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FROM THE FIELD

Investors Are Looking South Of the Border for Good Deals

Mexico is an untapped region of opportunity for flexible dealmakers who are creative enough to work around business and cultural differences

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Until very recently, Mexico had not been an attractive playground for private equity firms. The "boom or bust" cycles that have characterized the Mexican economy over the years spooked even the most intrepid investors. Legal and regulatory obstacles made it difficult to invest in private equity. Good targets were hard to find. Families often refused to sell their companies. In short, Mexico's macroeconomic problems, together with a general lack of structural incentives, diverted the tidal wave of global capital from inundating Mexico's borders. Indeed, in the past, Mexico consistently had ranked low in global surveys rating relative attractiveness for private equity investment.

Mexican companies have become more amenable to partnering with private equity groups in an effort to expand their capital base, increase their market knowledge, and diversify their holdings.

All that is changing, however, and Mexico is fast becoming a bastion of private equity capital inflows. The government has implemented legal and structural reforms. Inflation is under control. The economy has been growing steadily, debt is relatively cheap, and, perhaps most importantly, private equity and hedge funds want to invest in emerging markets. China and India have been focal points for investors in recent years, leaving Mexico as an untapped region of opportunity.

As a result, there has been a dramatic increase in interest and deal flow in Mexico over the last couple of years, with private equity groups raising large sums of money for investments in the country. U.S.-based behemoths like **Carlyle Group**, **Advent International**, and **Darby Overseas Investments** have been scouring Mexico for opportunities and have been completing deals. Total investments in Mexico increased from approximately $1.5 billion in 2004 to more than $3.4 billion in 2006, according to the Asociacion Mexicana de Capital Privado (AMEXCAP). Of these amounts, private equity firms raised $347 million for investment in Mexico in 2004, as compared with approximately $1 billion in 2006.

The hype about Mexico in the private equity community is bullish. Fund managers view the country as an attractive market and expect a continued increase in deal flow there over the next few years. Like the rest of Latin America, Mexico is expected to become a major center of private equity.

The Winds of Change

Since 2005, Mexico has enacted significant reforms designed to reduce legal impediments to private equity investment and to enhance heightened transparency and disclosures. In contrast with the past, Mexican companies today can issue preferred stock, grant registration rights, and limit the liability of their directors. Shareholders of Mexican companies can now agree to transfer restrictions, such as tag-along and drag-along rights. Voting blocks representing more than 10% of a company's capitalization have rights to appoint board members and to call or postpone shareholder meetings. Voting blocks above 15% can initiate derivative actions.

To meet the needs of private equity investors that wanted an exit strategy for their investment, the new Securities Market Law — promulgated in late 2005 — created a new type of company called the sociedad anonima promotora de inversion (SAPI), which is generally easier to list on the Mexican stock exchange.

In short, the changes have created more flexibility and certainty for private equity firms in Mexico. These reforms, together with relative political and macroeconomic stability in Mexico and a growing middle class, have fostered growth

of domestic and foreign-owned private equity funds focused within Mexico's borders. According to AMEXCAP, there are currently 37 active funds in Mexico, and more than half of these are subsidiaries of foreign companies.

Last year, Mexico attracted more investment than any other country in Latin America, including Brazil. And by most accounts, this trend seems certain to continue, buoyed by interest from U.S. investors focused on Mexican assets and a growing Mexican market populated by more than 103 million people. Indeed, given that more than two-thirds of the 37.4 million Hispanic Americans are of Mexican descent, the connections, liaisons, and cross-marketing opportunities between the United States and Mexico are particularly strong and promise to be resilient.

Big-Name Buyers

Recent high-profile deals by private equity firms in Mexico, as well as announcements of dedicated Mexico funds by these capital-rich players, support expectations for continued deal flow activity in the country. Deals include Advent's acquisition last year of **Controladora Milano**, the country's largest discount clothing retailer, and Carlyle's acquisition in late 2005 of a majority stake in **Hispanic Teleservices**, a provider of customized bilingual call center services. Carlyle has even set up offices in Mexico and established a Mexican buyout fund. Another PE giant, Darby Overseas, owns stakes in several Mexican companies, such as construction company **Grupo Empresarial Metropolitano** and generic drug maker **Laboratorios Kendrick**.

In addition to these high-visibility investors, Mexico is also being visited by smaller, regional and industry-specialized PE shops that focus primarily on Mexico's plethora of small and midsized enterprises. These include groups like **Conduit Capital Partners** and **ZN Mexico Capital Management**, whose middle-market focus has been greeted by an ever-growing selection of lucrative opportunities in Mexico.

> More than 60% of the Mexican population is under the age of 30, and those market sectors that cater to young people will benefit from this demographic trend.

Dealmaking Challenges

Despite the recent legal reforms, private equity groups still face impediments in getting deals done in Mexico. Small- and medium-sized businesses that have been managed by the same family or "grupos," sometimes for generations, generally dominate Mexico's business framework, creating a somewhat insular business community that is not always amenable to change or open to new ideas and is reluctant to giving up control of businesses.

