Blackstone

The Connection

Joe Zidle | Chief Investment Strategist, Private Wealth Solutions

Irony, Optimism, and AI

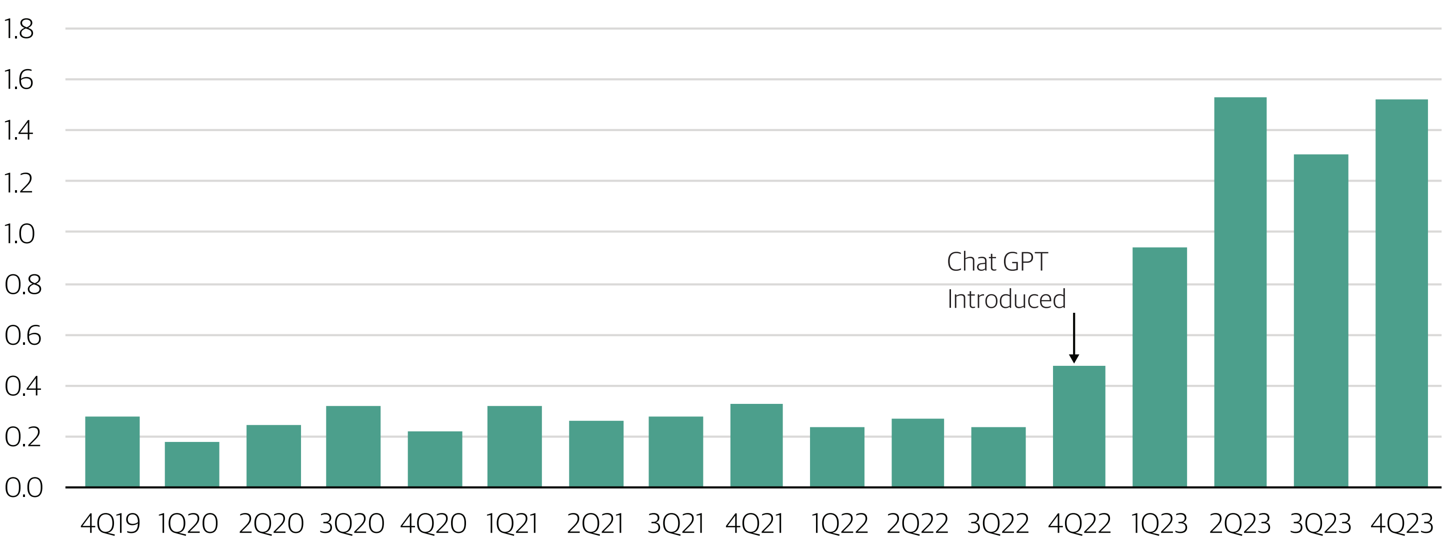
"I've seen the future, and it works" was one of the more memorable turns of phrase from renowned American journalist Lincoln Steffens. Unfortunately, it dates to 1919, when Steffens had just returned from Communist Russia. His assertion, though eloquently phrased, starkly contrasted with the harsh realities of a political and economic system where little worked as envisioned.

Today, as we explore the trends unfolding in artificial intelligence (AI), I find that Steffens' words take on new meaning in that they blend irony and optimism. There's little doubt that AI has the potential to drive productivity and growth throughout the economy in ways equal to or greater than the 1990s technology boom and other tech revolutions before that one. But an irony of new technology is that no matter how disruptive it is, traditional economic forces determine its trajectory and economic impact. In my view, understanding this dynamic is key to skillful asset allocation in the next cycle.

Optimistic About the Future of AI

"Is AI in a bubble?" That's one of the questions we're asked the most these days. No doubt, the AI fervor has propelled the Magnificent Seven to dizzying heights. It's not just these tech giants, though. Companies across sectors have been quick to highlight AI in their strategic discussions. AI is now discussed at least once on every S&P 500 earnings call. Some companies have even overstated their AI capabilities, leading the Securities Exchange Commission (SEC) to caution against AI washing and urge transparency about actual AI utilization.

Figure 1: Aritifical Intelligence Mentions Per S&P Earnings Call



Source: Bloomberg, as of 12/31/2023.

We're optimistic about the potential for AI-driven growth and productivity enhancements in the next business cycle and beyond. But it isn't unusual for investors in public markets to get ahead of themselves with new technologies. There's often a lag between market speculation and the tangible realization of the technological advancements. The biggest benefits to growth from the 90's tech boom arrived well after their stock prices fell.

