SPECIAL FEATURE

The case for investing in Spain today

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Spain's macroeconomic and fiscal imbalances, as well as asset prices, are correcting, increasing the attractiveness of Spain as a destination for foreign investment. Nevertheless, investors' misperceptions are still generating capital outflows.

As a result of recent reform efforts, Spain's structural imbalances are adjusting, providing the country with a competitive, export-driven growth model. EU liquidity facilities will allow Spain to remain solvent at the sovereign and banking level. Under the efficient market hypothesis, Spain represents an opportunity for appealing risk adjusted investment returns–with asset prices for today's Spain at minimum historic levels. However, investors are failing to take advantage of opportunities due to existing negative perceptions over the Spanish economy.

From the perspective of an institutional investor, consider the following two investment scenarios:

a) A country with: a current account deficit of close to 10% of GDP, financed principally through portfolio investments; a GDP growth rate of 4%, channeled through credit growth of over 25% per annum (i.e. credit intensity of 4:1); a fiscal surplus of 2%, leveraged by *non-recurring* taxation (driven by a housing bubble), which is used to finance *recurring* expenses; and asset prices (real estate, bonds, and equities) at maximum historic levels.

b) A country with: a balanced current account thanks to ballooning exports, which increased by 7% of GDP in 3 years; a GDP decline of only 1% in spite of a decline in credit of 7%; a fiscal deficit below 5% with a fiscal package of 11% of GDP implemented to cut the structural deficit to zero; and asset prices at minimum historic levels.

Whether to invest in country "A" or "B" depends on whether you believe risk adjusted investment returns are driven by behavioral finance or the efficient market hypothesis. The efficient market hypothesis clearly favors option "B", but in reality, investors overwhelmingly chose option "A".

And they lost money.

Country "A" and "B" are both Spain, but "A" is Spain in 2006, and "B" is Spain in 2012. One would expect that the combination of risky factors in 2006 would result in low asset prices and portfolio outflows, yet the country received 208 billion euros in inflows. In 2012, the aforementioned risks were addressed, which should have resulted in a lower risk associated with investments in the country, together with historically low asset prices, yet 80 billion euros left the country.

We face an intriguing example of behavioral finance. This article will analyze why Spain is a

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much better investment opportunity in 2013 than in the past, from a risk adjusted perspective, and why the adjustments undertaken in the past years give Spain a clear competitive advantage in trade that provides the country with a clear growth model. This article does the following: a) demystifies the Spanish economy, as investors should base decisions on facts, not myths, b) provides data to support the thesis that Spain is a solvent, though illiquid, country with sufficient liquidity provided by the EU, and c) explains why Spanish exports are reaching record highs with further upside in the years to come.

Myths of the Spanish economy

Myth #1: Spain's debt is 363% of GDP, the third largest in the world (see Exhibit 1), and as Spain cannot print its own money, it will default

This is wrong. The total amount of debt in the country is under 268% of GDP. This myth is wrong on several bases. First, even if a country has the power to print its own money (Japan, UK), it can still default through inflation. Second, banks' wholesale debt should not be added to the rest of the nation's debt to calculate total debt (i.e. if you owe 100,000 euros to a bank and the bank to a wholesale investor, you should not double count this debt). Third, intercompany loans (i.e. Inditex lending money to Zara) represent 27% of GDP, and these should be netted out of the country's total debt. Fourth, toxic debt (real estate related debt) represents 40% of GDP at gross value but only 20% at net value, as it has been provisioned at 50% already. Fifth, Spain has some of the most important infrastructure companies in the world, which use project financing for international projects, without recourse to the parent company. This debt represents 10% of GDP. Sixth, Spanish companies have invested 44% of GDP overseas in the last 12 years. Should Telefónica's debt to support the acquisition of O2 be backed by the UK's GDP or by Spain's GDP?

Myth #2: Spanish authorities are reckless in spending

This is also untrue. Exhibit 2 shows that aggregated public spending in Spain is the second lowest in the West. Spain's problem is not public *spending,* but public *income,* which is well below that of other European countries. Once the fiscal package is finished by 2014, Spain will become the country in the West with the lowest weight of Government expenditures, which should provide an attractive prospect for investors.

Myth #3: Spain is not competitive

This is inaccurate. Spanish unit labor costs (ULC) have declined 4% since 2008, while the ULCs of its three major trading partners have risen 5-10% (see Exhibit 3). This means that Spain has regained competitiveness in the range of 9-14%, which explains the country's soaring exports.

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Myth #4: Spain does not have a growth model to end its crisis

Exports in Spain have increased 18% since 2008, *vs.* Germany at 12%, France at 5%, and Italy at 4% (see Exhibit 4). Spanish exports of goods and services (services mainly include tourism, which will provide Spain a net surplus of close to 5% of GDP, making it the second largest touristic power in the world after the US) will provide the growth model that the country needs to leave the crisis behind. Spain's significant competitive advantages in ULC leave many years of further upside in terms of trade of goods and services.

Myth #5: The worst is yet to come for Spain

This is disputable. In the absence of currency devaluation, the main adjustment the country must make will be in lower labor costs, as we have seen before. This has allowed the country to close more than 10% of GDP in its current account deficit in five years, a remarkable task. The country has entered into trade surplus ex-energy as well as trade surplus with energy and services, for the first time since the inception of the euro (Exhibit 5).

Myth #6: Europe will allow Spain to leave the euro

This is very unlikely. Spain leaving the euro would probably imply the same for Italy and therefore the end of the euro altogether. A “new” Deutsche Mark would revalue 40-50%, and Germany’s exports (more than 40% of its GDP) would sink. The financial cost for Germany driven by this fact, plus the losses accrued through the ECB target II system (Exhibit 6) and in the German banking books would be much higher than the cost of sustaining the euro. Additionally, the euro is an instrument to create further political union, and it is thus far achieving it.

Myth #7: Spain will not reform

This is false. Spain is undertaking a fiscal adjustment of 11% of GDP (substantially more than in the UK or the US) and supply side reforms not undertaken in decades. Supply side reforms can generate a further 8.6% of GDP and 2 million jobs before 2020 (Exhibit 7).

Myth #8: Spanish banks’ deposits are fleeing the country, pushing the banking system towards the brink of collapse

This is mostly false. When the Government in November 2011 capped deposits’ retribution, the banks convinced many clients to switch to commercial paper, which does not have caps to interest rates and which does not count as deposits. Once the cap was abolished (August 2012), much of that money returned to deposits (Exhibit 8).

