A stall to set out

By Henny Sender and Daniel Schäfer

Carlyle has to confront not only a sharply weaker business environment but a threat to the favourable tax treatment it has had

Late last year, Carlyle's three co-founders sent contacts a short seasonal video starring themselves. In it, David Rubenstein, the main public face of the US private equity group, attempts to convince two bemused young girls to invest a quarter of their allowances in his lemonade-stand business. He tells them he plans to take the operation global and promises them returns of 25 per cent.

It was an effort to humanise what author Michael Lewis once depicted as the "access capitalists" – a reference to the web of political connections that characterised Carlyle's formative years – as the private equity group prepares to go public some time between April and June.

The planned listing comes years after Mr Rubenstein first predicted that one day all the big private equity firms would themselves become public companies. Carlyle, however, is coming to the market at a time when investors have become sceptical about prospects for the industry. The group plans to raise a relatively modest $100m and, although the overall value this will put on it remains unclear, the capitalisation will be a small fraction of what rival Blackstone achieved when it floated in 2007.

Today, private equity titans are fighting against renewed accusations of being privileged, out of touch, tax-dodging parasites. But this battle has concealed another problem: the possibility that the best days of what has become a $1tn industry worldwide now lie behind it – and that a 25 per cent return from the lemonade-stand business or any other represents the good old days.

Since they came to prominence in the 1980s, US buy-out funds' returns have been on a consistent downward trend, a study published this month by the London Business School reveals. By 2008, the end of the period the research covers, profits had reached zero.

The fear of lower returns is therefore not unique to the Washington-based Carlyle. But because Carlyle is now readying its listing, it is the one under closest scrutiny. That scrutiny raises many larger questions about the future of the industry.

At a private equity conference in Hong Kong in November, Mr Rubenstein himself candidly presented the bear case, with slides that show just how disappointing the past five years have been for the industry. As of the third quarter of 2011, global deal volume was 82 per cent below the 2007 high and money returned to investors from company disposals fell 44 per cent short of the peak reached the same year. Grimmest of all, fresh capital collected by the industry was 76 per cent lower than before the credit-fuelled buy-out bubble burst in 2008.

For the first time, industry players fret that the performance of their most recent funds may fall short. Indeed, funds raised after 2006 may be so disappointing that the fabled formulas at the heart of the money machine that has made billionaires of the top groups' founders might no longer work.

Generally, private equity groups raise funds and take 20 per cent of profits for their partners. Since buy-out executives contribute only small parts of the money in each fund themselves, it is as if they get to collect interest on other people's bank accounts.

There is one caveat, though. Before groups can take their cut – called “carried interest” – their investors have to make a return of 8-9 per cent on their money on the entire fund. If the performance is not good enough, the managers keep nothing.

That caveat was irrelevant during private equity’s glory days but that is no longer the case. Now, many of the titans quietly worry that they might have to go further and return money that they have already collected on individual deals to investors at the end of the fund life. For example, the offer memorandum for Carlyle’s listing notes that if all its funds were frozen as of last September, shortfalls in performance would mean it would have to give its investors $150m that it had already taken for itself.

“Such hurdles have always been set at absolute levels, rather than in any relationship to the overall market,” says an executive at one large group. “But when the public market is zero or negative it is a different game. The job of private equity has been to beat the public equity market – but by how much? The profit model is a huge secular challenge.”

The offer memo delivers a similarly sombre message. Such documents are supposed to delineate every conceivable risk thought up by the most alarmist lawyers. But many of the risks identified in Carlyle’s case are not just remote possibilities. “Market conditions at times were significantly more favourable for generating positive performance ... than the market conditions we experienced in the past three years and may continue to experience for the foreseeable future,” it states.

Another issue is tax. A rise is in prospect in the US – from a preferential 15 per cent rate to being treated as ordinary income – and possibly in several European countries as well. If this occurs, the document suggests, the firm may increase the money it pays its executives to compensate for that bill and could also issue more equity. That means shareholders rather than the principals would pay the price and face dilution.

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In private, many buy-out executives admit that private equity's heyday may never return. Cheap and plentiful bank debt that historically boosted profits has largely evaporated and investors are pushing for a greater share in the fees.

Not only have fund investors' returns been damaged. Public shareholders have had their noses bloodied as well. Shares of Carlyle's US main rival Blackstone, which listed right at the top of the market – have roughly halved since reaching their peak a few days afterwards. In the same time frame, the S&P 500 index is down by only 6 per cent.

The one thing buy-out groups can these days influence is the growth of the assets they manage. Because public market investors value the business on the size of these, it makes sense to go public. That is why Carlyle's first chart in its offer memo shows the steady increase in its assets under management. In just the first nine months of last year, these rose from $107bn to $148bn, as the group took over other asset managers. But the Carlyle funds that generate the highest rate of carried interest – of about 20 per cent – were relatively cautious in putting money to work during the period: $8.3bn compared with $10.1bn for all of 2010.

Blackstone, which has been diversifying its asset base, has made far more from property than from corporate buy-outs over the past three years; Jonathan Gray, the rival's real-estate head, is thought likely to take over the helm when co-founder Steve Schwarzman retires. But Carlyle has suffered several setbacks in its own attempts to diversify.

