The Case for Spain

Ignacio de la Torre, Ph. D.
idelatorre@arcanogroup.com
November, 2012

ARCANO

Agenda

Executive Summary

- Journalists and analysts have spread a number of myths that paint an excessively pessimistic picture of the Spanish economy. This presentation and its corresponding report address these misconceptions. Spain is facing difficult times, but its problems are often exaggerated

- Spain is solvent:
  - Assets are valued over 700% of GDP while debts are below 270%
  - After recapitalizing Spanish banks, the contagion effect with the Sovereign should be over
  - A fiscal package to reduce the deficit by 11% of GDP is being implemented

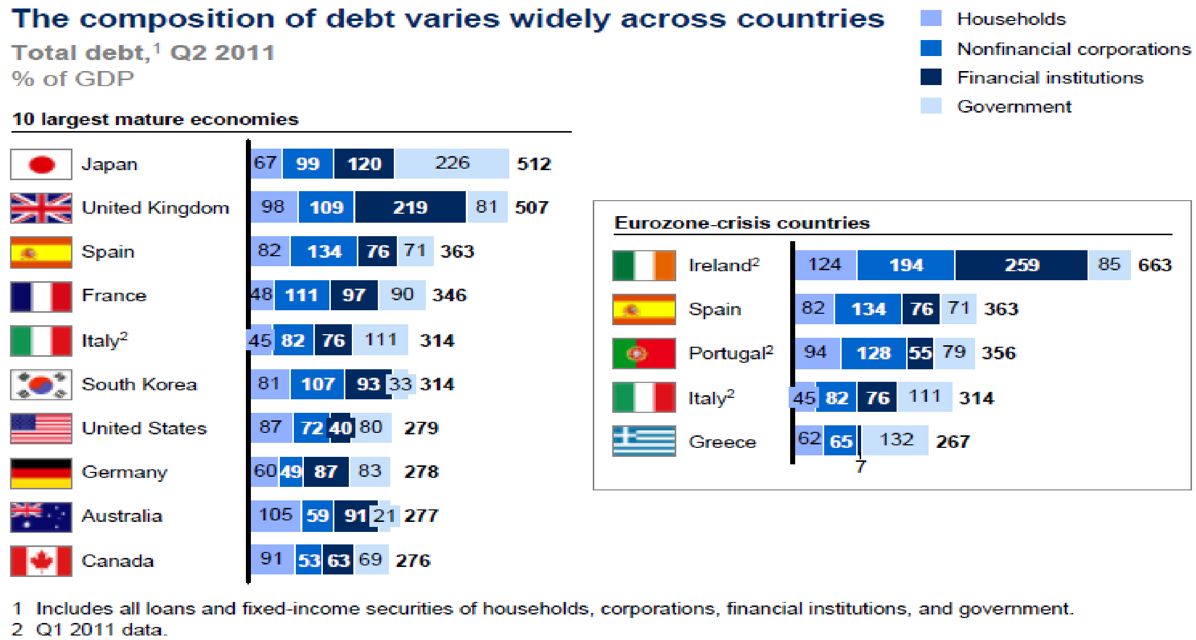
- Spain is competitive and able to grow:
  - Exports are at record highs (above €200 bn., 22% of GDP), and they should keep growing due to a cheap and productive labor force
  - Revenues from tourism and other services are also at historic highs (€60 bn.) and continue to grow
  - Entrepreneurs and SMEs, supported by world class large companies, should lead Spain's economic growth model going forward

<u>With enhanced fundamentals and depressed valuations, we believe now is a fantastic moment to invest in Spain</u>

Agenda

Myth 1: Spain's Debt / GDP is 363%, therefore the country is near collapse

Misrepresentation of Spanish Debt



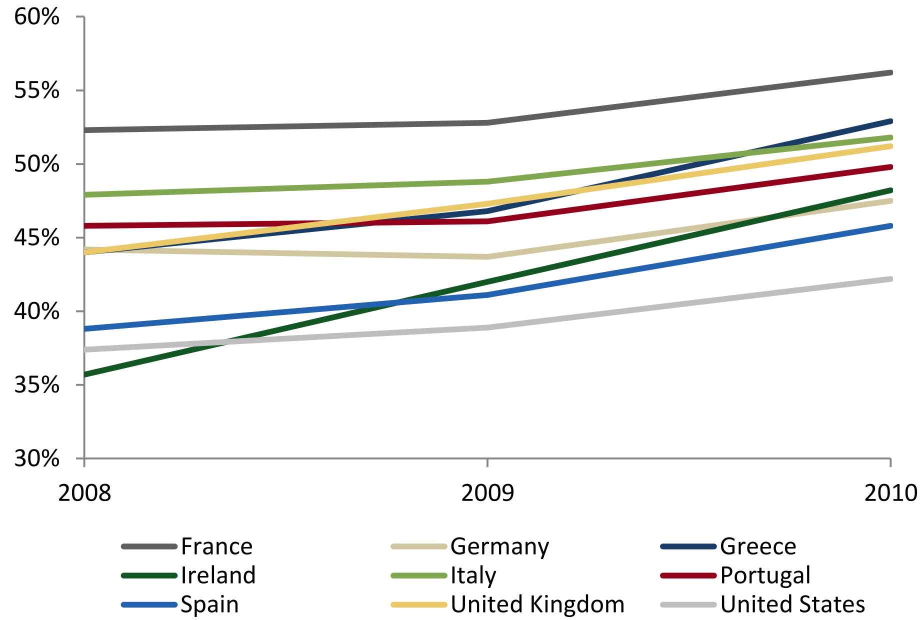
Source: McKinsey Global Institute, "Debt and deleveraging: Uneven progress on the path to growth," January 2012, p. 13

- Real leverage is 268%, not 363%, as financial corporations' debts should not be double counted. If you owe €100,000 to your bank and the bank owes this €100,000 to a foreign investor, total debt is €100,000, not €200,000

- Real leverage of corporations should be adjusted due to: i) amounts lent to corporations by Spanish banks, to avoid double counting (27% of GDP), ii) Inter-company loans, also double counted (27% of GDP), iii) 40% of GDP of this debt is real estate which is being provisioned at 20% of GDP (50% of total), iv) Debts related to investments made in international businesses, which do not contribute to Spanish GDP (44% of GDP)

Myth 2: Spain is uniquely reckless in spending

Government spending as a % of GDP

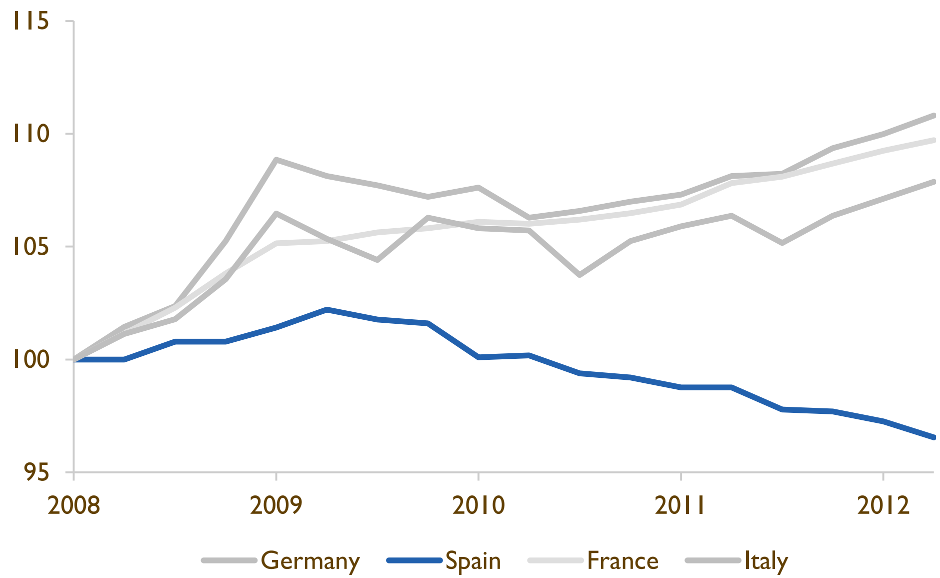


Source: The Heritage Foundation

- Spain's government spends less as a % of GDP than that of most other Eurozone countries and the UK, both before and after the crisis (Spain had close to a 2% fiscal surplus in 2007)
- Spain's government is taking serious measures to correct the fiscal deficit, both through cost reduction programs (including controlling spending by regional and local governments) as well as tax increases. Local Governments are cutting costs 7% YTD
- In relative terms, Spain's fiscal woes are more closely related to low tax revenues than to excessive spending

