

INVESTMENT MEMORANDUM

TO: Professor Mihir Desai
FROM: Daniel Pechman and Brian Osias
RE: The Mexican Housing Success Story as a Template for Brazil and China
DATE: December 12, 2005

Executive Summary

- Based on our prior work¹, we have presented an analysis of
 - (a) why Mexico has been successful in rapidly expanding its housing sector thereby creating a long-term secular growth story, and
 - (b) why the Mexican Home Builders (Ara, Geo, Homex and Urbi) continue to represent attractive investment opportunities.
- Utilizing the Mexican experience as a template, we analyzed the Brazilian and Chinese housing sectors and assessed their potential.
- Brazil
 - The Country has the opportunity to replicate Mexico's success, but needs a few more years to establish the fundamentals (including macroeconomic stability, lower interest rates and a viable mortgage system) for the middle-income housing story to really take hold.
 - We have analyzed a few of the major home builders, and we believe Cyrela provides investors with a solid current investment and an embedded call option on the eventual, secular growth of middle-class housing in Brazil.
- China
 - The Country's housing sector is expanding rapidly, and we believe it will continue to follow a long-term, sustainable growth trajectory.
 - We have identified the stocks of a few specific home builders (China Vanke, Hopson, and Shanghai Forte) that we believe still present investors with attractive opportunities for future gains.

Overview

Why is the housing sector in emerging markets a compelling investment theme today?

The increasing wealth in many emerging markets is creating a burgeoning middle class, which is focused on improving its standard of living. Using the World Bank's benchmark for defining middle class (income over US\$3,000), the number of people reaching this level will nearly double in the BRIC economies over the next three years.² "Experience in other economies has shown that as incomes cross the [US]\$3,000 threshold, there is a period of rapid expansion in the size of the middle class and acceleration in consumer demand."³ In addition, many of these countries are facing major housing shortages. The enlarged middle class with its new wealth will be able to purchase professionally constructed housing to address its needs. And, the global trend toward urbanization is expected to result in the migration of seventy million people per year to urban communities who will also require new housing.⁴ In addition, important banking and legal reforms in some countries coupled with greater

¹ Brian Osias analyzed the Mexican Homebuilders extensively over the past summer while working at Tremblant Capital. Please see the Mexican related sources in the bibliography for a list of the resources that were utilized for this work.

² 13D Research, Inc., *The Ultimate Contagion: The Coming Boom in Emerging Markets, Part VI, Global Housing Shortage*, October 2005.

³ 13D Research, Inc. *The Ultimate Contagion*.

⁴ 13D Research, Inc. *The Ultimate Contagion*.

macroeconomic stability have resulted in more advanced mortgage systems further accelerating growth in housing. These trends together have and will continue to produce a long-term, secular growth story in the housing industry in emerging markets.

Mexico's Accomplishment

Mexico has been extremely successful in increasing the number of professionally constructed homes available for lower and middle income families. The country currently has an estimated 4-5 million unit housing deficit with 750K net new households being formed each year.⁵ Under the leadership of President Fox, the country will have increased the number of mortgages to meet this demand from 346,000 granted per year when he entered office in 2000 to 750,000 per year by the time he leaves office in 2006.⁶ This achievement has been the result of both the Fox Administration's reforms of government agencies in charge of issuing mortgages to low income families as well as other regulatory and legal changes related to mortgage lending. In addition, the improved macroeconomic stability in Mexico has decreased interest rates making mortgage borrowing more attractive to new homebuyers. Lastly, stability in the banking sector has reinvigorated the commercial mortgage market for middle and upper income housing. Together, these factors have led to a stable and growing housing sector, which is addressing a critical need of the Mexican population and has created attractive investment opportunities.⁷

The Opportunity in Brazil

Using the Mexican housing story as a template and also looking at the success of Chile and Spain, we have analyzed a few investment opportunities in the Brazilian housing industry. The Brazilian housing sector is lagging behind its more successful peers but it shares many similar, positive attributes that should also result in long-term sustainable growth for the industry. The key question is not IF but WHEN will the growth occur.⁸

According to a 2005 study made by *Fundação João Pinheiro*, a government think tank, Brazil has a housing deficit of 7.2 million units, which represents 17% of the country's families. The mortgage lending market also has tremendous potential, as the current penetration of real estate financing is non-existent. Considering only private-sector loans, Brazil has the lowest ratio of mortgages to GDP of 1.7% amongst its Latin American peers⁹. Other studies support these findings. According to SECOVI (the São Paulo Trade Association for Companies Involved in Purchase, Sale, Lease and Administration of Residential and Commercial Properties), Brazil had a shortage of approximately 6.7 million housing units in 2000. Also, the CBIC (Câmara Brasileira da Indústria da Construção, or Construction Company Brazilian Association) estimates that it would be necessary to build 600,000 homes a year for 20 years in order to eliminate the current housing deficit.

China's Potential

China's urbanization along with the growth of its middle class has continued to drive the expansion of its housing sector.¹⁰ As in the Mexico's case, a series of legal reforms contributed to dramatic expansion of the housing stock from 1998 through 2004. More recently, fears of a property bubble have surfaced, and, as it periodically has done in the past, the government has taken an active role in trying to end speculation in the market. Despite this, the basic demand for more housing across the

⁵ Harvard Joint Center for Housing Studies, *The State of Mexican Housing 2004*.

⁶ Marcelo Telles et al. *Mexican housing sector: A constructive look at industry fundamentals*. Credit Suisse First Boston, January 2005.

⁷ Ibid.

⁸ Roberto Attuch et al., *When will Brazilian mortgages grow as they do in Mexico and Chile?* Credit Suisse First Boston, August 2005.

⁹ Ibid.

¹⁰ Liang, Hong and Ma, Ning. *China's Property Market: Fallacies of an Imminent Bubble Burst*. Goldman Sachs. December 10, 2004.

country persists, and the larger, well-capitalized builders have an opportunity with their substantial land holdings to serve this need and continue along a sustainable growth path.¹¹

Mexico - Business Analysis - Investment Strengths

Investment Strengths – Compelling Demand¹²

There are a number of trends and factors that have made Mexican homebuilding an attractive investment opportunity today. The large housing deficit and the strong growth in household formation have created a virtually insatiable demand for housing in the near-term. Mexico currently has a 4-5 million unit housing deficit that has resulted in multiple families living within the same structure and families living in homes that need to be replaced or repaired. While population growth is projected to be around 1%+ per year, household growth is estimated to be 3% per annum due to the youth of the population. This growth creates the need for 750,000 new homes per year, which the mortgage system should satisfy for the first time in 2006 (Softec, a housing consultancy, estimates that new home construction in 2004 was US\$15 billion with approximately 560,000 mortgages issued.). Prior to 2006, household growth continued to add to the overall deficit.

Investment Strengths – Strong and Stable Mortgage System

In addition to offering an attractive opportunity for companies involved in the supply side of the housing sector, the housing deficit has also helped create the political will to make critical reforms to Mexico's mortgage and legal systems. Prior to the Fox administration's reform efforts, the government-backed agency involved in granting the majority of the mortgages for lower and middle income workers, Infonavit, was a corrupt and ineffective institution.¹³ The Fox administration transformed Infonavit, which is funded from direct taxpayer contributions instead of general tax revenues, into a transparent and apolitical body by standardizing its rules for granting mortgages and holding its leadership accountable to widely publicized goals instead of the historic political cronyism. In addition, legal reforms were passed to clarify foreclosure rules enabling mortgage lending to be more easily expanded to the poorer segments of society. These reforms have removed political gridlock from the mortgage system and have been the catalyst for rapid and sustained growth.

Because of the virtually unlimited demand for housing, the availability of credit in the mortgage market is the rate limiting factor for expansion of the sector. With the Fox Administration's reforms, the availability of mortgages has expanded rapidly (19% CAGR for 2001-2004)¹⁴, which has directly translated into growth of the housing stock. In addition, Infonavit estimates the annual mortgage growth from 2004-2009 should be 13%, which continue to produce attractive investment opportunities.

In particular, the commercial mortgage market for the middle and upper income housing segments has been reignited and should experience 15-20%+ growth for the next few years.¹⁵ Mortgage lending by commercial banks is growing rapidly as they have now reentered the market in full force after a long absence that began with the peso crisis in 1994. At that time, the banks suffered tremendous losses as the consumers who had taken out variable rate mortgages went bankrupt due to exploding interest rates. New ownership of the local banks by multinationals (HSBC, BBVA, Santander, Citigroup) has provided firm credit support for the Mexican subsidiaries adding an important level of confidence to the system. Also, the introduction of a fixed-rate mortgage product has convinced borrowers to reenter the market in larger numbers. In addition, Infonavit and the commercial banks are working to further develop the securitization market, which should lead to additional growth opportunities. Overall, a well-functioning mortgage system has greatly expanded the housing purchase options for home buyers who previously could only use cash for their transactions.

¹¹ Zheng, Joan et al. *China's Housing Market: Rebounding Again?* Merrill Lynch. November 24, 2005.

¹² Jorge Kuri. *Overview of Mexican Housing Market*. Morgan Stanley. April 2004.

¹³ Ibid.

¹⁴ Marcelo Telles et al. *Mexican housing sector: A constructive look at industry fundamentals*. Credit Suisse First Boston, January 2005.

¹⁵ Based on conversations with Mexican mortgage bankers that Brian Osias had this past summer.

*Investment Strength – Near-Term Macroeconomic Stability*¹⁶

Also, the decrease in interest rates has been critical to the growth of the mortgage sector. Mexico's macroeconomic stability caused interest rates to drop dramatically from the high teens in 2000 and early 2001 to high single digits in 2004. This improvement was due to Mexico being granted an investment grade rating on its government debt in 2000, to an independent central bank that aggressively restrained inflation, and to the generally prudent fiscal policies of the Fox government. With rates projected to remain stable, mortgages should become more attractive to a greater portion of the population.

