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The changing face of Luxembourg and private equity

David Bailey, managing partner of Augentius Fund Administration

The private equity industry has known Luxembourg for many years. It has primarily used the domicile as a suitable location for holding companies (such as Soparfis – sociétés de participations financières, a type of holding company tax-resident in Luxembourg) to facilitate pan-European transactions. A number of groups have even set up their own offices in Luxembourg to ensure "form and substance". However, despite being the largest fund domicile within Europe (with €1,706bn of fund assets under administration) and the world's largest fund distribution hub, Luxembourg was never really used as a fund domicile by the private equity community – but this is beginning to change.

Over the past five years, Luxembourg has worked hard to create suitable legislation to accommodate private equity fund structures. The Sicar (investment company in risk capital) was created in 2004, with the legislation being further revised in 2008, and the SIF (specialised investment fund) in 2007.

With these structures, Luxembourg has created the ability to accommodate both limited partnership and corporate entities with substantial flexibility. In addition, access is provided to the numerous double-taxation agreements that Luxembourg has put in place over the years and for which it is renowned.

Not only has Luxembourg changed its legislation to accommodate private equity, but its regulator the CSSF (Commission de Surveillance du Secteur Financier) has become more pragmatic on timings. The CSSF had a reputation for being very slow in providing approvals (as had other regulators in the past) but substantial efforts have been made to reduce the time and process involved in providing the necessary regulatory approval for funds, where the fund is targeted at "professional investors".

(It is worth noting that as in many offshore jurisdictions, the regulator does need to approve the fund prior to its launch. This, of course, differs to the UK, where the fund manager is approved by the FSA).

As a consequence, Luxembourg has started to gain increasing recognition as a private equity hub. Add in the unknown quantity of the AIFM Directive (which is, without doubt, taking political pot shots at the traditional offshore locations of Guernsey, Jersey, Cayman and Isle of Man) and Luxembourg is well placed.

Some buyout practitioners have, however, had a dislike for using Luxembourg. Among other requirements, they must appoint depository banks and for all administration to be carried out by a Luxembourg administrator. It has been argued that these and the other requirements increase costs and can create inefficiences. Others are happy with these additional levels and, indeed, a number of them currently appear in the AIFM Directive, although whether they appear in the final legislation remains to be seen.

For some investors (limited partners) who are penalised with additional tax liabilities for investing in some offshore domiciles (for example, those based in France), Luxembourg is an attractive domicile. In addition, with governments, state pension funds and others being pressured to avoid investing via "black listed" domiciles (whatever and whoever they may turn out to be) Luxembourg is well positioned to attract both funds and investors into the domicile.

So, Luxembourg has both the legislation and the regulatory desire to continue to increase its share of private equity funds, and there are increasing regulatory and industry influences that will encourage an ever more GPs to consider Luxembourg as a fund domicile. How well equipped is Luxembourg to handle such funds?

Given its position as a fund centre, numerous fund administrators and banks are located within Luxembourg. To many, private equity is a new entity but Luxembourg and its populous are both entrepreneurial and sophisticated. They have learnt and adapted to new products and structures over the past 20 years, and many will seek to explore the opportunity.

Its legal and audit capabilities are strong with many local and international firms having been present in the domicile for many years. However, private equity is different to any other asset class from an administrative point of view. It does use different structures (generally, limited partnerships), the administrative processes are different (there is no such thing as a net asset value) and there is a need to have the capability to issue individual capital statements to individual investors. Indeed, the number of investors in a private equity fund are few, but they do expect individual treatment and servicing.

Not all administrators are capable of providing such levels of service and have neither the infrastructure nor technology to meet the needs of GPs or LPS. With the attraction of growth this creates the opportunity for other specialist administrators to enter the domicile … and Augentius will be one of them.

A tradition of innovation at a time of crisis

Alain Kinsch, partner and head of private equity at Ernst & Young, Luxembourg, and Axelle Ferey, senior manager

Luxembourg has been active in structuring and servicing private equity funds and deals for more than 20 years. Over the past twelve months, its traditional capacity to react quickly with innovative solutions has been essential in meeting the new qualitative and quantitative needs of the private equity industry in the wake of the economic downturn.

Non-regulated vehicles, such as Soparfis (sociétés de participations financières), have been widely used to structure tax-efficient international transactions due to their access to the large network of double-tax treaties concluded by Luxembourg (more than 50). The market crisis triggered significant developments to the way private equity acquisitions have been structured or restructured and the Luxembourg Soparfi proved particularly fit to structure buy back operations, debt acquisitions or debt to equity swaps aiming at enhancing liquidity among private equity players.

