

SPANISH EQUITIES

Surprise, Surprise

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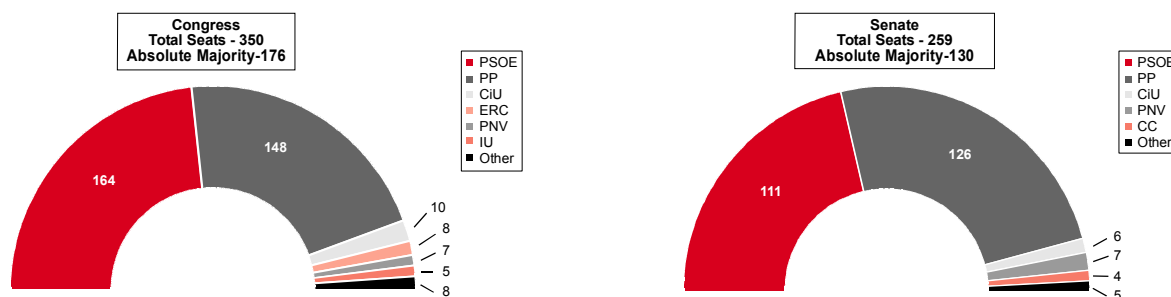
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**Spanish Equity
Research Team**

- **Two specific issues have shocked the Spanish equity market over the past week.** The tragic terrorist attacks in Madrid and the surprise victory of the Socialist party (PSOE) in the March 14 elections have taken their toll with a 10% slump in three sessions. Although the Spanish market has started to rebound, the equity risk premium of the Spanish market might remain high in the coming two months until the new government is formed and the main guidelines of its four-year tenure are outlined.
- **PSOE sends a message of stability.** The day after the elections, the PSOE sent a market-friendly message to allay the market's traditional fear of socialist governments. The PSOE promised: little intervention in the economy and in private companies; liberalisation of regulated sectors; fiscal austerity and maintenance of a balanced budget; stronger international relations (particularly with other EU members); labour reform; tax reforms without increasing fiscal pressures; and an open-minded approach to business consolidation.
- **We maintain a cautious view on the Spanish market.** The new government (as any new unknown government) will have to deliver on its market-friendly promises and build up market confidence. In electric utilities, we like companies with low exposure to the domestic regulated business like **Unión Fenosa**, 'green' players like **Gamesa** and **Abengoa** and we are encouraged by the growth profile of **Aguas de Barcelona**. We also like **Repsol YPF**. In telecoms, the lowest regulatory risk should be found in **Telefónica Móviles** and in the construction sector, we prefer the international diversification of **Ferrovial** and the defensive nature of **Acciona**. Metal stocks linked to international markets like **Ence**, **Arcelor** and **Acerinox** should also attract attention. The improving Spanish advertising market and potentially positive regulatory changes might benefit **Prisa** and **Sogecable** and stocks like **TPI** and **Recoletos**, with their high dividend yield, could also be good options.

Results of Spanish 2004 Elections – Congress and Senate



Source: Ministry of the Interior.



SURPRISE, SURPRISE

THE RESULTS

PSOE planning to govern without formal coalition

Contradicting the pre-election polls, the PP (conservative party) was punished in the general elections, and the PSOE will form a new government in early April. It is worthwhile highlighting here that given the distribution of seats in Congress, if the PP votes against the PSOE's proposals, the socialists will need the support of at least two other parties to push legislation through. The PSOE has said it does not plan to seek a formal coalition with other parties and will form a single-party government. It will seek support on specific issues from other forces on a case-by-case basis. The PSOE will most likely look for support from the two left wing parties, ERC and IU, with whom it forms a coalition in the Catalan government. Other parties (the Catalan conservative group, CiU and the conservatives from the Canary islands, CC) are open to reaching agreements on specific issues, giving the PSOE a more conservative alternative. Also, PP support on key issues regarding national security and national unity should not be ruled out.

