An evolving asset class

Keynote Interview with PEI

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This sponsored article was first published in Private Equity International May 2024

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A number of factors have accelerated the growth of the GP stakes market over the last 15 years, says Michael Rees, co-president of Blue Owl Capital and head of the GP Strategic Capital platform

Q&A

Why does the GP stakes market exist and what has been Blue Owl's role in developing it?

The GP stakes market evolved out of a confluence of three major trends: first was the institutionalisation of the private equity market, which is now entering its fifth decade, with the bulk of the bigger firms now more than 25 years old.

Second was rapid growth in the overall value of assets in private markets – this has more than quadrupled since 2008, going from $3 trillion to around $13 trillion today, driven both by consistent outperformance and fresh capital formation. And finally, there was a flip from an asset-light to an asset-heavy industry. The overall commitment of money to funds managed by the industry has grown from below 1 percent in 2009 to approximately 5 percent now.

So, the industry grew four-fold, the capital per dollar grew five-fold, and that meant you had a capital need that had gone up 20-fold in that timeframe. The maturing of the industry coupled with that growth in the need for capital resulted in a vacuum that was originally self-funded, but soon required external capital to augment it. That is where we stepped in to become a provider of growth capital to a growing industry. We raised $5.3 billion in 2016, creating the largest ever GP stakes fund at that time.

Q&A

How do structural growth trends in private markets drive the need for GP stakes capital?

Just as the aforementioned growth was taking place, the PE industry was going from a very simple business model of raising one fund, investing it and then four years later raising another fund, to the creation of asset management businesses with multiple product lines operating on a global basis.

The leading players in the market wanted to bring on strategic partners to help them navigate that radical shift. GP strategic capital providers like us, who provide both the long duration capital and the strategic advice, met the needs of those GPs. Ultimately, this is why GP stakes has grown and proliferated so much as a strategy over that period.

We are now seeing the acceleration of that transition, brought on by the events of the last 18 months. Difficult market conditions made fundraising from the two traditional private markets investors – US pensions, and endowments and foundations – more challenging. They also made way for four newer cohorts of investors – sovereign wealth funds, insurers, corporate pensions and private wealth investors – to access the market.

The business model that was needed to service that first group was relatively simple – however, the client relationship model needed to service all six of those groups is complex. As these GPs are growing and diversifying their earnings streams and building infrastructure to address the new client segments, that increased complexity is fuelling a need for a larger balance sheet and stronger partnerships.

Blue Owl is able to offer these services in two ways: first, the sizes of our private markets-focused portfolios are significant, ranging from $5.3 billion-$12.9 billion. This allows us to meet the capital needs of even the largest firms. Second, our team of around 50 professionals focuses solely on making these relationships strategic. This team has scaled headcount and capabilities as the needs of our partners have evolved, and now includes advisory services across 10 pillars ranging from capital strategy to data science.

Q&A

How and when did GP stakes become an asset class in its own right?

Investors have become more attracted to GP stakes because of the strategy's track record with returns, the differentiated profile of those returns, and increased familiarity with the strategy. However, the real catalyst to it becoming an asset class in its own right came as investors recently heightened their focus on DPI in additional to IRR as a key performance metric, seeking strategies that could return their cash more quickly.

We have seen a real increase in both the number and the types of investors coming into the GP stakes asset class. These strategies typically don't have J-curves and can begin paying out cash-flow literally the quarter after their final close. In an environment like today, where allocations can be stretched, having something that can yield immediate returns is very attractive.

These strategies focus on building long-term equity upside while also yielding, which is a combination that can be hard to find and is well suited to the needs of those three categories of investors that are growing their allocations to private markets: sovereign wealth funds, insurance and private wealth.

Since 2016, we have gone on to raise a $9 billion fund and a $12.9 billion fund. The availability of that volume of capital has also broadened the aperture and the opportunity for clients that need a big firm to partner with that can write big cheques.

Q&A

What does the balance between growth capital and strategic partnerships look like in a typical GP stakes transaction?

Capital need is always the catalyst for a GP seeking an investment. However, they are often amazed at how much they go on to engage with and leverage the resources of our strategic platform. If you asked our 44 private equity GPs what has surprised them most about our partnership, many would say the involvement we had in helping them develop their business, given that is never the primary motivator. People often ask us if the larger, more developed GPs we partner with really have a need for our strategic advisory services. GPs come to the GP stakes market almost exclusively from a position of strength. Weak firms don't sell stakes; strong firms do. So, there is a natural self-selection – the firms we partner with are inquisitive and very interested in understanding where they benchmark against market best practice, particularly as this is an industry where reference points aren't readily available. Our strategic development services are free and there is no obligation to use them, so the extremely high levels of engagement across the board tell you something about our insights.

If a GP has the opportunity to expand – often to go global or to launch a larger fund – they will need more capital than they have. That is why they come to us – and then they find there are plenty of additional benefits to be had as well.

Q&A

How have you built and strengthened Blue Owl's market position since inception?

We are the largest business dedicated to GP stakes, having invested over $31 billion of capital. We have a 60 percent market share of all the capital ever raised for GP stakes, and our share of the larger deals (which we classify as the $600 million-plus cheques) is around 90 percent. This includes 14 follow-on transactions with existing partners, demonstrating the strength of the relationships we build post-transaction.

People often say that there are a lot of entrants into this space, but you can count the major players in GP stakes on two hands. Compared with many other asset classes – and for an industry with such a large and growing investable universe – there is a small universe of players, and something of a capital constraint. That means that with our differentiated scale, focus and value-accretive proposition, pricing has remained fair and relatively consistent since 2015.

GP stakes deals are complex and bespoke transactions that require a specialist team. Our senior investment team has been dedicated to this space for 15 years

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with zero turnover, which means we bring considerable collective experience. Transactions often take five to seven years from the point we initiate contact with a GP to the point they need external strategic capital, so that continuity is immensely important.

We have also completed more than 80 transactions with alternatives managers through various cycles and have seen the majority of the transactions that have gone through the market, allowing us to build a sizeable body of proprietary data. This informs our pattern recognition and the quality of our underwriting. As a business, Blue Owl is truly focused on its mission, focusing on GP stakes, real estate and credit. This means we can be more targeted and scale more easily to meet our clients’ needs.

Q&A

What have been the key innovations in the industry so far, and what does the future of GP stakes look like?

As a group, we believe Blue Owl has been responsible for two of private markets’ largest financial innovations in the last decade or so: the first was a large-scale GP stakes strategy, and the other was large-scale permanent capital institutional business development companies, from which we have built our direct lending business.

On the GP solutions side, we have more recently launched a joint venture with Lunate, an Abu Dhabi-headquartered independent alternative invest-ment manager with over $105 billion in AUM. This partnership will provide growth capital to leading mid-sized private capital GPs, which are smaller than our typical target size.

Going forward, the GP stakes industry has access to a very broad and diversified portfolio of firms that it owns and has the opportunity to create an index fund-like product for private markets, accessible to the wealth channel and the 401k channel. We believe GP stakes strategies are uniquely positioned to deliver that kind of product because of their diversification and breadth.

It used to be that GPs were extremely worried about how the investor community would look at a GP stakes deal. However, in the evolution that has occurred over the last 15 years, investors have warmed to this idea and now look at it almost as a badge of honour. They see a firm as truly institutional quality when it achieves a scale that means it can establish a GP stakes partnership.

The private markets are just scratching the surface in GP stakes. We believe the overall industry will double in size in the next five years, creating great potential growth for GP stakes strategies.

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