

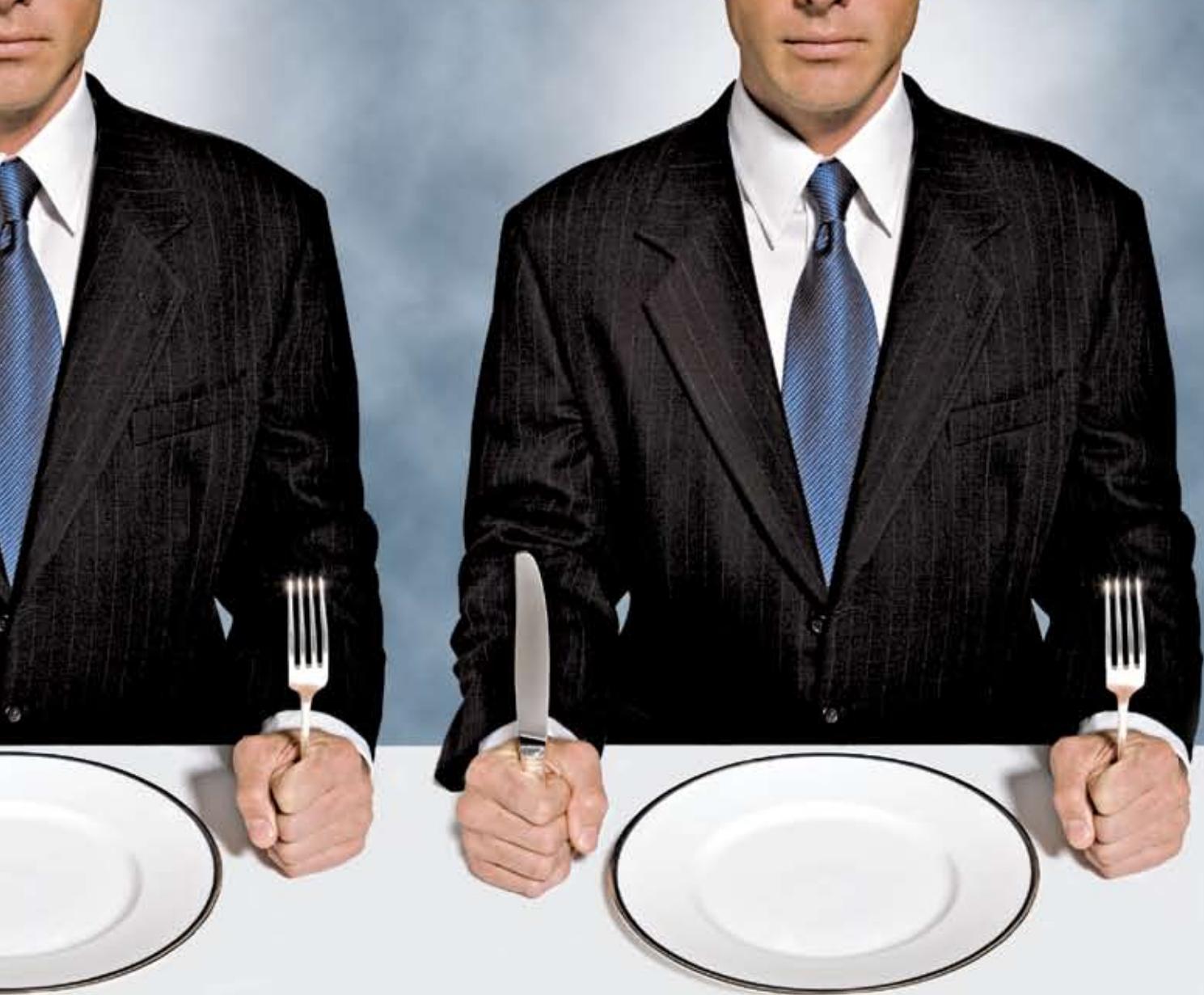


Gluttons at the Gate

Private equity firms are using slick new tricks

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

FREDRIK BRODEN



to gorge on corporate assets. A story of excess.

BY EMILY THORNTON

million by yearend—despite Hawkeye’s having earned just \$1.5 million in the six months through June.

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 extract-

ing 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 (page 68).

