



Sourcing Capital through Mexico's CKD Structure: the Next Phase

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As a measure to mitigate the effects of the global financial crisis, Mexican regulators introduced in August 2009 significant regulatory changes to create a new asset class known as *Certificados de Capital de Desarrollo* ("**Structured Equity Securities**" or "**CKDs**") with the main purpose being to create sources of capital for Mexican companies and infrastructure or other projects located in Mexico and, in turn, support economic growth. The regulators' intention was also that the principal sources of capital came from Mexican mandatory pension funds (*sociedades de inversión especializadas de fondos para el retiro*, "**Siefores**"). Thus, as part of those changes, Siefores' investment rules were amended in order to allow for the possibility of making investments in private equity and infrastructure projects through the CKD structure, which had previously been banned.

Siefores are the most important institutional investors in the Mexican financial market, with funds under management of more than US\$115 billion as of December 2011, of which up to 10% or approximately US\$10 billion may be allocated to CKDs. Therefore, it is not surprising that Siefores have been given a critical role in the creation, shaping and development of the new market and, in particular, in defining the characteristics of the CKDs. Accordingly, the current regulatory framework has been designed to overcome certain legal restrictions applicable to Siefores, most importantly the requirement that investment by Siefores be limited to publicly offered securities. This particular legal issue made it necessary for the CKDs to be structured through a publicly traded security registered on the National Securities Registry (*Registro Nacional de Valores*) and listed to trade on the Mexican Stock Exchange (*Bolsa Mexicana de Valores, S.A.B. de C.V.*).

The unique structure of the CKD vehicle presents challenges in balancing the varied needs of the stakeholders involved and the securities regulations applicable to all issuers, as is the case of the CKD issuing trust, regarding matters such as governance mechanisms, investor's rights and initial and ongoing disclosure, and other international standards of practice in private equity with regard to investor protections and confidentiality of information.

For non-Mexican private equity investors, these issues, along with the costs associated with setting up and maintaining a CKD, should be carefully assessed prior to making a decision to invest directly in a CKD. It is likely that non-Mexican investors will consider the CKD structure to

be more complex and inefficient relative to the standard structures used in the international private equity market and, as a result it may be more appealing for such investors to be seek out managers providing a parallel structure through which investments may be made alongside the CKD.

Under the current regulations, CKDs are structured through Mexican trusts created to issue the CKDs to be placed and offered through a public offering on the Mexican Stock Exchange. There are basically two types of CKDs: (i) those issued to finance an individual company or project located in Mexico, and (ii) those issued to finance a private equity fund in order to invest in multiple companies or assets in Mexico based on a business plan and certain eligibility criteria determined by the sponsoring manager. To date, all CKDs, except for one, have been structured in accordance with option (ii) as private equity funds.

Offerings

The first phase of CKD offerings, between August 2009 and July 2011, resulted in sixteen completed issuances and two reopenings, representing a total amount of US\$2.9 billion. The sectors to which these CKDs are dedicated are as follows: five to infrastructure for an amount of US\$1.3 billion, four to real estate for an amount of US\$600 million and seven to pure private equity for an amount of US\$1 billion. All of these CKD's were pre-funded by investors, mainly Siefores. Figure 1 details the number and aggregate amount of CKD offerings issued during this period.

Figure 1: Offerings During Initial Phase of CKD Structure, 2009–2011

| | Number of CKD Offerings (including reopenings) | Total Proceeds from Offerings |
|--------------|--|-------------------------------|
| 2009 | 4 | US\$0.890 billion |
| 2010 | 9 | US\$1.600 billion |
| 2011 | 5 | US\$0.470 billion |
| Total | 18 | US\$2.960 billion |

Regulatory Amendments

Following the initial regulatory changes in August 2009, Siefores were unsatisfied with the requirement regarding CKDs being completely pre-funded with payment in full made at the placement date, as opposed to the capital commitments scheme more generally used in private equity. This specific limitation had a direct impact on the return that Siefores received from their investments in CKDs. Siefores thus became active promoters of changes to the regulations, culminating in amendments to the legislation enacted in July 2011 that allow for the issuance of CKDs with a capital commitments scheme.