Figure 1. Distribution of Power in Congress after 2004 Elections Versus 2000 Elections

| Party | Political Description | March 2004 | | March 2000 | | Difference | |
|-------|-----------------------|------------|---------|------------|---------|------------|---------|
| | | MPs | % Votes | MPs | % Votes | MPs | % Votes |
| PSOE | Socialist | 164 | 42.64 | 125 | 34.16 | 39 | 8.48 |
| PP | Conservative | 148 | 37.64 | 183 | 44.52 | -35 | -6.88 |
| CiU | Catalan conservatives | 10 | 3.24 | 15 | 4.19 | -5 | -0.95 |
| ERC | Catalan left-wing | 8 | 2.54 | 1 | 0.84 | 7 | 1.70 |
| PNV | Basque conservatives | 7 | 1.63 | 7 | 1.53 | 0 | 0.10 |
| IU | Left-wing coalition | 5 | 4.96 | 8 | 5.45 | -3 | -0.49 |
| Other | | 8 | 7.31 | 11 | 9.31 | -3 | -2.00 |

Source: Ministry of Internal Affairs

PSOE: A RENEWED ALTERNATIVE

In the past four years, the PSOE has renewed its ranks under the leadership of José Luis Rodríguez Zapatero. Since the disastrous results in the 2000 general elections, which the PP won with an absolute majority, the PSOE has been able to regenerate and present itself as a credible alternative. However, there is still a great deal of uncertainty in several areas, which we discuss below.

Politics and Government

The new parliament will be constituted on April 2 and the voting to appoint Mr Rodríguez Zapatero as the new prime minister will probably take place in late April. The formation of a new government will follow and Mr Rodríguez Zapatero has pledged to have an equal number of male and female members in his cabinet. The make-up of the new government will be based on two or three vice-presidents (VPs, overseeing social affairs, economic affairs and policy) and 16 ministries that will report to the VPs. The current ministries of Economy and the Treasury may be merged and the Ministry of Science and Technology could be combined with that of Education. The Ministry of Industry could be revived and the Ministry of the Interior will probably be transformed into a Ministry of Security.



Figure 2. Timetable for Formation of a New Government

| Date | Event |
|-------------------------|--|
| March 30 | Official results published in the BOE. |
| April 2 | Constitution of parliament. Election of presidents of Congress (probably Manuel Marín) and Senate. |
| Following two weeks | Political leaders meet the King. |
| Last two weeks of April | Parliamentary vote on Rodríguez Zapatero's candidacy for prime minister. In the first round, an absolute majority is required (176 MPs); in the second, a simple majority is sufficient. |

(*): *Boletín Oficial del Estado*, the official State gazette.
Source: Expansión.

Apart from the cabinet changes, the PSOE will probably also replace about 80 politically-appointed positions in the different ministries. The management teams of the State TV and radio (RTVE and RNE) are likely to be changed, as will the Attorney General and two members of the Constitutional Court. The new government aims to strengthen the power of some regulators, although the mandate of some of their top managers is not due for renewal in the short run: Bank of Spain (mandate ends July 2006), Anti-trust Court (October 2005), telecommunications watchdog (December 2008), energy watchdog (April 2005) and Spanish financial markets regulator, the CNMV (October 2004).

Figure 3. Main Candidates for Key Positions in the PSOE Government

| Candidate | Ministry | Former Position | Profile |
|------------------------|------------------------------------|--|----------------------------------|
| Miguel Sebastián | DPM/M Economy | Professor and chief economist at financial institution | Independent, technocrat |
| Jesús Caldera | VP Policy | PSOE speaker in Congress | Zapatero's right-hand man |
| Micaela Navarro | DPM/M Social Affairs | | |
| Trinidad Jimenez | DPM/M Social Affairs | Candidate for Mayor of Madrid | |
| José Bono | M Defence | President of Castilla-La Mancha autonomous region | Charismatic, moderate politician |
| Miguel Angel Moratinos | M Foreign Affairs | Diplomat | Expert on Arab countries |
| José Antonio Alonso | M Justice | Judge | |
| Carmen Calvo | M Culture | Head of culture in Andalusian autonomous region | |
| Mercedes Cabrera | M Education | University professor | |
| María Jesús Sansegundo | M Education | University professor | |
| Fernando Moraleda | M Agriculture | General secretary of the agriculture association | |
| Antonio Gutiérrez | M Labour | Trade union leader | |
| Magdalena Alvarez | M Economy or Public Administration | Head of economy for Andalusian autonomous region | |
| Cristina Narbona | M Environment | Member of the last PSOE government | |
| José Segura | M Infrastructure | | |
| Jordi Sevilla | M Labour | Speaker for economic affairs in Congress | |

(*) DPM = deputy prime minister; M = minister.
Source: El País, Expansión and Cinco Días.

