Final Transcript

Blackstone Group: 2013 Second Quarter Earnings Call

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SPEAKERS

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Tony James, President and Chief Operating Officer

Laurence Tosi, Chief Financial Officer

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

Weston Tucker, Senior Vice President, Head of Investor Relations

ANALYSTS

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Matt Kelley – Morgan Stanley

William Katz – Citigroup

Daniel Fannon – Jeffries

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Roger Freeman – Barclays Capital

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PRESENTATION

Coordinator Welcome to the Blackstone Second Quarter 2013 Investor Call. At this time, I would like to turn the call over to Joan Solotar, Senior Managing Director, External Relations and Strategy.

J. Solotar Great. Thanks, Chantilly. Good morning and happy summer, and welcome to our Second Quarter 2013 Conference Call. I'm joined today by Steve Schwarzman, Chairman and CEO, who is calling in from Europe; Tony James, President and Chief Operating Officer; Laurence Tosi, Chief Financial Officer; and Weston Tucker, Head of investor relations.

Earlier this morning, we issued a press release and a slide presentation illustrating our results, hopefully you have that, and it's also available on our website. We're going to file the 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 Factors section of our 10-K report. We do not undertake any duty to update forward-looking statements. We will refer to non-GAAP measures on the call, and for reconciliations for those refer to our press release.

I'd also like to remind you that nothing on the call constitutes an offer to sell or solicits as an offer to purchase any interest in any Blackstone fund. This audio cast is copyrighted material of Blackstone and may not be duplicated, reproduced or rebroadcast without consent.

A quick recap of our results, we reported Economic Net Income or ENI of $0.62 for the second quarter, that's up sharply from $0.19 in the second quarter of last year mostly driven by higher management fees and higher performance fees in every one of our businesses. Distributable earnings were also up $0.28 for the second quarter, that's a 73% increase from last year second quarter, and for the year-to-date period distributable earnings were $0.62 per unit, which was nearly double the prior year period.

As always, if you have any questions on anything in the earnings materials please call me or Weston after the call, and because we do have a lot of folks dialed in if you could limit your initial questions to one or two, and then just get back in the queue. Thanks.

Now I'll turn it over to Steve Schwarzman.

S. Schwarzman Thanks, Joan, and thanks for joining our call. Investors across almost all asset classes recently have been concerned about the prospect of rising interest rates, as you can tell from the earlier call that Tony was handling. It appears that markets predictably overreacted initially to the Fed's indication on when and how it might start tapering its bond purchase program.

Stock markets in the U.S., which initially declined up to 8%, have now recovered in only three weeks to regain record levels. Interest rates have started to decline slowly from market peaks as investors recognize that the Fed will act with prudence not to stifle the economic recovery.

Higher rates, as Tony mentioned, are not, per se, negative for Blackstone, as investors may have initially believed. Historically, we've performed well in periods of rising rates, and we are well positioned today given our mix of businesses and investments. When rates rise in tandem with better economic activity the result is higher cash flows for most of our private equity and real estate assets, and higher returns for our hedge fund solutions businesses. Our credit operations benefit because they tend to invest in floating rate not fixed rate assets, and they obtain higher yields on their mezzanine and rescue lending assets.

To share an example with some numbers, in real estate we looked back at periods of rising rates during the last 20 years to see the impact on values. In each of these periods plus the following year commercial real estate values rose between 4% and 15% on an annualized basis in both the private and public markets. So that question you asked Tony, in the past 20 years in each of these periods where interest rates went up on commercial real estate plus the following year commercial real estate values rose between 4% and 15% on an annualized basis in both the private and public markets.

Going back further but this time on the residential side interest rates rose in 26 of the past 50 years, and in every single one of those years when interest rates rose home prices actually increased. The prevalence of investors and their concerns on the real estate side are basically belied by the facts.

Our business and returns benefit from strengthening economic activity, and today we see pockets of significant strength in the U.S. economy including housing, auto, energy, and technology. This is offset to some degree by pressure on consumers as well as the continuing federal government dysfunction, which reduces confidence generally.

In our own private equity portfolio trends are improving, as Tony mentioned, with year-on-year revenue growth of 5% and EBITDA up 8% both in the second quarter; 8% increase in EBITDA in the quarter is a good thing. This helped drive continued appreciation of our portfolio of 5.4% for the quarter and 29% over the last 12 months or nearly $8 billion in total equity value appreciation. Make sure you understand that, 29% increase in our private equity portfolio in a year.

Our real estate business has achieved similarly strong performance so far this year with our opportunistic funds appreciating 5.7% for the quarter, in line with what private equity was doing basically, and 19% over the past 12 months. This was helped by sustained strong cash flow in Hilton, our largest investment, which grew 17% EBITDA in the first half of 2013 and now has over 4,000 hotels globally; 17% growth the first half is really fantastic.

Our hedge fund solutions business or BAAM had a positive return of 2% in the quarter, and is up over 13% for the past 12 months. This performance is double the HFR Index with only one-third of the market's volatility. As the largest allocator to hedge funds globally our scale gives us many advantages including capacity with the best managers, broad insights to market trends, and access to the best ideas.

Finally, our various credit strategies in GSO rose 5% to 7% for the second quarter despite a selloff in the last month and remarkably 22% to 42% for the past 12 months sharply outperforming virtually every benchmark for that period.

As a result of our compelling investment performance across market and economic cycles we've been able to raise dramatically more capital than any of our peers. For example, we raised $14 billion in the second quarter alone, most of which was in our real estate and credit businesses.

In real estate we had our first Asia fund closing of $1.5 billion marking a strong investor reception to our first dedicated fund in the region. We're targeting a total raise of $4 billion for this strategy, which will be one of the largest first fund raises in our history.

