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## Recent Carlyle Group Activity in Mexico: Is the Private Equity Market in Mexico on the Rise?

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## **Executive Summary**

The Carlyle Group, a global private equity firm, recently entered the Mexican market in an ambitious push to capitalize on what is perceived to be an overall increase in private equity opportunities in Mexico. From a market perspective, Mexico has several competitive advantages over other economies, including greater openness to foreign investment, particularly—owing to NAFTA and subsequent free-trade agreements—by the United States; large-scale government privatization plans, particularly in the energy sector; and a stable and growing economy, as evidenced by attractive interest rates, improved access to credit, a growing consumer market and ever-increasing commercial ties to the Hispanic population in the United States.

This paper explores the attractiveness of the Mexican private equity market as well as the current strategy of The Carlyle Group there. We will argue that due to Carlyle's unique capabilities as a local *and* global firm, as well as its tremendous political power and influence, Carlyle will be successful in Mexico. In addition, because the private equity industry in Latin America went into a deep downturn during 2001 and has only begun to re-emerge over the last two years, Carlyle has chosen to re-enter a landscape that is relatively clear of competition, providing the firm with a distinct first-mover advantage. For these reasons and others, The Carlyle Group is well positioned for private equity success in Mexico during the next five to ten years.

## 1. The Carlyle Group: An Overview

### 1.1. Introduction

The Carlyle Group is one of the world's largest private equity firms, with more than \$18.3 billion under management.<sup>1</sup> Carlyle offers more than 20 funds in four primary investment areas: management-led buyouts; real estate; leveraged finance; and venture capital. Supported by a team of some 300 or more investment professionals, Carlyle maintains offices in 14 countries and focuses on sectors in which it has demonstrated expertise and the opportunity to leverage its portfolio. The firm's investments have focused in the following areas: aerospace and defense; automotive and transportation; consumer; energy and power; health care; industrial; real estate; technology and business services; and telecommunications and media. Telecom operators alone account for approximately 30 percent of Carlyle's current investments, according to some estimates.<sup>2</sup>

### 1.2. Investment Strategy

A list of valuable contacts and a unique investment strategy set Carlyle apart from other private equity firms. The firm focuses on industries such as defense and telecommunications, where government spending, regulations and policies are critical in defining market potential and growth. Unlike its competitors in the military-industrial complex or investment banking, Carlyle does not lobby Congress or the White House to fund pet projects or push for legislation that would further its interests. Instead, it has hired a stable of former statesmen and senior officials, including former President George H.W. Bush, former Secretary of State James Baker, III and former British Prime Minister John Major, to exploit their experience in government and diplomacy to open doors and gather intelligence on investment opportunities.

Carlyle focuses exclusively on direct investment and therefore does not offer advisory services. "We have avoided advisory," Edward J. Mathias, one of Carlyle's founders, said in a February 2002 *Washington Post* article. "There was just a feeling that it consumed resources."<sup>3</sup>

Publicly announced initial investments by Carlyle suggest a pattern of creating economic networks. The Carlyle investment philosophy is more or less centered on the following criteria:

- Companies developing technologies and products that have the potential for global markets.

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<sup>1</sup> The Carlyle Group Web site, [www.thecarlylegroup.com](http://www.thecarlylegroup.com).

<sup>2</sup> Datamonitor's ComputerWire, June 22, 2004, [www.computerwire.com](http://www.computerwire.com).

<sup>3</sup> N. Johnston, "Investing in a Success Strategy: Milestone Merchant Partners Focuses on Advising, Private Equity Funding," *The Washington Post*, February 4, 2002.

- Initial investment around the incubation level, especially for Asian and European companies.
- Companies that can potentially benefit from matchmaking with other Carlyle portfolio companies.
- Companies whose products or services have some level of commercial standing and are economically scaleable.

