Spotlight on reforms in Mexico

Mexico has recently risen to a prominent place on many investors' radar screens. If its transformation is successful, Mexico might prove itself the best investment opportunity of the moment

Mexico's President Enrique Peña Nieto and former Italian Prime Minister Enrico Letta during a welcome ceremony in the National Palace, Mexico City, January 2014

Mexico is set to put rivals in the shade

Emerging markets have been rightly criticized for squandering favorable global conditions by not taking decisive steps to guarantee their long-term economic health. Mexico has been a gratifying exception to the rule

Under the helm of President Enrique Peña Nieto, the second largest economy in Latin America has implemented an impressive number of structural reforms that have lifted the image of the country in the eyes of international investors. Areas that seemed out of reach for political leaders, such as the oil sector, the education system, competition and labor laws, are going through significant changes that could help Mexico realize its potential. Although GDP growth was mediocre in 2013, international markets seem to have realized that much of the groundwork has been laid for a brighter future.

Today, Mexico's fiscal position is solid, unemployment is low and the economy has gained in competitiveness against rivals such as China. The proximity to the giant US market is a natural advantage enhanced by membership of the North American Free Trade Area and large reserves of oil. Mexico has also been able to diversify its economy, exporting a growing volume of non-oil products to different parts of the world. As domestic hurdles to development are reduced, there are reasons for optimism about the country.

The opportunities presented by the Mexican economy are outlined in this report, together with certain challenges and risks that Mexico still faces on its road to prosperity. After all, enough inefficiencies remain in the economy for things to go wrong if the government falters in its reformist zeal. But the reforms proposed so far should make Mexico an increasingly interesting destination for investors. A revamped energy sector and a demonstrated need for more infrastructure investment are just a couple of the areas where opportunities could be found in a country that promises soon to be a different and brighter place. ■

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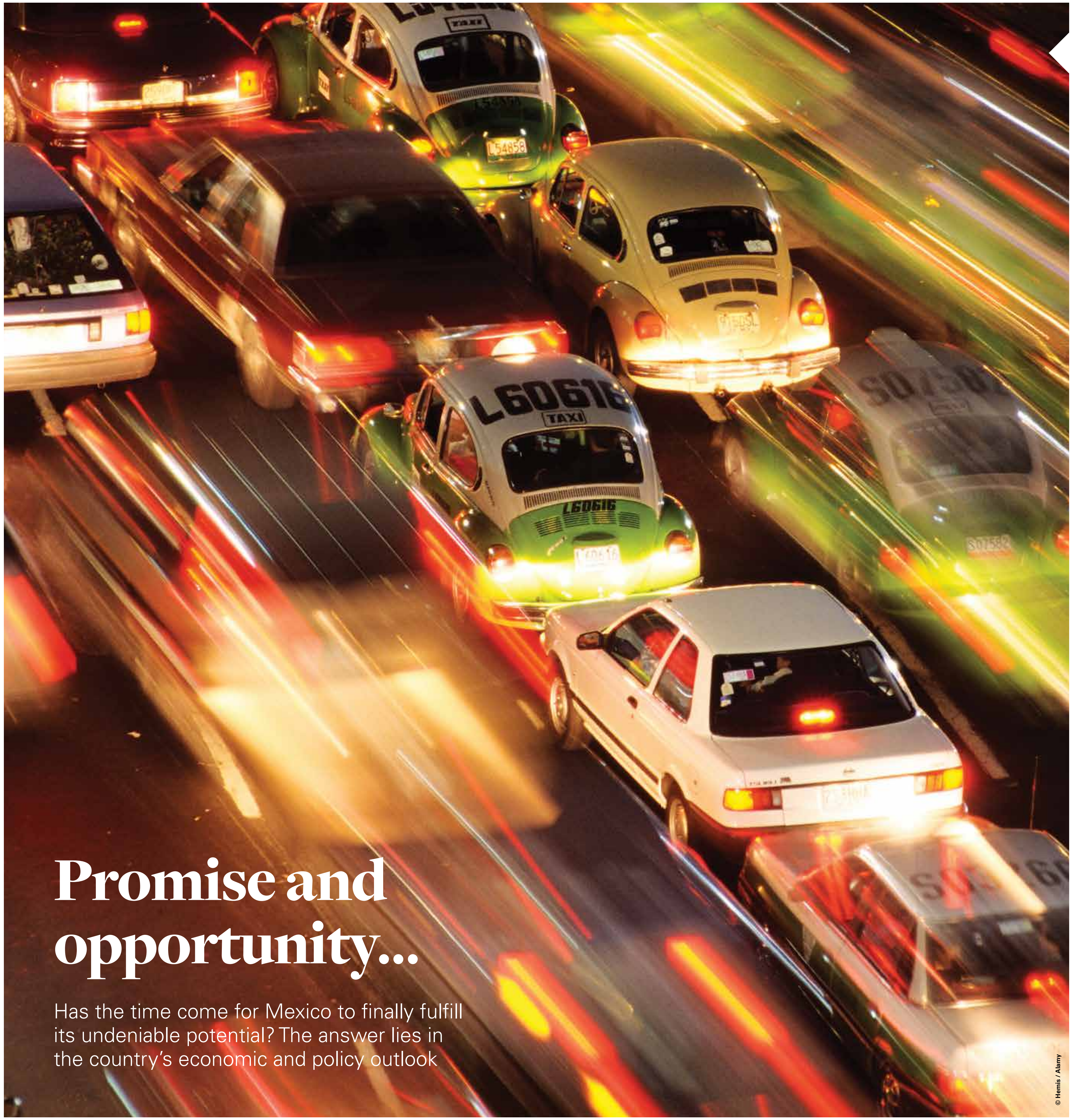

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Traffic jam in the heart of downtown Mexico City

Promise and opportunity...

