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Risks and Returns in GP Stakes Investing

Assessing the primary factors to consider in the space

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Credits & contact

Research
WYLIE FERNYHOUGH Senior Analyst, PE
wylie.fernyhough@pitchbook.com

Data
ZANE CARMEAN Quantitative Research Analyst

Design
KELILAH KING Junior Graphic Designer

Contact PitchBook

RESEARCH
reports@pitchbook.com

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***Other relevant research:** We covered the GP stakes competitive landscape, diving into the market segments and consequential firms. Scenario analysis in this note uses our forthcoming GP valuation model which leverages our initial fund valuation framework.*

Key takeaways

- **GP staking in top-end firms naturally assumes the least risk, because fewer of these established firms are likely to fail.** Just 3% of the firms that have reached the top tier abruptly fail, while small GPs have a much higher rate of failure, approaching 25%. Middle-market firm failures were near the midpoint at 11.6%.

- **Commensurate with a lower failure rate and less risk taking, GP stakes' returns are lower at the top end of the spectrum, with the base case producing gross IRRs in the low 20s.** GP staking in the middle market often presents a base case where returns are five percentage points higher, and the base case for acquiring GP stakes in small firms produces gross IRRs near the low 30s.

- **AUM growth in the firms selling a stake, which is most closely tied to performance, drives GP staking success.** The GPs with the highest rates of AUM growth have an outsized proportion of previous funds in the top or second quartile for net IRR compared to the average manager.

- **We find performance is most persistent in real estate, followed by buyout and debt, respectively.** This highlights the importance of understanding the underlying return drivers so GP staking firms can know whether performance is repeatable and scalable.

- **Some GP stakes investors take on added levels of risk to complete deals at lower headline prices by conceding on key deal terms and rights.** This could put GP stakes investors and LPs in a weaker position down the road, especially if these terms and rights must be renegotiated before a liquidity event (i.e., the rights and terms are not transferable).

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Introduction

As GP stakes managers continue to close on minority stakes transactions and as capital continues to pour into GP staking funds at a breakneck pace, LPs are looking to quantify the risk-and-return tradeoffs in this burgeoning segment of the PE market. Many LPs know private capital AUM is expected to continue swelling over the next decade and that GP stakes deals are structured to deliver a near 1x gross MOIC even in a downside scenario. This report seeks to quantify these points and delineate key drivers of risk and return while running a scenario analysis on GP stakes returns.

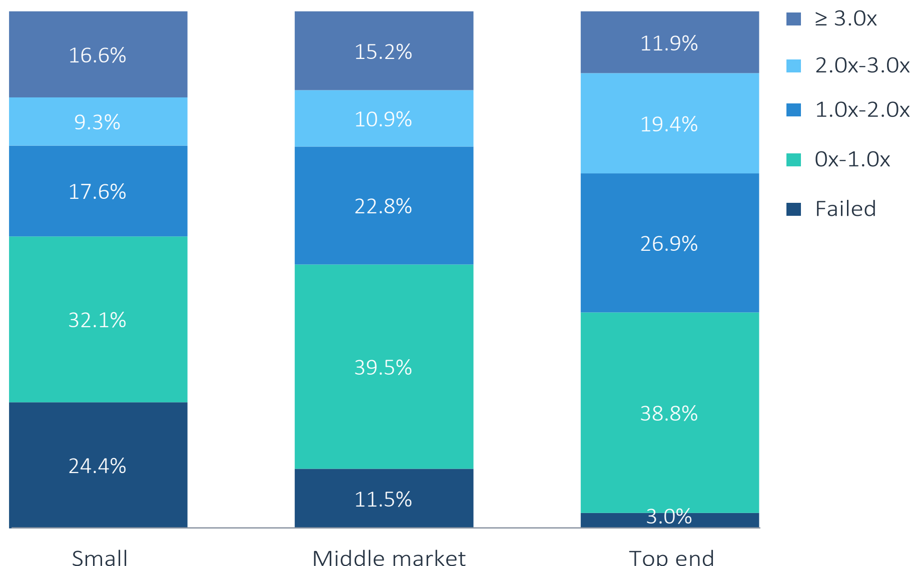
GP stakes deal performance analysis

While private capital AUM has grown at a steady rate over the past decade, individual GPs often experience varied results. Some GPs go on to grow AUM by 2.5x in a decade, whereas AUM for others remains flat. A manager's AUM growth is so important because it can mean the difference between a 5.0x-plus gross MOIC or a 1.5x gross MOIC on a GP stakes investment. To quantify outcomes for GP growth, we broke private capital firms that were active between 2006-2010 into size cohorts: top end, middle market, and small.[1] The results compare their fundraising totals for the 10 years prior to their inclusion in one of these size cohorts to their 10-year fundraising total after that point. We used fundraising rather than AUM because many smaller managers do not list accurate enough AUM changes over time.

We did not find the ensuing results too surprising. GP staking firms targeting top-end managers face virtually no risk of them failing, while nearly one-quarter of small managers do not go on to raise another fund. However, we see that these managers are the most likely to see explosive growth, with 16.6% of them seeing a 3x-plus jump in fundraising in the next decade on a forward-looking basis. This data also illustrates that nearly 60% of the top-end GPs go on to see positive fundraising growth, while just over 40% of small and spinout managers experienced record fundraising upticks.

1: We define the top end as having raised $8 billion or more in the prior decade, middle market as having raised between $1.5 billion and $8 billion in the last decade, and small as having raised between $500 million and $1.5 billion in the last decade.

Figure 1. Difference in total capital raised for target GPs* in the decades prior to and following activity in 2006 and 2010



Source: PitchBook | **Geography:** Global
*As of September 2, 2020

With a firmer understanding of the fundraising/AUM growth scenarios and corresponding probabilities, we used our forthcoming GP valuation model to project GP stakes returns based on each scenario. We modeled potential outcomes from taking equity stakes in hypothetical buyout managers across five scenarios—out of business, no growth, low growth, base case, and a bull case—across our three size buckets, top end, middle market, and small. An appendix attached at the end of this research report details all the pertinent assumptions for each scenario.

As one would expect, top-end GP staking often exhibits a slightly lower return profile with less volatility, while pursuing stakes in smaller GPs can produce higher returns but assumes more risk, on average. Even in "no growth" situations, where a GP's AUM remains approximately flat into perpetuity, GP staking firms targeting middle market and small or spinout managers can hit gross IRRs between the mid-teens to the low 20s. Additionally, with multi-year seller financing and securitization financed dividends, GP staking portfolios with top-end and middle-market firms may deliver even higher IRRs and quicker payback periods, though the eventual DPI and MOIC would remain largely unaffected. These assumed returns are also calculated on an unlevered basis, similar to other growth equity deals, which helps derisk these investments compared to traditional PE investments and provide higher paybacks in worst case scenarios.

