IN-DEPTH

Real Estate M&A And Private Equity

LUXEMBOURG

Real Estate M&A and Private Equity

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In-Depth: Real Estate M&A and Private Equity (formerly The Real Estate M&A and Private Equity Review) is a multinational guide for understanding and navigating the increasingly complex and dynamic world of liquid real estate and the transactions that mostly produce it. Leading practitioners from around the globe offer practical insights into what is going on around the conference tables and in the markets in their jurisdiction, with an eye to cross-border trends and transactions.

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Luxembourg

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Introduction

Development of the real estate market in Luxembourg

Luxembourg was originally an agricultural country, but the discovery of iron ore around the mid-nineteenth century, and the development of a powerful iron and steel industry, grew the Grand Duchy's wealth until the 1970s.

Aware of the risk of relying on only one sector, the political authorities had been working towards industrial diversification since the 1960s, and this is still ongoing.

These actions have been highly successful; today, the financial sector is the main driver of Luxembourg's economy. The financial centre is one of the top international financial centres, and Luxembourg's fund industry is the largest in the European Union and the second-largest in the world, just after the US.

In that context, the Grand Duchy has become the leading domicile in Europe for fund vehicles investing directly or indirectly in internationally diversified real estate portfolios.

Prior to the pandemic, on the asset side, Luxembourg's demographics, strategic geographical position, and political and economic stability had a huge impact on the development of its real estate market. The demand was reinforced at the time due to Brexit and the arrival of some financial and insurance sector players and their employees.

The pandemic, increased working from home policies and uncertainties around the consequences of the high inflation period have impacted the market. These have resulted in 2022 and 2023 being very difficult years for the real estate market.

Luxembourg real estate market: asset side

For the real estate market, 2023 was an annus horribilis. High inflation, interest rate increases and high construction costs have paralysed both real estate investment and construction markets.

The office market was severely impacted, with very limited investment due to rising investment yields.

Compared to the record year of 2022, the volume of real estate transactions dropped by approximately 39 per cent in 2023 to around €531 million; and, compared to 2018–2022, volume collapsed by 65 per cent.[1]

In the retail market, 2023 represented a stable year in terms of take-up because of stable rents.

The residential sector (in future state of completion) faced a decrease of more than 60 per cent between the second quarter of 2022 and the second quarter of 2023, principally caused by the significant decrease of rental investments. A decrease of more than 50 per cent was also seen in building plot sales.

Year in review

M&A transactions

There is no specific market or transactional information to report.

Private equity transactions

The most significant private equity transactions of the past few years to be reported are summarised below.

Kronos

In August 2023, BGL BNP Paribas sold its historical headquarters in the Kirchberg district of Luxembourg City to KPMG and BPI. BPI intends to redevelop the site, including developing new 31,000m² headquarters for KPMG.

Connex Avenue

In November 2023, Felix Giorgetti Group sold the Connex Avenue building, a 3,000m² office building in Luxembourg City, to Luxembourg Business Registers.

Royal Park

In March 2024, Pontegadea, the family holding company of Amancio Ortega (Inditex), acquired the Royal Park in Luxembourg City from Baltisse. With an estimated investment of €175 million, it is the largest transaction on the real estate market so far in 2024.

Real estate companies and firms

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

Absence of publicly traded REITs and REOCs

Luxembourg has neither a real estate investment trust regime nor publicly traded real estate operating companies.

Real estate private equity firms – footprint and structure

Real estate investment funds (REIFs) are predominantly structured using the following fund regimes:

1. specialised investment fund (SIF), governed by the Luxembourg law of 13 February 2007 relating to specialised investment funds (the SIF Law);

2. reserved alternative investment fund (RAIF), governed by the Luxembourg law of 23 July 2016 on reserved alternative investment funds (the RAIF Law);
3. investment company in risk capital (SICAR), governed by the Luxembourg law of 15 June 2004 relating to the investment company in risk capital (the SICAR Law);
4. unregulated alternative investment fund (AIF) structured as a common or special partnership (unregulated AIF partnership), governed by the Luxembourg law of 10 August 1915 on commercial companies (the Company Law); and
5. undertakings for collective investment governed by Part II of the Luxembourg law of 17 December 2010 relating to undertakings for collective investment (Part II UCI).