Lack of experience

The new government will have limited management experience, except for certain ministerial candidates that are currently in the government of some autonomous regions (eg, Mr José Bono, president of the Castilla-La Mancha region).

The new PSOE government will have to deal with some key issues on the domestic front: (1) the change in the degree of autonomy of some regions; (2) changes in the economic framework of some regions; and (3) reform of the Senate, the Anti-trust Court and other official government bodies.

The PSOE will also have to deal with key issues in the international arena: (1) the future of the European Constitution (blocked by the former PP government because it would eliminate the blocking minority rights conceded to Spain in Nice); (2) the renegotiation of EU structural funds for Spain in 2007-13; (3) the relationship with the US; (4) the withdrawal of Spanish troops from Iraq; and (5) the negotiation of the EU Emissions Trading Scheme (ETS).

Economic and Fiscal Policy

Revolutionary fiscal reform

The PSOE has undertaken to carry out a revolutionary fiscal reform, which includes a flat 30% personal income tax rate (versus the current five tranches, the lowest being 18% and the highest 45%) and a reduction in the corporate tax rate from 35% to 30%. Also, most of the current exemptions and deductions are to be eliminated, particularly the deduction for home purchases by individuals, the reduced tax rate on capital gains for individuals (currently at 15%) and the tax deductibility of goodwill for companies.

Public spending and economic intervention

The market's fear that socialist governments tend to increase public spending sharply and to take a more interventionist approach to the economy has been addressed by the PSOE, which has pledged to maintain fiscal austerity (without increasing fiscal pressure) and to keep a balanced budget (in aggregate throughout its four-year term). The PSOE has also stated that it intends to avoid interfering in the economy. For example, the concerns voiced by the market regarding the replacement of the management teams at former state-owned companies – appointed by the PP before the privatisation process ended – have been placated by the PSOE, which has called for stability. On the other hand, the PSOE has already stated that it will not block M&A activity in Spain (specifically, the PSOE stated that it would have allowed the Gas Natural-Iberdrola deal).

In terms of public spending, it seems that the new government will be inclined to raise the budget for education, social security and healthcare and reduce contributions to the defence budget.

Labour market reform

Another issue will be the reform of the labour market in order to increase the quality of employment and to reduce unemployment without reducing the cost of layoffs. In this connection, some companies undergoing restructuring (Altadis, ACS, Telefónica and Ebro Puleva) might be negatively affected. Linked to the fostering of employment in Spain, the PSOE could protect SMEs by toughening the conditions for opening new shopping malls in Spain.



