Private Equity for Real Estate in Mexico: overview, challenges and opportunities

by

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Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development
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ABSTRACT

Considering Mexico's size and fundamentals, the Private Equity Industry in Mexico is underdeveloped but quickly growing. In an emerging market with over 60% of its population in its work force, and whose middle class will almost double by 2025, opportunities are emerging in all sectors. Private Equity funds could play a key role in financing and seizing them.

Private Equity has had a low penetration in Mexico because of an immature financial sector, a legal system with a weak judiciary branch and a high concentration of family-owned businesses without institutional practices, among other reasons. However, this sector's potential in coming years is significant. The industry attempts to double its size by the end of this decade, translating into more available money at better prices. The question is: how can the government and industry leaders unlock this potential? Several actions at all levels of the public and private sectors are needed to access available capital. The purpose of this thesis is to show the trends, opportunities and challenges regarding the Mexican Private Equity Industry, focusing on real estate investments. Today, the investment cycle in the real estate arena is complete, generating confidence for Private Equity funds. A lack of supply in the Mexican market, regulatory changes allowing local pension funds to invest in alternative investments, and the introduction of Mexican Real Estate Investment Trusts as institutional buyers have provided managers and developers everything they need to capitalize real estate investment opportunities. Still, there are multiple challenges for the growth of the Private Equity Industry: authorities need to ensure regulation enforcement, existing vehicles such as "Structured Equity Securities" must improve for fund managers to raise and deploy capital, and the reforms underway (specifically the financial reform) must bring better long-term debt opportunities.

If public and private entities decide to get in the same boat, Private Equity Investments can bring unprecedented benefits for funds, developers and the whole nation. The equity is now available and regulatory framework seems more investor-friendly. It is the turn for industry leaders and managers to guide their businesses in seeking institutional funding and thus contributing to Mexico's growth.

Thesis Supervisor: Professor Albert Saiz
Title: Daniel Rose Associate Professor of Urban Economics and Real Estate, Department of Urban Studies and Center for Real Estate

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Acknowledgements

I have always believed that collaboration and the sharing of ideas are the best means to make the most of everything. Following that principle, I discussed my thesis topic with people whom I knew would enhance its results. I would like to thank everyone who helped me learn from this process and write the present thesis.

My sincere gratitude goes to my advisor Dr. Albert Saiz, especially for his patience and guidance on this thesis.

Additionally, I would like to thank others that made this study possible by sharing their insight, knowledge and inspiring vision with me. Special appreciations to Alberto de la Garza E. (Internacional de Inversiones), Antonio Elosua (Ucalli), Antonio Ruiz (Grupo IGS), Carlos Muñoz (Grupo 4S), Edgar Maldonado (Grupo Acosta Verde), Eduardo Garza (Evalor), Guillermo Díaz (JLL), Javier Domínguez T. (Ritch Mueller), Jaime Martínez (Fibra MTY), Javier Llaca (Fibra MTY), Jesús Acosta V. (Grupo Acosta Verde), Jorge Ávalos (Fibra MTY), Roberto Garza (Abella Desarrollos) and Santiago Mancebo (JLL). The meetings I had with them enlightened my understanding of the subject and allowed me to get a sense of the pulse of the private equity and real estate industries in Mexico.

Last but not least, I wish to thank my wife for constantly being with me through every single situation and for making this journey an unforgettable one, my family, for supporting me through my entire life: my mother, for always being encouraging and cheering me up, and special thanks to my father, an amazing man who taught me by example that leadership entails great responsibility and that success is for those who manage to set goals and work hard to achieve them.

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I
Introduction

Globalization is a reality. With advances in transportation, telecommunication and technology in general, the geographic and cultural boundaries appear to be less of an issue for humanity lately. Mobility has increased and being reachable is not an asset anymore; instead, it is a must. Today, investors and fund managers consider opportunities outside their own country with greater ease and confidence. It is also true that developed countries have learned some of the consequences of pouring money into one single asset class (such as real estate in the USA) and today, they are more willing to look abroad. Even though fund managers normally prefer to invest in markets in which they have a good knowledge and expertise, investment is becoming increasingly international. Nowadays, there is no homeland for money and capital flows are coming back and forth: Norwegian and Chinese investments are "flying to quality" to the United States, and investments from New York-based funds going to South Asia and Latin America. It is not new to say that, in developed countries, there is a lot of money ready to be allocated, but there are not enough worthy opportunities. Low-priced debt in these markets can allow returns on equity to be sufficient. Given recent past experiences (e.g. Financial Crisis 2008), managers might prefer to invest somewhere else instead of making highly leveraged investments in "safer" economies.

For developing countries, most of the times the case is different. There might be worthy opportunities, but not investors willing to seize them. Furthermore, there might be good investment opportunities and investors ready lo allocate the cash, but there are no ideal vehicles to make the investment; also, there might be investors, opportunities and vehicles, but the legal framework is not in place. In some cases, it is even more basic than that: there is a lack of local management experience and that could be one of the main reasons for international investors not to be willing to invest in emerging markets. Aside from international investors, the absence of adequate vehicles or management experience can also be a cause for the investment industry to be underdeveloped in some countries.

Emerging countries are known for their growth potential but they are also known for having economical and political instability, which is the origin of most of these problems. Without the proper economic fundamentals and political certainty, investment opportunities are perceived as high-risk investments, thus frustrating the capital inflows into the country. So, real estate investments are directly affected by this standpoint, hence risking the nation's development and planned infrastructure.

To address this problem in emerging economies for the particular case of Mexico, the purpose of this thesis is to show the future opportunities regarding the Mexican Private Equity Industry focusing on real estate investments. In order to achieve this goal, it is necessary to show the history and development of Private Equity (PE) and Real Estate (RE) in Mexico to try to forecast upcoming trends.

The present study first approaches the situation by placing Mexico in context through a comparison of this country to some of its Latin American peers and other comparable economies around the world. Moreover, it provides a general overview of Mexico, including population, geography, economic fundamentals, politics and reforms underway. Later, it comments on how the Private Equity Industry (PEI) has evolved over the years, including some of its recent history, particularly describing its actual status with detail about the real estate market and investment. Once the situation is described, a forecast of the industry direction and outcome is presented particularly in terms of the worthy opportunities regarding private equity (PE) opportunity funds with a focus on real estate. The information is cross-referenced with comments and recommendations made by industry leaders in a previous survey, in order to have a better understanding of the future trends. The study concludes by showing the current potential for PE in Mexico (opportunities and trends), the way it can be unlocked (challenges) and the approach through which Mexico could take advantage of a more dynamic Private Equity Industry.

The information presented is the result of quantitative and qualitative research. Background information for this thesis is based on academic research papers, industry research, business articles, PE associations, and information presented on forums. Additionally, this study includes a survey conducted in May and June of 2015. In over 60 to 90 minutes of numerous individual live interviews, interviewees were asked several questions to extract information to corroborate the literature research and, more importantly, to elicit the emerging trends they envision for the following years. Participants include Mexican Private Equity and Real Estate Industry leaders. This thesis presents a summary of the results obtained after processing all the qualitative answers into one single response, which encompasses the concepts that are common to all interviewees.

II

Mexico: general overview

Mexico is the 14th largest country in the world and has the same territory as four of the largest countries in Europe: Germany, France, Sweden and Spain. It has more than 2,982 km (1,864 mi) from end to end, which equals the distance from Barcelona to Moscow and has a +3,000 km border with the United States of America[1]. Together with Canada and the USA, Mexico is part of NAFTA (North America Trade Agreement). According to CONAPO (The Mexican National Population Council), Mexico has more than 121 million inhabitants, equal to the populations of Colombia, Spain and Australia combined, with a median age of 27 years.

Mexico's economy is the 15th largest in the world and is projected to climb to the 8th place by 2050[2]It has a Gross Domestic Product (GDP) of 1,260 million USD and a per capita GDP of 10,307 USD[3]. Services account for 60% of the total GDP. Thanks to its trade agreements, Mexico got 42 Billion USD Foreign Direct Investment (FDI) in 2013[4]. It is an industrialized economy now considered the 16th larger exporter in the world.

Regarding Macroeconomic stability, Mexico is in 49th position among 148 countries in terms of the Macroeconomic Environment Pillar which is composed by five variables: government budget balance, gross national savings, inflation, government debt and country credit rating. The country's public debt as a percent of GDP stands at 46.5%, below that of Brazil, India, Spain and the United States. Additionally, Mexico has a lower credit risk than countries like Argentina, Spain, Russia and India[5].

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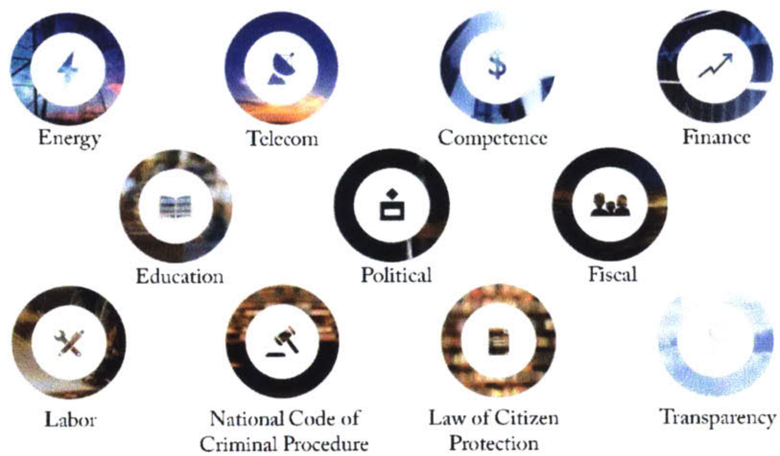
[1] PROMEXICO: Mexico's strengths
[2] HSBC: The World in 2050: from the top 30 to the top 100.
[3] The World Bank
[4] Secretaría de Economía
[5] The World Economic Forum: Global Competitiveness

Reforms at a Glance

Mexico has had a stable political environment. President Enrique Peña Nieto took office in December 2012 and, apart from security issues, the country has displayed improvements in its economic indicators. President Peña's administration has the commitment to promote reforms that foster the country's economic outlook. Many of them have been proposed and some are already on their way:

Figure 2.0: Reforms in Mexico[6]



- Energy Reform: opens up to competition the existing State monopoly in the electricity and oil sectors. This reform has had interesting results, like a decrease in electrical bills paid by households and companies: High voltage rates: 26.3% decrease, Medium voltage: 20.5% and Commercial: 10.3%). (Rates as of June 2015).
- Financial Reform: more credit at lower rates through competition in the banking sector.
- Telecommunications Reform: prevents market concentration and anti-competitive behavior. Opens up to foreign investment (100% in telecommunications and 49% in broadcasting) and creates conditions for greater access to information.

[6] PROMEXICO with information of reformas.gob.mx

- Fiscal Reform: improves the tax system, eliminating loopholes, enhancing compliance and promoting formal job creation.
- Antitrust Reform: strengthens the institutional framework, providing constitutional autonomy and stronger attributions to the regulator, in order to create competitive markets in all sectors.
- Labor Reform: creates new labor contracts, providing flexibility to the labor market.

From the reforms mentioned above, it is expected that the Energy reform will have an impact of an additional 1% of GDP growth and the Telecom and Financial reforms combined could also have an effect of nearly 1%.

Why Mexico?

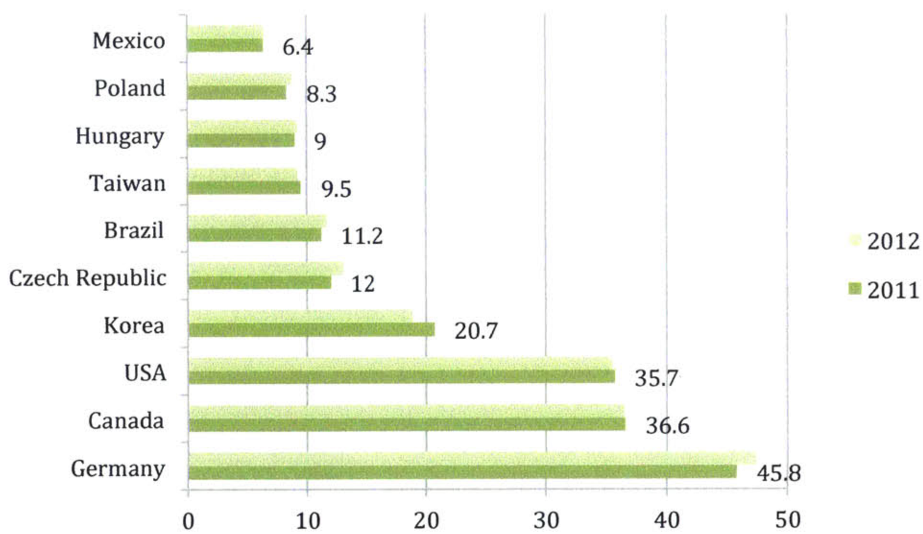
Mexico has evolved over the last 20 years and ceased to be a protectionist economy to become one of the most favorable business environments in the world. The privatization of national industries, deregulation of the economy and aggressive trade liberalization has led the way in this aspect and it is anticipated that these trends will continue. Indicators contrasting conditions in the 1990s with the current situation exemplify the change of the Mexican economy best.

Mexico is one of the most competitive countries in the world for productive investment due to its macroeconomic and political stability, low inflation, size and strength of its domestic market, economic growth rate, and capacity to produce advanced manufacturing. It is an open economy that guarantees access to international markets through a network of free trade agreements. Mexico can leverage not only its strategic location and competitive costs to service global markets but also its pool of young and highly-skilled human capital.

Mexico has a projected Foreign Direct Investment of 29,000 Million USD for 2015[7]. Some reasons that Mexico is a good investment destination are:

- Competitive labor costs offering savings compared to other investment choices in the Americas, Europe or Asia.

Figure 2.1: Compensation Cost in Manufacturing per Employee (USD/hour)[8]



- Ease of operation: an investor only requires 6 procedures and 9 days to open a business and 11 procedures and 82 days to obtain a building permit.
- Business closure: in Mexico creditors can have a recovery rate[9] of 67 cents per invested dollar in 1.8 years.
- Network of free trade agreements and trade procedures signed with 45 nations makes Mexico one of the most open countries to international trade in the world, with preferential access to over one billion potential consumers representing over 60% of global GDP.