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 Eq-

uity 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. “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

Dividends Many voracious buyout firms are leaving companies depleted

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 (chart, page 66). 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., 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. 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. 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 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. for its advisory work on its own deal in 2004, more than twice the \$18 million Celanese paid Goldman Sachs, its adviser. Warner Music

Warning Signs

As private equity firms become more powerful, several distinct trends have emerged that suggest the industry is running unchecked

HUGE DIVIDENDS AND FEES

Firms are pulling record sums from the companies they own—in one case \$1 billion. They're charging enormous fees for everything from dispensing advice to covering their taxes.

SERIAL CHARGES

Buyout firms are collecting big payments from companies several times a year, sometimes so much that it impairs the companies' financial strength.

DEBT BOMBS

Firms are loading up companies with so much debt that their credit ratings are suffering; some of them are even ending up in bankruptcy.

QUICK FLIPS

Firms are bringing private companies to the public stock market at record speed, in some cases less than a year after buying them.

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 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's four private-equity owners—Bain Capital, Donaldson, Lufkin & Jenrette Merchant Banking, JPMorgan Partners, 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. 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.

Serial Charges

The list of reasons for fees grows and grows

“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. shows how reliant firms have be-

come 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 deals have raised eyebrows. Medical-device maker Alphatec Holdings Inc. 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. 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

Private Equity Goes Over the Top

Insider Trading: The SEC is looking into private equity deals.

How Big Is Big? A slide show ranks the top 10 buyout firms.

Paydays: Take a peek at how much private equity executives earned last year.

Listen In: Executive Editor John A. Byrne's podcast with Associate Editor Emily Thornton.



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Debt Bombs

Some firms load companies up with so much debt they land in bankruptcy

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

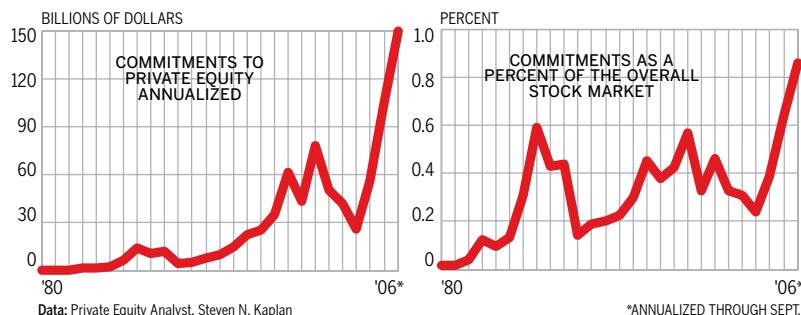
structure. Should the business go under, loan holders have first dibs on the remaining assets; only after they take their cuts are the claims of creditors with unsecured debts considered. With so much money in private equity right now, "more firms are interested in take-control strategies," says Lisa 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

Gold Rush

The amount of money investors are committing to private equity funds has reached record highs



“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.” ■

Looking Out for Number One

The private-equity gold rush is encouraging some fund executives to cross the line. While cases of fraud at private equity firms are rare, some schemes are outright brazen. Consider the case of John A. Orecchio. On Sept. 8, the Securities & Exchange Commission charged the 40-year-old president and co-owner of AA Capital Partners Inc. and the firm with fraud, alleging that at least \$10.7 million had been misappropriated from pension-fund investors.

Chicago’s AA Capital Partners carved out a small but comfortable niche in the world of private equity.

The firm manages \$194 million for six unions. When Orecchio asked clients to put \$68 million in trust accounts to be used at the firm’s discretion for “capital calls,” it appeared to be business as usual.

But law enforcers allege much behind-the-scenes malfeasance. A total of \$5.7 million was allegedly diverted from clients’ trust accounts between May, 2004, and October, 2005. Some of that went to a horse farm in Michigan and a company that manages a strip club in Detroit, both of which were owned by Orecchio. He allegedly described the money to his chief investment officer as “reimbursements” for what he claimed was a miscalculation of taxes, and



Fraud Allegations

Charges of outright stealing taint some private equity firms

the CFO carried out the money transfers. The SEC alleges an additional \$5 million in client funds was used to cover a shortfall between the firm’s revenues and operating expenses.

