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Trends & Developments

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Is it Mexico's moment?

For over two decades, both domestic and foreign investors have been expecting Mexico's fragmented congress and antagonist political parties to reach an agreement to pass the structural and economic reforms that are so needed for Mexico to reach its potential and strive to become one of the main emerging economies of the world. Despite the lingering global economic slump and Mexico's high trade dependency on the United States, as a result of recent administrations' responsible management of the country's finances, Mexico has demonstrated economic stability and moderate growth.

Mexico's stock exchange index has reached record highs, domestic equity and debt capital markets have been active, achieving greater depth, and the availability of credit to Mexican small and mid-cap businesses from the local financial institutions is evident and showing consistent growth. Mexico's strategic geographical location and its unparalleled free trade agreement portfolio give Mexican exports impressive access to global markets. To cap it all off, Mexico's middle class and low-income consumers have been steadily growing, not only as a result of the easier access to credit, but also due to increasing formal (and informal) employment opportunities.

Government reforms

It is no secret that Mexico's economy is still struggling to be competitive but investors are again focusing on Mexico and interest has been boosted by President Peña Nieto's apparent ability to free some of the congressional gridlocks. Following several years of political paralysis, Mexico's three major political parties have signed the so-called "Pact for Mexico", under which they have agreed – in principle - on many reform proposals on issues that have

held Mexico back for decades. The Pact is indeed an ambitious and wide-ranging list of measures which aims to turn Mexico into one of the world's high-growth emerging markets.

Among the structural reforms that have recently been enacted or that are being prepared, the labour, amparo (constitutional appeal), telecoms, antitrust, energy and tax reforms are of special relevance to investors generally and to Mexico's M&A and capital markets activity.

The labour reforms enacted by Felipe Calderon's government, but clearly backed by President Peña Nieto, were passed in November of last year. The changes in the regulation of outsourcing activities and employment positions, among other amendments under the new labour bill, will likely cause many Mexican companies to undergo corporate reorganisations.

Furthermore, certain amendments to Mexico's constitution were passed by congress in March 2013. The amendments, among other substantial changes to amparo proceedings, have set new parameters for granting a suspension of or protection against acts of authority. The latter will be of particular relevance to those industries which operate under governmental concessions or permits. The real impact of these new parameters remains to be seen but undoubtedly they are certainly worth considering when investing in companies whose core operations depend on governmental concessions, such as telecoms and mining.

"Pact for Mexico"

Also very recently, as part of the "Pact for Mexico", the President and leaders of Mexico's three main political parties presented an all-encompassing overhaul of the laws regulating telecommunications and antitrust, which includes – among other relevant structural changes - the regulators' authority to require a dominant company to divest some of its assets, the long-awaited auctioning of new private television networks and the elimination of the existing foreign investment restrictions in telecommunications and media. Thus the bill, which may result in the de-consolidation of certain telecoms industries such as fixed and mobile telephony, will certainly lead to acquisition opportunities in the sector. Given the capital intensiveness of the industry, players may range from strategic transnational companies to specialised funds that capture institutional investors with deep pockets in Mexico or abroad.

Transforming the energy sector

The government is also moving forward with its plan to transform Mexico's energy sector and particularly – one of Mexico's sacred cows – the state oil company, PEMEX. Politicians are apparently being more practical and are finally leaving behind 20th century doctrines that did little for Mexico. To date, PEMEX remains protected – crippled, some would say – not only by the Mexican constitution under which private investment in the state oil monopoly is not permitted but also by a high tax burden that withers away its much-needed capital for exploration and exploitation activities. Mexico's oil dilemma is a simple one: it has the oil but not the tools to exploit it. According to PEMEX officials, Mexico has proven reserves of 13.8 billion barrels and another 26.5 billion barrels are likely to be found in the deep

waters of the Gulf of Mexico. However, Mexico's deepwater Gulf territory is extremely vast for PEMEX to explore and exploit alone and, most importantly, PEMEX lacks experience beyond shallow waters. Mexico's oil & gas infrastructure and M&A activity would certainly be boosted by a comprehensive energy reform which, it is thought, would allow PEMEX to create joint ventures with experienced international players in the industry. A sign of the expected increase of activities in the sector is the relatively recent formation of several private equity funds which will be focused on investing in companies that operate as PEMEX's suppliers and service providers.

Tax reforms

Also expected during the second half of this year is the tax reform that will unquestionably have an impact on M&A activity. Among other areas where change is expected, it is anticipated that the new bill will cover areas that include the elimination of tax consolidation, the expansion of the value added tax base, limitation of flat tax and inclusion of special taxes on financial transactions and mining operations.

Capital markets

Activity in M&A is also being bolstered by active Mexican capital markets, which are a reflection of the solid investment opportunities that institutional and retail investors consider can be found in Mexico. The ability to capture funds through the issuance of equity, debt, certificados de capital de desarrollo, or CKDs, as well as certificados fiduciarios bursátiles inmobiliarios by FIBRAs (vehicles for real estate financing), continues to contribute to the flurry of transactions in the mergers and acquisitions market in Mexico.

Approximately 30% of the CKD issuances are funds devoted to real estate investments, giving rise to a dynamic market in all real estate sectors, including industrial and retail. Furthermore, the three FIBRAs that are in place in Mexico and abroad have raised close to MXN54 billion, giving a significant boost to real estate acquisition activity in Mexico on two fronts. Firstly, the structuring of some of those transactions entailed significant acquisitions of real estate portfolios that were contributed to the FIBRA (as was the case of Macquarie's FIBRA); and secondly, as FIBRAs expand, further acquisitions are expected to enhance and grow them. It is also worth mentioning that legislative changes to allow investment in infrastructure projects through FIBRA-like structures are being analysed by the regulator.

Infrastructure

Another sector that has grown significantly, and is expected to continue growing, is infrastructure-related M&A. During the last six years, private sector participants interested in investing in projects with long-term and stable revenue streams have participated in Mexican public-private partnership opportunities which include toll roads, hospitals and schools. Some of these PPP deals have now matured and, consequently, a secondary market has begun to emerge for these types of deals, which normally arise when the initial private sector investor sees an opportunity to crystallise an appreciation in the value of its equity investment

or when the developers have a need to reassign their capital in new projects. An increasing demand from domestic and foreign funds (including pension funds) seeking stable yields in this type of projects will significantly boost the infrastructure M&A activity in the coming years.

Conclusion

In addition to these specialised sectors, and the participation of investors through vehicles created by the Mexican market, traditional private equity funds that have been able to raise significant amounts of commitment are on the prowl for value-creating investments and acquisitions. Mexico is seeing and is expected to continue seeing activity on all levels – small cap, middle market and the large or even mega transactions.

We, like many others that believe in Mexico's great potential, are hopeful that the effective implementation of the above-mentioned structural reforms, coupled with responsible management of the country's federal, state and municipal finances as well as a strong and stable Mexican economy, will serve as the backbone to healthy capital markets and increased M&A and private equity activity in Mexico in the coming years.