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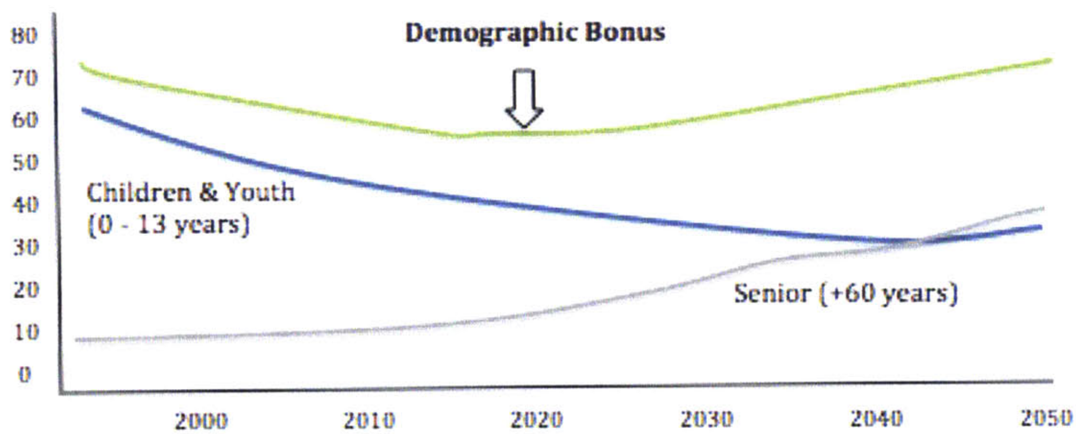
[7] PROMEXICO with information of Ministry of Economy, UNCTAD Q2 figures

[8] US Bureaus of Labor Statistics, 2014

[9] The recovery rate represents the payment to creditors and share holders following closure of a busines. The higher it is, the stronger the economic system, since more resources are available to open new businesses.

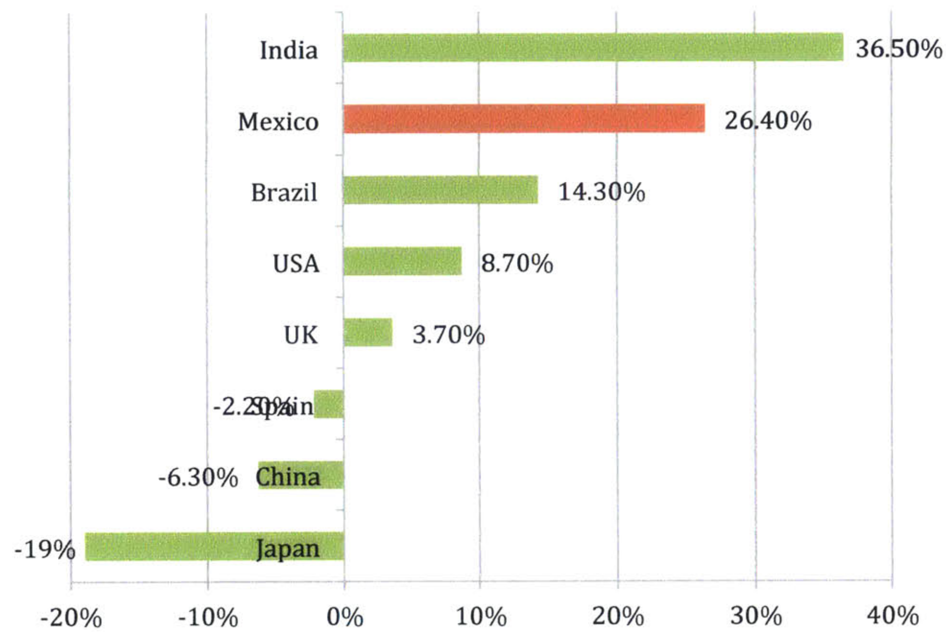
- Demographic bonus that will last for the next two decades. From 2010 to 2035, Mexico's working population will increase by more than 26%[10]. It is estimated that during the next two decades Mexico's population in working age will be more than 80 million people and will continue to represent more than 60% of the population.

Figure 2.2: Demographic Bonus (1990-2050)
(Number of dependents for every 100 individuals in working age in Mexico)



[10] UN Population Division 2011 and The Economist Intelligence Unit in KKR Report

Figure 2.3: Working Age Population per Country
(2010 – 2035 % change)



- Trained personnel: in 2012 more than 100 thousand engineering and technology students graduated from Mexican institutions[11], which represents a very attractive supply of skills for foreign companies.

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[11] National Association of Universities and Institutions of Higher Education

Figure 2.4: Comparison of Graduates per Country

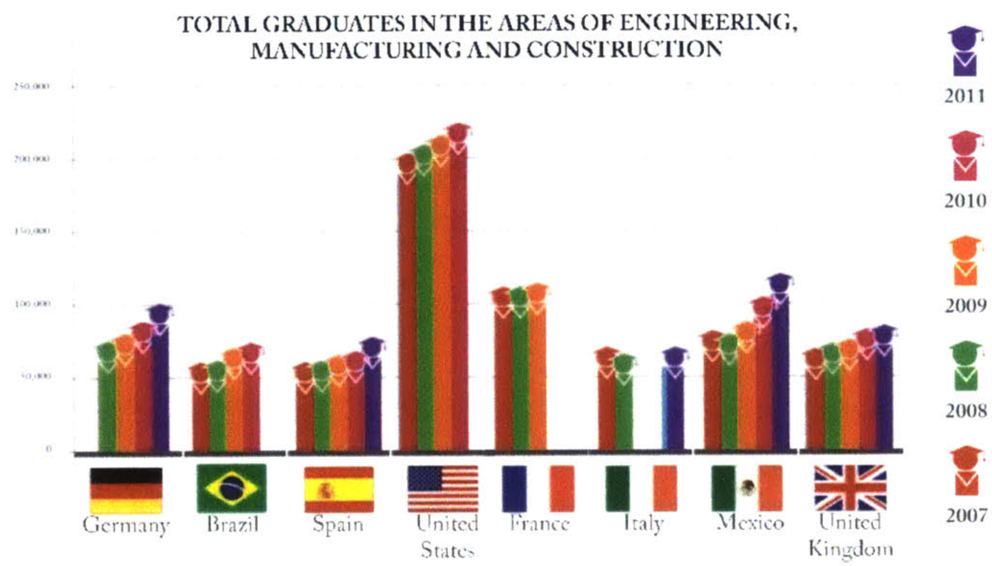
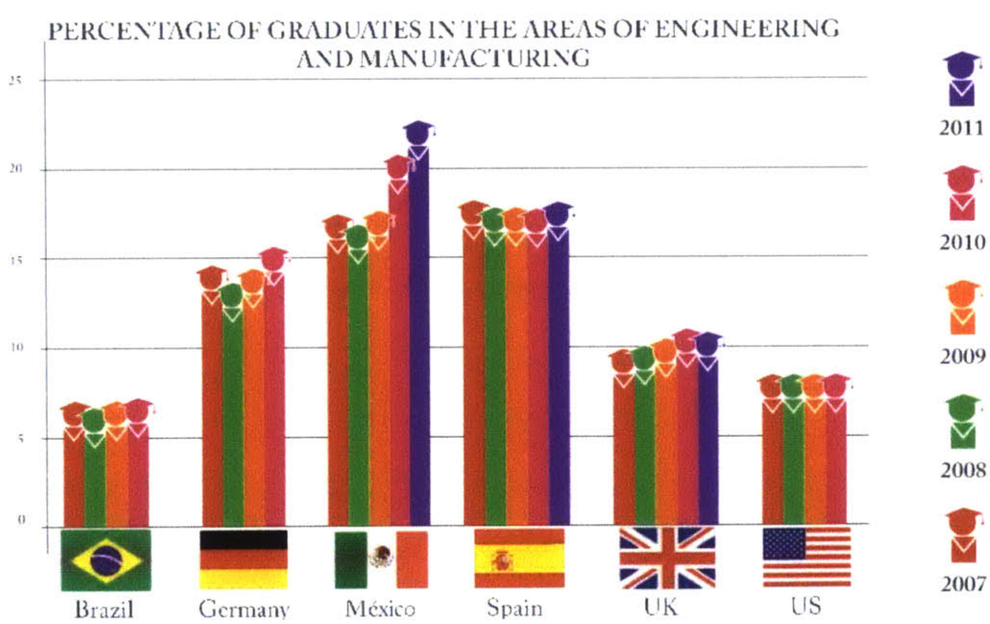


Figure 2.5: Graduates in Engineering and Manufacturing



- Cultural power: the country's cultural wealth enriches the business experience for foreign firms in a human and professional sense.

- Mexico leads exports in key sectors: 4th auto parts exporter, 5th exporter of computers, 10th exporter of cellphones, main exporter of medical devices in Latin America
- 5th oil producer in the world.
- 8th most visited country in the world with +20 million visitors.

The economic outlook remains tied to the underlying strength of the US economy (Mexico's primary trading and investment partner) and the ongoing process of structural reforms. In the years to come, Mexico needs to continue progressing in different fronts, including infrastructure, legal certainty, deregulation and security, in order to improve the business environment for local and international investors.

III

Private Equity in Mexico

History of Private Equity in Mexico

Private Equity (PE) investments in Latin America started after the crisis of the eighties, when global banks had to take equity stakes in local companies in exchange for their non-performing loans. After that, the industry started taking off by doing mostly late-stage investments in established companies. Venture capital funds where not even known in the area almost after year 2000, when the Internet boom helped promote new technology businesses.

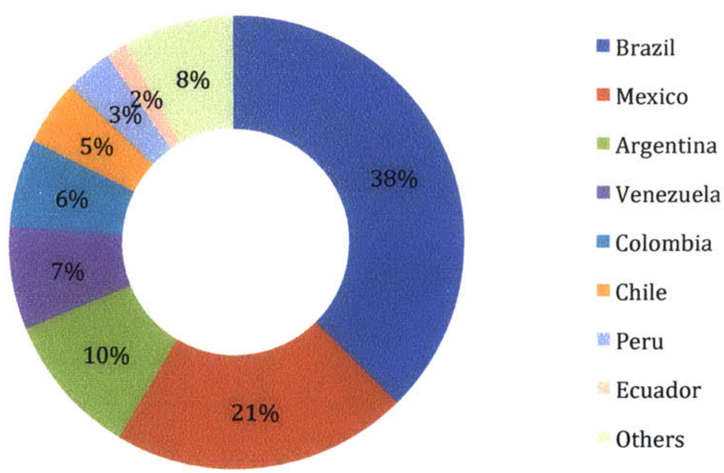
In Mexico, it is said that the first major effort to raise money was made in 1987 with the development of private equity vehicles called SINCAS (Societies of Capital Investment). The main objectives of these vehicles were: (i) to create an adequate vehicle to pool money from small and medium investors via the public market and then invest it in companies at different stages, (ii) to encourage growth for local enterprises by being an alternative source of capital, and (iii) to promote and finance investments. The business model worked for some time. Around 260 firms got funding from SINCAS and 11 did an IPO in the Mexican Stock Market (Jugos del Valle, Corporación GEO, Grupo Comercial Gomo, etc). According to some investors, one of the main reasons that these vehicles did not take off was the overregulation of Mexican authorities.

While SINCAS were not thriving, foreign funds managed by teams from overseas started to invest in Latin America and Mexico. Later on, local administrators accessed managing positions in these funds. Finally, around the year 2000, more than 20 years after SINCAS were created, Mexican fund managers started to appear. These groups started to raise capital from HNWI (high net worth individuals) and US investors, and later, from local pension funds.

Overview: Private Equity Industry in Mexico

Although Mexico has been one of the main recipients of private equity investment in Latin America, analysts agree that it has received less investment than what the size of the economy would suggest, relative to the other economies in the region. Considering its GDP, Mexico should attract at least 21% of the PE devoted to Latin America, which has not been the case according to analysts.

Figure 3.0: GDP Latin America



Even though Mexico has a strong market and above-reasonable economic fundamentals, the PE activity is well behind, compared to countries under similar circumstances. To give an overall perspective, it is always helpful to compare Mexico to other countries:

Figure 3.1: Mexico vs. Top Emerging Countries[13]

Driver	Mexico	China	India	Russia	Turkey
Strength of Market: Size & Population	•Median Age: 27.4 •Population: 115 million •*Literacy rate:86.9%	•Median Age: 35.9 •Population: 1.34 billion •*Literacy rate: 92.2%	•Median Age: 26.5 •Population: 1.2 billion •*Literacy rate: 61.0%	•Median Age: 38.8 •Population: 138 million •*Literacy rate: 99.6%	•Median Age: 28.8 •Population: 80 million •*Literacy rate: 87.4%
Economic Strength: GDP & Inflation	•Unemployment:5.2% •*GDP-capita: 10,046 •GDP growth: 4.0% •Inflation (annual): 3.5%	•Unemployment:6.5% •*GDP-capita : 5,433 •GDP growth: 9.2% •Inflation (annual): 5.5%	•Unemployment: 9.8% •*GDP-capita : 1,392 •GDP growth: 7.2% •Inflation (annual): 8.9%	•Unemployment: 6.6% •*GDP-capita: 13,398 •GDP growth: 4.3% •Inflation (annual): 8.4%	•Unemployment: 9.8% •*GDP-capita : 9,757 •GDP growth: 8.5% •Inflation (annual): 6.5%
Strength of Trade	•Export (US$b): 336 •Import (US$b): 342 •External Debt (US$b): 204 •Ext. Debt / Exports: 61%	•Export (US$tr): 1.9 •Import (US$tr): 1.7 •External Debt (US$b): 697 •Ext. Debt / Exports: 37%	•Export (US$b): 299 •Import (US$b): 461 •External Debt (US$b): 290 •Ext. Debt / Exports: 97%	•Export (US$b): 521 •Import (US$b): 323 •External Debt (US$b): 519 •Ext. Debt / Exports: 100%	•Export (US$b): 144 •Import (US$b): 233 •External Debt (US$b): 307 •Ext. Debt / Exports: 214%
Fiscal Prudence	•Debt (US$b): 427 •Revenues (US$b):263 •Reserves (US$b):142 •Debt / GDP: 37.0% •Reserves / Debt: 33%	•Debt (US$b): 3,174 •Rev. (US$b):1,649 •Reserves (US$b):3,236 •Debt / GDP: 43.5% •Reserves / Debt: 102%	•Debt (US$b): 814 •Revenues (US$b): 196 •Reserves (US$b):298 •Debt / GDP: 48.5% •Reserves / Debt: 37%	•Debt (US$b): 154 •Rev. (US$b): 383 •Reserves (US$b): 499 •Debt / GDP: 8.3% •Reserves / Debt: 325%	•Debt (US$b): 311 •Rev. (US$b):177 •Reserves (US$b):88 •Debt / GDP: 39.9% •Reserves / Debt: 28%
Ease of Doing Business Ranking	•Starting Business: 75 •Enforcing Contracts: 81 •Resolving insolvency: 24 •Trading cross borders: 59 •Protecting investors: 46	•Starting Bus.: 151 •Enforcing Cont.: 16 •Resolving insolvency: 75 •Trading cross borders: 60 •Protecting investors: 97	•Starting Bus.: 166 •Enforcing Cont.: 182 •Resolving insolvency: 128 •Trading cross borders: 109 •Protecting investors: 46	•Starting Bus.: 111 •Enforcing Cont.: 13 •Resolving insolvency: 60 •Trading cross borders: 160 •Protecting investors: 111	•Starting Business 61 •Enforcing Contracts: 51 •Resolving insolvency: 120 •Trading cross borders: 80 •Protecting investors: 65

Figure 3.2: Mexico vs. Latin American Economies[13]

