The Anatomy of a GP Stakes Fund

An Investment for All Seasons

December 2024

Key takeaways

- A larger number of diverse investors are allocating to GP stakes due to increasing familiarity with the asset class, the strategy's cross-cycle track record and a heightened focus on DPI.
- Investors who are less familiar with the strategy often ask how they should classify GP stakes within their portfolios and what the closest comparable investment might be.
- Individual components of a GP stakes strategy have been likened to private equity, private credit and secondaries strategies, with these combined characteristics offering investors a differentiated returns profile that is arguably impossible to replicate in any other single investment.
- The cash flow returns from a GP stakes investment, which come from management fees, carried interest and balance sheet returns, can be further bifurcated into (i) legacy cash flow from existing, in-the-ground funds and assets, and (ii) future cash flow from the GP's continued fundraising and investment activity.
- With larger, more established GPs who have numerous legacy funds and billions of dollars of in-the-ground assets, accrued carry exists that will convert to cash when harvested.
- The ongoing nature of a GP stakes portfolio allows investors to build returns over a long-term horizon, compounding an even larger MOIC.
- We believe a GP stakes investment can be viewed as the acquisition of recurring management fees, a continuously refreshing secondary position in the funds managed by the GP and upside potential from both carried interest and the potential realization of the equity value in the firm, should a minority position or the firm itself be sold over time.

Executive Summary

Both the number and the types of investors allocating to GP stakes strategies have increased in recent years, driven by the strategy's strong absolute historical performance, differentiated returns, and investors' increased familiarity with the benefits of GP economics. That being said, given the relatively new nature of the asset class, more allocation-minded prospective investors are asking "which bucket should I put GP stakes in?" or "what type of exposure is a GP stakes investments most similar to?".

Many regard GP stakes as private equity-like exposure, not only because portfolio investments are typically made in private equity managers, but also because of the typical GP stake funds' target returns and the potential capital appreciation of the underlying firms. Other investors have looked at the stable and growing cash flow profile of a portfolio of GP stakes and bucketed the investment in their credit or yield-oriented allocations, while yet others consider the early cash flows from the realization of in-the-ground, visible assets, as most akin to a secondaries strategy. The truth, in our view, is that a GP stakes investment is really a combination of attributes from all of these potentially comparable investments.

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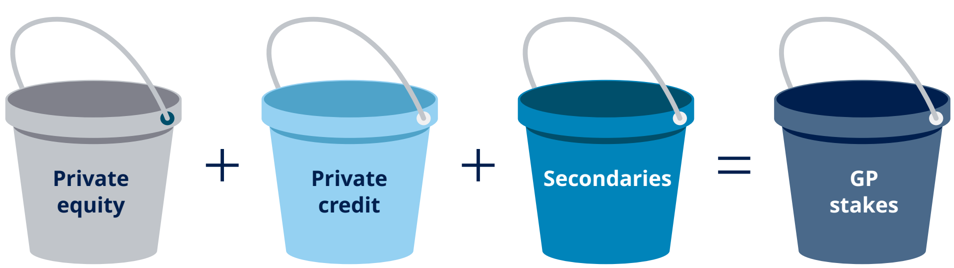
Purchasing a stake in a GP entitles an owner to three economic cash flow streams: management fee profits, balance sheet return and carried interest. The management fee profits are long-dated, contracted fees; the balance sheet return captures gross fund returns of the GP's co-investment in underlying funds; and the carried interest provides potential upside from the underlying funds of the partner managers.

Which bucket should GP stakes go in?

