PitchBook

How GP Stakes Investing Is Becoming Less Rare

A review of the uptick in GP stakes investing

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Key takeaways

- General partner (GP) stakes dealmaking in 2018 has already matched the annual record. With more than a quarter left in the year, investors have already completed 14 GP stakes deals. Transactions are increasingly targeted toward GPs with closed-end fund strategies, with 10 such deals so far in 2018.
- Managers receiving GP stakes investments boast industry-leading performance. Of the more than 250 closed-end funds raised by managers with GP stakes-backing analyzed in this note, 35% were in the top quartile of their peer group in PitchBook Benchmarks. Furthermore, only 19% of those funds were in the bottom quartile.
- GP stakes investors target managers with above-average fund size step-ups. However, we have yet to see evidence that managers alter their fundraising tendencies in response to a GP stakes investment.

For a history of GP stakes investing and a primer on the strategy, please read our last note.

Disclosure: James Gelfer was formerly an Associate with Goldman Sachs' AIMS group.

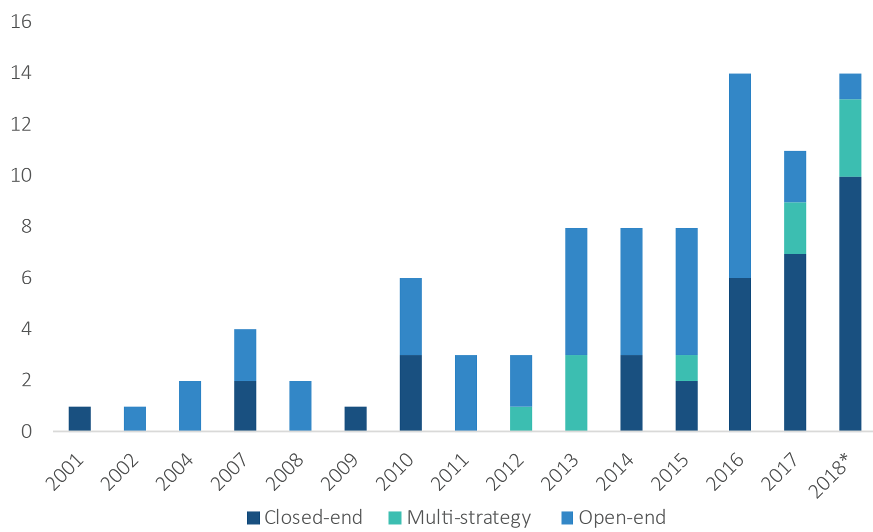
Published on August 27, 2018

Overview of recent deal activity

The building wave of GP stakes deals shows no signs of cresting, with deal activity through mid-August already surpassing the full-year total from 2017 and matching the all-time record set in 2016. Dealmakers continue to gravitate toward GPs focused on closed-end fund strategies and away from GPs (namely hedge funds) that are susceptible to limited partner (LP) redemptions (see "Lines in the sand"). Investments continue to be concentrated in name-brand firms, most of which have been explicit in how they plan to use the capital. Indeed, the rationale for raising outside capital has not changed since we published our first note on the space, with a trio of deals in 2018 highlighting the three primary reasons cited by GPs.

2018 GP stakes activity already at record levels

GP stake deals by target firm's fund strategy



Source: PitchBook
*As of August 11, 2018

Round Hill Capital, a real estate-focused GP, will use the money from an investment by Dyal Capital earlier this year to launch initiatives in new sectors and geographies. The tech-focused buyout firm Francisco Partners is utilizing its GP stakes investment to increase the firm's capital commitments to its own funds. And Clearlake Capital, which closed on $3.6 billion for its latest buyout fund, will use the proceeds from its GP stakes investment to seed a new senior credit strategy.

All else being equal, GP stakes investors are likely to pursue managers that will use the investment for endeavors accretive to the value of the underlying management company. Through that lens, GPs seeking capital primarily to facilitate succession planning or to fulfill commitments to their own funds will also need to identify plans to create value for investors by growing fee-generating assets under management (AUM), entering new businesses or implementing plans to improve operational efficiency.

Lines in the sand

In our initial GP stakes note, we used the terms “private equity” and “hedge fund” to demarcate the firms being targeted in GP stakes transactions. While these fairly broad terms were adequate in the early days of GP stakes investing, the strategy has expanded into more niche areas as additional capital has flooded into the space. Indeed, managers focused on the full gamut of strategies—from energy and real estate, to credit and secondaries—have received GP stakes investments. This underscores the fact that the purpose of the delineation between “private equity” and “hedge fund” is really a matter of distinguishing between whether a GP is primarily oriented toward closed-end or open-end fund strategies. For our purposes, closed-end funds refer to investment vehicles that are not subject to investor redemptions (e.g., buyout, venture capital, private credit, etc.), while open-end refers to strategies in which periodic redemptions are possible (namely hedge funds and long-only equity strategies).

