BLACKSTONE First Quarter 2016 Earnings Media Call
April 21, 2015 9:30 a.m. ET

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Blackstone 1st Quarter 2016 Media Call. At this time all lines are in a listen-only mode. Later, we'll conduct-a-question and answer session, and instructions will be given at that time. And as a reminder, today's call is being recorded.

I would now like to turn the conference over to the Senior Managing Director, Christine Anderson. Please go ahead.

Christine Anderson: Good morning, everyone. With me today is Tony James, Blackstone's President and Chief Operating Officer; Michael Chae, our Chief Financial Officer; and Joan Solotar, Senior Managing Director and Head of Multi-Asset Investing as well as External Relations. This is our 2016 first quarter earnings call for the media.

As we do every quarter, Tony will summarize the highlights of the quarter, and then we'll be happy to take your questions. Before I hand it over to Tony, I'll just remind you that we do have an analyst call later today at 11 a.m. Dial-in details are in the press release and on our website. I'd encourage you to listen to that. Tony?

Tony James: Thanks, Christine. Good morning, everyone, and thank you very much for joining us.

Overall, the firm continues to perform very well despite a challenging investment environment. Let me summarize. We navigated market turmoil around the globe and still managed to post positive returns in our core funds. We raised substantial new capital, growing AUM in double digits. Our portfolio companies and real estate assets continue to grow operating income at a healthy pace, and we were very active investing new capital in high-returning opportunities.

Although the S&P recovered from its big initial drop during the first quarter, other markets were not so lucky. Currencies, commodities, energy, emerging markets, and low-rated credit were all hit, some hard. This volatility was reflected in the quarter's carrying value of our assets despite their solid underlying operating performance.

We also opted to hold back on some of our realizations, which has proven to be a wise decision based on recent market movements. Notwithstanding the turbulence, when the dust settled we had positive appreciation in the quarter for our major drawdown funds, although the gains were obviously much lower than last year's all-time record quarter. Accordingly, this led us to book lower revenues in 2016, and ENI and distributable earnings declined in concert with revenues. These short-term declines reflect the normal volatility of the markets in which we live and have already started to reverse in the second quarter.

Our portfolio companies continue to perform well, growing EBITDA at 6.4% and paying down debt with free cash flow. As I have said before, as long as our portfolio companies continue to perform like this, holding off on dispositions simply means we will realize bigger gains later.

Meanwhile, AUM continues to grow, jumping 11% over last year to $344 billion despite—I say despite returning $48 billion to our investors.

Investors the world over are shifting an increasing proportion of their assets to alternatives, and we are the prime beneficiary. This is reflected directly in fundraising. We had a very solid first quarter, raising about $17 billion. We have a similar sized fundraising backlog for this quarter that we're in now as LPs continue to entrust us with record amounts of new capital.

We also capitalized on market turmoil with active deployment, putting to work a very substantial $6.7 billion in the first quarter alone. This brings us to a record $34 billion of capital invested over the last 12 months. It is this high level of activity at a good point in the cycle that lays the foundation for substantial future gains.

Almost 40% of the capital invested was in areas new to us in just the last four years, and that underscores our continuing innovation. And we still have $89 billion of dry powder to take advantage of additional opportunities that emerge out of the recent market turmoil.

Valuations have become markedly more attractive than they were a year ago in energy, emerging markets, low-rated credit, and stock prices of many companies. Returns on the portfolios were stable in a shaky world. In private equity, the portfolio increased 1.7% during the quarter despite market softness.

Our portfolio companies continue to grow EBITDA in low-to-mid single digits, and although the economy is still moving steadily forward, it is spotty and the momentum, according to our CEO, seems to be flagging somewhat. In the real estate portfolio, it appreciated a similar amount, 1.8% in the first quarter. BAAM saw its composite decline 2.9% in comparison to the global index that was off about 1% in dollar terms.

GSO's vehicles range from a drop of 3.3% to plus 0.6% depending on the strategy as GSO navigated through January and February, the second most violent period in the history of leveraged loans. Despite the short-term impact, the vaporization, and I use that term advisably, of liquidity in low-rated credit markets provides us with tremendous long-term opportunities going forward for our locked up funds.