Myth #9: Spain’s CDS imply that Spain is the fifth country in the world most likely to default

This is untrue. According to CDS spreads, Spain is riskier than Indonesia, Russia, Kazakhstan, and Romania (Exhibit 9). The 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 the 1960s). Countries default once they reach very high levels of Government debt (above 120% of GDP), cannot access liquidity, and are unable to grow. Spain is not in this situation.

Myth #10: Spaniards don’t work hard

This is false. According to the OECD, Spain is the third developed country with the longest hours worked. Productivity per hour is 10-15% below the Eurozone average, but salary per hour is 35% below the Eurozone average (Exhibit 10). Cheap labor costs, high relative productivity, and long hours worked explain the success of Spanish exports and why foreign direct investment (FDI) is up 100% between 2011-2012.

Spain is solvent

It is evident that to assess an institution’s solvency, one must analyze both assets and liabilities. Unfortunately, there has been much written on Spain’s solvency without performing this analysis in detail. We have performed this analysis to show the inherent solvency of Spain. Financial assets are reported by the Bank of Spain every three months. The task of calculating the value of non-financial assets was undertaken by FUNCAS in 2008, which is based on the register of public property and adjusted for 2007 real estate prices. We have reduced the value they provided in 2008 by 50% to fully reflect declines in housing prices of

36% since the start of the crisis plus an additional 14% margin. The country's debts stand at 268% (this includes much "debt" incurred in foreign countries). Assets represent more than 700% of GDP. We find that each of the three major agents of the economy (Government, which includes local governments, Corporates and Households) are in a positive equity position (see Exhibit 11).

The problem of Spain is lack of liquidity, not lack of solvency. This lack of liquidity is derived from the fact that 80% of households' savings are concentrated in illiquid real estate, compared to a European average of 50% (Exhibit 12). It is true though that a solvent but illiquid party can default through illiquidity. Yet, during 2012, two milestones were achieved that allowed Spain to secure enough liquidity from the EU to avoid insolvency:

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First, at a sovereign level, the European Stability Mechanism (ESM) entered into effect in September 2012. Together with the European line of credit of the International Monetary Fund (IMF), the lending capability of these rescue vehicles stands above the debt maturities of Italy and Spain combined in 2013 and 2014. For the first time since the inception of the euro crisis, rescue mechanisms' lending power stands above debt maturities. This is a key milestone in the development of a new financial architecture (Exhibit 13).

Second, at a banking level, the European Central Bank (ECB) provided unlimited liquidity to Eurozone banks in February 2012 through the Long Term Repurchase Operations (LTRO). Spanish banks have a loan to deposit ratio of 150%, which implies that close to 0.6 trillion euros need to be financed in wholesale markets. Investors correctly assumed that if this debt was not refinanced, many Spanish banks could fail because of this liquidity issue. Furthermore, Spanish banks did not fully recognize the extent of their losses incurred through foolish lending policies in real estate related sectors between 2001-2007. Out of the total expected banking losses of close to 20% of GDP, only 10% had been recognized by January 2011. During 2012, the introduction of two royal decrees increased this figure to 16%. Finally, a few banks were intervened and recapitalized at the end of 2012 through an EU loan, totaling 4% of GDP. Much of the Spanish banking system, therefore, has been restored to solvency.

Investors also correctly assumed that if full losses were recognized, then a relevant portion of the Spanish banking system would be insolvent. The consequence of this is that the wholesale debt would fall into the hands of the Sovereign, increasing the value of its debt from 80% to 140% of GDP, close to insolvency levels. Thanks to ECB action, though, 0.4 trillion euros out of the 0.6 trillion have been refinanced by the ECB at very favorable conditions, so liquidity risk has been addressed. From a solvency point of view, decisive actions were taken to restore solvency during 2012. The investment implication is that it is incorrect at this stage to add the banking sector wholesale debt to that of the Sovereign, which should lead to a reassessment of the Sovereign's risk level. All in all, the contagion effect from the banks to the Sovereign seems to be over (Exhibit 14).

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Spain has a growth engine: Exports of goods and services

By 2012, Spain reached a historic milestone since its entry into the Eurozone: for the first time, exports of goods and services exceeded imports (Exhibit 15). This is a remarkable fact taking into account that the country had been accumulating trade deficits since 1998, and these were the main reason it held current account deficits (which exceeded 10% of GDP in 2006) and a net international debtor position (around 90% of GDP). As Spain enters into current account surplus (expected by 2013), a key weakness of the country will have disappeared, and the net international debtor position will begin to decline as Spain becomes a net exporter of capital.

What is the main driver behind this transition? - the deflation of real wages (a consequence of high unemployment) and enhanced productivity, which together have resulted in a reduction in Unit Labor Costs (Exhibit 16).

Spain's competitive rise can be explained by: a) a competitive labor force, with costs at 20 euros/hour and falling, *vs.* 27-33 euros in Italy, Germany, and France, despite differences in productivity per hour worked ranging between only 0-11% (Exhibit 17), b) Spanish work ethic, as Spaniards work 25% more (in terms of hours per year) than employees from these other countries, and c) low elasticity of Spanish exports (Spain kept its world market share of exports in the boom years despite increasing unit labor costs), see (Exhibit 18). With tourism receipts at record highs (Spain is already the second country in the world in tourism revenues, after the US) and subdued imports due to weak consumption, Spain should enter a current account surplus by 2013, for the first time since the euro started.

Furthermore, Spain is reforming. The country has implemented supply side reforms, including much needed labor reforms not undertaken in over 50 years, which could boost future GDP growth. Unit Labor Costs are down 6.4% since 2008 (while those of Germany's are up 2.6%), and labor reform has ended the connection between inflation and salary increases (Exhibit 19). Fiscally, the country is performing adjustments totaling 11% of GDP between 2012-2014, making the effort one of the broadest in its history. Local administrations are complying with unpopular cost-cutting efforts such as medicine co-payment, as the refinancing of their maturing debt by the central government is contingent on fiscal responsibility; therefore, regions are complying and should continue to do so.

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a) entrepreneurship (the number of new companies being created is startingto increase), b) R&D, which has been steadily increasing and resulting in a record number of patents filed, c) re-industrialization which already represents 17% of GDP and climbing, and d) SME financing, which is key to generating jobs, as SMEs represent 65% of GDP and 80% of employment.