Over the past four years, an increasing number of private equity funds have been set up in Luxembourg thanks to the successful implementation of two new, lightly regulated onshore fund vehicles: the Sicar (investment company in risk capital), launched in June 2004 and the SIF (specialised investment funds), launched in February 2007. The Sicar regime was updated in October 2008 in light of the experience gained by buyout practitioners.

Today, financial sector regulatory body the CSSF (Commission de Surveillance du Secteur Financier) says it has registered 229 Sicars and 906 SIFs. The two vehicles have been among the continental Europe vehicles of choice and have been used by many of the top 20 private equity houses, as well as by small and mid-sized players to invest in buyouts, venture capital, mezzanine, funds of private equity funds or, more recently, in renewable energies, infrastructure and private equity microfinance.

The four key advantages of these two complementary vehicles are: (i) access to a regulated domicile and superior brand, which especially deserves to be underlined in the context of unprecedented calls for transparency and stricter regulation in the current draft EU-Directive on Alternative Investment Fund Manager, a text likely to bring significant changes to the current services offered by private equity fund administrators and broaden the scope of their potential service offering; (ii) tax neutrality for investors and high tax efficiency for GPs; (iii) flexibility in structuring through various corporate forms, variable capital and compartments; (iv) operational efficiency achieved by an explicit consolidation exemption, for instance.

In addition, Luxembourg has built a real private equity cluster and Luxembourg-based service providers offer a comprehensive range of customised services, with teams specialising in structuring private equity acquisitions as well as transaction advisory, fund administration, custody, audit, legal and tax services. In that respect, Luxembourg reached a major milestone last year in establishing itself as the third major centre for private equity in Europe, alongside London and the Channel Islands: several large traditional fund administrators have begun to launch private equity desks, while specialist boutiques from London, Jersey and Guernsey are showing strong signals that they are well advanced in their plans to establish operations in Luxembourg.

Thus, the factors which have contributed to Luxembourg's success expand far beyond tax considerations and would be of little value if there were no infrastructure on the ground. The human capital present in Luxembourg has a wealth of experience with dealing private equity, not least of which includes a deep understanding of the private equity business, the structures involved, and a keen appreciation of the varying needs of the different stakeholders. Furthermore, Luxembourg is a small and stable democracy, which allows its business-minded government and public bodies a unique degree of nimbleness and flexibility.

This has enabled the Grand Duchy to win international recognition as a pre-eminent jurisdiction for private equity funds and deals alike and to adapt rapidly to the changing business landscape of recent months.

The main challenge facing the Luxembourg financial centre is the EU AIFM Directive issued by the European Commission last spring and under discussion in the Parliament and Council. If Luxembourg welcomes the proposal to harmonise European standards of regulation and support greater transparency in private equity investor reporting and valuation, it is, however, very concerned about the means the Directive presently foresees to achieve these goals.

Over the next few months, Luxembourg will therefore continue to engage in a constructive dialogue with all stakeholders to take into account both the legitimate objectives of the Commission and the concerns of the industry.

Meeting new challenges

Oliver Smiddy: What factors generally govern a private equity firm's (GP's) choice of fund domicile?

David Bailey: The fund domicile is generally determined by what the limited partner [LP, the investor in funds] wants. That has to be the overriding factor. A general partner [the private equity firm] taking a financial product into the market place has to look at what will suit the investors in that product. Other factors will come into play, however. In the first instance, a decision might be driven by legal and tax considerations, but that needs to be cross-checked against the needs of the investors.

Alain Kinsch: Many factors influence the decision. They include cost efficiency, the flexibility of the legal and regulatory frameworks, whether it is a business-orientated environment, the responsiveness of the regulator and government, political and legal stability, the tax regime and predictability of tax treatment, availability of a product portfolio randing from regulated to non-regulated structures, the availability and quality of service providers, and whether there is a skilled and multilingual workforce.

Discussion participants

Above, from left:
Oliver Smiddy, associate editor, Private Equity News
David Bailey, managing partner, Augentius
Alain Kinsch, partner and head of private equity, Ernst & Young, Luxembourg
Below, from left:
Axelle Ferey, senior manager private equity product development, Ernst & Young, Luxembourg
Kai Braun, manager and private equity advisory services leader, Ernst & Young, Luxembourg
Martin Hollywood, executive director private equity transaction tax, Ernst & Young, Luxembourg

OS: What are the regulatory differences between Luxembourg and other jurisdictions and who are its chief competitors?

DB: Its competitors are the obvious ones like Guernsey and Jersey. In terms of the regulatory differences, Luxembourg is a highly regulated environment. Historically one of the criticisms of it as a domicile was the amount of time it took to do things due to the regulator there. The regulator does pay a lot of attention to everything that goes on and likes to get involved.

