PitchBook

New Horizons for PE

A comparison of corporate structures for publicly traded PE firms

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Contents

Key Takeaways	1
Introduction	2
Not All Firms Are Created Equal	3
Value in the Eye of the Shareholder	4
Even Corporate PE Firms Have Partners	5
Second-Mover Advantage?	6

Key Takeaways

- Spurred by new US tax laws, Ares has become the first public PE firm to convert from a partnership to a C-Corp, potentially opening the door for other firms to make similar moves.

- By switching to a C-Corp, the shares of PE firms could become eligible for indices and gain exposure to new investors by being included in retail products, potentially leading to higher valuations. Other firms will be closely watching developments with Ares' stock to see how investors respond to the switch.

- However, changing to a corporate structure means that performance-related income will be taxed at the corporate rate before being distributed to shareholders. As such, firms that make the switch are likely to resemble Ares, with a relatively higher proportion of management fees compared to performance fees.

Introduction

Newly enacted US tax legislation has seemingly provided a long-awaited catalyst for the first major publicly traded alternative asset manager to transition from a partnership to a C-Corp. The prospect of publicly traded PE firms converting from partnerships to corporate structures has been discussed for some time, with the tactic viewed as a solution to the common belief that PE firms' shares are perpetually undervalued.

Firms have been locked in a proverbial game of chicken, however, with no one daring to act first. The quotable Leon Black, CEO of Apollo, has gone as far as to describe the current situation as "classic game theory." The topic began to pick up steam throughout 2017, though. One sign that the tide was turning came when the activist hedge fund ValueAct took a stake in KKR. While not explicitly advocating for KKR to adopt a C-Corp structure, ValueAct did present the idea as an option to boost KKR's share price.

In February, Ares became the first firm to blink and officially announce its conversion to a C-corp. On its recent earnings call, Ares COO and CFO Michael McFerran succinctly summed up the rationale for the switch: "We believe [this] will simplify our structure, broaden our potential investor base, improve our liquidity and trading volume, and provide a more attractive currency for strategic acquisitions."

Now that Ares has played its hand, the question is, Who will be next to follow suit?

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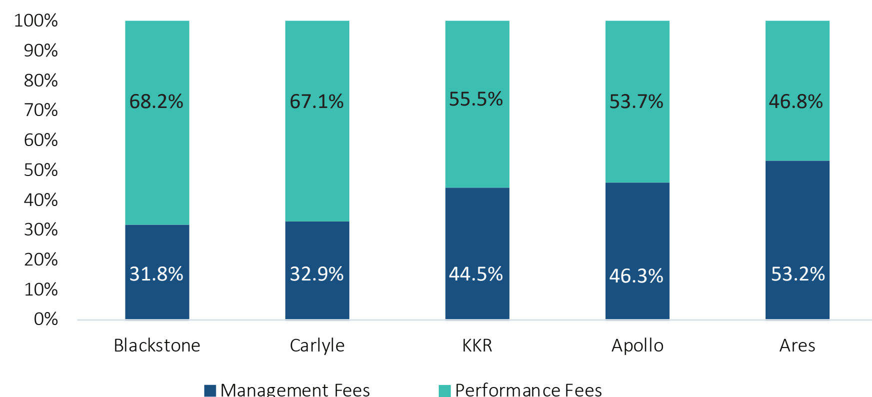
Not All Firms Are Created Equal

Several variables need to be considered prior to converting, as some firms are better suited for the corporate structure. When organized as partnerships (as is the case with most public PE firms), companies can funnel performance-related income (e.g., carried interest) directly to shareholders, where it is taxed as capital gains. Under the corporate structure, however, that performance income first will be taxed at the corporate rate. As such, how the firm generates revenue is perhaps the most important consideration.

The business mix of Ares, for example, lends itself particularly well to the C-Corp model. Ares' relatively low proportion of income from performance fees is one reason why it was the first to make the switch. According to the firm, management fee revenue has averaged 80% of total fee income since it went public. In Ares' case, the heavy skew toward management fees comes almost entirely from the firm's credit business, which is relatively large in relation to other firms , with the firm delivering fee-related earnings that were roughly 8x performance-related earnings. As part of the move, Ares is aligning its equity shares more with its core business and will "begin paying a steady, quarterly dividend for each calendar year based on the growth in our after-tax core fee related earnings," McFerran said, adding that "this dividend policy should reduce the historical volatility of our distributions." While Ares is reserving the right to declare special dividends, the firm "intends to retain performance fee earnings to fund future growth and for potential share repurchases." This means that investors will receive a lower dividend than they could potentially, but that capital will be reinvested without incurring the individual tax rate, mitigating some of the downside of the new structure.

