

# Investing in Spain

Dove and Hawk visit Spain



November 2013

# Social and Economic Update

Dolly Dove persuades Harry Hawk that they need to escape the long winter nights in search of some winter sun in Spain. Whilst in Madrid they debate whether Spain is really coming out of their profound crisis and if the country's optimistic economic news is in fact sustainable.



**Dove:** Bienvenido a España mi amigo. That was an easy flight wasn't it? The weather is absolutely glorious — just what the doctor ordered!

**Hawk:** The weather's great I'll give you that Dolly, but I reckon Spain is still in the doldrums.

**Dove:** You've been down on Spain for years. You didn't even want to come on this short holiday. What's wrong with you? You used to love coming here. The food, the shopping, the football, the history and the culture, not to mention the weather.

**Hawk:** Times have changed Dolly. This country has been in a mess and they still have some major problems to face up to. Spain may well be the 5th largest country in the EU, but it's prospects are still bleak.



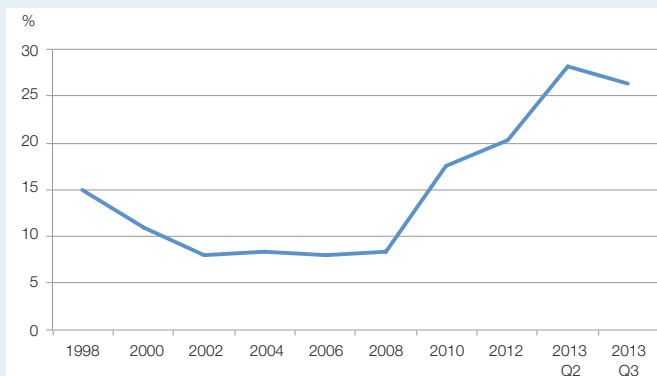
**Dove:** It doesn't feel like that here in Madrid - there's a real buzz to the place and it's absolutely heaving.

**Hawk:** I can't understand that. All I've read recently has been saying that Spain has an unemployment rate of over 25%. Even if it is falling slowly it is still the highest in Europe. It's even worse for the under 25s - up to 50% apparently. Where are the Spanish getting their money from?

**Dove:** There is high unemployment Harry, no doubt of that, but Spain's unemployment rate has always been high compared to the rest of Europe. Even in the recent boom years of 2005-2007 unemployment was never less than 8%.

**Spain is experiencing very high unemployment, driven in part by a large hidden economy**

## Spanish Unemployment Rates



Source: Instituto Nacional de Estadística

**Hawk:** So I suppose you're going to tell me that this is because Spain has such a huge hidden economy?

**Dove:** Absolutely Harry. Spain's hidden economy represents an estimated 29% of GDP and if that problem was resolved then the official unemployment rate would fall by around 25%!

**Hawk:** Well why doesn't the Spanish government do something about it? Having such a high unemployment rate sends a really bad message to the world and potential investors.

**Dove:** It's one of the new government's main priorities — clamping down on people who do not declare their employment and also people who have moved their money overseas.

**Hawk:** The government promised to do things when it was elected but have they? Spain's problems were so big and the Government came to power with both hands tied firmly behind their backs.

**Dove:** From what I've heard Harry, Spain was one of the first countries to implement austerity measures. They recognised they had to act and did. They reduced their government budget deficit from 11.2% in 2009 to just over 6% today and have also implemented other tough reforms requested by the EU such as labour and pension reforms.

**Hawk:** That's all well and good Dolly, but their actions haven't got them very far have they? Spain still has a huge debt level!

**Dove:** That's very true Harry but a large government balance sheet is not necessarily a bad thing. Expansion in the US has generated the kind of economic growth Spain badly needs. In any case, Spain's debt to GDP ratio is not outrageously high when viewed in the context of the rest of the EU. The UK and France have similar levels of borrowing to Spain and the cost of servicing that borrowing has come down recently.

