The Blackstone Group L.P. (NYSE: BX) Recommendation: Long Report Date: November 2, 2018

Executive Summary

The Blackstone Group is the world's largest alternative asset management firm, currently with $457 billion of assets under management. Since its founding in 1985, Blackstone has achieved extraordinary growth with its asset base compounding at over 50% annually over the past 33 years. Headquartered in New York, the firm employs nearly 2,500 people in 23 offices worldwide.

Blackstone's business model is simple. The limited partners commit capital into Blackstone's funds. Blackstone then charges management fees (~90 basis points on average) over the life of the fund. This income stream is contractual and recurring. In addition, Blackstone also earns performance fees when pre-determined investment returns are achieved. This income stream can be volatile and unpredictable in any given year, but over the long run, Blackstone has consistently managed to hit its return hurdles (99% of past funds generated performance fees).

Investment Thesis

Blackstone is a high-quality business that displays fast growth, limited need for capital reinvestment, talent-based moats, high margins, recurring revenue base, loyal customers, and invaluable brand. It can continue to create significant shareholder value due to the following key factors:

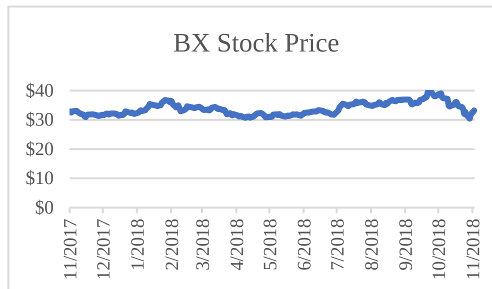
- *Blackstone can continue to grow its AUM*, driven by scaling of existing strategies and launching new strategies.
- *Blackstone is set up to generate satisfying returns for its limited partners*, especially large asset owners (e.g. pensions, SWFs).
- *Long-term capital base creates predictable, high-quality earnings*, as the longevity of its asset continues to improve.
- *Well-diversified asset mix helps the firm weather macroeconomic cycles*, which set the firm apart from peers.
- *Blackstone is run by highly capable and aligned managers*, led by Stephen Schwarzman and Jonathan Gray.
- *Complexity around earnings and corporate structure* creates opportunity for long-term investors.

Key Risks

- *Blackstone's operation is susceptible to macroeconomic risks.*
- *Elevated valuation could negatively affect Blackstone's opportunity set and returns.*
- *There are risks involved in the firm's succession strategy.*
- *Tax laws create uncertainty around Blackstone's business.*

Company Statistics

Current Share Price:	$33.20
Price Target (2019YE):	$46.88
Implied Upside:	41.2%
52-Week Range:	$29.57-40.60
Market Cap:	$39,712MM
Avg. Daily Volume:	4.15MM
P/Diluted EPS:	12.1x
Dividend Yield (LTM):	7.2%



Source: Bloomberg

Financial Projections:

	2017A	2018E	2019E	2020E
AUM ($MM)				
Private Equity	70,141	80,662	96,794	111,314
Real Estate	83,985	94,063	108,172	124,398
Hedge Fund Solutions	69,914	74,109	77,073	80,156
Credit	111,304	133,565	146,922	154,268
Total Fee-Earning AUM	335,344	382,399	428,962	470,136
YoY Growth	*21.0%*	*14.0%*	*12.2%*	*9.6%*
Revenue ($MM)				
Management Fees	2,771	3,183	3,648	3,826
Performance Fees	3,712	3,922	4,939	4,828
Other Income	308	579	576	659
Total Revenue	6,790	7,684	9,164	9,313
Earnings Metrics ($MM)				
Fee-Related Earnings	950	1,013	1,114	1,320
Performance Earnings	2,221	2,287	2,908	2,863
Economic Income	3,479	3,879	4,598	4,842
Per Share Earnings				
Fee-Related Earnings	$0.79	$0.84	$0.92	$1.08
Performance Earnings	$1.85	$1.89	$2.40	$2.35
Economic Income	$2.90	$3.21	$3.79	$3.98

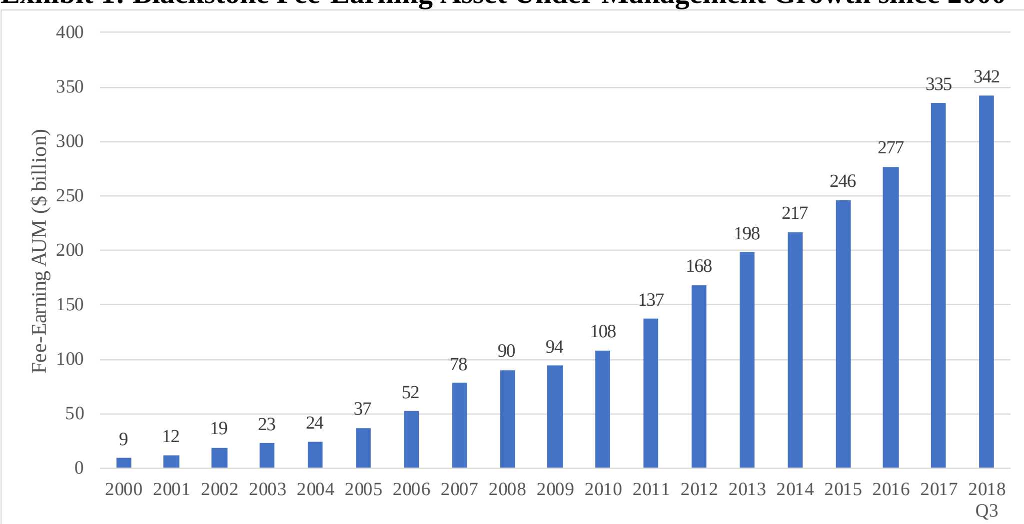
Valuation:

	Per Share	Multiple		Value
2020E FRE	$ 1.08	18x	Fwd P/E	$ 19.51
2020E Perf Earnings	2.35	10x	Fwd P/E	23.51
2019E Cash&B/S Inv	3.86	1x	P/B	3.86
			2019 Year-End Target Price	**$ 46.88**

Company Overview

The Blackstone Group is the world's largest alternative asset management firm, with $457 billion of assets under management as of September 30, 2018. The firm was founded in 1985 with a staff of four, including the two co-founders Stephen A. Schwarzman and Peter G. Peterson, and an asset base of $400,000. Its first private equity fund was launched in 1987 with less than $1 million. From that rather modest beginning, Blackstone has achieved extraordinary growth over the last three decades. Its asset base compounded at over 50% annually over the past 33 years (see **Exhibit 1** for the firm's AUM growth trajectory since 2000). Today, in addition to the almost half a trillion dollars of assets it manages, Blackstone employs nearly 2,500 investment and non-investment professionals in 23 offices worldwide; its 180 portfolio companies employ over 500,000 people across the globe. In fact, Blackstone's portfolio companies, tallied together, rank among the top 5 private employers in the United States, and the firm itself is one of the largest private landowners in the nation, highlighting the scale and economic significance the firm commands.

Exhibit 1: Blackstone Fee-Earning Asset Under Management Growth since 2000



Source: Blackstone

What has enabled this growth is simple: extraordinary returns. As Mr. Schwarzman likes to say, the Blackstone model "begins and ends with investment performance." Indeed, as shown in Exhibit 2 below, the firm has delivered strong results across all of its investment strategies. Its flagship private equity strategy delivered 15% net returns to limited partners, beating the S&P 500 by over 700 basis points. Across the firm, Blackstone has generated over $200 billion of gains since inception for its investors. An impressive track record spanning such a long time period firmly establishes Blackstone as the go-to alternative asset manager for institutional investors all over the world.

Exhibit 2: Blackstone Track Record by Strategy

Blackstone Strategy vs. Public Index	Inception	Net Returns since Inception
Private Equity	1987	15%
S&P 500 TR		*9%*
Real Estate	1991	16%
NCREIF-ODCE Core		*7%*
Hedge Fund Solutions	2000	6%
HFRI FoF		*3%*
Credit	2007	15%
CS High Yield		*8%*

Source: Blackstone

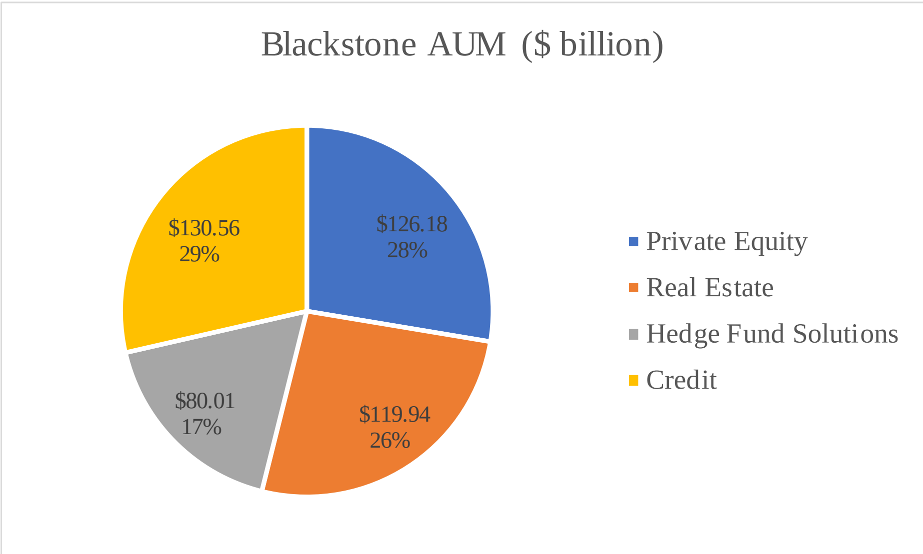
The other driver of Blackstone's asset growth is product innovation. Mr. Schwarzman routinely touts the firm's entrepreneurial spirit, and has clearly outlined the firm's innovation strategy in his annual chairman's letter:

> *We continue to innovate new products and strategies in two main ways: first, by extending our existing businesses, including into new regions and in more permanent capital vehicles further along the risk/return spectrum, and second, by moving into new businesses when we identify a paradigm shift in the market that has created unique investment opportunities… At Blackstone, we don't start a business unless we believe we can be the industry leader."*

Blackstone's asset growth since its IPO in 2007 perfectly illustrates the firm's dedication to product innovation. 60% of the firm's current AUM comes from strategies and funds that are created after its IPO in 2007 – in fact, during this time period, new strategies' AUM compounded at 45% annually, compared to 10% for existing strategies. Even if we simply look at the firm's fundraising activities in the past year, there is plenty of evidence. In the extension of existing strategy category, the firm launched its first ever regional private equity fund with a dedicated Asia fund, which closed with $1.6 billion of capital commitment. In the new strategy category, the firm launched its infrastructure platform with up to $20 billion in commitment from one lead investor. Indeed, the breadth of Blackstone's product offering is a key differentiator against its competitors.

Today, Blackstone's AUM falls into four broad reporting segments: private equity, real estate, hedge fund solutions, and credit. Within these reporting segments, there are more than a dozen distinct strategies operating at multi-billion-dollar scale. **Exhibit 3** breaks down the firm's current AUM by strategy. This asset mix is more diverse than any of Blackstone's competitors, most of which are concentrated in one or at most two asset classes, and positions the firm well for most macroeconomic environments.

Exhibit 3: Blackstone's Current AUM Breakdown



Source: Blackstone

Blackstone's business model is simple. Its investors, the limited partners, commit capital into Blackstone's funds. Blackstone then charges management fees, typically in the range of 0.25% to 1.75%, based on committed capital over the life of the fund, often times spanning over a decade. This income stream is contractual and recurring. In addition to management fees, Blackstone also earns performance fees when pre-determined investment returns are achieved. While performance fee income is dependent on market environment and economic cycles and can be highly volatile and unpredictable in any given year, over the long run, Blackstone has consistently managed to hit its return hurdle – 99% of its past funds have generated performance fees. 2017, for instance, was a record year for Blackstone, with the firm realizing $55 billion of investments and harvesting over $3.5 billion in performance fee revenue.

