Pzena Investment Management, Inc.
Form 10-Q
November 01, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended September 30, 2013
Or
o 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 Incorporation or Organization)	(I.R.S. Employer Identification No.)

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

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 x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Date 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 x No o
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 o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

As of October 31, 2013, there were 12,148,057 outstanding shares of the registrant’s Class A common stock, par value $0.01 per share.

As of October 31, 2013, there were 52,347,732 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, 2012. 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, 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 September 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Cash and Cash Equivalents	$34,962	$32,645
Restricted Cash	1,031	1,030
Due from Broker	232	22
Advisory Fees Receivable	19,900	14,626
Investments, at Fair Value	7,237	5,170
Receivable from Related Parties	126	83
Other Receivables	565	51
Prepaid Expenses and Other Assets	758	585
Deferred Tax Asset, Net of Valuation Allowance of $54,353 and $59,917 in 2013 and 2012, respectively	13,254	9,688
Property and Equipment, Net of Accumulated Depreciation of $2,798 and $2,695 in 2013 and 2012, respectively	829	779
TOTAL ASSETS	$78,894	$64,679
LIABILITIES AND EQUITY		
Liabilities:		
Accounts Payable and Accrued Expenses	$14,577	$4,305
Due to Broker	64	23
Liability to Selling and Converting Shareholders	12,859	9,656
Lease Liability	884	1,203
Deferred Compensation Liability	1,649	1,327
Other Liabilities	135	199
TOTAL LIABILITIES	30,168	16,713
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; 12,177,202 and 11,149,941 Shares Issued and Outstanding in 2013 and 2012, respectively)	120	111
Class B Common Stock (Par Value $0.000001; 750,000,000 Shares Authorized; 52,190,656 and 53,482,324 Shares Issued and Outstanding in 2013 and 2012, respectively)	—	—
Additional Paid-In Capital	10,548	11,765
Retained Earnings	4,578	2,693
Total Pzena Investment Mangement, Inc.'s Equity	15,246	14,569
Non-Controlling Interests	33,480	33,397
TOTAL EQUITY	48,726	47,966
TOTAL LIABILITIES AND EQUITY	$78,894	$64,679

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 September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
REVENUE	$24,046	$18,861	$67,020	$56,968
EXPENSES				
Compensation and Benefits Expense	9,100	7,689	27,622	23,874
General and Administrative Expense	1,995	1,764	5,747	5,383
Total Operating Expenses	11,095	9,453	33,369	29,257
Operating Income	12,951	9,408	33,651	27,711
OTHER INCOME/(EXPENSE)				
Interest Income	30	51	84	146
Interest Expense	—	—	—	(26)
Dividend Income	52	43	168	101
Net Realized and Unrealized Gain/ (Loss) from Investments	498	395	1,763	1,061
Change in Liability to Selling and Converting Shareholders	(3,257)	(1,684)	(4,525)	(2,342)
Other (Expense)	(71)	(44)	(159)	(11)
Total Other Income/ (Expense)	(2,748)	(1,239)	(2,669)	(1,071)
Income Before Income Taxes	10,203	8,169	30,982	26,640
Income Tax (Benefit)/ Expense	(2,084)	(827)	(1,288)	953
Net Income	12,287	8,996	32,270	25,687
Less: Net Income Attributable to Non-Controlling Interests	10,331	7,733	27,879	22,803
Net Income Attributable to Pzena Investment Management, Inc.	$1,956	$1,263	$4,391	$2,884
Net Income for Basic Earnings per Share	$1,956	$1,263	$4,391	$2,884
Basic Earnings per Share	$0.16	$0.12	$0.37	$0.27
Basic Weighted Average Shares Outstanding	12,209,978	10,780,603	11,934,142	10,640,878
Net Income for Diluted Earnings per Share	$7,866	$5,562	$20,129	$15,594
Diluted Earnings per Share	$0.12	$0.09	$0.30	$0.24
Diluted Weighted Average Shares Outstanding[1]	66,714,033	65,404,610	66,610,381	65,382,457
Cash Dividends per Share of Class A Common Stock	$0.03	$0.03	$0.22	$0.25

