

Edgar Filing: Pzena Investment Management, Inc. - Form 10-K

Pzena Investment Management, Inc.

Form 10-K

March 13, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2016

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission file number 001-33761

PZENA INVESTMENT MANAGEMENT, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware 20-8999751

(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification No.)

320 Park Avenue

New York, New York 10022

(Address of Principal Executive Offices)

Registrant's telephone number, including area code: (212) 355-1600

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
---------------------	---

Class A Common Stock, par value \$.01 per share	New York Stock Exchange
---	-------------------------

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the

Act. Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer
(Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes No

The aggregate market value of the common equity held by non-affiliates of the registrant as of June 30, 2016, the last business day of its most recently completed second fiscal quarter, was approximately \$120.2 million based on the

Edgar Filing: Pzena Investment Management, Inc. - Form 10-K

closing sale price of \$7.61 per share of Class A common stock of the registrant on such date on the New York Stock Exchange. For purposes of this calculation only, it is assumed that the affiliates of the registrant include only directors and executive officers of the registrant.

As of March 9, 2017, there were 17,365,024 outstanding shares of the registrant's Class A common stock, par value \$0.01 per share.

As of March 9, 2017, there were 51,164,689 outstanding shares of the registrant's Class B common stock, par value \$0.000001 per share.

DOCUMENTS INCORPORATED BY REFERENCE

None.

TABLE OF CONTENTS

TABLE OF CONTENTS

	Page
<u>Cautionary Statement Regarding Forward-Looking Statements</u>	<u>ii</u>
<u>PART I</u>	
<u>Item 1. Business</u>	<u>1</u>
<u>Item 1A. Risk Factors</u>	<u>11</u>
<u>Item 1B. Unresolved Staff Comments</u>	<u>22</u>
<u>Item 2. Properties</u>	<u>22</u>
<u>Item 3. Legal Proceedings</u>	<u>22</u>
<u>Item 4. Mine Safety Disclosure</u>	<u>22</u>
<u>PART II</u>	
<u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>23</u>
<u>Item 6. Selected Financial Data</u>	<u>25</u>
<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>27</u>
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>43</u>
<u>Item 8. Financial Statements and Supplementary Data</u>	<u>44</u>
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>44</u>
<u>Item 9A. Controls and Procedures</u>	<u>44</u>
<u>Item 9B. Other Information</u>	<u>45</u>
<u>PART III</u>	
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	<u>46</u>
<u>Item 11. Executive Compensation</u>	<u>46</u>
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>46</u>
<u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u>	<u>46</u>
<u>Item 14. Principal Accountant Fees and Services</u>	<u>46</u>
<u>PART IV</u>	
<u>Item 15. Exhibits and Financial Statement Schedules</u>	<u>47</u>
<u>Item 16. Form of 10-K Summary</u>	<u>50</u>
<u>SIGNATURES</u>	<u>51</u>

TABLE OF CONTENTS

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K, or Annual Report, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 27E of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements provide our current views, expectations, or forecasts, of future events and performance and include statements about our expectations, beliefs, plans, objectives, intentions, assumptions and other statements that are not historical facts. Words or phrases such as "anticipate," "believe," "continue," "ongoing," "estimate," "expect," "intend," "may," "plan," "potential," "predict," "project" or phrases, or the negatives of those words or phrases, may identify forward-looking statements, but the absence of these words does not necessarily mean that a statement is not forward-looking.

Forward-looking statements are subject to known and unknown risks and uncertainties, including but not limited to those noted below and described in Part I, Item 1A — "Risk Factors" of this Annual Report, and are based on assumptions and estimates. If one or more of these risks or uncertainties materialize, or if one or more of our assumptions or estimates prove incorrect, our actual results could differ materially from those expected or implied by the forward-looking statements. Accordingly, you should not unduly rely on any forward-looking statements. The forward-looking statements in this Annual Report, speak only as of the date of this Annual Report. There may be additional risks, uncertainties and factors that we do not currently view as material or that are not known. We undertake no obligation to publicly revise any forward-looking statements to reflect circumstances or events after the date of this Annual Report, or to reflect the occurrence of unanticipated events. You should, however, review the factors and risks we describe in the reports we will file from time to time with the Securities and Exchange Commission, or SEC, after the date of this Annual Report.

Forward-looking statements include, but are not limited to, statements about:

- our ability to respond to global economic, market, business and geopolitical conditions;
- our anticipated future results of operations and operating cash flows;
- our successful formulation and execution of business strategies and investment policies;
- our financing plans and the availability of short- or long-term borrowing, or equity financing;
- our competitive position and the effects of competition on our business;
- our ability to identify and capture potential growth opportunities available to us;
- the recruitment and retention of our employees;
- our expected levels of compensation for our employees;
- our potential operating performance, achievements, efficiency and cost reduction efforts;
- our expected tax rate;
- changes in interest rates;
- our expectation with respect to the economy, capital markets, the market for asset management services and other industry trends; and
- the impact of future legislation and regulation, and changes in existing legislation and regulation, on our business.

