

Mexico Equity Market Themes in 2008

a Presentation for

**2008 Latin American Cities Conference
Mexico City, Mexico**

Panel I: The Mexican Economy in the Eyes of Wall Street

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March 11, 2008

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Mexico Equity Market Themes

- **Macroeconomy & Policy Backdrop**
 - A slowing U.S. economy and the transmission to Mexico through the balance of payments
 - Mexico's policy response – Part Keynesian, part populist
 - Will higher inflation be the result?
- **The Anti-Trust Agenda: Winners and Losers**
 - Good for growth, bad for large-cap stocks
 - First targets are in media and telecoms
 - Are retail banks next?
- **Energy Reform in Mexico**
 - What form will restructuring of the energy sector take?
 - Who will benefit from the regional trend in energy investment?
- **2008: A Turning Point for *Sifore* Participation in Local Stocks?**
 - New reforms to the system set for 2008
 - How much new participation in the equity market can we expect?
- **Putting it All Together: Views on Equities in 2008**
 - Poor U.S. economy, threat of inflation, anti-trust agenda, corporate taxes will keep sentiment poor
 - We like infrastructure plays, beneficiaries of energy reform, defensive stocks, small and medium-sized start-ups
 - We avoid large cap telecoms, retail banks

Macroeconomy & Policy Backdrop

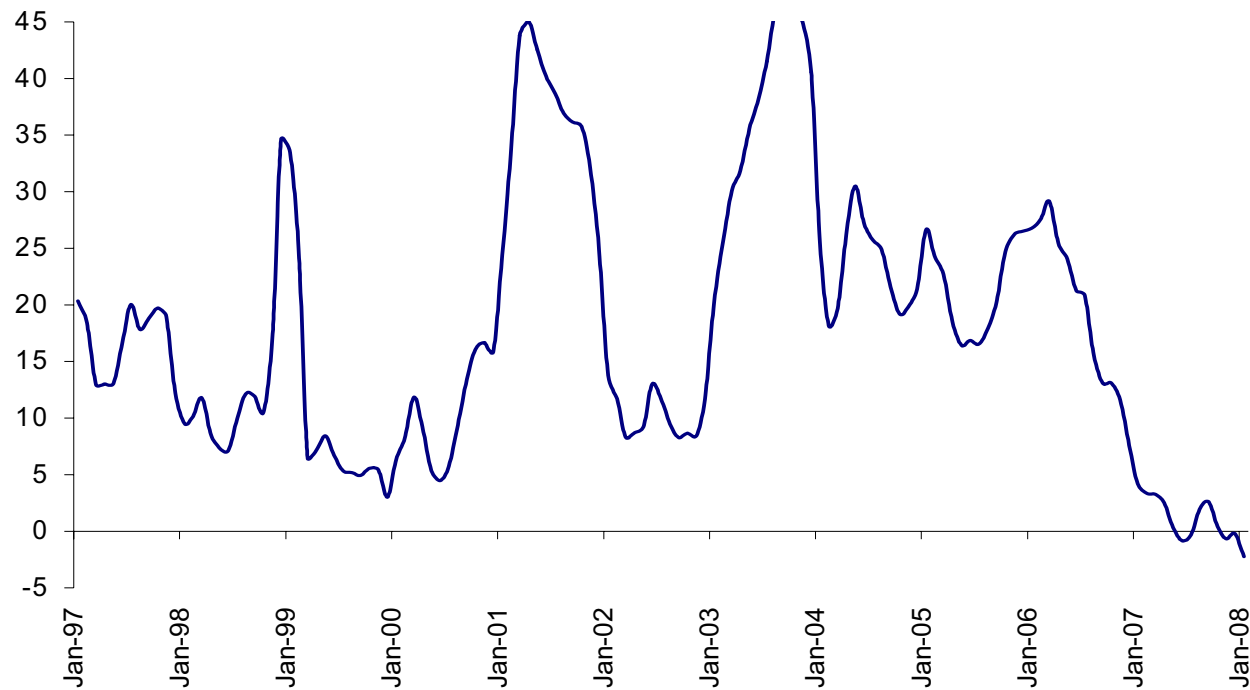
- In short run, a material two-quarter slowdown in U.S., spreading to Europe, China
- Emerging markets will not “decouple” from U.S. consumer-led slowdown
- In long run, structural weakness of USD and USD-bloc currencies as Bretton Woods II monetary arrangement dissolves slowly
- Rush to commodities is result of need to hedge against U.S. dollar weakness
- Commodity rush is causing inflation in countries with large food component in CPI basket, and countries that are unwilling to let local currency appreciate
- Policy response in most emerging markets should be to boost domestic consumption and fixed asset investment in non-export industries, allow currencies to appreciate against U.S. dollar, depend less on export sector
- ...but given long legacy of Bretton Woods II, this is not politically feasible everywhere

Macroeconomy & Policy Backdrop

- **Mexico is at risk from U.S. slowdown through the negative implications for the balance of payments**
 - **Remittances decline as employment in key U.S. sectors (i.e., construction) deteriorates**
 - **Historical relationship between remittance growth and new unemployment claims in construction sector**
 - **Mexico's manufacturing exports affected in consumer product areas**
 - **Manufacturing is slowing**
 - **Tourism receipts could decline as discretionary spending in U.S. declines**
 - **Has not happened yet as MXN declines with USD against Euro, other currencies**
 - **Foreign direct investment from U.S. declines as cost of funding rises**
 - **Failure to strongly diversify FDI away from U.S. and manufacturing**

Macroeconomy & Policy Backdrop

Mexico: Remittances, Year over Year Change, 3-mo. Moving Average (Jan. 1997 – Jan. 2008)



