“RECENT REFORMS GOVERNING AFORES INVESTMENTS”

Australia-Mexico Infrastructure Finance Forum 2016

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I. Introduction

II. ¿Why should pension funds invest in infrastructure?

III. Recent evolution of Mexico´s Pension System

IV. Recent regulatory changes

V. Opportunities ahead

VI. Challenges

VII. Conclusions
• In the development of the Mexican pension system multiple goals coexist simultaneously.

• While several key players (authorities and different industries) participate in its development, the actions and decisions of the pension fund regulator (CONSAR) should be geared strictly towards realizing the higher possible replacement rates for our savers.

• How?
  • more diversification,
  • strengthened corporate governance,
  • industry’s human capital,
  • improved decision making process (due-diligence),
  • better risk management,
  • better returns

• It is in this overall framework that pension funds should be able to participate in infrastructure investments.
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Pension funds and infrastructure (ADVANTAGES):

- Investment in infrastructure projects **CAN** offer several advantages to pension funds:
  - Long term nature of pension fund liabilities allows for **maturity matching** between assets in portfolios and infrastructure projects
  - Usually low correlation with other financial asset classes
  - May offer stable and predictable long term **cash flows**
  - May offer an **inflation hedge**
  - Emerging markets infrastructure needs are enormous
  - Because of budgetary and fiscal reasons, **governments favors private investment in infrastructure projects**
  - Structural reforms open up the scope and possibilities for considerable infrastructure investments in new sectors
II. CONCEPTUAL FRAMEWORK

Pension funds and infrastructure (RISKS):

• Infrastructure investments, however, carry significant risks:

  – Market risks: demand and price considerations, delays in payments

  – Operational risks: cost increases, project modifications, shortages in input supply, technical failures, contract rupture

  – Financial risks: volatility in rates of return and currencies

  – Political risks: weak rule of law environment, change of rules and regulations, etc.
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PENSION FUNDS’ assets US $140.1 billion.

Mexican Pension Funds’ assets under management

During the last 10 years, Pension Funds’ assets under management have increased 15.60% annually.

Pension Fund’s asset under management represent 23.56% of domestic savings and contribute to the growth of financial savings.

Pension Funds’ assets under management represents 14.21% of the GDP.
Currently there are six asset classes:

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<td>Alternatives*</td>
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<td>Commodities</td>
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* Includes: PE, VC, Projects Finance, Infrastructure, Real Estate; all of the financing in Mexico

Within each asset class, restrictions have been relaxed, e.g.: stock picking, international debt with lower credit ratings, more FX and some can be used with more freedom, more variety of structuring of alternatives financing, among others.
As a consequence, there has been a major portfolio diversification.
Investments in infrastructure amounts to the equivalent of USD 16.7 billion (20.93% of the total outstanding) through corporate bonds and structured securities.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Holding of Siefores</th>
<th>Total in circulation</th>
<th>% of holding</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOFOL HIPOTECARIA</td>
<td>556</td>
<td>6,228</td>
<td>8.93%</td>
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<tr>
<td>INFONAVIT</td>
<td>25,995</td>
<td>68,727</td>
<td>37.82%</td>
</tr>
<tr>
<td>FOVISSSTE</td>
<td>27,205</td>
<td>80,775</td>
<td>33.68%</td>
</tr>
<tr>
<td>BORHIS</td>
<td>3,496</td>
<td>21,686</td>
<td>16.12%</td>
</tr>
<tr>
<td>CFE</td>
<td>42,051</td>
<td>212,090</td>
<td>19.83%</td>
</tr>
<tr>
<td>PEMEX</td>
<td>68,362</td>
<td>643,156</td>
<td>10.63%</td>
</tr>
<tr>
<td>Highways, States, Municipalities</td>
<td>75,507</td>
<td>234,500</td>
<td>32.20%</td>
</tr>
<tr>
<td>Alternatives</td>
<td>31,229</td>
<td>43,814</td>
<td>71.27%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>274,400</td>
<td>1,310,976</td>
<td>20.93%</td>
</tr>
<tr>
<td>USD TOTAL</td>
<td>16,630</td>
<td>79,453</td>
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</tbody>
</table>

* Includes PEMEX and CFE international issuance (EUROPESOS).
** Includes investments classified as Local Governments and Infrastructure
*** Includes only Infrastructure Funding Structured Securities.
AFOREs finance 85% of total CKDs (100 billion pesos) and 30% of FIBRAhs (43 billion pesos)

Evolution of CKDs and FIBRAhs
Positions of AFOREs
(millions of pesos)

TOTAL: 142,988 mdp
Through the investment of CKDs, AFOREs have financed a growing range of projects and firms.

