Investing in Spain

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Crisis of trust as downturn ends

National institutions face hostile scrutiny and there is a threat of secession, writes *Tobias Buck*

Royal succession: King Felipe VI acknowledges the crowd on the day of his coronation last week following his father's abdication from the throne on June 2 Getty

When Spaniards speak about "the crisis" these days, it is no longer clear which crisis they are referring to.

Until recently, it was obvious that *la crísis* could only mean the brutal economic downturn triggered by the bursting of Spain's housing bubble six years ago. Today, however, the word may just as easily refer to the deepening political and institutional crisis that has engulfed the country.

Symptoms of this second Spanish crisis have, of course, been visible for some time, and are closely linked to the bitter economic hardship suffered by millions of Spanish families in recent years.

Now, however, they appear with greater frequency, and in ever more sensitive parts of the body politic. Rebuilding trust in the state and its institutions will take a Herculean effort, and this time neither the European Commission nor the European Central Bank nor the International Monetary Fund will be there to help.

"The economic crisis has made people realise our political system is less perfect than they thought. Trust in our institutions has collapsed," says Antonio Barroso, a political analyst at Teneo Intelligence, a consultancy.

Politicians, parties and parliament, the government and the judiciary, the monarchy and the constitution, business and the unions – they are all facing hostile scrutiny as never before.

In the region of Catalonia, meanwhile, more and more people say they want to have nothing to do with the state of Spain. Secessionist pressures are on the rise, and will come to a head in November, when the regional government plans a referendum on Catalonia's political future.

The depth of the institutional crisis became starkly apparent on June 2, when King Juan Carlos stunned the country by announcing his abdication in favour of his son, Felipe VI. His decision was based on a number of factors, including poor health and a series of scandals and public missteps by royal family members. But there is no doubt that Juan Carlos was growing increasingly concerned about Spain's shifting political landscape.

The dominance of the country's two established parties, the Popular party on the right and the Socialists on the left, is under serious threat.

At last month's European elections, their share of the vote fell below 50 per cent for the first time. A small but significant number of voters deserted them for insurgent, anti-establishment parties such as Podemos, which took 8 per cent of the vote.

No one knows if the trend towards fragmentation will continue. The royal house was, by all accounts, becoming more anxious that Spain's broad political consensus in favour of the monarchy might shatter in the years ahead. By securing the transition to Felipe VI, the monarchy looks safe for several decades.

The same cannot be said for other pillars of the state. The biggest challenge, without doubt, lies in Catalonia, where disaffection with Spain has reached such proportions that a large share of the population – perhaps as many as half – are seeking a historic break with the rest of the country.

Artur Mas, the Catalan president, has called for an independence referendum, albeit non-binding, for November 9. Mariano Rajoy, the Spanish prime minister, insists that such a plebiscite is illegal. He has the support of the Spanish parliament and constitutional court behind him.

Most analysts agree that a Catalan climbdown is not on the cards: if Madrid blocks the referendum, Mr Mas is expected to call an early election, in the hope that Catalans will give overwhelming support to

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Distressed asset seekers spot quality amid the debris

Hedge funds

Managers have moved from a short to longer-term view, writes *Miles Johnson*

It seems only a short time ago that Spain was what hedge fund managers called "a clear short".

With banks reluctant to admit the consequences of a property collapse and government loath to admit that its banks might need additional capital, hedge fund managers swarmed in to bet against the economy.

Over the past year, the position has almost entirely reversed as hedge funds have rushed to profit from the recovery and scoop up undervalued assets.

The rationale behind the return of hedge funds to Spain varies according to the type of fund. Some seek distressed opportunities to make quick profits; others seek high quality but underpriced companies for longer term holdings.

As public finances have shown signs of stabilising and the risk of eurozone break up has faded, many managers' fear of touching Spanish assets has passed.

This has allowed reassessment of the values that many companies were trading at compared with other locations, such as the US.

A London-based hedge fund investor says: "Many people were looking for value in Spain, because if Europe was cheap in comparison with the US, Spain was very cheap."

Some hedge funds, such as $1.5bn Amber Capital, raised a special fund to invest in southern Europe and buy into high quality companies in Spain and Italy.

José de la Rosa, who manages the $350m fund, wanted to take advantage of Spanish valuations to build a portfolio that he could hold for the long term. "We have tried to buy the quality in the periphery, companies that are well run with little debt," he says.

> 'If Europe was cheap in comparison with the US, Spain was very cheap'

"Others are buying highly levered companies with the view that they will be restructured. We are positioned in quality."

Aside from lower valuations than in other European markets, hedge funds have been attracted to specific themes in Spain.

Spanish property, which through the bursting of a decade-long bubble was the driver of the financial crisis, has been a focus for hedge fund investors over the past year, as banks speeded up their offloading of property assets.

Such big names in the hedge fund world as George Soros and John Paulson were among backers of the Spanish property investment trust Hispania Activos Inmobiliarios in February, as they saw the chance to exploit low valuations and distressed deals.

Mr Paulson and Mr Soros each took a €92m stake in the €500m listing in one of the strongest statements of hedge fund interest in Spain since the easing of the crisis.

Last year, funds associated with Mr Soros, who has closed his fund to outside investors in order to manage his family money, took a stake in FCC, the indebted construction company, when few others wanted to touch the sector.

Others followed this search for some of the most damaged and indebted property and construction companies, knowing that Spain's improved credit worthiness and the cooling of the European sovereign bond crisis would send their share prices surging.

