

Pzena Investment Management, Inc.  
Form 10-Q  
May 02, 2014  
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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 March 31, 2014

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

(State or Other Jurisdiction of  
Incorporation or Organization)

120 West 45th Street

New York, New York 10036

(Address of Principal Executive Offices) (Zip Code)

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

20-8999751

(I.R.S. Employer

Identification No.)

Not Applicable

(Former name, former address, and former fiscal year if changed since last report)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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As of May 2, 2014, there were 12,176,592 outstanding shares of the registrant's Class A common stock, par value \$0.01 per share.

As of May 2, 2014, there were 53,012,836 outstanding shares of the registrant's Class B common stock, par value \$0.000001 per share.

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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 potentially inaccurate assumptions that 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, 2013. Accordingly, you should not unduly rely on these forward-looking statements, which speak only as of the date of this Quarterly Report. We undertake no obligation to publicly revise any forward-looking statements 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, or SEC, after the date of this Quarterly Report on Form 10-Q.

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

- our anticipated future results of operations and operating cash flows;
  - our 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;
  - potential growth opportunities available to us;
  - the recruitment and retention of our employees;
  - our expected levels of compensation for our employees;
  - our potential operating performance, achievements, efficiency, and cost reduction efforts;
  - our expected tax rate;
  - changes in interest rates;
  - our expectation with respect to the economy, capital markets, the market for asset management services, and other industry trends; and
  - the impact of future legislation and regulation, and changes in existing legislation and regulation, on our business.
- 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.

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## 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 March 31, 2014 (unaudited)	December 31, 2013
<b>ASSETS</b>		
Cash and Cash Equivalents	\$25,754	\$33,878
Restricted Cash	316	316
Due from Broker	754	58
Advisory Fees Receivable	23,401	23,947
Investments, at Fair Value	12,995	7,621
Receivable from Related Parties	211	119
Other Receivables	564	550
Prepaid Expenses and Other Assets	882	577
Deferred Tax Asset, Net of Valuation Allowance of \$46,849 and \$53,973 in 2014 and 2013, respectively	11,337	12,312
Property and Equipment, Net of Accumulated Depreciation of \$2,901 and \$2,850 in 2014 and 2013, respectively	863	835
<b>TOTAL ASSETS</b>	<b>\$77,077</b>	<b>\$80,213</b>
<b>LIABILITIES AND EQUITY</b>		
Liabilities:		
Accounts Payable and Accrued Expenses	\$6,751	\$5,570
Due to Broker	5,233	5
Liability to Selling and Converting Shareholders	10,959	12,777
Lease Liability	672	778
Deferred Compensation Liability	615	2,339
Other Liabilities	104	195
<b>TOTAL LIABILITIES</b>	<b>24,334</b>	<b>21,664</b>
Equity:		
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; 12,176,592 and 12,158,057 Shares Issued and Outstanding in 121 2014 and 2013, respectively)		121
Class B Common Stock (Par Value \$0.000001; 750,000,000 Shares Authorized; 52,834,679 and 52,820,720 Shares Issued and Outstanding in — 2014 and 2013, respectively)		—
Additional Paid-In Capital	9,939	9,750
Retained Earnings	4,773	6,491
Total Pzena Investment Management, Inc.'s Equity	14,833	16,362
Non-Controlling Interests	37,910	42,187
<b>TOTAL EQUITY</b>	<b>52,743</b>	<b>58,549</b>
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>\$77,077</b>	<b>\$80,213</b>

See accompanying notes to unaudited consolidated financial statements.



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PZENA INVESTMENT MANAGEMENT, INC.  
 UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (in thousands, except share and per-share amounts)

	For the Three Months Ended March 31,	
	2014	2013
REVENUE	\$26,401	\$20,842
EXPENSES		
Compensation and Benefits Expense	10,050	9,608
General and Administrative Expense	2,320	1,809
Total Operating Expenses	12,370	11,417
Operating Income	14,031	9,425
OTHER INCOME/(EXPENSE)		
Interest Income	15	27
Dividend Income	50	29
Net Realized and Unrealized Gain from Investments	104	851
Change in Liability to Selling and Converting Shareholders	(127	) (1,039
Other (Expense)	(89	) (40
Total Other (Expense)	(47	) (172
Income Before Income Taxes	13,984	9,253
Income Tax Expense/ (Benefit)	1,683	(438
Net Income	12,301	9,691
Less: Net Income Attributable to Non-Controlling Interests	10,853	8,522
Net Income Attributable to Pzena Investment Management, Inc.	\$1,448	\$1,169
Net Income for Basic Earnings per Share	\$1,448	\$1,169
Basic Earnings per Share	\$0.12	\$0.10
Basic Weighted Average Shares Outstanding	12,176,592	11,267,021
Net Income for Diluted Earnings per Share	\$7,576	\$5,806
Diluted Earnings per Share	\$0.11	\$0.09
Diluted Weighted Average Shares Outstanding <sup>1</sup>	67,929,783	66,583,836
Cash Dividends per Share of Class A Common Stock	\$0.26	\$0.16

<sup>1</sup> Under the "two-class method," restricted Class B units that are considered participating securities are required to be included in the computation of diluted earnings per share.

See accompanying notes to unaudited consolidated financial statements.

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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	Retained Earnings	Non-Controlling Interests	Total
Balance at December 31, 2013	12,158,057	52,820,720	\$121	\$9,750	\$6,491	\$ 42,187	\$58,549
Amortization of Non-Cash Compensation	18,535	17,435	—	161	—	700	861
Directors' Shares	—	—	—	22	—	94	116
Net Income	—	—	—	—	1,448	10,853	12,301
Repurchase and Retirement of Class B Units	—	(3,476 )	—	(8 )	—	(33 )	(41 )
Class A Cash Dividends Declared and Paid (\$0.26 per share)	—	—	—	—	(3,166 )	—	(3,166 )
Contributions from Non-Controlling Interests	—	—	—	—	—	948	948
Distributions to Non-Controlling Interests	—	—	—	—	—	(16,825 )	(16,825 )
Other	—	—	—	14	—	(14 )	—
Balance at March 31, 2014	12,176,592	52,834,679	\$121	\$9,939	\$4,773	\$ 37,910	\$52,743

See accompanying notes to unaudited consolidated financial statements.



