BLACKSTONED

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Contents

Preface

When Blackstone listed itself less than a year ago, it was one of a raft of deals that Wall Street likened to the investment opportunity of a lifetime. For the first time ever, public investors were being given a chance to stash their money alongside Steve Schwarzman. What a disappointment this has turned out to be.

Since going public in June, the company's shareholders have lost half their investment. Meanwhile, the managers that sold stock in the IPO, such as founders Pete Peterson and Schwarzman, walked away with hundreds of millions of dollars.

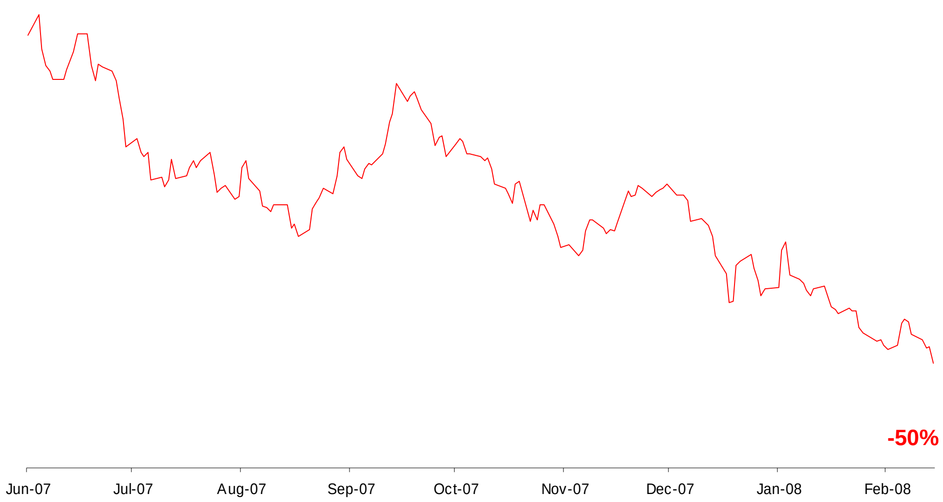
Leading up to the offering, breakingviews wasn't shy in pointing out that Blackstone pushed the limits – with governance, price, and its statement in going public. After all, the company listed after years of cataloguing the reasons companies perform better in private. The $31 offer price valued the firm at a significant premium to other financial institutions. It took just a couple of months before it slipped below breakingviews' $21 a share target price. And investors, who are now sobered by their losses, have non-voting shares with no say. How could this have happened?

This is the breakingviews Blackstone saga.

Rob Cox and Lauren Silva
breakingviews.com

March 2008

Blackstone share price June 22 2007 to present



The benefits of going public

By Rob Cox

Context news: *Blackstone Group, the private equity fund manager and advisory firm, is preparing to file for an initial public offering in the next couple of weeks, according to CNBC. The firm, founded by Stephen Schwarzman and Pete Peterson, has chosen Citigroup and Lehman Brothers to manage the offering, according to a WSJ.com report. Schwarzman reportedly owns about 40% of the equity of Blackstone's management company.*

Blackstone declined to comment.

According to the firm's website, Blackstone manages $28bn in private equity funds, $13bn in real estate funds, and another $23bn in hedge funds, distressed debt and other investment management vehicles. The firm also has a boutique that advises companies on mergers, financing and bankruptcy restructuring.

Considered view: When Blackstone boss Steve Schwarzman makes the case for private equity, he catalogues the reasons why companies perform better when working for his buyout shop than for public shareholders. So it's ironic that Schwarzman may now be considering an initial public offering of the firm he co-founded 22 years ago. A Blackstone IPO would probably pave the wave for other buyout firms to float. Given the booming conditions in this industry, it's probably a good time to sell. Yet such an action is hard to square with Schwarzman's public stance on the benefits of going private.

Buyout barons want to persuade the managers of large public companies to flee the public markets. They argue that companies under their control are not tied up with regulations. Senior executives don't have to waste precious hours complying with cumbersome regulations like Sarbanes-Oxley,

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which Schwarzman has called "the best thing that's happened to our business". Then there are financial inducements to take their firms private - the opportunity for executives to make heaps more money without the embarrassing side-effect of Securities and Exchange Commission disclosure.

Buyout shops also pride themselves in running their companies with a long-term focus. That means their managers don't have to worry about what Schwarzman has dubbed "the tyranny of quarterly earnings". They can also skip all those tedious conference calls and road shows with the institutions and hedge funds that mark their own performance in three-month increments.

