The Legal 500 Country Comparative Guides

Mexico: Private Equity

This country-specific Q&A provides an overview of private equity laws and regulations applicable in Mexico.

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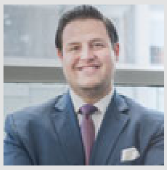

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1. **What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?**

   There is no specific official data that is publicly available in México that allows to determine such proportion.

   M&A activity in Mexico in 2020 continued to show an even steeper decline than it did back in 2019. In particular, private investment in Mexico for 3Q20 decreased 20.8% with respect to the same period of last year.

   The foregoing can largely be attributed to the challenging economic and political circumstances in Mexico and worldwide. On the one hand, the administration of Mexico's president – Andres Manuel López Obrador (AMLO) – has continued to set policies that have scared away investments, including the counter reform of the energy reform of 2012 which allowed the participation of private investment in this sector, the cancellation of major public-private investments that were considered key for the country; the implementation of projects such as the Dos Bocas refinery and the Tren Maya, which viability has been questioned; and several actions against the rule of law. On the other hand the COVID-19 pandemic has generated adverse global economic conditions that have also affected Mexico.

   On the positive side, the successful renegotiation of the USMCA trade agreement in the context of the new economic relationship between the US and China, is expected to significantly increase the activity in México. Also, the current economic context will generate attractive investment opportunities that could put a focus in Mexico.

2. **What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?**

   The main difference rests on the nature of the sale. Financial sponsors generally seek clean and unencumbered exits from their investment (portfolio company) so as to allow them to upstream the return of their investors, whereas trade sellers seek to maximize gain regardless of the undertaking of risks.

3. **On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?**

   As a first step, a stock purchase agreement is recommended to be executed between buyer and seller in order to define, among others, the stock to be transferred, the purchase price, and the representations and warranties regarding the target and the stapled indemnity obligations and applicable exceptions (caps, deductibles, *deminimis*, anti-sandbagging, etc.). Once the agreement is signed and upon satisfaction of the agreed conditions to closing (if any), the stock certificates representing the transferred shares must be endorsed (endoso en propiedad) by seller to buyer. Likewise, seller must cause the target company to register the transfer in its stock registry book (l*ibro de registro de acciones*) – this last requirement is essential given that the Mexican General Law of Business Organizations (*Ley General de Sociedades Mercantiles*) sets forth that business organizations incorporated in Mexico will consider the persons registered in the aforementioned registry book as the shareholders thereof.

Additionally, in terms of the aforementioned statute the relevant target entity will have to file a notice before the Ministry of the Economy (*Secretaría de Economía*) with regards to the transfer of shares. Such notice is filed electronically through the electronic system of the Ministry of the Economy, and its terms (name, nationality, and address of the shareholders) will remain strictly confidential.

There are no transfer taxes payable in the context of the acquisition of shares. That said, seller will likely be required to pay income tax on the capital gains from the sale. The tax rate will apply on a case-by-case basis depending on the particular characteristics of seller (e.g. being a non-tax resident, double taxation treaties, etc.).

In addition to the foregoing, potential investors may also acquire shares of target companies via a direct subscription of stock. This is a typical structure where one or more investors decide to participate in the equity of a Mexican company without a transfer of stock by the current shareholders, only their dilution. This type of acquisition is generally more efficient from a tax perspective as certain tax attributes of the target under Mexican law can be used.

4. **How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?**

The structuring of acquisitions through an SPV is common in transactions in Mexico. To provide comfort to seller, guarantees (*obligación solidaria*) by parent companies or UBOs are often put in place, thus giving seller a direct claim in case of a breach by buyer. Equity and debt commitment letters are also used in order to provide comfort to seller that the purchasing SPV will ultimately have the funds required to carry out the acquisition.

5. **How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?**

There is no general rule in México with respect to pricing mechanisms, that said, traditional pricing mechanisms to closing accounts are seen more often than “locked box” mechanisms.