### 1.3. The Carlyle Group's Entry into Mexico

In December 2003, The Carlyle Group announced it would open a Mexico City office to pursue the company's first-ever buyout activities in Mexico.<sup>4</sup> Since opening, the office has appeared to follow the firm's established model of gathering a team of well-connected individuals who understand the market and can judge the pulse of government action in select industries. Luis Tellez, former Mexican energy minister and former executive vice president of DESC, a Mexican industrial conglomerate, and Joaquin Avila, a former co-head of Latin America for Lehman Brothers, share leadership of Carlyle's Mexican activities. In February 2004, Clinton administration veteran Mack McLarty also joined the firm as a senior adviser. "The time is right to invest in Mexico and Carlyle," Mr. Tellez said in a press release. "With its global platform and credibility in the markets, [Carlyle] will be the first major player to make this type of commitment."<sup>5</sup>

## 2. The Private Equity Environment in Mexico and Latin America

### 2.1. Introduction

Private equity has a short and checkered history in Latin America, dating back only to the mid-1980s. Before then, large multi- or transnational corporations generally made the majority of foreign direct investments in companies in the region, and there was little or no foreign private capital available for small to mid-sized enterprises. Private equity investments were limited to debt-swap programs, multilateral financial institutions and privatizations (Johnson 2002).

The early 1990s witnessed the first Latin America buyout activity, which reached a peak between 1997 and 1999 and overlapped with the venture capital boom and bust of 1998 to 2000, before both forms of activity declined greatly in 2001 (Johnson 2002). Beginning in 2003 and continuing through the first half of 2004, major players such as The Carlyle Group, JP Morgan Partners and Baring America Partners, LLC, led a strong re-entry of buyout funds to Latin American markets.

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<sup>4</sup> The Carlyle Group, "Carlyle Group to Begin Investing in Mexico," press release, December 15, 2003.

<sup>5</sup> Ibid.

## 2.2. 1998–2002: Boom and Bust

The largest private equity boom in the history of Latin America occurred in the late 1990s, and the scale of investments was staggering compared to the previous history of activity in the region. For example, in a landmark transaction in December 1999, Goldman Sachs and two partners paid \$500 million for an 18 percent stake in Clarin, a media group based in Buenos Aires. *Latin Finance* magazine estimates that more than \$15 billion in private equity was pumped into the region in the short period between 1998 and 2000 (Barham 2003).

In 1998, at the height of the boom, private investors put \$5 billion into Latin American companies, many of which did not survive (Smith 2003). In 1999, investors put \$3.69 billion into the region, followed by \$2.8 billion in 2000 and a staggering post-bust drop to \$93.2 million in 2001.<sup>6</sup> During the Internet boom of 1999 and 2000, the region saw about 500 Internet-related deals, according to Ernest Bacharach, who oversees investments for Advent International Corp. (X.AVT), a Boston-based private equity firm.<sup>7</sup>

Business confidence in Latin America began falling in 1999 with the devaluation of the Brazilian currency, which sent the economies of Argentina and Uruguay into deep recessions that continue to this day. Private equity investments in Brazil decreased sharply, from a high of \$1.9 billion in 1998 to a low of \$93 million in 2001, with a slight bounce to only \$140 million in 2002. Also, following the currency devaluation, private equity investment all but completely evaporated in Argentina by 2002.<sup>8</sup>

In stark contrast to the high-water mark of \$5 billion in 1998, 2002 saw only \$710 million in private equity investments in the region (Smith 2003). That year, the Dallas-based buyout shop Hicks, Muse, Tate & Furst, Inc., which had invested approximately \$1.5 billion in Mexico and the rest of the region, closed the doors of its Mexico City office. GE Private Equity, which had been a major player in the region during the boom, shut down its Mexico City arm that same year (Smith 2003).

## 2.3. 2002–2003: Market Re-entry

Throughout 2002, the private equity industry in Latin America remained in a deep downturn. The Small to mid-sized business (SMB) market segment received the majority of placements, with most deals in the \$5 to \$10 million range, suggesting that most private equity investors were taking a diversified “many bets” investing approach to the region (Smith 2003). In Mexico specifically, businesses saw \$93 million and \$86 million in private equity investments during 2001 and 2002, respectively (Smith 2003).