As a comparison, in the UK, a GP would be approved by the FSA but every fund it raised would not need to be. In Luxembourg, the regulator has to approve every fund raised. But it has sensibly put in place quick approval processes.

Luxembourg historically has grown an enormous business out of becoming a centre for pan-European retail products, and more recently for pan-European institutional products. It is well known to players in Germany, France and Italy. Pretty much everyone there speaks four languages as a matter of course.

AK: The flexibility, pragmatism and business-oriented mindset of authorities mean the process for incorporating a company or a fund structure is fast and smooth.

Having easily accessible authorities means it is possible to have direct contact with them and with the financial sector regulator, the CSSF [Commission de Surveillance du Secteur Financier], in particular.

The legislature and regulator are responsive to business and industry needs thanks to an ongoing communication programme. They are proactive in the promotion of new products meeting the needs of the financial sector professionals. They constantly adapt the regulatory framework with an aim to maintain the right balance between regulation, first-class investors' protection as well as flexibility to set up innovative products.

OS: Where does it rank relative to other jurisdictions?

AK: It is in the top three with London and the Channel Islands, which are its chief competitors. Overall it is a very popular fund jurisdiction and increasingly popular for private equity.

OS: How do the tax advantages between Luxembourg and other jurisdictions differ?

Martin Hollywood: Luxembourg has access to well over 50 double-tax treaties, and also to EU directives. These points, coupled with the attractive domestic tax regime, make Luxembourg a very competitive jurisdiction. While the domestic headline corporate tax rate of approximately 28% is comparable to other European jurisdictions, there are a

number of provisions which reduce the effective rate to far below the headline rate, making Luxembourg the jurisdiction of choice for holding company location.

OS: Is more punitive regulation likely to limit the tax advantages provided by certain jurisdictions? How will jurisdictions like Luxembourg react to this?

DB: Governments are short of money at the moment and they are looking around for whatever they can find. It would be very difficult for governments to change some of the arrangements put in place. But if those arrangements were to disappear, it would cause some problems.

MH: Luxembourg does not see regulation as necessarily punitive. Its approach is pragmatic and as one of the EU founding members, Luxembourg has always displayed a culture of constructive dialogue. This can be seen, for instance, regarding the Alternative Investment Fund Managers Directive co-decision process.

Considering the increased role of alternative investments in the global economy, we acknowledge the need for an EU common approach and believe that appropriate regulation as well as harmonisation of standards and rules could become key success factors for the future competitiveness of European private equity. Given the political momentum behind the directive, it seems clear that regulation will come into force in some form. Luxembourg is, however, very concerned about the means the directive currently foresees to achieve these goals and will therefore continue to engage in a constructive dialogue with all stakeholders.

OS: What effect will the potential directive and the recent attention focusing on offshore and onshore jurisdictions have on Luxembourg?

DB: Marketing is probably the biggest issue from a domiciliary perspective. If a fund is domiciled outside the EU, it won't be able to market into Europe for three years after its formation. At the moment, the Channel Islands, Isle of Man and Cayman Islands, for example, are outside the EU. That is an issue given their popularity as domiciles. There is a chance they could be given equivalence to EU countries but there is no guarantee.

There are political sensitivities concerning perceived tax havens. Cayman itself is in a difficult financial position. If these domiciles do not receive EU equivalence, funds will have to find alternative EU-based domiciles like the UK, Luxembourg, and possibly Dublin or Malta. Because of potential uncertainty about offshore jurisdictions, general partners are starting to consider their options for future funds.

Luxembourg now has all the sensible and necessary legislation in place to manage any influx. The legal fraternity in Luxembourg is familiar with private equity. The buyout industry has been using Luxembourg for some time now, although mainly for SPIVs [special purpose investments vehicles]. We see it growing in popularity.

OS: Has the recent attention focusing on offshore and onshore jurisdictions – characterized as tax-havens in the mainstream media – affected the popularity of Luxembourg as a jurisdiction? What steps have been take to address concerns?

MH: Not at all. These attacks were more focused on the typical "zero tax" type of locations. The inclusion of Luxembourg was mainly because of the exchange of information clauses in Luxembourg's double-tax treaties. Luxembourg has already amended more than 12 treaties to include the OECD [Organisation for Economic Co-operation and Development] standard wording on exchange of information, and progress is being made on others.

OS: Are there disadvantages to using Luxembourg as a jurisdiction?

Axelle Ferey: No, especially in the current context of a call for increased regulation and transparency in the financial system, we believe that Luxembourg is ideally positioned to act as an entry gate to Europe, both from a product and a manager perspective, and could fully benefit from its unique financial market infrastructure as well as excellent reputation as an onshore financial centre.