The SEC asked a judge to appoint a lawyer to take control of AA Capital. The lawyer has since brought in forensic accountants to comb through AA Capital’s records. Among the items: \$4.3 million in travel and entertainment expenses that

Orecchio racked up in 2006, \$1 million of which appeared to be routed to interest groups such as the Michigan Democrats and Citizens for Greater Detroit. Hundreds of thousands of dollars went to private-plane rentals and visits to nightclubs in Las Vegas. “We know how much [money] is left,” says the court-appointed lawyer, W. Scott Porterfield, although he declines to reveal the amount. The more complicated question, he says, is to what extent investors’ money was commingled, devoted to Orecchio’s many personal expenses, or disguised as “capital calls.” Through his lawyer, Orecchio declined comment.

AA Capital Partners isn’t the only one tainted by fraud charges. In June, 2005, Todd Berman, a founder and partner of the New York private-equity firm Chartwell Investments, began serving a five-year sentence in a Pennsylvania prison for stealing more than \$3.6 million from the firm, its portfolio companies, and its investors. Berman pleaded guilty to fraud charges brought by the Justice Dept.

For 18 months, Berman misled Chartwell’s investors concerning the financial condition of one of the firm’s portfolio companies by falsely claiming it needed to borrow funds to meet operating expenses. Instead, Berman transferred the money to his personal bank account, along with fees paid by portfolio companies. Berman also charged some 600 personal expenses to the companies and the firm, many of which were incurred while he was on vacation. They included a private-jet bill for \$78,795 for a trip to South Africa and an \$80,468 bill for a trip to Antigua, according to the Justice Dept. Berman could not be reached for comment. Chartwell Investments declined comment.

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PRIVATE EQUITY

**BUY IT, STRIP IT,
THEN FLIP IT**

The quick IPO at Hertz makes buyout firms look more like fast-buck artists than turnaround pros. Investor beware

BY DAVID HENRY AND EMILY THORNTON

THIS MIGHT GO DOWN AS the year of the swashbuckling buyout. On July 24 three big private-equity players offered \$33 billion to snap up hospital operator HCA Inc. in what would be the biggest leveraged deal in history.

But a much quieter event a few days earlier might be a better example of the excesses this era has wrought. On July 14, less than seven months after the private-equity trio of Clayton, Dubilier & Rice, Carlyle Group, and Merrill Lynch Global Private Equity bought Hertz Corp. from the ailing Ford Motor Co. for \$14 billion, the group filed a preliminary prospectus with the Securities & Exchange Commission to sell shares in an initial public offering.

Buyout firms are celebrated for their ability to take on huge debts, buy neglected companies, turn them around over the course of several years, and sell them to public investors for huge profits. Since 2001 they have delivered to their investors annualized returns in excess of 20%, and have attracted record amounts of capital to buy even bigger companies (page 98). But the quick “strip and flip” the Hertz buyout firms are pulling off makes them look more

like fast-buck artists than thoughtful turnaround specialists.

The Hertz crew hasn't said how much of the company it intends to sell. But it sure hasn't been shy about backing up the Brinks truck. Three weeks before the initial IPO filing, the owners had Hertz take out a loan to pay themselves a \$1 billion

special dividend—nearly half of the \$2.3 billion in cash it had invested in December. So hungry were they for the cash that they collected it even before recruiting a new CEO to run the company. Needless to say, special dividends like this substantially improve the buyout firms' risk-reward prospects. Principals at the three buyout firms would not comment while the deal is in registration.

In their filing, the owners say they intend to use the new money from public stock investors to repay the \$1 billion loan that paid for their dividend. They could also recoup some of the rest of the cash they put up. Regardless, they will retain majority ownership of the company after the IPO.

The Hertz group is hardly alone in its zeal to go public. Buyout firms have pocketed \$9 billion this year in 32 IPOs. On average they've raised \$287 million with each listing, compared with the \$169 million raised by companies with no buyout firms involved. In total, their companies account for 29% of all IPOs, up from slightly less than 5% in 2000, according to Thomson Financial.

The question is: Will the Hertz deal be good for public investors? If other recent

**Rent-a-
Company**

Leveraged buyout firms took a quick ride with Hertz

JUNE, 2005 Ford files for IPO of Hertz to take it public

SEPTEMBER, 2005 Ford drops IPO, agrees to sell Hertz for \$14 billion in LBO

DECEMBER, 2005 LBO group puts up \$2.3 billion in cash for deal, borrows the rest

JUNE, 2006 LBO group pays itself \$1 billion obtained from new Hertz debt

JULY, 2006 LBO group files for IPO

Data: Company reports, Standard & Poor's

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News & Insights

CHARRED Burger King's stock is down 12.6% since its IPO

IPOs are any indication, the answer is a resounding no. On average, the stocks of companies taken public by buyout firms this year have fallen 6%. In contrast, shares of companies that have gone public without any assistance from buyout firms have risen 0.7%. And shares of companies that make up the Standard & Poor's 500-stock index have gained 1%.

