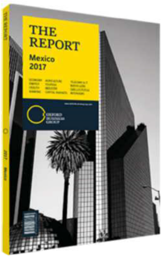

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