The Real Estate M&A and Private Equity Review

Third Edition

Editors
Adam Emmerich and Robin Panovka

The Law Reviews

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THE REAL ESTATE M&A AND PRIVATE EQUITY REVIEW

Third Edition

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Editors
Adam Emmerich and Robin Panovka

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Chapter 15

LUXEMBOURG

Pierre Beissel and Stessie Soccio[1]

I OVERVIEW OF THE MARKET

i Development of the real estate market in Luxembourg

Before being a major financial marketplace, Luxembourg was initially an agricultural country. As the first EU country to adopt the European directive governing UCITS[2] into national law in 1988, Luxembourg achieved a major turning point in its history by becoming the principal centre for investment funds in Europe and in the world. Luxembourg has emerged as the leading domicile in Europe for vehicles investing directly or indirectly in internationally diversified real estate portfolios. Currently, assets managed by Luxembourg investment funds represent (1) approximately 26.3 per cent of the total assets managed by investment funds in the European Union, putting Luxembourg in first place, and (2) approximately 9.1 per cent of the total market share worldwide, ranking Luxembourg second after the United States.

Its demographics and strategic geographical position have had an enormous impact on the real estate market in Luxembourg and this is set to continue. The demand for office and residential space is very high relative to the country's size, and this is a main driver for continued growth. The total value of the office market in Luxembourg was estimated at around €23 billion in 2014. 2016 ended as the best year since 2007, exceeding the billion-euro volume for the first time at €1.016 billion, and 5 per cent higher than a year ago thanks to large transactions, primarily including office buildings.[3] Based on projections provided by PricewaterhouseCoopers Luxembourg (PwC), this market is expected to grow by a compounded annual rate of 5.9 per cent until 2020, reaching a total value of some €32 billion.[4] Within the Luxembourg real estate market, residential investment is by far the strongest. Its total value was over €122 billion in 2014 and it will continue to grow at a compounded annual rate of 5 per cent to nearly €158 billion by 2020.[5] The rental market (focused on apartment letting) is also important in the Grand Duchy of Luxembourg but it is mainly concentrated in Luxembourg City and its neighbouring areas.

In 2016, 45 per cent of Luxembourg's working population was composed of cross-border workers. This factor combined with the steady growth of the resident population explains the rapid increase of major infrastructure projects and strategic challenges. One of the main factors that guarantee sustainable growth for the Luxembourg real estate sector is the political

1 Pierre Beissel is a partner and Stessie Soccio is a senior associate at Arendt & Medernach. This chapter is accurate as of July 2017.

2 Undertakings for collective investment in transferable securities.

3 Jones Lang Lasalle, 'Office market report Luxembourg: 4th quarter 2016', p. 6.

4 Projections from PwC in 'Luxembourg Real Estate 2020: Building blocks for success', 2015, p. 17.

5 Projections from PwC in 'Luxembourg Real Estate 2020: Building blocks for success', 2015, p. 20.

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and economic stability, which is key for foreign investors to invest in the country, to set up their headquarter or European hub of operations. Following its growth in the past years, the investment market has become more and more international. Investors from Europe comprise 83 per cent of the market, with the remainder coming from the Americas, Asia and the Middle East.

ii The Luxembourg market of real estate investment funds

The number of real estate fund units has continued to grow during the past few years, bringing the total number of real estate fund units domiciled in and operated from Luxembourg to 315 in 2016.[6] The annual Real Estate Investment Funds Survey by the Association of the Luxembourg Fund Industry (ALFI) in conjunction with Ernst and Young Luxembourg revealed that real estate assets in Luxembourg had reached more than €39 billion by the middle of 2015, up from €32 billion a year before. The total number of real estate investment funds (REIFs) increased by 10 per cent from the previous ALFI survey and between 2006 and 2016 the number of direct REIFs has grown by a compounded annual rate of 16.45 per cent.[7] 2016 was another good year for Luxembourg-domiciled REIFs, as the population expanded by 26 direct funds, of which three are manager-regulated alternative investment funds (AIFs), and one is a RAIF (as defined below). This brought the total number of REIFs surveyed to 256 vehicles, including 12 SICARs (as defined below), 13 manager-regulated AIFs[8] and one RAIF.[9]