DB: Although it has the necessary infrastructure, there is no doubt it can be an expensive domicile in terms of, for example, labour and real estate. Luxembourg is also quite new in private equity funds. Therefore the knowledge and expertise relative to more established jurisdictions with longer private equity pedigrees is probably a bit less.

But despite that lack of experience, it has legislated well. It is an amazingly nimble domicile. It is a small country but amazingly

competitive and able to move fast to address perceived needs.

Luxembourg is also less restrictive from an employment perspective than other non-EU domiciles. No work permits are needed for other EU nationals and there are no issues over housing permits and the like.

OS: How easy has it been to lure the necessary human capital to Luxembourg from other jurisdictions?

AF: Luxembourg has an established reputation for its well-educated and highly-qualified workforce, with the fund industry directly employing more than 13,000 people (about 4% of active population).

Its location at the heart of Europe with very good infrastructure network and first-class healthcare facilities also make Luxembourg a European hub very much appreciated by a multilingual and internationally-oriented workforce. Today more than 100 citizenships are represented in Luxembourg and 60% of employees in the banking sector hold non-Luxembourg passports. Nearly 42% of Luxembourg inhabitants are foreigners.

OS: How is Luxembourg changing as the private equity and venture capital industry continues to evolve?

AF: Luxembourg has a tradition of innovation. It has developed from a place used for structuring private equity acquisitions through intermediary vehicles 20 years ago to become a popular fund domicile today.

DB: Luxembourg has developed to accommodate hedge funds and in the last five years has begun to focus more on private equity. For the last 20 years the buyout industry has used it as a domicile for various holding companies. As a result of the vast number of double-tax agreements, a large number of SPIVs and SPACs [special-purpose acquisition companies] are based there now. An enormous percentage of the population now works in fund administration or fund-related jobs.

OS: In broad terms, who are the main fund administration providers and what range of services do they offer?

Kai Braun: There are three key groups offering fund administration services: the major banks, private banks and specialised administrators. Most provide a full service, including custody of assets and accounting in accordance with various standards. Administrators also offer investor management services, reporting to regulators and investors, waterfall calculation and cash management for capital calls.

OS: How are the Luxembourg service providers (lawyers, administrators and so on) adapting to service the private equity industry?

DB: Over the last 10 years, many London-based law firms have either set up their own offices in Luxembourg or created joint ventures with local firms. Luxembourg has become an important location for international law firms too, a strong indication of its popularity. All the large accountancy firms and banks are there. These providers are already servicing the private equity community from other locations, so as Luxembourg develops its private equity "product", all the legal and accounting firms are readily able to provide advice and expertise.

As far as administrators go, private equity is new to the vast majority of local providers and we are aware of poor service standards from some. This creates an opportunity for specialist providers such as Augentius.

AK: A lot of investment has been done in the five past years with regards to administration of private equity funds – dedicated servicing desks, specialised IT systems, specialised lawyers, consultants and auditors.

OS: How has the global recession affected Luxembourg and how is the jurisdiction preparing for recovery?

AK: After enjoying impressive growth over the past four years, the Luxembourg private equity sector has had to confront a different market environment over the past 12 months.

Significant changes have been seen in particular in the style and strategy of new funds and the kind of transactions. Luxembourg has been able to adapt its solution offering to the qualitative and quantitative changes in the private equity industry.

Apart from a slower growth in new private equity funds and acquisition structures put in place due to lower deal activity, there has been a qualitative shift in the type of private equity funds being launched, with an upsurge in the establishment of niche funds that specialise in a particular geographical area or industry sector. These funds are still traditional private equity funds but they are in general smaller than those launched in the recent past and tend to focus on equity-financed deals because leverage has largely dried up. There is also a clear trend towards investments related to renewable energy, with private equity houses having built up new expertise in areas such as wind and solar energy, Kyoto Protocol carbon credits, heavy infrastructure projects, land and timber.

The market crisis has also presented challenges that have brought several significant developments to the way private equity acquistions have been structured or restructured. The ability to buy back, invariably at a discount, acquisition debt from third-party lenders, or the flexibility to structure debt-to-equity swaps which help to enhance liquidity have been warmly welcomed by the private equity industry.

So, notwithstanding the financial crisis, Luxembourg has proven itself to be a solid and sustainable market, with an ability to adapt quickly to the changing face of the market.

OS: Thank you.

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Hugh Stacey
London
Director, Business Development
tel +44 20 7397 5489
hugh.stacey@augentius.com

David Bailey
London
Managing Partner
tel +44 20 7397 5453
david@augentius.com

Barry Carroll
New York
President & CEO
tel +1 917 484 8222
barry@augentius.com

www.augentius.com