

The Unfulfilled Need of Venture Capital in Mexico

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Abstract: The importance of supporting and encouraging a venture capital industry is integral for Mexico's economic development and financial stability. The focus of this paper is to discuss the current venture capital situation in Mexico. The approach is to provide an overall understanding of the key mechanisms that develop or impede the financing of enterprises in Mexico. Thus, this paper analyses Mexico's economic status, financial sectors, regulatory framework, changes in the industry, and how each correlate with the current and future Mexican venture capital industry.

Key Words: Mexico, venture capital, alternative assets, small and medium sized enterprises, framework, value-added industry.

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1. INTRODUCTION

The emerging trend of private equity¹ has sectors of the global financial industry in a race for lucrative potential. Mexico, a country having endured numerous economic transformations, is at the forefront for experiencing this upcoming wave of capitalism. Although private equity is not new to the world of finance *per se*, it is the most modern approach for

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growth and opportunity as a means of financing, aside from traditional bank borrowings and the stock exchange- proving to be a successful business and economic booster.²

Given the global success of private equity, the purpose of this paper is to focus on how the industry has impacted Latin America, particularly how Mexico has fared with the emerging trend. The focal point is to characterize the progress of the venture capital³ industry in Mexico. In doing so, it is imperative to explore the chief factors that form the backbone of the Mexican private equity industry. Thus, this paper analyses Mexico's economy, financial sectors, regulatory framework, changes in the industry, and how each correlate with the current and future venture capital industry in Mexico.

2. MEXICAN ECONOMY

2.1 Macro Outlook

Mexico's recent reformations have greatly facilitated the transition for stronger macroeconomic stability founded on the following: a lower country risk premium (when compared with Latin American counterparts Argentina & Brazil),⁴ a stronger investment grade economy, an independent Central Bank, lower inflation rates,⁵ and a decrease in interest rates.⁶ This macroeconomic stability, when carefully analysed, identifies two key factors that help explain the present constancy in the Mexican economy: 1) Mexico's current population status⁷ and 2) Mexico's shift in macroeconomic policies. Importantly, from these two factors stem other imperative economic advancements (i.e. economic convergence), all of which have cohesively played a large part in placing Mexico amongst the twelve largest economies in the world.⁸

2.1.1 Population and Policy Shifting

Mexico's growing population, the tenth largest in the world, is quickly gaining access to disposable income and is experiencing a demographic distribution similar to the United States (U.S.) in the 70's.⁹ This distribution is generally considered to be an evolving population bonus that correlates with development and growth; a phenomenon that will continually be experienced within the next ten years. As a result, Mexico's youthful population has successfully maintained a per capita gross domestic product (GDP) above and beyond what is institutionally necessary for subsistence.¹⁰

Mexico's shift in macroeconomic policies has established a foundation for an open free-flowing economy.¹¹ This shift-strategy has allowed Mexico

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to advantageously align itself and enter into free-trade agreements with neighbours in the Americas as well as with Europe and Israel. Currently, it is estimated that native Mexican products reach more than 860 million consumers in thirty-two countries.¹² In time, this policy has transformed Mexico into the eighth leading exporter in the world, representing a drastic evolution from protectionism to more of a *laissez-faire* economy.¹³

2.1.2 Economic Convergence

Through its network of agreements, Mexico has become a new country with strategic preferential access to some of the largest economic markets in the world, including the U.S.¹⁴ Its regional connection with the U.S. makes the North American Free-Trade Agreement (NAFTA) one of Mexico's most important and relevant trade agreements.¹⁵ Therefore, as a result of its dedication toward developing an economic neighbourly relationship with the U.S., the Mexican economy has constructively converged its economic cycle to that of the U.S. (See **Table 1. Mexico-US industrial cycles**).

Economic convergence has openly attracted many foreign enterprises to establish exclusive manufacturing operations in Mexico, most notably in the automotive sector. In 2000, Mexico became the tenth largest automotive producer in the world, producing approximately two million vehicles annually.¹⁶ Further, global competition in terms of cheap labour has favourably refocused Mexico's competitive advantage approach toward "greater-value-added" manufacturing.¹⁷ In turn, the growth in the automotive manufacturing sector has produced and will foreseeably produce a growing need for research and development (R&D), ultimately fostering greater technological advancements for the entire industry. Thus, the openness of the Mexican economy, in connection with a globalising competitive environment, is constructively shifting Mexico to be a "greater-value-added" manufacturer supported by a strong productive work-force (See **Table 2. Manufacturing productivity in Mexico**).

2.1.3 Macro Result

Collectively, the aforementioned economic advancements in conjunction with the evolving global perspective of Mexico as a stable economy, have positioned Mexico as the third largest recipient of foreign direct investment (FDI).¹⁸ This reinforces a strong positive economic overview, as many of these investments directly ascribe to infrastructure and other capital goods. Hence, FDI, as it pertains to Mexican enterprises in the form of venture capital is an investment form with strong growth potential.

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2.2 Micro Outlook

Mexico is home to 3.7 million “formal” enterprises (formal SMEs).¹⁹ Formal SMEs are recognised as enterprises officially registered to conduct business or provide services to the industry. However, a larger portion of Mexico’s economy is occupied by the informal business sector. Sources estimate that out of 105 million Mexican citizens, the informal sector roughly encompasses up to 10 million enterprises, accounting for 12-25% of Mexico’s GDP. Thus, combining both the formal and informal sector, Mexico appears to be a country with a strong entrepreneurial culture. A 2001 study identified that Mexico has 18% of its population involved in entrepreneurial activities, representing the highest percentage of the 29 countries featured.²⁰

However, a more careful interpretation shows that these results may be deceiving. Evidence suggests that a large percentage of Mexicans are primarily being motivated to establish enterprises due to the lack of viable employment opportunities.²¹ Mexico’s “enterprise-community” demonstrates that out of the 3.7 million “formal SMEs,” 96% fall within the micro enterprise category. Micro enterprises form 25% of Mexico’s GDP and generate an annual average of approximately only \$49,000 U.S. dollars each (See **Table 3 below. Enterprises in Mexico**). This, in turn, identifies that enterprises in Mexico are being started on the basis of necessity rather than on competitive advantage. Further, it is also evident that Mexico’s GDP is being controlled by a diminutive percentage of companies or individuals, resulting in an extremely skewed wealth distribution.²²

Table.3. Enterprises in Mexico (U.S. dollars)

	<i>Average GDP per firm</i>	<i># of Firms</i>	<i>% of Firms</i>	<i>Total GDP (billions)</i>	<i>% of GDP</i>
Total	\$187,704	3,700,000	100.0%	\$694.50	100%
Micro	\$48,881	3,552,000	96.0%	\$173.63	25%
Small	\$853,200	122,100	3.3%	\$104.18	15%
Medium	\$5,631,120	18,500	0.5%	\$104.18	15%
Large	\$42,233,400	7,400	0.2%	\$312.53	45%

Source: Adapted from INEGI statistics, 2002.

2.2.1 Micro Result

In order for SMEs to take advantage of the strong macro environment, access to early-stage financing is vital. SMEs probability of success would increase if they had access to intelligent money. But, the stability differences between the macro and micro levels are impeding this possibility. Mexico’s micro economy is clearly on a different spectrum

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when compared to the macro economy. The micro level has yet to develop the essential changes needed to achieve the same sophistication and stabilisation prowess of the macro level. Thus, promoting and establishing a strong venture capital industry may prove to launch the micro environment, helping align both levels in order to achieve a more parallel economy.