The bubble question has merit, but in my view the better question about AI right now is, "What does it mean for the real economy over the long term?" For example, and likely to the relief of many, technological advancements do not necessarily come at the cost of employment. Rather, new technologies often lead to the creation of jobs that previously didn't exist. Approximately 85% of employment growth in the last 80 years can be attributed to new technologies.[1] While the automobile industry rendered horse and buggy drivers obsolete and sent many a horse to the glue factory, it simultaneously generated new opportunities in manufacturing, sales, and repair services. Today, nearly 60% of workers are engaged in jobs that did not exist in 1940.[2]

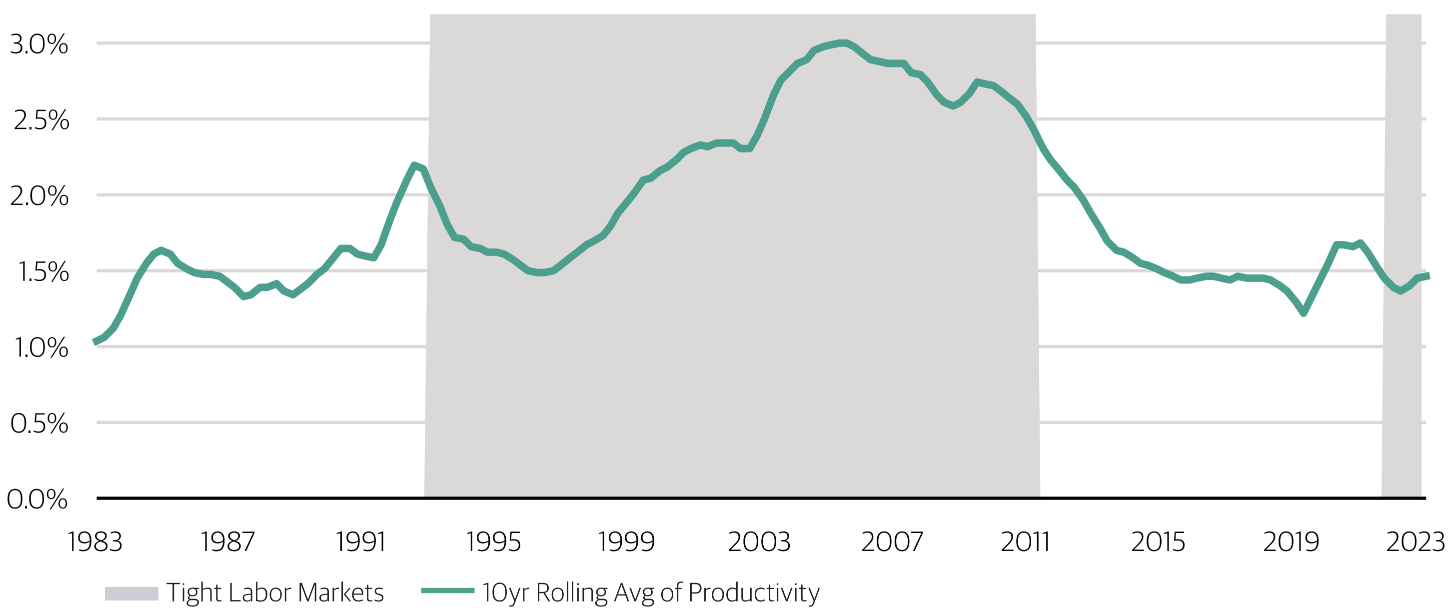
AI's an Additive to Economic Forces Already Firing

As disruptive as AI seems, the traditional dynamics underpinning productivity growth are already present in the economy, and they're unrelated to AI. We know from the 1990s, the last significant period of productivity growth, that tight labor markets and fixed investment work hand in hand. In our inaugural Connection, we wrote about how we expect the US to enter a virtuous cycle where tight labor markets spur investment, which in turn increases productivity while expanding the economy and keeping inflation in check. These seeds were planted pre-COVID when the US started running out of cheap labor. In 2018, the unemployment rate fell below 4% from the post-Global Financial Crisis (GFC) high of nearly 10% while wage pressure rose to a 10-year high.[3]

Beginning in 2018, without a surplus of inexpensive labor, companies started investing for growth. Private fixed investment as a share of GDP recovered from post-GFC lows, and that initial wave is helping to drive productivity growth today. We see AI's contribution to productivity further out on the horizon and being an additive factor to the traditional drivers present today.

Figure 2: US Labor Productivity

(rolling 10-year average of annual percent change)



Source: US Bureau of Economic Analysis and US Bureau of Labor Statistics, as of 12/31/2023. Tight labor markets defined as period when the rolling 10-year average of the prime age employment to population ratio is 78 or above.