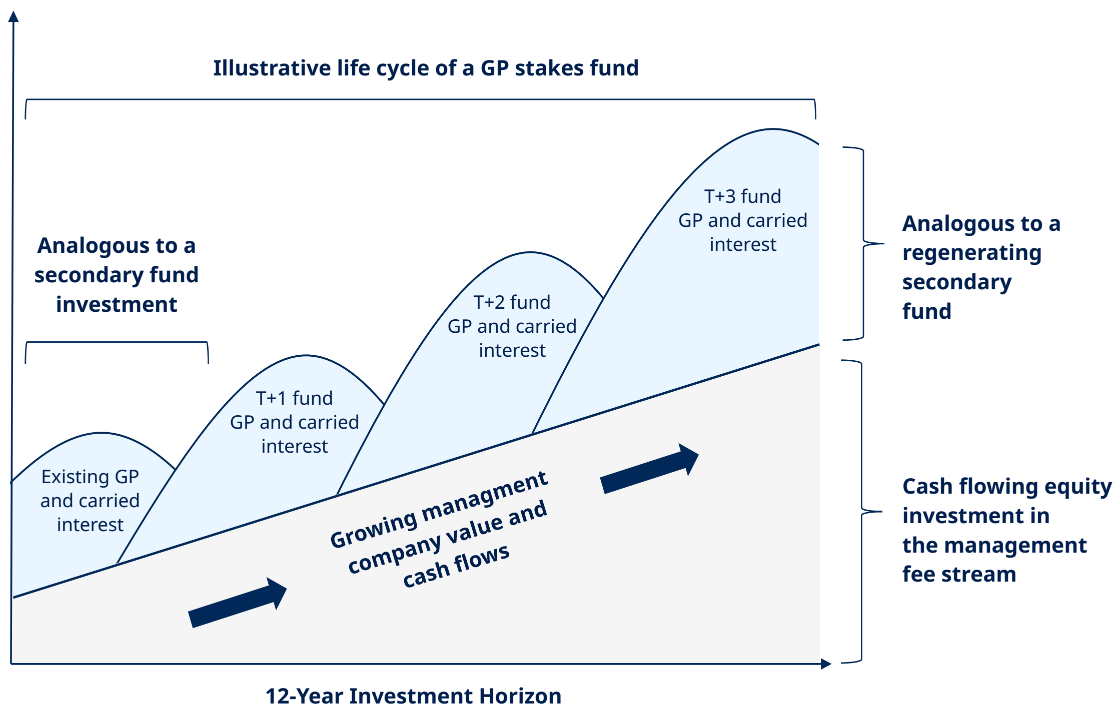


In this paper, we break down the cash flows and returns derived from a GP stakes investment and highlight the features that are, in many respects, analogous to other private capital asset classes. We separate (i) legacy cash flow generated from the "harvesting" of existing assets – in some cases investments made by the GP across multiple vintages and strategies many years before a stake is acquired, (ii) the potential stable and growing yield generated through an ownership of the Management Company, and finally (iii) cash flow that will be derived from the harvesting of future portfolios of assets for as long as the GP continues its investment activity.

We also take a deeper dive into the less familiar side-by-side returns analysis of a GP stakes versus secondaries strategy and explore whether a GP stakes investment can be viewed as the purchase of the recurring management fee profits of a stable and growing asset management firm, plus the fees generated by a continuously refreshing secondary position – potentially at attractive valuations and on a fee-free basis – in the current and future funds managed by one of these leading GPs.

Figure 1

Is a GP stakes investment simply the acquisition of a management company growing in value plus a perpetually regenerating secondaries-like portfolio?[1]



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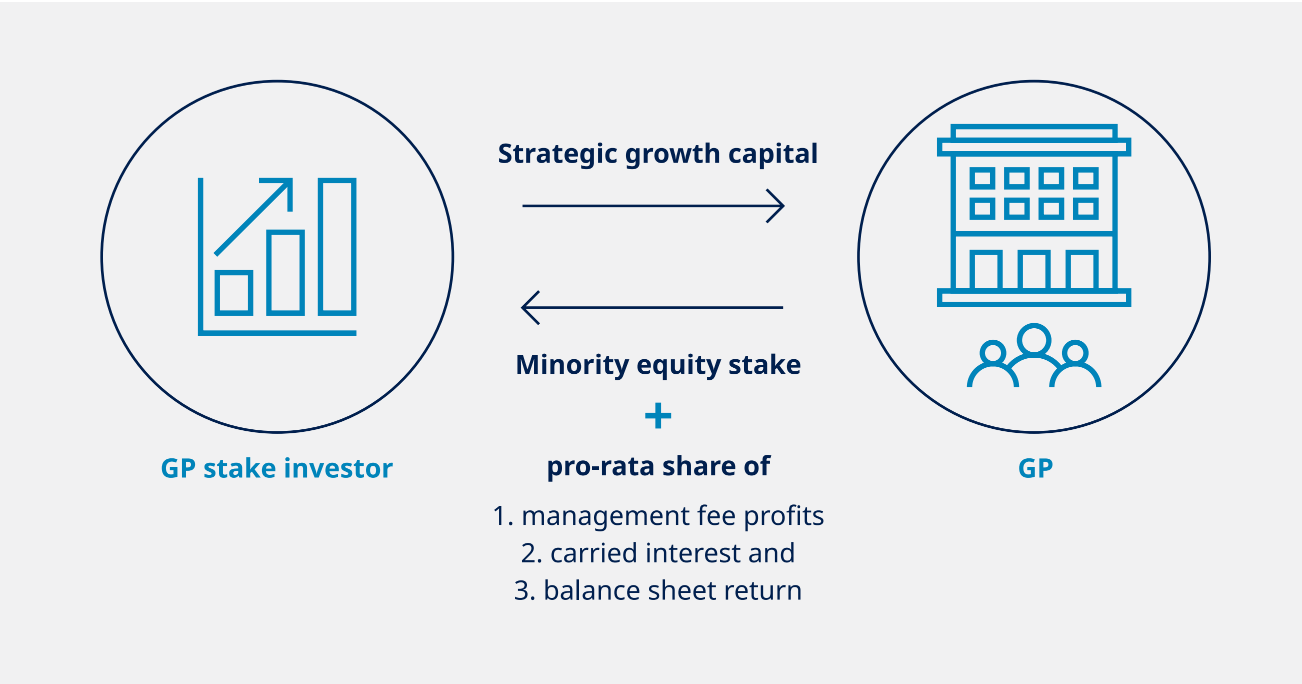
[1] *For illustrative purposes only. There is no guarantee that solutions will be the same or similar for all situations.*

