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Carlyle Changes Its Stripes

By diversifying into a broad range of assets and deals, it aims to flourish long after the buyout boom fizzles

In the two decades since private equity firms first stormed the business world, they've been called a lot of things, from raiders to barbarians. But only one firm has been tagged in the popular imagination with warmongering, treason, and acting as cold-eyed architects of government conspiracies. The broadsides got to be more than David M. Rubenstein, William E. Conway Jr., and Daniel A. D'Aniello, founders of Washington's Carlyle Group, could take. "It was nauseating," Rubenstein says.

Carlyle, founded 20 years ago in the shadow of Washington's power centers, long went about its business far from the public eye. Its ranks were larded with the politically connected, including former Presidents, Cabinet members, even former British Prime Minister John Major. It used its partners' collective relationships to build a lucrative business buying, transforming, and selling companies--particularly defense companies that did business with governments.

Carlyle might have continued happily in that niche except for the confluence of three events. First there were the terrorist attacks of September 11. In the aftermath, conspiracy theorists seized on Carlyle's huge profits, intense secrecy, and close dealings with wealthy Saudi investors. The scrutiny reached a crescendo in Michael Moore's documentary *Fahrenheit 9/11*, which made Carlyle seem like the sort of company image-conscious investors like public pension funds might choose to avoid. The second factor was the tsunami of capital that has been sloshing around the globe for five years, providing almost limitless funding for the kind of dealmaking that is Carlyle's specialty. All that liquidity has brought with it immense opportunity as well as stiff new competition. Finally, there's the succession issue. Carlyle's baby boomer founders can see retirement around the corner. And they badly want the firm, their legacy, to outlast them.

At this make-or-break juncture, Carlyle's founders, billionaires all, decided to refashion their firm radically--to transform it into something more ambitious, more diverse, and more lasting.

Stage I of what some have dubbed the Great Experiment was largely cosmetic. The founders asked members of the bin Laden family to take back their money. They sat down with George H.W. Bush and John Major and discussed, improbable though it might seem, how the two were no longer wanted as senior advisers because they hurt the firm's image. Out went former Reagan Defense Secretary Frank C. Carlucci as chairman. In came highly regarded former chairman and CEO of IBM (IBM), Louis V. Gerstner Jr., along with former Securities & Exchange Commission Chairman Arthur Levitt, former General Electric (GE) Vice-Chairman David Calhoun, and former Time Inc. (TWX) Editor-in-Chief Norman Pearlstine, among others, to underscore Carlyle's commitment to portfolio diversification and upright corporate citizenship. Carlyle also pared back its defense holdings dramatically.

Stage II went much further and, indeed, might come to redefine the very nature of private equity. While other major buyout firms raise a few massive funds that hunt big prey--companies they can take private, rejigger financially, and, eventually, sell off or take public again--Carlyle has spread its money among no fewer than 48 funds around the world. Whereas the other giant firms--Blackstone Group, Kohlberg Kravis Roberts, and Texas Pacific Group--manage just 14, 7, and 6 funds, respectively, according to Thomson Financial, Carlyle launched a mind-boggling 11 in 2005 and 11 more in 2006.

More important, Carlyle now deals in a broad swath of alternative assets that include venture capital, real estate, collateralized debt obligations, and other investing exotica, which now make up a third of its assets. Rubenstein expects that percentage to grow to half by 2012. By getting into so many different areas, Carlyle seeks to exploit lucrative opportunities now and gain flexibility later when the booming buyout market slumps. The risk lies in getting it right. Having never managed such disparate assets before, Carlyle is on a steep learning curve. And it will be competing with traders and managers who have seen every kind of market--up, down, sideways.

Carlyle's radical makeover has turned the firm into the biggest fund-raising juggernaut the private equity world has ever seen. By the end of this year it expects to have an unprecedented $85 billion in investor commitments under management, up sixfold from 2001 and more than any other firm expects. Rubenstein sees the total swelling to as much as $300 billion by 2012. This year alone, Carlyle plans to raise a record $34 billion. Thanks to the surging debt markets, which are pumping up leveraged buyouts, that easily translates into more than $200 billion in purchasing power, enough for Carlyle to take out, say, Yahoo! (YHOO), Caterpillar (CAT), and FedEx (FDX) and still have $100 billion left over. "People probably look at them with a bit of envy," says Joncarlo Mark, a senior portfolio manager at California Public Employees' Retirement System (CalPERS), which owns 5.5% of the firm. Texas Pacific co-founder David Bonderman considers Conway, Carlyle's chief investment officer, "one of the best in our business."