Figure 2. GP stakes gross return scenario analysis

GP size	Metric	Firm failure	No growth	Low growth	Base case	Bull case
Top end	Scenario probability	3.0%	38.8%	26.9%	19.4%	11.9%
	Gross IRR	-14.2%	10.7%	18.2%	21.2%	24.2%
	Gross DPI	0.68x	1.03x	1.46x	1.65x	1.85x
	Gross MOIC	0.68x	1.84x	3.01x	3.77x	4.84x
	Gross DPI breakeven	N/A	11.8 years	8.8 years	8.3 years	8.0 years
	Gross average yield	8.9%	12.2%	16.0%	17.8%	19.8%
Middle market	Scenario probability	11.6%	39.9%	22.7%	10.7%	15.1%
	Gross IRR	-3.1%	15.2%	22.8%	26.2%	29.8%
	Gross DPI	0.92x	1.41x	2.07x	2.36x	2.68x
	Gross MOIC	0.92x	2.25x	3.75x	4.96x	6.86x
	Gross DPI breakeven	N/A	9.25 years	6.5 years	6.3 years	6.3 years
	Gross average yield	9.9%	14.5%	20.4%	23.2%	26.4%
Small	Scenario probability	24.3%	32.1%	17.7%	9.3%	16.6%
	Gross IRR	8.8%	21.6%	28.7%	32.2%	35.4%
	Gross DPI	1.28x	2.03x	3.03x	3.57x	4.17x
	Gross MOIC	1.28x	2.94x	4.77x	6.64x	9.04x
	Gross DPI breakeven	5.3 years	5.0 years	5.0 years	5.0 years	4.8 years
	Gross average yield	11.4%	18.4%	27.2%	32.4%	38.3%

Source: PitchBook

Note: Assumes a 12-year holding period. The other relevant assumptions are in the appendix section. Gross average yield is a simple average of the investment's gross quarterly cash yield in Years 1-12. We use the quarter's cash inflows divided by the stake's purchase price.

Manager selection plays a major part in GP stakes investing. GP staking firms can improve their outcomes by avoiding the underperforming managers and/or by investing in the quickest-growing firms. To visualize how powerful manager selection is, we compared four scenarios in the accompanying table, which serves as a probability-weighted return analysis using the scenarios and probabilities listed in Figure 2, a scenario in which the GP stakes firm avoids the bottom 10% of outcomes, a scenario in which the GP stakes firm avoids the bottom 25% of outcomes, and a scenario in which the GP staking investor avoids all "firm failure" and "no growth" outcomes. While top-end GP staking scenarios see marginal difference, GP staking firms targeting small and spinout managers can boost performance by nearly five percentage points by avoiding bottom-quartile outcomes.

While historical data would lead us to believe GP staking firms should achieve the probability-weighted returns, we believe their returns will be higher. First, the act of selling a stake inherently means the GP intends to be around for the long haul and reinvest in their business by raising the GP commitment and/or expanding strategy offerings. The act of selling a minority equity stake may also help institutionalize and push ownership down the organizational structure, helping with employee retention and diminishing the risk of key employees leaving. Furthermore, poorly performing managers—the ones who are unlikely to remain in business—are also unlikely to receive offers from GP stakes firms. However, if private market AUM growth slows in the coming decade, returns could be lower.

Figure 3. GP stakes probability-weighted returns scenarios

GP size	Metric	Probability weighted	Returns without worst 10%	Returns without worst 25%	Returns avoiding "no growth" or "firm failure" cases
Top end	Gross IRR	15.6%	17.0%	18.2%	20.4%
	Gross DPI	1.35x	1.40x	1.47x	1.60x
	Gross MOIC	2.85x	3.00x	3.23x	3.64x
	Gross DPI breakeven	9.8 years	9.6 years	9.2 years	8.4 years
	Gross average yield	15.1%	15.5%	16.2%	17.4%
Middle market	Gross IRR	18.2%	20.5%	22.0%	25.7%
	Gross DPI	1.80x	1.89x	2.00x	2.32x
	Gross MOIC	3.42x	3.70x	4.02x	4.99x
	Gross DPI breakeven	7.8 years	7.7 years	7.4 years	6.4 years
	Gross average yield	18.8%	19.7%	20.6%	22.9%
Small	Gross IRR	23.0%	24.6%	27.6%	32.0%
	Gross DPI	2.52x	2.66x	2.93x	3.58x
	Gross MOIC	4.22x	4.55x	5.18x	6.80x
	Gross DPI breakeven	5.0 years	5.0 years	4.9 years	4.9 years
	Gross average yield	22.9%	24.1%	26.6%	32.5%

Source: PitchBook
Note: Assumes a 12-year holding period. The other relevant assumptions are in the appendix section.

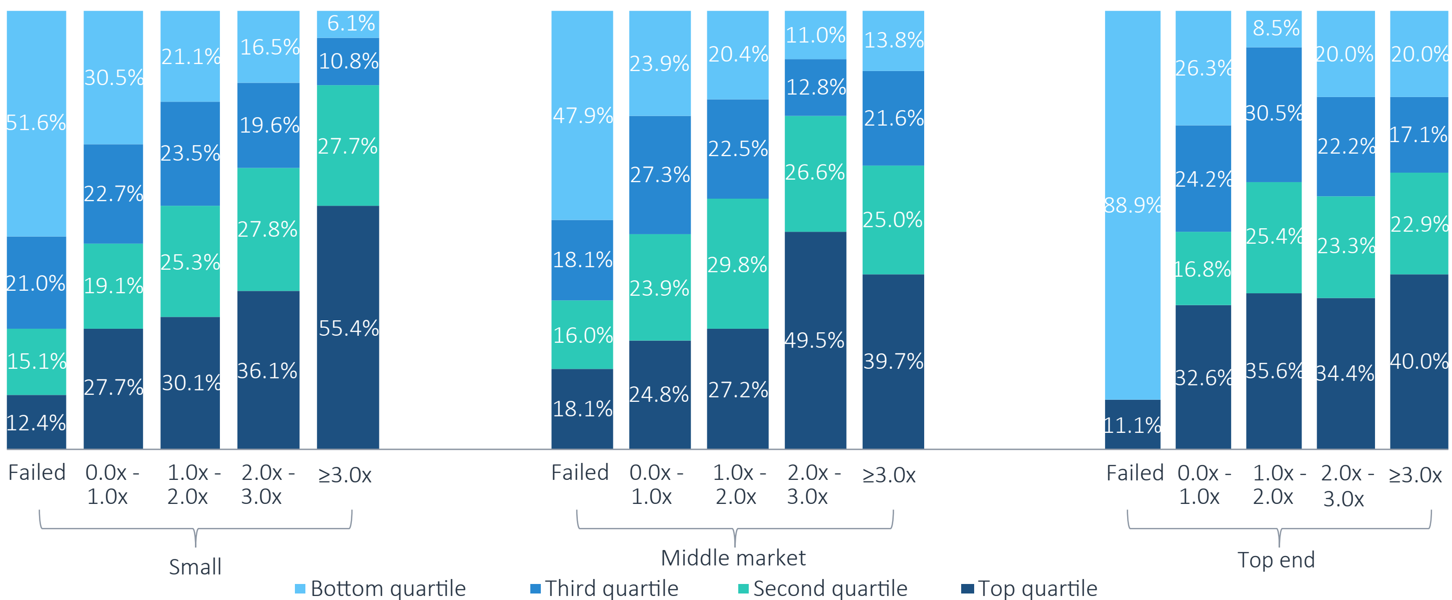
GP performance

Fund performance and AUM growth

Using this framework for GP fundraising distributions, we sought to understand how important a GP's fund performance was to the firm's overall success at growing assets. While healthy performance is important to growing assets, the