Except for the unregulated AIF partnership, which is a manager-regulated product, and RAIFs, all other Luxembourg REIFs formed under the above-listed regimes are regulated funds and require prior approval of the Financial Sector Supervisory Commission (CSSF). In addition, REIFs can take different legal forms and be set up using different structures.

Regulatory regimes

The 2023 annual Real Estate Investment Funds Survey by the Association of the Luxembourg Fund Industry (the 2023 ALFI Survey) reveals that the RAIF and SIF regimes are the favoured regulatory regimes for REIFs in Luxembourg. Following a significant and continuous increase in their usage over recent years, the Survey reports a prevalence of the RAIF regime over the SIF regime in 2023, confirming the attraction of the RAIF regime as a popular option for structuring real estate-focused investment funds. The main difference between the SIF and the RAIF is that the RAIF is not subject to direct supervision of the CSSF and therefore allows more flexibility in terms of time to market as there is no need for prior regulatory approval to launch a RAIF. Otherwise, the regimes are very similar (if not identical).

Neither SIFs nor RAIFs are subject to any restrictions in terms of eligible assets, subject to a risk diversification requirement. They may invest in property consisting of land or buildings, or both, registered in the name of the SIF or RAIF, and equity or debt instruments, or both, issued by real estate companies whose exclusive purpose is the acquisition, promotion and sale, as well as letting and tenanting, of real estate as well as various long-term real estate-related interests such as surface ownership, lease holds and option rights on real estate assets. In general, the risk diversification is complied with if a SIF or RAIF does not invest more than 30 per cent of its assets or subscription commitments into a single property or the same property right or the same issuer of property rights. In practice, a ramp-up period of up to four years can be foreseen during which the diversification requirement does not apply. Neither SIFs nor RAIFs are subject to any borrowing restrictions.

In terms of capital raising, both SIFs and RAIFs are reserved to well-informed investors: that is, investors that are institutional investors, professional investors or investors that declare their adherence to the status of well-informed investor and either invest at least €100,000 (effective as of 28 July 2023 following the entry into force of the Luxembourg Law of 21 July 2023 (the Modernisation Law), amending, inter alia, the SIF Law and the RAIF Law (formerly well-informed investors were required to invest at least €125,000)) in

a SIF or RAIF or produce an attestation from a regulated bank, investment firm, authorised alternative investment fund manager (AIFM) or management company within the meaning of Directive 2009/65/EC, certifying the investor's expertise, experience and knowledge to appraise in an appropriate manner an investment in a SIF or RAIF. A RAIF must be managed by a European authorised AIF manager (AIFM) and, hence, benefits from the European passport to raise capital from professional investors in the European Economic Area (EEA). A SIF may be structured either as an AIF or a fund not qualifying as an AIF and, if structured as an AIF, may be managed either by an authorised or a registered AIFM. If managed by an authorised AIFM, a SIF also benefits from the European passport to raise capital from professional investors in the EEA. Raising capital from high net wealth individuals qualifying as well-informed investors requires a country-by-country analysis in terms of target jurisdictions.

The growing trend of 'retailisation' of AIFs is currently causing a comeback of Part II UCIs. The main difference from the SIF and RAIF regimes is that a Part II UCI can be offered to retail investors (in compliance with applicable local rules). A Part II UCI is subject to a stricter diversification rule than the SIF or RAIF: it may not invest more than 20 per cent of its net assets in a single property, this restriction being effective at the date of acquisition of the relevant property (subject to a ramp-up period of a maximum of four years). The aggregate of all borrowings of a REIF structured as a Part II UCI may not exceed, on average, 50 per cent of the valuation of all its properties. Similar to a SIF, the Part II UCI cannot be established without prior CSSF authorisation. Similar to a RAIF, a Part II UCI is an AIF by law and must appoint either a registered or authorised AIFM (depending on the total assets under management of the manager).

