FORTUNE
AMERICAN WEALTH

Somewhere beyond the reach of the average-Joe investor, there is a realm of wealth creation that makes buying and selling stocks, bonds, and mutual funds look like child's play. And what happens inside this exclusive enclave is roiling the economy in a way that it never has before.

Private MONEY

BY RIK KIRKLAND

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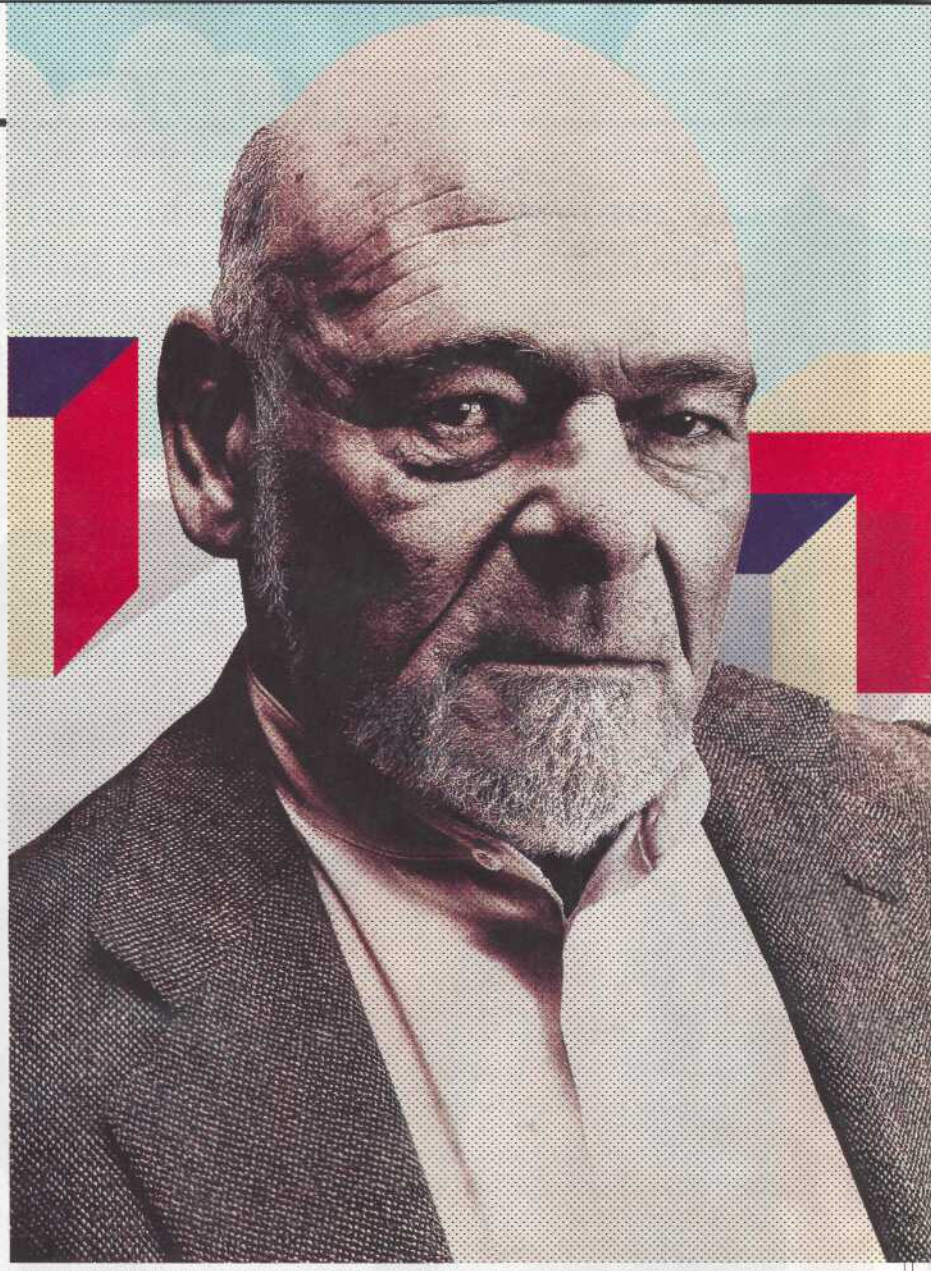


THEY CALL HIM THE GRAVEDANCER Sam Zell earned the nickname buying troubled companies. He just pocketed $900 million for his own untroubled one.