3. MEXICO'S FINANCIAL SECTOR: CONVENTIONAL

3.1 Commercial Banks

Mexico's institutionalised bank-based system was historically known as a government controlled relationship-driven lending system that conveniently favoured certain conglomerates, "grupos."²³ This bank-based model is primarily predicated on bank loans (commercial and retail), a model that shares similarities with the financial systems of countries like Japan, Korea and Germany, and finances its borrowers through private debt. However, a moderate change in Mexico's more recently privatised financial system²⁴ is creating a trend that relies more on public markets to enhance overall economic activity.²⁵

The current downside for Mexico's bank-based financial system is that only 20% of enterprises, primarily consisting of large exporting companies, have access to lending.²⁶ Even with the recent growth in bank lending activities, it is explicitly evident that from the time of Mexico's latest crisis,²⁷ the availability of retail bank loans has since predominantly focused on economic consumption and mortgage lending (**See Table 4. Loans and loan targets**). Thus, the scarcity of commercial lending for Mexican enterprises has hindered potential development and growth. Leaving the majority of Mexican enterprises with no other alternative but self-financing.

3.2 Public Equity Market

Mexico's stock exchange, "Bolsa Mexican de Valores" (BMV) is a shallow private limited liability institution owned by brokerage houses. Small and focused on individuals or large well-established enterprises, the BMV has played a minor role in Mexico's overall financial sector.²⁸ To date, the BMV has proven to be an illiquid market lacking strong institutional investing. However, the current BMV situation is potentially bound for change due to the inaugural investments of Mexican pension funds in the public equity market (see sections 4.2.1 & 7.2 below). Irrespective of these potential changes, the present overall lack of penetration by the conventional financial sector, in turn, makes it

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opportune and important for Mexico to develop and encourage a stronger non-conventional alternative assets industry.

4. MEXICO'S FINANCIAL SECTOR: NON-CONVENTIONAL

4.1 Alternative Assets

Developing Mexico's microeconomic structure may well rest upon the future of institutionalising an economy well grounded on financing through alternative assets.²⁹ Establishing an industry suitable for growth potential in alternative assets requires an initial role from "Friends, Family and Fools" (FFF) and "Angel Investors."³⁰ Before exploring the status of the institutionalised alternative assets industry in Mexico, it is important to analyse the non-institutionalised early-early stage investors: FFF and "Angel Investors" in the Mexican economy.

4.1.1 Non-institutionalised Early-Early Stage Investors

- **FFF-**³¹ Mexico has yet to develop a sound FFF culture. As previously indicated, Mexico's skewed income distribution establishes that the number of people with the capability of investing in enterprises is extremely small. Financing through FFF depends on the social network of the entrepreneur. Normally, in Mexico, the most common active form of non-institutionalised early-early stage investing is through wealthy family members (rarely friends and others). However, entrepreneurs with access to wealthy family members typically already have the disposable capital needed to fund their enterprise. Therefore, they are generally not as reliant on initial investors as would be an entrepreneur without wealthy family contacts.
- **Angel Investors-**³² Mexico lacks individual "Angel Investors." As previously stated, Mexico's skewed income distribution lacks the creation of new wealth and significant retirement savings, thus limiting social mobility. "Angel investors" characteristically reinvest in an industry that helped them achieve personal prosperity, or invest in industries where they have ample personal experience. Mexico's retired high-net worth individuals normally inherit their net worth, and thus, have no entrepreneurial objectives. When high-net worth individuals do invest, they are typically more interested in concentrated ownership. Further, cultural influences also find it more commonly acceptable for high-net worth individuals to redistribute and reinvest capital amongst immediate family members (part of FFF), thus providing

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this form of fund access only to a minuscule portion of the population.

4.1.2 Institutional Equity Investors

- **Private Equity-** Private equity investing is a relatively recent phenomenon to Mexico.³³ The global representation of private equity indicates that the distribution and dedication of private equity funding in Latin America to the rest of the world is almost non-existent (**See Table 5. PE in Latin America & the world; See also, Table 6. Dedicated Latin American funds**). When directly analysing the limited distribution of private equity within Latin America, it becomes apparent that Mexico is comparatively trailing behind many other regional countries in receipt of private equity. Taking into consideration Mexico's GDP in comparison to the rest of the Latin American region, Mexico should arguably be attracting a substantially larger percentage of private equity (40% or more). However, Mexico's present allocated status shows a disproportionate piece of the Latin American private equity pie. (**See Table 7. Latin American recipients of private equity**). Various reasons may attribute as to why Mexico receives a limited and uneven distribution of private equity within Latin America:

- **Underdeveloped financial infrastructure and the lack of a sophisticated financial community.** In comparison to the rest of Latin America, Mexico fell behind in establishing and developing an investment banking sector.³⁴ Mexico's latency is attributable to the fact that until 1991 and 1992, Mexico was regulated by a government operated banking system.
- **Influence of the "grupos" on the financial industry.** "Grupos" have created immeasurable obstacles to private equity investors. As previously identified, many of these "grupos" have had preferential access to credit, thus generating an unfair advantage when competing with private equity funds.³⁵
- **Other industry barriers.** Previous and current customary business practices, including the lack of: entrepreneurship, corporate governance, proficient middle management, and the informal administration of local business practices (high family ownership concentration), have all produced unwelcoming industry barriers.³⁶

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4.2 Investors in the Mexican Arena

During the last 10 years, the industry has predominately been governed by foreign investors who primarily focus on late-stage investments. However, this trend is starting to change as Mexican institutional players begin taking a larger role in Mexican investing practices. Mexico is gradually entering a refocused trend that targets and values early-stage investment potential.

4.2.1 Mexican Institutional Players

Mexican institutional players are slowly developing an initiated interest toward investing in private equity. Among these institutional investors are the ever important pension funds. Mexican pension funds currently play a limited role in the alternative assets industry. However, as institutional investors begin joining the investment ranks, much of the future may be strongly dependent upon their involvement. Below is a description of Mexico's current institutional investors, excluding professionally created private equity and venture capital funds.

- **Private Pension Funds**- Mexico's largest private pension fund is "Inbursa," which is unsurprisingly a financial arm of Mexico's largest conglomerate- "Grupo Carso." Inbursa's pension fund is estimated to have an available capital purse of approximately \$8 billion U.S. dollars. However, Inbursa's investment objectives are linked to those of "Grupo Carso," whose business practice is more tailored toward acquiring distressed companies and maintaining them as part of the conglomerate's strategy. Thus, private equity investments are not part of Inbursa's particular expertise or within its current business strategy. Most other Mexican private pension funds are relatively small and normally lack the experience and sophistication required for successful private equity investments.
- **Public Pension Funds**- Mexico's public pension funds consists of retirement administration funds known as, "Adminstradoras de Fondos para el Retiro" (AFORES). This public pension fund system was implemented in Mexico in the early 90's as an adapted form of the Chilean pension fund model. At the end of 2004, Mexico's AFORE system recorded a purse of \$55 billion U.S. dollars, approximately 8.52% of Mexico's GDP, and had a compound annual growth rate (CAGR) of 224% since inception in 1997. The AFORE system has gradually expanded its investment possibilities. Initially, AFORES were only allowed to invest in Mexican treasury bills, and then in AAA rated bonds, but most

