Public PE Firms and C-Corp Conversions

An analysis of Ares and KKR following their announced conversions

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Key takeaways

- **Among publicly traded PE firms, debates about the merits of converting from partnerships to c-corps have intensified in recent quarters.** Now that Ares and KKR have made the switch, executives at Blackstone have remained open to the idea while Apollo seems more hesitant.

- **While some analysts have pointed to Ares and KKR as providing evidence for the efficacy of the switch, preliminary evidence is mixed.** Both stocks surged on the initial news, but KKR's shares have since fallen in line with peers while Ares' shares have trailed the pack since the announcement.

- **We think it is too early for a verdict on the value of a c-corp conversion for PE firms.** Some institutional investors have increased their allocations to Ares and KKR, but the most significant benefits will come if and when major indices begin to include the stocks.

Published on October 5, 2018

Overview

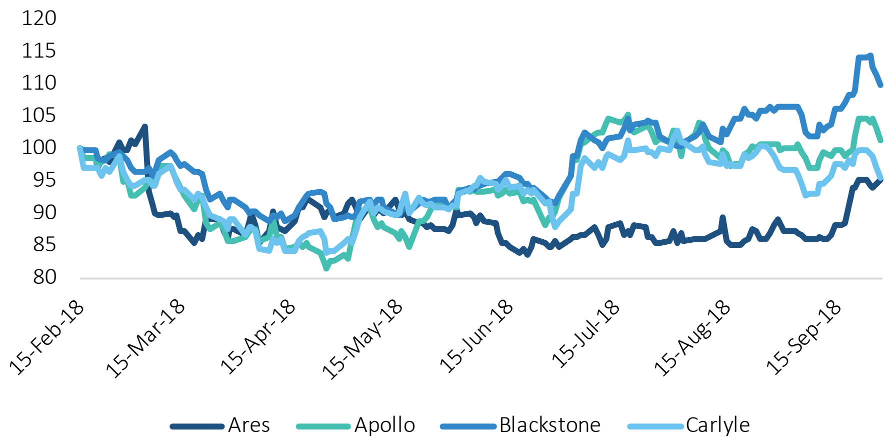
After entertaining the idea of an IPO for years, TPG has officially decided to remain private and instead seek private financing. "We have chosen not to be a public company and not to define ourselves around AUM," or assets under management, said Jim Coulter, a co-founder of TPG, during a recent meeting with the Oregon Investment Council. Instead, the firm is reportedly seeking outside investment in the form of a GP stake deal—a strategy that is becoming an alternative way for PE firms to expand their ownership base. Aside from the headaches of being public that are common to companies across industries, many publicly traded PE firms have lamented how traditional equity investors have valued their shares, claiming that a fundamental misunderstanding of their business model, combined with PE firms' earnings volatility and partnership structure—among other factors—result in persistent undervaluation. Another pitfall of the partnership structure is that it precludes the firms' shares from inclusion in many major stock indices, which are the basis for many of the popular passive equity products in the market today.

As we detailed in a previous analyst note, some public PE firms have attempted to address these perceived market dislocations by converting from a partnership to a c-corp structure—an option that became more feasible following the US tax reforms implemented earlier this year. Ares was the first firm to make the announcement in February 2018 and was quickly followed by KKR. Other firms are closely watching how Ares and KKR fare to determine whether they should make the switch, too. While some have pointed to Ares and KKR as providing evidence for the efficacy of the switch, we think the evidence is mixed, and it is too early for a verdict.

First mover advantage?

When Ares in mid-February first announced its decision to convert to a c-corp, the stock enjoyed a sizable bump compared to its peers. That sugar high was short-lived, however, as shares subsequently sold off and short-term performance reverted to levels comparable with other public PE firms. The downturn has persisted in the ensuing months, with Ares underperforming since June—precisely the opposite development than was anticipated.

Ares stock has underperformed since it announced its c-corp conversion
Stock prices rebased to 100 on February 15, 2018



Source: PitchBook
*Through September 27, 2018

Part of the underperformance can be attributed to fundamentals, as Ares' earnings fell short of analysts' expectations in both the first and second quarters. To be sure, the firm reported a relatively sizable loss in 1Q, but this was not a new development, as the firm's traditional financial metrics have lagged those of its competitors for several years, including multiple quarters with net losses. Despite recent pressure on the stock, CEO and president Michael Arougheti continues to provide a rosy outlook, stating that "we expect this to be our best year yet of fundraising," which should translate into robust management fees for years to come.

