RESCUE REMEDY

Will Spain's newly created 'bad bank' put the country back on the road to good health? Caroline Hill reports

As Spain's economic woes roll on and Spain Inc continues to draw negative publicity worldwide, the impact of the country's banking crisis is inevitably having a severe knock-on effect on law firms. Deal activity is down, particularly in the corporate sector, and Garrigues managing partner Fernando Vives says: "The reduction in credit has impacted directly on M&A and all the fields that are concerned with M&A, ie public law and environmental law. Law firms will suffer from a reduced number of M&A deals."

In December, Garrigues announced a 5% dip in revenues for 2011-12 which, in light of the market conditions, it decreed to be "a highly satisfactory year" – not just in terms of economics, but the way the firm had met the crisis head-on. Cuatrecasas Goncalves Pereira meanwhile saw a marginal rise of 1.2% to €245.6m (£211.5m).

Gomez-Acebo & Pombo ended the year 1.4% down on 2011, with a turnover of €61.9m (£52.6m). Managing partner Manuel Martin comments: "The reason is simple. We have less M&A and finance and transactional work."

The reason firms have less transactional work can be viewed in equally as simple terms, given that Spain's banking sector is now a shadow of its former self in terms of size, standing at around 30% of pre-crisis levels after a wave of consolidations and bailouts last year.

"If you look at the financial sector, there used to be around 50 to 60 banks and savings banks, but we will end this year with around 20," adds Martin.

Last year, two days after nationalising Bankia – the consolidated bank formed from several of the country's savings banks – Prime Minister Mariano Rajoy's government launched drastic banking reforms, forcing banks to set aside a €30bn (£26bn) financial cushion and merge to form viable entities where they were struggling to achieve that alone.

This consolidation, together with further pressure from Europe as a condition of receiving an EU bailout last year, has created a number of highly lucrative, albeit in some cases end-of-the-road, M&A mandates. Last year, for one, Perez-Llorca advised Banco Pastor on its integration with Banco Popular by an exchange of shares, in a transaction valued at around €1.5bn (£1.3bn).

Silver linings

In January it was announced that Spain's economy had contracted by 0.7% in the last three months of 2012, plunging the country deeper into recession.

Perhaps in contrast to these underlying numbers, Spain's leading law firms saw an increase in activity in the second half of the year and a note of optimism is creeping in when it comes to their forecasts for the first half of 2013. Some of this activity is a knock-on effect from the reforms and restructuring, which are forcing banks to cut staff numbers and salaries, leading to a wave of employment issues.

Vives says: "The situation in the country has increased the volume

Spain's prime minister Mariano Rajoy launched major banking reforms following Bankia's nationalisation last year

of work in some areas, especially labour law, which is booming at the moment because there is a lot of restructuring of the labour market and discussions about the new direction of labour law."

However, partners point to systemic reforms including the creation of Spain's bad bank, known by its Spanish acronym Sareb, as the root cause of this activity. Sareb, which opened at the end of last year, will house up to €60bn (£51bn) of various types of troubled property assets owned mostly by the country's four nationalised lenders: Bankia, Novacaixagalicia, CatalunyaCaixa and Banco de Valencia.

Sareb was a condition of the Memorandum of Understanding (MoU) agreed between the Spanish and European authorities to clear the way for the first, €37bn (£32bn) instalment of a €100bn (£86bn) EU rescue package.

The MoU also required stress testing of banks to determine their capital needs and recapitalisation or restructuring of the most vulnerable banks. While Spain did not formally request bailout money until December, there was a flurry of activity behind the scenes to put in place these requirements, including the creation of the Fund for Orderly Bank Restructuring (FROB), the public entity responsible for the transfer of assets to Sareb.

Law firm Cuatrecasas Goncalves Pereira was appointed to represent FROB. M&A partner Fernando Vivar recalls: "From the beginning, we were directed to assist the Spanish Government to help on a blueprint. The company had to be established to acquire assets by the end of November and beginning of December.

"We managed to do something very complicated in one month. We performed €77bn (£66bn) of transactions in one month. The time constraint reflected the Spanish Government's need to comply with the MoU." Working around the clock, the firm imposed a restriction on holidays until Christmas.

The deal volume is reflected in Thomson Reuters M&A tables for Spain in 2012 published last month, where Cuatrecasas came out in first place with €52bn (£45bn) of transactions, ahead of Garrigues in second place on €30bn (£26bn) and Uria Menendez on €9bn (£8bn) of deals in the year.

