Final Transcript

Blackstone: 2012 Fourth Quarter and Year End Earnings Call

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SPEAKERS
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Laurence Tosi, Chief Financial Officer
Joan Solotar, Senior Managing Director, Head of External Relations and Strategy

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PRESENTATION

Coordinator Welcome to the Blackstone Fourth Quarter and Full Year 2012 Earnings Conference call. I would now like to turn the call over to Joan Solotar, Senior Managing Director, Head of External Relations & Strategy. Please proceed.

J. Solotar Great, thanks, Erica. Good morning and welcome, everyone, to our fourth quarter and full year 2012 conference call. I'm here today with Steve Schwarzman, Chairman and CEO; Tony James, President and Chief Operating Officer; Laurence Tosi, Chief Financial Officer, and Kathy Skero, our Financial Director and Principal Accounting Officer.

Earlier this morning we issued a press release and a slide presentation illustrating our results. That's available on our website. We're going to file the 10-K at the end of next month. So just to remind you, the call may include forward-looking statements, which by their nature are uncertain and outside of the firms' control. Actual results may differ materially.

For a discussion of some of the risks that could affect the firms' results, please see the Risk Factor's section of the 10-K. And we don't undertake any duty to update forward-looking statements. We will refer to non-GAAP measures on the call. For those reconciliations, you'll find them in the press release.

And I also want to remind you that nothing on this call constitutes an offer to sell or a solicitation of an offer to purchase any interest in any Blackstone funds.

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Moving on to the results, just a very quick recap, we reported Economic Net Income or ENI of $0.59 per unit for the fourth quarter. That's up from $0.42 in the fourth quarter of last year. We reported the full year ENI of $1.77 per unit for 2012, and that's up sharply from $1.38 in 2011. The improvement was driven mostly by growth in fee-related earnings due to higher asset levels, as well as greater appreciation in the underlying portfolio assets really across the board.

For the fourth quarter of 2012, distributable earnings were $494 million or $0.39 per common unit. That's more than double last year's fourth quarter. And for the full year, we generated distributable earnings of $0.85 per common unit. That's up from $0.60 in 2011.

We'll be paying out $0.42 per unit distribution related to the fourth quarter to common unit holders of record as of February 11. This includes the true-up from the first three quarters of 2012. So that payment date will be February 19, which hopefully you've noticed is moved up about six weeks from last year's payment date.

For 2013, we've made a change to the distribution. We've increased the base quarterly distribution by 20% to $0.12 from $0.10, and we're also going to pay out the excess net cash available on a current basis, so that there won't be a fourth quarter true-up. Investors will just get the cash earlier.

And then one final note from me, we're going to host our third Blackstone Investor Day on Friday, May 3. That will be in New York at the Waldorf. We sent out a Save the Date email, but if you didn't receive it and you want to attend, just follow up with me or Weston Tucker after the call. In addition, let us know if you have any questions and we'll hopefully speak to you later.

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

S. Schwarzman Good morning and thanks a lot for joining our call.

The fourth quarter capped a successful and eventful 2012 for Blackstone as we continued our trend of strong growth and performance against a backdrop of market volatility, political dysfunction and regulatory uncertainty. We grew our earnings by 30% to $2 billion; our best performance since becoming a public company. And our distributable cash rose 48% to over one billion dollars.

We ended the year with record total assets under management of $210 billion, up 26% year-over-year, marking yet another year of double-digit organic growth, despite the fact that several of our businesses were already the largest in the world. We've grown assets an average of 28% per year over the last 20 years. Today we remain the only alternative manager with leading scale and performance in all the major asset categories. As a result, I believe Blackstone remains THE global leader in the alternative space.

As we continue to take share in all of our businesses, our scale and leadership helps drive a virtuous circle of better performance and further growth. We've had consistently strong investment performance across market cycles since our inception 28 years ago and 2012 was no exception.

Our Private Equity funds rose 7% in the fourth quarter versus negative returns for the market, and that shows the uncorrelated nature of some of these things, with strong gains in both of our private and public portfolios of 6% and 10% respectively. The Private Equity funds rose 14% for the full year, also beating the markets, with basically all of the return coming in just the second half of the year. Our BCP V Global fund had a gain last year of $2 billion, almost entirely in the second half as well, although it did not drive carry because it is currently below the preferred hurdle and is now being held at 1.2 times cost.

Our current BCP VI funds and our Energy fund in Private Equity, however, are both above their respective hurdles and are marked at 1.2 times and 1.7 times respectively, despite the fact that both funds are early in their investment periods. In addition, our BCP IV fund has $2.8 billion of capital still in the ground and that fund is marked at 2.7 times the cost, including realized proceeds for net IRR of 37%. So when Private Equity works, it really works, much like it's doing for our two current investible funds.

Our Real Estate business saw similarly strong performance in 2012, with our opportunistic funds appreciating 14% for the full year and our debt strategy drawdown funds up 13%, our debt strategy hedge funds appreciated 18%. All of our global funds, as well as our current European Focus funds in real estate, our fully in carry and as of yearend we had accrued $1.3 billion in carry net of compensation in our Real Estate business.

Our BREP VII Global fund, the biggest in the world, which we've been investing for about a year and a half, has already achieved a net IRR of 31%, which is actually pretty amazing.

Moving on to our hedge fund Solutions business, which had a composite return of 9% in 2012, this is roughly double the HFR benchmark, which is what's used in the hedge fund world, so we're earning double the benchmark with only one quarter of the market's volatility. Which, again, is pretty unusual from a risk perspective.

Our size and reputation continue to give us a competitive advantage, and we've generated consistent top quartile or often top decile returns over the last one, three and five-year periods. And as Tony told you on the earlier call, this is one reason why we're rapidly gaining in share in this business.

And our Credit business had a truly standout year in many regards, but notably in terms of fund performance across all of their strategies. Within our Flagship funds, Mezzanine returned a net 26%. For those of you who really follow this stuff, Mezzanine is supposed to be earning a lot less than Equity returns, and this is a 2007 Mezzanine fund earning 26%. Our Rescue Lending fund was up 16% and our Credit Hedge funds rose 13%. All of these dramatically beating benchmarks.

Our consistently good performance, across asset classes and through market cycles, is a critical differentiating factor for us versus other asset managers. We seek to preserve and protect our investors' capital in down markets. That is a prime tenet of how we run the firm. We're here to preserve and protect our investors' capital. And we harvest our gains when the markets are more constructive, which is something we told you about over a period and now we're moving in this period. This stability and consistency results in deeper relationships with our LP's and a greater share of wallet with them and strong long-term relationships.

We've raised at Blackstone $34 billion of capital in 2012, which is actually a pretty stunning number. That excludes the assets we acquired by buying Harbor Master and Capital Trust.