main thing that stands out is how detrimental bottom-quartile funds can be for the longevity of a GP. Bottom-quartile funds made up 45% or more of the funds that GPs raised before failing. We also noticed that top- and second-quartile fund performance are essential to sustained AUM growth, but less so the larger a manager becomes. Top-end GPs in the most successful fundraising cohort saw 39.5% of funds in the bottom two quartiles, while the top fundraising cohort for middle-market GPs saw 35.8% of funds in the bottom two quartiles and just 16.8% for small managers. While performance is important to becoming a top-end firm, growth from that point is more likely predicated on past performance, performance consistency, the IR team, and LP relationships than producing top-quartile funds.

Figure 4. Fund IRR quartiles by fundraising growth bucket



Source: PitchBook | **Geography:** Global
*Fundraising data as of September 2, 2020;
fund performance data as of December 31, 2019

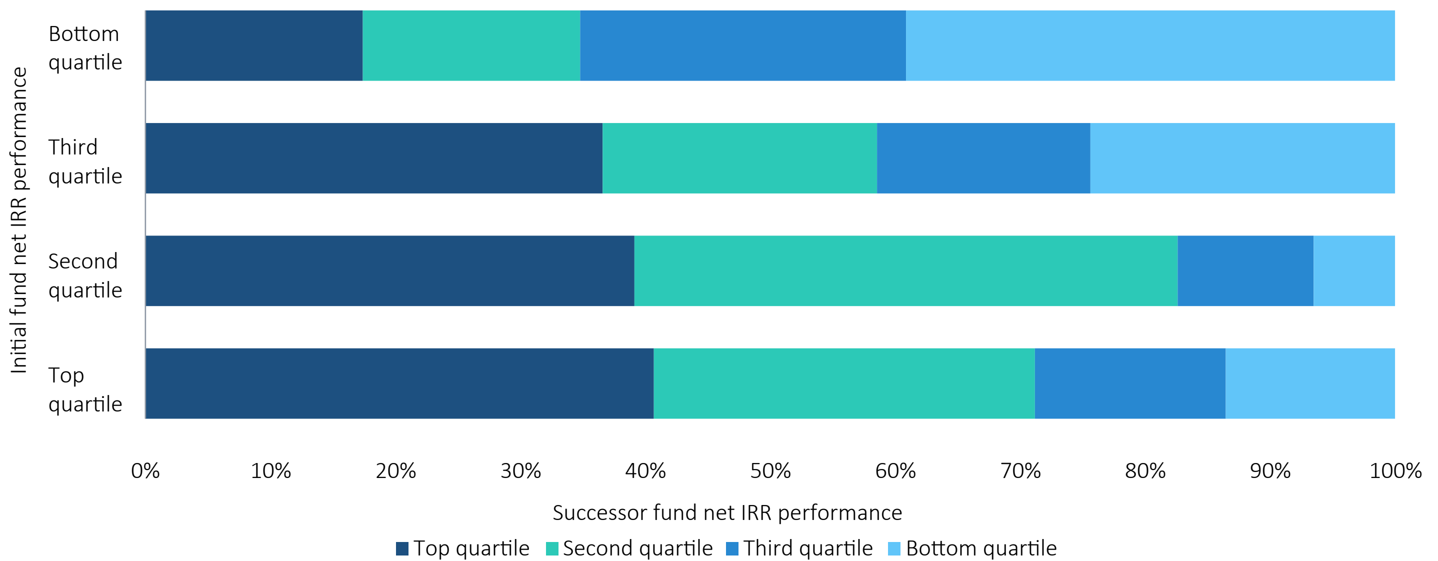
Performance assumptions

Underlying performance assumptions drive the expected carry values but also influence step-up projections and more. Overestimating performance presents a substantial risk to GP stakes investments, which is why most GP staking firms project diminishing outperformance into the future. GP stakes investors need to be certain that any level of GP outperformance is not just defensible long term, but that the strategy is scalable as well if the GP is planning to grow. Some GP strategies require smaller fund sizes to remain competitive and cannot produce differentiated performance with massive funds. GP stakes firms often perform a bottoms-up, performance disaggregation analysis, which breaks out the underlying performance drivers for a GP—such as organic growth, inorganic growth, cost cutting, etc.—to better understand how their past performance was achieved. This can help GP stakes investors understand how a GP creates value and whether their past performance was due to skill or happenstance.

While there is some performance persistency in private markets, top-quartile managers do not always remain top-quartile, just as bottom-quartile managers do not always remain at the bottom. To see how performance persistence

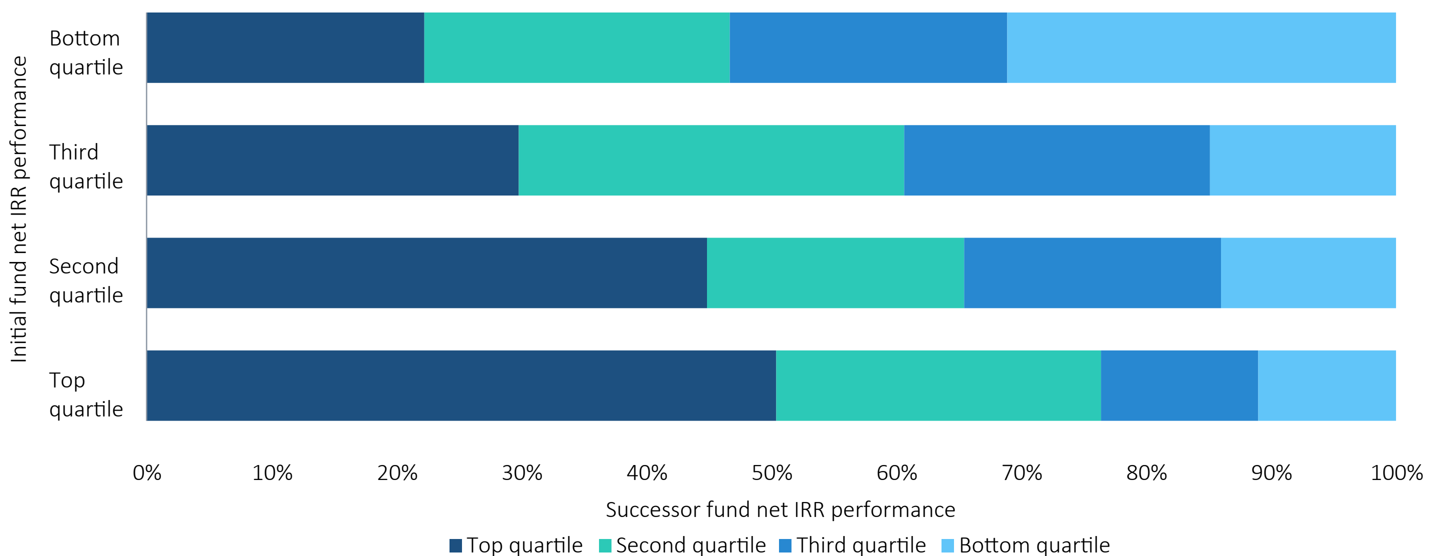
differs by strategy, we compared the persistence of net IRR quartiles for buyout, real estate, and debt managers. We found that performance was slightly more persistent in real estate, where 50% of top-quartile managers stayed in the top quartile, followed by buyout, and lastly debt, where 40% of top-quartile managers had top-quartile successor funds. This indicates that GP staking firms need to be extra cautious when choosing private debt managers because there appears to be less repeatable alpha in the space—perhaps due to the lower dispersion of returns in fixed income more generally—compared to buyout or real estate. We also see that performance persistence diminishes with size, likely indicating that some strategies are not scalable.