Less popular for real estate assets, the SICAR is a customised vehicle originally conceived for investment in venture capital. Similar to a SIF, it may or may not be structured as an AIF and is subject to direct supervision by the CSSF. SICARs are not subject to any diversification requirements. However, a REIF can only be structured as a SICAR if the target real estate investment is considered as risk capital. This investment must be made through special purpose vehicles as a SICAR cannot acquire real estate directly. Eligibility criteria for target real estate investment is based on the concept of development. The SICAR regime is used to implement value-enhancing real estate strategies where the purpose is to achieve high yields through development or repositioning of properties. A SICAR may not be used to make a long-term, passive investment in stabilised real estate assets.

Finally, REIFs that are not subject to any product-specific laws are often structured as unregulated AIF partnerships with or without legal personality. Unregulated AIF partnerships are popular because they can be set up very quickly (without prior CSSF approval) and offer extreme operational flexibility (being very similar to Delaware or Cayman limited partnerships). They are not subject to any investment or borrowing restrictions and, if managed by a European authorised AIFM, they can raise capital from professional investors in the EEA using the European passport of their manager.

Legal forms

All of the above fund types (except for unregulated AIF partnerships and SICARs) may be organised under any of the following three categories.

1. Common fund (FCP): this is a contractual type of fund that is not a legal entity. An FCP is a co-proprietorship of assets that are managed on behalf of the joint owners (investors) by a management company that takes all the decisions relating to the investments and operations of the FCP. Investors subscribe for units, which represent a portion of the net assets of the FCP, and they are only liable up to the amount they have contributed. Rights and obligations of unitholders are defined in the management regulations, and they only have voting rights to the extent provided for in the management regulations.
2. Investment company with variable capital (SICAV): this is a corporate type of fund that has a legal personality (unless formed as a special limited partnership). The SICAV acronym means that the capital is increased or reduced automatically as a result of new subscriptions or redemptions without requiring any formalities such as shareholders' approval or intervention of a notary. A SIF, RAIF or, since the entry into force of the Modernisation Law on 28 July 2023, a Part II UCI structured as a SICAV can adopt any corporate form (formerly, a Part II UCI structured as a SICAV could only take the form of a public company (SA)).
3. Investment company with fixed capital (SICAF): this is a corporate-type fund that has a legal personality and is subject to specific formalities in terms of variation of its capitalisation (unless formed as a special limited partnership).

According to the 2023 ALFI Survey, the legal forms of the special or common limited partnership (SCS/SCSp) are the preferred choice in terms of legal structure, either in the form of a SICAV combined with the SIF regime, or set up as unregulated AIFs. Although they have been in slight decline since 2022, a trend for FCPs has been observed over the past year, notably in the context of the retailisation of professional REIFs.

REIFs (other than those structured as unregulated AIF partnerships) may be further organised as single funds or as umbrella (multi-compartment) funds. An umbrella fund is composed of one or more compartments, each of which is linked to a specific portfolio of investments that are legally segregated from the investment portfolios pertaining to the other compartments. This is the ring-fencing principle. The umbrella fund constitutes one single legal entity (SICAV/SICAF) or contractual arrangement (FCP); however, the assets of each compartment can only be used to satisfy the rights of investors in that particular compartment and the rights of creditors whose claims have arisen in connection with the operation of that particular compartment. Within an umbrella fund, compartments may have different investment policies or be restricted to certain types of investors, or both (e.g., for a co-investor).

In addition, it is also possible to create various classes of units or shares in the REIF organised as a single fund or within each compartment of an umbrella REIF. These classes of units or shares may differ, inter alia, as to their fee structure, distribution policy and type of investors, or track the performance of a specific underlying asset.

