PRIVATE EQUITY
INSIGHT/OUT

Sustainable Investment "Made in Luxembourg"

GP-Led Secondaries

Fundraising with Part II Funds

Issue 24, December 2022

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Dear members, friends and partners,

Are you ready for the usual year-end sprint which might comprise some last minute due diligence processes, potential deals or mandates, the closing of the accounts, the preparation of 2023 and hopefully also some "classy" events? Once again this hectic period will lead to a peak of hyperactivity at least until Christmas before unleashing a short but important momentum filled with joy and quality time to be spent with your family, friends and beloved ones in Luxembourg or all over.

In Q4 2022 we launched a prolific campaign of international roadshows starting in London before heading to the North American continent in excellent company including the Luxembourg delegation composed of H.R.H. The Crown Prince Guillaume and H.E. The Minister of Economy Franz Fayot in NYC. We then "discovered" Canada and hosted in Toronto some local GPs before attending the "Slush" conference in Helsinki which proved that the VC and start-up industries are, despite the current uncertainty, delays and temporary gloom, steadily preparing the next big innovations and success stories, which will once again change or inspire the world we live in.

This year's "Insights" conference was also well-attended and attracted many passionate experts focusing on fundraising/IR activities who are interested in the evolution of the Luxembourg PE/VC hub and model. The democratisation of the private markets and assets is certainly another strategic topic which will raise lots of attention and gain traction over the next months.

This "Insight Out" edition contains many robust "ingredients" which could pave the way to new successes including for example the "2's" package (ELTIF 2, Part II and SFDR Level 2). ESG will be THE priority of Q1 2023 (cf. our cover story) and its proper implementation will require a high level of care and efforts (internal and external ones to be synchronised with your service providers or partners). Next to the expenses, it will require smart human capital, a serious portion of confidence in the future and a longer "breath", perspective which will fortify the "value creation" model (including also the non-financial value-add), its resilience and patient performance. Rome was not built in a day, neither our Fund industry and despite the present economic climate (lower fundraising, deal & exit volumes; higher inflation, supply chain disruptions, interest rates increases and geopolitical uncertainty), we should keep calm and carry on since we are absolutely well equipped to stand these complicated times and will be ready once we need to accelerate again. In the meantime let's focus on our portfolio companies, nurture them, "boost" them with the right actions/financing, use the adequate tools and transform them as initially planned into the champions we had foreseen.

In this context, the LPEA Board, ExCom and team wishes you some restful days, happy holidays, a good health and a successful 2023 vintage!

Stephane Pesch
CEO, LPEA

Claus Mansfeldt
Chairman, LPEA

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Rebranded PE training by HEC Liège Luxembourg with LPEA

The former Sacred Heart University PE certificate will now be managed by HEC Liege Luxembourg and will consist of a dedicated PE course and a set of industry related classes. This focused programme on the alternative asset universe targets financial sector professionals in Luxembourg, or anyone looking to start a career in PE and alternative asset classes. Practitioners will actively participate in delivering all courses sharing first-hand insight into their activity.

The course covers PE, VC, RE, Infrastructure and Private Debt, as well as their strategies, actors, and structures. Topics include fundraising, typical transactions valuation, value creation, exit strategies, tax structuring, among many other subjects

More Information:

Luxembourg VC Guide

The LPEA, together with Silicon Luxembourg have launched the Luxembourg Venture Capital Guide. The VC sector is a key player for the financing of the real economy and a major driver of the local entrepreneurial ecosystem. This publication sheds the light on Luxembourg-based VCs and helps startups navigate the ecosystem and find the most suitable investors.

More Information:

5th LPEA Academy adds AML/KYC module

Since its launch in 2020, the LPEA Academy has attracted 345 participants and involved more than 50 speakers sharing their practical knowledge of the whole value chain. We are happy to announce the fifth iteration of the Academy this coming March. A course on AML/KYC has been added to the ten other themes composing the curriculum, which combines both foundation and advanced courses.

The Academy is delivered in a digital format and therefore offering increased flexibility to participants based in Luxembourg or abroad. All sessions will take place during the lunch break and will be recorded for short term reviewing.

More Information:

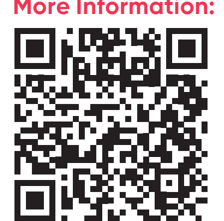
Job Fair dedicated to Private Equity

Talent attraction is one of the biggest challenges of the PE/VC sector. To answer this need, the LPEA organises its digital job fair to attract young and seasoned professionals in Luxembourg. This initiative gives them the opportunity to meet with HR specialists and PE/VC practitioners representing some of Luxembourg's biggest players in the sector.

In 2022, two editions of the job fair took place, the first in March and the second in October. In total 550 candidates took part which resulted in 340 job interviews by 24 recruiters.

The next job fair will be organised in March 2022.

More Information:



Sustainable makes more than business sense

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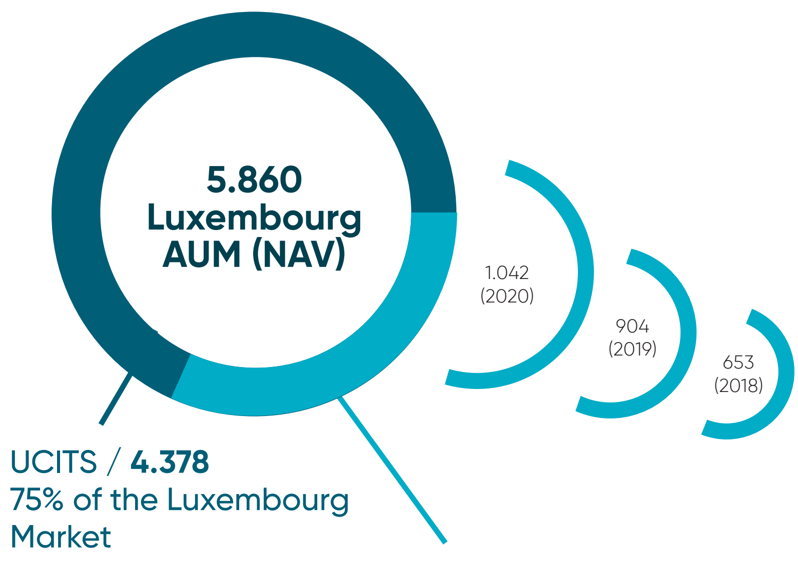
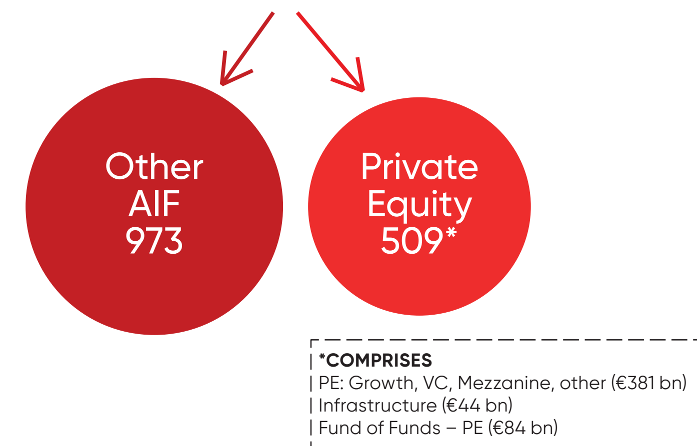
Market size of PE in Luxembourg

Figures (in bn Eur)

Source: AIFM Reporting Dashboard 2021 - Published in October 2022



AIF / **1.482** / 25% of the Luxembourg Market



KPMG Private Debt Fund Survey 2022

It's been another year of growth for the private debt market, proving itself once again as a strong asset class. With €267.8 billion in AuM now, there was an impressive 45.4% average growth of AuM this past year. Trends seen in the past continue to gain traction; the report shows that 45% of private debt funds are structured as RAIFs (up 9% compared to 2021), and that Europe continues to be the geographical investment target of choice with 43% of respondents.

Read the results:

500.000.000+ AuM For PE in Luxembourg

The CSSF published its AIFM Dashboard report in October 2022, shedding new light on the Private Equity activity in Luxembourg.

According to the latest regulator's figures, Private Equity accounts for at least EUR 509 bn of Net Asset Value (NAV) in Luxembourg. The report captures data submitted by 6.932 Luxembourg AIFMs as of 31.12.2021. Overall, AIFMs' NAV increased by 42% in 2021 with the most significant push driven by Private Equity funds that grew by 84%.

Private Equity funds represent the largest single category with EUR 381 bn and 1410 funds. When combined with Funds of Private Equity Funds and Infrastructure, the sector amounts to EUR 509 bn.

Due to reporting parameters, it is not possible to separately assess the size of Private Debt funds (see Private debt fund survey 2022 news hereunder). The report also excludes non-Luxembourg AIFMs that, due to regulatory reasons, do not report to the CSSF.

The Private Equity footprint in Luxembourg is estimated to extend beyond the above mark given that the recent Private Equity market growth is mainly driven by new (and larger) funds which have commitments that have not yet been called.

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By **Luis Galveias,**
COO, LPEA

↘ Interview of Gregory Fayolle, founder of ORAXYS

ORAXYS: Doubling Down on a Sustainable Investment "Made in Luxembourg"

The Luxembourg fund manager ORAXYS is renewing its commitments in the Luxembourg-Belgian manufacturer of tailor-made windows Wako Group at the same time that the company opens up its share capital to BGL BNP Paribas. In the coming pages all the stakeholders involved in this partnership will share their vision of this long-lasting success story. ORAXYS' founder Gregory Fayolle kick starts this interview series by introducing the firm's investment strategy and describing the reason behind this second commitment in Wako Group.

Let us start by ORAXYS, a Luxembourg anchored specialized Private Equity firm.

ORAXYS is a private equity firm specialized in Growth and Buyout with profitable European SMEs that market environment-friendly products and services. ORAXYS is based in Luxembourg, manages EUR 110M commitments from families and is active since 2008. The team of ORAXYS is made of both financial and industrial professionals to bring sector expertise and business added-value. The team is invested financially in the funds alongside the investors. The first fund is fully invested, developed and divested with an average value creation multiple of 2.3x per exit. Some companies that have been accompanied to accelerate growth include for example Leosphere (France, lidars to optimize onshore and offshore wind farms), Lasea (Belgium, laser-robots to eco-manufacture), Orege (France, equipment to treat effluents and sludge), Les Comptoirs de la Bio (France, organic supermarkets chain) or Aremis Group (Belgium, advisory to optimize space and energy in buildings). The second fund has been launched for investment in 2021 and is the one now investinging in Wako Group.

Your investment strategy is also very aligned with having a positive impact. Can you share more about it?

We invest in profitable SMEs that market products or services with a positive impact on Nature Preservation, Resource Efficiency or Health Well-Being to generate both financial and environmental performance.

We look for committed and experienced management teams, businesses with competitive advantage and sales ranging from EUR 10M to EUR 50M, positive EBIT and headquartered in Luxembourg, Belgium, Netherlands, France or Switzerland. We also evaluate if we are capable of bringing added value to accelerate growth (coaching on strategy and management, bringing international business networks, sourcing M&A opportunities). ↘

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Philippe Augustin (BGL BNP Paribas), Gregory Fayolle (ORAXYS), Raynald de Briey (Wako Group), Anne-Sophie Dufresne (BGL BNP Paribas), Patrick de Briey (Wako Group).

Regarding portfolio management, we are investing with a target of 11 companies and a range of EUR 5M to EUR 15M per company,, in one or two rounds, aiming for a 50/50 mix of Buyout & Growth, managing with proactive shareholder position (Board membership, ESG policy) and holding shares on average for a 5-year period.

What attracted you in WAKO back in 2016, and why did you decide to reinvest again now with ORAXYS Environment fund 2?
In 2016, ORAXYS Environment 1 saw an interesting family business with an energy efficiency positioning and an opportunity to structure a growth strategy. Six years later in 2022, after a competitive process and the door opened by BGL BNP Paribas, ORAXYS Environment 2 saw a great opportunity to continue building on this efficient partnership with the management and to further develop new projects linked with digitalization.

Do you think sustainable investments require longer holding periods?
SMEs need medium-term shareholders to partner with, to be able to invest, develop and strengthen organizations, and to create value. ORAXYS stays for 5 years on average in the share capital. Sustainable means that you take care of all stakeholders, including employees, clients and suppliers for example. It does not mean however that it requires systematically longer holding periods.

What do you hope WAKO will become by the end of your holding period?
Based on its expertise on premium customized windows, Wako Group has the capacity to become a recognized supplier of complementary solutions for building's energy efficiency.