Figure 5. Performance persistence for buyout managers



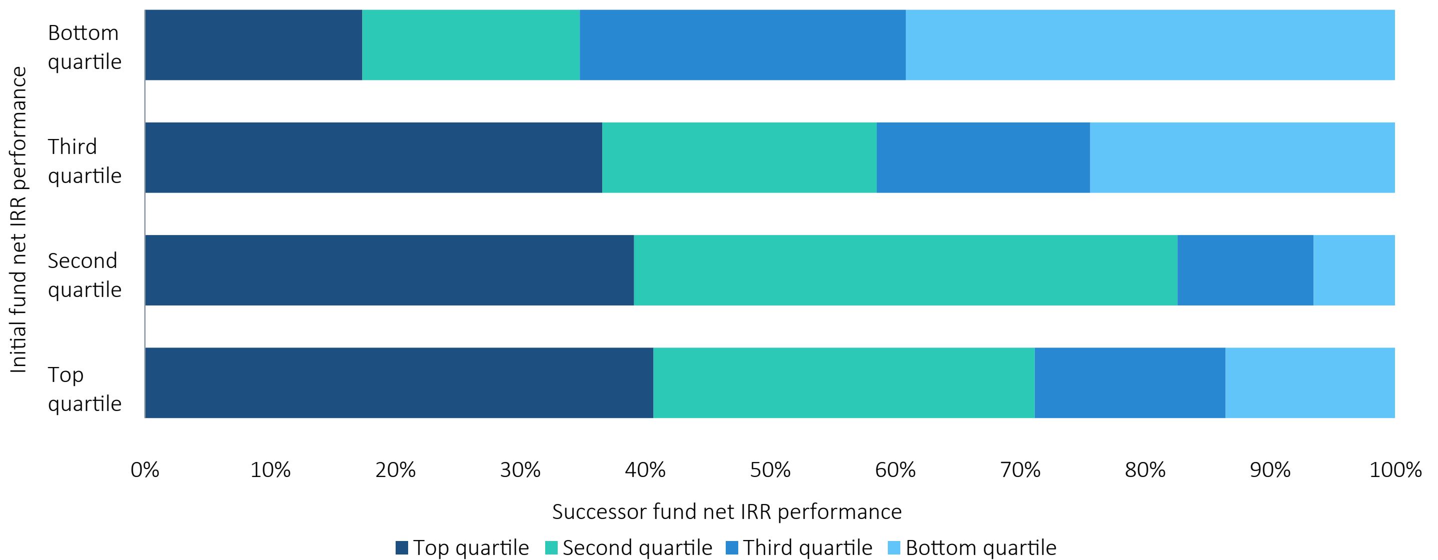
Source: PitchBook | **Geography:** Global
*As of December 31, 2019

