association of the luxembourg fund industry

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New EU legislation gives Luxembourg further boost as European private assets fund leader

Despite a backdrop of continuing economic and political uncertainty, as well as growing international conflict, Luxembourg continues to consolidate its leadership in the European private assets investment market, and in particular as the primary hub for the rapidly-expanding private debt market, according to speakers at the ALFI Private Assets Conference 2024 at the grand duchy's LuxExpo The Box conference and exhibition centre on 25 and 26 September.

With central banks starting to lower interest rates in response to falling inflation and cautious optimism that European economies, while labouring, are unlikely to experience a significant slump, the unwinding of tight monetary policy offers a fresh incentive for investors.

The gradual decline in fixed income returns is encouraging a shift towards asset classes such as private equity and venture capital, real estate and infrastructure, and private debt.

Over the past two decades Luxembourg has been positioning itself to exploit the growing appeal of alternative assets and strategies to complement the country's dominant role as a domicile and servicing centre for cross-border retail UCITS funds, according to ALFI CEO Serge Weyland.

He pointed to the enactment of the risk capital investment company (SICAR) legislation in 2004 – "initially a niche for investments like venture capital, shipping and wine funds" – followed three years later by the introduction of the specialised investment fund (SIF), the special limited partnership (SLSp) together with the country's adoption of the EU's Alternative Investment Fund Managers Directive (AIFMD) in 2013 and the unregulated but indirectly supervised reserved alternative investment fund (RAIF) in 2016.

Democratisation of alternative strategies

This framework, Mr Weyland said, has enabled Luxembourg's private assets sector to grow at a compound annual rate of 20% over the past five years to €2.3 trillion, and it now accounts for around one-third of the country's total investment fund assets. Demand from international investors has been boosted by the decline of the longstanding 60:40 equity-bond asset allocation formula, as well as an increased focus on diversification, particularly after traditional asset classes plunged in tandem in 2022.

There’s also a growing trend toward the democratisation of alternative strategies as individual investors become more willing to accept reduced liquidity, like institutions, in exchange for the potential of higher returns from assets held for longer periods. An important catalyst has been the revised European Long Term Investment Fund Regulation, dubbed ELTIF 2.0, which has prompted a surge of around 40 new fund launches this year; around two-thirds of the total and virtually all cross-border ELTIFs are domiciled in Luxembourg.

The cost of doing business and time to market are key concerns for the fund industry, Mr Weyland said, and it faces ongoing operational challenges, as well as increased regulatory scrutiny – witness current consultations in the EU and elsewhere about the potential risks posed by non-bank financial intermediaries – although he argued that the growth of private debt sector in fact may be well reducing systemic risk rather than increasing it.

But there are welcome signs of support from Luxembourg’s government, including the planned subscription tax exemption for actively-managed exchange-traded funds, the revised income tax regime to make the country more attractive to the highly-skilled individuals the sector needs to recruit from abroad, and an initial 1% reduction in corporate income tax scheduled for next January.

Adverse factors

Keynote speaker Christopher Hunter, private investment director in the private client practice at investment firm Cambridge Associates, acknowledges that the past two years have been challenging in terms of performance, although he is confident about the long-term effectiveness of private assets as a key element of clients’ portfolios.

He pointed to adverse factors such as the surge in interest rates since 2022, investment restrictions prompted by worsening international relations with countries including China and Russia, and political pressure on the taxation of carried interest as capital gains rather than income. With private equity firms struggling to exit portfolio companies, returns have declined (even more in venture capital), and fundraising has fallen to its lowest level in a decade.

But Hunter said the industry and its investors have responded, for example through the rapid growth of the secondaries market, and expects liquidity slowly to return to normal as interest rates decline, enabling asset managers to exploit a vast but evolving and complex opportunity set. He argued that to be fit for the future, managers must embrace diversity and sustainability and in particular bring next-generation thinking into their decision-making and control structures.