What added value do you offer to WAKO?
For 6 years, Marc Van Ossel, one of ORAXYS' industrial team partners and former executive committee member of Saint-Gobain, chaired the Board of the Wako Group and brought his experience in management, industrialization and marketing in the building industry. This year, Sabine Everaet, another ORAXYS' industrial team partner and former Chief Digital and IT Officer of The Coca-Cola Company for the EMEA region, was named Chairwoman of the Board of Wako Group and is currently involved in the strategy with digitalization.

Do you see any particular advantage of investing in a local firm and in Luxembourg in particular?
ORAXYS is very proud to partner with companies based in Luxembourg. Interactions with management and other partners are facilitated with proximity. In parallel, we can bring our European and international business networks. ●

> **"ORAXYS Environment 2 saw a great opportunity to continue building on this efficient partnership with the management and to further develop new projects linked with digitalization."**
>
> Gregory Fayolle

Gregory Fayoll

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By **Johann Herz**,
Head of Events and Communication, LPEA

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Patrick and Raynald de Briey

Interview of Patrick and Raynald de Briey, Managing Directors, Wako Group

Meeting the Right Partners

The Wako Group has been working together with ORAXYS since 2016 and has recently opened its share capital to BGL BNP Paribas. Interview with brothers Raynald and Patrick de Briey, co-leading this 90-year old company.

WAKO Group is a "Be-Lux" success story. Tell us briefly about what you do and your history.
Wako was founded in 1930 and is high-end producer of aluminium and PVC windows and doors with B2B and B2C activities in Belgium and Luxembourg. Our headquarter is located in Differdange and we operate on two other locations – Redange (Luxembourg) and Suarlee (Belgium).

Our family took over the Wako group in the 90s. It was originally a business focused on window shutters and PVC windows owned by the family Wagner and Koepges (Wa-Ko). Wako brand had a good image in the Luxembourg market, so we made the choice to keep it and ensure its sustainability.

Our target has never been to become a big company. We expanded from 30 staff member in 1995 to 250, but this growth was organic and driven by client demand.

> **"We had the chance to meet a partner who assisted us with in the industrialisation of our business and helped us build a brighter future."**
>
> Raynald de Briey

The latest funding however, is a clear investment in growth. Can you share your strategy?

We are now looking to enlarge our market. Penetrating the Flemish market, for instance, remains a challenge for Luxembourg and Walloon companies and this is one of the targets of our five year business plan, which we elaborated with our partners.

Diversification is another element of our growth strategy. When we took over the company we only had the PVC know-how. To increase our offer, we rapidly decided to invest into a Belgian company specialised in Aluminium and that had a dedicated and specialised production site. Last year, we built a new plant in Belgium three times the size of the original one, and all aluminium production has been transferred to this new site. We now have these two competence centers.

Although our current production capacity is suitable to existing demand, in view of future growth we will need to make new investment for logistics and ethical reasons. We abide to circular economy principles and we want to keep our values alive.

Why did you partner up with a Private Equity firm and how did the process go?

This is now the second Private Equity partnership phase we are involved in as we have been in business with ORAXYS for a while now. The first collaboration was generated by a family reorganization. Our father - actively involved in the company – died suddenly. His shares were transferred to our other two brothers whom were not active in the business. As we did not have the financial capacity to buy out the 40% share of our brothers, we turned to Private Equity. This process would eventually solve the problem but we had to ensure an alignment of interest between the historical owners and a new Private Equity investor regarding the future of the company. ORAXYS was in synch with our way of working, thinking and values. Promoting resource efficiency and environment-friendly solutions is a very important factor in their investments and their contribution helped us to reach carbon neutrality two years ago.

Last September, BGL BNP Paribas - our privileged long term partner on the banking side - joined the table as a financial partner, without board involvement.

Does it make a difference to have your investor nearby?

The fact that all stakeholders are located in Luxembourg is an advantage, as they know the environment in which we have to develop. I do not think we would have the same discussions with an Asian or American investor.

What is the value of an investor such as ORAXYS?

Sharing views and interest with

> **"We decided to be ambitious and to embrace scope 3 of the Stockholm Convention as it also accounts for the carbon emissions of both our suppliers and clients."**
>
> Patrick de Briey

ORAXYS obviously helps. We had the chance to meet a partner who assisted us with in the industrialisation of our business and helped us build a brighter future. It has been very helpful and the benefit was mutual - the first fund of ORAXYS closed on a high note.

ORAXYS's method is different from the several competitors we met. They bring a business added value with a long-term view and are heavily involved in promoting environment-friendly solutions. Furthermore, one of their dedicated industrial experts is member of our board and challenges our strategic choices. This is very welcome as they share with us valuable insights in the activities we are working on.

Please tell us more about your carbon footprint?

I think we were one of the first SMEs taking the decision to reach carbon neutrality by the end of 2020. Of course we cannot reduce our emissions to zero. We are a company with all the entailed production and logistics.

The first carbon footprint analysis took about one year to run. We produced 15,000 tons of C02 a year. We decided to be ambitious and to embrace scope 3 of the Stockholm Convention - the most widespread standard – as it also accounts for the carbon emissions of both our suppliers and clients. We therefore organised a sort of team building with all the staff to identify the priorities and action we could put in place relatively rapidly to reduce our emissions. In three years' time we reduced our footprint by 25%. The rest is compensated through a Belgian-Luxembourgish NGO, named Graine de Vie, which has planted 45 million trees in Africa (Madagascar, Benin, Togo and Cameron). It's a very small NGO but very efficient. Graine de Vie has a EUR 600,000 budget, with a EUR 30.000 (5%) stemming from Wako's contribution. This donation compensates our carbon footprint deficit. Their objective is to reach 1 billion trees planted and to expand the projects and the management model to neighbouring countries. It is a very nice project and very close to our hearts. ●

COVER STORY

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By **Evi Gkini,**
Business Development
and Project Manager

Interview of Anne-Sophie Dufresne
Membre of the Executive Committee, Head of Banque des Entreprises, CIB and BGL BNP Paribas Development
And Philippe Augustin, Head of BGL BNP Paribas Development

The First of Many Investments in the Luxembourg Real Economy

Recently launched, BGL BNP Paribas Development invests in profitable, mature or growing SMEs and Midcap companies with a special focus on sustainability. This interview of Anne-Sophie Dufresne and Philippe Augustin showcases the mutual trust between the Wako Group and BGL BNP Paribas.

Can you briefly describe BGL BNP Paribas Development?

Anne-Sophie Dufresne (ASD): BGL BNP Paribas Development was launched in 2021 as there was a real need in the Luxembourgish SME/ Midcap market. The decision has been taken at the occasion of our 100th anniversary. It is for me a strong symbol of the commitment of BGL BNP Paribas toward the SME world and the economic development of the country in general.
Different types of companies were identified:

- companies with capital needs for investments dedicated to improving their competitive positioning.
- those with transforming large scale investment programs, either for internal or external growth, with eventually limited own means of current shareholders and
- companies facing a need of generation handover in their shareholding or having to tackle the transition between generations.

Thus, the objective of BGL BNP Paribas Development is to intervene during a period, alongside current shareholders or with new shareholders, to accompany the company in a transformation period, with growth perspectives. Our aim is to provide capital (equity or mezzanine) to Luxembourg based SMEs in order to contribute to accelerate or secure their transition and growth, with a special attention to their sustainable journey.

Philippe Augustin (PA): Indeed, the aim is to support, speed up, facilitate their growth, to strengthen their balance sheets and increase their resilience against future future crisis, headwinds. We can for example provide growth capital (organic growth, capex or acquisitions), facilitate the reorganization of the capital (exit of a minority shareholder for example), or finance LBOs alongside the existing management or a new management team.

As a partner in the long run, our relationship is based on trust and dialogue, and we focus on the long-term value creation for all the stakeholders. Furthermore, as a minority investor, we don't interfere in the daily management of the company. But thanks to our experience – both in Luxembourg and within the BNP Paribas Group – we challenge the management in a constructive way to help them in their financial and strategic decisions.

ASD: Having a private equity partner allows the companies to enter the next growth phase, to future-proof their business, to be stronger. Our ambition is to participate and support to the rise of the next Luxembourgish, regional, or even European champions.

This new activity is 100% in line with the Group's commitment to double its investments in equity by 2024. The same approach has been deployed in France since more than 30 years, in Belgium since more than 20 years and in Poland since 2014. We started in 2021 and Italy just also started in 2022.

© Nader Ghavami.

> **"Having a private equity partner allows the companies to enter the next growth phase, to future-proof their business, to be stronger."**

What is the investment strategy of BGL BNP Paribas Development?

ASD: BGL BNP Paribas Development acts as a friendly and flexible minority investor. For instance, we intend to make direct investments in non-listed Luxembourg-based SMEs/companies, active in the commercial, industrial or technological sectors, so a pretty large scope in terms of sector but always ensuring that the criteria of sustainability is well integrated in the company activity and development.

We focus on profitable, mature or growing SMEs with a minimum turnover of EUR 10M, it could be less if the profitability criteria are met. We aim for a minority interest up to 33% and our investment size lies between EUR 1-10M with a sweet spot between EUR 3-5M. Our investment horizon lies between 5-10 years. Given the fact that we invest our own equity, we can be more flexible in terms of exit or reinvestments.

PA: Sometimes it is also helpful to explain what we are not: we are no venture capitalists. Indeed, this requires deep sector expertise in specific verticals that we don't necessarily have. Though, we decided to invest in the Luxembourg based Space fund Orbital in order to contribute to the development of the Luxembourg Space sector. Furthermore, we do not invest in Real Estate or in recovery transactions.

Do you have a particular interest for ESG-driven companies?

PA: Over the years, we have built a strong internal ESG analysis expertise, both at local and Group level, to assess sustainability strategy of the client. The ESG risks and the performance of the client, the sector related topics, and the benchmark of the company with its competitors are analysed.

ASD: As a large European banking institution, our role is to drive the sustainable transition of our economy. Through the Net Zero Banking Alliance, we are committed to financing a carbon-neutral economy by 2050 and to supporting our clients in this essential transformation.

We engage in sustainability dialogue as we want to make our clients future proof and try to prepare them to the changing ESG regulations, such as the Corporate Social Responsibility Directive or the EU Taxonomy. For instance, from 2026, all SMEs with over 250 employees or EUR 40M turnover will have to measure and publish their carbon footprint.

Is there a certain level of Private Equity education to do so that your targeted firm understand its role?

PA: It depends. In the case of Wako, there was clearly no need for any kind of PE education as they already partnered with ORAXYS since 2016. But not all the companies have the same level of education. For example, we have been working on primary Leveraged Buyouts (LBOs), where the management/owners have absolutely no experience with PE players and hence we focus a little more to explain the value proposition.

ASD: Having a private equity partner has to be considered as an opportunity to rethink and challenge the strategy in a constructive way and to create value through new operational and financial KPIs, a new governance, improved operational set-ups,…

Are you a purely financial partner or do you also become involved in the management of the firm?

PA: Even if we are not involved in the management of the company, we do not see our role as a purely financial partner or equity provider. We propose to participate, if requested, in defining the strategy of the Group, to give our position regarding potential acquisitions, investments or opening new markets for example.

ASD: Through our presence, we try to provide financial and strategic advice to help implement internal and external growth plans, but always without interfering in the operational management of the companies. ●

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By **Joseph Marks,**
Senior Managing Director – Head of Secondaries, Capital Dynamics

Mauro Pfister,
Managing Director – Secondaries, Capital Dynamics

and **Yvan Chene,**
Managing Director – Secondaries, Capital Dynamics

GP-Led Secondaries: Reshaping the Landscape for Investors, Fund Managers and Portfolio Companies

Although still a young asset class, GP-led secondary transactions have become an integral and dominant part of the private equity secondaries market, with an abundance of blue chip sponsors and billion-dollar deals now commonplace. GP-led secondaries have doubled over the past few years – constituting about half of the secondary market transaction volume today versus less than one quarter of the market in 2017. The GP-led segment of the market is poised for further strong growth in a secondaries market expected to exceed USD 200 billion by 2025.

What are GP-led secondary transactions?

As the name suggests, the General Partner ("GP") initiates the deal in a GP-led transaction. The motivations for these transactions vary, but in general, GP-leds allow the manager and investors a combination of liquidity (i.e. returning cash to current Limited Partners ("LPs")) and ability to prolong the holding period.

What is driving the GP-led market?

GP-leds allow sponsors to actively manage their portfolios. Transaction rationales include (i) extending asset duration; (ii) securing additional capital and (iii) proactively generating liquidity for LPs.

