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SPANISH FINANCIAL MARKETS IN 2021: PERSPECTIVES AFTER COVID-19

The world grounded to a halt in 2020, hitting Spain's economy particularly hard. But after a tumultuous year that saw financial markets dip in the Spring and then grow to record heights in the Fall, the financial outlook for Spain in 2021 is bright. The debt rally of 2020 is poised to continue through the first half of the year, helping companies bridge gaps in revenue caused by an endless string of lockdowns and travel restrictions, refinance existing debt at record-low interest rates and support businesses particularly hard-hit by the pandemic. As the hunt for yield among investors grows more intense, a larger number of opportunistic sub-investment grade companies are likely to access the Spanish high yield bond market. But this year is also likely to see a burst M&A activity boosted by high levels of corporate liquidity and private equity dry powder as well as a revival of Spain's IPO market, which has been dormant for the last couple of years.

Key issues:

- Spain's financial markets are expected to rebound in 2021.
- Spurred by low interest rates, Spanish corporates and sovereigns are likely to enter the debt markets in large volumes with a growing focus on ESG.
- Analysts expect a revival of Spain's IPO market and an active M&A scene propped up by an improving macroeconomic backdrop, high valuations, increasing appetite for risk and large volumes of private equity dry powder.
- Consolidation is likely in recently booming industries that were badly hit by the pandemic, such as travel, hospitality and real estate.
- High demand for renewables and TMT assets will likely continue in 2021.
- Opportunities in the tech and healthcare industries are likely during the year.

A STORMY YEAR: 2020 REVISITED

After years of strong and balanced growth, Spain's economy was upended in 2020 as successive governments started imposing sweeping lockdown and travel restrictions to curb the spread of the COVID-19 virus. The early stages of the pandemic were particularly severe in Spain.

The IMF and OECD estimate that Spain's GDP contracted by approximately 11.6% in 2020, the highest among developed economies. The impact was particularly acute in the tourism and hospitality sectors, which are central to the Spanish economy. Unemployment grew sharply in 2020 and is expected to hover around 21.9% in 2021, higher even than in Greece.

Following the unexpected and precipitous collapse of financial markets in the spring, American and European companies rushed to secure liquidity by drawing down almost $124 billion from their credit lines in just three weeks, thereby raising concerns of a global liquidity crunch. Governments and central banks around the world reacted swiftly and aggressively to avert what looked like an inevitable economic catastrophe.

On the fiscal front, governments set out rescue packages on a scale that exceeded even the financial crisis of 2008. European governments extended loan guarantees, tax cuts, payment holidays, bailouts and generous furlough packages to protect workers. Spain's public debt increased to 114% during the year to fund these emergency measures. In America, Congress approved a $2 trillion stimulus package earlier in spring, followed by an additional $900 billion stimulus bill in late December, which is expected to double in 2021 with Joe Biden's proposed $1.9 trillion stimulus package.

On the monetary front, the response was similarly aggressive. To alleviate the strain on the plumbing of the global financial system caused by a desperate rush for cash on both sides of the Atlantic, America's Federal Reserve (the Fed) unleashed a huge amount of liquidity into the market. Other foreign central banks, including the European Central Bank, the Bank of England and the Bank of Japan quickly followed. They cut interest rates and rolled out a sweeping bond-buying program of approximately $5 trillion (two-and-half times as much as during the peak of the 2008 financial crisis). Investor confidence returned in strides and the floodgates opened to fresh corporate debt raising.

The flood of liquidity and cheap debt made possible by the Fed's and ECB's emergency aid measures gave investors the confidence to go back into the market. What followed is the largest corporate borrowing spree on record, which companies used to plug the hole in their revenue resulting from the shutdown of the global economy and avoid bankruptcy. This burst of activity in the global financial markets was further electrified by the announcement of a vaccine at the end of the year. At the close of 2020, the world's non-financial companies had raised a striking $3.6 trillion from the public markets.

Capital Markets

Low interest rates and backstopping by the European Central Bank led to a boom in the European capital markets, to which an increasing number of companies turned in order to raise capital during the second half of 2020. European debt issuances surpassed a total of €2.16 trillion for the first time on record, up 17% compared to 2019. This included €122.8 billion raised by Spanish companies, primarily in the banking, energy and retail sectors; the highest full year total since 2010.

Activity in the equity capital markets was also spurred to record highs, with deal activity in the Americas and Asia jumping more than 70% from the previous year. Companies raised more money through stock market listings in 2020 than in any year besides 2007, as a rebound in equities valuations attracted businesses and special purpose acquisition vehicles (SPACs) to list in the United States. Businesses worldwide raised almost $300 billion through flotations globally in 2020, including a record $159 billion in America, which included the successful public debuts of tech businesses such as DoorDash and Airbnb.

