



Theme V

What are the near-term and long-term risks for these stocks, especially after surging prices in 2013?

With these stocks up a median 60% in 2013, the risks naturally become worth considering to a greater extent than over the past year. However, we see near-term downside being limited as long as the cyclical tailwinds remain favorable (e.g. strengthening economy, good capital markets activity with stable-to-higher market levels, good fundraising & organic growth). This said, we outline numerous near- and long-term risks for these stocks below.

Economic slowdown, with related market pressures

A reversion in the economy, be it the US or other major industrialized nations (or collectively most of the major emerging markets), is easily the greatest risk for these stocks given their earnings leverage to economic cycles. While we do not believe we would see the level of price compression that Blackstone experienced in the financial crisis (each of these other Alts came public well after the financial crisis) when BX shares for a brief time in March of 2009 were down nearly 90% from their peak shortly after the IPO in June of 2007 (and have only recently recovered to levels above the IPO price), the stocks could easily underperform significantly upon speculation of a recession, until investors sort their theses out.

We think a large part of the near-90% compression was due not only to IPO pricing near the market peak, but also the uncertain impact of such a deep financial crisis on the private equity business model. Now that it has been proven that not only is private equity able to withstand a deep bear market, but also the lower market prices provide excellent entry points for their investments and contribute to much stronger long-term IRRs, we think the next economic cycle downturn will be much less severe than the BX situation. This said, with these stocks up a median 60% in 2013 (and BX over 100%), we do not see any material chance of a recession as being priced into these stocks, so if that scenario began to emerge (as it had at certain points during 2010-12), this could drive significant underperformance in the stocks. At this stage in the economic cycle, earnings profiles for the Alts in 2014 should remain supportive, with increasing realizations generating good sequential distributable earnings growth for at least the next several quarters.

A potential valley in distributions in private equity cycle

Longer-term however (~2017-19), we think it will become difficult for the Alts to grow from potentially peak distributable earnings in 2015-16 for much of the group, given the firms will have likely exhausted a large portion of embedded gains through realizations. To combat this, the firms will need to maintain the current healthy pace of fundraising for at least the next 1-2 years and be able to deploy capital in attractive opportunities, which could become scarcer if capital markets remain robust. Thus, we think a key risk for these stocks as we approach that part of the cycle, will be an expected drop off in distributable earnings until the most recently raised funds can enter distribution mode. Investors will be watching this inflection closely, and the stocks may very well underperform before it occurs.