PICTURE YOUR FAVORITE teacher from junior high. Now picture her clutching her retirement savings and chasing the same deal as a room filled with posh investment bankers and flinty real estate moguls. It is an arresting image, yet during the battle for Sam Zell's Equity Office Properties, the Pennsylvania Public School Employees Retirement System was playing on not just one but three sides of the largest leveraged buyout of all time. The $62 billion fund had done well in the past with high-risk investments, but this time the teachers had a lot of skin in the game. Their retirement fund had a $23 million stake in EOP's failed pursuer Vornado Realty Trust and a $48 million stake in the target, EOP, and last February it also committed up to $200 million to the ultimate winner, Blackstone's Real Estate Partners Fund V. The result: The teachers ended up bidding against themselves. And as the battle between Blackstone and Vornado drove the pricetag higher, every dollar the Pennsylvania pension fund gained on its EOP investment was, in effect, being offset by the higher price that Blackstone now had to pay. Not to mention, as part of the price of victory, the teachers now have the privilege of handing Blackstone a 2% management fee and 20% of any future profits, plus a share of the hefty deal fees the firm will also charge for its labors.

The majority of these public servants are undoubtedly oblivious to the role that private equity is playing in their lives, and they are not alone. Do you start your day with a cup of Dunkin' Donuts coffee and lunch at Burger King? Shop at J. Crew, Toys "R" Us, Neiman Marcus? Rent cars from Hertz, watch movies at a Loews cinema, gamble at Harrah's, or sleep at a Fairmont hotel? All these as well as less visible products and services—the gas heat for many homes, cable systems, the satellites that enable your daughter's text-messaging, the hospital that replaced Aunt Millie's hip—are controlled (or were recently bought, then sold) by private-equity firms. And rumors continue to swirl that once-untouchable names such as Gap, Dell, Home Depot, even IBM could one day be sucked into the private-equity vortex. "The whole world of corporate ownership is undergoing dramatic changes, every bit as dramatic as when mutual funds first appeared," says investment fund manager Eddie Lampert.

Private equity is at the center of that change. Of the record $1.56 trillion spent on mergers and acquisitions in the U.S. last year, private-equity buyouts accounted for 25% of the action, up from 10% in 2005. Private equity's firepower has never been greater. Last year firms in the U.S. raised a record $156 billion in new capital. According to Blackstone, the global buyout industry currently has $400 billion available to be invested. With leverage, that $400 billion represents as much as $2 trillion in potential buying power. (To put this in perspective, U.S. mutual funds have more than $10 trillion in assets.)

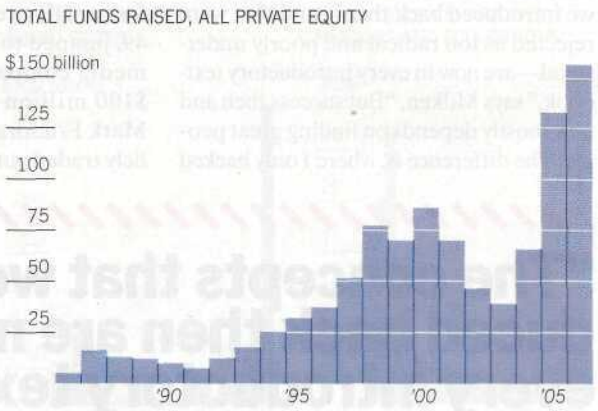
Because private-equity funds, like hedge funds, are classified as "alternative investments," the two are often lumped together. And they do share common ground. Investing in both is limited to those with deep pockets, who can presumably handle the greater risk. Both feature lavish fee structures—variations on the "2 and 20" formula, in which general partners take a 2% fee for simply managing the assets they control and a 20% slice out of any incremental profits they deliver. Both soared in the wake of the 2000-01 market meltdown, which persuaded well-heeled investors that riding the market indexes (Dow 36,000! Nasdaq 10,000!) wasn't automatically going to make them richer.

