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LUXEMBOURG

Real Estate Investment Funds in Luxembourg

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Veronica Aroutiunian, partner, is a member of the Investment Management practice group in our Luxembourg office. She focuses on structuring and formation of alternative investment funds, particularly within the real assets sector. She is also a member of the Real Estate Industry focus team and the Regional Team France.

Veronica specialises in fund structuring, with a special focus on private equity, real estate and infrastructure funds. She advises clients on the regulatory and corporate aspects of structuring, establishing, operating and marketing Luxembourg regulated investment vehicles (Part II UCIs, SIFs and SICARs) and unregulated investment vehicles (including RAIFs and Luxembourg partnerships).

Before joining Loyens & Loeff, Veronica served as an associate in the financial services and investment management departments of various top-ranked law firms in Luxembourg. In the early stages of her career, she gained a broad experience in funds with liquid strategies (hedge funds) and retail investors (such as UCITS).

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Ana Nicoleta Andreiana, partner, is a member of the Corporate Practice Group in our Luxembourg office. Ana is also a member of the Loyens & Loeff Private Equity focus team.

Ana specialises in private equity matters and advises a range of sponsors on a wide range of corporate and transactional matters, including day-to-day corporate and governance aspects, co-investments and joint ventures, acquisition funding, and complex restructurings that often include cross-border elements. She also has additional significant experience in finance and in debt and equity capital markets projects.

Ana regularly offers specialist corporate advice to a number of fund and fund manager clients, working regularly side-by-side with our investment management team to provide a full-fledged cross-departmental service to private equity clients.

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BIO

Maude Royer, senior associate, is a member of the Investment Management Practice Group in our Luxembourg office. She focuses on fund finance transactions and is a member of the Private Equity team.

Maude acts on a full range of finance transactions, with particular focus on fund finance. She acts at all levels of the fund capital structure, advising investment funds (including real estate, private equity, infrastructure and debt funds, as well as funds of funds), fund managers and financial institutions. Her expertise includes capital call financing, GP financing, NAV financing and other hybrid products, asset-based financing, real estate financing and general corporate financing.

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Introduction

Looking to raise capital in Europe and around the world and invest in real estate? Choose a Luxembourg investment fund.

Luxembourg's adaptable legal and tax environment has positioned it as a European hub for diverse investment vehicles, particularly real estate funds, catering to global investors' needs. Its robust security interest system bolsters creditor protection, establishing it as a secure global financing domicile. Asset management through pooled funds often involves special purpose vehicles for ringfencing and tax efficiency. With 80+ double tax treaties and evolving corporate laws, Luxembourg provides streamlined options for acquisitions, joint ventures, and employee participation schemes.

Structuring of Luxembourg REIFs

Within a sophisticated Luxembourg toolbox, the choice of the real estate investment fund (**REIF**) vehicle typically depends on the target market in terms of capital raising and investment opportunities. Luxembourg REIFs can take the form of regulated entities, under direct supervision by the CSSF (Luxembourg's regulator), or unregulated entities and can either be managed by a European manager, authorized to market the fund through the European passport regime, or by a registered or non-European manager utilising national private placement regimes to raise funds. These REIF products can be categorised into two groups: (i) retail REIFs with strict investment limitations and (ii) REIFs tailored for professional and high-net-worth investors offering varying degrees of investment flexibility. For managers pursuing diverse investment strategies, such as targeting specific sectors or regions, Luxembourg REIFs often facilitate the structuring of multi-compartment (or umbrella) vehicles. In an umbrella, each compartment is associated with a distinct investment portfolio segregated from other compartments' portfolios via legal ring-fencing. This ensures that the assets of each compartment solely serve the rights of investors and creditors related to that specific compartment.

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Managers aiming at retail investors must structure their Luxembourg REIF as an Undertaking for Collective Investments, governed by Part II of the Law of 17 December 2010 (**Part II UCI**). Part II UCI requires prior approval and ongoing oversight by the CSSF, and the appointment of an alternative investment fund manager (**AIFM**) authorised under the Directive 2011/61/EU on Alternative Investment Fund Managers (**AIFMD**). It stands as Luxembourg's sole alternative investment fund accessible to retail investors. However, the distribution of Part II UCIs to retail investors within the European Economic Area (**EEA**) is contingent upon local regulations in each respective jurisdiction, as there is no European retail passport under the AIFMD.

Part II UCI may invest in diverse real estate assets and strategies, as long as it doesn't allocate over 20% of net assets to a single property (this limit becomes effective upon property acquisition, and after a maximum four-year ramp-up period). Additionally, the aggregate borrowing of Part II UCI cannot exceed an average of 50% of the valuation of its properties.

