

# GP Stakes Essentials: Understanding the Basics

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# GP Stakes Essentials: Understanding the Basics

Private equity firms have become so well known for buying and selling ownership interests in companies that it is often overlooked that private equity firms are also companies that can be bought and sold.

Private equity firms that specialize in acquiring and subsequently monetizing ownership interests in other private markets sponsors are referred to as “GP stakes” firms. GP stakes offer investors access to the economics of private markets sponsors which are often highly profitable companies in an industry characterized by secular growth. Given the distinct return drivers relative to other private equity strategies, institutional investors have increasingly sought to diversify and enhance their portfolios through exposure to GP stakes strategies. This primer covers what a GP stake is, delves into the private markets industry dynamics that make this style of investing compelling, and outlines the ways in which an investor can participate in this unique return stream.

## What is a GP Stake?



A GP stake is a minority ownership interest (typically 10%-25%) in the management company and general partnership of a private markets sponsor (“GPs” or “sponsors”). Private markets sponsors focus on strategies including, but not limited to, buyout, growth equity, infrastructure, real estate, and private credit. Similar to an ownership stake in any other company, a GP stake is a perpetual and transferable interest which can be financed or sold.

# What are the Return Drivers of a GP Stake?

While GP stakes investments are heavily negotiated transactions with a range of structuring options that can influence the potential performance profile, the core components of return are consistent across transactions. GP stakes investors participate in a pro-rata portion of the overall cash flow profile of a given sponsor, which can include three revenue streams earned by the sponsor across each of its current and future funds:



**Fee Related Earnings (“FRE”):** Earnings associated with recurring management fees and other fees tied to running the business offset by associated expenses of the business (e.g. employee compensation).



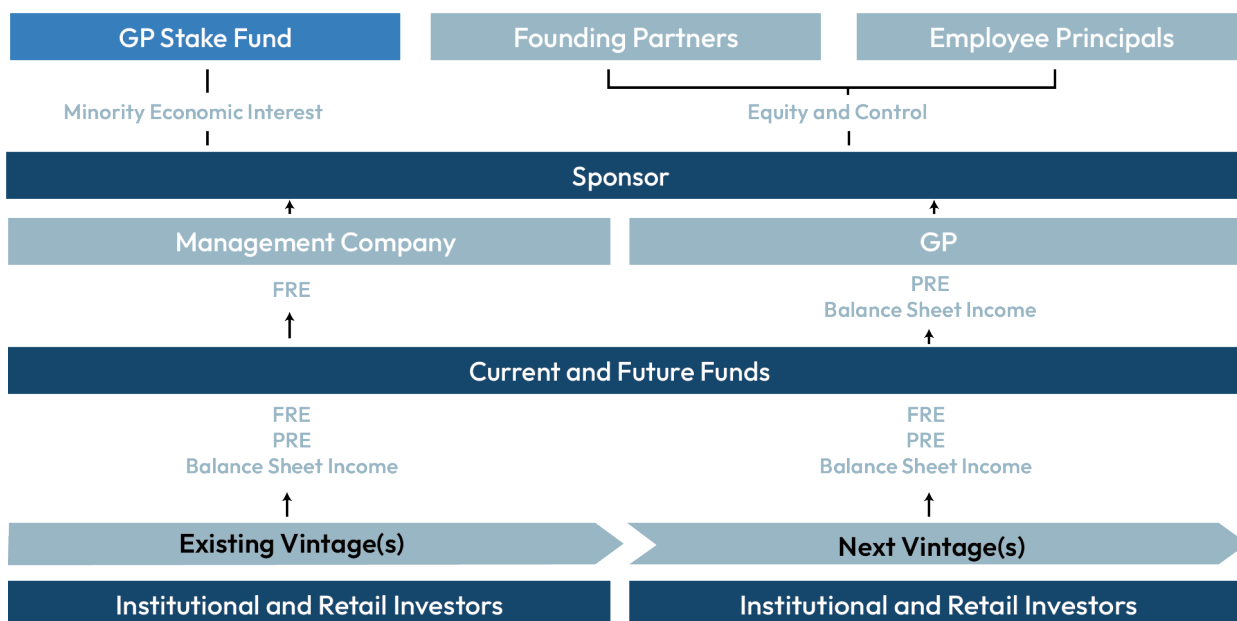
**Performance Related Earnings (“PRE”):** Earnings associated with carried interest or performance fees generated on a given fund’s profits above a preferred return after deducting variable performance-based compensation paid to employees.