Aside from the stock price, industry professionals are also watching to see if converting to a c-corp will lead institutional investors to increase their allocations to the stock. To that end, while Ares' share price does not seem to have been buoyed by the conversion, institutional ownership has increased considerably since the conversion announcement. Institutions have more than doubled their holdings in Ares stock from fewer than 14 million shares at the end of 2017 to nearly 30 million shares through the end of 2Q 2018. Some of the notable funds making new allocations include BlueMountain Capital, Partners Group and Point72. The uptake has even been stronger among mutual funds, which have roughly tripled their holdings to more than 20 million shares.

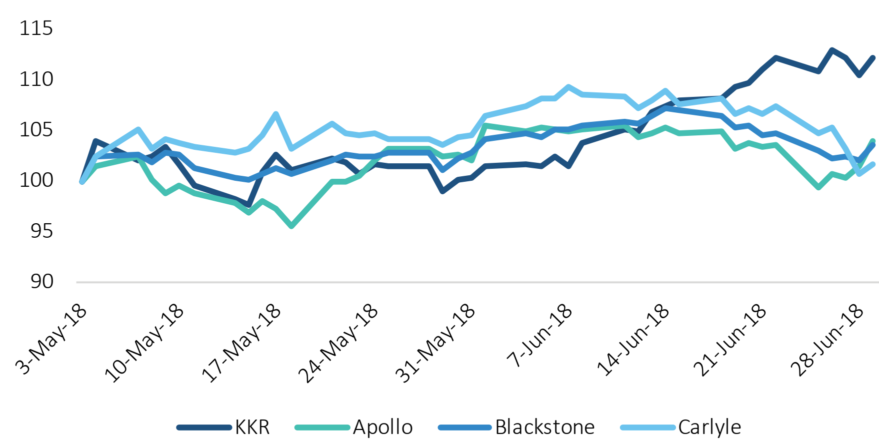
Fashionably late

Similar to Ares, KKR's shares saw a sizable pop in its stock price when it announced on May 3, 2018 its plans to convert to a c-corp. But unlike Ares, KKR boasts particularly strong financials, which should help to better sustain the stock price appreciation. Since 2012, KKR has reported a loss in only one-quarter—by far the fewest of any of the public PE firms in this analysis.

Following the initial surge, the stock continued to outperform and gained momentum throughout 2Q until the firm officially converted on July 1, 2018. In the ensuing weeks, the stock encountered some turbulence and underperformed peers for a period before appreciating throughout September. As a result, KKR's shares are up about 6% since July 1, 2018, which is in line with Apollo and Carlyle but lags Blackstone.

KKR stock steadily appreciated following its announcement

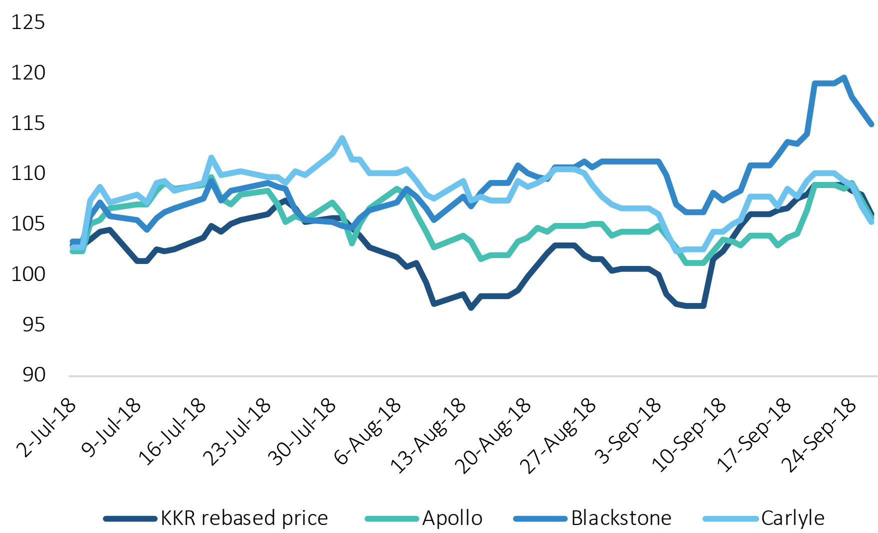
Stock prices rebased to 100 on May 3, 2018



