The Carlyle Group at Morgan Stanley Virtual Financials Conference 2020

Mike Cyprys: Good morning, everyone. I'm Mike Cyprys, Morgan Stanley's Brokers and Asset Managers Analyst. Thanks for joining us this morning at the Morgan Stanley Financials Conference. Before we get started, I've been asked to direct your attention to important disclosures on the Morgan Stanley research disclosure website at morganstanley.com/researchdisclosures. And if you have any questions about these disclosures, please reach out to your Morgan Stanley sales representative. So with that out of the way, welcome to our fireside chat with the Carlyle Group.

And this morning, we have with us Glenn Youngkin, Carlyle's Co-CEO. Glenn has been with the company for over 24 years and as Co-CEO, along with Kewsong Lee. As many of you know, Carlyle is a diversified alternative asset manager with about $220 billion of client assets under management today across private equity, real estate, real assets, credit and investment solutions. Glenn welcome. Thanks for joining us today.

Glenn Youngkin: Mike, thank you and I really appreciate you hosting in this new format. And so I'm looking forward to it. Mike, what I'd like to do, if I could, is just spend a few minutes going through a few slides and then we'll have plenty of time for Q&A, if that's okay with you.

Mike Cyprys: Sounds perfect. Over to you, Glenn. Perfect.

Glenn Youngkin: Perfect. Thank you. So for all of you on the phone, we have placed today's presentation on our website, at our web portal or on the investor portal, but also available of course on the webcast. And I'd encourage you to follow along if you can. But please let me start with a most important issue of the day. We find ourselves at an unimaginable moment in our country. And as we have just begun to climb out of what we all know is the worst health and economic challenge we've ever faced, we now have the abhorrent and tragic events over the last few weeks that just remind us how much real work we have in front of us in order to heal our country.

I must say, I have been incredibly proud of my Carlyle colleagues and over the last three months and four months, but particularly over the last few weeks, reflecting the values that we love about Carlyle. We've come together in an extraordinary way. We've preformed at high, high levels since the pandemic first hit in China. But on top of that, we've come together as a firm to really reflect our values and how to make positive change in the face of these real, real racial tensions that we are experiencing that really claw at the fabric of our country. I must say, I'm prouder to be at Carlyle today than I ever have been in what will be 25 years next month.

So to move onto the presentation, I'm going to start on Page 3 and hit a few of the slides. So as you all know, Carlyle continues to be a leading global investment manager. We have just under $220 billion of assets under management. As we said in our last earnings call, we entered 2020 with great momentum following record fundraising for us over the previous four years with $74 billion of investment available.

At the beginning of the pandemic, we were incredibly focused on both our people and our portfolio and that served us very well. And yes, there's more work to do but it served us incredibly well. And we continue, as a result, to be able to focus on our core business priorities of expanding our key business lines and growing earnings. And we've had some very nice events over the course of the last few weeks, particularly with regards to the final closing of the Fortitude Re-Transaction, which we've been updating you on over the last couple years.

And then finally, we continue to offer an attractive shareholder value and investment proposition. And I'll walk through particularly an update on index inclusion data that I think is important to everybody. I'm going to turn us to Page 5, which really does highlight the momentum that we brought with us into 2020 and that has served us well through the pandemic.

First, fee-related earnings coming out of 2019 were running at about $450 million. Just to put that in context, that was more than double than 2017 levels and our margins had increased to 28%. Our fee-earning AUM continues to be sticky and long-term, with 98% in long-term locked up fee structures. And as I mentioned, our dry powder of $74 billion is a very, very strong asset for us now.

Our funds, despite the fact that we did mark them down at the end of the first quarter, continue to be well-positioned to generate performance revenue with $1.2 billion of net accrued carry at the end of the first quarter. And you've heard us talk about our global credit business as our top priority to grow over the last few years. And we continue to see good progress there with that business at roughly $50 billion of AUM at the end of the first quarter.

