MEKETA
INVESTMENT GROUP

GP Stakes Investing

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Private market investment strategies continue to expand while providing differentiated risk/return profiles. Capital investments into private market management companies, known as "GP stakes",[1] are an example of this expansion. GP stakes provide a differentiated way to participate in the potentially attractive economics of private market firms ("GPs" or "managers"). The primary focus of a typical GP stakes transaction is to purchase a minority ownership position of a private market manager, commonly around 20%, and participate in a combination of the management fees, pro rata share of the proceeds of GP commitments to funds, and/or performance fees (i.e., carried interest).

Minority investments into private market firms were, in general, made initially by larger institutional investors on a one-off basis, commonly with an orientation toward developing a strategic relationship with the GP. These investments typically represented large, existing relationships within an investor's portfolio, and the strategic investment in the private market firm was often intended to increase the opportunity set for future transactions,[2] provide the manager with additional balance sheet support, and ultimately strengthen the GP/LP relationship.

The market for GP stakes investing has grown such that there are now dedicated commingled investment vehicles that are targeting these transactions, allowing for a broader spectrum of private market investors to participate. Initial GP stakes investment activity focused on the hedge fund space, but over the past ten years it has evolved to include a broader spectrum of "alternative" asset classes, including private equity, real estate, infrastructure, natural resources, private credit, and hedge funds. A combination of the stability of projected cashflows associated with the locked-up capital, combined with the increased willingness of private market firms to sell minority stakes, has contributed to this evolution.

GP stakes investment strategies have also evolved to incorporate a degree of specialization, including a transaction focus that ranges from smaller, high growth private market firms to larger, well-established firms. In addition, some strategies also include significant limited partner commitments (i.e., "seeding" or "anchor" commitments).

GP stakes managers

The market for GP stakes investing has grown significantly over the past ten years, with a handful of firms raising multiple funds focused on GP stakes. Fund sizes for managers targeting GP stakes is commonly a function of the target market, but fund sizes have increased with the largest reaching ~$12 billion.[3]

[1] General partners, or GPs, oversee and run the business of a private market investment partnership.

[2] Commonly in the form of increased access to co-investment, but it could include other products and economic benefits.

[3] Per Preqin.

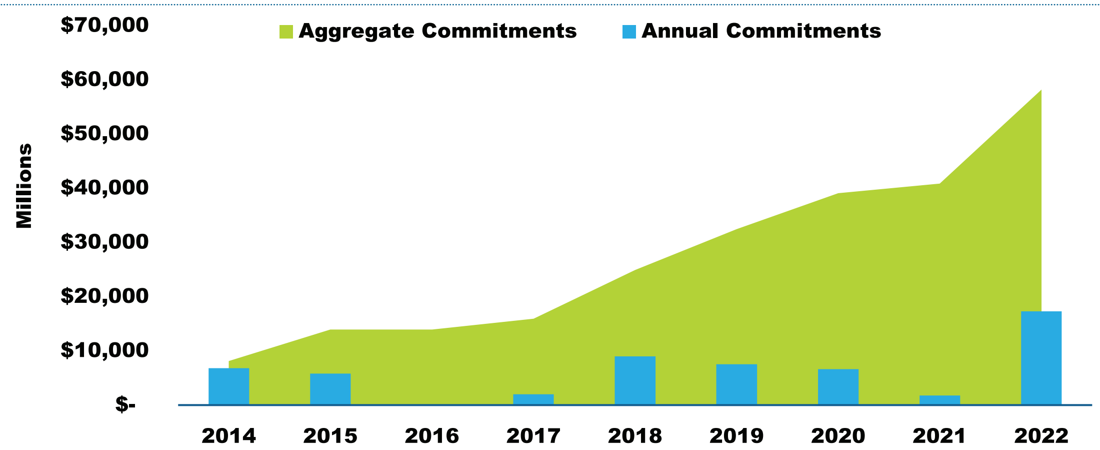

FIGURE 1
GP Stakes Fundraising

Source: Preqin, Meketa, as of April 2023.

The universe of GP stakes funds has grown, with differentiation primarily across the target AUM of the underlying private market manager. While not intended to be an exhaustive list, the market map below outlines the spectrum of funds raised over the past several years, highlighting the range of fund sizes and target AUM.