**Balance Sheet Income:** Returns associated with co-investment capital made as a GP commitment.

## Exhibit 1: GP Stake Economic Entitlements

### Illustrative GP Stake



A GP stakes investor seeks to generate returns from distributions related to the three cash flow streams noted above which provide current income and long-term growth potential across all market environments. FRE distributions offer a consistent and potentially growing yield and provide downside protection; often this component of return alone can generate close to investment cost and is viewed as predictable, bond-like income. PRE and balance sheet income distributions are tied to investment realizations which means they are more variable in nature, and their precise timing is not known ex-ante, but these distributions can offer meaningful upside return potential, particularly as a firm scales its funds. In addition to these three cash flow components, capital appreciation of the GP stake itself provides further return potential to the investor. A performing GP stake investment can often be monetized at an attractive price through a sale, recapitalization or other financing event.



# Why Do GPs Consider Selling a Stake?

As shown in Exhibit 2, there are a myriad of catalysts for a GP stake transaction, but generally a sponsor is either **(1)** seeking to monetize a portion of the firm's enterprise value to provide liquidity for existing owners/shareholders or **(2)** seeking capital to finance growth initiatives (e.g., to scale existing products or launch new products, firms may require additional capital for GP commitments or to meet ongoing operational requirements such as investing in infrastructure and technology or hiring additional personnel).

Beyond financial capital, a GP stakes investor can also provide strategic advice and implementation

support across a variety of dimensions, including, but not limited to, executive strategy, product development, distribution assistance, talent management, operational consulting, and cost savings, which can help GPs navigate a competitive and evolving market and build additional franchise value. Depending on its motivation for a sale, a sponsor might be focused on what strategic value a GP stakes investor can offer beyond the initial capital infusion. As such, the ability of a GP stakes firm to offer additional value creation services may influence its ability to effectively source and close targeted transactions.

## Exhibit 2: Potential Motivations for a GP to Sell a Stake



### New Products

- \* Capitalize a new product and hire personnel
- \* Firm expansion into adjacent fund strategies and business lines



### Balance Sheet Enhancement

- \* A sponsor may need to increase its GP commitment to facilitate larger fund size
- \* Strengthen a firm's balance sheet for various accretive investments



### Capital Structure Reorganization

- \* Buy out external shareholders or retired partners
- \* Retire loans
- \* Alignment with a value added strategic partner



### Succession Planning

- \* Align future leadership and enhance business durability through an equity redistribution plan
- \* Retention planning for next generation investment talent



### Strategic Advisory

- \* Institutional partner to help strengthen the firm and grow the business
- \* A well-known institution's exhaustive diligence process and alignment is a branding event

# What are the Typical Terms of a GP Stake Sale?

Private markets firms are reliant on relatively mobile human capital. As such, GP stakes are carefully structured to preserve alignment and an entrepreneurial culture to promote business durability. The leadership team of the sponsor will continue to own the vast majority of the economics and have a strong incentive to grow the firm profitably. GP stakes investors may advise the sponsor, but do not assume day-to-day management responsibilities, leaving decision making autonomy with firm leadership; the sponsor's investment process, reporting lines, and branding are likely to remain unchanged. The GP stakes investor is usually granted information and management access rights and seeks contractual protections to safeguard the value of the economic entitlements acquired. For example, the GP stakes investor may seek anti-dilution protections (including through restrictions on future equity issuances and pre-emptive rights), place limitations on expenses, and will typically have consent rights over significant events such as debt incurrence, changes to tax structure or governance, or other actions that may have a disproportionate adverse impact on the value of the ownership interest. Investments are typically conditioned upon key individuals entering into long-term employment agreements and other restrictive arrangements with various forfeiture provisions to contractually tie and economically align such persons to the long-term success of the business. Other critical protections and rights focus on the ability to generate liquidity and preserve the transferability of the stake. The precise form of each of the aforementioned rights and protections is the subject of intense negotiation.

