S&P Global Ratings

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Amid Political Uncertainties, Spanish Corporates To Enjoy Robust But Slower Economic Growth

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Key Takeaways

- Spanish corporates should continue to benefit from good economic and credit fundamentals. GDP growth in Spain is set to slow to 2.7% in 2018, 2.3% in 2019, and 2.0% in 2020, but will continue to outpace the eurozone's.
- Political uncertainty has yet to meaningfully affect growth prospects or require a substantial risk premium. It remains the main risk factor for Spanish corporates, alongside potential world trade-related disruptions.
- The formation of a new government in Spain has no immediate impact on its credit ratings. In our view, there is currently a lack of visibility about the details of the government's economic policy strategy. However, given Prime Minister Sanchez's commitment to the execution of the existing draft budget for 2018, we do not expect any significant deviation in the budgetary consolidation path.
- Export- and consumer-oriented industries should continue to benefit particularly from this favorable environment, while investment-related industries should recover somewhat.
- Our economic outlook is reflected in Spanish corporate ratings, which display a higher proportion of positive outlooks than in Europe overall (14% versus 8%) and a more favorable net outlook bias (+7.1% versus -5.3%).

Most Spanish corporates nowadays are optimistic about their future, though the path to the current scenario has not been easy. It follows one of the worst economic and financial crises in Spain's recent history. The economic recovery owes much to substantial structural reforms Spanish authorities have implemented, particularly to the labor market and Spanish banking system. The turnaround also found support from the European Central Bank's accommodative stance. As a result, since 2014, Spanish corporates have not only benefited from the robust economic recovery, but also from a marked increase in exports, a substantial reduction in household debt resulting in rising consumption levels, as well as a large drop in the cost of funding—all of which have boosted earnings. In addition, the Spanish banking sector made steady progress toward restoring its creditworthiness, which the bursting of the real estate bubble and subsequent economic recession had severely impaired.

At the same time, the social fracture caused by the deep economic and financial crisis has reshaped the political front. High unemployment, the increase in precarious work, as well as cuts in government spending have splintered the Spanish political spectrum. The previous minority government's capacity to implement policy was constrained by the fragmented parliament, as shown by its delay in passing the 2018 budget. Following the parliamentary vote of no-confidence on June 1, a new government led by the Socialist party and Prime Minister Pedro Sanchez will be formed in the next few days. Given the current political landscape characterized by a weak government, the situation in Catalonia, and the upcoming preparation of the 2019 budget, we believe the possibility of early elections cannot be excluded. (For further information on our views about the change of government see "The Appointment Of The New Government In Spain Has No Immediate Effect On The Sovereign Rating," published on June 3, 2018.)

Meanwhile, the conflict between the Spanish government and the regional government of Catalonia has been consuming policymakers and preventing the authorities from paying more attention to outstanding economic policy challenges. Currently, S&P Global Ratings has no visibility about the timing of a possible resolution to the conflict or the shape it might take. However, the situation in Catalonia has not materially weakened the economy's performance overall. Elsewhere in Europe, recent developments in Italy have added some uncertainty and financial markets have seen a spike in Italian government bonds yields. However, the contagion to other eurozone members such as Spain has remained contained so far, as economic fundamentals in southern Europe have much improved since the 2011-2013 sovereign crisis in the region.

Despite this political uncertainty, we expect the Spanish economy to continue expanding at a solid but slower pace, with GDP growth of 2.7% in 2018, 2.3% in 2019, and 2.0% in 2020. Nevertheless, a further rise in oil prices could hurt economic growth. Plus, Spain's further budgetary consolidation, the gradual normalization of the ECB's monetary policy stance, and still-low wages will likely contain private spending growth, leading to a deceleration of economic growth over 2019-2021. What's more, the fading impact of previous tax cuts and gradually rising inflation are throwing shade on the outlook for consumption. At the same time, we expect that Spain's general government debt will decline only slowly over 2018-2021, alongside gradually narrowing budget deficits, unless a more resolute policy effort is made by the authorities. Despite this, we expect the Spanish economy to grow during 2018-2021 at rates above the eurozone average, a testament to the strength of the underlying economic growth fundamentals.

In the sections that follow, we give our views about the outlook for the Spanish economy and for industrial sectors from autos to utilities. The appendix includes our view about the outlook on our ratings on Spanish corporates.

OUTLOOK FOR THE SPANISH ECONOMY

Spain's Economic Recovery Still Has More Fuel

- Spain's economy is continuing to outperform other eurozone economies on the back of global economic improvements.
- We forecast Spain's real GDP growth will continue this year and next, but at a slower rate of 2.7% in 2018 and 2.3% in 2019, compared with 3.0% in 2017.
- Diminishing pent-up demand and weaker household purchasing power due to rising prices are likely to dampen growth prospects.
- Household indebtedness has fallen considerably since the beginning of the crisis. It stood at 60% of GDP in the third quarter of 2017, down from 84% in 2009. This should limit the vulnerability of consumers to higher interest rates in the longer run.

The global economy is currently growing at its fastest pace in seven years and the momentum is broad-based, with 120 countries showing positive economic growth last year according to the IMF. A recovery in global investment is fueling the momentum and augmenting decent consumer spending growth. What's more, for the first time since the financial crisis, the current expansion in world trade has two legs: developed markets as well as emerging economies are equally contributing to the surge. Overall we expect global GDP to rise about 4% in 2018 from 3.7% last year.

We believe financial conditions, especially in the eurozone, should not meaningfully deteriorate in the next year and a half. The ECB continues to focus on inflation prospects in the context of stronger GDP growth overall. Headline inflation is showing no sustainable signs of a pickup yet and we forecast it will not exceed 1.5% in 2018 (1.7% in 2019). Although labor market conditions are improving across the EU, the jobless rate remains rather elevated (we expect 8.2% this year, compared with 9.1% in 2017) and accordingly wage growth remains subdued. Therefore, we expect the ECB to normalize its monetary policy very slowly, first by ending its asset purchase program by end-2018, and only then starting to contemplate interest rate increases. The latter could in our view imply first a rise in the deposit rate on bank excess reserves, currently at -0.40%. Then, in a second stage in the course of the second half of next year, a first increase in the ECB's main refinancing rate, currently at 0.00%. Recent developments in Italy have created some turmoil on capital markets and caused Italian yields to spike. At this point, we do not expect meaningful contagion to other eurozone members, and indeed Spanish sovereign yields so far have experienced a modest increase. In a worse-case scenario whereby economic growth prospects in Italy--the European Monetary Union's third-largest economy--would be damaged as investors and consumer confidence collapses, the ECB would most likely postpone the end of its quantitative easing program.

That said, the prime risks that could hurt eurozone growth prospects appear to be mainly exogenous. The risk of a trade war has rattled markets in recent months even though little has been implemented as of yet--such as the proposed 25% tariff on roughly 1,300 Chinese products worth $50 billion in U.S. imports and the Chinese retaliatory 25% tariff on 106 U.S. products worth $50 billion of Chinese imports from the U.S. What has been implemented (steel/aluminum tariffs) has been offset to a certain extent by exemptions and exclusions. Meanwhile, hopes for a quick conclusion to NAFTA negotiations between the U.S., Canada, and Mexico still appear rather unrealistic. In short, although trade tensions have yet to move the needle on actual activity, the immediate source of concern is their potential indirect impact on growth through sentiment.

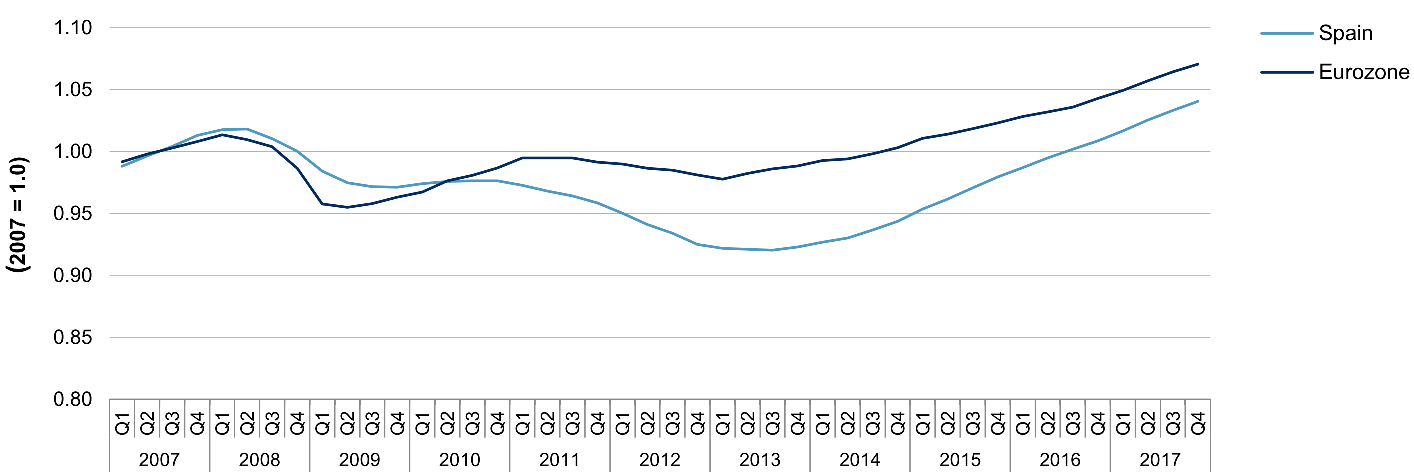
Another area of concern relates to the potential reaction of international bond markets to the looming increase in the U.S. fiscal deficit. The fiscal package recently adopted amounts to about 1.5% of GDP and should support stronger short-term growth but will also likely be associated with higher inflation and a bigger fiscal deficit. The bond markets' reaction so far to the fiscal expansion and tightening by the U.S. Federal Reserve has been rather modest. This is in part due to structural factors on the back of increasing risk aversion, leading investors to search for safe assets--such as U.S. treasuries. In turn, the term premium associated with long-term bond yields has remained negative, keeping bond yields low by historical standards. However, a strong reaction from bond investors could lead to a spike in yields affecting global capital markets. Tighter financing conditions would then weaken growth prospects in developed as well as emerging markets.

