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King of Capital

Debutants

- Private equity's power on Wall Street had never been greater. Where buyout firms had once been supplicants of the banks they relied on the finance their takeovers, the banks had grown addicted to the torrent of fees the firms were generating and now bent over backward to oblige the Blackstones of the world. In a telling episode in 2004, the investment arms of Credit Suisse First Boston and JPMorgan Chase, two of the world's largest banks, made the mistake of outbidding Blackstone, Kohlberg Kravis, and TPG for an Irish drugmaker, Warner Chilcott. Outraged, Kohlberg Kravis cofounder Henry Kravis and TPG's Jim Coulter read the banks the riot act. How dare they compete with their biggest clients! The drug takeover went through, but the banks got the message. JP Morgan Chase soon shed the private equity subsidiary that had bid on the drug company and Credit Suisse barred its private equity group from competing for large companies of the sort that Blackstone, TPG, and Kohlberg Kravis target
- The industry had come of age in the heyday of corporate raiders, saber-rattling financiers who launched hostile takeover bids and worked to overthrow managements. Buyout firms rarely made hostile bids, preferring to strike deals with management before buying a company. But in many cases they swooped in to buy companies that were under siege and, once in control, they often laid off workers and broke companies into pieces just like the raiders. Thus they, too, came to seen as "asset strippers" who attacked companies and feasted on their carcasses, selling off good assets for a quick profit, and leaving just the bones weighed down by piles of debt
- The backlash against the buyout boom of the 2000s began in Europe, where a German cabinet member publicly branded private equity and hedge funds "locusts" and British unions lobbied to rein in these takeovers. By the time the starry canopy was being strung in the Park Avenue Armory for Schwarzman's birthday party, the blowback had come Stateside. American unions feared the new wave of LBOs would lead to job losses, and the enormous profits being generated by private equity and hedge funds had caught the eye of Congress
- In fact, the acts for which private equity firms are usually indicated - the laying off workers, selling assets, and generally shaking up the status quo - are the stock in trade of most corporations today. More workers are likely to lose their jobs in a merger of competitors than they are in an LBO. But because a buyout represents a different form of ownership and the company is virtually assured of changing hands again in a few years, the process naturally stirs anxieties

- The claim that private equity systematically damages companies is just wrong. The buyout business never would have survived if that were true. Few executives would stay on - as they typically do - if they thought the business was marked for demolition. Most important, private equity firms wouldn't be able to sell their companies if they made a habit of gutting them. The public pension funds that are the biggest investors in buyout funds would stop writing checks if they thought private equity was all about job destruction
- A growing body of academic research has debunked the strip-and-flip caricature. It turns out, for instance, that the stocks of private equity-owned companies that go public perform better than shares of newly public companies on average, belying the notion that buyouts leave companies hobbled. As for jobs, private equity-owned companies turn out to be about on par with other businesses, cutting fractionally more jobs in the early years after a buyout on average but adding more jobs than the average company over the longer haul. In theory, the debt they pile on the companies they buy should make them more vulnerable, but the failure rate for companies that have undergone LBOs hasn't differed much from that of similar private and public companies over several decades, and by some measures it is actually lower
- Though the strip-and-flip image persists, the biggest private equity profits typically derive from buying out-of-favor or troubled companies and reviving them, or from expanding businesses. Many of Blackstone's most successful investments have been growth plays. It built a small British amusements operator, Merlin Entertainments, into a major international player, for example, with Legoland toy parks and Madame Tussauds wax museums across two continents. Likewise it transformed a humdrum German bottle maker, Gerresheimer AG, into a much more profitable manufacturer of sophisticated pharmaceutical packaging. It has also staked start-ups, including an oil exploration company that found a major new oil field off the coast of West Africa. None of these fit the cliche of the strip-and-flip
- Contrary to the allegation that buyout firms are just out for a quick buck, CEOs of companies like Merlin and Gerresheimer say they were free to take a longer-term approach under private equity owners than they had been able to do when their businesses were owned by public companies that were obsessed with producing steady short-term profits
- Compared with other parts of the financial system and the stock markets, however, private equity fared well. Indeed, the risks and the leverage of the buyout industry were modest relative to those borne by banks and mortgage companies. A small fraction of private equity-owned companies failed, but they

didn't take down other institutions, they required no government bailouts, and their owners didn't melt down

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Houdaille Magic, Lehman Angst

- Hellman goes so far as to compare Schwarzman to Felix Rohatyn of Lazard Freres, the most accomplished merger banker of the 1960s and 1970s who gained wide praise, too, for orchestrating a restructuring of New York City's debt in 1975 that spared the city from bankruptcy

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The Drexel Decade

- Several confluent factors were fueling the rise in buyout activity. Corporate conglomerates, the publicly traded holding companies of the 1960s that assembled vast stables of unrelated businesses under a single parent, had fallen out of favor with investors and were selling off their pieces. At the same time, the notion of a "core business" had penetrated the corporate psyche, prompting boards of directors and CEOs to ask which parts of their businesses were essential and which were not. The latter were often sold off. Together these trends ensured a steady diet of acquisition targets for the buyout firms
- In the early days of the buyout, many of the target companies were family-owned businesses. Sometimes one generation, or a branch of a family, wanted to cash out. An LBO firm could buy control with the other family members, who remained as managers. But as the firms had greater and greater amounts of capital at their disposal, they increasingly took on bigger businesses, including public companies like Houdaille and sizable subsidiaries of conglomerates
- Equity was the smallest slice of the leveraged-buyout financing pie - in that era usually just 5-15 percent of the total price. The rest was debt, typically a combination of bank loans and something called mezzanine debt. The bank debt was senior, which meant it was paid off first if the company got in trouble. Because the mezzanine loans were subordinate to the bank loans and would be paid off only if something was left after the banks' claims were satisfied, they were risky and carried very high interest rates. Until the mid-1980s, there were few lenders willing to provide junior debt to companies with high levels of debt like the typical LBO company. A handful of big insurance companies, including Prudential Insurance Company of America, Metropolitan Life Insurance Company, and Allstate Insurance Company, supplied most of the mezzanine debt, and it was far and away the hardest piece of the financing for buyout firms to round up
- On the debt side of the LBO equation, US banks flush with petrodollars from oil-rich clients in the Middle East and Japanese banks eager to grab a piece of the merger business in the States began building their presence and pumping huge sums into buy-out loans. At the same time, a new form of financing emerged from the Beverly Hills branch of a second-tier investment bank. The brainchild of a young banker there named Michael Milken, the new financing was politely called high-yield debt but was universally known as the junk bond, or junk for short. Until Milken, bonds were the preserve of solid companies - the sort of companies

that investors could feel confident would pay off their obligations in installments steadily for ten or twenty or fifty years. Milken's insight was that there were lots of young or heavily indebted companies that needed to borrow but couldn't tap the mainstream bond markets and that there were investors ready to provide them financing if the interest rate was high enough to compensate for the added risk. Renowned for his work ethic, he put in sixteen-hour days starting at 4:30 AM California time, an hour and a half before the markets opened in New York