One example was Polygon, a UK-based hedge fund, which profited from trading in Colonial, a Spanish property company that completed a €1.2bn capital increase in April, helping reduce the debt of a company once seen as almost beyond repair.

Another important catalyst that hedge fund managers have identified as having the potential to offer big returns is the need for Spain's banks, and potentially the state itself, to continue to sell down stakes in companies.

While Bankia, the savings bank that in 2012 was the subject of Spain's largest ever financial rescue, has sold most of its holdings in large listed companies, other banks still control stakes in smaller listed companies.

These will most probably be disposed of in the coming years. This, experts reason, should gradually eradicate less "shareholder-friendly" owners, such as local governments, from Spain's listed companies and help their share prices.

Yet, while Spain has swung from one of the most shunned countries for hedge funds to one of the most loved in three years, most managers agree the opportunity to make fast money in Spain may have all but passed.

While select and esoteric situations may crop up, those who have remained invested in the country must do so for at least the medium term. Some argue valuations have moved far too far upwards and that investors have started to misprice the risks they are taking.

Crisis of trust as growth returns

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regional political parties that support independence.

If that bet comes off, a new Catalan parliament could be tempted to issue a unilateral declaration of independence, plunging the country into a constitutional crisis unparalleled since Spain's transition to democracy in the late 1970s.

Fears that Spain may be heading for a period of political instability have yet to resonate with investors.

Indeed, this month, the yield on Spanish sovereign bonds fell below those of the US, while the Ibex-35 index of large listed companies reached a new multi-year high.

Market confidence in the Spanish economy has recovered to pre-crisis levels, helped by recent ECB policies and signs of a broader turnround in the eurozone.

"I hope the markets are right and Spaniards will somehow find a way to resolve the tensions," says Luis Garicano, a professor of economy at the London School of Economics.

"But," he adds, "I am surprised that every time news points to instability, there is no reaction. You have a populist party such as Podemos coming from nowhere and getting 8 per cent, and there is not the slightest response in the markets."

There is no shortage of politicians and officials who offer a tranquil reading of the political situation.

They point out, rightly, that the long recession is over, that economic growth is accelerating and that unemployment has finally started to fall. And they argue, with some justification, that both the Socialists and the PP have probably reached their electoral nadir.

The former are due to elect a new leader next month, while the latter stand to profit from an improving economy, with growth expected to exceed 2 per cent next year.

What is more, Spain's electoral system makes it fiendishly difficult for small parties to gain a large number of seats in parliament. That means the next legislature could end up looking less fragmented than current polls – and widespread public discontent with the main parties – suggest.

As for Catalonia, the Rajoy government seems to be pinning its hopes on the region's commercial elite and middle class.

The assumption in Madrid is that, sooner or later, the economic risks associated with independence will drive a wedge between mainstream Catalan society and the secessionist movement. The anti-independence camp also hopes disaffection with Spain will start to decrease as the broader economy improves.

> 'I am surprised that every time news points to instability, there is no reaction in the markets'

It is a hope, however, that appears fanciful to say the least. "Here in Madrid, they just don't understand the seriousness of the Catalan problem," says one well-connected business leader in the Spanish capital.

Like a growing number of his peers, he believes that "the risk of political instability in Spain is huge."

What is clear is that Spain faces challenges on several key fronts: the economic crisis is easing but unemployment is still appallingly high and debt levels remain worrying.

The situation in Catalonia is volatile, while the country in general is gripped by a crisis of confidence in the political system.

In a nation that still bears the scars of civil war and dictatorship, one should never underestimate the political and social forces promoting stability.

But rarely has Spain's immediate future been so hard to forecast.

Vultures may have had their richest pickings

Private equity

The best could be over, writes *Anne-Sylvaine Chassany*

What a difference three years make.

In 2011, Spain was a land so economically toxic that only a handful of vulture funds dared venture into it. These days, you can find all kinds of private equity birds flocking there.

They are keen to buy anything from companies, infrastructure, loans and property – and they are doing so in such numbers that dealmakers are starting to wonder whether the bargains may have vanished.

"We felt, two to three years ago, that Spain was over-shorted," says Gabriel Caillaux, a London-based partner at General Atlantic. "Now the trade is going away. It may have gone already."

A year ago, General Atlantic and fellow US private equity group Warburg Pincus purchased a 50 per cent stake in Banco Santander's asset management business, in a €2bn deal. Spain's largest bank had spent years trying to sell the unit, which has about two-thirds of its assets under management in its domestic market.

"The deal would attract much more competition if it were done today," Mr Caillaux notes. "Santander two years ago was happy to work with us and Warburg Pincus. Now, it would be us and Blackstone and KKR, and so on," he says.

> 'Every single group has an interest here these days – partly because of the supply of deals'

With the economy showing signs of improvement and the threat of another eurozone debt crisis having receded, deal activity has been buoyant.

More than $3.4bn worth of Spanish buyouts have been announced so far this year, a third more than in the same period a year ago, according to data compiled by Thomson Reuters. This is also the biggest amount since the 2007 peak of $3.54bn.

Cinven is among those that have recently decided to gamble on the country again. This month, the London-based fund manager agreed to buy the fibre telecommunication network of Spanish utility Gas Natural for $510m.

To clinch the deal in a sector it had identified and researched over the past year, Cinven made a knock-out fully funded offer to the seller to squelch competition.

The move came after Cinven's unsuccessful €2bn bid for Applus, the Barcelona-based product certification specialist owned by Carlyle and Investindustrial, which instead decided to float the company in May to tap into Spain's buoyant stock market.

