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Keywords

investment considerations, foreign investment law, acquiring real estate, taxation, leading business advantages, significant risks and challenges

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Practical advice for investing in tourism and lodging projects in Mexico

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Abstract

This paper assesses the present status of how to go about doing business in Mexico and focuses on a series of areas concerning acquisitions, franchising and joint-venture partnerships as they relate to the hotel and resort industry. Addressed in this paper will be Mexico as a key location, risks and challenges of investment in Mexico and various ways to structure deals. It will further review the challenges of dealing with the local agencies to obtain government permits and licences.

INTRODUCTION

For centuries, Mexico has possessed a vibrant history — from the mysteries of the ancient Mayan civilisation to the strides of today's contemporary leaders, an exotic topography rich in natural resources, as well as diverse cultural characteristics carried on from generation to generation. Every year Mexico provides millions of visitors with distinctive experiences, from the breathtaking beaches of the Yucatan Peninsula to the cosmopolitan environment of Mexico City. As a result of its natural treasures and reputation as an exciting tourism destination, Mexico has, in recent decades, experienced an influx of foreign investors, particularly in the hospitality industry, lured by the region's vast opportunities and proximity to the USA and its large market of leisure travellers.

Mexico occupies seventh place on the list of most visited tourist destinations in the world, with a 3.6 per cent annual increase in visitors since 1994. According to the Ministry of Tourism, or *Sectur*, stay-over tourism arrivals were at 15.9 million visitors for the first ten months of 2002, with overall visitors at 82.1 million, excluding cruise ship passengers.¹ With over 420,000 hotel rooms and nearly 10,000 properties, the travel and tourism industry is a major contributor to Mexico's economy.

The World Travel and Tourism Council recently published the following data concerning the magnitude and economic impact of the travel and tourism sector in Mexico.²

— Total demand: Travel and tourism is expected to generate US\$71.0bn of economic activity in 2001, growing to US\$178.4bn

by 2011. Travel and tourism demand is expected to grow by 4.4 per cent per annum, in real terms, between 2001 and 2011.

- Gross domestic product: The travel and tourism industry was expected to contribute 3.0 per cent to gross domestic product (GDP) in 2001 (US\$19.4bn), rising to US\$35.5bn (2.2 per cent of total) by 2011.
- Employment: In 2001, travel and tourism economy employment was estimated at 2,730,500 jobs or 8.3 per cent of total employment, which is one in every 12 jobs. By 2011 this should grow to 3,951,740 jobs, 9.2 per cent of total employment or one in every 10.9 jobs. The 880,027 travel and tourism industry jobs accounted for 2.7 per cent of total employment in 2001 and are forecast to rise to 908,024 jobs or 2.1 per cent of the total by 2011.
- Exports: Travel and tourism was expected to generate 13.4 per cent of total exports (US\$19.5bn) in 2001, growing to US\$44.1bn (13.5 per cent of total) in 2011.
- Capital investment: Capital investment in travel and tourism was estimated at US\$16.1bn or 11.5 per cent of total investment in 2001. By 2011, this should reach US\$66.2bn or 11.9 per cent of total investment.

Tourism's importance

These figures demonstrate the importance as well as the resilience of the tourism sector, as the country has certainly faced multiple challenges in recent years, such as economic swings, international events and natural disasters. As one of Latin America's better-performing tourism markets, Mexico's outlook is prompting a growing number of foreign companies and investors to establish strategic alliances and investment partnerships in its lodging sector.

THE BUSINESS ENVIRONMENT AND INVESTMENT CONSIDERATIONS

Influencing factor

There are a great number of reasons for the increase in the number of lodging companies and investors doing business in Mexico. The most salient will be addressed in this paper.

Economic growth and increasing stability

For many international hotel companies, Mexico is considered the gateway to Latin America, as it offers an expanding and more stable economy relative to many other markets in the region. The 29 August 2002 edition of *The Economist* demonstrates this. The latest figures showed that GDP grew by 2.1 per cent in the second quarter of 2002, compared with the same period in 2001. *The Economist* has also forecast that GDP growth should strengthen from 2 per cent in 2002 to 3.4 per cent in 2003, as the external environment improves further. The country's economic performance has been influenced by the North American Free Trade Agreement (NAFTA).³

