

# MULTILATERAL INVESTMENT FUND

## I. BASIC INFORMATION

Country/Region:	Mexico		
Program Name/Number:	Equity and subordinated debt financing for a new small farms and SME-specialized financial intermediary in Mexico (ME-M1007)		
Team:	Nathaniel Jackson (MIF/INV), team leader; Takatoshi Kamezawa, (MIF/INV), and Ana Cecilia Savastano (IIC)		
Date of Request:	June 2004		
Beneficiaries:	Small farms and small and medium-sized enterprises in Mexico		
Executing Agency:	Banco Ve por Más, S.A. (Bx+)		
Financing Plan:	MIF Subordinated Debt (Window IIIB):	US\$	2,500,000
	MIF Equity (Window IIIB):	US\$	2,500,000
	Banco Bx+ (Shareholders capital)	US\$	30,400,000
	Total Project Funding	US\$	35,400,000
Total MIF Funding	MIF Subordinated Debt (Window IIIB):	US\$	2,500,000
	MIF Equity (Window IIIB):	US\$	2,500,000
	MIF technical assistance (Window IIIA):	US\$	75,000
	Total MIF funding	US\$	5,075,000
Tentative Dates:	EVP: April 2005		

## II. BACKGROUND

- 2.1. **Background.** The Mexican banking industry has undergone trauma in the last 25 years - nationalization in 1982, reprivatization in the early 1990's, crisis and a wrenching process of recapitalization following the peso devaluation in December 1994. As the industry began to recover around 2000, several large foreign banks bought all of the largest Mexican institutions except Banorte – Citigroup/Banamex, Banco BBVA/Bancomer, Banco Santander Central Hispano/Banca Serfin, HSBC/Bital, and Scotiabank/Inverlat. As a result foreign banks now control more than 85% of all Mexican bank assets. There is also significant concentration in the industry, with the four largest banks accounting for almost 80% of total bank assets.
- 2.2. **The Problem.** Lending is, in most of the cases, a bank's main function in most countries, but not in Mexico. The result is that while Mexico's US\$ 600 billion economy is the largest in Latin America, its banking system remains pitifully small. Mexico's banks have assets of US\$174.25 billion, barely a third of GDP. Credit to the private sector is only 9% of GDP and deposits are equivalent to 21% of GDP, both among the lowest levels in Latin America according to Standard & Poors. Bank lending overall has remained relatively flat since 2000, and fell 3.75% last year. Banks in Mexico have their balance sheets full of low risk government bonds and public sector loans and increased profits by charging their customers fees on practically every transaction. Public sector obligations currently represent 42% of the banks' total assets. At the same time, total

bank financing for the agricultural sector in Mexico fell 40% between 2000 and 2002 due to perceptions of greater risk and lower profitability than other forms of lending.

- 2.3. This trend is doing little to help Mexico's credit starved SME and small farms, which are too small to access the capital markets and are of little interest to the large banks. Banks are unwilling to enter this sector because of, among other reasons, the perception of high risks, funding problems and high transactions costs. The result is that SMEs have mostly come to depend on the suppliers for credit. The suppliers, in turn, have little choice but to comply, if they want their customers to stay in business and sell their products. Sustainable growth in Mexico is still constrained by illiquid capital markets and an underdeveloped financial market that limits access to short-term financing for all but the largest firms. In President Fox own words: "Without credit there's no growth, without growth, no development".
- 2.4. **Program Rationale and Additionality.** The shareholders of Banco Bx+ see a great opportunity in lending to two segments: agriculture, which is completely ignored by the larger banks, and SMEs. These assumptions are based on the following factors: (i) by utilizing lines of credit and guarantees offered by FIRA ("Fideicomisos Instituidos en Relación con la Agricultura), Banco Bx+'s current management team (formerly at Bital) became one of the largest providers of credit to the agricultural sector and has the skills to do it again; and (ii) the Bank has the commitment and strategy in place to target the SME market that is neglected by the larger banks.
- 2.5. Banco Bx+ is the first bank at a national level that is basing its credit strategy on attending the agricultural sector and SMEs, socially worthy target markets due to their impact in growth and employment generation. The innovative methodology that the Bank's management developed at Bital to channel FIRA funds through rural intermediaries benefited a large number of small producers - and yet was low-risk - and will be replicated. With respect to SME lending, the Bank has hired the kind of people it needs to develop this program and is also exploring new ways to reach urban microenterprises through established micro-lending institutions. If Banco Bx+ is successful in implementing a business plan targeting what are normally considered high-risk sectors, it will provide a demonstration effect for other institutions throughout Latin America.
- 2.6. Banco Bx+, as a new institution relatively unknown to the market, will face difficulties in obtaining additional capital to grow and create a solid franchise. This project will convey a positive signal to other potential investors about the financial outcome and corporate governance standards of this new bank. For the first time, Banco Bx+ will be opening its equity ownership to an institutional investor, thereby improving its transparency, governance and long-term funding. The MIF will be the driver to attract additional investors in the new institution.
- 2.7. **Reformulated Proposal for Project.** The POC originally approved a previous Abstract for Banco Ve por Más on August 6, 2004 which consisted solely of a \$2,000,000 equity investment and a \$75,000 grant. Given BX+'s strong start in 2004, management of BX+ has subsequently requested that the MIF increase its equity and/or long term subordinated debt investment in BX+ so that they can leverage these funds to receive greater funding for xxx loans from FIRA. (See paragraphs xx for more details on these funding arrangements.) Since the MIF wishes to help BX+ in maximizing its potential lending impact in its targeted sectors, but at the same time wishes to limit its equity exposure to 50% of the total investment amount, the MIF is now proposing an equity stake of \$2.5 million and a long-term bullet subordinated debt loan.

