Scalability: A Predictive Attribute for Outperformance

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Continuing our series on predictive attributes for outperformance, this month we discuss scalability. Scalability refers to the potential for a company to increase its operations (and revenues) substantially, without incurring substantial marginal costs or requiring significant capital expenditures to support the revenue expansion.

In order to understand the appeal of scalable businesses from an investment perspective, let us compare the net income impact of an increase in revenues on low and high marginal cost businesses. An example of a low marginal cost business might be a financial services firm, while a manufacturing company is a high marginal cost business—the production of each additional car requires more of every type of input (raw materials, labor, power, transportation, etc.) whereas the cost of managing $100 million in assets might be scarcely greater, if at all, than the cost of managing $50 million.

Profit Impact of Revenue Increase on High and Low Marginal Cost Businesses

Assumptions:	
Revenues:	$1,000,000
Operating margin:	10%
Operating income:	100,000
Interest expense:	30,000
Taxes (35%):	24,500
Net income:	**$ 45,500**

Now, let's assume a 5% revenue increase. For the high marginal cost business, we apply the same 10% operating margin as in the first scenario, while for the low marginal cost business, we assume no increase in operating expenses.

High-marginal-cost business		Low-marginal-cost business	
Revenues:	$1,050,000	Revenues:	$1,050,000
Operating Income:	105,000	Operating Income:	150,000
Interest expense:	30,000	Interest Expense:	30,000
Taxes (35%):	26,250	Taxes (35%):	42,000
Net income:	$**48,750**	**Net income:**	**$78,000**
Profit increase:	**7.14%**	**Profit increase:**	**71.4%**

The above example illustrates the natural operating leverage in a low marginal cost business that also has certain fixed costs, such that a modest increase in revenues exclusive of an increase in operating costs has a multiplier impact upon earnings. When the operating costs are scaled with revenues, as in the high marginal cost example above, the resulting profit increase is a modest 7.14%. The dramatic 71% expansion in the net profit margin for the low marginal cost business results from the revenue increase flowing directly (or nearly directly) to operating income.

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Private equity companies are interesting examples of scalable businesses. One of the drivers of their scalability is comparable to that operating at traditional asset management companies: an increase in assets under management does not necessarily require an increase in fixed costs, but does result in increased management and incentive fees (and therefore expanded profit margins). Other reasons, as described below, include the substantial unallocated capital held by many of the private equity firms, as a result of which they have the potential to significantly increase their level of revenue-generating assets without even raising additional funds.

The private equity business is fairly new to the public markets. In June 2007, The Blackstone Group LP ("BX" or "Blackstone") came public, followed by KKR & Co. ("KKR") in July 2010, and Apollo Global Management, LLC ("APO" or "Apollo") in March 2011. Oaktree Capital Group, LLC ("OAK" or "Oaktree," which is not a pure-play private equity company, but which does operate in that space) listed in April of 2012[1].

Incomplete valuation metrics

One of the complications with evaluating private equity companies is that it's very difficult—and some would assert impossible—to know what their earnings actually are. The reason it's difficult to know their true earnings are that there are various ways of computing them.

The standard methodology, using Generally Accepted Accounting Principles ("GAAP"), does not provide a complete picture of these businesses. Private equity firms control private companies, in large part, through the funds of their clients. The private equity companies themselves have equity investments in those companies and therefore, in most instances, they're required under GAAP to consolidate the financial statements on an accounting basis, even though the private equity firm might not be legally or financially liable for the debt or losses of those investees. The companies in question are highly leveraged and, in many instances, are highly cyclical as well—of course the optimal time for a private equity company to invest in these companies is when they are in a down cycle, and therefore available at attractive valuations. The consolidation of these acquired companies creates an appearance of lower earnings, or even losses, in the private equity business, even when such losses exist only in abstraction.

To remedy this situation, many private equity companies report a non-GAAP accounting measure: economic net income (or simply economic income). Economic income, as defined by Blackstone in their latest annual report is "segment net income before taxes excluding transaction-related charges." This is similar to the adjusted EBITDA[2] evaluation metric commonly utilized by management and financial analysts to evaluate many high cash flow businesses. Despite the wide acceptance of adjusted EBITDA, the market has yet to fully

[1] Prior to its IPO, shares of Oaktree were traded in the 144A market, whereby unregistered securities may be traded among qualified institutional buyers.
[2] Earnings before interest, taxes, depreciation, and amortization.

embrace economic income as a valuation metric. The following table displays the difference between GAAP and economic net income for the private equity firms discussed above.

2012 Economic Net Income vs GAAP Income

Ticker	Company	Economic Net Income *($ in millions)*	GAAP Net Income *($ in millions)*
BX	Blackstone	$1,995.3	$218.6
KKR	KKR	2,130.9	560.8
APO	Apollo	1,634.4	171.5
OAK	Oaktree	971.7	107.8

Source: Company reports

According to GAAP, Blackstone earned $219 million, but economic net income, as tabulated by Blackstone, was $2.0 billion. That's a big difference. Similarly, according to GAAP, KKR earned $561 million in 2012. In accordance with the principles, such as they are, of economic net income, KKR made $2.1 billion. Oaktree reported economic net income of $972 million, compared to GAAP net income of $108 million.