In 2016, 73 per cent of the 230 direct funds were created in the form of a Fonds Commun de Placement (FCP) (excluding investment companies in risk capital (SICARs)), usually in combination with the specialised investment fund (SIF) regime.[10] The trend towards the FCP form has continued to reverse in line with the 2015 ALFI survey compared with findings from earlier surveys, since investment companies with variable capital (SICAVs) now account for 46 per cent. The most recent development in legal structuring has been the updating of the limited partnership laws in Luxembourg in 2013 (SCS and SCSp) with 57 funds reported (22 per cent) in 2016.[11] Since the introduction of these new laws, the number of SCS or SCSp funds and other regulated vehicles has significantly increased, while the set-up of FCPs has decreased. The SCS and SCSp are very attractive because of their flexibility and alignment with common law-style limited partnerships.

In 2016, new fund launches were triggered overwhelmingly by initiators from Europe, with German, Benelux, UK and US initiators being the most active.[12] The most common target sector remains the 'multi-sector' with 53 per cent (compared with 61 per cent in the ALFI 2015 survey). Among the sectors themselves, the categories 'retail', 'office' and

6 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 6.

7 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 4.

8 A manager-regulated AIF refers to an investment fund that is not established under a regulated fund regime in Luxembourg (e.g., SIF/SICAR), but instead is formed solely under corporate or partnership law. The managers of such a vehicle are typically themselves regulated or registered directly under the AIFMD (as defined herein).

9 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 4.

10 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 11.

11 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 11.

12 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 4.

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'residential' are equally represented this year, with 26 per cent, 23 per cent and 22 per cent respectively. Of the direct funds surveyed, 80 per cent invest in Europe, whereas 9 per cent of funds invest globally and 6 per cent in the Asia Pacific region.[13]

II RECENT MARKET ACTIVITY

Since 2014, while a major return of German institutional investors and French insurance companies within real estate transactions has been observed, the most striking factor has been the arrival of many investment funds from the United States and even the Middle East. It is for this reason that while Union Investment and Axa have been constantly increasing their presence, Blackstone, Starwood and Moor Park Capital have made a highly visible entry, and a sovereign fund, the Abu Dhabi Investment Authority, or ADIA, has acquired the project that will change the face of Luxembourg city centre.

i M&A transactions

Some of the most significant M&A transactions of the past few years (local and international deals) are summarised below.

Local deals

Acquisition of two properties in Luxembourg by the Felix Giorgetti group

In 2015, the Felix Giorgetti group made a partnership with Immobel and CLI for the purchase, through an asset deal for a total of €47 million, of two properties in the cities of Luxembourg and Differdange on which mixed real estate projects (office, retail and housing) will be developed (40,000 square metres in Luxembourg and 2,350 square metres in Differdange).

ii Private equity transactions

Local deals

Le Dôme

Blackstone carried out the acquisition of Le Dôme, a 22,000 square-metre office building located in Luxembourg city's station district, at the end of 2014. At that time, this was the largest transaction seen in Luxembourg since 2007. In 2016, the building hosting ArcelorMittal's headquarters in the Gare district was reportedly bought by the French asset management firm Amundi; the Le Dôme – Espace Pétrusse building was acquired by Amundi for €130 million.

Atrium Business Park

In the fourth quarter of 2016, German fund KanAm sold the Atrium Business Park in Bertrange, totalling approximately 50,000 square metres, for an estimated €250 million. The acquirer is another German investor, Deka. This sale, combined with that of the Espace Petrusse building sold earlier this year, realised around €380 million in 2016 for KanAm from its former Luxembourg portfolio.

