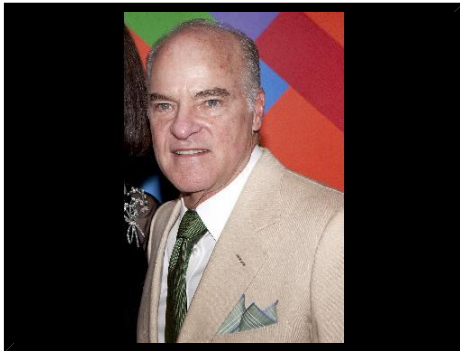


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Pension Plans' Private-Equity Cash Depleted as Profits Shrink

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By Jason Kelly and Jonathan Keehner



Aug. 20 (Bloomberg) -- U.S. pension funds contributed to the record \$1.2 trillion that private-equity firms raised this decade. Three of the biggest investors, state pensions in California, Oregon and Washington, plunked down at least \$53.8 billion. So far, they only have dwindling paper profits and a lot less cash to show the millions of policemen, teachers and other civil servants in their retirement plans.

The California Public Employees' Retirement System, the Washington State Investment Board and the Oregon Public Employees' Retirement Fund -- among the few pension managers to disclose details of their investments -- had recouped just \$22.1 billion in cash by the end of 2008 from buyout funds started since 2000, according to data compiled by Bloomberg. That amounts to a shortfall of 59 percent. In total, they haven't reaped a paper gain from funds formed in the past seven years.

The wisdom of those investment decisions hangs on the remaining value private-equity firms assign to companies they snapped up in 2006 and 2007, during the peak of the buyout boom. For the California, Oregon and Washington plans, that figure totaled \$15.8 billion at the beginning of the year.

While some investors say they're confident the private-equity industry's traditional practice of taking over companies will pay off, others have been shaken by a credit contraction that froze deal-making, eroded the value of the assets on private-equity firms' books and prevented them from cashing out in public share sales.

'Can't Eat IRRs'

Now pension managers on both ends of the spectrum are looking skeptically at the so-called internal rate of return buyout firms calculate to gauge their results.

"I work for over 400,000 employees, and they can't eat IRRs," said [Gary Bruebaker](#), the chief investment officer of the Washington State Investment Board. "At the end of the day, I care about how much do I give you, and how much money do I get back."

Private-equity firms pool money from so-called limited partners -- pension funds, endowments, wealthy families and sovereign wealth funds -- and use that cash, along with money borrowed from banks, for corporate takeovers. The buyout managers aim to boost profits through cost cuts, acquisitions or added lines of business, then reap a return for themselves and their investors in a public stock offering or a sale to another buyer.

The buyout firms also levy fees, typically 2 percent of the assets they oversee annually and 20 percent of profits from successful investments. That's helped make the titans of the industry into billionaires.

Avago IPO

[Stephen Schwarzman](#), the 62-year-old co-founder and chairman of [Blackstone Group LP](#), the

biggest private-equity firm, ranked 261st on the 2009 Forbes list of the world's richest people, with an estimated net worth of \$2.5 billion. KKR & Co. LP co-founder **Henry Kravis**, 65, topped that with \$3 billion, while Carlyle Group co-founder **David Rubenstein**, 60, weighed in at \$1.4 billion.

Buyout managers, and some pension funds, downplay their cash returns so far this decade and counsel patience, saying that investments often look worse in the years immediately after they're made. Blackstone's Schwarzman told backers on an Aug. 6 conference call he expected his New York-based firm to take some of its companies public in 2010. KKR, also in New York, sold shares in **Avago Technologies Ltd.** through an IPO earlier this month, raising \$648 million.

Harvard's Sales

Pension funds also say that over time, private-equity returns compare favorably to the **Standard & Poor's 500 Index**, which declined 28 percent from the beginning of 2000 through the end of last year. Bruebaker says his Washington fund had an 8.2 percent average annual gain from its buyout investments in the past 10 years, compared with a 3.9 percent drop in the S&P.

While investors can sell publicly traded stocks as needed, buyout funds keep money tied up for years, said **Steven Kaplan**, a professor at the University of Chicago's Booth School of Business.

"With private equity, you're taking on a liquidity risk, which people did miscalculate," said Kaplan, who has studied takeover returns.

University endowments and philanthropic foundations hurt by the worst economic crisis since the Great Depression have struggled to sell their stakes in private-equity funds to raise cash. Investors including Harvard University, in Cambridge, Massachusetts, planned to raise more than \$100 billion through so-called secondary sales of limited partnership interests, some at discounts of at least 50 percent, people familiar with the effort said last year.

