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## COVER STORY

### Gluttons At The Gate

Private equity are using slick new tricks to gorge on corporate assets. A story of excess.



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- Three weeks after giant private-equity firm Thomas H. Lee Partners agreed to buy an 80% stake of Iowa Falls ethanol producer Hawkeye Holdings in May, Hawkeye filed registration papers with the Securities & Exchange Commission to go public. The buyout deal hadn't even closed yet, but Thomas H. Lee was already looking forward to an initial public offering expected to generate a huge profit on its \$312 million investment. The firm didn't just cross its fingers and wait, however: It took \$20 million from Hawkeye as an advisory fee for negotiating the buyout and a \$1 million "management fee"--and will soon take about \$6 million to meet its own tax obligations. All told, Thomas H. Lee will collect payments of around \$27 million by yearend--despite Hawkeye's having earned just \$1.5 million in the six months through June.



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**These are crazy times in the private-equity business. It used to be that buyout firms would spend 5 to 10 years reorganizing, rationalizing, and polishing companies they owned before filing to take them public. Thomas H. Lee couldn't have created much lasting economic value in the three weeks before the filing, but that didn't stop it from writing itself huge checks from Hawkeye's ledger. Thomas H. Lee and Hawkeye declined to comment.**

**Buyout firms have always been aggressive. But an ethos of instant gratification has started to spread through the business in ways that are only now coming into view. Firms are extracting record dividends within months of buying companies, often financed by loading them up with huge amounts of debt. Some are quietly going back to the till over and over to collect an array of dubious fees. Some are trying to flip their holdings back onto the public markets faster than they've ever dared before. A few are using financial engineering and bankruptcy proceedings to wrest control of companies. At the extremes, the quick-money mindset is manifesting itself in possibly illegal activity: Some private equity executives are being investigated for outright fraud.**

Taken together, these trends serve as a warning that the private-equity business has entered a historic period of excess. "It feels a lot like 1999 in venture capital," says Steven N. Kaplan, finance professor at the University of Chicago. Indeed, it shares elements of both the late-1990s VC craze, in which too much money flooded into investment managers' hands, as well as the 1980s buyout binge, in which swaggering dealmakers hunted bigger and bigger prey. But the fast money--and the increasingly creative ways of getting it--set this era apart. "The deal environment is as frothy as I've ever seen it," says Michael Madden, managing partner of private equity firm BlackEagle Partners Inc. "There are still opportunities to make good returns, but you have to have a special angle to achieve them."

Like any feeding frenzy, this one began with just a few nibbles. The stock market crash of 2000-02 sent corporate valuations plummeting. Interest rates touched 40-year lows. With stocks in disarray and little yield to be gleaned from bonds, big investors such as pension funds and university endowments began putting more money in private equity. The buyout firms, benefiting from the most generous borrowing terms in memory, cranked up their dealmaking machines. They also helped resuscitate the IPO market, bringing public companies that were actually making money--a welcome change from the sketchy offerings of the dot-com days. As the market recovered, those stocks bolted out of the gate. And because buyout firms retain controlling stakes even after an IPO, their results zoomed, too, as the stocks rose. Annual returns of 20% or more have been commonplace.

The success has lured more money into private equity than ever before--a record \$159 billion so far this year, compared with \$41 billion in all of 2003, estimates researcher Private Equity Intelligence. The first \$5 billion fund popped up in 1996; now, Kohlberg Kravis Roberts, Blackstone Group, and Texas Pacific Group are each raising \$15 billion funds.

And that's the main problem: There's so much money sloshing around that everyone wants a quick cut. "For the management of the company, [a buyout is] usually a windfall," says Wall Street veteran Felix G. Rohatyn, now a senior adviser at Lehman Brothers Inc. ([LEH](#)) "For the private equity firms with cheap money and a very well structured fee schedule, it's a wonderful business. The risk is ultimately in the margins they leave themselves to deal with bad times."

