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Building the Venture Capital Industry in Mexico

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Definitions of "venture capital"(VC)—also known as "risk capital"—vary, but this term generally refers to equity investments in growth-oriented companies that have the potential to develop into significant economic contributors. Venture capital investing has grown in industrialized countries from a small investment pool in the early 1970s to a mainstream asset class that is a viable and significant part of the institutional and corporate investment portfolio.

In many developing countries, VC investing remains a nascent industry. However, investment in private equity has been picking up in Mexico and throughout Latin America over the past year as investors regain confidence in the region and learn to select deals more wisely. Mexican authorities want to keep investors coming back and to increase investments in smaller riskier ventures that would support the sizeable small and medium enterprise segment of the Mexican economy.

For that to happen, however, a number of reforms are needed. The Mexican government has been working in collaboration with the private sector to identify the reforms needed to strengthen and grow the venture capital industry. Political impetus for these reforms came in 2002, when the Fox administration identified development of the venture capital industry as a priority and included it as a goal in the Partnership for Prosperity Agreement signed by Presidents Fox and Bush. In order to implement the mandate set out by the heads of state, the Mexico–U.S. Task Force on Venture Capital was established, with broad representation from government, multilateral institutions such as the Inter-American Development Bank, and the private sector. A study commissioned by the Mexican development bank, Nacional Financiera, SNC (NAFIN), pinpointed the key issues affecting the growth of venture capital investment in Mexico and recommended an action plan for reform.

Clearing the Path

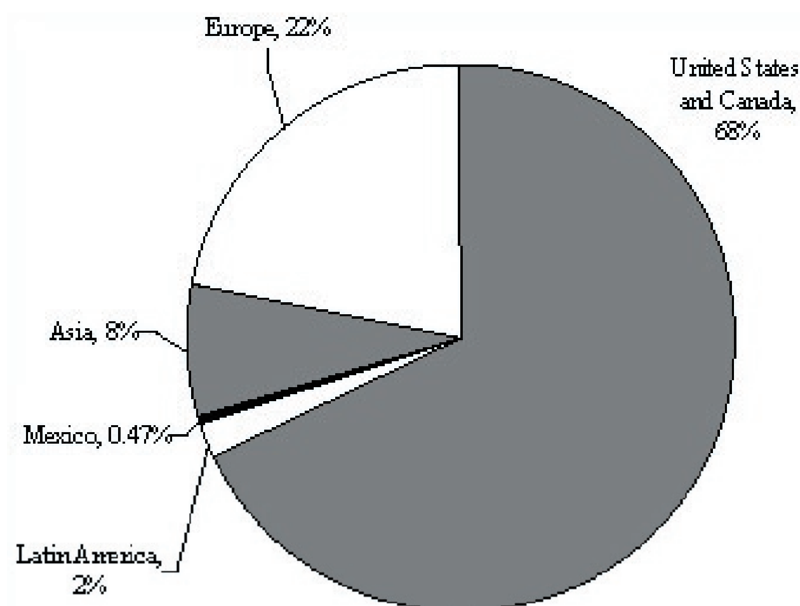
Before a venture capital industry can thrive in Mexico, several obstacles to investment must be removed. The recommended reforms address the key issues that were identified by the Task Force team as critical to creating an appropriate environment for venture capital in Mexico and, in particular, to facilitating increased flow of capital into small and medium enterprises.

For one thing, Mexico needs an appropriate domestic investment vehicle for venture investing. Mexican corporate forms lack fiscal transparency. That is, they do not allow for an entity to serve as a tax pass-through in which taxes are assessed only to the owners and not to the corporation. Thus, incorporation in Mexico potentially results in double taxation, that is, taxation of the fund and also of the investor. Even the corporate form created by the government in the early 1990s specifically to foster venture capital, the *Sociedad de Inversión de Capital* (SINCA), does not have fiscal transparency and is subject to levels of supervision and regulation that inhibit venture investing, despite recent reforms of the SINCA regulatory regime.

