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Unpacking PE Firm Valuations: Part I

A review of various challenges investors have valuing public PE firms

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Key takeaways

- **The five largest publicly traded PE firms have switched their corporate structures from partnerships to C-Corps, which has led to shareholders substantially boosting the value of their shares.** This turn of events has altered the arithmetic for large GPs seeking capital, some of which may now choose an IPO rather than a GP stakes investment.

- **Valuations for smaller GPs, however, still vary between public and private markets.** Smaller GPs trade at a premium and would need to see a further rise in public valuations before foregoing GP stakes capital for an IPO.

- **PE firms are still poorly understood by public investors due to differences in AUM, revenue and return strategy, which make comparisons difficult.** Fund-level economics and profitability metrics for these companies are also difficult to understand. We believe some public PE firms are doing a good job of improving visibility, but there is room to go.

Introduction

Public PE firms—namely the big five: Blackstone (NYSE: BX), KKR (NYSE: KKR), Apollo (NYSE: APO), The Carlyle Group (NASDAQ: CG) and Ares (NYSE: ARES)—have long been some of the most poorly understood companies trading on the US public exchanges. Many of them have meaningfully expanded outside of their core offerings, with operations spanning several strategies and geographies. The complexity of their offerings, which has led to a more diverse and robust revenue stream, is difficult for investors to value. Additionally, most public market practitioners undervalue carried interest ("carry") because they doubt the long-term resilience of PE returns and struggle to accurately account for carry's variable timing.

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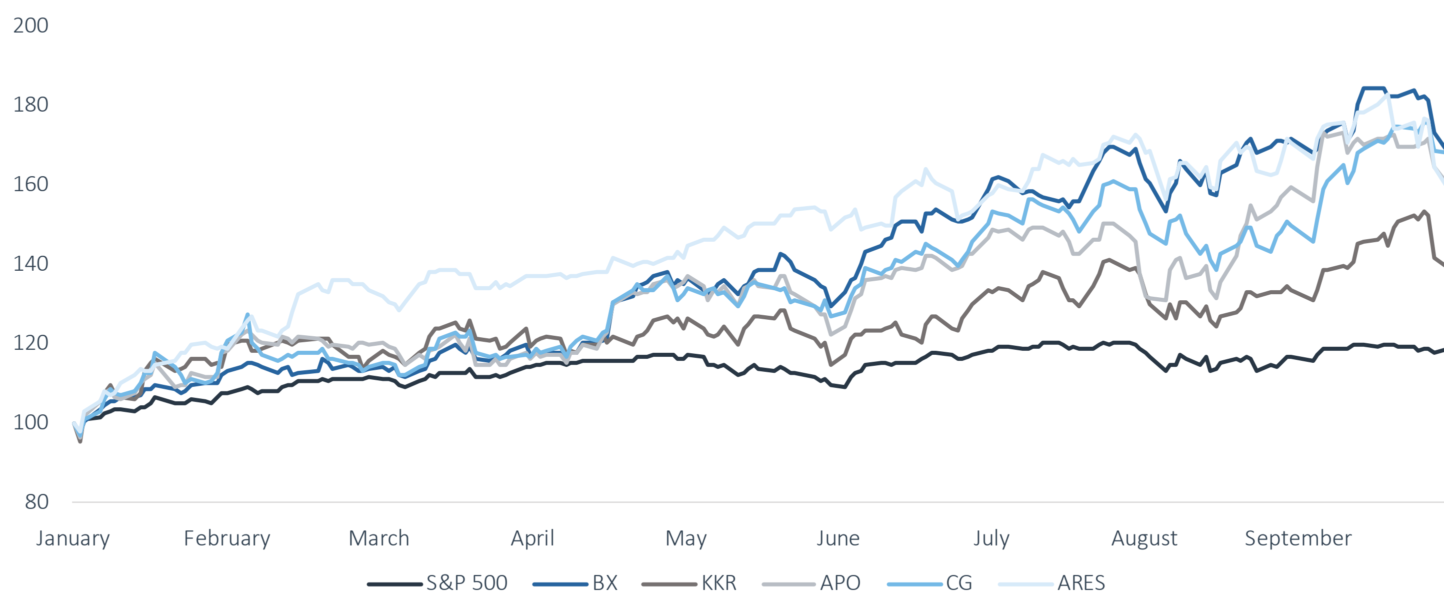
In order to earn higher valuations, executives at public PE firms have switched their corporate structures from publicly traded partnerships to C-Corps, and some have even expanded voting rights to shareholders. Public investors have reacted favorably and have since bid public PE firms' shares up. Apollo's co-founder Joshua Harris recently noted the progress in how public investors have been valuing public PE firms' shares.[1] Through 3Q 2019, valuations for four of the five public GPs selected for this analysis have risen 60% or more compared to the S&P 500's 20% rise; the laggard, KKR, is still up nearly 40% YTD. However, we believe valuation gaps will continue until the dual-class share structures are abandoned, allowing these firms to be added to S&P and Russell indices, and until the firms lift the portion of revenue coming from management fees.