During the fourth quarter, we had a first close on our new Rescue Lending fund in GSO, which has already reached the size of our first fund at $3.3 billion and we expect we'll reach the $4 billion to $5 billion this year for that fund. Also in our GSO area, we priced our third CLO of 2012. If you'll remember, that market was dead as a door nail two years ago, raising over $500 million, bringing our CLO and other customized credit strategy fund raising to $8.5 billion for the full year. In both Credit and Hedge Fund solutions, our ongoing diversification continues to drive strong asset growth.

Our Hedge Fund Solutions segment reported $2.4 billion in net inflows in 2012 or $2.8 billion, including the January 1 subscriptions. This represents 8% of the aggregate inflows of all hedge funds. Sometimes these calls throw a lot of numbers at you, but imagine that we've raised 8% of the aggregate inflows of all hedge funds just at Blackstone. It's in sharp contrast to the continued outflows for the traditional fund-of-funds industry.

Through ongoing innovation of our customized solutions business for our clients, we completely differentiated ourselves away from a traditional model. The result is that of the top ten fund-of-funds managers four years ago, our Hedge Funds Solutions Group is the only one that has grown AUM, and we've doubled in that timeframe. Every other manager has lost assets, so I think our team there, led by Tom Hill, has really been doing something very right.

In Real Estate, we began fund raising for our next Debt Strategies drawdown fund, and we also started raising our first dedicated pool of capital in Asia, a very important initiative for us. We've become the most active, opportunistic real estate investor in Asia, deploying $1.5 billion over the past few years, plus building a deal team of nearly 50 people in 6 offices. So this fund is a natural extension of our efforts there.

We're often asked: What is Blackstone's asset mix going to look like in a few years and what are our fund raising targets? The hallmark of our firm's continued growth is innovation, targeting opportunities that are new in the market and launching new products to help our limited partners, where we can take advantage of these opportunities and maintain our track record of strong performance and help our investors. Our culture builds upon this. Over $70 billion of our current AUM of $210 billion come from new products, strategies and regions, where we didn't even have businesses five years ago. So this is a business that prospers with innovation and it's necessary.

Today we have a total of $35 billion in dry powder to invest over the coming years, and our product innovation should continue to create new and unique investment platforms for our investors who are our most valued relationships.

Now in terms of capital deployment, we've been very active in putting our capital to work. Our investment pace has been at record levels. It's a good thing, with over $18 billion in total capital, deployed or committed, in 2012, and over $8 billion in just the fourth quarter. Following a record year of issuance that we talked about earlier with Tony, in both the investment grade and leveraged finance markets, the financing environment for new deals in 2013 remains attractive; credit spreads are trending at mid-cycle norms. What that means in English is that spreads have come in, so we're getting to a bit more traditional relationships. But with benchmark rates at historic lows, borrowers are able to lock-in favorable rates. Credit issuance remains a mix of funding for new LBO's, dividend recaps and opportunistic pricing, while asset prices have increased in certain sectors and regions, and that happens when credit comes in like that.

We are still seeing attractive opportunities in many places in the world, including energy, which has been a huge exposure for us; distressed and overleveraged real estate, where we're the largest in the world; India, where it's a good time to buy because it looks like it's not as strong as it's been – that's usually when you want to make your bets – and consumer finance.

In credit, the search for yield continues to drive demand for products. With the Fed driving rates down to less than 2% for treasuries, people are really starved for yield. And the pullback by banks has resulted in a lot of opportunities for the firm.

Now in terms of realizations, if you think about the environment, our investors saw us preserve and grow their capital in the last down cycle. We talked about that and we weren't as popular with you, because we didn't sell things at low prices to make you happy. Well, now we're making you happy. And now I think it's becoming increasingly evident that we're reaching an inflection point in terms of realizations, assuming markets remain constructive.

We've had $12.6 billion of realizations in 2012, with half of that in just the fourth quarter. So it shows what happens when things line up for us in terms of scale. This drove realized performance fee and investment income revenue of over $720 million for the year. Roughly half of our performance fee revenue in 2012 was from our annual incentive fee businesses within Hedge Fund Solutions and Credit, which generally crystallize in the fourth quarter, so that’s when you see it.

As these businesses have grown and more assets move above high watermarks, in the case of Hedge Fund Solutions, the ability to generate annual incentive fees becomes much greater and much more predictable.

Fourth quarter realizations picked up for both Real Estate and Private Equity as well. We sold our Sun West Senior Living business, a $220 million investment at a multiple of invested capital of 2.4 times after a two year hold period. When real estate works, it really works – 2.4 times your money in two years? If we did that with every piece of real estate, we’d be managing most of the money in the world. But it does happen and it isn’t just an odd outcome.

For Real Estate, given the maturity profile of our assets and the buy it, fix it, sell it approach, and the underlying bid in the market for stabilized assets, particularly with low yields that people are trying to run away from and get some more current income, we expect this year and next year to be substantially higher years for realizations than in the past few years.

In Private Equity, most of our fourth quarter realizations were in BCP V, including the sale of Alliant Insurance Services to a financial buyer at a nice profit, and the public offering of PBF Energy, which is a refinery business, which we brought public at five times our original cost. I believe the price was $26.00 a share and now it's somewhere in the low 30s. I think it's around $32.00. So that's not bad performance for about 4-5 weeks.

We also completed another follow-on sale of a portion of our investment in Team Health, an investment in BCP IV, which generated a multiple of invested capital of four times our investors' money, which of course generates significant carry over time for the firm. We've taken eight companies public in the last two years, which we will sell down opportunistically and we've had more pending, including filings for Sea World, Pinnacle Foods and Michaels. And by the way, at Sea World we're opening a new penguin area. It's going to be absolutely fantastic. You should definitely go down there and take your family, because I'm seeing what the thing looks like and it's fun. We actually had two penguins here at the firm a few weeks ago on our board room table. I'm not sure exactly what that's saying about us, but it was amusing.

In summary, it's now been over five and a half years since we launched Blackstone's initial public offering. During that time, and who would have imagined it, we've navigated the worst financial crisis in memory; a deep and long-lasting global recession, and massive derisking and deleveraging across the globe. Despite these momentous events, we've grown assets every single year, with strong organic growth in every one of our investment businesses because of the loyalty of our limited partners and their sagacity. And the fact that we protected their capital when almost no one else did, and we're really focused on servicing our limited partners. We've also paid out a cumulative $4.56 per common unit in cash distributions, despite depressed realization levels.

Our growth is indicative of the secular shift towards alternatives that's underway and has been for quite some time. With increasing allocations, driven by funding gaps at pension funds and endowments around the world, and growth in new limited partner capital pools of sovereign wealth funds, for example, who haven't been in this asset class, who realized that the returns are much, much higher than convention investments, and the risk, in fact, is lower. And whenever you get high returns with low risk, money flows in that direction and that's our business.

