Final Transcript
THE BLACKSTONE GROUP: 2013 First Quarter Earnings Call
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SPEAKERS
Joan Solotar - Senior Managing Director, Head of External Relations & Strategy
Steve Schwarzman - Chairman and Chief Executive Officer
Tony James - President and Chief Operating Officer
Laurence Tosi - Chief Financial Officer

ANALYSTS
Bill Katz - Citigroup
Michael Carrier - Bank of America
Robert Lee – KBW
Roger Freeman- Barclays
Howard Chen- Credit Suisse
Patrick Davitt- Autonomous
Dan Fannon- Jeffries
Matt Kelley- Morgan Stanley
Mark Irizarry- Goldman Sachs
Chris Kotowski- Oppenheimer

PRESENTATION
Coordinator Welcome to the
Blackstone First
Quarter 2013 Investor call. And now, I’d like to turn the call over to Joan Solotar, Senior Managing Director, Head of External Relations and Strategy. Please proceed.

J. Solotar

Great. Thanks, Chantilay. Good morning, everyone. Welcome to Blackstone’s First Quarter 2013 Conference call. So today, I’m here with Steve Schwarzman, Chairman and CEO; Tony James, President and Chief Operating Officer, and Laurence Tosi, Chief Financial Officer. Earlier this morning, we issued a press release and the slide presentation illustrating our results, which are also available on our Web site. We expect to file our 10-Q in a few weeks.

I’d like to remind you that today’s call may include forward-looking statements, which are uncertain and outside of the firm’s control. Actual results may differ materially. For a discussion of some of the risks that could affect the firm’s results, please see the Risk Factor section of our 10-K report.
We do not undertake any duty to update any forward-looking statements, and we will refer to non-GAAP measures on the call. For reconciliations, please refer to our press release.

I’d also like to remind you that nothing on this call constitutes an offer to sell or solicit of an offer to purchase any interest in any Blackstone fund, and the audiocast is copyrighted material of Blackstone and may not be duplicated, reproduced or rebroadcast without consent.

So, a quick recap of our results; we reported economic net income or ENI of $0.55 per unit for the first quarter. That’s up from $0.44 in the first quarter of last year. The improvement was largely driven by sharply higher performance fees from greater appreciation in the underlying portfolio assets really in every one of the businesses.

Distributable earnings were $379 million, or $0.33 per common unit for the first quarter of 2013, more than double last year’s first quarter, and we’ll be paying a $0.30 distribution to common
of record as of April 29th, which reflects the $0.33 in
distributable earnings less $0.03 in retained capital per unit.

And then lastly, we’re hosting our third Blackstone Investor Day
on Friday, May 3rd at the Waldorf in New York. We sent out
registration e-mails and many of you have registered, but if you
didn’t receive on and you’d like to attend, please follow-up with
either me or Weston Tucker after the call. And as always, let us
know if you have any questions following the call as well. With
that, I’ll turn it over to Steve Schwarzman.

S. Schwarzman Good morning to all of you, and thank you for joining our call.
It’s been a terrific start to the year. First quarter revenues were
up 29% year-over-year, and earnings rose 28% as all of our
investing business posted another quarter of great returns and
strong inflows.

Assets under management grew by 15% to a record $218
billion despite a sharp increase in cash realizations to $6 billion
in the first quarter. While many of our businesses are already
the largest of their kind in the world, every one reported another
quarter of double-digit AUM growth as our limited partner investors entrusted us with greater amounts of capital.

One of the defining characteristics of our ability to achieve this continued growth is innovation. We stay attuned to market dislocations and long-term trends that provide scale investment opportunities. We meet investor needs with unique and better solutions, and then we have the best people to execute. This is what we do here at Blackstone.

Almost $76 billion of our current AUM of $218 billion comes from new products, new strategies, and new regions that didn’t exist for us at the time of our IPO six years ago. These assets contribute meaningfully to our average AUM growth of 28% over the past 20 years, and I don’t think there are many businesses in finance that have any kind of record of this type.

We have several innovative products either recently launched or in progress. Two weeks ago, we launched the first actively managed ETF in partnership with State Street Global Advisors, a leading distributor of ETF products as you know and a well-
established retail distribution channel. The new fund trades under the sticker SRLN, and is fondly called “sirloin.” I obviously didn’t have anything to do with this name because I don’t eat red meat, but hopefully other people will.

This is an exciting new product and with our investment track record and brand, we believe it has the potential over time to become as large as some of the largest open-end mutual funds focused on bank loans. The potential on this is really very big. It’s hard to know how it will develop, but these types of products often gets into the tens of billions of dollars. So, we have an aspirational goal, though we have no idea how this will develop.

Also in credit, our new rescue lending fundraise is progressing very well, and the fund has already surpassed the size of our first fund at $3.3 billion. We fully expect to hit our $5 billion cap by the time of our final close in June, and this is a fund that is not investing. So, it’s not included in our fee-earning AUM, but will roll in as we invest over the next few years.
Recall we also hit the cap on our second mezzanine fund last year. So, the GSO team here at Blackstone is really doing a terrific job.

We raised over $3 billion in our CLO and other customized credit strategy platform, which included pricing two new CLOs in the first quarter. If you will remember, this market was completely dead two to three years ago and some people questioned whether it would revive. In fact, it's not only alive and well. It's particularly alive and well right now.

This also includes great successes we’re having with our retail business development company platform, which is raising well over $500 million in equity per quarter. That’s per quarter. Gross fee earning assets in this strategy have now reached $7 billion including leverage.

Our hedge fund solution segment is also broadening distribution channels and diversifying product offerings, driving strong capital inflows and market share gains. BAAM, as we affectionately call our hedge fund solutions area, is a clear
leader globally in this space, and reported $1.2 billion in gross inflows in the quarter and $900 million on a net basis excluding another $950 million or almost a billion dollars of April inflows.

Some of BAAM’s new initiatives include expanding our platforms to invest in special situation opportunities and hedge fund stakes, as well as developing hedge fund solutions for the individual investor marketplace.

Our real estate platform remains very active around the world and in both our opportunistic and debt strategy businesses. In April, we had a first close on our new debt strategies drawdown fund of $2 billion, and are targeting a final close of $3 billion, which is way below the demand for this product. We cap the fund at this amount in order to match its size with the current market opportunity.

