MEXICO

Ritch Mueller

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A closer look at financing structures for venture capital in Mexico

Santiago Llano and Juan José Paullada of Ritch Mueller discuss financing venture capital projects in Mexico.

The Mexican venture capital (VC) market has thrived throughout the past 10 years. According to numbers published by the Mexican Capital Association (Amexcap) the Mexican VC industry has grown 15.8% throughout the past 10 years, currently holding assets under management worth more than US$2.3 billion.

Although this statistic is eclipsed when compared to VC transactions in startup nest countries like the US, Latin American startups are rapidly luring in resources from VC giants that are seeking for niche opportunities amid regions that currently suffer from significant underinvestment, and the tax considerations of doing so is often overlooked.

How is VC funding typically structured?

There is no one-size-fits-all behind the corporate engineering for financing start-ups, where typical structures vary to some extent but are all based on the same guiding principle: investors compromise their capital expecting a high-return venture, while companies seek cheap funding to develop the next great idea.

Equity

In this pursuit, investors may simply invest in a company's equity by committing their capital in exchange for shares. Under equity structures, investors are typically unable to cash out returns until the company distributes profits or until divesting privately or through a public offering (IPO). It is rare to see profit distributions in these kinds of investments -at least on their earlier stages- as they are capital intense projects that normally squeeze all available cash-flows to develop the business.

Equity investors will typically obtain preferred stock, as opposed to common shares, in exchange for their capital, which carry certain economic and corporate governance advantages that common shares lack (i.e. exclusive profit distributions upon late stage liquidity events at high valuations or anti-dilution/voting rights).

Convertible debt

Start-up companies that issue equity at early stages will often face dilution of their equity participation since the valuation at which they accept equity funding does not match with the actual upside of successfully developing their business model.

A potential alternative – and very popular within the VC industry – is acquiring participation through convertible debt. Through this financing alternative, investors lend money to a company in exchange for an unsecured promissory note to repay the funds plus a market interest. Generally, while the notes are unconverted, investors keep limited corporate governance privileges or voting rights in the company, allowing the founders to freely develop the business during early stages, although they do vest equity value increase (or decrease) and interest.

Once (if) the company successfully develops and grows in value, the notes are exchanged for enough shares to repay the debt, typically through a put option to be exercised by the company.

These shares (preferred equity) are issued to investors at a discount to compensate for the risk taken at the earlier stages of the business, and carry the typical corporate rights that are given to angel investors and VC funds in these kind of deals.

The discounted valuation is normally determined by the multiples in which future investors (subsequent financing rounds) come in and is often times capped at a certain rates of return.

Tax implications on convertible debt structures

Income tax in Mexico is triggered on an accrual basis meaning that Mexican corporations holding convertible notes could pay taxes before the interest is effectively collected.

In case of foreign corporations, withholding taxes are triggered on the date in which the obligation becomes due or at the time the payment is made. Withholding tax rates on interest paid to foreign residents varies depending on the payer/payee, but with no double tax treaty protection, the statutory rate may reach up to 40%.

When the investor is a Mexican individual, the rules are different. Mexican legislation provides individuals with an option to be taxed on interest income on a cash basis, which means that the individual investor will not have to pay any taxes until the interest payments are effectively made (i.e. when the notes are converted).

At some point, what was originally classified as debt will be converted to equity, and there are further implications to consider at that point, especially if the intention is to sell the new shares to a third party. Once the notes are converted, the investor gets cost basis on the purchased shares, but careful analysis is necessary in order to avoid taxation on gross proceeds (FMV) upon an eventual divestment event, as could be the case of individual investors or foreign residents.

As a general rule, non-residents or Mexican individuals are subject to tax at a rate of 25% and 20%, respectively, on the gross proceeds obtained upon a sale of shares, without any deduction. Alternatively, upon election by the seller, the transfer may taxed at a 35% rate (may be lower for individuals) on the net gain to the extent that the seller complies with certain requirements.

Warrants

Another alternative for financing venture capital projects in Mexico that may allow for a tax efficient structure is through the issuance of warrants, once the equity investment is made.

A warrant is essentially an option issued by a company that gives investors the right (not the obligation) to purchase stock at a specific price within a pre-established period.

From a tax standpoint, the idea behind this financing structure is to characterise the investment as equity from the moment in which the investor injects capital into the company, in order to avoid accrual taxation on interest.

Corporate and economic rights are then structured through a shareholder's agreement, in which both the investors and the founding partners design formulas that allow them to allocate these corporate and economic rights depending on several factual circumstances that will be typically linked to the economic performance of the company.

If structured adequately, these alternatives may avoid tax inefficiencies that require investors to write checks for tax payments on income they have not obtained from their venture capital investments, and may allow for efficient divestment consequences on capital gains.

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