### III. PROGRAM OBJECTIVES AND DESCRIPTION

- 3.1. **Objectives.** The general objective of this project is to expand the coverage of the Mexican financial system to small farms and SMEs. The specific objectives are to: (i) provide equity and subordinated

debt financing to a new SME-specialized financial intermediary; and (ii) test new ways of addressing the issues of funding, transactions costs and risk minimization that limit lending to SMEs. The subordinated debt tranche would be for ten years, thereby fulfilling the conditions for Tier One capital of the Basel II Capital Accords.

- 3.2. The project's desired outcomes are: (i) the capitalization of a new small farms and SME-specialized and sustainable lending institution; (ii) to provide financing to at least 375 SMEs over the next five years; and (ii) to attain a small farms portfolio of at least US\$200MM over the next five years.
- 3.3. **Description.** Of the sectors that form the core of the Bank's business strategy, the most important is agribusiness. The focus on agribusiness lending derives from two factors: the lack of financing for this sector and the long and successful experience of Banco Bx+'s management in building this business at Bital. Bital, under the current management of Banco Bx+, rose to become the largest user of FIRA's rediscount lines for agricultural lending. FIRA has already approved a rediscount line of up to US\$90.4MM for Banco Bx+.
- 3.4. Banco Bx+ plans to follow the practice it developed in Bital and place these funds directly with one of the following types of rural intermediaries: (i) producer organizations; (ii) distributors and processors in the production chain; (iii) specialized financial intermediaries; (iv) private sugar mills; and (v) suppliers of equipment or agricultural inputs. These organizations will in turn onlend the funds to the small producers who are their clients or members.
- 3.5. The rate at which FIRA lends depends on the overall income of the end beneficiaries. The price to Banco Bx+, is TIEE<sup>1</sup>-6, TIEE-1.75 or TIEE, to which the Bank will add an intermediation margin of about 5%. As Banco Bx+ plans most of its activity to be with rural intermediaries lending to small producers, it will be able to benefit from FIRA's TIEE-6 program. The rural intermediary must onlend the money to its members or clients at essentially the same rate it receives it, recovering some administrative costs. A typical end beneficiary will have sales of US\$2,600 and receive a loan of US\$1,740.
- 3.6. The risk of these transactions to Banco Bx+ is greatly reduced by the way they are structured and by FIRA's guarantees. In the rare case that the credit recipient can provide 1:1 fixed asset guarantees, FIRA will guarantee 40% of the loan. More typically, such guarantees will be unavailable, and the Bank will instead require a liquid guarantee equivalent to 30% of the loan amount. Of the remaining 70% exposure, FIRA will guarantee 90%. Thus, the Banco Bx+'s total exposure in such transactions is only 7% of the loan amount.
- 3.7. The second principal market is the SME sector, mostly ignored by the large Mexican banks because of the difficulty in structuring appropriate programs. Banco Bx+ is aware of this problem and intends to design different programs for the various subsectors. Its initial business lending program is designed for companies with sales between US\$870,000 and US\$17.3MM. Size of loans will range from US\$260,000 to US\$2.6MM. Credit applicants must be formally registered as a business, possess some historic financial information and have been in operation for at least two years. They will also be asked to provide a fixed asset or personal guarantees. Unlike its agribusiness lending activity that will be nationwide, Banco Bx+ will at the beginning only make business loans in metropolitan areas where it has physical presence. Banco Bx+ is hiring account executives with at least ten years of experience as it recognizes that the account executive will have to play the role of financial adviser to SME clients and therefore must be highly experienced.

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<sup>1</sup> TIEE is Mexico's interbank rate and currently stands at about 7.0%.

