

Pzena Investment Management, Inc.  
Form 10-Q  
November 06, 2018  
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Quarterly Period Ended September 30, 2018

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) (Zip Code)

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

Not Applicable

(Former Address of Principal Executive Offices) (Zip Code)

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

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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. Yes No

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

As of November 5, 2018, there were 17,323,691 outstanding shares of the registrant's Class A common stock, par value \$0.01 per share.

As of November 5, 2018, there were 51,979,177 outstanding shares of the registrant's Class B common stock, par value \$0.000001 per share.

Table of Contents

PZENA INVESTMENT MANAGEMENT, INC.

FORM 10-Q

TABLE OF CONTENTS

	Page
<u>PART I — FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Statements of Financial Condition of Pzena Investment Management, Inc. as of September 30, 2018 (unaudited) and December 31, 2017</u>	1
<u>Consolidated Statements of Operations (unaudited) of Pzena Investment Management, Inc. for the Three and Nine Months Ended September 30, 2018 and 2017</u>	2
<u>Consolidated Statements of Comprehensive Income (unaudited) of Pzena Investment Management, Inc. for the Three and Nine Months Ended September 30, 2018 and 2017</u>	3
<u>Consolidated Statement of Changes in Equity (unaudited) of Pzena Investment Management, Inc. for the Nine Months Ended September 30, 2018 and 2017</u>	4
<u>Consolidated Statements of Cash Flows (unaudited) of Pzena Investment Management, Inc. for the Three and Nine Months Ended September 30, 2018 and 2017</u>	5
<u>Notes to the Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	24
Item 4. <u>Controls and Procedures</u>	39
<u>PART II — OTHER INFORMATION</u>	
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	41
Item 6. <u>Exhibits</u>	42
<u>SIGNATURES</u>	43



Table of Contents

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements. Forward-looking statements provide our current expectations, or forecasts, of future events. Forward-looking statements 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,” “predict,” “project” or similar words 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 and are based on our views, plans, estimates, and expectations. Potentially inaccurate assumptions could cause actual results to differ materially from those expected or implied by the forward-looking statements. Our actual results could differ materially from those anticipated in forward-looking statements for many reasons, including the factors described in Item 1A, “Risk Factors” in Part I of our Annual Report on Form 10-K for our fiscal year ended December 31, 2017. Accordingly, you should not unduly rely on these forward-looking statements, which speak only as of the date they are made. We undertake no obligation to publicly revise any forward-looking statements included in this Quarterly Report to reflect circumstances or events after the date of this Quarterly 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 (“SEC”), after the date of this Quarterly Report on Form 10-Q.

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 effective recruitment and retention of our key executives and 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 expectations 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.
- The reports that we file with the SEC, accessible on the SEC’s website at [www.sec.gov](http://www.sec.gov), identify additional factors that can affect forward-looking statements.



Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PZENA INVESTMENT MANAGEMENT, INC.

## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(in thousands, except share and per-share amounts)

	As of September 30, 2018	December 31, 2017 (unaudited)
<b>ASSETS</b>		
Cash and Cash Equivalents (\$3,679 and \$3,717) <sup>1</sup>	\$31,913	\$ 63,414
Restricted Cash	1,026	1,017
Due from Broker (\$576 and \$1,485) <sup>1</sup>	894	1,875
Advisory Fees Receivable	34,398	32,531
Investments (\$3,623 and \$3,927) <sup>1</sup>	58,170	21,737
Receivable from Related Parties	1,251	1,453
Other Receivables (\$14 and \$15) <sup>1</sup>	196	132
Prepaid Expenses and Other Assets	906	990
Deferred Tax Asset	35,984	39,639
Property and Equipment, Net of Accumulated Depreciation of \$3,804 and \$3,063, respectively	5,631	6,259
<b>TOTAL ASSETS</b>	<b>\$170,369</b>	<b>\$ 169,047</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities:</b>		
Accounts Payable and Accrued Expenses (\$16 and \$14) <sup>1</sup>	\$31,962	\$ 31,983
Due to Broker (\$321 and \$0) <sup>1</sup>	608	144
Liability to Selling and Converting Shareholders	36,441	36,441
Deferred Compensation Liability	3,490	918
Other Liabilities (\$150 and \$0) <sup>1</sup>	415	272
<b>TOTAL LIABILITIES</b>	<b>72,916</b>	<b>69,758</b>
<b>Commitments and Contingencies (see Note 12)</b>		
<b>Equity:</b>		
Preferred Stock (Par Value \$0.01; 200,000,000 Shares Authorized; None Outstanding)	—	—
Class A Common Stock (Par Value \$0.01; 750,000,000 Shares Authorized; 17,364,299 and 18,096,554 Shares Issued and Outstanding in 2018 and 2017, respectively)	173	180
Class B Common Stock (Par Value \$0.000001; 750,000,000 Shares Authorized; 51,930,427 and 50,709,673 Shares Issued and Outstanding in 2018 and 2017, respectively)	—	—
Additional Paid-In Capital	2,372	7,915

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

Retained Earnings	26,854	24,214
Accumulated Other Comprehensive Loss	18	(5 )
Total Pzena Investment Management, Inc.'s Equity	29,417	32,304
Non-Controlling Interests	68,036	66,985
TOTAL EQUITY	97,453	99,289
TOTAL LIABILITIES AND EQUITY	\$170,369	\$ 169,047

1 Asset and liability amounts in parentheses represent the aggregated balances at September 30, 2018 and December 31, 2017 attributable to Pzena International Value Service (a series of Pzena Investment Management, LLC), Pzena Investment Management Special Situations, LLC, and Pzena U.S. Best Ideas (GP), LLC, which were variable interest entities as of September 30, 2018 and December 31, 2017, respectively. Aggregated balances of variable interest entities at September 30, 2018 also reflect Pzena Global Best Ideas (GP), LLC.

See accompanying notes to unaudited consolidated financial statements.



Table of Contents

## PZENA INVESTMENT MANAGEMENT, INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per-share amounts)

	For the Three Months		For the Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
REVENUE	\$39,580	\$36,229	\$117,180	\$102,386
EXPENSES				
Compensation and Benefits Expense	16,122	14,763	47,520	44,681
General and Administrative Expense	3,322	3,062	9,856	9,585
Total Operating Expenses	19,444	17,825	57,376	54,266
Operating Income	20,136	18,404	59,804	48,120
OTHER INCOME				
Interest Income	234	76	382	106
Dividend Income	52	117	127	318
Net Realized and Unrealized Gains/ (Losses) from Investments	142	626	(71 )	1,719
Equity in Earnings/ (Losses) of Affiliates	204	428	(73 )	1,083
Other (Expense)/ Income	(27 )	59	(22 )	178
Total Other Income	605	1,306	343	3,404
Income Before Income Taxes	20,741	19,710	60,147	51,524
Income Tax Expense	1,294	2,493	5,677	6,460
Net Income	19,447	17,217	54,470	45,064
Less: Net Income Attributable to Non-Controlling Interests	15,185	14,228	43,213	37,110
Net Income Attributable to Pzena Investment Management, Inc.	\$4,262	\$2,989	\$11,257	\$7,954
Net Income for Basic Earnings per Share	\$4,262	\$2,989	\$11,257	\$7,954
Basic Earnings per Share	\$0.24	\$0.17	\$0.63	\$0.46
Basic Weighted Average Shares Outstanding <sup>1</sup>	17,489,380	17,285,307	17,752,788	17,319,948
Net Income for Diluted Earnings per Share	\$15,786	\$11,862	\$44,033	\$31,077
Diluted Earnings per Share	\$0.22	\$0.17	\$0.61	\$0.44
Diluted Weighted Average Shares Outstanding <sup>1</sup>	71,677,806	70,763,213	71,934,411	70,845,892
Cash Dividends per Share of Class A Common Stock	\$0.03	\$0.03	\$0.48	\$0.34

<sup>1</sup> The Company issues restricted shares of Class A common stock and restricted Class B units that have non-forfeitable dividend rights. Under the "two-class method," these shares and units are considered participating securities and are required to be included in the computation of basic and diluted earnings per share.



See accompanying notes to unaudited consolidated financial statements.

2

---

Table of Contents

PZENA INVESTMENT MANAGEMENT, INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
NET INCOME	\$19,447	\$17,217	\$54,470	\$45,064
OTHER COMPREHENSIVE (LOSS)/ GAIN				
Foreign Currency Translation Adjustment	(27 )	48	(90 )	104
Total Other Comprehensive (Loss)/ Gain	(27 )	48	(90 )	104
Comprehensive Income	19,420	17,265	54,380	45,168
Less: Comprehensive Income Attributable to Non-Controlling Interests	15,151	14,264	43,100	37,188
Total Comprehensive Income Attributable to Pzena Investment Management, Inc.	\$4,269	\$3,001	\$11,280	\$7,980



See accompanying notes to unaudited consolidated financial statements.

3

---

Table of Contents

## PZENA INVESTMENT MANAGEMENT, INC.

## UNAUDITED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(in thousands, except share and per-share amounts)

	Shares of Class A Common Stock	Shares of Class B Common Stock	Class A Common Stock	Additional Paid-in Capital	Accumulated		Non-Controlling Interests	Total Equity
					Income/(Loss)	Reserve		
Balance at December 31, 2017	18,096,554	50,709,673	\$ 180	\$ 7,915	\$ (5 )	\$ 24,214	\$ 66,985	\$ 99,289
Amortization of Non-Cash Compensation	10,000	26,178	—	963	—	—	2,758	3,721
Issuance of Shares under Equity Incentive Plan	—	300,931	—	1,096	—	—	3,095	4,191
Sale of Shares under Equity Incentive Plan	—	897,515	—	1,342	—	—	3,849	5,191
Directors' Share Grants	—	—	—	116	—	—	333	449
Net Income	—	—	—	—	—	11,257	43,213	54,470
Foreign Currency Translation Adjustments	—	—	—	—	23	—	(113 )	(90 )
Repurchase and Retirement of Class A Common Stock	(742,255 )	—	(7 )	(7,494 )	—	—	—	(7,501 )
Repurchase and Retirement of Class B Units	—	(3,870 )	—	(11 )	—	—	(30 )	(41 )
Class A Cash Dividends Declared and Paid (\$0.48 per share)	—	—	—	—	—	(8,617 )	—	(8,617 )
Tax Impact of Transactions with Non-Controlling Shareholders	—	—	—	(420 )	—	—	—	(420 )
Contributions from Non-Controlling Interests	—	—	—	—	—	—	61	61

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

Distributions to Non-Controlling Interests	—	—	—	—	—	—	(53,250 )	(53,250 )
Other	—	—	—	(1,135 )	—	—	1,135	—
Balance at September 30, 2018	17,364,299	51,930,427	\$ 173	\$ 2,372	\$ 18	\$ 26,854	\$ 68,036	\$ 97,453
Accumulated								
	Shares of	Shares of			Other			
	Class A	Class B	Class A	Additional	Comprehensive	Retained	Non-Controlling	
	Common Stock	Common Stock	Common Stock	Stock	In Capital	Earnings	Interests	Total Equity
Balance at December 31, 2016	17,340,090	50,461,598	\$ 173	\$ 5,996	\$ (25 )	\$ 22,349	\$ 52,841	\$ 81,334
Adjustment for the Cumulative Effect of Applying ASU 2016-09	—	—	—	—	—	1,377	—	1,377
Adjusted Balance at January 1, 2017	17,340,090	50,461,598	173	5,996	(25 )	23,726	52,841	82,711
Amortization of Non-Cash Compensation	24,934	22,410	—	801	—	—	2,340	3,141
Issuance of Shares under Equity Incentive Plan	—	620,543	—	1,118	—	—	3,295	4,413
Sale of Shares under Equity Incentive Plan	—	29,426	—	47	—	—	140	187
Directors' Share Grants	—	—	—	96	—	—	286	382
Net Income	—	—	—	—	—	7,954	37,110	45,064
Foreign Currency Translation Adjustments	—	—	—	—	26	—	78	104
Repurchase and Retirement of Class A Common Stock	(79,717 )	—	(1 )	(707 )	—	—	—	(708 )
Repurchase and Retirement of Class B Units	—	(2,897 )	—	(10 )	—	—	(29 )	(39 )
Class A Cash Dividends Declared and Paid (\$0.34 per share)	—	—	—	—	—	(5,902 )	—	(5,902 )
Contributions from Non-Controlling Interests	—	—	—	—	—	—	4,054	4,054



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

Distributions to Non-Controlling Interests	—	—	—	—	—	—	(39,841 )	(39,841 )
Other	—	—	—	(285 )	—	—	285	—
Balance at September 30, 2017	17,285,307	51,131,080	\$ 172	\$ 7,056	\$ 1	\$ 25,778	\$ 60,559	\$ 93,566

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

## PZENA INVESTMENT MANAGEMENT, INC.

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Three Months		For the Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
<b>OPERATING ACTIVITIES</b>				
Net Income	\$ 19,447	\$ 17,217	\$ 54,470	\$ 45,064
Adjustments to Reconcile Net Income to Cash Provided by Operating Activities:				
Depreciation	245	256	746	757
Loss on Disposal of Fixed Assets	—	—	—	6
Non-Cash Compensation	2,383	2,937	7,211	7,868
Directors' Share Grants	102	100	449	382
Net Realized and Unrealized (Gains)/ Losses from Investments	(142 )	(626 )	71	(1,719 )
Equity in (Earnings)/ Losses of Affiliates	(204 )	(428 )	73	(1,083 )
Accretion of Discount	(41 )	—	(41 )	—
Foreign Currency Translation Adjustments	(27 )	48	(90 )	104
Deferred Income Taxes	551	1,744	3,234	4,400
Changes in Operating Assets and Liabilities:				
Advisory Fees Receivable	(747 )	(2,182 )	(1,867 )	(5,580 )
Due from Broker	(166 )	692	1,031	749
Prepaid Expenses and Other Assets	52	164	20	246
Due to Broker	133	(37 )	464	554
Accounts Payable, Accrued Expenses, and Other Liabilities	9,178	4,678	3,396	(1,308 )
Purchases of Equity Securities and Securities Sold Short	(8,561 )	(8,265 )	(21,122)	(33,456)
Proceeds from Equity Securities and Securities Sold Short	6,603	7,777	19,575	30,858
Net Cash Provided by Operating Activities	28,806	24,075	67,620	47,842
<b>INVESTING ACTIVITIES</b>				
Purchases of Investments	(35,062)	(129 )	(35,499)	(614 )
Proceeds from Sale of Investments	102	718	460	1,047
Payments from/ (to) Related Parties	859	15	202	(462 )
Purchases of Property and Equipment	(87 )	(177 )	(118 )	(222 )
Net Cash (Used in)/ Provided by Investing Activities	(34,188)	427	(34,955)	(251 )
<b>FINANCING ACTIVITIES</b>				
Repurchase and Retirement of Class A Common Stock	(2,019 )	—	(7,501 )	(708 )
Repurchase and Retirement of Class B Units	—	—	(41 )	(39 )
Sale of Shares under Equity Incentive Plan	3	107	5,191	187
Distributions to Non-Controlling Interests	(12,733)	(11,052)	(53,250)	(39,841)

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

Contributions from Non-Controlling Interests	30	415	61	4,054
Dividends	(525 )	(519 )	(8,617 )	(5,902 )
Net Cash Used in Financing Activities	(15,244)	(11,049)	(64,157)	(42,249)
<b>NET CHANGE IN CASH, CASH EQUIVALENTS AND RESTRICTED CASH</b>	<b>\$(20,626)</b>	<b>\$13,453</b>	<b>\$(31,492)</b>	<b>\$5,342</b>
<b>CASH, CASH EQUIVALENTS AND RESTRICTED CASH - Beginning of Period</b>	<b>\$53,565</b>	<b>\$39,047</b>	<b>\$64,431</b>	<b>\$47,158</b>
<b>Net Change in Cash, Cash Equivalents and Restricted Cash</b>	<b>(20,626)</b>	<b>13,453</b>	<b>(31,492)</b>	<b>5,342</b>
<b>CASH, CASH EQUIVALENTS AND RESTRICTED CASH - End of Period</b>	<b>\$32,939</b>	<b>\$52,500</b>	<b>\$32,939</b>	<b>\$52,500</b>
<b>Supplementary Cash Flow Information:</b>				
Issuances of Shares under Equity Incentive Plan	\$—	\$—	\$4,191	\$4,413
Income Taxes Paid	\$85	\$253	\$500	\$797

See accompanying notes to unaudited consolidated financial statements.

