



Private Debt in Spain

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GEOGRAPHIC SERIES
ON SPAIN

Introduction

Spain is an increasingly attractive market for private debt investors. As the country's banking sector faces another wave of mergers, direct lenders will have the opportunity to expand on the back of the banks' reduced capacity to cover the mid-market space.

As the economy recovers from Covid, we expect the number of Spanish direct lending deals in 2021 to bounce back to 2019 levels. Pemberton opened its Madrid office in 2020 to support all our local clients, and Spain is an important part of our strategy to build pan-European portfolios for investors.

December 2020

Why invest in Spain?

Spain is the fifth-largest economy in Europe and the fourth-largest in the Eurozone. Like most of Western Europe, it has been badly affected by the Covid pandemic, and the growth of direct lending stalled in 1H 2020 - though only temporarily in our view.

The economic cycle in Spain has been very different from that in the rest of Europe. While the Financial Crisis in the UK was effectively over by 2009, in Spain it was only after 2013 that the country emerged from its effects. “However, after that the country enjoyed several years of strong growth and falling unemployment (2013-19) on the back of several structural reform efforts and an improving situation for corporates’ financial and cash positions,” said Leticia Ruenes (Pemberton’s Managing Director and Head of Spain),

Due to the impact of Covid the Spanish economy will contract by about 11% in 2020. The extent of the pandemic’s impact was partly structural. For example, the tourist sector, a prime victim of anti-Covid measures everywhere, represented about 12% of the pre-pandemic economy. However, the Spanish Government is forecasting 9.8% growth for 2021, which would represent a strong rebound.¹

Politically the situation has stabilised. After several years of political stalemate, in January 2020 the Socialist party agreed a coalition government with the far-left party Unidas Podemos. It is the first time a coalition government has taken charge in Spain’s democratic history, and this political outcome is viewed by most analysts as the

least favourable for business growth and investment, particularly due to the planned increases in corporate tax rates generally and a special, higher rate for both the finance and energy sectors.

However, during the pandemic the Government has been able to pass the necessary budgetary measures to support the economy and protect businesses, although a more aggressive fiscal policy has already been announced to come into force from 2021.

Ruenes notes that the political situation over the past few years has not deterred investors from putting their money into investment opportunities in the country, both on the debt and equity side. Part of the reason for this, she says: “is that Spanish businesses post Global Financial Crisis (GFC) have focused on diversifying their footprint, particularly from a geographical standpoint, thus reducing their reliance on the Spanish economy.”