Fee breakdown (FY 2017)



Source: PitchBook, company filings

Perhaps the biggest motivating factor for switching from a partnership to a corporation is that it could lead to higher valuations

Reducing the volatility of distributions makes sense for Ares, but what about firms that have revenue more skewed toward traditional closed-end funds? In these instances, the firm's performance relies more heavily on performance fees, which translates to more volatility in returns and makes a steady dividend more difficult to achieve. Carlyle provides a good case in point: While the firm generates significantly less revenue than most of its peers, it historically earns roughly 10 percentage points more of its income via performance fees. As such, switching to a C-Corp structure would be particularly costly when returning capital to shareholders. Because of this reality, we think converting to a corporate structure is likely untenable for firms like Carlyle and Blackstone, which rely heavily on performance fees.

Value in the Eye of the Shareholder

But dividends are only one component to consider. Alleged mis-valuation of its shares has been a persistent gripe amongst public PE firms, with one explanation being that the partnership structure makes PE firms ineligible for many institutional investors and investment products. So perhaps the biggest motivating factor for switching from a partnership to a corporation is that it could lead to higher valuations by opening the door to previously untapped investor bases, particularly in the realm of passive investments.

The methodology of many index creators explicitly excludes partnerships, meaning that shares of public PE firms often don't find their way into index-based retail products. By simply changing their structure, PE firms could facilitate the inclusion of their shares into products like ETFs and defined contribution plan offerings, as well as other passive instruments increasingly used by even the most sophisticated investors.

However, simply changing the corporate structure may not be enough to attract new investors. To that end, another investor relations issue for PE firms is the outsized control of many founders and insiders; Blackstone's common shares, for example, have no voting rights. Unless PE firms are willing to cede some of this power, they could continue to be excluded from certain designations (like some tech companies with dual-class shares).

When discussing the decision-making process behind its potential change, KKR has claimed that its "institutional ownership is lower than most traditional corporations," with the implication being that this is weighing on the share price. Even when an institution is not explicitly restricted from investing in partnerships, many choose to avoid them due to the additional tax and legal costs associated with preparing Schedule K-1s (the unique tax docs used by partnerships).

To be sure, for firms that do make the switch, the decision will be predicated on the belief that it will be accretive for shareholders. KKR CFO Williams J. Janetschek estimated that the firm's after-tax ENI in 2017 would have been 17% lower if it were restructured as a corporation, with other firms reporting similar analyses. As for the implications on share prices, KKR would need "to see approximately two turns of multiple expansion, all else being equal, for a breakeven stock price." Some think that may be doable—a recent report by Morgan Stanley asserted that converting to a C-Corp could propel share prices as much as 26% higher.

But other analysts assert that a portion of the upside of the corporate structure may already be baked into the share prices of some public PE firms. Prior to its formal announcement, Ares was long-rumored to be the lead contender to make the switch. And while the stock saw a pop of 8% following the news, the gains were smaller than previously predicted and shares traded down in subsequent days. Rival firms undoubtedly will be looking at price movements over the next several quarters to judge the efficacy of the move.

Even Corporate PE Firms Have Partners

We think that public PE firms run the risk of shifting their focus from their core business toward managing their public company personas

Analysts covering public PE firms naturally default to the shareholders' point of view, but these firms have fiduciary duties to a host of other investors too. To that end, one constituency that is overlooked in this debate is limited partners (LPs)—the investors who commit capital to private market funds and without whom this industry would cease to exist. The most straightforward concern is that all of this is a distraction. With seemingly every public PE firm being explicit about the time and resources being poured into analyzing the decision to convert to a C-Corp, we think that public PE firms run the risk of shifting their focus from their core business (i.e., managing investment funds) toward managing their public company personas.

Alignment of interests is also a potential issue. Before committing to a PE fund, LPs want to ensure the GPs have "skin in the game" and generate the bulk of their remuneration through performance fees. All else being equal, the fact that a firm relies more heavily on performance fees is a positive from the LP perspective, indicating a tight alignment of interests with the GP; however, this mix of income is a headwind for firms that might adopt a corporate structure. Particularly with the recent consolidation happening in the industry, LPs have been leery of so-called "asset gatherers," which are GPs that may unduly expand their strategy offering to bolster management fees.

Second-Mover advantage?

Are PE firms prioritizing stock price and management fees over performance-related income and the taxability of earnings?

In this context, should LPs be skeptical of PE firms that shift to a corporate structure? Are PE firms prioritizing stock price and management fees over performance-related income and the taxability of earnings? Seth Bernstein, CEO and president of Alliance-Bernstein, has shot down the C-Corp structure for that very reason: "I'd rather have our unitholders paying the lowest level of taxes at the greatest defensible position that we can." But the C-Corp structure is not one-size-fits-all, and no one yet understands the full long-term effects the change will have. Recent changes to the US tax code—namely the slashing of the corporate rate from 35% to 21%—have lessened some of this impact. Still, the consequences of shedding the partnership structure will be real.

Ares will certainly provide a helpful data point for others considering the move. KKR is widely assumed to be the next to make the leap, with Credit Suisse positing the move as a foregone conclusion in a recent research piece. Apollo is another likely candidate given its reliance on management fees. But with the decision to convert to a C-Corp being irreversible, as the tax costs and structural complexity are prohibitive, we expect to see most firms adopt a wait-and-see approach to see how the first mover fairs.

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