Has the time come for Mexico to finally fulfill its undeniable potential? The answer lies in the country's economic and policy outlook

> **"Mexico is probably the country that offers the best opportunities for investment in the world, given its sound public finances, the favorable demographics, the availability of an educated, trained workforce and the new legal framework**

Mexico is changing — and the signs are that this time it's definitely changing for the better. In the past year, a lot of good work has been done to ensure the future looks promising for this important economy. With support from opposition politicians, the Mexican government is pushing forward an ambitious set of structural reforms that aims to tackle some of the most deeply entrenched problems in the country. The reformist drive has impressed, and even surprised, many observers of Latin American economies.

In February of this year, US President Barack Obama said the reforms implemented by President Enrique Peña Nieto "promise to make Mexico more competitive and increase opportunity for the people of Mexico". This view has been echoed by investors and international organizations, such as the OECD (Organisation for Economic Co-operation and Development), which has described the pace of change as "breathtaking". For its part, credit rating agency Moody's has recently upgraded Mexican sovereign debt to single A status. Mexico is now one of only two countries in Latin America to have this high a rating. It is true the economy failed to deliver last year, when growth fell well below official projections. But it is a common view that, while other emerging markets, such as Brazil and Turkey, are set for a rough ride, conditions have been created for Mexico to thrive.

"Mexico is probably the country that offers the best opportunities for investment in the world, given its sound public finances, the favorable demographics, the availability of an educated, trained workforce and the new legal framework," says Vicente Corta Fernandez, senior partner of White & Case in Mexico City.

The good feeling about Mexico has much to do with external factors. The economy should be a clear winner as the United States continues to recover, and wage inflation in China has increased the ability of Mexican industries to export to their northern neighbors. The country has reduced its dependence on oil by expanding the range of products it sells abroad, with the automotive sector becoming the single biggest contributor to Mexico's export revenues. And a flurry of bilateral trade agreements has minimized the exposure of the country's exports to the cyclical movements of American consumer demand.

19% Ratio of Mexican government revenue to GDP

No.5 By 2050, Mexico is expected to be the fifth largest economy in the world

But there is an important internal element driving up optimism among investors too. Ever since he came to power in 2012, President Peña Nieto has shown remarkable reformist zeal. Soon after taking over, he launched an ambitious program, known as Pacto por Mexico (Pact for Mexico), that deals with some of the thorniest issues around, including the energy sector, education, the tax system and banking. He has managed to bring opposition parties into the fold, convincing them to align with the government in votes that coincided with their own policies. And an impressive number of reforms have effectively been approved by Mexico's Congress in the past 18 months.

"Reforms allowing private investors to participate in sectors that formerly were monopolies of the Mexican government opened up tremendous opportunities for Mexican corporates and foreign investors in 2013," says Mr. Corta Fernandez. "The energy and telecommunications sectors, and competition law are among the areas most impacted by reform legislation and attracting investors' attention."

President Peña Nieto's program also benefited from a relaxation of labor laws initiated by the previous government and approved by Congress at the beginning of his mandate. "A very significant effort has been made in the past year to put structural reforms in place in order to really boost the economy," says Sean Goldstein, a partner at White & Case in Mexico City. "There seems to be the political will in the ruling party to carry on with the process."

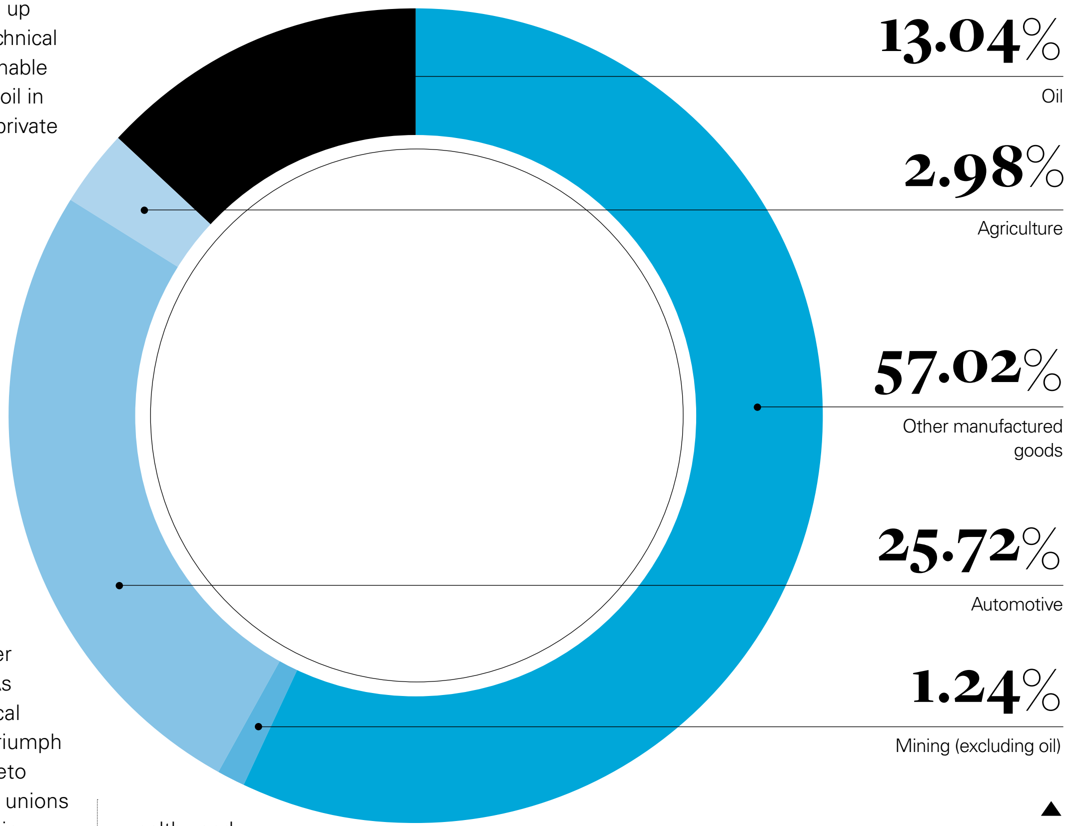
The president's biggest victory so far was scored in December, when Congress approved the end of the 75-year-old stranglehold that state-owned firm PEMEX had on the oil sector. Mexico has some of the largest oil reserves in the world, but production has decreased in recent years as PEMEX failed to make the investments required to keep up with increasingly complex technical demands. The Bill does not enable foreign companies to extract oil in Mexico, but it contemplates private ownership of hydrocarbons after they are taken from under the ground. The state monopoly in electricity markets has also ended. Both measures combined are expected to result in higher production of oil and lower electricity prices for companies and consumers, as well as tens of billions of dollars in foreign direct investments in the energy sector.

