

Care for a Sliver of the Private-Equity Pie?

Small investors can now buy in (but maybe they shouldn't)

By Kimberly Palmer

The exclusive private-equity club is now accepting new members. But joining comes with risks.

Fortress Investment Group and the Blackstone Group have both gone public this year. Now Kohlberg Kravis Roberts, perhaps best known for its 1988 leveraged buyout of RJR Nabisco (remember *Barbarians at the Gate?*), says it will follow suit. So for the first time, average investors can buy stock in private-equity firms, whose investment funds were typically open only to institutional investors and wealthy individuals.

Private equity makes its money by acquiring public companies—like Blackstone's recently announced \$27 billion buyout of Hilton Hotels—installing a new management team, and then selling the improved company back to the public or to another company for an often hefty profit.

Big numbers. Blackstone manages \$88.4 billion in assets and reported \$2.3 billion in profit last year. Fortress, with \$36 billion in assets under management, netted \$443 million. But prospective investors will want to look beyond that number-candy.

While private-equity funds have generated annual returns of 20 percent and higher over the past decade, many in the industry question whether they will continue to do so. The International Monetary Fund and the research company Moody's have both is-

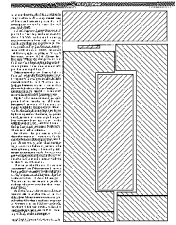
sued warnings about the industry, noting that the companies have thrived with historically low interest rates, which have been rising. Private-equity firms borrow extensively to finance deals; if that money costs more, they won't be able to leverage such steep gains. The firms have also benefited from low tax rates, something Congress may soon change for those that go public. Many private-equity profits are taxed at the 15 percent capital gains rate;

some legislators think the 35 percent corporate tax should apply.

"Any prudent investor should expect that over the next 10 years, returns will be lower," says Roger Freeman, senior analyst at Lehman Brothers. Still, he expects Fortress to outperform other stocks in the financial sector over the next year.

Private-equity firms charge not only a management fee, usually 1 to 2 percent of assets managed, but an incentive fee, often 20 percent of profits. That gives companies like Fortress and Blackstone a steady source of income from management, which generates about a third of revenue, and a more volatile one, which accounts for the rest. Buyers of shares in the firms aren't investing directly in the funds that the companies manage, though, but in the private-equity companies themselves.

"Long-term growth prospects are very good for these guys," says Scott Appleby, founder of Appleby Capital, a financial advisory firm. He



likens investing in a company like Fortress to investing in a mutual fund, because the company invests in other companies that it thinks will grow. Fortress recently said it would buy into a Florida real-estate company and a casino operator.

Private-equity shares, though, are likely to be more volatile than those of mutual funds, because their profits rely heavily on when company partners decide to sell off investments. "Some years they will have big wins, and some years they won't have any," says Steven Kaplan, a professor at the University of Chicago Graduate School of Business.

Costly. While Morningstar analyst Jeffrey Ptak thinks private equity is "prodigiously profitable," he warns against buying such pricey shares. Fortress was trading near \$24 last week, but Ptak values it at only around \$17, based on his estimation of the company's future cash flows. Plus, Fortress shares' price-to-earnings ratio is about twice that of investment banking giant Goldman Sachs, making Goldman a cheaper buy.

Ptak also notes that private-equity firms go public when they think they'll snag the top price. Hence, investors in Fortress and Blackstone now may be buying at the market's peak. And don't think for a second that your 100 shares will put you on equal ground with the guys in the \$1,000 suits. Investors have limited voting rights and claims on the firms' profits. "I'd love to be a general partner, but they're not letting you invest at that level," says Peter Cohan, president of a management consulting and venture capital firm that bears his name.

Private-equity firms are untested on the stock market. Blackstone, priced at \$31 per share before it went public on June 22, shot up to \$38 during its first day of trading, generating plump returns for those who bought and sold quickly. Shares have since dropped back down to the \$30 area. Fortress, priced at \$18.50 a share for its initial public offering, doubled to \$37 on its first day, February 8. It has since settled in the mid-\$20s, no bargain for many who bought in the aftermarket. Research suggests that investors who trade in companies after their debut don't fare well.

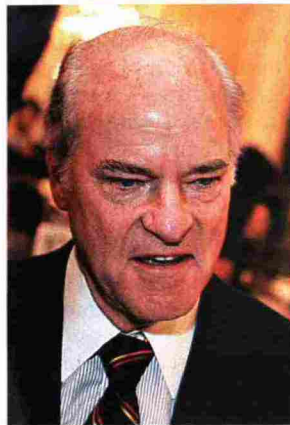
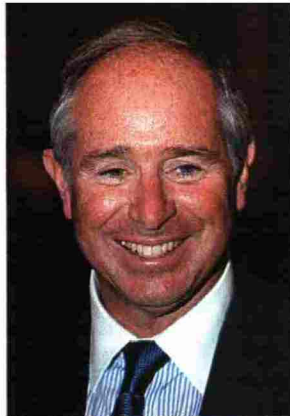
So, caution is advised. "You have some of the smartest minds in the world trying to get these things public before Congress doubles the tax and lenders tighten capital," says Ken Kamen, president of Mercadien Asset Management. "Right

now is a time for buyer beware." ●

THE BIGGEST PRIVATE-EQUITY DEALS

DATE	PRIVATE-EQUITY BUYER	TARGET (INDUSTRY)	PRICE (BILLIONS)
June 30, 2007	Teachers Private Capital et al.	BCE (telecommunications)	\$47.2
Feb. 25, 2007	Kohlberg Kravis Roberts Texas Pacific Group et al.	TXU (energy and power)	\$44.4
Nov. 19, 2006	Blackstone Group	Equity Office Properties Trust (real estate)	\$37.7
July 24, 2006	Bain Capital Kohlberg Kravis Roberts et al.	HCA (healthcare)	\$32.2
May 29, 2006	GS Capital Partners, AIG, Carlyle Group et al.	Kinder Morgan (energy and power)	\$27.5

Source: Thomson Financial



TITANS. Blackstone CEO Stephen Schwarzman (top) and Kohlberg Kravis Roberts senior partner Henry Kravis