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PUERTO RICO'S PRIVATE SECTOR: **OPTIMISTIC** ABOUT OUR ECONOMIC FUTURE

By Carlos Márquez, José Carmona &
Lawson D. Thurston Pages 14-20



...but positive action must be taken **NOW!**

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The return of optimism

Private-sector leaders confident the sun will rise on Puerto Rico's economy. The question is when and what can we do?



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“I feel we could start seeing, by the first semester of this year, certain positive movement in some sectors of the economy, and, by the second semester, we could perhaps begin to see how these projects [to be financed by the federal economic-stimulus package] spearhead consumer optimism. As consumers see positive signs in all of this, our situation will reach bottom, and we will begin to see more optimism and more investments,” said Troy Wright, president and CEO of Scotiabank.

It's the first glimmer of hope in the otherwise dark hour of Puerto Rico's economy.

Headed for a fourth straight year of negative

economic growth, with the government running a current fiscal-year deficit of \$3.2 billion (or almost 40% of the \$8.5 billion central-government budget), and business and consumer confidence hitting bottom, the outlook has appeared dismal, up to now.

The partial closing of the Puerto Rico government in May 2006, its deteriorating fiscal situation, increases in utilities, skyrocketing oil prices, manufacturing-plant shutdowns, business bankruptcies and employee layoffs are among the factors that have contributed to the island's three-year-old recession. More recently, the situation was exacerbated by a year-old recession on the U.S. mainland and in many parts of the industrialized world, triggered by a near collapse of the global housing and financial markets, which are all reflected in Puerto Rico's more than 13% unemployment rate.

Against that background, the local government

is considering a series of measures—all rather painful—to cut costs drastically and increase revenue. Although it has yet to announce which specific measures it will adopt, the message is slowly but surely getting across to all sectors—business leaders, consumers and organized labor—that just as in many states in the nation facing similar, albeit not quite so severe, economic circumstances, the medicine will be bitter, but will have to be taken.

That seems to be the consensus of a top-notch panel of private-sector business leaders and economists, who sat down with CARIBBEAN BUSINESS for an exclusive preview of what they'll say next week during Economic Perspectives 2009, an economic forum hosted by the Puerto Rico Chamber of Commerce and Manufacturers and Economists associations.

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In short, the island's private sector is optimistic the sun will rise and Puerto Rico's economic future will be bright, but they are just as certain that to restore trust and confidence in the economy by both businesses and consumers, corrective actions must be taken now to avoid an even larger disaster.

"The private sector has to be the agent of positive change in our economy. If the economy is 90% perception, the message of optimism, hope and trust must come from the private sector. I believe there are several positive factors that all of us, even the media, have been ignoring," said José Julián Álvarez, president of the Puerto Rico Chamber of Commerce.

"I see 2009 as a transformation year where the economy will begin a turnaround toward economic growth. Even if it's through external factors more than anything else but, definitely, factors that will help improve the island's economic situation, I believe we should focus on those positive things. Puerto Ricans have the capacity to move our economic agenda forward as we have done it more than once in the past," Álvarez added.

"I have no doubt the construction and housing industry is going to move forward. The question is when, but it's good for the island that it be sooner than later. We then have to stimulate consumer demand to prevent further unemployment. We aren't going to start building new homes until the existing inventory moves," said Rafael Rojo, president of the Puerto Rico Home Builders Association.

"Without a doubt, the big trigger that accelerated the recession was the government shutdown. When you see a government employee—one of the supposedly safest jobs—without a paycheck, they and their families began to create a huge cloud of uncertainty over Puerto Rico. When the consumer loses confidence, an economy comes to a stop. From then on, at least with respect to the construction and housing industry, that's when we noticed a very fast pace of optioned homes being cancelled," Rojo said.

"Without entering into politics, certainly the change in government brought hope that everyone was eager to see, but we must say the start of the new government has been a little shaky, in the sense that we haven't seen that hope materialize. Consumers aren't aware, can't see the light at the end of the tunnel and, until that happens, consumers won't begin to spend," Rojo added.

THE END OF 'SHARED GOVERNMENT'

"At the same time, you can see perhaps where a change in the administration could create a new positive sentiment and, again, I haven't been here long enough to be indicted as a political partisan of any particular stripe. I just look at the facts, and there really seems to be a positive sentiment about Gov. Fortuño coming in, which is one of the noneconomic factors that can create a positive sentiment and build confidence. This is more of a nonbusiness, noneconomic factor, but a lot of people discount the fact that sentiment and



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Troy Wright,
president & CEO of Scotiabank de Puerto Rico

perception are strong drivers of economic action," Wright said.