Table of Contents

Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements

Note 1—Organization

Pzena Investment Management, Inc. (the “Company”) is the sole managing member of its operating company, Pzena Investment Management, LLC (the “operating company”). As a result, the Company: (i) consolidates the financial results of the operating company and reflects the membership interests in the operating company that it does not own as a non-controlling interest in its consolidated financial statements; and (ii) recognizes income generated from its economic interest in the operating company’s net income.

The operating company is an investment adviser registered under the Investment Advisers Act of 1940 and is headquartered in New York, New York. As of September 30, 2018, the operating company managed assets in a variety of value-oriented investment strategies across a wide range of market capitalizations in both U.S. and non-U.S. capital markets.

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

The Company, through its interest in the operating company, has consolidated the results of operations and financial condition of the following entities as of September 30, 2018:

Legal Entity	Type of Entity (Date of Formation)	Ownership at September 30, 2018
Pzena Investment Management, Pty	Australian Proprietary Limited Company (12/16/2009)	100.0%
Pzena Financial Services, LLC	Delaware Limited Liability Company (10/15/2013)	100.0%
Pzena Investment Management, LTD	England and Wales Private Limited Company (01/08/2015)	100.0%
Pzena U.S. Best Ideas (GP), LLC	Delaware Limited Liability Company (11/16/2017)	100.0%
Pzena Global Best Ideas (GP), LLC	Delaware Limited Liability Company (2/15/2018)	100.0%
Pzena International Small Cap Value Fund, a series of Advisors Series Trust	Open-end Management Investment Company, series of Delaware Statutory Trust (6/28/2018)	100.0%
Pzena Investment Management Special Situations, LLC	Delaware Limited Liability Company (12/01/2010)	99.9%
Pzena International Value Service, a series of Pzena Investment Management International, LLC	Delaware Limited Liability Company (12/22/2003)	53.1%

Note 2—Significant Accounting Policies

**Basis of Presentation:**

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) and related Securities and Exchange Commission (“SEC”) rules and regulations.

**Principles of Consolidation:**

The Company’s policy is to consolidate those entities in which it has a direct or indirect controlling financial interest based on either the voting interest model or the variable interest model. As such, the Company consolidates majority-owned subsidiaries in which it has a controlling financial interest, and certain investment vehicles the operating company sponsors for which it is the investment adviser that are considered to be variable-interest entities (“VIEs”), and for which the Company is deemed to be the primary beneficiary.

Pursuant to the Consolidation Topic of the FASB Accounting Standards Codification (“FASB ASC”), for legal entities evaluated for consolidation, the Company determines whether interests it holds and fees paid to the entity qualify as a variable interest. If it is determined that the Company does not have a variable interest in the entity, no further analysis is required and the Company does not consolidate the entity. If it is determined that the Company has a variable interest, it considers its direct

## Table of Contents

economic interests and the proportionate indirect interests through related parties to determine if it is the primary beneficiary of the VIE.

For equity investments where the Company does not control the investee, and where it is not the primary beneficiary of a VIE, but can exert significant influence over the financial and operating policies of the investee, the Company follows the equity method of accounting. The evaluation of whether the Company exerts control or significant influence over the financial and operating policies of the investee requires significant judgment based on the facts and circumstances surrounding each investment. Factors considered in these evaluations may include the type of investment, the legal structure of the investee, the terms of the investment agreement, or other agreements with the investee.

The Company analyzes entities structured as series funds which comply with the requirements included in the Investment Company Act of 1940 for registered mutual funds as voting interest entities because the shareholders are deemed to have the ability to direct the activities of the fund that most significantly impact the fund's economic performance.

### Consolidated Entities

The Company consolidates the financial results of the operating company and records in its own equity its pro-rata share of transactions that impact the operating company's net equity, including unit and option issuances, repurchases, and retirements. The operating company's pro-rata share of such transactions are recorded as an adjustment to additional paid-in capital or non-controlling interests, as applicable, on the consolidated statements of financial condition.

The majority-owned subsidiaries in which the Company, through its interest in the operating company, has a controlling financial interest and the VIEs for which the Company is deemed to be the primary beneficiary are collectively referred to as "consolidated subsidiaries." Non-controlling interests recorded on the consolidated financial statements of the Company include the non-controlling interests of the outside investors in each of these entities, as well as those of the operating company. All significant inter-company transactions and balances have been eliminated through consolidation.

During 2014, the Company provided the initial cash investment for three Pzena mutual funds in an effort to generate an investment performance track record to attract third-party investors. During 2016, the Company provided the initial cash investment for the launch of a fourth Pzena mutual fund: the Pzena Small Cap Value Fund. During the three months ended September 30, 2018, the Company provided the initial cash investment for the launch of a fifth Pzena mutual fund: the Pzena International Small Cap Value Fund. Due to their series fund structure, registration, and compliance with the requirements of the Investment Company Act of 1940, these funds are analyzed for consolidation under the voting interest model. As a result of the Company's initial interests, it consolidated the Pzena Mid Cap Value Fund, Pzena Long/Short Value Fund, Pzena Emerging Markets Value Fund, Pzena Small Cap Value Fund, and Pzena International Small Cap Value Fund. On July 11, 2016, due to additional subscriptions into the Pzena Small Cap Value Fund, the Company's ownership decreased to 36.1%. On November 9, 2017 and December 21, 2017, due to additional subscriptions into the Pzena Mid Cap Value Fund and Pzena Long/Short Value Fund, respectively, the Company's ownership decreased to 41.7% and 35.5%, respectively. As the Company was no longer deemed to control the funds, the Company deconsolidated the entities, removed the related assets, liabilities and non-controlling interest from its balance sheet and classified the Company's remaining investments as equity method investments.

The operating company is the managing member of Pzena International Value Service, a series of Pzena Investment Management International, LLC. The operating company is considered the primary beneficiary of this entity. At September 30, 2018, Pzena International Value Service's \$3.3 million in net assets was included in the Company's consolidated statements of financial condition.

These consolidated investment partnerships are investment companies and apply specialized industry accounting for investment companies. The Company has retained this specialized accounting for these investment partnerships pursuant to U.S. GAAP.

#### Non-Consolidated Variable Interest Entities

VIEs that are not consolidated receive investment management services from the operating company and are generally private investment partnerships sponsored by the operating company. The total net assets of these VIEs was approximately \$250.1 million and \$165.5 million at September 30, 2018 and December 31, 2017, respectively.

As of September 30, 2018 and December 31, 2017, the operating company had \$3.0 million in investments in certain of these firm-sponsored vehicles, the majority of which are primarily held to satisfy certain of the Company's obligations under its deferred compensation programs, for which the Company was not deemed to be the primary beneficiary. The Company's exposure to risk in the non-consolidated VIEs is generally limited to any equity investment and any uncollected management

Table of Contents

fees. As of September 30, 2018 and December 31, 2017, the Company's maximum exposure to loss as a result of its involvement with the non-consolidated VIEs was \$3.3 million and \$3.2 million, respectively.

Accounting Pronouncements Adopted in 2018:

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the goods or services. The Company completed its overall assessment of its revenue streams and review of related contracts potentially affected by the new standard, including base management fees, performance fees, and fulcrum fee arrangements. Based on this assessment, the Company concluded that ASU No. 2014-09 did not change the method in which the Company currently recognizes revenue. The Company also completed its evaluation of certain costs related to revenue streams to determine whether such costs should be presented as expenses or contra-revenue. Based on its evaluation, the Company concluded that the classification of fund expense cap reimbursements should change upon adoption. The Company adopted ASU No. 2014-09 as of January 1, 2018 using a modified retrospective approach. The adoption of the new standard requires the Company to present fund expense cap reimbursements net against Revenue. Prior to adoption, these expense cap reimbursements were presented as a component of General and Administrative Expense. These classification changes resulted in immaterial changes to both revenue and expense. In accordance with the historic method of accounting under ASC Topic 605, Revenue and General and Administrative Expenses would have been higher by \$0.2 million and \$0.6 million for the three and nine months ended September 30, 2018, respectively. As the implementation of the new standard did not impact the measurement or recognition of revenue, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Consistent with the modified retrospective approach, the Company did not adjust prior period amounts for the fund expense cap reimbursement reclassifications noted above. The Company has included additional disclosures associated with the disaggregation of revenue and performance obligations.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230)." This update provides specific guidance on cash flow classification issues, which is intended to reduce the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The Company adopted ASU No. 2016-15 as of January 1, 2018. The adoption did not have a material impact on the consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." This update requires entities to show the changes in the total cash, cash equivalents, restricted cash, and restricted cash equivalents in the statement of cash flows. The Company adopted ASU No. 2016-18 as of January 1, 2018 using a retrospective approach. Upon adoption, the net change in cash presented in the consolidated statement of cash flows will reflect the total of cash and restricted cash.

Management's Use of Estimates:

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses for the period. Actual results could materially differ from those estimates.



Table of Contents

## Revenue Recognition:

Revenue, comprised of advisory fee income, is recognized over the period in which advisory services are provided. Advisory fee income includes management fees that are calculated based on percentages of assets under management (“AUM”), generally billed quarterly, either in arrears or advance, depending on the applicable contractual terms. Advisory fee income also includes performance fees that may be earned by the Company depending on the investment return of the AUM, as well as fulcrum fee arrangements. Performance fee arrangements generally entitle the Company to participate, on a fixed-percentage basis, in any returns generated in excess of an agreed-upon benchmark. The Company’s participation percentage in such return differentials is then multiplied by AUM to determine the performance fees earned. In general, returns are calculated on an annualized basis over the contract’s measurement period, which usually extends to three years. Performance fees are generally payable annually or quarterly. Fulcrum fee arrangements require a reduction in the base fee, or allow for a performance fee if the relevant investment strategy underperforms or outperforms, respectively, the agreed-upon benchmark over the contract’s measurement period, which extends to three years. Fulcrum fees are generally payable quarterly. Following the Revenue Recognition Topic of the FASB ASC, performance fee income is recorded at the conclusion of the contractual performance period, when it is probable that significant reversal of the performance fee will not occur. Upon adoption of ASU No. 2014-09 on January 1, 2018, advisory fee income also includes fund expense cap reimbursements which are required to be presented net against Revenue rather than as a component of General and Administrative Expense.

Revenue from advisory fees is disaggregated into categories based on the composition of the Company's client base and advisory fee structure for the three and nine months ended September 30, 2018 and 2017:

Revenue	For the Three Months		For the Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
	(in thousands)			
<b>Separately Managed Accounts</b>				
Asset-Based Fees	\$19,578	\$19,407	\$58,820	\$55,593
Performance-Based Fees	—	349	—	410
<b>Total Separately Managed Fees</b>	<b>19,578</b>	<b>19,756</b>	<b>58,820</b>	<b>56,003</b>
<b>Sub-Advised Accounts</b>				
Asset-Based Fees	\$15,860	\$13,493	\$46,772	\$38,157
Decrease in Asset-Based Fees	—	—	—	—
Performance-Based Fees	756	580	2,551	1,280
<b>Total Sub-Advised Fees</b>	<b>16,616</b>	<b>14,073</b>	<b>49,323</b>	<b>39,437</b>
<b>Pzena Funds</b>				
Asset-Based Fees	\$3,537	\$2,400	\$9,658	\$6,946
Expense Cap Reimbursements	(151 )	—	(633 )	—
Performance-Based Fees	—	—	12	—
<b>Total Pzena Funds Fees</b>	<b>3,386</b>	<b>2,400</b>	<b>9,037</b>	<b>6,946</b>

Total	\$39,580	\$36,229	\$117,180	\$102,386
-------	----------	----------	-----------	-----------

Cash and Cash Equivalents:

At September 30, 2018 and December 31, 2017, Cash and Cash Equivalents was \$31.9 million and \$63.4 million, respectively. The Company considers all money market funds and highly-liquid debt instruments with an original maturity of three months or less at the time of purchase to be cash equivalents. The Company maintains its cash in bank deposits, other accounts whose balances often exceed federally insured limits and treasury money market funds. Cash is stated at cost, which approximates fair value.

Interest on cash and cash equivalents is recorded as Interest Income on an accrual basis in the consolidated statements of operations.

Table of Contents

## Restricted Cash:

At both September 30, 2018 and December 31, 2017, the Company had \$1.0 million of compensating balances recorded in Restricted Cash in the consolidated statements of financial condition. These balances reflect a letter of credit issued by a third party in lieu of a cash security deposit, as required by the Company's lease for its corporate headquarters.

The following table reconciles cash, cash equivalents, and restricted cash per the consolidated statements of cash flows to the consolidated statements of financial condition.

	September 30, 2018	June 30, 2018	December 31, 2017	September 30, 2017	June 30, 2017	December 31, 2016
	(in thousands)					
Cash and Cash Equivalents	\$31,913	\$52,541	\$ 63,414	\$ 47,910	\$34,749	\$ 43,522
Restricted Cash	1,026	1,024	1,017	4,590	4,298	3,636
Total	\$32,939	\$53,565	\$ 64,431	\$ 52,500	\$39,047	\$ 47,158

## Due to/from Broker:

Due to/from Broker consists primarily of amounts payable/receivable for unsettled securities transactions held/initiated at the clearing brokers of the Company's consolidated subsidiaries.

## Non-Cash Compensation:

All non-cash compensation awards granted have varying vesting schedules and are issued at prices equal to the assessed fair market value at the time of issuance. Expenses associated with these awards are recognized over the period during which employees are required to provide service. The Company accounts for forfeitures as they occur.

## Investments:

## Investments, at Fair Value

Investments, at Fair Value consist of equity securities at fair value and trading debt securities held by the Company and its consolidated subsidiaries, as well as investments in open-ended registered mutual funds. Management determines the appropriate classification of its investments at the time of purchase and re-evaluates such determination on an ongoing basis. Dividends and interest income associated with the Company's investments and the investments of the Company's consolidated subsidiaries are recognized as Dividend Income on an ex-dividend basis and Interest Income, respectively, in the consolidated statements of operations.

All such investments are recorded at fair value, with net realized and unrealized gains and losses recognized as a component of Net Realized and Unrealized Gains/ (Losses) from Investments in the consolidated statements of operations.

Investments in equity method investees

The Company accounted for its investments in certain private investment partnerships in which the Company has non-controlling interests and exercises significant influence, using the equity method. These investments are included in Investments in the Company's consolidated statements of financial condition. The carrying value of these investments are recorded at the amount of capital reported by the private investment partnership or mutual fund. The capital account for each entity reflects any contributions paid to, distributions received from, and equity earnings of, the relevant entity. The earnings of these investments are recognized as in Equity in Earnings/ (Losses) of Affiliates in the consolidated statements of operations.

Investments in equity method investees are evaluated for impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If the carrying amounts of the assets exceed their respective fair values, additional impairment tests are performed to measure the amounts of impairment losses, if any. During the three and nine months ended September 30, 2018 and 2017, no impairment losses were recognized.