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<sup>6</sup> Mike Esterl, “Latin America’s Private Equity Drought Deepens,” Dow Jones International News, August 15, 2003.

<sup>7</sup> Ibid.

<sup>8</sup> Economist Intelligence Unit ViewsWire, “Latin America Finance: Private Equity Groups Look to Long Term,” February 20, 2003, [www.viewswire.com](http://www.viewswire.com).

Despite low deployment of capital in 2002, evidence of rejuvenation was provided by increased fundraising activity in Mexico after Protego, an investment advisory boutique based in Mexico City, partnered with Discovery Capital of Norwalk, Connecticut, to raise \$250 million for a Mexican fund dedicated to investments in industrial parks, tourism complexes and housing and office construction. According to Pedro Aspe, the former Mexican finance minister and current head of Protego, "If you are going to get into private equity in Mexico you better make sure you are going into the right sector. Sector analysis needs to be rigorous and deep, and you need to put your money into areas where productivity growth is good relative to the US and China" (Smith 2003).

In a KPMG survey of participants at a conference on Latin American private equity held by *The Economist* magazine in late 2002, 44 percent of respondents said that, during the next two years, they planned to focus their investments on Mexican companies.<sup>9</sup> These plans were realized through 2003, as private equity investments rose in Latin America and particularly in Mexico, a trend that regional experts predicted in 2004 were likely to continue.<sup>10</sup> Mexico's attractiveness lies in its investment-grade rating, a reasonably stable economy, strong ties to the United States and strong cross-marketing links with the U.S. Hispanic population. Mexico remains a safer haven for private investment than Brazil or Argentina, where full recovery is still a long way off.

#### 2.4. 2004: Returning Optimism

In the spring of 2004, Richard Frank, the CEO of Darby Overseas Investments, predicted that fundraising for private equity investments in Latin America would likely double over 2003 figures, amid growing optimism about the region's prospects.<sup>11</sup> Although Brazil and Mexico are still the leading countries for private equity investments, firms such as Darby are beginning to look at distressed investing in previously abandoned Argentina. Mexico's IPC index, which tracks the country's 35 leading stocks, rose 5 percent in March of 2004, the twelfth month in a row of increases and the longest stretch of gains since 1990 (Leerskov 2004). According to Carlyle managing director Joaquin Avila, "As opposed to most of Latin America, Mexico has shown a lot of economic stability . . . if you look at macroeconomic figures there is very little inflation now and sovereign borrowing costs are lower than many of the well-known names among U.S. corporates" (Leerskov 2004).

Avila has consistently expressed optimism concerning continued private equity investment in Mexico, and it is clear that the future of private investment in both Mexico and Latin America will be driven by firms that tend to "make the market." Darby

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<sup>9</sup> Ibid.

<sup>10</sup> Mexico Analytica, "Mexico an Attractive Market for US Private Investment," September 1, 2003, [http://www.sif.com.mx/sif\\_ing/Admon\\_Sub/Picfarac/reglas/mexico-analytica.html](http://www.sif.com.mx/sif_ing/Admon_Sub/Picfarac/reglas/mexico-analytica.html).

<sup>11</sup> Stephen Wisniewski, "Latin America Private Equity Fundraising Back on the Rise," Dow Jones Newswires, March 27, 2004.

Investments CEO Frank said recently that, although he believes fundraising in Mexico could reach \$2 billion, “It all depends what some of the big firms such as The Carlyle Group do.”<sup>12</sup> In Mexico, as in much of the world, Carlyle is the 2,000-pound gorilla.

