MEXICO AFTER THE TUMBLE

by John C. Melaniphy, CRE

On December 20, 1994, Mexico once again stumbled. The peso lost its value and plummeted against the dollar and other world currencies. Most Counselors of Real Estate (CREs) who had been advising both Mexican and American clients in Mexico knew the peso was overvalued. However, no one expected it would be a free-fall. This was not the first time the peso had plummeted in Mexico. The 1982 devaluation was far more dramatic in Mexico than the current problem. This time the difference was how the global money markets reacted. With significantly better electronics, money roared out of Mexico at warp speed, and with it went the hopes and dreams of Mexico's rising middle class for the next three to five years. "If you are in business in Mexico, you must prepare for something like this occurring every eight to ten years," said a Mexican retailer. "It is a fact of life!"

This article will examine the situation which preceded the fall, the major influencing issues that brought it about and where I see the Mexican economy headed in the near future.

Prior To Devaluation

Demographics

During most of 1994, Mexico was considered by many as the crown jewel of opportunity. Located on the southern border of the United States, Mexico was, by American standards, an underdeveloped country. With a population of approximately 87 million, projected at 97 million by the year 2000, Mexico's population is about 37 percent of the United States',[1] but about three times larger than Canada's. However, in Mexico about half the people are under the age of 18 which makes its population much younger than either the United States' or Canada's. Population growth in most Mexican cities ranges between two and three percent annually. Contrary to almost anywhere in the U.S., the children's department in the major Mexican department stores usually covers an entire floor. Mexico City, considered by many as the fastest growing major city in the world, has a population of between 15 million and 23 million depending on whom one believes. The Mexican census is not known for accuracy. In reality, Mexico City's population is closer to 19 million people, which nevertheless represents about 21 percent of the nation's population.

Retail Sales

Mexico's total retail sales grew from an estimated $66 billion in 1990 to $83 billion[2] in 1992, an increase of 25.7 percent. In 1993, the growth slowed somewhat due to the influence of the U.S. recession.

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Nevertheless, retail sales rose to an estimated $102 billion, or $19 billion over the previous year. This rise in growth continued up until the devaluation. In contrast, while the U.S. is enormously larger in retail sales, its sales growth has been about $18 to $25 billion annually. Mexico's growth was in the same league, even though the overall U.S. retail sales amount is over $1,900 billion.[3]

Economic Growth

Before the devaluation, household income in Mexico was rising, the middle class was growing and the demand for just about everything was expanding. Conditions were reminiscent of the U.S. in 1947 following World War II when the country was poised for an explosive growth in population, jobs and income. In Mexico, the expansion generated purchasing power which, in turn, created a demand for housing, cars, shopping centers and other indications of the *good life*. As the middle-class Mexican looked at the economy, he or she saw inflation decline below 10 percent (from 150 percent in 1982-1983), interest rates down to 20 percent,[4] a stabilized and predictable peso (devalued at one peso per day) and credit availability from banks and retailers. Demand for well-educated people was strong and overall expectations for the economy were high.

The Chiapas uprising in Mexico received a great deal of media attention as a major problem. However, it was a non-event and did not play a role in the governmental or economic problems. The area where the uprising occurred is so far removed physically from 99 percent of the Mexican population, that it had virtually no impact on the country. If it wasn't that the international media forced the Mexican government to take action, nothing would have happened.

In 1994 NAFTA, the North American Free Trade Agreement between the United States, Mexico and Canada, established a free trade zone between the three countries. Expectations were high that each country would benefit from the other's economies. For Mexico the agreement represented jobs, capital, new plants and equipment and most of all, a higher standard of living. Outsiders saw it as virgin territory, cheap labor, explosive growth, rising demand for foreign products, rising income for housing, cars, shopping centers, office buildings, hotels, industrial parks, road construction and all forms of infrastructure. Unfortunately, most development and expansion were being financed with short term debt in hopes of attracting long term foreign capital.