Conference participants were introduced to a range of the strategies now opening up to private asset funds, from recorded music portfolios to logistics in Eastern Europe, renewable energy and private equity investments in Africa. Partner Camille Brunel said Rive Private Investment was able to benefit from opportunities in renewables thanks to its expertise at project level, noting that the sector generates plenty of cashflow and offers relatively easily available liquidity, but "requires huge asset management capability".

NAV financing under scrutiny

Johan Hattingh, CEO of Arch Emerging Market Partners, pointed out that Africa's population is forecast to grow from 1.5 billion people today to 2.5 billion by 2050, when it will account for nearly 30% of the world's population. Meanwhile the continent has enormous potential to supply in-demand minerals and to cut the 40% losses from food production resulting from inadequate storage facilities and distribution infrastructure.

NAV financing in the alternative funds sector has been a target of criticism in recent months, attracting closer scrutiny from regulators concerned about its implications for overall private equity leverage and potential knock-on effects on financial stability. However, speakers focused on its value-creating capabilities as well as transparency issues, underwriting processes and operational challenges.

Daniel Sinclair, partner at Ares Management, highlighted the flexibility of fund-level leverage rather than portfolio company leverage, and its potential to enhance growth and value creation through funding of additional investment in managers' existing portfolio companies. This is particularly valuable in the current sluggish exit market, where assets are often being held longer than originally anticipated/previously foreseen.

Matthew Kirsch, managing director in charge of NAV financing at Pemberton Capital Advisors, emphasised the importance of understanding the collateral provided by asset managers, who need to communicate transparently with their limited partners about the reasons for adding leverage. These include creating liquidity for investors when exit deals are unavailable at the right price, but Mr Sinclair said 85% of NAV financing was channelled into value creation within managers' portfolio.

Greater investor focus on specialisation

NAV financing does not represent adding leverage on top of existing borrowing, Mr Kirsch argued, because it is typically applied to seasoned portfolios, after initial leverage taken out for acquisitions has been paid down and risks within the portfolio have been reduced. And, he added, most transactions are with top-performing fund sponsors.

Fundraising remains robust in strategies such as secondary market transactions, according to Florian Bentele, global head of private markets legal at Allianz Global Investors, who also pointed to the growth of private credit amid a generalised shift from equity to debt. But Miao Wang, a partner at A&O Sherman, noted that the market is becoming more difficult for generalist GPs as investor focus becomes more concentrated and specialised.

Panel members agreed that Luxembourg remained the leading domicile considered for fund structuring. "There is a very pro-business environment, an accessible and pragmatic regulator and economic and financial stability, as well as market expertise at service providers," said Dale Quarry, CEO of International Financial Data Services in the grand duchy. Francesca Fihri, a director at KPMG Tax and Advisory, noted that Luxembourg benefits from the capabilities of specialists recruited from all over the world, adding that Luxembourg's triple-A sovereign debt rating, a rare attribute, is also important to some institutions.

While speakers also drew attention to the growing concentration of ELTIFs in the grand duchy and the potential contribution of individual investment flows, Ms Wang pointed out that institutional money still accounts for as much as 80% of inflows. Mr Bentele expressed scepticism about the degree to which retail savings can be channelled into long-term investment, arguing that semi-liquid funds entail an inevitable trade-off: the higher the liquidity, the lower the performance. Added Ms Quarry: "The challenge is to figure out the model, who the investors are, and what kind of trading, gating and currencies are involved. What you would like may not be what the market can do."

Private banks as drivers of alternative strategies

The global alternative market, including $5.5 trillion (EUR 5 trillion approx.) in hedge funds, is forecast to reach an aggregate $29 trillion (EUR 26.4 approx.) by 2029, according to Alex Murray, head of real assets research at Preqin. He said private equity assets under management were set to more than double from the end of 2023 to $11.97 trillion (EUR 11 trillion approx.), although the firm is less confident about the sector's performance over the next five years. Preqin expects private debt to grow at a compound annual rate of 12% up to 2029, with European-focused real estate fundraising set to outpace private markets overall by 0.8 percentage points.