Spain's economy shows resilience, but growth is set to slow

According to our latest forecast for Spain published in March, real GDP growth is forecast to slow from 3.0% in 2017 to 2.7% in 2018 and 2.3% in 2019. These estimates reflect robust short-term indicators and a healthy eurozone outlook. Overall, the economy has shown commendable resilience to a wide spectrum of economic and political risks and recently outperformed most other eurozone members after a sharp contraction in activity at the beginning of the Great Recession. The latest GDP figures for Spain still portray an economy that has not lost any steam in the beginning of this year, in contrast to the slowdown seen across most of the eurozone. According to the latest estimate, quarterly GDP growth held up in the first quarter, expanding by 0.7% for a third consecutive quarter.

Chart 1

The Spanish Economy Has Fully Recovered From The Two Post-2008 Recessions



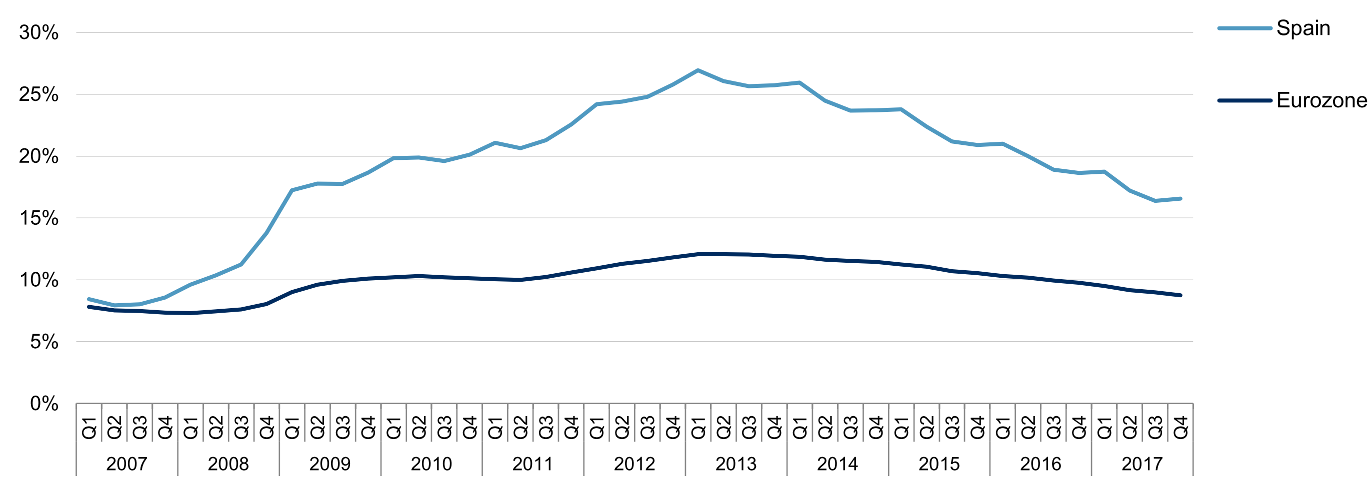
Source: Eurostat.

Yet, we expect the expansion to lose some steam during 2018-2019. Short-term growth prospects are likely to be met with diminishing pent-up demand and the effects of rising prices on household purchasing power. Inflation rose to 1.2% in March and 1.1% in April (due mainly to exceptional factors such as the timing of the Easter holidays that took place in March this year but in April in 2017, causing some volatility in core inflation). We expect a higher read going forward, with an average of 1.4% for the year. Faced with higher inflation, households will have limited room to spend because their savings ratio is close to its lowest in a decade. On the other hand, the personal sector's indebtedness has fallen considerably since the beginning of the crisis: Household debt stood at 60% of GDP in the third quarter of 2017, down from 84% in 2009.

More puzzling is the situation in the labor market, which hasn't bounced back as robustly as the economy. Although unemployment has been falling sharply since 2013, the jobless rate remains elevated by eurozone standards (16.4% in fourth-quarter 2017).

Chart 2

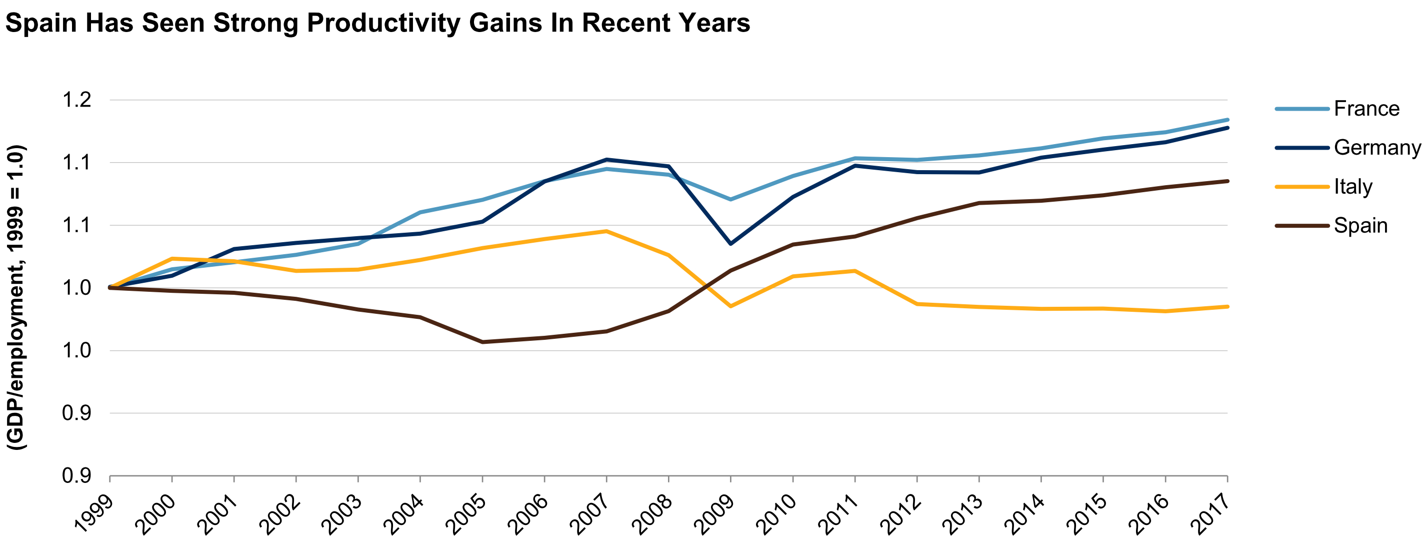
Spain's Unemployment Rate Is Still Well Above The Eurozone Average



Source: Eurostat, Instituto Nacional de Estadística (INE).

Structural rigidities certainly explain part of this gap between employment and overall economic growth. At the same time, the bounce in productive investment since 2013 has generated strong productivity gains (admittedly from low levels compared with the EU average; see chart 3). Capital formation rose by an annual average 5.6% in real terms since 2013, contributing to a meaningful improvement in the economy's overall competitiveness. What has happened, we believe, is that the rise in capital has capped the increase in labor being employed.

Chart 3



Sources: Eurostat, S&P Global Ratings' Calculations.

Meanwhile, exports reached a new record high in 2017 as Spain continued to reap the benefits of improved competitiveness and stronger global trade. In addition, record tourism, which represents 10% of GDP, continues to boost services exports. Yet, we expect export growth to ease slightly this year as world trade growth levels off. Spain's export portfolio covers a wide range of products but still relies heavily on automotive (vehicles and components), with just passenger vehicles accounting for 10.2% of the nominal value of merchandise exports. Semifinished products, equipment goods, and food are the other main export sectors. Spain's exports still consist essentially of goods with low-to-medium amounts of high technology, which means that price competitiveness still plays an important role. The recent decline of the euro exchange rate could be helpful in that respect.

No meaningful economic impact from the Catalonia crisis

Has the Catalan separatism crisis hurt the Spanish economy, or will it? Dire predictions have been made, but hard data to support them are difficult to come by. We think the effect, if any, is likely to be felt only in the long term and mostly through the foreign investment channel. Balance-of-payments data for fourth-quarter 2017 show a €11 billion quarterly drop in foreign direct investment (FDI), with net FDI for the whole of the year as low as €5 billion, which is below the dip seen at the height of the financial crisis in 2009.

On a related note, it's interesting to point out that Airef, Spain's independent agency for fiscal responsibility, has revised upward its 2018 growth projection for the country. However, while last October the agency estimated that Catalonia would outgrow the Spanish average by 0.4%, it estimated in March that the region will grow 0.2% less than the country as a whole. But that still means a growth rate above 2.5% for Catalonia this year, according to Airef.