Politics/Government

Prior to his election and even afterward, President Ernesto Zedillo was virtually unknown throughout Mexico. While many higher-ups in the PRI party (Party Revolutionary Institutional) were aware of him, the general population was not. He was selected following the assassination of the candidate identified by the former President Salinas. Being an unknown has created some confusion regarding what Zedillo stands for and how he will govern Mexico. The presidential elections in which he was elected were perhaps the freest of political corruption in recent times. Moreover, as president he appears to lean toward an open government and judicial system totally different from the past 50 years under PRI rule. This is all very new to the Mexicans. The two state governorships being elected this summer should provide an indication of where this government is headed.

Unfortunately, the first true test of Zedillo's capability occurred just three weeks after his inauguration when the country's financial reserves came under pressure to meet short term governmental borrowing payments. As word leaked out, concern mounted that Mexico might not be able to meet its short term debt obligations. Without notifying the financial community, the new president waffled.

Instead of going to New York and explaining the problem to world money managers, he chose to let the peso float against the U.S. dollar and announced a 15 percent devaluation. The global money markets reacted almost instantly by dumping the peso, selling Mexican stocks and cutting off investment funds. Consequently, the value of the peso was driven down from about 3.4 to the dollar on December 19th, to a new low on March 9th of 7.45 pesos to the dollar. It has since recovered to between 6 and 6.5 pesos to the dollar. The impact, from the Mexican standpoint, has been to make dollar-denominated-debt twice as costly.

Moreover, with crisis abounding, President Zedillo waited two weeks before presenting an austerity plan to improve the situation. During those two weeks, the country's financial markets were ravaged. Between $15 and $20 billion in investment capital fled the country. Under the much-awaited Zedillo Plan, interest rates on existing loans were adjusted causing rates to rise between 80 to 100 percent.[5] Imagine, if you owned a home or a new automobile and the interest rate climbed to this level. The Mexican banks, which had borrowed dollars extensively from other foreign currencies, now found themselves almost insolvent. They began to call loans or foreclose on defaults. Unfortunately, the Mexican middle class is losing its homes and cars because its income has not risen sufficiently to cover the higher cost of debt.

Virtually, all planned income-producing real estate projects have been stopped, along with most construction. None will be able to restart until foreign capital is encouraged to return to Mexico. My

firm had been consulting on the two biggest new malls in Mexico, both of which were under construction in December 1994. They were being financed with short term borrowings from Mexican banks. They now sit with naked steel and construction stopped until long term capital can be found to complete the projects.

After The Fall

President Clinton moved quickly to promote financial relief for Mexico. A loan guarantee program was designed whereby Mexico could pay off short term debt and float new borrowings. Without adequate loan reserves, Mexico would have experienced an even worse situation, and recovery would have taken ten or more years. Mexico is the U.S.'s biggest trading partner thus, any problem there certainly affects our exports. Even with the merits and benefits of U.S. assistance, the impact upon Mexicans can clearly be seen:

