Mexico: basking in the sun

Notes from the road

Emerging Markets Equity team

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"Given the macroeconomic prospects and the quality of investment opportunities, we would not be surprised to see Mexico becoming a more significant part of emerging markets over the next 5-10 years."

Flying in over Mexico City at night, where the twinkling city lights seem to stretch for miles on end, can make you easily forget that Mexico is still a developing country. Considered to be one of the largest cities in the world, it is a vast city that is home to most of the companies we met with on the trip.

It had been a few years since our last visit, and overall, we came back with an optimistic feeling, not only regarding the outlook for the country but also the equity market. Investors have been neglecting Mexico and Latin America more widely over the last decade, with the region representing more than 20% of the MSCI EM Index in 2010 compared to less than 10% today, and Mexico's weight in the index declining from over 10% in 2002 to below 3% today. Given the macroeconomic prospects and the quality of investment opportunities, we would not be surprised to see Mexico becoming a more significant part of emerging markets over the next 5-10 years.

Flying into Mexico City.

Nearshoring

'Nearshoring' has been the big buzzword associated with Mexico in recent years and it was also an important theme for our trip. Nearshoring refers to U.S. companies moving production closer to their bases and consumers, and Mexico has emerged as one of the clear front-runners of this trend as a consequence of China-U.S. geopolitical tensions. As Mexico's northern neighbour looks to reduce its reliance on China, investment in Mexico from companies like Tesla, BMW, and GM is booming. Recently, Mexico's import share from the U.S. overtook China's share, making Mexico the U.S.'s largest trading partner. In addition to its obvious geographical benefit, Mexico's free-trade agreements and its large, low-cost labour force are key advantages.

> "Our general sense on nearshoring is that it is still in its early stages and likely to continue for years to come."

During the trip we did a 'nearshoring visit' to Monterrey, one of the main industrial hubs in northern Mexico. Here we visited industrial parks and came away with an understanding that demand for industrial real estate is thriving. Vacancy rates are close to zero and a lot of new manufacturing space is leased out before construction is even finished. Our general sense on nearshoring is that it is still in its early stages and likely to continue for years to come.

While the Mexico nearshoring narrative looks positive in the long run, many of the companies and people we spoke to also mentioned the risks in relation to this unfolding story. Mexico needs to build electricity and water infrastructure to meet the increasing manufacturing demand and the country is currently still too reliant on fossil fuels. Future policy alignment with investment in electricity generation will be crucial in order to take full advantage of this extraordinary opportunity.

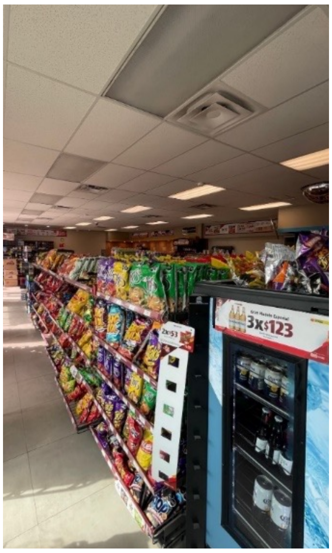
Politics

The summer of 2024 will mark the beginning of a new chapter in the Mexican political landscape. The next presidential election will be held and the current president, Andrés Manuel López Obrador ("AMLO"), will need to stand down, due to constitutional laws limiting him to a single six-year term. Most people we spoke to believe that the sitting Morena party will win, given AMLO's remarkably high approval ratings above 60%, classing him as one of the most popular presidents in the world. Former Mexico City mayor, Claudia Sheinbaum, is the front-running candidate for the Morena party and thus the most probable next president of the country. Meanwhile though, the leading opposition candidate, the outspoken Xóchitl Gálvez, has a remarkably noteworthy profile. The daughter of an indigenous father and a mixed-race mother, she comes from humble origins and has credibility as a corruption fighter. Therefore, when Mexicans go to the polls next June, they will almost certainly choose between two women for president – a first in the country's history.

Industrial park and warehouse visit in Monterrey in northern Mexico.

Even though the immensely popular AMLO has promised to completely retire from politics once his six-year term in office comes to an end, he is still trying to make his mark in his final year as president. We were reminded of this when, shortly after arriving in Mexico, the government changed the regulation of the three private airport operators in the country for the first time in 25 years. With that, AMLO sent a clear message that he is still very much in charge. The Mexican airport stocks had been some of the most profitable companies and best performing stocks in the country in the last decade. It will be interesting to see if this turns out to be a one off or if regulatory interference becomes a bigger theme heading into the election next June.

View of Mexico City from a company office.



Oxxo convenience store visit, owned by FEMSA.

Walmex supermarket visit, tortillas in cart – ready to be put on shelves.

Mexico's equity market

A distinctive feature of the Mexican equity market is that it is dominated by family-owned companies. While Mexico is home to many strong franchises with structural growth opportunities and high quality management teams, historically, family interests and holding company structures have not always been shareholder friendly. However, the tides are changing. During our trip, we met with large companies like Alfa and FEMSA that are in the process of simplifying their group structures, improving transparency, and focusing on core business strengths. We also saw that certain Mexican 'fibras', the term for some of the country's leading real estate companies, have started thinking about reforming their fee structures, which would be an encouraging signal for corporate governance. Overall, we believe that these company-level improvements should put Mexican corporates in an increasingly more positive light.

Consumption and financialisation

It became clear to us on the trip that Mexico has attractive long-term thematic drivers, in particular domestic consumption and financialisation. In the consumer realm, it is remarkable to observe how strong some U.S. brands are in Mexico. Coca-Cola, Starbucks, and Walmart all have strong brand equity in the nation. For instance, Coca-Cola consumption is deeply embedded in cultural habits and Mexico has the highest per capita consumption in the world of this soft drink. Starbucks is synonymous with coffee in Mexico, with the chain estimated to have more than 70% market share. Many Mexican companies indirectly benefit from the strength of these brands, such as Coca-Cola bottlers, restaurant operators and, of course, Walmex – the most successful Walmart subsidiary outside of the U.S..

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Mexico's high informality of the job market translates into very low bancarisation in the country. As Latin America's second largest economy, Mexico could have the highest growth potential in financial services over the long term. As an example, Mexico has the lowest per capita credit card penetration within major Latin American countries and it is still largely a cash economy.

During our trip, we did a retail tour and visited several stores, including Oxxo which is the leading convenience chain store brand across Mexico and the main asset of FEMSA, as well as Walmex's supermarkets. Both FEMSA and Walmex have been successful at catering to Mexican tastes and are increasingly investing in digital and fintech initiatives to attempt to take advantage of the low financial services penetration in the country.

Reflecting on our trip, we have returned with increased conviction that Mexico is an attractive long-term investment destination. And in spite of the positive outlook, the market valuations look fairly cheap in a historical context. Shorter-term risks exist, such as potentially increasing political interference in markets ahead of the election, as well as the possible spillover effect if we see a U.S. recession. However, we are enthusiastic about the future for the Mexican companies that we own across our portfolios.

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