Business Description

One of the most accomplished investors we have come across defines a high-quality business as follows:

> *What makes a great business? It's fast-growing. It's got limited need for capital, so it grows without capital. It's a magnet for talent. It produces high margins, despite the fact that it's got great talent. It's anchored by a recurring revenue base, which gives it protection in a downside environment. It generates significant free cash flow to share with its shareholders. It has loyal customers. It's got a global franchise, and it has a real moat around its business, generally associated with scale. And really importantly, it has invaluable brand equity that attracts people and customers and allows it to grow.*

The investor who said this is Jonathan Gray, Blackstone's Chief Operating Officer and Mr. Schwarzman's heir-apparent, and yes, the business he is describing is Blackstone itself. Objectivity aside, we think this is a good definition for what a great business should be. Let's look at the criteria one by one in the context of Blackstone.

Growth: The firm's asset growth directly translates into greater earnings power. Over the past decade, Blackstone's management fee income ("Fee Related Earnings") has compounded at a CAGR of 15%, nearly tripling from $0.5 billion in 2008 to $1.4 billion today. Including performance fee income, the firm's earnings ("Distributable Earnings") essentially grew by 5x over the past decade.

Limited need for capital: While this growth is already impressive in and by itself, what is even more remarkable is that Blackstone used virtually no capital to pull it off. Blackstone has a stated policy of distributing 85% of the free cash flows to its investors – since its IPO, the firm has cumulatively distributed over $16 per share, or over half of the stock's IPO price, to its shareholders. Today, out of the $457 billion the firm manages, only $2 billion comes from its own balance sheet (in comparison, Blackstone employees have over $6 billion invested in the various Blackstone funds).

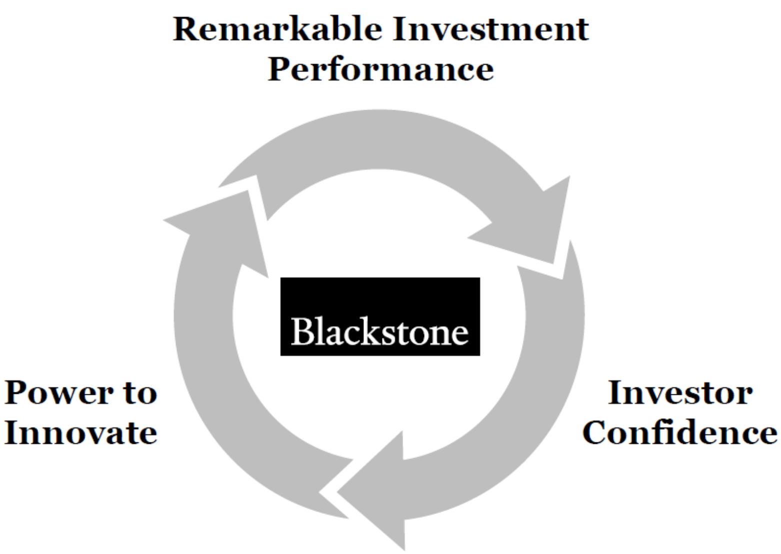
Attracting and retaining talent: The reason Blackstone is able to grow without capital is that it operates in a human capital-driven business. As Mr. Schwarzman has said in numerous occasions, Blackstone's largest and most important asset is its talented people. And indeed, the firm is a magnet for talent. For its most recent 2018 analyst class, Blackstone received nearly 15,000 applications, from which it hired 86 people, for an acceptance rate of 0.6%, 10 times lower than the most selective Ivy League university. And once these young talents join the firm, Blackstone does a great job retaining them. Jonathan Gray is the perfect example. He joined the firm in 1992 straight out of Wharton, and has been with the firm ever since. In 2005, he was promoted to run the real estate business, and earlier this year, he was promoted to the firm's President and Chief Operating Officer, solidifying his position as Mr. Schwarzman's heir-apparent. Indeed, most of the firm's 11 management committee members are homegrown talents, with an average tenure with Blackstone of 18 years.

High margin: One of the tools that Blackstone uses to retain the talents is high compensations. The firm pays out roughly half of its management fee and performance fee income in compensation expenses. We should point out here that while the financial media obsesses with how much Mr. Schwarzman takes home each year, approximately 85% of compensation is actually paid to employees outside of the senior leadership team (the vast majority of Mr. Schwarzman's income comes in the form of dividends he receives through his ownership stake in the firm). While these expenses are certainly high, there is little else that Blackstone needs to spend money on. In fact, Blackstone consistently earns 50% pre-tax profit margin, higher than most of its alternative asset manager peers, not to mention the average S&P 500 company. Remarkably, the firm makes $1.6 million in pre-tax profit per employee, demonstrating its strong operating leverage.

Recurring revenue base: Given the contractual nature of Blackstone's management fee income, its revenue is highly stable and recurring. Only 10% of the firm's AUM can be redeemed from Blackstone within a year. The rest of the assets are in long-duration closed-end vehicles with an average remaining fund life of 12 years. One area where Blackstone has been focusing on in recently years is perpetual capital, which has grown from $9 billion five years ago to $64 billion today. This is capital invested in vehicles with indefinite term. Remarkably, as Blackstone has grown its asset base, it has also managed to increase its longevity as well.

Loyal customers: To say Blackstone's customers are loyal would be an understatement. When the limited partners invest with the firm, they are typically entrusting their capital with Blackstone for years, if not decades. Blackstone earns this trust by delivering outstanding investment returns, and has continued to deepen the relationships with their limited partners by offering broader and more diverse funds and strategies. The firm's top 25 limited partners, on average, are invested in nine Blackstone strategies, up from four in 2014. As shown in **Exhibit 4** below, through performance and innovation, Blackstone has created a virtuous cycle that has made it the go-to destination for institutional investors all over the world.

