Mexican Energy + Private Capital

Expert views on a major investment opportunity

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General David Petraeus of KKR
Riverstone founder David Leuschen

And leaders from
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Unlocking Mexico’s Potential
Three experts discuss the impact of energy market regulatory changes

Why Riverstone Likes Mexico
David Leuschen of energy-focused PE firm Riverstone on why the firm opened an office in Mexico

Petraeus Backs Mexico
Former CIA chief General David Petraeus, now of the KKR Global Institute, is a “qualified optimist” on the country

Partners Group’s Fermaca Investment
Why Partners Group invested $750M in a Mexican gas pipeline group

Investing in Mexico’s Infrastructure
Macquarie Mexican Infrastructure Fund’s Jonathan Davis Arzac explains how reforms will aid private capital investment

Mexico’s Energy Sector by the Numbers

Reforms Will Boost Mexican Economy
KKR Global Institute’s Vance Serchuk and KKR’s Henry McVey discuss why Mexico is an appealing market

Expert Q&A
With EY’s Alfredo Alvarez

Welcome to Privcap’s special report, Mexican Energy + Private Capital, an exploration of one of the most exciting investment opportunities currently open to private capital investors. The report is presented with the support of EY.

Inside you’ll find insight from former CIA chief David Petraeus, who now works with the KKR Global Institute, alongside interviews with experts from Riverstone Holdings, KKR, Conduit Capital Partners, Partners Group, Macquarie Group, and EY.

All of the firms featured in the report are currently investing in the US upstream midstream downstream opportunities and have a keen interest in the revolutionary changes in Mexico, where private investor CAPEX in the energy sector could reach $350B within five years, according to data from EY.

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Unlocking Mexico’s Potential

Regulatory changes in Mexico are opening up the country’s booming energy market to private equity investments

The Panelists

George Osorio  
Managing Partner,  
Conduit Capital Partners

Maximiliano Del Vento  
Vice President,  
Partners Group

Oscar Lopez-Velarde  
Tax Partner,  
Latin American Business Center,  
EY


Del Vento previously worked at Merrill Lynch, covering private clients and middle-market institutions in Latin America, and as an associate at Bank of America Merrill Lynch global investment bank. He holds a master’s degree from the University of Barcelona, an LL.M. from the University of Torcuato Di Tella, and a law degree from the University of Belgrano.

Lopez-Velarde is a Mexican licensed attorney and tax leader for the country’s oil and gas industry. He has recently been the Mexican leading adviser for two of the major oil-field services companies connected with the Contratos Incentivados granted to companies by PEMEX. He is a professor of Tax Law and International Taxation at the Iberoamericana University.

A sense of excitement surrounds the new energy investment opportunities in Mexico which can be heard from a few people who have actually complete private equity deals in the space.

Consider, for example, a story told by George Osorio, managing partner of Conduit Capital Partners, a private equity firm specializing in energy, which completed a hydroelectric investment in Mexico in 2002. The difficulty of that project convinced Osorio that investments in Mexico would always be characterized by complexity and pain. He relates encounters he had in the early 2000s with Mexican regulatory officials: “We would have discussions with [government entities] CRE and CFE…and we were trying to start the conversation about opening up the sector, opening it up for private investment and potentially privatization. We would literally be laughed at as they said that would never happen in Mexico: ‘It’s too nationalistic. This is part of our national resource, and we don’t intend to ever open it up.’ Fifteen years later, look where we are—it’s happening.”
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Osorio says he is optimistic that the benefits of the reform will be obvious enough to policymakers that the reforms are likely to remain in place, whether or not there is a change of government. He believes that Mexico will avoid some of the “growing pains” of countries like Argentina and Venezuela because of its strong ties with the U.S. and Canada. He says that while the reforms do not yet promise “straight-out privatization,”
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Petraeus believes Mexico’s potential is significant, given the growing middle class, the country’s manufacturing boom, and its oil and gas resources.

The cost of labor in Mexico is now only a bit more expensive than in China, following a decade of double-digit increases in the cost of Chinese labor, which means manufacturing may be “in-shored” back to Mexico. Improved technology would also help boost productivity in Mexico.

“There is no question that Mexico’s got a variety of different challenges, but there’s also no question that President Peña Nieto has really been taking them on quite head-on,” Petraeus says, noting in particular the energy sector reform, which should encourage investment and allow higher volumes of oil and gas production.