According to the table, the largest deal of the year was the transfer of €30bn (£26bn) of toxic assets from Bankia to Sareb on 31 December.

Investors

The establishment of Sareb – which is to be owned by a majority of private investors – has also opened up roles for other law firms. Vivar says: "It's a huge opportunity for all the players. There is a huge amount of assets."

Sareb's investors include Banco Santander, CaixaBank, Banco Sabadell, Kutxabank and Banco Popular Espanol, with newer investors reported to be Deutsche Bank, Barclays, Bankinter, Ibercaja and Mapfre.

Garrigues and Gomez-Acebo & Pombo are known to be advising investors. Elsewhere, law firm Perez-Llorca has advised a regulatory body in connection with Sareb. The capital requirements under global regulatory standard Basel III and the MoU have also created a new tier of investors as financial institutions dispose of capital-consuming assets into the open market, both real estate and non-performing loan portfolios.

Last year, Perez-Llorca advised a tier-one US investment fund in the acquisition of a €250m (£215m) non-performing loan portfolio, including mortgage-backed credits, from a leading Spanish bank.

The firm also advised a US investment fund on the acquisition through a joint venture with a group of local investors of a €100m (£86m) non-performing loan portfolio from a leading Spanish financial institution, and on the acquisition of a €1bn (£859m) non-performing loan portfolio from a leading Spanish bank.

The portfolios are typically consumer loans such as credit

Continued on page 20

Continued from page 19

cards, and Perez-Llorca corporate and finance partner Fernando Quicios says: "We are advising on disposals to international banks and hedge funds. There is an appetite in the market; the discounts at which those assets are offered is significant."

The depressed property prices mean Spanish law firms are also witnessing an increase in foreign investment in real estate.

Vives says: "The decrease in real estate is obvious but in the last few months we have seen an increase in interest from foreign investors in Spanish real estate.

"The prices have reduced by 30-40% and this is producing a situation where foreign investors are looking at investment."

The end of December saw Cuatrecasas close a significant property deal in Madrid for clients Anchorage Capital Partners and private alternative investment manager Varde Partners. The deal is regarded by the firm as a sign that investors are now looking at the Spanish market with a new, longer-term eye.

Market perception

In one further sign that the domestic market is easing, Spanish companies have been able to issue debt in the past few weeks.

January saw Red Electrica Financiaciones issue €400m (£340m) of senior notes listed on the Luxembourg Stock Exchange and BBVA Senior Finance issue €1.5bn (£1.3bn) of fixed-rate notes. Both were represented by Cuatrecasas.

One partner comments: "In August, the situation was very bad and the Spanish business community was very sceptical. But now it feels like we're moving towards a recovery."

It is this feeling of progress that is winning Rajoy's government a return in confidence from the business community. Although there are still questions from outside Spain, Sareb, in particular, is viewed within the country as the right solution, albeit that the Spainish Government's hands were tied and it had little choice but to set the bank up.

"Sareb is going to accelerate the solution of the financial sector," says Martin. "It will mean financial institutions are again in a position to lend money to the domestic market, bringing activity back."

Vivar adds: "It's going to be considered the most important thing to create the idea that everything is changing and getting into a good shape."

It does beg the question, why did the Spanish Government wait four years after the crisis first hit to set up a bad bank? By comparison, Ireland's bad bank the National Asset Management Agency was created in 2009.

'The situation in the country has increased the volume of work in some areas, especially labour law, which is booming at the moment' Fernando Vives, Garrigues

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Early indications are that the problems of Bankia have been far more effectively addressed by Sareb than any interim measures. Bankia was created in 2010 from the merger of seven savings banks, which then hived off their toxic real estate assets to holding company Banco Financiero y de Ahorros.

But, rather than solving the banks' problems, the merger magnified them and, after an initial public offering in 2011, in May 2012 Bankia requested a €19bn (£16bn) bailout, causing shareholders to lose an estimated $2bn (£1.2bn).

However, while partners may quietly voice the view that the Government would have been better to have taken the plunge earlier, the move would have been extremely unpopular and more expensive before market prices dropped to their current levels.

But it is easier to make a call with the benefit of hindsight, says Vives: "It is very easy to say two years later that things could have been done in a different way. Today, we know the US authority would decide to help Lehman to avoid its bankruptcy."