Exhibit 4: Blackstone Virtuous Cycle



Source: Blackstone

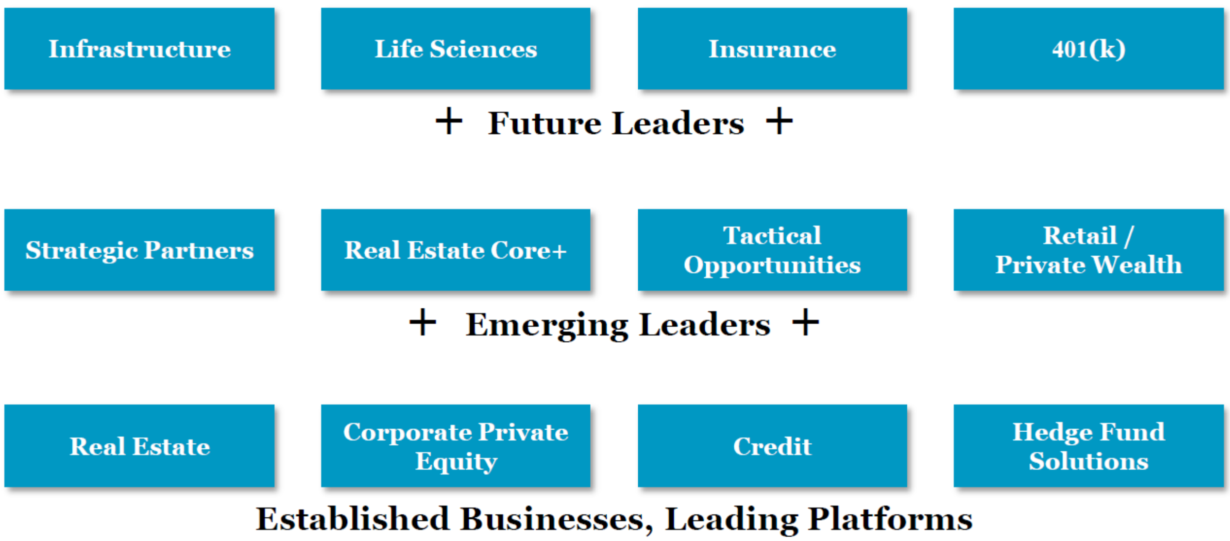
Invaluable brand: Brand image is particularly important when the product or service contains intangible elements. An illiquid investment vehicle certainly fits that description. When an investor decides whether to invest in a fund or not, he has to rely largely on his qualitative evaluation of the fund manager's investment acumen, process and organizational capabilities. Blackstone's brand image of consistent excellence significantly lowers the cognitive barrier for the investor to make the decision to invest. Just as the old saying "no Chief Information Officer ever gets fired for buying IBM" – no Chief Investment Officer ever gets fired for investing in Blackstone. And Blackstone is keenly aware of the power of its brand, as Mr. Schwarzman made clear during an earnings call back in 2015:

> *We like to think that the companies that are similar to Blackstone include many of the great companies in the world. Among these companies are companies like Apple, Google, Alibaba, Samsung, Disney, Amazon, Boeing, Daimler, Nike, BMW, Starbucks, Caterpillar, Hermes, Luxottica, Whole Foods, Bosch, McKinsey, Bloomberg, Chanel, and numerous others we don't have time to list here. All of these firms have built enormous brand recognition.*

Investment Thesis

Blackstone can continue to grow its AUM. It would not be an overstatement to call Blackstone a fundraising machine. The firm has grown its AUM by $350 billion since its IPO in 2007 despite returning $260 billion to limited partners. The firm's gross inflows of over $400 billion over the last five years nearly match the next three largest competitors combined. Last year, Blackstone set a firm and industry record in raising $108 billion in a single year. The pace of asset growth remains unabated. At the firm's most recent investor day, Blackstone management has guided toward $600 billion of total AUM in two years, $800 billion in four to six years, and over $1 trillion in eight years. The vast majority of new assets to be raised will come from new strategies, such as the real estate core+ funds, the tactical opportunities fund, and the infrastructure platform (see **Exhibit 5** below for detail).

Exhibit 5: Blackstone Fund Strategy Roadmap



Source: Blackstone.

We view management's target as challenging but achievable. From a bottom-up perspective, the firm has demonstrated a proven ability to scale existing strategies and launch new strategies. Most notably, Blackstone in recent years has entered the insurance and private wealth management businesses, both areas with significantly capacity to grow (potentially over $100 billion each) relative to its legacy strategies. From a top-down perspective, Blackstone's market penetration remains relatively low despite its already massive scale. According to a Willis Towers Watson study, the entire institutional investment market is over $50 trillion in size, which would imply Blackstone's current market share is still below 1%. In fact, a recent Preqin survey showed that private alternative strategies remain one of institutional investors' favorite asset class, with over 80% of respondents looking to either increase or maintain their allocation. As more capital flows into these strategies, Blackstone is well positioned to become the largest beneficiary.

Blackstone is set up to generate satisfying returns for its limited partners. Whether Blackstone can hit its fundraising target hinges on its ability to continue to produce satisfying investment returns. As the firm grows in size, the natural question to ask is if it will negatively affect the returns. We think the answer is yes, and the degradation in returns has already occurred in many of the firm's strategies. However, we believe Blackstone's value proposition to its investors is not to deliver the highest possible returns, but to deliver satisfying returns at large scale. For large pensions and sovereign wealth funds, being able to deploy hundreds of millions or even billions with Blackstone and earning a reliable 10% return is almost certainly preferable to finding an array of funds and hoping to earn a higher 15% return.

