INVESTING IN Spain

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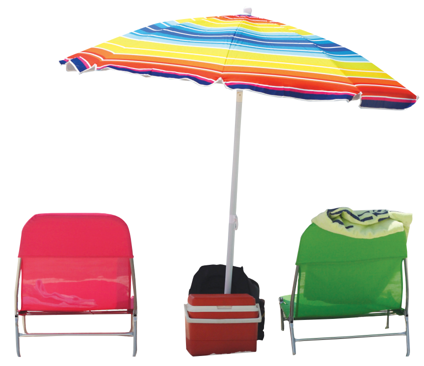

Online

Spain's tired old sun and sea tourism model is under pressure. Heavy investment is needed to spruce up its image

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Recovery elusive but darkest days have passed

Early reforms have helped but there is a long way to go before the country is back on track, explains **Victor Mallet**

Tough choices: José Luis Rodríguez Zapatero, the prime minister, is being forced to make some difficult decisions AFP

In two years of global economic crisis, the darkest days to date for Spain, for its financial system and for José Luis Rodríguez Zapatero, the prime minister, came not with the collapse of Lehman Brothers in the autumn of 2008, but in the supposedly sunny months of May and June this year.

The European Union and the International Monetary Fund had unveiled a €110bn bail-out for Greece amid a sovereign debt crisis affecting weaker members of the eurozone. A week later, on May 10, the EU and the IMF announced a further €750bn in rescue funds for fear that Spain, Portugal and Ireland might go the way of Greece.

On the following day, President Barack Obama took the unusual step of calling Mr Zapatero and told him to take "resolute action" to save the Spanish and eurozone economies. And the day after that, the Spanish prime minister launched a harsh austerity plan to reduce the budget deficit, cutting civil service pay by 5 per cent. For weeks, most Spanish banks found it impossible to raise money on wholesale finance markets, even for short-term liquidity, and were forced to increase their reliance on emergency funds offered by the European Central Bank.

Mr Zapatero – a career Socialist politician forced by the financial markets to adopt radically restrictive fiscal policies and to liberalise the labour market – went into something of a funk and shut himself up in the Moncloa prime ministerial complex, according to people who know him.

Since July, however, Spanish confidence, and Mr Zapatero's in particular, have rebounded.

Victory for Spain in the World Cup football final did no harm. More importantly from a financial point of view, the Kingdom of Spain and the stronger banks have again shouldered their way eagerly into the bond markets, issuing billions of euros worth of treasury bills and bonds secured on mortgage portfolios.

Graphs of the spreads over German bunds – showing the extra interest rate costs borne by European debtor nations compared with Germany's – have been bracketing Spain with Italy, suggesting that Spain has successfully decoupled itself from the high-risk peripheral eurozone states of Greece, Ireland and Portugal. The cost of new government debt fell sharply as European interest rates dipped and perceptions of Spain improved.

In September, Mr Zapatero – already notorious in Spain for having refused to admit for months that there was any crisis in the first place – went so far as to declare in New York that he thought the Spanish and eurozone debt crises were over.

Sceptical economists and Spanish bankers say he has spoken too soon, and some fear that the government is starting to ease the fiscal straitjacket prematurely.

Elena Salgado, finance minister, and José Blanco, public works minister, said in August they would restore €500m previously cut from the state infrastructure budget for 2011.

The main official message is that Spain remains committed to austerity and to budget targets designed to reduce the deficit from 11.1 per cent of gross domestic product in 2009 to 6 per cent of GDP next year. Indeed, the government was confronted with a general strike on September 29 organised by its former allies in the trade union movement.

But there is a second message: that Spain now has a little extra room for manoeuvre because tax income is higher than expected, while cost-cutting is proceeding apace.

Shortly after Ms Salgado announced a budget for 2011 that she called "the most austere" of recent years – including tax rises for the rich and a 16 per cent cut in spending by government ministries – official figures were released showing the central government budget deficit for the current year from January to August had fallen 42 per cent from the same period last year.

Sceptics, including Barcelona-based economist Edward Hugh, say this last number is the result of "data engineering" because it hides the continuing transfer of the deficit from the centre to the autonomous regions and Spain's municipalities, a process that does nothing to reduce the total public sector deficit.

Apart from the deficit, the biggest concern for investors and businesses is the lack of economic growth.

The budget and the country's GDP performance are of course connected, and there is therefore some sympathy among business leaders for the Zapatero administration's attempts to maintain enough spending to keep GDP growing.

That reflects the fact that Ireland's harsh austerity plan seems to have fulfilled the gloomy predictions of Keynesians by throttling growth rather than fostering recovery.

The problem for Spain is that no one is sure what the future sources of growth will be, following the collapse

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Inside this issue

Less bank financing but lots of distressed opportunities

Private equity

Mark Mulligan looks at how the industry is coping with changed circumstances

When CVC announced in August it was paying about €1.7bn for a 15.5 per cent stake in Abertis, the Barcelona-based infrastructure group, there were mutterings of surprise. Most private equity groups prefer deals that bring either management or equity control.