*Investment Strengths – Other Opportunities for Secular Growth*¹⁷

Two other opportunities for growth specifically available for the homebuilders involve market share gains and mix shift. The home building market is extremely fragmented (the top 5 builders control less than 25% of the market and there are over 2000 builders). While most of the large companies have not been gaining share due to the rapid growth of the market, they should eventually be able to use their economies of scale to take share from the multitude of small builders as the market matures. Also, the homebuilders have an opportunity to earn higher margins by building middle and upper income housing as compared with units for the lower-income segment. Because growth in the number of commercial mortgages has enabled demand for these more expensive segments to increase, the large builders are shifting their production toward middle and higher end homes to increase their top and bottom line growth.

*Investment Strengths – Defensible Business Opportunity*¹⁸

In addition to the attractive and stable growth opportunity in the sector, the Mexican homebuilders represent strong, defensible businesses. A simple analysis of Porter's Five Forces reveals on balance that the homebuilders are well positioned to grow and prosper in their current business.

In terms of the rivalry in the industry, the rapid growth of the sector has allowed the large players to grow quickly without interfering with each other's expansion. Also, the industry remains highly fragmented, which presents a long-term opportunity for the large players to gain market share as noted above.

While new entrants could enter the market (there are 2,000 builders today), there are barriers that protect the competitiveness of the large existing players including: (a) economies of scale and the use of technology to improve the efficiency of their operations, (b) better access to financing, (c) large land holdings (both directly and through option and joint venture agreements) and (d) local knowledge of markets and regulations.

As noted above, the power of the buyers in the sector is a function of the availability of credit since demand cannot be satisfied in the near-term. The public and private sector efforts to grow the mortgage industry should lead to commensurate growth in the housing stock.

Professionally built, new construction is the primary housing option for new home buyers as substitutes are limited. The rental market is small and uncompetitive, and the secondary housing market is basically non-existent. Self-built housing accounted for 50% of new construction and 2/3rds of the existing housing stock in 2003.¹⁹ While this is decreasing as credit has become more available, it still represents a large outlet for unmet demand.

Lastly, the large builders have become efficient purchasers of materials due to their economies-of-scale and their use of technology leading to continued margin improvement. While they are subject to changes in commodity prices, they have been able to manage their suppliers well. Also, the builders have demonstrated various levels of sophistication in their land strategies using a combination of outright

¹⁶ Jorge Kuri. *Overview of Mexican Housing Market*. Morgan Stanley. April 2004.

¹⁷ Marcelo Telles et al. *Mexican housing sector: A constructive look at industry fundamentals*. Credit Suisse First Boston, January 2005.

¹⁸ Based on a presentation that Michael Porter gave regarding the US homebuilders. We no longer have the presentation, but Brian Osias adapted the themes in Porter's presentation to the Mexican builders as part of his work from the summer.

¹⁹ Harvard Joint Center for Housing Studies, *The State of Mexican Housing 2004*.

purchases, deferred payment plans, options and JVs to acquire land.²⁰ Overall, the builders are well positioned to benefit from the rapid top line growth of the industry with opportunity for achieving continued margin expansion.

Mexico - Business Analysis - Investment Risks²¹

Investment Risks – Political Headline Risk

Mexico and eleven other Latin American economies have Presidential elections scheduled for the next year. While these may pose political headline risk for Mexican stocks, the outcome of the Mexican election should not change the government's approach to housing or the sector's positive fundamentals. Growth in the housing sector is widely recognized as positive for all segments of Mexican society.

Investment Risks – Longer-Term Macroeconomic Stability

While the near-term outlook is stable, Mexico's long-term prosperity is not guaranteed, and the country could face stalled growth if important structural reforms are not implemented or the US economy goes into recession. While this will not have a direct impact on the Mexican housing market, it would likely slow the consumption patterns of potential homebuyers. Given the large pent up demand for housing, the marginal homebuyer will likely still purchase a home under these scenarios, but will probably buy a less expensive house.

Investment Risks – Slowdown in mortgage growth

While there are many positive trends pointing in the direction of continued mortgage growth, there are a few scenarios that could reverse this trend. Large increase in interest rates, in addition to either accompanying or causing a slowdown in the overall Mexican economy, would make mortgages less attractive. Also, the commercial banks are now playing an important role in the provision of mortgages for the middle class. At this point the banks are finding the mortgage business to be very profitable (lending at 12% and paying 2% on deposits). While this spread will probably narrow, growth in the market will be a function of the banks' confidence going forward.²²

Investment Risks – Pricing Pressure

The homebuilders could face potential sales price pressure in the future even though this has not been the case to date. This risk is based on Infonavit's, which is the government-backed mortgage provider, continued push to provide housing for the poorer segments of Mexican society. There is a possibility that Infonavit's efforts could cause a decrease in revenues for the builders. The mix shift toward the lower income segment has been offset to date by the greater demand for middle income homes due to the availability of mortgages from the commercial banks. Also, some of the builders have experienced price decreases as they have reached out to broader segments of the population. This has not been a problem in the aggregate, but could be an issue in the future.

Investment Risks – Exchange Rate

US investors need to decide whether they want to make a separate bet on the Mexican peso when investing in the Mexican builders. The peso has appreciated due to greater Mexican macroeconomic stability and the rising price of oil, but it remains volatile. If investors do not want to make this additional investment decision, they may hedge their exposure to the peso but at a cost.

Mexico - Financial Analysis

In addition to the solid business case in favor of the Mexican builders, there is also a strong financial case that suggests these companies represent attractive investment opportunities (see the comparable companies analysis in the Brazilian section of the paper). Importantly, the Mexican homebuilders have produced returns on capital as well as returns on incremental capital employed in the

²⁰ Based on conversations with US home builders (Ryland and Standard Pacific) from Brian Osias' summer work.

²¹ Jorge Kuri. *Overview of Mexican Housing Market*. Morgan Stanley. April 2004.

²² Based on conversations Brian Osias had with various mortgage officers from Mexican commercial banks this past summer.

high teens and low twenties.²³ These rates are due to solid profit margins (in the low teens) and efficient asset turnover. In addition, the companies have the ability to produce a solid stream of free cash flow, but have chosen to reinvest these funds into their businesses in general given the attractive growth opportunities that lie ahead. Projecting their performance over the next few years, however, demonstrates that they will have the ability to generate solid cash flows.

Valuations for these companies also remain appealing. On a forward P/E basis, these companies are trading in the low teens, which is attractive given their long-term, projected earnings growth. Also, using a discounted cash flow analysis, the companies have substantial upside potential to their current valuations.²⁴

Brazil - Business Analysis - Investment Strengths

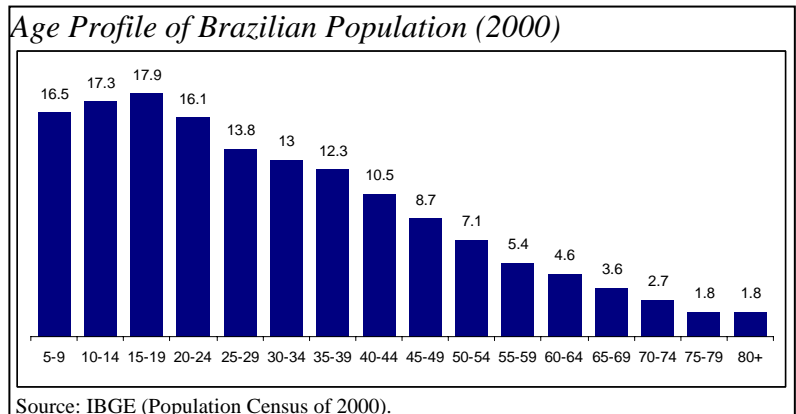
Investment Strengths – Compelling Demand

Similar to the situation in Mexico, Brazilian homebuilders and mortgage banks have a tremendous growth opportunity that could translate in the near future into a remarkable investment opportunity. To put the size of this in perspective, the Brazilian construction industry accounted for approximately 7.2% of the country's GDP in 2003, according to data compiled by IBGE. Also, a survey conducted by the business school Fundação Getúlio Vargas (FGV) reported that the building sector supply chain accounted for 13.2% of Brazilian GDP from 1998-2000. However, Brazil's total investment in home building has not been sufficient to deal with the 7 million unit housing shortage noted in the aforementioned studies by *Fundação João Pinheiro* and SECOVI.

As is the case in Mexico, the Brazilian housing shortage is likely to continue to expand. The growth in the Brazilian population (1.6% from 1991-2000), the high percentage of young

people, the population's gradual aging trend, the decline in the number of inhabitants per household and the socio-cultural preference of people to own their homes all combine to support the high potential demand for residential real estate property in Brazil over the next ten years. Despite the narrowing of the age structure base, the youth of Brazil still represent a large potential for real estate property demand for the next couple of decades. In 2000, the population under 25 years old represented 49.7% of Brazil's total population versus 35.4% in the U.S. and 28.9% in Western Europe.

The increase in the number of households and the decrease in the number of inhabitants per household will also translate into the need for more housing. From 1991 through 2000, the number of households increased by 12.4 million, representing a growth rate of 3.6%, compared with a population growth of 1.6% in the period. In 1970, the average number of inhabitants per household was 5.28. In 2000, this number fell to 3.79. The reduction is mainly due to the decline in the average number of children per family and to an increase in single-occupant households. In ten years, the percentage of households with one inhabitant rose from 7.5% to 10.2% of the total number of households. Finally, the significant rise in home ownership reflects a socio-cultural shift. Despite the high interest rates in place in the 1990s, home ownership as a percentage of total homes rose from 70.8% to 73.7% from 1993 to 2003, while rental occupancy fell from 15.3% to 15.0% and "assigned homes" (involving the transfer of property from one party to another) dropped from 13.4% to 10.7%.



²³ Based on detailed operating models Brian Osias built this past summer.

²⁴ Ibid.

Investment Strengths – Potential Multiplier Effect of Homebuilding

Given the vacuum in mortgage lending due to the absence of Brazilian banks (a ridiculous 0.1% of GDP), real estate developers have taken charge and granted much of the real estate financing to date. Developers accounted for 68% of the total real estate financing in Brazil as of 1999, and this figure has only increased ever since. With a large percentage of the builders’ funds dedicated to financing, they have had fewer resources available for financing new projects, further diminishing the housing supply and exacerbating the housing deficit in Brazil.

