Luis Cervantes Shares Thoughts on Building the Equity Capital Markets in Mexico

Developing the Mexican Capital Markets

Mexico is an exciting emerging market for global investors. It is a large, growing and young country. It has produced world-class entrepreneurs that have founded global champions across industries. At General Atlantic, Mexico represents approximately five percent of our global portfolio of more than US$28 billion. Those Mexican investments were selected among thousands of investment opportunities we evaluated across the globe.

Despite the attractiveness of Mexico as an investment destination, its capital markets remain deeply underdeveloped. Supply of investment opportunities is limited, with just 160[i] listed companies (vs. more than three thousand[ii] in India) and less than 300 corporate debt issuers[iii] (vs. ~3,000 in the US[iv]). Demand for these investments is also scarce, with only 264,000 brokerage accounts[v] (vs. over 20 million[vi] in the US) and over 70%[vii] of pension fund assets invested in fixed income products.

It is our view that developing the capital markets should be among the top priorities for all market participants in Mexico: regulators, investors, issuers and intermediaries. Research indicates that the size of the capital markets is positively correlated with economic development (growth in the size of the stock market has a 1-to-1 causal relationship with growth in GDP per Capita[viii]). Furthermore, capital market liquidity enables investors and issuers to meet their requirements in the market, reducing investment silver bullet. The development of the capital markets will result from the interaction of many interventions rather than from a single initiative. These are the initiatives we believe would boost both supply and demand of capital market products in Mexico:

- **Pension Fund Regulation**. Mexico has one of the lowest pension fund contribution ratios among OECD countries (6% vs average of 18%[x]). Increasing the size of the pension industry by ten percentage points of GDP could result in a growth of seven percentage points of GDP in the size of the stock market[xi]. Furthermore, regulation that prohibits investments by pension funds in local mutual funds should be amended as this is limiting the emergence of a competitive asset management industry.
- **Development of the Independent Financial Advisors ("IFAs") industry to distribute investment products**. Close to 80%[xii] of financial products in Mexico are still distributed thru bank branches. In Brazil, we have seen independent brokerage firms with as many as 4,000[xiii] IFAs capture over 30% market share in the equity brokerage industry. Regulators need to promote and appropriately regulate IFAs. Local asset managers should embrace this distribution channel and serve it thru open architecture platforms.

- **Financial Education for retail investors.** There are three[xiv] times more cryptocurrency accounts than brokerage accounts in Mexico, and nearly 60%[xv] of retail assets are invested in checking accounts, highlighting the lack of financial sophistication among retail investors. The BMV and BIVA should form partnerships with EdTech providers to develop online financial education courses for retail investors. The preparation and advertisement of these courses should be financed by intermediaries in return for the right to offer brokerage accounts to the graduates of these courses. Intermediaries should continue investing in technological platforms, including the development of robo-advisors, to facilitate market access for retail investors.
- **Tax incentives for retail investors.** Only one in every 500 Mexicans trade in the stock exchange (vs. one in every 10 Americans)[xvi]. Thailand's decision to eliminate capital gain taxes for retail investors resulted in a 2x[xvii] growth in the number of retail brokerage accounts in five years (retail investors now represent 55%[xviii] of average volume traded in Thailand). We believe that in Brazil, a tax provision allowing investors to compensate taxes across mutual funds ("Conta e Ordem") significantly accelerated inflows into the industry. If similar incentives were offered in Mexico, they likely would accelerate the development of a sizable retail investor network.
- **Incentives for new issuers.** The number of public issuers in Mexico has decreased in recent decades[xix]. Regulation should allow for the listing of dual classes of shares (voting and no voting) in order to motivate family own businesses that do not want to lose control. This is a common practice across most developed equity capital markets. We also believe that the recent regulation that aims to reduce the capital gain tax for new issuers should be implemented as soon as possible with no exceptions.
- **Performance of IPOs.** There have only been 20 IPOs since 2014, with an average share price performance of -11%[xx]. Intermediaries should be accountable on educating new issuers on the importance of delivering short-term results post-IPO. Half of new issuers since 2014 have missed its short term operating income targets by more than 5% and have thus achieved an average return of –29% on its stocks[xxi], hampering the attractiveness of IPO's as an investment product.
- **Liquidity and market makers**. Only 42 issuers in Mexico have sufficient liquidity[xxii]. Regulation allowing for the borrowing of securities (key enabler for short sellers) should be implemented as soon as possible. In addition, the exchanges and intermediaries should double down on its market making efforts, especially for mid and small-cap issuers.
- **Autonomous regulatory body**. The CNBV is tasked with the quasi-impossible mandate of regulating both the banking and the securities industries. The complexity and relative size of the banking industry prevents the CNBV to dedicate enough resources to the development of the emergent securities industry. An independent regulator should be appointed with the dual-mandate to develop and regulate the securities industry.