- KKR was one of the first clients to test Drexel at this new game, accepting Milken's invitation to help finance a $330 million buyout of Cole National, an eyewear, toy, and giftware retailer, in 1984. Though Drexel's debt was expensive, the terms still beat those of Prudential, and KKR soon stopped tapping insurers altogether and drew exclusively on Drexel's seemingly bottomless well of junk capital. Kravis called Drexel's ability to drum up big dollars in a flash "the damnedest thing I'd ever seen." Before long, the insurance companies' mezzanine debt mostly disappeared from large deals, replaced by cheaper junk from Drexel
- Like wolves, the raiders stalked stumbling or poorly run public companies that had fallen behind the herd, and they bought them in LBOs. Like the buyout firms, the raiders were forever on the lookout for companies whose stocks traded for less than they thought the companies were worth - because they had valuable assets that weren't reflected in the stock price or because the companies were inefficiently managed. Both the raiders and the buyout firms sought hidden value that could be captured by splitting up companies to expose the latent value of their parts. But, despite their assertions to the contrary, the raiders generally had little interest in taking control of the firms they targeted, and - unlike buyout firms, which usually wooed the top executives of the companies they sought - the raiders dedicated themselves to taunting and eventually ousting management
- The hunted and the hunters each portrayed the other side in stark caricatures, and there was more than a grain of truth to what each side said. Many corporate bigwigs did in fact fit the raiders' stock image. The eighties were an era of the imperial CEO, who packed his board with cronies, kept a private jet (or two or three), and spent millions on celebrity sporting events and trips that added little on the bottom line. Doing right by shareholders wasn't high on every CEO's agenda, so it wasn't hard for the raiders to cast themselves as militant reformers intent on liberating businesses from the clutches of venal, high-living CEOs who cared more about their perks than about shareholders
- Even though the buyout firms used the same type of financing for their takeovers as the raiders, their arms and tactics were different. For starters, their intention was to gain control. Their investors put up money to buy companies, not to trade stocks. And unlike the raiders, buyout firms almost never pressed hostile bids against the wishes of management. In LBO circles, launching an all-out raid was all but taboo. KKR touted itself as sponsoring friendly collaborations with existing managers, which it dubbed "partnerships with management." More than once - most famously in the case of Safeway in 1986 - KKR played the "white knight," joining forces with management in an LBO to repel a belligerent bidder. Indeed, the buyout firms were often kept in check by their own investors, for many public and corporate pension plans insisted that the firms they invested with do only

friendly deals. But such opportunism hardly helped their image. They were seen as just one wing of the same disruptive, rapacious army making war on the corporate status quo. “We came into a contested situation, so we looked like a raider,” says KKR’s longtime lawyer Dick Beattie

- Moreover, the buyout firms, like an Icahn or a Perelman, did not shy from whacking excess costs at the companies they’d taken over. Both shared a view that corporate America was riddled with inefficiencies. (“We don’t have assistants to assistants anymore,” the chairman of Owens-Illinois told Fortune magazine in 1988, the year after KKR bought the glass and packaging company. “In fact, we don’t have assistants.”)

Who Are You Guys?

- With the financial world polarized by the wave of hostile takeover bids, Peterson and Schwarzman knew that they would have to choose sides. In 1985 the backlash against the raiders and Drexel had not reached its peak, but it was clear to them how they would ally themselves in the battles over corporate control. From day one, Blackstone pledged its loyalty to management. “Drexel was viewed by many in both the business and the financial establishment in a very unfavourable way, because they were like uninvited guests at many parties and they insisted on staying,” Schwarzman says. “We wanted to be consistent with what we were doing at Lehman, and we didn’t see how we could be counseling corporations one day and then turning around and attacking them the next. We wanted the corporate establishment to trust us”
- The pair’s fund-raising trips were often fruitless. They were treated cavalierly, sometimes boorishly. Schwarzman, who arranged the trips, dragged Peterson with him to pitch the Delta Airlines pension plan in Atlanta one brutally hot day. Their taxi driver got lost and left them to walk the last half mile to the office. Peterson, weighed down with a suitcase, a bulky briefcase, and a suit bag, was drenched in sweat when they arrived. They were greeted by two pension officials, who escorted them to a room in the basement of the building and offered them to get them coffee - and then asked them to chip into the coffee fund. At the end of their long presentation, Peterson and Schwarzman asked for the managers’ reaction, only to learn Delta’s fund didn’t invest in LBO funds. “They said they had just wanted to meet us because we were well known,” Schwarzman says. “The walk back was even hotter than the walk there. I thought Pete was going to kill me”
- An excursion to Boston was equally galling. They flew there one Friday for a 4:00 PM meeting Schwarzman had lined up with officials at the Massachusetts Institute of Technology’s endowment. When they arrived at MIT, the receptionist informed them she had no record of the appointment, there was no one remaining in the office on the eve of the weekend. The two partners left, muttering imprecations under their breath. Adding insult to injury, they emerged from the building to find themselves in a torrential downpour with no umbrellas. They retraced their steps in order to call a cab from the endowment office but it was locked. They took up positions on opposite street corners, hoping to hail a taxi in the driving rain, but to no avail. Finally, Schwarzman, ever the bargainer, rapped

on the window of a cab stopped at a red light and offered the passenger a deal: $20 to have the driver take him and Peterson to the airport. It was the only pitch they made that day that succeeded

- Prundential insisted that Blackstone not collect a dime of the profits until Prudential and other investors had earned a 9 percent compounded annual return on every dollar they'd pledged to the fund. This concept of a "hurdle rate" - a threshold profit that had to be achieved before the fund manager earns any profits - would eventually become a standard term in buyout partnership agreements. Prudential also insisted that Blackstone pay investors in the fund 25 percent of the net revenue Blackstone made from its M&A advisory work, even on deals not connected to the fund. At the time, Blackstone still was forking out much of that revenue to Shearson under Schwarzman's severance agreement, which would end the following year
- Three most important sources of investment capital at the time: the insurance industry, pension funds and Japanese financial firms