The size of the deal was also anticlimactic, coming after the firm admitted in July to plans for a €11bn-€12bn leveraged buy-out in concert with majority shareholders ACS, the Spanish construction group, and Catalan savings banks La Caixa.

This scheme was scuppered partly by lack of bank financing – providing evidence, if more were needed, that the golden age of highly-leveraged buy-outs that ended with the global financial crisis has not returned.

"Mega leveraged buy-out in the traditional mould is still out of vogue," says Juan Díaz-Laviada, managing director of Advent International in Spain.

However, although large deals are hard to execute in today's financial conditions, investor interest in private equity as an asset class remains strong.

"The leverage model and pricing multiples have been reined in, but private equity is one of the few investment classes to survive the financial crisis without real casualties," says Mark Heappey, 3i partner in Spain.

And although there are isolated cases of unused cash being returned to investors, global, pan-European and Spanish firms have identified opportunities in the country this year.

As elsewhere, activity is dominated by pass-the-parcel acquisitions, where one firm or group of firms sells to another. One recent example is the €250m sale of eDreams, the Barcelona-based online travel portal, to Permira, the pan-European firm, by TA Associates of the US.

With weak pricing and constant turbulence making stock market floats a risky undertaking, financial sponsors have been deprived of a popular exit strategy. But one notable exception is Amadeus, the Madrid-based travel services group taken private in 2005, in Spain's largest-ever LBO. It returned to market in June in a ground-breaking deal valuing it at €4.9bn. However, initial public offerings remain scarce. In any case, the absence of a small- and mid-cap investment culture means the stock market is normally an option only for bigger companies.

There have been casualties: Apax recently lost equity control of Panrico, the Catalan bakery group bought at the height of the credit bubble, after a debt swap by banks. Sales to industrial groups have also been hit by tight financing conditions and a corporate tendency towards deleveraging.

At the same time, this trend is throwing up opportunities, especially for private equity groups interested in energy and transport infrastructure.

"It is the spin-offs, the carve-out and the deleveraging in general where most of the action is at the moment," says Advent's Mr Díaz-Laviada.

Although finally going to specialist infrastructure funds run by Goldman Sachs, the recent sale of the gas distribution network of Endesa, the Spanish utility, drew interest from conventional private equity firms.

Financial sponsors also took a look at the Spanish ports business of ACS and distribution assets put up for sale by Gas Natural Fenosa, another energy utility. Similarly, the sale of TransMediterranean, the ferry business controlled by energy and infrastructure group Acciona, has drawn some interest from private equity.

It is not just Spain's over-geared energy and infrastructure groups that are shedding non-core assets to reduce debt. Advent is close to agreeing the purchase of Tinsa, a property surveying company controlled by a group of cajas, or savings banks, which are under pressure to improve balance sheets.

The crisis has also shaken the very core of Spain's corporate sector, which is dominated by family-owned companies with annual sales of €100m or less.

Many were caught out by the credit squeeze and ensuing recession, embarking on expansion plans just as consumer demand fell. "The small to mid-sized companies that have not internationalised are often the first to sink when the domestic economy stagnates," says Steven J. Matlin, whose eponymous firm provides advisory services to the sector. "We are seeing opportunities for private equity to invest where banks have stopped lending."

According to 3i's Mr Heappey, this range of often crisis-related opportunities has put private equity in Spain on track for one of its best ever years, in terms of total equity committed, following a disastrous 2008 and 2009.

"Basically, there are two types of investor at the moment," he says. "There are those who see Spain as a tremendous opportunity, and those who remain nervous about putting their money here."

Banks and cajas not yet out of the woods

High rise: cajas are trying to offload repossessed real estate on low-interest mortgages Alamy

Finance

Fears of a two-tier banking system are still rife, writes **Victor Mallet**

To say that the past year has been a turbulent one for Spain's banking system would be an understatement.

Yet most of the commercial banks and unlisted savings banks, the *cajas de ahorros*, appear to have emerged from the financial crisis and subsequent recession in better shape than Spanish regulators or bankers dared hope – and in better shape than some of their European peers.

The reasons for this resilience in the face of possible disaster are well known.

First, Spanish lenders benefited from strict supervision by the Bank of Spain and from large reserves of counter-cyclical bad loan provisions. More than €18bn of these reserves have been used since the start of 2008.

Second, the smaller cajas – many of which were over-dependent on the housing market and controlled by regional politicians – have been pushed by the central bank into a series of mergers with stronger partners. Although most will retain their brands, the number of caja holding groups has been reduced from 45 to 18.