13 ALFI survey, 'Luxembourg Real Estate Investment Funds 2016', p. 4.

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International deals: Luxembourg as a hub

Acquisition of the Vendôme Saint Honoré building in Paris

In 2016, Norge Bank Investment Management acquired the Vendôme Saint Honoré building in Paris for a total of €1 billion. The sellers of the property were Trajan Luxembourg Sàrl and Trajan Luxembourg II Sàrl, both controlled by private investors John Magnier and JP McManus, both Irish businessmen and racehorse owners. Norges Bank Real Estate Management is a real estate investment firm based in Norway. It operates as a subsidiary of Norges Bank Investment Management.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

No REIT legislation and no publicly traded REOCs

Even though Luxembourg does not have REIT-specific legislation or publicly traded REOCs, its existing investment vehicles – whether regulated or not – offer the flexibility required to favourably structure real estate investments for a variety of investors in a plurality of target countries. It is often the combination of the different vehicles that offers flexible and tax-efficient investment structures for pan-European real estate investments.

Listing of real estate investment structures on the Luxembourg Stock Exchange (LuxSE)

Listing the widest range of securities in Europe, including shares, units, warrants, global depositary receipts, certificates or debt securities, LuxSE offers an attractive trading platform for real estate investment structures. It provides a strong regulatory framework in line with the EU Directives on securities markets, allowing access to a fast, flexible and secure listing process, as well as to timely and transparent information thereby building strong foundations on which to raise funds and build investor confidence. Listing in Luxembourg is relatively straightforward and flexible. A listing agent is not mandatory.

ii Real estate PE firms – footprint and structure

Legal framework for real estate PE firms – introduction

Luxembourg is often used as the location of choice of professional, institutional and private investors for companies acquiring real estate. The choice of the legal form and regime will depend notably on (1) the target investors, (2) the investment strategy pursued, (3) the tax components, and (4) the marketing strategy. The Luxembourg legal framework also encourages the development of real estate funds and is diverse and flexible to meet a wide range of investor needs, and the Luxembourg taxation regime is a key factor when considering whether to choose an unregulated or regulated real estate investment vehicle for international investors.

AIF qualification

Luxembourg real estate investment vehicles, whether regulated or not, may qualify as AIFs within the meaning of the Alternative Investment Funds Managers Directive (AIFMD). The AIFMD was transposed into Luxembourg law by the law of 12 July 2013 on alternative

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investment fund managers (the AIFM Law). The AIFM Law regulates AIF managers (AIFM), but it also contains various provisions applicable to qualifying AIFs, regardless of whether the AIF has been set up as a regulated vehicle or as a non-regulated vehicle.

Regulatory framework: regulated versus unregulated structures

Regulated structures are those fund vehicles that are authorised and supervised by the Commission de Surveillance du Secteur Financier (CSSF). The primary law applicable to regulated funds is the law of 17 December 2010 relating to undertakings for collective investment (UCIs Part II), as amended (the 2010 Law). The UCI Part II is the sole regulated real estate vehicle that can be offered to retail investors, subject to the compliance with the 2010 Law providing certain protections to investors in such a vehicle.

The 2010 Law is complemented by the law of 13 February 2007 on SIFs, as amended (the SIF Law). Interests in funds that are subject to the SIF law may only be sold to 'well-informed investors'. In addition to the usual market of institutional and professional investors, this opens SIFs to high-net-worth individuals who meet the requirements of the SIF law. Though not specifically designed for real estate, the SIF offers a great deal of flexibility, which makes it a very appealing real estate investment vehicle. The SIF is not restricted to real estate investments. SIFs are not subject to general investment restrictions but must ensure adequate risk of diversification and disclosure. With the 2007 SIF Law, Luxembourg has also been able to cope with the great demand for alternative investment vehicles from investors around the world. This is reflected in the significant number of regulated funds investing in real estate assets that have been created under this regime.

There is also another Luxembourg vehicle, the SICAR, which is not classified as a fund but aims at directly or indirectly contributing assets to innovative projects with value creation at the level of portfolio companies (e.g., development projects, refurbishment) without being subject to risk-spreading requirements.

