

Marketability on a Spectrum

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Marketability is often referenced in a binary way: “marketable” or “non-marketable.” We know not all “non marketable” interests are created equally. Restricted stock studies that help inform our understanding of lack of marketability cite size metrics (i.e. larger companies in terms of revenue, assets, equity, etc. are more marketable) and risk metrics (i.e. profitability, volatility, and distribution paying capacity) as important. We also know investor rights such as transfer restrictions and put option rights along with trading activity influence marketability.

These factors impact marketability of assets typically identified as “non marketable,” such as an interest in a private business with no ready and active market to transact such an interest. It is easy to identify this phenomenon in “non-marketable” interests, but it may also be observed in interests that are traditionally considered “marketable.” This evidence can help us confirm our previous understanding of factors of marketability while also advancing our paradigm and lexicon to marketability on a spectrum.

In light of Public Law 115–97, formerly known as the Tax Cuts and Jobs Act of 2017, a few large alternative asset managers have announced and/or elected to convert to C-Corporations (“C-Corp”) from their traditionally more tax friendly pass-through structures (limited liability companies and partnerships). This list of companies (the “Companies”) includes Apollo Global Management, Inc. (“APO”), The Blackstone Group Inc. (“BX”), KKR & Co. Inc. (“KKR”), Ares Management Corporation (“ARES”), and Carlyle Group L.P. (“CG”). Despite the narrowing of the gap between C-Corp and pass-through tax liabilities¹, C-Corps will likely still have higher overall tax burdens. So what is motivating this archetype shift and what has been the reaction to this shift from markets? Marketability may be the answer.

An interest in the Companies would traditionally fall into the “marketable” designation, however market evidence around their conversions may indicate that their market pricing reflected some level of lack of marketability. See the Appendices for a summary of historic prices, trading volumes, volatility, and performance relative to the Benchmark² for the Companies.

¹ Pass-through tax liability is understood to include investor level taxes and assumes no eligibility for the deduction outlined in Internal Revenue Code § 199A.

² Invesco Global Listed Private Equity ETF (the “Benchmark” or “ARCA:PSP”) is an exchange traded fund launched and managed by Invesco Capital Management LLC. The fund invests in listed private equity companies.

Overall, the Companies³ outperformed the Benchmark over the period from announcement date to conversion date (the “Conversion Period”) as indicated by their growth relative to the average 20 trading days (or approximately one month) prior to the Conversion Period (the “Base Period”). Beyond the Conversion Period, the majority of the Companies had sustained outperformance of the Benchmark during the 20 trading days including and following the conversion date. Additionally, the Companies experienced sustained, significant increases in trade volumes after the announcement date over the Base Period. While experiencing higher volatility during the Conversion Period, volatilities normalized after the conversion dates.

As a preset, let’s take some shortcuts in this discussion. Price and value are often improperly conflated. While price is an extrinsic expression of value, price and value are not always equivalent. For purposes of understanding this issue of marketability, let’s assume price and value are interchangeable concepts because they’re similarly affected by this phenomenon.

Based on market data, the Companies are more valuable post-conversion. This value change is unlikely attributable to a change in after-tax cash flows to investors as previously discussed due to anticipated increased tax expenses. Enhanced marketability of interests in the Companies provides a potential answer.

A C-Corp could be considered more marketable than a pass-through entity for a number of reasons: (1) an investor in a C-Corp is not subject to the same administrative requirement and tax liability which is potentially unshielded by distributions; (2) the pool of potential investors in a pass through entity, even a publicly traded one, is inherently smaller due to restrictions that limit some mutual funds and other institutional investors from investing; (3) C-Corps have potential to be included in indexes that are otherwise restricted by mandates; and (4) additional investor rights than under previous structure.

In turn, the conversions of the Companies have created a large pool of new potential investors consisting of institutional investors and indexes. Additionally, institutional investors and indexes regularly trade shares to maintain strategies and rebalance their funds. We can observe this in the sustained increase in performance over the Benchmark for the Companies. The notable exception of the Companies that have completed conversion is ARES, which is the smallest in terms of market capitalization and the least likely for inclusion in indexes.

As demonstrated in Appendixes A-1 and A-2, the Companies experienced increases in price and trading volume after their announcement dates and again after their conversion dates. As previously mentioned, this increase was unlikely due to a change in cash flows as the Companies would likely be subject to higher overall taxes. The improvements are most directly an effect of improved marketability since institutional investors can now hold these equities. All of this indicates that equities of the Companies which were previously considered “marketable” were in fact suffering to a degree from lack of marketability.

These concepts arise in “marketable” public interests but aren’t isolated and can be applied to and improve our understanding of lack of marketability for “non marketable” private investments. The Companies are an interesting demonstration of the magnitude of marketability and a call to better our understanding of marketability on a broader spectrum.

³ With the exception of CG which had not completed its expected 1/1/20 conversion as of this publication; however based on data through 10/31/19, CG had outperformed the Benchmark since the announcement date.

