Convenience matters Serving the new Mexican consumer



In this report

- **2** Mexico: Stability amidst global volatility
- **4** More than just tequila: Significance of the retail and consumer sector
- **8** More pesos in the pocket: The sector takes off
- 12 Convenience matters
- **16** In the shadows: The vast informal market
- **22** Building capability muscles and aligning your operating model
- **29** The winning concoction: Local knowledge, global expertise
- **31** Unlocking the enablers for growth



Foreword

As the world's developing markets face a time of volatility, Mexico stands out as one of the key markets weathering the storm. It is doing so through sustained evolution and slow but steady growth in many dimensions. The retail and consumer sector is one industry which has the potential to exceed Mexico's average national future growth. This will be driven by a combination of economic and socio-demographic trends, the progressive implementation of a comprehensive set of critical reforms which should improve disposable income, and the innovation of the various players in the sector in tailoring their offerings and business models to appeal to Mexican consumers.

Much has been said about 'the Two Mexicos' - 'the formal and the informal Mexico' or 'the developed and underdeveloped Mexico'. It is true that Mexico continues to be a country with many stark contrasts. In our opinion these will create a compounding effect which will generate significant longterm growth opportunities for the retail and consumer sector. We believe that consumers from 'the Two Mexicos' will continue to mesh together and fuel the middle class, both from the formal and informal segments. We also expect the sector to evolve rapidly, as millennials increasingly join the economy and shape spending and shopping habits.

Arguably, retail and consumer reflects the opportunities emerging from the duality of the Mexican economy better than any other sector:

- Modern format retail stores and multinational franchises such as Walmart and Starbucks are constantly growing and developing, alongside the resilient traditional 'changarros' and adapted concepts such as OXXO and Farmacias Similares.
- International brands such as Coca-Cola and Frito-Lay coexist and compete with incumbent local brands such as Bimbo and Jumex, and numerous artisanal products that are ubiquitous to Mexican consumers.
- Consumers seamlessly alternate from modern to traditional channels, and from formal ones to informal ones, based on convenience and occasions to fit their evolving lifestyles.

In the future, Mexican consumers from both groups will want more convenience and more choices to suit their lifestyles, and they will increasingly expect their retailers and their brands to do more to earn their loyalty. To successfully capture the opportunities with the new Mexican consumer, retailers and manufacturers will need to adopt more innovative business models. These will need to be based on a combination of world-class capabilities, such as supply chain efficiencies, with Mexico-specific capabilities, such as providing access to credit for the informal consumer and facilitating the transition into the middle class and the formal economy.

There are excellent examples of such companies in Mexico. A retailer like FAMSA has managed to properly balance the risk required to serve this more informal segment of consumers, through a combination of deep consumer knowledge and alternative contact channels, while also leveraging its traditional stores and offerings, not just to gain access to these new consumers, but also to earn increased loyalty from them.

The successful retailers and consumer goods companies in Mexico will be those which are willing and able to develop flexible business models, while leveraging local networks of suppliers and partners that can complement them in better serving the Mexican consumer. Having a global brand, the best technology or the strongest global processes will not be enough to guarantee success.

Much has been said about the Mexican opportunity. We believe it is there for retail and consumer players to capture through a combination of foundational and innovative capabilities, smart tailoring of products and services to increase convenience for consumers joining the middle class, and a willingness to adapt and evolve with them through this journey.



David WijeratneGrowth Markets Centre Leader



Carlos NavarroPartner, PwC Mexico

Mexico: Stability amidst global volatility

The engine behind the Mexican economy is big and already in motion.
Mexico will be very different in 10 years.

The belief that the growth markets will lead global growth has been shaken over the past year by events in key markets such as the impending economic contraction of Brazil and Russia, the slowdown in China's GDP growth and increasing pessimism in South Africa. One of the exceptions at present is India, where economic growth is holding up, but much-needed reforms are yet to be passed and this could hamper growth here too.

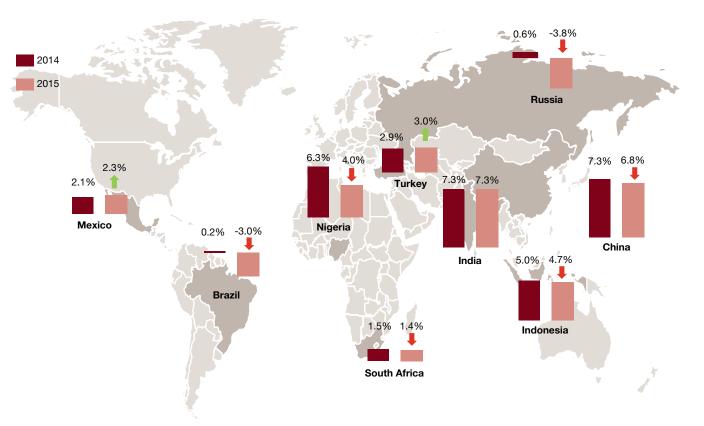
However, Mexico has managed to avoid the most dangerous pitfalls that have slowed growth in these other markets and is still able to boast a positive economic growth of 2.3% over 2015 (see Figure 1). While growth is not stellar, it marks a positive difference amidst the slowing emerging markets.

Alberto Torrado,

Chairman, ALSEA (a leading multi-brand restaurant operator in Latin America)

Figure 1: Mexico's resilient growth stands out among other growth markets

Annual GDP growth of selected growth markets (%)



Source: International Monetary Fund (IMF)

The Mexican economic resilience is buoyed by the economic recovery of its northern neighbour, the US, combined with a sharp depreciation of the Peso against the US Dollar, down 15% in 2015.1 These two factors have enabled Mexico to grow its automotive manufacturing and export industry to another level, which has partially offset the impacts of the drop in global oil prices that threatened to slow the country's recovery, as revenue from its oil products contributed to almost a third of the country's GDP.2

The Trans-Pacific Partnership (TPP), signed in October 2015 on the back of the Pacific Alliance, holds potential for a larger market for companies that have already taken advantage of the North American Free Trade Agreement (NAFTA). The Pacific Alliance agreement had previously granted Mexico access to a wider market beyond NAFTA, with reduced tariffs between Chile, Peru and Colombia, Now, with the Trans-Pacific Partnership, Mexico will be able to expand trade beyond the Pacific Rim nations to new markets with reduced tariffs leading to further economic growth.

The long-term growth of the Mexican economy is primarily based on the potential of the country's demographics. The Mexican population currently comprises 127 million people, with a third of Mexicans below the age of 15, no more than 10% older than 65, and a median age in 2015 of only 27. These attributes position Mexico well to enjoy an increasing working age demographic which will facilitate domestic consumption and drive economic growth (see Figure 2).

Mexican business leaders and associations interviewed by PwC's Growth Markets Centre as part of this study expressed optimism about the future of the economy; in particular, expectations for the future of the retail and consumer industry remain promising.

Figure 2: Mexico is in a good position to enjoy its demographic dividend

Population by age group (million)



Source: UN Economic Commission for Latin America and the Caribbean (ECLAC)

More than just tequila: Significance of the retail and consumer sector

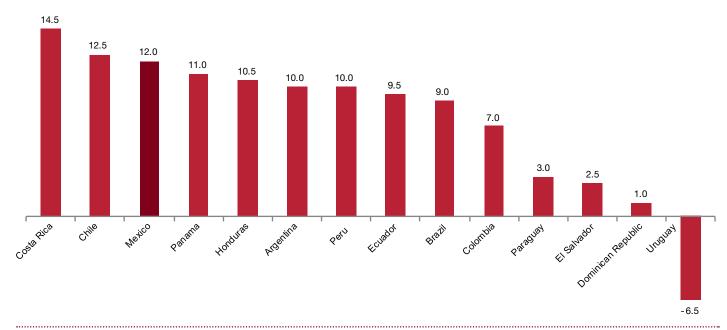
Mexico's retail and consumer industry is an important engine of its economy, with household spending accounting for approximately 60% of the country's total economic output.³ The sector's growth has a tremendous impact on the country's economy, with retail sales lifting Mexico's 2015 Q3 GDP to a surprising 2.6% annual growth – the fastest growth in two years.