BC Partners, another London-based buyout house, had also submitted a firm offer for Applus.

"We've been looking at buying assets in Spain in the past few years," Jorge Quemada, a Cinven partner, says. "We've been luckier this time."

Cinven is likely to revive a plan to open an office in Madrid, following in the footsteps this year of KKR.

The reopening of the initial public offering market in Spain, led by eDreams Odigeo, the online travel agent backed by private equity houses Permira and Ardian, has helped lift the mood. The Madrid flotation of the company that operates under the Opodo brand in the UK, helped dispel memories of the disastrous listing of Bankia in 2011.

Growing appetite from industrial groups seeking to buy into the Spanish recovery has also allowed buyout groups to boost their returns on investments made before the crash, fuelling a more positive sentiment towards the country.

Providence Equity Partners made a 60 per cent cumulative profit on its investment in Ono, the country's second largest cable operator, when it sold its stake to Vodafone in March. The US buyout house had written down the value of its stake by 80 per cent during the downturn.

Investindustrial and KKR sold Avincis, which started as a helicopter operator based in Alicante, to Babcock International, after expanding the business through acquisitions in Italy, France, Scandinavia and the UK.

Bill Gates, in October, invested €113.5m to become the second largest shareholder in Spanish builder FCC.

Spanish regulators have been supportive, says Mr Caillaux. "They are pro-business. They want to attract foreign capital."

The government has started Fondo ICO Global, a €1.2bn fund that aims to back local private equity and venture teams whose portfolios have been wrecked by the downturn.

Foreign funds looking for non-performing bank assets – such as Apollo, Lone Star or Centerbridge – have never been busier, as lenders start disposing of units and loans after increasing provisions.

"You find competition for every portfolio," says Andrew Jenke, a director at KPMG Portfolio Solutions. "Every private equity group has an interest in Spain these days. It's partly because of the supply of deals. There are €160bn of reported non-performing loans on banks' balance sheets."

Jaime Bergel, a partner at HIG Europe, warns that investors have become too optimistic about Spain: "Private and public spending has not recovered."

Cinven's Jorge Quemada, too, is taken aback by the level of excitement for his country. "Spain was not as bad as investors thought two years ago and I don't think this is the Eldorado people think it is now."

Lenders enjoy renascent spirit

Banking The signs emerge of a fragile yet steady revival, writes *Richard Stovin-Bradford*

A little over a year ago, the leaning tower of Bankia's headquarters on the Paseo de la Castellana, Madrid's main thoroughfare, provided a gleaming – if unintentional – symbol of all that was wrong with Spain's banks.

Knocked hard by a decade of carefree property lending that culminated in a €19.2bn loss in 2012, Bankia was the biggest of a handful of banks rescued by the government, forcing Spain into a €100bn sovereign bailout.

Today, a resurgent Bankia carries with it the hopes of Spain's fragile – but determined – recovery. The government has even started to sell down its 68 per cent stake.

The lender's shares trade at 1.4 times book value – well above average eurozone and Spanish multiples of about 0.8 times and 1.2 times – and up from barely 0.1 times mid-crisis.

Analysts say that valuation looks stretched, as if investors have arrived at the fiesta too early – especially as the scars of Spanish banks' darkest days are still apparent. True, bank profits are rebounding off the low base set by the drastic bad loan provisions imposed by the Bank of Spain. But many lenders' revenue growth remains lacklustre.

Net interest margins have recovered sharply since the insane "deposit war" that broke out in early 2010, when banks offered ever higher rates to lure depositors. Santander was paying 0.91 per cent on time deposits in Spain in the first quarter, compared with 2.04 per cent a year ago.

But credit demand remains subdued and private and public debt high. In Santander's case, overall income fell despite the margin improvement, as its domestic loan book contracted by 9.4 per cent. By contrast, Banco Sabadell's net interest income rose by 17.5 per cent in the same period.

Josep Oliu Creus, Sabadell's chairman, says: "This year, the driver of Spanish bank earnings will be falling provisions and improved interest income, which, in our case, has risen for three consecutive quarters."

Even so, like other banks, Sabadell juiced its first-quarter revenue with trading income, making more from trading than lending – though it used its 223 per cent leap in trading income to boost bad loan provisions. Analysts argue that reliance on trading income can detract from earnings quality.

Onwards and upwards: the government has begun to sell down its original 68 per cent Bankia stake Bloomberg

Santander and BBVA, Spain's most international banks, rely less on their domestic market. Excluding property portfolios in run-off, it accounted for 14 per cent of the first-quarter profit of Santander's operating areas and 36 per cent of BBVA's. Currency weakness in their Latin America units, however, dented overall profit. Bankers accept the need to be bolder with cost cuts. "With such low interest rates, it is absolutely essential to be a low-cost producer," says Jaime Sáenz de Tejada, BBVA's strategy and finance head. BBVA's first quarter costs fell 7.9 per cent from a year ago.

Bank of Spain data show that non-performing loans (NPLs) still accounted for a high 13.4 per cent of lending at the end of March. But declining bad loan charges have helped drive profit recovery. Banks report a slower pace of bad loan formation and some have sold bad loan portfolios to bring down their ratios.

Perversely, post-crisis measures have created an anomaly, notes Nick Anderson, an analyst at Berenberg Bank. "Banks have been able to clean up their balance sheets by selling NPLs and other assets, because buyers have benefited from low interest rates and the associated liquidity," he says, "yet low rates also mean banks' revenue is struggling."

With loan quality still in doubt, investors increasingly demand a common equity tier one capital ratio of more than 10 per cent of risk-weighted assets. Banks have been creative about capital raising.

