HOW PRIVATE EQUITY COULD REVIVE THE ECONOMY

By Peter Carbonara
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Photograph by Bill Wadman

Armed with $1 trillion, the firms are cranking up their dealmaking. That will pump capital into the markets

Donald B. Marron, founder of the *$3* billion private equity firm Lightyear Capital, has been eyeing financial wreckage for more than a year. In early 2008 Marron, the former chairman and chief executive of brokerage PaineWebber, sent teams of analysts to scout out more than 200 struggling U.S. financial firms. So far Marron has made only one deal, buying a stake in student lender Higher One last summer. But the 74-year-old art aficionado, whose starkly modern New York office brims with abstract paintings, says dealmaking will soon pick up dramatically. "We expect this trend to continue," he says.

While some attention has been paid to the vultures now circling the troubled banking sector, private equity is beginning to venture out across the economy in search of deals big and small. Glen T. Matsumoto, a partner in Swedish buyout shop EQT Partners, is looking for more ways to spend the $1.5 billion his firm has amassed for infrastructure and energy plays, having picked up Michigan energy company Midland Cogeneration Venture in March. Brian A. Rich of Catalyst Partners, an upstart buyout shop with $300 million in assets, recently plowed £5.6 million into Mindbody, a California software company. He's hoping to invest in more cash-starved technology and media outfits. "We think it's a great time to put capital out," says 48-year-old Rich, who ran Toronto Dominion's U.S. merchant banking arm before starting Catalyst in 2000.

It's been a rough two years for private equity firms, those freewheeling and much-vilified financiers who buy companies only to sell them later for a profit. The buyout boom that ended in 2007 wasn't pretty; many of the deals made at the height of the frenzy have been disasters. Bankruptcy courts are littered with private equity blunders, including household names Chrysler, Tribune, and Linens 'n Things. Such high-profile blowups heightened private equity's reputation as a group of fast-buck artists who are better at destroying companies than running them.

But a strange thing has happened. While the experts were proclaiming—and maybe even celebrating—their death, private equity firms were quietly bulking up their war chests and readying themselves for a new wave of deals. By some measures they're stronger than ever: Firms are sitting on a record $1 trillion with which to make new purchases, according to research firm Preqin. "They are showing up at the party with a wheelbarrow full of cash," says Donna Hitscherich, a professor at Columbia Business School.

EQT's Matsumoto picked up Midland Cogeneration in March for $650 million

Slowly and deliberately, firms are mobilizing their forces to exploit huge opportunities being created by the recession. Some big buyout firms, filling the void created by the financial crisis, are acting like traditional investment banks, providing loans to troubled companies and even advising executives on mergers. Some firms are aggressively hiring and firing buyout specialists, turning the cold eye they usually

train on companies onto themselves. Other firms are prowling bankruptcy courts in search of cheap assets or are capitalizing on government stimulus spending. "There is every reason to believe that private equity will have tremendous opportunity once we hit bottom," says Colin Blaydon, director of the Center for Private Equity & Entrepreneurship at Dartmouth's Tuck School of Business.

When private equity starts cranking up its dealmaking machine-and it will, eventually—the $1 trillion it has amassed could help revive the economy by pumping crucial capital into the markets. "Private equity will be an integral part of this country's economic recovery," says Gregg Slager, a senior partner at accounting firm Ernst & Young. Noted Stephen A. Schwarzman, founder of Blackstone Group, in the private equity firm's March annual report: "Getting the world economy moving again will take more than government intervention."

ToCarlyle's Sarkozy, "the time is ripe" to buy into banks, **both** in the U.S. and abroad

STILL ATTRACTING INVESTORS

Private equity's surprising resurgence is a study in managing through a downturn. With markets and businesses blowing up all around them, buyout firms calmly made their case to big investors that they were still worthy stewards of capital. In 2008 they attracted $554 billion from pension funds, university endowments, and other big investors, down only modestly from the record $625 billion the previous year. Even this year's seemingly small tally thus far of £49 billion still puts private equity on track to match 2004's total of $206 billion, the sixth-highest ever.