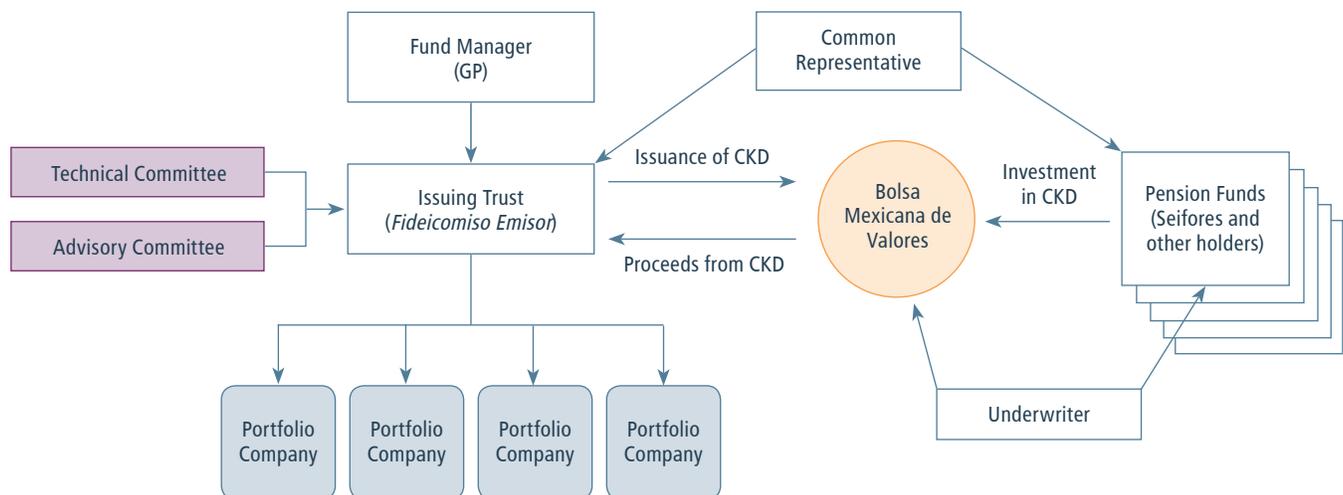
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Despite expectations that the new rules would lead to faster growth in CKD offerings, in reality, once the regulatory changes were introduced, CKD offerings slowed down dramatically, as shown in Figure 1. This was perhaps attributable to the full appreciation by all participants, and potential investors in particular, of the risks associated with the revised structure and related provisions.

Among the amendments introduced in July 2011, two in particular are worth note: (a) the introduction of a provision allowing for a capital commitments scheme within the CKD structure, which requires at least 20 percent of the face value of the CKD to be pre-funded, with the balance available to be called by the manager as needed; and (b) an increase in the maximum amount of a single CKD that may be purchased by Siefores, revised upward from 35 percent to up to 80 percent if the manager or other qualified investors have committed to contribute at least 20 percent of the total amount of the CKD offering.

The July 2011 regulatory changes have two main objectives: first, from a financial perspective, to create the possibility for a more efficient structure by introducing the capital commitments scheme and, second, to simplify the negotiation process with potential investors, in particular

Figure 2: Illustrative CKD Structure



Source: CKD prospectuses, IFLR.

Siefores, by increasing the amount that a single group of Siefores may contribute to close a CKD. However, in the CKD market, both managers and Siefores alike are still embroiled in the process of reviewing and analyzing the new regulatory framework and the capital commitment proposals in order to fully understand the associated risks of such investments.

Therefore, 2012 will be a very interesting year for the industry as the CKD structures move into their next phase. Potential investors and Siefores in particular, together with each manager, will have to decide on the structure to be adopted for each potential CKD, either pre-funded or partially funded initially and with capital commitments. This should bring a second phase of CKD offerings and it should not surprise us to see both CKD structures being used. It will ultimately depend on each investor's assessment of the advantages or disadvantages of one structure versus the other. ●●

About the Author



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Note to the reader: For additional information on CKDs and other structures related to domestic capital in Latin American markets, please see the *EMPEA Insight: Local Pension Capital in Latin America*, July 2011. Members can access the publication free of charge at www.empea.net.

Sources: All information included in this article has been obtained from CKDs base prospectus available at the website of the Mexican Stock Exchange: www.bmv.com.mx, as well as information provided on the websites of the National Banking and Securities Commission: www.cnbv.gob.mx, and of the Ministry of Finance: www.shcp.gob.mx.