TABLE OF CONTENTS

Preliminary Notes

In this Annual Report, “we,” “our,” “us,” and “the Company” refer to Pzena Investment Management, Inc. and its consolidated subsidiaries.

Each Russell Index referred to in this Annual Report is a registered trademark or trade name of Frank Russell Company®. Frank Russell Company® is the owner of all copyrights relating to these indices and is the source of the performance statistics of these indices that are referred to herein.

Information with respect to Morgan Stanley Capital International, which we refer to as MSCI, requires a license from MSCI. All MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. MSCI is the owner of all copyrights relating to these indices and is the source of the performance statistics of these indices that are referred to in this Annual Report.

The S&P 500 Index is licensed from Standard & Poor's Financial Services LLC, which is the source of the performance statistics of this index.

TABLE OF CONTENTS

PART I.

ITEM 1. BUSINESS

Overview

Pzena Investment Management, Inc. was formed in 2007 and is the sole managing member of Pzena Investment Management, LLC, which is our operating company. Founded in 1995, Pzena Investment Management, LLC is a value-oriented investment management company. We believe that we have established a positive, team-oriented culture that enables us to attract and retain highly qualified people. Since our inception, over twenty years ago, we have built a diverse, global client base of respected and sophisticated institutional investors, select third-party distributed mutual funds for which we act as sub-investment adviser, and funds for which we act as investment adviser.

Pzena Investment Management, LLC is comprised of Class A and Class B membership units, each of which have an identical economic interest in the operating company. As a holding company, we hold all the Class A membership units and recognize income generated from our economic interest in our operating company's net income. The Class B membership units of the operating company are held by employees and certain outside members. For each Class A membership unit held, we have issued one corresponding share of Class A common stock, par value \$0.01 per share, which entitles the holder to one vote per share. For each Class B membership unit, we have issued one corresponding share of Class B common stock, par value \$0.000001 per share, which entitles the holder to five votes per share without dividend rights, as described below in the graphic illustration. As of December 31, 2016, we owned approximately 25.6% of the economic interest in our operating company and our Class A shareholders hold approximately 6.4% of our voting interests.

Pzena Investment Management, Inc. also serves as the general partner of Pzena Investment Management, LP, a partnership formed with the objective of aggregating employee ownership in one entity.

The graphic below illustrates our holding company structure and ownership as of December 31, 2016.

(1) As of December 31, 2016, the members of Pzena Investment Management, LLC, other than us, consisted of: Our named executive officers and their estate planning vehicles, who collectively held, through direct and indirect interests, approximately 54.2% of the economic interests in Pzena Investment Management, LLC.

32 of our other employee members and their estate planning vehicles, who collectively held, through direct and indirect interests, approximately 4.2% of the economic interests in Pzena Investment Management, LLC.

Certain other members of our operating company, including one of our directors and his related entities, and former employees, who collectively held, through direct and indirect interests, approximately 16.0% of the economic interests in Pzena Investment Management, LLC.

TABLE OF CONTENTS

- (2) Each share of Class A common stock is entitled to one vote per share.
Each share of Class B common stock is entitled to five votes per share for so long as the number of shares of Class B common stock outstanding represents at least 20% of all shares of common stock outstanding. Holders of Class
- (3) B common stock have the right to receive the par value of the Class B common stock held by them upon our liquidation, dissolution or winding up, but do not share in dividends.
- (4) As of December 31, 2016, we held 17,355,024 Class A units of Pzena Investment Management, LLC, which represented the right to receive 25.6% of the distributions made by Pzena Investment Management, LLC.
As of December 31, 2016, the principals collectively held 50,502,655 Class B units of Pzena Investment
- (5) Management, LLC, which represented the right to receive 74.4% of the distributions made by Pzena Investment Management, LLC.
Pursuant to the operating agreement of our operating company, each vested Class B unit is exchangeable for a share of the Company's Class A common stock, subject to certain timing and volume restrictions. When a vested Class B unit is exchanged for a share of Class A common stock, or is forfeited, a corresponding share of the Company's Class B common stock will automatically be redeemed and cancelled. When a share of Class A
- (6) common stock or Class B unit is repurchased and retired, a corresponding membership unit or share of Class B common stock is redeemed and cancelled, respectively. Conversely, to the extent that we issue shares of Class A common stock, or additional Class B units pursuant to our equity incentive plans, the corresponding Class A membership units or shares of Class B common stock will be issued, respectively.

