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Goldman Finds Investing for Itself Rewarding

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Private equity has paid off handsomely for [Henry M. Paulson Jr.](#), the former chief executive of [Goldman Sachs](#).

For the last two years, Mr. Paulson, now the Treasury secretary, has banked \$24 million in investment returns from lucrative partnerships made available to top Goldman executives. The sudden flowering of these investments — last year, Mr. Paulson's return was \$12.7 million, according to the firm's 2006 proxy — signals vividly how Goldman's growing private-equity business has been gushing profits not only for the firm's executives, but also for the investment bank as a whole.

The rush of investment banks to replicate the Goldman model — using internal private-equity funds as a profit stream and as a means to fertilize its investment banking and asset management businesses — is the latest example of copycat economics on Wall Street.

Fees from the traditional business of advising companies on underwritings and mergers have been squeezed by corporate clients who have become less beholden to their investment bankers.

Private equity, on the other hand, whose essence is investing directly in companies, selling for a profit and inviting select clients along for the ride, has become the most mercenary, and right now the most popular, of Wall Street fads.

Last week, [Merrill Lynch](#), a firm that until recently had no principal investment business to speak of, said private-equity profits significantly buoyed its second-quarter results. That new push was underlined by its stake in this week's \$31.6 billion buyout of the hospital chain [HCA](#), the biggest private-equity deal to date.

At [Morgan Stanley](#), the chief executive, [John J. Mack](#), has scrambled to rebuild the private-equity business that the firm spun off not long ago.

“Investment banking has become a loss leader for the principal investments area,” said Richard J. Barrett, a former top investment banker at Credit Suisse First Boston. “The name of the game is principal investments, including private equity.”

But this relentless focus on the bottom line, or being “long-term greedy” in Goldman parlance, has exposed fault lines between its relationship bankers, who owe fidelity to

their blue-chip roster of corporate clients, and its private-equity bankers, whose first priority is the multibillion-dollar funds they manage.

At Goldman, this evolution from a business oriented toward advisory work to one focused on using its own money to make money has already manifested itself in its leadership. For decades, an investment banker has either been sharing power at the firm, running it or making a run for the top slot. Now, with the departure of Mr. Paulson, a lifelong relationship banker, Lloyd C. Blankfein, the chief executive, and his two top deputies on the Goldman board all hail from the trading side. While John S. Weinberg, an investment banker, was recently named vice chairman, he was not awarded a board seat.

Goldman Sachs now manages more than \$20 billion in private-equity funds and is currently raising capital for a 13th fund — one that has the potential, given today's exuberance, of surpassing the record \$15 billion recently raised by the Blackstone Group. According to research by Sanford C. Bernstein & Company, Goldman's private-equity business accounted for 8 percent of Goldman's pretax earnings, a contribution to the bottom line that no other investment bank on Wall Street can match. (The firm does not break out detailed numbers relating to its private-equity business.)

The man behind Goldman's private-equity business is Richard A. Friedman, who has run the business since 1991. Unlike such private-equity barons as Henry R. Kravis, Stephen A. Schwarzman of Blackstone and David M. Rubenstein of the Carlyle Group, all billionaires who enjoy the public fruits of their high positions, Mr. Friedman, in the Goldman tradition, prefers a backstage role.

Goldman officials declined to comment for this article.

Goldman's rivals are quick to criticize the firm for putting its own interests ahead of those of clients — always without attribution, it should be said. Underlying these criticisms is a sentiment not often nakedly expressed on Wall Street: envy. A senior executive from a rival firm, discussing Goldman's investment in Sumitomo Mitsui, the Japanese bank, in which its \$1 billion commitment in 2003 has grown to \$4.7 billion, once expressed wonder at the beauty of that deal.

Indeed there is much to be envious about. According to the Bernstein report, Goldman private equity earned \$679 million in pretax profit last year — \$375 million of it investment banking fees from the firm's own deals. The margins on the business are rich as well: 50 percent according to Bernstein, a level far exceeding the firm's overall margin.

Last year, nearly \$4 billion was returned to investors — including pension funds, well-heeled clients and employees at the firm — in the Goldman funds.

To be sure, there have been some lean years for Goldman Sachs private equity, including a troublesome foray into technology investments during the 1990's bubble.

And for the firm, minefields abound. Not only must Goldman avoid antagonizing its corporate clients, the firm also does not want to alienate clients like Kohlberg Kravis Roberts, Blackstone and other big private-equity firms that each pay out nearly \$700 million a year in fees to investment bankers.

“I’m amazed that Goldman has been able to walk this very thin line between investment banking and merchant banking,” said Brad Hintz, a Bernstein analyst and the author of the report. “And the fact that Merrill is imitating Goldman tells you that the Goldman model was right.”

It is a precarious straddle. Through July of this year, Goldman’s buyout division ranked second in revenue, behind the Apollo Management of Leon Black, but surpassing Kohlberg Kravis and Blackstone. At the same time, the firm placed second — to [J. P. Morgan](#) Chase — in fees generated from servicing those very same firms, according to Dealogic.

This year, the firm’s merchant bankers in Europe stepped away from a deal with BAA, operator of Heathrow and Gatwick Airports in London, when the interests of its bankers and investors clashed. In June, citing the rich price, Goldman withdrew from a consortium bidding for Univision; that bid competed against Televisa, a long-term corporate client of Goldman, and Kohlberg Kravis, a primary buyout client. This spring, Goldman was a lead manager of a public offering of a Kohlberg Kravis fund in Amsterdam.

Goldman executives sometimes refer to such friction as factory accidents: they are to be avoided at all possible costs, but are also an unavoidable result of the complexities of their business operation. And just as a profitable factory would not close after a worker sustains an injury, neither should Goldman shut its lucrative moneymaking apparatus just because the firm, on occasion, finds itself in a conflict.

One investment banker who competes frequently with Goldman put the debate over conflicts this way: At Goldman, they like conflicts, because the more conflicts there are, the more business there is.

Take the recent management-led buyout of [Kinder Morgan](#) by a group of investors including Goldman Sachs. Goldman is a principal investor, and an adviser. The arrangement is called controlling the deal and it has become the ne plus ultra in banking confections on Wall Street. Such deals are referred to as triple plays — fees come from investing and advising as well as from financing debt.

For Mr. Friedman, 53, the ride has been a good one.

Leo J. Hindery Jr., the former telecommunications executive who served with Mr. Friedman on the board of the YES Network, the cable station for the New York Yankees and a Goldman holding, sees Mr. Friedman, known within the firm for his love of

basketball, as cut from the same cloth as a past generation of Goldman principal investors.

“They will haul him out of there dead,” said Mr. Hindery, who calls the lanky Mr. Friedman a frustrated power forward.

“He talks about Gus Levy and L. Jay Tenenbaum in reverential terms,” he said, referring to legends from Goldman’s past.

But, just as investment bankers like John L. Thornton, the former president, and Gene T. Sykes, the media deal maker, defined the Goldman relationship banker who offers discreet advice to corporate executives, Mr. Friedman and his growing family of funds have given color to a darker-hued picture of the Goldman banker. One where the emphasis can at times be on what the client can do for Goldman, as opposed to what Goldman can do for the client.