YTD stock performance of select GPs and S&P 500 rebased to 100 in January 2019



Source: PitchBook | **Geography:** Global
*As of September 30, 2019

Other PE firms are taking note of their public counterparts' rising valuations. EQT, one of the largest European PE firms, recently completed its IPO. This was the first major PE firm to raise capital from public equity markets in over six years. Months earlier, it appeared EQT would go the GP stakes route to seek capital. After the successful jumps in stock price that the five large public

1: "Apollo's Josh Harris Talks Private Markets at Delivering Alpha," Institutional Investors, Christine Idzelis, September 19, 2019

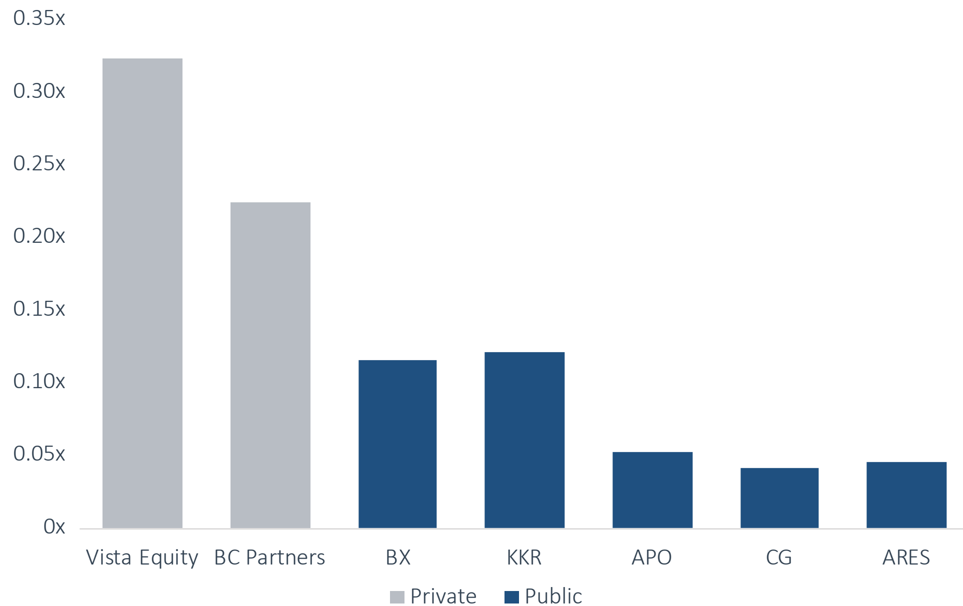
GPs experienced following their C-Corp conversions, however, EQT instead decided to list publicly. Not only have the jumps in valuation changed the calculus for major PE firms seeking liquidity or expansion capital, it could challenge the GP stakes market at a time when a select few managers are raising record sums of capital for the strategy. The valuation gap between public and private GPs has closed substantially as public firms have rallied through 2019, and we may see more large firms follow EQT's lead, but this valuation gap persists. In this note, we will lay out some of the reasons we believe this to be true as well as offer some frameworks on how to think about factors driving the underlying businesses.