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Right on Track

- Blackstone would have to vie for investors, talent, and deals with these flashier upstarts. None of the new players held a candle to KKR, though. It had recently amassed a $6.1 billion warchest- far and away the biggest buyout fund ever - and controlled about a third of the $15 billion to $20 billion of equity the buyout industry had stockpiled to date. It was no easy task to compete, for KKR was raking in profits on a scale its founders couldn't have imagined a decade earlier. In May 1988, Henry Kravis and other KKR partners personally pocketed $130 million in profits on just one investment: Storer Communications, a broadcaster they had bought just three years earlier, which they sold for more than $3 billion. KKR had pulled off gargantuan buyouts of name-brand companies - a $4.8 billion deal for the supermarket chain Safeway in 1986 and the $8.7 billion buyout of Beatrice Foods the same year. Late in 1988 KKR would reassert its dominance when it clinched by far the largest buyout ever, the $31.3 billion take-private of the tobacco and food giant RJR Nabisco - a bid that would define the era, crystallize the public image of private equity investors as buccaneers, and set a record that would not be matched for eighteen years
- One way that buyout firms make profits is to use the cash flow to pay down the buyout debt. In the industry's early days, deals were formulated with the aim of retiring every dollar of debt within five to seven years. That way, when the business was finally sold, the buyout firm reaped all the proceeds because there was no debt to pay off. A second way to generate a gain is to boost cash flow itself, through revenue increases, cost cuts, or a combination, in order to increase the company's value when it is sold. Using cash flows, there is also a third way to book a gain without an outright sale. If a company has paid down its debt substantially, it can turn around and reborrow against its cash flow in order to pay its owners a dividend. That is known as dividend recapitalization
- If this seems a bit like conjuring profits from nothing, that's largely what happened. Transtar, like Gibson Greeting, was a prime example of buying at the

right time, leveraging to the hilt, and milking every drop of cash flow for profit. Soon enough, rising prices and a floundering economy would change the rules of the game, forcing buyout firms to focus more intently on improving fundamental corporate performance to generate profits and less on financial sleights-of-hand

- In addition to differentiating Blackstone from the competition, Schwarzman also believed the partnerships heightened Blackstone's odds of success. Having a co-owner intimately familiar with the business - typically one that was a major customer or supplier and therefore had an interest in its thriving - would give Blackstone an advantage over competing buyout firms, staffed as they were with financial whizzes who had never run a business or met a payroll. With the prices for whole businesses escalating in step with the stock market in the late 1980s, Schwarzman felt Blackstone "needed an edge to safely do deals in a higher-priced environment"
- The partnership approach also fit with Schwarzman's innate cautiousness. In some partnerships, Schwarzman went so far as to barter away some of Blackstone's potential upside for downside insurance, in the form of a right to sell out to its partner several years later at a preset price or valuation. Some of the firm's rivals viewed such trade-offs with bemusement. To their way of thinking, ceding power and profit to hedge the downside was downright lily-livered. "We always thought Blackstone's corporate model was bullshit," sniffs one. "It was like they couldn't stand on their own; they needed help and made a lot of concessions to get it"
- Schwarzman's preoccupation with the possible downside was more than a reasoned response to the market dynamics of the day. It was a gut-level reflex, a kind of bete noire or obsession, former colleagues say. The rudimentary rule of investing, that one must risk money to make money, "is something Steve always had a hard time coping with," says one former partner. For a world-class investor, "his risk-aversion was really extraordinary." Schwarzman acknowledges as much. "We are more risk-averse than other private equity firms, and part of it is visceral. I don't like failure and losing money is failing. It's a personal thing that has turned into a strategy here"

Running Off the Rails

- Arbitrageurs - arbs for short - bet on the likelihood and timing of takeovers and mergers that have been announced but not yet completed. Typically, a target's stock will sell for less than the offer price to reflect the risk that the deal may not go through and the fact that, even if the deal is completed, the shareholder can't collect until sometime in the future. If something goes wrong with a deal, the target's stock can plummet, but in spite of the risk, many big brokerages wagered tens of millions of dollars on takeover stocks and earned a pile of profits in the eighties with the explosion of takeover activity

Ending of an Era, Beginning of an Image Problem

- Though the downturn that began in 2007 lasted longer and inflicted far wider damage than that of the early 1990s - no major commercial or investment banks foundered in early nineties as Bear Stearns and Lehman Brothers did in 2008 - both shared a root cause: overexuberant borrowing. In both cases, scores of lending institutions went under and buyout firms strained to keep debt-laden holdings afloat. Then, as later, buyout players that had binged on leverage would have a nasty hangover
- What made Safeway so ripe for an LBO was the fact that it had never scrutinized how it used its capital, whether its investments were paying off, or where it was making and losing money. KKR set to work at once analyzing Safeway's real estate to determine which properties were so marginal as grocery stores that the company was better off disposing of them. The test was not what the company had paid for properties years before, but what they were worth today. That was the real measure of the capital tied up in the property, and viewed that way, many of the stores didn't pass muster. Those were sold off
- The slashing "cut plenty of muscle with the fat, both from Safeway's holdings and from its labor force, and deferred capital improvements in favor of the all-consuming debt," the Journal declared in its 1990 piece. But Safeway's growth in the nineties disproved that. When the restructuring was complete, Safeway had contracted from twenty-four hundred to fourteen hundred stores, and from $20 billion in sales to $14 billion - a shrinking act that would have been virtually unthinkable for a public company to attempt, because stockholders and investment analysts would never tolerate the risks. Yet, remarkably, cash flow rose 250 percent during the coming decade. Capital spending, which had been cut in half from 1987 to 1989 during the divestiture program, was restored in 1990 after Safeway's debt had been reduced and the company set out on a new expansion, this time targeting profitable markets
- It was the beginning of a new age in market capitalism, one with constant upheaval and less security for executives and workers alike. But it instilled a discipline and incited a new drive for efficiency with payoffs for the economy as a whole - so much so that it permanently reshaped the thinking of public company managers. No longer were the public markets populated with scores of companies worth less as a whole than the sum of their parts. As managers worked to eliminate that disparity, there were fewer and fewer easy pickings for the raiders and buyout firms

Fresh Faces

- A second new business emerged almost unintentionally, a by-product of the need to invest the $100 million Blackstone had received from Nikko. Blackstone's abortive risk-arbitrage fling in 1989 had eaten into the original hoard, but Schwarzman shuddered at the thought of putting the cash at risk in the turbulent markets. Still, the firm couldn't afford to leave the capital invested in low-paying certificates of deposit forever. Batten, who had been charged with managing the

money, hit on a solution. That summer he proposed that Blackstone divvy up the money and invest it with a half-dozen successful hedge funds, so named because they hedged their bets by deploying capital across an array of securities and currencies and could sell short when they thought the markets were headed down. The aim was to make money in down as well as up markets, and the best of the funds habitually had outstripped the stock market's performance. At the time, hedge funds were a small galaxy in the financial cosmos, but a handful of proven stars had emerged, including George Soros, Michael Steinhardt, Paul Tudor Jones II, and Julian Robertson. Despite his initial reluctance, Schwarzman signed off on Batten's suggestion, and Batten proceeded to set up a fund-of-funds, taking stakes with six managers, the most illustrious being Roberson. But Schwarzman, who had never been a trader, was jittery as ever about losses and kept a sharp eye trained on the monthly results. "The first month the funds were up three percent and Steve was happy," recalls Batten. "The second month they were up four percent, and Steve was even happier." But around the fourth month Robertson posted a 4 percent loss and Schwarzman was beside himself

