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Blackstone's C-Corp Conversion

Blackstone is making the leap; will other PE firms follow?

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Introduction

Blackstone (NYSE: BX) has decided to convert from a partnership to a C-Corporation, nearly a year after Ares (NYSE: ARES) and KKR (NYSE: KKR) made the switch. The declaration came when the company announced 1Q 2019 financial results, and Blackstone will officially begin trading as a C-Corp in July. As we discussed in a previous note, the switch from a partnership to a C-Corp structure became more attractive following the US tax reforms implemented in 2018.

The switch—which is more or less irreversible—is an attempt to cure the undervaluation purported by public PE firms, which have traditionally been organized as a partnership structure. The highly complex financials, exclusion from public indices and mutual funds, and hassle of filing K-1s has led to the common complaint that their shares are perpetually undervalued. Blackstone asserts they trade at a 30% discount to comparable market multiples. This conversion caps off a series of attempts by Blackstone to boost returns, including share buybacks and simplified financial statements (e.g. Blackstone now reports fee-related earnings and distributable income instead of the more ill-defined economic net income), which executives believe will lead to a "meaningfully higher valuation."

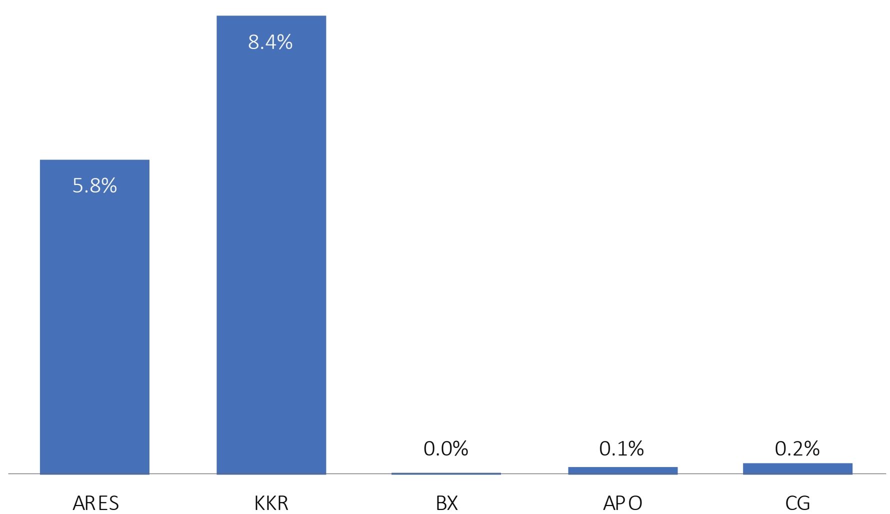
Published on April 23, 2019

Broader ownership

In a prepared remark, Blackstone chairman and co-founder, Steve Schwarzman, said, "we believe the decision to convert will make it significantly easier for both domestic and international investors to own our stock and should drive greater value for all of our shareholders over time." He later claimed on CNBC's "Squawk Box" that the conversion would "double the number of people able to own the stock."

One alleged reason for undervaluation is that partnerships are excluded from many public indices and passive investment products. Since converting to C-Corps, both Ares and KKR have seen increases in institutional ownership of their shares. This is acutely evident when looking at the exchange traded fund (ETF) ownership levels for the C-Corp PE firms (i.e. KKR and Ares) compared to the publicly traded partnerships. We expect Blackstone's institutional ownership to increase even further after its conversion because it is significantly larger than the other PE firms and, therefore, has a higher likelihood of inclusion in marquee indices and investment products. Remarkably, Blackstone's current $45 billion market cap is larger than more than 70% of S&P 500 constituents, ranking the firm above Aon (NYSE: AON) and Prudential (NYSE: PRU). Schwarzman hinted at this, saying "Blackstone will also become eligible for inclusion in several market indices."