In our real estate debt strategies areas we raised $2 billion for our new drawdown fund during the second quarter alone, followed by additional flows in July that brought us to $3.5 billion of available capital. In late May we raised an additional

$660 million for our permanent capital commercial mortgage vehicle Blackstone Mortgage Trust, which we call BXMT, in an oversubscribed offering where we could have sold three or four times that amount. In total our real estate debt strategies business started in 2008 and is now over $10 billion in size.

In credit GSO we continue to see strong inflows in to our various products. This is a sharp contrast to the record outflows you've been seeing from bond mutual funds, which is not our business.

Our new rescue lending vehicle has raised $5 billion, reaching its cap, and this is more than 50% larger than our prior rescue fund, which also hit its cap. In fact, all of the flagship drawdown funds we've raised since GSO joined Blackstone in 2008 have reached their respective caps so the GSO team really is doing a terrific job.

Also in credit, our new ETF, which trades under the ticker SRLN, has raised $375 million since its commencement in April making it the most successful of any new ETF launched in

2013. We expect continued growth as many investors trade out of the long duration assets and fixed rate assets in to floating rate products like SRLN and the other things we do throughout GSO.

Our hedge fund solutions business reported $1.6 billion in net inflows in the second quarter despite the fact that the second and fourth quarters are the primary redemption quarters. Year-to-date net inflows were $2.5 billion. In private equity we're continuing to pursue strong LP interest for our tactical opportunities business, which raised an additional $325 million during the quarter.

In terms of capital deployment, investors frequently ask us if we can invest all the capital that we're raising with the same types of returns we've delivered historically. By the way, they've been asking that question for over 20 years. The answer is that we continue to find very attractive opportunities to put capital to work around the world leveraging our brand, expertise, and our ability to move large amounts of capital quickly. We invested nearly $4 billion in the second quarter and committed to deploy another $3 billion, which has not yet closed as of quarter end. That reflects a very attractive pace for just one quarter. As far as returns go, we haven't reduced return requirements in any of our funds.

Real estate remains our most active business in terms of new investments, and client investment opportunities remain globally with lots of distressed or open leveraged asset enabling us to buy at a discount to physical replacement cost.

The competitive landscape remains attractive with very little competition for large scale deals. During the quarter we invested two-thirds of our capital in the United States, one-quarter in Europe. We also committed to our first large-scale joint deal with our partner in Brazil, Patria, to acquire controlling interest in their nation's best-in-class branded national developer of residential lots.

In credit the low rate environment we saw for most of the first half of the year while great for realizations made it more difficult to deploy capital. However, as rates move up it's good for opportunistic credit investment. For example, in 2011 we invested approximately one-third of our first rescue lending fund in the months following S&P's downgrade of the U.S. rating.

In private equity competition remains high for new investments, but we've been able to leverage our global network and brand to source exclusive and proprietary deals. Financing for new buyouts remains available on attractive terms, although lenders have more demand for floating rate leveraged loans than for fixed rate bonds over the near term given expectations for rate increases.

The last topic I'd like to discuss is our realization activity, which is the biggest driver of cash earnings for our public investors. Realizations rose to $6.6 billion in the second quarter, up from $1.5 billion last year. I'll just give you that number again because there are so many numbers in these presentations. Realizations rose to $6.6 billion, up from $1.5 billion last year. Over the past 12 months we've had $21 billion in total realizations. Activity increased sharply in every business.

In credit we had $2.7 billion in realizations for the quarter, primarily reflecting CLO activity, as well as realizations out of our first mezzanine fund as a lot of people prepaid. In private equity we had $1.6 billion of realizations in the quarter, mostly in BCP V, which did not drive cash carried interest yet. This includes the very successful IPO for Sea World, which is priced at $27 a share, the top end of the filing range, and has since traded up another 42%.

Since the beginning of last year private equity realizations totaled nearly $8 billion, which is a really big number, as healthy capital markets have allowed several public market exits including five IPOs and 17 secondaries. We have three more private equity IPOs on file, and we foresee several more in the coming quarters.

Lastly in real estate, we had over $2 billion of realizations in the quarter; more than double last year's second quarter, generating $175 million in realized performance fees versus $21 million last year. This was largely driven by the sale of our remaining General Growth Properties stock with a 2.3 times multiple of our investment after a 2.5 year hold. If we could do that with everything that would be a very happy world and we do it with a vast number of our investments.

We also announced the sale of our EDT retail portfolio to DDR at a multiple of our $350 million investment of approximately two times, and that was double the money we've earned for our investors after only a one-year hold. We expect this sale to close in October. The capital is fully recyclable as it's in our BREP VII fund.

Looking forward, we remain confident we'll see further acceleration in activity later this year and next year. In fact, this morning we filed an IPO of Brixmor, one of the largest grocery anchored shopping center companies, which is our third largest real estate investment.

In summary, we feel great about our business, which we believe is greatly positioned in the alternative investment area as the only firm of its type with world scale operations in real estate, private equity, hedge funds, and credit. We've raised over the last two years more capital than our four closest competitors together. Our team is extremely experienced with an unalterable commitment to excellence in all we do. I continue to believe our stock is significantly undervalued.

With that, I'd like to ask Laurence Tosi (LT) to take over with a review of our financial results.

L. Tosi Thank you, Steve. Good morning, everyone. By almost any measure it has been a record start to 2013. Blackstone continues on a steady trend of industry leading growth as total AUM reached a record $230 billion, up 21% year-over-year marked by $42 billion of inflows and $25 billion of value created together which far outpaced the $28 billion of capital returned to investors over the same period.

