Photo by Brian Ehrig
Kearney, New York

# Reigniting growth in private equity and venture capital in Mexico

FONDO DE FONDOS
CORPORACIÓN MEXICANA DE INVERSIONES DE CAPITAL S.A. DE C.V.

KEARNEY

# How a collaborative ecosystem can help the industry reach its full potential

# Introduction

These are exciting times for Mexico's private equity (PE) and venture capital (VC) industry. Over the past decade, the market has evolved to become the second largest in Latin America. The country has also taken advantage of its large population and demographics to become a hub for VC investments, with local companies attracting more foreign capital in recent years. Even amid the economic impact of the pandemic, the industry has been resilient, closing attractive deals and staying on track to reach greater-than-expected levels of investment. As international markets have shown, a healthy PE/VC ecosystem fuels entrepreneurial growth and promotes an influx of capital, creating benefits in several levels of the economy. For these reasons, PE/VC success is essential for Mexico to maintain momentum and continue to leverage capital markets for growth opportunities.

Nevertheless, several challenges are holding the industry back from reaching its full potential. Since 2015, fundraising levels have been on a downward trajectory, new managers have been hard to come by, and the complex environment for exits and recent regulatory changes have generated great uncertainty for local and international investors. As a result, Mexico's PE/VC industry is at a tipping point. To flourish, all key market stakeholders will need to take an active role—collaborating to drive the industry forward.

In this paper, Fondo de Fondos and Kearney provide a perspective of Mexico's PE/VC industry, laying out its strengths and challenges as well as the elements that can fuel long-term success. We also share specific actions to support and boost the market's development for years to come.

The document contains an overview of the PE/VC industry in Mexico, detailing its recent growth, characteristics, and identified challenges. We then deep dive into three sections. First, we show an analysis of the role and impact of Fondo de Fondos in the Mexican market. Then we detail macro trends impacting the PE/VC markets and our perspectives going forward. Finally, we deep dive into five key factors that will enable Mexico to reach full potential in the local PE/VC industry.

# Overview

## Mexico is Latin America's second-largest PE/VC market

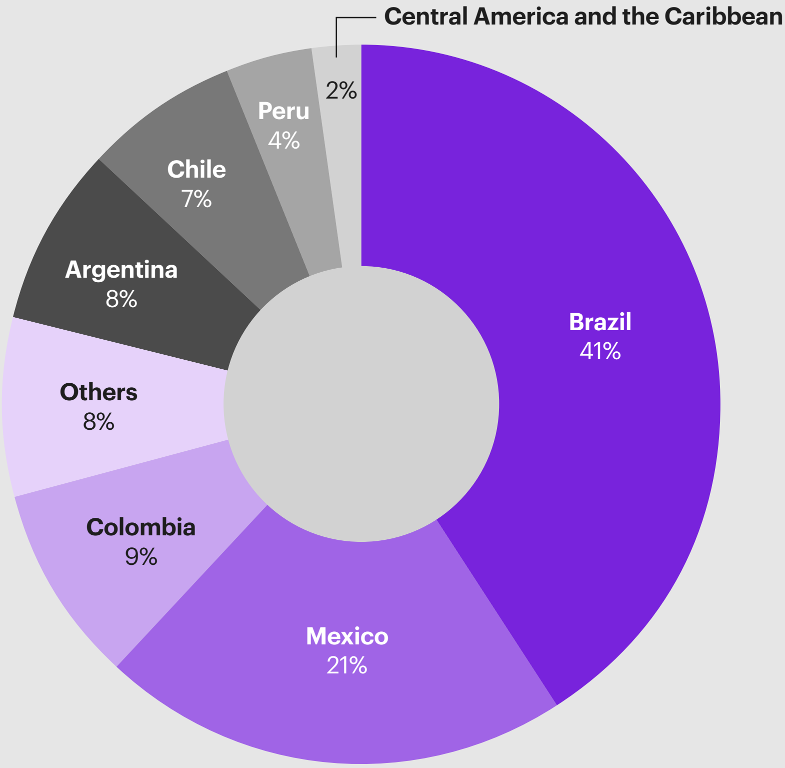
Private equity and venture capital markets around the world are thriving with more than 7,600 institutional investors participating. The capital invested in PE/VC has been growing since 2014, with a total CAGR of about 7 percent. While developed economies accounted for most of the institutional investor base (76 percent of investors are in North America and Europe), recent PE/VC growth has been noticeable in emerging markets, where investments have grown 14 percent a year for the past six years.[1] In Latin America, funds have invested more than $38 billion in more than 2,000 deals over the past five years, and about 200 local active institutional investors are operating in the region. Brazil, the regional leader, is home to 41 percent of the region's investments, boosted by strong pension-fund support and a burgeoning VC ecosystem. Mexico has positioned itself as the second-largest PE/VC market in Latin America with 21 percent of the region's investments and 23 percent of all transactions over the past five years (see figure 1 on page 3).[2]

**A healthy PE/VC ecosystem fuels entrepreneurial growth and promotes an influx of capital, creating benefits in several levels of the economy.**

[1] Preqin
[2] Latin American Venture Capital Association

Figure 1
**Mexico is Latin America's second-largest private equity and venture capital market**

Private equity and venture capital investments in Latin America
(Invested capital, 2019)