'Retail sales and consumer credit helped fuel 'moderate growth", Banco de Mexico Governor Agustín Carstens said, bringing attention to Mexico not only as an export economy, but also increasingly a consumer economy.⁴ Mexico has witnessed significant growth in its middle class over the past 15 years.* The World Bank estimates that the middle class in Mexico grew by 12% between 1995 and 2010, ranking amongst the highest growth countries in Latin America (see Figure 3) and it is estimated to grow by a further 3.8 million households to more than 18 million households by 2030 – a market equivalent to the size of all households in Spain.5

Mexico's economy (and with it the retail and consumer industry) is brimming with potential. With a high contribution of household spending to Mexico's economic output, supported by the rising middle class, the retail and consumer sector is positioned to be a key driver for Mexico's long-term economic growth.

Figure 3: The growth in Mexico's middle class is among the greatest in Latin America and the Caribbean

Change in middle class as a percentage of population (percentage points), 19952010



Source: World Bank

^{*} The middle class refers to individuals who fall between the working class and the upper class within a societal hierarchy. The World Bank defines middle class within the income bracket of US\$10 – \$50 per capita per day. Euromonitor defines it as the middle earning 10% of households (Decile 5 household)



Mexico's reforms: Is it still Mexico's moment?

The growth of Mexico's retail and consumer sector and its wider market is happening against the backdrop of some significant structural reforms. President Peña came to power in 2012 promising a wave of reforms to boost economic development, and even though some of the benefits may not have reached their full potential, there are signs that retail and consumer companies are already benefiting from them.



To boost oil and gas exploration and production which has been in decline for the past 10 years, Mexico ended the 75-year state oil monopoly by opening the sector to foreign investment in 2013. It was envisaged that this move would increase long-term oil production by 75% and attract US\$50 billion in investments by 2018.7

The reform is also intended to increase competition and improve economic opportunities. Eduardo Reyes Bravo, a director with PwC Mexico's infrastructure and energy practice, explained: 'One of the key elements of the reform is to enable competition in the market,' he said. 'Competition should bring better prices to industry, which, in turn, can be more competitive, increasing exports, generating new employment and reducing prices in the local market.'8

Two years on, private companies in the upstream sector are still grappling with the mixed market response in the two rounds of bids for oil and gas exploration rights. However, it is the retail and consumer companies which are already reaping benefits in the downstream sector. With the new regulation that allows petrol station outlets to be privately owned, retailer Fomento Económico Mexicano (FEMSA), Latin America's largest convenience store chain, has announced the acquisition of 227 gas station franchises. The acquisition seeks to complement the FEMSA-owned OXXO retail outlets which are located close to the gas stations. The operation of OXXO stores and the gas station outlets will generate greater consumer traffic.



Labour reform is another landmark change, introduced to increase market flexibility and reduce hiring costs, whilst improving productivity and market competitiveness.

The labour reform intends to provide flexibility in the hiring and releasing of talent by allowing companies to cut severance payments, hire workers by the hour, introduce trial periods of up to six months and address the issues of underperforming workers. The labour reform also includes a planned social security overhaul which aims to attract some of the workers from the 'informal economy' into formal employment. Even though companies will need to pay more in labour tax, the reform also brings about the flexibility to upscale or downsize its labour force to meet business needs.

Companies are expected to benefit from a more efficient job market and an increase in productivity and, if the reform delivers on its promise to create an extra 400,000 formal jobs a year, it could increase economic growth by 0.3%.9



In a bid to confront obesity and diabetes, Mexico imposed a tax of one peso per litre of sugary drinks and an 8% tax on other high-calorie foods in October 2013.

It was a major blow for carbonated drinks companies such as Coca-Cola and Arca Continental, which in 2014 experienced a decline in sales for the first time since 2008. In autumn 2014, Coca-Cola FEMSA cut some 1,300 jobs and increased prices by around 16% in its home market as a result of the sugar tax.10

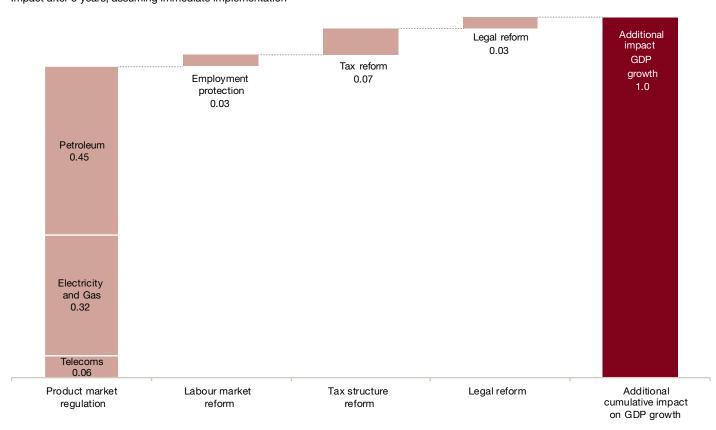
However, there is belief that the sector will continue to enjoy growth in the long-term and this view is shared by some of the largest global fast-moving consumer goods (FMCG) players. Pepsi has since announced a plan to invest US\$5 billion in Mexico over the next five years, while Nestlé in January 2014 announced plans to invest US\$1 billion to build an infant nutrition factory in western Mexico.11

'The investment we are making is a clear sign of the commitment we have to Mexico and our long-term view of the market,' Nestlé's CEO Paul Bulcke affirms.¹²

While some of the initial excitement has been met with challenges, the market remains optimistic that it is still 'Mexico's moment' and the reforms will bring material change in the long term. The Organisation for Economic Co-operation and Development (OECD) predicts that the reforms could increase GDP growth by one percentage point within five years of implementation (see Figure 4).

Figure 4: OECD predicts an increase in GDP growth by 1% upon successful implementation of reforms

Impact of reform on GDP growth in the medium term (% of GDP)* OECD estimates of legislated and envisioned reforms Impact after 5 years, assuming immediate implementation



Pacto por Mexico Reforms

Source: United Nations, 2015

^{*} The financial and education reforms are also likely to have a significant impact on growth (the latter mainly in the long term), but have not been included in the table because of difficulties in quantifying the impact.

More pesos in the pocket: The sector takes off

Household consumption, which includes spending on key consumer products such as clothing, grocery and food and drinks, has dropped 2.2% from 2012 to 2015, but is expected to rebound in 2016 (see Figure 5) on the back of a drop in unemployment, a rise in real wages and an increase in remittances.* This makes it an opportune moment for companies to enter or expand in the market to capture a share of the growing opportunity.

