KEYNOTE INTERVIEW

How to structure GP stakes deals

From transferability restrictions to non-competes, careful structuring of GP stakes transactions can help ensure they work for all parties, say Debevoise & Plimpton partners Geoffrey Burgess and Matthew Dickman

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Q What are GP stakes investors typically looking for in a deal?

Matthew Dickman: GP stakes investors are typically looking for top-tier firms that are expected to grow. They want to see strong track records of performance and recent fundraising, and in some cases they also want to see plans in place to launch new products. These investments are premised on predictable cashflow streams from management fee income, coupled with potential upside from carry and participation in the underlying funds.

Geoffrey Burgess: In addition to dedicated GP stakes funds, there are also other kinds of staking investors with different objectives.

A sovereign wealth fund or insurance company, for example, may acquire a stake as part of a wider relationship-building exercise that also enables them to invest in funds on preferential terms. Staking investments can be seen as a package to effectively reduce management fees and improve overall fund economics. These strategic relationship transactions are all very bespoke depending on the participants' underlying goals.

Q Conversely, what is driving GP demand for outside investment?

MD: One driver is the increased cost of running a PE firm. From hiring teams to financing ever larger GP commitments and expanding into new geographies and strategies, this has become a much more capital-intensive industry.

GB: We have seen increased demand for outside investment in an environment where return of capital has been slow. The prevalence of continuation vehicles has added to the issue because the liquidity options made available to LPs in these transactions are often not available to GPs. Management teams are expected to reinvest all proceeds, taking no money off the table.

Managing generational transition is another key driver. GP stakes investments can allow founders to cash out, while creating an incentivisation framework that allows a wider group of professionals to take ownership of the business.

Q What needs to be considered to ensure the next generation of talent is not disenfranchised by the GP stakes deal and that key professionals do not leave?

MD: Staking investors recognise that they need alignment with all the key investment professionals at a firm, not just those participating in the staking transaction. Everyone needs to be incentivised to maximise the value of the firm. In some cases, a new management incentivisation plan will be established, allowing the next generation to participate or earn their way into the management company over time.

There has also been a lot of discussion on the enforceability of non-competes recently, but we still see restrictive covenants being put in place for founders in GP stakes transactions.

GB: There is a lot of value in carried interest arrangements, so this is a key area of focus in GP stakes deals. Carry can be broken down into house carry, that might be for sale, and team carry, that cannot be touched. The staking firm will take a percentage of the management fee earnings and a percentage of the house carry for identified funds. Preserving that team carry is vital for retention.

Q What are GPs' priorities in these deals?

GB: If it is a purely financial investment, rather than a strategic relationship, the team will want the stakes investor's role to be as passive as possible. The stakes investor may be involved in strategic decisions, such as launching a new strategy, but the manager will want to retain operational independence when it comes to fundraising and making investments. GPs will also seek to keep control when it comes to team composition, compensation and carry allocation.

MD: I agree that managers want to retain independence around the day-to-day running of the business, but they are often looking for some strategic value-add from the GP stakes investor, as well. That could mean strategic consulting, or supply chain management, or assistance with fundraising. Different stakes investors bring different value-add to the table. They also have inside knowledge of how competitor firms are dealing with growing pains. That information flow can be beneficial.

Q Does that potential for information flow also create sensitivities?

MD: GPs are certainly concerned about the level of information they are required to give to a GP stakes investor and where that information goes next. There are typically very tight limits regarding what information can be passed to ultimate investors in GP stakes transactions, including LPs in stakes funds.

Q What sensitivities exist around the transferability of stakes investments?

GB: Unless the staking investor is a strategic investor or a permanent capital vehicle, it will ultimately be looking for an exit. Managers look to put restrictions in place preventing sales to any direct competitors. If the staking investor is a strategic investor, then those concerns are alleviated to a degree.

There has been a significant increase in manager consolidation in recent years, and having a staking investor adds another layer of complexity in the event of a change of control transaction. However, there are also some advantages to having a staking investor in these circumstances. Not only does the growth that has been made possible by the outside investment increase the overall value of the firm, but it also acts as a price-setting mechanism, which can be influential and potentially beneficial in a sale situation.

Q What advice would you offer a GP contemplating a stake sale for the first time?

GB: I would emphasise that a staking transaction is very different to the investment activity that management teams carry out every day on behalf of their funds. Some managers are surprised by the nature of the issues that arise.

These staking firms have become highly sophisticated in what they do. An investor may express interest in buying a stake, for example, but only if certain steps are taken to strengthen the organisation, such as reorganising incentivisation structures. These deals can fundamentally change the way a firm operates. That is something GPs need to be prepared for.

MD: I would add that the sale of a minority interest to a GP stakes investor is not a manager's only option when it comes to raising capital today. There are NAV facilities being made available to management companies, as well as preferred equity, or revenue sharing arrangements with strategic LPs. GPs need to consider what their strategic goals are and what they want to achieve to decide which solution best fits their needs. ■