Sponsors opportunistically use GP-leds to hold onto their most promising assets. Single asset continuation funds are increasingly used as an alternative to traditional exit paths (i.e. M&A, IPO) for the sponsors' best performing assets. For example, if the buy & build program of a fund's 'trophy' asset is performing above expectations but, unfortunately, that fund is out of capital, by transferring that asset to a new continuation vehicle and adding additional capital, the buy and build program can be successfully sustained.

> **"For LPs, a GP-led process may allow them to de-risk their portfolio, accelerate liquidity and accommodate an LP strategy shift, among other factors."**

For LPs, a GP-led process may allow them to de-risk their portfolio, accelerate liquidity and accommodate an LP strategy shift, among other factors. With GP-leds typically being more concentrated transactions, they allow LPs to target certain industries, assets and geographies - for example, more defensive sectors in challenging macroeconomic environments.

The benefits and risks of GP-led secondaries:

One of the most attractive factors in the GP-led market is something we call Positive Selection Bias. GPs have an intimate knowledge of their portfolio companies and (perhaps unsurprisingly) prefer to continue to manage their most promising assets. As a result, the continuation-vehicle's market opportunity set is skewed towards the most attractive assets under high-performing funds and quality managers. Capital Dynamics believes that the best GP-led opportunities are alongside brand-name sponsors (with demonstrable track records of success), in the star assets where they have a strong conviction to stay invested in, and where there is a strong rationale to provide the option of early liquidity to interested LPs.

Another important benefit of GP-leds is Limited Blind Pool Risk. GP-leds limit the blind pool risk generally associated with traditional private equity investing, and allow secondary buyers the opportunity to look through a portfolio or asset and diligence deals to a point where there are very few questions left unanswered. In addition, it is generally less risky to invest in assets with which the GP, particularly a high-quality GP, is already familiar. GPs are keenly aware of the most pressing issues and opportunities to address within management, operations and the market in which the assets operate, leading to accelerated value-creation plans. For new investors, gaining access to attractive and otherwise unavailable assets is particularly enticing.

However, GP-led secondaries are not without risk, and given the many potential conflicts of interest, should be approached carefully. Some of the more notable risks involve asset concentration and fair valuation. It's therefore important for investors to consider the merits of each transaction individually as well as within the context of their broader portfolio.

The link between ESG and GP-led secondaries

Once a relatively small part of the conversation, ESG is now driving discussions and influencing corporate agendas globally. The qualities of GP-led deals allow for ESG levers to be pulled at the due diligence phase and other stages in the transaction process. In many ways, these transactions allow for a more transparent process and much more comprehensive review of the GP's underlying assets. With a greater degree of scrutiny applied to GP-leds compared to traditional transactions, there are now many ways for both buyers and investors to identify and remedy ESG related risks.

Capital Dynamics' approach to GP-led secondaries

Capital Dynamics benefits from a focus on smaller GP-led transactions, which is an area of the market with high deal flow and very few experienced buyers with the experience to lead more complex GP-led transactions from both a structuring and underwriting perspective. The firm's strong relationships with more than 350 global mid-market managers, leveraging our primary, co-investment and credit platforms, allows us to source and capture many GP-led secondaries transactions while achieving favorable terms and structures and reducing downside risk. ●

INSIGHTS

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By **Alex Bozoglou,**
Head of Investments,
Titanbay

Uncertainty – What Does it Mean for Private Equity Investments?

If investors can take away one key lesson from the past few years, it is to always expect the unexpected. From the global financial crisis to the Covid-19 pandemic and more recently Russia's war in Ukraine, financial markets have lurched from one bout of volatility to another. That backdrop has prompted investors to rethink how to invest in a more unstable world and how to best navigate the economic challenges that instability is creating.

Take rising inflation. Many economists had suggested the rise in inflation in the wake of the pandemic would be temporary. Yet it has proved difficult to shake off as supply chain constraints and surging oil prices have kept inflationary pressures elevated. In the US, prices have accelerated at the fastest pace in 40 years, hitting a high of 9.1% in June before easing back to 8.2% in September. In the UK, the Bank of England is forecasting annual inflation will hit a peak of 11%—the highest since the early 80s—as the country grapples with a cost-of-living crisis. Eurozone inflation hit double figures in September for the first time in the currency-bloc's history.

Central banks were initially slow to react, buying into the idea that inflationary effects would be transitory. Now—led by the US Federal Reserve—monetary authorities are rapidly cranking rates higher in an attempt to tame that inflation. By early November, the Fed had raised rates six times this year, including four consecutive 75 basis point hikes. The last time the Fed increased rates by 75 basis points in one go was back in 1994. In late October, the European Central Bank doubled its benchmark interest to 1.5%—its highest level since 2009.

Tighter monetary policy is already having a negative impact on financial markets, with global equity indices suffering a sharp decline this year. US equities, for example, have fallen by around a fifth since January, dragged lower by a rout in tech stocks. Facebook parent company Meta has lost 70% of its value this year—equivalent to more than half a trillion dollars—while Google parent Alphabet has lost almost a third.

Economic growth is also decelerating at a faster pace than expected. The IMF forecasts global growth will slow to 3.2% this year from 6% in 2021.

Private markets have not been entirely immune to the wider volatility, with rising rates already impacting asset prices. Some private tech startups that previously had investors rushing to write cheques are starting to experience frostier funding conditions, resulting in significant down rounds. Buy now, pay later provider Klarna, for instance, raised $800 million in July at a valuation of $6.7 billion—down from $45.6 billion a year earlier, or a drop of 85%.

Exits are also becoming trickier to execute. Private equity-backed IPOs fell 93% in the first half of the year as public markets were effectively closed to new issuance, according to EY. Overall, exit activity had dropped 35% by the end of June[1].

Meantime, deal activity has slowed compared to last year. In the US, private equity deal value declined to $415 billion in the first half of the year, a 28% fall compared to the same period in 2021, according to Mergermarket. Even so, that still puts it on track to hit the second highest annual deal value since Mergermarket started tracking deals in 2006[2].

Private equity markets are continuing to outperform public markets as well. European private equity funds were posting an internal rate of return (IRR) of just over 15% at the end of June compared to returns of around 6% for large-cap European equity indices[3].

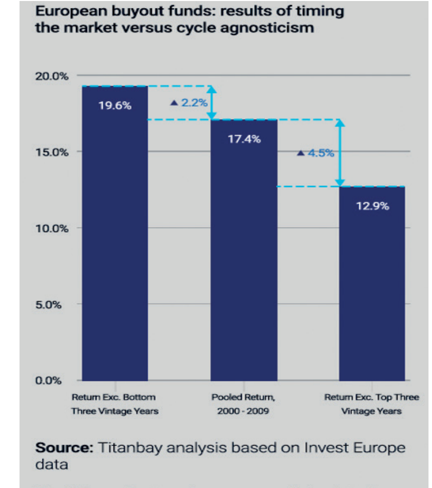
> **Private markets have also historically rebounded quickly from economic downturns, with private equity enjoying some of its best-performing vintages during recovery phases"**
>
> Alex Bozoglou

Private markets have also historically rebounded quickly from economic downturns, with private equity enjoying some of its best-performing vintages during recovery phases—notably those vintages that came immediately after the dotcom crash and the global financial crisis. Part of the reason for this outperformance is that valuations tend to be lower and competition for deals less intense after periods of market stress, leaving more runway to amp returns. Therefore while economic conditions are expected to weaken in the months ahead, private equity funds can potentially take advantage of more favourable entry points.

As PwC pointed out in its midyear private equity outlook, falling public market valuations make for attractive private equity targets. However, it added that the old playbook of cutting costs and growing through acquisitions will not be enough this time around to deliver the scale of returns private market investors have become accustomed to in the past. Instead firms will need to seek transformation opportunities through digitisation and new technology to drive growth[4].

Investors might choose to navigate the current backdrop by seeking general partners with strong track records across market cycles, given that the difference in IRR between the top and bottom quartile of funds can be hefty. They are also likely to aim to build well-diversified portfolios that combine a range of vintages, strategies and geographies.

Sitting out periods of market stress and attempting to time re-entry can be a risky tactic. Using Invest Europe data, we analysed European buyout performance between 2000 and 2009, as shown in the chart below.



Source: Titanbay analysis based on Invest Europe data

Disclaimer: Past performance, and simulated past performance, is not a reliable indicator of future performance.

Our results showed that timing the market correctly would naturally lead to better investment returns, but on average outperformance would only be around two percentage points higher than staying invested and riding out any volatility. By contrast, average returns excluding the top three vintage years—something investors would potentially miss out on if they try and call when the market has bottomed out—were almost five percentage points lower than holding through periods of market turmoil.

Despite the broader macro headwinds, the outlook for private markets remains positive. Management consultancy Bain & Company says inflation-recession cycles can be relatively short-lived[5], while the long-term fundamentals underpinning private markets are unchanged—limited partners are not looking to reduce allocations to the asset class, while funds are still sitting on wads of unspent cash. Dry powder across private capital as a whole was $3.2 trillion in August, according to Pitchbook[6]. That backdrop means that while volatility is likely to persist in the near term, private markets are potentially well placed to weather the current market storm. ●

1 https://www.ey.com/en_gl/private-equity/pulse
2 https://www.whitecase.com/insight-our-thinking/us-ma-h1-2022-private-equity-firms-battle-headwinds-h1
3 Source: Invest Europe, based on Cambridge Associates data, June 2022.
4 https://www.pwc.com/us/en/industries/financial-services/library/private-equity-deals-outlook.html
5 https://www.bain.com/insights/shifting-gears-private-equity-report-midyear-2022/
6 https://pitchbook.com/newsletter/what-dry-powder-levels-mean-for-investors-in-a-changing-market

Important disclosures:

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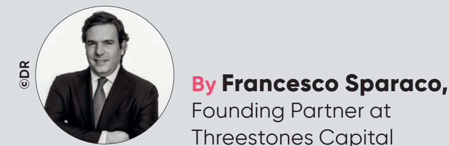
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By Francesco Sparaco,
Founding Partner at
Threestones Capital

Alternative Investment in Healthcare: Transitioning from Niche to an Established Asset Class

There are a number of factors holding back thematic alternative allocations over the past years, ranging from a re-evaluation of global priorities following the pandemic to the escalation of the war in Ukraine. These factors are also combined with a dimming economic outlook as inflation and interest rates rise present new challenges for institutional and retail investors. However, despite all the challenges the aging population and the increase in healthcare expenditure have become important demand drivers for healthcare services and healthcare real estate, including long-term residential care facilities. Thus, as European senior housing and healthcare attract more institutional capital, they are becoming less alternative and continue creating new opportunities for global investors.

Demography as an investment opportunity in Europe

According to recent research by BNP Paribas Asset Management, changes in global demographics have led European investors to healthcare opportunities that are "significantly attractive". Approximately 95% of European and Asian investors indicated that healthcare is critical to their asset allocations in Europe, the US, and Asia.

As a result, new opportunities also arise and investing in sectors that can meet these demographic challenges provide long-term opportunities. Asset managers across Europe are already seeing a shift toward thematic investing, including senior housing, as investors seek to meet specific needs and take advantage of longer-term trends as part of a diversified investment strategy.

Senior living: where the new opportunities lie

Savill's latest research report reveals that nursing homes have proven to be a countercyclical asset class that performs strongly during economic downturns. The European elderly care home market was worth €115bn in 2022, according to Healthcare Business International. The private sector accounts for 40%, or €46 billion, while the UK and Germany - the two largest private markets for nursing homes - account for the majority of this, €32 billion (70%), according to Savill's.

The nursing home sector in Europe, supported by compelling supply and demand fundamentals and an aging population, nevertheless has many nuances. In order to succeed in this industry investors need to understand all the specifics of regulation, spending and cultural approach towards senior care in each market. Although many nursing home operators and investors have increased their market share in recent years, the European nursing home markets remain highly fragmented. For example, according to Savill's, consolidation rates - the market share of the five largest operators in England, France, Spain and Germany - range from 11% to 13%. Belgium is the most consolidated market at 25%. This offers opportunities for investors and operators to expand their portfolios to other countries on the continent.

ESG in healthcare: an absolute must?

Some industry experts claim that the senior housing and healthcare sector meets all three ESG criteria. If you look closely, it is indeed true: a well-designed ESG plan is now an integral part of any investment strategy, and this trend is being driven by investors and lenders rather than regulators. Regulation may also differ depending on the country, so companies need to adapt and be proactive.

In the health sector, it is common for the social impact to come first and the sustainability aspect to be considered later, while the environmental aspect is usually achieved through the capex improvements that reduce service charges.

