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**GREAT FUND INSIGHTS**

# Luxembourg - a leading hub for alternative investments and a hedge against uncertainty

**Natacha Oskian** Hello and welcome to Allen & Overy's Luxembourg Podcast series on alternative investment funds. My name is Natacha Oskian and today we will be talking about the economic importance of the alternative investment space. We will look at how it has been adjusted during the Covid crisis and last, but not least, we will also look at why Europe, and more specifically Luxembourg, is such a significant hub for alternatives and examine some of the changes alternative investment managers are experiencing today. What influences their ability to raise and deploy capital across Europe and why are they all using Luxembourg? To help navigate these things I am joined today by two of our partners from the Allen & Overy Luxembourg office, Peter Myners and Patrick Mischo.
Hello and welcome.

**Patrick Mischo** Hi, Natacha, thanks for having us.

**Peter Myners** Hi, Natacha.

**Natacha Oskian** Hello, both. So first I would like to introduce Peter. Peter is a specialist lawyer in corporate law and advises on the establishment and operation of Luxembourg investment platforms for alternative investment managers. He is also an expert in M&A (Mergers and Acquisitions), including domestic and cross-border deals. Peter is also the co-head of Allen & Overy's Alternative Investment Initiative globally and Exco member of the Luxembourg Private Equity Association. Now I would also like to introduce Patrick Mischo. So Patrick is the office Senior Partner and specialises in Tax. He also advises on the structuring of Luxembourg regulated and unregulated alternative investment vehicles. Patrick is a member of the board of the Luxembourg Private Equity Association and together with Peter they are both relationship partners for some of the major alternative investment players in the world. Welcome. So to start, I am going to ask Peter, what is the alternative space?

**Peter Myners** Thanks, Natacha. Good question. Well, of course the word "alternative" is a bit of a misnomer these days. The alternative space has in fact become the mainstream space and I'll give you a few stats to prove that and to give you a sense of the scale of the industry.

**Peter Myners** The latest 2019 Annual Preqin Global Private Equity and Venture Capital Report estimates that there were approximately USD3.41 trillion of assets under management in the alternative investment sector across the different asset classes. Dry powder was at an all-time high level of USD1.21 billion, meaning the money available to deploy and make new investments is twice what was reported in 2010 and of course you need to add to that dry powder leverage and co-investment funds, so the actual amount is incredibly high. But what exactly do we mean by private capital or alternative investment? Well, we basically mean all of the different asset classes that are private, in terms of private capital, so we're not talking about public stock markets, we're talking about private equity, venture capital, infrastructure, real estate and credit and hedge. But how have we got to such dizzying numbers? Well, of course the space has been helped by a number of different tailwinds, not least the low interest environment which is pushing investors who need to obtain a certain yield away from the public markets and towards private capital and of course there we're talking about the pension funds that you and I depend on, Natacha, for our old age. They need to find the right levels of yield and of course strike the right balance between yield maximisation and the approach to risk. Another factor that has driven investors towards private capital is the sheer volatility that we've seen in recent times in the public markets and the tightening of public markets, meaning fewer issuers and more volatility as a result. Also, alternative investment funds tend to benefit from being slightly less regulated than some of their public competitors; let's compare, for example, credit funds with traditional banks. In the private credit space debt funds don't need to worry as much about things like capital regulatory requirements, which hold them back, and, of course, once you start delivering good returns to investors, successful funds attract additional investors and fundraising becomes exponential. So that's the picture from a sort of macro perspective. There's a huge amount of capital going into this industry and it's led to an expansion of the firms that manage that capital, both geographic and also in terms of asset strategy or asset class, and also a greater specialisation in terms of sectors.

So, for example, traditional private equity buyout houses have added real deep sector expertise, whether it's technology or healthcare or retail, and traditional private equity buyout houses have moved into things like real estate or credit or infrastructure, so you've seen funds become more flexible in terms of the things that they can invest in, and, going the other way, we've seen many of the more traditional debt players move into equity – well, starting with mezzanine loans and moving into equity – so it's a very dynamic and rapidly evolving sector and sometimes different parts of these firms are going after the same deals but at different parts of the capital structure, so the buyout team, for example, would be going after the equity but the private credit team would come in on the debt side of the same target company. Of course there are regulatory and conflicts issues to be thought about in that context.

So there's an awful lot going on and a lot of that action is coming through Luxembourg, as you well know, Natacha.

**Natacha Oskian** Thanks, Peter. That was a very comprehensive overview of what the alternative investment space is about. You mentioned high volumes of dry powder that were available before the current pandemic and the deals that were very expensive back then: as the crisis has hit the economy in general in some sectors such as airlines, travel and hospitality, they are severely affected by the pandemic in particular, so how did all this impact the alternative investment space today?