Third, banks and cajas survived the European Union "stress tests" for banks in July without any unpleasant financial surprises. Five of the seven European lenders that failed the test were Spanish cajas, but Spain's high failure rate was largely because it subjected almost its entire banking system to the testing. Other countries exposed only half their banks.

"If the Bank of Spain had analysed only 75 per cent of the [Spanish] system, nobody would have failed the test," Emilio Botín, executive chairman of Santander, the biggest Spanish bank, said in a speech in September.

As autumn approaches, Spain is no longer regarded as being at imminent risk of default on its sovereign debt, which has helped to ease the pressure on its banks.

At times during the summer, Spanish banks and cajas found it almost impossible to raise long-term money – or even short-term liquidity – on wholesale markets. That has changed in the past few weeks, and stronger banks have taken the opportunity to issue billions of euros of covered bonds.

The bad loan ratio has not risen as high as expected, and in July stood at 5.3 per cent of assets in spite of the continued weakness of the housing market following the bursting of the property bubble three years ago.

Basel III, the new regulatory agreement that will raise minimum capital requirements for the world's banks, caused consternation in Germany but passed almost without a murmur in Spain. Its lenders either meet the 2019 targets already, or are expected to do so by then.

As if to underline the confidence of Spanish banks, Santander, the biggest eurozone bank by market capitalisation, has continued its policy of acquisitions in both developed and developing markets.

All this apparently good news cannot hide the fact, however, that several Spanish lenders – particularly cajas – are still weak.

The danger, according to bankers and bank analysts in Madrid, is that Spain is developing a two-tier banking system. At the top, strong institutions such as Santander, BBVA and La Caixa remain profitable and capable of raising money on international markets.

At the bottom, lossmaking cajas can neither borrow on the markets, nor attract enough customer deposits. They remain dependent on cheap (1 per cent), short-term finance from the European Central Bank – as well as expensive (7.75 per cent) longer-term borrowing from Spain's Frob, the Fund for Orderly Bank Restructuring.

Iñigo Vega, bank analyst at Iberian Equities, the broker, noted recently that it was only the stronger Spanish lenders that had been able to raise money commercially, "which leaves 50 per cent of the system still out of the market".

Combined net profits (excluding minorities) at 42 cajas and the Confederación Española de Cajas de Ahorros (Ceca), fell to €2.54bn in the six months to June, down 29 per cent from 2009, according to Ceca.

José Antonio Olavarrieta, Ceca director-general, said that all cajas were profitable on June 30 and would continue to be in profit at the end of this year. The real situation, however, is somewhat worse because Ceca has excluded Caja Castilla La Mancha and CajaSur, the two seized by the Bank of Spain when they faced collapse as a result of bad loans.

One problem, bankers say, is that the restructuring of the cajas is unfinished. Several of the merged entities have yet to close unwanted branches and lay off surplus staff, steps that will be politically sensitive and unpopular but financially essential if the cajas are to return sustainably to profit and repay debt.

"Structurally, there have been changes," says one Spanish bank executive. "But nothing is happening as a result. The cajas have been forced to integrate, but are doing nothing."

Another problem is that there are grave doubts among analysts and independent economists about the reliability of publicly available bad loan statistics, particularly given that banks have tended to shunt the problem into the future by acquiring billions of euros of repossessed real estate and then trying to offload it with low-interest, 40-year mortgages.

The Spanish banking crisis, in short, has not so far lived up to its billing among foreign critics as a European financial disaster in the making. But with economic growth expected to be flat in the coming two years and the pie of available bank business shrinking, the crisis is not yet over either.

Lack of economic activity and of loan growth; interest rate distortions that make it expensive for banks to obtain funds even though they are offering mortgages at low rates; and deteriorating credit quality – all these add up to a difficult business climate.

"The combination of these is very traumatic for banks," says the bank executive. "For the Spanish financial system, the situation is very worrying."

Bad loans, repossessions and write-offs

	Bad loan ratio (%)	Repossessions (%)	Write-offs (%)	Damaged assets (%)
2007	0.9	0	0.2	1.1
2008	3.4	1.4	0.6	5.4
2009	5.1	3.6	1.2	9.8
2010*	5.6	4.2	2.6	12.4
2011*	4.9	4.2	4.2	13.3
2012*	3.8	4.2	5.8	13.8
2013*	3.0	4.2	7.0	14.2

* Forecasts

Sources: AFI: Bank of Spain

Writing is on the wall for gold-plated employee contracts

Guest Column

DAVID MATHIESON

"It's not enough to be world champions in football – now let's be world champions in creating jobs!" declares the slogan on a wall in the centre of Madrid. A surprisingly articulate example of graffiti and a sign of the times. According to recent polls, unemployment has become the most pressing concern for Spaniards.

A trail of abysmal statistics reveals why: the number of unemployed has doubled since 2007 and now stands at just over 20 per cent of the workforce – more than twice the eurozone average. Since the end of 2007, more than 2m workers have lost their jobs in Spain, presenting the government with a huge fiscal problem.