Cultural barriers constitute the most significant obstacle for PE shops doing business in Mexico. These barriers have strong historical roots and still pervade the mindset of many Mexican business owners today. The business culture is defined by a general distrust of outsiders and an aversion to "revealing secrets" to people outside of their relationship network. Many owners in Mexico have managed their businesses without external interference or involvement for years. And private equity is still a foreign concept. Transparency and external influence on or control of a family-run business are generally anathema to the prevalent business mindset. Many companies are reluctant to provide information for competitive, personal, tax, and security reasons. And this is directly at odds with the fundamental approach of the private equity model, which mandates external involvement in an investment.

Therefore, wise investors must be willing to shed much of their traditional ways of doing business and learn the cultural ropes as part of the price of landing good deals. Flexible, creative investors who are alert to potential sticking points and who can work around business and cultural differences should be able to get a foot in the door and cement successful transactions.

In recent years, private equity groups have employed a multi-faceted approach to targeting potential partners and businesses intended to pierce the veil of cultural resistance to private equity in Mexico. This approach includes using professional intermediaries — such as investment banks, private bankers, and mutual contacts — to overcome cultural barriers and help set realistic expectations about the processes necessary to consummate a deal.

Some private equity firms also invite potential partners in Mexico to meet with managers of their other portfolio investments to facilitate a better understanding of the private equity approach to, for example, corporate governance, management oversight, and information requirements. Finally, some PE groups like Carlyle have established local teams and a local presence in Mexico as a key strategic element in assisting their funds in overcoming cultural obstructions.

Another obstacle to private equity investment in Mexico is finding the right management team. Typically, PE shops seek top entrepreneurial talent to run their portfolio businesses and to implement their strategic plans. This can be particularly difficult to do in Mexico, however, where many managers are unfamiliar with the private equity model and where private equity firms lack a strong track record of success in finding good prospects. While the trend has been changing in recent years, particularly in the services sector, it's still a significant challenge for private

equity groups. Without this key element, many investors will not go forward with an otherwise attractive deal.

Private equity firms have tried to tackle the challenge of finding the right managerial team by luring top talent in Mexico with incentive packages and safety nets in case the investment does not achieve targeted goals. This is not always easy to do, as it often requires local connections and contacts to convince good managers to leave their current positions. Nevertheless, the hope of most PE firms in Mexico is that, as private equity investment increases and becomes better understood in the country, and as success stories proliferate, PE firms will be able to attract the best teams to run portfolio companies.

A third obstacle to private equity investment is overcoming the economic motives and expectations of Mexican business owners. In some cases, controlling shareholders negotiate with PE groups only as a means to "shop" for a good price, without having a serious intent to sell, or only to sell at significantly above-market valuations. In other instances, the business owner will demand a large premium over the fair market value of the company as compensation for parting with perks and extraordinary benefits, such as above-market salaries and bonuses. Similarly, aggressive tax planning practices employed by family-run businesses may simply not be compatible with a private equity appetite for a more conservative approach. These issues can sometimes create price differentials that seem insuperable, particularly in view of the minimum targeted return on investment of 25% to 30% sought by most private equity firms.

To overcome these obstacles and avoid lost time and delays, sophisticated PE shops often attack these issues head-on, early in the process. To bridge the gap in valuation expectations, private equity groups can resort to ratchet mechanisms, earn-outs, or profit-sharing arrangements as ways to motivate an owner to do a deal where a significant portion of the purchase price will be paid in the future if certain financial targets are met. Investment bankers also serve a crucial role in screening companies and ensuring that the expectations of business owners are aligned with the realities of the private equity market.

Finally, PE firms will often meet directly with the principals of the business to avoid any concerns about owners "shopping" the company without having a serious intent of actually consummating a deal. This moral persuasion is often enough to separate the serious players from the teasers.

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Private Equity Deal Drivers

In our opinion, the principal drivers of private equity investment in Mexico are the country's relatively young population, a stable economic environment, cheap debt, a growing services sector, and increasing competition from Chinese manufactured goods. Successful investments will generally take these dynamics into account. However, each of these drivers has implications for specific market sectors of the Mexican economy and must be evaluated together with other macroeconomic trends that could have an impact on the specific investment.

Currently in Mexico, more than 60% of the population is under the age of 30, according to Mexico's National Institute of Statistics, Geography, and Informatics. As a result, we believe that those market sectors that cater to young people will benefit from this demographic trend. These include consumer goods, such as food and beverages, packaging, education, child entertainment, office supplies, and housing and building materials.

That being said, while the Mexican population remains relatively young, it's also aging. In 1990, there were approximately 3.5 million Mexicans over the age of 65, or about 3.7% of the country's total population. By 2030, it's estimated that there will be approximately 15.2 million Mexicans over the age of 65, or about 15.2% of the population. This trend is also creating a growing demand for health products and services, such as diagnostic laboratories, ambulance services, and the like.