Including the April close, our real estate debt strategy’s platform is now $9 billion in total, up from zero in 2008 and as I mentioned, we could have made it significantly larger. Also in real estate, we launched our first dedicated pool in Asia earlier
this year, and expect a first close in the second quarter in excess of one billion dollars.

Lastly in real estate, we continue to generate strong inflows from co-investment in our large deals, which earn fees, and we’ve raised nearly $2 billion in co-investment in the last two quarters alone. So, if you annualized that, which you actually shouldn’t, that $2 billion times four would be $8 billion, which would be raising more than the largest fund in the world other than our own just through co-investment.

One final note on fundraising, our tactical opportunities business, which is a special situations platform with a broad investment mandate across asset classes, raised an additional one billion dollars in the first quarter, bringing its total size to $2.7 billion currently. This product has received strong interest from some of our largest limited partner investors, and has the potential to be quite significant over time, which I believe it will be.
In aggregate, we raised $8.5 billion in capital in the first quarter. Central to our ability to continue raising this much is our track record of generating attractive returns and ultimately better performance than what can be achieved by our investors in other asset classes. Our first quarter performance was consistent with this trend.

In real estate, our opportunistic investments rose over 6%, or $2.4 billion in total appreciation. In terms of fundamentals, it's more of the same with ongoing improvement across all subsectors, largely on the back of limited new supply of product and moderate economic growth. Our BREP-VII Global Fund, which started investing in the third quarter of 2011, the largest such fund in the world, has already achieved a net IRR of 32%. Let me just go over that one again.

The largest fund in the world, so we’re not supposed to have good performance according to a lot of theoretical models, which has not turned out to be the case for us, and it’s up 32% net of fees. It’s really an amazing performance. All of our global funds, as well as our current European fund, are fully in
carry. Real estate's accrued performance fees net of compensation increased to $1.4 billion despite higher realization, which equates to $1.28 a share.

Our private equity portfolio, not to be left behind, rose 8% in the first quarter, with over $2 billion in equity value appreciation net of the negative impact of foreign exchange. Most of this gain was in our full invested BCP V fund. The fund, as you know, is below the preferred return hurdle. Now, it's by 9% on the total enterprise value basis, which is a good improvement from the 12% gap that we reported last quarter. So, we're not that far away from getting into carry, although it's hard to predict exactly how that will develop. The fund is now held at 1.3 times cost, including realized proceeds.

Our portfolio companies are performing well in a tough economic environment, and we’re leveraging the strength of the platform and our portfolio operations to create real sustainable value for our companies and our limited partner investors. We also tapped into the strength of the credit markets, which Tony talked about on the earlier call, during the quarter to execute
over $20 billion in portfolio company debt financings, driving substantial interest savings across our portfolio overall. These savings translate into a multiple value appreciation.

As our funds have continued to create value and post strong returns, recent market conditions have increasingly enabled us to convert this value into cash earnings for our investors. I stated in our last call that it was becoming increasingly evident we’ve reached an inflexion point in terms of realizations as long as markets remain constructive. While on a quarterly basis realizations are always lumpy, our first quarter distributable earnings of $379 million were our second best quarter ever as a public company in about the last six years, trailing only the last quarter. This brings our six-month total to $870 million.

Our $6 billion in total realizations in the first quarter is up from just over $2 billion last year. That’s three times. Our credit business was half of this amount, driven by CLO activity, as well as realizations out of our first mezzanine fund, which generated an inception-to-date return of 19%. If you can make 19% after fees in mezzanine, that’s about as good as most
people have done in equity returns, if not better. It's a pretty remarkable performance by the GSO group.

In real estate, we had nearly one billion dollars of real estate this quarter, double last year’s first quarter, generating $72 million in realized performance fees versus $9 million the year before. So, that’s $72 million up from $9 million. We remain confident that we will see a material pickup in this level later in this year and next year.

In private equity, we’ve also been active, generating $140 million in realized carry in the first quarter, up from only $4 million the year before. So, if you keep track of this blizzard of numbers, you’ll see that private equity had much larger realizations in that sense than real estate.

We completed ten equity capital market transactions, including nearly $2 billion of secondary share sales. The average multiple of invested capital in these transactions was 2.7 times your money. Any way you look at it, when you’re selling things at 2.7 times investor’s money, it compares better than the stock
market, that this is why people continue to give us increasingly large amounts of money over time to do what we do. As the M&A environment for corporates has been somewhat restrained over the past few years, we’ve seen more of a concentration towards public market exits for some of our more mature investments, though I think this will change over time given the enormous liquidity that companies have.

In addition to several secondary offerings, at the very end of the first quarter, we completed a successful IPO, Pinnacle Foods. This priced at $20 a share, at the top end of the filing range, and has since traded up further. We did not sell down any of our interest in this offering. We have a few more IPOs on file, and we expect several others in the coming quarters. So, this part of our business is doing quite well.

In summary, we’re very excited about the prospects we see in each of our businesses. We’ve launched or are launching a number of new and innovative products in every business line, and are broadening our distribution channels.
As we continue to attract more capital, our diversity and global presence enable us to identify attractive opportunities to deploy this capital, sowing the seeds for future returns. We’ve seen sharp increases, very sharp increases in cash realizations recently and in good markets, we will continue to harvest the value we’ve created, driving good returns for our public shareholders.

Our firm is in terrific shape, both in terms of growth of assets, our capital position, performance for our investors, number of new products, our personnel, which is really absolutely terrific. The people here are really excellent in what we do, and a culture where we have a sense of mission to be the best performing firm that we can be for our investors. So, the state at the end of the first quarter is a very positive one, certainly from my perspective.

L. Tosi

Okay, Steve, thanks. Blackstone’s first quarter was a record start to the year with $1.3 billion of revenue, up 29% year-over-year; on record performance fees and investment income up $739 million, which was up 57% year-over-year.
The firm’s results reflect not just the impact of a single strong quarter, but also the earnings momentum created by sustained fund performance and growth, which Steve outlined and the earnings leverage that combination generates. To give you better insight into how we think about the firm’s performance and earnings potential, I’ll focus my comments on three core earnings drivers: Capital formation, value creation, and gain of realization.

