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## For the unrepressed

David M. Rubenstein, founder and co-CEO of the Carlyle Group, used the occasion of a talk in Miami last week to recall the arcadia of easy money, effortless fund raising and record-breaking deal making that came to a screeching halt in 2007. Why, said Rubenstein, in that culminating year, the fattest of five fat years, global buyout transactions worth \$860 billion were signed, sealed and delivered.

But then—wouldn't you know it?—proceeded five lean years. In the upswing, all seemed certain, but in the bad times, doubt descended. "[A]ll the deals that were done in the golden age," Rubenstein mused, "would they survive? No. 2, would the firms themselves survive, because they had done so many deals that didn't look good, would they be around? No. 3, would investors fund their capital?"

To each of these questions, Rubenstein was able to reply "yes." Of the 25 biggest deals done in the golden age, he said, only two failed. The largest private equity funds survived, and the limited partners met their financial commitments. So the world loves the big public purveyors of private equity and so-called alternative assets? It absolutely does not, on which fact hangs a story.

Blackstone (BX on the New York Stock Exchange) and KKR & Co. (KKR, also on the Big Board) are the subjects at hand. However, as usual, interest rates, even our tiny ones, lurk not far offstage. While the Federal Reserve has managed to "repress" Mom and Pop with its zero-percent funds rate, it has not so much as laid a glove

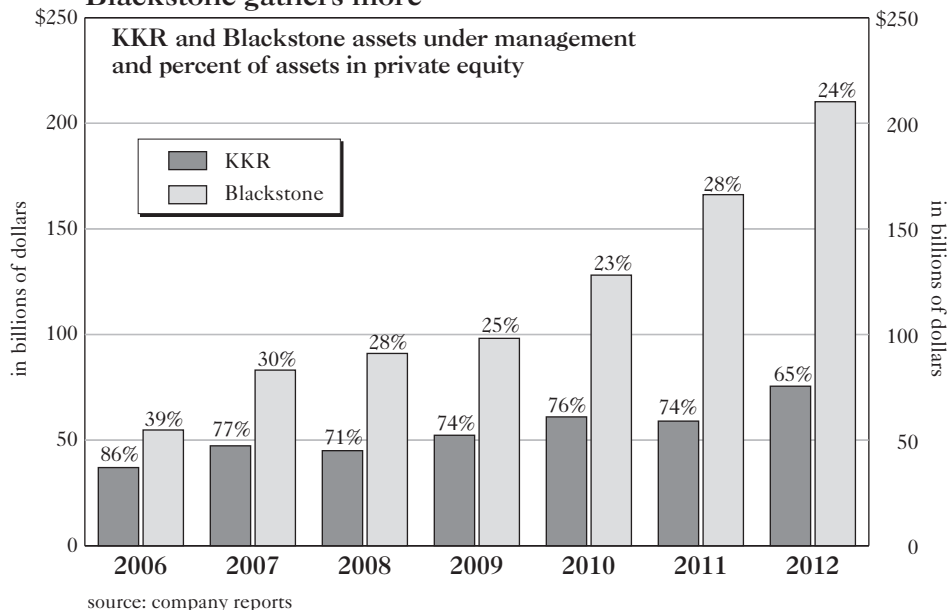
on Henry R. Kravis—or, in view of the new Heinz acquisition, on Warren Buffett, either. In preview, we remain bullish on BX (see *Grant's*, Oct. 7, 2011, and July 27, 2012). And we stake out a new bullish position in KKR, which, over the trailing 12 months, paid out a 6.8% dividend, 70 basis points higher than today's average junk-bond yield. It isn't every cycle in which the common equity of a private equity firm outyields the speculative-grade debt that that firm's client companies use to go private.

KKR and Blackstone should be the easiest businesses in the world to understand. They raise money. It is theirs for 10 years and more. They invest it—KKR, chiefly in private equity, Blackstone in p.e. plus real estate, hedge

funds and credit funds. They derive fees of 1.5% a year and a carried interest of 20% on successful investments. The businesses grow and grow, and the earnings compound and compound.

