Institutional private equity emerges

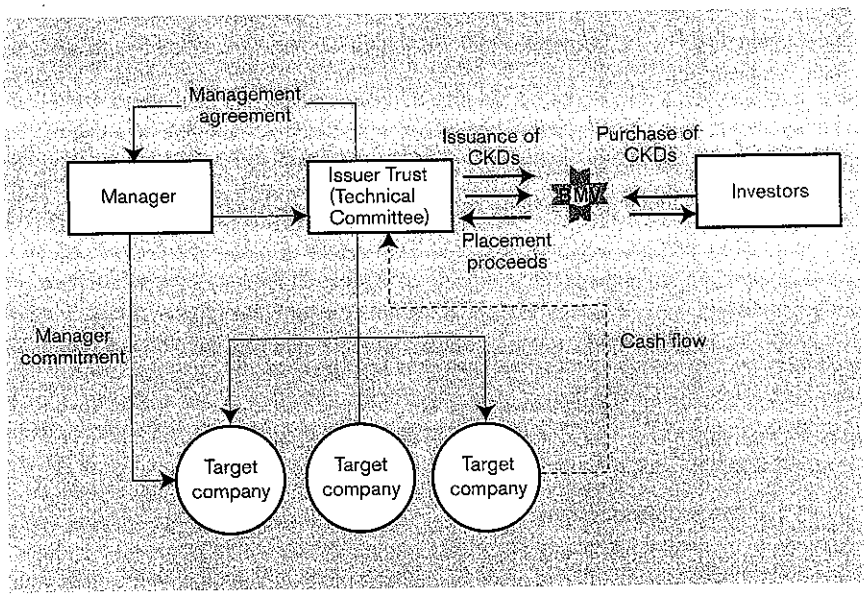
Creel García-Cuéllar Aiza y Enríquez's M&A group assesses the likely impact of CKDs in Mexico

Although over the last decade, private equity transactions have increased at a steady pace in Mexico (both in volume of deals and in size of individual investments) the overall contribution of private equity as a source of capital remains an unquestionably small portion of the overall domestic economy. While there are differences of opinion within the industry as to the main causes of its lack of growth (especially when compared to other economies including those within Latin-America) the absence of local sources of capital is commonly mentioned.

In 2006, as a result of a thorough overhaul of Mexico's Securities Markets Law, a new type of corporate entity known as the SAPIS (*Sociedades Anónimas Promotora de Inversión*) was introduced to the market as a new form of limited liability corporation especially designed to serve as recipient of private equity capital. Although this was much needed as a first step, it is now clear that the mere availability of a suitable vehicle to receive private equity investment cannot in itself attract the capital investment required in Mexico.

Before July 2009, Mexican pension funds, or AFORES (*Administradoras de Fondos para el Retiro*) as they are known in Mexico, were not allowed to invest in private equity on account of specific investment regime restrictions. It was only after such date that those restrictions were relaxed through the creation of a new type of equity linked notes, known as *Certificados de Capital de Desarrollo* or CKDs, which are traded on the Mexican Stock Exchange (*Bolsa Mexicana de Valores*). Today, such flexibilization enables AFORES to invest directly in private equity for the first time and creates the opportunity for private equity funds to raise capital from the AFORES through the issuance of the CKDs.

The 15 existing AFORES currently have approximately $150 billion (US$12 billion) to invest in CKDs. With only 7 completed CKDs deals as of the end of the first half of 2010, the success of CKDs in significantly boosting the Mexican private equity sector is promising but still uncertain.



How CKDs work

Perhaps through more complexity than would be necessary, a CKD deal works as follows:

A fund manager, acting as sponsor, creates a Mexican issuer trust (*fideicomiso emisor*) which in turn obtains the necessary approvals from Mexico's securities regulator, the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*) to issue and publicly offer CKDs in Mexico through the Mexican Stock Exchange. The product of the placement of the CKDs is invested in the target companies as equity, debt, or as a combination of both. The issuer trust then enters into a management agreement with a fund manager, who is responsible for finding and recommending investments. Once such investments are approved and made, the fund manager is responsible for managing them until their divestiture is completed. Cash flows received by the issuer trust from the target companies (whether these derive from interest and principal payments, dividends or divestitures) are distributed to the investors until such investors receive a certain targeted IRR, and thereafter to the manager (as a promote) and the investors in predetermined percentages. Under a CKD structure, in order to align the interests of the manager and the investors, the manager typically acquires a commitment to co-invest a certain percentage of the overall investment (in practice such commitments have ranged from 2% to 20%) with the fund. The performance of a CKD is linked to the performance of the target companies in which the issuer trust invests. The type of investments that the target companies will make informally classifies CKD structures: private equity; infrastructure and real estate. The following is a diagram that illustrates an issuance of CKDs on its simplest form.

Corporate governance

Similar to a publicly listed company, an issuer of CKDs is subject to strict regulation relating to disclosure, directors' duties, minority rights and corporate governance generally. Under such regulation, a minority of CKDs holders' (regardless of their management skills or experience) has a say on or can veto investment decisions. Needless to say, this is a noteworthy nuisance for fund managers who are accustomed, or at least hope, to operate within a genuine private equity environment.

Although CKDs holders' interference in investment decisions can be negotiated and

"The success of CKDs in significantly boosting the Mexican private equity sector is promising but still uncertain"

contractually avoided, such negotiations have not proven to be particularly simple when the holders are the AFORES. The across-the-board application of rules (which are understandably applied to publicly listed companies) underlines some of the drawbacks in the newly born CKD regulation.