- In an IPO, typically, big stockholders like Blackstone sell at most a small portion of their shares. The market often can't absorb all the stock of a company at one time, and investors will balk if they think existing investors want to cut and run. In many cases, the existing shareholders sell no shares, and the IPO consists solely of shares newly issued by the company equivalent to, say, a 15 or 20 or 25 percent stake. While the new stock waters down existing investors' stakes, the IPO raises new capital for the business and establishes a public-market value for the stock, opening an avenue for the company's backers to sell their shares and lock up profits later

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The Divorces and a Battle of the Minds

- The profit split was not what pushed Peterson and Schwarzman apart, says an investment banker who is a friend of Peterson's, but rather values and style. "With Pete, it wasn't the money. Money didn't matter to Pete the way it did to Steve," says the banker, who describes Peterson's material cravings as modest, certainly by Schwarzman's standards. "What eventually got to Pete was Steve's lifestyle, his flashing his wealth, his drawing attention to himself. That's not what Pete is about"
- Though to this day both tout their relationship as "the longest-lasting partnership on Wall Street," by the 2000s their relations were frayed and they carped about each other to friends. Schwarzman would grumble about Peterson still collecting millions but contributing little, while Peterson would snipe about Schwarzman's crass displays of wealth

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Back in Business

- Scarred by the failures of scores of businesses they'd helped lever to the hilt, the Wall Street banks wised up, imposing a stricter lending regimen. Unlike the old days, when buyout sponsors could get away with inserting a mere silver of equity - 10 percent or less of the purchase price - lenders now demanded that they have

much more at risk. From 1993 through the early 2000s, lenders almost demanded at least 20 percent and often 30 percent of the cost to be financed with equity. That forced a new calculus on the LBO set. No longer could they take control of massive enterprises with a smidgen of their own money, as KKR had done with RJR and Beatrice. With less debt for the same quantum of equity, the average size of LBOs inevitably shrank. With less leverage, sponsors were also staring at lower returns, because minute gains in a company's value could no longer be multiplied ten or twenty times. The only good news was that the price tags for companies came down

- The new emphasis on value building was accompanied by a new terminology. "LBO" and "buyout" had become so tarnished that buyout firms started branding what they did as "private equity." British buyout firms, meanwhile, took to calling their deals "management buyouts" to highlight that the business would be run by familiar faces, though the managers seldom had a controlling stake
- With hindsight, there was a pattern to the failures. All were highly cyclical companies whose fortunes seesawed with the economy. None were dominant, or even terribly competitive, in their fields. In some cases the opposite was true: The businesses had intractable problems that made it impossible for them to gain traction against bigger and stronger rivals. No one inside Blackstone really understood the businesses that well. On top of all that, Blackstone bought many of them at the wrong time in the economic cycle. It would up overpaying and piling on too much debt. It had stacked the deck against itself. "These were all medium-sized, cyclical businesses that we bought within two or three years of an economic top," says Schwarzman. "We paid too much for some of them. We had ambitious plans for them that turned out to be very difficult to execute." The losses taught the firm several lessons, he says. First, "don't pay too much when you're buying cyclicals," he says. Second, "don't have ambitious turnaround expectations for medium-sized companies. Don't expect to reinvent them." Third, if an investment calls for reengineering operations, "don't have it be a Blackstone-manufactured plan." Rather, develop a plan in consultation with seasoned executives and consultants knowledgeable enough to judge if the plan will fly

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Tuning in Profits

- The "old economy" of boring, profitable, but slow-and-steady companies was being eclipsed by the high-tech "new economy." The IPO of Netscape Communications in April 1995 is usually pegged as the turning point. At the time the Internet was still in its infancy. For most people, it meant e-mail and perhaps some America Online chat rooms. Netscape's browser, which the company gave away free, enabled a new generation of websites loaded with photos and snappy typefaces and introduced a generation to what many still called by its formal name, the World Wide Web. For Netscape's founders, the company was more than just a software business. They were on a mission to "democratize information" via the Internet, and they sold the public on the proposition - literally. The company went public at $28 per share, valuing the start-up at $1.1 billion. Investors who hadn't been able to buy shares in the IPO itself were so desperate

to get a piece of the action that they drove the stock up to $75 on its first day of trading

- Make money? That was so old economy. There was no need to do that now. The mere prospect of huge profits down the road was enough to lure the public. Instead of profits, the financial metric became “burn rate” - how much of its backers’ cash a company chewed through every month or year
- The epicenter of the US buyout industry is Midtown Manhattan, where Blackstone, KKR, Apollo, Warburg Pincus, and dozens of other firms are headquartered within a few blocks of one another in a world of starched shirts and Hermes ties, chauffeured Mercedes and office towers. Ground zero of the venture world is Sand Hill Road, a landscaped boulevard rising into the gentle, suburban hills behind Palo Alto, California. There capital flows in a dress-down world of khakis and golf shirts, low-rise office compounds surrounded by groves of live oaks and towering eucalyptuses. Venture capitalists drive themselves to work in Ferraris and Porsches
- The investment styles were as different as the dress codes. Venture investing involves an entirely different type of risk. VCs seed scores of small companies that often have little or no revenue, and many of those that do take in revenue are nonetheless losing money. No bank would lend to these businesses, but they need equity capital for research and to build out their businesses. The VCs know that many of their companies will fizzle but hope that a few will be spectacularly successful. It is a scatter-shot approach, like tossing apple seeds and hoping a healthy tree or two will spring up. VCs make bets on which entrepreneur will achieve a technological breakthrough first, who can get to market fastest, and whose product will dominate its market - events whose likelihood defies precise projections
- That is a world away from buyouts. If venture investing is a game of long, daring passes, many incomplete, the LBO game is fought a yard at a time on the ground. To be a private equity investor, you need to be a kind of control freak - someone who can patiently map out all the scenarios, good and bad, first to make sure your company won’t go bust and second, to see how it can be improved incrementally to lift its value. Buyout investing focuses on cash flow because banks won’t lend money, and bond buyers won’t buy bonds, unless they are confident a company will be able to pay its creditors through thick and thin. Private equity investing means burrowing into businesses and performing minutely tuned analyses. Could revenue be boosted a point or two? How much would pass through to the bottomline? What costs could be taken out to notch up the profit margin a fraction? Could we shave a quarter of a point off the interest rate on the debt? If the company has problems, how much of a cushion is there before it defaults? If private equity investors do their job right, things more often than not will play out more or less in line with their projections
- Because venture investments are so much more unpredictable, venture investing requires a degree of passion - a belief in the product and its potential and, very often, in its value to society. Venture capitalists talk of nurturing “disruptive technologies” that will upend existing industries and lay the groundwork for new ones, in the way that diesel locomotives displaced steam engines, personal