We utilize a classic value approach to investing and seek to make investments in good businesses at low prices, which requires:

- willingness to invest in companies before their stock prices reflect signs of business improvement, and
- significant patience, based upon our understanding of the business' fundamentals, and our long-term investment horizon.

Our approach and process aim to achieve attractive returns over the long term. We manage assets in value-oriented investment strategies reflecting varying degrees of portfolio concentrations across a wide range of market capitalizations in both U.S. and non-U.S. capital markets.

Our assets under management, or AUM, was \$30.0 billion at December 31, 2016, and we managed money on behalf of institutions, acted as sub-investment adviser to a variety of SEC-registered mutual funds and non-U.S. funds as well as investment adviser to certain Pzena SEC-registered mutual funds and non-U.S. funds.

Our operating company is led by a committee, consisting of our Chief Executive Officer (CEO), Mr. Richard S. Pzena; each of our Presidents, Messrs. John P. Goetz and William L. Lipsey; our Executive Vice President, Mr. Michael D. Peterson; and our Chief Operating Officer (COO), Mr. Gary J. Bachman (the "Executive Committee").

Our Competitive Strengths

We believe that the following are our competitive strengths:

Focus on Investment Excellence. We recognize that we must achieve investment excellence in order to attain long-term business success. All of our business decisions, including the design of our investment process and our willingness to limit AUM in our investment strategies, are focused on producing attractive long-term investment results. We believe that our long-term investment performance, together with our willingness to close our strategies to new investors in order to optimize the prospects for future performance, has contributed to our positive reputation among our clients and the institutional consultants who advise them.

- Consistency of Investment Process. Since our inception over twenty years ago, we have utilized a classic value investment approach and a systematic, disciplined investment process to construct portfolios for our investment strategies in U.S. and non-U.S. markets across all market capitalizations. The consistency of our process has allowed us to leverage the same investment team to launch new strategies. We believe that our consistent investment process has resulted in our strong brand recognition in the investment community.

Diverse and High Quality Client Base. We believe that we have developed a favorable reputation in the institutional investment community. This is evidenced by our strong relationships with institutional investors, investment consultants, and mutual fund providers, as well as the diversity and sophistication of our investors. For more information concerning our client base, see “Our Client Relationships and Distribution Approach” below.

TABLE OF CONTENTS

Experienced Investment Professionals and a Team-Oriented Approach. We believe that our greatest asset is the experience of the individuals on our team. For more information on our investment team, see “Our Investment Team” below.

Employee Retention. We have focused on building an environment that we believe is attractive to talented investment professionals. Important among our practices are our team-oriented approach to investment decisions, rotation of coverage areas among individuals, and our culture of employee ownership.

Culture of Ownership. We believe the key contributors to our success should have significant ownership of our business. Since our inception, we have communicated to all our employees that they have the opportunity to become members of our operating company. As of December 31, 2016, we had 38 employee members positioned within all of our functional areas. We believe this ownership model results in a shared sense of purpose with our clients and their advisers. We intend to continue fostering a culture of ownership through our equity incentive plans, which are designed to align our team’s interests with those of our stockholders and clients. We believe this culture of ownership contributes to our team orientation and connection with clients.

Our Business Strategy

The key to our success is continued long-term investment performance. In conjunction with this, we believe the following strategies will enable us to grow our business over time:

- **Unwavering Focus on Classic Value Investing.** We view our unwavering focus on long-term classic value investment excellence to be the key driver of our business success.

Capitalize on Growth Opportunities Created By Our Global Strategies. Among both institutional and retail investors industry-wide, over the past few years, there have been increasing levels of investments in portfolios including non-U.S. equities. As of December 31, 2016, the total AUM in our International (ex-U.S.) Value strategies, Global Value strategies, Emerging Markets Value strategy, European Value strategy, and other non-U.S. strategies was \$14.4 billion, or 48.0% of our overall AUM. Our global capability provides opportunity for implementation of our strategies around the world.

Work with Our Strong Consultant Relationships. We believe that we have built strong relationships with the leading investment consulting firms who advise potential institutional clients. Historically, new accounts sourced through consultant-led searches have been a large driver of our inflows and are expected to be a major component of our future inflows. We estimate that approximately 70% of all retirement plan assets are advised by investment consultants, with a relatively small number of these consultants representing a significant majority of these relationships. As a result of a consistent servicing effort over our history, we have built strong relationships with consulting firms that we believe are the most important. New accounts sourced through consultant-led searches have been a large driver of our historical growth and are expected to be a major component of our future growth. As of December 31, 2016, our largest consultant relationship represented approximately 10% of our AUM.

