KEYNOTE INTERVIEW

A slice of the action

Increasingly seen as a solution to a range of GP funding needs and as an attractive source of returns, minority GP stake sales are on the rise, says Thomas Liaudet at Campbell Lutyens

Minority GP stake sales, in which investors buy a share of a GP's management company, are becoming more commonplace as investors look for additional ways of gaining private markets exposure and as managers seek funding to meet their strategic goals. But they are far from straightforward to complete, says Thomas Liaudet, partner and global head of GP capital advisory at Campbell Lutyens. Despite this complexity, he explains why these deals are gaining popularity among GPs and investors alike.

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Q How has the GP minority stakes market developed over the past five to 10 years?

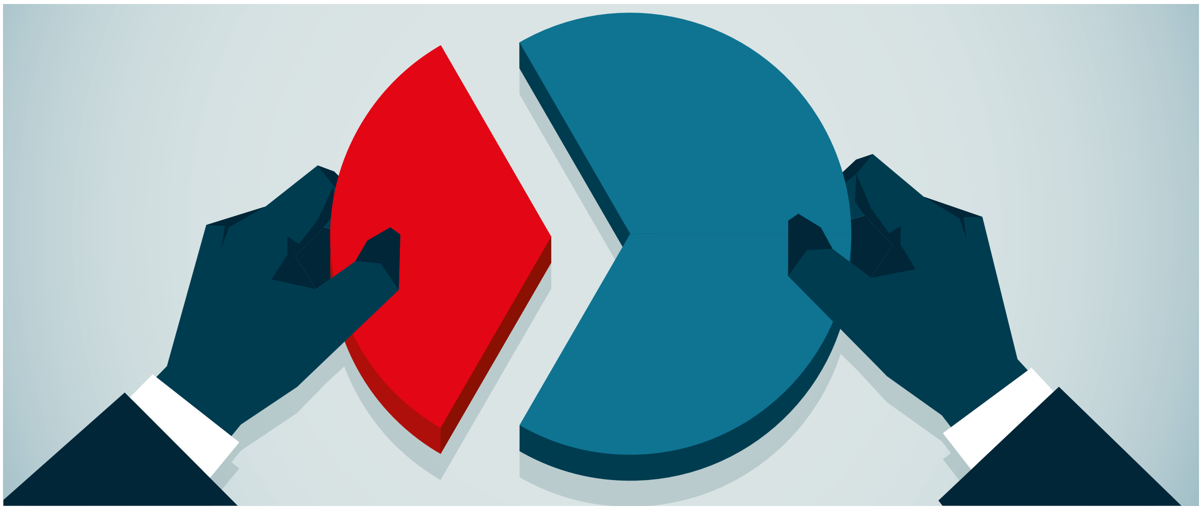
We saw steady growth up until around two years ago and since then transactions have increased meaningfully. Back in 2012 and 2013, there were around 15 minority GP stake deals a year; 2020 was the first year that deal numbers surpassed 30 and then in 2021, there were 51. This year so far is on track to match last year's volumes – we have seen 41 to date.

However, there has been a change in market composition over that time. Early on, most GPs seeking minority capital were hedge funds, but since around 2016, private equity has overtaken these. More recently, infrastructure and private debt funds have also become more involved in the market, so the activity is now spread quite broadly across private markets.

Q What has driven this growth?

The drivers here fall into three main categories. The first is managers seeking to manage their own liquidity – so in this category we would place solutions to address firm founders retiring and succession issues, as well as buying out legacy shareholders, anchor investors and/or parents. These drivers are consistently in the market and are more acute today as private markets firms mature.

The second is around funding growth. This includes funding GP commitments as pressure mounts from investors for these to increase and as fund sizes get larger. GPs are looking to increase their commitments in part as a fundraising tool. Some GPs are also selling minority stakes to launch



Q Where do minority GP stakes tend to sit in LP portfolios and how are exit routes developing?

LPs can either invest indirectly, where they invest in a specialist fund to gain a portfolio of investments and, potentially, access to co-investments, or they can invest directly. The deals tend to sit in the private markets basket, but very few LPs have systematic allocations to minority GP stakes and so they tend to be opportunistic in their approach.

On exits, investors generally need to see these as long-term plays – the horizon is up to 10 years, and often longer. They also need to accept that, as minority investors, they will have limited control over exit routes and timing.

An IPO is one way of exiting and that can offer either full or partial liquidity. The GP being acquired is another way of exiting, or sometimes GPs buy back some or all of an investor's stake. Interestingly, there have been a few examples of GP stake investments being realised after a few years only. It's demonstrating a healthy level of activity in that market.

new products, extend their platform and hire more people organically, while others may be looking to do so through acquisitions, which can accelerate growth considerably. In theory, GPs could use working capital to fund this, but many, especially those with below $10 billion in assets under management, don't have a balance sheet of their own.