Each of our investment businesses again saw double digit increases in AUM as every segment ended the quarter at record levels of assets. Our sustained growth is the result of both our ability to achieve returns for our fund investors and to continually innovate new products and ideas. We leverage the leading scale and performance of our core global funds, which serve as anchors to launch adjacent complimentary strategies. This competitive advantage is evident in our strategic efforts in the high-net worth channels.

While you may have read about recent forays in to this fast and growing segment by industry competitors, Blackstone has invested heavily in this market for several years. As a result of those efforts, today we have an efficient scaled distribution effort and have created one of the fastest growing capital sources for every single one of our businesses. In true Blackstone fashion virtually every senior manager in the firm has personally dedicated time and effort to developing this channel and the platform we have built has raised more than $14 billion of assets including $5.4 billion raised in the past 12 months alone.

The Blackstone brand and historical performance are compelling to this market as evidenced by our last several fund raisers literally selling out on some of the world's biggest retail channels. As Tony highlighted this morning, we think we're in the very early stages of the impact that this channel can have on the firm.

Turning to earnings, Blackstone's diversity and fund outperformance overcame market headwinds in the second quarter. Revenue for the first half of the year reached a record $2.7 billion, up 66% over the same period last year, and earnings nearly doubled to $1.3 billion at a 50% margin. The main driver of revenue was fund performance, which produced 150% increase in performance fees to $1.3 billion for the first half of the year, also a record. The fastest growing component of Blackstone's earnings continued to be realizations, which helped double distributable earnings to $730 million for the first half of the year.

Some further observations and facts about Blackstone's second quarter and first half results: At quarter end the net performance fee receivable, a key forward indicator of earnings, reached a record $2.5 billion. In real estate the net performance fee receivable is now $1.6 billion, as $30 billion of assets are generating performance fees and an increasing favorable environment for realizations.

Private equity now has $633 million of net accrued performance fees with $500 million of that in BCP IV, which is 47% publically traded. Additionally, BCP VI and BREP (our energy fund) are both accruing in full carry and are 28% and 48% public respectively.

Our 2007 vintage fund BCP V continued to make good progress towards the preferred return threshold. In the last year BCP V created $5 billion of value, almost having ($3.7 billion) the amount needed to reach the carry threshold.

The credit performance fees grew 80% year-over-year proving that business is not only largely isolated from rate rises but actually grows and benefits in the current and expected rate environment.

In hedge fund solutions 96% of eligible assets are now generating performance fees in the first half of $100 million, up five-fold, which also drove an 80% growth in first half earnings.

You should remember that incentive fees in hedge fund solutions and our credit hedge funds accrue through the year but are largely earned in the fourth quarter from a cash realization perspective. Currently, we have $0.14 per unit accrued in the first half alone based on the strong performance of those funds.

Additionally, advisory posted a strong quarter, particularly in restructuring which had one of the best starts to a year in its history. Our strategic M&A and fundraising businesses all posted double digit gains in revenue versus the first quarter.

The strength in fundamental earnings has also impacted the firm’s balance sheet, which includes a total of $7 billion in net assets or $6.31 a unit in the second quarter, up nearly 40% over the same period last year.

As part of our continuing effort to lead in terms of transparency and unit holder alignment we announced today that we would no longer reduce distributable earnings by the non-cash expense associated with equity related awards. These awards consistent with GAAP have always been part of our historical compensation expense and ratios, and that will not change. Cash distribution, however, will no longer be reduced by this expense, which added $0.01 per unit to our distributable earnings and cash payout this quarter.

This new policy would have added $0.08 a unit to distributions for the full year 2012 with $0.06 of the $0.08 coming in the fourth quarter when most of these awards are made and expensed against earnings. Historically, these awards are 8% to 9% of fee-based compensation, and we expect that to remain the case with respect to timing and amounts. The historical impact of this increase to distributable earnings can be seen on Page 30 of this morning's release in detail.

I should also point out that over six years since we went public our share count has only slightly increased by 38 million shares or 3.4%, roughly 60 basis points a year.

In closing a few key data points to consider, over the past five years Blackstone has nearly doubled assets. We've increased earnings nine-fold at 56% compound annual growth rate, and distributed $3.5 billion of cash to investors including $1.3 billion in the last 12 months alone.

Looking forward the key drivers of future performance demonstrate the momentum behind our positioning against a dynamic market backdrop. We now have $95 billion in performance fee earning assets, up 63% year-over-year across 100 different funds and vehicles providing a broad base of earnings power for future value creation.

We also have record dry powder of $39 billion, up $3 billion year-over-year despite $16 billion in capital deployed over the last 12 months. And finally, we have $17 billion in committed capital not yet earning management fees, and several scaled fundraising initiatives underway.

On behalf of everyone at Blackstone, we thank you for your time and joining this call, and we welcome any questions you may have.

Coordinator Instructions given.

J. Solotar And just a reminder, if you can limit it to one question first go-round, and then queue up just because we have a long list.

Coordinator Your first question comes from the line of Matt Kelley of Morgan Stanley.

M. Kelly So just curious, the commentary on the real estate investments was really interesting, so it seems as though, especially given … where the lifecycle for a lot of these real estate investments had shortened, so I'm just curious, Steve, to get your view on how close we are to—and I know that's a broad statement but if you think about it in real estate portfolio how close we are to getting back more regular, normal, as you think about it, lifecycles for these investments or if we're still in kind of a very short lifecycle when you think about spending them?

S. Schwarzman I don't think our lifecycle has changed materially. What's happening is when we buy things, I guess, our approach is buy it, fix it, sell it, and that happens over periods that vary slightly with changed in economic activity. So you're seeing that accelerate in the U.S. because we started buying very large amounts of real estate really about three years ago in real scale, and we've been the largest purchaser in the world with vastly exceeding multiples of anyone else.

