Is UK private equity investment in line for a Brexit boost?

James Falla reports on a new global research project from law firm Mourant Ozannes

Brexit should not prove to be a long-term threat for the British private equity industry, according to new research conducted by Mourant Ozannes.

The law firm interviewed 260 PE firms in North America, Europe and Asia back in August.

And though the survey revealed that there were a number of delays to fund launches across Europe immediately following the referendum vote, industry professionals said they were still optimistic.

They said they expected to see an increase in UK-based institutional investment, compared to the EU, once the Brexit move has been completed, and were looking for an easing of European regulation.

'It seems that there are hopes for some relief from AIFMD regulation post-Brexit when the UK is outside the EU. Almost 100% of respondents told us AIFMD has made raising funds from EU-based investors more challenging,' said Ben Robins, Jersey-based global head of investment funds at Mourant Ozannes.

'Couple this with survey results revealing that limited and general partners expect Brexit to result in greater investment from UK-based investors and declining investment from Europe, and it's clear that UK private equity fund-raising will become easier in the post-Brexit environment, whilst European fund raising will remain challenging.'

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The study, revealed that immediately following the EU referendum vote, half (50%) of EU-based GPs (excluding the UK) deferred fund launches, with more than two-fifths (44%) considering doing so. In the UK, more than two thirds (69%) of GPs were deferring launches, with almost a fifth (19%) considering doing so.

The Brexit vote is also spurring the EU PE community to reflect on the most suitable fund locations. Almost one in five (17%) of EU-based GPs are considering changing the jurisdiction of fund launches, due to uncertainty around regulation and tax. This is even higher among UK GPs (41%).

Implications for the islands?

The EU PE community uses a variety of fund domiciles, and the Channel Islands are seen as a significant player. Other popular domiciles have included the Cayman Islands, particularly for US or Asian investors, Delaware for US investors, and some domestic EU centres, including the UK itself and Sweden.

'The offshore domiciles have tended to be chosen where a private equity house is raising funds from a wider range of global investors,' said Mr Robins. 'Luxembourg, traditionally a retail funds hub, is now making a big play for a piece of this global PE market.'

'There is a long track record of UK private equity houses working symbiotically with the Channel Islands, and we think there is every reason for that relationship to continue to our mutual advantage'

GPs based in the EU currently have to comply with the EU's Alternative Investment Fund Manager's Directive which creates significant additional operational burdens and costs, but brings with it what Mr Robins called 'the marginal advantage' of a pan-EU marketing passport – a marketing carrot for the stick of more operational complexity, that is the Luxembourg proposition.

At present, GPs based in the islands do not have to comply with all those AIFMD requirements but can only market into the EU using the national private placement regimes of individual member states – easy in some states, harder in others, but workable in practice.

The UK investor market for PE funds is significant, Mr Robins said. Statistics show that the UK is the key market for European private equity investment with nearly a quarter of the market, closely followed by Switzerland at 20% and the Netherlands at 19%. In short, 62% of the European private equity investor base is situated in the UK (which, after Brexit, will be outside the EU), Switzerland (outside the EU) and the Netherlands, which has a very usable private placement regime.

'Post-Brexit, the question of whether a GP would choose to locate itself in the EU [ex-UK] or outside [whether offshore, in the UK or elsewhere], will therefore likely turn on the extent to which that GP, in its global fundraising efforts, is targeting a large proportion of its investors in the [non-UK] EU market or not,' he said.

'Those with only marginal numbers of EU investors are unlikely to want to submit themselves to the additional costs and burdens of AIFMD compliance by operating from the EU. Those seeking a greater proportion of non-EU investors will weigh-up the relative advantages of offshore domiciles and non-EU onshore domiciles, possibly including the UK itself, but are likely to see greater tax and regulatory certainty and stability offshore as before – their investor base is sophisticated, after all.

'There is a long track record of UK private equity houses working symbiotically with the Channel Islands, using Channel Islands funds and service providers, and we think there is every reason for that relationship to continue to our mutual advantage. This all points to continued PE opportunities for the Channel Islands in future, once the UK has exited the EU.

'Some resolutely "continental EU" business is likely to be lost, but much "rest of world", particularly Anglo-Saxon, business – where the investor universe is larger – is there to be sustained and won.'

An issue of regulatory confidence

Almost half (47%) of UK GPs and 39% of European GPs also revealed that their confidence in the UK regulatory environment had fallen since the Brexit vote. This is also visible on the other side of the Channel, with a third of European GPs and 38% of UK GPs reporting a decrease in regulatory confidence in the EU following the referendum vote.

'There is no doubt that the picture is not all doom and gloom'

'The impact of Brexit has, understandably, been most dramatically felt in the UK and Europe. There was a notable slowdown in fundraising and transactional work as we approached the day of the referendum, and any momentum that still remained was quickly lost once the vote became clear,' said Mr Robins.