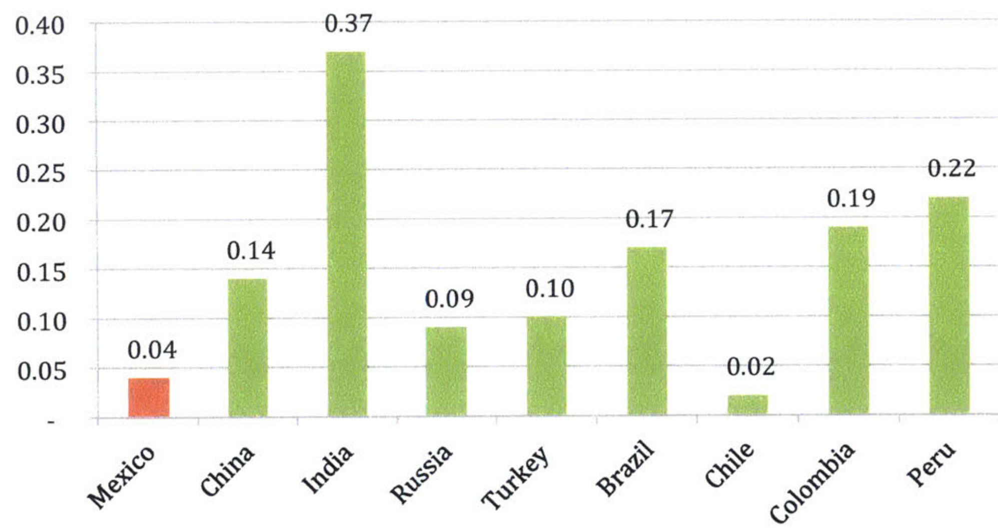
Driver	Mexico	Brazil	Chile	Colombia	Peru
Strength of Market: Size & Population	•Median Age: 27.4 •Population: 115 million •*Literacy rate:86.9%	•Median Age: 29.6 •Population: 206 million •*Literacy rate: 88.6%	•Median Age: 32.8 •Population: 17 million •*Literacy rate: 95.7%	•Median Age: 28.3 •Population: 45 million •*Literacy rate: 90.4%	•Median Age: 26.5 •Population: 30 million •*Literacy rate: 92.9%
Economic Strength: GDP & Inflation	•Unemployment:5.2% •*GDP-capita: 10,046 •GDP growth: 4.0% •Inflation (annual): 3.5%	•Unemployment:6.0% •*GDP-capita : 12,119 •GDP growth: 2.7% •Inflation (annual): 6.5%	•Unemployment:6.6% •*GDP-capita : 14,554 •GDP growth: 5.9% •Inflation (annual): 3.3%	•Unemployment:10.8% •*GDP-capita: 7,259 •GDP growth: 5.9% •Inflation (annual): 3.7%	•Unemployment:7.9% •*GDP-capita : 5,872 •GDP growth: 6.9% •Inflation (annual): 3.4%
Strength of Trade	•Export (US$b): 336 •Import (US$b): 342 •External Debt (US$b): 204 •Ext. Debt / Exports: 61%	•Export (US$b): 251 •Import (US$b): 220 •External Debt (US$b): 410 •Ext. Debt / Exports: 163%	•Export (US$b): 86 •Import (US$b): 72 •External Debt (US$b): 99 •Ext. Debt / Exports: 115%	•Export (US$b): 57 •Import (US$b): 55 •External Debt (US$b): 70 •Ext. Debt / Exports: 124%	•Export (US$b): 46 •Import (US$b): 37 •External Debt (US$b): 37 •Ext. Debt / Exports: 80%
Fiscal Prudence	•Debt (US$b): 427 •Revenues (US$b):263 •Reserves (US$b):142 •Debt / GDP: 37.0% •Reserves / Debt: 33%	•Debt (US$b): 1,354 •Revenues (US$b):977 •Reserves (US$b):358 •Debt / GDP: 54.4% •Reserves / Debt: 26%	•Debt (US$b): 23 •Revenues (US$b):56 •Reserves (US$b):41 •Debt / GDP: 9.4% •Reserves / Debt: 177%	•Debt (US$b): 150 •Revenues (US$b):90 •Reserves (US$b):32 •Debt / GDP: 45.6% •Reserves / Debt: 22%	•Debt (US$b): 38 •Revenues (US$b):36 •Reserves (US$b):49 •Debt / GDP: 21.7% •Reserves / Debt: 130%
Ease of Doing Business Ranking	•Starting Business 75 •Enforcing Contracts: 81 •Resolving insolvency: 24 •Trading cross borders: 59 •Protecting investors: 46	•Starting Bus. 120 •Enforcing Cont.: 118 •Resolving insolvency: 136 •Trading cross borders: 121 •Protecting investors: 79	•Starting Business 27 •Enforcing Contracts: 67 •Resolving insolvency: 110 •Trading cross borders: 62 •Protecting investors: 29	•Starting Business 65 •Enforcing Contracts: 149 •Resolving insolvency: 12 •Trading cross borders: 87 •Protecting investors: 5	•Starting Business 55 •Enforcing Contracts: 111 •Resolving insolvency: 100 •Trading cross borders: 56 •Protecting investors: 17

As illustrated in the charts above, Mexico manages to be well-ranked among comparable countries. It has a very safe and prudent economy with a remarkable strength of trade, not to mention a very low percent of unemployment and one of the top GDPs per capita; both of these acting as good indicators that the middle class should continue to grow, resulting in interesting changes in consumer spending habits and housing demand.

[13] Asociación Mexicana de Capital Privado

These facts, in theory should imply that the private equity sector in Mexico is booming, but in truth, it is not. As shown in the graph below, Mexico has struggled to get a fair PE penetration and is far behind its peers. PE penetration refers to the comparison of the total investments made via PE funds to the country's GDP.

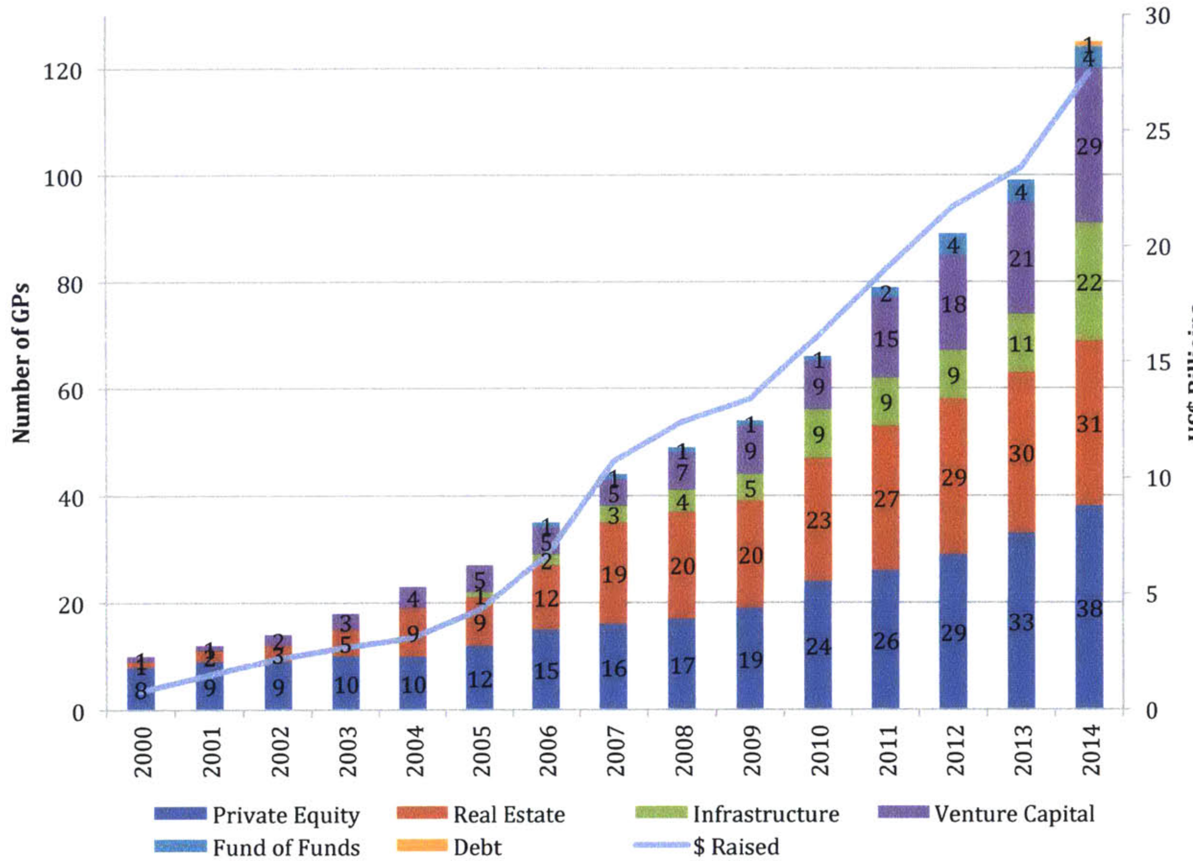
Figure 3.3: PE Penetration (PE Investments/GDP)[13]



How can it be possible that smaller and younger countries have a bigger PE industry? How can Turkey's PE penetration, 2.5 times bigger than Mexico, and Colombia's, almost 5 times larger be explained? Is it a cultural matter? Is Mexico developing enough opportunities to cater institutional funds? Are the regulations in place? An assessment of the present state of the Mexican PEI is necessary in order to address some specific reasons for these questions.

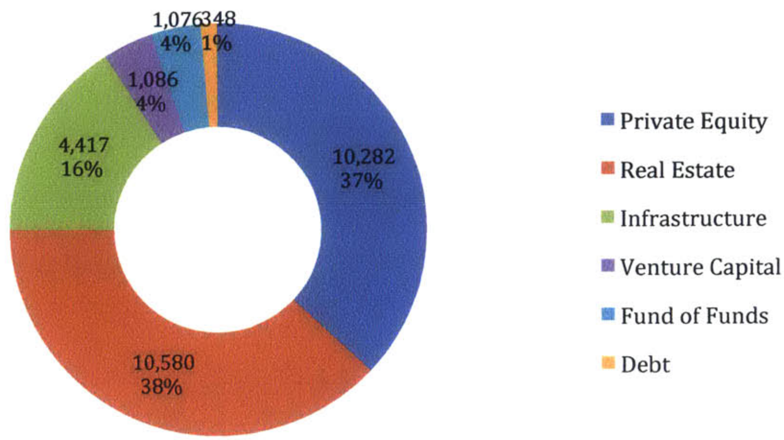
Even though the PE activity in Mexico is behind, it has been growing in the last years, doubling its size (raised capital) from 2009 until the end of 2014. At the beginning of 2015, Private Equity Funds in Latin America with operations in Mexico raised a total of $27.5 Billion US dollars (from US$14 Billion in 2009). Also, the number of general partners (GP) has been steadily growing since the year 2000, with several of these spinning off from Global Funds, while others coming from local Investment Banking firms and Family Offices.

Figure 3.4: Raised Capital and Number of Funds[13]



It is important to remark that more than half of the capital raised has been deployed in the real estate and infrastructure sectors, which investors have seen as better options for a good return compared to the assumed risk.

Figure 3.5: PE Allocation[13]



The graph above shows how the real estate industry is a major player with more than 10.5 USD billion invested. An interesting observation to make is that there is virtually no money allocated for debt purposes in the private sector, whereas in other markets, some of the investments from life insurance companies and pension funds are devoted to long term financing, which in Mexico is hard to get.

In most Private Equity Industries, the key players or the bulk of investors are normally foreign funds, endowments, pension funds, HNWI and family offices. Inside Mexico, some of these players did not seem completely supported. Investors had a hard time trying to invest in a more efficient way until recently.

In 2009, the Mexican government passed a regulation that allowed local pension funds to invest up to 20% of their assets under management in alternative assets. For pension funds to be able to invest, they have to do it through a CKD (Certificados de Capital de Desarrollo or "Structured Equity Securities"), which is a listed vehicle with special considerations, or through other listed vehicles such as FIBRAS (Fideicomisos de Inversión en Bienes Raíces, a similar vehicle to US REITs). This regulation was key for the creation of new funds and thus a catalyst to attract more foreign flows to existing General Partners.

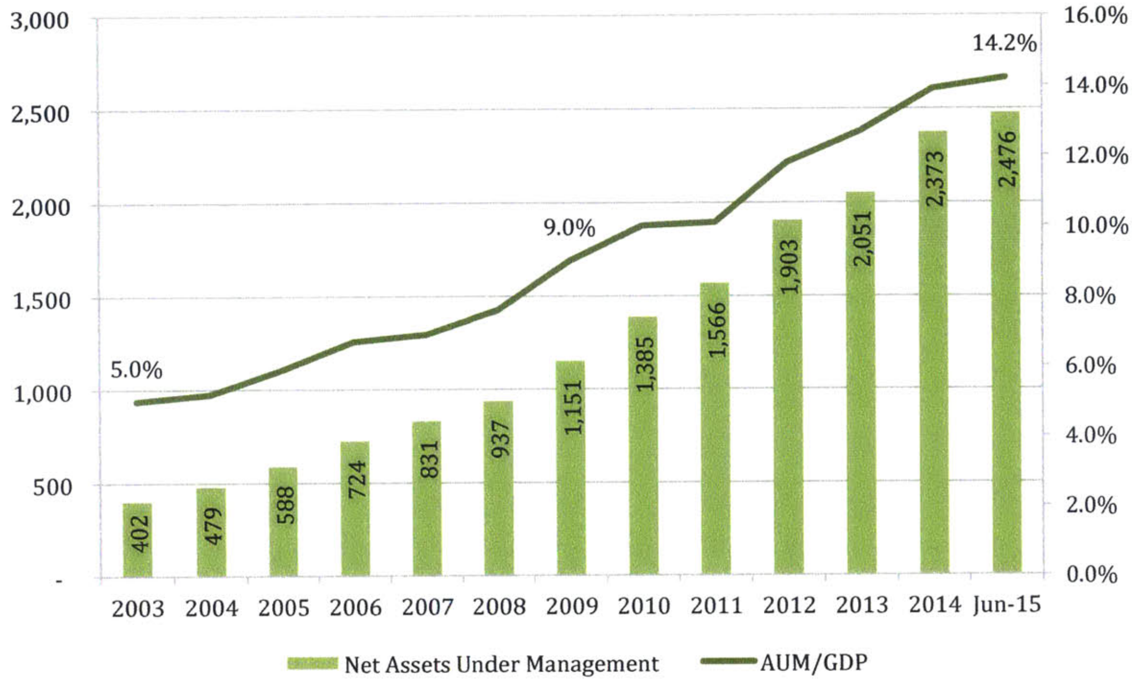
Mexican Pension Funds: strategic investors for the development of Private Equity

Since the creation of the pension system in 1997, CONSAR (Comisión Nacional del Sistema del Ahorro para el Retiro or "National Commission for the Pension System") has set four basic investment goals: security of resources, better pensions, financial market depth, and economic growth. The mechanisms to achieve these are diversification, liberalization of investment regime, financial innovation and financing projects.

