

# Market Intelligence

## PRIVATE EQUITY 2020

Global interview panel led by Simpson Thacher & Bartlett

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# Mexico

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He has a diverse corporate practice with focus on M&A and corporate and commercial transactions, including domestic and cross-border mergers, carve outs and divestitures, joint ventures, private equity deals and IT transactions, with an emphasis on consumer goods, energy and technology sectors.

His clients include public companies listed in the Dow Jones, S&P, DAX, Nikkei and BMV, some of the most profitable Forbes 100 Top Brands as well as some of the largest and most innovative private equity and venture capital funds. He also regularly advises clients in information technology and telecom related transactions and matters, including outsourcing, software, patent and media content licensing, e-commerce and internet regulation, data privacy and fintech.

Santiago Barraza is an associate of Von Wobeser y Sierra, SC, engaged mainly in corporate, M&A and banking and finance.

Santiago has more than eight years of experience in cross-border transactions with high levels of complexity. Due to his versatility as a lawyer, Santiago is also part of Von Wobeser's energy and natural resources, and financial services industries groups, and he creatively supports the firm's marketing subcommittee.

Santiago's practice is focused on operations and transactions with financial components, which has necessarily taken him to lead the most important matters in the firm regarding acquisitions, restructuring, financings, the fintech sector and even compliance in financial-related topics.

## 1 | What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

While there has been a general decrease in the number and value of private equity buyouts and investments in Mexico, particularly in the second quarter of 2020, the most significant development has been a shift in focus to certain specific sectors. During the past year, we have seen that private equity buyouts and investments tend to focus on the retail, information services, financial, e-commerce, healthcare and technology sectors. Such trends might be related to the impact of the covid-19 pandemic. There were some other sectors that naturally had to slow down due to the imposed measures and social distancing, such as the infrastructure sector. Additionally, over the past few months, transactions regarding the energy sector have also decreased due to the new administration's stance towards private investment in the sector and ensuing regulatory uncertainty. Nonetheless, there is cautious optimism that the pipeline of deals for these sectors will improve in the upcoming months, mainly because there is great need of investment in energy infrastructure projects.

One of the sectors that has gained popularity and has become a trend for private equity investments is the fintech sector. Between just 2017 and 2019, the fintech market grew 145 per cent in Mexico. As a result of the enactment of the Fintech Act and its supplemental regulation, national and foreign investments in fintech entities have grown exponentially.

Since the number of companies listed in the Mexican stock market (in the Mexican Stock Exchange (BMV) or in the Institutional Stock Exchange) is rather low, even if compared to other Latin American countries, and such companies are typically mature (and thus with less growth potential), stock market valuations have not had a heavy impact for buyout firms.

Over the past decade, although we have seen some large-scale transactions, private equity buyouts and investments have focused on small, mid-sized companies, as well as on start-ups. Mexico has historically been a country with family businesses and this a clear reflection of that tradition.

## 2 | Looking at types of investments and transactions, are private equity firms primarily pursuing straight buyouts, or are other opportunities, such as minority-stake investments, partnerships or add-on acquisitions, also being explored?

After the 2008 financial crisis, the private equity market in Mexico has consistently increased and become one of the strongest markets in Latin America. During this



period, and since the private equity market in Mexico is still developing, firms have explored a variety of investments, from straight buyouts to add-on acquisitions, minority-stake investments, leveraged buyouts, and mezzanine financings.

Portfolio company activity has raised significantly in the past several years. Many private equity firms have benefited from some financing instruments offered by the stock exchanges, such as development equity certificates (CKDs), in order to invest in portfolio companies.

Regarding investment hotspots, the fintech industry, which has been consolidated in Mexico with the Fintech Act, has certainly become a trend for private equity investments in the country. It would be difficult to determine if there was a specific trend regarding types of transactions over the past year in Mexico (even more so when considering the impact of covid-19 in Latin America).

With respect to the 2020 theme of investment focus, we have seen a keen interest of private equity firms in environmental, social and corporate governance (ESG) investments. This is because this area has gathered significant momentum over the past few years in the United States and there is always a tendency to copy behaviour from our business partner. Now more than ever, the importance of ESG

“A great number of private equity-related deals and transactions registered in Mexico are executed by foreign investors.”

issues on companies and firms is crucial in their valuation. This common theme of investment has been recently confirmed in Mexico through the launching of the first ESG index in the Mexican stock market this past June.