To facilitate distribution to retail investors in the EEA, managers can incorporate a European Long Term Investment Fund (ELTIF) 'wrapper' into their Part II UCI. A Part II UCI, or a compartment thereof, could benefit of the ELTIF label and distribution passport available under the amended Regulation 2015/760, provided the AIFM is EU-authorsied, and over 55% of capital is invested in eligible real assets. ELTIFs entail stricter investment rules than Part II UCIs without ELTIF wrapper, including limitations on techniques like short selling, repos, securities lending and use of financial derivatives. ELTIFs can only be set up as master-feeder structures, provided both the feeder and the master are ELTIFs, and fund-of-fund ELTIFs can only target European AIFs.

ELTIF lures retail investors in EEA with distribution passport whereas Part II UCI offers structuring flexibilities (open/closed-ended, limited/unlimited term). There is growing interest in hybrid models with ELTIF compartments under umbrella Part II UCIs.

Managers targeting professional and semi-professional investors can opt for various Luxembourg REIF regimes:

(i) Specialised Investment Fund (**SIF**) under the Law of 13 February 2007
(ii) Investment Company in Risk Capital (**SICAR**) under the Law of 15 June 2004
(iii) Reserved Alternative Investment Fund (**RAIF**) under the Law of 23 July 2016

These REIFs are reserved to 'well-informed investors', i.e., institutional investors, professional investors and investors who have confirmed in writing that they adhere to the well-informed investor status, and who either invest a minimum of EUR 100,000 or have been assessed by an eligible financial institution.

SIFs and SIF-like RAIFs can invest in various real estate assets and pursue any real estate strategy, subject to a 30% concentration rule. SICARs and SICAR-like RAIFs are not subject to diversification requirements but may only invest indirectly via entities in 'risk capital' qualifying assets with an intention to develop a project (no core/core plus strategies).

SIFs and SICARs require prior CSSF approval, while RAIFs are formed and operate without CSSF's involvement. However, whereas SIFs and SICARs may be managed by registered or non-European AIFMs, a RAIF must appoint an EU-authorised AIFM.

It is also possible to structure a Luxembourg REIF outside the ambit of product laws, taking on any Luxembourg corporate form, contingent on AIFMD compliance. The most favored entity is the Luxembourg special limited partnership, functioning as an alternative investment fund, managed by an EU-authorised AIFM, registered European AIFM, or non-European AIFM, depending on assets under management, and the requirement for a European marketing passport to raise capital. Such REIFs are exempt from CSSF supervision and investment constraints.

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Except SICARs,
Luxembourg REIFs can be SICAVs (variable capital investment companies) or FCPs (co-ownership managed by Luxembourg management company). A SICAV is a Luxembourg company (of any type) whose capital constantly fluctuates, without any further formalities, with changes in subscriptions, redemptions and valuation of assets, so that it is at all times equal to the net asset value of the company (i.e., the value of its assets minus liabilities). An FCP is not a legal entity. Investors subscribe for units in the FCP which represent a portion of the net assets, and they are only liable up to the amount they have contributed. Voting rights are typically absent for FCP investors, and decisions regarding investments and operations rest with the management company, unless otherwise specified in fund documentation.

The administration of a Luxembourg REIF requires the appointment of a Luxembourg depositary, responsible for verifying asset ownership. Eligible depositaries encompass Luxembourg credit institutions and professional depositaries for assets other than financial instruments.

The annual report of a Luxembourg REIF must be audited by a Luxembourg authorised independent auditor (*réviseur d'entreprises agréé*). Luxembourg GAAP and IFRS are the applicable accounting standards, except for unregulated alternative investment funds in the form of special limited partnerships.

The registered office and central administration of a Luxembourg REIF must reside in Luxembourg. Hence, in instances where adequate internal resources are lacking, the appointment of a domiciliary and fund administrator, overseen by the CSSF, is necessary for the administration of a Luxembourg REIF.

External financing solutions for Luxembourg REIFs

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External financing solutions are available to managers of Luxembourg REIFs at all levels of the capital structure.

The subscription line financing is a useful liquidity tool, frequently used by REIF managers. Also called, capital call facility, this financing is provided by lenders directly to the fund, where the recourse of the lenders is to the uncalled investor commitments of the fund. These arrangements are usually short-term facilities used to bridge the capital contributions of the investors and are subject to a borrowing base, determined by the value of the investors' available commitments satisfying certain eligibility criteria. Typically, the security package is comprised of a pledge by the fund of its rights under the uncalled investors' commitments, and the claims against the investors in relation thereto, as well as of a pledge over the bank account dedicated to investors' contributions.

Luxembourg REIFs' managers may also have access to net asset value (NAV) or asset-backed financing arrangements. These borrowing arrangements are facilities made available to the fund (or an SPV held by the fund) with recourse to the fund's portfolio of assets. Given that the borrowing base is calculated on the net asset value of the assets of the fund (being the primary source of repayment), this financing product is usually made available at an advanced stage of the investment period, once the REIF has acquired sufficient investments. Lenders will analyse the underlying investments, as well as cash flows and other distributions that the REIF will receive from those investments. The security package may be composed of pledge over shares, receivables, loans and/or bank accounts into which investments proceeds are to be paid with the aim to allow the lender to control the underlying assets or distributions paid on such assets. NAV facilities may be used for working capital, follow-on investments, distributions or provide liquidity to distressed portfolio companies.

