REAL ESTATE & PROJECT FINANCE REPORT 2010: CHANGING FORTUNES - THE SLOWDOWN IN IBERIA'S REAL ESTATE MARKET

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There is little doubt that the construction boom that has helped underpin Spain's economic growth over the past decade is coming to an end, say lawyers - with the housing sector most affected. The issue is how will this play out in the market and will the same reversal spread to Portugal. But where some see trouble others see opportunity, with an expectation of increasing sector M&A and even an upturn in private equity interest

There is little doubt that the construction and real estate boom that has helped drive the dynamism of the Spanish economy over the past decade is coming to an end, say Iberia's lawyers. The consensus is that Spain's housing sector is the worst affected, with the coastal second home market suffering the most.

The issue is how will this affect the wider market, and will the same reversal of fortunes experienced in Spain be replicated in Portugal, where it continues to play an equally significant role in the country's economic well-being.

Optimism

Despite the evident decline in the Spanish real estate market there nonetheless remains a measured degree of optimism among real estate lawyers within Spanish law firms. There is strong demand for office and retail property and an apparent increase in demand for logistics facilities, they say.

Lawyers highlight also the continuing flow of financing, refinancing and capital markets work – the end of the year will likely see the IPO of developer Tremón. While many are hoping to capitalise on the appetite for international expansion among the largest real estate players – Metrovacesa, for example, is now the owner of London's most expensive property following its €1.6bn acquisition of HSBC's Canary Wharf headquarters – others point to an apparent emerging trend for the sale and leaseback of property.

Iberian Lawyer research reveals therefore that many practice heads predict continuing practice growth, in excess of 10% over the coming year. In Portugal lawyers are however less optimistic, having a less diversified client base, and where the consensus is for growth of less than 10%.

Similar predictions are presented by those focusing on construction , although again there remains a band of lawyers on both sides of the border that go against the prevailing logic, and suggest continuing strong levels of growth.

Many developers have found themselves exposed and there is a scramble towards diversification both domestically and internationally, they say, with an upturn in demand for M&Aadvice, and even growing private equity interest.

Many of Spain's largest construction companies are clearly already well positioned in Central and Eastern Europe, where Ferrovial has acquired Poland's largest listed contractor Budimex, and Acciona is now the owner of another major Polish operator Mostosta.

Companies are also finding success in Asia and in the US, where Cintra has emerged as a major road concessions player.

The optimism in Portugal is influenced by the continuing promise of major PPP/PFI projects, but where a decision is still to be made on the Lisbon airport and fast-rail RAVE projects. Lawyers there nonetheless predict practice growth in excess of 10%, while a significant minority predict growth over 20%.

But with fewer big projects on the horizon lawyers in Spain are notably less confident. While PPP/PFI continues to keep firms busy the scale of projects is very much reduced. As Spain enters an election year there is a belief that this will change little in the short-term, and consequently many predict a flat year.

Planning delays

Among the issues highlighted by lawyers as having the most impact on the real estate market are the delays and frequent changes in government planning and administrative policy.

The issue is identified as the number one concern among Portuguese lawyers. 'Delays in decision-making are among the most important obstacles to real estate investors either Portuguese or foreign,' say António da Cunha Reis and Vitor Marques da Cruz at Lisbon's F. Castelo Branco & Associados.

'Bureaucracy and delay continue to be problems, and which need to be urgently addressed,' agrees Ricardo Campos at Barrocas Sarmento Neves. 'Clients are faced with an everincreasing number of regulations, which also does little to help ensure consistency of policy throughout the different regions of the country.'

The Portuguese government has sought to address the issue through legislative and administrative reforms, with the 'Simplex' program, but nonetheless lawyers highlight that large tracts of regional and municipal policy are under revision.

But the issue is not confined to Portugal. 'The weight of administrative bureaucracy and the time necessary to approve projects is a clear obstacle to investment and to the market being more lively,' says Ignacio Albiñana at Uría Menéndez. 'Players are, nevertheless, used to such a complex reality and development margins have to take into consideration such a risk pattern.'

Fellow partner Fernando Azofra highlights the scale of issues involved. 'It is not unusual that the start of a project may require authorisations and clearances from different administrative bodies that may be counted in the hundreds.'

Xavier Junquera, managing partner of Baker & McKenzie, also notes the negative impact of corruption. 'Due to several scandalous situations derived from political corruption in some southern Spanish City Halls, the licenses emission process in Spain has suffered several delays which are clearly affecting the real estate projects developed in Spain.'

Change is however coming, which presents clear opportunities, notes Juan Martínez Calvo, director of Deloitte's public law practice in Spain. 'The regions planning laws must now be adapted to the new 2007 state planning law, and the changes in regulation will offer new opportunities to sophisticated players in the real estate arena.'

Slowdown

The slowdown in construction volumes is affecting law firms practices on both sides of the border, although many lawyers emphasise that different business sectors are feeling the effects more than others.