We imagine that the development of a mortgage market in Brazil would free up developers’ capital, in much the same way that both the recent partnerships between banks and retailers have freed up capital for retailers to extend their networks and invest in their businesses. Also, growth in the real estate sector creates an important multiplier effect – as the real estate market develops, there’s a related rise in employment and real wage levels. For the sake of comparison to peers, the construction sector employs roughly 1% of the population in Brazil, versus 2.5% in Chile.

Investment Strengths – Integrated Business Model for Residential Homebuilders

Like the Mexicans, some Brazilian home builders operate under a fully integrated business model, from land acquisition to the sales and post-sales strategies, creating sustainability and high ROIC.

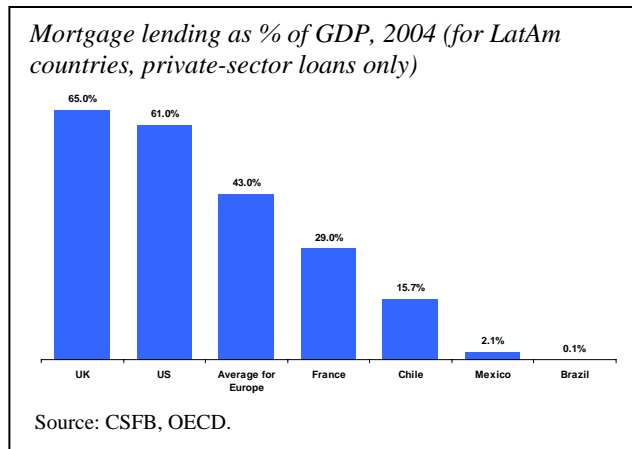
Brazil - Business Analysis - Investment Risks

Investment Risks – Nonexistent Mortgage Market

Mortgage markets are still not very developed in Latin America as a whole, and this is especially true in Brazil. After many years of economic and political instability, its mortgage market is practically non-existent given that mortgage loans represent only 0.1% of GDP (the ratio including channeled-lending requirements has been stable at 1.7% of GDP for the past two years). Based on Mexico’s experience,

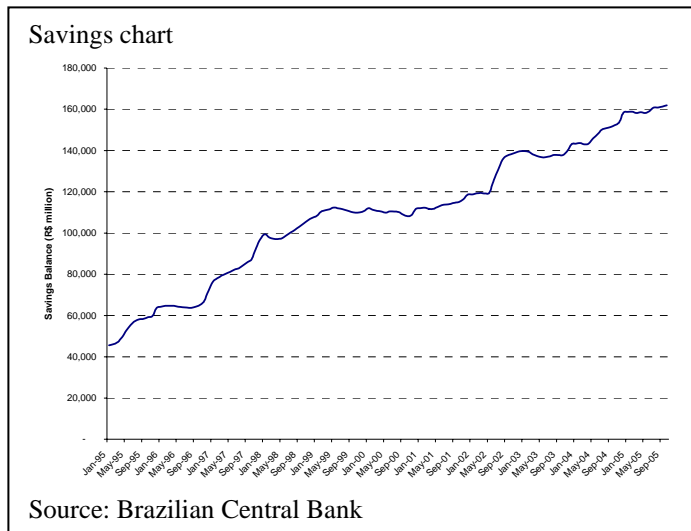
Brazil’s housing industry will not be able to flourish until the mortgage system is improved.

Given the low growth observed in savings deposits in Brazil over the last few years and the low



penetration of mortgage loans in the economy, it should not be surprising that there is high pent-up demand for long-term funding and real estate financing in Brazil.

The amount in *Poupança* (savings deposits for the general public) today represents the main source of private funding channeled to real estate financing. These accounts earn low rates, currently TR + 6% (or 9.5% annually). From 1999 to 2001 and again in 2005, the amounts invested in *Poupança* have not only been relatively flat in real terms, but have also lost their relative importance among other deposits in the banking system.²⁵



²⁵ Ana Carla Abrão Costa, “Mercado de Crédito: Uma Análise Econométrica dos Volumes de Crédito Total e Habitacional no Brasil”, Brazilian Central Bank of Brazil ISSN. 1519-1028, 2004, p. 11.

The lack of economic growth, record high interest rates, political and economic instability and other hindrances within the banking system have led Brazil to experience a decrease in mortgage lending over the past few years, as unmarked mortgage lending has shown a -22% real CAGR since 2001 and total mortgages have decreased by a real CAGR of -3% since 2003.

The government recently passed legislation to make mortgage lending more appealing to the banking industry. While the new legislation appears to have improved the foreclosure procedures for lending, it does not adequately address the cumbersome lending requirements currently imposed on the banking system.

The existing complex legislation is a result of well-intentioned public policies from 1964 (SFH) and 1997 (SFI), which aimed to provide cheap home financing for the low-income population. The funding for this system was designed to come from savings through a wage compulsory retention (FGTS) program and required savings accounts (*Poupança*). Private retail banks are penalized for not using such channel-funding towards mortgage financing, through a lower remuneration of their compulsory deposits at the Central Bank. This web of cross-subsidies and penalties needs to be simplified to allow a market-based system to flourish. The government should then grant separate incentives to the banks to ensure that lower income workers receive mortgages as well.²⁶

Investment Risks – Extremely High Short Term Interest Rates

Brazil has probably the highest real interest rate among all emerging market countries – an astonishing 13% expected for 2005. Lack of macroeconomic stability for an extended period of time has prevented Brazil from lowering this rate. Unfortunately this policy has prevented interest rates from falling below the 10% (nominal) threshold, which seems to have been the hurdle rate for sustainable growth in the housing sector in Mexico, Chile and Spain. Until that benchmark is achieved, rapid growth in the mortgage market is going to continue to be challenging.

Investment Risks – Political Risk and Recent Scandals

The government of the president, Luiz Inácio Lula da Silva, has been undermined by a corruption scandal and will face mounting political challenges as the October 2006 legislative and presidential elections approach. Opinion polls continue to suggest a high degree of uncertainty surrounding Mr da Silva's prospects of securing re-election for a second term.

Even though the election result is unlikely to have a major impact on economic policy, political turmoil may delay the approval of important pieces of legislation that are much needed to improve the regulatory framework of the home building industry. The congress recently approved Provisional Measure 255 (the so-called "MP do Bem"), which is now awaiting final presidential approval. It will promote a better guarantee for lenders, tax incentives for real estate borrowers, and exempted income tax on real estate receivables which will yield an extra 2% of revenues to the bottom line of construction companies.

Despite the controversy surrounding his government, Mr da Silva's has exhibited a practical approach toward the mortgage problem. This was exemplified by his government's approval of the Law 10.932/04, which granted mortgage lenders improved fiduciary guarantees, as well as Law 10.931/04, which has decreased the average time for asset foreclosure to 9 months.

Investment Risks – Longer-Term Macroeconomic Stability

While the near term outlook for Brazil is positive, as Moody's has recently upgraded the country's sovereign rating and the country risk has reached the lowest spread since the nineteenth century, Brazil's continuous growth and prosperity are far from assured. The last two months of GDP figures (Oct and Nov/2005) showed a strong deceleration of the economy towards the end of the year. A revaluation of the

²⁶ "Latin American Banks / Housing & Construction When will Brazilian mortgages grow as they do in Mexico and Chile?" Attuch, Roberto et al. Credit Suisse First Boston. August 26, 2005.

Brazilian Real versus the US dollar could also undermine the country's competitive position and take a toll on its exports. A strong influx of dollars into the economy throughout 2005 was the main reason for the 22% currency revaluation year-to-date.

The difficult economic situation in Brazil during the first half of the 1990s, when inflation and interest rates were high, led to almost a total disappearance of financing for residential properties. According to data from the Central Bank of Brazil, financing for residential buildings, through the *Sistema Financeiro de Habitação* (the Brazilian government's financing system for home purchases, or SFH), fell from an average of approximately 500,000 units per year during the early 1980s to an average of approximately 120,000 units per year by the late 1980s. In the first half of the 1990s, this average fell to 50,000 units a year²⁷.

Given the high public debt/GDP ratio, Brazil's fiscal policy needs to be tight, regardless of who wins the 2007 elections. The government will likely continue to hold firm to the target of 4.25% GDP growth for 2006, despite pressures for higher spending in infrastructure and social programs.

Brazil is also exposed to the risks of an international capital markets crisis similar to the 1997/1998 meltdown given its history with prolonged periods of hyper-inflation. A similar event could push the country toward a new round of devaluation, recession and inflation.

Investment Risks – Weak Regulatory Framework

The development and construction of residential projects are subject to numerous federal laws, norms and regulations including state and municipal zoning rules, consumer protections and government measures relating to sales on credit. The regulations can especially slow new construction and interfere with credit policy. Also, the main obstacles to the system are not only in the legal framework, but also in the application of the law by Judges.

Brazil - Specific Investment Ideas

In order to identify potential investment opportunities for the anticipated real estate market boom for lower- and middle-income housing in Brazil, we have analyzed the whole value-chain of homebuilding which includes, but is not limited to:

- Residential Construction
- Basic & Fabricated Materials (namely Steel Products)**
- Non Metallic Minerals (namely Clay and Refractory Manufacturing)**
- Other Industries (Fixtures, and Wood Products)**
- Real Estate Financing & Mortgage*

Most of the players surveyed were private/family-owned companies while only a small number are publicly traded. Our filter for potential public stock ideas included (i) stock liquidity - as measured per average trading volume, (ii) free float – as % of stock in circulation, and (iii) company size - as per its revenues level. We only analyzed one private company (Gafisa), as we expect its IPO in the near future.