Figure 4. Main Points of the PSOE's Economic and Fiscal Programme

| Issues | PSOE |
|-------------------------------------|--|
| Personal taxes | <ul style="list-style-type: none"> Flat 30% tax rate, with two tax brackets initially (top tax rate to be held the current 40%), to be reduced to just one bracket in the future vs the current five. Tax exempt portion of income to be raised to €10,000 per year (plus €3,000 per child). Personal tax deductions to be eliminated (pension funds, home purchases, etc). No tax on redemption of pension funds. Lower net worth taxes. Elimination of inheritance tax for low-and medium-income levels. Indexation of tax exemptions to CPI. |
| Corporate taxes | <ul style="list-style-type: none"> Corporate tax rate cut to 30% from 35%. Corporate tax deductions to be eliminated. |
| Capital gains taxes and other items | <ul style="list-style-type: none"> Taxes on capital gains to be raised to 30% from 15%. Elimination of deductions for pension fund contributions. Change in taxation on some mutual funds (SIMCAVs, variable capital security investment companies). |
| Special taxes | <ul style="list-style-type: none"> Higher taxes on tobacco and alcohol. |
| Budget stability | <ul style="list-style-type: none"> Key (no changes expected). No increases in public outlays as a percentage of GDP |
| Productivity | <ul style="list-style-type: none"> Incentives and policies to raise productivity to 1.5% from the current 0.5% over four years. |
| M&A activity | <ul style="list-style-type: none"> No impediments to M&A activity among Spanish companies. |
| S&Ls | <ul style="list-style-type: none"> No specific messages on transparency and independence. |
| Liberalisation processes | <ul style="list-style-type: none"> Greater liberalisation in sectors like utilities, gas, telecoms, healthcare (pharmaceuticals) and commercial distribution. |
| Families | <ul style="list-style-type: none"> Sliding scale of increasing deductions for children. |
| Housing | <ul style="list-style-type: none"> End of personal income tax deductions for house purchases (this measure could be postponed). Creation of a State agency to promote rentals. Optimisation of rental market efficiency. Liberalisation of land and 25% of new land to build devoted to State-subsidised housing (VPO). |
| Infrastructure | <ul style="list-style-type: none"> No change in form of financing (public + private). |
| Pensions | <ul style="list-style-type: none"> Lowest pensions to be raised by 26% over four years. |
| Labour market | <ul style="list-style-type: none"> Reform of law on temporary employment. Reform of State job centre system. Minimum wage to be raised to €600/month from €460.50/month. |
| Tax collection agencies | <ul style="list-style-type: none"> Creation of tax collection agencies for each of the 17 autonomous communities, coordinated by a central agency. |
| Energy | <ul style="list-style-type: none"> Nuclear energy to be phased out over 20 years. |
| VAT | <ul style="list-style-type: none"> VAT on foodstuffs to be cut to 4% from the current 7%. VAT on 'cultural items' (eg, newspapers, books, magazines, etc) to be cut to 1%. |

Source: PP, PSOE, *Expansión* and *Cinco Días*.

IMPACT ON SECTORS

Regulation, management changes and terrorist fears

In principle, any change in government brings uncertainty about the potential negative impact on regulated sectors. In particular, the PSOE has stated that it is willing to increase competition in regulated sectors, create strong sector agencies and foster M&A activity. This, coupled with fears of management changes in former State-owned companies (like Telefónica, Repsol YPF, Endesa, BBVA and Altadis), should increase the Spanish market's risk premium due to the high weighting of regulated sectors. Adding more pressure on the Spanish market, the terrorist attacks carried out on March 11 increased the doubts about the impact on Spain's all-important tourism industry.

Telecoms

**We prefer
T.Móviles in
telecoms**

The PSOE programme needs to be clarified, as it currently includes vague ambitions like increasing competition, fostering investment by companies, developing the cable industry, etc. In particular, the regulated part of Telefónica's business (fixed telephony in Spain) could be impacted on two fronts: (1) a reduction in the monthly fee (and/or cancellation of the 4% increase approved last year and not yet implemented); and (2) a reduction in the ADSL wholesale price and in termination rates (which would affect Telefónica Móviles). Other potential negative impacts could arise from the ongoing restructuring at Telefónica de España, changes in Telefónica's management team and the tax deductibility of the recent acquisition of Bellsouth's mobile assets in Latin America.

Utilities/Energy

**Play Aguas de
Barcelona,
Gamesa, Abengoa
and U. Fenosa**

Electric utilities could suffer from the implementation of the Kyoto protocol in the EU. As Spain is likely to overshoot the emission targets for 2010 by about 25%, it will have to buy green certificates in the EU Emission Trading Scheme (ETS). The PSOE has committed to submitting the National Allocation Plan (NAP), distributing green certificates, to Brussels as soon as possible. Nevertheless, the new government will ask for a delay in the submission deadline, and will try to broker a solution with the rest of the political parties and the companies involved in order to spread the cost of covering the shortfall in its emissions-reduction target. Moreover, although the PSOE had previously stated that it would phase out Spain's nuclear plants over the next twenty years (about 25% of Spain's current generation capacity), since the elections it has said that it expects new technologies to permit the closure of these plants by that date, otherwise nuclear energy will continue to be used for a time. The PSOE's programme clearly promotes green energy (very positive for Gamesa and Abengoa), which should also be reinforced by the recently approved renewable energy bill. Considering these issues and possible management reshuffles at formerly State-owned companies, we would prefer Iberdrola to Endesa in the short term. The incoming government's positive stance on M&A activity in the sector should increase speculation on take-over moves in Spain, which should favour U. Fenosa. Aguas de Barcelona has low regulatory risk (dependent upon local authorities), an attractive growth profile and the possibility of benefiting from better relations with the Argentine government (closer to the PSOE than the PP, according to Argentine president Nestor Kirchner). Repsol YPF should also benefit from improved relations between the Spanish and Argentine governments, high oil prices, the scope to continue strengthening its financial structure, potential new discoveries in 2004 and debt-rating upgrades.