computers and laser and inkjet printers rendered the typewriter obsolete and digital photography supplanted film. No amount of number crunching can predict if a new website will capture the public's imagination or whether a biotech startup's research will succeed in developing a drug to treat cancer. The payoff comes from seeding dozens of long shots. To sustain the process, the VCs and the entrepreneurs they back to believe, and during the boom of the 1990s they had that faith in spades. The buyout types, with their dense spreadsheets and elaborately engineered debt structures, never promised to transform the world. They had no religion to offer the investing masses

- The passion for the new technology became contagious in the second half of the 1990s and began to alter the calculus for buyout firms far removed from Silicon Valley, as capital that might have gone to LBO funds began flowing into venture funds. Executives and business school graduates, too, were gravitating to tech companies, hoping to be paid in stock so they could make a fortune when the companies went public

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An Expensive Trip to Germany

- Competing with the VCs wasn't really an option, though. That took in-depth knowledge of tech industries ranging from semi-conductors and software to websites and biotechs - sectors where private equity firms had little if any expertise and few contacts. Moreover, entrepreneurs flocked to the venture firms that had backed the most successful investments. Why would they come to Blackstone, which had no track record and was on the wrong coast? Buyout firms that tried to intrude on the Californian finance turf were likely to get only companies that had been rejected by the top VCs. KKR formed a JV with the venture firm Accel, and Carlyle launched venture funds, but they never left a big mark

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Ahead of the Curve

- When stock and bond markets fall, that's another way of saying that the price of capital has risen: Investors demand higher returns because they perceive more risk, and companies have to offer more stock to raise the same amount of new equity capital and must pay higher interest rates to borrow. When the world at large is preoccupied with what can go wrong and afraid to stake money, those brave enough to invest can exact a very high price. Blackstone's deal making in 2001 and 2002 reflected that fact of economic life

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Good Chemistry, Perfect Timing

- Identifying the target was one thing; buying a public company in Germany was another. Private equity had received a frosty reception in Germany, where managements were reluctant to sell out to investors who would unload their companies again in a few years. It was a cultural matter, in part. German firms tend to be paternalistic, guarding their workforces and preserving corporate traditions. In addition, large German companies are required by law to give nearly

half the seats on the boards to employee representatives, who uniformly regard private equity firms with suspicion. As result, private equity firms had made many more investments in Britain and France, even though their economies were much smaller

- German companies have a reputation for being plodding and bureaucratic
- "You've got to have a lot of respect for the cycles," Chu says, looking back. "No matter how smart an investor you are and no matter how great the company and its management team are, if you invested in the US or European chemicals in 2007 and exited in 2010, you'd take a loss"

Cash Out, Ante Up Again

- Taking companies public wasn't the only way to cash in on the market turnabout. There was also the dividend recapitalization - leveraging up the company to pay a dividend. Together, the surging economy and the resuscitated credit markets made those the profit-taking methods of choice in many cases. Suppose a company had been acquired for $1 billion with relatively little leverage in 2002, when credit markets were tight, and it had debt of just $500 million. If the improving economy had pushed cash flows up 20 percent, the company could now borrow an additional $100 million (20 percent of $500 million) assuming its bankers applied the same debt-to-cash flow figure they had when they financed the deal originally. That money could then be paid out to the company's owners
- The recaps were an irresistible move for buyout firms, because they allowed them to earn back part of their investment quickly, without the drawn-out process of an auction or an IPO, and the faster they returned money to their investors, the higher their annual rates of return
- The mix of institutions investing in buyout funds looked very different in the 2000s from what it had when Peterson and Schwarzman first went rapping on doors in 1986 and 1987. Back then they called first on insurance companies and Japanese banks and brokerage houses. Only at the end did they raise money from two corporate pension funds, General Motors' and General Electric's. By the late 1990s, banks and insurers together were providing only 15 percent or so of the money in buyout and venture funds, and state and local government pension funds had emerged as the leading backers of buyouts, furnishing roughly half the investment capital. The typical pension fund still kept half or more of its money in ordinary stocks, and a large slice in bonds, but pension managers increasingly were adhering to an economic model known as modern portfolio theory. This taught that overall returns could be maximized by layering in small amounts of nontraditional, high-returning assets such as buyout, venture, and hedge funds and real estate. Although they were riskier and illiquid (the investor's money was tied up longer), adding these so-called alternative assets diversified a pension portfolio so that the overall risks were no greater, the theory held
- The breathtaking sums pouring in changed the business in several ways. With such large war chests, the top buyout firms would not be content to buy a $500 million company here and a $1 billion company there. It would simply take too

long and involve too much work to invest their money at that rate. They would have to find bigger targets, and now the debt markets allowed them to finance deals on a much grander scale

- Private equity's share kept ascending even after corporations began pursuing mergers again. By 2004 it hit 13 percent in the United States and 16 percent in Europe, and it would rise past 20 percent before the cycle was over. With plenty of cheap debt at its disposal, private equity became a potent force in the markets and the economy. The mere prospect of becoming a buyout target could lift the price of a stock that was otherwise languishing, and corporations began to rethink their own capital structures. If a buyout firm could put more debt on the company so that any gain in the company's value was magnified in the value of its stock, companies began to ask themselves, why couldn't we do the same to give our public shareholders a higher return on their shares? In some cases, hedge funds and other activist investors urged companies to perform their own dividend recaps, borrowing more money to pay a dividend or to buy in some of their shares
- The sheer magnitude of the funds and the deals had another side effect on the business, one that troubled some investors. The fixed 1.5 percent to 2 percent management fees the firms charged their investors, and the transaction fees they tacked on when they bought or sold a company, had grown so large in absolute dollar terms that they had become a wellhead of income at large private equity houses, rather than just a way of ensuring that some money was coming in the door in tough times. By mid-decade, firms like Blackstone and KKR were deriving roughly a third of their revenue from the fixed fees rather than from investment profits, enough to make the firms' partners exceedingly rich regardless of the fate of their investments. Cynics began to wonder if the partners' cushy income was undercutting their motivation to make money for their investors. The driving force of the business, they feared, had become asset accumulation for its own sake, not investing for profit