GP stakes investment overview

1. Three principal sources of cash flow return[2]

In a typical GP stakes investment, a GP stakes firm will provide strategic growth capital to a GP in exchange for a minority equity interest (~10-30%) in the business and a proportionate share of the GP's cash earnings from the day of closing.



The GP stakes firm's earnings can be generated from three principal sources[3]:

1 Management fee profits

- Contracted management fee profits, typically at attractive margins
- Long duration capital base (typical fund life 8-10 years) with very low counterparty risk (e.g. pension funds, sovereign wealth funds, insurance companies etc.)
- In public markets, management fees are rewarded with very high multiples

2 Carried interest

- Performance fees, based on the portfolio gains of all the underlying funds
- Similar economic exposure to GP commitments
- With many larger, established GPs, there can be numerous legacy funds and billions of dollars of in the ground accrued carry

3 Balance sheet return

- Capital gains returned from the GP's initial co-investment into its underlying funds, alongside the LPs, typically on a fee-free basis
- Gross exposure to the performance of the underlying funds

[2,3] *For illustrative purposes only. There is no guarantee that solutions will be the same or similar for all situations.*

GP stakes investment overview

2. Composition of a GP stakes transaction[4]

Management company value
(growing enterprise)

- Acquire a growing alternative asset management business, which derives cash flows from (1) stable management fee profits, and (2) carried interest
- Asset management business continues to accrete in value based on fundraising and performance success of the firm

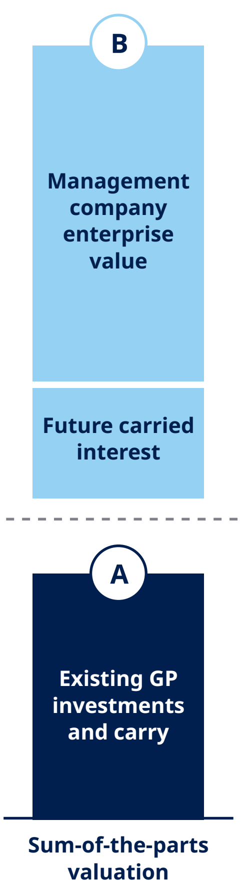
GP investments
(in-ground)

- Acquire pro-rata share of existing GP co-investments across all underlying funds today (typically on a fee-free basis)
- The in-ground investments will convert to cash as portfolio harvests and then the firm will invest its GP commitment in future vehicles

Carried interest
(in-ground)