Figure 6. Performance persistence for real estate managers



Source: PitchBook | **Geography:** Global
*As of December 31, 2019

Figure 7. Performance persistence for debt managers

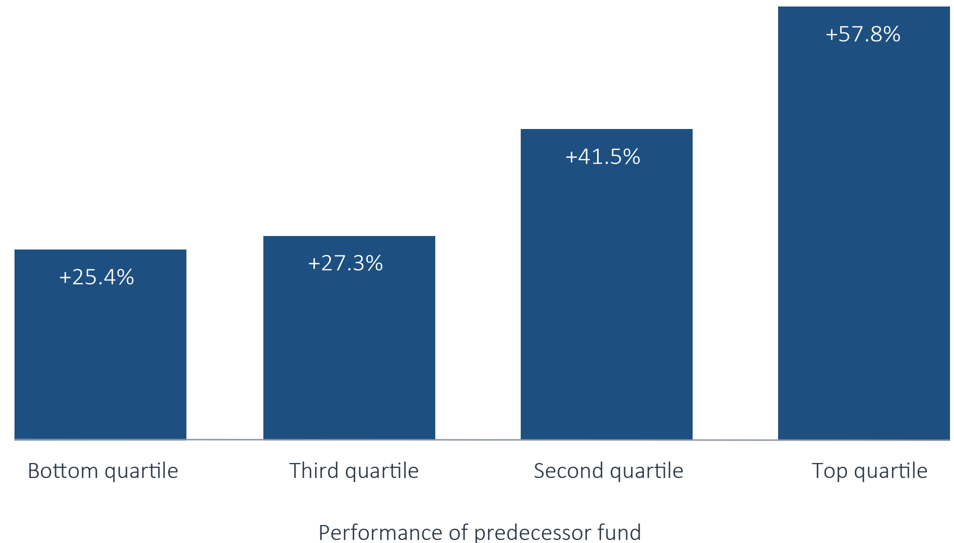


Source: PitchBook | **Geography:** Global
*As of December 31, 2019

Other return drivers

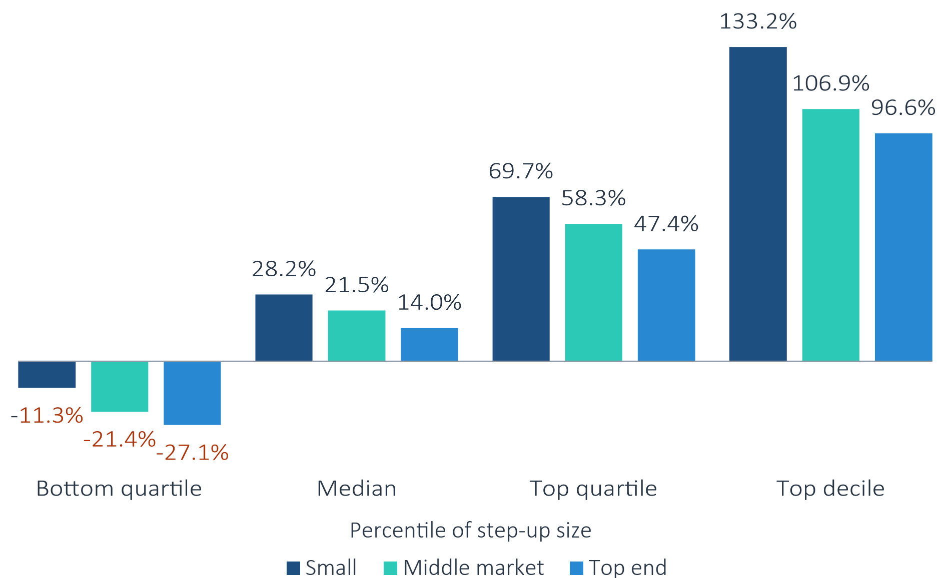
While a GP's performance can make or break a GP staking deal, everything that goes along with well-performing GPs—including higher step-ups, expansion of strategy offerings, and more—really drives AUM growth and GP stakes deal returns. Top-performing firms typically achieve higher step-ups and grow AUM more quickly. We looked at median fund step-ups for buyout funds by the previous fund's quartile and found a massive disparity between top-performing funds and bottom-quartile funds. In fact, we found that most bottom-quartile fund managers, especially for small GPs, do not go on to raise another fund. Additionally, the disparity between top-quartile and top-decile—in terms of step-up size, not related to fund performance—is massive, with the top-decile step-ups coming in almost twice as high as the top quartile. This again illustrates how much manager selection can propel returns for GP stakes investors. We see a healthy variation in size as well, with larger GPs typically seeing smaller step-ups over time. This makes intuitive sense and affirms that GP stakes investors cannot simply rely on straight-line projections from previous fund step-ups going forward.

Figure 8. Fund step-ups by predecessor fund performance



Source: PitchBook | **Geography:** Global
*Fundraising data as of September 2, 2020;
fund performance data as of December 31, 2019

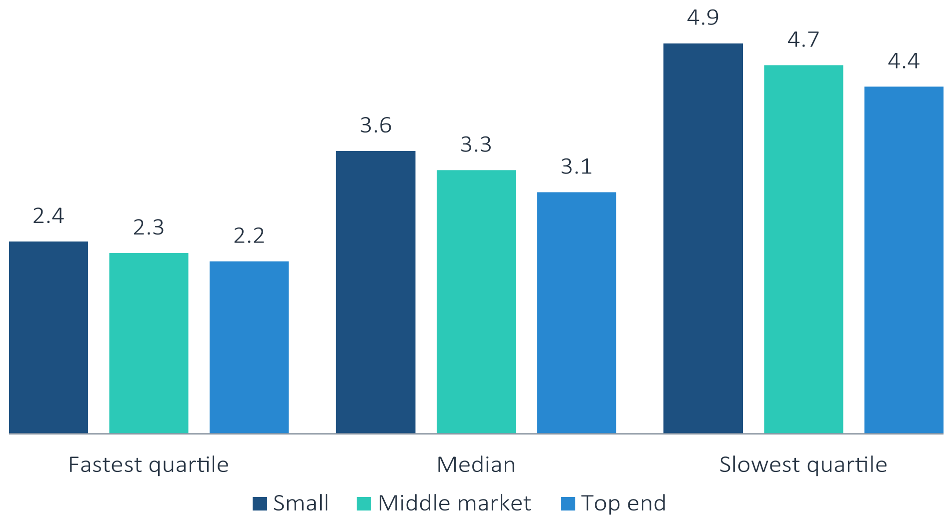
Figure 9. Quartile distribution of step-ups by GP size



Source: PitchBook | **Geography:** Global
*As of December 31, 2019
Note: The quartiles listed are in reference to step-up sizes rather than previous fund performance.

Beyond step-ups, the amount of time that a GP takes between fundraises and the number of its strategy offerings can meaningfully alter a GP's AUM growth. The time between funds is a frequently glossed over assumption that can have profound effects on a GP's valuation. For example, shortening the time between funds from five years to four can result in a 25% lift to AUM, all else equal. We find that large managers need less time between funds, and GP stakes investors may want to account for this in forward projections. Larger managers have typically invested multiple funds, meaning their investment process is honed, and the larger GPs tend to have more developed investment teams capable of quickly deploying capital.

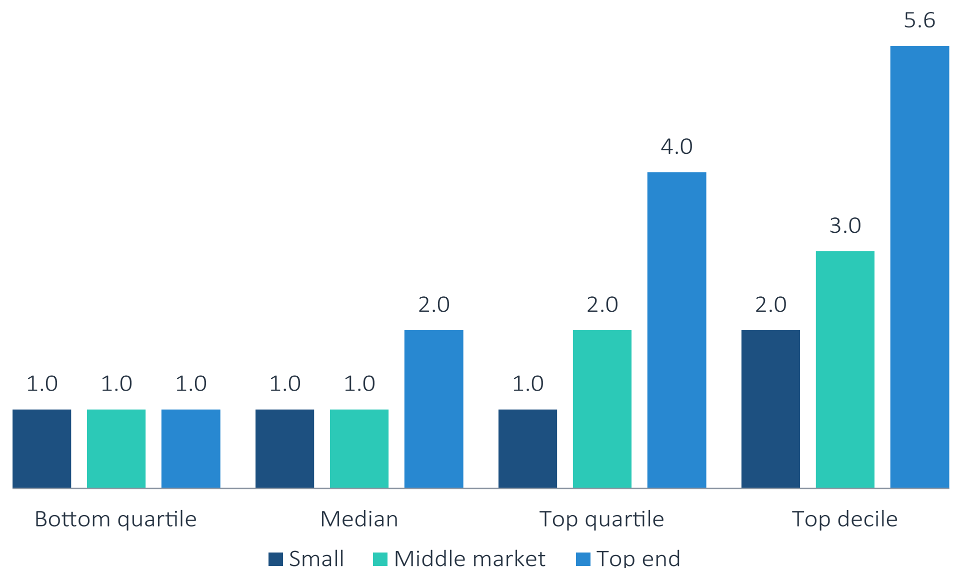
Figure 10. Time between funds (years) for GPs by GP size



Source: PitchBook | **Geography:** Global
*As of September 2, 2020
Note: The quartiles listed are in reference to time between funds rather than previous fund performance.

Strategy expansion is typically reserved for the top-end GPs, though some middle-market firms may offer additional strategies after hitting a couple billion dollars in AUM. Not only does expanding to additional strategies help boost AUM, but it also stabilizes a firm and makes a GP less reliant on a single strategy. One recent example of a GP launching a new fund after selling a stake is Leonard Green & Partners. The firm closed on a $2.75 billion middle-market fund—its first buyout fund other than its flagship strategy—alongside its larger $12.0 billion flagship fund in 2019. This expansion followed the sale of a minority equity stake to Blackstone in 2017. Another example is Francisco Partners, which launched a credit strategy in 2020 after selling a stake to Blackstone and Petershill in 2018.

Figure 11. Number of fund strategies by GP size



Source: PitchBook | **Geography:** Global
*As of September 2, 2020
The quartiles listed are in reference to the number of strategies a GP offers rather than previous fund performance.