The passage of NAFTA in January 1994 between Mexico, the

NAFTA's economic impact

USA and Canada has been a major catalyst for economic growth. Since its inception, Mexico's trade with the USA and Canada has tripled. Partly due to its participation in NAFTA and its proximity to the USA, Mexico today is more closely associated with the US market than other markets in Latin America and is increasingly affected by the upward and downward turns of the US economy. For example, Mexico is heavily dependent on the USA, which takes 89 per cent of its exports, and US and Canadian investment accounted for 73.3 per cent of the total foreign direct investment of US\$13.6bn in the country in 2002.⁴

Supporting its growing attractiveness as a prime region for investment is the January 2003 BAA investment grade given to Mexico by Moody's Investors' Service. Along with Chile and El Salvador, Mexico is one of only three countries in Latin America receiving an investment grade rating. In Mexico's case, Moody's rating is a reflection of the country's deepening link with the US economy, increased resilience to shocks and contagion and political maturation towards a multi-party system. This investment grade rating is significant in that it opens the market to investment from select institutional investors which face minimum rating requirements for their foreign investment activities. Additional support for Mexico's economic outlook in 2003 comes from the 7 March 2003 forecast of The Economist Intelligence Unit.⁵ According to The Economist Intelligence Unit, Mexico's position is secure owing to its geographical location, which is allowing it to graduate from being a supplier of cheap labour to becoming a logistically integrated link in the manufacturing processes of its northern neighbour.

The role of Fonatur

In the mid-1970s the Mexican government realised that the resort and tourism industry could be a major contributor to the economy of Mexico. Sectur, through its investment and development agency, Fonatur, began the planning and development of mega-projects. Since its inception, Fonatur has created five important resorts of international reputation: Cancún, Ixtapa/Zihuatanejo, Los Cabos, Loreto and Bahias de Huatulco. It has also been active in planning and promoting ten mega-projects in other destinations throughout Mexico.

Fonatur's functions are essentially to master plan and develop the national tourist centres, finance the expansion of tourism services and support direct investment in the development of tourism facilities. Acting as a master developer, Fonatur creates infrastructure and other conditions that are conducive to lodging development. Land titles, utilities and services, ongoing maintenance and operation, promotional support and government collaboration are a few of the benefits that Fonatur can help facilitate. Additionally, maintenance and operation of the destinations' urban and resort infrastructures provide an added

Mexico's master developer

BancoMext's role

value to the real estate properties built in Fonatur's resorts. Furthermore, investors in Fonatur destinations receive optimum positioning due to their worldwide promotion and recognition.

Working closely with Fonatur to attract foreign investors to Fonatur destinations is BancoMext — the Mexican Bank for Foreign Trade. BancoMext offers an array of incentives to such investors.⁶

Financial incentives

- Negotiation and granting of facilities for construction and enhancement of infrastructure to enable business incorporation and operation.
- Granting of credit loans under preferential conditions through development funds provided by the federal government, commercial banks and development banks.
- Fixed asset and working capital loans to promote exports and new technologies' development.

Tax incentives

Exemption, discharge, refund and temporary reduction in the following taxes or duties are contemplated:

- payroll tax
- fees on services provided by the Public Registry of Property and Commerce
- real estate taxes
- taxes on soil use and construction licences
- taxes on real estate purchases, among others.

Other incentives

- labour training programmes
- financial support for labour training
- executive consultancy
- programmes of administrative simplification and a sole window.

In order to make investing in the lodging sector in Mexico even more attractive, some local governments also offer interesting incentives. For instance, some state and local governments may grant reduced pricing on state-owned land, offer tax abatements or make contributions towards payroll expenses during labour training.

Government incentives

Foreign investment law and purchasing real estate

A portion of the tourism sector's current success can be attributed to the 1993 establishment of the federal Foreign Investment Law. According to Fonatur, the law was designed to promote competitiveness, provide legal certainty to foreign investment in Mexico and establish clear rules to lead international capital to productive activities.⁷ These features include the elimination of certain legal restrictions on equity investments by foreigners in

Key aspects of law

Mexico, the establishment and simplification of investment procedures, and the development of a legal process that provides certainty, permanency and security. Key aspects of the law are the ability to possess and repatriate 100 per cent of real estate ownership, profits, royalties and dividends and the permission to purchase up to 100 per cent of capital stock in Mexican companies, acquire fixed assets, penetrate new areas of economic activity and operate establishments.

A foreign individual investor planning to invest in real estate in Mexico must first understand this law, specifically if it intends to invest in the popular restricted zones — 100km from the Mexican border and 50km from the coastline. These desirable zones offer direct proximity to the USA and support key commercial and tourism establishments, making the property highly valuable. For foreign individual investors to bypass this restriction they must set up a trust known as a *fideicomiso* and their purpose of investment must be commercial, tourism or industry related.