Financials

**B. Popular should
be the safe haven**

The PSOE has acknowledged that a 'real estate bubble' exists and party officials have issued statements on abolishing tax deductions for the purchase of new houses. These issues are likely to affect Spanish residential promoters and, until clarified, could delay projects. Moreover, less favourable tax treatment of certain financial instruments (capital gains on financial products held for over a year would be taxed at 30%, rather than the current 15%) and the taxation of contributions to pension funds (in exchange for tax breaks on redemption) might affect the asset management industry's volumes. A deceleration in mortgage volumes and doubts on the allocation of funds could penalise financial entities. In our view, Banco Popular should be the least affected Spanish financial stock under these circumstances.



Construction/Real Estate

Ferrovial and Acciona are still defensive

The government changeover might delay civil works and infrastructure projects, and probably lead to the re-assessment of some in the longer term. Although the PSOE is committed to a significant investment in infrastructure with the current financing structure (combining public and private initiatives), the re-negotiation of the structural funds might increase this uncertainty, as the net amount Spain is to receive in 2007-13 is expected to fall by nearly 50% versus the previous period. The expected deceleration in the real estate market could hit construction stocks (eg, ACS and FCC), housebuilders (eg, Metrovacesa and Urbis) and building materials companies (eg, Uralita). The latter is also set to be affected by the PSOE's pledge to stop the controversial National Hydrological Plan. Moreover, companies with an internal restructuring story (eg, ACS) and those that have benefited from M&A rumours (eg, FCC) might experience some share price weakness. The most defensive bets in this scenario should be Ferrovial (given its relatively higher international diversification and lower weighting of the construction activity in Spain) and Acciona (as its net cash position of €1bn provides a firm support).

Other Sectors

Negative on Altadis

The likely increase in special taxes on tobacco combined with the difficulties in implementing the proposed restructuring programme, as well as the possible changes in the management team and the tax deductibility of the goodwill on the Moroccan acquisition should penalise Altadis.

Keep an eye on Indra and Amper

Fears that the new government could reduce the defence budget should hit Indra and Amper. The former would also be affected by the expected deterioration in the relationship between Spain and the US. However, a tighter defence budget does not necessarily mean lower revenues for Indra and Amper as the IT component should continue to grow and concern on terrorism is likely to force greater security. Also, the PSOE has stated its intention of increasing R&D by 25% pa over the coming years. In this scenario, Prosegur should benefit from greater demand for security and unaltered growth prospects in its Latam business.

Positive on media

The media sector, given its high beta, has reacted negatively to the increase in the equity risk premium. However, stocks like Sogecable and Prisa should benefit from lower regulatory risk. TPI and Recoletos should be boosted by a good performance by the advertising sector and the support given by the stocks' high dividend yields.

Positive on metal stocks: Ence, Acerinox, Arcelor

We also maintain our positive stance on cyclical sectors, where pricing is already improving and volumes are starting to pick up. The companies involved have relatively high international exposure and virtually no domestic regulation. Ence, Acerinox and Arcelor would be our top picks.

VALUATION

Limited upside potential

The upside potential to our IBEX35 target level of 8700 points (10%) seems limited at this stage. Spain's underperformance versus the rest of Europe in the past few weeks – driven by heightened concerns in the wake of the terrorist attacks and uncertainty on the political front – has eroded the slight premium at which Spain traded in mid-February. Nevertheless, we maintain our cautious stance on the Spanish equity market. In the weeks ahead, the increase in country risk, linked to uncertainty about the political changes and the high weighting of regulated sectors and construction in the Spanish equity market, might take its toll.