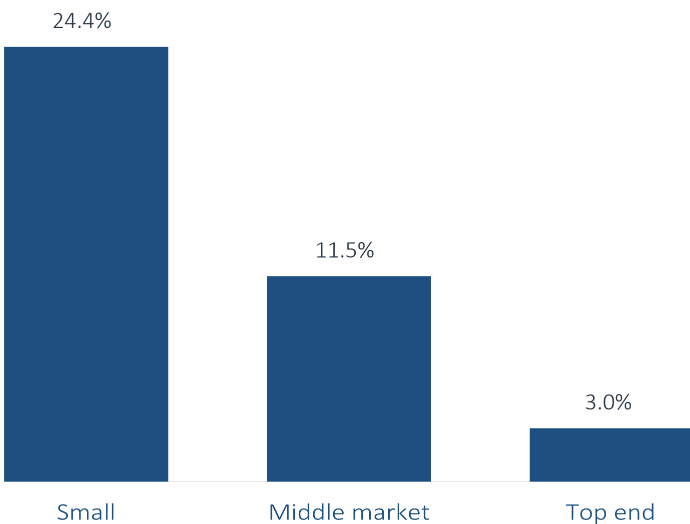
GP staking risks

Investing in GPs that fail

GP staking firms face many risks, but investing in GPs that fail can be the most consequential regarding fund performance erosion. Looking at our fundraising analysis, we found that nearly a quarter of any given small or spinout managers have not gone on to raise another fund. This failure rate is massive compared to the 3.0% we see in top-end managers. For added context, no top-end GP has failed in nearly 20 years, the last time being in the early 2000s when the top two top-end managers produced four bottom-quartile funds each.

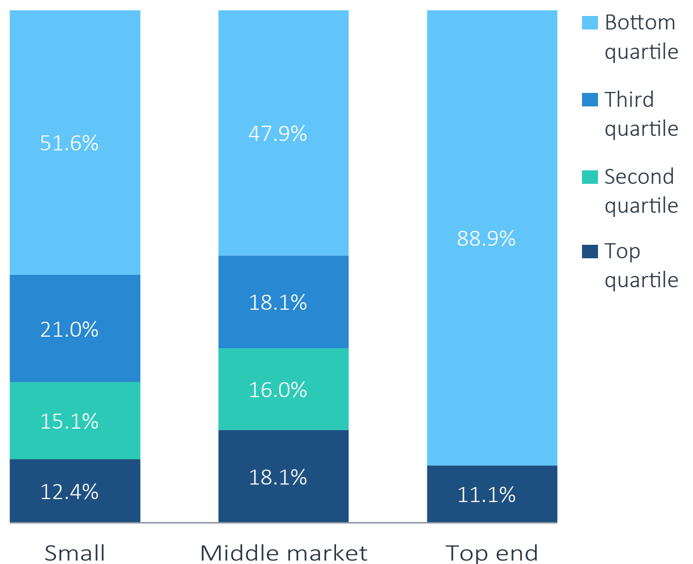
GPs go under for any number of reasons, but performance appears to be the largest cause. A poorly performing fund at a firm with an established track record, such as Silver Lake, will likely be excused by LPs, but for a GP managing its third or fourth fund, bottom-quartile performance can be an existential experience. Partner exits can also cause younger firms to fail. These young GPs are often led by one or two founding partners and often struggle to keep going if one decides to leave because of internal strife, health reasons, better offers, or other issues.

Figure 12. Proportion of GPs that failed by size



Source: PitchBook | **Geography:** Global
*As of September 2, 2020

Figure 13. Fund performance quartile for GPs that failed



Source: PitchBook | **Geography:** Global
*Fundraising data as of September 2, 2020; fund performance data as of December 31, 2019

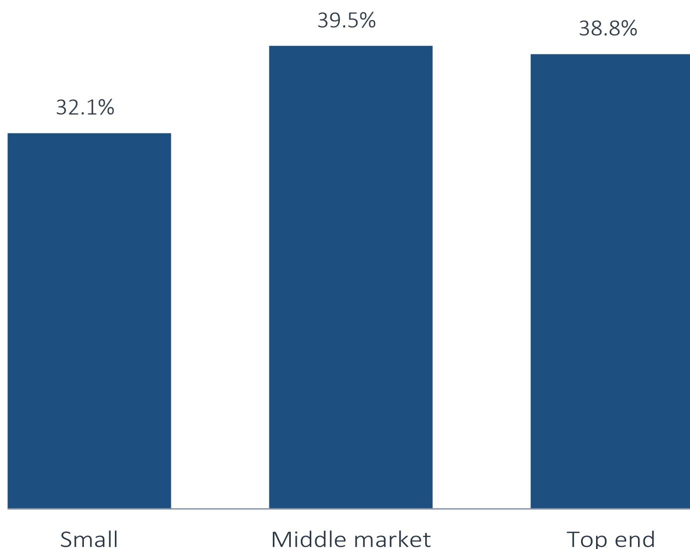
Buying a stake in a manager that ends up going out of business is rare though. Employment agreements and financial incentives most often persuade managers to stick around, especially after selling a stake. However, even when a firm does go out of business, the loss for GP staking investors is less than one may expect because the contractually obligated management fees often come close to recouping all of an investor's initial capital. Investments in firms often come right as they are closing on a new fund, and much of the capital typically goes on the GP's balance sheet. Additionally, GP staking firms usually

buy into the earned but unrealized carry a manager already has, and they can receive payments of management fees and carry a decade into the future, even if a manager fails to raise another fund. GP stakes investments into top-end and middle-market managers will often return between 0.7x and 0.9x even if the manager fails. GP stakes investments into small firms often return more than 1.0x in the event of a firm failure because the purchase price is so low.

Investing in GPs that do not grow

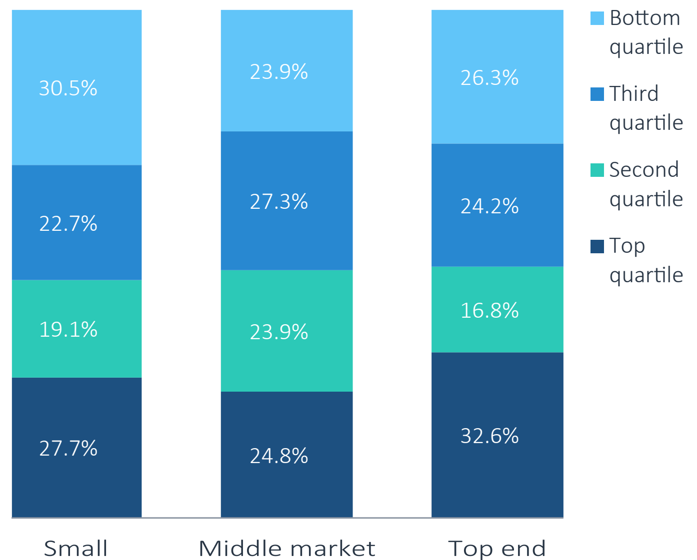
GP staking firms also risk investing in managers that end up slowly shrinking or not growing at all, which is a more common issue than managers going under completely. As we see, nearly one-third of the small or spinout managers fall into the negative-to-no growth bucket, while nearly 40% of the top-end GPs do. However, this outcome still allows GP staking firms to produce respectable returns. Using a 12-year holding period, we estimate that buying a stake in a middle-market firm that does not grow can still produce a gross MOIC of 2.25x and a gross IRR of 15% in that time frame. Curiously, returns are nearly evenly distributed among each quartile of top-end, middle-market, and small managers with negative to no growth. Looking at the underlying data, some of the GPs that have negative-to-no growth with top-quartile performance pursue lower step-ups and take more time between funds—perhaps staying disciplined to following their strategy—while GPs with third quartile and bottom-quartile funds are shrinking.