However, recent scandals involving elder care facility operators have shown us that it is not always possible to check all three ESG boxes even in the healthcare industry. The lack of robustness of some operators, particularly post-Covid-19, continues to be a major concern for investors and once again underscores the importance of ESG when considering new investments.

Why invest in healthcare alternatives

Alternative investment in healthcare has proven to be economically resilient compared to other sectors and offers investors more confidence in the market.

From a real estate perspective, long-term leases indexed to CPI, averaging 15-25 years with operators, as well as rent levels that reflect the economic potential of individual projects, are distinct advantages of investing in this sector. Experienced fund managers typically look for properties with redevelopment potential to hedge against the risk that leases will not be renewed and to find another use for the property, for example as residential accommodation.

The underlying growth in the care providers sector, as well as the potential for companies consolidation and transformation also provides attractive opportunities for Private Equity investors. The combination of strategic financial investors with seasoned entrepreneurs offers a distinctive value proposition to capitalize on long-term market dynamics, increasing further privatisation due to public expenditure reduction.

It is also important to ensure that the fund manager has the necessary expertise to access capital, find local over-the-counter opportunities, and structure the deals. Partnerships with operators with a strong reputation and recognized financial capabilities, and adherence to ESG and sustainability principles are important factors to look for when investing in the sector, especially in a modern environment where investors primarily work with funds that share their values and vision of this world.

> **"Asset managers are already seeing a shift toward thematic investing as investors seek to take advantage of longer-term trends as part of a diversified investment strategy."**
> Francesco Sparaco

Conclusion

Compared to other asset classes, healthcare private markets offer attractive returns, despite increasing competition among investors. In case of an upcoming recession this sector will have more defensive qualities. Seasoned investors who are looking for compelling investment opportunities and take a holistic approach are increasingly integrating healthcare investments into their investment strategy with sustainability and ESG in mind thus making the industry more and more open to all types of investors. ●

INSIGHTS

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By **Frederic Azemard,**
Partner at TR Capital

Asian Secondaries: a Large and Growing Secular Opportunity

TR Capital is a leading secondary private equity investor in the Asia Pacific region, investing in innovative companies in the technology, consumer and healthcare sectors. With a 15-year track record, the firm manages $1.2 billion in AUM. Frederic Azemard is one of the firm's three Managing Partners and is sharing his views today on the state of Asia Secondaries market.

What has been investors' appetite to investing in Asia or China nowadays?

2022 has been an interesting, albeit challenging, year for investors on the fundraising trail. In the first half of 2022 we spent some time travelling across the globe, meeting with investors and prospects who are keen to invest in the continued growth in Asia. But with so many negative headwinds in the macroeconomic landscape, we were preparing ourselves for any eventuality.

The result? We were able to raise over half of the fundraising target for our newest fund, TR Capital V, within a few weeks, attracting investors with our Secondaries strategy.

With investor sentiment from North America dampening due to acute geopolitical considerations, we found great reception from European investors. Asia PE funds which had traditionally raised capital mostly from North American investors are now doing more to attract European investors. In particular, while previously the vast majority of Asia PE funds only offered Cayman Island structures, an increasing number are now starting to offer AIFMD-compliant Luxembourg fund structures to facilitate investment by European LPs. Almost all European investors in our new fund opted to invest through the available Luxembourg structure.

The growing adoption of Luxembourg structures, which address European investors' tax and regulatory needs, should further increase European LP interest in the Asia PE market and advance Luxembourg's status as the fund domicile of choice. With fewer North America investors looking to add Asia exposure at the moment, European investors can take this opportunity to access and develop long-term relationships with some of the best Asian managers.

How big is the opportunity in Asia Private Equity as an asset class?

Over the past decade, the Private Equity market in Asia has exploded in size. From 2010 to 2020, Asia Private Equity (PE) and Venture Capital (VC) funds raised a whopping $1.6 trillion in assets under management (AUM), a figure that is 6 times larger than the amount raised the decade prior[1].

1 Source: Bain & Company, Global Private Equity Report 2022

> **"From 2010 to 2020, PE and VC funds raised a whopping $1.6 trillion in assets under management, a figure that is 6 times larger than the amount raised the decade prior."**
>
> Frederic Azemard

Asia Pacific-focused funds now account for about 30% of global PE AUM; in relative terms, the past decade has seen Asia PE AUM grow 2.4x and 3.0x faster than PE AUM in North America and Europe respectively.

How does this feed into your Secondaries strategy?

As a result of this increased flow of capital into Asia PE, companies have remained private for longer. The availability of growth capital had mitigated the need to tap the public markets for further funding, enabling companies to focus on gaining significant scale before seeking an IPO. Furthermore, the IPO market has softened significantly, forcing PE funds to consider other exit avenues.

The continued growth of the Asia PE market and the extended time horizon for companies to exit have fuelled an exit overhang, where investments have far outpaced exits and distributions. The value of unrealized assets held by Asian PE funds with vintages six years or older stood at $523 billion as of the end of 2020, more than double that in 2018. Further, in 2021, exit volumes as a percentage of investment volumes in the Asia PE market was 58%, which significantly trails the 85% recorded in the global PE market. In sum, it is not difficult to conclude that Asian PE funds are under increasing pressure to return capital to their limited partners.

The combination of a large and growing exit overhang and an increasing number of motivated sellers coming under pressure to exit unrealized assets, has naturally created an environment for the Secondaries PE market in Asia to flourish.

One further factor which favours Secondaries in Asia is that the market is underpenetrated when compared to the traditional VC, Growth and Buyout strategies. In the three years from 2019 to 2021, Asia-focused funds accounted for 15% of all amounts committed to all VC/PE funds globally, whereas only 2% of all amounts committed to Secondaries funds globally was dedicated to Asia. As such, Asia Secondaries investors face less competition than both global Secondaries investors and Asia-focused investors in VC, Growth and Buyout strategies.

Recent news out of Asia has indeed been quite negative, particularly in China. Why do you believe it is a good time to start investing in this asset class and gain exposure to the China market in particular?

Asian markets are currently at an inflection point. The public markets have corrected, and this will likely be reflected in the private markets over the next few quarters. For this reason, we are pleased to have held a strong first closing for TR Capital V, which gives us dry powder to deploy as valuations come down. We are now entering a buyers' market in Asia and there is a window of opportunity to reprice high-quality assets at attractive entry valuations in our target markets of China, India and Southeast Asia.

China has been subject of intense scrutiny over the regulatory actions it had taken in respect of the education, technology, property and gaming sectors, its "Zero-Covid" approach, and the ongoing disagreement relating to compliance of requirements relating to audit inspections and investigations of Chinese companies listed in the US capital markets. This has resulted in investor sentiment for Chinese investments being at the lowest point we have seen in the past 30 years.

That said, in the medium to longer term China remains an attractive place in which to invest given the continued growth and innovation in the economy. As it will also likely become the world's largest economy by the end

Asia Pacific-focused funds now account for about 30% of global PE AUM; in relative terms, the past decade has seen Asia PE AUM grow 2.4x and 3.0x faster than PE AUM in North America and Europe respectively. "

Frederic Azemard

of the decade, we believe China is too large for investors to ignore. The key is to focus on opportunities in industries and sectors which will propel the continued growth and efficiency of the domestic Chinese economy, such as cutting-edge technology (e.g., AI, quantum computing, etc.), advanced manufacturing and healthcare (especially biotech and novel drugs). Lastly, given China had not implemented aggressive quantitative easing over the past decade (as other economies have done), there is a reasonable probability that once the current COVID-19 wave subsides, China will embark on a series of fiscal and monetary policies designed to stimulate its domestic economy – just like it did in 2008.

We have already seen a significant increase in the pipeline of secondary investment opportunities in China. In the current environment, holders of Chinese PE assets will be under even greater pressure to seek liquidity and become strongly motivated or (in some cases) forced sellers, and there will be opportunities to acquire high quality assets on attractive terms.

How does this compare with the outlook in your other target markets – India and Southeast Asia? Are you seeing increased opportunities there as well?

In 2021, for the first time in several years, the rate of PE investment growth in India outpaced China - deal value in India increased by 47% from 2020, compared to 23% in China[2]. This influx of capital has resulted in elevated pricing in the Indian markets (both public and private), which are due for a correction. In particular, the Indian economy is still recovering from two difficult years, during which the country had to grapple with multiple lockdowns due to the COVID-19 pandemic.

That said, COVID-19 accelerated the digitization of many parts of the economy, which should create attractive investment opportunities in companies that can take advantage of this trend. We continue to view the best opportunities in the medium to long term will be in high quality innovative leaders which are at the forefront of India's digitization transition. The secondary market is the best avenue through which to invest in these companies, as exits tend to take even longer in India.

As for Southeast Asia, the ASEAN region is a diverse market underpinned by common structural growth drivers: young populations and high digital penetration rates. By 2030, 65% of the region's population of close to 600 million is projected to be middle class[3]. For us, the most attractive markets within the region are Vietnam and Singapore.

There is a rich universe of innovative companies in this region which received VC backing as start-ups six years ago and are now the leaders in their sectors. The local IPO market is small and so the exit paths for such companies in Southeast Asia are less proven. We are anticipating that as funds come under pressure to generate distributions to raise subsequent funds, attractive investment opportunities will emerge for secondary investors. ●

2 Bain Asia Pacific Private Equity Report 2022

3 https://www.uobgroup.com/asean-insights/markets/asean-growing-consumer-markets.page?path=data/ai/61&cr=segment

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By **Stephane Pesch,**
CEO, LPEA

Interview of Greg Durst, Managing Director, Corporate Development & Engagement, ILPA

The Voice of the Limited Partners

Greg Durst, shares the Institutional Limited Partners Association's mandate and the association engagement on building the private market community.

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Greg Durst

Can you introduce ILPA in a few words?

We are the sole LP-only association in private markets. We have over 600 institutional members from across the spectrum – public and private pension plans, endowments and foundations, insurance companies and banks, sovereign wealth funds, DFI's and family offices. Though our base is in North America, we have roughly 110 members in Europe – our fastest growing region.

What is on top of Institutional Limited Partners' agenda these days?

There are several subjects which span across the LP and GP industries.

- ESG – We are leading the Secretariat for the ESG Data Convergence Initiative, sparked by CalPERS and Carlyle and now representing nearly 100 participants;
- Diversity in Action – Our program with nearly 300 signatories from GPs and LPs to standardize diversity reporting and share best practices in building more representative teams in the industry;
- Regulation – Working with LPs, GPs and other industry players to help the SEC shape the next program of changes to the Private Funds Advisors rules so that we enhance alignment, transparency and good governance; and
- Convening – Since returning to in-person events in April 2022, we have now brought our community together for four major community events: our Members' Conference, our Legal Conference and two ILPA Summits (London and New York). We have a critical role to play in bringing our LP members for high quality, peer-to-peer interactions and enable our members to meet top quality GPs and service providers to achieve their programs' goals.

As you are about to open a European office, what is your strategy to address the needs of European investors?

Our goal is to build on our core activities – learning, convening and presenting the LP voice – to ensure maximum benefit for the LP community. You will see more European LP education, more engagement with policy makers, more connection with our fellow private markets associations and more events and conversations to build the private markets communities. All of the above is built on deepening our ties to our members in the region with dedicated staff, consistent outreach from our leadership and active engagement from our board, with special emphasis from our European board members. ●

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By **Caroline Pimpaud,**
Partner, DLA Piper

And **Johanna Fouriner,**
Investment Funds Lawyer,
DLA Piper

Are Carbon Funds an Answer to Carbon Reduction?

As the world faces the devasting effects of global warming, reduction of carbon dioxide and greenhouse gases is one of the most compelling challenges of the 21st century. Can the emergence of carbon funds be part of the solution?

In response to the continuous pressure on individuals and businesses to invest in more climate-conscious projects, institutional investors, corporates and individuals have developed a significant appetite to invest in projects that aim to reduce their carbon dioxide emissions or offset their carbon emissions. One of the main challenges for these investors, in their objective to meet climate-change goals, is to find the right projects managed by the right team of experts, mitigating the risk of being exposed to greenwashing. Greenwashing is the practice of gaining an unfair competitive advantage by marketing a product as environmentally friendly, when in fact basic environmental standards have not been met.

Carbon funds offer the opportunity to invest in projects that aim to reduce or remove greenhouse gases from the atmosphere and generate carbon credits. Looking at the market, these projects seem to offer a suitable opportunity for a broad range of investors, including institutional investors, corporates and individuals to offset their own carbon emissions by directly or indirectly acquiring the carbon credits generated.