SECTOR OUTLOOK

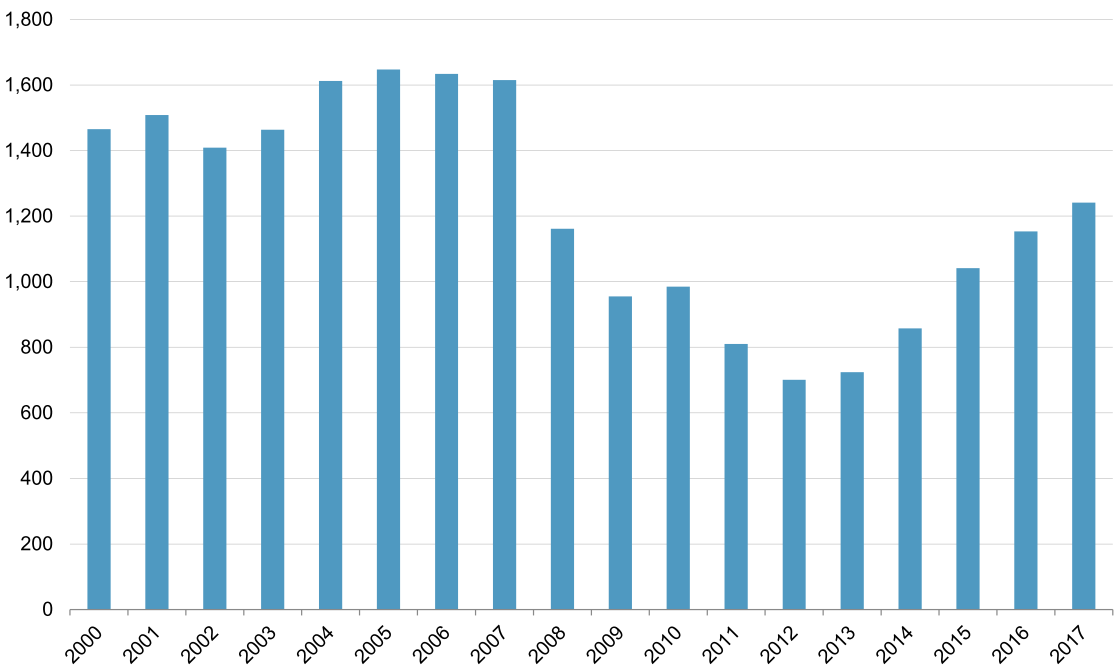
- Broadly speaking, we expect stable credit quality for most Spanish corporate industries during the remainder of 2018 and in 2019, supported by positive macroeconomic trends and continuing access to low-cost funding.
- Export- and consumer-oriented industries should continue to benefit particularly from favorable economic conditions, while investment-related industries should recover somewhat thanks to increased private investment.
- However, political uncertainty in Spain and the slow normalization of the ECB's monetary policy are likely to make the cost of funding somewhat less attractive for the country and corporates for the rest of 2018 and in 2019.
- Also, we expect some industries to face additional hurdles, such as regulatory changes in the transportation and renewables industries and digital disruption in the retail and apparel industries.
- Others will benefit, such as the oil & gas industry, from the rise in oil prices and the telecoms industry from continuing revenue growth in spite of competition.
- We forecast that Spain's real GDP growth will slow in the next 18-24 months due to inflationary pressures, weak productivity growth, and structurally high unemployment.

Autos: Spain Has Become A Magnet For Automotive Investment

With 1.2 million to 1.3 million vehicles sold each year, the Spanish automotive market ranks No. 5 in registrations in Western Europe after Germany, France, Italy, and the U.K. The steady growth of passenger car registrations since 2013 reflects improved economic conditions in the country (see chart 4).

Chart 4

Registrations Of New Passenger Cars Have Been Rising Since 2013



Source: Statista 2008.

In 2017, the Spanish car market grew at just over 8% for the full year and enjoyed the best result since 2007, with vehicle registrations of 1.23 million. Although the market has not yet broken its previous record of 1.6 million registrations between 2004 and 2007, all indicators suggest that momentum has not slowed.

In 2017, the Spanish car market grew at just over 8% for the full year and enjoyed the best results since 2007.

Spain has become a magnet for automotive investment. The large global original equipment makers (OEMs) have historically looked at Spain as the Western European country of choice for vehicle assembly, based on advantages provided by its integrated logistics; mature supply base; and available pool of skilled, low-cost labor compared with the European average. Indeed, the industry is regularly promoted by the government as a beacon of success and a reflection of the reviving Spanish economy, based on wage moderation, productivity growth, and exports.

Following its acquisition of Opel, PSA Group is the market leader in Spain, with a 21.7% share. Volkswagen group is still in second position, with 19.8%, as gains for Seat have been offset by falling market share for the Volkswagen brand. Renault-Nissan-Mitsubishi is in third position.

In Europe, vehicle emissions reduction remains a key trend. Diesel share of European new car sales in March was 36.7%, down a record 8.6 percentage points year on year. Markets whose diesel share is falling steeply include Spain, the U.K., Austria, and Ireland. In Spain, diesel car volumes were down 25% in first-quarter 2018, marking the most relevant decline after the U.K. and France. However, in the latter two countries, incentives to support the purchase of electric cars include premiums for switching from diesel. Their incentives are also higher than the existing scheme in Spain, where the country's main city councils (for example Madrid, Barcelona, Zaragoza, and Valencia) are reducing the annual circulation tax (ownership tax) for electric and fuel-efficient vehicles by 75%. Reductions are applied on company car taxes for pure electric and plug-in hybrid vehicles (30%), for hybrids, and for liquefied petroleum gas (LPG) and compressed natural gas (CNG) vehicles (20%). These incentives have not supported a major transition to alternative fuel vehicles to date. In Spain, the share of electric, chargeable vehicles is significantly below 1% versus 29% in Norway, based on latest available data (Source: European Automobile Manufacturers' Association 2017).

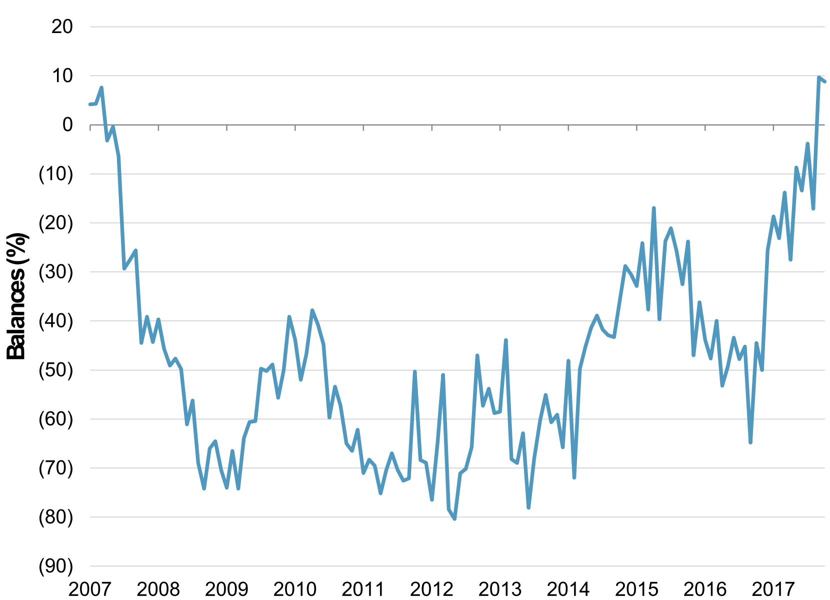
In Spain we rate two auto suppliers, Gestamp and Grupo Antolin. For most auto suppliers, the disruptive trend toward electrification and away from the traditional combustion engine--especially diesel--will be far more important than overall market volume expectations.

Construction: Still Recovering From The Heavy Slump

The Spanish construction market is continuing on its recovery path after the wrenching downturn during the country's economic crisis. According to Euroconstruct, construction output in Spain is expected to have grown 4.1% in 2017 and a further 3.5%-4% in 2018-2019. The Spanish construction market is finding support from increased cement consumption that reached 12.3 metric tons in 2017, up 11% on 2016, and should post an additional 12% growth in 2018 to reach 13.7 Mt, according to Spanish cement association Oficemen. Business confidence has also gradually been improving since 2012 (see chart 5). However, metrics remain well below precrisis values. We estimate that broad construction turnover in Spain, which includes industrial construction, is still about 50% lower than its peak in 2007.

Chart 5

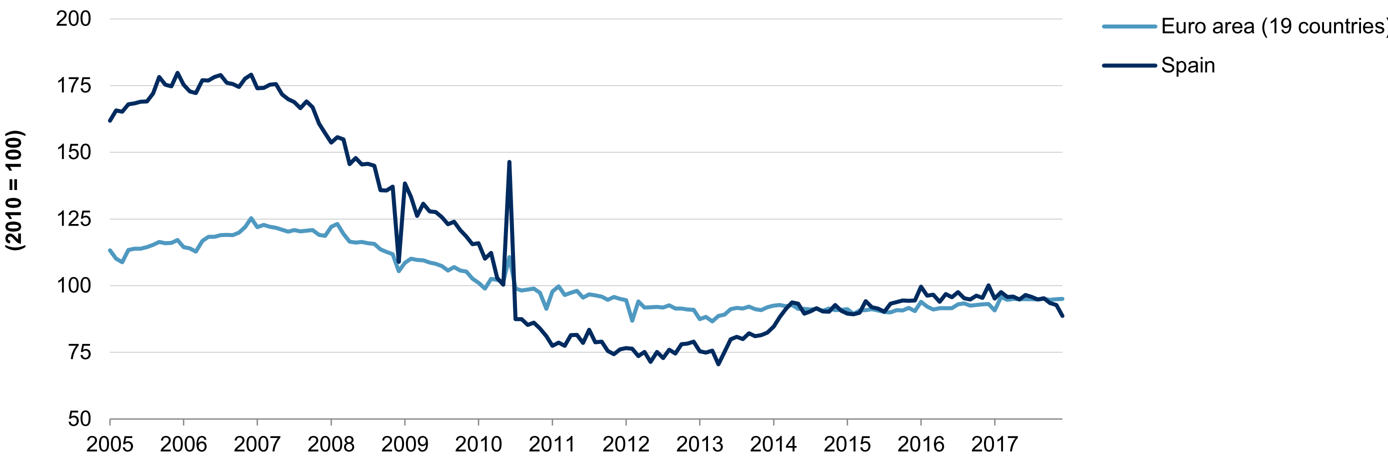
Business Confidence Has Been Improving Since 2012
Spain construction confidence indicator



Source: European Commission.