Figure 14. Proportion of GPs in the negative-to-no growth cohort by size



Source: PitchBook | Geography: Global
*As of September 2, 2020

Figure 15. Fund performance quartile for GPs in the negative-to-no growth cohort



Source: PitchBook | Geography: Global
*Fundraising data as of September 2, 2020; fund performance data as of December 31, 2019

Strategic planning

Longer-term business value also poses a risk (and potential upside driver) in GP stakes investments. While an enduring business is typically more certain with longer-term outperformance, small back- and middle-office tweaks can help the

GP institutionalize and last for multiple generations. This is not to say that GPs that sell a stake need extensive work to be viable long term, but rather each manager has their own unique set up that must change with time, especially if the GP wants to be in business for generations to come. One of the first things GP staking investors look to implement is a succession plan to mitigate key person risk. Succession planning is often a difficult balancing act because GP stakes firms may be dealing with big personalities looking to remain in control for longer than the next generation would like. Two ways around this are to have multiple executives at the top, making a firm less reliant on one individual, and to create an ownership culture. An ownership culture is often a great way to retain the junior directors. In fact, many GPs use some of the equity sale proceeds to boost the next generation's firm ownership percentage. Additional areas where GP staking firms may help the managers in which they invest include marketing, IR, legal, HR, and other internal operations. Some decisions, such as when to stop outsourcing legal counsel and HR, can have longer term effects on business value as the GP scales. For all these reasons and more, it is imperative that GP staking firms plan at least one generation ahead and have the resources to help when partner firms need to make operational changes.

Deal terms and rights

While we do not expect all LPs and non-GP staking investors to understand the minutiae of every GP stakes deal, it is important to have a broad understanding of how the deal terms and rights protect the investors and align interests between parties in what is meant to be a decade-plus-long partnership. Some GP stakes firms will seek a lower headline price by conceding on key deal terms and rights. On the other hand, some GPs can secure more favorable terms on certain points as they leverage their position in times of heightened buy-side competition. Furthermore, it is important to know whether rights transfer with equity ownership or whether any new buyer must go back and renegotiate with the GP before any investors are granted liquidity. The following terms and rights are meant to be a generalized overview of where the industry is headed, and industry participants should understand that GP stakes arrangements between a GP and an LP—such as a family office or insurance company—is likely to be even more bespoke.

Several deal terms and rights help GP stakes firms derisk investments from the start. Joseph Schwartz, an investment funds and M&A attorney at Sidley Austin who has drafted and advised on many GP stakes legal documents, provided us with more context. "GP stake buyers often seek more robust minority protections and governance rights as compared to a minority investor in a private operating company," he said. "In the VC space, for example, operating companies tend to be financed by multiple investors over a number of financing rounds, so the nature and extent of minority protections are few and typically limited to preservation of core economics. GPs, on the other hand, typically are proprietary and closely held businesses that (usually) partner with a single GP staking firm. Further, certain GP stake investors want to—and may be expected to—help institutionalize the GP, so a heightened level of involvement and associated rights are common."[2]

More so than a typical operating company, the assets of a GP's business are people and their networks, which raises employment, competition, and reputational issues. Because of this, GP staking firms may take out life insurance on key persons.

2: Joseph Schwartz, email correspondence with Wylie Fernyhough, August 31, 2020

Furthermore, GP staking firms often seek long-term employment contracts for the key person(s) at the target firm and likely also include non-compete and non-solicitation restrictions. The GP stakes investor will likely also include consent rights surrounding termination of key person(s) in a deal.

From a governance perspective, although most GP stakes investors are not interested in day-to-day control of the GP in which they are investing—especially the investment decisions that GP target makes—they will often demand certain information and management access rights. For some, a limited set of veto rights over significant events and basic inspection and access to information rights will suffice. For most, however, checks and controls on GP governance are more important and robust. Many GP stakes deals also include representation by the investor on the target GP's board (or similar governing body) and/or management committee observer rights. Governance rights may also include limitations on certain expenses, cooperation covenants with respect to tax matters, and even redemption rights in case of adverse events. According to Schwartz, "A crucial, but sometimes overlooked, point is the governance arrangement between or among the controlling principals. For example, deadlock resolution mechanics (e.g., buy/sell provisions) in the case of a GP under joint control of multiple principals is important, as a GP stakes investor may otherwise suffer significant value erosion if an irreconcilable dispute emerges among the active, controlling principals."[3]

From an economic perspective, GP stakes investors often seek additional risk-mitigating features, such as protections against dilution (with certain exceptions) and economic leakage. In all cases, the buyer receives preemption rights. GP stakes deals also typically include consent rights pertaining to: non-pro-rata distribution of equity; issuance of securities that rank senior to those issued to the GP stakes buyer; registration rights in the event of an IPO, firm mergers, acquisitions, or divestitures; materially changing the firm's capital structure, governance, or accounting methods; related party transactions; conducting business through a non-wholly owned subsidiary; delaying distributions other than for ordinary course reserves and/or some agreed upon "cushion," and more. Some additional protections that GP stakes investors may seek include: tag-along sale rights, restrictions on transfers to competitors, rights of first offer or refusal on any equity or asset transfers, a mutual "standstill" on ownership transfers for some time, and restrictions on majority sales unless a certain return threshold is met.

LP risks

LPs face the added layer of risk in selecting a manager that goes under and thereby letting uncalled capital sitting idle for a few years. LPs that commit to only one or two GP staking firms targeting the middle market or small GPs could end up seeing little to no return on what was supposed to be their entire GP stakes allocation if a GP staking firm fails to secure a final close on their fund. While this risk is somewhat lessened if the GP never calls down the capital, earmarking a $20 million-plus commitment to a GP that goes under can still drag on overall performance. There are currently four to six firms seeking stakes in middle-market GPs and actively raising capital, with a similar number targeting small and spinout managers. Some are already showing signs of stress and, if history is any indication, one or more are likely to fail. We have seen this with firms such as Magnetar, GP Interests, and Cannon Street Capital, among others, that sought to raise GP stakes capital for a

3: Joseph Schwartz, email correspondence with Wylie Fernyhough, August 31, 2020

couple years before calling it quits. However, LPs contend with the risk of failure in any allocation to a first-time manager and will undertake the same diligence process to vet these firms. LPs must also be aware of whether the GP stakes investor prioritizes raising capital and investing no matter the cost or whether there is a focus on deal price, terms and rights, and forging a long-term partnership.

