

BEHIND THE BUYOUTS

INSIDE THE WORLD OF PRIVATE EQUITY

Prepared by the
Service Employees
International Union

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EXECUTIVE SUMMARY

Largely unknown outside the financial world, an industry called “private equity” is reshaping the American economy almost daily, controlling a large and growing swath of U.S. industry, including the market leaders in major industries.

“Private equity” is a broad term that encompasses a range of strategies for investing in industrial and service companies whose common stock is not traded on public stock exchanges. While private equity runs the gamut from small venture capital investments in brand-new start-up companies to multibillion-dollar buyouts of well-known public companies, the focus of this report is on corporate buyouts.

The private equity buyout industry, armed with more than a half-trillion dollars of capital, is today engineering financial deals that together are larger than the annual budgets of most of the world’s countries. This financial juggernaut is generating hefty returns to its investors, extraordinary riches for its executives, and newly relevant questions about the impact of its business practices on American workers, businesses, communities, and the nation.



Lack of Transparency

Unlike publicly traded companies that are subject to federal securities laws and regulations, private equity buyout firms operate virtually free of oversight and public accountability, their profits and practices largely hidden from view.

Utilizing the limited information available to the public, this report provides a snapshot for everyday investors, workers, community members, and the public about the private equity buyout industry and its practices, spotlighting the leading firms, and examining the inner workings of five private equity buyout deals for their impact on workers.

The report is provided as a resource for people and organizations who may not be business or financial experts, but whose lives, jobs, investments, or communities are or could be affected by private equity buyouts.

The Top Five Private Equity Buyout Firms

Bain Capital (Bain), the **Blackstone Group** (Blackstone), the **Carlyle Group** (Carlyle), **Kohlberg Kravis Roberts & Co. (KKR)** and **TPG** (formerly Texas Pacific Group) have emerged as the five largest firms in the buyout industry in both size and influence.

These firms raise the most money, have the largest number of investment professionals and offices across the globe, and often set standards for the industry. Their leading executives are billionaires and they have put together the industry's biggest deals, many for tens of billions of dollars.

“Behind the Buyouts:” A Look Inside Five Private Equity Deals

Five recent buyout deals illustrate many of the negative impacts deals can have on workers and communities, but also the potential opportunity presented by private equity transactions.

To be sure, the buyout deals and money-generating strategies that are generating immense wealth for this industry and its investors often can have harsh consequences for workers and the companies they buy and sell.

For the artists and other clients of Warner Music, a corporate restructuring driven by the Thomas H. Lee buyout hollowed-out a once-proud music company, harming its image in the music industry and potentially reducing its long-term value.

For the retirees at Intelsat who spent their careers building the value of that company, for the 4,000 KB Toys employees laid off after the company declared bankruptcy under the weight of a crushing debt load, and for the Hertz employees laid off in the wake of a lucrative quick flip, private equity corporate strategies uprooted lives and negatively impacted hardworking families.

In every case, the workers themselves had almost no voice in the process, little information about the firms that now controlled their employers, and no role in developing the plans that were going to change their lives for the worse.

One example, the case of the Onex buyout of the Boeing plants, shows the opportunity that deals present if the private equity buyout industry were to focus on creating economic benefits not only for the executives, but also for workers at the companies they own.

Conclusion

The private equity industry's profits come during a period of historic income inequality in America. There is no doubt that the income being accumulated in the buyout business is a major contributor to the concentration of wealth among the top 1 percent of Americans. Yet questions about the role the private equity industry could play in addressing this national challenge remain—until now—unasked, and unanswered.

There is more than enough wealth in the private equity industry for the buyout firms to continue to prosper while also adapting their business model to expand opportunities to benefit workers, communities, and the nation.

SEIU Principles for the Private Equity Buyout Industry

With these concerns and opportunities in mind, SEIU recommends the following principles for the private equity buyout industry:

1. The buyout industry should play by the same set of rules as everyone else.

- The industry should provide transparency and disclosure about their businesses, their deals, their income, their plans for the companies they buy and sell, and the risks of the debt they load onto portfolio companies
- The industry should invest in the health, security, and long-term prosperity of America by supporting equitable tax rates and the elimination of loopholes that increase the tax burden on working Americans
- The industry should work to build confidence in the securities markets by eliminating conflicts of interest and other potential abuses in their deals

2. Workers should have a voice in the deals and benefit from their outcome.

- Workers should have a seat at the table when deals are being made
- Private equity deals should create economic opportunities that align the long-term interests of everyone that builds the value of a company, from direct employees and contract workers to senior management
- Workers should have paychecks that can support a family
- Workers should have quality, affordable health care coverage
- Workers should have secure retirement benefits
- Workers should have a voice at work—meaning the freedom to join a union using majority sign-up without interference from any party

3. Community stakeholders should have a voice in the deals and benefit from their outcome.

- Buyout firms should play a proactive and constructive role in the communities affected by their deals
- Community stakeholders should be involved as deals are being made
- The private equity buyout industry and community stakeholders should use wealth generated by deals to improve the quality of life, the environment, the health, the safety, and the long-term stability of communities

INTRODUCTION

Largely unknown outside the financial world, an industry called “private equity” is reshaping the American economy, with huge new deals announced almost daily.

“Private equity” is a broad term that encompasses a range of strategies for investing in industrial and service companies whose common stock is not traded on public stock exchanges. While private equity runs the gamut from small venture capital investments in brand-new start-up companies to multibillion-dollar buyouts of well-known public companies, the focus of this report is on corporate buyouts.

With ownership of brand name companies such as Burger King, AMC movie theaters, Dunkin’ Donuts, Michaels Arts and Crafts, Hertz, and Linens ‘n’ Things, the private equity industry controls a large and growing swath of U.S. industry, including the market leaders in major industries. In the last year alone, private equity buyout firms have taken ownership of the nation’s largest office building landlord, Equity Office Properties, the nation’s largest hospital chain, HCA, the world’s largest casino company, Harrah’s Entertainment, and one of the nation’s largest providers of cleaning and food services, Aramark.

Consider these facts:

- The biggest five private equity deals together are larger than the annual budgets of all but 16 of the world's largest nations. The five biggest deals involved more money than the annual budgets of Russia and India.
- The annual revenue of the largest private equity firms and their portfolio companies would give private equity four of the top 25 spots in the Fortune 500. One firm, Kohlberg Kravis Roberts & Co. would crack the top 10. These private equity firms have more annual revenue than companies such as Bank of America, JP Morgan Chase, and Berkshire Hathaway.
- The top 20 private equity firms alone control companies that employ nearly 4 million workers.
- There were a record \$197 billion worth of private equity mergers in first quarter of 2007 alone.¹
- Industry analysts say a \$100 billion private equity buyout deal is not out of the question—putting huge companies such as Dell, Boeing, and Apple Computer within range of the buyout industry.

This financial juggernaut is generating hefty returns to investors, and extraordinary riches for the top executives of private equity firms.

And while the industry is not a new one, private equity's acquisitions and influence are growing exponentially, raising newly relevant questions about the impact of its business practices on American workers, businesses, communities, and the nation.

Incredible Wealth, Incredible Disparity

Though exact figures are hard to come by, the hallmark of the private equity industry is the incredible wealth being created for the small number of individuals who drive the buyout business.

The key principals at the largest private equity firms are billionaires. Using money from banks, insurance companies, pension funds, and other wealthy individual investors, they continue to launch corporate buyouts worth billions, even tens of billions of dollars, extracting fees of hundreds of millions of dollars from the companies they buy and often generating profits of 20 percent or more.

These profits come during a period of historic income inequality in America, at a time when millions of Americans are working harder and harder for less, with less health care, less retirement security, and less time to spend with their children. According to a report released in March 2007 by two leading economists, the top 1 percent of Americans—those with incomes above \$350,000—received the largest share of national income since 1928.²

The top 300,000 Americans enjoyed almost as much income as the bottom 150 million Americans combined. The top group received 440 times as much as people in the bottom half, doubling the gap from the 80s. And experts say the data may actually *understate* the income disparity.³

The American public and leading experts alike are voicing concerns over the rising inequality. In a December 2006 *Los Angeles Times/Bloomberg* national poll, 75 percent of respondents said the income gap is a “serious problem.” And former Federal Reserve

Chairman Alan Greenspan recently said, “This (growing inequality) is not the type of thing which a democratic society can really accept without addressing.”

There is no doubt the income being accumulated in the buyout business is a major contributor to the concentration of wealth among the top one percent of Americans. Yet questions about the role the private equity industry could play in addressing this national challenge remain—until now—unasked, and unanswered.

Limited Public Information

Unlike publicly traded companies that are subject to federal securities laws and regulations as well as to daily scrutiny by financial analysts and the business media, private equity buyout firms operate virtually free of oversight and public accountability, their profits and practices largely hidden from view. Far from a coincidence, this lack of transparency is built into their business model, providing buyout firms with investment advantages that publicly traded companies do not enjoy.