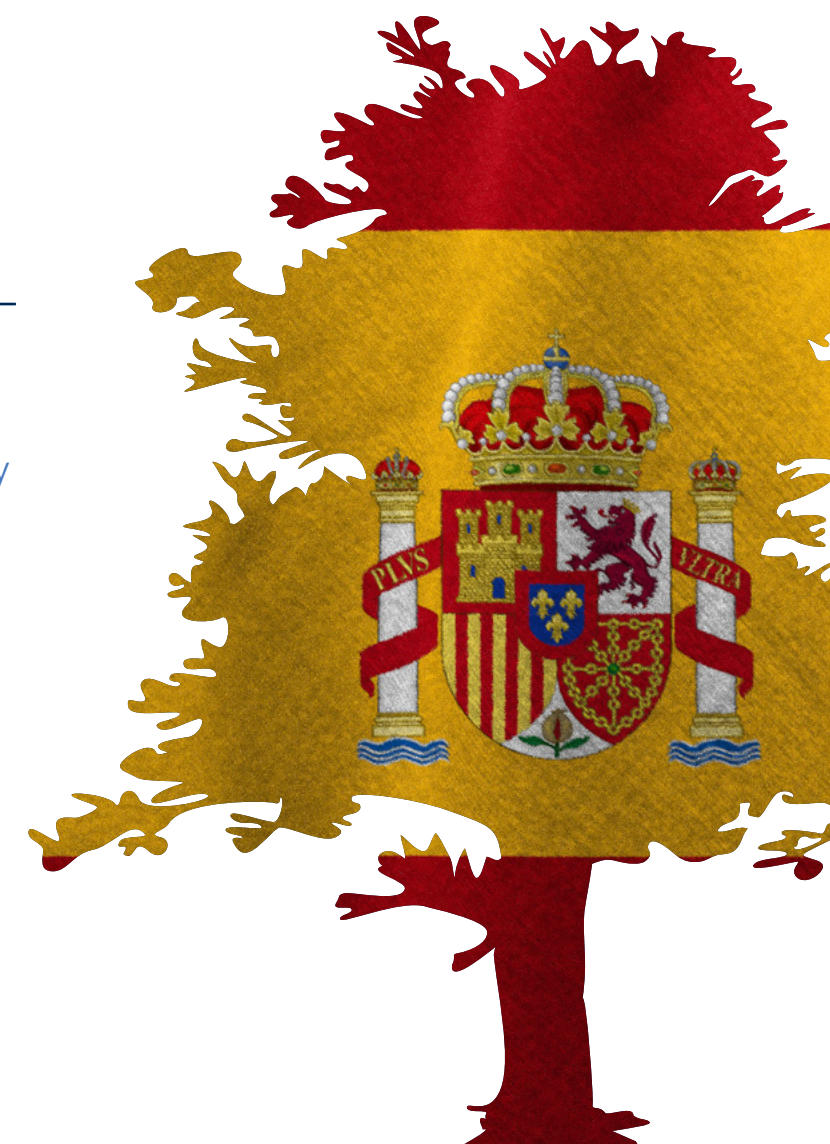
As a result, PE investment in Spain has progressively increased up to its all-time high in 2019 with c. €8.5 billion invested², and international funds representing c. 75-80% of that volume each year. However, from January to September 2020, the investment of PE funds in Spain fell by 37%, to €3.7 billion, in line with the global decline, according to data revealed in the LPs & GPs Spanish Conference held by EY and ASCRI (Spain’s PE and VC trade association). Despite falling investment, these figures also reveal that domestic companies remain in the spotlight of international investors, who have disbursed 80% of the total amount in 116 investments, in line with

the same data from the same period last year. That said, the amount of PE investment remains in line with that of the rest of the EU in terms of the percentage of GDP and accounts for just 0.67%.

According to Deloitte’s Alternative Lender Deal Tracker report, Spain has recorded 118 direct lending transactions in the last 31 quarters - since January 2012. Although that figure seems small when compared to the 880 transactions recorded in the UK (the cradle of direct lending in Europe), it puts Spain in fourth position, only surpassed by two other markets: France and Germany. Direct lending is a trend that in Spain has just begun and which most experts believe will grow exponentially in the future.

Against this mixed backdrop, the level of direct lending activity in Spain during 2020 was - unsurprisingly - lower than in 2019. No more than 15 deals are expected to be closed in 2020 compared with 36 in 2019. This gap is mainly explained by the low activity seen in H1, when just four deals were closed³ as most of the sale or refinancing processes were put on hold given the uncertainty the lockdown brought. However, from June onwards, once lockdown restrictions were lifted, M&A activity resumed, this time very much focused on resilient sectors that coped well through the lockdown or even benefitted from the uncertain environment.

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1. <https://www.elmundo.es/economia/macroeconomia/2020/12/01/5fc6146421efa0d0688b4684.html>

2. Spanish private equity trade body ASCRI www.ascrri.org/en/large-deals-spur-investment-volume-in-spain-up-to-8500me

3. Deloitte Alternative Deal Tracker Autumn 2020

Continuing PE interest in Spanish SMEs

Small and medium-sized companies (SMEs) are an important part of the Spanish economy. There are about 145,000 SMEs and they employ roughly 4 million people⁴.

“The economy has a larger proportion of family or entrepreneur owned businesses than many Northern European countries, and such businesses tend to be run conservatively with lower levels of leverage - an appealing attribute for private equity investors,” said Leticia Ruenes.

When Covid struck Spain, the immediate aim of PE firms was to ensure the survival of their investee companies, especially access to sufficient liquidity. Then, as the pandemic continued, it became clear that there was a growing divide between the worst-affected sectors (where exit plans may be delayed by years), and those sectors that have thrived in the changed circumstances,

such as health, technology and food⁵. These sectors are now attracting all the interest, with valuations expected to increase by competition.

During these first nine months of the year, the main players at the mid-market level (operations between €10 and 100 million in terms of investment) were national funds, which increased their investment to €1,229 million (almost 6% more than a year ago) in 48 transactions. This fact is especially striking because of the size of the national economy and the business breakdown.

