Growth Oriented GP Stakes: Why Lower Middle Market GP Stakes Offer a Superior Risk-Reward

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The GP stakes landscape has evolved significantly over the last decade and the menu of investable options has become increasingly nuanced. There are many ways to acquire an economic interest in a GP at different points in its development, but not all are created equal. In this paper, we will explore why growth stage, lower middle market GP stakes represent the most attractive segment of the market.

Overview

A GP stake investment can be made at any stage in a sponsor's lifecycle. Like broader private equity, GP stakes firms typically specialize in a particular market capitalization segment such as large cap sponsors, upper middle market sponsors, or lower middle market sponsors. While the core economic entitlements of all GP stakes investments are the same - pro-rata participation in the overall cash flow profile of a given GP which includes management fees, carried interest, and balance sheet income - the transaction dynamics differ materially. To explore these differences, we segment the universe of acquisition targets into sponsors with between $500M and $3B in AUM (lower middle market sponsors), and sponsors with greater than $3B in AUM (upper middle market or large cap sponsors).

Exhibit 1: Lower Middle Market GP Stakes vs. Upper Middle Market / Large Cap GP Stakes

	Lower Middle Market GP Stakes	Upper Middle Market/ Large Cap GP Stakes
Sponsor Description	• Next-generation firms • <12 years of operating history • AUM between $500M and $3B • Typically raising Fund II through Fund IV	• Mature firms • >12 years of operating history • AUM greater than $3B • Typically raising Fund V+
Transaction Motivation	Accelerate business growth	Liquidity event for partners
Primary Proceeds for Funding Growth/ GP Commitment	Significant; core part of transaction	Varies; not typically a core part of transaction
Secondary Proceeds Paid to GP Founders/Leadership	Limited; staged; success based	Significant; upfront
Deal Structuring	Potential for proprietary deal flow generally allows for more bespoke structures with additional downside risk mitigation	Auction process with commoditized deal terms
Value Creation Potential	Generally high; potential for outsized impact related to implementation support and advice across all aspects of the business including capital formation, product development, talent management, and operational advisory	Generally low; potential for impact is more limited given the more established nature of the firm
Liquidity/ Exit Potential	Generally high; potential buyer universe is large	Generally low; size limits potential buyer universe

Alignment / Transaction Motivation: "Cash In" vs. "Cash Out"

Alignment in all GP stakes transactions is typically strong since these are minority ownership positions where the leadership team of the sponsor maintains decision making autonomy and continues to hold the vast majority of the firm's economics. On a relative basis, however, GP stakes involving lower middle market sponsors tend to offer more alignment because the core leadership team is expected to remain in place post-transaction and is primarily seeking capital to invest into the business.

In industry lexicon, transaction proceeds which are invested into the business are referred to as "primary proceeds" and transaction proceeds which are paid out to existing shareholders are referred to as "secondary proceeds." The proportion of secondary proceeds to primary proceeds can be instructive in understanding a GP's alignment. The purchase consideration in transactions involving lower middle market sponsors is typically comprised of mostly primary proceeds; the investment goes onto the firm's balance sheet and can be used to increase the GP commitment, make strategic hires, and expand strategy offerings, or may be utilized for other growth purposes designed to enhance enterprise value. By contrast, the purchase consideration in transactions involving large cap sponsors is typically predominately comprised of secondary proceeds; large cap sponsors have already achieved substantial growth, and the founders are often seeking to diversify personally by monetizing a portion of the firm's value and reinvesting the proceeds outside of the firm. An additional risk factor is introduced when one or more founders or members of senior leadership take a reduced role or step back entirely as a part of the transaction; often in these succession related situations, the strongest historical contributors will no longer drive investment decisions and the firm's future performance potential may be less certain.

Negotiating Power

Firms investing in lower middle market GP stakes tend to have more negotiating power than their peers who focus on large cap and upper middle market GP stakes due to how transactions are sourced and the comparative supply and demand dynamics in each market segment. As described further below, there is far less capital pursuing a much larger opportunity set in the lower middle market which combined with the potential for a proprietarily sourced transaction can result in more favorable pricing and deal terms.

