COUNTRY COMPARATIVE GUIDES 2024

The Legal 500 Country Comparative Guides

Mexico

PRIVATE EQUITY

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

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

According to Transactional Track Record ("TTR"), out of the 428 transactions that were made public over the past 24 months, 275 had a financial sponsor as buyer or seller, representing 64.25 % of the overall transactions.

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

The main difference rests on the nature of the transaction. Financial sponsors generally seek clean and unencumbered exits from their investment (portfolio company) so as to allow them to upstream the return of their investors, whereas trade sellers seek to maximize gain regardless of the undertaking of risks. The main differences are the way in which transactions are structured and the content of the drafted contracts (indemnification provisions, clawback mechanisms, granting collateral or securities).

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

First, the target company's bylaws and, if any, shareholders' agreement must be reviewed to determine if there are any special applicable provisions determined by the shareholders to transfer shares such as rights of first offer, rights of first option, approval from the board of directors or the shareholders' meeting (either generally or from that specific series of shares), drag-along rights, tag-along rights, among others. If any of these special conditions for the transfer were to exist, those conditions must be fulfilled, waived or the governing documents must be amended.

In the event that there are no special conditions established by the shareholders or once these have been fulfilled, the requirements for transferring the shares are as follows: (i) a stock purchase agreement ("SPA") must be executed by and between the buyer and the seller, with the appearance of the target company acknowledging the transfer; (ii) once the closing conditions of the SPA, if any, are met, the stock certificates representing the transferred shares must be endorsed in ownership (*endoso en propiedad*) and delivered by the seller to the buyer; (iii) the target company must register the buyer as the new shareholder in its stock registry book (*libro de registro de acciones*); and (iv) the target company shall cause the filing of notices of the transfer with the Electronic Gazette of Business Corporations (*Sistema de Publicaciones de Sociedades Mercantiles*), National Registry of Foreign Investment (*Registro Nacional de Inversión Extranjera*), Federal Taxpayer Registry (*Registro Federal de Contribuyentes*), among other special registries that might apply per industry.

There are no transfer taxes for the sale of the shares; however, the sellers will be subject to income tax at rates that vary depending on the nature and country of residency for tax purposes, of the seller. In the case of non-resident sellers, it is worth noting that the general rule under the Income Tax Law (*Ley del Impuesto sobre la Renta*) is for the tax to be determined on the gross proceeds from the sale and not on the gain, and thus it is very relevant that non-resident sellers review in detail the specific income tax liabilities that may arise upon a sale of shares issued by Mexican resident companies.

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

The structuring of acquisitions through an SPV is common in transactions in Mexico. To provide comfort to seller, guarantees (*obligación solidaria*) by parent

companies or UBOs are often put in place, thus giving seller a direct claim in case of a breach by the buyer SPV. Oftentimes letters of credit are also obtained to provide comfort to seller that the purchasing SPV will ultimately have the funds required to carry out the acquisition.

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

There is no general rule in Mexico in respect to pricing mechanisms; that being said, traditional pricing mechanisms such as “completion accounts” are seen more often than “locked box” mechanisms.

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

Risk is usually allocated through the terms and conditions of the purchase agreement, mainly through:

a) Representations and warranties.- These are given by the target company and seller, and are usually broadly and heavily negotiated , and include, among others, title to assets, capacity, compliance, due authorization, no contravention, tax, financial information, litigation, labor, liabilities (judicial, environmental, etc.) etc. On the buy-side, these are usually limited to capacity, due authorization and financial solvency. Some representations and warranties are also usually qualified with a “material adverse effect” condition.

b) Conduct of business.- In transactions where signing and closing are differed, conduct of business clauses, whereby the target company and seller agree to comply with certain positive and negative covenants to protect buyer, are common.

c) Closing conditions.- In Mexico, once closing conditions are met, the purchase agreement becomes fully binding for the parties. Specific performance can be claimed by either party in such scenarios.

d) Indemnities.- Indemnity clauses are usually divided into those arising from breaches to fundamental representations and warranties, and all other breaches.

e) The caps, baskets, deductibles and claim periods will depend on such type of breaches. Breaches will typically be exempt if fully disclosed.

f) “Sand-bagging” / “anti-sandbagging” mechanisms are also commonly negotiated.

g) Clawback and holdback mechanisms are typically implemented and commonly seen.

Although still not generally used, R&W insurance has been used in recent transactions.

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

The use of W&I insurance is not very common in Mexico, although we are starting to see more insured transactions. It is more commonly seen in the context of cross-border transactions with agreements governed by foreign law or where it is possible to have a foreign insurer issuing such insurance.

8. How active have financial sponsors been in acquiring publicly listed companies?

According to TTR, in the last two years there has been a 86% increase compared to the two immediately preceding years. Therefore, we note an increase in these types of transactions. Furthermore, in terms of deal value, 2022 closed with a total of USD$1.6 Billion; while to date, during 2023 deals accounting for a total value of USD$1.1 Billion have been closed or announced, considering only those transactions where value is disclosed.

We expect the increase in these types of transactions to continue during 2023.

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

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In Mexico, there are: (a) certain activities that are reserved exclusively for the national government (no private investment is permitted at all); (b) certain activities in which only Mexicans are able to participate; (c) certain activities in which foreign investment is limited to certain percentages ranging from 10% to 49%; (d) certain activities in which foreign investment requires prior authorization from the Nation Foreign Investment Commission (*Comisión Nacional de Inversiones*

Extranjeras) to exceed a participation of 49%, when the deal exceeds certain threshold; and (e) activities that have no foreign investment limits.

