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■ *Cash Machine*

In Today's Buyouts, Payday
For Firms Is Never Far Away
New Owners Extract Stream
Of Charges and Dividends,
Running Up Company Debt
Burger King's Menu of Fees
By GREG IP and HENNY SENDER
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When a trio of private investment firms acquired Burger King Corp. in late 2002, the chain was unprofitable. But immediately, it started paying off for the investors.

At the time of the acquisition, Burger King paid its new owners -- Texas Pacific Group, the private-equity arm of **Goldman Sachs Group Inc.** and Bain Capital -- \$22.4 million of unspecified "professional fees." Burger King also started paying the group quarterly management fees for monitoring its business, serving on its board and other services. The total reached \$29 million by this year.



PRIVATE MONEY
The New Financial Order

First in a series

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- [In HCA Deal, a Risky Bet on Growth](#)¹
- [Barbarians at the Bedside: How Firms Plan to Profit](#)²
- [Who's Who:](#)³ Major private-equity firms, players, deals and holdings
- [Timeline:](#)⁴ Milestones in the industry's growth since the mid-1990s.
- [Big Buyouts:](#)⁵ Almost all of the largest buyouts have occurred in the past two years. [See the biggest announced U.S. buyouts](#)⁶.

In February, after three years of restructuring efforts under the new owners, Burger

before the sale, Burger King paid the owners a \$367 million dividend. The company justified it in part by saying it had produced cash "in excess" of its needs - and then borrowed to make the rich payment. Burger King also paid the owners a \$30 million fee to terminate their management agreement.

According to company filings, the three firms collected a total of \$448 million in dividends and fees from Burger King -- approximately what they initially invested. All that took place before the May stock sale, which valued their remaining stakes at \$1.8 billion -- more than triple their original investment.

These are the new rules of the private-equity game, part of a growing wave of private money reshaping global financial markets. Just yesterday, hospital operator **HCA Inc.** announced it would be taken private by Bain Capital, Kohlberg, Kravis Roberts & Co., **Merrill Lynch & Co.** and HCA managers and founders for \$21.3 billion plus assumed debt. Excluding debt, it would be the second largest buyout on record, after KKR's \$25 billion buyout of RJR Nabisco Inc. in 1989, and the second time HCA has been taken private. ([See related article.](#)⁷)

In many of their deals, the private-equity firms have turned the buyout game on its head. In the late 1980s, it was a high-risk, high-reward business that sometimes took years to pay off. Nowadays, buyouts can often generate income for the firms almost immediately, long before a significant turnaround in the company has occurred. And since acquired companies frequently borrow money to pay off the new owners, many are left saddled with debt.



Crowning moment

The Burger King at the NYSE, on May 18, when the company went public.

Having it their way

Some of the payouts from Burger King to its private-equity sponsors, in millions:

Dividends	\$367.00
Quarterly management fees	29.00
Fee paid at acquisition	22.40
Fee to terminate management fees	30.00
Reimburse sponsors' legal fees	0.50
Reimburse sponsors' other expenses	0.65
Interest	55.00
Goldman's IPO underwriting fee	6.35
Total:	\$510.9

Sources: company filings; Thomson Financial

A slew of companies -- Burger King, **Warner Music Group**, mattress maker Simmons Bedding Co. and Remington Arms Co. -- have paid their private-equity owners large dividends mostly financed with debt. In late June, the parent of Hertz Corp. borrowed to pay a \$1 billion dividend to Clayton, Dubilier & Rice Inc., Carlyle Group and Merrill Lynch, which acquired the company last December. They reaped that bonanza even though the rental-car company swung to a loss in the first quarter, primarily due to higher interest payments on debt incurred to complete the deal. Hertz has since announced plans for an initial public

stock offering, whose proceeds will go to pay down that debt. A spokesman for Hertz declined to comment on the dividend.

Since 2003, companies have borrowed \$69 billion primarily to pay dividends to private-equity owners, according to Standard & Poor's Corp. That compares with \$10 billion in the previous six years.

