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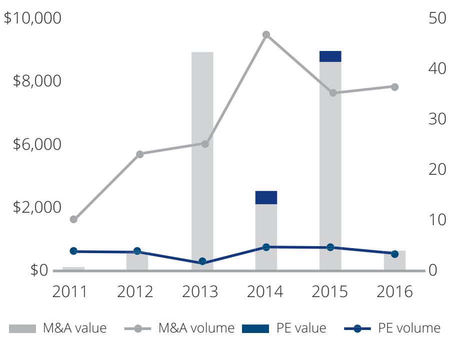
Mexico Mergers and Acquisitions

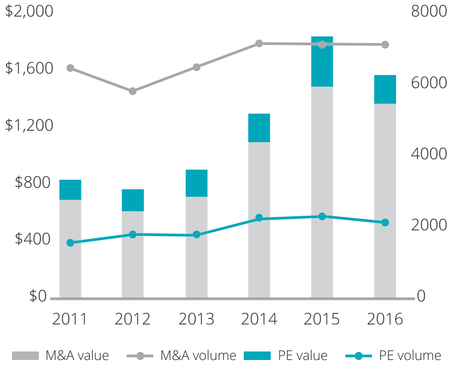
What's ahead: The potential impact of the new US administration

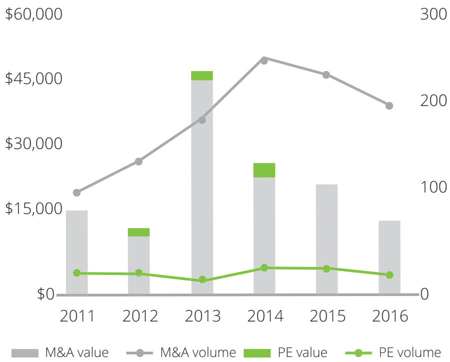
Amid daily headlines speculating on the overhaul of the North American Free Trade Agreement (NAFTA), it's easy to overlook the fact that Mexico is one of the United States main trading partners—and that the relationship goes both ways. According to the many recent statistics from the US Census Bureau, the two countries exchanged approximately $525 billion in goods in 2016, with a trade imbalance of about $63 billion, or 12%[1].

These strong trade connections make Mexico a natural destination for US companies and investors looking to invest abroad. In fact, the US has been one of the top foreign acquirers in Mexico, accounting for about 16% of all M&A transactions in the past five years.



As the US M&A market has flourished, however, Mexico's has been less predictable, with declines in both value and volume over the past three years.





This choppiness is due in part to some exceptionally large transactions in certain years, such as a large US telecommunications company acquisition of two Mexican telecommunications companies for a combined value of about US$4 billion in 2015[2]. Uncertainty around intended industry reforms in Mexico have also contributed to the declines.

Now, as US President Donald J. Trump initiates a new and more domestically-oriented trade stance, many questions are emerging about the potential impact on trade and M&A with Mexico.

The most obvious concern is that President Trump's intent to renegotiate (or even abolish) NAFTA could further chill Mexican M&A in sectors that are vulnerable to higher tariffs; namely manufacturing and agriculture. Conversely, other sectors in Mexico—including energy, telecommunications, and financial services—are unlikely to see immediate impacts from the forecasted changes in the US. Some sectors may even see a more robust appetite for deals from US companies that find new domestic policies more favorable to their businesses.

In the background lurks another factor that could sway interest in Mexico: the volatility of the peso. Since 2015, the peso has generally declined against the dollar, but with many peaks and valleys along the way[3]. As a result, private investment funds, banks and companies that have capital in dollars will likely want to take a closer look at Mexico, thanks to the stronger currency position they are in. Likewise, Mexican companies that operate in pesos but carry debt in dollars may be more willing to collaborate or even divest assets in order to reduce financial leverage.

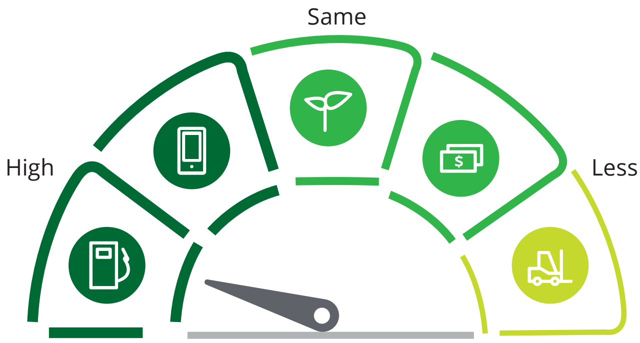
Add to these factors the expected election of a new Mexican president in 2018, and uncertainty is about the only thing that's clear. Historically, however, many M&A transactions have been spurred by changes in regulations, structural reforms and the introduction of new technologies. Given the rich landscape of potential upheavals, we look at the opportunities and challenges that may arise for M&A transactions in each of Mexico's largest sectors.