According to managing partner Justina Deveikyte, her consultancy Novantigo expects the global private wealth market for private market strategies to grow to between $10 trillion (EUR 9.1 approx.) and $13 trillion (EUR 11.8 approx.) over the eight years to 2032, leading to increased competition between providers of evergreen funds – a term preferred by many market participants to 'semi-liquid' – for access to private banks' restricted product offering in each asset class. At least for now, she said, Luxembourg Part II funds, as well as RAIFs, are typically preferred by banks, and between them added nearly $5 billion (EUR 4.6 billion approx.) in net inflows in the second quarter – compared with no more than $500 million (EUR 455 million approx.) for ELTIFs.

A survey by KPMG Luxembourg commissioned by ALFI at the conference has revealed that aggregate assets under management in Luxembourg-domiciled debt funds totalled EUR 510 billion at the end of December 2023, up 21.5% from six months earlier, according to data from 13 depositary banks that between them are estimated to account for between 90% and 95% of the market.

The study also found that unregulated debt fund vehicles significantly outpaced regulated entities, increasing their market share by 22 percentage points to 63% since June 2023. According to KPMG alternative investment tax partner Julien Bieber, special limited partnerships accounted for 86% of unregulated debt funds; RAIFs made up 62% of the regulated and indirectly regulated fund category, gaining nine percentage points in a year, while the share of SIFs dropped by six percentage points.

Benefits of continuation funds

The issues faced by general partners in exiting investments over the past two years have prompted increasing establishment of continuation funds as successors to existing investment vehicles. The process must be very open and transparent, said Herbert Thomas, general counsel at ECE Real Estate Partners, and investors must not be led to believe this is the only option, but continuation funds "can provide a lot of benefit for GPs, existing investors who can cash out, as well as new investors".

One way or another, they are here to stay, said European Investment Fund head of secondaries Joaquín Ruiz. He notes that a report by London investment banking boutique Evercore Private Capital found the proportion of GPs that had established continuation vehicles, were in the process of doing so or would consider it, had risen from 30% in 2018 to 80% four years later. While the strategy inevitably gives rise to the possibility of conflicts of interest, Mr Ruiz said, the issue is how such conflicts are managed.

The first panel on the conference's second day examined the business agenda for alternative fund businesses. Private banking and wealth management clients are the key priority in the private assets market for Soraya Kamel, head of business development at Allfunds Alternative Solutions, who said Allfunds Bank's aim was to break down the barriers to investment and make access to private market funds as easy as for UCITS.

The evolution in investment strategies was illustrated by Stephen Robertson, CEO and founder of Metis Partners, whose specialisation is lending to companies against the value of their intellectual property assets – "unlocking hidden value", he said. Given the scope of Luxembourg's proven fund toolkit, evolution in existing products rather than radical revolution can meet clients' needs, argued Alexandra Serban-Liebsch, head of continental Europe business operations at fund governance, risk and compliance service provider Waystone.

Fund financing – borrower's market

Robertson and Serban-Liebsch agreed that technology is a critical factor in the private assets value chain, with a major focus on making data management more efficient, as well as to enhance fund distribution. Mr Robertson pointed to the increasingly important role of technology in areas including asset allocation, due diligence on assets and verifying valuations, as well as identifying profitable investment opportunities.

Fund financing is currently a borrower's market, argued Aegon Asset Management senior portfolio manager Jules Koekkoek. With alternative providers such as sovereign wealth funds and pension schemes entering the market, borrowing terms are under pressure, he said; lenders offering subscription lines at the beginning of a fund's life are increasingly willing to accept that no capital calls are made on limited partners at the outset.

Dirk Kaiser, managing director for EMEA fund finance at Wells Fargo, noted that the current period is extremely challenging for many private market asset classes, with few exits, limited distributions to investors and sub-par fundraising. Nevertheless, he sees green shoots emerging as interest rates come down, while new entrants are set to expand financing capabilities as a whole. "This is the most important development in the past five years," he said.

The Luxembourg Stock Exchange is stepping up efforts to boost liquidity for all asset classes, including listed funds, to take advantage of the growing appetite among non-professional investors for a more diverse range of assets and strategies, according to Carlo Oly, the exchange operator's head of relationship management, who acknowledged the importance of a vibrant secondary market in particular for products such as ELTIFs.

