OCTOBER 24, 2024 • 7 MIN READ

Why GP stakes transactions may soon be on the rise in Canada

AUTHORS


Danielle Kline


Sarah Strong

In the world of private equity investing, the most common and well-known transactions are traditional fund investments or co-investments, where third-party limited partners pool capital for purposes of investing in the underlying portfolio assets of a fund. In recent years, however, the trend of GP stakes, a market that has been well-developed south of the border, is beginning to gain traction in Canada.

What is GP stakes investing?

A GP stakes investment is a transaction whereby a third-party investor acquires an interest in an investment fund manager or general partner (as opposed to investing in the investment fund itself). These transactions are typically structured to entitle the investor to receive a portion of the management fees or carried interest (if and when realized) – or both and may obligate the investor to fund its proportionate share of the GP commitment.

Management fees are the most certain source of income for a GP stakes investor, which make more mature sponsors, with multiple funds generating management fee revenue and a proven track record to support the success of future funds, the most appealing targets in a GP stakes transaction.

Why participate in a GP stakes transaction?

Many sponsors are attracted to GP stakes transactions because of the opportunity they provide to invest in the growth of the sponsor's business. A GP stakes transaction will often increase the manager's balance sheet, giving the sponsor more capital to invest in growth opportunities, such as building out new strategies and growing its team of investment professionals. For this reason, many GP stakes transactions are structured, at least in part, as primary transactions, with a significant amount of the proceeds being funded to the balance sheet of the GP, which also serves to create alignment between the investor and the principals. A GP stakes investor, particularly one that is passive, will want the selling parties to stand behind the fund's future performance alongside their new investor, at least for the sponsor's current funds and subsequent funds formed in the near term.

While investments in fund managers are commonly structured as passive minority investments, leaving the day-to-day operations of the manager to the principals of the sponsor, and in Canada, we have seen a number of recent strategic partnerships between PE sponsors and institutional investors. In addition to the actual injection of cash into the business, these strategic partnerships can also support the growth of the business by offering the sponsor access to key resources and an expanded network of potential investors and investment opportunities.

In addition to bolstering the sponsor's balance sheet, asset managers are also drawn to GP stakes transactions where they can monetize their sweat equity and are thus willing to sell a portion of the GP in exchange for cash proceeds. Aside from undergoing an IPO, which can bring about its own set of challenges for sponsors, there are limited liquidity opportunities for fund principals.

By virtue of the fact that GP stakes investment valuations are often based on the present value of a sponsor's future streams of income, selling a stake in a GP allows the sponsor to de-risk future fund performance and increase cash in hand. As noted above, such cash can be used to invest in the business or, depending on the terms of the deal, allow key principals participating in the transaction to take cash off the table. This is especially relevant for seasoned founders considering their exit timeline and desire to transition the operational responsibility to the next generation of investment professionals.

Preparing for a GP stakes transaction

There are a number of preparatory activities that sponsors considering bringing on a GP stakes investor can do in order to help prepare their organization for a GP staking deal.

First, it's important to consider what facts and circumstances could prohibit or limit the ability of a GP to bring in an investor. This should be considered both with respect to ownership and control of the fund general partner and management company, as well as ownership of the GP commit and carried interest. In particular, there may be legal restrictions on selling a stake in the GP in the fund's governing documents or pursuant to the governing documents of the GP entities. If such restrictions exist, understanding the process for obtaining the necessary consents will be critical to the success of the transaction.

Similarly, buy-in from other members of the investment team, along with existing fund LPs, will be critical to the success of the transaction and will be of utmost importance to prospective investors. Socializing the possibility of a GP stakes transaction, and the timing and messaging for those discussions, with fund LPs and internal stakeholders is a process that will need to be carefully managed by the sponsor.

In addition, the structuring of a GP stakes transaction, particularly for mature sponsors with multiple funds, is another component that can bring about some complexity. As with any investment, ensuring the parties can agree on a post-closing investment structure for the investor (both for current and subsequent investment funds) will be of particular importance for the sponsor and its investor, and should be tackled as early on in the process as possible to ensure there is alignment among the parties.

Finally, participating in a GP stakes transaction can be a transformative process for a sponsor, its investment professionals and its underlying funds, particularly in a situation where a sponsor is seeking a strategic, rather than a passive, investment, or where the transaction is motivated by a succession plan. It will be critical to the success of the transaction for both the sponsor and the investor to understand, maintain and further develop the sponsor's unique firm culture and organizational objectives while at the same time optimizing their strategic partnership and the growth opportunities that come along with it. Both the sponsor and the investor should be motivated to work closely with each other in the lead-up to the closing to ensure that the culture, values and strategic priorities of the parties align.

Current state of GP stakes transactions

In the United States, there is a well-established market for both primary and secondary GP stakes transactions, and a number of funds have been raised to invest exclusively in private equity GPs. In Canada, while we have seen a mix of both strategic partnerships and passive GP stakes investments over the last number of years, the GP stakes market is just beginning to develop.

As we move through 2024, not unlike other market trends emerging from the U.S., we anticipate that the developments made in the U.S. GP stakes market will continue to make their way north of the border. With the strong performance of Canadian PE funds in recent years, it is expected that U.S.-based GP stakes funds will look to expand their investment base to include the well-established Canadian private equity market.

In addition, the Canadian private equity landscape is seeing a number of sponsors reach a stage of generational transfer, where founders are seeking exit or transitional opportunities. This, in conjunction with the fact that asset accumulators are continuing to look for avenues to deploy capital in the private markets, means Canadian PE funds are well positioned for an uptick in GP stakes transactions. For these reasons, it is anticipated that there will be continued interest in participating in GP stakes transactions in Canada in the years to come.

To discuss these issues, please contact the author(s).