But here's where they differ. While hedge funds mostly have individuals as investors, PE firms get the bulk of their money from institutions (roughly half from pension funds, another big chunk from banks, insurers, endowments, and foundations, and only 7% or so from individuals). Though so-called activist investors running hedge funds at times noisily pressure public companies into making changes to boost stock prices—think Nelson Peltz or Carl Icahn—most rarely end up owning companies; nor do they want to.

So what does this mean for those of us who don't wear pinstripes or dine where the elephants bump? Are we moving into an era when we have both a public and a private economy in the same way we have a public and a private educational system? Do Blackstone and its peers really take broken companies, mend their wings, and set them free in the public markets? And how big can private equity get, anyway?

TONS OF FUNDS

PRIVATE EQUITY MAY FOLLOW THE BUSINESS CYCLE, BUT THE FUNDS ARE GETTING BIGGER EACH TIME AROUND.



SOURCE: THOMSON FINANCIAL

WHY NOW?

"Cheap debt is the rocket fuel for this, but it's not the only driver," says Rich Friedman, longtime head of merchant banking at Goldman Sachs, whose private-equity business has some $27 billion of assets (including a big chunk of the firm's and its employees' capital). "In terms of governance, management focus, and strategic decision-making, the private-equity model is usually superior to that of publicly held companies."

Every PE firm today sings from the same hymnal, which has several tunes. There's the ownership one. Unlike the "quick-hit artists" at hedge funds, says Blackstone vice chairman Tony James, "we are long-term investors who succeed only when our companies succeed."

That's typically followed by the it's-all-about-the-talent chorus. "Today anyone can raise equity and borrow money," says the Carlyle Group's co-founder David Rubenstein. "What's rare are two things: a deal everyone isn't clamoring to get into, and people who know how to operate the companies we buy. Given a choice between hiring an experienced investor for our firm and landing a guy who's run a leveraged buyout, I'd take the latter."

A BRIEF HISTORY OF PRIVATE EQUITY

HOW AN INDUSTRY WENT FROM ZERO TO $2 TRILLION IN JUST 30 YEARS, AND DEALMAKERS ONCE DISMISSED AS "BOOTSTRAPPERS" BOUGHT A LOT OF COMPANIES, RACKED UP SOME HUGE HITS, AND REBOUNDED FROM A FEW COLOSSAL FLOPS.

'76

The most famous three letters in private equity are born when George Roberts, Jerome Kohlberg, and Henry Kravis (below, left to right) leave Bear Stearns to open their buyout shop.

'79

KKR buys machine-tool maker Houdaille for $355 million, the first takeover of a public company. Also in '79, Merrill Lynch becomes the first bank to allocate capital to buyouts.

'81

After a loosening of public pension fund investing restrictions in the late '70s, Oregon becomes the first state to be a limited partner in private equity: Its fund forks over $178 million to KKR.

'84

John Kluge (right, with wife Patricia) takes Metromedia private in the first $1 billion buyout.

MAY KKR bids for Esmark but loses to Beatrice—only to return in '85 to buy Beatrice in the first hostile LBO.

'88

Revco

Drugstore chain Revco goes under when it can't meet its debt payments. It's still the biggest LBO ($1.6 billion by Salomon Brothers in 1986) ever to go bankrupt.

