Public Private Equity: Volatility vs. Franchise Value

This article is excerpted from a letter by MOI Global instructor Patrick Brennan, portfolio manager of Brennan Asset Management.

Throughout our past letters, we have discussed how public values and capital structures often look far different than those of private companies and noted how several of our current names would likely be the exact types of names (predictable businesses that generate substantial free cash flows) that have made private equity firms substantial money over the years. The private equity name is a bit of misnomer, considering that the largest firms are now public entities which are now referred to as alternative investment managers. These firms are often in the headlines on a daily basis, given their role in various merger transactions and their ubiquitous capital raising activity. The firms are also regularly lambasted for their extravagant pay to senior executives and are often whipping boys in any discussion about tax fairness. Despite their incredible growth in total assets under management (AUM), the stocks have generally been underperformers. As just one example, Blackstone's (BX) stock is essentially flat since its public offering in 2007 (they have paid out $16.49 in dividends over this time period), while its AUM has roughly quintupled.

Private equity firms generally pay themselves an underlying management and incentive fee equal to a percentage of total profits above a hurdle rate of return. While the timing of the latter is nearly impossible to predict (and very difficult for investors to model), the carry fees offer enormous payouts over a cycle. And despite the higher fee levels, the alternative managers generally show significant outperformance relative to their benchmarks. Furthermore, investor assets are often locked up for multi-year periods, sometimes as long as 10-20 years, depending on the fund.

Additionally, the alternative managers have successfully expanded their franchises into private credit, real estate, insurance among several other verticals and nearly all have posted strong growth. These characteristics contrast with traditional managers who normally charge only base management fees, offer daily liquidity, have posted mixed results versus benchmarks and have suffered meaningful AUM losses to index funds. As the alternative equity firms are generally structured as partnerships, the vast majority of the businesses' tax burden is pushed to the individual limited partners. So, which model sounds more attractive? Well, this is more difficult to ascertain if one simply looks at trading multiples, even considering the traditional managers' significant 2018 stock pullbacks.

	Market Cap ($B)	2018E P/E	2019E P/E	LTM Flows/ BoP AUM	2018E Dividend Yield
Franklin Resources	$18.0	10.4x	10.0x	-3.4%	12.1%
Invesco	$0.4	9.6x	9.3x	2.0%	4.4%
Janus Henderson	$6.3	11.8x	10.2x	-1.8%	4.8%
Legg Mason	$3.0	10.1x	10.3x	-3.0%	3.7%
Waddell & Reed	$1.6	9.8x	9.5x	-11.6%	5.2%
Apollo Group	$14.3	18.7x	9.3x	16.1%	5.8%
Blackstone	$42.1	11.2x	10.6x	8.2%	6.4%
Carlyle Group	$8.1	9.9x	7.2x	5.0%	4.2%
KKR	$22.9	15.4x	12.5x	7.9%	2.2%
Oaktree	$6.5	12.0x	9.8x	-7.2%	6.9%

Source: Morgan Stanley Research

There are various explanations for the above contradiction. Some argue that the golden era for private equity cannot continue and returns are likely to compress, especially since such large amounts of committed but uninvested funds (dry powder) must be invested at high prices. Others argue that returns are merely a function of leverage and sector selection, and there is little to no alpha after these adjustments.[3] There is the possibility of tax law change on the carried interest and the certainty of interest deduction limitations. Additionally, a big market pullback will delay performance fees and could meaningfully lower earnings. Finally, these names are complex, have volatile earnings/stock prices and have K1 structures that make them difficult for many institutions to own. While all factors partially explain the valuation differentials, we suspect the last might be the dominant factor.

We have watched these names from a distance for years but passed for various reasons (including in 2010…particularly brilliant on our part), partially because of the worry about a change in the taxation of carried interest (still a concern) and the "cycle" timing. These names will sell off during market turmoil and therefore a better time to purchase would certainly be during a market dislocation. But, as we continued to do work over the past year, we spent more time thinking about the difficulty of trying to recreate these models. It might take 20+ years to create the track record and institutional goodwill that these names have attained. Should the firms technically compare their leveraged returns to leveraged S&P 500 returns? Sure, but how many investors could handle the volatility associated with that strategy? How many institutions have access to the deal flow, contact bases and data from all the various deals closed (and passed on) over time?