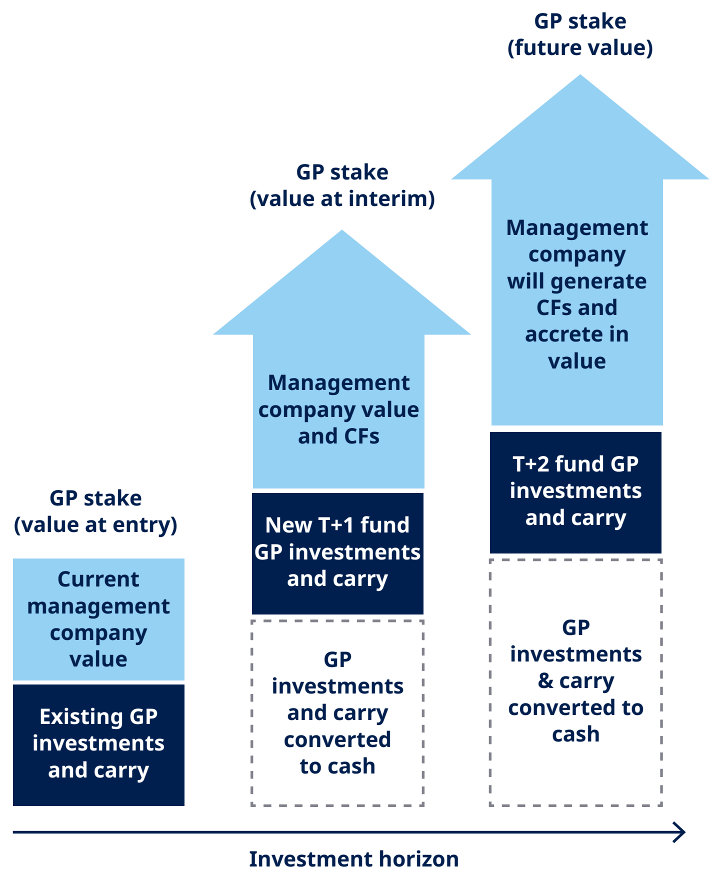
- Acquire pro-rata share of carried interest generated across all underlying assets (performance sharing)
- The in-ground carried interest will convert to cash as portfolio harvests, however portfolio will organically regenerate as the firm invests in future vehicles

3. Representative GP stake entry valuation[5]



- Represents acquisition of an alternative manager at an attractive discount to publicly traded comps
- Recurring management fee profits produces stable and growing cashflow yields
- Participation in future portfolio gains into perpetuity

- Acquire existing assets at discount to NAV (greater than typical secondary discount)



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Secondary investment overview

A fund portfolio secondary transaction typically refers to the sale of a LP commitment in a fund or portfolio of funds, before the underlying investments have fully matured, with returns for the buyer derived from the entry discount to NAV and the one-time harvesting of the investments within the defined secondary portfolio (the "Secondary Portfolio").

So, are GP stake investments analogous with secondary investments?

Certain similarities exist between GP stakes and secondaries as asset classes; for example, a significant component of a GP stakes investment return is generated from capital invested in a GP's underlying funds as GP co-investment on a fee-free/carry-free (i.e. "gross") basis. The entirety of a Secondary Portfolio's return is similarly generated by fund returns, net in this case, with returns further enhanced by any discount to NAV the secondary manager was able to negotiate at purchase. Once realized, the Secondary Portfolio proceeds are fully returned to the investor and are required to be reinvested in a new opportunity. In a GP Stake investment, the GP co-investment portfolio fund investments are perpetually regenerated as subsequent funds are raised, typically in increasing size.

But, what are the differences?

In a GP Stake investment, layered onto this fund exposure is a recurring component of cash distributions and the buildup of equity value within the Management Company, which enable an investor in a GP stake strategy the potential to generate returns that may compound to a greater overall MOIC than available from a Secondary Portfolio.

Diversification, early cash distributions and risk mitigation... sound familiar?

Secondary private equity managers seek to buy fund interests at a discount to NAV, with the goal of structuring highly diversified portfolios with mature investments that are close to harvesting and, as a result, generate quick cash distributions, a mitigated or eliminated "J-curve" (i.e., negative returns) and high net IRRs, with a lower risk profile than traditional, primary private equity fund commitments. Over the course of a fund life, returns for successful secondary managers are typically driven more by capital appreciation than by the mark-up of a discounted purchase price to NAV.

Blue Owl's GP Strategic Capital platform acquires minority equity positions in leading alternative asset managers. Our objective is to construct highly diversified portfolios to generate early and attractive cash distributions, and to help mitigate risk for our investors with contractual downside protection. The team also seeks to achieve significant capital appreciation over time, as equity owners in growing firm enterprises with real terminal value based on the continued fundraising success and investment performance of our partners.

