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LATINLAWYER *Reference* - Acquisition Finance 2016 - Mexico Questionnaire

1. What was the level of debt-financed M&A in your jurisdiction in 2015? Was there any industry or sector (eg, energy, infrastructure, financial companies, natural resources) that saw any noteworthy uptick in M&A and related financing deal activity in 2015 in your jurisdiction?

During 2015, the number of M&A deals experienced a 10% decrease in comparison with 2014 (dropping from 337 to 303); however, during the same period, the aggregated investment value of said deals increased 4% (from US$33,885 million to US$35,297 million). The real estate subsector was most active during the period (73 deals), with the financial and insurance subsector coming in second (29 deals), followed by the food industry subsector (23 deals), and the internet subsector (17 deals). Mexican purchasers conducted 11 acquisitions abroad (including Brazil, Colombia, Jamaica, Italy, Luxemburg, Spain, and U.S.A.). There were 15 acquisitions conducted in Mexico by foreigners (including purchasers from Belgium, Canada, Chile, China, Israel, Spain and U.S.A.)*

*Approximate figures. Source: www.TTRecord.com

2. What types of investors are the most frequent sources of acquisition financing in your jurisdiction?

In Mexico, most debt-financed M&A deals are funded by domestic and foreign banks. Bond markets have also become an increasingly important source of financing, but on a smaller scale. While private equity investment continues to trend to higher and deeper participation in the Mexican market, the presence of alternative funding is not significant.

3. What types of debt instruments do you most frequently see for local acquisition financings?

The most common types of debt instruments are term loans granted by banking institutions. Mexican currency is frequently used for domestic transactions (ie, local sellers and local purchasers), and US dollars and euros for international transactions. Both Mexican and foreign banking institutions participate in these transactions. Whether such loans are bilateral or syndicated credit facilities typically depends on the size of the relevant transaction; however, syndicated loans have become increasingly important, as they are usually less expensive than traditional bilateral credit facilities.

4. What are the usual maturities and amortisation profiles of acquisition-financing credit facilities?

Maturities and amortisation profiles are variable and depend on the specific transaction. The most common maturities tend to be of medium or long terms (five to ten years), depending on the size of the transaction irrespective of the nationality of the lenders.

5. Are there legal, banking, currency exchange, regulatory or other considerations that favour certain sources of funds over others? For instance, mandatory reserve or deposit requirements? Do the requirements vary by type and location of investor or lender? Were there any changes in the regulatory environment in 2015 that are likely to affect M&A and related financing deal activity?

For local finance transactions, multiple purpose financial entities (*sociedades financieras de objeto multiple*; 'Sofoms') have become increasingly important in the Mexican lending industry. Additionally to benefiting from a preferential tax regime (not being subject to thin-cap rules, interest payments made or received not being subject to VAT, among others), Sofoms are also afforded certain procedural advantages on loan collection, and if not linked to other regulated financial institutions, they are not subject to capitalisation requirements nor a heavy regulatory framework such as the one applicable to commercial banks.

In addition to the foregoing, certain tax considerations pertaining to the nationality of the relevant lender may favour loans granted by foreign investors (generally, no VAT is applicable to interest payments made to foreign tax residents and a reduced withholding tax rate may be applicable as well). Please see question 6.

6. What is the withholding tax treatment of acquisition finance loans made by, and bonds purchased by, foreign investors in your jurisdiction? Do the rules favour or disfavour non-traditional debt investors (eg, hedge funds, foreign sovereign wealth funds or foreign pension funds)? Were there any changes in tax laws in 2015 that are likely to affect M&A and related financing deal activity?

In general, non-traditional debt is still subject to an unfavourable tax environment in Mexico. Although principal repayments are not subject to withholding tax, the latter is applicable to interest payments (which are broadly defined and include commissions and certain gains on the sale of notes). Such withholding tax ranges from 4.9 per cent on payments made to banks that are residents in a country with whom Mexico has entered into a tax treaty, to 40 per cent on related-party transactions where the lender's income is subject to a preferential tax regime (ie, jurisdictions that tax income at a rate lower than 22.5 per cent). The general withholding tax rate is 35 per cent and most of the tax treaties set forth a 15 per cent withholding tax.