I know Mike and I will talk about fee-related earnings but we continue to place fee-related earnings growth as a very important priority in our business management at the end of the first quarter. Just given the material uncertainties of the year, we let everyone know that our original guidance of $475 million for the quarter we needed to revise and we expect a range between $400 million and $450 million for FRE this year. As the year progresses, of course, we will update everyone on our progress against our FRE goals.

As I said, dry powder continues to be a real asset for us following our strong fundraising. The dry powder is across all of our segments and it does give us the real capability to continue to invest steadily. We did tell everyone that as a result of the pandemic, we felt like investment pace would slow down in the second half of the year, naturally, as everyone finds their footing as the economy slowly recovers.

With that said, the platform that Carlyle has become over the last six or seven years really does represent extraordinary investment capacity. Roughly, 50% more investment capacity today than we had back in the 2012 to 2015 level. And while we clearly were very, very focused on supporting our portfolio and making sure that we had broad support from across the firm for every aspect of our portfolio at the beginning of the pandemic, and we continue to do that today, we have begun to shift our focus to, of course, investing.

And the tip of the spear, of course, is in our global credit business, which is very active. But we continue to see new opportunities emerge in Asia, a number of our growth sectors, and across our solutions business, and particularly in secondaries. And we have announced a number of transactions over the last few weeks that really do represent that activity.

As I said, our portfolio, as I move to Slide 8, is well positioned amongst a challenging market. We have $143 billion of fair value in the ground and our track record over a long period of time, particularly in our large buyout business, really does reflect the focus we have on portfolio construction, on the style of investing that really made Carlyle one of the top performers over so many years.

And in fact, we do our best work during difficult times. When we look back, on the right hand side of this slide, when we look back at our fund performance during the great financial crisis, which is reflective of absolutely the same kind of investing approach we have today, we saw very strong performance for funds that were invested prior to and during the great financial crisis. And therefore, that gives us confidence that as we manage through this crisis, we in fact have constructed the portfolios well and will continue to see strong performance on a go-forward basis.

As I mentioned earlier, the global credit business continues to perform. It's one of our top priorities. Total AUM has reached roughly $50 billion, which is an 18% growth rate over the last three years. And of course, our fee-related earnings are just under $50 million. And that is a serious step in the right direction. Although as we have expressed in just about every earnings call, this takes time.

And so we have built out very strong teams and now, we're starting to scale. And in this current environment, as I said, this is our busiest group right now and we're encouraged by not only the capabilities and the support from investors, but also the opportunities that they are seeing.

I mentioned earlier the Fortitude closing and that was just the final step of our establishment of our insurance platform. To remind everybody, we originally took roughly a 20% position in Fortitude in partnership with AIG. And this last step represents bringing together a number of Carlyle investors and T&D holdings to purchase from AIG approximately, collectively, 97% of Fortitude when you take into account our original position.

Fortitude Re has $43 billion of total assets and as you will all remember, as part of this transaction, roughly $6 billion of those assets are being rotated into private capital strategies managed by Carlyle. So we're excited about this final step. It solidifies Fortitude as a source of long-term capital for us but on top of that, now, we're well positioned to grow through acquisitions by looking at adding on additional runoff blocks of insurance portfolios.

We do make money here in three ways. We of course have our investment income off of the balance sheet investment that we made in Fortitude. And then as the assets rotate into Carlyle Funds or investment activities, we of course earn management fees from those assets and have the potential to earn performance revenues off of them as well.

And the last main topic I want to cover is just the continued progress we've made following our conversion to a full C-corp. As you remember, we converted to a full C-corp with one share, one vote back in January. We have seen increased trading activity and volume, which is what we hoped. And so we're very pleased with that. And on top of that, index inclusion was a major thesis and we're starting to see that happen as well with the MSCI USA Index series including us on May 29, the Russell announcing last week that we will be included in their reconstitution on June 26, and with the CRSP index transitioning and reconstituting between June 17 and June 23.

And we expect to be added to the S&P and BGI total market indices. And we're always aware of the fact that we are available to be added to the S&P flagship index. But of course, that is a process, which takes time and is not under our control, but we have to be admitted.

