BLACKSTONE Second Quarter 2016 Earnings Investor Call
July 21, 2016 11:00 a.m. ET

Operator: Good day, ladies and gentlemen, and welcome to the Blackstone Second Quarter 2016 Investor Call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session. As a reminder, this conference is being recorded for replay purposes. And I would now like to turn the conference over to your host for today, Mr. Weston Tucker, Head of Investor Relations. Please proceed.

Weston Tucker: Great. Thanks, Jasmine. Good morning and welcome to Blackstone's second quarter 2016 conference call. I'm joined today by Steve Schwarzman, Chairman and CEO, who is joining us from Europe; Tony James, President and Chief Operating Officer; Michael Chae, our Chief Financial Officer; and Joan Solotar, Head of Multi-Asset Investing as well as External Relations. Earlier this morning, we issued a press release and slide presentation, illustrating our results, which are available on the website. We expect to file our 10-Q report 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, and may differ from actual results materially. We do not undertake any duty to update these statements.

For a discussion of some of the risks that could affect results, please see Risk Factors section of our 10-K. We will also refer to non-GAAP measures on this call, and you'll find reconciliations in the press release. Also, note that nothing on this call constitutes an offer to sell or a solicitation of an offer to purchase an interest in any Blackstone fund. This audiocast is copyrighted material of Blackstone, and may not be duplicated without consent.

So a quick recap of our results. We reported GAAP net income of $463 million for the quarter, that's up 32% from the prior year, and GAAP net income attributable to Blackstone of $199 million. Economic Net Income or ENI rose to $520 million or $0.44 per unit, and Distributable Earnings were $503 million in the second quarter, or $0.42 per common unit, which equates to a distribution of $0.36, and that'll be paid to holders of record as of August 1.
With that, I'll now turn the call over to Steve.

Steve Schwarzman: Thanks, Weston. And thank you for joining our call. Blackstone delivered strong results in the second quarter with healthy Economic Net Income, substantial Distributable Earnings, and another quarter of what I expect will be the best fundraising success in the alternatives space. Our royalties continue to entrust us with more of their capital to manage in these uncertain markets. Despite strong realization activity, we again grew our assets under management to a record level, reaching $356 billion. We're executing against a macro background characterized by uncertainty, low and slowing growth, and an astonishing low interest rates around the world.

The 10-year U.S. treasury recently hit its lowest point ever, and one-third of developed nations' sovereign debt is trading at negative yields, and I think two-thirds are trading below 1%. We've been going through an extraordinarily strange period recently. Really starting last summer with the scare set off by Chinese currency devaluation. We then experienced a worse start of the year for equities since the Great Depression, and even greater chaos in the debt markets caused by an incorrect read of weakness in China and weakening trends in the U.S. That was followed by a sharp and surprising market rally, which left many money managers wrong footed only to be hit again by Brexit in the last week of the quarter. And today, the S&P has moved back to an all-time high. Go figure.

All kinds of odd things are happening that are affecting markets generally, and are presenting what we expect could be very interesting investment opportunities. Blackstone's fund structure with over 70% of our capital locked up for the life of the fund at a weighted average remaining life of greater than eight years gives us enormous flexibility, coupled with our large scale dry powder capital of nearly $100 billion. We are perhaps best positioned of any firm to move quickly on opportunities around the world. Limited partner investors are seeking better returns and less volatility in this challenging environment.

Current very low interest rates globally, coupled with high market valuations in many areas, means that many LPs simply can't earn satisfactory returns with their current portfolios, and are increasingly looking for the types of investment solutions that alternative managers can offer. Blackstone has been, and I believe will continue to be one of the greatest beneficiaries of this trend, coming off a period where we've raised $132 billion in the past 18 months. Our global scale then helps us find interesting ways to deploy that capital across all our platforms. In Private Equity, for example, we're seeing much higher levels of deal flow, particularly in the energy area.

We've also been very active recently, as Tony mentioned, in Europe, in Real Estate and Credit. Importantly, we are not passive buyers of any market, and only need to do relatively few deals in each of our areas, focusing on those unique opportunities where we can create value. This ultimately translates into better performance. Our Private Equity and Real Estate funds were up 2% to 2.5% in the quarter, 4% to 6.5% year-to-date and 8% to 15% annualized since the start of last year, outperforming global markets over all of these periods.

In Credit, our gross returns were between 7% to 10% for the quarter, outperforming the relevant indices, and frankly on an absolute basis really shooting the lights out. In our Hedge Fund area, BAAM's composite, as Tony mentioned, were up 1.4% gross in the quarter, with roughly one-third the volatility of the market. All of our businesses are effectively navigating this unusual and challenging environment. That fundamental performance, which I mentioned, has not yet translated into significant appreciation for Blackstone stock, which has suffered from shifting investor sentiment, concerns over the macro environment, and most recently Brexit, as compared to where we were a year ago.

The Brexit result has created fallout in markets and politics, most obviously pronounced in the UK. The immediate adverse impact to public security prices has largely reversed early in the third quarter. Although certain currencies like the pound, of course, have not recovered. In the near term, transaction activity in the UK should be slower, as decision-makers for businesses remains uncertain and market participants digest the potential impacts of the many different ways that Brexit can evolve. Longer-term, Brexit will likely have some modest adverse impact on global GDP, although it's too early to assess the full extent given unanswered questions, like whether the UK will retain access to the European single market.

Brexit will possibly constrain access to capital in Europe, and you're seeing those tremors hitting the banks, and will embolden the populist, anti-trade, anti-immigration movements across the continent, which is not good for the flow of capital and trade. For Blackstone, roughly 4% of our invested assets are in the UK, primarily in our Real Estate and Tactical Opportunities areas. We believe this direct exposure is quite manageable, although we did adjust the private valuations for certain affected investments to reflect a more cautious outlook, which Michael will discuss in more detail.

Our second quarter marks also reflected currency and public stock movement, the latter of which has reversed. I believe this is further illustration of why investors shouldn't put undue reliance on short-term mark-to-market fluctuations. The referendum had a big impact on risk sentiment and notably on asset management stocks. BX similarly declined from already depressed levels, although we've rebounded a bit. I believe this was overdone, given our very manageable exposure to the region, and the fundamental underlying strength of our firm.

However, as we've seen many times in the past, markets tend to overshoot when there is uncertainty added to the equation. On the positive side, I expect Brexit to create many investment opportunities over time, which we're well positioned to assess and pursue. Importantly, since the results of the referendum, which seems on the one hand, it happened just yesterday, and on the other hand, feels like it happened a long time ago now, but it was only four weeks ago. Blackstone invested or committed over $2 billion in the last four weeks to new deals. Several of those were in Europe, including a stake in the Swedish residential business and office complex in Berlin, but most importantly and recently, a logistics portfolio in the UK we bought from a property fund seeking liquidity.

We also invested in two new oil and gas deals in the U.S., one of which was the first investment in our BCP VII Private Equity fund, and we completed several new deals in Tac Opps and GSO. We also completed or signed up in the last four weeks $7 billion of realization since Brexit. So if you think the world stopped, you should keep thinking – it hasn't. These sales were mostly in Real Estate, including several office and hotel assets in the U.S., most of our stake of a public company in Asia and six successful stock sales across Private Equity and Real Estate. It's pretty amazing.