Although born in Puerto Rico, Wright has spent most of his professional life outside the island and took over the operations of Scotiabank de Puerto Rico just five months ago.

Álvarez believes there is a need to start changing people's negative attitude, and there are various positive indications that are going to have a positive effect on the economy.

"The end of the so-called 'shared government' will be positive. One party (New Progressive Party, NPP) controls the executive, both houses of the Legislature and the vast majority of the municipalities. That will give Puerto Rico some direction. The uncertainty of what's going to happen shouldn't be in people's minds. Secondly, the U.S. federal government has made a \$1.4 billion investment in local banks, and that amount could reach \$2 billion, if other local banks participate.



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In addition, the Federal Deposit Insurance Corp.'s (FDIC) insurance coverage was increased from \$100,000 to \$250,000 per depositor. Third, there has been a drastic reduction in the price of oil. Fourth, there is the Obama Economic Stimulus Plan, which could put more than \$6 billion into the local economy in the next two years," Álvarez said.

"I don't remember a governor who has achieved the position with such a positive feeling as Fortuño. He has the Legislature and, eventually, the Supreme Court," said Rodrigo Masses, president of Makro Importers & Distributors Inc.

"There is a world of opportunities on the local front. We have a new economic incentives law, which some people have forgotten. This law is a mechanism to bring more investments, jobs and revenue to Puerto Rico. Then, there is an enormous

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opportunity with public-private partnerships (PPPs) to do even more infrastructure investment using private-sector money. We recognize the government doesn't have the borrowing capacity to invest in infrastructure. This private investment is going to create more jobs, bring in more money from abroad, and that will be positive for our economy," Álvarez said.

"We also have proposals from the private sector for several things, including bringing down the cost of doing business, improving labor legislation, improving energy generation and reducing its cost, streamlining the permits process, as well as proposals in the tax and fiscal areas. We feel the way to increase government revenue isn't by raising taxes, but by lowering them," Álvarez concluded.

BANKING SECTOR

Wright believes things really started to go badly in Puerto Rico with the government shutdown in 2006. "It started a bad trend in the economy and eroded confidence. People became skittish and worried about the economy. It was the point of inflection, where things started to really go down," he said.

"An economic recovery doesn't usually begin in all sectors at the same time. There might be areas where you see something positive going on first. Although we will continue to see, at least until the summer, strong adjustments in the U.S. economy, in Puerto Rico, we have already done many adjustments. At the same time, I believe we will begin to see sectors showing positive results," Wright said.

"This is like a bomb we don't want to drop. We have to diffuse the bomb so the economy starts rolling again. I'm still unclear about where the plans are regarding the use of the monies we are about to receive from the federal government and the economic activity it will create," Wright added.

The residential-construction industry has been a major driver of the economy and the banking sector in Puerto Rico but, today, it is one of the major issues facing the banking sector as the direct result of a lack of demand. The banking sector has financed billions of dollars' worth of residential and real-estate construction projects, many of which are falling into a situation where the sales of completed units are coming well below what was anticipated.

"For example, if you have an average \$250,000-per-unit project with 400 units, you conservatively would expect to sell 10 to 15 units a month and be able to pay off the construction loan within 12 to 24 months after the project is finished. Now, in many cases, the problem is the pent-up demand in the residential industry is showing that the units are selling at perhaps 1 to 2 per month. This means these construction loans won't be repaid at the rate originally anticipated. It gets complicated because developers are running into cash-flow issues and the loan needs to be serviced. So, what is happening is that the banking



"If something has distinguished the construction industry on local and national levels, it is that we aren't asking for a bailout for these companies. What we need is to stimulate consumers so they can see the light at the end of the tunnel... giving the consumer a reason to come down from the fence and purchase a home."