Sources: Latin American Venture Capital Association; Kearney analysis

## Mexican PE/VC has deployed $28 billion in investments

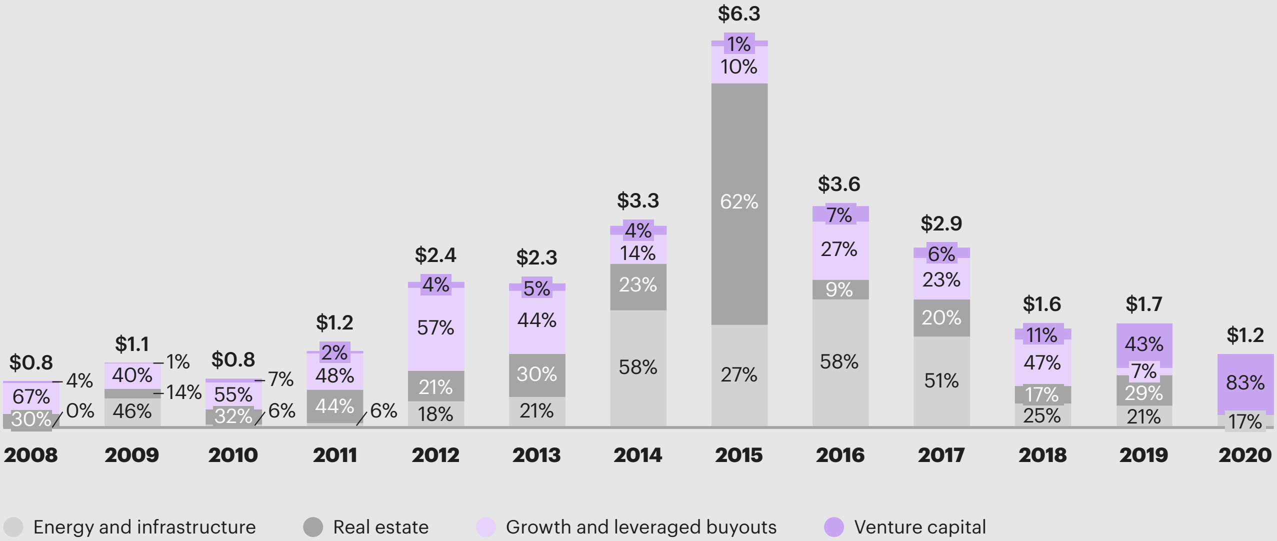
Since 2008, Mexico's PE/VC market has accumulated more than $56 billion in commitments with about 50 percent deployed (see figure 2 on page 4).[3] During 2020, fund managers deployed $1.2 billion in investments across about 100 deals.[4] However, over the past five years, local fundraising volumes have been slowing down. Real estate and infrastructure investments have shown an especially steep decline. Meanwhile, investors have shown a growing interest in venture capital and growth equity as the entrepreneurial environment continues to develop.

Mexico has long had the foundations for a successful VC ecosystem with a large consumer market, closeness to the United States, and experienced entrepreneurs. Nevertheless, fundraising has been hard to come by because of limited capital sources and a lack of a structured ecosystem to enable growth across various stages of maturity. In recent years, V C investments have grown considerably with technology-driven companies raising large sums of capital from local and international investors. For example, used-car marketplace Kavak became the first Mexican unicorn as a result of a strong fundraising series powered by renowned institutional investors. Other tech-focused companies such as Konfio, Clip, and Kueski have disrupted the financial services industry, raising more than $100 million in recent years. As a result of incremental interest in VC, Mexico has established itself as a regional leader in consumer services and fintechs, with 48 percent of VC investments being allocated across these two sectors.[5] Additionally, the government has had a central role in supporting the sector through regulation and the FinTech Law, which was launched in 2018.

[3] AMEXCAP, Crunchbase, Kearney Analysis
[4] Crunchbase
[5] Crunchbase

Figure 2
**Mexico's private equity and venture capital industry has deployed around 50% ($29 billion) of total commitments since 2008**

Invested capital of private equity and venture capital funds in Mexico
($ billion by asset class)




Sources: AMEXCAP, Crunchbase; Kearney analysis

One of the key factors in the development of Mexico's PE/VC industry in recent years has been the active involvement of institutional investors, including the Mexican pension fund Administradoras de Fondos para el Retiro (AFORES), foreign investors, and entities such as Fondo de Fondos. These investors have been key capital sources for local and international fund managers seeking to allocate capital in Mexican companies, yet the market still lags in institutional investor portfolio allocation to PE/VC compared with other comparative markets in the region, mainly Brazil.

**Investors have shown a growing interest in venture capital and growth equity as the entrepreneurial environment continues to develop.**

## CKDs and CERPIs have raised $11 billion since 2009, albeit with mixed results

In Mexico, pension funds and insurance companies can't directly invest in PE/VC vehicles. However, to enable participation of these institutional investors in the market, two publicly listed investment vehicles were created: In 2009, the Mexican stock exchange introduced long-term investment vehicles called **CKDs** (*certificados bursatiles de desarrollo*, or development capital certificates). These structures have been used to finance projects in mining, infrastructure, technology, and telecom among other industries exclusively in the Mexican market. With a similar structure as CKDs, **CERPIs** (*certificados bursátiles fiduciarios de proyectos de inversión*, or investment projects stock certificates) are listed under restricted offers to allow institutional investors to allocate capital in foreign investments through funds for up to 90 percent of the committed capital. These two instruments have streamlined the AFORES' large investment capabilities into PE/VC markets, raising about $11 billion in capital commitments since 2009, albeit with mixed performance results. The longest-tenured CKDs are wrapping up their divestment processes, facing harsh economic conditions and low M&A activity—signaling potential complications for exits. Meanwhile, CERPIs have accumulated more than $9.4 billion in capital commitments, of which only 24 percent has been called so far.[6] Nevertheless, these investments still represent a very small percentage of the total AFORES portfolio (only about 6 percent), proving there is room for growth compared with the 10 percent global average allocation to PE/VC from institutional investors.[7] Although CKDs and CERPIs have been a welcome alternative for raising PE/VC capital in Mexico, they have come at a high cost for investors in terms of both expected performance and operating costs—revealing the structural challenges that need to be addressed for the market to reach its full potential.