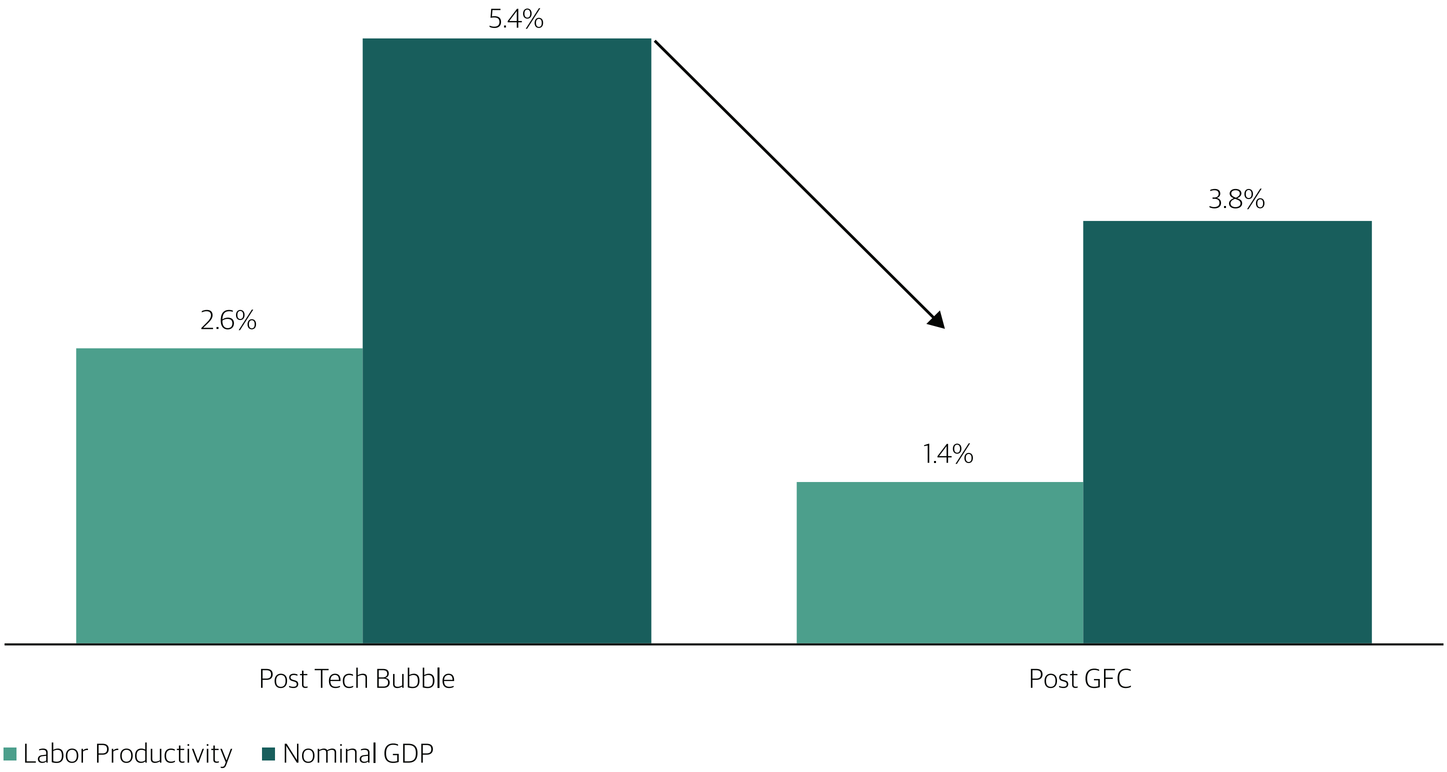
1. The Labor Market Impacts of Technological Change: From Unbridled Enthusiasm to Qualified Optimism to Vast Uncertainty (David Autor, 2022).
2. The Labor Market Impacts of Technological Change: From Unbridled Enthusiasm to Qualified Optimism to Vast Uncertainty (David Autor, 2022).
3. US Bureau of Labor Statistics. Wages and salaries data refers to year-over-year increase in Employment Cost Index.

Productivity can be hard to measure, especially when it's associated with technology. It was the famous economist Robert Solow who said in 1987 that "You can see the computer age everywhere but in the productivity." And when you consider that Candy Crush has been downloaded more times than Microsoft Office, we should view the data with some skepticism.[4]

But at the most basic level, productivity is a measure of efficiency of the inputs (capital, labor and technology) used to produce outputs (goods and services). After a wave of investment in the 90s, productivity boomed and pushed economic growth higher. Contrast that with the post-GFC environment when the economy was saddled with excess capacity and cheap labor and investment fell.

Figure 3: 10-Year Average Labor Productivity and Nominal GDP

(% year-over-year, seasonally adjusted)



Source: Bloomberg, US Bureau of Economic Analysis, as of 12/31/2023. Labor productivity represents non-farm business sector labor productivity. Post-tech bubble is from 3/31/2002 to 9/30/2007. Post-GFC is from 9/30/2009 to 9/30/2019.

The next innovation wave, the widespread adoption of AI, is still out on the horizon. To get there requires large amounts of capital and expertise. Take the demand for data centers as an example. Currently, 98% of data centers are under lease, and to build one takes 18–24 months on average. Utility connections take additional time, with an average wait time for permitting of more than 3 years. It's also expensive; on average it costs upwards of $500M to construct a single data center.[5]

Demand for AI-related expertise is also booming. Engineers skilled in large language models command a 44% premium in median annual compensation compared to non-AI skilled software engineers.[6] As Global Head of Data Science Matt Katz discusses in the Guest Column, a recent survey of approximately 200 Blackstone portfolio company executives found that greater than 50% said their primary challenges were sourcing skilled talent and understanding AI's potential benefits for their business.

4. Google Play, Apple App Store. Cumulative downloads as of April 2024.
5. CBRE, datacenterHawk, and Green Street. Vacancy rate data are annual as of 12/31/2023. Permitting wait times are as of December 12, 2023. Construction costs published April 2024 and represents data from both the US and Europe. Construction estimates are a combination of 50% colocation / 50% hyperscale.
6. Levels.fyi. Based on median total annual compensation.