'Money in the Ground'

Rubenstein, of Washington-based Carlyle, acknowledges that the buyout industry faces tough questions.

"People have a lot of money in the ground and today it's probably not worth what they had intended, but a turn-around in valuations is now beginning," Rubenstein said in an interview. "You'll probably see general partners and limited partners focused more on multiples of equity rather than just IRRs."

Representatives of Washington, Calpers and Oregon all said they remain committed to private equity, and pointed to the long-term nature of the investments.

"The market is in a trough," Oregon spokesman **James Sinks** said. "The picture would've looked different at the end of 2007." Calpers spokesman **Clark McKinley** noted that Calpers in June raised its target commitment to private equity to 14 percent of assets from 10 percent.

"That's an affirmation of our confidence in the asset class," he said.

Schwarzman and Kravis declined to comment for this article.

'A Snapshot'

"We are hopefully toward the end of the absolute worst recession of our lifetimes," said Washington's Bruebaker. "If you take a snapshot right now, things might not look good. These are 10- to 12-year investments and we believe they'll be much better than what we see today."

Bruebaker's fund and the Oregon Public Employees' Retirement Fund warmed to buyouts during the 1980s, and Calpers joined in 1990. Today, among U.S. pension plans, Calpers is the largest investor in private-equity funds, while Washington and Oregon are the third- and fourth-biggest, respectively, according to San Francisco-based consulting firm Probitas Partners Inc.

The three state funds, which serve more than 2 million people, collectively more than doubled their buyout commitments in 2005, to \$8 billion from \$3.1 billion. They ramped up even more the next year, when commitments climbed to \$18.7 billion, the data show.

Chrysler, TXU

All told, private-equity firms raked in \$1.2 trillion from 2000 through 2008, according to London-based researcher Prequin Ltd. The influx of money, coupled with cheap debt-funding from Wall Street banks eager to collect fees, fueled record-setting takeovers. Nine of the 10 biggest deals were announced from 2005 to mid-2007 as buyout firms acquired the likes of hotel operator Hilton Hotels Corp. and power producer [TXU Corp.](#)

The buyouts ground to a halt after the subprime-mortgage market collapsed in late-2007, extinguishing investor demand for high-yield, high-risk debt. The dollar value of deals has dwindled to \$42.2 billion so far this year from \$212.2 billion in 2008, according to data compiled by Bloomberg.

Private-equity firms unable to cash out of investments have spent much of the credit crisis reworking the capital structures of their debt-laden companies. Chrysler LLC, the carmaker that Cerberus Capital Management LP bought in 2007 for \$7.4 billion, and doormaker Masonite International Corp., which KKR purchased in 2005 for C\$3 billion (\$2.4 billion), filed for bankruptcy this year.

Marked-to-Market

At the same time, changes in accounting rules have cast a spotlight on the current value of private-equity investments.

The Financial Accounting Standards Board's so-called Statement No. 157, which went into effect at the end of 2007, requires investors, including private-equity managers, to gauge the fair value of holdings that aren't traded. While most buyout firms typically carried their investments at cost, FAS 157 mandates quarterly assessments of current value.

Such marking-to-market means private-equity funds must tell investors how much their stakes are worth at that moment, even if the managers are planning to hang onto them for years.

"Getting carried away by looking at mark-to-market in my personal view can lead you to an incorrect conclusion for the longer term," Blackstone's Schwarzman said on the Aug. 6 conference call.

Blackstone spokesman [Peter Rose](#) says it's premature to judge recent investments, such as those made by the \$21.7 billion fund the firm set up in 2007.

'Profound Losses'

Schwarzman, who created Blackstone in 1985 with [Peter G. Peterson](#), has said their unspent capital -- about \$29 billion -- will enable them to buy companies at depressed prices and generate profits as the global economy recovers.

Others see signs that the private-equity business is undergoing a transformation. Carlyle's Rubenstein predicted that deals in the current environment will be smaller and less reliant on debt. Individual funds already being marketed to investors won't top \$10 billion, and subsequent efforts won't exceed \$5 billion to \$6 billion, he said.

"These are major structural changes taking place," said Dayton Carr, founder of VCFA Group, a New York-based firm that buys interests in private-equity and venture-capital funds. "The basic economy has had huge issues. A lot of the funds will be smaller."

The upheaval is reflected in the attitudes of pension-fund investors, who are watching and waiting for cash to come in the door.

"When managers are forced to put a hard value on their holdings, we're seeing some profound losses," said [William Atwood](#), the executive director of the Illinois State Board of Investment, an \$9 billion pension fund. "The rubber hits the road when cash is returned."

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