Source: Banco de Mexico

Macroeconomy & Policy Backdrop

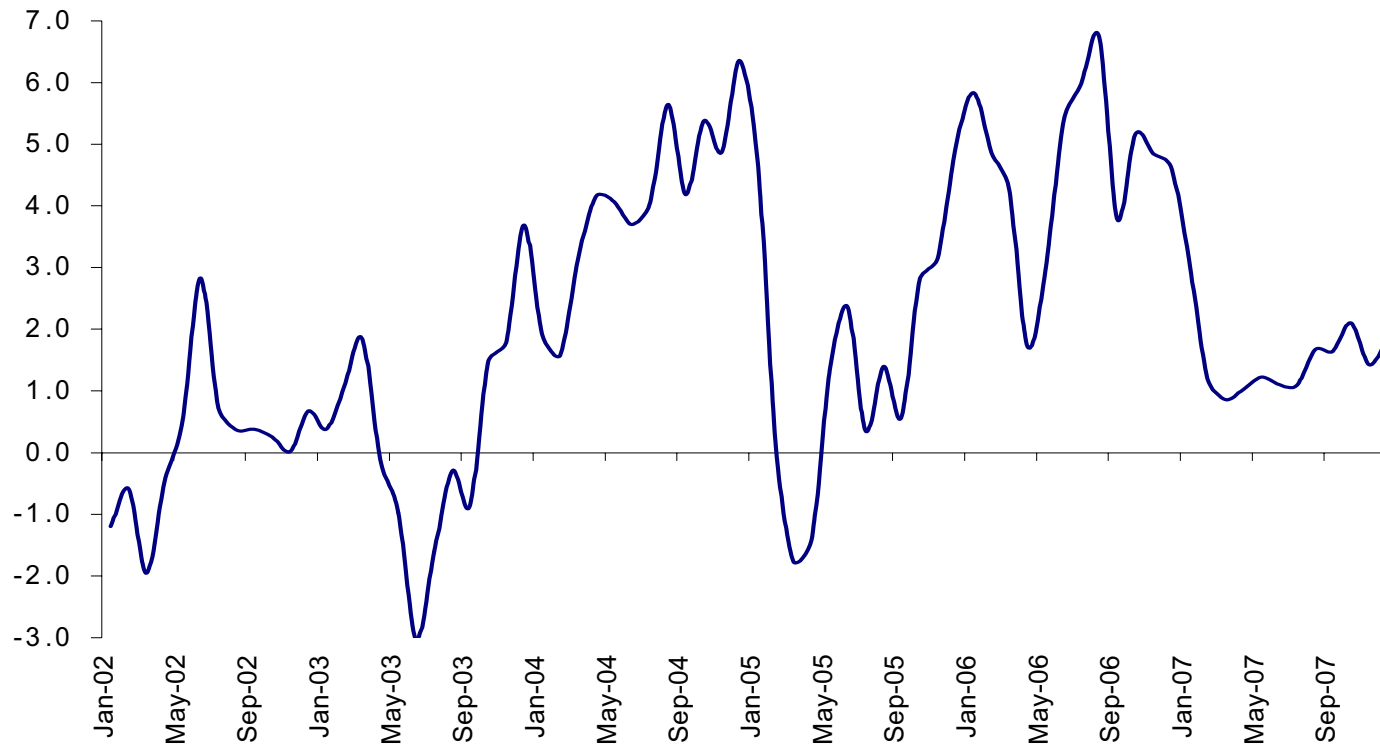
Mexico: Trends in Manufacturing Employment



Source: Bloomberg LP

Macroeconomy & Policy Backdrop

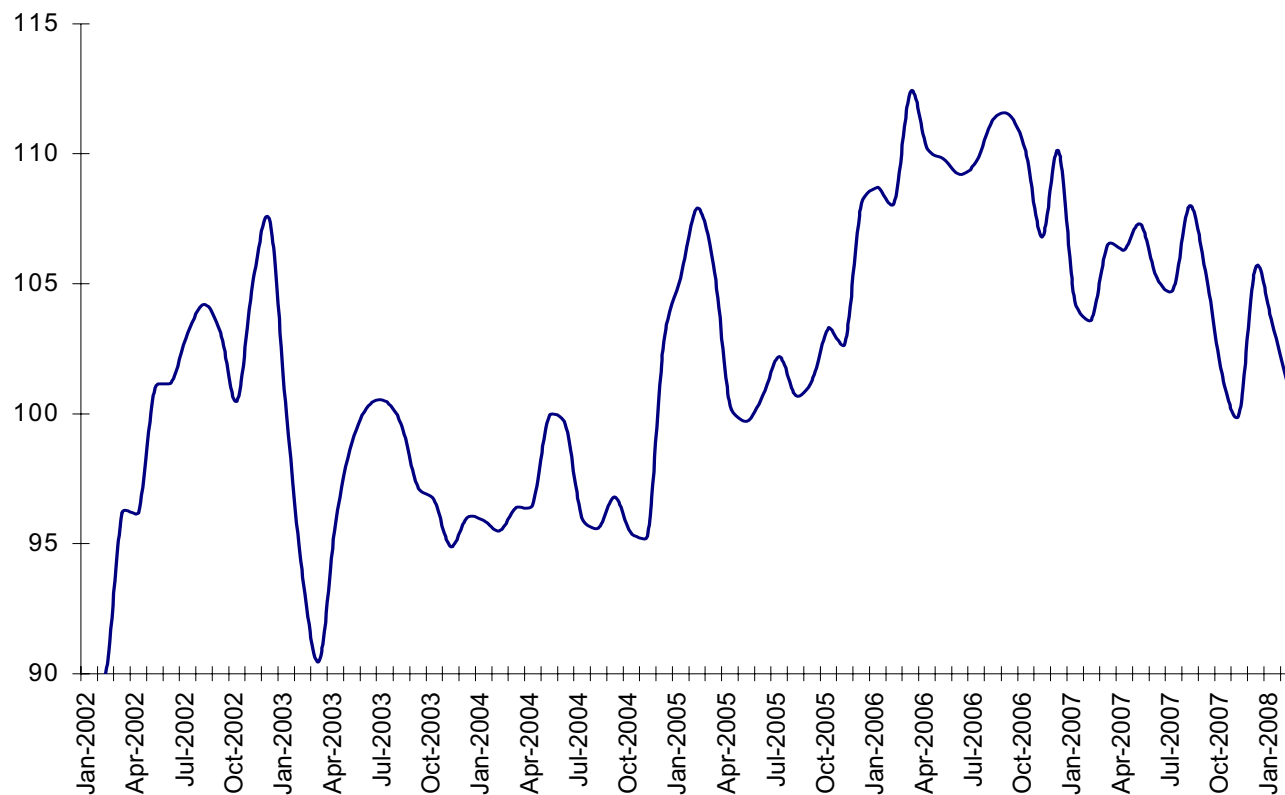
Mexico: Industrial production, Year over Year Change (Jan. 2002 – Dec. 2007)



Source: INEGI

Macroeconomy & Policy Backdrop

Mexico: Consumer Confidence Index (Jan. 2002 – Feb. 2008)

