Trade

Venture Capitalists Look to Mexico and Latin America

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It's hot south of the border these days. The hugely favorable economic climate of Latin America is drawing the attention of major U.S. venture capitalists, who see recent changes in these countries as an opportunity for investment and development.

This trend began nearly two decades ago as Latin American economies recovered from the banking crisis of the 1980s. In that period, more countries—particularly Mexico—started looking outside their borders and to the United States for financing.

Although they have experienced some ups and downs over the past 15 years, these emerging markets have remained attractive to investment. In the past, many financial experts suggested a maximum one percent portfolio investment in emerging markets. Today, however, their suggestions are often in the 20 percent range, because the emerging markets are really where the world's wealth is going.

U.S. and other foreign investors are experiencing greater confidence in the political and regulatory environments in Latin America, particularly in Brazil and Mexico, which are the two biggest economies in the region.

While many of the largest banks in the United States were threatened, or even went under, during the recent economic meltdown, this was not the case in Latin America—even though the U.S. and Latin American economies in the aggregate are somewhat intertwined. In the U.S., we are used to seeing our government and the IMF bail out Latin American banks, but for the first time in the history of our two economies, the tables were turned.

The Latin American economies were spared, in large part, because their mortgage systems are completely different from the U.S. system. Most Latin American mortgages are subsidized by the government. As a result, there was none of the speculation of housing prices and method of finance that we experienced here in the U.S. So as the U.S. economy struggles to recover, Latin American banks are enjoying a very stable deposit base and low-risk assets—and very little to do in terms of recovery from the economic downturn.

Within the last few months, there has been an explosion in the amount of access that Latin American companies have to U.S. capital. Interestingly, the market had been completely closed up to mid-2009, when changes began taking place rapidly. One of the first indications of this change came when the Mexican homebuilder Javer completed the first high-yield deal in Latin America in more than a year. Since then, there have been at least 20 debt deals in Latin America, primarily Mexico and Brazil. A number of equity deals have also been completed from the two countries.

There are at least two reasons why Mexico is one of the most promising Latin American countries, in terms of increasing opportunities for U.S. venture capital firms. First, there has been a continued increase in venture capital investing now that the country has had investment-grade status for more than a year, and firms are more comfortable with risk-profile investing there.In addition, Mexico recently passed legislation that allows public listing of venture capital funds. There are now at least eight such funds that are registered or in the registration process with the CNBB, the Mexican equivalent of the SEC.

In part, as a result of these two recent developments, there are a number of large international venture capital firms that are interested in developing in Mexico—or are already closing deals. For instance, Javer, the Mexican homebuilder, was just purchased by U.S.-based Southern Cross. This was one of the very few purchases of a controlling interest in a family-owned Mexican company.

Activity such as this is a sign of things to come, with venture capitalists purchasing controlling interests in Mexican companies, as well as businesses throughout Latin America. Housing development is a particularly hot industry right now, especially in Brazil and Mexico. Equity International, for example, has been hugely successful in venture capital investing in the real estate business in Mexico and Brazil. The company took Homex, Mexico's first major housing company, public. It is now the largest housing company in the country.

Advent International has probably been the most active U.S. venture capital firm in Mexico. The company has acquired everything from restaurant chains to duty free stores and has been quite successful. In addition, The Carlyle Group has made six to eight investments over the approximately five years it has had a presence in Mexico. Although Carlyle has made significantly fewer investments than Advent, some of those investments have been fairly significant. In addition to U.S. and international firms, some very competitive local venture capital firms have achieved remarkable success in their countries. In Mexico, these homegrown venture capital firms seem to outperform the foreign firms. Two that stand out are Nexxus Capital, located in Mexico City and Protego, which is now actually part of the U.S. firm Greenhill & Co., LLC.

There is continued momentum in terms of venture capital investing in light of Mexico's risk profile. Many U.S. investors—particularly retail investors—have been concerned about narcoterrorists and the country's ongoing drug trafficking, but that really doesn't seem to have deterred the more sophisticated venture capital funds. The attractiveness of the Latin American market is driven by a few recent changes in the region. For one thing, the rate of GDP growth in most Latin American countries has actually been higher than the GDP growth in the U.S.

