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Financial

DEALMAKERS Terence O'Hara

### **Carlyle Increases Its Interest in Debt Deals**

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Carlyle Group, among the biggest buyers of private companies, is busily expanding its corporate loan operation.

The Washington firm built its reputation as a buyer in leveraged deals, investing some of its own money and borrowing the rest. The other side of the coin in those deals has always been debt, and the banks and specialized lenders that finance the acquisitions are in many ways the back-seat partners to the Carlyles of the world.

Now Carlyle is making a bid to become a major player in the debt side of the buyout world as well, with some new funds to invest in and originate corporate, high-yield debt, including loans to finance buyouts.

Carlyle's interest in debt is not new. It has had a high-yield debt investment operation for six years, focusing mostly on junk bonds and high-yield senior bank debt, said Michael J. Zupon, the Carlyle managing director who runs its leveraged finance group, which includes most of Carlyle's corporate debt-related investment funds. All told, the leveraged finance group has eight funds managing about \$3 billion. In the past year, however, Carlyle has gone from being an investor in existing corporate high-yield loans to a direct originator of them.

According to a Securities and Exchange Commission filing, Carlyle Mezzanine Partners LP this fall raised about \$100 million of a planned \$400 million fund from 34 investors. Though that was the first public record indicating that Carlyle was raising new money in its leveraged finance group, industry sources say Carlyle is raising money for a broad array of debt-related investments, including a "credit hedge fund" and a fund to buy debt of troubled companies.

(Carlyle is also raising its fourth U.S. buyout fund, according to sources outside the firm. With a target of \$5 billion, it would be its biggest fund. But that's another story. Christopher W. Ullman, a Carlyle spokesman, declined to comment on any aspect of the company's fundraising.)

In private equity circles, and within the company, there has been a great deal of speculation about the broader strategy at work with these new debt-related funds.

Carlyle invests other people's money and relatively little of its own. Its investment vehicles are funded by limited partners, mostly institutional and wealthy individual investors. The firm itself, led and owned, mostly, by Daniel A. D'Aniello, William E. Conway Jr. and David M. Rubenstein, its three senior partners, makes its money from management fees and its cut of any gains that are realized. In the buyout business, firms typically, though by no means universally, make a recurring management fee of 2 percent of the value of a fund, and get a 20 percent cut of any realized return.

Carlyle has been systematically diversifying both its investments and investors in the past five years. Carlyle has its core corporate buyout business, plus a real estate investment arm and a venture capital group, all of which invest in the United States and abroad. The growth of its corporate debt business is considered the latest push to make Carlyle one of the only integrated large private equity firms, with enough diversification to even out the lumpy returns inherent in investing in private companies.

In part because of its diversification strategy, Carlyle, with more than \$18 billion under management, is widely considered in the industry as the best candidate for an initial public offering. Public-company investors like steady returns, not lumpy ones.

Ullman said there are no plans for an IPO. Rubenstein has said in the past that "someday" one of the several large, privately held buyout firms will go public, a statement industry observers and many people at Carlyle have interpreted as his preference for Carlyle. An IPO would have the benefit, for Rubenstein and his co-founders, of turning their stake into cash without selling the firm.

Zupon, who is based in New York, said he has hired seven people in the past year to get the mezzanine loan unit going, including several senior people from Trust Company of the West's mezzanine group. Mezzanine loans are typically used to finance leveraged buyouts of mid-size private companies. Such loans can be highly profitable but carry far more risk than a standard secured commercial loan. Some of Carlyle's biggest competitors in the business are local, Allied Capital Corp. and CapitalSource Inc., among them.

Zupon joined Carlyle in 1999. He ran part of Merrill Lynch's high-yield loan and bond underwriting business and has spent most of his career in the high-yield debt market for a number of commercial and investment banks.

Carlyle's credit hedge fund, which will make investments in a variety of debt instruments, is run by Zupon and his high-yield bond team; Carlyle is looking to hire someone to lead that effort.

Zupon's distressed-debt team has six people, most hired in the past year. The distressed-debt fund, called Carlyle Strategic Partners, buys corporate debt of troubled companies, including those in default.

Zupon said Carlyle has some inherent advantages over its competitors in the debt markets. First, it's a big firm, with more than 300 investment professionals, many of whom have deep experience in the industries in which Zupon invests. During down periods in the commercial lending markets, he said, the leveraged finance group relies on Carlyle's own experts to help it price the risk and identify undervalued loans to buy.

"In the credit market, the top performers are those that avoid problems," he said. "I think Carlyle has an advantage."

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