But you open up the companies' SEC filings and you shake your head in dismay. Non-cash charges litter the profit and loss statement. The balance sheet is swollen with the assets and liabilities of consolidated portfolio companies. Then, too, the shareholders of KKR and Blackstone are not exactly shareholders; rather, they are "unit holders." The difference is not important except at tax time, when the unit holders receive a Schedule K-1 in the mail. "As a partner in a partnership," KKR advises, "you are taxed on your

### Blackstone gathers more



allocable share of KKR's income, irrespective of whether cash distributions are made to you." It's as if you were a partner in a hedge fund.

"For the unit holders' sake as well as for its own," colleague Evan Lorenz notes, "the alternative-investments industry reports 'economic net income,' a non-GAAP measure of pretax income as well as results according to GAAP. Economic net income erases non-cash charges as well as certain revenues and certain expenses at company-managed funds. And ENI encompasses unrealized gains in portfolio investments as well as realized ones. The difference between GAAP-sanctioned net income and company-sponsored ENI can be enormous. Thus, KKR trades at 8.1 times trailing GAAP net income but at only 6.2 times trailing ENI. Blackstone trades at 46.7 times trailing net income but only 10.8 times ENI.

Mr. Market, who refuses to cotton to ENI, has a bad taste in his mouth about BX and KKR. The former came public at the very peak of the market in June 2007. The latter went public through a reverse merger with a Guernsey-listed affiliate that finally produced the NYSE-listed KKR in 2010. Then, too, there seemed something fishy about the firms whose very reason for being was private ownerships selling shares in themselves to the public. "Mark my words," said the writer of a comment on the DealBook story disclosing Kravis's filing for a Big Board listing, "KKR will cash out their private holdings and common investors will be left holding the bag. Common investors, beware thieves of PE are circling in the water. They are vultures and sharks. They will steal your hard-earned money."

It's our contention, rather, that the public can steal the shares, or units, of Blackstone and KKR—especially at today's valuations. The principal risk to this lawful taking is an explosion in our central bank-manhandled financial markets. In his talk, Rubenstein pointed out that the private equity business has flourished in all seasons of credit and interest rates. Against the special hazards presented by today's monetary policy, compelling equity valuations provide a layer or two of welcome armor.

It takes some peeling back to see that KKR is a very cheap stock. It's quoted today at \$18. Net cash per KKR share totals \$1.27, investments in company-managed funds another \$8.60 per share.

Combine the two and subtract from the \$18 share price. Now apply a P/E multiple—not even an ENI multiple—to the remainder. What you have is a stock selling at 3.7 times trailing GAAP net income and at 2.8 times adjusted ENI.

Perform the same operation on Blackstone. Subtract the sum of net cash and co-investments per share of \$4.49 from the \$19.15 share price. What you have is a stock trading at 35.8 times trailing net income and 8.3 times ENI.

"Since we began writing about Blackstone in 2011," Lorenz points out, "the share price has jumped by 61%, to \$19.15 from \$11.91, while assets under management have soared by 32%, to \$210.2 billion from \$158.7 billion. Blackstone, not quite three times bigger than KKR, is the most diversified of the public alternative asset managers. Under its care is \$51 billion of assets in private equity, \$56.7 billion in real estate, \$46.1 billion in hedge funds of one stripe or another and \$56.4 billion in credit funds."

Much smaller and less diversified than Blackstone, KKR is a freak of capitalistic nature. Founded in 1976, it has produced returns of 26% per annum since inception (a fact in no way to be confused with probable returns over the next 36 years). It was the barbarian at the gate with RJR Nabisco in 1988, and it achieved the largest leveraged corporate transaction of all time with its ill-omened purchase of TXU Corp. in 2007. Today, the company manages \$75.5 billion in assets, of which \$49.1 billion comprise private equity funds, the specialty of the house, and \$26.4 billion consists of public market funds that invest in credit, equities and specialty finance. Of the major public alternative asset managers, KKR has the biggest concentration of assets in private equity.