6. **What are the typical methods and constructs of how risk is allocated between a buyer and seller?**

Risk is usually allocated through the terms and conditions of the purchase agreement, mainly through: Representations and warranties.- These are given by the target company and seller, and are usually full-fledged when involving a material equity percentage, and include, among others, title to assets, capacity, compliance, due authorization, no contravention, tax, financial information, litigation, labor, etc. On the buy-side, these are usually limited to capacity, due authorization and financial solvency. Representations and warranties are also usually subject to the existence of a “material adverse effect”. Conduct of business.- In transactions where signing and closing are differed, conduct of business clauses, whereby the target company and seller agree to comply with certain positive and negative covenants to protect buyer, are common. Closing conditions.- In Mexico, once closing conditions are met, the purchase agreement becomes fully binding for the parties. Specific performance can be claimed by either party in such scenario. Indemnities.- Indemnity clauses are usually divided into those arising from breaches to fundamental representations and warranties, and all other breaches. The caps, baskets (deductible and de minimis) and claim periods will depend on such type of breaches. Breaches will typically be exempt if fully disclosed. “Sand-bagging” / “anti-sandbagging” mechanisms can also be included.

7. **How prevalent is the use of W&I insurance in your transactions?**

The use of W&I insurance is not common in Mexico. When seen it is usually in the context of cross-border transactions with agreements governed by foreign law.

8. **How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?**

Given the latest political and economic environment in Mexico, the securities market has been somewhat stalled with some decent activity in tender offers for publicly listed companies. The most recent tender offer took place back in October and was launched for the 17% float of Bio Pappel, S.A.B. de C.V.

Regarding infrastructure assets, several innovative legal vehicles have been included in the applicable legislation. These vehicles have been designed to promote investment in Mexican infrastructure, and include FIBRAs (REIT-equivalent), FIBRA-Es, CKDs, CERPIs and FICAPs. Due to the foregoing, PE sponsors have been much more active on the infrastructure side. It is worth noting that the current administration in Mexico has promised to promote investment in this sector.

9. **Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?**

Mexico has been, historically, a somewhat protectionist country when it comes to foreign investment. That said, in recent years it has become much more open. In line with the foregoing, the Mexican Foreign Investment Law *(Ley de Inversión Extranjera*) sets forth certain restrictions applicable for few strategic activities and sectors, which are reserved to: Government agencies. For example, nuclear energy generation, exploration and extraction of oil and hydrocarbons, issuance of paper currency, minting of coin, and others. Mexican companies with no foregoing investment. For example, land passenger or freight transportation. Mexican companies where foreign capital ownership is limited to a certain percentage. For example, manufacturing of explosives or firearms, radio broadcasting, and others. Foreign investment in other specialized sectors may be subject to prior authorization by the National Foreign Investment Commission (C*omisión Nacional de Inversiones Extranjeras*) (e.g. private education).

Also, as a result of the counter reform to the 2012 energy reform that could potentially be implemented by the administration of Mexico's president – Andres Manuel López Obrador (AMLO), several areas in the energy and infrastructure sector that were opened to foreign private investments, could be restricted again.

10. **How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?**

Under Mexican law, specifically under the Federal Antitrust Law (*Ley Federal de Competencia Económica*), merger clearance is only required to the extent the transaction meets any of the following:

1.- The amount of the transaction exceeding USD$75 Million (approx.).

2.- The amount of the transaction exceeding USD$35 Million and the parties involved having sales or assets in Mexico for USD$200 Million (approx.).

3.- The transaction involving the acquisition of more than 35% of the assets or shares of an entity having sales or assets in Mexico for USD$75 Million (approx.).

Merger clearance is almost always jointly requested by both parties and is typically structured as a condition to closing. The foregoing, in the understanding that "hell or high water" mechanisms are not common in Mexico.

11. **Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?**

Both mechanisms (equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside) or a mixture thereof are used in our jurisdiction.

12. **How are management incentive schemes typically structured?**

There is no general rule and it varies depending on the deal itself. That said, management schemes in PE-related transactions, usually involve the granting of stock options (or alternatively, and most recommend, phantom stock due to corporate governance or employment law concerns) to key members of management, earn-out payments, and other forms of performance-based compensation.

13. **Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?**

There are no specific tax rules regarding management incentive schemes themselves, however, the general tax framework in Mexico will apply and the particular rules will depend on the proposed incentive scheme. In general, vested stock may be taxed on the capital gains obtained by the relevant executives when transferring their shares back to the company (if possible) or to a third party. The applicable tax rate will hinge on the income bracket of the specific executive, but it will usually range between 30-35% percent. Likewise, executives that are tax residents in Mexico and who hold-on to vested stock will be subject to a 10% tax on dividends received. Any other form of incentive scheme involving a cash payment to management such as earnout or performance-based compensation will likely be subject to income tax at a rate between 30-35% percent as mentioned above.

