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Mexico Mergers and Acquisitions Outlook 2017

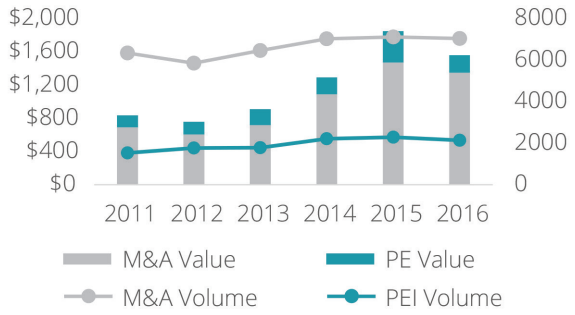
Will M&A transactions increase or decrease in the Mexican market given a new American administration?

Content

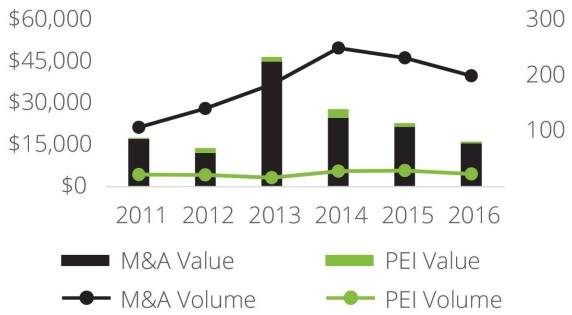
What is the relationship between Mexico and the United States in terms of M&A issues?

Mexico is the United States' main trading partner. However, growth in M&A[1] in the US has not been necessarily reflected in Mexico. In the last three years, the value of M&A activity in the United States has increased by 21% with a stable volume of transactions. On the other hand, Mexico has experienced decreases in both volume and value of M&A activity by 22% and 46%[2] respectively.

US (US Billions)[3,4]



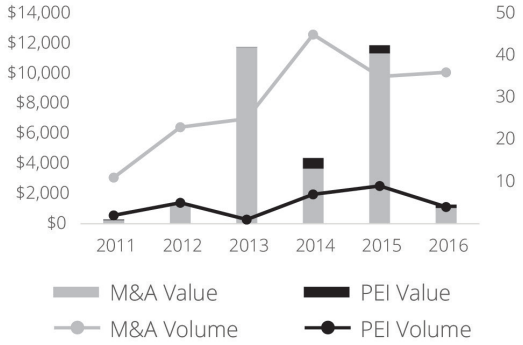
Mexico (US Millions)[2,3,4]



In the last 5 years, the volume of Inbound transactions of North American companies in Mexico has represented an average of 16% of the total transactions. In 2016, there was a very significant reduction in the reported value of North American transactions in Mexico.

Historically, many of the transactions in M&A activity have been derived from changes in regulations, structural reforms and introduction of new technologies. Given this fact, the possibility of regulatory changes in the United States coupled with structural reforms in Mexico can open up opportunities and challenges in various sectors. We believe that the energy, telecommunications, manufacturing and financial services will be most affected.

M&A Transactions from USA in Mexico (USD Millions) [2,5]



Enrique Peña Nieto - President of Mexico and Donald J. Trump - President of the United States will eventually have to meet to lay the groundwork for the negotiation of NAFTA. We have decided to analyze this impact on the M&A sector in Mexico by analyzing not only trade policy, but also monetary and fiscal policy as tools that the United States can use to seek greater generation of employment and economic growth.

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1 Mergers and Acquisitions will be henceforth referred to as M&A
2 The value of approximately 50% of transactions in Mexico are not reported so this value was not included
3 For all years the figures include data from January 1 to November 30
4 M&A: Mergers and Acquisitions. PEI: Private Equity Investment for its abbreviations in English
5 Inbound: Cash flow from a foreign country to Mexico. Outbound: Cash flow from Mexico to a foreign country. Domestic: cash flow between companies in national territory

New Administration Policies

Since his presidential campaign and now in office, Donald J. Trump has highlighted, among other things: (1) the importance of the role of manufacturing in the process of income generation and economic growth, (2) fiscal and regulatory frameworks that help investments transferred from the US and (3) poor trade negotiations that inhibit foreign direct investment in the US.