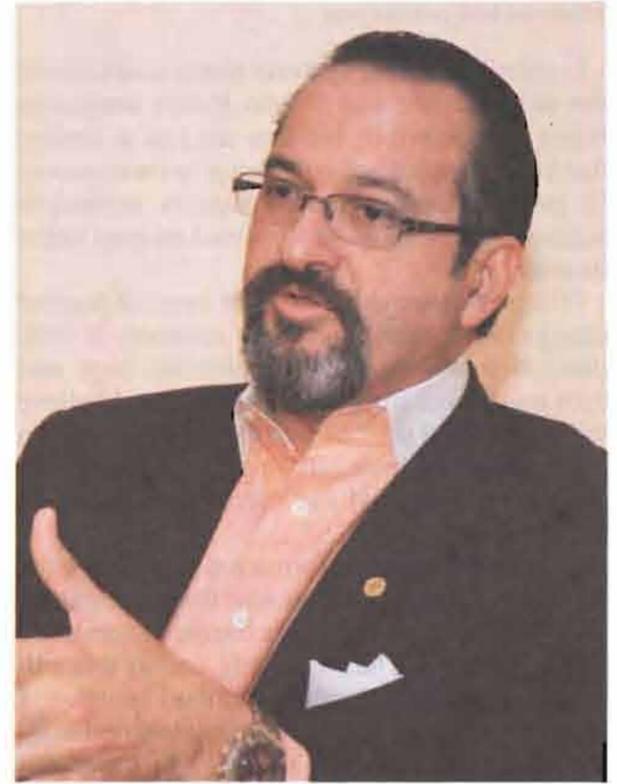
Rafael Rojo,
president of the Puerto Rico
Home Builders Association

industry is carrying a substantial number of these construction loans, which is one of the main reasons why today you're finding many Puerto Rico banks have come under pressure," Wright explained.

CONSUMER CONFIDENCE MUST RETURN

According to Wright, we need to see a return of consumer confidence. Nobody would buy something today that they think is going to be worth less in 12, 18 or 24 months. The first thing that must be restored is consumer confidence.

"That's why many are holding back, because they might think they'll get a better price rather



"Necessity is the mother of invention, and the situation we are living in will promote innovation and make us more competitive."

Rodrigo Masses,
president of Makro Importers & Distributors, Inc.
(a PRMA manufacturing-sector representative)

than take a risk with what's out there. Therefore, we need to come up with a solution. We're talking with developers to come up with innovative ideas. Among the ideas we've seen so far is to change the use of the property, if it isn't going to be able to be sold. Perhaps they could be turned into and used as rentals... One thing we've seen is to turn them into, perhaps, a condominium building to be rented and used as assisted living. We recently saw an example of that," Wright explained.

"We are looking at innovative ways to put each project to use, maybe converting them to tourism or tapping into new markets. For example, in Miami, they have been trying to bring in investors from Asia to create new demand. We have to create new demand for new housing in Puerto Rico," he added.

"Secondly, it's the retail [consumer] market itself: mortgages, credit cards, personal loans... These are areas of great concern as retail delinquencies rise. It really reflects what's going on in our economy and the rising unemployment levels resulting in a toxic situation, because banks

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again have to be more cautious, but it also is a very real signal of what's going on with the health of the economy. It's a natural phenomenon; it isn't a surprise because, without employment, comes less availability for people to pay in a timely basis," the banker said.

"As an industry [banking], we are trying to manage that situation, working with customers and using different types of programs and to ensure we keep our customers within certain parameters through loss-mitigation programs. Greater economic activity will reduce delinquency-level rates," Wright said.

"That's a very active area of the banking sector now, but I think new lending is also very important. With the industry the way it is, the reaction of the banking sector has been to tighten lending parameters. When you tighten lending parameters, it makes it harder for people to get credit. At the same time, there's a great deal of opportunity with some banking programs with the federal government. The Federal Housing Administration has come up with extremely smart and good programs, showing people how to take advantage of them and getting them into homes," Wright continued.

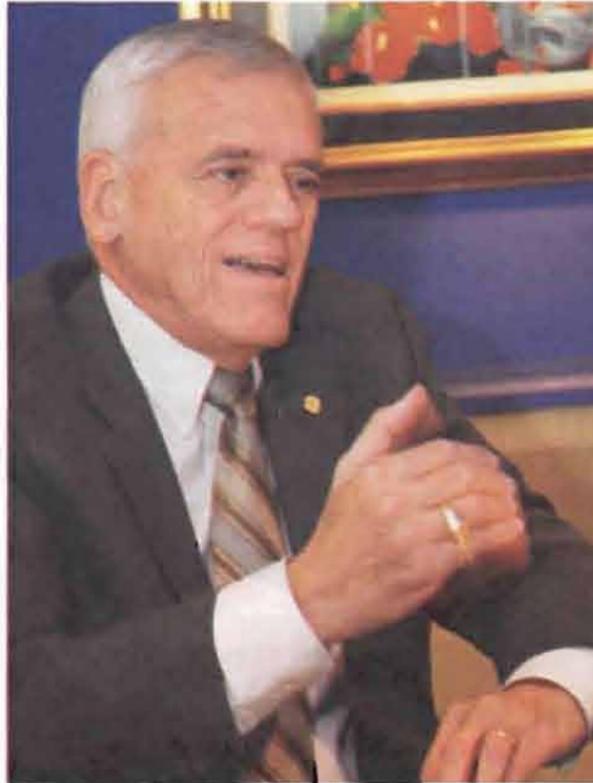
The challenge, again, is trying to overcome the current environment and get people to borrow. "I think part of the challenge here is the demand issue. Banks are lending and are looking into lending more, but there must be an underlining demand," he noted.

