Luxembourg Private Equity
& Venture Capital Association

Newsletter

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Editorial

Dear Member of the LPEA, dear reader,

The second half of 2011 was marked by a number of initiatives that LPEA has actively participated in to further shape the landscape for private equity in Luxembourg. As a member of the HCPF (Haut Comité de la Place Financière) AIF Committee I can indeed report that comprehensive proposals on a number of topics are being made to the Government, including as to taxation, a limited partnership regime, a light Manager regulation framework and more.

On the AIFMD front ESMA has issued its final technical advice in November. The reception by the industry was mixed. While a number of issues raised during the consultation process have been addressed, there remain subjects that are of considerable ongoing concern as industry comments and proposals seem to have been ignored altogether or the advice has left significant room for interpretation to the Members States. However, the Commission is not bound by this advice, so market participants should continue to work with the Commission as well as national legislators and regulators to ensure that a sensible and proportionate approach is finally adopted. The Commission is expected to publish its Level 2 implementing measures in the first half of 2012.

On a positive note, in early December the European Commission presented its action plan for *SMEs*, including a proposal to introduce a *European Passport for Venture Capital Funds*. If adopted, it would make it easier for managers of venture capital funds to raise capital across the EU and thus to avoid the potentially adverse impact the AIFMD could have on these actors. From my personal perspective certainly a step in the right direction.

The analysis of the *Private Equity Survey* we have initiated over the summer is nearing its end. I would like to thank all of you who have responded to the survey, as well as the Market Intelligence Committee, under who's leadership this initiative has been implemented, for your contributions. And while the response rate left a lot to desire it was an important first step in establishing a data set on the industry's footprint in Luxembourg.
As a sneak preview here are a few learnings from the survey :

- 60 % of respondents consider Luxembourg very good or excellent for investment holding purposes ; for fund domiciliation activity the vote was 41 % excellent or very good, indicating that there is a potential for improvement;
- Assets under management are currently estimated to be north of € 100 bn and are expected to increase by 40 % over the coming three years;
- The industry employs approximately 1.800 people and the expectation is that employment will grow by 7 % annually over the coming three years.

The full results will be available in January.

The Promotion Committee has completed a major piece of work in producing the LPEA « Private Equity in Luxembourg » brochure, which is intended to give practitioners a comprehensive overview of the private equity business environment in Luxembourg. I would encourage every practitioner to use this at his discretion to further the knowledge anbout Luxembourg within their respective organizations, nationally and internationally. Please feel free to request a set of bound copies from Paul Junck (*paul.junck@lpea.lu*). The brochure will be available on our website in January 2012.

LPEA will be organizing a New Years reception at the end of January. You will be receiving an inivitation in the beginning of 2012.

With best regards and my best wishes for a festive holiday season.

Hans-Jürgen Schmitz
President of the LPEA

ESMA's final report

After more than two years of intense negotiations and lobbying efforts, the Directive was finally approved on 8 June 2011 (*Directive 2011/61/EC*), published on July 1 in the Official Journal of the European Union and entered into force 20 days later, on July 21, 2011. The Directive only represents the first level of a more complex legislative process. The Directive itself lays the ground for additional rulemaking and guidelines for its full and effective implementation. While these additional rules are (again) to be prepared by the European Commission ("EC"), the EC has reached out to the European Securities and Markets Authority ("ESMA") for assistance.

On November 16, 2011, following the consultations of July 13, 2011 *(ESMA/2011/209)* and August 23, 2011 (*ESMA/2011/270*) ESMA issued its final report (*ESMA/2011/379*), i.e., its technical advice, to the EC on possible implementing measures of the Directive on Alternative Investment Fund Managers ("AIFMD").

The EC has now less than one year to prepare and issue final implementing (i.e., Level II) measures. ESMA's intervention marks a turning point in this regulatory marathon, marked by the initial 2009 solo performance of the EC, which has eventually developed into a team effort of European financial or securities regulators assisting ESMA with the regulatory workload at last combined with an unprecedented industry consultation.

The LPEA AIFMD task force worked extensively over the summer to contribute to the consultation process, thus supporting the lobbying effort lead by EVCA.

ESMA's final advice is organized around the four initial working groups dealing with general provisions, authorization and operating conditions in Part I; with the depositaries in Part II; with transparency requirements and leverage in Part III and supervision and third country issues in Part IV.

It may initially be said that ESMA's advice deviates very little from the initial consultations issued in July and August. However, where it does, the outcome is generally in line with industry requests and those of the private equity industry in particular. A number of open issues remain, especially those issues which go back to the Directive itself and which can neither be fixed by ESMA nor, at this stage, by the European Commission (other than by reviewing the AIFMD itself). On a few ESMA did not take the various stakeholders views into account. In respect of those, the lobbying efforts must and will continue with the EC. By and large we may also confirm that the overall approach taken by ESMA has been to align the AIFMD requirements as much as possible with the existing provisions of the UCITS Directive and MiFID and to introduce proportionality where possible.