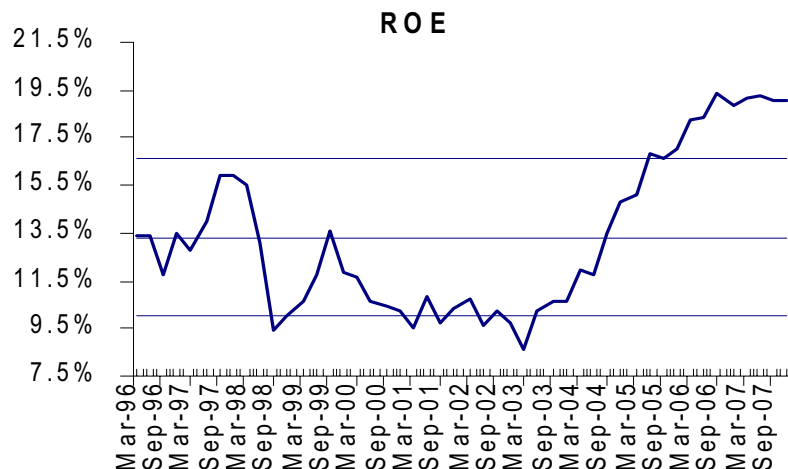


Source: INEGI

Macroeconomy & Policy Backdrop

For our database sample of 35 listed Mexican companies, return on equity has been high (~20%)...

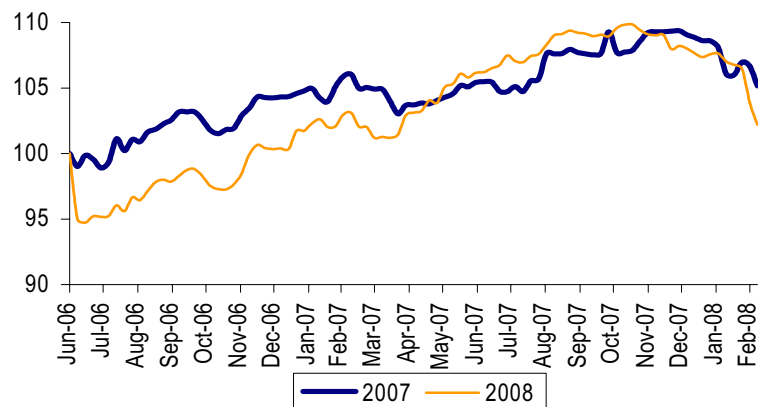
Mexico: Return on Equity



Source: Bloomberg; IBES; Bear Stearns & Co.

Mexico: EPS Estimates Index (June 2006=100)

EPS Estimates Index (Local Currency)



Source: Bloomberg; IBES; Bear Stearns & Co.

...But forward (consensus) estimates for 2008 earnings have moved sharply lower since October 2007

Macroeconomy & Policy Backdrop

- Mexico's macroeconomic policy response has been part Keynesian, part populist
 - Sticks with Keynes' balanced-budget multiplier – new taxes, new spending, new investment incentives
 - Burden of revenue increase in fiscal reform of 2007 falls on corporations, through IETU, other taxes
 - Favors companies with low large asset base / high capital expenditure programs
 - Disfavors companies with historically low effective tax rates
 - Revenue assignment favors state & local infrastructure programs, federal infrastructure programs
 - New fiscal stimulus of March 2008 also emphasizes infrastructure, marginally reduces corporate tax burden

Macroeconomy & Policy Backdrop

Mexico: Changes in Public Revenues as a Result of Fiscal Reform, as a Percentage of GDP

	2008	2009	2010	2011	2012
APPROVED FISCAL REFORM					
Federal Level, Total (1 + 2 + 3 + 4)	1.1	1.4	1.7	1.9	2.1
1. New Control Tax (IETU)	1.1	1.1	1.2	1.2	1.2
2. Tax on Cash Deposits	0	0.1	0.1	0.1	0.1
3. Efficiency Gains in Tax Collection*	0.2	0.4	0.6	0.8	1.0
3.1 At Level of Income Tax	0.1	0.3	0.4	0.5	0.7
3.2 At Level of VAT	0.1	0.1	0.2	0.3	0.3
4. Removal of Asset Tax (IMPA)	-0.2	-0.2	-0.2	-0.2	-0.2
PROPOSED FISCAL REFORM					
Federal Level (Total)	1.5	2.2	2.4	2.6	2.8
CETU (URCF)	1.3	1.8	1.8	1.8	1.8
Efficiency Gains in Tax Collection*	0.2	0.4	0.6	0.8	1.0
Difference	0.4	0.8	0.7	0.7	0.7
EXPECTED REVENUE ASSIGNMENT					
Stays at Federal Government	0.8				
Distributed to Federal Entities (Total)	0.3				

Source: SHCP; Bear, Stearns & Co. Inc.

Note: These revenues do not incorporate the additional cash flow that Pemex will enjoy due to a reduction in its tax rate.

Macroeconomy & Policy Backdrop

- But mixed into Keynesian stimulus is series of price controls
 - Tortilla accords
 - Supermarket accords (covering 300 products)
 - First electricity tariff reductions
 - Delay of fuel tax surcharge
 - Second electricity tariff reductions

- In Mexico, CPI inflation has moderated, mostly in the product categories affected by administered price controls