The resurgence of the buyout investors, and their new skill at quickly extracting money long before any turnaround bears fruit, are signs of the ascendance of private money and its broad impact on the world of finance. The new power players are private financiers -- hedge funds, buyout firms and venture capital firms -- that often operate with limited scrutiny from the public and regulators.

Collectively, hedge funds, which invest in all types of assets; venture-capital firms, which invest in early-stage companies; and buyout firms, which generally buy mature businesses, managed some \$1.5 trillion world-wide in 2005. That compares with \$54 trillion managed by pension, insurance and mutual funds, according to International Financial Services, London, an industry group.

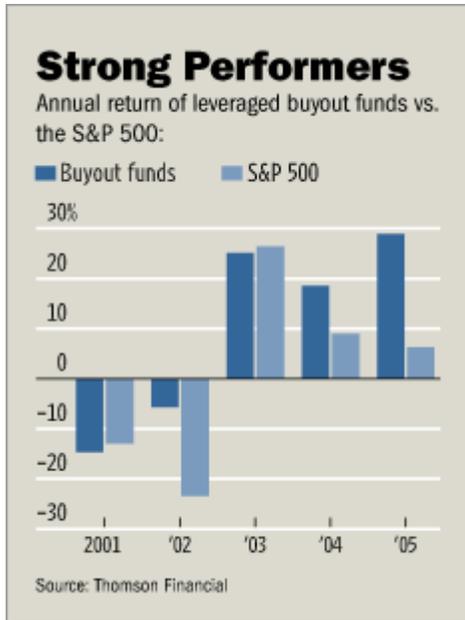
But the comparison understates the large and growing influence of private money. Hedge funds have become the biggest source of trading volume and commissions for the brokerage industry, sometimes accounting for half the daily volume at the New York and London stock exchanges, according to traders.

Growing Role

Private money is also playing a growing role in mergers and acquisitions, an area long dominated by companies. So far this year, buyout funds have been involved in 24% of mergers and acquisitions by value, according to Thomson, up from the 14% in 1988, the peak of the previous buyout boom. Venture-capital firms now manage \$259 billion, more than six times as much as a decade ago, according to Thomson and the National Venture Capital Association.

Proponents say hedge funds give markets flexibility and encourage risk taking, key underpinnings to a dynamic economy. Venture-capital funds have nurtured many smaller companies, and private-equity firms have made the tough choices to turn around a host of troubled companies.

The many ways to generate returns from private equity -- collecting dividends, and fees for advising, stock underwriting and management -- are drawing Wall Street firms. Last week both **J.P. Morgan Chase & Co.** and Merrill Lynch cited hefty private-equity gains for steep rises in second-quarter profits. Goldman Sachs is now one of the largest private-equity investors in the world. In May, Goldman, along with other investors, teamed up with the management of **Kinder Morgan Inc.** in an agreement to buy out the pipeline operator for \$13.5 billion, plus assumed debt. And Merrill is a lead investor in the blockbuster HCA deal.



The new quick-profit buyout game is fueled by low interest rates and willing credit markets. They let private-equity firms use their investors' capital, and lots of debt, to buy mature companies like Burger King from public shareholders or corporate parents.

Buyout funds averaged annual returns of 24% in 2004 and 2005, according to Thomson Financial, triple the return of Standard & Poor's 500 stock index. The returns have set off a scramble by investors ranging from college endowments to rich individuals to get in on the private-equity world.

But the payouts to private-equity firms that often follow deals come at the cost of

mounting debts for the acquired companies. One caution sign: Two-thirds of the loans issued to pay dividends to private-equity firms are rated single-B or lower, a highly speculative rating, according to S&P. Historically, more than a quarter of loans rated single-B have defaulted after five years, S&P says. If interest rates keep rising or the economy stumbles, many of those companies could find themselves in trouble. Some might be forced to cut jobs or capital spending to manage their debt burden. Some could go bankrupt.

Michael Madden, a veteran investment banker who now runs his own private-equity firm, BlackEagle Partners LLC, says fees charged by private-equity firms can be compensation for the time and manpower required to turn around a company. They're less defensible, he says, if the buyout firm is simply attending board meetings "and not living on the scene day to day."