Chart 6

Construction Turnover Is Still Well Below Its 2007 Peak
Production of construction in Spain, monthly turnover



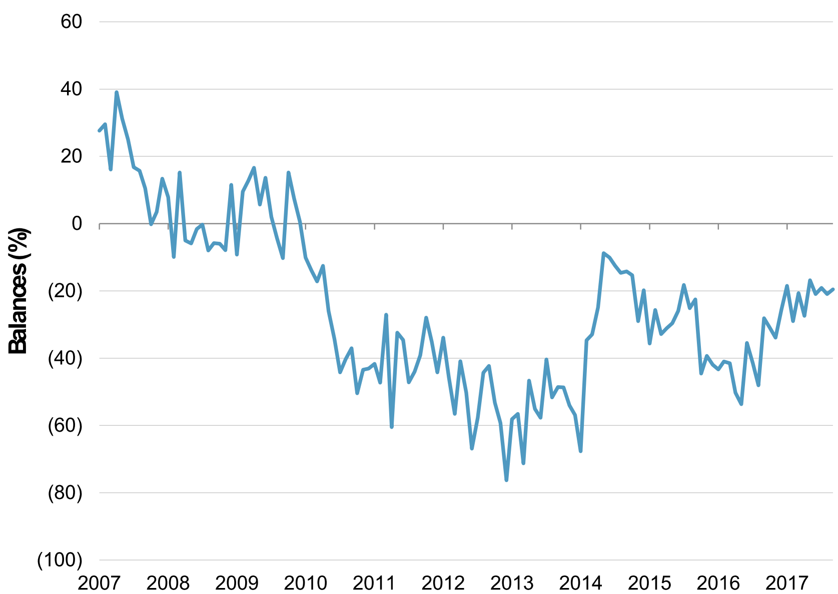
Source: Eurostat.

The residential construction segment is attracting the highest expectations in terms of growth in the next few years. Output growth in 2017 approached about 10%, according to estimates by Euroconstruct, and should further progress by about 5% in both 2018 and 2019. Access to housing has been steadily improving, supported by less stringent credit conditions and the beginning of a price recovery since 2016 that followed a decline in house prices by 36% in 2008-2015. In our view, the moderation of growth in 2018 and 2019 from 2017 may reflect a post-recession equilibrium, where structural factors, such as the absence of demographic growth, should not support much higher growth in the next few years.

At the same time, the performance of the civil engineering segment remains subdued and business confidence is still weak. Euroconstruct estimates that production output declined 6.4% in 2017, following a drop of 12% in 2016 due to political uncertainty and a stagnation in public tenders as result of contracting public budgets. Oficemen said cement demand from the segment stood at a low 5Mt in 2017, which compares with 19Mt in 2008. As such, we remain cautious about any significant turnaround in the short term, though most forecasting institutions expect a modest rebound sometime this year.

Chart 7

Civil Engineering Business Confidence Is Still Weak
Civil engineering confidence indicator



Source: European Commission.

In a positive development, last year the government launched the Extraordinary Plan for Investments in Roads, calling for investment of about €5 billion in 2018-2021. According to the government, the program will involve investment in 2,000 kilometers of roads around Spain, including completion of unfinished highways. The government also said the plan would be the first part of an investment program that should involve high-speed rail works and water infrastructure works, in collaboration with private initiative. As such, we expect some tendering of concessions already in 2018.

Construction companies that we rate in Spain have significantly diversified their activities outside the country during past decade, particularly in North America, the rest of Europe, and Australia, and have become fairly immune to local construction market trends. Spanish civil engineering construction today accounts for less than 10% of both ACS's and Ferrovial's revenues. We expect Ferrovial to keep a good competitive position in the service and construction business and to continue leveraging the currently solid performance of its infrastructure assets. However, we anticipate that 2018 operating performance will be weaker than 2017, reflecting tough market conditions in U.K. business services. ACS group operating performance in 2017 has continued to be solid in the construction division and stable in the industrial services division; we expect the group to consolidate its results in 2018-2019, thanks to a focus on cash flow generation and disciplined working capital management.

Commodities: Business Diversification Helps Companies Protect Credit Quality

Spain's oil and gas companies are exposed to global macroeconomic and price developments as well as local dynamics. Throughout the decline in oil prices in recent years, Repsol's performance has exhibited greater stability than many peers as a result of its integrated model, with upstream and downstream businesses. The group's relatively bigger downstream refining and chemicals assets, compared with larger peers, has meant that cash generation, earnings, and credit metrics have been less volatile. Repsol's production mix is weighted towards gas, further reducing the direct exposure to oil prices. This said, we anticipate a less pronounced rebound in Repsol's performance if oil prices remain firm or strengthen.

As far as our ratings are concerned, Repsol's financial discipline and focus on deleveraging underpinned our 'BBB-' long-term issuer credit rating, even as the Talisman acquisition closed just as oil prices were collapsing. It also supported the subsequent upgrade to 'BBB'.

Such business diversification within a group can be credit supportive in our view, where the dynamics of different divisions can result in less volatile cash generation. To varying degrees, companies like Cepsa S.A. and GALP Energia S.P.G.S, S.A. share this characteristic.

For many commodity companies, the financial, as well as strategic, choices made by management teams will be increasingly important for the evolution of our ratings and views on credit quality. With more supportive prices, lower costs, and affordable capital expenditure, the extent to which companies use the good times to build up financial cushions is as important for ratings today and in the future as the absolute level of hydrocarbon prices and refining margins. Paying down gross debt can be a meaningful credit hedge for future market and cash flow volatility.

Over the next decades, demand for transport fuels, especially for light vehicles, is likely to decline as the adoption of electric and autonomous vehicles accelerates. In the next few years, however, we forecast that global oil product demand growth will remain robust at comfortably over 1 million barrels a day. The near-term losses from incipient electric vehicle adoption are small in comparison. Platts Analytics has estimated that for every 1 million new electric vehicles, about 20,000 barrels a day of oil demand are lost. We see the adoption of IMO 2020 bunker fuel sulphur standards as a nearer-term source of additional uncertainty for refining margins.

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Consumer Goods And Retail: Non-Food Segments Are Growing; Food Continues To Struggle

According to ShopperTrak, the Spanish retail sector recovered in 2017 (0.4% growth) and was one of the better-performing industries in first-quarter 2018, with a 2% increase in footfall. This improvement was mainly due to Spain's improved general economic and job conditions, which have increased household purchasing power. Yet, the broad Spanish retail sector faces a number of threats including competition, the advent of online, unemployment, and the change in weather patterns.

Apparel

This segment, which accounts for about 66% of fashion retail spending in Spain, grew 3.4% in value in 2017. This includes accessories (5.3%), footwear (-8.2%), and home textiles (-3.4%). Growth in the sector was mainly due to an increase in spending per individual rather than to promotions. Inditex (not rated) continues to be the leader in fast fashion in Spain and beyond, offering consumers catwalk-inspired designs at affordable prices. Digital penetration is still relatively low in Spain in terms of revenue share (11%), but in line with the European average (11.3%). Overall, the Spanish apparel retail sector is well placed in terms of logistics, supply chain, and distribution channels. However, we expect competition from the likes of Asos, Amazon, and other online operators will continue to increase. Companies such as Zara, Mango, Cortefiel, or El Corte Ingles will need to continue to invest heavily in omnichannel capabilities to stay competitive. In addition, when internal demand starts moderating over the next 18-24 months, we expect to see an increasingly harsh competitive landscape.

Grocery

With one of the most fragmented grocery markets in Europe, where the five-largest retail operators (Mercadona, Dia, Carrefour, Auchan (Alcampo), and Eroski) barely control 50% of the market among them, the Spanish market is also one of the most competitive in the region, despite the country's growth and of high tourism levels. In addition, like elsewhere in Europe, consumers are increasingly moving from hypermarkets located in shopping malls in the outskirts of cities to discounters and convenience stores located in city centers where they can shop more frequently. As a result, many grocers have opened convenience stores in city centers, including Mercadona, Carrefour, and Alcampo (Auchan). This increased competition weakened the results of some of these players in 2017, primarily Dia, which had traditionally enjoyed less competition in city centers.

Expansion in the convenience category is a focus for most food retailers, alongside modernization and expansion of their existing networks. We believe the Spanish retail market will remain very competitive in 2018 and 2019, particularly in the convenience and proximity store formats in city centers. We also expect that online grocery penetration (currently at only 2%) will accelerate in the next three to five years, reflecting changing consumer behaviors. Nonetheless, we expect discounters like Mercadona to continue doing well because of their strong private-label penetration, lean cost structure, and increasingly healthy propositions such as organic, free-range food.