Energy reform was symbolic due to the emotionally charged character of the oil sector in Mexico. As important from a psychological point of view has been the triumph scored by President Peña Nieto against the powerful teacher unions that for decades put hurdles in the way of the modernization of education in the country, often with the active support of the PRI (Institutional Revolutionary Party). The president has succeeded in approving sweeping education reforms, and has moved against the unions in a decisive way.

Another major area is tax reform, where President Peña Nieto approved a package of measures that simplifies the tax code for businesses, imposes a capital gains tax on share dividends, closes loopholes and tax exemptions, and raises taxes paid by the nation's wealthiest. The goal is to boost tax revenues by 3 percent of GDP by 2018 to fund higher spending in areas such as healthcare and education. "The fiscal reform has a definite populist tone, by promising increased benefits, taxing the wealthy and going after those who have not traditionally paid taxes," says Duncan Wood, director of the Mexican Institute at the Wilson Center, in Washington. "However, there is clearly a broader economic and political logic behind this." Mr. Wood notes that Mexico has the lowest ratio of government revenue to GDP among OECD members at 19 percent, so raising taxes on the wealthy and companies is hardly unjustified. He also points out that there is a justified perception in the country that the tax payments of wealthier citizens and corporations fall well below international standards. And by targeting the better off, the tax reform brought the additional perk of helping to convince the left-wing opposition to support other reforms.

Changes in the banking sector have been aimed at increasing competition, protecting consumer rights and reducing bank fees. But these changes have also enhanced the ability of lenders to recover bad loans by taking over assets presented by consumers as collateral for debt. The goal is to create conditions for banks to provide funding for both consumers and companies, as the credit sector continues to be underdeveloped in the country.

"If President Peña Nieto's program is ultimately successful, private investors from Mexico and abroad should be able to find plenty of opportunities to get involved in the country's development push. For example, in areas such as infrastructure, which is always in need of a boost in a country that is growing at a healthy pace," says Chris Hansen, a partner at White & Case. Mr. Corta Fernandez continues "Infrastructure is relatively well developed in Mexico, but the needs are still huge. It is probable, for example, that a new airport will be built in Mexico City. If so, it will mean a large project in one of the biggest cities in the world, and will certainly attract international investors." He notes that there is talk in Mexico about investments in toll roads and railways, which have been favored by foreign investors in other emerging markets, including Brazil. And the country's commercial relationship with China, which is still



Mexican exports in 2013

Source: INEGI

> **"The fiscal reform has a definite populist tone, by promising increased benefits and taxing the wealthy**

MAIN REFORMS IN MEXICO 2013

Reform Bill	Constitutional reform needed	Senate	House of Representatives	State Assemblies	Enacted
Education	Yes	Passed	Passed	Passed	Yes
Telecommunications	Yes	Passed	Passed	Passed	Yes
Transparency	Yes	Passed	Passed	Pending	No
Political/elections	Yes	Passed	Passed	Pending	No
Energy	Yes	Passed	Passed	Passed	Yes
Financial services	No	Passed	Passed	-	Yes
Fiscal	No	Passed	Passed	-	Yes
Anti-corruption	No	Passed	Pending	-	No
Federal district political reform	No	Passed	Pending	-	No
National criminal procedural code	No	Passed	Pending	-	No
Right to respond	No	Pending	Passed	-	No

Source: *Forbes* 2014

nascent, is fast developing and could result in a steadier flow of Chinese investments in various sectors of the Mexican economy.

"With the transformative reforms that we are pushing ahead, Mexico is moving towards modernity and prosperity," President Peña Nieto said in February. But he should avoid any temptation to declare "mission accomplished". Progress has been clear so far, but the work is hardly over. The effectiveness of the reforms is still subject to the approval by Congress of secondary legislation: a process which promises to generate plenty of political wrangling. In February, for example, the government lodged a Bill that aims to increase competition in sectors, such as telecommunications, which are dominated by powerful monopolies. The Bill grants powers to federal authorities to act swiftly against a wide range of practices deemed to be contrary to the principles of fair economic competition. Mr. Goldstein notes, however, that business groups, which have a stronghold on sectors of the Mexican economy, are unlikely to surrender their privileges without a fight. President Peña Nieto is also preparing a further Bill to promote agricultural reform, an area that could prove to be tricky, as it affects a traditional power base of the PRI.