Under this framework we will analyze monetary, fiscal and commercial policies as tools that the current administration has at its disposal to influence the economic behavior of the country.

Monetary

Monetary policy has been the pillar used by the Federal Reserve in order to boost the economy in recent years. However, after almost seven years of interest rates between 0.00% and 0.25%, inflation approaching the Fed's target of 2.00% and unemployment close to full employment, monetary policy is insufficient as a tool for accelerating economic growth. In December 2016, there was an increase of 25 base points of interest rates. The executive members of the Fed predict that in 2017, there will be three increases of 25 base points that can bring the interest rate between 1.50% and 1.75%[6]. However, in spite of the increase in interest rates, these will remain at historically low levels, allowing companies to continue to acquire cheap loans.

Although the intention of the US president's monetary policy has not been clear, it should be noted that he will be able to appoint two of the seven members of the Fed's board this year, however, it will only be until 2018 when the Yanet Yellen´s period ends. The president can only really impact the Federal Reserve by appointing the representative leader of the institution.

Fiscal

In fiscal matters, Trump has promised to modify the current policy on two major fronts: the tax code and government investment. The first point revolves around the reduction of taxes, since the new administration has proposed to reduce corporate taxes from 35% to 15%, trying to encourage investment to accelerate economic recovery and thus reduce tax evasion. In addition, it will seek to reduce the cost of repatriation of income to 10%. Both initiatives will increase cash flows so companies can increase investment in organic and inorganic growth.

This policy will add competitiveness to the business sector in the United States so its impact must be evaluated in Mexico in order to take the necessary measures and maintain investments in our country.

6 Torry, Harriet. "Fed Raises Rates for First Time in 2016, Anticipates 3 Increases in 2017" Wall Street Journal. N.p., 15 Dec. 2016. Website. 20 Dec 2016.

The second point is focused on increasing, together with private initiative, investment in infrastructure in order to modernize it, hoping to generate jobs and boost investment. However, with lower tax revenues the government may have to issue debt to generate resources, which could bring the national debt to 86% of GDP in a decade, 11% more than it is today[7]. In addition, the new administration will have the challenge of obtaining the support of the congress to approve such a drastic fiscal expenditure.

Commercial

The new administration intends to implement a protectionist trade policy that seeks to review and establish better trade conditions with low-cost labor countries such as China and Mexico, specifically the NAFTA and TTP agreements.

The new administration seeks to renegotiate or abandon in its entirety the North American Free Trade Agreement (NAFTA) which is critical for the national export sector, even more so when 80% of Mexico's exports are directed to the US market[8].

It is unlikely that 35% tariffs could be implemented, as Trump has proposed, as these would violate the rules of the World Trade Organization (WTO). The WTO has set a ceiling on goods export tariffs of around 3% or 4% so that the United States would have to either move away from the WTO or renegotiate its terms[9]. Similarly, Mexico could also increase import tariffs jeopardizing the United States, since Mexico is the second most important market for American exports.

On the other hand, the new administration announced, on January 23, its withdrawal of the United States from the Trans-Pacific Partnership (TPP). This could either terminate the agreement or force significant changes in the agreement between the remaining countries.

As a result of the exit from the US, it would be important to analyze how much Mexico benefits from this treaty because of the existence of other trade agreements. There may be an opportunity for bilateral agreements and reinforcing Mexico´s presence in regions of Latin America, Europe and the Middle East.

Changes in NAFTA terms can open up opportunities in sectors that are not currently included in the treaties. As has happened previously, companies will seek to take advantage of such opportunities with foreign direct investment or penetrating the Mexican market, such as telecommunications and biotechnology, e-commerce and energy.