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recently as of January 2005, AFORES can invest in the Mexican Stock Exchange (BMV).³⁷

- Insurance Companies- As a result of Mexico's growing economic liberalisation, Mexico only has two main domestic insurance companies remaining: Inbursa and Grupo Nacional Provincial (GNP). Inbursa, as previously identified, is not particularly interested in the private equity industry and GNP currently only has a small investment in one local private equity fund. Further, the global trend of industrial consolidation has attracted many international players to acquire a large portion of Mexican insurance companies.³⁸ However, this experience has created unexpected difficulties for private equity administrators in Mexico. Efforts toward attracting and raising capital from the insurance industry are proving to be problematic. It follows that local operations lack investment power. Investment decisions are typically made directly from international headquarters abroad. Generally, headquarters are unfamiliar with the Mexican insurance industry investment regulations that allow insurance companies to invest a portion of their reserves in local private equity funds.³⁹ Thus, said unfamiliarity with local regulations is causing a chilling effect on private equity investments.
- Endowments- Mexico's endowment structure is close to non-existent. To date, no record is readily available regarding any substantial endowment investments in Mexico. Such a financial structure is an uncommon figure in Mexico, as schools and universities have yet to either secure the necessary funding for such an investing approach or learn to apply them appropriately.
- Government Agencies- The "Nacional Financiera Banca de Desarrollo" (NAFIN) is one of the most important benefactors in Mexico's private equity industry (particularly venture capital). In total, NAFIN has directly invested \$150 million U.S. dollars in venture capital and early stage initiatives and \$50 million U.S. dollars in private equity funds in Mexico.⁴⁰ Apart from NAFIN, the Ministry of Economics has a program granting \$12 million U.S. dollars to finance start-ups, and Mexico's "National Council for Science and Technology" (Conacyt) has \$7 million U.S. dollars allocated for the same purpose.

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4.2.2 Foreign Investors

Available data suggests that 87% of the private equity transactions in Mexico between 1995 and 2001 were carried out by U.S. investors.⁴¹ Nonetheless, joining these funds is a small presence of foreign investors who have established minority interests in several funds.⁴² Normally, investors rarely dedicated specifically tailored funds designed for exclusive direct investment in Mexico. Rather, investment interests and fund strategies were defined more regionally, for example, investing in Latin America. However, Mexico is slowly establishing regional economic independence. Recently, more funds have instituted local presence by raising capital specifically designed for Mexican investment opportunities.⁴³

Further, when identifying the specific practices of private equity in Mexico, it becomes significantly apparent that funds investing in Mexico have historically focused on late-stage financing.⁴⁴ Thus, it is easier for enterprises to raise larger amounts of capital funding in later-stage private equity as opposed to early-stage venture capital. This essentially recognises an almost non-existent venture capital culture, which ultimately disallows start-up enterprises from obtaining important financing.⁴⁵ The timid nature in Mexican venture capital investing may be due to the fact that venture capital investments require significant framework strategies (legal & regulatory) for the protection of the high potential risk factors implied. As a result, the Mexican government is taking a strong initiative allowing for better structured and more flexible strategies, in order to help develop and facilitate venture capital investing in Mexico.

5. MEXICO'S CURRENT FRAMEWORK: LEGAL & REGULATORY

Venture capital is a financial approach that revolves strictly around investing. The venture capital sector is obsolete without the presence of the willing participants that put forth capital and invest in high-risk profile companies in hope of profitable returns. The cycle of venture capital is compromised on one end by entrepreneurs who identify innovative ideas and launch enterprises and on the other end by the investors who finance them. Thus, venture capital may be summarized as one big "relationship"- a relationship between investors and funds, a relationship between funds and managers, and a relationship between funds, managers and entrepreneurs. However, this relationship is based on the potential success and productivity of an enterprise.

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Additionally, creating successful investment “relationships” is not solely determined on the exclusive basis of financial objectives. Most successful investments analytically strategise all aspects of an industry, significantly taking into consideration the ever important legal regime in which the potential investments will be structured. Structuring venture capital financing requires a flexible corporate law regime that bestows a wide variety of enforceable legal instruments. An inadequate and inflexible legal regime may be an obstacle for the successful formation of needed venture relationships. Although Mexico’s legal system is well developed, its codified nature tends to encumber flexibility, inadequately providing the fast adoption of flexible legal mechanisms required in the industry.⁴⁶ Below, important legal aspects are analysed with special attention concentrated on laws that are directly related with venture capital investing.⁴⁷

- Pre-emptive Rights- Mexican law grants all company stockholders pre-emptive rights. These rights give the stockholders the right to purchase their *pro rata* portion of any new stock that the Mexican company intends to issue.⁴⁸ Pre-emptive rights primarily protect minority stockholders from being diluted and help maintain stockholder ownership percentage. Mexican stockholders may not waive their pre-emptive rights prior to the issuance of new stock; this ultimately prevents the Mexican company from issuing future equity in the form of stock options, warrants, anti-dilution rights, and registration rights.
- Stock Options and Warrants- Both stock options and warrants give its holder the right to purchase a certain amount of company equity for a specific price at a certain period of time. Options are typically given to company employees or consultants as incentives to work for the company and also to enhance work production (granting them the opportunity to take interest in the company). Warrants are typically given to investors and third-parties as a sweetener or “kicker” to induce investment.⁴⁹ However, due to the automatic pre-emption rights previously discussed, Mexican law does not allow for the structuring of either options or warrants.
- Voting Agreements- Voting agreements are usually designed for minority members to protect themselves against the majority by entering into agreements that bind stockholders to vote in a certain manner. However, voting agreements obligating stockholders to vote their shares in a certain way is prohibited in Mexico. Mexican law zealously protects the voting rights of all

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stockholders and thus does not allow stockholders to waive their right to vote or agree in advance to vote in a certain manner.⁵⁰

- Redemption Rights- Redemption occurs when the company repurchases its stock from the stockholder. There are typically two forms of redemption, a “put option” and a “call option.” A “put option” is a voluntary redemption right that allows the investor to force the company to redeem (repurchase) its stock for cash at a specified price and time. A “call option” is an involuntary redemption that allows the company to redeem (repurchase) its stock at a specified time upon a contingent occurrence. Mexican law prohibits private companies from redeeming their stock unless it is judicially ordered for the purpose of satisfying credit obligations. Importantly, Mexican companies listed in the National Securities Registry “Registro Nacional de Valores” are exempt from this prohibition.⁵¹
- Dividend Rights- Dividend rights are synonymous with the offering of preferred stock.⁵² Private equity investors typically obtain preferred stock with dividend rights, meaning that the company is required to pay declared dividend rights to the preferred stockholder before paying common stockholders. Mexico allows dividend rights, however, a Mexican company may not pay dividends to its stockholders unless losses in the capital from prior years have been accommodated or the stockholders have approved a reduction in the company’s capital and other actions.⁵³
- Contingent Liabilities- Mexican law provides that a new stockholder in a company is liable for all pre-existing obligations of the company (retroactive liability).
- Minority Stockholder Rights- Mexico has weak minority stockholder rights. Stockholders with 33% interest in a company may effectuate certain actions on the minority. For example, any stockholder or group of stockholders holding at least 33% of the capital stock may, at any time, call a stockholders meeting. Holders of 33% interest may postpone for three days the vote on any resolution or authorisation on any matter believed to be insufficiently informed. These, among others, exemplify the manner in which majority stockholders maintain a dominant position over the minority.⁵⁴