### **3. The Carlyle Group and the Future of Private Equity in Mexico and Latin America**

#### **3.1. Overview**

Carlyle is more ambitious than most private equity players in Mexico, which typically invest no more than \$50 million in a single company. Carlyle has more than \$18 billion in assets and, according to Joaquin Avila, has the capacity to do very substantial deals. “If the right opportunity arises we think we can pull resources from all over the world and do very large transactions [in Mexico],” Avila said in a recent article in *Latin Finance*. “They won’t be our bread and butter, but we are prepared to do them when they present themselves” (Galloway 2004).

#### **3.2. The Local Environment**

Avila has said that the owners of privately held companies are becoming more receptive to outside investors owing to the competitive pressures imposed by globalization. Because many companies have taken on significant leverage, the price gap has narrowed and owners have realized that it may be necessary to own less of a “better pie” than more of a lesser pie, and are therefore willing to cede somewhat to the demands of private investors. The outlook for private equity investing in Mexico has improved because of economic stability, low interest rates, improved access to credit and growing consumer markets. Investors maintain that domestically oriented companies are good targets for private investing because of the country’s integration with the United States, its largest trading partner.

The Carlyle Group and other private equity firms focused on Mexico’s domestic market also stand to benefit from a demographic shift that is concentrating the country’s population growth in the 18- to 45-year age range. “[Mexico] is going from a population pyramid that is wide at the base to one that is wide in the middle. . . . This trend is creating demand for jobs, housing, financial services and consumer goods,” said Carlos Sales, principal of the Discovery Americas I fund (Galloway 2004). Also, the Mexican economy is so tightly correlated generally with the U.S. economy that the 2004 presidential election will doubtless have the effect of stimulating growth and a continued trend away from the stagnation that Mexico has experienced in recent years.

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<sup>12</sup> Ibid.

### 3.3. The Carlyle Advantage

We see four main reasons why Carlyle will be a big winner in the Mexican private equity marketplace:

- *Easing of Government Restrictions*—The government development bank Nafinsa and others are presently lobbying Congress to ease some of obstacles to the growth of the private equity industry in Mexico, which include excessive regulation, tax disincentives and federally mandated restrictions on corporate governance. “We are trying to develop the concept that this is an industry, that investors are adults who can put in money and measure its risks. The concept of institutional investors and qualified investors in Mexico is very important,” said Eduardo Mapes, the director of venture capital at Nafinsa (Galloway 2004).
- *Privatization of the Energy Sector Plays to Carlyle’s Global Influence*—If the Mexican government adequately invests the tax dollars it receives from foreign direct investments in local businesses, Mexico can begin to build a strong local economy not totally dependent on the resources provided by U.S. companies. Conversely, it will not be possible for Mexico to rise above the status of an emerging market if only the short-term strategy of flooding the country with U.S. dollars and building local job growth through the presence of U.S. companies is pursued.

Mexico must also shape a broader approach to its future that incorporates the short-term actions needed to begin to grow in the long run. In 2003, 54 percent of all federal government revenues came from Pemex, the national energy company, which has a constitutionally mandated monopoly on all oil and gas production in Mexico.<sup>13</sup> In terms of the energy sector, reform initiatives have been proposed to deregulate the energy markets. Because Mexico’s economy badly needs expansion of its natural gas, electricity and power generation capacity (a similar situation to that of China), the government would like to pass legislation that favors private sector activity and competition in the supply of energy, at least for the large industrial firms.

The Carlyle Group will benefit from this type of industrial plan. If the government deregulates the energy sector, the firm will in a sense have its investments subsidized by a friendly government within which it has tremendous influence: Carlyle’s Tellez was Mexico’s secretary of energy from 1997 to 2000. It is exactly this type of inside influence—the kind that Carlyle is so good at leveraging—that will make energy investments in Mexico more secure for The Carlyle Group than for other private equity firms.

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<sup>13</sup> Pemex Web site, [www.pemex.com/index.cfm](http://www.pemex.com/index.cfm).

