Paul|Weiss

Private Equity Digest

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GP Stakes Investing – Doing the Deal

In this issue of the Private Equity Digest, we continue our discussion with Paul, Weiss M&A partner and Corporate Department Deputy Chair Ariel J. Deckelbaum and Paul, Weiss M&A partner Ellen Ching on GP stakes investing, with a focus on standard terms, diligence and valuation considerations and execution risks.

Q: Last time, we discussed the recent uptick in GP stakes deal activity.[1] Has this affected the overall negotiation process for these deals?

EC: Yes, in many cases GP stakes deals are negotiated more quickly as they become more common. Market players and advisors now have established experience negotiating GP stakes transactions, and deal terms are becoming more standardized. These are competitive processes with multiple bidders, which are currently resulting in higher valuations and more favorable terms for the GP.

Q: As we noted earlier, these deals are usually minority stakes investments. How are these deals typically structured?

AD: The investor purchases an equity interest in the GP, either directly from the GP (a primary sale) or from a principal of the GP selling his or her stake in the firm (a secondary sale). Primary sales are currently the most prevalent.

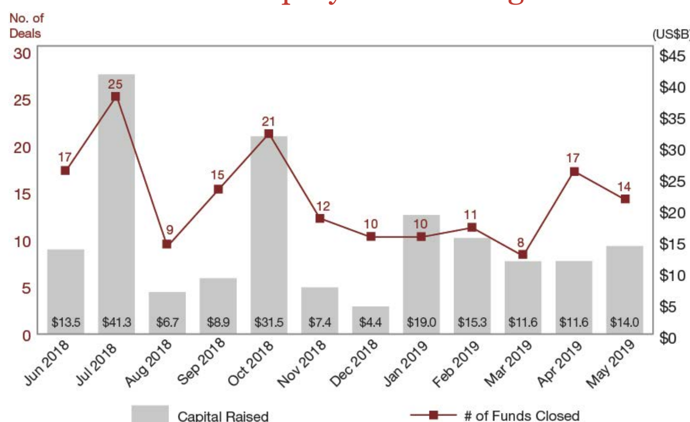
In either case, these GP stakes interests are usually perpetual, with no defined path to exit for the investor.

Alternatively, the transaction can be structured so that the investor receives a share of revenues, which requires greater emphasis on defining permitted expenses. In an equity investment structure, there should be greater alignment between the target firm's management and the investor.

Q: Is the purchase price typically paid up front?

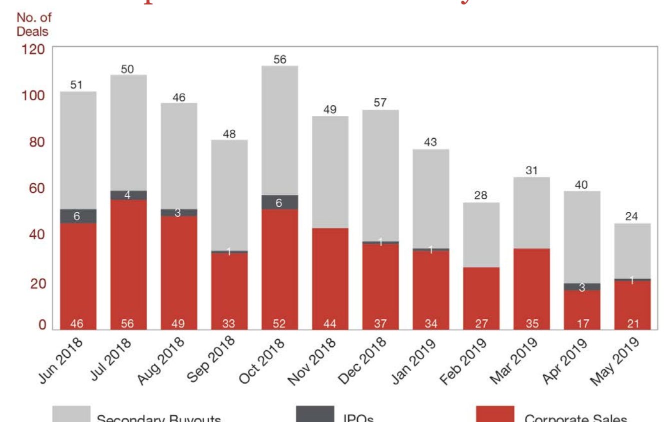
EC: No. Typically, 20% to 35% of the purchase price is funded at closing, with the remainder paid in installments within two to four years of closing, depending on the GP's planned use of the proceeds. Installment plans allow sellers to attract a higher valuation through deferred value and to plan around the liquidity needs of the target firm. Installment plans may include a mechanism by which the firm can accelerate the next tranche if short-term liquidity needs hit earlier.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits by Number



Source: Pitchbook

Q: *What revenue streams can the investor access?*

EC: The purchased interest of the investor represents a percentage of each of the three revenue streams earned by the GP: net management fees, carried interest and co-investments. Distributions of net management fees typically begin at the closing date of the transaction, but the management fees to be distributed may accrue from an earlier date – such as the date of the balance sheet used by the target firm to market the deal. Distributions of management fees are generally required to be made on a semi-annual or other periodic basis. Carried interest and co-investment payments are generally received at the same time as the other principals, which means that payments can vary depending on the waterfall structure (*i.e.*, European versus U.S. style).

