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Venture Capital 2024

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MEXICO

Law and Practice

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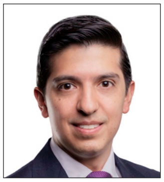

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1. Trends

1.1 VC Market

The most sizable/landmark VC-related transactions over the past 12 months include the following:

- QED Investors led a USD25 million Series A+ for Zubale, a Mexican fulfilment services marketplace connecting independent contractors with retailers;
- Third Prime led a USD6.5 million round for Finerio Connect, a Mexican fintech offering businesses an API for enterprise account management, with participation from Alaya Capital, Visa and Bancolombia Ventures;
- NAZCA and IDB Invest led a USD15.5 million Series A for Wonder Brands, a Mexico- and Argentina-based e-commerce aggregator looking to acquire independent brands selling on platforms such as Amazon and Mercado Libre, with participation from CoVenture, SilverCircle, Korify Capital, Infinitas Capital and GBM Mexico;
- Mexico-based personal finance management and lending platform Klar secured a USD100 million credit line from Victory Park Capital;
- Dalus Capital and Foundation Capital led a USD10 million seed round for Clivi, a Mexican diabetes healthcare delivery platform, with participation from FEMSA Ventures, Cathay Innovation, Quiet Capital, 500 Global, Next Billion Ventures and Conexo;
- IDB Invest provided a USD15 million structured loan to Habi, a Colombian residential real estate platform, to launch operations in Mexico;
- Community Investment Management provided a USD50 million credit line to Stori, a Mexico-based credit card issuer for the underbanked;
- Niya Partners and Tribe Capital led a USD20 million Series A for Kapital, a Mexican finance management platform for SMEs, with participation from Broom Ventures, FoundersX, True Capital Management, Pioneer Fund, Kube VC, MyAsia VC and angel Arash Ferdowshi (Dropbox);
- Mexico-based embedded lending infrastructure company R2 closed a USD100 million warehouse facility from Community Investment Management;
- L Catterton made an undisclosed follow-on investment in Ben & Frank, a Mexico-based D2C eyewear brand; and
- GGV led a USD60 million Series B+ for Clara, a Mexican corporate expense management platform, with participation from Endeavor Catalyst, Citi Ventures, Acrew Capital, Ethos, Commerce Ventures, Goanna Capital, Bayhouse Capital and Fluente Ventures, and follow-on from Monashees, Coatue and others.

1.2 Key Trends

The venture capital ecosystem suffered a slowdown in Mexico over the last 12 months. Start-ups continue to implement structures in which the holding company is located outside of Mexico, as that allows them to attract venture capital funds from outside Mexico. Valuations have not changed substantially, and transactions have been reduced due to the limited funds in the region.

1.3 Key Industries

Software continues to be highly attractive for venture capital investments, including SaS, marketplaces, e-commerce aggregators, etc. Other attractive industries include financial services, such as neobanks/finance management platforms, credit card issuers and payment processors, as well as edtech and healthtech.

2. VC Funds

2.1 Fund Structure

VC funds are typically organised as trusts or *asociaciones de participación*, which are the two Mexican vehicles that are deemed transparent for tax purposes. VC funds typically have a General Partner or Manager that takes all or most of the decisions. The corporate documentation that will govern the affairs of the fund is the trust agreement or the *asociación en participación* agreement, together with the professional services agreement with the Manager of the fund.

Decisions are typically adopted by the Manager or General Partner, and by an Investment Committee. In some cases, certain major key decisions need to be approved by a majority or special majority of investors.

2.2 Fund Economics

Venture capital principals typically assist by identifying investment opportunities for the fund, conducting due diligence on target companies, helping to manage portfolio companies, and performing a variety of other duties. In exchange, they are entitled to receive a management fee and a carried interest. They also generally co-invest in the fund, with other investors. As in other jurisdictions, venture capital funds in Mexico typically include customary investor protections, such as key man provisions, manager removal events, dedication of time by key managers, conflict of interest provisions, non-compete and non-solicitation, among others.

2.3 Fund Regulation

Venture capital funds are not regulated in Mexico.