Myth 3: Spain is not competitive

Evolution of Spanish competitiveness (ULC) vs. main trading partners

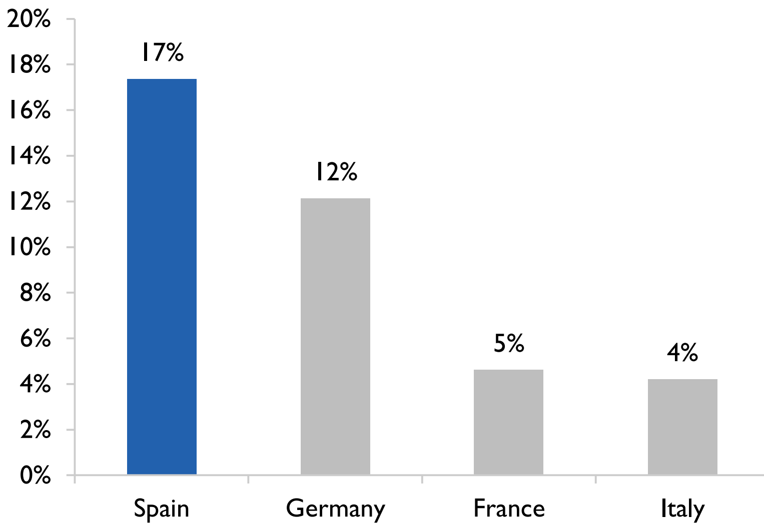


Source: Eurostat

- As an index of Spain's competitiveness, Unit Labor Costs declined 4% since 2008, compared to that of Spain's trading partners, which increased 5-10%
- Therefore, Spain has regained competitiveness of between 9-14% in cost terms, allowing exports to thrive

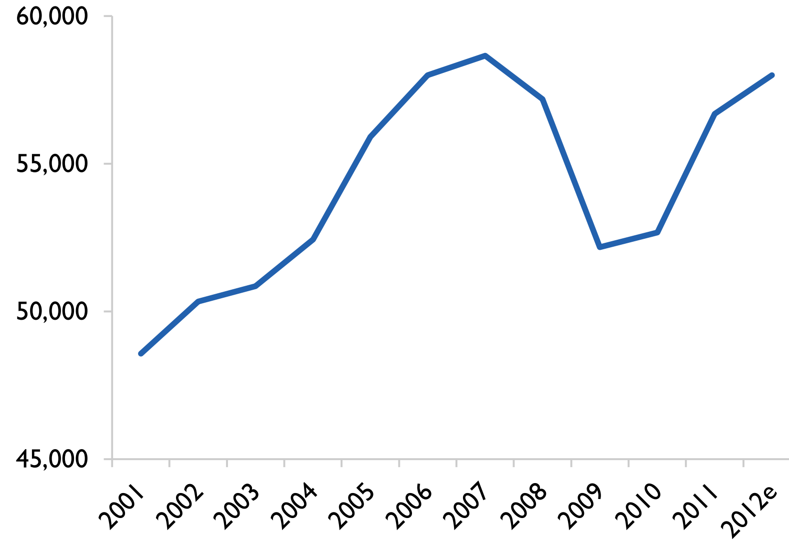
Myth 4: Spain has no growth engine to end the crisis

Export growth evolution since 2008-2012



Source: Eurostat

Total number of tourists per year (thousands)



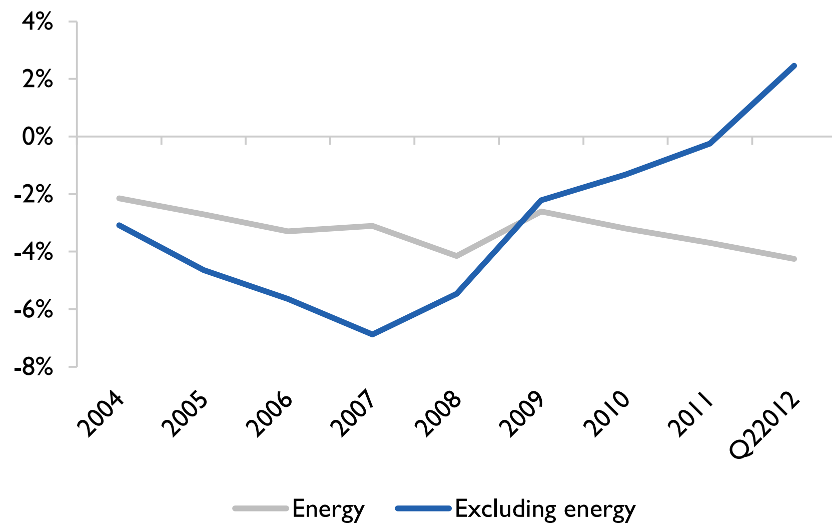
Source: INE

- Spanish exports and gross tourism revenues are at a historic highs (above €200 bn. and €60 bn. per year, respectively)
- Low labor costs, increased labor flexibility, and world class social (particularly the healthcare system) and capital infrastructures create an environment conducive to growth, even if the country maintains low levels of public investment in the coming years

ARCANO

Myth 5: Spain still has plenty adjustments to make, following the examples of other crises

Trade deficit evolution



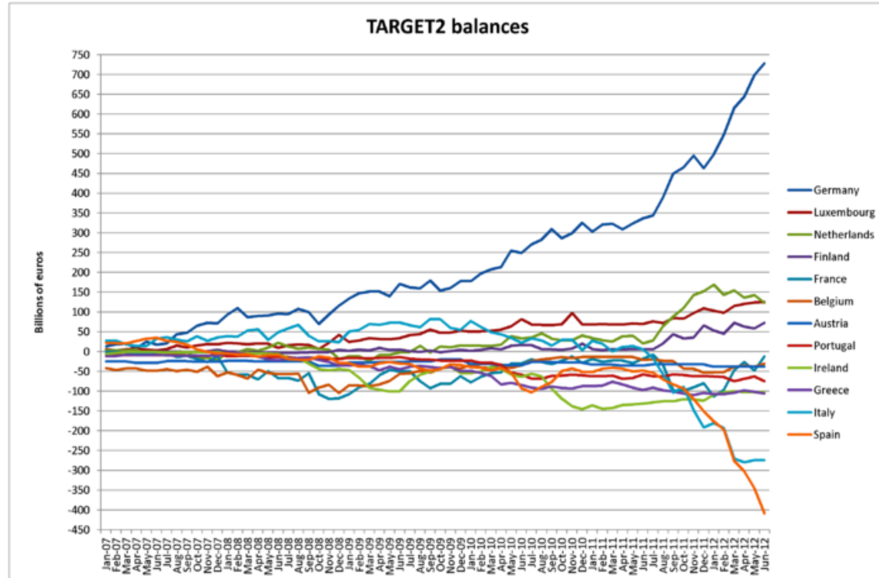
Source: INE

- Spain has already tackled three key adjustments:
  - As a result of the a significant drop in imports and an increased level of exports, excluding energy, an 8% trade deficit has turned into a 3% surplus by 2012, reducing the need for external financing to a minimum
  - The financial sector is set to have provisioned close to €200 bn. by year-end 2012, as house prices are adjusting in line with those of other economies
  - As discussed further in the forthcoming slides, the Spanish labor force has become much more competitive

Myth 6: Europe will let Spain exit the Euro

➢ An eventual exit of Spain from the euro zone would be far more costly than supporting its liquidity needs. The foreseeable consequences of a Spanish exit would be:

- Immediate insolvency of the ECB, due to TARGET2 imbalances
- Sizeable loses in the German and French banking books
- Contagion effect on Italy leading to a likely breakup of the Euro
- Sharp recession in export-led economies
- Potentially devastating implications to the European Union as an economic and political project



ARCANO

Myth 7: Spain will not reform

Fiscal reform *already being implemented*:

	2012 (€ bn.)	2013 (€ bn.)	2014 (€ bn.)
April Adjustments	43.1	19.6	0
July Adjustments	13.5	22.9	20.1
Total	**56.6**	**42.5**	**20.1**
% of GDP	5.4%	4.0%	1.9%

Supply side reforms *already being implemented*:

	Effect on GDP (cumulative until 2020)	Effect on employment (number of employed persons) (cumulative until 2020)
Services Directive	1.2	39,000
Labor Reform	4.5	1,763,000
Pensions Reform	0.4	71,000
Financial Sector Reform	1.6	96,000
Law on Budget Stability and Financial Sustainability	0.9	18,000
Total	**8.6**	**1,987,000**

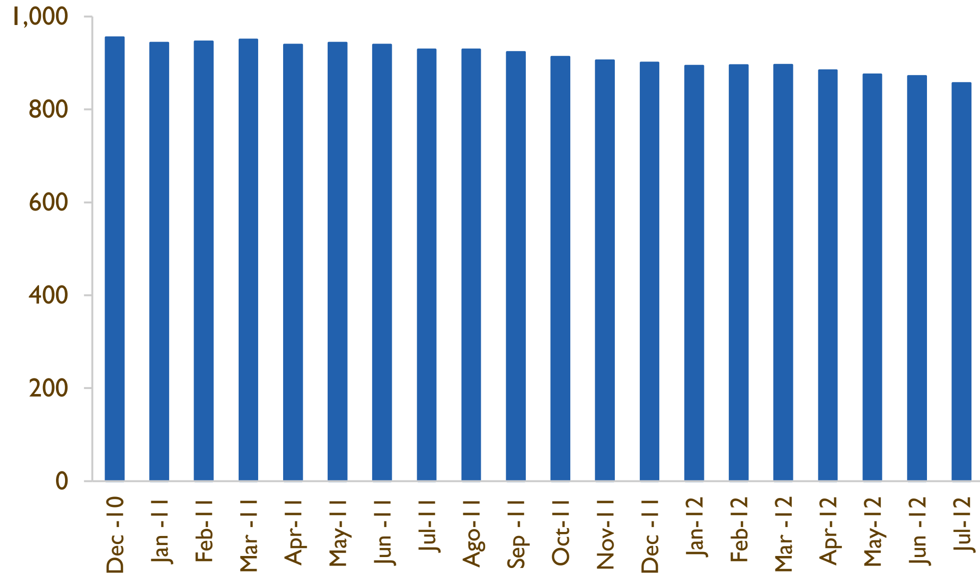
Source: Spanish Treasury

- Spain is carrying out an 11.3% fiscal adjustment, one of the broadest in the OECD in recent history. Supply side reforms can boost GDP by almost 9% in the coming years

ARCANO

Myth 8: Spain is bleeding its deposit base

Retail and corporate deposits in Spain (€bn.)