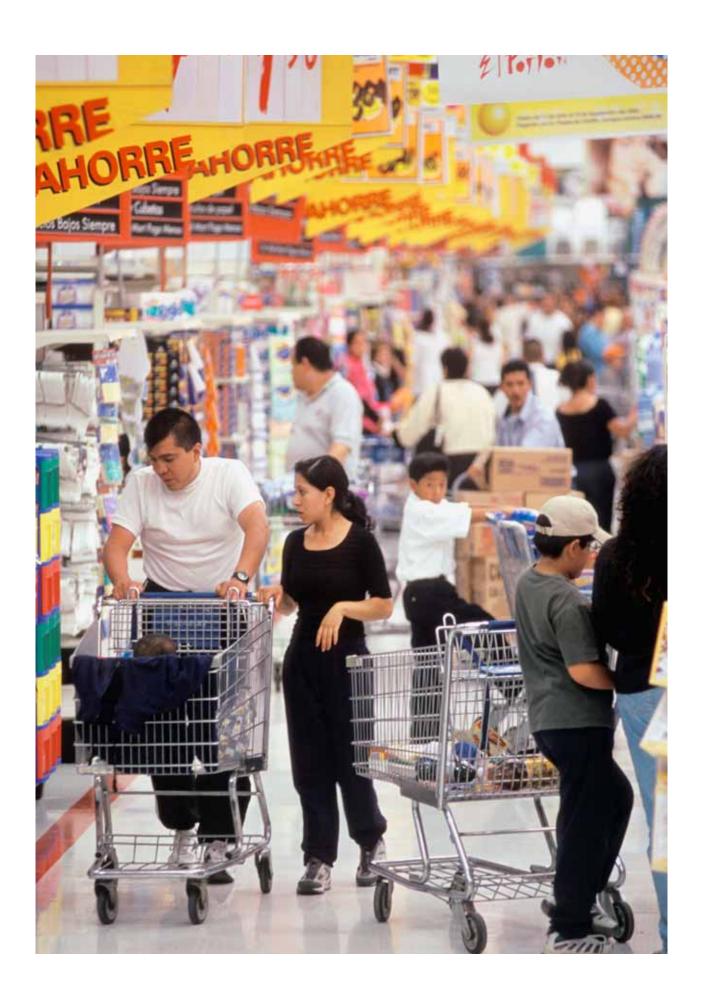
Following the rise of household consumption, retail sales surged by 6.8% in July 2015 from the same month in the previous year (see Figure 6), while the unemployment rate remained at a low 4.6% as of Q3 2015. 13 In the same trend, the consumer confidence index reversed its previous gloom and rose to a three-month high in October 2015, reflecting the increase in optimism on the economic situation.14

Figure 5: Household consumption is set to grow with the drop in unemployment, rise in real wages and increase in remittance

Household consumption expenditure (current US\$ bn), y-o-y growth (%)



^{*} Remittance refers to personal transfers and employee compensation of workers who are employed in an economy where they are not resident and of residents employed by nonresident entities.



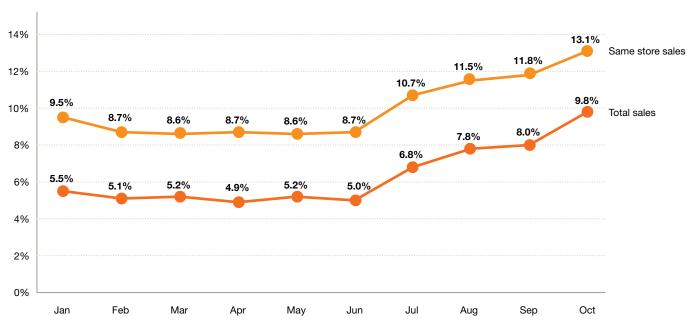
A combination of a drop in unemployment, rise in real wages, and the increase in remittances from abroad are putting more pesos in people's pockets, leading to a consumer-led recovery. While Mexico is enjoying lower unemployment rates, Brazil and Chile face contrary winds. Unemployment rates in Brazil and Chile both rose by 6.6% in 2015 according to IMF estimates. The number of formal jobs being created in Mexico is 4.5% higher than a year ago and wages have also increased by 4.6%, while inflation is at its lowest in almost five decades at 2.5%, contributing to a favourable environment for consumer spending.¹⁵

The increase in remittances from the US also adds to the rise in consumer spending. In 2015, Mexican migrants forwarded US\$24.77 billion of remittance, up 4.8% from 2014. Remittance contributes to approximately 2% of Mexico's GDP, which is about a third of the value of automotive production in Mexico.¹⁶

This strengthening in consumer spending has helped drive Mexico's retail sales, and this can be clearly seen in increase of same-store sales.* Same store sales in Mexico increased by 8.1% in December 2015 compared to the same month in the previous year, more than the Mexican Association of Supermarkets and Department Stores (ANTAD) had anticipated. As these figures may not include the millions of Mexicans shopping below the taxpayer's radar at the street market, 'true' consumer spending is likely to be higher.

Figure 6: Mexico is experiencing rising retail sales

Retail store sales performance (year-on-year % change, 2015)



Source: ANTAD, The Mexican Retailers' Association

^{* &#}x27;Same-store sales' compare revenues earned by a retail chain's established outlets that have been opened for at least a year. Same store sales allow the company to determine what portion of the new sales has come from established stores, indicating that existing customers are coming back more frequently, spending more or bringing other customers.



entering the market

The Mexican consumer story has already captivated many international players, with many more eyeing the market as a hunting ground for new consumers, which is creating anxiety for companies to get ahead of the game amidst intensifying competition.

Major iconic brands are choosing Mexico to mark their debut in the Latin American region. Mexico's appeal reaches far and wide to examples including the Swedish retailing giant Hennes & Mauritz (H&M), US clothing retailer Abercrombie & Fitch and online retailing giant Amazon. Dunkin Donuts also announced an aggressive comeback after five years of absence from the market.

'This is the right time to enter Mexico. The country has a stable economy, a strong middle class and a strong sense of premium brands with international names,' David Leino, Senior Vice President of Global Real Estate for Abercrombie & Fitch, was quoted as saying in Forbes Life Mexico.¹⁷

With the rising market opportunities and increasing competition, both foreign and Mexican companies need to develop market-relevant, flexible business models to address consumer preferences in a profitable manner. Should they fail to do so, companies risk being vulnerable to the changing priorities of demanding consumers, emerging channels and new entrants.

Convenience matters

It is often said that there are two Mexicos – one developed and formal, and another less developed and more informal, but consumers from both sides make up Mexico's growing middle class who are seeking products and services that appeal to what they value.

Consumers within both the formal and informal economy share similar values and needs. For companies to fully capitalise on the projected growth of the Mexican consumer market, they need first to appreciate what both these consumers value most.

The confluence of a growing middle class and rising disposable incomes has set the foundation for a gradual but sustained growth in consumer spending. Consumers across both the formal and informal economies are becoming increasingly affluent and well-informed, making them more demanding in terms of what they want to spend their money on. This prompts a shift from purchasing decisions driven by price alone, and convenience is increasingly valued in purchase decisions.

The value of convenience is growing with the hectic pace of work and heavy traffic in the Mexican cities affecting all consumer segments. Higher numbers of working women also increase the demand for convenience as they have less time for grocery shopping, housekeeping and taking care of children. Consumers are time poor and are looking for efficient shopping experiences which also provide what they want at the price they want. Convenience is greatly valued and consumers are willing to pay a premium for it.

The growth of the convenience store sector is already a testament to this trend. One in four retail dollars is spent in a convenience store in Mexico, ¹⁸ expanding the market at a compound annual growth rate (CAGR) of 5.1% through 2009-2014. The demand for convenience has also influenced how major supermarket retailers grow their business. In Mexico, you can just as easily buy a motorcycle at the same place where you buy a mattress for your bed, all in one location in a store such as Grupo FAMSA.