There's a vast variety of offsetting carbon emission projects as each project has its own features. Available locally or internationally, offset carbon projects include supporting reforestation efforts by planting trees to absorb carbon dioxide from the air and the soil, fostering the use of renewable energy such as solar energy by setting up solar panels or energy generated from a wind farm, or cleaning polluted water to reduce the need for individuals to chemically treat or boil water. All these projects can generate carbon credits. As one carbon credit corresponds to one metric ton of removed, reduced or avoided carbon emissions or equivalent greenhouse gases, the carbon credits generated are used to compensate for the emission of one ton of carbon or equivalent greenhouse gases.

Carbon funds, like traditional investment funds, are used to pool money from several investors, leading to a multiplier effect on investment opportunities. The management of these carbon funds will be entrusted to skilled managers whose expertise is decisive when it comes to both the funds' performance and its compliance in a heavily regulated environment.

By way of example, when it comes to investments on the territory of indigenous people and local communities, a deep knowledge and understanding of local rules and regulations is crucial to ensure that those people's rights over carbon on their lands are complied with and safeguarded. In that respect, the expertise and credentials of asset managers are of tremendous value to help investors to make proper ESG-compliant investments.

As sustainability becomes a cornerstone topic in Luxembourg, the financial centre is positioning itself as a strategic and competitive jurisdiction for investors mindful of reducing their carbon footprint. This trend relies on having trustworthy asset managers with the specific professional knowledge and expertise required to manage carbon funds. ●

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By **Shanu Sherwani,**
CIO AM Investment Management
and Partner at Antwort Capital

Listed Private Equity is an Attractive Option for Private Investors Wanting Exposure to Private Equity.

For a simple reason, Private Equity has attracted trillions of dollars. Over the past two decades, it has provided investors with greater returns by capitalizing on opportunities to capture rapid growth and improve the efficiency of existing enterprises.

According to Morgan Stanley, private markets will reach approximately $12.5 trillion in 2025, up from approximately $7.2 trillion in 2020. The investment bank estimates that buyouts, growth equity, and venture capital account for approximately 69% of the sector. Private-equity firms, whose funds have long been a backbone of pensions and other institutions, are hurrying to create new products that would appeal to wealthy individuals and market them to the financial advisers who manage their money.

The number of publicly traded corporations in the United States is significantly lower than it was in the late 1990s. Executives in the industry and market historians anticipate a further decline, as even multibillion-dollar businesses delay coming public due to easy access to private capital. And Private Equity firms will continue to search public markets for buyout candidates.

There is a correlation between the decline of public businesses and the expansion of private market activity. This year, stocks have been hammered by spiralling inflation, rising interest rates, and worries of a recession, closing the door on the majority of new public offerings. Even if market conditions improve in the years to come, many private companies may delay their IPO for lengthy durations.

Nonetheless, many private investors have found it difficult to seize these chances. The majority of Private Equity funds can have significant entry barriers. They may require multi-year financial commitments, substantial minimum contributions, and fees that are considerably greater than those of public equity funds.

Private Equity is attractive to many private investors because it allows them to invest in small-cap firms with large-cap potential that have been gradually disappearing from the public market.

In addition, Private Equity firms that effectively provide favorable returns for their investors are likely to attract capital, expand, and achieve desirable market valuations.

Traditional clients of investment firms, such pension plans and sovereign wealth funds, continue to allocate a substantial amount of their assets to private markets. However, many have reached their limit. The risk of a recession has driven the top Private Equity firms, which are now publicly traded, to search for a new growth frontier. Individual investors, who had limited access to Private Equity and loans in the past, qualify.

Listed Private Equity presents a viable option. By investing in the individual stocks of publicly traded firms that specialize in private equity, investors can acquire exposure to this asset class while avoiding a number of its common downsides.

A number of studies have demonstrated that Private Equity outperforms the market. According to research provided by Cliffwater in March 2021, Private Equity allocations by U.S. state pensions achieved a premium of 3.8% above public equity investments over the 20-year period ending on June 30, 2020.

Researchers attribute this alpha production to the illiquidity of the asset class, the talent and experience of the funds' managers, and the ability of Private Equity firms to invest in promising companies, particularly early-stage growth companies that have not yet gone public.

Listed Private Equity has traditionally outperformed the MSCI World index over the past three, five, ten, and fifteen years, as measured by the Global Listed Private Equity Index, which holds shares in the leading global Private Equity firms.

Adding listed Private Equity to a portfolio can increase absolute returns and may be a better choice than adding equity exposure in a diversified portfolio.

FlexShares, a publicly traded Private Equity UCITS ETF, examined three hypothetical portfolios with three distinct stock-bond ratios over a 20-year period to illustrate this. They substituted a portion of the equity component with unlisted Private Equity. They contrasted it to an option that seeks to boost returns by increasing the portfolio's exposure to equities. According to the Sharpe ratio, relative and risk-adjusted returns were greater in all three scenarios than in portfolios with greater equity exposure.

By investing in listed Private Equity or Private Equity portfolios through feeder funds, an investor can generate alpha.

> **"By investing in listed Private Equity or Private Equity portfolios through feeder funds, an investor can generate alpha."**
>
> Shanu Sherwani

HYPOTHETICAL BACKTESTED RETURNS OVER 20 YEARS

Conservative portfolio	Portfolio 1 (75 bonds/ 25 Equity)	Portfolio 2 (70 bonds/ 30 Equity)	Portfolio 3 (75 bonds/20 Equity/ 5 Listed PE)
Annualised Return	4.0%	4.2%	4.4%
Annualised Risk	7.2%	7.7%	7.6%
Sharpe Ratio	0.5	0.5	0.6
Balanced portfolio	**Portfolio 1 (50 bonds/ 50 Equity)**	**Portfolio 2 (40 bonds/ 60 Equity)**	**Portfolio 3 (50 bonds/40 Equity/ 10 Listed PE)**
Annualised Return	4.9%	5.2%	5.6%
Annualised Risk	9.9%	11.3%	10.8%
Sharpe Ratio	0.5	0.5	0.6
Risk seeking portfolio	**Portfolio 1 (25 bonds/ 75 Equity)**	**Portfolio 2 (10 bonds/ 90 Equity)**	**Portfolio 3 (25 bonds/60 Equity/ 15 Listed PE)**
Annualised Return	5.7%	6.0%	6.6%
Annualised Risk	13.3%	15.5%	14.7%
Sharpe Ratio	0.4	0.5	0.5

Source: Northern Trust, Foxberry, Bloomberg. December 2002 - June 2022. Backtest used for Global Listed Private Equity Index. Past performance is not indicative of future results. Returns reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index.

And, if they invest through a fund or ETF that holds a portfolio of Private Equity firms, customers will have access to this possibility via a vehicle that provides:

- Greater liquidity and transparency compared to conventional private equity. In lieu of locking up capital for years, the investor holds a security that is exchanged and evaluated on a daily basis.
- More diversity. By providing exposure to a diversified range of the industry's top players, a fund or ETF that incorporates a group of listed Private Equity managers can avoid the potential "picking the winners" issue.

While no one can predict how the economy and markets will perform in the following years, most forecasts predict that economic growth will stop and stock and bond returns will be muted. In such a situation, a class of assets with the ability to generate alpha, such as private equity, could be particularly attractive.

Historically, Private Equity firms have been able to capitalize on periods of slow growth to identify investment opportunities in companies that have fallen out of favor. Listed Private Equity is a long-term investment, but there are grounds to assume that it is well-suited to the current market. ●

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Rising Interest Rates and Potential Implications for the Private Equity Sector

The favorable financial, economic and political environment of the 2010s brought significant benefits for fund management companies, allowing them to grow exceptionally well. History does not repeat itself and the 2020s began with the COVID-19 crisis, resulting in the global economy stagnating for several months and the return of public interventionism.

The year 2022 has been a decisive turning point for financial players, especially fund managers. Energy and commodity crises and galloping inflation saw the Federal Reserve System and the European Central Bank adapting their monetary policies and increase the interest rates. In a future of technological revolution and climate change, the intervention and support of alternative investment funds in the local and global economy are more important than ever.

In this context, the rising of interest rates could create several short-term commercial and structural issues for fund managers, particularly for private equity (PE) players. In the medium-to-long term, combined with other economic and cyclical factors, the high interest rates could impact their financial model and catalyze specialization and diversification trends.

One of the main concern of the interest rate hike is the investors' continued appetite for Internal Rate of Return (IRR). In a context of low to even negative interest rates, the investor would logically decide to allocate their funding strategy to capital investment, with asset prices and multiples continuing to favor the leveraged deals. Therefore, for over a decade until 2021, a prudent investor would have had a substantial IRR when investing in pure PE[1] funds for a limited risk over the investment period. Conversely, with higher interest rates creating a difficult economic environment for underlying companies, the cautious investor could prefer to allocate its funding to other asset classes, such as debt funds, which are less risky.

The second consideration is the rising cost of the external financing for acquisitions and the structural impact on investments. This rise should imply an increase of the invested equity and a decrease in the internal return due to the deleveraging scenario of the investment. As a nuance to the lack of external financing, we note that the fund managers can still rely on the dry powder reserves, to temporarily offset hard and soft equity increases.

The inflation and the interest rise also impact the portfolio company's ability to service external debt. In a growing economy with no inflation, a company with strong operating and financial margins can cope with the cost of its debt increasing. However, today's global economy is marked by double-digit inflation, driven by supply chain disruptions and rising costs of both raw materials and the energy. In this environment, the businesses are already under severe margin pressure and could struggle to tackle higher financing costs. Despite central banks' interventions, investors, particularly in the UK and Europe, still believe that inflation will remain above 3%.[2]This will undoubtedly lead to a slowdown in businesses.

Subsequently, the fund managers are to deal with the probable contraction of the underlying valuations of their portfolio investments. Whatever the methods used, the financial performance of operating groups would likely deteriorate, depending on their sector of activity and their exposition to the inflation bias. As low or even negative interest rates have mechanically boosted asset values, conversely, a rise in interest rates and the value of money will trigger valuation adjustments, as recent corrections in the equity markets have shown.

On that basis, to achieve similar performance targets than in the past, it is likely that fund managers may have to hold their investments longer in the coming decade. We also note that the exits through Initial Public Offering (IPO) in the US have significantly slow down due to the market conditions.[3]

From a fund raising perspective, the latest figures for 2021 show record fundraising in Europe[4], the UK[5] and the US [6]in terms of the number of deals completed (both mega and non-mega funds).[7] However, early 2022 figures for these regions indicate a significant slowdown in the number of rounds and fundraising[8] deals, both in volume and amount.[9]

Undoubtedly, the year 2022 marks a transition to a new economic period. It is thus expected that the change in the economic and financial paradigm, coupled with ongoing technological and environmental revolutions, will accelerate and accentuate the PE industry's specialization and diversification. More than ever, increased investment selectivity, the sectorization and diversification of investments, value creation, and underlying assets' increased operational capacity is set to dominate the PE business from 2023. ●

> " It is expected that the change in the economic and financial paradigm, coupled with ongoing technological and environmental revolutions, will accelerate and accentuate the PE industry's specialization and diversification. "

1 Pitchbook, Q3 2022 Quantitative perspectives, US Market Insights, September 26, 2022, page 4.

2 Tobias Adrian, Interest Rate Increases, Volatile Markets Signal Rising Financial Stability Risks, International Monetary Fund, October 11, 2022.

3 Pitchbook, Q3 2022 Quantitative perspectives: US Market Insights, page 40.

4 Preqin, Preqin 2022: Alternatives in Europe, figure 1.8.

5 Preqin, Preqin 2022: Alternatives in Europe, figures 6.1 and 6.2.

6 Pitchbook, Q3 2022 Quantitative perspectives: US Market Insights, page 33.

7 Pitchbook, Q3 2022 Quantitative perspectives: US Market Insights, page 27; Preqin, Preqin 2022: Alternatives in Europe, figure 1.5.

8 Pitchbook, Q3 2022 Quantitative perspectives: US Market Insights, page 28; Preqin, Preqin 2022: Alternatives in Europe, figure 1.8.

9 Preqin, Preqin 2022: Alternatives in Europe, figures 1.5 and 6.1.

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By **Johannes Höring,**
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Family Offices and AIFMD II: The View from Luxembourg

Family offices restructuring alternative investments will have to rethink their strategies as tighter AIFMD II regulations loom. Johannes Höring, Head of AIFM, Intertrust Group, provides the view from Luxembourg.