Further challenges facing President Peña Nieto include tackling perennial woes of Mexicans, such as violence and crime, for which the government has already been mauled for a lack of decisive action. And investors could very well change their mind about Mexico as tapering by the US Federal Reserve Bank picks up steam and money once again begins to flow out of emerging markets. In fact, last year the country suffered with emerging-market malaise and managed to grow a meager 1.1 percent, according to official government figures. All of this only shows that the transformation of Mexico continues to be an ongoing process.

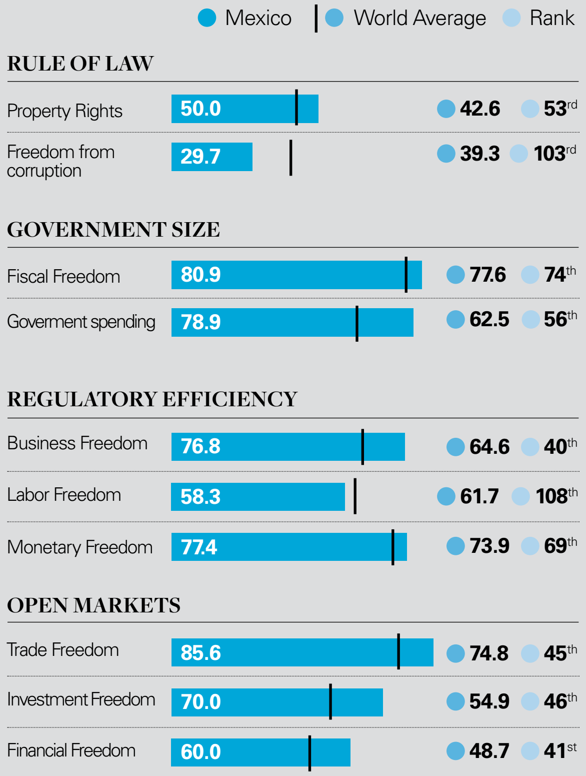
"In order to maintain growth rates that are sufficiently robust to continue narrowing the income gap in relation to advanced countries, a number of growth bottlenecks need to be addressed," the OECD advised in a report released in late February. "These include infrastructure shortfalls, pervasive state control in business activities and uneven access to quality education. A better balance in social protection is also needed to foster job creation in formal sectors."

> **"What investors are seeing today is a country that is doing the right things and making very brave moves**

Mr. Corta Fernandez concludes: "If Mexico was already a developed economy, it would not be so attractive. What investors are seeing today is a country that is doing the right things and making very brave moves." President Peña Nieto has so far deserved the praise he has received. But there is no doubt that his job is far from complete. ■

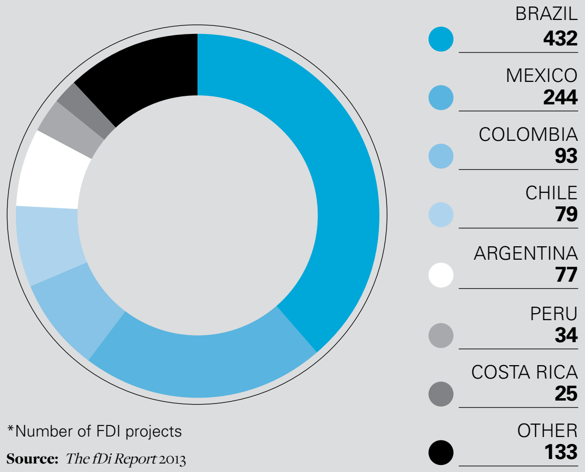
Mexico: Investment landscape & business analysis