**Spain has a similar government debt to GDP ratio as other major European countries**

## Government Debt as a Percentage of GDP

	2010 %	2011 %	2012 %	2013 (forecast) %	2014 (forecast) %
Spain	61.7	70.4	86.0	93.7	99.1
Germany	82.4	80.4	81.9	80.4	78.1
France	82.3	85.8	90.2	93.5	94.8
UK	78.5	84.3	88.8	92.1	95.3
Italy	119.3	120.8	127.0	132.3	133.1

Source: Eurostat / IMF

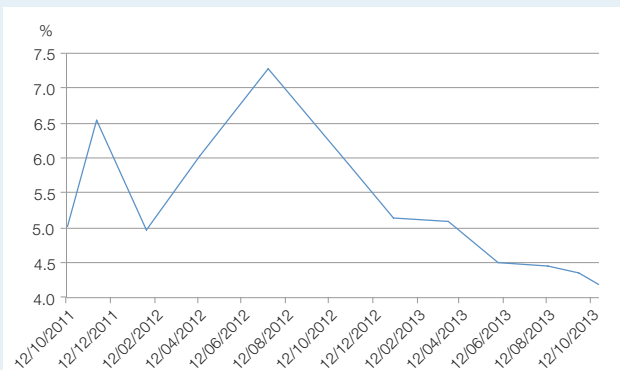


**Hawk:** Net borrowing increasing might not be all bad but weren't 10 year bond rates over 7% last year? Berlusconi resigned when Italy's reached 7%, a level widely regarded as being unsustainable. It's a brave bird who invests when rates are that volatile.

**Dove:** Yes Harry that's true but it was a short-lived crisis. Things have changed and there is much more stability now. Spain has gone through a period of relative calm, bond rates are close to 4% and foreign investment has doubled compared to last year.

### Spanish Government Bonds have been more stable over recent months

#### Spanish Government 10 Year Bonds



Source: BNP Q3 2013

**Hawk:** How has all the uncertainty affected economic growth? Is Spain still in recession?

**Dove:** Spain came out of recession in Q3 2013 and modest growth is expected in 2014. The difference now is that the growth is based on a more sustainable model and exports and tourism are growing at record levels.

### Spain is forecast to experience modest economic growth

#### Spanish Economic Forecasts - Year on Year Variations

	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 Forecast (%)	2014 Forecast (%)
GDP	-3.8	-0.2	0.1	-1.6	-1.5	0.9
Exports	-10.4	15.3	8.6	2.4	7.7	6.5
CPI	-0.2	2.0	3.1	2.4	1.8	1.5

Source: Focus Economics Forecasts, October 2013

**Hawk:** So what's going to drive this supposed growth? Tourism?

**Dove:** Tourism will be important as it represents 12% of Spain's GDP. Encouragingly the number of tourists visiting Spain this year is up nearly 8% on last year and they are spending more money whilst they are here.



**Hawk:** But Spain can't rely solely on tourism. If countries like the UK, France and Germany re-enter recession then they won't holiday abroad will they? These three countries alone represent half of all Spain's tourists and they would really feel the pinch.

**Dove:** That's why Spain's export sector is also crucial. In the year to date exports have shown an annualised increase of about 20%. Continuing export growth will be important for Spain's on-going recovery.

**Hawk:** I see Spain even export their banks! Santander seem to be everywhere at the moment. How are the other Spanish banks getting on - they were in big trouble when the crisis hit?

**Dove:** The biggest problem was in the Spanish Cajas, the smaller savings banks that ended up with large delinquent loan books. But this has been tackled effectively and although there was a 40 billion Euro bailout from the EU, the system has now been restructured and the problems are being resolved.

**Hawk:** What? So the Spanish banks are OK now? Utter rubbish Dolly.

**Dove:** I accept that the banking sector is not out of the woods. However the signs are encouraging. Bankia, another bank that had to be rescued, is now showing profits, whilst Santander and BBVA are also showing large increases in profits. The main problem that still remains is accessing new credit for business growth.

**Hawk:** So what has been done to try and resolve Spain's banking issues, if anything?

**Dove:** A lot has been done. The Cajas have undergone major restructuring and recapitalisation which has resulted in only 12 of the original 45 surviving. Solvency requirement tests and banking regulations have been introduced and don't forget the government has set up SAREB to take up the bad real estate exposure in the system. The final part of the restructuring is also in hand with the auction of Nova Caixa Galicia and Catalunya Bank. However, the most important change, that of a single EU regulatory body, is still pending.