When a *fideicomiso* is established through a Mexican bank, the land becomes property of the trust. As a beneficiary of the trust, the foreign investor essentially obtains full use and enjoyment. The beneficiary may use, dispose of, encumber and sell its rights, and it may receive any income earned from the underlying real estate. Typically, trusts have a duration of 50 years and can be extended at the request of the interested party. In order to set up this trust, permission must first be granted by the Department of Foreign Affairs.⁸

Real estate acquisition

For corporate investors, real estate can be acquired through an asset transaction or a stock purchase. When conducting an asset transaction, all assets to be acquired are included in the purchase contract, including non-real estate assets such as equipment, trademarks and inventory. An investor may opt for an asset transaction as it can decrease the likelihood that liabilities such as income taxes, payroll withholding taxes and legal claims against the seller will be inherited. This transaction structure offers flexibility, yet it may impact on the investor's bottom line as it usually results in higher transaction expenses and higher taxes (10–15 per cent). When conducting a stock purchase, all shares of a company's stock are transferred to the investor. In many cases, however, the purchaser may also inherit liabilities related to the companies' past activities. Yet through a stock purchase, investors can typically reduce tax implications and take advantage of treaties with the UK, USA and Europe.

When conducting a raw land or hotel purchase in Mexico, there are a few other factors to keep in mind. It is imperative that the purchaser verifies that the desired real estate is registered in the name of the seller at the corresponding public registry of property. The purchaser should also verify that the property title is clear and that real estate taxes have been paid. In this regard, the investor might consider title insurance, for the concept has gained

Understanding taxation

acceptance in Mexico and is now required by many international lenders. Several US-based companies have issued policies to major international real estate investors over the past several years.⁹

Taxation

Beginning in 2003, the corporate income tax rate will be 34 per cent, and this rate is scheduled to be reduced to 33 per cent for 2004 and to 32 per cent for 2005 and subsequent years. An asset tax is calculated as 1.8 per cent of the average yearly value of fixed and financial assets and is essentially an alternative minimum tax payable in the event the asset tax amount exceeds the regular income tax due. This asset tax is applicable only after the pre-opening period and the first three years of operations, also known as the holiday period. The tax rates applicable to royalties, technical assistance, patents and trade names range from 25 to 34 per cent according to the income tax law, but they can be lower depending on the corresponding tax treaty.

The Mexican government has implemented agreements to prevent double taxation on international companies operating and investing in Mexico. Today, tax treaties or similar agreements are in effect with many countries, including the UK and the USA. These agreements essentially involve tax credits in those countries where foreign investment is originated for taxes paid in Mexico on salaries and service fees, profits, dividends, royalties and interest paid on loans, among others.

Companies must be aware that state and municipal taxation is also applicable. Payroll taxes are paid in 28 states, ranging from a low 0.9 per cent in Baja California to a high 2.5 per cent in the state of Mexico. Additionally, certain real estate taxes need to be considered, including property taxes or *prediales*, which are based on *valor catastral* (an assessed value determined by the government's *catastral* office) and a capital gains tax due upon sale of land.¹⁰

MARKET STRENGTHS AND OPPORTUNITIES

As mentioned, Mexico is supported by abundant natural and cultural resources, and has an exceptional geographic location with proximity to major feeder markets in the USA. To complement these strengths, Mexico also offers an excellent air service to many tourism and commercial markets, an established and well-funded tourism promotion programme and tourism infrastructure and relatively low operating costs. Furthermore, through the government's efforts in promoting travel and tourism as an important industry segment — and a viable professional career path — Mexico has gained an excellent reputation for service and value.

Orient-Express Vice President Dean Andrews feels that Mexico offers many advantages to the foreign investor.

'Doing business in Mexico has real and immediate advantages as compared to the Caribbean, namely, lower cost of labor, greater

Service and value

government cooperation, the perception of proximity for US travelers, greater airlift and a built-in client base. We feel the potential is strong enough that we are currently looking for other opportunities in the market that fit in with the Orient-Express collection.’¹¹

Robert Roskind, President of the LCP Group and an investor in a partnership to develop a hotel in Los Cabos, also saw many advantages to doing business in Mexico.