Capital formation: Over the last 12 months, Blackstone’s global marketing platform, network of LPs, and continued innovation generated $34 billion of inflows. In fact, as Steve outlined, several of our newest and largest fundraisers have resulted in the firm reaching caps or capacity, evidencing the demand for alternatives in general and the power of Blackstone’s track record and brand in particular.

Consistent robust inflows and value creation more than offset the $23 billion of capital return to investors over the last year, allowing the firm to grow 15% to a record $218 billion. Further,
despite the $17 billion of capital invested or committed across the firm, the global capital formation capabilities of Blackstone were able to maintain the level of available capital, or dry powder at $36 billion at the end of the first quarter.

Value creation: The sustained fund performance across all of Blackstone’s businesses created $18 billion in value for fund investors over the last 12 months and $7 billion in the first three months of this year alone. The value creation reflected in fund performance can also be seen in a couple of key measures of earnings potential. Total performance fee earning assets reached a record $88.5 billion across 90 distinct funds currently generating cash performance fees. That total is up from 54% in total over the last year.

Sustained fund performance also has the direct effect of accelerating accrued performance fee revenue, which reached a total of $604 million for the quarter as the base value of assets upon which we earn performance fees continues to expand. This earnings dynamic also impacts the net
performance fee receivable, which reached a record $2.3 billion, or $2 per unit at the end of the quarter.

Another key indicator of value creation is the sharp growth in total net value of cash and investments on the balance sheet, which grew over $1.50 in the last year to $5.93 per unit, up 34% year-over-year, which further creates value for shareholders. Now, onto gain realization.

Our gain realization activity over the last year has strengthened materially, which resulted in $929 million in realized cash performance fees paid, and $0.92 per unit in total distributions to unit holders over the last 12 months. In the first quarter, the firm executed 40 different transactions that generated another $6 billion in realizations across the 90 funds earning performance fees. These realizations are, of course, the key driver behind the more than doubling of distributable earnings year-over-year to $379 million, and represent the strongest first quarter in the firm’s history.
Over the last 12 months, the cash generating components of earnings, or ENI, which are realized performance fees and fee related earnings, have grown to 64% of our total earnings, up from 49% in 2011. What is perhaps most interesting about the performance is that as gain realizations and cash payouts to unit holders have strengthened considerably, the value creation elements of our balanced earnings continue to expand Blackstone’s forward earnings potential.

As I mentioned last quarter, as Blackstone’s earnings have steadily and consistently grown and diversified over time, it afforded us the opportunity to enhance unit holder value by increasing our quarterly base distribution by 20% to $0.12 per unit. We also moved to a current quarter payout policy, and accelerated the timing of that distribution. For the first quarter, our distributable earnings grew to 33% per unit and we will distribute $0.30 per unit, or three times our last year’s payout to our unit holders of record on April 29th, a date that comes before some managers even report earnings.
In a period where public equity and debt markets are impacted by a sharp increase in risk capital and historically low rates, finding and creating value in the largest markets becomes more difficult. We have consistently invested in Blackstone’s capabilities to find opportunities to create value where others cannot.

Blackstone’s culture of innovation, global reach, unmatched diversity of strategies, and trusted brand uniquely position us as a solution provider to the world’s largest pools of capital. Our public units give all investors liquid exposure to the fast growing asset classes we manage which can find those opportunities, often complex or illiquid, to create sustainable value across markets and convert that value into a consistently high cash yield.

The first quarter, again, demonstrated how sustained strong performance across Blackstone’s funds can and will drive long-term value and cash earnings for our unit holders. Joan?
J. Solotar  Great. So, on behalf of everyone at Blackstone, thanks for joining the call and we’re going to take your questions now. If I can ask if you can just keep your first rounds to one or two questions and then go back in the queue just so we can get to everyone.

Coordinator  Your first question comes from the line of Bill Katz with Citigroup.

B. Katz  Steve, I’m curious if you could flush out the retail growth opportunity. It seems like you and some of your peers are particularly focused on trying to crack into that particular area sort of, I think under your discussion of forwarding that distribution. So, could you talk about a) what your strategy is from a distribution perspective and b) what types of products are you look at here, and sort of in that construct, how you’re thinking about redemption risk as you build out the business? Thank you.

T. James  Bill, it’s Tony. I’ll take that one, and I hit this briefly on the press call, but we basically think retail opportunity is big for our
industry and for ourselves. It’s big for the industry because the total amount of high net worth assets is bigger than the total amount of institutional assets. Whereas institutions tend to have 10% to 20% of their assets in alternatives, retail tends to do one-percent to 2%. So, that shows you the scale that could be potential. So, we’re excited about that.

We’re actually hitting that. Every single one of our businesses has at least one and maybe multiple ways that they’re accessing retail investors. That might be defined by channel, or it might be defined by form of product. Form of product could be partnership, sort of special purpose entities that a distribution arm would setup to distribute LP interest in one of our main funds, or it could be publicly traded vehicles like the ETF that Steve mentioned, or like BDCs, or like closed-end funds, or like mortgage REITs; all of which we have.

So, I would say it’s across the board, it’s across the retail channels, and it’s in multiple forms.
B. Katz: Okay, thank you. Just my follow-up question; when you look at the dynamic between cash return and growth fee-paying AUM, obviously there’s a little bit of a depressant on fee-paying AUM to the extent you were very successful in generating realizations and so forth. How do you think about the ability to grow fee-paying AUM? I think it up about 2% sequentially, a little bit lower than your long-term average. If the realization cycle picks up, what are the key drivers to that growth going forward?

S. Schwarzman: What happens with AUM, when you raise a fund, you get a bump and then when you sell things, you take away from the value of those assets. That kind of sort of wave phenomena is endemic in our business. We have a lot of assets in different parts of our business.

The way you keep the business going, which is great for the people who work here because everybody gets a chance to have platforms to grow in where they can be important and grow professionally and it has a good result financially, is to expand new products, to move into new geographic areas to
the extent that all these things always have to be measured against producing great returns for investors. We just don’t do this stuff to manage to some earnings expectation. We do it if we see great opportunities to produce superior returns for our limited partners. You also grow your business by taking advantage of different channels.