Utilizing the limited information available to the public, this report provides a snapshot for everyday investors, workers, community members, and the public about the private equity buyout industry and its practices, spotlighting the leading firms, and examining the inner workings of five private equity buyout deals for their impact on workers. The report is provided as a resource for people and organizations who may not be business or financial experts, but whose lives, jobs, investments, or communities are or could be affected by private equity buyouts.

The report presents:

- An explanation of how private equity works, the firms’ basic business model, and the incredible wealth they are generating for themselves and their limited partners;
- A look inside the industry’s five largest firms, the Carlyle Group, Blackstone Group, TPG, Kohlberg, Kravis, Roberts & Co., and Bain Capital. The profiles examine the firms’ principals, some of their biggest deals, their investment industries, and how each of them are so profitable they are “printing money”; and
- An examination of five recent buyout deals that illustrate the impact private equity transactions can have on workers and their communities at the companies being bought and sold.

And while the lack of public information available about private equity precludes a full, comprehensive analysis of this industry, this report presents a broad overview of the private equity buyout firms and their sometimes controversial business practices that are driving the new economy.



About SEIU

With 1.8 million members, SEIU (Service Employees International Union) is the fastest-growing union in North America. SEIU is America’s largest union of health care workers, property services workers, and the second largest union of public services workers. A top priority of SEIU members is fighting to secure quality, affordable health care for all Americans. SEIU is helping to unite working families, business leaders, community leaders, and policy-makers to find real solutions to the health care crisis.

SEIU members participate in pension funds with more than \$1 trillion in assets, most of which invest 5 percent to 10 percent of their assets in private equity. SEIU is a long-time advocate of responsible corporate governance practices and an active member of the Council of Institutional Investors, an organization of more than 130 pension funds whose assets exceed \$3 trillion.

INSIDE THE WORLD OF THE PRIVATE EQUITY BUYOUT INDUSTRY

P rivate equity buyouts are generally conducted by private partnerships that involve three main actors: 1) investors, 2) private equity firms and 3) the companies they purchase, known as “portfolio companies.”

Investors in private equity are typically institutional investors such as pension funds, insurance companies and endowments, as well as high net-worth individuals. These investors are commonly referred to as “limited partners;” they have limited liability, but also limited control over the management of the funds.⁴ They invest significant amounts of assets in private equity funds for a fixed period of time, usually 10 years, during which time they cannot access their investment. At the end of the fixed period, the funds must be returned to the limited partner investors.

Most of the control of the investments remains in the hands of the private equity firms themselves, often referred to as the “general partners.” They are responsible for raising the money for the funds, which can vary in size from \$5 million to \$10 million for a small venture capital firm to more than \$15 billion for a very large buyout firm.

A typical private equity firm will raise a new fund every three to four years. Each fund becomes the private equity firm’s working capital for a new wave of investments in portfolio companies. The firms also work to identify, acquire, and manage all the portfolio companies in which they invest their funds.

Once a private equity buyout firm has invested in a portfolio company, it usually assumes complete control of the company. It may keep the company's senior managers in place or it may bring in outside managers of its choosing. Even if the portfolio company's management remains in place, a member of the buyout firm typically joins the board and the firm has final say over how the company is run. After a period of ownership, the private equity firm will sell its stake in the portfolio company on a stock market through an Initial Public Offering (IPO), to a larger company in the same industry or to another private equity firm.

Over the past 20 years, private equity has outperformed the S&P Index, a common benchmark for stock market investments, by up to 44 percent.⁵ Private equity can offer higher returns than traditional investments such as stocks and bonds, but private equity investments are also riskier because they are less diversified and more difficult to sell.

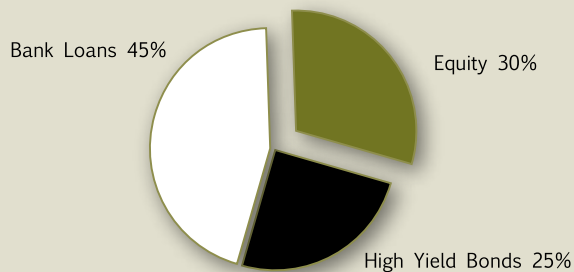
Leveraged buyouts

Portfolio companies are rarely purchased using only the equity of the buyout firm. In order to increase the number of transactions a particular fund can make, as well as to increase returns and spread risk, the private equity firm uses debt—or leverage—to finance a significant proportion of each deal.

A leveraged buyout is a lot like buying a house with a mortgage. With a down payment of 20 percent in cash, an individual can get a mortgage for the remaining 80 percent of the cost of the house, using the house itself as collateral. Similarly, a private equity firm could take \$200 million raised from investors to buy out a company worth \$1 billion. To complete the deal, the buyout firm uses the \$200 million in equity plus the value of the company as collateral to borrow the remaining \$800 million needed to finance the purchase of the company.

Like mortgage lenders who check that borrowers have sufficient income to cover their mortgage payments, lenders who provide the debt to finance leveraged buyouts seek to ensure portfolio companies have sufficient cash flows to service the payments on the debt. If a portfolio company that has undergone a leveraged buyout cannot make its debt payments, the company can be forced into bankruptcy by its creditors. Under most circumstances however, in contrast to a home mortgage, the private equity firm and its investors who funded the equity portion of the deal are not liable to repay this debt.

How a Typical Buyout is Financed



How Money is Made

Unlike a typical investment in shares of a publicly traded company, which may provide periodic dividend payouts or which can be sold at any time, an investor in private equity makes money only when the firm sells or “exits” the portfolio companies that make up the fund. Such exits can include partial sales, complete sales, or “recapitalizations.” In a recapitalization, the private equity firm pays itself a special dividend typically funded by having the portfolio company borrow more money.

The limited partners in a given private equity fund typically receive together about 80 percent of the profits from the deal. The remaining 20 percent is kept by the private equity firm as its fee for making a profit for the investors. This profit is typically called “the carry,” or “carried interest.” In addition to the carry, private equity firms charge a 1.5 percent to 2 percent annual management fee. Many private equity firms also charge management fees to the portfolio companies in which they invest, though this revenue is usually shared with investors. Some firms have also begun charging transaction fees

where the private equity firm receives a percentage of the value of any acquisition or sale of a portfolio company. For the largest buyouts, these transaction fees alone can be worth hundreds of millions of dollars.

Impact of debt levels on LBO returns

Leverage is not only central to acquiring portfolio companies but it also plays a major role in successful private equity firms' high returns. The simple example below illustrates how higher debt levels can produce higher returns on investments that are otherwise identical.

Investment A

1. Buy a \$100 company with \$100 cash
 2. Sell the company for \$120 cash after one year
- $\$120 - \$100 = \$20 = 20\%$ Return on Investment (ROI)

Investment B

1. Buy a \$100 company with \$50 cash and \$50 debt @ 10% interest
 2. Make one \$5 interest payment
 3. Sell company for \$120 cash after one year
 4. Repay \$50 loan
- $\$120 - \$5 - \$50 - \$50 = \$15 = 30\%$ ROI

Investment C

1. Buy a \$100 company with \$25 cash and \$75 debt @ 10% interest
 2. Make one \$7.50 interest payment
 3. Sell company for \$120 cash after one year
 4. Repay \$75 loan
- $\$120 - \$7.50 - \$75 - \$25 = \$12.50 = 50\%$ ROI

As this example shows, Investment C earns the highest returns by using the least amount of cash and the most debt. This picture would be reversed if the investments all lost money, which is one of the reasons leveraged buyouts are considered risky investments.



Private Equity and Taxes

Like all sophisticated companies, private equity firms aggressively manage the tax liabilities of their own firms and those of their portfolio companies. For example, according to the *Financial Times*, Blackstone paid taxes at a rate of 1.4 percent last year.⁶ If it had been taxed at the 34.5 percent rate that applies to companies such as Goldman Sachs, for example, Blackstone's tax bill last year would have increased from just \$32 million to nearly \$800 million.⁷

Policy-makers are focusing on three unique tax advantages enjoyed by private equity firms and their partners:

1. The tax treatment of debt vs. equity

Buyout firms depend on leverage to meet their target returns. One benefit of relying on debt financing to acquire portfolio companies is that buyout firms can deduct their interest costs from portfolio companies' profits, effectively reducing taxable income. Public companies, which are more heavily financed with shareholders' equity and often face shareholder opposition to the aggressive use of debt, are generally unable to avail themselves of this tax provision to the same extent.⁸ The tax advantages of debt also allow buyout firms to bid more aggressively for acquisition targets than most public companies.⁹ According to Jay Ritter, a Professor of Finance at the University of Florida, the "consensus is that [the tax advantages of using debt financing] can add more than 10

percent to the value of a bid” for an acquisition, allowing aggressive users of debt such as buyout firms to outbid potential acquirers that rely more on cash or equity.¹⁰ Tax authorities in the United Kingdom and Germany currently are considering curtailing buyout companies’ ability to deduct interest payments.¹¹