To circumvent this problem, investors create offshore funds as vehicles for equity investments in Mexico, but this approach

Worldwide Private Equity Pool

($637 billion)



Note: Cumulative funds raised as of December 1999.

Source: Eduardo Mapes, NAFIN.

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increases transaction costs and presents its own set of challenges. One problem has been that regulations governing the tax treatment of offshore vehicles have been inconsistent and prone to change. Currently, Mexican authorities have ruled that U.S. partnerships and limited liability companies are not recognized as fiscally transparent for Mexican tax purposes. Also, funds incorporated in a country determined to be a "low tax jurisdiction" are subject to a 40 percent tax on gross capital gains payable on share transfers. These constraints prompt many fund sponsors to incorporate in Toronto or use a Quebec Limited Partnership (LP) as the vehicle of choice inasmuch as these options are considered fiscally transparent for Mexican tax purposes and Canada is not a tax haven. However, these funds cannot locate their offices or managers in Mexico—that is, create a "tax presence"—without risking a paradoxical *increase* in tax liability. Furthermore, the Quebec LP structure places what investors consider excessive power in the fund administrator and provides insufficient participation by investors in decision making.

Mexican corporate law prohibits a number of venture investing practices common in other countries, in particular, practices related to the rights of minority shareholders. For example, controlling shareholders in a Mexican corporation may neither waive their right to vote nor covenant in advance how they will vote on critical company issues. A new shareholder is subject to all of the preexisting liabilities of the corporation. The repurchase of shares is limited. Constraints exist on the use of dividends. Existing shareholders have a right of participation in all new offerings involving an increase of capital. Among other things, this inhibits the creation of stock options, warrants, or similar instruments. A shareholder cannot waive in advance

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this preemptive right to subscribe to future offerings. Investors who want to operate their investments with corporate governance provisions to which they are accustomed will create offshore holding companies for investments in Mexican companies—a strategy that again raises transaction costs.

Another reason investors choose to create offshore holding companies is to avoid the legal uncertainty associated with the Mexican judicial system. Although reforms are underway, the Mexican legal system is considered slow and unreliable. Deals structured under Mexican law will often include self-executing mechanisms worked into venture agreements to ensure the fulfillment of contractual matters that might otherwise be enforceable in the courts. This legal uncertainty also leads some fund managers to become more rigid in regard to investment terms and control.

A vibrant venture capital industry requires more than simply establishing the right structure for investments. As with any country, Mexico needs investors willing to fund the deals, plausible exit strategies for those investors, and quality investment opportunities, or deal flow, from a large cadre of risk-taking entrepreneurs.

Currently, foreign investors provide the vast majority of equity investment in Mexico. Substantial untapped resources exist domestically within institutional investors. Regulations governing insurance companies were modified in 2001 to allow them to invest up to 1 percent of reserves in venture capital. One insurance company has recently made an investment into an international fund and another is currently considering participation in a new fund. Similar reforms are needed for pension funds, which currently are required to obtain Congressional approval before investing in venture capital. As a result of a 2001 reform, insurance companies can invest up to 1 percent of reserves in venture capital, but investment from insurance companies into venture capital has not yet been realized. No tax incentive exists in Mexico to promote venture investing by other institutions in the private sector.

Exits of course represent a key issue throughout the Latin America. In this region, the opportunities for IPOs, which in part fueled the boom in the U.S. venture industry, do not exist. The Mexican stock market is small and does not offer venture capital funds an adequate vehicle for profitably exiting from their investment. Over-the-counter (OTC) trading is nonexistent. Mexican financial institutions have not been active in either financing the private sale to management or refinancing of venture deals as a means of assisting the venture fund's exit. Most exits thus occur through trade sales and buyouts by other investor groups.

