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Takeover Artists Quench Thirst

Many Private-Equity Firms Drain Out Dividends and Fees, Saddling Companies With Debt

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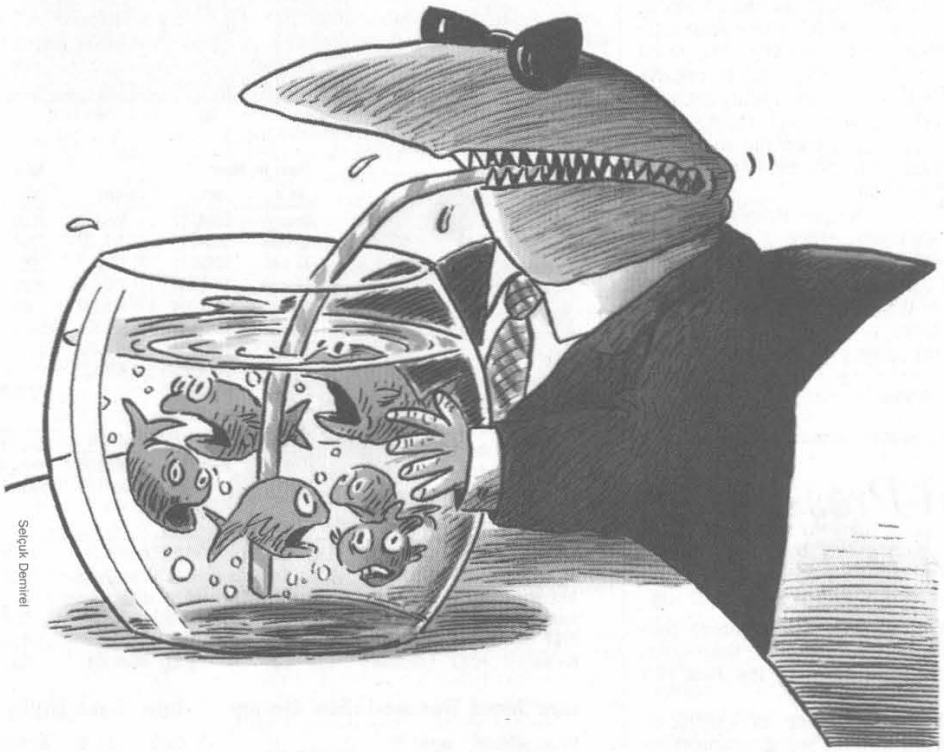

Selçuk Demirel

DEALS & DEAL MAKERS

THE INK HAD BARELY dried on the sale documents about a year ago when the new private-equity owners of satellite operator Intelsat—**Apax Partners** Inc., **Apollo Management**, **Madison Dearborn Partners** and **Permira Advisers**—paid themselves a $350 million dividend financed with newly issued Intelsat debt.

In a technique practically unheard of just five years ago, private-equity firms, emboldened by easy financing, are paying themselves lavish dividends and fees from the companies they acquire. Typically, private-equity firms have generated returns by acquiring companies with a mix of cash and debt, taking them private, restructuring them and then either taking them public or selling them.

But a favorable financing environment has given rise to a high volume of dividends and fees, often paid well ahead of any operational turnaround, primarily through the aggressive issuance of debt by the acquired companies. A spokesman for Apollo, which led the Intelsat transaction, declined to comment.

In the past two years, private-equity firms garnered more than $50 billion from so-called dividend recapitalizations, according to Standard & Poor's Corp. By contrast, there were virtually no such dividend financings just five years ago. As much as 50% of the returns that buyout firms have paid their investors in the past two years came from such dividends, financed mostly with new debt, according to calculations by some private-equity firms.

The pace of the dividends is dizzying. **Blackstone Group** bought Celanese Corp. for $3.4 billion in June 2004, contributing $650 million of the purchase price. In the nine months following the closing, Celanese paid Blackstone $1.3 billion in dividends.