And so, we’ve had for several years here, and actually much longer, a use of retail distribution that Tony talked about earlier, and that bringing our products to high net worth investors is a logical evolution. The technology has gotten better and better to do that on feeder fund side and these type of investors were typically scared to death of the financial crisis and basically went to cash, which was the exact wrong thing to do - just buy the buy. It’s a pattern that gets repeated from time....

But, putting money in our types of products yields much higher returns. I’m asked reasonably often during the year to talk to groups of high net worth financial advisors and I basically say to them, “Why would you invest in the products you normally do if you can make two to three times your money and have happier
customers if you put them into our products?” I think that’s not a sophisticated sales pitch, but it actually happens to be one that’s pretty compelling.

The people managing these large high net worth groups increasingly want to get their customers into these types of products because the customers are better served and because we’ve got not only a great array of products, more than anybody else in the world, no one close, but we also have a brand name that people can trust because we’re very risk adverse and we tend to be highly diversified in what we do. So, we’re a pair of safe hands, but with high performance historically. And so, by rolling that distribution channel out over time is another source of growth for us.

So, part of what we do is follow the opportunities to create products and move around the world in terms of gathering money. Outside of the United States, the Blackstone name is really, really powerful. It’s powerful in the United States too, but I’m saying is a differentiating item. It’s a great name to bring to a market.
T. James Bill, let me answer your question on AUM growth. So, we’ve got this kind of seesaw cycle a bit, which you pointed out, which is, on the one hand, when you go through a big realization, you start shedding AUM. And then at the same time, when you’re in your big fundraising, it’s lumpy because, particularly if you’re doing the mega funds that are the core funds. In real estate, private equity, places like that, you get big step-ups.

So, it’s not totally smooth and those things don’t always correlate. So, you’ll have flatter periods as you’re not raising a big fund, but you are divesting and then you’ll have spurts when the big fund comes in and you’re not divesting much.

I think when you smooth that out, you can expect us to have high single digits, low double-digits, long-term AUM growth, at least that’s what we expect, and I think actually the structure of our business as it grows is getting smoother in that because we’re having more and more funds that are always in the market and because some of our funds, increasingly a number of them, particularly some of the GSO and credit-related stuff,
only come in to fee-paying AUM once they start being drawn down. So, that’s a much steadier kind of thing. It’s disconnected from the big raise cycle.

But, we think in, as I say, high single digits probably is what it averages out over time, but you’ll have somewhat softer periods and somewhat spurtier periods, but it should tend towards the smoother.

B. Katz Okay. Thanks for taking my questions. I appreciate it.

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

M. Carrier Thanks for taking the question. You guys gave a decent amount of color just on the realization environment. You’ve been pretty active and it’s driving healthy distributable earnings.

On the deployment front, I just wanted to get like maybe an update. Activity across the industry has slowed a bit.
Valuations have picked up, I think you guys had mentioned when you look at valuations, whether it’s being driven by central bank policy versus fundamentals. So, where do you see the opportunities going forward just given the fairly strong move in the markets, which obviously has been positive on the exit front?

S. Schwarzman It depends on the business line that we’re in. They do have different characteristics. Real estate is just still basically, by historic standards, smoking and has not impacted that as much, although you can start seeing a little tightening there. It’s affected private equity the most.

We had a slow investment rate for the current quarter, but I don’t look at life in terms of quarters. I know you do. It’s a bit of an artifice and we look at what happens in a year or two. We missed one or two large situations where we would have ended up just putting a billion dollars or more in just one transaction and then these numbers would have looked different.
So, that’s a bit of a luck of the draw type of thing. You also need to pick your shots as to where you work and developing a product that’s more direct, well we have a number of deals going on like that as opposed to some of this auction product like Life Technologies, which we lost to a strategic, is the way you go about doing that. To the extent that the deal business picks up, that our GSO people have a lot of opportunities there with their drawdown funds. And so, a bit of this is a wax and wane kind of phenomena.

T. James Mike, let me weigh in on that. It sounded like you posed your questions on primarily private equity. I mean obviously, real estate is at some kind of huge level. So, there’s no shortage of opportunities there.

So, let me focus on private equity. We’re still seeing—prices are high as a general industrial LBO market, but we try to avoid that unless we have some kind of special sauce anyway. But, we’ve put a lot of money into energy very successfully; continue to see a lot of interesting investments there. We put a lot of money into sort of—and private companies or companies that
can’t access public markets, whether debt or equity, has been a really good place for us, both our credit business and our private equity business.

So, private credit has gotten historically higher returns in relation to public credit. Similarly, on the equity side, small companies that can’t access public markets need growth capital, want to consolidate their industry. There’s still a lot of interesting things there, but they’re smaller companies for the most part.

And then, there are still some industries which are capital constrained from the financial crisis. Those have not healed yet. The markets have not opened up for them yet.

There’s various regulatory-driven capital needs that are kind of distorting supply and demand, and creating anomalies, which we’ve been focusing on. And of course, Europe is not a hot market. There are some interesting things there depending on where you look.
So, when we look around the world, we’re still seeing plenty of interesting things to look at. We’re being disciplined. In the last 12 months, I think we’ve put out $4.4 billion in private equity. That’s probably a higher than sustainable investment pace for us. So, we don’t feel that constrained by a lack of opportunities at all.

M. Carrier Okay, that’s helpful color. Just as a follow-up; on BCP V, so you guys have made some good improvement, particularly this quarter, just in closing that gap. But, when I look at 2014 estimates and stuff, there’s a pretty wide range out there. So, I just wanted to make sure that we look at this correctly.

So, if I just take like the last three quarters since the market has rebounded, it looks like the markets had been up in that time frame from 15% to 20%. And then, if I look at kind of the equity or the fair value improvement in your performance or in that gap, it’s gone from like 36% to 22% and enterprise value has gone from like 13% to 9%.
And so, when you guys report performance, we always look at that fair value metric, which is at like that 22%, but I know you guys look at that enterprise value metric, which is at 9%. I’m just trying to like tie the two, or what we should be focused on when we look at the performance of the fund.