## Table of Contents

### Securities Valuation:

Investments in equity securities for which market quotations are available are valued at the last reported price or closing price on the primary market or exchange on which they trade. If no reported equity sales occurred on the valuation date, equity investments are valued at the bid price. Investments in registered mutual funds are carried at fair value at their respective net asset values as of the valuation date. Otherwise, fair values for investment securities are based on Level 2 or Level 3 inputs detailed in Note 9. Transactions are recorded on a trade date basis.

The net realized gain or loss on sales of equity securities and securities sold short is determined on a specific identification basis and is included in Net Realized and Unrealized Gains/ (Losses) from Investments in the consolidated statements of operations.

### Concentrations of Credit Risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, amounts due from brokers, and advisory fees receivable. The Company maintains its cash in bank deposits and other accounts whose balances often exceed federally insured limits.

The concentration of credit risk with respect to advisory fees receivable is generally limited due to the short payment terms extended to clients by the Company. On a periodic basis, the Company evaluates its advisory fees receivable and establishes an allowance for doubtful accounts, if necessary, based on a history of past write-offs, collections, and current credit conditions. For the three and nine months ended September 30, 2018, approximately 11.3% and 11.8%, respectively, of the Company's advisory fees were generated from advisory agreements with one client relationship. For both the three and nine months ended September 30, 2017 approximately 11.2% of the Company's advisory fees were generated from advisory agreements with one client relationship. At both September 30, 2018 and December 31, 2017, there was no allowance for doubtful accounts.

### Property and Equipment:

Property and equipment is carried at cost, less accumulated depreciation and amortization. Depreciation is provided on a straight-line basis over the estimated useful lives of the respective assets, except for leasehold improvements, which range from three to seven years. Leasehold improvements are amortized on a straight-line basis over the shorter of the useful life of the improvements or the remaining lease term.

### Business Segments:

The Company views its operations as comprising one operating segment.

### Income Taxes:

The Company is a "C" corporation under the Internal Revenue Code, and thus liable for federal, state, and local taxes on the income derived from its economic interest in its operating company. The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. It has not made a provision for federal or state income taxes because it is the individual responsibility of each of the operating company's members (including the Company) to separately report their proportionate share of the operating company's taxable income or loss. The operating company has made a provision for New York City Unincorporated Business Tax ("UBT") and its consolidated subsidiary Pzena Investment Management, LTD has made a provision for U.K. income taxes. The effective tax rate

for interim periods represents the Company's best estimate of the effective tax rate expected to be applied to the full fiscal year, adjusted for discrete items recognized during the quarter.

Judgment is required in evaluating the Company's uncertain tax positions and determining its provision for income taxes. The Company establishes liabilities for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. These liabilities are established when the Company believes that certain positions might be challenged despite its belief that its tax return positions are in accordance with applicable tax laws. The Company adjusts these liabilities in light of changing facts and circumstances, such as the closing of a tax audit, new tax legislation or the change of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will affect the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the effect of reserve provisions and changes to reserves that are considered appropriate. It is also the Company's

Table of Contents

policy to recognize accrued interest, and penalties associated with uncertain tax positions in Income Tax Expense on the consolidated statements of operations.

The Company and its consolidated subsidiaries account for all U.S. federal, state, local, and U.K. taxation pursuant to the asset and liability method, which requires deferred income tax assets and liabilities to be recorded for temporary differences between the carrying amount and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future, based on enacted tax laws and rates applicable to the periods in which the temporary differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount more-likely-than-not to be realized. At both September 30, 2018 and December 31, 2017, the Company did not have a valuation allowance recorded against its deferred tax assets.

The income tax expense, or benefit, is the tax payable or refundable for the period, plus or minus the change during the period in deferred tax assets and liabilities. The Company records its deferred tax liabilities as a component of other liabilities in the consolidated statements of financial condition. All excess tax benefits or tax deficiencies related to stock- and unit-transactions are reflected in the consolidated statements of operations as a component of the provision for income taxes.

**Tax Receivable Agreement:**

The Company's purchase of membership units of the operating company concurrent with the initial public offering, and the subsequent and future exchanges by holders of Class B units of the operating company for shares of Class A common stock (pursuant to the exchange rights provided for in the operating company's operating agreement), have resulted in, and are expected to continue to result in, increases in the Company's share of the tax basis of the tangible and intangible assets of the operating company, which will increase the tax depreciation and amortization deductions that otherwise would not have been available to the Company. These increases in tax basis and tax depreciation and amortization are each deductible for tax purposes over a period of 15 years and have reduced, and are expected to continue to reduce, the amount of cash taxes that the Company would otherwise be required to pay in the future. The Company has entered into a tax receivable agreement with past, current, and future members of the operating company that requires the Company to pay to any member involved in any exchange transaction 85% of the amount of cash tax savings, if any, in U.S. federal, state and local income tax or foreign or franchise tax that it realizes as a result of these increases in tax basis and, in limited cases, transfers or prior increases in tax basis. The Company expects to benefit from the remaining 15% of cash tax savings, if any, in income tax it realizes. Payments under the tax receivable agreement will be based on the tax reporting positions that the Company will determine. The Company will not be reimbursed for any payments previously made under the tax receivable agreement if a tax basis increase is successfully challenged by the Internal Revenue Service.

The Company records an increase in deferred tax assets for the estimated income tax effects of the increases in tax basis based on enacted federal and state tax rates at the date of the exchange. The Company records 85% of the estimated realizable tax benefit (which is the recorded deferred tax asset less any recorded valuation allowance) as an increase to the liability due under the tax receivable agreement, which is reflected as the liability to selling and converting shareholders in the accompanying consolidated financial statements. The remaining 15% of the estimated realizable tax benefit is initially recorded as an increase to the Company's additional paid-in capital. All of the effects to the deferred tax asset of changes in any of the estimates after the tax year of the exchange will be reflected in the provision for income taxes. Similarly, the effect of subsequent changes in the enacted tax rates will be reflected in the provision for income taxes.

If the Company exercises its right to terminate the tax receivable agreement early, the Company will be obligated to make an early termination payment to the selling and converting shareholders, based upon the net present value (based upon certain assumptions and deemed events set forth in the tax receivable agreement) of all payments that would be required to be paid by the Company under the tax receivable agreement. If certain change of control events were to occur, the Company would be obligated to make an early termination payment.

Foreign Currency:

The functional currency of the Company is the U.S. Dollar. Assets and liabilities of foreign operations whose functional currency is not the U.S. Dollar are translated at the exchange rate in effect at the applicable reporting date, and the consolidated statements of operations are translated at the average exchange rates in effect during the applicable period. A charge or credit is recorded to other comprehensive (loss)/ income to reflect the translation of these amounts to the extent the non-U.S. currency is designated the functional currency of the subsidiary. Non-functional currency related transaction gains and losses are immediately recorded in the consolidated statements of operations. For the three and nine months ended September 30, 2018,



Table of Contents

the Company recorded less than \$0.1 million and \$0.1 million of other comprehensive loss, respectively, associated with foreign currency translation adjustments. For the three and nine months ended September 30, 2017, the Company recorded less than \$0.1 million and \$0.1 million, respectively, of other comprehensive income associated with foreign currency translation adjustments.

Investment securities and other assets and liabilities denominated in foreign currencies are remeasured into U.S. Dollar amounts at the date of valuation. Purchases and sales of investment securities, and income and expense items denominated in foreign currencies, are remeasured into U.S. Dollar amounts on the respective dates of such transactions.

The Company does not isolate the portion of the results of its operations resulting from the impact of fluctuations in foreign exchange rates on its non-U.S. investments. Such fluctuations are included in Net Realized and Unrealized Gains/ (Losses) from Investments in the consolidated statements of operations.

Reported net realized foreign exchange gains or losses arise from sales of foreign currencies, currency gains or losses realized between the trade and settlement dates on securities transactions, and the difference between the amounts of dividends, interest, foreign withholding taxes, and other receivables and payables recorded on the Company's consolidated statements of financial condition and the U.S. Dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the fair values of assets and liabilities resulting from changes in exchange rates.

Recently Issued Accounting Pronouncements Not Yet Adopted:

In September 2018, the FASB issued ASU No. 2018-15, "Intangibles – Goodwill and Other Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract." This new guidance requires a customer in a cloud computing arrangement that is a service contract to follow the internal-use software guidance in ASC 350-40 to determine which implementation costs to capitalize as assets or expense as incurred. The guidance is effective for the fiscal years and interim periods within those years beginning after December 15, 2019. Early adoption is permitted. The Company is currently assessing the impact of this standard, however, does not expect the standard to have a material impact on the consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326)." This new guidance requires the use of an "expected loss" model, rather than an "incurred loss" model, for financial instruments measured at amortized cost and also requires companies to record allowances for available-for-sale debt securities rather than reduce the carrying amount. The guidance is effective for the fiscal years and interim periods within those years beginning after December 15, 2019. The guidance should be applied using a retrospective approach. The Company is currently assessing the impact of this standard, however, does not expect the standard to have a material impact on the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." This amended standard was written to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The new standard requires lessees to recognize a right-of-use asset and lease liability for all leases with terms of more than 12 months. Recognition, measurement and presentation of expenses will depend on classification as a finance or operating lease. The amendments also require certain quantitative and qualitative disclosure. Accounting guidance for lessors is largely unchanged. This guidance is effective for the fiscal years and interim periods within those years beginning after

December 15, 2018 and requires a modified retrospective approach to adoption. The Company is currently evaluating the impact of adoption on its consolidated financial statements. The standard is expected to result in an increase in total assets and total liabilities but will not have a significant impact on the consolidated statement of operations.

Note 3—Compensation and Benefits

Compensation and benefits expense to employees and members is comprised of the following:

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Cash Compensation and Other Benefits	\$13,739	\$11,826	\$40,309	\$36,813
Non-Cash Compensation	2,383	2,937	7,211	7,868
Total Compensation and Benefits Expense	\$16,122	\$14,763	\$47,520	\$44,681

Table of Contents

All non-cash compensation awards granted have varying vesting schedules and are issued at prices equal to the assessed fair market value at the time of issuance, as discussed below. No new non-cash compensation awards were issued during the three months ended September 30, 2018 and 2017. Details of non-cash compensation awards granted during the nine months ended September 30, 2018 and 2017 are as follows:

	For the Nine Months Ended September 30,			
	2018		2017	
	Amount	Fair Value <sup>1</sup>	Amount	Fair Value <sup>1</sup>
Restricted Class B Units	9,372	\$ 10.67	40,500	\$ 11.11
Options to Purchase Shares of Class A Common Stock <sup>2</sup>	—	\$ —	50,000	\$ 3.04
Options to Purchase Delayed Exchange Class B Units <sup>3</sup>	1,380,128	\$ 1.95	2,630,000	\$ 2.30
Options to Purchase Class B Units <sup>2</sup>	—	\$ —	320,000	\$ 3.04

1 Represents the grant date fair value per share, unit, or option.

2 Represents options to purchase shares of Class A common stock or Class B units. These options become exercisable five years from the date of grant.

3 Represents options to purchase Delayed Exchange Class B units issued under 2006 Equity Incentive Plan (as defined below). These options become exercisable five years from the date of grant. Upon exercise, the resulting Delayed Exchange Class B units may not be exchanged pursuant the Amended and Restated Operating Agreement until the seventh anniversary of the exercise date and are not entitled to any benefits under the Tax Receivable Agreement.

As part of the Company's year-end bonus structure, certain employee members may elect to have all or part of year-end cash compensation paid in the form of cash, or equity issued pursuant to Pzena Investment Management, LLC Amended and Restated 2006 Equity Incentive Plan ("the 2006 Equity Incentive Plan"). For the year ended December 31, 2017, \$4.2 million of cash compensation was elected to be paid in the form of equity, which was issued and vested immediately on January 1, 2018. Details of awards associated with these elections issued on January 1, 2018 are as follows:

	January 1, 2018	
	Amount	Fair Value <sup>1</sup>
Options to Purchase Delayed Exchange Class B Units <sup>2</sup>	1,062,820	\$ 1.95
Delayed Exchange Class B Units <sup>3</sup>	300,931	\$ 7.04

1 Represents the grant date fair value per share or unit.

2 Represents phantom Class B units issued under the 2006 Equity Incentive Plan. These phantom units vest ratably over ten years starting immediately and are not entitled to receive dividend or dividend equivalents until vested.

Represents Class B units issued under the 2006 Equity Incentive Plan. These units vest immediately upon grant, but may not be exchanged pursuant to the Amended and Restated Operating Agreement of the operating company until the seventh anniversary of the date of grant. These units are also not entitled to any benefits under the Tax Receivable Agreement between the Company and members of the operating company.

Pursuant to the 2006 Equity Incentive Plan, the operating company issues Class B units, phantom Class B units and options to purchase Class B units. The operating company also issues Delayed Exchange Class B units pursuant to the 2006 Equity Incentive Plan. These Delayed Exchange Class B units vest immediately upon grant, but may not be exchanged pursuant to the Amended and Restated Operating Agreement of the operating company until at least the seventh anniversary of the date of grant. These Delayed Exchange Class B units are also not entitled to any benefit under the Tax Receivable Agreement between the Company and members of the operating company. The operating company also issues phantom Delayed Exchange Class B units and options to purchase Delayed Exchange Class B units. Under the Pzena Investment Management, Inc. 2007 Equity Incentive Plan (“the 2007 Equity Incentive Plan”), the Company issues shares of restricted Class A common stock and contingently vesting options to acquire shares of Class A common stock. During each of the three and nine months ended September 30, 2018 and 2017, no contingently vesting options vested. During the three months ended September 30, 2018 and 2017, 479 and 15,749 Delayed Exchange Class B units were issued to certain employee members, respectively, for approximately less than \$0.1 million and \$0.1 million in cash, respectively. During the nine months ended September 30, 2018 and 2017, 897,515 and 29,426 Delayed Exchange Class B units were issued to certain employee members, respectively, for approximately \$5.2 million and \$0.2 million in cash, respectively.

Under the Pzena Investment Management, LLC Amended and Restated Bonus Plan (the “Bonus Plan”), eligible employees whose compensation is in excess of certain thresholds are required to defer a portion of that excess. These deferred amounts may be invested, at the employee’s discretion, in certain investment options designated by the Compensation Committee of the

Table of Contents

Company's Board of Directors. Amounts deferred in any calendar year reduce that year's compensation expense and are amortized and vest ratably over a four-year period commencing the following year. The Company also issued to certain of its employees deferred compensation with certain investment options that also vest ratably over a four-year period. During the three months ended September 30, 2018, \$0.3 million in deferred compensation investments was forfeited due to an employee departure. As of September 30, 2018 and December 31, 2017, the liability associated with all deferred compensation investment accounts was \$3.5 million and \$0.9 million, respectively.

Pursuant to the Pzena Investment Management, Inc. Non-Employee Director Deferred Compensation Plan (the "Director Plan"), non-employee directors may elect to have all or part of their compensation otherwise payable in cash, deferred in the form of phantom shares of Class A common stock of the Company issued under the 2007 Equity Incentive Plan. Elections to defer compensation under the Director Plan are made on a year-to-year basis. Distributions under the Director Plan are made in a single distribution of shares of Class A common stock at such time as elected by the participant when the deferral was made. Since inception of the Director Plan in 2009, the Company's directors have elected to defer 100% of their compensation in the form of phantom shares of Class A common stock. Amounts deferred in any calendar year are amortized over the calendar year and reflected as General and Administrative Expense. As of September 30, 2018 and December 31, 2017, there were 386,377 and 336,016 phantom shares of Class A common stock outstanding, respectively. For the three and nine months ended September 30, 2018 and 2017, no distributions were made under the Director Plan.

As of September 30, 2018 and December 31, 2017, the Company had approximately \$27.7 million and \$32.6 million, respectively, in unrecorded compensation expense related to unvested awards issued pursuant to its Bonus Plan and certain agreements; Class B units, option grants, Delayed Exchange Class B units, and phantom Class B units issued under the 2006 Equity Incentive Plan; and restricted Class A common stock and contingently vesting option grants issued under the 2007 Equity Incentive Plan. The Company anticipates that this unrecorded cost will amortize over the respective vesting periods of the awards.

