Berkshire Capital | NEWSLETTER | 1st-Quarter 2013

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Private Equity "Big Five" Extend Their Portfolios

In 2006, private equity firms accounted for 18% of the $4 trillion in deals worldwide, or some $740 billion — nearly six times the level in 2000. The industry also raised more than $500 billion for new investments, including a record-setting $22 billion by **Blackstone Group** for a single fund. The following year, Blackstone bested competitors to pay $39 billion for Equity Office Properties while **KKR & Co.** joined other investors in ponying up $44 billion for Texas utility TXU. For private equity players, the sky appeared to be the limit. "It's not impossible that a $100 billion deal will happen in the next several years," **Carlyle Group** co-founder David Rubenstein told *Newsweek* in March 2007.

Needless to say, a lot has changed since those heady days. For one thing, institutional investors are taking a harder look at performance and fees. The industry itself has been lowering expectations, with Rubenstein telling *Bloomberg Businessweek* this year that returns "probably will come down compared to the historic highs we had 10 years ago." (Rubenstein still placed Carlyle's annual target at an attractive 20%, though that's down from the historic average of 30%, excluding fees.) Fundraising has become more challenging — dropping to half the level of 2006-2008 — but the industry is also finding it tougher to identify worthwhile investments. Preqin figures private equity firms worldwide are sitting on $1 trillion in unused funds, including some $100 billion that must be returned to investors if it isn't deployed by the end of the year.

The result: while private equity firms have recaptured some of the swagger they lost during the financial crisis — including paydays that are among the most attractive in the financial services industry — they have also been adapting. The evolution is particularly evident among the formerly private "big five" publicly traded U.S. firms, which have been expanding their services and product lines to deliver steadier growth. In the process, they have constructed a "one-stop shopping" alternatives model that allows them to broaden the dialogue with the world's largest institutional investors. But the story doesn't end there, as that model is in turn placing pressure on alternatives boutiques competing for the same pool of institutional investors. The predictable conclusion to all this maneuvering: consolidation, as the big five scoop up the smaller alternatives rivals they are crowding out.

For the big five, diversification has primarily meant adding credit products and hedge fund or fund of funds capabilities — although Carlyle last year acquired a majority stake in prominent fixed income manager **TCW** (via two of its private equity funds) and in 2011 took a minority stake in a Texas wealth manager. (To date, Europe's largest private equity firms have shunned diversification and remained private, including **CVC Capital Partners**, **Permira** and **Terra Firma**.)

In reworking their strategic plans, the publicly traded firms have two purposes. First, diversification adds predictable fee income that can help smooth out often volatile private equity performance fees (private

continued on next page

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equity investments also generate management fees). Since there are natural limits on the number of companies the firms can acquire in any period of time, diversification also provides new avenues for growth. Additionally, investors generally assign higher multiples to the sort of steady fee income earned on hedge funds and structured products than they do to performance fees. Just as importantly, the "supermarket" model allows private equity players to capture a larger share of their institutional investors' wallets.

Following the underachieving cumulative returns of the last decade-plus — and the looming prospect of paying real checks to hordes of retiring baby boomers — pension funds are attempting to both manage risk and enhance returns by boosting their alternatives allocations. "One of the trends that we're seeing is a continued need for alternatives within the investor base," Adena Friedman, Carlyle's chief financial officer and managing director, told investors last September. "And certainly in the public pension world, the funding gap continues to grow — and, therefore, the need for alternatives also continues to grow."

According to the latest data from *Pension & Investments*, the top 100 U.S. public pension funds had a collective 20% alternatives allocation in 2011 — eight percentage points higher than in 2007. For example, the troubled $11 billion State Employees' Retirement System of Illinois has boosted its hedge fund target allocation by five points to 10% since 2007. New Jersey's pension system, also significantly underfunded, has increased its overall alternatives allocation 10 points to 16% since 2007.

By building a product portfolio covering private equity, credit investments, and hedge funds and fund of hedge funds, private equity firms can lay out a menu of alternatives options for their institutional clients in one sitting. For institutions, one-stop shopping has significant benefits, since it lessens some of the complexity involved in making mandate decisions and can facilitate a more holistic portfolio review. "Almost all of the people who put money into the alternative area are looking to simplify their lives, not make them more complex," Blackstone chairman and CEO Stephen Schwarzman told analysts during the company's January 2013 earnings call. "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 pick up share." The big five — **Apollo Global Management**, Blackstone, Carlyle, **Fortress Investment Group** and KKR — also provide institutional investors with the benefit of transparency.

With a few exceptions, those firms have stuck to their knitting by sticking to alternative products. Carlyle Group, which went public last year, has been the most active buyer of assets, having made numerous acquisitions to extend the alternative capabilities in its fast-growing Global Market Strategies (GMS) unit. Since 2010, this includes five deals for collateralized loan obligations, among them the $2.8 billion of European CLO management contracts purchased last year from Dallas alternatives investor **Highland Capital Management**. That deal helped bring the total of such instruments in Carlyle's portfolio to $16 billion by year-end. Since 2012, Carlyle has used that leverage to launch five new-issue CLOs, including a $605 million vehicle investing in corporate leveraged loans and high yield bonds that closed in February 2013. In total, the five CLOs raised nearly $3 billion. "We can add another CLO without adding additional headcount so it's a very scalable part of our business," Adena Friedman told investors last September.

