Final Transcript

THE BLACKSTONE GROUP: Third Quarter 2014 Investor Call

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SPEAKERS

Joan Solotar – Senior Managing Director, Head of External Relations and Strategy

Steve Schwarzman – Chairman and CEO

Laurence Tosi – CFO

Tony James – President and COO

ANALYSTS

Craig Siegenthaler – Credit Suisse

Bill Katz – Citi

Michael Kim – Sandler O'Neill

Michael Carrier – Bank of America

Marc Irizarry – Goldman Sachs

Glenn Schorr – ISI

Robert Lee – KBW

Devin Ryan – JMP Securities

Brian Bedell – Deutsche Bank

Bulent Ozcan – Royal Bank of Canada

PRESENTATION

Coordinator Good day, ladies and gentlemen. Welcome to Blackstone's Third Quarter 2014 Investor Call. My name is Lisa and I'll be your operator for today. At this time, all participants are in listen-only mode. Later, we will conduct a question and answer session. As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the conference over to your host for today, Ms. Joan Solotar, Senior Managing Director, Head of External Relations and Strategy. Please proceed, ma'am.

J. Solotar Great. Thank you, Lisa. Good morning, everyone. Welcome to Blackstone's Third Quarter 2014 conference call. I'm joined today by Steve Schwarzman, Chairman and CEO; Tony James, President and Chief Operating Officer; Laurence Tosi, CFO; and Weston Tucker, Head of IR.

Earlier this morning, we issued our press release and slide presentation illustrating our results, which are available on the website. We expect to file the 10-Q in the next few weeks.

I'd like to remind you that the call may include forward-looking statements, which are uncertain and outside of the firm's control and actual results may differ materially. For a discussion of some of the risks, please see the "Risk Factors" section of our 10-K. We don't undertake any duty to update forward-looking statements. We will refer to non-GAAP measures on the call, and you can find the reconciliations in our press release. I'd also like to remind you that nothing on this call constitutes an offer to sell or a solicitation of an offer to purchase an interest in any of our funds. The audio cast is copyrighted and can't be duplicated, reproduced, or rebroadcast without consent.

So a quick recap of our results: We reported record third quarter economic net income (ENI) of $0.66. That's up from $0.56 in last year's third quarter, and it was driven by both higher performance and management fees. Distributable earnings of $672 million or $0.53 per common unit were also a third quarter record and more than double last year's third quarter. Of that amount, we'll be paying a distribution of $0.44 per unit to shareholders of record as of October 27th.

With that, I'll turn it over to Steve Schwarzman.

S. Schwarzman Good morning and thank you for joining our call, or maybe not such a good morning depending upon what you own in the markets today. Blackstone, however, has had a terrific quarter, which was a record third quarter for ENI, cash earnings, and assets under management. In fact, in every major area – investment performance, capital raising, investment activity levels, and realizations – the firm is producing record or near record results.

Our investment performance continues to significantly outperform the public markets. Over the past 12 months, we've created $35 billion in total appreciation across our funds. It's a staggering number.

Even in the third quarter, most of our funds delivered returns that were multiples of their comparable market indices. Our real estate funds were up 6% for the quarter, and 28% for the past year. Our private equity funds were up 4% overall for the quarter, and 28% for the prior year.

Our credit drawdown funds, as Tony indicated earlier, were up between 8% and 15% gross for the quarter – the stock market barely went up – and 30% to 34% for the year. Altogether, this is a really stunning performance. This performance, along with strong demand for alternative products, continues to drive significant capital inflows to the firm.

Against a positive secular backdrop of limited partner investors allocating more to alternatives, which I think we told you in prior calls was going to happen, and also reducing the number of managers they do business with – which we also indicated we thought would happen. Blackstone is, I believe, the best-positioned firm to capture and grow market share, and that's occurring. We're doing this in all of our businesses. As our global investing platforms have become more diversified, we continually have new funds in the market, and our capital inflows are no longer the step functions they were years ago when we were a lot smaller firm.

Blackstone has raised $13 billion just in the current quarter and $55 billion over the past year, which is by far a record. In the past two years, we've raised $100 billion. That's greater than the total size of many of our closest competitors. It's a real testament to the performance of our products and our relationships and depth of relationship with our limited partners.

We have $42 billion in dry powder capital to invest, and with leading global platforms in each of our investment businesses, we're able to find many interesting opportunities to deploy this capital. We invested or committed a record amount in the third quarter of $10 billion, bringing us to nearly $30 billion over the past year as a result of our unique position. Over 30% of the $30 billion was in Europe, primarily in real estate, as we're taking advantage of the current distress there.

GSO completed the largest investment in its history, for example, a $1 billion acquisition financing package that they were uniquely positioned to execute. Private equity invested in several very-carefully selected and conservatively-structured deals. Our new European real estate fund, as Tony mentioned, is now two-thirds invested or committed after only one year. We were waiting for the European real estate sales to break open, and it did, and we were ready, and we've executed.

Because of our rapid deployment, we've agreed with our investors to expand the size of what was already the largest fund of its kind ever raised in Europe by an additional 1.5 billion euros. That will bring the total fund to 6.6 billion euros or approximately $8.8 billion, bringing us wealth to continue to take advantage of the distressed opportunities in Europe. This is really quite remarkable and exemplifies how quickly Blackstone can raise and deploy large scale capital to take advantage of a vintage or market opportunity, minimizing any J-curve.

In private equity, we very selectively pursued transactions, usually, with low double-digit unlevered target returns and enhanced those returns further with prudent levels of leverage. We've been doing this for about 28 years, and it really works out extremely well for our investors. In fact, despite having an active weekly calendar deal sheet, the vast majority of our corporate private equity capital deployed was actually only in ten to fifteen transactions. It's a very small number of actual transactions when you look at it on the global basis, which is why we can be so careful in terms of setting up things we think are very sensible for our investors with minimum downside and a lot of upside.