So what, exactly, is Carlyle? Part buyout shop, part investment bank, part asset-management firm, it has set out on a course all its own. "There are going to be some major financial institutions that emerge from the phenomenal growth [in private equity] of the last years," says Colin Blaydon, director of the Center for Private Equity & Entrepreneurship at Dartmouth's Tuck School of Business. "Carlyle is very deliberately moving in that direction. It looks a bit like the mid-'80s, when a handful of big, multiline investment-banking firms emerged as the bulge bracket."

Make no mistake--Carlyle is already massive. It owns nearly 200 companies that generate a combined $68 billion in revenue and employ 200,000 people. Last year it bought a new company approximately once every three days and sold one almost once a week--all while dabbling in increasingly esoteric investments.

Such feats might qualify Rubenstein for Master of the Universe status, but his New York office certainly doesn't announce it. Bespectacled and tightly wound, Rubenstein, 57, sits behind a dark mahogany desk so spare it's hard to believe he ever uses it. And the place has none of the typical trappings of the private equity elite. No photographs of Rubenstein with famous people (though he knows plenty). No artwork. No "love me" collages of degrees and awards. "[Carlyle] is a serious money-management business," says Rubenstein, "and we have to operate it that way if it's to have duration beyond the founders." Besides, he says, his austere offices in Washington and New York serve as reminders that he could lose everything at any moment. "I don't have things on the walls because I might have to take them down," he says. Rubenstein is ascetic by nature. He shuns red meat, avoids alcohol and desserts, and limits his business attire to navy pin-striped suits.

Rubenstein doesn't have much time to gaze at the walls anyway. With money flowing in so fast and opportunities increasing exponentially, the firm's expansion is creating problems buyout shops have never had to deal with before.

Coping with the hypergrowth is Stage III of the Great Experiment. Carlyle has overhauled its management structure, decentralizing decision-making in a way that would shock the typical larger-than-life buyout baron. Now, instead of relying on the founders to bless every deal, it sprinkles investment committees around the firm, each made up of managers from different funds and backgrounds. Before memos reach THE TOP, they have to make it through each fund's committee. If a big deal in, say, Japan, looks tempting, the Japan fund might solicit money from bigger Carlyle funds, which perform their own due diligence. This is management more along the lines of a professionally run, shareholder-owned corporation than a private partnership where the founders' dictates, wise or not, carry the force of law. In the annals of business, it's the juncture at which many a hot boutique has failed. Rubenstein says big private equity firms, including his own, will one day be publicly held.

The new setup allows Carlyle's founders, known inside the firm as "DBD" for David-Bill-Daniel, to concentrate on what they do best. Rubenstein travels the globe 260 days a year to raise funds. The fiery Conway, 57, scrambles to put the money to work. D'Aniello, 60, is chief operating officer and, in many ways, the glue of the operation. Underneath DBD and Chairman Gerstner, a web of investment managers runs money while seasoned executives not only manage companies but beat the bushes looking for deals. Carlyle estimates that at any one time it has headhunters conducting 10 to 15 searches for high-level talent. When Carlyle and its partners landed Calhoun, they were willing to pay him $100 million. Carlyle has promoted 50 of its people to the level of partner--a path that typically takes 12 years. Below them sit associates, who earn about $150,000 to start.

Central to Carlyle's Great Experiment is old-fashioned risk management. The more diverse the assets, say finance textbooks, the better the risk-adjusted returns. Carlyle has long been known as one of the most risk-averse of the major firms. Its main U.S. buyout fund has lost money on only 4% of its investments, making it one of the most consistent performers in an industry that typically sees losses on 10% to 15% of its positions, according to Hamilton Lane, an institutional money-management and advisory firm. Thus far, Carlyle's aversion to risk hasn't come at the expense of returns. Quite the opposite: Since its founding in 1987 it has generated annualized after-fee returns of 26%, compared with the industry average in the mid-teens. But already, DBD is telling investors they shouldn't expect private equity returns of 30% a year to continue.

Carlyle's longtime focus on small and midmarket deals--less than $1 billion--has also set it apart from the other megafirms. In buyouts, KKR and Blackstone concentrate on the biggest acquisitions, while Texas Pacific Group is known for doing difficult deals that other firms won't touch. Carlyle's specialty is turning small deals into big successes. Even its most ardent former skeptic praises the approach. Stephen L. Norris, one of the firm's original five founders, split in 1995 in a bitter fight over Carlyle's direction. "I was wrong," Norris says flatly. "David is a billionaire, and I'm not." (The other original partner, Greg A. Rosenbaum, left during the first year.)