### 3 | What were the recent keynote deals? And what made them stand out?

One of the keynote deals during the past few months was the US\$125 million raised by AlphaCredit during a Series B round, led by SoftBank. This transaction provides further evidence that the country is increasingly becoming a hotspot for fintech startups. AlphaCredit plans to use the capital raised to continue its expansion and leverage the competitive advantages of its business model.

Despite a decrease in the number of transactions in the energy sector, private equity firm Demham Capital committed US\$250 million to Ceiba Energy, which is an owner, developer and operator of renewable energy and natural gas assets in Mexico and Latin America. Ceiba's target markets include Mexico, Colombia, Brazil, Chile, Panama and Peru. The company is committed to growth through a combination of targeted M&A, and brownfield and greenfield development.

With regards to fundraising, the private equity firm HarbourVest Partners Mexico raised US\$170 million through the Series B issue of an fiduciary investment project securitisation certificate (CERPI) offering on the BMV. In the past few months, many private equity firms have found a source of financing through debt securities issued in the Mexican stock market.

Arc Labs made a US\$25 million debt investment in Flat.mx, a Mexican property technology company focused on the purchase, renovation and resale of residential real estate. This transaction will allow Flat to scale up its purchasing of real estate properties in Mexico as it looks to provide a customer friendly, tech-enabled solution to the real estate industry. This was one of several debt investments that took place in recent years in connection with the technology industry, which has been placed as one of the hotspots for investments in the country.

**4 | Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? How are those challenges evolving?**

A great number of private equity-related deals and transactions registered in Mexico are executed by foreign investors. Therefore, private equity M&A in Mexico tend to be cross-border. Some of the challenges that legal advisers in face when it comes to multi-jurisdictional deals is related to the Mexican business culture. In Mexico there are several family-owned businesses that are managed though orthodox methods and risk averse approach, which represents a challenge in the transactions, despite the legal vehicles that are used to structure the transaction, which tend to be customary.

Nonetheless, this has positively evolved in the past few years due to the globalisation and technological advances. We have seen these two factors directly impact some of our oldest clients, forcing them to renew their 'business rules' and internal governance and policies, making it easier for external advisers (legal, financial and accountants) to prepare and execute a multi-jurisdictional deal.

**5 | What are some of the current issues and trends in financing for private equity transactions? Have there been any notable developments in the availability or the terms of debt financing for buyers over the past year or so?**

In the past decade, there have been some regulatory developments that have benefited private equity financing. Certain debt financing instruments, such as CERPIs and CKDs (which are debt instruments traded in the Mexican stock exchanges) have

gained popularity in the private equity industry and have been a successful source of financing.

Due to the covid-19 pandemic, and the uncertainty it has generated within the market, banks have taken a conservative approach in providing financing to companies with steady cash flows and strong track record. Therefore, other financing alternatives have gained relevance, such as mezzanine and senior debt granted under more flexible terms. Nonetheless in the past few years, Mexico has shown a growth in private equity investments and, therefore, it is now placed as one of the leading markets in Latin America for general partner investments. The covid-19 pandemic has caused a deceleration in private equity growth in Mexico, but it is expected that investment will continue to gain relevance in the country and, with it, the availability of debt financing for buyers should change in a positive way also.

## 6 | How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

The changes on the private equity legal scene in Mexico have been always related to the most important projects and investment strategies of the government. During the past few years (and derived from Peña Nieto's administration), there have been regulatory developments in regards to the fintech industry. These developments have helped consolidating the fintech industry in the country and has contributed to place it as one of the hotspots for investments in Latin America.

Moreover, as part of a tax reform passed in December 2019, the Mexican legislation was amended to grant a tax incentive to foreign entities that administers private equity capital investments in the country. With this incentive, foreign entities that administer private equity capital investments, and are considered fiscally transparent entities, will also be considered transparent for Mexican income tax purposes. This means that the shareholders of such entities would be able to apply and benefit from the double taxation or applicable multilateral treaties.