A second issue is deposits, which are actually much lower in the banking system here than you would normally find in other places. A strong deposit base has always been the key success factor for banks and is something Puerto Rico needs to look at and how to capture more deposits for the banking system. According to Wright, one thing that would be very helpful for the banking sector is if it could gain greater core deposits. Puerto Rico has a very high percentage of brokered deposits, which are funded with wholesale deposits like brokered certificates of deposit (CDs) from other financial institutions, which are substantially more expensive than core deposits.

Wright believes that from both a regulatory and consumer-awareness point of view, a great advantage for banks in Puerto Rico is that they are covered by FDIC insurance. "They are good institutions for making deposits, and we should try to encourage, as much as possible, depositing in local banks. We must educate people about how banking works, so people don't put their money under their mattresses, but bring it into the banks. That's probably one of the biggest challenges," he noted.

Also on the positive side, Wright explained that the toxic debt problem in many of the U.S. financial institutions didn't directly have an impact on Puerto Rico.

"Puerto Rico banks don't really hold those types of toxic assets that created a lot of problems for the U.S. banking system. Puerto Rico banks,



"We are confident there shouldn't be additional factors that have a negative impact on the multinational manufacturing base because of the nature of what is produced on the island, such as pharmaceuticals, medical equipment, scientific instruments and aeronautics... local manufacturing companies have already taken the necessary measures, and I don't believe there will be more substantial adjustments."

William Riefkohl,
executive vice president of the
Puerto Rico Manufacturers Association

generally, have stayed away from those types of investments. What we have is our local problem, which is the construction industry and the rest of the construction side, but I think one thing we can say proudly about the Puerto Rico banking system is that it had very little exposure to the 'toxic waste' type of loans.

"The issue in Puerto Rico is actual real-estate loans that were made for land and construction. During the past few years, many people who weren't really experienced developers began to become involved with building projects. They

saw an opportunity, and it was easy at the time," Wright said.

Both Popular and FirstBank have received a substantial amount of money (\$1.4 billion) under the federal Troubled Assets Relief Program (TARP). Now, that money needs to be leveraged and put into the system. That's the idea behind TARP. A number of other Puerto Rico banks have applied for TARP money, and the process is still unwinding in terms of getting approvals. Wright believes that influx of money into local banks will be beneficial to the local economy in the short term.

CONSTRUCTION SECTOR

"To move the construction and the housing industry forward, we have done everything we can on the supply side. The industry has done absolutely everything it can. We have drastically lowered new construction volume, which is fatal for the economy and in terms of unemployment. The construction industry has lost at least 16,000 jobs," Rojo said.

"Various developers have provided multiple incentives that range from modest to dramatic. In some cases, prices have been lowered substantially, and that's all we can do from the supply side. The problem isn't on the supply side but on the demand side. There's talk about a Criollo Stimulus package, but we haven't seen it, and we need it urgently as we need to promote demand," he added.

"If something has distinguished the construction industry on local and national levels, it is that we aren't asking for a bailout for these companies. What we need is to stimulate consumers so they can see the light at the end of the tunnel. For our particular industry, the government needs to somehow stimulate it economically so the consumer has a reason to come down from the fence and purchase a home," Rojo said.

He added that most of the inventory out there, contrary to public perception, is of affordable homes. About 80% of the inventory is priced below \$300,000. Only about 20% are homes priced above \$300,000.

"As for the previous housing tax-incentive program, it was extremely successful, even the \$220 million the government placed in the hands of consumers without repayment requirements. It was cost-effective, not a gift. It was a good government investment that bore fruit. If it hadn't been for the 9,000 newly constructed homes in inventory, which moved, thanks to that program, we wouldn't have been able to build 6,500 new homes last year. These homes generate economic activity, create jobs and revenue for the government that wouldn't have happened had the housing incentives not been given," Rojo said.