Public versus private

In an August 2019 deal, a GP stakes investment valued BC Partners, which has approximately $25 billion in AUM, up to $5.6 billion. Blackstone, the priciest of the public GPs, is valued around $60 billion, or just over one tenth of its approximately $550 billion in AUM.[2] Although BC Partners likely offers more growth opportunity than Blackstone and has a higher proportion of its AUM in higher-fee, commingled vehicles, it achieved approximately twice the valuation multiple. The firm's valuation is not an anomaly, though. Vista Equity Partners, which received a minority investment from Dyal, achieved a $4.3 billion valuation in July 2015 despite having raised just $13.3 billion at that point. We cannot back into the revenues or profits of the private GPs; however, the ratio of market cap or valuation to total AUM shows how substantially valuations can vary. BC Partners saw approximately 22 cents in value per dollar of AUM compared to Blackstone at 12 cents, though both paled in comparison to Vista, which saw over 32 cents.

2: Blackstone notes that AUM includes certain co-investments managed by them as well as separately managed accounts. These accounts will have lower fees and be priced lower than traditional PE AUM. These assets account for a non-inconsequential portion of AUM, though the comparison still stands that private GPs are valued higher than public ones.

Ratio of market cap to AUM for select GPs



Source: Public filings & PitchBook | **Geography:** Global
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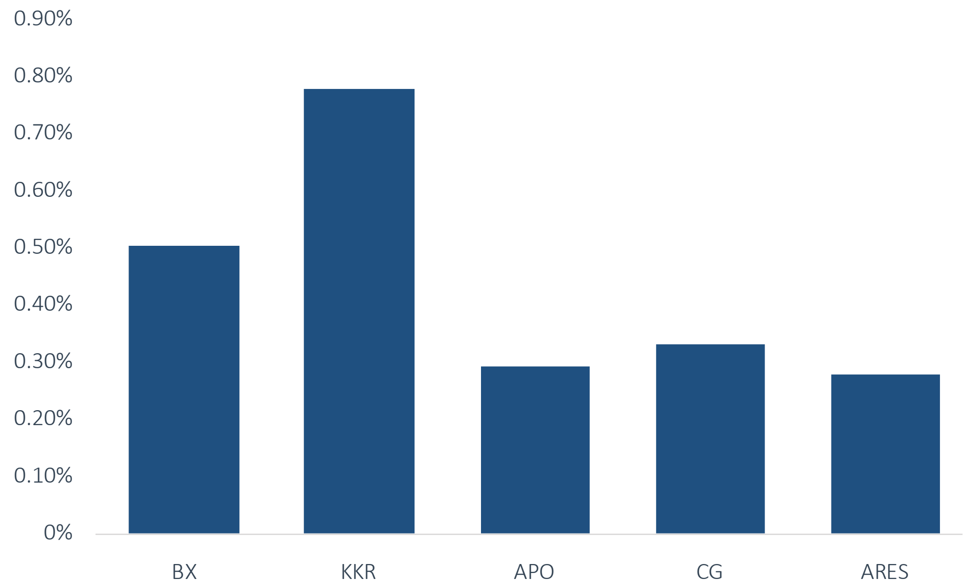
It is not as simple as comparing AUM to valuations, however, because real estate and PE tend to earn higher fees per dollar of AUM than credit and separately managed accounts. Using the proportion of distributable earnings to AUM as a proxy for AUM profitability, we see that Blackstone and KKR are the most profitable per dollar of AUM at well over twice the rates seen at Apollo, Carlyle and Ares.[3]

Valuations still showcase the difference in public and private markets, though. We believe PE firms will continue to eschew publicly listing until they can not only achieve the valuations seen in private markets but trade at a premium to compensate for the stresses posed by reporting and additional transparency into a GP's finances. However, as EQT has illustrated, there are other benefits that may entice some of the largest PE firms to pursue IPOs rather than GP stakes investments.