Unregulated vehicles are typically set up as companies or partnerships under the law of 10 August 1915 on commercial companies, as amended (the 1915 Law). They often take the form of a private limited company (Sàrl), a partnership limited by shares (SCA) or a limited partnership with or without legal personality (SCS or SCSp). When companies have as their main purpose the holding and financing of participations in other companies (which in their turn may own real estate), these companies are often referred to as SOPARFIs. While unregulated vehicles operate in a manner similar to regulated funds, unregulated vehicles offer greater flexibility (for example, in terms of choice of service providers) and lower set-up and operating costs (as opposed to investment vehicles subject to regulatory oversight and restrictions). Regulated vehicles benefit from, among other things, a favourable tax status and a high level of investor protection. Although not specifically designed for real estate, the time-efficient nature of the SOPARFI makes it very suitable for real estate. It is not subject to risk-spreading requirements nor is it restricted to any specific types of investments.

Unregulated vehicles tend to have a small group of investors and a simple capital structure. Notwithstanding the foregoing, unregulated vehicles may have a greater total size than regulated funds with more investors.

Finally, the reserved alternative investment fund (RAIF) vehicle was introduced by the Luxembourg law of 23 July 2016 (the RAIF Law). The RAIF, which is also subject to the 1915 Law, combines the characteristics and structuring flexibilities of Luxembourg regulated SIFs and SICARs qualifying as AIFs managed by an authorised AIFM, except that RAIFs are not subject to CSSF approval before they are launched. This new structure is viewed

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as complementing Luxembourg's attractive range of investment fund products and again demonstrates the understanding the Luxembourg legislator has of the needs of the fund industry to best serve the interests of investors. The RAIF structure allows real estate fund initiators to set up Luxembourg-domiciled funds that are not subject to regulatory approval by the Luxembourg supervisory authority. This option permits the achievement of a significantly enhanced time-to-market for new fund launches. The RAIF Law will significantly compete with the SIF Law regime in Luxembourg in the near future.

Legal structures

Real estate funds governed by the 2010 Law, the SIF Law or the RAIF Law may be set up either in corporate form (e.g., SICAV-SCA or SICAF-SA), in contractual form (FCP) or as a limited partnership (SCS or SCSp). A key determining factor in the selection of one of these structures is the tax regime applicable to investors: FCPs and limited partnerships are tax transparent, whereas SOPARFIs, SICAVs and SICAFs are opaque for tax purposes.

IV TRANSACTIONS

i Legal frameworks and deal structures

Deal structures

When two companies are contemplating an M&A transaction, a crucial preliminary consideration is the legal structure that the transaction should adopt. Determining the transaction structure may be challenging as the buyer and target often have competing interests and different perspectives.

Two types of transactions are mainly carried out in Luxembourg:

a the sale of an existing portfolio (asset or share deal). In the past few years, the number of this type of transaction increased considerably as some German funds that had to be liquidated proceeded to sell their existing portfolios; and

b the sale of a project generally through a share deal with a binding engagement on the developer to build a specific office or retail building for first-class tenants for at least 75 per cent of the surface area.

When transferring real estate in an asset deal, one company will sell directly the property or real estate assets to another company, while in a share deal, the shares of the company owning the property or real estate assets are sold. Both structures are used, but we have noticed that the majority of real estate transactions in Luxembourg are generally carried out through a share deal as the target company that holds the building carries forward its losses and the purchaser avoids registration duty. However, if the purchaser has adopted the form of a SIF and the targeted building generates profit (rents), an asset deal could be deemed more suitable and interesting, as the SIF is exempt from corporate income tax and net worth tax.

Normal process to acquire a property or a real estate project in Luxembourg

Real estate transactions usually begin with negotiations performed under a confidentiality and exclusivity agreement. In a first step, they are materialised either with a letter of intent or head of terms to be countersigned by the seller (binding or not and with an exclusivity clause or not until the execution of a share purchase agreement). After having executed the letter of intent, the buyer performs several due diligence processes to determine, identify, assess and

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limit the risks associated with the acquisition of the real estate assets (legal, administrative and tax, financial audit review, as well as environmental and technical due diligence checks). If the outcome of the due diligence process is not positive (e.g., lack of due authorisations), it may be viewed as a deal-breaker item. Further to the findings of the due diligence process, a share purchase agreement (SPA) should be drafted to secure the sale. The content thereof is subject to the outcome of the due diligence process and depends on the tax and financial structure of the contemplated transaction. The SPA will be subject to the law of contract in general and the specific rules applicable to sales. As soon as there is mutual consent between seller and purchaser as to the specific asset and the price, a sale agreement is thus concluded even if the asset does not yet exist. It is, however, important to be prudent with regards to the preliminary agreements or binding letters, as these could be viewed by the Luxembourg courts as a binding sale and purchase agreement between the parties.