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Wanted: Public Investors

- Private equity manager's dream, the Holy Grail - true permanent capital raised in the public markets, obviating the need for laborious fund-raising campaigns and broadening the class of investors sponsors could tap

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Too Good to Be True

- Apart from the size, the other striking thing about the rash of megadeals in 2005 was that, except for Hertz and Dunkin' Donuts, the companies were all publicly traded. The sheer scale of the new LBO funds all but dictated that their sponsors go after public companies, because there simply weren't enough big subsidiaries and private companies for sale to soak up the billions that the firms had to deploy. That meant the focus would shift heavily back from Europe to the United States, where big targets were more plentiful and there were fewer legal impediments to taking public companies private

- The take-privates, as they were known, also reflected a new social acceptance of private equity. CEOs who had once looked askance at buyout artists were now only too happy to offer up their companies. The Sarbanes-Oxley law enacted after the Enron and other corporate scandals early in the decade had imposed new disclosure obligations and new liabilities on companies and their managers, which executives groused a distraction and a drain on their time. Offered the chance to answer only to private equity executives, and not to stock analysts and hedge funds that always seemed to think they knew better than management what to do, many CEOs found the going-private option tempting. At least as important, the private equity firms offered executives equity stakes that potentially could make them much richer than they could ever hope to become collecting stock options in a public company. “Sign me up!” CEOs said
- By the 2000s, lending syndicates and bond financing were merging through a process known as securitization. Banks still made loans up front, but rather than divvying them up with other banks, they bundled them with scores of loans to other companies and sold slices of those bundles to investors. The process was known as securitization because it repackaged loans as widely sold securities similar to bonds or stocks
- In early 2005, rates on high-yield debt were just 3 percent above those on US treasury bonds, implying that they carried little risk. That spread was near its all-time low of 1987, and it stayed near there for the next two years
- “Inevitably when people look back at this period, they will say this is the golden age for private equity because money is being made very readily,” Carlyle’s cofounder David Rubenstein told an audience at the beginning of 2006. It was indeed private equity’s moment. That year private equity firms initiated one of every five mergers globally and even more, 29 percent, in the United States. Blackstone’s partners, though, had decidedly mixed feelings about the bonanza. They began to worry that the market was overheating
- “It’s very hard when everyone around you is bidding on things and buying a lot of things to stick to your guns and say, ‘No, no, I think it’s overpaying,’” says James. “Your people start pushing back. They’re deal people; they want to do deals. We allowed ourselves - the pull pressures from our own people and the push pressures from the market - to be dragged along. We had the brakes on but the car was still being pushed”

Office Party

- Leventhal’s view was that, in the best markets, where it was hard to build new offices, you would make money over the long run if you bought buildings below their replacement cost, because prices had a natural tendency to rise where the supply couldn’t expand much
- Zell drove a hard bargain on a technical issue, too: the breakup fee that EOP would have to pay Blackstone if it opted to accept a higher bid. Zell was adamant that the deal have a low breakup fee so that other bidders would not be deterred from making offers. (A company that trumps the original deal with a higher offer

effectively must absorb the breakup fee, because the target's value is reduced by the amount of the fee it pays out.) EOP's directors had not shopped the company around because they were worried that word would leak out, but they had fiduciary duties to their shareholders to try to get the best price. If they were going to sign a deal with Blackstone without inviting other bids up front, the cost of getting out of that agreement had to be cheap. Breakup fees are meant to reward the first bidder for putting in the work to formulate a bid - a sort of token of appreciation for the loser. Typically they run 2-3 percent of the total value of the target's stock. Gray grudgingly agreed to a $200 million fee, or just 1 percent of EOP's market capitalization - not high enough to deter a serious bidder

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Going Public - Very Public

- Schwarzman never missed a chance to put down KKR, as he did when he called it a "one-trick pony" to BusinessWeek, and he conspicuously neglected to invite Kravis to his birthday party in 2007. While it was hard at times to distinguish between what was a genuine blood feud and what was simply good newspaper copy, there was nonetheless more than a bit of truth to the quip of someone who knows them both that "the psycho-dynamics of Steve and Henry drove an entire industry"
- An IPO would make sense only if the price was right, but there was no way James and Schwarzman were going to open up Blackstone's books to Morgan Stanley - not even to Porat, whom James had known for twenty years and had once tried to recruit to DLJ. No one outside the firm - not even rank-and-file Blackstone partners - knew what the firm as a whole made. And Morgan Stanley was a competitor in private equity, real estate investing, and merger advice. James' solution was to give Morgan Stanley some theoretical numbers. "We told them they would be disguised" but representative of the business, James explains. "Then we created a fictional set of numbers that reflected trends, mix, and margins but did not give absolute levels." Based on the valuations the bankers came back with, Blackstone would get a sense of what it might be worth without tipping its financial hand
- Blackstone was organized as a partnership and partnerships generally don't pay corporate taxes. Instead, their partners pay income tax on their respective shares of the partnership's profits
- There was no small irony in the move to take Blackstone public at a time when the firm was playing a starring role in a sweeping privatization of American and European business. But there were powerful reasons for Blackstone itself to move in the opposite direction. While its partners spent their days trying to devise ways to sell the assets Blackstone owned at a profit, they had no way of capturing the value in the business they had built
- Getting Blackstone into some form that could be taken public entailed a herculean effort by the lawyers and accountants. To begin with, there was no one Blackstone. The "firm" was a cluster of a hundred or so partnerships and corporations and funds with contractual ties and overlapping management and ownership but no single parent company whose shares could be sold to the

public. Control was complicated, too. Peterson and Schwarzman alone had voting rights in the buyout and M&A businesses. They divvied up the profits to the partners in those groups and consulted them, but the other partners had no legal right to a say in management. By contrast, the managers of the real estate arm - including its founder, John Schreiber, who was even a Blackstone partner or employee - controlled half of the voting rights for that business, with Blackstone holding the other half. To go public, Blackstone would have to create a single entity - ultimately two entities - at the top of the corporate pyramid

- As it happened, June 11 was the day that Blackstone finally revealed Schwarzman's pay: $398.3 million in 2006 alone. The figure was mind-boggling. It was nine times what Lloyd Blankfein, Schwarzman's counterpart at Goldman Sachs, made that year in cash and stock, though Goldman had thirty times as many employees and was universally acknowledged to be the most successful firm on Wall Street. Schwarzman's pay was twice what the top five executives at Goldman together took home. It attested to the profits private equity was churning out and revealed how rich Schwarzman had become owing to his nearly 30 percent stake in Blackstone
- The offering was not simply a breakthrough for private equity, but was the biggest IPO in the United States in five years, and it put Blackstone squarely in the top tier of Wall Street firms. Blackstone was now worth as much as Lehman Brothers, where Peterson and Schwarzman had launched their banking careers, and a third as much as Goldman Sachs. Blackstone had arrived