## Key challenges must be addressed for PE/VC in Mexico to reach its full potential

In the wake of a strong growth trend that started in 2008, PE/VC in Mexico has stagnated in recent years. This slowdown can be attributed to a variety of factors, including market maturity and structural challenges. In terms of market depth—stock market size, sophistication, initial public offering (IPO) volume, debt market size, and transaction volume—Mexico has consistently ranked lower than regional peers in recent years. The IPO activity has been shut down for almost three years as companies have opted for nontraditional structures, including strategic trade sales or special purpose acquisition companies (SPACs), rather than Mexico's stock exchange. Additionally, market penetration (PE as a percentage of GDP) is still low compared with global averages and even smaller markets such as Peru. Mexico ranks below countries such as Chile and Brazil when it comes to PE/VC market quality and attractiveness for foreign investors (see figure 3 on page 6).[8]

Generating positive outcomes will require structural changes and close collaboration between the public and private sectors. To understand what is limiting Mexico's PE/VC growth, we interviewed more than 50 stakeholders, including fund managers, institutional investors, regulators, and industry experts.

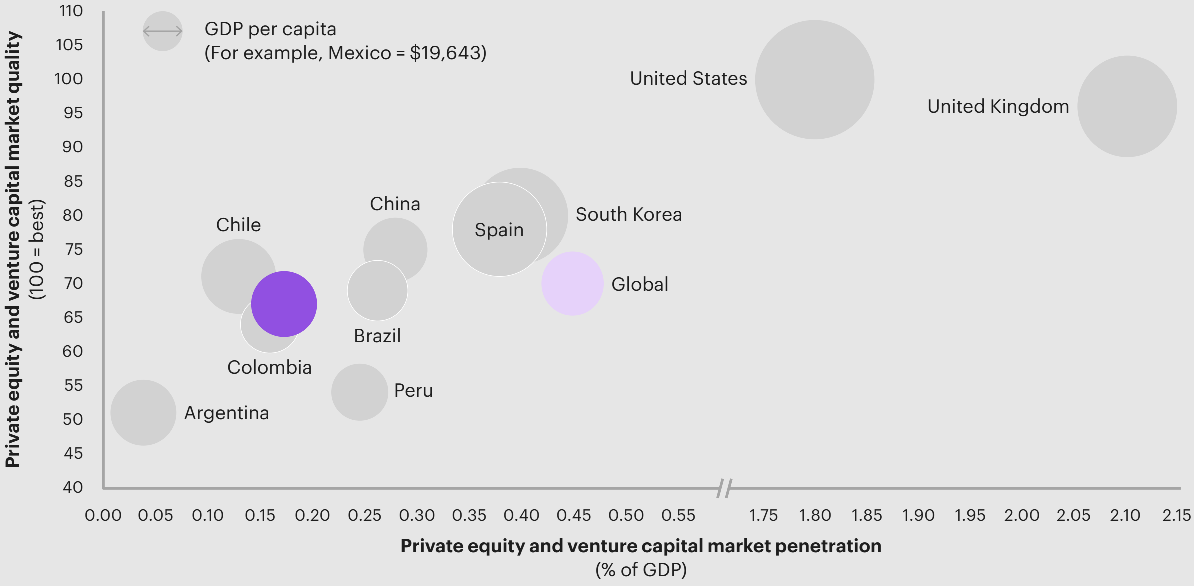
[6] 414 Capital
[7] Preqin
[8] Latin American Venture Capital Association, International Monetary Fund, Kearney Analysis

Figure 3

**Mexico ranks low in market quality and attractiveness for private equity and venture capital investors**

Private equity and venture capital global markets development

(2019, market quality and penetration)




Sources: Latin American Venture Capital Association, International Monetary Fund; Kearney analysis

Our research revealed the following challenges:

**Limited fundraising sources.** Mexico has long been an attractive market for institutional investors, yet market uncertainty, economic slowdown, and political concerns have limited the sources of capital over the past few years. Additionally, local regulation for alternative investments, specifically related to taxation, has been detrimental for institutional investors, leading them to focus on other Latin American markets. Mexico's PE/VC institutional investors represent only 16 percent of all Latin American investors and less than 1 percent on a global scale.[9] The industry is at a tipping point, with market players calling for more action to attract institutional investor capital flows into PE/VC investments.

**Investment ecosystem gaps.** With an ecosystem that has not reached maturity, Mexico is still in the process of closing initial PE/VC cycles, which markets such as Brazil have already done. The industry does not yet have a structured flow of capital or an ecosystem dynamic that enables companies to grow from angel investments and seed rounds into more mature private-equity financing. Additionally, the decision to disband the National Institute for Entrepreneurs (INADEM) left a gap in the ecosystem in terms of government support and funding for early-stage start-ups and entrepreneurs that further exacerbated structural problems. More developed markets ensured a robust pipeline for investment opportunities by guaranteeing that companies had access to financing and advisory from early to later stages. For example, US regulations changed to allow for direct loans to small and medium-size enterprises (SMEs), pension funds were enabled to directly invest in PE and other alternative asset classes, tax reforms to capital gains and simplification of the reporting requirements of general partners (GPs) were enacted to increase capital deployment, and the government and regulatory institutions played an active role in supporting the constant growth of the PE/VC industry over the past several decades.

[9] Preqin

**Complex environment market conditions for exits.** One of the main issues for fund managers has been exiting investments. The Mexican stock market has low depth, low transaction volume, and reduced liquidity to make IPOs attractive exit strategies. In 2018 and 2019, there were no IPOs registered in the local market. There are also few strategic buyers per sector, shifting pricing power toward acquirers and forcing investors to accept lower prices or seek alternatives for exiting. By comparison, Mexico's PE/VC is about half the size of Brazil's both in terms of investment and transaction volume, but Brazil's exit activity surpassed Mexico by almost three times in recent years. The difference is largely attributed to IPOs, which represent half of Brazil's exit strategies while Mexico has been mainly focused on strategic acquisitions.

