Mexico

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1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

The full array of private equity transactions have been structured and finalised in Mexico in recent years. Most international private equity investors with a presence in Mexico tend to favour majority or control acquisitions, while local investors tend to be more flexible and open to acquiring minority stakes. Transactions involving convertible debt and hybrid instruments are less prevalent.

Funds, and most specifically CKD funds (which are publicly offered in order to be able to receive funds from Mexican pension funds), are formed as Mexican trusts established with a Mexican trustee. In turn, the funds are managed by a fund manager, typically as an SA or SRL. Trusts are also commonly used to raise funds from other domestic investors (ie, not pension funds). Foreign funds are typically channelled through foreign pass-through entities established and domiciled in jurisdictions with which Mexico has entered into a treaty to avoid double taxation (eg, US, Canada, the Netherlands, Belgium and Spain).

As far as investments are concerned, the preference is to have target companies incorporated as SAPIs, considering that the Securities Market Law (SML) exempts SAPIs from the application of certain restrictive provisions of the General Law of Commercial Companies (GLCC). This exemption allows shareholders to execute shareholders' agreements wherein they freely negotiate investment and governance arrangements otherwise prohibited or limited under the GLCC (eg, voting restrictions, punitive dilution remedies, transfer restrictions, and liquidity and exit provisions).

Notwithstanding the foregoing, US investors often insist on having target companies incorporated as SRLs, which the US Internal Revenue Service considers eligible for pass-through treatment in the US. However, in private equity transactions the SAPI gives the investor greater certainty in terms of the enforcement of minority rights and transfer restrictions, and ultimately its exit strategy through an initial public offering (IPO) or otherwise. SRLs cannot be listed on a stock market, hence precluding an IPO exit unless the SRL transforms into an SA.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

Private equity transactions are subject to normal commercial law and fund managers are subject to normal performance requirements provided in commercial law for managers of any commercial company.

A company listed in the Mexican Stock Exchange that goes private would be released from all the statutory and regulatory requirements applicable to listed companies, such as corporate governance, reporting requirements and limitations on transactions entered into with insiders.

The corporate governance of a public company in Mexico remains unaffected after giving effect to a private equity transaction. However, there are many features of a typical private equity deal that cannot be implemented in Mexican publicly traded companies and that are incompatible with the laws governing such companies. Under Mexican law, it is extremely complex to give effect to investor veto rights, supermajority protections, board appointment rights and transfer restrictions (eg, rights of first offer).

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What procedural safeguards (eg, special committees of independent directors), if any, do public companies use when considering transactions? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

Generally speaking, for a public company in Mexico to go private, 95 per cent of their voting and non-voting shareholders would have to approve the delisting, and a public tender offer for the shares held by investors (ie, other than the controlling shareholders) must be launched at a price equal to the greater of:

- the adjusted book value of the shares as of the latest reported quarter; and
- the weighted average of the share price (as quoted by the Mexican Stock Exchange) during the previous 30 trading days within a maximum period of six months.

The board of directors, within the 10 business days following the date on which the tender offer is launched, and after having heard the company's corporate practices committee, must prepare and disclose a statement with respect to the price of the tender offer. Any director with a conflict of interest must abstain from issuing a vote with respect to the tender offer and all directors' senior officers must disclose whether they are participating or not in the tender offer. The board's statement may be delivered together with a fairness opinion issued by an independent expert retained by the board of directors at the request of the company's corporate practices committee or its audit committee.

Likewise, if any person or group of persons (including a private equity fund) intends to acquire, directly or indirectly, through one or more simultaneous or successive transactions, 30 per cent or more of a public company, such person must carry out a public tender offer to purchase the corresponding shares for specific percentages up to 100 per cent, if such person intends to acquire control of the public company, which may be waived by the Mexican Banking and

Securities Commission (CNBV) and if, among other things, the board of directors of the target, with the prior opinion of the corporate practices committee, so agrees. Once such a tender offer is launched and until the corresponding expiration date, the public company, its directors and officers must refrain from entering into transactions affecting minority stockholders. Similarly to a going-private tender offer, the board of directors must, after having heard the company's corporate practices committee, prepare and disclose a statement with respect to the price of the tender offer, which may be coupled with a fairness opinion issued by an independent expert retained by the board of directors at the request of the audit committee. Additionally, the directors and senior officers must disclose whether they are participating or not in the tender offer.

