KEYNOTE INTERVIEW

Missing piece of the puzzle

Now that continuation funds are providing fresh liquidity options, LPs are waking up to the appeal of GP stakes investing, according to Proskauer partners Jennifer Dunn, Grant Darwin and Ryan Carpenter

SPONSOR
PROSKAUER

Q How do LPs view GP stakes investment and its potential impact on LP-GP alignment?

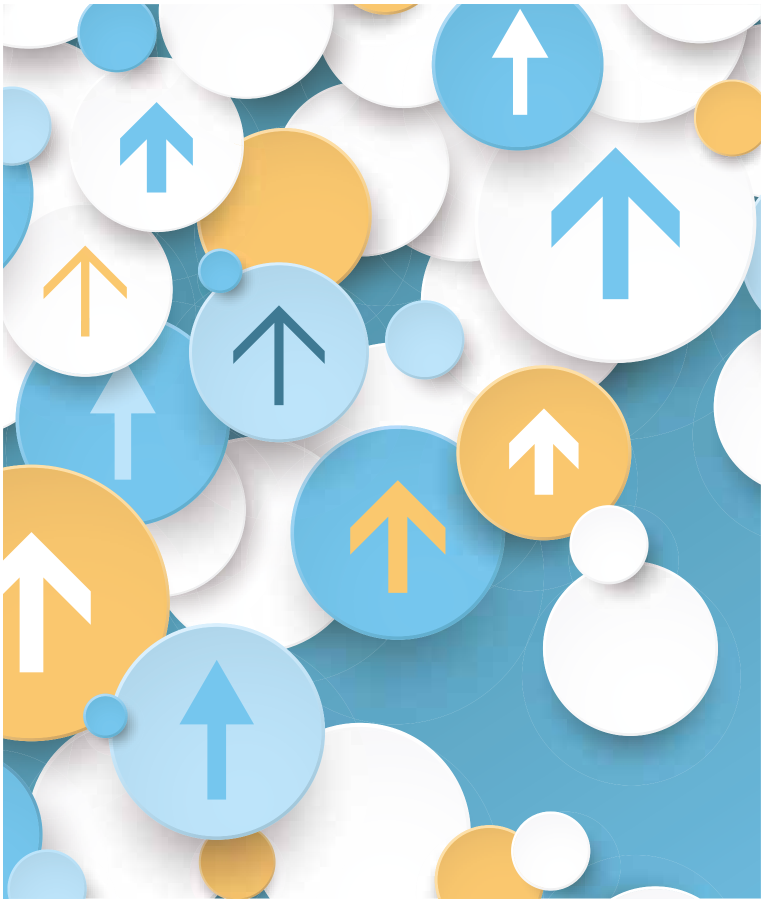
Jennifer Dunn: In recent years, LPs have taken on more exposure to GP stakes deals and have developed a better understanding of the product. Historically, the main LP concern has been that GP stake investment by a third party risked diluting the alignment between GP and LP, but over time it has been shown that GP stake deals are not just pure liquidity plays for GPs.

Often, the deal terms in documents will require capital from a GP stake deal to be primary capital or otherwise reinvested in the business. These transactions are growth plays for firms that want to grow their assets under management, expand their headcount and expand the product offerings on their platforms.

LPs have also noted that if a GP stakes investor is putting capital into a manager, it signals that the investor has conviction in the team and investment strategy. This is particularly the case for emerging managers, where GP stakes investors are providing new firms with start-up capital to build their businesses.

Over the years, it has become more expensive to grow a firm – the regulatory obligations alone are significantly greater than they used to be – and GP stakes investors are helping managers to bear those start-up costs. GP stakes investment, then, helps managers to grow and scale, which ultimately benefits LPs.

Grant Darwin: It's worth adding that LPs have also become familiar with the established GP stakes funds, and there is something to be said about the validation that their involvement brings for an LP's decision to make an allocation to that manager. When a GP stakes fund, particularly some of the blue-chip players, gets under the hood of a manager and is prepared to invest for the long term, that is a massive vote of confidence in a firm. That should give an LP confidence and comfort that the GP is on an upwards trajectory, is thoughtful about its future and scale, and will have additional capital and resources to grow.



How interested are LPs in making allocations to GP stakes funds?

RC: Appetite is increasing. The emergence of brand-name GP stakes firms does signal that there is a certain level of quality in the market, as these investors bring a high level of due diligence and operational rigour to bear when backing GPs. It also signals that there is a deep opportunity set in the market. LPs can take confidence that there will be dealflow in the pipeline.