2. Taxing carried interest as capital gains instead of income

The primary source of revenue for a successful private equity firm is the percentage of profits earned when portfolio companies are sold or recapitalized. This “carried interest,” which is usually about 20 percent of the profits from the sale of a portfolio company, is retained by the private equity firm as compensation for earning a good return for its investors. The firm then distributes the “carry” to its owners and employees, with the founders and senior partners taking the lion’s share. The firm’s partners do not pay ordinary income tax on their portion of the carry—a rate of 35 percent—but instead pay the lower capital gains tax—a rate of only 15 percent. For example, paying taxes on \$1 billion of carried interest at the capital gains rate of 15 percent instead of the typical income tax rate of 35 percent saves private equity principals more than \$200 million in taxes. Recent press accounts suggest that members of Congress, including the ranking Republican member of the U.S. Senate Finance Committee, are considering changing the tax regime to tax carried interest at ordinary income tax rates.¹² An anonymous Senate aide was quoted in the *Financial Times* saying “We are looking into instances where funds may be using tax strategies to convert what would be income into capital gains for tax advantage.”¹³

3. A potential tax-advantaged corporate structure created when private equity firms go public

This year, major private equity firms are beginning to sell shares to the public not just in their portfolio companies, which they have always done to exit their investments, but in the private equity firm itself. Private equity firms considering selling themselves in a public offering may have discovered a creative way to pay lower entity-level taxes than other public companies. Following a path blazed by the hedge fund and private equity firm Fortress Investment Group in its IPO earlier this year, Blackstone Group has announced plans to go public as a master limited partnership. According to *Reuters*, “under U.S. tax law, master limited partnerships do not pay the 35 percent corporate tax rate, but rather distribute nearly all their profits to common unit holders who individually are allowed to pay 15 percent capital gains tax rates.”¹⁴ “I don’t think Congress had this in mind when it wrote the publicly traded partnership rules in 1987,” Victor Fleischer, a law professor at the University of Colorado in Boulder, told *Reuters*. He added, “there’s some risk that the IRS could rule against Blackstone and say that the structure isn’t any good, and I think there’s a significant risk that Congress could change the rules.”¹⁵

Policy-makers are beginning to question whether providing the private equity buyout industry with these tax advantages benefits society as a whole and the overall economy, or whether they simply make it easier for private equity to acquire and profit from companies at the expense of public shareholders and federal and state tax revenues.

Private Equity and Job Creation

There is little reliable quantitative analysis about the private equity buyout industry's impact on job creation. As *Business Week* bluntly notes, however, "buyout shops have always been associated with job losses."¹⁶ Even industry studies that make bold claims that buyouts are creating jobs acknowledge that in many cases jobs are lost.¹⁷

A detailed study of more than 1,300 buyouts in Great Britain between 1999 and 2004 by the independent Centre for Management Buy Out Research puts industry claims in perspective. Overall, buyouts result in job losses during the first year. After six years, more than 60 percent of firms have added jobs—while more than 35 percent have cut jobs. In contrast to management buyouts, (situations where existing management partners with a private equity firm), where the study finds that companies increased employment by 36 percent on average, buyouts where the private equity firm installs new management indicate job losses of more than 18 percent after six years.¹⁸

Even in the cases where buyouts result in job growth, it is unclear that workers are benefiting. Industry studies make little attempt to look behind the numbers at what is happening to workers and communities:

- What types of jobs are the buyouts creating?
- Are the jobs that buyouts create full time or part time?
- Are wages of both existing and new workers going up or down?
- Do these new jobs come with health insurance and retirement benefits?
- Where are the new jobs located? Are the buyout firms investing in the communities where offices and plants are located? Or are they shifting jobs elsewhere in the United States or overseas where the pay is lower?
- What impact does the job restructuring have on the local economy and tax base?
- What is the real impact of these buyouts on workers, families, and communities?

Industry Studies: Questionable Assumptions, Methodologies, Conclusions

Industry groups claim that buyouts create jobs. But since private companies do not publicly disclose information about their employees or company growth, industry claims are difficult to evaluate. Studies based on self-reported information from a limited set of companies may not paint a reliable picture of what is happening across the economy or in all industries.

A close look at some of the studies provides a number of

reasons for treating their numbers with caution.

A recent A.T. Kearney report, a meta-review of 12 existing studies, claims that private equity created 600,000 jobs in the United States between 2000 and 2003.¹⁹ But the Kearney report actually sheds no light on the impact of *buyouts* on employment because it doesn't distinguish buyouts from venture capital that provides seed money to start up new businesses.

While such broad studies may help the private equity industry attempt to shape public perception of its industry, they do little to help the public understand what is really happening when the buyout specialists take over established companies.

A 2005 study by the Center for Entrepreneurial and Financial Studies (CEFS) for the European Private Equity and Venture Capital Association claims that more than 400,000 net jobs were created in Europe by buyout-financed companies between 2000 and 2004.²⁰ The study's claims are based on self-reported information from a small set of portfolio companies—just 99 out of more than 1,400 companies that underwent a buyout during the period studied.

Any evaluation of how buyouts result in employment growth must distinguish between organic growth and growth through acquisitions and mergers. The CEFS study does not attempt to explain what led to employment growth at specific companies. Instead, the study simply assumes that all employment changes of 20 percent or less are due to organic growth. The study provides no rationale for using the 20 percent figure.²¹

A recent *Financial Times* analysis of the 30 biggest deals in Europe during 2003 and 2004 found that employment at the acquired companies increased 25 percent since the deals were completed.²² But this claim is based on figures that have not been adjusted to account for nonorganic growth. The *Financial Times* claims that net job growth at the acquired firms totaled nearly 37,000. Analysis of the *Times'* figures shows that nearly 50,000 jobs were added and about 12,500 jobs were lost. Most of the 37,000 new jobs, however, were added through acquisitions, including 22,000 attributed to Blackstone's purchase of Southern Cross, which was then merged into other Blackstone buyout companies. These are not jobs the buyouts created. While it is true that most of the job losses in these 30 deals can be attributed to companies selling parts of their business, actual net job growth was just a fraction of the total claimed by the *Financial Times*.

Despite claims by recent reports that private equity buyouts create jobs, serious problems with the studies' methodology, assumptions, and conclusions raise significant questions about the reports accuracy and reliability.

Private Equity Public Policy Concerns

There are a number of practices of private equity buyout firms that are creating widespread concern among public policy-makers, securities markets, and other stakeholders.

- 1. Quick Flips.** Private equity typically owns companies for three to five years, seeks to improve operations and profitability, and then relists the companies as healthier and better suited for long-term growth. Increasingly in recent years private equity has sought to increase their funds' investment returns by liquidating part or all of their investment more quickly. To accomplish this they engage in "quick flips," relisting companies within a year or two of taking them private, with more leverage, but few if any operational improvements. They also cause their portfolio companies to borrow more money to pay the private equity firm a special dividend, sometimes within months of the original acquisition.
- 2. Conflicts of Interest.** The managers and directors of a public company owe a fiduciary duty to maximize returns to shareholders. But when private equity invites those same managers or directors to participate in a leveraged buyout, their interest shifts to help the private equity group get the lowest price possible for the company. More than one commentator has suggested that this inherent conflict should be regulated by prohibiting management participation in buyouts.²³ In addition, the big private equity firms are now the largest customers and generators of fees to the global investment banks and commercial banks for their stock and bond underwriting, bank lending and investment banking advisory services. These multifaceted relationships with firms such as Goldman Sachs, Merrill Lynch, and JPMorgan Chase led Robert Kindler, vice chairman for investment banking at Morgan Stanley, to say at a recent panel at the Corporate Law Institute at Tulane University, "We are all totally conflicted — get used to it."²⁴
- 3. Debt Risk.** Leverage is the key to the high returns private equity is able to generate (see box on Page 13). The easy credit markets of the last few years have helped fuel the surge in private equity, and the persistence of relatively low interest rates with steady economic growth has meant that there have been relatively few defaults among private equity-owned companies. In addition, the banks that are underwriting most of this debt are repackaging it and selling it to other lenders and investors, laying off the risk on others with limited additional due diligence by the new creditors. One result is a relaxing of underwriting standards by the original lenders, with debt that is "covenant-light" or even "covenant-free." Observers and policymakers worry about the impact a sudden downturn in the economy or an increase in interest rates will have on portfolio companies and the ripple effect of a rash of defaults on the broader financial markets.
- 4. Private Equity Exuberance:** Private equity firms raised \$215 billion in 2006—the most ever. The total exceeds the amounts raised during the last private equity bubble, in 2000. For 2007, buyout firms are hoping to raise even more—as much as \$400 billion.²⁵ With all this capital being raised, it increases the competition for deals, increasing the likelihood some firms will overpay for deals or do deals that make less economic sense. In addition, a significant downturn in the public equity markets would severely impair the ability of private equity to exit deals that were poorly conceived, highly leveraged, or overvalued.