Amen, adds Michael Milken, whose nearly single-handed creation of the junk-bond market in the 1970s gave rise to the first great LBO wave of the 1980s. "The concepts and financial structures that we introduced back then—and that were rejected as too radical and poorly understood—are now in every introductory textbook," says Milken. "But success then and now mostly depends on finding great people. The difference is, where I only backed strong individuals who wanted to start or buy a business—Steve Wynn in gaming, Len Riggio in books, Craig McCaw in cellular, and Bill McGowan in telecom—the private-equity industry today has the scale to first buy up assets and then match them up with the right managers."

"The concepts that we introduced back then are now in every introductory textbook," says Milken.

Another difference between Milken's era and today is that instead of merely bankrolling entrepreneurs, private-equity firms are co-opting CEOs. There are the elder statesmen—Lou Gerstner, Jack Welch, Larry Bossidy, Jim Kilts, John Browne, and many more—who have joined private-equity firms rather than retire to the golf-and-board-of-directors circuit. More troubling for the future of publicly traded companies is that a generation of potential FORTUNE 500 CEO talent will continue to go private. Part of the allure is escaping the tyranny of quarterly numbers, Sarb-Ox, and shareholder activism. Then there's the lucre. Last year former GE vice chairman David Calhoun, 49, jumped to run the newly privatized media company VNU for a reported $100 million pay package. Similarly, Mark Frissora left his CEO job at publicly traded auto-parts maker Tenneco to run Hertz, which is jointly owned by Carlyle, Clayton Dubilier & Rice, and Merrill Lynch. The brain drain doesn't end there: While reporting this story, I got an unsolicited e-mail from an outfit called Private Equity Access promising that "as a leading executive" I was a "prime candidate" to run a PE-owned company. For a special introductory annual fee of just $149, it would match me with the right partner firm and make my dream of "better pay and greater freedom" come true. (Ah, yes.)

Already this alternative universe controls assets approaching 10% of the value of the companies listed on the New York Stock Exchange. McKinsey (a company for which I do the occasional project) estimates that the industry's Big Four—Blackstone, Carlyle, Texas Pacific Group, and Kohlberg Kravis Roberts—are today among the world's 15 most valuable non-oil private companies. If they were publicly traded, their market caps would range from $60 billion to $80 billion. That vaults them into a league alongside such familiar giants as Morgan Stanley, Apple, and Boeing.

HAS PRIVATE EQUITY PEAKED?

A mounting number of signs suggest that the top is in sight: frantic levels of fundraising, ever-rising premiums, the frenzy among novices to get a piece of the action through new publicly traded buyout funds and got-to-have-'em IPOs such as Fortress Investment Group's. This alternative-investment boutique run by Goldman and BlackRock vets became the first hedge fund to trade on the NYSE on Feb. 9, delivering nearly $10 billion in value to its five principals within hours of the opening bell.

One way to call the top is to look at where newly minted MBAs are headed. The best candidates are as excited about private equity today as many of their predecessors were about becoming venture capitalists in Silicon Valley a decade ago. Today's PE novices are drawn by first-year compensation that can hit $1.2 million with deferred bonuses (more than double the annual dough previous "it" jobs at hedge funds offered)—and by something else. "People just see it as more fun—that sense of ownership private equity offers vs. merely providing a service in traditional consulting or investment banking," says Philip Delves Broughton, a 2006 HBS grad.

'89

KKR buys RJR Nabisco for $31.1 billion, as chronicled in *Barbarians at the Gate* (below).

'90

FEBRUARY Junk-bond house Drexel Burnham Lambert files for bankruptcy. Two months later the firm's top trader, Mike Milken (right), goes to jail.

MAY A deal for Sealy turns into the "burning bed" when the debt can't be sold. First Boston's bailout ends up forcing the bank to merge with Credit Suisse.

'91

Investors in buyout firm Adler & Shaykin ask for their money back as the sinking debt market dries up new deals. Money for new funds hits a low point, with only $7.45 billion raised.