These are the very companies that were supposed to benefit from comprehensive turnaround plans. The secret to buyout firms' success in recent years has ostensibly been their ability to fix up struggling companies once they've been privatized, then collect windfalls after taking them public again. Private ownership allows managers to take drastic measures that aren't easily carried out under public scrutiny, such as slashing costs and shedding unnecessary assets and operations.

But are buyout firms really doing that? You certainly can't tell from the stock market performances of the ones taken public this year. Almost two-thirds are now underwater—some deeply so (table). In a July 20 report following the Hertz announcement, Thomson Financial had two words for its clients considering buy-

ing shares of companies taken public by buyout firms: *caveat emptor*.

IPOs like the Hertz deal have fared poorly this year. The other ubiquitous consumer company to go public, Burger King Holdings Inc., was down 12.6% from its offering on May 17 through July 24. And another company taken public less than a year after its purchase has slumped, too: Managed care provider HealthSpring Inc. was down 7.9% through July 24.

The buyout firms have their own investors, and it's hard to fault them for taking advantage of the accommodating stock and credit markets to grab cash when they can. But what keeps enticing investors to buy into these IPOs? The hope of good long-term performance, it seems. Soon-to-be-released research by professor Josh Lerner at the Harvard Business School will show that in the last two decades, companies taken public by buyout firms have outperformed other IPOs and the major market indexes. That's because buyout firms usually take three to 10

years to carry out the sort of operational improvements that could justify their huge payouts in IPOs.

But the Hertz trio has owned the company only since Dec. 20. The new chief executive, Mark P. Frissora, formerly chairman and CEO of auto parts supplier Tenneco Inc., reported to work on July 19—five days after the IPO registration was filed. He's the first Hertz CEO who hasn't come from within the company or the industry, notes Neil Abrams, a rental car industry consultant and former Hertz executive. Since the buyout firms took over in December, the only substantial operational change Hertz has made is to hold customers more accountable for dings and dents, says Joe Brancatelli of Joesentme.com, a frequent-traveler Web site.

What the buyout firms can do quickly is use their financial might. The Hertz trio easily delivered money Ford craved. And before the purchase closed, the buyers arranged to take advantage of the strong demand for fixed-income investments by

Buyout firms have pocketed \$9 billion this year in 32 IPOs

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securitizing Hertz rental cars. In other words, they hocked the cars and raised \$6.1 billion toward funding the buyout—on better terms than if they had borrowed in the junk-bond market, as was common in earlier buyout waves.

The trouble is, putting up assets as collateral reduces a company's financial flexibility. That's one reason Standard & Poor's, the credit-rating agency, downgraded Hertz from investment-grade to speculative, or junk, status after the buyout. S&P says Hertz has pledged two-thirds of its assets now, vs. just 10% before the buyout.

SQUEEZED

HERTZ WILL NEED flexibility as it faces a backwash from the troubles at Ford and General Motors Corp. As the automakers cut production capacity, they're not unloading cars to the rental companies as cheaply as they once did. Hertz says its costs won't be nearly as predictable in the future. Already, higher car costs from Detroit have pushed Hertz' depreciation costs up 17% for 2006 models. The business is also at risk of higher oil prices pushing up airline fares and reducing air traffic. About 72% of Hertz' car rental revenues come from airports. And the new LBO debt will hurt. Hertz' first-quarter interest expense jumped 112%, prompting a net loss of \$49 million, compared with net income of \$21 million a year earlier.

Hertz' new owners do have plans to strengthen the business. One strategy: to boost rentals away from airports. Such operational improvements should lift profit margins, which are down from 2000 levels, according to the preliminary prospectus. And Hertz, the world's second-largest rental car chain after Enterprise Rent-A-Car Co. with 7,600 rental locations in 145 countries, notes that it's one of the world's best-known brands. With that kind of base, the buyout boys should have room to turn around the company they've been so quick to load up with debt. Eventually.