1 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, 2012	11,149,941	53,482,324	$111	$11,765	$2,693	$ 33,397	$47,966
Unit Conversion	1,328,334	(1,328,334)	13	746	—	(640)	119
Amortization of Non-Cash Compensation	7,414	36,666	—	403	—	1,781	2,184
Directors' Shares	45,818	—	—	47	—	207	254
Net Income	—	—	—	—	4,391	27,879	32,270
Repurchase and Retirement of Class A Common Stock	(354,305)	—	(4)	(2,209)	—	—	(2,213)
Repurchase and Retirement of Class B Unit Options	—	—	—	(14)		(57)	(71)
Class A Cash Dividends Declared and Paid ($0.22 per share)	—	—	—	—	(2,506)	—	(2,506)
Contributions from Non-Controlling Interests	—	—	—	—	—	128	128
Distributions to Non-Controlling Interests	—	—	—	—	—	(29,405)	(29,405)
Other	—	—	—	(190)		190	—
Balance at September 30, 2013	12,177,202	52,190,656	$120	$10,548	$4,578	$ 33,480	$48,726

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 September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
OPERATING ACTIVITIES				
Net Income	$12,287	$8,996	$32,270	$25,687
Adjustments to Reconcile Net Income to Cash Provided by Operating Activities:				
Depreciation	47	56	124	171
Disposal of Fixed Assets	—	—	—	(93)
Non-Cash Compensation	1,313	722	3,832	2,073
Director Share Grant	104	70	254	210
Net Realized and Unrealized (Gain) from Investments	(498)	(395)	(1,763)	(1,061)
Change in Liability to Selling and Converting Shareholders	3,257	1,684	4,525	2,342
Deferred Income Taxes	(2,881)	(1,440)	(2,788)	(829)
Changes in Operating Assets and Liabilities:				
Advisory Fees Receivable	(1,526)	(184)	(5,274)	103
Due from Broker	(147)	(1,769)	(210)	(3,287)
Restricted Cash	—	—	(1)	—
Prepaid Expenses and Other Assets	(121)	144	(687)	200
Due to Broker	(4)	326	41	1,741
Accounts Payable, Accrued Expenses, and Other Liabilities	4,506	3,831	8,898	8,088
Tax Receivable Agreement Payments	—	—	(2,000)	(2,093)
Change in Lease Liability	(107)	(153)	(319)	(460)
Purchases of Investments	(10,235)	(24,861)	(63,441)	(56,284)
Proceeds from Sale of Investments	11,843	24,780	64,545	56,735
Net Cash Provided by Operating Activities	17,838	11,807	38,006	33,243
INVESTING ACTIVITIES				
Purchases of Investments in Deferred Compensation Plan	(24)	(30)	(1,483)	(492)
Proceeds from Investments in Deferred Compensation Plan	—	—	78	544
Payments from/ (to) Related Parties	5	(61)	(43)	(95)
Purchase of Property and Equipment	(169)	(3)	(174)	(4)
Net Cash (Used in)/Provided by Investing Activities	(188)	(94)	(1,622)	(47)
FINANCING ACTIVITIES				
Repurchase and Retirement of Class A Common Stock	(529)	(127)	(2,213)	(252)
Repurchase and Retirement of Class B Unit Options	—	(15)	(71)	(15)
Distributions to Non-Controlling Interests	(7,596)	(5,014)	(29,405)	(27,284)
Contributions from Non-Controlling Interests	128	—	128	45
Dividends	(366)	(317)	(2,506)	(2,643)
Net Cash Used in Financing Activities	(8,363)	(5,473)	(34,067)	(30,149)
NET CHANGE IN CASH	$9,287	$6,240	$2,317	$3,047

CASH AND CASH EQUIVALENTS - Beginning of Period	$25,675	$31,890	$32,645	$35,083
Net Change in Cash	9,287	6,240	2,317	3,047
CASH AND CASH EQUIVALENTS - End of Period	$34,962	$38,130	$34,962	$38,130
Supplementary Cash Flow Information:				
In-Kind Distribution to Non-Controlling Interests of Equity Securities, at Fair Value	$—	$—	$—	$371
Interest Paid	$—	$—	$—	$26
Income Taxes Paid	$668	$577	$2,501	$2,310