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The suite of reforms are “the best thing that could happen, and I’m not just saying for Mexico—for the region, including the U.S., including its neighbors, including all of South America,” says Osorio. “This has far-reaching effects, and I don’t think people appreciate it.”

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Osorio, a pan-Latin American investor, is enthused about Mexico as a destination for his firm’s investment activities. “Mexico is our number one target, by far, out of all the countries in the region,” he says.

But as someone who has completed three deals in Mexico, Osorio cautions that energy projects in particular need to begin with community buy-in—a cultural factor that the reforms do not negate. “The thing I would say about Mexico investing is that, unlike any other country in Latin America, development means you talk to the community first,” he says. “Forget the feasibility studies, forget your energy research, forget your legal structures. You need to talk to the community first.”

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Much remains to be seen in the way the reforms are implemented in Mexico, but the savviest energy investors in the private equity market seem to agree: The changes in Mexico are real, and the moves to participate in a new market opportunity are emphatic.
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Macquarie Group established a presence in Mexico five years ago, focusing on infrastructure investing. Jonathan Davis Arzac heads a fund in the country and explains how reforms are helping private capital investments.

Jonathan Davis Arzac is executive chairman of the Macquarie Mexican Infrastructure Fund. He was previously president at DAVAR Consultores and president at Mexico’s National banking and Securities Commission. He received degrees from Universidad Nacional Autonoma de Mexico.

Privcap: There’s a big focus on reforms in Mexico in terms of foreign and domestic private capital flowing into the country. How do you see those reforms affecting your business in Mexico and also private equity?

Arzac: Macquarie focuses on infrastructure, and there will be a lot of opportunities there and in the energy sector due to the reforms being passed. These reforms bring private investment into Mexico to complement the projects that need to be built for which the government has no capital, and to give security to investors in their programs guaranteeing that laws will not be turned around once they bring their investments in.

In the energy sector, the reform as it stands today opens up the sector that was exclusively for the monopoly that the government has in the oil industry. Today, in theory, private companies will be able to participate upstream in the exploration fields, as well as downstream—things that weren’t possible before.

Privcap: We talked about the possibility of—as the reforms get formalized—venturing into the energy market. Do you expect Macquarie’s focus to remain in energy infrastructure investing?

Arzac: Taking into account the structural reforms in terms of energy, Macquarie would not be that interested in upstream activities, but certainly in mid-stream and downstream. We’ve had several conversations with government officials and see a great interest in inviting the private sector through public/private partnerships, or to let the private sector completely take over things like refineries, to get involved in transportation or distribution, not only of hydrocarbons like oil but also electricity and power-generating units.

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Arzac: In Mexico, we have rich wind resources. We’ve identified areas in the state of Oaxaca where we are interested in building a wind farm, and we’ve been working towards that objective. In order to create a project from scratch, you have to do a lot of work-permitting with the environmental authorities, with the federal commission of electricity, with the regulator of power. We have to put together a consortium of investors because, for the fund, these investments are quite big, and we don’t have the size to take it all on ourselves, and we like to diversify risk. It’s an investment of over $1B and would probably become the largest wind farm created in one stage of all Latin America.
Mexico’s Energy Sector and PE, by the Numbers

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Source: Pitchbook

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Source: Binational Center Library/ Texas A&M International University; EY

Private Owners Gaining Ground
Mexico’s current privately owned electric capacity growth

Source: U.S. Energy Information Administration
Reforms Will Boost Mexican Economy

KKR Global Institute’s Vance Serchuk and KKR’s Henry McVey on the changes that will make the country a bigger target for private equity investment, and other factors that make it an appealing market

There are numerous reasons to be bullish on investing in Mexico, says KKR’s head of global macro and asset allocation, Henry McVey. McVey says Mexico’s demographics remain positive, commercial property rents are cheap, and once financial services reforms are completed, credit is likely to flow, which should boost consumer spending and corporate spending in small and medium businesses.

Meanwhile, Mexico has strong internal demand from domestic consumers, with close to 70 percent of the country’s GDP created by consumption, compared to China’s 36 percent. Mexico also has higher GDP per capita than most emerging markets, at $11,000.

“From a macro standpoint, this is wildly different from other things we see in the emerging-market opportunity set,” McVey says.

