Flatt: Oaktree should excel even more with Brookfield behind it

Relevance at every point in the cycle

In buying Oaktree and capturing its credit business, Brookfield now has capital to serve its clients at all times, its chief executive Bruce Flatt tells Jonathan Brasse

Oaktree's co-founder Howard Marks insists his firm's $4.7 billion sale of a 62 percent stake to Toronto-based asset management giant Brookfield is "not a timing thing" in the context of him calling the top of the alternatives market cycle. On the other hand, speak to Bruce Flatt, Brookfield's chief executive, and you'll hear that timing does seem to play a part.

"Our view is that this is a great firm that can thrive in any environment," he tells *PERE*. "Despite that, obviously when stress in credit is robust, they excel more." With the excess equity now sloshing around most private investment markets, there is lack of such distress to be located; Oaktree admitted as much on recent earnings calls. On one call in February, Marks acknowledged how he was "starting to salivate" back in December amid volatile equity markets, a partial US government shutdown and escalating tariff fights between China and the US, only to witness markets rebound and no escalation in distressed deals.

Consequently, with many markets bobbing along the top of their cycles, Oaktree has found hitting targets challenging. For instance, its distressed debt strategy recorded a composite gross return of 10 percent last year – still positive, but down from 18 percent in 2017, according to previous *PERE* coverage. "There are points in time when things can get done and points where they can't," says Flatt. "At this point in time, it was opportune that the parties could think about a deal."

"We're not fundraising for a big fund right now, but they're in the market. I think we can be helpful to them because many of our clients are looking to other strategies. To the extent we can coordinate activities, we will do so"
Bruce Flatt

"Our view is we should prepare for the future," he adds. "At this point in the cycle, having Oaktree's business and Brookfield's muscle behind it will, I think, see us prepared for when the time comes in the future for their franchise to excel. They would excel anyway, but with our capacity behind them, they should excel even more and that will be good for all of us."

Whether Brookfield acquired Oaktree at an opportunistic time is debatable, particularly when you observe the Oaktree share price, which was $45 at its floatation in April 2012 and a dollar higher at the announcement of Brookfield's takeover last month – although it added $5 on the news. While Marks says: "I think Oaktree and public ownership was not a perfect fit," Flatt says Oaktree's shareholders will not suffer for that. Beyond the approximately 12 percent premium Brookfield is paying to acquire Oaktree, by paying for the deal in cash or higher valued Brookfield stock, they will have the chance to "come along for the ride," he says. "They're not getting $49 a share, but $50 and cents as [Brookfield's stock] trades today."

When asked about absorbing a company which is not a good public market fit into one which evidently has been – Brookfield stock today trades at more than five times the value a decade ago – Flatt opines: "Our firm is close to a $50 billion equity business and Oaktree's market cap is approximately $6 billion. It was an illiquid security focused on one business which it was very good at. Maybe it's the wrong time in the market for that. Our business, on the other hand, is very liquid, very broad, very global and multi-product. Therefore, it is a totally different security. Not better or worse, just different."

Talk of share characteristics leads us to visit the question often asked of listed asset managers: was this deal conducted more for shareholders or fund investors? One senior executive at one of Brookfield's closest rivals tells *PERE* it is imperative that managers diversify their revenue sources to ensure their shares are durable: "I think you'll see more of that type of consolidation of different alternatives firms led by the other large, publicly-listed managers," he says. "Having a diversified fee stream with multiple different funds that can play the different cycles occurring in the various strategies should make profits less lumpy and more robust."

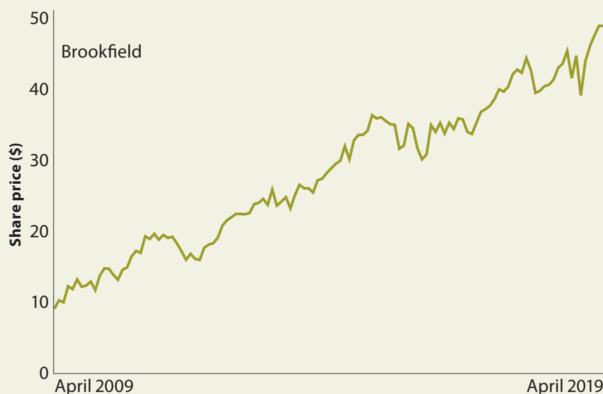
Flatt responds: "The franchise and all our people are dedicated to one simple thing: serving investors and making money for them. To the extent we make money for them, they pay us a small amount." The firm generated a gross annual run rate of fees plus carry of $3 billion from $138 billion of fee-earning capital, according to its latest annual review. Flatt says no shareholder ever asks about where Brookfield's priorities reside. "Over 25 years, our stock investors have earned a 17 percent compound return so, no, none of them ask that question. When we do this over a long period of time, people tend to trust the things we do."

Cyclical resilience is the goal

To most outsiders, a credit strategy was the missing piece in an otherwise complete alternatives market offering, albeit one with a dominant hard assets piece. With the acquisition of

A tale of two shares

While Brookfield's public performance has seen its valuation increase fivefold in the last decade, since Oaktree went public in 2012, its stock has stayed flat



Source: *Yahoo! Finance*

Oaktree, credit becomes Brookfield's second biggest strategy – somewhat lagging behind its $188 billion real estate business, but ahead of its $61 billion infrastructure business and way ahead of its $42 billion private equity platform. So, with the addition of $66.5 billion in credit assets, does Flatt consider the firm to be cyclically resilient? Flatt says this is the aim. "Our goal is to ensure we have capital to serve our clients at every point in the economic cycle."