Listings in Europe, by contrast were lethargic. At $20.3 billion, they were down by a tenth from 2019 and stood at almost half of 2018 levels. Spanish equity offerings in 2020 surpassed those of 2019 in terms of size (€7.2 billion compared €6.6 billion), but with only 11 deals completed in 2020, the Spanish equity market registered its lowest level of activity since 2008. Volumes were driven by follow-ons and significantly boosted by Cellnex Telecom's €4.0 billion rights offer, the largest Spanish follow-on since Santander's €7.0 billion right issue in 2017. Only two Spanish IPOs priced in 2020: Soltec (€150

million) and Aspy Prevencion (€35 million). Idealista, which was expected to come to market in 2020, cancelled its IPO due to its acquisition by EQT.

M&A and Private Markets

Despite the energic return of global financial markets in the second half of 2020, M&A activity in Europe was muted, floundering to its lowest level since 2013. Spain, in particular, registered only 429 deals, the lowest volume in seven years. There were fewer buyouts and exits in 2020 than in recent years, with just 96 buyouts with a total value of €12.9 billion (the lowest level since 2016) and 46 exits with a total value of €16.1 billion (ahead of 2019 but behind 2018 levels).

However, the total value of €45.3 billion exceeded the €41.5 billion registered in 2019, largely driven by the take-private jumbo deal of Spanish telecoms operator MasMovil, the ongoing merger of two of the country's banks, Caixabank and Bankia, the sale of a controlling stake in Portuguese motorways operator, Brisa, and the €2.0 billion acquisition by EDP - Energias de Portugal of a 75.1% stake in Viesgo Infrastructures Energetics.

THE YEAR AHEAD: 2021 OUTLOOK

Despite a historic rally in the global financial markets, Spain started 2021 amid a deep recession, a fresh breakout of COVID infections and a deeply divided government. However, the technical fundamentals suggest that there is reason for optimism this year.

With the ongoing roll out of the vaccine and the continued fiscal support from the Spanish government and the European Union (from which Spain expects to receive €140 billion in loans, of which €72.7 billion will be non-refundable), the Spanish macroeconomic environment will likely improve as businesses fully reopen and international travel resumes, breathing life back to the hospitality, entertainment and travel industries. As external demand recovers gradually, exports of manufactured and agricultural goods will act as an important contributor to growth.

Low interest rates and continued support from the European Central Bank will also provide an environment that is highly favorable to financial and corporate transactions. The change in market sentiment was tangible at the end of 2020 when, in November, the Ibex climbed 25% in response of news of a vaccine rollout.

Debt Markets

The world is not yet quite back to normal and further lockdowns and restrained economic activity is expected to continue during the first half of the year. This means that companies will still be in need of liquidity to make up the loss in revenue during this period and avoid bankruptcy. But unlike the trend seen in 2020, where European companies relied heavily on bank lending and government grants, they are increasingly likely to raise these funds in the public markets in 2021, which, thanks to the unprecedented level of central bank stimulus, have become less costly.

There will continue to be a lot of demand for issuers that have a compelling credit story, more than sufficient liquidity, and where investors feel like they are being well compensated for the risk. 2021 will probably see a number of

refinancings of cross-over credits as well, pushing the hunt for yield down the rating spectrum.

Indeed, lower credits are also likely to access the high-yield bond markets in larger numbers than in 2020. Central bank support provides liquidity to the market, but it also depresses yields, setting out a hunt for yield. Money is likely to flow into high-yield funds and drag yields on the lower rungs of the rating ladder lower. In America, for example, issuers sold high yield bonds worth more than $400 billion in 2020. El Corte Inglés, Masmóvil and Empark are the Spanish companies that accessed the high yield bond market in 2020 and more companies are likely to do so in 2021, especially COVID-19 impacted names in the hospitality, travel and retail industries in order to refinance more cheaply or push out maturities.

But it is no secret that the recovery from COVID-19 will be far from painless and that many companies will either not survive or be forced into bankruptcy. Within the region, Spain, Italy and Greece are the countries expected to see the most distressed deal volume.

Equity Markets

Share prices were on a rollercoaster in 2020. In March, asset managers were terrified by a sharp drop in stock prices as countries locked down, only to see them rise swiftly in the second half of the year, led by technology stocks in America. Even banks and energy firms usually shunned by investors rebounded in the last stretch of the year thanks to positive news about the impending rollout of COVID-19 vaccines.

