Private Equity Moving Into Public Spotlight

Industry moves to pre-empt calls for regulation as it remains the hot ticket in high-end investment.

By Jacob Freedman

Two decades ago, Carl Icahn and Ivan Boesky epitomized the excesses of Wall Street: takeover artists who commanded vast fortunes and bought companies like they were shopping for groceries. Then came the hedge fund operators of the 1990s, high flyers whose risky business was splashed on the front pages with the multibillion-dollar collapse of Long-Term Capital Management.

Now a new breed of operators, with hundreds of billions of dollars at their disposal, has taken the place of the Boeskys and the Long-Term Capitals as the Kings of the Street — and the source of growing concern that corporate value is being sacrificed to profiteering.

These so-called private-equity firms, some of which evolved from the leveraged buyout movement of the 1980s, are using vast pools of pension fund deposits, the money of the super-rich and other reserves of cash to acquire companies with the intent of selling them after a few years for substantial profit.

In the past year, these firms have orchestrated the $15 billion purchase of Hertz Corp., the No. 1 car rental agency, and a $5 billion deal for retailer Neiman Marcus. Private-equity groups are still in the bidding for the Philadelphia Inquirer and several of the other newspapers purchased last month by McClatchy Co. from Knight-Ridder Inc. And they may wind up supplying the money to buy six cities’ port operations that belong to Dubai’s DP World.

Private-equity funds exist almost entirely outside the reach of government regulation. But their rapid growth, and the fact that corporate and public-employee pensions and other institutional investors are pouring in their money, have sparked suggestions that they should be subject to no less than the minimal federal supervision newly accorded to hedge funds, their more adventurous cousins.

On the Rise

Investments in private-equity buyout funds are soaring, having become more popular as venture capital funds lost favor after the 1990s dot-com bust.

Annual investments in buyout and venture capital funds
In billions of dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Buyout</th>
<th>Venture Capital</th>
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<tbody>
<tr>
<td>1995</td>
<td>$3.9</td>
<td>$23.7</td>
</tr>
<tr>
<td>2000</td>
<td>$107.5</td>
<td>$81.0</td>
</tr>
<tr>
<td>2002</td>
<td>$23.7</td>
<td>$81.0</td>
</tr>
<tr>
<td>2005</td>
<td>$81.0</td>
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Sources: Thomson Venture Economics, National Venture Capital Association

Four of the biggest firms — the Blackstone Group, the Carlyle Group, the Texas Pacific Group, Kohlberg Kravis Roberts and Co. — are discussing the need to start a Washington-based trade association to tell their story and head off moves by regulators. The fear is that concerns might turn into tough new rules should a private-equity deal fail spectacularly, roiling the financial markets or causing a consumer outcry.

“Private equity has become the subject of cocktail talk — just as at one time hedge funds or day-trading became the subject of cocktail talk,” said Arthur Levitt, who was chairman of the Securities and Exchange Commission from 1993 to 2001. Levitt, who’s now a senior adviser to Carlyle, said that to protect themselves private-equity firms should “remove the environment of mystery that surrounds their activities because their formula is not unique, nor does it necessarily have to be mysterious.”

Colin C. Blaydon, director of the Center for Private Equity and Entrepreneurship at Dartmouth College’s Tuck School of Business, says private-equity firms see a need to tackle these issues or face tighter regulation. “The last thing they want to hear is a knock on the door from Washington,” he said.

Similar but Different

In the pantheon of capital-rich investment operations, private-equity companies, venture capital firms and hedge funds draw exclusively upon the same well-heeled sources of wealth. That’s where the similarities begin to end.

Private-equity firms are closely related to venture capital firms. Both hope to profit from the success of the companies in which they invest. But where venture capital firms concentrate on risky startups, private-equity groups acquire established companies that are regarded as undervalued — sometimes from one another, sometimes in a process similar to old-fashioned leveraged buyouts of publicly traded shares, but often with less debt.

These operations are unlike hedge funds, which try to capitalize on short-term investments and tend to use complicated trading strategies involving options and other derivative financial instruments. Sometimes hedge funds bet against the shares of companies they don’t own in hopes of profiting from a falling price.