The structure of the market has changed, and for investors that can buy and hold illiquid instruments, the return premiums that can be earned have never been better. The collective results of our businesses this quarter illustrate one of the great things about alternatives, their ability to limit losses in sloppy markets while being well-positioned to realize substantial upside in positive environments. Locked up capital means we can be patient sellers when markets are not favorable and aggressive buyers when other investors retreat and prices are attractive. There will always be choppy periods in the market, but they do nothing to diminish Blackstone's long-term value.

So what do you get with Blackstone? You get the only firm that is a leading participant across the full spectrum of alternative asset classes and product areas. You get a rigorous yet creative investment firm that consistently generates superior returns through market cycles. You get the strongest limited partner franchise in the world, a global leader that is gaining market share faster than ever. You get a product innovator that continuously generates and develops new products and services to serve its customers and drive growth.

You get a remarkable talent pool in every facet of the business, from the extraordinary young people entering the firm to the deepest management bench of any firm in financial services. And you get a stock that both pays out a high current yield and benefits from the long-term double-digit sector growth of our business.

With that, I'll be happy to take questions. Arthur?

Christine Anderson: Arthur?

Operator: Yes? Ready for questions?

Christine Anderson: We're ready for our first question. Thank you.

Operator: Our first question is from Devin Banerjee. Please go ahead.

Devin Banerjee: Hi, Tony. It's Devin from *Bloomberg*. Thanks for your time. When you say held back on some realizations, do you mean IPOs, sales to strategics or both? And, I guess depending on how you answer that, what needs to change for those conditions to improve?

Tony James: Well, I really mean more than anything, frankly secondary sales in the market companies that are already public, but it would also include IPOs, although usually as you know, Devin, with IPO, we don't sell a lot of shares so that doesn't really amount to much of a realization.

Strategics, for the right price and the right buyer, they have been pretty active, so we have not had to hold back there and have several interesting conversations going on. And I think that's just a question of do we like the stock price or don't we? There was a time when Hilton was down at 17, and now it's back up in the 20s, so we watch that day to day. I don't think a lot has to change for us to be starting to harvest some of that. In the last week we've had several secondary sales.

Devin Banerjee: Got you. One more question if I may. Can you give us an update on Blackstone's efforts to create liquid product for the retail channel, and specifically following the closure of the Multi-Manager Mutual Fund, how many 40 Act offerings would you like to have in the next, say three years and what level of assets are you sort of targeting here?

Tony James: Well, I just want to clarify, we didn't close the Multi-Manager Mutual Fund at all. In fact, we redeemed the Fidelity part of that, but that was a minority of the money we had in management and that product is still growing very nicely and is still performing very nicely. I would say that we expect to get in the double digit billions on this kind of stuff, but exact targets—I don't know. It is open ended, the beauty of it is we take in money when it's available.

Devin Banerjee: Alright. I thought the Multi-Manager Fund, BXMMX, was closing or are you going to continue that just without the Fidelity piece?

Tony James: Yeah. Michael, do you want to take this?

Michael Chae: Sure. Devin, it's Michael. There was the Fidelity Fund, which there will be a two-part redemption from, and in the meantime from launch, only a few years ago we launched what we actually called the Clone Fund, in the US, a mutual fund product, and in Europe eventually launched a UCITS daily liquidity product.

It's been tremendously successful in both fronts. So we've gone from about $1 billion a few years ago to over $6 billion in our own funds away from the product that we did with Fidelity, so we were always, from the beginning, preparing for sort of a multi-node strategy. We executed on it, and just as a metric, at the end of the first quarter in terms of the growth in the overall strategy in the last 12 months, it was about 84%. So tremendous growth, and we're very positive about it. The strategy, broadly, is alive and well and has a huge momentum.

Tony James: Yes. So think of this as one product in which Fidelity was an investor, was our seed investor where we did the original product development, but the product has well outgrown them and is doing very well.

Devin Banerjee: Sorry, Michael, can you spell the—not the UCITS fund, the other one— did you say Chrome? When you said the name of the strategy.

Michael Chae: Clone. It was basically a parallel product that we developed on our own and that's really the biggest element of the strategy today and obviously it goes forward.

Devin Banerjee: Okay. Thanks.

Christine Anderson: Arthur, we'll take the next question.