Graphs Source: Transactional Track Record—Mexico Transactions Index 2011–2016—https://www.ttrecord.com/en/. Includes all reported mergers and acquisitions, venture capital and private equity transactions carried out by local or foreign entities in Mexico or by Mexican investors abroad. Approximately half of these transactions do not disclose values.

M&A opportunities and challenges in Mexico's largest sectors

The industries in Mexico that are likely to be most affected were selected based on two principal factors: our assessment of the policies that the new US administration may adopt, and the structural reforms that have already been enacted in Mexico.

Each sector throughout the report has been given a color coded rating on a scale of either high, same or less that reflects our perspective on the number of M&A transactions by sector. Consideration has been given whether these will be greater, equal or lower than those made in 2016.



Energy

Mexico's recent reforms in the energy sector have made it easier for foreign investors to enter. Despite external challenges such as falling oil prices, 2016 saw some movement in the number of deals. Six of the seven transactions in 2016 were made by foreign acquirers, including Australia's BHP and China's CNOOC.

These conditions are unlikely to be affected by US trade negotiations in the near term. Mexican reforms will continue to unfold this year, with the fourth Ronda Uno tenders, investment projects in infrastructure, distribution and logistics centers, the release of fuels and the latest tenders in the drilling and oil exploration process. More assets are also likely to come to market, thanks to government reforms and financial pressures on local producers like Pemex. With a strong dollar leading to more expensive debt and less revenue from the sale of oil, local oil companies may try to sell more properties or create strategic partnerships to focus on improving productivity.

To the extent that oil prices keep rising and investors choose to buy the energy assets that are emerging, the energy industry stands to receive between US$5 billion and US$7 billion in investment beginning in 2017 and 2018[4]. The majority of big players like BP, Shell, Exxon, Trafigura, Gulf, Transcanada have shown interest in entering the market on different levels of the supply chain. A number are already partnering with Mexican companies to participate in these tenders, such as ExxonMobil pairing with Total E & P Mexico and Sierra Offshore with PC Carigali Mexico.

At the same time, the new Trump administration may positively impact the North American energy industry. Trump has expressed a desire to encourage the hydrocarbon industry and strengthen production related to fossil fuels, putting them above the interests of renewable energies. The US president has also proposed facilitating the construction of infrastructure, especially in the area of transportation and distribution, and deregulating the industry to boost its economic recovery.

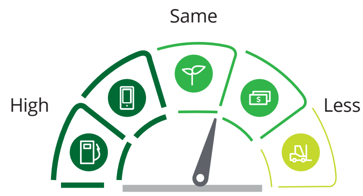
With a stronger US energy industry, rising US dollar, increased Mexican asset supply and robust global appetite for M&A in the energy sector, investment and M&A transactions in Mexico's energy companies by US firms could well increase in 2017 and beyond.

Technology, Media and Telecommunications

Mexico has only recently begun opening its doors to foreign capital in the telecommunications sector. The introduction of industry reforms in 2013 eliminated some of the major barriers to entry, including a 49% foreign direct investment limit and some of the monopolistic practices that local player America Movil enjoyed. As a result, nearly 50% of M&A transactions in 2016 involved a US private equity company or fund. Large companies also participated; with a major US-based multinational telecommunication firm buying two in Mexico for approximately $4 billion in 2015.[5]

Since NAFTA does not currently include the telecommunications sector, a new trade agreement is unlikely to affect investment and M&A interest in this sector in the near term.

Longer term, however, there may be a spillover effect in which changes to NAFTA drive renegotiations in other industries, possibly to help replace business that could be lost in manufacturing. The industry is already expanding to some degree, as six new cable providers (known as MVNOs)including Buenocell, Inaecom, Neus Mobile, Quickly Phone and Maxcom are expected to start operations using the Telcel network owned by America Movil within the next several years.



Agriculture

As a major producer and exporter of avocados, green peppers and tomatoes, Mexico has a strong agricultural sector. Agriculture accounted for approximately 3% of its national GDP last year, and is expected to yield steady growth of about 3% per year between 2010 and 2020. Exports of organic produce have been exceptionally robust, with that category averaging a 9% growth rate since 2010[6].

Similar to the manufacturing sector, the US is currently one of Mexico's top buyers of agricultural products, accounting for 70% of all exports in this industry. The relationship goes both ways, as Mexico is also a major importer of US-produced food. Last year, 88% of Mexico's agricultural imports came from the US[7].

With the possibility of NAFTA renegotiations introducing new tariffs, a number of changes could occur in agriculture. Most immediately, tariffs may encourage the country to boost its domestic production to meet its growing demand locally, and also find new trading partners where imports are required.