KKR Global Institute executive director Vance Serchuk says President Peña Nieto, who came to office in July 2012, has been able to bring about structural reform through the Pact for Mexico. The country’s three major political parties have joined to push through changes in areas like energy, telecommunications, and governance.

This is a three-to-five-to-seven-year play. You have to know where you want to participate. It’s important to have local expertise, and it’s important to be with the right people. Ultimately, the private equity business there will continue to grow, and it’s important that, in private equity, you can target where you see the key changes.”

Serchuk says security remains a concern for investors, with a weak role of law and legal institutions like prisons and courts, and little in the way of structural reforms from the Peña Nieto government.

“For investors, it also means you’ve got to take this into consideration and really be granular in your analysis of how you might be exposed to these kinds of risks,” Serchuk says.

Evolution of GPs and Capital Commitments in Mexico (2000-2013)

Source: AmexCap 2014
“Room for Everyone” to Invest in Mexican Energy

Reforms to a major energy market spell opportunity for a broad swath of investors, says Alfredo Alvarez of EY

Investors and operators on both sides of the border are still digesting the news that Mexican energy is now a private sector opportunity.

Alfredo Alvarez, a partner in EY’s New York and Mexico City offices, was one of those hoping for the changes. “There was a lot of enthusiasm in the market,” he says, “but at the same time a little bit of skepticism before the final reforms were approved.”

After President Enrique Peña Nieto took office in 2012, a series of structural reforms were put in place, including an ambitious plan to open the country’s energy sector to private investors. Since the 1930s, Pemex, the government-owned petroleum company, has been the only player in Mexico’s energy sector.

Since the reforms passed, Alvarez says he’s been contacted by several private equity firms, both foreign and local, including those that have been successful in the real estate market of Mexico. He began hearing from people in the PE space, long before the laws were published in early August. “They were saying, ‘We’re here, but we’re still thinking,’” he says, “Now the noise is ‘We’re here, [and] we want to get in.’”

Even though the reforms have just been made law, Alvarez says that state-owned Pemex and the regulators have already begun looking at analyzing joint ventures for certain oil fields. He adds that “we could start seeing the first bids for JVs with Pemex maybe announced this year or early 2015.”

All three segments of oil and gas—upstream, midstream, and downstream—are fully open for private investment. “We’ll certainly be seeing the first news of outside investment in 2014,” says Alvarez.

“Private equity will be active in all of the areas the reforms have opened up, and some firms are trying to play in several areas rather than sticking to a certain segment,” says Alvarez.

Though the reforms have passed, private investors should still expect some surprises as they take advantage of the new rules, he says, adding that “approval was so clear, with the rules so well prepared, that everyone’s really optimistic that any challenges will be resolved.”

We expect a refinement of certain rules, and some regulations have yet to be published. Alvarez points out, “We’re not expecting something that will change the rules, but will assist in the implementation of the rules.”

In the end, it comes down to capital; the size of the investment Mexico will need in all energy sectors reflects that there is space for anyone who wants to invest.

The views reflected in this article are the views of the author and do not necessarily reflect the views of the global Ernst & Young organization or its member firms.
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PRIVATE CAPITAL AND THE TRANSFORMED NORTH AMERICAN OPPORTUNITY

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JOANN RICH
Director of Private Markets, Washington University Investment Management Company

R. JAMES WOOLSEY
Former Head, Central Intelligence Agency

FERNANDO CALVILLO ALVAREZ
CEO & President, Fermaca Group

JOHN HOFMEISTER
Former President, Shell Oil Founder, Citizens for Affordable Energy

MICHAEL McMahan
Managing Director, Energy Investment Team, Pine Brook

For more information, contact Gill Torren, gtorren@privcap.com, 646-233-4559
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The Panelists

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Consider, for example, a story told by George Osorio, managing partner of Conduit Capital Partners, a private equity firm specializing in energy, which completed a hydroelectric investment in Mexico in 2002. The difficulty of that project convinced Osorio that investments in Mexico would always be characterized by complexity and pain. He relates encounters he had in the early 2000s with Mexican regulatory officials: “We would have discussions with [government entities] CRE and CFE...and we were trying to start the conversation about opening up the sector, opening it up for private investment and potentially privatization. We would literally be laughed at as they said that would never happen in Mexico: ‘It’s too nationalistic. This is part of our national resource, and we don’t intend to ever open it up.’ Fifteen years later, look where we are—it’s happening.”

