

THE PRIVATE EQUITY
REVIEW

SIXTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

THE PRIVATE EQUITY REVIEW

The Private Equity Review

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PREFACE

The sixth edition of *The Private Equity Review* comes on the heels of a solid but at times uneven 2016 for private equity. Deal activity and fundraising were strong in North America, Europe and Asia, but the year ended with uncertainty in the face of Brexit, a new United States administration and continued challenges in developing economies such as Brazil. Nevertheless, we expect private equity will continue to play an important role in global financial markets, not only in North America and Western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. As large global private equity powerhouses extend their reach into new markets, home-grown private equity firms, many of whose principals learned the business working for those industry leaders, have sprung up in many jurisdictions to compete using their local know-how.

As the industry continues to become more geographically diverse, private equity professionals need guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 29 different countries, with observations and advice on private equity deal making and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

While no one can predict exactly how private equity will fare in 2017, it can confidently be said that it will continue to play an important role in the global economy. Private equity by its very nature continually seeks out new, profitable investment opportunities, so its further expansion into growing emerging markets is also inevitable. It remains to be seen how local markets and policymakers respond.

I want to thank everyone who contributed their time and labour to making this sixth edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2017

MEXICO

*Andrés Nieto Sánchez de Tagle*¹

I OVERVIEW

i Deal activity

Private equity in Mexico is focused on investment in primarily small and mid-sized companies that are not traded in the stock market, with horizontal investments made over three to seven years, during which time investors seek to build the companies up to later sell their investment either to a strategic investor or, in some cases, through a public tender offer in the Mexican stock exchange. Both public and private entities try to create incentives for a more open culture towards private equity; nonetheless, it is still seen as an objective that is hard to reach for most small companies, or as a way to lose control of family-run companies. These perspectives, among other factors, mean that private equity in Mexico has less importance than it has in other emerging countries.

One noteworthy reason for resistance to private equity in Mexico has been the lack of competitive markets. According to an OECD study, prices in the country have been 40 per cent higher than they would have been in a competitive market. Consequently, during recent years, Mexican authorities have worked on creating regulations to make the country more competitive, and to strengthen and promote the growth of private investment, both national and foreign, in sectors to which it did not previously have access. The government's support of investments is already showing results and giving Mexico an advantage compared with other emerging market peers.

While this can be seen in both the opening up of the energy sector to private investment, as explained later, and the creation of public funds to encourage the development of small and mid-sized companies, one of the primary challenges private equity is facing is the reluctance of entrepreneurs and families managing many of the companies in Mexico to surrender control of their companies, and to accept external investment by capital funds as partners or shareholders. Despite this adverse 'cultural' issue, private equity has been gradually and rapidly gaining relevance in the country in the past few years.

For example, fundraising activities have been increasing since 2009, when the government allowed retirement fund administrators to invest in private equity vehicles. According to EMPEA's special report on private equity in Mexico, fundraising for Mexico-dedicated vehicles has grown from US\$574 million in 2009 to US\$2.1 billion in 2015. Moreover, trust in alternative funding schemes has soared recently because of financial stability and increasing return rates. Financial growth and well-publicised successes, together with the latest amendments to the applicable laws, have broadened the base for private equity

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operations. The range of opportunities for private equity has been expanded beyond the usual targets to incorporate a wide variety of projects. Consequently, the possibilities for aggressive expansion in the future seem very promising.

The greater part of private equity in Mexico comes from foreign investors, and there is, therefore, a tendency to engage in cross-border transactions. Mexico's regulations tend to generate interest from global investors, and there are several industries that offer great opportunities for private equity investments. The energy sector is a good example, with regulatory benefits even for cross-border transactions. The end of the state monopoly in this sector with the 2013 energy reform and the new regulations that have been issued have opened the sector to private investment, allowing Mexico to become an attractive market for private equity.

Apart from the well-known energy sector, other sectors such as fintech, health, telecommunications, and consumer goods and services have also been targeted by both national and international investors interested in entering the Mexican market. Mexico has also made a series of significant reforms in telecommunications that have created a more attractive environment for private equity. In this sense, according to Luis Videgaray, former Treasury and Public Credit Minister, a reform regarding fintech was planned for 2016. For the moment, however, Mexico still lacks a legal framework in this matter, although it is expected at any time. This is also the case for crowdfunding. Since fintech is already important for private equity and the government is boosting national and international investments, we look forward to regulation of the fintech sector, which might increase activity levels, or at least provide certainty for investors.