Consumer goods

Spain is one of the largest producers of agricultural consumer goods in Europe and we rate several companies in the sector such as Deoleo (olive oil) and Planasa (berry plants). We expect these companies will face substantial weather-related risks in the coming years as Spain is to be one of the countries most affected by climate change, according to European Environment Agency. It stands to reason that retailers and consumer companies will need to adapt their offer to climatological changes, if they are to maintain their creditworthiness.

The broad Spanish retail sector faces a number of threats including competition, the advent of online, unemployment, and the change in weather patterns.

For example, we recently downgraded Spanish olive oil bottler Deoleo due to its operating performance in 2017 and 2018. Spain, which is still the biggest producer of olive oil, with 45% of global production, will likely see its production decrease by close to 10% in coming years due to drought and high spring temperatures. Because Spain and Italy remain the first- and second-largest olive oil producers, respectively, their crop yields will continue to drive global prices. This supply risk has exacerbated the volatility that propelled prices toward record highs in 2015: extra virgin oil reached €4,316 per ton on July 31, 2015, compared with €3,154.5/ton at the same time in 2016. The price reached €3,794.7/ton at the end-July 2017 following additional uncertainties, such as weather conditions, about the October harvest.

It is important to note that the Spanish government also passed legislation in February 2018 for about 10% lower sugar, salt, and fat content in more than 3,500 food and drink products over the next three years. We note that, in line with European consumers, Spanish consumers are increasingly focusing on healthy dietary patterns, which should result in higher growth for healthy, natural, and organic food products. In line with the rest of Europe, we also expect the share of private-label food penetration to increase in Spain in years to come.

Infrastructure: Healthy Growth Prospects Ahead For Roads, Ports, Car Parks, And Airports

Sustained economic growth, low interest rates, and positive inflation are driving asset performance and valuations for Spain's infrastructure sector. Relatively low oil prices and new technologies and business models will continue to stimulate growth for transportation infrastructure assets, including car parks, roads, airports, and ports. Passenger, freight, and vehicle throughput of rated transportation infrastructure assets in Spain are expanding at between 1.5x-3.0x economic growth, depending on the sector.

We expect Spanish infrastructure corporates in the road sector to look home for deal flow as a healthy pipeline of project-financed transportation infrastructure assets are coming to market in Spain. That's despite another dry year for greenfield public-private partnerships (PPP) across Europe. Spain's pipeline comprises 20 new road PPP, which we expect to attract €5 billion in private investment. Initially expected to arrive to the market in 2018 and 2019, the program might face delays. These may arise from expropriations, which are attracting controversy. Preliminary drafts indicate the private sector will bear the risk of cost overruns and express doubts about the procedure and timing of the expropriations.

Apart from the road PPPs, there's the sale of a package of the "Radiales," the nine PPP toll roads around Madrid and the southeast built just before the European financial crisis on extremely optimistic traffic projections and expropriation costs, which have since gone bankrupt. This year, these PPP roads are reverting to the government. The impact of these roads on the government's balance sheet, if they are not sold before the end of the financial year, is a strong incentive for a retender before the end of 2018, even if net proceeds are uncertain. That's because of the higher-than-expected expropriation costs, the compensation for earlier termination (also known as RPA – Responsabilidad Patrimonial de la Administración) payment to debtholders, and the limited upside in valuation because of a lack of a recovery in traffic on the Radiales (that in 2016 was still 23.4% lower than in 2006). We understand the defaulted roads will be tendered through two portfolios: a first portfolio comprising the toll roads in the center of the country and a second one with the concessions in the southeast. For our research about the Radiales see "The Experience Of Early Termination Gives Food For Thought To Investors In Spanish Concessions," published on Jan. 22, 2015.

Sustained economic growth, low interest rates, and positive inflation are driving asset performance and valuations for Spain's infrastructure sector.

Low interest rates, growing pension liabilities, and abundant liquidity--together with the decline of greenfield opportunities in Europe--will continue to drive up demand for and valuations of infrastructure assets and stimulate deal flow for mergers and acquisitions (M&A). Last year, car park transactions dominated the M&A league in transportation in Spain. In 2018 we expect the bid of Atlantia and ACS for Abertis and the sale of the Radiales to attract most of the investment in brownfield assets.

Our stable outlook across our rated roads portfolio reflects our view of stable earnings generation performance, mostly linked to GDP growth. The negative outlooks are mostly linked to acquisition activity. We could see some rating pressure coming from a deterioration in financial risk profiles (debt to EBITDA for the toll road portfolio globally has the lowest headroom compared to airports or ports, averaging 4x for the past three years). Contributing to the performance of infrastructure transportation assets in 2017 were urban road traffic increases, a growing number of seats deployed by airlines in Spain (redirected from destinations in Turkey or Egypt), and the airports tariff regime approved by the regulator last year (factoring in a tariff freeze for the next five years). The main risk we see for these assets in the near future is the possibility of an abrupt change in the economic cycle or quantitative easing, and the response from their respective economic pricing regulators.

Leisure: Improving Prospects On The Back Of Economic Growth And Despite Disruptive Risks

Given the discretionary nature of demand for leisure services, where economic indicators are tightly correlated with consumer spending, we expect that positive economic tailwinds will lift the travel, lodging, gaming, and theme park industries, as well as other leisure-related subindustries.

The lodging business outlook continues to improve, after record tourist arrivals in Spain during 2017 (81.8 million, which is up 8.6% on 2016, according to the Instituto Nacional de Estadística). Major hotel groups recorded increased revenue per room (RevPar) in 2017, mainly driven by a higher average daily rate (ADR) rather than increased occupancy. This is despite the notable fall in tourists to Catalonia in the last quarter of 2017 because of political disputes, demonstrated by a 13.9% year-on-year drop in tourist arrivals in December. We also note the marked decrease in activity in the late summer following the terrorist attack in Las Ramblas in mid-August 2017, which affected both arrivals and bookings. The weaker tourism sector for Catalonia did not materially affect the results of Spain's large lodging groups, however, given the latter's wide geographical diversification.

In our opinion, geopolitical conditions and threats of terrorist attacks are among the main risks affecting the broad leisure industry. New business models, such as the growing Airbnb market, are an added risk. We believe the traditional hotel industry could face long-term risks if providers of alternative accommodations, such as Airbnb, created more standardized and consistent offerings, especially those that appeal to business and luxury travelers. We also note that Airbnb could have a bigger impact on RevPar during economic downturns given lower average prices and highly elastic supply.

The lodging business outlook continues to improve, after record tourist arrivals in Spain during 2017.

We continue to see benefits for online travel businesses from consumers' migration to online offers, including for our rated companies eDreams and Hotelbeds. However, not everyone in the industry has adapted so quickly and so well to the new online world. In this increasingly competitive market, those that cannot respond competitively to digital disruption will likely be consolidated in the medium term.

Despite several recent tax hikes and regulatory changes in the gaming industry across different European countries, Spanish regulation has remained broadly unchanged over the past few years, and we do not foresee any major changes in the near term. In Spain, gaming regulations can vary regionally, which creates complexities and inefficiencies for companies operating nationally. We expect the gaming industry to continue consolidating because scale is of the essence given a significant fixed-cost base for building or maintaining online platforms, casinos, and machines; acquiring or renewing licenses; and for marketing costs. We nevertheless assume that the quasi-monopolistically state-owned lottery business will continue dominating the local market, with nearly 30% market share, while sports betting and online gaming will remain the main industry growth drivers in years to come.

For theme park operators, we believe smaller "regional" operators will continue to benefit from their closer proximity to guests and more affordable tickets than for larger destination parks. As macroeconomic conditions weaken, leading to a pullback in consumer discretionary spending, we expect customers to postpone more expensive trips to destination parks in favor of cheaper day trips to regional parks. Nonetheless, we expect PortAventura, a pure destination park, to post a solid performance in 2018, aided by an uptick in consumer spending, and despite the Catalan political dispute. This is mostly driven by the ramp-up of Ferrari Land. Even though it attracted fewer visitors than expected in its first year after opening in April 2017, we expect growth to pick up through 2018. At the same time, we typically see a risk in its high EBITDA concentration in the summer months, which exposes the group to high-impact shocks in the case of unforeseen events such as security threats, weather, or safety issues.

Real Estate: Recovering Solidly In 2018

Overall, the real estate sector should continue to benefit from the good fundamentals of the Spanish economy, with solid occupancy levels and robust rental growth across all asset classes. However, we remain cautious about the impact political tensions between Catalonia and the central government could have on the real estate market, particularly for the Catalan region. The persistence of political tensions will likely impinge most on the office market in the region, driven by corporate sentiment, as well as on hotel owners. The residential, logistics, and retail segments should prove more resilient, as demographic growth and consumer spending remain supportive. In the recreational segment, real estate companies that usually have a portion of their rental income linked to the gross profit of their tenants could be negatively affected by the drop in the number of tourists in the region.

Despite this unstable political landscape, overall investor and corporate sentiment is positive, with investment volumes at about €12.9 billion in 2017 compared with around €10 billion in previous years excluding corporate deals. We expect similar investment levels for 2018, which will also see active corporate activity. Inmobiliaria Colonial successfully completed the acquisition of Axiare Patrimonio in February, and certain key players in the market are likely to launch an IPO during the year.

We expect similar investment levels for 2018, which will also see active corporate activity.