#### BRIMMING WITH CASH

Buyout firms are in business to generate returns for their investors, pure and simple. The faster they can do it, the better. During the boom of the 1980s, firms were fewer, smaller, and poorer. Their main strategy was to take over a company, issue a ton of high-interest-rate bonds, and then, over many years, try to produce enough financial improvements to make the deal pay off by selling the company or taking it public. The firms would pay themselves dividends from time to time, but usually after making at least some progress toward the larger goal.

Today firms are brimming with cash, and they're sinking more of it into bigger companies--in many cases even joining together in "club deals." With more skin in the game, they're extracting what they can, as quickly as they can, from companies to satisfy their investors. And since they're buying bigger companies, the amounts are soaring. Some justify it with euphemisms such as "an early return of capital." Critics liken it to strip mining and say dividends and other fees are becoming goals in themselves. "You can make a lot of money just on the fees," says Kaplan. "The concern is how much of that is driving [buyout] activity."

Now that the largest firms have as much as \$30 billion in assets, their 1% to 2% management fees alone guarantee hundreds of millions of dollars annually. The average

pay of a managing general partner at a big private-equity firm rocketed to \$6.1 million in 2005, up 93% from 2004, according to compensation research outfit Holt Private Equity Consultants. Jostling with the old familiar names like KKR, Carlyle Group, and Texas Pacific are fast-rising firms like Vector Capital, Veritas Capital, and Tennenbaum Capital Partners.

One way to gauge today's potential dealmaking power compared with the past is to analyze the capital commitments investors make to buyout funds as a percentage of the stock market's total value. By this measure, today's firms are more powerful than ever before, half-again eclipsing the 1987 peak. Yet deals are being done with much less leverage than was used during the 1980s. That suggests buyout firms could get a whole lot stronger. Some speculate that a \$90 billion deal is possible, dwarfing the record \$33 billion paid for hospital chain HCA Inc. ([HCA](#)), including debt.

The consequences of the fast-money mentality could be troublesome.

Intentionally or not, the corporate raiders of the past did some beneficial things for the business world. Then as now, their sole purpose was to generate returns, but they often succeeded in adding value to the broken companies they bought. As tales of their massive layoffs and other cost-cutting spread, the raiders frightened corporate executives into making efficiency improvements preemptively--helping the U.S. economy regain its strength. At their best, private equity firms managed to impose discipline on others.

Now many seem to be leaving companies worse off. The stocks of companies buyout firms have taken public are way off the historical pattern. From 1980 to 2002, buyout-backed IPOs outperformed non-buyout-backed IPOs, according to a study by Josh Lerner of Harvard Business School and Jerry Cao of Boston College. True to form, they've also beaten other IPOs from 2003 onward, by nearly four percentage points, according to Thomson Financial Corp. ([TOC](#)) But in 2006, buyout-backed IPOs are trailing other IPOs by nearly 10 percentage points. It's no wonder performance is slipping: With firms finding ever-more-novel ways to reclaim big chunks of their initial investments quickly, their incentive to produce lasting improvements may be diminishing. Too many appetizers spoil the meal.

And while the leverage being used in deals is much less than in the '80s, many buyout firms are loading up companies with debt after the fact to finance their big dividend and fee payments. Banks have lent companies \$71 billion since 2003 to pay dividends to private-equity owners, up from \$10 billion during the previous six years, according to Standard & Poor's LCD, which, like *BusinessWeek*, is a unit of The McGraw-Hill Companies ([MHP](#)). Credit ratings are falling fast. And while debt defaults are still ultralow by historical standards--around 1%--they're sure to rise. "If you look at the overall phenomenon, it has to mean an increase in defaults," says Solomon B. Samson, chief rating officer of corporate issuers at S&P. "And now that you have larger companies that are taking these big risks, you'd expect some of them to fall off the cliff." When that happens, employees and debt holders will suffer.