The development of new ways to carry out transactions in Mexico is undoubtedly making the Mexican market more attractive to foreign investors. Additionally, private equity M&A in the country also continues to grow because of the exit options, which are expected to increase in the next few years. From 2000 until now, private equity in Mexico has accumulated more than US\$30 billion. As markets and needs grow, there is an equivalent need for managing parties to be able to respond rapidly and efficiently. Consequently, private equity sponsors that may add value with hands-on expertise and many other management skills are now preferred to pure capital investments. Generally speaking, private equity sponsors do not have specific supervision or treatment under the law, although certain acts require regulatory compliance, and tax issues must be addressed carefully because of the nature of these operations. Nonetheless, every financial player must be aware of the importance of having well-prepared legal counsel for the design and review of operations. From the supervision point of view, authorities do not intervene in the day-to-day business of a company as long as there has been careful planning and design in the early stages of the project, and only in regulated industries.

In other schemes, as with publicly listed corporations, issuers of capital development certificates (CKDs) are subject to stricter regulation relating to disclosure, directors' duties, corporate governance and minority rights. Hence, the need for legal advisers is also increasing, and more specialisation is required. The main challenges for legal advisers in Mexico in the area of private equity is knowing and understanding the needs of all the practices and subjects involved in private equity transactions. In this regard, legal advisers must know the practices and the legal structure of private equity investors, as well as being familiar with the company culture in Mexico. As previously mentioned, many Mexican enterprises are family

businesses that tend to be reluctant to surrender control of their companies. There are also various challenges to be overcome in an international transaction that can have implications in labour, finance and other areas.

ii Operation of the market

Mexican companies looking to obtain funding to develop their business can do so primarily through:

- a* contributions of capital from their partners or shareholders;
- b* financing by the government;
- c* private equity;
- d* project finance;
- e* financing by banking institutions; and
- f* financing through the securities market.

Each of these options requires the preparation and negotiation of different legal instruments that make it possible to carry out these types of transactions, and the time it takes depends on the complexity of each transaction.

Regarding private equity, Mexico's industry is basically composed of funds with different investment strategies. Generally speaking, there are four types of funds. The first type is private equity funds, which normally function with one of the following investment strategies:

- a* growth, investing in companies that are looking for expansion, entering new markets or financing a strategic acquisition;
- b* leveraged buyouts, specialised in acquiring companies via external capital;
- c* mezzanine capital, which allows for more flexibility as less guarantees are required (meaning more risk and higher costs); or
- d* distressed or special situations, which invest in companies or assets that are facing difficult situations.

The second type of funds, venture capital funds, seek to invest in companies in their early stages, known as start-ups. The third type of fund invests specifically in real estate for residential, tourist, commercial or industrial use. Finally, the fourth type of fund specialises in infrastructure for transport, energy or other sectors.

Normally, to create a private equity fund, there are several steps to follow. First, the investors interested in creating the fund should form a team to identify, give structure to and plan the process for investment and exit or disinvestment. In other words, the assigned people need to establish a clear investment strategy, which will vary depending on, *inter alia*, the investment strategy or goal, the sector and participants, as previously explained. They must then appoint an investment committee, which will be in charge of administering the fund. To finance the internal structure, funds can receive income from the following sources: management fees (generally from 1.5 to 2.5 per cent, depending on the fund's size and sector); carried interest or carry returns that correspond to the fund administrator; and other sources.

Once the goals are established, the team to achieve them appointed and the internal financing scheme settled, the second step is fundraising. This step is usually fairly complicated and might take a long time. In this sense, different scenarios must be considered in the

planning phase in the event that goals are not reached within the planned periods of time. It implies a process of advertising and selling to investors (nature persons, corporations, other funds, etc.), and the administrator of the fund is in charge of this process.

Once the fund has gained the commitment of the necessary investors, it can then continue with the third step: the legal formalisation of the work done to date. This means, basically, incorporating the fund operator and the investment vehicle. The structure will vary, again, depending on a fairly large number of factors. This step is explained in Section II, *infra*.