'95

KKR sells its last stake in a struggling RJR Nabisco. Investors lost nearly $1 billion on the deal.

2000

Seagate

As the golden age of venture capital wanes, Silver Lake and Texas Pacific kick off a new LBO boom with a $2 billion deal for Seagate's hard-drive business.

Another cloud on private equity's horizon is pushback from the government and from public-company directors who are upset over the notion that corporate America has been selling itself too cheaply. A special board committee at Cablevision recently rejected the Dolan family's bid to take it private. Similarly, a number of normally mute institutional investors, including that trillion-dollar gorilla, Fidelity, are now leading a fight to reject the Mays family's $26 billion buyout of Clear Channel Communications.

GE's Jeffrey Immelt, who's shopping around his plastics division for $10 billion and change, is pushing back too. He insisted last month that buyout firms could not band together to bid, an implicit acknowledgment that such "club deals," as they are known, are anticompetitive. (For several months now the Justice Department's antitrust division has been studying these instances where several firms bid together rather than against one another. But if any action is forthcoming, most observers believe it would likely be civil, not criminal: an old-fashioned restraint-of-trade case reminiscent of when the airlines were called on the carpet for price-fixing.) No wonder the leading private-equity firms are setting up their first lobbying groups in Washington and London.

BUT WHAT ABOUT THE RETURNS?

Private equity owes much of its reputation among investors to a variation on the "Lake Woebegon effect": Read the funds' prospectuses, and you might think this is a world where everyone is above average. The truth is, if you could have purchased an index of all private-equity funds, you'd be living in a world of hurt.

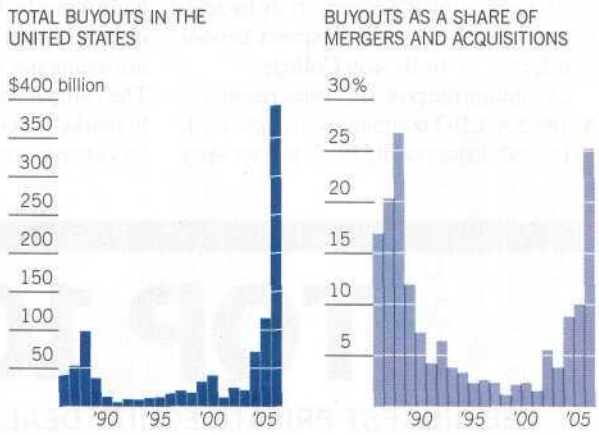
In his 2005 book, *Unconventional Success*, David Swensen, whose 22-year stint managing Yale's endowment fund has established him as one of the world's best investors, put it this way: "The large majority of buyout funds fail to add sufficient value to overcome a grossly unreasonable fee structure." Swensen also notes that merely adding comparable leverage to the S&P 500 delivers returns that beat the buyout boys like a rented mule. Study after study confirms his finding.

McKinsey recently analyzed the results of 106 mid-market funds and 57 large-cap funds raised in the U.S. between 1995 and 2001, and matched them against comparably timed public-market investments. The showing of the top quartile of PE funds is indeed stellar: They handily outperformed, delivering average annual gains of 23% and 17%, respectively, with the best corning in as high as 57% and 28%—far ahead of the 11.5% and 5% returns of the public indexes. The shocker is that more than half of these funds came in well under the indexes, sometimes as much as 20% or more below.

Surveying a larger group of funds over a longer period—from 1980 to 2001—Steve Kaplan of the University of Chicago and Antoinette Schoar of MIT found that while the average fund just beat the S&P 500, it trailed slightly after accounting for the private-equity man's cut. Nor is it a good sign that so many deals are being done at this well-advanced moment in the business cycle. "Historically, the highest returns in the buyout business have come from investments that were made during a recession or in the early stages of economic recovery," points out George Siguler, managing director of Siguler Guff, a thriving niche PE firm with $3.5 billion under management.

