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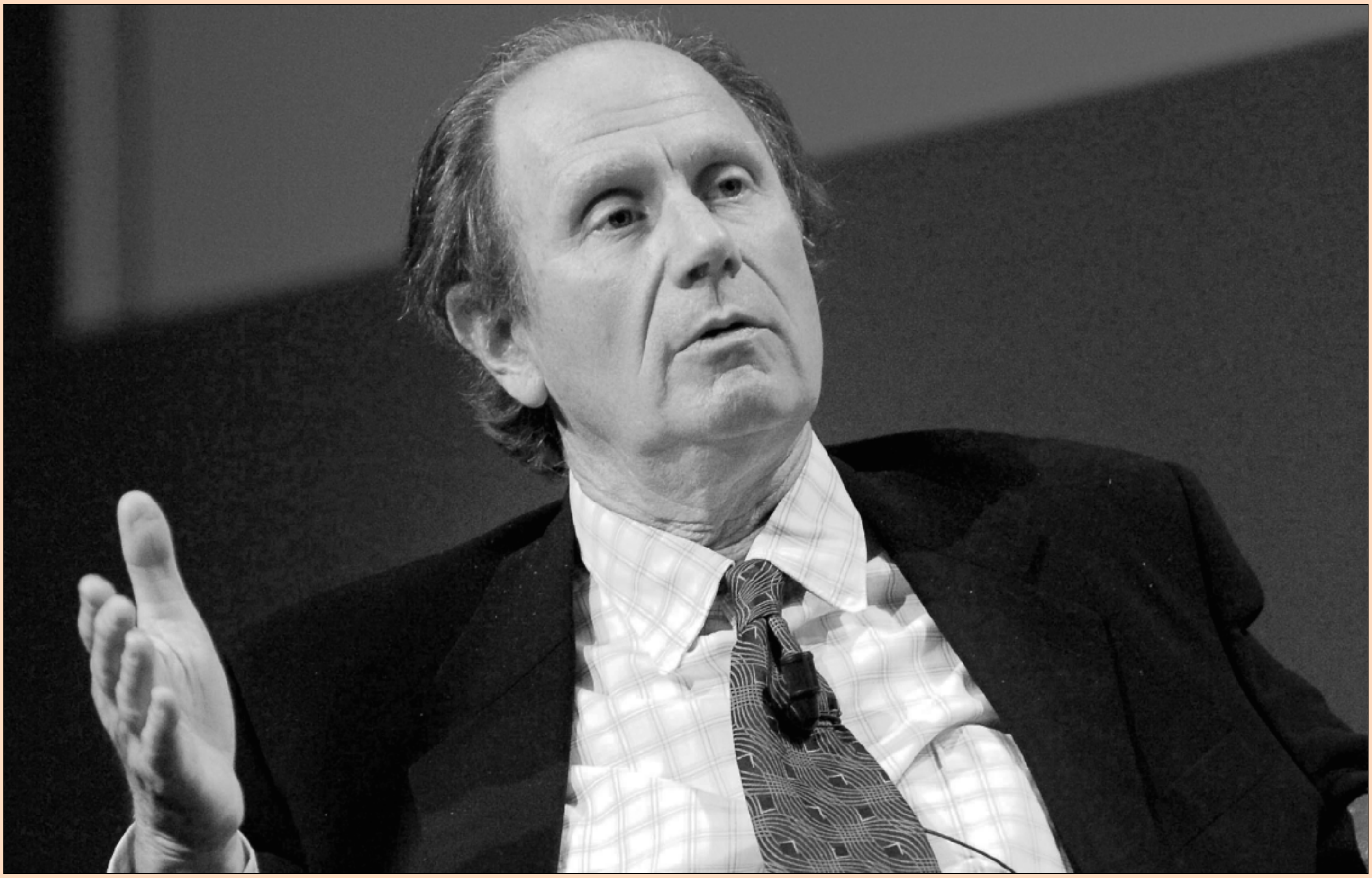
Comment & Analysis

TEXAS PACIFIC GROUP The firm's founders believe they are well placed to weather a turn in the interest rate cycle, write **Peter Smith** and **James Politi**

Against the flow: how 'private equity's Google' is profiting from contrarianism



Admirers of David Bonderman credit him with turning Texas Pacific Group into the most global of the big players in private equity, although some worry that the firm's rapid expansion may have stretched it too thinly Bloomberg

For David Bonderman it was a disconcerting moment. At an investment conference in Frankfurt last year, the co-founder of Texas Pacific Group, the private equity fund, glanced up at an overhead screen to find his face crudely superimposed on the head of a dinosaur.

