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Three Valuation Considerations for GPs Seeking Outside Capital

As alternative fund managers institutionalize their business and processes, many are seeking minority-stake investments

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When investment pros look back at 2017, many will probably recognize it as a defining year for PE. As PE deal multiples reached unprecedented heights, no longer is it enough for sponsors to rely purely on leverage and multiple expansion to generate returns. Rather, the ongoing maturation of the asset class is driving GPs to institutionalize both their business and processes. And it's against this backdrop that several top names have either already taken on outside capital or are considering minority investments that can position their business for this evolving era.

Over the past 18 months, middle-market stalwarts such as Riverside Company, Arclight Capital, TSG Consumer Partners and several others have each sold minority stakes in their respective management companies. In the case of Riverside, for instance, the investment seemed to coincide with the strategic expansion of the firm's product set into complementary strategies such as non-control capital. For Arclight, the investment reportedly was not only to fund future growth, but also helped to effect a succession plan in which certain founders monetized their ownership interests. Others, meanwhile, have used these transactions to fund executive distributions, which can ease the burden for junior partners to commit to new funds.

What many fund managers are discovering, however, is that selling a stake in their partnership can be far more challenging than merely exiting a portfolio company. For one, these transactions have ramifications that can be felt throughout the partnership for years to come, potentially influencing future fundraising efforts, recruiting and succession planning and, often, the overall direction of the firm as smaller partnerships evolve into larger institutions with hardened processes and protocols. The other challenge is that while these deals are becoming more popular, each one often differs in scope and objective. But given the growing propensity of these transactions, we've outlined three considerations around valuation for GPs considering such a transaction.

Consideration One: A Market-based Approach

In traditional M&A, the process of finding relevant comparables is fairly cut and dried. For alternative fund managers, though, not only are relevant comps few and far between, but the valuations can fluctuate based on several variables. The forward P/E ratios of several publicly held alternative managers, for instance, range from approximately 8x estimated earnings to more than 12x. This reflects the incongruities that exist between even the largest and most diversified firms. But when one considers the illiquidity discount for private partnerships and, then, the differences in the maturity, scale and investment strategies of most mid-market firms, it becomes that much harder to reach a consensus around an agreed-upon multiple.

Consideration Two: The Income Approach

Given the challenges of finding apples-to-apples comps, most management company valuations will apply an income approach to assess fee-related earnings that are then used to support a sum-of-the-parts valuation. In this scenario, cash flows are adjusted for systematic or market risk, using discount rates determined via pricing models (such as CAPM). This provides an anticipated rate of return for traditional management fee income streams. Evaluations around carry, however, remain quite subjective since it is contingent on the performance and exit timing of the underlying portfolio companies. Discount rates applied to these performance-related earnings, as a result, tend to be higher based on several factors ranging from the target rates of return identified in LP offering documents to industry benchmarks that factor in the size, focus-area and vintage year of the funds.

Consideration Three: Understanding How the Objective Informs the Valuation

In most cases, the minority stakes being acquired are non-voting, passively held positions. But whether the investment is premised on seeding new strategies to grow the business or designed to effect a possible succession plan, the investments can draw scrutiny from existing and prospective LPs. Within the partnership these deals can also be a source of internal dissension if the economics of the partnership change significantly. Junior partners, for instance, will want to understand the extent to which the investments dilute future carry. While these questions can be easy to resolve, the sensitivities often influence the deal terms and, ultimately, the price.

In light of the industry's ongoing maturation, it's likely that 2018 will only see more GPs pursue these types of transactions. Indeed, the recent activity would suggest that it is a sellers' market, particularly as portfolios further strengthen, AUM growth accelerates, and as demand from institutional investors percolates. But whatever the goal, the scrutiny these deals often receive underscores the need for experienced and objective oversight to realize both the existing and future value of the partnership and ensure the firm is positioned well for the evolving landscape.