Privcap/Report

Context for Private Capital Investment

Q4 2014

Mexican Energy + Private Capital

Expert views on a major investment opportunity

Featuring:

General David Petraeus of KKR
Riverstone founder David Leuschen

And leaders from

Partners Group • Macquarie
Conduit Capital Partners • EY

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

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

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

For more intelligence on how to best take advantage of the private capital investment opportunities presented by the North American energy revolution, please join us at Privcap's Energy Game Change 2015 conference in Houston on December 10. More information is available at www.energygamechange.com.

Unlocking Mexico's Potential

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

The Panelists

George Osorio
Managing Partner, Conduit Capital Partners

Osorio co-founded Conduit in 2003. He serves as the senior investment Manager for the Latin power funds. Osorio previously worked at Scudder and Lehman Brothers' Emerging Markets Group. Before Lehman, he worked at Chase Manhattan Bank. Osorio holds an economics degree from Cornell University and an M.B.A. from Columbia Business School.

Maximiliano Del Vento
Vice President, Partners Group

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

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

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

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

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

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What is happening in Mexico should indeed energize private investors around the world, as well as domestic advocates for Mexican growth. Most discussed are the amendments to the Mexican constitution enacted by lawmakers late in 2013 that create several models for foreign investment in Mexican hydrocarbon. But Mexico's domestic economy is also growing such that the demand for energy will spell an investment opportunity.

The scope of potential investment is huge, with capital expenditure across the sector possibly at $350B, according to figures from the Binational Center Library and Texas A&M International University.

Oscar Lopez-Velarde, tax partner at EY's Latin American Business Center, describes the reforms as a "game changer" and a huge opportunity for those looking to invest in upstream, midstream, and downstream opportunities. The underdeveloped pipeline network through—and to—Mexico is just one area begging for outside investment, while there is also massive need for new refineries.

In addition, a number of private equity firms are already starting to create joint ventures with Mexican partners to bid on tenders for exploration and production projects. Lopez says Mexico does not yet have the framework for master limited-partnership investment but that the government and tax authorities are working on a similar framework to attract more capital: "A year ago, when the constitutional discussion was started in Congress, nobody believed that energy reform would happen. Now we have pretty much all the framework ready in Congress. The Senate has started to approve the power laws, so it is happening."

Osorio says he is optimistic that the benefits of the reform will be obvious enough to policymakers that the reforms are likely to remain in place, whether or not there is a change of government. He believes that Mexico will avoid some of the "growing pains" of countries like Argentina and Venezuela because of its strong ties with the U.S. and Canada. He says that while

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Why Riverstone Likes Mexico

David Leuschen of energy-focused Riverstone Holdings tells Privcap why his firm opened an office in Mexico

"We look at it from a macro standpoint," he tells Privcap. "With the U.S. headed towards 10 million barrels a day of [oil] production, Canada having the possibility of about five, and Mexico having two or two and a half with a possibility of getting to five, you've got a very exciting and interesting North American block in the energy picture of something that could be 20 million barrels a day of production," Leuschen tells Privcap, of his firm's decision to add a Mexico office to its three existing locations.

Riverstone has raised about $27B of equity capital since it was founded in 2000 by Leuschen and Pierre F. Lapeyre, Jr. The firm focuses on buyout and growth opportunities in exploration, production, midstream, oilfield services, power and renewables sectors, having raised five energy and power funds and two renewables funds since its inception.

Leuschen says Riverstone is keen to play an integral part in building that North American production bloc, which means it cannot afford to ignore Mexico. "Talking Mexico is like imagining that, up to this point, we haven't been able to invest in Canada and then somehow we got a phone call from Toronto and the whole country is open to folks like us," he says. "It has to be something we focus on."

But don't expect Riverstone to rush in with a major investment.

"We tend to investment-spend on the front-end, and we start small," he says. "We're very humble when it comes to the kind of opportunities we expect there."

