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LEXOLOGY
Getting The Deal Through

Market Intelligence

PRIVATE EQUITY
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Global interview panel lead by Simpson Thacher & Bartlett LLP

Lexology GTDT Market Intelligence provides a unique perspective on evolving legal and regulatory landscapes.

Led by Simpson Thacher & Bartlett LLP, this Private Equity volume features discussion and analysis of emerging trends and hot topics within key jurisdictions worldwide.

Market Intelligence offers readers a highly accessible take on the crucial issues of the day and an opportunity to discover more about the people behind the most significant cases and deals.

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Luxembourg

Ronnen J Gaito is the founder of the law firm of RJ Gaito SARL (2011). He is a member of the Luxembourg Bar, a solicitor in England and Wales, a New York attorney and the Luxembourg chapter chair of the international section of the New York State Bar Association. Ronnen's practice focuses on advising clients on structuring Luxembourg investment vehicles, private equity and venture capital transactions, mergers and acquisitions, joint ventures, corporate finance (debt and equity offering), fund formation, corporate governance matters as well as post-transaction cross-border dispute resolution and litigation. Ronnen's most recent experience has involved extensive structuring of worldwide investment structures for renewable energy firms and preparation of their international debt financing and private equity acquisition. In addition, his work has extended to group reorganisations for the purpose of optimising exit strategies and IPOs, debt facilities and negotiations of complex technology licensing agreements. He provides extensive Luxembourg law advice for major international law firms.

Martin has over 26 year's experience working in the area of international tax gained within a Big Four environment, focussing mainly on alternative investment funds. He has advised many of the largest global private equity players on the market, advising on the structuring of investment funds and holding platforms, and on the various stages through the life-cycle of a fund, from the structuring of investment acquisition – including management incentive programmes, co-investment and participation by business founders – through the holding period, including liquidity events, refinancing, emergency financing and partial disposals – to the final exit, whether through a sale to a secondary PE buyer, a strategic investor or by way of IPO. Martin is the tax director at RJ Gaito, where he continues to be involved in the structuring of transactions.

1 What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

Following strong years from 2017–2022 that were underpinned by technology and real estate transactions, post-pandemic inflationary pressures, interest rate rises and the war in Ukraine have had an impact on deal volumes and reduced valuations. The cost of debt financing deals has been a key factor in deal flows. A vibrant Luxembourg real estate sector is now seeing a sharp downturn and clients who have used venture debt have come under significant pressure. However, in 2022, we have seen a significant uptick in renewable energy transactions in debt or equity and renewable energy firms wishing to optimise their group activities to position themselves for growth in the coming years and a continuous growth of private debt fund activities.

2 Looking at types of investments and transactions, are private equity firms primarily pursuing straight buyouts, or are other opportunities, such as minority-stake investments, partnerships or add-on acquisitions, also being explored?

Luxembourg itself is not a large market in terms of target businesses for PE investors, and we see only a small number of Luxembourg headquartered businesses being acquired by PE. Luxembourg is rather used as a fund and investment platform domicile for making acquisitions.

We see a variety of strategies being pursued, with not only traditional majority buyouts (a lot of the time with founders and management remaining as minority investors), but also some firms have launched separate funds to pursue minority stakes. This latter strategy

Ronnen J Gaito

Martin Hollywood

does come with some different concerns, however, because the PE stakeholder will not have a significant influence over how the investment is funded. With this inflexibility, due to the majority investor holding the pen on how the deal is structured, some degree of work can be necessary for the minority investor – that is, our client – to ensure the investment remains viable in terms of tax leakage and IRR metric.

3 What were the recent keynote deals? And what made them stand out?

One of our firm's recent keynote deals was leading the construction of a pan-European and Latin American solar energy project finance platform valued at over €200 million and a subsequent debt raising

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transactions exceeding €100 million required for capitalising the transactions.

The transactions required the coordination of lawyers and tax advisors in five jurisdictions with over 50 legal entities involved. It required an intensely interdisciplinary transaction team with deep knowledge of group reorganisations, M&A, equity and debt financing as well as understanding of international arbitration. It demonstrated our capabilities in cross-border transactions and business operations, as well as dispute resolution capabilities.

4 Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? How are those challenges evolving?

M&A deals are inevitably cross-border in nature, because you have investors in a variety of jurisdictions, the fund and investment platform in Luxembourg, the top of the target group in another jurisdiction and in the majority of cases the target will operate in more than one jurisdiction.

When it comes to tax, this presents challenges in terms of how the investment is funded – that is, how much equity versus how much debt – and elicits all sorts of questions in terms of how much debt would it be appropriate to be borne by the target entities. This is of course primarily a business decision, but causes tax issues in all of the relevant territories in terms of whether any debt that is advanced is done so at an arm's-length basis.