More importantly, however, our scale and performance are increasingly driving economic and competitive advantages in every business we're in, resulting in very large share gains for the firm. I'm excited, as you can tell – not always excitable – but I'm excited right now about our leadership positions we've built and reinforced for each of our businesses, including the remarkable people we have here at the firm. It's really a fantastic team of experienced people who are on a mission to do well for you and to do well for our limited partners. And I believe that as a combined firm we're better positioned than ever to identify and make great investments, deliver very solid outperformance, and drive good returns for our public market unitholders.

With that, I'll ask LT to take over with a review of our financial results.

L. Tosi Thank you, Steve. Good morning, everyone, and thank you for joining our call.

A few thoughts on AUM and growth, the fourth quarter of 2012 provided a strong finish to another solid year by Blackstone by almost any measure. All of our investment businesses generated double-digit growth in assets for the third straight year, propelling total AUM up 26 percentage points to a record $210 billion at the end of the year. Ninety percent of those assets came from pure, organic growth, with the remainder reflecting assets we strategically acquired to broaden our investment capabilities.

Over the past 24 months, Blackstone has had $96 billion of gross inflows and $61 billion of new inflows, with the difference coming from the $35 billion in capital we returned to our investors.

A few thoughts on earning drivers. Fund performance and sustained valued creation are the primary drivers of Blackstone's business model and our financial performance. Our 2012 revenues grew 24% to a record $4 billion on a 36% increase in performance fees to $1.6 billion, and our continued fee revenue growth to a record $2.2 billion, which was also up 14% year-over-year. That continued strong revenue growth, combined with margin expansion, helped generate $2 billion in full year earnings, up 30% from the prior year.

An important sign of continued momentum can be seen in the components of our $2 billion in earnings, as net realizations and fee earnings increased to almost 60% of the total earnings, reflecting record asset growth in an increasingly favorable environment for realizations. The combined net realization and fee earning components of our earnings have more than doubled since 2009, with the sharpest increase coming over the last year, particularly in the fourth quarter. The depth of that increase is evidenced by the fact that the $724 million in realization revenue was generated by over 200 distinct transactions across more than 60 funds in the last year alone.

At the same time our earnings continued their fast pace of growth, we continued to make critical investments in capabilities across our platform, including expanded fund offerings, global opportunity origination, portfolio operations, LP marketing and support, and technology & risk management, all of which have helped generate sustained double-digit organic growth.

We have made these disciplined investments in growth without sacrificing profitability, which resulted in 50% margins for the full year and reached 55% in the fourth quarter. In periods with healthy incentive fees, there’s meaningful operating leverage to Blackstone’s business model.

A few observations on the balance sheet, Blackstone finished the year with $6.7 billion, or $5.95 per unit in total cash and investments, of which $2.3 billion is in cash and liquid investments. Another $2.2 billion is in highly diversified investments, primarily in Private Equity Real Estate, which grew as carrying values increased and are now being held at 1.3 times cost across more than 250 distinct assets in over 95 different funds and structures.

Strong value creation drove our current performance fee receivable, net of compensation expense, to a record $2.2 billion, or almost $2.00 per unit. The majority of that receivable is driven by more than $80 billion of assets under management in our mature funds, which are currently paying performance fees as investments are realized. Newer funds, still in our investment period, are also accruing performance fees that will set the stage for future cash realizations.

A couple of comments on distributions. As Blackstone's earnings have steadily grown and diversified over the last few years, it affords us the opportunity to increase our quarterly-based distribution by 20% to $0.12 per unit. Additionally, to create better alignment and timing for our unit holders, we will distribute cash earnings above $0.12 per unit in the current quarter as earned.

Finally, we will also accelerate the payment of our quarterly distribution by nearly six weeks. In this case we'll be paying our fourth quarter distribution on February 19th for record holders as of February 11th. We anticipate that investors will better value the higher quarterly base and the accelerated cash flow.

In closing, 2012 was an exciting year at Blackstone in which we have continued to see returns on the investments and decisions we have made over the last several years. Now almost 1,800 people strong in 25 offices globally, we have invested record levels of capital since the crisis, in what we believe will prove to be attractive levels. Today, despite these activity levels, we still maintain an additional near-record level of available capital to invest in new strategies and ideas across the firms' businesses, and an interesting time in global markets.

All of us here at Blackstone have worked hard together to put the firm in this position and we are more focused than ever, not on what we've accomplished so far, but our outlook and what we have yet to achieve. On behalf of everyone at Blackstone, thank you for joining the call and we welcome any questions you may have.

J. Solotar — And before we take questions, we have a very large number of folks on the call and we now have 17 analysts covering us. So if you can, at least for the first round, just limit it to one or two questions and then just put yourself back in the queue, that would be great. Okay, let's go.

Coordinator — Our first question comes from the line of Howard Chen with Credit Suisse. Please proceed.

H. Chen — Good morning, everyone. Steve, over the past few quarters we've heard a tone of caution from you and Tony, given the low level of rates, the rallying equity markets, the fragility in the recovery and these policy risks that we've all been talking about. And then today, we're hearing a markedly more positive tone; or at least that's what I hear. So I'm just hoping you could add some color on what you all see across the market in your portfolio companies that's maybe changed the mindset a bit.

S. Schwarzman Yes, I think, Howard, that you do detect a different tone. Maybe I had one more cup of coffee than I should have, but we're seeing strength in the housing sector, which is certainly something new in the last five years or so, and that's an asset that is typically the largest asset that most Americans own. And there's virtually no place where housing is going down, and there are many, many places where housing is going up. So I think that's an area of real significant change.

If you look at autos, you're also seeing almost a doubling from the bottom in terms of auto production. So that's saying something about something.

And third, from traveling abroad, pretty extensively, the impact of potential energy independence on our country here in the United States is viewed – forget how we view it here in the United States – but from the perspective of people abroad as a really paradigm-changing type of change. And assuming that nothing goes wrong with approvals to do fracking and we keep producing these very large amounts of natural gas, this is an engine that could really drive real future growth in ways that are really wholly unanticipated.

On the other side, you see these mediocre results from the fourth quarter in terms of GDP. Not every area that we're involved with is showing that kind of growth. Some of that softness comes out of government spending and some other things, and so we don't have a free pass. But what we are seeing with our business is that the spread between ill-liquid securities and the returns we can make, and what people typically can get – not necessarily from last year and the last half on the stock market, but on fixed income instruments – is so huge that it's driving our business in terms of flows, and that compression will also increase the value of assets. It may make it a little harder to set up some things, but it takes this huge amount of assets that we have in the ground where we've been improving these things and it will create, in all probability, a pop in all those asset values that you'll see washing through sort of our financial statements.