View convenience through the customer

The appeal to convenience ought to be considered beyond the typical ways companies serve their customers. Consumer needs often lie across industries, companies therefore need to adapt to address this. For instance, someone going on a short trip overseas will need to interact with multiple vendors such as car rental firms, hotel accommodation and tour service providers. However, Mexicans are ultimately concerned with the end-toend experience, which can be addressed by partnerships across industries.

The Hertz franchisee AVASA recognises the unmet need and brings its rental vehicles closer to the Mexican end user. Traditionally, car rental companies concentrate on providing convenience through improving their website interface and offering more varied payment options. However, the greatest inconvenience for consumers lies in the geographical distance between retail stores and transportation nodes.

To address the gap in convenience between the retail and car rental experience, AVASA made a bold move and established an exclusive partnership with Walmart to operate at its 268 stores. With the agreement, AVASA is able to run a rental facility that houses seven vehicles at each station. AVASA also managed to advertise inside the supermarket and provide for the use of Walmart credit cards for car rental. The partnership between companies from the car rental industry and the retail industry has positioned Hertz at closer proximity to the local market, smartly integrated into daily lifestyle.

Recognising a similar gap in convenience between the public transport and car rental industry, AVASA also ventured into bus terminals, making it the first such model between a car rental and a bus terminal in Mexico. Convenience is an important factor for car rental, whether in the tourist or local market. AVASA sited itself right at the nexus of transportation transfers.19 AVASA's comprehensive interpretation of the value of convenience led it to revise its business model, differentiating it from its competition.

To successfully differentiate from their competition, companies need to break away from industry norms and adopt a consumer lens to explore how to improve convenience for consumers. Convenience is increasingly important in the Mexican market. Companies will need the right merchandising, client segmentation practice and technology to best align their offering to appeal to the increasing focus on accessibility of goods and services.

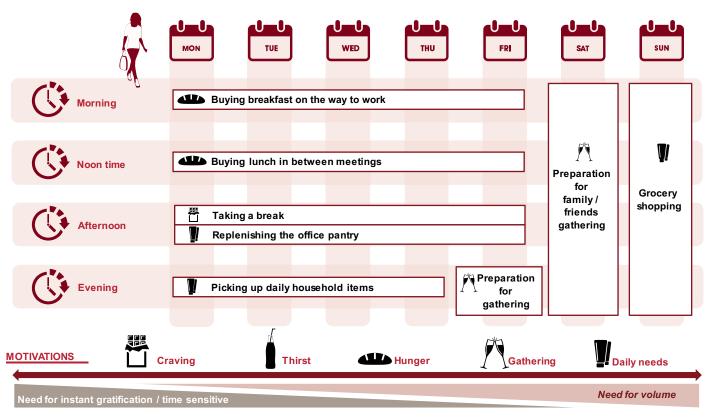
One consumer – multiple needs and motivations

Mexican consumers have multiple needs to be met at different times of the day. For example, a woman walking into a convenience store in downtown Paseo de La Reforma on a Tuesday at 12pm is probably looking to buy a sandwich in between her corporate meetings. The same woman walking into a convenience store on a Sunday evening might be replenishing the body shampoo that she forgot to buy earlier in the week (see Figure 7). Consumers have different needs and their buying motivations differ depending on the needs they have at a given context, location and time. By segmenting the market only by consumer groups, companies risk overlooking the latent motivations that differ at each trip and create real value which appeals to their needs at the moment.

A good way to characterise the market as consumers live moment-to-moment is to do so through the buyer's motivation for specific trips. Retailers can capitalise on true, in-the-moment motivations to customise the product categories and even the size of the product to carry. This way, retailers can provide real value at the right place at the right time. They can also optimise their precious shelf space on products that actually matter. By segmenting the market by trip motivations, it opens up possibilities not only to streamline stock-keeping units (SKUs), but also to tailor front-door product placements and bundled promotions in the morning versus during lunchtime or at night.

Figure 7: Mexican consumers have multiple needs to be met at different times of the day

Example of a typical Mexican consumer journey in a week





Case study: OXXO designs convenience outlets to cater to different trip motivations

To provide consumers with the convenience they desire, OXXO takes an additional step beyond consumer segmenting to trip motivation. It designs its points of sale around the buyer's motivation on the trip – thirst, craving, hunger, reunion and daily needs. For example, breakfast items are given prominence in the morning nearer to hospitals and working areas. Two-litre bottles of soda are provided where there are people gathering and pantries need replenishment. Home stores get more grocery space while working area stores get more space for snacks. OXXO stayed close to the nine million shoppers it served daily with a keen understanding of what they want. For example, it drives promotional and bundled offerings by offering cigarettes with a free lighter, or a bottle of soda bundled with a discounted energy drink.

Convenience is increasingly important to the rising middle class among Mexican consumers, due to increasing affluence and a hectic lifestyle. Companies need to reassess how they deliver these values through the customer lens and recognise the differing needs of a consumer. The ability to understand the market through various means, such as via employees, as well as the ability to connect to the market through the local culture, will put companies ahead of their competition.

Convenience is equally important to both the informal and the formal segments. However, companies in emerging markets often focus on the formal segment in the growing middle class to capture opportunities, leaving the informal market overlooked. The informal market shares similar purchasing power and values and is likely to be attracted to similar value propositions.

In the shadows: The vast informal market

The Mexican growth story is often accompanied by an undertone of the shadow market which remains largely unseen.

What defines the informal market?

Like many growth markets which have matured from a largely informal economy to a more structured one, a large part of the Mexican population still falls outside the formal economy.

The Mexican informal economy consists of unregistered and mainly small businesses. Amongst them you will see the seller of stuffed maize patties, also known as 'tlacoyos', along a downtown sidewalk, or the owner of a small family-owned restaurant.

Members of Mexico's informal economy include 25% of the 105,000 taxis on the road, as well as 60% of the construction housing workforce. These people not only make a living outside the formal employment sector, but also have no bank. 60% of Mexicans do not have bank accounts, but instead keep their money in a community saving club or at home earning no interest at all.²¹

These people in the informal market also form part of Mexico's growing middle class. However, companies often overlook their existence as potential consumers as they appear risky and hard to address. This is mainly due to the fact that they do not have any health insurance, social security or labour rights protecting their jobs, and hence they remain under the taxman's radar. Despite this, some share similar earning power and values to those in the formal market, which presents an untapped market opportunity.

What then differentiates a consumer in the informal market from the rest? Consider Arturo and Ricardo (see Figure 8).

Figure 8: Comparison of a typical Mexican consumer in the formal and informal sector



Consumer profile	Age and gender	35, Male	35, Male	Identical profile, would likely be
	Job	Restaurant waiter	Restaurant waiter	attracted to similar selling propositions
	Household structure	Married with a child	Married with a child	
Earning • power	Gross annual salary (US\$)*	8,800	5,808	
	Less: Income tax (~17%)	1,145	0	
	Less: Social security contribution (~9.23%)	812	0	
	Net income	6,842	5,808	Comparable earning power
Obligations and rights	Payment of tax	Yes	No	Unequal rights. Limited access to credit affects purchasing power in the informal market
	Access to credit	Yes	Limited	
	Health insurance	Yes	No	
	Employment contract and rights	Yes	No	

^{*} Estimates based on the study on formal and informal market by Jorge O. Moreno Trevino²², and study on the Income Differences on Mexico's Northern Border by Rogelio Varela Llamas²³, for indicative illustration only. Based on exchange rate as of 5 February 2016, 1 USD = 18.271 MXN

As you can see, consumers in the formal and informal sector can have a similar consumer profile, needs and purchasing power. Both 'Arturo' and 'Ricardo' are of the same age and are supporting a family with a child. Value propositions that appeal to Arturo in his purchasing will likely appeal to Ricardo as well. Even though Ricardo might have slightly lower pay than Arturo for a similar skillset and job, they broadly fall under the same band in terms of earning power.