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 September 30, 2013, 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, through its investment in its operating company, has consolidated the results of operations and financial condition of the following entities as of September 30, 2013:

Legal Entity	Type of Entity (Date of Formation)	Operating Company's Ownership at September 30, 2013	
Pzena Investment Management, Pty	Australian Proprietary Limited Company (12/16/2009)	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)	0.0	%
Pzena International Value Service, a series of Pzena Investment Management International, LLC	Delaware Limited Liability Company (12/22/2003)	0.0	%

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, which includes Pzena Investment Management, Pty and Pzena Investment Management Special Situations, LLC. The Company also consolidates variable-interest entities (“VIEs”) where the Company is deemed to be the primary beneficiary, which includes Pzena Investment Funds Trust, Pzena Large Cap Value Fund (“Pzena Large Cap Value Fund”) and Pzena International Value Service, a series of Pzena Investment Management International, LLC (“Pzena International Value Fund”). 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.” As required by the Consolidation Topic of the Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”), the Company also consolidates non-variable-interest entities in which it acts or acted as the general partner or managing member. All of these entities represent or represented private investment partnerships over which the Company exercises or exercised control. 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.

The operating company is the managing member of Pzena International Value Fund. As of February 1, 2011, as a result of a shift in the equity ownership of that fund on that date, the operating company was considered the primary beneficiary of this fund and, as a result, the fund was consolidated with the Company as of that date. At September 30, 2013, Pzena International Value Fund's $1.2 million in net assets were included in the Company's consolidated statements of financial condition.

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 September 30, 2013, the Pzena Large Cap Value Fund's $1.2 million in net assets were included in the Company's consolidated statements of financial condition.

All of the consolidated investment partnerships are investment companies under the American Institute of Certified Public Accountants Audit and Accounting Guide for Investment Companies. The Company has retained the specialized accounting for these partnerships pursuant to the Consolidation of Partnerships and Similar Entities Subtopic of the FASB ASC. Thus, the Company reports these investment partnerships' investments in Investments, at Fair Value, with net realized and unrealized gains and losses reported in earnings in the consolidated statements of operations.

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 international (ex-U.S.) value strategies. The total net assets of these VIEs was approximately $167.1 million and $150.9 million at September 30, 2013 and December 31, 2012, 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 FASB ASC, such performance fee income is recorded at the conclusion of the contractual performance period, when all contingencies are resolved. For the three and nine months ended September 30, 2013, the Company recognized approximately $0.7 million and $0.8 million in performance fee income, respectively. The Company did not recognize any performance fee income for the three months ended September 30, 2012. Approximately $0.3 million in such fees were recognized for the nine months ended September 30, 2012.

Cash and Cash Equivalents:

At September 30, 2013 and December 31, 2012, Cash and Cash Equivalents was $35.0 million and $32.6 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 $1.0 million at September 30, 2013 and December 31, 2012 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 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 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 September 30, 2013:

	Level 1 (in thousands)	Level 2	Level 3
Assets:			
Equity Securities	$2,357	$—	$—
Investments in Mutual Funds	4,880	—	—
Total Fair Value	$7,237	$—	$—

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

The following table presents these instruments' fair value at December 31, 2012:

	Level 1	Level 2	Level 3
	(in thousands)		
Assets:			
Equity Securities	$2,225	$—	$—
Investments in Mutual Funds	2,945	—	—
Total Fair Value	$5,170	$—	$—

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 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 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 September 30, 2013 and December 31, 2012, 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”).

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

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 September 30, 2013, the Company had a $54.4 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, 2012, the Company had a $59.9 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.