The cycle is changing now in Europe where that will be an investment cycle that will take longer to come out of by the nature of the underlying European economy, which is evidencing virtually no growth. Asia will have another cycle still because it's continuing to grow but its experiencing real estate credit shortages as some of those economies grow slower and the economies generate other problems besides just real estate developers who can't sell out projects.

I don't think we're experiencing something slower; we're just dealing with the maceration cycles in different geographic areas.

J. Solotar And as it relates to the hold time itself I think it's fairly typical when you're buying at distressed assets the rise can happen faster, and so the hold times can be shorter. As we've talked about, for assets that were bought in '06, '07 perhaps the hold time there has been longer than typical.

T. James I think you'll see in general across all of our business in rising markets what happens is that we make an investment we have a target value we think is sort of intrinsic value, and we try to buy below intrinsic value in down markets. Then in rising markets sometimes the values get up to that level quicker whether it's private equity, real estate, credit, all of them, and so you'll see holding periods come in a little bit in rising markets and extend in declining markets and it kind of depends on how quickly we can get assets and realize what we think is their intrinsic value.

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

M. Kim Just a follow-up on the real estate fund, can you just talk about the thinking behind the Brixmor IPO filing, particularly as it relates to your outlook to real estate more broadly? Is this kind of the first step of the exit strategy where you're selling down sort of the ownership stake over time similar to the process you typically follow on the private equity side, and does that suggest you still see more upside here to come broadly speaking?

T. James Let me tackle that, Michael. First of all, I can't comment on Brixmor. As you know, it's publically filed so we're very limited in what we can say on that. But I think one of the things about real estate is we have the option to both take some of these platforms that we've created publically, so Brixmor the bulk of it was bought in one thing but then we've added on other pieces and we have a management team there so it could be an offering company, but also depending on the asset you could also sell off assets piece …. We have a lot of flexibility as to how we do that.

I think there's still more value to come in real estate but there are some assets that are getting near their intrinsic value, and when it's a public stock you kind of got to go public. We actually try to price our public offerings at a bargain to the initial IPO buyers so that the stocks trade up and people are happy. We don't generally sell much or any of our ownership when it actually IPOs. Usually we take it public a little bit in advance of the time we actually expect to be harvesting most of our capital, and at lower prices than we want.

S. Schwarzman And Brixmor, we bought this company during the financial crisis, and the company didn't have as much ability to invest in tenant improvements, vacancies were up. We made those investments and vacancies have improved and that's a more normalized type of business at this point and it's appropriate to take that in to market where it should trade in a satisfactory way.

M. Kim And then if I could just follow up with one quick one for LT. Anything notable on the expense side this quarter, particularly looking at base comp is there any lumpiness related to maybe a pickup in fundraising activity that we should be thinking about in terms of trends going forward?

L. Tosi No I think it was a relatively ordinary quarter. Any of the anomalies were really quite small and it wasn't related to fundraising. It's the same comp ratio year-over-year. I would say the business mix is a little different because advisory had a stronger quarter.

S. Schwarzman We have done a lot of new hiring and a lot of that is extending in some of these … to support the growth you've seen but also to support future growth initiatives that we have that we're just starting to roll out.

Coordinator Your next question comes from the line of Dan Fannon of Jefferies.

D. Fannon I guess to start maybe if you could comment on M&A broadly why it's kind of been lackluster from an industry perspective and thinking about it maybe from the perspective of your portfolio companies and their appetite to do deals in this environment it just seems like we've been waiting for M&A to pick up and it's just taking a long time.

T. James Okay. Well, I agree. Why, you probably have as much an opinion as I do. My own view is companies are uncertain about their futures, and I think a lot of that uncertainty M&A is from regulatory in Washington, frankly, and we're talking about the U.S. and the rules are changing. They're not sure what that does to the economy. Are we going to have another crisis over the debt ceiling in the fall? What's that going to do? One thing or another so I think companies in the U.S. are sitting on the sidelines. They're happy to be in cash. They're happy to be secure, and I think that's one factor.

Then I think some of the exciting markets that people are all hot about, generally speaking the brick markets, are all showing issues right now, all four of the BRICs are. A lot of the acquisition activity that corporations have done has been to drive growth, and a lot of it has been to make investments in those markets. Those markets are looking like they have some issues.

I think M&A is going to stay restrained. Now, our portfolio companies, in general, don't do a lot of M&A except around the ones that are consolidation plays. Those continue to rollout and continue to make consolidating acquisitions but they're small. You're not going to see those in terms of moving the needle and getting a lot or any press.

Coordinator	Your next question comes from the line of William Katz of Citigroup.

W. Katz	Could you give us an update on the retail initiative? I think at your Analyst Day you mentioned you sort of "cracked the code" of an opportunity to bring the hedge fund in to the mutual fund wrapper, and that was expected to rollout in June. Any update there, and I do have a follow up?

J. Solotar We actually announced this week that we will be rolling out a product. We can't really talk about distribution partners and all that yet. You'll hear from us in the future, but it's a product that we're really excited about. It took a very long time to figure out. We think we're unique in the ability to execute this the way we are given our positioning in the hedge fund solutions space, and it's an exciting product. It's probably a bit early to say much more given that the rollout hasn't happened.

T. James But what we can say is essentially for retail investors it will give them access to some of the leading hedge fund managers but still preserve their ability to have daily liquidity and daily marks. That was a bit of the trick is commutating both of those things and we think we've done that, and we have a strong distribution partner. We hope it works and it will be well-received.