However, a lack of access to credit can limit purchases by consumers in the informal market. Due to a lack of credit history and official employment documentation to establish credibility,

Ricardo will find it difficult to borrow from a bank. As a result, he takes longer to save up for big household expenditures such as buying or renovating a house, and purchasing a car. Consumers such as Ricardo will need to pay for items in cash and in full, or with a larger deposit if they have managed to get access to any form of credit.

What makes the informal market so attractive?

While most Mexicans in the informal market have a relatively lower income than their counterparts in the formal market, the collective population represents a market with latent demand to be explored. Mexico has one of the largest informal economies in Latin America (see Figure 10), and it makes a significant contribution to the economy.

In 2014, Mexico's National Institute of Statistics and Geography (INEGI) made its first estimation that the informal economy contributed an average of 26% of the gross domestic product (GDP) over the decade from 2003 to 2012. The informal economy has been growing at 2.2% on average in the ten years considered, just slightly trailing the 2.76% recorded for the economy as a whole (see Figure 9). These businesses employ approximately 30 million people – six in ten Mexican workers – who are

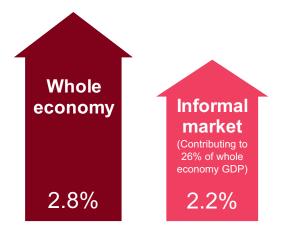
shunned by banks. The national association of supermarkets, ANTAD, estimated that the sales by informal stores might be four times the level of modern-format store sales.

To enhance the success of their market penetration, retail and consumer companies need to gain access to the Mexican consumers in the informal market whose needs are waiting to be addressed. However, it will take some time before the Mexican government can wrestle through the labyrinth of issues to lift Mexicans out of the informal market.

So what can companies do in the meantime to address this untapped potential in the informal consumer market, and also to support the government in accelerating the inclusion of this sector of society?

Figure 9: The informal market has a significant presence in Mexico

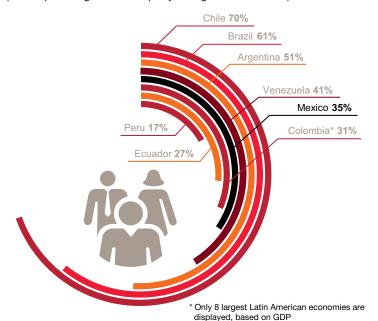
Average GDP growth rate from 2003 to 2012



Source: Mexico's National Institute of Statistics and Geography (INEGI)

Figure 10: Mexico has one of the largest informal economies in Latin America

Contributors or affiliates of pension as a percentage of total workers aged 15-64 years (%, around 2010) (Smaller percentage indicates a proxy for larger informal market)



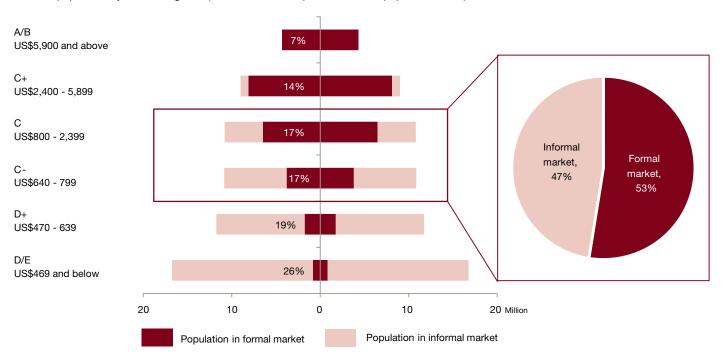
Source: OECD, 2012

Addressing the informal market

The informal market is often perceived to be a land of challenging opportunities where many commercial propositions struggle to take off. The first step in addressing the potential of the informal sector is to break the stigma and recognise that some of the consumers in the informal market are not too different from the ones in the formal market. As such, the informal market can potentially be an expansion of what was offered to the growing middle class (see Figure 11).

Figure 11: Companies' proposition to the middle class can potentially be expanded to the informal market

Mexican population by income segment (Household income per month, % of population, 2012)*



Source: FAMSA Information Memorandum 2015, IMAI 2012

* Indicative based on data from FAMSA Information Memorandum 2015 and IMAI, with market extrapolations²⁴ Based on exchange rate as of 5 February 2016, 1 USD = 18.271 MXN

However, the informal market holds additional credit risks that companies need to address. Even though some in this segment have a similar earning power to the Mexicans within the formal sector, only 30% have an earning power that can be ascertained – which poses a challenge to credit assessment.

So how can companies penetrate the informal market in a way that mitigates risk?

This is where large retail businesses which have established or are able to develop lending facilities, such as Grupo FAMSA, are well positioned to capture the opportunity. The unbanked population visits retail stores such as FAMSA frequently and these interactions are an integral part of life. Retailers such as these are in a good position to address the issue of access to credit as they have deep knowledge of the consumers who visit their stores, as well as a good understanding of the risks that they are willing to bear. They can also set up bank branches quickly at a low cost within their existing storefronts.

Credit penetration in Mexico

Mexico notably has among the lowest credit penetration in Latin America, as the large informal economy shuts many consumers out of the system. Many who do not report income to tax authorities have problems establishing their credit history to justify lending. While Brazil's GDP per capita is about 15% higher than Mexico's, it has three times the number of banks per 10,000 people. 95% of business in Mexico is made up of microbusiness, of which only 7% are in the formal sector with access to credit.²⁵

By operating beside retail outlets, retailers are able to increase their sales by targeting the consumption moment, triggering spending when they need it most.

Credit risk can be managed in innovative ways. To establish the borrower's credibility, companies can approve or reject financing based on testimonials from the borrower's employer, family and friends, as well as an initial down payment. Very often, Mexicans cannot pay back a loan in the prescribed time due to irregular income and poor financial management. By arranging for weekly payments instead of monthly payments to break down the value of each payment, companies instil a sense of discipline in the repayment routine. An initial down payment is arranged to ensure the borrower's commitment to the

purchase, as well as to minimise the default risk that the company is facing. As most customers do not have access to banking systems, they will make a physical trip to the stores to pay, therefore creating more opportunities to cross-sell.

The synergy of a retail business with credit facility helps the company to capture demand in the informal market. Unlike banks, which operate under intensive banking regulation, the retail business does not have to subject customers to complex rules that they do not understand. The business model can also be built around the behaviour of this large consumer group, for example, being open every day to cater to their customer base which often rely on daily earnings.

Case study: Grupo FAMSA addresses the informal market through credit

With over 370 stores in more than 75 cities throughout Mexico, Grupo FAMSA is a large Mexican retailer of household goods, ranging from furniture, electronics and clothing to cellular phones and even motorcycles. It provides credit to the mass market, which can depend on it to buy daily necessities.

'The business is well adjusted for the consumers in the large middle-low income group. With FAMSA, they do not have to deal with rules that they do not know. FAMSA is open every day to cater to the customer's needs,' says Luis Gerardo Villarreal, the Chief Operating Officer of Grupo FAMSA, a leading retailer in Mexico.