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Thus, what is analysed above is a description and application of Mexican corporate law in its most general form. These issues are particularly addressed as general caveats because they are routinely encountered in all forms of private equity investments including venture capital. It is commonly understood in the world of finance that in most early-stage venture capital transactions, investors generally have a set timeframe in which they seek to sell their respective company interest. Therefore, exit strategies are routinely important and become a major aspect of structuring an investment. The previously analysed legal issues may have the potential unintended effect on investment exit strategies in Mexico. This is not to say that they completely damper private equity investments in Mexico, but they do make structuring a deal relatively time consuming and costly. Given the adequate time and expertise, most of the issues may be circumvented and alleviated through the careful formation of legal structures (i.e. Trusts)⁵⁵ or the strategic planning of alternative mechanisms (i.e. U.S. holding company).⁵⁶

However, through NAFIN's efforts in attempting to develop a Mexican venture capital industry, the Mexican government has intently lobbied to modify and change the previously identified legal and regulatory framework limitations (see section 7.4 below). Such efforts may prove to advantageously alleviate the high costs and regulatory limitations associated with current Mexican venture capital investment structures.

6. ENCOURAGING VENTURE CAPITAL IN MEXICO: WHY?

After World War II, entrepreneurship initiatives in the U.S. were responsible for 90% of employment creation, 95% of radical enterprise innovation, and 50% of technological innovations.⁵⁷ Since 1980, 90% of 37 million employment opportunities were created by early-stage enterprises with high-growth potential.⁵⁸ Supporting and encouraging a venture capital industry is integral for Mexico's current and future development and growth. A strong and flourishing SME environment may prove to spawn Mexico's future stability.

6.1 *Aligning Mexico's Economy*

Mexico is a growing economy with a population ripe for sophisticated growth and development. Venture capital funding may prove to be the determinant factor helping align Mexico's developed macro and underdeveloped micro economy by regulating the much needed change in the micro-level. Encouraging venture capital in Mexico may serve as the

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transitional catalyst for developing a sophisticated micro economy, whereupon, SMEs can successfully mature, grow, and develop with the population. An increase in early-stage SME investing will facilitate the stabilisation of early ventures, helping them develop into larger profitable enterprises. Venture capital's probable pour-over effects into varying economic aspects may help create the needed fluidity in the financial sector; aiding Mexico's skewed wealth distribution concerns and helping create a wider range of wealth redistribution.

6.2 The Rising Perception of Venture Capital in Mexico

It is generally understood that universities and institutions commonly teach and implement programs that revolve around what the professors, students, community, and the market is persuasively seeking and requesting.⁵⁹ The knowledge of the private equity industry in Mexico is quickly evolving. Mexican universities and MBA programs are beginning to take note of the changes and are starting to incorporate entrepreneurship and investment skills courses to their curricula. Major universities like the "Instituto Tecnológico y de Estudios Superiores de Monterrey" (ITESM), the "Universidad Anáhuac" (Anahuac), and the "Universidad Autónoma de México" (UNAM), are tailoring to the needs of the industry and have courses and programs that specifically deal with entrepreneurship. Other major universities like the "Instituto Tecnológico Autónomo de México" (ITAM) have instituted a specialised course program that directly addresses all levels of entrepreneurial ventures, including venture capital and private equity in Mexico. Thus, the presence and implementation of academic programs formulated to address entrepreneurship, venture capital, and private equity shows that Mexico is developing an entrepreneurial culture. Its future entrepreneurs and investors believe that developing the industry is progressively important for Mexico's future as well as an important source of potential profit.

6.3 Local Fund Management

Private equity and venture capital funds are beginning to establish their operations in Mexico with the administrative depth of local fund managers. Funds are securing local presence in order to avoid the previous mistakes of trying to govern and manage funds from abroad. International and local funds are appointing Mexican managers that directly know the industry and the situation. Local administration is helping assure investors that their investments are being managed by a well-organised and specifically tailored fund with local strategies and "know-how." Thus, the establishment of local fund operations is creating a more-sophisticated and educated local financial community, whereupon, local administrators may soon acquire industrial mobility and begin

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associating themselves with new funds or eventually create and develop their own.

6.4 Generating New Technologies through the Funding of SMEs

Due to the strong influential development of Mexico's manufacturing sector, the workforce is beginning to effectively mould to a value-added regiment. The numerous manufacturing plants in Mexico have consistently required the generation of R&D (oftentimes locally). Mexico's workforce is adapting to the needs of a versatile market and providing the requisites for technical knowledge in R&D. The commitment to R&D creates greater long-term value for jobs and the economy.

Mexico's growing population, emerging greater-value added industry and work-force, substantial cost benefits regarding qualified research, experimentation, and considerably lower employee compensation, all help induce potential productive innovation in Mexico. But yet, many SME industries and technological sectors with extremely high-growth potential and high-returns continue to lack adequate sources of venture capital funding. Mexican companies like "Neology" have previously encountered great difficulty when attempting to attract venture capital funding in Mexico.

- Neology is a company that specialises in wireless identification and authentication space based on radio frequency identification (RFID) chip technology. It was originally founded in 2000 as a Mexican company named Bank Note Corporation (BNC) and has since financed a merger with SCS, an American company to form what is now Neology. Neology, even with its current strong Mexican presence, opted to become a U.S. based entity for several reasons, including the deficient funding available for growth and expansion due to lack of credibility as a Mexican company involved in a high-tech business. Neology currently has 26 patents for innovations originating in Mexico with another 200 that are still pending, and sales with roughly close to \$11 million U.S. dollars. Neology is one of four global leaders in RFID technology, conducting business in Mexico, U.S., Central America, South America, Asia, and the Middle East.⁶⁰

Mexico is experiencing innovative growth but faces the reality of the potential rundown of high-growth enterprises for lack of early investment capital. A recent study shows that productive innovation and competitive advantages are valuably being produced through the formation of Mexican

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entrepreneurial and technological clusters.⁶¹ The most important developed industrious cluster is in Guadalajara, Jalisco (cluster region). In this southwestern location, numerous enterprises have successfully developed a microelectronics component market, focusing on design and R&D. The majority of these enterprises are compactly located within the cluster region and primarily sell directly to original equipment manufactures (OEMs) - encompassing 70% of their overall sales. The cluster region's key to maintaining early-stage stability with innovation and competitive advantage revolves around the concentration of the enterprises' capabilities on related technologies. The majority of these enterprises have been soundly established for over 2 years and are currently generating revenues well over \$500,000 U.S. dollars.

However, many of the enterprises in the cluster region identify that lack of capital is their major constraint for potential growth. Collectively, the materialisation of patents by these enterprises is extremely infrequent due to the deficiency in early-stage capital. Normally, the OEM's they directly supply ultimately develop both, the end-product and the patents. Hence, venture capital is the missing link needed to help recycle potentially innovative enterprises from degrading into dying companies for lack of early-stage funding (i.e. cluster region).