Operator: Our next question is from Matt Kaminski with *The Wall Street Journal*. Please go ahead.

Matt Kaminski: Hi, guys, thanks for the time. Tony, how has the buying environment changed given the rally the last few weeks in equities, credit, oil and other assets?

Tony James: Well, let's see. Well, let's take it market by market. I would say that while equities have rallied, there is still some very good values out there and we're, of course, we're not buying the market. We're not buying market averages, so we just have to find the companies that are left behind or forgotten or where there's improvement opportunity, most particularly.

And it still feels a lot better than it did to me a year ago generally. We've got some products trying to take advantage of the credit markets. They've come back, but again, there's specific issues, I think, which represent a great buy where you'd have to believe sustained higher level defaults than we had in 2009 to justify the current pricing, and so we're still looking to put money to work in the credit markets.

In real estate, I think the US has gotten a bit pricier although there's still values to be had, but Europe is booming for us. In energy, there'll be plenty of opportunities for years to come. As prices could come back, companies will resume their drilling activity and they'll need the access to capital to do that, and I think we'll see some continued good values there.

Matt Kaminski: And then on kind of a separate note, a former Blackstone employee has been in the news the last couple of months. Did you guys find any evidence of bad behavior while Caspersen was with the firm?

Tony James: No, we did not.

Matt Kaminski: Okay.

Tony James: He was not with us long, of course, but we didn't.

Matt Kaminski: Alright. And then one more if I could. We've started to see sort of a divergence in terms of how you and some of your peers approach returning capital to common unitholders. What's been the investor feedback on buyback policy and some of the new thinking on dividends from one of your peers?

Tony James: I'm going to ask Michael Chae to address that.

Michael Chae: I think in terms of feedback from investors, which is maybe distinct from the occasional Q&A on a call with analysts, our investors in my experience, our experience, are quite supportive of our capital strategy and frankly, a lot of them, they bought us to own us for the long-term on a fundamental basis. Many see a buyback as a sort of something of short-term benefit.

And our own capital strategy has a number of different parts, and the alternative uses for capital that we see instead of buying back stock have very powerful returns that we've demonstrated for years, whether it's organic expansion or the occasional acquisition. So we feel comfortable with our strategy, and our investors from our perspective are supportive.

Tony James: Yes. Let me just clarify. Eighty-five percent of all the money we earn goes back to investors directly through distributions. That little bit we're holding back is the growth capital that fuels the growth of the firm. So if we can put up $1 and raise $50 of LP money, the return on that dollar that we put up support all the carries, and all the management fees on the $50 is massive.

Matt Kaminski: Right. Okay. Alright. Thanks a lot, guys.

Operator: And our next question comes from the line of Steve Gelsi with *Buyouts*. Please go ahead.

Steve Gelsi: Hi, Tony, how are you doing today?

Tony James: Good, Steve. How about you?

Steve Gelsi: Good. I'm enjoying the spring weather. So just a quick question. Your AUM grew 11% to $344 billion despite returning $48 billion to investors. Is that $40 billion just in the past year? I just want to clarify on that.

Tony James: Yes, $48 billion in the last 12 months.

Steve Gelsi: Okay. Great. And a very solid—you raised $17 billion in the quarter. Can I get a little bit more color on that? Specifically, Tony, are you seeing long range, maybe less demand for pooled funds and more demand from big LPs for separately managed accounts and direct yields? In other words, do you think over time, you might be seeing more money coming in for those types of vehicles rather than funds? So it's kind of two questions there.

Tony James: Steve, I'll answer the second part of your question, and then Michael will give you the breakdown of the $17 billion. The simple answer is yes, there's more and more demand from the biggest LPs for SMAs as opposed to the regular way, fund investors, and some of those SMAs are around new investment strategies. Sometimes when we do an SMA for one very sophisticated investor, it's proof of concept, and then we can build a whole fund class around that. So we're very encouraging of those new SMAs in new areas.

The other kind of SMA often bundles our products together and gives investors certain kinds of risks and return characteristics, and really we're the only firm that can do that because we're the only one who has multiple building blocks to really be able to do that. So that's another big advantage to Blackstone. So this whole trend of SMAs and strategic investing plays to our strength.

