

GP Stakes in an Institutional Portfolio

Theorizing on portfolio location and weighting

PitchBook is a Morningstar company. Comprehensive, accurate, and hard-to-find data for professionals doing business in the private markets.

Credits & contact

PitchBook Data, Inc.

John Gabbert Founder, CEO
Nizar Tarhuni Senior Director,
Institutional Research & Editorial

Institutional Research Group

Analysis

Wylie Fernyhough Senior Analyst, PE lead
wylie.fernough@pitchbook.com
pbinstitutionalresearch@pitchbook.com

Publishing

Designed by **Caroline Suttie**

Published on October 8, 2021

Key takeaways

- Allocating to a GP stakes fund is unlike any other type of private equity strategy. These funds offer a substantial yield component—often 7% to 10% gross initially, or higher. Additionally, these funds benefit when the underlying private capital firms perform well, and the structure offers differentiated downside protection.
- Because the GP stakes strategy is so different in its yield component, return drivers, and downside protection, it can be difficult to select the right bucket within an institutional portfolio. These funds may fall into the growth or credit special situations buckets. However, we believe a hybrid method or placement within a miscellaneous/tactical opportunities bucket are better approaches for most institutional allocators.
- The weighting of a GP stakes allocation may vary depending on an LP's liquidity preferences, cash needs, time horizons, and more. However, by weighting the strategy based on the investable market value of privately held firms, an allocation of 4% to 8% of the alternatives bucket appears appropriate.
- Beyond monetary gains, committing to select GP stakes funds may offer LPs strategic benefits as well. Examples include forging tight relationships with a core group of quality firms, potential co-investment and warehouse opportunities, the ability to seed new strategy launches, and possibly receiving allocations to otherwise oversubscribed funds.

Contents

Key takeaways	1
Previous research	1
Introduction	2
Unique aspects of the strategy	2
Where to place GP stakes funds in a portfolio	4
GP stakes allocations within private markets portfolio	6
Portfolio weighting	7
Strategic considerations	8
Closing thoughts	9

Previous research

GP stakes is the act of buying passive, minority equity stakes in asset managers that are formed, in part, as general partners and receive funding from limited partners. These investments are now made mostly in closed-end private capital firms but include hedge funds as well. Please see our previous research on the space to get a better understanding of the [market size](#), [monetization paths](#), and [more](#).

Introduction

After producing many research pieces on the GP stakes space during the past couple years, we have received many questions from LPs asking how to think about an allocation to GP stakes. We must note: Nothing in this analysis is meant to convince any institution or individual to allocate to GP stakes, nor is this financial, legal, or any other type of professional advice. The decision to allocate to GP stakes is unique to each institution or individual and their respective cash needs, liquidity preferences, alternatives weightings, time horizons, and more. Some institutions vow to never allocate to the space because they do not wish to profit off the very fees they loathe to pay. Others are considering a first-time allocation, whether they view GP stakes favorably on its risk/reward merits alone or seek to invest in the funds as a kind of fee reimbursement. This analysis parses through what differentiates the strategy, suggests where to bucket it within a private markets allocation, and explores a framework on how to weight it. The strategy has distinctive revenue drivers, downside protection, and payoff structure, which makes it difficult to determine the proper portfolio bucket and weighting for GP stakes.

Unique aspects of the strategy

Before jumping into where the strategy belongs in a portfolio, it is important to understand key underlying risk and return drivers, as well as why the strategy is distinct.

Yield

GP stakes funds are often pitched as yield investments: Portfolios often have gross cash-on-cash yields in the 7% to 10% range initially and can grow to the mid-teens for a mature portfolio. The yield is somewhat stable as well, although a lumpier return profile will be present when the underlying managers produce outsized monetizations and the GP stakes fund collects its slice of the underlying GPs' carry. Despite creating some reinvestment risk, uneven distributions to the upside are often viewed favorably. The consistent income component of GP stakes funds is perhaps the largest differentiator from typical buyout or growth equity investments, wherein little cash, if any, is returned to LPs before investments are exited. Buyout funds usually have minimal income because free cash flow is often either used to pay down debt or reinvested in portfolio companies rather than distributed to LPs—especially early on. Growth portfolios, wherein portfolio companies that are making little to no profit, usually produce no income until the investments are sold. For buyout and growth equity, capital appreciation is the goal, and dividend recaps are an exception to the dearth of income.¹

1: We modeled the return profile of GP stakes portfolios in a [previous analysis](#).

While yield is often a driver of LP investment into GP stakes funds, capital appreciation can also be substantial in this strategy. In a decade or less, an underlying GP's fund sizes can swell by more than 3x, thereby also lifting the private capital firm's multiple. For example, Aurora Capital Group raised a \$900.0 million fund in 2011 and a \$3.16 billion fund in 2020.