Interest income deriving from Mexican sources received by hedge funds and sovereign funds is generally subject to withholding tax; however, in the case of real estate financing, foreign pension funds are exempt from withholding tax on income deriving from Mexican sources.

7. Are there limitations on the ability of the parties to choose a foreign law as the governing law of the financing or to select a foreign forum for dispute resolution?

Generally, Mexican law recognises legal relationships validly created in any foreign jurisdiction; however, certain exceptions may be applicable. Choosing foreign laws to govern a contract would be invalid if (i) such choice of law is used to evade fundamental principles of Mexican law and/or (ii) such foreign law or its application violates fundamental principles of Mexican law. Additionally, Mexican law provides that the creation and extinction of in rem rights on assets is governed by the law of the jurisdiction where the assets are located. Therefore, applicable law for assets located within Mexican territory would be Mexican law, regardless of the governing law chosen by the parties. In practice, determining whether a choice of law provision is valid may prove difficult when dealing with intangible assets or moveable assets that will be located in different jurisdictions throughout the term of a contract.

Mexican law provides that parties may select one or more jurisdictions for purposes of dispute resolution; however (i) the parties may only chose courts located at (a) the domicile of either of the parties, (b) the place where obligations will be fulfilled, or (c) where the asset subject matter of the agreement is located; (ii) all parties must waive their right to all other jurisdictions (ie, agreeing to the jurisdiction of certain courts will not suffice, waiving the jurisdiction of any and all other courts is necessary); and (iii) disputes pertaining to *in rem* rights over real estate located in Mexico may only be heard by the courts sitting at the real estate's location.

It is also important to consider that in any proceedings brought to the courts of Mexico for the enforcement of a foreign judgment, Mexican courts would apply Mexican procedural laws.

8. Does the local insolvency regime treat lenders under an unsecured credit facility on a on a *pari passu* basis with all other unsecured obligations of the debtor?

Mexican bankruptcy law sets forth the following order of priority: (i) payment of labour claims for salaries and severance payments for the two calendar years preceding an insolvency judgment; (ii) payments to secured creditors (including costs and expenses relating to foreclosure and the enforcement of their respective rights), but only to the extent of the value of their respective collateral; (iii) payment of liabilities and obligations of the estate of the insolvent entity (ie, management costs, fees and expenses incurred after the insolvency judgment); (iv) payment of litigation costs and expenses, and fees and expenses of the court approved inspector, mediator and any appointed receivers (*síndicos*); (v) payment of labour claims (different than those described above) and tax claims; (vi) payments to other creditors that qualify as 'privileged' under Mexican commercial laws (eg, creditors that are entitled to retain an asset until payment is made), but only to the extent of the value of the respective privilege; (vii) payments to unsecured creditors; and (viii) payments to subordinated creditors (eg, creditors that agreed to be subordinated and unsecured related-party claims).

9. Discuss the legal and practical limitations on obtaining a valid and perfected security interest. Are there any documentation formalities required by local law to make the security interest enforceable against the debtor and third parties? Is it possible to create a floating blanket lien on all of the debtor's assets?

Security trusts, share pledges, floating lien pledges and mortgages are the most common means of securing financing transactions. In order to perfect mortgages, security trusts and floating lien pledges, a Mexican law governed agreement must be entered into, notarised and registered in the local Public Registry of Property (in case of mortgages or security trusts holding real estate) or the Sole Registry of Moveable Guaranties (in case of floating lien pledges and security trusts holding moveable assets). In order to perfect a share pledge, the relevant share certificates must be endorsed as collateral, delivered to the creditor, and the pledge thereon must be registered in the corporate books of the debtor.

Legal limitations include: (i) the relevant security agreements must be governed by Mexican law (and translated into Spanish to be notarised); (ii) procedural rights may not be waived; and (iii) self-help remedies are not available.

Practical limitations include: (i) notaries' fees and registration duties sometimes being determined based on a percentage of the guaranteed amount; (ii) a publicly available and centralised registry of liens over real estate does not exist; and (iii) although a centralised registry of liens over moveable assets does exist, liens created previously to its creation in local registries are still effective.