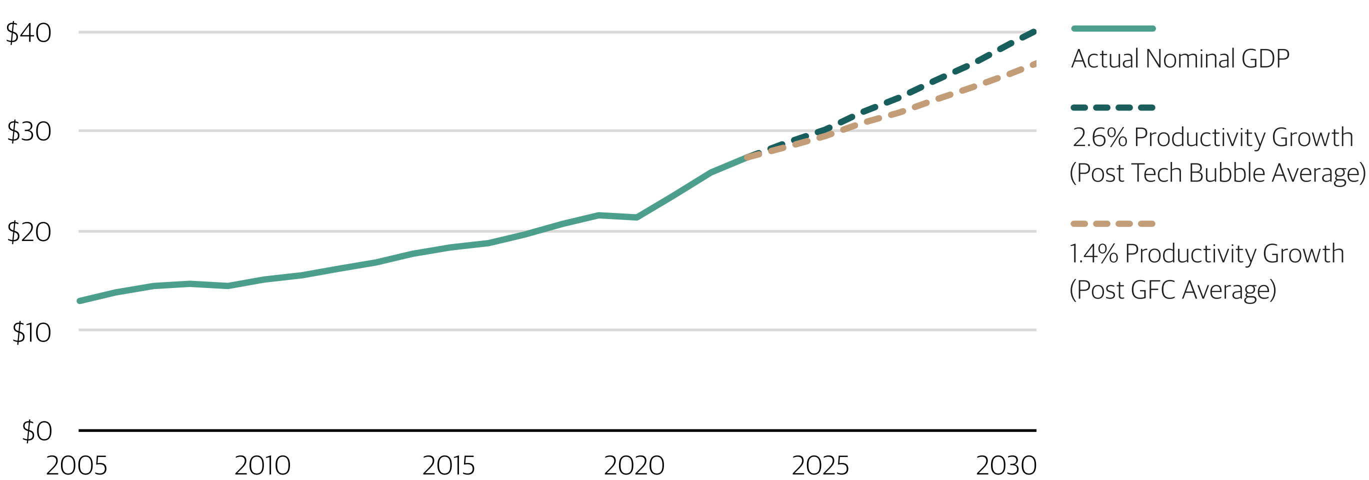
Prep for a New Set of Drivers in the Next Cycle

In our view, successfully deploying AI technology can be fundamental to optimization, allowing companies to deleverage more and return capital to investors faster with the additional turns of margin improvement. We believe the scale and expertise that it takes to build a competitive advantage with AI reinforce the theme of alpha over beta with skilled managers.

The largest technology companies today are more profitable and have higher margins than prior tech booms, but we highlight that it may be established companies in mature industries that have the potential to benefit the most from AI at the application level. "Old economy" stocks have a profit margin of 10% compared to the Information Technology sector at 27%.[7] If these old economy firms can increase margins from 10% to 12% by utilizing AI, that is a 20% improvement in profitability compared to already highly profitable tech companies.[8]

More broadly, the current economic conditions lay the foundation for a future cycle of positive growth. Productivity can provide an incremental boost to GDP with the same number of inputs leading to higher revenues for firms and higher real wages for employees. We illustrate an example of the possible value-add of productivity and its impact to future economic growth by comparing the long-term average and post-GFC productivity rates.

Figure 4: Projected US Nominal GDP Based on Productivity Growth Rates



Source: Blackstone Investment Strategy Calculations, US Bureau of Labor Statistics and US Bureau of Economic Analysis, as of 12/31/2023. Future nominal GDP (beginning in 2024) is comprised of 3 assumptions: (1) a constant labor force growth of 0.40% per annum using the long-term growth assumptions from the Federal Reserve,[9] constant inflation of 2.1% per annum using the spread between a long-term inflation assumption (2.5%), (2) the average spread between the GDP inflator and headline CPI from 1990-2023 (0.40%), and (3) either a post tech bubble average of productivity growth or post-GFC average of productivity growth. Post tech bubble average is from 3/31/2002 to 9/30/2007. Post-GFC average is from 9/30/2009 to 9/30/2019.

A virtuous cycle with stronger economic growth is one more reason to believe that this next cycle will look a lot different than the last and compel advisors to adapt portfolios to a different set of performance drivers.

7. Bloomberg, Standard & Poor's as of 12/31/2023. "Old economy" defined as financials, utilities, energy, industrials, materials, health care and consumer staples sectors.
8. Bloomberg, Standard & Poor's as of 12/31/2023. "Old economy" defined as financials, utilities, energy, industrials, materials, health care and consumer staples sectors.
9. Federal Reserve, *Labor Force and Macroeconomic Projections Overview and Highlights 2022-32.*

Accelerating Value with AI

Matt Katz
Senior Managing Director, Global Head of Data Science

The private equity landscape has undergone seismic shifts in Blackstone's almost four-decade history. Our objective has always been the same, though: to deliver for our investors. What has evolved over time is how we deliver. Today, we see AI as a principle means of adding value to our companies and helping them accelerate growth.

The Analytics Imperative

We hear consistently from the leadership teams at our companies that while they understand the imperative to invest in more advanced technologies, knowing where to begin is a real challenge. At our CEO Conference in early March, where we convened over 200 CEOs from the Blackstone ecosystem, almost 60% told us that access to talent and understanding the highest value applications of AI for their business were the primary barriers holding them back.