But the question remains how Blackstone can reliably generate that satisfying level of returns. There are a few factors that give us comfort. First, it's the talents that permeate the entire firm. Blackstone attracts and retains the best talents in the industry, and that is true across every segment it operates in. This high intellectual capital is an unmistakable edge in generating returns. Second, the firm's scale also provides an advantage in creating unique access to deals. Blackstone's recent transaction to acquire a controlling stake in the financial and risk unit of Thompson Reuters showcases that strength. At $20 billion enterprise value, there are very few firms that can compete with Blackstone on that deal (in fact, roughly 75% of the completed transactions in Blackstone's most recent flagship private equity fund are bilaterally-negotiated, non-auction deals). Finally, Blackstone delivers significant value-add to its portfolio companies, and therefore has far greater influence on the outcome of its investments than the average private equity investors. The Blackstone team clearly has confidence in its own ability to generate attractive returns, demonstrated by the $6 billion of personal capital the team has put into various Blackstone funds.

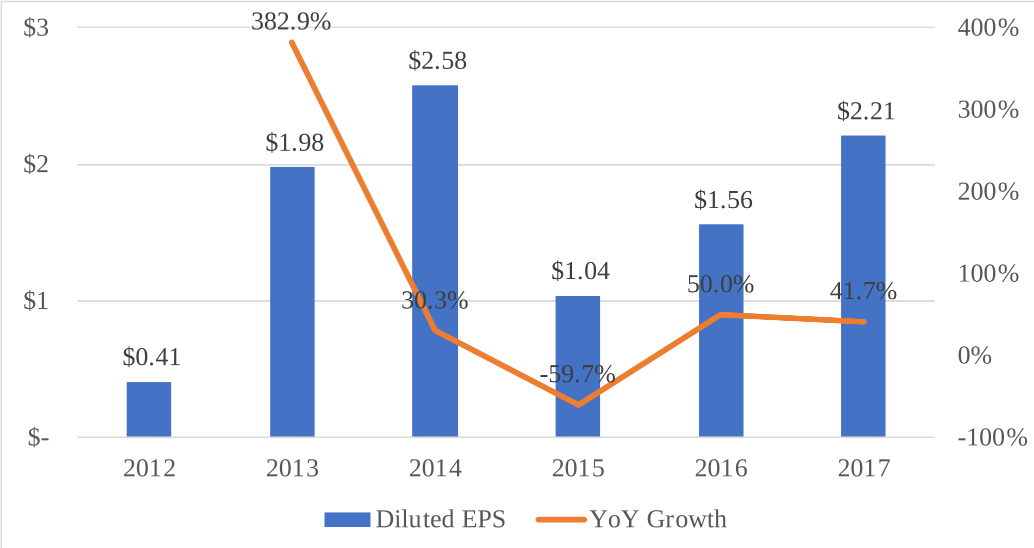
Long-term capital base creates predictable, high-quality earnings. Blackstone has successfully managed to not only grow its asset base, but also improve its longevity. The average contractual life of its funds has lengthened from eight to 12 years in the last five years. The firm is increasingly focused on raising capital in perpetual vehicles, such as the infrastructure platform and the real estate core+ funds. This shift toward more perpetual capital also improves the firm's bottom-line. These vehicles typically charge performance fees based on the funds' net asset value based on a pre-determined timetable. Therefore, unlike in the traditional private equity and real estate funds, Blackstone does not need to sell the underlying assets to realize the performance fee revenue. The financial impact of this is a more predictable and recurring earnings stream.

Well-diversified asset mix helps the firm weather macroeconomic cycles. A key differentiator of Blackstone against the other alternative asset managers is that Blackstone has the most diversified asset base. Its $457 billion of AUM is split across four broad categories (private equity, real estate, credit, and hedge fund solutions) and more than a dozen distinct strategies, allowing the firm to generate attractive returns throughout macroeconomic cycles. In fact, since its inception, Blackstone has always been disciplined in deploying capital, aiming to take advantage of downturns and capitalize on up cycles. Today, the firm has close to $100 million of dry powder, ready to pounce when opportunities arise.

Blackstone is run by highly capable managers whose interests are well aligned with investors. Blackstone's senior management team is extremely capable. In particular, Mr. Schwarzman, the firm's co-founder who continues to serve as CEO and Chairman, is instrumental in guiding the company over the past three decades to achieve the success it enjoys today. His heir-apparent, Mr. Gray, has also proven to be a capable investor and executive, leading the real estate division to be the firm's most profitable unit and the most successful player in the industry. Below them, each division and even subdivision are run by highly talented leaders, most of whom are promoted from within Blackstone. Moreover, the management team is highly aligned with investors. Mr. Schwarzman is by far the largest shareholder, with roughly 20% ownership (albeit through a different share class). Tellingly, Mr. Schwarzman has never sold a single share since Blackstone's IPO. The senior management team combined owns 30% of the firm, creating a strong culture of ownership throughout the executive level.

Complexity around earnings and corporate structure creates opportunity for long-term investors. Blackstone is a difficult stock to value. The company's GAAP earnings are highly volatile given the cyclicality of performance-fee income, which is realized only when an investment is exited. As shown in **Exhibit 6** below, the firm's GAAP EPS has fluctuated significantly year-over-year, depending on where the firm is in the investment and harvesting cycle with its capital. This dynamic creates a high degree of uncertainty for sell-side analysts who typically focus only on the next few quarters.