While we refer to the more detailed analysis of the ESMA advice prepared and published by EVCA, we wish to highlight a few important outcomes for the purpose of this newsletter.

The advice thus provides useful guidance in respect of the scope of the AIFMD. The determination of the value of the assets under management will have to be made by reference to the total value of assets under management. Any reference to the net asset value or to subscription commitments has been abandoned. Provided that a private equity AIF does not have recourse to leverage itself, any leverage at intermediate special purpose vehicle level would be disregarded for the leverage test, though would ultimately be taken into account for the determination of the total value of the assets under management. Consequently, private equity fund managers will in most cases be assessed against the EUR 500 million threshold. Whilst this two pronged approach seems to be shared by many readers of the advice, differing interpretations still leave room for doubt.

The outcome on initial capital and own funds, while problematic from the outset for private equity managers, has now been dealt with in a more pragmatic manner as recommended by the industry. It remains to be seen how quickly the insurance coverage providers will adjust their offering and at what cost. With respect to the alternative of keeping additional own funds (in cash) ESMA has generally adopted the industry's preferred option to base the amount of additional own funds on the value of the portfolio of AIF managed by the AIFM (i.e. 0.01% of the value of the portfolios managed by the AIFM).

ESMA's final advice also outlines the detailed conditions under which a delegation of functions by the AIFM is possible. The final advice does not substantially divert from the consultation paper, which is important news for Luxembourg based AIFM.
In particular with respect to the delegation of portfolio management and risk management functions it is clarified that such delegation is generally only possible to another, externally appointed AIFM authorized under the AIFMD, an investment firm authorized under MiFID to perform portfolio management, a credit institution authorized under *Directive 2006/48/EC* having the authorization to perform portfolio management under MiFID or management companies under the UCITS Directive. For third country asset managers, the final guidance will be a significant relief as the "equivalence" requirement is dropped for "effective" supervision instead.

In Part II, the advice on depositaries covers the following issues: appointment of the depositary, general criteria for assessing the effective prudential regulation and supervision of third countries, the depositaries duties and the depositary's liability regime.
While a detailed account of the advice goes beyond the scope of this newsletter, LPEA is actively lobbying for the option offered in the AIFMD that the depositary function also be performed by non-banking institutions where the assets under management consist mainly of non-bankable assets. This would in particular be the case for private equity portfolios. It is also noteworthy that ESMA no longer suggests that with respect to AIF's investing in illiquid assets an ex ante oversight duty may be advisable.
To the contrary the advice now clarifies that an ex ante control would probably not be possible. The advice thus sets out that a procedure be set-up to verify on an ex post basis "in most cases" the compliance of the AIF with applicable law and the AIF rules.

Part III provides detailed advice on the determination of leverage, in particular, the methodologies to be adopted for its calculation and transparency. This advice is generally in line with current regulatory requirements in Luxembourg and does not give rise to additional comments.

Lastly Part IV covers the implementing measures on co-operation agreements with third country authorities and the determination of the Member State of Reference for non-EU AIFM. This part is of particular relevance for Luxembourg as it has always positioned itself as a European gateway for managers and advisors established in third countries. This and other topics of special relevance for the Luxembourg market will be the subject matter of special publications.

While the European Commission has started its work on the final implementation measures, it remains in principle free to take the ESMA advice into account or not. It is though largely expected that the European Commission will closely follow this advice. Industry participants are thus well advised to have a closer look at the ESMA advice as early as possible.

Gilles Dusemon
Technical Committees Leader of the LPEA

What's new at LPEA?

- **Membership: strong increase**

  Our Association has now 75 members out of which 33 are Full members and 42 are Associate members.
  A year ago, we had 49 members (22 Full members and 27 Associate members).

- **LPEA Brochure: Private Equity in Luxembourg**

  This brochure aims to provide Private Equity professionals and their advisors with a comprehensive yet focused overview of the general business, legal, tax and regulatory environment that Luxembourg offers to the Private Equity industry.

- **ALFI European Alternative Investment Funds Conference, Luxembourg**

  The LPEA sponsored this international event and Hans-Jürgen Schmitz presented the main challenges and opportunities for Private Equity going forward.

- **AIFM Directive**

  The LPEA participated in the ESMA consultation on the possible implementing measures of the Alternative Investment Fund Managers Directive and is now analyzing ESMA's final report published on November 16th, 2011.

- **New European regime for Venture Capital**

  Together with ALFI, the LPEA submitted a response to the European Commission's public consultation document on a new European regime for Venture Capital.

- **Central Bank of Luxembourg (CBL)**

  The LPEA met representatives from the CBL in order to clarify the regulation 2011/8 which imposes new statistical reporting obligations from companies which contract loans or issue debt securities or derivative instruments to finance its affiliated companies.

- **Calendar**

  AGM:

7 May 2012	6 p.m.

  Board of Directors:

30 January 2012	4 p.m.
26 March 2012	4 p.m.
2 July 2012	4 p.m.
22 October 2012	4 p.m.

Events

- **EVCA Responsible Investment Summit**

Date: 31st January 2012
Location: Brussels

Smart, sustainable and inclusive capital for 2020 Europe.