Diversified exposure to private capital

The fundamental drivers of GP stakes fund returns are distinctive when compared with buyout or growth equity funds. Investors in GP stakes funds are rewarded when portfolio companies—in this case, investment firms that raise closed-end funds—raise larger funds, return to market sooner, achieve better returns, and charge higher fees. As with other private equity strategies, LPs investing through GP stakes funds can fine-tune their allocation to focus on larger, middle-market, or smaller managers. A GP stakes fund's return drivers, management fees and fund performance—which drives the underlying GP's performance fees and balance sheet investments—are also distinctive. Management fees are contractually obligated, while carried interest provides healthy upside potential depending on underlying fund performance. In effect, this strategy pays off when private capital firms and their funds perform well.

Downside protection

Because of the locked-in management fees derived from the underlying private capital firm, the worst-case scenario for GP stakes investments is often less severe than with buyout or standard growth equity investments. If a private capital firm that sold a stake does not go on to raise another fund, the GP stakes investment will likely still recoup 70% to 90%—or more—of the original cost—even when accounting for fund fees. Pricing is often the largest variable, wherein higher prices mean less downside protection. On the other hand, buyouts and growth investments may see equity holders completely wiped out when things go wrong. Just as with the yield component, the downside elements mean the risk and return tradeoff for GP stakes funds is more akin to real estate or mezzanine strategies than buyout or growth equity. Additionally, relationships with LPs are sticky. As analyzed in a [previous report](#) about the space's risk profiles, thus far, firms that receive equity backing from an outside investor have low-single-digit failure rates.

Where to place GP stakes funds in a portfolio

Growth equity

Within the private equity portfolio, placing a GP stakes allocation in the growth equity bucket is a popular choice, despite the variation in risk and return. At face value, choosing growth equity makes sense. Though they can sometimes be revenue shares or structured equity deals, GP stakes deals are more frequently passive, minority equity deals—as are traditional growth equity deals. Both investment strategies are typically structured around providing growth capital to the invested companies, though GP stakes deals may also include founding partners selling secondary equity rather than just primary.

When compared with the more growth-oriented small or middle-market GP stakes space, deals with \$50 billion+ AUM managers are likely to have less of a growth tilt over 10+ years. This means that different bucketing may be appropriate depending upon which end of the spectrum an allocator commits to. More on the competitive landscape can be found [here](#).

Credit special situations (or elsewhere within the yield bucket)

Because of the yield elements inherent in GP stakes investments, some LPs decide to place some or all of their allocations in the credit special situations bucket. There is some merit to this approach. Similar to fixed-income assets, private equity fund management fees are contractually obligated payments that are typically based on committed capital once a fund is launched and then switched to invested capital after the investment period. From the beginning, private credit funds are usually based on invested capital.

Launched funds from a single manager provide a fixed-income-like payoff from management fees, and some equity-like risk exists regarding the timing, size, and duration of future funds. However, the management fees produced from a portfolio of firms have less idiosyncratic risk and can be modeled with relatively high degrees of certainty. Because the GP stake investment is structured as a pure bottom-line equity stake rather than a gross revenue share, both the ability to model and the fixed-income-like nature of the fees are somewhat diminished. With the former, the staker's participation in management fees is subject to equity-like risks, including expenses and other liabilities. While these expenses and liabilities are fairly predictable, there is no protection against unexpected material liabilities in a pure bottom-line equity stake structure. That said, elements exist that diminish other types of fixed-income risk. According to Joseph Schwartz, an investment fund and M&A attorney at Sidley Austin who has drafted and advised on many GP stakes legal documents, because the management fees are accrued by the fund and owed to the sponsor—which is a related party—the counterparty risk attendant in typical fixed-income portfolios is mitigated—if not eliminated entirely.²

2: Telephone interview with Joseph Schwartz, interviewer Wylie Fernyhough, October 1, 2021.

GP stakes allocations typically offer a 7% to 10% gross yield with upside optionality, thus making the risk/reward profile of the strategy more similar to some exotic credit products such as mezzanine or hybrid value (a debt/equity hybrid product) than to growth equity. GP stakes firms are often proponents of LPs placing allocations in their yield bucket because they would rather compete for allocation dollars against credit products due to the much lower expected returns with most yield strategies. However, because this is an equity investment, placing all of the allocation in the credit special situations bucket proves questionable. The GP stakes fund's payoff from management fees alone is credit-like, but the income from performance fees and balance sheet investments complicates this return profile. Moreover, if a GP stakes allocation takes longer to produce the targeted yield than anticipated, cash flow pressures in the portfolio—such as the yield bucket producing insufficient income in a given year—could result. Because of this, placing a GP stakes fund allocation in the yield bucket is potentially riskier for the LP than within one of the private equity buckets.