As for deal flow, Mexico does have a large and vital entrepreneurial economy. Nevertheless, an underlying culture that fosters specifically venture-oriented entrepreneurship must be developed further. Traditional family-based business norms and negative attitudes toward risk-taking present specific challenges. Additionally, entrepreneurs and their advisors are generally unfamiliar with the venture capital model and the process of venture financing. More entrepreneurially-oriented business training programs are needed: seminars for training venture investors and fund managers are beginning to emerge but these opportunities are few in number and often limited in scope.

Lessons from Abroad

In order to address these issues with specific actions, the U.S.-Mexico Task Force on Venture Capital looked closely at the experience of five countries—the United States, Spain, Chile, Taiwan, and Israel—in developing a venture capital industry. Five key lessons emerged from that review. First, the task force found that an appropriate tax regime is critical to the venture capital industry. Investment vehicles that are not subject to double taxation, such as the limited partnership and limited liability company in the United States, are the norm. Tax incentives have been widely used worldwide to stimulate venture capital investments, and almost all countries in Europe provide some form of tax incentives. As a general rule, incentives that favor successful investment and do not reward losses have been found to be most effective. For example, in the United States, the reduction of capital gains taxes is viewed as having made a significant contribution to the growth of venture capital investments.

The second lesson concerns corporate governance. In countries where the corporate code does not allow for the governance provisions expected by venture investors, a

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common strategy has been to pursue a noncoercive approach to reform, using "opt-in" plans. Under this approach, a business can choose to be subject to an alternative set of corporate governance rules and ethical standards that increase transparency and encourage venture capital operations. Chile adopted an opt-in corporate governance code requirement in 2000 for companies that seek low interest loans from the government's development-finance agency. Similarly, in 1998, Spain adopted a voluntary opt-in code for publicly traded companies.

Third, of the countries studied, only the United States and Chile have encouraged venture investments by pension funds. The impact of institutional investors taking part in the venture industry has been significant in the United States, where a change in regulatory interpretation by federal pension authorities in the 1970s led pension funds to become the single most important source of U.S. venture funds, providing about half of all such funding over the past 20 years.

Fourth, in attempts to further exit options, venture capital reforms have not attempted to change national stock markets. Instead, these reforms have focused on the creation of new, minimally regulated OTC exchanges in which small ventures can make an initial public offering and become actively traded. Successful, well-established markets for small companies exist in Bermuda, Israel, Taiwan, and the United States, but of these only Taiwan and the United States have active OTC markets, and both those countries have strong and long-standing "equity cultures." In Bermuda, a model was developed that focuses on trading only among qualified investors.

Finally, many countries today purposefully support venture capital development through activities designed to build a culture that fosters venture capital and entrepreneurship. These activities include: funding basic science and research and development activities, providing political leadership and aid for venture "catalyst" and technology commercialization agencies, funding research parks and business incubator buildings, promoting entrepreneurial education, creating venture funds, redirecting workforce education programs toward the needs of a competitive economy, reforming intellectual property policies, and advancing public education.

A Plan for Growth

Based on the analysis of the key issues in Mexico and lessons learned from international experience, the Task Force recommended a series of reforms, most of which have been taken on by NAFIN and are currently under refinement with Mexican policymakers and private sector industry leaders:

An appropriate legal and regulatory framework for local investment vehicles. Core legal reforms include the passage of a new law that sets a framework for venture capital investing. This law would establish, as a minimum, a definition of an appropriate investment vehicle that serves as a tax pass-through so that only the investor is subject to the assessment of taxes (and can carry out its own tax planning). The reform also includes the deferment of taxes on investors until a distribution is made by the fund, as well as the establishment of a regulatory framework directed toward investment by qualified and institutional investors. Where the venture fund is limited to such investors, the regulatory regime can be focused on adequate disclosure rather than on detailed substantive regulation.