We also formed a joint venture with our private equity company Change Healthcare with McKesson and received a $6.6 billion debt financing commitment, which will result in substantial realization early next year. And also, it's been a busy four weeks. We won multiple LP mandates of $1 billion or greater, each. That's not an aggregate of $1 billion, those are several commitments of $1 billion-plus.

Our businesses are in terrific shape. 2016 should be a big year for fund raising with $38 billion already raised in the first half. We've generated attractive investment performance and protected and grew our LPs' capital. And we continue to invest in our people and our businesses and build on our leadership position in every area.

We had $16 billion of realizations in the first half, despite some delays and weakness in the first quarter in fact – basically the world locked up for the first week of the quarter, and almost nothing could be done. I expect 2016 to continue to be a good year for realizations; U.S. and Asia are certainly still wide open for business. The U.S. in particular, is a safe haven in today's world. And there is enormous liquidity around the globe looking for a home. As a result, I would expect significant cash flows to U.S. markets, as interest rates remain globally depressed. As I said, over 70% of Blackstone's invested capital is in the U.S., and so we could see many opportunities for realizations, which should also be positive for our Distributable Earnings.

For our unitholders, if you simply ignore realizations and focus solely on our fee related earnings, we have a clear line of sight towards strong double-digit growth in fee earnings for next year. This alone could generate approximately $1 per unit or more depending upon the timing of certain events, particularly funds being launched. You should know, which I actually didn't, that the S&P is yielding around 2% today. It's incredibly low. And we don't see why our mostly locked up fee earnings shouldn't be capitalized in our stock price, at a similar if not lower yield to the S&P. You could do the math. A 2% yield, the same as the S&P, on $1 of fee related earnings implies a $50 stock price, not the $26 where we are today. I know this seems hard to believe, but it happens to be mathematically true, and finance is supposed to have something to do with mathematics.

At a 3% yield, which is a 50% premium to the S&P for long-term locked in cash income – and I wouldn't understand, why you'd need a premium – it implies a stock price of over $30, and that's giving no consideration to realizations, which have already added $0.40 per unit to Distributable Earnings in the first half of the year, and which have averaged almost $2 per unit in Distributable Earnings over the past three years.

So when you put this all together, I think the math is sort of simple. And Blackstone sort of has earnings in two pieces: one, fee-earning income, which is highly predictable, and which deserves a market multiple at a minimum, and that takes you to much, much higher levels than where you are today; as well as our distributions from realizations, which always happen, and that's our primary business: good investments for our limited partners. And that's why they give us so much money. So I leave that all to you. Blackstone is the dominant firm and reference institution in the alternative asset management industry. You may be surprised to learn that Blackstone's market cap is roughly the same size as our next five public competitors combined.

I'll say that one again, because it surprised me a bit: Blackstone's market cap is roughly the same size as our next five public competitors combined. And I hope we can all agree that Blackstone is very much on sale today. I remain confident that this valuation mismatch will correct itself over time. But that's up to you, not to me. In the meanwhile, we'll continue to focus on what we've always done: creating great investment products and returns for our limited partners.

I'm really so proud of what all of our colleagues have achieved at Blackstone.

Now, thank you for joining the call. I'm going to turn things over to our Chief Financial Officer, Michael Chae. Michael?

Michael S. Chae: Thanks, Steve, and good morning everyone. Our results in the second quarter and first half of the year reflects strong execution across all of our businesses, despite the volatile market backdrop that Steve discussed.

Our funds delivered good returns across the board, beating benchmarks. Our Economic Net Income and Distributable Earnings both rose significantly from the first quarter. And our capital metrics remained strong with healthy realization and investment activity and continued very powerful fundraising trends. Total AUM rose 7% year-over-year to a record $356 billion, driven by $21 billion of inflows in the quarter and $70 billion over the past 12 months. Fee-Earning AUM rose double-digits by 11% to a record $266 billion, partly driven by the launch of the investment period for BCP VII in early May. That launch triggered a step-down in management fees in BCP VI and the onset of a six-month fee holiday for BCP VII, which will end in November. BCP VII alone will generate nearly $250 million per year in fee revenues, starting next year.

Despite the temporary negative impact of the fee holiday, fee-related earnings rose 27% in the second quarter to $226 million. There is some noise in the comparison to last year's second quarter, which included the advisory businesses and a significant one-time expense item. But even adjusting for those, the increase was a robust 16%.

ENI was a healthy $520 million in the second quarter, our best performance in the past five quarters. Performance fees increased from a more muted first quarter with good relative returns across businesses.

I'll provide more context to returns in a moment, but first I'd like to address the impact of Brexit on our financials, which we know you're interested in. There are three components; currency, marks in our private portfolio and movement in our publics. First, in terms of currency, only 4% of our invested capital is denominated in British pounds and this represents less than 3% of our total AUM.

The exposure is further mitigated in a couple of respects. A meaningful portion of these assets is currency-hedged in some form and much of it sits in euro-denominated funds, which helps mute the impact from a fund performance standpoint as the pound weakened less against the euro than the U.S. dollar. All of this amounted to ENI impact in the quarter from the pound devaluation of less than $50 million across the firm.

Second, the mark-to-market impact to our private investment portfolio outside of currency effects was also around $50 million on an ENI basis. The areas of our private portfolio exposure are discrete, and in aggregate, quite manageable we believe. 4% of our Real Estate AUM and 6.5% of its invested capital is UK-based, comprised of a mix of high-quality logistics assets, fully-leased student housing, hotel and office properties. We marked down our UK office portfolio, notwithstanding how comfortable we feel with our basis in these assets. This represented the bulk of the total firm-wide private mark-to-market impact mentioned above, yet its overall financial impact to the firm was small relative to the scale and diversity of the firm's asset base.

The firm's remaining direct equity exposure is primarily in our Tactical Opportunities business, which has several high-quality assets in the UK. While the immediate operational impact from Brexit to these assets appears limited, a subset was marked down modestly to reflect a generally more conservative market outlook. The ENI impact was minimal in the single-digit millions.

In Corporate Private Equity, the direct Brexit impact was de minimis as we had sold almost $4 billion of seasoned UK assets in 2014 and 2015 at a significant profit, substantially exiting our portfolio there.

And finally, in Credit, the impact was also modest. Most of our investments are currency-hedged on a principal basis and we have a limited number of investments with operational exposure in the UK.

The third and remaining area of impact to ENI was from the general equity market down-draft in the days after Brexit that impacted our publics. This too constituted less than $50 million of ENI impact.

Importantly, the aggregate decline in our publics quickly reversed itself in this quarter, and then some, in the first several weeks of the third quarter. Further to this, against the backdrop of this market rebound, in the four weeks since Brexit, as Steve mentioned, we've in fact signed or closed over $7 billion of realizations in over 15 transactions across the firm.

Now, I'd like to review briefly the highlights of the results for each of our businesses. In Credit, GSO had an excellent second quarter. Gross returns for the Performing Credit and Distressed Strategies were plus 10% and plus 7% respectively, marking a strong rebound following a particularly difficult period in the markets. This was driven in significant part by strong performance in the energy portfolio across the platform and by liquid portfolio gains.

GSO had a tremendous fundraising quarter, $7.3 billion of inflows – its second best fundraising quarter ever. The list is long and interesting: first, we closed on $4.2 billion for our third mezzanine fund in the second quarter in July, and expect to hit our hard cap of $6.5 billion based on strong global demand. Second, we quickly raised a new $1 billion vehicle, targeting liquid opportunities arising from market dislocation. Third, we priced three CLOs this year, totaling $1.7 billion, including the largest deals in the U.S. and Europe this year. And fourth, GSO will receive a significant allocation from the capital recently raised by our newly formed Harrington Re reinsurance company, in partnership with AXIS Capital, which raised $600 million in the largest such offering in the market this year.

