Legislative revamp offers fund promoters new opportunities

By *Anonymous*
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Members of Luxembourg's private equity industry are optimistic about the future despite the slowdown that has sharply curbed growth in the sector, from fundraising for new vehicles to buyout transactions and especially exits, over the past couple of years. They cite growing international interest in the grand duchy as a domicile for both fund and transaction vehicles and as a centre for service providers such as administrators and custodians.

In particular, there is confidence that Luxembourg is well equipped to meet the industry's needs with a range of vehicles that have been tailored to the requirements of the international financial industry, including the financial participation company (Soparfi), the risk capital investment company (Sicar) and the specialised investment fund (SIF), as well as a partnership structure that practitioners say can provide effectively the same benefits as limited partnerships established in the Channel Islands or the UK.

It is against these jurisdictions, which up to now have accounted for a large proportion of Europe's private equity sector, that Luxembourg now measures itself, and industry members say it does not come up short - as evidenced by the number of specialist alternative fund administration firms from the UK, Jersey and Guernsey that are looking at establishing a Luxembourg presence or have already opened an office there.

A wide range of factors underlie Luxembourg's emergence as a leading centre for private equity activity over the past five years, but local professionals cite in particular the willingness of the political authorities to follow the industry's lead in devising legislation that offers an attractive environment for private equity, and the openness and flexibility of the regulator, the Financial Sector Supervisory Authority (CSSF).

They also point to the quality of a workforce that has enabled firms to develop skilled private equity teams in a relatively short space of time. In addition, they say, efforts by the government and by the industry body, the Association of the Luxembourg Fund Industry (Alfi), to promote the jurisdiction to professionals abroad, notably in the US, the Middle East and Asia, are starting to bear fruit.

'Luxembourg has positioned itself strongly over the past two years, especially to encourage the development of the SIF as an alternative fund vehicle,' says Olivier Sciales, a partner with Luxembourg law firm Chevalier & Sciales. 'Alfi and the government have emphasised the fact that funds have a Luxembourg custodian and administrative agent supervised by the regulator. It's been very advantageous for Luxembourg to promote a regulated vehicle in an economic environment where the trend globally is toward much greater regulation of alternative funds.'

Sciales notes that for more than two decades Luxembourg's financial industry has acted as a magnet for skilled individuals from neighbouring regions of Belgium, France and Germany, as well as bringing in experienced professionals from all round the world. Over the same period the country has become more business-friendly by lowering both individual and corporate income tax rates to levels to levels competitive with most other EU member states.

'Luxembourg has been a big generator of skilled jobs within the region and the expertise of its workforce has grown steadily over the years,' he says. This has also been a factor in the industry's cost base, once a source of serious concern to its leaders and to the authorities, moving to a much more sustainable level.

It helps, of course, that the Grand Duchy has been a centre of domicile and servicing activity for the European cross-border retail fund industry for the past two decades and that it has long handled a

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small number of alternative funds aimed at professional and institutional investors despite the lack of a legal framework specifically designed to accommodate them.

In addition, the launch in the 1980s of the Soparfi - itself conceived in part as a replacement for the venerable Luxembourg holding company introduced in 1929 - offered private equity firms and others a particularly suitable intermediate vehicle for cross-border acquisitions. 'US or UK funds that invest in countries like Germany or France use intermediary Luxembourg Soparfis as SPVs for tax optimisation purposes, using the double taxation treaties concluded by Luxembourg,' says Alain Kinsch, a partner and head of private equity at Ernst & Young Luxembourg.

It is technically possible to use Soparfis to structure private equity fund vehicles, but Luxembourg played a relatively small role in this area until the introduction in June 2004 of the Sicar as a fully taxable corporate vehicle specifically designed to attract private equity buyout and venture capital business. Then in February 2007 it was followed by the SIF, a fund aimed at all kinds of alternative managers with a light-touch regulatory regime that notably allows funds to be launched before authorisation documents have to be filed with the CSSF.

Industry professionals say that for a while the SIF stole some of the Sicar's thunder because, while the fund has certain disadvantage as a private equity vehicle, such as risk diversification rules, it did offer the considerable advantage of allowing the creation of sub-funds within the overall structure. However, the disparity has now been remedied with the passage of legislation last October that added this feature to the Sicar, which as a result is again gaining popularity for private equity funds.

'Giving the Sicar the ability to have compartments and umbrella structures will improve its attractiveness,' says Vincent Lebrun, a tax partner and private equity leader with PricewaterhouseCoopers in Luxembourg. 'It is a good example of Luxembourg being flexible and moving in a virtuous circle. SIFs took a lot of interesting features from the Sicar in terms of flexible investment guidelines, and it brought umbrella capabilities to the table. Then the Sicar added that capability. The regulator deserves praise for being active in seizing opportunities to improve the product.'

Lebrun also believes that the ability to offer a regulated fund vehicle will prove increasingly compelling to private equity houses, although the effect will only gradually become visible as the industry's life cycle progresses and older funds come to the end of their lives, giving place to new vehicles. 'Existing private equity funds will disappear and new ones will be created, and there will be more small- and mid-cap funds in the future,' he says. 'These new funds will look to vehicles that are regulated to some extent, for the simple reason that it provides a certain level of comfort to potential new investors. That's where Luxembourg could be quite attractive.'

This is all the more important at a time when the European Union has unveiled draft legislation designed to ensure continent-wide standards of regulation for all types of alternative fund. Although details of the Directive on Alternative Investment Fund Managers have yet to be finalised, and the current version is under attack from both from critics that argue it imposes intolerable burdens on the industry and others who believe it does not go far enough, it seems inevitable that in future the sector will be subject to a greater degree of regulatory oversight, and that institutions will be under pressure to justify investment decisions to their own stakeholders.

In the meantime, according to Kinsch, the industry is having to adapt to an economic environment very different from the one that nurtured the global private equity boom in the middle years of this decade. 'The crisis has had a dual impact upon Luxembourg,' he says. 'First, fewer private equity funds are being launched and planned funds are being delayed, not particularly because general partners face problems attracting money from investors but more because they think prices in the market will continue to decline.

'So there is a quantitative decline in the number of new funds, but also a qualitative shift in the type of funds being launched. There are more niche funds that concentrate on either a particular geographical area or industry sector. They tend to be smaller in size because there is not much leverage around. But there is also a trend toward anything related to renewable energy, in areas such as wind and solar energy, Kyoto Protocol carbon credits, heavy infrastructure projects, land and

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timber. And more and more private equity houses are getting interested in financial services.'

At the transaction vehicle level, he says, there is a switch from new acquisitions to restructuring of existing portfolio companies, many of which were laden down with debt during the boom years when leverage was freely available, cheap and had few strings attached. 'A lot is happening involving restructuring of portfolio companies that are no longer able to repay their debt because they don't have the cash,' he says.

Adds Jean-Michel Schmit, a Luxembourg partner with Benelux law firm NautaDutilh: 'Activity has slowed, investors are very prudent or cannot afford to put more money into private equity structures, so cash flow has slowed and also acquisitions. Private equity houses are also paying close attention to making sure their existing portfolio companies are not going bankrupt.

'However, quite recently a feeling has emerged that rock bottom has been reached and that we should get ready to think about investing again not too far in the future, because everything is very cheap and there may be a lot of opportunities. Plenty of funds still have lots of money, and the choice must be made whether that should be invested to put existing portfolio companies in better shape or in other acquisitions.'

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