Expand Our Non-U.S. Client Base. In recent years, we have increased our efforts to develop our non-U.S. client base. Through our strong relationships with global consultants, we have been able to accelerate the development of our relationships with their non-U.S. branches. Over time, we aim to achieve growth of this client base through these relationships and by directly calling on the world’s largest institutional investors. We have also sought to expand our non-U.S. base through our relationships with non-U.S. mutual funds and other investment fund advisers. During 2015, we expanded our physical presence to three continents with the launch of a business development and client service office in London, in addition to our headquarters in the United States and representative office in Melbourne. To date, our marketing efforts have resulted in client relationships in fifteen non-U.S. countries, including the United

Kingdom, Luxembourg, Australia and Canada. As of December 31, 2016, we managed \$8.9 billion on behalf of non-U.S. clients.

Provide Access To Our Strategies Through a Range of Investment Vehicles and Distribution Channels. Our clients access our investment strategies through a range of investment vehicles and distribution channels, including separately managed accounts, mutual funds that we sub-advise, and certain private placement vehicles and non-U.S. funds that we offer to institutional investors. During 2014 we launched three SEC-registered Pzena mutual funds for which we act as investment adviser in an effort to expand the access investors have to our strategies. During 2016 we launched a fourth SEC-registered Pzena mutual fund and continue to develop intermediary relationships to grow retail distribution channels. For more information concerning access to our strategies and our distribution approach, see “Our Client Relationships and Distribution Approach” below.

TABLE OF CONTENTS

Employ Global Team to Serve Clients and Prospects. Our business development and client service professionals are critical to our business, as noted below under "Business Development and Client Service Teams," and are generally focused geographically. In addition to our headquarters in the United States and representative office in Melbourne, we have four dedicated professionals located in our London office. During 2015 we demonstrated our commitment to the retail market with an expanded two person leadership team focusing on the growth of our distribution capabilities and intermediary business across channels. In 2016, we added three sales professionals to this intermediary distribution team.

Our Investment Team

We have built an investment team that is well-suited to implement our classic value investment strategy. The members of our investment team have a diverse set of backgrounds, including former corporate management, private equity, management consulting, accounting, and Wall Street professionals. Their diverse business backgrounds are instrumental in enabling us to make investments in companies where we would be comfortable owning the entire business for a three- to five-year period. We look beyond temporary earnings shortfalls that result in stock price declines, which may lead others to forego investment opportunities, if we believe the long-term fundamentals of a company remain attractive.

As of December 31, 2016, we had a 25-member investment team. Each member serves as a research analyst, and certain members of the team also have portfolio management responsibilities. There are generally three portfolio managers for each investment strategy. These three managers have joint decision-making responsibility, and each has "veto authority" over all decisions regarding the relevant portfolio. Research analysts have sector and company-level research responsibilities which span all of our investment strategies, including those with a non-U.S. focus. In order to facilitate the professional development of our team, and to keep a fresh perspective on the companies in our investment portfolios, our research analysts generally rotate industry coverage every three to four years.

We follow a collaborative, consensus-oriented approach to making investment decisions, such that all members of our investment team, irrespective of their seniority, can play a significant role in this decision making process. We hold weekly research review meetings attended by all portfolio managers and relevant research analysts, and that are open to other employees, at which we openly discuss and debate our findings regarding the normalized earnings power of potential portfolio companies. In addition, we hold daily morning meetings, attended by our portfolio managers, research analysts, portfolio implementation, and client service personnel, in order to review developments in our holdings and set a trading strategy for the day. These meetings are critical for sharing relevant developments and analysis of the companies in our portfolios. We believe that our collaborative culture is attractive to our investment professionals.

Our Investment Strategies

As of December 31, 2016, our approximately \$30.0 billion in AUM was invested in a variety of value-oriented investment strategies, representing differing degrees of concentration, and capitalization segments of U.S. and non-U.S. markets. See "Item 7 — Management's Discussion and Analysis of Financial Condition & Results of Operations — Operating Results — Assets Under Management and Flows" for additional details about our strategies.

TABLE OF CONTENTS

The following table identifies our current U.S. and non-U.S. investment strategies, and the allocation of our AUM among them, as of December 31, 2016, 2015, and 2014:

Strategy ¹	As of December		
	31,		
	2016	2015	2014
U.S. Strategies	(in billions)		
Large Cap Value	\$9.4	\$9.9	\$11.9
Mid Cap Value	2.5	1.8	1.8
Value	2.0	1.6	1.8
Small Cap Value	1.6	1.1	1.3
Other U.S. Strategies	0.1	0.1	—
Global and Non-U.S. Strategies			
International (ex-U.S.)Value	4.9	4.2	3.4
Global Value	4.6	4.2	5.6
Emerging Markets Value	2.6	1.8	1.1
European Value	2.1	1.1	0.7
Other Global and Non-U.S. Strategies	0.2	0.2	0.1
Total	\$		