Perspective of the Mexican Private Equity Industry

Should European and US LP's start paying more attention to private equity managers in Mexico?

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The state of the private equity market in Mexico is one of exceptional opportunity. Fernando Fabre of Endeavor and I made this statement when we wrote our paper *The Development and Impact of Private Equity in Mexico* back in July of 2005. The following reasons were the basis for such an assertion:

- First and foremost, Mexico is running on almost a decade of improving macroeconomic stability thanks to: tight public finance management; decreasing inflation rates, currently at the 3 to 4% level; a floating exchange rate regime; diminishing external debt and growing international reserves – today net external indebtedness has become negative; a strong and rapidly growing internal savings base thanks to the pension system reform enacted by President Zedillo; thriving and deepening local capital markets – especially fixed income related– evidenced by a peso denominated sovereign yield curve stretching out to 30 years, at single digit rates[1]; and, last but not least, an investment grade rating that has been improving since March of 2000.

- There has been important advancement in solving some problems that have historically hindered the development of private equity in Mexico, for example: in the past, government money flowed insufficiently and haphazardly to private equity funds, today the government has created a professionally managed fund of funds that has concentrated the private equity portfolios of the four institutions that had invested in the past and has earmarked more than $250 million in fresh money to continue supporting successful and emerging managers investing in Mexico; the legal and regulatory framework has improved, the new securities law approved in

[1] This was unthinkable a mere 12 years ago when the definition of long term interest rate was an 85% 90 day Cete.

2005 strengthens minority shareholders rights and provides for the execution and enforcement of shareholders agreements that were illegal in the past; other improvements to legislation such as a new bankruptcy law, a mutual fund act and the insurance company law stand to benefit the industry. The development of the equity market in general and IPOs in particular will benefit from these initiatives. Listed markets will, however, begin to really develop as a by product of an increased activity in the private equity landscape and not, necessarily, the other way around.

- Investment opportunities are there for the taking. When you combine a stable economy with bullish demographics you get a slew of possibilities in a wide range of sectors like retail, housing, food related industries (food service, restaurants, beverages), financial services, telecommunications, tourism, infrastructure, off-shoring, real estate, etc. Being a neighbor to the largest consumer market in the world, a not insignificant part of which comprises a rapidly growing Hispanic population, presents cross border business prospects and the chance to exploit commercial ties and cross marketing opportunities.

- International and local funds have slowly been populating the private equity landscape. There are the international funds with a local presence like Advent, going through its third fund and Carlyle going through its first; there are the foreign managers that teamed with local players like Zephyr and Nexxus, Discovery and Protego, Darby and BBVA; and there are the more adventurous emerging local fund managers that have decided to go it alone, such as Industrial Global Solutions, Fondo MIF and the Nafta Fund. Amexcap, the Mexican Private Equity Association, now has in excess of 25 associates and membership is growing. New players that have or are looking to establish a local presence include Southern Cross, GE Capital, Scotia Capital, vSpring Capital, AIG, Hispania Capital Partners, etc.

- Other contributing factors are the increasing availability of debt to finance buyouts and to leverage a fund's equity participation; and a growing receptiveness of the Mexican businessman and family company to accept the

> return and control requirements of a financial partner, a change that has been brought about by the demands of globalization, generational change and indirectly by falling interest rates.

In our paper, we identified two major factors that should contribute to detonate the private equity industry in a way that could replicate what happened in the US starting in the 80's, and more recently in Europe and in other emerging economies. The first recommendation was to lobby for a local vehicle that emulates the US limited partnership both in terms of corporate structure and pass through tax treatment so that funds could be incorporated locally in Mexico without having to go to Canada or the next jurisdiction the tax authorities would not oppose. This would substantially lower start-up costs and permit smaller funds, with maybe a regional or industry focus, to emerge and channel investment to the large and largely neglected SME Mexican market. The second and more important recommendation was to lobby for a modification in the investment regime of the pension system so that Afores (Mexican defined contribution pension funds) could invest in alternative asset classes. With this measure, part of the $70 billion pension fund assets (which will more than double in the next ten years) could be put to work in financing promising private companies in Mexico while increasing the expected return and lowering the risk of their portfolios.