2.4 Particularities

The venture capital ecosystem has accelerated in Mexico in recent years, especially in 2021 when VC investment boomed. Venture capital fund investments are generally made in start-ups and SMEs, which are important engines of employment creation and economic growth. There are certain impact funds whose investment thesis opportunity is to drive a positive social, technological and environmental impact upon its investments, while funds-of-funds hold the dual mandate of generating attractive risk-adjusted returns while promoting the private equity ecosystem in Mexico.

3. Investments in VC Portfolio Companies

3.1 Due Diligence

In-depth due diligence usually focuses on corporate, material contracts, intellectual property, employment matters, tax, litigation and regulatory matters. Generally, counsel is asked to provide a report on red flags only, limited to identifying material contingencies of the target.

3.2 Process

A new financing round would generally take between one and two months as of the date legal and tax due diligence begins. Negotiations of the term sheet and commercial due diligence are carried out before legal and tax due diligence begins, and the investment agreements are negotiated while the legal and tax due diligence is being carried out. VC counsel will take the lead in preparing the investment agreements; if more than one VC fund is participating in the financing round, the leading VC will take the lead in negotiating the agreements, but all of the VCs participating in the financing round will have to agree upon the agreements.

3.3 Investment Structure

Preferred shares grant the corresponding shareholder preferred rights, which may include preferred dividends, a certain number of board seats, anti-dilution protections, and a liquidity or liquidation preference.

3.4 Documentation

The typical key documents comprising a financing round in a growth company in Mexico are a Subscription Agreement and a Shareholders' Agreement (which are incorporated into the bylaws of the company), together with the ancillary documents related thereto, such as shareholder resolutions and other closing corporate documents. Simple agreements for future equity (SAFEs) are commonly used in the US but lack certain terms and conditions that may prevent investors subscribing and paying for the corresponding shares.

As opposed to the US, where existing templates from the National Venture Capital Association are available, there are no templates that the market relies upon in Mexico; however, there are certain US practices that have been taken into consideration and imported and tailored to Mexico.

3.5 Investor Safeguards

VC investors are typically able to include weighted average (as opposed to full ratchet) anti-dilution provisions, liquidation preference provisions and pre-emptive rights for the subscription of new shares. Anti-dilution and liquidation preference provisions are generally effective for a certain period of time. Pre-emptive rights are typically granted to all investors, including founders, but excluding employees.

3.6 Corporate Governance

VC investors typically have the right to appoint a Board Member and the right to call shareholders' meetings. They do not generally have veto rights, unless they hold approximately 15% or more of the voting shares. VC investors typically do not have drag-along or similar liquidity rights, unless they hold approximately 50% or more of the voting shares. Redemption rights (or similar put rights against the company) are not typically granted to VC investors.

3.7 Contractual Protection

Customary representations and warranties include fundamental representations (ownership of shares, due organisation, capacity and legal authority), operational representations related to the company's business, tax representations, anti-money laundering, anti-corruption and data privacy laws. Covenants are related to interim operating provisions that affect or restrict how the company operates from the date of the agreement and until closing – ie, operating in the ordinary course of business. Post-closing, founders are also bound by non-compete provisions, and investors have access to financial information, among others.

Indemnity provisions are limited to fraud or wilful misconduct.

4. Government Inducements

4.1 Subsidy Programmes

There are no government/quasi-government programmes to incentivise (equity) financings in growth companies in Mexico.

4.2 Tax Treatment

Mexican Tax Treatment

There are no particular tax incentives geared towards investment in growth/start-up/VC fund portfolio companies, so all these Mexican entities receive the same tax treatment as any other Mexican resident entity. They are required to determine their Mexican income tax on an annual basis, applying a flat 30% corporate income tax rate to their "taxable result", which is determined by subtracting the following from their annual gross taxable income:

- authorised deductions;
- the employees' profit-sharing amount paid in the corresponding fiscal year; and
- the Net Operating Losses (NOLs) from previous years.

Implications for Non-Mexican Investors Investing in Growth/Start-Ups/VC Funds in Mexico

Pursuant to Mexican tax provisions, Mexican-source income earned by non-Mexican residents is generally subject to Mexican withholding tax. Capital gains derived from the transfer of shares are considered to be from a Mexican source if the issuer of the shares is a Mexican resident entity or if the accounting value of the shares is represented, directly or indirectly, more than 50% by immovable property located in Mexico.