The risk of backing a GP staking firm that fails is not very relevant when LPs allocate to Dyal, Petershill, or Blackstone, which is why the top three firms active in this strategy continue to garner outsized proportions of capital raised for it. Some LPs are willing to trade five percentage points of return if they can be more certain of an investment's outcome.

However, GP staking firms focused on the middle market in particular seem to have learned from past mistakes. Some, including Stonyrock and RidgeLake, pursued sizable amounts of seed capital, which helps to derisk LP commitments by allowing these newer managers to make several GP stakes investments and prove out their thesis and process ahead of time. Other GP staking firms, such as Bonaccord, Stonyrock, and Investcorp Strategic Capital Holdings, have also partnered with large institutional asset managers, which can help lift them off the ground sooner and provide more value to the GPs in which they invest. These changes may help more GP staking managers from this generation—including those targeting the middle market, spinout, and small managers—find success. LPs also take less risk when allocating to first-time GP stakes funds that have already raised substantial amounts of capital. For example, Bonaccord Capital Partners has now reportedly surpassed the halfway point of its fundraising target, meaning LPs committing to the fund now are taking less risk than LPs that committed a year or more ago.

Conclusion

In GP stakes investing, both risks and returns are high. Many LPs choose to mitigate some of those risks by investing with top-end GPs but may miss out on the potential returns generated by some middle-market or small manager-focused GP staking firms. With so much capital flowing into both veteran firms and newcomers in the GP stakes market across so many deals, we believe we are living through the most exciting time in the strategy's history. As this transaction type becomes more normalized as a means for GPs to raise permanent capital and/or hasten their growth plans, it should allow for more deals to close and capital to be deployed, especially with middle-market and small managers. We also believe change is in store for GP stakes, with a good chance that one firm exits the market and a new firm likely enters in the next 12 to 18 months. With all this attention on fundraising and deals, eventual liquidity options have received much less interest. We will be watching the market closely and continue to follow its evolution and plan on covering monetization options in an upcoming GP stakes research report.

Appendix

Figure 16. Scenario analysis assumptions

GP size	Metric	Firm failure	No growth	Low growth	Base case	Bull case
Top end	NTM ENI entry multiple	10.5x	10.5x	10.5x	10.5x	10.5x
	NTM ENI exit multiple	NA	9.5x	10.5x	11.0x	11.5x
	Target GP fund gross MOIC	1.0x	1.5x then 2.25x	1.9x	2.1x	2.35x
	Target GP fund length	12 years	12 years	12 years	12 years	12 years
	Number of strategies	2	2	2	2	3
	Target GP fund step-ups	NA	-$1B then 0%	$500M	25% then +$1B	35%
	Beginning fund size	$4.5B	$4.5B	$4.5B	$4.5B	$4.5B
	Ending fund size	NA	$3.5B	$6.0B	$7.6B	$11.1B
	Target GP 2nd fund step-ups	NA	Discontinued	$50M	25%	35%
	Beginning 2nd fund size	$850M	$850M	$850M	$850M	$850M
	Ending 2nd fund size	NA	NA	$1.0B	$1.7B	$2.1B
	GP stake holding time	NA	12 years	12 years	12 years	12 years
Middle market	NTM ENI entry multiple	8.0x	8.0x	8.0x	8.0x	8.0x
	NTM ENI exit multiple	NA	7.0x	8.0x	9.0x	10.0x
	Target GP fund gross MOIC	1.0x	1.5x then 2.25x	2.1x	2.35x	2.5x
	Target GP fund length	12 years	12 years	12 years	12 years	12 years
	Number of strategies	1	1	1	1	2
	Target GP fund step-ups	NA	-$500M then 0%	15%	30%	45%
	Beginning fund size	$2.0B	$2.0B	$2.0B	$2.0B	$2.0B
	Ending fund size	NA	$1.5B	$3.0B	$4.4B	$6.1B
	GP stake holding time	NA	12 years	12 years	12 years	12 years
Small	NTM ENI entry multiple	6.0x	6.0x	6.0x	6.0x	6.0x
	NTM ENI exit multiple	NA	5.0x	6.0x	7.0x	7.5x
	Target GP fund gross MOIC	1.0x	1.5x then 2.25x	2.1x	2.35x	2.5x
	Target GP fund length	12 years	12 years	12 years	12 years	12 years
	Number of strategies	1	1	1	1	1
	Target GP fund step-ups	NA	-$125M then 0%	$50M	30%	50%
	Beginning fund size	$500M	$500M	$500M	$500M	$500M
	Ending fund size	NA	$375M	$650M	$1.1B	$1.7B
	GP stake holding time	NA	12 years	12 years	12 years	12 years

Source: PitchBook

Note: We assume all GP stakes deals are evenly split between management fee and carry. Some deals are structured to have 20% fees and 10% carry, for example, but they are also evenly split because half of the carry is expected to be allocated to individuals at the firm meaning it is 20% of the GP's carry, matching the fee percentage. Additionally, we assume that all staking deals give the buyer 100% pro-rata economics but are paid out over four years at the top end, three years at the middle market, and two years for small & spinout. We assume 50% of carry is allocated to the GP's staff and half is allocated to the GP, effectively giving it a 50% margin in all cases. For top-end GPs, we assumed a 60% net margin for management fees. In the no-growth scenario, we dropped the margin to 55% in Year 8. For middle-market GPs, we assumed a 50% net margin for management fees. In the bull scenario, we raised the margin to 55% in Year 8 and beyond. In the no-growth scenario, we cut margins to 45% in Year 8 and beyond. For small GPs, we assumed a 40% net margin for management fees. In the bull scenario, we boosted the margins to 45% in Year 8 and beyond. In the failure scenarios, we assumed management fee margins diminished by five percentage points per year in Year 6 and beyond and assumed no terminal value for all GP sizes. For time between funds, we used four years across the board. We could have been more aggressive in assumptions for the top-end and middle-market but felt we should not underwrite perfect fundraising. Additionally, while the four-year span was more appropriate for small GPs, our step-up assumptions are very conservative, likely underestimating returns in the base and bull cases. The bull cases in the middle market and top end assume a new $850 million strategy is launched when the stake is sold.

In researching model assumptions for these returns, we found that middle-market staking deals were often done with seller financing of three or four years. This discrepancy is not found at the top end where virtually all deals include four years of seller financing or investing in small GPs, where seller financing is either not used explicitly. Rather, payments to the GP are drawn down over time as needed. While this single year of financing may not seem meaningful, we found it could affect gross IRRs by approximately three percentage points and gross average yields by nearly two percentage points. LPs looking to compare return projections from different GP staking firms should be aware of these underlying assumptions as well as holding period, fund step-ups, and more.

Figure 17. Middle-market GP stakes seller financing term analysis

Seller financing	Metric	Firm failure	No growth	Low growth	Base case	Bull case
Three year	Gross IRR	-3.1%	15.2%	22.8%	26.2%	29.8%
	Gross average yield	9.9%	14.5%	20.4%	23.2%	26.4%
Four year	Gross IRR	-3.8%	17.0%	25.5%	29.1%	33.0%
	Gross average yield	12.0%	16.6%	22.5%	25.3%	28.5%

Source: PitchBook