SPECTRUM
Asset Management

Spanish Banks Are Fundamentally Sound, But Not *Banco Popular*

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Uncertainty about distressed Spanish bank Banco Popular (POP) has also led to concern about Spain's banking system.

POP's common shares have been in steady decline since the beginning of the global financial crisis (GFC) in 2007. In the past five years the shares have plummeted more than 90% in value. More recently, the shares have further languished due to POP's low capital (current common equity tier 1 ratio is ~7.3%), weak asset quality/reserve coverage and liquidity problems. Management is exploring options to get the bank back on track through non-core asset sales and/or a capital raise, as well as a potential acquisition by a stronger Spanish bank. However, while organic sales could help to de-risk the bank, it is doubtful POP would be able to issue new equity. POP's positives include the bank's strong brand recognition and domestic market share, particularly in profitable small and medium-sized enterprises, as well as a high share of deposit funding. Most potential acquirors have thus far declined to pursue a merger, leaving Banco Santander (SAN) as the only viable bank that may be interested in rescuing POP. Without an imminent clear executable strategy, POP is facing a possible "bail-in" under European bank resolution rules.

Unlike POP, the Spanish banking system has been exhibiting good profitability, benefitting from lower loss provisions due to reduced credit costs. We believe the banking system of Spain is fundamentally sound given an improved operating environment supported by good economic growth. Since Europe exited recession in early 2013, Spain's economy has outpaced that of its Euro and EU members owing to an increase in exports, private consumption and investment. Spain's real GDP is close to pre-GFC levels. While Spain's labor market remains weak with unemployment of 18% (second highest in Europe whose average is ~8%), this has improved markedly from recessionary highs of some 26%.

POP's two additional tier one (AT1) contingent convertible capital securities (CoCos) could be the first CoCo securities to experience a coupon stoppage — payments are due in July for the 8.25s and 11.5s — and/or equity conversion given the bank's pressing solvency needs. *Spectrum notes that POP's weakened credit profile is the prime catalyst for any potential AT1 impairment, rather than from structural risks in CoCos.* CoCos were designed by European regulators as loss absorption, Basel III compliant instruments to support a bank and its senior debt holders and depositors. **In our opinion, CoCos issued by financials with solid credit fundamentals are among the most attractive structures in the investable preferred securities universe.**

Banco Popular is an isolated credit problem, not a Spanish banking problem. The bank's solvency and asset quality issues have been long-standing. **Spectrum has never owned any investments in Banco Popular.**

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