KEYNOTE INTERVIEW

Funding the future

GP stakes investing has evolved from de-risking founders to providing growth capital and connectivity to the next generation of talent, say global co-heads of Petershill at Goldman Sachs Alternatives, Ali Raissi-Dehkordy and Robert Hamilton Kelly

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Q How has GP stakes investing evolved over time?

Ali Raissi-Dehkordy: When we launched the Petershill business in 2007 and explained to investors that we wanted to make private equity investments in alternatives firms, they didn't know what we were talking about. At that time, GP stakes investing wasn't a recognised strategy or asset class.

We had seen that alternative asset management is an amazing industry that has successfully driven capital, innovation and value creation in all the other industries it finances – but, interestingly, there was very little capital focused on financing the private equity firms themselves. Here, we saw an opportunity to provide the same financing and support that PE provides to other sectors to the alternatives industry itself.

Over the past 17 years, the firms we partner with have become more complex, sophisticated and diversified, and the demand for capital to support alignment, retention and growth has significantly increased. Furthermore, we have experienced the retirement of the founder generation in many of these firms. The capital that those founders had compounded over several decades was frequently used as general partner co-investment in order to demonstrate alignment to investors. The next generation of leadership therefore needs a replacement for that compounded capital as new generations take the reins.

As the business of GP stakes investing has evolved, we have moved from de-risking the original founder generation to providing this new generation with growth capital, insight and strategic connectivity. It is no longer just about accessing funding – it is about finding the best non-control partner you can.

Q What is driving the popularity of GP stakes investing for LPs?

Robert Hamilton Kelly: A big part of the attraction has been the value creation we have achieved over the past 17 years, which has itself been based on the attractiveness of the underlying firms we partner with. These are incredible businesses boasting recurring fee revenues stretching out for 10-plus years, as well as double-digit growth rates. That isn't a profile you see in many other industries.

Furthermore, there is no J-curve. You start getting capital back through yield and income from the funds in year one.

Finally, our clients get a lot of strategic benefits both from coming into established firms where they want to allocate capital or co-investment, and from the opportunity for thorough engagement with our earlier-stage investments, where we provide new firms with their first capital in return for taking economics in the business.

ARD: In many cases, our clients are LPs in the firms we partner with – they are effectively the consumers of the products that these firms produce. This strategy therefore allows them to get closer to firms they already know well.

That idea was a key driver when we first started our business. There were some major LPs out there that understood the growth opportunity that alternatives represented and wanted to play a strategic role in that future. That narrative continues to this day. Investors see GP stakes strategies as a source of yielding investment in a high-growth industry that also provides connectivity to other parts of their private markets investment programmes.

Q How can GP stakes investing improve LP-GP alignment?

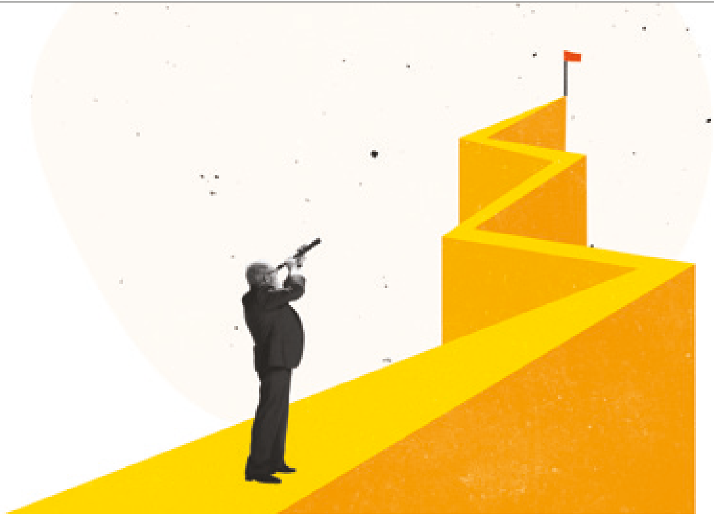
ARD: In many cases, our investments are driven by what we call primary capital. Rather than selling a slice of the business and reducing ownership, the partners who run the firm are looking to raise a balance sheet from which to invest in their own business and funds.

Indeed, in some cases, GPs have used our capital to increase their GP commitment from 2 or 3 percent to 5-10 percent. This enhances alignment from their LPs' perspective because it means the team investing the fund is not just relying on the management fees, or even performance fees, but also has a great deal at stake in terms of the outcome of its own capital in the funds.