GSO was also quite active in deploying capital, investing or committing $1.7 billion this quarter. The two most significant areas of activity are in Europe, including the unit tranche debt commitment at well over €600 million that is the largest to date in European market, and energy, where the second quarter marked a resumption in activity and enhanced deal flow which continues apace.

In Hedge Fund Solutions, BAAM's composite gross return was up 1.4% in the quarter, making up some ground after a challenging first quarter. While much of BAAM's incentive-fee-eligible

AUM fell below its high water mark in the first quarter, given the market headwinds, the second quarter 's positive progress leaves a significant portion of this capital closer to the point of crossing back over.

Demand for BAAM's products remained strong; including July 1 subscriptions, year-to-date gross inflows were over $6 billion. Net inflows for the same period were over $1.4 billion, despite the impact of the expected large redemption in our individual investor solutions area, which we discussed last quarter. Excluding that redemption, year-to-date net inflows were a very strong $2.6 billion. We've also locked in some very large mandates which will come in later this year and are having active discussions for several more, so the outlook for the second half is quite positive from a flow perspective.

So the picture here is one of fundamental strength and momentum in the BAAM business, notwithstanding the broader questions about the industry which reached a heightened level in the same quarter.

In Corporate Private Equity, our funds appreciated 2.5% in the quarter. We've been carefully navigating a low-growth, high-price environment with a disciplined focus that has helped us avoid some of the problem areas in the market over the past few years.

With $30 billion of dry powder today in Corporate Private Equity, including our new BCP VII fund and new core platform, we are well-positioned to take advantage of dislocation.

In the energy space in particular, as we've discussed for several quarters, although we've raised a lot of capital, we chose to keep our powder dry over the last year and wait for the right moment. That patience paid off and this quarter we started to really see the opportunity set ripening, and have recently committed or deployed about $1.5 billion of equity in several investments and have a strong pipeline.

We've remained active on the realization side in Corporate Private Equity, with $3.1 billion sold in the second quarter, mostly in BCP V. As you know, BCP V is substantially in carry on a total fund basis and we continue to accrue carry with additional gains. If everything were sold today, we'd crystallize and pay out the fund's entire current net performance receivable of $373 million.

Despite this, some of our recent sales in BCP V have not yet converted into Distributable Earnings. The reason is that we've recently sold some large investments at lower multiples of invested capital that, given the long hold periods, did not exceed the accumulated preferred return and we need to make up such deals' shortfall with additional realized gains elsewhere before carry can be paid.

Simply put, this is a timing issue that arises from the sequencing of investment realizations. And as I highlighted on last quarter's call, this could persist over the next couple quarters. That said, we have good momentum in realization activity that we expect will drive Distributable Earnings, particularly from our Real Estate business. With regard to Real Estate, our overall performance remains very strong. Despite some bumpiness in the quarter in public markets and the markdowns in our UK office portfolio that I discussed, our opportunistic funds were up 2.2% and core+ up 2.1% in the quarter.

The overall healthy fundamental operating environment and positive supply-demand dynamics in most regions and subsectors creates continued opportunities. We deployed or committed $2.6 billion in the quarter and in the first two weeks of the third quarter we have consummated four new transactions, including three in Europe that emanated to different degrees from the post-Brexit turmoil.

We realized $3.4 billion in the quarter and the global hunt for yield is sustaining demand for the type of Real Estate we own, particularly in the U.S. In addition, we currently have in excess of $4 billion of equity realizations from asset sales under contract and an upbeat outlook for the pipeline of private and public market realization opportunities.

I'd like to close my remarks today with a bit of a longer-term perspective for our business, to complement and echo what Steve said about our value. The dual drivers of our long-term value, as Steve said, are of course our fee-related earnings and our performance fees. As Steve said and as I've discussed in the past, we expect a powerful upswing in FRE next year based on capital already raised. And as Steve said, this is a recurring, dependable high-margin cash flow stream, mostly generated by management fees from capital locked up contractually for an average of 8.5 years, and as that stream grows, it will become an even more visible part of our earnings machine.

With respect to our performance fees, the driver of that future value is the capital that is put to work that will season in value and eventually be harvested. And it's important to step back and appreciate the extraordinary position that we're in in that regard.

At the end of the quarter, we had $269 billion of performance-fee-eligible AUM, of which $174 billion was invested with $121 billion in drawdown funds. That's what I call our “value in the ground” position. That is approximately triple the amount we had in the ground five years ago. In 2015, we generated around $2.50 per unit in performance fee distributions, over 80% of which was harvested from sales originating from that far smaller “value in the ground” position from five years ago.

If we deliver investment performance even close to what we've done historically with three times the value in the ground today, we believe that bodes very well for the growth and value of our future performance fees. And while performance fees can be less predictable in the short term, over longer periods of time we believe they are highly predictable, given our track record. While public investors have only been witnessing this dynamic for a relatively short period of time since our IPO, our LPs have seen us do this consistently for 30 years. And the fact that these investors continue to entrust us with more and more of their capital to manage is indeed the best endorsement.

With that, we thank you for joining the call and would like to open it up now for questions.

Weston Tucker: Thanks, Jasmine, if you could open up for questions – but before you do, if I could just ask everybody in the line, we have a fairly full queue, so please limit your first call-in to one question and one follow-on. That would be terrific.

Operator: Thank you. And our first question comes from the line of Alex Blostein with Goldman Sachs. Please proceed.

Alex Blostein: Thanks. Good morning, everybody. Just want to start off with the backdrop for fee-related earnings. So $60 billion is not currently earning management fees, up quite significantly from the prior quarter, so clearly a very large number. So I was hoping you guys can run us through the expected timing of how this is going to play into the management fee growth over the next year to year and a half. And then more importantly I guess as we think about the margins, they've been ranged down on the fee-related earnings set for the last couple of years. So, again, as we kind of start to think about the growth on the top-line, how should the margins progress on the back of it?

Michael Chae: Well, I think, taking the second one first, Alex, I think we've seen obviously low-double-digit AUM growth over a long period of time now and we expect that to continue, as well as fee-earning AUM growth, in the high single digits to low double digits over time.
On a fee-related earnings margin basis, there is obviously some noise from time to time in the numbers and you have to adjust for those. But if you step back and look at sort of the longer trajectory over the last five years, we did 36.4% FRE margin in the second quarter. That's exactly what it was for all of 2015, although we kind of got there differently.

And if you look over a longer period of time, that has grown by 700 basis points over a five-year period. And again, while there's occasional ebbs and flows in that trajectory, the trajectory has been on an upward trend and we expect that to continue.

Alexander Blostein: Got it. And then just for my follow-up, Steve, if I may just ask you again around the capital return dynamic, it comes up pretty frequently, but given the underperformance of the shares obviously over the last several months here, I just wondered if you guys have given any thought to the buyback because it does seem to come up pretty frequently for you guys?

Steve Schwarzman: Why don't I delegate that one to Tony?

Tony James: Alex, we looked at that again after the last quarter frankly and we just feel a few things – that we can earn a huge return on the capital that we have on our balance sheet. We tend to put up a small amount of the fund – it's an enabling capital that allows us to raise LP capital. And if you look at the return on that capital that comes from LP management fees, performance fees and all that, it's compellingly high. Now, we're in a business where we pay out 85% of our earnings. We don't accumulate a lot of cash flow and at double-digit growth, high-single-digit, low-double-digit growth, as Michael said, we're needing that to feed that capital in and to drive the growth of business.