Trends and challenges

The overall trend observed over the past several years is that Luxembourg REIFs are leaning towards simplification of structures and strategies. Unless structured as SICARs, which by

definition are opportunistic, Luxembourg REIFs predominantly pursue a core strategy, with continuous and significant growth in core-plus funds, focusing on more than one sector.

Although the 2023 ALFI Survey indicates a continual increase in closed-ended funds, the growing interest of the wealth management industry in alternative assets is expected to drive up the number of open-ended unitised REIFs for years to come. In this respect, one of the key challenges for REIFs remains liquidity management, which was recently brought back into focus by the European Commission in the review of the Alternative Investment Fund Managers Directive (AIFMD), which led to the publication of Directive (EU) 2024/927 of 13 March 2024 amending the AIFMD (AIFMD II) in the Official Journal of the EU on 26 March 2024. The AIFMD II entered into force on 15 April 2024. Member States have until 16 April 2026 to transpose the AIFMD II into national law. Under the AIFMD II, AIFMs managing open-ended AIFs are able to temporarily suspend subscriptions, repurchase and redemptions, or activate or deactivate one of the other liquidity risk management tools set out in Points 2 to 8 of Annex V to the AIFMD II, which sets out a minimum list of liquidity management tools that should be available anywhere in the EU and will be further developed via regulatory technical standards from the European Securities and Markets Authority. The tools include redemption gates, extension of notice periods, redemption fees, an anti-dilution levy, dual pricing and swing pricing. Upon transposition of the AIFMD II into national law, temporary suspensions will only be permitted in exceptional circumstances where this is justified and in the interests of investors. The AIFM will be expected to implement detailed policies and procedures in relation to the activation and deactivation of selected liquidity management tools, as well as associated operational and administrative arrangements. AIFMs will be required to notify the competent authorities about activating or deactivating a selected liquidity management tool.

Finally, a key trend and challenge over recent years has been investors' and the industry's growing interest in environmental, social and governance matters. The European Union's goal to become climate neutral by 2050 has been recently translated into a regulation (the Taxonomy Regulation),[2] which aims to make it easier to determine the ecological sustainability of an investment and stimulate the reorientation towards sustainable finance. As a consequence of the Taxonomy Regulation and the related Disclosure Regulation, significant opportunities are emerging, along with challenges that REIFs need to consider, as these regulations introduce new transparency obligations for financial products. In this context, sustainability is becoming a critical aspect with a direct impact on properties and investments. In the future, higher demand and better financing conditions are likely to be expected for properties and investments offering a higher level of sustainability, with the Taxonomy Regulation sustainability criteria expected to become key factors in value creation.

Transactions

Legal frameworks and deal structures

Subject of the deal

The majority of real estate transactions (office, retail, healthcare, residential or warehouse) relate to existing and completed buildings. However, real estate developments can be acquired in future state of completion no matter the investment sector. This kind of transaction can be structured either as a forward purchase or a forward funding. Their names are similar; their operations, however, are different.

In a forward purchase structure, the parties agree to sign a sale and purchase agreement, either for the shares of the company owning real estate under development or for the real estate itself (see below), under the condition precedent of the completion of the works (in most cases, this is provisional acceptance). Transfer of ownership therefore occurs only after provisional acceptance, meaning that the investor-buyer will neither bear the construction risk nor the risk of insolvency of the developer-seller. This could also ease the financing of the transaction, which is generally negotiated before signing but with draw-down only on completion.

In a forward funding structure, the parties agree to sign a sale and purchase agreement, either for the shares of the company owning real estate under development or for the real estate itself, without a condition precedent of completion of the works. To mitigate the risk for the investor-buyer, parties usually agree on a condition precedent of definitive permits. Contrary to the forward purchase, the sale – and thus the transfer of ownership – occurs prior to the completion of the construction works and the price is paid upfront, generally in instalments over the construction process. This also means that, except for forward funding regulations prescribed under the law, the parties have to contractually agree on the process and allocation of risks during the entire construction process.