L. Tosi  Michael, it’s LT. As you just did the math, they’re actually the same numbers. We prefer to show the total enterprise value number because that’s more akin to what’s happening in general markets when you look at the S&P or other indicators. But you can, just as you did, calculate it on a levered basis where you’re taking advantage of the leverage and then it’s a bigger number to reach, but you have the advantage of the leverage so that the total enterprise value has to go up by less.

So, it’s just a matter of presentation. We thought it was simpler for more investors to show it on a total enterprise basis, but we give you enough numbers so you can also calculate what it is on an equity basis.

M. Carrier  Okay, got it. Thanks a lot.
Your next question comes from the line of Robert Lee with KBW. Please proceed.

The first one is it seems like every financial that’s reasonably successful or very successful has a target on it. I’m just curious. Is there anything besides the ever-present carried interest in the recent budget proposals or regulatory proposals out there that warrant you taking extra close to look at, or it could be problematic if enacted?

That’s a good question. We always spend a lot of time worrying about risk here. If you look at our initial prospectus or you look at whatever we produce by way of documents that we file on a regular basis, there’s always a list of these kinds of risks.

I don’t know that any of us think there’s anything on the horizon other than Washington-type issues that really should impact the business in any significant way given the momentum that it’s had longer-term. There’s a trend to define contribution as
opposed to defined benefit plans, which on a very long-term basis may have some impact. But to the extent we pivot to going to individual investors and more sovereign wealth funds, we can ameliorate that. We always have the risk of our own performance, which firm-wide has been really terrific. That’s something that we’re always laser-like focused on.

But, in terms of external types of things, we have a little bit of investors sometimes wanting to go direct on certain types of deals. That’s a relatively small impact to our business and we’ve grown right through that. We find new ways to partner with these types of investors and certain types of things.

So I think it really is more government-oriented things and passing things in Washington, we’re all finding out now, is pretty difficult to do. Without making too much of a political statement, it’s hard to imagine when 90% of Americans are in favor some types of background checks that we can’t get a vote on it.

So even though Washington things could have some interest, in terms of potential negative things that people mention almost in
passing, like getting rid of interest deductibility, which is just on the list of something that came up a few weeks ago, a lot of these things that make some headlines, I think, are quite unlikely in the context of the world we’re living in today to really be effective.

But that’s the area that I think from an overall point of view we worry about the most. Just doing our business and making excellent returns for our customers, that’s something we’re pretty focused on and it’s part of the firm’s culture. We don’t knowingly do anything that is straying from achieving that objective.

So I’d say on balance, from a risk perspective, it certainly appears from being thoughtful about it that we’re in a relatively low threat level to the firm in any way, expect for these types of Washington-oriented issues, and most of those we can find a way to grow through, frankly.

T. James Actually, Robert, I’d say to the contrary. We actually think that the market’s where—I think Goldman Sachs published a report
where they projected returns for the next five or tens years recently and they projected the stock market returns at like 5.5% and credit intends to stay high yield in the 3% and investment grade and government bonds 0%, actually investment grade close to 0%.

So if you think about a traditional investor that’s got to earn 7.5% to 8% to make his payments to stay solvent with no beneficiaries and if the equity returns are 5.5% and the credit returns are at best, depending on the credit spectrum, 2% and traditionally people have 60% towards equities and 40% towards debt, you’re talking about a portfolio earning 3.5% if that’s all you’re doing.

It’s a killer and it’s going to be a huge societal burden. The taxpayer’s got to pay it or you’re just having insolvent pension plans. I don’t know how society deals with that in any painless way.

The only painless way, truthfully, is to earn more on the portfolio. And the only way to do that is to move your money to
alternatives because there you can have pretty consistent, uncorrelated returns that are way above. In a good alternatives portfolio you have tons of confidence of being way above your liquid market alternatives.

And so we see it the other way. We see that the trends are inexorable. It doesn’t matter about where private equity is popular or this or that. They have no choice. There’s no better answer for society than these institutions moving substantially more capital into alternatives.

S. Schwarzman If you just look at, for example, we’ve got 1,600 basis points, long-term performance in real estate over the stock market. How could you not allocate more, as Tony’s talking about to that? To that … we’re in the 900-1,000 in private equity. Why would you not do that, increasing size?

Our credit business has earned major multiples over those areas and all of them are way above the actuarial rates. So this isn’t like a theory. This is reality. There is nowhere to go to solve the problems other than the kinds of things that are
horrible types of alternatives for society. We think our business is really extremely well positioned for the future.

R. Lee  Maybe just following up to that, one of your peers has talked about them believing, I guess, a couple years down the road, two, three, four, that it’s inevitable that they’ll find a way to put more alternative products into defined contribution plans.

Do you guys, I assume, I don’t know if you do, share that confidence? Do you see it as being a realistic potential in the foreseeable future?

T. James  Absolutely. If you look in Australia, you’ll see a lot of alternatives already in the equivalent of defined contribution plans. We’ve developed specific products right now that are going into defined contribution plans, daily marks, daily liquidity, that sort of stuff. So absolutely we’ll see that and we’re already there.
Coordinator: Your next question comes from the line of Roger Freeman with Barclays. Please proceed.

R. Freeman: Just to pick up on this last point and kind of carry this out, if you moved—I guess, how much capacity do you think there is to generate these consistently high returns?

If you look at how you generate the returns, improving the businesses that you buy, some of it's financial capital structure related, if you move the kind of money that would have to move into sort of private equity and similar investment to solve … issue, does that change the dynamic?

T. James: No, I don't think so. We haven't seen any diminution of the returns as our businesses scaled. And remember, as we grow we're not just growing the same three funds over and over and over again. We have a lot of new products.

And let's take private equity for example. When private equity initially started 20 years ago you focused on small, because you
couldn’t finance big, mundane industrial companies that were slow growing in the United States. You’d never do a tech company. You’d never to a growth equity. You’d never do a large deal. You’d never do a deal in Europe, Asia or Latin America.

The scope has widened dramatically and continues to widen. So we haven’t seen any limits to scale and, as I say, it’s not just doing the same old thing bigger. It’s really expanding the horizons and the number of things you can do well.

R. Freeman My other question would just be on proprietary data points. I’m always interested in kind of what you’re getting out of your many portfolio companies. There’s a lot of talk about more slow down again. Are you seeing that?