PAST VS. PRESENT

PRIVATE EQUITY ACCOUNTED FOR A QUARTER OF ALL M&A LAST YEAR—BUT THAT STILL DOESN'T TOP THE 1988 PEAK.



SOURCE: THOMSON FINANCIAL

'04

WARNER CHILCOTT

Texas Pacific, KKR, and Blackstone lose Warner Chilcott to J.P. Morgan and CSFB. The banks prove they're real players in LBOs.

'05

JANUARY Blackstone is accused of "flipping" Celanese in a $1 billion IPO just nine months after taking it private, but the stock soars anyway.

APRIL Goldman Sachs raises an $8.5 billion fund, the biggest ever for a bank.

SEPTEMBER Apollo closes the first $10 billion buyout fund.

The Blackstone Group

'06

JULY CEO Jack Bovender Jr. (right) helped take HCA private for $32.7 billion, topping RJR Nabisco.

OCTOBER Justice Dept. says it's looking into club deals.

'07

JANUARY GE's Jeff Immelt (below) says he won't sell the plastics division in a club deal.

FEBRUARY Blackstone doesn't take long to set a new deal record: It announces a solo $39 billion buyout of Equity Office Properties.

IS PRIVATE EQUITY GOOD OR EVIL? A fair yardstick for measuring the success of a private-equity firm's management skill is: Does it leave a company operationally better than it found it? The best evidence that's happening is a recent study by Josh Lerner of the Harvard Business School and Jerry Cao of Boston College.

Examining the post-IPO track records of nearly 500 LBO companies brought back to the public market by PE firms between 1980 and 2002, they found their value rose faster on average than both the overall indexes and the shares of new firms not backed by private equity. "Right through 2005, the central tendency we found paints quite a pretty picture," says Lerner. In addition, Lerner and Cao's study found an intriguing stat for the average stock picker: The companies private-equity firms bring to market after owning them for a year or less imderperform the market by *5%* over the next three years, but those they hold for three or more years outperform by 18%.

"Our model is really best in those periods of a company's life cycle where transformation is critical," explains Donald Gogel, CEO of Clayton Dubilier & Rice, which fashions itself as a "craft" PE shop that concentrates on only two or three big deals a year. "Our edge comes when changes are required that disrupt the smooth earnings-growth trajectory expected of public companies." Even changes dismissed as clever financial engineering, Gogel argues, may often be founded on nitty-gritty expertise. His firm studied both Hertz and the securitized debt market for more than three years, he says, before concluding that "we could push the boundaries of how much a rental fleet could be securitized by many billions of dollars." And so they did.

With all due respect for the industry's executional moxie, the main reason private equity has an edge these days is its ability to load up balance sheets with cheap debt. (You literally have to go back to before World War I to find a time when credit spreads were this narrow.) "While we remain focused on earning most of our returns through growth and operational improvements, many of the large deals of the past few years rely mainly on leverage," says Bill Ford, CEO of General Atlantic, which has $12 billion under management.

GE's Immelt seconds that emotion. Of the 30 or so buyout deals he looks at each year, he told the *Financial Times* in November, "the vast majority only add value through financial rather than operational improvements." Immelt added that if he were to order any of GE's top managers to nearly double profits in three years—and allow them to then "drop the reins"—"almost any of them could do it."

Other seasoned observers also fret that a newly fervid trading mentality among private-equity players—bringing an LBO company back to public markets faster than the more normal five- to seven-year time frame; more deals done by flipping companies among PE firms rather than going public; and above all, the industry's growing penchant for taking out profits as fast as possible through leveraged "dividend recaps" and excessive management fees—offers disturbing confirmation that the engine is overheating. "How will private-equity firms continue to make money by just flipping and flipping and flipping?"