Our behavior remains contrary to what you may hear about capital-chasing deals and sacrificing returns. We're taking additional risks in order to move capital.

Since the end of the third quarter, obviously, public markets have clearly deteriorated significantly, with a sharp increase in volatility, you can see on your screens and see on television. The S&P and global indices are both down 6%. Credit indices have also declined with widening spreads and, frankly, a lot less liquidity than people expected. Hedge funds are being forced to unwind positions and, sometimes, are doing them voluntarily; and capital markets, generally, have seen a decrease in liquidity, as I mentioned.

I'd like to make two important points on this development; first, we are uniquely positioned to take advantage of the market volatility across all of our businesses. We've seen the public markets correct many times before, and as always it will present the potential for abnormal deal flow with favorable risk-adjusted returns. With one of the largest pools of dry powder capital, we can and will move quickly to respond to market dislocations. These types of investment environments end up becoming our best vintages. Our job is to look at the markets and the world objectively, not emotionally.

Second, as it relates to Blackstone's current investments and our performance going forward, public markets, alone, do not dictate realizations for us. We also rely on strategic and private sale opportunities, which would include the liquidation, for example, of our office portfolio in real estate. We closed the sale of $2 billion of our Boston office portfolio in the third quarter, and have approximately $12 billion of office assets remaining in liquidation.

In addition, our growing base and expanding diversity of monies under management drives greater ongoing fee-related earnings, which are part of our distributions to shareholders. In other words, we're not hostages of the stock market. We have a lot of mechanisms for realizing investments, and we are never forced sellers, unlike almost all other market operators.

Given the long-term and locked up nature of our funds, with no redemptions, we do not sell at inopportune times, as I have seen people do repeatedly in times of market uncertainty. In fact, our portfolio companies are in great shape. The best shape they've been in in many, many years and continue to see strong operating results, so if we have to wait from time to time for realization, it's not a bad option. A market readjustment might delay certain public market dispositions in the near term, but things have a habit of changing, but if the timing is impacted, we expect our companies to continue to grow very nicely while we wait, compounding our returns for our investors where they end up being very pleased when we sell these investments.

The public markets tend to overshoot and undershoot what's going on in the economy. Investment sentiment, now, we all know is very negative. What we see, however, is that the US is growing nicely, particularly, in our real estate area and where we're seeing sustained positive fundamentals across every sector of our portfolio.

In our private equity companies, revenue and EBITDA trends remain quite strong, up 7% and 10%, respectively, year-over-year, well ahead of the average company. The US market is currently trading somewhere around 15 times earnings; although, it seems to move around a lot every day, which doesn't seem unreasonable. Very low interest rates and declining oil prices should be good for growth in most countries of the world.

We feel very good about our current portfolio and particularly good about our ability to invest when other people have fear. On the advisory side, we also have tremendous momentum. Our M&A backlog is more than double what it was this time last year. That's double. Our restructuring group was just recognized by Thomson Reuters as the number one distressed advisory business in the world. And Park Hill is the clear number one in the placement business in the world, and it's projecting a record year this year.

As we announced last week, we'll be spinning these businesses into an independent publicly-traded firm at some point next year, and we're very excited about the opportunity for them. There couldn't be a better time, other than the market uncertainty, to launch this new company given the significant market opportunities that exist for a top-notch, independent and diversified advisory practice. With such a talented team, untethered from our larger asset management business, which creates conflict, and under Paul Taubman's leadership, one of the top bankers and advisors in the world, I believe we're creating something that will be truly special.

Feedback from our clients and potential clients has been extraordinarily favorable. Our shareholders should benefit as standalone advisory businesses generally trade at significantly higher multiples in the public markets than Blackstone does. A better earnings trajectory, coupled with a better multiple, should equal a compelling value for our shareholders.

In summary, I couldn't be more pleased with our third quarter performance. I'm excited about the firm. We're wonderfully positioned, and I expect a lot of good things to be happening over the forthcoming years.

With that, I'll ask Laurence Tosi to take over with a review of our financial results, and then we'll be taking questions. There are a lot of them for us because I think the current market environment gets people curious as to what's going on generally and what we're seeing.

L. Tosi Okay. Thank you, Steve. Thank you, everyone, for joining the call. The one takeaway we want to leave investors with today is that while market movements are, by their very nature, temporary, the momentum of Blackstone's performance is not. In the third quarter, the S&P saw volatility and a peak-to-trough value differential of 5.3%, similar to the volatility seen in the fourth quarter to date. It still ended up largely flat on low growth and earnings for the index companies.

Against this rather lackluster backdrop, Blackstone has produced record third quarter and year-to-date earnings while posting above-market fund performance in almost all of our investing businesses. The key to Blackstone lies, not in short-term public market fluctuations, but in longer term trends like the availability of credit, mispricing of liquidity, bank downsizing, regional capital constraints, supply and demand imbalances, strategic opportunities, back of new construction, asset price devaluation, and operating underperformance. These are operating risk drivers that make up Blackstone's expertise, not public market metrics.

The 30% returns across Private Equity, Real Estate and Credit funds over the last 12 months reflect strong underlying portfolio company and asset performance, as Steve outlined. These are some of the best fundamentals and operating performances we have seen across these asset classes. Similarly, BAAM outperforms most in difficult markets, while also maintaining one-third of the volatility of the S&P, which is why that business is seeing both record inflows of $12 billion over the last 12 months, while outpacing the broader market in returns year-to-date.