Complying with the EU's Alternative Investment Fund Managers Directive (AIFMD) has never been a big concern for many family offices. But a new generation seeking to restructure their investments may find itself increasingly affected. Some family offices, driven by a need to create reporting efficiencies and optimise tax, are looking to restructure their alternative investments. The search for better returns in difficult market conditions has led many family offices to incorporate investment funds into their core strategy.

Meanwhile, rising compliance costs and requirements arising from new legislation will require family offices to reassess their investment models and strategies. Many family offices have been creating standalone funds, reserved alternative funds and even regulated strategies such as the Luxembourg Specialised Investment Funds. This means they must decide whether it makes sense to create their own supervised funds management company (ManCo) or authorised alternative investment fund manager (AIFM).

But creating a ManCo or an AIFM from scratch requires deep pockets: firms have to invest in operational and compliance infrastructure, apply for regulatory approval and manage the corresponding risks and liabilities. It also requires more resources than most family offices have, while taking a significant amount of time. European and US-based family offices may fall under AIFMD in certain circumstances. As a result, they will need to carefully design the structure of investments and co-investments in Europe to manage overall exposure. So when a non-EU family office co-invests with European investors, for example, the vehicle will fall under AIFMD regulation.

How will the proposed changes to AIFMD regulations affect family offices?

Proposed changes to the current AIFMD regulations – AIFMD II – could mean even tighter checks and requirements for fund managers when they take effect in 2024. Among key proposals in the updated directive are new rules for fund management delegation. Current regulations allow self-managed investment vehicles or their management companies to appoint third-party investment managers and advisers. The Luxembourg fund industry is largely based on this model.

Under the new proposals, the European Securities and Markets Authority (ESMA) must be notified if the alternative fund delegates more to non-EU countries than to itself. There are also rule changes for loan origination funds, which are increasingly popular with investors. While the AIFMD II proposals broaden fund managers' remits by adding originating loans to their list of activities, they also introduce further restrictions. For example, AIFs cannot provide loans exceeding 20% of the fund's capital to a single borrower that is a financial institution or collective investment undertaking. It also prevents funds from lending to their fund manager or their staff, their depositary or an entity to which the fund manager has delegated functions. There is also a new requirement for alternative funds to retain 5% of the notional value of loans they originate and subsequently sell on the secondary market. However this may change, according to the Council of the European Union's recent response to the proposals.

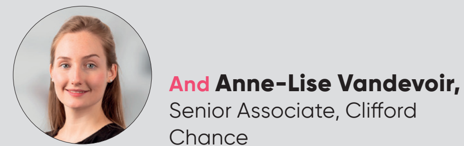
> **When a non-EU family office co-invests with European investors, for example, the vehicle will fall under AIFMD regulation.**
>
> Johannes Höring

What does AIFMD II mean for Luxembourg?

The proposals will be crucial for Luxembourg's growing private debt market. As AIFMs are required to analyse fully, understand, interpret, implement and remain in compliance with the revised regulatory and compliance directives, the impact on internal resources, which may already be stretched, could be significant. While AIFMD II may create additional reporting requirements for businesses, it can also be an opportunity for the Luxembourg fund industry, requiring more people and an even stronger financial services infrastructure.

The Undertakings for the Collective Investment in Transferable Securities (UCITS) directive proved a huge success, while the AIFMD allowed Luxembourg to market its funds across the EU. AIFMD II could have a similar impact. The drive to create a degree of harmonisation between the UCITS directive and the AIFMD could result in an EU product that can be marketed easily to other places.

As the largest funds industry in Europe, Luxembourg offers family offices a variety of regulated and unregulated vehicles – such as the Société en Commandite Simple (SCS), Société en Commandite Spéciale (SCSp) and Reserved Alternative Investment Fund (RAIF) – all of which can be easily marketed across the EU. In addition to offering a robust regulatory regime, Luxembourg stands out when it comes to sustainability, ranking seventh in the 2022 edition of the Global Green Financial Index. ●



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ELTIF II – What is on the Horizon?

Keen interest is currently given by the Luxembourg fund industry to the "ELTIF" reform, standing for the "European long-term investment fund": A European fund regime introduced in 2015 by the "ELTIF Regulation"[1] and which is currently being reviewed. The "ELTIF" is an EU Label granted to alternative investment funds, targeting EU long-term investments into EU businesses and infrastructure by pooling capital from both private and institutional investors.

The ELTIF register[2], a central public register identifying each ELTIF authorised under the ELTIF Regulation, currently counts 86 ELTIFs (of which 50 are domiciled in the Grand Duchy of Luxembourg[3]). In 2021, ELTIFs only reached approximately EUR 2,4bn of net assets under management.

1 Regulation (EU) 2015/760 as regards the scope of eligible assets and investments, the portfolio composition and diversification requirements, the borrowing of cash and other fund rules and as regards requirements pertaining to the authorisation, investment policies and operating conditions of European long-term investment funds.
2 Monitored and kept up to date by the European Securities and Markets Authority (ESMA) and last updated on 3 October 2022 (https://www.esma.europa.eu/document/register-authorised-european-long-term-investment-funds-eltifs).
3 As at 3 October 2022, 13 ELTIFs were identified for Italy, 21 ELTIFs for France and 2 for Spain.

Today, more than ever, promoting and facilitating long-term finance in the Union is key. Faced with the low enthusiasm around ELTIF I, a full revamp of the ELTIF legal framework is currently in motion.

Luxembourg being already at the forefront of this market (albeit the market is small at the moment), it is with high interest that the Luxembourg fund industry monitors developments in this space.

"Retailisation"

In light of the variety of fund vehicles already included in the Luxembourg toolbox, some of which are bound by considerably less stringent rules than those applicable to the ELTIF, the upside of the ELTIF for institutionals is of questionable value. The ELTIF, however, fits perfectly into the "retailisation" trend the Luxembourg fund industry has been witnessing these past two years. Unlike a normal alternative investment fund, the ELTIF has an EU label and EU cross-border passporting regime for retail investors.

In general, the ELTIF review aims to increase attractiveness for retail investors by removing the EUR 10 000 initial minimum entry ticket, as well as the 10% limitation on aggregate investment, establishing the ELTIF as the true alternative retail investment fund product of choice.

As mentioned before, the current ELTIF framework contains relatively stringent requirements, applicable to both retail and professional investors, which are not necessarily warranted for professional investors requiring less protection. As a remedy, the ELTIF reform will introduce more flexible rules that are adaptable to the relevant investor type. ELTIFs distributed to professional investors will be able to disregard the risk diversification requirements and use leverage up to a threshold of 100% of the ELTIF's capital (instead of the 30% threshold currently in place). On the other hand, additional safeguards for retail investors exist by requiring ELTIF managers to perform a suitability test and to issue written alerts in cases of excessive risk-taking.

Global Portfolio

ELTIF-eligible investments must represent long-term investments in the real economy and contribute to the financing of a sustainable growth of the Union's economy. Although the eligibility of assets of the ELTIF does not depend on whether these assets are "green" or not, the ELTIF state of

> **“The main reasons for choosing the ELTIF, instead of a classical Luxembourg fund, remain the EU marketing passport to retail investors, as well as the "ELTIF label" that may be useful from a distribution perspective.”**

mind is largely aligned with the current "ESG" trend in the fund industry, notably motivated by SFDR[4] and the Taxonomy Regulation[5].

On the subject of eligibility of assets, the intention of the ELTIF II proposal is to increase diversification of the ELTIF investment portfolio, both geographically and in terms of investment type. In terms of "real assets", into which a direct investment by the ELTIF is intended to be permitted, the current ELTIF framework requires individual real assets to be valued at EUR 10 000 000, at least. Under the revised framework, this amount will be reduced to EUR 1 000 000.

A second eligible asset of the ELTIF is the "qualifying portfolio undertaking". The ELTIF Regulation requires that investments in equity or quasi-equity instruments of the qualifying portfolio undertaking can only take place where those undertakings are majority-owned subsidiaries of the ELTIF, substantially limiting the scope of the potential scope of eligible asset-base. Under the reform, ELTIFs will have the possibility to conduct minority co-investment in investment opportunities, enabling ELTIFs to obtain additional flexibility in implementing their investment strategies, attracting more promoters of investment projects and increasing the range of possible eligible target assets, all of which is essential for the implementation of indirect investment strategies.

4 Regulation (EU) 2019/2088 of the European Parliament and of the Council.
5 Regulation (EU) 2020/852 of the European Parliament and of the Council.

Finally, the ELTIF II provides for a widened geographical scope of infrastructure projects into which the ELTIF may make long-term investments. The "real assets" eligible for ELTIFs were previously bound to projects contributing to the EU objective of smart, sustainable and inclusive growth. The proposal intends to amend the "real asset" definition by extending it to any asset that has an intrinsic value due to its substance and properties, regardless of whether such property is located within or outside the Union. The current ELTIF II proposal goes even further, by specifically allowing a majority of an ELTIF's assets, or the main revenue or profit generation of such assets, to be located in a third country.

Closed-ended in nature

The ELTIF eligible assets are highly illiquid in nature, and therefore not necessarily compatible with the intention of the ELTIF reform to make the ELTIF open-ended, as preferred by retail investors. The reform will provide for additional flexibility in terms of redemptions, including safeguards to be put in place in this regard by the ELTIF manager, but it is yet to be seen whether the highly illiquid and long-term nature of eligible investments is truly compatible with having an open-ended fund.

Fund-of-funds strategies

Going forward, ELTIFs would also be widely permitted to be structured as fund-of-funds, enabling a rapid exposure to illiquid assets, such as Private Equity. Today, eligible target funds for ELTIFs are limited to EuVECAs[6] and EuSEFs[7] only. The proposal intends to broaden the scope of eligible collective investment undertakings to UCITS[8] and EU AIFs[9] managed by EU AIFMs[10]. Despite these fund-of-funds strategies being limited to the EU, this was a long-awaited change by the industry.

To conclude, the review of the ELTIF Regulation will definitely increase the attractiveness of the ELTIF. Luxembourg, as the clear market leader in ELTIFs, will profit from the new regime. However, the main reasons for choosing the ELTIF, instead of a classical Luxembourg fund, remain the EU marketing passport to retail investors, as well as the "ELTIF label" that may be useful from a distribution perspective. The additional general flexibility of the operating rules is, of course, highly welcomed as well. ●

6 European venture capital funds (EuVECAs).
7 European social entrepreneurship funds (EuSEFs).
8 Undertakings for collective investment in transferable securities (UCITS).
9 EU alternative investment funds (EU AIFs).
10 EU alternative investment fund managers (EU AIFMs).

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Retailisation of Private Assets: The Luxembourg Part II Fund

Both the US Securities and Exchange Commission[1] and the European Commission have in recent years explored ways to facilitate access by retail investors to private assets. Higher returns and lower volatility compared to public markets are among the main arguments for private investors to seek alternatives to the traditional stock market and to mutual investment funds. Financial advisers are also keen on diversifying their clients' portfolio allocations.

Success in the United States

Large US sponsors have been able to tap into this market by launching open-ended, NAV subscription-based funds alongside their traditional closed-ended, commitment-based funds designed for professional investors. These open-ended funds usually offer redemption rights of up to 2% per month or 5% per quarter. In the US, they are mainly structured as real estate investment trusts (REITs) or business development companies (BDCs) for private debt.

The current trend in Europe

The same US sponsors now seek to replicate these structures through European vehicles, designed to be sold through private wealth channels to non-US investors. Considering its cross-border fund distribution expertise, Luxembourg was well positioned to host these initiatives. More surprisingly, the vehicle of choice has been determined to be an old type of vehicle, supervised by the CSSF.

Why Part II Funds?

Undertakings for collective investment subject to Part II of the UCI Law[2] ("Part II Funds") are subject to a robust regulatory framework but offer sufficient flexibility to replicate the main characteristics of their US equivalents.
Part II Funds mirroring US structures have already been approved for real estate, private debt and private equity, with infrastructure soon to be approved as well.
A key advantage of Part II Funds is that they are available to all types of investors. Considering the illiquidity of the underlying asset classes, the CSSF however requires a minimum investment of around EUR 25.000 to warrant a certain level of sophistication from retail investors. This remains a clear advantage over other types of vehicles and in particular reserved alternative investment funds ("RAIFs") or specialised investment funds ("SIFs"), which are only available to well-informed investors (i.e. minimum EUR 125.000 investment for non-professional investors).

Part II Funds, being AIFs and falling under AIFMD, benefit from the European passport for distribution to professional investors. They may however be marketed to retail investors in Luxembourg and, subject to certain local restrictions, to retail or semi-retail investors in most European jurisdictions, either directly or through a local supervised feeder fund. Marketing to retail investors outside the European Union is also possible under local private placement regimes.