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PZENA INVESTMENT MANAGEMENT, INC.  
 UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (in thousands)

	For the Three Months Ended March 31,	
	2014	2013
<b>OPERATING ACTIVITIES</b>		
Net Income	\$ 12,301	\$ 9,691
Adjustments to Reconcile Net Income to Cash Provided by Operating Activities:		
Depreciation	53	39
Non-Cash Compensation	1,476	1,294
Director Share Grant	116	75
Net Realized and Unrealized (Gain) from Investments	(104)	(851)
Change in Liability to Selling and Converting Shareholders	127	1,039
Deferred Income Taxes	970	(434)
Changes in Operating Assets and Liabilities:		
Advisory Fees Receivable	546	(2,175)
Due from Broker	(696)	(1,617)
Restricted Cash	—	(1)
Prepaid Expenses and Other Assets	(319)	(793)
Due to Broker	5,228	1,626
Accounts Payable, Accrued Expenses, and Other Liabilities	(1,244)	1,079
Tax Receivable Agreement Payments	(1,945)	(2,000)
Change in Lease Liability	(106)	(106)
Purchases of Investments	(15,355)	(33,260)
Proceeds from Sale of Investments	10,063	33,698
Net Cash Provided by Operating Activities	11,111	7,304
<b>INVESTING ACTIVITIES</b>		
Purchases of Investments in Deferred Compensation Plan	(519)	(1,459)
Proceeds from Investments in Deferred Compensation Plan	541	78
Payments from/ (to) Related Parties	(92)	(47)
Purchase of Property and Equipment	(81)	—
Net Cash (Used in)/Provided by Investing Activities	(151)	(1,428)
<b>FINANCING ACTIVITIES</b>		
Repurchase and Retirement of Class A Common Stock	—	(667)
Repurchase and Retirement of Class B Units	(41)	—
Distributions to Non-Controlling Interests	(16,825)	(11,623)
Contributions from Non-Controlling Interests	948	—
Dividends	(3,166)	(1,772)
Net Cash Used in Financing Activities	(19,084)	(14,062)
<b>NET CHANGE IN CASH</b>	<b>\$(8,124)</b>	<b>\$(8,186)</b>
<b>CASH AND CASH EQUIVALENTS - Beginning of Period</b>	<b>\$ 33,878</b>	<b>\$ 32,645</b>
Net Change in Cash	(8,124)	(8,186)
<b>CASH AND CASH EQUIVALENTS - End of Period</b>	<b>\$ 25,754</b>	<b>\$ 24,459</b>
Supplementary Cash Flow Information:		
Income Taxes Paid	\$ 891	\$ 869

See accompanying notes to unaudited consolidated financial statements.



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Pzena Investment Management, Inc.  
Notes to Unaudited Consolidated Financial Statements

## Note 1—Organization

Pzena Investment Management, Inc. (the “Company”) functions as 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 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 which is registered under the Investment Advisers Act of 1940 and is headquartered in New York, New York. As of March 31, 2014, 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 has consolidated the results of operations and financial condition of the following entities as of March 31, 2014:

Legal Entity	Type of Entity (Date of Formation)	Operating Company's Ownership at March 31, 2014	
Pzena Investment Management, Pty	Australian Proprietary Limited Company (12/16/2009)	100.0	%
Pzena Financial Service, LLC	Delaware Limited Liability Company (10/15/2013)	100.0	%
Pzena Emerging Markets Focused Value Fund, a series of Advisors Series Trust	Open-end Management Investment Company, series of Delaware Statutory Trust (3/31/2014)	100.0	%
Pzena Long/Short Value Fund, a series of Advisors Series Trust	Open-end Management Investment Company, series of Delaware Statutory Trust (3/31/2014)	100.0	%
Pzena Mid Cap Focused Value Fund, a series of Advisors Series Trust	Open-end Management Investment Company, series of Delaware Statutory Trust (3/31/2014)	100.0	%
Pzena Investment Management Special Situations, LLC	Delaware Limited Liability Company (12/01/2010)	99.9	%
Pzena Investment Funds Trust, Pzena Large Cap Value Fund	Massachusetts Trust (11/01/2002)	—	%
Pzena International Value Service, a series of Pzena Investment Management International, LLC	Delaware Limited Liability Company (12/22/2003)	—	%

## Note 2—Significant Accounting Policies

## Basis of Presentation:

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) and related Securities and Exchange Commission (“SEC”) rules and regulations. The Company’s policy is to consolidate all majority-owned subsidiaries in which it has a controlling financial interest. The Company also

consolidates variable-interest entities (“VIEs”) where the Company is deemed to be the primary beneficiary. These majority-owned subsidiaries in which the Company has a controlling financial interest and the VIEs where 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.

On March 31, 2014, the operating company launched the Pzena Emerging Markets Focused Value Fund, Pzena Long/Short Value Fund, and Pzena Mid Cap Focused Value Fund, for which it acts as the investment advisor. On March 31, 2014, the Company provided the initial cash investment in an effort to generate an investment performance track record to attract third-party investors. As of March 31, 2014, the Company had an initial investment representing 100% of the ownership in each entity. As a result, the entities were consolidated with the Company as of March 31, 2014. At March 31, 2014, the aggregate of Pzena Emerging Markets Focused Value Fund, Pzena Long/Short Value Fund, and Pzena Mid Cap Focused Value Fund's \$6.0 million in net assets were

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

included in the Company's consolidated statements of financial condition. The operating company, as Investment Manager of these 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. No such expenses were recognized during three months ended March 31, 2014.

Pzena Large Cap Value Fund is a Massachusetts Trust in which a majority of the trustees are members of the executive committee of the operating company. A majority of the trustees do not hold equity investments in this trust. Since the holders of the equity investments in this partnership lack a controlling financial interest in it, this entity is deemed to be a VIE. The Company is considered the primary beneficiary of this VIE. At March 31, 2014, the Pzena Large Cap Value Fund's \$1.1 million in net assets were included in the Company's consolidated statements of financial condition.