Our first recommendation has been achieved. Amexcap formed an interdisciplinary task force that worked with the finance ministry in passing legislation to introduce the Ficar, a trust structure that resembles a limited partnership. Today, at least two funds have chosen to incorporate locally as a Ficar. Our second recommendation could very well be a reality before the end of the year. Amexcap is working with the finance ministry and Consar (the pension fund regulating agency) to pass legislation that will allow the Afores to invest in private equity and other alternative investments. We hope to have good news in this front in the near future.

There has been a lot of buzz about the BRIC economies; I for one, am very surprised that there is no M in BRIC. Mexico has the demographics of a BRIC with the benefit of being inserted in the North American economy. Mexico shows the potential of a BRIC with the advantage of a lower risk profile and a higher probability of convergence. Quoting from Goldman Sachs Global Economics Paper No. 134, "There is a major distinction between the BRICs *potential* and the *reality*. The key to turning one into the other […] relies largely on the BRICs finding and keeping in place the *conditions* for growth. […] Demographic advantage is not sufficient." The key to fulfilling the BRICs potential is called convergence and the country with more probability of converging to developed country income levels among emerging economies is, without a doubt, Mexico.

If our statement that "the private equity market in Mexico presents an exceptional opportunity" was true in 2005, it is even more so today. I predict a rapid development of our industry in the next 5 years and beyond.

A *trend* and a *proof* support my prediction. The *trend*: Back in 2003 when Antonio Ruiz Galindo and I were fundraising for IGS' Mexico Real Estate Investments, *some* foreign institutional money was already flowing into the *industrial* real estate market and the fund wanted to capitalize on that opportunity by becoming a builder of industrial portfolios. In the last five years, excess returns in the industrial real estate market have been arbitraged out and money has been flowing into commercial real estate, retail, low income and residential housing, second homes, hotels and resorts, and even speculative development, infrastructure and land acquisition. A natural progression should be for institutional money to begin flowing into private equity. The trend has started to happen.

The *proof*: When Michelle invited me to participate in this conference a few days after President Calderón took office, our panel agenda included the topic "What is the effect of López Obrador's campaign of civil disobedience?" I wrote to Michelle telling her that by the date of the Conference Lopez Obrador would be i) a disgrace to his party; and ii) nothing more than a political curiosity. Mr. López was wiped out from the agenda as he has been from the Mexican political landscape.

Should European and US LP's start paying more attention to Private Equity Managers in Mexico? They better if they don't want to miss out on a tremendous opportunity.