Partly that's because returns haven't been as awful as feared. Private equity funds lost an estimated 20% in 2008. That was on a par with hedge funds and handily beat U.S. stocks (-37%), real estate (-38%), and commodities (-47%). Big investors think private equity will perform better in the future, too. U.S. corporate pensions are assuming their private equity holdings will return 10.1% a year over the next five years, compared with an estimated 7.8% for hedge funds, according to research firm Greenwich Associates.

The nation's largest pension fund, California Public Employees' Retirement System, even boosted its target for private equity holdings in its portfolio by four percentage points last year. "We're strongly committed to private equity, which helps diversify the portfolios of long-term investors," says CalPERS' spokesman Clark McKinley. Robert Hunkeler, who manages the $13.1 billion in International Paper's pension funds, says he's keeping his stake in private equity at 5% despite recent losses.

The next few years will be dismal for many firms, no question. Buyout shops may be sitting on piles of cash for new purchases, but their portfolios also are stuffed with companies at risk of folding unless they can refinance their debt. Boston Consulting Group estimates that 20% to 40% of private equity firms will disappear altogether in the next few years.

But the wiliest players have inoculated themselves from the worst of the pain. During the boom years, firms used a number of slick tricks to extract money from companies right away and ease potential losses. First they loaded the companies they bought with debt and kept the proceeds for themselves. Then they collected ongoing management fees from those same companies.

Often they did both. Kohlberg Kravis Roberts, founded in 1976 by Henry R. Kravis and George R. Roberts, pulled off the biggest buyout ever in October 2007 when it joined with another big firm, TPG, to buy Texas utility TXU for $45 billion. {KKR also pulled off the largest transaction during the last buyout boom with its $31 billion bid for RJR Nabisco in 1989, the controversial deal immortalized in the book Barbarians *at the Gate.)* After picking up TXU, KKR and its private equity partners immediately collected $300 million from TXU for "certain services" associated with the deal, according to filings with the Securities & Exchange Commission. Plus, the firms are "entitled to receive an aggregate annual management fee of S35 million," which "will increase *2%* annually." TPG and KKR declined to comment.

Private equity firms also exploited the remarkably easy lending environment during the boom, negotiating financing terms with unprecedented flexibility. Firms often had to put up minimal capital to close a deal. The maneuvers are paying off now.

Consider the tale of Chrysler. Cerberus Capital Management—named after the mythical three-headed dog that guards the gate of Hades—bought the troubled carmaker in May 2007 for $7.4 billion. Founder Stephen A. Feinberg, a secretive financier with blue-collar roots, has, with hard-nosed dealmaking, transformed Cerberus over the years from a scrappy vulture into a private equity stalwart. In the case of Chrysler, Cerberus contributed only $1.2 billion in cash. And even though Chrysler has filed for Chapter n, Cerberus isn't likely to lose all of that money; it may be able to offset some of its losses with Chrysler Financial, the carmaker's lending arm, which isn't part of the bankruptcy. Cerberus could merge the lender with another Cerberus investment, GMAC Financial. "It is a big hit," says one Cerberus executive of the bankruptcy. "But it won't break the company."

