Ares Energy Funds Underperformance Exacerbated by Failed Kayne Anderson Merger

Merger collapse costs Ares amidst slow EIF V fundraising, raising questions about the strategic focus of the firm’s energy investments.

**KEY POINTS**

- Ares EIF funds III and IV have generated net returns since inception of 5.9% and 12.4%, respectively, well below Ares’ own target of 15-17%.
- The collapse of the proposed merger with Kayne Anderson left Ares with $51.3 million in transaction-related expenses and an obligation to invest $150 million in Kayne Energy Funds.
- Although EIF V began fundraising at the outset of 2015, no capital was raised until the fourth quarter, after the Kayne merger collapse. Fundraising for EIF V has moved slower than four comparable energy funds raised over a similar period.

In May 2015 UNITE HERE examined Ares Management’s track record in the energy sector as the company launched its newest fund, Energy Investors Fund V. We noted that with its acquisition of Energy Investors Funds (EIF), Ares inherited a history of underperformance, as the last three of the four EIF funds performed substantially below peers and benchmarks.¹

One year later, the EIF funds continue to underperform. Ares’ collapsed merger with energy-focused manager Kayne Anderson raises further questions about the strategic focus of Ares’ energy investments.

**Persistent Underperformance**

In a June 2016 investor presentation, Ares reported net returns since inception for EIF III and IV of 5.9% and 12.4%, respectively² – well below Ares’ own target of 15-17%.³ At year-end 2015, prior to the latest market downturn, Ares reported EIF III and IV net returns of 6.3% and 13.7%, respectively.⁴ This past December a Morningstar analyst wrote that “the additions of

**Targeted & Actual Net Returns for Ares Energy Funds as of June 2016**

<table>
<thead>
<tr>
<th>Ares Target</th>
<th>15-17%</th>
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<tbody>
<tr>
<td>EIF IV</td>
<td>12.4%</td>
</tr>
<tr>
<td>EIF III</td>
<td>5.9%</td>
</tr>
</tbody>
</table>

Sources: June 2016 Investor Presentation² and 2015 Annual Report³
AREA and Energy Investor Funds added about $10 billion in real estate and energy AUM to Ares, but the profitability contributions to Ares have been limited at this point,” adding that “they are not particularly exceptional versus similar acquisitions made by peers.”

Problems Exacerbated by Failed Merger

Ares’ proposed merger with alternative asset manager Kayne Anderson was intended to boost Ares’ performance in the energy sector.

During the July 2015 conference call announcing the merger, Ares CEO Tony Ressler emphasized the addition of Kayne’s energy “expertise,” its relationship network “with high net worth clients,” and management fee growth through more long-term, locked-up capital. Ares reportedly said that the deal would significantly increase [Ares’] fee-related earnings. Fitch Ratings saw the merger’s “potential benefits” as providing Ares with “a broader investment base, with cross-sell opportunities; enhanced predictability of fees over time, given the locked-in nature of the majority of investor capital; and upside potential to the firm’s FEBITDA margins, given increased economies of scale and a lower blended compensation ratio.”

The merger was terminated in October when, according to the Financial Times, “the buyout groups disagreed on how to combine their operations amid the oil prices crash.” In the preceding year Kayne’s energy funds lost more than 40% of their value, with much of that loss coming since the deal was announced in July. The declining value of Kayne’s funds “reduced or eliminated the expected accretion from the deal,” said a SunTrust analyst to the Financial Times.

Costs of the Merger’s Collapse

The merger’s cancellation generated significant expenses for Ares and led Fitch to report in November 2015 that Ares’ “positive rating momentum may be slowed.” Fitch also characterized the termination as “highly unexpected” considering that to help finance the deal Ares had raised $325 million of debt capital, which upon the merger’s collapse was redeemed at 101% of the principal amount plus accrued and unpaid interest.

Ares incurred a total of $51.3 million in expenses related to the failed merger: $30 million to reimburse Kayne Anderson for transaction-related costs, and $21.3 million in other expenses including $3.3 million associated with the redemption of the notes. Such costs “do not create long-term value for the firm,” wrote Fitch.

The ratings report also cautioned about Ares’ growing debt and energy exposure as oil and gas prices tumbled.
“Ares’ liquidity profile is sound, but weaker than many higher-rated peers… The use of leverage to fund Kayne commitments along with pre-existing co-investment commitments, at current leverage levels, is viewed unfavorably, as the use of proceeds generate more volatile investment income, not FEBITDA. Fitch is also mindful of the increased energy exposure on the balance sheet.” — November 2015 Fitch Ratings Report

In connection with the merger cancellation, Ares agreed to invest $150 million in Kayne funds: $50 million in Kayne Anderson Energy Fund VII; $50 million in Kayne Anderson Private Energy Income Fund; and $50 million either in a separately managed account that will invest in MLP marketable securities and midstream energy companies or in one or more commingled hedge funds managed by Kayne. Of the total $150 million commitment, half was paid by Ares CEO Tony Ressler ($60 million) and Director John Kissick ($15 million).

