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## Is Private Equity Giving Hertz a Boost?

By [ANDREW ROSS SORKIN](#)

LAST fall, Mark P. Frissora, the newly hired chief executive of Hertz, kept running into the same question from potential investors.

Hertz, which [Ford](#) had sold just 11 months earlier to a consortium of private equity firms for \$14 billion, was trying to sell shares to the public in an offering that valued it at \$17 billion. As Mr. Frissora tried to drum up interest in the offering, skeptical investors kept asking him the same question: Why was Hertz worth \$3 billion more in less than a year?

“I had to spend the first 15 minutes of every road-show meeting trying to explain this,” Mr. Frissora said in a recent interview, still sounding somewhat exasperated by the experience.

His job was not made any easier by the fact that the private equity investors — the Carlyle Group, Clayton, Dubilier & Rice and an investment arm of [Merrill Lynch](#) — had piled \$12 billion in debt on the company, and then paid themselves a \$1 billion dividend, which amounted to nearly half of the \$2.3 billion in cash they had invested.

“Very smart investors thought there couldn’t possibly be any value left,” Mr. Frissora said.

Judging by the company’s share price, many investors have changed their minds. Since the initial public offering in November, Hertz’s shares have risen 43 percent from their \$15 offering price, to \$21.51.

Indeed, Hertz now looks as if it was not necessarily the model of the big, bad buyout that its fiercest critics had suggested. Its private equity owners looked at the business with fresh eyes and made a number of changes that improved operating performance. By streamlining how the company cleaned and refueled vehicles, they doubled the number of cars that could be processed every hour and re-rented. Hertz was able to do so without huge reductions in the work force: it cut less than 5 percent of 32,000 jobs.

Even so, the private equity guys also saddled Hertz with billions of dollars in debt, which is taking its toll on the company. Interest expenses of \$901 million pushed Hertz’s net income

down to \$116 million in 2006, from \$350 million the year before. That gives the company less maneuvering room should the economy — or its own revenue — slacken. Still, analysts say they remain uniformly optimistic because Hertz's pre-debt performance has been improving sharply this year. And while it carries a big pile of debt, it has less than other recently privatized companies and just slightly more than Avis Budget.

Still, it is unclear whether Hertz is the exception or the rule of the recent buyout boom. Tightening credit markets pose a threat to all companies carrying big debt loads. For example, [Freescale Semiconductor](#), which was taken private last year, saw its debt trade at 91 cents on the dollar last week amid concerns about the company's financial prospects. But default rates on corporate debt currently remain near record lows of about 0.7 percent. If interest rates rise and debt payments skyrocket, some private equity darlings could stumble. In the 2001 recession, the default rate rose to 8.3 percent.

"Hertz is an example of a success story, but you have to be unbelievably courageous to believe history won't repeat itself with some other companies," said Steven Rattner, co-founder of the Quadrangle Group, the private investment firm, who has been sounding the alarm about the dangers of cheap debt. "We're not magicians or alchemists."

Nonetheless, a close look at the industry over its three-decade history shows that, on average, the firms have actually managed to improve, at least marginally, the businesses they own. "The empirical evidence is actually quite good," said Steven N. Kaplan, a professor at the [University of Chicago](#) Graduate School of Business, who conducted the seminal study on the subject in the 1980s. "There is no evidence in any large sample study that they harm operating performance."

No one has completed studies of the most recent boom, which has its own set of new wrinkles: bigger targets, higher premiums and much bigger upfront fees, all of which strain comparisons with private equity's performance in earlier decades. Few academics appear to be studying the operational performance of recent buyout targets, but Edith Hotchkiss, a finance professor at [Boston College](#), has been running the numbers. She is scrutinizing 176 companies taken over from 1990 to 2006, and her conclusion so far is positive.

"We continue to see operating gains," she says, but she cautions that profit margins among the current takeover targets don't match the operational returns of earlier decades. "The magnitudes are not as high," she says.

SO how, exactly, did Hertz justify the \$3 billion in new value before its I.P.O.? Easily, Mr. Frissora said, as he leaned back in a chair in a conference room at Spencer Stuart, the recruiting firm that brought him to Hertz. But his candid answer was not a complete ode to

Hertz's private equity owners.

He said a third of the value was simply a result of “market-related timing”: because of increased air travel, shares of other travel-related companies had jumped sharply since Hertz was acquired.

“It had nothing to do with private equity,” he said nonchalantly, though he gave his bosses at the private equity firms credit for making a good bet on the market. Mr. Frissora ascribed another third of the increase in value to the performance of Hertz's equipment rental business — not its traditional car rental business, but equipment used in construction — which took off as a result of the housing boom and better internal processes. Again, it is not an improvement that can be attributed entirely to the private equity owners.

And finally, he said, “They bought it at a discount.”

Ford, he explained, was in distress and needed cash quickly when it sold Hertz. Rather than pursue an I.P.O. and take in the risks associated with an offering, Ford chose to sell. It was a heated auction, but “Ford could have gotten more money for it if they had done what private equity did,” he said.

It is a refrain heard again and again by shareholders across the country who feel that they have been shortchanged by corporations too quick to sell when private equity comes calling. Laura B. Resnikoff, an associate professor and the director of the private equity program at the Columbia Business School, who is doing a case study on Hertz, said she grapples with the issue constantly. “A good management team at a public company could do all of this, of course. And yet, we don't see management teams doing it.”