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Anthony Venette, CPA/ABV, is an Engagement Leader at Empire. Anthony has been involved in the valuation of various classes of equity, general and limited partnership interests, carried interest, limited liability company membership interests, C-Corporations, S-Corporations, stock options, and warrants. These valuations have been for purposes including gift and estate tax planning, financial reporting under ASC 820, employee stock ownership plan administration, and other corporate planning and reporting. Anthony received his BS degree in Accounting and his MBA with a concentration in Accounting from the St. John Fisher College Bittner School of Business.

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Apollo Global Management, Inc.				
	20 days prior to Announce Date (Base)	Announcement	Conversion	20 days including/after Conversion Date
Date(s)	4/3/19 - 5/1/19	5/2/19	9/5/19	9/5/19 - 10/3/19
Price (Average)	\$30.56	\$33.04	\$40.95	\$39.71
Price Growth over Base	N/A	8.1%	34.0%	29.9%
Volume (Average)	978,570	3,016,710	13,894,580	4,115,173
Volume Growth over Base	N/A	208.3%	1319.9%	320.5%
Historic Volatility (20 day)	N/A	26.0%	47.2%	31.3%
Implied Volatility	N/A	24.0%	33.6%	37.7%



The Blackstone Group Inc.				
	20 days prior to Announce Date (Base)	Announcement	Conversion	20 days including/after Conversion Date
Date(s)	3/20/19 - 4/17/19	4/18/19	7/1/19	7/1/19 - 7/29/19
Price (Average)	\$34.91	\$38.62	\$46.58	\$47.08
Growth over Base	N/A	10.6%	33.4%	34.9%
Volume (Average)	2,250,433	28,121,360	56,734,260	8,839,003
Volume Growth over Base	N/A	1149.6%	2421.0%	292.8%
Historic Volatility (20 day)	N/A	30.0%	25.4%	23.9%
Implied Volatility	N/A	19.0%	21.6%	22.6%



KKR & Co. Inc.				
	20 days prior to Announce Date (Base)	Announcement	Conversion	20 days including/after Conversion Date
Date(s)	4/4/18 - 5/2/18	5/3/18	7/2/18	7/2/18 - 7/30/18
Price (Average)	\$20.76	\$22.14	\$25.93	\$26.97
Growth over Base	N/A	6.6%	24.9%	29.9%
Volume (Average)	2,066,904	11,826,770	23,224,600	8,935,055
Volume Growth over Base	N/A	472.2%	1023.6%	332.3%
Historic Volatility (20 day)	N/A	21.0%	21.8%	19.2%
Implied Volatility	N/A	25.0%	29.1%	22.1%

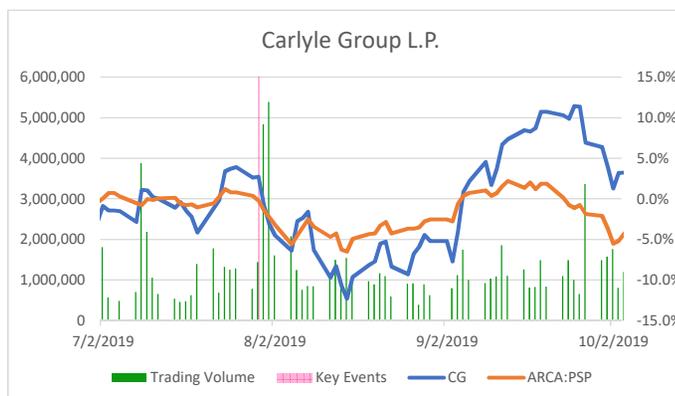


Note: Price data reflects closing price. Price and trading data obtained from S&P Capital IQ. Volatility data obtained from Bloomberg Network.

Ares Management Corporation				
	20 days prior to Announce Date (Base)	Announcement	Conversion	20 days including/after Conversion Date
Date(s)	1/17/18 - 2/14/18	2/15/18	3/1/18	3/1/18 - 3/29/18
Price (Average)	\$23.31	\$24.45	\$24.75	\$22.10
Growth over Base	N/A	4.9%	6.2%	-5.2%
Volume (Average)	119,530	352,850	127,540	1,027,594
Volume Growth over Base	N/A	195.2%	6.7%	759.7%
Historic Volatility (20 day)	N/A	55.0%	51.1%	45.0%
Implied Volatility	N/A	40.0%	33.8%	35.9%



Carlyle Group L.P.				
	20 days prior to Announce Date (Base)	Announcement	Most Recently Available Information	20 days including/after Conversion Date
Date(s)	7/2/19 - 7/30/19	7/31/19	10/31/19	1/1/20 - 1/29/20
Price (Average)	\$24.03	\$23.85	\$27.28	N/A
Growth over Base	N/A	-0.7%	13.5%	N/A
Volume (Average)	1,116,144	4,840,910	717,420	N/A
Volume Growth over Base	N/A	333.7%	-35.7%	N/A
Historic Volatility (20 day)	N/A	30.0%	N/A	N/A
Implied Volatility	N/A	30.0%	N/A	N/A



Note: Price data reflects closing price. Price and trading data obtained from S&P Capital IQ. Volatility data obtained from Bloomberg Network.