FAT, FATTER, FATTEST

But for now, business is booming, and signs of excess are popping up all over. The most glaring are the dividends. Once unthinkable, the \$1 billion threshold has been crossed several times now. Most recently, in June, Clayton, Dubilier & Rice, Carlyle Group, and Merrill Lynch ([MER](#)) collected \$1 billion just six months after buying rental car company Hertz Corp. for \$15 billion. With the dividend, the trio earned back almost half of the \$2.3 billion they put up in cash. All of the buyout firms declined to comment on the transaction, as did Hertz.

Fees, meanwhile, are getting bigger and more creative. Nowadays, when a private-equity

firm buys a company, it typically collects a toll for giving itself advice on the deal, sometimes more than investment bankers receive. Blackstone Group took \$45 million from Celanese Corp. ([CE](#)) for its advisory work on its own deal in 2004, more than twice the \$18 million Celanese paid Goldman Sachs ([GS](#)), its adviser. Warner Music ([WMG](#)) paid its owners, Bain Capital, Thomas H. Lee, and Providence Equity Partners, a \$75 million advisory fee. Blackstone, Bain, Providence, and Thomas H. Lee declined to comment. (In March, Thomas H. Lee left the firm he founded and started a buyout shop called Lee Equity Partners.)

Private-equity firms are beefing up charges for management expertise, too. In 2005, a trio of private-equity owners of SMART Modular Technologies ([SMOD](#)) collected nearly \$3 million for this purpose, more than the \$2 million in total that the five members of the company's management team earned that year. SMART Modular CEO Iain MacKenzie says there are no hard feelings toward his bosses. In his view, the company's owners deserved more because they shepherded SMART Modular through a restructuring. "We, as a management team, would not have had the knowhow, the financial acumen, and the pressure to bring about that level of change," he says.

#### DIP AND DIP AGAIN

Private equity firms even charge companies for no longer taking their advice. Specialty pharmaceutical maker Warner Chilcott ([WCRX](#))'s four private-equity owners--Bain Capital, Donaldson, Lufkin & Jenrette Merchant Banking, JPMorgan Partners ([JPM](#)), and Thomas H. Lee--recently collected \$27.4 million as compensation for terminating their advisory arrangements when the company went public in September, even though the company is unprofitable. All four firms declined comment.

To be sure, most firms still pay attention to operations. Texas Pacific Group bought J. Crew Group Inc. ([JCG](#)) in 1997 and spent nine years fixing it up before taking it public in June. The firm rejiggered operations so thoroughly that public investors couldn't help being impressed; the stock has zoomed 64%. "People in private equity want to make money based on value creation, not fee income," says private equity veteran Robert Finkel, managing partner of Chicago's Prism Capital Corp. "But," he says, "there are those who focus more on the latter than they should."

As the list of occasions for gathering fees and dividends grows, many firms are going to the well often, sometimes within months of their previous collection. At satellite operator Intelsat Global Services, a pack of private-equity owners--Apax Partners, Apollo Management, MDP Global Investors, and Permira Advisers--accumulated \$576 million in dividends and fees in multiple installments within a year of buying it for \$513 million in 2005. This, despite the company's posting a \$325 million loss last year. Intelsat has \$360 million in cash, while its debt has doubled, to \$4.79 billion. The new load led to multiple cuts in the company's credit rating. In February, Intelsat said in filings with the SEC that it reduced its workforce by 20%, laying off 194 people, to "optimize margins and free cash flow."

Like many other companies owned by private equity firms, Intelsat says struggles with profitability are unrelated to the higher debt burden brought about to finance payments to its owners. The layoffs were necessary for the company to make the transition from an intergovernmental organization to a company run for profit, explains Intelsat spokeswoman Dianne J. VanBeber. Besides, she says, Intelsat has enough cash to support the payments. "The company generates strong free cash flows, and since our capital expenditure cycle was largely completed, cash would continue to build on our balance sheet. Our owners took advantage of this and used the opportunity to give some of the free cash flow to themselves." Through VanBeber, Intelsat's owners declined to comment.