An appropriate legal and regulatory framework for foreign investment vehicles. If investment vehicles are considered a tax pass-through under their host country law, the Mexican government should recognize them as pass-through entities as well. This would render U.S. limited partnerships and limited liability companies appropriate vehicles for investing in Mexico. Furthermore, a ruling is needed on the definition of "permanent establishment" such that offshore funds would be able to manage operations from Mexico without a tax presence in Mexico.

Appropriate corporate governance of portfolio companies. A regime of special exceptions to the existing Mercantile Code should be established. Such a regime would allow companies to be governed by a specific set of corporate governance provisions, pertaining especially to minority shareholder rights. A minimal regulatory system of registry should be created for those companies that opt-in to the exception regime, with an enforcement authority

to sanction companies that do not comply with the new provisions.

Tax incentive for risk capital investments. A reduction in capital gains taxes for venture capital investments is recommended because it favors only positive investment outcomes and does not reward losses.

Mechanisms for exiting investments. An unregulated private placement market for institutional and qualified investors to trade unlisted shares among themselves should be established in the short term. Over the medium to long term, the development of an automated OTC market for unlisted companies should be considered. Other strategies that facilitate exits—such as authorizing and fostering Employee Stock Ownership Plans and encouraging financial institutions to provide loans for management buyouts—should also be explored.

Involvement of institutional investors. Reforms already in place for insurance companies should be expanded to allow for VC investment by all institutional investors. The participation of institutional investors in risk capital should be encouraged through legal authorization, education, public information campaigns, and discussion forums. The participation of banks in a multi-faceted way in the risk capital industry should also be facilitated.

Expansion of public sector programs to catalyze investments. The Mexican government's current equity program managed by NAFIN must be strengthened, with additional staff, increased flexibility of and autonomy from bureaucratic processes, and staff training. Over the medium to long term, development of additional public sector programs to catalyze private investment could be considered. Such a program could include the establishment of a fund of funds managed by an independent private firm that would serve as the gatekeeper and manage funds.

Status of Reforms

These recommendations were developed through a dynamic process in consultation with Mexican government authorities, the private sector, and international financial institutions. Therefore, debate and negotiation around these issues are already underway. By the end of 2003, the Mexican Ministry of Finance, as well as the National Banking and Securities Commission, had agreed with NAFIN to move forward with reforms to establish a local fiscally transparent investment vehicle, create an opt-in regime for corporate governance, and create working groups to refine the full reform agenda.

Much remains to be done. In the meantime, however, successful implementation of these reforms is expected to strengthen Mexico's position as a prime market for venture capital investment.

Note: This article originated with a report prepared under the guidance of Eduardo Mapes of Nacional Financiera, SNC in Mexico, with the collaboration of a team of local and international consultants. The study was funded by the U.S. Trade and Development Agency.◆

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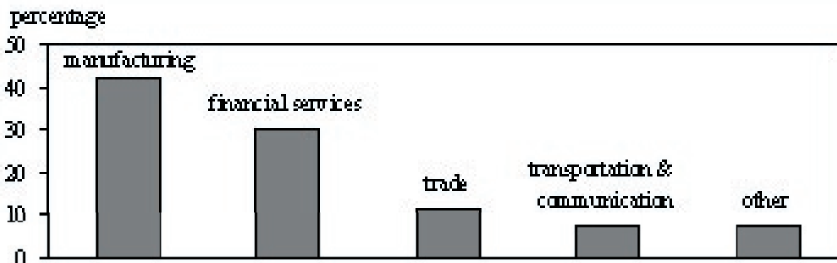
Foreign Direct Investment in Mexico by Country of Origin, Type, and Sector, 2002

Country of Origin	Investment (*$millions*)
United States	7,071
Netherlands	485.9
Germany	476.0
Switzerland	260.5
Spain	239.8

Type of investment	$billions
New investment	6.6
Reinvested profits	2.2
Intercompany transfers	2.7
Imports of fixed assets	2.0



Source: Mexico Economic and Financial Statistics Data Book (Mexico City: Secretaria de Hacienda y Credito Publico, March 2003).

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