

Firms Go Private In Search of Deeper Pockets

By David Cho Washington Post Staff Writer Wednesday, January 31, 2007; A01

The world may be eating more doughnuts now that Jon Luther's firm, Dunkin' Brands, has joined the most prominent trend on Wall Street these days: going private.

Since three private-equity firms bought out the Dunkin' Donuts parent for \$2.4 billion in 2005, Luther has doubled store growth, retooled his executives' pay and opened his first branches in Asia. And he did it behind a veil of privacy, away from the glare of analysts and federal regulators.

All of this was made possible by the deep pockets of private-equity firms. "These are not barbarians at the gate," Luther said. "They are more partners than owners."

Not since junk bonds has an alternative form of investment risen to prominence as quickly as private equity, an obscure world where fund managers risk billions to buy and try to turn around slumping companies, and then sell them for a profit.

With unprecedented sums in their coffers, private-equity firms have the ability to buy all but the biggest companies. Among their prize catches are Toys R Us, Neiman Marcus, Hertz, Burger King, [Harrah's Entertainment](#), [Clear Channel Communications](#) and HCA, the nation's largest hospital company.

Last year, private-equity firms spent a record \$540 billion to acquire companies in virtually every sector, up from \$59 billion three years ago, and in the process have been dramatically changing the cast of powerbrokers on Wall Street. Although average investors can benefit from the run-up in stock prices during one of these buyouts, the trend has concentrated control of major swaths of U.S. industry in the hands of a few wealthy groups that do not have to reveal much about their operations.

This year began with the biggest proposed private buyout on record -- for [Equity Office Properties Trust](#), the nation's largest office landlord. Blackstone Group last week put forth a \$38.3 billion buyout offer, which would include the assumption of Equity Office's \$16 billion debt. That bested a \$38 billion bid earlier this month by a group of real estate investors led by [Vornado Realty Trust](#). Today is the deadline for that group to make a counter bid.

The surge in private deals is raising concerns in Washington. The Justice Department is looking into whether some of these buyouts are anti-competitive. Last week, the Federal Trade Commission ordered District-based Carlyle Group, the nation's largest private-equity firm, to give up management control and its board seats at Magellan Midstream because Carlyle is part of the group buying oil pipeline operator [Kinder Morgan](#) for \$22 billion. The two energy-distribution companies dominate the same 11 markets

across the Southeast United States.

Unlike the late 1990s, when founders of Internet start-ups dreamed of seeing their ticker symbol stream across public exchanges, going private is suddenly in vogue.

The success of private equity has drawn the affluent and powerful, including former president George H.W. Bush, former Massachusetts governor Mitt Romney and U2's Bono, as well as such corporate luminaries as Jack Welch, the retired head of [General Electric](#), and the former chief executives of Wells Fargo, IBM and [Procter & Gamble](#).

"Today there isn't a public board out there that hasn't talked once about private equity, whereas five years ago it may have been the exception," said Jordan Hitch, managing director at private-equity shop Bain Capital. "The sexiness of being public has been diluted."

Private-equity firms usually accept money from only super-wealthy investors and huge institutions like pension funds. As massive private funds formed over the past few years and returned about 25 percent annually -- with top performers getting 40 percent or higher -- nearly all major pensions reallocated their holdings, pouring billions into the sector despite the higher risks. These pensions now are tied to how private equity navigates the economy, said Colin Blaydon, director of the Center for Private Equity and Entrepreneurship.

Private equity "is seen by pension funds as their best hope," Blaydon said. It will have a huge impact on "the average worker -- teachers, firemen, the guys on the assembly line. . . . It is a big part of their retirement benefit."

But this murky world is not easy to grasp and can be risky. The deals are complex in how debt and financial tools are used to acquire firms. Also, private companies do not have to submit financial statements to the Securities and Exchange Commission or hold public conference calls with analysts.

Yet private equity's imprint on Wall Street is unmistakable. When recent rumors emerged of a possible deal for [Home Depot](#), the company's stock rose while the price of its corporate bonds dropped -- a sign that both stock and bond holders thought a private buyout was possible, despite the company's market capitalization of \$87 billion, said Michael Dahood, a fixed-income analyst at Sterne, Agee & Leach Group.

Analysts say even bigger buyouts than the one proposed for Equity Office could happen this year since private-equity firms often team up to buy companies. Private buyouts drove the volume of mergers and acquisitions to a near record last year, accounting for 30 percent of announced deals, according to Bloomberg Financial. In the 1980s and '90s, that figure had been between 3 and 5 percent.

"If one firm is capable of taking down a \$30 billion firm, where is the ceiling for what two or three or

four private-equity firms could do [together]?" said Robert Keiser, vice president of proprietary research at Thomson Financial.

Some analysts are concerned that this trend -- like the dot-com era of the late 1990s -- is a bubble that will burst during a downturn when the money for acquisitions becomes harder to borrow. They add that it is hard to track what many of these firms are doing.

"When a credit downturn occurs, there's the potential here for quite high default rates and large losses for debt holders," said Ken Emery of Moody's Investor Service.

For their part, chief executives say going private can be a boon to business. [Burlington Coat Factory Warehouse](#) agreed to a private buyout last year after 34 years as a family-owned business. The stock had been languishing when Bain Capital bought the firm for \$2.1 billion. Since then, said chief executive Mark Nesci, the firm has invested in new technology and customer research -- expenditures that may pay off down the road but could adversely affect earnings the next quarter.

"As a private company, if the results take a little longer to produce than expected, we don't get crucified," Nesci said.

Chief executives typically restructure executive compensation after a private buyout to align performance and pay. Luther of Dunkin' Brands, for one, insisted that all of his officers invest in the business.

This does not mean pay is lower in the private sector. Millard "Mickey" Drexler, whom private-equity shop Texas Pacific Group hired to run J. Crew, earned a modest \$200,000 salary. But he was allowed to invest his own money and held a 12 percent stake when the retailer was spun back to the public market in what was one of the most successful initial public offerings of 2006. The value of his shares is estimated at \$194 million.

Private-equity firms make money by charging pensions and other investors about a 2 percent fee each year, meaning a \$1 billion fund would produce \$20 million for the fund managers. They aim to sell these companies in about three to five years, typically reaping 20 percent of the gain, with the rest going to investors. In some cases, the pressure to sell has created a slash-and-burn attitude. The billionaire investor Warren Buffett decried this aspect of private equity and criticized the firms for bilking investors with high fees.

Private-equity firms acquire companies through leveraged buyouts. In general, firms have two sources of cash for operations, debt and equity. Private-equity buyouts aim to load companies up with lots of debt.

The concept is akin to buying a house with a small down payment. If a buyer purchases a \$100,000 home with \$10,000 in cash and a \$90,000 mortgage loan, that person would enjoy a bigger percentage gain if the house rises in value than someone who buys it outright. The downside, of course, is the risk of taking on so much debt -- a homeowner may not be able to make the mortgage payments. The buyer also could

lose the down payment if the value of the property falls.

In recent years, borrowing massive sums has become easier, with more favorable terms offered to borrowers. This cheap credit has been the primary driver behind the surge in leveraged buyouts.

Many industry buffs say this party won't last forever. Even Blackstone Group co-founder Steve Schwarzman said last week that he expects returns from private-equity firms like his to decline as the business cycle turns.

Others say that even if returns decline, companies in the long run would be strengthened by the turnaround efforts of private-equity firms.

"Money has become a commodity," said Daniel D'Aniello, co-founder of Carlyle Group. "It's what you add on the shop-room floor that will make the real difference."

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