As a general rule, transfers of Mexican shares by non-Mexican residents are subject to tax at a rate of 25% on the gross proceeds of the transaction (ie, sale price, fair market value), without any deduction. Alternatively, upon election by the seller, the transfer of shares may be subject to tax on the net gain. Under this election, the gain (if any) realised upon the transfer of Mexican shares should be subject to a 35% tax rate, before consideration for applicable treaty rates, to the extent that certain requirements are met, including appointing a legal representative in Mexico. In addition, non-Mexican residents may be subject to a 10% withholding tax when the entity distributes dividends. The 10% tax rate can be reduced by claiming the benefits of a tax treaty.

Tax Treatment for Common Investment Structures

There is a growing trend of investing in Mexican growth/start-ups/VC fund portfolio companies using Cayman entities or US limited liability companies (LLCs) that are not subject to US taxes. In principle, this investment structure seems to be tax efficient since only the direct transfer of shares issued by Mexican resident entities or the indirect transfer of shares in Mexican land-rich assets are subject to taxes in Mexico. This trend has led to increased transfers of Mexican investments, assuming that there will be no capital gains taxes if investors sell the Cayman entity or the US LLC.

However, Mexican tax residency is determined based on factors such as the main place of business administration or effective management, rather than merely the location of incorporation. Under these structures, many holding companies, where operations and management remain in Mexico, are likely to be considered Mexican tax residents, making the sale of their shares subject to Mexican income tax.

Implications for Mexican Investors

Mexican residents (entities and individuals) are subject to income tax on income from worldwide sources. Consequently, Mexican entities are taxed in Mexico at a rate of 30% on income earned from this type of investment (except for dividends distributed by Mexican legal entities, which qualify as non-taxable income), and

Mexican individuals are subject to a progressive tax rate of up to 35%. Mexican individuals who receive dividends from non-Mexican resident companies should be subject to an additional 10% tax rate.

4.3 Government Endorsement

A systematic issue for VC funds in Mexico is identifying exit strategies that maximise the value of their investments. Mexico's securities market is a natural exit strategy for many investors, such as VC funds, but is relatively illiquid and has shrunk over the past few years. In December 2023, a series of structural amendments to the Mexican Securities Market Law, supported by Mexico, were enacted to:

- incorporate a new simplified procedure for the registration of securities in the Mexican National Securities Registry; and
- make amendments to the issuers' corporate regime aimed at revitalising the Mexican securities market, including the removal of the ceiling for non-voting stock.

5. Employment Incentives

5.1 General

Long-term commitment is often sought by offering equity (or equity-linked incentives) to employees, which provides them with a sense of ownership and aligns the incentives for employees with those for equity holders.

5.2 Securities

Incentive plans are typically structured as stock options, phantom shares, performance bonuses or profit sharing mechanisms. In Mexico, companies tend to prefer to grant stock options, which are typically the most burdensome to implement. ESOP shares are typically kept in the treasury of the company and are given (assigned) to the employees for subscription and payment upon certain conditions provided for in their employment agreements being met. Such shares are typically non-voting shares and are subject to special transfer provisions. These incentives usually create corporate, labour and tax concerns, and should be structured carefully.

5.3 Taxation of Instruments

The tax considerations that determine the structure of an incentive pool are diverse. Firstly, it is important to consider the type of incentive offered, whether it is in the form of stock options, phantom shares, performance bonuses or profit sharing, among others. Each of these incentives may have different tax implications for both the company and the beneficiaries.

Secondly, it is relevant to consider the applicable tax treatment for each type of income or benefit. For instance, stock options may be subject to tax at the time of subscription of the shares, while phantom shares or performance bonuses may be taxed at the time of payment of the economic benefits.

In addition, the applicable tax rate may vary depending on the type and amount of income; however, most such benefits (when paid either in cash or in shares) are deemed salary payments for Mexican tax purposes.

In summary, when structuring an incentive pool, it is crucial to consider not only the type of incentive offered but also the tax implications for both the company and the beneficiaries, including the applicable tax rate and the timing of taxable events.

5.4 Implementation

How the implementation of an investment round and the set-up/installation of an employee incentive programme typically inter-relate depends on whether stock options have vested or not, and whether the investment of such stock options may dilute the share participation of the investor as a result. Due to the formalities to issue new shares in Mexico, determining the number of shares that would correspond to the investor can be a complex issue.