The purchase consideration paid by an investor in exchange for a GP stake can take a variety of forms including, but not limited to, cash, preferred equity, working capital, and balance sheet investments, and is based on the specific needs of a sponsor. The purchase price can all be paid upfront or be staged over a multi-year period and may contain contingent payments tied to the sponsor meeting or exceeding its stated business plan; to the extent a deferred purchase arrangement is utilized there may be mechanisms by which the sponsor can accelerate to the next tranche of capital if liquidity needs manifest sooner. Generally, any portion of the purchase consideration that is reinvested into the business is referred to as "primary proceeds" and any liquidity that is provided to existing shareholders of the sponsor is referred to as "secondary proceeds." Primary proceeds generally offer more alignment, but secondary proceeds can serve to aid a firm in reorganizing its capital structure to remove a passive shareholder or partner that is no longer adding value, or as a succession planning tool to allow for a generational transition and potential future success.

## How are GP Stakes Valued?

The purchase price for a GP stake will be based on an assessment of a sponsor's franchise value, which will be informed by traditional valuation methods including discounted cash flow and multiple analysis. Each cash flow stream will receive a separate discount rate and multiple which reflects the riskiness of the underlying cash flows. FRE typically represents the highest quality earnings given its contractual nature and trades at a lower discount rate and higher multiple than PRE, which offers a potentially more lucrative revenue stream but has uncertainty in timing and ultimate magnitude. There are also differences between existing funds and future funds. To project cash flows, a GP stakes investor will need to take a view on the asset raising and performance potential of a sponsor across different market environments. Thus, a GP stakes investor should evaluate a sponsor across myriad areas including management's leadership qualities and vision, the firm's ability to scale the platform through existing or adjacent products, quality of existing LP relationships, brand awareness, distribution effectiveness, historical track record, incentive alignment, and talent retention mechanisms.<sup>1</sup>

1) Past performance is not indicative of future results.