Conclusion

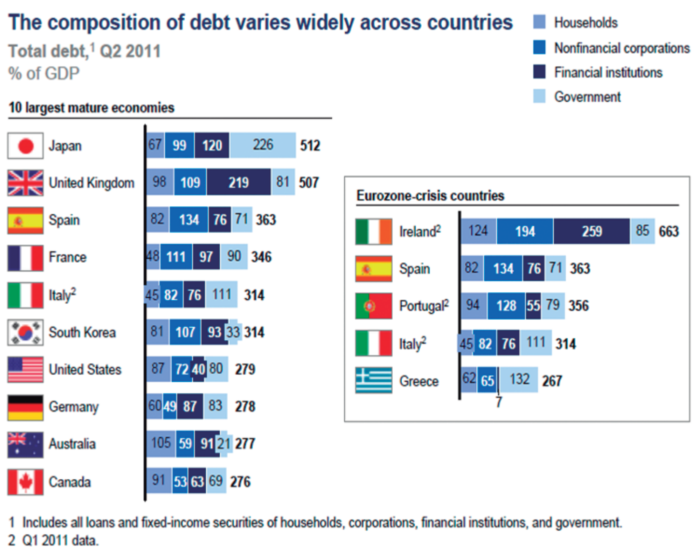
In times of need, a country's best qualities come forth. Spain is currently facing one of its most difficult economic periods since 1959, when an enormous devaluation of the peseta took place. Historically, Spain has adjusted its economy through devaluations, which prompted systemic capital flight. This is the first time in which the country is adjusting its structural problems. Therefore, the euro can be perceived as a weakness, but also as a historic opportunity, as it is imposing discipline in the country. Despite all of the country's fragilities, it is critical to remember Spain's capacity to reinvent itself in the 30 years after the Franco dictatorship, having built a strong corporate sector with companies that are world leaders in their industries, an unthinkable feat only 20 years ago. Indeed, changes in Spanish companies and society in general are already pushing the country towards external demand with initial signs of success. These changes are critical to reinvigorating the country going forward.

As in any economy, the country's evolution from negative growth to positive growth will depend on several key factors: a) a competitive corporate sector; b) a high quality physical infrastructure; c) capacity to finance growth (new capital investments, working capital needs, etc.); d) an efficient public system in terms of providing basic social needs (security, health, education) as well as a legal system that enables companies to flourish; e) growth of SMEs to create employment; and f) the confidence of consumers.

As indicated in this paper, we believe Spain has a truly competitive corporate sector, and there is no question that Spain has one of the best physical infrastructures in the world. However, financing is beyond scarce, and public finances are under strain, calling into question the sustainability of the social benefits enjoyed by Spaniards (including one of the world's best health systems), resulting in an extremely low level of consumer confidence.

Exhibit 1

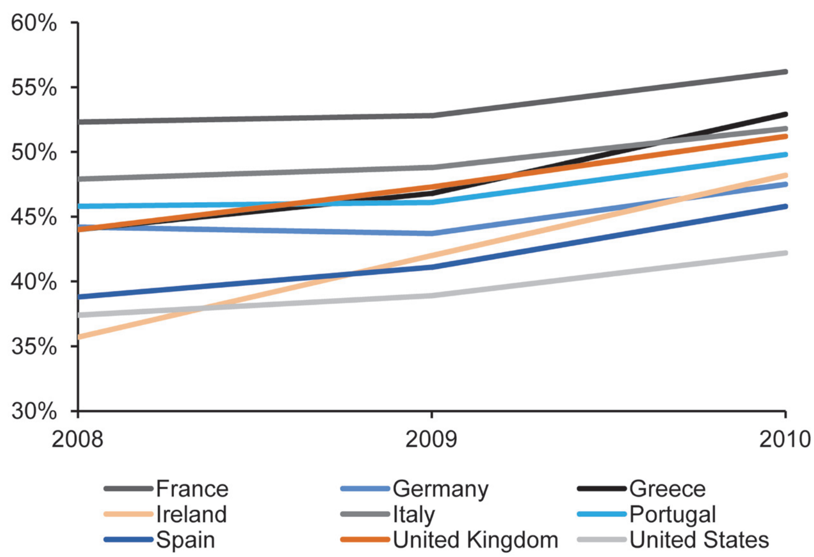
Misrepresentation of Spanish debt



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

Exhibit 2

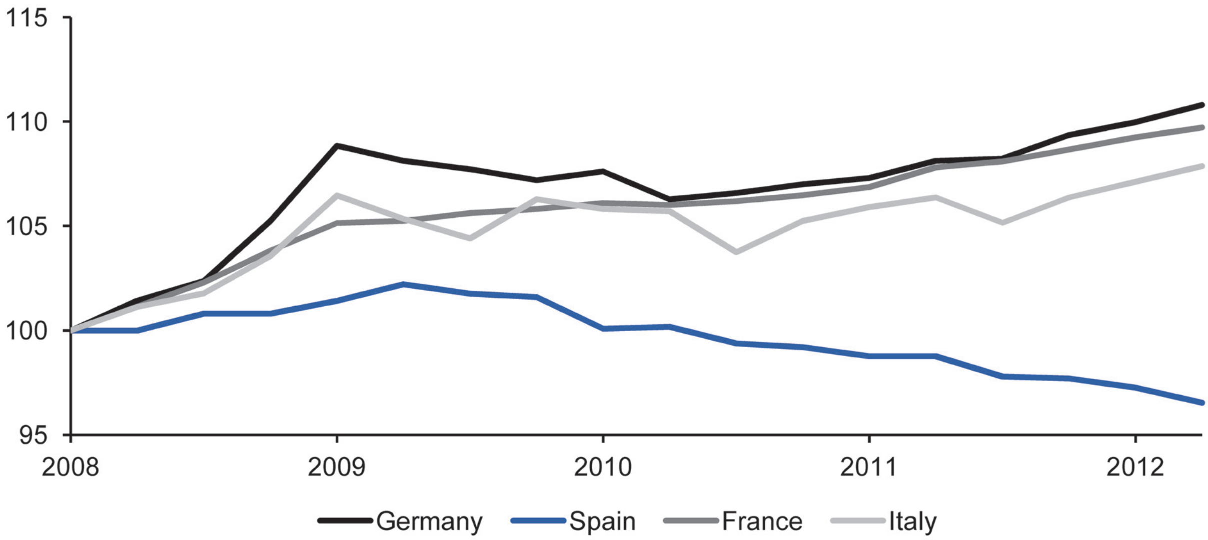
Government spending as a % of GDP



Source: The Heritage Foundation.