Jon Moulton, head of Alchemy, a much smaller rival, was using a presentation to assert, none too subtly, that the world's large buy-out groups were suffering from gigantism. Soon they would falter and only extinction lay ahead.

But Mr Bonderman secured a sweet revenge. Just a year later, at the same conference, he was able to trumpet a stellar performance – not only by TPG but other large buy-out funds. A sample of 10 of the largest funds raised between 2001 and 2004 had generated average annual returns of 37.4 per cent. In contrast, mid-market funds had delivered returns of just 3.4 per cent, Mr Bonderman pointed out, in a neat sideswipe at the market segment occupied by Alchemy.

Now TPG is putting the finishing touches to a buy-out fund that has raised close to $15bn, the biggest in private equity's history and nearly double the record set only a year ago.

In a rare interview, Jim Coulter, Ivy League-educated co-founder of TPG, displays the solidity and *sang froid* that is his trademark. One banker who knows both men describes Mr Coulter as "alter ego" to the intellectual and mercurial Mr Bonderman. "Jim is ...the classic right hand man. He is everything that Bonderman is not and he makes things happen," he says.

The company itself is viewed less as an institution and more as a breeding ground for innovation. One mergers and acquisitions banker specialising in private equity deals says: "If KKR is GE, TPG is Google."

The comparison is apt. TPG is headquarted only 35 miles north of Silicon Valley, in an office that affords sweeping views of the Golden Gate Bridge, Alcatraz and San Francisco's TransAmerica Pyramid skyscraper.

It was not always so: from the conference room where weekly partner meetings are held, Mr Coulter, can point across the bay to the small building in Sausalito where TPG's first four-person office was set up in 1992.

Admirers would say that Messrs Bonderman and Coulter have turned the group into the

'He makes things happen': Jim Coulter

most global and nimble of the large players in private equity, rivalled only by Washington-based Carlyle. But while few are prepared publicly to voice criticisms – such is the duo's star power within the industry – questions are increasingly being asked sotto voce about whether their ambitions may outrun their abilities as they seek to take TPG into the stratosphere.

Mr Coulter, 46, who runs TPG's day-to-day operations while the 63-year-old Mr Bonderman is on the road, has always kept a low profile. But now the attention TPG is attracting as manager of the world's largest buy-out fund is encouraging him to step out of the shadows.

Perhaps with one eye on critics such as Alchemy, he is keen to explain TPG's evolution and how the group plans to tackle the next decade. "Private equity is evolving from a cottage industry into a specialised, highly-tooled global industry and we are part of that process," he says.

Its recent landmark fundraising represented the latest endorsement of the large buy-out groups as a distinct asset class, in which the highest returns are being generated from buying large businesses, loading them with debt and selling them a few years later for a profit. But it was also a statement about TPG.

In exceeding the size of the funds raised by all its rivals, TPG capitalised on its superior track record since it was formally established in 1993 and on investors' expectations that success will continue to come its way even as the private equity industry appears to be facing the end of a boom cycle.

Private equity groups are having to transform their business models in response to changing conditions, whether by raising billions via publicly traded investment vehicles in Amsterdam, making strategic minority investments in large public companies or moving into different regions and related investment disciplines such as real estate, hedge funds and debt.

The rise in interest rates means the era of cheap debt financing that has underpinned the boom is ending, and returns from traditional buy-outs are expected to drop.

There is also a scramble among the largest groups to create the most enduring institution, capable of outliving each firm's pioneers.

Amid these challenges, TPG appears well positioned. It was among the first to see Asia as fertile ground for deals and was also quick to establish a European business. Its deals range from traditional buy-outs, such as SunGard Data Systems, to tricky turnrounds such as retailer J.Crew, to minority investments such as Lenovo (See page 3).