“Other” private equity, opportunistic, tactical opportunities

Another common place for GP stakes to land is the “other” bucket within a private equity allocation, which is effectively the undefinable bucket for many allocators. Some LPs have an opportunistic or tactical opportunities bucket in addition to the “other” category, while others combine all three. Regardless of the designation, the miscellaneous bucket can be a sensible location for this strategy and likely the most suitable option for many LPs. The yield component from management fees and the growth component from carried interest and balance sheet investments make it especially tricky to compare with any other private equity strategy.

Hybrid

While some of the previous buckets make sense for many LPs, other ways to conceptualize GP stakes allocations exist. Some LPs have a location for “too hard to figure out” and count their allocations there. Another, more advanced way of thinking about a GP stakes allocation is a hybrid model that splits the allocation into two buckets within the private markets portfolio. With this model, LPs apply one multiple to the annual management fee stream and place this within the opportunistic credit bucket because the fees are bond-like due to their contractually obligated nature and achieve a similar yield. Then, the carried interest and GP balance sheet investments receive another multiple and are placed within the “other” or growth equity private equity bucket. This method allows an LP to look through the allocation with greater nuance and allocate the two return drivers with similar investments in terms of risk and return profiles. This method is likely best for sophisticated LPs that want to group the GP stakes strategy's two distinct income streams into the most appropriate risk/reward bucket for each.

GP stakes allocations within private markets portfolio

These tables exemplify a simplified version of a private markets portfolio, wherein a new GP stakes fund allocation could sit within the broader private markets portfolio. Allocation weightings do change in this illustration and are assumed to come from cash in the private markets portfolio. A discussion on from where to potentially pull allocation dollars comes later in this analysis.

Mock portfolio without a GP stakes allocation

	Strategy	Fund	Weighting
Cash			10.0%
Private equity	Buyout	Buyout Fund 1	15.0%
		Buyout Fund 2	10.0%
		Buyout Fund 3	12.5%
	Growth	Growth Fund 1	6.2%
		Growth Fund 2	2.5%
		Growth Fund 3	10.0%
	Tactical opportunities	Tac ops Fund 1	2.5%
Private credit	Direct lending	Direct lending Fund 1	8.8%
		Direct lending Fund 2	7.5%
	Mezzanine	Mezzanine Fund 1	5.0%
		Mezzanine Fund 1	6.2%
	Special situations	Special situations Fund 1	3.8%
Total			100.0%

Source: PitchBook | Note: For illustrative purposes only

Mock portfolio with a GP stakes allocation in the tactical opportunities bucket

	Strategy	Fund	Weighting
Cash			2.5%
Private equity	Buyout	Buyout Fund 1	15.0%
		Buyout Fund 2	10.0%
		Buyout Fund 3	12.5%
	Growth	Growth Fund 1	6.2%
		Growth Fund 2	2.5%
		Growth Fund 3	10.0%
	Tactical opportunities	Tac ops Fund 1	2.5%
		GP stakes Fund 1	7.5%
Private credit	Direct lending	Direct lending Fund 1	8.8%
		Direct lending Fund 2	7.5%
	Mezzanine	Mezzanine Fund 1	5.0%
		Mezzanine Fund 1	6.2%
	Special situations	Special situations Fund 1	3.8%
Total			100.0%

Source: PitchBook | Note: For illustrative purposes only

Mock portfolio with a GP stakes allocation using the hybrid approach

	Strategy	Fund	Weighting
Cash			2.5%
Private equity	Buyout	Buyout Fund 1	15.0%
		Buyout Fund 2	10.0%
		Buyout Fund 3	12.5%
	Growth	Growth Fund 1	6.2%
		Growth Fund 2	2.5%
		Growth Fund 3	10.0%
	Tactical opportunities	Tac ops Fund 1	2.5%
		GP stakes Fund 1(A)*	3.0%
Private credit	Direct lending	Direct lending Fund 1	8.8%
		Direct lending Fund 2	7.5%
	Mezzanine	Mezzanine Fund 1	5.0%
		Mezzanine Fund 1	6.2%
	Special situations	Special situations Fund 1	3.8%
		GP stakes Fund 1(B)*	4.5%
Total			100.0%

Source: PitchBook | Note: For illustrative purposes only

*This is an illustration of how an LP could account for one GP stakes fund in two portfolio buckets by breaking out and valuing the allocation by risk/return streams.