But in the meantime, be careful how much you pay them for their shares. If Burger King and the other IPOs are any indication, Hertz' stock might stall out just after hitting the public freeway. "Buyout firms sell when they can," says veteran money manager Michael Holland at Holland & Co., who was a partner at the Blackstone Group before setting up his own shop in 1995. "You have to overcome the initial skepticism about the fact that a smart person is selling something." Caveat emptor indeed. ■

—With David Kiley in Detroit

Initial Public Awfulness

Most of the 32 IPOs backed by private-equity firms in 2006 have fared poorly

Companies	Buyout IPO Date (2006)	Amount raised from IPO (millions of dollars)	Return to investors*
1. H&E EQUIPMENT SERVICES	Jan. 30	226	46.2%
2. KOPPERS HOLDINGS	Jan. 31	161	39.6
3. HOUSTON WIRE & CABLE	June 14	110	35.6
4. J. CREW GROUP	June 27	432	25.7
5. ENERGY TRANSFER EQUITY	Feb. 3	507	22.6
6. REGENCY ENERGY PARTNERS	Jan. 30	283	20.9
7. PGT INDUSTRIES	June 27	123	11.9
8. AMCOMP	Feb. 9	97	9.4
9. NIGHTHAWK RADIOLOGY HOLDINGS	Feb. 8	116	9.4
10. ALLIED WORLD ASSURANCE	July 11	344	1.8
11. VERASUN ENERGY	June 13	483	1.0
12. LINN ENERGY	Jan. 12	261	-0.2
13. RAM HOLDINGS	Apr. 27	141	-5.4
14. EXCO RESOURCES	Feb. 8	697	-6.9
15. HEALTHSPRING	Feb. 2	422	-7.9
16. MAGELLAN MIDSTREAM HOLDINGS	Feb. 9	539	-12.2
17. BURGER KING HOLDINGS	May 17	489	-12.6
18. TOWN SPORTS INTERNATIONAL	June 1	116	-14.3
19. GOLFSMITH INTERNATIONAL	June 14	69	-15.2
20. EAGLE TEST SYSTEMS	Mar. 8	101	-15.5
21. SMART MODULAR TECHNOLOGIES	Feb. 2	164	-17.1
22. SEALY	Apr. 6	515	-18.1
23. COMPLETE PRODUCTION SERVICES	Apr. 20	718	-19.5
24. GOODMAN GLOBAL	Apr. 5	487	-22.3
25. CPI INTERNATIONAL	Apr. 27	127	-22.6
26. CASTLE BRANDS	Apr. 5	31	-23.2
27. CLAYTON HOLDINGS	Mar. 23	127	-29
28. MORGANS HOTEL GROUP	Feb. 13	360	-29.8
29. AVENTINE RENEWABLE ENERGY	June 28	389	-31.7
30. DYNACORP INTERNATIONAL	May 3	375	-34.2
31. ALPHATEC HOLDINGS	June 2	84	-38.9
32. COREL	Apr. 25	104	-40.3
AVERAGE FOR BUYOUT-BACKED IPOs		287	-6.0
AVERAGE FOR NON-BUYOUT BACKED IPOs		169	0.7
AVERAGE FOR ALL 2006 IPOs		203	-1.3
STANDARD & POOR'S 500 INDEX			1.0

*Through July 24

Data: Thomson Financial

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News Analysis & Commentary

IPO WATCH

WHERE'S THE BEEF?

Burger King's upcoming IPO looks lucrative...for the private-equity firms doing the deal. While they make even more cash, the chain's long-term debt could hit \$1 billion. **BY DEAN FOUST**

ON A SUNNY SEPTEMBER day in 2004, Burger King Corp.'s new CEO, Gregory D. Brenneman, drove into the parking lot of the company's Miami headquarters dressed up as the fast-food chain's well-known mascot, the King. After a pep rally to congratulate the 700 assembled employees for their role in Burger King's nascent turnaround, Brenneman and other execs handed out burlap bags stamped with big dollar signs. The sacks were stuffed with bonus checks. And they were three times larger than the previous year's. It was a gesture that endeared the new boss to his troops.