3: We believe Blackstone's DE was well below normal rates over the past 12 months and has a similar rate of DE/AUM as KKR.



Source: Public filings | **Geography:** Global
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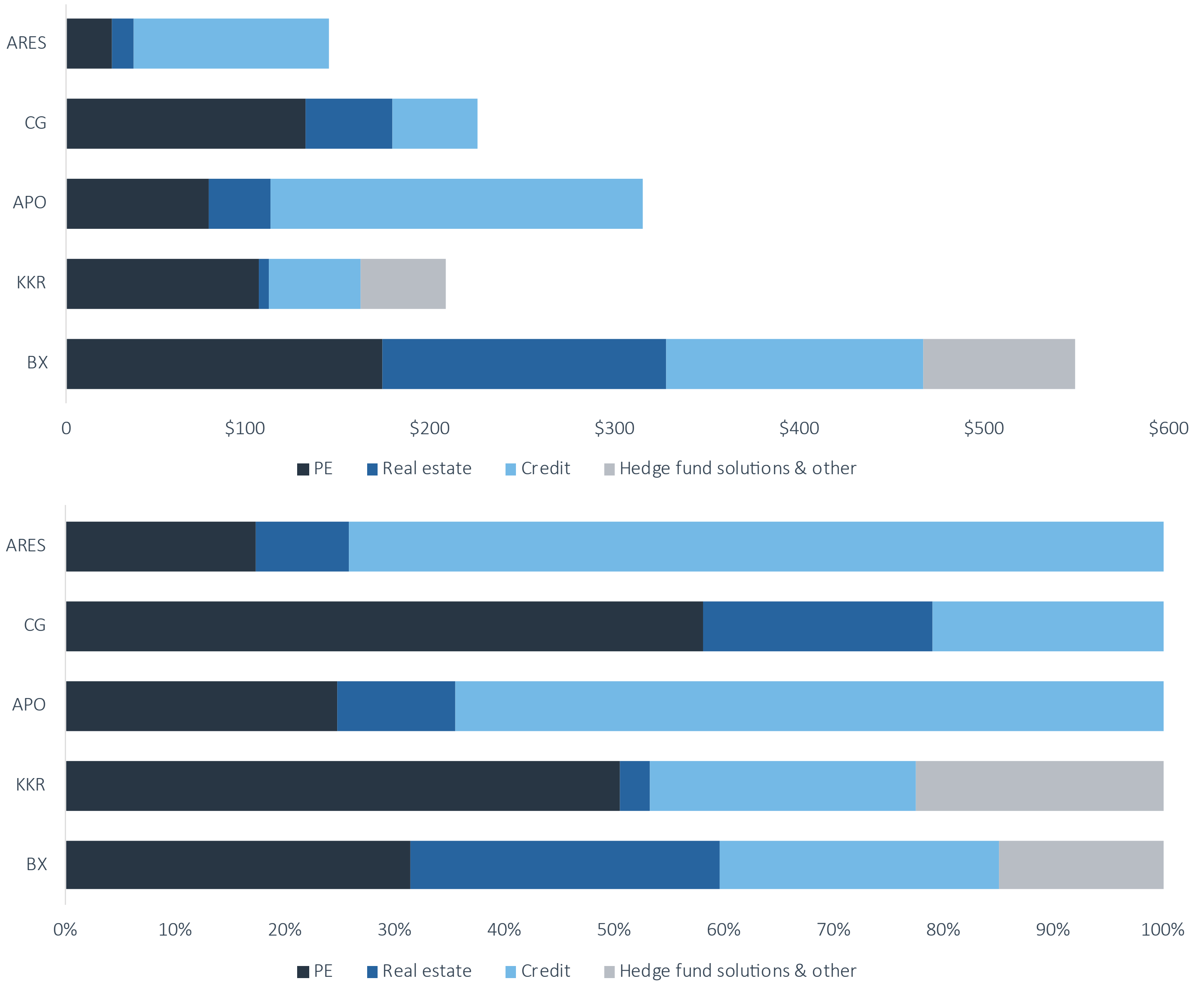
AUM and revenue breakdowns