Structure of the deal

A real estate transaction is structured either through an asset deal or a share deal.

In an asset deal, the subject of the transaction is the asset itself. In a share deal, the transaction concerns the acquisition by the purchaser of the shares issued by a company holding the asset.

Both structures are observed in Luxembourg. However, the majority of transactions in Luxembourg are structured as a share deal mainly because these are not subject to real estate transfer taxes.

Acquisition agreement terms

Letter of intent

Real estate transactions usually start with the negotiation and the execution of a letter of intent containing the most important commercial and financial parameters of the transaction, referring to the envisaged steps until closing of the transaction and granting to the candidate purchaser an exclusivity period.

Sale agreement

The sale agreement usually contains conditions precedent, representations and warranties, indemnification clauses and covenants. The content of the sale agreement also reflects the outcome of the due diligence exercises performed by the purchaser's advisers for the technical, legal and tax aspects.

Imported from the UK market, Luxembourg is experiencing an upward trend in the usage of warranty and indemnity insurance, which covers undisclosed risks for the period prior to closing. Parties usually negotiate their terms of acquisition and then provide the purchase agreement to an insurance broker. The insurance company usually reviews the agreed representations and warranties to, as the case may be, exclude some from the insurance coverage. Usual exclusions concern the condition of the properties, certain environmental matters and transfer pricing.

The market is currently experiencing the development of tax insurance to guarantee identified risks, which generally excludes transfer pricing. In this process, the purchaser must provide the insurance with a robust defence memorandum stating the arguments in favour of the taxpayer and the likelihood of success in the case of litigation.

Asset deal

A real estate transaction is often completed in two phases.

The parties enter into a private sale agreement, the content of which is freely determined by the parties. Once completed, the agreement is valid and enforceable between the parties. However, the sale contemplated on the private sale agreement is not enforceable towards third parties.

For this reason, the transfer of ownership contemplated in the private sale agreement needs to be recorded in the Mortgage Register. To do so, the sale must be enacted in a deed, which must be signed before a notary public.

Share deal

Share deal real estate transactions are subject to only one document: a share purchase agreement (which does not need to be recorded or enacted in a notarial deed).

Financing considerations

Financing real estate depends on the structure chosen, the development stage of the real estate or the type of acquisition (shares versus asset deal).

Either the fund is directly financed by a master facility agreement or the financing is directly granted to a special purpose vehicle (being a direct or indirect subsidiary of the fund). The latter is usually used for development financing or direct asset financing.

In share deals, the holding company will usually be the borrower under the relevant financing to acquire the shares of the target entity and the debt will be pushed down to the target.

The security packages typically implemented are a mortgage over the real estate, a pledge over the bank accounts (rent account, etc.), a pledge over receivables (intra-group

or third-party debtors) or assignment of insurance for the benefit of the lender, and a pledge over the shares of the company holding the estate. Inter-creditor or subordination agreements are also contracted to subordinate any intra-group loans.

Luxembourg is also a prime location for international real estate financing. Luxembourg vehicles are usually used in the financing structure, not only for corporate or tax reasons, but also to strengthen the lender's position, especially when a double LuxCo structure is implemented. The efficiency of the enforcement of security (notably enforcement of share pledge) is greatly appreciated by the lenders.

Tax considerations

As a matter of general principle, real estate income (be it current income or capital gains) is taxed in the country in which the real estate is situated.

Real estate situated in Luxembourg

The tax treatment of income from real estate situated in Luxembourg depends on the investor.

Assuming the real estate is owned by a Luxembourg company, any real estate income is subject to ordinary Luxembourg corporate income taxation at an aggregate rate of 24.94 per cent (for companies having their registered office in Luxembourg City, for the tax year 2024). On top of that, the unitary value of the real estate is subject to an incremental net wealth tax charge at a rate of 0.5 per cent for a company having a net wealth below €500 million and at a rate of 0.05 per cent applied to any excess. It should be noted that the unitary value is currently (still) determined based on a rate card dating back to 1941, because of which these values are significantly lower than the current fair market values of the buildings concerned. Luxembourg property companies can, subject to certain limits and exceptions, deduct general operating expenses and interest expenses as well as depreciation charges from their taxable basis.

