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Patrimonio Hoy: A Financial Perspective (Abridged)

In June 2004, Francisco Garza, president of CEMEX North America & Trading, was preparing for a meeting with his management team to decide the future of Patrimonio Hoy (PH). PH was an innovative savings and loan program aimed at serving the housing needs of Mexico's low-income population, leveraging CEMEX's existing distribution system. Garza had founded the program in 1998, when he was in charge of CEMEX Mexico, after realizing that 40% of CEMEX's end users were low-income individual home builders and that the company knew little about this segment. From a small market research project, PH had become a highly visible CEMEX program that had served 75,000 families in 22 Mexican cities and was the recipient of media attention and various accolades. Already, there was a desire to expand the program to other countries such as Egypt, Venezuela, Colombia, and the Philippines where CEMEX had major operations. Yet within his own team there was no consensus as to how PH should be viewed by CEMEX. Was this an innovative expression of corporate social responsibility or a new line of business? His own intuition was that low-income populations benefit more by being treated not as objects of charity but as clients. He also felt that the program could make financial sense for both the corporation and its clients. But could he prove it?

CEMEX

Garza joined CEMEX in 1988 and quickly rose to the top as his supervisors appreciated his sharp intellect, commitment to employee development, focus on client services, and strong work ethic. CEMEX was headquartered in Monterrey, Mexico and was a publicly traded company in its home country with ADSes[1] on the New York Stock Exchange. CEMEX had become the third-largest cement manufacturer in the world and the 10th-largest company in Mexico, with total sales of $7.2 billion. Its production capacity was 81.5 million tons per year (27.2 million tons in Mexico) as of December 31, 2003. Domestically, sales represented 34% of its business, and its market share was 52%. The company employed 25,000 people in over 30 countries. It had an equity market capitalization of $9.4 billion.

[1] American Depositary Shares (ADSes) are stocks of foreign public companies that banks or brokerage firms buy in large quantities and reissue on a U.S. exchange market.

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Housing in Mexico

Mexico was the 10th-largest economy in the world and the largest in Latin America with gross domestic product (GDP) of $626 billion in 2003, ahead of Brazil's ($492 billion) and Argentina's ($127 billion). With a population of 104 million, the country had a GDP per capita in 2003 of $6,112, which ranked first in Latin America.[2] However, the bottom 20% of Mexico's population accounted for only 3.6% of the country's income, while the top 20% represented a share of 58.2%. As with many Latin American countries, inflation had plagued Mexico, with a peak of 52% in 1995, but by 2003 it had moderated considerably, settling down to an average between 2001 and 2003 of 4.7% and with Mexico's central bank estimating that it would remain at or below that level at least until 2008.[3]

Mexico's housing consisted of 24 million units with an estimated value of $1.1 trillion, although two-thirds were worth less than $38,000 each. Approximately half of all new homes each year were self-built, with construction materials accounting for most of a family's savings.[4]

Mexico's housing situation was not dissimilar to that of other economies where long-term credit was scarce and where growth and income expectations were plagued by uncertainty. People who built their own homes usually did it gradually, adding one wall and eventually one room at a time over several years. CEMEX estimated that there were 16 million self-built homes in Mexico and projected that this segment added 2.2 million new rooms each year. People seldom had land titles and often lacked basic services such as electricity, sewerage, garbage collection, potable water, and pavement.

The Mexican mortgage market was a puny 6% of GDP versus 55% in the United States, and only 5% of homes had mortgages. In addition to the lack of mortgage financing, Mexicans had to consider the risk to their homes at a time of financial crisis, such as when interest rates spiked to 95% per annum in 1995.