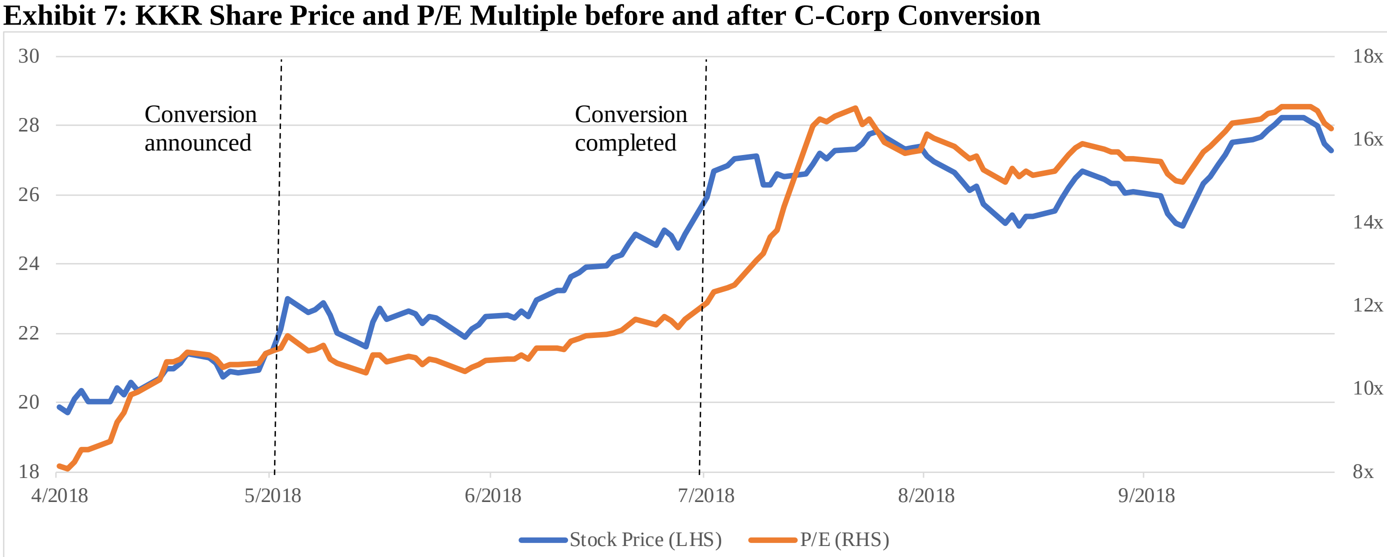
Exhibit 6: Blackstone Diluted EPS Trend



Source: CapitalIQ

In addition, Blackstone is structured as a publicly traded partnership for tax purposes, instead of a traditional C-Corp, which prohibits many institutional investors from owning the stock and precludes itself from major public market indices for technical reasons. Competitors such as KKR and Ares have converted to C-Corp after the recent tax reform. As KKR noted when it made the announcement to convert its structure, the move is "designed to broaden our investor base, simplify our structure and make it easier to invest in our shares." As shown in **Exhibit 7** below, KKR's share price has responded positively. Blackstone has so far resisted this idea but recently signaled that they had been evaluating the potential benefits of converting to a C-Corp structure. The fact that the management team is carefully weighing the pros and cons of such an important decision highlights their dedication to long-term shareholder value creation. While we believe these factors indeed have been a drag on the stock price, they also represent opportunities for flexible, patient investors who can hold the stock over the long term.

Exhibit 7: KKR Share Price and P/E Multiple before and after C-Corp Conversion



Source: Bloomberg

Return Projection

For our valuation of Blackstone, we project give years out to 2023. We believe that at the current share price of $33.20 (as of November 2, 2018), the stock offers significant near-term upside (with 2019 year-end price over $46) and long-term return potentials (over 20% four-year IRR), with very low downside risk. In addition, the firm has a proven track record of paying out 85% of its free cash flows to shareholders – on a trailing 12-month basis, the stock is yielding over 7%. Therefore, shareholders are getting paid to wait for the thesis to play out.

AUM Growth: As should have become clear by this point, the key driver of Blackstone's revenue and earnings growth is the continued growth of its asset base. We forecast in our base case that over the next five years, Blackstone can grow its fee-earning assets under management at a CAGR of 9%, which is over 600 basis points behind its asset growth rate in the last five years. See **Exhibit 8** below for more detail of our AUM projection. In our projection, we assume that the majority of the asset growth will come from strategies that have been launched in recent years. We should note that our forecast is quite conservative relative to management guidance. Blackstone recently revealed a near-term fundraising pipeline of over $150 billion in several proven and emerging strategies to be completed by the end of 2019. Given the firm's track record of hitting and even over-delivering on its fundraising goals, we would not be surprised to see Blackstone beat our forecasts by a meaningful margin.

Exhibit 8: Blackstone Asset Growth Projection

($MM)	2017A	2018E	2019E	2020E	2021E	2022E	2023E	*2019-2023 CAGR*
Fee-Earning AUM	335,344	382,399	428,962	470,136	509,236	546,713	588,022	
YoY Growth	*21.0%*	*14.0%*	*12.2%*	*9.6%*	*8.3%*	*7.4%*	*7.6%*	*9.0%*
By Segment								
Private Equity	70,141	80,662	96,794	111,314	128,011	140,812	154,893	*9.9%*
Real Estate	83,985	94,063	108,172	124,398	140,570	158,844	179,494	*10.7%*
Hedge Fund Solutions	69,914	74,109	77,073	80,156	81,759	83,395	85,062	*2.0%*
Credit	111,304	133,565	146,922	154,268	158,896	163,663	168,572	*2.8%*

Sources: Blackstone, authors' analysis.

Fee-Related Earnings (FRE): For simplicity's sake, we calculate FRE as Blackstone's management fee revenue less all expenses excluding performance-related compensation expenses. Note this is different from Blackstone's own definition which also excludes equity-based compensation and interest expenses. This is an important metric because it measures whether Blackstone can cover all of its operating expenses and generate profits based on the contractual management fee revenue alone. Blackstone has demonstrated impressive pricing power over the past decade, with the average management fee charged relatively stable at around 90 basis points even as the firm's asset base grew and diversified. Going forward, we project a gradual step-down as more of Blackstone's assets come from perpetual vehicles which charges lower fees to compensate for its longevity. However, we believe we will see increasing operating leverage as the firm scales even further, improving pre-tax FRE margin from low-30s to high-30s in the next five years. We believe Blackstone can earn $1.33 per share of FRE by 2023 in our base-case scenario (see **Exhibit 9** below for detail).