In September, Riverstone and EnCap Investments announced a deal to back Mexico's first independent exploration and company, Sierra Oil & Gas S. de R.L. de C.V., with a combined $525M in capital. ◆

David Petraeus, KKR Global Institute

Petraeus Backs Mexico

Former CIA chief General David Petraeus, now with the KKR Global Institute, is optimistic about Mexico but says the country's road to prosperity is not without speed bumps

General David Petraeus says he draws on the intelligence he garnered during his time at the CIA to inform his worldview.

When it comes to Mexico and its investment opportunities, he describes himself as a "qualified optimist." Petraeus, who now works with the KKR Global Institute, says the qualification relates to the challenges to the rule of law that exist in the country.

He says security, particularly the threat of the massive criminal enterprises involved in Mexico's narcotics sector, remains a concern. But the country's government has been making efforts to address the issue, particularly in the manufacturing hub of Monterey State, where initiatives have been introduced to reestablish the rule of law and help the economy meet its full potential.

Petraeus believes Mexico's potential is significant, given the growing middle class, the country's manufacturing boom, and its oil and gas resources.

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

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

"Their view clearly is that if you can get outside investment expertise [and] technology, they can reverse that," he says. "And that's a very good bet." ◆

the reforms do not yet promise "straight-out privatization," they do seem poised to deliver "creeping privatization."

Commenting on the Comision Federal de Electricidad (CFE, the state-owned power monopoly), Osorio notes that legal changes will allow producers to supply power to companies or municipalities in deals over which the CFE will have limited control, a change he says is "dramatic" and "profound."

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

Global investment firm Partners Group definitely appreciates the Mexican opportunity. Based in Zurich, Partners Group had been quite interested in the North American oil and gas market but was hesitant about getting involved in the U.S. space prowled by so many competitive MLPs, says Maximiliano Del Vento, a vice president at the firm.

Instead, Partners Group looked further south and struck a deal with Fermaca, Mexico's second-largest gas pipeline company. The firm invested an initial $750M in Fermaca. Noting Mexico's share of the fertile Eagle Ford shale formation, Del Vento says that Fermaca will be transporting "the same resources, the same shale gas. The only difference is that there is a line on the floor that separates Mexico from Texas. So we've found this amazing asset and incredible management team, and we were able to work with management on a transaction that makes sense for everybody."

Del Vento says the stake in Fermaca positions his firm well to enjoy an expected wave of growth as Mexico seeks to increase its energy infrastructure. "We think there is a huge opportunity for the company to participate in the tenders that are coming to market," he says. "There is a multibillion-dollar opportunity in

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the midstream to build the infrastructure in Mexico. If you look at the government plan, they expect to auction approximately 10,000 kilometers of traditional natural gas pipelines over the next few years."

Del Vento further estimates that the legal reforms could help lift Mexican GDP between 1 percent and 1.5 percent, depending on how the laws are implemented.

"We think that things [will] be implemented well and in a very market-friendly way," he says, given that the aim of the laws is to attract more foreign direct investment, create jobs, improve productivity, and increase living standards.

EY's Lopez agrees that the scope of the opportunity is large and stresses that there are opportunities for different-sized players as well as different types of players: "You will find the big projects, the huge pipelines, but also smaller pipelines already being built. If you go to the offshore, we know that the majors will probably get the first deep-sea projects. We are also seeing Mexican companies operating on the onshore business. We are putting in place a couple of companies funded by private equity that are planning to do investments that range between $500M and $1B. We see room for everybody, honestly. There will be room for the big guys, for the midsize projects, and also for a lot of the small things that need to be built in Mexico."

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

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

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Jean Perarnaud, Partners Group

Partners Group's Fermaca Investment

In 2013, Partners Group invested $750M in Mexican gas pipeline owner Fermaca after years of searching for energy investment opportunities in the U.S.

Partners Group had been searching for midstream energy investments in the U.S. for several years but had been deterred by competition from MLPs and foreign investors. So when the opportunity to invest in pipeline owner and manager Fermaca Group arose, the firm started to look south, says Partners Group managing director Jean Perarnaud.