‘In Los Cabos, there is excellent airlift. Direct flights to Los Cabos are offered by many airlines from many US cities. The area has a reputation for being a premier golf and fishing destination, with the expectation of someday rivaling Palm Springs and Phoenix. There is a much lower cost structure than if you were to invest in the US. Overall, the economics are better. Lastly, Mexico is capital-starved, providing a higher rate of return on your investment.’¹²

The LCP Group’s project is slated for completion in 2005. Also familiar with Mexico’s opportunities is OBM International Limited. Recently contracted as the design-consulting firm for two new town planning projects, OBM will be the master-planners for the mixed-use developments Marazul and La Rocca. Marazul, located in Playa del Carmen, comprises 150 hectares programmed for tourism, residential and commercial usage. La Rocca, set in world-renowned Cancun, includes a golf club — ‘Tournament Players Club’ — and residential development on 202 hectares, as well as a beach village on ten hectares.

Operating costs

When a foreign company is interested in establishing hotel operations in Mexico, a significant consideration is given to operating costs. In 2000, HVS International, major industry analysts, published a study in the *Journal of Leisure Property* that concluded that investors could obtain substantial savings in hotel operations in Mexico. For instance, in Mexico hotel operating costs are approximately 65 per cent of total revenue, whereas in the USA or Europe, they remain at 75 per cent of total revenue.¹³ One caveat regarding operating costs is that labour laws and collective bargaining agreements in Mexico are somewhat different to those in the USA. Not understanding the implications of the labour laws on labour costs and the dynamics of the labour unions in the lodging sector can result in unexpected expenses and liabilities and, in some cases, major misunderstandings.

Brand growth

At present there is a substantial opportunity for international brand expansion in Mexico, as more than 70 per cent of the hotel rooms in the country are not affiliated with a brand. Moreover, domestic

Operational awareness

business and leisure travellers are now demanding mid-priced and economy lodging products. For example, Carlson Hotels' Radisson and Country Inn products are targeted for expansion in Mexico in the near future to cater to the business clientele working with the many manufacturing and assembly plants. Hilton's Garden Inn brand is also expanding in many of the secondary markets in the country to serve the international and domestic business traveller. Also, the establishment of Mexican-owned hotel brands, such as Posadas de Mexico's Fiesta Inn brand, has created additional opportunities for franchising in Mexico's hospitality industry.

Luxury hotel development

Demand for five-star resorts and upscale commercial hotels

A recent phenomenon is the development of luxury hotels in resort destinations, such as the entrance of the Four Seasons in the Punta de Mita area north of Puerto Vallarta and Rosewood's highly successful Ventanas del Paraiso in Cabo San Lucas. These properties capitalised on the transformation of their respective markets into world-renown golf destinations by capturing the affluent golf travel market. Catering to the high-end, adventurous traveller, Orient-Express also found Mexico to be an important country in which to invest. Orient-Express acquired Maroma Resort in the Riviera Maya. Dean Andrews, Vice President of Orient-Express, found doing business in Mexico advantageous. 'With the recent acquisition of Maroma, we learned a great deal about Mexico and its appeal as an emerging luxury market — both from our clients' perspective, as well as from an investor view.'¹⁴

NH Hotels, the third largest hotel group in Europe and a leading hotel chain for business travellers, acquired Mexico's Krystal hotel chain in 2001. Expanding into the Mexican market provided NH with a strong presence in key commercial regions that host a substantial number of US business travellers. Gabriel Burgio, President and Chief Executive Officer of NH Hotels, stated in the 21 June 2002 issue of *Hospitality Net*:

'American clients are discovering our properties and are pleased with the service, quality and convenient locations of our hotels. These satisfied customers are, in fact, among our highest repeat guests. The timing is right to create a better understanding and awareness of the NH Hotel product with the business traveler and corporate travel planner in the North American market.'¹⁵

Niche products

While tourism activity and resort development in Mexico has traditionally focused on the sun, sand and sea experiences offered by the renowned beach resorts, there is increasing interest in the development of ecotourism and cultural tourism products. The emergence of a substantial number of affluent travellers from the USA and Europe, interested in nature, the environment, history and regional culture, has led to the demand for these alternative

Alternative tourism products

experiences. Examples of such emerging products are the lodges in the Copper Canyon area of the Sierra Madre, the renovation of the historic haciendas and development of boutique jungle lodges in the Yucatan and the renovation and conversion of lodging facilities in the colonial cities of Querétaro, San Miguel de Allende and San Luis Potosí.