The Players

One of the reasons private equity has gotten so much attention is the increasing frequency with which large publicly traded companies are going private in leveraged buyouts.

According to *The Wall Street Journal*, eight of the 10 largest buyouts ever in the United States were announced in the last 12 months.

A handful of large buyout firms were involved in nearly all these headline grabbing deals. Of the hundreds of buyout firms worldwide, Bain Capital (Bain), Blackstone Group (Blackstone), the Carlyle Group (Carlyle), Kohlberg Kravis Roberts & Co. (KKR), and TPG (formerly Texas Pacific Group) have emerged as the five largest buyout firms in this growing industry.

The funds they are raising for their acquisitions are huge. In 2007, KKR and Blackstone each announced they are building \$20 billion funds.²⁶ TPG has raised, and Carlyle is currently raising, \$15 billion funds.²⁷ Bain has a \$10 billion fund.²⁸ In total, these five firms will soon have \$80 billion in funds, which could conservatively translate to more than \$1 billion in fund management alone.

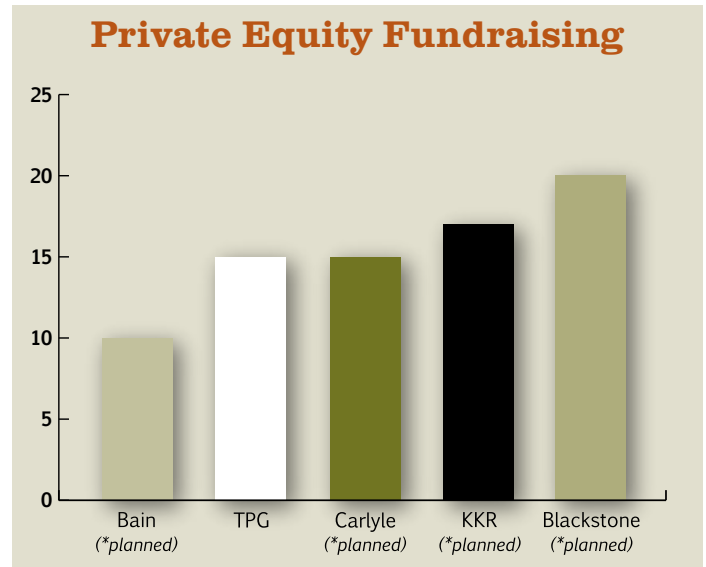
The large portfolios of the biggest buyout players illustrate their reach into and influence over the economy. According to Carlyle's Web site, companies owned by Carlyle employ more than 200,000 people worldwide²⁹ while *The Wall Street Journal* reports that there are more than 500,000 employees at KKR-controlled firms.³⁰ If viewed as corporate conglomerates, these employment figures put the biggest buyout firms in the same league as Verizon and FedEx in the case of Carlyle, and McDonalds in the case of KKR.³¹ Overall, the five largest buyout firms control companies that employ more than 2 million workers.³²

“Club Deals”

But even with the increased fund-raising capacity of the top firms, some of the biggest deals are beyond the purchasing power of any one firm; increasingly, private equity firms are joining together for specific transactions. These “club deals” allow the firms to share risk and purchase ever larger companies.³³

These buyouts often involve familiar brand-name companies worth billions of dollars and which employ thousands of people. For example, the table below lists 10 of the largest private equity buyouts announced in the past two years; all but one was a “club deal.” The value of these deals totaled more than \$270 billion and estimates based on public filings suggest that 630,000 employees were involved.

Several of the nation's largest firms, including Kohlberg Kravis Roberts & Co., the Carlyle Group, Clayton, Dubilier & Rice and Silver Lake Partners, have received letters from the Justice Department seeking broad information about their business practices and involvements in club deal auctions going back to 2003. The inquiry appears to be part of a civil investigation into whether these big buyout firms may have conspired to restrict competition and hold auction prices down by forming bidding groups and agreeing not to compete against each other when multiple firms are interested in the same deal.³⁴



The 20 Largest Players

Private Equity Investment Firm	Assets Under Management	Portfolio Company Employees
Blackstone	\$79 Billion	350,000
Carlyle Group	\$56 Billion	200,000
Bain Capital	\$40 Billion	662,000
Texas Pacific Group	\$30 Billion	300,000
KKR	\$27 Billion	540,000
Cerberus	\$22 Billion	363,000
Providence Equity Partners	\$21 Billion	86,000
TH Lee	\$20 Billion	391,000
Welsh, Carson Anderson & Stowe	\$16 Billion	62,000
Hellman & Friedman	\$16 Billion	73,000
Warburg Pincus	\$15 Billion	375,000
Madison Dearborn	\$14 Billion	149,000
Apollo Management	\$13 Billion	297,000
TA Associates	\$10 Billion	28,000
CCMP Capital Advisors, LLC	\$10 Billion	379,000
Goldman Sachs Capital Partners	\$9 Billion	1,050,000
DLJ Merchant Banking Partners	\$7 Billion	63,000
Vestar	\$7 Billion	53,000
Silver Lake Partners	\$6 Billion	301,000
Clayton, Dubilier & Rice	\$5 Billion	109,000
Onex	\$5 Billion	167,000



The Ten Largest Buyouts

Date Announced	Acquired Company	Private Equity Firm(s)	Approximate Acquisition Price (\$bil)	Estimated # of Employees
2/24/2007	TXU Corporation*	KKR, TPG	45	7,262
11/20/2006	Equity Office Properties	Blackstone	39	2,300
7/24/2006	HCA Inc.	Bain, KKR, Merrill Lynch	33	186,000
04/02/2007	First Data Corp	KKR	29	29,000
10/2/2006	Harrah's Entertainment Inc.	Apollo Management, TPG	28	85,000
11/16/2006	Clear Channel Communications*	Bain, Thomas H. Lee	27	26,500
8/28/2006	Kinder Morgan	Carlyle, Goldman Sachs, AIG, Bill Morgan, Fayez Sarofim, Mike Morgan, Riverstone Holdings, Richard D. Kinder	22	8,481
9/15/2006	Freescale	Blackstone, Carlyle, Permira Advisors, TPG, Stone Tower Capital	18	22,700
1/23/2006	Albertson's	Cerberus Capital, Kimco Realty and others including SuperValu and CVS	17	234,000
11/13/2005	Hertz	Carlyle, CD&R, Merrill Lynch	15	31,500

THE TOP FIVE PRIVATE EQUITY BUYOUT FIRMS

The five largest private equity buyout firms raise the most money, have the largest number of investment professionals and offices across the globe, and often set standards for the industry.

Carlyle: The Deals

Kinder Morgan:

\$22 billion

2006, (with Riverstone Holdings LLC)

Energy infrastructure provider³⁵

Freescale Semiconductor:

\$17.6 billion

2006, (with TPG; Blackstone; Permira)

Semiconductor maker³⁶

Hertz:

\$15 billion

2005, (with Clayton Dubilier & Rice, Merrill Lynch)

Rent-a-car company³⁷

VNU Group (Nielsen):

\$10 billion

2006, (with Blackstone, KKR, Thomas H. Lee Partners, Hellman & Friedman, Alpinvest Partners)

Information and media company³⁸

The Carlyle Group

Headquarters: Washington, D.C.

The Company

Founded in 1987, The Carlyle Group, with \$56 billion in assets currently under management,³⁹ has historically been known as the most politically connected private equity firm, capitalizing on its connections—George Bush Sr. and Jr., Frank Carlucci, John Major, and James Baker III previously served as advisers—to raise funds and secure government contracts. After controversy surrounding its political ties, Carlyle reduced its exposure to companies reliant on government contracts, particularly defense contracts, and focused on diversifying its portfolio.⁴⁰ Carlyle has also evolved from a specialist in deals under \$1 billion to become “a big game hunter,” cutting a number of multibillion-dollar club deals with fellow top-five private equity firms since 2005.⁴¹ Carlyle is currently raising a \$15 billion U.S. buyouts fund, nearly double its last fund.⁴²

Carlyle invests in a wide range of industries, including aerospace and defense, automotive and transportation, consumer and retail, energy and power, health care, industrial, real estate, technology and business services, and telecommunications and media. Either alone or as part of club deals, Carlyle has bought out such well-known companies as Loews Cinemas, Dunkin’ Brands (Dunkin’ Donuts and Baskin Robbins), and Del Monte Foods. At present, Carlyle’s portfolio includes approximately 140 companies⁴³ which in turn employ more than 200,000 workers and have \$68 billion in sales.⁴⁴

If Carlyle’s portfolio constituted one publicly traded corporation, it would hold spot No. 21 in the Fortune 500.

The Moneymakers

Carlyle’s key decision-makers are its three founding partners—David Rubenstein, Daniel D’Aniello, and William Conway—and the company’s chairman, Louis V. Gerstner Jr.