Schwarzman argues that this patient approach creates value for companies. Public "shareholders are not willing to put up with delayed gratification", he says. Buyout firms focus on the cash flows their companies produce. These are a more relevant measure of investment returns than earnings per share, which can be manipulated through accounting sleight-of-hand.

Following this argument to its conclusion suggests that private equity firms should themselves remain private. So what benefit does the public market confer to Blackstone? In a word: liquidity. That is what the recent IPO of Fortress, a manager of hedge and private equity funds, showed. That firm's valuation, at 30% of assets under management, implies Blackstone's asset management arm is worth well in excess of $20bn. Throw in its advisory businesses and Schwarzman's personal stake could be $8bn. What's more he can cash in some of these gains, without losing control of his firm. For that he has the public markets to thank.

Published 16 March 2007

Blackstoned

By Rob Cox and Lauren Silva

Context news: *The Blackstone Group, a private equity fund started by Steve Schwarzman and Pete Peterson, filed a prospectus on March 21 to issue public securities. Blackstone follows the lead of Fortress, another private equity and hedge fund group that went public earlier this year.*

The IPO will be structured as a master limited partnership, a type of public equity structure where owners of the securities hold units instead of shares. Schwarzman and other members of senior management will be converting their private ownership stake into public units. The private equity firm plans on raising $4bn in the IPO.

Morgan Stanley and Citigroup are the lead underwriters. Merrill Lynch, Credit Suisse, Lehman Brothers, and Deutsche Bank are all acting as joint book-running managers of the deal.

Considered view: What's Blackstone worth? In reality, the answer is whatever investors caught up in their fervour to own a slice of the leader in the hottest sector of the financial services business will be willing to pay for it. But the firm's IPO filing for the first time offers a roadmap for a more measured valuation approach. Something close to about $25bn looks about right.

The firm founded by Stephen Schwarzman and Pete Peterson last year reported net income of $2.3bn from managing a bevy of alternative asset vehicles and advising companies on deals. On Goldman Sachs's multiple of 10.7 times last year's earnings, Blackstone would be worth $24.6bn.

But wait a second, is Goldman really the right comparison? Goldman's business is, to be sure, far more diversified than Blackstone's. It is a leader in advisory, as well as in capital markets and trading. But, like Blackstone, a lot of Goldman's

revenues are derived from placing bets with its capital and are difficult to predict.

So in that respect, the multiple of earnings shouldn't be all that dissimilar. If anything, one could argue that because Goldman shareholders at least have a say in voting for directors and on other important matters related to strategy they should be given a premium. Blackstone's unit-holders will have no voting rights whatsoever.

But let's look at Blackstone another way, by valuing its three separate income streams. Advisory revenues and management fees on the funds it oversees are pretty predictable, so they probably deserve a higher multiple. Blackstone reported $1.1bn in these revenues last year and tallied up expenses of $553m. That's a pre-tax profit of $567m. On a generous multiple of 18 times, that would deliver some $10.2bn of value.

The real juice for Blackstone's bottom line, however, comes from its slice of profits on the funds it manages - typically around 20%. Last year, Blackstone generated an amazing $1.73bn of this so-called "carried interest". The question, however, is how investors should value these earnings. After all, they are volatile. In the 2002 downturn, Blackstone reported net losses on its investments of some $440m.

So it only seems fair to give these profits a much lower multiple than the steadier fees that come from the management and advisory businesses. At nine times, around half of the multiple, last year's carried interest might be worth about $15bn. Combined with the other revenues, that values Blackstone at about $26bn. That's also, coincidentally, 33% of its assets under management - bang in line with the way investors have priced Fortress, a rival hedge and private equity fund operator which went public in February.

But the real value of Blackstone - the first major private equity leader to go public - will be whatever investors bid the stock at.

And in this liquidity-mad environment, that could mean the sky is the limit.

Published 22 March 2007

A different kind of company

By Edward Chancellor

Context news: *Blackstone's prospectus for its initial public offering suggests that it will be "a different kind of public company".*

The private equity firm promises:

- *Management with a long-term perspective*
- *Continued focus on limited partner investors in investment funds*
- *Use of leverage to enhance returns*
- *Partnership management structure*
- *No golden parachutes/CEO compensation*

Considered view: Blackstone is experiencing Google-like growth. And, like the internet giant, the private equity firm promises to be a "different kind of public company". But whereas Google swore not to be evil, Blackstone has a rather less novel idea.