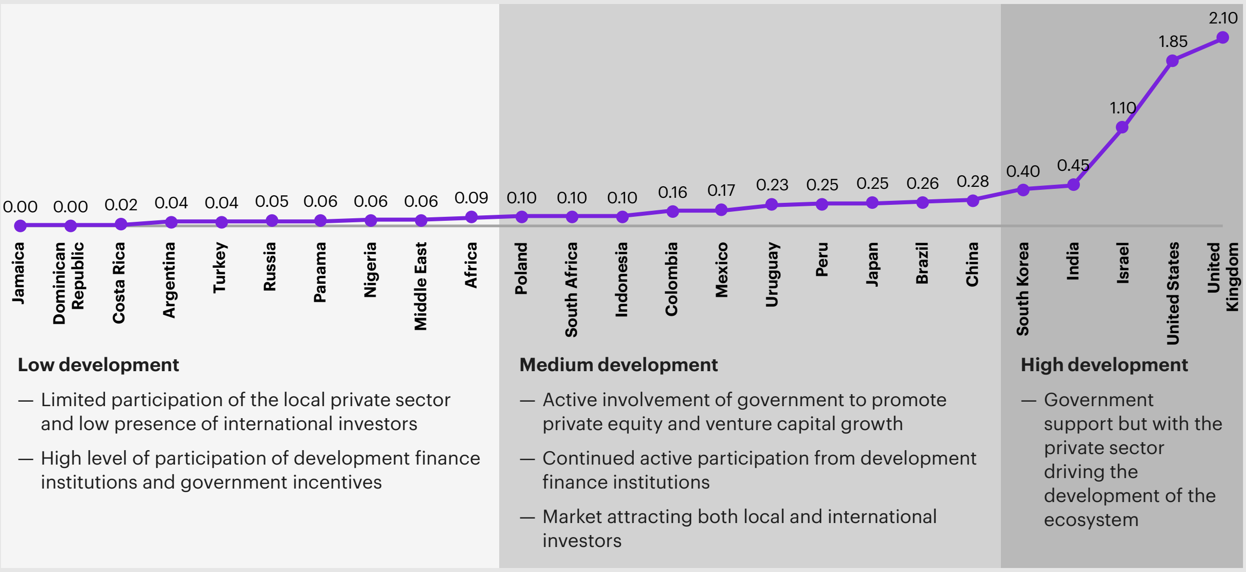
**Regulatory uncertainty in the market.** Recent changes in the Mexican Income Tax Law (articles 4-A and 205, enforceable in 2021) will transfer the application of income tax from foreign institutional investors directly to local limited partnership vehicles (loss of tax transparency). According to the law addenda, if a foreign institutional investor invests in a Mexican fund or vehicle, they will have to pay income tax at the vehicle level regardless of the investor's taxation nature in their home country. This clearly has a negative impact on the local PE/VC markets, so the industry has requested modifications and exceptions to the law. As an initial response, a general stimulus was approved to return tax transparency to certain investment vehicles; however, requisites for application may exclude some of the most common structures used in the industry. In this sense, there are still questions and risks associated with the implementation of the law starting in early 2021. As a result, PE/VC funds will now be forced to do a thorough assessment of their portfolio to understand the impact of the law and accordingly plan for significant restructures or other mitigation efforts to ensure their investors are unaffected.

In summary, Mexican PE/VC markets are at a key inflection point in which there is a need for the ecosystem stakeholders to work together to reach full potential. There is no one-size-fits-all solution, but there are steps that can be taken to generate new fundraising sources, improve the investment ecosystem, and create viable exit strategies.

## Generating positive outcomes will require structural changes and close collaboration between the public and private sectors.

Figure 4
**Mexico has room to grow by developing its private equity and venture capital industry**

Private equity and venture capital investments
(% GDP, 2018)




Sources: Emerging Markets Private Equity Association, Latin American Venture Capital Association; Kearney analysis

## Lessons learned from international markets

In other regions, the public sector's involvement has proven to be crucial for PE/VC market development. Internationally, governments have pushed for the development of the PE/VC industry and private capital not only to spearhead capital investments, but also as a strategy to push the growth and empowerment of the entrepreneurial ecosystem through increases in EBITDA and valuation multiples. For example, the United States designed incentives for venture capital through the Small Business Jobs Act as the country aimed to both boost capital markets and support the development of privately owned business. This thesis applies to markets across the world, and Mexico can continue to benefit from backing and developing its PE/VC industry to boost the growing market of SMEs (see figure 4). Lastly, Mexico can fuel industry growth by using a similar approach as developed markets in terms of regulation and a fund of funds, such as investment structures. For example, Yozma Capital Group in Israel started out as a government-backed fund of funds that invested in local VC markets using both public and private capital sources. Throughout the 1990s, the fund's investments created a robust VC ecosystem in Israel, attracting local and international investors. At the end of a decade, Yozma decided to sell its holdings and go private, having accomplished its mission to create a mature, self-sustaining ecosystem.[10]

Similarly, Mexico's government and some development banks operating through Fondo de Fondos have played a key role in boosting the local PE/VC industry by streamlining public and private investments and generating a positive socioeconomic and financial impact. While the industry wrestles with the challenge of reaching maturity, the role of Fondo de Fondos becomes even more relevant.

[10] Yozma Group, OCDE

# The role of Fondo de Fondos in Mexico's PE/VC industry

## Fondo de Fondos' mission has been to develop the PE/VC industry in Mexico with the support of Mexican development banks

Fondo de Fondos (FdeF) is a specialized investment firm founded in 2006 with the mission of boosting the development of Mexican private capital markets by investing in PE/VC fund managers and co-investing through a fund of funds structure. FdeF has streamlined development bank resources for these types of investments and continues playing a role in attracting foreign investors and capital to the Mexican market. The objective is to replicate the success of developed PE/VC markets such as the United States, the United Kingdom, and Israel, which greatly benefited from institutions such as FdeF supporting early stages of market development. Private capital markets are a crucial component of economic growth. For example, from 2010 to 2018, PE/VC-backed companies in the United States achieved 10 percent higher growth rates in job generation and 16 percent higher revenues than other companies.[11]

Since its inception, FdeF has had a positive impact on the Mexican economy, achieving solid financial performance and generating positive socioeconomic results. Looking ahead, the primary challenge for FdeF will be to help the PE/VC industry reach a mature state in which it becomes self-sustainable and less dependent on government-backed initiatives to maintain growth within the ecosystem.

