

## **The Recycle Industry LBOs Return as Private Equity**

The name may be different, but the game is still the same. **In the 1980s, the catch phrase was "leveraged buyouts," while today the moniker is "private equity"** ("PE"). Most famous of the leveraged buyouts was the \$30.6 billion hostile takeover of RJR Nabisco in 1989, which was chronicled in the book *"Barbarians at the Gate."* To prove that little has changed, leading that assault was the buyout firm of Kohlberg Kravis Roberts, the same firm that is # 2 on *Fortune* magazine's "March 2007 Private Equity Power List."

While many investors view the world of "alternative investments," such as private equity, as the domain of wealthy individuals, pension funds, and insurance companies, they may be oblivious to the role that private equity is playing in their everyday lives. **If your day includes a cup of Dunkin' Donuts coffee, a drive-through at Burger King or shopping with J. Crew, Toys "R" Us or Neiman Marcus, you have done business first hand with private equity buyouts. Other familiar names include Hertz rental cars, Loews cinemas, Harrah's casinos and Fairmont hotels along with the HCA hospital chain and Spanish-language TV network, Univision.**

Thomson Financial reported that during 2006, private-equity firms bought 654 U.S. companies for a record \$375 billion. And according to Blackstone Group, #1 on the Fortune Power List, the global buyout industry currently has \$400 billion in equity available to be invested. With leverage, that \$400 billion represents as much as \$2 trillion in potential buying power, equal to 20% of the value of all U.S. mutual fund assets.

Before passing judgment on whether private equity is good for the investment world, we need to understand what it is and how it is supposed to work. **Private equity (PE) refers to the practice whereby groups of investors, notably private equity firms and their clients, buy out all the**

**publicly traded stock of target companies. These companies are then said to "go private."**

Typically, the purchase is aided by a high level of borrowed money, explaining why the same process was labeled during the 1980s as "leveraged buyouts" (leverage referring to the borrowing), or LBOs. The question remains, "What makes going private so attractive, and what accounts for the 20-year average return of 13.2% which has handily outpaced the 9.7% average return posted by the bellwether Standard & Poor's 500 index?"

### **Added Value or Hocus Pocus?**

The following hypothetical and somewhat simplified case illustrations are provided by the Carlyle Group (#3 on Fortune's private equity power list). In each example, the Company "taken private" has \$10 million dollars in annual profits and is purchased for ten times that, or \$100 million. The initial acquisition structure calls for the private equity firm to put up \$30 million in equity, with the remaining \$70 million borrowed.

In case #1, new management has no impact and/or the equity markets are uncooperative and profits remain unchanged. Five years later, they're still a \$10 million profit company. But the \$10 million in annual profits have been used to repay \$30 million in debt. (Lower taxes help, because the interest payments from the borrowing are tax-deductible.) The company is then resold for the same \$100 million. Interestingly, **the private equity firm has doubled its original investment of \$30 million (nearly a 15% annual compounded rate of return)** as it has used \$40 million to repay the remaining debt and is left with \$60 million.

Alternatively, we assume that profits increased to \$15 million after five years. The restructuring instituted by the private equity firm has been successful with expenses reduced, bloated management eliminated, and reinvestment in successful new products achieved. The company is resold, again for ten times profits, but in this case receives \$150 million. After repaying the

\$70 million loan, the private equity firm nets \$80 million, almost triple its initial investment (A 21.7% compounded annual return). On the surface, the recipe for private equity success seems easy. As described in *The Economist's* private equity article entitled *Caveat Investor: "Take an underperforming company. Add some generous helpings of debt, a few spoonfuls of management incentives and trim all the fat. Leave to cook for five years and you have a feast of profits."*

Given the number of infamous LBO flameouts, such as the \$1.6 billion Revco drugstore transaction that ended in bankruptcy in 1988, the formula for success is obviously more complicated. In studying this issue, authors Geoffrey Colvin and Ram Charan of *Fortune* magazine (*Private Lives*, November 27, 2006) found, "there are management strategies and techniques that enable PE-owned firms to produce stunning results that others can't match." For example, since PE firms want to realize their profit within a 3-5 year horizon by reselling their acquisitions back to the public via an IPO (Initial Public Offering) or "flipping" the company to another PE firm with a slightly longer time horizon, **the only objective is effecting positive change, and doing it at breakneck speed.**

Motivating management also goes far beyond the typical public company executive compensation packages that include stock options, restricted stock, and benefits that are layered on top of an already hefty base pay. Since private companies have no obligation to report executive pay in SEC filings, they are free to offer signing bonuses or back-end payouts that would likely generate a public outcry from shareholder activists and the press.

**No matter how tightly the compensation package is tied to performance however, there is no higher motivation than having one's own money invested in the deal.** In the Dunkin' Donuts transaction, CEO Jon Luther insisted that all officers invest a substantial amount of their personal money. As reported by Luther, "There's now a very different discipline in how you spend money . . . if it doesn't grow the business, why would you do it?"