# Why are GP Stakes Compelling Investments?

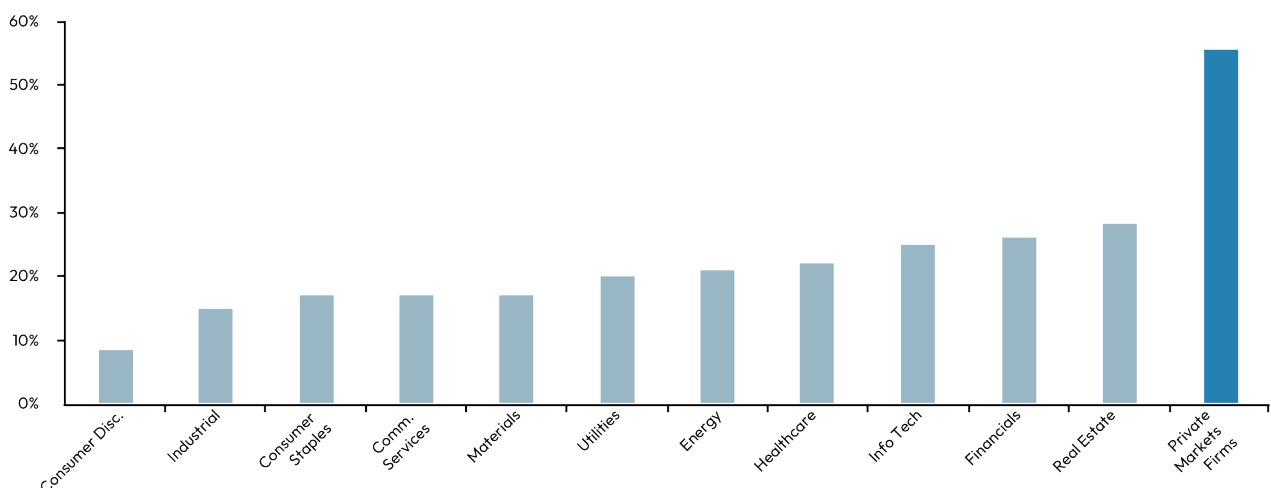


A GP Stake affords an investor the opportunity to **participate in the economics** of **highly profitable companies** with **strong growth** prospects driven by secular tailwinds in private markets fundraising. GP stakes strategies potentially enable investors to capture returns associated with the overall category growth of private markets.

## Highly Cash Generative Business Model

Private markets sponsors benefit from strong business fundamentals. Sponsors typically earn a management fee on committed or invested capital and are entitled to collect a carried interest or performance-based fee on net profits. Management fees are contractually obligated and paid on a fixed schedule, offering a stable revenue stream for the life of an underlying fund which can last up to ten years or longer. As sponsors raise additional and potentially larger funds, this revenue stream continues to expand and often rises faster than the costs associated with managing the firm. As a result of this operating leverage, **sponsors can have operating margins of 40-70%** or higher. Carried interest revenues are tied to ultimate investments performance gains, and thus exhibit more variability than the management fee revenues, but offer considerable upside potential.

### Exhibit 3: Publicly-Traded Private Markets Firms Have Historically Achieved Higher EBIT Margins Than Other Industries<sup>2</sup>