Steve Gelsi: With the SMAs, is there an example that you can say that you can mention that you started out as an SMA and is now fund?

Tony James: Well, our whole core-plus real estate area is a good example of that.

Steve Gelsi: Okay. Okay. Thanks.

Operator: Our next question comes from the line of Jeff Goldfarb with *Breakingviews*. Please go ahead.

Jeff Goldfarb: Hi, guys. You may have seen that there is an SEC concept release that came out with regard to public filings, and one of the questions they pose is whether investors and the market benefit from quarterly reporting and whether or not the issues just revise or eliminate the rules requiring quarterly reporting. I was wondering if you guys had a view on that.

Tony James: Well, I can't say I've studied this much, but my own view is investors benefit from quarterly reporting. The more information—and we've always run our company to be as transparent as possible in every facet of our business, and that's frequency of information, it's the depth of information, it's the clarity of presentation. We just think that if we let it all hang out and are very transparent, investors will understand our company better, and they'll appreciate it better.

Jeff Goldfarb: I mean, I guess my follow-up to that would be given a lot of the public comments that Steve has made about valuations and then sort of the volatility that comes out in a quarter like this, whether or not that—I mean, certainly I would agree with you on the transparency point but whether or not it then ultimately hurts you in terms of valuation and how investors perceive the company because of the volatility.

Tony James: Well, we have a highly volatile stock, and I don't think that's something investors generally like, but it is what it is. We are in some ways a derivative on the market because of our carries and we hold a lot of public stocks, but I don't think transparency or quarterly reporting or anything else creates that. If anything, I think the more transparent we are and the more available data is, it actually helps investors mitigate that.

Now, before we go onto the next question, I want to ask Michael to finish the response to Steve's question on the $17 billion.

Michael Chae: Sure. Steve, the breakout is actually in some detail in our 8-K in page 19. It was really, again, a balanced attack across all our businesses – real estate about $9 billion, the hedge fund area $3 billion, private equity $3 billion, credit about $2 billion, and that was actually across something like 15 or 16 distinct products.

Some of the biggest fundraisers were a big closing for our Fifth Europe Fund for real estate which will ultimately be we think at least $7 billion and larger than the prior fund, a couple billion for our Real Estate Debt Fund, $1.5 billion for our Secondary Partners Fund VII, a meaningful closing on our new core private equity strategy which should complete in the coming several months, and so on.

And then, for our hedge fund and credit areas, notwithstanding, again, some of the sort of noise in the market, they're sort of proving their competitive position in the market by continuing to raise money, being supported by their clients. For example, in the case of our hedge fund, net inflows even in a tough first quarter where you're reading about outflows for the industry overall.

Operator: And our next question comes from the line of Shasha Dai with *The Wall Street Journal*. Please go ahead.

Shasha Dai: Good morning, everybody. Hi, Tony. I have a couple quick questions about GSO for the quarter, realizing that January and February were really brutal for everybody involved in the credit business, and also I totally get your comments about the long-term strategy of Blackstone.

I wonder if you could give some color on the negative returns from both performing credit and distressed on a net return basis. In the performing credit area, the negative net 0.4% return, does that mean there was some default in the loan portfolio and how much of that came from energy?

Tony James: Obviously, we've got a lot of detail on this so I'm going to turn that over to Michael.

Shasha Dai: Okay. Hi, Michael.

Michael Chae: Just maybe by way of clarification—hi. Our performing credit cluster as shown in our 8-K was actually positive 0.6%.

Shasha Dai: Okay. Well, I was looking at net, net return for—

Michael Chae: I thought you were talking about the gross. Okay. And the performing credit cluster is our Mezzanine Fund, our BDCs, by and large, and both areas with great long-term performance, as you know. Our Mezzanine Fund is about to, and I should have noted this in the fundraise, about to complete a closing on its third fund in the next quarter too, which will be something like a $6 billion fund.

Energy obviously had an impact on performance—not that much financial impact on the firm, by the way, from a sort of ENI standpoint. Energy is a large part of the overall leveraged credit market, something like 20% plus. For GSO it's actually less than 20%. And in the mezzanine and in our drawdown area, mezzanine and cap solutions, energy returns over the long-term have actually been very strong, in the mid-20s or so.