The two most-established GP stakes investors—Dyal and AIMS—began their strategies by investing almost exclusively in open-end managers. But both firms have steadily shifted their strategies toward GPs focused on closed-end funds, while virtually eliminating their investment activity in open-ended fund managers. Since 2016, more than 80% of Dyal’s deals have been for closed-end GPs, while AIMS hasn’t invested in an open-ended GP since 2015. Blackstone, whose GP stakes strategy has a smaller track record, has followed a similar path. Going forward, we expect GP stakes deals to be highly concentrated in closed-end managers. But not every investor is following the same playbook. Rosemont Investment Partners was one of the earliest investors to acquire stakes in asset managers—although the firm also engages in full acquisitions—and has remained focused almost exclusively on managers with open-end fund strategies. In June, Rosemont announced a new partnership with insurer Market Corp., under which it will transition into a permanent capital structure.

Friend or foe?

The GP stakes investment strategy has rapidly become one of the most-discussed topics in private capital markets. The most intriguing development of 2018 has been the willingness of prominent GP stakes investors to partner with one another in dealmaking. In July 2018, Goldman Sachs' AIMS group and Blackstone (which runs its GP stakes business through Blackstone Alternative Asset Management) combined to inject Francisco Partners with balance-sheet capital to sustain the firm's momentum after it closed on nearly $4 billion in 2017 for its latest buyout fund.

While this club deal could easily be dismissed as a one-off, it was preceded by a similar transaction in which Dyal and AIMS partnered for the first time to make an investment in Clearlake Capital, a buyout manager that will use the funding to launch a senior credit strategy. With many in the industry already raising questions about potential conflicts of interest arising from the presence of external investors, introducing additional stakeholders to the equation only seems to muddy the picture further. Additionally, with the limited number of investors pursuing GP stakes, the fact that the three biggest players have invested alongside one another raises questions about the competitiveness of the market and a potential lack of opportunities.

To that end, the scope for deal sourcing is beginning to widen. Dyal recently announced an investment in Golub Capital, a publicly traded middle-market lender, in a deal that epitomizes how GP stakes investing is in many ways serving as a nontraditional capital source for firms that may have previously tapped public markets. We think GP management companies represent attractive investment opportunities, but publicly traded PE firms have been consistently undervalued, which has deterred new listings.

Indeed, a consistent gripe among publicly traded PE firms is that traditional equity investors do not know how to properly value their business, leading to persistent undervaluation. (This has been one impetus for the recent enthusiasm for public PE firms to evolve their business model from a partnership to a corporation.) Since GP stakes investors generally have decades of private-market experience, they presumably have a better understanding of the PE business model than a public equity analyst who may cover the space only as a subset of broader financial services coverage. Furthermore, GP stakes investors have the latitude to structure deals in a variety of ways, often creating hybrid debtequity instruments that allow them to tailor the risk/return profile to their preference. As a result, the GP stakes strategy is likely to lead to a better alignment of incentives and more agreement on valuation between the GPs and outside investors. We expect this to lead to significantly more GP stakes deals in the future and currently view the strategy as the best means of achieving diversified exposure to the underlying businesses of alternative asset managers.

Newcomers

Recent GP stakes deal activity has been dominated by well-known incumbents, but the next wave of GP stakes investors is in development. AlpInvest—an arm of the Carlyle Group—has become a key player in the secondary market and is targeting $500 million for an initial GP stakes vehicle. But it has taken awhile for the effort to get off the ground after the strategy's leader left AlpInvest in mid-2017. Prior to his departure, the Wall Street Journal initially announced the launch of the strategy back in 2016 with a more ambitious target of $1.5 billion.

The LP secondaries strategy seems to be a gateway to making GP stake investments. In the aforementioned investment in Clearlake, Dyal and AIMS invested alongside the prominent LP secondaries investor Landmark Partners, marking the first time we've seen the firm execute a GP stakes investment. It will be interesting to see if this foray marks the initiation of a more formal effort by Landmark. Aberdeen Asset Management is also getting into the GP stakes game. After hiring a team from Guggenheim Partners, Aberdeen created a group called Bonaccord Capital Partners that is currently targeting $1 billion for a debut fund. And Magnetar Capital, which received a GP stakes investment of its own in 2015 from Blackstone, is launching a GP stakes strategy itself after hiring Tom Morgan away from Hycroft.