Blackstone boss Steve Schwarzman has been accused of inconsistency for extolling the benefits of taking companies private while planning to take his own baby public. But he has a plan. For a start, the public Blackstone won't pay any attention to quarterly earnings expectations. Instead, it promises a "long-term perspective". Schwarzman also believes that continuing to focus on the interests of customers - the limited partners in its funds - will be in the best interest of shareholders.

The firm plans to retain its partnership structure which, Blackstone claims, has been the source of its past success. It will adopt a holding company structure, with outside investors buying "units" rather than shares. But since they will have little say on what goes on at Blackstone, the structure will worsen the "agency problem" - the separation of ownership from management – that Schwarzman has so loudly complained about in the past.

This combination of a long-term focus on generating returns with management independence from shareholder pressure doesn't sound particularly novel. In fact, it's rather similar to Berkshire Hathaway under Warren Buffett. But Schwarzman will do something that Buffett won't. Blackstone intends to "use leverage to enhance returns", boosting its debt to equity ratio up to four to one. Since Blackstone's earnings already derive from companies loaded down with debt, that's a huge amount of leverage.

The prospectus warns that "the risk of loss associated with a leveraged entity is generally greater than for companies with comparatively less debt." Schwarzman and his partners didn't get rich worrying about the dangers of debt. Now they're hoping prospective investors will be similarly unconcerned. Given Blackstone's extraordinary growth rate - revenues are up fivefold since 2002 - that's a safe bet.

Published 22 March 2007

History repeats itself

By Lauren Silva

Context news: *Blackstone, the private equity firm founded by Steve Schwarzman, is in the midst of taking the leveraged buyout firm to the public market. Blackstone is offering units, not shares, which will give shareholders fewer voting rights than* *in a typical public company.*

Narragansett Capital, a private equity firm run by Arthur Little was a public private equity firm over twenty years ago. It went public in 1960. In 1984, the firm's management team tried to take the company private. That deal was thwarted after Ben Stein, a vocal shareholder with only 100 shares, objected the deal.

Considered view: Blackstone envy is spreading like wildfire. The private equity firm's IPO looks set to make its founder Steve Schwarzman a billionaire eight times over. But before rivals follow suit, they should brush up on a little history. The tribulations of Narragansett Capital, a formerly listed LBO firm run by financier Arthur Little, provide an instructive tale about the challenges private equity firms face in the fishbowl of the public marketplace.

Narragansett Capital first listed shares in the 1960s. But in the early 1980s, Narragansett's management team, some of whom later founded Providence Equity, became frustrated with the niggling hassles that accompany public ownership. Chief among them was the need to manage earnings, an especially difficult task when, like Blackstone, your business model is predicated on producing long-term above-market returns.

Narragansett was governed by the Investment Advisers Act of 1940, which required Narragansett to go through strict compliance rigmarole when acquiring companies. Little was quoted at the time saying these regulations were "a noose which gets tighter and tighter". So Narragansett's principals launched a deal to take the firm private. Though they were thwarted in these efforts by, eek, a dissident shareholder, they eventually sold the firm to Monarch Capital and its assets were liquidated. Jonathan Nelson, one of its leading lights, is now Providence's chief.

Now, there are important differences between Narragansett and today's LBO funds. Blackstone, for example, isn't structured as a "40 Act" company. But the irony shouldn't be lost on those considering whether to list shares in their buyout funds. Little's frustrations of 20 years ago sound eerily familiar to those voiced by chief executives today about the Sarbanes-Oxley act.

Indeed, the motivations for taking Narragansett private in the 1980s mirror the ones Blackstone's founder Steve Schwarzman cites when pitching his services to public company bosses. He says the regulations of public ownership can be burdensome and executives become slaves to quarterly earnings pressures. Amazing how quickly such sympathies can melt away at the prospect of becoming a mega-billionaire.

Published 11 June 2007

A Netscape moment

By Lauren Silva and Rob Cox

Context news: *Shares of private equity giant Blackstone jumped 13% in their debut. On June 21 shares were priced at $31, and traded between $35 and $37. Fortress, another alternative asset manager that listed shares in February, jumped 68% in its debut.*

Private equity firm KKR has also decided to push forward on a public offering. The private equity fund founded by Henry Kravis has hired Morgan Stanley and Citigroup to work on its IPO.