Patrimonio Hoy

Patrimonio Hoy (Patrimony Today) was the name CEMEX chose for the program designed to reach out to the Mexican self-construction market. The term in Spanish implied more than economic net worth; it connoted personal values and an individual's heritage. Garza launched the program in July 1998, with the primary objective of learning about a key segment of cement end users about which the company knew very little. The management team entrusted with the project sent consultants and employees to Mesa Colorada, a poor community of 90,000 residents on the outskirts of Guadalajara. Over 18 months, in the words of Hector Ureta, PH's director of development of self-construction, one of the team's most significant discoveries was,

> …the realization that we stood a chance to have a real impact on people's lives. We viewed people not just as consumers but as human beings… Most families devoted their weekends to building their homes, and they were often deceived by sellers of building materials. They were treated poorly, often got the wrong or lower-quality materials for the price they were paying, did not receive materials on time, and were cheated in the

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2 IMF World Economic Outlook, http:/www.imf.org/external pubs/ft/weo/2004/02/data/index.htm, November 5, 2004.

3 Source: *Encuesta Sobre las Expectativas de los Especialistas en Economia del Sector Privado*, Banco de Mexico, August 2004.

4 Based on *Mexican Housing Overview 2003*, published by Softec SC, Mexico, January 2003.

weight of what they received. Furthermore, many of them had no architectural skills to develop a reasonable construction plan.

A New Way to Build

As part of their research, the PH team found that a typical low-income family built a room of 100 square feet in the course of 208 weeks, as allowed by their spare time and their ability to spend on cement and other building materials, usually at an average rate of M$46[5] per week at current prices.

The PH program was divided into seven cycles of 10 weeks and permitted completion of a 100-square-foot room after 70 weeks. Each family contributed M$120 per week for the entire seven cycles. Of that, M$105 per week went to the purchase of materials and M$15 per week was a PH membership fee. Families allocated their credit to whatever materials they needed, not just cement. After the first two installments of each 10-week cycle, PH advanced all the construction materials to be covered by the payments of the respective cycle, financing these materials for the remaining eight weeks and fixing their price for the entire seven cycles. CEMEX absorbed any price increases during that period, for both cement and the other materials. In 2003, the inflation rate for construction costs was 7.1% per annum.[6]

Each family had discretion over what type of room to construct. It could be a kitchen, bathroom, bedroom, dining room, or living room. An experienced architect or well-trained engineer provided by PH delivered a floor plan to the family based on the family's specifications, an itemized materials list, and a delivery schedule. Typically, a CEMEX distributor delivered the materials to the families after week two of each cycle. However, distributors sometimes held the materials in their warehouses until the customers requested them, considerably reducing the waste and pilferage that came with open-air storage in the *ejidos*. PH distributed the materials through 150 outlets, of which 30 were premier CEMEX Construrama distributors and 120 were smaller retailers that CEMEX served directly. Garza notified all CEMEX distributors that the company would immediately sever its relationship with anybody caught short-selling to PH customers.

PH found that on average their customer consumed 34 kilograms (kgs) of cement per week. Not only was the PH customer able to build faster, but he or she ended up using less cement. As a result of inefficiency, waste, spoilage, theft, and retailer dishonesty, the rule of thumb was that for an equivalent room a family outside the PH program used approximately 30% more cement and other materials.

Families were referred to PH *promotoras* (promoters), local townspeople who had developed a strong sales network within their communities. PH also attracted new types of *promotoras*, such as church fund-raisers or teachers. *Promotoras* historically sold cosmetics, lingerie, clothing, home appliances, and other products door to door. Further, *promotoras* were usually trusted by their community to provide good products at reasonable prices. PH was a complementary product and provided excellent synergies to a *promotora's* product line. In addition, customers who performed well and became identified with the program were themselves invited to join as *promotoras*. Ninety percent of *promotoras* were women. "This is not surprising," contended one of the PH managers. "They are the ones who remain at home, worry about family integration, and are more concerned with long-term welfare." On a weekly basis, *promotoras* met with their sales leaders, who reviewed their performance and established their budgets for the following week.

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[5] M$ = Mexican peso. The average exchange rate in 2003 was $1 = M$10.80.

[6] Source: Banco de Mexico (www.bancodemexico.gob.mx).