Note 4 – Employee Benefit Plans

The operating company has a Profit Sharing and Savings Plan for the benefit of substantially all employees. The Profit Sharing and Savings Plan is a defined contribution profit sharing plan with a 401(k) deferral component. All full-time employees and certain part-time employees who have met the age and length of service requirements are eligible to participate in the plan. The plan allows participating employees to make elective deferrals of compensation up to the annual limits which are set by law. The plan provides for a discretionary annual contribution by the operating company which is determined by a formula based on the salaries of eligible employees as defined by the plan. For the three and nine months ended September 30, 2018, the expense recognized in connection with this plan was \$0.1 million and \$0.9 million, respectively. For the three and nine months ended September 30, 2017, the expense recognized in connection with this plan was \$0.1 million and \$0.9 million, respectively.

Note 5—Earnings per Share

Basic earnings per share is computed by dividing the Company's net income attributable to its common stockholders by the weighted average number of shares outstanding during the reporting period.

Under the two-class method of computing basic earnings per share, basic earnings per share is calculated by dividing net income for basic earnings per share by the weighted average number of common shares outstanding during the period. The two-class method includes an earnings allocation formula that determines earnings per share for each participating security according to dividends declared and undistributed earnings for the period. The Company's net

income for basic earnings per share is reduced by the amount allocated to participating restricted shares of Class A common stock which participate for purposes of calculating earnings per share.

15

---

Table of Contents

For the three and nine months ended September 30, 2018 and 2017, the Company's basic earnings per share was determined as follows:

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
	(in thousands, except share and per share amounts)			
Net Income for Basic Earnings per Share Allocated to:				
Class A Common Stock	\$4,262	\$2,989	\$11,257	\$7,952
Participating Shares of Restricted Class A Common Stock	—	—	—	2
Total Net Income for Basic Earnings per Share	\$4,262	\$2,989	\$11,257	\$7,954
Basic Weighted-Average Shares Outstanding	17,489,380	17,285,307	17,752,788	17,316,392
Add: Participating Shares of Restricted Class A Common Stock <sup>1</sup>	—	—	—	3,556
Total Basic Weighted-Average Shares Outstanding	17,489,380	17,285,307	17,752,788	17,319,948
Basic Earnings per Share	\$0.24	\$0.17	\$0.63	\$0.46

<sup>1</sup> Certain unvested shares of Class A common stock granted to employees have nonforfeitable rights to dividends and therefore participate fully in the results of the Company from the date they are granted. They are included in the computation of basic earnings per share using the two-class method for participating securities.

Diluted earnings per share adjusts this calculation to reflect the impact of all outstanding membership units of the operating company, phantom Class B units, phantom Delayed Exchange Class B units, phantom Class A common stock, outstanding options to purchase Class B units, options to purchase Delayed Exchange Class B units, options to purchase Class A common stock, and restricted Class A common stock, to the extent they would have a dilutive effect on net income per share for the reporting period. Net income for diluted earnings per share assumes that all outstanding operating company membership units are converted into Company stock at the beginning of the reporting period and the resulting change to the Company's net income associated with its increased interest in the operating company is taxed at the Company's effective tax rate, exclusive of one-time charges and adjustments associated with both the valuation allowance and the liability to selling and converting shareholders and other one-time charges.

For the three and nine months ended September 30, 2018 and 2017, the Company's diluted net income was determined as follows:

	For the Three Months		For the Nine Months	
	Ended		Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	(in thousands)			
	\$15,169	\$14,013	\$43,200	\$36,518

Net Income Attributable to Non-Controlling Interests of Pzena Investment Management, LLC				
Less: Assumed Corporate Income Taxes	3,645	5,140	10,424	13,395
Assumed After-Tax Income of Pzena Investment Management, LLC	11,524	8,873	32,776	23,123
Net Income of Pzena Investment Management, Inc.	4,262	2,989	11,257	7,954
Diluted Net Income	\$15,786	\$11,862	\$44,033	\$31,077

Under the two-class method of computing diluted earnings per share, diluted earnings per share is calculated by dividing net income for diluted earnings per share by the weighted average number of common shares outstanding during the period, plus the dilutive effect of any potential common shares outstanding during the period using the more dilutive of the treasury method or two-class method. The two-class method includes an earnings allocation formula that determines earnings per share for each participating security according to dividends declared and undistributed earnings for the period. The Company's net income for diluted earnings per share is reduced by the amount allocated to participating restricted Class B units for purposes of calculating earnings per share. Dividend equivalent distributions paid per share on the operating company's unvested restricted Class B units are equal to the dividends paid per Company Class A common stock.



Table of Contents

For the three and nine months ended September 30, 2018 and 2017, the Company's diluted earnings per share were determined as follows:

	For the Three Months		For the Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
(in thousands, except share and per share amounts)				
<b>Diluted Net Income Allocated to:</b>				
Class A Common Stock	\$15,775	\$11,851	\$44,002	\$31,047
Participating Shares of Restricted Class A Common Stock	—	—	—	2
Participating Class B Units	11	11	31	28
<b>Total Diluted Net Income Attributable to Shareholders</b>	<b>\$15,786</b>	<b>\$11,862</b>	<b>\$44,033</b>	<b>\$31,077</b>
<b>Total Basic Weighted-Average Shares Outstanding</b>	<b>17,489,380</b>	<b>17,285,307</b>	<b>17,752,788</b>	<b>17,319,948</b>
Dilutive Effect of Class B Units	51,930,114	51,123,950	51,537,499	51,108,273
Dilutive Effect of Options <sup>1</sup>	691,159	579,881	1,071,344	474,785
Dilutive Effect of Phantom Class B Units & Phantom Shares of Class A Common Stock	1,461,725	1,636,784	1,463,747	1,808,570
Dilutive Effect of Restricted Shares of Class A Common Stock <sup>2</sup>	56,828	72,405	60,433	69,430
Dilutive Weighted-Average Shares Outstanding	71,629,206	70,698,327	71,885,811	70,781,006
Add: Participating Class B Units <sup>3</sup>	48,600	64,886	48,600	64,886
<b>Total Dilutive Weighted-Average Shares Outstanding</b>	<b>71,677,806</b>	<b>70,763,213</b>	<b>71,934,411</b>	<b>70,845,892</b>
<b>Diluted Earnings per Share</b>	<b>\$0.22</b>	<b>\$0.17</b>	<b>\$0.61</b>	<b>\$0.44</b>

1 Represents the dilutive effect of options to purchase operating company Class B units and Company Class A common stock.

2 Certain restricted shares of Class A common stock granted to employees are not entitled to dividend or dividend equivalent payments until they are vested and are therefore non-participating securities and are not included in the computation of basic earnings per share. They are included in the computation of diluted earnings per share when the effect is dilutive using the treasury stock method.

3 Unvested Class B Units granted to employees have nonforfeitable rights to dividend equivalent distributions and therefore participate fully in the results of the operating company's operations from the date they are granted. They are included in the computation of diluted earnings per share using the two-class method for participating securities. Approximately 0.1 million options to purchase shares of Class A common stock and 2.0 million contingent options to purchase shares of Class A common stock were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2018, as their inclusion would have had an antidilutive effect based on current market prices or because the option had contingent vesting requirements that were not met. Approximately 0.4 million options to purchase Class B units were excluded from the calculation of diluted earnings per share for both the three and nine months ended September 30, 2018 as their inclusion would have had an antidilutive effect based on current market prices. Approximately 0.7 million options to purchase Class B units, 0.1 million options to purchase shares of Class A common stock, and 2.0 million contingent options to purchase shares of Class A common stock were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30,

2017, as their inclusion would have had an antidilutive effect based on current market prices or because the option had contingent vesting requirements that were not met.

Note 6—Shareholders' Equity

The Company functions as the sole managing member of the operating company. As a result, the Company: (i) consolidates the financial results of the operating company and reflects the membership interest in it that it does not own as a non-controlling interest in its consolidated financial statements; and (ii) recognizes income generated from its economic interest in the operating company's net income. Class A and Class B units of the operating company have the same economic rights per unit. As of September 30, 2018, the holders of Class A common stock of the Company and the holders of Class B units of the operating company held approximately 25.0% and 75.0%, respectively, of the economic interests in the operations of the business. As of December 31, 2017, the holders of Class A common stock of the Company and the holders of Class B units of the operating company held approximately 26.3% and 73.7%, respectively, of the economic interests in the operations of the business.

Each Class B unit of the operating company is issued with a corresponding share of the Company's Class B common stock, par value \$0.000001 per share. Holders of Class B common stock have the right to receive the par value of the Class B

Table of Contents

common stock held by them upon our liquidation, dissolution or winding up, but do not share in dividends. Each share of the Company's Class B common stock entitles its holder to five votes, until the first time that the number of shares of Class B common stock outstanding constitutes less than 20% of the number of all shares of the Company's common stock outstanding. From such time and thereafter, each share of the Company's Class B common stock entitles its holder to one vote. When a Class B unit is exchanged for a share of the Company's Class A common stock or forfeited, a corresponding share of the Company's Class B common stock will automatically be redeemed and canceled. Conversely, to the extent that the Company causes the operating company to issue additional Class B units to employees pursuant to its equity incentive plan, these additional holders of Class B units would be entitled to receive a corresponding number of shares of the Company's Class B common stock (including if the Class B units awarded are subject to vesting).

All holders of the Company's Class B common stock have entered into a stockholders' agreement, pursuant to which they agreed to vote all shares of Class B common stock then held by them, with the majority of votes of Class B common stockholders taken in a preliminary vote of the Class B common stockholders.

The outstanding shares of the Company's Class A common stock represent 100% of the rights of the holders of all classes of the Company's capital stock to receive distributions, except that holders of Class B common stock will have the right to receive the class's par value upon the Company's liquidation, dissolution or winding up.

Pursuant to the operating agreement of the operating company, each vested Class B unit is exchangeable for a share of the Company's Class A common stock, subject to certain exchange timing and volume limitations. These acquisitions of additional operating company membership was treated as a reorganization of entities under common control as required by the Business Combinations Topic of the FASB ASC.

The Company's share repurchase program was announced on April 24, 2012. The Board of Directors authorized the Company to repurchase up to an aggregate of \$10 million of the Company's outstanding Class A common stock and the operating company's Class B units on the open market and in private transactions in accordance with applicable securities laws. On February 11, 2014, the Company announced that its Board of Directors approved an increase of \$20 million in the aggregate amount authorized under the program. On April 19, 2018, the Company announced that its Board of Directors approved an additional increase of \$30 million in the aggregate amount authorized under the program. The timing, number and value of common shares and units repurchased are subject to the Company's discretion. The Company's share repurchase program is not subject to an expiration date and may be suspended, discontinued, or modified at any time, for any reason.

During the nine months ended September 30, 2018, the Company purchased and retired 742,255 shares of Class A common stock and 3,870 Class B units under the current repurchase authorization at a weighted average price per share of \$10.10 and \$10.67, respectively. During the nine months ended September 30, 2017, the Company purchased and retired 79,717 shares of Class A common stock and 2,897 Class B units under the repurchase authorization at a weighted average price per unit of \$8.88 and \$11.11, respectively. The Company records the repurchase of shares and units at cost based on the trade date of the transaction.

Note 7—Non-Controlling Interests

Net Income Attributable to Non-Controlling Interests in the operations of the Company's operating company and consolidated subsidiaries is comprised of the following:

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

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Non-Controlling Interests of Pzena Investment Management, LLC	\$15,169	\$14,013	\$43,200	\$36,518
Non-Controlling Interests of Consolidated Subsidiaries	16	215	13	592
Net Income Attributable to Non-Controlling Interests	\$15,185	\$14,228	\$43,213	\$37,110

Distributions to non-controlling interests represent tax allocations and dividend equivalents paid to the members of the operating company, as well as withdrawals from the Company's consolidated subsidiaries. Contributions from non-controlling interests represent contributions to the Company's consolidated subsidiaries.

Table of Contents

## Note 8—Investments

The following is a summary of Investments:

	As of	
	September 30,	December 31,
	2018	2017
	(in thousands)	
<b>Equity Investments, at Fair Value</b>		
Equity Securities	\$6,962	\$ 5,452
Mutual Funds	22,048	—
<b>Total Equity Investments, at Fair Value</b>	<b>29,010</b>	<b>5,452</b>
<b>Trading Securities</b>		
U.S. Treasury Bills	11,662	—
Corporate Bonds	1,289	—
<b>Total Trading Securities</b>	<b>12,951</b>	<b>—</b>
Investments in Equity Method Investees	16,209	16,285
<b>Total</b>	<b>\$58,170</b>	<b>\$ 21,737</b>

## Investment, at Fair Value

Investments, at Fair Value consisted of the following at September 30, 2018:

	Unrealized		
	Cost	Gain/(Loss)	Fair
	(in thousands)		
Equity Securities	\$6,375	\$ 587	\$6,962
Mutual Funds	22,048	—	22,048
<b>Total Equity Investments, at Fair Value</b>	<b>\$28,423</b>	<b>\$ 587</b>	<b>\$29,010</b>

	Unrealized		
	Amortized	Gain/(Loss)	Fair
	Cost		Value
	(in thousands)		
U.S. Treasury Bills	\$11,664	\$ (2 )	\$11,662
Corporate Bonds	1,290	(1 )	1,289
<b>Total Trading Securities</b>	<b>\$12,954</b>	<b>\$ (3 )</b>	<b>\$12,951</b>

Investments, at Fair Value consisted of the following at December 31, 2017:

	Unrealized		Fair
	Cost	Gain/(Loss)	Value
	(in thousands)		
Equity Securities	\$4,399	\$ 1,053	\$5,452
Total Equity Investments, at Fair Value	\$4,399	\$ 1,053	\$5,452

#### Equity Investments, at Fair Value

Equity investments, at fair value consist of equity securities held by the Company's consolidated subsidiaries and individual investments held directly by the Company primarily for the purpose of satisfying certain of the Company's obligations under its deferred compensation program. Equity investments, at fair value also includes investments in open-ended registered mutual funds for which the Company has neither control nor the ability to exercise significant influence. Equity investments are measured at fair value based on quoted market prices or published net asset values.

Table of Contents

Trading Securities

Trading securities consists of fixed income investments held directly by Company. Fixed income investments are carried at fair value based on quoted market prices or market prices obtained from independent pricing services engaged by management.

Investments in Equity Method Investees

The operating company sponsors and provides investment management services to certain private investment partnerships and Pzena mutual funds through which it offers its investment strategies. The Company has made investments in certain of these private investment partnerships and mutual funds to satisfy its obligations under the Company's deferred compensation program and provide the initial cash investment in our mutual funds. The Company holds a non-controlling interest and exercises significant influence in these entities, and accounts for its investments as equity method investments which are included in Equity Method Investments on the consolidated statements of financial condition. As of September 30, 2018, the Company's investments range between 1% and 16% of the capital of these entities and have an aggregate carrying value of \$16.2 million.

Note 9—Fair Value Measurements

The Fair Value Measurements and Disclosures Topic of the FASB ASC defines fair value as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The Fair Value Measurements and Disclosures Topic of the FASB ASC also establishes a framework for measuring fair value and a valuation hierarchy based upon the observability of inputs used in the valuation of an asset or liability. Classification within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The valuation hierarchy contains three levels: (i) valuation inputs are unadjusted quoted market prices for identical assets or liabilities in active markets (Level 1); (ii) valuation inputs are quoted prices for identical assets or liabilities in markets that are not active, quoted market prices for similar assets and liabilities in active markets, and other observable inputs directly or indirectly related to the asset or liability being measured (Level 2); and (iii) valuation inputs are unobservable and significant to the fair value measurement (Level 3).

