Q&A

# MOUNIR GUEN

## MVision

*MVision's Mounir Guen outlines the options open to private equity firms when taking on third-party capital and strategic reasons for doing so.*

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### Private equity managers are taking on third-party investment into their respective management companies in ever greater numbers. Why is this happening?

Usually private equity firms will explore options for taking on outside investment when they have a business model or strategy that requires a balance sheet capital in some form. Firms may be growing rapidly or have ambitions to initiate new products that require investment.

You will also see firms look at third-party investment when the founders are ready to realise value from the organisations they have built and/or are preparing for their succession.

A third scenario is when franchises experience rapid expansion in their funds under management and seek a way to help emerging generations of partners, who are in their thirties and forties, to meet GP commitments on large funds. These has emerged because of waterfall structures and carry is taxed in some jurisdictions. It means that carry is touched much later than it used to be, creating an need within firms to find the capital.

### What options are open to firms and what are the pros and cons of each option?

We have seen large managers in the US and now in Europe go down the IPO route. If you are a large firm it opens up access to deep pools of capital, which is attractive. It provides capital and liquidity and gives you a working balance sheet. On the downside you can find yourself moving from operating as a private company to a public one almost overnight, and that brings with it a whole new set of regulatory, compliance, disclosure obligations and operating changes.

Then there are the private, third-party investors that will take passive stakes in private equity managers. This can help facilitate succession, allow founders to realise value in a clean transaction and allow founders to realise value from their businesses at attractive valuations.

Historically a retiring founder would come to an agreement with the partnership to buy out his or her stake. The third-party investors have come in and are able to pay much higher prices, which from a purely financial point of view is very attractive.

But there is always an emotional element to these transactions that extends beyond just the financial side. It adds an additional layer of complexity to these deals.

There are also scenarios where family groups and asset managers who will help institutions to fund their balance sheets or realise value for founders. There are a number of examples of this model in Europe.

Finally, there are structured financing solutions from secondaries firms that can provide a lump sum of capital today structured against future cash flows. This capital could work out a little more expensive at the front end, but the upside is that it does not require a firm to sell a position in its management company, which if the firm is successful will be worth a lot in the future.

Whatever option a manager chooses, these transactions are part of the fabric of today's activities.

### What do LPs make of this? If a manager takes on outside investment into the GP, does that change an LP's view?

Investors do pay attention to it and it does matter. LPs are fixated on how the economics of the investment teams they back are shared.

Right now the magic number is 20 per cent. If a third-party is taking more than 20 per cent of the economics of the manager then LPs may start to feel uncomfortable. If the economics of the manager are split 50/50 between the team and the third-party investor a fundraising starts to become very hard.

If you interview a panel of investors about the construction of their portfolios, most of them will be hesitant to commit to captive firms because they have had lots of mixed experiences.

This is put down to the balance between the economics of the team to which investors are giving equity and the captive's owner, and the dynamic with the owner.

When third-party capital comes in similar concerns arise. Investors monitor the exposure when stakes in the management company are sold on multiple occasions when the assets under management rise.

### LP interests aside, are there any other dynamics managers should consider before taking on third-party capital?

What happens when the buyer of a stake in your firm wants to exit? In most scenarios the only exit is probably going to be an IPO, so a manager can unexpectedly land up becoming linked to a public company, even though that wasn't really the plan.

You can end up in that position very quickly, where the biggest owner of the GP is more than any of their senior partners individually.

Coming back to the LP side, a popular fund manager that has sold a few stakes in the management company will probably not have much push back if the performance is stunning. But if performance turns, something that wasn't an issue can become one.

It can be an excuse for LPs to excuse themselves from relationships. ●

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