T. James We’re seeing, I would say—it depends on the where in the world, but let’s start with the U.S. because I think that’s what you’re primarily asking about. We’re seeing anemic growth. It is growth but it’s anemic. Europe is flat to down and Asia is growing.
S. Schwarzman  There are different areas of strengths, of course. The whole housing area, for example, you’ve seen housing starts are now a little over a million up from sort of at the bottom it was 500,000-600,000. You’ve got autos that are still doing quite well, about 15.5 million units, which are up from about 8.5 to 9 million units at the bottom.

So these areas have strength, as does the money at least going into the energy complex. That area yields more, of course, in terms of return. The commodity price for oil was $10 higher the way it was a month or two ago. But that area has really very significant strength, as people are working with the shale all over the country. It’s a revolution in terms of what’s going on there. That’s the strength of the economy.

I think what Tony was alluding to, correctly so, is that there obviously is some impact that’s being felt through the economy from the issue of the reversal of the cuts on withholding at year-end. Those reversals, no one can be sure exactly what’s
triggering what. You’ve had huge tax increases on upper income people. You’ve had the sequestration.

So economists have generally said that those refractors would have a negative impact on the economy in the 1.5% to 2% growth rate and you have some of these other offsetting factors. That leads you to a compromise growth rate.

So you don’t see the strength all through the economy the way you wish you did and then confidence levels over the last few months have been down, in large part because as you watch what’s going on in Washington you really have to shake your head. How do you maintain confidence in an optimum way when outcomes appear to be pretty sub-optimum?

So you put that together and I think you’ve got a scenario in line with what Tony’s talking about but you get there different ways and our different businesses are impacted in different ways because of that.
T. James

And if you peel back and look at it by consumer, the sequestration, the payroll tax, the affordable care act, those things hit the low-end consumer a lot harder. We’re seeing the low-end of the consumer even stepping back a bit but the high end stays pretty strong.

Of course it’s also got its regional overlay. Like for example, in England, which is doing very poorly, overall London’s rocking and the rest of the country’s suffering. So you see some funny patterns.

As Steve said, it’s not homogenous in that way and that’s reflected—anyone asking about our portfolio, because I know you’re asking about the overall environment, but you see these pockets of strength, pockets of weakness but overall pretty anemic.

Coordinator

Your next question comes from the line of Howard Chen with Credit Suisse. Please Proceed.
S. Schwarzman: Good morning, Howard, I heard you’re in the baby business. Is that true?

H. Chen: Yes, thanks so much, Steve. Steve, on realizations, the meaningful pickup and activity, particularly in private equity, just given all the value you have on the ground in real estate, I was hoping you could talk a bit more about your process of selectively calling, lining up the higher quality properties and preparing the market for just more active harvesting within real estate specifically?

S. Schwarzman: Well we’ve got a very interesting situation in real estate. We own wonderful things that appear to be going up in value a lot. So our timing of putting investments in the ground has been really good. We’ve been the largest investor in the world by far over the last several years globally in real estate.

We do sort of a regular analysis of what we think has sort of breached its improvement potential. Jon Gray has a very snappy description of our real estate business, which is buy it, fix it, sell it. So when we’re passed the fix it part of the equation
then we look to sell it. It depends where the markets are in terms of availability of capital.

At that point, if we think capital’s going to be rushing into an area then you’d rather wait a little bit because the price will go up. But we’ve got a lot of things that we’re actively contemplating. I really can’t say more than that. We’re on the good side of the cycle for sure, in terms of realizations in real estate.

H. Chen Then just my follow up more broadly on harvesting. As you said, you’re beginning to more actively harvest and yet the pipeline, if you look at your portfolio value and net accrued performance fees, they’re refilling faster than you’re harvesting.

So my thinking is maybe we’re all underestimating the magnitude of this harvesting cycle versus prior ones? You’ve seen a lot of these cycles, Steve and Tony. I’m just curious; how do you think about that?
S. Schwarzman: I'll answer that one very quickly and Tony can add. I think the issue is really the strength of the economy. If we had an economy that was really moving along, you'd see a lot of stuff being sold very quickly. Part of it is just responding to that. When the time is right there'll be an enormous volume of stuff.

In every cycle, when you get closer to the midpoint to the top of the cycle there's enormous M&A activity and it's not because we need realizations. It's the way the system works. We've had a system that's been beaten up, in part by the financial crisis, but in part by the governmental response to it and confidence being lower than it would normally be.

At a certain point that'll burn off and then there'll be a lot more. So I don't know that it changes things in a material way. It's just looking at what's going on in society. When we have great assets we want to get a great price when we go to sell them.

T. James Howard: Let me paint a picture for you. Imagine that housing comes alive and the stimulus from the energy and this U.S. economy starts growing not at sort of 2% but at 4%, which
could easily happen out a ways. We get a little inflation so the nominal grows 6%. Earnings of companies are very strong.

The stock market, which now has the S&P P/E of say 14 goes back to where it was at about 2020. The dividend yield, the S&P, which is the universe of that sort of, would go from two-ish back down to about half where it was before.

So you’ve got a very strong stock market. You’ve got corporations with a very low cost to capital sitting on a ton of cash and they want to go buy a bunch of stuff. We’ve got all these equities or real estate or whatever on leverage.

The math is simple, but if you there’s a company where a quarter of the capital structure is equity and three quarters debt and that value goes up 50%, your equity triples. So imagine what can happen in the right environment, both in terms of the dollar size but also the returns.
We’ve seen this in the past. I’m trying to think back. Back in early 2000s, I think it was our BCP III was $0.30 on the dollar and it ended up being 2.2 times at one point. So the swing back can be very, very powerful, both in scale and in returns. So we’re keeping our fingers crossed.

J. Solotar

And on top of all of that, you have new products and new funds that are first being invested. So if you were only to look at one fund in isolation, what's been said is absolutely true. But now you have areas like energy, tac-ops, next year you'll have, hopefully, BREP Asia, etc. and this is all new money going in the ground that also contributes to the ENI. So $75 billion of what’s been raised since the IPO is in new product.

