



We do not see this on the horizon for at least the next 12-18 months, given our expectation that realizations will continue to improve sequentially on a quarterly basis well into 2015, albeit lumpy from quarter-to-quarter. The situation with APO will be a good test for this, as we expect their largest funds to exhaust most of their embedded realized gains over the next several quarters, and the next fund (Fund VIII) is unlikely to reach realization mode until sometime well after 2016, in our view. It will also be interesting to gauge the pace of realizations vs. fundraising across the Alts space over the next several years, as it is quite possible that funds raised over the past 2-3 years could begin realizing gains by 2016, helping to bridge the valley in around 2017-18 we expect to see for the PE industry broadly. CG looks to be in the best position in this regard right now among its Alt peers.

Higher interest and/or a credit cycle

With the view that higher interest rates hurts the financing capabilities of private equity portfolio companies, investors sometimes look at the Alts as having considerable downside risks in a rising rate backdrop. However the Alt mgmt teams have increasingly stated they are not concerned given their portfolio companies' cash flows would improve nominally in a rising rate backdrop, as well as benefit from economic expansion. This has helped eased concerns and the stocks have traded better against spikes in yields recently, nevertheless the risk remains that these stocks could underperform other financials in a rising rate backdrop. Separately, should credit begin to deteriorate, certain asset classes can depreciate significantly as investors in those assets become concerned about defaults, even well before the economy shows signs of weakening. This could negatively impact asset values and fund flows for the credit-oriented strategies at the Alts – the largest of which from a concentration perspective are at OAK, APO, and BX..

Difficulty in narrowing P/E gap with traditional asset managers

The Alts trade at significant P/E discounts to the traditional asset managers for a variety of reasons even outside of the greater leverage to economic cycles. These include 1) earnings are very difficult to model both in the short- and long-term, hence reducing conviction in stocks with low forecasting ability, especially vs. easier-to-model fee-based asset management businesses, 2) the corporate/partnership organizational and financial structure is complex & difficult to become comfortable with, 3) the units and their distribution structure are prohibitive for some investment portfolios, and 4) the public floats are low and there is long-term overhang as partners monetize stakes. To the extent investors do not gain overcome these issues, there is risk the Alts will fail to narrow their P/E gap to the asset managers, which is part of our bullish thesis on the group.

Taxation and regulatory risks

From time-to-time there have been fears of tax reform that would either target carried interest (converting it to income to be taxed at marginal rates) or taxation on the partnership structure. To the extent legislators propose this type of tax reform again, and certainly if anything were to be enacted, it could reduce the distributable earnings for the Alts and would likely pressure the stocks. On the regulatory front, right now the Alts are not a major target for financial reform, as the banks have been, though should this change for any reason, (particularly if the Alts were becoming more involved in financing) it would negatively impact the stocks.