Among those groups bearing the brunt of the crisis are young people. Nearly 43 per cent of workers aged between 16 and 24 are without a job – double the figure for neighbouring countries, such as France or Italy.

While these figures are undoubtedly a result of the downturn, all the evidence suggests that the collapse of demand in the Spanish economy has merely exacerbated long-standing structural problems in the labour market.

To an extent these rigidities are a legacy from General Franco's corporatist state, which organised the workforce through nationally negotiated agreements.

These sectoral deals, or *convenios*, continue to exercise control over workers' terms and conditions from rates of pay to job descriptions. The lucky (including many older and public-sector workers) have fixed contracts affording extensive privileges; the less fortunate have temporary contracts that offer little or no protection.

Following Franco's death, successive generations of politicians ducked the sensitive issue of labour market reform, preferring to focus on modernising other parts of the economy or simply encouraging the construction boom that absorbed huge numbers of unskilled workers.

Now, however, the exigencies of the crisis and pressure from the markets, the European Union and the International Monetary Fund are forcing Spain into making the long overdue reforms. With domestic growth stalled, José Luis Rodríguez Zapatero, the Socialist prime minister, is looking at supply-side reforms to boost competitiveness and create jobs.

'Months of negotiations between employers and the unions failed to produce any significant proposals'

After months of fruitless negotiations between employers and the unions failed to produce any significant proposals, the government unilaterally introduced a package of labour market reforms in June.

The new law (currently being signed off by parliament) contains four key measures. First, redundancy costs will be cut, making it cheaper to fire workers. Second, new contracts will make it easier for employers to switch workers between tasks. Third, workers on temporary contracts will get more protection. Fourth, private employment agencies will be allowed to compete for public sector contracts for training and work placement.

This last proposal could have important implications. Up to now, the Spanish state has taken little interest in helping the unemployed into work.

However, British companies such as A4e (Action for Employment), which works with more than 20 governments to implement labour market policies, is talking to Spanish politicians about what a programme to help the unemployed might look like. This represents a sea-change in attitude – less state intervention to preserve the privileges of those in work will be balanced by more state intervention to help the unemployed into work.

Whether Mr Zapatero, who is struggling in the opinion polls, has the political will to see the proposed changes through is an open question.

The unions, which generally represent people in work with fixed contracts, called a one-day general strike last week. The disruption may be repeated and Mr Zapatero's ability to face the unions down will be a crucial test of his premiership and Spain's com-petitiveness.

The country may have four years to prepare the defence of its World Cup soccer title, but, as even the graffiti artists of Madrid are aware, Spain does not have that long to fix a labour market badly in need of reform.

David Mathieson is a Madrid-based analyst

Historic city hopes to revive its prosperous past

Seville

Andalucia's capital must compete with Madrid for investment, writes **Victor Mallet**

No longer paved with gold: Seville, the former gateway to the new world, is striving to rediscover some of its past success Alamy

Seville – which has risen and fallen during its Roman, Muslim and Spanish Christian eras – has a big advantage in its struggle to rise again today: a cultural and commercial history that is rich in every sense.

"A thing of admiration not seen in any other port is the sight of carts dragged by four oxen which, when the fleets come in, carry the silver and gold bars from the portside to the Trading House of the Indies," wrote Alonso Morgado, a 16th-century historian quoted in Elizabeth Nash's cultural and literary history of the Andalucian capital*.

"No less marvellous is the sight of the enormous riches accumulated in many streets in Seville inhabited by merchants from Flanders, Greece, Genoa, France, Italy, England and other parts, and from the Indies and Portugal . . . The area is full of silversmiths, jewellers, sculptors, silkweavers and haberdashers of immense wealth."

That was the time of Seville's apogee, shortly after Christopher Columbus had set off from what is still one of Europe's biggest inland ports and discovered the Americas, and the Spanish crown had in 1503 granted the city a monopoly of trade with the New World. Like the monopoly, the immensely wealthy merchants have long since disappeared.

Seville must now compete with other Spanish cities for foreign and domestic investment. Like other regional centres, it is faced with the overwhelming financial dominance of the capital, Madrid.

The Madrid region has not only received two-thirds of Spain's inward foreign direct investment over the past 10 years. It has also become Europe's centre for business with Latin America, whether for European multinationals investing in the Americas or for big companies from emerging markets such as Mexico moving into Europe.

Felipe González, the former prime minister and a *sevillano* himself, provided one solution by promoting Seville as the site for the 1992 World Expo (on the 500th anniversary of Columbus's expedition, its theme was The Age of Discovery).

He also ensured that Spain's first high-speed train line would link Madrid and Seville in the same year – although Barcelona would have been a more obvious choice.

So Seville does not lack infrastructure. The airport and the motorways of Andalucía are more than adequate to serve a city of 700,000.