**Peter Myners** Thanks, Natacha. Well, it's true that at the end of the bull run, which I think we can probably all agree well and truly ended in Q1 of the calendar year 2020, towards the end of that bull run competition for assets was a real factor, but I would say that the Covid crisis has had two main effects, at least from our perspective. The first is in terms of capital raising.

**Peter Myners** Now, existing funds have been pivoted towards opportunistic investments and I've already mentioned the term 'flexible capital'. In our experience the terms of funds have become more flexible to enable asset managers or alternative investment managers, to pivot towards, for example, distressed opportunities and managers have been raising capital that's dedicated to the opportunistic investment set that now presents itself on the market, so there's a huge amount of capital raising that's been going on, and, again, a lot of that has been taking place through Luxembourg, but there's been a second impact, which is on the deal side, and I would say initially, after the Covid crisis hit, many of our clients were looking to trade in terms of liquid investments, so many of the bonds were trading down, bonds which were funding otherwise healthy businesses were trading down, as a result of worries in the market generally and so many of our clients opportunistically bought into those positions, but those were quite liquid deals, and on the more illiquid side we didn't see a huge amount happening. Now things are changing and more illiquid deals are starting to happen, quite a few big private equity deals, the logistics sector is pretty hot in the real estate space, infrastructure, green energy, quite a lot going on. But of course some asset managers will have been bruised particularly. You mentioned the hospitality and the travel sectors, Natacha. Obviously if you are sitting on a portfolio of hotels right now, you're not feeling as bullish as somebody who would maybe be focussing more on the technology that we are using to run this call, for example.

**Natacha Oskian** Thanks, Peter, And now to talk about Luxembourg and its famous legal toolbox. Patrick, why has Luxembourg developed into the hub for the alternative investment space and what makes it so special and distinct from other countries?

**Patrick Mischo** Well, I know, Natacha. I think maybe you can describe it as a jurisdiction which is used to structure different types of, let's say, legal arrangements. Luxembourg today is widely used as a hub to set up alternative investment funds, so-called upstream or fund formation, but also to structure and execute transactions at trans-investment portfolio level, so-called downstream transactions. When I say transactions, I will refer to different types of transactions which will typically involve acquisitions, so there could be acquisitions of real assets like real estate and infrastructure for real estate and infrastructure funds but could also, for instance, be acquisitions of operating companies or funds running a private equity strategy.

When I say transactions I also refer to the debt financing. These funds very often take on to finance the acquisitions so there could, for instance, be bank financing and there could also be financing uptake where they kept the markets to basically carry out the acquisitions. Often, where we structure these transactions, you will see the use of Luxembourg SPVs, so-called Special Purpose vehicles which sponsors of the funds would use to carry out the acquisitions and enter into the related funds and transactions. So the way I sometimes describe this is that Luxembourg is used, on the one hand side, basically to raise capital in Europe by the use of alternative investment funds and, on the other hand side, once you have raised the capital, of course, you need to deploy it so you need to deploy it by investing into European companies, for instance by using SPVs.

**Natacha Oskian** I see. So, Patrick, why has Luxembourg been so successful?

**Patrick Mischo** I think Luxembourg has been extremely successful on the fund side for several reasons. The first reason is that we have an extremely broad legal toolbox so we have a range of investment features we can use to structure funds, regulated and unregulated funds, and I guess the best example here is the Luxembourg Limited Partnership.

**Patrick Mischo** It's a tool which has basically been reformed from a number of years ago and which has become extremely successful because it's an extremely flexible tool which allows the GPs, the sponsors, to enter into arrangements with the investors, the LPs, from around the world. When we basically revamped that tool a number of years ago, we wanted to make sure that sponsors had something similar to what they experienced previously, in other typical country jurisdictions like, for instance, the Channel Islands or the Cayman Islands, which were frequently used as well as a hub to set up funds. But there is another reason for the success story I would say. That's really the regulatory changes and trends we went through over the last ten years since the previous financial crisis back in 2008-2009, so, of course, the alternative space, as we call it today, didn't used to be a regulated space at all. It was fully unregulated. So it's only by the introduction of the AIFMD, the so-called Alternative Investment Fund Managers Directive, that that space became regulated. Luxembourg has always been a hub for regulated funds for so-called mutual funds or UCTIS funds. But there were other trends, such as the so-called BAPS Action Plan, the Action Plan on Base Erosion and Profit Shifting, which was carried out by the OECD, and then last but not least, the more recent event of course is Brexit, which was the trigger event, and it really resulted in a situation whereby Luxembourg was heavily used by the managers to set up funds, but also alternative investment fund management companies in particular, to keep access to the European single market in the post-Brexit world. All these reasons make Luxembourg the jurisdiction of choice and the hub for alternative investment funds.