²⁷ "Latin American Banks / Housing & Construction When will Brazilian mortgages grow as they do in Mexico and Chile?" Attuch, Roberto et al. Credit Suisse First Boston. August 26, 2005.

| Company Name | Economic Sector | Market Cap (US\$ mm) | 9m'05 Sales (US\$ mm) | Gross Margin % | Profit | ROE % | P/E x |
|------------------|---|-------------------------|--------------------------|-------------------|--------|----------|----------|
| Belgo Mineira ON | Steel Product Manufacturing | 7,609 | 3,488 | 39.1 | 21.8 | 17.5 | 4.3 |
| Gerdau Met ON | Steel Product Manufacturing | 2,285 | 7,362 | 27.9 | 6.5 | 37 | 3.7 |
| Cyrela Realt ON | Residential Building Construction | 1,815 | 255 | 48.1 | 19.1 | 12.1 | 29 |
| Gafisa PN | Residential Building Construction | n/a | 146 | 29.0 | 6.0 | 6.4 | n/a |
| Rossi Resid ON | Residential Building Construction | 322 | 131 | 28.9 | 4.7 | 6.5 | 37.6 |
| Portobello PN | Clay Product and Refractory Manufacturing | 94 | 152 | 30.4 | -3.5 | -36.1 | -13.8 |
| Eternit ON | Roofing Tiles and Non Metallic Mineral Mfcg | 104 | 119 | 44.8 | 8.3 | 12.6 | 7.8 |
| Duratex PN | Wood Product and Fixtures Manufacturing | 687 | 423 | 41.6 | 11.1 | 13.4 | 11 |

Source: Economatica

* Real Estate Financing sector - We are not comfortable recommending any of the Brazilian banks based solely on our growth assumptions for the mortgage market. Currently mortgage volume is extremely low (0.1% of GDP) with no player controlling a disproportionate share of the market. We expect the large local banks to be the leading mortgage players in the long term since foreign penetration of the sector is low (17%) (This is a sharp contrast to Mexico, which has 84% foreign ownership of its banking industry.). As further consolidation of the banking system erodes high margins for traditional products and removes the smaller niche players, the largest players (Caixa, Bradesco, Itaú, Unibanco, Santander and ABN Real) will focus on dominating the mortgage market. The consensus among the largest players in Brazil is that the mortgage market should begin to grow as it has in Mexico and Chile within the next 3-5 years.

** As for the other remaining industries associated with home building, there are certainly attractive investment opportunities in these sectors. However, as with the banking sector, the pending Brazilian housing boom does not represent a large enough opportunity for these companies in the near-term. We have therefore decided not to make any recommendations in these industries and instead will focus on the home builders.

Financial Analysis

Given the broad scope of this memo, we will rely on a Multiples analysis as well as a comparison of operating metrics including returns on capital and equity and free cash flow yields to analyze the various investment opportunities. While we would prefer to create full-blown operating models and DCF analyses to further investigate our recommendations, but we will save this for a follow-up analysis. We recognize that using a Multiples analysis has some shortcomings that a DCF approach would better address.

For our Multiple Analysis, we have focused on P/E over EV/EBITDA for peer comparisons. We believe this makes sense because of differences in approaches to borrowing between the Mexican and Brazilian companies as well as because of the lower tax rate for CBR.²⁸ Also, below are some operating comparisons of the Brazilian and Mexican builders, which we will refer to in our company analysis below.

²⁸ Telles, Marcelo et al. CSFB report, "Cyrela Brazil Realty: Initiating Coverage", November 2005.

Residential Building Construction



Cyrela Brazil Realty ON (Ticker: CYRE3/CBR)

Company Description

CBR is a leading home builder in Brazil's two most important and prosperous markets, São Paulo and Rio de Janeiro. It is mainly involved in the construction of luxury residential apartments in attractive locations for upper and upper-middle income customers (92% of total 2005E revenues). CBR also develops, leases and sells high-tech and luxury office buildings, and, to a lesser extent, leases and manages shopping centers. In addition, CBR has begun to develop "large residential communities for middle-income customers"²⁹,

As a result of its follow-on equity offering in September 2005, CBR's controlling shareholder, Mr. Elie Horn, reduced his stake in the company from 90.4% to 52.2%. Also, CBR's market cap reached US\$1.8 billion as its share price soared from R\$15 to R\$27.

Overall, we like the company's business model and believe it will be a major beneficiary of the coming middle class housing boom. While it trades at a P/E higher than its Mexican peers, we believe CBR is an attractive BUY due to both its strong base business serving the upper end of the housing market and the implied call option available to investors from CBR's eventual participation in the middle income housing sector.

*Investment Rationale*³⁰

- i. Integrated Business Model: Like the Mexican builders, CBR's business includes all steps from executing land acquisitions, to constructing homes, to carrying out both the sales and post-sales efforts. This strategy allows it realize economies of scale and production improvements due to efficient communication throughout its organization.
- ii. Higher-Margin Segments: CBR's focus on higher priced housing has allowed it to consistently earn high margins.
- iii. Middle-income housing starting to gain traction: Around 70% of the company's projects are going to be targeted towards the middle-income sector, and the company "plans to launch 5 middle-income projects between May-06 and Mar-07."³¹
- iv. Top Brand: CBR is "recognized for quality construction."³²
- v. Market Leader: While the housing sector in Brazil like Mexico is fragmented, CBR has leading positions in its two markets -- 5.6% in São Paulo and 24.1% in Rio de Janeiro.
- vi. Efficient Use of Capital: CBR uses creative ways of buying land (such as paying for land with apartments instead of cash) and JV's (given its strong brand) to conserve its capital. Also, CBR's own successful real estate agency has increased the percentage of pre-sold units from 45.5% in 2003 to 61.7% in 2004 further improving capital utilization.
- vii. Highest Levels of Corporate Governance: "By abiding to the "Novo Mercado" regulations, minority shareholders are provided with a high degree of protection, including: (1) only one class of shares with full voting rights and 100% tag-along protection; (2) minimum free float requirement of 25%; and (3) a market arbitration panel to help solve corporate disputes."³³
- viii. Liquidity: CBR is currently the only listed real estate company with sizeable liquidity and market float in Brazil.

²⁹ Ibid.

³⁰ Ibid.

³¹ Ibid.

³² Ibid.

³³ Ibid.

Financial Analysis

| Company (US\$ mm) | Shares Out. | Price Local | FX Rate | Share Price | Market Cap. | Net Debt | EV |
|----------------------|----------------|----------------|------------|----------------|----------------|----------|-------|
| CBR | 148,712 | \$ 27.12 | 2.25 | \$ 12.04 | 1,791 | (163) | 1,628 |
| ROSSI | 386,815 | \$ 1.85 | 2.25 | \$ 0.82 | 317 | 54 | 371 |
| SARE | 382,905 | \$ 10.74 | 10.54 | \$ 1.02 | 390 | 19 | 409 |
| HOMEX | 335,870 | \$ 52.65 | 10.54 | \$ 5.00 | 1,678 | 218 | 1,896 |
| GEO | 532,692 | \$ 36.06 | 10.54 | \$ 3.42 | 1,822 | 136 | 1,958 |
| URBI | 298,590 | \$ 72.25 | 10.54 | \$ 6.86 | 2,047 | 54 | 2,101 |
| ARA | 328,212 | \$ 43.92 | 10.54 | \$ 4.17 | 1,368 | (98) | 1,270 |

* Trading data as of Dec-08-2005

| Company | ROE | | | P/E | | | FCF/EV | | | ROIC | | |
|---------|-------|-------|-------|-------|-------|-------|--------|-------|-------|-------|-------|-------|
| | 2005E | 2006E | 2007E | 2005E | 2006E | 2007E | 2005E | 2006E | 2007E | 2005E | 2006E | 2007E |
| CBR | 16.6% | 24.6% | 25.0% | 33.9 | 15.2 | 12.7 | 1.0% | -2.9% | 3.1% | 27.6% | 30.8% | 32.3% |
| ROSSI | 12.5% | 16.5% | N/A | 20.6 | 13.7 | N/A | 4.8% | 4.9% | N/A | 9.1% | 12.5% | N/A |
| SARE | 14.7% | 13.4% | 13.7% | 14.7 | 11.2 | 9.3 | 0.0% | 0.9% | 0.1% | N/A | N/A | N/A |
| HOMEX | 18.9% | 20.7% | N/A | 16.8 | 12.5 | 9.4 | N/A | N/A | N/A | 27.7% | 21.8% | N/A |
| GEO | 22.8% | 22.8% | 20.1% | 19.9 | 15.8 | 13.0 | 1.3% | 1.9% | 1.6% | 25.5% | 23.9% | N/A |
| URBI | 21.0% | 20.2% | 19.9% | 18.2 | 14.2 | 12.2 | 2.1% | 2.2% | 5.1% | 21.2% | 22.3% | N/A |
| ARA | 16.7% | 15.9% | 14.5% | 13.0 | 11.0 | 10.4 | 1.2% | 2.8% | 5.1% | 17.6% | 17.6% | N/A |
| Avg Mex | 18.8% | 18.6% | 17.0% | 16.5 | 12.9 | 10.9 | 1.2% | 2.0% | 3.0% | 23.0% | 19.5% | N/A |

* Source: I/B/E/S Analyst's Earnings Estimates, CSFB report, Bloomberg, Economica, Fator Corretora

- i. **ROE:** CBR has an estimated ROE for 2006 and 2007 around 600 to 800 basis-points higher than its Mexican peers.
- ii. **P/E:** Given a recent rally in CBR's stock price coupled with a strengthening of the Brazilian currency, CBR is trading at a higher P/E than its Mexican peers (15.2 vs. 12.9 for 2006E and 12.7 vs. 10.9 for 2007E).
- iii. CBR has a superior ROIC compared to its peers of 470 basis-points for 2005E and an astonishing 1140 basis-points in 2006E.

Investment Risks³⁴

- i. **Fragmented Market:** The large number of players in the housing market suggests a highly competitive landscape. "In Sao Paulo, 10 players account for only 22% of the market."³⁵
- ii. **Foreign Threat:** The high returns being earned by Brazilian builders may invite additional foreign competition. This has already occurred to some degree with the entry of commercial real estate companies such as Tischman in the residential market in Sao Paulo (luxury and upper-middle segments).
- iii. **Land Availability:** "Increasingly limited availability of land in prime areas"³⁶ will likely cause land prices to rise.
- iv. **Lack of Geographic Diversification:** CBR is only in two markets (São Paulo and Rio de Janeiro). It is therefore completely dependent on the movements of these property markets.

³⁴ Ibid.

³⁵ Ibid.

³⁶ Ibid.