7. A FUTURE IN THE PRESENT: MEXICO'S CURRENT VENTURE CAPITAL STATUS

As previously identified in section 4.2, Mexico has an almost non-existent venture capital industry. Most private equity financing to date has occurred in late-stage private equity transactions. However, numerous governmental institutions and non-profit organisations are pushing for an early-stage venture capital investment industry. Thus, Mexico is currently solidifying its position and establishing an understanding for venture capital. But a thriving venture capital industry requires more than simply establishing the right structure for investment and the likeliness of potential opportunities.⁶² Venture capital needs a deal flow environment from venture capital players, financial fluidity, strong entrepreneurship, an appropriate domestic investment vehicle, and potential exit mechanisms.⁶³

7.1 Current Players

Local and international efforts have played a developing role in the Mexican venture capital industry. Local funds and enterprises such as Ncubo, Ventana, Visionaria, and international funds like CVC Venture Capital and Pegasus; have maintained venture capital investments in Mexico. Other local investment funds have also participated with their

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efforts but fail to qualify as venture capital funds due to their lack of formal institutionalisation.

Importantly, Mexico has more recently experienced the emergence of one particular committed venture capital fund, Intel Capital, a corporate managed venture capital fund established by Intel Corporation.⁶⁴ Intel Capital established its local presence in Mexico just a few years back; it has a U.S. based investment committee with a team of Mexican managers currently organised in Mexico City. However, Intel Capital is not a traditional risk-driven venture capital fund. Intel Capital does not particularly look for investment exit strategies. Their primary objective as a corporate venture capital fund (CVC) is to adapt new technologies through synergies. Intel Capital is more driven by the development of intellectual property being produced by the companies they invest in, ultimately expanding the use of its products and enhancing the corporations overall performance. To date, Intel Capital has a total of 16 investments in Latin America with 7 of them in Mexico. Therefore, regardless of their investing objectives, domestic and international funds and enterprises, including CVC's like Intel Capital, bring the much needed venture capital deal-flow innovation and credibility to Mexico, that other investors should follow.

7.2 Fluidity and Exit Development

As briefly discussed in section 4.2.1, pension funds are one of the key elements that allow private equity to establish fluidity. Mexico's public pension fund system (AFORES), were previously required to invest only in fixed-income securities. However, the governmental committee for the national commission on Mexico's retirement saving system, "la Junta de Gobierno de la Comisión Nacional del Sistema de Ahorro para el Retiro" approved modifications to the AFORES investment structure. As of January 2005, AFORES will be allowed to invest up to 20% of their assets in foreign securities, and up to 15% in foreign and local stocks through equity-linked notes that guarantee principal.⁶⁵ This new development in the Mexican pension fund system allows for AFORES to structure investments in the Mexican Stock Exchange (BMV).

As pension fund levels are significant determinants of venture investing over time⁶⁶ and private and public pension funds are the largest contributors of private equity investments in the U.S.,⁶⁷ in theory, the entry of AFORES to the BMV will help facilitate SMEs access to needed funding by creating deeper financial markets. Therefore, escalating the possibility of Initial Public Offerings (IPO) and creating financial fluidity

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through IPO exits. This, in turn, will entice new investors to partake in the venture capital industry in Mexico.

Further, it is optimistically expected that in 2005 AFORES will roughly invest \$2 billion U.S. dollars in the Mexican Stock Exchange (BMV). The inauguration of AFORE investments into the Mexican Stock Exchange (BMV), may soon prove to integrally help transform the microeconomic environment to the same level and degree of sophistication as the macro. Furthermore, the private equity industry is intently lobbying to allow the expansion of AFORES to invest in private equity funds. In doing so, the current existence of various Mexican buy-out funds may prove to be an opportune exit source for potential venture capital investments.

7.3 Strong Entrepreneurship

In response to the lack of early-stage investment opportunities, NAFIN,⁶⁸ in collaboration with various other organizations including Mexico's CONACYT,⁶⁹ are attempting to establish and develop an emerging early-stage financing market in Mexico. NAFIN has successfully initiated and implemented programs aiding both entrepreneurs and investors in their quest for resources.⁷⁰ NAFIN's primary objective is to develop a culture for early-stage development by cultivating investment opportunities through modernisation and competitiveness. Further, in an effort to promote high value-added entrepreneurship in emerging markets like Mexico, the non-governmental organization Endeavor has opened branches in numerous Latin American cities including Mexico City.⁷¹ Endeavor primarily assists in the start-up and early-stage level of enterprises, granting exposure both to Mexican entrepreneurs and potential investors. Endeavor promotes and encourages an entrepreneurial culture by generating and instilling model qualities for Mexico's current and future entrepreneurs and investors. Thus, the process of establishing the need and understanding for a strong early-stage venture capital industry is now in process, breeding risk taking entrepreneurs and creating opportunities in quality investments.

7.4 Better Regulation, More Transparency and Increasing the Exit Alternatives

Mexico's governmental executive branch is currently proposing to change and amend the laws governing the Mexican Stock Exchange "Ley de Mercado de Valores," in order to create an appealing investment vehicle. The conceptual purpose is to modernise the Mexican stock market, create transparency, and ultimately develop a venture capital industry for SMEs. The proposed initiative would establish a domestic vehicle for venture investing; to what is currently being referred to as "sociedad anónima

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promotora de inversión” (investment promoting corporation “IPC”). The underlying purpose is to provide SMEs with an attractive corporate structure to help induce investment by requiring a better documented track-record (which is commonly required by providers of risk capital), ultimately transcending SMEs into public companies. Thus, forming an IPC will be a voluntary approach subjecting the enterprise to stricter disclosure and corporate governance requirements coupled with greater minority stockholder rights. IPC’s will be allowed to register in the Mexican Stock Exchange (BMV) without formally enlisting. In other words, the IPC will be allotted 3 years to establish the formal structural requirements for market participation.

All else equal, IPC’s will be afforded exceptions to the current General Law of Business Organizations “Ley General de Sociedades Mercantiles,” in order to help attract and fully carry out favourable venture capital investments. They will be structurally equipped to provide potential investors with: voting agreements, exit strategies (redemption rights, repurchase, tag-along, drag-along etc.),⁷² and allow restrictions on stockholder pre-emptive rights. This will be a great structural advantage for investment agreements, reducing both time and costs. As previously identified in section 5.1, Mexican law does not currently adopt such practices. It follows that this initiative has recently been presented and approved by the Mexican Senate. However, the bill still awaits approval from Congress. If approved, this proposition will historically transform the investment structure in Mexico, thereby creating venture capital investment mechanisms and exit strategies commonly used in the global practice.⁷³

8. CONCLUDING THOUGHTS

The venture capital industry in Mexico is reaching a turning point based on the following principles:

1. A country with a strong investment grade and a stable economy represents a good macroeconomic case for institutional investors.
2. The continued evolution toward “value-added” manufacturing and the creation of diverse R&D initiatives in several industries is proving successful.
3. The emergence of regional technological clusters and the presence of successful technology-focused start-ups generate good investing opportunities.