Asset deal

In an asset deal, the buyer purchases only the real estate assets – and assumes only those liabilities – that are specifically specified in the purchase agreement. In this case, the purchaser will generally only inherit those liabilities that it specifically assumes pursuant to the terms of the asset purchase agreement. Some liabilities, such as environmental liabilities, may follow the related assets without a specific assumption in the asset purchase agreement. Where the purchaser is reluctant to acquire certain liabilities of the target company, the purchaser will generally prefer an asset deal. Therefore, the risks and potential liabilities assumed as a result of the acquisition are, in principle, limited to the acquired assets and liabilities. When acquiring real assets through the acquisition of shares of the company that owns the real estate assets, all underlying assets and liabilities are (indirectly) transferred as well.

From a legal point of view, the acquisition of real estate through an asset deal is most often carried out in two distinct phases: (1) a private agreement between parties, and (2) a notarial deed.

Private agreement

The private agreement may be constituted by a number of legal mechanisms such as an offer letter, an undertaking to sell or, most often, by a preliminary sale and purchase agreement.

Parties are free to negotiate the terms and conditions of such agreements, in any language, and no standard forms are imposed. The effect of preliminary sale and purchase agreements is to bind the parties, and the transfer of ownership documented in such contracts is perfectly valid. However, these agreements are not enforceable against third parties; for them to become enforceable against third parties, a notarial deed is required.

Notarial deed

To have the transfer of ownership registered and to confer rights against third parties, the transfer of title needs to be recorded at the mortgage register. The registered deed will take the form of an authentic deed with respect to its date and content and is valid between parties and fully enforceable against third parties. The signing of this public notarial deed will include the release of the securities granted on the assets guaranteed by the seller, as well as the warranty against defects or latent defects and any pollution.

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Share deal

Instead of the direct acquisition of real estate, quite often special purpose vehicles are set up for tax reasons, whereby the company holding the real estate can be acquired or sold. The purchaser will acquire the shares of the target company and will therefore indirectly take ownership of all of the target company's assets.

ii Acquisition agreement terms

Asset deal

Particular attention must be paid to the following clauses:

a release of mortgages;
b any termination provisions linked to the vendor's privilege (should the amount not be fully paid at the signing date);
c contractual limitation of the warranty against eviction and any hidden defects;
d warranty on the surface area and on the lease agreements signed;
e warranty that the building has obtained all the administrative authorisations; and
f warranty that no pre-emption rights in favour of third parties nor risk of nullity of the sale exists.

As the Luxembourg Civil Code provides that a true possessor shall acquire an ownership title through simple occupancy without any interruption during 30 years, a purchaser should request a public notary to verify the title over this period and to have the seller warrant the ownership.

Share deal

The SPA generally contains the most common boilerplate clauses set out in this kind of agreement, and in particular:

a share purchase price and payment conditions (several forms of purchase price adjustments can be considered);
b conditions precedent (reimbursement of loans, acquisition of a plot of land, obtaining of building permits, etc.);
c the absence of material adverse change between the signing and the closing;
d the process until completion (information obligations of the seller towards the purchaser and, to a certain extent, veto power of the purchaser on major issues regarding construction, handing-over and letting);
e conditions subsequent (such as authorisation to be obtained, follow-up for the final acceptance of the project and fine tuning re daily operating of the building);
f representations and warranties of the buyer and the seller;
g arbitration clause for accounting and construction matters;
h terms of the prescription of claims between 12 and 24 months after the closing of the transaction; and
i provisions, such as insurance, to limit the liability and exclude any claims for facts disclosed before the signing or for those claims for which the purchaser can seek indemnities against third parties.

Regarding the insurance, it should be noted that the parties focus more and more on warranty insurances, particularly in distressed M&A situations.