'Construction in Spain has clearly slowed down as a result of the international credit squeeze,' says Albiñana at Uría Menéndez. 'However, hotel, retail and office space projects have not been hit as negatively as residential ones, while the PPP/PFI sector has proved immune to the downturn in the real estate cycle.'

Junquera at Baker & McKenzie in Barcelona highlights the correlation between the tougher financial conditions and deal size. 'As there is less external financing, projects will necessarily need to reduce in cost and volume.'

Significant, says Duarte Garin at Uría Menéndez in Lisbon, has been the effect of a drop in public investment and public works on construction levels in Portugal. 'What construction projects there are, are almost exclusively based on private projects.'

Private equity, sale and leaseback

Spanish lawyers are now seeing private equity companies take stakes in medium-size real estate companies, but some question whether such purchases are for long-term or for short-term gain, with an emerging trend for the sale and leaseback of property portfolios.

Despite the credit squeeze and the negative publicity surrounding the real estate market, real estate businesses remain a relatively lowrisk- market but with high entry prices, says Ignacio Albiñana at Uría Menéndez. 'Private equity houses have however fuelled the market by corporate divestiture, ie they buy an operating business and immediately sell the real estate portfolios.'

Santander is among those to have rediscovered the attraction of sale and leaseback transactions, and is close to selling off its entire portfolio of 1,200 branches, historic buildings and even its headquarters at Boadilla – for an estimated combined total of €4bn.

'Sale and leaseback operations may increase in 2008 as a result of companies not having easy access to external finance due to the effects of the credit crisis. This seems to be a trend, specially in a situation where cap rates keep on being compressed,' believes Fernando Azofra at Uría Menéndez.

Not so, says Emilio Gómez at Lovells. 'Many significant portfolios have already been put on the market, and therefore this will not have a significant impact over the next 12 months.'

'Since the conclusion of Portugal's highway programme, investment in infrastructure construction has decreased, particularly with the country's two biggest projects still on hold – the new Lisbon Airport and RAVE rail link,' explains Albano Sarmento at Barrocas Sarmento Neves. 'The commercial construction sector, with the exception of real estate, is in need of a boost in investment and new projects to recharge it.'

Nonetheless he remains optimistic. His firm is currently involved in one of the biggest construction projects currently underway in Portugal, the 63MW Moura Photovoltaic Project, which will be the biggest solar plant in the world. Others are even more optimistic, 'In our opinion, so far there is no downturn in the Portuguese real estate and construction market,' says Frederico Pereira Coutinho at GPCB, who points to the continued strong demand for tourism developments.

Falling values

Despite the relative drop in construction levels, and the significant fall in demand for new housing, lawyers nonetheless state that in most instances deal values remain high.

'We do not expect a significant fall in deal values since the tendency is that the big transactions will remain just as attractive as they have been over the past 12 months,' says Emilio Goméz at Lovells.

'With the exception of some sub-sectors, such as coastal residential developments, we have not yet seen real estate values fall,' agrees Victor Casarrubios at Jones Day in Madrid. 'But this may yet happen if the sub-prime crisis goes from a crisis in confidence to a crisis in value.'

Any significant fall in values will inevitably raise the ratio of transaction costs to profits in the PPP/PFI market also, believes Carlos de Cárdenas at Uría Menéndez.

'In recent years we have seen some efforts to tackle this problem, including batching together homogenous projects to spread the transaction costs among a variety of small, non-complex projects. But the outcome has been inconclusive and it is yet to be seen whether this can be effectively implemented in sectors that are more heavily regulated by different administrations, for instance, municipal schools, hospitals or libraries.'

The issue in Portugal is conversely one of rising prices and deal values note António da Cunha Reis and Vitor Marques da Cruz at F Castelo Branco.

Miguel Marques dos Santos at Garrigues in Portugal agrees. 'The fact is that up until now we have experienced a clear growth in the volume and value of transactions in which we have been involved. The sub-prime crises will have an effect on the Portuguese market, but the important transactions will continue to occur.'

But rising prices can also have a negative impact suggest some, prompting investors to look to new markets. 'Spanish real estate investors are becoming increasingly sophisticated and, accordingly, more demanding in respect of the legal advice they require. Real estate companies are increasingly looking towards international markets, and traditional 'real estate law' advice is simply not sufficient nowadays,' says Lourdes Ayala at Araoz & Rueda.

The negative effect has also been seen in a drop in inbound investment, notes Junquera at Baker & McKenzie. 'The impact of annual property price increases of around 15% coupled with less attractive financial rates has provoked an important decrease of foreign investment in the real estate market in Spain.'

The view from Portugal is however that despite some increases in development costs, notably VAT, prices still have some way to go and this is attracting new players to the market.

'Institutional investors are moving into real estate and construction, which is creating a need for more sophisticated legal advice and close attention to the legal assistance,' says Nuno Sá Carvalho at GPCB.