We're also seeing more traditional PE firms exploring the GP stakes strategy. TPG, whose Sixth Street Partners credit business received a GP stakes investment of its own from Dyal in 2017, recently nixed its plans to go public and will instead seek additional outside capital. But, more interestingly, TPG made its own minority investment in NewQuest Capital, an Asia-based secondaries firm. This deal also illustrates how GP stakes deals are expanding to managers with strategies outside of traditional buyouts (see "Lines in the sand"). Leaders of many investment firms have unabashedly expressed their desire to grow their businesses in new areas, and we think the GP stakes strategy is an obvious area for expansion.

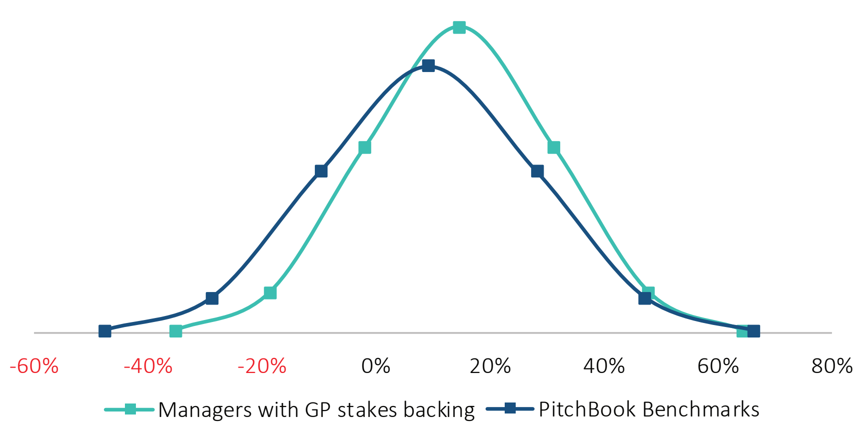
Big-game hunting

With a relatively small but well-capitalized universe of GP stakes investors, many of the deals executed up to this point have been confined to brand name GPs with well-established businesses and stellar track records. While the economic outcomes for GP stakes investors are less dependent on the manager's fund performance than an LP, fund performance is a useful tool to assess how the targets of GP stakes deals stack up against their peers.

The PitchBook Platform currently has performance data for more than 250 funds raised by managers who have received a GP stakes investment, with 35% of those vehicles posting top-quartile performance. These GPs also appear adept at mitigating downside risk, with only 19% of funds falling into the bottom quartile. With the GP stakes strategy still in its infancy and only 45 closed-end or multi-strategy managers having received an investment, we expected dealmaking to be highly concentrated in top-performing firms—and that is indeed what these data points suggest.

For these firms, the question is whether the influence of an outside investor will alter the trajectory of historical performance. So far, it's too early to tell—but this will be a topic we will actively investigate as the GP stakes strategy matures.

GP stakes investors target firms with superior returns
Distribution of fund IRRs (all vintages through 2015)



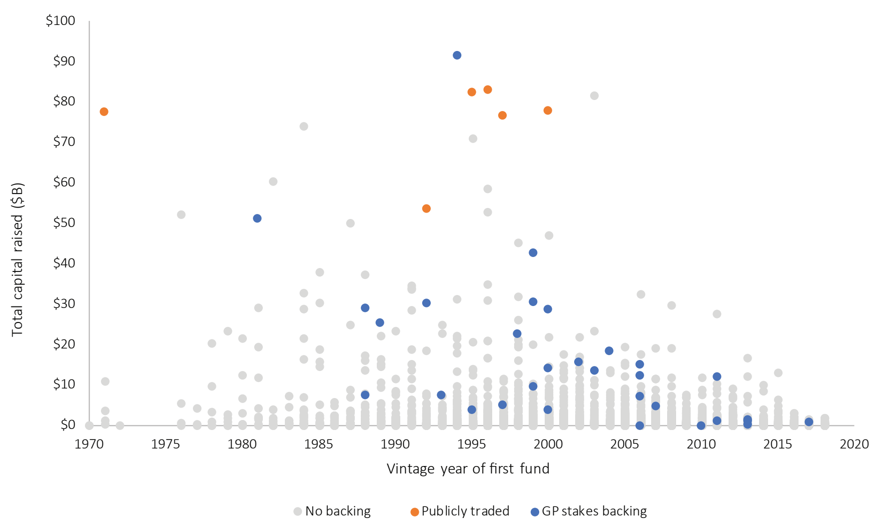
Source: PitchBook
*As of December 31, 2017

Knowing the performance profile of these firms, it follows that they would also lead the pack when it comes to fundraising. Indeed, the average closed-end firm that has received a GP stakes investment launched its first fund in 2001 and has raised more than $23 billion; this compares to an average first fund vintage of 2005 and $1 billion raised for PE firms that have not received a GP stakes investment and are not publicly traded.