Finally, there are sales to strategic investors, which have been growing recently. These can offer GPs the opportunity to raise more than capital, depending on who the investors are. Buyers might, for example, be able to bring a global footprint, experience of acquiring other GPs or help with retail distribution. Some managers may also have an ambition to go public in the near-to-medium term and by selling a minority stake, they are setting a valuation on their business today that allows them to show, a few years down the line, what they have achieved.

Q Why are they attractive to investors?

GP businesses are attractive for a few reasons. They tend to operate closed-end funds and that gives investors good visibility on future cashflows. Once a fund has closed, you know what the fees and income will be for the next 10 years because clients are locked in, and that generates yield for investors. In some deals, investors can also participate in carried interest and if you have a strong manager, you can assume returns of around 3x. That can give investors another set of cashflows and the structuring there can provide both yield and upside – that is attractive from a financial return perspective.

There are other reasons, including that investors want to foster closer relationships with GPs and perhaps benefit from more co-investment opportunities. For more strategic investors, the attraction may be that they gain new exposures.

Q What type of investor is participating in the market?

There is a range of investors including financial investors, such as those running specialist GP minority stake platforms. There are also many LPs buying GP stakes to get close to managers, such as large family offices, insurance companies and some of the sovereign wealth funds. On the strategic investment side, we are tending to see a mix of asset managers, including the big platform GPs. So, it is quite a broad mix, which is not necessarily something many GPs are aware of when they approach us about these deals. The universe is constantly evolving in fact, albeit the set of specialist financial investors remain relatively constant with very few new entrants of scale.

Q What are the main challenges in these investments?

Getting to the right valuation can be a challenge. Investors need to look at a variety of factors, such as the franchise reputation and brand, fundraising capability, the economics it can achieve and the quality and diversity of the LP base – and this is key because this will determine whether it will be able to raise successor funds, how large they will be and how long this will take.

Other factors include governance, such as how a firm is run, how key individuals are aligned with the firm's future success and issues around DE&I approaches. Then there is the financial due diligence that should analyse the management fee streams, costs, EBITDA, carried interest and the GP commitment.

These are all interlinked, and investors need to get their assumptions right if they are to arrive at an appropriate valuation and structure for the deal. That takes insight, skill and experience, as well as an understanding of how to benchmark deals against others.

Q How are minority GP stake deals valued and structured?

The three key variables in reaching a valuation are management fees, carried interest and the GP commitment history, and each are treated differently. It is important to note different investments may have a different structure. So, if a 20 percent GP stake is sold to one investor and 20 percent to another, they may well not be comparable because one may only include 20 percent of fees and the other may encompass 20 percent fees and 5 percent of future carry.

When it comes to valuing management fees, the main consideration is to determine the fees' discount rate for current and future funds. The costs also need to be factored in. The discount rate is compared with public market companies and so for a larger manager with diverse products, the discount could be in the low single digits, for a privately held manager of lesser scale, it would be in the 10-15 percent range and in current market conditions towards the higher part of that range.

For carry, you would apply a discount rate of 15-25 percent for a private markets firm, but this depends on the strategy – private credit and biotech investments have very different risk, returns and timeframes, for example. You would look at the whole model to come up with a net present value.

Then, you would typically also look at comparisons, either on the listed markets or among other comparable transactions. The management fee EBITDA is usually between 10x and 20x based on next year's fees. We have seen some movement here as public markets have declined in value, so some managers that might have traded at 20x last year are now doing so at 16x, for example. We would expect the carry EBITDA to be around a half to a third lower than the management fee EBITDA as a back of the envelope rule, however it remains specific to each manager.

As you can see, the different revenues are treated differently and we do see structuring techniques, such as deferred payments being used, depending on the motivation for the sale. For example, a GP selling to fund a GP commitment might not need the capital until two years out, or if it's for a future acquisition, the capital may not be needed until a target is found and the deal is reaching completion. Earn-outs are also commonly used to bridge gaps in pricing expectations – and I would expect these to be more in evidence if the fundraising market continues to be tough through next year.

Q What is the medium- to longer-term picture for minority GP stake deals?

It's a growing market, across volume of deals, type of buyers and quantum of capital directed towards it. The historical drivers for growth are not going away – there will always be a need to solve succession issues and GPs will continue to need capital to grow their business. At the same time, they need to fund larger GP commitments than in the past. Minority GP stake sales are becoming seen as an intelligent tool to support further growth.

LPs are also becoming increasingly supportive of these deals – something that wasn't necessarily always the case 10 years ago – on the proviso that they are being done for the right reasons. Investors have an interest in ensuring they are committed to a strong GP, after all. ■

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