The advantages of private company management extend beyond just these pay issues. **The theory behind private equity is that the ownership model is better and more efficient than the traditional public-shareholding model. Most often cited are the freedom from regulation (particularly Sarbanes-Oxley), the stock market and media.** Colvin and Charan found that some 40% of a public company CEO's time was consumed trying to "placate and massage the public markets." The authors concluded that what private-equity firms have figured out how to do is "Attract and keep the world's best managers, focus them extraordinarily well, provide strong incentives, free them from distractions, give them all the (board of directors) help they can use, and let them do what they can do." **When well executed, the combination of financial structuring and motivated, adept, private management can ignite a profit explosion.**

Not everyone, however, is so enthralled by the private equity model. Commenting on the business execution and operational improvement claims of the PE industry, GE CEO Jeff Immelt compared the perpetual life of his company to the almost "incubator" approach of PE "flips" stating, "If I 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." Even PE market participants like Rich Friedman, head of merchant banking at Goldman Sachs, whose PE business has \$27 billion in assets concedes that **"Cheap debt is the rocket fuel" for private equity.**

### **The New Junk Bonds Called CLOs**

Nearly everybody remembers the days of Michael Milken, the "junk-bond king" from Drexel Burnham who engineered the debt structure that fueled the LBOs. But who are the lenders supplying all this Private Equity debt and how will this round of leverage end up? Again, it may be an unsuspecting crowd. **Income investors, battered by years of sub-par yields have flocked to the higher returning CLOs or collateralized loan obligations, representing packaged slices of these leveraged loan pies.** In terms of risk, Edward Altman, professor of finance and director of fixed income and debt

research at the Salomon Center at New York University, warned that **more than 50 percent of the loans tied to highly leveraged transactions in 2006 involved companies whose bonds or loan financing received a CCC rating, the lowest and most risky given to new financings.** “Traditionally, these financings result in a fairly high default rate,” Altman said citing his statistics which show that **one-third of CCC- rated bonds default within three years of issuance, and about 50 percent default within five years.**

Putting it most bluntly is PE critic David Swensen, 22-year veteran manager of Yale University’s endowment fund, who stated in his 2005 book, *Unconventional Success*, “The large majority of buyout funds fail to add sufficient value to overcome a grossly unreasonable fee structure.” Citing the typical 2% management and 20% of profit participation fees, **Swensen notes that merely adding comparable leverage to the S&P 500 delivers returns that beat the buyout boys “like a rented mule.”** And long-term buyer and owner of companies Warren Buffett of Berkshire Hathaway answered his own question, “How will private-equity firms continue to make money by just flipping and flipping and flipping? They’ll make it on fees, fees, fees.”

So what, actually, is the performance record for the Private Equity industry? According to a study by McKinsey, **the returns for 106 mid-market and 57 large-cap PE funds raised in the U.S. between 1995 and 2001 showed that the top quartile of PE funds easily outperformed,** gaining 23% and 17%, respectively, compared to the 11.5% and 5% returns posted by the public index benchmarks. Interestingly, though not surprising, the “best of the best” PE firms generated returns as high as 57% and 28% for the two categories, while **more than half of the total funds came in far under the indexes.** In response to these impressive performance statistics, critics of the industry cite several facts. First, in 1991 there were just 57 funds competing for deals while the number had risen to 686 by the end of ’06. Second, the \$430 billion in private-equity funds raised last year was more than the total garnered by the industry between 1990 and 1998. Finally, as cautioned by George Siguler, managing director of PE firm Siguler Guff,

**“Historically, the highest returns in the buyout business have come from investments that were made during periods of declining interest rates, a recession or in the early stages of economic recovery.”**

Today, since the life cycles of most Private Equity deals are arguably closer to their beginning (“going private” date) than their end (“going back public” date), it is hard to tell what the outcomes will eventually be. Where companies to be taken private have been carefully chosen and the financing appropriately structured, the benefits are likely to be plentiful. But, in attempting to judge the future of Private Equity, what better way could there be than observing the actions of two of the major players in the industry.

