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Banking & Finance Report 2014: Sea of liquidity

Spain and Portugal have experienced an increase in fund-based financing over the last year as investors from overseas take advantage of the opportunity presented by the banks reluctance to lend. But how committed are funds to the Iberian market? Some lawyers argue that they are merely opportunists that will soon turn their attention elsewhere.

Spain is inspiring confidence among international fund managers, according to lawyers. Investment in the country is one of the hot topics of discussion, particularly among London-based funds. Not only are they eyeing up distressed loans, they are also considering opportunities for direct lending, with joint ventures with banks one scenario that could become increasingly common. Funds have spotted an opportunity in the Spanish market as banks are still showing a reluctance to lend. Whether or not funds are a good thing is the subject of intense debate. Some lawyers argue that they are merely looking to make a quick profit in Spain, before turning their attention elsewhere. But others claim that there are significant distinctions to be drawn between different types of funds – while some may be opportunistic, others are looking to create value and, at the same time, take the issue of reputational risk seriously.

Opinions vary on whether providing legal advice to a fund is a profitable venture. Some lawyers say that, while banks continue to cut costs, funds are much less afraid of legal fees and that consequently, advising a fund is a financially rewarding undertaking. However, there is another school of thought that maintains that advising an opportunistic fund is a rather thankless task – for example, they expect deals for distressed debt to be completed quickly, perhaps overnight, and consequently are not prepared to pay a lot of money for such a service.

And the view from Portugal? The country´s expected exit from the EU/IMF bailout programme has raise hopes of an upturn in international financing conditions and an increase in the liquidity of Portuguese banks, allowing them to provide more financing to companies and individuals. However, this does not change the fact that there are still important challenges for the banking sector relating to the deleveraging requirements, increased capital ratios, and the public recapitalisation plans implemented by several Portuguese banks. As is the case in Spain, Portugal has experienced a significant increase in fund-based financing.

Funds head for Spain

Confidence in Spain is returning with funds entering the market and taking over the role traditionally assumed by banks, lawyers say. “There are more international financial institutions and funds interested in buying and financing assets,” says Gaspar Atienza Becerril, Partner at Garrigues. “There is a new trust in Spain.” There is particular interest from UK-based funds, according to Salvador Ruiz Bachs, Partner at Allen & Overy. “In London, everyone is talking about Spain,” he says. “New players are looking at distressed loans in the secondary market, but soon they will start talking about the primary market.”

There are also opportunities for investment funds to become involved in direct lending, according to Ángel Pérez López, Partner at Uría Menéndez. “There could be new lending platforms set up as joint ventures with banks: funds would contribute with liquidity and banks with client relationship, knowledge of the market and structuring capabilities,” he says. Fernando Lillo, Of Counsel at Jones Day, says that direct lending by funds and individuals is an area where there is significant activity.

“We´re seeing more small deals – foreign investors have liquidity and are active in the real estate sector – they rely very much on legal advice, they are taking advantage of the retreat of banks and many investors are entering into those small financings.”

Juan Barona, Partner at Linklaters, observes that there is a trend for companies to go to the bond market because it is cheaper than bank lending. He adds: “There is a feeling that there is a sea of liquidity – funds is a huge universe, some are focused on short term investment, some funds are interested in equity and some are looking at long term investment.” Barona also says that pension funds are playing a key role in investment in construction companies and that they often prefer pension funds because the leverage is higher and they are not as aggressive.

Araoz & Rueda Partner Guillermo Yuste thinks the funds will be here for the long term. He says: “Who would know a few years ago that companies would borrow money from funds? But we were forced to accept the new players in the market, and now that borrowers are getting used to them, they provide an alternative which is likely to stay.”

Unfair reputation

With regard to legal fees, funds have a different perception than banks, says one Madrid-based partner. “The legal fees we charge are peanuts to them [funds] whereas banks are cutting costs – the distressed debt guys are better payers,” he says. Another banking partner argues that many of the new funds entering the market are receiving bad publicity, sometimes unfairly. “There is a wide spectrum of funds – they are not all opportunistic institutions, there is another type of player that is here to create value – they are concerned about more than money and have concerns about legal and reputational risk.” But the view of Javier Menchén, a Partner in Ramón y Cajal Abogados, is that funds are investing in Spain to make quick profits.