L. Tosi

I’ll add one last fact, Howard, since we’re all answering, is that if look at the last 12 months, in 2005, '06 and '07 we had $1 billion of realized performance fees. We’ve achieved that again in the last 12 months.

And all the comments you just heard where we feel like we’re more towards the beginning than the end, the firm back then
was at $75 billion in AUM and now we're at $218 and the
performance fee earning asset base is bigger than the entire
size of the firm during those three years.

H. Chen  Great, thanks everyone. My only follow up, Tony, is who is
treasury secretary in that scenario?

T. James  Well, are you volunteering? Apparently not.

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

P. Davitt  Is there a large incremental operating expense investment
associated with bringing in the large Asia Real Estate Fund or is
it largely using teams already in place from the legacy real
estate business? In other words, could we expect to see a big
margin bump when that starts earning fees?
T. James  It’s entirely with an existing team. We’ve been investing in Asia for five years. We have a fully built out team. We don’t need any more bodies.

P. Davitt  And then sticking in real estate, to the extend there’s an opportunity to sell individual properties, I imagine it’s fair to assume that real estate realizations could continue to pick up regardless of what equity market environment is, particularly when you think about the size of pools of capital and the reason for the pools of capital that are forming from sovereigns in particular to buy that kind of stuff.

S. Schwarzman  You’re absolutely right. And in fact, most of our real estate exits will not have anything to do with public markets.

Coordinator  Your next question comes from the line of Dan Fannon with Jeffries. Please proceed.

D. Fannon  Tony, I think you mentioned on the media call a beginning of an M&A pickup. I’m just wondering if that’s something you’re
seeing just from the broader market or that’s actually coming from conversations at your portfolio companies or within the real estate portfolio?

T. James I was referring to the corporate market less real estate, although there’s a robust demand for high quality properties on the real estate side, as well, that’s picked up. But on the corporate side, it’s not so much from our conversations, as what we see in terms of competition for properties.

We see that through our advisory guys, the activity levels of their clients have really picked up again, the number of things they’re looking at. So it’s more observational than trying to imply that we were going to be selling a bunch of companies near term.

D. Fannon And then within GSO it does seem like they’re out marketing a lot of funds right now. Can you highlight some of the strategies and maybe the potential in terms of AUM goals within certain of those buckets?
T. James: Well, as I think Steve mentioned, they’ve got CLOs in the market. They’re working on their distressed lending fund called Capital Solutions. That will hit its cap shortly. They’ve got strategies for retail products, like a retail energy credit product.

They have a fund that does private loans and floating rate loans to companies that are small, so small business originated stuff. They have—help me out, guys. They have the ETF we mentioned. They have various SMAs that they’re talking about. The hedge fund is always open and has had great results.

S. Schwarzman: They have about seven different—

T. James: Six.

S. Schwarzman: Is it six?

T. James: Six, yes.
S. Schwarzman  Six different products that are currently available to investors. I don’t think we should be projecting for you exactly what each one’s going to get. I’ve got my own assessment and my own fantasy life, so to speak, with each one of those in terms of what they could be. I think that it’s fair to say that GSO will continue to be in a major growth mode.

Coordinator Your next question comes from the line of Matt Kelley with Morgan Stanley. Please proceed.

M. Kelley I wanted to switch course a little bit to the BAAM business. I’m just hoping you guys can give a little bit of color on the latest trends in your LP space, who the incremental subscribers are and, particularly, is that an area where you think you can get meaningfully bigger and higher net worth in retail?

S. Schwarzman BAAM gets about half of its flows from its existing investors. So we have very happy investors, and as you can tell from tracking
it, the inflows are way more than the outflows. In effect, this is a custom design business.

The days when this was all fund-of-funds business, selling a standardized product is way over. The people who have stayed in that model have shrunk and this whole industry of the “fund-of-funds” is about half of what it was before the crash.

We’ve increased our size significantly. What we do is we’re designing different types of products. We’re putting overlays on portfolios to enhance performance. We’re coming up with new draw-down products. We’re hiring more people who are capital committers themselves, and we’re evolving this model in a way that works for the largest institutional clients in the world.

T. James I would say the client base is still largely institutional but we have some retail products out there. We have a registered investment company that was started up last year on one retail system and it’s expanding to other retail systems. We’re working on some defined contribution products in that area,
which can also be embedded in insurance and other things like that, but for the most part it’s still institutional money.

In terms of the composition of the institutional money, they’ve gotten more—the U.S. investors’ account for a smaller percentage today. They’re still growing but the faster growth, I guess is a better way to put it, is coming on from the international side.

S. Schwarzman And we do all kinds of really sophisticated types of modeling to these large clients, way beyond just efficient from peer types of stuff. They, increasingly, are working closely with us and relying on us to help them with allocations within this type of area and some other types of areas.

M. Kelley Then one follow up from me, sorry to beat a dead horse. On BCP V, again, good move this quarter; still only 28% of the unrealized investments it looks like are public. So how should we think about that going forward with some of the S-1s you have on file? If you can help us understand maybe where Pinnacle or other investments have been marked prior to taking
them public so we can understand kind of the magnitude of some of the lift going forward?

S. Schwarzman I'll let L.T. handle that.

L. Tosi In concept, we’re like 9% away from an enterprise value from getting into carry. On the other hand, we’re measuring that against an 8% hurdle that keeps moving against us. So we need to create value in the companies above that moving 8% target, which actually is a little higher when you add some fees.

S. Schwarzman So one of the ways to think about it is that typically and historically, when you take the numbers L.T. was discussing, that when we tend to realize investments historically they’ve been like 25% to 30% over the mark that we have. So as you analyze the situation, and that’s a hard thing to do just based on faith, but historically that’s what it’s been.

That’s on the equity side not on the whole enterprise side. The way I try to think about this is if we continue to improve the
company and if markets are hospitable, we should have a built-in pop if the future is like the past, which gets us in a better position to eat up that differential.

L. Tosi The only thing I’d add to that is—and are you referring to the 28% that’s currently public—of the three IPOs or S-1s that are on file that Steve mentioned in his comments, two of them are relatively large investments and that would be Sea World and Michael’s.

So you could see a considerable increase in the amount that was public as those convert from our private holdings to public. It could be ten percentage points or more depending on the final valuation, if you have the starting point at 28% as public today.