In the case of Apollo, according to GAAP, the company earned $172 million in 2012, but according to economic net income, it earned $1.6 billion. Given that the company trades at a market capitalization of $8.2 billion (as of March 29, 2013), it is trading at an earnings multiple of either 47x or 5x. It is not clear which, if either, is an accurate reflection of profitability. However, it is clear that, should the earnings at the portfolio companies expand, so too will those recorded by Apollo, which may result in a narrowing gap between the values of the two metrics—which is to say that the positive earnings and valuation possibilities for these public private equity companies could be quite substantial.

Unallocated Assets

The next table shows the market capitalization and the assets under management ("AUM") of the companies in question.

	Market Cap* *($ in billions)*	AUM *($ in billions)*
Blackstone	$22.4	$210.0
KKR	13.7	75.5
Apollo Global Mgmt.	8.2	113.0
Oaktree Capital	7.7	77.1

**Market caps reflect fully diluted share counts.*
Source: Company reports and Bloomberg. Market cap data as of 3/29/2013.

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An important distinction about the private equity business, as opposed to standard asset management, is that having $210 billion of assets under management doesn't necessarily mean that the company has actually invested $210 billion, nor does it mean that it has a lot of money in cash; it just means that the clients are committed to provide that cash when the company calls for it, and it is entitled to charge a fee on the amount of committed capital. At year-end 2012, Blackstone had $35 billion of committed, undrawn capital. Oaktree, which participates in both traditional asset management and in private equity fund management, had $11.2 billion in uncalled capital commitments at year-end 2012.

In addition to the equity that they have raised, many private equity companies have issued debt under favorable terms. Hence, these companies have substantial "dry powder," or assets that are not yet producing returns. If they deploy their capital at attractive valuations, the companies have the potential to control a significant amount of assets—this is a component of the scalability of their businesses.

With that in mind, let's use Blackstone as an example. Let us presume that the $210 billion of AUM is committed capital. Let us further presume a robust IPO[3] market so that when the private companies in which Blackstone has invested come public, their market value rises by a weighted average of 20%. This would represent appreciation of $42 billion (20% of the $210 billion AUM). Depending on the high water marks/return hurdles and profit participation[4] for various entities related to a given fund, some portion of this appreciation will be distributed to Blackstone's shareholders. This distribution could be considerable—on the order of 40% of the realized 20% appreciation (or $16.8 billion), leaving $25.2 billion attributable to its shareholders. Ignoring the management fees but not the incentive fees, which in the interest of simplicity we will assume are approximately 25% of the gains attributable to the shareholders, Blackstone could realize an approximately $6.3 billion incentive fee on the $42 billion increase in the value of its invested AUM.

Therefore, with very little stretch of the imagination, it's possible to imagine Blackstone, a company with an approximately $22 billion market capitalization, earning $6.3 billion in incentive fees (ignoring any other fees). What if, instead of a 20% increase in the value of those investments, it was a 40% increase, which, though an intrepid assumption, is still readily conceivable? In fact, both Blackstone's GAAP and economic net income results were substantially higher in 2012 than in 2011, and the company earned $300 million in realized incentive fees in 2012, compared to $89 million in 2011.

[3] Initial Public Offering

[4] Blackstone has various agreements in place regarding the management fees, carried interest and incentive fees that are provided to employees and other related parties prior to distribution to shareholders. These fees are also subject to a high water mark and or minimum return hurdle.

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A further note on Oaktree: due to its participation in "traditional" asset management, the Oaktree business model is also scalable in a more straightforward way. As assets under management grow, so too do management fees realized by the firm, even though doubling assets under management in a fund from $5 billion to $10 billion does not result in a concomitant increase in expenses incurred by Oaktree.

In addition to the scalability of their business models, the companies discussed above are all owner-operators. Senior management at the companies includes renowned investors such as Henry Kravis (KKR), Leon Black (Apollo), and Howard Marks (Oaktree). These are individuals with records of success and deep networks that lend them an information advantage and often times favorable terms-of-trades: they are considered desirable partners, and therefore are likely to be approached first with investment opportunities. As an example, just recently, John Malone's Liberty Media Corporation announced plans to purchase a large stake in Charter Communications, Inc., a large, domestic U.S. cable company, from private equity funds managed by, or affiliated with, managers including Apollo and Oaktree.

As noted earlier, many of these companies have issued debt recently under favorable terms—as such, they are beneficiaries of the current, low interest rate environment. Instead of assuming credit risk by purchasing bonds issued by leveraged companies, why not purchase shares of the publicly-traded private equity companies orchestrating leveraged buyouts? Taking advantage of the current low interest rate environment to raise debt is the type of opportunistic action that is not uncommon at owner-operator companies. As an example, in February 2012 Apollo led a leveraged buyout of the oil and gas exploration and production units of El Paso Corporation, financed with 63% debt and 37% equity.

The patience to extend the investment time horizon in order to effectively monetize private equity investments is also typical of owner-operators. These publicly-traded private equity companies are equity yield curve investments: their portfolio companies have value that we believe is not yet reflected in the trading price of the private equity company, and there is little visibility as to when the assets will be monetized. At the same time, private equity fund managers are making equity yield curve investments of their own by allocating funds to companies which they believe have the potential to provide strong returns in the long term, but which may not have a clear liquidity event at the outset.

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