TPG's investment philosophy decrees its dealmakers should have the flexibility to seize opportunities in any corner of the world using whatever structure will deliver results.

That will often involve taking controlling equity stakes but it may also mean securing small stakes in bio-technology businesses and investing in different layers of the capital structure, including debt instruments.

It was in the vanguard in another area too. In 2004 TPG formed a hedge fund, a move that has since been replicated by several rivals. The new venture, called TPG-Axon, is based in New York and managed by Dinakar Singh, a former high-flyer at Goldman Sachs.

"They were clearly ahead of the curve on the industry's development. They were thinking about private equity 10 years ago the way it is thought of today: not just US, not just one product",

> 'During the locust debate TPG seemed less repentant than other firms like KKR and Blackstone . . . They didn't help the industry's cause'

says one corporate lawyer in New York who specialises in private equity.

TPG's founding coup involved Continental Airlines, the ailing US carrier that fell into bankruptcy in the early 1990s. At the time both Mr Bonderman and Mr Coulter were helping to manage the fortune of Fort Worth's Robert

M. Bass family. But the duo split from the oil billionaires to buy Continental.

Without a fund or formal backing, and little track record as independent investors, setting their sights on the airline was a massive gamble.

But, defying the sceptics, they managed to raise a debt and equity package that secured it. They ultimately converted their equity investment of $66m into nearly $700m, an impressive home run on a maiden deal.

Continental was to entrench TPG's reputation as one of the smartest private equity investors. It bore the hallmarks of what was to become the group's defining style: complex and counter-cyclical investments with a splash of daring. A banker in San Francisco says they specialise in "catch a falling knife" type deals.

The Continental deal also proved the calling card that brought TPG to Europe in 1995. It joined forces with Richard Branson, the Virgin airlines entrepreneur, to create what would become Virgin Entertainment cinemas.

Subsequently, TPG notched up an impressive array of deals around the world, including investments in Ducati motorcycles, Seagate Technology and MEMC Electronic Materials. More recently it has profited from the initial public offerings of Burger King, J Crew and Debenhams, the UK department store group, and the sale of Texas Genco to NRG Energy for $5.6bn.

By any standards its performance has been exceptional. According to a fundraising document the FT obtained from an investor, TPG has realised $20.1bn from putting $7.2bn into 67 investments – a multiple of 2.8 times capital invested.

Mr Coulter admits to some mistakes but is canny enough to present them as evidence of vitality, quoting Woody Allen on film-making: "If you're not failing every now and again, it's a sign you're not doing anything very innovative." He elaborates: "We got over-weight in telecoms and we zeroed out on a number of those investments."

TPG has some problem children in its current portfolio: Mr Coulter refers to them as the three Gs. They are Gate Gourmet, the airline catering group that was stricken by industrial action in the US and UK last year; Grohe, the German bathroom products producer that became embroiled in the debate about whether US investors were "locusts" stripping German assets, and Gemplus, the smart-card maker.

To some, such difficulties are harbingers of future failure. "Their ambitions far outstrip their abilities: I can't believe they haven't made more mistakes already," says one New York banker.

However, others take a different view. John Barber of Helix Associates, a firm that sources investors for private equity funds, says: "I would bet on them winning in the cycle to come," adding that TPG's history of buying "large companies in viable businesses but with bad balance sheets" will help them weather the tricky times to come.

"Their culture still remains more entrepreneurial than corporate and their investment style is more contrarian than conventional," Mr Barber adds.

RESPECTABLE RETURNS

- Since 1985 to the end of last year, Texas Pacific Group has returned $16.7bn to investors; it has $8.9bn of unrealised investments, giving a total value of $25.6bn.
- Cumulative invested capital is $11.5bn, giving an equity multiple of 2.2 times the original investment.
- This represents a gross internal rate of return of 54 per cent, outperforming a weighted combination of the S&P500 index and the Nasdaq over the period.

Whatever lies ahead, TPG is now firmly established as a substantial economic entity. Its portfolio companies employ close to 300,000 people and generate annual revenues of $65bn. Aggregating these companies would create a business in the top 20 of the Fortune 500.