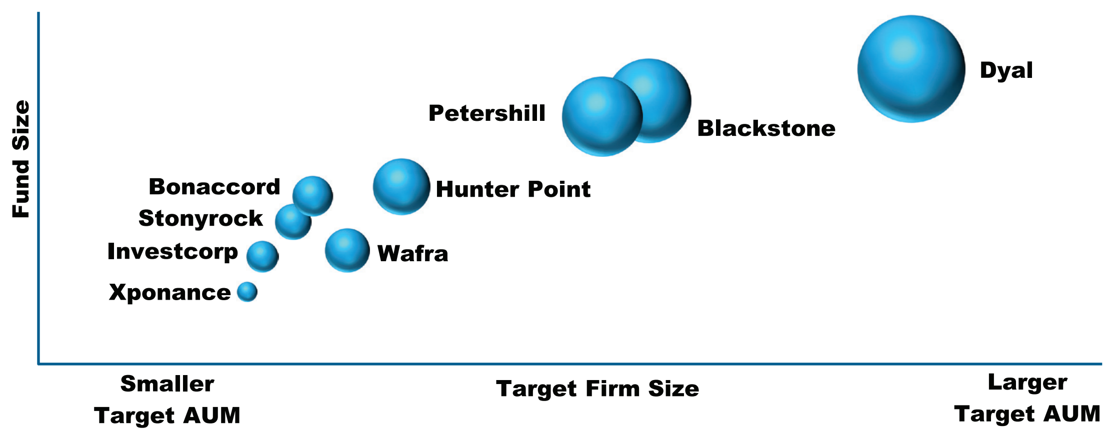

FIGURE 2
GP Stakes Funds Market Map

Source: Preqin, Meketa, as of December 31, 2022.

Return profile

The return profile of a GP stakes investment opportunity will vary depending upon the manager's specific investment strategy, but the primary components of return are generated through a combination of management fees (or revenue share), GP commitments to their underlying fund(s), and carried interest. This results in a profile that is expected to provide a significant proportion of the return through regular cash distributions/yield from the management fees, with additional capital appreciation, or "upside", potentially achieved over the longer term from the performance of the underlying funds and/or a share of carried interest.

→ Management fees are paid on a fixed schedule, contractually obligated, over the life of an underlying partnership (typically ten years or more). This provides a consistent source of cash distributions that are expected to be relatively stable. As managers raise additional partnerships, this management fee cash flow should increase with expected subsequent larger funds sizes, only partially offset by the sunsetting of prior partnerships. This component of the GP stakes return should be a material contributor to the ultimate return profile and is commonly modeled to generate at least investment cost (i.e., the management fees earned from the ownership in the underlying GP will offset the cost of the GP stakes fund itself).

- A second component of return comes from the pro rata share of the GP's co-investment in their underlying funds. The return generated is gross of fees (i.e., no management fee or carry) on their underlying transactions. This return should exhibit more variability than the management fee return stream, but with more upside potential over longer time periods. The potential range of outcomes can vary by strategy, with lower risk/return exposures in areas such as private credit and infrastructure, to higher risk/return profiles associated with private equity firms.

- Carried interest allocations are a third, and even less predictable, component of the GP stakes investment strategy. This exposure provides significant potential for upside from underlying partnerships that generate strong performance. A material component of a GP stakes investment strategy is identifying and partnering with underlying firms capable of generating high risk-adjusted returns (i.e., above preferred return hurdles), thus resulting in the payment of carried interest.

- The final component of the GP stakes return profile is the exit of the minority ownership position in the underlying private market firm, ideally at a gain relative to the initial purchase price. The holding periods and expected return associated with the minority position is uncertain, and there have been limited realizations to date. GP stakes investment funds have exhibited the ability to generate liquidity but generating returns through sale of a GP investment remains relatively unproven.

There are limited observations for mature GP stakes fund performance at this time, preventing an in-depth analysis of actual results. However, most GP stakes investment funds should produce a relatively stable return profile, de-risking over time as distributions are returned, with additional upside generated via participation in carried interest distributions and sale of the equity ownership positions. Still, it is likely that the risk/return profiles can range widely. For example, a fund targeting stakes in large, established GPs will probably have a different profile than a fund targeting small, emerging managers that typically include anchor positions.

Why do GPs take minority investments?

