Publicly-Traded Private Equity Firms

February 2014

With tax season fast approaching, K-1-generating securities come up frequently in client discussions. It is timely, then, to review why we hold publicly-traded private equity companies, a number of which are structured as LPs, in some of the portfolios. You might find some of the reasons surprising.

In the world of asset allocation, there are three varieties of publicly-traded private equity firms. The first are those that manage private equity funds and collect management and performance fees. The second class consists of firms that simply invest their own capital in private companies. The third class is comprised of firms that make debt and equity investments in private equity deals.

Examples of the first class of publicly-traded private equity firms include Kohlberg Kravis Roberts & Co. L.P. (KKR), The Blackstone Group L.P. (BX), and Oaktree Capital Group, LLC (OAK). Examples of the second class are Wendel SA (MF FP), Exor SpA (EXO IM) and, to some extent, Reinet Investments SCA (REI SJ). Examples of the third class are American Capital, Ltd. (ACAS), Main Street Capital, Gladstone Capital Corp. (MAIN), and Prospect Capital Corp. (PSEC).

The shareholders of companies in the first group (KKR, Blackstone, et al.) will receive the return on the private equity company's participation in various private equity deals, plus that portion of management and incentive fees that is not paid to the employees, which is to say gross of fees. In contradistinction, an investor in the private equity deals themselves—i.e., the direct client of, say, KKR, who invests as a limited partner in one of the KKR private equity pools—receives the return on the very same investments net of a management and incentive fee. In no case do the investors in the pools of the private equity deals themselves share in the incentive and management fees on the deals.

The shareholders of the first group of firms (KKR, Blackstone, et al.) have daily liquidity, while the investors in the private equity partnerships have, at a minimum, 10-year lockups, side pocket provisions, extensions at the behest of the manager, and other restrictions. Also, a management fee is paid on any capital that is uncommitted. It seems unlikely that the shareholders of a publicly-traded private equity firm could possibly underperform the actual deals. For that to happen, the manager would have to charge negative fees to its clientele.

Collectively, eight publicly-traded private equity firms represent a great portion of the industry. They include KKR, Blackstone, Oaktree, Apollo Global Management LLC (APO), Brookfield Asset

Management Inc. (BAM), The Carlyle Group LP (CG), Fortress Investment Group LLC (FIG), and Onex Corp. (OCX CN). It seems there is no scenario in which the equity of publicly-traded private equity managers does not do better than the individual deals, or partnerships, except if one is fortunate enough to buy into an extraordinarily good partnership. However, there is no way to make the proper assessment in advance, since one must commit the capital before the deals are executed.

Another way of looking at this situation is to examine it from the point of view of the public equity manager who might contemplate purchasing shares of the private equity manager. The private equity manager, in many cases, will pay a control premium to take a public company private. Once it is private, the manager applies a large amount of leverage to it, values it only occasionally, calls it an asset class, and then asserts that the risk has been reduced. The publicly-traded orchestrator of that deal is deemed to be in the high-risk class, an assessment evidenced by the fact that many of the aforementioned private equity firms often trade at discounts to their liquidation value. The participant in the pool, locked up for a decade or more, is said to be in the low-risk class. This is an amazing way of looking at things.

Consider *Private Equity International Magazine*'s list of the top 15 private equity firms.

Top 15 Private Equity Firms
TPG Capital L. P.
Carlyle Group LP (CG)
The Blackstone Group L.P. (BX)
Kohlberg Kravis Roberts & Co. L. P. (KKR)
Warburg Pincus, LLC
The Goldman Sachs Group, Inc. (GS)
Advent International Corp. (13620Z)
Apollo Global Management LLC (APO)
Bain Capital
CVC Capital Partners
Riverstone Holdings Ltd. (RSTON SP)
General Atlantic LLC
JP Morgan Chase & Co. (JPM)
Oaktree Capital Group LLC (OAK)
Lone Star Funds

Source: Private Equity International Magazine

Some of these firms are publicly-traded—those for which private equity represents the bulk of their business and which are listed in the US include: Oaktree, KKR, Blackstone, Apollo, and Carlyle. If one buys the publicly-traded firms, one is aware of at least some of the characteristics of the deals one is purchasing. If one buys into one of their partnerships, one has no idea what deals one will be getting.

Essentially, their strategy is to buy publicly-traded companies, pay a premium to bring them private, add leverage, apply a formulaic valuation (which has the effect of producing relatively smooth quarterly changes in the valuation, as opposed to the ordinary experience of a public market price), and declare that the risk has been reduced. However, those very deals are, in truth, publicly-quoted each and every day because they comprise the publicly-traded vehicle. How can one ignore that difference? Yet, that reality is being ignored, which is truly extraordinary.