Echoing Mr Bonderman's views, Mr Coulter says he is dubious about the outlook for mid-market generalist firms. He sees a future for niche players and large global groups with sectoral expertise. "Scale does matter in private equity, especially if you also build knowledge and capability in sectors."

TPG's presence in Asia via its Hong Kong-based Newbridge affiliate is also a trump card. It arrived in Asia nearly a decade before rivals such as Blackstone and Kohlberg Kravis Roberts. Of TPG's role in Asia Mr Coulter says: "It is not the money they are looking for.

They are looking for partners with global expertise."

Thus far TPG has remained a contrarian, counter-cyclical investor, while not overindulging in risk. Its professionals are strung across the world but maintain close ties to head office even while nurturing local connections.

And yet, there are areas in which TPG could run into trouble. The balance between risky and safe investments could tilt too far towards one side or the other and its global network of private equity dealmakers could slip out of the orbit of the mother ship in San Francisco.

Critics point out that it has undertaken a large number of problematic deals, such as Gate Gourmet, that have devoured management time and diverted attention that could otherwise have been devoted to making lucrative new investments.

"During the whole locust debate TPG seemed less repentant than other firms like KKR and Blackstone who, publicly at least, said they cared about stakeholder interests," one private equity investor said. "They certainly didn't help the industry's wider cause." He adds: "They are not exactly known for their light touch."

Their continued success hinges on whether a new generation of dealmakers will have the talent to replicate the founders' achievements. Succession planning is afoot, in part to prevent the brightest prospects leaving the firm in frustration. TPG's recent fundraising document implicitly anoints a group of "senior professionals", including Richard Boyce, Jonathan Coslet, Kelvin Davis, James Gates, and John Marren of the US, and Philippe Costeletos and Stephen Peel of the London office.

But with the firm still going from strength to strength, Messrs Bonder-man and Coulter will not be passing the baton just yet.

FIFTEEN OF THE BEST

Selected TPG transactions: the US

- Seagate Technology (March 2000). Value at acquisition: $2.1bn
- The Neiman Marcus Group (May 2005) $5.1bn
- Metro-Goldwyn-Mayer (Sept 2004) $5.1bn
- Burger King (July 2002) $1.5bn
- MEMC (Oct 2001) $295m

Europe

- Debenhams (Oct 2003) $3.3bn
- TIM Hellas (April 2005) $2.1bn
- Eutelsat Communications (Feb 2004) $3.8bn
- Punch Taverns (May 1999) $4.5bn
- Findexa (Sept 2001) $700m

Asia

- Myer Department Stores (May 2006) $1bn
- Korea First Bank (Jan 2000) $934m
- Taishin Financial Holding Co (March 2006) $850m
- Matrix Laboratories (May 2004) $467m
- Shenzhen Development Bank Company (Dec 2004) $837m

From auction defeat to the political firing line

The sale of IBM's PC business to Lenovo of China in December 2004 was hailed as a milestone in the country's economic ascent. For Texas Pacific Group, however, it represented only the sour and unfamiliar taste of failure. The private equity group had competed unsuccessfully in the auction.

But TPG was to reap a share of the spoils after all.

Soon after the Lenovo deal was announced Jim Coulter, the firm's co-founder, met Mary Ma, Lenovo's chief financial officer and lead negotiator on the deal. The two agreed that there were good reasons to co-operate. Lenovo needed TPG not for capital, which had become commoditised in a world awash with private equity, but for its expertise in turning businesses around.

On TPG's side, the logic of taking a stake in Lenovo was perhaps even more compelling than the original idea of buying IBM's PC business. By teaming up with a Chinese company TPG could combine IBM's high margins and Lenovo's low-cost structure, and potentially score one of the biggest successes in the history of private equity.

The commitment was made when TPG agreed to take a $250m stake, split with Newbridge, in Lenovo, while General Atlantic, another private equity group, took a smaller $100m chunk of the business.

The investment reflected TPG's basic philosophy of deal-making: identify an opportunity, commit to it and pursue it even if some of the initial assumptions change.

In making the investment, the firm's global network proved invaluable. The technology team in San Francisco played a big role, as did financiers on the ground in China, where TPG's sister firm Newbridge already had strong roots.