More information: *www.evca.eu*

EVCA Academy: Fundraising & Investor Relations Master Class

Date: 15th – 16th February 2012.
Location: Brussels

The course programme includes topics such as fundraising process, reporting, disclosure, investor relations management issues and case studies.

More information: *www.evca.eu*

SuperReturn International 2012

Date: 27th February – 1st March 2012.
Location: Berlin

The flagship event in the SuperReturn global series of private equity and venture capital.

More information: *www.informaglobalevents.com*

EVCA Investors' Forum

Date: 14th – 15th March 2012.
Location: Geneva

The EVCA's Investors Forum is the annual meeting place for over 2000 of the world's major investors in private equity and their GP's.

More information: *www.evca.eu*

Private equity activity, a resilient business model focused on value creation

A study recently released by Ernst & Young and conducted for the sixth consecutive year in Europe provides a valuable view into the performance and methods of private equity, based on the analysis of nearly 400 of the largest European businesses private equity has exited over the last six years. The study is of particular interest in so far as we did not only built on public data but also on confidential interviews with former private equity businesses of the exited businesses. Overall, it provides new empirical evidence that private equity investment creates lasting value throughout economic cycles.

We have summarized below the key findings of the study:

2010 has seen a sharp rise of private equity exit activity in 2010 in Europe as compared to the lows of 2009 and 2008 (57 exits completed in 2010 vs just over 30 in 2008 and 2009). This pick-up in exit activity has been partially driven by the return of IPOs in the context of more positive public equity markets (a total of 11 portfolio companies exited via IPO across Europe in 2010 – the highest number since 2006) as well as by the return of secondary buyouts. Despite these good news the difficult conditions over the past three years have resulted in a further ageing of private equity portfolios, which establishes itself at 4.2 years in Europe in December 2010. With the current exit levels, it would take more than 10 years to exist the current stock of portfolio companies .

However, the private equity business model proved resilient and able to successfully weather the storm. The study provides elements to understand why.

When looking more closely at value creation drivers in private equity, EBITDA growth through operational improvement remains the most important one, rather than multiple expansion (the difference between entry and exit pricing), leverage or cost reduction. In particular, within operational improvement, organic revenue growth is proportionally the largest contributor and accounts for 46% of profit growth across the period in Europe. Perhaps more striking, the study found evidence that private equity is achieving organic revenue growth not only through investment expertise, or by choosing the right markets but also, and mainly, through the execution of fundamental changes in the way portfolio companies are operating.

In that respect, having the right management in place right from the very start appears to be critical to superior returns. Indeed, research shows that replacing management during the investment adds up to 1.6 years in Europe and even 2 years in North America to the average holding period, and reduces returns anywhere from 10-40% depending on deal and geography. Thus, failing to have the right team at the beginning of a deal can prove costly to businesses, especially during difficult economic times characterized by continued volatility in the markets. In terms of management profile, private equity houses increasingly use operating partners to work with management teams in order to achieve additional business improvement.

This also relates to the time spent by private equity firms with their portfolio companies, which increased in 2010 according to the study findings. Partly due to the recession and a slowdown in deal activity, this trend also reflects a greater focus of private equity firms on designing and delivering on profit growth strategies.

Last but not least, selling well and best practices in that respect is another topic covered by the study. The study reveals that private equity is investing more time and effort in preparing the business for sale, to ensure the best possible outcome. In particular, two key elements stand out in this year's research as best practices leading to successful selling: early engagement with management, potential new owners and advisers on the potential sale on the one hand, and preparing high quality sell-side information to describe the business and tackle any uncertainties, on the other hand.

Uncertainty and nervousness are prevailing today, with a threat of a double-dip recession and extreme volatility in the public markets. This could definitely impact the private equity market, through reduced access to financing and thereby investments. Other challenges facing private equity firms include the need to realize a large number of companies in portfolio. However, Limited Partners are not just seeking crystallized returns from the private equity firms they will back in the future. They are also increasingly looking for evidence of operational improvement in portfolio companies. And that is where the validity of the private equity business model comes back: as clearly established by the study's major findings, the private equity business model is a robust and active form of ownership that drives growth in the companies it backs through fundamental and transformative change. This will not change.

Alain Kinsch
Vice-President of the LPEA

About LPEA

LPEA is a non-profit organization serving a threefold mission:

- Towards its members, represent and promote the interests of Private Equity and Venture Capital players based in Luxembourg.
- Towards Luxembourg, support government and private initiatives to enhance the attractiveness, competitiveness and efficiency of the Luxembourg economic, legal, regulatory and operational framework as an international hub for carrying out Private Equity and Venture Capital business and/or servicing the industry in all its dimensions.
- Towards the European Venture Capital and Private Equity Association (EVCA) and other relevant international industry bodies, represent the interests of the members of the LPEA and the industry as well as Luxembourg as a place for doing Private Equity and Venture Capital business.

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