Given the attractive economics of private market firms, investors may question why managers would sell minority positions. A skeptic may feel that transactions are completed to provide liquidity or an exit to existing owners/founders, but that is just one potential transaction incentive. The primary purpose referenced by GP stakes managers for minority transactions is to provide capital for growth initiatives. This additional capital might be used by the GPs to make a larger commitment to their funds (to enhance the alignment of interest with LPs), to establish new products (which may require the addition of new teams), or to expand platforms (e.g., targeting a new asset class in the private markets or a new geography). The capital may also serve to aid in the evolution of a firm through succession planning or removing restrictive ownership structures (e.g., buying out silent or other passive owners). Transactions including a liquidity event must balance the potential disruption of current, successful leadership, with establishing new leadership to allow for a generational transition and potential future success.

Value add

As minority owners, the GP stakes managers may be able to provide value add services on a collaborative basis with the goal of increasing management fee streams and potential carried interest payments over the long-term. Much of these efforts focus on the long-term growth and stability of the firm's AUM by targeting client growth, business development, and product expansion. This may include introductions to additional limited partners to expand and increase the capital base. Providing insight and guidance on product expansion and associated market analytics is another area of potential value add many GP stakes managers seek to provide. The GP may also value guidance on best practices across a variety of areas, including human capital, organizational design, and diversity and inclusion policies. While these activities may not be key drivers in the ultimate return of the GP stakes transaction, the GP stakes manager's ability to provide such services and guidance may be important in their ability to source and close targeted transactions.

Considerations

These are considerations that may change the risk/return profile of a GP stakes investment strategy or significantly influence the ultimate return of a transaction.

→ GP stakes investment funds likely require a holding period that is even longer than a typical private equity fund, as the formal partnership term is commonly open ended without an established termination date. Proposed investment models typically project returns to be generated over a 10+ year period. Given the uncertainty associated with the ultimate exit of the minority positions, the duration of GP stakes investments is undetermined and has been a primary concern for potential investors as proposed exit routes are unproven. Theoretically, there are multiple avenues to provide exits to investors, which include recapitalizations, secondary sales, and public listing, but actual exits have been limited. Some GP stakes managers have issued debt financing to return capital back to investors, in addition to partial realizations of existing individual holdings (via both private transactions and IPO). As the GP stakes market continues to mature, a secondary market for minority ownership positions in private market firms may also develop and expand liquidity options.

→ The pricing/valuation associated with GP stakes can vary across investment opportunity. A significant proportion of GP stakes investment funds target the larger end of the market, typically transacting with stable, successful firms with more established and diversified sources of revenue. These transactions may command a relatively higher price given the stability of the firm's projected cash flows. Further, both the market and the lifecycle of a fund can be cyclical. Transacting at the peak of a private market firm's lifecycle, possibly with more optimistic projections than are warranted, may dampen returns. The projected return profile may rely more heavily on the underlying manager's ability to raise subsequent funds and generate carried interest through strong investment performance, and these two factors are likely to be significantly correlated. In contrast, some GP stakes investment funds target the smaller end of the market, investing in less proven investment firms. These transactions incorporate greater organizational risk, but the relative pricing may be more attractive with greater long-term upside growth potential. While these transactions also require successful investment performance results and subsequent fund raises, organizational considerations are more likely to introduce increased variability of outcomes.

- GP stakes managers typically prefer that the proceeds of such transactions be used for growth, in the form of additional investment in the underlying firm's resources, future GP commitments, product expansion, etc. If, instead, a material component of the capital is utilized to provide liquidity for existing owners, the transaction could be considered riskier due to a potential shift in alignment of interests. For example, a generational transition or succession planning transaction may require higher conviction by the GP stakes manager in the remaining investment team.

- Some GP stakes strategies include a "seeding" or "anchoring" component, where a portion of the capital is committed as an LP with additional upside provided through the GP stakes exposure. These transactions would have similar components to the traditional GP stakes transactions discussed above, but ultimately a larger proportion of the investment return would be generated from the traditional LP commitment, altering the return profile.

Conclusion

GP stakes investment strategies offer a differentiated approach to accessing the attractive economics associated with private market managers. This is still a relatively nascent segment of the market, with limited competition, and evolving investment strategies that may target specific aspects of the private markets. While primarily considered a minority position in a private market investment firm, the return profile has distinct components, with a significant proportion of projected return coming from the management fee return stream, and upside potential coming from higher returning, more volatile carried interest exposures.

GP stakes are highly negotiated transactions, with a range of structuring options that can significantly shape the potential return profile. GP stakes investment funds are long-dated, or even undated, investment vehicles with the final liquidation of the minority ownership positions remaining less proven. As a result, these strategies may be appropriate for investors that are seeking a unique approach to accessing private market firm economics and are comfortable with the long-term, illiquid nature associated with the investment strategy.

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