7 Timiraos, Nick. "Donald Trump Would Boost Debt More Than Hillary Clinton" Wall Street Journal. N.p., 26 Sep. 2016. Web. 28 Dec 2016.
8 "Relación México – Estados Unidos". Webpage of the Presidencial Office Mexico 30 Dec 2016.
9 Gazcón, Felipe. "Si Trump cancela TLCAN habrá crisis en su país y esto lo demuestra". Dinero en Imagen. N.p., 21 Nov. 2016. Web 19 Dec. 2016.

Mexico Mergers and Acquisitions Outlook 2017

Overview of M&A by Sector in Mexico

Industries expected to be most impacted were identified based on two principal factors: the analysis of the policies which may be adopted by the new US administration and the structural reforms approved in Mexico. For each of these industries, an analysis was conducted to identify: the outlook by sector for 2017 and also the impact that could result in terms of increased mergers and acquisitions in Mexico.

The image refers to our perspective on the number of M&A transactions by sector, considering whether these will be greater, equal or lower than those made in 2016.

Manufacturing

The US president has promised to renegotiate NAFTA. The US is expected to negotiate terms that protect domestic production, a fact that is relevant if we consider that 80% of Mexican exports are destined to the United States.[10] This is commonly achieved by raising import tariffs which in turn would inflate prices of Mexican products. During his campaign he mentioned the importance of producing in the United States and generating jobs, especially in the automotive sector which is intended to support the big Detroit manufacturers.

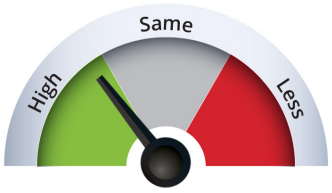
The Mexican manufacturing sector grew at a compound annual growth of 6.7% between 2010 and 2015. 90% of the exports made by the country were from this sector[11]. This growth has been driven by two factors. First, exports and imports to the United States favored by the signing of NAFTA in 1994 and, secondly, the entry of a large number of multinational companies.

However, the low cost of production is not the only factor for which multinationals decide to invest in Mexico. Our country has commercial agreements with 44 countries and a geographical position with access to the main markets of the world. As a result, foreign companies, including the United States, will continue to consider Mexico as an option for investment.

The magnitude of the impact on the economy generated by changes in NAFTA remains to be defined, but the US president's stance in negotiating more favorable terms for the US is evident. Should policies be implemented, exports could fall significantly to the detriment of many export-dependent firms, and motivate others to withdraw their investments and even move all of their output to the US to avoid high tariffs. In the manufacturing sector, it is still uncertain what impact the new administration can bring in strategies of entry and association of companies or separation of assets, until the true scope of trade policy is known.

10 "Mexico - United States relationship ". Mexican Presidency Website. 30 Dec 2016.
11 Inegi. Summary of the merchandise trade balance of Mexico (opportune figures).

Energy



The arrival of the new administration will positively impact the North American energy industry as it wishes to encourage the hydrocarbon industry and strengthen production related to fossil fuels, putting them above the interests of renewable energies. The US president has proposed facilitating the construction of infrastructure, especially in the area of transportation and distribution, and deregulate the industry to boost its economic recovery.

In Mexico there will also be very relevant movements in the industry as a result of: 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. All of these factors will encourage investment and movement in the Mexican market.

Mexico has become an investment focus for the United States, for local private companies and other countries that perceive the Energy Reform as a great opportunity to position themselves in the Mexican market. Starting in 2017 and 2018, it is expected that the energy industry will receive between $5 and $7 USD billion in investment. 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[12]. It is true that deregulation will make the United States more attractive for investment but at the same time, it will face more aggressive competition.

New investments, which generate mergers or acquisitions, may come from foreign companies as recently happened with the Australian firm BHP and China's CNOOC. Although the boom expected from the energy reform did not meet expectations in 2016, the first movements of mergers and acquisitions were seen in that same year. Seven out of the six transactions made were by foreign companies.