Now Brenneman is trying to win over a much tougher crowd: Wall Street investors. Sometime this spring, Burger King's owners, a group of private-equity firms that includes Texas Pacific Group, Bain Capital Partners, and Goldman Sachs Funds, plan to raise up to \$600 million in an initial public offering. Assuming the IPO is successful, the private-equity guys will have nearly doubled their

original investment—while retaining a majority stake in Burger King. Not bad for about three years' work.

The coming Burger King IPO offers a window onto the clubby world of cash-rich private-equity players and how they make their billions. During the 1980s, firms such as Kohlberg Kravis Roberts & Co. and Blackstone Group LP borrowed heavily to buy companies, broke them up, and sold off the pieces at huge profits.

"LIPSTICK ON A PIG"

NOWADAYS PRIVATE-EQUITY firms often spend hundreds of millions of their own money on an acquisition (BW—Feb. 27). Just as often, though, they load up the companies with debt and use the money to pay themselves special dividends and other fees that allow them to profit even if the company itself struggles. Then the backers take the company public, often pocketing the lion's share of the offering.

That is basically how the Burger King saga is unfolding. For investors hoping to get in on the IPO, the question is whether the burger

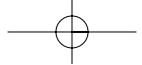
MARK LUND

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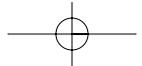
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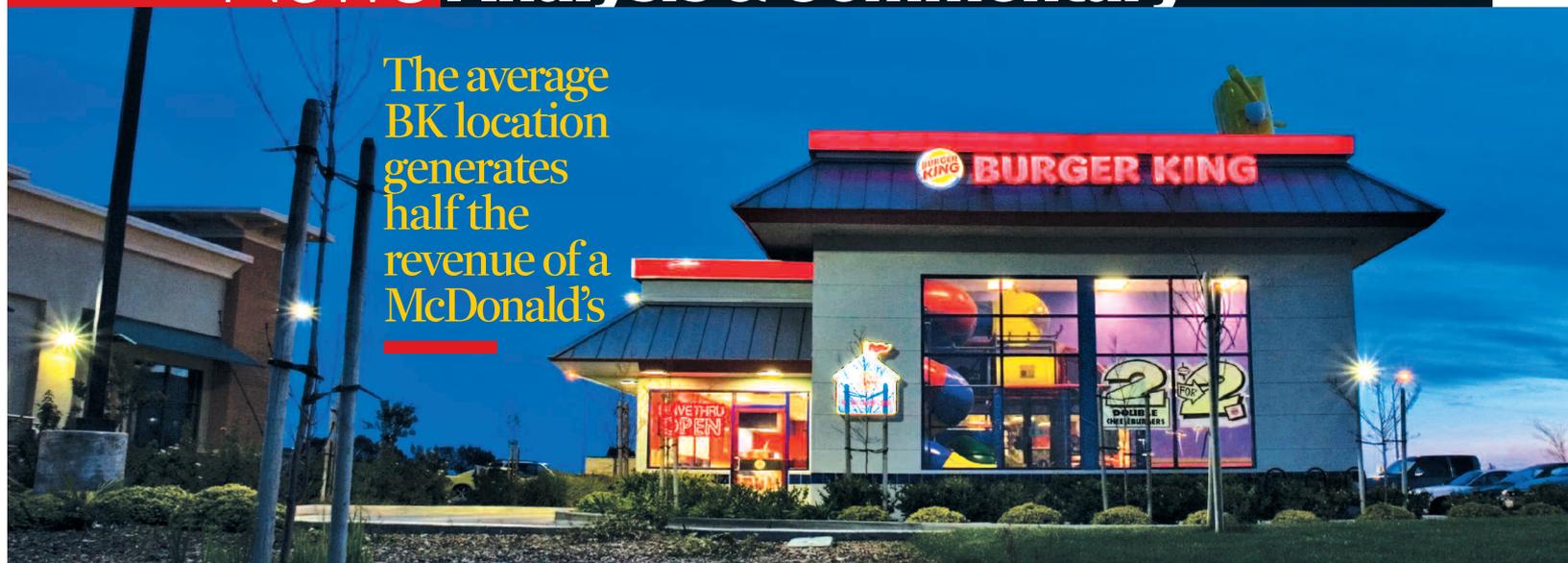
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News Analysis & Commentary

The average BK location generates half the revenue of a McDonald's



chain is really on the road to recovery. Critics argue that since an initial rebound in traffic after private-equity players bought the company from Diageo PLC, Burger King's sales growth again is starting to lag rivals.