14. **Are senior managers subject to non-competes and if so what is the general duration?**

It is common for sponsors to request certain key members of management to enter into noncompete arrangements in Mexico. Be that as it may, courts in Mexico have been inconsistent in the enforceability of these sort of agreements, mainly on the basis of the constitutional protection of the right to work and to freely carry out any legal activity. To mitigate the risk of a court declaring a non-compete as invalid, it is important to: restrict it to a specific and reasonable territory and activity; not completely hinder the possibility of the executive to participate in non-related fields; subject the arrangement to a reasonable time frame (typically 12 to 36 months); and to provide for compensation during the time that the relevant executive is bound by the non-compete. The inclusion of pre-agreed commercial monetary penalties is also advisable as a mean of enforcement of this type of agreements.

15. **How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?**

In the case of an equity transaction and depending on whether the acquisition is for a minority or majority stake, sponsors usually seek presence on the board, veto powers over certain super-majority matters at the shareholder and board levels (e.g. mergers, disposal of assets, change of business line, etc.), as well as other protections regarding their exit from the investment, ranging from tag-along and drag-along rights as well as preferential rights in a potential IPO. The foregoing is either documented in a shareholders' agreement or is reflected straight in the bylaws of the acquired company. Regarding debt transactions, sponsors are also likely to request board presence and will want to have a say over certain corporate and business matters – this is typically structured through positive and negative covenants in the loan agreement. Likewise, if the deal involves a syndicate of sponsors, as lenders, the relationship between the members of the syndicate and their rights with respect to the debt investment will mostly likely be set forth in an intercreditor agreement.

16. **Is it common to use management pooling vehicles where there are a large number of employee shareholders?**

It varies from transaction to transaction. Some incentive schemes imply members of management holding non-voting stock with the company or controlling shareholder (or sponsor) holding a call right to acquire those shares upon the exit of a specific officer. The acquisition price may vary depending on whether the officer is exiting willfully or if she is being dismissed without cause. That said, in other transactions where there is a strong desire to bring-in talent, key officers are pooled in one single vehicle that participates with full corporate and economic rights in the target company.

17. **What are the most commonly used debt finance capital structures across small, medium and large financings?**

There is no specific rule. That said for small and mid-size deals the typical financing structure relies on traditional banks funding secured loan facilities. On the other hand, larger deals may involve senior and subordinated financing, syndication structures, as well as other forms of convertible debt instruments.

18. **Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?**

From a few years back the debt financing sector in Mexico basically became fully open and subject to certain restrictions any entity may provide financial assistance. That said, such assistance and any collateral stapled thereto must be specifically contemplated in the lending company's bylaws and is usually subject to previous corporate approval.

19. **For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?**

There is no standard form of credit agreement in Mexico, it varies depending on the specific transaction and the lenders involved. That said, there is a general understanding of the market terms applicable to each debt financing structure among banks, legal advisors and other specialized firms involved in the transactions. The level of negotiation will also depend on the deal itself.

20. **What have been the key areas of negotiation between borrowers and lenders in the last two years?**

Financing deals in Mexico have traditionally been negotiated on a “take it or leave it” basis, with certain provisions being subject to little room for negotiation. That said, in recent years borrowers have pushed for more protection in key areas, including with respect to early maturity, assignment by lender requiring consent, cure periods on default, limiting default scenarios, among others. In addition, commercial terms (interest rates, breakage costs, etc.) are highly negotiated as well. Restricción y Denuncia provisions (discretionary reduction of the credit line and discretionary termination of the facility by the lender) that were considered market in Mexican loans, have recently been negotiated by borrowers to limit them to certain and specific scenarios.

21. **Have you seen an increase or use of private equity credit funds as sources of debt capital?**

There are several PE credit funds that provide debt capital in Mexico, both domestic and international, and they have become recurrent players in the Mexican PE market specifically with regards to the Fintech sector. It is yet to be seen how Mexico’s current forecasts will affect their role in the coming years.