

Debt linked to huge buyouts is tightening the vise

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Private equity firms embarked on one of the biggest spending sprees in corporate history for nearly three years, using borrowed money to gobble up huge swaths of industries and some of the biggest names — Neiman Marcus, Metro-Goldwyn-Mayer and Toys "R" Us.

The new owners then saddled the companies with the billions of dollars of debt used to buy them. But now many of the loans and bonds sold to finance the deals are about to come due at the worst possible time.

So, like homeowners with an adjustable rate mortgage that just went up, some of private equity's titans are facing a huge squeeze. And that is coming at the same time consumers are staying home with their wallets closed.

Already this year, big retailers backed by private equity, like Linens 'n Things, Mervyn's and Steve & Barry's, have filed for bankruptcy.

Analysts expect an even broader array of companies backed by private equity — including resorts like Harrah's Entertainment and lenders like GMAC, the financing arm of General Motors — to face even more pressure as profits shrivel and creditors come knocking.

"There's absolutely going to be a lot of pain to go around," said Josh Lerner, a professor of investment banking at Harvard Business School. "The big question is how apocalyptic it will be."

Private equity firms, which are lightly regulated, use investors' money to buy undervalued public companies and take them private. The difficulty of companies that have been acquired by private equity firms to get new credit could have enormous implications for the economy.

People who work for companies owned by private equity firms could lose their jobs as firms cut costs to meet their debt obligations. And private equity firms like Apollo Management, which owns Harrah's and Linens 'n Things, face deep markdowns on the value of their holdings.

Pension funds and college endowments that invested their money into in these funds in recent years hoping for big returns are likely to suffer as well, and many of those investors could face a cash squeeze, as they are forced to hold onto their investments for years until the economy recovers.

"The dangling other shoe is now about to drop," said Jeffrey Sonnenfeld, senior associate dean of the Yale School of Management.

When the economy was booming, the firms made huge profits by cutting costs at their new acquisitions, improving operations and then turning around and selling them. In 2007, at the height of the bubble, such deals totaled \$796 billion, or more than 16 percent of the \$4.83 trillion in all the deals made globally that year, according to data from Dealogic.

Firms like the Blackstone Group and Kohlberg Kravis Roberts & Company, faced an image problem at the height of the bubble for excessive compensation and beneficial tax treatment, but their returns were so high that even investors like pension funds were drawn in. Now these firms, built on enormous amounts of debt, are being forced to go back to the financial markets just as those markets have nearly frozen up.

If history is any guide, the worst may be yet to come. Steven Kaplan, a professor at University of Chicago Graduate School of Business, found that nearly 30 percent of all big public-to-private deals made from 1986 to 1989 defaulted. Afterward, private equity players were called to testify before Congress, and movies like "Wall Street" and "Other People's Money" depicted financiers as greedy criminals.

To be sure, many companies that were not purchased by private equity firms are also struggling. Circuit City, the longtime seller of consumer electronics, is trying to avoid filing for bankruptcy. And publicly traded automakers like General Motors are troubled, too. (GM wants to merge with Chrysler, which is owned by a private equity firm.)

Many industry insiders and analysts contend that companies backed by private equity will not suffer nearly as much as those in the late 1980s because the firms pushed for better financing conditions that allow them to keep operating even if they cannot make their debt payments.

For example, in an effort to save cash, six of Apollo's portfolio companies, including Claire's Stores, Harrah's and Realogy, have announced this year that they will pay some of their bonds' interest by issuing more debt.

Kaplan said he believed that while "it isn't going to be pretty," today's deals "are much less fragile and used less leverage." He contended that "on a relative basis to investment banks and hedge funds, private equity may be in a better place" because of its long-term focus.

Stephen Schwarzman, chairman of Blackstone Group, remains committed to the future of private equity. "The people rooting for the collapse of

private equity are going to be disappointed," he said. While some companies may find themselves in trouble, he said, many more will be able to ride out a downturn in the economy because of the less restrictive financing conditions that banks agreed to earlier.

He added that he believed that now may be the best time for private equity because of the investment opportunities amid the crisis. "Historically, downturns are when the most money gets made," he said. Shares of Blackstone are hovering at around \$10, down from the \$31 they were at when Blackstone went public in June 2007. (Fortress Investment Group, another big firm, is trading at \$4.90 a share, down from its initial price of \$35 in February 2007.)

Lerner, of the Harvard Business School, said that trouble among private equity firms would probably "precipitate hard questions about the compensation and fee structure" in the industry. The firms generally take fees of 2 percent of all money managed and 20 percent of profits. "I would not be surprised if they try to head off the criticism by returning capital," he said.

The problem for the past deals is that many firms waded into economically sensitive sectors like retailing and restaurants. Firms like Apollo, Cerberus Capital Management and Sun Capital Partners purchased several troubled companies to turn around from 2004 through the first half of 2007.

In the case of Linens 'n Things, a longtime also-ran to Bed, Bath & Beyond, Apollo knew that it had a tough job ahead of it, yet it still added heavy debt. Two months before Linens 'n Things was acquired, it reported \$2.1 million in long-term debt; by Dec. 31, 2007, that amount had exploded to \$855 million.

At the time, private equity firms assumed that they could refinance their portfolio companies' debt cheaply. But many appear to have been blindsided by the size and severity of the credit market meltdown, which has left lenders unable or unwilling to provide more money.

In what seems a worrisome trend, many bonds of private equity-backed companies have recently plummeted in value, signaling worries about their solvency. These include Michaels, the crafts store co-owned by Bain Capital and the Blackstone Group; Dollar General, a low-price retailer taken private by Kohlberg Kravis Roberts; and Realogy, the parent company of the real estate brokerage firms Coldwell Banker and Century 21 that is owned by Apollo Management.

The bonds issued by Harrah's Entertainment, for example, were trading at 16.5 cents on the dollar, indicating investors' belief that the company was drawing closer to a potential default. Harrah's, too,

was saddled with a lot of debt when it was taken private. A month before the completion of the Harrah's takeover, the company reported \$12.4 billion in long-term debt. By June 30, that figure had swollen to \$23.9 billion. Harrah's has already begun making selective staff cuts and has begun scaling back costs, even cutting back hours in its VIP lounge and the complimentary rooms and meals for its best customers.

"Unfortunately, the worst-case scenario is now looking like the best case scenario," analysts from CreditSights, a research firm, wrote in a research note on Oct. 17 about Harrah's. "While the company could be able to pull through unscathed, the market is giving little credit to do so."