With a strong dollar leading to more expensive debt and less revenue from the sale of oil, it is possible for Pemex to try dispose of certain assets or create strategic partnerships in some of its lines of business to focus on improving its productivity. This may lead to more asset separation opportunities.

Consequently, because of the need for PEMEX and CFE to dispose of assets and business lines, domestic mergers and acquisitions are expected. If to the above scenario the following are added: the appreciation of the dollar versus the peso, the support manifested by the new US administration to the oil and gas sector (which can boost the industry in that country), and the potential increased investment in Mexico, a promising panorama for this sector, in 2017 is expected. Additionally, it is projected that globally 74% of the energy industry is considering a M&A operation this year.

12 Lilia, González. "Logística Energética Traerá Más Inversiones". El Economista. N.p., 20 Dec. 2016. Website. 26 Dec 2016

Technology, Media and Telecommunications

Despite the free trade agreement, it was only until the telecommunications reform that companies like AT&T and Virgin Mobile were able to penetrate the Mexican market with greater force. The treaty did not include major subsectors such as telephone which could, in fact, benefit from a new trade agreement. In 2017, a renegotiation of the NAFTA is expected. This represents an opportunity for the telephone segment to be included and improved. A favorable renegotiation coupled with telecommunications reform could further open the doors for foreign companies, mainly from the United States, to invest in Mexico. In 2016, nearly 50% of mergers and acquisitions transactions which were undertaken in this sector, were made by a US private equity company or funds[13].

48%

of the inbound - outbound transactions were with USA

The introduction of the telecommunications reform in 2013, eliminated, among other things, the 49% foreign direct investment limit, forced América Móvil to open its infrastructure and competition was encouraged. Since that time the arrival of new players in this sector has been observed. For example, AT&T bought Iusacell at a price of $ 2.5 USD Billion.

In the next few years, six new MVNOs[14] including Buenocell, Inaecom, Neus Mobile, Quickly Phone and Maxcom are expected to start operations using the Telcel network owned by America Movil.

Internet of Things

Sigfox ha anunciado el despliegue de su red IoT[15] en asociación con IoTNet México

"As the IoT market matures beyond its basic use in public and logistics services, we expect Sigfox to forge more partnerships." BMI

New companies grow in relevance

35% of transactions recorded in 2016 involved Start Ups vs. 15% in 2015.

13 Transactional Track Record.
14 MVNO: Mobile Virtual Network Operator
15 Internet of Things

Financial Services and Insurance

The US financial sector had the slowest start among the various S&P 500 industries at the beginning of 2016; However, since the election of the US president, bank stocks have risen to historic levels close to those before 2007. Several factors have generated positive expectations for the US financial sector. Such factors include: the assignment of some former members of Wall Street firms to the President´s economic cabinet whose intention is to deregulate the industry with changes to the Dodd-Frank, rising interest rates that benefit lenders and the prospects for economic growth.

On the other hand, there was much M&A activity in 2016 in the Mexican financial and insurance sector. In fact, it was the second largest industry in number of operations only surpassed by the real estate sector in that same year. Solid performance strengthened by investor confidence from major banks such as HSBC, Santander and BBVA have fueled this movement in the industry. Also, the arrival of new technologies have generated major changes in the financial and insurance industry, with complex and redundant processes; the inclusion of new technologies to improve customer service and internal processes have become critical. This has also boosted banks´ aspirations to invest and seek other companies whose technological capabilities may help them improve their performance and customer attraction.

As a result of these regulatory changes in the United States, it is possible to see more mergers and acquisitions. Banks will have more cash reserves and will benefit from increased deregulation, and with such a globalized economy, this may impact the entire region. Additionally, there are banks with a global presence that intend to continue their investments in Mexico. Meanwhile there are others which have been divesting in different locations. Such are the cases of Citibank and HSBC in Latin America, this can generate both investments and divestments in national territory.

