COMMENTARY

October 16, 2009

Dear clients and colleagues,

Spain

Although Spain was among the countries that were hit the hardest by the global recession, we are still convinced there are good investment opportunities to be found in that market. We recently met with the management team of twelve Spanish companies we had been monitoring. Overall, their outlook is rather positive. Here is a quick review of these on-site visits.

Despite some signs of economic improvement, Spain may take longer to emerge from what is now its worst recession in 60 years. While experts expect the majority of economies to post positive real GDP growth next year, Spain may see a return to positive GDP only in 2011. During many years the country failed to diversify its economy, which was excessively exposed to the construction sector. From 1997 to 2007, the size of Spain's construction sector accounted for 19% of its GDP, twice Europe's 10%. During several years, residential construction was running at an annual pace of 800,000 homes, twice its sustainable demand. This real estate bubble has left Spain with an inventory of more than one million homes, which should take about three years to be absorbed by the market.

On the banking side, unlike its U.S. counterpart, a stricter regulation from the Spanish central bank has prevented financial institutions to invest massively in risky assets. Until today, the main issue with banks has been liquidity, not solvency, although the liquidity deficit causes credit restrictions and the increase of unemployment is pushing up default levels. Bad loans to total credit rose to 4.9% in August. With an unemployment rate that is likely to soar to more than 20%, the bad/loan ratio could easily exceed 8% going into 2010.

As we have mentioned before, our value added lies in our ability to select undervalued companies that can exceed the average industry return. We understand the path to recovery in Spain will take time, but we feel like there is a fair amount of good companies to be considered. We believe companies that are taking steps to expand their international presence should be better positioned to experience strong sales growth in the coming years. And since there is a strong cultural fit, Spanish companies tapping into Latin America are sometimes more efficient than other international players expanding into this region. With the increasing importance of Brazil in the global economy, we are pleased to see many Spanish companies taking full advantage of the growth opportunity Latin America has to offer.

We have not changed our view regarding our two Spanish holding: Prosegur & Baron de Ley. We remain very positive on those names.

Regards,
The Global Alpha Team