BDO KNOWS INTERNATIONAL PRIVATE EQUITY: SPOTLIGHT ON MEXICO

For the past several years, Mexico’s economy has been on the up and up. Government reforms, a booming services sector, the growing availability of credit, remittances from foreign workers and a solid currency exchange rate have all fostered steady growth for the country. While this growth has slowed somewhat in 2016 (in fact, for the first time in three years, the Mexican economy shrank in Q2 2016), the longer-term outlook for Mexico remains optimistic—and private equity (PE) investors have taken notice.

Fred Campos, managing director of Transaction Advisory Services at BDO USA, and Jerry Seade, international tax principal at BDO USA, sat down with Bernardo Soto, partner at BDO Mexico, to discuss the latest PE trends in the region. Here are some insights from their conversation.

When we originally spoke in 2015 about private equity investment trends in Mexico, Latin America was on the rise as an attractive target. However, the region has fallen on harder economic times over the past year. Why do you think this happened, and what does this mean for future investment in Mexico?

Several countries in Latin America are facing economic hardship—Brazil, once the model of growth and modernization, is among the hardest hit. Luckily, Mexico has not been so strongly affected, though it has experienced some speed bumps.

The ongoing oil price slump, combined with the recent contraction of the Mexican economy, has cooled investor interest somewhat. The Mexican government has made significant strides to open up its promising energy sector to outside investment but, in a low oil-price environment, few investors are looking to enter this market right now. Similar to what you’re seeing in the U.S., PE firms with an interest in the energy industry largely remain on the sidelines as they wait for oil prices to stabilize, and then rise to more desirable levels.

But this does not mean investment opportunities have dried up. The Mexican government continues to pursue legislative changes to further open up the country to foreign investment. The liberalization of the energy and telecom sector persists—though it is proceeding at a slightly slower pace due to the sluggishness of the overall economy—and the government remains committed to harmonizing its business policies with other major global players. There is also greater collaboration to encourage regional economic and stock integration within Latin America; in 2013, Mexico became a part of the Pacific trade block, along with Chile, Colombia and Peru.

Which industries do you think will be most attractive to investors looking into Mexico?

Even though interest has waned over the past year or so, the energy sector remains a promising medium-term investment opportunity. The first round of offshore lease auctions, which began in summer 2015, got off to a slow start. However, despite continued stress in the industry, we did see interest grow with each subsequent auction.

The next block of leases is up for auction in December of this year and, as of this past May, 14 companies had already signed up to bid.
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Growing; according to the Washington Post, more than $100 million in venture capital dollars has been invested in Guadalajara-based startups since 2014.

What type of capital flow are you seeing coming into Mexico right now?

We’re seeing capital flowing in from different parts of the world with a great deal coming from North America. Mexican family-owned companies are seeking local investment, which is driving many larger U.S. private equity firms to carve out subsegments of existing funds to dedicate solely to Mexico.

Many international companies are targeting small to mid-size Mexican companies, with revenues ranging from $25 to $50 million.

As I noted above, Chinese investors have also taken an interest in Mexico in recent months.

What is the untapped market in Mexico or the next hot opportunity for PE investment locally?

We’re seeing a resurgence in manufacturing—specifically, in the auto industry. This was a hot sector prior to the economic downturn in 2008, and it is slowly coming back. For many companies in this space, the end goal is to turn a profit by exporting goods to the United States.

The textile and mining industries may also be the next big opportunity for investment, especially small companies ripe to be acquired. But these are heavily unionized industries, and investors must remain cognizant of labor laws and unions.

Finally, we may expect to see some growing investor interest in the tourism industry. Mexico remains a popular vacation destination for many North American travelers, but some government officials believe the country may see a modest boost among tourists wary of recent terror attacks in popular European destinations, such as France and Belgium. Mexico’s wine and spirits industry is also growing and attracting tourist attention—which means investors may soon follow.

What tax considerations should PE investors think about as they contemplate investments in Mexico?

Taxes are always a challenge, especially among foreign investors unfamiliar with local laws. Nevertheless, Mexico has some tax advantages that should prove attractive to PE firms looking to do business in Latin America. We have relatively low income tax rates and, most recently, the government has started mulling a reduction in the tax rate PE funds must pay to take portfolio companies public from 35 percent to 10 percent. The government is also considering updating the tax code to allow PE firms to use losses to offset taxes on gains. It’s clear, then, that Mexico is actively looking to court PE investors.

From a more immediate perspective, there are a number of tax laws potential PE investors should familiarize themselves with. For the last six years, corporations have been subject to thorough reviews requiring stringent compliance, especially in regards to value-added and federal income tax, and understanding and preparing for these reviews is essential. They should also evaluate the potential tax implications related to asset acquisitions versus business combinations. Unlike in other countries, such as Brazil, asset acquisitions can be particularly attractive in Mexico, but tax diligence is crucial to determining whether the transaction will qualify as an asset acquisition and protect the buyer from successor liability.

For more information about private equity in Latin America, take a look at our Q&As with Brazil and Argentina, or contact:

FRED CAMPOS, Miami
305-420-8044 / fcampos@bdo.com

LEE DURAN, San Diego
858-431-3410 / lduran@bdo.com

SCOTT HENDON, Dallas
214-665-0750 / shendon@bdo.com

JERRY SEADE, Houston
713-548-0877 / jseade@bdo.com

BERNARDO SOTO, Méx¡co
+52 (55) 8503 4200
Bernardo.Soto@bdo.comexico.com

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