David Rubenstein: Co-founder Rubenstein is former deputy domestic policy adviser to the Carter administration.⁴⁵ Rubenstein’s current net worth is estimated at more than \$1 billion, though he has said that he himself has lost track of it due to the volume of investments he has through the firm.⁴⁶ Rubenstein’s properties include a Georgian-style Bethesda, Md., home valued at \$1.7 million, a 10,000-square-foot chalet in Beaver Creek, Colo., and a compound in Nantucket, Mass., large enough to accommodate 30 overnight guests.⁴⁷



Source: Fred Rousier/Reuters/Landov

David Rubenstein

William E. Conway: Prior to co-founding the Carlyle Group, he worked at MCI, where he became senior vice president and chief financial officer. According to the trade journal *The Deal*, “Conway green-lights or kills every one of Carlyle’s prospective LBO and venture investments throughout the world.”⁴⁸ Like Rubenstein, his current net worth is estimated at more than \$1 billion.⁴⁹ In 1999, Conway purchased a 17,000-square-foot mansion built on a seven-acre expanse with a view of the Potomac River. In 2005, he sold the property for \$24.5 million.⁵⁰

Daniel A. D’Aniello: Prior to founding Carlyle, D’Aniello was a vice president at the Marriott Corp. Press accounts also indicate that D’Aniello runs most of the day-to-day operations of Carlyle. His current net worth is estimated at more than \$1 billion.⁵¹

Louis V. Gerstner Jr.: Gerstner, the former CEO of IBM, was brought in as chairman in 2003 as part of an effort to shift Carlyle’s reputation as “the CIA of the business world” and to help the company build an organization that will outlast its founders.⁵² According to D’Aniello, Gerstner is “one phone call away from every chief executive officer in the United States.”⁵³ In 2003, Forbes calculated Gerstner’s net worth at \$600 million. Gerstner’s home in Greenwich, Conn., is valued at \$12.2 million.

Printing Money

- In December, 2005 Carlyle along with Clayton, Dubilier & Rice, and Merrill Lynch bought out Hertz from the Ford Motor Co. Carlyle contributed approximately \$750 million in equity. In June 2006, the sponsors paid themselves a special dividend of \$1 billion, and in November 2006, less than one year after buying the company, they took it public, while retaining a two-thirds stake in the company. For its \$750 million investment, Carlyle received proceeds totaling more than \$400 million, while its remaining stake was worth \$1.3 billion at the time of the IPO. That adds up to a return of 128 percent in less than one year’s time.⁵⁴

The Blackstone Group

Headquarters: New York, N.Y.

The Company

Founded in 1985, the Blackstone Group has more than \$78 billion in assets under management.⁶¹ Blackstone has multiple lines of business in addition to buyouts, including real estate, corporate debt funds, and hedge funds. Blackstone also provides mergers and acquisitions and restructuring advice to corporate clients. In 2006, Blackstone raised a record \$15.6 billion private equity fund, then later upped its size to \$20 billion.⁶²

Blackstone invests in a wide range of industries, including chemicals, communications, energy, entertainment, health care, insurance, lodging, manufacturing, technology, transportation, and waste management.⁶³ Based on total amounts invested, the bulk of Blackstone’s investments have been in consumer-related companies and the transportation sector.⁶⁴ Either alone or as part of club deals, Blackstone has bought out such well-known companies as Michaels Stores, Madame Tussauds, and LaQuinta Inns.⁶⁵ At present, the firm owns controlling stakes in 47 companies producing more than \$85 billion in revenues⁶⁶ and that together employ more than 350,000 workers.⁶⁷

If Blackstone’s portfolio constituted one publicly traded corporation, it would hold spot No. 12 in the Fortune 500.

Blackstone: The Deals

Equity Office Properties:

\$39 billion

2007

Real estate investment trust⁵⁵

Tele Danmark:

\$15.3 billion

2005, (with KKR)

Phone company⁵⁶

SunGard Data Systems:

\$11.3 billion

2005, (with Silver Lake Partners, Bain Capital, Goldman Sachs Capital Partners, KKR, Providence Equity Partners)

Corporate data and security⁵⁷

VNU Group (Nielsen):

\$10 billion

2006, (with Carlyle, KKR, Thomas H. Lee Partners, Hellman & Friedman, AlPInvest Partners)

Information and media company⁵⁸

Michaels Arts and Crafts Stores:

\$6 billion

2006, (with Bain Capital Partners Arts and crafts materials retailer⁵⁹

Freescal Semiconductor:

\$17.6 billion

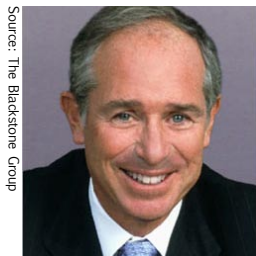
2006, (with Carlyle, TPG, Permira)

Semiconductor maker⁶⁰

On March 22, Blackstone filed a registration statement with the SEC by which it intends to sell a portion of its business to the public. Blackstone explained in its initial S-1 filing that the public offering would allow it to tap a new permanent capital source to expand its business, enhance its brand, provide an acquisition currency for strategic acquisitions, give it a new way to incentivize its employees, and allow its founders to liquidate some of their holdings in the company. Published reports indicate that Blackstone hopes to raise up to \$4 billion through the IPO.⁶⁸

The Moneymakers

Blackstone has 57 senior managing directors. However, the key money-makers and decision-makers are the company's two founding partners and the firm's president:



Source: The Blackstone Group

Stephen Schwarzman

Stephen Schwarzman: Forbes Magazine ranked Blackstone co-founder Schwarzman as No. 73 on their list of wealthiest Americans, estimating his net worth at \$3.5 billion.⁶⁹ He lives in a 35-room Park Avenue triplex purchased for \$30 million, and also owns a 13,000-square-foot mansion in Palm Beach, Fla., a home in East Hampton, N.Y., and one in Jamaica.⁷⁰ This past February, Schwarzman threw a well-chronicled 60th birthday party for himself at a cost of \$3 million.⁷¹ However, Schwarzman has also indicated a concern about growing inequality of wealth, “[T]he middle class in the United States hasn’t done as well over the last 20 years as people in the high end. Part of the compact in America is that everybody’s got to do better.”⁷²

Peter G. Peterson: Former chairman and CEO of Lehman Brothers, Blackstone co-founder Peterson was Richard Nixon’s secretary of Commerce and now chairman of the Council on Foreign Relations. He has spoken very publicly against the mounting federal deficit. In a recent interview for the *Financial Times*, Peterson stated that middle-class Americans were more concerned about their own futures than about the rich, suggesting that “the American Dream still exists in the hearts and minds of the majority of Americans.”⁷³

Hamilton “Tony” James: James is widely seen as the heir apparent to Stephen Schwarzman. Prior to joining Blackstone, James worked at Donaldson, Lufkin & Jenrette (DLJ), an investment banking firm, where he demonstrated his financial acumen during the merger mania of the 1980s. At that time, *The Wall Street Journal* characterized him as a “merger whiz kid;” and by the age of 35, he was already earning more than \$1 million annually.⁷⁴ However, \$1 million was penny change to him. “I can’t resist the temptation to say ‘\$1 million sounds like a lot of money, but it’s really not,’” he said. “No one’s going to shed any tears for us. But the fact is, it’s easy to make \$1 million and not accumulate a lot.”⁷⁵

Printing Money

- In 2006, Blackstone collected \$852 million in fund management fees (not including the fees received for the Equity Office Properties deal). In 2005, Blackstone made \$370 million in fund management fees.⁷⁶
- In July 2004 Blackstone closed its purchase of German chemicals company Celanese AG for \$3.8 billion, of which Blackstone contributed \$641 million in equity.⁷⁷ Within one year, in January 2005, Blackstone conducted an IPO and relisted Celanese on the New York Stock Exchange, earning \$3 billion—a 368 percent return on its investment.⁷⁸

Kohlberg, Kravis, Roberts & Company

Headquarters: New York, N.Y.

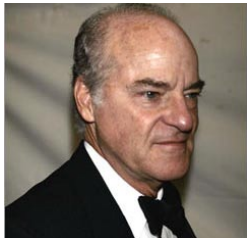
The Company

Kohlberg, Kravis, Roberts & Co (KKR) is one of the oldest private equity firms having been founded in 1976, and is known for high-profile deals such as the hostile takeover of RJR Nabisco for \$31 billion in 1989, inspiring the bestseller, *Barbarians at the Gate*. KKR continues to make headlines with announcements of leveraged buy-outs of well-known companies such as First Data and Dollar General. In the first quarter of 2007, KKR has announced more buyouts globally than any of its competitors.⁸⁵

According to the firm's Web site, KKR has invested in 150 deals with a total aggregate value of \$279 billion.⁸⁶ In 2006, KKR invested \$6.9 billion in 12 companies and participated in about \$104 billion of deals.⁸⁷ It is raising \$20 billion for its global buyout fund and related entities. It owns 35 companies with a combined \$95 billion in annual revenue and more than 500,000 employees.⁸⁸

If KKR's portfolio constituted one publicly traded corporation, it would hold spot No. 10 in the Fortune 500.

