European Long Term Investment Funds (ELTIF): a vehicle for private market strategies

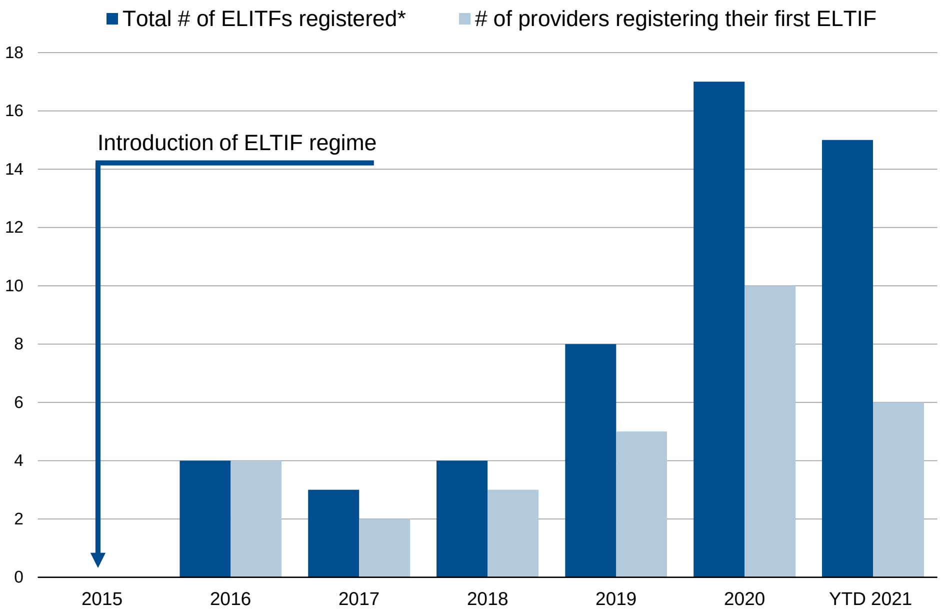
Scope Analysis

With the ELTIF Regulation, the EU created a new fund regime in 2015 that combines the characteristics of closed-end funds with those of UCITS funds. This gives high net worth and affluent private investors standardised, regulated access to illiquid asset classes such as private equity and infrastructure throughout Europe.

European Long Term Investment Funds are a regulatory regime, not a product class. The European Commission has designed them as Alternative Investment Funds (public AIFs) that can be structured in different European legal forms, for example as a conventional SICAV, a Kommanditgesellschaft (KG), a Limited Partnership (LP) or in other forms. The unifying element is the regulatory framework. The aim of the ELTIF regime is to enable long-term investments in illiquid private market assets i.e. in non-listed investments such as infrastructure projects, private equity and private debt.

Since their introduction six years ago to the end of September 2021, 51 ELTIFs from 30 providers have been registered with the European Securities and Markets Authority (ESMA). According to ESMA, as of April 2021, they had approximately EUR 2.4bn in assets under management. The market for ELTIFs has thus gotten off to a subdued start but in the past two years, the market has noticeably picked up. More than half of the registered ELTIFs have originated in the past two years, and the number of providers has more than doubled since the beginning of 2020. The most active providers include Amundi, Azimut, BlackRock, Commerz Real, Muzinich and Partners Group.

Figure 1: A positive trend after a slow start: registered ELTIFs and new providers per year since launch



Sources: Overview of registered ELITFs from ESMA (as of September 2021) here. Public Consultation on the Review of the ELTIF Framework (as of June 2020) here.

*Registration date of one vehicle unknown, excluded from graph.

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Investor protection is at the heart of the regime

The ELTIF regime is a child of crisis. After the global financial crisis of 2008, the European Commission had identified a structural investment backlog for infrastructure projects. At the same time, it was assumed that there would be a large supply of capital available not only from institutional investors but also from private investors.

However, in the past, many private investors in particular had had bad experiences with investing in closed-end funds. Therefore, with ELTIFs, regulator developed a regime that focuses on investor protection. The following five criteria are particularly important.

EU regulator does not permit fund-of-funds

Cost transparency: ELTIFs have to provide all costs and fees in a comprehensible way for investors over the entire term. Regulator do not allow fund-of-funds structures that would lead to multiple and incomprehensible fee levels and dilute returns. ELTIFs basically make direct investments.

Capital must be allocated to at least 10 assets

Risk diversification: Unlike previously popular closed-end funds, for example with ship or aircraft investments, single-asset investments are not possible with ELTIFs. Instead, capital must be distributed among at least 10 assets, and no single investment may account for more than 10% of the total portfolio. Each individual investment must amount to at least EUR 10m.