Level 1 assets consist primarily of cash equivalents and equity investments at fair value. Cash investments in actively traded money market funds are measured at net asset values. Equity securities are exchange-traded securities with quoted prices in active markets. The fair value of investments in mutual funds are based on a published net asset values.

Level 2 assets consist of debt securities for which the fair values are determined using independent third-party broker or dealer price quotes. U.S. Treasury bills are valued upon quoted market prices for similar assets in active markets, quoted prices for identical or similar assets that are not active and inputs other than quoted prices that are observable or corroborated by observable market data. The fair value of corporate bonds is measured using various techniques, which consider recently executed transactions in securities of the issuer or comparable issuers, market price quotations (where observable), bond spreads and fundamental data relating to the issuer.

The investments in equity method investees are held at their carrying value.

The following table presents these instruments' fair value at September 30, 2018:

	Level 1	Level 2	Level 3	Total
	(in thousands)			
<b>Cash Equivalents:</b>				
Money Market Funds	\$7,072	\$—	\$ —	\$7,072
U.S. Treasury Bills	—	2,034	—	2,034
<b>Equity Investments, at Fair Value:</b>				
Equity Securities	6,962	—	—	6,962
Mutual Funds	22,048	—	—	22,048
<b>Trading Securities:</b>				
U.S. Treasury Bills	—	11,662	—	11,662
Corporate Bonds	—	1,289	—	1,289



Table of Contents

The following table presents these instruments' fair value at December 31, 2017:

	Level 1	Level 2	Level 3	Total
	(in thousands)			
Equity Investments, at Fair Value:				
Equity Securities	\$5,452	\$ —	\$ —	\$5,452

Transfers among levels, if any, are recorded as of the beginning of the reporting period. For each of the three and nine months ended September 30, 2018 and 2017, there were no transfers between levels. In addition, the Company did not hold any Level 3 securities as of September 30, 2018 and did not hold any Level 2 or Level 3 securities as of December 31, 2017.

## Note 10—Property and Equipment

Property and Equipment, Net of Accumulated Depreciation is comprised of the following:

	As of	
	September 30,	December 31,
	2018	2017
	(in thousands)	
Leasehold Improvements	\$6,832	\$ 6,832
Furniture and Fixtures	1,191	1,190
Computer Hardware	768	686
Computer Software	370	333
Office Equipment	274	281
Total	9,435	9,322
Less: Accumulated Depreciation and Amortization	(3,804)	(3,063)
Total	\$5,631	\$ 6,259

Depreciation is included in general and administrative expense and totaled approximately \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2018, respectively. For the three and nine months ended September 30, 2017, depreciation totaled approximately \$0.3 million and \$0.8 million, respectively.

## Note 11—Related Party Transactions

For the three months ended September 30, 2018 and 2017, the Company earned \$0.3 million and \$0.1 million, respectively, in investment advisory fees from unconsolidated VIEs that receive investment management services

from the Company. For the nine months ended September 30, 2018 and 2017, the Company earned \$0.8 million and \$0.3 million, respectively, in such fees.

The Company offers loans to employees, excluding executive officers, for the purpose of financing tax obligations associated with compensatory stock and unit vesting. Loans are generally written for a seven-year period, at an interest rate equivalent to the Applicable Federal Rate, payable in annual installments, and collateralized by shares and units held by the employee. As of September 30, 2018 and December 31, 2017, the Company had approximately \$1.0 million and \$1.4 million, respectively, of such loans outstanding.

The operating company, as investment adviser for certain Pzena branded SEC-registered mutual funds, private placement funds, and non-U.S. funds, has contractually agreed to waive a portion or all of its management fees and pay fund expenses to ensure that the annual operating expenses of the funds stay below certain established total expense ratio thresholds. For the three and nine months ended September 30, 2018, the Company recognized \$0.2 million and \$0.8 million of such expenses, respectively. For the three and nine months ended September 30, 2017, the Company recognized \$0.2 million and \$0.8 million of such expenses.

The operating company manages personal funds of certain of the Company's employees, including the CEO, and its two Presidents. The operating company also manages accounts beneficially owned by a private fund in which certain of the Company's executive officers invest. Investments by employees in individual accounts are permitted only at the discretion of

Table of Contents

the executive committee of the operating company, but are generally not subject to the same minimum investment levels that are required of outside investors. The operating company also manages personal funds of some of its employees' family members. Pursuant to the respective investment management agreements, the operating company waives or reduces its regular advisory fees for these accounts and personal funds. In addition, the operating company pays custody and administrative fees for certain of these accounts and personal funds in order to incubate products or preserve performance history. The aggregate value of the fees that the Company waived related to the Company's executive officers, other employees, and family members, was approximately \$0.2 million and \$0.5 million for the three and nine months ended September 30, 2018, respectively. For each of the three and nine months ended September 30, 2017, the Company waived \$0.2 million and \$0.6 million in such fees, respectively.

Note 12—Commitments and Contingencies

In the normal course of business, the Company enters into agreements that include indemnities in favor of third parties, such as engagement letters with advisers and consultants. In certain cases, the Company may have recourse against third parties with respect to these indemnities. The Company maintains insurance policies that may provide coverage against certain claims under these indemnities. The Company has had no claims or payments pursuant to these agreements, and it believes the likelihood of a claim being made is remote. Utilizing the methodology in the Guarantees Topic of the FASB ASC, the Company's estimate of the value of such guarantees is de minimis, therefore, no accrual has been made in the consolidated financial statements.

The Company leases office space under a non-cancelable operating lease agreement, which expires on December 31, 2025. The Company recognizes minimum lease expense for its headquarters on a straight-line basis over the lease term. During the third quarter of 2016, the Company terminated its five-year sublease agreement which commenced on May 1, 2015. The Company entered into a new four-year sublease agreement commencing on October 1, 2016 that is cancelable by either the Company or sublessee given appropriate notice after the thirty-first month following the commencement of the sublease agreement. The sublease agreement is for certain office space associated with the Company's operating lease agreement in its corporate headquarters. Sublease income will continue to decrease annual lease expense by approximately \$0.4 million per year.

During the three and nine months ended September 30, 2018, lease expenses were \$0.5 million and \$1.6 million, respectively, and are included in general and administrative expense. During the three and nine months ended September 30, 2017, lease expenses were \$0.5 million and \$1.6 million, respectively. This lease expense includes expenses associated with the Company's office spaces in the U.K. and Australia. Lease expenses for the three and nine months ended September 30, 2018 were net of \$0.1 million and \$0.3 million of sublease income, respectively. Lease expenses for the three and nine months ended September 30, 2017 were net of \$0.1 million and \$0.3 million of sublease income, respectively.

Note 13—Income Taxes

The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. The operating company has made a provision for New York City Unincorporated Business Tax ("UBT") and its consolidated subsidiary Pzena Investment Management, LTD has made a provision for U.K. income taxes. The Company's provision for income taxes reflects U.S. federal, state, and local incomes taxes on its allocable portion of the operating company's income. The Company's effective tax rate for the nine months ended September 30, 2018 and 2017 was 9.4% and 12.5%, respectively. The effective tax rate includes a rate benefit attributable to the fact that approximately 74.4% and 74.7% of the operating company's earnings were not subject to corporate-level taxes for the nine months ended September 30, 2018 and 2017, respectively. Income before income taxes includes net income

attributable to non-controlling interests and not taxable to the Company, which reduces the effective tax rate.

The Income Taxes Topic of the FASB ASC establishes the minimum threshold for recognizing, and a system for measuring, the benefits of tax return positions in financial statements.

As of September 30, 2018 and December 31, 2017, the Company had \$6.0 million and \$4.7 million in unrecognized tax benefits that, if recognized, would affect the provision for income taxes. During the three months ended September 30, 2018, the Company reversed \$0.5 million of uncertain tax positions liabilities and interest related to unincorporated and other business taxes due to the expiration of the statute of limitations for a prior tax year. As of September 30, 2018 and December 31, 2017, the Company had interest related to unrecognized tax benefits of \$0.7 million and \$0.5 million, respectively. As of September 30, 2018 and December 31, 2017, no penalty accruals were recorded.

Table of Contents

As of September 30, 2018 and December 31, 2017, the net values of all deferred tax assets were approximately \$36.0 million and \$39.6 million, respectively. These deferred tax assets primarily reflect the future tax benefits associated with the Company's initial public offering, and the subsequent and future exchanges by holders of Class B units of the operating company for shares of Class A common stock. At September 30, 2018 and December 31, 2017, the Company did not have a valuation allowance recorded against its deferred tax assets.

Note 14—Subsequent Events

On October 16, 2018, the Company's Board of Directors approved a quarterly dividend of \$0.03 per share of its Class A common stock to be declared on October 18, 2018, that will be paid on November 23, 2018 to holders of record on October 30, 2018.

No other subsequent events necessitated disclosures and/or adjustments.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

We are an investment management firm that utilizes a classic value investment approach across all of our investment strategies. We currently manage assets in a variety of value-oriented investment strategies across a wide range of market capitalizations in both U.S. and non-U.S. capital markets. At September 30, 2018, our assets under management, or AUM, was \$38.9 billion. We manage separate accounts on behalf of institutions, act as sub-investment adviser for a variety of SEC-registered mutual funds and non-U.S. funds, and act as investment adviser for the Pzena mutual funds, private placement funds and non-U.S. funds.

We function as the sole managing member of our operating company, Pzena Investment Management, LLC (the "operating company"). As a result, we: (i) consolidate the financial results of our operating company with our own, and reflect the membership interest in it that we do not own as a non-controlling interest in our consolidated financial statements; and (ii) recognize income generated from our economic interest in our operating company's net income. As of September 30, 2018, the holders of Class A common stock (through the Company) and the holders of Class B units of our operating company held approximately 25.0% and 75.0%, respectively, of the economic interests in the operations of our business.

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

Certain of our named executive officers and employees have interests in Pzena Investment Management, LP and certain estate planning vehicles through which they indirectly own Class B units of our operating company. As of September 30, 2018, through direct and indirect interests, our five named executive officers; 40 other employee members; and certain other members of our operating company, including one of our directors, his related entities, and certain former employees, collectively held 50.3%, 5.2%, and 19.5% of the economic interests in our operating company, respectively.

Net Income

Diluted net income and diluted earnings per share were \$15.8 million and \$0.22, respectively, for the three months ended September 30, 2018, and \$11.9 million and \$0.17, respectively, for the three months ended September 30, 2017. Diluted net income and diluted earnings per share were \$44.0 million and \$0.61, respectively, for the nine months ended September 30, 2018, and \$31.1 million and \$0.44, respectively, for the nine months ended September 30, 2017.

In evaluating our financial condition and results of operations, we also review non-GAAP measures of earnings, which are adjusted to exclude accounting adjustments related to our deferred tax asset generated by the Company's initial public offering and subsequent Class B unit conversions, as well as our tax receivable agreement and the associated liability to our selling and converting shareholders. No such adjustments were made to the GAAP results for the three and nine months ended September 30, 2018 and 2017.

Net income for diluted earnings per share generally assumes all operating company membership units are converted into Company stock at the beginning of the reporting period, and the resulting change to our net income associated with our increased interest in the operating company is taxed at our historical effective tax rate, exclusive of the adjustments related to changes in the valuation allowance recorded against the deferred tax asset and other discrete and permanently non-deductible items. Our effective tax rate was 24.0% and 24.1%, respectively, for the three and

nine months ended September 30, 2018, and 36.7% for the three and nine months ended September 30, 2017. See “Operating Results - Income Tax Expense” below.

## Revenue

We generate revenue primarily from management fees and performance fees, which we collectively refer to as our advisory fees, by managing assets on behalf of our separately managed and sub-advised accounts, as well as our Pzena funds. Our advisory fee income is primarily based on our AUM, as discussed below, and recognized over the period in which investment management services are provided. In accordance with the Revenue Recognition Topic of the Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”), income from performance fees is recorded at the conclusion of the contractual performance period, when it is probable that significant reversal of the performance fee will not occur. Upon adoption of ASU No. 2014-09 on January 1, 2018, advisory fee income also includes fund expense cap reimbursements which are required to be presented net against revenue rather than as a component of general and administrative expense.

## Table of Contents

Our advisory fees are primarily driven by the level of our AUM. Our AUM increases or decreases with the net inflows or outflows of funds into our various investment strategies and with the investment performance thereof. In order to increase our AUM and expand our business, we must develop and market investment strategies that suit the investment needs of our target clients, and provide attractive returns over the long term. The value and composition of our AUM, and our ability to continue to attract clients depends on a variety of factors as described in "Item 1 — Risk Factors — Risks Related to Our Business — Our primary source of revenue is derived from management fees, which are directly tied to the levels of our assets under management. Fluctuations in AUM therefore will directly impact our revenue" of our Annual Report on Form 10-K for the year ended December 31, 2017.

For our separately managed accounts, we are paid fees according to a schedule, which varies by investment strategy. The substantial majority of these accounts pay us management fees pursuant to a schedule by which the rate we earn on the AUM declines as the amount of AUM increases.

Pursuant to our sub-investment advisory agreements with our clients and advisory agreements with Pzena branded funds, we are generally paid a management fee according to a schedule in which the rate we earn on the AUM declines as the amount of AUM increases. Certain of these funds pay us fixed-rate management fees. Due to the substantially larger account size of certain of these accounts, the average advisory fees we earn on them, as a percentage of AUM, are lower than the advisory fees we earn on our separately managed accounts.

Advisory fees we earn on separately managed accounts are generally based on the value of AUM at a specific date on a quarterly basis. Certain of our separately managed accounts, and all of our sub-advised accounts, are calculated based on the average of the monthly or daily market value. Advisory fees are also generally adjusted for any cash flows into or out of a portfolio, where the cash flow represents greater than 10% of the value of the portfolio. While a specific group of accounts may use the same fee rate, the calculation methodology may differ as described above.

Certain of our clients pay us performance fees according to the performance of their accounts relative to certain agreed-upon benchmarks, which results in a lower base fee, but allows for us to earn higher fees if the relevant investment strategy outperforms the agreed-upon benchmark. Some performance-based fee arrangements include high-water mark provisions, which generally provide that if a client account underperforms relative to its performance target, it must gain back such underperformance before we can collect future performance-based fees. Fulcrum fee arrangements require a reduction in the base fee, or allow for a performance fee if the relevant investment strategy underperforms or outperforms, respectively, the agreed-upon benchmark.

Our advisory fees may fluctuate based on a number of factors, including the following:

- changes in AUM due to appreciation or depreciation of our investment portfolios, and the levels of the contribution and withdrawal of assets by new and existing clients;
- distribution of AUM among our investment strategies, which have differing fee schedules;
- distribution of AUM between separately managed accounts and sub-advised accounts, for which we generally earn lower overall advisory fees; and
- the level of our performance with respect to accounts on which we are paid performance fees or have fulcrum fee arrangements.

### Expenses

Our expenses consist primarily of Compensation and Benefits Expense, as well as General and Administrative Expense. Our largest expense is Compensation and Benefits, which includes the salaries, bonuses, equity-based compensation, and related benefits and payroll costs attributable to our employee members and



employees. Compensation and benefits packages are benchmarked against relevant industry and geographic peer groups in order to attract and retain qualified personnel. General and Administrative Expense includes lease expenses, professional and outside services fees, depreciation, the costs associated with operating and maintaining our research, trading and portfolio accounting systems, the costs associated with being a public company, and other expenses. Our occupancy-related costs and professional services expenses, in particular, generally increase or decrease in relative proportion to the overall size and scale of our business operations.