**Natacha Oskian** Thanks, Patrick. You touched on the deployment of capital in Luxembourg. Now, Peter, can you perhaps comment on that across Europe?

**Peter Myners** Sure, Natacha. So what we are seeing is the deployment of capital from Luxembourg investment platforms into deals throughout Europe and even beyond. Whether that's a real estate acquisition in Greece, a portfolio company acquisition in Spain, a shopping mall in Germany, it's a very diverse range of assets but the common denominator seems, at least to us, to be the use of the Luxembourg investment platform. Why is that? Well, Patrick has given some reasons and I will chip in as a corporate lawyer. I am a corporate lawyer, so I would say this, but I think, in large part, it is very much because of our flexible corporate law regime.

We have a long menu of different types of vehicles and each of those vehicles is the subject of very flexible legal regimes. So if you want a transparent vehicle, a tax transparent vehicle or an opaque vehicle, if you want to limit liability away from your master holding company or fund, if you want to play with voting rights, if you want to play with economic rights, both of which can be very useful in joint venture, co-investment or management incentivisation structures or asset manager promote structures, or if you want to deploy tag or drag mechanisms and be confident that they will be enforceable, these are all very good reasons for using Luxembourg corporate law and Luxembourg corporate vehicles.

So there's lots going on and lots of reasons why people would use Luxembourg structures and of course what that's resulted in, is an enormous number of SPVs a galaxy of SPVs, and some of the bigger players in the industry have 500, 600, sometimes up to 1000, Luxembourg companies and of course, with that kind of scale, you need to think about operational efficiency and there's no doubt that we've now moved into an era where there are lots of well-trodden paths, lots of familiar ways in which you can structure investments and as a result, there's a real opportunity to drive down costs. I think Luxembourg remains a cheapish place to hire talented people and the people that we do hire here tend to be multi-lingual and of course, if you are an alternative investment manager doing deals across Europe, that can be very attractive.

**Peter Myners** We've also got our Banking Collateral Act, which is also very attractive in particular towards creditors. So if you are a bank or a debt fund lending into a Luxembourg borrower with collateral governed by our Collateral Act, you can be pretty confident that you will be able to enforce the security in the event of a problem from the borrower and that contrasts sometimes with some of the long-winded, unpredictable legal systems in some of the southern European countries and so we often see Luxembourg being chosen specifically because of the ability to enforce a share pledge over a Luxembourg holding company. Now, of course, we have seen quite a few of those enforcements or at least threatened enforcements during the course of the last nine/ten months and generally I would say that Luxembourg law, the Luxembourg corporate vehicles, and all of the sort of governance regimes that go around them, have held up pretty well in the face of some fairly formidable challenges in the form of Covid and of course its effect on different borrower groups around Europe. I would say, in general, things like limited liability structuring, enforceability of clauses, the governance around distributions, has all worked very well, although of course there have been some complexities in relation to specific scenarios. So we don't take anything for granted but I do think that what we can be confident of is that the toolbox, as Patrick puts it, will remain dynamic and we'll make sure that as the trends within the industry develop, Luxembourg remains attractive.

**Natacha Oskian** Thanks, Peter. Well, that's all very promising. So, pretty mind boggling amount of change in the industry is presumably still ahead of us as a result of the pandemic. Let's stay on the side of the Luxembourg territory for now. Patrick, what does it mean for Luxembourg as a broader financial centre and what other trends do you see coming?

**Patrick Mischo** Well, Natacha, as you can see there has been a lot of action here over the last number of years and I think the real game changer has been the fact that the alternative managers basically beefed-up the operational substance in Luxembourg. So today the sponsors have a significant presence here in terms of operations: there has also been a shift in the types of functions they are running out of Luxembourg, We would say, probably about 10 or 15 years ago, they didn't have that many people on the ground and the people they had on the ground were probably more focussed on back-office functions. I think we moved away from back-office to the mid office, such as risk management and compliance and even to the front office. So today, what we see is that sponsors have also added higher added value functions to the operations which are fully plucked into the global organisations. These people are actually based in Luxembourg. They are designing and running the investment funds but they also are structuring and executing the transactions on the acquisition side, on the finances side, and so we have a number of teams which are today based in Luxembourg, whether that is leading teams, tax teams, finance teams, but also portfolio managers, and so there has certainly been a game changer and the landscape is totally different today compared to ten years ago. Also what you see is that there has been an alignment between the operations and the structures. That's actually very much in line with what the OECD has requested under the BAPS Action Plan and we feel that's also going to make sure that the structures they run via Luxembourg are much more robust these days from a tax perspective than before. The regulatory trends I mentioned before have also triggered some of these changes because there is clearly a kind of a convergence in terms of the regulatory and tax substance requirements. These also led to different types of set-ups which sponsors maintain today in Luxembourg.