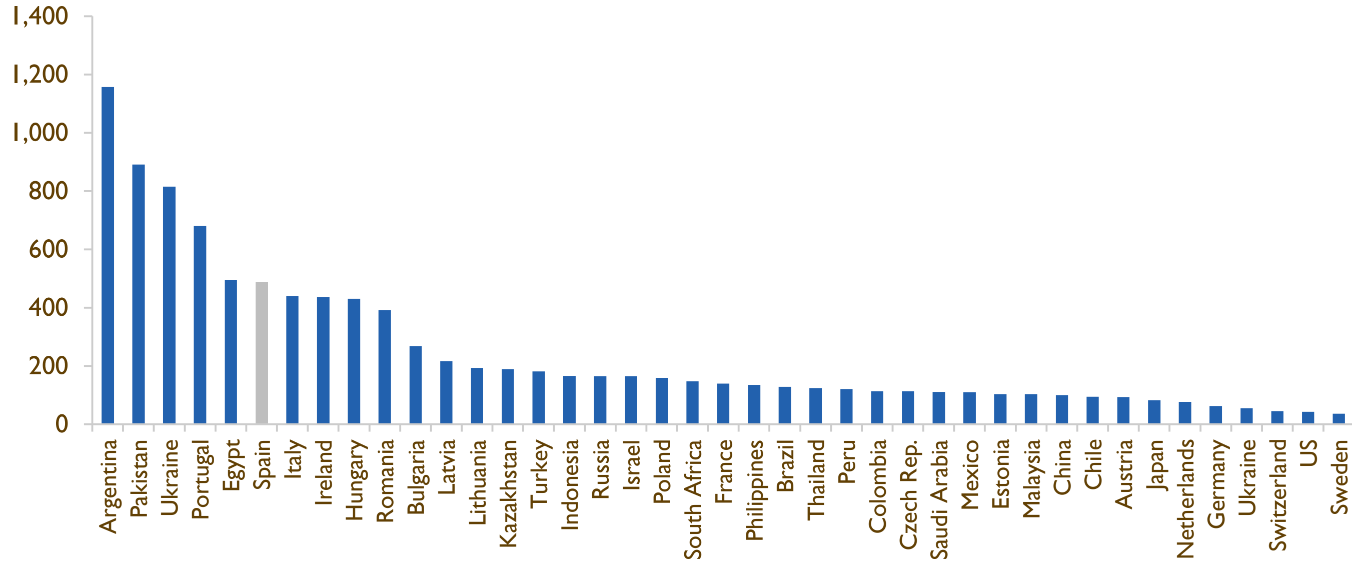


Source: Bank of Spain

- High quality deposits (resident retail and corporate deposits), which banks assume to be a stable funding source, are down only 2-3%; this hardly qualifies as a real deposit flight
- The drop in the total deposit figures (6.7% YTD as of July 2012) are mostly technical in nature and have not had a real negative impact on the financial system funding

Myth 9: According to the CDS "wisdom", Spain is riskier than many small emerging economies

Sovereign CDS spread



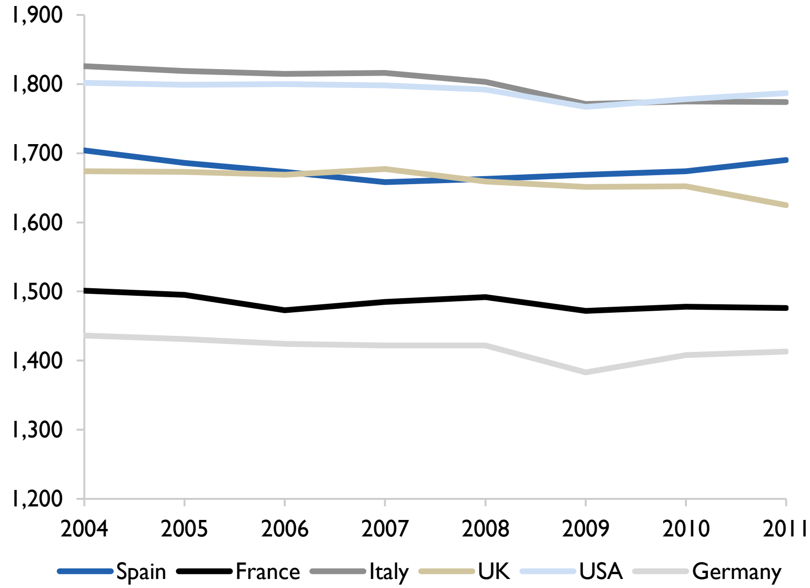
Source: Factset

- According to CDS spreads, Spain is riskier than Indonesia, Russia, Kazakhstan, and Romania
- Last time Spain defaulted was in 1883
- Credit default swaps do not reflect political stability (democracy) nor stability provided by a strong middle class (built in Spain during 1960s)
- Countries default once they reach very high levels of Government debt (above 120% of GDP), cannot access liquidity and are not able to grow. Spain is not in this situation

ARCANO

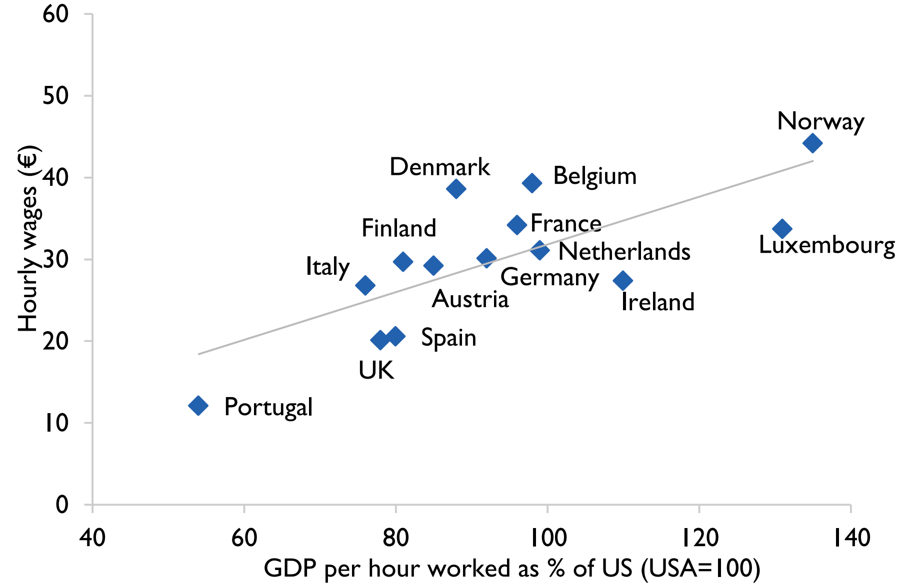
Myth 10: Spaniards don't work hard

Average hours worked per year



Source: OECD

Unit labor costs and GDP per hour worked (2011)



Source: Eurostat, OECD

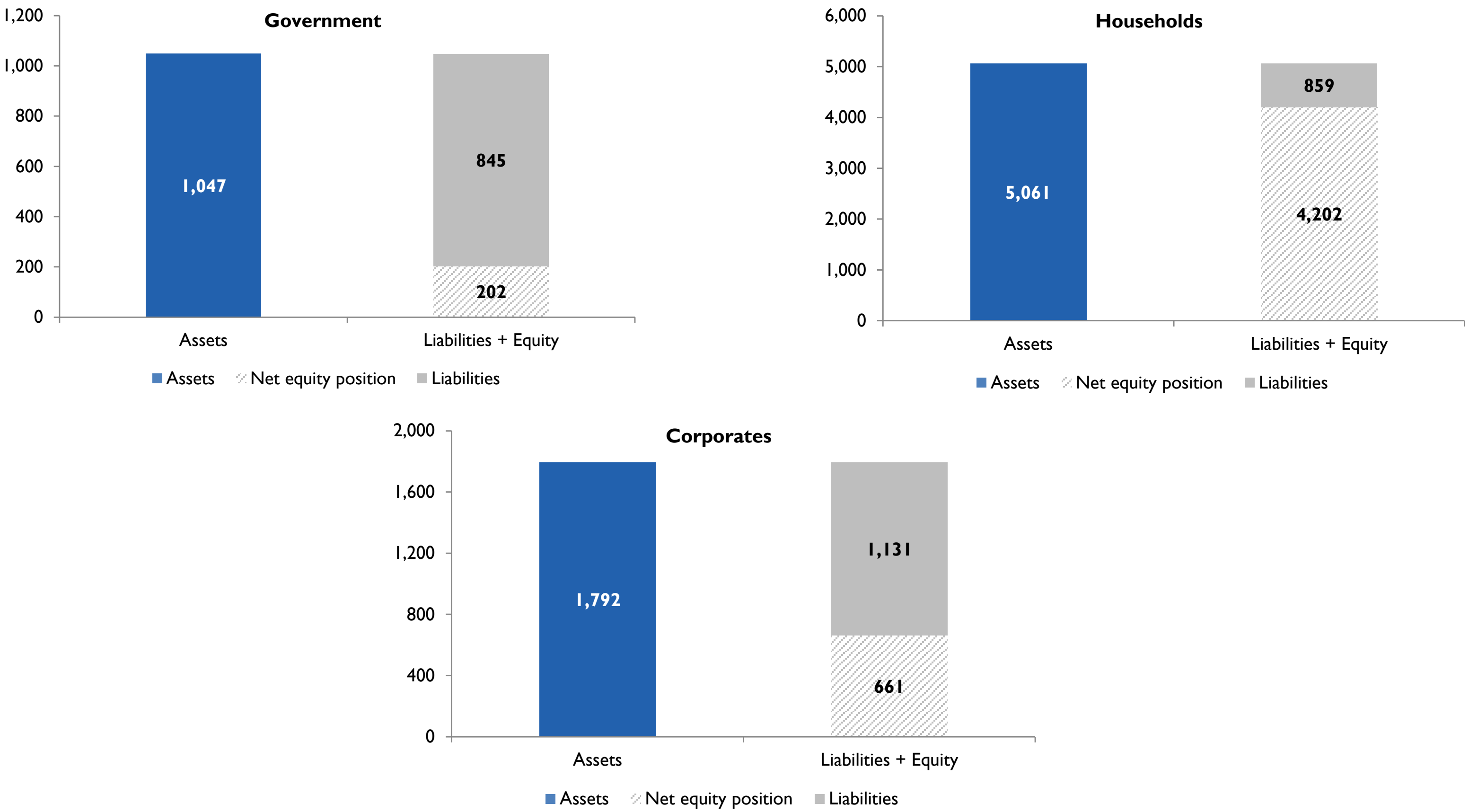
- The Spanish labor force works more hours per year than that of most other countries in the world, in line with the UK and just below the US
- Comparing Spanish labor costs and its productivity per head, Spain is one of the most attractive countries in the world from an investment perspective