ECONOMIC FREEDOM SCORE



Source: *Index of Economic Freedom*, Heritage 2014

TOP 7 FDI DESTINATION COUNTRIES IN LATIN AMERICA



*Number of FDI projects

Source: *The fDi Report 2013*

RANKING: EASE OF DOING BUSINESS IN MEXICO BY REGION

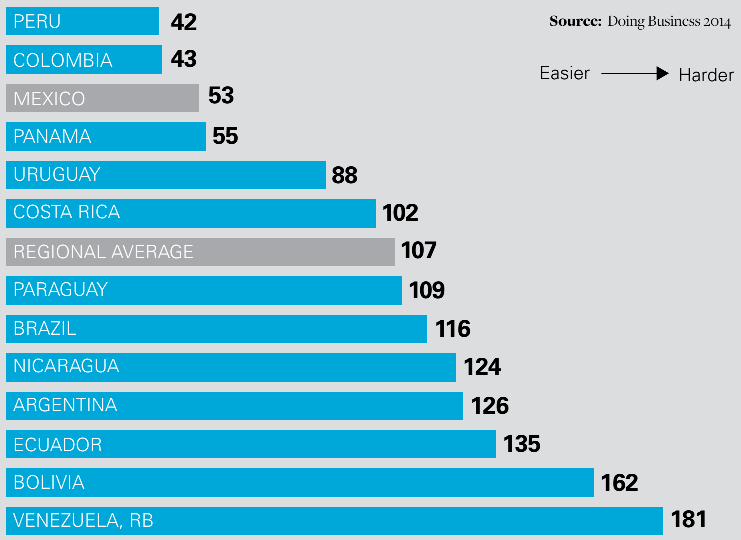
Source: Doing Business in Mexico 2012

SNAPSHOT OF THE ECONOMY 2012-2017

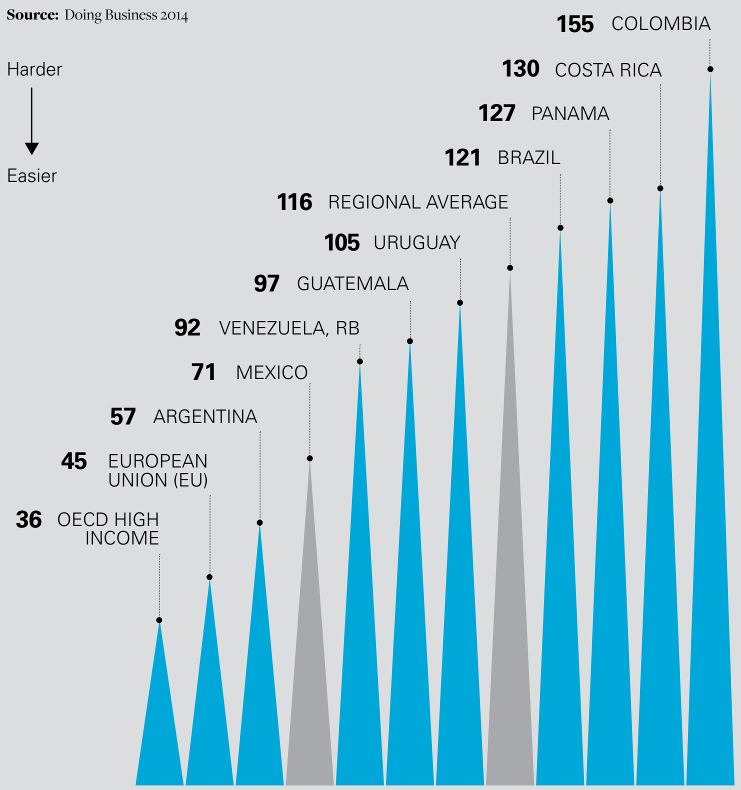
	2012	2013	2014e	2015e	2016e	2017e
Real GDP growth (% per year)	3.6	1.2	3.9	4.1	4.2	4.1
Current account balance (% of GDP)	-1.2	-1.9	-1.1	-1.0	-1.3	-1.3
External debt total (% of GDP)	25.1	24.6	24.0	23.4	23.1	22.8
Short-term interest rate (%)	4.4	3.8	3.9	4.9	5.3	5.7
Government balance (% of GDP)	-2.2	-1.9	-2.5	-2.6	-2.7	-2.8
Nominal GDP (US$bn)	1,179.2	1,251.8	1,335.7	1,424.5	1,500.2	1,585.9
GDP per capita (US$ current prices)	9,743.4	10,217.1	10,773.6	11,358.6	11,831.5	12,374.0

Source: Oxford Economics

RANKING: EASE OF DOING BUSINESS IN LATIN AMERICAN ECONOMIES



RANKING: ABILITY TO ENFORCE CONTRACTS IN LATIN AMERICA



Reforms opening economy to investment

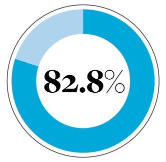
Despite state opposition to foreign financial intervention in key sectors for decades, the Mexican government is in the process of implementing legislation to fully open the economy. If its transformation is successful, Mexico might prove to be the best investment opportunity in Latin America

While investors have eagerly followed events in the BRIC countries of Brazil, Russia, India and China, a new group of growing emerging economies have captured their interest. MINT is the new BRIC where Mexico, Indonesia, Nigeria and Turkey represent a huge new investment opportunity. Mexico has a stable economic, political and business environment, as well as access to global markets. If it is to truly modernize, however, a massive investment of capital will be required, which has driven the decision to open Mexico's economy.

Transformations of the banking, energy, telecommunications, education and financial services sectors have all been put into motion and, as such, these sectors will all be looking for capital. Iker Arriola, a partner at White & Case, says: "The very good news is that our political parties, despite their differences and the imperfection of politics, have agreed to a change of the status quo."

Mexico's government historically maintained state ownership of critically important sectors — petroleum exploration and exploitation; energy production, transmission and distribution; transportation; nuclear power; postal services; coinage; and supervision of ports of entry. Not even Mexican nationals were allowed to invest. This led to significant underinvestment in infrastructure. Such demonstrable need, combined with proposed legislation allowing private investors to have a more prominent role in previously restricted sectors, have positioned these sectors as prime targets for international investment.

Eliminating the state monopoly and opening the oil sector to international investment and contractors with the necessary expertise to extract Mexico's large and proven reserves will have a significant impact. Mr. Arriola says, "The change to the rules around investment in oil and gas is a change of the economic model itself. Now everyone will be allowed to participate in the exploitation of oil and gas, electricity generation and petrochemicals. The full supply chain will be opened." The oil supply chain to date has been controlled by state oil giant PEMEX, but the reforms will allow suppliers to render services and products throughout the supply chain. This will mean an increasing need, according to Mr. Arriola, for "alliances through corporations and joint ventures to combine local knowledge with the skills and capital required from foreign partners."



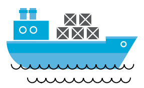
of Mexico's exports are in manufacturing