What you saw in the first quarter was obviously sort of a historic turmoil in the sector and substantially all of—and mark-to-market impact on our portfolio. But substantially all of it was unrealized. And if you look in our, say, our mezzanine portfolio, you've got many of our companies in the energy area—by the way, in those funds we've exited a fair amount over time which is what supports those returns I mentioned.

Many of the energy companies in our portfolio are performing fine, and we feel quite good about them. And of course in an environment like this, you've got a number of companies that our team is working hard on and supporting and protecting value and ultimately sees long-term recovery and value. So the bottom line is you're seeing substantially all unrealized mark-to-market impact in the face of what may turn out to have been the bottom in the energy market and in any event a very turbulent time.

Shasha Dai: Okay. I appreciate the additional color. If I may ask a quick follow-up question. Also in the GSO segment which is distressed strategy, I noticed that there was hedge fund rescue, lending, distressed energy, but just the negative net income of 3.9% for the quarter, how much of that came from public market investment, how much from private markets?

Tony James: Almost all public market marks.

Sasha Dai: Okay.

Tony James: Particularly in the hedge funds.

Shasha Dai: Okay. Good. Last question, it's also related. The distressed strategy seemed to be expanding the team. David Flannery recently joined GSO from Anchorage to focus on distressed in both public and private markets, so what does that tell us about how you view the opportunity in the distressed strategies?

Tony James: Well, I think, as I tried to mention in my comments, I think what you're seeing in the credit markets is a technical backup, so in other words a backup in price is not reflecting really long-term default rates or economic recessions or things like that but purely lack of liquidity.

And what's come from the banks and the regulators and whatnot is the liquidity has just completely evaporated in this market. So what does that mean? That means the companies that need to access that debt capital are going to be much more dependent on private markets and private investors like us and it means that for a while it looked like when the credit markets where the high yield markets were really hot that you could do anything in the public market, and it was hard to be a mezzanine investor.

Now, it's a great time to be a mezzanine or a rescue lender because you can earn remarkable returns, I think, for the risk, and that's driven by, as I say, not defaults, not companies failing, not economic weakness but driven by liquidity factors really imposed on the market by the regulators.

And Steve's been very articulate about the cost of lack of liquidity in the market. So having said that, for us it's a wonderful, long-term change for this business, and we're bulking up with some great talent which we can get in this market to prepare for the future to do more.

Shasha Dai: Excellent. Thank you so much, everybody.

Operator: And our final question comes from the line of Anastasia Donde, *Private Debt Investor*. Please go ahead.

Anastasia Donde: Hi, guys. I actually had a few more questions about GSO. I noticed that you restructured the returns that you're reporting a little bit where it's performing credit and distressed now, and it used to be rescue lending so I'm just wondering if you're renaming rescue lending to distressed or there's more behind that.

Michael Chae: Anastasia, it's Michael. It's really an attempt to actually be more comprehensive in reflecting the performance of the segment. I think the reporting started some time ago with sort of three discreet funds, the hedge fund, cap solutions and the mezz fund. Obviously over time the complex of products has expanded, and so these new cluster definitions are meant to capture more breadth in terms of the products out of GSO.

Anastasia Donde: Right. Right. I'm just wondering what the difference is between David Flannery's role and David Posnick's role.

Tony James: They're going to share leadership of the group.

Anastasia Donde: Okay. Great.

Tony James: David Posnick is on the West Coast and David Flannery is on the East Coast.

Anastasia Donde: And one other thing, I'm just wondering if you're planning to keep investing as much money in energy considering some of the declines within GSO for the past three quarters that have been around energy. And I know you have two big funds dedicated to the sector, I'm just wondering if there's been much deployment in those yet.

Tony James: Well, Anastasia, as you point out, we have two big funds dedicated to the sector that we raised thinking there'd be great opportunities. The deployment of both is very limited, very limited so far, and we think it'll be a very active sector. We're eager to put that money to work, so yes, we expect that to ramp up.

Anastasia Donde: Okay. Good. That's all. Thanks for taking my questions.

Tony James: Thank you.

Operator: And there are no further questions. Please continue, Christine.

Christine Anderson: That concludes our first quarter call. Thank you very much, everyone, and I'm around all day today, as are other members of the team should you have any questions.