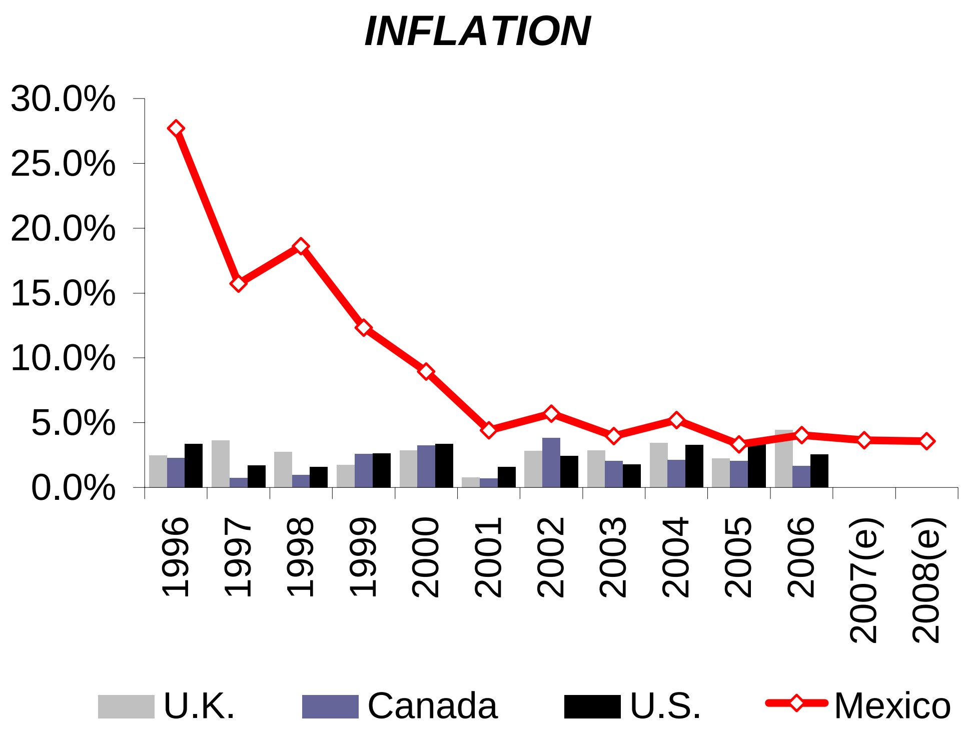


Chart 1. Inflation has converged to developed country levels

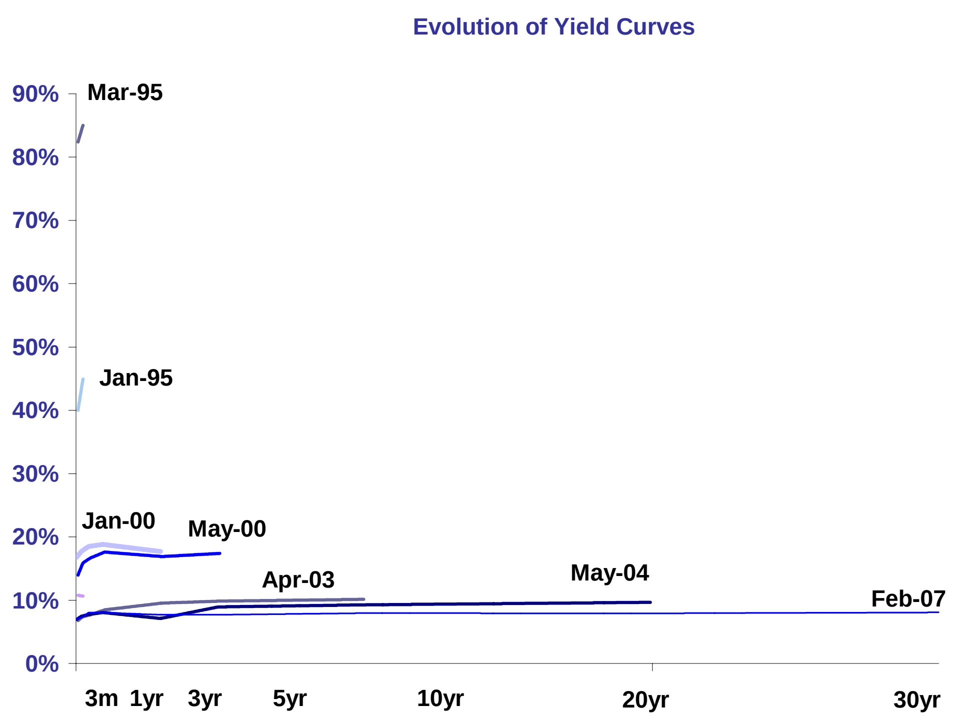


Chart 2. A single digit, liquid, long term, peso denominated yield curve has contributed to the development of the capital markets.