Looking ahead, Spain should continue to attract private equity investment, as many of the fundamentals that underpin such interest have not changed. Spain has a great track record of strong returns from PE investments,

a shift to various forms of private capital and many Spanish companies need the access to the capital and experience that private equity provides. PE interest in the country remains strong⁶.

Another piece of data that reflects the health of the sector is that of the huge amount of money available to invest (‘dry powder’). In terms of fundraising, national funds had raised €1,384 million as of September, 34% more than a year ago. To this figure we should also add the capital commitments raised by the great international players of the sector present in Spain such as Cinven, EQT and Advent, among others.

Considering both national and international players, experts put the total dry powder available in Spain at c. €4 billion⁷. This figure is not only a powerful weapon available to the sector to take advantage of the opportunities arising from this new crisis, but also a good shield for its investee companies to get through an unprecedented recession with greater ease as PE funds

will be able to make additional capital injections to the more troubled companies in their portfolio.

PE investors can also analyse new investment opportunities with the knowledge that they have that dry powder to use. Opportunities that, in many cases, are not linked to new investments, but rather to purchases related to sectors or companies in which they are already present, in a so-called ‘buy & build’ strategy.

There could also be a rebound in mid-market M&A activity in 2021 as those companies that have survived look to position themselves for the post-pandemic world. This would further boost demand for direct lending.

“We have also seen an increased demand for acquisition lines, where borrowers that have so far fared well throughout lockdown are looking to reinforce their leading position,” said Ruenes.

4. EU's SBA Fact Sheet 2019

5. <https://revistas.eleconomista.es/capital-privado/2020/octubre/los-fondos-alargan-sus-inversiones-por-la-pandemia-KM5068387>

6. <https://revistas.eleconomista.es/capital-privado/2020/noviembre/la-inversion-del-capital-riesgo-en-espana-cae-el-37-por-el-coronavirus-EK5387723>

7. https://cincodias.elpais.com/cincodias/2020/09/24/mercados/1600974237_390534.html



A positive outlook for direct lending

Despite the short-term Covid-driven problems, we take a positive view of the prospects for direct lending in Spain in 2021 and beyond. There will be fewer bank players in the market, creating opportunities for direct lenders to expand their market share from the current 20%.

Spain has traditionally had a strong dependence on bank financing. The consolidation of the Spanish banking system that followed the GFC of 2007-2010 reduced the number of banks and savings banks from 55 in 2009 to just 13 by H1 2020. After the wave of mergers between 2009 and 2014, in the last six years there were only two deals of note. However, the Spanish banking sector is clearly entering another period of consolidation that is forecast to reduce the number of banks to around five large institutions, plus a few smaller/regional entities. CaixaBank and Bankia are expected to merge in Q1 2021, Unicaja and Liberbank have agreed to join forces, and analysts expect Sabadell to find a partner, although the initial discussions with BBVA seemed to have ended as of early December⁸.

In stark contrast to the situation during the GFC, Spain's banks now have good levels of liquidity and solvency, but a sustained period of low interest margins has reduced their profitability. The upcoming consolidation should help the sector to make the necessary operational savings, but those mergers are likely to bring concentration issues, allowing direct lenders to seize the initiative. Bank mergers typically result in lower credit limits for the merged entity, so a reduction in the number of institutions will – on past experience – also mean a reduced size for individual tickets. Banks are also reported to be more cautious about club deals, concerned about their ability to get out of a deal if something goes wrong⁹.

“Banks are more focused on existing clients - ICO lines,

refinancings, waivers and restructurings when needed - than expanding their client base,” said Pemberton's Ruenes.

“After a rather hectic March-June period when the banks' focus was on delivering government scheme loans, our perception is that risk departments are following a more conservative approach. This was initially translated into less aggressive terms being offered, which in turn reduced leverage by c. 1x EBITDA on average. There is more focus on internal matters such as waiver requests and covenant breaches by portfolio companies, and a reduced appetite for risk that has increased the number of institutions required to complete a financing, delaying processes and increasing execution risk,” she adds.

All this will help those direct lenders who can step in and take up the slack. Given that they already have the advantages of flexibility, bigger single tickets and speed of decision-making, continued medium-term growth for the sector looks quite secure.