- The inflation rate had risen from an annual rate of about 10 percent in 1994 to approximately 50 percent today.
- Retail sales have declined between 30 and 50 percent, depending upon the type of retail store. Automobiles, furniture, appliances and other durable goods are down over 50 percent in sales, while supermarkets and pharmacies are down about 30 percent.
- Interest rates are now in the 80 to 100 percent range for short term funds. There basically are no long term funds available or being sought at these rates.
- Imported goods now cost double what they were before devaluation.
- Dollar-denominated-debt now costs twice the amount borrowed in repayment.
- Gasoline prices have been raised as part of the austerity plan.
- A value-added tax of between 10 and 15 percent has been imposed on most merchandise.
- Income taxes have been raised.
- Wages and salaries have been permitted to increase by 15 percent to offset the rising costs and taxes. The increase is inadequate to cover the rising costs.
- The Mexican economy will probably shrink by about four percent in 1995.
- Many Mexican banks are close to if not insolvent because of dollar or Eurodollar borrowings from foreign sources that must be repaid in kind. Also, defaults on loans to small businesses and individuals for homes and automobiles have compounded the problem.
- Mexican banks, in conjunction with the Mexican government, held an RTC type auction of non-performing and under-performing assets. The value of properties auctioned was valued at over $100 million. Buyers needed deep pockets and had to buy at significant discounts to cover the long holding periods likely to be required.
- Office buildings are being offered for sale with a wide range of prices. Class AAA (our A) buildings are selling at about a 15 to 20 percent discount. Class AA (our B) buildings are being offered at discounts ranging from 25 to 35 percent to raise needed capital for debt ridden owners. Class A (our C) buildings are going begging.
- Most major shopping centers are condominiums and therefore, with some exceptions, the rental markets are generally for small stores. Nevertheless, since devaluation, rents for existing well located space are off 10 to 15 percent. Vacancies have risen as small retailers fail or liquidate. The substantial decline in retail sales will continue to increase vacancies even in the best centers and business districts. Community based shopping centers have experienced even higher failures and vacancy. Rents in these types of centers are off as much as 30 percent. The bigger problem is finding retail tenants for store space. Recently, a real estate consultant called to discuss a major new mixed use project in downtown Mexico City. He has been engaged, since devaluation, to advise a large Mexican bank on the status of its retail investment. Rents in the development were projected at an average of $50 to $60 per square meter per month (about $55 to $67 per square foot annually). Today, the only interest in the property has come from one retailer who offered approximately $40 per square meter per month (roughly $45 per square foot annually). Beyond that there is no current demand. My experience in Mexico tells me that for the next two to three years it will be very difficult to average rents above $35 to $40 per square foot per month for any new developments. That is why most new retail projects are mothballed until the economy improves.
- There has been increasing interest from U.S. based investors who recognize that the current economic situation will not last forever. I see them moving to acquire or invest in well-located but unfinished mall projects where major Mexican and U.S. department stores are likely to be the primary anchors. Because debt capital is so scarce, U. S. investors who can generate capital to finish the projects are in an excellent position to invest at a substantial discount. It is important however, to invest as equals and avoid putting in capital until all the approvals have been obtained, along with agreements from the major anchors.

- Industrial development near the U.S. border in the Maquiladora zones continues to expand as a result of devaluation. Industrial firms want to take advantage of the even lower peso wages in Mexico. Maquiladora zones are areas designated by the Mexican Government near the U.S./Mexican border. Foreign companies located within these zones are permitted to import duty free components for assembly. Also tariffs are paid only for the value added to the products. Therefore, it is much cheaper to manufacture components elsewhere, ship them to a Maquiladora zone, assemble the components and ship them back to the U. S. According to existing Mexican law, the Maquiladora zones will lose their special tax status in 2001. Another reason for the increased interest in these areas is the cheaper construction costs that are available since devaluation. Construction savings today can range between 20 and 30 percent.
- Housing is a mixed bag. Demand for new middle-class housing has drastically declined because of the pressure on middle-class income. Living expenses for the middle-class have risen dramatically, while their income growth is restricted under the president's austerity program. The demand for government guaranteed housing continues because of the housing shortage in Mexico. Even so, the total volume of government guaranteed housing is down because of the austerity program. For those wealthy Mexicans who protected their assets during the recent devaluation, now is the time to expand their existing homes or build new ones.
- Probably the greatest impact of devaluation and the austerity program will be the loss of between 1.2 and 2.0 million jobs, which will further depress the Mexican economy.

The Immediate Future—Issues To Be Resolved

The first major issue to consider for anyone investing in Mexico is its political stability. Unfortunately, both Mexicans and foreigners alike are concerned with the lack of leadership provided by the current administration. There does not appear to be any clear economic plan or direction. Until the government is perceived as working toward a stable economy and currency, it will be difficult to obtain the needed foreign investment capital. Among retailers, there is a minority school of thought that this is a great time to develop in Mexico since so many retailers are financially strapped. Regardless, those who decide to proceed will need considerable capital and be willing to wait a very long time to recover their investments.