Credit crunch

The potential recovery of the real estate market, particularly in Spain, will ultimately depend on the confidence of the finance sector believe many lawyers. While many applaud the ability of Spain's leading lenders to have avoided the subprime market, the prevailing sentiment across the finance and banking sector will ensure however that there will continue to be a very tight hold of the purse strings for the foreseeable future.

One notable impact of the global credit crunch, says Emilio Gómez at Lovells 'Has been the shift in the balance of power between borrowers and lenders; with the lenders now having more bargaining power.'

Another inevitable result believes Carlos de Cárdenas at Uría Menéndez is a flight to quality from over-hot sectors (such as residential). 'Money will pour into financial products, such as PPP/PFI related assets, which are backed by investment grade payment streams. The Spanish PPP/PFI market offers a huge variety of sectors and an assorted range of risk transfer to the private sector.'

Of increasing significance now say some, is the overdue implementation of Spain's Transport Infrastructure Program (PEIT). The central government's proposed €242 billion investment in roads and rail over 2005-2020, 40% of which is to be financed through PPP/PFI.

'We are at an uncertain stage as regards the real importance of the global financial crisis and of the national real estate crisis,' says Luis Zurera of Perez-Llorca. 'Clients are initiating the negotiation of fewer transactions and are not certain that they will conclude them. Despite this, what they all have in common is that in a few months there will be good purchase opportunities for which they are still waiting.'

Changing relations

The changing face of Iberia's real estate sector is also having an impact of law firms relations with clients. Anotable trend, says Rafael Truan at Díaz-Bastien & Truan Abogados is clients increasing emphasis on specialisation.

'We have been noticing that clients place more emphasis on values like credibility and quality, when electing law firms to provide advice on complex transactions rather than the price of legal fees,' agrees Clifford Chance partner Carlos Portocarrero.

'Clients are increasingly demanding, first because of the fees limitation and, second and more significant, for the quality and safety level they claim in legal services,' agrees Xavier Serramalera, partner at Roca Junyent.

Fernando Igartua at Gómez-Acebo & Pombo accepts there is increased fee pressure, but also more intervention by clients at the preliminary stages of deals notably in PPP/PFI.

'Additionally there is a more formal approach to law firm selection, which is to be welcomed,' he says.

But some firms are unhappy with rising fee pressures. 'Some of the Anglo-Saxon law firms that have started to operate real estate and construction practices over the past few years seem to be more interested in working on large transactions than in being profitable,' says one partner at a leading Spanish practice.

Many of the same general trends are also to be seen in Portugal, say lawyers, where clients are becoming increasingly sophisticated and demanding more certainty in terms of costs, including fixed fee solutions. Also significant say some has been the introduction of stricter public procurement rules by the public sector.

'Clients are being more selective in their projects and are increasingly averse to risk. Also there is a higher fee control, notably when the work involves due diligence,' says Paulo Trindade Costa at Miranda.

Others however state that it remains business as usual. 'In most cases, clients are seeking law firms which have the appropriate skills, experience, team and focus for its transactions,' says Pereira Coutinho at GPCB.

'Our clients, who are mostly international clients, have maintained the normal fee pressure. They obviously want value for money but we may not say that we have felt any difference in relation to what happened before,' says Marques dos Santos at Garrigues.

Diversification

Whatever affects the Spanish market will inevitably also affect Portugal, states Rui Peixoto Duarte at Abreu Advogados. Likely therefore say many, will be another upturn in interest among Spanish, and other international investors for Portuguese real estate assets.

'Our experience is that retail properties continue to represent an interesting product to investors, but we are also now experiencing an increase in the area of tourism developments,' says Pedro Sáragga Leal at PLMJ.

In addition Portugal has also seen over the last few years significant legislative amendments intended to reinvigorate its lease market and increase investor interest in its older properties.

But Portugal is not the only destination for Spain's real estate players. An increasing number are looking to Central and Eastern Europe – and taking their lawyers with them – while others are looking towards the Middle East, Turkey and China. Portuguese players themselves are now also looking towards the Middle East and Africa.

'Risk diversification, in markets and jurisdictions, will define the successful business strategies for the next 12 months,' believes Emilio Gómez at Lovells.

'For a while we shall see fewer highlyleveraged real estate transactions due to lack of liquidity in the financial markets. On the other hand, investors who have equity will find better opportunities for attractive deals and less competition in a market where, during the years of the 'property boom', all of the real estate players – investors and developers – were fighting for the same product,' says Victoria Llavero at Gómez- Acebo & Pombo.

The general belief among Iberia's lawyers is therefore that the over-heated Spanish housing market was probably due for a correction, which has come.

So long as confidence remains sufficiently high in the sovereign-level debt that underpins Spain's burgeoning (and Portugal's emerging) PPP/PFI sectors, and there is no wider corporate decline, then the market as a whole should remain buoyant.

And if only governments would adopt some Keynesian interference, and finally approve the landmark Lisbon airport and RAVE rail link, and in Spain the PEIT, then Iberia's real estate and construction sectors could once again be back on a high.