And we've continued to conclude that our LPs, our unitholders, are better off by us continuing to grow this business and put this capital up with very, very high returns than to buy in shares. And so far, as we've analyzed it, we think that's the better view.

At some point of course, our stock gets – we think that the stock is a bargain here, and at some point, even though we can earn sort of 40%, 50% returns on incremental capital, we will look at buying our shares. But so far, we've been more concerned about building a great company, continuing the growth and serving our LPs than trying to manage short-term stock price.

Alexander Blostein: Got it, great.

Weston Tucker: And then, Alex, just to follow up on your first question, just some of the dimension about $60 billion not earning management fees, a big chunk of that is our BCP VII fund, as Michael mentioned, that will flip on in the fourth quarter in November. We've also got a fair amount of dry powder in credit, in our mezzanine, our new mezzanine fund in Real Estate that earns as invested, and that will be over the next several years. So it's a bit of a mix between capital that would be turned on in the next year versus when it's invested.

Alexander Blostein: Yeah. Got it. Thanks so much.

Operator: Our next question comes from the line of Craig Siegenthaler with Credit Suisse. Please proceed.

Craig Siegenthaler: Hey, good morning.

Weston Tucker: Good morning, Craig.

Tony James: Good morning.

Craig Siegenthaler: So on fundraising first. It's been a very strong two-year capital-raising cycle here for Blackstone. And I think the $21 billion in 2Q is probably much better than anyone was forecasting, but I wanted to get your perspective on how aggregate capital-raising trends could really trend over the next 12 months, just with all the recent fund closings, and maybe you can also help us with the largest potential strategies that are either open or could open given the majority of the last fund is now committed or invested?

Tony James: Okay. You want to me start on that? Fundraising for our business is lumpy. And when it comes to draw-down funds, when you have the flagship funds, you tend to have a big year and then it tends to slow down a little bit. However, as our firm's become more diversified, we have more and more funds all the time that are in the market and any one time we might have dozens or more, number one. Number two, we are constantly – I want to emphasize innovation. What really drives this company is innovation and we're constantly having new products and a lot of times that starts off with a separate account with a few big investors to do something different. And once we get that money invested then we convert it more towards a fund and take it to a broader market.

And then third, increasingly we have always-open funds and permanent capital vehicles and things that are in the market every quarter and every month and every day. We take in daily capital with a bunch of our products. So what you're seeing is the business shifting. We continue to have the big flagship funds and those hit in 2015, but the business is shifting towards constant new things and more always-open. So you're seeing that lumpiness level out. And that's why you're having surprisingly high fundraisings in the absence of the big global funds.

Now, I'm going to turn it over to Michael to talk specifically about how that plays out a little bit.

Joan Solotar: Without mentioning by name.

Tony James: And then in terms of specific funds that we are going to be entering the market, the private placement exemptions require that we not mention them by name. So, we can take that – you can take that offline with some of the investor people.

Michael Chae: Craig, I'll just briefly put a fine point on what Tony said, if you step back and look at our annual inflow pace, last year we obviously had a monster year, $94 billion or so. In the prior three years 2012, 2013, 2014, when we were definitely a smaller firm in terms of product set, we averaged between kind of $47 billion and $60 billion, actually, in each of those three years. And I think over the next year or so, it will probably fall within that range. We've generally outperformed our kind of prior-year forecast on our fundraising because things just happened and we innovated as Tony said. And that pipeline is a combination, without getting into specifics of both I think obvious successor funds to funds you're well aware of, roman numerals III and so forth, of different funds – we're in Credit, Real Estate, regional funds et cetera. And then also new products and then as Tony said, some of these always-on fundraising products like in the Real Estate area.

Steve Schwarzman: There is no segment of our business that doesn't have multiple new products entering the market.

Craig Siegenthaler: Thanks. And just as my follow-up on fees, parts of the hedge-fund industry are adjusting their fee structures lower, but there is actually a few good examples in the off-segment where actually you're seeing higher fees and I think BCP VII, you saw a modest fee increase from fund VI.

So I am just wondering, can you talk about where the industry is seeing fee pressure and also contrast that to how Blackstone's fees are trending, because I don't think you've actually seen any sort of negative fee adjustments significantly even in the Hedge Fund side of your business.

Tony James: Yeah, I think your perception is generally right. We're not seeing across the board much in the way of fee pressure at this moment. Of course, we've kind of led the industry with I think good fees for our LPs all the way through. We've never been a fee gouger. And we've voluntarily led the industry in changing how we treated certain transaction-oriented fees and voluntarily relied more on management fees than those things.

But at this point, it's pretty stable, even in the Hedge Fund area. And then we have a mix shift going on though that overlays against that. So in the Hedge Fund area, we're adding more high margin products, but in some of the other areas like Real Estate, BPP for example is a somewhat lower-fee product and so is Core Private Equity and PE.

So there are some variations going on in the mix of products by segment. But in general, if you look at product by product, we are not seeing significant fee pressures.

Michael Chae: And to Tony's point, if you – to put numbers on it, if you do the math, which I think you can from public data of management fee rates across the whole platform, i.e., our management fees or base fees over our weighted average fee earning AUM over any period of time – as Tony said, the numbers will tell you over the last year, two-and-a-half years, it's been very stable, so within like one or two basis points across the whole firm over the last couple of years. Now, there's different things going on within that. The mix shift Tony mentioned, but then also in terms of underlying funds, and I think I mentioned this a couple of quarters ago, if you look at our flagship private equity fund, if you look at our flagship global real estate fund, our flagship European fund, the effective management fee rate, once you get through the fee holiday, but taking that into account, will be higher in those three products than in their predecessor funds.

Craig Siegenthaler: Thank you.

Operator: And we do have Mr. Dan Fannon back with Jefferies. Please proceed.

Dan Fannon: Thanks. Can you hear me now?

Weston Tucker: Hey, Dan. We can.

Dan Fannon: All right. Sorry about that. Can you provide some additional color on BAAM. Obviously, the industry headwinds are there, but you continue to take inflows, you're adding new clients. Just wondering if you're getting a greater share of the wallet from existing clients or what's coming from the kind of new clients to firm?

Tony James: Well, I think we've been getting greater share from the clients for a long time. I mean, the actual – step back from the hedge fund industry, and look at the hedge fund fund of funds industry, that's been in decline for several years, yet our business has been growing rapidly over that period of time. And it's really hard – I mean, it's a remarkable job that they've done in that business, because to be the industry leader and a dominant industry leader and still grow market share, it's not too easy to find examples of that around the world, and they've pulled that off.

They've pulled that off though again by innovation. If all they were was a standard hedge fund fund of funds, you wouldn't see this picture. But their ability to create new products and serve their customers in new ways and have those be higher margin products – it's been remarkable. And they've got some really big ideas coming that could add tens of billions, and I'm not going to get into what those are. But I think that they may be heading for a growth spurt actually here. So yes, we're taking market share, but it's by being creative and it's creating new things, it's not trying to just grab more of the old.

Dan Fannon: Thanks. That's helpful. And then on the $7 billion in sales that you guys have highlighted thus far in the third quarter, I know it's across a multitude of strategies and products. But I guess, can you highlight specifically kind of the end markets and kind of some of the bigger transactions and kind of how we can think about the flow-through potentially through to Distributable Earnings?

