Update: PE Firms Converting to C Corporations

By Donald P. Board • Wood LLP

Earlier this year, two giant private equity firms converted from publicly traded partnerships to C corporations. Some in the financial press speculated that the firms (Ares Management and KKR) might be the first in a wave of PTPs assuming the burden of double taxation in the hope of increasing the market value of their shares. [*See generally* Donald P. Board, *Why Are*

(Some) Publicly Traded Partnerships Electing to Be Taxed as C Corporations?, THE M&A TAX REPORT 1 (Aug. 2018).]

It is a commonplace that the market "undervalues" private equity firms taxed as PTPs. Their managers hypothesize that this is a side effect of passthrough taxation, which depresses demand for PTP stock. Tax-exempt and foreign investors have little appetite for the UBTI and ECI that these firms generate, so they steer clear of their shares.

Managers contend that U.S. taxable investors don't want to deal with getting a Schedule K-1, especially if it triggers an obligation to file tax returns in multiple states. They also note that institutional investors are frequently prohibited from investing in firms taxed as partnerships. PTP shares are ineligible for inclusion in popular indices and retail investment products, further reducing demand.

On this analysis, exiting Subchapter K is a capital idea, but it has always been dismissed because of the corporate income tax. Now that the corporate rate has been slashed from 35 to 21 percent, the unthinkable has become thinkable. Ares and KKR decided to take the plunge—will others follow?

First Report Card

So far, the remaining PTPs—Blackstone, Apollo, and Carlyle—are standing pat. Ares and KKR enjoyed initial price bumps, which certainly stirred the pot. However, now that things have settled down, it is unclear whether electing into Subchapter C has produced any net benefit.

On February 14, 2018, the day before Ares announced its plan to convert, its stock was trading at $22.70 per share. On November 12, Ares closed at $21.73, about a four percent decline. Over the same period, the S&P 500 gained about one percent.

Things went considerably better over at KKR. The firm's shares closed at $21.50 on May 2, right before its announcement. On November 12, they were selling for $22.81, about a six percent increase, while the S&P was up about the same amount.

Of course, these are short-term price movements, with many confounding factors, so it is impossible to reach a final verdict regarding the merits of conversion. But, at this point, it certainly doesn't appear that liberating a publicly traded PE firm from the coils of Subchapter K is the proverbial game-changer. The alleged benefits of expanding the firm's investor base may roughly compensate for the corporate tax, but is that as far as they go?

Institutional investment in Ares and KKR is up, but the companies' shares have not yet been added to major stock indices. This means they still haven't found their way into retail investment products. Consequently, these two early adopters would probably argue that the jury is still out on their conversion strategy—in fact, it hasn't even been empaneled.

Unreasonable Compensation?

One commentator has argued that blaming the underperformance of publicly traded PE firms on limitations on their investor bases misses the point. The real problem is that top managers of the lagging firms are being paid way too much money. [*See* Stephen Gandel, *Private Equity's Biggest Mystery Has a Simple Answer*, BLOOMBERG OPINION (July 20, 2018).]

The commentator added up the total value, including dividends, that went into the pockets of eight top executives at four publicly traded private equity firms during 2015–2017. He then considered how the returns that shareholders earned during this period compared with what they would have made if they had simply invested in the S&P 500.

During 2015, the eight executives came away with a jaw-dropping $1.9 billion. They must have been doing a fantastic job. But 2015 wasn't exactly a banner year for the PE firms' shareholders, who *lost* $13.7 billion compared with an equivalent investment in the S&P.

In 2016, the executives raked in another $1.1 billion. This time, shareholders managed to outperform the S&P, but only by $573 million. That's about 52 percent of what these eight individuals got.

The shareholders did better than the executives in 2017. As a group, they made $5 billion more than they would have by investing in the S&P. That was good news, but the shareholders had to "pay" the eight execs $1.8 billion to get it.

Putting the three years together, the eight executives made about $4.8 billion. Their shareholders, on the other hand, *lost* $9.2 billion relative to the S&P 500.

The commentator argues that these skewed results have created "distrust" among investors. *That* is what depresses the firms' market values, not shareholders' fear of receiving a Schedule K-1. So, it is no surprise that moving an underperforming firm into Subchapter C does not usher in the millennium.

The problem with this analysis is that most of the payments flowing to the top executives were *dividends* on their stock in their respective firms. Consider Stephen Schwarzman, CEO and co-founder of Blackstone. In 2017 alone, he picked up a titanic $787 million.

Mr. Schwarzman was paid a modest salary ($350,000), and he did not receive a cash bonus. However, he earned $125 million from carried interests and incentive fees, which might lead shareholders to wonder whether he was overcompensated. The rest of his haul—$661 million—consisted of dividends on his 19-percent stake in the company.

Where did Mr. Schwarzman get his shares? If they simply represent his continuing interest as a co-founder of Blackstone, we can't say that his dividends came at the expense of the company's other shareholders. However, to the extent that his shares derive from stock or options granted after Blackstone went public (2007), the commentator would have a point.

Even if Mr. Schwarzman's 19 percent could be traced to dilutive transactions, one might assume that his large block would still align his interests with those of the public shareholders. As the owner of almost a fifth of the company's stock, he would ordinarily have a very healthy incentive to avoid undervaluation of Blackstone's shares.

But if Mr. Schwarzman—and his heirs—are not planning to sell, what the market thinks could be irrelevant. In fact, a depressed stock price for Blackstone would be a *good* thing for estate tax purposes. So, one cannot assume that Mr. Schwarzman's status as a major shareholder will temper the insider's normal incentive to feather his own nest.

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