With respect to the private equity regulatory and policy landscapes, it is safe to say that we still need to wait for the third year of Andrés Manuel López Obrador's administration (which will mark the halfway point of his mandate) to analyse and determine if there will be significant changes in laws and regulations that will affect private equity (trends seem to suggest that new provisions related with corporate governance will be enacted and this could potentially affect funds and investment vehicles in a positive way). Despite the lukewarm relationship between the current administration and the private sector, the covid-19 pandemic will trigger a demand of investment that the public sector will not be able to satisfy by itself.



7 | What are the current attitudes towards private equity among policymakers and the public? Does shareholder activism play a significant role in your jurisdiction?

On the one hand, and although private equity transactions have not reached the levels expected, during the past several years policymakers have shown a positive attitude regarding to private equity. This has been evidenced with certain regulatory developments and tax policies that had been passed, which are intended to improve the conditions for private equity investments in the country.

On other hand, and even though private equity transactions have shown an increase in the last few years, the business culture in Mexico has been a challenge for private equity, since many entrepreneurs and family-owned businesses tend to resist to include outside investors and management. Nevertheless, as part of the growth that start-up companies have had in the past few years, private equity has been placed as an important source of funding for these companies, which has generated more confidence before entrepreneurs and family-owned businesses.

With respect to shareholder activism, ever since the last major amendment to the General Law of Corporations, the influence of minority shareholders and partial owners has been noticed in deals and negotiations in Mexico. With the legal and contractual entitlement to a variety of rights, most of the major stakeholders in Mexican corporations and entities (including board members and managers) have plenty of actions to deploy direct strategies on the company. This, however, has remained the same in past years; we have not seen any major changes in that regard.

**8 | What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?**

Levels of exit in Mexico have been higher than other years for the obvious reason: covid-19. Leaving such exogenous shock aside, it would be difficult to determine if the level of exit activity in Mexico has been normal or not. You must remember that, even before the pandemic, the world economy, and Mexico's in particular, was already entering a recession. That naturally entails exits from all kind of investments.

During the past few years, the most common exist routes we have seen in the private equity market is M&A. As part of this, we have seen direct transfers to other private equity funds, as well as the sale of shares acquired by the investor to another shareholder of the company. In terms of venture capital transactions, the most common exit type we have seen is strategic.

**9 | Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?**

Due to the regulatory developments and instruments that have been developed, funds are now allowed to raise funds from investors in a more efficient and easy way. As an example, in recent years pensions funds were allowed to invest in private equity firms. This has created a big opportunity for private equity and has favoured sponsors and pension plans as investors. Moreover, the legal landscape allows sponsors to raise funds not only from national investors, but also from foreign investors. Recently we have seen huge interest from foreign investors to invest in private equity firms located in the country.

Since 2009, because of the government authorising retirement fund administrators to invest in private equity, fundraising activities have been increasing. Fundraising is now much easier because funds can raise both national and international capital, and because the latest amendments to the legislation have made the process more effective. This has also helped the expansion of the base for private equity and investment.

“Fundraising levels have decreased compared to past years.”

Even though there are opportunities for private equity investment in the country, with the covid-19 pandemic, fundraising levels have decreased compared to past years. Nonetheless, once the pandemic is controlled, it is expected that this issue will be reverted.

10 | Talk us through a typical fundraising. What are the timelines, structures and the key contractual points? What are the most significant legal issues specific to your jurisdiction?

Fundraising in Mexico is not much different from other countries. It could be generally divided into three phases:

- definition;
- structure; and
- implementation.

First, the definition phase, which usually takes from one to three months (depending on the level of complexity of the idea or vehicle). A general pitch at this phase can



be made with certain investors (family, friends or close acquaintances), but the main objective is to define and validate the vehicle for the fund with internal and external advisers. Then comes the structure phase, where the purpose is to start incorporating the required entities and preparing the necessary documents for the implementation of the vehicle. Pitches at this phase are crucial for the projections and expectations of managers and other investors, and they should be more straightforward, considering that the main object and structure of the has been determined. Angel investors, institutional investors and venture capitals are welcome in this phase, which should take somewhere around two to six months. Finally, there is the implementation phase, which requires prior funds raised to happen. It is the formal set-up of the vehicle and can take from two to six months (depending on the number and type of investors). Funding at this stage (and up until the maturity of the firm) should be expected from Series A to D.

Structures and contractual points depend on several factors such as the idea, industry, and vehicle. It would be complicated to generalise structures in Mexico, but many choose to go with flexible corporations or specialised trusts.