## Fondo de Fondos' impact on Mexican companies

FdeF has had an active role in attracting investments into Mexican companies (see figure 5 on page 10). Furthermore, since its inception, FdeF's performance has fared well against both Mexico's stock market and overall emerging markets equities. Fund managers in FdeF's investment portfolio have also benefited from a seal of approval that enabled them to raise capital with foreign investors and attract international fund managers to allocate capital in the market.

This confidence has translated into positive socioeconomic results. In the five years following FdeF's investments, SMEs saw a 6.3x multiplier effect in revenues. Also, portfolio companies exhibit 1.4x higher average labor productivity (income per number of employees) than national averages. Notably, portfolio companies in health, logistics, and financial services have had labor efficiency ratios three to five times higher than national averages in Mexico. Lastly, FdeF's activity has proven to be essential for job creation as more than 80 percent of portfolio companies have created more than 500,000 jobs since their initial investments.[12]

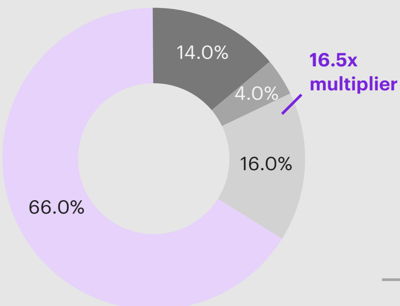
In the near term, as the Mexican PE/VC industry faces a tipping point, the involvement and continuous support of FdeF will be crucial to reigniting growth to push the industry toward maturity and ensure the continuation of positive results for investors and portfolio companies alike. However, the industry's success must not rest solely on the shoulders of a few players, and there is a crucial need for the PE/VC ecosystem and its stakeholders to collaborate to ensure the market successfully overcomes current challenges and reaches long-term success.

[11] Growth Economy
[12] Fondo de Fondos, AMEXCAP, Nacional Financiera, INEGI

Figure 5
**Fondo de Fondo has helped draw investors to Mexican companies**

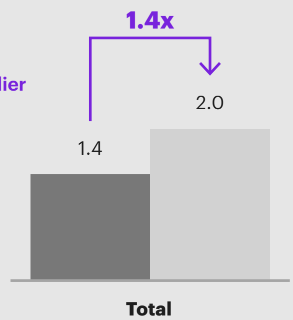
Fondo de Fondo's impact on the Mexican economy

**Foreign capital attraction**
(2020)



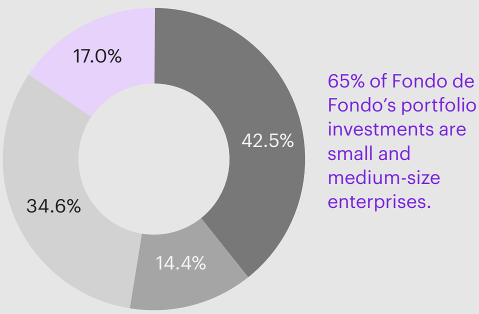

- CKDs[1]
- National investors
- Fondo de Fondo
- Foreign investors

**High labor productivity**
(Mexico: revenues/employees, million Mexican pesos, 2018)




- Average market productivity
- Fondo de Fondo-backed companies

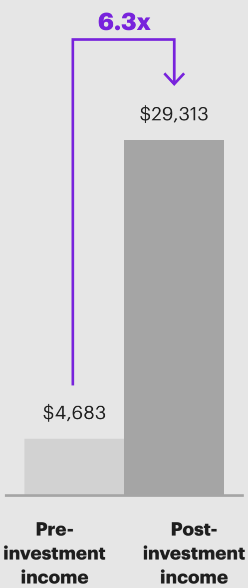
**Support for small and medium-size enterprises**
(2006–2019)



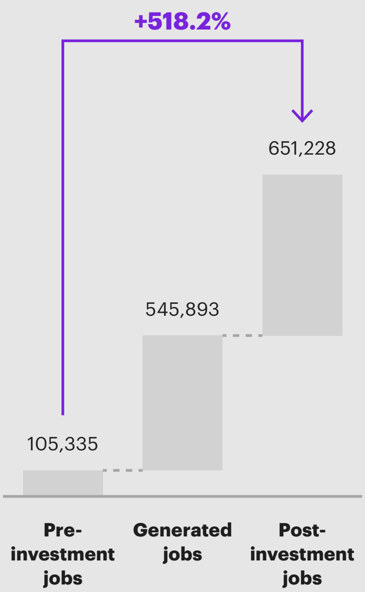

- Micro
- Small
- Medium
- Large

**Increase in revenues for SMBs supported by Fondo de Fondos**
(million Mexican pesos, 2019)

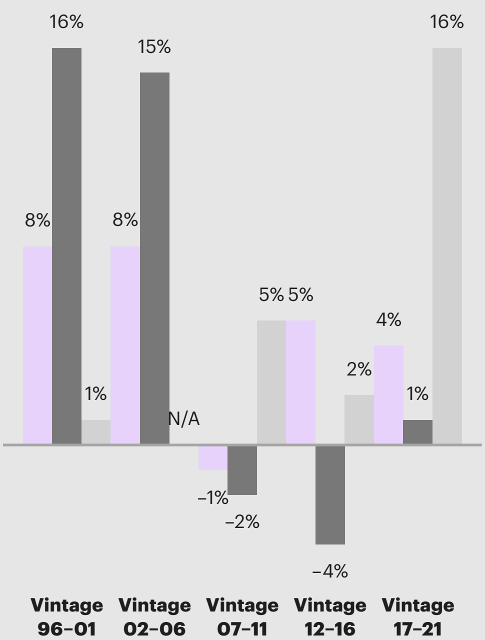
Average growth time frame: 4.8 years




**Job generation of Mexican companies supported by Fondo de Fondos**
(2006–2019)




**Fondo de Fondos' investments performance**
(IRR, December 2020)




- Fondo de Fondos
- IPC
- EEM[2]

[1] CKDs are certificados bursatiles de desarrollo or development capital certificates.
[2] IPC is Indice de Precios al Consumidor. EEM is MSCI Emerging Markets ETF.
Sources: Fondo de Fondos, AMEXCAP, Nacional Financiera, National Institute of Statistics and Geography; Kearney analysis

# Macro trends impacting PE/VC markets

## COVID-19 impact on Mexico's PE/VC markets

The pandemic has had a profound impact on global financial markets, even compared with historical economic crises such as the 2009 recession. Virtually every economy around the world declined in 2020 as a result of COVID-19, with Latin America being one of the most affected regions. Mexico in particular experienced a steep decline in economic activity, leading to high unemployment, a slowdown in commercial activity, and an overall economic slowdown (-9 percent expected GDP fall in 2020).[13] As a result, Mexico's PE/VC industry faced a complicated fundraising environment with low availability of capital sources, reduced transaction volume, and overall negative prospects for growth across sectors.