In addition, there are various rules introduced within the European Union designed to limit the tax deductibility of interest on debt, introduced as part of the EU Anti-Tax Avoidance Directive (ATAD).

Also included in this package of ATAD rules are those that target instances where there is a disparity in how a debt is viewed, resulting in different tax treatments in different jurisdictions.

5 What are some of the current issues and trends in financing for private equity transactions? Have there been any notable developments in the availability or the terms of debt financing for buyers over the past year or so?

The tightening of the monitoring conditions and the extra cautious approach of traditional banking lenders have resulted in a contraction in the availability of credit. It is now a general consensus in the market that private credit is the flavour of the day. With secured transaction, lenders, including Luxembourg lenders, are highly sensitive to the borrower's repayment capacity and quality of the collateral. Debt documents are demanding, and a high degree of collateral and parent guarantees are needed.

In addition, the market requires elaborate covenants and contractual protections for creditors, which can help them identify issues with a company's balance sheet before it runs into serious problems. Lenders are not satisfied with a single point of enforcement and require collateral at many levels of the structure.

We are also seeing more and more fintech companies enter the private debt space generally targeting smaller SMEs including sole traders. In those instances, loans are typically smaller in size and unsecured.

6 How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

From a tax perspective, the main issues facing private equity transactions are the ATAD rules.

The ATAD rules relating to the tax deductibility of interest seek to restrict tax deduction by reference to the yardstick of a business's EBITDA. Therefore, if a deal is debt funded and interest on that debt is being incurred by the business acquired by PE, you might have a situation where interest is not deductible against profits, but the corresponding interest income (for the borrower) is being taxed in the hands of the investors. This does have the effect of there being careful consideration as to the amount of debt that is used to acquire a target.

The second strand of the enacted ATAD rules with an effect on PE concerns hybrid situations. This relates to situations where a debt instrument or an entity within the overall investment structure (from the investor down to the target group) receives a different treatment from different taxing jurisdictions.

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For example, whether the terms and conditions of the debt make it appear to be a debt or more like equity in nature, or whether an entity is viewed as being a flow-through for tax purposes.

Since a consistent approach by each country's tax system does not exist, when it comes to debt the lending country might treat what is legally a debt as equity, and the borrower may treat it as debt. This means that interest is treated as interest by the borrower, which is generally tax deductible, but the lender may treat it as an equity return, resulting in a more beneficial tax treatment.

The rules relating to entities target similar issues.

These new rules mean that a lot more work needs to go into assessing whether there is an unintended breach of these rules; for example, resulting from the nature and location of establishment of investors – that is, there is no 'motive test' that can be used to say that no tax benefit was being sought, and the breach of the rules is just an accident of the composition of the investor population.

> "We see a variety of strategies being pursued, with not only traditional majority buyouts (a lot of the time with founders and management remaining as minority investors), but also some firms have launched separate funds to pursue minority stakes."

7 What are the current attitudes towards private equity among policymakers and the public? Does shareholder activism play a significant role in your jurisdiction?

The incumbent government is vocally in favour of private equity, which it sees as one of the pillars of growth for the country. We have seen Luxembourg grow as a location for investment funds over the years, and it has been for many years the second largest location for investment funds globally, after the United States. Historically, this position was based on retail funds, but now the alternative funds sector is similar in size to the retail sector in terms of assets under management.

The government has positively encouraged the growth of middle-office, and where possible front-office, functions in the country, building on the back-office functions that historically took place here. This has resulted in a number of key global players locating significant functions in Luxembourg.

8 What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?

In our experience, the level of exits is currently quite low compared to pre-pandemic years. The profound impact of tightened monetary policies has had an impact on exits.

Bearing in mind that the Luxembourg market tends to serve an international deal structuring platform and, unlike larger economies where the significant private equity transactions take place, our data and experience show that exits are primarily effected via traditional

acquisitions or otherwise trade sales, and leveraged M&A or public listings are the exception.

Recent transactions underpin the high interest that the Luxembourg banking sector continues to attract despite significant regulatory headwinds and increased compliance requirements. Among these transactions are Banque Havilland selling its institutional banking business to Banco Inversis that belongs to Spain's Banca March with a strategy of supporting Spanish and Latin American clients in Luxembourg, as well as the merger of Fideuram Bank Luxembourg (a wholly owned subsidiary of Intesa Sanpaolo) with Compagnie de Banque Privée Quilvest.

These transactions signify the resilience of the banking sector and its long-term prospects as an international banking sector.

9 Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?