Sale through intermediaries

The issue of securities based on the Part II Fund's net asset value, without any need for subscription commitments, enables intermediaries to aggregate orders and act as nominees. It facilitates the distribution of the fund by banking institutions offering it to their private clients on an international basis.

1 Expanding Retail Access to Private Markets, Small Business Capital Formation Advisory Committee, https://www.sec.gov/spotlight/sbcfac/expanding-retail-access-to-private-markets-finley.pdf

2 Luxembourg law of 17 December 2010 relating to undertakings for collective investment

> **"Considering the illiquid nature of the underlying assets, particular attention should be brought to ensuring that the portfolio composition enables the fund to deliver the required liquidity to meet shareholders' redemption rights."**

Structuring

Part II Funds can be set up under a contractual form (fonds commun de placement) and a corporate form (currently only the société anomyme). Each Part II Fund may also be set up as an umbrella structure i.e. with one or multiple subfunds. The master/feeder regime set out in the AIFMD is also available to Part II Funds investing at least 85% of their assets in units or shares of another AIF.[3]

Certain considerations when marketing to retail investors

While the ESMA Performance Fee Guidelines do not apply to open-ended venture capital or private equity AIFs marketed to retail investors, certain Part II Funds which are marketed to retail investors may fall under the requirements of the ESMA Guidelines on Performance Fees[4].

Liquidity

Considering the illiquid nature of the underlying assets, particular attention should be brought to ensuring that the portfolio composition enables the fund to deliver the required liquidity to meet shareholders' redemption rights. The warehousing of certain assets in order for the fund to quickly have an adequate portfolio seems to make a difference.

Alternative to Part II Funds

The European Long Term Investment Fund ("ELTIF") offers a better marketing passport than the AIFMD one, as it gives access to retail investors across Europe. The ELTIF being in essence a label and a regulation which applies on top of existing rules, it is possible to structure an ELTIF as a Part II Fund but other fund regimes are possible, in particular RAIFs and SIFs.

ELTIFs face a number of constraints. At least 70% of their assets need to be invested in eligible assets (i.e. equity and quasi-equity, debt instruments, loans and real assets with at least 10 million euros asset size). This is currently more stringent than the Part II Fund limits (i.e. 20% diversification requirement, subject to derogations). Borrowing for ELTIFs is limited to 30% of net assets whereas existing Part II Funds may borrow in excess of 60% in certain circumstances. ELTIFs are not allowed to invest in derivative instruments for investment purposes and they are currently not permitted to invest in other undertakings for collective investment, except in other ELTIFs, EuVECAs or EuSEFs.

Additional flexibility will be brought in the course of next year through a revised ELTIF regime, adopting the same 20% diversification rule as for Part II Funds and lowering the current requirement of 60% to be invested in real assets. The revised definition of real assets[5] will include asset such as infrastructure, intellectual property, real assets and attached rights (i.e water rights, minerals, etc) and provide for a decreased reduced asset size of EUR 1 million. ELTIFs may in the future take advantage of the master-feeder and funds of funds regimes.

The ELTIF however largely remains a closed-ended fund although the new regime proposes to open ELTIFs to the secondary market by offering redemptions to investors against subscriptions from new or existing investors[6].

The European Commission also proposes to remove "unjustified barriers preventing retail investors from having access to ELTIFs"[7] by no longer requiring a EUR 10.000 entry ticket and removing the maximum 10% exposure limit.

European asset managers, not using US vehicles as precedents, seem more open to tailoring a product to the ELTIF regulation and certain US sponsors are starting to follow that path as well.
The momentum however seems on the side of the Part II Funds, considering the weight of US managers. ●

3 Article 1 (42) and (43) of the Luxembourg Law of 12 July 2013 on alternative asset fund managers (the "AIFM Law")

4 The Guidelines apply to UCITS management companies and to AIFMs of AIFs allowed by Member States to market their units to retail investors in their territory in accordance with Article 43 of the AIFM Directive, except for closed-ended AIFs and open-ended AIFs that are EuVECAs1 (or other types of venture capital AIFs), EuSEFs2 , private equity AIFs or real estate AIFs Guidelines On performance fees in UCITS and certain types of AIFs, 05/11/2020 | ESMA34-39-992 EN

5 any assets that have intrinsic value due to their substance and properties

6 Michel Storck, Isabelle Riassetto, Fonds européens d'investissement à long terms, Revue de droit bancaire et financier, N°1, janvier-février 2022, page 48

7 Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2015/760 as regards the scope of eligible assets and investments, the portfolio composition and diversification requirements, the borrowing of cash and other fund rules and as regards requirements pertaining to the authorisation, investment policies and operating conditions of European long-term, COM(2021) 722 final 2021/0377 (COD) investment funds

INSIGHTS

By the KPMG,
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SFDR Level II – A Game Changer for Private Equity Managers?

The SFDR1 is a transparency exercise which requires standardised disclosures on sustainability topics at product and at entity levels2. The level I of SFDR already entered into force as of 10th March, 2021, and the level II, supplemented by Regulatory Technical Standards (RTS) will be applicable as of 1st January, 2023. Market participants have been requested by the local regulator to provide the RTS already by 31st October, 2022, to allow the regulator to comment, review and ensure the approval by the 1st January 2023.

Where managers of traditional financial products found a certain alignment around SFDR with upcoming filings and reporting, alternative products managers such as Private Equity (PE) and Real Estate (RE), are still struggling to update the investment strategy as to include ESG characteristics, monitoring and reporting, which will impact their distribution capacity as well as their brand image. The lack of clear definitions by the regulationsncoupled with poor ESG data quality, have led alternative managers to a cautious approach towards the SFDR, in order to avoid over-commitments with the risk of product reclassification in the coming months.

1 Sustainable Finance Disclosure Regulation, EU 2019/2088

2 The RTS specifies the details and content and presentation of the information in precontractual documents and periodic reports (specific templates for SFDR Article 8 products and specific templates for SFDR Article 9 products); product level website disclosures (no templates are provided by the RTS, however the requirements are laid out for SFDR Art 8 products and SFDR Art 9 products). The publication of the Principal Adverse Impacts Statement (PASI) requires disclosures that does not distinguish on how a product is classified. However as it regards the quantitative reporting on Principal Adverse Impacts (PAI) KPIs- KPIs will differ depending on the asset class.

1. Pre-transaction:

1.1 Investment Strategy

The PE and RE industries are both similarly poised to make a significant impact, as funds are traditionally more involved in the decision making process of their investee companies and are strategically positioned to advance the transition towards ESG integration. The RE sector is responsible for nearly 40% of greenhouse gas emissions[3], which makes it clear that it has a pivotal role in supporting the decarbonisation of the global economy and meeting the ambitions of the EU Green Deal. As a result, most of the RE Asset Managers classifying their products as article 8 or 9 have a Net-Zero strategy coupled with the integration of social aspects in the investment strategy (e.g. social housing). PE firms with a sustainable investment strategy use binding sustainability criteria to select their investments, and are able to deploy capital across the whole industry spectrum to achieve multiple environmental and social targets through portfolio companies. However, questions remain on how to determine the overall sustainability performance of investees and investment products and what are the minimum thresholds for asset allocation and risk management, accounting for capital expenditure plans over time.

3 UNEP FI

As a market practice, it is expected that E/S characteristics apply to a minimum of 75% - 80% of eligible assets and to 100% of sustainable investments for article 9 products, although the ESG data coverage observed is often lower.

In addition, due to the lack of clear definitions by the RTS, RE and PE managers are struggling with their products' SFDR classification. Specifically, when RE Asset Managers intend to buy existing or under development properties to achieve a Net-Zero objective whereas the properties are not yet considered as "green" but have a decarbonization plan - Can those strategies classify as article 9?

A good solution for article 9 products is also to use the 17 UN Sustainable Development Goals (SDGs) to assess and measure of the E or S objectives and contributions for both PE and RE managers. Nevertheless, through the sustainable investment objective the actors need to demonstrate how they are contributing to the respective objective, by means of relevant sustainability indicators or by using an index that has been designated as a reference benchmark.

1.2 Screening & Due Diligence

When it comes to the ESG due diligence process, generally RE actors have been using the INREV DDQ. In contrast, PE firms employ in-house questionnaires to gather sustainability metrics data from their individual portfolio, and use this internal information to construct proprietary non-financial performance benchmarks. Subsequently, these in-house benchmarks are used to screen the financial and non-financial performance of portfolio companies, determining a comparable ESG score among investments, and to evaluate the ongoing status of the firm's sustainability.

With regards to reporting on Principal Adverse Impacts (PAI), the RTS have defined specific metrics for exposures to RE. Underlying the formula and criteria for the calculation of exposures to "energy inefficient real estate" are the nearly zero energy building (NZEB), primary energy demand (PED) and energy performance certificate (EPC) metrics. On the PE side, some firms choose to report as well on PAI to increase the ESG performance of their products and better address investors' expectations, for example. Data is required from their individual portfolio and product investments which need to be aggregated at portfolio level. Some example of chosen PAI are greenhouse gas emissions, hazardous waste, biodiversity, etc.

When assessing sustainability risks, a survey conducted by the BVI in August 2021[4] revealed the RE sector had issues in identifying Sustainability Risks (SRs), due to a lack of models to identify and evaluate those risks and the impact on the returns of investments. To date, the most commonly used methodologies for the assessment of sustainability risks are implicit methods which include exclusions, principles based screening and investment limits. The environmental impacts of RE are embedded throughout the entire value chain from land usage, materials sourcing and community impact.

4 BVI Survey on the Integration of Sustainability Risks in Risk Management

2. Post transaction:

2.1 Ownership & Monitoring

Both RE and PE actors need to have well-defined metrics which they need to monitor and report on to ensure compliance. Therefore, in the Due Diligence (DD) phase they need to ensure the investee company is actually able to report on the required metrics and these metrics could be included in wraps and warranties to ensure the obligation of the portfolio to report. Active monitoring also includes divestment decisions in case of underperformance of the investee company, an additional obligation that could be covered from the DD phase.

Whereas the traditional financial products are mainly using ESG data providers, the private market is still figuring out an alternative. With an increasing demand from investors and regulators to disclose sustainable metrics, data management is the main challenge of private market players. To align industry indicators, OSCRE International[5] recently launched an Environmental Data Standards Project. On the Real Estate side, market participants are using benchmarks such as GRESB, the EU Paris aligned or the EU Climate transition benchmarks to monitor the ESG performance of their assets. The CREEM[6] tool is also used to follow assets decarbonization pathways and green capital expenditures. Notable indicators for green building projects often include energy and carbon performance, water efficiency and savings, waste management and certification standards (LEED, BREAM, etc.).

Due to the diversified investments of PE funds, tracking the ESG performance of portfolio companies requires a more holistic approach, employing standardized measurement metrics across the entire investee spectrum to determine the sustainability of the fund. The ESG Data Convergence Initiative identified core ESG metrics for portfolio companies to report on, standardizing the reporting and measurement methodology. Furthermore, monitoring the sustainability performance of portfolio companies includes measuring the compliance with AML, KYC and good governance practices, as defined by the SFDR. Ultimately, the establishment of common sustainability reporting practices allows for the comparison of the sustainability performance across portfolio, funds and investment firms, increasing the overall transparency of the industry.

5 OSCRE Announced on 03/10/2022

6 Carbon Risk Real Estate Monitor Project

2.2 Exit

At the exit level, PE companies can leverage the sustainability characteristics of their investments and the intrinsic value of impact investing to achieve better financial performance. However, the role of ESG characteristics in the valuation exit approach is still undefined. Specifically, it is unclear whether sustainable investments should be appraised at a higher value, applying a "green premium", or non-sustainable investments should be penalized through a valuation discount. Regarding the RE Asset Managers, they are trying to increase the exit value of their investments thanks to green buildings certifications - properties with energy certifications such as LEED or Energy Star are usually associated with rental premiums and lower vacancy rates[7] - or green refurbishments. At the same time, these type of green assets can benefit from lower credit/insurance costs.

What's next?

Integrating sustainability in the investment strategy through the SFDR was due to be bumpy, with risk adverse approaches rather than opportunistic ones. As the regulatory framework strengthens and the market practices evolve, , there is ground for optimism as alternative players will have access to more ESG data and performance measurements to avoid greenwashing and achieve the wider ambitions of the Paris agreements. ●

7 PitchBook article published on 18/06/2022 : ESG and Impact Investing in Private Market Real Estate

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Setting the Tone: Market in Crypto Assets Regulation

> **"The digital world is likely to co-exist with the traditional one and we are probably at the dawn of an important evolution of the financial sector."**

What is MICA ?