Proportion of market cap held by ETFs



Source: ETF Channel
*As of April 17, 2019

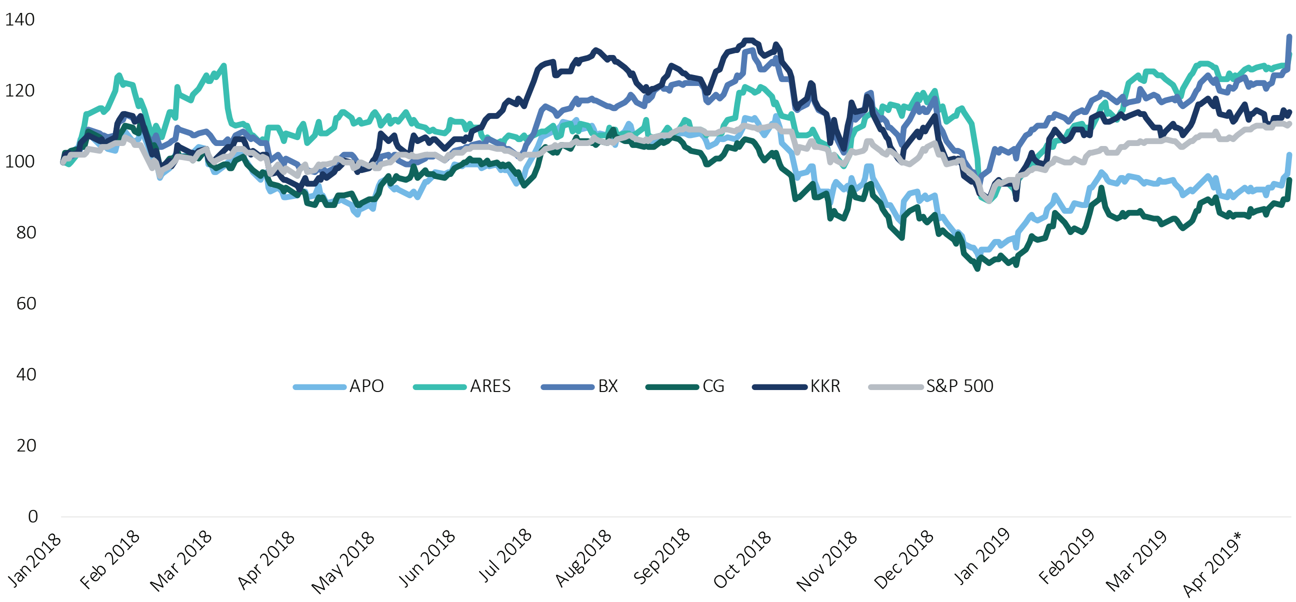
Suitability

Blackstone appears well suited for the conversion, with a majority of revenues coming from management fees in 2018. For a C-Corp, a higher portion of revenue derived from management fees is preferable because performance-related income will be taxed at the corporate rate before being distributed to shareholders. Under the partnership structure, performance income (carry) flows directly to shareholders at capital gains rates, bypassing taxation at the corporate level. In 2018, Blackstone saw a rise in the portion of revenues derived from management fees. Overall, the conversion means Blackstone will incur "a modest tax cost," though this will likely be recouped later as earnings are expected to become increasingly recurring in nature. Additionally, in the case of a recession—though we are not calling for one—we would expect carry revenue to undergo a prolonged dip, leading management fee revenues to make up an even greater portion of revenues, further benefiting the C-Corp structure.

Performance

While ownership levels and revenue composition certainly informed the decision making behind Blackstone's change, the ultimate motive behind the move is stock price performance.

Stock price performance rebased to 100 in January 2018



Source: PitchBook
*As of April 18, 2019

When discussing performance, Schwarzman noted that other firms that had made the switch (i.e. KKR and Ares) had experienced strong price appreciation, a meaningful pickup in trading volume and an increase in mutual and index fund ownership. At first, when KKR and Ares made the change, the market reaction was underwhelming, with the companies' stocks generally lagging. However, over a year after the conversion, KKR and Ares share prices are far outperforming Apollo and The Carlyle Group. In fact, the level of outperformance of their peers in this timeframe is nearly 30%—close to the 26% boost in value that a Morgan Stanley report suggested the C-Corp conversion may cause.

Looking forward

Only time will tell if PE firms will benefit from irrevocable change to a C-Corp, but thus far the decision has been fruitful for those that have made the leap, and Blackstone is well positioned to enjoy similar benefits. Although the firm's income will be subject to another layer of taxation, other public PE firms that have converted to a C-Corp have increased ownership from passive vehicles and from institutions, leading to value accretion that has been a net benefit for long-term shareholders. Performance for these companies has outpaced PE firms that have not made the shift. We believe the companies that have chosen the C-Corp route will continue to realize material advantages relative to their publicly traded brethren.

Looking ahead, we think Carlyle is likely to follow suit at some point given Blackstone's shift and the relative similarities in its fee makeup. Whether Apollo will convert to a C-Corp is more challenging to foretell. The company's collateralized loan obligation business and turnaround strategy for PE make the firm structure more conducive to a partnership model than the other public firms. Additionally, Apollo's founder and CEO, Leon Black, has publicly downplayed the possibility. On the prospect of converting to a C-Corp, he said at the Goldman Sachs Financial Services Conference, "Frankly, I would love to have a shareholder base that included a lot more long only investors. I would love to get in an index. The question is at what cost?" Black said it may take a year to judge whether the conversion of its peers is sustainable or not. However, share price outperformance over the longer term by the other publicly traded PE firms may sway Apollo to jump on the bandwagon. The market, though, may be assuming they will make the switch; Apollo and Carlyle have traded up significantly in the days following Blackstone's announcement whereas KKR and Ares have been more or less flat.