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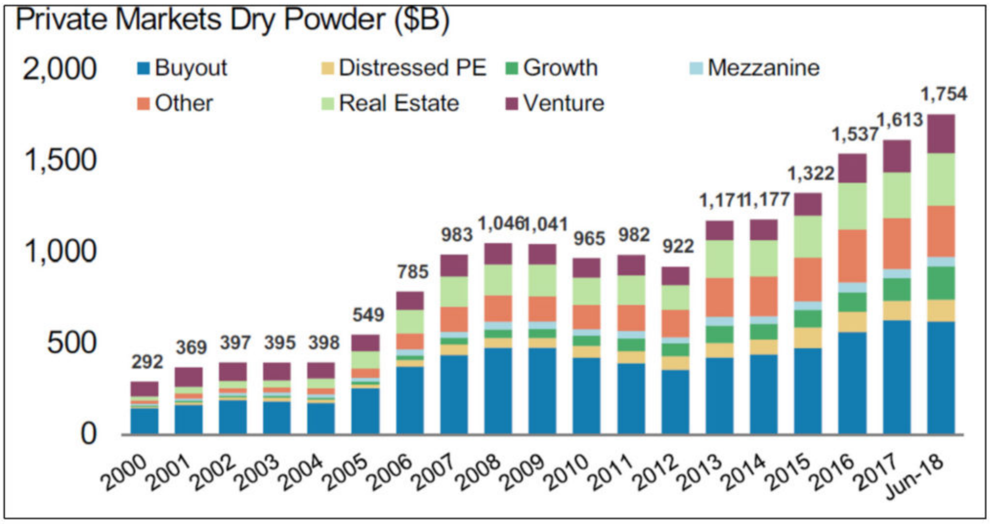
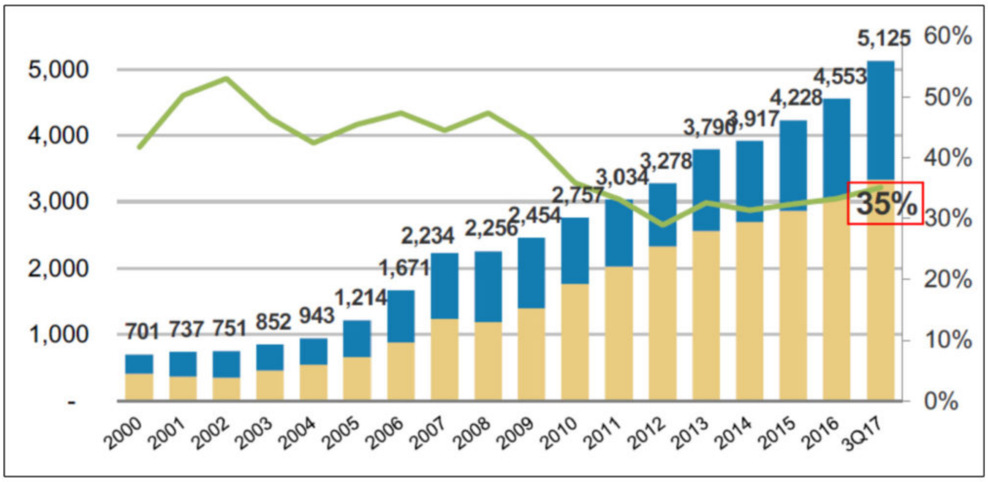
Blackstone Historical Returns		
	Net Total IRR	Current Committed Capital ($B)
Private Equity IRR (1993)[4]	15.0%	$79.0
Real Estate (1994)	16.0%	$95.6
Total Credit (2007)	14.0%	$33.6

It is true that any market pullback will delay performance fees. But, with the private equity industry sitting on nearly $1.7 trillion in dry powder, these names would be well positioned to benefit from market declines. And while these nearly incomprehensible levels of funds might appear impossible to rationally invest, it should be noted that private markets are far larger than in past years with the total percentage of dry powder as a percentage of unrealized fair value actually below its longer-term average.



Source: Prequin, Morgan Stanley Research



Source: Prequin, Morgan Stanley Research

As noted, the industry's fund-raising capabilities are immense. We can attest to the difficulty of raising small amounts of money. How likely would it be for a new firm to start at zero and eventually raise over $100 billion? On the most simplistic basis, it is worth asking: "What will be the alternative industry's organic AUM levels over the next 1, 3, and 5 years?" We suspect the answer is "higher to significantly higher." At a 2014 investor day, BX estimated fee growth of 12% annually, a 60% discount to historical levels. It is worth noting that some of the frequently discussed structural changes could conceivably help the largest alternative managers. Often the largest, most recognizable alternative managers take market share within the alternative space as institutions consolidate relationships. It is costly to closely track multiple managers and therefore the largest names often benefit when institutions reduce the number of mangers and/or benefit or suffer little damage when institutions reduce alternative allocations.

Blackstone Historical AUM and Distributable Earnings

	2013	2014	2015	2016	2017
Total AUM ($B)	$266	$290	$336	$367	$434
Fee Earning AUM ($B)	$198	$217	$246	$277	$335
Distributable Earnings	$1,859	$3,055	$3,835	$2,122	$3,876

The alternative asset managers typically are valued on the basis of fee-related earnings, current carried interest and existing balance sheet assets. While one can argue that other firms screen cheaper on these metrics or have more room to grow total AUM (unclear they will actually do so), we believe that BX has the most diverse revenue stream and the strongest fund-raising franchise and therefore initiated a smaller position. Again, it is better to purchase these names during periods of market turmoil and therefore we've left substantial room to scale into the positions over time. Other alternative managers, with KKR the most recent, have announced plans to convert into a publicly traded company, willingly choosing to pay taxes in hopes that investors ascribe a higher multiple for the structure simplicity. BX pays less in taxes and such a decision would therefore be even more costly from a tax perspective. While a conversion would undoubtedly move shares higher shorter- term, we hope BX decides against such a move and instead opts to repurchase additional shares. We've heard that complex, tax-avoiding firms can actually do fairly well over time.

[3] *Financial Analyst Journal* Volume 72, July/August 2016: *A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market*, Jean-François L'Her, CFA, Rossitsa Stoyanova, Kathryn Shaw, William Scott, CFA, and Charissa Lai, CFA.
[4] We show the year of each strategy's first fund.