Source: INEGI

US$40bn

Amount of inward FDI in 2013

Source: Reuters



40%

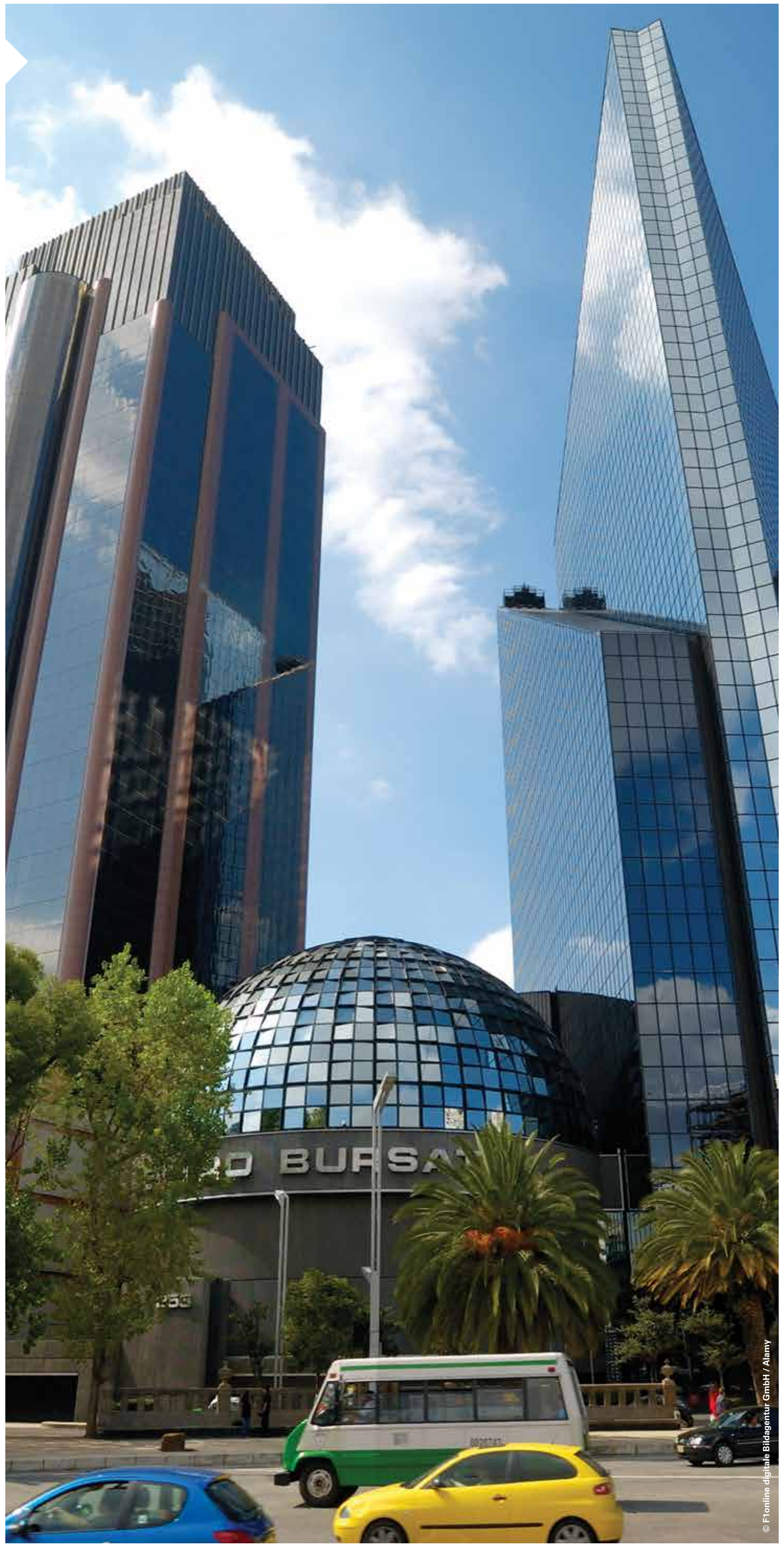
Mexico's share of total exports from Latin America

Source: LATIA

These changes are also likely to encourage increased levels of mergers and acquisitions (M&A) activity. Uncertainty around the reforms meant low levels of M&A activity in 2012, but this picked up significantly in 2013. M&A in the energy sector and related service companies is expected to show considerable growth, while similar reforms are expected to see comparable transaction growth in telecoms, infrastructure and renewable energy. While tax reforms may affect rules around material import and export, overall expectations for growth are positive.

Historically, Mexico only welcomed foreign direct investment (FDI) through Mexican subsidiaries. It has, however, remained the most important measurement of investment. 2010 saw a 53 percent increase in FDI, almost all of which was in mining, financial services, manufacturing and retail. 2011 saw US$12.7 billion in FDI, while 2012 saw US$15.5 billion and grew to a record US$35 billion in 2013. At the Davos economic summit in February 2014, Mexico's President Enrique Peña Nieto announced PepsiCo, Nestlé and Cisco would be making combined new investments of more than US$7.3 billion in his country. As FDI in Mexico increases, so will the knock-on effect in terms of job creation, rising exports and further growth.

Mexico Stock Exchange, Mexico City



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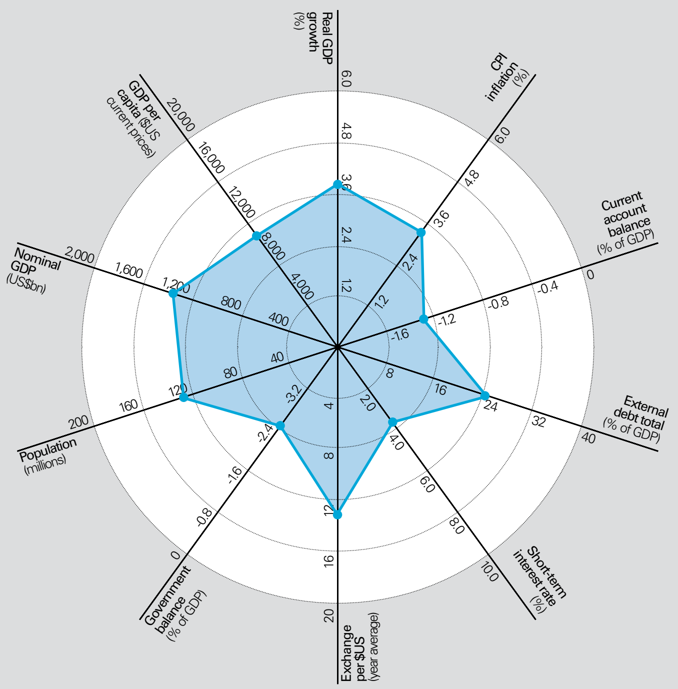
> "The change to the rules around investment in oil and gas is a change of the economic model itself

Manufacturing, where Mexico is already a world-leading player, is also expected to see continued growth. Partly due to its free trade agreements, Mexico is the fifteenth largest exporter in the world and accounts for 40 percent of the region's total trade. On a country basis, 80 percent of Mexico's exports are in manufacturing and high-value manufacturing at that. Mexico has become a leading car manufacturer, with production outstripping that of the United States and Canada.