W. Katz My follow-up question is just in the hedge fund solutions business I'm sort of curious if you look year-on-year I think volumes are a bit down this July versus a year ago. What's the general appetite for that product set at this point in time in the institutional channel? Are you seeing any kind of … in that business?

T. James No. I think it's exactly the same picture we've seen. In fact, in general that business is just a lower risk way to participate in markets so that business shines when markets get lumpy, volatile, or in terms of relative performance go down. When you have very hot bull markets it lags a little bit.

I mentioned in my press call that just in the second quarter when the global equity markets were down about 2% our hedge fund solutions composite was up about 1% so in one quarter 300 basis point outperformance. We do that with, generally speaking, somewhere between one-quarter and one-third of the volatility of the public markets. If you look at how that product has performed in the ten worst down months of the last five years I think our investors have about broken even in those months whereas the public markets are down high-single digits on average in those months.

It’s really sort of the lower risk way to play the markets. While it might lag the performance a little in the up markets when you look at the relative performance of that product versus the public markets through the full cycle because you don’t have the down lags even if you give a little on the upside we tended to outperform public equity markets with lower risk. That’s the beauty of that product.

As investors we’re really positive and really ebullient at some points the flows just might slow down a little bit, but we’re still getting great reception across the board.

J. Solotar Yes. If you look at just comparing because there’s seasonality I think it’s good to look year-over-year. This year second quarter we had net flows of about $1.6 billion, last year second quarter we had net flows of a little over $400 million so we’re not seeing momentum slow.

L. Tosi … earnings are up … assets are up 18% year-over-year and I also think what’s important with this business—and as Tom went through on Investor Day—a key trend that continues is a lot of the inflows and strengths are towards their customized products and some of their newer strategies that they're rolling out. That very positive trend for that business and really for the stickiness of their assets … continues.

Coordinator Your next question comes from the line of Howard Chen of Credit Suisse.

H. Chen I want to go back to where Steve began on higher rates and Tony where you spent much of the morning. I agree it's been an area of focus for the investment community. Specifically on realization and fundraising activity do you think higher rates alter your view of timing of the harvesting cycle if rising rates come with higher growth expectations, a change in tax rates, et cetera? Second, do you believe in LP allocation behavior changes in a rising rate environment, you know putting aside all the mega trends that we talk about?

T. James Okay. Let's see, if higher rates are connected to stronger economic activity I think it's a net positive across our businesses both for the portfolio and for new investing. If higher rates come in a weak economic environment that would be—I don't see that happening but I might give a different answer to that. Then part of it is what happens to the equity markets. If higher rates associated with a much lower stock market that would negatively impact realizations. If rates go up gradually and associated with stronger economies and a strong stock market then that wouldn't. It's not just rates I guess is what I'm trying to say. It kind of depends on what's going on with the other factors.

On balance I think we're really well-positioned in our portfolio of existing assets to benefit from the conditions that are likely to prevail when rates go up, and higher rates will definitely help us on new investment activity. Then we have a lot of products, which actually benefit from higher rates because they're floating rates like our BXMT, our Blackstone Mortgage Trust, for example it's all floating rates. Higher rates, higher dividends for shareholders, the value should go up it shouldn't go down. It's kind of a mixed picture.

In terms of the impact on LPs, again I don't see it changing their allocations. I mean they're expecting not to earn very much on fixed income so I suppose if rates went up high enough fixed income would look attractive, but on the other hand they'll take a lot of mark-to-markets. It will be very, very painful. A sharp and significant increase to rate is probably not good because like markdowns that will get in to asset allocation issues and they'll look at fixed income as having a more attractive go-forward return.

Based on the surveys we've done on LPs they've been thinking that Treasuries and investment grades will—future returns will be somewhere between zero and 2% on their fixed income portfolio. They've been thinking that as equity markets go forward returns will be something in the 6% range. So no matter how you mix those 50/40 or two-thirds/one-third, no matter how you mix them, what mix you put on public securities, you get low single digit returns if you're a big institution, and that just doesn't get them there. If you're a pension fund that doesn't pay for your liabilities so that's why they're shifting to alternatives, and I don't see rates going up enough to change that.

H. Chen And my follow up is we saw some further payoffs on the securities underwriting business with participation in Pinnacle and Sea World being notable ones that stick out to us, so was just hoping for any postmortem thoughts you all had on how that process went for you and ultimately where you see this evolving to.

T. James Hang on, Steve wants to make a comment first, and then one of us will get to that.

S. Schwarzman Along this interest rate comment, people get very worried about this and the type of worry that's appropriate is a Volcker-type of reaction to inflation where in the early 80s Volcker just broke the back of inflation by driving rates to a point where the economy faltered, and he got inflation under control.

When we talk about rising rates in this environment we have extremely low levels of inflation, and so rising rates ought to be a very moderate type of phenomenon and it's clearly being micromanaged by the Fed to not really hurt an economic recovery.

In that type of world, what Tony is saying is absolutely true and as you look at the firm's performance over years, you'll see that because we're such large owners of the operating assets at the firms who are assigned that we do much better when those assets earn more money and the economies are growing than we do with any minor movements in cap rates in real estate or multiples.

To get multiples to really come in in the stock markets you've really got to jam on interest rates and I don't think the pre-conditions for that actually exist today, so I can foresee with a gradual increase in rates exceeded by a growth in the economy, that's a good thing for us and it isn't a supposition. It has always been a good thing for us at the firm.

Okay, so, again, your question about how we feel about the IPOs we've done, I'd say we never feel the public markets really quite appreciate the beauty of our children, but I would say generally speaking that the experience has been good and maybe it's just because we went through a period of time where the experience was terrible and so it's just much better now.