In addition, U.S. and other foreign investors are experiencing greater confidence in the political and regulatory environments in Latin America, particularly in Brazil and Mexico, which are the two biggest economies in the region. Political moderates run both countries, and investors have become comfortable with these governments. Also, there have been regulatory reforms that create more transparent capital markets and reporting structures, as well as increased effectiveness of tax collection in many Latin American countries.

If we take a step back and look at the macroeconomic environment in many of these countries, we see that the development of a middle class is driving this tremendous growth and relative political stability.

Homex, the Mexican homebuilding company, provides an interesting example of this phenomenon. Homex now builds hundreds of thousands of lower-income homes, for which there is a great demand (as is the case in almost all Latin American countries, especially Mexico and Brazil). The population growth of young families is skyrocketing, and there is a dire need for housing for these people. This creates a nice intersection between capitalism and the economic needs of the countries, where there's an unlimited demand for a certain product and a perceived need for additional financing.

A few years back, Sam Zell at Equity International, as well as others, recognized this unfulfilled demand for housing. Starting about six years ago, he provided the seed capital for Homex, which is now the largest housing company in Mexico. Gafisa, another Sam Zell-affiliated company in Brazil, has experienced similar success. Such investments have helped to develop a middle class that is tied to homeownership and other middle-class ideals. The exponential growth of this class of people who believe they have a stake in their society has been the key component of growth in a lot of industries in Latin America—consumer products, housing, food, and so forth.

It is important to note that the growth of markets elsewhere in the world has also contributed significantly to Latin America's rise. In particular, the growth of the Chinese economy has had a huge impact. A lot of Latin American countries are resource-rich, so they have enjoyed significant benefits from the economic development in China.

This Latin American-Asian relationship will likely strengthen even further as China's demands for access to Latin America's natural resources create an infrastructure in the region that will enable resources to flow back to China. We will see billions of dollars invested in infrastructure for that purpose. For Latin America, this economic boom promises continued political and social stability.

Peru and Chile are two countries that stand to benefit the most from a relationship with the East. Peru's prominence is often surprising to U.S. investors, mostly because a lot of people don't realize that Peru has a huge economy—largely tied to Asia—and that the country has investment-grade status.

Chile has always had a strong economy. Among its impressive business community is the largest copper company in the world. Just as in Peru, there is significant investment from Asia, which creates export-driven economic development. In addition, years before any other Latin American country, Chile began the kind of state sponsored pension funds that are oriented exclusively toward the development of the country's economy. A lot of Latin American countries—including Mexico—have copied that successful approach.

Having been the originator of this model, Chile has the greatest momentum in the region and has been the most successful to date at capturing its domestic capital and putting it to work in its own economy. As a result, the country is basically self-supporting now in terms of major infrastructure and economic capital development.

Clearly, the recent surge in Latin American investment is powered by a remarkably strong return on overseas investing—significantly better returns than those on U.S. investments. Incidentally, this has been the case for the past decade, not just since the onset of the U.S. economic crisis.

In 2010, look for more investment of venture capital, but also more liquidation of portfolio investments. Typically, these investments have to be liquidated over three to five years to provide some return to the venture capital fund investors. Since a lot of firms started investing in Mexico three to five years ago, they're anxious to begin that liquidation process.However, because of the worldwide economic crisis, capital markets—particularly equity capital markets—have been somewhat inaccessible over the past 12 to 18 months. We're just now beginning to see the re-emergence of capital markets in Latin America, particularly high-yield capital markets. This activity usually signals the coming availability of equity.

As a result, we should see more liquidity for venture capital investors in 2010. Along with the reopening of the capital markets, there are more international funds that are interested in purchasing on a direct basis. It is hard for venture capital funds to raise more money when they haven't been able to liquidate their investments, but these opportunities should arise within the next six to nine months. The only potential hindrances to further expansion of capital markets in Latin America are inflation and political instability. A spike in inflation generally leads to political unrest. However, barring those unlikely complications, the climate for venture capitalists will remain hot as investors in the U.S. and abroad eye the enormous, still not fully tapped possibilities in the region.

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