Transfers of real estate situated in Luxembourg by way of an asset deal can be subject to registration and transcription duties at a maximum rate of 10 per cent. Share deals are not subject to registration and transcription duties.

Real estate situated outside Luxembourg

Investors can invest in real estate situated outside Luxembourg. Based on its extensive double tax treaty network, Luxembourg generally should not have the right to levy tax over the income or capital gains derived from, or the net wealth allocable to, the real estate.

Luxembourg as an investment jurisdiction

Luxembourg has become the default jurisdiction for real estate investments and investment funds. Fund managers frequently set up Luxembourg pooling vehicles, such as SIFs, RAIFs, undertakings for collective investment in transferable securities or unregulated partnerships, as investor-facing entities. If properly structured, no material tax

leakage should occur at the level of these pooling vehicles. Luxembourg fund vehicles are generally not subject to withholding tax in Luxembourg.

Since 2021, Luxembourg has levied a 20 per cent tax on certain types of income realised by certain tax-opaque investment entities that invest into real estate situated in Luxembourg. This levy does not apply for investments in real estate located abroad.

Luxembourg is also frequently used as a jurisdiction of choice for the establishment of intermediate holding, joint venture or acquisition vehicles. In general, these entities are organised as private limited liability companies and are regular taxpayers in Luxembourg. When properly structured, they should not be subject to a material tax burden in Luxembourg. Different from investment funds, Luxembourg holding companies are subject to withholding taxation in Luxembourg. However, a wide range of exemptions or rate reductions are available. In addition, at arm's-length interest payments, loan principal repayments or liquidation distributions are not subject to Luxembourg withholding tax.

It should be noted that Luxembourg does currently not offer a specific tax regime applicable to REITs.

Finally, investment funds should also monitor their exposure towards Pillar Two, the global minimum tax rules, which entered into force in Luxembourg in 2024. Even though exemptions for certain real estate investment vehicles exist, this does not shield all entities within a given group from a potential exposure towards Pillar Two.

Cross-border complications and solutions

In addition to EU anti-money laundering requirements and EU sanctions, Luxembourg has introduced a foreign direct investment (FDI) regime.[3] Effective as of 1 September 2023, the prior approval mechanism will apply to FDI in a Luxembourg entity carrying out critical activities that may adversely affect national security or public order.

Corporate real estate

The current trend in corporate real estate is based on asset classes, and not on the type of investor. For the hotel and leisure and (care) housing sectors, the trend is to separate the operating company (opco) and the property company (propco), with the investor keeping the propco and the opco being carved out, generally via a regular sale of the business. A standard (long-term) lease agreement is then concluded between the opco and the propco. Specifically in the hotel sector, one single structure remains the standard, with the operation being taken care of via a hotel management agreement.

Outlook and conclusions

The year 2023 was particularly difficult on the investment side. Despite observers expecting recovery in 2024, the first half of the year has remained challenging.

The economic situation is solid in Luxembourg, notably due to low unemployment. A recovery of the investment market is expected in the second half of 2024, driven by an increase in rents (notably for offices) and confidence that expected and proposed yields will rebalance.

The Luxembourg market remains attractive, especially in the office market, which remains stronger than in other EU countries due to Luxembourg having one of the lowest office vacancy rates in the region.[4]

Endnotes

1 JLL, 'Luxembourg Office Market Report 2023'. ^ Back to section

2 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088. ^ Back to section

3 The Luxembourg Law of 14 July 2023 establishing a national screening mechanism for FDI and implementing Regulation (EU) 2019/452 was published in the Official Gazette of 19 July 2023. ^ Back to section

4 JLL, 'Luxembourg Office Market Report 2023'. ^ Back to section

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