6. Exits

6.1 Investor Exit Rights

The exit-related provisions that typically govern the shareholders' rights amongst one another in relation to a sale or IPO of the venture or another liquidity event include a right of first offer, a tag along and a drag along, as well as piggyback and registration rights. A right of first offer provision is often included to give certain major VC investors the first option to purchase the shares of the company in a potential sale before they are offered to other third parties. A tag along is granted to the VC investors for any transfer by a key holder for which the rights of first offer are not exercised. A drag along right is typically granted to shareholders representing more than 50% of the share ownership, who will then generally be able to force the other shareholders to co-sell their shares to a prospective buyer who wishes to acquire the entire company. Documentation may also include lock-ups (especially for founders, for a certain period of time) and customary exemptions thereto for permitted transfers.

The decision of which exit strategy to pursue is typically made by the company's board of directors, with input from the company's management team and advisers. The decision is based on a number of factors, including the stage of the company's development, the market conditions at the time, and the preferences of the shareholders.

6.2 IPO Exits

Mexico's securities market is relatively illiquid. The lack of penetration of financial services in the general population, coupled with a limited number of institutional and qualified investors, low valuations and significant delays in the review process by Mexican regulators, has relegated the Mexican securities market as a viable exit strategy or even an attractive alternative for VC funds. No primary IPOs from Mexican issuers have taken place since 2020, and the most recent IPO by a Mexican company was registered in the US exclusively, not in Mexico.

6.3 Pre-IPO Liquidity

There is very limited liquidity and the few options would be among VC funds or PE funds that have begun to do VC investments and are looking to obtain control. Although it is not very common, employees sometimes have the option to participate in buybacks. The main challenge is that all distributions, including buybacks, are made pro rata; if there is the intention to distribute them non-pro rata, different series of shares would need to be created so that such non-pro rata distributions are a special right of a particular series.

7. Regulation

7.1 Securities Offerings

Any public offering of securities in Mexico requires the prior registration of the securities with the National Securities Registry maintained by the Mexican Banking and Securities Commission (CNBV). However, the recently enacted reform to the Securities Market Law enables a company to conduct a public offer pursuant to an expedited process, known as a simplified registration process, in which case the CNBV's review and approval are not required. However, only institutional and qualified investors are entitled to purchase stock issued pursuant to a simplified registration process, which may limit the liquidity. Both traditional and simplified registration processes require the preparation of a prospectus or supplement and filing for registration with the CNBV or the corresponding Mexican stock exchange, respectively.

7.2 Restrictions

Foreign (and national) VC investors may be restricted from investing in certain sectors of the Mexican economy, which are regulated. There may be foreign investment restrictions, as is the case in transportation, mining and telecommunications, and/or the need to obtain prior approval to invest, as is the case in insurance companies, fintech or banking. Depending on the sector in which the target company operates, applicable restrictions may apply.

Trends and Developments

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Real Estate in Mexico: An Introduction

Mexico offers a wide range of opportunities for venture capital funds and companies looking to receive investment from venture capital funds. Venture capital in Mexico has been experiencing dynamic changes and growth, driven by a robust start-up ecosystem, technological innovation and an increasingly favourable regulatory environment. Venture capital in Mexico began approximately 14 years ago, and 2021 was a record year for the ecosystem, having approximately 167 deals with an investment of approximately USD4.7 billion.

In terms of industries, software, fintech, consumer services and data companies have been the preference for venture capital funds, with the fintech industry attracting the most such funding in Mexico over the last four years.

In terms of the distribution of investments by country in Latin America, Brazil has received the most venture capital investments, followed by Mexico. Chile and Colombia have also received significant investments.

Fintech

Fintech is one of the most active sectors, with neobanks/finance management platforms, credit card issuers and payment processors attracting many investments from venture capital funds.

Mexico lags in terms of financial inclusion, with only 37% of adults having accounts as of 2021, and just 32% having made or received digital payments. This means that more than 60% of adults do not have access to formal financial services such as banking, saving and credit. By developing and implementing more fintech solutions, the Mexican government expects to fix this lack of access to the financial system.