More than anyone, our fund investors understand and appreciate the long-cycle benefits of investing with Blackstone. Over the last year, we had record organic inflows of $55 billion, but perhaps most interesting is that 65% of that amount, or almost $36 billion of the inflows came from new funds, new businesses, and new strategies we didn’t launch until a few years ago as we continue to innovate best-in-class products, ideas and extensions across Blackstone.

We also had $18 billion of inflows over the last year in evergreen funds that are always in the market, giving us continuing access to new capital. Some of those funds are specifically created for high net worth individuals, where we have raised a record $10 billion over the last 12 months, representing a new and growing market for us, where there is a broad demand for Blackstone's unmatched product quality, depth, brand, and performance.

Over the last several years, almost all of Blackstone's drawdown funds have hit their caps. This strength is continuing for alternatives, in general, and Blackstone in particular. We are currently fundraising our second energy fund, which is well on its way towards our $4.5 billion cap. We're also raising our second Tactical Opportunities strategy, which we think could exceed the $5 billion we raised for the first fund.

Our new Core Plus real estate platform is nearing $2 billion in commitments. We are launching new strategies in our secondary business, which just closed on $4.4 billion for its newest fund, nearly doubling the last pre-Blackstone fund, in part, by accessing channels uniquely developed by Blackstone. We're also adding 1.5 billion euros to our fourth European real estate fund, which is double the size of its predecessor fund. These fund raisers will drive growth for Blackstone, and that is before we even begin to launch our flagship seventh global private equity fund this year and our eighth global real estate fund early next year. All of this comes at a time where we are returning record levels of capital to our investors at attractive returns.

Record AUM, and consistent fund performance on a growing base of assets accelerates earnings and distributions even in volatile or flat public markets. This is exactly what we've already been seeing this year. Our record year-to-date ENI easily outpaced record fund performance, posting a 47% increase to $2.9 billion. Realization activity was also robust and continued unabated in a flat, but sometimes volatile market, driving distributable earnings up 85% to $1.9 billion, another record.

In both cases, the performance was broad based and that, for investors, is a unique balance only Blackstone can deliver. Further note that while markets can impact ENI temporarily, distributable earnings is a longer cycle reflection of both sustained inflows and the value created in our funds where we focus on decade long returns and never unjust quarters or even single years.

First, we are at record levels of locked in fee revenues and profits; up 22% on record inflows; a consistent source of cash earnings regardless of market conditions. Secondly, our realizations are also of greater scale and more diverse across a wider set of growing businesses than ever before.

Some details; the momentum of realizations has been building over the last several quarters with the second and third quarters of this year marking our best realized performance fees ever. Distributable earnings year-to-date reflects over 150 different transactions; only 50% of those transactions involve public markets. The remainder was generated by private sales, operating earnings and refinancings. None of that activity is dependent on the public market, or occurs at a spot price.

Our forward outlook for realizations has a similar public and private split. Blackstone's financial profile has also been strengthening at a rate greater than the broader markets. At the end of the quarter, Blackstone had a record $8.72 a unit on our balance sheet; up 34% in just one year. Our liquidity profile has also improved as we ended the quarter with record cash and treasury investments of $2.56 per unit.

We currently have $4.3 billion, or $3.78 per unit in net accrued performance fees, and another $931 million, or $0.81 per unit of investment gains on the balance sheet. Together, this represents $4.59 per unit of future cash earnings and 64% of that amount is in assets that are public, liquidating or paid annually.

Our record results for the quarter and the last 12 months reflect sustained fund returns, strengthening of our market position and earnings momentum that will certainly outlast current market volatility. For whatever reason, what drives Blackstone and what drives Blackstone's stock price appears, to date, to be two entirely different and somewhat unrelated dynamics. We do know that Blackstone's performance is driven by long-term value creation in our funds which, in turn, drives the growth of our asset base and our earnings performance. Today, those dynamics are unchanged and have never been stronger.

With that, we'll open it up for questions.

Coordinator (Operator instructions.) Your first question comes from the line of Craig Siegenthaler with Credit Suisse. Please proceed.

C. Siegenthaler Hi, thank you. Good morning. First, on BCP VII, I'm just wondering, did any of the recent market weakness have any driver, in terms of the timing, of starting to raise that fund here in the fourth quarter just given improving asset class valuations broadly here?

S. Schwarzman This is Steve. I'd say absolutely not for that. We have a strong investment rate, and it's time to raise funds. Typically, as you know, when you get around 75% invested you go out to market. We're approaching that, and so there's nothing other than normal course in that.

One of the interesting things, a trend, that's going on as opposed to several years ago is that the larger sized funds are becoming much more popular, if you will, than they had been. That's a good sign for that fundraising, and that's an across-the-board type of phenomenon; not just involving Blackstone.

T. James Market funds and alternatives also. Alternatives in general are growing as part of LP's portfolios.

C. Siegenthaler Thank you.

Coordinator Your next question comes from the line of Bill Katz with Citi. Please proceed.

B. Katz Yes. Thank you very much for taking the question. Just two unrelated questions. The first question I have is, as you mentioned in your opening remarks that the flexibility to exit and selectivity on private equity deals and still applying some good underlying rate of return; both levered and unlevered. Just a question that I think's affecting the group and your stock to some degree is, how are you thinking about funding availability given the fact that credit spreads have backed up a little bit, and some banks have been highlighting the riskiness in the levered loan markets. How do you think about financing growth from here?

S. Schwarzman My own sense is—and Tony can give what his view is, things cycle a bit in terms of the availability of credit. We haven't been seeing that this is a problem, and we may have a somewhat idiosyncratic portfolio or the types of transactions we're doing. In our model, private equity availability of capital is the most important criteria. The cost of money goes up and down a little bit; it doesn't affect return too much, surprisingly. At the moment, we haven't really experienced what you're describing.