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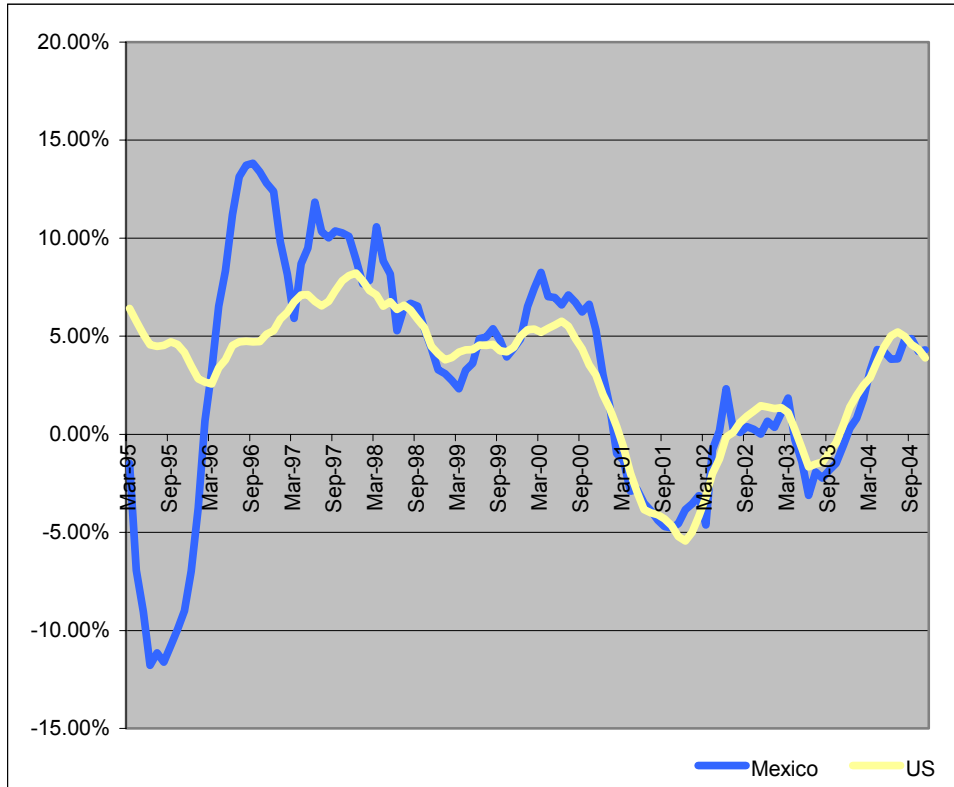
4. Intel Capital's track record of seven investments in a relatively short period of time is a compelling example of early-stage investment in high-growth industries in Mexico.
5. The Mexican government is continually investing in all stages of private equity, with a refocused trend toward early-stage investment practices.
6. The regulation of the industry is transitioning a change that will create greater transparency and access to new exit opportunities (i.e. "sociedad anónima promotora de inversión").
7. Mexico has been effective in attracting private equity funds (buy-out and real-estate) that are paving the way for venture capital funds. These private equity funds are potentially establishing natural exit opportunities for venture capital investments.
8. Pension funds' investments in the BMV will generate liquidity and depth in the public market, helping increase the promise of IPOs.
9. The creation of a local private equity management community is developing the growing capabilities to support the administration of newly growing funds.
10. The generation of substantive information and the promotion of knowledge about both entrepreneurship and venture capital by non-profit organisations, universities, and publications are helping consolidate the private equity industry.

In essence, Mexico is a rising economy with expanding opportunities. The venture capital industry in Mexico is currently in its infancy stages-gearing for a future of potential growth. Not only are the policies and economics rapidly aligning to support the industry, but a high demand for early-stage investments is currently in place. If Mexico's micro environment is ever going to reach the same level of macro stability, it must be supported by a sophisticated financial sector that attentively focuses on early-stage enterprises. Ultimately, this approach will resourcefully generate a more dynamic Mexican economy, complemented with a stronger entrepreneurial culture.

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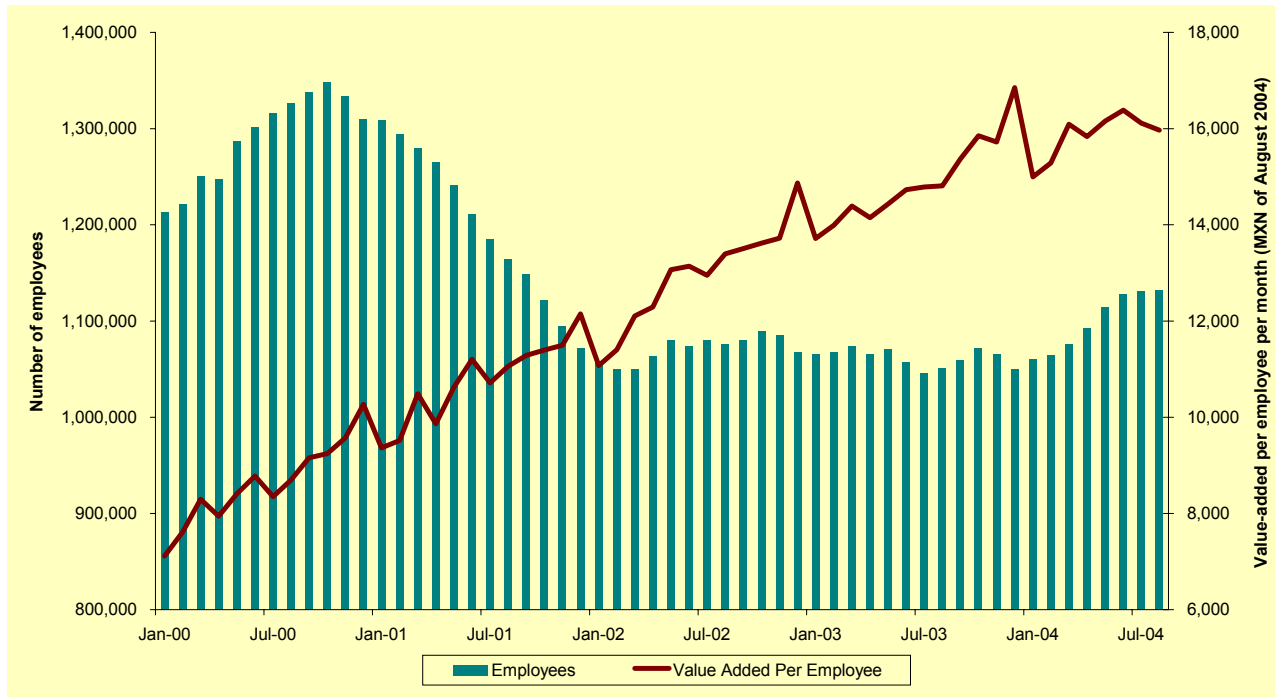
TABLES