Figure 5. Comparative European Valuations, 2003E-05F

| | Mkt Cap (€ mn) | P/E (x) | | | EPS 05F CAGR (%) | EV/EBITDA (x) | | | | P/CF (x) | | | | CFPS | | GDY (%) | | P/BV (x) | |
|------------------|-------------------|---------|------|------|---------------------|---------------|-----|-----|----------|----------|------|-----|----------|------|-----|---------|-----|----------|--|
| | | 03E | 04F | 05F | | 03E | 04F | 05F | CAGR (%) | 03E | 04F | 05F | CAGR (%) | 04F | 05F | 04F | 05F | | |
| France (CAC40) | 775,425 | 20.4 | 15.2 | 13.2 | 16.2 | 8.4 | 7.7 | 6.9 | 4.2 | 67.3 | 9.6 | 8.5 | 6.3 | 2.5 | 2.8 | 2.5 | 2.2 | | |
| Germany (DAX30) | 535,455 | 22.5 | 14.6 | 12.1 | 34.2 | 7.3 | 6.1 | 5.4 | 4.7 | 7.9 | 7.1 | 6.6 | 4.9 | 2.5 | 2.8 | 2.0 | 1.8 | | |
| Italy (MIB30) | 398,887 | 18.9 | 15.8 | 14.8 | 22.2 | 6.8 | 6.4 | 6.0 | 5.1 | 7.3 | 7.0 | 6.6 | 4.7 | 3.9 | 4.0 | 2.5 | 2.4 | | |
| Portugal (PSI20) | 46,897 | 19.5 | 16.2 | 13.5 | 22.0 | 8.5 | 7.9 | 7.3 | 7.9 | 7.0 | 6.5 | 5.8 | 12.0 | 2.8 | 3.1 | 2.2 | 2.0 | | |
| Spain (IBEX35) | 330,113 | 15.9 | 18.2 | 12.7 | 18.6 | 8.9 | 7.7 | 6.8 | 6.7 | 7.7 | 7.7 | 6.8 | 7.5 | 3.2 | 3.5 | 3.0 | 2.6 | | |
| DJ Stoxx 600 | 5,670,313 | 24.8 | 15.3 | 13.5 | 14.2 | 11.4 | 8.8 | 6.5 | 6.1 | 16.6 | 8.2 | 7.4 | 5.4 | 3.0 | 3.3 | 2.8 | 2.5 | | |
| DJ Stoxx 50 | 2,510,469 | 17.2 | 14.6 | 13.3 | 15.4 | 8.8 | 8.1 | 7.4 | 4.2 | 10.9 | 10.1 | 9.4 | 5.1 | 3.2 | 3.5 | 2.7 | 2.5 | | |
| DJ Eurostoxx 50 | 1,656,782 | 19.3 | 14.4 | 12.8 | 22.4 | 7.2 | 6.8 | 6.2 | 4.2 | 37.4 | 8.3 | 7.7 | 5.2 | 3.2 | 3.5 | 2.5 | 2.3 | | |

Source: Santander Central Hispano Bolsa estimates and forecasts.

ANALYST CERTIFICATION: We, Jesús Gómez, Antonio Espasa and Cristina Bergón hereby certify that the views expressed in this research report accurately reflect our personal views about the subject companies and their securities. We also certify that we have not been promised compensation either directly or indirectly for expressing the recommendations in this report.

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Key to Investment Codes¹

| | |
|--------------------|--------------------------|
| Buy | Upside of more than 20%. |
| Hold | Upside of 15%-20%. |
| Underweight | Upside of less than 15%. |

(1) Target prices set from January to June are for December 31 of the current year. Target prices set from July to December are for December 31 of the following year.

IMPORTANT DISCLOSURES:

Santander Central Hispano Bolsa expects to receive or intends to seek compensation for investment banking services from the following companies in the next three months: FCC, Altadis, Aguas de Barcelona, Telefónica, Sogecable, Prisa, Indra, Endesa, Iberdrola and Unión Fenosa.

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Santander Central Hispano Bolsa has managed or co-managed a public offering of the following companies' securities in the past 12 months: Repsol YPF, Telefónica, Endesa, Iberdrola and Unión Fenosa.

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