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Synthesis

Private Equity Implications of COVID-19 in Emerging Markets

A digital gathering with top Country Heads of PE in Mexico

By Carlos Vázquez, Antonio Purón, and Ricardo Weihmann

During these unprecedented times, the PE industry in Mexico is facing great challenges as it operates in one of the emerging markets that had already been suffering from low growth levels over the past years. The COVID-19 crisis has raised the bar for the challenge and the need to prepare for an even worse scenario; however, this could also bring new opportunities for the sector.

Egon Zehnder gathered 18 Country Heads from the private equity sector in Mexico for a virtual meeting on April 14, 2020, to share their points of view in the wake of the COVID-19 crisis. The attendees found important differences between the realities of Mexico and developed countries. There was agreement that the worst is, unfortunately, yet to come.

The next 60 to 90 days will be critical to determine the real impact. GDP growth is expected to be negatively impacted 7 percent to 10 percent in 2020, and the economic recovery will likely be slow (approximately 14-18 months). The central topics of the discussion revolved around maintaining employment as much as possible, preventing a liquidity crisis in the system, and establishing a closer dialogue with regulators and government.

Maintaining Employment and Supporting the Financially Vulnerable

The attendees agreed that the current, short-term priority is in maintaining employment at their portfolio companies and securing enough liquidity to navigate the rough waters ahead. Social and governmental pressure to maintain job security is very high in Mexico. Communicating and working together early on with unions and employees on alternative mechanisms to avoid layoffs (e.g., temporary salary discounts, early vacations, etc.) becomes paramount.

Before considering immediate layoffs, participants agreed that it is preferred to reduce salaries temporarily, starting at the top, and trying to protect those who are most financially vulnerable. “We have to move intelligently and ahead of the government or social expectations,” one leader said. Furthermore, it is extremely important to communicate these measures efficiently and institutionally within the companies, manage the potential threats of negative social media and channel these communications through the CEO.

Prepare for the Worst

The most likely scenario is that of a slow and gradual economic recovery. The cure and the vaccine for Covid-19 are not expected to be announced anytime soon, and consequently the return of the workforce will be gradual (COVID-19 immune certified staff will return first). This will have an impact on consumption spending, thus limiting the cash flow businesses will be able to produce, particularly SMEs.

The economic incentives announced by the government will not be enough to wage an economic downturn that will probably last 14 to 18 months. “We are just seeing the tip of the iceberg,” an attendee shared. “The economic downturn could also translate into higher levels of crime and social fabric deterioration.” For businesses, securing liquidity and access to credit lines will be vital. While the government has started to disperse some liquidity through its development bank, the speed has been rather slow and most SMEs are not qualified to receive such funding.

Out-of-the-Ordinary Opportunities

In this low-growth environment, PE in Mexico will be more of a “special situations” play. The lack of liquidity in the system will drown many SMEs, and opportunities may materialize to acquire prime portfolios or companies with good fundamentals.

In addition, this could also represent a historical opportunity for PE firms. SMEs with solid fundamentals, but in need for liquidity or diversification, could be more open to sell important stakes to PE firms at attractive valuation levels.

Resiliency in Digital

Certain high tech portfolio companies and digital start-ups have benefited from this crisis. The SoftBank effect (which recently committed large amounts of funding in Mexico and Latin America) will help maintain liquidity in selected companies and sectors. For instance, Fintechs focused on SMEs could suffer once the liquidity crisis is triggered, particularly those with lower capitalization levels. However, some investment banks could come to the rescue with their special situations offering to fill the void.

Digital companies should be able to maintain the advantage of their variable cost base and low headcount levels, which would make them more resilient to the crisis. Opportunities in the digital sector are likely to focus on consumer credit, health, safety, and cybersecurity. The potential winners will be those who maintain their focus on digital product development to emerge stronger post-crisis.

An Open Dialogue Between Government and Private Sector

The Mexican government maintains some room to maneuver and could eventually improve the economic incentives when reality catches up. Local pension funds (Afores) and foreign investment will not become sources of new liquidity for the PE sector. The government will require accelerating fiscal policy stimulus and including a broader base of SMEs into the economic relief programs.

Participants agreed that it is of the utmost importance to maintain a close and honest dialogue with regulators and the government. Ensuring an adequate dispersion of liquidity to companies and SMEs through the parallel financial system will significantly reduce the negative impact of the crisis

During the gathering, all attendees showed a high spirit of collaboration ("we are in the same boat") by sharing ideas and contacts to explore new ways of supporting each other.

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Covid-19 Micro-Website

We have launched a micro website where this and other informative pieces are posted. This site will be regularly updated: click here for further details.

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