'While a "hard-Brexit" currently looks more likely, there remains a lot of uncertainty about what the UK's separation from the European Union will actually look like. We expect this to continue to weigh on transactional activity, especially institutional-backed deal flow.

'However, despite the lack of clarity, we have seen above-expectation deal-flow since the summer, which could see the UK market stabilise as we move through towards the end of the year. With the findings from this study also revealing a great deal of optimism in the private equity market, there is no doubt the picture is not all doom and gloom.'

Until Brexit occurs, AIFMD will apply to UK GPs, but it remains uncertain whether the UK will choose to perpetuate its AIFMD-compliant regime to maximise the possibility of UK GPs accessing the third country AIFM passport, when it is created, through being 'equivalent', or seek to de-regulate its GPs to an extent to appear more 'business-friendly' to asset managers looking to remain in, or move to, the UK, Mr Robins added.

'The political mood music in the EU has not signalled the former and in the UK it has not signalled the latter. No-one yet knows how that debate will resolve itself but UK GP's may not want to remain in the UK if they have to continue to meet full AIFMD regulatory standards without the benefit of a passport.

'Similarly, given the size of the UK investor market, the wisdom of establishing an EU GP to target EU (including UK) investors will be sorely tested post-Brexit. The UK will no longer be in a position to assert its traditionally tempering influence on EU regulation, including any future tightening of AIFMD and many other new EU financial services directives.

'This all creates a level of real uncertainty with the future UK and EU regulatory environment which, happily, we do not feel to the same extent in the Channel Islands. In the Channel Islands we already have non-AIFMD compliant regimes for GPs targeting non-EU investors, partially-compliant regimes for AIFMD private placement, and the option of a fully-compliant regime should the third country passport open up for CI GPs. None of that will change, just the extent to which, depending on where their investors are based, PE clients decide to take up each of our different options.

What is the state of the private equity market today?

'In short, our research showed that global sentiment was reasonably positive, but more mixed when it came to regional focus, with the UK faring better than the EU,' Mr Robins said.

'Notwithstanding the market volatility and geopolitical uncertainties of the age, 88% of the private equity professionals surveyed were positive about the global PE outlook over the next 12 months. It's too early to tell what impact the US election result will have on global PE investment. And that figure rose to 93% among those based in the UK.

'As regards UK PE investment, although 33% of those surveyed believed the Brexit vote would decrease investment in UK companies, 41% predicted an increase in UK investment, with the rest expecting no effect. In contrast, almost half (47%) of those surveyed believed the recent Brexit vote would decrease PE investment in (non-UK) European companies – 14% more than those that believed the UK would be negatively impacted.

'What we see at the coalface in 2016 is that Channel Islands-based private equity funds continue to raise multi-billion dollar PE mega funds for global investment with relative ease.'

The Channel Islands and private equity

Ben Robins from Mourant Ozannes gives us the lowdown

What part do the islands play in the global PE world?

Since the 1990s, the Channel Islands have hosted a large number of global private equity funds, particularly those formed for investment in businesses in the UK and Europe, but also more further afield, including Asia and Africa. The islands host a good number of the 'mega' private equity funds, capable of raising many billions of dollars, but also many small, new, and mid-sized funds, raising in the region of $100m. to $500m. The islands provide a broad range of expert support services to these funds, including specialist fund administration, non-executive directors, audit, legal and financing services, and have a track record of running them successfully, through all the positive and negative economic cycles experienced in the last 20 years.

The islands are also often chosen as efficient domiciles in which to create the holding companies through which private equity funds hold their portfolio companies, particularly UK ones, facilitating the easy return of income and capital to the fund in a tax-efficient way, avoiding multiple layers of double or triple taxation. In short, both islands have become global centres of excellence for the formation and operation of private equity funds and their holding structures.

What impact does PE positivity have on the islands' economies?

Given the size and importance of the expert PE-supporting infrastructure that has grown in the Channel Islands, both in operating the funds themselves and in servicing holding companies for PE deal-making, the extent to which market conditions favour PE fund raising and deal-making is an important bellwether for the islands' PE-related economic activity. More PE fundraising and deal-making, in circumstances in which the fundamentals of our own CI offering remain largely unchanged, feels like good news.

Why did Mourant Ozannes carry out the survey?

Assisting with offshore private equity fund formation and deal structuring are areas of real strategic focus for our firm. Private equity fundraising and investing is globalising. Existing PE clients are seeking out deals and investors around the world and we are seeking to support them wherever they are active. We have long had a solid grounding in the European private equity industry through our market-leading Channel Island practices and we are now capitalising on opportunities in the US and adjacent markets through our Cayman and BVI offices, and in Asia through our fast-growing Hong Kong office. As part of that drive, we are seeking to understand better what our clients and their investors are thinking and to raise our own profile as an offshore law firm with real global market insight in this area. Commissioning this research has proved very useful in both respects.