- *Carlyle's "Global Vision and Local Insight"*—The specific competitive advantage that Carlyle possesses lies in the fact that, despite its standing as the world's largest private equity firm, it is really made up of local firms in individual countries, each of which has a unique approach tailored to the local environment, yet is able to draw on the firm's global resources to ensure that both advantages—size and locality—are fully leveraged.<sup>14</sup> The Carlyle Group Web site states: "We have Global Vision: Local Insight—*Global* because Carlyle operates 22 funds in 14 countries; *Local* because our nearly 300 investment professionals work in their home countries."<sup>15</sup> It is clear that this approach is being deployed in Mexico. The Carlyle team comprises power players in the country, and the firm's tremendous influence in the energy sector worldwide will complement its "local insight," providing Carlyle with the results it is seeking.
- *More Resources Available than the Competition*—As far as competition from other private equity firms is concerned, we see the following groups attempting to compete with Carlyle in Mexico: Hicks, Muse, Tate & Furst; Kohlberg Kravis Roberts & Co.; and Texas Pacific Group. While opportunities in Mexico are sufficiently great to spread profits among numerous private equity firms, The Carlyle Group is uniquely positioned to take advantage of those opportunities because it is in the upper echelon of private equity firms in terms of global reach.

### 3.4. Exit Strategies for Carlyle

At a recent meeting in New York, the chairman of Italy's SanPaolo-IMI Group, Enrico Salza, remarked that, based on his entrepreneurial experience, "You don't want to kill your competitor because you want to keep someone alive out there so that there is a buyer for your business."<sup>16</sup> The Carlyle Group understands this fully. The Carlyle Web site states: "Rather than swing for the fences with every investment, we strive for consistency, hitting singles, doubles and triples with far fewer strike-outs." What this means is that the firm seeks to succeed but not dominate, because the goal of a private equity firm is to exit at 30 percent IRR or better consistently, not just once in a while. In Mexico, Carlyle will pre-select businesses through a combination of expertise and influence, ensuring at least singles, if not doubles or triples, as it has done in other emerging markets such as China.

The Carlyle Group will monetize its investments by selling out to strategic players or through management buyouts.<sup>17</sup> Demand from multinationals that want to buy into the Mexican market will likely drive the majority of exits for The Carlyle Group.

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<sup>14</sup> David Luhnnow, "Latin America Lures Investors," *The Asian Wall Street Journal*, January 21, 2004.

<sup>15</sup> The Carlyle Group, "The Company," [www.thecarlylegroup.com/eng/company/13-company737.html](http://www.thecarlylegroup.com/eng/company/13-company737.html).

<sup>16</sup> Enrico Salza, Chairman, SanPaolo-IMI Group, NOVA/ALUB Bocconi meeting, New York City, October 5, 2004.

<sup>17</sup> *Ibid.*

#### **4. Conclusion**

Chastened by misguided investments during the boom of the late 1990s, but emboldened by economic rebound and growth in the region, private equity investors have begun to re-enter the Latin American market. This is particularly true in Mexico, where The Carlyle Group and other funds have set up shop and begun to place bets on local businesses in stable and growing sectors of the economy. If economic stability and growth continue in Mexico, and if the overall recovery of the world economy accelerates in 2005, we can expect that Carlyle will continue to place private equity investments in Mexican businesses and attempt to grow those investments, eventually exiting via sales to multinational corporations looking to enter the Mexican market or through management buyouts.

The Carlyle Group has assembled a strong management team in Avila and Tellez to lead its efforts. Although we were not able to assess the exact amount of funds committed to the Mexican market, we believe the number is substantial.

The Carlyle Group will be successful in Mexico for a number of reasons. It is structured as a local firm with a global vision and has put in place a stellar Mexico City team that has insight, power and influence in those sectors where Carlyle has the most influence in the U.S. and other parts of the world. This unique approach to investing in developing countries—which has been so successful in other emerging markets—combined with positive economic trends in Mexico and a government that will seek to privatize and subsidize key industries where The Carlyle Group is an inside player, should produce consistent returns on investments that will make Carlyle a major winner in the re-emerging private equity market in Mexico.

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