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Blackstone – Capitalising on a changing industry landscape

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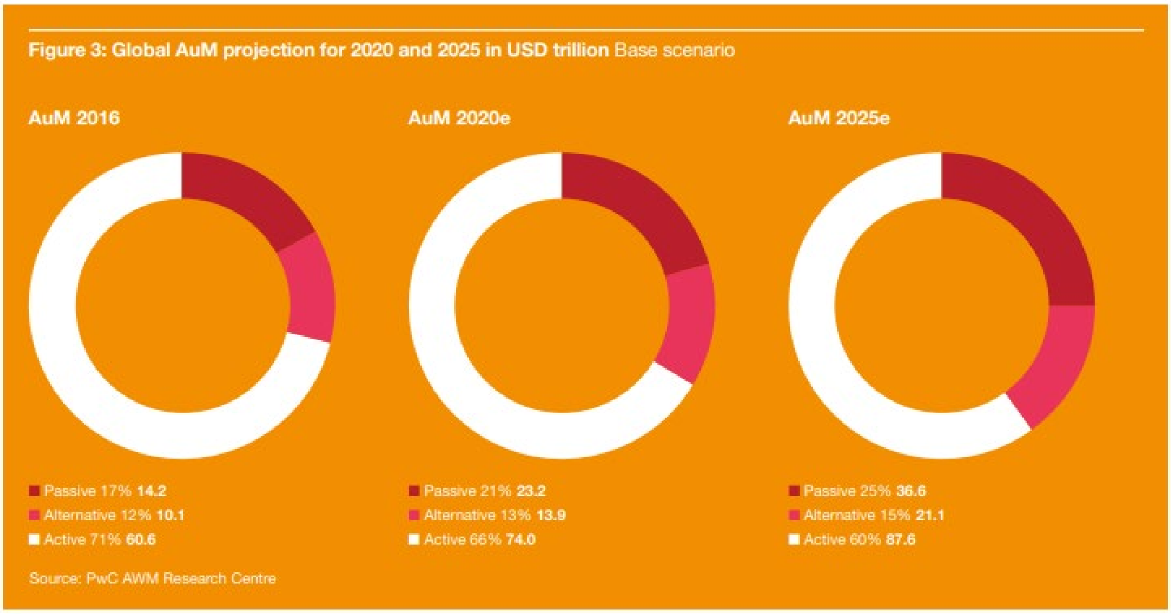
The Blackstone Group is the world's largest alternative investment firm, specialising in private equity, real estate, credit, and hedge fund investment strategies.

A rapidly changing industry landscape has led to growing demand for passive and alternative investment products, at the expense of traditional actively-managed funds and resulting in a fund-raising "super cycle" for large, diversified firms such as Blackstone.

A shift towards passive and alternative investment strategies

For a number of years there has been a bifurcation in the asset management industry, with demand shifting away from traditional active asset management towards passively managed products due, in part, to historically high fees that often did not reflect outperformance against the market. At the same time, interest in alternative asset managers has increased as investors look for uncorrelated returns in alternative investment classes such as private equity, real estate, credit and infrastructure.