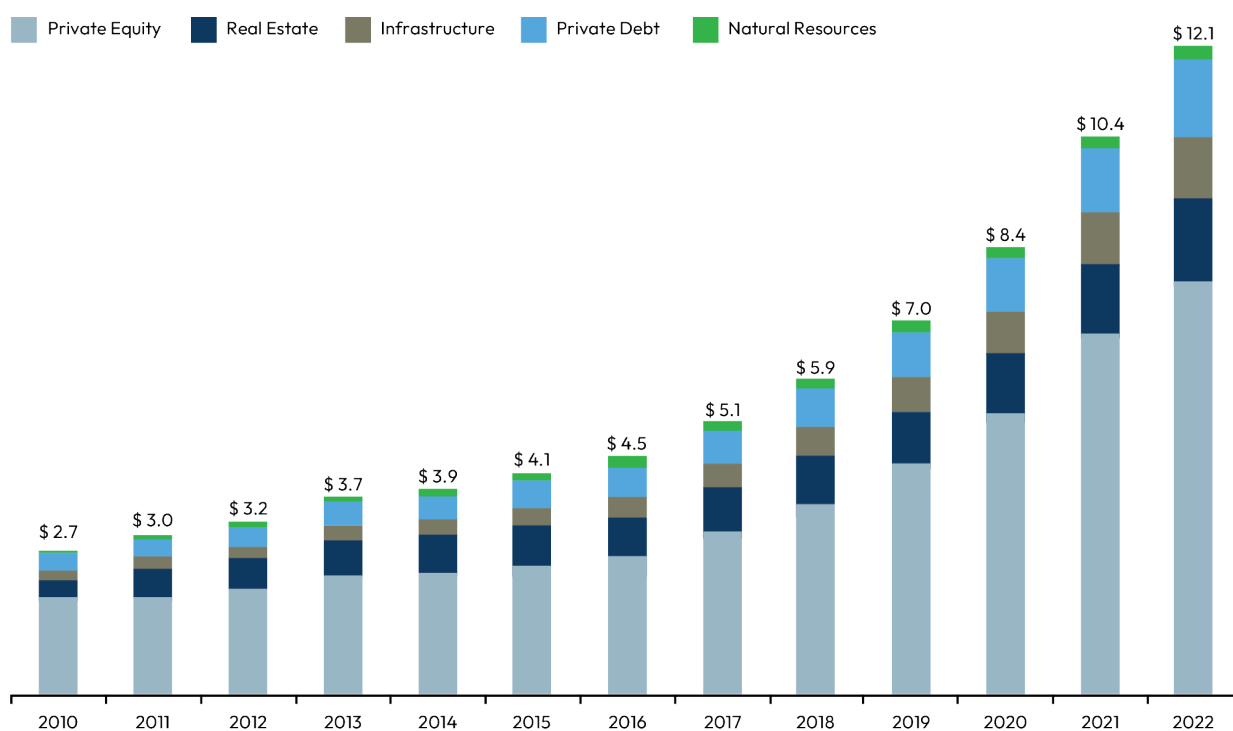


2) Capital IQ as of 2022; Private Markets Firms margin is an Azimut calculation based on the 2022 quarterly and annual filings of the following publicly traded firms: Blackstone, Brookfield Asset Management, KKR & Co, Apollo Global Management, Blue Owl Capital, Ares Management Corporation, Carlyle Group, TPG Capital, StepStone Group, and GCM Grosvenor.

# Secular Growth of Private Markets

The private markets industry has experienced substantial growth since 2010 driven by increased allocations from institutional investors seeking strong risk-adjusted returns. As shown in Exhibit 4, **private markets assets under management (“AUM”) increased four-fold from 2010 to 2022** growing from \$2.7 trillion to \$12.1 trillion over the referenced period, representing a compound annual growth rate of 13.3%<sup>3</sup>. Market research suggests that the industry’s long-term growth prospects remain robust. According to Preqin, private markets AUM is forecasted to eclipse \$20 trillion by 2028<sup>4</sup>. Experts expect this forecasted growth to be underpinned by continued support from institutional investors and increased allocations from retail investors, which have historically been an underserved segment by private markets sponsors but represent over \$50 trillion in assets<sup>5</sup>.

## Exhibit 4: Private Markets AUM Growth<sup>6</sup>



The GP stakes industry is expected to continue to expand as a natural consequence of the growth in private markets more broadly; to participate in industry growth and successfully scale their firms, sponsors often recognize the benefits of seeking the capital solutions offered by GP stakes firms, especially as the balance sheet capital required to support the sponsor’s expansion exceeds the profits that can be reinvested back into the firm. In addition to offering an increasing opportunity set for GP stakes investors, the growth trajectory of the private markets industry also enhances return potential as an individual sponsor’s economics expand with increased fund sizes.

3) Preqin Pro; Private markets is defined as Private Equity, Private Debt, Real Estate, Infrastructure and Natural Resources