## Table of Contents

Our expenses may fluctuate due to a number of factors, including the following:

- variations in the level of total compensation expense due to, among other things, bonuses, awards of equity to our employees and employee members of our operating company, changes in our employee count and mix, and competitive factors; and
- general and administrative expenses, such as rent, professional service fees and data-related costs, incurred, as necessary, to run our business.

### Other Income

Other Income is derived primarily from investment income or loss arising from our consolidated subsidiaries, income or loss generated by our investments, and interest income generated on our cash balances. Other Income is also affected by changes in our estimates of the liability due to our selling and converting shareholders associated with payments owed to them under the tax receivable agreement, which was executed in connection with our reorganization and initial public offering on October 30, 2007. As discussed further below under “Tax Receivable Agreement,” this liability represents 85% of the amount of cash savings, if any, in U.S. federal, state, and local income tax that we realize as a result of the amortization of the increases in tax basis generated from our acquisitions of our operating company’s units from our selling and converting shareholders. We expect the interest and investment components of Other Income, in the aggregate, to fluctuate based on market conditions and the performance of our consolidated entities and other investments.

### Non-Controlling Interests

We are the sole managing member of our operating company and control its business and affairs and, therefore, consolidate its financial results with ours. In light of our employees’ and outside investors’ direct and indirect interests in our operating company, we have reflected their membership interests as non-controlling interest in our consolidated financial statements. As of September 30, 2018, the holders of Class A common stock of the Company and the holders of Class B units of the operating company held approximately 25.0% and 75.0%, respectively, of the economic interests in the operations of the business. In addition, our operating company consolidates the results of operations of the private investment partnerships over which we exercise a controlling influence. Non-controlling interests recorded in our consolidated financial statements include the non-controlling interests of the outside investors in these consolidated subsidiaries.

### Operating Results

#### Assets Under Management and Flows

As of September 30, 2018 and 2017, our AUM of approximately \$38.9 billion and \$35.4 billion, respectively, was invested in a variety of value-oriented investment strategies, representing distinct capitalization segments of U.S. and non-U.S. equity markets. The assets under management and performance of our largest investment strategies as of September 30, 2018 are further described below. We follow the same investment process for each of these strategies. Our investment strategies are distinguished by the market capitalization ranges from which we select securities for their portfolios, which we refer to as each strategy’s investment universe, as well as the regions in which we invest and the degree to which we concentrate on a limited number of holdings. While our investment process includes ongoing review of companies in the investment universes described below, our actual investments may include companies outside of the relevant market capitalization range at the time of our investment. In addition, the number of holdings typically found in the portfolios of each of our investment strategies may vary, as described below.



Table of Contents

The following tables describe the allocation of our AUM among our investment strategies and the domicile of our accounts, as of September 30, 2018 and 2017:

Strategy	AUM at September 30, 2018 2017 (in billions)	
	<b>U.S. Value Strategies</b>	
Large Cap Value	\$10.8	\$10.5
Mid Cap Value	2.9	2.7
Value	2.2	2.1
Small Cap Value	1.6	1.6
Other U.S. Strategies	0.2	0.1
<b>Total U.S. Value Strategies</b>	<b>17.7</b>	<b>17.0</b>
<b>Global and Non-U.S. Value Strategies</b>		
International Value	6.7	5.8
Global Value	6.6	5.6
Emerging Markets Value	4.1	3.8
European Value	3.5	3.1
Other Global and Non-U.S. Strategies	0.3	0.1
<b>Total Global and Non-U.S. Value Strategies</b>	<b>21.2</b>	<b>18.4</b>
<b>Total</b>	<b>\$38.9</b>	<b>\$35.4</b>

Account Domicile	AUM at September 30, 2018 2017 (in billions)	
	U.S.	\$26.7
Non-U.S.	12.2	11.5
<b>Total</b>	<b>\$38.9</b>	<b>\$35.4</b>

Table of Contents

The following table indicates the annualized returns, gross and net (which represents annualized returns prior to, and after, payment of advisory fees, respectively), of our largest investment strategies from their inception to September 30, 2018, and in the five-year, three-year, and one-year periods ended September 30, 2018, as well as the performance of the market index which is most commonly used by our clients to compare the performance of the relevant investment strategy.

Investment Strategy (Inception Date)	Period Ended September 30, 2018 <sup>1</sup>			
	Inception	5 Years	3 Years	1 Year
<b>Large Cap Value (July 2012)</b>				
Annualized Gross Returns	14.9%	11.6 %	15.3 %	9.3 %
Annualized Net Returns	14.7%	11.5 %	15.1 %	9.1 %
Russell 1000 <sup>®</sup> Value Index	13.2%	10.7 %	13.6 %	9.5 %
<b>International Value (November 2008)</b>				
Annualized Gross Returns	10.9%	5.5 %	10.8 %	4.1 %
Annualized Net Returns	10.6%	5.1 %	10.4 %	3.8 %
MSCI EAFE <sup>®</sup> Index—Net/U.S.\$	7.8 %	4.4 %	9.2 %	2.7 %
<b>Large Cap Focused Value (October 2000)</b>				
Annualized Gross Returns	7.7 %	11.4 %	15.5 %	7.6 %
Annualized Net Returns	7.2 %	10.9 %	15.0 %	7.2 %
Russell 1000 <sup>®</sup> Value Index	7.0 %	10.7 %	13.6 %	9.5 %
<b>Emerging Markets Focused Value (January 2008)</b>				
Annualized Gross Returns	3.5 %	4.4 %	16.0 %	1.6 %
Annualized Net Returns	2.6 %	3.6 %	15.2 %	0.9 %
MSCI <sup>®</sup> Emerging Markets Index—Net/U.S.\$	0.8 %	3.6 %	12.4 %	-0.8 %
<b>European Focused Value (August 2008)</b>				
Annualized Gross Returns	5.9 %	4.4 %	9.8 %	0.3 %
Annualized Net Returns	5.5 %	4.0 %	9.4 %	-0.1 %
MSCI <sup>®</sup> Europe Index – Net/U.S.\$	2.7 %	3.7 %	7.7 %	-0.3 %
<b>Global Value (January 2010)</b>				
Annualized Gross Returns	9.2 %	8.2 %	12.6 %	5.5 %
Annualized Net Returns	8.9 %	7.8 %	12.2 %	5.2 %
MSCI <sup>®</sup> World Index – Net/U.S.\$	9.6 %	9.3 %	13.5 %	11.2 %
<b>Mid Cap Value (April 2014)</b>				
Annualized Gross Returns	9.0 %	N/A	14.2 %	4.9 %
Annualized Net Returns	8.7 %	N/A	13.9 %	4.6 %
Russell Mid Cap <sup>®</sup> Value Index	8.7 %	N/A	13.1 %	8.8 %
<b>Global Focused Value (January 2004)</b>				
Annualized Gross Returns	6.0 %	7.8 %	12.6 %	4.6 %
Annualized Net Returns	5.3 %	7.1 %	11.9 %	4.0 %
MSCI <sup>®</sup> All Country World Index – Net/U.S.\$	7.3 %	8.7 %	13.4 %	9.8 %
<b>Focused Value (January 1996)</b>				
Annualized Gross Returns	10.9%	10.9 %	14.4 %	4.9 %

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

Annualized Net Returns	10.1%	10.3 %	13.9 %	4.5 %
Russell 1000 <sup>®</sup> Value Index	9.0 %	10.7 %	13.6 %	9.5 %
Small Cap Focused Value (January 1996)				
Annualized Gross Returns	14.0%	12.6 %	16.6 %	9.7 %
Annualized Net Returns	12.8%	11.5 %	15.4 %	8.6 %
Russell 2000 <sup>®</sup> Value Index	10.1%	9.9 %	16.1 %	9.3 %
International Focused Value (January 2004)				
Annualized Gross Returns	6.9 %	5.8 %	11.9 %	4.4 %
Annualized Net Returns	6.1 %	5.2 %	11.3 %	3.8 %
MSCI <sup>®</sup> All Country World ex-U.S. Index – Net/U.S.\$	6.2 %	4.1 %	10.0 %	1.8 %
Mid Cap Focused Value (September 1998)				

Table of Contents

Annualized Gross Returns	12.9%	11.0%	15.0%	5.5%
Annualized Net Returns	12.1%	10.3%	14.3%	4.9%
Russell Mid Cap <sup>®</sup> Value Index	10.5%	10.7%	13.1%	8.8%

<sup>1</sup>The historical returns of these investment strategies are not necessarily indicative of their future performance, or the future performance of any of our other current or future investment strategies.

<sup>2</sup>Net of applicable withholding taxes and presented in U.S. Dollars

**Large Cap Value.** This strategy reflects a portfolio composed of approximately 50 to 80 stocks drawn from a universe of 500 of the largest U.S. listed companies, based on market capitalization. This strategy was launched in July 2012. At September 30, 2018, the Large Cap Value strategy generated a one-year annualized gross return of 9.3%, underperforming its benchmark. The top detracting sector was the financial services sector, partially offset by the performance of the consumer staples sector.

**International Value.** This strategy reflects a portfolio composed of approximately 60 to 80 stocks drawn from a universe of 1,500 of the largest companies across the world excluding the United States, based on market capitalization. This strategy was launched in November 2008. At September 30, 2018, the International Value strategy generated a one-year annualized gross return of 4.1%, outperforming its benchmark. The top contributing sectors included energy, consumer discretionary and information technology, partially offset by the performance of the industrials and financial services sectors.

**Large Cap Focused Value.** This strategy reflects a portfolio composed of approximately 30 to 40 stocks drawn from a universe of 500 of the largest U.S. listed companies, based on market capitalization. This strategy was launched in October 2000. At September 30, 2018, the Large Cap Focused Value strategy generated a one-year annualized gross return of 7.6%, underperforming its benchmark. The top detracting sector was the financial services sector, partially offset by our lack of exposure to the consumer staples sector.

**Emerging Markets Focused Value.** This strategy reflects a portfolio composed of approximately 40 to 80 stocks drawn from a universe of 1,500 of the largest emerging market companies, based on market capitalization. This strategy was launched in January 2008. At September 30, 2018, the Emerging Markets Focused Value strategy generated a one-year annualized gross return of 1.6%, outperforming its benchmark. The top contributing sectors were the energy and information technology sectors.

**European Focused Value.** This strategy reflects a portfolio composed of approximately 40 to 50 stocks drawn from a universe of 750 of the largest European companies, based on market capitalization. This strategy was launched in August 2008. At September 30, 2018, the European Focused Value strategy generated a one-year annualized gross return of 0.3%, outperforming its benchmark. This outperformance was driven by the energy and information technology sectors as well as the performance of certain German stocks, partially offset by the performance of the industrials and financial services sectors.

**Global Value.** This strategy reflects a portfolio composed of approximately 60 to 95 stocks drawn from a universe of 2,000 of the largest companies across the world, based on market capitalization. This strategy was launched in January 2010. At September 30, 2018, the Global Value strategy generated a one-year annualized gross return of 5.5%, underperforming its benchmark. The top detracting sectors were the information technology, financial services, consumer discretionary, and industrials sectors, partially offset by the performance of the consumer staples sector.

Mid Cap Value. This strategy reflects a portfolio composed of approximately 50 to 80 stocks drawn from a universe of U.S. listed companies ranked from the 201st to 1,200th largest, based on market capitalization. This strategy was launched in April 2014. At September 30, 2018, the Mid Cap Value strategy generated a one-year annualized gross return of 4.9%, underperforming its benchmark. The top detracting sectors were the health care and materials and processing sectors.

Global Focused Value. This strategy reflects a portfolio composed of approximately 40 to 60 stocks drawn from a universe of 2,000 of the largest companies across the world, based on market capitalization. This strategy was launched in January 2004. At September 30, 2018, the Global Focused Value strategy generated a one-year annualized gross return of 4.6%, underperforming its benchmark. The top detracting sectors were the financial services, information technology, consumer discretionary, health care and industrials sectors, partially offset by the performance of the consumer staples sector.

Focused Value. This strategy reflects a portfolio composed of a portfolio of approximately 30 to 40 stocks drawn from a universe of 1,000 of the largest U.S. listed companies, based on market capitalization. This strategy was launched in January 1996. At September 30, 2018, the Focused Value strategy generated a one-year annualized gross return of 4.9%, underperforming its benchmark. The top detracting sectors were the financial services, health care and consumer discretionary sectors, partially offset by our lack of exposure to the consumer staples sector.



Table of Contents

Small Cap Focused Value. This strategy reflects a portfolio composed of approximately 40 to 50 stocks drawn from a universe of U.S. listed companies ranked from the 1,001st to 3,000th largest, based on market capitalization. This strategy was launched in January 1996. At September 30, 2018, the Small Cap Focused Value strategy generated a one-year annualized gross return of 9.7%, outperforming its benchmark. The top contributing sectors were the financial services and producer durables sectors, partially offset by the performance of the technology and health care sectors.

International Focused Value. This strategy reflects a portfolio composed of approximately 30 to 50 stocks drawn from a universe of 1,500 of the largest companies across the world excluding the United States, based on market capitalization. This strategy was launched in January 2004. At September 30, 2018, the International Focused Value strategy generated a one-year annualized gross return of 4.4%, outperforming its benchmark. The top contributing sectors were the information technology, energy and consumer staples sector, partially offset by the performance of the industrials and financial services sectors.

Mid Cap Focused Value. This strategy reflects a portfolio composed of approximately 30 to 40 stocks drawn from a universe of U.S. listed companies ranked from the 201st to 1,200th largest, based on market capitalization. This strategy was launched in September 1998. At September 30, 2018, the Mid Cap Focused Value strategy generated a one-year annualized gross return of 5.5%, underperforming its benchmark. The top detracting sectors were the materials and processing and health care sectors.

Our earnings and cash flows are heavily dependent upon prevailing financial market conditions. Significant increases or decreases in the various securities markets, particularly the equities markets, can have a material impact on our results of operations, financial condition, and cash flows.

Table of Contents

The change in AUM in our separately managed accounts, sub-advised accounts, and Pzena funds for the three and nine months ended September 30, 2018 and 2017 is described below. Inflows are composed of the investment of new or additional assets by new or existing clients. Outflows consist of redemptions of assets by existing clients.

Assets Under Management (\$ billions)	For the Three Months		For the Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
<b>Separately Managed Accounts</b>				
Assets				
Beginning of Period	\$ 13.8	\$ 13.8	\$ 15.0	\$ 12.5
Inflows	0.8	0.1	1.5	1.1
Outflows	(0.3 )	(0.3 )	(1.7 )	(1.2 )
Net Flows	0.5	(0.2 )	(0.2 )	(0.1 )
Market Appreciation/(Depreciation)	0.3	0.7	(0.2 )	1.9
End of Period	\$ 14.6	\$ 14.3	\$ 14.6	\$ 14.3
<b>Sub-Advised Accounts</b>				
Assets				
Beginning of Period	\$ 21.2	\$ 18.2	\$ 21.8	\$ 16.3
Inflows	1.0	0.8	2.4	2.2
Outflows	(0.5 )	(0.3 )	(1.8 )	(1.0 )
Net Flows	0.5	0.5	0.6	1.2
Market Appreciation/(Depreciation)	0.5	1.0	(0.2 )	2.2
End of Period	\$ 22.2	\$ 19.7	\$ 22.2	\$ 19.7
<b>Pzena Funds</b>				
Assets				
Beginning of Period	\$ 1.9	\$ 1.5	\$ 1.7	\$ 1.2
Inflows	0.2	—	0.5	0.2
Outflows	(0.1 )	(0.1 )	(0.1 )	(0.3 )
Net Flows	0.1	(0.1 )	0.4	(0.1 )
Market Appreciation/(Depreciation)	0.1	—	—	0.3
End of Period	\$ 2.1	\$ 1.4	\$ 2.1	\$ 1.4
<b>Total</b>				
Assets				
Beginning of Period	\$ 36.9	\$ 33.5	\$ 38.5	\$ 30.0
Inflows	2.0	0.9	4.4	3.5
Outflows	(0.9 )	(0.7 )	(3.6 )	(2.5 )
Net Flows	1.1	0.2	0.8	1.0

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

Market Appreciation/(Depreciation)	0.9	1.7	(0.4 )	4.4
End of Period	\$38.9	\$35.4	\$38.9	\$35.4

Three Months Ended September 30, 2018 and September 30, 2017

At September 30, 2018, we managed \$14.6 billion in separately managed accounts, \$22.2 billion in sub-advised accounts, and \$2.1 billion in Pzena funds, for a total of \$38.9 billion in assets under management. For the three months ended September 30, 2018, we experienced total gross inflows of \$2.0 billion and market appreciation of \$0.9 billion, partially offset by total gross outflows of \$0.9 billion. Assets in separately managed accounts increased by \$0.8 billion, or 5.8%, from \$13.8 billion at June 30, 2018, due to \$0.8 billion in gross inflows and \$0.3 billion in market appreciation, partially offset by \$0.3 billion in gross outflows. Assets in sub-advised accounts increased by \$1.0 billion, or 4.7%, from \$21.2 billion at June 30,

Table of Contents

2018, due to \$1.0 billion in gross inflows and \$0.5 billion in market appreciation, partially offset by \$0.5 billion in gross outflows. Assets in Pzena funds increased by \$0.2 billion, or 10.5%, from \$1.9 billion at June 30, 2018, due to \$0.2 billion in gross inflows and \$0.1 in market appreciation, partially offset by \$0.1 billion in gross outflows.