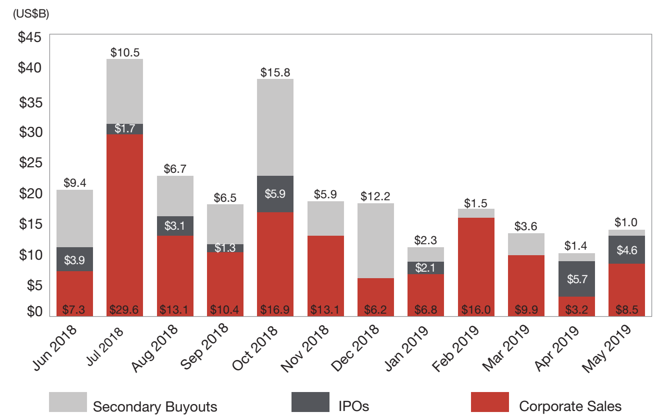
Q: *What types of governance provisions do investors care about?*

EC: Investors are not looking for day-to-day control of the target firm, but they do want to protect their economic entitlements and align management interests with their own. So, investors are usually granted one or more board seats or observer rights – as well as information and management access rights – to monitor the actions of the GP. However, because the concept of a board is new for many managers, whether the board exerts the right level of control for investors depends on the governance arrangements at each firm.

To protect the value of their investment, investors typically receive protections against dilution, including by restricting future equity issuances to employees and pre-emptive rights. Unlike more typical antidilution provisions, however, investors are generally not subject to dilution for issuances to employees and may be subject to an overall cap on dilution. On the flip side, investors are also often limited in their ability to benefit from accretion to their equity stake beyond their initial level of investment.

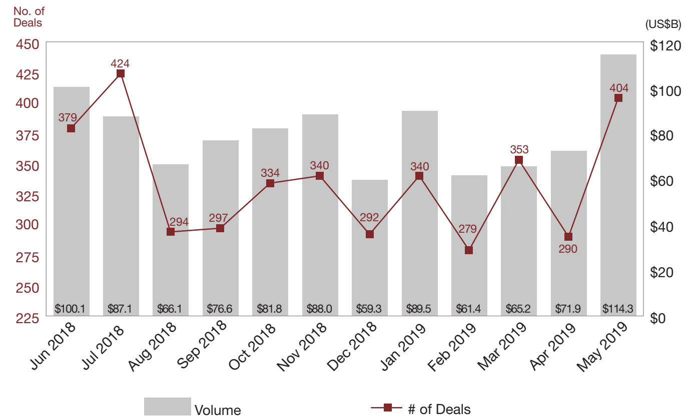
Investors also negotiate veto rights over significant events, such as changes to the capital structure of the company in a manner adverse to the investor, the issuance of new equity, any non-pro rata distributions, any encumbrances over the firm's revenue, any business combinations, mergers or sales of stock or assets or any possible IPO. Certain investors may also request the right to participate in co-investment opportunities.