Last but not least, I would like to mention the boom of the secondaries market, The growing importance of environment and social and governance issues, the emergence of new forms of co-investment structures such as sidecars and various forms of fund financing are trends that are there to stay. In one of our next podcasts we'll dig deeper into some of these trends.

**Natacha Oskian** Great, I mean that's quite a transformational change that you speak about. Burning question, Peter, you are an English qualified Lawyer based in the Luxembourg office. Does that mean you only practise English law?

**Peter Myners** Well, I'm actually dual qualified, Natacha, so English and Luxembourg qualified, and I'm happy that I am because everything I do is, or most of the things I do, are cross-border and we are definitely seeing a shift in the applicable governing law from traditional English or New York law governed documents towards Luxembourg law governed documents. We don't have any hard statistics for that but, certainly anecdotally, as a deal lawyer, I'm seeing more and more shareholders' agreements, SPAs and also flagship fund documents being governed by Luxembourg law and there have been one or two announcements, quite public announcements, that one or two of the European institutions will start to use Luxembourg law as opposed to English law. That is not to say English law is a relic of the past – we still see lots of documents governed by English law – but the point that I am trying to make is that Luxembourg law is more and more trusted by transaction counterparties for serious transaction documents and that trust has developed and also a certain familiarity has developed around Luxembourg law. I mentioned earlier well-trodden paths; you know a shareholders' agreement looks and feels like other shareholders' agreements and Luxembourg law plays its part in that consistency. I think also the Luxembourg legal community has played its part. The law firms in Luxembourg have scaled up, generally, and added a degree of sophistication and maybe that took some time, but of course, if you have experienced an explosion of growth, as Luxembourg has, then inevitably it takes some time for service providers, not just law firms, to catch up, but we are investing heavily in A&O Luxembourg's office and our competitors are certainly not showing any signs of letting up either.

And I think I've mentioned once or twice now but if you are doing a deal into a southern European jurisdiction, then Luxembourg law and Luxembourg courts and arbitration might offer a higher degree of certainty in terms of dispute process than that southern European jurisdiction. We also see counterparties coming together and choosing Luxembourg law because of its neutrality. So imagine a Chinese investor, on the one hand, and either an English or an American counterparty, rather than taking English law or U.S. law, or indeed Chinese law, those counterparties may decide to opt for Luxembourg law because of its neutrality. So clearly this amazing bull run that we had has now stopped and I think probably what we will see is an increasing number of disputes, just statistically from the number of contracts which are governed by Luxembourg law and Luxembourg courts, and of course the big question is, how will the Luxembourg courts react to a wave of disputes coming before them?

**Natacha Oskian** Fantastic. I think you have demystified the role that Luxembourg plays or the alternative investment space. There is a lot that we could speak about; you've touched on some of the modern trends, you've looked at the legal landscape, and I think that was insightful, thank you for that. Can I ask both of you to share your final thoughts. Peter, shall we start with you?

**Peter Myners** Sure, Natacha. Well, my final thoughts are really that I think we are now in an eco-system here in Luxembourg. It's not Mayfair, it's not Manhattan, but over the course of the last ten, 20, even 30 years, funds have been front and centre of the strategy of the government and the financial sector and now there are service providers across the spectrum of service requirements. There are increasingly substantial teams of alternative investment managers and there are also quite a few investors here on the ground and we all interact with each other and that interaction is catalysed by some of the great associations that are here in Luxembourg, for example the Luxembourg Private Equity Association, ALFI, or even Luxembourg for Finance, and I think that is probably the magic ingredient: it's the interaction among the industry players and the connection to the government via these associations.

**Peter Myners** It remains a small country even if there is an enormous amount of capital flowing through it and you can be quite nimble and dynamic as a country and react and foresee developments in the alternative investment industry as they occur.

**Natacha Oskian** Thanks, Peter. Patrick, over to you.

**Patrick Mischo** Thanks, Natacha. Well, I would like to add the use of technology by the managers and their service providers. I actually think that's really going to be the key challenge for the future because it's essential to become more efficient. The Covid crisis has just accelerated this trend. I think our clients and ourselves are looking at that space and it's really exciting because we are confronted with plenty of new questions and also focussing on how to use technology to become more efficient in terms of delivery of legal services. So I think that is really something which is on top of our minds; we are working closely together with our clients in the alternative space to basically make that happen.

**Natacha Oskian** Thanks, Patrick; thanks, Peter. Well, it's exciting; you have left us much food for thought. Thank you for sharing your insights and have a good day.

**Patrick Mischo** Thank you very much, Natacha.