The growth of retirement savings will allow AFOREs (Administradora de Fondos para el Retiro or "Pension Funds") to keep playing a main role as investors. Under a conservative scenario, the CONSAR estimates that AFOREs will reach 225 USD Billion worth of assets under management by 2019[14]. This growth, added to the new investment opportunities in strategic sectors, constitutes a historical moment for AFOREs that should be capitalized on.

[14] CONSAR: Challenges and Opportunities for the Pension Funds System in Mexico.

Figure 3.6: AFOREs' Assets Under Management / GDP[14]



Through time, CONSAR has made gradual but significant adjustments to the investment regime in order to help pension funds get better returns by promoting economic growth in the country.

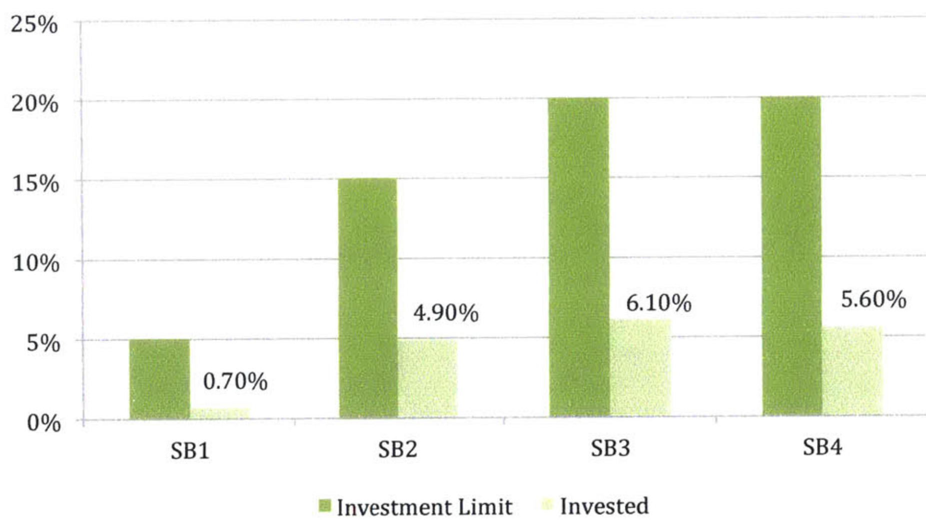
Figure 3.7: SIEFOREs' investment regime[14]

	97	98	99	01	02	03	04	05	06	07	08	09	10	11	12	13	14
Debt	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Currencies	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Equity	×	×	×	×	×	×	×	×	✓	✓	✓	✓	✓	✓	✓	✓	✓
CKDs & FIBRAs	×	×	×	×	×	×	×	×	×	×	✓	✓	✓	✓	✓	✓	✓
Structured Assets	×	×	×	×	×	×	×	×	×	×	✓	✓	✓	✓	✓	✓	✓
Commodities	×	×	×	×	×	×	×	×	×	×	×	×	×	×	✓	✓	✓
Swaptions	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	✓
REITs	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	×	✓

Although the regulation that allowed AFOREs to invest in alternative investments was passed more than five years ago, AFOREs have only committed 5.2% of the ~18% they are allowed to. This occurs most probably due to the complexity and difficulty of creating a CKD for the GPs.

AFOREs are divided into four fund categories (SIEFOREs) depending on the age of the contributor and each one has its own limit to invest in alternative assets. The chart below shows the limit for each class and, from that limit, the amount that has already been allocated.

Figure 3.8: SIEFOREs' Investment Limits[15]



The broader set of investment opportunities has translated into a lower concentration in securities issued by Mexico's Federal Government and encouraged higher diversification of portfolios. In 1998, more than 97% of their assets were government securities; today, this figure is only 51.7%[16]. An increasing amount of pension savings are being invested in productive projects, generating a virtuous cycle: employee's savings are invested in productive projects that foster employment and thus, economic growth, which in turn

[15] AMAFORE: Reporte del Sistema de Ahorro para el Retiro. Febrero 2015
[16] CONSAR: Financial Vice-Presidency and AMAFORE: Composición del Portafolio Global.

bring macroeconomic stability and competitive returns, causing the cycle to start all over again with investing employee's savings in productive projects.

AFOREs have a total of roughly 165 USD billion under management, meaning that they can invest up to 29 USD billion in alternative investments, so there are still more than US$20 Billion to be allocated. Pension funds need to be ready to undertake the opportunities flourishing from the reforms and this is why CONSAR is still modifying the pension funds' legal and regulatory frameworks. Some important topics to address are inclusions of new vehicles in the investment regime, the strengthening of AFOREs corporate government and the alignment of incentives for long-term investment.

The following reforms are needed regarding the ability of AFOREs to invest in upcoming openings:

Pending reforms to Mexico's Pension Fund System Law

- Performance fee
- Further expansion of investment regime
- Corporate governance strengthening
- More faculties to execute a risk based supervision
- Private offerings[17].

The challenges ahead for the pension funds are:

- System coverage is limited
- A challenging investment environment
- Management fees are still high
- Complementary savings are not enough
- Mass of workers is insufficient

[17] Private offerings have clear advantages for AFOREs, however their risks should be mitigated through regulations.

- Old pension systems are still in operation and their liabilities are growing
- Financial literacy is deficient

CKDs: a vehicle that enables local pension funds to invest in alternative investments

The "Certificados de Capital de Desarrollo" or "Structured Equity Securities" (CKDs) are structured investment vehicles similar to private equity funds, used to finance specific projects, such as ventures related to real estate and infrastructure, highways, ports, mines, power generation and technology projects. In these vehicles, investments can be in the form of debt or equity and 80% of the profit should be distributed at the end of each fiscal exercise. CKDs are expected to invest in development of projects and companies and give pension funds the opportunity to participate in the upcoming businesses around the Energy Reform and the Infrastructure National Plan.

There are different types of CKDs aiming at different opportunities:

- Forest Projects: development and commercialization of plants and wood in Campeche.
- Infrastructure: hospitals, universities, highways, airports and logistic platforms.
- Financial assets: subordinated/mezzanine/convertible loans and loan portfolios.
- Real estate: retail, office, industrial and housing uses.
- Private equity: e-commerce, health industry, touristic services, foods and restaurants.
- Energy: hydroelectric power stations, oil platoforms, etc.

As of June 2015, CKDs have raised US$8.18 Billion (~66% raised from AFOREs)[18] in 44 specialized vehicles and there are twelve more in the pipeline, including international

[18] CONSAR

GPs such as: Abraaj, Hines, and Credit Suisse[19]. Number of CKDs and amount invested per sector are presented bellow.

Figure 3.9: Number of CKDs per Sector

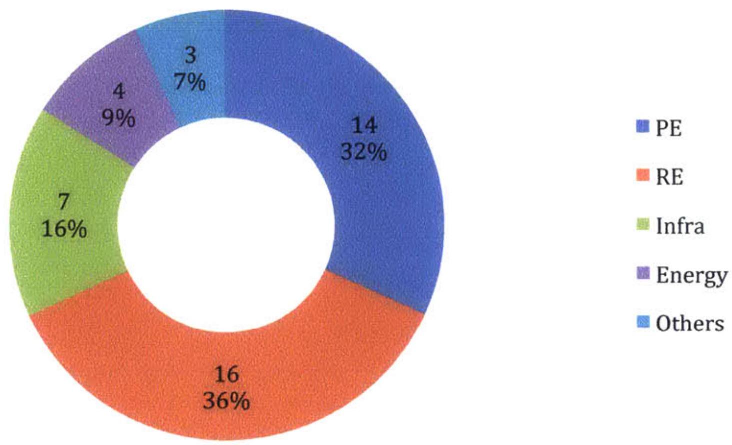
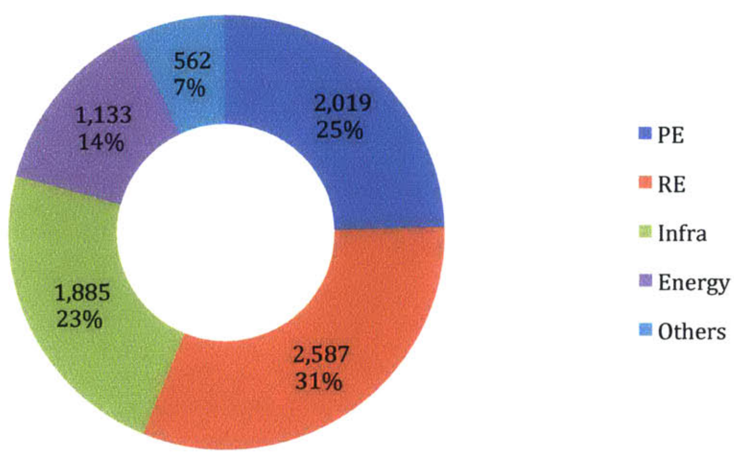


Figure 3.10: Investments of CKDs per Sector (USD Million)



[19] There were also 9 listed FIBRAs at the end of 2014, with a total market capitalization of 18.1 USD Billion (according to REIT.com). This vehicle will be explained in detail over the next chapter.

CKDs are raised and managed by PE firms. Just as in the PEI, managers charge fees and get a promote for every dollar earned above a pre-established benchmark. As of today, most of the CKDs have similar fee structures including: 1.5% - 2% management fee and a 80% - 20% split above a certain preferred return that usually is between 8 and 11% depending on the targeted sector (10.15% on average for RE). The following table shows a summary of the listed CKDs including their industry, date and fees.

Figure 3.11: Listed CKDs (June 2014)[20]

Name	Type	$ Raised (MXNM)	$Raised (USDM)	Date	Term	Adm. Fee	Pref.	Split
Santa Genoveva	Others	1,650	110	Jul-08	20	n/a	n/a	N/A
RCO	Infrast	6,550	437	Oct-09	28.5	n/a	n/a	N/A
Wamex	PE	1,417	94	Nov-09	10	2.00%	12.50%	80-20%
Macquarie	Infrast	3,415	228	Dec-09	27	1.50%	8.00%	80-20%
Atlas Discovery	PE	1,161	77	Dec-09	10	2.00%	8% in USD	80-20%
Nexxus	PE	2,631	175	Mar-10	10	2.00%	10.00%	80-20%
Prologis	RE	3,300	220	Jul-10	10	1.00%	9% in USD	80-20%
Promecap	PE	2,503	167	Aug-10	10	2.00%	9.00%	80-20%
Prudential	RE	3,095	206	Aug-10	10	1.75%	12.00%	80-20%
Artha	RE	2,440	163	Oct-10	10	2.00%	12.00%	80-20%
Navix	Energy	4,002	267	Dec-10	10	1.00%	25.00%	80-20%
I2	Infrast	2,737	182	Dec-10	15	2.00%	10.00%	80-20%
Marhnos	Infrast	1,000	67	Dec-10	30	n/a	n/a	100-0%
EMX	PE	1,530	102	Mar-11	10	2.00%	10.00%	80-20%
Vertex	RE	1,671	111	Mar-11	10	2.00%	9.00%	80-20%
Capital I	RE	1,530	102	Apr-11	6	2.00%	11.50%	80-20%
IGS - I	RE	575	38	Oct-10	10	2.00%	12.00%	80-20%
IGS - R	RE	513	34	Oct-10	10	2.00%	12.00%	80-20%
MRP	RE	5,000	333	Mar-12	15	1.65%	9.00%	80-20%
Planigrupo	RE	2,475	165	May-12	9	1.75%	10.00%	80-20%
Northgate	PE	553	37	Jul-12	10	1.50%	IPC+5%	95-5%
Latin Idea	PE	615	41	Jul-12	10	2.00%	13.00%	80-20%
Pine Bridge	PE	1,384	92	Aug-12	10	1.00%	8.00%	95-5%
GBM	Infrast	2,253	150	Sep-12	10	1.65%	10.00%	80-20%

[20] Capital 414 Inc.: Certificados de Capital de Desarrollo (CKDs) – Actualización Trimestral Junio 2015

FINSA	RE	2,750	183	Sep-12	9	1.75%	9% in USD	80-20%
Credit Suisse	Others	5,487	366	Nov-12	7.5	1.25%	9.00%	85-15%
Axis	Energy	3,801	253	Dec-12	10	1.70%	13% in USD	80-20%
Nexxus	PE	816	54	Jun-13	10	2.00%	10.00%	80-20%
GBM	Others	1,300	87	Aug-13	5	0.90%	8.00%	80-20%
Walton	RE	2,602	173	Oct-13	10	1.75%	10.00%	80-20%
Artha	RE	553	37	Oct-13	10	1.50%	9.00%	80-20%
Artha	RE	1,526	102	Dec-13	10	1.50%	9.00%	80-20%
Acon	PE	400	27	May-14	10	2.00%	8% in USD	80-20%
I2	Infrast	2,000	133	Aug-14	15	1.50%	10.00%	80-20%
Axis	Energy	1,200	80	Nov-14	10	1.80%	13% in USD	80-20%
Axis	Energy	750	50	Nov-14	10	1.80%	13% in USD	80-20%
EXI	Infast	164	11	Dec-14	12	1.50%	9.00%	80-20%
Atlas Discovery	PE	407	27	Dec-14	10	2.00%	8% in USD	80-20%
Atlas Discovery	PE	41	3	Dec-14	10	2.00%	8% in USD	80-20%
Promecap	PE	700	47	Dec-14	10	2.00%	9.00%	80-20%
PMIC LATAM	PE	656	44	Mar-15	14	1.00%	10.00%	95-5%
Artha	Energy	113	8	Apr-15	10	1.50%	9.00%	80-20%
Artha	Energy	577	38	Apr-15	10	1.50%	9.00%	80-20%
Fibra Uno	RE	1,200	80	Jun-15	8	1.25%	10.00%	80-20%
Total		81,043	5,403					

* The only funds without "catch up" are: Santa Genoveva, RCO and Marhnos,

As evident in the information presented, PE has had a low penetration, but it seems that it is on its way to become an important player in the private sector. There are numerous reasons for why fundraising in Mexico has been behind the rest of its Latin American peers. Industry leaders and authorities should be aware of these. According to specialists and people that have studied the topic, the main causes for a low PE penetration in Mexico are the following:

- Underdeveloped financial infrastructure and the lack of a sophisticated financial community. For example, the investment banking sector came late to Mexico: JP Morgan, probably the investment bank with the greatest commitment in Latin America, has had presence in Argentina and Brazil since 1968 but only opened its offices in Mexico in 1980.
- Mexico's financial sector is not well developed. Businesses without tangible assets and/or positive cash flows cannot raise debt, which depresses entrepreneurship.

- Influence of big industrial groups as an obstacle to PE investors. These groups where very active in the 90's and they had a preferential access to credit when competing for deals with PE firms.
- Local business practices: family ownership concentration. Companies still see giving equity as giving away control, instead of looking at the other side of the equation and visualizing growth potential and professionalization, among other benefits.
- Lack of professional and middle management.
- The Mexican legal system, which is based on civil law, is characterized by a relatively weak judiciary branch and offers relatively little protection to shareholders. Also, investors' rights are far from guaranteed.
- Historically, Mexico has had one of the highest ownership rates in the world, making it easier for large groups to gain deals thanks to good relationships between them and also good connections with the government and local banks.