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Last but not least, by application of the general principles of Luxembourg civil law, the essence of a share transfer includes the transfer of title to the shares. As a result, the transfer of shares includes the transfer of title to the shares and assumes that the seller has a valid title. However, share purchase agreements under Luxembourg law typically provide for very strict seller's warranties and indemnities explicitly relating to the seller's title to the shares.

iii Financing considerations

Depending on their legal form, SOPARFIs, SIFs and UCIs Part II may be financed through a variety of equity, debt and hybrid instruments (including (convertible) preferred equity certificates – i.e., CPECs and PECs) for these transactions. The acquisition of real estate assets or shares is also generally made through financing from a bank. Transactions are typically structured with a combination of equity and senior bank debt. For projects that are sold in two steps (signing and closing), the future purchaser may replace the banking loans with a mezzanine loan. Luxembourg regulations provide for a wide range of tools to secure first the financing of construction works and second the acquisition costs (i.e., mortgage, pledge over the shares or bank accounts or receivables, assignment of receivables, assignments of rental income or assignment of VAT claim and a joint and several guarantee).

ix Tax considerations

Generality

As a general rule, income derived from real estate is taxed in the country of location of the real estate assets. In contrast, profits from the sale of shares in a real estate asset held through a foreign company are taxed in the country of residence of the seller, according to the ordinary rules of double tax treaties (to be checked on a case-by-case basis).

Asset deal

Following the general situs principle applicable, income from the sale of real estate is taxed in the country where the real estate is located (with some exceptions for some double tax treaties).

Registration duties are applicable to transactions triggering the transfer of real estate located in Luxembourg. The registration duties are assessed on the higher of the purchase price and the fair market value.

Pursuant to Article 44, Section 1(f) of the Luxembourg VAT law, transfers of real estate are exempt from VAT; as a result no VAT is due when a transfer takes place and, accordingly, no input-VAT deduction is granted. There are two main exceptions to this: the transfer of ownership of a property before construction is started is always subject to VAT, and other transfers of property are subject to VAT if a VAT option form is filed with the VAT authorities. The advantage of this second exception is that the seller has the right to deduct its input VAT on overheads and investment costs.

Share deal

The disposal of the shares of a special purpose vehicle is opaque for registration tax purposes and is not subject to any Luxembourg registration tax or stamp duty, if the disposal is not recorded in a Luxembourg notarial deed. If the share purchase agreement is voluntarily registered, a fixed registration of €12 would apply.

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V CORPORATE REAL ESTATE

The 2006 boom in M&A was fuelled by increasing liquidity and the willingness of banks to finance acquisitions – and private equity funds played a major role. The pace of M&A activity shows no signs of slowing down and intense competition in the market has led buyers to seek new ways to increase third-party leverage and reduce financing costs. A key method is the 'opco/propco' structure. Luxembourg companies in local and international deals have also followed this trend and in some transactions, they own real estate assets in property companies separated from the operating companies. This structure is also applicable to some international deals, in which Luxembourg is involved as a hub.

VI OUTLOOK

The market for real estate investment vehicles in Luxembourg is constantly developing to provide investors with flexible and innovative real estate investment products. The growth in the number of real estate investment vehicles set up in Luxembourg has outpaced the European average and makes Luxembourg one of the best choices for real estate funds. Luxembourg remains the leading European domicile for vehicles investing in international real estate and this position will increase in the coming years as a result of Brexit. Following Brexit, funds established in the United Kingdom will automatically become 'third-country' funds and UK-based fund managers will become third-country managers, for the purposes of the AIFMD.

Consequently, the United Kingdom will lose its European passport for cross-border distribution of investments funds. London City operators would have to move parts of their services to financial centres. Luxembourg could have a good hand in this game, as it specialises in investment funds. Many funds from the United Kingdom already have a subsidiary in Luxembourg, where funds are conceived and registered before they are managed elsewhere, primarily in the City of London. Luxembourg will reinforce this subsidiary position and become the entry point to the European market.

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Appendix 1

ABOUT THE AUTHORS

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Arendt & Medernach

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