<table>
<thead>
<tr>
<th>Type of CKD</th>
<th>As a % of investment by AFOREs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate</td>
<td>32.4%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>28.5%</td>
</tr>
<tr>
<td>Capital</td>
<td>24.4%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>7.4%</td>
</tr>
<tr>
<td>Forestry</td>
<td>4.6%</td>
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<tr>
<td>Energy</td>
<td>2.7%</td>
</tr>
</tbody>
</table>
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IV. RECENT REGULATORY CHANGES ADOPTED BY THE BOARD OF CONSAR

- CONSAR regulation has pushed pension funds’ to focus on the most relevant variables
  - How infrastructure plays in the long term asset allocation
  - How liquidity needs of the pension funds co-exists with long term financing
  - Make sure execution abides by internal agreements
  - Assess system-wide risks and project specific risks
  - How to select the manager: DDQ
  - How the project fits into the investment strategy
  - Deepen the understanding of the non-financial risks
    - Legal, technological, political, operational, social, environmental, etc.
IV. RECENT REGULATORY CHANGES ADOPTED BY THE BOARD OF CONSAR

1. New investment vehicles
   1.1 CERPIs y Fibra E
   1.2 Broader space for the AFOREs to invest in long term projects

2. Strengthening of the due diligence process for long term investments
   2.1 Clearer rules and requirements for investing in new vehicles
   2.2 Upgrading management capabilities and funds’ corporate governance

3. Introduction of Benchmark per Fund

4. Expanding the calculation horizon of the Net Returns Indicator (IRN)
IV. RECENT REGULATORY CHANGES ADOPTED BY THE BOARD OF CONSAR

CERPI

✓ Better aligned with the model of limited partnership at the international level
✓ Technical investment decisions are transferred to experts
✓ Issuance will be more expeditious
✓ The investment prospectus has to contain the investment thesis, the project sales policies and treatment of investment with possible conflict of interest
✓ Emphasis on conflict of interest risks

Fibra E

✓ Facilitates investments in energy and infrastructure sectors with a vehicle that offers fiscal advantages and the liquidity of a stock that is listed in the Stock Exchange
IV. RECENT REGULATORY CHANGES ADOPTED BY THE BOARD OF CONSAR

CKDs and CERPIs are very flexible investment vehicles

Type of CKDs and CERPIs

- Project Finance
- Infrastructure
- Real Estate
- Private Equity
- Financial Assets

CKDs/CERPIs can be used to finance:

- Different stages of the development of a real project
- Any economic sector or activity
- And financial structures can be adjusted

The projects must be developed in Mexico

The new CERPI will have a committee focused on conflicts of interest, and investors will not participate in projects’ selection. Their scale and managers track record are expected to be larger and longer, respectively.
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V. OPPORTUNITIES AHEAD: STRUCTURAL REFORMS WILL OPEN UP NEW AND MAJOR INVESTMENT OPPORTUNITIES FOR AFORES

Structural reforms:

1. Telecommunications
2. Competition
3. Financial sector
4. Energy

New business opportunities will open up in several sectors

Pension funds will continue to play a fundamental role in financing long term projects
It is expected that total **AUM of AFOREs will continue to grow** at a significant pace

**Assets under management by AFOREs**

(billions of pesos)

*Projections are solely used for the presentation purposes and should only be used as a guidance*
V. OPPORTUNITIES AHEAD

Mexican pension funds need more diversification

Source: OECD
V. OPPORTUNITIES AHEAD

- Where will future returns come from?

Historic real returns of Mexico’s pension system (2003-2015)
V. OPPORTUNITIES AHEAD

Favorable environment to boost long term investments:

- Growth of assets under management by SIEFOREs
- New investment opportunities
- An environment of lower returns and needs for major diversifications

Favorable moment to boost long term investments
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VI. CHALLENGES FOR LONG TERM INVESTMENTS

- Factors that may **hinder investments** in long term projects

<table>
<thead>
<tr>
<th>Demand-side obstacles</th>
<th>Supply-side obstacles</th>
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<tbody>
<tr>
<td>Demand constraints</td>
<td>Supply constraints</td>
</tr>
<tr>
<td>1. Short term focus: commercial war</td>
<td>1. Depth of Mexican financial markets</td>
</tr>
<tr>
<td>2. Analytical capabilities of AFOREs</td>
<td>2. Scarcity of projects and managers</td>
</tr>
<tr>
<td>// lack of competition</td>
<td></td>
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<tr>
<td>3. Legal restrictions</td>
<td>3. Political/social/ legal risks</td>
</tr>
</tbody>
</table>

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VI. CHALLENGES FOR LONG TERM INVESTMENTS

- The regulation should continue to incentivize pension funds’ to focus on other relevant variables
  - Fees structure
  - Stage of the project, sector and region, step in the value chain
  - Return and risk drivers, stressed scenarios
  - Type of financing vehicle, water fall, leverage, FX risk
  - Other system-wide variables
    - Supply and demand equilibrium
    - Regulation and competition, and long term dynamics
    - Income (pricing policies) and guarantees (performance and demand risks)
    - Terms of private participation, other co-investors and government’s role
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• Mexico’s current conditions offer significant opportunities for the AFOREs to participate actively as Mexico’s main institutional investors in long term projects.

• Recent regulatory changes by CONSAR to the pension system seek to:
  o Offer more opportunities for diversification
  o Strengthen the industry’s human capital
  o Expand investment horizons of the AFOREs industry
  o Generate higher returns in the medium and long term in an adequate environment of risk evaluation

• It is imperative to continue with the development of internal capabilities in the pension fund industry as well as to continue with the liberalization of investment Regime and other fundamental changes to the pension system.
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