Tony James: Sure. Michael?

Michael Chae: Sure, Dan. The $7 billion which is both realizations we put under contract and actually sold, it's a mix across the firm. The biggest part comes from Real Estate. And then within that for Real Estate and Private Equity it is a mix of public sales. We've done a bunch actually in the last two weeks or three weeks and also private sales, particularly, with respect to Real Estate, but also taking into account for example that changed McKesson deal, which is quite a transformational deal that we signed up that Steve mentioned.

So it's really, it's a lot of different deals and in terms of contribution, especially as it relates to Real Estate, it should be very healthy.

Dan Fannon: Great. Thank you.

Operator: And our next question comes from the line of Robert Lee with KBW. Please proceed.

Robert Lee: Thanks. Good morning, everyone. This is maybe going back to the Hedge Fund Solutions, I was just wondering, if maybe you can put a little bit more finer point on where you stand with the high water marks, I mean, kind of how far away is kind of the bulk of assets and what would it take to start pushing more of the strategies there into incentive-generating?

Michael Chae: Sure. Robert, this is Michael. Much of the dollar is under the high-water mark, the vast majority. They were above the high water mark at the end of the fourth quarter and they went below it in the first quarter because the industry pressures and being down 2.9% across the platform. So the numbers are basically that 90% of the incentive-fee-eligible AUM is below the high water mark, but of that 90%, the vast, vast majority, again, about 90% of it, is on average 2.5% below the high water mark.

So those are the numbers and they're kind of intuitive, when you think about what happened in the first quarter and then what happened in the second quarter. And obviously, our team at BAAM feels optimistic about, near term, getting back out of that. Now, the reality is it's investor by investor, in terms of what the high water mark is, but that's the sense of kind of blended average across the platform.

Robert Lee: All right, great. And this may be a follow-up, and sticking with the Hedge Fund Solutions business, I'm just curious if any of your recent experience maybe with the Fidelity funding and taking money out of a product pretty rapidly, I would think – any thoughts that maybe, gee, the liquid alt part of that business is targeting the high-net-worth market, while maybe a lot of potential assets, are rethinking that, gee, given that potential volatility of assets and uncertainty around flows and lower fee points in some cases that it's maybe really still the opportunity you thought it was a few years ago? Or any change in the sentiment around that?

Tony James: Yeah, No. Well, I think we're just as optimistic about it as ever. In fact it was the very success of that product that led to the redemption. So let me explain that. We originally worked this out with three years of R&D and whatnot and worked it out [unintelligible] Fidelity , but they got a pretty good deal. We then created a product for which there was an awful lot of demand elsewhere and frankly better fees. And we didn't have infinite capacity in that product. So needless to say, we weren't going to continue to grow the low fee form of it. And so we moved our focus on to other investors and that continued to grow.

So the AUM in that business is growing very nicely and I expect it to continue to grow very nicely. I mean, what a great product for retail investors to be able to get access to what only institutions have, but do it with a lot of liquidity.

Robert Lee: Great. Thanks for taking my questions.

Weston Tucker: Thanks, Rob.

Operator: And our next question comes from the line of Patrick Davitt with Autonomous. Please proceed.

Patrick Davitt: Hey, good morning. Thanks for taking my question. You highlighted energy on the very strong credit performance. Is there anything idiosyncratic within those marks that are specific to certain positions that drove the very strong performance or was it really just the shift in spreads in commodity prices?

Tony James: Well, we don't have hundreds of names in that. Yeah, there are certainly a few big deals which moved it, but at the same time the shift in perceptions and commodity prices moved everything. So I think the answer is both. But we saw some bonds of energy companies that – and I'm not saying we own these companies – but if you look in the market, you'll see bonds of energy companies that traded down to single-digit prices and now they're back up into the $20s, and they're still insolvent companies. But wow, what a run. So I think you really have to unpack it name-by-name. However, all names move together. So I think, as I say, the answer is both.

Patrick Davitt: Okay, great. That's all I got.

Operator: And our next question comes from the line of Glenn Schorr with Evercore ISI. Please proceed.

Glenn Schorr: Hi, thanks very much. Quickie on Invitation Homes: A, if you could remind us what it's marked at on the books, and more importantly, it's been this great growth story but I'm curious at some point does it transition from a growth and acquisition story to just more of a management company, just a quick comment would be great.

Tony James: We don't do specific marks on specific assets so I'm not going to get into that. I would say – it's been a great investment. We continue to be very optimistic about where home prices are in the cycle. I don't even think we're in mid-cycle yet. So I think there’s a – in terms of homebuilding and general activities, prices have come up a lot – as a result, we're still buying some homes. But it's harder to buy in the volume that we once did. And so it's becoming a more mature investment in terms of rate of growth. And we still think there's potential to be had. And is it more of a management company? Sure it is, because we got a lot of homes and we want to serve those renters really well. We want to be a great landlord, and we're continuing to try to do that in a flawless way. And it's a big global business with lots and lots of customers and you never get it perfectly, so we're working on that.

Glenn Schorr: Okay, appreciate that. Just one quickie on the CLO business, you mentioned you did a couple of them already. A lot of players in the market had slowed down because of some of the risk retention rules, but I think there is some workarounds starting to happen or risk retention vehicles potentially. I'm not sure if you’re creating something similar, but curious for your outlook for your CLO business specifically.

Tony James: Well, I think that it’ll be market driven. We need to buy assets at good prices and we need to have liabilities at good prices. And we kind of operate – both have to be available. I think that we're a good provider of capital, I think if anything, structured products would be harder for the banks and it's opening up more opportunity for us. And it's not just in CLOs, but it's also on the mortgage side. And we're as, I think, creative as anyone in having capital relief and sort of vehicles.

Michael Chae: And on risk retention, as Tony just said, obviously, there is Europe and the U.S. In Europe the rule has been in place for longer and we have structures that deal with that nicely and in the U.S. we think we have our arms around it as well.

Tony James: And the rules are somewhat different, between the two areas. So yeah – but anyway, yeah, so we're working on that along with everyone else.

Glenn Schorr: Okay. Thanks so much.

Operator: And our next question comes from the line of William Katz with Citigroup. Please proceed.

Bill Katz: Okay, good afternoon everybody. So, Tony, I think in prior statements somewhere you had mentioned that you wouldn't be surprised if there was a pretty sizeable shake-out in the hedge fund industry. Sort of wondering if you could sort of update your thoughts on that, and then how does Blackstone sort of do in that backdrop and where might some of those assets go to?

Tony James: Yeah. So, you can't read headlines and know what was said. So, what we're seeing is, I don't think we see a collapse in the hedge fund industry at all, but what we're seeing is a lot of turmoil in there. And then the turmoil is moving – assets are moving from one form of manager to another form of manager. Frankly we expect to see assets move from human managers to machine managers. We also expect to see assets moving from high-fee managers to lower-fee managers or lower-fee vehicles, and in some cases, assets moving from vehicles with lots of liquidity to assets with less liquidity. And all of this is happening at once.

But I think fundamentally, when you have an industry which has underperformed the market averages and charges 2% and 20%, there's going to be a lot of fee pressure on a lot of managers. And indeed, a 2% management fee is one thing if you're earning 10% gross – it's another thing if you're earnings 4% gross obviously.