Commercial real estate is likely to continue to perform solidly during 2018. The office market should benefit from the supportive macroeconomic environment and the decrease in unemployment, which would translate into good occupancy levels and robust rental growth above inflation. We also expect further positive revaluation gains in the segment on the back of good asset performance and steady investor interest, especially in Madrid, where we have also seen certain yield compression during 2017. The retail market should gain support from the boost in private consumption. However, the sector will continue to face similar challenges as in the rest of Europe, such as the steady development of online retail, which is progressing in Spain but is still below levels seen in the U.K. or Scandinavia. On the other hand, the logistics segment will benefit from this e-commerce phenomenon in a market where supply is currently limited. This explains the record levels of investments in this market segment in 2017, with €1.2 billion deployed (versus €600 million in 2014), and the good performance of logistic assets located in premium locations, with high occupancy levels and mid-to-high-single-digit rental growth for 2017.

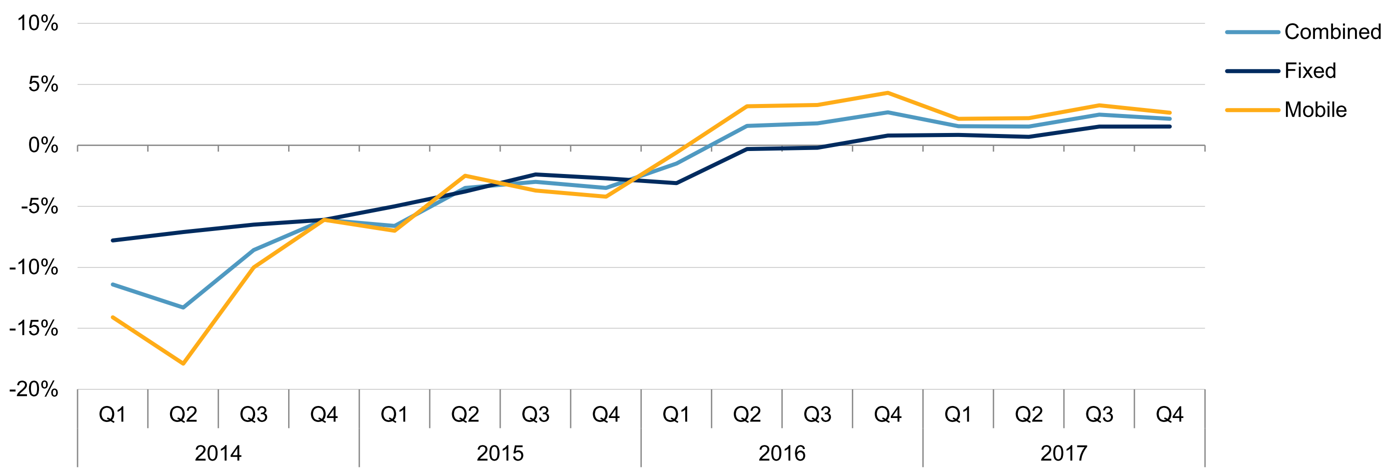
The Spanish residential real estate market will continue to recover from the post-2008 contraction when prices fell by 37% between third-quarter 2007 and the trough in first-quarter 2014. According to Tinsa, a real estate company, average prices rose 4.2% year on year in the final quarter of 2017. The city of Madrid overtook Barcelona, with an annual increase of 17% against 14.8% for the capital of Catalonia where prices dropped 1.7% in the last three months of 2017, reflecting the unstable situation in the region. We expect the rise in prices will continue in 2018 (3.5%) and we estimate that transactions in the country as a whole should grow about 8% in 2018.

Telecom: Strong Growth And Low Customer Churn Set To Continue, Benefiting From Fiber Investment

Spanish market trends have improved strongly over the past three years, with positive service revenue growth since second-quarter 2016, and total 2017 growth of about 1.9% (see chart 8). We expect growth will continue at about 2%-3% over the next two years, and operators will benefit from the high degree of convergence and fiber investment already achieved. In our view, this will allow for more constructive pricing with less churn risk and less ongoing capital expenditure compared with what's required in many other European markets.

Chart 8

Revenue Growth In Spain's Telecom Market Has Improved Strongly Over The Past Three Years



Sources: Company filings, S&P Global Ratings.

Key supports, in our view, are the increasing penetration of converged bundles and fiber broadband. More than 50% of Spanish consumers took bundled subscriptions of fixed and mobile services as of year-end 2017. For example, 85% of Orange consumer broadband customers were converged as of first-quarter 2018. This has lowered churn rates, with mobile churn in particular down more than 50% from an average of 40% in 2012 to below 20% today. This lower elasticity has also allowed for monetization of mobile data through more-for-more offerings.

Spain has one of highest levels of fiber to the premises (FTTP) coverage in Europe. Household coverage reached 63% in 2016 and we expect it to stand at about 70% today. In our view, more favorable conditions and cheaper labor help make FTTP investments significantly less expensive per household than for other Western European markets. Penetration is also strong, at 39% of fixed broadband subscribers in 2017, one of the highest rates outside of the Baltics. This should allow for gradual price increases as customers convert to fiber, are upsold to faster fiber speeds, or purchase additional services like pay-TV. Indeed, the three main carriers (Telefonica, Vodafone, and Orange) were all able to raise prices in 2017, and did not suffer material customer churn. With strong fiber coverage, we also expect lower capex requirements (about 14% of revenues through 2019, excluding spectrum costs) compared with a European average of 18%-19%, allowing for more free cash flow conversion and financial flexibility.

We forecast rational behavior by the big carriers will continue, although the market remains very competitive. Given relatively high telecom prices in the Spanish market, we cannot exclude the risk of pricing pressure, particularly if smaller players become more aggressive. Masmovil in particular has targeted value-conscious customers as it attempts to scale up its customer base. Its revenue share remains limited, and our base case remains positive for the overall market, but should their pricing and customer additions prompt a strong reaction from peers, we could lower our forecast for the market.

Utilities: A Stable Regulatory Environment And Rebounding Generation Activities

Our rating outlooks on Spanish utilities are all stable, but could be affected by forthcoming political changes to tariffs and remuneration in the energy system. The first of these reviews is for renewables this year, the first remuneration review for this segment since the new framework was set in 2014. Spain has always been at the forefront of the development of renewables, notably wind and solar. This year's review will very likely reduce the current remuneration for renewables that is based on a return of 7.4% of the asset base. We believe the extent of this revision will be a good signal for upcoming reviews of gas and electricity regulated networks, planned for 2020 and 2021, respectively.

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In the meantime, following the results of the auctions of 2016 and 2017, renewables projects seem far less likely to receive subsidies and may generate all of their revenues directly from the market (for further details see: "The End To Subsidies: The Beginning Of A New Era For Spanish Renewables?" published Feb. 7, 2018). In practice, we believe this means two things: first, risk appetite from investors is increasing significantly for this type of asset; and second, investors anticipate the rapid development of long-term power purchase agreements from the private sector, which are currently almost nonexistent in Europe. We are now seeing the first signs of such contracts emerging, which could be promising and allow for much improved visibility on cash flows, and ultimately better access to capital for their financing. The Spanish solar association UNEF says discussions are under way for the construction of projects with a total capacity of 24 GW. This would mean that, excluding the 3.9 GW of the auctions, Spain would develop up to 20 GW of new photovoltaic projects with no subsidies. This would significantly alter the power market competitive landscape and may in turn have long-term implications on the Spanish pool price.

For the regulated power and gas networks, we believe three themes will dominate over the coming two years:

- Regulatory reviews. Beyond the remuneration pressure mentioned above, these will also eventually help build a track record of consistency and predictability of the frameworks, and ultimately provide additional cash flow visibility for the sector.
- M&A. We believe this could potentially be a rating driver this year, as was the case in recent years following the disposal of networks by EDP and Gas Natural, changes in shareholders for Redexis, and international growth by Enagas and Red Electrica.
- A possible change in financial policies. This could be driven by the search for higher shareholder returns given relatively recent high acquisition multiples, and could eventually pressure the ratings. We believe this will most likely be tested when new remuneration is known.

Overall, we expect 2018 results to be stable to relatively positive for Spanish utilities, on the back of a still stable regulatory remuneration and our expectations of a marked rebound on generation activities after an extremely poor hydrological year in 2017, which we expect to be better this year.

APPENDIX: RATINGS OUTLOOK

Ratings On Spanish Corporates Are Benefiting From Positive Economic Trends

- We see stable credit quality in 2018, as indicated by our outlook distribution for our universe of rated Spanish companies, in line with our expectations for European companies as a whole.
- Most companies should benefit from positive economic trends. The higher portion of positive outlooks than for Western Europe shows that Spanish corporates should benefit from the country's positive economic momentum, despite the Catalonian political crisis.
- We have seen a 37% increase in the number of Spanish nonfinancial corporates we rate to 50 as of May 2018 since the end of 2014.
- The median rating on Spanish companies was 'BB' as of March 2018, with investment-grade ratings accounting for 43% of the total.