Mr Coulter lent his support during the negotiations and ultimately decided to join Lenovo's board. "Jim is always looking ahead, asking the most probing questions. He doesn't let us off the hook with anything," says Bill Amelio, Dell's former Asia-Pacific chief, who was hired by TPG's internal recruiting team to run Lenovo once the deal was completed.

But any hopes that the Lenovo investment would immediately turn to gold have been dispelled. In fact, the new Lenovo has had mixed fortunes since taking over the IBM PC business. On the one hand, the company made substantial progress when it introduced its own branded products outside China, and successfully sponsored this year's Winter Olympics in Italy.

But Lenovo has also been grappling with enormous change and dislocation. At the end of May its fiscal year results showed net profits dropping to HK$173.24m ($22.3m) – lower than analysts expected – from HK$1.12bn a year earlier.

This fall came in spite of a fourfold jump in revenues to HK$103.55bn, and followed a restructuring plan involving 1,000 job cuts. Dealing with anti-Chinese sentiment in Washington has also been a challenge.

Although the acquisition was approved by the US government's inter-agency committee on foreign investment (CFIUS) relatively quickly, Lenovo's vulnerability on the political front has been highlighted on a number of occasions. Most recently, the State Department said it would limit its use of Lenovo's PCs to unclassified work on security grounds after receiving complaints from a number of politicians.

Lenovo's management can remain confident that, from a business perspective, they are in good hands. Complex deals are TPG's metier, as the firm proved in the lucrative turnrounds of Continental Airlines, Burger King and J.Crew.

But in entering Washington's shark-infested waters, Lenovo might not have picked the ideal partner: one of TPG's weaknesses is that it is less politically connected than some of its rivals, such as Blackstone or Carlyle.

James Politi

Texas Pacific chief eyes Asia

■ Bonderman says private equity investment cycle may be nearing peak ■ US seen by co-founder as less important in world market

By Peter Smith in London and James Politi in New York

David Bonderman, veteran buyout chief and co-founder of Texas Pacific Group, has acknowledged that the private equity investment cycle may be approaching a peak but has hit back at critics who claim the industry is awash with too much cash chasing too few deals.

Mr Bonderman told the Financial Times that there were "vastly more opportunities" to invest than ever before, highlighting the potential of Asia and a broader variety of industrial sectors, including established technology groups.

His comments come shortly after TPG raised the world's largest buy-out fund of close to $15bn, consolidating the group's presence at the top of the private equity hierarchy alongside firms such as Blackstone, Carlyle and Kohlberg Kravis Roberts.

"The world capital base has grown much faster than private equity," he said, adding that even if private equity firms raised $300bn this year it only represented the market capitalisation of Microsoft or twice the market value of Google.

Private Equity Intelligence, the London-based business information group, says a record $283bn was raised last year by private equity firms, while an estimated 790 firms are on investor roadshows seeking to raise an aggregate $340bn.

Thomson Financial, the data provider, said private equity firms took part in transactions worth $297bn last year, a record level of deal-making. So far this year $272bn worth of deals have been announced.

The figures include deals where private equity groups team up with a company to buy an asset. However, Mr Bonder-man warned that the prices being paid for businesses could be near the peak. "We have been in an up-cycle for five years. I think we are now sometime late into the cycle."

His comments echo statements made in recent months by his peers in the private equity industry, who are seeking to reassure investors that the buy-out boom will not end in a painful bust. In an interview with the FT in January, George Roberts, co-founder of KKR, said: "We may be incorrect with our projections but we are not being reckless [with our investments]."

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>
> DAVID BONDERMAN
> BUY-OUT VETERAN

Mr Bonderman also highlighted the US market's relatively less important role in the world market. "In 1985, more than 80 per cent of all private equity was in the US. Fast forward to 2005 and the US is only about 40 per cent and Europe is about the same size." Asia now accounted for 35 per cent of world gross domestic product, compared with a quarter each for the US and Europe, he said.

"Over time, our business will begin to follow GDP. Our business should be based where the economics are," he said. "I have been in this business for 25 years and it has always been said too much money was chasing too few deals. TPG has among the strongest international network of any of the large buy-out groups, with 10 offices in seven countries."