Considered view: Blackstone's debut may not look like another Netscape moment for the private equity industry. After all, shares of Steve Schwarzman's buyout shop popped just 13% on their debut. The internet browser that kicked off the dotcom boom in 1995 doubled. Even Fortress, a smaller rival to Blackstone, saw a 68% surge on its premiere.

But like the Netscape IPO, Blackstone's $7.1bn share sale - including a chunk sold to China - is the clearest sign yet that investors have suspended their disbelief when judging the private equity boom. The $39bn value they have put on Blackstone ignores significant headwinds the firm, and the industry as a whole, face. KKR's willingness to follow Blackstone into the public markets suggests investors will be willing to look at the glass half full for some time to come.

Sure, there are differences between a Netscape and a Blackstone. The former was a novelty at the time - the first large internet company to go public. Shares were hard to value. The firm had no profits and only $17m in revenue. But not unlike the arguments in favour of buying Blackstone, investors were promised an irresistible growth story. And Netscape's hugely successful IPO opened the flood gates for other dotcom listings. Investors sorely regretted most of those purchases.

Investors are valuing Blackstone at more than 30 times historic pro-forma earnings because they believe they are not only sustainable, but beatable. They have not factored in threats to the industry's exploitation of tax loopholes, which may be worth 20% of profits; the fact that compensation costs at Blackstone will rise over time. On June 22, Democratic Congressmen introduced a bill that would tax carried interest at the income tax rate rather than capital gains tax rate.

Nor have investors seemed to factor in macro-economics, such as the effect rising credit spreads will have on LBOs. Investors in Netscape did the same thing. It worked for a while. And then it didn't.

Published 22 June 2007

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You can't fool the public

By Lauren Silva

Context news: *Blackstone’s shares have dropped below their initial public offering price just minutes into the third day of trading, according to Bloomberg. The private equity firm’s stock, which priced on June 21 at $31 a share and started trading on June 22, closed at $30.75.*

Earlier in the day, the private equity firm sold an additional 20m shares worth $620m. The order was filled as part of the greenshoe, or shares set aside in case investor demand is strong. Over $230m raised from the greenshoe went to Steve Schwarzman.

Considered view: It didn't take long for Blackstone's public investors to realise the real value of the private equity firm. Just minutes into its third trading day, its stock dropped below the offer price of $31 a share. This isn't surprising. Founder Steve Schwarzman pushed the envelope in every way.

First, he went public just as a tax bill began circulating in Congress that could lop billions off Blackstone's value. He also gave shareholders skimpy voting rights, something that was sure to make the shares trade at a discount to fair value. And the stock always looked expensive. The offering valued Blackstone at an earnings multiple nearly three times bigger than what the market awards Goldman Sachs. In fact, a close look at Blackstone's numbers reveals that the private equity giant may actually be worth a third less than the $35bn implied in its offer price.

Despite this, Schwarzman's underwriters exercised their greenshoe over-allotment option, issuing an additional 20m shares, just this morning. Schwarzman's chunk of the proceeds from that issue comes to about $230m.

The stock's decline shouldn't surprise investors who bothered to read the fine print in Blackstone's prospectus. But those who only looked for a ride on the reputation of Schwarzman and his firm may have more disappointing days to come.

Published 26 June 2007

Luck or genius?

By Lauren Silva and Richard Beales

Context news: *Since Blackstone went public, its shares have fallen about 20%. Carlyle has postponed its planned public offering. Questions have also been raised over the IPO plans of Kohlberg Kravis Roberts, which first filed to go public in early July.*

Considered view: Steve Schwarzman has come in for a lot of stick lately. Some of his private equity peers blame him for jeopardizing their advantaged tax status with conspicuous consumption and the aggressive structural features of Blackstone's recent public offering. And investors in the offering are certainly feeling pain too, with the shares off about 20% in little more than two months.

But the Blackstone founder certainly has done something right. He took the firm public just before a sharp turn in the credit markets, which has, in effect, halted the leveraged buyout industry. With that bit of fancy timing, he's single-handedly trumped competitors like Carlyle and Kohlberg Kravis Roberts, who may have to shelve their own IPO plans in a very unpromising equity market.

This certainly makes Blackstone's managers look more on the ball than peers. But to date, Schwarzman and his minions have been the only ones to benefit. He cashed in about $675m-worth of shares in the IPO, a stake that would now be worth about

$130m less. Meanwhile, the Chinese investment group that bought nearly a 10% interest in the private equity firm is reeling from a huge loss.