As investors, we believe the capabilities that we have built around data science and AI give us a meaningful advantage, from driving real value in our businesses to seeking returns for our limited partners. Our 50-plus data scientists are deeply integrated into our investing process for our private market equity-oriented strategies, and they have worked directly with leadership at over 70 of our companies to help deploy advanced analytics and AI.

The scale of our platform as the world's largest alternative asset manager provides further benefits. It allows us to derive insights from over 230 portfolio companies and over 12,500 real estate assets, and to develop technologies and applications that we can deploy across our portfolio. Our model's been successful, with applications like pricing, opportunity prioritization, labor staffing, and generative AI-based content creation and customer engagement driving meaningful impact. We aim to effectively leverage the central infrastructure and application layers to accelerate the deployment of these technologies into our companies, driving faster time-to-value and meaningfully de-risking the investments.

Our Data Science and AI Capabilities in Action

Our strategy in helping our companies drive value creation through AI considers a dual-pronged approach. On the one hand, we are seeking to broadly enable all our companies by providing the tools, resources, and preferred partnerships they need to be successful. This includes access to a 300+ strong community of advanced analytics leaders, team members, and C-level executives across our companies. This community is powered by thought leadership, successful case studies of applied AI and data science, and opportunities to connect with peers.

We also engage on a more hands-on basis with some of our larger controlled portfolio companies where we help define their AI strategy, build and deploy models, and hire the leadership they need to take their initiatives forward. Further, we selectively deploy data scientists from our team to help companies build capabilities on the ground via our secondment program, which has been a central feature of many of our most impactful engagements.

But AI and data science aren't just tools that we apply to strengthen our companies; they're often a part of the way we determine which companies to invest in. Our decision-making process frequently includes using more robust quantitative techniques to underwrite the financial and operating performance of potential targets and providing a qualitative assessment of a target's claims about their AI capabilities. We recently evaluated a company that made significant claims about the data moat that they built being hard for competitors to replicate. In just a few hours, we were able to replicate the performance of their models by rapidly prototyping a competitive technology using the latest large language models. The insights we gained significantly changed our perception of the disruption risk for the business and contributed to our decision to pass on the deal.

We're also proactively pursuing companies that we view as poised to directly benefit from or central to enabling the AI megatrend. Investments like Vectra, which uses AI to interrupt cyberattacks in the cloud, exemplify the former, more direct approach; our investments in data centers, like QTS, exemplify the latter, more derivative approach. Our 2021 acquisition of QTS, the largest data center provider by leased megawatt in the US, was the largest transaction in data center history at the time.

Blackstone's AI Advantage

The scale and breadth of our impact is what energizes me about the AI opportunity at Blackstone. It positions us not only to make attractive investments and accelerate growth under our ownership, but also to gather more data, build better solutions, and attract better talent—advantages that we apply in a virtuous cycle as we seek to drive lasting value. I'm excited to continue supporting our CEOs on AI, and I look forward to the transformations we can unlock as these technologies evolve.

Manager Selection Is Key in Private Markets

Anders Nielsen | Managing Director, Private Wealth Solutions and **Brendan Conway** | Principal, Private Wealth Solutions

In the January issue of the Connection, we argued that the current uncertain macro environment is a good time to shift portfolios towards a higher strategic allocation to private assets. Each of the major private asset classes offers unique features which add arrows to an investor's quiver that are particularly valuable in uncertain times.

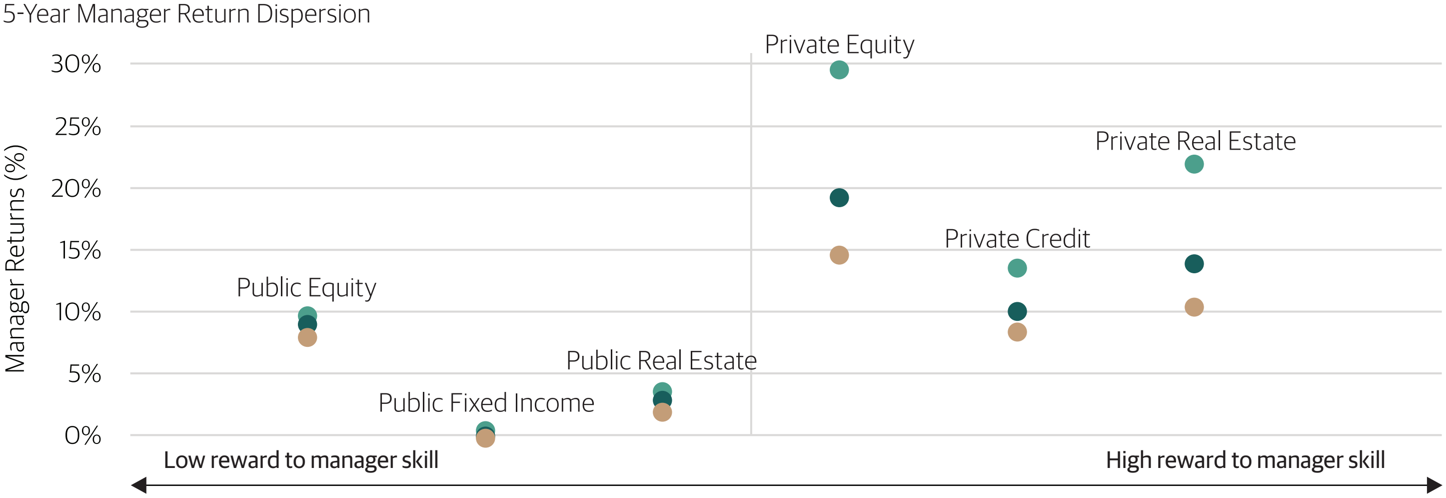
Private credit currently offers a high yield while being more senior in the capital structure than equities. Private equities have outperformed public equities over time, but importantly also around recessions. Private real estate has historically offered a degree of inflation protection. All three asset classes offer diversification to traditional portfolios, which is a scarcer commodity in the current environment.[10]