The Fintech Law was implemented in 2018, providing clear rules to help spur investment in this sector. According to the Mexican Banking and Securities Commission (CNBV), financial inclusion in Mexico has four fundamental components:

- access – infrastructure available to offer financial services and products;
- use – acquisition of one or more financial products or services;
- consumer protection – new or existing financial products and services are under a framework that guarantees transparency of information, fair treatment and good practices; and
- financial education – the population acquires the skills and knowledge to be able to correctly manage and plan their personal finances.

Fintech has played an important role in driving this change, which is why fintech (neobanks/finance management platforms, credit card issuers and payment processors) has been the preferred industry of the main venture capital funds.

Venture capital ecosystem

The venture capital ecosystem suffered a slowdown in Mexico in the last 12 months and it does not seem that 2024 will see a return to the record-breaking high of 2021. However, there are positive signs that venture capital activity is modestly picking up. In Mexico, and also across Latin America, some of the largest funds are looking to make investments in artificial intelligence, logistics and climate technology, including more investments in eco-friendly companies that provide or develop solutions for renewal energy generation, carbon removal and environmental monitoring, and in companies that place importance on environmental, social and governance (ESG) and are socially responsible. Venture capital funds will also focus on companies with diverse leadership teams and diverse and inclusive workplaces.

Valuations

Valuations have not changed substantially. Expectations between founders and investors continue to adjust, and transactions have been reduced due to the limited funds in the region. Venture capital funds are prioritising profitability and the existence of a good and conservative runway until the following round, due to the fact that funds are limited to follow-ons; therefore, venture capital funds are being more selective in their investments.

Structures

Reforms to Mexican laws have added obligations for Notary Publics to request documents and information from each equity or shareholder and from the beneficial owner of each of shareholder in order to comply with international standards that require minimum levels of transparency in connection with the beneficial owners of companies for tax purposes and to make it more difficult to hide criminal activities and illicit funds, by identifying the individual or groups of individuals (natural persons, behind legal entities) who effectively control or benefit financially from a legal entity. Following these changes, international funds have found it burdensome to incorporate Mexican entities, to say the least.

However, local and international investors continue to ask start-ups to implement a structure in which the holding will be a Cayman entity, if they have not already done so. As this is the entity in which the investors will be located, the Cayman entity will wholly own an intermediary company, typically an LLC incorporated in Delaware, which in turn will wholly-own the Mexican operating company. Depending on the investors of the venture capital fund, some investors, for tax reasons, have asked for a UK holding company instead of the Cayman entity, but the Cayman-Delaware-Mexican entity has been the predominant structure.

In this structure, the corporate governance and all financing agreements are generally governed by Cayman Islands law and the entire operation of the company, its intellectual property and employees are within the Mexican entity. Due to the substantial increase in the taxation of Mexican entities by the Mexican authorities, venture capital funds are starting to ask for confirmation that this structure and the Mexican operating entity are in compliance with Mexican laws.

Exit

Venture capital funds also choose the abovementioned structure for exit reasons, considering that such structure would be more attractive to international players and therefore a liquidity event would not be limited to local strategic players, thus broadening the spectrum to local and international buyers. Venture capital funds will most likely look for an exit in the securities market rather than a sale to a strategic player or another fund.

The Mexican securities market has been relatively illiquid and has shrunk over the past few years. In an effort to revitalise it, a reform to the Mexican Securities Market Law was proposed by the Mexican authorities, such as the Ministry of Finance and the CNBV, the Mexican stock exchanges – Mexican Stock Exchange (BMV) and the Institutional Stock Exchange (BIVA) – and the different associations representing financial and securities advisers and intermediaries. As a result, a series of structural amendments to the

Mexican Securities Market Law were enacted in December 2023, with the following main aims.

- To enable a company to conduct a public offer pursuant to an expedited process, known as a simplified registration process, in which case the CNBV's review and approval are not required. However, only institutional and qualified investors are entitled to purchase stock issued pursuant to a simplified registration process, which may limit the liquidity. Both traditional and simplified registration processes require the preparation of a prospectus or supplement, and filing for registration before the CNBV or the corresponding Mexican stock exchange, respectively.
- To make amendments to the issuers' corporate regime, including the removal of the ceiling for non-voting stock.

The venture capital environment in Mexico is expected to continue to grow, mainly due to the digital transformation and the supportive regulatory framework.

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