And terrible only in that it's very hard to get on public, the prices were low, it just kind of felt like a battle. And then a little while later the stocks are way higher and you just feel like you didn't have very good execution on the IPO process itself. Here I think we feel good about it. You know, we did PBF, the refinery company; we did Pinnacle Foods, we did SeaWorld;... did a residential mortgage REIT, we did our own mortgage REIT. We've got some other things coming out of real estate and private equity.

So, I think, all in all, if these markets hold up in this environment we feel very good about it.

H. Chen How about your view of your role of securities underwriter, as you're expanding that business a bit, how do you feel about traction there on some of those transactions?

T. James We're really pleased with that, actually. As the capital markets advisory, it's added revenues and it's kind of another little line of business for us, which is quite profitable and so on, but what makes me really pleased about it is I feel like we're getting much more insight into the IPO process, much better ability to actually do for our limited partners, much more informed and we have more expertise internally to make the right judgments when the chips are down.

So, I think it's a win-win; it's a win for our shareholders, it's a win for our limited partners and that's worked out really well.

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

M. Irizarry Great, thanks. Steve or Tony, maybe you can give a little more color on the operating performance in your real estate portfolio between hotels and maybe office properties and then I'm curious, as rates move higher what impact, if any, did that have on the valuations and when you think about the operating characteristics, whether it's RevPAR or rents, just how much flexibility in the real estate portfolio is there to see sort of an incremental uptick as growth improves in the operating characteristics of the real estate portfolio?

T. James Okay, well there's a lot of specifics there, so, in general, in our real estate portfolio, let's just start with that, appreciation of 5.9% last quarter was driven by the operating results, the NOI, not by changes in cap rates and things like that. Now, we do have some public holdings in that, which move around in public markets as well.

On the cap rates, cap rates have been low, really because base rates are low, Treasury rates are low, but the spreads over the base rates has not been low. So, as the economy goes up and as the real estate market intrinsically gets stronger, and with construction so limited, of new construction, I would expect spreads, as base rates go up, spreads come in a little bit and cushion the glow of higher Treasury rates if that happens.

And then, at the same time, you're getting the higher occupancies and the higher rents and the stronger outlook and so I actually think that scenario of an improving, just as Steve was saying, that scenario of an improving economy, especially with somewhat higher interest rates net-net will play through the portfolio to add value. I think that's important.

As for specifics, the hotel RevPARs are averaging up about 6% the last quarter. The office, I'd say every market, every single office market is improving, some are improving faster than others, some are sort of flat-ish, but every single one of them is improving to a greater or lesser degree.

When I look at the retail, well, you can see the growth reactive centers with bricks and mortar, you can see how that's doing, but all of the retail businesses, again, all retail sales look like they're coming up across the board as reflected in our centers. Warehouses, another industrial as we call it, it's another big area, again, all across the board coming up.

And then housing, obviously, is a big one, too, for us and I commented on that earlier, but, again, prices going up over 1% a month. So, I think it's pretty much across the board. We can dig into whatever methods you want and whatever asset class you want, but the pictures are saying that it's not only across asset class, it's the same in Southern California or Northwest or Boston or Washington, just sort of all the markets we're in it's the same picture.

And it's really driven by the fact that it's just very, very limited new supply and it doesn't take much economic growth to drive this and we've got enough economic growth and we've got enough with supply to have this look like a very favorable supply/demand now for several years because the new supply can't come on overnight, particularly if you're talking about office, it takes years.

And so we've got pretty good visibility on the runway and it looks pretty good for the next few years for us.

J. Solotar — And I think to add to that, what's also part of it is that the increases are good increases on top of what were large increases last year, so it's not like you have easy comparisons. We've just continued to see good growth.

T. James — As Steve talked about, I think where EBITDA is 17% for the first quarter, so it gives you a flavor for what can happen.

S. Schwarzman — We keep probing, when Tony and I meet every Monday with our real estate group about economic... because it's a potential indicator for us to help think through issues with other of our business lines and as consistently as we ask the question, are you seeing softness here or are you seeing softness there, the answer that comes back is no, we're not.

Things are good for us. It's a very straightforward, snappy reply and Tony gave you the pieces of it, but there is a sense of what we're seeing empirically that things are strong in that area.

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

M. Carrier I'm interested on the new opportunities front. You guys mentioned on the retail side the hedge fund product. Just given what you've done so far in the retail channel, when you think about that opportunity, you mentioned you're kind of at the beginning stages, is it more of a distribution opportunity, meaning continuing to gain traction with the current products or are there other product opportunities on the innovative side that now that you've done a decent amount of due diligence you can kind of plan ahead and so where are those areas?

And then just on the recent strategic partners deal, are there any other opportunities like that for Blackstone, to kind of take advantage of and then use that to grow your own business?

T. James So, it's both existing products and it's existing forms being offered to retail investors as well as new products and new forms. It's very hard to say. None of us would look at the retail market as being homogenous. You can say on the market and some of them are family offices where we talk to the CIOs of family offices and that feels an awful lot like an institution and they'd be very similar to existing products all the way down to sort of closed end funds or mortgage REITs where an unsophisticated investor can buy 100 shares for a thousand dollars and it's everything in between.

And so, on top of that we're thinking about new structures and things like that to embed our products in other things. And so, it's really across the board and, as I mentioned, we're at the early stages of that. And I'm not sure that totally answers the questions, but maybe just get to your second part and then you can come back if I didn't.

And strategic partners fits really well into that I think. Strategic partners, it's a great retail product, it's a great institutional product, too, but I think it really appeals to retail investors. Why? Because when they start drawing down money, they instantly start paying tax returns every quarter after that because they're buying mature funds that are in their harvesting period.