“Funds are taking an important place in today’s market – they know the situation in the Spanish market and are trying to get significant profits fast.”

Francisco José Bauzá, Head of Baker & McKenzie´s Madrid banking and finance practice, says the fact traditional bank lending continues to be constrained by tighter regulations, increased capital requirements and a more conservative approach to risk has opened up “significant business opportunities for alternative sources of credit”. Bauzá says Spanish banks, whose loan defaults forced Spain to negotiate a European bailout in 2012, have since been able to sell assets and reduce their level of exposure to the troubled real estate loans by 75 percent. He adds: “Many foreign investment funds, especially from the US, are actively participating in several sales involving Spanish real estate assets – including residential portfolios, non-performing loans, real estate loans, social housing, asset management divisions of Spanish banks, and office portfolios in sale and leaseback transactions.” José Bauzá says that, in addition, sovereign wealth funds from the Middle East, Norway, Singapore and China are also investing in Spain, especially in Spanish companies that have a strong presence in Latin America.

The establishment of the Alternative Fixed Income Market (known as MARF) has also created optimism. Xavier Foz, Partner at Roca Junyent, says MARF has raised expectations and is anticipated to be a success because investors that are “reluctant to invest in SME equity may be keener to invest in fixed income securities of medium-sized companies to diversify their portfolios”. However, Foz does add a caveat when he points out that, although it has been operating since last October, there has been one issuance on MARF.

Meanwhile, Úrsula García Giménez, Senior Manager at Deloitte Abogados, says the regulation implementing the Alternative Investment Fund Managers Directive (AIFMD) in Spain will create new private equity vehicles aimed at providing financing to SMEs.

With regard to infrastructure finance, Foz highlights the use in Spain of the Europe 2020 Project Bond Initiative developed by the European Investment Bank and the European Commission. The first project to benefit was the €1.7bn Castor underground gas storage plant off Spain’s Mediterranean coast.

“This initiative relies on public funds to improve the access of constructors to credit for the financing of large scale projects,” Foz says.

In addition, the development of several platforms for finance intermediation via internet platforms is notable, according to Foz. “Besides those operating under the common

schemes of crowdfunding or crowdlending, Spain has witnessed the appearance of operators that compete with financial entities in other traditional banking fields such as FX trading (Kantox) or discount of promissory notes or receivables (Finanzarel).” Fox adds that, while all the aforementioned alternative sources are intended to complement, rather than replace the banks – at least in the short to medium term – they may have beneficial consequences by reducing the dependency of Spanish companies on bank financing (which currently represents more than 80 percent of their total financial resources) and making the financial system itself more sustainable.

Meanwhile, Ashurst Partner Manuel López says that while crowdfunding may be unregulated at the moment, this could be about to change. “The Spanish Government has recently announced draft legislation that could be approved in 2014.”

Other significant developments include the amendments to the Spanish insolvency law, which have the objective of making refinancing agreements more efficient in order to help reduce the financial burden on, and deleverage, businesses that could potentially be viable, while respecting the expectations of the creditors who are encouraged to take an active part in processes aimed at turning companies around.

“These changes are massive,” says Freshfields Bruckhaus Deringer Partner, Ana López. “It´s a very powerful tool that should enhance the ability of parties to reach refinancing agreements.” Lawyers also say that the change to the insolvency law is good news for finance and restructuring lawyers as it will give them more room to manoeuvre while enabling them to do restructuring work without litigators. However, there are concerns that the new rules cast doubts over which party – either the bank or the company being rescued – will pay the legal fees incurred. “This could be a real problem,” says one banking partner.

Portugal: bailout exit

From Portugal´s perspective, Maria João Ricou, Managing Partner at Cuatrecasas, Gonçalves Pereira says the three-year financial stability programme approved for Portugal and executed under the supervision of the IMF, the EU and the ECB will be concluded on May 17th, 2014 and, at this stage, there is a strong belief that it will be able to have a “clean” exit from the programme and avoid a “precautionary programme”. She adds that the successful conclusion of the programme, as well as growth in the majority of European countries, and the decrease in the interest rate of European countries´ sovereign debt are very positive, and point to the slow return of the Portuguese Republic, Portuguese banks and significant corporate entities to international markets and to traditional financing.