Since one of the main safe harbours relating to the compliance of fiduciary duties by directors of a public company is a reliance on the opinion of independent experts, it is common to see such opinions being requested by the board.

Any transaction between the public company and a 'related person', such as senior management, members of the board or significant shareholders, must be cleared by the board of directors (with no participation from directors having a conflict of interest in connection therewith) with the prior opinion of the company's corporate practices committee.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

There are no specific disclosure issues in connection with going-private transactions or other private equity transactions involving a public company; however, the general rules relating to non-public material information (ie, no one in possession of non-public material information may trade on the related securities, transfer such information or tip anyone off in connection therewith) is particularly relevant when the public company itself is acting as purchaser or seller of its own shares, such that, the public company must disclose to the public all price-sensitive information before entering into any going-private transaction or any other private equity transaction.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

Depending on the nature of the assets held or of the industry or sector in which a company carries on its business activities, that company requires certain regulatory approvals to carry out the transaction. In addition, the thresholds set forth under Mexican antitrust laws should be reviewed to determine whether or not the contemplated transaction requires approval from the antitrust authority.

For a going-private and private equity transaction involving a public company that requires the launch of a tender offer, the prior authorisation of the CNBV is also required. Typically, the authorisation process takes between four and six weeks. Once authorised, the tender offer must last no less than 20 business days.

6 Purchase agreements

What purchase agreement provisions are specific to private equity transactions?

Generally speaking, Mexico has followed the US and other foreign private equity markets in connection with the typical provisions found in purchase agreements of private equity transactions which include the execution of shareholders' agreements and the amendment of the target's bylaws to implement corporate governance and other private equity provisions (please see question 13).

As mentioned above, purchase agreements will generally also include a provision of conditions for closing of the transaction, addressing, among others, the possible need to obtain the approval of Mexico's Federal Competition Commission as well any other third party consents that may be required.

Purchase price adjustments, holdbacks, carve-outs, cash-outs and escrow arrangements are all provisions commonly used in Mexican practice to adjust the purchase price and reassure the purchaser that it will be indemnified from any losses or purchase price adjustments or reassure the seller that sufficient funds to pay the purchase price exist.

As far as governing law is concerned, foreign private equity investors increasingly allow Mexican law to govern the purchase agreement as well as the shareholders' agreement. However, US private equity investors often insist on New York law as the governing law of the transaction agreements (including the escrow agreement) but, when they accept Mexican law, disputes are almost invariably submitted to commercial arbitration outside of Mexico.

7 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations of when a private equity sponsor should discuss management participation following the completion of a going-private transaction?

Other than what was discussed in question 3 (regarding disclosure requirements from senior officers and directors of the public company), the SML does not impose restrictions on the participation of managers of the target company in going-private transactions.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

From a due diligence perspective, investors place great emphasis on tax compliance, tax inspections, tax contingencies and the tax liabilities of the target company, and often negotiate special indemnities dealing with any such liabilities that have the sponsors indemnifying the investor from any and all pre-closing tax liabilities during the applicable statute of limitations.

As far as structuring the investment is concerned, significant attention is placed on ensuring that the amounts invested are recognised as a basis for the purposes of calculating capital gains at the time of exiting investments. Foreign investors devote a lot of time to structuring the appropriate investment vehicles, and taking advantage of favourable tax treaties to which Mexico is a signatory, potentially exempting sale transactions from taxes in Mexico, but always supporting the structuring with real and concrete business reasons. Currently, dividends are not subject to withholding taxes in Mexico.

In the event of transactions involving shareholder loans, thin capitalisation rules must be complied with to ensure the deductibility of interest payments, and investors should be mindful of withholding taxes on interest, which may range from 4.9 per cent to 40 per cent.

Generally speaking, golden parachutes and stock options granted to certain officers of the Mexican entity, either by the parent company or by such Mexican entity, are treated as salary for Mexican tax purposes. It is common practice for Mexican entities to grant certain additional retirement schemes and compensation plans to those established in the Mexican Labour Law. Such plans are generally structured through trusts for the benefit of the officers and employees.

From a Mexican legal and tax perspective, a share acquisition cannot be classified as an asset acquisition; however, the opposite may occur if, in an asset deal, the acquisition involves all of the assets of the relevant business of the seller (the asset acquisition is

considered as an acquisition of the going concern), in which case the tax liabilities and claims follow the assets and the buyer may be statutorily jointly liable with the sellers for any unpaid taxes of previous fiscal years.