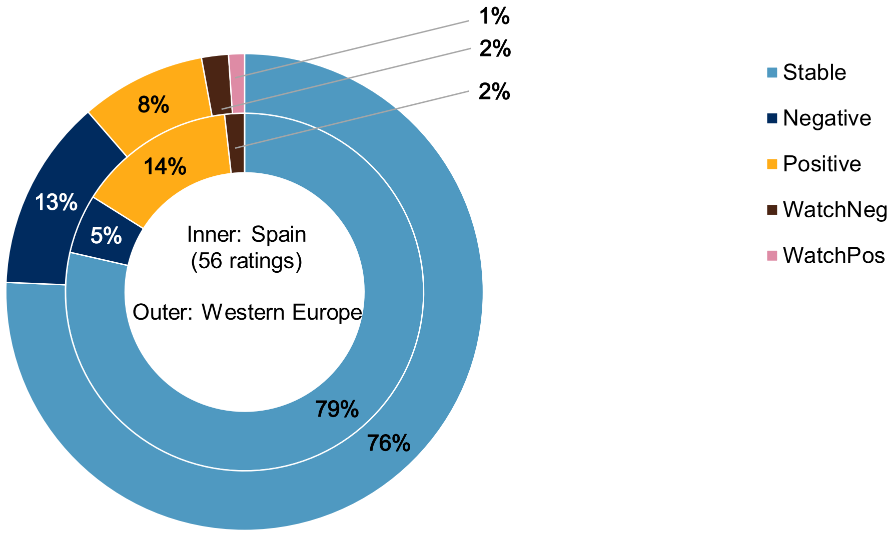
The Spanish nonfinancial corporations we rate are predominantly large and international companies spanning many sectors. Overall, the performance of these companies was damaged by the country's economic downturn. But, since 2014, they have benefited from the economic recovery in tandem with the global upturn.

The outlook distribution of Spanish companies we rate indicates stable credit quality in 2018, which is in line with our expectations for European companies as a whole. As of end-April 2018, about 79% carried a stable outlook, 14% a positive outlook, and 5% a negative outlook (see chart 9). The higher (lower) amount of positive (negative) outlooks, in comparison with our rated universe in Western Europe, factors in our view that Spanish corporates should benefit from this positive economic momentum in the coming years.

Reflecting the economic recovery and good momentum in the economy, our net outlook balance for Spanish corporates (positive minus negative outlooks) also compares positively with that for the rest of Western Europe (see chart 10).

Chart 9

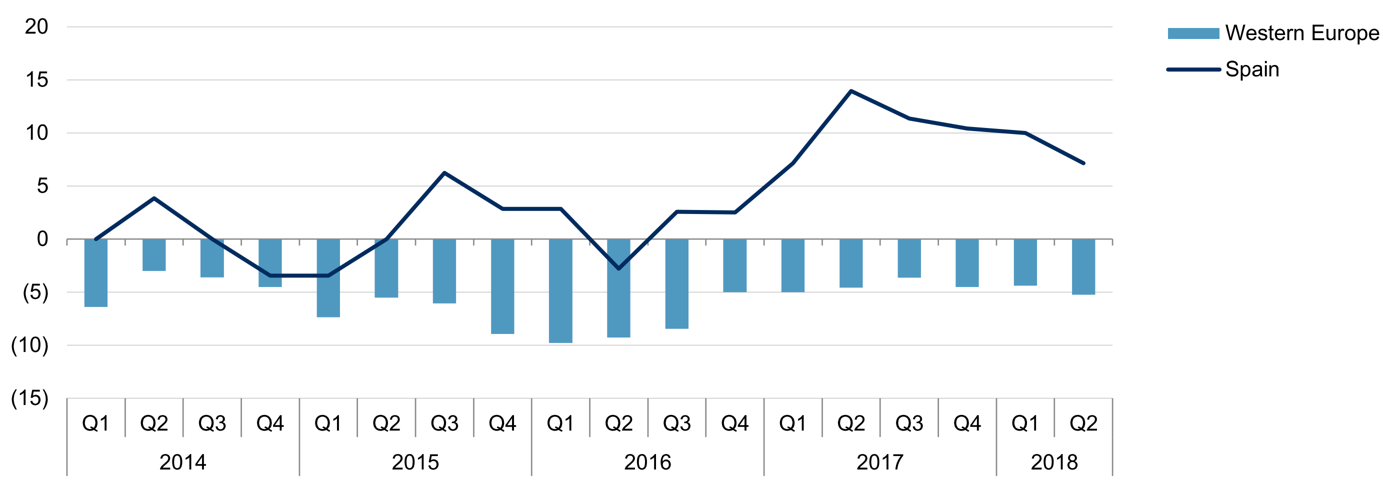
Three-Quarters Of Rated Spanish Corporates Have Stable Outlooks



Source: S&P Global Ratings' calculations.

Chart 10

Spanish Corporate Net Outlook Bias Compares Favorably With The Rest Of Western Europe



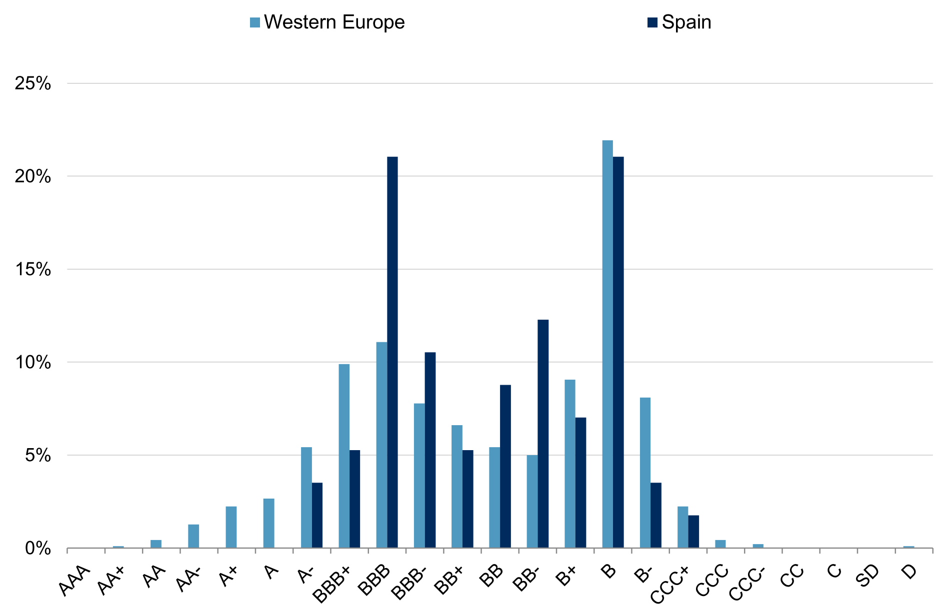
Source: S&P Global Ratings' calculations. Net outlook bias shows the percentage of positive outlooks for the rated universe less the percentage of negative outlooks.

Negative outlooks on Spanish companies reflect a risk of deterioration in the credit quality of the companies due to M&A transactions, or to case-specific circumstances, rather than worsened operating conditions in Spain.

S&P Global Ratings rates 50 Spanish corporates publicly. The current ratings span the full rating scale, but are slightly more concentrated in the speculative-grade area ('BB+' or lower; see chart 11). Currently, Enagas S.A. (A-/Negative/A-2) and Red Electrica Corporacion S.A. (A-/Stable/A-2) are the highest-rated Spanish nonfinancial corporates. The credit profile of these entities continues to be supported by the regulatory regime that oversees their activities in their respective markets and their stable and predictable cash flows. At the other end of the spectrum, Deoleo, S.A. (CCC+/Stable/--) is the lowest Spanish nonfinancial corporate credit rating, explained by the firm's elevated debt burden and a challenging operating environment stemming from volatile olive oil prices.

Chart 11

Spanish Corporate Ratings Are Slightly More Concentrated In the Speculative-Grade Range



Source: S&P Global Ratings' calculations.

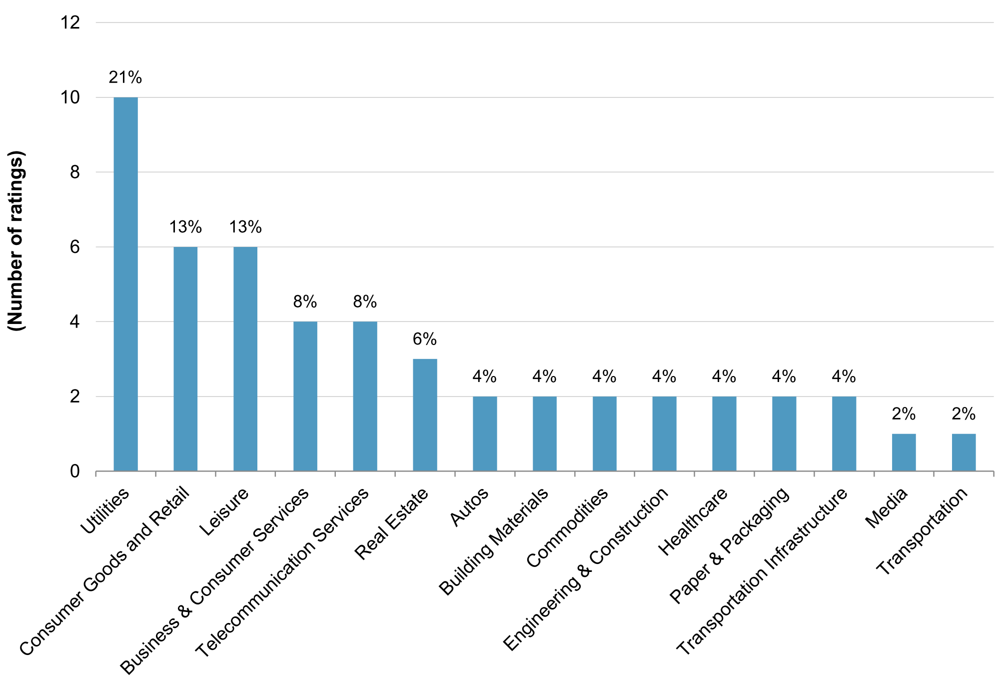
A material portion (43%) of our Spanish rated entities are in the investment-grade category (ratings of 'BBB-' or higher). This is a reflection of the substantial weight of low-risk industries, such as utilities and real estate, in our portfolio, as well as the high coverage of leading corporates in each of the different sectors (Prosegur Compania de Seguridad S.A., Repsol S.A., Distribuidora Internacional de Alimentacion S.A. or Telefonica S.A.).