Finally, we do believe that we continue to present an attractive investment opportunity. Our fee-related earnings growth profile over the last number of years, and the change in the mix of our earnings to having a much larger component that is FRE, but also the prospects of growing DE as a whole as our performance fees grow over time. Our dividend continues to be attractive at over 3% and in fact, that dividend we would hope to grow over time as FRE grows.

And finally, we do think, although we have had I think a very attractive stock price performance over the last period of time, we do think that we continue to have opportunity relative to our peers for valuation improvement. So thank you for that and Mike, with that, I'd love to go back and let's -- we would be sitting down together at the front of the room in those nice big chairs. But let's have a fireside chat.

Mike Cyprys: That's right and just to be mindful of time, we have about 15 minutes left. So maybe we'll start off on the macro, Glenn. Carlyle has over 200 portfolio companies, including a large number in Asia and so I'd be interested to hear your perspective, looking through that lens, what are you seeing in terms of how the global economy is reopening? And what's your take on the macro outlook here?

Glenn Youngkin: So first, we do indeed have a really interesting lens through our big portfolio, as you say. And our data suggests that first of all, in Asia, particularly, and in China, that the economic rebound in China has been very V-shaped. It hasn't recovered to the same level as it was as they went into the pandemic. But China has, from an economic activity standpoint, recovered pretty quickly.

We do think, however, that there is a bit if plateauing going on right now in China and that plateauing really does reflect the challenges in of course the rest of the global economy, but also, I think, the continued recognition that the COVID-19 virus has not been eradicated and still poses threats. And we do think that this recovery and then a bit of plateauing in fact does provide insights into how the both European and the United States economies might recover.

Of course, what we've seen in Europe and the United States is a real reflection of the fact that the economy bottomed at the end of April for Europe and the end of April beginning of May for the United States. And of course, with the gradual reopening across Europe and across the United States, we are seeing real economic pickup.

I do think it's important, however, to recognize that this is coming off of a very low base, that the economic pickup will happen in fits and starts. This opening will have a challenge here and there and it will not be linear by any means. And so we've been quite measured, I think, in our expectations of the pace of the rebound and pace of the recovery of the economy. Although we have seen real recovery off of the bottom.

And I think, Mike, the last thing I would say is that we do across the portfolio see differences in sector performance, of course. And there are some sectors, which really have not been impacted. And in fact, have been positively impacted by the opportunities that have presented during the COVID-19 pandemic.

And then there's other pieces of our portfolio, of course, that have been more impacted. And it's the mix of all of that, which brings our perspectives that, as I said, that we are seeing a rebound. We expect it to, in fact, improve. We do think that it will have moments of fits and starts but we do expect it to improve. But there will be a bit of plateauing eventually as we still wait for a final resolution from the virus.

Mike Cyprys: Great. And against that backdrop, you have about $74 billion in dry powder today and given the recovery that we're seeing in public markets, can you talk about maybe where you're seeing the most compelling opportunities to deploy capital today, how that is evolving, and what sectors, geographic regions stand out most to you from an attractiveness standpoint?

Glenn Youngkin: Well, first as I said, our credit business has been busy, continues to be busy. And as we all know, in any economic crisis, credit really is the first opportunity. And so that part of our business we continue to be quite supportive of and they are very active. And then of course what we're seeing around the world is the beginnings of investment opportunities presented themselves in Asia first. It was the first part of the world to recover. And then we're starting to see similar opportunities in Europe and the United States as things recover.

But I want to make sure I'm appropriately cautious here for everyone. Investment pace in the back half of the year will be slower than if it was in a normalized period, by definition. And that just reflects the realities of not only the economic recovery and the challenges that we faced, but also some of the challenges in just conducting private equity style deals today.

With that said, we are seeing some opportunities. We've been investing and I think that the further we get into this recovery, the more confident we will get. Our deep teams, our sector teams are critically important to executing against those themes. And then of course, the Carlyle Bench at 1 Carlyle that brings all of our portfolio support continues to play an incredibly important part as well.

So Mike, I think where we were back at the earnings call where we felt like we were predominantly on defense, other than really our credit business and maybe secondaries, and a few things in Asia, I think we're leaning in more, seeing better opportunities but not at the expense of continuing to support the portfolio.