Collections were not a significant concern, as default rates were extremely low. People protected their credit rating to continue in the program. To date, the nonperforming portfolio was less than 1% of sales. Only 0.4% of sales were written off in 2003. According to a local PH salesperson in Cerro Colorado, "Poor people lack economic capital, but they have social capital." PH was designed with many incentives to make people pay on time. For creditworthy individuals there were program upgrades where the amount of credit was higher, that is, families received materials before they got to pay 20% of their scheduled payments. Moreover, given that the PH customers often had no credit history, PH issued testimonial letters to other suppliers and credit institutions on behalf of families that were prompt payers. Borrowing costs for this population segment nevertheless were higher than in conventional banking. For example, Compartamos, the leading lender to this segment in Mexico and the largest microfinance institution in Latin America, charged effective annual interest rates that generally ranged between 75% and 90%.[7] Meanwhile, the interest rate on savings was minimal, as most of PH customers did not have bank accounts.

Exhibit 1 shows an example of housing prior to PH and a typical PH project under construction and upon completion. In a situation often characterized by severe overcrowding, an additional room provided welcome relief. "My husband and I slept in one room, my four children in another, but my youngest child had to sleep every night in the parlor, and I always felt this diminished him," a mother said, recalling her days prior to PH.[8] Under these circumstances, few rooms were available for the rental market. In the neighborhoods where PH had offices, CEMEX estimated that a room with a shared bath rented for M$50 a week, establishing a floor on the value of a completed room.

Looking Ahead

By March 2004, PH had achieved its goal of providing consumer information to the CEMEX sales force and marketing staff. It had created a new line of business for CEMEX, developed an intricate sales force with 48 offices in 22 Mexican cities, and achieved high customer loyalty. Its penetration was growing, the program having served 42,500 customers in 2003.

According to Arturo Ledezma, one of PH's elite Construrama distributors, "The fact that CEMEX got to deal directly with customers through Patrimonio Hoy drove us to think that perhaps we were giving up part of our business, but we were happy to see that our business grew 20% after the first couple of years in the program." Some felt that when all things were considered, the balance was positive. Alicia Guerrero, another PH distributor, commented, "We feel good about Patrimonio Hoy because we sell more, our credit risk is lower, and our margins are similar to our other sales. When we sell to contractors, we have to cut prices, and they don't pay well." However, PH reached end users directly, and some distributors expressed serious concerns about CEMEX's long-term goals.

Ureta, the manager involved with PH since its inception, was a strong champion of the program, both within the company and in various public venues:

> Someone like Maria Diega [a client] would have taken her entire life to build the seven rooms and stairs she was able to build with us in five years. Our program has become a vehicle for social mobilization in Mexican society… A woman came to me, with tears in her eyes, to say that her 16-year-old son had brought her M$130 out of his first paycheck as a delivery boy and told her, 'Mom, I want you to give this to Patrimonio Hoy in my name. I want us to build me a room…' Yet our proposal is a business proposal… Many of

[7] Source: SOFOL Compartamos.

[8] Source: CEMEX film on Patrimonio Hoy.

> the children of the families that we are serving in the e*jidos* and *colonias* will become masons…and they are likely to remember our name with warm feelings.

Juan Romero, president of CEMEX Mexico, recognized these virtues but was apprehensive about expanding PH. The issues for him revolved around scale, implementation, and political risk. He wondered whether PH would ever become a major line of business for CEMEX in Mexico and worried about capital investment, project management, and quality control. On the other hand, with the visibility of PH came several awards and public recognition, but he was concerned about the potential backlash to a profitable line of business that had as its customers the country's poor. He argued that there was more value in the creation of goodwill for CEMEX in different parts of the world than in treating PH as a legitimate business with significant profit potential within Mexico.

After listening to Romero and Ureta, Garza remained enthusiastic about PH but was acutely aware of the complexities of the many issues involved. He thanked both executives for their input and sat down to prepare his recommendations to the CEMEX chairman and CEO.

Exhibit 1 Patrimonio Hoy: A View from the Street

Before

Before and Current, and "Wires of Hope"

Family at Work

Interior of Doña Diega's Home

Source: Photographs taken by Professor Arthur Segel.