Is Blackstone Setting a Bridge Too Far?

The Equity Office Deal Uses Loan Strategy That Prompts Memory of Federated Fiasco

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Remember the Federated Department Stores disaster? The Wall Street bankers financing Blackstone Group's $36 billion takeover of **Equity Office Properties** seem to have forgotten this sobering lesson.

In the late 1980s, First Boston handed the then-princely sum of $1.2 billion to an eccentric Canadian businessman, Robert Campeau, who was buying Federated. The money was provided as a bridge loan, which First Boston planned to pass on to other financial institutions. That proved more difficult than expected and the bank ended up holding a chunk of the debt. When Federated went bust in 1990, First Boston was forced to sell itself to Credit Suisse.

The Federated debacle hasn't scared bankers off from bridge financing. In today's leveraged-buyout frenzy, they have even taken the risk up a notch or two. Consider how **Goldman Sachs Group**, **Bank of America** and **Bear Stearns** are backing Blackstone. The Equity Office buyout will consist of $29.6 billion of debt and $3.2 billion from Blackstone. The final $3.5 billion comes as an "equity bridge" from the lenders.

This provides temporary funds for Blackstone to take out Equity Office stockholders. But unlike an old-fashioned bridge loan, the lenders are getting equity in exchange for their loans. That puts them at the bottom of the capital structure, which makes them highly vulnerable in the event of a bankruptcy. The equity bridge closely resembles what on Wall Street is called a block trade. That's when an investment bank on behalf of a client takes an equity position in a public company that it hopes to quickly offload in the public markets. In the Equity Office case, the firms plan to sell the $3.5 billion block of equity to other LBO firms and hedge funds.

But this deal is much more dangerous than a conventional block trade. The providers of the equity bridge run the risk that demand for illiquid private equity investments will dry up or that the highly leveraged Equity Office runs into problems. As Federated demonstrated, large bridge loans for buyouts can produce ruinous losses when market conditions change.

So why would the banks take on such risk? For the same reason First Boston did -- the fees. It received over $125 million in fees from Federated. At the time, First Boston's leading deal-maker, Bruce Wasserstein, hailed a new era of investment banking. Blackstone's backers prefer not to talk. Given the vast spoils on offer, it's understandable why Goldman, Bear and Bank of America are risking their shareholders' capital. But this is a hot potato they have to pass on before the music stops.

Outsourcing CEOs

Infosys, the Indian outsourcing titan, has a number of cost advantages over its U.S. competitors. But its greatest cost benefit may lie at the top of the company. **Infosys**, which this past week

kicked off a $1.6 billion secondary offering on Nasdaq, pays its chairman and chief executive $100,000 each and its highest paid top manager $250,000. That's peanuts compared with Infosys' U.S. counterparts.

Though software contracting isn't a particularly highly paid industry, two of Infosys' American competitors, **Accenture** and **Electronic Data Systems**, paid their top managers $6.1 million and $8.7 million, respectively, in 2005. Shareholders don't get extra value for money when paying top dollar for U.S. managers. Infosys' competitors are perfectly decent companies, but Infosys' two top managers, Narayana Murthy and Nandan Nilekani, are giants of the industry who founded the company in 1978 and have built it to a $29 billion market value. Admittedly they also own enough Infosys shares to be worth $1 billion or so, but other senior managers at Infosys don't get paid a fortune, either.

In the U.S., the average Fortune 500 CEO is paid more than 400 times as much as the average employee. Shareholders also bear the cost of the myriad senior vice presidents who clutter U.S. corporations -- many of whom receive 100 times an average worker's wages. With such overpaid bureaucracies, top management remuneration in U.S. companies is often an important fraction of total wage costs.

Harvard professor Lucian Bebchuk, a critic of executive compensation trends, calculates that senior managers receive up to 10% of after-tax profits in any single year. On this arithmetic, companies could save as much by outsourcing 100 top management jobs to India as by eliminating 10,000 workers. But America's club of corporate executives won't be looking too closely at this form of outsourcing.

Wii Shall Overcome

Sony and **Microsoft** are battling to put their PlayStation 3 and Xbox 360 videogame consoles under Christmas trees. At stake is the right to lock consumers into buying highly profitable games for years to come. But their focus on technological one-upmanship could leave smaller rival **Nintendo** on top.

Both machines are more supercomputer than toy. They are costly to design and build. Microsoft, for example, has never made a profit on selling Xboxes. Unfortunately, it has never recouped enough from selling games to make up for the losses. **Sony** loses as much as $300 on each PlayStation 3. The cost of components will fall over time. But so will the price of the consoles.

Smaller Nintendo can't afford this arms race. So it has opted out. Its new Wii console doesn't even support high-definition graphics. If you're a hardcore gamer who loves seeing blood spatter in 3D, this isn't the machine for you.

This has forced Nintendo to focus on a different class of customer, such as children and retirees with time on their hands. The Wii is only half the price of the PlayStation 3. Its games also tend to be nonviolent, more intuitive to play and original.

While Nintendo's strategy may be dictated by economic necessity, shareholders have no reason to complain. It hasn't lost money in a decade. Moreover, the stock has doubled in the past year -- wildly outperforming **Sony** and Microsoft. Going after the kids and grandma can be far more profitable than a technological arms race for game geeks.