Mike Cyprys: Okay. Great. And then maybe shifting to your portfolio about $140 billion of invested capital. We saw some marked markdowns in the first quarter. How are you navigating some of the more challenging situations in the portfolio today? Maybe you could talk to some of the actions that you've been taking given the recovery in equity markets to see we see a large portion of these negative marks get reversed here in the second quarter.

Glenn Youngkin: Well. So first of all, as you said, the portfolio did get marked down at the end of the first quarter, just to remind everybody. Our private equity portfolio was down 8% in Q1. Our real estate portfolio was down 1%. Energy was of course weaker at down roughly a little over 20%. All of those compared favorably to public indices. But of course, the reality, as you all know, the private portfolios don't tend to swing as far down, nor as far up as public portfolios do on a quarter-to-quarter basis. Over a long period of time, 1-year, 3-year, 5-year, of course, we continue to see strong outperformance relative to those indices.

With regards specifically to the portfolio, we of course have spent an enormous amount of time making sure that we have management fully supported by our Carlyle portfolio support teams. We've worked very hard to make sure that liquidity issues are addressed. And then we continue to work hard to support the companies to take advantage of opportunities. I think oftentimes, we do think that being on defense all the time in these moments is that characteristic. I have to say we've had a few moments like our recent IPO of Zoom Info where the market presented an opportunity for us to take public a very good portfolio company.

And so Mike, it's across the spectrum where we're of course supporting those companies that are facing challenges. We're working to reinforce companies that we think have some growth opportunities in this market. And of course, where there's a company like Zoom Info, we're letting it take its next step and supporting it as it goes public.

Mike Cyprys: On the conference call, you mentioned the performance fees over the next couple of quarters are (inaudible) first quarter levels. Can you just give us an update on where things stand today in the context of the significant equity market rally that we've seen so far this quarter?

Glenn Youngkin: Yes. So Mike, I do think that our expectations that not only investment activity but exit activity will of course be slower in the second half than one would otherwise want, just given the pandemic are still appropriate. But we do see opportunities to in fact seek exit opportunities and we're pursuing those. As I said, the Zoom Info IPO was helpful in recognizing just how good a company that is. But we've also had a chance to sell some blocks of stock in some of our assets and we've been able to close a few sales.

But I think I just want to manage everyone's expectations. Overall exit activity, again, will be slower than we otherwise would have thought at the beginning of the year because of the COVID-19 pandemic. And that will just, I think, slow down our exit pace, at least for this year. Notwithstanding that, our portfolio did have a number of well-positioned companies for exits. And as soon as we can, we'll pursue those.

Mike Cyprys: Great. And then looking to your fee earning AUM, asset levels have held about flat over the past year compared to about 30% growth or so that we saw in 2018. Maybe you could talk a little bit about your strategy to accelerate growth in fee earning AUM, and which businesses and strategies would you expect to be the largest contributors as you look forward from here?

Glenn Youngkin: So of course, as I said when I started, our focus on growing fee-related earnings continues and that's both and absolute growth and improving margins. To put it in context, of course, over the last four years, we were in a major fundraising, multiyear cycle or period and that really did drive a very large scaling across the business. And we're just in a slightly slower fundraising period now. As you remember, at the beginning of the year, we guided everybody to roughly $20 billion of fundraising this year. And as we said, we thought there might be a few challenges to that as a result of COVID-19. But it is just not a big fundraising period for us although it's a consistent fundraising period for us.

And so what we will do to continue to drive FRE growth and margin expansion is continue to be efficient, continue to raise capital in those select businesses that are raising capital. And as a result, we think we can continue to drive over the intermediate term FRE growth after we get through this year. And then on top of that, we'll move into our multiyear fundraising cycle thereafter.

Also, we do expect, as we said earlier, that growth in overall DE will accelerate as well as performance fees will grow in those years as well. With regards to the segments that we see the most growth, we've talked about credit and credit continues to be our top priority for growth. Although we do see, of course, over the next number of years, real growth opportunities across the other segments as well. But given the credit -- the opportunity to continually raise money in credit, and the importance of credit on our platform, and then finally, the relatively young profile of credit with regards to portfolio construction by all of our investors, it's really where private equity was ten years ago. We just think there's continued opportunities for private credit to grow.