The PEI is behind but it is not new in Mexico. There is a lot of work that has been done already and a lot of gathered experience through the years. The industry should learn from mistakes in the past and focus on how to get the ideal investing conditions in the country. Positive results were obtained in a recent study made by the Mexican Association of Private Equity and Venture Capital in collaboration with KPMG. The report concludes that interesting returns where achieved by enterprises that got funding from PE firms. The average annual rate at which sales grew was 36 %, the annual rate for EBITDA was 44%, and jobs grew at a 16.5% annually (+369,000 new jobs). This results should encourage PE firms to invest in Mexico and on the other side, companies should be aware of the benefits their companies can get from external funding.

IV

Private Equity in Real Estate

To assess the current state of real estate financing, it is necessary to become familiarized with how real estate has been financed over the past years, beginning in the 1970s. Back then, cities where not only developed but also shaped by prosperous families looking to allocate their wealth – typically coming from their own industrial businesses – to assets in which their fortune was going to be safe through time and from which they could also collect a fixed income on an annual basis. In those days, having money meant that a person could be a developer. As time passed, real estate development started to change: pools of investors and syndications started to play a key role in the finances of real estate. A developer would go to his relatives (better known as "friends and family") to raise sufficient capital to develop a single project[23]. With these resources, developers would normally do one project at a time, as money was scarce, considering that most of the development was funded with pure equity mostly. Obtaining financing from the banks was not a feasible alternative, in spite of Mexico's already-developed financial system. Over the last decade, the finances of real estate, especially funding, have been changing due to the willingness of foreign and local institutional investors to participate in the Mexican real estate.

Today, real estate investment through Private Equity funds is a reality. Over the last years, managers have been actively investing in real estate acquisitions and development opportunities. Apart from obvious market openings in Mexico, real estate investment has been promoted by specific regulatory changes, such as the creation of vehicles like CKDs and FIBRAS that enable foreign investors, local pension funds and even small investors to participate in the built environment.

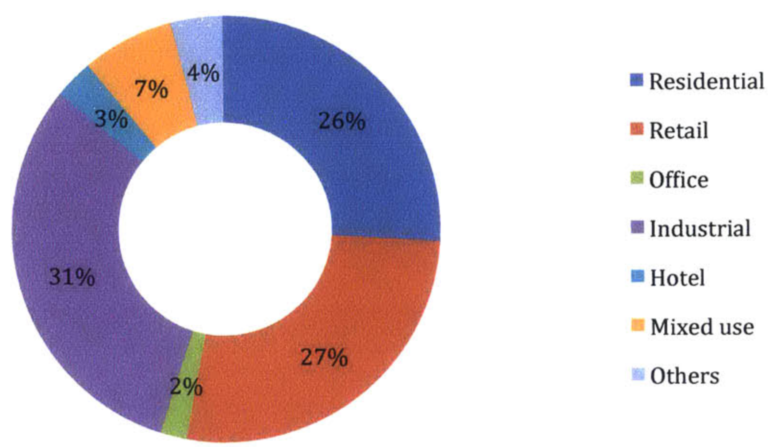
[23] Not the same case for industrial, which has normally been more advanced and appealing in terms of financing to institutional investors than other uses.

The first fund specialized in real estate was raised in the late 90s. Since then, the number of General Partners has been steadily increasing to 9 RE managers in 2005, then to 23 in 2010 and now to more than 31 active GPs by June 2015. According to AMEXCAP, from the total of 27.5 USD billion committed to invest in Mexican funds, 38% or 10.58 USD billion have been dedicated to Real Estate investments divided into 18 funds, but 4 of them happen to manage 71% of the total investment.

Overview of Real Estate Investment

Real estate has been an appealing field to investors since the late 1990s. Traditionally, PE firms have preferred to invest in industrial and retail uses, but also in residential and some other uses as shown in the graph below.

Figure 4.0: Real Estate Investment Diversification (1995-2014)

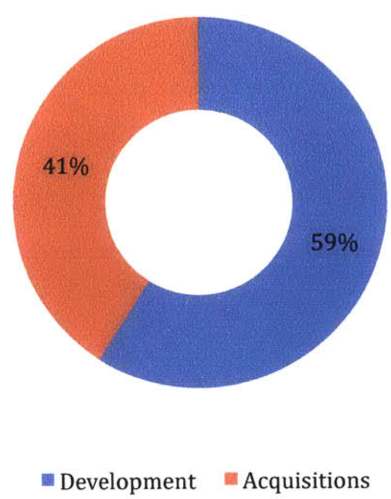


There are some remarkable findings resulting from the survey and study "Inversión de Fondos Inmobiliarios y de Infraestructura de México" (Investments by Real Estate and

Infrastructure Funds in Mexico) made by Deloitte in collaboration with Amexcap[24]. Ten GPs where surveyed and their responses help the understanding of how the PEI operated in the RE field during 2013 and moreover, use this as a proxy to better forecast the near future. The key outcomes are shown below:

- Only during 2013, the total investment[25] made by the 10 participants was 2,177 USD million. From that, 1,284 million USD was allocated to development of real estate projects and 893 million USD to acquisitions, which involved assets on different stages.

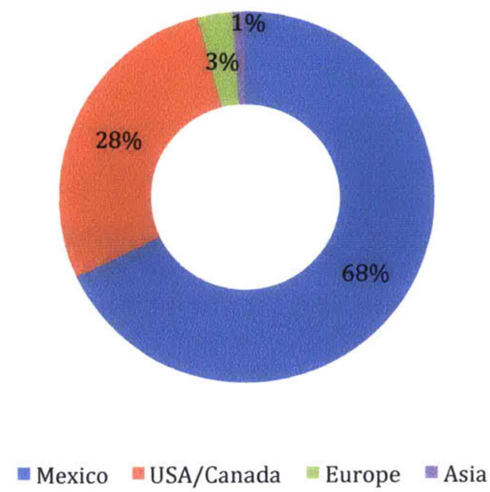
Figure 4.1: Distribution of capital in Real Estate Investments



- The total equity invested by the participants was 1,192 USD million (≈55% from total) from which Mexican investors contributed 68%.

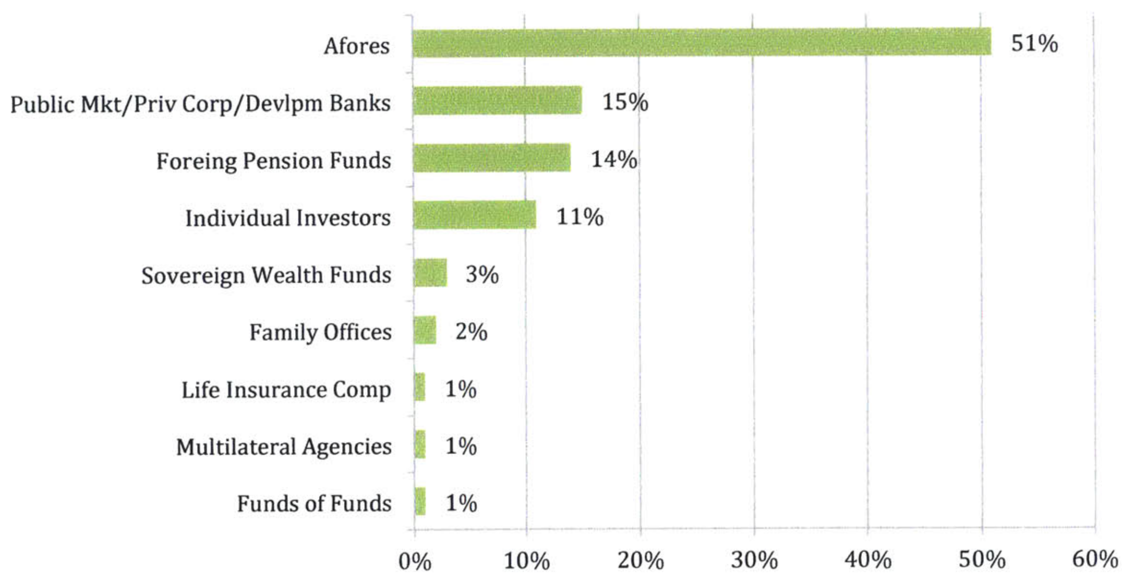
Figure 4.2: Sources of Capital by Region

[24] Inversión de Fondos Inmobiliarios y de Infraestructura en México. Amexcap sent a digital survey to 16 GPs from which 10 replied effectively. The assessment consisted of questions regarding assets under management, sources of investment, geographic and uses allocation, average rents, occupation and trends.
[25] Includes equity, reinvestments and debt.



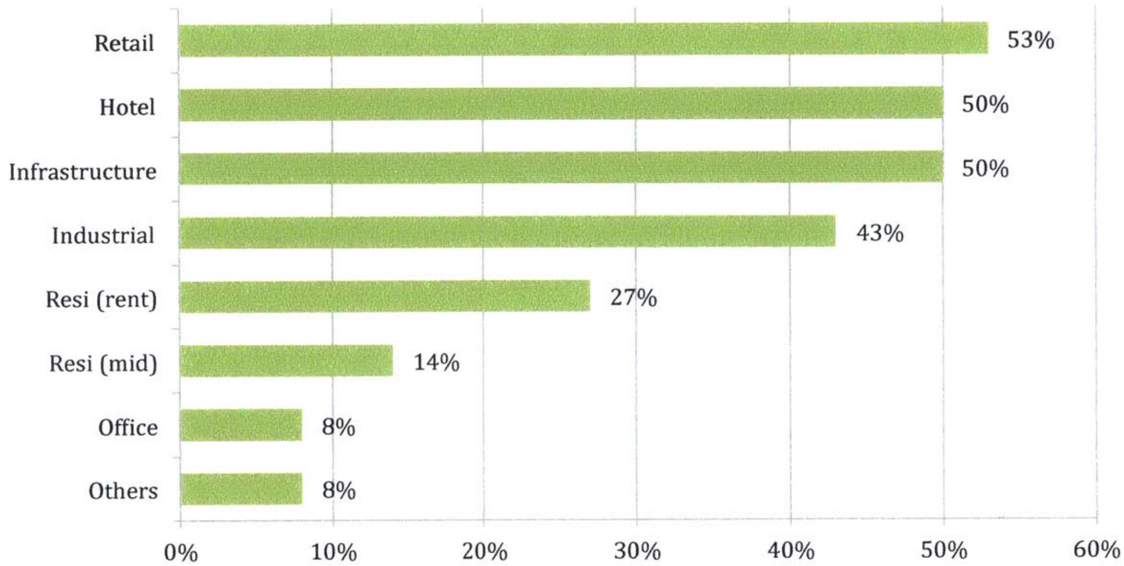
- AFOREs (local pension funds) are the most common source of funding, followed by public markets and private corporations.

Figure 4.3: Sources of Capital



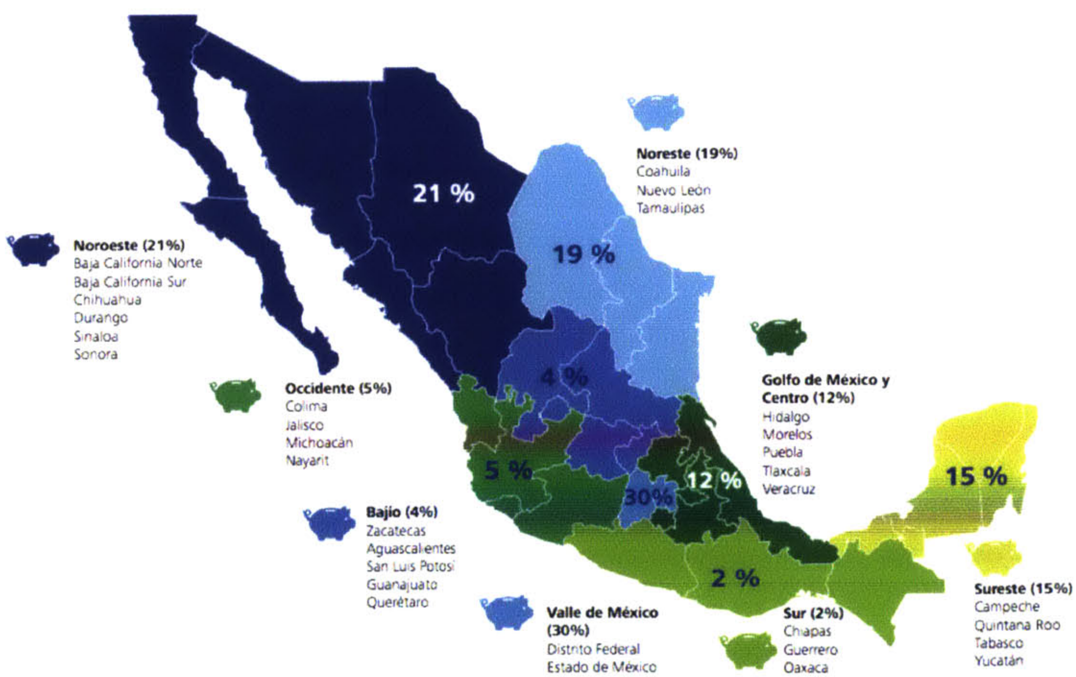
- The leverage (loan to cost), used to finance developments and acquisitions, varies among uses. Not all the participants responded but the median shows that retail is the most leveraged use, followed by hotel and infrastructure.

Figure 4.4: Leverage (Loan to Cost)



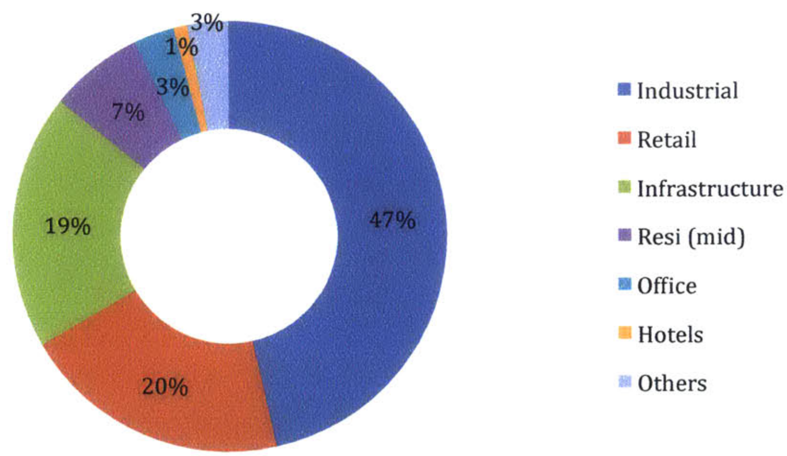
- 70% (≈1,500 USD million) was invested in Mexico Distrito Federal, Estado de México and the north of the country as shown in the diagram below.

Figure 4.5: Investment by Region



- Industrial use was the preferred investment for the GPs with a clear advantage over the rest of the uses.

Figure 4.6: Investment by Use



- The average rents that the surveyed GPs are charging go from 1.26 USD to 5.06 USD on industrial and from 3.8 USD to 24.2 USD on retail. Rents strongly depend on location and quality of the asset.

