Luxembourg Private Credit Funds: Market Analysis and Outlook

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Pursuant to a well-known proverb, "interest on debts grows without rain". Whether this is cautionary advice for borrowers or an encouragement for lenders can be left to individual interpretation. Fact is, however, that both worldwide and in the Luxembourg investment funds industry the private credit market is a popular and quickly growing market segment. The present article aims to shed some light on current trends and developments, based on recent empirical data pulled from surveys.

Before going into further detail, it appears useful to briefly mention which assets are referred to when talking about "private credit". The term "private" in this context means that the relevant loans are not traded on public markets, as opposed to corporate bonds which have been a very common asset class for a long time. They are rather negotiated individually and not distributed through a stock exchange, and can form part of a portfolio of an investment fund. The underlying loans can relate to the (re-)financing of any sector of the economy, such as a company in general terms (referred to as a corporate loan), a real estate or infrastructure project or also consumer loans such as credit card debts.

The private credit market has grown substantially over the last decade, which is generally explained by a growing reticence of banks, due to regulatory pressure (in particular capital ratios), to remain engaged in this segment, and the possibility for private credit funds to act quicker and often with more market knowledge and pragmatism. Pursuant to a recent survey by the Alternative Credit Council[1], it is estimated that the size of the global private credit market now amounts to around US$ 3 trillion, with strong and stable growth rates despite a number of economical challenges over the past years.

The largest segment in this market with close to 60% of market share is the direct financing of companies (corporate lending), but with an increasing tendency towards real estate, infrastructure and asset backed lending. The trend towards the financing of so-called real assets is expected to accelerate, due to government policies with a focus on energy and infrastructure investments.

The development in Luxembourg mirrors this development, where the assets under management of private credit funds are now estimated at EUR 510 billion, with rather spectacular growth rates of 21.5% in the last six months of 2023 only. While private credit funds are, admittedly, a more recent asset class, their growth trajectory over the past years with upwards of 40% p.a. confirms the view observed more generally that, at least in the recent years, the dynamic of the alternative asset sector in Luxembourg surpasses that of the traditional UCITS segment.

Another clear trend that emerges from a recent survey performed by the Luxembourg fund association ALFI and KPMG[2] concerns the choice of investment vehicle: The structures that are under the direct supervision of the CSSF and therefore require an approval process before becoming operational – with a negative impact on their time to market – are in a steep decline, which is a tendency shared with the entire private assets sector in general. While the market share of specialised investment funds (SIF) decreases (from 49% to 32% of funds subject to a dedicated product law), that of the reserved alternative investment fund (RAIF) rises to 62%.

Both are, however, eclipsed by alternative investment funds in the form of partnerships (special limited partnerships – SCSp – especially): Almost two thirds of all Luxembourg private credit funds opt for this form (63%, up from 45% just a year earlier), while RAIFs and SIFs together only amount to 37%. Such tendency is likely the result of a preference of anglo-saxon fund initiators for a corporate type that they are very familiar with, combined with the additional flexibility in terms of the content of the partnership agreement and the absence of a subscription tax to be paid. The main advantage of the RAIF, which is the possibility to structure it as an umbrella entity with several compartments, does not appear to be a strong argument in many cases, as the majority of private credit funds are single compartment structures.

Another interesting aspect is that the vast majority of private credit funds (74%) are closed-ended, and therefore do not provide an exit possibility for investors during their term. This is also in line with the preference stated in the amended AIFM Directive[3] concerning loan-originating funds. It means, however, that all those rather complicated rules on liquidity management that have been included in the newly amended text will only apply to a small portion of loan-originating funds.

An attentive analysis of the survey data reveals another salient point in this context: In terms of the investment strategy of private credit funds, there is an almost even split between those funds that can grant loans themselves, and those that invest into already existing debt on the secondary market. Consequently, about half of all private credit funds will not be in scope of the new rules set out in the AIFM Directive, as these only apply to loan-originating funds and not to debt participating funds. That appears to quite clearly confirm the argument of the industry, raised during the negotiations about these new rules, that they are unnecessary and have very little added value for investors in practice. Did not a well-known Italian banker recently mention something about avoiding to create unnecessary complexity and bureaucracy?

Speaking of investors, those that invest into Luxembourg private credit funds are almost exclusively institutional or professional investors. Only 6% are retail investors, and that segment is actually shrinking. At least for the moment there is therefore no discernible trend for a retailization of any significance. This can change, however, and the fairly recent publication of the guidelines (RTS) for ELTIF structures has the potential to fuel a stronger development of this product aimed at retail investors over the next years.

Luxembourg private credit funds invest predominantly (60%) in Europe, be it the European Union or other European countries, and most invest in several countries. On a global level, investments into the United States dominate the private credit market and account for roughly half of all investments into this market segment, while for Luxembourg funds the figure only rises to 16% of their investments. Part of an explanation for this may be that the asset class is less mature in Europe than in the U.S., and that cross-border lending (or credit activities for alternative investment funds as such) has not been possible in all European states due to a disparate legal environment for such activity. A positive aspect of the amendments to the AIFM Directive relating to loan-originating funds should consist in that it can be expected to simplify and harmonise the activity of private credit funds within the EU. Another consequence hoped for is that private credit funds should grow in size, as today they are fairly small: 87% of them have a capitalisation below EUR 1 billion.

Another much debated topic, sustainable finance, is at least so far rather absent in the private credit market. Outside the EU it is, if at all mentioned, seen more as a reporting topic and it is unlikely that this will change fundamentally over the next years, considering the priorities that can be expected of the new U.S. government. Among Luxembourg debt funds, more than three quarters are so-called art. 6 funds that have no particular aspirations in terms of ESG strategy. While the portion of so-called art. 8 funds with some level of ESG integration has slightly grown (by 2%), most of that will most likely be a re-categorisation of the more ambitious art. 9 funds as a result of tighter regulatory scrutiny of these products. From the feedback received from private credit funds initiators through the survey, it does not appear as if for them (or rather their investors) ESG is currently a priority.

In summary it can be observed that the private credit market as such and debt funds in particular play an increasing role in a sector that was traditionally occupied by banks, and that it has become a vital part of the financing of what is sometimes referred to as the "real economy". Luxembourg's wide array of choices in terms of investment vehicles and early embrace of private credit activity for alternative investment funds gives it a competitive advantage in this fast-growing sector. The upcoming rules for loan-originating funds in the amended AIFM Directive should not change this, albeit increase the compliance burden for market participants.

* *https://www.vdblaw.com/*

1) *https://www.aima.org/compass/insights/private-credit/financing-the-economy-2024.html*
2) *https://www.alfi.lu/en-gb/news/kpmg-alfi-private-debt-funds-survey-2024*
3) The amendments to the AIFM Directive were published in March 2024 and will need to be implemented into national law by April 2026.