But transport infrastructure alone does not attract the investors needed to create jobs. Indeed, in the case of Seville, it has done the opposite by providing the means to serve the city from factories elsewhere. Andalucía's unemployment rate is a shockingly high 28 per cent of the workforce, although in the province of Seville the rate is 25 per cent and in the city itself 21 per cent – close to the average for Spain.

Seville's response has been to focus on service industries such as tourism and conferences, where it has an in-built cultural advantage, to promote high-technology investment in areas such as aerospace and to expand the river port to ease the export of the region's agricultural produce.

"Andalucía in general and Seville in particular have a very strong tourism industry," says Carlos Vázquez Galán, the city official responsible for the economy and employment. He is speaking, aptly enough, in his office in the Silver Tower, part of the fortifications built for the city by the Moors in the 13th century.

"Seville has the biggest old quarter of southern Europe. We have an attraction factor for cultural tourism that sustains itself throughout the year."

Among other investments, Seville is in the process of trebling its capacity for hosting conferences to 9,000 people at a time. The port, meanwhile, has been endowed with a new lock gate and other dock works to enhance capacity.

Seville's weakness is that it remains heavily dependent on government spending that has shrunk with the onset of the economic crisis: new metro lines to serve the congested city centre have been put on hold. It also depends on a small number of large industrial companies such as Airbus Military, which assembles the A400M military transport aircraft here; Renault, which makes vehicle gearboxes; and Abengoa, the renewable energy group.

For the time being, Seville has benefited from the relative strength of the Spanish tourism trade over the past few months, and employment in the sector increased 4 per cent in the year to June.

Mr Vázquez in the Silver Tower is nevertheless realistic about the city's immediate prospects for recovery given the stagnant state of the Spanish economy. "The economy won't recover without better demand, and demand won't recover without a reduction of unemployment," he says.

The tourist shops selling souvenirs and cheap flamenco dancing dresses remain a far cry from the prosperous haberdashers of the 16th century.

Nor is there enough wealth today, as Alonso Morgado thought there was in the 1500s, "to pave the streets of Seville with bricks of gold, silver and precious stones instead of bricks of clay".

**Seville, Córdoba and Granada: a cultural and literary history, Signal Books, 2005*

Basque Country Global outlook in industrial heartland

The green valleys and centuries-old villages of the Basque Country seem an incongruous setting for the workshops of Spain's industrial heartland. Its rolling landscapes, wild beaches and rustic air are reminiscent of rural Ireland.

However, the region – more readily identified with ETA, the violent separatist group – has a proud metallurgical heritage.

Mines and foundries fed the industrial revolution and then the Basque Country's own shipyards before global competition forced it to readjust its ambitions.

After a period of painful transition, the region re-emerged as a supplier of components and production systems to European – and increasingly, global – carmakers and energy groups. Car parts alone account for about 17 per cent of regional gross domestic product, a higher proportion than in Germany.

Companies such as Ingeteam, which supplies electronic and mechanical parts to the energy sector, have also flourished under Spain's decade-long push into renewable technologies.

This industrial base – and less speculative property and financial activity – has made the Basque Country more crisis-resistant than the rest of Spain.

According to the regional government, the economy contracted 3.3 per cent last year, compared with 3.9 per cent for Spain as a whole. Unemployment, at about 10 per cent, is half the national rate and in line with the European Union average.

The Basque Country is also home to Iberdrola, Spain's biggest listed electricity company, and Construcciones y Auxiliar de Ferrocarriles (CAF), the stock market-listed train manufacturer.

For the most part, however, its companies are either family concerns or small- to mid-sized conglomerates. Not only are they more agile than listed groups based in Madrid, but they were quick to move production abroad to save money and stay close to their main clients. Indeed, global spread saved many from disaster, when demand for cars collapsed in the US and Europe.

'Geographic diversity has meant less suffering' - Ignacio Martín'

"To us, geographic diversity has been very important," says Ignacio Martín, CIE Automotive chief executive, which has 68 plants around the world. "It has meant less suffering during the downturn."

Even with this geographical diversity, the company saw turnover drop from an all-time high of €1.4bn in 2008 to below €1.2bn last year. Car scrappage schemes and similar incentives have helped sales this year, but the longer-term survival of the Basque Country's parts makers depends on global expansion and investment in research and development.

At the new Automotive Intelligence Centre (AIC) near Bilbao, the main industrial city, sector leaders research new production processes, materials and technologies in an effort to secure the automotive cluster's future in one of the world's most competitive sectors.

Large components groups such as CIE were quick to set up offices and laboratories in the €62m, 30,000 sq m complex. However, there is space there for companies of all sizes, and ideas are shared, just as global carmakers have moved towards production, research and technology alliances.

Typical of the smaller manufacturers to benefit from residence at the facility is ACE, which specialises in aluminium callipers and iron anchors for disc brakes.