And so that's the reason why you're hearing more enthusiasm from me. I'm sure Tony will give you something a bit more sober, but it's the nature of our personalities.

T. James Hey, I didn't have any coffee this morning.

H. Chen Great. For my followup, just circling back to Europe, Steve, you said …, you noted in the past the irony that the assets haven't really, the distressed assets haven't really moved because the markets would be too onerous for the institutions that hold them. Given the rallying that we've seen in asset prices and the seemingly improved Basal III readiness that some of these management teams at least talk about, are you detecting any kind of change in that …in the region?

S. Schwarzman The asset class that will trade the most is in Real Estate, not corporate stuff in terms of loans. And Real Estate still has some of the issues that you mentioned. On the other hand, what happens is different countries decide at different times that in some cases when those assets have gone into operations, which are no longer just private sector, when banks collapse and things get sold, some of those are starting to move. For example, we just bought a good-sized hotel in Dublin where we think we can do quite well, but we have to fix it all up and so forth. And so we're seeing a steady flow of those, but Basal III makes it somewhat hard for financial institutions across the board to just blow things out.

I think in a funny way that as those assets increase in value, it will make it easier for some of those assets to move, because they'll result in less write-offs and then we have to make sure that if we are the buyer of those, we can improve them enough to make our returns.

H. Chen Thanks for taking the questions.

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

M. Kim Hey guys, good afternoon. First, Steve, you touched on this earlier, but just on the realization front, things obviously stepped up towards the end of the year. So, just curious to get your take on sort of the trajectory going forward as you kind of look across the Private Equity, Real Estate and Credit businesses, and then just some of the drivers behind the continued step-up.

S. Schwarzman I'd like to throw that over to Tony. I mean, I can give you that answer, but nobody knows that answer, right? That's really the problem.

It should be an acceleration, just given where real estate markets are moving. And if the stock market stays up, we'll see more and more of this in the Private Equity area. But I think, Tony—

T. James Well, I think Steve answered the question, basically. Just to separate those three into categories, I don't see a lot of realizations near-term in Credit. We've had some pretty good realizations, and the challenge, of course with a lot of our Credit businesses are refinancing, and now we're getting money back that we'd like to keep out there earning higher returns because companies are able to refinance cheaper.

With respect to Private Equity, we had three big realizations, sizable realizations at the end of the year. We've got two IPO's on file. We've got a number of other public companies that we're discussing access in the equity markets. So I would say that Private Equity will be driven heavily by the stock market as things now look at. We don't have a lot of strategic discussions going on, but we do have a lot of our companies looking at equity financings and the distributions that will flow from that.

Real Estate is where I think you'll see the big activity in terms of dollar scale, because those assets are lumpy and there's a very good – we've had them a long time, we had a lot of assets that we've held since 2007, and there's a very good bid for those assets because cap rates are low and a lot of people want the security of hard assets. And even though the economy isn't all that strong, the lack of availability in commercial real estate means that commercial real estate results are very strong. Commercial real estate results are much stronger than the economy, if you will, so we're seeing stronger operating results in real estate than we are in our companies, which means that we're going to push those along further. In other words, the investments have matured quicker and then we've got a very good bid for them, so I think that's where you'll see the activity and I think you can expect 2013 to be bigger than 2012, and I don't really want to be much more specific than that.

J. Solotar Just want to add one more thing. We're now of the size where both BAAM and GSO have contributed pretty good incentive fees, and those crystallized in the fourth quarter, so there's a bit of seasonality to it, and assuming regular performance that should continue.

M. Kim	Understood. Then maybe one for LT. Looks like both base and performance fee compensation stepped down in the quarter. Was that just a function of maybe lower fund raising activities on the base side and then maybe more of a shift in the mix of funds generating carry this quarter?

L. Tosi	It was a shift in the mix of funds, particularly with respect to where you see most of that occurring was in BAAM and GSO where they had very strong incentive fees. And typically when you have a very strong incentive fee quarter, the base compensation number will be slightly lower.

M. Kim	Okay, thanks for taking my questions.

Coordinator	Your next question comes from Patrick Davitt with Autonomous Research.

P. Davitt: Good morning. There's an increasing concern about a1994-like scenario in the credit markets, and given how big you've gotten in that business, could you speak a little bit how you prepare for a risk like that in terms of managing the risk in your portfolio of Credit assets?

S. Schwarzman: Yes, I think our people in our Credit area are reasonably wary of the level of interest rates. I mean, the Fed has been very aggressive, as we all know, in terms of buying government debt and keeping interest rates low until they like the level of unemployment is, which is lower than where it is. At some point that's going to reverse and that's going to be one unhappy day for people who are very long, and that's going to happen. The only problem is nobody knows exactly when it's going to happen, but you know it's going to happen.

And so given how low interest rates are, there's a reasonable chance that you can get hurt if you're really not in floating rate, if you maintain a current position and you don't structure yourself well. So we've been significant sellers of some of that exposure, and that's the way we're dealing with it. I'd say with caution.

T. James Just to flesh it out a bit, our guys have moved their portfolios shorter in duration, they've moved from fixed to floating, they've moved up the balance sheet and they're sitting on a lot of cash on the portfolios where you can move.

With respect to the drawdown funds which are long-term illiquid securities, their securities are a much higher rate – 400-500 basis points above the rate that bonds in the high yield market trade, because the spreads for illiquidity have widened out. So if the market backs up, you'd actually expect the spreads to contract a little and they'd be somewhat protected, number one.

Number two, typically their debt to cash flow is three to five times cash flow versus five to seven in the public market, so they tend to be less levered and have bigger equity cushions. So we've taken an approach that I would say in this market is reasonably defensive, and have still been able to earn some pretty good returns.

P. Davitt Thanks. Finally, in BCP V, it looks like the realized net IRR fell to one percent from 31%. Can you talk about the dynamics driving that?

L. Tosi I think you might be on BCP V, mixing a couple of numbers. BCP V is now at 1.2 times total … So I think you're maybe just transposing numbers.

P. Davitt I'm looking at the 3Q press release that shows a 31% net realized IRR for BCP V.

L. Tosi That's just the realized piece and that's on VI.

P. Davitt Oh, okay. It says V. I'm looking at it right now, but we can talk about it offline.

J. Solotar I think you're just looking at, you're comparing total fund to realized.

P. Davitt Maybe there's a typo. We can talk about it offline.

Coordinator Our next question comes from the line of Dan Fannon with Jeffries.

D. Fannon Thanks. Just thinking about investment opportunities, it sounds based on a lot of your commentary you're pretty optimistic about what's out there as well as looking at 4Q pace of activity accelerated. So, the $12 billion of AUM not earning fees today and kind of the flow through into the management fees over time, any ball park on how we should think about that?