Overall, Mexico's economic position is sound, with reserves three times its sovereign debt, at $163 billion, and has become a darling of the emerging markets. In February 2014, Mexico became only the second country in Latin America, after Chile, to earn an A-grade sovereign rating as Moody's upgraded it from Baaa1 with a stable outlook to A3, based on the current reform process. At the same time, its geographic position, as well as its free trade and economic partnership agreements, give Mexico preferential access to 44 markets and more than a billion consumers.

The domestic market could provide a further significant engine for growth. Over the next 20 years, the working population is expected to reach about 62 million, equivalent to the population of the UK. At the same time, the middle class is growing rapidly, with

2014 ECONOMIC INDICATORS



Source: Oxford Economics

CREDIT RATING — MINT COUNTRIES

	S&P RATING	MOODY'S	FITCH
MEXICO	BBB+	A3	BBB+
INDONESIA	BB+	BAA3	BBB-
NIGERIA	BB-	BA3	BB-
TURKEY	BB+	BAA3	BBB-

Source: Trading Economics 2014

increasing amounts of disposable income, much of which is spent on consumer goods. This growth in disposable income has also led to an increased focus on education. There are more than 745,000 university students in engineering and technology programs. Each year, 115,000 engineers graduate, more than the rest of Latin America put together and even more than the United States.

But there are a number of risks that must be managed. One of the central risks of doing business in Mexico is the pervasiveness of corruption. The lack of transparency in procurement in many previously restricted sectors has meant levels of corruption can be hard to ascertain and there is an urgent need to improve the judicial system. Like many other emerging markets, the country performs badly in global rankings of corruption perception, and that perception is shared by Mexicans themselves. The latest *Corruption Barometer* published by Transparency International reported that more than 50 percent of respondents believed corruption has increased significantly in recent years.

Local trade associations have estimated that about 15 percent of the investment made by companies in Mexico City is spent on bribes. The cost of corruption to the economy has been estimated by the IUCN Commission on Environmental, Economic and Social Policy at almost 10 percent of GDP, hardly the kind of luxury a developing nation filled with social problems can afford. According to America's Heritage Foundation: "Corruption is deeply embedded culturally and remains pervasive at all levels of society, fed by and entrenching the power of monopolists, party bosses and other mafias."

> **"Every year, Mexico graduates 115,000 engineers, more than the rest of Latin America combined, even more than the United States**

While the previous government has attempted to address corruption, campaigners say that these efforts have mostly been ineffective. Increasing concern about corruption and increasing media coverage of corruption stories suggest Mexico is becoming less tolerant of corruption. Part of the reform process is intended to increase transparency and provide less scope for corruption. "Corruption is present in every country in the world and Mexico is not an exception. We know it is something that needs to be tackled," says Vicente Corta Fernandez, senior partner at White & Case in Mexico City. "The government is working to implement stronger controls that should reduce corruption in the country. Our experience, however, is that people who want to do business in Mexico in a legitimate fashion do not need to engage in corrupt practices."

One of the areas that must be addressed in order to tackle corruption is the enormous income gap in Mexico. Much of its reported drug violence takes place in isolated regions where there is little social, financial or educational support. However, Mr. Arriola says: "This government has an honest recognition of the problem and is determined to address it." One of the first moves the current government has made is to approach the social and environmental causes of poverty and gang violence, through investment in education, healthcare and social services. At Davos 2014, for example, President Peña Nieto announced investment of US$3.4 billion in social and infrastructure programs in the state of Michoacán, where drug gangs and vigilantes have clashed. It is hoped that intelligent intervention in the causes of corruption will have a significant impact on the transparency of the Mexican economy.

> **"Opportunities for public-private partnerships will arise everywhere the public budget is short and needs exist for the population and the economy. The reforms are the big engine that will change the way that Mexico generates wealth**

There are a number of options available for private investors looking to take advantage of the Mexican opportunity. Mexico's stock exchange is small, which means that the IPO (initial public offering) market is not dynamic and many of Mexico's largest companies remain in family hands. Many private equity funds have found negotiating with family-owned businesses challenging, but the new regulatory framework is expected to force investors and foreign-owned businesses alike to seek new opportunities.

According to Mr. Arriola, the new generation is more interested in modernization, acquisitions, listings and even sales. Adoption of the new framework is expected to increase the number and complexity of transactions as longstanding monopolies will have to compete with new investors. This means a likely increase in the level and values of deals ranging from direct investment, joint ventures and M&A.

Of the new reforms, the most important to economic growth are considered to be banking, taxation and competition law. The reforms are expected to incentivize banks to return to lending, through the provision of more competition and more protection. For example, changes have been made to the bankruptcy law to give banks greater confidence in providing loans. Mr. Arriola sees the changes to the law regarding investment in energy as indicative of the fundamental transformation Mexico is undergoing.