> "Principally, the differences derive from the firm versus fund-level ownership models.

Figure 2

Investment characteristics of GP stake vs secondary fund[6]

	GP stake	Secondary
Ownership	Firm level: management company and GP	Fund level: LP commitment
Source of return	Management fee profits, balance sheet return and carried interest	Initial entry discount and the harvesting of the position in the acquired portfolio
J-curve	Limited: Investors receive recurring distributions from management fee profits, carried interest and balance sheet return immediately after the fund begins investing	Limited: The discount and mark-up effect of assets that are closer to harvesting, mean investors may benefit from shorter duration and faster return of capital
Diversification	High: Exposure to every current and future fund managed by the GP, diversified by vintage, size, industry, asset class and geography	High: Secondaries managers can diversify their holdings based on the maturity, manager, strategy, geography, industry and vintage of primary funds available
Capital appreciation	Significant potential upside: Permanent equity in a growing enterprise with real terminal value (not simply liquidating a portfolio)	Limited to one-time portfolio: Returns for successful secondaries funds are typically driven more by capital appreciation and value-add rather than by discount markups

So where do the asset classes diverge?

Principally, the differences derive from the firm versus fund-level ownership models.

In the secondary fund ownership model, total return in a single investment is driven by the initial discount and mark-up effect, which is unique to the secondary investor, and the one-time liquidation value of the Secondary Portfolio, alongside all the other investors in the fund (see figure 2). Risk mitigation comes through the maturity of the assets, as issues often come to light in the early years of ownership, reduced J-curve, limited blind-pool, entry discount and of course, diversification across a portfolio of secondary positions.

As an investor in a GP stake transaction, your economic exposure to fund performance is as a result of your ownership at the firm-level, and is not limited to existing funds, but to all funds the GP will raise in the future.

In a *single* GP stake investment, returns are driven by:

(i) the conversion to cash of a continuously regenerating portfolio of assets, typically across all past, present and future funds in the GP's ecosystem from the GP's capital investments and carried interest,

(ii) the recurring management fee profits, again from both existing and future funds, which provide an added layer of downside protection cross-cycle, and

(iii) equity ownership in a growing enterprise with real terminal value, not simply the liquidation value of a set of assets in a particular fund.

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"GP Alpha"

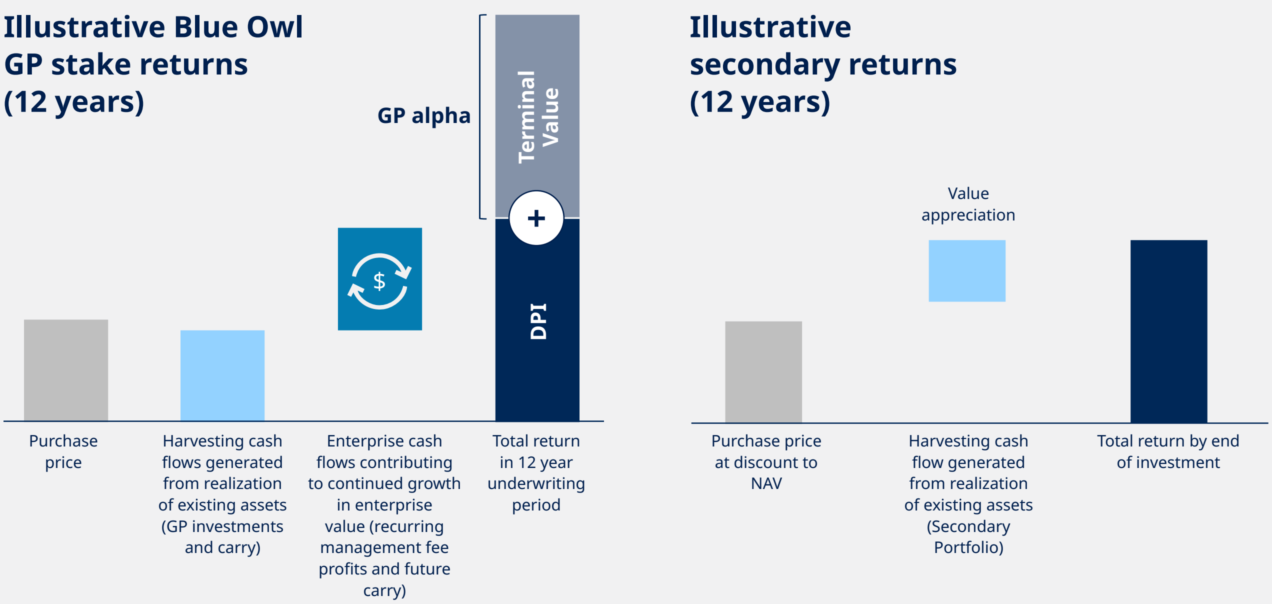
While the conversion to cash mechanics of (i) above are comparable to a secondary investment, the ongoing and regenerating nature of a GP stakes portfolio is a critical distinction and underpins long term compounding value.