T. James Bill, I will add two things. First of all, as I said many times before, but I just want to remind the audience here, hot credit markets tend to be difficult markets for us to earn high returns on new investments. If the credit markets cooled off in private equity, we would welcome this, first.

Secondly, we have been shying away from maximizing leverage in private equity for some time, just feeling there was just too much credit available with leveraging the companies too heavily. As I think Steve mentioned, we look at the real driver of our investing is unlevered returns and they have to get to the levels. Then, we use credit markets to enhance that and magnify it, but they've gone overboard.

So a lot of what we've been doing specifically in investing in private equity has been growth investments. I mentioned on the press call, energy investments where we're actually going out and finding hydrocarbons or building generation facilities and so on and so forth, which are not particularly credit market dependent and not also equity market or anything else dependent. So we're not worried, I guess.

S. Schwarzman I think one other thing is Blackstone, taken as a group is, in most years, the largest generator of fees to the financial community in the world. So, if there's credit to allocate, we tend to be well positioned to get that credit. Also, from memory, I don't know that throughout our whole complex of real estate and private equity and other types of investing, that we've ever lost money for any bank in the firm's history.

This type of positioning, in terms of protecting the banking system when we borrow money, as well as being historically one of the top fee payers in the world, really positions us very well. When Tony said he's not concerned about, in effect, the difficulty of borrowing money, that when times are tough borrowing, generally, prices go down. Then, there's a cycle where credit improves, and if you can buy things when those prices go down, you always get wonderful vintage returns; it's just logical. We don't look at any of this as a problem. In a way, it's a competitive advantage for the firm.

B. Katz Okay. Thank you for that perspective. My second question, unrelated; you mentioned in your press release you had some good success in European retail funds. Could you talk a little bit about how you see that opportunity over the next several years, and I'm thinking maybe if you add in the prism of either product opportunity or incremental distribution relationships?

L. Tosi Okay. I think, though, you're referring to the comment in the BAAM portion where we were talking about the UCITS Funds that we released in Europe?

B. Katz Correct.

L. Tosi Yes. It's two things at play. First is, BAAM has been hard at work for several years at different ways that they can create customized or tailored versions of their products and risk exposures for the retail audience. The launch of our first ever UCITS Fund in Europe is an extension of that, so on a macro basis we're talking about addressing retail with retail tailored products within BAAM and, more recently, putting out the UCITS structure.

There are other funds at Blackstone in other businesses that are more liquid that will benefit from a UCITS-type structure that we can then offer to that European retail base, and that's some of the beauty of having the technology or the learning, if you will, fund-by-fund, we can pass that on to the other funds as we offer them. It's another way of accessing that market. The UCITS structures are very popular and dominate the high-net worth channels in Europe, and the ability of BAAM, frankly, over a couple years to tailor to that audience is really a great growth opportunity.

B. Katz Okay. Thank you.

Coordinator Your next question comes from the line of Michael Kim with Sandler O'Neill. Please proceed.

M. Kim Hi, guys. Good morning. My question has to do with the outsized growth that you talked about coming from newer strategies that you brought to market over the last few years. Just wondering how you're thinking about product development, broadly speaking these days, going forward. Then, related to that; as these newer strategies continue to season, what's the dynamic between letting incremental revenues fall to the bottom line versus continuing to reinvest in the business as that cycle plays through?

S. Schwarzman Well, just in terms of developing new products, we actually have a very good procedure here. We have once a year strategic planning sessions for each of our four major business groups. At that meeting, each group brings in two to three new ideas of ways that we can serve investors better, generate high returns for them, which tends to be, in effect, packaged as a new product. Then we debate among the management committee members and the group as to which one has the best upside for our investors, and how executable that is.

Depending upon the ease of introduction, we either do one of them in a year, assuming there's something really good to do, or if there's really something terrific with two of them, we'll do two of them as long as we have the human capital to execute. And it's a wonderful way to run a business because it gives younger people and developing talents the opportunity, with supervision, to run these new businesses. We have a steady stream of these now. Ten years ago, some of us had to invent these things, very fewer in number. It's a system.

In terms of the second part of your question, we don't want for financial resources to prosecute growth strategies at the firm. In other words, if there's something terrific to do we will do it because, as you know, markets are somewhat fragile. There's a moment for different strategies, and our job is to hit that moment where we can generate really outsized returns for our clients and our investors. We don't hesitate to spend whatever it takes to set up any new product if it's really terrific. So, it's a simple, simple way we do things.

T. James Michael, let me just in general we've never had more new products than we have now, and the new products we have never had more opportunity to be huge, so more runway ahead of them. We're not talking about starting something that's niche and that is what it is. We're talking about things which could be huge even in the scheme of Blackstone. So, I think we have the richest, biggest, longest term, strongest new product set we've ever had, and yes, there is a lag, and we lose money for the first few years on a new product typically, and that investment is flowed through the P&L. So, the future is to come.

M. Kim Great. That's helpful. Thanks for taking my question.

Coordinator Your next question comes from the line of Glenn Schorr with ISI. Please proceed.

G. Schorr Thanks very much. Two quickies. One is fourth quarter is always or historically has been a very good performance fee quarter for you all and performance over the last 12 months has been excellent, as you pointed out. How much does the volatility that we've seen in October dent what should have been really good expectations for the performance? If you have any color around how we should think about that for the fourth quarter, it would be great.

L. Tosi Glenn, it's LT, a couple things, you're correct. Typically, the fourth quarter for us, let's just talk about locked-in fee growth and deal activity tends to be busy as there is some seasonality to our business. We tend to have about 28% to 30% of a full year’s fee-related activities are in the fourth quarter and that’s been true for several years. So, I don't think these short-term market fluctuations will dent that.