The operating company is the managing member of Pzena International Value Fund. The operating company is considered the primary beneficiary of this entity. As a result, the entity was consolidated as of February 1, 2011. At March 31, 2014, Pzena International Value Fund's \$2.3 million in net assets were included in the Company's consolidated statements of financial condition.

VIEs that are not consolidated continue to receive investment management services from the Company, and are vehicles through which the Company offers its Global Value and/or Non-U.S. Value Strategies. The total net assets of these VIEs was approximately \$270.5 million and \$244.2 million at March 31, 2014 and December 31, 2013, respectively. Neither the Company nor the operating company were exposed to losses as a result of its involvement with these entities because they had no direct investment in them.

The Company 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 adjustments to additional paid-in capital or non-controlling interests, as applicable, on the consolidated statements of financial position.

Management's Use of Estimates:

The preparation of financial statements in conformity with 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 financial statements, and the reported amounts of revenues and expenses for the period. Actual results could differ from those estimates.

Fair Values of Financial Instruments:

The carrying amounts of all financial instruments in the consolidated statements of financial condition are presented at their fair value.

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 their contractual terms. Advisory fee income also includes performance fees that may be earned by the Company depending on the

investment return of the assets under management. 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. Following the preferred method identified in the Revenue Recognition Topic of the Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC"), such performance fee income is recorded at the conclusion of the contractual performance period, when all contingencies are resolved. For the three months ended March 31, 2014 and 2013, the Company recognized approximately \$0.3 million and less than \$0.1 million in performance fee income, respectively.

Cash and Cash Equivalents:

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

At March 31, 2014 and December 31, 2013, Cash and Cash Equivalents was \$25.8 million and \$33.9 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 and other accounts whose balances often exceed federally insured limits.

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

Restricted Cash:

The Company maintained compensating balances of \$0.3 million at March 31, 2014 and December 31, 2013 as collateral for 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 New York office space. Such amounts are recorded in Restricted Cash in the consolidated statements of financial condition.

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.

Investments, at Fair Value:

Investments, at Fair Value represents the securities held by the Company and its consolidated subsidiaries, as well as investments in third-party mutual funds. The Company's investments in third-party mutual funds are held to satisfy the Company's obligations under its deferred compensation program. Dividends associated with the investments of the Company's consolidated subsidiaries are recorded as dividend income on an ex-dividend basis in the consolidated statement of operations.

All such investments are recorded at fair value, with net realized and unrealized gains and losses reported in earnings in the consolidated statements of operations.

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 transparency 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).

The Company's fair value measurements relate to its consolidated investments in equity securities, which are exchange-traded securities with quoted prices in active markets, and its investments in third-party mutual funds, which have a readily available net asset value per share. The fair value measurements of the equity securities and

investments in mutual funds have been classified as Level 1.

The following table presents these instruments' fair value at March 31, 2014:

	Level 1 (in thousands)	Level 2	Level 3
Assets:			
Equity Securities	\$7,722	\$—	\$—
Investments in Mutual Funds	5,273	—	—
Total Fair Value	\$12,995	\$—	\$—

The following table presents these instruments' fair value at December 31, 2013:

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

	Level 1 (in thousands)	Level 2	Level 3
Assets:			
Equity Securities	\$2,364	\$—	\$—
Investments in Mutual Funds	5,257	—	—
Total Fair Value	\$7,621	\$—	\$—

For the three months ended March 31, 2014 and 2013, there were no transfers between levels. In addition, the Company did not hold any Level 2 or 3 securities during these periods.

**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 third-party mutual funds are valued at the closing net asset value per share of the fund on the day of valuation. Transactions are recorded on a trade date basis.

The net realized gain or loss on sales of securities and investments in third-party mutual funds is determined on a specific identification basis and is included in Net Realized and Unrealized Gain/(Loss) 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 and cash equivalents 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 and collections and current credit conditions. At March 31, 2014 and December 31, 2013, no allowance for doubtful accounts was deemed necessary.

**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, 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. Similarly, the income of the Company’s consolidated subsidiaries is not subject to income taxes, since it is allocated to each partnership’s individual partners. The operating company has made a provision for New York City Unincorporated Business Tax (“UBT”).

Judgment is required in evaluating the Company's uncertain tax positions and determining its provision for income taxes. The Company establishes reserves for tax-related uncertainties based on estimates of whether, and the extent to which,

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

additional taxes will be due. These reserves 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 reserves 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 policy to recognize accrued interest, and penalties associated with uncertain tax positions in Income Tax Expense/(Benefit) on the consolidated statement of operations. For the three months ended March 31, 2014 and 2013, no such expenses were recognized. As of March 31, 2014 and December 31, 2013, no such accruals were recorded.

The Company and its consolidated subsidiaries account for all federal, state, and local 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 March 31, 2014, the Company had a \$46.8 million valuation allowance against deferred tax assets recorded as part of the Company's initial public offering and the subsequent exchanges of Class B units for shares of its Class A common stock. At December 31, 2013, the Company had a \$54.0 million valuation allowance against these 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.

Excess tax benefits related to stock- and unit-transactions are not recognized until they result in a reduction of cash taxes payable. The benefit of these excess tax benefits will be recorded in equity when they reduce cash taxes payable. The Company will only recognize a tax benefit from stock- and unit-based awards in Additional Paid-In Capital if an incremental tax benefit is realized after all other tax benefits currently available have been utilized. For the three months ended March 31, 2014, the Company had less than \$0.1 million in tax benefits associated with stock- and unit-based awards that it was not able to recognize. There were no unrecognized tax benefits for the three months ended March 31, 2013.

Foreign Currency:

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 Gain/(Loss) 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, and foreign withholding taxes recorded on the Company's books 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.

The functional currency of the Company is the United States Dollar. The functional currency of the Company's representative office in Australia is the Australian Dollar. Assets and liabilities of this office are translated at the spot 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. For the three months ended March 31, 2014 and 2013, the Company did not record any accumulated other comprehensive income.