As far as export partners, Mexico is already in the process of creating a bilateral trade agreement with the European Union (EU) to cover organic produce. The EU accounts for more than 40% of global organic produce consumption market, closely trailing the US at 43%. Mexico may well benefit from the NAFTA renegotiations by expanding the reach of its dynamic agricultural sector.

As broad as the agricultural sector is, since 2008, just a few deals have closed for a total valuation of US$829 million. Among the most significant deals in recent years include the acquisitions of sugar mills from the government and Mexico-based Bachoco acquiring the US-based Morris Hatchery poultry farm assets[8]. Bunge North America's efforts to acquire Mexico-based Minsa is underway, yet the deal has faced a number of disruptions[9].

NAFTA re-negotiations are not likely to have an immediate impact on M&A in the Mexican agricultural industry, but as Mexico pursues new commercial partners, new alliances could also benefit M&A activity.

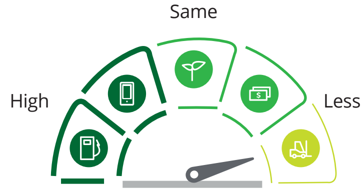
Financial Services & Insurance

Last year, Mexico's financial and insurance sector was one of the hottest for M&A activity, surpassed only by real estate in number of transactions. Major international banks such as HSBC, Santander and BBVA have helped fuel this movement, with many wanting to continue to expand their global presence by investing in Mexico. Also, the arrival of new technologies has generated major changes in the financial and insurance industry, from finding new ways to secure data to better ways of providing customer service. This has also boosted banks´ aspirations to invest and seek other companies, especially those in the fintech sector, whose technological capabilities may help them improve their performance.

Changes in the US are unlikely to impede the momentum in this sector. In fact, since the election of President Trump, US bank stocks have risen to historic levels, close to those before 2007[10]. Several factors have generated positive expectations for the US financial sector, including the appointment of some former members of Wall Street firms to the President´s economic cabinet, Trump's efforts to deregulate the industry with changes to the Dodd-Frank, and rising interest rates that benefit lenders.

If the Trump administration is able to decrease regulation in the US financial sector, it is likely we will see more mergers and acquisitions, as banks may have more cash reserves to spend and their costs of doing business could decline. With a globalized economy, we expect this will affect Mexico as well as other regions.

As a result, we expect the Mexican financial sector will continue to be a major source of M&A activity in Mexico.



Manufacturing

Manufacturing is a cornerstone of the Mexican economy. In the last five years, the sector has seen strong growth, expanding at a compound annual rate of nearly 7% between 2010 and 2015.[11] This growth has been driven by two factors: NAFTA and the entry of a large number of multinational companies that have set up operations in Mexico. In fact, manufactured goods represent the vast majority of Mexico's exports, and 80% of them are destined for the US in any given year[12].

Given the heavy dependence on US buyers, manufacturing is the sector that will be most immediately vulnerable under a NAFTA renegotiation. In general, the US could raise import tariffs to protect its domestic production. If enacted, higher import tariffs may likely inflate the prices of Mexican products in the US, putting Mexican goods at a competitive disadvantage.

New policies could also affect the number of multinationals establishing operations in Mexico. Should policies that prioritize US domestic concerns be implemented, Mexican exports could fall significantly to the detriment of many export-dependent firms, and motivate others to withdraw their investments. In a worst-case scenario, manufacturers could move many of their production processes to the US to avoid high tariffs.

However, it's important to remember that the US is not Mexico's only trading partner. Mexico has commercial agreements with 44 countries and an advantageous geographical position with access to the main markets of the world. If Mexico can ramp up these agreements effectively over the long-term, foreign companies, including the United States, should continue to consider it an attractive option for investment.

Conclusion

While it is too early to precisely estimate the impact of the new US administration—or a revised NAFTA—on M&A opportunities in Mexico, it's clear that major changes may lie ahead. With those changes, and throughout the uncertainty that precedes them, may come high-quality opportunities for savvy investors to enter Mexico in new ways.

Conditions are ripe on both sides for renewed interest in Mexican M&A. In the US, President Trump's agenda could fuel a greater appetite for M&A in a number of sectors, thanks to business regulations that are slated to be more favorable to industry. In Mexico, an expected election next year creates uncertainty, and the potential for high tariffs could damage the manufacturing sector. However, with many other sectors opening up to global investors in new ways thanks to recent reforms, there are likely to be many novel ways for outsiders to enter the Mexican economy.

While fluctuating conditions will almost inevitably entail some losses, it's important to look for the opportunities they create. Considering the longstanding and productive trading relationship that Mexico and the US maintain, we expect that US companies will continue to find reasons to invest in and engage with the region, even if the sector mix of that investment ultimately undergoes significant shifts.

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End notes

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