With respect to performance fees and the performance quarter to date, we saw some volatility in the third quarter, and it turned out to be a great quarter. We'll just have to wait and see.

G. Schorr Another unanswerable one is curious on how you think about the potential of a buyback in the context of great growth, great performance, you've been vocal enough that you'd think the stock is cheap, so do I, yet you've got to manage the fact that the float is small. The reason I ask is the share account each quarter has been up a little bit year-on-year, nothing material, but this pops to mind.

T. James	It pops to our mind too, and we actually think the liquidity in the stock is pretty good by comparison to the rest of the industry, but we haven't made any decisions.

S. Schwarzman	I think our liquidity equals pretty close to the liquidity of the whole rest of the industry. So, in that sense, it's pretty close to that. So, we think we have good liquidity and I think our valuations wouldn't surprise you, but I often turn out to be right on these. It is sort of really like what are we thinking, frankly.

J. Solotar	I think, Glenn, you raise a good point. The free float now is about $15 billion or so, and that's continued to move up, and over time, we would expect the whole sector's free float will move up into more mature territory. So, I think it's just following the path of other financial services subsectors when they were born and became more mature like you saw with the whole brokerage industry. But as Steve mentioned, relative to the rest of the group, I think—if you look at our average daily trading volume, I think it equals more than pretty much everyone else combined. So, there seems to be good liquidity.

G. Schorr Thanks very much.

Coordinator Your next question comes from the line of Patrick Davitt with Autonomous. Please proceed.

P. Davitt Good morning. Thanks for taking my question. I wanted to focus a little bit on energy exposure and oil in particular, and how you think or how we should think about $80 oil or even lower flowing through private marks or if you even think that's much of an issue. And secondarily, does the collapse in the oil price change your view on that niche as kind of a major growth engine for your business?

T. James Okay. So, I don't think we think a lower oil price will have a very big impact on our marks. There are some companies we still own that are dependent on oil, particularly Kosmos, that trades publicly on the stock market. So, you'll know what that's doing on marks, you can see what happens to the stock price.

With respect to a lot of our private oil-oriented assets, most of them have been sold, frankly, and lately we've been mostly buying gas figuring that was nearer a low ebb and oil was pretty high. That view has been pretty accurate.

And then in general, lower energy costs and lower feedstock costs and so on for a lot of our companies actually are helpful for margins. And so, how all that plays through on balance, I'm not even sure it's negative at all, but I must say I'm not sure.

Dislocation in the energy business, we think this is a temporary dislocation of oil price. We think that our long-term view of oil prices really hasn’t changed. Our long-term view of energy prices was below the price levels in the last two years, and it's probably a bit above today's spot price, but we review that periodically. Our investments that we've made in energy will be quite successful if oil prices even stay at this level.

P. Davitt That's helpful. Thanks.

Coordinator Your next question comes from the line of Robert Lee with KBW. Please proceed.

R. Lee Thank you. Good morning. Can you maybe update us on—there are so many fundraisers, sometimes I lose track, but where things stand maybe with BREP VIII kind of how you're thinking about that. I'm also curious on BCP VII and maybe also the next BREP fund, are you seeing any change in kind of the typical LP demands, particularly maybe around the demands for co-invest. Is it backing off at all? Is it kind of getting more pressure for co-invest opportunities as part of a commitment? Just kind of some color on that would be helpful.

T. James So, BREP VIII will be, Steve's going to chime in in a minute. BREP VIII, it looks like it will be sort of early next year sometime most likely. BCP probably late this year most likely. And yes, there's a lot more interest on part of the LPs for co-invest.

S. Schwarzman What I'd say is that almost every fund, I'm not aware of any, but I'm just trying to not be criticized by my General Counsel, but every fund that we've offered over the last several years has like been significantly oversubscribed. So, when you ask a question of what we do think is going to happen to BREP VIII, or where we typically in real estate have been the signature investor, where people like to put money and that's been the empirical reality giving us huge multiples of what other people have raised, we don't know anything in the environment that's going to change that. We can't guarantee that, but that's what we'd expect to have happen.

In Private Equity, we're going to market. We've had a very successful Fund VI so far, and we have a lot of activity and we'll see how that goes. There is more of a demand for co-investment, but it is interesting that we're being regularly approached for very large capital allocations by some of the largest investors in the world, way beyond what we've ever experienced, and sort of—as sort of part of a package, they'd like to see sort of in some cases, more co-investment.

What we find, which is fascinating, is that when we offer co-investment to people who ask for it, they don't often take it. I don't quite understand that, but they're trying to balance their own portfolios, and they have their own reasons for not wanting to do something at a given point in time given the demands on their overall payments to beneficiaries or whatever, and so, in a way we think this is something that makes sense from their perspective; it certainly makes sense from ours.

And these are like discussions, and net-net, the evolving world appears to be a very good one for a firm like ourselves. So, it's not an issue that's unexpected, and in many cases, in the olden days, like four years ago, when we needed more money for an individual transaction because of size, we would call another firm that's a competitor of ours and team up and make an investment. It works really nicely to have our own limited partners put up that money. It makes them happy, gives us more control of the deal, less shared control because typically you know we're in charge of that investment. So, it's an interesting phenomenon, but it works very well for us.

R. Lee Maybe one other just quick question for LT. This is almost a modeling question, but look at the taxes that jumped up a bit in the quarter, anything specific driving that?

L. Tosi Sure, Rob. So, there are really two factors at play. The more material factors, so what you're referring to is our tax rate typically runs around 2.5% to 3%. It jumped up to about 9% this quarter. So, that’s a 6-percentage point difference, a large part of that is related to the fact that it was a very good, in fact, record realization quarter in GSO, those realizations are on the mezz funds and the rescue funds, which are typically ordinary income funds, and so, there's a higher tax rate associated with them. That’s number one.