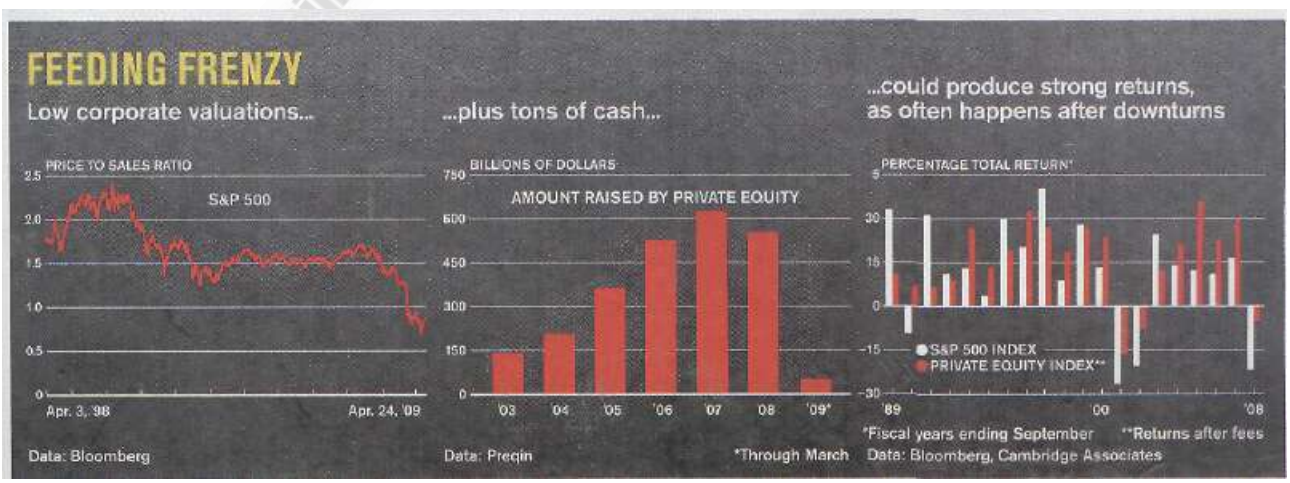
To be sure, the days of larger-than-life dealmaking are over. Banks are no longer providing the loans that fuel the biggest buyouts. Small purchases will replace megabuyouts, and firms will likely focus their energies on sprucing up operations rather than extracting fees and engineering financial gains. "It's back to the future," says WilliamE. Ford, chief executive of General Atlantic, a private equity firm with $13 billion in assets.

Some firms have even begun to deemphasize buyouts, quietly transforming themselves into diversified financial players that provide a wide array of money management, trading, and advisory services. Schwarzman, the 62-year-old head of Blackstone Group, is aggressively filling the void left by the Lehmans of the world. Schwarzman's ambitions are as grand as his New York City apartment, a 35-room triplex once owned by John D. Rockefeller. At the firm's start in 1985, Schwarzman and co-founder Peter G. Peterson shared a secretary and oversaw a grubstake of just $400,000. Today Schwarzman, infamous for a lavish birthday party he threw himself in 2007, sits atop more than 890 billion in assets and employs more than 1,340 people. Blackstone collected $410 million last year—not from its bread-and-butter buyout business but from advising other companies on mergers, acquisitions, and restructurings. Said Schwarzman in the firm's annual report:" Our financial advisory group delivered record fees last year by meeting the demand for a trusted, independent adviser."

PROFITING FROM THE PAIN

Blackstone's advisory clients range from troubled insurer AIG to the Ukrainian government. In December Tim Coleman, who co-heads Blackstone's reorganization and restructuring group, flew to Detroit to meet with Ford Motor's CEO, Alan Mullaly, and other top executives. Colernan's recommendation: Rework the debt. After that initial meeting, Mullaly hired Blackstone and Goldman Sachs to dispense advice. The three companies spent the next few months brainstorming and hashing out strategies at Ford's headquarters. "We worked 'round the clock," says Coleman. "There wasn't room for anyone's ego to get involved." They brought their plan to bondholders in April, offering to exchange $1.8 billion in debt for 51.3 billion in equity. The investors agreed.

Like all tough-minded investors, private equity firms are busy looking for ways to profit from rivals' pain—and even



their own. College friends Rodger R. Krouse and Marc J. Leder are among the most aggressive. The two left Lehman Brothers in 1995 to forge their own firm, Sun Capital Partners, in Boca Raton, Fla. They had a tough time muscling into the clubby world of private equity, but since 2002 Sun Capital has bought more than 200 small and midsize companies and earned 20% a year. Among its holdings: restaurant chain Friendly Ice Cream and bagel chain Bruegger's Enterprises. More than 10 of Sun Capital's companies have filed for Chapter 11, including retailer Big 10 Tires, auto parts supplier Fluid Routing Solutions, and department store Mervyns. But Krouse and Leder, both 47, are capitalizing on the trouble by doling out high-interest, short-term loans to some of its bankruptcy victims. Sun Capital declined to comment.

Few private equity portfolios are as troubled as that of New York's Apollo Management—but even its list of losers is presenting opportunities. The $45 billion Apollo owns bankrupt retailer Linens 'n Things, along with struggling casino chain Harrah's Entertainment and real estate firm Realogy. But Apollo recently raised $15 billion for new investments and plans to use a quarter of that stash to buy distressed debt, including the debt of some of its own holdings.