Santander has sold stakes in listed subsidiaries in the Americas and other assets. Sabadell raised capital through a rights issue and brought in new investors from Latin America, as did Banco Popular.

The Bank of Spain has limited the cash portion of bank dividends to 25 per cent. Last year, lenders were able to reclassify €30bn of deferred tax assets from property lending losses as state-guaranteed tax credits that count towards regulatory capital.

Rapid consolidation post-crisis has created a smaller number of better-capitalised banks. Further consolidation beckons, as Spanish bankers talk irrepressibly of making bolt-on acquisitions of loan portfolios or branch networks in Spain.

Santander has bought a majority stake in the consumer lending business of department store group El Corte Inglés. Banco Popular is reportedly in talks to buy Citigroup's Spanish retail banking and credit card business.

The banks must negotiate one more hurdle before they can grow more fully into stock market ratings that increasingly look stretched: the ECB's comprehensive review of eurozone banks, due in the autumn, with its strict stress tests. But Spain's bankers are mostly more upbeat about their renascent growth than their European peers. How fortunes change.

Latin America acts to cushion the blows

Investment

Former colonies have helped take the edge off the crisis, writes *Ian Mount*

After the Brazilian entrepreneur Marcelo Weisz sold Crio-Cord, the Madrid stem cell preservation company he founded in 2004, he searched for opportunities in the medical testing field.

When he looked at Brazil, he saw a €350m specialised medical testing market that was growing 20 per cent annually, compared with Spain's stable €60m market.

But he did not buy in Brazil. In March 2011 he bought 70 per cent of Cerba, a Barcelona clinical analysis company for €3.5m.

Mr Weisz still has access to the growing Brazilian market; Cerba collects samples in Brazil and sends them to Barcelona for testing. But by buying in Spain, he avoided Brazil's long import delays on medical equipment.

Businesses in Spain were cheap after the financial crisis and offered access to the larger EU market. There were monetary considerations, too.

"The big motive is the stability of the euro," he says. "Investing in Brazil or other emerging countries involves a big currency risk."

In recent years, what was a one-way investment flow has become two-way, as Latin American investors have put their money into Spain. According to Spain's BBVA bank, flows of foreign direct investment from Latin America into Spain began to grow in 2001 and in 2010 equalled Spanish investments in Latin America, at €8.8bn.

Where once "the world expanded in Latin America," says Javier Santiso, an economics professor at Madrid's Esade business school, "now, Latin America is expanding into the world."

The question is whether that is a long-term trend or a crisis-inspired bubble.

Spanish banks and utilities moved into Latin America after its economies opened to foreign investment in the 1990s. Between 1992 and 2001, Spanish businesses invested €80.4bn in Latin America, beside the US's €97.7bn, says the Elcano institute in Madrid.

While BBVA reports higher revenues and profits in Mexico than in Spain, Banco Santander says it makes more profit in Latin America than in Europe, the US and UK combined.

Such Latin American diversification has helped Spanish businesses weather the crisis at home.

Áreas, a travel, restaurant and retail company based in Barcelona, first moved into Latin America in the 1990s.

In 2006, it used its Mexican operations as a base for moving into the US. The US provides about 25 per cent of Áreas's €650m annual revenues, down from a 2007 peak of €720m.

"We lost a lot of income in Spain during the crisis," says Áreas chief Pedro Fontana. "The growth in the US basically compensated for the drop in Spain."

But as Latin America has grown, its businesses have turned the investment flow back and moved into Spain.

Between 2008 and 2013, Latin American companies spent more than $9.2bn buying Spanish companies, according to the market analysis firm Dealogic. Mexican companies were especially active, buying the bus company Avanza (for $1.1bn), Sara Lee's Spanish bakery operations ($154m) and a majority of the Campofrio food group ($1.2bn).

Pedro Fontana, chief executive of Áreas

For many, it was a logical way to diversify and expand, just as Spanish groups had done. There was also a price consideration: after the crash, many Spanish companies were on the market at fire-sale prices

"If there had been no crisis in Europe, a lot of these opportunities would not have existed," says Mr Santiso. "Neither Campofrio nor Sara Lee would have been possible to buy."

For many Latin American companies, Spain offers a common language, access to the EU's common market and sometimes cheaper deals than in their own region. That said, the flow of Latin American investment into Spain is far from a reverse colonisation. To a large extent, the figures reflect Spanish companies investing less in Latin America, something likely to change once Spain's economy improves.

Pankaj Ghemawat, a professor at Iese business school in Barcelona, says: "It's not exactly Latin America taking over, no matter how much that would cater to how they feel about the former colonial master."

In 2012, Latin America accounted for only 10 per cent of the foreign direct investment into Spain.

Instead, with signs of a Spanish recovery, it seems more likely the investment flow will be healthy both ways.

"It's a much more bidirectional relationship now," says Mr Santiso.

Buyers and sellers haggle out a price

Property

Commercial sector picks up as foreign funds buy office space and shopping centres but residential market lags behind, writes *Ian Mount*

After John Carrafiell co-founded GreenOak Real Estate in 2010, the firm's first investments were in New York, London and Tokyo. But in February, GreenOak and several partners announced that, after almost a year of talks, they had moved into Spain's downtrodden property market and bought eight shopping centres for €160m.

"There was very little done [in Spain] before the summer of 2013," says Mr Carrafiell, who was formerly the global co-head of Morgan Stanley Real Estate. "There is always a period of adjustment in terms of where buyers and sellers see value."