Note 3—Compensation and Benefits

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

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

	For the Three Months Ended	
	March 31,	
	2014	2013
	(in thousands)	
Cash Compensation and Other Benefits	\$8,574	\$8,388
Non-Cash Compensation	1,476	1,220
Total Compensation and Benefits Expense	\$10,050	\$9,608

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. Details of Class B units, phantom Class B units and restricted shares of Class A common stock awarded during the three months ended March 31, 2014 and 2013 are as follows:

	For the Three Months Ended March 31,			
	2014		2013	
	Amount	Fair Value <sup>1</sup>	Amount	Fair Value <sup>1</sup>
Class B Units	32,479	\$11.76	18,517	\$5.40
Deferred Compensation Phantom Class B Units	22,959	\$11.76	68,518	\$5.40
Restricted Shares of Class A Common Stock	—	\$—	100,000	\$4.41

<sup>1</sup> Represents the grant date estimated fair value per share or unit.

Pursuant to the Pzena Investment Management, LLC Amended and Restated 2006 Equity Incentive Plan (“the 2006 Equity Incentive Plan”), the operating company issues Class B units, phantom Class B units and options to purchase 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 options to acquire shares of Class A common stock.

Under the Pzena Investment Management, LLC Amended and Restated Bonus Plan (the “Bonus Plan”), eligible employees whose cash compensation is in excess of certain thresholds have a portion of that excess mandatorily deferred. These deferred amounts may be invested, at the employee’s discretion, in certain third-party mutual funds, phantom Class B units, or money market funds. Amounts deferred in any calendar year reduce that year’s cash compensation expense and are amortized and vest ratably over a four-year period commencing the following year. As of March 31, 2014 and December 31, 2013, the liability associated with deferred compensation investment accounts was \$0.6 million and \$2.3 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 the compensation otherwise payable to the director in cash, deferred in the form of phantom shares of Class A common stock of the Company. Elections to defer compensation under the Director Plan are made on a year-to-year basis. Distributions under the Director Plan shall be 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 March 31, 2014 and December 31, 2013, there were 188,620 and 158,882 phantom shares of Class A common stock outstanding, respectively. For the three months ended March 31, 2014 and 2013 no distributions were made under the Director

plan.

The Company issues to certain of its employees delayed-vesting cash awards. For the three months ended March 31, 2014 and 2013 no such awards were granted. Previously awarded delayed-vesting cash awards have varying vesting schedules with \$1.1 million to be paid at the end of 2014 and the remaining \$0.4 million to be paid at the end of 2015.

As of March 31, 2014 and December 31, 2013, the Company had approximately \$28.7 million and \$29.7 million, respectively, in unrecorded compensation expense related to unvested awards issued pursuant to its Bonus Plan; Class B units, option grants, and phantom Class B units issued under the 2006 Equity Incentive Plan; and restricted Class A common stock issued under the 2007 Equity Incentive Plan. The Company anticipates that this unrecorded cost will amortize over the respective vesting periods of the awards.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

## 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 months ended March 31, 2014 and 2013, the expense recognized in connection with this plan was \$0.3 million and \$0.2 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. For the three months ended March 31, 2014 and 2013, the Company's basic earnings per share was determined as follows:

	For the Three Months Ended March 31,	
	2014	2013
	(in thousands, except share and per share amounts)	
Net Income for Basic Earnings per Share	\$ 1,448	\$ 1,169
Basic Weighted-Average Shares Outstanding	12,176,592	11,267,021
Basic Earnings per Share	\$0.12	\$0.10

Diluted earnings per share adjusts this calculation to reflect the impact of all outstanding operating company membership units, phantom Class B units, phantom Class A common stock, outstanding Class B unit options, 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 generally assumes all outstanding operating company membership units are converted into Company stock at the beginning of the reporting period and the resulting change to Company net income associated with its increased interest in the operating company is taxed at the Company's effective tax rate, exclusive of adjustments associated with both the valuation allowance and the liability to selling and converting shareholders and other one-time charges.

For the three months ended March 31, 2014 and 2013, the Company's diluted net income was determined as follows:

	For the Three Months Ended March 31,	
	2014	2013
	(in thousands)	
Net Income Attributable to Non-Controlling Interests of Pzena Investment Management, LLC	\$ 10,780	\$ 8,114
Less: Assumed Corporate Income Taxes	4,652	3,477
Assumed After-Tax Income of Pzena Investment Management, LLC	6,128	4,637
Net Income of Pzena Investment Management, Inc.	1,448	1,169
Diluted Net Income	\$ 7,576	\$ 5,806

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



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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

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.

For the three months ended March 31, 2014 and 2013, the Company's diluted earnings per share were determined as follows:

	For the Three Months Ended March 31,	
	2014	2013
	(in thousands, except share and per share amounts)	
Diluted Net Income Allocated to:		
Class A Common Stock	\$7,559	\$5,792
Participating Class B Units	17	14
Total Diluted Net Income Attributable to Shareholders	\$7,576	\$5,806
Basic Weighted-Average Shares Outstanding	12,176,592	11,267,021
Dilutive Effect of B Units	52,834,679	53,356,638
Dilutive Effect of Options <sup>1</sup>	1,038,360	722,864
Dilutive Effect of Phantom Class B Units & Phantom Shares of Class A Common Stock	1,695,445	1,060,281
Dilutive Effect of Restricted Shares of Class A Common Stock <sup>2</sup>	38,765	19,706
Dilutive Weighted-Average Shares Outstanding	67,783,841	66,426,510
Add: Participating Class B Units <sup>3</sup>	145,942	157,326
Total Dilutive Weighted-Average Shares Outstanding	67,929,783	66,583,836
Diluted Earnings per Share	\$0.11	\$0.09

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

<sup>2</sup> 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.

<sup>3</sup> 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 0.8 million options to purchase Class B units were excluded from the calculation of diluted net income per share for each of the three months ended March 31, 2014, as their inclusion would have had an antidilutive effect based on current market prices. Approximately 1.1 million options to purchase Class B units and 1.0 million options to purchased Company Class A common stock were excluded from the calculation of diluted net income for each of the three months ended March 31, 2013, as their inclusion would have had an antidilutive effect for the respective periods based on market prices.