ARCANO

Agenda

Solvency = Assets - Debt

Balance sheets of Spanish government, corporates, and households

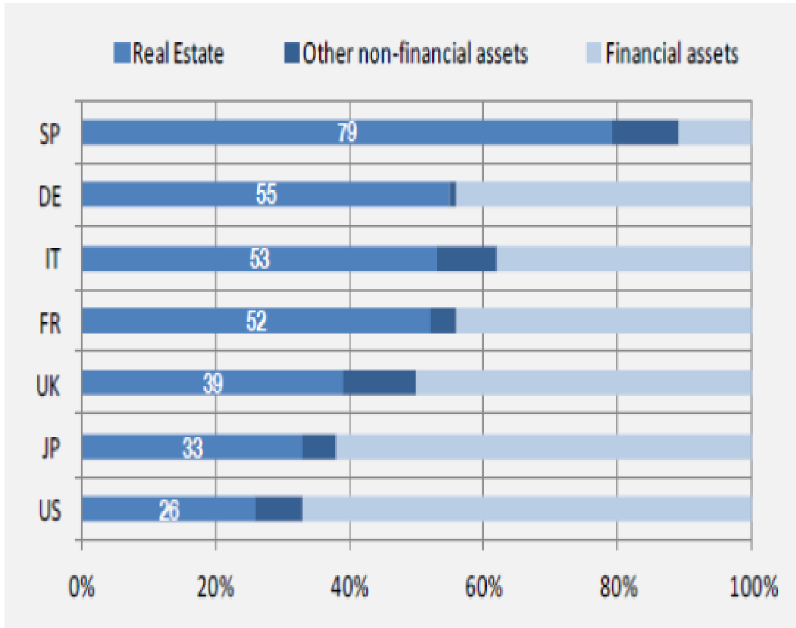


Source: Bank of Spain, Funcas, Arcano

- Spanish assets (financial and real estate, assuming 50% cuts in real estate prices) are well above debts. Spain is solvent, but illiquid
- 40% of GDP of corporate debt is real estate related, half of which is being provisioned

Spain is solvent, but illiquid

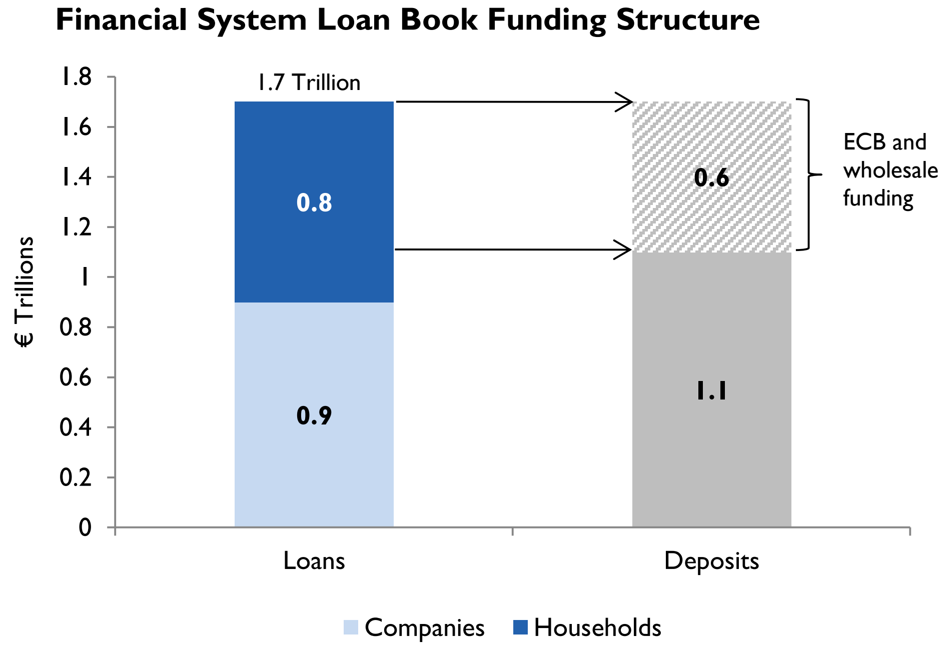
Asset split of households (% of total assets)



Source: Oliver Wyman

- Almost 80% of wealth is in illiquid real estate. Active tax policies need to be undertaken to balance Spain's savings structure

The Spanish financial system has addressed its main weaknesses

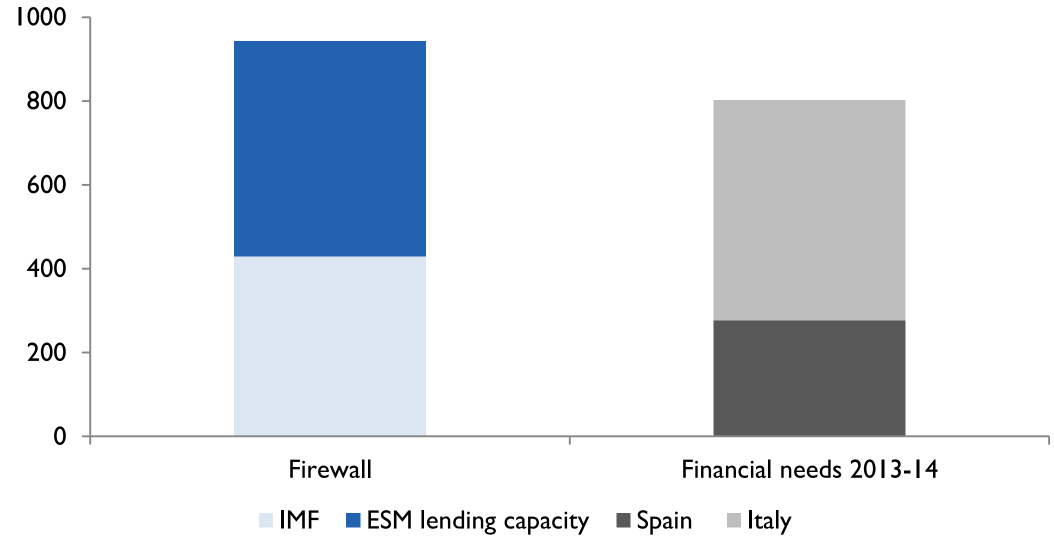


Source: Arcano, Bank of Spain

- Although it has taken much longer than it should have, the Spanish financial system is successfully addressing its liquidity and solvency weaknesses:
  - Liquidity: ECB has refinanced two thirds of the banks' wholesale funding, mostly with 3-year maturity funds, providing Spanish banks with certainty of funding and enough time to execute a necessary deleveraging process, already underway
  - Solvency: Total provisioning will reach 20% of GDP or about 15% of the system's loan book by 2013 while increasing capital ratios. This massive effort has been tackled by a mix of (i) operating profits, (ii) asset sales, (iii) rights issues, and (iv) Government capital injections

Liquidity risk has been limited

ESM/EFSF resources and gross financial public needs in Spain and Italy (€bn.)