Average capital raised diverges significantly between backings
GP comparison metrics by backing status

BACKING	AVERAGE CAPITAL RAISED ($B)	AVERAGE VINTAGE OF FIRST FUND
GP stakes	$23.4	2001
Non-GP stakes	$1.0	2005

Firms receiving GP stakes investment tend to be older and larger
GP comparison by backing status



Source: PitchBook
*As of August 11, 2018

As the accompanying charts illustrate, numerous managers fit the prototypical GP stakes target profile but have yet to receive an outside investment into their management company. So, despite the large sums being raised and the quickness with which Goldman Sachs AIMS and Dyal are returning to the fundraising trail, we think there is a sufficient supply of suitable targets to sustain the strategy for the foreseeable future. Furthermore, as GP stakes investors like AlpInvest and GP Interests—an aptly named newcomer—target smaller fund sizes, we see investment activity moving toward unexplored areas of the market, including smaller and less-established managers.

Course change?

GP stakes investing requires dealmakers to evaluate the economics of the managers underlying business, as opposed to how an LP assesses the performance potential of a specific fund. This means examining the business through the full gamut of viewpoints—from analyzing the LP-GP relationships and alignment of incentives, to understanding the nuances of how the GP management company generates revenue. Industry professionals active in the GP stakes space suggest that most deals are analyzed similarly to how a traditional equity investor would value a publicly traded firm, using standard metrics such as economic net income (ENI) and running standard DCFs. But perhaps the most important consideration is how the manager generates revenue, specifically the breakdown of management fees versus performance fees. As such, GP stakes investors tend to focus on the sustainability of the managers' revenue streams (i.e., how much capital is locked up, and for how long?) and the prospects for future fund offerings, specifically the anticipated time between funds and the expected step-up in fund size.

But what is good for a GP stakes investor may not necessarily benefit the LPs who are committing capital to the underlying funds. To that end, a common concern for LPs is that the manager receiving a GP stakes investment will subsequently evolve his or her strategy in a way that focuses on maximizing income for the management company perhaps at the detriment of underlying investments. One straightforward way to assess if a manager may be at risk of these inclinations is to look at fundraising activity, specifically any significant drop in the time between funds, significant step-ups in fund size or the initiation of new fund strategies outside of the GP's traditional purview.

To our surprise, we did not find evidence that GPs unduly increase their fund sizes following a GP stakes investment. But while GPs do not seem to aggressively alter their fund size targets as a result of a GP stakes investment, we do find that the historical step-up in fund size is larger for firms that have received a GP stakes investment (47%) compared to those that have not (38%). This is one data point that suggests GP stakes investors are actively targeting firms already exhibiting the characteristics desired by outside investors (e.g. growing AUM), as opposed to altering their strategy post-investment.

In addition to fund size, the cadence of fundraises is a factor considered by all stakeholders in a GP stakes transaction. Outside investments can raise concerns amongst LPs; when making a recent commitment to Vista Equity Partners' latest flagship fund, the Oregon Investment Council expressed concern that the Vista team may be disincentivized after the firm sold a GP stake in 2015. Another common worry among LPs is that the presence of an outside investor will encourage the manager to become an asset-gatherer more concerned with raising capital and collecting management fees than maximizing the value of investments. However, we found that the time between fundraises hovered around three years for both GPs that received outside investment and those that did not.

Perhaps more importantly, we did not observe an uptick in fundraising activity in the year following a GP stakes investment. Interestingly, however, we found that many recent GP stakes deals have come on the heels of fund closes. Francisco Partners, which received a capital infusion from a consortium of GP stakes investors in July, closed on a nearly $4 billion in 2017—a substantial increase from its $2.9 billion predecessor. It was a similar story for Clearlake Capital, which sold a 20% stake in May just a few months after closing on a $3.6 billion buyout fund—more than double the prior vehicle raised in 2015.

Looking forward

So far, GP stakes investors have been able to strategically place capital with premier firms that already exhibit favorable characteristics, including a strong track record and sufficient LP appetite showcased by large step-ups in fund sizes and the ability to successfully launch new strategies. We think investment prospects remain strong for GP stakes investors, but competition is primed to intensify as more inaugural GP stakes funds begin to deploy capital. As this happens, there will come a point when GP stakes investors move on to less attractive targets that may feel compelled to change their business model to attract and retain outside investment. This is the scenario of which all stakeholders need to be wary.