Investment regime

The investment regime for each CKD structure is tailored to the needs of the sponsor. It is set forth in the prospectus for the offering and in most cases, in the trust agreement itself. Although such investment regimes vary from deal to deal, common traits amongst the most recent private equity CKD structures have included maximum investment periods, divestiture periods and target companies/industries diversification thresholds.

A new era for private equity in Mexico

The advent of CKDs will multiply the availability of equity capital for Mexican projects and transactions. Unlike past periods during which Mexican projects largely competed with target companies in other regional jurisdictions (eg, emerging markets and other Latin American countries) private equity now has a significant pool of approximately $12 billion that can be invested in Mexico alone. With this new source of funds, the question has shifted from whether equity capital is available for a given transaction to whether there are enough deals to cater for so much local capital. This shift will almost certainly transform the Mexican private equity market into a seller friendly market with local funds and traditional international private equity investors competing for the same transactions.

Assuming Mexico's macroeconomic variables remain stable, this should translate into cheaper capital for target companies; the emergence of club deals among Mexican investors (it will, in light of the investment regime applicable to these funds, be difficult for any individual fund to do a large transaction on its own); and the infusion of private equity capital in sectors that have not previously been favoured by private equity in Mexico (such as state and municipal infrastructure projects). All in all, this new capital will mean increased M&A activity.

In these recent times of crisis and volatility, the emergence of a new source of capital is most welcome. Particularly as traditional sources of funding have retrenched or withdrawn altogether from risk. In that respect, the Federal government's initiative and follow-through in creating CKDs is a most timely and commendable effort.

Notwithstanding, as CKDs transactions multiply, and some falter prior to closing, the issue will be whether the regulator will be open to learning from the inefficiencies and deficiencies in the current CKD legislation and have the vision to amend it in order to make the fund formation process less costly and more expeditious. This would entail eliminating the requirement that CKDs be publicly offered and traded on a stock exchange, which is inconsistent with the concept of private equity. Most importantly, the hope is that the Federal government will heed calls to enact tax incentives aimed at attracting investors and capital into the private equity arena in Mexico.

"New capital will mean increased M&A activity"

"...Creel, García-Cuéllar, Aiza y Enríquez has consistently been one of Mexico's strongest M&A firms in recent years and continues to merit accolades through its involvement in many of Mexico's largest transactions..." "...Creel, García-Cuéllar, Aiza y Enríquez is an excellent firm, highly respected for its M&A work, and interviewees regarded its position in tier one as an accurate reflection of its standing in the market. Its prowess has brought it some of Mexico's biggest M&A transactions..."

IFLR-1000

CREEL

CREEL, GARCÍA-CUÉLLAR, AIZA Y ENRÍQUEZ

- **Firm profile:**

For over seventy five years, Creel, García-Cuéllar, Aiza y Enríquez, S.C. has been one of the leading full-service corporate law firms in Mexico. Our goal is to be the firm of choice for clients with the most demanding projects, and to contribute to their success through expert and quality legal advice. We focus on transactions with an international component, which exposes us to the most challenging cases in a variety of industries and practice areas.

- **Areas of practice:**

General Practice, Administrative, Antitrust, Arbitration, Banking, Bankruptcy, Capital Markets, Climate Change, Clean Development and Renewable Energy, Contracts, Corporate, Entertainment, Energy, Environmental, Finance, Franchising, Infrastructure, Investment, Insurance and Reinsurance, Intellectual Property, International Trade, Labor and Employment, Oil and Gas, Mining, Mergers and Acquisitions, Private Equity, Real Estate, Resorts and Leisure, Restructuring, Securities, Taxation, Tourism, Telecommunications and Transportation. Representation before all Governmental Agencies.

- **M&A practice:**

Creel, García-Cuéllar, Aiza y Enríquez, S.C. is an excellent firm highly respected for its M&A work, and interviewees regarded its position in tier one as an accurate reflection of its standing in the market. Its prowess has brought it some of Mexico's biggest M&A transactions. One of our core practice areas has traditionally been Mergers and Acquisitions, where we advise foreign and domestic clients on all aspects of buying, selling or combining companies and businesses across regulated and unregulated industries. Our main strength and competitive advantage in the field of M&A is our combination of transactional expertise, our specialized knowledge of most industry sectors and multi-disciplinary teams with lawyers from our different specialist groups, such as antitrust and competition, employment and labor, tax, real estate, environmental and intellectual property. Such transaction expertise, business acumen and multi-disciplinary breadth has proven time and time again to be an indispensable asset when structuring and executing on complex, innovative and time-sensitive M&A transactions.

The Firm has 9 partners specializing in M&A, and approximately 30 lawyers. The partners of the M&A practice group are (alphabetically): Carlos Creel C., Carlos del Río, Jean Michel Enriquez, Samuel Garcia Cuellar, Alfonso García-Mingo, Luis Gerardo Garcia, Eduardo Gonzalez, Jose Ruiz and Santiago Sepulveda.

Mexico City
Paseo de los Tamarindos No. 60, Bosque de las Lomas, 05120 México, D.F., Tel: +52 55 1105 0600

Monterrey, N.L.
Batallón de San Patricio No. 111, Ofna. 1802, Torre Comercial América, Valle Oriente, 66269
San Pedro Garza García, N.L., Tel: +52 81 8363 4221

www.creelmx.com