Coordinator Your next question comes from the line of Mark Irizarry with Goldman Sachs. Please proceed.
M. Irizarry  I just have a question on tactical opportunities. Can you talk a little bit about the strategies that you foresee within tac-ops? As a franchise, I guess, how big that could be? And then how should we think about the velocity of money in that fund relative to the rest of the private equity franchise?

S. Schwarzman  Tac-ops is really a terrific initiative. I don’t say that in a self-congratulatory way. I say it from an opportunity set perspective for us. It’s, I think, among people who do what we do, the only opportunity for investors to buy something that basically tries to get the most interesting things that you can find in both private equity, real estate, hedge fund area and credit.

There’s nobody else who does all these things, let alone does each one of them at a world scale level like we do and has great results in every one of those areas. By combining that opportunity set and being able to look across the firm, we do a number of things.

As Tony mentioned on the earlier call, the performance has turned out to be quite good. Sort of at the moment it’s sort of in
the mid 20s, even though we were only shooting for 15. But what’s important about it is that when we work with the largest pools of capital in the world on this fund there’s an enormous amount of interactivity between us and the senior people in those institutions.

What they’re doing is they’re going to school off of us and learning how we see what’s going on within these asset classes and we have interaction with them every week or two. This is like an opportunity for them, if they follow what we’re doing and if we’re correct, which we more less have been over many years, to impact their portfolios beyond what tac-ops does for them and make major impact on the rest of their portfolio.

So tac-ops is way more important than just tac-ops for those institutions. And what we’re finding is that no matter whom we sign up for this they love this because they’re keeping up to date and learning from us and improving the rest of their business. So the potential for this, I think, will continue.
The size, I’ve got my own number, but my general council is probably telling me not to tell you, as he’s just using his hands to tell me to not go there. But it’s a product that I think is going to grow and the consumers’ happiness with it is really high. Word of mouth, as well as the strategy, is, I think, a really compelling winner.

T. James Let me just flush out some of this. It includes things like real assets, ships, shopping centers in Brazil, some different things. It includes non-performing mortgages. It would include intangible assets, royalties, spectrum, mortgage servicing rights. It could include small equity investments.

So it's got a lot of different interesting components. It's global. It’s across all asset classes. It’s focused on illiquid assets and it’s trying to take advantage of things that no one else can really play today.

M. Irizarry And the velocity of the money in that strategy versus private equity, by the name tactical you’d think it was a little shorter term, if you will.
T. James  In a typical private equity fund the investment period’s six years. This investment period’s three. So you’d expect the capital raised to be put to work quicker in general.

M. Irizarry  And then just one follow up, on the comment of having, I guess, many more funds in more places as a business and maybe fewer bigger funds than you’ve had in the past, when you look at your line up of strategies today how much investing do you have to do in the overall franchise to sort of build out the places that you want to be and the strategies that you want to invest in? What’s the outlook for margins then?

T. James  I don’t want to say there are any fewer bigger funds. It’s the same number of bigger funds. But there are, in addition, a bunch of more focused funds that are hung around that central core.

We basically have in place the vast bulk of the architecture we need for that. Like for example, in the last 12 months, Private
Equity put a senior guy in Australia. Real Estate put a couple guys in Australia. But in terms of your modeling and what not, it’s just a continuation of the past.

We’ve always invested ahead of where we need into the future and there’s no spurt of cost. If anything, I would say we’re growing some of the products into the capability we have and that should catch up. Our product should catch up to our infrastructure and not the other way around.

Coordinator  And our last question comes from the line of Chris Kotowski with Oppenheimer. Please proceed.

C. Kotowski  I was just following up to an earlier question about the exits. I’m curious; if you compare the mix of exists today, strategic versus the IPO, it seems to me most of these exists these days—are they laborious? IPO followed by years of selling down in secondaries and obviously it’s much quicker and easier if they’re strategic exists.
I’m curious; is the mix different than it was in other cycles? So if you go back to the early 90’s and three or four years after that recession, is it typical that the strategics don’t get involved until late or are they unusually gun shy here?

T. James Let me just level set here. We have four basic ways that we exit investments. Just for your purposes, we exit investments through IPOs. We exit investments through strategic sales. We exit investments through secondary buyouts, in other words, sales to another private equity firm. And we exit investments through dividend re-capitalization. So we have four basic ways of doing that.

At any point in time, there’s usually one market or another that is more robust and there always has been. So there’s no typical cycle. In this cycle, the strategics have been relatively quiet and then lately we’ve done a lot of dividend re-capitalizations and a lot of IPOs. I want to come back to the IPOs in a minute.
Let’s say before the last nine months most of the exits of the industry were in secondary sales to buyout firms. The credit markets got hot before equity did so you could do dividend re-capitalizations and you could do secondary buyouts. That’s now morphed more towards dividend re-capitalizations, if the company has a pretty good growth ahead of it, and IPOs, and that will probably morph more towards strategics at some point.

The pattern of that ebbs and flows, as different market segments get relatively more robust or less robust. I don’t think this cycle feels any different fundamentally than before in that way.

Now the one thing I want to talk about IPOs is very often—you say it’s a laborious process and this and that once you get to the IPO. I understand what you mean by that, but quite often you get public and even before you’ve done your—sometime and not so long after that a strategic comes and buys it. So the IPO can lead to a strategic exit just as much as it can lead to laborious sell downs, if you will.
And then we don’t actually mind that laborious sell down process quite so much, because usually with the IPO we price a deal to make it a good experience for the starting investors. We very rarely think we’re actually getting full value in an IPO. To the contrary, we usually think we’re selling the first piece at a bargain. Even though that’s typically above our mark, it’s much less than we aspire to sell at.

So holding that money longer, letting a good company grow and a good management team do its thing, you might IPO it at two times your money and you might aspire to ultimately realize two-and-a-half or three times your money. If you have to wait a couple years for that, an added 25% to 50% gain isn’t bad. We don’t mind that. We don’t find that laborious. We just think of that as part of the process.

J. Solotar Great. Thanks, everyone, thanks for joining the call and again, feel free to follow up Weston or myself after for questions.

Coordinator Thank you for joining today’s conference. That concludes the presentation. You may now disconnect and have a great day.