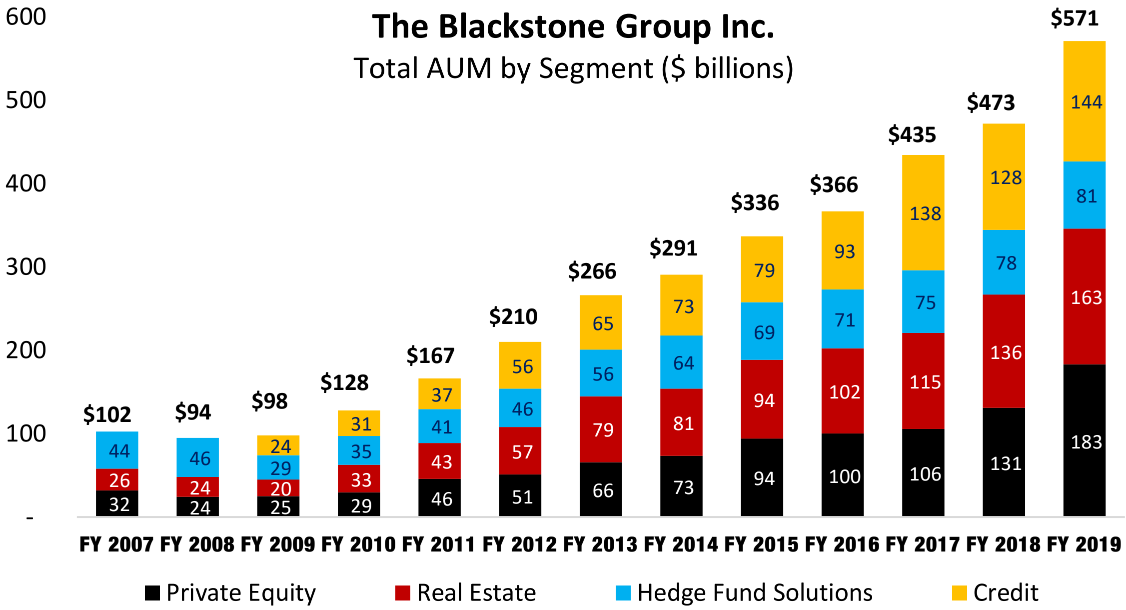


Growth in assets under management (AuM) for alternative investment firms has been strong and projections from PwC's Asset and Wealth Management Research Centre suggest this trend is likely to persist. Global assets under management in passive and alternative products looks set to grow at a rate of 9% - 10% per annum between 2020 and 2025, more than 2.5 times the growth rate expected from active products and an acceleration from the annual growth rate of 7.8% experienced between 2013 and 2018, according to Preqin.

Large, diversified firms dominate for a number of reasons

Large alternative asset management firms that offer access to a range of private assets, combined with scale and a global presence, have benefitted disproportionately from the demand for alternatives and Blackstone, as the largest of these firms, is no exception.

In their recently reported results for 4Q 2019, Blackstone recorded inflows of $134bn for the year and record AuM of $571 billion – a growth rate of 21% year on year, which shows an acceleration of the trend growth rate of over 15% per annum since 2007 and ahead of the overall alternative market growth rate.



Source: The Blackstone Group Inc – Annual Financial Statements

Barriers to entry and growing strategic competitive advantage

Despite operating in a highly competitive, performance-driven industry, Blackstone's established, long-term track record and diversified distribution and fund-raising networks raises the barriers to entry and provides a growing strategic competitive advantage. Its diversified, multi-asset class capability ensures that it is almost always a contender for new mandates and provides attractive cross-selling opportunities. Blackstone has existing relationships with over 1300 limited partners (LP's), with 20% of these LP's investing in all four of Blackstone's major asset class capabilities.

Product innovation and longer duration reduces the risk of realization

While traditional capital commitments of 7-10 years create attractive, long-duration, fee-earning opportunities and entrenches relationships with providers of capital, it nevertheless places pressure on firms to constantly raise capital as investments are realised and capital is returned to limited partners.

Through the introduction of Core + strategies in real estate and private equity, with product life cycles of 20 years or more, and through the launch of various permanent capital vehicles such as Blackstone Real Estate Income Trust, Blackstone has found innovative ways to reduce realisation risk and to lengthen the duration of its products. Results reported for 4Q 2019 showed that permanent capital vehicles now account for more than a quarter of fee-earning assets under management, which has a direct impact on the rating the market is prepared to afford the company. Longer duration, annuity-like earnings streams are more prized by investors than volatile, shorter-duration, performance-driven earnings streams.

Conversion from partnership to corporation

A further positive development arises from recent changes to US tax legislation that have made it more attractive for listed alternative asset management companies to collapse complex partnership structures and to incorporate. This has opened the way for these shares to be included in stock indexes, which attracts a new group of potential shareholders and has further supported the rerating of Blackstone and peers such as KKR.

Valuation following 96% return in 2019

Investors in Northstar funds have benefitted from meaningful exposure to Blackstone, which has consistently been a Top 10 holding over the past three and a half years. Blackstone was the largest holding in the Northstar Global Flexible Fund for most of 2019, generating a return of over 96% in US dollars.

Over the past three years, Blackstone has generated a return of over a 150%, approximately a third of which is attributable to a higher rating (from 15x to 24x) on distributable earnings, which accounts for both management fee and realised performance-related earnings. Given the embedded growth opportunity from conversion of AuM to fee-earning AuM, "dry powder" in private equity parlance, we see the forward price to distributable earnings multiple unwinding back to approximately 16 times over the course of the next five years – a relatively fair rating given our conservative base case assumptions for asset growth and management fee pressures.

While we see scope for further upside under a bull case scenario which allows for higher growth in AuM and scope for the rating to fall to 11x under this scenario, we are naturally more circumspect and mindful of the high beta nature of the investment, have been reducing exposure across our funds to allow for greater risk.

Glacier Research would like to thank Rory Spangenberg for his contribution to this week's Funds on Friday.

Rory Spangenberg,

Director of Global Equities

Rory is director of Global Equities at Northstar Asset Management and portfolio manager of the Northstar Global Flexible Fund. Rory joined Northstar in January 2017 following the acquisition of SignalHill Investment Management, which he founded. Prior to SignalHill, Rory spent 10 years with Investec managing global and domestic equity and income growth strategies in the Wealth & Investment division. Previously he was head of South African Research Sales at Investec in London and worked in research sales for Barnard Jacobs Mellet and as the equity portfolio manager of the Sasol Pension Fund. Rory has 21 years' investment experience.