In this and future issues we plan to look into the key decisions that are integral to implement this shift. Here we highlight the importance of manager selection, which we believe matters much more in private markets than in public markets.

This is illustrated in Figure 5 below, which shows the range of outcomes across managers that investors have experienced over the last five years. The range is much wider for private assets than for public assets. The significant dispersion underscores that the rewards to effective manager selection are high in private markets. The gap between the first and fourth quartile ranges from more than 5 percentage points (pp) over the period for Private Credit to ~15pp for Private Equity, whereas in public equities and credit the range is just a few percentage points. To us, the wider performance gap represents the range of approaches and capabilities that private markets managers can bring to the table.

Figure 5: The Range of Outcomes Is Much Wider Across Private Managers Than for Public Managers

5-Year Manager Return Dispersion



	Public Equity	Public Fixed Income	Public Real Estate	Private Equity	Private Credit	Private Real Estate
Returns						
Top Quartile ●	9.7%	0.4%	3.6%	29.6%	13.6%	22.0%
Median ●	9.0%	0.0%	2.9%	19.3%	10.1%	14.0%
Bottom Quartile ●	8.0%	-0.2%	1.9%	14.6%	8.4%	10.5%

Source: Morningstar, returns are over a five-year period from 10/1/2018-9/31/2023 (Open-end funds): Public Equities (US Large Blend); Public Fixed Income (US Intermediate Core Bonds); Public Real Estate (US Real Estate). Preqin, returns are for 2018 vintages that have last reported between 9/30/2022-9/30/2023. (North America, Closed funds): Private Equity (Buyout), Private Credit (all Private Debt strategies); Private Real Estate (Co-invest, Core, Core+, Debt, Value Added, FoF). Investments in less liquid private market strategies are by nature risky and typically involve a high degree of leverage. The returns indicated above are long-term and represent well-known asset class indices and are not meant to be predictive of the performance of any particular fund, nor are they meant to suggest that all private funds result in positive returns or would avoid loss of principal.

10. Diversification does not ensure a profit or protect against loss in declining markets.

The key drivers of performance for private assets have evolved over time. As described by Matt Katz earlier, AI is becoming a powerful tool which private market managers can implement to help add value and drive growth in investments.

This applies beyond private equity. From a macro perspective we believe the next cycle will be different (see Joe Zidle's essay earlier in this edition) and see less expansion of valuation multiples for many assets than we have been used to due to a more volatile interest rate environment. This means that more of the investment outcome in general has to come from cash flows and cash flow growth. We believe managers' capacity to drive this type of growth will be a key determinant of future differentiation.

At Blackstone we look into this environment with optimism. We believe we have three key advantages:

Scale

Scale matters, in our view. With over 1 trillion dollars in assets under management, Blackstone invests across regions, industries and asset classes and therefore benefits from the knowledge, resources, and critical mass required to take advantage of opportunities on a global scale.

Track Record

The firm's performance is characterized by strong risk-adjusted returns across a broad and expanding range of asset classes and through all types of economic conditions for nearly four decades.

Value Creation

Blackstone further differentiates itself with a dedicated Portfolio Operations team. This group of functional experts is focused on partnering with portfolio companies in order to drive operational improvements using the firm's scale and expertise. The implementation of AI written by Matt Katz is one example of this work.