At September 30, 2017, we managed \$14.3 billion in separately managed accounts, \$19.7 billion in sub-advised accounts, and \$1.4 billion in Pzena funds, for a total of \$35.4 billion in assets under management. For the three months ended September 30, 2017, we experienced market appreciation of \$1.7 billion and total gross inflows of \$0.9 billion, partially offset by total gross outflows of \$0.7 billion. Assets in separately managed accounts increased by \$0.5 billion, or 3.6%, from \$13.8 billion at June 30, 2017, due to \$0.7 billion in market appreciation and \$0.1 billion in gross inflows, partially offset by \$0.3 billion in gross outflows. Assets in sub-advised accounts increased by \$1.5 billion, or 8.2%, from \$18.2 billion at June 30, 2017, due to \$1.0 billion in market appreciation and \$0.8 billion in gross inflows, partially offset by \$0.3 billion in gross outflows. Assets in Pzena funds decreased by \$0.1 billion, or 6.7%, from \$1.5 billion at June 30, 2017 due to \$0.1 billion in gross outflows.

#### Nine Months Ended September 30, 2018 and September 30, 2017

For the nine months ended September 30, 2018, we experienced total gross inflows of \$4.4 billion, which were partially offset by total gross outflows of \$3.6 billion and market depreciation of \$0.4 billion. Assets in separately managed accounts decreased by \$0.4 billion, or 2.7%, from \$15.0 billion at December 31, 2017 due to \$1.7 billion in gross outflows and \$0.2 billion in market depreciation, partially offset by \$1.5 billion in gross inflows. Assets in sub-advised accounts increased by \$0.4 billion, or 1.8%, from \$21.8 billion at December 31, 2017 due to \$2.4 billion in gross inflows, partially offset by \$1.8 billion in gross outflows and \$0.2 billion in market depreciation. Assets in Pzena funds increased by \$0.4 billion, or 23.5%, from \$1.7 billion at December 31, 2017 due to \$0.5 billion in gross inflows, partially offset by \$0.1 billion in gross outflows.

For the nine months ended September 30, 2017, we experienced market appreciation of \$4.4 billion and total gross inflows of \$3.5 billion, which were partially offset by total gross outflows of \$2.5 billion. Assets in separately managed accounts increased by \$1.8 billion, or 14.4%, from \$12.5 billion at December 31, 2016 due to \$1.9 billion in market appreciation and \$1.1 billion in gross inflows, partially offset by \$1.2 billion in gross outflows. Assets in sub-advised accounts increased by \$3.4 billion, or 20.9%, from \$16.3 billion at December 31, 2016 due to \$2.2 billion in gross inflows and \$2.2 billion in market appreciation, partially offset by \$1.0 billion in gross outflows. Assets in Pzena funds increased by \$0.2 billion, or 16.7%, from \$1.2 billion at December 31, 2016 due to \$0.3 billion in market appreciation and \$0.2 billion in gross inflows, partially offset by \$0.3 billion in gross outflows.

#### Revenue

Our revenue from advisory fees earned on our separately managed accounts, sub-advised accounts, and Pzena funds for the three and nine months ended September 30, 2018 and 2017 is described below:

	For the Three Months		For the Nine Months	
	Ended		Ended	
Revenue	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017

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

	(in thousands)			
Separately Managed Accounts	\$19,578	\$19,756	\$58,820	\$56,003
Sub-Advised Accounts	16,616	14,073	49,323	39,437
Pzena Funds	3,386	2,400	9,037	6,946
Total	\$39,580	\$36,229	\$117,180	\$102,386

Three Months Ended September 30, 2018 and September 30, 2017

Our total revenue increased by \$3.4 million, or 9.2%, to \$39.6 million for the three months ended September 30, 2018, from \$36.2 million for the three months ended September 30, 2017. This change was driven primarily by an increase in our average AUM due to net inflows and market appreciation. Average AUM increased 11.3% to \$38.3 billion from \$34.4 billion for the three months ended September 30, 2018 and 2017, respectively. We recognized \$0.8 million in performance fees during the three months ended September 30, 2018. We recognized \$0.9 million in performance fees during the three months ended September 30, 2017.

Table of Contents

Our weighted average fees were 0.413% and 0.421% for the three months ended September 30, 2018 and 2017, respectively.

Average assets in separately managed accounts increased \$0.3 billion to \$14.3 billion for the three months ended September 30, 2018, from \$14.0 billion for the three months ended September 30, 2017, and had weighted average fees of 0.547% and 0.563% for the three months ended September 30, 2018 and 2017, respectively. The decrease in weighted average fee rate for separately managed accounts reflects a decrease in performance fees recognized and an increase in large client relationships that generally carry lower fee rates.

Average assets in sub-advised accounts increased \$3.1 billion to \$22.0 billion for the three months ended September 30, 2018, from \$18.9 billion for the three months ended September 30, 2017, and had weighted average fees of 0.302% and 0.298% for the three months ended September 30, 2018 and 2017, respectively.

Average assets in Pzena funds increased \$0.5 billion to \$2.0 billion for the three months ended September 30, 2018, from \$1.5 billion for the three months ended September 30, 2017, and had weighted average fees of 0.668% and 0.660% for the three months ended September 30, 2018 and 2017, respectively. The increase in weighted average fee rate for Pzena funds reflects an increase in assets in strategies that generally carry higher fees rates. This increase was partially offset by the adoption of the new revenue recognition standard, which requires fund expense cap reimbursements to be presented net against revenue. The Company adopted the new revenue recognition standard as of January 1, 2018 using a modified retrospective approach, and thus prior periods have not been restated. Excluding the impact of the revenue recognition presentation change, the weighted average fee rate for Pzena funds was 0.703% for the three months ended September 30, 2018, increasing from 0.660% for the three months ended September 30, 2017.

Nine Months Ended September 30, 2018 and September 30, 2017

Our total revenue increased by \$14.8 million, or 14.4%, to \$117.2 million for the nine months ended September 30, 2018, from \$102.4 million for the nine months ended September 30, 2017. This change was driven primarily by an increase in our average AUM due to market appreciation and net inflows. Average AUM increased 17.4% to \$38.5 billion from \$32.8 billion for the nine months ended September 30, 2018 and 2017, respectively.

Our weighted average fees were 0.406% and 0.416% for the nine months ended September 30, 2018 and 2017, respectively.

Average assets in separately managed accounts increased \$1.2 billion to \$14.6 billion for the nine months ended September 30, 2018, from \$13.4 billion for the nine months ended September 30, 2017, and had weighted average fees of 0.536% and 0.555% for the nine months ended September 30, 2018 and 2017, respectively.

Average assets in sub-advised accounts increased \$3.9 billion to \$21.9 billion for the nine months ended September 30, 2018, from \$18.0 billion for the nine months ended September 30, 2017, and had weighted average fees of 0.300% and 0.293% for the nine months ended September 30, 2018 and 2017, respectively.

Average assets in Pzena funds increased \$0.5 billion to \$1.9 billion for the nine months ended September 30, 2018, from \$1.4 billion for the nine months ended September 30, 2017, and had weighted average fees of 0.628% and 0.665% for the nine months ended September 30, 2018 and 2017, respectively. The decrease in Pzena funds weighted average fee rate reflects the adoption of the new revenue recognition standard, which requires fund expense cap reimbursements to be presented net against revenue. The Company adopted the new revenue recognition standard as

of January 1, 2018 using a modified retrospective approach, and thus prior periods have not been restated. Excluding the impact of the revenue recognition presentation change, the weighted average fee rate for Pzena funds was 0.676% for the nine months ended September 30, 2018.

Table of Contents

## Expenses

Our operating expenses are driven primarily by our compensation and benefits costs. The table below describes the components of our operating expenses for the three and nine months ended September 30, 2018 and 2017.

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Cash Compensation and Other Benefits	\$ 13,739	\$ 11,826	\$ 40,309	\$ 36,813
Other Non-Cash Compensation	2,383	2,937	7,211	7,868
Total Compensation and Benefits Expense	16,122	14,763	47,520	44,681
General and Administrative Expense	3,322	3,062	9,856	9,585
Total Operating Expenses	\$ 19,444	\$ 17,825	\$ 57,376	\$ 54,266

## Three Months Ended September 30, 2018 and September 30, 2017

Total operating expenses increased by \$1.6 million, or 9.1%, to \$19.4 million for the three months ended September 30, 2018, from \$17.8 million for the three months ended September 30, 2017. This increase reflects an increase in compensation and benefits expense and an increase in general and administrative expense.

Compensation and benefits expense increased by approximately \$1.4 million, or 9.2%, to \$16.1 million for the three months ended September 30, 2018, from \$14.8 million for the three months ended September 30, 2017. This increase reflects an increase in compensation rates. The decrease in non-cash compensation expense reflects the acceleration of deferred compensation associated with employee departures during the three months ended September 30, 2017 that did not recur during the three months ended September 30, 2018.

General and administrative expense increased by \$0.3 million, or 8.5%, to \$3.3 million for the three months ended September 30, 2018 from \$3.1 million for the three months ended September 30, 2017. The increase in general and administrative expense reflects an increase in business activities.

## Nine Months Ended September 30, 2018 and September 30, 2017

Total operating expenses increased by \$3.1 million, or 5.7%, to \$57.4 million for the nine months ended September 30, 2018, from \$54.3 million for the nine months ended September 30, 2017. This increase was attributable to an increase in our compensation and benefits expense and an increase in general and administrative expense.

Compensation and benefits expense increased by approximately \$2.8 million, or 6.4%, to \$47.5 million for the nine months ended September 30, 2018, from \$44.7 million for the nine months ended September 30, 2017. This increase reflects an increase in compensation rates. The decrease in non-cash compensation expense reflects the acceleration of



deferred compensation associated with employee departures during the nine months ended September 30, 2017 that did not recur during the nine months ended September 30, 2018.

General and administrative expense increased by \$0.3 million, or 2.8%, to \$9.9 million for the nine months ended September 30, 2018, from \$9.6 million for the nine months ended September 30, 2017. The increase in general and administrative expense reflects an increase in business activities.

#### Other Income

##### Three Months Ended September 30, 2018 and September 30, 2017

Other Income was \$0.6 million for the three months ended September 30, 2018, and consisted primarily of \$0.2 million in interest income, \$0.2 million in equity in the earnings of affiliates, and \$0.1 million in income related to net realized and unrealized gains from investments. Other Income was \$1.3 million for the three months ended September 30, 2017, and consisted primarily of \$0.6 million in income related to net realized and unrealized gains from investments, \$0.4 million in equity in the earnings of affiliates, \$0.1 million in dividend income, and \$0.1 million in interest income.

Table of Contents

## Nine Months Ended September 30, 2018 and September 30, 2017

Other Income was \$0.3 million for the nine months ended September 30, 2018, and consisted primarily of \$0.4 million in interest income and \$0.1 million in dividend income, partially offset by \$0.1 million in equity in the losses of affiliates and \$0.1 million in expense related to net realized and unrealized losses from investments. Other Income was \$3.4 million for the nine months ended September 30, 2017, and consisted primarily of \$1.7 million in income related to net realized and unrealized gains from investments, \$1.1 million in equity in the earnings of affiliates, \$0.3 million in dividend income, and \$0.1 million in interest income.

## Income Tax Expense

For the three and nine months ended September 30, 2018 and 2017, components of our income tax expense are as follows:

	For the Three Months		For the Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Unincorporated and Other Business Tax Expenses	\$427	\$747	\$2,003	\$2,047
Total Corporate Tax Expense	867	1,746	3,674	4,413
Total Income Tax Expense	\$1,294	\$2,493	\$5,677	\$6,460

The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. The operating company has made a provision for New York City Unincorporated Business Tax ("UBT") and its consolidated subsidiary Pzena Investment Management, LTD has made a provision for U.K. income taxes. The Company's provision for income taxes reflects its U.S. federal, state, and local incomes taxes on its allocable portion of the operating company's income. The effective tax rate includes a rate benefit attributable to the fact that approximately 74.4% and 74.7% of the operating company's earnings were not subject to corporate-level taxes for the nine months ended September 30, 2018 and 2017, respectively. Income before income taxes includes net income attributable to non-controlling interests and not taxable to the Company, which reduces the effective tax rate. This favorable impact is partially offset by the impact of certain permanently non-deductible items. These factors are expected to continue to impact the effective tax rate for future years, although as the Company's economic interest in the operating company increases, the effective tax rate will likewise increase as more income will be subject to corporate-level taxes. The effective tax rate will also be affected by the discrete tax impact of future dividends on unvested share-based awards and future vesting of restricted share-based awards based on fluctuations in the trading price of the Company's Class A common stock between grant date and vesting date.

Excluding discrete and permanently non-deductible items, which includes the net income attributable to non-controlling interest, the Company's effective tax rate was 24.0% and 24.1%, respectively, for the three and nine months ended September 30, 2018, and 36.7% for both the three and nine months ended September 30, 2017.

Three Months Ended September 30, 2018 and September 30, 2017

Income Tax Expense was \$1.3 million for the three months ended September 30, 2018 and \$2.5 million for the three months ended September 30, 2017. Income tax expense for the three months ended September 30, 2018 consisted of \$0.4 million in operating company unincorporated and other business taxes and \$0.9 million of corporate income taxes. Income tax expense for the three months ended September 30, 2017 consisted of \$0.7 million in operating company unincorporated and other business taxes and \$1.7 million of corporate income taxes. The decrease in operating company unincorporated and other business taxes reflects a \$0.5 million benefit associated with the reversal of uncertain tax position liabilities and interest due to the expiration of the statute of limitations for a prior tax year, partially offset by an increase in net income. The decrease in corporate income taxes reflects a decrease in the effective tax rate as a result of the Tax Cuts and Jobs Act enacted in the fourth quarter of 2017, as well as an income tax benefit recognized during the three months ended September 30, 2018 associated a one-time adjustment to the deferred tax asset.