Gafisa ON

Company Description

Gafisa is one of the largest real estate companies in Brazil (\$198 million 2005E sales) with operations in construction and development mainly for the middle- and upper-income sectors in São Paulo and Rio de Janeiro. The company also offers services to third parties, a segment in which it has reported significant growth in the past two years. Gafisa is a private company controlled by GP Investimentos (63% ownership) and by Equity International Partners (EIP) (32% ownership)³⁷ Founded by Sam Zell in 1999, EIP has significant operations in developing markets, and is the most active investor in the Mexican market with 5 companies in its portfolio including Homex, listed on the NYSE. We expect Gafisa to list its share in the Bovespa – the São Paulo Stock Exchange sometime in 2006.³⁸

Investment Rationale

- i. Integrated Business Model
- ii. Successful Shareholding Restructuring: In 2004 Gafisa underwent a major financial and corporate restructuring process, due to the financial problems of one of its shareholders (CIMOB Companhia Imobiliária). The Company is now relying on the guidance of its new controlling shareholder, GP Investimentos, as well as on its new CEO.³⁹ Gafisa repurchased all of Cimob’s shares and no longer is negatively impacted by its previous association with this group.⁴⁰
- iii. Top Brand: The Company is well recognized for quality construction, and ranked 1st and 3rd in a listing of the most admired construction companies in Brazil in 2003 and 2004 respectively. This is particularly helpful in negotiating land deals with sellers who accept payment in apartments for their property.

Financial Analysis

A complete financial analysis of the company is constrained by the fact that Gafisa is privately-owned. Therefore we have limited our analysis to historical financial highlights.

The one valuation metric we do have is from EIP investment. EIP acquired a 32.2% stake in the company for a mere R\$134 million, valuing the company at US\$ 220 million (1.1x ‘05E sales or 6.9x ‘05E EBITDA), which is a very attractive price for Gafisa in comparison to Rossi (valued at 3.1x ‘05E Sales or 18.6x ‘05E EBITDA).

| US\$ MM | 2005E | 2004 | 2003 | 2002 |
|----------------------|-------|------|------|------|
| Net Revenue | 198 | 160 | 144 | 118 |
| EBITDA | 32 | 23 | 27 | 22 |
| <i>EBITDA Margin</i> | 16% | 14% | 19% | 19% |
| Net Debt | 12 | 40 | 55 | 20 |
| Shareholder's Equity | 156 | 68 | 55 | 38 |
| Net Debt / Equity | 7% | 59% | 101% | 53% |
| Net Income | 8 | 7 | 17 | 15 |
| <i>Net Margin</i> | 4% | 4% | 12% | 12% |

³⁷ “Standard & Poor’s assigns ‘brBBB’ National Scale rating to Gafisa S.A.,” The McGraw Hill Companies press release, July 19, 2005.

³⁸ Based on conversation with GP Investimentos.

³⁹ “Gafisa Reaches R\$ 2.8 million Net Income and R\$ 0.10 EPS in 2Q05,” Gafisa press release (São Paulo,Brazil, August, 2005).

⁴⁰ “Fitch Upgrades Ratings of Gafisa,” Fitch Ratings press release No. 338 (New York,NY, July 20, 2005).

Investment Risks

- i. Cash Flow in 2006/07: Despite being profitable, working capital pressures will be challenging for the company in 2006/2007 as its required increasing cash outflows to buy land (since its land bank has been depleted since 2004) will not be adequately balanced by cash inflows from revenues.⁴¹
- ii. Indebtedness: Additional short-term debt will be required to meet cash shortfalls in the 2006/07 period.⁴²
- iii. Land Availability: Given its short term financial pressure over the last 3 years, Gafisa halted additions to its land bank. Because of increasingly limited land in prime areas, its COGS will increase when it replenishes its reserves going forward.
- iv. Lack of Geographic Diversification: Like CBR, Gafisa is present only in two markets (São Paulo and Rio de Janeiro), which increases operational risk;



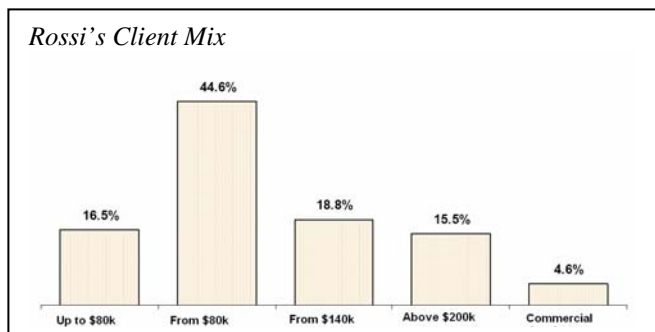
Rossi Residencial ON (Ticker: RSID3 / RSR2Y)

Company Description

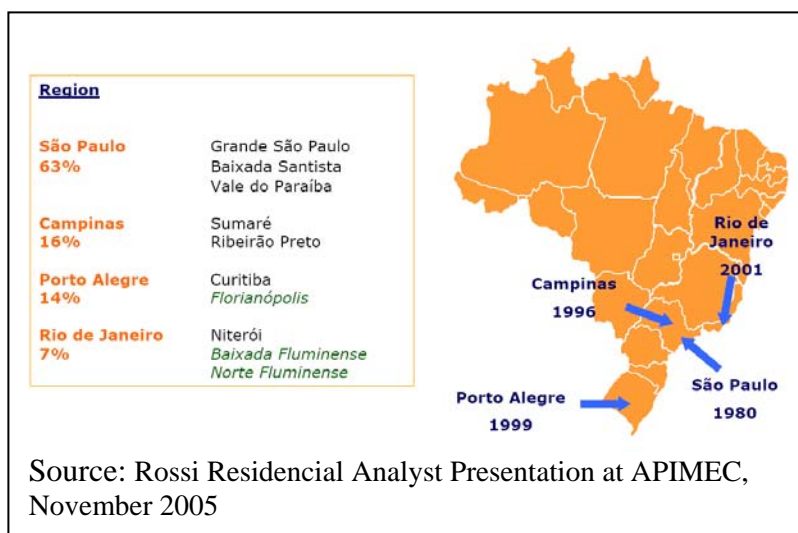
Rossi is a small-cap family-owned residential developer focused on lower- and middle-income class customers, with \$165 million 2005E sales and \$317 million market capitalization. The company is the third largest residential developer in Sao Paulo, which is the largest and most competitive Real Estate market in Brazil. The Rossi Group controls 91.5% of Rossi Residencial's common shares, and has significant influence in Brazil's construction and engineering sector.

Investment Rationale

- i. Pure-Play in Middle-Income Housing: Rossi is the only public home building company that serves the lower end of the housing spectrum. The Company has developed an expertise in managing the financing and collection of lower income clients. It also has developed a successful concept of horizontal condominiums (with lower construction cost and timing to completion) in planned communities.



- ii. Integrated Business Model: Rossi is similar to its Mexican peers in its approach to serving the lower end customer.
- iii. Geographical Diversification:⁴³ Contrary to CBR, Rossi has a highly diversified presence in Brazil with a strategy of acquiring land where urban centers are likely to expand. Despite the fact that São Paulo represents 63% of its sales, a large portion of it occurs in



Source: Rossi Residencial Analyst Presentation at APIMEC, November 2005

⁴¹ "Standard & Poor's assigns 'brBBB' National Scale rating to Gafisa S.A.," The McGraw Hill Companies press release, July 19, 2005.

⁴² Ibid.

⁴³ Rossi Residencial Analyst Presentation at APIMEC, November 2005

satellite cities such as Guarujá, Campinas, and Jacareí.

- iv. Land Bank: Rossi has 28 large properties in stock (average 465,000 sqft), an equivalent to three years of current sales spread among São Paulo, Rio de Janeiro, Campinas and Porto Alegre.
- v. Upside Potential: In case of continuous loosening of interest rates and reduced inflation in Brazil, Rossi is well-positioned to capture the best opportunities in the lower-end of the market.

Financial Analysis

| Company | Shares | Price | FX | Share | Market | Net Debt | EV |
|--------------|----------------|----------------|-------------|----------------|------------|-----------|------------|
| (US\$ mm) | Out. | Local | Rate | Price | Cap. | | |
| CBR | 148,712 | \$ 27.12 | 2.25 | \$ 12.04 | 1,791 | (163) | 1,628 |
| ROSSI | 386,815 | \$ 1.85 | 2.25 | \$ 0.82 | 317 | 54 | 371 |
| SARE | 382,905 | \$ 10.74 | 10.54 | \$ 1.02 | 390 | 19 | 409 |
| HOMEX | 335,870 | \$ 52.65 | 10.54 | \$ 5.00 | 1,678 | 218 | 1,896 |
| GEO | 532,692 | \$ 36.06 | 10.54 | \$ 3.42 | 1,822 | 136 | 1,958 |
| URBI | 298,590 | \$ 72.25 | 10.54 | \$ 6.86 | 2,047 | 54 | 2,101 |
| ARA | 328,212 | \$ 43.92 | 10.54 | \$ 4.17 | 1,368 | (98) | 1,270 |

* Trading data as of Dec-08-2005

| Company | ROE | | | P/E | | | FCF/EV | | | ROIC | | |
|----------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|------------|
| | 2005E | 2006E | 2007E | 2005E | 2006E | 2007E | 2005E | 2006E | 2007E | 2005E | 2006E | 2007E |
| CBR | 16.6% | 24.6% | 25.0% | 33.9 | 15.2 | 12.7 | 1.0% | -2.9% | 3.1% | 27.6% | 30.8% | 32.3% |
| ROSSI | 12.5% | 16.5% | N/A | 20.6 | 13.7 | N/A | 4.8% | 4.9% | N/A | 9.1% | 12.5% | N/A |
| SARE | 14.7% | 13.4% | 13.7% | 14.7 | 11.2 | 9.3 | 0.0% | 0.9% | 0.1% | N/A | N/A | N/A |
| HOMEX | 18.9% | 20.7% | N/A | 16.8 | 12.5 | 9.4 | N/A | N/A | N/A | 27.7% | 21.8% | N/A |
| GEO | 22.8% | 22.8% | 20.1% | 19.9 | 15.8 | 13.0 | 1.3% | 1.9% | 1.6% | 25.5% | 23.9% | N/A |
| URBI | 21.0% | 20.2% | 19.9% | 18.2 | 14.2 | 12.2 | 2.1% | 2.2% | 5.1% | 21.2% | 22.3% | N/A |
| ARA | 16.7% | 15.9% | 14.5% | 13.0 | 11.0 | 10.4 | 1.2% | 2.8% | 5.1% | 17.6% | 17.6% | N/A |
| Avg Mex | 18.8% | 18.6% | 17.0% | 16.5 | 12.9 | 10.9 | 1.2% | 2.0% | 3.0% | 23.0% | 19.5% | N/A |