## 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 March 31, 2014 and December 31, 2013, the holders of Class A common stock (through the Company) and the holders of Class B units of the operating company held approximately 18.7% and 81.3%, respectively, of the economic interests in the operations of the business.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

Each Class B unit of the operating company has a corresponding share of the Company's Class B common stock, par value \$0.000001 per share. 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 this 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 cancelled. 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, and acquired in the future, together on all matters submitted to a vote of the 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.

On March 20, 2013, certain of the operating company's members exchanged an aggregate of 1,328,334 of their Class B units for an equivalent number of shares of Company Class A common stock. No Class B units were exchanged during the three months ended March 31, 2014. These acquisitions of additional operating company membership interests were treated as reorganizations 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 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. 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 three months ended March 31, 2014, the Company purchased and retired 3,476 Class B units under the current repurchase authorization at an average price per unit of \$11.76. During the three months ended March 31, 2013, the Company purchased and retired 109,535 shares of Class A common stock under the repurchase authorization at an average price per share of \$6.08. The Company records the repurchase of shares and units at cost based on the trade date of the transaction.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

## 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:

	For the Three Months Ended March 31,	
	2014	2013
	(in thousands)	
Non-Controlling Interests of Pzena Investment Management, LLC	\$ 10,780	\$ 8,114
Non-Controlling Interests of Consolidated Subsidiaries	73	408
Net Income Attributable to Non-Controlling Interests	\$ 10,853	\$ 8,522

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

## Note 8—Investments, at Fair Value

Investments, at Fair Value consisted of the following at March 31, 2014:

	Cost	Unrealized Gain/(Loss)	Fair Value
	(in thousands)		
Equity Securities	\$7,092	\$630	\$7,722
Investments in Mutual Funds	4,196	1,077	5,273
Total	\$11,288	\$1,707	\$12,995

Investments, at Fair Value consisted of the following at December 31, 2013:

	Cost	Unrealized Gain/(Loss)	Fair Value
	(in thousands)		
Equity Securities	\$1,732	\$632	\$2,364
Investments in Mutual Funds	4,043	1,214	5,257
Total	\$5,775	\$1,846	\$7,621

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

## Note 9—Property and Equipment

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

	As of March 31, 2014	December 31, 2013
	(in thousands)	
Computer Hardware	\$ 1,221	\$ 1,141
Leasehold Improvements	1,219	1,219
Furniture and Fixtures	786	786
Computer Software	282	256
Office Equipment	256	283
Total	3,764	3,685
Less: Accumulated Depreciation and Amortization	(2,901	) (2,850
Total	\$ 863	\$ 835

Depreciation is included in general and administrative expense and totaled approximately \$0.1 million for each of the three months ended March 31, 2014 and 2013.

## Note 10—Related Party Transactions

For the three months ended March 31, 2014 and 2013, the Company earned \$0.6 million and \$0.4 million, respectively, in investment advisory fees from unconsolidated VIEs which receive investment management services from the Company.

At both March 31, 2014 and December 31, 2013, the Company had approximately \$0.1 million remaining of advances to an international investment company for organization and start-up costs, which are included in Receivable from Related Parties on the consolidated statements of financial condition. The operating company is the sponsor and investment manager of this entity. At March 31, 2014, the Company also had approximately \$0.1 million remaining of advances to three mutual funds launched in March of 2014 for certain reimbursable organization and start-up costs, which are included in Receivable from Related Parties on the consolidated statements of financial condition. The Company consolidates the results and net assets of these entities as of March 31, 2014.

At December 31, 2013, Receivable from Related Parties included approximately \$0.1 million of loans to employees. No loans to employees were recorded at March 31, 2014.

The operating company manages the personal funds of certain of the Company's employees, including the CEO, its two Presidents, and its two Executive Vice 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 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 the 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 \$0.1 million for the three months ended March 31, 2014 and 2013, respectively. The aggregate value of the custody and administrative fees paid related to the Company's executive officers, other employees, and family members was less than \$0.1 million for each of the three months ended March 31, 2014 and 2013.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

Note 11—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 advisors 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 October 31, 2015. The Company reflects minimum lease expense for its headquarters on a straight-line basis over the lease term. During the year ended December 31, 2011, the Company entered into a non-cancelable sublease agreement for certain excess office space associated with its operating lease agreement. The sublease agreement also expires on October 31, 2015.

Lease expenses were \$0.4 million and \$0.3 million for the three months ended March 31, 2014 and 2013, respectively, and are included in general and administrative expense.

Note 12—Income Taxes

The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. Neither it nor the Company's other consolidated subsidiaries have made a provision for federal or state income taxes because it is the individual responsibility of each of these entities' members (including the Company) to separately report their proportionate share of the respective entity's taxable income or loss. The operating company has made a provision for New York City UBT. The Company, as a "C" corporation under the Internal Revenue Code, is liable for federal, state and local taxes on the income derived from its economic interest in its operating company, which is net of UBT. Correspondingly, in its consolidated financial statements, the Company reports both the operating company's provision for UBT, as well as its provision for federal, state and local corporate taxes.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

The components of the income tax expense are as follows:

	For the Three Months Ended March 31,	
	2014	2013
	(in thousands)	
Current Provision:		
Unincorporated Business Taxes <sup>1</sup>	\$713	\$(4 )
Local Corporate Tax	—	—
State Corporate Tax	—	—
Federal Corporate Tax	—	—
Total Current Provision	\$713	\$(4 )
Deferred Provision:		
Unincorporated Business Taxes <sup>1</sup>	\$69	\$58
Local Corporate Tax	111	83
State Corporate Tax	232	147
Federal Corporate Tax	723	503
Total Deferred Provision	\$1,135	\$791
Change in Valuation Allowance	(767	) (1,225 )
Net Adjustment Related to Change in Effective Tax Rate	\$602	\$—
Total Income Tax Expense	\$1,683	\$(438 )

<sup>1</sup> During the three months ended March 31, 2013, the operating company recognized a \$0.6 million tax benefit associated with the amendment of prior year tax returns to change the methodology for state and local receipts.