9 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

Since 2012, Mexican publicly traded companies are required to report accounts using the International Financial Reporting Standards (IFRS). However, private Mexican companies are required to report accounts using the Mexican Financial Information Norms (NIFs). Although foreign investors often require Mexican companies to maintain parallel books in US GAAP or the IFRS, mostly for their own domestic reporting requirements, the metrics are normally used to calculate EBITDA and other relevant line items are based on the Mexican NIFs for the purposes of calculating true-ups and earn-outs.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? What issues are raised by existing indebtedness at a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

Funding of private equity investments is relatively straightforward. Most transactions are funded through direct capital contributions pursuant to capital increase resolutions adopted by the shareholders' meeting of the target company. Where investors require distributions on their investment on a 'current basis' and don't merely rely on annual dividends, then, subject to applicable thin-capitalisation and transfer pricing rules, some investments provide for a combination of direct capital contributions in exchange for shares or interest in the target company and shareholder loans. In the case of buy-outs, transactions are typically structured as stock purchases or redemption transactions.

With respect to leveraged buyouts (LBOs) in Mexico, the main consideration in structuring such transactions depends on the ability of the target companies to pay dividends and make distributions to its shareholders on a current basis to service acquisition loans. Hence, when structuring LBOs in Mexico, it is paramount to incur the acquisition financing at the level of the operating target companies, or to somehow restructure the debt after the closing so that the operating entities can actually service the debt without having to deal with the tax and other timing restrictions applicable to dividends under Mexican law. Also, in pricing acquisition financing, investors have to consider applicable withholding taxes on interest payments made to foreign lenders, and the potential incremental cost they represent in terms of gross-up provisions.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

The source of funds used to finance a going-private transaction must be disclosed in the tender offer documentation.

As far as specific provisions are concerned, one of the most controversial sections of the loan documents for any private equity deal, including going private transactions, is the conditions to drawdown section and specifically the MAE or MAC condition that directly affects the certainty of funds. It is hardly ever the case that the definition of MAE or MAC in the purchase agreements matches the definition in the loan documents and therefore the 'gap' is generally a risk that the private equity investor is asked to assume. In the context of a cross-border deal, the definition of MAE or MAC becomes even more complex when negotiating political or national risk language within the agreement. Having said that, we see that private equity investors are generally more comfortable with the legal and related risks involved in private equity transactions. Increasingly, investors focus on returns and less on country risk.

12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

Private equity transactions involving leverage may raise the same 'fraudulent conveyance' issues under the Mexican Insolvency Law as any other form of acquisition or investment, if:

- the terms and conditions of the transaction are clearly or materially below market;
- the transaction is completed within 270 calendar days (may be extended) before the date of the insolvency judgement;
- after the transaction, the target complies with the following insolvency standards:
  - the target defaults in its payment obligations with two or more creditors;
  - on the filing date of the insolvency request, 35 per cent or more of the company's liabilities have been delinquent for more than 30 days; and
- the target does not have sufficient liquid assets to pay at least 80 per cent of its due and payable liabilities on the date of filing of the insolvency request.

The risk of fraudulent conveyance is mitigated through due diligence, representations, warranties and ultimately indemnities.

13 Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms? Are there any statutory or other legal protections for minority shareholders?

Private equity transactions typically contemplate the establishment of specific governance rights for the applicable minority, such as the right to appoint a specific number of board members and members to applicable committees, the right to approve a negotiated list of 'major decisions' at the board or the shareholders' meeting, and the right to receive periodical financial information.

Shareholders' agreements also include provisions dealing with specific rights of different classes of shares held by the private equity investor with respect to:

- pre-emptive rights to subscribe and pay capital increases;
- board, committee member and surveillance appointments;
- available exit strategies (ie, registration rights in the Mexican stock Exchange and the possibility of an offering outside of Mexico, including 144A/Reg S offerings, are common together with piggyback rights);
- shareholder non-competes;
- dividend policy; and
- transfer restrictions (ie, ROFO, ROFR, lock-up periods, drag- and tag-along rights).

These rights are in addition to certain statutory minority rights, which include the right to appoint board members based on a certain percentage of shares held (eg, 10 per cent in the case of a SAPI or SAB and 25 per cent in case of a SA), and the need to obtain a supermajority vote in the case of certain decisions (eg, admission of new partners to a SRL, the transfer of equity interests issued by a SRL or the approval of any amendments to the target's by-laws).