The Money Makers



Henry Kravis

The two remaining founding partners,⁸⁹ Henry R. Kravis and George Roberts, are cousins and make all the key decisions about company transactions. Forbes lists them both as being worth \$2.6 billion, tied for No. 107 among the richest Americans.⁹⁰

Kravis is credited with being one of the key architects of the leveraged buyout where substantial amounts of debt are used to purchase companies. James B. Lee Jr. of JPMorgan Chase characterizes him as "the Roger Clemens of the industry. He was a winner when he was 20 years old, and he is a winner in his 60s."⁹¹

Printing Money

- In January 2004 KKR bought MTU Aero Engines from Daimler Chrysler for \$1.8 billion with a total equity investment of \$326 million.⁹² In June 2005, KKR floated MTU in an IPO and earned back \$590 million while retaining 29 percent of the company.⁹³ They sold their remaining stake in January 2006 for an additional \$570 million, for a total return exceeding 250 percent.
- In April of 2004, KKR acquired mattress-maker Sealy Corp. for approximately \$440 million in equity and \$1 billion in debt.⁹⁴ Although KKR invested only \$440 million of its own money in the deal, during the next two years it got back more than \$250 million (two special dividends, yearly management fees, a cancellation fee, and the sale of part of the company through an IPO) and still held a stake in the company worth more than \$900 million.⁹⁵

KKR: The Deals

KKR focuses on large deals, and was the fourth most-active dealmaker in 2006—it closed on 13 deals worth an estimated \$78 billion.⁷⁹ KKR's largest deals include:⁸⁰

TXU:

\$45 billion

2007 (pending), (with TPG, Goldman Sachs Capital Partners)

Electricity generation company⁸¹

HCA:

\$33 billion

2006, (with Bain Capital, Merrill Lynch)

For-profit hospital chain

RJR Nabisco:

\$31 billion

1989

Consumer goods manufacturer

First Data:

\$28 billion

2007 (pending),

Credit card processor

VNU Group (Nielsen):

\$10 billion

2006, (with Carlyle, Blackstone, Thomas H. Lee Partners, Hellman & Friedman, AlInvest Partners),

Information and media company⁸²

Biomet:

\$10.9 billion

2006, (with Blackstone, Goldman Sachs Capital Partners, TPG)

Orthopedic devices maker⁸³

SunGard Data Systems:

\$11.4 billion

2005, (with Silver Lake Partners, Bain Capital, Goldman Sachs Capital Partners, Blackstone, Providence Equity Partners)

Corporate data and security⁸⁴

TPG: The Deals

TXU:

\$45 billion
2007, (with KKR, Goldman Sachs Capital Partners)
Electricity generation company⁹⁶

Harrah's Entertainment:

2006
\$27.8 billion (with Apollo Management)
Casino entertainment company⁹⁷

Freescale Semiconductor:

\$17.6 billion
2006, (with Carlyle; Blackstone; Permira)
Semiconductor maker⁹⁸

Univision:

\$13.7 billion
2006, (with Madison Dearborn Partners; Providence Equity Partners; Thomas H. Lee Partners and Saban Capital Group)
Spanish-language media company⁹⁹

SunGard Data Systems:

\$11.4 billion
2005, (with Silver Lake Partners; Bain Capital; Blackstone; Goldman Sachs Capital Partners; KKR, Providence Equity Partners)
Corporate data and security¹⁰⁰

Biomet:

\$10.9 billion
2006, (with Blackstone, Goldman Sachs Capital Partners, KKR)
Orthopedic devices maker¹⁰¹

TPG (formerly Texas Pacific Group)

Headquarters: Fort Worth, Texas

The Company

Founded in 1992¹⁰², shortly after turning twice-bankrupt Continental Airlines into a serious contender in the airlines market, TPG is regarded as a turnaround expert and specialist in complex investments. In 2006, TPG was involved in \$101 billion worth of deals.¹⁰³ TPG's latest fund is worth \$15 billion.¹⁰⁴

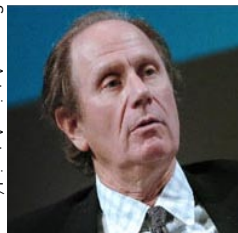
TPG's industry areas of focus are airlines, media and telecommunications, industrials, technology, and health care.¹⁰⁵ Either alone or as part of club deals, TPG has bought out such well-known companies as the J. Crew Group, Neiman Marcus, Burger King, MGM, and Harrah's Entertainment, the world's largest gaming company. TPG currently is seeking to buy three international airlines, Qantas in Australia, and Alitalia and Iberia in Europe.

TPG has lost at least one deal because of the risks posed by its management approach. In 2005, the Oregon Public Utility Commission rejected TPG's bid for Portland General Electric, citing debt burden and quick flip as major risks of the deal.¹⁰⁶ In addition, internal deal documents leaked to the press revealed TPG's plans for "wholesale layoffs and dramatic cuts in maintenance."¹⁰⁷

At present, the firm owns companies producing more than \$65 billion in revenues¹⁰⁸ that together employ nearly 300,000 workers.¹⁰⁹ If TPG's portfolio constituted one publicly traded corporation, it would hold spot No. 21 in the Fortune 500.

The Moneymakers

Source: Antoine Antoniol/
Bloomberg News/Landov



David Bonderman

David Bonderman: Bonderman, a former civil rights attorney,¹¹⁰ is the co-founder and chair of TPG, and is seen as the primary force behind the firm's development. He is worth approximately \$1 billion,¹¹¹ He serves on the board of several companies as well as several environmental groups, including The Wilderness Society, The Grand Canyon Trust, The World Wildlife Fund, and the American Himalayan Foundation.

James Coulter: A co-founder of TPG, Coulter started up the California office of TPG. Coulter serves on a number of TPG portfolio company boards, including J. Crew Group Inc., Lenovo Group Limited, Neiman Marcus Group Inc. and Seagate Technology.¹¹² He is co-chair of the Stanford University Development Steering Committee and a member of the Stanford Challenge Leadership Council.

Printing Money

- TPG made a sevenfold return on its \$42 million investment in a one-year quick flip of European air carrier Ryanair in the late 1990s. Michael O'Leary, president of Ryanair, offered his take on what happened: "[Bonderman] was looking for dumb companies that didn't realize they were on to a good thing. He kind of raped us. He got 20 percent for pretty much nothing. Sold us in '97 and made a fortune."¹¹³
- In October 2000, Petco was acquired by TPG and Leonard Green & Partners LP, in a \$600 million deal. TPG and Leonard Green invested \$200 million in the deal, but then collected an estimated \$23.8 million in management fees,¹¹⁴ and a \$1.2 billion payout as they made Petco public through a number of public offerings from 2002–2004, according to allegations in a recently filed class action suit.¹¹⁵ In July 2006, TPG and Leonard Green acquired Petco for a second time, in a \$1.8 billion deal.¹¹⁶ Days after the acquisition, Petco shareholders filed a class action law suit claiming "self-dealing and breach of fiduciary

duty” in the Superior Court of California. The plaintiffs charge Petco with blocking a \$33/share offer by PetSmart, and entering into a \$29/share deal that benefits Petco management and the buyout funds at the expense of shareholders.¹¹⁷ The case is pending.

Bain Capital, Inc.

Headquarters: Boston, Mass.

The Company

As of March 2007, Bain Capital had raised \$13 billion in private equity leveraged buyout funds.¹²⁴ Bain Capital Inc., formerly Bain & Co., is known for charging higher carried interest than average— 30 percent versus the standard 20 percent—and is a staple of the club deal circuit. Historically, nearly half of Bain’s deals have been club deals.¹²⁵ Bain’s club deals include Toys ‘R’ Us, with KKR and Vornado Realty Trust; AMC Entertainment, with JP Morgan, Apollo Management, Carlyle Group and Spectrum Equity Investors, and Burger King with TPG and Goldman Sachs Capital Partners. Overall, its total assets under management were valued at \$40 billion in 2007.¹²⁶ Bain’s most recent fund, “Bain Capital X,” raised \$10 billion in 2006, \$4 billion more than was originally anticipated.¹²⁷

The Moneymakers

Source: Clinton School Research Center



Joshua Bekenstein

Joshua Bekenstein: A graduate of Yale and Harvard, Bekenstein continues his ties to his alma mater, serving on Yale’s investment committee¹²⁸, a committee which has significant amounts invested with Bain Capital.¹²⁹ Bekenstein and his wife, Anita, are generous political donors, giving a total of \$431,000 to various candidates and PACs between 2004 and 2006.¹³⁰

Stephen Pagliuca: The grandson of a New York City shoemaker and the son of an army officer, Pagliuca is part owner of the Boston Celtics. Pagliuca was the lead partner on the HCA deal.¹³¹ Pagliuca’s net worth is estimated to be \$410 million.¹³²

Mark Nunnally: Nunnally was the lead partner in the Domino’s Pizza deal.