Nine Months Ended September 30, 2018 and September 30, 2017

Income Tax Expense was \$5.7 million for the nine months ended September 30, 2018 and \$6.5 million for the nine months ended September 30, 2017. Income tax expense for the nine months ended September 30, 2018 consisted of \$2.0 million in operating company unincorporated and other business taxes and of \$3.7 million of corporate income taxes. Income tax expense

## Table of Contents

for the nine months ended September 30, 2017 consisted of \$2.0 million in operating company unincorporated and other business taxes and \$4.4 million of corporate income taxes. The decrease in operating company unincorporated and other business taxes reflects a \$0.5 million benefit associated with the reversal of uncertain tax position liabilities and interest due to the expiration of the statute of limitations for a prior tax year, partially offset by an increase in net income. The decrease in corporate income taxes reflects a decrease in the effective tax rate as a result of the Tax Cuts and Jobs Act enacted in the fourth quarter of 2017, as well as an income tax benefit recognized during the three months ended September 30, 2018 associated with a one-time adjustment to the deferred tax asset.

### Net Income Attributable to Non-Controlling Interests

#### Three Months Ended September 30, 2018 and September 30, 2017

Net income attributable to non-controlling interests was \$15.2 million for the three months ended September 30, 2018, and consisted primarily of \$15.2 million associated with our employees' and outside investors' approximately 74.8% weighted average interest in the income of the operating company. Net income attributable to non-controlling interests was \$14.2 million for the three months ended September 30, 2017, and consisted of \$14.0 million associated with our employees' and outside investors' approximately 74.8% weighted average interest in the income of the operating company and \$0.2 million associated with the non-controlling interest in the income of our consolidated entities. The change in net income attributable to non-controlling interests primarily reflects the increase in net income for the three months ended September 30, 2018. We expect the interests in our operating company in subsequent periods to depend on changes in our shareholder's equity and the size and composition of Class B units awarded by our operating company's compensation plans.

#### Nine Months Ended September 30, 2018 and September 30, 2017

Net income attributable to non-controlling interests was \$43.2 million for the nine months ended September 30, 2018, and consisted primarily of \$43.2 million associated with our employees' and outside investors' approximately 74.4% weighted average interest in the income of the operating company. Net income attributable to non-controlling interests was \$37.1 million for the nine months ended September 30, 2017, and consisted of \$36.5 million associated with our employees' and outside investors' approximately 74.7% weighted average interest in the income of the operating company and \$0.6 million associated with the non-controlling interest in the losses of our consolidated entities. The change in net income attributable to non-controlling interests primarily reflects the increase in net income for the nine months ended September 30, 2018, partially offset by the decrease in our employees' and outside investors' weighted average interest in the income of the operating company. We expect the interests in our operating company in subsequent periods to depend on changes in our shareholder's equity and the size and composition of Class B units awarded by our operating company's compensation plans.

### Liquidity and Capital Resources

Historically, the working capital needs of our business have primarily been met through the cash generated by our operations. Distributions to members of our operating company are our largest use of cash. Other activities include purchases and sales of investments to fund our deferred compensation program, capital expenditures, and supporting strategic growth initiatives such as providing the initial cash investment in our mutual funds.

We expect to fund the liquidity needs of our business in the next twelve months, and over the long term, primarily through cash generated from operations. As an investment management company, our business is materially affected by conditions in the global financial markets and economic conditions throughout the world. Our liquidity is highly

dependent on the revenue and income from our operations, which is directly related to our levels of AUM. For the three months ended September 30, 2018, our average AUM and revenues increased by 11.3% and 9.2%, respectively, compared to our average AUM and revenues for the three months ended September 30, 2017. At September 30, 2018, cash and cash equivalents was \$31.9 million, inclusive of \$5.4 million in cash held by our consolidated subsidiaries. We also had \$35.0 million in investments in trading debt securities and an open-ended mutual fund that can be sold to meet future cash flow needs and approximately \$11.1 million in investments set aside to satisfy our obligations under our deferred compensation programs. Advisory fees receivable was \$34.4 million.

In determining the sufficiency of liquidity and capital resources to fund our business, we regularly monitor our liquidity position, including, among other things, cash, working capital, investments, long-term liabilities, lease commitments, and operating company distributions. Compensation is our largest expense. To the extent we deem necessary and appropriate to run our business, recognizing the need to retain our key personnel, we have the ability to change the absolute levels of our

## Table of Contents

compensation packages, as well as change the mix of their cash and non-cash components. Historically, we have not tied our level of compensation directly to revenue, as many Wall Street firms do. Correspondingly, there is not a linear relationship between our compensation and the revenues we generate. This generally has the effect of increasing operating margins in periods of increased revenues, but can reduce operating margins when revenue declines.

We regularly evaluate our staffing requirements and compensation levels with reference to our own liquidity position and external peer benchmarking data. The result of this review directly influences management's recommendations to our Board of Directors with respect to such staffing and compensation levels.

We anticipate that tax allocations and dividend equivalent payments to the members of our operating company, which consist of certain of our employees, unaffiliated persons, former employees, and us, will continue to be a material financing activity. Cash distributions to operating company members for partnership tax allocations would increase should the taxable income of the operating company increase. Dividend equivalent payments will depend on our dividend policy and the discretion of our Board of Directors, as discussed below.

We believe that our lack of long-term debt, and ability to vary cash compensation levels, have provided us with an appropriate degree of flexibility in providing for our liquidity needs.

### Dividend Policy

We are a holding company and our primary investment is our ownership of membership interests in our operating company. As a result, we depend upon distributions from our operating company to pay any dividends that our Board of Directors may declare to be paid to our Class A common stockholders. When, and if, our Board of Directors declares any such dividends, we then cause our operating company to make distributions to us in an amount sufficient to cover the dividends declared. Our dividend policy has certain risks and limitations, particularly with respect to liquidity. We may not pay dividends to our Class A common shareholders in amounts that have been paid to them in the past, or at all, if, among other things, we do not have the cash necessary to pay our intended dividends. To the extent we do not have cash on hand sufficient to pay dividends in the future, we may decide not to pay dividends. By paying cash dividends rather than investing that cash in our future growth, we risk slowing the pace of our growth, or not having a sufficient amount of cash to fund our operations or unanticipated capital expenditures, should the need arise.

On an annual basis, our Board of Directors targets a cash dividend payout ratio of approximately 60% to 70% of our non-GAAP diluted net income, subject to growth initiatives and other funding needs. Our ability to pay dividends is subject to the Board of Directors' discretion and may be limited by our holding company structure and applicable provisions of Delaware law.

### Tax Receivable Agreement

Our purchase of membership units of our operating company concurrent with our initial public offering, and the subsequent and future exchanges by holders of Class B units of our operating company for shares of our Class A common stock (pursuant to the exchange rights provided for in the operating company's operating agreement), has resulted in, and is expected to continue to result in, increases in our share of the tax basis of the tangible and intangible assets of our operating company, which will increase the tax depreciation and amortization deductions that otherwise would not have been available to us. These increases in tax basis and tax depreciation and amortization deductions have reduced, and are expected to continue to reduce, the amount of cash taxes that we would otherwise be required to

pay in the future. We entered into a tax receivable agreement with the current members of our operating company, the one member of our operating company immediately prior to our initial public offering who sold all membership units to us in connection with our initial public offering and any future holders of Class B units. This tax receivable agreement requires us to pay these members 85% of the amount of cash savings, if any, in U.S. federal, state and local income tax that we actually realize (or are deemed to realize in the case of an early termination payment by us, or a change in control, as described in the tax receivable agreement) as a result of the increases in tax basis described above and certain other tax benefits related to entering into the tax receivable agreement, including tax benefits attributable to payments under the tax receivable agreement.

#### Cash Flows

Three Months Ended September 30, 2018 and September 30, 2017

Cash, cash equivalents and restricted cash decreased \$20.6 million to \$32.9 million during the three months ended September 30, 2018 compared to a \$13.4 million increase in cash, cash equivalents and restricted cash to \$52.5 million during

## Table of Contents

the three months ended September 30, 2017. Net cash provided by operating activities increased \$4.7 million for the three months ended September 30, 2018 to \$28.8 million from \$24.1 million for the three months ended September 30, 2017. This increase in cash provided was primarily due to an increase in net income and changes in operating assets and liabilities, and working capital.

Net cash used in investing activities was \$34.2 million for the three months ended September 30, 2018, compared to net cash provided by investing activities of \$0.4 million for the three months ended September 30, 2017. The increase in cash used in investing activities was primarily due to a \$35.5 million increase in net purchases of investments, partially offset by a \$0.8 million increase in payments from related parties during the three months ended September 30, 2018.

Net cash used in financing activities increased \$4.2 million for the three months ended September 30, 2018 to \$15.2 million from \$11.0 million for the three months ended September 30, 2017. The increase in cash used is primarily due to a \$2.1 million increase in net distributions to non-controlling interests, a \$2.0 million increase in the repurchase and retirement of shares of Class A common stock, and a \$0.1 million decrease in cash received for the purchase of Delayed Exchange Class B Units during the three months ended September 30, 2018.

### Nine Months Ended September 30, 2018 and September 30, 2017

Cash, cash equivalents and restricted cash decreased \$31.5 million to \$32.9 million during the nine months ended September 30, 2018 compared to a \$5.3 million increase in cash, cash equivalents and restricted cash to \$52.5 million during the nine months ended September 30, 2017. Net cash provided by operating activities increased \$19.8 million in the nine months ended September 30, 2018 to \$67.6 million from \$47.8 million in the nine months ended September 30, 2017. This increase in cash provided was primarily due to an increase in net income and changes in operating assets and liabilities, and working capital.

Net cash used in investing activities increased \$34.7 million for the nine months ended September 30, 2018 to \$35.0 million from \$0.3 million for the nine months ended September 30, 2017. The increase was primarily due to a \$35.5 million increase in net purchases of investments, partially offset by a \$0.7 million decrease in payments to related parties during the nine months ended September 30, 2018.

Net cash used in financing activities increased \$21.9 million for the nine months ended September 30, 2018 to \$64.2 million from \$42.2 million for the nine months ended September 30, 2017. The increase in cash used is primarily due to a \$17.4 million increase in net distributions to non-controlling interests, a \$6.8 million increase in the repurchase and retirement of shares of Class A common stock and Class B units, and a \$2.7 million increase in dividend payments, partially offset by a \$5.0 million increase in cash received for the purchase of Delayed Exchange Class B Units during the nine months ended September 30, 2018.

### Contractual Obligations

The lease for our former corporate headquarters expired in October 2015. We entered into an 11-year lease agreement in June 2014, the term of which commenced in October 2014. Annual minimum rent during the term is approximately \$2.0 million. During the third quarter of 2016, we terminated a five-year sublease agreement which commenced on May 1, 2015. We entered into a new four-year sublease agreement commencing on October 1, 2016, which is cancelable by either the Company or sublessee given appropriate notice after the thirty-first month following the commencement of the sublease agreement. Sublease income decreases annual lease expense by approximately \$0.4 million per year.



#### Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of September 30, 2018.

#### Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements, in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"), requires management to make estimates and judgments that affect our reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under current circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that

## Table of Contents

are not readily available from other sources. We evaluate our estimates on an ongoing basis. Actual results may materially differ from these estimates under different assumptions or conditions.

Accounting policies are an integral part of our financial statements. A thorough understanding of these accounting policies is essential when reviewing our reported results of operations and our financial condition. Management believes that the critical accounting policies discussed below involve additional management judgment due to the sensitivity of the methods and assumptions used.

### Consolidation

Our policy is to consolidate all majority-owned subsidiaries in which we have a controlling financial interest and variable-interest entities of which we are deemed to be the primary beneficiary. We assess our consolidation practices regularly, as circumstances dictate. All significant inter-company transactions and balances have been eliminated.

### Income Taxes

We are a “C” corporation under the Internal Revenue Code, and thus liable for federal, state and local taxes on the income derived from our economic interest in our operating company. The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. Our operating company has not made a provision for federal or state income taxes because it is the responsibility of each of the operating company’s members (including us) to separately report their proportionate share of the operating company’s taxable income or loss. Similarly, the income of our consolidated subsidiaries is not subject to income taxes, as such income is allocated to each partnership’s individual partners. The operating company has made a provision for New York City Unincorporated Business Tax.

We recognize deferred tax assets and liabilities for the future tax consequences attributable to differences between the carrying amounts of existing assets and liabilities and their respective tax bases, net operating loss carryforwards and tax credits. A valuation allowance is recorded on our deferred tax assets when it is more-likely-than-not that all or a portion of such assets will not be realized. When evaluating the realizability of our deferred tax assets, all evidence, both positive and negative, is evaluated, which requires management to make significant judgments and assumptions. Items considered when evaluating the need for a valuation allowance include our forecast of future taxable income, future reversals of existing temporary differences, tax planning strategies and other relevant considerations.

We believe that the accounting estimate related to the valuation allowance is a critical accounting estimate because the underlying assumptions can change from period to period. For example, tax law changes, or variances in future projected operating performance, could result in a change in the valuation allowance. If we are not able to realize all or part of our net deferred tax assets in the future, an adjustment to our deferred tax asset valuation allowance would be charged to income tax expense in the period such determination was made.

Management's judgment is required in determining our provision for income taxes, evaluating our tax positions and establishing deferred tax assets and liabilities. The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. If the ultimate resolution of uncertainties is different from currently estimated, it could affect income tax expense and the effective tax rate.

### Recently Issued Accounting Pronouncements Not Yet Adopted

See Note 2, "Significant Accounting Policies — Recently Issued Accounting Pronouncements Not Yet Adopted" of the consolidated financial statements included in this Quarterly Report on Form 10-Q.

Item 4. Controls and Procedures.

During the course of the review of our consolidated financial statements as of September 30, 2018, our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2018, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated

Table of Contents

and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There have not been any changes in our internal control over financial reporting during the three and nine months ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

40

---

Table of Contents

## PART II. OTHER INFORMATION

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The table below sets forth information regarding purchases of our Class A Common Stock on a monthly basis during the three months ended September 30, 2018.

Period	(a) Total Number of Shares of Class A Common Stock Purchased	(b) Average Price Paid per Share of Class A Common Stock	(c) Total Number of Dollar Value of Shares Purchased as Shares that May	
			Part of Publicly Announced Plans or Programs <sup>1</sup>	Yet Be Purchased Under the Plans or Programs (in millions)
July 1, 2018 - July 31, 2018	96,151	\$ 9.36	96,151	\$ 29.2
August 1, 2018 - August 31, 2018	73,152	9.23	73,152	28.5
September 1, 2018 - September 30, 2018	47,482	9.33	47,482	28.0
Total	216,785	\$ 9.31	216,785	\$ 28.0

<sup>1</sup> Our share repurchase program was announced on April 24, 2012. The Board of Directors authorized us to repurchase an aggregate of \$10 million of our outstanding Class A common stock and the operating company's Class B units on the open market and in private transactions in accordance with applicable securities laws. In February 2014, the Company announced an increase of \$20 million in the aggregate amount authorized under the repurchase program. On April 19, 2018, the Company announced an additional increase of \$30 million in the aggregate amount authorized under the current program to repurchase Class A common stock and Class B units. The timing, number and value of common shares and units repurchased are subject to the Company's discretion. The Company's share repurchase program is not subject to an expiration date and may be suspended, discontinued, or modified at any time, for any reason.

Table of Contents

Item 6. Exhibits.

Exhibit Description of Exhibit

- 31.1 Certification of Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) (filed herewith)
- 31.2 Certification of Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) (filed herewith)
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
- 101 Materials from the Pzena Investment Management, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Operations, (iii) Consolidated Statement of Changes in Equity, (iv) Consolidated Statements of Cash Flows, and (vi) related Unaudited Notes to the Consolidated Financial Statements, tagged in detail (furnished herewith).

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 6, 2018

PZENA INVESTMENT MANAGEMENT, INC.

By: /s/ RICHARD S. PZENA  
Name: Richard S. Pzena  
Title: Chief Executive Officer  
(Principal Executive Officer)

By: /s/ JESSICA R. DORAN  
Name: Jessica R. Doran  
Title: Chief Financial Officer  
(Principal Financial and Accounting Officer)