But overheated debt markets have changed Carlyle's formula, at least for now. When interest rates plunged earlier in the decade, deal financing got much cheaper, and Carlyle took full advantage, making successively bigger purchases. Founder Conway acknowledges the worry. "Our business right now is being propelled by the rocket fuel of cheap debt," he says. "Rocket fuel is explosive, and you have to be careful how you handle it." Daniel F. Akerson, co-head of the firm's U.S. buyout fund, says one bank last year offered to give Carlyle twice the financing it needed for an acquisition. "That's when you say to yourself: Wow.' That's the craziness of it."

RED FLAGS

Such easy access to capital now can set up big trouble later on. To paraphrase Alan Greenspan, the worst of deals are made at the best of times. Right now almost all dealmakers look like geniuses. But history tells us that when the cycle turns, many who are riding the current wave of hope and euphoria will be washed out to sea. If interest rates rise, opportunities to refinance debt will disappear. Cash flows will shrivel. There will be bankruptcies.

Carlyle has a longer and more lustrous record than most firms, but there's no doubt it's getting increasingly audacious in its financial footwork. In June, along with partners Clayton, Dubilier & Rice and Merrill Lynch (MER), it collected an unprecedented $1 billion dividend from rental-car company Hertz (HTZ) just six months after taking it private for $15 billion--and then promptly took it public again, a lightning-quick flip in buyout land. Carlyle estimates it has already earned back 54% of its $765 million investment and points out that it and its partners still own 71% of the company and are managing it for the long term.

Conway makes no apologies for returning money to investors--institutions, pension funds, and wealthy individuals--as quickly as possible. He's paid to spot opportunities and seize them. For example, in 2002, Carlyle beat a pack of other firms to buy the Dex Media Yellow Pages Div. from struggling Qwest Communications International (Q) for $7 billion with partner Welsh, Carson, Anderson & Stowe. Then the largest buyout since RJR Nabisco, the deal was beset by regulatory hurdles and was ultimately carried out in two stages. (Carlyle made 2.6 times its investment when it took Dex public in 2004 and exited last year.)

When Stephen A. Schwarzman, CEO of Blackstone Group, called Rubenstein last August to gauge his interest in Austin (Tex.)-based Freescale Semiconductor, Carlyle's Great Experiment was put to the test. Schwarzman gave Carlyle only a few weeks to decide. So 40 investment professionals from the firm's U.S., Asian, Japanese, and European buyout funds got to work. They probed Freescale's ability to service its clients worldwide, researched its management team, and wrestled with the risks involved in the company's valuation, which had more than doubled in two years. Buyouts of tech companies, with their high capital expenditures and boom-and-bust product cycles, have been rare. Ultimately, the group decided the deal was worth the risk, and Carlyle bid alongside Blackstone.

Such moves have raised red flags among regulators. Carlyle is one of several firms that received letters from the Justice Dept. last fall asking for information on club deals. And the firm's sprawling portfolio is beginning to raise eyebrows, too. On Jan. 25 the Federal Trade Commission told Carlyle it could complete a $27.5 billion buyout of energy-distribution holding company Kinder Morgan Inc. (KMI) only if it agrees to give up operational control of another company it owns. Carlyle has gotten so big and so diverse that it's actually raising antitrust concerns--a first for a buyout firm.

Back in 1987 no one would have imagined that Carlyle's founders would one day count themselves among the private equity aristocracy. Rubenstein was an unhappy lawyer whose main calling card was a stint as a domestic policy adviser in the Carter Administration. Conway had dealt with junk-bond czar Michael R. Milken as treasurer and chief financial officer of MCI Communications but had little experience buying companies. D'Aniello's expertise was handling hotel financings at Marriott Corp. "People laughed at us," Rubenstein recalls.

With a bankroll of just $5 million, Carlyle struggled. It began by marketing Alaskan tax write-offs to corporations--hardly the stuff of Wall Street or Washington folklore. Its first attempt at a buyout turned into a painful learning experience. Carlyle hit up one of its founding investors, the Mellon family of Pittsburgh, for money to buy the restaurant chain Chi-Chi's. Then the group made a pilgrimage to Milken to get the rest of the money. They lost the auction to a company called Foodmaker and learned afterward that Milken had financed each of the four bidders. "It was stunning to us," recalls D'Aniello of his introduction to the buyout business. Milken was not available for comment.

Their fortunes turned when they wooed former Defense Secretary Carlucci to the firm in 1989. He delivered a sweet deal in his first year--a defense think tank called BDM International that was involved in large projects like manned space stations and, eventually, the deployment of Operation Desert Shield. "All these little jewels were coming available from larger companies that were looking to [pare their holdings to] find their core competencies," recalls D'Aniello. Carlyle was able to sell BDM in 1997 and make its investors 10.5 times their initial stake. The firm went on to become a force in the defense industry: Carlyle was one of the nation's 15 biggest defense contractors from 1998 to 2003, according to the Pentagon.