Why?

“The rate of change that private equity forces on portfolio companies is something most public companies are not comfortable with,” she said. Nor are public shareholders always willing to shoulder the burden of high debt loads. Perhaps most crucially, management often does not have the same incentives as a private equity owner to pursue such drastic change.

At public companies, which seek to deliver steady returns to shareholders, executives are often rewarded for playing it safe. At a private-equity-owned business, the system favors risk-taking: Management can earn huge pay packages if turnarounds succeed — and face quick dismissal if the status quo continues.

At Hertz, inertia seemed to rein. In the 25 years before Mr. Frissora's arrival, the company was run by only two chief executives. Neither reported to Ford's chief executive; each reported to a manager three layers below the chief financial officer. And its managers were paid some of their bonuses in Ford's poorly performing stock, hardly an incentive to increase performance.

George W. Tamke, a partner at Clayton, Dubilier & Rice and Hertz's chairman, says the company was "a corporate orphan." For the most part, Ford had left it alone as long as it hit its quarterly forecasts. That bred an insular culture that helped create a great brand, but not great business practices. For example, Hertz had its own printing facilities for marketing materials; it had never considered using an outside printer. The unit also had more than 600 computer programmers to manage its system, and even had its own security department. Forget about outsourcing. "They insourced everything," Mr. Frissora said.

Some think Hertz still isn't lean enough. Christina Woo, an analyst at [Morgan Stanley](#), who has been particularly bearish on the industry, in part because of too much price competition, suggests that Hertz still has ample expenses to slash.

Nonetheless, it appears that private equity has brought a new sense of discipline to the company. Mr. Frissora says he has to have weekly conversations with Mr. Tamke, and monthly updates with the private equity owners, who often pepper him with questions and suggestions. Those conversations are on top of the regular board meetings.

And the private equity firms have added new, more complex measuring sticks: return on capital; Ebitda, for earnings before income, taxes, depreciation and amortization; and a focus on cash flow. "They hadn't thought about that before," Mr. Frissora said.

In contrast to previous Hertz executives, whose salaries under Ford were so low they didn't have to be disclosed, Mr. Frissora has been paid handsomely for his work. His salary is \$950,000, but with bonuses, stock options and other grants he was given before Hertz's I.P.O., his payout is now worth more than \$30 million, at least on paper, and he stands to make even more money if Hertz's share price goes up. He also has invested \$6 million of his own money in Hertz.

At a Hertz outpost in a parking lot on the outskirts of O'Hare Airport in Chicago, the changes under private equity's watch are easy to see.

When Mr. Frissora joined Hertz from auto supplier Tenneco last year, he sent a team of managers to O'Hare for a "waste walk-around." Armed with stopwatches, digital cameras and clipboards, the group members evaluated every aspect of the business, from the airport shuttle

buses to the lighting in the bathrooms.

What did they find? The time it took to refuel and clean cars between uses was far too long. There were too many steps.

When a customer dropped off a car, it would be moved to a waiting pen, then taken to a gas pump. From there, an attendant would have to pull the car up to the cleaning station, where it would be vacuumed. It would then go through a washer. "And someone would run out of supplies every 15 minutes," Mr. Frissora said.

At the end of the evaluation, he made changes almost on the spot. Within days, the seven cleaning stations were moved to where cars are refueled so cleaning could be done at the same time. Eight hours of supplies were provided so that nobody ran out.

According to Mr. Frissora and his private equity bosses, the changes doubled the number of cars that could be processed every hour. That meant Hertz could have more cars on the road and fewer cars in its fleet.

Mr. Frissora also noticed another inefficiency: Too many Hertz cars were sitting idle on the weekends at airport areas, but were sold out in locations away from the airport in Chicago and nearby cities, where renters needed them for short trips. So now 20 employees, called "transporters," arrive every Thursday night at O'Hare and shuttle more than 300 cars off the airport lot into cities for the weekend. On Sunday nights, they take them back to O'Hare.

Now Hertz plans to use more transporters all over the country. The various changes at O'Hare have added \$1 million in revenue.

Then there is the greatest inefficiency: the buying and selling of cars. Some rivals, like Enterprise, are so good at it that rental income is just icing on the cake. Hertz, however, had been getting so much of its fleet from Ford for so long that it didn't bargain hard on price with other companies. "I'm used to beating each other up a bit on price," he said.

So Hertz has put into place professional purchasing methods, centralizing the process so it can wring better deals from automakers. Hertz was also taking too long to sell cars; it took an average of 36 days once Hertz took the car off the lot, found the title, fixed the car and found a dealership or auction to sell it. "Every day that the car sits it's depreciating," Mr. Frissora said.

Now, Hertz has cut the time to 15 days, saving the company \$30 million a year. And it is selling cars directly to the consumer online and using its facilities as a virtual dealership.

Hertz is aggressively renting environmentally friendly hybrids, a move that has helped in marketing and the bottom line. The hybrids have been so popular with customers, who pay \$6 a day more to rent one, that it plans to expand its fleet to about 3,500 by the end of 2008.

And if Mr. Frissora can pull it off, Hertz will solve most rental car customers' biggest nightmare: paying sky-high prices for gas when returning a car. He wants to offer gas at a competitive rate — which alone might make the buyout worth it.

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