Casino gaming

Although casinos were outlawed in 1934 for fear that Mexico might go the way of Cuba, where US gangsters used casinos as their power bases, a congressional tourism commission recently recommended that the government legalise casinos in tourism destinations such as Cancún and Acapulco. President Fox has publicly demonstrated his support for casinos for tourists. The proposed initial investment would be US\$1.8bn to build ten casinos nationwide, and the economic boost from casinos is estimated to be US\$3bn per year and 98,000 permanent jobs. The topic of legalising casino gaming continues to be a hotbed for debate, due partly to opposition from the Catholic Church and concerns about gambling abuse and corruption.¹⁶

Casino gaming debate

CHALLENGES AND THREATS

Although Mexico is a leading region for foreign tourism-related investment, it does not come without challenges and risks, as conducting business in Mexico is comparable to doing business in similarly emerging markets around the world.

Financing and investment parameters

Obtaining financing

Obtaining project debt financing in Mexico can be difficult, and if an investor is able to obtain financing, most lenders typically will not lend more than 50 per cent of project costs. In many cases, arranging debt financing with a domestic bank is not the best decision for lodging projects, for they are expensive, loan-to-value ratios are low and amortisation periods are relatively short. Although new lenders are demonstrating interest in the market, the historical dearth of debt capital, many projects are capitalised through private equity and from international opportunity funds.

The following summarises the historical parameters for international lenders and equity investors in lodging projects in Mexico.¹⁷

- Equity
 - 20–30 per cent unleveraged internal rates of return
 - 12–16 per cent capitalisation rates
- Debt
 - loan-to-value ratio of 50 per cent
 - amortisation terms ranging from five to 16 years
 - interest rate pricing of LIBOR + 450 to 600 basis points
 - debt coverage ratios ranging from 1.3–1.5.

When considering investments in existing projects, be aware that often there is a large spread between the bid and ask prices, commonly due to the different perceptions of value. More specifically, the international investor typically correlates acquisition price with the earnings of the operation, whereas the domestic owner may price their project based on the original development cost plus an inflation and profit premium. In terms of return expectations and horizons, prudent investors should adjust their typical yield requirements to account for the related market and industry risk and adopt a long-term perspective towards investment in the region.

Current issues

Lack of reliable market data

Because accurate and updated information on Mexico's hospitality markets is scarce and not available off the shelf, investors may find the due diligence process a bit frustrating when trying to resolve key issues related to market performance, pricing and operating and development costs. In order to obtain reliable market data and help expedite the diligence process, it is advisable to form a team of financial advisers and attorneys experienced in Mexico.

Political and social stability

Although Mexico's overall political stability continues to improve under President Vicente Fox's government, his PAN party may be facing strong opposition from the traditional ruling party, PRI, in the July 2003 congressional elections. A more divided congress could compromise his economic agenda and proposed social reforms for the remainder of his term. An increase in crime, particularly in urban areas and along the nation's highways, has prompted a heightened level of concern for the personal safety of travellers and residents in cities such as Mexico City, Guadalajara and Monterrey. Although drug trafficking activity has historically been low-key in tourism destinations, these organisations are a mounting problem for Mexican law enforcement and public officials in the major cities and border communities, as the perpetrators are adept at corrupting or intimidating public officials.

PARTING THOUGHTS

Building an expert team

Local partners

In most cases, it benefits the investor to obtain a local partner who understands the goals, objectives and message of the investor. The local partner can also play a major role in navigating the differences in business customs and practices that often face first-time investors. A good local partner must have an excellent grasp of the marketplace, the ability to contribute capital and/or expertise and an impeccable reputation. In fact, a thorough investigation of the background and track record of the local partner is imperative.

Experienced team

When planning to develop a hotel or resort project, it is highly recommended to seek the advice of professionals with substantial experience in the tourism and lodging sector in Mexico. For example, the legal system is based on Napoleonic law and the commercial dispute process can be quite different from that of a common law nation. Thus local and international counsel familiar with the principles and nuances of the code law should be retained. In the case of accounting and finance, advisers with experience on issues such as Mexican accounting principles, financial statement conversions and inflation accounting will be needed. Also, a reputable notary public should be chosen carefully, for the role of a *notario publico* in Mexico is much expanded and critical in successfully concluding a transaction.

In today's volatile global economy, Mexico is one of the bright spots for new lodging and tourism developments. Whether developing a boutique hotel or a mega-resort, Mexico's investment climate, proximity to the US market and cost structure are just a few examples of why many international hotel brands are seeking opportunities in this emerging market.

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