U.S. Sponsor-Backed Exits by Dollar Volume



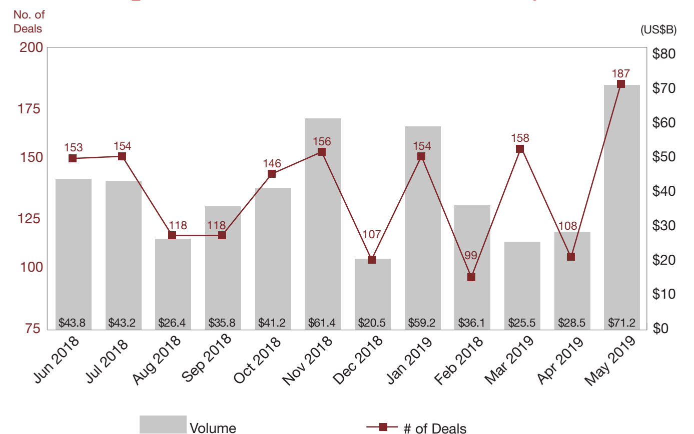
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Cortex

U.S. Sponsor-Related M&A Activity



Source: Cortex

Each metric in this publication that references deal volume by dollar value is calculated from the subset of the total number of deals that includes a disclosed deal value.

Q: What other types of provisions do investors want in these deals?

AD: Investors are also likely to request lock-up periods of five to seven years or longer for key persons through non-compete and non-solicitation restrictions, as well as sunset provisions for the retirement of key persons. This ensures alignment between management and the investor.

Other protections sought by investors may include: redemption rights in case of adverse events (such as key person events and/or specified regulatory events); lock-up periods for equity sales by key employees to third parties; registration rights in the event of an IPO; cooperation covenants with respect to tax matters; tag-along provisions; key person insurance; and limitations on certain expenses, such as private aircraft use.

Q: What contractual terms are important from the seller's point of view?

EC: Since this is currently a seller's market, sellers have considerable leverage to push back against investor requests, with an overarching goal of maintaining control over day-to-day operations. We're seeing looser exit provisions, no earn-outs, flexible use of proceeds, flexibility on future dilution and compensation needs and, in installment sales, punitive repercussions for payment default.

Sellers also typically want transfer restrictions from five to ten years after closing, during which time the investor may not transfer its interest. Even after the lock-up period, sellers may continue to require GP consent, or a right of first offer in favor of the GP, for transfers by the investor to certain parties such as competitors, or transfers that may result in material burdens on the business (such as disclosure or confidentiality obligations). Other protections that may be sought by sellers include drag-along rights and call rights to repurchase interests held by the investor under certain circumstances, such as a "bad actor" event or if ownership by the investor results in materially burdensome restrictions on the firm.

Q: What is involved in the valuation and due diligence process for GP stakes deals?

AD: Generally, GP stakes investing requires dealmakers to evaluate the economics of the investment manager as a whole, as opposed to assessing the performance of a specific fund or at the portfolio level. Characteristics that are crucial to the valuation of an investment manager (and therefore the focus of diligence) are team composition, the firm's ability to repeat its investment process, the firm's culture, client retention, talent retention and incentive alignment, brand awareness and distribution effectiveness.

Moreover, each revenue stream receives a separate valuation. The management fee trades at the highest multiple because it is the most stable revenue stream. Carry payments and co-investment revenues, on the other hand – while being the most potentially lucrative – are also the riskiest revenue streams and therefore trade at a discount.

Q: How do execution risks differ between GP stakes investments and typical M&A transactions?

EC: One key difference is that in GP stakes transactions, the talent is the focus of the purchase, as opposed to hard assets, operational synergies or other business concerns. So, it is crucial to understand firm culture and succession plans. Do certain key persons own significant stakes and will some of that equity roll to the acquiring entity? Aligning the incentives of these key persons should be an area of significant focus in order to ensure employee retention. Employees may be incentivized to stay by sufficient retained equity and bonus pools dedicated to personnel who stay on, and disincentivized to leave with non-competes and restrictive covenants. However, investors are aware that management teams will necessarily transition over time, especially given that a primary motivating factor for sellers is to facilitate such transitions. So, beyond ensuring employee retention, investors must assess the investment methodology of the firm and whether the culture of the firm will survive to the next generation.

1 For Part I of this article series, see https://www.paulweiss.com/practices/transactional/private-equity/publications/april-2019-private-equity-digest?id=28639.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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