Exhibit 3

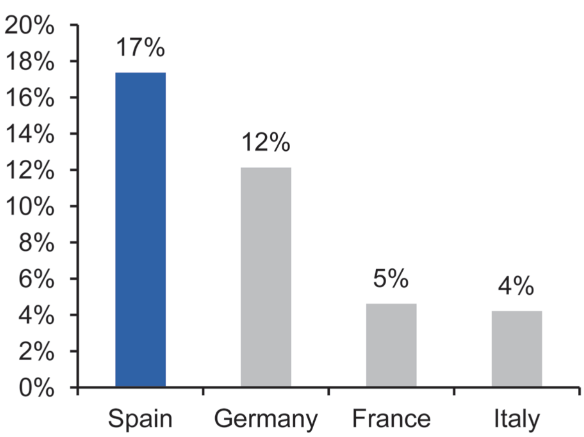
Evolution of Spanish competitiveness (ULC) *vs.* main trading partners



Source: Eurostat.

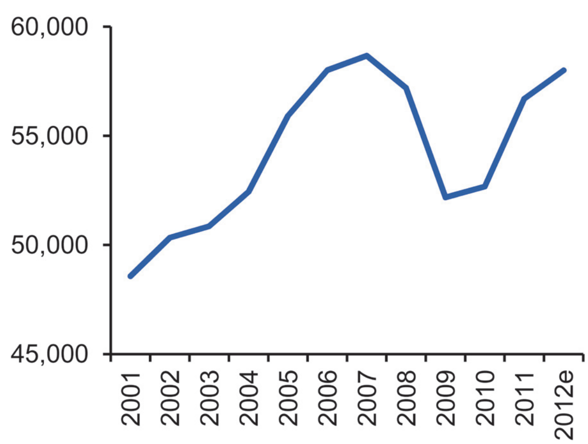
Exhibit 4

Export growth evolution since 2008-2012



Source: Eurostat.

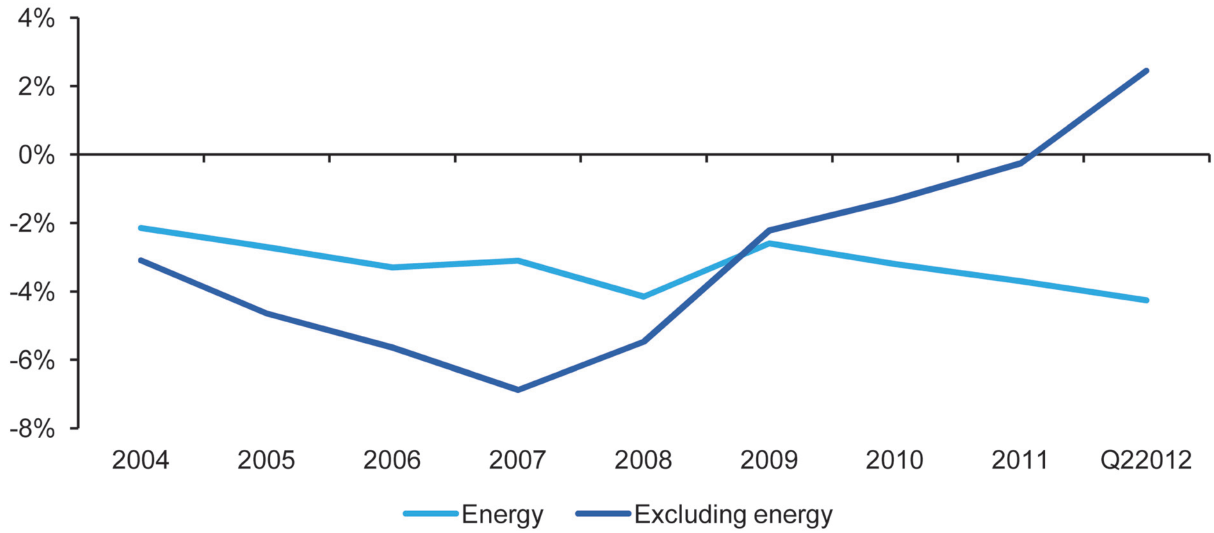
Total number of tourists per year (thousands)



Source: INE.

Exhibit 5

Trade deficit evolution



Source: INE.