With the right use of credit, companies can further expand their market presence. For instance, FAMSA proactively uses credit as a key lever to expand its market presence (see Figure 12). It has developed loyalty programs, a revolving credit and normal credit to different segments for different trips.

FAMSA staff identify the target districts within a specific distance from each store. They then knock on doors and explain that they can offer store credits on favourable terms. This is followed by an assessment of the person's creditworthiness using key questions captured via a mobile device. Their answers are evaluated over 72 hours so the person quickly knows if they can acquire credit at their local FAMSA store and if so, how much. The approval is followed by a separate team which goes to the house to offer the products. This approach has proved to be effective and door-todoor sales are already chalking up 10% of FAMSA sales.

Understanding that the majority of its customers do not have an official credit history, FAMSA also adopts techniques to manage credit risks.

Companies such as FAMSA are also working closely with the regulatory body to help them gain understanding of this credit landscape in the informal market.

Figure 12: Approaches and techniques used by FAMSA Mexico to manage credit risks

Focus area Techniques used

Establish credibility Review testimonials from the borrower's employer, family and friends

Request an initial down payment

Facilitate financial management

Arrange for weekly payments instead of monthly payment

Arrange for weekly payments instead of monthly payments to break down the value of each payment and to instil a sense of discipline in the repayment routine

Global best practices: Managing credit risk in a retail business in Brazil

There are several ways companies can leverage credit while keeping credit risk managed. Let's take the example of Casas Bahia, a retailer in Brazil. It has trained its employees to assess the creditworthiness of a potential customer without a credit history or

formal employment records (see Figure 13). The Growth Market Centre Series: 'The Retail and Consumer industry in Brazil – Navigating the downturn' provides a deeper insight on how the business works.²⁶

Figure 13: Approaches and techniques Casas Bahia used to manage credit risks

Focus area Techniques used

Establish credibility

Ask technical questions to determine if borrower is telling the truth

Facilitate financial management

Provide a physical passbook that is easy to carry to provide easy reference and reminder to customer to pay

Provide financial advice

Provide advice on which products to choose to suit affordability

The informal market holds untapped potential which is supported by consumers with similar earning power to those in the formal market, who are likely to be attracted to similar value propositions. With the right approach to address credit risks, the company's market development efforts can reach a wider audience and reap greater potential returns.

Companies looking for success in the Mexican retail sector need to consider new ways to grow by understanding the market dynamics and its needs. As such, it is critical to develop a flexible business model which will allow companies to respond effectively to market changes.



Building capability muscles and aligning your operating model

The right business model for Mexico's retail and consumer market

In order to address the ever-evolving values of Mexican consumers across both the informal and formal segments, organisations (both foreign and Mexican) need not only to ensure that they are in touch with what consumers value, but also to develop holistic and flexible business models. These models must address changing consumer values in times of high growth, as well as in

times of more moderate growth such as we have seen in certain growth markets during the latter part of 2015 and early 2016. While it is common for companies to retrench during challenging times, and focus on operational efficiencies to improve their bottom line, they need to be careful not to assume that consumer needs and values will remain unchanged during this period. This is because consumer segments in growth markets such as Mexico are quickly evolving and this is further complicated by the fact that consumers are moving between segments at a faster rate than in developed markets (see Figure 14).

The average Mexican is younger and has more disposable income than before and their needs are very different from others. Convenience is greatly valued today and retail organisations need to identify and address this now, while also keeping a close track on future transitions. Being out of sync may lead to a significant risk of missing out on market opportunities and losing the customer mindshare.

Figure 14: Consumer segments in growth markets vs developed markets



Developed markets

Growth markets

In addition to evolving consumer needs, flexible business and operating models need to be developed with the recognition that the business environment in growth markets is constantly maturing. There are still a number of institutional voids that prevent those business models which made foreign companies so successful in their home markets (developed) from

being leaders in growth markets (see Figure 15). Specific to Mexico, one of the challenges in business conditions has been certain gaps in the execution of large-scale initiatives and reforms. The labour reform is one such example – this landmark reform was expected to have an immediate and significant impact on improving flexibility in hiring, thereby creating a more efficient job market.

However, some aspects of its implementation have proved tricky; such as organisations finding it difficult to 'prove' employee underperformance in practical terms in order to achieve the intended benefits. Such execution gaps mean that companies still need to have a customised approach to employee hiring and retention, until all aspects of the reform are well implemented.

Figure 15: Business environment in growth markets vs developed markets



Developed markets



Growth markets

Customisation and flexibility to adapt to the local environment are critical to success, and therefore there is an urgent need for organisations to have a separate operating model for growth markets; with different elements designed to cater to changing consumer needs and the maturing business environment (see Figure 16).

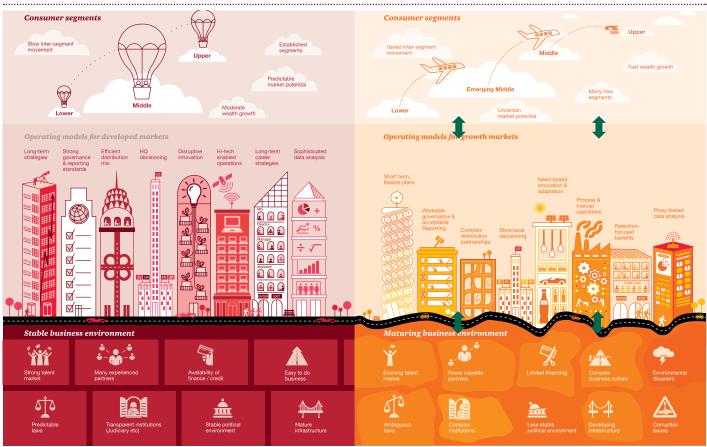
Figure 16: Key factors in the changing consumer needs and maturing business environment



The major elements of a growth markets operating model are provided in the figure below. Amongst these, the following are especially relevant for the Mexican retail and consumer industry:

- 1. Short-term flexible plans
- 2. Enhancing impact through partnerships
- 3. More local decision-making
- 4. Need-based innovation and adaptation
- 5. Employee alignment and retention
- 6. Need for 'practical' technology
 In the following paragraphs we
 highlight some of the aspects within
 each of these operating model
 components which retail and consumer
 companies should consider in order to
 be successful in the high potential but
 competitive market in Mexico.

Figure 17: Operating models in growth markets vs developed markets



Developed markets



Growth markets

1. Short-term, flexible plans

The overall requirement is for companies to be flexible and nimble by quickly understanding changes in the market environment and identifying what is of value to the customer; such as improved local presence, SKU availability, variation in product portfolio based on time of the day etc. Regular and frequent planning cycles allow firms to closely monitor market changes and recalibrate their way forward accordingly. This is especially important in Mexico given the rapid shifts in demographics which have led to frequent changes in customer needs and values.

As mentioned earlier, customers now attach a lot of importance to convenience throughout the buying process, and organisations which can quickly recognise this and customise their strategy will gain over others in the market. A sudden change in business conditions is another reason to be nimble - for example, the sugar tax imposed in Mexico had a significant impact on food and beverage companies. But leading players such as Pepsi and Nestlé have been able to quickly adapt to the new business environment and continue to focus on growth and investments in the country.11

2. Enhancing impact through partnerships

In many cases organisations invest heavily in enhancing in-house capabilities and processes; however, this is time consuming and results are not always guaranteed. Identifying areas of core competence requiring internal focus and those which can be developed through external partnerships is essential to improving operational effectiveness. Subsequently, the management of relationships with partners also plays a much more central role in growth markets. While processes and structures are indeed very important, managing and enhancing relationships with partners can also help in driving quick alignment and often leads to delivery beyond expectations; thereby creating incremental value for customers.