Depending on the type of sponsor, investors have had the upper hand for a while with the proliferation of new fund sponsors on the market. But the last 18 months or so has seen this exacerbated to some degree as investors, given market conditions over the past couple of years, seem to be considering at much more length where they choose to deploy their money. Larger investors are also looking more and more to directly invest in deals rather than allocating commitments to funds. This means that fundraising cycles are lengthening, with first closings being pushed back in some cases. There is a lot of pressure on the management fees or priority profit share that PE firms can include in the fund terms. The days of 2 per cent as standard are long gone.

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10 Talk us through a typical fundraising. What are the timelines, structures and the key contractual points? What are the most significant legal issues specific to your jurisdiction?

Typically, the process entails the general partner (GP) or the fund sponsors defining the terms and conditions of the fund, planning for the most adequate fund structure, meeting with the investors and negotiating funding commitments, preparing for due diligence and ultimately negotiating the fund's limited partnership agreement, and, if relevant, drafting the fund's offering memorandum and closing.

In a Luxembourg context, the critical decisions are determining the most suitable structure and the vehicle selection. The significant factors that the fund promoters will usually have to determine are whether to establish the fund as unregulated vehicles, either as unregulated Luxembourg limited partnerships (LPs) or a corporate form of partnership customarily used for the funds that are characterised as a 'sub-threshold fund' or LPs appointing an

alternative investment fund manager (AIFM) or, alternatively, as reserved alternative investment funds (RAIFs). These are only a few possible structures, but given the many other options and variations available, there are numerous permutations available depending on the particular circumstances, which clearly marks Luxembourg out as a unique and complete private equity fund ecosystem.

Other key terms we regard as industry standard are those related to governance of the fund that relate to GP removal, key person removal, most favoured nation clauses and fee clawbacks. Post-Brexit, we have seen a tendency to move away from standard English law as the governing law and relying on Luxembourg law with an arbitration clause of use of the Luxembourg courts. In this context, given that the documents are usually in English, we put a particular emphasis on the mechanism for enforcement of the provisions so that tribunals can provide the parties with the expected remedies.

11 How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?

Supervision of private equity sponsors is very much harmonized by EU legislation, and sponsors are subject to a whole plethora of legislation the most prominent of which are the Alternative Investment Fund Managers Directive (AIFMD), securities marketing regulations, the Markets in Financial Investments Directive and extra-statutory guidelines such as those issued by the European Securities and Market Authority.

The marketing and pre-marketing of funds is supervised and enforced by the Luxembourg Commission de Surveillance du Secteur Financier (CSSF). The CSSF is positioned as one of the leading financial regulators both within the European Union and internationally,

> "It is now a general consensus in the market that private credit is the flavour of the day."

closely monitoring and supervising the sponsors and players in the Luxembourg market, and issues guidelines for managing and conducting activities in the Luxembourg market. The CSSF seems determined to preserve Luxembourg's stellar reputation and continuously monitors the compliance obligations by all actors in the Luxembourg financial market.

Concrete examples of such supervision relate to pre-marketing of funds by AIFMs in which the CSSF strictly enforces the AIFMD rules on pre-marketing and emphasises the need to for a notification letter when conducting such activities. Reporting under Annex IV in respect of article 3(3) of the AIFMD for sub-threshold funds is also strictly supervised and therefore the sub-threshold has the effect of imposing a significant reporting and risk analysis burden on many sponsors and actors.

12 What effect has the AIFMD had or will it have on fundraising in your jurisdiction?

The AIFMD has been in force in domestic law since 2013, and Luxembourg was one of first member states to adapt to the directive's requirements, so the effects of the directive have already been felt for a decade and much could be discussed about its effects in general in a Luxembourg context. This regulatory framework has facilitated cross border business with its passporting regime and harmonisation throughout the European Union; however, it needs to be vigilantly observed by market players. The requirement to appoint an external AIFM has introduced obligations for service providers such as the engagement of depositories, risk management functions and auditors, some of which may be questionable in the context of professional investors.

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Inevitably regulation entails a cost and therefore it has increased the cost of doing business, specifically cross-border business. AIFs are not only faced with the higher costs but also with increased administrative burden. In addition, professional investors, which would usually require less protection, who wish to invest in AIFs on their own initiative are now required to observe the regulatory framework. Consequently, the European Union had to find innovative solutions and invigorate a potentially stifling high-growth investment environment. This produced the EuVECA and ELTIF for investment in SMEs in the European Union, which has thereby somewhat mitigated the effects of the AIFM.

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13 What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?

Apart from the EU initiatives already enacted, the European Union have proposed a third anti-tax avoidance directive, which would target the use of what they describe as 'shell companies'. This is currently only a proposed directive from the European Commission, which certainly has its critics within some member state governments, who feel that it is an exercise in over-reach by the Commission. However, it seems quite probable that a compromise will be reached, meaning that this will very probably become a directive before long. There is some lead time to this becoming effective, as member states need to have time to legislate domestically to transpose the directive, and the transposition deadline needs to be in advance of the first year the directive must take effect. So it is still not clear when the directive will take effect.