The remaining half of our portfolio falls into the speculative-grade category, widely spread among different industries (see chart 11). The percentage of speculative-grade issuers has risen significantly from end-2008. This reflects some negative rating actions that we have taken on Spanish companies since the beginning of the financial crisis in 2008. More importantly, however, it reflects newly assigned issuer ratings, particularly on midsize companies that have benefited over the past years from a growing high-yield bond market.

Spanish companies have exhibited a growing interest in tapping the debt capital markets since the end of the financial crisis. Historically, Spanish corporates have mainly relied on bank financing. However, the financial crisis, which harmed the credit standing of many banks, and changes in Basel banking regulations encouraged more Spanish corporates to turn to the bond markets to diversify their sources of funding while benefiting from historically low rates. Since 2015, they have increased bond issuances year on year and are securing attractive long-term terms through fixed-rate bond issuances. The higher number of bond issuances, which are usually rated, has consequently led to steady growth in the number of ratings issued by S&P Global Ratings.

Chart 12

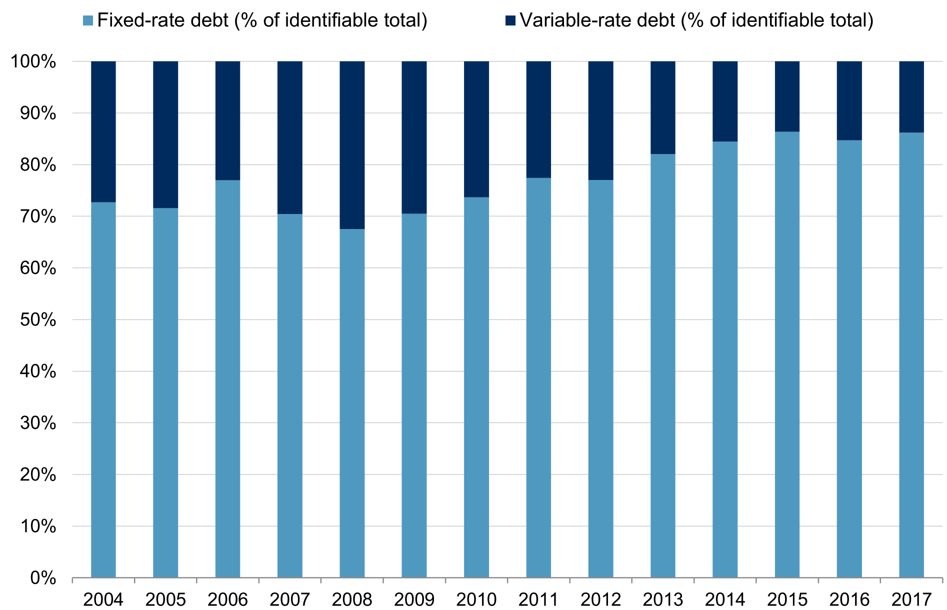
Utilities Constitute One-Fifth Of Rated Spanish Corporates



Source: S&P Global Ratings' calculations.

Chart 13

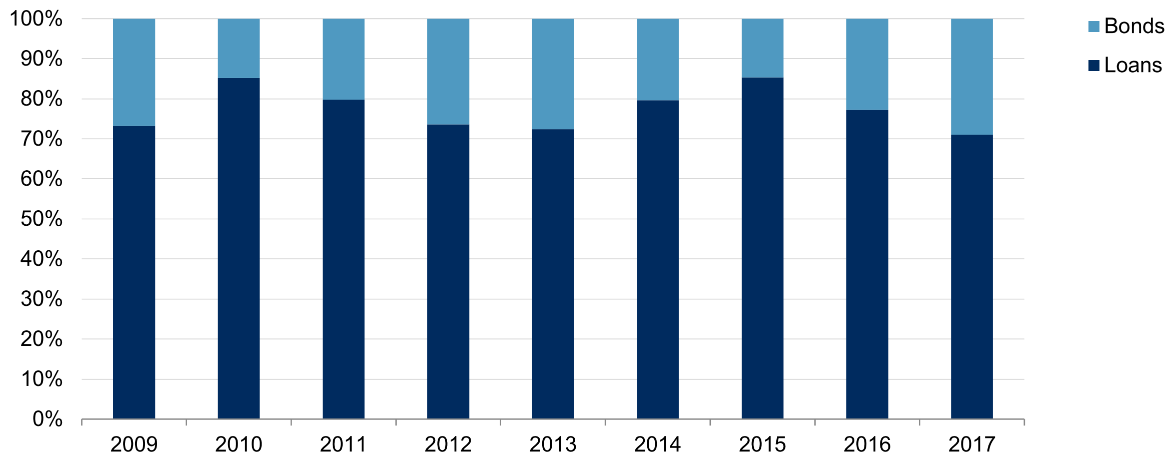
The Proportion Of Fixed-Rate Bonds In Spain Has Risen Since 2015



Source: S&P Global Ratings' calculations.

Chart 14

The Proportion Of Bonds Versus Loans In Spain Has Risen Since 2015



Source: S&P Global Ratings' calculations.

Table 1

Ratings On Spanish Corporates

Sector	Name	Rating	Outlook/Credit Watch	Short-Term Ratings
Autos	Gestamp Automocion S.A.	BB	Stable	--
Autos	Grupo Antolin Irausa S.A.	BB-	Stable	--
Building Materials	LSFX Flavum Bidco S.A.	B	Stable	--
Building Materials	CEMEX España, S.A.	BB	Stable	--
Business & Consumer Services	Haya Real Estate S.L.U	B-	Stable	--
Business & Consumer Services	Prosegur Cash, S.A.	BBB	Stable	A-2
Business & Consumer Services	Prosegur Compania De Seguridad S.A.	BBB	Stable	A-2
Commodities	Befesa S.A.	BB-	Stable	--
Commodities	Repsol S.A.	BBB	Stable	A-2
Consumer Goods and Retail	CatLuxe Acquistion Sarl	B	Stable	--
Consumer Goods and Retail	Deoleo, S.A.	CCC+	Stable	--
Consumer Goods and Retail	Grupo Embotellador ATIC, S.A.	B	Stable	--
Consumer Goods and Retail	Placin S.a.r.l	B	Stable	--
Consumer Goods and Retail	Distribuidora Internacional de Alimentacion S.A.	BBB-	Stable	--
Consumer Goods and Retail	Masaria Investments S.A.U.	B	Positive	--
Engineering & Construction	ACS, Actividades de Construccion y Servicios SA	BBB	Stable	A-2
Engineering & Construction	Ferrovial S.A.	BBB	Stable	A-2
Healthcare	Almirall S.A.	BB-	Negative	--

Table 1

Ratings On Spanish Corporates (cont.)

Sector	Name	Rating	Outlook/Credit Watch	Short-Term Ratings
Healthcare	Grifols S.A.	BB	Stable	--
Leisure	Amadeus IT Group S.A.	BBB	Positive	A-2
Leisure	Cirsa Gaming Corp. S.A.	BB-	Watch Neg	--
Leisure	Codere S.A.	B	Stable	--
Leisure	NH Hotel Group S.A.	B	Positive	--
Leisure	PAESA Entertainment Holding, S.L.	B-	Stable	--
Leisure	HNVR Midco	B	Stable	--
Leisure	eDreams ODIGEO, S.A.	B	Stable	--
Leisure	Joye Media S.L.	BB- Prelim	Watch Neg	--
Paper & Packaging	ENCE Energia y Celulosa S.A.	BB	Stable	--
Paper & Packaging	Lecta SA	B	Stable	B
Real Estate	Hispania Activos Inmobiliarios SOCIMI, S.A.	BBB-	Watch Neg	--
Real Estate	Inmobiliaria Colonial, SOCIMI, S.A.	BBB	Stable	A-2
Real Estate	MERLIN Properties SOCIMI, S.A.	BBB	Positive	--
Real Estate	Testa Residencial, SOCIMI, S.A.	BBB- Prelim	Positive	--
Telecommunication Services	Cellnex Telecom S.A.	BB+	Stable	--
Telecommunication Services	Euskaltel S.A.	BB-	Stable	--
Telecommunication Services	Telefonica S.A.	BBB	Stable	A-2
Telecommunication Services	Ufinet Telecom Holding SLU	B	Stable	--
Transportation	Bahia de las Isletas, S.L.	B+	Positive	--
Transportation Infrastructure	Abertis Infraestructuras S.A.	BBB	Stable	--
Transportation Infrastructure	MEIF 5 Arena Holdings SLU	BB	Stable	--
Utilities	Enagas S.A.	A-	Negative	A-2
Utilities	Endesa, S.A.	BBB+	Stable	A-2
Utilities	Gas Natural SDG, S.A.	BBB	Stable	A-2
Utilities	Iberdrola S.A.	BBB+	Stable	A-2
Utilities	Madrilena Red de Gas, S.A.U.	BBB	Stable	A-2
Utilities	NorteGas Energia Distribucion, S.A.U.	BBB-	Stable	--
Utilities	Red Electrica Corporacion S.A.	A-	Stable	A-2
Utilities	Redexis Gas, S.A.	BBB-	Stable	--
Utilities	Viesgo Generacion SLU	B+	Stable	--
Utilities	Viesgo Holdco S.A.U.	BBB-	Stable	A-3

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