Source: Bloomberg

- International liquidity mechanisms are larger than Sovereign liquidity needs
- The risk of contagion between Spain's Sovereign debt (85% of GDP) and banks' wholesale debt (over 50% of GDP) has been successfully addressed by: (i) the ECB's liquidity programs and (ii) the comprehensive financial sector reform carried out by the Spanish government, which will result in a much healthier and concentrated banking system

ARCANO

Unparalleled fiscal adjustment underway (11.3% of GDP)

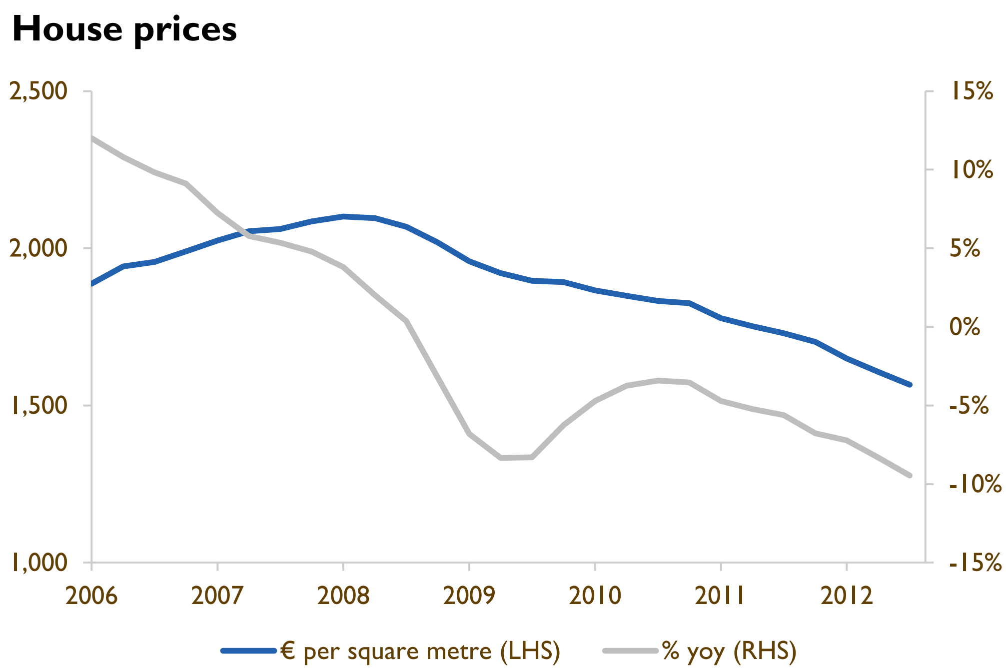
Spain´s fiscal consolidation program (Government's projections unless indicated)

	2012	2013	2014	Acum. 2012-2014
GDP growth	-1.5%	-0.5%	1.2%	-0.8%
GDP growth (IMF estimate)	-1.5%	-1.3%	1.0%	-1.8%
GDP growth (EU estimate)	-1.4%	-1.4%	0.8%	-2.0%
Target deficit (% of GDP)	6.3%	4.5%	2.8%	13.6%
IMF estimated deficit (% of GDP)	7.0%	5.7%	4.6%	17.3%
EU estimated deficit (% of GDP)	7.0%	6.0%	6.4%	19.4%
Target structural deficit (% of GDP)	3.0%	1.5%	0.0%	4.5%
Implied estructural adjustment (% of GDP)	3.0%	1.5%	1.5%	6.0%
Announced adjustment (% of GDP)	5.4%	4.0%	1.9%	11.3%
Estimated public debt (% of GDP)	85.3%	91.0%	95.6%	

Source: Spanish Treasury, IMF, EC (excludes accounting impact of valuation adjustments in bank aid; EC's 2014 forecast assumes tax cuts which are not realistic)

- By 2014, Spain's structural and fiscal deficits are expected to be reduced very significantly, even in the worst case economic scenario, allowing public debt to stabilize below 100% of GDP, which is lower than the expected level of France, UK, and USA

House prices are expected to bottom in 2013 after a 49% fall

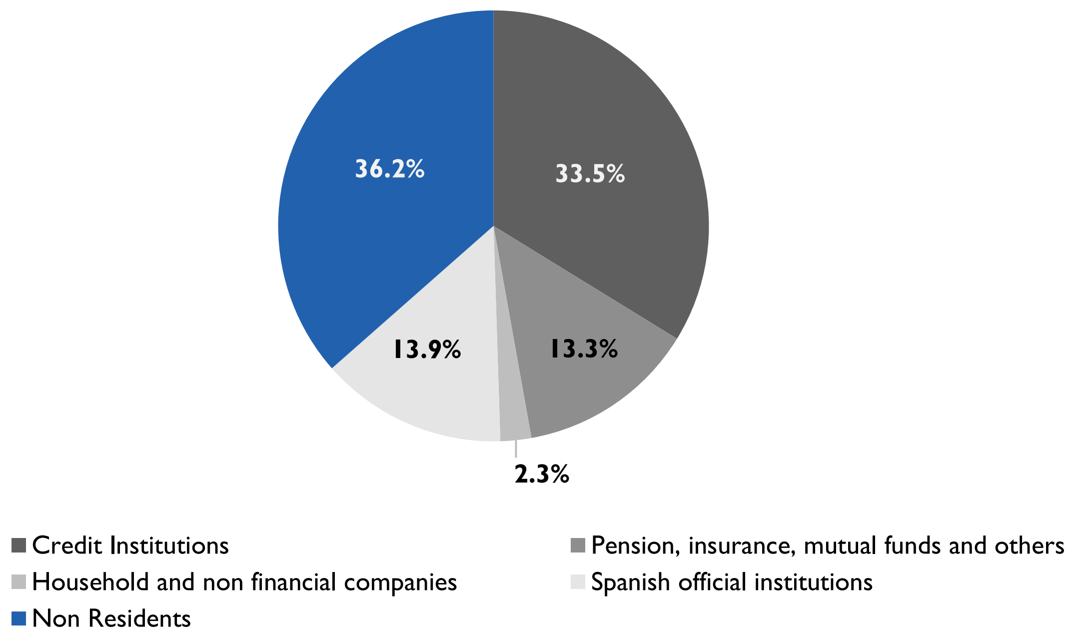


Source: Ministry of Development

- House prices should fall 10% in 2013 and stabilize going forward. By 2013, house prices will reach historic averages vs. disposable income. Total decline between 2008-2013 should reach 49%. The contagion effect from real estate to banks should be over

Government debt relies less on foreign capital

Spanish Government Debt by holder

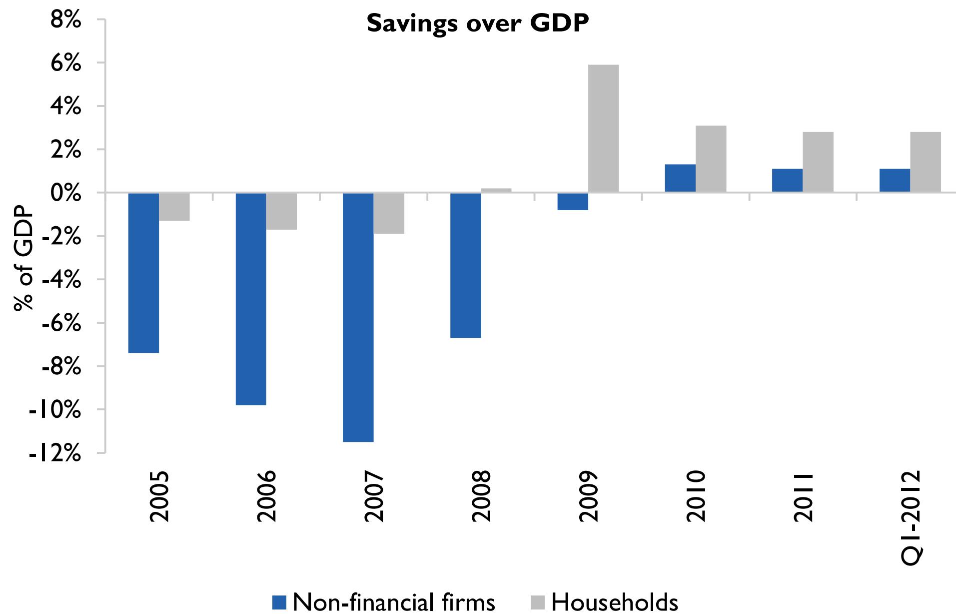


Source: Spanish Treasury, IMF

- Foreigners hold 36% of Government debt (down from 55% in 2009), reducing refinancing risk as Spanish financial institutions have picked up the balance

Private sector of Spain begins to save

Breakdown of private savings



Source: INE

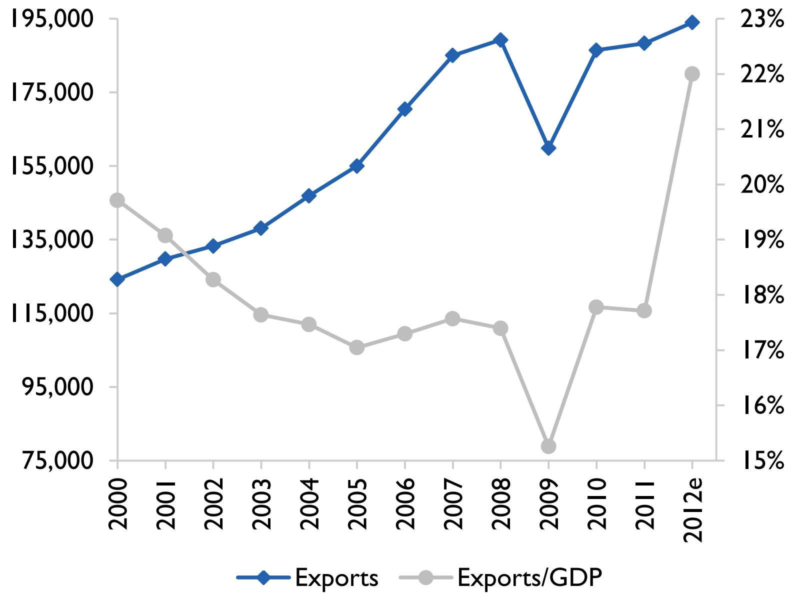
➢ Since 2010, the private sector of the economy has been saving almost 4% of GDP