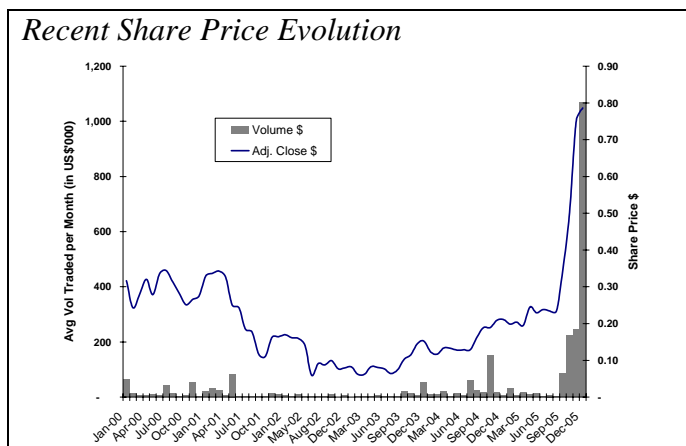
* Source: I/B/E/S Analyst's Earnings Estimates, CSFB report, Bloomberg, Economica, Fator Corretora

Rossi is still a small-cap with slim earnings, after many years of negative results and still incipient cash flow stream. Its P/E, ROE and ROIC demonstrate that its growth will be substantial over the next couple of years. Its share price has increased dramatically in the recent past although based on thin trading volumes.

Given the recent spike in share price and limited free float, we believe Rossi is a HOLD at this point.

Investment Risks

- i. Fragmented Market: To a lesser extent than CBR, Rossi is also exposed to a very competitive market. Rossi is shielded from incoming foreign competition, which is more focused on luxury clients and AAA commercial buildings.⁴⁴



⁴⁴ Rossi Residencial Equity Offering Prospectus, February 2003

- ii. Illiquid stock: As seen in the price evolution chart, a small capital inflow has a strong effect in the share price given very thin trading (US\$1 million/per month in Dec'05). The Rossi family controls 91.5% of the common stock;
- iii. Family-Owned Business: The Rossi Group is currently in its 4th generation and both management and Board are populated by family members, without significant outsiders;
- iv. Higher Idiosyncratic Risk: Given the fewer number of projects undertaken simultaneously, an individual project failure may result in an important loss to the company overall. As a developer, Rossi has a contractual right to quit a specific project 180 days prior to construction, and the company's strategy is to exercise such option in case that pre-sale of units does not achieve a 60% threshold.
- v. Limited Controlling Shareholder Access to Capital: As a private entity, The Rossi Group has limited access to funds, which may at times slow down the growth rate of Rossi in order to avoid dilution of its stake.⁴⁵
- vi. Higher Leverage than its Peers: Rossi has 17.0% debt / Mkt. Cap. vs. 4.2% for its Mexican peers and a net cash position for CBR. Given the high interest rates in Brazil, interest burden eats up most of its unlevered free cash flow;

China - Business Analysis - Investment Thesis

Investment Strength – Compelling Demand

Legal System Reforms

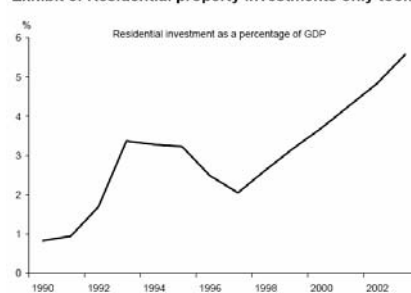
The growth of the housing sector in China has resulted from a combination of property market reforms, the expansion of the middle class, and the increasing urbanization of the population.⁴⁶ After China's reentry into the global economy in 1978, a limited private market for housing began to develop.

As in the case with Mexico, new government policies were necessary to push the market forward. The first substantive reforms of the housing sector took place in 1992 when the government started encouraging private citizens to purchase their own dwellings and also established provident housing funds to help workers save for this expense. Major restructuring of the sector, however, did not take place until the 1998 reforms, which accelerated the privatization of the housing sector and ended the practice of the state providing housing for workers. In addition, the government eased its requirements on mortgage lending, which gave a further boost to the private purchases of homes.⁴⁷ As illustrated by the graph to the right, investment in residential property has grown dramatically since this time.

Economic Growth and the Rise of the Middle Class

While policy reform was critical to creating a private housing market and the demand for home ownership, the growth of the housing sector has also been driven by the growth of the economy and the increasing wealth of the population. China's middle class, as defined by the World Bank's US\$3,000 income threshold, is expected to multiply to ten times its current size over the next decade.⁴⁸ In addition, this growing segment of the population is demanding improved living conditions as evidenced by the growth in the size of average dwellings. Also, as in Mexico's case, the Ministry of Construction believes upgrades are needed for two-thirds of current housing, which will create additional demand.⁴⁹

Exhibit 5: Residential property investments only took off in 1998



Source: CEIC, Goldman Sachs Research estimates.

⁴⁵ Rossi Residencial Equity Offering Prospectus, February 2003

⁴⁶ Liang, Hong and Ma, Ning. *China's Property Market: Fallacies of an Imminent Bubble Burst*. Goldman Sachs. December 10, 2004.

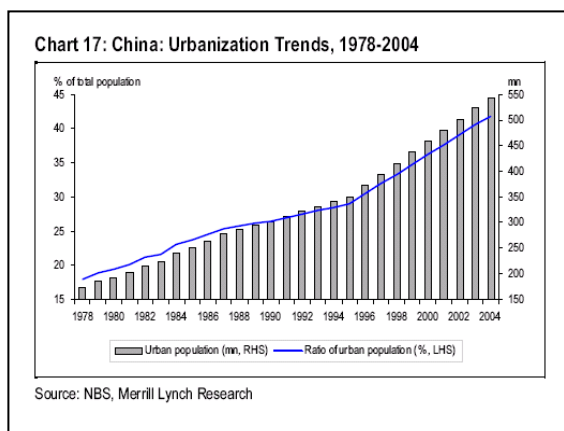
⁴⁷ "Housing's great leap forward" Sep 28th 2000 The Economist

⁴⁸ 13D Research, Inc. The Ultimate Contagion.

⁴⁹ "China's Housing Market: Rebounding Again?" Zheng, Joan et al. Merrill Lynch. November 24, 2005.

Urbanization

Beyond the expanding wealth of the population, growth in the housing sector has also been fueled by rural to urban migration as the population has moved toward the available economic opportunities. In comparison with its more industrialized neighbors (Japan, Korea and Malaysia have urban populations accounting for 66%, 81% and 65%), China's cities at 42% have the potential for continued development. However, this will be mitigated by the government's focus on improving living conditions in the rural communities.⁵⁰



below for sales growth). As with the case for Mexico, the fundamentals point towards continued secular growth, although at a slower pace than in the past.

Investment Strength – Mortgage System

The mortgage system in China is highly regulated by the government, but has experienced tremendous growth since mortgages were introduced in 1998. The official lending rate is below the critical 10% threshold that has been cited as an important barrier for rapid adoption of mortgages in Mexico and other emerging markets.⁵³ Some additional flexibility was added to the system this year when the

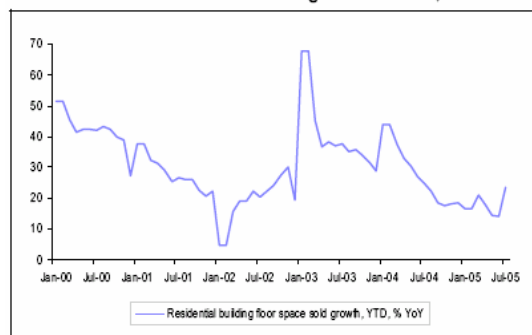
People's Bank of China allowed banks to discount mortgages from a base rate of 6.12% depending on the credit worthiness of their customers. This change should help introduce more rationality into the system, although its impact will be limited given that the discount can only be 10% below the official rate.⁵⁴ China's mortgage portfolios also have better asset quality than the overall loan books of most banks.⁵⁵ This makes mortgages more attractive for the banks further fueling their supply. While the Chinese mortgage system is certainly not as advanced as the Mexican system, it has successfully fueled housing growth to date, and the opportunities for future reform offer additional upside for the housing sector.

Investment Strength – Barriers to Entry Favor Large Builders

Like the Mexican market, the Chinese home building industry is extremely fragmented with the largest participants controlling only 5-8% of the market. Regulatory changes implemented over the last

There are some countervailing forces to this otherwise strong demand. The rapid growth that the housing market experience between early 2002 and early 2004, appears to have subsided as a large amount of pent up desire for housing was released during this period. Volumes still remain high, but the sector's growth rate has declined.⁵¹ Additionally, the young-dependency ratio (ratio of population under 15 years old to total population) has fallen sharply due to the impact of the one-child policy, and the formation of urban households has also slowed.⁵² These trends suggest reduced demand growth for housing, but the desire for better living conditions along with the other factors mentioned will continue to fuel demand (see graph

Chart 28: China: Residential Building Sales Growth, 2000-05



⁵⁰ Zheng, Joan et al. *China's Housing Market: Rebounding Again?* Merrill Lynch. November 24, 2005.

⁵¹ Ibid.

⁵² Merrill Lynch. *Don't Count Too Much on China's Consumption*. 30 September 2005.

⁵³ Attuch, Roberto et al. *Latin American Banks / Housing & Construction When will Brazilian mortgages grow as they do in Mexico and Chile?* Credit Suisse First Boston. August 26, 2005.

⁵⁴ Ma, Ning et al. *China: Banks. PBoC raised mortgage rates and reduced excess reserve rates; generally neutral for banks but negative for Hua Xia (U)* Goldman Sachs. March 17, 2005.