Exhibit 9: Blackstone Fee-Related Earnings Projection

($MM)	2017A	2018E	2019E	2020E	2021E	2022E	2023E
Management Fee Revenue	2,771	3,183	3,648	3,826	3,802	4,066	4,420
As % of Avg AUM	*0.90%*	*0.89%*	*0.90%*	*0.85%*	*0.78%*	*0.77%*	*0.78%*
Management Fee Comp Exp	1,203	1,431	1,641	1,698	1,669	1,798	1,958
Non-comp Exp	618	739	894	808	737	755	819
Pre-tax Fee-Related Earnings	950	1,013	1,114	1,320	1,396	1,513	1,643
Pre-tax FRE Margin	*34.3%*	*31.8%*	*30.5%*	*34.5%*	*36.7%*	*37.2%*	*37.2%*
Avg. Diluted Share Count	1,200	1,208	1,213	1,218	1,223	1,227	1,232
Pre-tax FRE per share ($)	0.79	0.84	0.92	1.08	1.14	1.23	1.33

Sources: Blackstone, authors' analysis.

Pre-Tax Net Income/Economic Income (EI): From FRE, we add back performance-related income (net of performance-related compensation expenses) and investment income. While performance-related income is highly uncertain in any given year, over three-to-five-year cycles, it is remarkably stable across different segments. As previously noted, 99% of past Blackstone funds have generated performance fee revenue. We are highly confident that its future funds will continue to do so on a consistent basis. Ignoring the uncertainty of timing, we believe that by 2023, the firm can earn up to $5 in Economic Income per share in our base-case scenario.

Sum-of-the-Parts Valuation: Given the different nature of Blackstone's earning streams, we use a sum-of-the-parts analysis to value Blackstone's share value. We start with the FRE part. We believe this is very high-quality earnings due to its contractual, recurring nature, and deserve an above-market multiple. Similar high-quality financial services firms, such as Moody's, S&P Global, and MSCI, trade at mid-to-high-20s pre-tax earnings multiples. We use a 18x forward multiple in our valuation. For the performance-related earnings, to account for its cyclicality and uncertainty, we use a lower 10x forward multiple. Finally, for the firm's net cash and investments on its balance sheet, we apply a 1x P/B multiple. This leads to a SOTP valuation of $46.88 per share, or 40% upside over Blackstone's current share price. Put it a different way, if we use the multiples described above to value FRE and net cash and balance sheet investments, the market is valuing the performance earnings at just 4x. As a sanity check, this target price implies a price/EI multiple of 11.8x, which is in fact slightly lower than the median alternative asset manager comps.

Exhibit 10: Sum-of-the-Parts Valuation

	Per Share	Multiple		Value
2020E Fee-Related Earnings	$ 1.08	18x	Fwd P/E	$ 19.51
2020E Performance Earnings	2.35	10x	Fwd P/E	23.51
2019E Net Cash and B/S Investments	3.86	1x	P/B	3.86
	2019 Year-End Target Price			**$ 46.88**
	Upside to Current Share Price			**41.2%**

Source: authors' analysis

Applying the same methodology to our 2023 estimates, we arrive at a 2022 year-end exit valuation of $57.96 per share. Assuming a dividend payout ratio of 85% and an effective tax rate of 20% (meaningfully higher than the firm's past tax rates to reflect uncertainty in tax policies), we believe we can earn a four-year IRR of over 20% on Blackstone, which is highly attractive for a business of this quality.

Downside protection: We see very low downside risk from this current share price. As noted above, FRE is highly recurring and stable, and together with the net cash and investments on Blackstone's balance sheet, it can support over 75% of Blackstone's current valuation. We stress test our assumptions on FRE multiple and estimated performance earnings in **Exhibit 11** below, which shows downside exist only in extreme situations where multiple drops to low-teens and only half of our estimated performance earnings come to fruition.

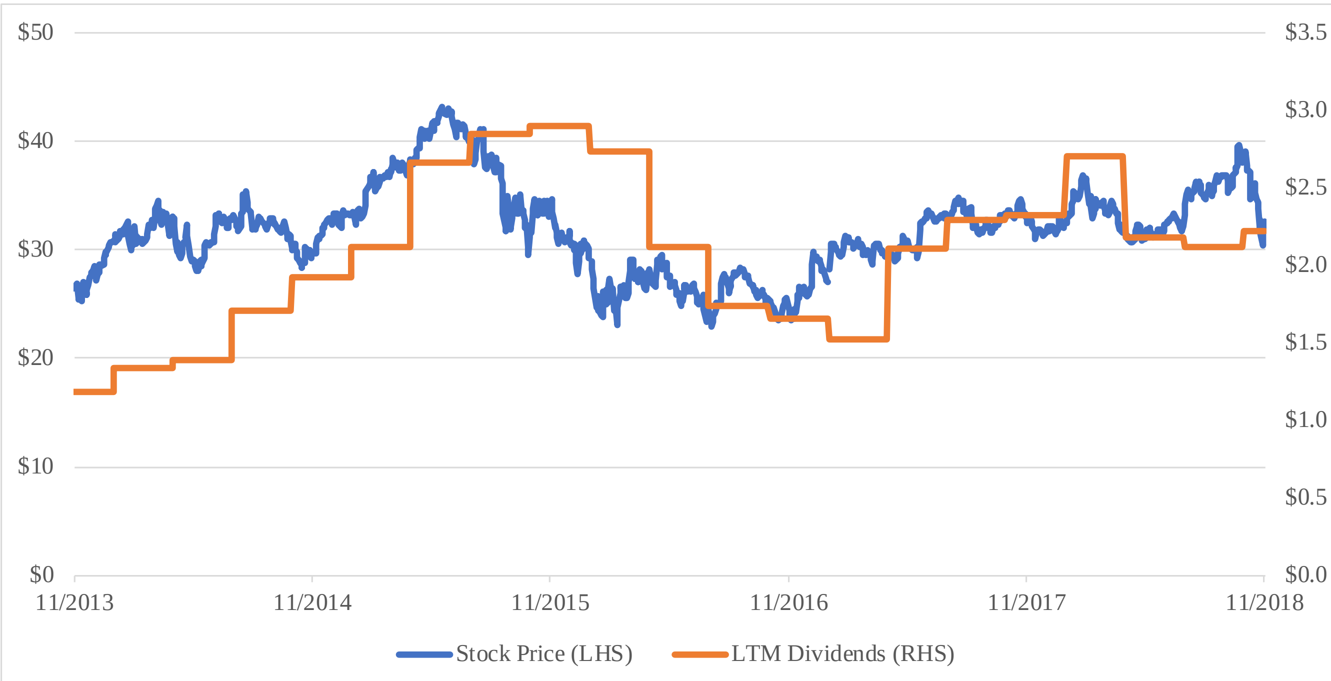
Exhibit 11: Stress Testing of Valuation Assumptions