T. James For some of the reasons we've mentioned, that is to say that general M&A activity is not all that high right now. And similarly, equity markets have come up and yields are low. It's been a better, it's not an easy environment to put a lot of money out. I would think that in our Credit business, for the reasons I mentioned, we're being cautious. In our Private Equity business the general level of deal activity is lower. And again, the debt has pushed up prices, we're being cautious. And in Real Estate, we have just been on a massive investment program with over $9 billion last year. That level is some kind of historic record and it's clearly not sustainable. There's still plenty of stuff to do, particularly in Europe, which is lagging the U.S., and increasingly in Asia, but I wouldn't be counting on continuing to put out $9 billion a year. I think the wheels would come off this place.

D. Fannon Just clarifying the change in the distribution policy with regards to the hold back, is it just a timing thing or as you look at the size of your balance sheet and the need, the investment opportunities you see from a corporate perspective, have they changed at all?

T. James No, they haven't. All we've done is changed, we raised the base level of dividend because our business has grown and we feel like we can give the investors' confidence that they'll get at least $0.12 a quarter, regardless of what all else happens in the world, and then we've just taken that true-up that we had in the fourth quarter and just spread that over the course of the year so people got their money earlier and we didn't have such a one big payment that some of us worry might distort trading patterns or whatnot of the stock. So investors will get what they earned quarterly instead of having to wait till the end of the year.

Coordinator Our next question comes from Matt Kelley with Morgan Stanley.

M. Kelley Good morning, guys. Specifically on Real Estate, it looks like you invested about $2.1 billion BREP 7 in the fourth quarter and maybe $3-3.5 billion over the second half of the year. So, with a little over $8 billion left, are you guys thinking about at this point raising BREP 8? I know that's kind of a leading question, but just curious how far out we may be based on the pace of investments you're making now.

T. James Well, we think that's still a ways out there. As I said, we don't expect this level of investment to be sustained. As you know, we have some other real estate products in the market and some of that will also affect the pace of investment of BREP 7. For example, right now if we do an Asian deal, 100% of it is funded by BREP 7 once we're in the market with an Asian fund, once we have the Asian fund, the Asian fund and BREP 7 will share the deal. So, I think it's a ways off still.

M. Kelley: Okay, then a followup for me would be, just in terms of BAAM, you mentioned that you raised 8% of funds for hedge funds last year, so going forward, I know that you guys have been able to take a lot of share in that space. You've been growing, the industry has been shrinking. Do you think that accelerates from here or are we kind of status quo and you take a little bit more share? How are you thinking about that going forward?

S. Schwarzman: The Hedge Funds Solutions business is a business that particularly thrives on innovation. And if you just do an exact same thing that you were doing before, it won't be so happy for you. And so we have a lot of really interesting things going on in that area; we've got a terrific team, we've got a number of new products that will be in the market this year that we think are going to be very well received that will keep that business growing. About 60% of our growth in a given year typically comes from our existing investors who are looking for different approaches, different solutions. And when we bring our products to the market, to the extent we've done a good job historically, we get a pretty good hearing. So I think it's really about introducing new things and managing what you've got really well.

Coordinator Our next question comes from Michael Carrier with Bank of America.

M. Carrier First question, you mentioned a few things on the seasonal side just in terms of the crystallization of some of the performance fees in Credit and BAAM. The two other items I just wanted to get some color on is in BAAM. The flows this quarter, usually it's relatively weak and then it starts to ramp up. So any color around that in terms of what you're seeing.

Then just on the Fee-Related Earnings, obviously a strong quarter. Some of that was driven by advisory and transaction revenues, so just what you saw in the fourth quarter, any like lumpy items in the outlook going into 2013.

J. Solotar On BAAM, they are lumpy, as you noted, and we actually have a good pipeline going into 2013. Not surprisingly because 2012 was one of our best relative performance years. So I think that was the issue there.

T. James So I'll take a whack at some of that, and LT, maybe you can fill in around me here. Just in terms of, BAAM's got a couple of very interesting products in the market and we think that they'll continue to gather assets. I'm personally hopeful that we'll do as well next year as we did this year. I don't see any reason why we wouldn't. We think there's a long runway ahead. I know the BAAM guys are talking about, well, a significantly greater AUM. Let's just put it that way. I don't want to put a number on that. As a long-term goal, I mean very significantly greater.

With respect to the seasonality of the business, all of our businesses are seasonal, actually, and one of the things that happened this year with the whole fiscal cliff negotiations and the tax rates going up, there's a lot of companies raced around and tried to do things to beat the end of the year. That might be selling assets, it might be paying dividends, it might be one thing or another. It also might just be companies wanting to refinance and take advantage of low interest rates not knowing what would happen with the fiscal cliff and not wanting to have the risk of that happening.

So, our M&A business had the best fourth quarter in history this quarter, and there are a lot of closings, so it was a rather frenetic fourth quarter and it was pretty much frenetic across the board, I would say. BAAM and GSO got the performance fee we talked about, M&A and the Advisory businesses had a bunch of closings. Although those businesses still have a pretty good backlog. Private Equity had three significant realizations; two equity financings and a sale of a company.

And Real Estate, both realizations and closings ramped way up. So all businesses really sort of got hot in the quarter.

M. Carrier That's helpful. Just as a followup, just on BCP V, when you look at, you always see some improvement in some of the performance, but when you look at some of the key industries, the investments that you made, is there anything that's changing or anything that's improving to a level that you feel it's worth bringing up, just in terms of the outlook of some of those areas, because obviously it's hidden in terms of exactly what's going on. But the environment is improving, so just any color on that is always helpful.

T. James Well, you know, Michael, it's the whole portfolio. It's a big portfolio, it's got 30 companies or something in it. It was up 7% for the quarter. The whole portfolio was doing well; it's not one thing and it's a combination of steady growth and the pay down of debt, which create, those two things create equity value.

LT can probably tell you, but our public portfolio, we have a bunch of public holdings there, so that goes up with the market, but I think our private portfolio was up more than the public portfolio.

L. Tosi In the fourth quarter actually the public was up more than the private.

S. Schwarzman I think as you look at that, it's really about growth and it's really about valuation level. To the extent that you would have a robust stock market over the next year or two, I don't know whether you will or you won't, but to the extent that you do, we share in that effect disproportionately, and we do that because we have our companies unlevered. So it's really leveraged equity, so that's very helpful.

To the extent that the U.S. economy or foreign economies where we have those types of assets, and I'm talking more in the private equity area now than some of our other ones, than we benefit from that kind of recovery as well. So those are two macro drivers that really affect us.