The equity ownership described in (iii) above can be seen as a component of the "GP Alpha" in a GP stakes investment. "GP Alpha" can be defined as the spread between the net returns generated by investments in a manager's funds, whether structured as primary investments or secondary investments, and the net returns generated by owning at the GP level. In the latter case, a GP stakes investor actually shares in the GP's management fee profits and carried interest, receives the gross return of each fund the GP manages through its ownership of a portion of the GP's capital commitments to the funds and, finally, also owns a portion of the equity value of the Management Company itself.

As mentioned earlier, a GP stakes investment underwriting base case is that it will be held for the long-term and an investor will receive cash flows from management fee profits, carried interest proceeds and balance sheet returns. However, a portfolio of minority stakes in large private market firms has additional value that could be unlocked for investors in a variety of ways, including, debt-financed dividend recapitalization, a coordinated secondary sale process or fund-level strip sale, the private sale of interests in the portfolio, an assisted liquidity provision, a private offering of securities relating to the portfolio or, ultimately, an IPO of the portfolio itself.

Figure 3

Break down of GP stake vs. secondary returns[7]



- GP stake investors typically underwrite to a private equity type return from the cash flows generated by the GP alone
- The investment is not reliant on the realization of the GP to deliver the return
- At the end of the underwriting period, the investor has achieved a PE-style return and still owns a growing enterprise that continues to "regenerate" returns
- This additional upside, or terminal value, is referred to as "GP alpha"

- Typical secondary returns are derived from the initial discount and mark-up effect and harvesting of the portfolio
- Total return tends to be driven more by capital appreciation than by discount mark-up
- Once harvested, the portfolio does not "regenerate"