As mentioned, public GPs can be so difficult to value because of their varied business models. Having a firm grasp of Apollo's business does not necessarily mean an investor knows how to value KKR. Each GP has unique drivers of revenue and profit growth, stemming from their individual asset bases. Credit earns a higher proportion of its capital from management fees while PE tends to be more carry heavy, and real estate sits somewhere in between the two.

Looking at the individual GPs, Blackstone is the most diverse in terms of revenue generation and is the only GP without a single strategy accounting for the bulk of its AUM. The firm also has several separate accounts as well as a hedge fund-of-funds business. Meanwhile, Apollo and Ares are credit-focused managers and should record higher proportions of management fees, which tend to be more stable than carry. On the other end of the spectrum, Carlyle and KKR have most assets in PE, which will produce swaths of carry, but the returns will be volatile. Valuing each public GP means understanding some of the underlying economics of PE, credit and real estate funds and investments.

AUM ($B) by strategy for select GPs



Source: Public filings | **Geography:** Global
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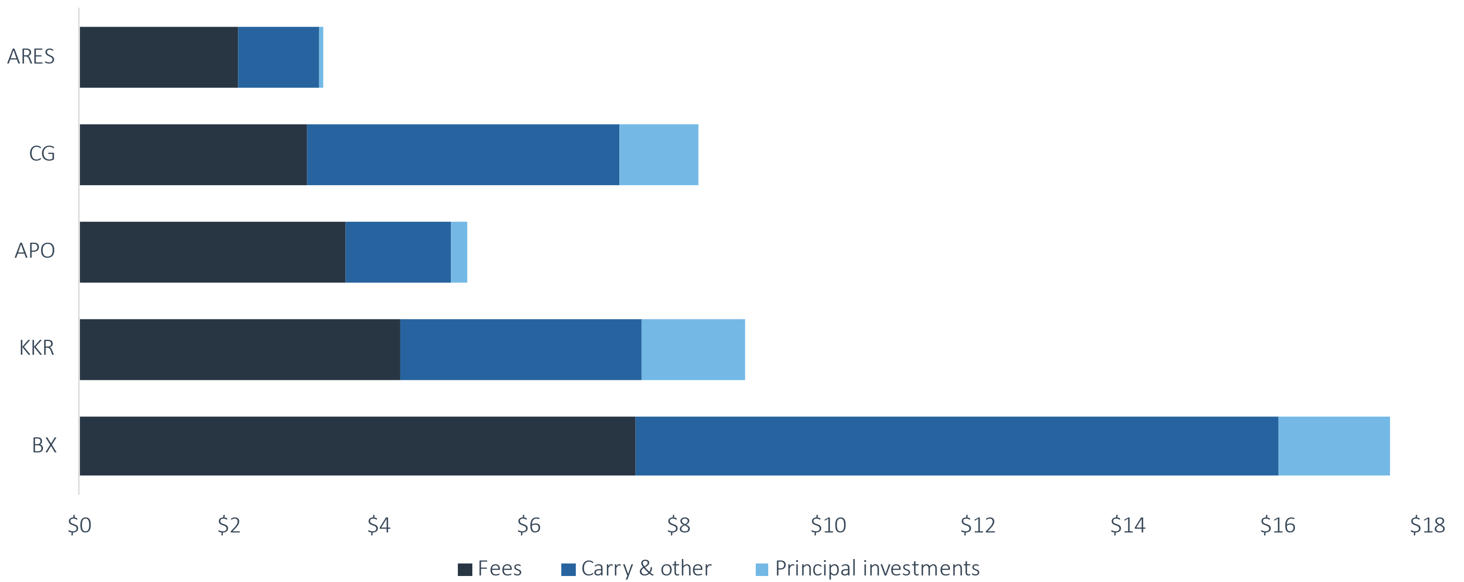
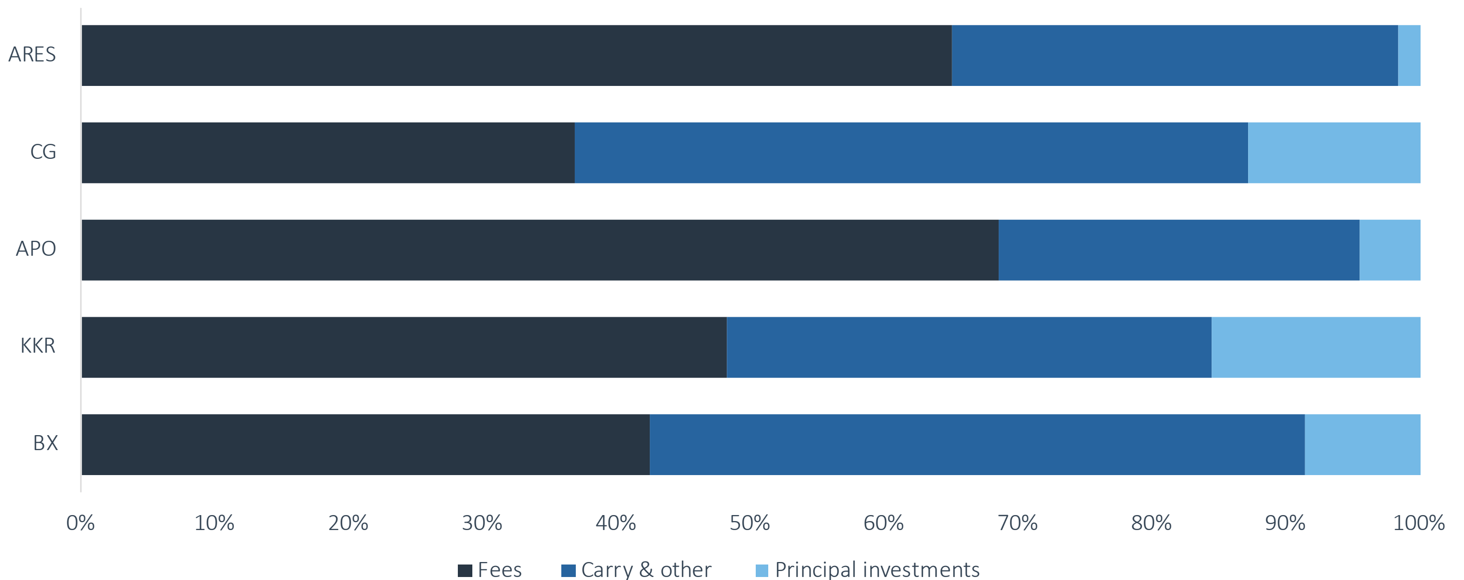
We see this play out in results over the past 10 quarters.[4] From 1Q 2017 through 2Q 2019, the makeup of fee and investment income differ dramatically between the five public GPs. Apollo and Ares receive their highest proportion of revenue from management fees, while Blackstone, KKR and Carlyle receive theirs from carry. Since carry is so volatile year to year, these specific GPs could be undervalued compared to peers. To counter this, we expect to see most managers attempt to tilt the balance in favor of fees to make earnings more predictable and achieve higher valuations over time.