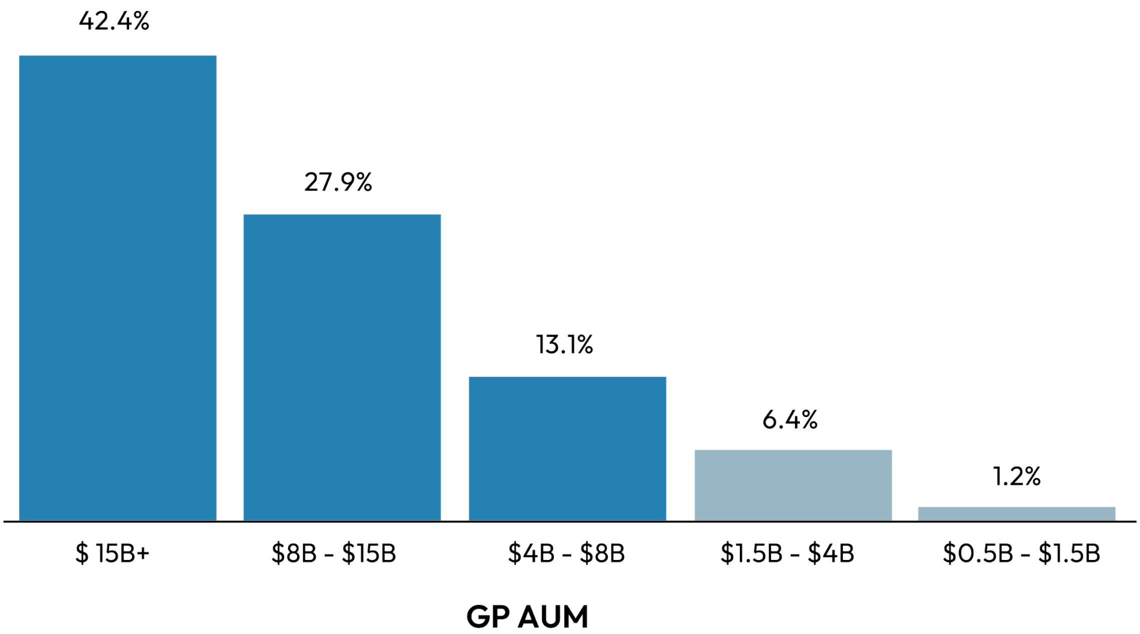
Auction Process vs. Proprietary Sourcing

Most transactions involving upper middle market and large cap sponsors involve auction processes. These are competitive processes with multiple bidders which often result in higher valuations. Additionally, transaction documents tend to be more standardized and there is less flexibility to negotiate bespoke structures or more favorable terms. By contrast, lower middle market GP stake targets can be identified through proprietary sourcing channels, allowing for direct negotiation and therefore more creative and aligned transaction structures with the potential of better protecting downside and maximizing value creation.

Supply/Demand Considerations

Private markets firms in the lower middle market outnumber large cap sponsors, and comparatively few have sold a minority stake. As shown in Exhibit 2, a material percentage of large cap and upper middle market sponsors have already sold a stake, affording those firms that have yet to sell a stake with pricing and negotiating power that is enhanced through participation in the auction processes noted above. By contrast, there is a large and growing universe of lower middle market sponsors who may seek the financial and strategic resources provided by a GP stakes firm.

Exhibit 2: Share of GPs that Have Sold A Minority Interest by Firm Size[1]



In spite of this, the preponderance of capital raised in the GP stakes industry continues to be focused on large cap and upper middle market sponsors. There is an estimated $20 billion in dry powder focused on this segment of the market, while there is less than $2 billion in dry power focused on GP stakes in lower middle market sponsors[2]. This suggests that there is a major funding gap for private markets firms that may be strong candidates for a GP stake transaction.