Born out of the merger in 2006 of businesses in the Basque Country and Poland, the company's growth, according to chief executive José Corrales, depends on acquisitions and innovation.

At the AIC, he says, the latter is taken care of: "In an industry as competitive as ours, you are best defined by the efficiencies extracted through innovation," he says. "We have access to some of the best minds in the business – something will rub off."

Mark Mulligan

Recovery elusive but at least the darkest days have passed

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of the home construction sector, and the ancillary services and mass employment that depended on it, over the past three years.

"A combination of manufacturing, cheap tourism and construction enabled an unprecedented development of the nation," wrote Javier Santiso, professor of economics at Esade business school, in "Spain 3.0", a recent paper that recommends a leap towards new products and services. "However, the pistons of the economy have now stopped firing."

It is a sign of the times that Spain's most successful companies today are not those that depend on the domestic market but those that have invested heavily abroad, including Inditex, which owns the Zara clothing brand, Santander, the biggest bank in the eurozone by market capitalisation, and Iberdrola, the electricity group.

Mr Zapatero and his ministers also talk of a "new economic model" based on innovation and environmentally sustainable industries. At present, however, it is the old-fashioned tourism industry that holds most hope for economic expansion. The sector has been recovering from the low point of 2009.

Even so, the government's economic forecasts, including one of 1.3 per cent growth for next year, are seen by others as excessively optimistic.

Analistas Financieros Internacionales, the consultancy, expects growth of just 0.4 per cent for 2011 after a contraction of 0.3 per cent this year.

Spain's sovereign bond spreads against Germany have again been widening, reaching nearly 200 basis points when this report went to press at the end of September. Investors remain fearful that international confidence in Spain, as well as the real economy, are once more in decline.

Luis Garicano, professor of economics and strategy at the London School of Economics, says: "An immediate, default-type crisis is probably no longer on the cards.

"But when it comes to low growth and economic paralysis – because the government, businesses and households are trying to repay debt and credit is hard to come by – that type of problem is not by any means over.

"I don't think anyone has a sense of recovery."

Well-heeled Europeans home in on top-end dwellings

Property

But the other end of the market is still reeling in the wake of the burst bubble, writes **Mark Mulligan**

In the hills above Marbella, in southern Spain, there is a recently built 2,500 sq m neo-Andalucian mansion, replete with home cinema and full-size gymnasium and spa.

From its terraces, looking out over lush landscaped gardens, a lagoon-shaped pool, waterfalls, fountains and a guest house, its future owner will be able to contemplate the point at which the Mediterranean Sea and the Atlantic Ocean meet, with the mountains of northern Morocco in the background.

Even in the depths of Spain's property downturn, rare, top-end homes are being sought out by wealthy Europeans looking for a place to retire, raise a family or escape to the sun.

The pace of sales, which slowed abruptly after the September 2008 collapse of Lehman Brothers, is starting to pick up again, say local agents.

However, the same cannot be said of the other end of Spain's second or holiday home market, which can be viewed on a short drive north-east of Marbella's mansions.

Thousands of empty or unfinished villas, town houses and apartments stand testament to the fervour of the country's first full-blown property bubble.

According to experts, badly located or poorly made flats set inland from the Mediterranean coast are the most problematic segment of Spain's huge residential overhang, along with large out-of-town developments. "Many of the estates should never have been built," says Carlos Ferrer-Bonsoms of Jones Lang LaSalle.

A blend of cheap and ready credit, lax or corrupt town planning, speculative enthusiasm, surging foreign demand and changing demographics combined to fuel a decade-long residential construction boom whose inevitable collapse was precipitated by the 2007 credit squeeze.

At the peak of the rush, in 2006, there were 800,000 housing starts in Spain, more than France, Germany and the UK combined.

By 2008 new starts were down sharply, along with sales, as economic buoyancy gave way to corporate bankruptcies, unemployment and a prolonged financing drought.

Most estimates put the number of unsold or unfinished new homes in Spain above 1m.

Thousands of developers and related companies – from the largest stock market listed property groups to family owned tile-makers, doorknob manufacturers and single-project speculators – are in receivership or stuck on a merry-go-round of refinancing talks with lenders keen to forestall or avoid foreclosure.

'It is the second home market that is proving a headache for the banks' - Carlos Ferrer-Bonsoms

The Bank of Spain calculates that banks are already holding about €60bn in acquired residential or commercial property on their books, but warned early this year that €165bn in loans to construction and property companies, more than a third of the total, could prove to be "problematic".

Property agents helping banks sell and let foreclosed residential and commercial stock say the figure is optimistic.

Many doubt that the banking system's bad-loan rate, of 5.5 per cent, tells the whole story, as lenders opt to renegotiate overdue mortgages rather than book them as arrears.