Money Sources

According to Fortune magazine, in 2006, Bain Capital raised \$13 billion in buyout funds largely from university endowments.¹³³ Contrary to most other large buyout firms, Bain does not rely on major public pension funds as a significant source of capital.

Printing Money

- As part of a club deal with Texas Pacific and Goldman Sachs, Burger King was acquired by Bain Capital in 2002 for \$1.5 billion, with Bain contributing an estimated \$190 million in equity. Two dividend recapitalizations in 2005 and 2006 resulted in the Burger King club participants recouping nearly all of their original equity investment. In May 2006, the buyout group took Burger King public.¹³⁴ Following a second share offering in February 2007, Bain still owned 19 percent of the company worth more than \$560 million. According to *The Deal*, the two stock offerings and dividend recaps earned Bain and the other Burger King investors four times their initial investment.¹³⁵
- According to Forbes, Bain and the other private equity firms that acquired Warner Music Group in 2003 made \$3.2 billion¹³⁶ on a \$1.25 billion investment in just a little over a year, and the company was still losing money at the time.¹³⁷ For more information about the Warner Music deal, see the next page.

Bain : The Deals

Bain was among the most active funds in 2006; it participated in 12 deals worth a total of \$85 billion.¹¹⁸ Notable deals include:

HCA:
\$33 billion
2006, (with KKR, Merrill Lynch)
For-profit hospital chain¹¹⁹

Michaels Arts and Crafts:
\$6 billion
2006, (with Blackstone)
Arts and crafts materials
retailer¹²⁰

Dunkin’ Brands:
\$ 2.4 billion
2006, (with Carlyle and Thomas
H. Lee)
Fast-food restaurant chain¹²¹

OSI Restaurant Partners Inc.:
\$3 billion,
2007 (pending)
Restaurant chain, including
Outback Steakhouse¹²²

Clear Channel Communications:
\$26.7 billion
2007 (pending), (with Thomas
H. Lee Partners)
Telecommunications
conglomerate¹²³

BEHIND THE BUYOUTS: A LOOK INSIDE FIVE PRIVATE EQUITY DEALS

1. Facing the Music: When corporate restructuring leads to disappointing returns

The Thomas H. Lee Buyout of Warner Music

In her 2003 Grammy Award-winning song, “Cry,” Warner Music artist Faith Hill asked if her partner could “pretend that he was feeling some pain.” Nine months later, Warner employees were getting a preview of the pain that was going to come with the private equity buyout of their employer. “Despite my personal fondness for the music business as well as for all of our wonderful managers and music group employees,” said the Time Warner CEO Dick Parsons, “I believe that this transaction is clearly in the best interests of our company’s shareholders.”¹³⁸

Paying \$2.6 billion, just more than half of which was debt, a group led by the buyout firm Thomas H. Lee and including Bain Capital, needed to quickly find ways to cut expenses to cover the high cost of their deal, which closed in February 2004.¹³⁹ Their plans for cost-cutting quickly became clear: consolidating divisions, laying off 20 percent of the workforce (1,000 employees), and ending contracts with nearly half of the artists on its roster.¹⁴⁰ As a result of the cuts, Warner shaved \$240 million off its expenses and reduced net losses for the year, although it was still losing more than \$100 million a year.¹⁴¹

Despite these losses, the private equity group quickly recouped some of its investment. In September of 2004 Warner Music returned \$342 million to the investors and paid a dividend of \$8 million on their preferred equity taken from existing cash. Two months later, the company took out a \$700 million loan, financed with CCC+ junk bonds, of which \$681 million was used to pay additional dividends to the investors and repurchase a significant portion of their common stock.¹⁴² At the same time, Warner Music faced a succession of subpoenas from then-New York Attorney General Elliott Spitzer as part of his investigation of payola schemes.¹⁴³ Spitzer’s investigation led Warner Music to reach a settlement, in which it agreed to stop giving financial incentives and promotional items to radio stations and their employees in exchange for airtime. As part of the settlement, Warner Music admitted the payoffs were improper, and agreed to abide by a higher standard.

The next spring, 18 months after the buyout, Warner announced it was making an initial public offering, hoping to raise \$750 million. Analysts and potential shareholders were underwhelmed by the offering; the offering range of \$22–\$24 per share ended up selling for just \$16.40 per share.¹⁴⁴ Some may have had little confidence in the long-term benefit of the quick cost-cutting by management, others may have been put-off by revelations in the initial filing that management had not fully addressed all the accounting problems identified when the company first went private.¹⁴⁵ Public investors’ concerns have been borne out, as after nearly two years, the stock is still trading for virtually the same price at which the shares were offered in the IPO, during a period when the S&P 500 has gained more than 20 percent.¹⁴⁶ According to an article in *Forbes*, the buyout partners made \$3.2 billion on a \$1.3 billion outlay in just a little more than a year—on a company that was losing money, and its good reputation.¹⁴⁷

2. Broadcasting Losses: An image of retirement insecurity

The “Zeus Holdings” Buyout of Intelsat

In 1969, millions of Americans were glued to their televisions, watching the first men to walk on the moon. Those images were made possible by a relatively new company called the International Telecommunications Satellite Consortium (Intelsat), originally an intergovernmental organization created by more than 100 nations. In the following decades, employees of Intelsat continued to improve telecommunications technology—bringing Olympic Games, World Cup matches, and the royal wedding of Charles and Diana to billions of television viewers.¹⁴⁸ In 2001, Intelsat became a privately owned company, and three years later was acquired for \$5 billion by a consortium of private equity firms—Apollo Management, Apax Partners, Madison Dearborn Partners and Permira.¹⁴⁹ The consortium invested \$515 million of their own money in the deal and called themselves “Zeus Holdings.”¹⁵⁰

The new company went to work slashing labor costs, reducing the workforce by 18 percent between June 2004 and September 2005¹⁵¹ and allegedly refusing to honor retiree medical benefits, claiming that promises to retirees made by the previous board do “not create obligations that are enforceable” against the present company, according to litigation filed in 2004.¹⁵² A retiree reported to *The Wall Street Journal* that these benefits are worth \$75 million.¹⁵³

In March 2007, Intelsat agreed to provide a new health plan for the retirees, to cover their “mental, dental, prescription drug and vision benefits.”¹⁵⁴ Intelsat also agreed to reimburse the retirees and their dependents for any out-of-pocket expenses exceeding the premiums under the prior plan, if made during the gap in coverage.¹⁵⁵ The settlement is subject to approval of the court, which is expected in July 2007. Once approved, the retirees will also be entitled to up to \$200,000 in attorneys’ fees to cover the cost of the litigation.¹⁵⁶

By the end of 2005, a little more than a year after the acquisition the cost cutting freed up enough cash flow for the private equity consortium to add more debt to the company’s balance sheet and pay themselves a total of \$548.8 million in special dividends,¹⁵⁷ more than their original investment while still owning the company outright.

3. Not Fun and Games: The harsh consequences of a crushing debt burden

The Bain Buyout of KB Toys

In December 2000, at the height of the busy Christmas shopping season, Bain Capital purchased KB Toys in a highly leveraged buyout worth \$300 million.¹⁵⁸ Bain invested only \$18.1 million of its own money and financed the rest with bank loans and other assorted I.O.U.s.¹⁵⁹

The early 2000s were a tough time for toy retailers, and competition was fierce from bulk discount sellers like Wal-Mart and Target.¹⁶⁰ Yet in April of 2002, KB Toys’ new owners implemented a dividend recap—a second mortgage of sorts—to pay Bain and several KB Toys executives a special dividend of \$120 million.¹⁶¹

KB Toys employees and creditors, on the other hand, were about to face some serious financial challenges. In January 2004, KB Toys filed for bankruptcy protection. The new year started off with announcements that at least 30 percent of stores would close and nearly a third of the workforce would lose their jobs.¹⁶² Employees, creditors, and the communities KB Toys served waited to learn where the cuts would take place.¹⁶³ In the

end, nearly 600 stores closed and 4,000 employees received pink slips.¹⁶⁴ Big Lots, from whom Bain had purchased KB Toys, had to reveal to its shareholders that not only had it not received payment on the \$45 million note, but that it was also left holding the bag on store leases that KB Toys defaulted on as it closed stores nationwide. As of the close of 2006, some landlords were still waiting for payment of old rents.¹⁶⁵

In an action to recover the note and other damages, Big Lots alleged that Bain Capital's 2002 dividend recap led to the company's bankruptcy, characterizing the practice as an "unjustified return on [their] investment in excess of ... 900 percent in a mere 16 months."¹⁶⁶ Bain Capital and KB Toys executives cited the difficulty of competing with the discount stores as the cause of the company's woes.¹⁶⁷ The Delaware state court dismissed Big Lots case, finding that Big Lots was limited to bankruptcy proceedings to enforce this claim.