Table 1. Mexico-U.S. industrial cycles
Source: Banxico, Federal Reserve



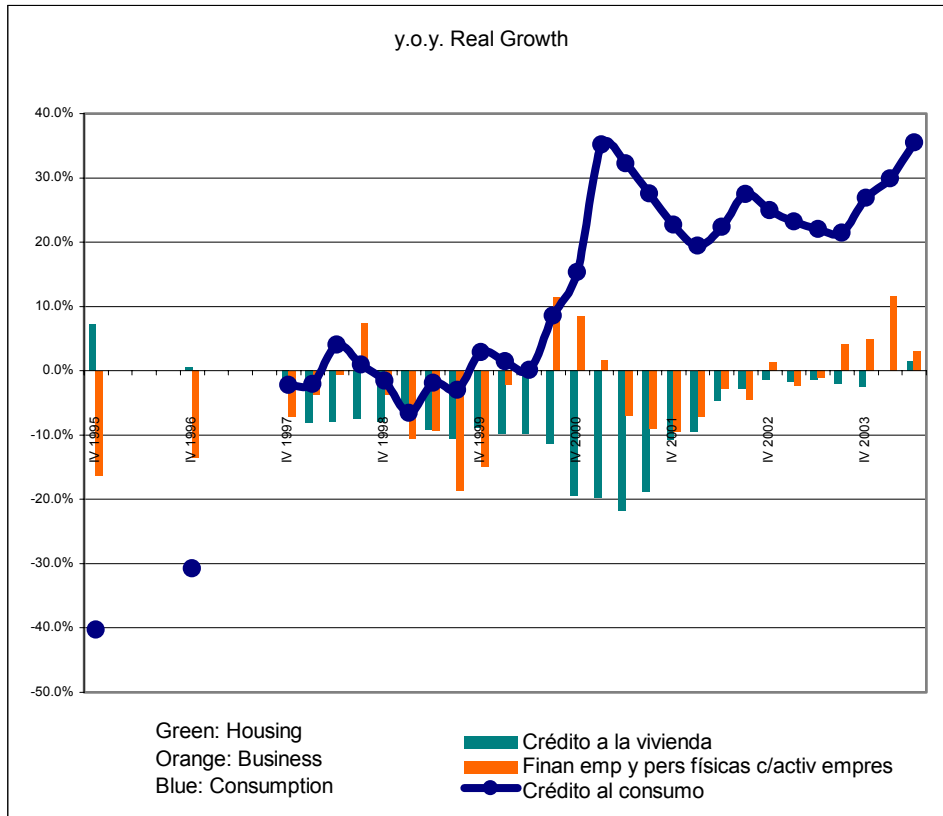
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Table 2. Manufacturing productivity in Mexico
Source: EGI



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Table 4. Loans and loan Targets
Source: Banxico



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Table 5. PE in Latin America & the world
Source: NAFIN

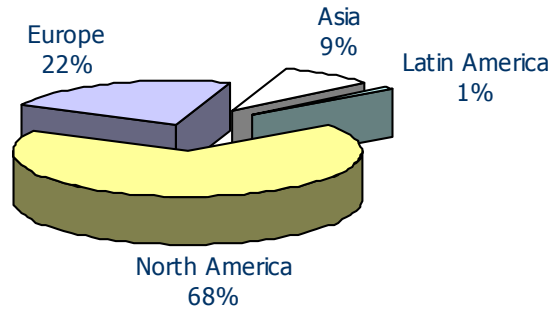
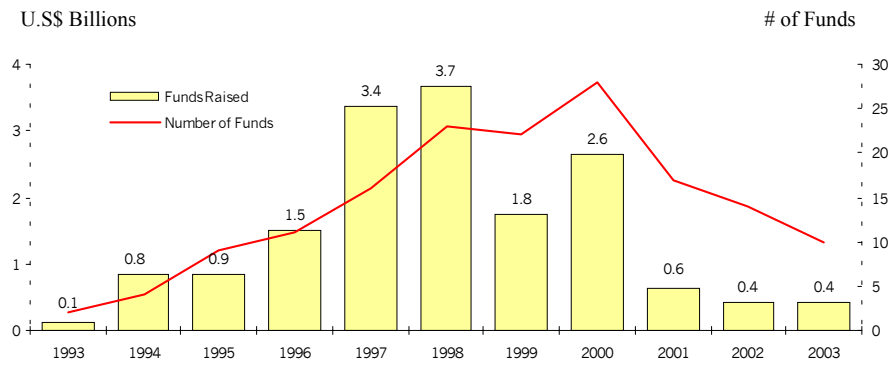
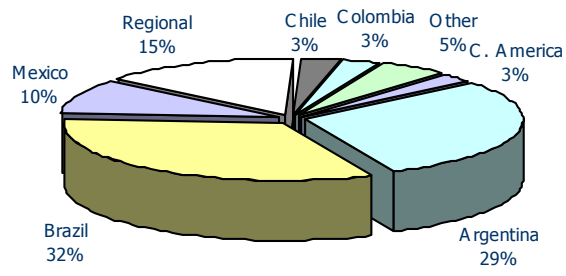


Table 6. Dedicated Latin American Funds
Source: VELA



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Table 7. Latin American Recipients of Private Equity
Source: AssetAlternatives, VELA
(1993-2003)



References and Notes

¹ Many consider “private equity” as identifying only later stage investments and “venture capital” as pertaining to investments in early stage companies. As used in this paper private equity entails the concept of obtaining investment in both early and later stage companies.

² The Economist (2004) “Kings of Capitalism: A survey of private equity,” 27th November, pp. 1-3. See also, Schneider, F. and Videgaray, L. (2001) “Private Equity in Mexico,” *Conference on Financial Markets in Mexico*, Centre for Research and Economic Development and Policy Reform at Stanford University, 5th- 6th October, pp. 2., available at: http://scid.stanford.edu/events/Mexican_Credit/videgaray_011002.pdf.

³ As used here, venture capital refers to the early-stage investment phase of private equity.

⁴ Bloomberg, Country Risk Analysis, 2004.

⁵ Banxico, Mexican Inflation Rate, 2004.

⁶ Banxico, Mexican Interest Rates, 2004

⁷ Population also includes reference to the Mexican work-force.

⁸ EIU

⁹ EIU

¹⁰ EIU, GDP per capita in Mexico, 2004.

¹¹ The shift in macroeconomic policies is focused toward opening the Mexican economy, thus allowing reciprocal market entry to a multitude of countries.

¹² See. http://www.nafinsa.com/finsa_fretrade.htm.

¹³ Economic growth may be partially accredited to the export industry, including exports in oil and more recently shifting toward an increase in manufacturing. See, World Trade Organization (2003) “*Leading Exporters & Importers in World Merchandise Trade (excluding intra- EU (15) trade)*,” available at:

http://www.wto.org/english/res_e/statis_e/its2004_e/section1_e/i06.xls

¹⁴ Marc Rieker (2004) “Mexico- The Secret Free Trade Giant,” *DePaul Business & Commercial Law Journal*, Spring, Vol. 2, pp. 441-442.

¹⁵ The North American Free Trade Agreement was signed by the United States, Canada, and Mexico.

¹⁶ “Mexico- The Secret Free Trade Giant,” supra note 14, at pp. 442.

¹⁷ Manufactures like Ford, General Motors, Chrysler, Volkswagen, BMW, Renault-Nissan, and Honda.

¹⁸ UNCTAD, EIU, Main FDI Global Destinations from 1994-2003

¹⁹ SMEs as used in this paper encompasses all Mexican enterprises. Such is done because the dominating majority of Mexican enterprises fall within the categories of micro, small, and/ or medium.

²⁰ Global Entrepreneurship Monitor

²¹ Fabre, F. and Smith, R. (2003) “Building and Entrepreneurial Culture in Mexico,” *Prepared for National Financiera, SNC*, May, pp. 34.

²² It is important to note that the richest person in Mexico controls 6.6% of the GDP. See, Expansion (2004) “El Poder del Cerdo,” 22 December.

²³ Based on historical intervention of government lending activities, the government’s control over access to credit went to favored enterprises and “grupos.” Allowing them to consistently play a leading role in the Mexican economy and effectuate influence on lending activities. Even after the privatisation of the banking industry in 1991 and 1992, “grupos” have continuously remained intertwined with the banking industry. See, Werner, H. (2001) “A New Year, New Latin American Strategy,” *Venture Capital*

Journal, March; see also, Charvel, Roberto (May 2001), “Capital Market in Mexico,” *Harvard Business School Case, Individual Study Research supervised by T. Kahna* pp. 9.