**Hawk:** Well good luck to them I say and let's hope they are making the right decisions and can really make a positive sustainable change to the economy. Anyway the sun has made me thirsty... so why don't we pop over to that bar for a drink and you can tell me about how the economic crisis has impacted on the real estate market.

# Investing in Spanish Real Estate

Over a jug of sangria Dove and Hawk assess the state of the Spanish commercial property investment market and discuss how the recent economic crisis has affected it.

**Dove:** This sangria is going down rather well Harry. Do you fancy another?

**Hawk:** A bit too well Dolly but, yes, I'll have another one thanks. Whilst we are waiting why don't you talk to me about the infamous 'property bubble'.

**Dove:** Firstly I should clarify that this bubble was predominantly about residential property. Spain built more houses than it needed during the boom years. There's no doubt about that. In some areas up to 20% of new houses still remain unsold! Most people associate the state of the property market in Spain with residential but that's not an accurate picture Harry.

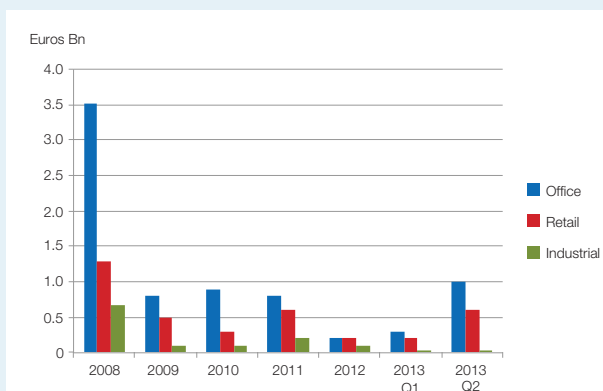


**Hawk:** So is the scepticism of foreign investors towards the Spanish commercial property market not justified then? Isn't weak economic growth, negative net absorption and falling rents keeping foreign investors away?

**Dove:** Absolutely. The numbers speak for themselves. In 2012 the cumulative volume of the commercial property investment market in Spain was less than one billion Euros, down 25% on 2008 volumes. That said, volumes in the first half of 2013 already exceed the whole of 2012 so it looks like investors are coming back, albeit slowly.

## 2012 investment volumes in Spain were the lowest for a decade

### Investment Volume by Real Estate Segment



Source: Savills

**Hawk:** Blimey. International investors really are staying away from Spain.

**Dove:** Yes, and there are a number of reasons for this including the economic instability, difficulties in accessing finance and the lack of quality products at market prices. Investors remain very conservative and those that are interested are now waiting for the 'perfect investment'.

**Hawk:** So are all international investors thinking along the same lines?

**Dove:** The German funds are tracking the market closely. They have an expectant attitude and will be very selective. However, they have not been very active to date. The larger funds are more active though and are showing interest in large portfolios.

**Hawk:** What about the opportunistic guys? Aren't they hovering over Spain waiting to pounce for their prey?

**Dove:** They have been waiting for a better balance between quality, price and return. There has been a mismatch between buyer and vendor expectations. However the gap is narrowing and this has led to more activity of late.

**Hawk:** Am I right in assuming that domestic investors are dominating the Spanish investment market then at present?

**Dove:** Private local buyers dominate for lot sizes of up to 40 million Euros. However more than 75% of this year's volume has been with international investors. The larger transactions have been the preserve of the large investment funds and listed property companies. All investors, irrespective of their size, are focusing on well-located, high quality buildings with a high occupancy rate, solvent tenants, on long leases at market rents.

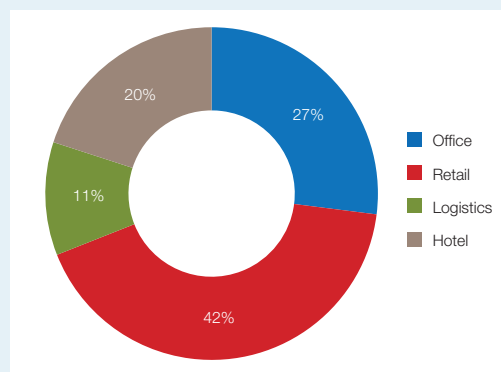
**Hawk:** In other words...prime assets!