Source: PitchBook
*Through June 30, 2018

Many industry professionals have tried to draw conclusions from short-term movements in the stock prices of Ares and KKR, but it is going to take several quarters—if not years—for us to fully understand the ramifications of the change. It's also important to keep in mind that the fates of their firms rely on more than their corporate structure. As PE firms assert, traditional valuation metrics are largely impractical [for valuing their businesses]; indeed, ratios like price-to-earnings vary drastically among firms. To that end, we'll be diving deeper in these PE firms' financials in an upcoming analyst note to provide additional insight into differences in their business models.

After its initial surge, KKR's shares slumped
Stock prices rebased to 100 on July 2, 2018



Source: PitchBook
*Through September 27, 2018

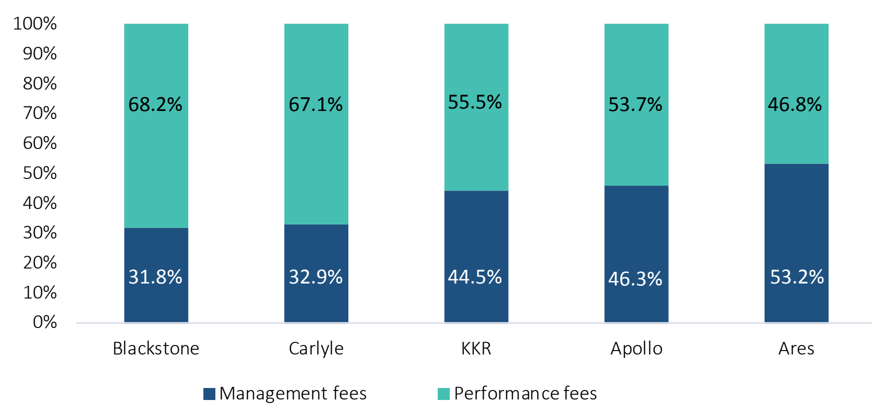
When it comes to KKR's ownership breakdown, the firm historically has had a relatively large institutional shareholder base compared to other PE firms. Institutions hold roughly two-thirds of KKR's stock, compared to less than 50% for most PE firms (the exception is Apollo, with Tiger Global and CalPERS owning about one-quarter of the shares). And while KKR has seen a small uptick in institutional ownership, it has been less significant than the boost enjoyed by Ares.

Who's next?

Now that some PE firms have made the proverbial leap of faith through a c-corp conversion, many industry professionals think it's simply a matter of when—not if—other firms follow suit. As we noted in previous research, the calculus makes the most sense for firms that generate more of the revenue from management fees rather than performance fees. Through that lens, Apollo is a logical bet to be the next firm to make the plunge; however, CEO Leon Black expressed some skepticism about the efficacy of the switch in the months following the Ares conversion.

Firms with higher proportions of management fees benefit most from the c-corp structure

Fee breakdown (FY 2017)



Source: PitchBook, company filings

Carlyle seems to be the next best-positioned firm to make the move based on its fee breakdown, but its leaders have been conspicuously quiet about the topic, speaking only in vague generalities. Somewhat surprisingly given its skew toward performance fees, Blackstone has seemed to be the most receptive of the major public firms still operating under the partnership structure to a c-corp conversion. During the firm's 2Q 2018 earnings call, CFO Michael Chae said that "KKR's recent stock performance relative to their change has been noteworthy" (although the stock has since slumped, as we mentioned previously). He added that "[Blackstone] will continue to take a deliberate and hard look at our options." Jon Gray, who has been pegged as the heir apparent to CEO Steve Schwarzman, expressed similar sentiments, emphasizing the need for a thoughtful approach before the firm embarks on that irreversible course.

Given the inconclusive results thus far, we expect other firms to wait until at least the second half of 2019 before making any decision to convert. That being said, TPG's decision to stay private is a strong indicator that many PE firms—particularly those structured as partnerships—do not see going public as an attractive value proposition, instead opting for private market options like GP stakes deals. For those that are already publicly traded, the goal is to change what they view as a categorical mispricing of their shares—and converting to a c-corp may be the only choice in the long term.