Deal Structuring and Downside Protection

Investors considering GP stakes often take the perspective that the lower middle market space is "risky", and the large cap space is "safe" and cite the fact that the latter are mature firms that will continue to persist, while the former may have a less certain future. In fact, the precise deal terms including pricing and structure and the continuity (or lack thereof) of the in-place leadership team has a heavy influence on the relative riskiness of any given GP stake, regardless of the size of the firm. As a general consideration, lower middle market GP stakes have a higher potential upside and a downside that is in line or better than the downside of large cap GP stakes.

GP stakes investing typically offer investors strong downside protection due to the nature of the businesses that are acquired and are often forecasted to return close to investment cost at a minimum. All sponsors from lower middle market to large cap benefit from locked-up capital which offers steady revenues from contractually obligated management fees for up to a decade or longer on each fund. These durable cash flows have led to high survival rates across private markets firms. Since 2000, less than 5% of private markets firms that have raised more than $500M across at least two fund vintages have not raised a successor vintage in the ensuing decade[3]. While large sponsors will obviously benefit from a higher absolute level of cash flows, this will be reflected in a higher purchase price for a given ownership level. If anything, lower middle market GP stakes deals may provide enhanced downside mitigation because (i) there is more flexibility on deal structure and (ii) the deals typically have a higher proportion of primary proceeds.

1) Source: Pitchbook; GP Stakes Deployment Opportunities (July 2021)
2) Source: Preqin Pro, Pitchbook, public web search; data as of November 2023. Azimut's internal research, data, views, and opinions as of the date hereof, which is not necessarily complete and includes subjective determinations.
3) Source: Preqin Pro; Azimut internal research

Large cap and upper middle market GP stakes are typically common equity deals and skew towards secondary proceeds. The heavy upfront cash consideration given to the founders/management team may heighten the risk for impairment or a potentially extended payback period if performance suffers or future fundraising targets are not met. Various contingencies on payouts can be introduced to help reduce this risk (e.g. earnouts), but, ultimately, the return of capital and multiple generation is very reliant on the in-place fee-generating infrastructure, as the transaction proceeds are not necessarily being used to reinvest into the business. By contrast, lower middle market GP stakes firms may contemplate preferred equity deals or other arrangements that provide a priority on a sponsor's cash flows until a minimum return threshold is met, and the transaction proceeds are primarily used to fund growth initiatives designed to amplify existing cash flows.

Post-Transaction Value Creation Potential

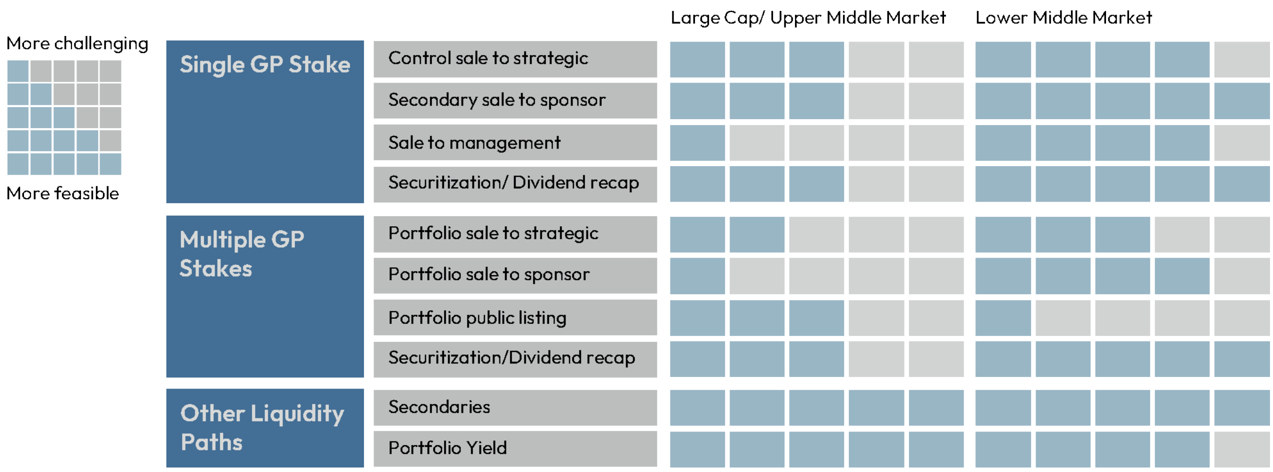
Private equity firms seek to generate returns through the implementation of post-acquisition value creation initiatives designed to improve the strategic focus and operational efficiency of their portfolio companies. Lower middle market companies often benefit the most from this outside expertise and support. Many GP stakes investment firms seek to generate alpha in an analogous fashion and offer strategic advice to sponsors in several critical areas including capital formation, product development, talent management, and business strategy.