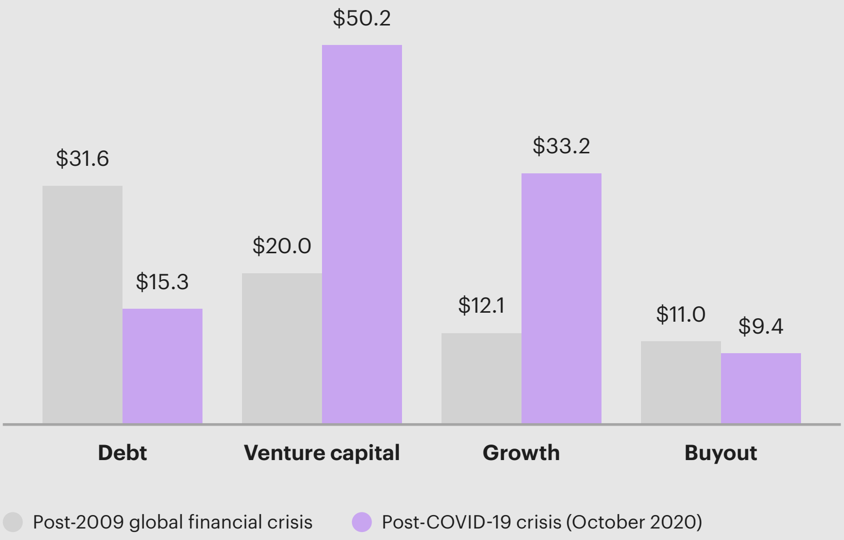
Initial expectations were for institutional investors to react similarly to the 2009 crisis aftermath: increasing their allocation in private debt vehicles, including structured debt, loans, mezzanine, and distressed funds. However, COVID-19 whet investors' appetite for asset classes and sectors in which consumer adoption was fast-tracked as a result of shelter-in-place restrictions. This time around, the market turned toward VC and growth equity funds allocating capital to sectors ranging from telecom and tech-based consumer services to banking and e-commerce. Global VC funds led fundraising among the top asset classes, with growth equity and debt following suit (see figure 6 on page 12).

The Mexican market followed this trend, with local VC deals thriving in 2020—raising more than $900 million in what will likely be a record year for the asset class. Among the largest deals, Kavak's series B ($385 million) brought Mexican start-ups under the spotlight. Within VC deals, about 50 percent of capital was allocated to series B and C, exhibiting investors' preference for more mature start-ups. Additionally, an overwhelming majority of deals—more than 80 percent—were backed by international investors, exhibiting a growing interest in the asset class from foreign capital.[14]

[13] International Monetary Fund
[14] CapitalIQ, Crunchbase

Figure 6
**Venture capital led fundraising among the top asset classes**

Fundraising for key private equity and venture capital categories following economic crises periods[1]
($ billion)




[1] Only considered funds raising more than $500 million
Sources: Capital IQ; Kearney analysis

## Road to recovery

Mexico's economic recovery along with the implementation of government policies favorable for private capital markets could foster the development and performance of the PE/VC industry. One key aspect will be the market's attractiveness for foreign investors. According to Kearney's 2020 FDI Confidence Index, Mexico fell out of the top 25 most attractive countries for foreign direct investment for the second time in the history of the Index. Concerns about economic growth prospects, political tensions, and security concerns have detracted foreign capital flows in recent years. Nevertheless, recent investments in specific sectors, such as the large VC investment rounds, and specific asset classes have raised foreign investors' confidence, generating a positive outlook for the medium term. This momentum should be capitalized on to reignite the growth of Mexico as a regional hub for PE/VC investments.

Another encouraging sign is the economic recovery of the United States. Both GDP and the stock market have shown a strong recovery with the S&P rising over 55 percent since its lowest point of 2020. Given Mexico's high dependence on its commercial relationship with the United States, a faster-than-expected recovery is a good sign for the Mexican economy.

Going forward, the industry's success will depend on market players' ability to collaborate and ensure that capital flows increase and investment opportunities attract both local and international institutional investors. A key set of actions is required to adopt alternative fundraising strategies, identify favorable asset classes and sectors for investments, and adopt best-in-class investment policies and for regulators to promote an investor-friendly PE/VC ecosystem.

# Key factors to reach Mexico's full potential in PE/VC

To identify the key factors that can ensure success in Mexico's PE/VC market, we interviewed institutional investors, fund managers, family offices, and regulators. Their opinion was unanimous: the market is at a tipping point. Although there is growth potential, overcoming the rising challenges and creating a mature, self-sustaining market will require collaboration between investors, fund managers, and regulators.

To overcome the industry's slowdown and maximize the market attractiveness for local and international investors, five industry drivers will need to be set in motion:

## Optimizing fundraising strategies

Funds in Mexico have encountered challenges to raising new capital. On a regional scale, fundraising is taking longer (in 2020, 50 percent of funds took more than 18 months to complete fundraising) and a lower number of GPs have been able to close funds (the third quarter of 2020 saw the lowest number of PE funds closed since 2015).[15] As a result, nontraditional fundraising strategies are becoming more relevant and could play a central role in enabling Mexican GPs to meet their fundraising requirements.