The market in crypto assets regulation ("**MiCA**") is one of the three pillars composing the digital finance package issued by the European Commission in September 2020 (the "**Digital Finance Package**"). The DLT pilot regime ("**DLT Pilot Regime**") and the digital operational resilience act ("**DORA**") are also part of the Digital Finance Package.

MiCA covers the issuance and provision of services over certain categories of crypto assets: asset-referenced token, E-money tokens and utility tokens (together, the "**crypto assets in Scope**"). It is worth highlighting that MiCA does not capture all types of crypto assets and all activities.

- Non fungible tokens ("NFT") fall out of the scope as long as these tokens do not have the features of crypto Assets in Scope.
- DeFi is also not part of the activities regulated by MiCA.

Why is there a need for a regulation?

MiCA is offering a European legal framework to a sector being currently subject to a strong evolution. This is part of the key objectives of the European Commission in order to promote and support digitalisation across the European Union, to embrace the digital revolution and to drive it with innovative firms to the benefit of consumers and businesses.

Considering that today, retail investors in Europe are exposed to crypto assets, but do not benefit from any protection scheme, the aim of MiCA is to define rules by which the protection to investors will be comparable to the one already deployed for financial instruments (qualifying as such under applicable MiFID rules).

The nature of the text, a regulation, is also of a particular importance. Opting for a regulation implies that there is no need to implement it at a national level (contrary to Directives) and that the rules are directly applicable across European Member States, hence achieving the objective to harmonise applicable rules within the European Union. We can point out that the entire Digital Finance Package has taken the form of regulations for harmonisation of the rules across Europe, and for a rapid implementation.

Are there other regulations/ guidelines on crypto assets in parallel to MICA?

MiCA creates a legal framework for crypto assets in Scope and certain services over these assets. The scope is therefore limited. For instance, financial instruments under MiFID (even in a tokenized form) are out of MiCA's scope. The use of a blockchain (distributed ledger technology, "DLT") does not necessarily means that market players are evolving within MiCA's area. The co-existence of MiCA with the DLT pilot regime contributes to proposing a European set of rules embracing both

- the use of technology for traditional market infrastructures (CSDs/ MTFs) falling into the scope of the DLT Pilot Regime and,
- the issuance and provision of services over crypto assets in Scope.

In parallel, third countries are also engaging in shaping rules applicable to crypto assets and to the provision of

related services. It is therefore necessary to consider the point at both European and International levels, especially because the issuance/provision of services over crypto assets can be frontierless.
In addition, it is also important to consider national initiatives. Having European regulation being, per se, directly applicable within European Member States does not preclude these Member States from adopting national provisions applying to crypto assets and to the use of DLT. The co-existence of European legal framework and national rules is therefore important when considering the legislative panorama and the possibilities offered.

In Luxembourg, we can refer to the Law of 1 March 2019 amending the Law of 1 August 2001 on the circulation of securities and the Law of 22 January 2021 amending the Law of 5 April 1993 on the financial sector and the Law of 6 April 2013 on dematerialised securities. Other bills are under legislative process, for example n°8055 notably for (i) adjusting the Luxembourg law on financial collateral arrangements and (ii) implementing the DLT Pilot Regime. In addition, CSSF also provided guidance on virtual assets (FAQs on virtual assets and White paper on DLT and blockchain).

Objectives of MICA

MiCA relies on four main objectives:

- Protecting consumers, investors and market integrity in consideration of the risks associated with crypto assets;
- Ensuring legal certainty by establishing a sound legal framework for crypto assets in Scope that are not covered by existing financial services legislation;
- Supporting innovation and fair competition in order to promote the development of Crypto Assets in Scope by instituting a safe and proportionate framework; and
- Ensuring financial stability, with the inclusion of safeguards to address potential risks to financial stability.

These objectives are common to the three regulations composing the Digital Finance Package. The European Commission's priority is thus to ensure that the transition towards digital era is controlled in order to promote and build up a secured, reassuring and welcoming framework for the handling of complex questions around digitalisation of European financial markets.

Industry implications: Obligation for market players

The MiCA initiative will impact the ability of market players to diversify their business by developing a crypto asset strategy. Entities willing to offer Crypto assets in Scope shall be authorised and will notably have to provide a white paper. In addition, entities willing to provide services over crypto assets in Scope (operation of trading platform, custody and administration services, execution of orders, …) shall also be authorised to do so and observe and comply with certain obligations contained in MiCA.
These elements will promote transparency and confidence in such products.

2023 will be a transitional year for MiCA (whereas the DLT Pilot Regime will officially start to apply as from 23 March 2023, the entry into application of MiCA is likely to be in 2024). During this transitional year, numbers of level 2 measures (regulatory technical standards) are expected on several elements, including major ones. For crypto assets service providers, essential points such as disclosure obligations, ESG elements, and service providers' authorisation regime shall be clarified in level 2 regulatory technical standards. The same goes for other very important elements of the regulation and it is of utmost importance to follow up forthcoming developments in order to have a full understanding of the applicable regime.

It is furthermore important to highlight that the protection of consumers also passes by the application of a coherent liability regime applicable to intermediaries/service providers. Market players are consensually of the view that it is crucial to have an appropriate liability regime so as to mirror as much as possible the liability regime in place for traditional assets (considering of course the specificities linked to the nature of the underlying assets). The well-known principle of the same activity, same risk, same rules is of essence in this context.

End of the "Wild West" era?

We commend the initiative, and the European Union will be at the forefront of the legislative development around crypto assets. However, missing elements and future developments are already identified in order to complete the package. The application of the entire Digital Finance Package shall not constitute a final achievement. This is likely to be a key milestone but there is a consensus of the industry on the necessity to regulate/offer a framework to other elements (DeFi, NFTs, …).

Future outlook

The appetite for crypto assets is there and there are plenty of business opportunities for both fintechs and traditional market players. The same goes for investment funds and issuers. The digital world is likely to co-exist with the traditional one and we are probably at the dawn of an important evolution of the financial sector.
The promotion of financial stability and, more generally, the prudent approach adopted by the European Commission contributes to balancing new risks emerging out of the digitalisation of financial market. This is even more important in an international context where competition is fierce.
This is likely to be a long journey, as it will imply an important learning curve for all market participants in order to understand the legal framework, to define standards and to cooperate with authorities. The educational phase will even be more important as we deal with new concepts and instruments. ●

LPEA COMMITTEE FOCUS

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By **Anja Grenner,** Co-Chair

And **Robert Brimeyer,** Co-Chair

Fund Administration: Luxembourg's Indispensable (and Underestimated) Industry Backbone

TC Fund Administration was set up in November 2021 and is therefore one of LPEA's most recent "kid on the block". We would have you believe that its creation was somehow connected to LPEA's current CEO, Stephane Pesch, who has a professional history in Fund Administration, and rightly so; in total there are, according to ALFI, 143 central administrators in Luxembourg[1] and 60 [2] of them are members of the LPEA. Time to give them a louder voice.

While the total number of administrators is high in absolute terms, a consolidation process already started a few years ago, which is by no means over. On the contrary, this is highly likely to continue over the coming years. As the Private Equity industry is undergoing continuous change - also, but not only, driven by AIFMD – administrators need to adapt to more regulation, quicker and more sophisticating reporting requirements, shorter life cycles, new types of investors, even more severe AML compliance requirements, increasing staff costs and decreasing margins, just to name a few. Some of the answers lie in increased automation, system enhancements, delegation of certain tasks to less expensive jurisdictions, low staff turnover and retention, among other solutions. And while the concept of AIFMs and Depositaries for alternative assets is a product of a still fairly recent piece of regulation and not necessarily needed for each and every Private Equity fund, tasks like domiciliation, accounting, transfer agency and corporate secretarial services remain indispensable for any Private Equity and Venture Capital fund.

Based on the above, the topics hereunder have been identified by all members of the Fund Administration Committee, as the most important ones to address in the coming months:

- **HR-related topics,** such as enhanced trainings for Administration staff (accountants and cosec staff certifications, improve branding and reputation of fund administrators).
- **AML-KYC Due Diligence,** issues covering the creation of a centralized and homogenised set of questions / register for all Lux service providers with the objective to simplify/standardise DD between them, as well as the discussion of a potential scoping of ISAE3402 certification with the CSSF and audit firms.
- **AML-KYC Practices & Investment Compliance,** with an alignment of AML-KYC Practices amongst service providers around Investor KYC and best practice relating to Investment KYC as a support to inhouse AIFMs
- **A structured approach towards the CSSF,** ensuring fund administrators are adequately represented with the CSSF as well as constructive dialogue with the regulator concerning typical weaknesses of administrators identified by them.

1 ALFI, data as of 30.06.2022

2 Excludes the BIG4 audit firms that provide accounting services

"While the total number of administrators is high in absolute terms, a consolidation process already started a few years ago, which is by no means over."

Andrea Manoli
Vistra

Anja Grenner
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Alex Michael
Cafico International

Cindy Nguyen
Caceis

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UIBT

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Welcome speech by Claus Mansfeldt, President of LPEA

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Stephane Pesch (LPEA) & Franz Gaul (Max Planck Foundation)

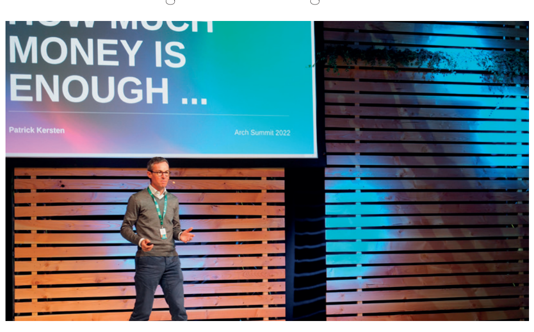
Stephane Pesch (LPEA)

Caroline Kragerud (Cube Infrastructure Managers), Hélène Noublanche (Coller Capital), Martine Kerschenmeyer (Advent International) and Laurent Hengesch (Ilavska Vuillermoz Capital)

Jerome Wigny (Elvinger Hoss Prussen) at the Luxembourg PE Networking Cocktail in London

Andrew Ritchie (Brown Brothers Harriman), Jocelyn Pidoux (iCapital) and Farhad Karim (Blackstone) at the Farhad Karim (Blackstone) at the Luxembourg PE Networking Cocktail in London

Charlotte Lahaije-Hultman (Vistra) at the Arch Summit



Patrick Kersten (Vesperia, Medination, Doctena, AtHome) at the Arch Summit

Yannick Oswald (Mangrove Capital Partners) at the Arch Summit

Adrian Aldinger (Arendt & Medernach), Eduard Von Kymmel (id Linked), Jane Wilkinson (Independent Director), Anke Jager (Independent Director), Thomas Albert (Swiss Life) at the Best Practices in Board Governance Conference

Karen O Sullivan (CSSF) at the Best Practices in Board Governance Conference

His Royal Highness Prince Guillaume and Stephane Pesch (LPEA) at the Luxembourg Private Equity Networking Breakfast in New York

Stephane Pesch (LPEA) at the Luxembourg Private Equity Networking Breakfast in New York

H.E. Mr. Franz Fayot, Luxembourg Minister of Economy at the Luxembourg Private Equity Networking Breakfast in New York

About LPEA

The Luxembourg Private Equity and Venture Capital Association (LPEA) is the most trusted and relevant representative body of Private Equity and Venture Capital practitioners with a presence in Luxembourg.
Created in 2010 by a leading group of Private Equity and Venture Capital players in Luxembourg, with 407 members today, LPEA plays a leading role locally actively promoting PE and VC in Luxembourg.
LPEA provides a dynamic and interactive platform which helps investors and advisors to navigate through latest trends in the industry.
International by nature, the association allows members to network, exchange experience, expand their knowledge and grow professionally attending workshops and trainings held on a regular basis.
If Luxembourg is your location of choice for Private Equity, LPEA is your choice to achieve outstanding results.
LPEA's mission towards its members is to represent and promote the interest of Private Equity and Venture Capital ("PE") players based in Luxembourg and abroad.
LPEA's mission towards Luxembourg is to support government and private initiatives to enhance the attractiveness of Luxembourg as an international hub for carrying out PE business and/or servicing the PE/VC industry in all its dimensions.
In summary, LPEA is the go-to platform where PE practitioners can share knowledge, network and get updated on the latest trends of the industry across the value chain.

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Side-by-side with you during your Investment Management & Funds journey

Wherever you are, and whatever your goal, we'll help you succeed

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