He caveats: "We never set goals on proportions. The numbers you see are a summation of the smart strategies in each sector. But if I had to guess, of course I'd say credit will be larger for us in the future than it is today because we're adding Oaktree and we hope they'll grow. Beyond that: on balance, our private equity business will continue to grow versus other strategies. As they face off against each other, we'll have to see how the numbers shake out."

Arguably, the asset class least impacted is real estate, as Flatt explains that Oaktree's $9.5 billion property platform has a wholly different strategy, even if both carry opportunistic risk-return profiles. According to a quarterly performance review published by US pension plan Contra Costa County Employees' Retirement Association, Oaktree's $2.92 billion Real Estate Opportunity Fund VII, which closed in 2016, was generating a net IRR of 39.6 percent as of December 31. Meanwhile, Brookfield's Strategic Real Estate Partners II fund, which attracted three times the equity the same year, was generating IRRs of 13 percent as of year-end.

Just as Oaktree's real estate head John Brady used a heavy- and middle-weight boxer analogy to describe how its strategy was not competitive with Brookfield's flagship fund series, Flatt likewise adopts an analogy, comparing Brookfield's funds to high-end, but widely popular Porsche sports cars and Oaktree's real estate business to Lamborghinis, also high-end, but niche in nature. Flatt says: "Theirs is not a bank and branch strategy like ours; theirs are boutique strategies, very focused."

As of last December, Oaktree Fund VII was 83 percent invested and an eighth offering is slated for this year. Flatt thinks Brookfield can assist Oaktree with its fundraisings, particularly when its own funds are closed – such as its equity real estate fund that closed on a firm-record $15 billion earlier this year. "We're not fundraising for a big fund right now so I think we can be helpful to them because many of our clients are looking to other strategies." Whether investors will in the future be visited by shared business development or marketing functions remains "to be determined," Flatt says. "To the extent we can coordinate activities, we will do so."

Consolidating its status

Subject to regulatory hurdles being cleared by the third quarter of the year, Brookfield consolidates its status as one of the world's alternative investment giants. That is something Flatt says is required by the world's largest institutional investors given the growth of their asset bases – and, within these, the growth of their allocations to alternatives too. "It is because of that we've increased the size of our funds."

"The scale of money keeps piling up in these funds. Some are now $100 billion, $200 billion, even up to $1 trillion. An investor, in all prudency, can be no more than 10 percent of a fund," Flatt explains. "If they need to put $500 million-$1 billion with a manager, they need a $5 billion, $10 billion or $15 billion fund or it's not relevant to them." Furthermore, Flatt says investors increasingly want to back the same brands

across strategies, finding comfort in familiarity. "If you've known a manager, have grown to trust them and they've delivered returns, then you'll do something with them repeatedly, and maybe adjacent to what you've done with them before. You'd do that over rolling the dice with someone else to see if they're any good."

Certainly, the private fundraising market data supports Flatt's assertion, with fewer closings across the sectors but increasingly larger funds as investors consolidate their manager relationships. According to *PEI* data, private real estate saw 166 closed-end funds hold final closings last year, 35 percent less than the 257 to close a year earlier. In private equity, 556 funds closed last year, 29 percent less than the year before; 60 infrastructure funds closed, 27 percent lower; and in private debt, 166 funds closed, 31 percent less than the year before. All four asset classes fell year-on-year since 2016 and the trendlines are continuing in 2019.

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Against this backdrop, Brookfield's challenge to New York-based Blackstone's dominance has polarized from a real estate rivalry to a cross-asset class contest. For instance, in May, the firm stole second on *PERE*'s signature top 50 private real estate managers ranking by capital raised over the last five years. The $29 billion it collected in that timeframe still trails Blackstone's tally of $49.8 billion, but was meaningfully ahead of third-place Starwood Capital's $21 billion haul, leading market observers to describe private real estate's opportunity fund universe as now having a leading two firms.

In buying Oaktree, similar commentary is emerging now about Brookfield's challenge to Blackstone on the broader private markets playing field, something both firms suggest is more hyped than substantiated. Initial media stated that Brookfield's acquisition of Oaktree meant it had $475 billion of assets under management versus $472 billion at Blackstone, a comparison both firms are quick to dispel as not like-for-like given that they measure their businesses differently.

"The numbers are actually a lot different," one Blackstone source says, adding that if it measured its assets as Brookfield does – including company debt – the reality would be $731 billion of assets under management, 54 percent bigger than a Brookfield-Oaktree tie-up. However, Brookfield operates a different business model than other private equity firms. For starters, the manager has $225 billion of balance sheet capital, which includes four listed partnerships.

Flatt highlights the importance of measuring the value of Brookfield's equity and also its funding model: "We think it's important to look at market capitalizations and the earnings out of alternatives versus AUM. People often focus on it, but I don't think AUM in-and-of-itself is a measure to focus on."

Market perceptions will largely be out of his control, and Flatt concedes as much. "You guys figure out the commentary," he says. In his control, on the other hand, are the moves Brookfield makes to grow its business. They have been largely organic under his tenure, but, with circumstances just ripe – opportunistic or not – he has seen reason for the firm to make its, and the private markets', most significant corporate outlay for years. ◻

Masses for the few

While the number of funds to have final closings have fallen year-on-year across asset classes, the average size of those to close has grown