Please note that structuring the deals in special ways could allow the participation of foreign investment in the activities mentioned in subsections (b), (c) and (d) above without breaching the Foreign Investment Law (*Ley de Inversión Extranjera*).

Please note that in most cases it is required to register or file a notice of update to the National Registry of Foreign Investment (*Registro Nacional de Inversión Extranjera*).

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

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

1.- The amount of the transaction exceeds USD$97 Million (approx.).

2.- The transaction involves the acquisition of more than 35% of the assets or shares of an entity having sales or assets in Mexico for at least USD$97 Million (approx.).

3.- The transaction involves an acquisition of assets or shares in an amount exceeding USD$45 Million (approx.) and the parties involved have sales or assets in Mexico for at least USD$259 Million (approx.).

Merger clearance is almost always jointly requested by both parties and is typically structured as a condition to effectiveness of the transaction.

11. Have you seen an increase in (A) the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside; and (B) 'continuation fund' transactions where a financial sponsor divests one or more portfolio companies to funds managed by the same sponsor?

According to TTR, in the last two years there has been a 39 % increase in the number of equity transactions compared to the two immediately preceding years, and in terms of deal value there has been a 19% increase considering only those transactions whose value was disclosed. In our experience, these types of transactions are usually structured as equity investments.

Although transactions can be structured as debt-like investments, these are generally for certain industries, being fintech and retail the most booming.

As to 'continuation fund' transactions, we start to see an increase in this market, particularly targeting assets of funds focused on real estate.

12. How are management incentive schemes typically structured?

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

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

Pursuant to the Income Tax Law (*Ley del Impuesto sobre la Renta*), the benefit obtained by employees who exercise an option to acquire shares issued by their employer (or a related party thereof) is treated as salary income. The amount of deemed salary income subject to tax is equal to the spread between the price paid for the stock (if any) and the fair market value of said shares.

Once the option to acquire stock is exercised, the amount considered as salary income will be treated as initial tax basis on those shares for future sales thereof, where the general tax framework in Mexico will apply and thus employees will be taxed on any capital gains obtained when transferring their shares. The applicable tax rate will hinge on the income bracket of the specific executive, but it will usually range between 30-35% percent.

Moreover, executives who hold on to vested stock and receive dividends will be required to consider said dividends as ordinary income subject to tax at the aforementioned progressive, and they will also be subject to an additional 10% tax on any such dividends received.

Any other form of incentive scheme involving a cash payment to management, such as an earn-out or performance-based compensation, will likely be treated as salary income and subject to income tax at the corresponding progressive rate, as mentioned above.

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

According to Mexican Law, there is no non-compete regulation for senior managers. However, it is common to enter into non-compete agreements between the company and the senior managers. In this regard, there are judicial criteria (not binding) that consider these agreements are valid and enforceable as long as they are restricted to a certain: (a) term (usually between 12 to 36 months); (b) territory; (c) clients; (d) industry and (e) activity, products or services. Therefore, it is highly recommended to limit these types of agreements as much as possible or otherwise they may be declared null and void.

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

In the case of an equity transaction and depending on whether the acquisition is for a minority or majority stake, sponsors usually seek presence on the board, veto powers over certain super-majority matters at the shareholder and board levels (e.g. mergers, disposal of assets, change of business line, etc.), as well as other protections regarding their divestment, such as tag-along and drag-along rights or deadlock provisions. The foregoing is either documented in a shareholders' agreement, directly in the bylaws of the target company, a voting trust in which the shares are conveyed, or through voting agreements.

Regarding debt transactions, sponsors are also likely to request board presence and will want to have a say over certain corporate and business matters – this is typically structured through positive and negative covenants in the loan agreement along with a veto power to engage further indebtedness. Likewise, if the deal involves a syndicate of sponsors, as lenders, the relationship between the members of the syndicate and their rights with respect to the debt investment will mostly likely be set forth in an intercreditor agreement, that is generally acknowledged by the borrower company.

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

Yes, it is common in Mexico to use trusts as a pooling vehicle, which allows the automatization of the allocation of rights among employees and the exercise of rights under such incentive plan. Having a third party (the trustee) managing the plan provides transparency and assurance that the rules of the incentive plan are followed without exception.

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

There are no specific rules nor instruments. For small and mid-size deals the typical financing structure relies on traditional banks funding secured loan facilities. Regarding new or small companies, where banking financing may not be available, it is common to see funding coming from investment funds. On the other hand, larger deals may involve senior and subordinated financing, syndication structures, as well as other forms of convertible debt instruments and private debt placements. For the largest deals, structures can include public debt placements and even securitizations.

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

No, there is no financial assistance legislation applicable to debt financing arrangements in Mexico.

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

There is no standard form of credit agreement in Mexico, it varies depending on the specific transaction, the lenders involved and the law firms involved on the lender side (typically proposing the financing agreement).

Despite the above, among institutional lenders and sophisticated creditors, as well as their legal advisors and other specialized firms involved in the transactions, there is a general understanding of the market terms applicable to each debt financing structures. The level of negotiation will also depend on the deal itself.

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

Financing deals in Mexico during the last two years have traditionally been negotiated on a “take it or leave it” basis, with certain provisions being subject to little room for negotiation. Moreover, in recent years borrowers have pushed for more protection in certain critical provisions to be covered in case of operational issues, including with respect to early maturity, assignment by lender requiring consent, cure periods on default, limiting default scenarios, among others. In addition, commercial terms (interest rates, breakage costs, etc.) are heavily negotiated. “Restricción” (discretionary reduction of the credit facility) and “denuncia” (discretionary ability to call an early termination of the facility before disbursement by the lender) provisions that were considered market in Mexican loans, have recently been negotiated by borrowers to be only applicable under certain specific scenarios.

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

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

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