ARCANO

Agenda

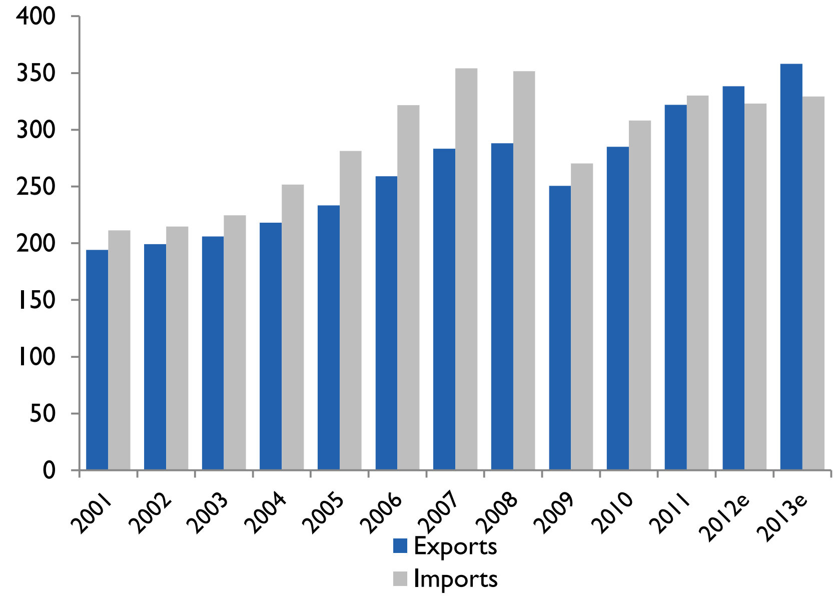
Spanish exports at record highs and continue to grow…

Evolution of Spanish exports (€ mm.)



Source: INE

Spanish exports and imports of goods and services (€ bn.)



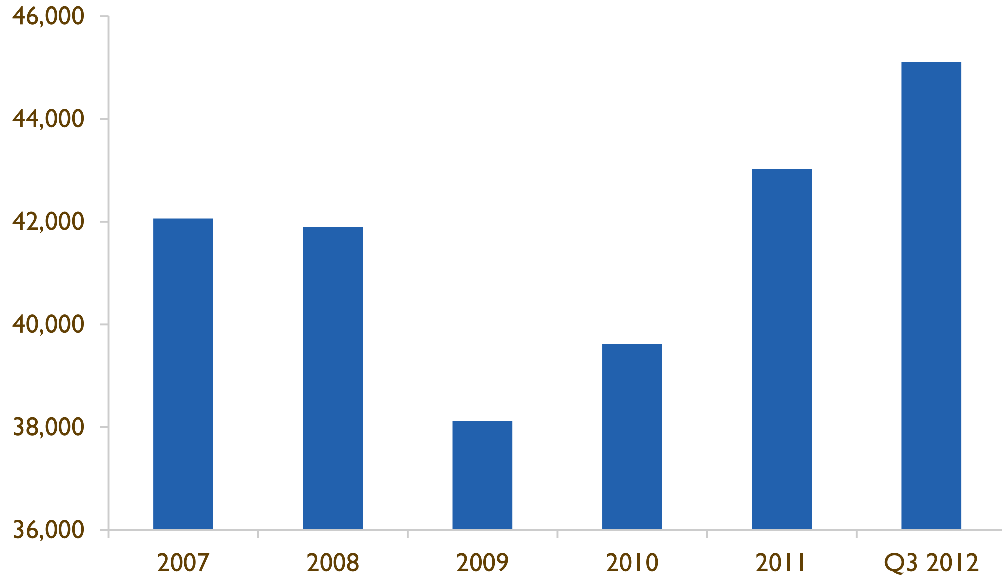
Source: Historical figures and projections provided by Eurostat

- Spain is already generating an ex-energy trade surplus
- Spain is entering into a positive trade balance of goods and services

ARCANO

The services and tourism sectors are at record highs…

Net revenue from tourism per year (€m)

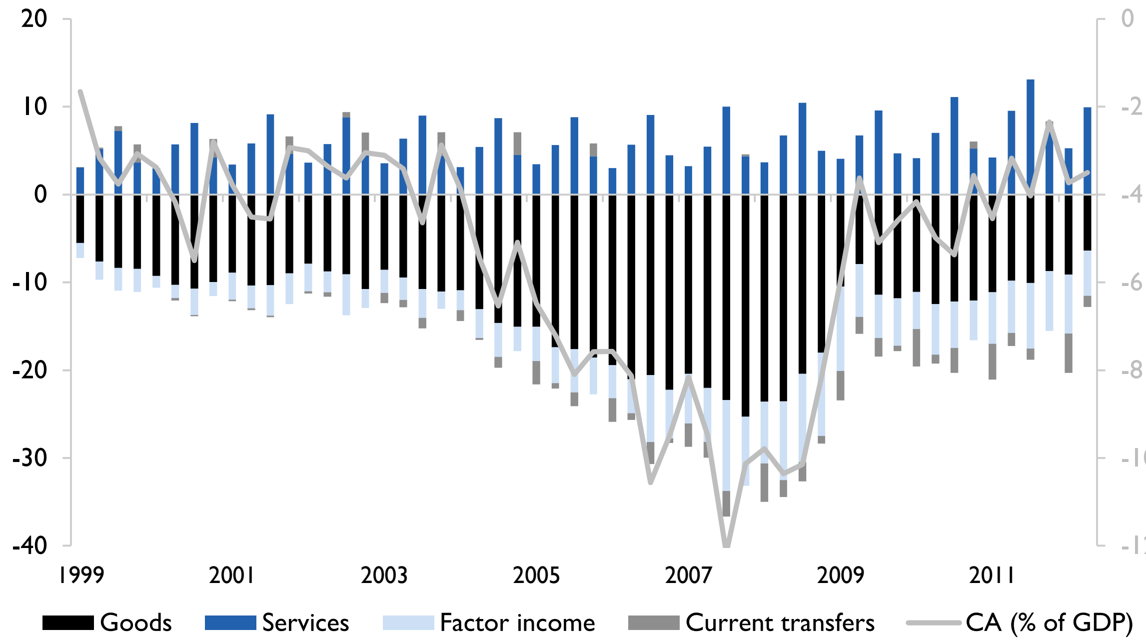


Source: INE. Gross revenues left by foreigners into Spain less money spent by Spaniards abroad

- Spanish touristic growth is structural

… allowing Spain to enter a current account surplus

Current account (€ bn.)

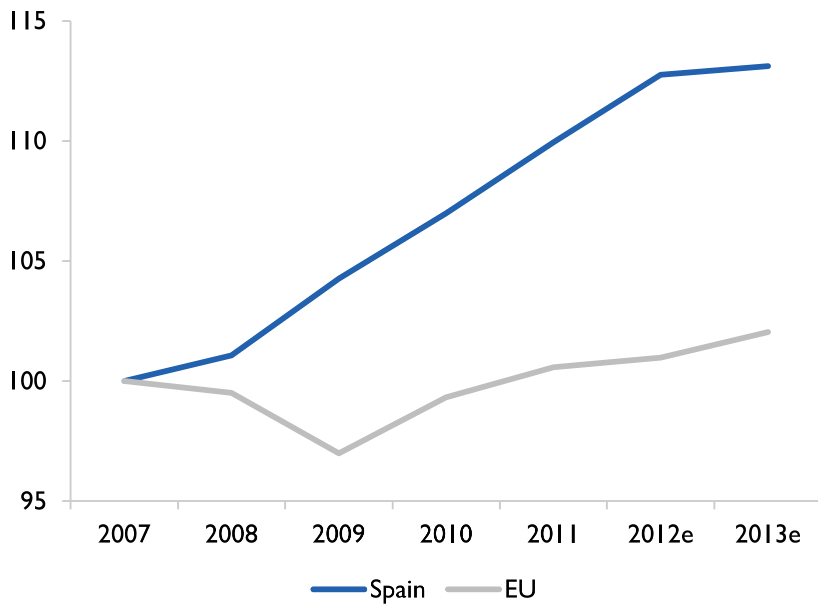


Source: Bank of Spain, OECD

- By 2013, Spain should reach current account surplus through record exports and tourism. This will help Spain to begin reducing its external debtor position