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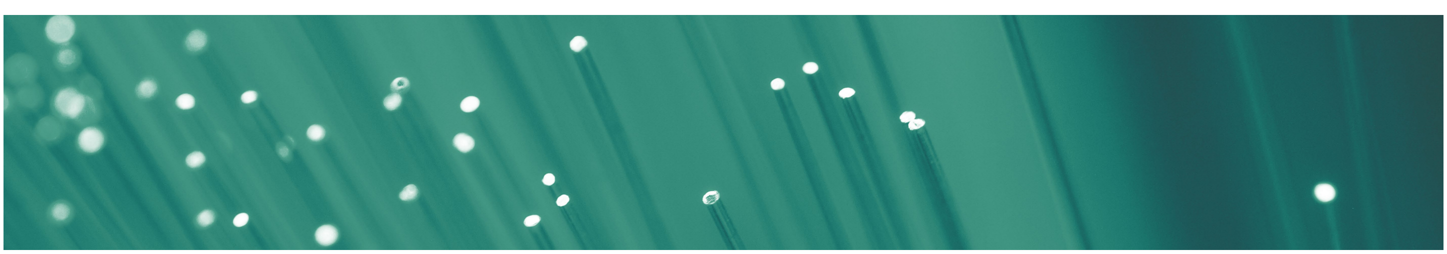
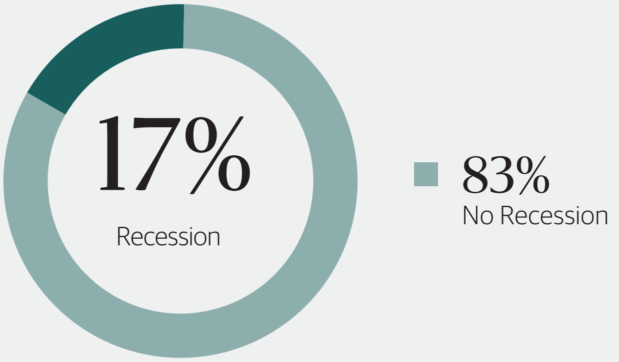


Through the Private Market Lens

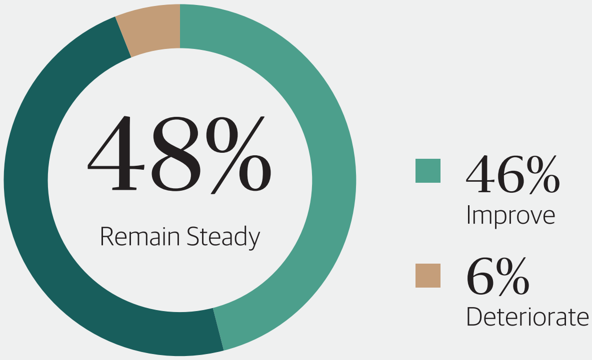
Blackstone's global portfolio spans more than 230 companies employing over 700,000 people. Each quarter, led by **Prakash Melwani, CIO of Corporate Private Equity**, we survey a sample of these companies' CEOs on the current business environment and what they see on the horizon. Explore a few key findings from our Q1 2024 survey of 83 Blackstone portfolio company CEOs (53 US CEOs).

CEOs don't see the economy tipping to a recession...

Only 17% of CEOs think there will be a recession in the next 12 months (US companies only).

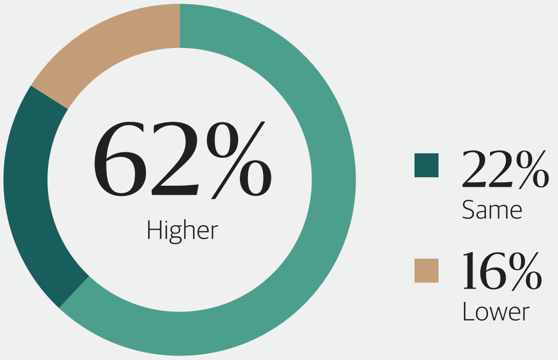


CEOs think that business conditions over the next six months will:

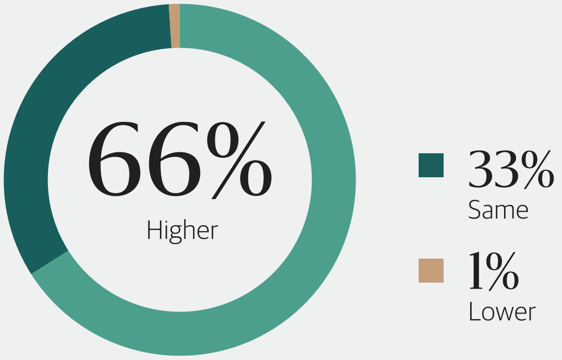


...and believe margins are still expanding

Do you expect operating margins in 2024 to be higher or lower than in 2023?