Exhibit 6

Target 2 balances

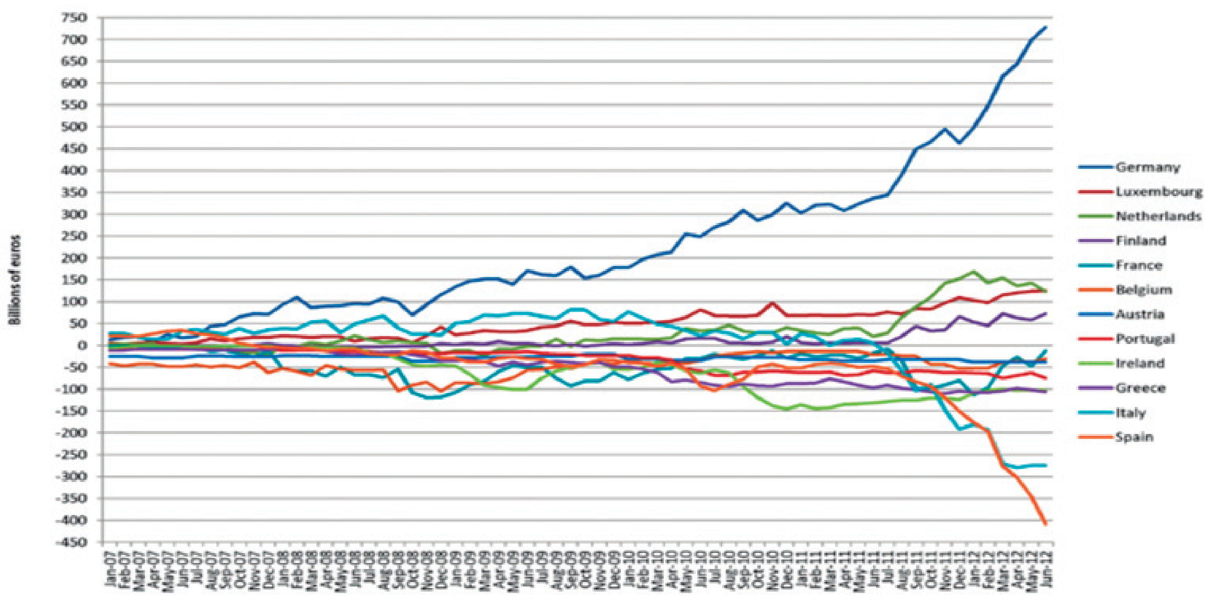


Exhibit 7

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%

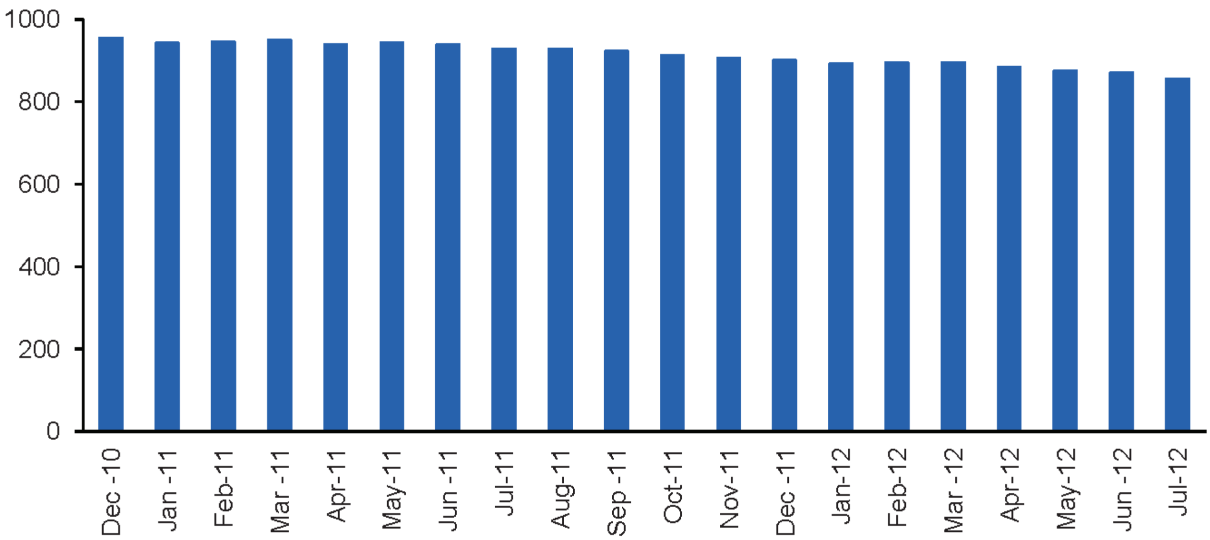
Supply side reforms *already being implemented*:

	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.

Exhibit 8

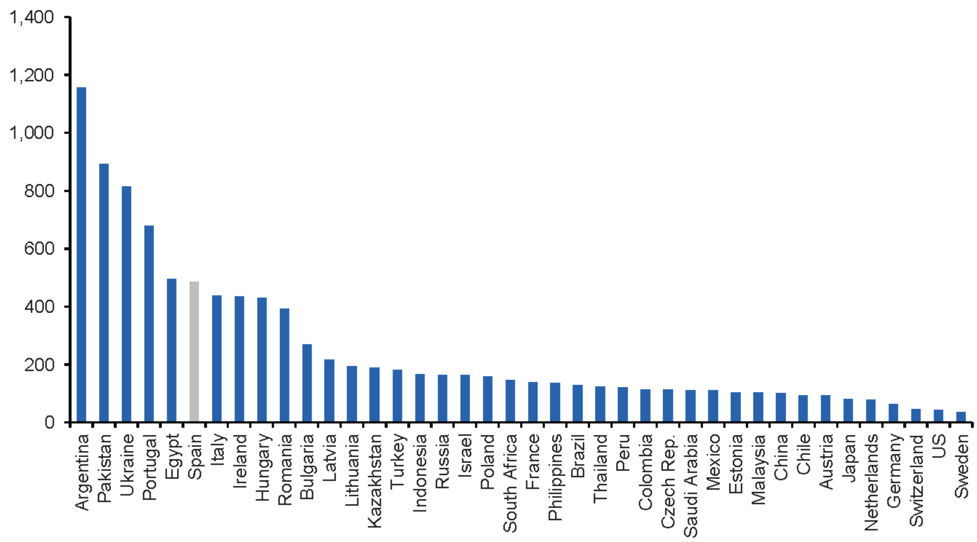
Retail and corporate deposits in Spain (€ bn.)



Source: Bank of Spain.

Exhibit 9

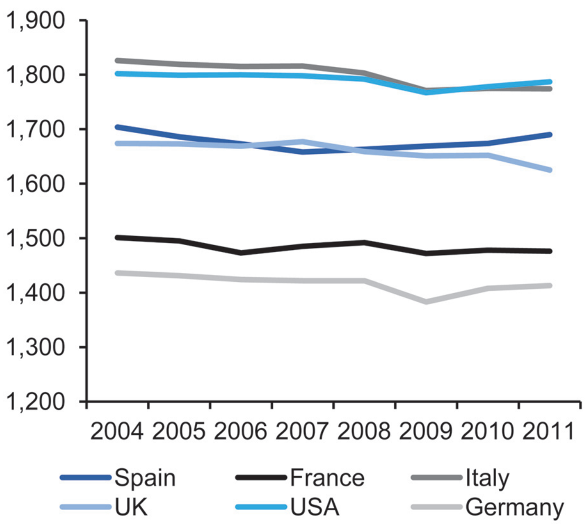
Sovereign CDS spread



Source: Factset.

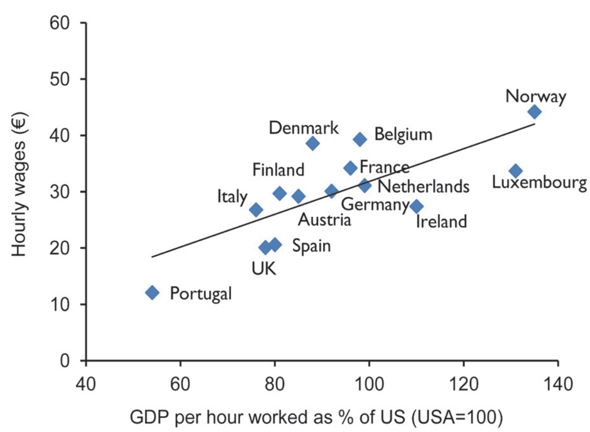
Exhibit 10

Average hours worked per year



Source: OECD.