Ricou says the improvement in international financing conditions will increase the liquidity of Portuguese banks and consequently it will allow them to grant more financing to companies and individuals who will have access again to bank lending, export financing, and mortgage loans, for example. But she acknowledges there are still important challenges for the banking sector relating to: the deleveraging requirements; the increased capital ratios of Portuguese banks; the public recapitalisation plans implemented by several Portuguese banks; the implementation of

the EU banking union which is expected to take place by the end of the year; as well as the need for banks to prepare themselves for the scrutiny of the stress tests they will be facing.

Hugo Rosa Ferreira, Partner at PLMJ, draws parallels with Spain when he says Portugal has experienced a surge of fund-based financing, though he adds that most of the investment is directed at acquiring banking credits in distressed assets or the distressed assets themselves. He adds alternative sources of financing "will help the economy by providing funding to parts of the economy that have been denied bank financing due to tighter rules and liquidity problems, while hopefully reducing the excessively high share of traditional bank financing." However, Vítor Pereira das Neves, Partner at AAA Advogados, observes that "our clients still look to banks as their main source of financing – it is worth noting, however, that, as of late, our clients tend to prefer resorting to international banks rather than domestic ones". Abreu Advogados Partner Sofia Santos Machado agrees that the majority of companies continue to rely on bank loans "with the exception of large listed companies that have been able to resort to the bond market and place such bonds with retail/institutional investors".

In the last year, the increase in liquidity and confidence has meant banks are starting to grant some financing, though limited, and alternative sources of financing are starting to kick in, according to Nuno Azevedo Neves, Partner at ABBC. Though he adds that while there are signs of change, "there is still a long way to go".

Campos Ferreira Sá Carneiro & Associados Partner António Rocha Alves argues that Portuguese banks should not be solely blamed for the "perceived insufficiency" of bank lending. He adds that a number of Portuguese companies are highly leveraged and are not generating the returns required to repay debt and turn out a decent profit, or, worse, are declaring losses. Rocha Alves says that though the adjustment in the private sector is progressing at a good pace, the process is not complete and more financing and corporate reorganisations are required. Diogo Leónidas Rocha, a Lisbon-based Partner at Garrigues, says local subsidiaries of international groups are more actively participating in high-yield bond markets and this might lead to local companies tapping the market.

Sovereign wealth funds

Companies are relying more on other sources of financing such as sovereign wealth funds from Asia, the Middle East and Africa, says Raposo Bernardo, Head of Banking and Finance at Nelson Raposo Bernardo. He adds that these have been "excellent solutions as a replacement for traditional bank financing". Raposo Bernardo says that financing by sovereign wealth funds requires collaboration between the company and an external financier who is interested in the company's business, in supporting it and creating synergies. "This is something that traditional bank financing does not allow because the bank lends the money and then doesn't have any intervention in company activities," he says.

Vitor Marques da Cruz, Partner at Marques da Cruz e Associados, says that it is becoming easier for companies to get finance. However, he adds: "It is important to

remember that Portuguese banks have had, in January, and for the fourth month in a row, the lowest financing income from all the European Banks in the last two years." Marques da Cruz says the government is seeking to create and implement credit alternatives to stimulate both national production and families' expenditure. "Examples of this initiative are the creation of a programme to finance and support professional internships, in which the State contributes with up to 70 percent of the trainee's wage, along with other benefits – there is also the possibility of applying for special credit with State guarantee, in some situations, there are a lot of requests for Mutual Guarantee Credit Schemes," he says.

Marques da Cruz adds that alternative sources of financing have been designed and requested, such as factoring, leasing and renting, among others. "Creation of capital investment companies, start-up financing lines for projects subject to contest and, of course, the division of the capital into shares to enter into the stock exchange market, are increasingly popular strategies in the last two years in Portugal."

"In cross-border financing, we note an increased appetite for IPOs and high yield bonds, which shows that investors are willing to take more risks, provided that they can get higher returns," says André Vasques Dias, Partner at Macedo Vitorino & Associados. "There is also an increasing interest in the equity and debt markets, as alternatives to more traditional bank financing - the recent changes to the rules on short term debt notes and the new tax rules, which are expected to be approved in 2014, will be a good incentive to this alternative source of financing."