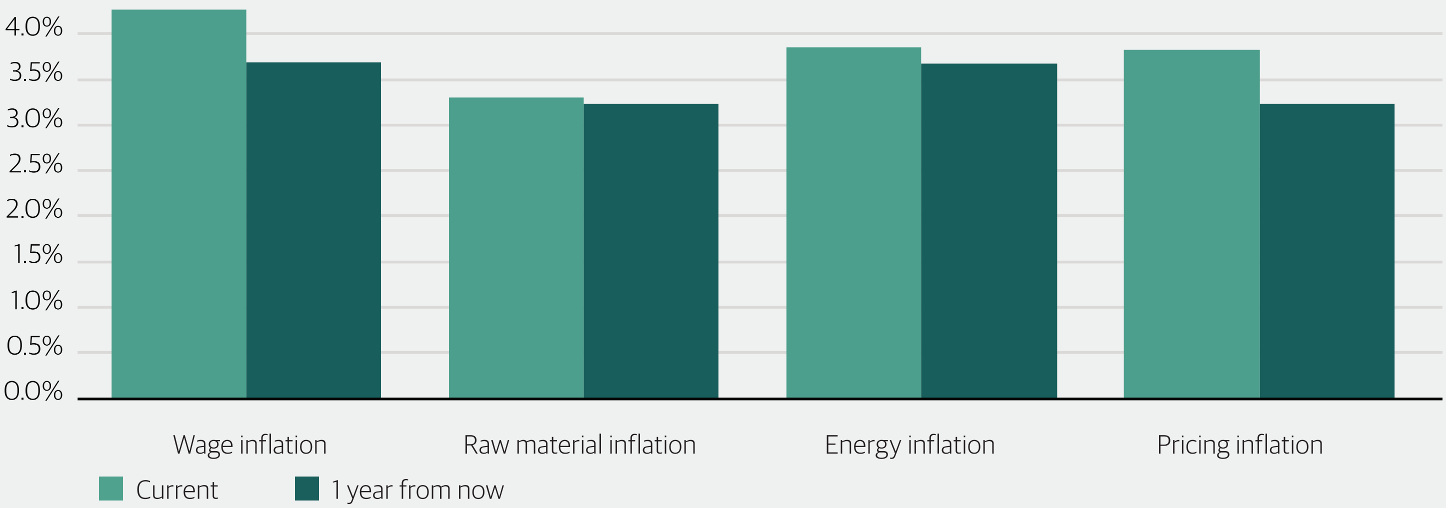


Do you expect operating margins in 2025 to be higher or lower than in 2024?



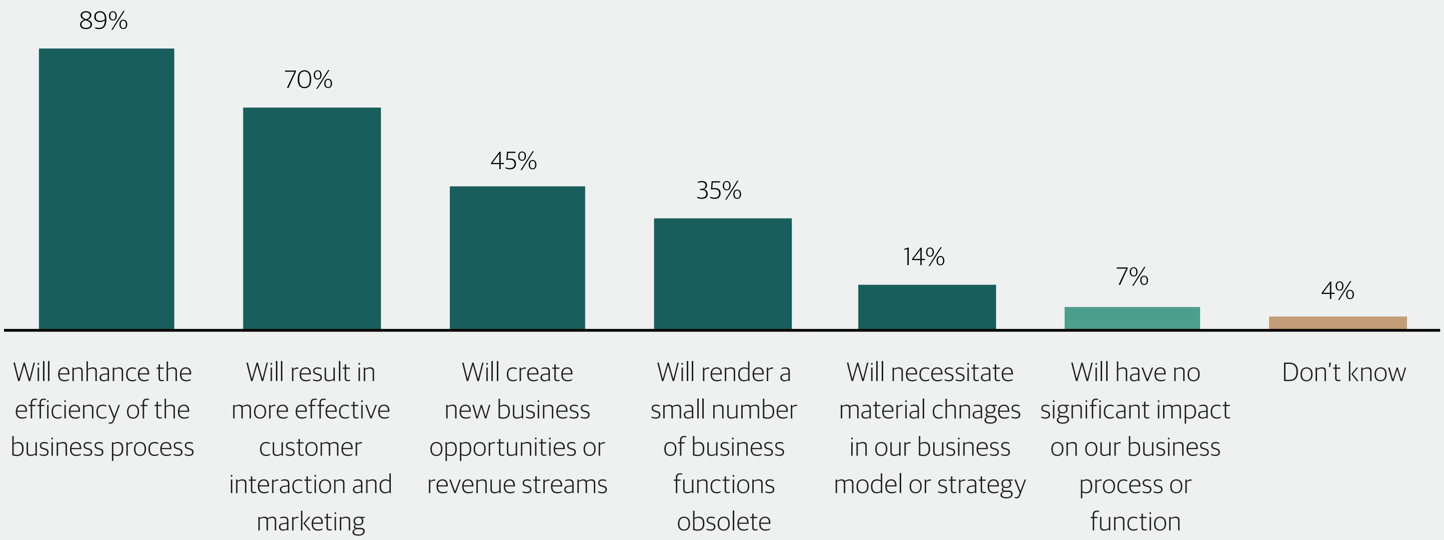
The Blackstone CEO survey referred to herein is a survey of a subset of portfolio company CEOs. For Q1 2024, the survey reflects responses from 83 Blackstone portfolio company CEOs (53 US CEOs) largely within Blackstone's private equity, real estate and credit businesses (the "CEO Survey"). Note that survey composition varies from quarter to quarter. The CEO Survey was initiated on March 7, 2024 and closed March 20, 2024. Quarter-over-quarter presentations reflect data only for companies who responded to the survey question in both quarters, which may result in a smaller subset of portfolio companies CEOs represented in such presentation than the overall CEO Survey. The responding portfolio companies are not necessarily a representative sample of companies across Blackstone's portfolio and the views expressed do not necessarily reflect the views of Blackstone. The views expressed reflect the responding CEOs' views as of the date of their responses, and Blackstone does not undertake any responsibility to advise you of any changes in such views. References to "CEO" or "CEOs" herein refer to respondents to the Q1 2024 Blackstone CEO survey. Note: See "Important Disclosures" for additional information about the survey and the views expressed within.

However, CEOs believe disinflation has slowed



CEOs are optimistic about the benefits AI will have on their business

What impact do you believe AI services will have on your business?[11]



Note: See "Important Disclosures" for additional information about the survey and the views expressed within..

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11. This question prompted CEOs to select all answers that apply. As such, percentages may sum to >100%.

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