In broad terms, the directive targets the oft-discussed subject of 'substance' – that is, the level of business rationale and presence of a particular company in the jurisdiction in which it is established. There are various tests to consider, but broadly speaking a company must have its own decision makers, who are not entirely drawn from unrelated businesses (third-party service providers), and should have their own premises in the territory they are in.

Failing the various tests could result in the loss of the benefit of other European directives, such as the Parent-Subsidiary Directive and the Interest and Royalties Directive.

It remains to be seen how this will play out in practice, because each directive only provides a 'minimum standard', and each country will interpret the rules laid down in the directive according to their own

legislative traditions and can choose to impose more draconian rules than are required by the directive.

However, private equity firms are already reacting to the directive, because in assessing the tests in the directive, it is necessary to look to the previous two years to make that assessment. Work is already being done to benchmark firms' adherence to the rules, as they might be interpreted currently, but this is in the absence of any transposition legislation from member states and no official interpretation of the transposition laws.

14 Looking ahead, what can we expect? What might be the main themes in the next 12 months for private equity deal activity and fundraising?

In the autumn of 2023, Luxembourg will have a new government that is very pro-business with the next prime minister likely to be Luc Frieden, a highly qualified and experienced politician, statesman and former finance minister, who understands the world of private equity and its importance to Luxembourg. The party to which he belongs, and who will lead the government coalition, is generally considered to be economically more liberal than their coalition partners, who formerly led the country's governing coalition for nearly 10 years. We are likely to see a more pragmatic business environment that will promote the Luxembourg private equity sector and cross border business being transacted via Luxembourg.

Until inflation is brought under control, and while interest rates remain high, private credit funds will remain an opportunistic approach taken by private equity to deploy their fund resources in the wake of the void left by traditional credit institutions.

A major development recently is the move by PE promoters to expand their potential investor base. Traditionally this has been composed primarily of institutional and specialist investors, including endowments and ultra-high net worth individuals. However, there have been recent moves to expand this traditional investor base to more 'retail' type investors, who would have historically found the potential returns particularly attractive, but would not have had any means of accessing this area of the market. This 'retailisation' of a historically closed market clearly entails the consideration of many areas of complexity to be able to offer these products to this section of the investor population, while safeguarding the investors' interests.

We see green energy, private and environmental, social and governance strategies as a major area of interest of PE funds supporting global growth of expanding energy companies, tech driven by AI and cyber security, healthcare and e-commerce driven investments will also be the subject matter of opportunistic deals.

However, industry leaders such as Bain & Company foresee the fundraising environment outlooks as challenging and requiring private equity firms to adjust to a new environment that is nimbler and investor focus and, needless to say, track record will be a key consideration.

With the support of Clarus Risk (www.clarusrisk.com).

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QUESTIONS

QUESTIONS

The Inside Track

What factors make private equity practice in your jurisdiction unique?

Luxembourg is one the world's leading jurisdictions for structuring private equity and venture capital funds; it provides a complete and closed-ended ecosystem for structuring those investments without the need for the use of other jurisdictions. The jurisdiction provides an unparalleled choice of legal vehicles that enable cross-border deal structuring, complemented by a banking and digital payments infrastructure.

The political stability of Luxembourg, the professionalism of its regulators and local service providers are determining factors in its success as a private equity hub.

According to the Luxembourg Private Equity and Venture Capital Association, the Luxembourg market hosts more than 260 authorised AIFMs and management companies and 862 registered AIFMs, as well as a large number of depositories and professional services firms. This concentration of services and expertise in one location creates an outstanding ecosystem for fund and asset management.

What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?

When choosing counsel for complex matters, it is important to understand whether the firm can:

- demonstrate experience in a cross-border environment;
- think strategically about the client's business and offer the most appropriately tailored solution for that particular client, including, but not limited to, non-legal issues, the most important of which are the client's banking facilities and international payment infrastructure; and
- understand if the same counsel can defend the tax and legal structure that it has put in place in an international context.

What interesting or unusual issues have you come across in recent matters?

In the current environment, we have been confronted with the need to coordinate multiple jurisdictions for tax and legal matters and bring into play our entire capabilities in tax, corporate structuring and governance, M&A, venture capital, venture debt and project debt financing, banking relationships and international arbitration, including, but not limited to, investor state arbitration taking place before the International Centre for Settlement of Investment Disputes tribunal at the World Bank.

About Market Intelligence

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Lexology GTDT: Market Intelligence provides a unique perspective on evolving legal and regulatory landscapes in major jurisdictions around the world. Through engaging, easily comparable interviews, the series provides the legal profession's thought leaders with a platform for sharing their views on current market conditions and developments in the law.

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