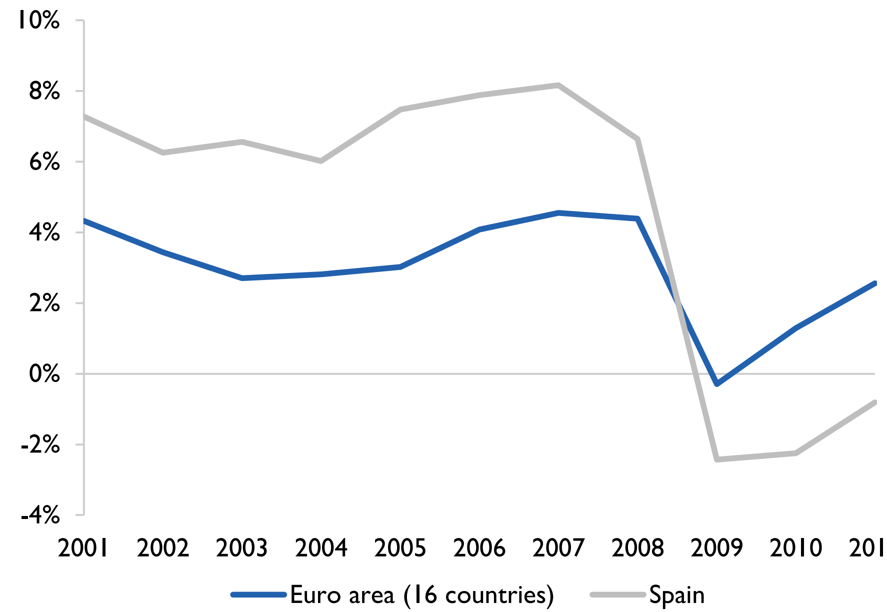
Enhanced productivity and lower real wages are making this possible

Labor productivity change (2007=100)



Source: INE

Real wages evolution (YOY%)



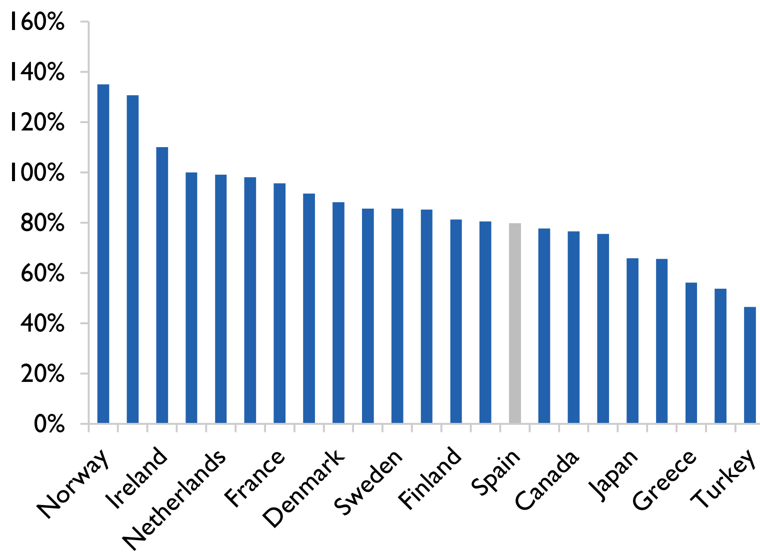
Source: Eurostat

- A productivity revolution and lower real wages have enhanced competitiveness, allowing companies to successfully substitute local sales with exports

ARCANO

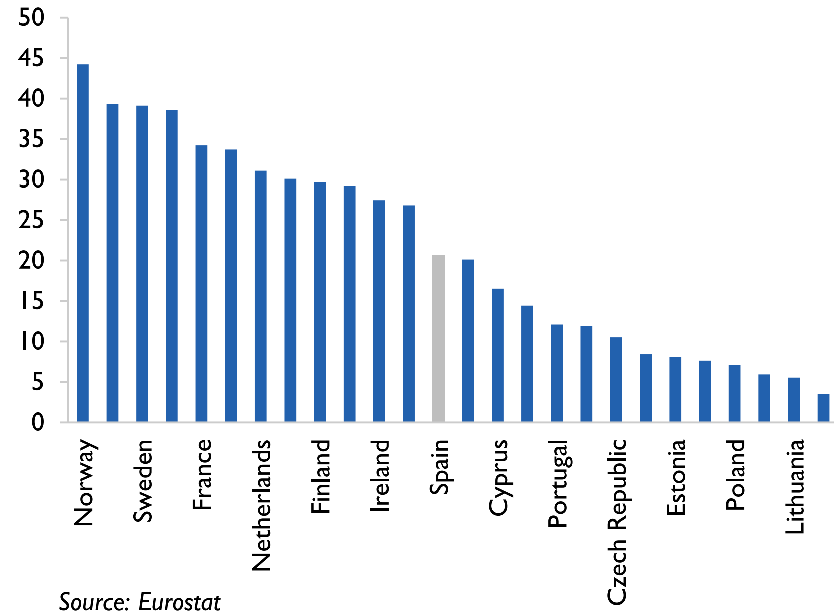
Spain today has a highly competitive labor force

Productivity/hour worked (US=100%, 2011)



Source: The Conference Board

Labor costs (€/hour)

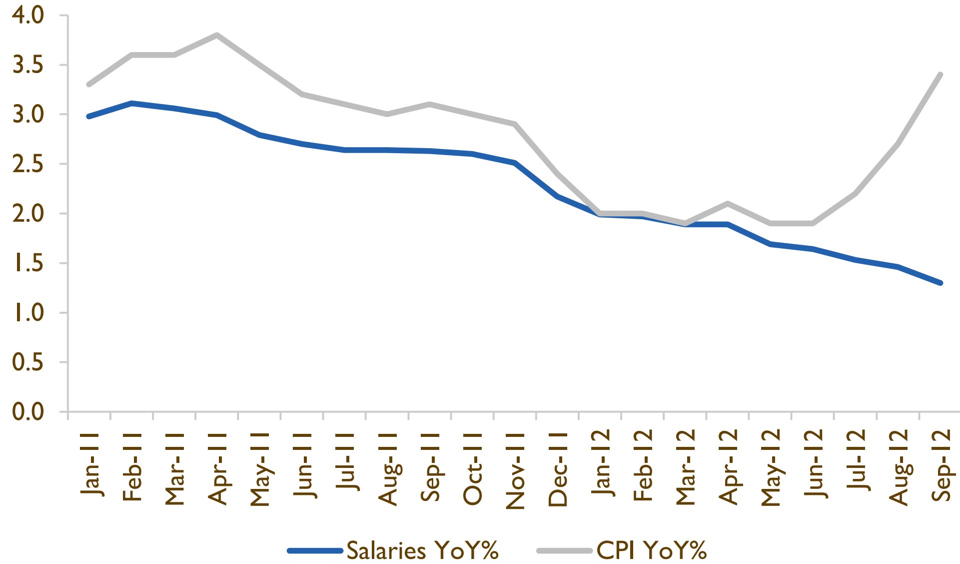


Source: Eurostat

- Spanish labor is 30% cheaper than the euro zone average, but productivity difference is less than 10%

… that works hard and is increasingly flexible

Difference between prices and salaries (YOY%)



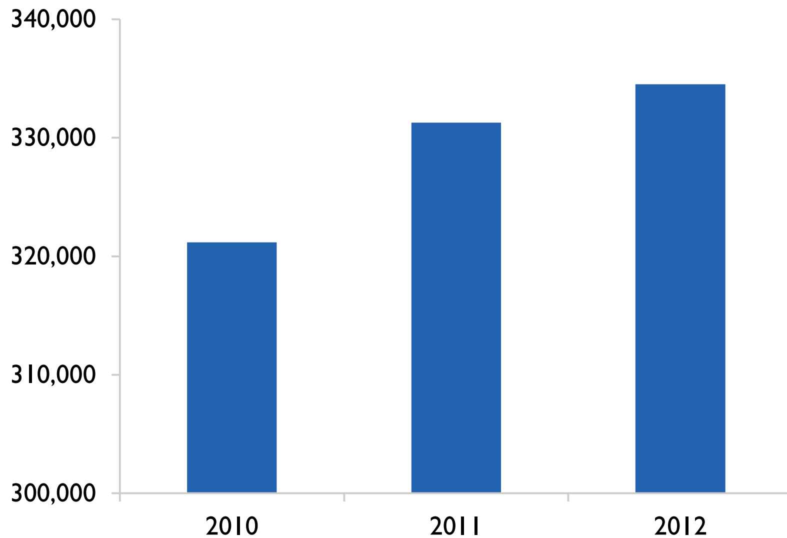
Source: Ministerio de Empleo y Seguridad Social, INE

- Spaniards work harder than most of its trading partners, in terms of hours worked. Following the labor reform, salary increases are no longer linked to inflation

ARCANO

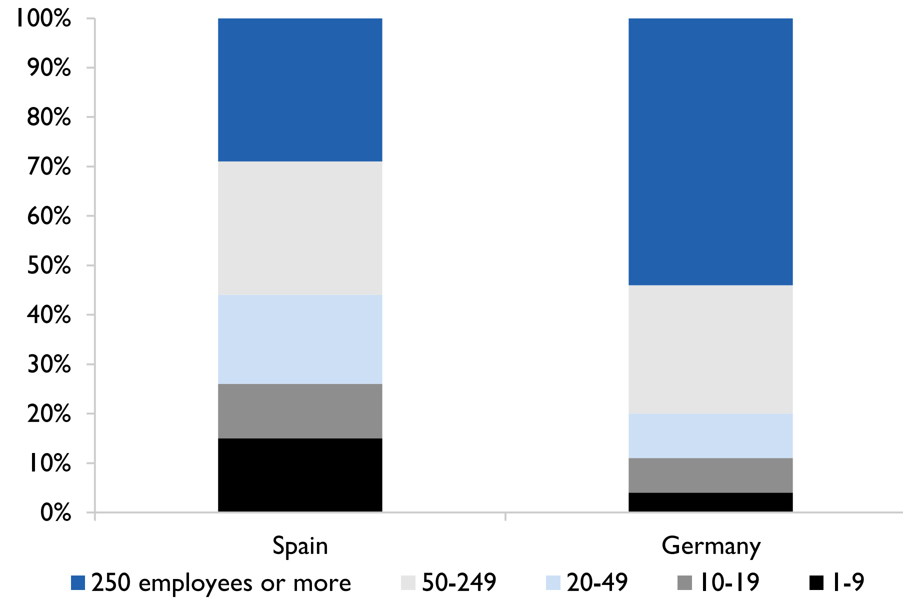
More new companies are being created than in the past…