**Dove:** Indeed but there is currently a shortage of prime product in all sectors, which is slowly pushing investors towards the consolidated secondary markets.



## Retail remains the favoured sector for investors

### Investment in Spain by Type of Asset



Source: BNP Paribas Real Estate, 2013

**Hawk:** What about the Spanish banks? They must have a huge amount of property on their balance sheets that they need to dispose of?

**Dove:** They sure did. The government however was quick to react and has set up a 'bad bank' akin to Ireland's NAMA called SAREB to buy more than 100 billion Euros of toxic property debt. The banks have also made large provisions that have been demanded by the government.

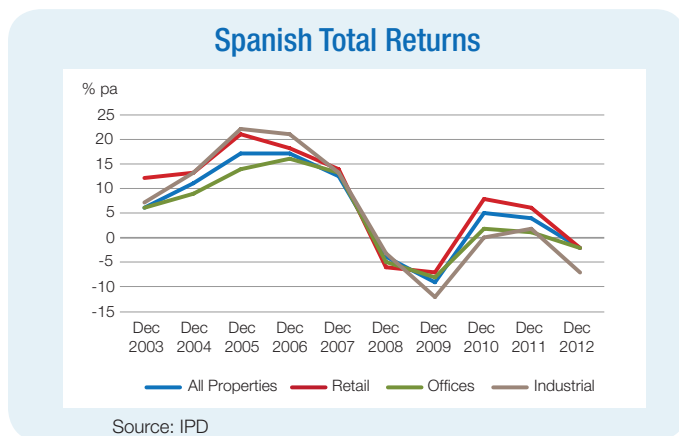
**Hawk:** It sounds like the government has done what was needed to put the banking system right. Just as well because Spain used to be the darling of international investors. Now look at it. I assume poor performance from the sector hasn't helped?

**Dove:** As you'd expect Harry, performance over the last couple of years hasn't been great and has been a clear reflection of the crisis.

**Hawk:** I bet the returns were negative!

**Dove:** Well 2012 was -2.1% but let's face it, everyone knows that valuations haven't been properly marked down to market. The figures should have come out much worse than that.

### Spanish total returns belie how poor the market has really been



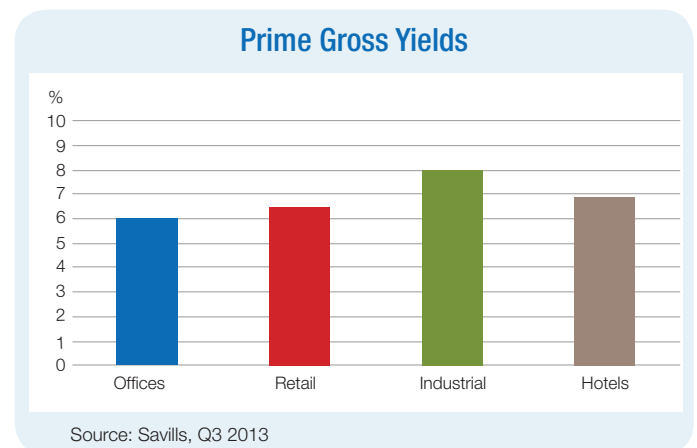
**Hawk:** And are capital values still falling Dolly?

**Dove:** That's the million dollar question. Speaking with the investment community here in Madrid, their view is that the market has reached the bottom and is starting to move. Investors are not just looking but buying. Yields for prime properties are stable and have been for a while now.

**Hawk:** Surely this yield stability is only due to a lack of transactions taking place? With Spanish 10 year bond yields averaging over 5.50% over the last year or so, how can prime yields for Madrid offices remain at 5.25%? Where's the logic behind that? Spanish valuers and agents must have a vested interest in not devaluing the assets so that they don't upset the apple cart again. Surely prime assets in the core markets have to be fully priced, if not over priced?

**Dove:** You may well be right Harry, but I am only going with what I've been told by the large agency firms. Whether the yields they publish would actually be achieved if the properties had to be sold...who knows? This year the bond rate has reached 4.25% (and is falling) and the most recent transactions in large shopping centres have been at around 7%.

### Prime yields for all sectors appear stable



**Hawk:** So cutting through all the bull, should investors be taking a closer look at what is going on in Spain? I'll bet most of them are adopting a 'wait and see what others do' approach.