Figure 4.7: Industrial - Average Rents by Location (USD)[26]

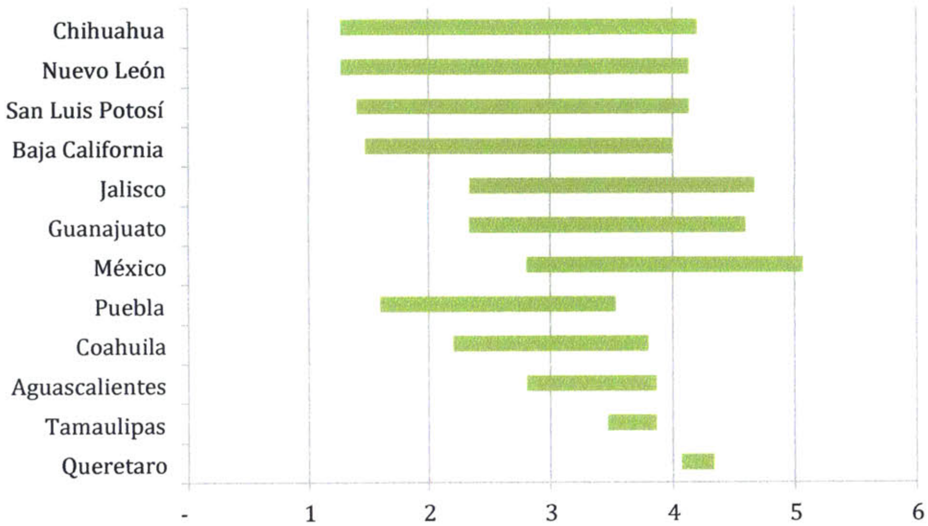
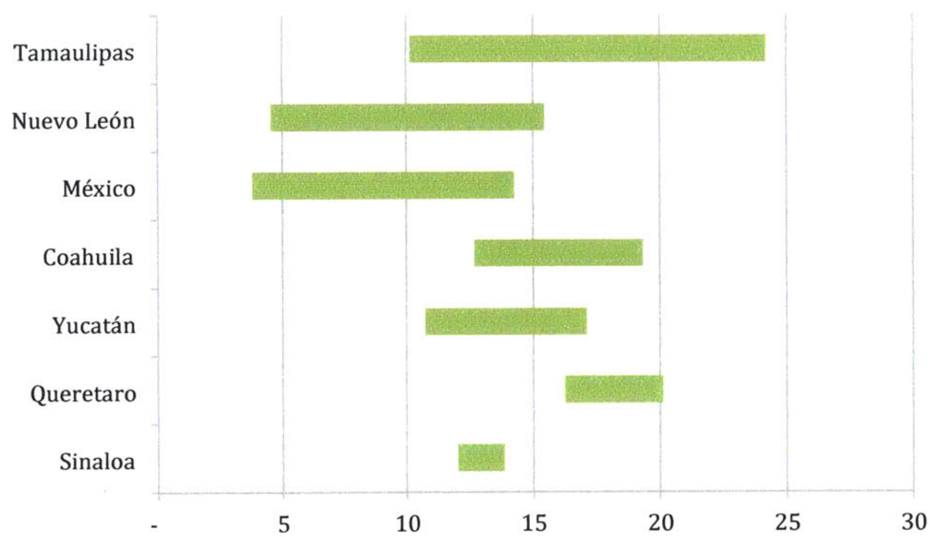


Figure 4.8: Retail - Average Rents by Location (USD)[26]



As seen in the previous summary of the PE investments in RE, the AFOREs are now playing a key role as capital providers for the RE industry, at least for this sample of GPs, which can be a good estimate to the rest of the industry.

[26] Exchange rate: 1 USD = 15 MXN

An interesting take away is to note how the GPs are investing in RE. It appears that almost 60% is going towards development projects, which have been always considered much riskier than acquisitions, especially in emerging markets. Is this an indicator that there is a lack of supply in the Mexican market? Or is this an indicator that managers have not been able to find sufficient worthy assets to acquire? Or, one step ahead: are there qualified assets ready to be purchased by institutional investors?

The investments made during 2013 seem to be very prudent considering that the invested equity accounted for 55% of the total amount, meaning the debt used should be equal or less than 45% of the total cost. The debt market in Mexico is not as developed as the financial market, providing a good reason for the GPs to be so "prudent". Also, the cost of debt for the typical developers is quite high.

The manufacturing industry is thriving in Mexico. The aeronautic and automotive industries have announced important investments over the last five years; in 2013, Mexico was the eight biggest vehicle producer in the world[27]. Thus, this could be a reason that the industrial realm is, by far, the most targeted use by PE investors. Apart from this, there are some other important features for investors to prefer the Mexican industrial market: contracts are signed in USD, tenants are usually institutional companies, the tenant mix is normally under control and there are several build-to-suit agreements, thus lowering the risk. One positive factor is that Mexico's industrial rents were averaging 65% below those in Brazil and 30% below those in Chile and Panama.

On the office use, the lack of investment might be explained by the shortage of real institutional assets. The office sector has been dominated by wealthy families that today own a big portion of the office buildings in the most important locations such as Mexico City and Monterrey. Besides, these buildings have a stratified ownership, meaning that a

[27] PROMEXICO: Te Damos Razones Para Invertir.

different investor can own each floor, ultimately making it harder to complete a deal or a selling agreement.

On more developed markets, residential use is a very safe play that appeals to many institutional investors. In Mexico, this is clearly not the case. Historically, most of the residential use has been developed for sale to the final customer. Investing in a development opportunity in which the developer intends to sell the homes/apartments sounds like a good idea when considering the speed at which the investor will get his or her capital (return) back. But if we think about funds and institutional investors, they might not be willing to undertake the risks that developing to sell implies: a small shift in the pace at which the apartments are being sold could mean a massive impact on the return for the investor. Not to mention what could happen if the project is caught in the middle of a cycle in which sales are just not there. Housing for sale could be a good business for an experimented local developer but not all investors are willing to assume that risk.

In Mexico, the home-ownership rate is at 76.4% and has been decreasing with time and the same goes to occupants per household, the number has come down drastically in the last 20 years. This implies that there is a fair size of a market for rentals considering that not a lot of professional developers have addressed the opportunity in the past.[28]

[28] Apendix 1

Figure 4.9: Housing Ownership Rate (%)

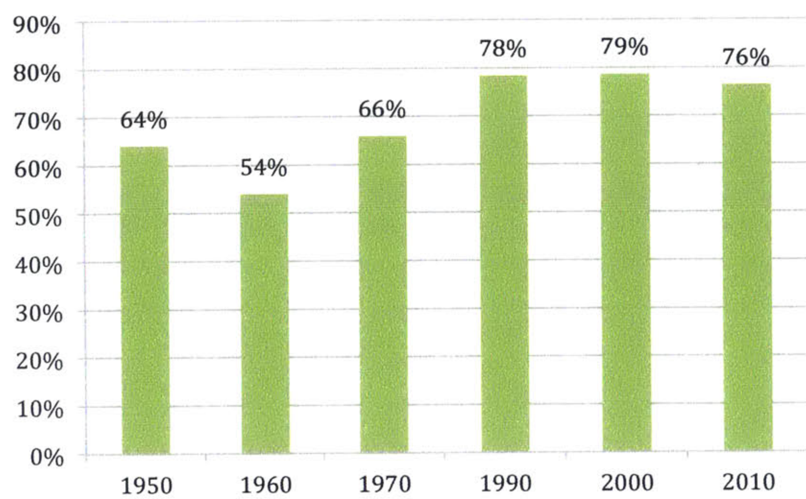
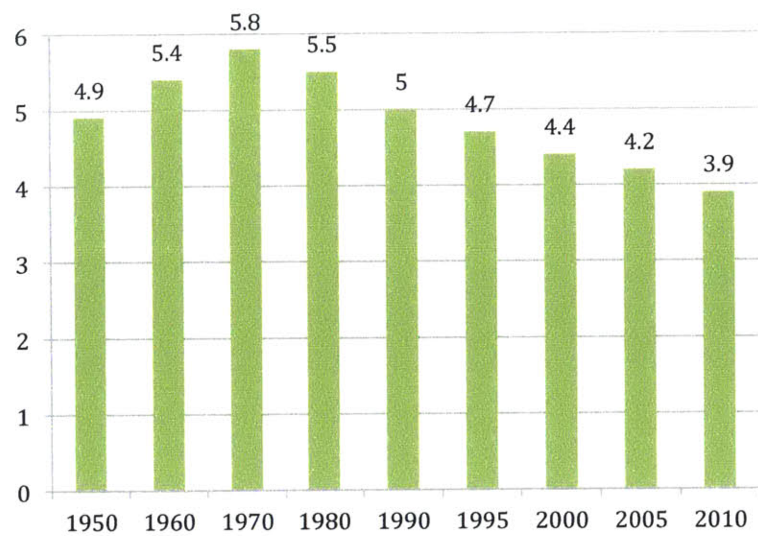


Figure 4.10: Occupants per Household



Retail remains an attractive use because of the country's growing middle class and purchasing power. From 2013, Mexican per capita consumer spending is forecasted to increase by 30% by 2017, compared to a regional growth average of 27% (PWC Retail Report 2013). Accelerated growth is expected outside of the main city areas of Mexico City, Guadalajara and Monterrey. The leading retail chains plan to increase their investment significantly, focused on new compact hypermarket stores in "second tier" cities. To give an example, Soriana plans to open 50 stores and Chedraui, another leading chain, plans to open 30 stores. The grocery segment is quite saturated by Oxxo, 7-eleven and Círculo K, but specialty retailers are entering through joint-ventures and franchises. Some examples are Sephora, Payless and H&M. In the food segment, Alsea, Mexico's leading fast food operator plans to open 500 new locations over the next 5 years. These are good indicators that the retail market will continue to grow over the following years.

FIBRAs: the perfect exit

FIBRAs are an investment trust vehicle under Mexican law dedicated to the acquisition and development of real estate assets in Mexico intended for leasing. FIBRAs are similar to real estate investment trusts, or REITs, in the United States. This vehicle provides an investment opportunity for institutional and small investors through the public market and, comparable to REITs, FIBRAs are subject to several policies. To better understand what these regulations are and how they differ from US regulations, a comparison of the main features is shown below.[29]

	Mexican FIBRAs	**U.S. REITs[30]**
Distributions	Must distribute at least 95% of net taxable income to investors annually.	Pay at least 90 of its taxable income in the form of shareholder dividends each year.
Investment Focus	Must invest at least 70% of total assets in real estate or rights derived from it. The remaining 30% (or less) must be held in Federal Government Securities or in shares of debt-instrument investment mutual funds.	Invest at least 75% of its total assets in real estate equity and/or debt.
Income Test	- Real Estate must be leased or held for lease unless it is under development.	- Derive at least 75% of its gross income from rents from real property, interest on mortgages

[29] Fibra Shop
[30] REIT.com

	- FIBRAs may provide financing to third parties for acquisition or construction of real estate secured by mortgages created on the leased assets.	financing real property or from sales of real estate. - Subject to tax penalty on sales of property "primary held for sale to customers in the ordinary course of business".
Others	- In order to maintain tax benefits, properties must be held by FIBRAs and not be sold for at least 4 years after completion or acquisition. - Mexican resident individuals without business activity are exempt from income tax on the sale of FIBRA-related CBFIs or shares. (Different treatment for non-Mexican holders).	- Not more than 25% of assets may consist of stock in taxable REIT subsidiaries, or TRS.

Similar to REITs, FIBRAs offer numerous benefits to investors including: diversification, liquidity and transparency through public markets and applicable taxable benefits among others.

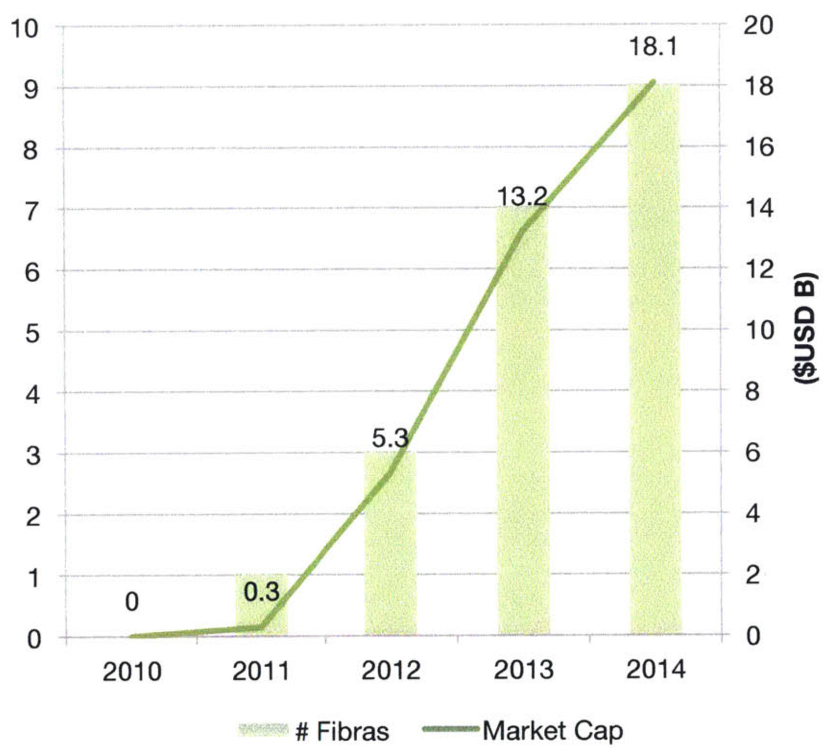
At the end of the last century, business groups started to acknowledge that the real estate industry did not have the capacity to draw institutional investment, not to mention debt. A market in which developers could raise equity or debt to finance medium or large-sized projects was non-existent.

After failing at their primary attempt to list the vehicle, Fibra Uno, the first FIBRA in the market was listed in March 2011. The initial portfolio consisted of 16 assets and the IPO (Initial Public Offer) was made for 300 USD million. Mexican investors bought 75% of the offer and foreign institutions bought the rest.

According to an interview with Andre El-Mann, CEO of the family-owned real estate group "e-Group" that later transitioned to Fibra Uno while he was still CEO, the groups decided to go public for 3 major reasons: (i) to open to the market and have access to capital that they did not have before, (ii) to have an institutional and professionallymanaged business, so that running a company does not automatically become the responsibility of family members and (iii) to gain tax benefits. On the same interview, he cites a case in which an existing client wanted to add 200,000 square feet of space to an 800,000 square-foot facility. He said that if he could not have provided the additional space, not only would they have lost 200,000 square feet, but they also would have lost the entire 1 million square feet, because the client would have found someone else to provide them with the space. According to him, access to capital makes it easier to build additional space more quickly.[31]

Since then, FIBRAs have grown substantially, from only 1 in 2011 to a total of 10 FIBRAs listed in the Mexican Stock Market (Bolsa Mexicana de Valores), with a market capitalization of roughly 245 MXN billion (16.35 USD billion[32]).