4) Preqin; Future of Alternatives 2028

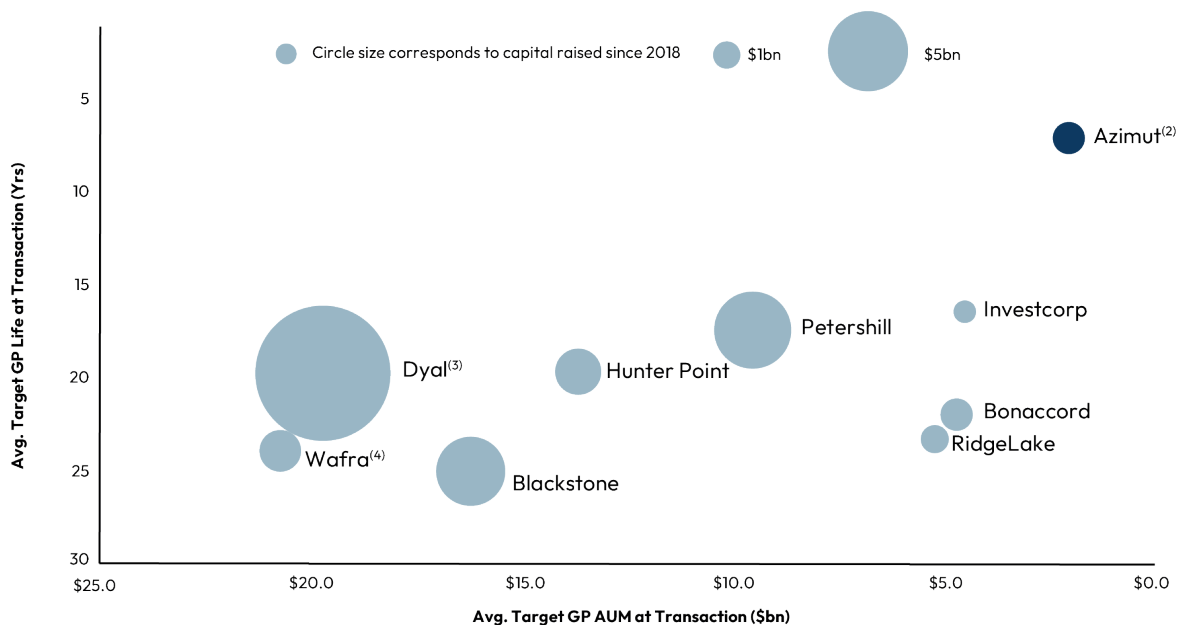
5) McKinsey Global Private Markets Review 2022. Private markets rally to new heights (March 2022)

6) Preqin Pro; Private Markets is defined to include Private Equity, Private Debt, Real Estate, Infrastructure and Natural Resources

# How Can Investors Access GP Stakes Investments?

The GP stakes industry has evolved significantly in the last decade with the emergence of firms raising vehicles focused on acquiring minority ownership interests in private markets sponsors. While not intended to be an exhaustive list, Exhibit 5 highlights a spectrum of firms that have raised funds over the last five years. These firms tend to differentiate by both the size (i.e., lower middle market vs. upper middle market vs. large cap) and type of the acquisition target type (i.e., private markets managers vs. alternative asset managers more broadly).

## Exhibit 5: GP Stakes Market Map



1. GP stakes transaction data shown is from January 2018 to November 2023. Sources: Preqin, Pitchbook, Public Information, Street Analysis, SEC Form ADV, AACF Proprietary Analysis  
 2. Azimut circle size represents the sum of i) invested capital in GP stakes transactions off the firm's balance sheet since 2019, and ii) target size for GP stakes fund launching in 2024  
 3. Dyal Capital Partners has been rebranded to Blue Owl GP Strategic Capital: Blue Owl announced in November 2023 that it intends to launch a middle market GP Stakes fund  
 4. Estimated figure; excludes investment activity Wafra makes through Capital Constellation

The existing funds provide a means for limited partners to access the economics of GP stakes that might otherwise be unattainable on a direct basis given the size and complexity of these transactions, which involve a considerable amount of negotiation and legal documentation, and often take months to consummate. The industry still has considerable room to expand as the preponderance of capital raised has been focused on upper middle market and large cap sponsors leaving investors with a dearth of options when it comes to investing in other market segments such as the attractive lower middle market.

## CONCLUSION

As private markets assets continue to grow, the GP stakes industry is anticipated to expand in tandem. For investors, buying a GP stake offers the chance to share in the meaningful economics of private markets sponsors and provides a distinct return profile; a GP stake return combines the capital appreciation and multiple generation potential of other private equity strategies with the current yield and downside protection of income-oriented strategies. For GPs, selling a stake offers a path to accelerated growth. Private markets sponsors are highly scalable businesses, and the leadership of these firms recognize that capital and strategic advice provided by a GP stake investor can enable their firms to successfully participate in broader industry growth trends.





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