Pedro Cardigos, Managing Partner of Cardigos, says: "We have seen more than ever, financing arrangements structured with embedded equity derivatives, which ultimately collateralise the loan which is materialised by an upfront bullet payment – in more straightforward transactions, financial pledges with rehypothecation features [where banks use, for their own purposes, assets that have been posted as collateral by their clients] have also been used to guarantee financing arrangements."

International and EU developments

European Union plans for all Eurozone banks to be regulated by the European Central Bank still lack clarity, according to one Madrid-based banking partner. He adds: "I´ve heard the European Central Bank wants national regulators to move to the ECB." He adds that this would be a good move because "you don´t want a new super regulator without the experience of regulating banks".

Meanwhile, according to Manuel Mingot, Partner at Broseta Abogados, the most important EU regulatory development that has impacted the Spanish market is one that was signed between Spain and the EU back in 2012, that is, the approval of the Memorandum of Understanding (MoU) on financial sector policy conditionality. He adds: "The MoU has resulted in the major banking recapitalisation of Group One and Group Two Spanish banks, subsequent mergers and concentration, a massive sale of distressed assets and non-performing loans and divestment from the banks' equity portfolios, attracting private equity houses, funds, institutional and investors generally."

With regard to Portugal´s EU bailout, Claudia Santos Cruz, Managing Partner of AVM Advogados, says that, under the terms of the loan, the government has lowered a budget deficit that was nearly 10 percent of gross domestic product in 2010 to under 5.5 percent in 2013. "Banks have been hard hit by the cuts, which have caused rising unemployment and falling consumption," she adds. "Recovery for Portuguese Banks has been tough, given how thin profit margins on lending have become. About 95 percent of outstanding home loans – which account for close to half of all bank credit in Portugal – are tied to the interbank Euribor rate, which has been cut to abnormally low levels over the past five years."

Rui Souto, associate at Pedro Raposo & Associados, says the Memorandum of Understanding between the Portuguese Government and the so-called "troika" – formed by the EU Commission, the European Central Bank and the IMF in 2011 – has been of paramount importance for the Portuguese market. "One of the main areas of concern of this document was the banking sector – the need to preserve the stability of the financial sector, the deleveraging of the banking sector, the strengthening of regulation and supervision, and the reinforcement of the Deposit Guarantee Fund – all these are objectives that are expressly provided in the Memorandum," Souto says. He adds that the need to close the Banco Português de Negócios (BPN) and streamline the state-owned Caixa Geral de Depósitos (CGD) have, given the size of these issues, had a great impact on the banking sector, as well as on public opinion. Meanwhile, Pedro Cassiano Santos, partner at Vieira de Almeida & Associados, says The CRR (Capital Requirements Regulation) and CRD IV (Capital Requirements Directive) are shaping the type of instruments bank will be using in their efforts to boost their capital.

Too many players

Souto adds that it is important not to forget that the implementation of Basel III continues. "All these factors, combined with the current economic crisis, have forced Portuguese banks to restructure and to adapt to a completely new reality – there were some lay-offs in some banks, but at the same time, banks are also trying to be more customer-focused and to diversify their range of services and products," he says. Souto predicts consolidation in the Portuguese banking market. "Currently there are maybe too many players in the market and almost all of them are going through some rough times – it will not be a surprise if some of them end up merging in the next couple of years."

Pedro Siza Vieira, Managing Partner of Linklaters´ Portugal practice, says Basel III – along with Capital Requirements Directive 4 – continues to place scrutiny on banks´ balance sheets and asset quality and subject them to periodic stress tests. This, along with plans for central regulation of European banks, has had an impact on the type of transactional work Linklaters is doing for banking and finance clients, Siza Vieira says.

However, a Madrid-based partner believes banks will ultimately find a way to work around Basel III. "They [banks] will change the rules, they will lean on the regulator, Basel III will not be there forever," he says. Meanwhile, Joaquín Sales, Partner at King & Wood Mallesons SJ Berwin argues that "history shows that banks are extremely

sophisticated institutions, which are able to find the crevices in regulations and develop products that take advantage of them".