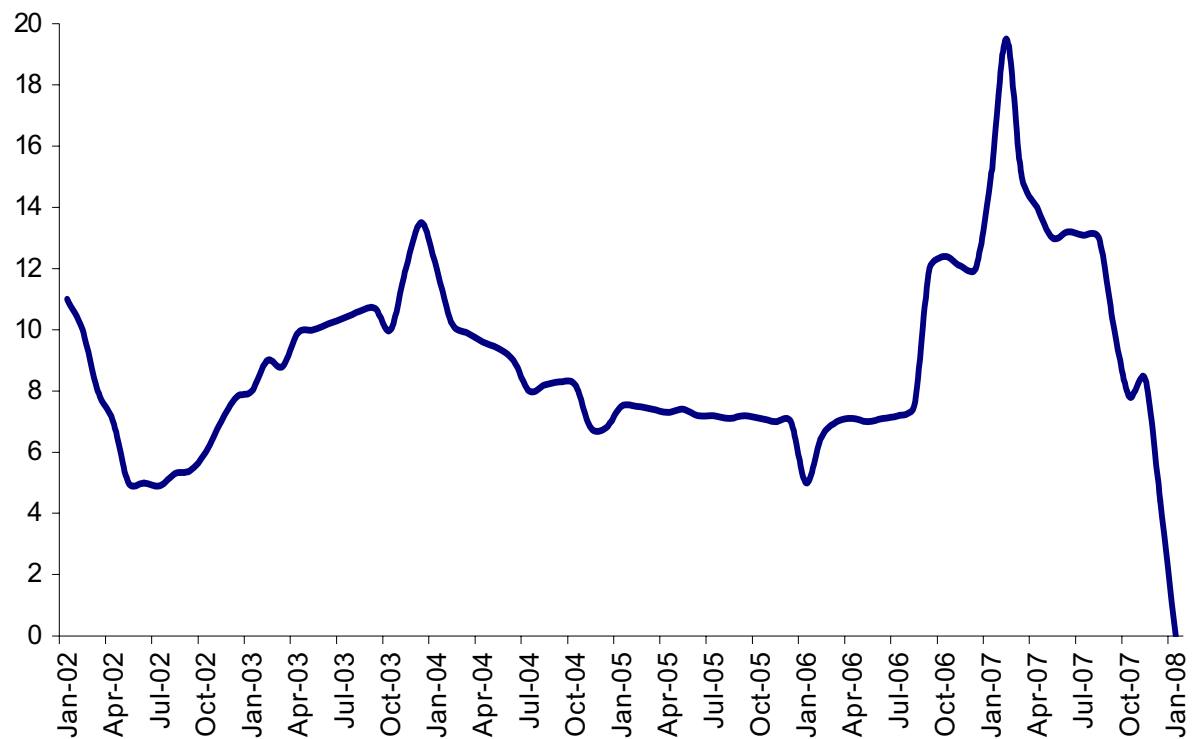
- But concern is that price controls are a way of dampening CPI Inflation, justifying low interest rates in the face of U.S. slowdown, higher inflation regionally

- Other measures besides 'headline inflation' are showing rising inflationary pressure – PPI, core CPI

- Risk is that inflation will be even greater in medium term as price controls expire

Macroeconomy & Policy Backdrop

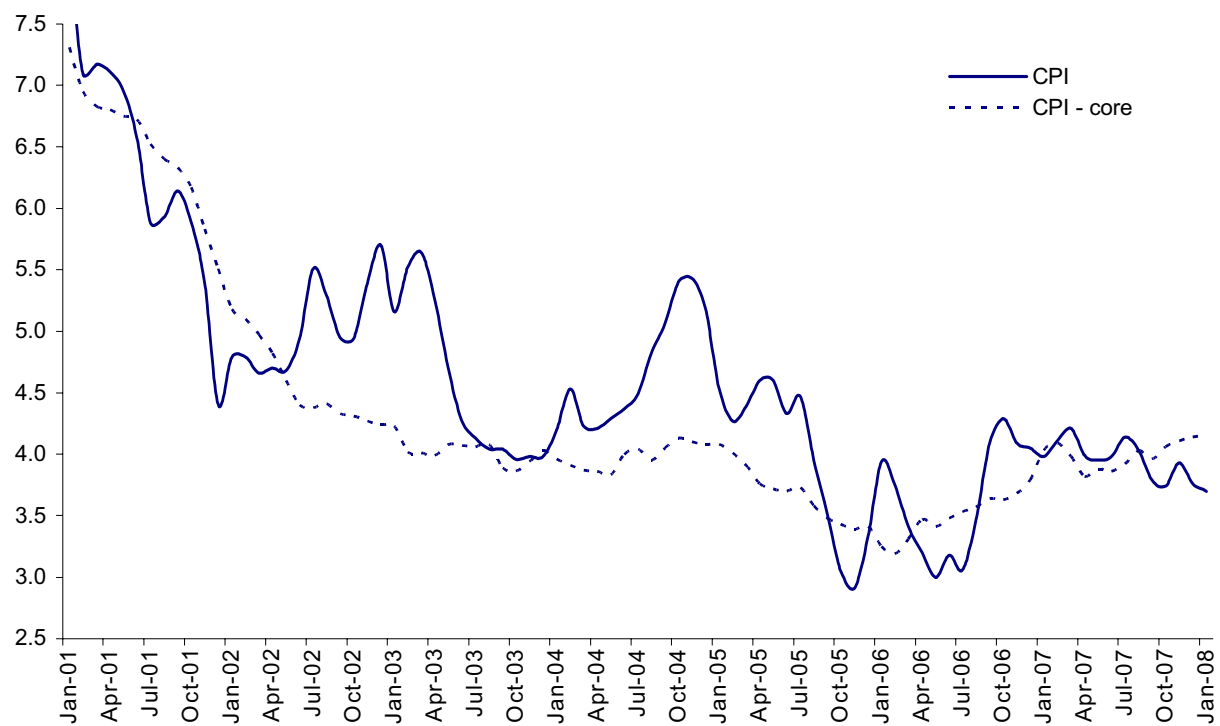
Mexico: Tortilla Price Index, Trailing 12-Month Percentage Rate of Change



Source: Central Bank of Mexico.

Macroeconomy & Policy Backdrop

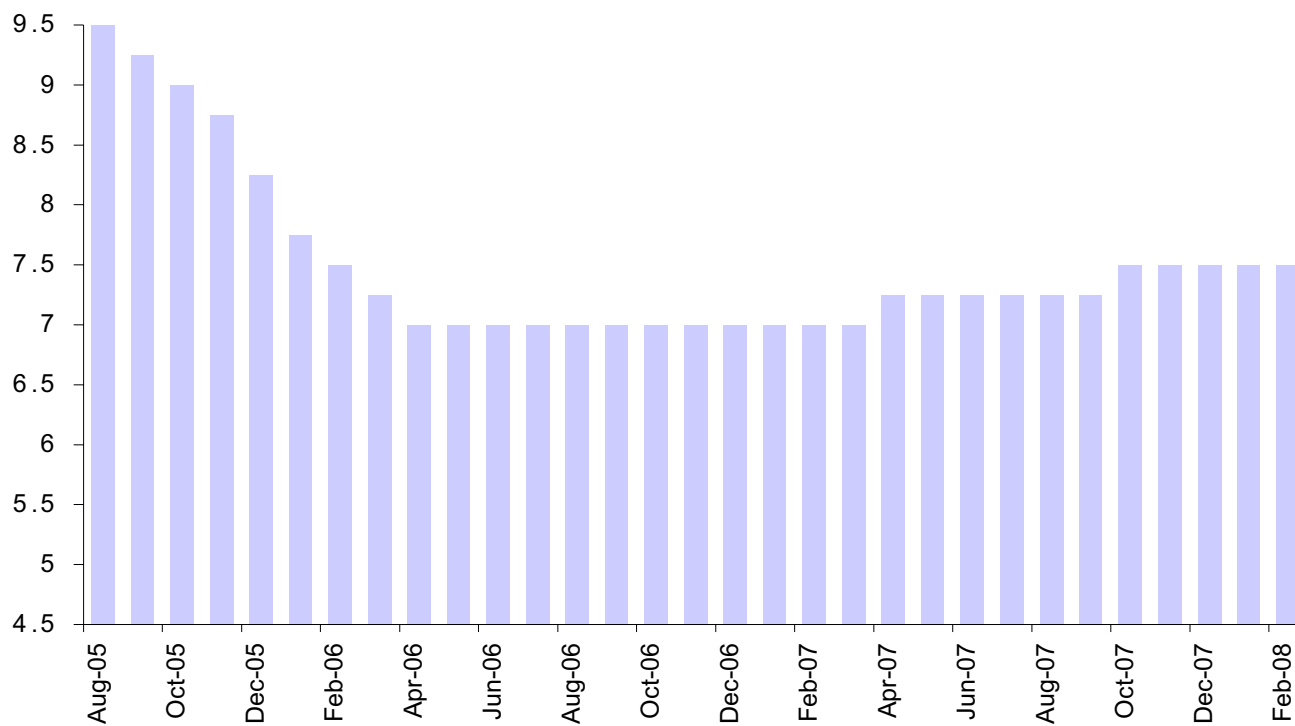
Mexico: Consumer Price Inflation (year over year, through January 2008)