Five strategies can benefit Mexico's market:

**Boosting traditional capital sources.** Institutional investors play a key role in developing PE/VC investments. The recent momentum driven by international funds' interest in Mexican VC needs to be capitalized in PE as well. Regulators will need to enable pension funds and insurance companies to access investment vehicles through more cost-efficient investment structures. Fund managers will have to complete investment and divestment cycles to generate more attractive returns and showcase the potential for PE/VC in Mexico to succeed in the long term.

**Adopting debt as a financing vehicle.** Debt structures offer a high degree of autonomy and flexibility for GPs. The industry has widely adopted structures such as subscription and net asset value (NAV) financing as GPs seek to boost returns. More than 30 percent of funds globally are using subscription financing to accelerate fundraising, and NAV financing—a credit facility that collateralizes portfolio investments—has been widely used in European markets. Leading investment managers ranging from Blackstone and TPG Capital to Carlyle and KKR & Co. have increased their use of borrowed capital at the beginning of the funds' lives. Nonetheless, adoption of these structures is low in Mexico. Going forward, financial institutions in Mexico and investment managers must evaluate international best practices and adopt PE/VC debt financing instruments as an alternative fundraising strategy for short- and medium-term obligations.[16]

[15] Preqin
[16] Financial Times, Sidley, Financial Times, Cadwalader, Preqin, Institutional Investor

**Engaging with secondaries for liquidity.** PE secondary transactions provide funds with liquidity to finance new vehicles or return capital to investors. This investment structure has grown considerably in the past few years and can be beneficial to Mexican fund managers struggling with longer-than-expected divestment periods. However, secondaries' pricing relies heavily on supply and demand. In 2020, secondary global transaction volume fell to the lowest levels since 2015 in terms of deal size, resulting in a 43 percent decrease over 2019. As a result, discounts in pricing became more prevalent with the average bid price over NAV falling from 88 percent to 80 percent in the past 12 months. In Mexico, secondaries are still a nascent strategy with a handful of funds exploring deals with local GPs. Nevertheless, with highly unreliable exit options, GPs could consider engaging international secondaries and seeking flexible structures to generate more liquidity for future fundraising. For example, Enfoca in Peru participated in a $950 million secondary transaction in 2018, in which the private equity fund manager sold the underlying portfolio of three of its funds to new investors to offer liquidity to existing investors and finance future investments.[17]

**Launching perpetual or permanent capital structures.** Growing in popularity among large GPs around the world, permanent capital structures enable fund managers to reinvest returns and distributions into existing investment vehicles. Large international funds such as Apollo, BlackRock, Carlyle, TPG Capital, and KKR & Co. have adopted this structure, not only to get more independence and facilitate the fundraising process, but also to extend the life of profitable investments. For example, Apollo controls about $160 billion (around half of its total assets under management), and Blackrock controls about $100 billion (around 20 percent of its total assets under management) through perpetual capital that they can reinvest into future vehicles. The growing popularity of perpetual capital structures could attract Mexican institutional investors to explore longer-term investments in PE/VC and help GPs manage portfolio companies with less constraints related to exit strategies in the short term.

**Incentivizing investments from new investor pools.** PE/VC in Mexico has yet to attract a steady capital inflow from investor pools, including mutual funds and family offices. The ongoing efforts from both the PE/VC association AMEXCAP and GPs to develop stronger relationships with these nontraditional investor pools should evaluate optimal legal structures to make the asset class more enticing for these investor pools.

[17] Greenhill Associates, Preqin, EMPEA, LAVCA

## Identifying the most attractive PE/VC asset classes

After interviewing the key market players, we believe the most sought-after asset classes in Mexico in the next 12 to 18 months will be venture capital, debt structures, and co-investments. Larger institutional investors such as pension funds and insurance companies are seeking fixed income and cash-flow stability to meet their liabilities with a reduced risk profile from investment valuations. As a result, they will prioritize debt-driven vehicles such as structured credit and mezzanine over traditional buyouts. Additionally, market players with more flexible portfolio strategies such as family offices will increase their allocation toward co-investments and VC as they seek attractive opportunities in high-growth sectors and increasing levels of decision-making and strategy inherence.

## Allocating investments to the top-performing PE/VC sectors

Even with the negative impacts of COVID-19, Mexico's PE/VC market still offers attractive sector-level investment opportunities. Kearney's proprietary methodology evaluates the most attractive sectors for investment based on research of key economic factors, scenario analysis with Kearney's Global Business Policy Council, interviews with key industry players, and an evaluation of potential PE/VC fund managers seeking to allocate capital in the coming years.

Our methodology indicates that the most attractive sectors in Mexico for PE/VC investors will be telecom, financial services, retail commerce, manufacturing, and logistics. The key drivers for these results are the acceleration of demand for consumer services and digital technologies as a result of COVID-19 that will greatly benefit VC in Mexico and the expected growth for manufacturing and logistics industries following the United States–Mexico–Canada Trade Agreement. Additionally, local and foreign institutional investors and fund managers expect these sectors to concentrate most of their investment pipeline in the upcoming 12 to 18 months, exemplifying great potential for these sectors to succeed.

## Adopting environmental, sustainable, and governance policies

PE/VC players around the world have adopted environmental, sustainable, and governance (ESG) criteria with the goal of fostering environmentally and socially conscious companies by streamlining investment capital. The topic has become more relevant in Mexico as the AFORES have set the goal to only invest in ESG-approved vehicles beginning in 2023.

However, the successful implementation of ESG policies is a complex process for fund managers. So far, 703 PE funds are registered to the United Nations Principles for Responsible Investment network of investors, out of which only 2 percent accurately report the impact of ESG practices on their portfolio according to specified guidelines. There are several obstacles to adoption, such as complexities in monitoring and reporting results as well as operating costs. It is estimated that ESG implementation can represent about 2 percent of fund managers' operating costs.[18] Mexican fund managers are encouraged to initiate the implementation process as soon as possible considering that this is a long-term commitment with several steps along the way. Mexico's PE/VC industry needs to make a collaborative effort to ensure that ESG best practices are successfully implemented and monitored. Fund managers will need to implement ESG throughout the investment process—from due diligence through decision-making, agreements, and monitoring—to ensure that Mexico is at the forefront of this key industry development.