There are signs of euphoria in the market. Even as profits slumped and the world was placed under lockdown, the S&P 500 benchmark index climbed by 14.3% in 2020, nearly double the typical return over the past 20 years. Further evidence of froth was the frenzy around initial public offerings in America. With more than 447 new share offerings and more than $165 billion raised, 2020 is the best year for the IPO market in 21 years. Companies raised more money through stock market listings in 2020 than in any year besides 2007. Businesses raised almost $300 billion through flotations globally in 2020.

A notable feature of the American IPO boom last year was the proliferation of SPAC listings. Close to the end of the year, these blank-cheque companies, which raise funds to acquire private targets and list them in the stock exchange by way of a reverse merger to avoid the cost, time and paperwork associated with a traditional IPO, had accounted for almost $76 billion of the cash raised in America. The trend is expected to continue in 2021.

Bankers and investors are wondering whether the SPAC phenomenon will migrate beyond the borders of the United States, but it seems unlikely at this point, at least in Europe, because the European market affords less flexibility to this sort of vehicles in the context of a reverse-listing (i.e., shareholder approval is still needed and prospectus of the acquired company needs to be prepared). But the acquisition and subsequent listing of European companies in America could take off in 2021. The UK electric vehicle maker Arrival, for example, is expected to merge with Nasdaq-listed CIIG in 2021.

Extreme levels of investor optimism, rising valuations and the indefatigable growth of the S&P 500 are raising questions of whether there is a bubble in the global equity markets that could pop in 2021. Most analysts believe, based on prospects for earnings and interest rates, that there isn't one -at least not

yet. Provided profits are strong following the recovery from the pandemic and interest rates remain low, stock prices look reasonable. It may therefore be premature to worry about a bubble and shares may continue to rally well into 2021.

Moreover, lower yields on government bonds and cash deposits (depressed by central banks' endless bond purchases) mean that there are few places for investors' money besides shares. So the equity markets are likely to remain strong in 2021 and take off particularly in Europe where their performance has lagged compared to the rest of the world.

After three years of frustrating underperformance, in which only three companies went public, the Spanish IPO market in particular is ripe for a revival in 2021. Leading the charge, should be the listings of renewable energy and technology companies. There are a number of potential candidates that have been laying the ground for a public exit over the years, but other names who haven't been particularly impacted by the pandemic may also emerge. Examples include companies like Repsol and Telefonica. The oil company, Repsol, is seeking minority investors or an IPO for its renewable energy division, as well as for its three other business areas: upstream, industrial and customer-centric. Meanwhile, telecoms company Telefonica, is also looking at carveouts. Moreover, renewable energy companies in particular, which tend to be smaller in size, may find IPOs to be the best instrument to raise capital.

The question, however, is whether public markets will be able to compete with private markets that are currently brimming with liquidity ready to be deployed. Intense competition and high valuation is likely to push large issuers to explore dual-track structure in order to maximize valuation.

M&A and Private Markets

Deal activity in the Iberian M&A space has been picking up steam since September 2020 as appetite for risk returned to the market. Auctions in the pipeline going into 2021 include Spanish renewable business, Helia Renovables, and Portuguese packaging company, Logoplaste.

But there are further reasons to believe that M&A will be a big feature of the market in 2021.

First, there is likely to be an attractive menu of assets up for sale. The pandemic has given companies new problems to solve and made some existing ones more pressing. M&A offers a fix. On the corporate side, debt-laden companies need to sell assets. Buyers may look to plug a strategic hole. The rationale for a deal may be to secure supply chains, diversify across geographies, build up digital or logistical capabilities, cut costs or simply bolster revenues.

But M&A activity is also likely to originate in the more traditional private equity space as sponsors look to dispose of assets that they have been forced to hold for longer than they expected while a host of attractive new opportunities arises after the pandemic-induced dust finally settles. In the runup to 2021, private equity firms were exiting several Iberian companies including Logoplaste, Alvinesa, Health Transportation Group and Itasa.

As the post-pandemic economy takes shape, corporate spinoffs and consolidation forces are likely to add to the supply of assets available for sale in the Iberian market. Macro-trends favorable to renewable energy and strong

appetite for these assets will likely create strong push towards consolidation in this sector. The same is true for TMT companies, which are looking to lighten their assets. And for banks. As demonstrated by the recent merger between Caixa Bank and Bankia, the sale of BBVA's assets in America and the aborted merger between BBVA and Sabadell, Spanish banks are looking to cut costs and find new income streams to bridge the revenue gap created by long-term low interest rates. And we are also likely to see consolidation pressures build up in what were booming industries as recently as 2019 that were badly hit by the pandemic such as travel, hospitality and real estate.