Debt capital limited to a maximum of 30%

Limited leverage: The ELTIF regime allows a maximum of 30% leverage at fund level. In addition, the use of derivatives is only permitted for hedging purposes. The possibilities for optimising the return on equity by means of financial engineering are strictly limited.

Minimum 70% must be invested in illiquid, unlisted investments

Investment barriers: At least 70% of the funds of an ELTIF must be invested in illiquid, unlisted assets. These include, in particular, infrastructure assets and equity investments in companies, but traditional tangible assets such as aircraft, ships or trains are also possible targets. Investments in companies from the financial sector are excluded, as are investments in commodities.

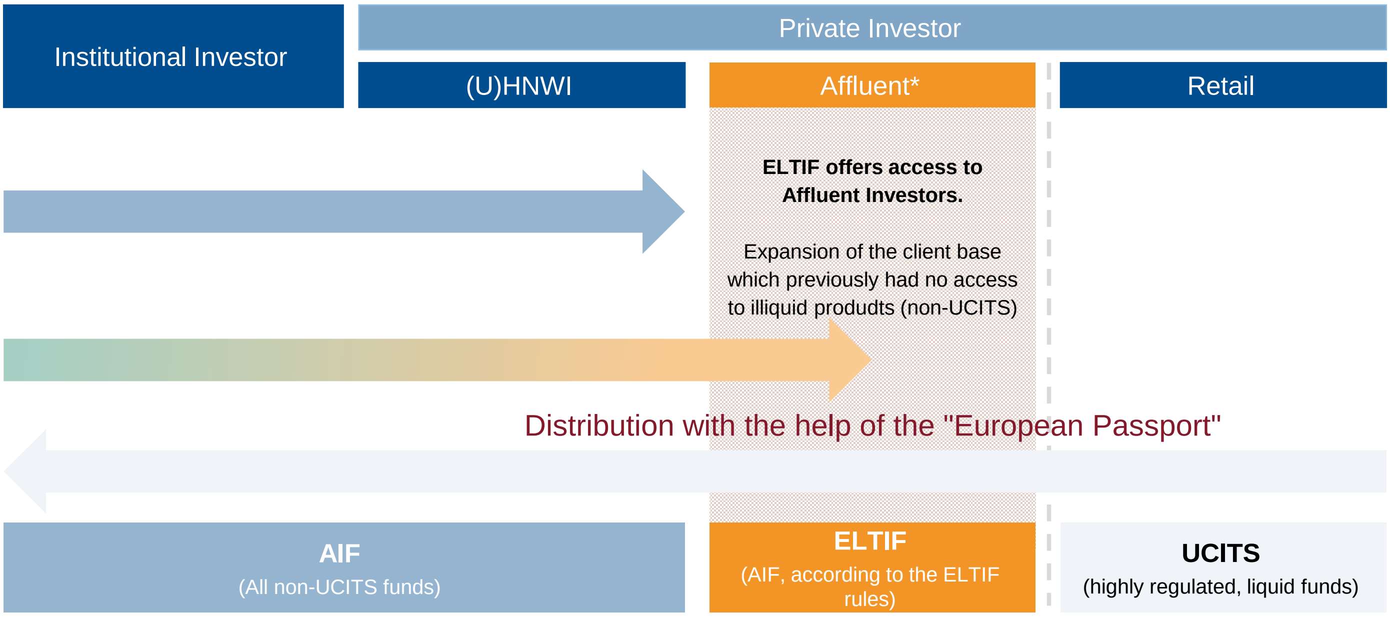
Real estate investments are possible but only if the investment serves long-term purposes with social or economic benefits. Pure real estate speculation is prohibited – even if the regulations do not precisely define the long-term requirement in this case.

Minimum investment amount is EUR 10,000

Minimum investment amount: Investors who have liquid assets of no more than EUR 500,000 can invest a maximum of 10% of their assets in ELTIFs. Since a minimum investment amount of EUR 10,000 also applies, the product is only accessible to investors with at least EUR 100,000 in liquid assets. As a rule, proof of assets is provided in the form of a self-disclosure/self-declaration.

In addition to institutional investors, the products are therefore likely to find their main market within qualified investors in private banking – specifically the affluent segment i.e. investors with assets of EUR 100,000 or more. This is precisely where ELTIFs fill a gap in the market by giving investors regulated access to illiquid asset classes.

Figure 2: Access to private markets – possible for affluent investors for the first time with ELTIFs



*Investors with investment assets greater than EUR 100,000.