Funds pay good fees

What are clients demanding from their banking and finance lawyers and what impact is this having on fees? "Often, to buy a ticket of distressed debt, funds need very quick advice on the assets and/or the facility to take advantage of a good opportunity, and even want that advice overnight" says Lillo. However, because funds need the advice very quickly, they are often not prepared to pay large fees, says one partner. "Because funds want the advice overnight, they are not willing to pay much money," he says.

However, another Madrid-based partner says the new players in the market ask their lawyers to work very hard and require tailor-made advice, and consequently they are "prepared to pay good fees".

Barona says that funds are keen to receive top legal advice in a very short timeframe including weekends. "They are less concerned with the fees and sometimes they even rather prefer to pay hourly rates," he says. "In this regard working for funds tend to be more rewarding for law firms although they are also more demanding."

Madalena Pizarro, Head of the Banking and Financing at CCA-Ontier, says clients continue to seek advice on refinancing and restructurings, considering that banks are still reluctant to lend money. She adds: "The truth is that not much money is going into the wider economy. The sale of banks´ assets, and in particular, non-performing loans, is still one of the key areas. Why? Not only do banks want to deleverage their balance sheets, but also, with regard to corporate loans, it allows buyers to try to control companies that are in a difficult financial situation. In some situations, the bank is not only the main creditor of such a company, but has even become its owner, which may lead to the sale of shares by the bank for a symbolic price, allowing the purchaser to obtain the effective control of such a company."

Ricardo Costa Macedo, Partner at Caiado Guerreiro, says clients are also asking for advice on transactions and projects involving the implementation of electronic pre-paid cards, e-money, the incorporation of foreign-owned subsidiaries in Portugal to provide factoring services, issuance of bonds and convertible bonds, registration of securities with the Portuguese authorities and financial restructuring assistance. He adds: "Clients are mainly worried about the stability of the market and the difficulties in accessing capital to fund their investments and request advice in order to find alternatives that best suit their investment needs."

Meanwhile, BDO Abogados Legal Department Director, Álvaro Marco, says US and Asian clients are seeking advice on mergers and acquisitions with a view to purchasing industrial companies because they understand that Spain offers good industrial prospects in addition to real estate and tourism.

Lacking confidence

Mafalda Barreto, Partner at Gómez-Acebo & Pombo, argues that the market trends have not changed and that insolvency issues are still the key area clients seek advice on. “Despite a sense that the economy is on the path to recovery, players are still very uncertain and unconfident about the future,” she says. “Additionally, the fact that most of the deals are in some way related to restructuring makes tailor-made insolvency advice essential – all scenarios have to be carefully forecasted and considered when modelling investments. The age of commoditised work is over and has been replaced by a constant need for qualified and experienced senior advice.”

Alexandre Jardim, Partner at Pbbr (Pedro Pinto, Bessa Monteiro, Branco, Reis, Alexandre Jardim & Associados), says that clients are mainly seeking advice on credit restructuring and credit assignment agreements. He adds that clients are also asking for advice on credit recovery and collection procedures (foreclosure and insolvency), as well as on judicial restructuring processes. Meanwhile, Jardim says banks need advice also on the disposal of non-core assets. He adds: “Most recently, we have seen Portuguese banks setting up acquisition finance or capex financing to Portuguese companies that are engaged in other markets, mainly Angola and Brazil.” Jardim also says that private equity clients are asking for advice on transactions involving real estate and companies that are exposed to markets in Brazil, Asia and Europe. Gustavo Ordonhas Oliveira, partner at SRS Advogados, notes that international funds are showing an increasing interest in prime real estate, in particular assets in the commercial, retail and logistics sectors. While Uría Menéndez-Proença de Carvalho, partner Pedro Ferreira Malaquias says his firm´s clients are seeking advice on secondary sales “driven by the need to deleverage balance sheets in anticipation of Basel III requirements and the need to raise cash”.

So, what does the future hold? With funds circling across Iberia as they sense an opportunity to plug a gap left by the reluctance of banks to lend, there is optimism that new lending platforms could emerge to offer much needed finance for struggling companies. However, how long the funds will remain interested is open to question, and there is a fear that they could, in time, turn their attention away from Spain and Portugal and direct it elsewhere, possibly towards Asia. But while the funds remain, lawyers say there is an opportunity to earn bigger fees than that paid by cost-cutting banks.