TOP 10

THE BIGGEST PRIVATE-EQUITY DEALS OF ALL TIME

(VALUES INCLUDE ASSUMED DEBT)

1 **$38.9 BILLION** **Target** Equity Office Properties Trust **Acquirer** Blackstone **Year** 2007 **Comments** A fierce bidding war drove up the price by $3 billion.

2 **$32.7 BILLION** **Target** Hospital Corp. of America **Acquirers** Bain, KKR, Merrill Lynch **Year** 2006 **Comments** The buyers, including the Frist family, paid only $5.5 billion in equity. The rest was debt.

3 **$31.1 BILLION** **Target** RJR Nabisco **Acquirer** KKR **Year** 1989 **Comments** It's the *Sgt. Pepper's* of PE: oft imitated but never topped—when adjusted for inflation.

4 **$27.4 BILLION** **Target** Harrah's Entertainment* **Acquirers** Apollo, Texas Pacific **Year** 2006 **Comments** The club's $90-per-share offer was a huge 35% premium over the casino's closing stock price.

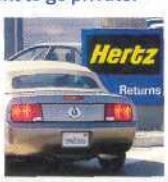
5 **$25.7 BILLION** **Target** Clear Channel Communications* **Acquirers** Bain, Thomas H. Lee **Year** 2006 **Comments** The Mays family's stake is valued at over $1 billion.

6 **$21.6 BILLION** **Target** Kinder Morgan* **Acquirers** Carlyle, Riverstone, Goldman Sachs **Year** 2006 **Comments** Goldman did the deal *and* earned fees from the buyers and seller.

7 **$17.6 BILLION** **Target** Freescale Semiconductor **Acquirers** Blackstone, Carlyle, Permira, Texas Pacific **Year** 2006 **Comments** U.K.-based Permira established a beachhead in U.S. megadeals.

8 **$17.4 BILLION** **Target** Albertson's **Acquirer** Cerberus **Year** 2006 **Comments** Joining with CVS and SuperValu, Cerberus spurred management to go private.

9 **$15.0 BILLION** **Target** Hertz **Acquirers** Carlyle, Clayton Dubilier & Rice, Merrill Lynch **Year** 2005 **Comments** Bought from Ford, then sold to the public a year later.



10 **$13.9 BILLION** **Target** TDC **Acquirers** Apax, Blackstone, KKR, Permira, Providence **Year** 2005 **Comments** The buyout of the Danish telecom is Europe's biggest private-equity deal so far.

* DEAL ANNOUNCED, NOT CLOSED.

asked Warren Buffett at Berkshire Hathaway's annual meeting last May. "They'll make it on fees, fees, fees."

WHERE DO WE GO FROM HERE?

In many ways we have been here before—two decades ago. In 1988, LBOs accounted for nearly one-third of all M&A in the U.S., more than the industry's share last year. In today's dollars, KKR's 1989 takeout of RJR Nabisco would be worth just over $50 billion, which makes it still the real-dollar champ. Croesus-like riches? In 1987, Mike Milken earned $550 million in salary and bonuses for his labors at Drexel Burnham—in inflation-adjusted currency that's nearly $1 billion.

The last good time ended not with a bang but with a mattress. In August 1989, right before the junk bond market first seized up, First Boston extended a $500 million bridge loan to a New York buyout firm that was taking a company called Ohio Mattress (now known as Sealy) private. When First Boston tried to unload its temporary bridge on the usual suspects, the buyers, unnerved by rising interest rates and the collapse of the main market maker, Drexel Burnham, balked. Liquidity went overnight from a virtual Niagara Falls to a veritable Sahara. First Boston was stuck with its loan, developed its own financial woes, and ultimately was subsumed by Credit Suisse. The deal became known as the "burning bed." Not such a riveting story, really, except for this little footnote. In May 1990, nine months after the bed first caught fire, one business magazine—not this one—concluded that "the lessons of Ohio Mattress won't be forgotten."