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 March 31, 2014 and December 31, 2013, the Company had available for U.S. federal income tax reporting purposes, a net operating loss carryforward of \$10.6 million and \$10.4 million, which expires in varying amounts during the tax years 2027 through 2033.

As of both March 31, 2014 and December 31, 2013, included in net operating losses are approximately \$1.0 million of deductions for excess stock- and unit- based transactions. The \$0.4 million of tax benefit associated with these deductions will be credited to Additional-Paid-In-Capital when such deductions reduce taxes payable. Although these net operating losses are included in the total carryforward amount, they are not reflected in the table of deferred tax assets as the excess tax benefits are not yet realized.

The Company and the operating company are generally no longer subject to U.S. Federal or state and local income tax examinations by tax authorities for any year prior to 2009. All tax years subsequent to, and including, 2009 are considered open and subject to examination by tax authorities. During 2013, the Company extended the statute of limitations for the 2009 tax year in association with the amendment of prior year tax returns to change the methodology for state and local receipts.

The acquisition of the operating company Class B units, noted below, has allowed the Company to make an election under Section 754 of the Internal Revenue Code (“Section 754”) to step up its tax basis in the net assets acquired. This step up is deductible for tax purposes over a 15-year period. Based on the net proceeds of the initial public offering and tax basis of the operating company, this election gave rise to an initial deferred tax asset of approximately \$68.7 million.



Pursuant to a tax receivable agreement signed between the members of the operating company and the Company, 85% of the cash savings generated by this election will be distributed to the selling and converting shareholders upon the realization of this benefit.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

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.

As discussed in Note 6, Shareholders' Equity, no Class B units were exchanged during the three months ended March 31, 2014. On March 20, 2013 certain of the operating company's members exchanged an aggregate of 1,328,334 of their Class B units for an equivalent number of shares of Company Class A common stock. The Company elected to step up its tax basis in the incremental assets acquired in accordance with Section 754. Based on the exchange-date fair values of the Company's common stock and the tax basis of the operating company, this election gave rise to a \$5.9 million deferred tax asset and corresponding \$5.0 million liability on March 20, 2013. The Company assessed the realizability of the deferred tax asset associated with this exchange and determined that a portion of the benefits would go unutilized. Consequently, the Company established a \$5.1 million valuation allowance to reduce the deferred tax asset to an amount more likely than not to be realized. These deferred tax assets remain available to the Company and can be used to reduce taxable income in future years. The Company similarly reduced the associated liability to selling and converting shareholders by \$4.4 million to reflect this change in the estimated realization of these assets. As required by the Income Taxes Topic of the FASB ASC, the Company recorded the effects of these transactions in equity.

During the three months ended March 31, 2014 and 2013, after giving effect to the exchange discussed earlier, the Company's valuation allowance was reduced by approximately \$0.8 million and \$1.2 million, respectively, due to revised estimates of future taxable income. Results for the three months ended March 31, 2014 also reflects a change in the Company's expected future tax benefits due to a change in New York State tax law and the methodology for receipts beginning at the start of the 2015 tax year. This change is reflected as a net adjustment to the Company's Section 754 deferred tax asset, valuation allowance, and other deferred tax assets. To reflect these changes in the estimated realization of the asset and its liability for future payments, the Company increased its liability to selling and converting shareholders by \$0.1 million and \$1.0 million for the three months ended March 31, 2014 and 2013, respectively. The effects of these changes to the deferred tax asset and liability to selling and converting shareholders were recorded as a component of the income tax expense and other expense, respectively, on the consolidated statements of operations.

As of March 31, 2014 and December 31, 2013, the net values of all deferred tax assets were approximately \$11.3 million and \$12.3 million, respectively.

The change in the Company's deferred tax assets, net of valuation allowance, for the three months ended March 31, 2014 is summarized as follows:

	Section 754	Other	Valuation Allowance	Total
	(in thousands)			
Balance at December 31, 2013	\$61,628	\$4,657	\$(53,973)	\$12,312
Deferred Tax (Expense)/Benefit	(1,104)	(36)	—	(1,140)
Unit Exchange	—	—	—	—
Change in Valuation Allowance	—	—	767	767
Net Adjustment to Deferred Tax Asset	\$(6,608)	\$(351)	\$6,357	\$(602)

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Balance at March 31, 2014	\$53,916	\$4,270	\$(46,849	)	\$11,337
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The change in the Company's deferred tax liabilities, which is included in other liabilities on the Company's consolidated statements of financial condition, for the three months ended March 31, 2014, is summarized as follows:

	Total (in thousands)
Balance at December 31, 2013	\$(39 )
Deferred Tax Expense	5
Balance at March 31, 2014	\$(34 )

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

The change in the Company's deferred tax assets, net of valuation allowance, for the three months ended March 31, 2013 is summarized as follows:

	Section 754	Other	Valuation Allowance	Total
	(in thousands)			
Balance at December 31, 2012	\$65,069	\$4,536	\$(59,917 )	\$9,688
Deferred Tax (Expense)/Benefit	(907 )	103	—	(804 )
Unit Exchange	5,935	—	(5,140 )	795
Change in Valuation Allowance	—	—	1,225	1,225
Balance at March 31, 2013	\$70,097	\$4,639	\$(63,832 )	\$10,904

The change in the Company's deferred tax liabilities for the three months ended March 31, 2013 is summarized as follows:

	Total (in thousands)
Balance at December 31, 2012	\$(59 )
Deferred Tax Expense	14
Balance at March 31, 2013	\$(45 )

## Note 13—Subsequent Events

The Company evaluated the need for disclosures and/or adjustments resulting from subsequent events through the date the financial statements were issued.

On April 22, 2014, the Company declared a quarterly dividend of \$0.03 per share of its Class A common stock which will be paid on May 29, 2014 to holders of record on May 15, 2014.