There is also a feeling that Spain's financial sector has benefited from the pain of being cut and bolstered where necessary.

Vives continues: "In any case, the position of Spain's financial sector has improved in a way that would have been impossible without a crisis like this. My feeling is that the Spanish Government is trying to do all that it can do.

"Obviously, in the short term, its policies will not be able increase the growth of the Spanish economy. But we need to go this way and in the medium to long term, it is the only way to reduce the debt and grow in the future."

Portugal

While the debt markets have eased, it is likely to be a while before foreign interest in Iberian M&A returns.

Spain's debt crisis, together with Portugal's own economic woes, have seen a significant decrease in both foreign investors looking for Iberian opportunity and Spanish companies buying a stake in Portuguese companies. Quicios says: "The flow of work between Portugal and Spain has been reduced. We are quite active in work with Portugal, but the global appetite in Spain and Portugal has shrunk."

According to Hugo Rosa Ferreira, a banking and finance partner at PLMJ's Lisbon office, the volume of work at the law firm has remained stable and largely unaffected by Spain's debt crisis. But this is largely due to the fact that the firm's clients have taken up business in new markets.

"There has been a shift from the focus on imports and exports from the Spanish market to other markets such as Africa and Brazil," he says.

"Our clients have looked elsewhere for work and the volume of legal services has remained relatively stable."

New horizons

While the legal community accepts that changes had to happen and that the banking sector is now in better shape – that it has reached a 'new normal' – it does mean some firms are being forced to cut staff.

"We are all trying to increase our level of profitability," says Gomez-Acebo's Martin, whose firm reduced its headcount by 8% over the past year, also using the process to ensure it has the best people on board.

Pre-crisis double-digit growth appears to be consigned to the past and the challenges currently befalling banks to curtail salaries and ensure capital requirements means cautious risk management will be more of a focus than profit margins. But set in this context, there is also much to be cheerful about, not least Morgan Stanley's recent prediction that Spain is in the top two countries for investment in 2013, second only to Switzerland.

One partner comments: "The fact is that Spain is the 12th largest economy in the world. This is not Greece with 50 million people. We have sophisticated consumer banks such as Banco Santander. Foreign investors were just waiting for the price to be right."

It seems confidence in Spain Inc is returning.

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THE BEGINNING OF A BEAUTIFUL FRIENDSHIP

Freshfields' Miriam Perez-Schafer and Alfonso de Marcos explain why China's growing interest in Spain's companies could see the two countries form a successful trade partnership in 2013

As one of the eurozone's main economies, Spain's severe economic downturn has been particularly trying for the EU and the countries forming part of the single currency. In the second half of 2011 – and particularly during 2012 – the ghost of a complete bailout of the Spanish economy and the break-up of the eurozone loomed as certain indicators, such as the yields of Spanish bonds, soared to critical levels.

During this time Spain's corporates, including blue chips, have suffered, with local demand for their products and services contracting and access to capital/debt markets and credit proving near to impossible.

However, they coped by reducing their exposure to the Spanish economy. In 2010, for the first time, foreign revenues of the companies listed in the IBEX 35 market exceeded 53% of the total. They also sold non-core assets to reduce debt (several corporates have announced and have been carrying out plans in this regard).

In addition, they sought to reinforce their capital structure by incorporating foreign investors. At the end of 2009, foreign investors held more than 40% of the capital of Spanish listed companies. The Spanish bank rescue, together with the reforms implemented by the Spanish Government, are restoring confidence.

While Spain will still suffer the effects of its recession in 2013, the worst of the sovereign debt crisis may be over and the bailout of the Spanish economy – which seemed all too probable last year – has been discarded, at least for the moment. Things are starting to look up and Spain is, once again, an attractive destination for foreign investment.

Opening new doors

Spanish companies have traditionally knocked on the door of Middle Eastern state-owned enterprises (SOEs). For decades, their presence was more symbolic than real. But in the past few years, Middle Eastern SOEs and sovereign wealth funds (SWFs) have made substantial investments in Spanish blue chips.

In a context characterised by a lack of credit, SOEs offer a significant advantage over other investors: they have sufficient funds and liquidity to undertake investments on their own, without the need for external financing. Examples include the investments in Spanish utility company Iberdrola (2011), oil company Cepsa (2011) and utility firm Gas Natural Fenosa (2011).