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What Goes Up Must Come Down

- By the end of summer of 2007, private equity firms, too, were getting skittish, and there was an epidemic of buyer's regret. Buyout firms and their banks - which by then were on the hook for more than $300 billion of LBO financing they couldn't sell - were squirming, looking for excuses to escape the deals they had struck. In some cases, like Home Depot's wholesale subsidiary, where the target's business dropped severely, there were legitimate legal grounds for calling things off or cutting the price. But many times the reasons looked like mere pretexts, and the targets cried foul and sued to try to force the buyers to go through with the deals so that their shareholders would get the benefit of the generous offers. The companies generally lost in court, because the takeover agreements had been drafted to make the buyers liable only for a fixed termination fee if they walked away - typically 2 percent or 3 percent of the deal value. Forking over hundreds of millions of dollars for nothing was a stiff penalty (that was the point), but it was better than being forced to pay a price that, as the economy and the markets headed south, now looked extravagant
- Whatever the merits of the legal positions, the cancellations and the wrangling took a toll on private equity's reputation. For a decade, private equity had sold itself as the fast and sure solution for sellers. Buyout firms had been pitching themselves as solid corporate citizens, telling companies that it was easier to do business with them than a corporation, where decisions had to filter through committees and boards of directors and sometimes were subject to shareholder approval. They may have won in court when challenged, but the fact was that

many of the industry's stars - Apollo, Bain, Blackstone, Carlyle, Cerberus, Clayton Dubilier, Fortress, Goldman Sachs Capital Partners and KKR - had all bailed out of deals or cut their prices when the going got tough

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Paying the Piper

- Private equity was in nowhere near as much trouble as the banking industry. Many banks, finance companies, and corporations relied on short-term borrowing that had to be refinanced constantly. When the capital markets froze up, institutions such as Bear Stearns, Lehman Brothers, and Merrill Lynch - even the giant Citigroup and the prestigious Morgan Stanley - faced insolvency when their debts came due unless they could find new capital in some other form. By contrast, buyout firms themselves bear essentially no debt, and the financing for their portfolio companies - both the equity and the debt - was safely locked in for years. Furthermore, even the most extreme LBOs were modestly leveraged compared with investment banks, many of which by 2007 were geared thirty to one. At that level, if the value of a bank's assets fell by even one-thirtieth, just 3.3 percent, its capital was wiped out. Compounding matters, the banks were investing their own equity in leveraged investments - baroquely structured mortgage securities, real estate, and LBOs. It was leverage on leverage, which put thin slivers of equity capital at extreme risk
- In an earlier era, under covenants in the companies' loans, creditors could have stepped in and taken control if the companies' cash flows fell below specified levels. Not this time. The "covenant lite" loans for many of the big LBOs had so few restrictions that there was little bondholders or lenders could do until a company actually ran out of cash and stopped paying. Companies like Freescale and Clear Channel that had pay-in-kind debt had even more flexibility. They could choose to pay their creditors with more paper, as both eventually opted to do - escalating rather than paying interest in some form, its day of reckoning would not arrive until 2011 to 2014, when its loans matured, giving its owners several years to turn things around. Blackstone's due dates were fairly typical. Its companies had virtually no debt maturing before 2013, but that year $34 billion was scheduled to come due and would have to be refinanced if the companies hadn't been sold by then
- Many buyouts done at market peak may turn out to be dead money - investments that may not lose money but tie up capital for years because they can't be sold, dragging down returns
- The push by some firms like Apollo, KKR, and Carlyle to diversify away from LBOs into other asset classes by launching business development companies and publicly traded debt funds also proved calamitous. A $900 million mortgage debt fund that Carlyle raised on the Amsterdam exchange, shortly after KKR launched its $5 billion equity fund, was leveraged with more than $22 billion of debt and capsized in 2008 when its lenders issued margin calls and seized all its assets. It was a complete wipeout. KKR Financial, a leveraged mortgage and corporate debt vehicle in the United States, had to be propped up by KKR and barely survived. Its shares sank from more than $29 in late 2007 to less than 50 cents in early 2009. Apollo Investment Corporation, the business development

company that Apollo created in 2004, beating Blackstone and others to the punch, took huge write-downs. Meanwhile, the shares of KKR Private Equity Investors, the landmark Amsterdam fund, lost more than 90 percent of their value by late 2008

- The colossal sell-off of stocks and bonds that ensued only compounded private equity's fund-raising problems. As investors dumped stocks, bonds, and other liquid assets at fire-sale prices, the value of their overall portfolios sank relative to their private equity holdings, which were valued based on their long-term potential and thus didn't slump as much. As a result, private equity rose as a percentage of the investors' total assets, which threw the investors' asset allocations out of whack. Private equity's investors had to curtail new commitments to buyout funds in order to rebalance their accounts
- Its stock price notwithstanding, Blackstone fared better than many competitors. Three years after the credit crisis began, only one of its holdings had gone bankrupt: Freedom Communications
- EOP had proved to be a disaster for the moguls who had bought buildings from Blackstone. Gray's deal had left a trail of carnage across the real estate industry. Harry Macklowe, who paid an unfathomable $6.6 billion for EOP's Manhattan office towers, lost them all a year later when his interim loans came due. By then, the mortgage market was frozen and the properties were worth far less than he had paid, so he was forced to turn them all over to his lenders, along with another trophy property, the General Motors Building on Fifth Avenue in Manhattan, which he had pledged as additional collateral. The fallout from EOP was felt all across the nation. Brian Maguire, the founder of Maguire Properties, which bought many of EOP's California properties, was booted out as CEO after the purchase left the company overextended. Thomas Properties, which acquired EOP's Austin, Texas, portfolio with Lehman Brothers, found itself in a bind when Lehman went bankrupt and couldn't supply some of the financing it had promised. Morgan Stanley's real estate fund handed its lenders the keys to five ex-EOP buildings in San Francisco two years after the bank bought them, and Tishman Speyer Properties defaulted on loans for three towers in Chicago it acquired from Blackstone. Even the crafty Sam Zell, who had personally pocketed $1 billion selling his EOP shares, came away a loser. He redeployed some of that money in a wildly overleveraged $8.2 billion buyout of Tribune Corporation, the publisher of the Chicago Tribune and the Los Angeles Times, which went burst in 2008. It was a particularly devastating collapse, for Zell financed the LBO in part with an employee stock ownership plan, and some employees lost both their jobs and their savings

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Value Builders or Quick-Buck Artists?