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

Overview

We are a public-equity 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 March 31, 2014, our assets under management, or AUM, was \$25.4 billion. We manage separate accounts on behalf of institutions and high net worth individuals, and act as sub-investment adviser for a variety of SEC-registered mutual funds and non-U.S. funds as well as advisor for our three newly formed SEC-registered mutual 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 March 31, 2014, the holders of Class A common stock (through the Company) and the holders of Class B units of our operating company held approximately 18.7% and 81.3%, respectively, of the economic interests in the operations of our business.

As of March 31, 2014 holders of Class B units of our operating company included five of our named executive officers and their estate planning vehicles, who collectively held approximately 58.2% of the economic interest in our operating company. As of March 31, 2014, 33 other employee members held approximately 3.1%, and certain other members of our operating company, including one of our directors and his related entities, and eight former employees, collectively held 20.0% of the economic interests in our operating company through ownership of Class B units.

Non-GAAP Net Income

Our results for the three months ended March 31, 2014 and 2013 included recurring adjustments related to our deferred tax asset generated by the Company's initial public offering and subsequent unit conversions as well as our tax receivable agreement and the associated liability to its selling and converting shareholders. We believe that these accounting adjustments add a measure of non-operational complexity which partially obscures the underlying performance of our business. In evaluating our financial condition and results of operations, we also review certain non-GAAP measures of earnings, which exclude these items. Excluding these adjustments, non-GAAP diluted net income and non-GAAP diluted earnings per share were \$7.5 million and \$0.11, respectively, for the three months ended March 31, 2014 and \$5.6 million and \$0.08, respectively, for three months ended March 31, 2013. GAAP and non-GAAP 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 effective tax rate, exclusive of the adjustments related to our tax receivable agreement and the associated liability to selling and converting shareholders other adjustments. Our effective tax rate, exclusive of these adjustments, was 43.2% for the three months ended March 31, 2014 and 42.8% for the three months ended March 31, 2013. See "Operating Results - Income Tax Expense" below.

We use these non-GAAP measures to assess the strength of the underlying operations of the business. We believe that these adjustments, and the non-GAAP measures derived from them, provide information to better analyze our operations between periods, and over time. We also use non-GAAP net income as one factor in determining the amount of dividends we pay. See "Dividend Policy" below. Investors should consider these non-GAAP measures in addition to, and not as a substitute for, financial measures prepared in accordance with GAAP.



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A reconciliation of the non-GAAP measures to the most comparable GAAP measures is included below:

	For the Three Months Ended March 31,	
	2014	2013
	(in thousands, except share and per share data)	
GAAP Net Income	\$1,448	\$1,169
Net Effect of Tax Receivable Agreement	(62	) (186
Non-GAAP Net Income	\$1,386	\$983
GAAP Net Income Attributable to Non-Controlling Interest of Pzena Investment Management, LLC	\$10,780	\$8,114
Less: Assumed Corporate Income Taxes	4,652	3,477
Assumed After-Tax Income of Pzena Investment Management, LLC	6,128	4,637
Non-GAAP Net Income of Pzena Investment Management, Inc.	1,386	983
Non-GAAP Diluted Net Income	\$7,514	\$5,620
Non-GAAP Diluted Earnings Per Share Attributable to Pzena Investment Management, Inc. Common Stockholders:		
Non-GAAP Net Income for Diluted Earnings per Share	\$7,514	\$5,620
Non-GAAP Diluted Earnings Per Share	\$0.11	\$0.08
Non-GAAP Diluted Weighted-Average Shares Outstanding	67,929,783	66,583,836

## 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 institutional accounts and for retail clients, which are generally open-end mutual funds catering primarily to retail investors. Our advisory fee income is recognized over the period in which investment management services are provided. Following the preferred method identified in 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 all contingencies are resolved.

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, will depend on a variety of factors including, among other things:

- our ability to educate our target clients about our classic value investment strategies and provide them with exceptional client service;
- the relative investment performance of our investment strategies, as compared to competing products and market indices;
- competitive conditions in the investment management and broader financial services sectors;

general economic conditions;  
investor sentiment and confidence; and  
our decision to close strategies when we deem it to be in the best interests of our clients.



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For our institutional 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 in which the rate we earn on the AUM declines as the amount of AUM increases.

Pursuant to our sub-investment advisory agreements with our retail clients, 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 institutional accounts.

Certain of our clients pay us fees according to the performance of their accounts relative to certain agreed-upon benchmarks, which results in a lower base fee, but allows us to earn higher fees if the relevant investment strategy outperforms the agreed-upon benchmark.

The majority of advisory fees we earn on institutional accounts is based on the value of our AUM at a specific date on a quarterly basis, either in arrears or advance. Advisory fees on certain of our institutional accounts, and with respect to all of our retail 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 method used to calculate the fee according to the fee rate schedule may differ as described above.

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 institutional accounts and retail 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.

## 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 office rent and other expenses, professional and outside services fees, depreciation, and the costs associated with operating and maintaining our research, trading, and portfolio accounting systems. 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.

We incur additional expenses associated with being a public company for, among other things, director and officer insurance, director fees, SEC reporting and compliance (including Sarbanes-Oxley and Dodd-Frank compliance), professional fees, transfer agent fees, and other similar expenses. These additional expenses have and will continue to reduce our net income.

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.

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### Other Income/(Expense)

Other Income/(Expense) is derived primarily from investment income or loss arising from our consolidated entities, income or loss generated by our investments in third-party mutual funds, and interest income generated on our cash balances. Other Income/(Expense) 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/(Expense), in the aggregate, to fluctuate based on market conditions and the performance of our consolidated entities and other investments.

### Non-Controlling Interests

Our operating company consolidates the results of operations of the private investment partnerships over which we exercise a controlling influence. 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' interest in our operating company, we have reflected their membership interests as a non-controlling interest in our consolidated financial statements. As a result, our income is primarily generated by our economic interest in our operating company's net income. As of March 31, 2014, the holders of Class A common stock (through the Company) and the holders of Class B units of the operating company held approximately 18.7% and 81.3%, respectively, of the economic interests in the operations of the business.