So, those forces are playing through. As far as we are concerned, we still think hedge funds play a very important role in a portfolio and give investors exposure to all kinds of different markets so they can pick their market and they can mix and match different exposures, commodities, emerging markets, takeovers, negative beta, positive high beta et cetera, et cetera, et cetera, and they're very important for portfolio construction.

And we think we're pretty uniquely situated to do that. And that we're in a position to use our market clout to extract better economics from the managers and largely offset our fees. So, as a result, people get an awful lot of value from us, and it's one of the reasons we're continuing to pick up assets and I think all this turmoil is actually helping us.

Bill Katz: Okay. Just a broad follow-up here, as you think about a world of slow economic growth, is it still fair to try and underwrite 20% returns in private equity real estate as historically been the case or should we be thinking about something a little bit more realistic?

Tony James: 20% growth in private equity real estate is totally realistic. So we are thinking about something that's realistic. Just want to be clear about that. Remember we're not buying the market, we're not buying economies, we're buying typically broken assets or undermanaged assets. And then we're taking those assets, managing them better, significantly increasing the earnings to the cash flow and converting them from orphans or weak players into core assets, core – either core assets with low cap rates in Real Estate or core assets with high PEs in Private Equity.

And if we can take a dog and create a great company, we'll get a pickup not only in the earnings but the multiples, and in real estate, if we're picking a broken asset and creating a core real estate asset we'll do the same. So as long as we can keep doing that it's fine; whether economic growth is 2% or 3% makes no difference to us. And that's what people worry about, when they say is going to be slower growth is that kind of thing. So yeah, we can still do very well, as long as there are assets in the world, or companies in the world that are not perfectly managed.

Bill Katz: Okay. Appreciate the perspective. Thank you very much.

Operator: And our next question comes from the line of Michael Cyprys with Morgan Stanley. Please proceed.

Michael Cyprys: Hi, good morning. Could you talk to some of the strategies behind the new opportunistic credit fund that you raised, I think it was about just under $1 billion that's focused on market dislocation, just any color you could share around the strategy there, the return targets, how big could this be, what sort of geographic regions or sectors that you find most appealing for this strategy?

Tony James: Sure. One of the areas of greatest dislocation, in terms of technical factors is credit. The regulatory changes, the capital pressures on the banks, the weakness of their balance sheets and all those things have accumulated to evaporate liquidity in the credit markets, as Steve in particular has been commenting on. And that's created a lot of pricing dislocation.

Earlier in the year, when we set this up, you could see pricing of credits across the board where you'd have to have default rates higher than in the depths of the financial crisis to justify those low prices, and why? Because there was a sort of a risk-off mentality, investors were pulling their money, and there's no liquidity in the market. So the pricing was terrible. So, I basically think credit markets and particularly illiquid credit markets are going to be a really, really great place to be going forward, thanks to the regulators and the government that are impairing the banks and the investment banks and the traditional providers of liquidity.

So very broadly this is a play on where we're benefiting from regulatory, if you – arguably overreach. With respect to regions, it's focused on the U.S. and Europe, where we have big credit markets, with good creditor rules. So if you are a creditor, you want to have good bankruptcy rules, good creditor protections. We're not speculating on sort of quasi-equity in some of the emerging markets on this. It's developed-markets focused and it's across all industries and they can buy everything from distressed to normal performing bonds that are just underpriced.

Michael Cyprys: And any color around the structure of the vehicle, drawdown-style I would assume, how long and what's sort of the economics for Blackstone?

Tony James: Yeah. It's drawdown and it's consistent in economics with all of our other credit vehicles.

Michael Cyprys: Got it. Okay. And then just, lastly on Harrington Re insurance transactions, $600 million raised, I think it was: could you shed any light on the strategy there and also the economics for Blackstone?

Tony James: Sure. I love Harrington Re. I personally tried to take the biggest bite the rules would let me because I think there was some – and I think Steve did too and I think there was some limitations on how much insiders could buy. I mean, this is a just – we're out of registration, right? So I can talk about it. This is a great – I love this. I'm glad you asked.

So this allows retail investors or institutional, but think about small retail investors to get the full panoply of Blackstone products in one set. You don't have go through a lot of brain damage and filling out papers and big minimums and all that to get into all these different funds. So first of all, you put money up, you get Blackstone returns across the portfolio and diversification, which is very steady, it's high return but when you get that kind of diversification, it's very steady.

We then, because we have a reinsurance partner and we invest in the float from the reinsurance, we get free leverage, so we get the returns on $1.50 for every $1 we put up – the Blackstone returns on $1.50 for every $1 that we put up.

And then, those returns accumulate tax free, because it's an insurance company. So they just keep accumulating, accumulating, accumulating. Instead of having to pay tax on your interest and your gains and all that, they accumulate tax-free, they get reinvested. Then, when we want to exit – and so the book value grows – then we want to exit, we will IPO this thing and we expect to get a premium to book value.

So then you get a markup on all that cumulated earnings that cumulated tax-free, and guess what, when you sell, it's capital gain. It's just a great product and for us – so that's from the investor standpoint. For Blackstone, it's permanent capital, we can put it any fund we want and we have a great reinsurance partner who is a real insurance company that is a really wonderful underwriter. We actually hope to make money on the insurance underwriting side of that as well.

So obviously, I like the product a lot for both Blackstone and for the investors. It's a win-win, like so many of our products are, which is good for us and it's good for our LPs as well.

Michael Cyprys: Great. Thank you.

Weston Tucker: Thanks, Mike.

Operator: And our next question comes from the line of Devin Ryan with JMP Securities. Please proceed.

Devin Ryan: Hey, thanks. Good afternoon. Maybe a first question here just on retail fundraising, now that we've had some time to digest the final Department of Labor fiduciary rule and I'm sure you guys have had conversations with your distribution partners at this point. I'm just curious if you're expecting any changes to product structures or how you sell through the various brokerages, whether it creates any timing disruption, really just trying to get a sense of feeling around the retail opportunity with some of the changes coming to the industry.

Tony James: Yeah. Those fiduciary rules are more focused on retirement plans, 401(k)s and things like that. So – so far, our distribution has been mostly to high-net-worth individuals and that's unaffected. Although we are increasingly creating products that are in more of a liquid sort of tradable form, which will be fine for fiduciary and those can go to smaller investors.

We are hopeful that my partner Joan will be able to crack open 401(k)s in a big way for alternatives someday, which would open up huge demand for our products, but that's a ways away and it has nothing to do with the fiduciary rules, I actually think ultimately those will be helpful.

Joan Solotar: Yeah. And in a way, we are in a great position, because we're entering these markets after all of the changes. So we've been able to evaluate everything and structure products that we think will be best in class and provide really terrific returns like others do on a net basis to investors.

Devin Ryan: Got it. That's very helpful. Thank you. And then just on the real estate platform and landscape. Bank regulators are increasing scrutiny just on the commercial real estate lending standards for the banks. So I'm just curious, if your view is shifting at all on the opportunity set in the U.S., meaning, does it feel like we're getting frothy at all there? On the other hand, I hear the comments that momentum is strong with dollars coming in to the U.S., so I'm just trying to get a sense of kind of the deployment trajectory versus kind of the modernization backdrop?

Tony James: Well, I think we're in reasonable balance is the answer. There is a pretty good bid for really high-quality stabilized assets because cap rates are low and they're safe assets and it's a great country with really solid economy. And so a lot of investors are happy to park their capital in those assets. On the other hand, we're not seeing any signs, in general, of overbuilding, the kind of frothiness that are the precursors to the collapse of real estate values.