Investing in Fermaca makes sense, because the company is involved in tapping the same resource as the companies Partners Group had been looking at on the U.S. side of the border, he says.

Partners Group's head of North American infrastructure investment, Todd Bright, says his firm is constantly assessing the global opportunity set from a number of different perspectives. Fermaca sits at the "nexus between two important global and international dynamics within the infrastructure space."

"Mexico is moving up the energy-per-capita consumption curve, driven by a growing middle class and urbanization, and Fermaca is capitalizing on both of those dynamics in two different geographies at one time," Bright says. "That's a powerful thing for our investors."

Perarnaud says one of the upsides to energy reform is the creation of a new market for electricity. "That means more gas will be needed to fire private consumption," he says. "In that sense, we are looking for new customers who can take more gas out of the pipeline than we currently own."

Fermaca Group CEO and president Fernando Calvillo Alvarez says regulatory reform in Mexico could help his company because it could develop further types of assets, including crude-oil pipelines, refinery-product pipelines, and terminals.

"The crucial thing is that we will have a power market, and when you have the cheapest gas in the world in front of you and the talent to bring that gas to Mexico, it presents a range of opportunities," Calvillo Alvarez says. ◆

Competition

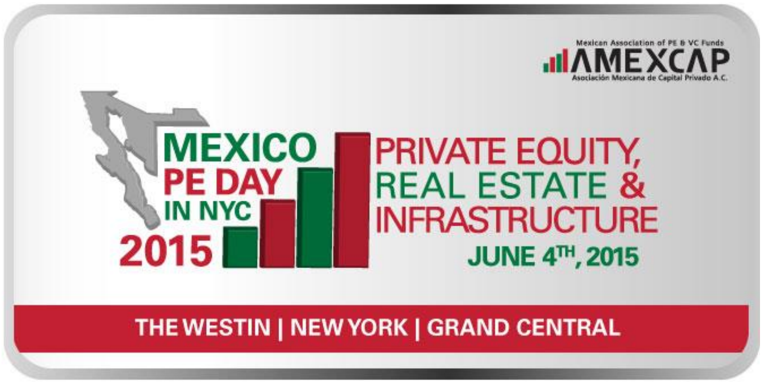
International investors are indeed coming to Mexico and bringing with them an inevitable dynamic in an attractive market—competition. Osorio says that as the government's stranglehold on the markets loosens, the number of participants investing in the sector—including financial institutions, pension funds, and others from around the world—will increase. But he sees this as a positive development for established private equity investors in that exit markets will open up. "When we first invested, we didn't know whether we were going to exit or not," he says. "With so many participants going into an investment-grade country, it just changes everything."

Osorio says a big issue for new entrants will be finding management teams with deep expertise, given the lack of private investment in the sector up until now.

Del Vento adds that private equity firms move similarly to how they operated in the real estate boom of the 1990s, deploying both Mexican and foreign management to make sure they have the expertise needed to operate in the sector.

The energy reforms are inspiring investment in other industries expected to benefit from the growth of Mexican energy. EY's Lopez says, "We are also starting to see a lot of private equity firms investing in construction companies or in companies that would be rendering services just as Mexican drillers. We're starting to see it in Mexican shipping companies…all over the areas that are being opened for private investors. It's a very positive outcome."

Much remains to be seen in the way the reforms are implemented in Mexico, but the savviest energy investors in the private equity market seem to agree: The changes in Mexico are real, and the moves to participate in a new market opportunity are emphatic. ◆



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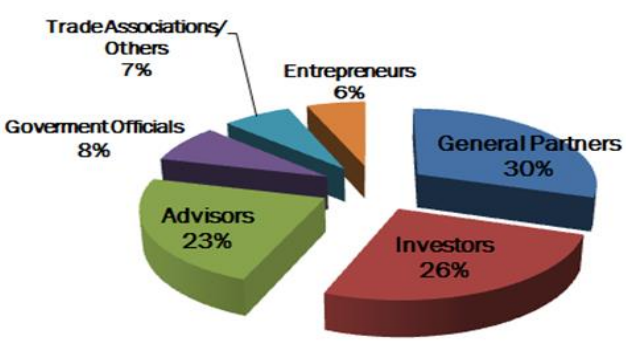
Mexico PE Day 2014
Participant breakdown:



VIP Speakers during our previous editions:
Amb. James Jones, Chairman, ManattJones Global Strategies
Amb. Arturo Sarukhán, Former Mexican Ambassador to the US
Carlos Ramírez Fuentes, President, National Retirement Savings System Commission, CONSAR
Carlos Roa, Chief of Staff Office of the CEO, PEMEX
María de los Ángeles González-Miranda, Mexican Ministry of Finance (SHCP), Representative before the Inter-American Development Bank, IDB in Washington.
Jacques Rogozinski, CEO, NAFIN
Felipe Vilá, Director General, Fondo de Fondos

2015 Agenda Topics:

- Examining the Mexican Political and Economic Landscape
- Mexico's Real Situation
- Pension Fund Participation in Domestic Project Financing and National Development
- Evaluating Mexico's Growth Equity Opportunities in Today's Market
- Mexico's Private Equity Success Stories
- Interpreting Reforms: Initial Expectations, Realities and Future Projections
- Investment Opportunities in the Energy and Infrastructure Sectors
- The Cresting Co-Investment Opportunity
- Real Estate Investment Trends and Opportunities Going Forward
- The Regulatory & Legal Scenario for Private Equity Investing in Mexico
- Healthcare: Hot Sector
- Investment Strategies and the LP/GP Relationship

Investing in Mexico's Infrastructure

Macquarie Group established a presence in Mexico five years ago, focusing on infrastructure investing. Jonathan Davis Arzac heads a fund in the country and explains how reforms are helping private capital investments.

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

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

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

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

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

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

The other area where we will have a lot of interest is in renewable energies. The program that was put in place by this administration is quite ambitious in terms of trying to develop renewable energy sources.

Privcap: Could you describe the investment thesis for your wind project and how things have evolved?

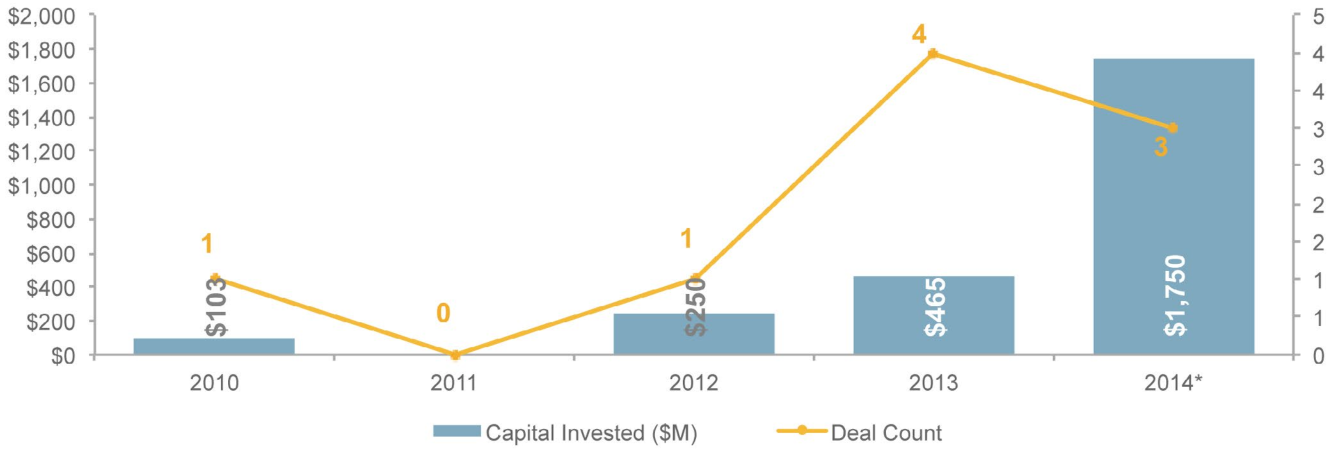
Arzac: In Mexico, we have rich wind resources. We've identified areas in the state of Oaxaca where we are interested in building a wind farm, and we've been working towards that objective. In order to create a project from scratch, you have to do a lot of work-permitting with the environmental authorities,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