The TXU debacle speaks volumes about KKR's franchise and survivorship. The \$1.8 billion the firm invested in what is today known as Energy Future Holdings Corp. is all but gone—95% has been written off. But KKR's 2006 Fund in which TXU made its pratfall has generated annual returns of 6.9%, thanks to the more than compensating success of HCA Inc. and Dollar General Corp.

"We look at managers in the context of their portfolio, not a specific investment," David Fann, CEO of TorreyCove Capital Partners, an advisory group whose clients are investors in

KKR's 2006 Fund, tells Lorenz. "On an overall fund basis, to have achieved approximately 7% IRR at this time in the fund's life, and in spite of the great financial crisis and during a period where some very large buyouts were completed, seems like a reasonably acceptable performance." Since 2006, the (unleveraged) S&P 500 has logged an annual rate of return of 3.3% with dividends reinvested.

Another sign of the strength of the KKR franchise is the non-deflation in the fees it charges; the limited partners may grumble, but they still pay. "The management fees are the same, the carried interest is the same, the fee split we have with our LPs is the same, the economics are the same" Craig Larson, KKR's manager of investor relations, advises Lorenz. There has been one concession, Larson notes, however. Henceforth, as in the firm's new North America Fund XI, there is a 7% hurdle rate—until that rate of profit is cleared, KKR will earn no performance fees.

The fourth quarter was a blowout, with ENI per share showing a 45% year-over-year gain and dividends per share jumping 119% to 70 cents a share. "We returned more cash to our LPs than we have in our 36-year history," says Larson. "So that backdrop is a very positive one when you're talking about fund raising and looking to raise new capital."

This year could deliver some happy surprises, too. While KKR's TXU-laden 2006 Fund has performed creditably, it has yet to deliver performance fees to the sponsor on account of the TXU loss. This is not a hurdle-rate problem (the \$16 billion 2006 fund has no such bar to clear), but rather a "netting-hole" problem. Having written down the value of a \$100 million investment by, say, \$50 million, KKR may harvest no incentive fees until its investors have realized compensating capital gains of at least \$50 million.

"Write-downs on investments such as TXU have created a very large hole, indeed," Lorenz relates. "As of Dec. 31, the deficit amounted to \$275 million. Last week, KKR and Bain Capital Partners disclosed in a prospectus that they would sell up to 50 million shares in HCA in a secondary offering for a total consideration of \$1.9 billion. With this sale, KKR may sew up the netting hole completely. This prospect figures largely in the bull story on KKR: 'The

market is ignoring this catalyst, which will highlight KKR's incentive income-generating potential,' one such advocate contends. 'In 2013, the majority of KKR's assets under management will be cash-carry eligible and contributing to distributions for the first time.'"

The listed KKR was seeded with redundant cash and co-investments that today top \$7 billion. Blackstone, which manages more than twice as much money as KKR, is somehow able to make do with \$5 billion in net cash and co-investments. Might KKR then be contemplating a special dividend or at least a stepped-up regular payout? Not to listen to management: "We are looking at investment opportunities overall from the balance sheet and we get most excited by the ROEs that we get investing off of the franchise and the business rather than do-

ing some special dividend or the like," Larson says. "We look at the growth in the overall balance sheet—that was up 24% in 2012—so we feel pretty good about value creation on the balance sheet instead of just distributing the cash. If we get to a point in time where the balance sheet is so liquid, and we don't see 20%-plus ROE opportunities, we could change our point of view and do some kind of special distribution. But that is not something that I expect we'll see in the near term or the medium term."

Final word goes to the investors who brought Blackstone to the attention to this publication in 2011. Then as now declining to have their names in the paper, the Blackstone—and KKR—bulls say they remain long. The credit backdrop is propitious, they note. The menu of investment

choices available to institutions in this time of financial repression remains limited. What's new and different now, they say, is the prospect over the next 12 months for a stepped-up pace of dispositions—and, therefore, for a stepped-up pace of earnings. "The dividends of both [KKR and Blackstone] are going to allow these things to yield over 10% in a low-yield world," as one of those investors says. "You get these things yielding over 10% and growing 25% a year, that's kind of the third piston that is now turning on that has never been on as a public company for these stocks, and we think this year is when the dividend turns on, and the dividend power is very big."



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