Meanwhile, **Thomas H. Lee Partners**, **Bain Capital** and **Providence Equity Partners**, along with Edgar Bronfman Jr., closed their purchase of Warner Music Group in February 2004. The group put in $1.25 billion of equity, more than one-third of the total purchase price. Two months later, Warner Music paid its new owners $200 million from the proceeds of a financing. Three subsequent dividend payments through May 2005 netted the investors an additional $1.23 billion. A Thomas H. Lee spokesman notes that some of those payments came out of cash flow rather than debt.

Some worry that by heaping enormous debt onto their portfolio companies to help pay the dividends, private-equity firms heighten the risk that the companies may fail if the economy stumbles. Should it "be about how far you can push things or should it be about how much flexibility you give your companies to deal with the unexpected?" asks Josh Lerner, a professor at Harvard Business School who has done research on the performance of private-equity firms. "You can see reason to worry in how much [money] they are pulling out."

But the private-equity firms say that, in general, they are doing what they are supposed to do: make

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Private-Equity Firms Drain Fees

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money for their investors.

Consider PanAmSat, which a **Kohlberg Kravis Roberts** & Co.-led investment group bought in August 2004 for $4.3 billion. In September 2004, the company issued $250 million of notes to pay a dividend to the buyers.

In March 2005, the company filed to go public, planning to use proceeds to pay off some debt and pay its owners an additional $200 million.

A spokesman for KKR adds that, over the course of about a year, debt at PanAmSat fell by $1 billion after the payout.

In August 2005, private-equity controlled Intelsat announced it was acquiring PanAmSat, creating the world's largest satellite-services operator.

Dividends aren't the only way private-equity firms mine their portfolio companies. Fees levied on portfolio companies, while small compared with the dividends the private-equity firms extract, also are growing as the size of buyouts swells. That, of course, is on top of the 20% to 30% of the profits on any deal that goes to the private-equity firm.

First there is a management fee, generally set at 1.5% of the total value of any individual deal. That is supposed to cover the operating costs and infrastructure of the private-equity firm: everything from office rent to the analysts who scour the financial statements of potential targets.

Then there are the fees the firm receives every time it does a deal. Firms also charge fees for advising portfolio companies every time these companies do a financing, even when 100% of the money raised may go to a dividend for its private-equity parent.

In addition, there are monitoring and oversight fees charged as a percentage of earnings, usually amounting to a couple of million dollars a year, as well as the usual fees for those who sit on the boards of the portfolio companies. And finally, when the portfolio company is sold or taken public, the private-equity firms may well charge a termination fee.

As the deals and the overall sums involved grow, the fees grow accordingly and become a profit center in their own right. "The fees were generally set when these organizations were smaller," says Harvard's Prof. Lerner.

The real problem is that the rising level of fees can undermine a private-equity firm's interest in turning around a portfolio company. For example, in its first quarter after listing in 2005, Celanese reported a net loss, partly because of $45 million in fees it paid to Blackstone and partly because of rising interest costs. A spokesman for Blackstone declined to comment.

The massive growth in fees has some investors irked. "Why do they need to get paid by their portfolio companies when they are already paid by their limited partners?" asks Bill Johnston, founder of **Bayon Capital** in San Francisco, which often invests in the publicly listed companies of private-equity firms.

Some private-equity firms agree. **Warburg Pincus** and **Vestar Capital Partners** are among those that don't generally charge their portfolio companies monitoring, financing-advisory or termination fees.

Good or bad, the fee and dividend boom may not be sustainable. Market conditions are deteriorating. Interest rates are going up.

The bond market is less enthusiastic about buyouts. It isn't clear to whom the buyout firms can sell all the companies they've bought over the past two years—except to each other.

That isn't likely to mean great bargains or great profits for either side.

Private-equity firms "say they have figured out how to do buyouts," says Prof. Lerner. But recent performance "has more to do with the capital markets than any lesson learned."