4: Because carry is so volatile, we decided to include the past 10 quarters to give a better glimpse at the average revenue breakdown.

For KKR, its capital markets business is included with its fees but is growing quickly and deserves some special attention. Through 2018, it generated just over one-third of KKR's fee revenue. The in-house investment bank now serves companies beyond just KKR's portfolio companies. In a testament to how much clout the business has built up on Wall Street, the firm was selected to help underwrite its first IPO for a company it did not own. KKR was slated to help take Silver Lake-backed Endeavor Group Holdings public alongside Goldman Sachs before the listing was shelved. Similarly, Blackstone has an advisory business. These businesses have significantly different models than private market funds, adding more complexity to any valuation efforts.

Cumulative revenue ($B) by source for select GPs (1Q 2017-2Q 2019)





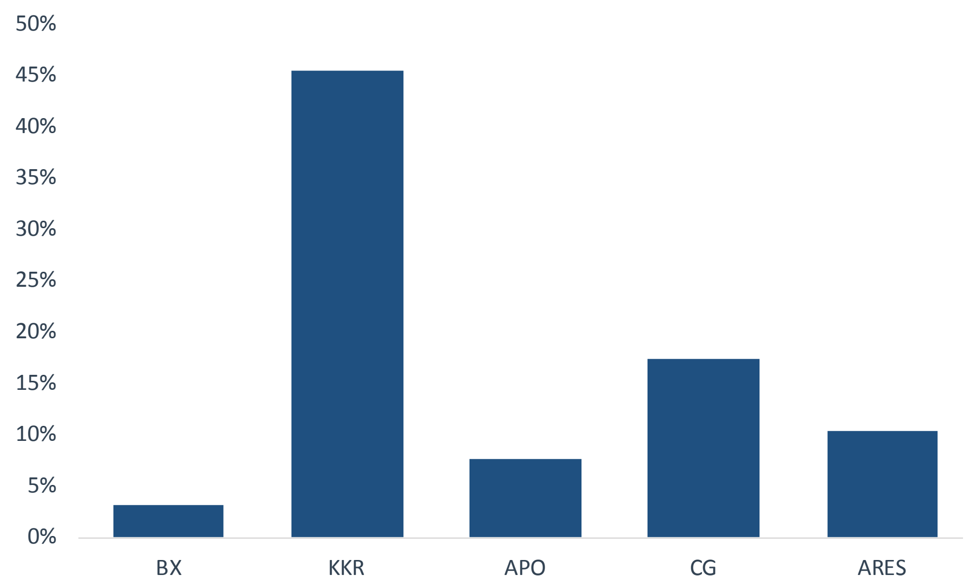
Source: Public filings | **Geography:** Global
*As of September 30, 2019

Idiosyncratic offerings

Beyond the differences in AUM composition and revenue streams, the five large GPs have undertaken unique strategies to produce returns for shareholders. The most idiosyncratic of these offerings belongs to KKR. The firm not only has a substantial capital markets business, but it also invests heavily off its own balance sheet. Investments include seeding new strategies and large commitments to in-house funds. Over 45% of the current share price is accounted for in balance sheet investments. The strategy bears some semblance to Paris-based Eurazeo (PAR: RF) and its hefty balance sheet investing. As a result of its strategy, KKR has a lower dividend yield than its peers, but a unique return profile more closely tied to the underlying private capital funds.

The firm's strategy is completely unique among US-based firms and could be a model for PE firms trying to raise their proportion of revenue that comes from management fees while keeping LP and GP interests aligned. LPs want to see carry generate a significant share of the GP's income, which means both parties profit if the fund performs well. GPs, however, want to derive more revenue from management fees, which are steadier and valued higher by investors. KKR's strategy of investing outsized amounts of its own capital in seeding new initiatives as well as investing alongside LPs in its funds could allow the firm to charge high management fees and keep interests aligned through high fund ownership holdings. The strategy also allows KKR to profit even more from well-performing funds beyond collecting carry, though it represents more risk.