Finally, when considering a minority interest investment in Mexican companies, private equity investors in closed corporations should

Update and trends

The last relevant change in Mexican law applicable to private equity investments occurred in 2006: the creation of the SAPI. Through this, many of the legal hurdles that private equity investors confronted in structuring corporate governance arrangements in Mexico were eliminated or mitigated. There have been no developments in the regulation for going-private transactions; all rules in connection therewith have been in effect since 2006.

note that the GLCC imposes very limited obligations on a company in terms of preparing and delivering financial and operating information to the shareholders. Therefore, investors need to specifically outline the nature of the information that the investment vehicle should produce and deliver, but also the process that must be followed by the parties in order to inspect books and records and to access the company's facilities and management, so as to ensure that it will have full access to the company's information.

14 Acquisitions of controlling stakes

Are there any requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

Yes. Mexican securities law allows public companies to include anti-takeover devices in their by-laws. A typical anti-takeover device would require that any acquisition of shares resulting in beneficial ownership of shares representing more than a certain percentage (typically 5 per cent) of the outstanding shares of a public company to be approved by the board of directors; whose approval or rejection must be announced within three months. Normally, shares acquired in violation of an anti-takeover provision would have no voting rights. In addition if, upon granting of the approval, any potential purchaser would acquire shares resulting in beneficial ownership of 30 per cent or more of our shares, a tender offer would have to be launched, as discussed in question 3.

15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a buyer? Does the answer change if a private equity firm sells a portfolio company to another private equity firm?

Mexico has seen the full spectrum of exit transactions for private equity investors. The type of exit depends on the prevailing economic cycle in Mexico and globally, as well as the industry and target company in question. There are many examples of exits through the capital markets as part of a global primary and secondary offering of shares, most often through a public offering in Mexico and a placement outside of Mexico pursuant to Regulation S and Rule 144A of the US Securities Act 1933. Likewise, there exist many and varied examples of private equity investors exiting through buy-outs, in some cases by another private equity investor and more commonly by a strategic buyer. With the SIEFORES (Mexican Pension Funds) now authorised to invest in IPOs, as well as the potential tax efficiency of selling through a recognised stock market, exits through secondary offerings and block trades are likely to become more and more commonplace.

As to the post-closing recourses for the benefit of buyers, private equity firms commonly agree indemnification covenants that are usually guaranteed by escrow agreements with respect of a portion of the purchase price paid by the buyer.

16 Portfolio company IPOs

What governance rights and other rights and restrictions typically included in a shareholders' agreement are permitted to survive an IPO? Are registration rights required for post-IPO sales of stock? What types of lock-up restrictions typically apply in connection with an IPO?

Any shareholders' agreements containing board appointment rights, veto rights, non-compete clauses, any agreements related to the sale, transfer or exercise of pre-emptive rights and any agreements which allow for the sale and purchase of shares, voting rights, and the sale of shares in a public offering must be notified to the company in order to allow the company to disclose such agreements to the investors through the stock exchanges on which its securities are being traded and to be made public in an annual report prepared by the company. These agreements:

- will be available for the public to review at the company's offices;
- will not be enforceable against the company and their breach will not affect the validity of the vote at shareholders' meetings; and
- will only be effective between the parties thereto until they have been disclosed to the public.

Although registration rights are not required for sale shares of the public company after an IPO on a private basis, only shares registered with CNBV may be traded on the Mexican Stock Exchange, thus taking advantage of the liquidity it might provide and specific tax benefits.

Typically, in the context of an IPO, the company's directors and officers agree, subject to certain exceptions, not to offer, pledge, sell, contract to sell, sell any option or contract to purchase, or purchase any option or contract to sell, grant any option, right or warrant for the sale of, or otherwise dispose of or transfer any shares that may have been in the company for a set period of time, which normally is around 180 days. These lock-up arrangements are not required by statute but rather a contractual obligation negotiated on a case-by-case basis with the underwriters of the IPO.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Real estate, consumer products and infrastructure are popular industries for private equity funds. A significant number of CKD funds are expressly focused on real estate and infrastructure. However, funds have increasingly focused on diverse sectors including education, health care and hospitality. Other than the foreign investment restrictions (please see question 18), which are relevant for foreign private equity funds, there are no regulatory restrictions that specifically limit targets for private equity transactions. However, it is important to consider that some sectors are subject to specific regulatory oversight and approval requirements from the federal government. Such sectors include telecommunications, transportation, electricity, gas, oil and petrochemical sectors, and financial services, among others. Each approval process is specific to the industry, although a common feature is that the approval is not subject to a deemed approval, and must be issued in writing by the competent authority.

