FARAD I.M.

MANCO/AIFM: Get prepared for the real evolution

Daniel Capocci, CEO, FARAD I.M. dcapocci@FARAD-IM.com

This is a translation of the article published in "AGEFI Luxembourg" on July 12th, 2023

The Luxembourgish Management Companies (ManCo) and AIFs landscape is experiencing a notable evolution. Following a period of substantial consolidation, the market, while remaining active, is now characterized by a distinct shift in dynamics. In light of these circumstances, there are several noteworthy elements to underscore regarding the industry's prospects and developments in the short and, more significantly, medium term.

THE INDUSTRY'S TRANSFORMATION IN FOUR KEY ELEMENTS

A first element to highlight is the significant escalation in costs of launching and, particularly, maintaining an investment fund management company, whether traditional and/or alternative, over the past few years. While just a few years ago, and more specifically after the publication of Circular 18/698, a fund manager with approximately EUR 1.5 billion in assets under management could be considered as viable, this is no longer the case today. Several factors that contribute to this phenomenon. Firstly, regulatory requirements and expectations have continuously evolved, not only pertaining to fighting against money laundering and terrorist financing but also extending to other areas. Consequently, stakeholders are facing an increasing number of requests for reporting and analysis, resulting in additional workload and an increase in the associated costs and expenses. In addition, the cost of living in Luxembourg has significantly risen over recent times. In this context, the automatic indexation of wages, indirectly affecting other outsourced expenditures (e.g., auditing and accounting fees) or the one of rental fees have a direct impact on the results while income derived from the assets under management does not undergo such indexation. Furthermore, the growing specialization of employees leads to increased costs. As the number of funds and alternative management companies expands, there is a heightened demand for highly skilled or specialized personnel in complex domains, contributing to higher costs in this regard.

A second element to highlight in the evolution of the Luxembourgish investment fund managers' landscape is the consolidation of the industry. Yes, we have witnessed a period of consolidation in recent years, but this is only the start. Why? Because it mainly affected third-party investment fund managers. These companies provide this service to investment fund promoters who lack the necessary license(s) to manage these investment products, the personnel, or the willingness to establish such activities locally. Looking ahead, we anticipate the next consolidation phase to occur among so-called internal or in-house investment fund managers. Here, we refer not to major management companies that established in Luxembourg post-Brexit, but rather to smaller-sized stakeholders. Many medium-sized asset managers have their own investment fund management company in Luxembourg. While this approach made sense when the viability thresholds were lower, it raises concerns about the relevance of maintaining a small internal team of 4-8 individuals to handle investment fund management in Luxembourg, especially when most activities are outsourced abroad.

> ***"The world of Luxembourg Management Companies and AIFs is undergoing significant changes. After several years of strong consolidation, the market, is now moving in a different direction."***

Instead, it would probably be more opportune to collaborate with third-party investment fund managers that possess the necessary resources and teams to provide a comprehensive and continuous service to these entities. Furthermore, from a financial perspective, this choice also makes sense as it allows for the implicit sharing of license fees, IT costs, and other expenses, creating a mutually beneficial situation. In this context, foreign asset managers no longer require a complete in-house team in Luxembourg and can delegate a portion of the business risks while reducing overall costs. Meanwhile, third-party investment fund managers benefit from economies of scale.

Ultimately, in many cases, the focus is on the operational implementation of investment strategies formulated in decision-making centers outside of Luxembourg. In this context, the evolution described would make full sense.

A third element to highlight is the maturity of the industry. The overall asset management industry, and more specifically the investment funds industry, has reached a state of full maturity. While access to the industry was limited to the wealthy a few decades ago, it has become accessible to everyone nowadays. Furthermore, this democratization of access is partly attributed to the advent of index funds or exchange-traded funds (ETFs), among other factors. One can start investing with only a few hundred euros. This development has put significant pressure on margins. Moreover, while central banks supported market liquidity in the aftermath of the 2008 crisis, recent interest rate hikes have substantially increased the value of money. As a result, participants in the asset management industry are now competing for a fixed amount of potential assets. In the event of a downturn following a prolonged bullish market, these assets could even decrease, which would put even more pressure on the industry, and particularly on smaller players.

A similar dynamic has been observed in the investment funds industry. Although it has experienced significant growth since the early 2000s, investment funds have become standardized products. This holds true, at a minimum, for the traditional and liquid investment funds. In what concern the standard illiquid strategies such as private equity, standardization has also begun. When we refer to the standardization of the industry, we are not referring to the standardization of investments, but rather to the return profiles offered. Ultimately, what clients are looking for returns on their investments.

The rest is a packaging that enables the fund promoters to sell their investment funds. After maturity, consolidation or decline often follows.

A final element that we would like to highlight is the possibility of having a Luxembourgish investment funds managed by a non-Luxembourgish regulated entity. Although this possibility has existed for a considerable period of time, it has remained relatively underutilized until now. With the market consolidation and its aforementioned developments (increasing costs), it is highly likely that more stakeholders will consider this alternative. As a result, this could indirectly lead to consolidation or, at least, a reduction in the size and/or number of investment fund managers, despite not directly impacting the overall size of the investment funds industry. It simply implies that an increasing number of funds will be managed from abroad.

CONCLUSION

The investment funds industry has reached full maturity. While there have been prior developments and a certain level of consolidation, it appears that we are now most likely at the beginning of further substantial evolution within the industry. The most agile and dynamic participants should be able to go through the challenges, but there is a business risk or, at the very least, a profitability risk for medium or smaller-sized participants who are failing to prepare for this significant evolution. Even though we may not label it as a revolution yet, it is conceivable that in ten years' time, when the industry has undergone this transformation, it may be perceived as such.

FARAD I.M.