Mike Cyprys: Great. And given that sort of growth outlook there and your comments earlier about the fee-related earnings for 2020, you mentioned the revised guidance that you had put out on your earnings call, $400 million to $450 million range. I guess how do you think about hitting the bottom end versus the high end and what would you say are the moving pieces to get to that higher end of the range?

Glenn Youngkin: Well, what we highlighted for everyone in April were three real factors from a revenue standpoint that we wanted to make sure everyone was fully aware of. And that was first, the fact with regard to CLOs, broadly, industry wide, in a period where there may be downturns and -- there might be downgrades in ratings. Then of course, the CLOs would have to reflect that in their overall revenue construct. And there's something called a subordinated fee and it can be deferred.

That's an industry wide construct and we just wanted to make sure we were transparent with everyone that if there are meaningful rating agency downgrades across the industry, that the sub-fees could be deferred. And as we get through the next number of quarters, we'll of course be able to update everyone there. We did tell everyone that at the end of the first quarter, we had a small amount of our sub-fees deferred.

We also did highlight, of course, that those sub-fees can be recaptured and in fact, our experience for the sub-fees for our portfolio that were deferred during the great financial crisis is all of them were recaptured. So that's one area, Mike, where the outcome of the industry wide rating agency actions will have some impact on where we come out in that range.

The second two areas of course has to do with fundraising and where our overall fundraising outcome for the year was going to be relative to where we thought. We were pleased with the $7.5 billion that we raised in the first quarter and it was raised in good areas for us. And then of course, the third area of just guidance management here was around transaction fees. And while we do not have a large amount of transaction fees at Carlyle that make up our revenue, of course, you have to be making investments and have activity in order to charge them. And in a world where we expected activity levels to decrease relative to normal periods, we would expect that there would be either some diminishing of our transaction fees. Although again, just based on activity levels in the fall, we'll of course reflect that accurately.

And then finally, when it comes to FRE, we do, of course, have the ability to manage our expenses. We are in very good control of the business. We are seeing some solid expense management across area that you would expect, like travel, et cetera. And on top of that, a large part of our compensation base of course is variable at year-end. So we feel like we have good levers to pull and as the back end of the year continues to evolve, then we'll have a much better view of where we're going to come out relative to that range.

Mike Cyprys: Great. And we're just about out of time. I'll just sneak in one last question here just on insurance. You touched on it a little earlier just on Fortitude. I was hoping you could talk a little bit more about the strategy here with Fortitude and in what ways is this similar or different than peers?

Glenn Youngkin: Right. So first of all, just Fortitude's positioning. And I want to reiterate that financially and from a reserve standpoint, Fortitude is in very good shape. We have an excess capital ratio, as of March 31, of 210%, which is well above our target ratio of 150%. And as a result, we are well capitalized. And that positions us to in fact, as I said in the earlier presentation, look at growing Fortitude Re through the acquisition of additional books of business. That’s an exciting time for us and our team is well prepared. We have a great management team there and we're excited about that process.

Fortitude Re, I think from a distinction standpoint, as we said, it's a global business. The liability base is a liability base that we understand well and that in fact, because it was originally a runoff portfolio, we're not writing new policies and therefore, in our view, taking on the risk of writing new policies. We're able to build the company through acquisitions, through acquisitions that we get to diligence well and know exactly what we're buying. And as a result, we're excited about the prospects to grow Fortitude Re. And I think that will only further what is a really attractive permanent capital base for us, but also a really competitive company in its industry. So we're excited about Fortitude Re.

Mike Cyprys: Great. And we're out of time, unfortunately, Glenn, but thank you so much for joining us today.

Glenn Youngkin: Mike, thank you and stay well please.

Mike Cyprys: Great. And everyone, please join us for our next session at the conference starting shortly at 11:00 a.m. Thank you.

Glenn Youngkin: Take care.