And they contend that the company paints an overly rosy picture in press releases and its recent Securities & Exchange Commission filing, in part by changing the way sales are tracked to give the appearance that they are on a solid upswing. What's more, Burger King is far more indebted than rivals McDonald's Corp. and Wendy's International Inc. That limits the fast-food chain's ability to reinvest in new products and restaurants. "This is as close to putting lipstick on a pig as you get," says a prominent Wall Street analyst who asked not to be identified.

Both Burger King and Texas Pacific declined comment on these and other matters, citing the restrictions against companies talking during the "quiet period" imposed by the SEC before IPOs. But some analysts and investors believe Texas Pacific and its partners are rushing Burger King to market before it's ready.

It's no secret why they want to get this deal done. Recent restaurant IPOs such as Chipotle Mexican Grill Inc. and Wendy's spinoff of the Tim Hortons Inc. doughnut chain were scorches. And if there's any firm that knows when and how to buy and sell companies, it's Texas

Pacific. Founder David Bonderman, a former bankruptcy attorney, made his name managing the oil wealth of Fort Worth's well-known Bass family. In the 1990s, Texas Pacific scored big with investments in Continental Airlines, Seagate Technology, and Oxford Health Plans. The firm was so successful that when Bonderman turned 60, in 2002, he hired the Rolling Stones to perform at a private bash in Las Vegas.

By all accounts, Bonderman and his investing partners got a great deal for Burg-

Then this past February, Burger King borrowed an additional \$350 million so its owners could pay themselves and its two partners a special \$367 million dividend. In addition, Texas Pacific and the other investors are getting \$30 million more to end a contract in which they received \$9 million a year in management fees from Burger King.

Assuming the private-equity owners use part of the \$600 million raised in the IPO to pay down the \$350 million loan, that leaves as much as \$250 million. Add

that to the \$367 million dividend and the \$30 million kill fee, and their take totals \$647 million, nearly double their original investment. It's all good for the owners, but Burger King ends up with \$1 billion in long-term debt—or more than double the relative debt loads carried by rivals like McDonald's, Wendy's, and Yum! Brands. That leaves Burger King in junk territory.

This would be bad enough if the company was cooking up beefy profits and sales gains. But that isn't happening. Burger King's profit margin for the fiscal year ended last June was just 2.4%,

vs. the 5.9% earned by Wendy's and 12.7% at McDonald's in calendar year 2005. Meanwhile, the average BK restaurant still generates just a little more than half the sales of a typical McDonald's. "They've turned the train around," says Dennis Lombardi, executive vice-president at WD Partners, a Columbus (Ohio)-

LBOs to IPOs

Leveraged buyout firms are looking to flip big chunks of their investments to public investors. Here is a partial list of pending offerings:

COMPANY (PROPOSED TICKER)	BUSINESS	LEAD BUYOUT FIRM
J. CREW GROUP (JGC)	Apparel and accessories	Texas Pacific Group
GOODMAN GLOBAL (GGL)	Heating, ventilation, products	Apollo Management
MERRILL CORP. (MRLL)	Business services	DLJ Merchant Banking
PROGRESS RAIL SERVICES (not available)	Locomotive and rail-car maintenance	One Equity Partners
SEALY (ZZ)	Mattresses	Kohlberg Kravis Roberts

Data: IPOHome.com, company filings

er King in 2003. Diageo originally sought \$2.26 billion for the burger chain, but Bonderman and his LBO partners succeeded in knocking the price down to \$1.5 billion. What's more, analysts believe Texas Pacific, Bain, and Goldman kicked in just \$325 million of their own money, opting to borrow the rest.

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Have It Whose Way?

Many private-equity firms, including Texas Pacific, follow the same playbook to extract big profits from the companies they acquire:

BORROW BIG-TIME Private-equity firms use heavy amounts of debt to minimize the cash they have to invest. For its \$1.5 billion acquisition of Burger King, Texas Pacific is believed to have invested just \$325 million of its own money, borrowing the rest.

PAY YOURSELF Private-equity firms aren't shy about pulling special dividends and fees out of their companies. Texas Pacific recently charged Burger King \$30 million to end its "management contract" and took out loans to pay itself and its partners a "special dividend" of \$367 million.