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 and nine months ended September 30, 2013 and 2012, 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:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Cash Compensation and Other Benefits	$7,787	$6,967	$23,864	$21,801
Non-Cash Compensation	1,313	722	3,758	2,073

Total Compensation and Benefits Expense	$9,100	$7,689	$27,622	$23,874

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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. For the three months ended September 30, 2013 and 2012, the operating company did not grant any non-cash compensation awards. Details of restricted Class B units and restricted shares of Class A common stock awarded during the nine months ended September 30, 2013 and 2012 are as follows:

	For the Nine Months Ended September 30, 2013		For the Nine Months Ended September 30, 2012	
	Amount	Fair Value[1]	Amount	Fair Value[1]
Restricted Class B Units	18,517	$5.40	53,116	$4.33
Restricted Shares of Class A Common Stock	100,000	$4.41	—	$—

1 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 restricted units, phantom Class B units and options to purchase units in our operating company. Under the Pzena Investment Management, Inc. 2007 Equity Incentive Plan ("the 2007 Equity Incentive Plan"), the Company issued 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 operating company Class B units, or money market funds. Amounts deferred in any calendar year reduce that year's cash compensation expense and are both amortized and vest ratably over a four-year period commencing the following year. As of September 30, 2013 and December 31, 2012, the liability associated with deferred compensation investment accounts was $1.6 million and $1.3 million, respectively.

For the three months ended September 30, 2013 and 2012, the Company recognized approximately $1.3 million and $0.7 million, respectively, in compensation and benefits expense associated with the amortization of all unvested operating company Class B units, option grants, and operating company phantom Class B units issued under the 2006 Equity Incentive Plan; restricted Class A common stock issued under the 2007 Equity Incentive Plan; and all unvested deferred compensation awards associated with the Bonus Plan. For the nine months ended September 30, 2013 and 2012, the Company recognized approximately $3.8 million and $2.1 million, respectively, in such compensation and benefits expense.

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 September 30, 2013 and December 31, 2012, there were 158,378 and 147,500 phantom shares of Class A common stock outstanding, respectively. On September 3, 2013, pursuant to the Director Plan and in association with the resignation of a director, 6,944 phantom shares of Class A common stock were forfeited and the Company distributed 45,818 phantom shares of Class A common stock in the form of shares of Class A common stock.

The Company issues to certain of its employees delayed-vesting cash awards. For the three and nine months ended September 30, 2013 and 2012 no such awards were granted. Delayed-vesting cash awards have varying vesting schedules with $1.0 million to be paid at the end of 2013 and the remaining $0.5 million to be paid at the end of 2014.

As of September 30, 2013 and December 31, 2012, the Company had approximately $20.5 million and $20.6 million, respectively, in unrecorded compensation expense related to unvested awards issued pursuant to its Bonus Plan; operating company Class B units, option grants, and operating company phantom Class B units issued under the 2006 Equity Incentive Plan; and restricted Class A common stock issued under the 2007 Equity Incentive Plan.

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Pzena Investment Management, Inc.
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Note 4 – Employee Benefit Plans

During 2011, the operating company implemented 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 each of the three months ended September 30, 2013 and 2012, the expense recognized in connection with this plan was $0.1 million. For each of the nine months ended September 30, 2013 and 2012, the expense recognized in connection with this plan was $0.5 million.

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 and nine months ended September 30, 2013 and 2012, the Company's basic earnings per share was determined as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands, except share and per share amounts)			
Net Income for Basic Earnings per Share	$1,956	$1,263	$4,391	$2,884
Basic Weighted-Average Shares Outstanding	12,209,978	10,780,603	11,934,142	10,640,878
Basic Earnings per Share	$0.16	$0.12	$0.37	$0.27

Diluted earnings per share adjusts this calculation to reflect the impact of all outstanding operating company membership units, phantom operating company Class B units, phantom Class A common stock, outstanding operating company 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.

For the three and nine months ended September 30, 2013 and 2012, the Company's diluted net income was determined as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Net Income Attributable to Non-Controlling Interests of Pzena Investment Management, LLC	$10,120	$7,523	$26,949	$22,240
Less: Assumed Corporate Income Taxes	4,210	3,224	11,211	9,530
Assumed After-Tax Income of Pzena Investment Management, LLC	5,910	4,299	15,738	12,710
Net Income of Pzena Investment Management, Inc.	1,956	1,263	4,391	2,884

Diluted Net Income	$ 7,866	$ 5,562	$ 20,129	$ 15,594

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.