Although Mexican legislation is flexible to a very great extent, a common legal issue we constantly find in private equity transactions is the regulation on specific activities and assets that are exclusively reserved for the government or are somehow restricted to third parties. Authorisations and concessions of this kind always seem to delay the closing of deals.

**11 | How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?**

Pursuant to Mexican laws, private equity sponsors are not specifically supervised. Therefore, they are not generally impacted in their day-to-day operations, unless they are considered as institutional investors (such as a pension funds or insurance companies). In this case, they shall comply with certain applicable regulations.

Nonetheless, certain acts carried out by sponsors require regulatory compliance and tax issues must be addresses carefully.

**12 | What effect has the AIFMD had on fundraising in your jurisdiction?**

Mexico's most important commercial and business partner is the United States. Our relationship with European countries and the European Union has grown and developed in the past years, but there is still a long way to go. As such, the AIFMD has not had a great impact on fundraising and transactions here.

**13 | What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?**

The main tax issues that private equity faces in Mexico are regarding income taxation. Ever since Mexico became a hotspot for private equity investments in Latin America, the tax authorities have implemented certain policies applicable to foreign entities that administer private equity funds in the country.

This year, a provision was included in the Income Tax Law to maintain the tax transparency for foreign legal figures (considered as such in its country of residence) that invest in legal entities in Mexico fulfilling certain requirements, which will come into force in 2021. If the requirements are not met, the foreign entity will be subject to taxation in Mexico and withholding tax rates, losing the fiscal transparency granted in favour of foreign entities that administer private equity funds in the country.

Additionally, if its main management or its headquarters are located in Mexico, the private equity firm will be considered tax resident in Mexico. Since several private

equity firms have, at least, one Mexican general partner, this could be considered as main management being located in Mexico, which would therefore mean the private equity firm could be considered a Mexican tax resident for income tax purposes.

Taxation of carried interest may depend on whether the requirements set forth above are complied with or not as well as the country of residence of the members of the fund and if a double taxation agreement is in place.

Regarding new reforms or modifications to the tax treatment to private equity investments, if political and economic conditions remain the same (even considering the covid-19 pandemic), we do not foresee major changes in the current treatment.

#### 14 | Looking ahead, what can we expect? What might be the main themes in the next 12 months for private equity deal activity and fundraising?

During the past few years, private equity in Mexico has been consolidating as one of the main sources of national and foreign investments in the country. As part of the regulatory developments and reforms that have taken place in various sectors, Mexico has become one of the leading countries for private equity investments in Latin America. Over the next year, due to the macroeconomic and political situation, we expect a decrease in the number of private equity investments and transactions, followed by a period of accelerated recovery. Despite the current global situation, Mexico's geographic position, its stable regulatory framework, its favourable relations with the United States and Canada embodied in the recently executed United States–Mexico–Canada Agreement, and the size of its internal GDP, continue to mean the country remains one of the most stable and attractive markets for private equity in Latin America.

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# The Inside Track

## What factors make private equity practice in your jurisdiction unique?

There are three chief factors. First, the low number of real publicly traded companies versus the amount of small and medium-sized enterprises (SMEs), which makes Mexico a great place to invest in SMEs. Second, the fact that it is common for public companies in Mexico to be controlled and managed outside of the local stock market, which, on the one hand, substantially limits the amount of public-to-private equity deals, but on the other hand increases the size of the deals. And third, our vicinity with the United States, which causes several synergies between US and Mexican firms in multi-jurisdictional deals.

## What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?

Four things: experience, experience, experience and experience. Regardless of the size of the firm, counsel must have experience not only in private equity deals, but in the industry where the target operates as well. It should also be implicit that experience requires the counsel to have experts in several areas of practice that are pertinent to Mexican law (ie, labour, tax, environmental) and in the specific industry where the target operates. The chosen firm should have experience in handling the required resources and in providing a timely response to private equity clients.

## What interesting or unusual issues have you come across in recent matters?

Multiple financial advisers for one party. This is common in our country for investment banking deals, where the middle-man plays an important role in the negotiation and, hence, it is sometimes useful to have diverse fairness opinions, valuations and even regular opinions. However, in private equity, this has come as a surprise in four of the past 10 deals our firm has handled. Given that our scope of work is limited to a legal advice, our opinion in this particular regard is limited as well – but we did find it unusual.

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