### **Better a Buyer or a Seller?**

The first is Mr. Sam Zell, the CEO and Chairman of Equity Office Properties (EOP), a firm just “taken private” by the Blackstone Group to the tune of \$39 billion. **Repeatedly recognized as one of the preeminent prognosticators of market peaks and valleys, Zell has obviously chosen to be a seller rather than a buyer, at least in commercial real estate.** The second is Stephen Schwarzman, CEO of Blackstone, and recently anointed the “New King of Wall Street” by *Fortune* magazine. Ironically, at the same time that Mr. Schwarzman is railing about the corporate governance manacles placed on public companies by the Sarbanes-Oxley Act and calling stock markets “overrated,” Blackstone is reported to be planning an IPO (Initial Public Offering) of as much as 10% of its own company. **If and when this transaction comes to market, do you think the seller or the buyer will get the better of the deal?**

*Christopher E. Grant*

### **Grant/GrossMendelsohn, LLC**

36 South Charles Street, 18<sup>th</sup> Floor  
Baltimore, MD 21201  
Office: 410 685-9685  
Facsimile: 410 752-1148  
E-mail: [chris@noloadria.com](mailto:chris@noloadria.com)

## 1<sup>st</sup> Quarter 2007 Market Review

Volatility characterized the first quarter of 2007 in which a one-day, 9% decline in Chinese equity markets was felt throughout the world. This decline led market participants to examine risks that were not, as of yet, fully discounted in the stock prices. Contributing to the sense of heightened market risk were the potential unwinding of the yen “carry trade” (in which one borrows at lower Japanese interest rates and invests proceeds into higher yielding investments elsewhere), weakness in the U.S. sub-prime housing market, public comments from past Federal Reserve presidents on the potential for recession, slowdown in the domestic economy, continuing upward pressure on energy prices, and international geo-political conflicts.

The DJIA experienced a turbulent quarter as it experienced both a 325 point (1.4%) rise to start the year and a one-day, 416-point (3.25%) drop (on February 27) that culminated in a fall of 735 points (5.75%) over nine trading sessions. The index eventually closed down 0.87% for the quarter. The S&P 500 and NASDAQ composites however, which experienced similar volatility, finished the quarter up 0.64% and 0.26%, respectively. (Please refer to the performance illustration to the right for comprehensive YTD returns.)

Out-performance by Mid Caps and a modest tilt towards growth highlighted the 1<sup>st</sup> quarter. Mid Cap Growth (4.07%) and Value (4.03%) styles took the limelight as investors turned their attention away from the often more popular Large Cap and Small Cap cousins. Growth stocks edged out their value counterparts in all three market capitalization categories. Time will tell if this is the beginning of a new trend or just a one-quarter aberration.

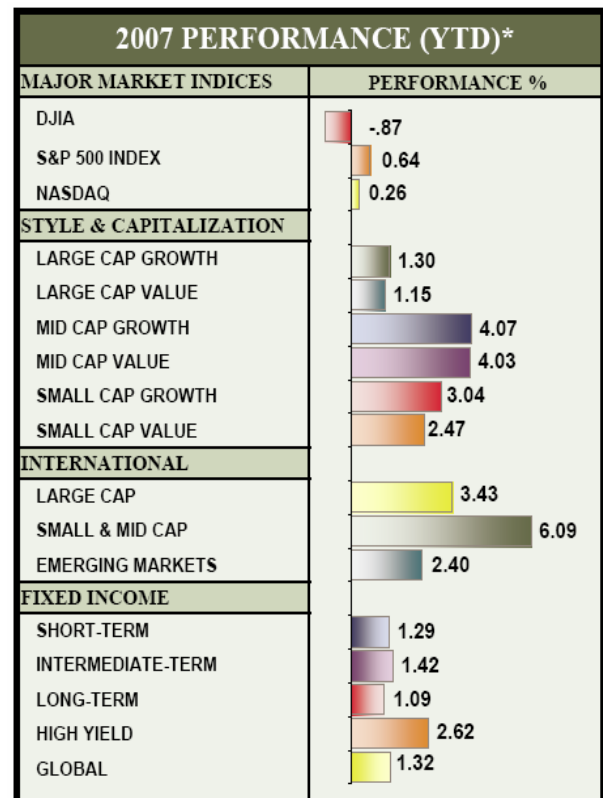
Top sectors included familiar winners from last year: Utilities (8.43%), Materials (8.38%), and Telecom Services (6.36%). Financials trailed other sectors and proved to be the worst performer, reflecting mortgage market weaknesses.

Mixed economic signals and inaction by the Fed in late 2006 continued into the first quarter of

2007. And although the last Federal Reserve meeting did not lead to changes in interest rates, a softening inflationary tone pushed bond yields *down* 0.21 and 0.05 basis points for the quarter (for two and 10-year maturities, respectively), and *up* 0.05 basis points for 30-year maturities – creating a normalized, yet essentially flat, yield curve.

Emerging markets, as a group, responded similarly to the fall in Chinese markets as the MSCI Emerging Markets index fell 10.23% between February 27 and March 5. Other international sectors experienced similar volatility, albeit to a lesser degree. But while domestic sectors and style groups struggled to reclaim their highs for the quarter, most international markets did. International Small and Mid Caps, often overlooked by investors, outperformed *all* other investment categories, rising 6.09% during the quarter – possibly setting the stage for a potentially rewarding 2007.

*Jim Hai*



Source Data: Morningstar, Inc. (investment category performance)

\*Year-to-date as of 03/31/2007