If stability comes to the government and the peso stabilizes at about 5.5 pesos to the dollar, the Mexican economy would be able to slowly emerge from this economic and financial mess. Furthermore, NAFTA regulations are not being applied as expected. United Parcel Service (UPS) has experienced the problem first hand. Mexican regulators will not permit UPS to use the same size trucks it uses in the United States, even though this size is used by Mexican competitors. Furthermore, President Zedillo's government appears to be much more pro-union than previously thought.

Both Mexican and U.S. department stores have experienced considerable problems with the Certificates of Origin required to import goods from outside the country. Many Mexican department stores did not receive their Christmas goods in time for the holidays because the items were held at the border by Mexican Customs. J.C. Penney recently opened two stores in May, one in Monterey and another in Leon, without all their goods because of the problem. The U.S. department stores or discount department stores involved are very concerned about receiving shipments and have scaled back their expansion plans partly because of this problem.

With construction stopped on almost all new income-producing projects, the need for foreign capital will become increasingly desperate as time passes. This may be further complicated because Mexican and U.S. retailers will be reluctant to pay rents in dollars. Thus, it will be even more difficult to lure foreign capital into Mexico.

Mexican Real Estate Over The Next Five Years

There are several answers to the question "What is the future of Mexican real estate over the next five years?" The first part of the answer depends upon political stability. If government reflects strong leadership and consistency, the world community will once again view Mexico as a place to invest capital. Another part of the answer lies in the attitude and perceptions of the Mexican people regarding their government. The general feeling now is that the government has failed the average Mexican by eroding his assets and security. Next, the Mexican economy must stabilize and grow so the average worker can begin to afford more than the necessities of life. Finally, the consumer must perceive improvement in his or her buying power.

The Mexican people have previously experienced similar economic situations and therefore, know how to protect themselves. This time however, they will be more wary, since the present freefall came with almost no warning. Also, the middle class has lost many of its hard won assets. Many lost cars and some lost or will lose homes. Their caution will affect existing shopping centers and other commercial developments. While they had a taste of credit cards, Mexicans will be slow to accumulate the large debt which existed in 1994. The value of existing shopping centers and retailers will

remain below 1994 levels but will gradually improve over the next three to four years. Most new developments will revert back to condominium projects which the retailers know and understand.

Office Market

The office market should be one of the first to return to some level of stability. While there was overbuilding in some cities, the office market generally is sound. There are over 70 million square feet of office space in Mexico City. First class space accounts for about 11,000,000 square feet, by our standards. Another 10 to 11 million is classified as first class by Mexican standards. Business failures and downsizing have increased office vacancies. Nevertheless, current vacancies will, in my opinion, begin to decline in 1996 if political stability is achieved. The new office building condominium with the highest rents and sale prices will be the slowest to improve occupancy. Many of these buildings were occupied by foreign companies who have either fled or downsized. However, they will return slowly.

Industrial Market

The industrial market will continue to grow if political stability occurs. The lower labor costs, the benefits of NAFTA and the Mexican government will encourage industrial investment. It will be necessary for the government to overcome its pro-union stance to inspire a continuing flow of new manufacturing plants in Mexico. Motorola is an example. The company has announced plans to invest $72 million in Mexico. A new plant will be built near Chihuahua, and an existing plant in Guadalajara will be modernized. The company indicated that it planned the investment before devaluation. After reviewing the current situation, it decided to proceed because of the cheaper manufacturing wages and the lower construction costs.

Housing

The housing market will return slowly. The sale of existing homes has slowed to a trickle from lack of mortgage funds. Limited development capital, few end loans and buyers will keep the housing market way below the 1994 level. In my opinion, it will be at least four to five years before housing demand returns to the 1994 levels.

In summary, Mexico has once again experienced what many thought would not happen. Remember, the Mexican zest for life will once again enable this economic crisis to reach a successful conclusion.

NOTES

1. Instituto Nacional de Estadistica Geografia e Informatica (I.N.E.G.I.) and Melaniphy & Associates, Inc., 1994.
2. Banco de Mexico, Nacional Financiera, and Melaniphy & Associates, Inc., 1994.
3. U.S. Department of Commerce, Bureau of the Census, Census of Retail Trade, 1994.
4. Banco de Mexico
5. Banco de Mexico