Finally, the fourth step is the investment phase. The process usually starts with the administrator of the fund and the representative of the company in which the fund will invest signing a letter of intent, to be followed by a due diligence process and the signing of a terms page in the event that it is all found to be satisfactory.

The due diligence consists of, among many other factors, a strategic analysis of a company's business model, a market analysis, study of the distribution and offer of products, economic competition, financial standing of the company, investment needs and legal implications. Conducting a proper due diligence is a key step to make a good informed decision. By means of the due diligence, the administrator should have a clear overall picture of the company, the market in which it competes, its needs, the risks it is facing, and the costs, goals, etc., affecting the business. Legal advisers are also key players in this process, as they guarantee, *inter alia*, the validity, adequacy and legality of the company, and its businesses and permits. An in-depth study of the situation of the company may prevent future problems. As mentioned before, once all this is found adequate and fitting within the fund's investment parameters, the company and the fund will establish the investment terms and sign a terms page, which normally express the type of investment, dividend rights, voting rights, preference in payment, protection clauses, conversion options, future contributions, selling clauses and any other terms that the parties agree upon.

Depending on the type of investment, once the fund has completed the previous steps and the investment is effectively done, the administrator would normally get involved in the company's operation. For example, some administrators ask to become board members, or to be granted authority to designate their own board member or members, depending on their total participation on the company – in short, whatever is deemed to be required, always keeping in mind the common goal: that of increasing the company's value as much as possible within a given period of time.

To close the cycle, the fund must establish, *inter alia*, an exit strategy, deadline, conditions and policies with very clear terms that should always be respected. This process and its options are analysed further below.

A key factor in the whole process is that, to achieve all of the above-mentioned, funds must obviously be run correctly. In this sense, investors in private equity funds have the most important role as controlling agents. Therefore, the investors and the fund meet regularly, and the investors receive reports at established intervals and undertake other activities to promote a good relationship between the investors and the fund.

Another key feature of private equity transactions is ensuring that management, who will be asked to deliver on the company's business plan, are appropriately incentivised and aligned with the sponsor. This is typically achieved with incentive equity arrangements put in place at the time of the sponsor's acquisition of, or investment in, the company. There are different schemes, including sweet equity, performance rights, and options that are exercisable into ordinary or profit interests. The choice between these alternatives depend on the type of private equity fund, and is often driven by exit structures and tax considerations.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Mexico does not have any specific laws applicable to private equity. Hence, private equity transactions are regulated indirectly through the commercial, civil and securities law and regulations. Nevertheless, legal developments have taken place as the market has continued to evolve. For example, the 2014 financial reform acknowledged CKDs, which are legal instruments that allow asset managers to channel the resources of pension funds (Afores, which were only legally able to invest in publicly offered securities) into projects. Hence, via CKDs, Afores now have a way to invest in private equity. The regulation of CKDs has been amended several times to adapt to the needs of the market and to make the process easier and faster. Besides CKDs, which have been successful, generating a total of 191,247 million Mexican pesos in 2015, there have been other legal developments in favour of private equity. This is the case of CerPIs and Fibra E (see Section IV, *infra*).

To create a fund, as detailed in Section I, *supra*, the third step in the process is designating the fund operator and an investment vehicle. Since there is no specific regulation of the matter, generally the fund's operator is incorporated as an SA or a SAPI, which are regular corporations that can enter into shareholder agreements and have drag-along and tag-along rights, unlike other types of companies in which these agreements or rights are not valid in court. After incorporating the operator, the fund must establish the investment vehicle. Examples of these vehicles are:

- a limited partnerships (similar to the Mexican *sociedad comandita por acciones*);
- b private equity investment trusts (FICAP), whose purpose is to invest, or that are finance companies not listed in the Mexican stock exchange for a maximum period of 10 years;
- c non-business trusts, which have less restrictions than a FICAP; and
- d capital investment companies, which might be inefficient for certain purposes due to their legal restrictions, such as not permitting first refusal rights.