Some sectors are a little more active-building than others, there's more building in multi-family for example in terms of where it feels like you are in the cycle, than in single-family homes – just looking at residential. So you have to kind of unpack the things. There is great demand for office space in Northern California with the tech boom and less so with suburban office space in some central parts of the country.

But across the board, we're still seeing good opportunities to put money out as well. And I would say though that five years ago, we were able to buy things at 40%, 50% discounts to physical replacement costs. We're still buying things at discounts to physical replacement costs, but the discounts have narrowed a lot. However, as long as we're buying at discounts to replacement costs, there's not going to be a lot of new building that crushes us, right? So, we feel very good about the new stuff we're buying.

Devin Ryan: Yeah. Okay, great. That's great color. Thank you.

Operator: And our next question comes from the line of Mike Carrier with Bank of America Merrill Lynch. Please proceed.

Mike Carrier: Hi, thanks a lot. First question, just on DE, and in part the quarter and just the outlook. So, in the quarter, just on fee-related earnings, it seems like in the Private Equity business, there was no step-down on the fees, just wanted to find out on the timing of that – and I understand the outlook in terms of the ramp in FRE in '17. And then on the realizations, Mike, I think you mentioned that even though there was $9 billion, some of the nuances there in terms of why we didn't see big realized performance fees, was that some of that was in BCP V. Just want to make sure that was the bulk of the reasoning. And then when we think about the rest of the portfolio, are there any other nuances like co-investments or anything else that could not flow through to DE like we typically expect?

Michael Chae: Sure, Mike. On the FRE question, there was a step-down in BCP VI in the quarter. And at the same time, the BCP VII lit up with the fee holiday. So that's why you'll see for a couple quarters sort of a trough period for corporate PE, FRE before, as we talked about in this call, it really takes off.

On the realization sort of DE conversion issue, I think we've actually covered the two points here. The first is the BCP V issue that I addressed pretty specifically in my remarks. And then the other is much less in effect, but the question was asked around, for example, the BAAM high water mark and that, from an incentive fee collections standpoint, that affects DE in the near term. So it's really those two things.

Weston Tucker: And then, hey, Mike, just to follow up on the first part. The reason you didn't see the sequential decline in base management fees in Private Equity is, as Michael said earlier, you have a lot of new products coming on. So, SP, Tac Opps, some of these other businesses that are growing that the reporting segment includes – is why these sequential management fees look like there wasn't a step-down.

Tony James: Yeah, and I think there is a point there that everyone should remember. And we present our business in four segments. But we're in a lot more than four businesses and they all have to – we have great products in 15 or 16 different businesses led by fantastic and discrete teams. The breadth, diversity and strength of our business is much more than appears if you just look at four silos.

Mike Carrier: Okay. That's helpful. Just a quick follow-up: when we look at the returns in the quarter, given the volatility, things held up relatively well. You guys mentioned how much money that's in the ground that you can generate or is carry-generating-eligible. But obviously there's a lot of macro factors, Brexit, that are weighing on investors' minds. So just wanted to see if you could give an update on portfolio company trends across Private Equity and Real Estate just to see how things are trending for the outlook for returns?

Tony James: Yeah. Okay. Well, in general our portfolio companies in Private Equity are growing in the low single digits. That has come down. We've had these conversations every quarter for the last five quarters or six quarters. That's generally – it's kind of been – the rate of growth has slowed each quarter over that period of time, I would say, as the recovery in the economy gets a little long in the tooth. But it's still, however, out-[unintelligible] the S&P 500 growth of earnings a lot.

In Real Estate, both occupancies are going up and rents are going up. And that's generally across the world and across asset classes. And I haven't seen any diminution of that. So I think those trends are continuing to be wind at our back.

Mike Carrier: Okay. Thanks a lot.

Operator: And our next question comes from the line of Chris Shutler with William Blair. Please proceed.

Chris Shutler: Hi, guys, good morning. In the Hedge Fund business with some of the new commitments you talked about having recently closed or that are in the pipeline, what kind of return expectations do those investors generally have for the Hedge Fund segment? Thanks.

Tony James: Well, again, you have to break that down by product, and I assume you're basically asking – I will assume that you're basically asking about our core hedge fund fund of funds domestic product.

Chris Shutler: Yes.

Tony James: And in that, I think they are hoping to get near S&P returns with about a quarter or third of the volatility.

Chris Shutler: Okay, got it. And then maybe just a follow up on the EBITDA growth question a second ago for Corporate PE, I mean, that's been in the low-to-mid single digits now for the last couple of quarters. I mean, if the EBITDA growth numbers remain, I guess, somewhat muted here, I mean, can you still achieve a 2x MOIC? I mean, does it just take longer? Mathematically, I would say it does, but any thoughts there?

Tony James: As I mentioned before, we're expecting to get the same returns in Private Equity that we've earned historically. So I'm very comfortable with that. One of the things about, I gave you the low to mid single-digits, but we're doing more and more things in Private Equity that are not just buyouts of traditional mature companies that are traded publicly. You look at where our money is going, there's a lot more buildups where we take a small company, great management team and assemble a national champion. There's a lot more investment in like oil and gas exploration. There's a lot more greenfield building of infrastructure like assets around the world. And all those things are not in the EBITDA growth rate because they're not mature sort of companies where you measure it that way. And those things are where most of our money is going, and they're offering extremely attractive returns.

Chris Shutler: Okay. Makes sense. Thank you.

Operator: And our next question comes from the line of Brian Bedell with Deutsche Bank. Please proceed.

Brian Bedell: Great. Thanks for taking my questions. Maybe just a follow on to that actually, in terms of deployment, it sounds like you are getting more innovative in trying to find opportunities. Maybe just to talk a little bit about some of the entry multiples in the U.S. with the market being relatively high here in a safe haven, and maybe contrast that with what you are thinking about the European opportunity given Brexit and NPLs there, and also the energy cycle in terms of sort of timing of opportunities there.

Tony James: Okay. Well, in the U.S., and you're focused on Private Equity, I assume – entry multiples are definitely higher, but I have several caveats. The availability, the cost of debt is also definitely lower. The availability of leverage is quite attractive. So the quantum of debt is higher. And we've shifted our focus towards companies that have, I would say, you'd ordinarily pay more because they're businesses with greater organic growth and ideally ones with where capital expenditures, or other capital needs to drive that growth, are low percentages of the free cash flow. So if we look at the unlevered returns we have, we're getting the same that we always did, but there’s mix shift and we react to market conditions, and we try to anticipate to be ahead of it, and be clever about that. But that, plus what I mentioned in the last question, Chris, is really why we’re still, we think, able to deliver really attractive returns in Private Equity.

As we move to Europe, Europe’s been a market that, where there is relatively less available – in Private Equity, there has been relatively less available. We've been, I think, pretty public about concerns about the long-term growth rate, growth of the Eurozone, structural integrity of the Eurozone, strength of the banking system in the Eurozone, the refugee crises and so on and so forth. So a lot of issues in Europe that the U.S. doesn't face. Yet prices in Europe have been not lowered to reflect those added challenges. And so that's made Europe a harder place to put a lot of money for us, but we still are looking at a lot of things. I think, Brexit, actually to the extent it makes people step back and knock some equity values down, will enhance our opportunity to Europe. Europe’s been tough for a while.