Source: Central Bank of Mexico.

Macroeconomy & Policy Backdrop

Mexico: Overnight Policy Interest Rate (Aug. 2005 – Feb. 2008)



Source: Banco de Mexico

The Anti-Trust Agenda: Winners and Losers

- Anti-trust, pro-competition agenda is born of view that monopolies/duopolies have...
 - Retarded innovation, lowered growth, constrained output
 - Earned monopoly rents, redistributed income away from working class

- Support across the political spectrum for anti-trust agenda
 - Political right sees it as pro-growth agenda
 - Political left sees it as re-distributional agenda

- New tools:
 - New Competition Law of 2006 - Empowers the Federal Competition Commission
 - More aggressive courts
 - New regulatory frameworks – Financial Transparency Law, Amendments to Law of Credit Institutions

- Good for growth by promoting competition and innovation, but poses risks to large-cap stocks

- Also, risk that administration adopts tactics of the left – overemphasis on price controls

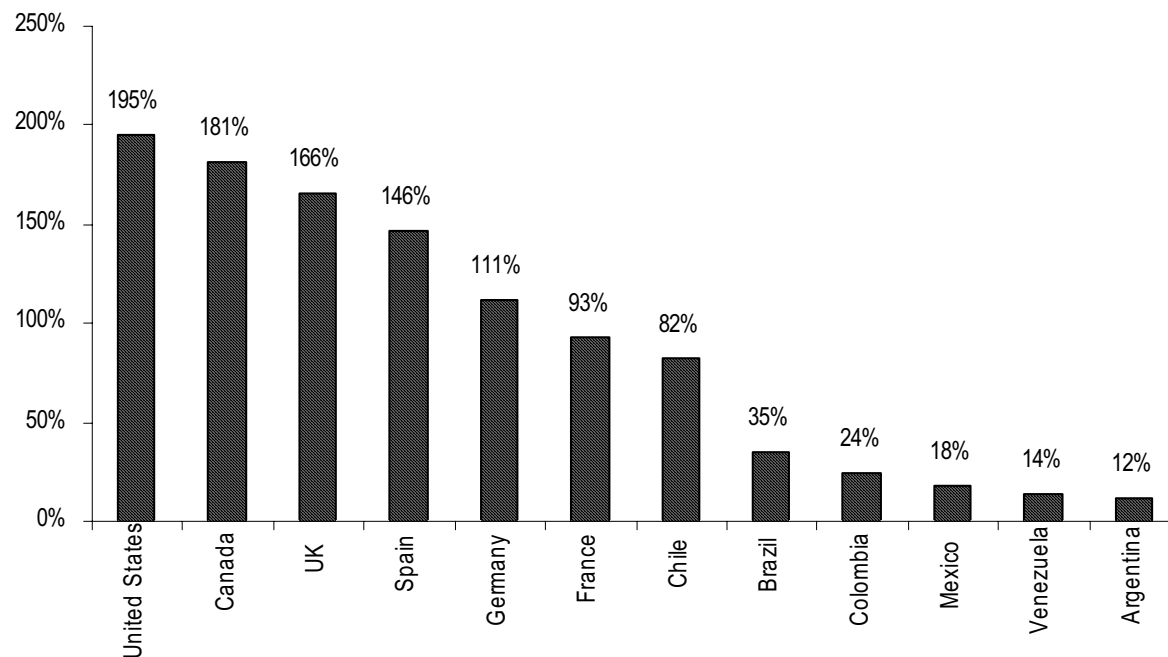
The Anti-Trust Agenda: Winners and Losers

- First targets have been media companies, telecom companies
 - Overturning of Media Law
 - “Must carry”/ “must offer” concessions from media outlets
 - Opening new cases against Telmex: market dominance, business practices, interconnection fees
 - Opening new cases against Telcel: interconnection fees
 - *Greatest risk is in the next few weeks; 2008 will be year of resolution on anti-trust issues*
 - Opportunity: government is providing regulatory support for new entrants, local-exchange carriers (CLECs)

- Are retail banks the next targets?
 - Policymakers see banks as having underserved population
 - Market power expressed through high fee generation, lack of fee transparency
 - 2007: Law of Transparency, amendments to Law of Credit Institutions
 - Agenda will be invoked through regulation of fees, new bank licenses, promotion of special-purpose banks
 - While bad for large retail banks, agenda could foster growth of related sectors (*business services, home building, securitization*)

The Anti-Trust Agenda: Winners and Losers

Mexico: Credit as a Percentage of GDP as of 2006



Source: ABM, with data from the World Development Indicators.