KB Toys emerged from bankruptcy in 2005 when a new owner—another private equity firm—invested \$20 million.¹⁶⁸ For the 4,000¹⁶⁹ former KB Toys employees who lost their jobs, it was a harsh lesson in the game of private equity buyouts.

4. Hertz So Good: The hidden costs of a “quick flip” **The Carlyle/Clayton Dubilier & Rice Buyout of Hertz Car Rental**

What is a dividend recapitalization and what are its risks?

In a dividend “recap,” private equity investors take out new debt on a company and then use all or part of this additional cash to pay themselves a special dividend. Thus, the dividend comes from debt and not from earnings, and the debt is used at least partially for a payout rather than investing in the company to increase its value.

According to Standard & Poor's, the volume of dividend recaps increased from \$3.9 billion in 2002 to \$40.5 billion in 2005, with the volume for the first six months of 2006 up an additional 23 percent over the equivalent period in 2005. In a recent survey of 75 private equity firms with funds of \$500 million or more, 97 percent of respondents stated that they planned to use recaps in portfolio companies in 2007 and 75 percent expected to increase their usage.

The benefits a recap provides to the private equity firm include: a quick return of funds to limited partners, thus increasing its internal rate of return, and the ability to cash out equity without selling the company or offering an IPO. However, by adding debt to already highly leveraged companies, the dividend recap increases a company's vulnerability to potential operational fluctuations or external changes that could result in either bankruptcy or restructuring.¹⁷⁰

Potential investors are told that one of the strengths of private equity investments is that they are not beholden to the tyranny of short-term returns like the public markets. “Private equity firms are not under public scrutiny ... so they can focus on long-term business growth,” they are told.¹⁷¹ And so when a consortium of private equity firms, including industry giant the Carlyle Group, Clayton, Dubilier & Rice (CD&R), and Merrill Lynch, bought Hertz, the car rental company, from the Ford Motor Company in the autumn of 2005 for \$15 billion, it was expected that they would formulate a long-term plan to build on the value of this household brand name.¹⁷²

But the firms had some short-term plans as well. Carlyle partner and fellow buyout firm CD&R realized that they could “push the boundaries of how much a rental fleet could be securitized by many billions of dollars.”¹⁷³ By leveraging the company's key asset with an eye on “flipping” or selling the company for a profit, the firms jeopardized the company's credit rating: Standard & Poor's downgraded the company's bonds to junk status.¹⁷⁴ Just six months after the deal was finalized, the new owners had Hertz take out another loan for nearly \$1 billion in order to pay themselves a special dividend.¹⁷⁵

A few weeks later—less than a year after buying out the company from Ford—Hertz announced that it would once again be going public.¹⁷⁶ In its IPO filing, Hertz stated that money from the public offering would be used to pay off the loan for the special dividends.¹⁷⁷

The November IPO raised \$1.3 billion, while the buyout group continued to own more than 70 percent of Hertz.¹⁷⁸ The buyout firms used most of what was left after paying off Hertz's \$1 billion loan to pay themselves another \$260 million in special dividends.¹⁷⁹

“Fast-buck artists” is the name that *Business Week* gave to the buyout consortium in their report on the Hertz IPO.¹⁸⁰ But while the buyout firms were paying themselves special dividends, profits at the company fell sharply due to the increased debt. For 2006, Hertz reported an increase in revenue of nearly 8 percent but a decline in net income of two-thirds due to an 80 percent

increase in total interest payments.¹⁸¹

And what became of Hertz's employees? Just a few days into 2007, Hertz announced it would be cutting jobs as part of its "productivity and efficiency" initiative.¹⁸² Altogether in the first two months of 2007, Hertz announced that it was eliminating 1,550 jobs, which represent close to 5 percent of the 31,500 workers Hertz employed at the end of 2006.¹⁸³ In March 2007, CEO Mark Frissora added that only one of every two workers who left the company was being replaced and that Hertz would be announcing more "layering and restructuring" initiatives later this year.¹⁸⁴

5. Come Fly With Me: Creating opportunities for workers

The Onex Buyout of Three Boeing Plants.

McAlester, Okla., is a community of 18,000 just off the Indian Nation Turnpike about 90 miles due south of Tulsa. A former coal town, McAlester is now best known as the home of the Oklahoma State Penitentiary, the McAlester Army Ammunition Plant and one of two former Boeing plants in the state. McAlester's residents are by no means wealthy—the median household income is about \$29,000 a year. The manufacturing jobs like the 300 that exist at the aircraft parts plant pay decent wages in a town where most have a high school diploma but few finish college.¹⁸⁵

In 2005, the stability of those jobs was in question. Boeing announced that it was selling the McAlester plant, as well as one in Tulsa and another in Wichita, Kan., to Onex, a private equity firm based in Toronto. Backed by an agreement with Boeing to subcontract to these plants major subassemblies of just about all its aircraft, Onex promised to invest \$1 billion to modernize the plants and expand employment.¹⁸⁶ But after the deal was made, Onex would not guarantee that it would keep all 9,080 jobs at the three plants (7,800 in Wichita, 1,060 in Tulsa, and 220 in McAlester).¹⁸⁷ Onex engaged in contentious bargaining with the plants' largely union workforce over job protections, and the protection of wages and benefits. The workers and their communities were concerned about the immediate impact of the deal on them.

The contracts that Onex eventually offered most workers called for immediate pay cuts and higher medical insurance premiums, but also shares of stock in the new company and promises of future raises.¹⁸⁸ Layoffs of 800 workers in Wichita and 256 of the workers at the Oklahoma plants added to the tension and uncertainty.¹⁸⁹

By late 2005, all the contracts were settled. They included various concessions in exchange for stock in the new company.¹⁹⁰ With booming aircraft orders in 2006, the company—now named "Spirit AeroSystems"—added new positions and by year-end the workforce had grown to 12,100 (10,000 in Wichita, 1,800 in Tulsa, and 300 in MacAlester) -- a 33 percent increase over the number of jobs at the time Onex bought the plants.¹⁹¹

In November 2006, Onex took Spirit public, allowing the buyout firm to recoup the money it had paid to Boeing—and providing a windfall to workers. McAlester's mechanics learned in early December that they could expect a check for \$20,000 and would retain 1,000 shares of stock—worth more than \$30,000.¹⁹²

Workers who persevered through a sometimes difficult transition finally came out ahead. "It'll be real good for the community," Mike Haskins, chair of the mechanics bargaining unit, told the *McAlester News Capital*. "There'll be a lot of extra cash in town around Christmas. A lot of it will go into the community." Haskins added that "some people have

been at Spirit for 30 years. We've got a really good crew. It reflects the work ethic for all the people that work there that the company has done so well.²⁷¹⁹³

Despite uncertainty, pay cuts and even layoffs for some workers, this is one private equity deal that in the end found a way to provide new economic opportunities and tangible benefits for workers. More new jobs were created, and a community that long had contributed to building a company's success got something back in return.



CONCLUSION

The buyout deals and money-generating strategies that are generating immense wealth for the private equity buyout industry and many of its investors can have harsh consequences for workers and the companies they buy and sell.

For the artists and other clients of Warner Music, the corporate restructuring driven by the Thomas H. Lee buyout hollowed-out a once-proud music company, harming its image in the music industry and potentially reducing its long-term value.

For the retirees at Intelsat who spent their careers building the value of that company, for the 4,000 KB Toys employees laid off after the company declared bankruptcy under the weight of a crushing debt load, and for the Hertz employees laid off in the wake of a lucrative quick flip, private equity corporate strategies uprooted lives and negatively impacted hardworking families.

In every case, the workers themselves had almost no voice in the process, little information about their new employers, and no role in developing the plans that were going to change their lives for the worse.

SEIU Principles for the Private Equity Buyout Industry

1. The buyout industry should play by the same set of rules as everyone else.

- The industry should provide transparency and disclosure about their businesses, their deals, their income, their plans for the companies they buy and sell, and the risks of the debt they load onto portfolio companies
- The industry should invest in the health, security, and long-term prosperity of America by supporting equitable tax rates and the elimination of loopholes that increase the tax burden on working Americans
- The industry should work to build confidence in the securities markets by eliminating conflicts of interest and other potential abuses in their deals

2. Workers should have a voice in the deals and benefit from their outcome.

- Workers should have a seat at the table when deals are being made
- Private equity deals should create economic opportunities that align the long-term interests of everyone that builds the value of a company, from direct employees and contract workers to senior management
- Workers should have paychecks that can support a family
- Workers should have quality, affordable health care coverage
- Workers should have secure retirement benefits
- Workers should have a voice at work—meaning the freedom to join a union using majority sign-up without interference from any party

3. Community stakeholders should have a voice in the deals and benefit from their outcome.

- Buyout firms should play a proactive and constructive role in the communities affected by their deals
- Community stakeholders should be involved as deals are being made
- The private equity buyout industry and community stakeholders should use wealth generated by deals to improve the quality of life, the environment, the health, the safety, and the long-term stability of communities

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