Luxembourg poised to benefit as pendulum swings toward regulation

By *Anonymous*
Created *03/06/2009 - 10:27*

Luxembourg's role as a centre for private equity activity is benefiting in different ways from the new global focus on greater supervision of alternative funds, even those aimed at institutional and other supposedly sophisticated investors, and the increased scrutiny of tax arrangements that have enabled fund providers and their investors to benefit from the domiciling of management entities, funds and transaction vehicles in so-called tax-neutral jurisdictions, including classic offshore centres but also countries like the grand duchy.

As a provider of regulated fund vehicles and companies, Luxembourg offers a full range of structures that enable private equity houses to structure investments in an efficient way; as a centre of fund administration expertise, it has expanded from its traditional strength in retail long-only investments to embrace hedge funds, private equity, property, funds of alternative funds and even more exotic asset classes; and in response to a clampdown on 'mailbox' fund management companies, private equity firms are creating a genuine presence on the ground in the grand duchy, taking advantage of the abundance of skilled and experienced personnel.

'Several private equity houses have been increasing their substance,' says Alain Kinsch, head of private equity at Ernst & Young. 'The initial trigger event has been the tax question, with foreign authorities asking firms to demonstrate substance in Luxembourg. First they set up an office with a couple of people, then they discover that ultimately it is cheaper to have all their structures administered in Luxembourg, because it is particularly efficient and cost-effective to do everything to do with administration and accounting here.'

One of the pioneers of this move was CVC, which describes its Luxembourg office as its headquarters, but other firms that have moved on from tax considerations to operational effectiveness include Carlyle Group, which is reported to have as many as 30 staff in its office, BC Partners, Cinven, Oaktree and Warburg Pincus, in addition to a cluster of genuinely home-grown venture capital firms such as Mangrove Partners, which was famously an early investor in Skype.

The Luxembourg staff typically include lawyers, tax experts and accountants, and the offices may be used for board meetings as well as for working on transactions in neighbouring countries such as Germany. This trend has been a significant contributory factor in the growth of the country's private equity community, Kinsch says: 'Two months ago we hosted a private equity breakfast on the topic of valuation in turbulent times. We had only 60 seats, and it was booked up in a few days. Five years ago there's no way we would have been able to get 60 people working in private equity for such a topic in Luxembourg.'

Vincent Lebrun, a tax partner and private equity leader at PricewaterhouseCoopers, argues that this trend ties in with the development of the country's third-party private equity administration sector. 'Luxembourg has a good reputation and a lot of clients are coming directly here,' he says. 'We just need to be sure that those people will be satisfied by the quality of service they receive. This has been understood by the local market, which is why we see more and more specialists. And the fact that some of the biggest private equity houses are opening offices in Luxembourg and putting staff there to manage their structures on a day-to-day basis very much helps the quality of our products.'

The administration industry has been swelled by the expansion of traditional long-only fund administrators, including both banks and specialist providers, into alternatives, as well as the arrival of firms from Jersey, Guernsey and the UK, the traditional centres of European private equity activity. The former category includes European Fund Administration, created in the 1990s from the fund services business of four local banks and now one of the leading players in the sector, which launched EFA Private Equity early last year.

'A business line focusing on real estate and private equity, it's a completely different set-up with its own people and systems because it's a very specialised field,' says EFA's head of product development and marketing Christophe Lentschat. 'After doing some research we came to the conclusion that the processes we needed to put in place were completely different both on the accounting side and the transfer agency side.'

Lentschat says the new business has enjoyed very strong development over its first year and continues to grow rapidly despite the general slowdown in the private equity market, with 40 sub-funds and EUR1.3bn in assets under administration at the end of last year. 'Private equity is still an asset class lowly correlated to others,' he says. 'And in the property sector we see a lot of people using Luxembourg vehicles for structuring real estate deals.'