**Dove:** Sticking their heads in the sand, more like it Harry. Until now they've probably been right to do so though and it can't have been easy for them. They have experienced similar scenarios across the whole of Europe and probably didn't know which way to turn next.

**Hawk:** Well if I was in their shoes, I'd be starting to carry out objective market research now and then making the most of the opportunities that exist. It has to be better to be pro-active than being reactive surely?



**Dove:** What you say Harry is easier said than done though. Very few of the international investors now have teams in Spain to provide them with the advice that they clearly need.

**Hawk:** I just don't think investors know who or what to believe. They have a problem because their agents are continuously telling them that values are stable and will remain so. It's time for some honest and frank discussions.

**Dove:** You're beginning to depress me Harry. Let's pay and fly up to Barcelona. The best football team in the world are playing tonight and I've always wanted to see Senor Messi in action.

**Hawk:** Good idea. Maybe a footballing exhibition will brighten our moods.

# Shopping and Working in Spain

From high up in the stands at the Nou Camp in Barcelona, Dolly and Harry discuss the main commercial property sectors and debate whether international investors with existing assets should remain in Spain or sell up.

**Hawk:** Barcelona do play some good football, don't they Dolly? Teams like this don't come around too often, believe me.



**Dove:** They are special no question of that, but just look at how many of their fans are wearing replica shirts. All 100,000 of them! Spanish retailing can't be faring too badly if shirt sales are anything to go by. It again proves my point that the Spanish do have money to spend.

**Hawk:** Yeah but how many of those retail units were empty in that shopping centre we stopped off at on the way over here from the airport? Plenty, let me tell you!

**Dove:** That was a secondary shopping centre and yes, vacancy rates for such centres are quite high at present, up to 25% in some places. The story though is quite different for prime centres and prime retail space (particularly in Barcelona and Madrid) where, despite challenging trading conditions, demand remains healthy.

## Prime retail rents have fallen by 30% since 2007

Prime Spanish Rents Shopping Centres Index



Source: Jones Lang LaSalle

Base year 2002 = 100

**Hawk:** You aren't going to tell me that retail rents have remained stable over this difficult period are you Dolly?

**Dove:** Of course not, Harry. Since the start of the crisis rents have dropped in some cases up to 30%. However on the whole, prime rents have broadly remained unchanged over the last year.

**Hawk:** That just doesn't make sense Dolly. Sluggish household consumption, a decline in disposable income and a rising unemployment rate should all point towards a further fall in retail rents.

**Dove:** Prime locations have been far more resilient but I accept that secondary locations continue to struggle. Vacancy rates have increased in these centres and rents have fallen as a

consequence. Larger incentives are also being given to retain and attract tenants. Despite this some major retailers are still expanding.

**Hawk:** Which retailers would want to expand in such challenging trading conditions? Are they mad?

**Dove:** Both national and international retailers Harry. Abercrombie & Fitch, Apple, Mango, Forever 21, Primark, Coach, Urban Outfitters, Brooks Brothers, Ethan Allen, Tory Burch, Sports Direct, For All Mankind and UGG for example have all expanded or are about to enter Spain. These guys aren't mugs are they? And to prove the point about take-up, all the new retail developments that have opened during the last two years are close to 100% let.

**Hawk:** What? People are still building new shopping centres? There's brave and then there's that!

**Dove:** The truth is Harry that the development pipeline has now practically stopped. Only 450,000 sq m was completed in 2012, well below the boom years. Don't forget though that most of these schemes were already committed and started before the crisis. There are however still some excellent opportunities to develop prime shopping centres across Spain.

**Hawk:** Given that there was so much retail development during the boom years, won't many shopping centres have to be reinventing themselves to stand out from the competition?

**Dove:** Absolutely. It will be very much a case of the survival of the fittest. Functional and economic obsolescence will be a problem for many centres but on the flip side this will give rise to opportunities for investors to add value.

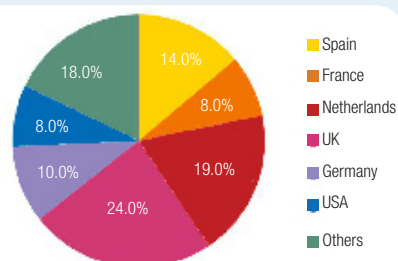
**Hawk:** That'll be a big ask for overseas investors, won't it? To invest more money in assets which have tanked in value.