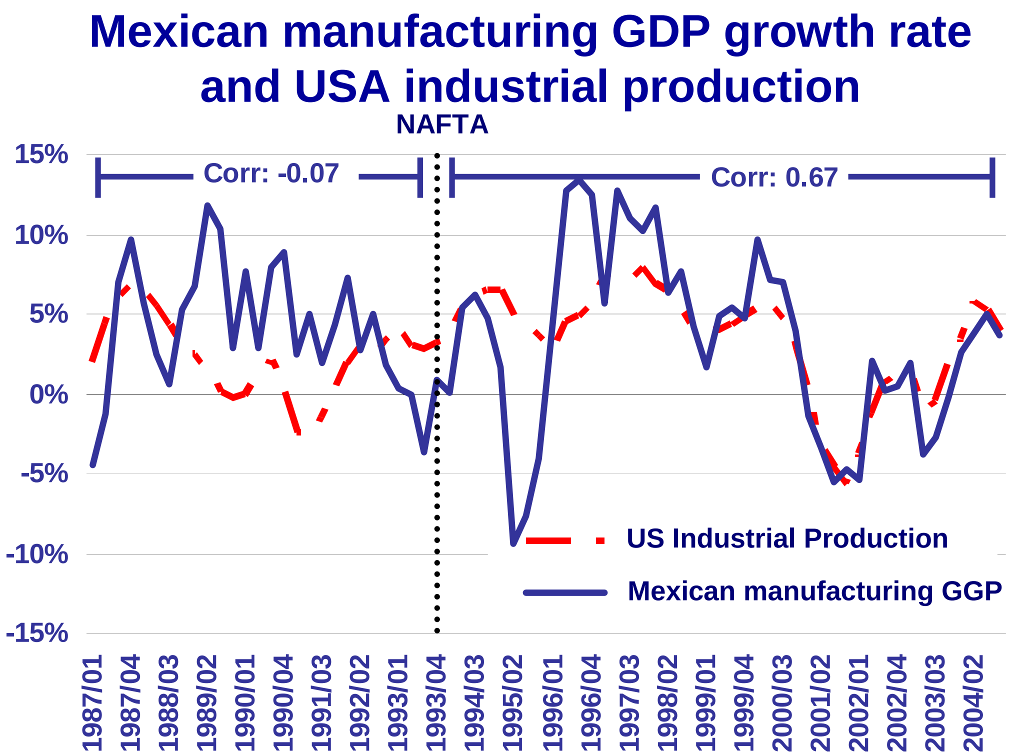


Chart 3. Mexican and US GDP Correlation. Mexico is converging to the North American Economy.

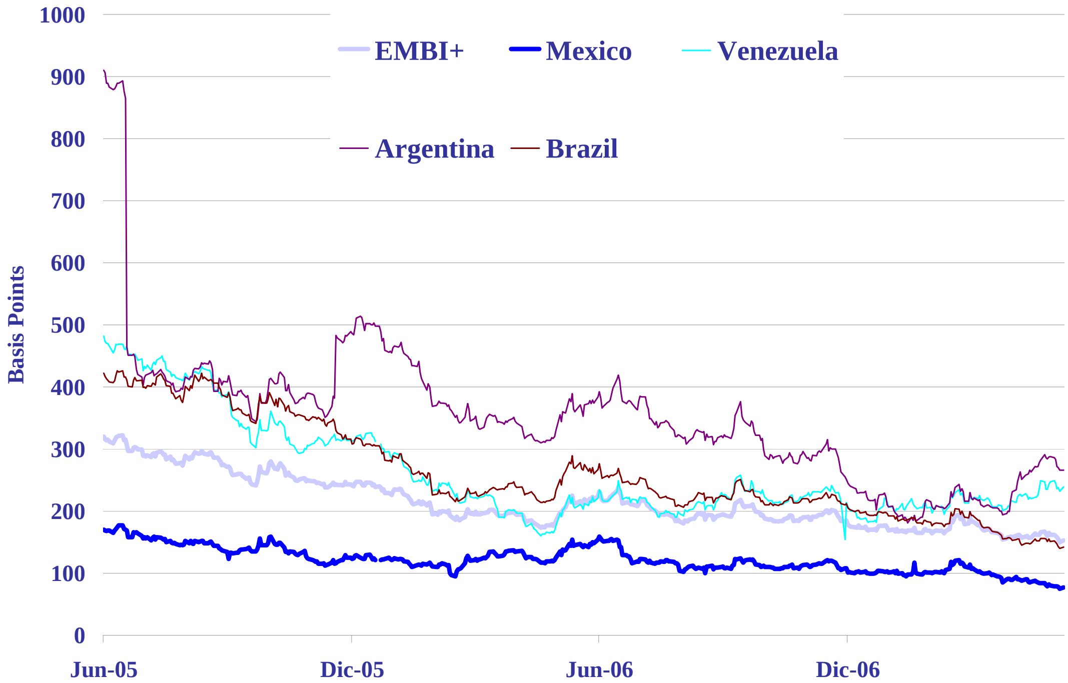


Chart 5. Country Risk. An improving investment grade rating has lowered Mexico's perceived risk.