Debt-for-asset or debt-equity swaps have also kept the delinquency low, according to UBS in a recent report. "Including the real estate swaps and our estimates on substandard loans, the troubled loans in the Spanish banking system moves to 14 per cent," it says.

Nonetheless, heavy discounting, favourable terms, rent-to-buy schemes and special staff offers by the banks on foreclosed homes are helping to shift stock. According to the latest government figures, Spanish house sales rose nearly 25 per cent in the second quarter, compared with the same period last year.

However, sales of new homes – of the type clinging to the hillside above the Costa del Sol – were up less than 5 per cent. Accordingly, new-home starts are likely to total 100,000 this year, or 12.5 per cent of the 2006 figure.

"There is still demand for primary residences from among the 25-35 year age group," says Mr Ferrer-Bonsoms. "It is the second home market, particularly along the coast, that is proving a headache for the banks."

Similarly, large-scale commuter estates, built outside cities and large towns towards the end of the property bubble, stand as grim reminders of the size of that bubble.

With overstretched developers in the bankruptcy courts, lenders are slashing sale prices or renting out cheaply in an attempt to avoid heavy write-downs while giving critical mass to the eerily underpopulated dormitory suburbs.

In the Valdeluz estate, about 65km north-east of Madrid, some apartment blocks are so sparsely occupied that residents could not afford to open and maintain the communal pool for the baking Castilian summer. In similar estates around the country, squatters are taking over.

Back in Marbella, in the flashy Puerto Banús area, Santander bank is offering smart, two-, three- and four-bedroom apartments located 200m from the beach at as much as 40 per cent below what the original developer – now bankrupt – was asking. Mortgages covering 100 per cent of the sale price are available to some buyers, but sales are sluggish.

Cloudy forecast for solar power

Renewable energy

Uncertainty over the direction of regulation is holding back the industry, writes **Mark Mulligan**

As a proxy for the history of energy diversification in Spain, Global Energy Services (GES) is hard to beat.

Founded in 1982 as Siemsa Cataluña, the company started life as an engineering services provider to petrochemical complexes in the country's industrial zones.

In 1991, it was bought by Gamesa, then a fledgling wind turbine manufacturer and wind park developer, under whose ownership it diversified into most generation technologies.

"When we became part of Gamesa, there were about 400 or 500 megawatts of wind-powered generation capacity in Spain," says Ricardo Moro, GES chief executive. Today, thanks largely to generous feed-in tariffs and other state price guarantees, there are close to 20,000MW scattered around the country, putting Spain's among the world's highest per-capita producers and users of wind energy.

In the process, Gamesa, which fed much of that development, has become a global leader and Iberdrola, the electricity generator, is the world's number one in terms of wind power capacity.

Close behind is Energias de Portugal Renováveis, the separately-listed renewable energy offshoot of Portugal's former state monopoly, which has made Madrid its base. Italian group Enel, which last year completed the takeover of Spanish utility Endesa, also plans a Madrid listing for its Green Energy business.

The internationalisation of these and other groups has spurred foreign investment by Spanish service providers such as GES. The company which, received its current name when private equity firm 3i bought it in 2006, is today present in 16 countries. However, even this geographical diversification has not been enough to cushion it against recent woes in Spain's renewable energy market.

Investment in the segment has dropped sharply in the past two years, as falling demand and lower wholesale power prices have combined with scarce financing and regulatory uncertainty, forcing companies to rethink their plans.

Solar energy using photovoltaic (PV) cells has been the hardest hit, caught between tight credit conditions, government austerity and an official crackdown on market abuses and overinvestment. From 44MW of installed capacity at the end of 2005, Spain today has about 3,500MW of PV capacity, according to the European Commission. However, most of that was installed before October 2008, when feed-in tariffs for new plants were slashed. These cuts, plus the financing crisis, capacity quotas and uncertainty about pricing regimes have put the brakes on fresh investment in the sector.

Investors in existing PV plants, meanwhile, fought unsuccessfully against plans by the government to cut prices retrospectively by limiting the number of production hours a day that qualify for the premium tariffs.

In spite of its broad geographical and business diversification, GES felt the impact: Mr Moro attributes a 25 per cent drop in revenues last year, to €530m, mainly to the absence of new photovoltaic installation contracts.

The company was also forced to lay off hundreds of workers. In Spain's industrialised Basque region, specialist engineering groups also suffered. Bilbao-based Ingeteam, among the world's biggest manufacturers of electrical and mechanical components for wind farms and solar parks, noted a marked drop in sales.

Stock market volatility and the eurozone debt crisis also added to the uncertainty, forcing a clutch of solar energy groups to postpone planned initial public offerings in Madrid.

Although bringing some order to the photovoltaic segment, and reaching temporary accords on pricing and capacity with thermo-solar and wind park operators, the government remains under pressure to bring clarity to longer-term energy policy. Its reluctance completely to deregulate electricity prices continues to create unease among potential investors. Analysts say it has little choice but to let market forces decide.