Many firms tap the public stock markets to bail their companies out of debt. Thomson Financial estimates that 55% of the proceeds from this year's buyout-backed IPOs were used, at least in part, to make payments to financial owners and creditors, vs. 21% of non-buyout-backed IPOs.

The case of San-Francisco's Bare Escentuals Inc. ([BARE](#)) shows how reliant firms have become on public stock investors. In 2005 the cosmetics maker took on \$412 million in debt, mostly to pay its owners, Boston's Berkshire Partners and San Francisco's JH Partners, a total of \$309 million in dividends and "transaction fees" in two installments eight months apart. The payments were a stretch for a company that earned only \$24 million in 2005. In September, 2005, Standard & Poor's revised its outlook for the company to "negative" from "stable," citing its "very aggressive financial policy."

Yet Bare Escentuals' owners, who bought the company in June, 2004, kept coming back to the trough. In June, 2006, despite S&P's decision in May to lower the company's credit rating from to B to B- and the company's soaring debt-payoff costs, Bare Escentuals began to borrow again to pay its owners even larger amounts: a \$340 million dividend, \$218,00 in management fees, and \$1.8 million in stock for arranging the dividend.

On Sept. 29, investors picked up the tab through an IPO. Most of the money raised was used to repay debt, except for \$1.8 million that went to the owners "as consideration for the termination of our management agreements with them." Bare Escentuals and its owners declined to comment on the payments. For now, the company is doing well both by its public investors and its owners. Its stock has jumped 44% since the IPO.

Most investors in buyout-backed IPOs have not been so lucky this year. Poor performance comes at a time when private-equity firms are attempting to rush companies into the public markets at warp speed. No one is likely to match the Thomas H. Lee-Hawkeye Holdings record of three weeks anytime soon. It's a special situation, perhaps, because the two were seeking to take advantage of the red-hot ethanol market. But other fast deals have raised eyebrows. Medical-device maker Alphatec Holdings Inc. ([ATEC](#)) went public in June, 15 months after being bought by Healthpoint Capital Partners Inc. In 2005, Alphatec paid Healthpoint a total of \$2.6 million in various advisory fees and rent. Its stock has plummeted 63%. "The way in which the market has valued the company is concerning and disappointing for us," says Alphatec Chief Financial Officer Steve Dixon, who points out that Healthpoint Capital maintains a 38% stake in the company.

Similarly, government services provider DynCorp International Inc. ([DCP](#)) filed its preliminary prospectus seven months after Veritas Capital Fund bought the company for \$775 million in cash and \$75 million of preferred stock in February, 2005. DynCorp paid \$12.1 million in fees in 2005, even though it posted a loss of \$3 million from February to April that year. DynCorp International's stock has tumbled 22% since its May IPO. Veritas Capital President Robert B. McKeon attributes the company's flagging stock price to an overall decline in the IPO market and in shares of middle-tier defense companies.

The big fees and quick flips are obvious attempts to unlock value right away. But the way the fees are funded is the real problem. Some buyout firms have loaded up companies with so much debt that they're ending up in bankruptcy or are about to. Already, a number of companies have been forced into Chapter 11 because their growing debt left no room to deal with operational challenges such as sudden spikes in raw material prices.

In February, 2004, for example, 16 months after San Francisco's Fremont Partners bought nutrition-bar maker Nellson Nutraceutical Inc. for \$300 million, the company borrowed \$100 million in part to pay Fremont a dividend of more than \$55 million, according to a creditor's filing in bankruptcy court. Nellson rationalized the dividend as a way to provide Fremont "an early return of capital" and to reduce Fremont's "risk in the investment,"

according to the filing.

But Nellson's energy bar sales went into a tailspin not long after the dividend. Eight months later, it was breaking loan agreements, according to bankruptcy filings. It filed for Chapter 11 protection in January. Fremont and Nellson declined to comment.