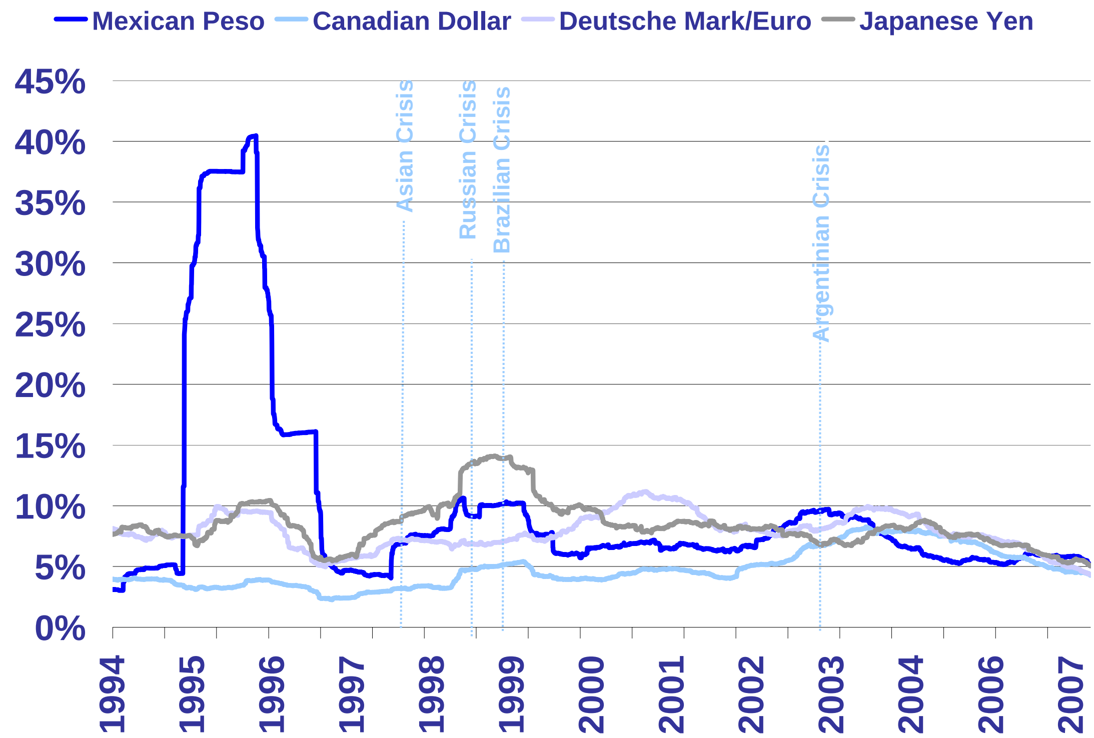


Chart 6. Exchange rate volatility. A floating exchange rate regime has fostered stability and allowed the economy to absorb external shocks.