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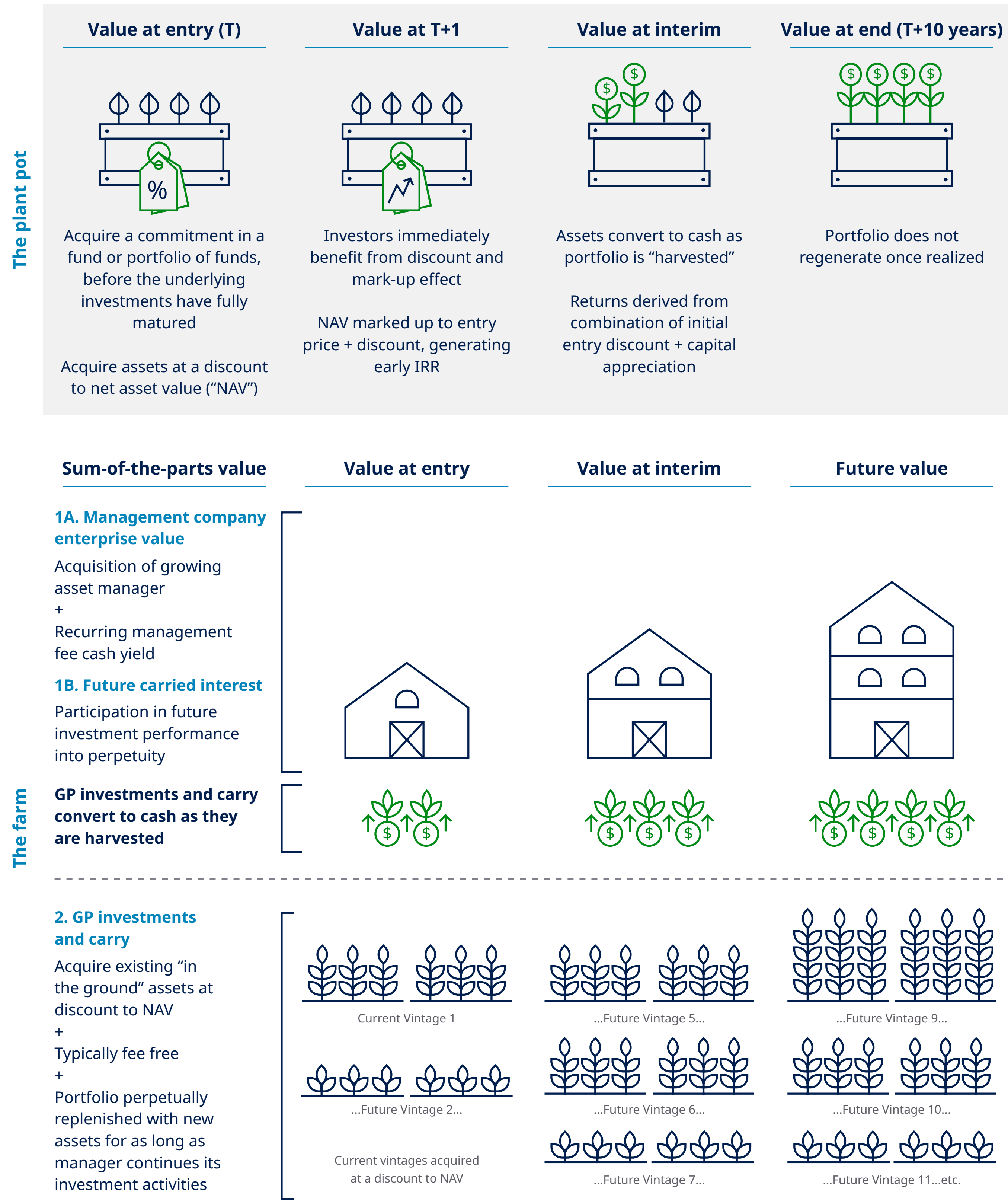
Below aims to capture the concept of regeneration and the power of GP economics in our depiction of the farm .

Figure 4

Secondaries (the plant pot) vs. GP stakes (the farm): the regenerative nature of the GP portfolio[8]



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Conclusion

Many aspects of GP stakes portfolios are comparable in behavior and economic exposure to other private capital asset classes. A strong argument could be made that secondaries are GP stakes' closest comparable strategy.

Both strategies can offer investors favorable cash flow dynamics, significant diversification and significant downside protection. Unlike a secondaries fund, which expires once its discrete set of portfolio assets are realized, the portfolio of assets in a GP stakes strategy is continuously replenished through the ongoing investment and fundraising activities of each GP. The regenerative nature of a GP stakes portfolio allows investors to potentially build returns over a long-term horizon, compounding an investor's MOIC and the investor also benefits from the component of GP Alpha discussed above.

Both GP stakes and secondaries have come into focus with the heightened attention on DPI in addition to IRR as a key performance metric. Strategies that have little to no J-curve, diversification and downside protection are increasingly seen as a necessary risk mitigant in portfolio construction. We believe that GP stakes can be complementary to secondaries and other private capital asset classes, with a differentiated returns profile that is designed to perform through market cycles and that we believe is impossible to replicate in any other single investment.

Michael D. Rees
Co-President & Head of GP Strategic Capital

Michael is Co-President of Blue Owl Capital, and Head of the GP Strategic Capital platform (formerly known as Dyal Capital). Michael is a pioneer in the GP stakes industry and manages funds that have purchased stakes in 66 alternative firms. Prior to founding Dyal, he was a founding employee of Neuberger Berman.

Cara Griffiths
Managing Director of GP Strategic Capital

Cara is a member of the GP Strategic Capital investment team. Cara was previously at Bank of America, where she was an adviser to Blue Owl. Based in London, Cara focuses on strategic projects, GP relationships, and client development activity across EMEA.

Glossary

Term	Definition
MOIC	Multiple of invested capital
DPI	Distribution to paid-in capital
IRR	Internal rate of return
NAV	Net asset value
In-the-ground	Investments that are held by the company at the time of the transaction
Harvesting	Investments that are held by the company post the investment period before final liquidation
Terminal Value	The growing enterprise of the Management Company via the continued fundraising success and investment performance of a manager or the potential liquidity events of the Management Company beyond the typical 10–12-year investment horizon

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