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Management Companies, Fees Are Key to Private-Equity IPOs

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For years now, private equity firms have been trying to access the vast pool of capital that makes up the public markets. But their efforts have for the most part failed, as they haven't been able to find a way to make their model palatable to public-market investors.

But in the wake of **Fortress Investment Group**'s successful public offering on the New York Stock Exchange, firms are hoping to follow in its footsteps.

The approach? Taking public the management company -- the legal entity that is owned by its founders and oversees its funds. Several firms have made similar offerings in Europe, including fund-of-funds manager Partners Group, but Fortress blazed the trail in the U.S. The approach is different from that used by Kohlberg Kravis Roberts & Co. and Apollo Management LP when they listed last summer in Amsterdam.

On Friday, a person familiar with the matter said Blackstone Group, a private investment powerhouse that has managed more than $64 billion, could file in the next two weeks for an IPO[1] in which it would sell a stake of about 10% in its management company. The sale could raise $4 billion, the person said.

VIDEO
[2]
WSJ Reporter Henny Sender[3] and others discuss the wisdom of a Blackstone IPO and the potential impact on other private-equity firms.
GOING PUBLIC

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An offering would further the move of long-secretive private equity and hedge funds into the stock markets and give investors another way to tap into those funds' heavy fees and exploding growth.

Past attempts by private-equity firms to access public capital have mostly taken the form of things like business development companies and publicly traded European funds, vehicles that are linked to firms' deals. The management company model is tied to a different flow of capital: the private equity firms' fees. Management companies typically lay claim to most, if not all, of the management fees generated by the private equity funds, using the capital to pay salaries and other operating costs. Management companies also collect a portion of funds' carried interest. When firms they take their management companies public, asset managers are effectively selling stakes in the portion of their current and future fees that go to the management companies.

Fortress sold 8.5% of its management company, or 34.3 million shares, in its IPO, which was underwritten by **Goldman Sachs Group** and **Lehman Brothers Holdings**. Its founders own the rest of the shares. The offering raised $645 million.

The management-company model also differs from the fund model in that the asset management firms, instead of investing the money in deals, use the cash from the IPO to build their businesses. The public investors who bought that 8.5% stake will see their shares become more valuable as Fortress raises more and bigger funds and generates more management fees. Their shares will also increase in value as Fortress exits investments, generating carried interest profits. The better the exits, the more value for public investors.

Raising capital for expansion is attractive to firms, especially in the rapidly globalizing economy, as opening far-flung offices in Asia or the Middle East can be capital intensive. But what's really driving the interest is these IPOs' ability to define a concrete value for the management companies and the people behind them.

Those firms that have tried to monetize their stakes have generally done so by selling shares of their management companies to their largest limited partners, who probably have a pretty good idea of what the firms are worth. The California Public Employees' Retirement System has at one time or another owned stakes in such firms as Thomas Weisel Partners and TPG Ventures, and still owns a 5.5% stake in Carlyle Group. More recently, Fortress sold a 15% stake to **Nomura Holdings** Inc. only months before its IPO.

But such tactics can undervalue a firm relative to what the public market thinks it is worth. The stake Fortress sold to Nomura valued the company at about $6 billion. Post-IPO, Fortress is worth some $10.7 billion.

Management companies wanting to go public will need to have diverse sources of capital -- like real estate funds, hedge funds and mezzanine funds in addition to buyout funds -- that guarantee a relatively steady flow of fees.

There are very few firms that fit that description currently. Not surprisingly, they're the biggest players in the business: Carlyle Group, Texas Pacific Group, Bain Capital and Kohlberg Kravis Roberts & Co. and Blackstone.

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