These problems have included two spectacular blow-ups – one in a European venture and the other at Carlyle Capital, a listed fund that invested in mortgage-backed securities with big leverage just as that market was about to go off the cliff. Costs associated with liquidating Carlyle Capital in 2008 amounted to about $150m. The firm still faces multiple lawsuits from investors who saw their money go to zero.

There is other litigation, related to allegations of payments to employees at US state pension funds in return for providing capital for Carlyle's funds. The group paid $20m to settle such charges from New York state but there are other suits that have not yet been resolved.

Moreover, downward pressure on the fees that Carlyle receives from fund investors is strong. "We have confronted and expect to continue to confront requests from a variety of investors and groups representing investors to decrease fees and to modify our carried interest and incentive fee structures," says the memo.

Geographical expansion may not be the answer either. Mr Rubenstein anticipates the day when China will be as important for the industry as is the US. But that day may never come. A single deal – its investment in Shanghai-based China Pacific Insurance, the country's third-biggest insurer, made Carlyle's reputation in China. The $740m it put in from 2005 for a minority stake has earned it an estimated $3bn, while the firm still holds shares worth about $1.5bn. In 2009, 79 per cent of all its accrued performance fees, or $525.5m, came from that one investment.

But Beijing would now be less likely to approve such a deal. For example, when Carlyle tried to buy first a majority and then a minority stake in a Chinese maker of construction equipment, it failed to gain approval. Today, most private equity activity in China consists of taking small minority stakes in public companies that are controlled in many cases by offshore vehicles and therefore do not require regulatory clearance.

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Carlyle is often more conservative than its peers. Groups including TPG and Blackstone, for instance, have recently worked alongside Russia's sovereign wealth fund to seek deals in that country – an offer Carlyle rejected. (Associates tell of Mr Rubenstein's aircraft leaving Moscow on a dreary day as he remarked that his ancestors were right to have quit Russia.)

Still, Mr Rubenstein is almost inexhaustible in his quest for the newest pocket of money and untapped sources of deals. That quest has taken him increasingly far afield. The use of his private jet over the past three years has added up to a $12.5m bill for Carlyle. (The workaholic Mr Rubenstein denies saying that the happiest day of his life was the day he could send emails from the air.)

The group itself is more of a franchise operation than its peers. In most private equity firms, for example, the managers of a fund share in the equity and profitability of the whole group. But Carlyle, which has dozens of funds, often hires managers who will have a piece of the upside in their own fund but not in the firm itself.

Multiple funds and what many see as the most professional fundraising machine on the planet: it is a model pioneered by Mr Rubenstein. He has moved Carlyle from being the ultimate "access capitalist" to a more professional organisation. Now aged 62, he is giving away 90 per cent of his wealth and is the only prominent private equity tycoon to join the philanthropic initiative of billionaires Bill Gates and Warren Buffett.

Yet not all deals can be clinched. In the video, one of the two girls tells the disappointed lemonade-stand operator, "I don't enter private equity deals with strangers," as she walks away, ignoring Mr Rubenstein's entreaties. The question now is about the extent to which investors might opt to do the same.

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Business model: A pay formula that may get carried away

Private equity's way of doing business has generated much controversy. Typically private equity firms buy up companies with huge amounts of debt and only a small amount of equity capital. Then costs and headcount are cut in order to generate the cash to repay the debt – and pay huge dividends, sometimes just days after acquisitions take place.

Whatever the debate about the business model, there is little doubt that it offers a path to fabulous riches for the founders of successful firms. In 2011, for example, the three founders of Carlyle – Bill Conway, Daniel D'Aniello and David Rubenstein – each took $138m in total remuneration. As well as a relatively modest salary of $275,000, they received discretionary bonuses of $3.5m. But by far the biggest chunk of their remuneration – an additional $134m each – came from their share of investors' profits.

Moreover, the three were able to determine their own pay. Mr D'Aniello recommended the level of the bonuses; his co-founders approved. At Carlyle pay is not determined by a "compensation" committee but by the founders. And because the three hold most of the equity at the top of the Carlyle structure, they automatically get the vast majority of the upside from the investments each Carlyle fund collects.

The same is true of the founding generation of all the big funds, from Blackstone's Steve Schwarzman, to KKR's Henry Kravis and George Roberts, and David Bonderman and Jim Coulter of TPG.

The upside is known as carried interest – or “carry” – and is the focus of much debate, largely because most of the money paid out is taxed at a 15 per cent rate, far lower than the income of many ordinary taxpayers. Most of the money at risk is that of investors – not of fund managers.

Officials in the US and elsewhere talk of abolishing the preferential tax rate and taxing gains as ordinary income. Yet that is unlikely to hit Carlyle’s founders too much. The firm’s initial public offering memo states that in the event of legislation it may increase total pay for the three men and issue more equity, presenting other shareholders with the prospect of dilution.

In its IPO memo, Carlyle, like other private equity firms, speaks of the advantages of creating ‘a currency’ in the form of shares with which to fund acquisitions and reward stars. (Some of the IPO proceeds will go towards paying down debt of $1.2bn.) Others see going public as a way to cash out. “It is all about liquidity for the founders,” says an adviser to private equity investors. “These are not easy businesses to sell.”

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