Attracting liquidity providers

While the Luxembourg exchange is already a leader in primary market listings of bonds, funds and other securities, it is seeking to attract international players to its secondary market, focusing initially on bonds but also encompassing other assets. Oly said that enhanced secondary market liquidity could benefit the individual investors that ELTIFs are intended to attract, although he acknowledged that the restricted size of Luxembourg's domestic market posed a challenge.

The question of liquidity is an increasingly complex challenge for lawyers specialising in fund structuring, according to CMS Luxembourg investment funds partner Benjamin Bada. That applies not only for funds open to non-professional investors but those targeted at institutions, which may themselves seek to negotiate down redemption notice periods, said UBS head of legal for EMEA alternative funds Felicia Efta. Notes Jan Hendrik Witte, CEO of Record Financial Group: "As ever, liquidity features come at a price."

Like other types of investment, private asset funds are subject to seemingly endless waves of regulation relating to sustainability, said Oliver O'Bryan, senior sustainability lead at Partners Group. However, he sees progress in the evolution from greenwashing, which has caught up several high-profile asset managers in recent years, to 'greenhushing' – firms staying quiet about their ESG achievements to avoid being accused of over-promising.

Mr O'Bryan said sustainability is now integral to the investment lifecycle and to risk-return considerations, but the biggest issue is access to relevant and reliable data. "The conversation has shifted from 'if' to 'how'," he said, while noting that a critical question remains as to whether asset owners are willing if necessary to accept lower returns.

Emerging crypto-investment infrastructure

In the past few years a crypto-asset investment infrastructure has started to take shape in Luxembourg, including asset manager Dair Capital, crypto-exchange BitFlyer Europe, AIFM 6 Monks and custodian Zodia Custody – in considerable part thanks to the openness of the CSSF to consider non-traditional assets, according to Dair's chief strategy officer, Rebecca Venis.

BitFlyer's Luxembourg CEO Ami Nagata pointed out that the exchange, established a decade ago, was the first business to be authorised by the regulator as a crypto-asset service provider. But 6 Monks head of portfolio management Quentin Werlé said the reluctance of banks to open accounts for crypto businesses, because they regard it as too risky, remained an issue. "Education is the answer," he said. "We are happy to provide training to organisations such as the Luxembourg police and the Financial Intelligence Unit, to help them understand what's happening in the crypto market."

Private markets participants, along with other financial institutions in Luxembourg, are hard at work examining the implications and potential applications of artificial intelligence, especially generative AI. "It is an evolution of machine learning that can provide not just analysis but actions," said Claudia Hauser, Microsoft's director of capital markets solutions, noting that use of ChatGPT went from one million in five days to 100 million in a month and now encompasses one-third of the world's internet users.

Gold-plating of AML requirements?

Panellists discussing the implications of the generative AI revolution emphasised that it remains far from the finished article, with Kneip Communication's director of data and innovation Ulf Herbig noting that depending on the use case, not all AI models may come up with the same results. Arguing that companies are better advised to test out how to use AI on free offerings rather than install an application that costs €2 million, he concluded that rather than replace people and jobs, AI should "make work more fun and more valued".

The conference concluded with an interview of Guilhem Ros, head of the fund anti-money laundering department at the CSSF, by Arendt & Medernach co-chair Claude Niedner. Mr Ros, who expressed satisfaction at the largely upbeat verdict from last year's inspection of Luxembourg by a Financial Action Task Force team, said the CSSF worked on the principle that if it asks industry members for information, the regulator must analyse and use it.

He resisted the suggestion that Luxembourg has 'gold-plated' AML requirements imposed by European legislation, insisting that the CSSF's approach to implementing statutory requirements must take into account the much greater size of the asset management industry compared with most other EU member states. And Mr Ros pointed out that in some areas, such as AML due diligence on the assets in which funds invest, the grand duchy's approach was becoming a model for Europe as a whole.