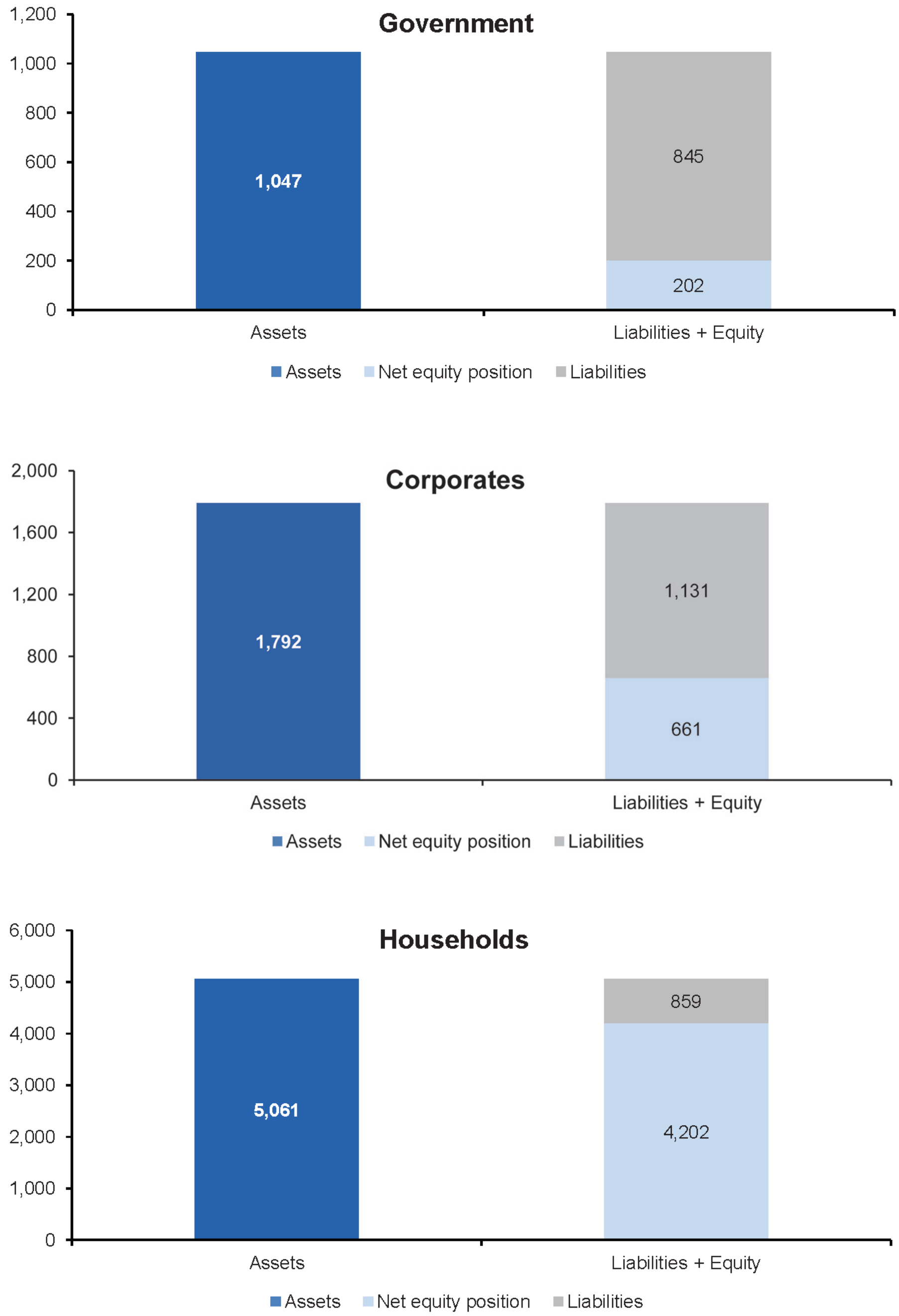
Unit labor costs and GDP per hour worked (2011)



Sources: Eurostat, OECD.

Exhibit 11

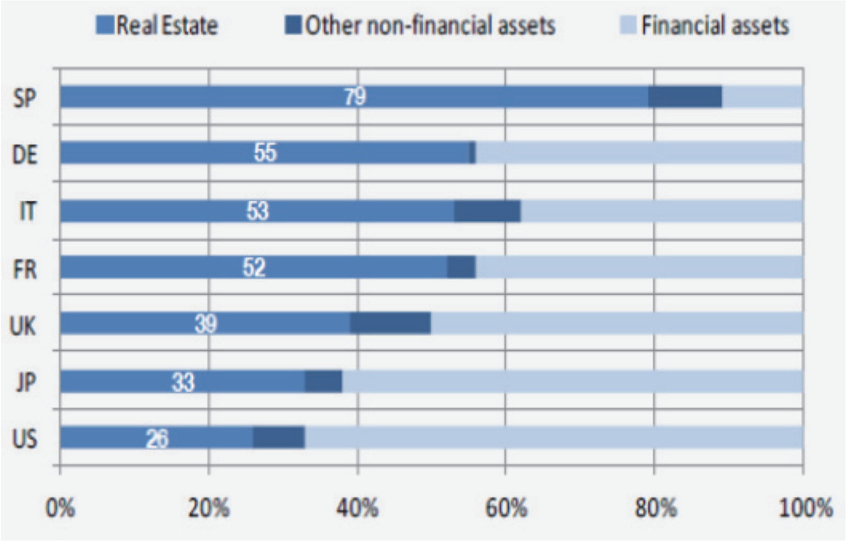
Balance sheets of Spanish government, corporates, and households



Sources: Bank of Spain, Funcas, Arcano.

Exhibit 12

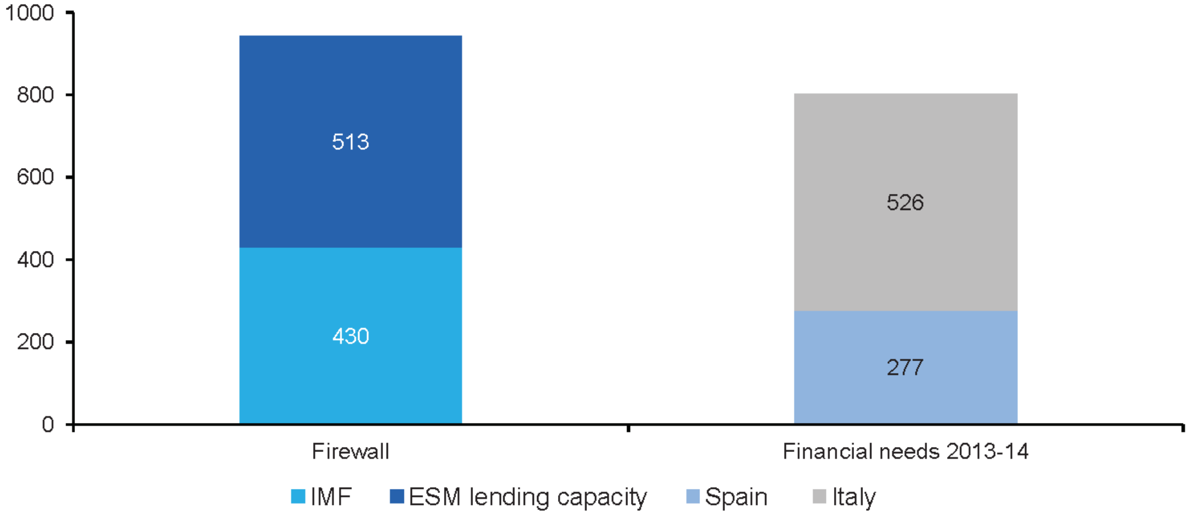
Asset split of households (% of total assets)