GreenOak's deal is not the only recent example of buyers and sellers finally agreeing a price. About €5bn was invested in Spanish commercial real estate last year, according to CBRE Spain, the property consultancy, more than twice the 2012 amount. After the government made economic reforms and indicators began to point upward, some investors decided Spain's market had bottomed and was worth a look.

"No one wanted to put a penny in Spain, because many people thought there was a huge risk of it leaving the euro," says Enrique Martínez, executive managing director of CBRE Spain. "But at a certain point, the investor community realised that this would not happen. At that point, it was the herd instinct."

At a recent property conference in Madrid, Marta Gómez, director of investor relations for Sareb, the "bad bank" formed in 2012 to hold €51bn in assets of Spain's bailed-out banks, said she had spoken in 2013 to 700 funds interested in Sareb's portfolio.

Last summer, Blackstone bought 1,860 Madrid apartments for €125.5m and Goldman Sachs partnered with a local firm to buy 3,000 more.

This year, Qatari funds bought Barcelona's Renaissance and Madrid's InterContinental hotels. And Canadian pension fund manager PSP Investments and a local partner bought Madrid's Castellana 200 complex for €140m.

The shopping centre market has been active, because many malls had foreign owners who were eager to deal, often because they had loans due that would be hard to refinance, says CBRE's Mr Martínez.

Patricio Palomar, director of research at CBRE Spain, expects retail space transactions to double this year, to about €2bn.

The office market has been slower. There were €54.6m of commercial office transactions in Barcelona during the first quarter of 2014, compared with €25m the same period last year, says Oriol Barrachina, chief executive of Cushman & Wakefield in Spain. whose data show the per square metre sale price for prime Madrid office space fell from more than €10,500 in 2006 to €5,200 today. Prime office rents fell from €42 to €24.50 a square metre. Both have recovered slightly in 2014.

The combination of lower prices and higher rental yields than Paris and London has attracted investors; prices have "clearly" bottomed and will begin to rise, says Mr Barrachina.

Signs of the times: property deals are still at only half their 2007 peak Bloomberg

The residential market is more complicated. After price tumbles of more than 50 per cent in some areas, the number of sales is rising. But nationwide prices are still falling, albeit slowly; May's year-on-year drop of 5.3 per cent was the lowest in three years, according to Fotocasa.es, the real estate portal.

Mark Stücklin, founder of the Spanish Property Insight website, notes that there are two residential markets in Spain: a healthy market for foreigners who pay cash for prime properties; and a difficult market for locals who cannot get mortgages.

Some prime neighbourhoods are seeing increases. In Barcelona, 21 of 35 districts recorded rising prices in May, according to Fotocasa; in Madrid, it was 22 of 52.

Still, there are drags on the residential market. Despite several big transactions, most portfolios for sale are not interesting for investment funds, says Fernando Encinar, co-founder of Idealista.com, a property website.

"Funds are interested in a condominium with 50 units and good profitability," he says. "What they are finding is dispersed collections of properties, and they don't have teams to manage all these units."

And despite a 2 per cent rise in home mortgages in March, the first in four years, most Spaniards cannot access the market, says Beatriz Toribio, head of research at Fotocasa.

"With unemployment and lack of access to credit, we can't talk about recuperation," she says. "Interest from foreigners isn't enough."

For now, property recovery is nascent. Indeed, the €5bn in deals in 2013 is still only half its 2007 peak.

"Spain has attracted a tremendous amount of interest and a lot of talk, but not as many people have actually got things done," says Mr Carrafiell.

That could change as Spain's economy improves. Mr Carrafiell says he expects consumer spending and other indicators to improve in 12-18 months, helping the market: "I don't know whether it will be in two or three or even four years, but I do think there will be a powerful recovery in Spain."

Risks remain despite signs of recovery

Economy
SARAH GORDON

The recovery in Spain's economy has been amply rewarded by investors.

Since the beginning of 2013, the main stock market index, the Ibex 35, has risen by 32 per cent. And with 10-year bond yields at 2.7 per cent, the government has never been able to borrow so cheaply.

In May, the International Monetary Fund endorsed the investors' seal of approval, saying Spain had "turned the corner".

It is reasonable to believe the improvement in the economy will continue. A survey of manufacturing last month climbed to its best reading in four years and marked the sixth month in a row that the survey had signalled an expansion in activity.

The recovery, initially driven by exports, has started to feed through into an improvement in domestic demand and business investment.

Investors have been right to take advantage of falling economic and financial risk. But they should remain alert, not just to the question marks over the sustainability of the economic recovery, but also to other risks lurking in the shadows.

One that has retreated there, but not disappeared, concerns the robustness of the financial system.

Spain's banks have done a good job of shifting risk off their balance sheets. But bank lending is still contracting, creating big problems for the many small and medium-sized companies that remain unable to access public bond markets.

And the level of indebtedness in the economy as a whole has barely budged since the peak of the financial crisis.

Lombard Street Research calculates that Spain's total debt – public and private – at three times gross domestic product, is little changed from 2010.

Spain is not the only eurozone country struggling with a huge debt burden. But reducing it, in the absence of inflation, will require sustained growth.

This seems unlikely.

Standard & Poor's, which recently upgraded Spain's credit rating, expects the economy to grow at 1.6 per cent a year on average until 2016.

Many of the banks' bad debts, rather than disappearing through default as has often been the case in the US, have simply been shifted, either into Sareb, the government's bad bank, or into the shadow banking system, often in the form of debt-funded European private equity buyers.