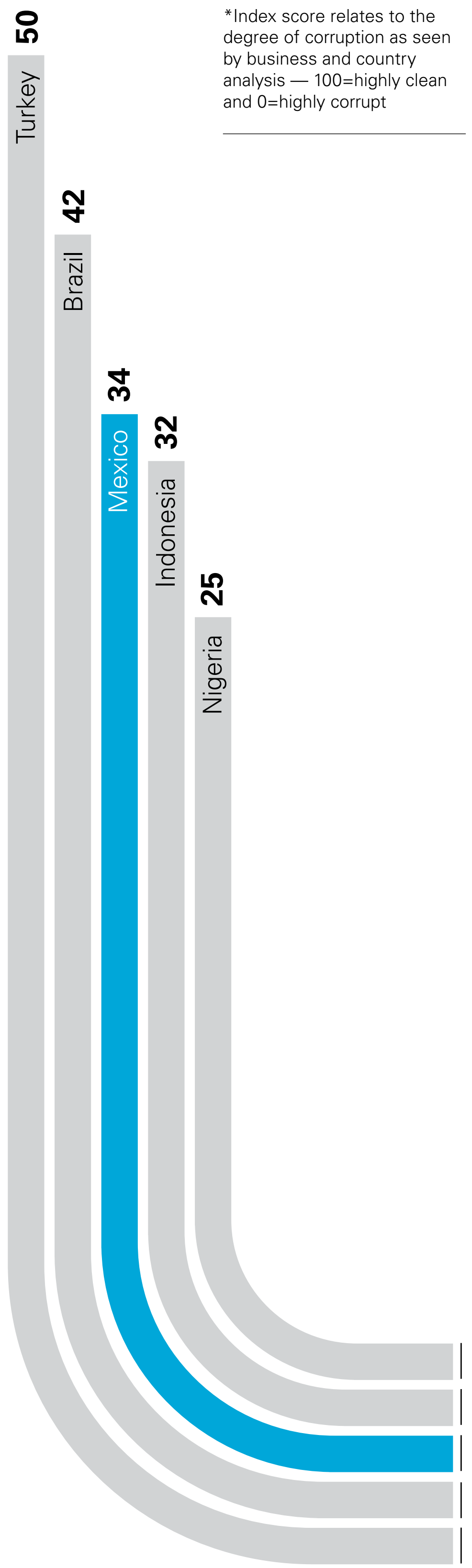
But he says: "We're in the very preliminary stages of transition." He points out that reform of the oil and gas sector currently is only at the constitutional level, and at least 20 secondary laws and regulations will need to be put in place or amended to give effect to the reforms. These secondary laws will require changes in institutions. As the energy market changes, for example, the operations of PEMEX will have to change, as will those of other institutions.

However, there is no question that the Mexican mindset on foreign investment has begun to change. Mr. Arriola expects great opportunities for investment. "Opportunities for public-private partnerships will arise everywhere the public budget is short, and needs exist for the population and the economy," he says. "The reforms are the big engine that will change the way Mexico generates wealth." ■

Corruption Perceptions Index 2013—MINT & Brazil

Source: Transparency International

*Index score relates to the degree of corruption as seen by business and country analysis — 100=highly clean and 0=highly corrupt



Record for project financing in Americas' petrochemical industry

A multi-billion-dollar deal in Mexico's petrochemical sector is blazing a trail for private investors

The Etileno XXI project is an example of the opportunities available to international investors in Mexico with reforms to the state monopoly over the oil sector. The company, Braskem Idesa SAPI, is a joint venture between Brazil's Braskem and Mexico's Grupo Idesa. It raised US$3.2 billion in financing for a US$4.5 billion integrated petrochemicals plant that was Mexico's first major private-sector petrochemicals project in more than 20 years.

What makes the Etileno XXI deal such an interesting case study is it highlights that the Mexican government is paying more than lip service to its promises of increased open investment opportunities.

The International Finance Corporation (IFC) was one of seven international, multilateral and domestic financial institutions funding the US$3.2 billion in project financing. The seven agencies, in addition to IFC, are Mexico's Banco Nacional de Comercio Exterior, Nacional Financiera also from Mexico, Brazil's Banco Nacional de Desenvolvimiento Econômico e Social, Export Development Canada, the Inter-American Development Bank and Italy's Export Credit Agency.

Etileno XXI will use Mexico's ethane resources to produce polyethylene, a common chemical building block in manufacturing plastics for the construction, consumer, automotive and agricultural industries. The plant, located at Nanchital, Veracruz, will include an ethane cracker with a capacity of 1.05 million tons a year of ethylene, as well as three polyethylene plants. Pemex Gas y Petroquímica Básica, the gas and basic petrochemicals subsidiary of the Mexican state oil company, will supply the ethane feedstock for the cracker.

The project is intended to make an important contribution to Mexico's overall economic growth. Not only will it create thousands of jobs in Mexico's south-east region, but it will also allow Mexico to produce more value-added petrochemical products in the down-stream gas supply chain. It is expected to address the imbalance in Mexico's current polyethylene production and demand. Annual imports of polyethylene cost Mexico between US$1.5 billion and US$2 billion a year.

The Etileno XXI deal has far greater significance, however, in highlighting the crucial impact Mexico's energy reforms can have on the Mexican economy. The relaxation of monopoly rules is likely to result in further exploitation of investment opportunities throughout the energy supply chain, allowing Mexico to use foreign capital to fulfill its development needs.

According to White & Case: "This project signals a re-emergence of the petrochemical sector in Mexico, which we hope will continue to benefit from the government's increased support of further opening the country's vast oil and gas resources for private investment and development." ■

$4.5bn

Total investment by Braskem & Idesa in the Etileno XXI project

20yrs

The Etileno XXI project is the first major private-sector petrochemical project in 20 years

Source: Hydrocarbon Processing

12,000+

Total direct and indirect jobs created by the Etileno XXI project

Source: Braskem

> **"The Etileno XXI deal highlights that the Mexican government is more than paying lip service to its promises of more open investment opportunities**

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