Source: Oliver Wyman.

Exhibit 13

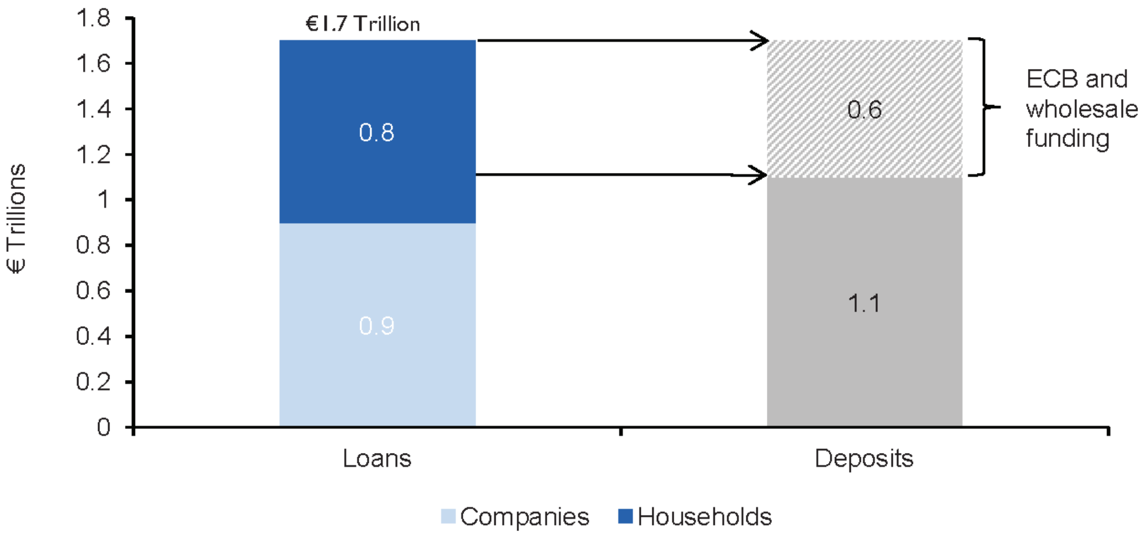
ESM/EFSF resources and gross financial public needs in Spain and Italy (€ bn.)



Source: Bloomberg.

Exhibit 14

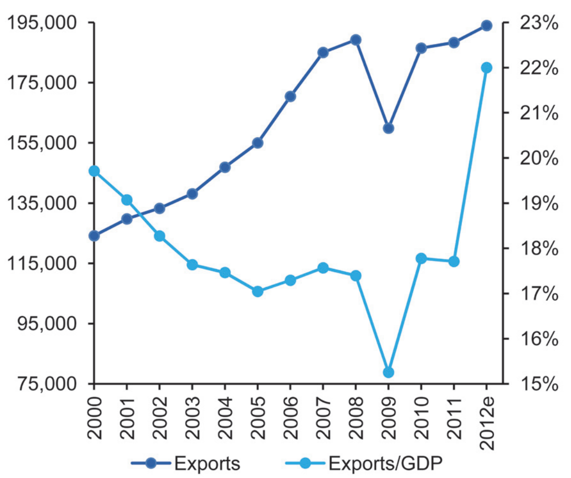
Financial system loan book funding structure



Sources: Arcano, Bank of Spain.

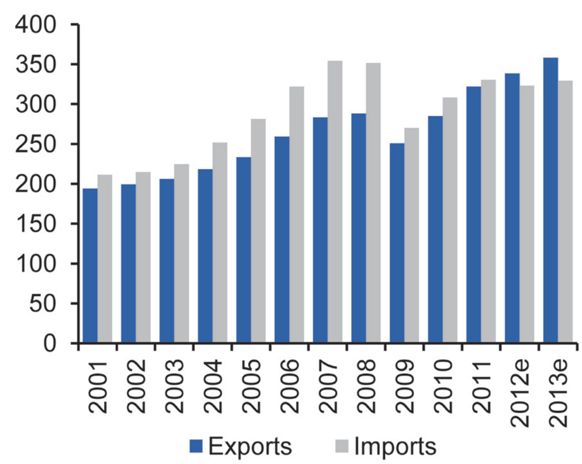
Exhibit 15

Evolution of Spanish exports (€ mm.)



Source: INE.

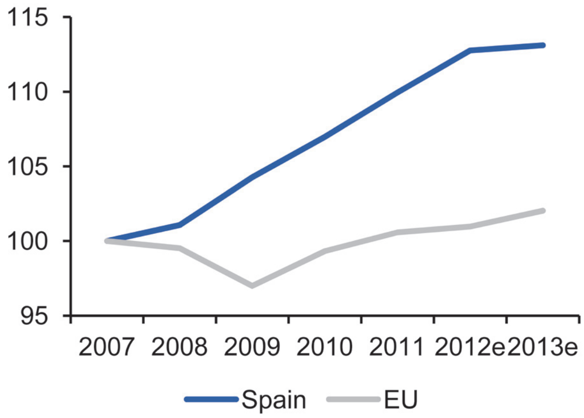
Spanish exports and imports of goods and services (€ bn.)



Sources: Historical figures and projections provided by Eurostat.