Creation of gross new companies



Source: Arcano, INE

Breakdown of companies by sizes: Spain vs. Germany

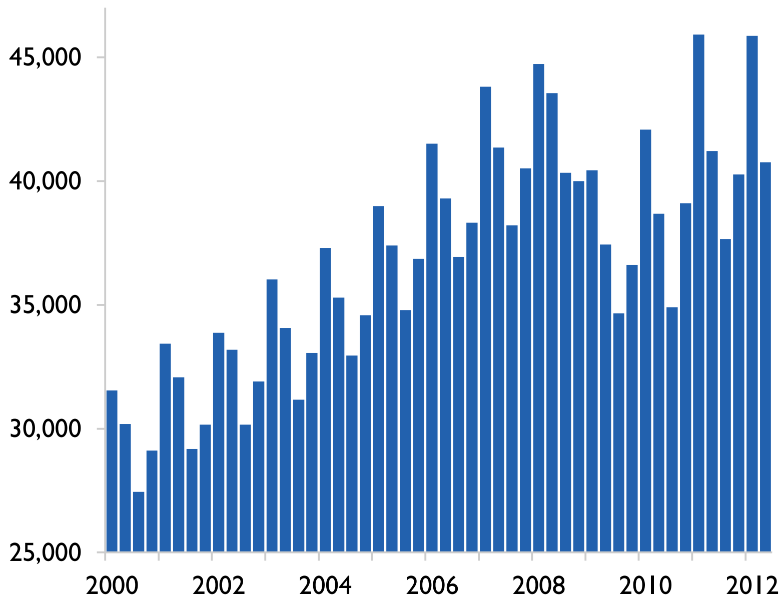


Source: Eurostat

- More than 320,000 new companies are being created every year, although one of the greatest challenges facing Spain's corporate sector is to increase the average size of its companies

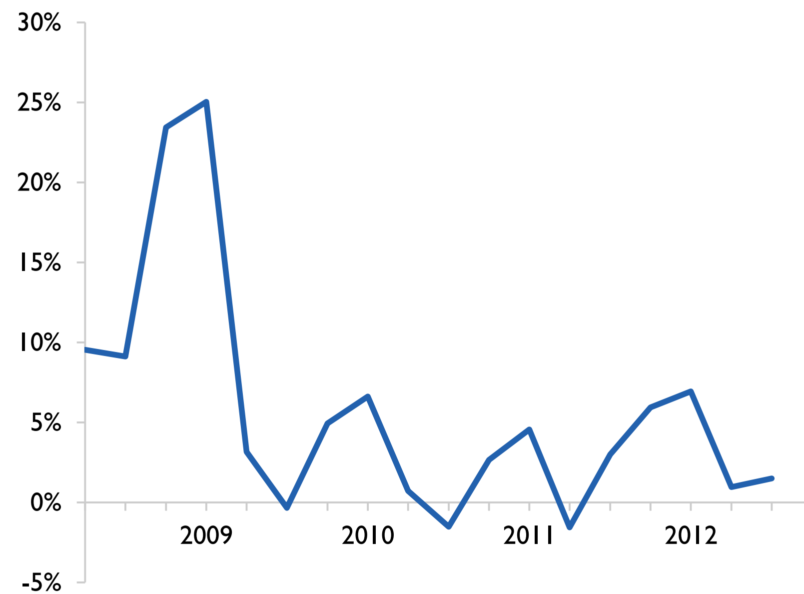
…that, together with a higher value-added industrial sector, will slowly help drive up employment and eventually growth

Evolution of Spanish value-added in the industrial sector



Source: INE

Unemployment QOQ growth evolution (EPA)



Source: INE

- The industrial and services sectors will be the main engine of Spain's GDP growth and employment, with industries increasing their value-added products
- Most of the employment adjustments should end by 2013. With consumption currently at depressed levels, stabilization of employment might lead to consumption growth from 2014 onwards

Agenda

Conclusions

Spain in 2006

- 11% Current Account deficit, the second largest in the world. For every 100 euros of GDP, 11 were financed by foreigners through short term money. This is the origin of the liquidity crisis
- 25% Credit Expansion. To grow GDP by one euro, Spain needed four euros of additional lending. This is the origin of the banking crisis
- Construction's weight in the economy increased to 12% of GDP
- Tax collection increased 4% of GDP due to real estate. Yet the Government used this money to hire more civil servants. This is the origin of the fiscal crisis

<u>Despite these risks, asset prices were at historic highs, and Spain attracted record inflows of portfolio money (€208 bn.)</u>

Spain in 2013

- Current Account surplus. 11% adjustment in 6 years. Yet GDP has only contracted 5%
- Loans down 5%. Private debt to GDP down 16% since 2009. Again, in spite of this, GDP only contracted 5%
- Construction is back to 6% of GDP, below historic average
- A fiscal package of 11% of GDP is being implemented. By 2014, structural deficit will reach 0%

<u>Despite lower risks, asset prices have plummeted, and significant portfolio money left Spain (€80bn. in 2012)</u>

Conclusions (cont.)

- Spain was not the best place to invest in 2006 but it could be in 2013
- Spain's condition is not as weak as many believe. Investors should disregard misguided "myths" about Spain when making investment decisions and focus on fundamentals
- Spain is solvent, but illiquid. The EU has established sufficient mechanisms to support Spain's need for liquidity. Spanish corporates, households, and the government are solvent
- Spanish banks are seeing the light at the end of the tunnel. There are 15 main banking groups left, leaving the sector well capitalized and with sufficient liquidity
- The contagion effect from real estate to banks, and from banks to the Government, should be over
- Spain is adjusting, fiscally and from a supply side point of view
- Spain is growing through external demand, as exports and tourism reach record highs
- Spain's cheap labor costs and high productivity explain why this growth is structural, not short term driven
- The crisis is producing a new generation of Spaniards focused on entrepreneurship, SMEs and R&D

Spain will emerge from its ashes, like the Phoenix!

Thanks!

ARCANO

Arcano: your local house of reference to invest in Spain

About Arcano (www.arcanogroup.com)

- A leading independent advisory services firm with presence in Europe and the United States. The company specializes in three areas: Investment Banking, Asset Management, and Multifamily Office
- Our team is formed by 70 qualified professionals that work to offer financial advisory services and tailored solutions for our clients with a unique, independent approach
- Arcano's Investment Banking unit is recognized as a leader in the small and mid-market segment of the Spanish market, including clients such as Private Equity firms, family owned companies and publicly traded corporations. Arcano also provides pre-IPO finance rounds to companies for deals ranging from €10 m. upwards to support expansion up to 2 years before the IPO; on the small cap side, Arcano helps small companies float on the Spanish Alternate Market (MAB) with offering sizes from €10 m. upwards, and it intermediates block trades in small caps in the Spanish equity markets

About the author

- Ignacio de la Torre has been a Partner of Arcano since 2008
- Fifteen years of experience in investment banking and capital markets, having worked in the equity research and equity sales departments of Deutsche Bank and UBS Investment Bank
- The author is also a part time Professor of Finance and Economics at IE Business School. He holds an MBA from Insead, a Ph. D. in History from UNED, an M. Sc. from ICADE, and a M. A. from UNED. He has authored four books and won the Everis prize in 2009

Disclaimer

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s) about the subject issuer and the securities of the issuer. In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Ignacio de la Torre.

This document has been prepared by Arcano Valores AV, S.A.U. (Arcano Valores). Arcano Valores is an investment firm regulated and registered under number 243 by the Spanish National Securities Market Commission (CNMV). This document is provided for information purposes only and must not be considered as an offer to sell or a solicitation of an offer to buy any financial instrument or to participate in any particular trading strategy. The information contained herein has been compiled from sources believed to be reliable, but while all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, we make no representation that it is accurate or complete and it should not be relied upon as such.

All opinions and estimates included herein constitute the current judgement of the author as at the date of this report and are subject to change without notice. Arcano Valores has no obligation to update, modify or amend this report or to otherwise notify a recipient thereof in the event that any opinion, forecast or estimate set forth herein, changes or subsequently becomes inaccurate

Arcano Valores has internal rules of conduct that contain, among other things, procedures to prevent conflicts of interest with respect to recommendations, including: the consideration of its Research Department as a separate area, Chinese Walls, and the possibility of establishing specific restrictions on research activity where appropriate. Arcano Valores' research reports contain a certification stating that they reflect the authors' own opinions. Arcano Valores may from time to time perform services for or solicit business from any company mentioned in this report. Neither Arcano Valores nor any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents. This report may not be reproduced, distributed or published by any recipient for any purpose.

This Equity Research was produced by:
Arcano Valores AV, S.A.U.
López de Hoyos, 42
28006 Madrid
+34 91 353 21 40
www.arcanogroup.com

ARCANO