The vast majority of going-private transactions in recent years in the Mexican market have been made by the existing controlling shareholders rather than as a result of an acquisition by a third party, and have included all sorts of industries.

From 2013 onwards we expect to see an increase in strategic M&A activity by local and foreign companies seeking alternatives within Mexico to increase their market share, which may prove to be another exit possibility for private equity investors.

18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

In addition to customary due diligence items that apply to all M&A transactions (whether stock or asset acquisitions), private equity investors need to take special care with respect to the possible tax effects of the transaction (see question 8), third party consents and regulatory approvals required to consummate the transaction, including antitrust approval (see question 20) and foreign investment restrictions as well as other closing conditions.

In connection with foreign investment restrictions, although the Mexican economy is largely open to foreign investment, very few sectors remain subject to specific restrictions. In general, under the Foreign Investment Law and its regulations, foreign investors may invest in both listed and unlisted Mexican companies, subject to a limited number of restrictions on investment in certain economic sectors which are, under the law, specifically reserved for Mexican nationals or the Mexican government. Activities such as petroleum, basic petrochemicals and electricity are reserved to the Mexican government and other areas – such as radio, television and transportation – are exclusively reserved to Mexican investors.

In a nutshell, up to 100 per cent foreign investment is accepted in companies and activities, except for the specific foreign ownership limitations in the following sectors:

- up to 10 per cent in co-operative production associations;
- up to 25 per cent in national air transportation;
- up to 49 per cent in insurance and bonding companies, exchange houses, leasing companies, factoring companies, investment funds, companies involved in the manufacture and sale of explosives and firearms, newspapers, cable TV, basic telephone services and port administration (note that the referred to limitation on foreign participation may not be exceeded directly or indirectly through trusts or other agreements or through indirect foreign participation); and
- a favourable resolution by the Foreign Investment Commission (FIC) is required for foreign investment to exceed 49 per cent in shipping companies, air terminals and cellular telephone services.

Other than such specific limitations on foreign investment participation, the FIC also needs to approve any proposed investment by foreigners in a company whose assets are worth in excess of the Mexican pesos equivalent of approximately US$200 million or more.

19 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

For club or group deals, the most important issue is how decisions are made within the investor group, which rights are conferred individually to each investor and which rights must be exercised by the group unanimously or by a specific majority of investors (eg, drag-along rights, demand registration rights). In addition, special consideration must be made where investors require specific forms of reporting by the portfolio company (eg, financial information pursuant to more than one set of accounting standard). Where the investors agree to act as a block relative to the other shareholders of the portfolio company, they may forego certain capital gains exemptions at the time of exit.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity buyer related to certainty of closing? How are these issues typically resolved?

The most important issues as to the certainty of closing are related to the transaction's authorisation by the Mexican Antitrust Commission (which may be required if the transaction reaches any of the premerger filing monetary thresholds provided in Mexican Competition Law) and other governmental authorisations that may be required for investments in foreign investment-restricted sectors or sectors subject to specific regulatory oversight (eg, telecommunications, transportation, electricity, gas, oil and petrochemical sectors, and financial services). These issues are usually resolved by closing conditions and termination rights if such authorisations are not obtained within a certain period.

Additionally, closing is usually conditioned to obtain the relevant corporate authorisations from both parties and the targets' shareholders' meeting (if required), to obtain third party consents required under material agreements for the target's business, and to the absence of a material adverse effect. As mentioned in question 11, the negotiation of the MAE or MAC definition is somewhat difficult, because of the allocation of risk it entails to the parties.

If problems or contingencies were identified during the diligence process, corrective measures may sometimes need to be taken before closing the investment. Accordingly, provisions can be carefully drafted in the agreement to establish obligations to correct any problems so that, at the time of making the investment, such problems are solved or the correction measure is waived by the private equity investor. Special care should be taken when drafting such conditions in order for them to be valid and enforceable under Mexican law; for example, counsel should keep in mind that the fulfilment or

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compliance of such conditions does not unilaterally depend on one of the parties, to avoid any risk of such condition being rendered null and void.

Finally, it should be noted by counsel that termination fees and break-up fees are not common in Mexico; however, the parties tend to agree on setting forth on a right by either party to receive a reimbursement of expenses incurred upon termination by the other party in certain circumstances.