**Dove:** Absolutely. Investors have some big decisions to make – not least whether to stay or go?

## The Spanish retail investment market has been dominated by Dutch, UK and Spanish investors

Purchasers by Nationality (2000-2012)



Source: Savills

Hawk: Well what would you be recommending they do Dolly?

Dove: Having spoken with the Spanish team at St Bride's Managers in Madrid, they reckon:-

- Poorly conceived and poorly managed centres will inevitably fail and possibly close.
- Prime centres should be okay not least as it will be a long time before anything new is built to compete with them.
- But pro-activity is paramount. A phrase they continually use is 'snooze and you lose'.

Hawk: Is their view the same for offices?

Dove: Very much so, but they are only interested in offices in Madrid and possibly Barcelona. Plus they are very picky about the locations and types of offices there.

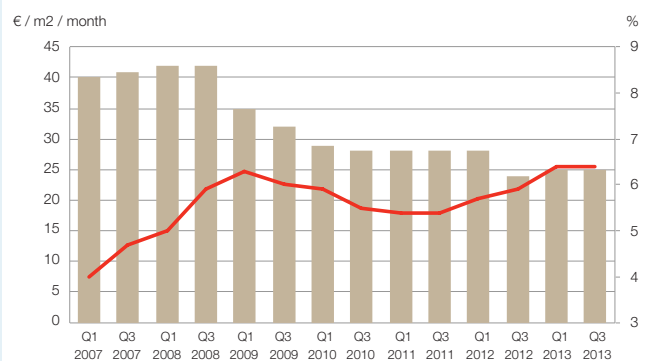


Hawk: Ah at last some sensible thinking. The office sector in Spain has taken a battering, hasn't it, so retrenching to the two main cities where any future demand will clearly come first has to be the most sensible approach, doesn't it?

Dove: It does indeed but St Bride's still urge real caution. Rents have fallen significantly during the economic crisis and yields have softened too. As a consequence, investors have been really badly burnt along the way.

Office rents appear to be stabilising

### Prime Office Rents and Yields in Madrid



Source: Savills

Hawk: So what are their current concerns?

Dove: Their principal concern is the stability of the economy. If the economy grows as envisaged there may be some opportunities to create value. But you have to be really careful.

Hawk: So are St Bride's saying that if your Spanish office investments aren't prime and aren't in either Madrid or Barcelona, then you could be sitting on ticking time-bombs?

Dove: That's right. However they feel the difficulty will be actually closing deals whether they are prime or not as the gap between buyers' and sellers' perceptions of value continues to grid-lock the market.



Hawk: So should investors be saying 'adios' then to Spanish offices or sticking around for the recovery?

Dove: The answer really depends on their willingness to get their hands dirty. The only way an investor will add value is by being pro-active.

Hawk: Is this the same story for industrials?

Dove: Absolutely. Tenant demand is currently very weak and whilst the industrial sector has potential in the medium term investors should only be looking at the main catchment areas.

The industrial sector is expected to only gradually improve as Spain recovers

### Spain's Main Logistic Catchment Areas



Source: CBRE

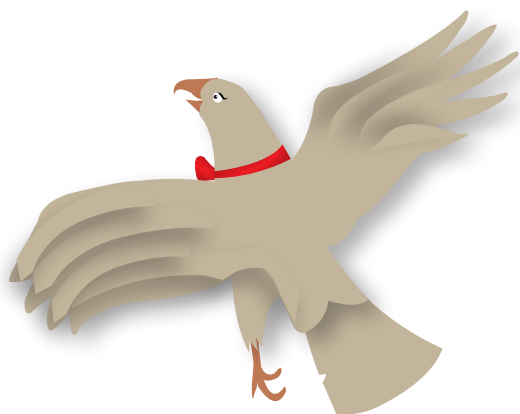
Hawk: Well this footie game is nearly over. Shall we leave now to beat the crowds and head back to the airport?

Dove: Good idea Harry but I hope you are leaving Spain in a better frame of mind than when you arrived.

Hawk: A little!

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