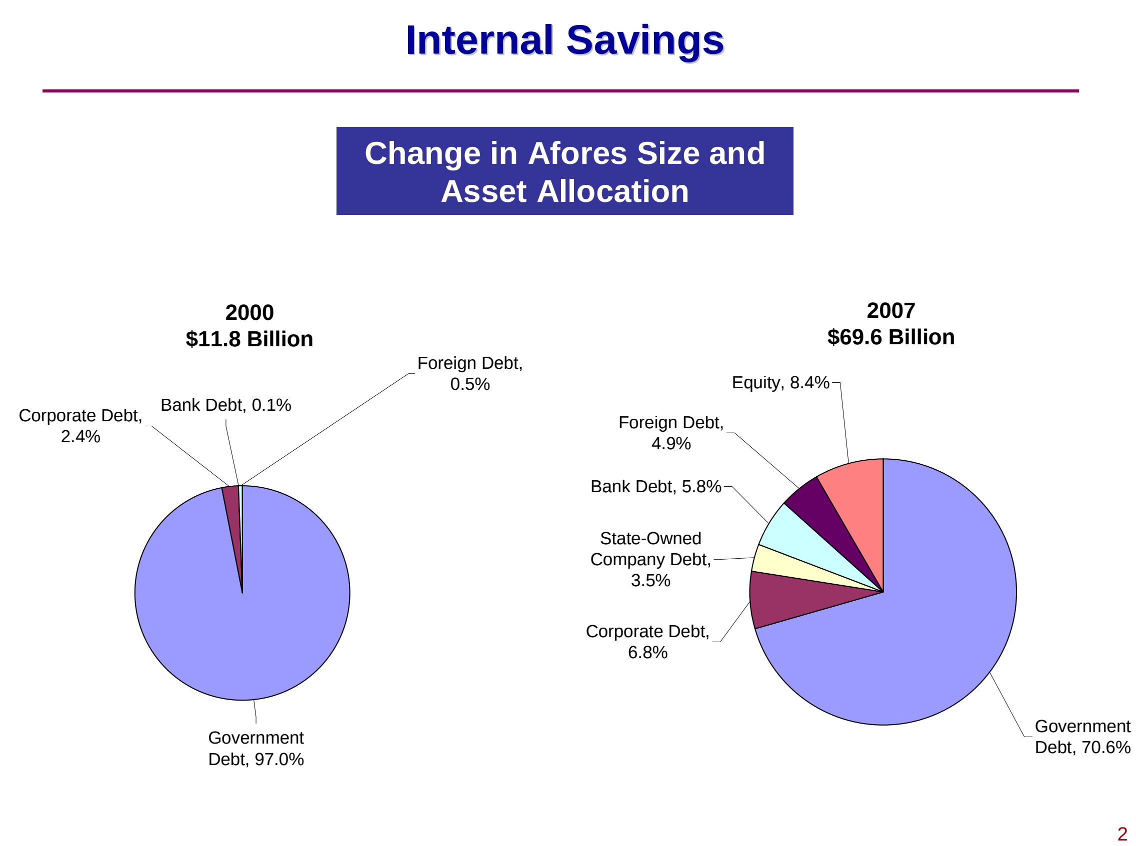
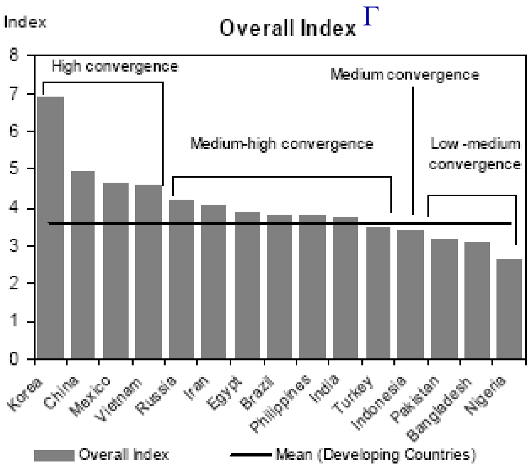


Chart 4. Pension Fund Asset Allocation. Substantial and growing internal savings are seeking diversification and higher returns.

The M in BRIC

Convergence

After China, Mexico is the most likely among the developing economies to converge to developed country income levels.*



GES Index Δ	Mexico	Brazil	Russia	India	China
Macroeconomic Stability					
Inflation	7	**12**	**10**	5	1
Government Deficit	2	**11**	1	**12**	7
External Debt	4	10	8	3	2
Macroeconomic Conditions					
Investment Rate	**7**	**12**	**9**	6	1
Openness of economy	6	**9**	5	**12**	2
Technological Capabilities					
Penetration of PCs	2	4	1	**11**	**7**
Phones	6	3	2	**9**	5
Internet	1	3	6	**11**	5
Human Capital					
Education	3	**13**	1	**12**	6
Life Expectancy	1	7	10	**12**	2
Political Conditions					
Political Stability	4	3	**9**	**7**	2
Rule of Law	5	4	**9**	3	6
Corruption	4	1	**9**	5	**6**
General Index	2	7	4	9	1

Excludes Korea.

Γ *Goldman Sachs Overall Convergence Index as reported in How Solid are the BRICs, Global Economics Paper 134, GS, Dec. 2005*

Δ *The number in the table indicates the place in which each country ranks in the individual components of the General Convergence Index among the BRICs and Next Eleven, excluding Korea. Highlighted in red are scores below the mean.*

High convergence + Low Risk + Geographical Proximity + No Language Barrier =
High Return/Risk and Benefit/Cost Ratios =
High Probability of Significant Returns

Reforma, May 4, 2007.
López Obrador (the duck with the presidential band): a curiosity wiped out from the political landscape.