Figure 4.11: Growth of FIBRAs



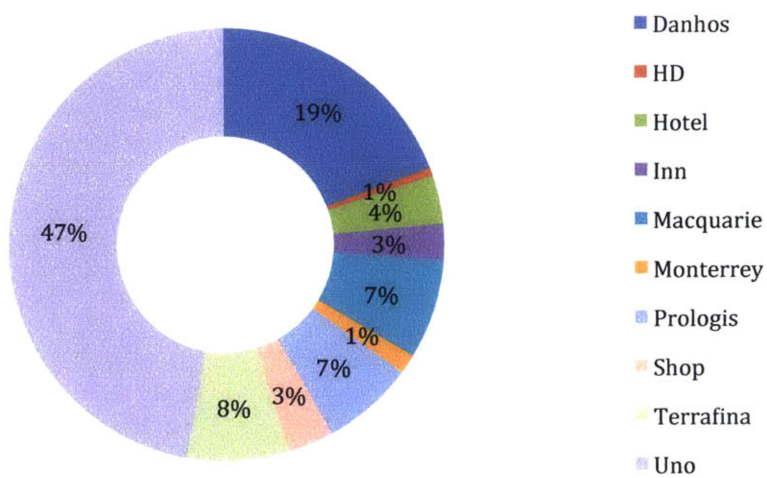
[31] REIT.com

[32] Exchange rate 1 USD = 15 MXN pesos

Figure 4.12: Listed FIBRAs

FIBRA	Ticker	Market Cap (MXN B)	Market Cap (USD M)	%	IPO	Use
Danhos	DANHOS13	47.33	3,155	19.31%	2013	Mixed
HD	FIBRHD15	1.50	100	0.61%	2015	Mixed
Hotel	FIHO12	8.83	589	3.60%	2012	Hotel
Inn	FINN13	6.62	441	2.70%	2013	Hotel
Macquarie	FIBRAMQ	18.11	1,207	7.39%	2012	Industrial
Monterrey	FMTY14	3.61	241	1.47%	2014	Mixed
Prologis	FIBRAPL	16.62	1,108	6.78%	2014	Industrial
Shop	FSHOP13	8.43	562	3.44%	2013	Retail
Terrafina	TERRA13	18.68	1,246	7.62%	2013	Industrial
Uno	FUNO11	115.36	7,691	47.07%	2011	Mixed

Figure 4.13: FIBRAs Market Share



Each FIBRA has a different type of management and fee structure. Some charge fees for acquisitions and others levy incentive fees. On the management side, most of the FIBRAs pay external companies to do the job, leading to high management fees. But this is about to change drastically. Motivated by the theory of economies of scale – the cost advantage that arises with increased output of a product – Fibra MTY launched its IPO in 2014 with an unprecedented advantage: assets are internally managed, no fees are charged for the service and no third parties are paid to supervise the operations of each property. There is a simple idea behind this: expenses should not be proportional (to certain extent) to the size of the portfolio. While the NOI (net operating income) curve could have an aggressive growth, the curve for PM (property management) expenses could stay nearly flat and still deliver the same results. If the rest of the FIBRAs want to stay competitive, they might want to migrate to a more shareholder-friendly fee structure and eventually become internally managed, just as the Monterrey-based trust. This is a clear example of how the REIT arena is rapidly changing in Mexico and how managers are willing to adopt better and new practices in order to be able to lure more institutional money.

The real estate field has been an attractive type of investment for institutional investors in Mexico, specifically the industrial and retail uses. PE funds have raised more than half of their equity from AFOREs and have invested mostly in development projects. Investments have been very concentrated in Mexico City and the northern part of Mexico, GPs have not explored beyond the typical investment destinations, which could be an opportunity in the future. With FIBRAs as the main exit for PE funds looking to cash out, PE managers today have a strong "harvest strategy" and investors can have more certainty about when are they going to be able to close the investment cycle, thus lowering risk and boosting returns.

V

Interview Results

As part of this thesis, some industry leaders were interviewed to get a sense of the pulse of the private equity and real estate industries. Over 60-minute live meetings with the interviewees, changes over the past year were discussed, along with an assessment of the actual situation and the trends that these leaders envision for the future. This chapter attempts to summarize the responses of each interviewee into single collective answers for each question. By the nature of a live interview, the majority but not all of the questions were asked to all the interviewees. For these reasons, the responses shown below are the author's interpretation of each of the responses and not the actual answers of the participants.

Q. Why is Private Equity (specifically in RE) so underdeveloped in Mexico?

A. Historically, there has been a lack of supply of institutional assets ready to be purchased by funds. The limited quantity has been bought already. For the industry to keep growing and to get a higher PE penetration, Mexico needs more qualified assets. Development can be the answer to this, but it takes time. The existing vehicles were just created less than five years ago and still need several iterations and improvements. In the case of CKDs, the process is very complicated and only a few managers are able to comply with all the regulations. Even though pensions have the money, there are not enough vehicles that they can use to invest.

Heretofore there were no exits and the uncertainty was high. Investors could not know for how long they were going to hold their investments. A true exit such as FIBRAs was recently introduced and the results are showing that this could help the PEI grow.

There is a very important cultural component behind the underserved PE industry in Mexico. Companies, in this case, real estate developers, do not want boards telling them what to do. They are used to running their businesses by their own rules, so if they can get the funding from traditional sources (normally passive investors), why bother to raise money from a fund?

Q. How has the Private Equity Industry evolved over the years and what should we expect for the rest of the decade?

A. The industry has grown from 4 funds to more than 125 over the last 15 years. What ignited the growth of PE firms and capital raised was the regulation passed by CONSAR that enabled AFOREs to invest in PE through listed vehicles. Traditionally, AFOREs were used to invest in government bonds and the transition to allocate their capital in riskier assets has not been easy, but according to the participants' judgment, it is taking place at a reasonable pace.

With this change, local fund managers can go and raise foreign capital more easily, once they are able to convey international managers that the biggest institutional investor in Mexico already has a commitment with them. Not only has the regulation allowed managers to raise money from local pensions, but it has also indirectly helped PE firms raise institutional capital from overseas.

Additionally, the government, through a series of regulations, has not been the best ally for the growth of the PEI. This is starting to change and the proposed changes in regulations promise to encourage PE investments in the country. The authorities will have more insight once the first investments made by CKDs have closed their cycles. By then, they will be better positioned to evaluate and make decisions.

In the real estate arena, PE activity has increased substantially. Prior to 2011, one inhibitor for real estate investment was that there was not a clear exit other than an IPO. After 2011, FIBRAs started to play a very important role in the investment cycle of most of the funds. They have been acquiring real estate all over the country, with a high concentration in Mexico City and other primary metropolises. Unlike in past years, currently there is a clear exit for real estate funds and they can easily develop or acquire an asset, stabilize it and turn around and sell it to a FIBRA at a cap rate around 8 – 9%, obviously depending on the use, type and tenants, among other characteristics.

With FIBRAs, there is a top layer of low-cost institutional capital in the market ready to buy almost every available opportunity. Naturally, local PE funds cannot compete with FIBRAs on the acquisitions ground, being this one of the main reasons that funds opt for development opportunities. Even though this might seem unfair, it is a huge opportunity for funds, because today they know that after completing the development cycle, they have an institutional client willing to purchase the entire project, whereas before, there was virtually nobody you could sell to.

FIBRAs also help the PE industry lower the uncertainty along with the assumed risk. Interviewees all agree that more than one FIBRA will be willing to buy an institutional-stabilized asset, so the key for fund managers is to find the right development partner that can generate an asset that would appeal to local institutional investors once it is stabilized. The alternative would be for fund managers to develop the asset in-house. Another observation that interviewees made was to start by asking institutional investors what their needs are (quality, spaces, ticket size, tenants, and maintenance) and develop accordingly, but always keeping in mind the end user's needs. They expressed that the main difficulty for doing this is that the initial money can come from HNWI and friends and family, and their objectives can vary significantly from those of institutional investors.

Q. How do lenders (commercial banks, financial institutions, etc.) participate and what are the typical terms for financing real estate?

A. Mexico has a very developed financial system but banks have not been able to approach mid-size or small real estate firms. It appears that credit is available only to big real estate developers, funds and FIBRAs, because the rates and terms at which the banks are willing to lend are not sustainable for the typical real estate firm.

According to the responses, FIBRAs or well-positioned funds could get a deal under the following estimated terms:

- Interest rate: 4.5 - 6.5% in USD
- Duration: 20-25 year amortization with balloon payments at 7 to 10 years with possibility to refinance.
- Long-term debt coverage ratio: 1.2 – 1.3 times.
- Loan to cost: up to 50% - 60% for construction loans

On the other hand, the rest of the developers and managers are not able to include a debt layer on their capital stack because it is expensive and practically unsustainable. These firms will get a 9% interest rate (approximately) for mid-term financing, plus fees and commissions making the use of leverage unviable to develop projects intended for leasing. Some developers complain about the procedures needed in order to obtain a loan. It seems as if banks do not want to lend money. One reason that loans are so expensive for these developers is that they consider there is not a strong competition between commercial banks. Banks are used to lending at high rates and historically have never made an effort to bring a more attractive solution to the market.

One good thing about the actual situation regarding terms with lenders is that nowadays you can use a pro-forma with a 9% exit cap rate and the banks will agree about this assumption. This has to do with the introduction of FIBRAs to the market. Today, a stabilized asset can be acquired by a FIBRA at a cap rate lower than 9%, whereas years ago, the assumed exit cap rate in pro-formas was around 12%. This means that banks are now actually lending more money in real terms because the disposition of the asset is being considered to be at a higher value, thereby increasing the return of the asset.

An interesting comment about lending was that most of the interviewees agree that Mexican banks lend over cash flows and not over guarantees. The foreclosure period can take more than three years, without considering corruption. This issue makes it hard for banks to rely on guarantees, making it more risky and therefore more expensive for them to lend.

The FIBRAs have been buying portfolios and with this they are liquidating the outstanding loans each asset had. This means that banks have all the money in their pockets ready to be used again in another development or acquisition. This and the recent gossip that foreign banks are starting operations in Mexico soon, should put some pressure on the banks, resulting in cheaper financing for developers.

Q. What are the returns expected by investors?

A. Local high net worth individuals (HNWI) and families are after a 17 – 20% annual return at a property level (before considering leverage). FIBRAs are buying at an 8% cap rate roughly. PE funds are targeting a 15% return in development projects. International investors such as dedicated funds are normally targeting at a 25 – 27% return before a haircut, which they normally do.

Developers say that local wealthy families are used to getting big returns and that this is why the cost of capital for small and mid-size developers can be quite high, considering the return demanded by their investors, who are usually their friends and family. This, combined with the high price of debt, makes it difficult for entrepreneurs to start their businesses, inhibiting competition and growth.

Projects for sale developed by small and mid-sized companies are normally funded with the sales of plan, construction loans and equity from friends and family. The typical capital stack is usually similar to the following:

- Sales of plan (pre-sales): 20 – 30%

- Construction loan: 40 – 50%
- Equity: 30 – 40%

One clear advantage for Mexican developers is that they can actually use the money they get from pre-sales for the construction of the project. At the end, the WACC (weighted average cost of capital) is normally around 13 – 15%.

Some developers think that right now there is a dislocation between return, debt price and risk in some uses, specifically in primary cities. A lot of equity has been invested by HNWI just because they have decided to put their money somewhere different than the bank, resulting in cap rates in prime residential being as low as 3.5 - 4%.

Q. What are the major challenges for real estate investors in Mexico?

A. Corruption and commercial lending to investors and developers were the top reasons mentioned in almost every single interview as the inhibitors of real estate investment in Mexico.

Corruption has been a "deal breaker" for more than one institution, and even more when we talk about foreign investors. Development projects incur in a huge risk in early stages because the uncertainty of getting a construction permit is gigantic. Sadly, but to mitigate this risk, the industry has relied on bribes to the authority in a neverending cycle. In the industry, it is said that the community itself is responsible for starting the corruption. Developers started bribing authorities to get better zoning and FAR (floor to area ratio) for their projects. This started to be the "way to go" for developers and authorities until it became a normal issue: most of the projects would pay an extra official fee in order to get a permit with the proper timing. Nowadays, the authorities feel entitled to receive money in exchange of a permit no matter if the project is following every single requirement imposed by the local zoning agency.

For professional investors, it is unconceivable to rely on the relationship between the developer and the authorities or the "political abilities" a specific developer might have. Furthermore, these practices will never comply with FCPA (Foreign Corrupt Practices Act)[33] regulations, which definitively constrain foreign investment in Mexico and limit the funding for real estate projects.

The lack of financing available to small and mid-sized developers is also affecting the growth of real estate in the country. How would somebody be able to fund a project intended for rent when the price of debt is around 9% and cap rates can be roughly 10%? For some of the interviewees, this could be one of the reasons that small developers and funds usually target projects intended for sale. They can finance these projects with pre-sales and construction loans. Besides that, long-term debt is not always available to this business class.

Another challenge mentioned by some interviewees has to do with the actual management scheme for FIBRAs. There is a concern that initial owners - families and business groups that initially contributed the properties – are the ones making the decisions. They are charging high fees and the interests might not be well aligned. This could generate tension between the management team, initial owners and investors in the near future.

<u>Q. If you could instantly fix one thing to help the Private Equity Industry, what would you fix?</u>

A. Corruption and eliminate constant changes regarding fiscal regulations.

<u>Q. What is missing in the Private Equity and Real Estate Industries?</u>

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[33] Federal U.S. law aimed at preventing the bribery of foreign government officials in an effort to obtain or retain business.

A. There are not enough well prepared portfolio managers in Mexico and most of them do not have a real estate background. Well-trained local managers could have a big advantage over foreign executives: they know the market and the right people better than anybody else.

There are not enough sources of capital for second and third tier developers. They cannot grow because they do not have the money to build a project and sometimes the second tier developers are the ones who are willing to take the risk to try secondary markets. There are no PE funds or debt willing to invest in developers with a short track record, inhibiting entrepreneurship in the industry.

There is a lack of information in the market. This would facilitate the job for everybody in the industry. With information, developers and investors would be able to make more accurate decisions, thus lowering the risk of development projects and acquisitions.

<u>Q. In Mexico, is there more money than projects or more projects than money?</u>
A. There is much more money than what the actual real estate market has to offer, specifically talking about institutional money chasing institutional-grade stabilized assets. This opens an opportunity for developers with the ability to create projects following the required standards by funds and FIBRAs.

One of the problems with assets has been that sometimes they are in good shape and with the proper maintenance but the ownership scheme is not the best and makes it difficult for investors to acquire. Stratified ownership was mentioned in some of the interviews as a common problem encountered when looking for assets. For managers it is hard to deal with 10 or 20 different owners in order to reach an agreement. A clear example of this can be the office sector in Mexico City, where a community owns most of it and they are not willing to sell, in other words, the ones that would sell cannot convince the rest of the owners to do so. A solution expressed by interviewees was to think about this since the conceptualization of the project, and make prior agreements of selling opportunities in a trust in which internal rules are established since the beginning.