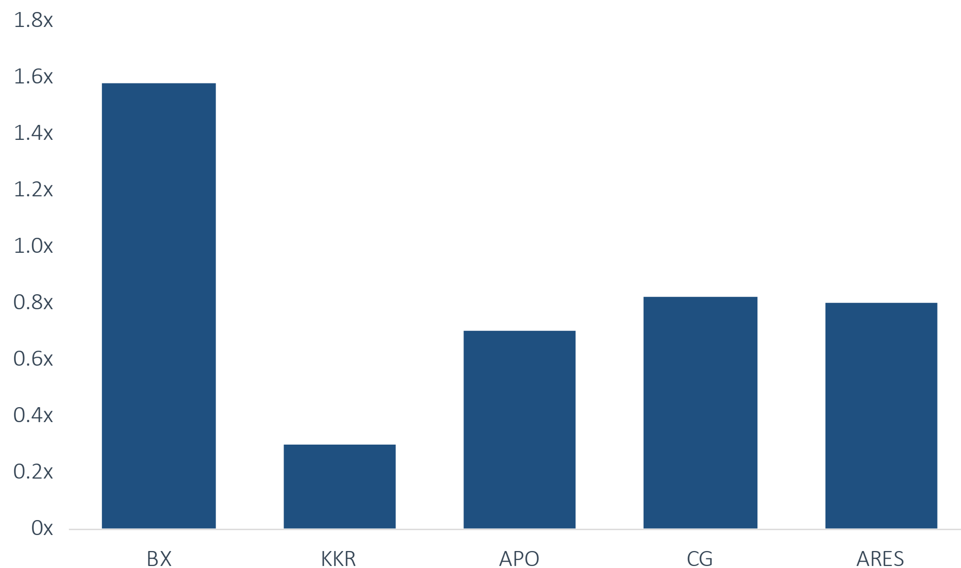
Balance sheet investments as proportion of market cap for select GPs



Source: Public filings | **Geography:** Global
*As of September 30, 2019

The other firms, however, have chosen to go a more traditional route and return capital, focusing on dividends and share repurchases. In addition to simply converting to C-Corps, many GPs are trying to pay dividends more regularly. After Ares announced its plan to convert to a C-Corp, COO and CFO Michael McFerran said, “In concurrence with this change, Ares will begin paying a steady, quarterly dividend for each calendar year based on the growth in our after-tax core fee-related earnings. This dividend policy should reduce the historical volatility of our distributions and allow us to retain a greater portion of our earnings for growth and potential share repurchases.”[5] We can see this in action as all the managers except for KKR pay out 70%-85% of distributable earnings on a regular basis. These GPs are clearly paying out capital more regularly to shareholders while KKR is reinvesting those earnings, in effect betting on itself.

Ratio of capital returned (dividends and buybacks) to distributable earnings (TTM) for select GPs[6]



Source: Public filings | **Geography:** Global
*As of September 30, 2019

5: “Ares Management, L.P. Reports Fourth Quarter and Full Year 2017 Results,” Ares, n.d.
6: Blackstone had an anomaly year in which DE dropped from last year. We expect their payout to be in line with Apollo, Carlyle, and Ares going forward.

Looking forward

Not only do AUM and revenue drivers vary widely between the big five public PE firms, but return strategies do as well. Public investors also heavily discount carry, due to its sporadic timing, and most believe AUM figures and revenues will fall with fund performance at some point. In follow-on notes, we will examine the economics of private capital funds to better understand how profitable they are depending on factors such as gross return, discount rate and management fees. Additionally, we will seek to value the firms based on AUM by strategy. Finally, we will compare our AUM valuation framework to a DCF valuation, as well as their current public stock prices. With this, we are seeking to determine how the market views each GP and hopefully help practitioners to better understand these firms.