In addition, we are typically one of

"[A] value-add partnership is a critical part of the rationale for entering into a GP stakes deal"

ROBERT HAMILTON KELLY



Q What do you believe the future holds for the GP stakes industry, and for your firm in particular?

Robert Hamilton Kelly: Our singular focus on mid-market firms has played out well so far, and we are still very early on in that opportunity set. There are a substantial number of firms in this space and that number is only growing every year.

Meanwhile, there is a clear trend among GPs more broadly to develop balance sheet flexibility. The very largest firms are using multiple sources of long-duration capital, ranging from institutional and retail to lock-up and insurance capital, on their balance sheets to enable them to be front footed about new opportunities. I think the rest of the market is thinking in those terms as well.

We will continue working with our partner firms, helping them achieve their goals and putting follow-on capital to work where needed. Meanwhile, we also stand to benefit from ongoing industry consolidation as larger alternatives businesses seek to buy high quality mid-market firms to build out their platforms.

the top five owners of equity in a firm. That means we are not just focused on the performance of the current fund, but also on all the funds that are to come. We not only want to ensure there is a high-quality team on the ground today, but we are also focused on ensuring the firm will still have a great culture and deep supply of talent to drive it forward in the future as well. Just like the best LPs, we want to make sure that alignment is cross-generational.

"For managers, [GP stakes investing] is no longer just about accessing funding – it is about finding the best non-control partner that you can"

ALI RAISSI-DEHKORDY

Q Are GPs looking for more than just money when they enter into a GP stakes deal?

RHK: The ability to bring capital into the business in order to enhance alignment, achieve scale, embrace new opportunities and retain talent in a thoughtful way is, of course, very important. However, a lot of firms also want to partner with us because of the expertise we have developed from doing this as a team for the past 17 years. What's more, we sit within a broader platform at Goldman Sachs, which has unique insight and data as a result of allocating billions of dollars to alternatives annually.

If a firm is thinking about expanding into a new product, sector or jurisdiction, we have the knowledge and intelligence to support them with that. If they are thinking about stepping into an adjacent asset class, that is something we can help them with, too. That value-add partnership is a critical part of the rationale for entering into a GP stakes deal.

Q What types of firms are the main focus for GP stakes investing?

RHK: That varies significantly across players in the space, but we have consistently focused on differentiated mid-market firms that we believe have their best days ahead of them. We look for high-quality teams with a top-quartile track record, which have shown a strong ability to manage their business in a thoughtful and responsible way. These are firms that will have demonstrated strong pricing power due to excess investor demand and moderate fund sizes.

These types of firms typically value our partnership. There is only so much we can do to help a $200 billion mega-platform that already has enormous resources, but there is a lot we can do to help a $5 billion firm. It is also far easier to grow a $5 billion firm into a $10 billion firm than it is to grow a $50 billion firm into a $100 billion firm.

Finally, because there are so many mid-market firms to choose from, that creates a strong negotiating dynamic on entry, while there is only a small number of very large private markets platforms that exist today.

Q What are the key challenges involved in GP stakes investing, and what qualities should investors look for in a manager to mitigate those risks?

ARD: Alignment is absolutely essential. We want to ensure management retains majority ownership and that the results the firm produces are going to drive the future wealth creation opportunities of that team. It is important that any transaction we enter into does not alter those dynamics, disincentivising future performance.

It also helps, of course, that we entered this space before the GFC and have now been through multiple market cycles. We have been able to test assumptions and observe how firms have performed in terms of actual cashflow versus marking to model. That operating track record gives us market insight into the investment activity and performance of underlying GPs, which is hard to replicate. When coupled with Goldman's interactivity in the private capital space as both an LP and service provider, we have a rare depth of data.

LPs considering investing in a GP stakes manager need to understand the GP stakes investors data and how they intend to diligence and underwrite the positions they take. The importance of that insight has only become more acute in the nuanced fundraising environment that we have experienced for the past two years: some firms are exceeding target today, while others are struggling. That is a real departure from what we have seen over the prior decade where strong markets and fundraising didn't really test assumptions.

This is an environment that will reveal whether stakes investors have been making the right assumptions around investment pacing, fundraising and realisations, or whether they have been optimistic. There have been a number of new players entering the GP stakes industry, and it remains to be seen how those new entrants will fare. ■