²⁴ Japan, Korea, and Germany are also trending similar changes.

²⁵ “Capital Markets in Mexico,” *supra* note 23, at pp. 9.

²⁶ “Building an Entrepreneurial Culture in Mexico,” *supra* note 21, at pp. 38.

²⁷ Tequila Crisis in 1994.

²⁸ Bhattacharya, U., Daouk, H., Jorgenson, B., Kehr, C.H. (1999) “When an Event is not an Event: The Curious Case of an Emerging Market,” *Journal of Financial Economics*, pp. 59-101.

²⁹ It is well understood that there are other forms of alternative assets (ie. Real estate and hedge funds) however, the concentration of this paper, is how alternative assets pertain to the private equity/venture capital market.

³⁰ In the financial industry, FFF and “Angel Investors” are commonly viewed as a form of venture capital. However, this paper identifies each as non-institutionalized early-early stage informal investors.

³¹ Within the early-stages of an entrepreneur’s enterprise, funding is gathered from a network of individuals typically close to the entrepreneur, commonly known as the circle of FFF. The concept for FFF is a form of short-term financing from individuals that are willing to invest their own personal capital in an entrepreneurship idea helping launch the enterprise.

³² Typically, “Angel Investors” are retired wealthy individuals who invest in small businesses, typically within an industry where they have previous experience and see possible high-growth potential. “Angel investors” are synonymous with early-stage investments in companies with a significant upside. Although, “Angel Investor” has been traditionally viewed as an individual investor, the term is now well understood to classify investments that proceed in the early-early stage of an enterprise in much the same way as the traditionally “Angel investor.” See, Chocce, G.R. (2003) “Necessary conditions for venture capital development in Latin America: the Chilean case,” *Int. J. Entrepreneurship and Innovation Management*, Vol. 3, Nos. 1/2, pp.139.

³³ Roberto Charvel and Juan Carlos de Yeregui (2002) “Private Equity in Latin America: The Mexican Case,” *Journal of Private Equity*, Winter.

³⁴ Institutions like JP Morgan did not establish a presence in Mexico until 1981.

³⁵ “A New Year, New Latin American Strategy,” *supra* note 23.

³⁶ La Porta, R., Lopez-de Silanes, F., Shleifer, A., Vishny, R.W., (1999) “Law and Finance” *Journal of Political Economy*, pp. 1113-1155.

³⁷ See, *Infra* Section 7 (The Future in the Present: Current Venture Capital Status in Mexico).

³⁸ International players such as: AIG, MetLife, ING and Allianz.

³⁹ Requires the pre-investment approval of the Treasury Department and the National Banking and Securities Commission. See, “Building an Entrepreneurial Culture in Mexico,” *supra* note 21, at pp. 39.

⁴⁰ *Id.* at pp. 44

⁴¹ “Private Equity in Mexico,” *supra* note 2, at pp. 16.

⁴² Canadian, Spanish, German, and French

⁴³ The Carlyle Group and BBVA are examples of funds establishing local presence.

⁴⁴ “Private Equity in Mexico,” *supra* note 2, at pp. 2.

⁴⁵ *Id.* at pp. 8.

⁴⁶ Morrison & Foerster LLP (2001) “The Need for Legal and Regulatory Reforms in Argentina, Brazil, Chile, El Salvador, and Mexico to Promote Risk Capital Investments in Small and Medium Enterprises,” February, available at:

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<http://www.mofo.com/news/index.cfm>. See also, Leeds R. and Sunderland J. (2003) "Private Equity in Emerging Markets: Rethinking the Approach," *J. Applied Corp. Fin.*, pp. 8-16.

⁴⁷ This section only summarizes important factors involved when structuring a venture capital deal in Mexico. For an in-depth approach toward the legal aspects of private equity in Mexico, see, Hallmark, J.B., Gonzalez, L.F., Pardo, S., and Hryck, D.M. (2003) "The Entrepreneur's Guide to Private Equity in Mexico," *Law and Business Review of the Americas*, Spring, Vol. 9, No. 2.

⁴⁸ Mexico's General Law of Business Organizations (*Ley General de Sociedades Mercantiles*), art. 132.

⁴⁹ Bagley, C.E. and Dauchy, C.E. (1998) "The Entrepreneur's Guide to Business Law," pp. 116.

⁵⁰ General Law of Business Organizations, supra note 48, at art. 198.

⁵¹ Id. at art. 134.

⁵² Preferred Stock is the form of equity most commonly used in private equity transactions. It helps protect the investment by giving additional preferential rights than those offered to common stock.

⁵³ General Law of Business Organizations, supra note 48, at arts. 18 and 19.

⁵⁴ "The Entrepreneur's Guide to Private Equity in Mexico" supra note 47, at pp. 386-390.

⁵⁵ Trusts are known as "Fideicomisos," which are commonly formed to avoid obstacles created by Mexico's corporate laws.

⁵⁶ Forming a U.S. holding company has numerous advantages when trying to attract investors: i) accessibility and security of the U.S. legal system ii) extensive exit opportunities with access to enormous U.S. capital markets iii) experience and support of a developed investment community that has greater accessibility to capital granting an overall positive perception of the company v) wide variety of flexible investment structures.

⁵⁷ Timmons J (2004) "New Venture Creation: Entrepreneurship for the 21st Century," Irwin McGraw Hill.

⁵⁸ Charvel R. and Gonzalez L.F. (2004) "El Capital Privado: Solución para el Crecimiento y Formación de Nuevas Empresas," *Dirección Estratégica*, quoted from Cesar Perez Barnes, June-August, No.10, pp.30.

⁵⁹ "Building an Entrepreneurial Culture in Mexico," supra note 21, at pp. 30.

⁶⁰ Endeavor -Mexico provided background information regarding Neology, See also, www.neology-rfid.com.

⁶¹ Padilla, R. (mimeo 2005) "Foreign Direct Investment and Indigenous Technological Capabilities Development in the Electronics Industry in Mexico," *Thesis for PhD in Science and Technology Policy at the University of Sussex- Science Policy Research Unit (SPRU)*.

⁶² Kappaz C. and McNees J.B. III (2004) "Building the Venture Capital Industry in Mexico," February, available at: <http://utopia.utexas.edu/articles/tbr/mexico.html>.

⁶³ Id.

⁶⁴ www.intel.com/capital

⁶⁵ Comisión Nacional del Sistema de Ahorro para el Retiro (2005), Bulletin No. 01/05, 16th January, available at: www.consar.gob.mx. See also, Case B.M. (2005) "Mexican Stock Exchange Beats Almost All Major Markets in 2004," *Knight Ridder/Tribune Business News (Dallas Morning News)*, 5th January.

⁶⁶ "Private Equity in Mexico," supra note 2, at pp. 7.

⁶⁷ Id.

⁶⁸ www.nafinsa.com

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⁶⁹ www.conacyt.com.mx

⁷⁰ Various programs supporting and helping entrepreneurs, including “*Programa de apoyo a emprendedores*” and “Fideicomiso de Apoyo a Emprendedores y Migrantes.”

⁷¹ Endeavor has branches in Chile, Argentina, Brazil, and Uruguay. See, <http://www.mx.endeavor.org/>

⁷² Supra section 5.1 for analysis

⁷³ See, <http://presidencia.gob.mx/buenasnoticias/> (November 16, 2004)