Upside/Downside vs.		Forward Multiple on 2020E FRE						
Current Price		10x	12x	14x	16x	18x	20x	22x
2020E Performance Earnings	$ 1.00	-25.6%	-19.1%	-12.5%	-6.0%	0.5%	7.0%	13.6%
	$ 1.25	-18.1%	-11.5%	-5.0%	1.5%	8.0%	14.6%	21.1%
	$ 1.50	-10.5%	-4.0%	2.5%	9.0%	15.6%	22.1%	28.6%
	$ 1.75	-3.0%	3.5%	10.0%	16.6%	23.1%	29.6%	36.2%
	$ 2.00	4.5%	11.1%	17.6%	24.1%	30.6%	37.2%	43.7%
	$ 2.25	12.1%	18.6%	25.1%	31.6%	38.2%	44.7%	51.2%
	$ 2.50	19.6%	26.1%	32.6%	39.2%	45.7%	52.2%	58.8%

Source: authors' analysis

We also gain comfort in the fact that shareholders are getting paid to waiting for the thesis to play out. Blackstone is currently one of the highest yielding stocks among large-cap companies, with its last-twelve-month dividend yield at over 7%. As shown in **Exhibit 12** below, Blackstone share price over time displays a relatively strong correlation with the dividends. We believe that Blackstone can make close to $4 in after-tax free cash flows per share by 2023, suggesting a dividend payout of over $3.2 per share. If we apply the five-year average dividend yield of 5% to that estimate, we get an exit share price of $65-70. While we recognize that dividend yield is not a particularly useful valuation tool, it does provide yet another lens through which we can see a clear pathway to stock price doubling over the next four-to-five years.

Exhibit 12: Blackstone Share Price vs. Last-Twelve-Month Dividends



Source: Bloomberg

<u>Key Risks</u>

Blackstone is susceptible to macroeconomic risks. As a firm that owns almost 200 portfolio companies across the world, Blackstone is clearly vulnerable to macroeconomic risks. In an economic downturn, Blackstone's operation will be negatively affected in the following ways. First, Blackstone will see fewer exit opportunities, leading to later realizations of investments than normally expected. Second, the firm will likely have reduced access to credit, especially low interest rate credit, which would not only affect deal structuring, but also return potentials. Third, a downturn will cause the value of its public equity holdings to decline. Last but not least, a tough economic and market environment will lower and even reverse the firm's asset growth pace. However, we believe that while all these factors would likely weigh down stock price in the short term (Blackstone shares fell by over 75% during the Great Financial Crisis, Blackstone is built to endure and even thrive in tough environments. Unlike traditional asset managers who face constant redemption fear, only 10% of Blackstone's asset can leave the firm within a year. And as previously noted, the firm has close to $100 billion of dry powder across strategies that can be deployed if and when the market turns sour.

Elevated valuation could negatively affect Blackstone's opportunity set and returns. The valuation level of public and private markets has been steadily rising since 2009. According to the aforementioned Preqin survey, institutional investors cite valuation as their number one concern when investing in the private equity asset class. In recent years, we are seeing an increasingly amount of transactions getting done at double digit EBITDA multiples compared to high-single-digit in the past. While we believe that Blackstone delivers strong value-add to its portfolio companies, multiple expansion has historically been a major driver of private equity returns. Removing this element from the return equation will clearly lower our prospective return projections. However, we should note that elevated valuations also provide a fertile environment for exits, as evidenced by Blackstone's record year of 2017 when the firm harvested over $50 billion of investments.

There are risks involved in the firm's succession strategy. Mr. Schwarzman is a visionary. He has been involved in all aspects of its operations since the firm's founding in 1985. Mr. Schwarzman is 71 years old, and is still fully committed to Blackstone and shows no desire to retire. However, the firm has started the succession planning process, with the latest step being the promotion of Jonathan Gray to the Chief Operating Officer position, which solidified his role as heir-apparent to Mr. Schwarzman. While Mr. Gray has proven himself as a highly capable investor and executive, succeeding Schwarzman is no easy task for anyone.

Tax laws create uncertainty around Blackstone's business. Blackstone's operation is affected by a number of changes passed in the recent US tax reform, including reduction in the federal corporate income tax rate, increase in holding period requirement for carried interest to be treated as long-term capital gains, and partial limitation on the deductibility of business interest expense. These changes have a mixed effect on Blackstone. The reduced federal income tax rate could precipitate Blackstone's conversion into a C-Corp. The stricter rules around carried interest, as well as increased effort to end the favored tax treatment of carried interest all together, will increase the tax liability and lower the distributable earnings of all private equity funds, including Blackstone's. And the limitation on the deductibility of business interest expense will also negatively affect Blackstone as most of its portfolio companies are relatively levered. Tax laws remain a hotly debated area in the US legislative body, and further reform could lead to more adverse effect on Blackstone.