KEYNOTE INTERVIEW

High stakes

Investment in private equity management companies is poised to proliferate, say Debevoise & Plimpton partners Geoff Burgess and Matt Dickman

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Q What has driven the recent increase in the acquisition of GP stakes?

Matt Dickman: I think the biggest driver has been the significant growth in the number and size of private funds. As firms have raised more funds for different strategies and as those funds have grown ever larger, the amount of capital required to run those businesses has increased. At the same time, there is now a broader array of players willing to make this type of investment – funds dedicated to acquiring GP stakes, sovereign wealth funds, insurance companies and other institutional investors. While the focus was heavily on US sponsors until relatively recently, we are now starting to see more transactions emerge elsewhere, particularly in Europe.

Q What are the advantages of this type of deal for the buyer?

MD: There are a range of different objectives depending on the nature of the buyer. The specialist funds operating in this space are primarily focused on the financial profile of these deals. These are typically growing businesses with steady cashflows emanating from the management fee, plus the potential upside of carried interest. That can be very attractive from a purely financial perspective.

There are also insurance companies, for example, that are looking to buy a stake in a GP to increase their asset management capabilities and put more capital from their balance sheet to work in private markets. Some buyers are also looking for a strategic partnership in a particular space, for example, sustainability.

Geoff Burgess: The financial profile of these deals is interesting because you are really buying two things – you are buying a stake in the management fee, but there is usually a share of the carry involved as well. Those are two different prospects when it comes to risk and return. Management fee earnings are usually stable and predictable.

At the same time, the carried interest can be worth a huge amount or very little at all. That is a different proposition to an LP investment in a fund, where you hope to get your investment back plus return, but if things go well, you are giving up some of that upside to the manager. With a GP stake, while the management fee provides stable income, the carried interest brings with it a major opportunity for outperformance.

Q Is the benefit for the GP purely the capital injection, or are there other advantages?

MD: It varies. It is important to understand that these transactions can be a primary sale (for cash that goes to the business), a secondary sale (for cash that goes to sellers) or a combination of the two. The primary proceeds are often used to finance growth initiatives, such as larger GP commitments to funds or hiring a new team to expand into a new geography or product line. The secondary proceeds can provide one or more individuals an opportunity to take some of the proceeds in return for giving up some of their interest in the business. It can be a useful tool, therefore, for facilitating succession or allowing seed investors in the business to exit.

Incentivising the next generation of investment professionals in a team can be very important and sponsors need to ensure those professionals know there will be sufficient economic interest for them as they continue to develop when considering these types of transactions.

GB: We have also seen a few deals in the market where the manager takes on an outside investor when preparing for an IPO. In that instance, the GP's objective is to establish a valuation which it will expect to exceed when it goes public. For the investor, this provides the opportunity to get into what will be a public company while it is still private, at a price that has some discount to what the market price is likely to be. This is not a practice that is particular to fund managers, of course. A lot of companies look to acclimatise the market to a high valuation by having investors come in pre-IPO to establish a floor.

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> **MATT DICKMAN**

Q What are some of the negotiation points that typically need to be overcome in these deals?

GB: There are often tax issues. There is also the question of what kind of operational governance rights the investor will receive. Typically, the manager will want free rein to raise funds and do deals, but there is a negotiation to be had over how much control the new partner expects around operations.

MD: It is important to distinguish between the different types of investors in these transactions. If you have a strategic investor that is buying a significant stake and looking to be more hands on, then there may be some disagreement over governance arrangements. If the buyer is a GP stakes fund set up to make passive investments in the space, they may be happy to take a lighter touch approach. Instead, they may be more focused on transfer restrictions, and the ability to get out of the investment in certain circumstances, for example, cause for removal or a key person event.

Where a fund is involved, the GP itself will be more sensitive to information flows, given the diverse LP base in that fund. There will typically be a lot of limitations on what can be shared with the buyer's underlying investors.

Q What about deals where we are seeing the outright sale of the management company?

GB: In those situations, you typically have a buyer that is looking to bring a new capability in-house. They are looking to fill a piece in the puzzle with an acquisition. As an example, there have been a series of recent deals involving large asset managers buying secondaries firms in order to complete their product offering, as well as insurance companies buying fund managers in their entirety. In those situations, the deal terms can be very different because you are not talking about a passive stake. The kind of questions that might arise there could include which members of the management team need to stay on and for how long, for example.

MD: In many cases, large, diversified asset managers already have a fundraising team and established relationships that can help their target to grow. Similarly, an insurance company buying a team outright will have capital on its balance sheet to deploy with that business. It is a way for them to put more capital to work.

Q How do you expect the GP stakes market to evolve?

MD: I think the market will continue to grow. In the US, we are now seeing sponsors sell second and third rounds of stakes to new investors. We are also seeing a lot more interest in European sponsors and we expect to see a wave of European management companies considering this type of deal. ■