So, an investor gives money and he starts getting "yield" right away and the investment cycle is quicker, they get the money put to work quicker and they get it back quicker. And that appeals to retail investors that care about liquidity, care about current yield. And the fund returns have been spectacular. So, I think that's a really good retail product.

One of the real appeals we saw in that acquisition, they were part of Credit Suisse and they had access and great support from the Credit Suisse retail system, but, of course, they weren't getting distribution from any other retail system for obvious reasons.

As part of Blackstone we expect to be able to continue to distribute to Credit Suisse's investors, but also to other firms investors and so that's I think one of the synergies, so to speak, that we identify. And it's a great product and it doesn't overlap with anything and it has wonderful consistent top quartile returns, sort of like consistent with private equity, so a good product.

Other acquisitions, yeah, we've got some other things that we're looking at, nothing that we're close to doing, but I think conceptually there are some interesting things out there.

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

P. Davitt We've seen BCP5 IRR go from 2% to 5% in just six months, largely I think on the back of the two very successful IPOs. I estimate they're both roughly 10% of the fund. My question is can you give us an idea of how many high concentration slugs there are left in that fund to really help boost the IR over that 8% bogie?

T. James Well, I don't know how many high concentration funds; the biggest investment in that fund is Hilton, so that's, obviously, one. I'm not exactly sure how to otherwise answer your question in terms of the number of them.

I would say, though, everything in that portfolio has got upside, in my view. We try to mark it conservatively. When we get in there and execute it almost always is a big increase over our mark looking at LT. What do you think the average increase from when we hit a realization then versus the prior quarter mark?

L. Tosi We looked at it for 10 years and it's cost between 25% and 30% and in a better market like this time it's even higher. So, if look at SeaWorld in performance, one was up 50% and one was up 70% versus our mark in the prior quarter before the IPO.

J. Solotar Recently, you probably saw there was an announcement of an acquisition of one of our publicly traded Team Health; Vanguard, sorry, where a year ago it was trading at eight and we had an all cash bid for 21 and that doesn't get factored in, obviously, into a month.

T. James The problem is these companies, they're lean and when revenues start to grow again a lot falls through the bottom line and then you've got leveraged capital structures and that value creeps to the equity really, really fast, so BCP3, I think, at some point it was marked down to less than half of I think cost and it ended up being over two times cost.

So, there's a lot of upside in these portfolios when the world turns.

P. Davitt — On the mechanics around the cash distributions and if that gets over the 8%, say you sell a few slugs of shares in SeaWorld over the next few months and then you get over that 8% will there be a huge slug of cash to come through the distribution when that happens or is that not how it works?

T. James — There are two separate questions there. One is for the fund investors and then one is for the public. When the fund itself starts accruing performance fees and then the realizations after that you'll begin to see the cash realizations push through to the public investors.

Today, given the activity in the portfolio, when we were talking about the increase of $5 billion over time, just to give you an idea, over the last 12 months there's been about $3.4 billion of cash in different ways returned to the investors in that fund and that's either from realizations, capitalizations or current income.

So, that level is already occurring at an increasingly rapid pace and once that does you can see the hurdle; once you get over the hurdle then you'll see the accruing of carry at the parent company and then you'll see it also go through to cash.

S. Schwarzman And don't forget there's a little bit of an odd thing that happens when you get over that hurdle for a while. You may have a cash out period where a disproportionate of the net gains go to the shareholders and the real estate had that a couple of quarters ago, so you've got some not totally linear things happing around the hurdle.

P. Davitt Right, that's an 80/20 catch up, right?

T. James That's right.

Coordinator Your next question comes from the line of Roger Freeman of Barclays. Please proceed.

R. Freeman Back on real estate, it sounds like maybe with the improving economic environment and the supply dynamics you've got a pretty positive outlook on valuations seen. Is the time frame over realizations of the real estate portfolio, has that maybe gone out a little bit from where it was six or nine months ago? It seems like there was more focus on sort of nearer term realizations. Maybe that's just...

T. James If so, I'm not sure it was a fair impression. I don't think we have; it's hard to forecast very specifically realization events and we really don't do that. We have a general idea of how a property is maturing and when we expect it to go market.

I would say in a couple of instances things have popped a little sooner in real estate and in some instances there are assets where it might take a little longer, but I don't think it's fundamentally changed. But it's lumpy. We're in a period of time where you can expect to see real estate realizations growing and a fair amount of them over the next 12 to 18 months, but predicting which quarter and what order and what kind of ramp is just not doable and it's too market dependent.

L. Tosi It's helpful, Roger, just to Tony's point, so obviously it's a longer cycle over time, but what we tend to look at from a trend basis is kind of the gross realizations, whatever that may be, it may be capitalizations, it may be current income, it may be sales, and we'll look at it over a relatively long tail. And on that basis, the number of transactions and actually the realized amount has increased quite steadily.

Let me just give you a couple of numbers, I'm going to give you for the whole firm because I think this question has been asked in different ways over the course of the call. Just to give you an idea, in the first half of 2012 we saw 64 deals produce cash generation of about $4.5 billion.

In the second half of 2012 that number went to 86 transactions and $80.6 billion. In the first half of this year, it's been 105 deals and $12.6 billion. So, while it's very lumpy, as the fundamentals increase you can start to see a longer term trend and you have to look at it that way. And, by the way, real estate followed that.

So, they basically doubled the amount of transactions in capital over the last 12 months that's actually generating. When it will happen, as Tony said, hard to tell, but that steady trend is increasing. You can see it in our numbers.

T. James	And we're still in the virtuous part of the realization cycle in a general way.

R. Freeman	Okay, that answers the question very well, thanks. And I guess, the second one on just back on this regional product and you can't say a lot, but as Tony already mentioned distribution partner. Is it one partner? And is that going to be an exclusive arrangement?