## Highlighting regulators' role in PE/VC market growth

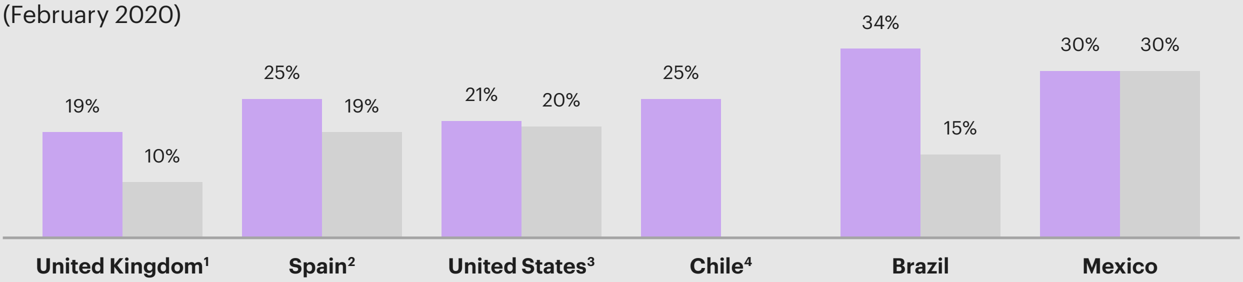
Active collaboration between regulators, fund managers, and institutional investors is necessary to ensure that Mexico's PE/VC regulatory landscape enables long-term sustained growth. In terms of taxation and fiscal policies, Mexico still has room for growth compared with regional peers and international best practices. For example, Brazil has tax benefits for international PE/VC investors, including favorable capital gains tax rates. Chile's regulator enabled funds to establish tax-favorable local vehicles to attract direct investments from pension funds in PE/VC. Developed markets such as the United States and the United Kingdom have long offered tax benefits for investments in SMEs to boost entrepreneurial development (see figure 7 on page 16). Mexico has started to take positive steps on this topic by reducing IPO exit taxes from 30 percent to 10 percent in 2019, but with low IPO activity, the impact has been immaterial to say the least. However, recent fiscal and tax regulations such as the Profit Taxing Law (articles 4-A and 225) have brought additional challenges to the local market as it will have a potential impact on the participation of foreign investors.

[18] UN PRI, Institutional Investor, Moody's

Figure 7

**Several developed markets offer tax benefits for investing in small and medium-size businesses**

Examples of tax regulations in developed private equity and venture capital markets
(February 2020)




**United Kingdom[1]:** The Enterprise Investment Scheme allows for a 30% tax exemption for small and medium-size enterprises if these are kept for more than three years. It also allows for loss compensation via profit tax exemptions if there are no capital gains.

**United States[3]:** In 2017, the corporate tax was reduced from 35% to 21%. In 2010, the Small Business Jobs Act exempted capital gains taxes for venture capital and small businesses investments longer than five years.

**Brazil:** There are benefits for foreign investors such as capital gains taxes exemptions.

**Mexico:** Initial public offering corporate taxes were reduced to 10% for 2019, 2020, and 2021. Distributions are taxed even if reinvested. There are no portfolio tax benefits; holdings are taxed on an individual basis.

● Corporate tax ● Capital gains tax

1 The capital gains tax can have a variation of up to 20%, according to tax bands.

2 Fixed surplus tax of 19% for European residents and 24% for foreigners

3 The corporate tax can show a variation of 0% to 12% depending on the state.

4 The corporate tax can show a variation of up to 27%, according to tax bands; the surplus tax is 0% for residents and 10% for foreigners.

Sources: Latin American Venture Capital Association, Latham & Watkins, Thomson Reuters, Jacques Delors Institut–Berlin, Private Equity Review, Mondaq, KPMG, Santander; Kearney analysis

On the regulatory side, the restriction for AFORES to directly invest in the PE/VC market has kept a large potential investment volume from reaching the industry. CKDs and CERPIs have helped bridge this gap, but additional regulation changes would be beneficial. For example, creating limited partnerships to reduce the management workload of specialized retirement fund investment companies, allowing for direct PE/VC market investments, and reducing the corporate governance requirement for investors would help reduce the operational costs associated with private market investments. Additionally, adopting taxation best practices for PE/VC portfolios versus single investments would increase overall returns.

In sum, Mexico has the potential to develop a strong investment ecosystem and become a successful PE/VC market. In the past five years, growth has decelerated, and market conditions have pushed the industry to a tipping point. Going forward, every player in the ecosystem must take decisive actions to help the industry overcome an array of escalating challenges, such as limited capital sources, adverse regulatory policies, and overall low collaboration among key stakeholders. For the next several years, Fondo de Fondos will still be an active player in the market by incentivizing and channeling investments with the goal of closing its cycle once they have helped to create a mature and independent market. Finally, regulators will have a key role in the development of the industry as policies such as tax transparency deeply affect the dynamics of the market. The actions taken over the next few years will determine the long-term success—and perhaps the very existence—of Mexico's PE/VC market.

# Authors

**Ricardo Haneine**
Partner, Mexico City
ricardo.haneine@kearney.com

**Dragan Zdravkovic**
Consultant, Mexico City
dragan.zdravkovic@kearney.com

**Felipe Vilá**
CEO, Fondo de Fondos
fvila@fondodefondos.com

## About Fondo de Fondos

Fund of Funds is a specialized investment firm. Since its establishment in 2006, Fund of Funds has promoted productive investment in Mexico and Latin America to catalyze the development and competitiveness of SMEs and the energy and infrastructure sectors. Fund of Funds has implemented a strategic plan to invest and develop private equity, venture capital, energy, and infrastructure, and impact investing funds. As an alternative asset manager, Fund of Funds manages third-party resources with best international practices, creating unique databases in the industry and selecting experts with a solid reputation and proven careers. Currently, it manages investment commitments in funds for nearly one billion dollars, and third-party resources that have decided to rely on the team's experience for another one billion dollars.

**fondodefondos.com.mx**

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