- 3.8. Funding for the SME lending program will come from either the Bank's own deposit base or from Nafinsa rediscount lines. Nafinsa has already approved a US\$4.35MM line. Nafinsa will provide 100% of the funding for eligible transactions at an interest rate of TIEE. Banco Bx+ can then add a margin of 4-6%. Nafinsa will guarantee 50% of the loan, if for short-term working capital purposes, and 70% of the loan, if it is utilized for a longer-term fixed asset purchase. While the guarantee aspect of the Nafinsa funding is attractive, the interest rate is not particularly so. Banco Bx+ will have to decide on a case-by-case basis whether it wishes to utilize the Nafinsa line, its own deposits or a combination of the two to fund its business loans.
- 3.9. As the program stands right now, Banco Bx+ will have difficulty reaching the smaller end of the spectrum, particularly because of the lack of available guarantees. Banco Bx+, if successful in growing, plans to reach out the rest of the country and to develop schemes similar to its agribusiness program that will allow it to lend to small businesses without requiring fixed asset guarantees.
- 3.10. Where Banco Bx+ is already active in financing small business is through the leasing company it acquired, Arrendadora Sofimex (renamed Arrendadora Ve por Más). As of May 31, 2004, the total portfolio of Arrendadora Ve por Más stood at US\$8.8MM, of which the past due portfolio was only 1.5% of the total. The current mix is about 80% financial leases and 20% pure leases. Arrendadora Ve por Más is trying to move the mix more towards pure leasing, a niche almost unattended in Mexico. Looking at the type of equipment Arrendadora Ve por Más leases, about 33% is automobiles, 29% cargo trucks, 12% industrial machinery and 11% real estate. The typical contract size is from US\$35,000 to \$44,000.
- 3.11. The third line of credit activity that Banco Bx+ plans to develop is mortgage lending for individuals. The great majority of mortgages in Mexico are provided through government trust funds and are directed to low-income housing. The Mexican banks retreated from financing middle-class housing after the mid-1990's crisis, currently being underserved. Banco Bx+ will only have a small presence in this market, mainly to serve its middle-class depositor clients.
- 3.12. Funding strategy. While a major part of Banco Bx+ credit portfolio will be funded through rediscount lines, the Bank will also fund itself by capturing deposits. Banco Bx+ does not intend to be a transactional bank. What Banco Bx+ plans to offer its clients are advantaged savings products. Its basic instrument is referred to as the *cuenta verde*, offering liquidity on demand while paying a privileged interest rate. In September 2004, the Bank began offering a checking account. The third product, designed for individuals, is a term deposit that will pay a rate beyond CETES. What will allow Banco Bx+ the ability to offer better rates than its largest competitors is the fact that its infrastructure costs will be far lower. The Bank intends to open only a single branch per city, remaining lean in this way, and most of the deposits will be made through electronic transfer from client's transactional banks. As a matter of policy, the Bank has decided not to accept cash deposits, as a protection against money-laundering. While the Bank only began to accept deposits at the end of May 2004, it had raised about US\$21.1MM by the end of October 2004. In order to enhance the products it offers its clientele, the Bank has acquired a small mutual funds manager called OFIN, Operadora de Sociedades de Inversión that currently offers five fixed-income funds and one equity fund. Its total assets under administration at the end of the first quarter were US\$21.9MM equivalent to a tiny 0.06% share of the total market. Unlike bank deposits, however, mutual fund deposits have to be invested in specific instruments and are not available for making loans.

## **IV. COST AND FINANCING**

- 4.1. Given: (i) Banco Bx+'s highly innovative nature and high-impact demonstration effect; (ii) the start-up profile of the institution that needs to use its cash flow for further investment; (iii) the need to signal confidence in the new institution to the market; and (iv) the multiplicative effect on lending created by augmenting the institution's capital base; the MIF is considering an equity investment of up to US\$ 2.5mm in common stock. Some key characteristics of this stock would be: (a) valuation close to the most recent subscription price on September 27<sup>th</sup> 2004 of MXP10.65 (approximately US\$0.95) plus inflation since the subscription date; (b) put option to existing shareholders of 1.25 of the Bank's book value per share after the fifth year; (c) transfer rights to sell shares to third parties; (d) pre-emptive and tag-along rights; and (e) special approval rights over key corporate events.
- 4.2. The subordinated debt loan is will be repaid in full at the end of ten years and will be based on a floating rate of six months LIBOR plus 4.5%. The proceeds from the issuance of the Subordinated Debt shall be used directly for small and medium-size enterprise lending or for providing infrastructure for these activities.
- 4.3. The project will also include a US\$ 75,000 component of technical assistance, to be managed and monitored by MIF, in order to finance periodic independent evaluations of the Fund on the MIF's behalf, for monitoring activities and legal advice.