Dividends, he says, allow private-equity firms to reap a quicker return than through an IPO or sale. That in turn attracts more investors, enabling more and bigger deals. "Are they logical?" Mr. Madden asks. "Yes. Do they increase the systemic risk in the buyout business? Absolutely."

Warburg Pincus and Vestar Capital Partners, two major private-equity firms, generally don't extract fees from their portfolio companies, though both sometimes take dividends. Executives at both firms say the practice of charging fees means the new owners' interests are no longer aligned with those of the company: The company can do poorly while the private-equity firms do well.

The case of **Dade Behring Inc.**, a medical diagnosis company, illustrates the risks when buyout firms take big payments. In 1994, Boston-based Bain Capital and the private-equity arm of Goldman Sachs bought Dade International, Deerfield, Ill., for about \$450 million. Of that, only \$85 million was the firms' own money.

Among private-equity firms, Bain is one of the largest recipients of dividends from its own companies, according to S&P. The firm, co-founded by Massachusetts Governor Mitt Romney, is also one of the most aggressive funds in the field. Last year, it bid for the entire National Hockey League.

In late 1996 Dade acquired a division from DuPont Co., boosting sales and debt. In 1997 it merged with Behring Diagnostics, a unit of Germany's Hoechst AG, which is now part of Sanofi-Aventis SA.

In 1999, Dade Behring borrowed again, in part to buy back a chunk of the equity stake belonging to Bain and Goldman. The \$365 million paid to the firms was more than four times their original equity investment. The payment helped boost Dade's long-term debt to \$902 million by the end of 1999, compared with \$373 million a year earlier.

Over the next few years, the euro weakened against the dollar. Since half of Dade Behring's sales were in Europe, the company had fewer dollars coming in. At the same time, rising interest rates meant higher payments on its increased debt load. To deal with the one-two hit, Dade-Behring laid off 1,000 of its 7,000 employees and shuttered factories. In 2001, Dade Behring considered filing for bankruptcy protection to restructure its debts.

Some creditors formed a committee that examined the conduct of Dade's owners, directors and advisers, including Bain and Goldman. According to a company securities filing, they considered bringing claims relating to "illegal dividends, illegal stock redemption and impairment of capital," among a long list of items.

Though they said there was no merit to the matter, Goldman and Bain agreed to forgive some Dade debt they had purchased from other lenders after their own initial equity investment. The creditors decided not to sue. In August 2002, with the consent of most creditors, the company filed for Chapter 11 bankruptcy protection.

A Bain spokesman says the company was struggling when it was acquired by the private-equity firms. "We grew it and improved the products through several mergers," he says. The purpose of the 1999 payment was to boost Hoechst's ownership stake, he says, adding that the company's debt was "quite modest" by today's standards. Goldman and Dade declined to comment.

Dade emerged from bankruptcy and went public in 2002. Shorn of much of its debt, and aided by a stronger euro, it recovered. Ultimately, the investment proved to be among the best performing companies in the Bain fund that held it, according to people familiar with the matter.

Intelsat Ratings Lose Altitude

At Intelsat Ltd., an operator of communications satellites, debt taken on to pay new owners has stirred controversy. The storied organization traces its roots to the international consortium that captured the first images of man walking on the moon and operated the hotline between Washington and Moscow. Jobs at the company were secure and well paid and came with generous benefits.

In 2001, Intelsat became a privately owned corporation. After originally seeking an IPO, it agreed in 2004 to be bought by private-equity firms Apollo Management, Apax Partners, Madison Dearborn Partners and Permira. When the deal closed in early 2005, it looked like a risky proposition: Just weeks earlier, one of the company's satellites failed, the second malfunction in a few months. The financiers discussed renegotiating the deal at a lower price but decided against it.

The group put up \$515 million of its own money to finance the acquisition for \$3 billion, plus assumed debt.

Despite the shaky start, the new owners quickly issued more debt to pay themselves a \$306 million dividend. Intelsat also paid the buyout firms a \$50 million "transaction and advisory fee," and over the course of 2005, \$21.5 million in other



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