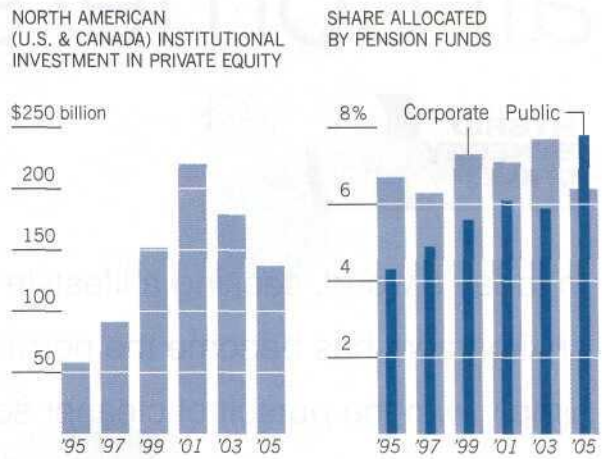
Actually, they pretty much have been.

What happens next in the debt and derivatives markets may have the biggest influence on how the latest boom ends. Here are some relevant data. Few of the individual megadeals today are as heavily leveraged as KKR was. But at more than $1.3 trillion, leveraged loans outstanding in the U.S. are at an all-time high and headed higher. The same is true for high-yield debt, securitized mortgages, collateralized debt obligations—you name it. While default rates are at record lows, credit quality by almost every measure has deteriorated: Debt-to-Ebitda ratios are where they were before the last downturn and rising; 55% of new leveraged loans are rated B+ or lower, also a record.

To Wilbur Ross, who's made a fortune timing the distressed debt market right, it points one way: to "a very big escalation in defaults."

FUELING THE FIRE

THE GROWTH RATE OF INSTITUTIONAL INVESTMENT IN PE IS DOWN, BUT PUBLIC PENSIONS ARE UPPING THEIR STAKE.



SOURCE: RUSSELL INVESTMENT GROUP, SURVEY OF 176 INSTITUTIONAL INVESTORS

Hovering over everything is the mind-blowing expansion of the global credit derivatives market, up from nowhere five years ago to $25 trillion—and headed toward $30 trillion. "How and when it happens I can't tell you," says prominent short-seller Jim Chanos. "But there's a train wreck coming."

None of the railroad owners will go that far, but they will admit that this whole fee thing is getting out of control, that there's too much deal flipping, that the risks are rising as they expand into foreign lands, that these days it's all too much about leverage, and that "the best time to sell is when the sun is shining," as one private equiteer told me. So, while private equity may well be an even bigger force when we look back from 2012, you might not want to bank on it.

The truth is, if you could have purchased an index of all private-equity funds, you'd be living in a world of hurt.

On that note, let's check in with a man who made his hay while the sun was shining: namely, Mr. Sam Zell. Zell, the CEO and chairman of Equity Office Properties, has an impressive track record when it comes to calling the market's twists and turns. It's less widely known that he is also on record in a more creative format: Every New Year he sends his friends elaborate modernistic music boxes that play parody versions of songs conveying his current economic outlook. In January 2000, for example, his gadget featured a kid staring at a naked emperor sitting atop a stack of *Wall Street Journals*, while a Paul Simon sound-alike crooned, "I'd like to help you all get rich at 23/There must be 50 ways to make a billion ... / Just add a dot-corn, Tom,/Front your name with an 'e,' Lee/Start auctioning toys, Roy ..." and so it went. And what was Sam's message in January 2006, months before a bidding war put $900 million in his pocket? A music box that featured a B.J. Thomas sound-alike crooning along to "Raindrops Keep Fallin' on My Head." The last verse concludes:

"Capital keeps rainin' on my head/So much is out there that the world is out of whack/When will we see balance back?/It's gonna be a long time till returns meet expectations./We need to be/Prepared for slim annuities."

So by all means, cue the trumpets. But let's hold the parade for private equity until we see just how well it copes when the next hard rain finally falls. B

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