We believe the Mexican equity market should grow by at least five times in order to catch up with the size of its economy and the quality of its entrepreneurs. Many market participants, with the strong support of the government, have been making good progress. Now is the time to double down and work together as an industry to achieve this goal.

[i] Source: www.bmv.com.mx as of February 2019. Includes FIBRAs

[ii] Source: Capital IQ as of February 2019

[iii] Source: www.bmv.com.mx as of February 2019

[iv] Source: Capital IQ as of February 2019. Number of companies with publicly traded debt

[v] Source: Comision Nacional Bancaria y de Valores as of September 2018

[vi] Source: Brokerage Accounts in the United States. Advanced Analytical Consulting Group and Deloitte for the U.S. Department of Labor. November 2015. Number based on 17 million households that own brokerage accounts and assuming a ratio of 1.2x accounts per household for conservative purposes

[vii] Source: www.consar.gob.mx as December 2018

[viii] Source: Capital Markets and Economic Growth: Long-Term Trends and Policy Challenges. Research Report. Christoph Kaserer and Mark Steffen Rapp. March 2014

[ix] Source: Enhancing Liquidity in Emerging Market Exchanges. Oliver Wyman and World Federation of Exchanges. June 2016

[x] Source: Pensions at a Glance 2017: OECD and G20 Indicators. OECD Publishing. December 2017

[xi] Source: Capital Markets and Economic Growth: Long-Term Trends and Policy Challenges. Research Report. Christoph Kaserer and Mark Steffen Rapp. March 2014

[xii]Comision Nacional Bancaria y de Valores as of September 2018

[xiii]GA Analysis based on XP data

[xiv] Source: El Universal. En México hay 800,000 usuarios de activos virtuales, según datos de Bitso. News Article. February 2019.

[xv] Source: Boston Consulting Group estimates. October 2018

[xvi] Number of brokerage accounts divided by population of each country. Comision Nacional Bancaria y de Valores as of September 2018. Brokerage Accounts in the United States. Advanced Analytical Consulting Group and Deloitte for the U.S. Department of Labor. November 2015.

[xvii] Source: Enhancing Liquidity in Emerging Market Exchanges. Oliver Wyman and World Federation of Exchanges. June 2016

[xviii] Source: Enhancing Liquidity in Emerging Market Exchanges. Oliver Wyman and World Federation of Exchanges. June 2016

[xix] Source: World Federation of Exchanges as of February 2019. Number of listed companies in Mexico decreased from 165 in 2003 to 130 in 2008 and increased to 160 in 2018

[xx] Source: Capital IQ as of February 2019. Excludes CFE, Airport and Vista.

[xxi] Source: Capital IQ as of February 2019. Operating income metric used: Net Income for financial institutions, EBITDA for the rest. Analysis excludes government entities, Special Purpose Acquisition Companies (“SPAC”), and companies for which there were no public estimates 90 days after the IPO

[xxii] Capital IQ as of February 2019. Sufficient liquidity defined as having at least $1M in ADTV in the last year