## **V. EXECUTING AGENCY AND EXECUTION STRUCTURE**

- 5.1. In 2003, Mr. Ruiz Sacristán, the former Director Genral of Bital (formerly Banco Internacional) and members of the del Valle family acquired on July 15, 2003 all the shares of the Mexican subsidiary of Dresdner Bank, and changed its name to Banco Ve por Más. Dresdner Bank had essentially ceased operations but held the dual attractions of possessing a banking license and approximately US\$32.3MM tax loss. During the last year, the management group, most of which previously worked together in Bital, has dedicated its time to putting in place all the systems, policies, controls and personnel necessary to operate a first-class financial institution. The group also made two further acquisitions: Arrendadora Sofimex, S.A. de C.V., a leasing company, and OFIN Operadora de Fondos de Inversión, S.A. de C.V., a manager of mutual funds. The National Banking Commission (CNBV) conducted three comprehensive inspections of the Bank in the first part of 2004. On May 24, 2004, Bx+ officially opened for operations.
- 5.2. The del Valle Family owns 44% of the bank. Other important shareholders are Eugenio Clariond, son of the owner of Monterey-based steel company Grupo Imsa; Juan Beckman, majority shareholder and CEO of Tequila Cuervo; Divo Milán, a financial sector executive; and Jaime Ruiz Sacristán, the Bank's CEO. Eduardo Tricio is the majority shareholder and CEO of dairy giant, Grupo Lala. The initial capitalization of the Bank was US\$30.4MM.
- 5.3. The Board of Directors consists of twelve members and their alternates, two of which are members of the del Valle family, six represent other shareholders of the Bank and three are independent. The Board has been meeting monthly during this start-up phase of the bank. The Board has several committees that meet on a regular basis: Audit Committee, Risk Management Committee, Treasury Committee, Credit Committee, and Committee for the Prevention of Operations with Illicit Funds.
- 5.4. Although Banco Bx+ is a new institution, it is characterized by a highly seasoned executive team, led by Jaime Ruiz Sacristán, which steered Bital through the debacle of the mid 1990's to its eventual and highly profitable sale to HSBC. Also considerably diminishing the risk of a new

institution is the fact that most of the management has worked together for the better part of a decade.

- 5.5. As a commercial bank, Banco Bx+ is subject to regulation in various forms by the Banco de México; the Instituto para la Protección de Ahorros Bancarios (“IPAB”), which is akin to the FDIC; and, ultimately, the CNBV. As a result of the banking crisis of the mid 1990’s and the huge cost of rescuing the system, the whole process of bank regulation and supervision in Mexico has become considerably tightened. Mexican banks are subject to the capitalization standards established in the Basel accords and will soon have to adapt to the provisions of Basel II.

## **VI. MAJOR ISSUES**

- 6.1. The following issues must be analyzed more accurately in the due diligence mission for this project:
- (i) One of the major risks that Banco Bx+ faces is a slower pace of accumulating deposits than expected to fund its credit program. The Team will analyze the convenience of negotiating an additional credit line to Banco Bx+;
  - (ii) The Bank is projecting a very low past-due portfolio of around 1%. While its leasing subsidiary is showing numbers just above this, the industry as a whole has a past due ratio of 4%. The Project Team will review its credit and supervision process and will try to measure the effect that will have on the Bank a deterioration of its portfolio, as well as on MIF’s equity;
  - (iii) The shareholders, outside the bank, recently acquired a brokerage operation (Casa de Bolsa Arka) from the IPAB (Mexico’s FDIC) at an extremely low price. They would like to contribute this to the bank but if they mark it to fair market value this will generate an immediate capital gain. However, they feel by contributing it at acquisition value it gives later entrants like ourselves who are buying at the pre-acquisition price an unfair benefit. The due diligence team will have to find agreement with the management that is acceptable to all shareholders.
- 6.2. The Project Team has prepared a draft term sheet with Banco Bx+ and pending approval of the POC, will negotiate the terms with Bx+ management.

## **VII. ENVIRONMENT & SOCIAL ISSUES**

- 7.1. Given the investment strategy of the Bank, the Project Team does not foresee any negative environmental impact. Banco Bx+ will manage the company in accordance with the IDB/MIF environmental and social guidelines for MIF-supported financial intermediaries<sup>2</sup>. As part of fulfilling the requirements of these guidelines, Banco Bx+ will be expected to participate in a MIF/IADB-approved training course on environmental and social review for financial intermediaries.

## **VIII. ACTION PLAN**

- 8.1. The following is a preliminary schedule for the project’s approval process:

CESI	February 2004
Due Diligence	March 2004
Donors Committee	May 2004

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<sup>2</sup> MIF/IDB Environmental and Social Guidelines for MIF Financial Intermediary Operations.  
<http://www.iadb.org/mif/>