Like broader private equity, the greatest value creation potential in GP stakes exists in the lower middle market. The typical lower middle market sponsor has focused its resources on developing the investment team and demonstrating success in its investment program. Senior professionals often have many responsibilities that would be split across multiple individuals in a larger firm. For example, the founder may be responsible for running the investment program, capital formation efforts, and business development. With strategic advice and an investment from a GP stakes firm, the sponsor can improve organizational efficiency by addressing its underinvestment in other areas of the business and formalizing governance or firm framework policies that may not be officially documented. In the process, the lower middle market sponsor can create the underpinnings of a more enduring business with a higher franchise value. This potential value creation is compelling for lower middle market sponsors and can result in flexibility around the financial terms of the transaction, as the selling sponsor is focused on securing a GP stake investor that can also serve as a strategic growth partner. By contrast, large cap and upper middle market sponsors typically already have robust distribution capabilities and established relationships with sizeable institutional investors, follow organizational best practices, and have talented professionals in finance, operations, and business development to support the investment team. In these circumstances, the GP stakes investor may offer limited value beyond financial capital; as a result, the management teams of large cap and upper middle market sponsors may exclusively focus on maximizing the financial consideration received for selling an ownership interest.

Liquidity / Monetization

Liquidity has been a significant area of focus for limited partners evaluating the GP stakes opportunity set. Outside of a full exit, investors in GP stakes are expected to collect ongoing yield related to distributions of management fees, carried interest, and balance sheet income. This high single digit to low double digit unlevered yield creates a self-amortizing feature, but as shown in Exhibit 3, there is a growing range of exit options for a single ownership interest or a portfolio of ownership interests.

Exhibit 3: Multiple Forms of Liquidity[4]



Lower middle market GP stakes have a clear liquidity advantage relative to large cap and upper middle market GP stakes. This advantage is driven by the amount of capital required to purchase a GP stake of each type and the resultant impact on the universe of potential buyers. A portfolio of ownership interests in lower middle market sponsors is generally of sufficient scale to take advantage of interim financing options to pull forward distributions for limited partners while preserving upside optionality. Additionally, each position is still small enough to allow for either a sale back to management or a sale to a strategic or a larger GP stakes firm. By contrast, realizing an exit is more challenging for large cap and upper middle market GP stakes firms given the sheer quantum of capital necessary to consummate a single stake let alone a portfolio level sale. These firms have raised multi-billion dollar vehicles and pay hundreds of millions of dollars for individual stakes; as a result, to provide portfolio level liquidity, it is likely that these firms will need to access capital via an IPO or through a large structured note.

Conclusion

As GP stakes have become increasingly prevalent over the last decade, the landscape has evolved to mirror the broader private markets industry with strategies covering the entire market capitalization spectrum from lower middle market sponsors to large cap sponsors. Investors that focus exclusively on large cap GP stakes may be missing the opportunity to access the return profile of this asset class in a liquidity advantaged fashion via the lower middle market segment. In fact, lower middle market GP stakes may offer better downside protection and more upside potential. As a function of where they are in their lifecycle, lower middle market sponsors have inherently greater organic growth potential, but still have roughly equivalent business stability to their larger peers; importantly, these sponsors are more likely to embrace feedback and benefit more from value creation initiatives which enhance franchise value in an expedited fashion.

4) Source: Pitchbook. “Monetizing GP Stakes: A Review and Analysis of GP Stakes Liquidity”; AACP market views and observations. For illustrative purposes only.