### Operating Results

#### Assets Under Management and Flows

As of March 31, 2014, our approximately \$25.4 billion of AUM was invested in a variety of value-oriented investment strategies, representing distinct capitalization segments of U.S. and non-U.S. equity markets. The performance of our largest investment strategies as of March 31, 2014 is 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.

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 March 31, 2014, and in the five-year, three-year, and one-year periods ended March 31, 2014, 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.

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Investment Strategy (Inception Date)	Period Ended March 31, 2014 <sup>1</sup>				
	Since Inception	5 Years	3 Years	1 Year	
Large Cap Focused Value (October 2000)					
Annualized Gross Returns	7.1	% 24.3	% 14.4	% 27.0	%
Annualized Net Returns	6.6	% 23.8	% 13.9	% 26.6	%
Russell 1000 <sup>®</sup> Value Index	6.4	% 21.8	% 14.8	% 21.6	%
Large Cap Expanded Value (July 2012)					
Annualized Gross Returns	29.6	% N/A	N/A	28.7	%
Annualized Net Returns	29.5	% N/A	N/A	28.5	%
Russell 1000 <sup>®</sup> Value Index	24.9	% N/A	N/A	21.6	%
Global Focused Value (January 2004)					
Annualized Gross Returns	6.2	% 23.2	% 12.3	% 31.0	%
Annualized Net Returns	5.4	% 22.4	% 11.6	% 30.2	%
MSCI <sup>®</sup> World Index—Net/U.\$. \$	6.9	% 18.3	% 10.2	% 19.1	%
International (ex-U.S) Expanded Value (November 2008)					
Annualized Gross Returns	17.1	% 22.1	% 10.8	% 28.4	%
Annualized Net Returns	16.8	% 21.7	% 10.5	% 28.0	%
MSCI <sup>®</sup> EAFE Index—Net/U.\$. \$	11.6	% 16.0	% 7.2	% 17.6	%
Focused Value (January 1996)					
Annualized Gross Returns	11.4	% 25.6	% 16.2	% 28.4	%
Annualized Net Returns	10.6	% 24.8	% 15.5	% 27.7	%
Russell 1000 <sup>®</sup> Value Index	9.0	% 21.8	% 14.8	% 21.6	%
Small Cap Focused Value (January 1996)					
Annualized Gross Returns	14.7	% 31.8	% 15.3	% 26.1	%
Annualized Net Returns	13.4	% 30.5	% 14.2	% 24.9	%
Russell 2000 <sup>®</sup> Value Index	10.5	% 23.3	% 12.7	% 22.6	%
Global Expanded Value (January 2010)					
Annualized Gross Returns	12.5	% —	% 12.3	% 29.5	%
Annualized Net Returns	12.2	% —	% 12.0	% 29.1	%
MSCI <sup>®</sup> World Index—Net/U.\$. \$	11.2	% —	% 10.2	% 19.1	%
Emerging Markets Focused Value (January 2008)					
Annualized Gross Returns	2.9	% 18.4	% 2.2	% 6.7	%
Annualized Net Returns	2.0	% 17.6	% 1.6	% 6.0	%
MSCI <sup>®</sup> Emerging Markets Index—Net/U.\$. \$	(1.2)	)% 14.5	% (2.9)	)% (1.4)	)%
European Focused Value (August 2008)					
Annualized Gross Returns	9.0	% 25.0	% 12.9	% 35.2	%
Annualized Net Returns	8.6	% 24.5	% 12.5	% 34.8	%
MSCI <sup>®</sup> Europe Index—Net/U.\$. \$	3.3	% 17.5	% 8.4	% 24.5	%
Mid Cap Focused Value (September 1998)					
Annualized Gross Returns	13.9	% 31.4	% 19.7	% 28.5	%
Annualized Net Returns	13.1	% 30.4	% 18.9	% 27.6	%
Russell Mid Cap <sup>®</sup> Value Index	11.0	% 26.4	% 15.2	% 23.0	%

<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. \$.

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**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 March 31, 2014, the Large Cap Focused Value strategy generated a one-year annualized gross return of 27.0%, outperforming its benchmark. The outperformance was broad based and primarily driven by our overweight position and stock selection in both the financial service and technology sectors and secondarily by our exposure in the energy sector.

**Large Cap Expanded 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 March 31, 2014, the Large Cap Expanded Value strategy generated a one-year annualized gross return of 28.7%, outperforming its benchmark. The outperformance was broad based and primarily driven by our overweight position and stock selection in both the financial service and technology sectors and secondarily by our exposure in the energy sector.

**Global Focused Value.** This strategy reflects a portfolio composed of approximately 40-60 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 March 31, 2014, the Global Focused Value strategy generated a one-year annualized gross return of 31.0%, outperforming its benchmark. This outperformance was primarily driven by our stock selection and overweight positions in the financial services and technology sectors, along with our stock selection in the industrials sector and underweight position in the consumer staples sector.

**International (ex-U.S.) Expanded Value.** This strategy reflects a portfolio composed of approximately 60-80 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 March 31, 2014, the International (ex-U.S.) Expanded Value strategy generated a one-year annualized gross return of 28.4%, outperforming its benchmark. The top contributors to relative performance included a broad number of holdings across a diverse range of industries, specifically certain stocks in the financial services, industrials, consumer staples, and technology sectors.

**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 March 31, 2014, the Focused Value strategy generated a one-year annualized gross return of 28.4%, outperforming its benchmark. The outperformance was broad based and primarily driven by our overweight position and stock selection in both the financial service and technology sectors and secondarily by our exposure in the energy sector.

**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 March 31, 2014, the Small Cap Focused Value strategy generated a one-year annualized gross return of 26.1%, outperforming its benchmark. A broad number of holdings across a diverse range of industries contributed to this outperformance, specifically certain stocks in the financial services, producer durables and technology sectors, partially offset by certain stocks in the consumer discretionary sector.

**Global Expanded Value.** This strategy reflects a portfolio composed of approximately 60-95 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 March 31, 2014, the Global Expanded Value strategy generated a one-year annualized gross return of 29.5%