Distribution of ELTIFs: settlement still fragmentary

In principle, an ELTIF can be distributed throughout the European Union via the European Passport as soon as it has been reviewed and approved by the relevant regulator in a Member State.

Private market investments become securities that can be held in custody accounts

One of the major distribution advantages is that private markets investments have been created in the form of securities that can be held in custody accounts and can be acquired directly via traditional fund platforms without the need for any intermediary administrator.

However, the platforms do have to make some modifications to actually list the products. As a result, the offering is not yet available across the board. With the exception of some regional platforms, however, ELTIF transactions can now generally be processed without problems via the large cross-regional settlement platforms such as Euroclear or Clearstream.

Keyword (il)liquidity: providers act inconsistently

Early redemption of units may or may not be possible

Investors in an ELTIF are making a long-term investment with a fixed term. This means that after closing, the fund providers do not have to allow shares to be redeemed early.

With regard to closing, the ELTIF regime does not require a classic capital call model as in traditional closed-end funds or private equity investments, where after capital commitment payment is always due as soon as the transactions have been executed. ELTIFs in which investors make a full payment from the outset are also widespread. This is a common simplification procedure, especially for minimum investment amounts. However, the funds do not usually hold high cash ratios over a long period of time.

Since all direct investments are generally associated with long-term maturities, are not regularly callable and, as private market investments, by definition not publicly tradeable, regulatory illiquidity takes account of the special nature of the investments. A premature mass redemption of ELTIF shares could quickly present providers with liquidity problems: precisely what the regulator wants to avoid.

Nevertheless, not all ELTIFs available on the market are designed as illiquid closed-end funds. Some offer partial liquidity. This may, for example, be linked to minimum holding periods, longer notice periods, early redemption fees or be limited in amount.

If there are mass redemption demands, redemption can be suspended to protect the interests of remaining investors. In terms of design, this is reminiscent of the now more restrictive approach to the redemption of shares in the open-end real estate funds so popular in Germany.

What are the return expectations for Private Equity markets?

Private equity is one of the most important asset classes for ELTIFs

One of the most important asset classes for the ELTIF is private equity. The private equity market has multiplied in recent decades. One major reason: according to a study by the US Census Bureau, the number of publicly-traded companies in the US has declined by 40% since the late 1980s. In contrast, the number of off-exchange companies has increased by 50%.

Illiquidity premium is a key return driver for private markets

Annual return expectations for private equity are in the high single-digit to low double-digit range over the long term. These comparatively high expected returns are, first of all, a premium for the illiquidity mentioned above.

Fund managers can use the capital more or less undisturbed to pursue their business plans, which generally run over several years. They can ride out interim disruptions caused by periods of economic weakness, for example, without target returns shifting fundamentally, or possibly only along the time axis.

In other words, it may take longer for an ELTIF to achieve the targeted return it has set itself, and the term of the investment may also be extended if this is provided for in the terms and conditions. The investor must be informed of the maximum possible term.

The risk/return positioning of providers also includes the two traditional factors of diversification and investment focus. In both cases, the regulator imposes certain requirements (see above), some of which providers voluntarily exceed.

In some cases, portfolios contain significantly more than the minimum 10 direct investments required. And in terms of investment strategy, some ELTIF initiators concentrate on investing in established companies with long-standing, proven business models, while venture capital or turnaround investments are rarely made.

Finally, the role of management deserves special attention. Fund managers take a completely different approach to investment decision-making than private investors. Looking at financial ratios, analyst reports and benchmarks are far less important and, given the private nature of investment targets, often not possible with the same transparency, timeliness and short termism.

Instead, direct investment specialists often see themselves as legal insiders because they are intensively involved with business models, growth targets, synergies and the potential for market development.

In some cases, therefore, providers deliberately invest only in majority or at least controlling interests rather than in co-investments. This gives them the opportunity to directly influence key operational decisions and to act as entrepreneurs.

Returns in private equity are generally less volatile than equity markets

Last but not least, private equity returns are generally less volatile than returns in public equity markets, so a private equity investment can also be an useful portfolio addition from a diversification perspective.

The future of ELTIFs: The review of the ELTIF Regulation.

The European Union is holding regular consultations on the review of the ELTIF Regulation. During the public consultations, many representatives of the investment industry are interested in making the ELTIFs more open to liquid instruments to make them more popular.

Currently, an ELTIF is only allowed to invest up to 30% of its capital in liquid UCITS. This could be liberalised after the review. Investor protection rules could also be partially dismantled to help ELTIFs develop, but on the other hand, this could lead to a dilution of investor protections. The first results of the review are not expected until the end of 2021 at the earliest.

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