Likewise, with the arrival of new technologies to the financial and insurance industry, it is possible to see investments in technology companies that can generate competitive advantages. Such is the case of the Fintechs that represent a potential market for acquisitions in the country. If to all of the above, we add the fact that the Fed has announced the rise to the reference rate, forcing a potential increase in rates by Banxico[16], banks will be benefited. Hence, the Mexican financial sector can continue to be a major engine in terms of mergers and acquisitions.

16 Central Bank of Mexico

Conclusions

M&A transactions in Mexico, both in value and volume, have declined over the last 4 years. The United States ranks first for M&A investments in Mexico with an estimated 16% of total transactions. Any significant change in the neighboring country will be relevant as far as estimating impact on our market is concerned.

In a survey conducted by Deloitte , where 1, 000 executives were asked about their outlook towards 2017, 75% of them expect the number of transactions to increase and 64% expect the value of the transactions will be higher. In general, there is still a lot of uncertainty in Mexico. However, it is possible to analyze an estimated impact by sectors.

With the political and economic changes expected to take place in 2017, the sectors that are most likely to benefit in M&A are the energy and telecommunications sectors. Since the arrival of the reforms in Mexico, these sectors have been opened, have experienced an increase in competition and have even seen the arrival of the first investments. Telecommunications is a sector that has not been covered under the NAFTA and US companies have shown their interest to increase their presence in the Mexican market. Therefore, it could be one of the sectors to be renegotiated in the trade agreement.

In the banking sector, there is a significant M&A opportunity. This is due to the possible deregulation in the US financial sector, the rise in the interest rate announced by the Fed and the adoption of new technologies. What will be the impact on remittances? Will there be any changes in the market to favor the repatriation of dividends? In addition, there have been many divestitures in the financial sector, this trend may continue so that companies may focus on activities of greater value.

It is the manufacturing sector which faces a possible increase in import tariffs as a measure to protect the US domestic market. If this occurs, it will cause a loss of competitiveness and it will be difficult to maintain the levels of investment and growth was achieved in the last four years. This will in turn impact transactions of M&A.

Depreciation of the peso is another factor that we consider important for the M&A market. Private investment funds, banks and companies which have capital in dollars will become more competitive. Likewise, depreciation of the peso puts pressure on companies whose functional currency is the peso but have debt in dollars. These companies may be forced to seek financial partners or divest in order to reduce financial leverage.

It is too early to be able to accurately estimate the impact of the new US administration on the Mexican M&A market, but we expect major changes and this will definitely generate opportunities.

Opportunities in the financial, energy and telecommunications sectors may be presented for both acquisitions and divestitures. How large the impact will be on these and other industries can only be evaluated once the plan and all the immediate actions of the US president together with the responses by Mexican administration to those plans are made known.

For all of the above reasons, 2017 will be a year of challenges for Mexico. This is due to the fact that a percentage of the country´s economic growth will depend on the policy adopted by the new US administration. However, the opportunities must be taken advantage of. Although uncertainty remains an important factor with the change of the federal administration in the US, Mexico is still one of its main trading partners and we believe that it would be difficult to change this situation.

Methodology

The data shown in this analysis includes all transactions recorded as completed in Transactional Track Record (TTR) in the period from 01/01/2011 to 11/30/2016 for transactions made in Mexico.

If transactions recorded as completed do not report value, they were included in the analysis. Approximately ~ 50% of total transactions reported the monetary value.

The completed transactions refer to mergers and acquisitions, venture capital and private equity transactions carried out by local or foreign entities in Mexico or by Mexican investors abroad.

Thomson Reuters was used as a source for US data. The information presented considers transactions completed between 01/01/2011 to 11/30/2016 involving US companies.

Contacts

Salvador Hernández
Lead Partner M&A - Consulting
shernandez@deloittemx.com

Guillermo Olguín
Lead Partner M&A - Advisory
golguin@deloittemx.com

www.deloitte.com/mx

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