Number two, the pre-IPO funds in real estate, which would be BREP IV and BREP V also had strong realizations, and those two actually run through an ordinary income vehicle. So, I would say it's a short-term spike in large regard related to those two phenomena, related to the realizations in those funds.

The second, to a lesser extent, impact on it is that much of the equity that we grant vests in the first half of the year, which lowers the tax rate as that gets deducted for tax reasons. So, Rob, with respect to modeling, I think that I'd continue to keep it to what it's been historically and I would view this as a one-time event.

R. Lee — Great. Thanks for taking my questions.

Coordinator — Your next question comes from the line of Devin Ryan with JMP Securities. Please proceed.

D. Ryan — Good morning. So, I just want to follow up I guess on the strong realizations in real estate just to make sure I understand.

So, BREP IV and BREP V, I know you guys had mentioned earlier in the year that we'd be seeing a pickup in realization activity. So, just trying to get some additional perspective there around how strong, kind of now we've had two really good quarters in realization and just get a sense of some perspective of, is this kind of a sustainable type of trend? I know it'll be lumpy, but are we now kind of at a more elevated potential level moving forward here for at least the foreseeable future?

T. James — With regards to BREP, we think what you've seen is sustainable and can even grow from here.

D. Ryan — Okay, good to hear. Just secondly, with respect to the $13 billion of gross flows, is there any way to break down how much came in from existing LP relationships and maybe how much of those flows are being generated from new relationships that you guys have made?

L. Tosi — This is LT. About 80% of those flows are coming from existing LPs. I did highlight in my speech that there are some new pockets of LPs as well that are contributing materially, and one of the exciting aspects of this is that we're also putting now a wider range of funds in front of the same LPs. So, the cross selling continues to gain momentum, and all those—the new pockets, the cross selling, we all view as sustainable trends.

D. Ryan Great. Appreciate the color, guys.

Coordinator Your next question comes from the line of Mike Carrier with Bank of America. Please proceed.

M. Carrier Thanks a lot. Steve, you mentioned up front, some of the color around the portfolio companies and how they're performing. Just curious can you give some perspective on maybe the European part of the business? It could be in either real estate or private equity, but what are the trends there may be in some of the sectors? And then, if the growth outlook does take a step down, how is that relative to what your expectations were in making some of these investments? And then for the portfolio companies, like what are their options to try to hit those returns, meaning driving stronger revenues, looking at expenses again, just what are the variables that they'll reconsider if the growth is slow?

S. Schwarzman I'd say in the European area, our biggest exposure has been in real estate. We have a very conservative view towards Europe. I guess you could, another word choice, you could capture that, which is unoptimistic. So, when we buy something there and we're buying very large amounts of different types of assets simply because there's an imbalance now with way more sellers than buyers which puts pressure on price. So we can create investments at a very good yield and then leverage them and get very satisfactory returns with no growth in individual markets simply because of the illiquidity there. We also, when we buy something, we try not to be passive buyers of anything, and we usually have some improvements planned of what can be done. And even if our market is flat, if an asset has not been maximized, our job, as Jon Gray would say it very nicely, is buy it, fix it, sell it, and our overall economic model is that we're not optimistic about economic growth in Europe. And so, we're consequently not disappointed when that growth is not there, and it's all part of that plan.

In terms of purchases of US assets and we were talking about it and Tony mentioned it in his remarks earlier, our investments in Fund VI have performed very well, very well. And we're not supposed to be selling securities on these calls so I guess I won't tell you how well it's doing, but it's like really good. And so, we’ve been a little surprised on the upside. That was not the case in fact four years ago. After the financial crisis, it was slow coming out of the chutes. Both real estate in the US and private equity in the US are doing better than our expectation there. So, that’s all good. So, that’s sort of how we see the two geographic areas that I think you asked about.

M. Carrier Yes, that's helpful. LT, just real quick, just given the volatility in the markets right now, with BCP V, just how much of a buffer do we have if it got back close to that, to the hurdle? And then, on the transaction fees in the quarter, it was pretty high. I just wanted to get any color on the outlook there.

L. Tosi Sure. So for BCP V, at the end of the quarter, it was about halfway through the catch up, and you'd need, if you were to reverse the carry that we've accrued year-to-date, you'd need about 10% decline in equity value to reverse it, so to just give you an idea of magnitude. So, it's been accumulating over some time.

With respect to transaction fees, the uptick in the quarter had to do with an interesting transaction really in real estate where you'll see in the line by line related to—what is effectively a disposition fee that they got on the syndication of a deal. So, it wasn't just their own sale, which was quite material, and that caused the uptick. Other than that, it was relatively flat quarter-over-quarter for transaction fees for the firm as a whole.

M. Carrier Okay. Thanks a lot.

Coordinator Your next question comes from the line of Marc Irizarry with Goldman Sachs. Please proceed.

M. Irizarry — Steve, I am just trying to figure out the impact the denominator effects have maybe had on the allocations to the firm across asset classes. If markets are more volatile and outlooks change around rates and global growth and public markets trade lower, do you think going forward that that could play a role in the percentage that investors might allocate to alternatives? Thanks.

S. Schwarzman — That's a good question, Marc. Obviously, if these funds shrink down 75% and they have no money of any type and the world is completely desperate, yes, that will have an impact on everybody in the business, even Goldman Sachs, a great firm. In a normal operating environment, since we're actually selling out everything that we've offered, we have a built-in buffer in terms of that shrinkage. There is also something very material going on, and that's the fact that not only are about half of large institutional investors increasing their exposure to alternatives, they're really shrinking the number of people, the number of firms they give money to.