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INTERVIEW /

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A breakdown of Mexico’s potential energy capex, by sector

Source: U.S. Energy Information Administration

Private Owners Gaining Ground
Mexico’s current privately owned electric capacity growth

Source: Binational Center Library/ Texas A&M International University; EY

Source: Pitchbook
Reforms Will Boost Mexican Economy

KKR Global Institute’s Vance Serchuk and KKR’s Henry McVey on the changes that will make the country a bigger target for private equity investment, and other factors that make it an appealing market

There are numerous reasons to be bullish on investing in Mexico, says KKR’s head of global macro and asset allocation, Henry McVey. McVey says Mexico’s demographics remain positive, commercial property rents are cheap, and once financial services reforms are completed, credit is likely to flow, which should boost consumer spending and corporate spending in small and medium businesses.

Meanwhile, Mexico has strong internal demand from domestic consumers, with close to 70 percent of the country’s GDP created by consumption, compared to China’s 36 percent. Mexico also has higher GDP per capita than most emerging markets, at $11,000.

“From a macro standpoint, this is wildly different from other things we see in the emerging-market opportunity set,” McVey says.

KKR Global Institute executive director Vance Serchuk says President Peña Nieto, who came to office in July 2012, has been able to bring about structural reform through the Pact for Mexico. The country’s three major political parties have joined to push through changes in areas like energy, telecommunications, and governance.

This is a three-to-five-to-seven-year play. You have to know where you want to participate. It’s important to have local expertise, and it’s important to be with the right people. Ultimately, the private equity business there will continue to grow, and it’s important that, in private equity, you can target where you see the key changes.”

Serchuk says security remains a concern for investors, with a weak role of law and legal institutions like prisons and courts, and little in the way of structural reforms from the Peña Nieto government.

“For investors, it also means you’ve got to take this into consideration and really be granular in your analysis of how you might be exposed to these kinds of risks,” Serchuk says.*
“Room for Everyone” to Invest in Mexican Energy

Reforms to a major energy market spell opportunity for a broad swath of investors, says Alfredo Alvarez of EY

Investors and operators on both sides of the border are still digesting the news that Mexican energy is now a private sector opportunity.

Alfredo Alvarez, a partner in EY’s New York and Mexico City offices, was one of those hoping for the changes. “There was a lot of enthusiasm in the market,” he says, “but at the same time a little bit of skepticism before the final reforms were approved.”

After President Enrique Peña Nieto took office in 2012, a series of structural reforms were put in place, including an ambitious plan to open the country’s energy sector to private investors. Since the 1930s, Pemex, the government-owned petroleum company, has been the only player in Mexico’s energy sector.

Since the reforms passed, Alvarez says he’s been contacted by several private equity firms, both foreign and local, including those that have been successful in the real estate market of Mexico. He began hearing from people in the PE space, long before the laws were published in early August. “They were saying, ‘We’re here, but we’re still thinking,’” he says, “Now the noise is ‘We’re here, [and] we want to get in.’”

Even though the reforms have just been made law, Alvarez says that state-owned Pemex and the regulators have already begun looking at analyzing joint ventures for certain oil fields. He adds that “we could start seeing the first bids for JVs with Pemex maybe announced this year or early 2015.”

All three segments of oil and gas—upstream, midstream, and downstream—are fully open for private investment. “We’ll certainly be seeing the first news of outside investment in 2014,” says Alvarez.

“Private equity will be active in all of the areas the reforms have opened up, and some firms are trying to play in several areas rather than sticking to a certain segment,” says Alvarez.

Though the reforms have passed, private investors should still expect some surprises as they take advantage of the new rules, he says, adding that “approval was so clear, with the rules so well prepared, that everyone’s really optimistic that any challenges will be resolved.”

We expect a refinement of certain rules, and some regulations have yet to be published. Alvarez points out, “We’re not expecting something that will change the rules, but will assist in the implementation of the rules.”

In the end, it comes down to capital; the size of the investment Mexico will need in all energy sectors reflects that there is space for anyone who wants to invest.

The views reflected in this article are the views of the author and do not necessarily reflect the views of the global Ernst & Young organization or its member firms.

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