The Anti-Trust Agenda: Winners and Losers

Mexico: Banking-Sector Fee Income as Percentage of Net Income

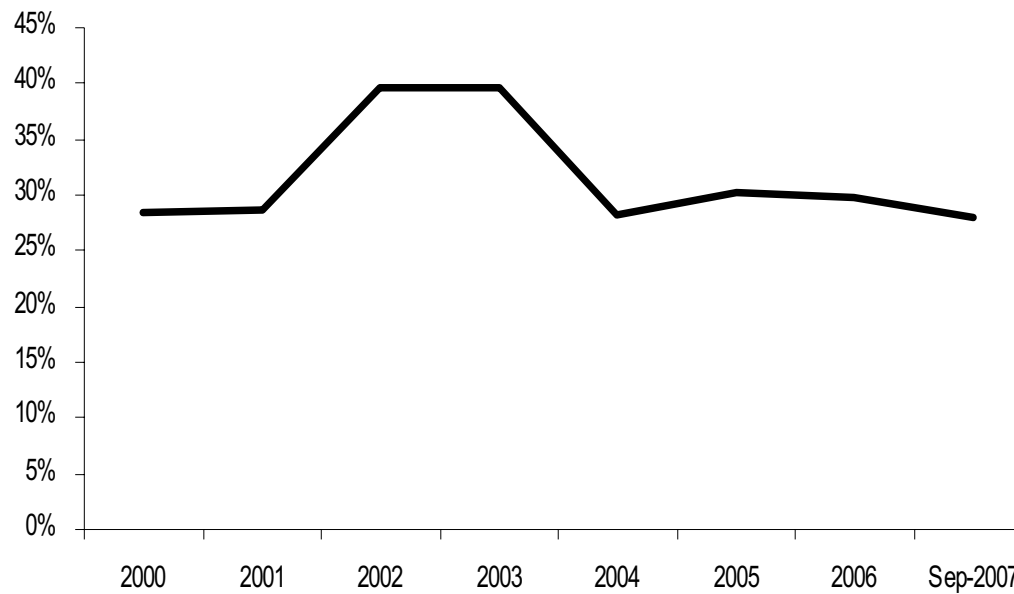
Mexico: Measures of Bank Penetration

	By 100,000 inhabitants		
	ATMs	Point of Sales Terminals (POS)	Bank Branches
Canada	164.2	1769	28.3
United States	133.5	1969	37.2
Brazil	78.6	716	9.7
Chile	31.5		10.7
Mexico	28.1	384	9.0
Argentina	16.4	N/A	10.1
Colombia	16.3	186	10.0

Source: ABM, with data from Banxico, CNBV, CEMLA, Bank of International Settlements, BCB, FEBRABAN, ABECS, Superintendencia de Bancos de Chile, and Canadian Banking Association. All the other data is for 2006 but in Mexico is as of December 2007.

The Anti-Trust Agenda: Winners and Losers

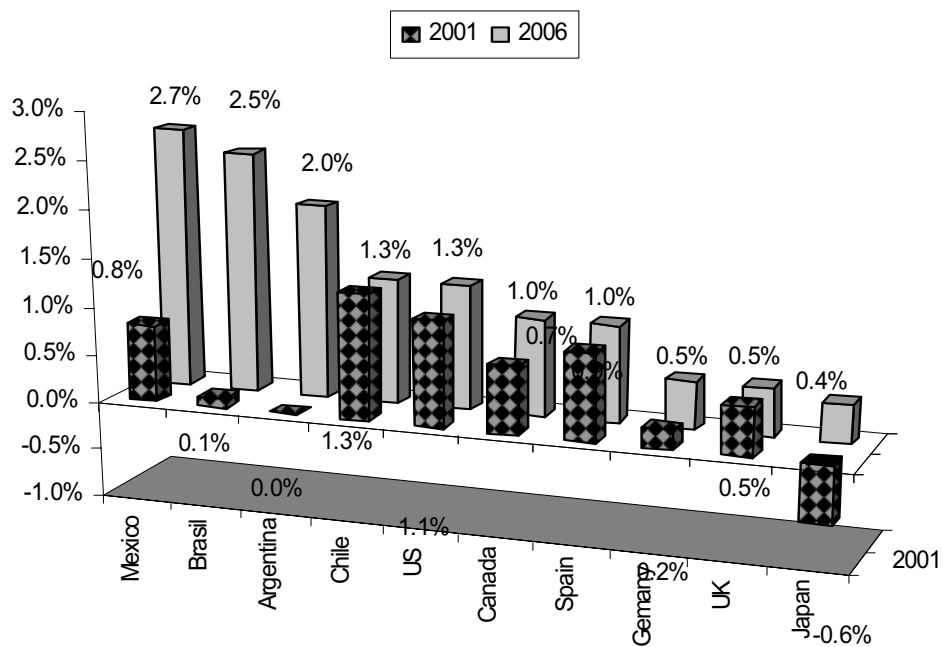
Mexico: Banking-Sector Fee Income as Percentage of Net Income



Source: ABM, with data of the CNBV.

The Anti-Trust Agenda: Winners and Losers

Average ROA at Commercial Banks, International Comparisons



Source: ABM, with data of IMF's Global Financial Stability Report and CNBV.

Energy Reform in Mexico

- Why energy reform?
 - Energy capex rose with Pemex reform of 2005 and tax reform of 2007
 - But capex needs to rise more to stabilize production levels and raise reserves
 - Goal is to raise operating and financial cash flow at Pemex
 - Funds for enhanced recovery onshore and in shallow waters is needed first
 - Long-term goals depend on deepwater E&D

- Political left has favored downstream development (more jobs).
 - Left agrees on reducing gasoline imports from the U.S.