- But is it a game of stripping, slashing and flipping that hurts companies and the economy? Even if buyouts don't inherently harm companies, do private equity firms actually add value to businesses while they control them? Or are they instead just like other successful equity investors, such as mutual funds or hedge funds, which buy and sell at a profit without altering the businesses in which they invest? The answer to the first question is clearly no. Private equity as an industry

does not harm the economy. The answer to the second and third is that they do sometimes add fundamental economic value, but a good portion of their profits derive from buying and selling at the right moments and leveraging up to accentuate their gains. But that's no sin

- In a study of 4,701 IPOs in the US over a twenty-three-year span to 2004, a French business professor commissioned by the European Parliament found that the stocks of private equity-backed companies did better than comparable companies, belying the notion that LBOs leave companies in tatters. It stands to reason. How could a form of investment that relies on selling companies for a profit survive if it systematically damaged the companies it owned? Why would sophisticated buyers like corporations acquire companies from private equity firms if they were known to strip them bare? The oft-repeated suggestion that buyout firms foist their companies on unsuspecting investors in IPOs likewise makes no sense. Most IPO are institutions such as mutual and hedge funds, banks and insurers, which would have caught on long ago if private equity-owned companies were weak and overpriced. Moreover, buyout firms almost always retain substantial stakes in their companies for years after they have gone public, as Blackstone did with Celanese and TRW, KKR did with Safeway and Clayton Dubilier did with Hertz, so their profits hinge on sustaining the companies' success over the long haul, not on dumping the stock at an inflated price and hightailing it
- Academic studies also debunk most of the other standard knocks on private equity: that it kills jobs, strips vital assets, and takes a shortsighted view of research and development. To be sure, buyouts often are followed by job cuts. But companies cut jobs all the time, with or without a takeover, so the test of private equity's impact is how it stacks up against the corporate world at large. The most exhaustive survey of the impact of private equity ownership on employees, which looked at more than forty-five hundred investments from 1980 to 2005, found that private equity-backed companies tended to slash jobs at a slightly higher than average rate in the first two years after a buyout but over time created more jobs than they eliminated. Contrary to what critics say, in the first four years following a buyout, companies owned by private equity firms add new positions at a faster clip than their public-company peers, though the gap then narrows, according to the 2008 study led by Harvard Business School professor Josh Lerner and funded by the non-profit World Economic Forum of Switzerland. The exception is in manufacturing, where the job growth is on a par with other companies
- As for quick flips, there are relatively few of those. Investments of less than two years accounted for just 12 percent of private equity backed companies, while 58 percent of the companies were held five years or more. The survey also found that contrary to common wisdom, private-equity owned companies generally don't stint on crucial research spending, though they do focus research dollars on core product lines, where the stakes are highest, while deemphasizing more speculative, peripheral research
- There are risks, of course, to leverage, which elevates a company's fixed costs, potentially endangering the business in a slowdown. In every recession since 1990, scores of companies have given way under their LBO debt loads. Still, the

overall casualty rate for private equity-owned companies has been remarkably light. The World Economic Forum study found that on average 1.2 percent of private equity-owned companies defaulted each year from 1970 to 2007 - a thirty-seven-year span that included three recessions. That was higher than the overall rate for all US companies, which was 0.6 percent, but still low, and it was well below the 1.6 percent for all companies that had bonds outstanding, which is arguably a more comparable pool than the set of all companies. Another study by the credit-rating agency Moody's Investors Service in 2008 found that private equity-owned companies had defaulted at much lower rates than other similarly leveraged companies while the economy was expanding in the mid-2000s. Any way you figure it, only a small fraction of companies that have gone through LBOs have failed. Those that have were often forced to cut jobs, but few of the businesses ceased to exist. Most were simply taken over by other companies, by new investors, or by their creditors (The latest recession, which has seen defaults spike, could put those comparisons to the test, of course)

- Blackstone and other big buyout shops have concluded that the only way they can outperform the stock market over the long haul is to systematically improve the companies they own. Bain Capital, which grew out of the Bain and Company consulting group, was one of the first to take that notion seriously and has the largest staff of experts and seasoned managers assigned to its investments. TPG long ago built a deep team of operational experts because it had a tradition of tackling messy turnaround situations that required a lot of know-how and attention. KKR, too, formed an internal team of managers in 2000 that now numbers forty, and Carlyle built up an inventory of executives on its payroll
- The contrast between public-company pay packages and the ones private equity firms install is striking. Under buyout firms, bonuses may be rewarded for increases in cash flow or other benchmarks over the midterm. But the real payoff for managers comes from their equity stakes, and they collect those gains only when companies are sold - a strong inducement for them to focus on improving the companies to make them more attractive to buyers. Moreover, CEOs and other senior managers are usually required to invest money in their companies and not just collect stock or options for free. Hence, they have their own money at risk

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Follow the Money

- Notwithstanding the risks of leverage and the private equity-backed companies that went under, private equity funds have beaten the overall average returns at major pension funds over the last three, five, and ten years. For pension managers who need to make up for losses in stocks and real estate in 2007 to 2009, private equity will seem very tempting
- After two years of knocking on investors' doors, by July 2010 Blackstone had raised just $13.5 billion for its next buyout fund, a huge come-down from the $21.7 billion fund it closed in 2007. KKR postponed its fund-raising plans altogether in 2009 because its investors were tapped out. Until buyout firms realize profits and send money back to the pension plans and other investors, their asset pools will slowly shrink. Even so, the longer-term trends work in the

favor of private equity, for as populations in the developed world age, pension plans will have more money to deploy, and private equity is likely to gain a bigger share of a bigger pot. In 2009, when private equity was taken for dead, three of the largest public pension funds, the trendsetting CalPERS and CalSTRS in California and New York State's pension plan, each decided to raise the portion of their assets going to private equity

- In the postcrisis era, private equity won't look like it did in 2006 and 2007, to be sure. Even the protagonists recognized at the time that it was a freakish period - too good to be true. With hindsight, the $20 billion-plus deals may look as anomalous as RJR Nabisco was in its day, when it was nearly four times the size of the next biggest LBO at that point. It may take a generation before there are buyouts on the scale of TXU, EOP, or Hilton again, many people in the business believe. The big question for private equity and its importance in the capital markets is not when the next $40 billion buyout occurs, but how long it takes before there are $5 billion or $10 billion deals - deals big enough to sustain private equity organizations on the scale they had operated at before the crash
- Twenty-five years on, Blackstone still conforms to the blue-print Peterson and Schwarzman drew up in 1985 for a new form of financial institution built around private equity with other niches added as opportunities arose. And, as the Chinese initiatives show, Schwarzman hasn't lost his knack for finding and supplying capital - and for spotting a way for Blackstone to get its cut