However, the Middle East is no longer the only door to knock on. Chinese outbound investment is rising exponentially, fuelled by the financial strength of Chinese companies and their desire to compete on a global basis, along with the Chinese Government's aim to balance inbound and outbound investment.

Historically, Chinese investment in Spain has been irregular and, with certain exceptions, low in value. But this is changing. During a visit to Spain in May 2012, Wu Bangguo, chairman of the Standing Committee of China's National People's Congress (NPC), said relations between China and Spain are at the best time in history. The country is now Spain's largest trade party outside the EU.

Given Spanish public companies' current share prices, which have decreased significantly during the downturn, this provides a positive framework for Chinese SWFs and other companies to seek opportunities to invest in Spanish blue chips. So far, there have been several examples of Chinese SWFs and Chinese companies (some of which are also SOEs) attempting to invest in and co-operate with Spanish companies.

Some have been successful, such as the China Unicom investment in Telefonica in 2009-11, and the collaboration established between the Spanish hotel chain Melia, the Chinese hotel group Jin Jiang in 2011 and the Chinese real estate group Greenland in 2012.

However, other ventures have not made it past the finish line, such as the failed investment by the Chinese group HNA for the Spanish hotel group NH Hoteles

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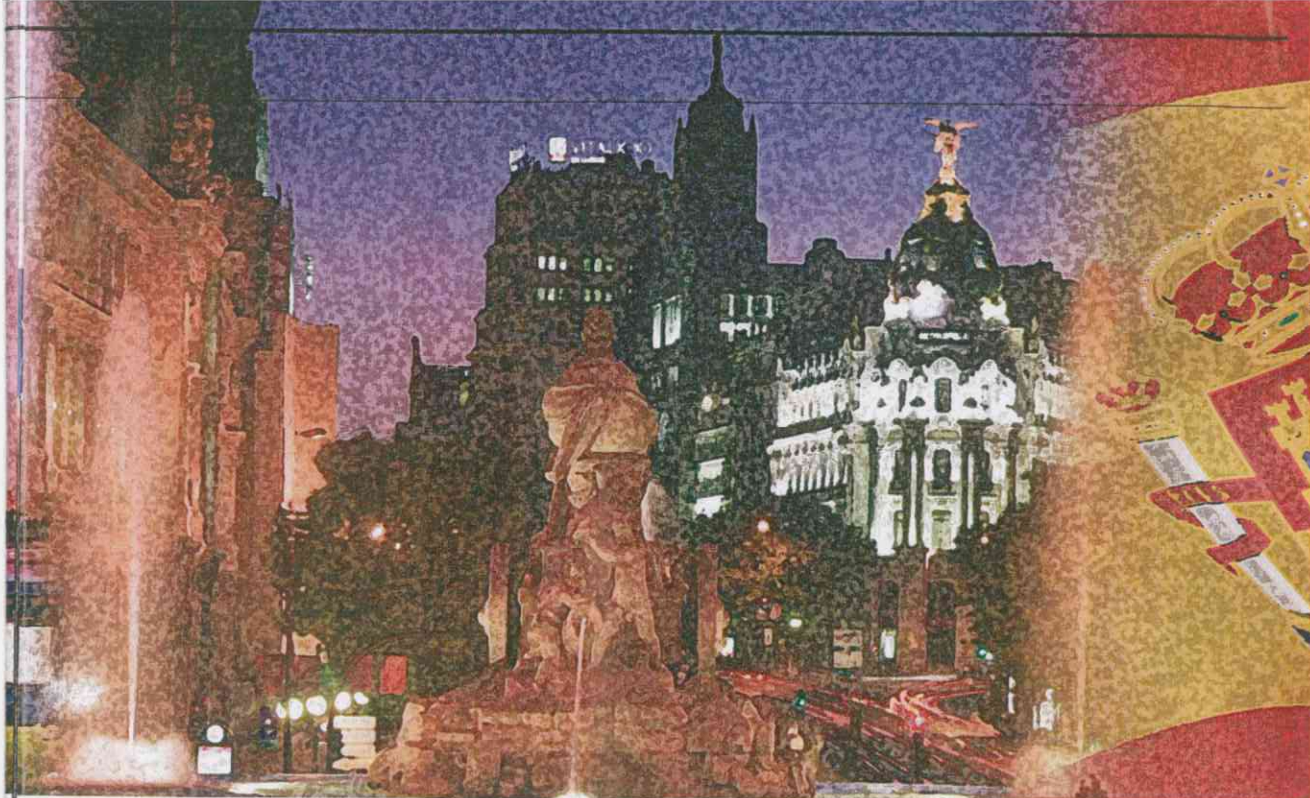

in 2011. But the trend is there. Timidly, more Chinese investors are seeking – and are being sought by – Spanish corporates.