So, what is happening with that phenomenon and it's quite widespread is it's hurting capital to the high-performing firms, sort of like ourselves, who can also handle significant amounts of money. So, if you have roughly half of an investor base increasing in our class, let's just say that markets are down 5% to 10%, given the fact that there will be a significant shrinkage of money managers that will be allocated to and the fact that we constantly, at least over the last X number of years, have been limited by investors as to how much money we can take, not what they'll give us, and every fund has limited us and we've blown over the caps so we have a lot of safety, if you will, built into that.

If markets give way to the point that there's catastrophe, then what happens is people just freeze, but I don't think that's part of this cycle. The US economy is doing quite nicely and I think we have like an overreaction going on because of health concerns and foreign policy concerns and all this stuff coming together that's just scaring people, and in a way you can't blame them because there's a sense that we're sort of out of control and that's being reflected into markets. But that's not, I don't think, sustainable.

T. James Let me make a couple comments. First of all, from five or six years ago, public markets are up 70% or something. I mean it's huge, it's up way more than these people have been able to allocate to alternatives.

Secondly, they're not becoming disinvested in alternatives. For several years, they've been getting back way more capital than they've actually been able to put out, which is causing them to run faster and faster to try to get up invested.

Thirdly, some of the markets like treasuries are actually appreciating in here, let's not forget that. And a few days in the public market, when year-to-date it's maybe off the peak 5% or 6% in the last few weeks, but boy, it's still at a pretty high level by most standards.

Then finally, where the new big flows coming are not so much some of these traditional pension funds with asset allocation and denominator issues, a lot of that money is coming from sovereign wealth funds and from foreign investors and what not that are wildly underinvested in alternatives where they're just beginning to move money into that, and so, there are a lot of trends here that overwhelm a few weak weeks in the stock market.

S. Schwarzman Right, and we're perceived by non-US investors as a US-based firm. Even though we operate globally, we are US based, and right now, the US is the number one developed market economy that non-US people as a rule want to be invested in, and they're very open about that. So, our positioning is quite good.

M. Irizarry Great. Thanks.

Coordinator Your next question comes from the line of Brian Bedell with Deutsche Bank. Please proceed.

B. Bedell Thanks for taking my questions. Maybe just to follow on the line of fundraising in a different way. I think Steve and Tony, you mentioned the pace of deployment or the opportunity for deployment could potentially improve with the dislocation in the markets. Two questions on that, maybe first, how quickly do you think that could improve given what we're seeing in the markets and if you can comment on the US versus non-US, and then, does that give you capacity? As you mentioned, Steve, you're oversubscribed in a lot of funds typically. Do you feel that gives you capacity to basically narrow that gap between oversubscription and what you actually raise?

T. James Let me comment on the deployment. First of all, I think we're all getting a bit really focused—overly focused on a few days in the public stock markets candidly. Our business isn't really a public markets business and things don’t move that quickly. It's a long-term business.

As Steve said, we buy assets. The value doesn't come so much from the purchase price or the exit multiple. It's a value we create in the assets which decouples the investment performance from economies and markets. The fundamental picture, frankly, notwithstanding a few bad days in the market, hasn't changed very much.

In terms of the deployment level, recognize, too, that the deployment levels are already extremely high. So, do I think that they'll go a lot higher from what they've been? No, I don't. Do I think that we'll be able to have maybe some juicier opportunities and some things that are a little easier to find? We've been working hard to find what we've been finding and to be able to sustain our deployment, I do think that. So, I'm not sure I quite—and that's the same for the US as well as the non-US. I don't like to picture that different. Things are already pretty troubled in Europe and there are some credit issues in Asia. So, I don't think—that hasn't really changed here obviously.

And then, in the US, in terms of the—particularly in real estate, rents are still going up. Occupancies are still going up with the stronger economy. There's still an ability when you have a stabilized building of high-quality real estate, there's still plenty of ability to finance it. So, I think we're going to continue to be able to sell assets, and I think the amount of distress in the US is still going to be low because we're still lagging the amount of building we should have had for the last six or seven years. So, I don't know that that changes much from the real estate side.

And on the private equity side, as I said, we've been focused more on that we haven’t been doing a lot of publics to privates anyway. I think we have a ways to go frankly before those get to be very attractive. So, not a big change from my perspective.

S. Schwarzman: Just supplementing one of the areas that Tony didn’t touch on, we will see a pickup in the GSO area. They’ve been waiting patiently for something bad to happen because they have tons of money and credit spreads were so tight that there wasn’t enough juice in this to really play, but what's happening now as a result of lack of liquidity in certain types of markets – and fear is that and outflows from junk and things of that type – is that you have some marvelous opportunities, and that is actionable in the short term. There will be certain types of extensions of credit to longer-term borrowers if public markets are reduced or closed for certain types of lower-rated long-term debt, well that's like a feast for the GSO group. That's like a perfect storm for their type of business.

We were talking yesterday to one of the senior people there, and Tony and I were meeting with the group, and they said there's some individual situation, bonds went down six points yesterday. So this is like a screaming buy. And those are opportunities because we're very liquid. We can take advantage of things like that and fear, what do they say, one man's, Shakespeare says, one man's tragedy is another one's comedy. And so, I think we'll be able to deploy significant resources there in response.

In terms of what Tony was talking about, you don't have those instant changes in the M&A markets to buy companies or buy real estate. Sometimes it really helps you get a deal done when you're in the midst of something and you have a blowout and somebody's a little reluctant and you're willing to close as close to where you were, and they say oh my goodness, I've had enough, you get an occasional accident like that, but it doesn’t change the full flow of things. But to the extent that as a buyer we've closed virtually every transaction we've ever announced in 29 years, it makes us a much better buyer in an uncertain world because the seller knows we will find a way to get that deal done and somebody else might not, and so, that’s good for us from a competitive perspective.