M. Carrier Thanks a lot.

Coordinator Our next question comes from the line of Bill Katz with Citigroup.

W. Katz Good afternoon, everybody. Just let me talk a little bit about the potential for realizations. I was wondering if you could comment on in prior cycles—I think since you've been a public company it's probably been a little more lumpy—but in prior cycles maybe the relationship between the yield on ENI. So in other words, fee related earnings and realizations relative to ENI in prior cycles, and then, within that I don't know if you can even talk to that in particular business lines like real estate and/or private equity at this point.

J. Solotar Generally, if you assume a two times MOIC and a four year going in investment period and four years coming out it will be a relationship of 2:1 over the life of the fund net earned carry to management fees. Historically, we've actually done better than two times, we've been closer to 2.5 times, so the ratio was even greater.

T. James Let me just make a note, too. So there are marks, which are in ENI of course, and then there are realizations, which are when those are crystalized and then ultimately paid out. Usually when we actually realize an investment there's a markup. Even though we carry our investments to fair market value, but conservative accounting is what it is and we try to be consistent on that.

When there are a lot of realizations, you also will have a tendency to have markups in ENI, and in both Real Estate and in Private Equity our realized events are usually at a pretty significant premium to our carrying values as of the prior period.

S. Schwarzman Typically over a cycle that's run historically in the 20% to 30% area over the mark and some of that is just the timing that we're selling into a particularly good time and so that would sort of affect that sale. As we look at our own business—and everybody looks at these things differently—we assume that when we are selling we will have a better outcome than the mark and in almost every example that really is the case. That is the way it tends to work in the vast, vast majority of cases. It's not an equal distribution in terms of above and below historically.

L. Tosi Bill, as I mentioned in my comments, we went back and we looked at exactly that through all the cycles back a long time and what Steve and Tony just pointed out is absolutely true. You do have an uptick in the mark at the time of exit. But what we looked at was over the last few years you've seen a strengthening of the component of our total earnings related to realizations in cash earnings. As I mentioned in my speech, it's about 60% for the full year 2012, up from the high 40s in the last two years. That's just an indicator of basically what we call the different components of earnings.

W. Katz I appreciate that. Okay. A follow up question is just the realization cycle picks up a little bit. I think you saw this dynamic in the fourth quarter, you know, fee paying AUM relatively flat, notwithstanding the strong year-on-year growth. It's a little hard to put the money to work and you were turning a fair amount. What's the outlook for fee paying AUM? Can we expect that to flatten out a little bit in the short-term here as we move to more of a harvesting period or you think you can still grow that simultaneous with a pickup of exits?

L. Tosi Well, it's a couple things. You're right, obviously when we have realizations that it's net. I gave some stats in my speech that you're looking at $96 billion of gross inflows net of $35 billion of return capital and realization gives you 61 of growth. I think a third of the fourth quarter had two factors. If you look in the press release on Page 21 it goes through the earning roll forward and you had very strong inflows, frankly, in the fourth quarter, $7.3 billion. The issue was you really had realizations on returns of capital of $8 billion and those really canceled each other out.

Looking forward there's a lot of—as Tony went through and Steve went through there are a lot of things that we're working on. There are a lot of new products. There's a lot of innovation across the firm, and so we wouldn't describe it as a flattening at all.

W. Katz Okay. Thanks for taking my questions.

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

M. Irizarry Just staying on the theme of the fee related earnings, L.T., can you talk about the $12 billion not yet earning base management fees? It's obviously spread across a few different buckets, but how should we think about the pace of either the drawdown of that capital or just the fee rates on that and what that means to your fee related earnings?

L. Tosi If you look at that, Marc, the way to look at it is the majority of that, let's say more than half, $7 billion to $12 billion, is related to our credit fund. That's capital that's been raised, committed, and will begin paying fees when it's deployed. You'd expect that to kind of steadily work its way in over time.

The same is true of the Hedge Fund Solutions piece, which is one, they have drawdown structures within Hedge Fund Solutions that will also drawdown over time. Real Estate and Private Equity is more transaction driven where over time they have reserved capital and other capital that they will deploy that will come in.

So if that full fee is in all those cases and the pacing we think will be relatively steady.

J. Solotar — I just want to add one more thing just to the prior question on the trends. If you looked across estimates, generally speaking realizations were under estimated, and therefore, fee paying AUM was over estimated. There's, of course, a relationship there because it's gross inflows less paying back capital …

there were any outflows, which obviously in drawdown funds you wouldn't have.

It is something to keep in mind that as we're expecting accelerated realizations, particularly in Real Estate and fund raising and some of those businesses the step function, there's going to be quarterly periods where they'll have differences and if you're selling a ton, you absolutely will see a flattening if not slightly declining trend in periods.

Over time we think the industry is going to have greater flows, we're going to continue to gain market share and so we still see a positive trend. But there absolutely could be periods with flattening to decline.

M. Irizarry — Steve, just a question on scale in areas maybe where if we can take this route, places maybe where you're subscale right now. Also, can you talk about some areas maybe where you don't see adequate capacity to grow? So I mean maybe some areas where there's a lot of growth geographically, strategically, and areas maybe where the capacity is somewhat constrained at this point.

S. Schwarzman The way we think about it is in each of our businesses and in Private Equity there's currently a lot of room to grow in the energy complex, and we've got a fund that we started that is absolutely shooting the lights out. It's like an IRR of 100% and 40% to 50% invested in one year. The opportunity to grow that business very substantially is just right in front of you because with that kind of investment record—and we've been doing this, I guess, for about 13, 14 years, we've never had a loss. It's pretty remarkable performance, and I would expect that to be significantly increased as we go ahead in the future.

That's sort of like a pioneering step out, if you will, and I think over time we'll find other areas that are natural areas of concentrations where we do things like that. We've got our Tech Ops business that started with some of the staffing lead by David Blitzer from Private Equity where there's a very large capability to expand that kind of business. That's the only place in the firm where we mix Private Equity, Real Estate, Credit, and Hedge funds in one product.

In Real Estate, there are just so many different areas to grow given the record that we have. I think Tony talked about the geographic expansion in Asia, which can develop a lot of different ways. We're already in Europe and the U.S. We have other opportunities of managing and we've got Mezzanine, which is principally a U.S. business and so that can expand geographically.

We also have managing the prospect if we choose to do it lower type return real estate at the moment. We're focused on the highest types of returns and there's a massive market of sort of people who are actually seeking lower returns with less leverage. So, the prospects there are really very, very substantial.

In the Hedge fund area I think we've answered your question on that. It wasn't your question. It was someone else's question on it.