VI
Conclusions

Private Equity in Mexico is underdeveloped, considering the country's size and fundamentals, but the industry is growing at a fast pace. In an emerging market were the middle class is going to almost double its size by 2025, there are going to be opportunities in all sectors and PE funds could play a key role in financing and seizing these openings.

The potential of the PE sector in Mexico in the coming years is enormous. As mentioned by an interviewee, the PEI is attempting to double its size by the end of this decade, which translates into more available money, possibly at better prices for managers (more competition among funds). The question is: how can the government and industry leaders unlock this potential? Several actions at all levels including the public and private sectors are needed in order to be able to invest the available capital. The following challenges are expected to be faced by the real estate and PE industries in the near future:

Challenges:

- Enforce regulations and policies: Mexico needs to start by making sure that existing laws are applied to their full extent (foreclosure being one of the most important). This will translate into more confidence among investors and lower risks. Only after making sure that the existing rules are being applied equally to everybody in the industry, the authority should think about creating new ones. What is the purpose of laws if they are not enforced? The law itself and its enforcement are equivalently important.
- Changes to the fiscal regulation: over the past 10-12 years, several fiscal reforms have been discussed, making investors unsure about how to approach investments. The government needs to make the rules clear for investors, so they

can plan on the long run and be willing to invest in Mexico beyond "for sale" projects.

- Improve vehicles available for pension funds: particularly CKDs are not optimal and need some changes. The regulations need to be improved but it is critical to do it at a slow pace. Specifically, pension funds must be dealt with carefully since they are dealing with the savings of Mexicans and their managers were used to investing in government bonds.
- Create a specialized vehicle to promote financing for infrastructure in the energy sector. Something similar to the US MLP (Master Limited Partnership) could be an intelligent solution. The Mexican MLP could be a long-term oriented vehicle similar to FIBRAs and CKDs in some ways.
- Prudence: FIBRAs can definitively help the industry grow, but managers need to be sensible enough to avoid a real estate bubble. Investors have been "hunting" assets in main cities primarily, but, acquisitions and new developments need to obey the real user demand each market has; developers should not only build because there is money available. Managers and developers need to be careful to avoid overbuilding because if this happens, the result could be higher vacancies and lower rents. An example of this is the office market in Mexico City, where the annual net absorption has been around 400,000 sqm (CBRE Market Research – Oficinas MX Insight 2014) and the construction rate has been of 1 million sqm in the last 3 years with a projected 1.4 million sqm for the next year. It is hard to believe that rents can increase in the near future. The same thing happens in Monterrey's office sector, where the annual absorption has been around 50,000 sqm per year and there are more than 300,000 sqm coming online over the next couple years, plus 100,000 sqm that were added in 2014. This suggests that vacancy is going to go up and rents might come down, while the market balances.
- Culture matters: local businessmen are still wary of accepting outside investment. They feel like losing control instead of getting interesting intangibles such as corporate experience, indirect professionalization, and a wider network. This will

take time, but fund administrators must work on communicating the benefits that PE firms provide. Industry associations could help in this respect.

- Financial reform: should bring more long-term debt opportunities with lower interest rates for small and mid-sized developers to foster entrepreneurship and competition. The banking industry should be able to keep up with the pace at which the private and capital markets are growing.
- Managers and developers should transition into more professional practices so they can be able to get institutional funding.

Trends

The FIBRAs' low cost of capital will give them a clear advantage over PE funds when competing for the acquisition of stabilized assets. For this reason, some of the PE funds will continue to consider development projects as their investment strategy. This is a good thing for the Mexican real estate market because now there are several players that can help close de investment cycle: the lack of supply in some sectors can be an opportunity for developers, who can finance their projects with PE funds, which in turn can sell to a FIBRA after stabilizing the asset, and then reinvest that money into another development opportunity, creating a virtuous cycle.

There is going to be a wave of new FIBRAs over the next years and more money is going to be invested through these vehicles. As of today, most of the available portfolios and assets have been acquired and the remaining ones are going to be sold at very high prices.

FIBRAs are going to keep buying most of the existing portfolios. The money available in the market thanks to the changes in the investing regulations of local pension funds and the appetite of the FIBRAS, added to the lack of institutional assets in Mexico, will boost the price of the remaining real estate and also increase the price of upcoming projects, which translates into development opportunities.

Also, FIBRAs should migrate into a more transparent and "investor friendly" vehicle to avoid conflicts of interest between the management team, initial owners and investors. FIBRAs could follow the evolution path that US REITs had back in the 90s. Some even say that FIBRAs can end up being a "REIT with a Mexican zip code".

The Private Equity Industry is going to keep growing and should double its size (capital raised) in three to four years. The industry players need to become more professional and reliable in order to catch some of the funding offered by PE firms.

Private Equity funds investing in real estate and infrastructure might need to start participating more and more in development projects, mostly because they cannot compete for acquisitions with FIBRAs. They are going to need to assume development risks and target higher returns. With the opening of the oil industry and energy sector, infrastructure projects are going to need funding and PE firms could become in the most important player. Another observation is that there is also going to be more competition on the equity side (more money chasing investment opportunities) and this will tend to lower the cost of capital for developers.

AFOREs might get away with being able to invest directly in real estate and infrastructure through private equity funds and/or developers. The government should be very careful on what to allow and what not to. Special attention should be placed into possible conflicts of interest. A regulation similar to that of the United States could be a solution: investments should be made through a trustee, whose investment committee makes the decisions. Interviewees agree that the actual management teams of the AFOREs are not ready to deal with real estate or infrastructure investment on their own. They do not have the expertise or the experience and there is a lot at stake. Even though

AFOREs might be enabled to invest directly, CONSAR should maintain regulatory hurdles and start with more relaxed policies once the managers have demonstrated their managerial skills.

The medium class is going to grow substantially and therefore there is going to be a shift in housing demand. Housing for rent is going to be a good possibility if the proper regulations are passed. Investors need more certainty in case tenants stop paying rent. If the government can fix this issue, residential use for rent will be very attractive to investors. Also, families will have more disposable income, so more retail development is going to be needed. In general, there is still a deficit of housing and shopping centers in growing cities in Mexico, so developers should try to close the gap between supply and a growing demand.

In the short and medium term, interest rates should go up following the Fed. In the long term, debt should tend to be less expensive for businesses and developers. Existing banks that used to lend money to real estate developers and investors got their money back when FIBRAs acquired the portfolios, so they should be motivated to re-allocate at least the money they lent in the past. Additionally, there are some foreign banks wanting to start operations in Mexico and this could lead to a more fair competition among financial institutions, causing interest rates to go down. The almost "free lunch" for banks in Mexico could be over during the next decade. The financial reform will enable the credit flow in the country.

Opportunities

- Patience will pay off. The real estate development industry is transitioning into a more professional sector. Developers are starting to understand what institutional investors need, so it is just a matter of time for them to start generating more qualified assets with proper ownership structures that meet investor standards.

- Second-tier cities can be great too. There are more than 30 cities with more than 500,000 habitants where there is a lack of real estate supply. Instead of fighting for overpriced assets in primary cities, investors should look at growing cities with strong demand and not enough supply.
- There are 20 USD billion to be raised from AFOREs. This could be just the starting point for Mexican fund managers. Having local pension funds on their side will help them raise foreign capital.
- There is a big opening for local fund managers with some experience in Mexican real estate. Apparently, a lack of local experience and/or skills makes international investors bring their own teams. If a local fund manager can demonstrate enough qualifications and a solid track record, he should be able to raise capital from local and foreign institutional investors.
- It appears that the existing commercial banks do not want to evolve and want to keep making big margins out of squeezing their clients' profits. There are a lot of openings in the debt arena for institutional investors. For instance, insurance companies could take advantage of this situation as well as foreign capital with local credit enhancement from AFOREs.
- Anything that has to do with providing service to the middle class will definitively have a strong demand in the future.
- Industry service providers able to find new niches for the virtually new vehicles could be seeing interesting opportunities. For example, due diligence work for portfolio buyouts, legal consulting, etc.

Smart Investments in Mexican Real Estate

Over the second chapter of this thesis, some reasons to invest in Mexico were exposed. Whether there are reforms on their way or a demographic bonus, most of the reasons seem to point towards more and more jobs in the country. As we have seen in the past, employment has always been an important growth driver for countries. Employment not only means people working, but with more jobs, more wealth is generated and real estate demand rises. Businesses need office space, employees need housing, places to shop and get medical assistance and schools for their children. Apart from that, there are basic fundamentals for the development of each use that are quickly reviewed below:

- Housing: with every single variable on its favor, the housing sector will thrive over the next years. Occupants per household have been historically decreasing, the marriage rate is decreasing, and even the divorce rate (unfortunately) is going up (Appendix 1). All these are clear reasons that housing in Mexico is a wise play. Specifically, housing for rent will be an interesting use to follow. Over the last 15 years, housing trends measured by INEGI show that the rental market grew from 21% to 24%. Even Infonavit (Instituto del Fondo Nacional de la Vivienda para los Trabajadores or Mexican Federal Institute of Workers' Housing) has introduced Arrendavit, a program to assist affiliates with rental housing.
- Retail: perhaps the biggest opportunity for developers and retailers is to fill the large retailer gap that exists outside the main city areas of Mexico City, Guadalajara and Monterrey. Additionally, there are more than 30 cities with populations exceeding 500,000, which is a good critical mass for shops to consider.
- Office: there are going to be brand new development opportunities after some private investments are made in the energy sector. Also, office development might follow the automotive and aerospace industries, so regions with high concentration of foreign investment in manufacturing will be a good places for office buildings.
- Industrial: the market for the service providers of bigger companies could be very interesting. Also, the closeness to the US, low labor costs and skilled local people will keep Mexico under the radar for every manufacturer that wants to increase production. The usual contractual terms for industrial developments will help the industry to get more funding from PE firms.
- Service: investors are targeting the healthcare industry, so the real estate around it might be a good opportunity to have in mind.

Some of the benefits that Mexican enterprises can get from the PEI are the following:

- Long-term horizon commitment, normally from three to ten years.
- PE firms add value by playing an active role on the board of directors. They contribute efficient managerial skills, experience and a powerful network.
- PE firms fund startups and entrepreneurs that otherwise cannot raise money. They normally do not have an initial cash flow to get access to credit so having a well-developed PEI could be a viable alternative to fund new ventures.
- PE funds can lower the risk associated with this type of investments by generating information needed by the sector and by doing strict due diligence and risk assessments. In the end, this could result in lower cost of capital for businesses.
- PE would add liquidity to the public markets via IPOs.

As mentioned above, Mexico can definitively benefit from a more dynamic PE industry. The increased private investment would help boost the country's GDP, increase jobs and promote entrepreneurship. The capital is now available, the initial regulations are in place and the "investment cycle" is now complete on the equity side. Now, it is the turn of executives and businesses to prepare themselves to get funding from institutional investors and thus contribute to Mexico's growth.

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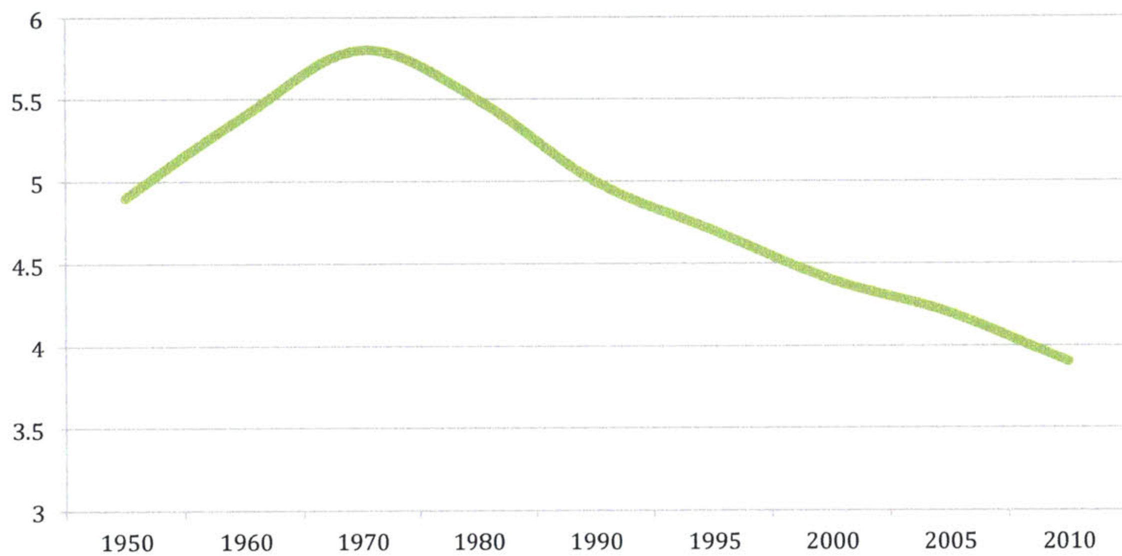
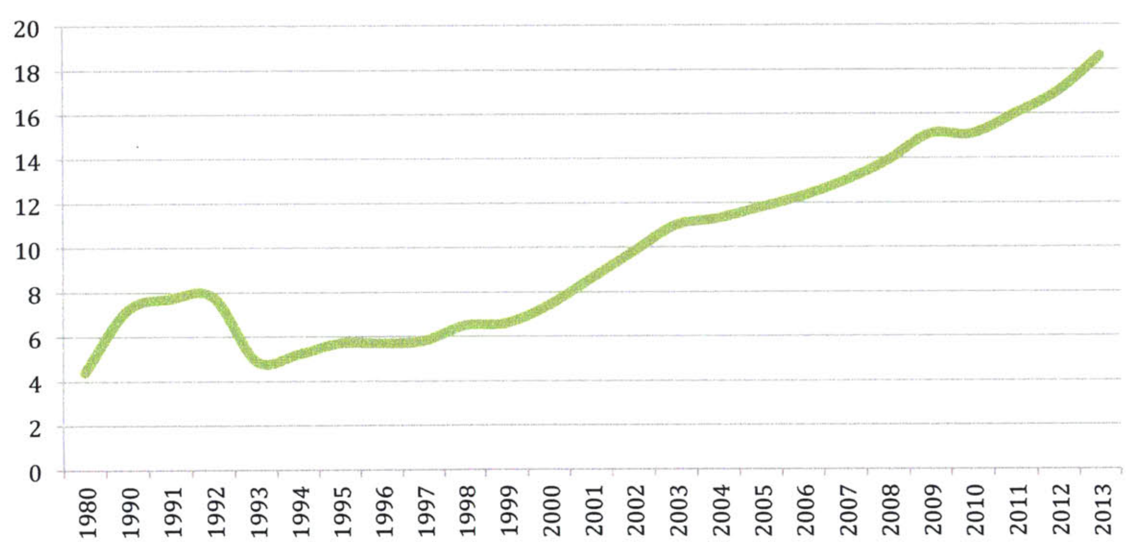
Appendix 1

Occupants per Household



Divorces per 100 marriages



Appendix 1 (continued)

Marriages per 1000 people