Down to business

Chinese investors fall into two camps: financial and industrial. Financial investors are seeking a steady flow of dividends from companies they invest in.

Industrial investors not only want financial return, but also the collaboration and the exchange of technology and know-how. No matter the nature, Chinese investments normally range between 5% and 15% of the target company's share capital, with the 30% Spanish mandatory bid threshold acting as a glass ceiling.

In addition to purely economic and financial considerations, such as price or projected revenues, Chinese investors may target specific stakes to benefit from additional rights under Spanish corporate law (eg shareholders holding at least 5% of the company's capital can call for extraordinary shareholders' meetings or contest board resolutions).

Chinese investors tend to approach and negotiate their investments with the target company rather than with significant shareholders. This means investments usually take the form of treasury stock transactions, equity issues or both.

Generally, treasury stock transactions, such as the one between China Unicom and Telefonica, are the fastest and easiest way to implement the investment (with a legal limit of 10%). In fact, treasury shares might be transferred through a plain stock market trade without entering into heavy documentation. These transactions also benefit from some pricing flexibility. But they require that the shareholders' meeting has previously authorised the company's board to deal in treasury shares.

As for equity issuances, the decision to increase the company's share capital is generally reserved in Spain to the shareholders' meeting. However, there are instances where the board may have been delegated the authority to increase the company's share capital by up to 50% and against cash contributions.

Interestingly, this delegation may also invest the board with the faculty to derogate, on the grounds of the company's corporate interest, preferential subscription rights that would otherwise correspond to the company's existing shareholders. This was the case in the failed HNA/NH Hoteles

Continued on page 25

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Continued from page 23
deal. Whenever this derogation is agreed, specific limits apply to share discounts (shares must be issued at a fair value; ie market value) and additional corporate documentation is required (including an independent auditor's report addressing the proposed issue price).

Chinese investors may also consider a combination of treasury stock and equity issues as a way to achieve a shareholding in excess of the 10% treasury stock threshold and make the deal more palatable by limiting the dilution of existing shareholders.

Other investment structures, such as equity-linked instruments (eg warrants or convertible/exchangeable bonds), are also available, but Chinese investors tend to prefer simple structures that can be quickly and easily implemented.

As a distinctive feature, Chinese industrial investors are usually eager to access the target company's board and, in most cases, enter into alliance and/or knowledge-sharing agreements. This was the case in the China Unicom-Telefonica deal, the aborted HNA-NH Hoteles deal and in the strategic alliance between Greenland and Melia.

Normally, these agreements provide for the promotion of joint investment opportunities, notably in China, where applicable regulations often require foreign investors to team up with local entities and sometimes also for the Chinese investor's right to access certain know-how of the Spanish corporation.

Pitfalls

Although Spain has become a more investor-friendly environment than it was traditionally, Chinese investors are nevertheless wary of certain difficulties that may arise; for example, foreign investment restrictions in strategic sectors such as defence or energy. And investors may be faced not only with Spanish regulatory hurdles but also – particularly when the investment is in companies operating at a multinational level – with regulatory restrictions in other jurisdictions.

In addition to these technical complexities, cultural differences can arise. A more complex decision-making process and the need for the Chinese government to authorise outbound investments must be appreciated and factored into any timetable.

Similarly, outbound deals are almost always negotiated and executed in English, but sometimes key decision makers will only read the Chinese versions of internal memos and papers, so it is important to make sure high-quality translations are available. These factors should not dissuade either party, but should be factored into the overall timetable of the transaction.

It may seem challenging today but, as Chinese investment in Spanish listed companies becomes more common, we are confident that the barriers will soften – even disappear in some cases – and what now seems unusual, exotic and overly complicated will prove to be, as Rick says to Louie at the end of Casablanca: "The beginning of a beautiful friendship."

Miriam Perez-Schafer and Alfonso de Marcos are senior associates at Freshfields Bruckhaus Deringer in Madrid.

'Chinese investors tend to approach their investments with the target company rather than with significant shareholders'
Miriam Perez-Schafer, Freshfields Bruckhaus Deringer

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