In Credit, we're actually quite geographically constrained to the United States, which is quite curious. Part of that is because of rule of law and the ability to protect security in other places, but we've moved—Tripp Smith, one of the three founding partners at GSO, was nice enough to go over to London, which most people would not think as hardship duty. It's a fun place to live actually, London, and we're going to be developing a bunch of products for that market.

There are people who do lend higher return money in Asia. We happen not to be part of that group, and longer term that's a terrific opportunity given the growth there.

So, each of our investment businesses has a lot of white space, if you will, to be growing and expanding, which is important not just for the reasons of this phone call. But it's important to provide opportunities for our younger people as they grow up, because the best thing we can do is take people who are trained in our core businesses and put them in these other businesses because they know how the firm looks at risk and reward, and you're just not dealing with people that you hire who don't have the same culture and the same focus on capital preservation.

M. Irizarry Great. Thanks.

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

J. Hopson On the housing comments, I guess a recovery is good for your existing investments, but curious if you can tell us if you're still seeing values there? Then in terms of interest rates and credit, et cetera, I hear you saying you're still defensive, but I'm curious why you wouldn't want to extend your own credit and perhaps even add leverage at the company level at this point?

T. James

Okay. Let me take housing first. As Steve mentioned, housing is getting a lot better but it's still way off the peak, and we still have a huge number of foreclosed homes that have not worked through the system. We still have a lot of stressed buyers, stressed people barely able to buy a home and meet the rent or not able to pay their mortgages. In my view we're a ways away from anything where you'd sort of feel like things have fully normalized.

I think what Steve was just saying, we're coming off like the body didn't even have a pulse and now it's getting a pulse and that should be sort of tailwinds for the economy. We agree with that but there's still plenty of opportunity in the housing area, and we are housing businesses in 12 cities. There are a lot more cities to go to and they're not all as far along as the cities we pick, which is why we pick the cities we pick. So lots of opportunity there is the bottom line.

In terms of the firm's own balance sheet, we did a debt issuance. A couple months back we thought were pretty great rates and pretty great maturity. In retrospect we were wrong.

We should have waited and done it now, but at the time we were looking at near historic low rates and somehow they've gotten even lower.

We're not intending to leverage up this balance sheet. We're in a business that doesn't need a lot of capital. I actually think we're entering a phase where these realizations and divestitures that Steve was talking about where we're going to actually throw off more capital than we need because the place we use capital is when we co-invest with the LPs. As we put those funds out the capital goes out, and then when we harvest the investments the capital comes back.

I think we're going to be more in the phase where we're getting more capital back than is going out, and I don't think we need—we're sitting on cash. We have a strong balance sheet. We want to keep a strong balance sheet so I don't see the need or the desire really to lever up.

J. Hopson — And what about at the investment level, your individual company investments? Would they want to extend maturities?

L. Tosi — They're actively doing that daily. I think we have four or five refinancing's on the debt side going on as we speak, and in some cases they're of course using some of that added capital to pay dividends. In other cases they're just lowering their cost of capital by refinancing existing debt, and some of the numbers that are in those realization numbers are dividends from re-levering the companies.

J. Hopson — Got it. Okay. Thank you.

Coordinator — Your next comes from the line of Robert Lee with KBW.

R. Lee — Good afternoon, guys, and thanks for your patience in taking all these questions. I had a question. You raised—as L.T. has pointed and you've all pointed out, you've raised a lot of capital the last several years to greatly expand the number of strategies. But as you kind of look at pools of capital are there specific—whether it's institutional asset pools in Asia or high net worth pools here in the U.S. or Europe—that you think for you guys are particularly untapped? And maybe kind of refresh us on some of your initiatives on kind of tapping those pools to capital.

S. Schwarzman I'd say we're a lot of places and the greatest opportunity for us is cross-sell our products to pools of capital. Since we're the only firm that really has this kind of scope we have a lot of opportunities to do that further, and in that regard the easiest marketing you have is with people who you're already invested with who like you. They trust you. They know the firm and as we come up with a continual number of new products then this is a natural way to go.

There are also new entrants who are not in some of our products who will be doing it. We have a pretty good competitive position to be able to be sort of first in this because the investment performance record has been so strong over a long period of time. We also have a really good brand name that makes these people comfortable.

I think there's another trend that is also helpful for us that almost all of people who put money in to the alternative area are looking to simplify their lives not make them more complex. They're looking to reduce the number of managers and move to the high-performing ones. We qualify in that bucket in basically every business line that we're in so that also gives us a natural ability to pickup share.

We're taking advantage of all these trends that are going our way. Sometimes we open up a whole continent; in other words, we were the first people basically, other than domestic, taking money in private equity from South America. That's going to be a growing area. It's not the biggest GDP area in the world, but as different parts of the world move to alternatives because of the performance characteristics we know the people. There are a whole variety of accounts that we visit that we don't have money from yet, but we're going to get it because they're going to want to put it out and some of them are early.

T. James Let me just jump in there too, Robert. The obvious parts of the world, which have big positive cash flows, are accumulating lots and lots of resources, you know sovereign wealth funds, and it's all over the world. It's not just necessarily the China ones you think. There are all kinds of smaller countries that are resource heavy and much are energy revenues driven that have lots of capital.

For the most part, in my own view, they're underrepresented in our kinds of products and will be shifting more towards that. We're see that happening and it comes in fits and starts but that's one area where I think you can expect to see foreign investors in general, but these sovereign wealth funds take more and more share from us, of our products.

Secondly, it's high net worth individuals. You look at high net worth individuals across the board they're 2% to 3% invested in alternatives whereas institutions are 20% to 25% invested. There's obviously a long way to go there before we or any of our industry is really fully represented in the high net worth channel. I think that's another big target of opportunity for us.

R. Lee All right. Great. That was my only question; thanks for taking it.

Coordinator Your next question comes for the line of Roger Freeman with Barclays.

R. Freeman Just a few questions. I'm probably missing something here but in your comments before you were talking about the markups on investments when you sell them. You said most of that in private equity is concentrated on BCP IV in the quarter. I'm just wondering why the threshold and the breadth didn't improve more. I think it was 13% last quarter, and then 12%. There's only going to be a 3% return. Maybe the math is wrong but wondering why it wouldn't have been up more.

L. Tosi Roger, I think there are two concepts that you're mixing. The first one was Steve made a comment that traditionally—and we've done research going back almost 20 years—the mark that we have before we go in to an exit event is typically 20% to 30% below. The reason for that is under the mark to market rules you can't take into consideration things like auction … et cetera. So there's inherent conservatism, if you will, built in marks. That's true in Real Estate and Private Equity. Now, real estate transactions take longer to get done so typically you have an earlier price indication.

But separate and apart from that I think was Tony's comment that in the fourth quarter of 2012 BCP IV had very strong returns, about 7%, and that actually pushed the total change in enterprise value necessary to cross the threshold down from 13% last quarter to 12% this quarter so we're making progress against that.