⁵⁵ Minyan Liu et al. *Mortgages in Focus* Morgan Stanley. March 15, 2005.

few years, however, now favor the larger builders. The main policy changes involved (a) requiring land sales to be more transparent, resulting in higher but fairer pricing and (b) increasing the capital requirements for developers.⁵⁶ With the balance of power in the industry shifting toward larger, well-capitalized builders, the industry is positioned for market share gains and further consolidation by the larger players.

Additionally, the Chinese builders share many of the benefits of the integrated delivery model of the Mexican builders realizing economies of scale and efficiently utilizing their asset base.

Investment Strength – Exchange Rate

Because of China's trade surplus and the government's monetary policy of pegging the RMB to a basket of currencies, there is widespread belief that China's currency would appreciate if its government allowed it to float freely. When the government recently changed its exchange rate policy from a fixed exchange rate with the US dollar to a fixed exchange rate with a group of currencies, the RMB appreciated, although only by two percent. The Economist Intelligence Unit and many investors believe the Chinese government will appreciate the RMB gradually, which provides US investors with protection for their investments in China as well as a potential separate source of upside.⁵⁷

China – Business Analysis - Investment Risks

Investment Risks – Political Interference & Stock Price Volatility

The home building sectors in Mexico and China are subject a variety of regulations, but the Chinese government is much more likely to interfere with the industry on an ongoing basis. While this intervention has been helpful at times, such as the encouragement of the introduction of mortgages in the late 1990s, it offers cause for concern as well. Most recently, the government introduced measures to prevent speculation, particularly in the Shanghai market. This effort appears to have been effective, but it also spooked the equity markets causing the stocks of the home builders to fall nearly 25%. The markets have since recovered, but concern over future government action remains.⁵⁸

Separately, a Supreme Court decision earlier this year has called into question whether mortgages are fully secured by collateral when it ruled that primary homes cannot be seized if they are necessary to the life of the borrower. The ruling in itself is vague, but it is also only likely to impact a small number of cases given the high quality of many mortgage portfolios. Still this is another example of government interference, and this ruling may slow the growth of the mortgage industry.⁵⁹

Investment Risks – Risks to Economic Growth

Housing markets are tied to the strength of the consumer, which is in turn dependent on the strength and stability of the economy. Continued macroeconomic stability for China, like Mexico, is important for the growth of this sector. China has demonstrated remarkably rapid real GDP growth of 9.4% since 1978, and this has certainly contributed to the impressive growth of the housing industry. Yet sustaining this growth is not guaranteed. To do so, China must continue to make important and difficult reforms while preserving an orderly political environment. While the Goldman Sachs team who developed the BRICs concept remains bullish on the outlook for China, the Economist Intelligence Unit is predicting a modest decline in China's growth rate as the RMB appreciates and export-led growth slows.^{60,61} While the Chinese government has shown a willingness to maintain pro-growth policies, a hard landing scenario for the Chinese economy would damage the housing sector as well. Without

⁵⁶ Merrill Lynch. *Don't Count Too Much on China's Consumption*. 30 September 2005.

⁵⁷ The Economist Intelligence Unit. *Country Report: China*. December 2005.

⁵⁸ Kenny Tse et al. *Short-term Panic or Long-term Carnage?* Morgan Stanley. March 17, 2005.

⁵⁹ Minyan Liu et al. *Mortgages in Focus* Morgan Stanley. March 15, 2005.

⁶⁰ The Economist Intelligence Unit. *Country Report: China*. December 2005.

⁶¹ Jim O'Neill et al. *Global Economics Weekly: China's Ascent: Can the Middle Kingdom Meet Its Dreams?* Goldman Sachs. November 16, 2005.

allowing market forces to equilibrate the housing market, the government may encounter a scenario that it is not able to successfully resolve through intervention.⁶²

Investment Risks – Prices

Property speculation in Shanghai reached an alarming level causing the government to intervene by implementing anti-speculative measures. The intervention had a dramatic impact sending prices down 22% quarter over quarter and with a negative impact on volumes as well. The effect on Shanghai focused luxury builders has been very noticeable. Most other cities, however, were not facing this same speculation and have continued to experience house price growth. Builders who have operations spread across the country have a natural hedge against exposure to regional price movements.

Investment Risks – Stock Price Volatility

With multiple housing related companies going public in the last few months, the sector has received a lot of attention and valuations have increased substantially. A recent IPO of the builder Agile attracted demand of 44x the size of the offering or US\$18Bn including a retail portion that was 240x oversubscribed. Also, many of shares of the large builders have rallied including a 36% and 133% gains for Vanke and China Overseas Land since July.⁶³ The large retail interest may be a result of the government's anti-speculation measures making direct real estate investment, which was popular amongst foreigners, more difficult. If this is the case, these investors may be looking for a quick profit and cause the stocks in the industry to face continued volatility.

Valuation

The table on the next page provides an overview of the Chinese home builder universe comparing the companies on valuation and operating metrics. While we would like to build detailed DCF analyses for the next stage of our analysis, the net asset value (NAV) figure is very similar to a DCF calculation providing an aggregate per share value of the outstanding projects of each company. Although some analysts contend that the builders should trade at a discount to the NAV, it seems to us however that the builders should trade in line with this figure assuming an appropriate discount rate was used for the NAV calculation. We therefore view discount to NAV as one metric of identifying attractive investment opportunities.

Additionally, we believe return on equity and return on capital employed provide important measures of the companies' profitability and ability to utilize their assets. We also view P/E multiples as a useful tool to triangulate around value. There is one important shortcoming of P/E multiples and ROE/ROCE analyses that has to do with the large land banks of some of the builders. These assets have values unto themselves, but may not contribute to near-term profits until they are developed. Ideally, a DCF analysis would address this issue by providing a present value of the land bank in combination with the present value of the future cash flow from the currently utilized asset base.

⁶² Liang, Hong and Ma, Ning. *China's Property Market: Fallacies of an Imminent Bubble Burst*. Goldman Sachs. December 10, 2004.

⁶³ Reuters. *China's Agile Property \$404 mln IPO price at top*. December 9 2005.

Chinese Home Builders

In HK Dollars

| | Share price | Mkt cap | Net | TEV | NAV | | Discount to NAV | | EPS | | | P/E | | As % of | | | | |
|-----------------------------------|---------------|---------------|----------------|--------------------|-------------------|-----------------------|-----------------------------|--------------|--------------|--------------|----------------|--------------|--------------|--------------|--------------|--------------|-------------|------------|
| | 12/9/2005 | US\$MM | Debt | US\$MM | From JPM | From MS(1) | From JPM | From MS(1) | FY05E | FY06E | FY07E | FY05E | FY06E | FY07E | TEV/EBITDA | TEV/EBIT | 52-wk Low | 52-wk High |
| Valuation Metrics | | | | | | | | | | | | | | | | | | |
| National Builders | | | | | | | | | | | | | | | | | | |
| China Overseas Land | 3.35 | 2,761 | 559 | 3,320 | 3.01 | 2.93 | 11% | 14% | 0.18 | 0.27 | 0.38 | 18.6x | 12.4x | 8.8x | 14.2x | 15.8x | 250% | 97% |
| China Vanke (CH) | 4.61 | 2,028 | 280 | 2,308 | 5.14 | 6.22 | -10% | -26% | 0.35 | 0.43 | 0.55 | 13.2x | 10.7x | 8.4x | 9.7x | 9.9x | 155% | 77% |
| New World China Land | 3.85 | 1,872 | (128) | 1,744 | 5.80 | | -34% | | 0.11 | 0.07 | 0.07 | 35.0x | 55.0x | 55.0x | 51.2x | 52.0x | 173% | 99% |
| Beijing Focused Builders | | | | | | | | | | | | | | | | | | |
| Beijing Capital Land | 2.30 | 201 | 440 | 641 | 3.39 | 3.24 | -32% | -29% | 0.16 | 0.14 | 0.42 | 14.4x | 16.4x | 5.5x | 12.0x | 12.7x | 145% | 85% |
| China Resources Land | 3.15 | 613 | 392 | 1,005 | 3.66 | 4.15 | -14% | -24% | 0.19 | 0.22 | 0.39 | 16.6x | 14.3x | 8.1x | 19.9x | 21.0x | 281% | 97% |
| Guangzhou Focused Builders | | | | | | | | | | | | | | | | | | |
| Guangzhou R&F Properties | 27.00 | 2,657 | 309 | 2,966 | 30.66 | 23.76 | -12% | 14% | 1.85 | 3.35 | 4.34 | 14.6x | 8.1x | 6.2x | NA | 17.9x | 250% | 97% |
| Hopson Development | 9.80 | 1,522 | 474 | 1,996 | 12.78 | 15.55 | -23% | -37% | 1.26 | 1.35 | 1.55 | 7.8x | 7.3x | 6.3x | 11.6x | 11.9x | 445% | 85% |
| Shanghai Focused Builders | | | | | | | | | | | | | | | | | | |
| Shanghai Forte | 2.92 | 332 | 95 | 426 | 3.53 | 4.11 | -17% | -29% | 0.30 | 0.35 | 0.43 | 9.7x | 8.4x | 6.8x | 4.2x | 4.2x | 157% | 94% |
| Shanghai Real Estate | 1.16 | 219 | 58 | 277 | 2.80 | 1.99 | -59% | -42% | 0.16 | 0.29 | 0.37 | 7.2x | 4.0x | 3.1x | 4.6x | 4.7x | 155% | 87% |
| Shui On Construction | 14.20 | 493 | | | 13.79 | | 3% | | 1.81 | 1.20 | 2.75 | 7.8x | 11.8x | 5.2x | | | | |
| | ROE | ROCE | Gearing | EBIT Margin | Net Margin | Free Cash Flow | Free Cash Flow Yield | | | | | | | | | | | |
| | FY05E | FY06E | FY05E | FY06E | FY05E | FY06E | FY05E | FY06E | FY05E | FY06E | FY05E | FY06E | FY07E | FY05E | FY06E | FY07E | | |
| Operating Metrics | | | | | | | | | | | | | | | | | | |
| National Builders | | | | | | | | | | | | | | | | | | |
| China Overseas Land | 10.60% | 14.60% | 10.40% | 15.40% | 38% | 26% | 22% | 28% | 15% | 23% | (630) | (204) | 665 | NM | NM | 3% | | |
| China Vanke (CH) | 16.90% | 17.40% | 15.60% | 16.00% | 30% | 38% | 19% | 17% | 12% | 12% | (916) | (593) | (889) | NM | NM | NM | | |
| New World China Land | 1.00% | 1.10% | 1.40% | 1.20% | -3% | -3% | 6% | 7% | 13% | 14% | (551) | (13) | (113) | NM | NM | NM | | |
| Beijing Focused Builders | | | | | | | | | | | | | | | | | | |
| Beijing Capital Land | 10.30% | 9.10% | 6.00% | 5.80% | 110% | 118% | 9% | 15% | 65% | 20% | (537) | (199) | 573 | NM | NM | 37% | | |
| China Resources Land | 7.20% | 8.20% | 6.80% | 8.80% | 60% | 58% | 18% | 21% | 10% | 10% | (77) | 24 | 448 | NM | 1% | 9% | | |
| Guangzhou Focused Builders | | | | | | | | | | | | | | | | | | |
| Guangzhou R&F Properties | 22.90% | 36.90% | 26.20% | 43.70% | 18% | 24% | 33% | 35% | 24% | 22% | 53 | 2,024 | 1,376 | 0% | 10% | 7% | | |
| Hopson Development | 21.50% | 23.40% | 23.40% | 31.50% | 58% | 33% | 33% | 35% | 18% | 19% | 4,733 | 2,118 | 1,219 | 40% | 18% | 10% | | |
| Shanghai Focused Builders | | | | | | | | | | | | | | | | | | |
| Shanghai Forte | 20.40% | 21.30% | 17.70% | 27.20% | 31% | 32% | 38% | 29% | 37% | 16% | (1,224) | 407 | 724 | NM | 16% | 28% | | |
| Shanghai Real Estate | 15.80% | 23.80% | 14.80% | 35.00% | 42% | 43% | 36% | 54% | 23% | 21% | (563) | 437 | (94) | NM | 26% | NM | | |
| Shui On Construction | 24.70% | 15.50% | 4.90% | 18.20% | 61% | 86% | 5% | 3% | 22% | 17% | (30) | (444) | 125 | NM | NM | 3% | | |