In the Mexican retail and consumer sector, the scope for partnerships can extend beyond the normal vendors and suppliers and include potential competitors as well. The informal market is quite large in Mexico, contributing about 26% of the overall GDP – typically traditional retail outlets (local stores) have been close to this section of consumers and form an

important part of the local community. Partnering (instead of competing) with these small, local stores can be mutually beneficial and may provide a significant advantage to large retail players towards increasing market penetration.

The way to grow is to support the small companies in their development the same way the big companies came in to develop.

Eduardo Padilla,

Chief Financial and Strategic Development Officer, Fomento Económico Mexicano (FEMSA) (which operates OXXO, a leading convenience store chain in Mexico)

Case study: Large supermarkets partner with smaller companies to develop the growth markets

Out of its 10,000 stores, Walmex operates about 2,300 stores in Mexico, making it the second biggest market for the retailer after the US. Walmex has concluded a provider assistance agreement to the small and mediumsized food and drink providers in Mexico to meet its objective of stocking domestic products. Under this arrangement, Walmex provides loans and other services such as logistics, business and production process assistance, connecting to the smaller businesses which may otherwise not have sufficient infrastructure to supply to Walmart.²⁷

Not far away in Colombia, a major supermarket and convenience store retailer Grupo Éxito has launched a sustainable commercial initiative called the Aliados Surtimax where it partners with owners of Colombian minimarts. Under this business model, Grupo Éxito provides technical advice on retail display, space planning, merchandising, access to a portfolio of private brands, and the Surtimax signage. At the same time, Grupo Éxito benefits from the network and personalised service of the traditional trade while minimising initial investment. Grupo Éxito has built a network of more than 500 stores at a low capital-expenditure rate of less than US\$500 per store.28

Eurocash SA, a leading wholesale retail company from Poland, is another example of this trend. To capitalise on the opportunity in the neighbourhood grocery stores where locals tend to shop four to five times a week on average, Eurocash partners with traditional trade retailers as franchisees under its abc convenience store and Delikatesy Centrum stores. This positions the company to gain from the growth of the traditional trade.²⁹

3. More local decision making

Achieving the right balance between local and global decision making is a major challenge often seen with multinational organisations. Typically, most companies in growth markets operate within a narrow range – where at one end, the local partner has a small impact on decision making and is more of a caretaker; while at the other where the local business is coordinating and driving synergies, but still does not have any real P&L control. However, the evolving customer segments and changing needs in Mexico, as well as the maturing business environment, requires slightly more control and responsibility to be delegated to the local entity, where they can play a key role in the decision making, raising the territory's profile at the global board level and controlling the local P&L as well.

In addition to local decision making at a corporate level, local decision making at an operational level is also important in the retail sector. In the Mexican retail sector, the situations which operational managers encounter on the ground on a

day-to-day basis vary immensely and are almost impossible to predict. This can include an odd request from a valued customer, or a sudden inventory crisis brought about by supplier oversight or error. Effectively dealing with these in a timely manner involves empowering the person best equipped to address the challenge, which is most often the store or operations manager situated locally. Appropriate delegation of authority to the local team can go a long way towards ensuring more efficient operations and a better customer experience.

It is important to emphasise accountabilities, not tasks.
Empowerment will help you move around fast.

Eduardo Padilla,

Chief Financial and Strategic Development Officer, Fomento Económico Mexicano (FEMSA) (which operates OXXO, a leading convenience store chain in Mexico)

Case study: OXXO localised decision making to each of its convenience stores – empowering them to manage the business

Localised decision making is not merely important between global and Mexican counterparts in a foreign company; it is also applicable to Mexican companies.

OXXO leverages empowerment to motivate its staff. In OXXO, as well as empowering ground staff to address operational issues, stores that perform to operate. For example, in OXXO, stores are being graded based on their performance, and those graded 'A' will be given more autonomy to operate.

This provides a greater sense of ownership and facilitates faster decision making, which helps the business respond fast in the market and relieves managers from time spent managing day-to-day operations.



4. Need-based innovation and adaptation

Developing new products in growth markets does not always require extensive investment in research and development. Instead, it is important to customise product and service offerings (often at low cost) swiftly based on market feedback. This is required because of frequent shifts in consumer need and values, typically seen in markets such as Mexico, which therefore requires retail and consumer companies to reinvent their product to cater to the 'new' market requirement. This sort of frequent 'innovation' requires a flexible organisation/product strategy, supported by close working between the sales, product and strategy teams to quickly obtain market insights and feedback, understand the changes in consumer needs and the corresponding

modifications required. This would allow for rapid innovation, leading to the revised product/service being launched within a shorter turnaround period.

5. Employee alignment and retention

A progressing economy and a fast-growing retail and consumer industry provide ample employment opportunities for Mexico's large working population. Organisations here face significant attrition, and filling in the gap requires additional time and monetary resources to be spent on hiring and training new employees. One of the leading causes of attrition in emerging markets is the lack of alignment between the employee target metrics and overall business goals. Quite often, company goals are not properly aligned (or the linkages are

often unclear) to department Key Performance Indicators (KPIs) and subsequently to individual Key Result Areas (KRAs). This may lead to a peculiar situation where employees (at the local store or warehouse) may have met their misaligned targets but still do not get rewarded appropriately due to lacklustre business output; leading to lower motivation and sub-optimal performance going forward, and finally attrition.

Strategic deployment and alignment of goals throughout the organisation helps ensure that individuals and departments are always linked to the bigger picture and are aware of the role they are expected to play towards achieving it. This also ensures that employee success and rewards are closely linked to the company's success, creating an environment of improved accountability and motivation.

Case study: Diageo Mexico innovates to stay ahead of the convenience trend

The expansion of the convenience channel with smaller formats also poses a new challenge for product companies. They are trying to best manage the limited retail shelf space available, while also competing against other suppliers vying for a share of sales. Diageo, a global leader in alcoholic drinks, rose to the challenge with the development of a new display – a postcard rack showing the array of products available. Shoppers can take the postcard to the cash register where it is exchanged for the product. This way, the twodimensional card can optimise precious space in the small box while getting the product in front of 10 million consumers walking into convenience stores across Mexico.

The space-efficient rack provides flexibility in positioning, and is often situated in high traffic areas, typically around beer, ice and chips. This idea also addressed the issue of product thefts in the store. Diageo implemented this in 2014 over 13,000 stores at a low cost. According to Andy Robertson, Diageo's Global Route to Consumer Director, the business grew 10 percentage points faster than the control set. The success represented a new growth of the spirits market as a category, and not simply brand switching within an established category.³⁰





Case study: Leading Mexican convenience chain adopts shared KPIs to ensure delivery of value

The leading convenience chain OXXO effectively uses shared KPIs to ensure product availability – a key customer proposition. This is difficult due to limited shelf space in the small store format which needs to be optimally utilised to ensure that supply meets demand. The ability for timely replenishment in small formats with limited storage space became the primary customer value proposition and the key to success for OXXO.

It is not easy to nurture the culture in its operating outlets across the whole of Mexico. One way OXXO has made it happen is to institutionalise shared KPIs. A shared focus on business outcomes will drive employees to find the optimal solution to achieve the end objectives. Most importantly, these shared KPIs are identical to the management's objectives and serve as

a self-balancing mechanism to addressing conflicting issues.

For example, store performance is a common KPI across functions within FEMSA. The FEMSA logistics team is accountable for both inventory levels and customer service. To ensure better customer service, the logistics team only delivers during quieter times before peak hours so that store staff are not distracted from serving customers.