In recent years, Mexico has maintained a stable economic environment, resulting in low interest rates. We believe that this macroeconomic stability benefits those sectors of the economy that rely on relatively cheap and stable debt, such as financial services, low-income housing, and infrastructure development, including, for example, ports, highways, and airports. In addition, this stability, coupled with a growing and more sophisticated banking system that has characterized the Mexican financial market in recent years, has resulted in increased availability of consumer credit, thus benefiting retailers and durable goods manufacturers.

Investment Hot Spots

Also in recent years, the growth of the services sector in Mexico has outpaced GDP growth. Although the services sector still represents a relatively low portion of total GDP as compared with more developed countries, we believe that the services sector will continue to grow and penetrate the Mexican economy. This will in turn result in benefits to those businesses

focused on services, including logistics, business process outsourcing (BPO), catering, and security services.

Despite the general trends favoring those market sectors catering to Mexico's young population, financial services and business services, other factors defining the Mexican market also need to be evaluated by private equity groups. For example, certain Mexican manufactured goods distributed in the NAFTA region have been largely displaced by competition from Chinese rivals. Accordingly, it probably would not be prudent to invest in those market sectors in Mexico that compete directly with Chinese goods, particularly in commodities and labor-intensive products or where transportation costs are a small fraction of total costs. This would include, for example, textiles, manufacturing, and certain steel products. Nevertheless, Mexican exporters can remain competitive in certain higher value-added products where time to market is more important to end users than costs, such as industrial valves and auto parts.

Similarly, investors should be cautious about investing in certain Mexican industries that are already dominated by hardy domestic incumbents. For example, the telecommunications, flat glass, cement, and the bakery markets in Mexico are consolidated already in large measure and are defined by dominant players with significant market power. Entry into these markets would be difficult for any investor and hard to justify given expected returns by PE firms.

In general, most professional investors in Mexico are seeking to find high-growth companies or opportunistic investments where the market drivers and dynamics discussed above coincide with strong historical growth and financial performance. Over the last year, PE investment has been focused on companies active in low-income housing, consumer credit, and consumer goods.

Going forward, many PE shops agree that the most attractive sectors for investment in Mexico will be real estate, energy, financial services, and consumer products. Some players are also enthusiastic about infrastructure and health care, which they believe will require substantial capital and overhaul in the near term.

Investment Outlook

Historically, returns on investment in Mexican companies have been disappointing for private equity groups, particularly when compared with comparables in developed economies, such as the United States and Europe. However, since 2003, investment performance has improved dramatically and the market has witnessed several successful and high-profile investment exits. These include **JPMorgan Partners**' sale of pharmaceuticals distributor **Grupo Marzam** to a group of private Mexican investors and its sale of disposable tableware products maker **Grupo Convermex** to **Merrill Lynch Global Private Equity**. Also, homebuilder **Desarrolladora Homex**, which had been partly owned by Chicago-based **Equity International Properties** and Mexico investment fund ZN Mexico, performed a successful IPO on the Mexican and New York stock exchanges several years ago.

In our view, the outlook for the Mexican private equity market is cautiously optimistic. The consensus among PE firms focused on Latin

America is that Mexico is and will remain an appealing market for private equity investment in the coming years. There are more experienced players in the market. There is a better understanding of the concept of private equity today and the investment model has been adapted to the local market. There are many desirable, medium-sized companies with talented managers. Relatively cheap, long-term, local financing is available. Exit opportunities, while still limited, are growing, and include the IPO market, sales to local and foreign strategic acquirers, and the secondary private equity market.

Global competition will also remain a robust driver for private equity investment in Mexico. As international players continue to compete with Mexico for its own and other markets — and particularly since China joined the World Trade Organization in 2001 — Mexican companies have become more amenable to partnering with private equity groups in an effort to expand their capital base, increase their market knowledge, and diversify their holdings. Thus, many Mexican incumbents and entrepreneurs realize that "doing nothing" in the current market is their biggest hindrance. This will continue to create opportunities for PE firms doing business in the country.

Working Within the System

However, Mexico is still an emerging market, and doing deals there is not for the impatient or the rigid. While most seasoned players agree that the recent reforms and relatively stable market conditions in Mexico are more sustainable than in the past, investors still need to moderate their expectations for the Mexican market. Successful PE groups stress the need to understand the Mexican cultural, political, business, and legal environments if they want to play in the sandbox. The business community remains clubby. Mexican businessmen are not always accustomed to corporate governance standards and financial disclosure requirements mandated by the private equity world. This can lead to prolonged timeframes for getting deals done and deploying capital.

According to KPMG's Sixth Annual Latin America Private Equity Survey, the primary causes for deal failure involving private equity transactions in Latin America are ineffective management teams and incomplete information regarding the targets.

To safeguard against these risks, it's imperative for private equity groups to conduct thorough due diligence investigations of Mexican targets using seasoned and experienced experts familiar with the business, financial, and legal terrain. Smart PE shops will also negotiate purchase contracts and shareholder agreements in Mexico that contain express and relatively stringent provisions to protect the investor against deficiencies.

Armed with these protections and the right outlook, Mexico promises viable opportunities for private equity players over the next few years.

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