Junk bonds are familiar territory for Apollo founder Leon Black. The 57-year-old started Apollo in 1990 after leaving Drexel Burnham Lambert, the notorious investment bank that collapsed that year. Black's interest in his own distressed debt is partly defensive and partly speculative. By buying back bonds aggressively, Black can try to prevent other vultures from picking up the debt and wresting control of his investments. He's also likely betting that the bond prices will rise in value and that he'll be able to sell them at a profit later. Apollo declined to comment.

FRENCH CONNECTION

Many private equity firms are taking a sharp pencil to their own books as well. Even as the giants are laying off staff and closing offices, they're recruiting specialists in fields where they see opportunities. Apollo, for example, added former Morgan Stanley banker Neil Shear to its new commodities group. In a burst of recent hiring, Blackstone picked up infrastructure specialists Trent Vichie and Michael Dorrell from the New York branch of Australia's Macquarie, among other recruits.

Carlyle Group, one of the largest and most secretive private equity firms, started preparing for a flood of bank deals last year. The 22-year-old firm, whose ranks have included such

MASTERS OF THIS UNIVERSE

The largest private equity firms are bulking up their war chests and readying themselves to make deals

COMPANY NAME POSITION/FOUNDER	ASSETS (BILLIONS)	STRENGTHS	WEAKNESSES
 Blackstone Group Chairman: Stephen Schwarzman	$91	The diversified financial firm invests in companies, real estate, mortgages, and debt. Blackstone made $410 million last year advising companies on mergers, acquisitions, and restructurings.	Shares are down 35% since the company's 2007 IPO. One holding, Hilton Hotels, has been battered by a drop in tourism.
 Carlyle Group Founders: David Rubenstein (left), Daniel D'Aniello, William Conway Jr.	$85.5	Carlyle uses its political clout to land deals. Former President George H.W. Bush and former Secretary of State James Baker III are among those who have worked for the firm.	New York Attorney General Andrew Cuomo is investigating whether Carlyle influenced pension fund managers to snag more business.
 Bain Capital Founders: Mitt Romney and seven partners	$60	Turnaround artists known for their strong management skills, the firm bought a 93% stake in Domino's Pizza in 1998 and sold it to the public six years later, returning 400% to investors.	Bain's portfolio is filled with troubled retailers, including craft chain Michaels and Guitar Center.
 Kohlberg, Kravis, & Roberts Founders: Henry Kravis (left) & George Roberts	$55	The firm—whose 1989 takeover of RJR Nabisco inspired the book *Barbarians at the Gate*—is poised to capitalize on infrastructure spending. It also is eyeing a South Korean brewer.	One KKR unit's shares plummeted after suffering a $40 million loss on bad mortgage investments.
 TPG Chairman: David Bonderman	$50	A specialist in reviving floundering businesses, TPG could scoop up assets in Chapter 11. The firm is skilled at collecting fees from its portfolio companies up front.	TPG lost $1.7 billion on its investment in Washington Mutual, which was seized by regulators and sold to JPMorgan Chase.
 Apollo Management Chairman: Leon Black	$45.1	With hundreds of names in its portfolio, Apollo can weather the downturn. One holding, big-box grocery store Smart & Final, is surging as consumers look for discounts.	Apollo has plenty of clunkers among its companies, including Harrah's and Realogy.

Rich of Catalyst Partners is hunting small tech and media companies

well-connected advisers as former President George H.W. Bush and former British Prime Minister John Major, has been expanding aggressively into real estate, venture capital, and other alternative assets—and has bagged some high-profile talent. Last year, Carlyle lured UBS investment banker P. Olivier Sarkozy, half brother of the French President. Sarkozy has advised on a number of bank deals, including ABN Amro's sale of LaSalle Bank to Bank of America for $21 billion, part of a breakup of the Dutch bank.

At Carlyle, Sarkozy spends much of his day poring over balance sheets and scouring troubled mortgage portfolios. He has been traversing the U. S. for the past few months, visiting local banks in tiny towns and regional players in urban areas. Now Sarkozy, along with Blackstone, Centerbridge, and W.L. Ross, are in discussions with management at Bank-United, a struggling lender in South Florida. "Private equity will be a prime catalyst in the necessary recapitalization of banks, both here and globally," says Sarkozy, 39. "The time is ripe."