The success of the approach has not only freed up store managers' time to focus on business objectives, it has also empowered the ground staff to address operational issues. The ground staff feels accountable to greater responsibilities and avoids developing tunnel vision on specific tasks. Adopting a shared KPI is an approach to put everyone on the same path, empower and motivate the workforce to deliver on the promise of convenience to the customers.

It is important to let the people know that they are part of the system, and that the system is affected by the interaction at every point.

Eduardo Padilla,

Chief Financial and Strategic Development Officer, Fomento Económico Mexicano (FEMSA) (which operates OXXO, a leading convenience store chain in Mexico)

6. Need for 'practical' technology

Consumers in Mexico increasingly value convenience, and technology can be a key enabler towards providing an enhanced experience throughout the customer journey. But simply deploying global off-the-shelf products can often have the opposite effect; with users viewing the solution as cumbersome and unnecessary. This viewpoint is mainly driven by poor infrastructure and ill-designed product features which are misaligned to local need.

It is critical that the right solution is deployed to address user needs, and provide a good working experience within the constraints of available infrastructure. Overall, using 'practical' technology solutions which focus on improving customer convenience will lead to wider adoption and usage. In today's digital age, online and mobile-enabled applications are a viable option towards achieving this objective – being cost effective and offering better flexibility for local customisation.

Case study: Grupo Modelo rides digital trend in Mexico

Anheuser-Busch InBev-owned Grupo Modelo has ridden on the digital trend by launching an online commerce site in Mexico for craft beers in early 2015. It has also developed mobile applications for beer ordering and delivery status updates to meet the surging demand for spectator sports events such as the FIFA World Cup and the Olympics. The company quickly followed up with a rollout of the digital home delivery service via its Bud Light brand in Northern Mexico in August 2015. Customers can make

orders via a phone call, online or by downloading a phone application. Modelo CEO Ricardo Tadeu said the company is 'betting on the digitalisation of consumption'.

The investment reflects the confidence the company has in the future where people will buy even more products through their phone and mobile applications, to have them delivered minutes later, appealing to young Mexicans' need for convenience, quick gratification and mobility.³¹



The winning concoction: Local knowledge, global expertise

Building strong capabilities requires time and investment, but the more critical ingredient is 'know-how'.

This can be built either by hiring leaders/teams with relevant expertise or through partnerships with other leading companies. Each of these approaches has its own advantages and challenges, but we see a rising trend in retail organisations entering into franchising partnerships to complement and learn from each other's strengths.

In the Mexican retail and consumer sector, franchising is a prevalent way to build capability. According to the Department of Economic Development of Missouri, the franchise sector grew between 9 and 12% in 2013, contributing significantly to the country's economic growth. The Mexican Franchise Association also believes that franchise laws and regulations are well defined to support the approximately 1,200 franchise concepts.

Foreign companies are looking for capable franchising partners who manage a portfolio of brands, with experience both of the local market and in dealing with foreign brands. In turn these local companies are no longer satisfied with a foreign company only bringing in a global brand. They are now looking for more investment in the form of capability enhancement and best practice. Merchandising strategies, retail supply chain management, operational efficiency and customer relationship management are some of the most important capabilities in the retail and consumer market. In Mexico, R&C organisations are seeking to develop focused capabilities through specific partnerships, and then looking to utilise these capabilities and learnings across the entire portfolio of businesses.

The business gains expertise and best practices from different global partners with strong capabilities in specific areas like technology, customer relationship management and kitchen efficiency.

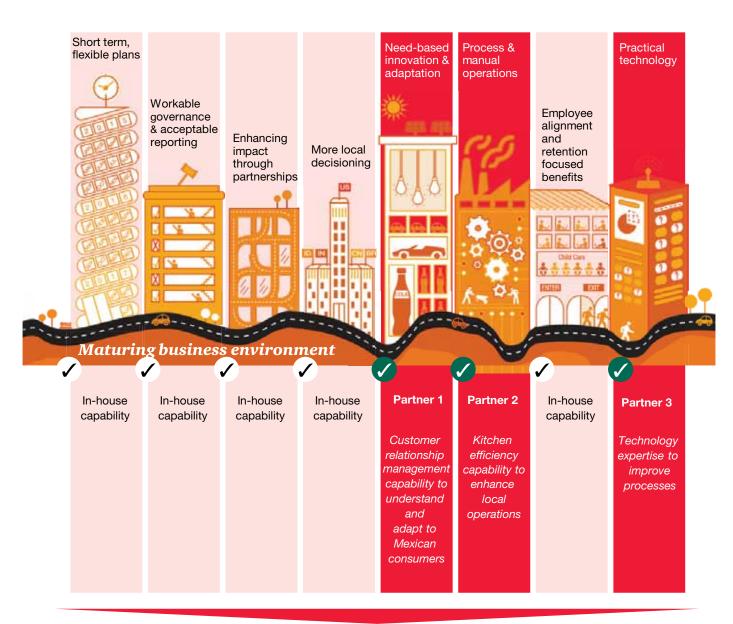
Alberto Torrado,

Chairman, ALSEA (a leading multi-brand restaurant operator in Latin America)

Case study: ALSEA develops strong operating capabilities through foreign partnerships

One such example is ALSEA, the leading multi-brand restaurant operator in Latin America, which has a number of well-known franchises under its umbrella, including leading global brands in the restaurants business. The US\$ 1.7 billion company operates more than 2,700 units of restaurant chains in Mexico, Spain, Chile, Argentina, Colombia and Brazil.

ALSEA's dominance in a fragmented restaurant industry is supported by strong operating capabilities developed through its growth, as well as through foreign partnerships. ALSEA has built its strengths in the knowledge of the local consumers, relationships with vendors and access to capital to develop its business in the region. As an established company holding multiple brands diversified across geography and income segments, ALSEA also deliberates on the key capabilities each additional brand is willing to invest that benefit the business as a whole. Figure 18 highlights the key capabilities each brand brings to the portfolio. These capabilities, when put together, complement each other as they fill in capability gaps to succeed in an emerging market.



Developing world class capabilities across the portfolio

Unlocking the enablers for growth

During this period of unpredictable and uneven growth across the developing markets, Mexico stands out as one of the key markets weathering this storm, particularly in the retail and consumer market. There are significant long-term growth opportunities within the Mexican retail and consumer market, not only across the formal segments of middle class consumers, but also in the informal segment. However, to address both of these groups successfully, companies need to adopt more innovative business models, which incorporate specific capabilities, such as providing access to consumer credit for those who find it hard to access credit through the traditional channels.

Retail companies like FAMSA have managed to identify the right balance of risk which they are prepared to digest when addressing this segment. They therefore feel confident in leveraging their other capabilities such as deep consumer knowledge and wide reach. This allows them not only to gain access to these new consumers, but also to gain loyalty from them.

To retain the loyalty of a busy Mexican consumer, regardless of which segment he or she is in, companies need to go beyond just understanding what goods they want and providing the financial measures to purchase these, but also make it convenient across each purchasing occasion.

Developing a flexible business model which understands these diverse consumer groups and their convenience needs is challenging for any foreign company entering the Mexican market. Here, finding the right local partner is key. However, a strong brand is not enough to secure such a partnership, as local Mexican companies are seeking partnerships which will enhance the maturity of their own capabilities. Companies looking to succeed in this attractive but complex market must be equipped with more than just a global brand. They also need a set of world class capabilities which can be adapted to strengthen those of local Mexican partners.

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