Over time, however, Blackstone will probably be at an advantage if its competitors don't manage to get out into the public market. That is not to say things will be easy in the short term. With debt markets less compliant, tougher times loom for the buyout industry even if markets stabilise. And there are still lingering issues from its IPO, such as rising compensation costs and the threat of higher private equity taxes - something Blackstone concedes could hit its market value further. Despite investors' inability to dictate anything to Blackstone's bosses given their lack of a shareholder vote that could give Blackstone some uncomfortable moments.

But crucially, Schwarzman et al, unlike their competitors, now have a currency to help them grow the private equity firm, both in its core business and beyond. Its premium stock price - it still fetches a richer multiple of earnings than financial groups such as Goldman Sachs - will certainly be a plus. Blackstone's shareholders could soon start clamouring for Schwarzman to take advantage of that. With the buyout industry facing headwinds, it could be the only way they will see a profit on their investment any time soon.

Published 23 August 2007

Living on borrowed time

By Lauren Silva

Context news: *Steve Schwarzman turns 61 on February 14.*

Considered view: Rod Stewart probably won’t perform at Steve Schwarzman’s 61st birthday party. The sexagenarian rocker, who headlined at the Blackstone boss’s 60th birthday bacchanal, is beginning a tour in the Antipodes next weekend. But Stewart wouldn't be the ideal headliner anyway. Barry Manilow's "We live on borrowed time" would capture the zeitgeist of Schwarzman's year better than Stewart's "Some guys have all the luck".

Last year at this time Schwarzman was on a roll. Blackstone was buying Equity Office Properties, then the largest LBO ever. The firm was prepping its public stock offering, which would take place in June. And the buyout industry was in a state of euphoria. Private equity firms break deal-size records for months to come.

But this year Schwarzman's birthday may be a more sombre affair. Blackstone's stock has lost over 40% of its value since the firm went public. Its shareholders have lost as much or more money than those who stuck with battered Merrill Lynch or Bear Stearns. They may be in for worse. Blackstone has unveiled only one buyout larger than $1bn since the end of the third quarter. And it has only offloaded one small portfolio company, according to Dealogic. Its fourth-quarter earnings will likely suffer. With buyout lending in the doldrums, Blackstone's dry spell could well continue for some time. Blackstone's troubles aren't different from those of other private equity firms. But it is one of the few in the public-market spotlight.

Despite the fallout from last year's party, Schwarzman was probably wise to enjoy himself when the times were good. After all, as Manilow sings, "No one can be sure when the loan will finally come due. But I'm loving all of mine, I know what time is for, I've borrowed it so I can spend it all right here with you."

Published 13 February 2008

Moving the goal posts

By Lauren Silva

Context news: *Blackstone's fourth quarter economic net income, the private equity firm's preferred earnings metric, declined to $88m, or eight cents a share, compared to $234m, or 21 cents a share in the previous quarter. Analysts were expecting around 20 cents a share, according to Bloomberg.*

The firm's private equity division wrote down several portfolio companies, resulting in negative revenue of $15m, compared to revenue of $227m in the previous quarter. Revenue in Blackstone's real estate division increased to $113m versus $109m in the previous quarter. Revenue in the marketable alternative asset management division rose 43% to $178.2m. Revenue in the advisory business rose 7% to $90.6m.

Assets under management rose to $102bn at end 2007, a 47% increase from a year earlier but only a 4% increase during the fourth quarter.

Stephen Schwarzman, chief executive, referred to a "meltdown" in credit markets and said: "Difficult market conditions in the US and Europe continue in 2008 and there is little visibility on when these conditions might improve."

Considered view: Blackstone went public last June at $31 a share. The stock has since lost more than half its value. The coming year could bring more pain if Blackstone's fourth quarter earnings are any indication. The company's shareholders need to reset their expectations.

Analysts underestimated the effects of the credit crunch on Blackstone's fourth quarter. They thought the firm's "economic net income", Blackstone's preferred measure of profits, would be about 20 cents a share. It came in at 8 cents a share.

Shareholders lopped another few percent off the stock price, which was already below $15.

The firm's management fees in its two largest divisions – private equity and real estate – were flat to down last quarter. It also took a $142m write-down in performance fees versus a $151m gain in the previous quarter, a reflection of lower valuations for its portfolio companies.