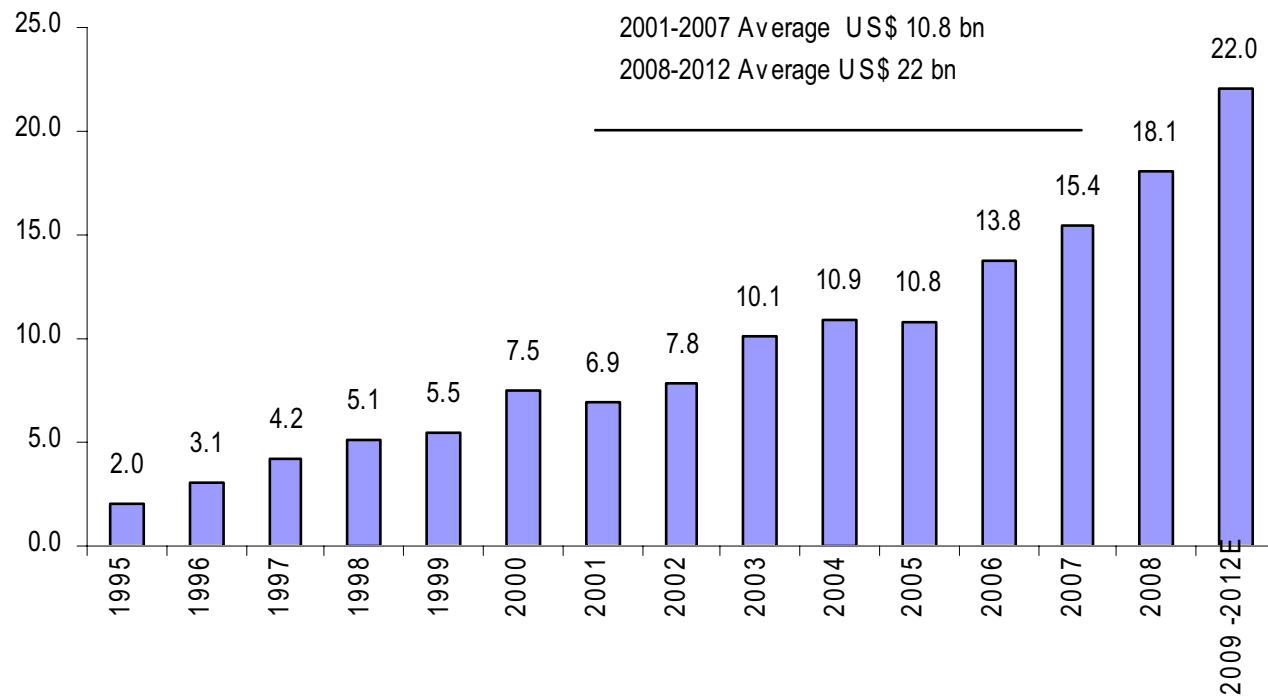
- Political right has favored upstream liberalization and development
 - Calderon has prioritized energy reform...
 - And PRI has edged toward compromise

Energy Reform in Mexico

- A common misconception among investors: “Energy reform must entail constitutional reform”
- But there are several non-constitutional forms that a compromise reform may take:
 - *Reform of bylaws that regulate constitutional restrictions on private capital*
 - *New bylaws could allow joint E&D in trans-border oilfields*
 - *Liberalize use of multiple service contracts in oil drilling*
 - *Changing to Pemex’s operating model and governance to improve transparency and flexibility*
- Energy (and fiscal) reform support more infrastructure spending, especially energy infrastructure
 - *General infrastructure and energy infrastructure companies*
 - *Specialty tubular goods*
 - *Oil-related maritime services*
 - *Potential strategic partners of Pemex*
 - *U.S. oil services companies*

Energy Reform in Mexico

Mexico: Historical and Projected Capex at Pemex (under Current Budgetary Scenario)



Source: Pemex; Bear Stearns & Co.

Energy Reform in Mexico

Mexico: Pemex's Monthly Gasoline Imports through November 2007 (in '000 barrels)

Mexico: Pemex Capex According to the National Development Plan, 2008-2012

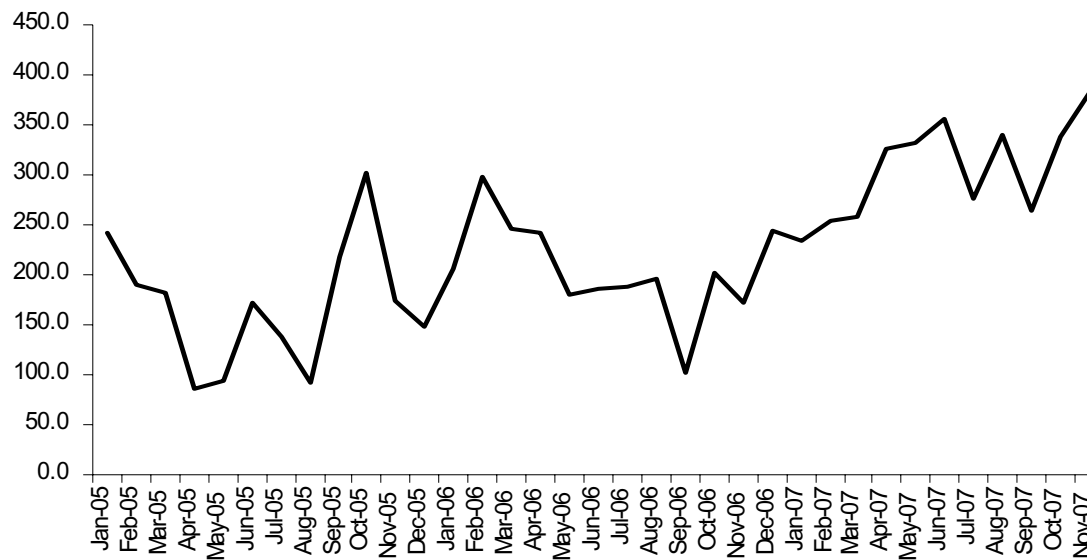
	in USD billion	% of Total
Exploration & Production	76.3	79%
Refining	14.8	15%
Gas	3.1	3%
Petrochemicals	2.7	3%

Source: Plan Nacional de Desarrollo; Pemex.

Source: Pemex.

Energy Reform in Mexico

**Mexico: Pemex's Monthly Gasoline Imports through November 2007
(in '000 barrels)**



Source: Pemex.

2008: A Turning Point for Siefore Participation in Local Stocks?