It is possible to create a floating blanket lien on all of the debtor's assets (including assets acquired after the closing date of the financing) pursuant to a floating lien pledge (*prenda sin transmisión de posesión*).

10. Does the local insolvency regime enable complex capital structures, for instance, recognising the validity of subordination of payment, subordination of liens, and other inter-creditor agreements?

Mexican law allows the execution of subordination and inter-creditor agreements; however, except for a limited number of instances where capital structures are specifically addressed by statute, the relevant agreements would generally be governed by common commercial and civil regulations, which allow parties to contracts to freely agree on their respective rights and obligations (provided third parties' interests and public policy are not contradicted).

Additionally, Mexican bankruptcy law does include provisions governing the agreements that may be reached by creditors once an entity is deemed insolvent.

11. If an equity investor provides some of the debt financing, do local insolvency rules afford those loans equal treatment as other (third-party) loans?

An equity investor providing financing may not be subject to the same treatment as a third-party lender if certain hypotheses to be deemed as a related party under Mexican bankruptcy law are verified. Relevant differences include:

(a) A rebuttable presumption of the financing being a fraudulent conveyance would exist if it were granted during the look-back period (generally 270 days, but may be extended to three years in case certain related parties are involved) and, among other hypotheses (i) the equity investor controls, is controlled by or is under common control with the debtor, or (ii) the same individuals hold positions on the board of directors or act as relevant officers of both entities; and

(b) Certain unsecured related parties are deemed as subordinated creditors (only being paid after all other creditors have).

12. Are there any other insolvency considerations that a foreign debt-investor or lender should be aware of?

Foreign debt-investors or lenders should note that, for purposes of determining the amount of all claims existing against an insolvent entity, (i) all unsecured peso denominated indebtedness are converted into investment units (*Unidades de Inversión*; 'UDIs', a Mexican inflation-pegged payment unit), and interest thereon will cease to accrue; (ii) all unsecured indebtedness denominated in foreign currencies are converted into Mexican pesos and subsequently into UDIs, and interest thereon will cease to accrue as well; and (iii) all secured indebtedness will be maintained in the agreed currency, and ordinary (but not default) interest thereon will continue to accrue up to an amount equivalent to the value of the relevant collateral.

13. What do you expect to see in terms of market developments for acquisition financings in 2016?

Some of the circumstances that affected Mexico's economic and political environment during 2015 have improved or stabilized; however, investors still remain cautious due to factors such as the historically low levels of oil prices; a depreciated Mexican peso; the Federal Reserve's decision to normalise its monetary policy, as well as the Mexican Central Bank's correlative reaction; unpredictability of twelve state elections; political developments in Brazil and the Eurozone; and the upcoming presidential elections in the United States.

Notwithstanding the foregoing, important governmental infrastructure projects, as well as considerable private corporations' expansion plans have been announced. Possible results of the foregoing include: (i) an increase in the number of financings used to complete strategic acquisitions, both in selected industries within the private sector and to participate in governmental bidding processes; (ii) cross-border acquisitions of targets, which stablished regional presence is desirable to expand the relevant purchaser's operations; and (iii) an increasing demand for long-term, fixed rate, Mexican peso denominated loans. If we add to this potential outcome, the political will to implement the structural reforms that have reshaped Mexico's legal regime and no drastic interference further affects its environment in the months to come, one can expect an optimistic forecast for acquisition financings in 2016.

Partner profiles

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Alfonso Razú focuses his practice in M&A, private equity and financial services. He has actively represented a broad range of buyers, sellers, investors and lenders in a number of substantial domestic and international transactions. He obtained his law degree from the Instituto Tecnológico Autónomo de México (2003) and earned an LLM degree from the University of Texas at Austin School of Law (2005).

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Javier has been a speaker of the "Entrepreneurship Course" organized by PwC/IMEF/UNAM (2014) and co-authored the Mexican section of "NYSE: Corporate Governance Guide" (December, 2014). Prior to joining Creel Abogados, Javier worked in the New York office of Davis Polk and Wardwell (foreign associate, 2009 - 2010). Javier is qualified to practice in Mexico and New York.

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