BARGAINS IN THE 'CANDY STORE'

Perhaps the most combative arena for private equity these days is"the bankruptcy courts. Buyout firms are swarming, making bids on busted businesses and in some cases entering into bidding wars. Lynn Tilton, the pugnacious founder of Patriarch Partners, spends much of her time in court fighting over cheap assets. The 49 -year-old Tilton, known for her flamboyance in stiletto heels, recently lost a contentious 16 - day auction for instant photography pioneer Polaroid to rivals Hilco Consumer Capital and Gordon Brothers Brands. She's appealing the decision. On Apr. 20 Tilton bought Stila Cosmetics, filling out a portfolio of troubled brand names that include mapmaker Rand McNally. Stila had fallen behind on its debt payments, and lenders took control of the makeup manufacturer. They called Tilton on a Friday night to make a deal. She talked with management on Sunday and by the following weekend owned the company. "I haven't seen anything like this in 35 years," Tilton says of the opportunities before her. "This is like a candy store for us "

The value in Patriarch's distressed plays isn't always obvious. Last summer Tilton bought a paper mill in Maine, since renamed Old Town Fuel & Fiber. But she didn't buy it just to make pulp. A main attraction for Tilton is the mill's $30 million grant from the Energy Dept. for a research program studying how to make biofuels from wood chips. Tilton wants to produce a biofuel called butanol at the plant, which can be used as aircraft fuel. That would create another potential opportunity, because Patriarch also owns a helicopter maker and an aircraft parts manufacturer.

Few investments look as appealing as those blessed by government dollars. As part of the $787 billion federal stimulus package signed into law in February, the government has earmarked $29 billion to patch crumbling roads, bridges, and schools. Thanks to Uncle Sam, the infrastructure investing trend is picking up. The states' cash crisis is also sparking interest. "With states facing real economic trouble, you will see further pressure on them to hand over infrastructure to private firms," says Ben Heap, co -head of infrastructure in UBS's private equity group. There were 127 infrastructure funds in 2008, up from 91 in 2006, according to research firm Probitas Partners.

When Sadek Wahba, investment chief at Morgan Stanley's $4 billion infrastructure fund, goes shopping for deals, he follows two main principles. First, invest only in public necessities. Second, make sure the concerns of local citizens are heard—to minimize political problems later. In December, Morgan Stanley and a group of investors paid $1.15 billion for 36,000 parking meters in Chicago. Wahba is converting the old coin-operated devices to electronic pay machines. "These assets are a good hedge against inflation, because you are providing a basic service," says 43-year-old Wahba.

But the best example of private equity's shrewdness in the downturn may be its ability to spiff up its sullied image. In Pittsburgh, Robert B. Fay and his brother Pat feared selling their 62-year-old construction business, Joseph B. Fay Co., to private equity, worried that a buyer would dismember the company and lay off staff. The family's lawyer called New York's FdG Associates after reading that the $300 million buyout firm had experience working with family-run businesses. In all, the Fay brothers met with six private equity firms. FdG's team wore casual khakis to its meeting to underscore its anti-Wall Street image, while rivals sent representatives in designer suits. The Fays identified with the FdG team instantly and agreed to sell to the firm in February. Says Bob Fay: "These guys came to us as partners, not vultures." BW

-With Tara Kalwarski in New York and David Welch in Detroit

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Old Stakes, New Value

Amid the ongoing cash crunch, some university endowments, insurers, and other big investors are looking to sell their investments in private equity funds. An Apr. 13 piece on Deal.com reports that Goldman Sachs recently launched a $5.5 billion fund to buy up those stakes on what's known as the secondary market. "Things may be tougher than usual in the world of private equity . . . but it just means more opportunities for Goldman," the author writes.

To read the full article, go to **http://bx.businessweek.com/private-equity/reference**

CARBONARA, Peter; GRENNBERG, Jessica S. How Private equity could revive the economy, **Business Week**, New York, May 18. 2009.