It helps that EFA is a well-regarded name in the European investment industry with more than EUR100bn in assets under administration at the end of last year, and the private equity business has benefited from some cross-selling to existing clients. 'EFA appeals a lot to private banks because of the backing of our shareholders, but also the mindset to serve the high end of the market, typically private banks that set up products for their clients with a mix of real estate, private equity and traditional assets,' he says.

'Some banks for which we have been servicing traditional funds are now creating more sophisticated products. At the same time, a lot of people who were working for large organisations in dealing rooms or on the sales side may end up creating their own boutiques. We are seeing a lot of contact with people who are looking to create their own independent businesses.'

Lentschat's optimism is shared by José-Benjamin Longrée, managing director of Caceis Bank Luxembourg, who says: 'One area of the business that is expanding very rapidly is private equity and real estate. To a certain extent this is because these products are successful thanks to their link to the real economy and the fact that in contrast to a Ucits III fund, private equity has an influence on portfolio companies.'

He argues that the most professional alternative managers protect their business during tough economic times through their readiness to conduct a dialogue with investors. 'While clients' assets may have fallen in value, the important thing is not just the quality of the portfolio but of the manager's relationship with investors. Very professional asset managers maintain an excellent relationship with institutional and high net worth investors, and explain everything that is happening with great transparency on an ongoing basis.'

Chris Adams, global product head for alternative funds at the Luxembourg branch of BNP Paribas Securities Services, notes that with the classic private equity industry constrained by the effects of deleveraging, the biggest area of growth recently for both Luxembourg and the Channel Islands has been in private equity funds holding real estate.

'Real estate is the major driver of growth, for a number of reasons,' he says. 'There is a perception in some markets that it's getting close to the bottom. Real estate is traditionally a more opportunistic asset class, so we see private equity structures investing predominantly in real estate, infrastructure and businesses like timber. Last year European managers raised more than USD100bn, more than the US for the first time, but how many big private equity deals are happening?'

In addition to real estate-oriented vehicles, Adams says clients are also launching distressed debt funds in a private equity structure, whereas previously they might have employed a hedge fund structure. 'With distressed structures, we look at whether the manager is really embedded in this industry or whether they are more of an opportunistic player. We're much more interested in people doing it for five or 10 years.

'We also need to know whether the manager will be able to respond appropriately to corporate events. What happens when the bonds default? It's our job to make sure the investors are protected, so what's important is that managers understand all the kinds of corporate events related to that type of investment. It's vital that we have confidence and comfort in the organisation we are delivering services to.'

Adams believes that an important issue for the private equity industry is the problem of how to exit from investments. 'For traditional private equity funds, there are four ways to get their money out: listing, trade sales, management buyouts or restructurings,' he says. 'You won't get much money on the stock market. We're beginning to see some trade sales in the pharmaceuticals industry, but it's sector-specific, and in banking and financial services - but for other reasons. Management buyouts require leverage, which has gone, and so does restructuring.

'Leverage-oriented deals have historically accounted for about 60 per cent of exits. There may be acquisition opportunities, but people will be worried exits six, eight or 10 years down the line. You have to hope things will have got easier, but that will still be a concern on investors' minds.'

In terms of competitiveness, however, industry members are confident that the grand duchy will continue to develop its appeal as a jurisdiction for private equity and other alternative funds. Olivier Sciales of law firm Chevalier & Sciales cites the role of the Luxembourg Stock Exchange in the listing of both foreign and Luxembourg funds. 'Not only do many institutions require a listing, but it can also offer tax benefits,' he says. 'In some jurisdictions the transfer of units may be treated differently from subscriptions and redemptions, and it can also offer a marketing advantage.'

Lentschat adds: 'Luxembourg has come a long way as a domicile and service centre for alternative funds from where we were 10 years ago, with its new regulations but also the development of service providers such as lawyers, tax advisers and other expertise. We have also been served by events in that when you see a push toward more and more regulation, Luxembourg compares well with other jurisdictions.'

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