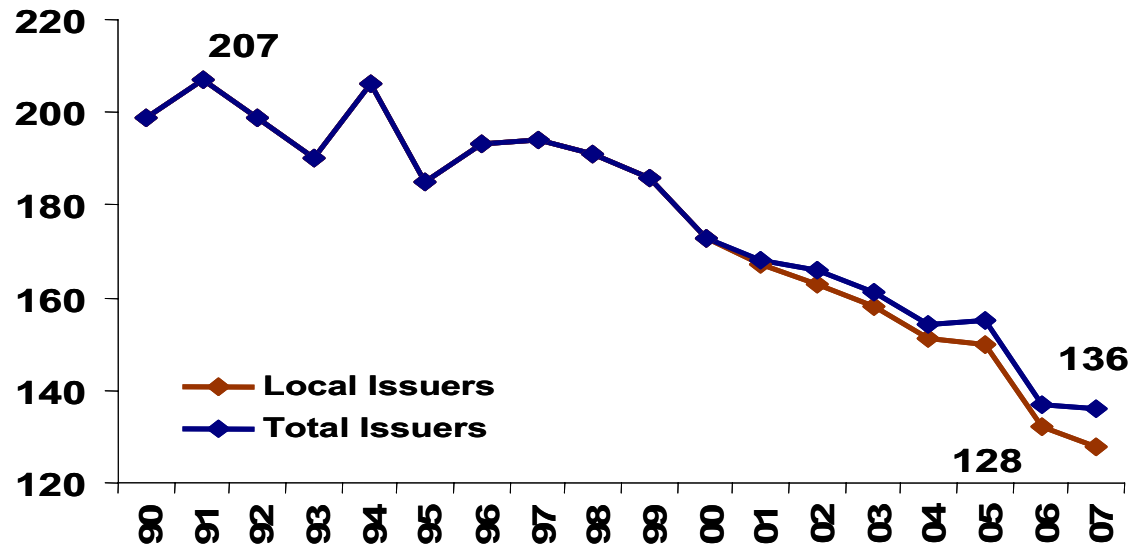
- Siefore pension funds have kept Mexican equity exposure rather low
 - A preference for foreign equity exposure; No home bias
 - Equities have been displaced by fixed income products in *siefore* portfolios
 - Despite investment mandate liberalizations, CONSAR did not encourage risk-taking from 2004 to 2007
 - Fee structure may not have encouraged risk-taking
 - Over time, this has likely penalized returns
 - . . . and may have helped slow development of the equity market in Mexico

2008: A Turning Point for Siefore Participation in Local Stocks?

- **New Life-Cycle Funds May Raise Mexican Equity Purchases by Siefores**
 - Life-Cycle Funds will have different risk classes - Increased limits for equity exposure in the riskiest classes of funds
 - New structure eliminates of purchase-based fees, allows for new investment products
 - Based on structure of the new regime, new flow purchases into Mexican equities may be US\$5-6 billion over 2008/09
 - Not a huge amount relative to market cap or annual volume (~\$425 billion and ~\$125 billion, respectively)...
 - ...but it is not insignificant and is a greater flow-purchase rate than the Siefores mustered in 2005-2007
 - Beginning in the mid- 2008, it could help to keep a bid under Mexican stocks if risk appetite among global investors falters
 - As local investors, the Siefores may also be more inclined to diversify equity exposure through *mid-cap*, *small-cap* indexes

2008: A Turning Point for Siefore Participation in Local Stocks?

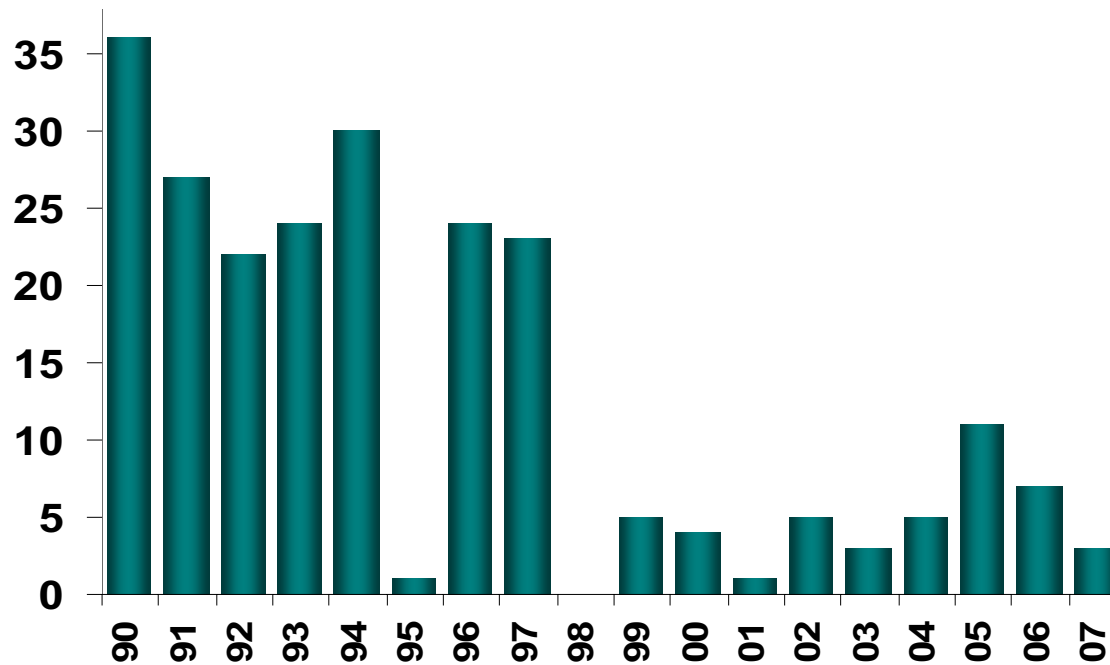
Mexico: Listed Companies



Source: CONSAR.; SHCP

2008: A Turning Point for Siefore Participation in Local Stocks?

Mexico: Number of IPOs



2008: A Turning Point for Siefore Participation in Local Stocks?

Mexico: Comparison of Life-Cycle Funds with Current System

Current System			Life-Cycle Proposal					
Fund Type	<u>SB1</u>	<u>SB2</u>	Fund Type	<u>SB1</u>	<u>SB2</u>	<u>SB3</u>	<u>SB4</u>	<u>SB5</u>
Category	"Safe"	"Riskier"	Category	Safest	—————→			Riskiest
Affiliate Age Category	56+	< 56	Affiliate Age Category	56+	46 - 55	37 to 45	27 to 36	< 26
AUM in Pesos	741 billion	83 billion	VaR Limit	0.60	1.00	1.30	1.60	2.00
Maximum in Equities	0%	15%	Maximum in Equities	0%	15%	20%	25%	30%
			Maximum in ABSs	10%	15%	20%	30%	40%
			Maximum in Other					
			Strutured Investments	0%	1%	5%	7.5%	10%
			Maximum in FIBRAS	0%	5%	5%	10%	10%
			Inflation Protection	Yes	No	No	No	No

Putting it All Together: Views on Equities in 2008

Poor U.S. economy, threat of inflation, anti-trust agenda, corporate taxes will keep sentiment for Mexican stocks relatively poor

We like:

infrastructure plays,
beneficiaries of energy reform,
defensive stocks, including retailers
Small-, and mid-cap indexes

We avoid:

large cap telecoms,
large retail banks

ADDENDUM

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Thierry Wizman

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Addendum section

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Market Overweight (MO) - Expect the industry to perform better than the primary market index for the region (S&P 500 in the US) over the next 12 months.

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