But the competition for these asset is likely to be fierce given eye-popping levels of liquidity available in the market.

High quality corporates, who rushed to draw down on their revolving facilities in March and raised cheap financing during 2020 are flush with cash. With shareholder payouts trimmed or suspended until the COVID-19 fog lifts, the cash held by the world's 3,000 most valuable listed non-financial companies has exploded to $7.6 trillion, from $5.7 trillion last year. With full coffers and subdued economic growth expectations, these companies may try to offset lacklustre organic growth prospects with an ambitious M&A program.

But Asset Managers are also brimming with cash. They are sitting on $2.6 trillion of dry powder, money they have raised to invest in leveraged buyouts, private debt, real estate, infrastructure and natural resources. That figure is double the level that had been raised just six years ago.

Moreover, the corporate-bond market, which reopened in the summer with a vengeance, makes cheap debt financing available for acquisitions and public-to-private transactions. The expectation is therefore that buyouts in 2021 will pick up. A number of auctions were pulled earlier in 2020 that may come back as soon as the vaccine rollout is complete and widespread lockdowns are over. That may not be until April or May, but it is likely to be a healthy year in the leveraged acquisition space.

New Trends

There is a strong expectation that investment in Iberian technology companies, startups and ESG credits will increase in the coming years.

TECHNOLOGY

Investment banks' revenue from the Spanish technology sector increased 87.6% in 2020, the highest increase of any sector. Notable transactions last year included the acquisition of Panda Security by WatchGuard Technologies and Amadeus IT Group's tapping of the equity and debt capital markets. Companies such as CornerJob Spain, Glovoapp and 21 Buttons App are all highly likely to IPO in 2021.

Investors will also keep a close eye on Barcelona's nascent tech scene. The Catalan city is now among the most successful start-up centers in Europe with a thriving tech city. In just five years, it has attracted almost $3 billion in private equity investment, more than Madrid, Dublin and Amsterdam, making it the fifth-biggest source of venture capital in Europe in 2019. In July 2020, the Spanish Stock Exchange (BME) and Barcelona Tech City entered into a partnership to create a Fintech Hub at the Barcelona Stock Exchange in order to facilitate startup's access to different sources of financing in the capital markets. Yet, despite Barcelona's pre-eminence, the tech scenes in Madrid

and Lisbon are also on the upswing and generate interest among private equity firms. These trends are likely to continue and accelerate in years to come.

ESG

ESG is gaining momentum in the global financial markets. While green bonds still represent a sliver of the overall debt market, they are an increasingly popular tool for companies to fund operations that are more environmentally friendly. Thirty of the world's biggest asset managers, which collectively oversee $9 trillion, have set a goal of achieving net zero carbon emissions across their investment portfolios by 2050. This will likely fuel a significant number of green issuances in the coming years.

Governments and companies are expected to issue $500 billion in green debt in 2021, nearly half the total that has been raised since the asset class's inception, according to a projection from Swedish bank SEB (compared to $270 billion in 2020 and $180 billion in 2019).

In Spain, sustainable finance (including bonds and syndicated loans) reached €30.1 billion in 2020, an increase of 22.4% compared to 2019. The Community of Madrid's debut €1.3 billion issuance was the largest sustainable bond of 2020 and the second largest on record, and this year the Kingdom of Spain is expected to set up a green sovereign bond program of approximately €50 billion. KKR, Civen and Providence's €3.2 billion leverage buyout of Masmovil Ibercom in July of 2020 was the largest ESG-linked loan on record in Spain. Santander topped the Spanish sustainable loan league table with a 19.8% market share and BBVA the sustainable bond league table with a 12.9% share.

CONCLUSION

After a steep decline in 2020, Spain's GDP is projected to grow by 5% in 2021 and 4% in 2022. According to the IMF, localized restrictions to address COVID-19 outbreaks and continued disruption to travel and tourism will be a drag on the recovery of the Spanish economy until the vaccine is widely deployed. High uncertainty and adverse labor market conditions marked by a high unemployment rate, will weigh on private consumption. But 2021 is likely to see a structural re-adjustment of the Spanish economy. With financial markets running hot, financing costs at record lows and boundless liquidity, Spain is likely to see a revival of its groggy IPO market, a march towards the consolidation of its banking, renewables, TMT, travel and hospitality sectors, large investments in infrastructure, a continued focus on ESG and a concerted push in the technology sector. To quote the American poet, Robert Frost, "the best way out, is always through".

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