The return profile is also attractive for LPs. GP stakes investment offers a hybrid return profile that includes income-like characteristics from management fee streams, as well as equity-like upside from carried interest. That makes GP stakes an interesting strategy to supplement a typical private equity investment portfolio.

JD: Another attraction is the diversity of the managers that GP stakes players invest in. As an LP, the strategy doesn't limit you to established buyout managers. You also see GP stakes deals taking place in private credit, hedge funds, infrastructure, real estate, venture capital and growth equity.

This positions a GP stakes strategy as a tidy way for LPs to gain exposure to different asset managers at different stages in their lifecycles, with different fee streams, performance compensation and realisation timelines.

The continued growth prospects in this space are so exciting. There is new capital coming in, and the strategy is expanding and growing in new markets, especially outside of the US. There is still so much more room to run, and we see top-tier investors focusing on executing in this space. It is a great time to be in the GP stakes market.

Ryan Carpenter: That is true, but GPs should still be sensitive to incumbent LP sentiment. It is important to outline the value-add for LPs, and to articulate why a given GP stakes investor is the right partner to further develop the business and drive better returns.

When there is a potential deal with a third-party GP stakes investor on the table, it is also worth considering whether any significant LPs would be interested in investing in the GP themselves. Certain LPs might appreciate a chance to kick the tyres and have a conversation about how they could add value for a firm before the manager looks to outsiders.

How has the exit path from GP stakes investments evolved? And what do the timelines to exit look like?

GD: At one point, LPs were concerned that GP stakes investments would be trapped with no clear path to liquidity. In recent months, the exit case has really been proven. There is now far greater confidence that the realisation piece of the puzzle is in place.

From a timeline perspective, a GP stakes investment will typically have a seven-year lock-up, often subject to a right of first offer or refusal of the GP or its principals. However, GP stakes firms are patient investors, and although they can explore exit options after seven years, they are unlikely to pursue an exit unless the GP is aligned. A buyer is going to be hesitant to invest in a deal where there is contention and disconnect between GP and the existing staker. An exit will typically be a collaborative exercise, to some degree.

In terms of exit pathways, this is where the market is getting really interesting. IPOs and sales to another asset manager used to be the primary options on the table. Selling to another staker has become an increasingly common exit route though, and the market has seen some GP stakes firms doing strip sales of some of their investments to orchestrate liquidity events. An exit to an insurer, asset manager or sovereign wealth fund remains an active exit pathway as well.

We expect to see an even more robust secondaries market developing in this space too, including the potential for dedicated GP stakes secondaries funds. As this segment grows, confidence that GP stakes secondaries is a big enough market will increase, thereby supporting the launch of more dedicated funds focusing on the strategy.

"In recent months, the exit case has really been proven"

GRANT DARWIN

We also see scope for more portfolio sales, where GP stakes investors sell down a portion of their interests in a portfolio of managers to obtain some liquidity without upsetting the whole applecart.

When you pull all these options together, it shows the emergence of a much more robust space for trading.

Q On the point about a secondaries-style structure evolving as an exit route, are there any other similarities between GP stakes and secondaries investment strategies?

RC: The return profiles may be slightly different, but the two strategies are fundamentally providing the same service, in that they offer liquidity solutions.

In the secondaries context, buyers are providing liquidity for LPs that want to move capital out of funds, while on the GP stakes side investors are often addressing an analogous issue for founding partners who have a disproportionate chunk of their wealth tied up in their firms and funds. The aim there is to diversify their personal holdings, but to do so in a way that accelerates growth opportunities for the firm that they have worked for so long to build.

JD: The processes behind the two strategies are very similar. They are both very due diligence-heavy, rely on a similar set of skills, and involve a deep dive into the GP and the GP's underlying assets.

The networks and relationships that underpin success in both strategies also overlap, and we have seen some firms take advantage of these synergies to house secondaries and GP stakes under one vertical.

GD: The evolution of a more robust secondaries market in the GP stakes space means that these two universes were always going to collide eventually.

"We have seen some firms house secondaries and GP stakes under one vertical"

JENNIFER DUNN

"LPs can take confidence that there will be dealflow in the pipeline"

RYAN CARPENTER

We expect this overlap to become particularly prominent when it comes to GP-led continuation fund deals done by GP stakes players. If you are a GP stakes manager and you see continuing value in a position that you hold, but you know that certain LPs in your fund will want to get liquidity, then a GP-led continuation fund deal is a good option.

As we see the GP stakes marketplace evolve, and as we see GP stakes funds approach the end of their vintages, the continuation fund structure is going to provide some of the same use cases that we've seen it provide to other segments of the alternative assets space. ■