With an accumulated tariff deficit – the difference between the costs of producing and delivering electricity to consumers and what they have been paying for the service over the past decade – of almost €18bn the government is faced with the unpleasant task of making voters pay the true cost of power connection.

The response of EdP Renováveis is typical: it recently reallocated investment earmarked for Spain to eastern Europe. "Companies need to have a clearer idea of what the regulatory framework will look like after 2012," says Rui Teixeira, chief financial officer. The heads of energy companies of all types and sizes are critical of successive governments' failure to bring order to supply and pricing.

Spain is nonetheless admired from abroad for its progressive renewables policies which have helped create international champions.

Sunrise: Sanlucar la Mayor is the world's largest solar energy plant Sipa

Enel, having won a brutal battle for control of Endesa, once Spain's largest electricity group, plans a Madrid listing as part of a spin-off of its renewables business. "Spain is an important market for renewable energy, with capacity expected to more than double over the next 10 years," says Maurizio Bezzeccheri, head of Enel Green Power for Iberia and Latin America. "Madrid has established itself as a reference market."

Asset sales and consolidation by established generators will throw up investment opportunities, as will the repowering of existing wind farms and the need to upgrade the transmission and distribution grid.

Raimundo Fernández-Cuesta, a Nomura utilities analyst, says: "I'm broadly upbeat on investment opportunities – but only so long as the government sorts out the regulatory issues soon."

International approach puts green group on road to success

Profile
Abengoa

Victor Mallet looks at the progress of the ambitious company

Which European companies are crisis-proof? The latest revenue and profit numbers from Abengoa, the Spanish alternative energy and environmental services group, suggest the global crisis had a surprisingly modest impact on at least one big company, in spite of its crippling effect on the broader Spanish economy.

Founded in Seville in 1941 as an electrical workshop, Abengoa has taken the two steps that mark out many of Spain's successful corporations from the failures: it has focused on high-technology operations and it has invested heavily abroad.

"Diversification has been one of the key elements of our strategy," says Manuel Sánchez, Abengoa's 47-year-old chief executive. "We continue to grow in Spain. But we are growing faster overseas."

More than two-thirds of revenues come from overseas investment in bioenergy, solar power, waste and water management, engineering and information technology.

"A lot of the growth that we expect for the company is going to be coming from the US," says Mr Sánchez, an electrical and software engineer who was previously chairman of Telvent, Abengoa's IT and process control company in the US, and who still lives in Washington DC.

Mr Sánchez does not deny that Abengoa has felt the cold winds of recession, nor that he is watching the political debates over energy policy and climate change in the US with concern, nor that the cost of financing such a capital-intensive business is an issue.

Net profit in the first half of this year fell 9 per cent to €100m (though profit would have been flat but for last year's sale of a stake in Telvent), on revenue that rose 37 per cent to €2.79bn.

"There's not a single company in the world that has not been affected one way or another by the global crisis," says Mr Sánchez. "We have felt some impact, particularly because conditions for financing are more demanding."

Over the past year and a half, Abengoa and Telvent have supplemented bank borrowings with five bond issues, and the group's net debt now stands at €5.5bn – about six times earnings before interest, tax, depreciation and amortisation (ebitda).

Moody's and Fitch, the credit rating agencies, have both rated Abengoa debt as non-investment grade.

Mr Sánchez, however, is confident that the money is being well spent and notes that ratios are skewed because nearly half the debt is invested in projects that have yet to start earning. He also points to the importance of a decision made 15 years ago to change the business model and concentrate on running integrated projects instead of simply building plant for others. The result is that more than a third of revenues come from recurrent sources.

"We've been able to grow at double-digit [rates] for the past years, and we think we can continue growing at similar rates for the next few years."

The plan is to double revenues and ebitda between 2009 and 2014. That is based partly on existing contracts, but also on the longer-term assumption that a transition from fossil fuels to other energy sources is both inevitable and desirable.

"The oil industry wants this change to happen slower – they know it's going to happen – and players in the renewables side such as Abengoa would like it to happen faster," says Mr Sánchez philosophically. He likens the transition to the shift from horses to motor vehicles a century ago.

He also acknowledges that the crisis may have damped enthusiasm for some forms of alternative energy, which are sometimes dismissed as too costly. But he points out that debates can be more complex than they seem, with many conservative Tea Party supporters in the US as eager as anyone to promote domestic energy production, from whatever sources, if it reduces US dependence on imported oil.

A decade ago, Abengoa had revenues of less than €1bn and profits a tenth of what they are now.

Today, the company is a member of the Ibex 35 stock exchange index of big Spanish companies and the owner of Telvent, the only Spanish company listed on Nasdaq.

Abengoa may not be a household name yet, but if Mr Sánchez has his way and the company continues to grow at its recent pace, that is likely to change.

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