And then, in energy, not sure what exactly you're interested in there, but I think it's important to remember that we've been big energy investors for a long time, this is not new. We're on our second dedicated fund, but even before our first dedicated fund we had a lot of energy, which is why we went out and raised a dedicated energy fund just so we didn't get over concentrated in that.

And that energy fund is both a global fund, and does things like oil and gas at the upstream, but it also buys power plants, and builds renewable assets. So usually in energy, what's bad for one in that spectrum can be good for another. And I think, what you need to keep in mind is, as oil and gas might get soft, maybe that means that the buyers of oil and gas have some real interesting opportunities. So we play the full spectrum, and right now we've got just a ton of opportunities there.

Brian Bedell: Thank you. That's great color. And maybe just one last one either for you or Steve – as pension plans think about allocations going forward and we have lower yields that could theoretically lower discount rating and raise liabilities, and we've got full equity markets and low rates for the fixed income side, so LDI strategies could even be perceived as less attractive. Obviously, you would think alternative strategies, particularly in Private Equity and long dated, would be much more in demand. What are you hearing from pension plans in investing more in alternatives? And then, with the fundraising being so strong and being largely oversubscribed, how can you meet the demand for that in terms of investable opportunities?

Steve Schwarzman: Well, I think I'll take that one, it’s Steve. On the pension funds, we've been having sort of a pretty remarkable run in terms of raising money, and it's one, a testament to the firm, and breadth and excellence of performance. And on the second factor it's the fact that these institutions typically are not hitting their assumptions, their actuarial-based assumptions, and they need to do that. And your assessment in my view, at any rate, of the way the world lays out is correct. And as we talk with our clients and new clients, they really need to find a way to make things work.

And so we're finding a broader range of people who want to invest more and more money in the alternatives space. And our existing clients tend to be stepping up their size significantly with managers they really like and trust. And I think, maybe everybody on a call says something like this, if it's their call, that you're a place of choice for those, but I think the numbers that we put up over years show that that is indeed the case. And I don't expect that to change certainly in the short-term because there is still enormous pressure to keep global interest rates low. In fact, that's accelerated after Brexit. My goodness, if two-thirds of the GDP is sort of 1% or lower for the 10-year, that's really stunning, I mean, how do you get that kind of really good performance? And we create that for them.

So I think that that will continue, and as to what we do with the overage, some of it goes to our competitors, actually – good for them, but we don't look at life like that. We keep inventing new things, because what we're trying to do is give investors the highest possible returns with the least risk, and we've been very successful with that. And so we just go off on our way and come up with new things. As Tony mentioned, each of our big business areas have sort of – as part of their strategic plan, products we've liked to introduce, there is only so much you can do without straining your people, because we have to continue to keep doing great stuff on what we promise.

But that's a virtuous circle for us right now. And I don't see what's going to change it, other than dramatically higher interest rates, and getting excited about 25-basis point moves or a 50-basis point move is being dramatic. It's only – it's sort of like the – what do they say, in the land of the blind the one-eyed man is king. It seems big, but it's in the context of the world, it's not really going to affect the economy very much – it will bang markets around a little bit, but I think there is really good headway here for the firm.

Tony James: And let me just say, I don't think this – certainly low interest rates, and by the way our perception of the equity market going forward is not going to do much better than 5% or 6%, has helped lately. But no institution, no pension fund out there could earn its return hurdle historically either without a big slug of alternatives. And so this is not new, and it's not temporary, and it's not a function of today's market conditions. If you go back and look at institutional investors, their highest return asset classes always are alternatives, for every holding period you can think of. And as a result, those institutions that made a larger commitment to alternatives have higher historical returns.

And one of the really – one of the ironies about the global financial crisis that's good for us, is that when everything collapsed, the perception was, well, alternatives are riskier, you're really going to take pain then. Well, guess what? They actually held their values better than public markets, debt or equity, other – and by debt, I mean, not government bonds, obviously, flight to quality there. But people saw wow, alternatives have really held their value in that. So there's a growing perception of maybe they are not that risky after all, and they are certainly uncorrelated.

And so I don't think the interest in alternatives and the move to alternatives is a temporary thing driven by today's market conditions. It's been going on a long time. The people that move first and move more have done better, both in terms of consistency of returns and how high their returns are, and I think it's going to keep on going.

Brian Bedell: Great. No, that's great perspective. Thanks so much guys.

Operator: And our final question comes from the line of Eric Berg with RBC Capital Markets. Please proceed.

Eric Berg: Thanks for fitting me in. I have been struck by how many investors continue to believe, even though you've addressed this topic time and again, that the decline in rates and the extremely low rates have helped returns to your LPs in ways that are simply not repeatable. In other words, these investors understand the quality of your people and your business model, they get all of that, but they are concerned that if rates rise from here, you just won't be able to do as well for your LPs as you've done in the past. So my question is, you keep saying, it's not true, they are worried about it, what is your latest thinking about what would happen over the long run to the returns that you would deliver in say, Real Estate and Private Equity if we went to a more normal rate environment? Thanks.

Steve Schwarzman: Well, doesn't that some of that have to do with why rates are going up? If you've got an overheated economy, our types of investing tends to do very well in that. If you have high levels of inflation, that's sort of made for the Real Estate business, and it creates very interesting returns on a nominal basis. And we've lived in this industry, which I've been hanging around since the early 1980s when it started, and I think, Tony did like five years later something like that. And we made good money.

Tony James: Five years before, Steve.

Steve Schwarzman: Oh, really? I didn't realize you were that old. You can do well or do poorly in a lot of different environments. And we're not a bond fund per say as a firm, where rates go down and you make accidental money. We're trying to create value wherever we go.

And sometimes, you fix your interest rate so that if you sense things are going up in a way that isn't going to benefit you, you limit your costs. So I'm not trying to be adversarial about it. But I think, it's much more nuanced sort of approach. Tony, I cut you off, for a sec. So I apologize.

Tony James: No, no. I was just going to say, usually what we find is, when rates go up, it's against the backdrop of economic strength. So it's probably going to – if we kind of bump along with a really anemic economy, rates probably stay low a long time. If they go up to what you're talking about, then it's probably a pretty strong economy, and that's going to be good for us across the board, first of all. Secondly, in terms of putting new money out, it will just be easier, I mean, a rising tide lifts all boats, and you hear about the zero interest rates being financial repression. So as the financial repression goes away, the new money will I think have an easier time earning returns.

Now your existing assets, to the extent they're interest rate sensitive, could be hurt in that, if you're holding them and if they're long duration. And so what we've done, for example, in our

Credit business, we don't have a lot of long duration fixed rate assets – we're short duration, we got a lot of cash, there are a lot of transformation stories, there are restructurings, there are recapitalizations. There are things that are not going to be particularly interest rate driven. In Real Estate, as Steve mentioned, you get inflation, you're going to get rent growth, you're going to get – and so on and so forth. That should be okay. And in our mortgage REIT, everything we have in that mortgage REIT, everything is floating rate. So actually, higher interest rates, they are right a pass-through – that are good. And Private Equity, I think, again, we might pay a little bit more for debt, but again, strong economic background has got to be helpful. So no matter where I look in the business, I think it generally becomes easier and better for us.

Eric Berg: Thank you.

Weston Tucker: Thanks, Eric.

Operator: And at this time, I would now turn the call back over to Mr. Weston Tucker for closing remarks.

Weston Tucker: Great. Thanks everybody for joining us this morning. And we're looking forward to talking to you next quarter.

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