The European Central Bank's asset quality review, due in the autumn, will pick up the improvement in the capital positions of Spain's largest banks, but will not capture the risks remaining outside them.

The second underestimated risk is political. According to the IMF, 5.9m Spaniards are unemployed, more than half of them for longer than a year. The absolute number may be falling – it dropped for the fourth month in a row in May. But it still represents more than a quarter of the working population.

Not only does this put huge social strains on the country and its people, but it will also keep a lid on any recovery in domestic demand and on growth. Average household income is still below pre-crisis levels and the unemployed cannot afford to spend.

High unemployment is one of several factors that will hamper the government's attempts to pursue further reforms.

Spain's policymakers have made painful decisions about spending, taxes and pensions. But to sustain the improvements in competitiveness to which these have contributed will require further action.

Disincentives to hiring, such as the highly protected nature of permanent contracts, need to be addressed, as do the regulatory barriers to creating and operating businesses. The IMF has identified 2,700 of these, mainly at regional level.

> Unemployment will hamper the government's attempts to pursue further reforms.

Drumming up popular support for such measures will prove challenging in an environment where growth has picked up but its benefits – in particular larger falls in the number of people out of work – are not felt by many.

The other political risk on the horizon is the possibility of Catalonia voting to secede in November. Business leaders in the region have, on the whole, remained reticent about how an independent Catalonia would affect them.

Given that the region represents a fifth of the country's output and that, admittedly on the Catalan government's estimates, it makes more than €16bn of fiscal transfers to the centre each year, the financial impact of a secession – not to mention the resulting political and social fissures – should not be underestimated.

Central government is putting up a robust defence against a referendum in Catalonia. But with polls showing that half the Catalan population would vote for independence, investors ignore political risk at their peril.

Electricity industry absorbs the shock of reforms

Energy

Subsidy cut on renewables takes its toll but there may be light ahead, writes *Martin Roberts*

Before the economic crisis, Spain was a haven for energy investors. Generous subsidies to renewables turned the country into one of the world's leading producers of wind and solar power, while high electricity and gas demand fuelled infrastructure growth.

The subsidies to renewables, however, widened the deficit between regulated prices and energy production costs, a serious concern for successive governments.

The deficit – including subsidies to coal, consumers in Spain's islands and payments to utilities dating back to privatisation – has reached €30bn.

After years of wrangling, the government last year pushed through reforms to tackle the deficit by slashing subsidies – some retroactively – and raising taxes. Investors have been up in arms ever since.

The country's largest power utility, Iberdrola, produces about a quarter of its electricity in Spain from renewable sources, mainly wind farms. It estimates that the reforms cost it €801m in 2013 and already €255m more in the first quarter of 2014 than in the same period last year.

"We had been hoping for a reform that gave clarity to the sector, resolved the tariff deficit, resolved structural distortions and established a framework to invest with reasonable returns," says an Iberdrola representative. "Instead, we have had a series of reforms whose primary aim is to raise tax revenue."

Iberdrola generates 57 per cent of its power outside Spain and has responded to the reforms by increasing its investment in other countries. Out of a total of €8.9bn it has earmarked for investment for 2014-16, it plans to invest 85 per cent on projects abroad, including offshore wind farms in the North Sea.

"Investments will continue in Spain, but they will be on maintenance and not for now on new projects," the representative adds.

Analysts say the reforms, while painful, have at least in theory stopped the deficit growing and that the former renewables subsidy scheme was unsustainable.

"Many investors had internal rates of return of more than 20 per cent," says Victor Peiro, analyst at brokerage Beka Finance.

They could expect to recoup investments within four to five years. "That was too attractive for some people," he adds. "The government realised that and changes had to be made. The current system makes more sense."

The other bugbear for energy investors in Spain is overcapacity because of optimistic demand forecasts made in the pre-crisis years.

Spain's power stations can generate up to 108GW, or more than twice the highest demand they have ever had to meet, which was 45GW in 2007.

"You will probably have to wait several years for many [power] projects to be implemented. There will be some for now, but not many," Mr Peiro says.

Stirred up: investors in wind farms have been up in arms

Electricity demand has been in decline since 2008, although some analysts expect it to bottom out this year in view of the nascent recovery by the economy as a whole.

Another hurdle that the electricity industry has to clear is the ability to generate power at a price that makes ailing Spanish industry competitive with its European neighbours.

In its latest report, Spain's energy regulator estimates that while the benchmark 2015 futures contract for power in Spain fell 3 per cent in March, to €47.08 per megawatt-hour, it was trading well above levels in France (€42.58) and Germany (€34.27).

The natural gas industry will also need to undergo reforms, probably in 2015, but they are not expected to be nearly as drastic as was the case with the electricity industry.

It, too, has fallen victim to ambitious forecasts, and to renewables taking a bigger share of Spain's energy mix.

The end result is that investors have poured billions into building gas-fired generators, gas pipelines from Algeria and regasification plants in ports, which are working at nowhere near capacity.

All this infrastructure has at least diversified Spain's supplies and could cut Europe's dependence on Russian gas by 12 per cent – if the EU throws its weight behind a pipeline project across the Pyrenees that would allow Spain to sell its gas glut to France and the rest of the continent.

"Spain could become part of the solution for Europe's crisis in security of supplies," says Antoni Peris, head of Spain's gas industry group, Sedigas, with reference to the continent's dependence on Russian supplies in the context of the Ukraine crisis.

Alvaro Navarro, an analyst with investment services company Ahorro, says last year's electricity reforms will have an impact on this year's company results.

"But after that, I believe revenues and earnings from the electricity business should stabilise," he adds.