B. Bedell Great. That’s really helpful. And maybe just one quick follow up. I know you guys talked about the realization mix between strategic buyers and private sales versus the IPO market. So, maybe if the IPO market does shut down for any reason, if the market gets worse, do you see that shift changing much more towards the M&A side from an exit perspective or do you think you might end up just being more patient and waiting for that to rebound?

S. Schwarzman First of all, the M&A side closes down periodically. It's not an odd outcome. When it's going on and it's rolling, people tend to think it happens all the time, it'll always happen.

And so, we've lived through a lot of cycles, and we switch our realizations whether they're sort of recaps, whether they're individual sales, we do what—it's sort of like a restaurant, what's the special of the day here, and you can order what they're serving but you can't order what's not on the menu. So, if for some reasons, they stock out of IPOs for sale, then we just move what we're doing, we keep compounding these companies, which as we said in the prepared remarks is going really well. And so, then we pop out periodically and we make it work then and you see much larger realizations at that time, but this isn't a world that shuts down.

T. James So, let me make a couple comments. First of all, when your EBITDA of a company is growing at 10% as they are on a weighted-average basis and you're leveraged, so in other words a lot of the capital structure is getting that equity, the accretion to equity just by waiting is very substantial. And so, we are paid to wait. Our LPs are paid to wait. We make more money by waiting as its carry grows in value. So, understand that waiting is not at all a bad thing for us. I realize the public likes first a penny today, there are two pennies tomorrow, but we get richer by waiting, and our investors will get richer by waiting.

Secondly, IPOs are not exit events. IPOs are the most volatile part of the equity market, but we have something like 40% of our private equity portfolio is already public. We can sell those shares at values that are consistent with our marks and our carries and all that. We can sell those shares anytime we want. We're not—we can do block trades. We can do secondary.

That's not the end of the whip. The IPOs are on the whip, but the irony about that is we don't sell in the IPOs generally speaking. We have an awful lot of real estate, public securities in our real estate business as well. There are tens of billions of dollars across the firm. So, that is still imminently executable into the public markets if we want to. But then I come back to my first point is the value accretion is so high, that we kind of like making more money, and that's what we get paid to do for our LPs and for our public investors as well.

Fundamentally to your question, of course, if equity markets shut down completely and if equity markets get hammered, then the percentage of our liquidations from equity markets will go down, and as Steve said, we've had years when it's been all strategic or recaps or other things or tertiary buyouts and what not and no equity, and that's fine. We're not a one-trick pony here.

B. Bedell That's super helpful. Thanks so much.

Coordinator Our final question comes from the line of Bulent Ozcan with Royal Bank of Canada. Please proceed.

B. Ozcan I have a question regarding the credit business. Can your credit business participate or provide financing to your LBOs and your private equity portfolio companies, or are there certain restrictions that reported that would prohibit you from basically providing financing?

T. James So, our credit business it varies, but you know our credit business is not one business, it's multiple businesses and very similar by business, but in general, our credit business can provide financing to our products as long as at least half of the credit is provided by third parties on the same terms.

B. Ozcan So, liquidation, it shouldn't be an issue if there's no liquidity in the market because you'll be able to finance your own deals so to speak.

T. James Well, our credit guys would only do that if that's the best available return for the risk at a moment and time. I don't want you to overstate that actually.

B. Ozcan My second question would be on performance in the credit business. It seems like the hedge fund strategies had a not so strong of a quarter but you've seen a very strong quarter out of the Mezzanine funds and the Rescue Lending funds. Could you just give some perspective on what was driving the performance comparing 3Q to 2Q?

T. James Okay. So, I actually think that the hedge funds have performed very well, frankly. Remember, this—and I think with the backups and the volatility of the market lately, their performance is going to particularly shine. The hedge funds tend to underperform when there's very low volatility in big bull markets. It's very hard for a fund that’s managing risk now and hedging to keep up with the indices. So, our investors couldn’t be happier with the hedge fund performance, and they're even happier now with that investment than they were before the recent market volatility and backup.

And as regards to the performance of the credit funds, they’ve had a confluence of a few factors. First of all, defaults have been near zero. So, they’ve made great selections of the credits. Secondly, when they make those things, they tend to get equity kickers and things like that, which have appreciated a lot.

Thirdly, as credit markets rally, two things happen. Number one, obviously, the interest rate that you put on in a higher interest rate environment, there's capital appreciation because it's a debt instrument, but then too, a lot of issuers will sometimes refinance you and pay you out and pay you a call premium and some things like that, which accrues to the benefit of our investors obviously.

Then finally, just operating performance with the underlying companies has been really good, and again, as I was mentioning before with the response to the last question, when you have a leveraged capital structure and you're operating firms, the underlying company is good, the equity appreciates a lot, the equity kickers appreciate a lot and the lowest tranche of the capital structure in terms of the credit instruments pick up credit quality very fast and therefore appreciate quickly.

B. Ozcan Just a final question since I'm the last one on the call. So, I was just wondering about your credit business. You're contemplating about spinning off your advisory business given that the valuation could increase significantly as a standalone company. Could we see this with other business segments such as credit? It seems like the market has carved so high of a multiple on the credit businesses versus part of...

T. James I know the question and the answer is no, absolutely not. I hope that’s clear. Absolutely not. There are a lot of synergies with this business. We do a lot—there's a lot of magic that makes this firm go. It's a core part of the business, and you certainly won't see that spun off.

B. Ozcan Thank you very much.

J. Solotar Great. Thanks, everybody, and we look forward to following up with Q&A after the call.

Coordinator Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.