"Nonetheless, we must make it very clear that we, as an industry, aren't in a position—nor do we consider it prudent due to the government's fiscal situation—to ask for a repeat of the housing-incentives program. Tax credits are a shortcut through the pain of having a complex system like

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ours, which makes doing business so difficult. If they want to take away the shortcut, then they first must fix the structural problems. Otherwise, where's the economic stimulus? We aren't just talking about credits for the construction industry, but for all industries. By avoiding fixing the structural problems of doing business in Puerto Rico, we have resorted to providing tax credits to mitigate the problem," Rojo explained.

BRIGHT SPOTS FOR MANUFACTURING

As a whole, the manufacturing sector in Puerto Rico has become very lean and economically efficient in recent years. It has continually reinvented itself, adjusting to constant pressures not just from the three-year-old local recession but from the enormous pressures the worldwide manufacturing industry is facing.

Yet, despite the challenging environment, some companies recently have expanded or been established on the island with significant investments. Companies such as Coopervision in Juana Díaz (\$170 million), Microsoft in Humacao (\$50 million), Agiotech in Aguadilla (\$13 million), Axon P.R. (new business) in Isabela (\$22 million), Medtronic in Juncos (\$60 million) and Honeywell's announcement to add 1,000 jobs in Aguadilla, were among some of the recent developments in a positive direction. Besides biotechnology and medical devices, aerospace segments of the manufacturing industry represent a growing opportunity for Puerto Rico.

As the manufacturing industry looks forward, there are some bright spots that could serve to bring Puerto Rico back from the economic brink and serve as a springboard toward making the

island a top manufacturing jurisdiction.

The No. 1 challenge for manufacturing has been the cost of operating plants on the island, led by high energy costs. For the first time, Puerto Rico has a tax incentives law (Law No. 73) that opens the door to facilitate a complete change in the way energy has historically been provided.

The Puerto Rico Manufacturers Association (PRMA), for the first time in Puerto Rico's history, has put together an energy alliance cluster that is supported by every sector of industry. "All sectors have come together to ensure the future of energy in Puerto Rico is one that is more competitive, aggressive and efficient, including helping transform the Puerto Rico Electric Power Authority (Prepa). For the first time, we were able to include the 'beginning of the end' of Prepa's monopoly in the industrial incentive law. From now on, there will be transparency," said William Riefkohl, executive vice president of the PRMA.

"There is a situation that is very positive for Puerto Rico. People have acknowledged there must be a change in the government structure and that is a positive development. We must transform and shrink it. In addition, there is a new president [Barack Obama] and a new secretary of State [Hillary Clinton] and we will have a bundle of federal funds coming into Puerto Rico's economy," Masses added.

"We are confident there shouldn't be additional factors that have a negative impact on the multinational manufacturing base because of the nature of what is produced on the island, such as pharmaceuticals, medical equipment, scientific instruments and aeronautics. Manufacturing represents 11% of the employment, 40% of the gross domestic product and 90% of exports. There

shouldn't be any additional negative impact in 2009; if more jobs are lost, it will be because of a lack of competitiveness," Riefkohl said.

However, among the local manufacturing sectors that could be negatively affected are durable goods, such as furniture, which is intrinsically related to the construction sector. Nevertheless, Riefkohl believes the local food-products manufacturing sector could benefit from the economic situation since more people would decide to eat at home.

"After three years of economic recession, local manufacturing companies have already taken the necessary measures, and I don't believe there will be more substantial adjustments," Riefkohl added.

"There will be increases in the amount of money circulating in the economy. The Obama administration will try to have the investments from his economic stimulus package stay home and not be diverted to China or other foreign markets, making sure the materials used for infrastructure investment, such as bridges and schools, are mainly U.S.-made. We can't continue to do the same thing and expect to improve results. We just can't continue to maintain countries such as Venezuela and Dubai [United Arab Emirates] with our money and limited resources. At the same time, the government is making the local industry uncompetitive with the highest cost for electricity and water and labor legislation," he said.

"We must ensure that the money being invested here stays in Puerto Rico and shouldn't continue to spend the money on foreign architects or other service providers or to buy nonlocal products. Necessity is the mother of invention, and the situation we are living in will promote innovation and make us more competitive," Masses added. ■