The outlook hardly looks promising, either. Blackstone hasn't closed a single deal over $2bn in size since the beginning of the year. Transaction fees, which made up a quarter of the company's total private equity and real estate revenues in 2007, will probably decline. Moreover, further stock market falls could make it still harder to offload portfolio companies at a profit and prompt further write-downs in Blackstone's portfolio.

In short, the credit crunch has changed the buyout world, and Blackstone's earnings show just how much. Blackstone's stock looked expensive when it went public. The majority of analysts think it now looks cheap. The problem is that buyout firms are operating in a far tougher environment than even a pessimist could have considered possible in the middle of 2007.

Of course, there are some glimmers of hope. Blackstone's hedge fund and advisory businesses are growing. But these two divisions are still small compared to Blackstone's core buyout activities - they only made up about a third of total revenue in 2007. Blackstone's growth still depends on buyouts. It has money to invest, but pretty much everything else is working against it. That suggests 2008 could be a barren year. The tough new realities suggest that investors shouldn't view the stock as a bargain.

Published 10 March 2008

A (fictional) letter from Stephen Schwarzman on the proposed LBO of Blackstone Group

By Edward Chancellor

1 June 2012

The Blackstone Group
345 Park Avenue,
New York NY 10154

Ladies and Gentlemen:

I am, together with my general partners and funds managed by our firm, pleased to propose to acquire, for a purchase price of $15 in cash per unit, all of the outstanding common units, representing limited partners' interests in Blackstone Group L.P. (the "Group"). Our offer to acquire the Chinese government's minority stake in the Group for the same price has already been accepted. Our proposal provides a substantial premium for all of the Group's common unit holders. If this offer is accepted, Blackstone Group will de-list from the New York Stock Exchange ("NYSE").

Conditions in our business have not been easy in the five years since we first issued securities on the NYSE. To many unit holders, who bought into the initial public offering and are now sitting on a large capital loss, that may seem like an understatement. Yet although we have made our share of mistakes, the substantial decline in the value of Blackstone's securities is largely a result of factors beyond our control.

Looking back over this difficult period, most of our problems can be ascribed to deteriorating economic conditions; extraordinary convulsions in the credit markets; a worsening political and legal environment for the buyout industry; and the consequences of what is now commonly referred to as the "private equity bubble". I will briefly examine each of these issues in turn.

1. The Macro-Economic Climate: When Blackstone came to the market in the summer of 2007, economic conditions were remarkably benign. Most economists agree that the decision by Congress to impose punitive tariffs on Chinese imports during the first year of the Clinton administration represented a turning point. Since that date, consumer price inflation has returned to levels not witnessed for two decades. Both nominal and real interest rates have soared as Asian savings were no longer recycled into dollar-denominated assets. These developments have had a negative impact on the prices of all long-dated assets. Our real estate business has been particularly badly hit by the collapse of property prices.

Blackstone, along with other private equity firms, was prepared for a downturn. We had hedged against a rise in interest rates. Weak covenants on many of our loans and the increased use of payment-in-kind notes provided a respite for many of our portfolio companies when the hard times began. However, the severity of the recession of 2010, which was statistically a three-standard deviation event, was worse than our models had anticipated. Even though we have experienced only a handful of bankruptcies among our companies, many of the survivors are currently valued by the market at less than we paid for them.

2. The Credit Market Crisis: You will all be familiar with the convulsions of the credit markets in recent years. During the buyout boom, loans to finance LBOs were available in seemingly limitless quantities and risk premiums were absurdly low. This was largely a consequence of the recycling of Asian savings and innovations in the credit markets.

In those days, hedge funds had a stupendous appetite for leveraged loans which were bundled into securities, such as collateralized debt obligations. This market had never been stress-tested by a recession. During the late financial crisis,

however, many credit hedge funds blew up.

Since then, the rating agencies have become stricter in their ratings of CDOs. As a result, the market for securitizations of corporate loans has contracted. Furthermore, commercial banks are now wary of our industry after several of them experienced sizeable losses on their bridge loans to LBOs. Today credit is less available and risk premiums on leveraged loans have risen - permanently, I fear.

3. The Buyout Backlash: By early 2007, it was clear that the rapid growth of private equity was inciting a wave of public opposition in both the US and Europe. That is why our industry established the Private Equity Council in Washington to explain our case. At the time, I personally expended much time and effort educating the media on this subject.