And secondly, on the earlier call, Tony, you were talking about a dynamic as providing daily liquidity, but investors also having to, I guess, understand, take some limits on that to sort of get access to the higher returns the hedge funds can offer. How does that play out? Will there be daily limits?

T. James I don't think I said that, actually. And I can't get into the terms right now and, frankly, I don't even know all the details of it, so I really can't go further other than to say it combines, for this purpose until it's fully unveiled I'd just like to keep it; it allows investors to have a daily liquidity feature that they want, but it gives them access to some top hedge fund managers, which they also should want and we hope they will.

Coordinator Your next question comes from the line of Jeff Hopson of Stifel Nicolaus. Please proceed.

J. Hopson On real estate, you mentioned that in terms of your investing opportunities that there's still a fair amount of distressed companies out there. Could you expand on that a little bit and even on the leverage this year or over leverage this year? I would expect perhaps the ability of the current owners to, I guess refinance, but any additional comments on that issue?

T. James Well, I think in the U.S. that's happening. It's not like all the distress is gone by any means, but markets are healthier, properties are doing better and the markets are very accommodating. So, in the U.S. that's starting to happen and there's definitely less distress than there was a year ago.

In Europe, though, I don't think that's happening and to the contrary, there's been a lot of distress in Europe, but the spigots are starting to loosen up in the sense that people are starting to face that and want to sell assets and want to move assets.

And also there were a number of, in some cases, there were a number of sort of temporary patches put on where creditors cut a borrow some slack or expanded some things and those are coming up again and borrowers are having a hard time renewing that.

So, what we're seeing the banks start to sell more in Europe and that activity level is high. And then I would say in Asia, it's a bit different. There's the well publicized credit squeeze that's going on in China, but it's also happening in India and it's happening in Brazil and it's happening in some other places and so the real estate financing is kind of drying up in those markets and that's opening up some opportunities.

So, it's kind of the locus has shifted a little, but in the U.S. I think your perception is right. Distress is waning.

J. Hopson Okay. And then in private equity, post-Q2 despite some volatility in the equity markets, it almost seems like the environment for realizations, at least through the IPO process seem to have improved given that, one, equity markets have rebounded, outperforming some other asset classes and some of the IPOs having done well. Would you say that post-Q2 that the IPO process of realizations has actually improved a little bit?

T. James — It depends on what you're comparing it to. It was pretty good in the beginning of Q2 and then, of course, June was a little bit choppier and how it's back to where it was, so I think it's yeah. So, I guess compared to June it's definitely improved. I don't know that it's much different from sort of the April/May time frame when it was pretty good.

J. Solotar — Just generally speaking if you looked at markets in the third quarter to date they're all up solidly and that's true across every sector.

Coordinator — Our final question comes from the line of Chris Kotowski of Oppenheimer. Please proceed.

C. Kotowski — Just reflecting on Steve's comments at the open, I'm not sure that what hit the stocks so much early part of a couple of weeks ago was the rates as much as it was one of your peers commenting that, "There is an almost Biblical opportunity to sell assets here," and that just created the fear that there's a fragile window that's about to shut.

So, I guess the question is can we infer from the facts that you're holding on to assets like Hilton, even though hotel stocks are hot and EBITDA is up 17% and from that that you disagree with that point of view that this is a Biblical opportunity to sell? And, I guess, just for a follow-up to Tony, you said we're still in the virtuous part of the cycle. What gives you comfort of not getting to the crappy part of the cycle?

T. James Okay, obviously, we filed Brixmor today out of real estate, we've got some other things to sell out of real estate, we've got three IPOs on file for private equity. So, we obviously think that for the right asset this is a good environment to start seeking some access. And we're doing that.

But there are other assets like..., for example, where you can have that kind of growth in EBITDA with the kind of leveraged capital structure is on that company, equity accretion is tremendous and you kind of want to let your winners run a little bit because you're accreting a lot of value for your shareholders every quarter.

And we think that was a great company and we think we'll have plenty of excellent options; we'll have recap options, we'll have M&A options, we'll have IPO options, we'll have all kinds of things. So, we're not in any rush.

We feel like there's always a balance there. You're looking at the current market conditions and you're also looking at the fundamental growth of equity value in the company and trying to balance those. And so, I think that I guess I was saying I think we don't see the window shutting right away. And, indeed, you might get hotter if the economy improves and corporations get more confident about their future you might see the corporate exchange and control market, the M&A market, get hotter and that be to our benefit.

So, what I meant by the virtuous part of the cycle was not so much how to predict markets, but in terms of what was going on with our; markets are pretty good, a), so the avenues are open and, b) in terms of what was going on with our assets they're coming to the stabler, and particular in real estate, I think that was a comment about real estate.

We have this buy it, fix it, sell it. Our operations, a lot of the assets are getting through the fixed stage when they'd normally look to exit and the windows are open and I think we're going to have another 12 to 18 months of good activity on that.

J. Solotar Chris, I would say just based on the incoming questions everyone was asking about interest rates, concern about interest rates, so I might disagree somewhat. And I think there wasn't a clear, and maybe there still isn't a fully clear, understanding of how GSO is positioned. It's private market transactions at floating rate so they actually benefit in a rising rate environment.

And we even thought with the Blackstone Mortgage Trust, which is commercial mortgages, initially got hit with residential rates, where you kind of play a curve and here we're not. Again, it's floating rate they have in their tier for every hundred basis point increase in rates there's a commensurate increase in income. So, hopefully, there's a better understanding today than there was two weeks ago, but I still think we have a way to go.

Great. Thanks, everyone, and we look forward to catching up after the call as well.

Coordinator Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.