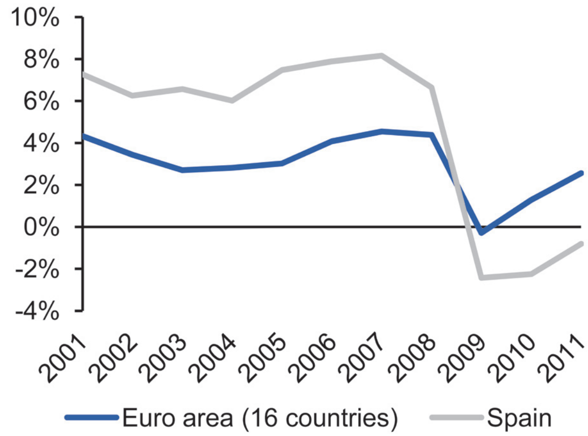
Exhibit 16

Labor productivity change (2007=100)



Source: INE.

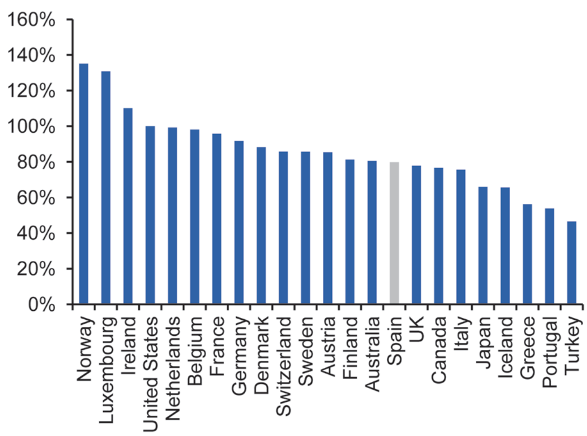
Real wages evolution (YOY%)



Source: Eurostat.

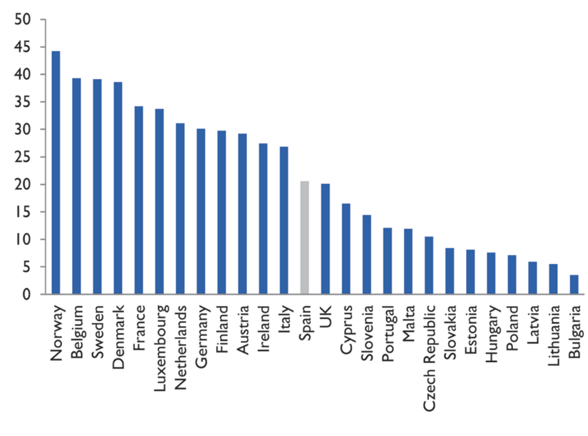
Exhibit 17

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



Source: The Conference Board.

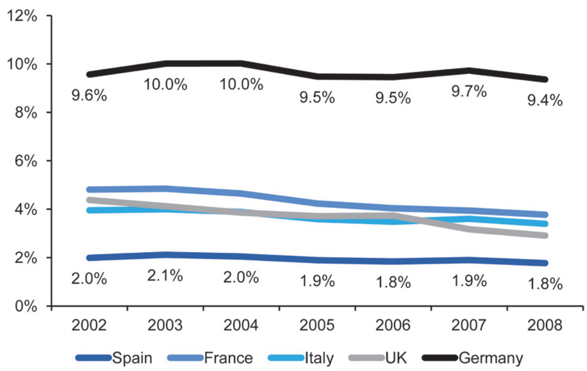
Labor costs (€/hour)



Source: Eurostat.

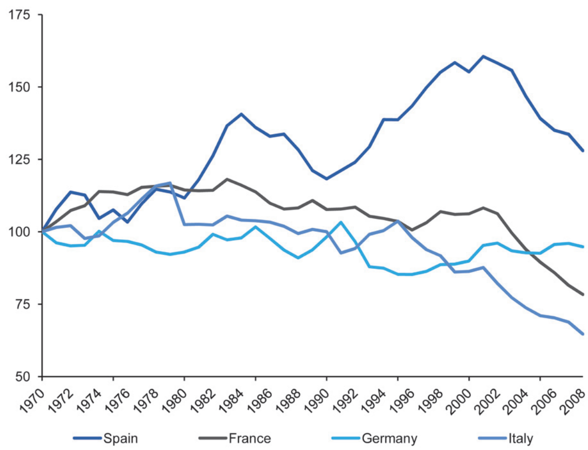
Exhibit 18

Spain´s market share in exports



Source: Eurostat.

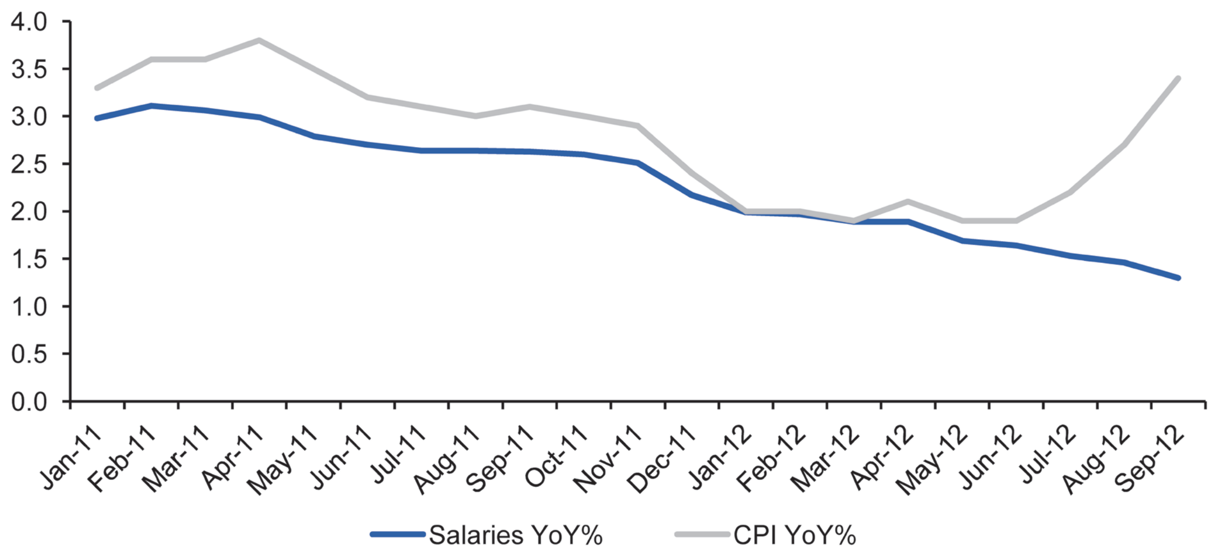
Share in world exports of selected European countries



Source: OECD.

Exhibit 19

Difference between prices and salaries (YOY%)



Sources: Ministry of Labor and Social Security, INE.