By 2005, thanks to the diversification strategy, it wasn't even among the top 100 defense contractors. Today, investment professionals in New York, Washington, Los Angeles, and London buy and sell loans, stocks, bonds, and other securities. Their largest holdings are in secured bank loans. But on the 42nd floor of Carlyle's New York office, some now trade in the securities of deeply distressed companies--the kind that Carlyle's buyout business once refused to touch.

ACROSS THE GLOBE

The seeds of that business were sown in 2002, when debt was getting cheaper and Managing Director Michael J. Zupon convinced DBD that there were profitable opportunities in distressed companies. He had taken a position in the bonds of an aerospace company at less than 50 cents on the dollar, and the company's executives pitched him on buying preferred stock. Keenly aware of Carlyle's expertise in aerospace, Zupon consulted with one of the firm's senior dealmakers in the sector. The two decided that Carlyle's high-yield fund and its U.S. buyout fund should buy the $15 million stake. Its value soared to $45 million in 18 months. "That was the catalyst," Zupon says. The business has since expanded into buying companies outright. One of the group's first purchases was titanium-component maker Stellex Aerostructures Inc., which Carlyle had once considered acquiring. The distressed team bought it after it emerged from bankruptcy in 2004. Two years later it sold for 6.3 times what Carlyle paid.

At the other end of the investing spectrum, a group of 50 people spread out in Washington, San Francisco, Mumbai, Beijing, Shanghai, Hong Kong, and London are looking to put $3.6 billion to work in venture and other deals. "We're seeing a set of opportunities with strong growth attributes but which just don't lend themselves to the traditional leveraged-buyout approach," explains Brooke B. Coburn, who co-heads Carlyle's American venture fund. Most of the group's investments are in small businesses and fledgling divisions carved from companies. For example, the U.S. venture group paid $44 million for the English-as-a-second-language instruction division of publicly traded Laureate Education Inc. (LAUR) (LAUR) in 2005. Carlyle's venture team saw an chance to expand dramatically. The company's revenues have surged 70%, to more than $120 million.

Increasingly, Carlyle is also backing entrepreneurs who have little more than a patent. One investment is with a group that patented the idea for an advanced liposuction machine. In theory it damages fat cells with ultrasound waves so they can be secreted naturally, eliminating the need for surgery. "We've been in [that investment] for five to six years, and [the company] has no revenue at this point," says Coburn. Carlyle has invested $6.7 million.

In China, Carlyle's venture fund focuses on consumer-oriented investments like Ctrip.com, the Chinese version of Travelocity (TSG). Carlyle invested $8 million, took it public, and reaped $117 million. In India, Carlyle is backing technology, including a company called Claris Lifesciences Ltd., which makes low-cost medicines and hospital-care products.

Carlyle may soon become even more far-flung. Its recent hiring of a team of traders from hedge fund Amaranth Advisors, which lost $6 billion last year on bad natural gas bets, has prompted speculation that Carlyle is preparing to launch a hedge fund. There's also talk that the firm may start new buyout funds focusing on emerging markets. On Jan. 28, Carlyle announced the hiring of a dealmaker in Cairo to oversee investments in Egypt and North Africa. Citing SEC restrictions, the firm declined to comment on potential new funds.

Investors like the new, diversified approach. "The remarkable thing about the firm [is that] a lot of their funds have done exceptionally well," says CalPERS' Mark. "But you [also] have the safety net of the broader organization."

The biggest question facing Carlyle is whether it can maintain the discipline and top-notch performance it has been known for through this period of hypergrowth. The tension between Rubenstein rushing out new funds and Conway racing to find the financial expertise to keep up is palpable. Good investment professionals "don't grow on trees," Conway complains. "You talk to a headhunter who says: I know 50 of those people.' Then you hire the headhunter and...the 50 becomes 3."

With so much money flowing in, finding and keeping talent has become an obsession. D'Aniello, who oversees Carlyle's real estate and energy investments, has been moonlighting as the firm's management guru. He has hired human resources staff to attract top people, implemented 360-degree performance reviews, started succession planning, instituted Carlyle's annual management retreat, and spearheaded an initiative called "One Carlyle," designed to encourage teamwork across borders and silos. What could be more corporate-sounding?

"We don't want isolationists," D'Aniello says of the employees he's trying to attract to sustain his firm long into the future. "We also don't want crybabies. And we don't want mercenaries--people who are here to put a notch on their own gun. We want people to help us build a cannon."

By Emily Thornton, with Dawn Kopecki in Washington, David Polek in New York, Kenji Hall in Tokyo, and Carol Matlack in Paris