



The New Face of Capitalism

Private buyers are gobbling up some of the premier names in corporate America

By Kit R. Roane
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In 2000, Riverside took control of a small manufacturer of trailer jack stands and couplers named HammerBlow. The company was a leader in its field, but the owner had died, and his estate wanted to sell. Kohl liked the company's management and inexpensive manufacturing process. While working to expand the company's operation and reduce its costs, he bought other companies in the towing and trailer-hitch market and combined them under the HammerBlow brand. In about two years, he had tripled the company's revenues to \$108 million. In 2003, he sold the company for \$143 million to a competitor, TriMas, also owned by private-equity interests.

"This isn't drive-by investing or financial engineering," says Kohl. "This is value created through a lot of heavy lifting. We don't just get our hands dirty—we get our whole bodies filthy working to build the companies."

A recent study by economists Jerry Cao of Boston College and Josh Lerner of Harvard Business School counters the perception that private-equity firms are flip artists. Their examination of 496 companies taken public by private-equity firms between 1980 and 2002 found that the share prices of these companies tended to outperform those of both other initial public offerings and the general market. Companies held privately for more than a year did best of all when released into the public markets again.

But the barbarians-at-the-gate perception is grounded in some fact. Standard & Poor's recently found that private-equity firms had loaded their acquisitions with more than \$25 billion in debt over the past year just to fund dividends for themselves. Exceedingly rare at the beginning of the decade, these payouts have become commonplace. Sometimes the buyout firms (the general partners) take their profits even before their investors—pension funds, endowments, and other limited partners—have recouped their investment.

In the case of Hertz Global Holdings, a private-equity consortium led by the Carlyle Group paid itself a \$1 billion dividend less than six months after putting up \$2.3 billion to buy the company from Ford Motor Co. in 2005 for a total of \$15 billion, including assumed debt. The firms took Hertz public again last week.

The deal has gained the attention of the Justice Department. But bond watchers are also worried. Citing this case, S&P argued that such equity extractions, known as dividend recapitalizations, greatly increase a company's chance of defaulting on its debt, while also leaving the private-equity partners less concerned about fixing underlying troubles.

This may be a worrisome trend because a sluggish IPO market has made it less likely that many of these deals can be spun out to investors as IPOs after a year or so. "It is not a wonderful time for private equity in some ways because their ultimate exit strategy is to go public, and you don't

have a nicely behaved equity market right now," says Satya Pradhuman, Merrill Lynch's chief small-company strategist, who tracks leveraged buyouts.

Instead, some targets of leveraged buyouts find themselves sold repeatedly from one private-equity firm to another, with each deal often leading to a dividend recapitalization that yanks cash from the company's balance sheet. For some private-equity firms, the dividend recap has become the exit strategy.

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