As one might expect, the fallout of the bankruptcy has been painful. Nellson owned a plant in tiny upstate Ira, N.Y., and was the town's largest employer, according to Cayuga County legislator Paul Dudley. The plant shut down in March, 2005, and the space remains vacant. Says Dudley: "It was a good source of employment for about 100 people. How many were able to get new jobs I don't know. This is a rural community, and people no longer have the luxury of working [just] two miles from home." On Oct. 16, the U.N. issued a warning about the potential economic dangers facing countries because of private equity firms' short investment time horizons.

Buyout shops have always been associated with job losses, but they've always rationalized them as necessary steps to make companies stronger. There's no way to defend what some critics allege has become a new tool in the private equity kit: intentionally driving target companies into bankruptcy to seize control of their assets. The name for the practice on Wall Street is "loans to own." By making a secured loan directly to a company, a firm can vault itself to the top of a company's capital structure. Should the business go under, loan holders have first dibs on the remaining assets; only after they take their cuts are the claims of creditors with unsecured debts considered. With so much money in private equity right now, "more firms are interested in take-control strategies," says Lisa G. Beckerman, partner at law firm Akin Gump Strauss Hauer & Feld.

At Radnor Holdings Corp. in Radnor, Pa., debts to private-equity firm Tennenbaum Capital Partners have sparked controversy. Radnor makes disposable cutlery, Styrofoam cups, and the like. In October, 2005, Tennenbaum made a \$25 million equity investment in Radnor that allowed it a seat on the company's board. Two months later, it lent Radnor \$95 million, with Radnor's machinery and property used as collateral. Then in April, 2006, it lent an additional \$23.5 million as high fuel, transportation, and resin prices squeezed Radnor's profit margins. To make ends meet, Radnor shuttered one plant and reduced its workforce by 10%, or 67 people. Radnor declined comment.

By August, the company was forced to file for protection under Chapter 11. Soon afterward, Radnor announced it had accepted a \$225 million bid from Tennenbaum for all of its assets. A group of unsecured creditors allege in a filing with the bankruptcy court in Delaware that Tennenbaum engaged in a "carefully scripted effort to force the debtors to shed legitimate arms-length financial and other obligations in order to facilitate Tennenbaum's acquisition of the debtors' cleansed assets."

"You can call us dumb, but you can't call us venal," says founder and senior managing partner Michael E. Tennenbaum, who insists his firm made the loans in good faith. "In 10 years, we've had a handful of times where we have had to foreclose, and we don't like it."

With small blowups like Radnor happening more often as firms push boundaries further and further, experts are beginning to assess the potential damage. "We're at a cyclical high," says Andrew Metrick, professor of finance at the University of Pennsylvania's Wharton School. "Whether that results in a storm or a soft landing is unclear."

Already, private equity returns are starting to cool. On average, funds lost ground in the second quarter, according to a Merrill Lynch report. "You have, at this point, a record amount of money committed," says Kaplan of the University of Chicago. "In the past, there were two other times when you had that much money--in 1987, and 1998-99--and in both cases returns weren't so good." After a few more down quarters the inflows that have

pumped private equity to absurd heights might start slowing down.

Of course, if returns suffer for too long, firms might grow even more desperate to engineer some quick fixes. If the troubling trends that have emerged in the past year persist, public shareholders and bondholders, not to mention the employees of affected companies, could be in for real trouble.

John Adler has to straddle many competing interests. As director of a private-equity team at the Service Employees International Union, he's responsible for keeping the union's returns strong. He also might be buying into some of the very investment firms that could jeopardize jobs of the people he serves. For now, though, he's taking the excesses of the private-equity market in stride. Says Adler: "Putting the right opportunities together with the right capital can really be a good situation for our members. Private equity owns a huge swath of the economy, and it's growing."

By Emily Thornton  
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