“As the Covid pandemic continues to impact economies across Europe, we may see the private debt market in Spain become more consolidated, similarly to what we experienced following the Global Financial Crisis of 2008 when banks retrenched from the loan market and regulators encouraged more sources of non-bank lending,” said Ruenes.

The experience of Covid has told lenders a lot about the true credit quality of companies. Those that have performed well in 2020 – and some have performed very strongly – are naturally receiving a lot of attention from lenders, and therefore, their valuations have held up or even increased.



We also expect a big change in many corporates' approach to financing over the next two years. In 2020 the focus was naturally on securing liquidity, often by means of loans guaranteed by state agency ICO, which approved €140bn of lines. ICO guaranteed 60-80% of bank loans, with an initial one-year repayment holiday (now extended by another year) and amortisation only from 2022¹⁰. In the short term this provided thankful companies with a liquidity safety net, but this was done at the expense of increasing leverage which might bring solvency issues.

From 2021, corporates will need to begin to rebalance their capital structures and look for more long-term solutions beyond securing liquidity. As a result, we expect the number of re-financings to grow in 2021 and through 2022.

Spain's legal framework remains more lender-friendly than, say, Italy or Portugal but less so than in the UK. During the pandemic a relaxation in the insolvency laws has provided more time for Spanish borrowers and lenders to reach agreement.

When Covid hit there was some flexing in the terms of insolvency, with the two-month period for companies to file for insolvency being waived so long as the State of Emergency continued (this now extended to March 2021). At one level this was purely practical – the courts were closed and likely to stay that way for some time – but it also gave borrowers and lenders more ability to negotiate the terms of any restructuring¹¹. Meanwhile only voluntary insolvency procedures are being accepted and creditors cannot file for insolvency.

There are still issues around the delays suffered by most proceedings and the need to adapt Spanish legislation to changed economic conditions. According to Baker & McKenzie: “the trend of the Spanish legislation is to invigorate the out-of-court refinancing solutions and, most significantly, the purchase of distressed assets and operating productive units within insolvency proceedings¹².”

So in terms of overall activity - and given that many of the sale or refinancing processes expected to take place in 2020 have been delayed to 2021 - we expect Spanish direct lending deals in 2021 to return to 2019 levels, with c. 30 deals in total. Looking further ahead, Pemberton's Ruenes thinks that the 20% of the lending market currently taken by direct lenders could grow to 30-40% by 2025.

8. https://cincodias.elpais.com/cincodias/2020/09/11/companias/1599849568_554343.html

9. Debtwire Midmarket Chatter 1/12/20

10. <https://www.ico.es/web/ico/linea-avales-covid-19>

11. Note from Ashurst Spain 23/3/20

12. Baker & McKenzie, Global Insolvency and Restructuring Guide

Pemberton’s growing commitment to Spain

In September 2020 we officially opened our Madrid office, which is Pemberton’s eighth in Europe. This move reinforces our commitment to Spain and recognises the opportunities that we continue to see as the country recovers from the effects of the pandemic.

“In every country where we operate we focus on being local and developing long-term relationships,” said Ruenes. As of December 2020, Pemberton’s total portfolio in Spain was €740 million¹³.

“The speed and lower execution risk - combined with our capacity to provide tailor-made financings - have been highly valued by our clients. As we continue to reinforce

our presence in Spain, we look forward to playing a part in growing the region’s private debt market, allowing it to become a real financing alternative for expanding local mid-market companies.”

One interesting development, and a good example of the intention to create and strengthen long-term relationships with main local players, is the recent agreement Pemberton has signed with one of the main Spanish banks to become its fund of reference. This agreement shows the potential for a symbiotic relationship between traditional banks and direct lenders, where Pemberton wants to play a key role.

Figure 1: Pemberton’s Spanish private debt deals (to December 2020)

Project	Sector	Sponsor	Notes
Lion	Building materials	Carlyle	LBO
Casa	Advisory	n/a	Growth financing
Calcium	Healthcare	Advent	LBO
Alaska	Food and beverage	InvestIndustrial	LBO
Natasha	Industrials	InvestIndustrial	LBO
Mirage	Healthcare	n/a	Refinancing/Growth financing
Alaska II	Food and beverage	InvestIndustrial	Add-on facility

13. Committed, including Acquisition Facilities

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