Consequently, within this framework, as in any other type of company, national or foreign sponsors would need to assure control over their investment through, *inter alia*, shareholders' agreements, assuring majority percentages and board representation. Negotiations will depend on the amount to be invested and the needs of the company: in other words, on the leverage each party holds on his or her side.

A consideration before investing is making clear the limitations applicable to foreigners. According to the Foreign Investment Law, foreigners have certain limitations as to their ownership and control of, and participation in, the companies and sectors in which they can invest (usually related to national security). There are also certain sectors in which they cannot invest at all, as they are exclusively reserved for Mexicans: for example, the national transportation of passengers, tourism, loading, development banking and certain professional services. In other activities, foreign participation is limited to a maximum percentage.

That said, we need to clarify that Mexico is a fairly open market, and the aforementioned in fact implies very few and specific restrictions. As previously mentioned, all regulation is built with the specific intent of facilitating foreign investment into the country. It is worth noting that Mexico has many commercial treaties and agreements with other countries, and the trend is to keep it that way.

ii Fiduciary duties and liabilities

The fiduciary duties and liabilities of sponsors are no different than they would be in any other business relationship. Their scope will first be drawn up and delimited in the letter of intent. Once the investment agreement is reached, they will be set in a term sheet or a shareholders' agreement, depending on the existing structure and the steps to follow to make effective the investment.

There are several crucial elements in every relationship that may give rise to complaints or problems in the future. Private equity funds usually have relatively short to medium-term objectives that might not coincide with the company's objectives. This said, when negotiating, it is very important that the deadlines and objectives of each party are well known, if not aligned. What might interest one party in the short term might not interest the other party, but might be complementary, because when the time comes to exit, the fund might seek a completely different strategy to exit the investment motivated by different objectives and goals, and it will probably be facing different responsibilities before its own investors.

The most common ways for a private equity firm to exit an investment are an IPO, a secondary deal (acquisition, sale), repurchase by the promoters or, in a last-case and probably never-desired scenario, a liquidation. The structuring considerations will depend on many factors, and every deal will be unique. What is really important and common to all deals is bearing in mind that time is of the essence, and requirements need to be very carefully considered to avoid problems and misunderstandings; in addition, a disinvestment operation might take quite a long time.

Considerations for foreign investors might arise precisely from a timing perspective, as all the processes involving foreign companies might require extra time. Due diligence processes usually take longer, and verification of documents requires coordination among several parties, which always results in more time and money being expended. Otherwise, as previously mentioned, other than some tax considerations, Mexico is a fairly straightforward and dynamic country in which to invest and disinvest.

III YEAR IN REVIEW

During 2015, two deals stood out. A fund named Credit Suisse Mexico Credit Opportunities Trust II and managed by Credit Suisse Emerging Markets Credit Opportunities (EMCO) raised US\$751 million. This fund was created regarding diversified private credit. RIVERCK 15, managed by Riverstone Holdings, raised US\$733. RIVERCK 15 was a fund created for the acquisition of real estate assets. These two correspond to the second and third-largest Mexico-dedicated funds up to December 2015. By the end of 2016, some private equity firms, such as Alsis Funds, focused their investments in Mexico in the real estate housing sector. This fund stated that in 2017, its plan is to invest in about 25 projects.

Private equity firms are looking at Mexican targets as a base from which to develop their Latin American business, and are interested in Mexican firms already doing business in other countries. This results in very interesting projects that involve not only Mexican operations, but also other operations in other countries in the region. Overall, investments from 2000 to 2014 focused majorly on electronic commerce, telecommunications and financial services. However, as previously mentioned, two more sectors are now gaining more investment: health, and consumer goods and services.

i Financing

Private equity in Mexico is increasing significantly as a result of several financial reforms that have taken place in recent years. The government's developments have had a favourable impact in the market, promoting investment even in sectors that were previously exclusively reserved for the state, such as the oil sector. In less than a decade, private investments have multiplied every year. For the past two years, Mexico has been a leading market in Latin America for general partner investment. However, Mexico's market is still below expectation, although capital funds continue to grow within the market. Regulatory reforms are expected to continue with the growth of private investment. Nevertheless, the structural reforms that have entered into force have already had consequences.