I wish our efforts had been more successful. Since 2007 two tax changes have hurt our industry's profitability. Several countries in Europe, including Germany, have followed Denmark's lead in removing the tax deductibility of interest payments for leveraged buyouts. Although the US did not follow, the Internal Revenue Service has succeeded in forcing a change in the tax treatment of private equity's performance fees (known as the "carried interest"). Previously, the carried interest was taxed at the capital gains tax rate of 15%. After this tax loophole was closed, these fees have been taxed at the corporate rate. This change wiped nearly 20% off our 2008 earnings.

The buyout backlash worsened after the recession, which was accompanied by bankruptcies at several high profile LBOs. During the Senate hearings into the private equity industry, the dismal performance of many buyout funds, especially the 2006 and 2007 vintages, came under scrutiny. The fees charged by private equity firms were also widely criticized in the light of losses experienced by many pension funds. It is scarcely an exaggeration to say that private equity has become the scapegoat for all our economic woes. The upshot was that public pension plans have been forbidden by federal law from making any further buyout investments. This has been a serious blow. Up to that date, public pensions accounted for around 40% of Blackstone's investor base.

4. The "Private Equity Bubble": The entire buyout industry, including Blackstone, must accept its share of responsibility for our current woes. At the time of our IPO, corporate valuations and profits had for several years been rising in tandem. This created a golden age for buyouts. With hindsight, it's clear that we became overconfident.

At the time, too much private equity money was chasing too few opportunities. We found it difficult to resist the urge to raise ever larger funds. And we put that money to work too quickly. In the takeover frenzy, many private equity firms became overstretched. There was a collective loss of investment discipline. Too many businesses were bought at large premiums when profits were approaching a cyclical peak. Given the fees on offer and the ease of flipping assets only months after acquiring them, our behaviour is understandable.

Not only have corporate valuations substantially declined, it has become more difficult to exit from LBOs. Blackstone's own success in rapidly cashing out of its $39bn investments in Equity Office Properties back in early 2007, encouraged others to pursue even bigger targets. Since the IPO market has been closed these past years, many private equity firms, including Blackstone, have been stuck with their mega-cap acquisitions.

When competition heated up during the "bubble" period, private equity firms were also driven into buying more cyclical businesses. The dramatic failure of Freescale Semiconductor, in which Blackstone was a minority investor, provides a cautionary tale against the dangers of putting too much debt on companies with volatile earnings streams. Furthermore, in order to boost returns, we piled too much debt onto companies.

Personally, I blame the banks which towards the end of the boom would offer to lend more than we estimated the businesses were worth. Still, had macro-economic conditions remained favourable, these investments would have proved extremely profitable. Alas, that has not been the case.

Finally, I would like to comment briefly on Blackstone's own performance over the past five years. Although our recent investment record is disappointing by historic standards, Blackstone has retained its position among the top quartile of private equity firms. We have also experienced fewer bankruptcies pro rata than our competitors.

Despite recent losses, I am pleased to say that Blackstone has substantially outperformed the Dow Jones Private Equity Index, which comprises around a dozen firms, including Apollo, Carlyle, Macquarie, and TPG, as well as a number of listed buyout funds. Nevertheless, we believe the market substantially undervalues our business. At the time of our IPO, Blackstone was valued at nearly 50% of assets under management. Today, it commands a small premium to traditional investment firms.

Although the private equity industry will never again be as profitable as it was a few years back, I believe opportunities remain. But our historic business model of leverage-and-flip no longer works. As Cerberus has shown with its successful investment in Chrysler, private equity really can add value when it tackles difficult situations. At Blackstone, we intend to roll up our sleeves and work harder in future.

However, we now view the stock market listing as a distraction. Although we have eschewed providing guidance to analysts, the quarterly Wall Street reviews have hampered our ability to take a long-term view with our investments. Activist investors have demanded that we change the status of our listed "units" into normal shares, with voting and other traditional rights accorded to shareholders.

This is not acceptable to us. Nor can we comply with the demands by our Chinese minority investors for senior management changes. Instead, my partners and I are offering to purchase all the Group's outstanding common units. Although the offer is well below the flotation price, it represents a substantial premium to where the securities have traded lately.

Of course, no binding obligation on the part of the undersigned or the Group shall arise with respect to the proposal or any transaction unless and until a definitive agreement satisfactory to us and recommended by the Special Committee and approved by the Board of Directors is executed and delivered.

We look forward to discussing our proposal with you further in the near future.

Very truly yours,
Stephen Schwarzman

Published 13 June 2007

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