GO PUBLIC AGAIN Firms usually take the company public again within a few years, reaping large paydays. When Burger King goes public, Texas Pacific and its partners will have already nearly doubled their original investment. Not a bad result for about three years' work.

Data: SEC filings; BusinessWeek

based restaurant development firm. "But I'm not sure it's out of the tunnel."

To be fair, Brenneman, who helped get Continental Airlines airborne again during the 1990s, hasn't exactly been sitting around watching the grass grow. A hard-working son of Mennonites, who spent summers as a teen shoveling hay on his grandfather's Kansas wheat farm, Brenneman got busy the moment he became CEO in August, 2004. The goal was to go public by 2006, so Brenneman had little time to show results.

SKIMPY PROFITS

HE DOVE INTO the job, getting new products such as Chicken Fries, the Angus Steak Burger, and the Tendercrisp chicken sandwich out into restaurants. To boost morale and improve communication with the troops, Brenneman, 44, delivers folksy voice mails every Friday, updating employees and franchisees about the latest results and initiatives.

Helping franchisees earn more money was another priority, so he boosted group purchasing and commissioned the design of a smaller prototype store that is more than 25% cheaper to build. And to solidify Burger King's standing with highly coveted "superfans"—men aged 18 to 34—Brenneman rolled out a new male-oriented ad campaign that depicts the King mascot playing in NFL games.

The initiatives seemingly have paid off: After earning just \$5 million in the fiscal year ended June, 2004—Texas Pacific's first full year of ownership—Burger King reported profits of \$47 million in the following 12 months.

But for a company that raked in \$1.9 billion in revenues in its last fiscal year, that's a pretty skimpy return. And it's fair to ask whether Burger King achieved its

numbers by whacking advertising. According to TNS Media Intelligence, a New York media-tracking service, Burger King spent \$268.7 million on national advertising in 2005. That's \$54 million less than the year before and \$120 million less than in 2002, the last year Diageo owned the company, albeit with slightly more restaurants. Had Burger King spent what it did in 2004, its \$47 million profit would have been lower.

Brenneman & Co. also claim that sales at stores open more than one year—a common industry measure—have been rising steadily for seven straight quarters. But heads turned in restaurant industry circles when Burger King last year started reporting sales on a quarterly basis instead of monthly. Many chains, including McDonald's, report same-store sales every month. And some analysts wonder whether Burger King's switch was an attempt to mask a sales drop during some months. After a 6.7% rise in same-store sales during April, the last month that Burger King disclosed monthly numbers, the company reported second-quarter sales rose just 1.8%, suggesting that sales were negative in May or June.

It doesn't help matters that Burger King's relations with the chain's franchisees have been less than stellar. While some praise Brenneman for his efforts to boost sales, others complain that Texas Pacific hasn't done enough to help struggling operators get back on their feet. They and their lawyers say Burger King has pushed struggling franchisees who filed for bankruptcy protection to close their underperforming stores and go out of business.

Matters grew so acrimonious that, last October, the company severed ties with the National Franchisee Association Inc.,

which represents the operators of about 6,000 Burger King restaurants. In a letter to the association, John W. Chidsey, Burger King's president and chief financial officer, blasted the group's leaders for failing to support plans to expand hours, promote a value menu, gift cards, and other initiatives.

OPPORTUNE TIMING

IN THE MONTHS SINCE, Burger King has tried to sideline the NFA by holding separate discussions with the franchisees it deems more cooperative. The company began talking to the NFA again in February. The group's new head, Joseph D. Anghelone, praises Brenneman and his team as being "very professional and dynamic," but he notes that Burger King is still in arrears on \$1.7 million in support payments owed to the association. Burger King in its prospectus says relations are improving.

In the end, the Burger King IPO will likely succeed. Given the heavy demand for the IPOs of Chipotle and Tim Hortons, some investors think Texas Pacific picked an opportune time to begin unwinding its stake in the fast-food chain. "I've learned to never bet against Texas Pacific," says Peter L. Goldman, a portfolio manager at Chicago Asset Management Co., which oversees \$750 million in investor funds. "They've created value in tough circumstances. Failing that, they've always succeeded in easing out of their mistakes."

But for investors, the question remains whether Burger King's owners have truly set the company on a sustainable path or are simply trying to pawn off a business with less beef than bun. ■

—With Brian Grow and Coleman Cowan in Atlanta, Michael Arndt in Chicago, and David Henry in New York

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