They were two totally separate things and I apologize that they got confused.

R. Freeman Okay. That's helpful. Then with respect to sort of the general M&A environment, you obviously had a strong quarter in advisory. I'm wondering, one, if that was more sort of restructurings versus maybe more traditional M&A type advisory. Then two, do you think that the—at least for corporates or strategics—environment and the clarity is improved enough to kind of get the impasse start to … with strategics not wanting to sell because of the political and other uncertainty or is the debt ceiling get pushed off to May still a big overhang?

T. James In the fourth quarter it was M&A that had the big quarter and it is a lumpy business. We had a couple of very big transactions close with big fees, but the backlog built too and the backlogs are not only the biggest it's been in a long time but the best quality in terms of likelihood of the deals closing. That business is doing pretty well, but I don't think you should read too much in to that as to whether it's an indicator of the overall M&A market because we're a small player in that market.

Restructuring actually has a decent quarter and, frankly, for us it was probably a bigger pleasant surprise because we expected in this part of the cycle when troubled companies can finance out of their problems that business to be much slower than it actually has been. They had a great year and it's a credit to those guys to get a near record year in an environment when I think their whole restructuring industry is very slow.

Sorry, Roger, what was your other question?

R. Freeman Just I guess it's been extrapolating from your point of view going forward.

T. James I'd be curious as to what Steve thinks about that. I notice that we have some people saying, "Oh it's going to be a big M&A year", and some people think it's not going to be. I'm going to let Steve comment on that.

S. Schwarzman I think there's still a bit of an overhang from this political stuff and it's very hard making decisions when you don't know what's going to happen with the sequester. You don't know what's going to happen with overall GDP. You don't know whether the government is going to get shutdown on a continuing resolution. These are not confidence inspiring uncertainties. When you think the economy is going up and you pick up your newspaper and you find out that in the fourth quarter it actually declined GDP it doesn't make you run out to your Board and say, "Let's expand in to this."

I think, as Tony has said, there's a wall of cash in the corporate community and if there's something that's cheap you'll do it. Is there enormous optimism that would make you want to buy extra capacity when there's still a lot of slack in the economy? I don't think so. There are some interesting things. You've got value investors or whatever they're called today. They used to be called raiders but they have a more elegant name.

[*Inaudible*…]

S. Schwarzman Oh yes they're activists. We can actually learn something from these guys in terms of renaming themselves since private equity doesn't apparently have as much attractiveness as a marketing name as activists. Not that we want to be activists, which we're not, but just the name change makes these guys better. There are some discontinuities that create some flow in that business.

I think on balance we're in a better position for M&A activity, but I don't see—until the governmental stuff gets straightened out and people know what the rules of the road really are going to be—that we'll go in to a really accelerated period. I would guess, since you put it to me, that sort of M&A activity will be up somewhere between 10% and 20% this year. I don't think it'll be at the same level but I don't see us as part of the V here on M&A activity, and I'm not talking Blackstone. I'm talking on a broader basis.

R. Freeman: Okay. Thanks a lot, appreciate it.

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

C. Kotowski: I just had a question about the credit business and how the consent of a carrier structure there and how one should think about it in a rising rate environment that Steve talked about earlier. Are they benchmarked against the performance of high-yield or are they benchmarked in terms of absolute returns? If it's the latter then during a rising rate environment could one anticipate a nuclear winter for performance in carry in the credit business if that happens?

S. Schwarzman Actually, I don't think so because if you look at the composition of their business they've got a giant CLO business. Basically, we're the largest owner of leverage bank loans in the world. Okay. It's just like a big deal and those loans float up so they're not going to get hurt with that. In fact, it's a great place to hide, and we've got some products if you'd like to put some of your own money in it. That's a good thing.

On our drawdown funds, we don't make mezzanine loans and rescue loans that are meant to be out long enough that basically you get crushed when things go up. Usually what happens, usually, is that when interest rates go up it's often in response to an increasing economy. When your economy is increasing people will finance us out of those positions with higher stock markets and companies that get in better financial shape because their credit has improved, which enables them to flee us, because we're basically custom manufacturers of credit extension, and go to more normal types of areas.

The rates on the money we put out when it's fixed are pretty high, and so we don't have to force ourselves out at a bad time. We actually don't have as much risk. We have more risk in our Hedge Fund, which is, I guess, about $3.5 billion, and we try and keep that hedged actually. That's why we call it a hedge fund. We try not to have that kind of exposure. It's not like we're a long junk bond manager as principal who is about to get buried. That's not the construction of our business.

T. James — Let me comment on a couple of those things there. First of all, the Hedge Fund doesn't have any hurdle at all but it does have high water mark. The drawdown funds have set hurdles. They're not tied to benchmarks, but they're fairly low in relation to the spread that they earn. The environment where interest rates go up I think will be a relatively strong economy and that's when the Fed will allow rates to come up. In that economy the drawdown funds have substantial equity interest, usually in the form of warrants on their investments. They're not usually just buying a 15 … security without an equity kicker.

What's tended to happen is it's not a bad thing when rates go up so much because the duration of their holdings go out. Right now they're being refinanced and having to put that money to work. As the duration of their holding goes up they get high interest rates longer, and their equity interest become a very substantial amount of money. A high proportion of the return is sort of equity options they get for free when they put money in to a distressed company or a private subordinated debt company. A strong economy has an offset there.

With respect to the senior debt business, which a lot of what Steve mentioned floating rate was CLOs but a lot of it is also separate accounts and things. When rates go up those rates float up and they actually earn more money, and so they're protected from the marks. If you look at the rate increase periods in the last six rate increase periods you'll see that the best performing fixed income asset class, which had significant positive performance, was floating rate senior secured debt. Investment grade debt actually a negative performance; high-yield debt because of the high interest rates had small positive performance; but floating rate senior secured debt had like 6% or 7% (my recollection is) positive returns in rising interest rate environments.

As Steve started off with saying, I don't think it's going to be a problem.

C. Kotowski All right. Just as a follow up, if you think back to your experiences in 1994 when you had the big increase, any other major pitfalls or opportunities that we should be thinking about in terms of your experience back then?

T. James Well, I can say this speaking for me—and Steve and I are both old enough I'm afraid that we were actually doing this back then—

S. Schwarzman We were doing that, unfortunately, way before then.

T. James —the returns to the private equity world were spectacular back then, but, of course, the leverage ratios were huge and there was a lot of—sort of the markets weren't as efficient and there was less competition. I don't know. The lessons are hard to draw on that one I think.

C. Kotowski Okay. Fair enough. That's it for me. Thank you.

J. Solotar Great. Thank you, everyone and Weston and I are around to take follow up calls.

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