For the three and nine months ended September 30, 2013 and 2012, the Company's diluted earnings per share were determined as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands, except share and per share amounts)			
Diluted Net Income Allocated to:				
Class A Common Stock	$7,847	$5,541	$20,081	$15,535
Participating Class B Restricted Units	19	21	48	59
Total Diluted Net Income Attributable to Shareholders	$7,866	$5,562	$20,129	$15,594
Basic Weighted-Average Shares Outstanding	12,209,978	10,780,603	11,934,142	10,640,878
Dilutive Effect of Operating Company B Units	52,190,656	53,814,700	52,575,046	53,930,945
Dilutive Effect of Options [1]	703,313	428,080	654,788	451,138
Dilutive Effect of Phantom Operating Company Class B Units & Phantom Shares of Class A Common Stock	1,413,976	135,740	1,260,163	114,009
Dilutive Effect of Restricted Shares of Class A Common Stock [2]	39,034	—	29,000	—
Dilutive Weighted-Average Shares Outstanding	66,556,957	65,159,123	66,453,139	65,136,970
Add: Participating Restricted Operating Company Class B Units[3]	157,076	245,487	157,242	245,487
Total Dilutive Weighted-Average Shares Outstanding	66,714,033	65,404,610	66,610,381	65,382,457
Diluted Earnings per Share	$0.12	$0.09	$0.30	$0.24

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 Restricted 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 1.2 million options to purchase Class B units and 1.0 million options to purchase Company Class A common stock were excluded from the calculation of diluted net income per share for each of the three and nine months ended September 30, 2013, as their inclusion would have had an antidilutive effect based on current market prices. Approximately 1.7 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 and nine months ended September 30, 2012, 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 September 30, 2013, the holders of Class A common stock (through the Company) and the holders of Class B units of the operating company held approximately 18.9% and 81.1%, respectively, of the economic interests in the operations of the business. As of December 31, 2012, the holders of Class A common stock (through the Company) and the holders of Class B units of the operating company held approximately 17.2% and 82.8%, respectively, of the economic interests in the operations of the business.

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, and August 31, 2012, certain of the operating company's members exchanged an aggregate of 1,328,334 and 722,521, respectively, of their Class B units for an equivalent number of shares of Company Class A common stock. 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.

On April 30, 2013, the Company repurchased and retired 55,000 options to purchase Class B units.

As of September 3, 2013, the Company issued 45,818 shares of Class A common stock in connection with the distribution of deferred compensation pursuant to the Director Plan.

The Company's current 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. 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 September 30, 2013 and 2012, the Company purchased and retired 79,208 and 24,666 shares of Class A common stock, respectively, under the current repurchase authorization at an average price per share of $6.68 and $5.15, respectively. During the nine months ended September 30, 2013 and 2012, the Company purchased and retired 354,305 and 53,120 shares of Class A common stock, respectively, under the current repurchase authorization at an average price per share of $6.24 and $4.74, respectively. The Company records the repurchase of shares and units at cost based on the trade date of the transaction.

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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 September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Non-Controlling Interests of Pzena Investment Management, LLC	$10,120	$7,523	$26,949	$22,240
Non-Controlling Interests of Consolidated Investment Partnerships	211	210	930	563
Net Income Attributable to Non-Controlling Interests	$10,331	$7,733	$27,879	$22,803

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 September 30, 2013:

	Cost	Unrealized Gain/(Loss)	Fair Value
	(in thousands)		
Equity Securities	$1,851	$506	$2,357
Investments in Mutual Funds	4,008	872	4,880
Total	$5,859	$1,378	$7,237

Investments, at Fair Value consisted of the following at December 31, 2012:

	Cost	Unrealized Gain/(Loss)	Fair Value
	(in thousands)		
Equity Securities	$1,988	$237	$2,225
Investments in Mutual Funds	2,561	384	2,945
Total	$4,549	$621	$5,170

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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 September 30, 2013	December 31, 2012
	(in thousands)	
Leasehold Improvements	$ 1,219	$ 1,219
Computer Hardware	1,082	982
Furniture and Fixtures	788	788
Computer Software	283	271
Office Equipment	255	214
Total	3,627	3,474
Less: Accumulated Depreciation and Amortization	(2,798)	(2,695)
Total	$ 829	$ 779

Depreciation is included in general and administrative expense and totaled approximately $0.1 million for each of the three and nine months ended September 30, 2013. For the three and nine months ended September 30,