"Most of the reforms have been enacted, although there are still adjustments to be made.

"But we have left behind the period of maximum regulatory uncertainty."

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Foreign opportunities sought as home market splutters

Construction

Overseas projects help keep groups in business, writes *Martin Roberts*

Large construction groups were hit hard when Spain's property bubble burst. Builders such as ACS, FCC and Sacyr saw up to 80 per cent of their domestic market vanish, as the private and public sector slashed spending on new projects.

Investment in the sector as a whole more than halved between the final quarter of 2007 and the last three months of 2013, from €58.4bn to €25.4bn, according to estimates by Spain's national building confederation.

Juan Béjar, FCC's vice-chairman and chief executive, says: "I believe real estate is going to recover faster than people think, but public investment in infrastructure will remain quite weak, at least, for the next two or three years."

To make matters worse, many companies borrowed in the boom years in an attempt to diversify, only for their debts to pile up after the crisis hit in 2008.

Sacyr bought 20 per cent of Repsol, the oil company, but was forced by creditor banks to halve its stake.

Others invested in renewable energy but suffered when the government cut back formerly generous subsidies last year.

Several companies joined forces to bid for toll road concessions in Spain, but were hit when traffic flows declined. The government is planning a €2.3bn bailout for the toll roads.

The construction companies have sought richer pickings abroad.

Sacyr and OHL are leading respective consortiums to expand the Panama Canal and to build a high-speed rail link in Saudi Arabia between the cities of Medina and Mecca.

ACS, meanwhile, has acquired Hochtief, the German construction company.

Today, analysts say Spain's six largest construction companies rely on overseas projects.

Such schemes account for 84 per cent of the companies' order books – a turnround from 2007, when the domestic economy was still booming and the proportion was 30 per cent.

Juan Moreno, an analyst with Ahorro Corporación, says: "The companies are well aware that the construction business in Spain will take years to get back to what it was, because there is an oversupply of infrastructure in the country."

He adds: "The crisis came when the companies were highly leveraged. Now we are seeing the fall in construction activity bottoming out in Spain, the companies are growing internationally and there is some substantial deleveraging."

While the market remains subdued, the mood in the industry has brightened, not only because of big contracts abroad, but also because companies have shed non-core assets and reduced debt.

Sacyr sold its stake in two Madrid hospitals in the first three months of the year, as well as a holding in the Seville metro.

At present, the company is engaged in selling Vallehermoso, its property division and removing €1.2bn in associated debts from its balance sheet in the process. Sacyr has already cut €400m in debt linked to Vallehermoso after handing over assets to creditor banks. It plans to dispose of the remainder of the division's assets and debt by the end of the year.

> 'Companies are growing internationally and there is substantial deleveraging'

FCC, which has interests in infrastructure and energy as well as construction, plans to generate cash until its net debt is no more than three times earnings before interest, taxes, depreciation and amortisation.

"More than 80 per cent of the divestment plan is complete," FCC's Mr Béjar says. "Our €2.2bn divestments target will be achieved by the end of the year."

At the end of the first quarter this year, the big six had trimmed their total debts by 9.1 per cent from a year previously, to €33.98bn.

Construction companies have benefited from a drop in borrowing costs, on the back of a fall in sovereign debt yields since Spain was in the depths of its crisis in 2012.

Rafael Fernández, an analyst at Beka Finance, says this reduction may allow the government to spend more on civil engineering after it meets deficit reduction targets.

"Construction has been the big job creator in recent years, because it typically employs two or three times more than other sectors, and the government's big concern is to reduce the unemployment rate to below 20 per cent," he says.

A revival of investor appetite can be seen by the fact that, after a private placement of shares in April, Sacyr managed to increase its capital by €166m and sold a €250m convertible bond in May.

OHL, meanwhile, sold a €400m bond in March and plans to issue up to €3bn in debt. FCC, for its part, has recently lured investors such as Bill Gates and George Soros.

Looking ahead, Mr Moreno expects to see the market bottoming out at home, bigger international growth and more deleveraging.

"These will be key factors in 2014, which could be the year of the sector's recapitalisation," he says.

Jobs may prove vital to Rajoy's election fortunes

Employment Prime minister professes confidence, writes *Tobias Buck*

Mariano Rajoy knows that his chances of winning the next general election are likely to turn on one simple fact – whether the nascent economic recovery feeds through into the disaster zone that is the Spanish labour market.

In recent declarations, Spain's prime minister has sounded increasingly confident. He has promised repeatedly that unemployment will be lower at the end of next year – when elections are held – than at the end of 2011, when his government took office. "We have broken the trend of employment destruction," Mr Rajoy declared last month.

The latest labour market data offer some support for the prime minister's assertion, but they also illustrate the scale of the challenge facing the country in the years ahead.

Last month, the number of registered unemployed people fell by almost 112,000 on the previous month, with strong signs that the decline was not just the result of a shrinking workforce but of a real boost in hiring. New labour contracts were sharply up and the number of workers affiliated to the social security system rose by almost 200,000, the biggest increase ever recorded.

"Right now, after eight months of continuous growth in employment, we can be pretty certain the recovery has started," says Marcel Jansen, a professor of economy at the Autonomous University of Madrid.

"What we are seeing is surprisingly strong job creation, given how low economic growth still is. It suggests that companies have been shedding labour for so long that even a small pick-up in activity forces them to hire workers."

Along with other labour market experts, however, Prof Jansen warns that it will take many years for Spain's crisis-scarred labour market to recover fully and that many unemployed people face the risk of permanent exclusion.