Mexico's Energy Sector and PE, by the Numbers

Figures from the Mexican energy market show the growing opportunity for private capital investment in the sector

Deal Numbers Rising but Still Few

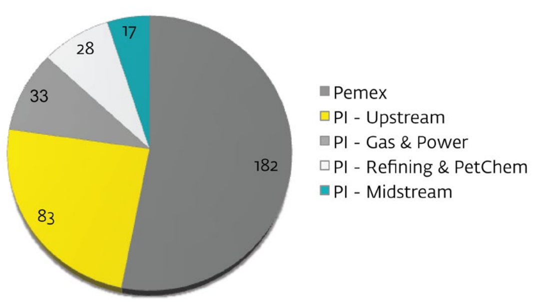
Mexican private equity energy deal flow by year



Source: Pitchbook

Potential Capex is Huge

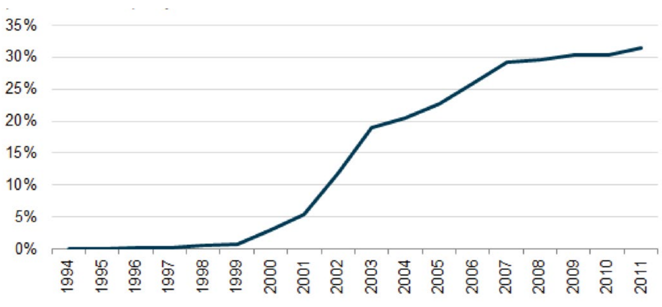
A breakdown of Mexico's potential energy capex, by sector



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

Private Owners Gaining Ground

Mexico's current privately owned electric capacity growth



Source: U.S. Energy Information Administration

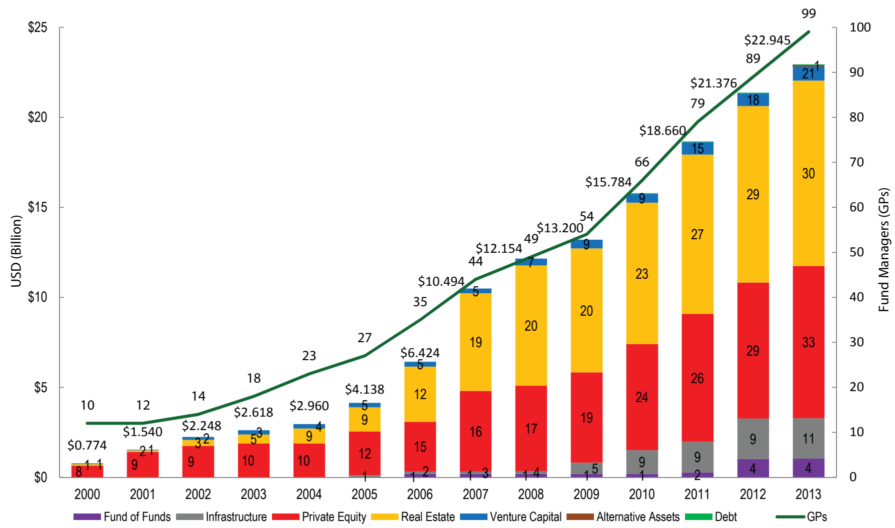
Reforms Will Boost Mexican Economy

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

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

PE is Growing in Mexico

As the economy grows, so too does Mexico's private capital under management



Source: AmexCap 2014

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

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

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

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

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

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

"Room for Everyone" to Invest in Mexican Energy

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

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

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

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

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

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

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

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

Though the reforms have passed, private investors should still expect some surprises as they take advantage of the new rules, he says, adding that "approval was so clear, with the rules so well prepared, that everyone's really optimistic

Alfredo Alvarez
EY

that any challenges will be resolved."

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

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

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