

M&A Trends in Mexico

I. Introduction.

As in the rest of the world, we saw a significant downturn of M&A activity in Mexico. In the case of Mexico, such downturn due not only to the COVID pandemic but also to the political climate. At the outset of the COVID outbreak, M&A related activity had to do more with interpretation of preexisting clauses and negotiation on their applicability in light of the COVID situation. Among other items, the parties argued as to what *operating in the ordinary course* and *compliance with laws* pre-closing covenants meant, and to what extent did a *material adverse effect* exit actually applied.

Although uncertainty continues to be a fact and the Mexican political clouds have not vanished, the current normality is being assumed and is allowing to analyze M&A opportunities that could be materialized in the coming months. Potential acquirers have come to an understanding of the new needs and opportunities that resulted from the COVID pandemic. At the same time companies are focusing on their core businesses and capital needs, which is translating into carve-out transactions and targeted investments. New needs are expected to remain, and opportunities may be pursued considering the important amount of cash in the hands of potential acquirers. These circumstances and the huge governmental economic support extended by some governments (Mexico not being one of them), is taking the market to new record highs again. It still remains to be seen if this behavior will sustain or if it is rather artificial. However, for the time being, there are M&A opportunities worth being considered.

II. Initial reaction upon COVID outbreak in Mexico.

The initial reaction upon the outbreak in Mexico was a shift in the mindset of the companies. Companies were already being cautious due to the current political climate in Mexico. However, the COVID outbreak resulted in an aggressive change to a survival mindset, leaving growth, expansion and compliance of budgets to a second front. Companies needed to analyze the main cash outflows, the legal alternatives available to cope with them, and the impact in their activities of the innumerable governmental decrees issued at a federal and local level to handle the health emergency.

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On the cash outflow front, the main expenses that were initially analyzed were payroll and major contracts.

On the payroll area, the manner in which the federal government declared the emergency did not allow the companies to use the resources available under the labor law to reduce the payment of salaries, and eventually terminate employment relationships. The government was very vocal in making clear that it was not expected for companies to reduce salaries, although they were mandated to suspend operations. In practice, this resulted in negotiations with employees for a temporary reduction of salaries, work shifts, elimination of bonuses, and in certain cases termination of employment relationships. The labor courts were closed and, therefore, there was no third-party available to mediate or resolve upon the uncertainty.

From a contractual perspective, Mexican law does contemplate force majeure as a valid cause to excuse from the compliance of contractual obligations generally. Mexican law also contemplates the possibility of re-negotiating contractual relationships when major and extraordinary changes in the circumstances result in inequality. This relief is available in certain state laws. If not available there, it could still be argued on a constitutional level. Our legal provisions provide for an effort to reach a negotiated solution to redistribute the burden among the parties and then reach out to the courts for a resolution if they are not able to reach an agreement within certain term. As in the labor front, courts were closed and the parties were not able to look to them for an independent resolution in the absence of a negotiated agreement with their counter party. This allowed for most companies to be able to reach temporary negotiated solutions with their counter parties in major contracts, including transactional. For those cases where the parties were not able to reach a temporary negotiated solution, it is yet to be seen if the courts will actually consider the COVID situation as sufficient force majeure to excuse the parties from complying under their contractual relationships, and if they will consider that the statutory term within which parties should try to renegotiate before going to courts will not be an obstacle in light of the prevailing circumstances. Mexican courts are open again, but their work backlog and COVID related restrictions to operate in the ordinary course are considerable.

From the operational standpoint, companies needed to analyze emergency resolutions issued on a very constant basis at federal and local level, sometimes

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even contradicting themselves, to determine if they could continue to operate and the arguments that could apply in such situation.

III. Current situation and outlook.

Companies have generally absorbed the COVID situation during the last six months. Some companies have pursued or are in the process of pursuing reorganization relief in Mexico or abroad to be able to continue operating. Others are starting to look ahead in the new normality analyzing opportunities resulting from distressed companies, new market and consumption trends in the COVID reality and scarce governmental support.

For those analyzing their ability to survive on a solvent basis, it is essential to make a quick assessment of their economic situation in light of realistic business plans, assess their current debt to equity ratio and consider additional financing resources. The reduction of debt rates resolved by Central Banks and the uncertain reaction of the stock markets may allow for financing or refinancing transactions to be implemented, including through debt placements. Mezzanine debt may also be an alternative, as bank financing in the current circumstances may not necessarily be one.

For those players interested in pursuing growth and acquisition opportunities it is essential to analyze companies and sectors. There are companies that want to focus in their core, and let go of what is not essential to that core. This will result in carveout opportunities. Other companies will need cash support which will allow growth capital and minority investments. From a sectors perspective, it is important to analyze and focus on the most resilient sectors. There are expenses that one may live without, and others that are a necessity. Education, health, food, logistics, and technology are some of the essentials. Analysis of online supply versus in store supply will be key. Technology is a must and those targets that move to a digital scale will have more value. Online education, fintech, e-commerce, and last mile logistics, among others, will be definitely winners. For these winners the satellite add-ons will also be very important and represent attractive targets.

Targets with strong corporate governance and integrity (transparency, accountability and security) qualities will be more attractive. ESG standards are therefore expected to continue impacting investment decisions.

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Other aspects to consider are supply chains. Strong and resilient supply chains are key.

These new market and consumption trends and tendencies resulting from the COVID are expected to remain constant even after the health emergency is over.

On the deal-making front, there does not seem to be alignment in valuation between interested buyers and potential sellers. Therefore, significant discussion as to the actual value of the target should be expected. Also, it is important to focus on technology for deal making. Virtual data rooms, advanced analytics and cloud computing will be important. Experience in carve-outs and in markets in distress deal-making will be essential. Certain clauses will need to be carefully drafted in light of the current situation. Among others, force majeure and ordinary course of business provisions will require special attention. The tax analysis in a world with a lot of new rules due to the COVID will also be a must.

Although governmental support in Mexico is scarce, Mexico has maintained an open borders policy with respect to foreign investment. That is, unlike other countries that may have afforded economic support to their industries while increasing the level of scrutiny towards foreign investors interested to participate in their markets, Mexico did not give much on the economic support side, but did not increase the level of scrutiny for foreign investors either. The federal government has been meeting with potential foreign investors to address their main concerns and give them certainty on their investment plans. The federal government also sees the National Fund of Infrastructure, the Fund of Funds (federal government fund aimed to support venture capital) and even PENSIONISSSTE (pension fund of governmental employees) as a source of potential financing and support for new substantial projects. The new USMCA with significant impact in the automotive regulation, dispute settlement mechanisms and intellectual property protection, among other main differences with old NAFTA, is seen by the government as a great milestone that is expected to allow foreign investment to continue flowing to Mexico. It is of course yet to be seen if this will actually be the case.

IV. Conclusion.

In a world where one of the only constants may be change and uncertainty, it is worth making a pause to analyze actual opportunities that result from convoluted

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times. New normality, demographic bonuses and markets in distress, among other circumstances, allow for savvy investors to pursue opportunities that will remain attractive for consumers in this new world. The current times do call for an holistic analysis of all of the factors that could affect a deal in these interesting times. To the extent that the Mexican government is able to convey certainty for long term investments, Mexico will benefit, in this analysis, from the relocation of supply chains from Asia to America, geopolitical tensions, and interesting demographic bonuses, that may be well served with a resilient and substantial manufacturing capacity at very competitive costs, which Mexico has developed throughout the years.

Jorge León Orantes B.
Santamarina y Steta, S.C.
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