Indeed, to get a better picture of the depth of Spain's unemployment crisis, one has to look not at the monthly data, but at the quarterly labour market surveys published by the national statistics office. The latest, released in April, found that six years after the start of the crisis there are still 5.9m people out of a job – down from last year's record high but not by much.

Work wanted: jobless total is near 6m

The survey confirmed that Spain's pool of labour is shrinking steadily. This is in part because of migration but also because many unemployed have become so disillusioned that they have given up the search for a job and have dropped out of the statistics.

This effect helps explain why the unemployment rate rose to 25.9 per cent over the latest quarter, even though the number of unemployed fell slightly.

The youth jobless rate also rose, with 55 per cent of workers under the age of 25 out of work

Much of the new hiring is concentrated in low-skilled services sectors, especially tourism, mostly through temporary rather than permanent contracts. "Employment is growing but the quality of work is deteriorating," says Prof Jansen.

Such concerns pale when set against the most pernicious legacy of the recent crisis: long-term unemployment. Three in five jobless Spaniards are classified as long-term unemployed, meaning they have been looking for work for at least a year. Close to 1.3m Spaniards have been out of a job for more than three years – often suffering a near-complete erosion of their skills.

Their situation is linked directly to the heart of Spain's economic crisis: the bursting of the debt-fuelled housing bubble after 2008.

During the decade-long boom, the construction sector sucked in huge numbers of workers, offering easy money for largely low-skilled work. When the crisis hit, hundreds of thousands ended up in the streets without the basic school-leaving certificate or any kind of vocational training.

The fear is that millions of Spaniards will drift ever further away not just from the labour market, but also from society at large. For those who have no job, and who can no longer rely on unemployment benefits or other forms of state support, the risk of social exclusion grows by the day.

Analysts say that the government's sweeping labour market reform of 2012, the cornerstone of Madrid's economic reform effort, is doing little to help the long-term unemployed.

The reform injected greater flexibility into the labour market, by allowing more companies to strike wage deals at factory level rather than as part of a collective industry agreement. It also made it cheaper and easier to fire workers.

Though deeply controversial, the reform is widely credited for helping the private sector keep wages down and restore the country's export competitiveness. But lowering wages does nothing to help workers who lack the skills for the job in the first place.

Madrid must, say analysts, overhaul Spain's "active" labour market policies with more targeted measures to train the jobless for a return to work.

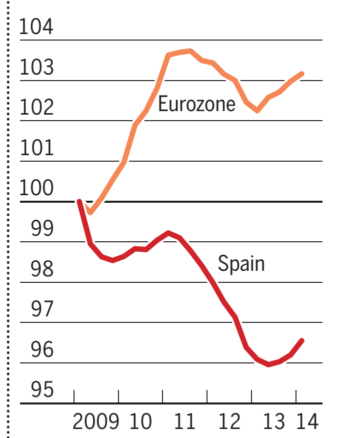
"Our public employment services are absolutely not prepared for the task ahead of them," says Prof Jansen, pointing out that just 2 per cent of new labour contracts are brokered by Spanish job centres.

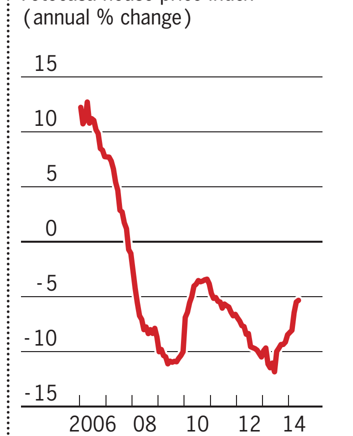
In its latest report on the Spanish economy, the International Monetary Fund voices the same concern, arguing that "more needs to be done, especially by regional governments, to help the unemployed improve their skills and find work". The IMF says Spain should use more private job placement agencies, allow more competition in training services and create a single portal for job vacancies for the entire country.

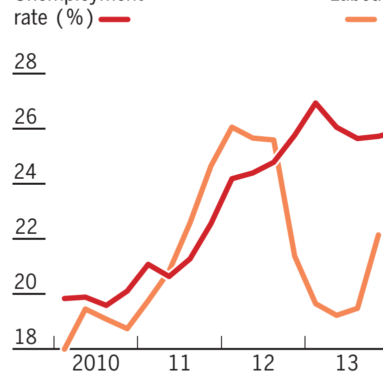
The government of Mr Rajoy has promised to table a new package of labour market reforms before the summer, with special emphasis on active labour market measures. If the prime minister wants to fulfil his election promise for next year, he and his ministers have their work cut out.

> 'Employment is growing but the quality of work is deteriorating'

Labour's pain

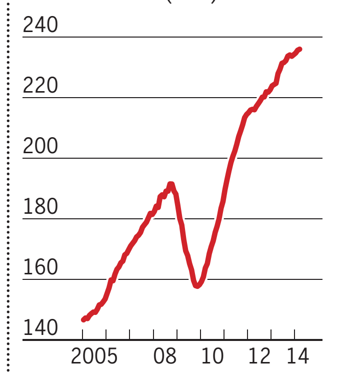






Unemployment rates Q1 2014 (%)

Age	Sex	Rate
16-19 year old	Females	72.7
	Males	68.3
20-24 year old	Females	52.0
	Males	53.7
25-54 year old	Females	25.3
	Males	23.6
55 years & above	Females	19.0
	Males	20.3



Sources: Eurostat; Thomson Reuters Datastream; Haver Analytics * 4-quarter moving average FT graphic

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