The energy reform, for instance, has been closely followed by private equity participants due to the opportunities created by the opening of this sector. Even though oil prices have fallen, benefits from the energy reform of 2013 have emerged in Mexico. For the past two years, the energy sector has assumed an important role in the country due to the opening up for private investment. With the opening of the energy sector to foreign and private investment, capital funds have expanded their investment asset classes to include the energy sector in both direct majority acquisitions and minority-stake investments. Additionally, and as a result of the opening of such industries to foreign and private investment, both *Petróleos Mexicanos* and the Federal Electricity Commission, officially 'productive state enterprises', can now enter into alliances, associations or joint venture schemes with foreign investors to develop certain energy sector-related activities in the different downstream, midstream and upstream sectors, which will, in turn, play an important role in the market by allowing capital funds to participate in these types of transactions.

ii Key terms of recent control transactions

In the fintech industry, Nexus Capital has just announced its investment in Translatum Holding to develop a fintech platform and position itself as one of the leading companies in providing services to send money from the United States to Mexico and other Latin-American countries.

Several mezzanine funds were launched by the end of 2016: for example, Adobe Capital, after the success of its first mezzanine fund, launched a second one with the same objective of supporting the growth of social and environmental companies; and Vector Partners, a company related to Vector Casa de Bolsa, in alliance with, *inter alia*, the International Finance Corporation (World Bank Group), launched México Mezzanine Uno, a fund that will request less guarantees to give small and medium-sized companies a better chance of obtaining financing.

In addition, in the food industry, Glisco Partners invested in the Hunan Group, owner of 14 restaurants in Mexico City, to boost its growth and strengthen its financial position as well as its internal corporate governance.

iii Exits

In early 2017 we saw a fund-to-fund transfer: EMX Capital sold Arabela, SA de CV to Adas Capital. Arabela, a direct selling company for beauty and other women's products, is a leader in the Mexican market.

In January 2017, Grupo IGS sold one of its portfolios including nine buildings, meaning that the group has disinvested a total of 40 per cent of its industrial and residential portfolio.

IV REGULATORY DEVELOPMENTS

Among the legal developments that have taken place due to the investing environment in Mexico, two developments in 2015 saw the legislation regarding the Real Estate Trust for the Energy Sector and Infrastructure (Fibra E) and investment project certificates (CerPIs). Fibra E vehicles are investment vehicles similar to Fibras, Mexican real estate trusts, which have been successful in recent years and which can increase the financing of projects in the energy sector.

In October 2016, the Fibra Vía (the new Fibra E), issued by Pinfra, concluded the first public offering in Mexico of 394.5 million energy investment trust and infrastructure certificates. The placement reached a total of 11,835.07 million pesos and was considered very successful because of its acceptance among investors. Regarding CerPIs, on 30 September 2016, the first CerPI was placed in the Mexican stock market by Mira Manager, a real estate company focused on the development of urban mixed use communities in Mexico, for a maximum amount of 4 billion pesos and a first issue for 800 million pesos.

CerPIs and Fibra E have not yet been widely used, but are expected to be instruments that boost the capital of investments in Mexico. Still, we can expect that the legal aspect of private equity will continue evolving.

V OUTLOOK

Since 2009, private equity in Mexico has been a growing market. CKDs boosted transactions when pension funds began participating. Fundraising is now much easier, because funds are able to raise both national and international capital and because legislation is making the process more effective. Nonetheless, publicly traded companies are typically controlled outside the stock market (by a family or other closely held group), which substantially limits public-to-private equity deals. Mexican firms are very reluctant to give away control or even provide transparency as a condition to accept private equity. Many Mexican firms and their owners and managers lack experience in private equity transactions (it is not perceived as an integral part of a firm's growth strategy, but as a way to lose control and direction of the firm), so deals in Mexico can sometimes move very slowly, which private equity firms may find frustrating given the fast-paced nature of their typical transactions.

Even with the ongoing culture of the family company, Mexico is gradually becoming a good country to invest in, with one of the most attractive prospects being the energy sector. Additionally, fintech and telecommunications appear to be sectors to follow closely for investment opportunities, which will be encouraged by regulatory policies.

Other regulatory reforms regarding competitive markets and anticorruption will undoubtedly be important steps for Mexico towards playing a significant role globally in terms of investment.

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