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Executives Hedge Their Own IPOs

Stakeholders Borrow
To Pay Themselves
Pre-Sale Dividends

By KATE KELLY
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Private-equity and hedge-fund executives have found a way to get windfalls before their companies even go public, potentially cushioning their losses if the value of their ownership stakes eventually falls on the open market.

Here is how it works: Wall Street's investment banks loan these private firms significant sums of cash as the companies consider initial public offerings of shares. The loan money then is used to pay fat dividends to top stakeholders, typically senior executives in the companies, and can be paid down later with IPO proceeds or management fees and the like.

- **The Issue:** Private-equity and hedge-fund executives have found a way to use their ownership stakes to get cash windfalls before their companies go public.
- **Background:** These payments will cushion losses for these executives if their shares later fall in the open market.
- **Behind the Scenes:** Wall Street firms, keen to win lucrative investment-banking assignments, are taking on more risk. If a firm that takes a dividend decides not to go public, it could take years for the loan extended to pay the dividend to be paid back.



This upfront payment allows the company's owners an early opportunity to parlay their equity stakes into cash. If their company's stock falls after the public offering, they already have benefited from some of their holdings, potentially mitigating their losses. Often, top executives in companies are prohibited from selling for a certain period after a public offering. So, an early dividend frees up some money beforehand -- a bit like getting a bonus before the year starts, reducing the risk of a lower bonus if your performance tanks.

Executives at Apollo Management, which is moving toward a \$1.5 billion private sale of 10% of the private-equity firm and considering

a public offering later this year, are among those looking to get a dividend, according to people familiar with the matter. Bankers at **J.P. Morgan Chase & Co.**, which is representing Apollo, have spent recent weeks trying to persuade other Wall Street firms to help provide Apollo with a \$1 billion loan, these people say. The loan would be used to fund a pre-offering dividend to Apollo's top executives, including founder Leon Black, who owns about half the company. A spokesman for Apollo declined to comment.

Last year, **Fortress Investment Group**, the New York money manager that recently became the first U.S. hedge fund to sell shares in an IPO, borrowed \$750 million from a consortium of lenders, freeing up \$250 million that it put toward a dividend to five key executives in the process. Blackstone Group, which announced plans late last month to undertake a roughly \$4 billion IPO by selling a 10% stake of the company, is also contemplating a similar dividend, according to people familiar with the matter.

Banks' willingness to lend money for such dividends, even before a company's offering is a sure thing, is a testament to the growing clout of private money managers on Wall Street, where hedge funds and private-equity firms contribute ever-larger portions of firms' investment-banking fees. Securities firms are keen to loan the money, as they hope it will help them win lucrative underwriting business down the road.

The dividends can have a downside. Investors considering buying the stock of these newly public companies may become leery about the additional debt, say investment bankers, and that could end up lowering the initial price of the shares. If the offering doesn't come together as planned, the money manager may have to pay down the debt with revenue from other sources. A shelved IPO could also be bad news for the lenders, which may have to wait years to get their money back. And

some people say the move by some of Wall Street's shrewdest players to lock in their profits quickly is also a sign these firms may not be a good buy.

"Smart people sell when they think they're overvalued," says Steve Kaplan, a finance professor at the University of Chicago's graduate school of business who teaches private equity. "Here, they can borrow in order to pay themselves a dividend because I'm sure they have management fees locked in for a while, so they're able to pay off the loan. But why they want to do it so quickly and lock it in, suggests that they're overvalued."

Not everyone agrees. While "some investors may balk at the large distributions the principals have given themselves, we note that each of the 5 principals [at Fortress] created this firm from 'scratch' and continue to own a majority of it," Bank of America Corp. research analyst Michael Hecht wrote in a recent research note. He has a "buy" rating on the firm.

These early dividends -- which some money managers consider to be part of the normal cash distributions to their principal players -- are ripped from the traditional private-equity playbook. Companies taken private by firms such as Apollo often borrow money to pay dividends to their owners before going public again, a way of returning cash immediately to the private-equity firms. On Wall Street, these are sometimes known as a "midnight dividend" because the dividend is often paid out just before the IPO.

Fortress, whose successful offering of approximately \$600 million in early February is regarded as a bellwether deal in the money-management industry, paid out hundreds of millions in dividends before its offering. Last June, Fortress borrowed \$750 million from a group of banks that included a number of the underwriters of its eventual IPO, according to people familiar with the matter.

According to regulatory filings, \$250 million of the June loan was used to pay out a cash "distribution" that same year to Fortress's five principal shareholders, including Chairman and Chief Executive Wesley Edens. In total, they received about \$600 million more before the offering from other sources. They then paid down \$250 million of the June bank loan by using proceeds from the IPO.

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