Hybrid products combining subscription financing and NAV financing features may also be used by Luxembourg REIFs.

At asset level, a secured loan made by third party lenders remains the key financing tool for managers of REIFs, with two main types of product: the investment loan (financing of an existing property let to existing tenants) and the development loan (financing of a purchase and development of a property). The borrowing entity is usually the company holding the real estate asset and the typical security package for these financings are a mortgage over the financed property, as well as security interests over any other of the borrower's assets, such as bank accounts into which any accounts or proceeds are paid. It is also common for the shareholder of the borrower to pledge all its interests (shares and claims) in the borrower. In addition, in a development loan, lenders will also seek to take security over the rights of the developer in respect of any development documents during the construction phase. Lenders may also require that the REIF provides credit support for the obligations of the borrowing entities (notably equity commitment letters or guarantees).

Where the amount of the loan to be advanced (combined with the REIF's equity contribution) is not sufficient to finance the project, mezzanine financing solutions, which will be structurally or contractually subordinated to the senior lenders' debt, can be implemented to bridge the gap.

A view from underneath the REIF – SPVs, co-investments, and joint ventures

In addition to being the jurisdiction of choice for the establishment of the fund, Luxembourg is also a suitable destination for the asset acquisition structure of the REIF due to its flexible but predictable tax, legal, regulatory and general commercial environment. In addition, Luxembourg collateral law offers a unique blend of flexibility and certainty for the creation, perfection and enforcement of security interests (in particular over the shares of a Luxembourg company), making Luxembourg a jurisdiction of choice for structuring leveraged finance transactions in particular.

An important point of attention from a Luxembourg law perspective is the fact that Luxembourg follows the "real seat" theory, which means that - unlike other jurisdictions such as the Netherlands, Ireland and the United Kingdom, which follow the "incorporation" theory - a Luxembourg entity is considered to be a Luxembourg entity and subject to Luxembourg law only, to the extent that it has its "real seat" in Luxembourg. Many different terms are used in connection with this concept - 'central administration', 'principal place of business', 'effective management', 'domicile' - with Luxembourg company law referring to both 'central administration' and 'domicile'. Under Luxembourg company law, there is a rebuttable presumption as a matter of law that the central administration of a company is located at the address of its registered office.

The presence or substance of the company in Luxembourg may also be a condition for access to tax benefits (in particular under tax treaties). In the case of a tax transparent fund, such access to tax treaty benefits may be particularly important for the Luxembourg company (typically a SARL and often referred to as a Master HoldCo) that sits immediately below the REIF, and is used by the REIF as an investment platform.

A chain of Luxembourg companies is often involved in the acquisition structure set up below the Master HoldCo in order to meet the various liability shield, tax or financing structuring requirements. For investments of a REIF, the Luxembourg *société à responsabilité limitée* (SARL) remains the most popular choice for financing entities and acquisition vehicles further down the chain.

A leveraged acquisition structure will typically include at least one other mid-tier holding SARL above the SPV used to invest in the property, with additional holding SARLs potentially added to the chain to facilitate co-investments or joint ventures.

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While typical joint ventures between the REIF (via a chain of subsidiaries) and the asset manager are designed to marry the interests of the capital provider with the expertise and asset servicing knowledge of the asset manager, while ensuring that the manager has sufficient "skin in the game", co-investments are becoming increasingly popular with investors seeking to gain more direct exposure to interesting and attractive assets, while benefiting from a better deal on fees, or a better grip on governance and exit strategy.

A wide range of financing structures are available under Luxembourg law. Typically, transactions are funded by investors through a variety of different financing instruments, split between equity (ordinary shares, preference shares, warrants) and debt (loans, bonds, preference shares), with most transactions involving a combination of two or more such instruments. Bank financing is typically secured by pledge agreements (most commonly share pledges, receivables pledges and account pledges).

In terms of exit, the most common full exit mechanism is the sale of the SPV holding the assets, followed by the liquidation of the holding stack. In a partial exit scenario, cash is returned to the REIF through share redemptions, dividend distributions or debt repayments, or a combination of these.

Conclusion

The Luxembourg real estate fund landscape is characterised by several notable trends. One prominent trend is the sustained growth of larger funds, boasting assets under management exceeding one billion EUR. Despite current concerns about rising interest rates, the appetite for alternative investments and private assets is steadily growing. Investors are looking for innovative products aligning with long-term objectives and diversification. Alternatives, including real estate, are also becoming integral to pension solutions. With interest rates stabilising as central bank policies become more predictable, a renewed interest in real estate investments is anticipated, with a particular focus on sustainability, underlining the sector's resilience and potential upswing. With its global reputation for real estate investment funds, Luxembourg is well equipped to provide solutions for all stages and needs of the real estate fund and investment lifecycle, and is expected to remain at the forefront of developments.

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