Portfolio weighting

Determining a portfolio weighting for GP stakes is part art and part science. We provide allocators with a starting point based on some simple assumptions. Though figures vary, private capital firms typically trade at 15% to 30% of their AUM. For example, credit firms usually trade at the lower end of the range—and perhaps even below it—while private equity firms often trade at the higher end and above. Globally, there is approximately \$10 trillion in private capital AUM. Going off the low point implies at least a \$1.5 trillion enterprise value (EV) for all private capital firms, both public and privately held. Much of this EV is in public markets though, with Blackstone (NYSE: BX) alone at an approximately \$140 billion market cap. However, nonpublic firms possess a sizable amount of value, at around \$1 trillion—though the addressable market is smaller because these are minority stakes only, not all firms will sell, and many firms are too low quality. These factors likely cut the addressable market's total EV down to around \$750 billion.

This raises several weighting options. Based solely on a cap weighted allocation, one could assume a 15% allocation to GP stakes within the private capital bucket is reasonable given that approximately 15% of the value of private assets—such as corporate equity, credit, and real estate—resides in the firms managing these assets. However, the addressable market is half the size, and GPs usually sell only 20% of the firm's EV, which means not every allocator could feasibly deploy this much capital into the GP stakes space. Accounting for these factors, a long-run allocation in the 4% to 8% range as a proportion of the private capital bucket appears appropriate. However, the 4% to 8% range may not be suitable for everyone. Some allocators with whom we have spoken are more bullish and allocate 15%+ of their privates allocation to GP stakes, while others have a single fund allocation at 2% or less of their privates bucket.

Another element to consider is the duration of GP stakes funds, which are often set up as 10-year+ or perpetual life vehicles. This means that LPs may not experience the classic private market problem of constantly needing to allocate to new funds to maintain a target allocation weighting. However, with Petershill recently announcing an IPO that will provide liquidity for fund II and fund III LPs, allocators may be faced with needing to re-up to remain invested in the strategy. Other options that have been floated, such as continuation funds, offer different challenges to maintaining an allocation but give the optionality to LPs, especially during the GP-led transaction.

Strategic considerations

The relationship-building possibilities that accompany a GP stakes fund commitment must also be considered. Some LPs in certain GP stakes funds may see benefits to their allocation beyond the fund returns. However, each GP staking firm approaches this differently. Some invest purely as financial sponsors, while others take a more strategic and partnership-based approach. One approach is not necessarily better than another, and every LP should decide what best suits them. In most cases, GP stakes funds will invest in eight to 12 firms. The partnership-focused GP stakes firms often seek to offer their fund LPs co-investment and secondaries opportunities with the firms in the portfolio when available. Whether co-investment opportunities arise or not, these LPs can establish much closer relationships with the group of managers in the fund, which can lead to procuring allocations in oversubscribed funds, as well as one-off co-investment or warehouse opportunities and seeding new strategy launches. Some GP stakes investors seek to offer something akin to the Capital Constellation model but with more mature managers.³

3: Capital Constellation is a consortium of large, sophisticated allocators that formed an entity meant to back private capital firms. Capital Constellation seeds and takes GP stakes in smaller firms—those with under \$3 billion in AUM. These LPs vow to act as highly strategic partners; they allocate to future funds for the GPs they back and receive economics in the firms they help to grow.

In some cases, co-investment opportunities are available in the GP stakes funds themselves. However, LPs will unsurprisingly need to pledge a sizable fund commitment to be considered for a co-investment. Using the firms targeting middle-market GPs as an example, if an LP is willing to write a \$150 million+ check for a \$1 billion fund, co-investments are likely possible. The larger the commitment and more strategic benefits the LP brings, the higher the co-investment reward. This would be a co-investment in select GP stake deals—typically ones too large for the fund alone, such as a \$350 million deal out of a \$1 billion fund.

Closing thoughts

However LPs decide to invest and allocate, there are myriad financial and strategic elements to consider with GP stakes. It is perfectly reasonable that allocators will disagree on whether to allocate to the strategy at all, where it falls within their private capital strategy buckets, and what the proper weighting should be. Some institutions view an allocation to GP stakes as a type of fee reimbursement, while others compare it to real estate, credit, growth equity, and other strategies on the risk/reward spectrum to make allocation and weighting decisions. Additionally, allocators may decide GP stakes can go into one of several buckets and then allocate capital out of the most underweight substrategy bucket. Some LPs will deploy capital into the space by choosing to boost their overall private markets allocation, though others will need to select the bucket from which to divert capital if none in the portfolio are underweighted. In that case, funding GP stakes allocations from private market buckets with a similar risk and return profile may be sensible. All these elements of a GP stakes allocation are complex, and our analysts are happy to discuss these considerations with prospective or current investors.