Ares had invested $32.6 million of the remaining $75 million obligation as of March 31, 2016. Ares has not reported which subsidiaries made these investments, nor what impact these investments may have on Ares limited partners.

“The termination of the merger raises questions about Ares’ strategic planning,” according to Fitch, which added that it had heightened its focus on “the firm’s ability to produce positive operating leverage in order to yield margin expansion.”

**EIF V Fundraising Undermined?**

The effort spent on the failed merger may have distracted Ares from EIF V fundraising and from making timely energy investments.

Ares fifth power private equity fund, EIF V, was incorporated in January, 2015, and aims to raise $2-3 billion to invest in power generation, midstream energy infrastructure and transmission.

Ares reported in its 2015 earnings presentation that all of the $371 million in new equity commitments in EIF V were raised in the fourth quarter of 2015 – at least 11 months after EIF V was incorporated. (In the first quarter of 2016, Ares disclosed roughly $3 billion in new commitments to other funds, including more than $2.1 billion to another private equity fund, ACOF V; but reported no additional commitments to EIF V.) This means that EIF V’s fundraising proceeded at a rate of roughly $34 million per month since inception – slower than comparable funds raised over a similar period (see chart).
Fundraising Pace of EIF V and Comparable Energy Funds

<table>
<thead>
<tr>
<th>Fund</th>
<th>Date Incorporated</th>
<th>Status</th>
<th>Target Size ($mn)</th>
<th>Total Raised ($mn)</th>
<th>Date Closed or Most Recent Report</th>
<th>Mos.</th>
<th>Pace per Mo. ($mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ares Energy Investors Fund V</td>
<td>1/28/15</td>
<td>Raising</td>
<td>2-3,000</td>
<td>371</td>
<td>12/31/15*</td>
<td>11</td>
<td>33.8</td>
</tr>
<tr>
<td>Kayne Anderson Energy Fund VII</td>
<td>2/20/15</td>
<td>Raising</td>
<td>1,600</td>
<td>700</td>
<td>12/17/15</td>
<td>10</td>
<td>70.0</td>
</tr>
<tr>
<td>Apollo Natural Resources Fund II</td>
<td>12/10/14</td>
<td>Closed</td>
<td>3,000</td>
<td>1,953</td>
<td>4/1/16</td>
<td>16</td>
<td>122.1</td>
</tr>
<tr>
<td>EnerVest Energy Institutional Fund XIV</td>
<td>12/10/14</td>
<td>Closed</td>
<td>3,000</td>
<td>2,400</td>
<td>11/30/15</td>
<td>12</td>
<td>200.0</td>
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<tr>
<td>EnCap Energy Capital Fund X</td>
<td>12/12/14</td>
<td>Closed</td>
<td>5,000</td>
<td>6,500</td>
<td>4/30/15</td>
<td>5</td>
<td>1,300.0</td>
</tr>
</tbody>
</table>

* End of EIF V timeframe is the end of 4th quarter in which all of the capital was reportedly raised.

Questions for Investors

- Why did Ares cancel the proposed merger with Kayne Anderson?
- Did Ares’ shareholders and/or limited partners bear any costs from the $51.3 million in transaction expenses or the $325 million note redemption?
- Given the anticipated benefits of the merger to Ares energy portfolio, how will its collapse impact the performance of Ares energy and infrastructure investments?
- Which Ares entities are investing in Kayne Funds as part of the merger termination agreement and what are the terms of those investments?
- Why are Ares affiliates and executives making investments with a third-party fund manager when EIF V still hasn’t hit its fundraising target?


3 Ares Management 2015 annual report https://www.sec.gov/Archives/edgar/data/1176948/000155837016003647/ares-20151231x10k.htm

4 Ares Management 2015 annual report https://www.sec.gov/Archives/edgar/data/1176948/000155837016003647/ares-20151231x10k.htm


16 Wall Street Journal stock quotes indicate that between the deal’s announcement in July and the Fitch report in November, the price of crude oil and natural gas had declined about 25% and 20%, respectively.


19 Ares Management 2015 annual report https://www.sec.gov/Archives/edgar/data/1176948/000155837016003647/ares-20151231x10k.htm
20 Ares Management 1Q 2016 report https://www.sec.gov/Archives/edgar/data/1176948/000155837016005746/ares-20160331x10q.htm


22 Delaware Corporate Registry: https://icis.corp.delaware.gov/Ecorp/EntitySearch/NameSearch.aspx


