Are private buyouts good for the economy?
Deep-pocketed investors are banding together to buy companies, restructure them, and sell them back on stock exchanges for huge profits.

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By Mark Trumbull

The new birth of Burger King Corp. this year delivered the beef to the investing public: Under private management, the long-struggling company turned a corner and then made shares available on the New York Stock Exchange.

But the managers kept some major side orders to themselves. They took out a big loan and paid themselves a $367 million dividend and other fees as well. In all, they extracted cash worth about one-sixth of Burger King's market value.

That's one whopper of a payout, and it's not unusual these days.

Increasingly, investors with deep pockets are banding together to form "private equity funds." Just as the leveraged buyout firms did in the 1980s, they are buying up companies, restructuring them, and then selling them back on public stock exchanges often for a supersized profit.

The practice isn't new, but it remains controversial. And the scale of the trend far exceeds what it was back when Henry Kravis and Michael Milken made their magazine cover debuts.

Hardly a week goes by without more major deals being announced. Meanwhile, the very success of these buyout funds is attracting billions more dollars from investors raising the prospect of many more buyouts in coming months. In essence, the wealthy are deciding that if you want to make money in stocks, the stock market isn't the place to do it.

"Private equity is a very big deal. It has moved from the periphery of the capital markets 20 years ago much closer toward the center," says Robert Bruner, dean of the University of Virginia's Darden Graduate Business School.

With money pouring in from pension funds and other deep pockets, the trend shows no signs of stopping. It could end up engulfing companies as diverse as the Los Angeles
Times newspaper and ailing automotive supplier Delphi Corp. Just last week, Bill Gates and a Saudi prince were among the investors backing a private buyout of Four Seasons hotels, while another buyout fund announced its plan to acquire the Outback Steakhouse.

Private equity is Wall Street jargon for massive funds pools of money from large investors used for owning and managing companies in private, rather than as companies listed on public stock exchanges.

Success begets more investment, especially at a time of rather tepid performance by traditional stocks and bonds. Like hedge funds, real estate, and commodities, private equity has become a new money magnet.

Sometimes the private equity funds pour their cash into young companies, but more of it has been going into buyouts of mature companies like Burger King or Hertz.

To supporters, the deals reflect the dynamism of America's capital markets, in which companies are made, remade, and sometimes broken into pieces by savvy investors. The result, arguably, is that capital finds its most efficient use. It not only enriches owners but helps to make companies more efficient and US workers among the most productive in the world. "We are all better off when companies operate well," Mr. Bruner says.

But skeptics, including some within the investment community, voice a number of concerns.

They say the deals are doing much more for the acquirers than for the economy at large, or even for the traditional shareholders who are forced to sell when the deals happen.

Indeed, the latest buyout wave may raise questions about both the virtue of private equity funds (are they really helping the companies that much?) and about the performance of traditional, publicly traded companies (why can't they do as well for their investors?).

"There is now little question that chief executives across America are increasingly content to allow private equity firms to somehow 'magically' deliver sparkling returns to their shareholders, which they themselves were incapable of producing during their time at the helm," write Henry McVey and David McNellis in a recent market strategy report for the investment bank Morgan Stanley in New York.
They argue that US corporations have essentially become too cautious about investing in new ideas to grow their business. The result is a buildup of cash, and a decline in debt.

That's one reason some of these public companies become tempting targets for private equity funds. The private buyers will plan to do some things that improve the business, so it can be resold later at a higher price. But they will also, often, tap free cash or borrow to provide dividends and fees that guarantee a high rate of return even before they sell.

Burger King is a case in point. In 2002, a group of private equity funds bought the restaurant brand for $1.5 billion from its parent company, Diageo.

The private owners went through several CEOs, but finally got the hamburger chain sizzling again, with sales boosted by a value menu and new products. In the process, they made sure to get an early slice of the profits, with the $367 million dividend and other fees.

Clearly, the rich are getting richer here. But arguably the economy is also somewhat better off. Analysts see a larger, healthier company than in 2002. Burger King's market value is now more than $2 billion.

If the private equity had merely hollowed out the company with its cash extraction, it wouldn't be worth that much today, some experts point out.

But if private equity is helping corporate America be more productive, the returns may diminish at some point—partly because it's harder to find lucrative deals.

"I definitely think the returns [to private equity] are not going to be as robust as they've been," says Colin Blaydon, an expert on private equity at Dartmouth College's Tuck School of Business in Hanover, N.H.