Rising apprehensions about the risks posed by buyout companies to the pensioners whose retirement security rests in their hands, and to the survival of the companies they control, has yet to spark interest at the SEC in reinventing private-equity funds. In fact, the agency intentionally carved out an exception for private equity when it placed limited rules on hedge funds, whose operations, unlike those of private-equity companies, have raised questions of fraud and a systemic threat to markets.
Levitt says that because private-equity firms are so dissimilar to hedge funds there’s no need for outside supervision. But he says the industry would benefit from greater self-regulation, adding that “the talk of the formation of a trade group is a step in the right direction.” (In addition, the Private Equity Industry Guidelines Group has established some standards for valuing portfolios.)

The industry touts itself as a source of innovation and an engine for economic growth, rather than a threat to capital markets. The SEC agreed that private equity posed little risk of fraud in a review of the hedge fund industry done three years ago.

“But the same kind of arguments that caused the SEC to do something in the hedge fund area could cause them to do something in the private-equity area,” said Barry P. Barbash, a lawyer with Willkie Farr & Gallagher who represents private-equity firms and headed the SEC’s Division of Investment Management under Levitt.

The new hedge fund rule, which took effect Feb. 1, requires most fund managers to report basic information about themselves and their funds, which can be publicly reviewed and scrutinized by SEC auditors.

Established private-equity firms, such as Carlyle, say they are nervous that more players, including some hedge funds, are getting into their game — increasing the risk in their view that these activities might attract the attention of regulators and even Congress. “Whenever a new investment vehicle captures as much money as has been captured by private equity, it will attract marginal players,” said Levitt. “They think they can hang out a shingle and be a private-equity firm.”

GOING GANGBUSTERS

In the first quarter of 2006, private-equity buyout funds raised $20.8 billion from investors, according to Thomson Venture Economics. That represents a 56 percent increase from the first quarter of 2005, a record year in which $89 billion flowed into these funds, almost quadruple the amount raised in 2002.

Buyout firms often raise eyebrows because of their hefty management fees and aggressive strategies, and their legacy from the era of hostile, highly leveraged acquisitions.

“The perception in Washington is that venture capital wears white hats and are job creators; buyouts wear black hats and are job destroyers,” said Mark G. Heesen, president of the National Venture Capital Association, an organization that has a venture capital focus and also represents some groups engaged in buyouts. “That is not the reality, but that is the perception by many.”

That perception is rooted in the wave of 1980s corporate takeovers — including the record-setting $25 billion purchase of RJR Nabisco by Kohlberg Kravis Roberts in 1989 — accomplished almost entirely with borrowing. And they were often designed to split a company and sell off its more valuable operations.

The buyout industry has matured since, said Dartmouth’s Blydon, and now focuses more on improving the value of companies through stronger management and less on hostile takeover bids. Today, he said, “these are collaborative deals with people on both sides saying: Look, there are benefits to all of us, including a takeout of our shareholders at an attractive valuation.”

Although large amounts of debt still characterize most private-equity deals, buyout firms now typically put up one-third of the acquisition cost, much more than in the past.

But concerns remain. In recent years, buyout funds have been particularly successful at earning big returns in a market of low interest rates for corporate borrowing.

Many profitable transactions involved refinancing a company’s existing debt — an avenue for quick money that may not continue as interest rates rise. Investors, however, are signaling that they expect big gains to continue, and industry observers say they expect larger and larger deals in the next few years.

PENSION PARTICIPANTS

Much of the growth in buyout funds has come from corporate and public-employee pension plans. Many of which are relative newcomers to the private-equity world. “They are in an anxious and desperate search for where they can get yields on their investment to help shore up some of their funding problems,” Blydon said.

Corporate plans increased their buyout and venture capital allocations to 4.3 percent in 2005 from 3.4 percent in 2002, according to Greenwich Associates, a consulting firm. Investments by public-employee plans have also increased. In a survey Greenwich conducted last fall, pension managers said they expected private equity funds to yield the best returns of any asset class — including hedge funds — and a third of the managers said they were planning “significant” increases in private-equity investments.

Increased investments by pensions has led to pressure for disclosure and heightened tension over the proprietary information of private-equity firms. The California Public Employees’ Retirement System (Calpers), the largest public pension fund, with more than $200 billion in assets, was forced in 2004 to disclose the fees it paid private-equity fund managers and the performance of those funds.

Calpers opposed disclosure, arguing that it would be excluded from top-tier funds as a result. Faced with choosing between disclosure and losing access to investment opportunities, California, Virginia and Texas have enacted disclosure exemptions. Other states are moving in that direction.

Still, it would probably take the failure of a large buyout to raise concerns in Washington. Even at the peak of the corporate takeovers in the 1980s, efforts in Congress to rein in the activity went nowhere.