KEYNOTE INTERVIEW

How will Brexit shape private equity in Europe?

Negotiations drag on but private equity managers are making a pre-emptive strike, says LIS | Sanne managing director Pierre Weimerskirch

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Q How do you expect Brexit to impact Europe's private equity industry and how are managers responding?

The European private equity market has been extremely well integrated for the past 10 years, particularly with the publication of the Alternative Investment Fund Managers Directive in 2013. London has really been the hub of the European private equity industry. Brexit, however, has put that situation in jeopardy.

On the one hand, I do not believe investment will be greatly impacted. Firms will continue to pursue the most attractive opportunities wherever they may be. I expect we will see major changes when it comes to the management of funds. Significant changes have already taken place with some of the larger UK managers raising parallel structures in onshore EU jurisdictions, alongside their UK, Scottish or Channel Islands structures, in order to be able to raise capital from European LPs.

The other big question, of course, relates to management services. Currently, even funds that are domiciled in Luxembourg may be managed out of London offices. This is done under the passporting rights afforded by AIFMD. As we know, those rights will end on 31 December, 2020 and the UK will then be considered a third-party country by European regulators, in the same way as the US or Singapore are.

As a third-party country, UK managers will no longer automatically be able to provide their portfolio management services to EU onshore private equity funds. To do so, they will need to be recognised as an equivalent jurisdiction by Europe's regulators.

That could become a thorny political issue because the minute the EU recognises the UK as an equivalent jurisdiction, then other jurisdictions will come knocking on the door. It is a potentially contentious issue, which is exactly why we are seeing so many UK managers reorganise their operating

models and setting up shop on the continent.

Q Luxembourg has been a big beneficiary of this trend. Why do you think that is?
To be honest, it has been something of a surprise. When the Brexit vote initially took place in 2016, we would have expected a large proportion of UK managers to relocate to Dublin, given the advantages of a common language. But that has not been the case. The majority of firms have chosen Luxembourg as a domicile for their fund structures and to open an office.

The key reason for this appears to be the Luxembourg partnership regime. The regime was modernised in 2013 and is very similar to the Cayman partnership or Scottish partnership that Anglo Saxon managers are so familiar with. No other European jurisdiction has that type of partnership, including Ireland. Furthermore, continental European institutional investors are very comfortable with Luxembourg as a jurisdiction as they have historically invested significantly in Luxembourg-based vehicles. Combined, I think these are the two main drivers behind the region's success.

Q How has covid-19 impacted the private equity industry in Europe? In particular, how well has the asset class fared when it comes to remote operations?
I do not think that covid-19 has had a particularly significant impact on private equity operations. We are lucky, as an industry, that we deal in bits and bytes. We deal with information and that information can be shared very easily through electronic means. It took most managers a couple of days, or perhaps a week, to switch to home-office mode and today things are pretty much working as smoothly as they did before coronavirus struck.

Of course, there was an initial slowdown in dealflow, but now most due diligence is being conducted remotely with the myriad tools that are available. There tends to be a lot more reference taking involved and there is still some work that needs to be done physically on site, but that is limited to a minority of tasks. Overall, the industry has been quick to adapt and disruption has been minimal.

> *"I expect we will see major changes when it comes to the management of funds"*

Q How does the current crisis differ to the global financial crisis? What lessons have been learnt?
Things certainly seem to be playing out differently this time around. We have not seen the same sharp drop in asset prices. It was the banks, of course, that triggered the financial crisis, and so there was less liquidity in the market. Private equity houses had challenges in accessing credit to finance deals. With covid-19, there is a huge amount of liquidity in the market and so prices have not adjusted nearly so much.

Certain sectors have been hit hard, such as entertainment, travel and hospitality. But, at the same time, sectors such as healthcare and IT are booming. That was not the case in the financial crisis when every industry was impacted. Furthermore, a lot of lessons have been learnt in the past decade. This time private equity managers were better prepared, reacted more quickly and had more firepower at their disposal to respond to both the threat and the opportunity.

Q How do you expect LP appetite for the asset class to hold up overall?
UK and US institutional investors have been making substantial allocations to private equity for a long time. But continental European institutional investors have only really started stepping up their target exposure to the asset class for the past five years. They are moving from low single-digit allocations of perhaps 3-5 percent, to mid-teen allocations of between 12 and even 20 percent. That is a substantial amount of additional capital flowing into private equity.

The reason, of course, is that these investors are having to manage their assets and liabilities and right now, returns from other investment opportunities are limited. Historically, most European pension funds would have focused their attention on fixed income. With interest rates at zero, or even negative, there are no returns to be generated there. The obvious place to look, then, is private equity. I am confident, therefore, that LP appetite for private equity will grow over the next three to five years.

Q Do you anticipate this money flowing predominantly into the big brand mega funds? Or is there also room for emerging managers to make an appearance?
We are seeing more teams leaving larger managers to set up shop on their own. So, on the one hand, there will be the large, global houses, raising tens of billions. But on the other hand, we will see more niche houses being launched. That is an exciting evolution for the industry. ■