Source: JP Morgan (October 2005), Morgan Stanley (October 2005), Citigroup (October 2005) and Capital IQ (December 2005)
1. Hopson NAV from Citigroup report.

China - Specific Investment Ideas

The equity markets for Chinese housing stocks have rallied substantially over the last few months, resulting in a more limited set of appealing investment opportunities. More specifically, recent fundraisings by certain builders have brought increased attention to the sector, and, at the same time, concerns over the impact of the government's anti-speculative measures have subsided. Even though many of the national builders have excellent businesses, they are simply priced to perfection at this point. While we do highlight a regional and a national builder with solid business models and interesting valuations, we also suggest a contrarian pick and recommend purchasing a Shanghai focused stock that we believe still has upside potential. More specifically, we suggest investing in Shanghai Forte because it predominantly serves the low-end of the Shanghai population, which should not be impacted by the government's recent anti-speculative measures. Below we have outlined our recommended investment strategy taking these factors into consideration, and have provided some company specific investment strengths and risks.

National Builders

In reviewing the list of the builders, we generally believe the national builders have the most solid, defensible business models because of their natural insulation against region-specific property market problems and their greater economies of scale. The national builders have therefore not been heavily exposed to the price declines that have occurred in Shanghai. They do however face margin pressure as they expand their operations across the country as pricing is lower in the secondary markets they are entering leading to lower profitability.

China Vanke

China Vanke seems to still present an interesting opportunity as it is trading at a modest discount to its NAV (10-26%) and a reasonable P/E particularly off 2007 EPS (8.4x). With solid returns on capital and equity (mid to high teens), we believe the company presents an attractive but not perfect choice.

Strengths

- Vanke is the largest builder in China, and has an established track record of realizing economies of scale and translating this into continuous profit growth (5-year EPS CAGR of 27%).⁶⁴
- The Company's business model is focused on middle class housing making it a prime beneficiary of our secular growth story.⁶⁵
- Access to capital, which the company has due to its size and scale, will be important as it continues its growth trajectory.

Weaknesses

- As regional builders expand nationally, the Company's market power may begin to be eroded. However, this will be only a gradual threat given the wide-range of current growth opportunities.
- About 20% of the Company's land bank is located in the Shanghai/Yangtze River Delta. Given the Company is focused on housing for the middle class, this should not be a large problem.

For similar reasons to China Vanke, China Overseas Land & Investment (COLI) Company has an excellent business model because of its national presence. On an NAV and FCF yield basis, the company appears to be too expensive for us to feel comfortable recommending it at this time.

Regional Builders

Guangzhou

Some regional builders, however, do have excellent business models as cities such as Guangzhou are growing faster than the country as a whole. These builders have the chance to build local economies of scale to exercise their market power. In the case of Guangzhou, the stock market has recognized this opportunity and the stocks of the two companies focused on this region have increased rapidly over the last few months. While both Guangzhou R&F and Hopson appear inexpensive on a P/E basis and have very impressive returns on capital and equity, Guangzhou R&F seems almost fully valued on an NAV basis.

Hopson

Hopson continues to trade a much steeper discount to NAV with solid growth prospects and free cash flow generation. We are excited about the long-term opportunity for this company, and we recommend that investors buy this stock.

Strengths

- Hopson targets the middle income consumer with its product providing insulation from any further tightening measures by the government.⁶⁶
- Hopson has eight years of land on its books allowing for clear and smooth growth prospects.⁶⁷ Also, with such a large land bank, Hopson can buy land opportunistically going forward like the Mexican players who also have substantial land holdings. Additionally, it can focus on producing FCF given its lower reinvestment requirements.
- The Company is expanding into other markets (Beijing, Tianjin, Shanghai, and Huizhou)⁶⁸ providing further growth opportunities.
- In addition to strong GDP growth, Guangzhou also has a robust primary and emerging secondary housing market.⁶⁹

⁶⁴ Sung, Douglas. *Asia Home Builders Primers: China A Secular Uptrend* JP Morgan. 13 October 2005.

⁶⁵ Ibid.

⁶⁶ Tsang, Tony. *Hopson Development Capitalizing on Strong Demand* Citigroup. October 3, 2005.

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ Ibid.

Weaknesses

- Expanding from a being a regional player to a national player is not without risks. However, given the firm's strong FCF, the company should be able to adequately finance the growth.
- The stock is now trading 445% above its 52wk low. While we have made our valuation assessment without looking at where the stock has traded in the past, we believe it is important to note that the positive re-rating⁷⁰ of the Company could be reversed as quickly as it was established given the volatility in this market.
- While the company reduced its leverage this summer after raising capital through a private placement⁷¹, the Company still has the highest leverage amongst its peers. It should be able to reduce this using the FCF it will generate over the next few years.

Beijing Builders

For the Beijing builders, they do appear to be cheap on a valuation basis considering their discount to NAV and their P/E multiples, but their lower returns on capital and equity make them less attractive. Their projected free cash flow generation and stronger earnings by 2007 make them potentially more interesting, but we would prefer to stick with builders with stronger near-term operating performance given the volatility of this market.

Shanghai Builders

Finally, while Shanghai's high end property market will undoubtedly continue to suffer from the government's anti-speculative measures, the lower-end of the market for first time home buyers should remain robust. The market prices of the Shanghai builders have largely rebounded, but not to the degree of some of the other regional builders. Therefore the Shanghai builders who are serving the lower end of the market seem to still present a decent investment opportunity.

Shanghai Forte is a "suburban housing developer targeting mainly first-time buyers."⁷²

Strengths

- JP Morgan estimates that 72% of the company's sales volume will be priced below Rmb8,000/sq m, which appeals to first-time buyers. Pricing for this type of unit should not suffer as much as the higher end of the market.⁷³
- Shanghai Forte is also working on expanding its successful operations across the country, which should yield large profits beginning in 2007. Investors who are pricing the company off near-term earnings weakness may be missing this longer-term opportunity.
- The Company appears likely to generate strong free cash flow by 2006 and 2007 suggesting attractive FCF/equity yields for current investors. The company also has a high return on capital and return on equity to support its FCF yield.
- While Shanghai Forte's 2005 EPS figure is inflated due to a one-time gain, earnings are set to accelerate in 2006.
- The company is trading at an attractive valuation given its discount to NAV, its P/E and its FCF yield.

⁷⁰ Ibid.

⁷¹ Sung, Douglas. *Asia Home Builders Primers: China A Secular Uptrend* JP Morgan. 13 October 2005.

⁷² Sung, Douglas. *Shanghai Forte Land Company Limited Beyond Shanghai - Corrected Note supersedes any previous versions*. JP Morgan. 20 September 2005.

⁷³ Ibid.

Weaknesses

- The company will lose some high priced and high margin business in Shanghai as it will need to adjust its luxury unit prices in-line with the market trends. Because this is not the company's main business, it will be able to withstand this loss.
- Expanding its operations across China certainly increases the operating risk of the business. Also, as the company enters new cities, it will face margin pressure due to lower sales prices in these areas.

Shanghai Real Estate is a pure-play investment focused on the Shanghai market, but it is fully exposed to the luxury end of the sector. Its projects are precisely the properties that have been hit by the price collapse in the market. The company is trading at a large discount to NAV and low P/E multiples, but this is likely due to earnings estimates that are too aggressive as opposed to a valuation disconnect. The company does have an attractive real estate portfolio outside of the housing sector that the market may not be fully appreciating, but we do not feel comfortable recommended this stock based on a theme not related to our core secular growth story.

Next Steps

We propose conducting a series of additional analyses on Cyrela, Shanghai Forte, China Vanke and Hopson to confirm our recommendations. We would like to build full DCF models and recalculate the NAV for each of these companies to ensure that sufficient value remains for each of these opportunities. Also, we would like to have conversations with each of the management teams to gain a more detailed understanding of their views on capital allocation and the future growth plans for the businesses.

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In addition, the public filings of all of the builders mentioned in this report were also referenced. And conversations took place with the senior management teams of the Mexican builders and mortgage officers of the major Mexican banks.