In 2012, Carlyle also bought a 55% stake in a New York hedge fund specializing in commodities, **Vermillion Asset Management** (AUM: $2.2 billion), marking the third hedge fund acquisition it has made in the last three years, including the majority stake it took in 2011 in **Emerging Sovereign Group**, an emerging markets equity and macroeconomic manager. In explaining the company's strategy during an earnings conference call in February, Co-CEO William Conway said Carlyle targets "hedge funds that are pretty unique as opposed to building a fund of funds business," noting that the firm has asked itself "what particular asset classes" investors "might find intriguing, like a commodities hedge fund or a long-short credit hedge fund or an emerging markets hedge fund."

By the end of 2012, Carlyle had $33 billion in AUM in its GMS unit, compared with $13 billion in 2009, with the business accounting for nearly one-quarter of distributable earnings. Carlyle has identified four other areas for potential expansion: fund of hedge funds; outsourced chief investment officer services; customized managed account solutions; and third-party reporting and administrative services.

KKR has been another active acquirer, gaining entry to the fund of hedge funds business last year through the purchase of one of the largest such players, **Prisma Capital Partners** (AUM: $8.5 billion). Founded in 2004, Prisma provides liquid, customized portfolios involving from a half-dozen to more than 30 managers, a niche that has enabled the firm to generate strong growth against the backdrop of a declining fund of funds industry. But Prisma has additional strategic value for KKR: providing access to dozens of new institutional clients — a potential cross-selling bonanza. Prisma was wrapped inside KKR's Public Markets unit, which includes credit products and a direct hedge fund. Public Markets AUM has doubled since 2009 to more than $26 billion to account for a third of KKR's overall AUM.

In January of this year, KKR added a minority stake in another alternative manager, **Nephila Capital** (AUM: $8 billion), which invests in reinsurance risk products related to natural catastrophes and weather. In the February earnings call, Scott Nuttall, KKR global head of Capital and Asset Management, said Nephila provides investors with "returns that are not correlated with the public markets" and described the deal as part of a strategy in which KKR assumes stakes "in existing hedge funds, plug(s) them in part into our relationships, and hopefully help(s) them scale." Nephila said KKR's "global

network of relationships, infrastructure and management expertise" can create new opportunities for its business.

Blackstone, with $210 billion in AUM, has built perhaps the most broadly based alternatives portfolio among its publicly traded peers, with more property and credit-related assets ($57 billion and $56 billion, respectively) than private equity ($51 billion). In addition, with $46 billion in AUM, Blackstone runs the largest fund of hedge funds business in the world. The fund of funds business is also notable for its growth profile, with AUM doubling over the last four years.

In recent years, Blackstone's most significant alternative acquisition involved credit manager **GSO Capital Partners**. But following that 2008 deal, the company picked up additional credit assets in 2010 and 2011, including for European leveraged loan manager Harbourmaster Capital. Three years ago, Blackstone also acquired a minority stake in Brazil's **Patria**, which manages $6.5 billion in private equity, real estate and hedge funds. At the time, Blackstone said Patria provided its clients with "the fast-expanding business opportunities" in that market.

Apollo Global Management and Fortress Investment Group have also extended their non-private-equity businesses via acquisition. For Apollo, that included two CLO-related deals in 2011 (the year it went public) for Stone Tower Capital and Gulf Stream Management, which combined had $20 billion in CLOs. Driven by inflows and acquisitions, the company saw its credit-related AUM double last year to $64 billion, or more than half of total AUM, to surpass the private equity unit (AUM: $38 billion). In addition, Apollo has a smaller real estate unit. Fortress, with $53 billion in AUM, also provides a mix of private equity, hedge funds and credit products, the latter of which were enhanced by the 2010 acquisition of CW Financial Services, at the time a leading commercial real estate debt platform and the second-largest servicer of commercial mortgage-backed securities. That same year, Fortress took a big step into traditional asset management when it bought fixed income institutional manager **Logan Circle Partners**, a business that by the end of 2012 has seen AUM jump by $8 billion since the acquisition to more than $20 billion.

For boutique firms operating in the alternatives market, the pressure to sell has been growing, as they confront a future in which institutions increasingly gravitate toward larger alternative investors, including the publicly traded private equity firms that can provide broad-based investment "solutions." Independent firms must also grapple with the regulatory issues and costs afflicting the range of asset managers in the post-crisis world, along with general costs related to technology and other back-office functions. The sale to a Blackstone or Carlyle can eliminate those issues, while providing additional benefits in the areas of distribution, new clients and marketing. At the time of the sale to KKR, Prisma co-founder and managing partner Girish Reddy explained his rationale this way: "We decided to join KKR because we felt it would give us a unique advantage. Our job is to generate strong returns for clients, and we believe KKR's knowledge, talent and global footprint will help us continue to make sound decisions and identify new opportunities for our investors." As a bonus, Prisma was able to maintain its brand name. ▲

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