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Crony Reform

How the access capitalists at the Carlyle Group became real businessmen.
By Daniel Gross
Posted Tuesday, April 15, 2003, at 1:43 PM PT

Ever since Michael Lewis coined the term "access capitalist" in his 1993 *New Republic* cover story on the Carlyle Group, the Washington-based private equity firm has stood as a shining example of how connections and favors can trump business experience and skills. Staffed almost entirely by ex-government officials and investing primarily in defense companies that derived most of their revenues from government contracts, the Carlyle Group for much of its existence occupied a dismal niche—a cranny inhospitable to democracy, fairness, and free enterprise. *The Iron Triangle*, journalist Dan Briody's brisk new book about Carlyle, details many of the unsavory deals that had been the group's specialty.

But in recent years—though it's gone largely unnoticed, even in Briody's comprehensive treatment—Carlyle has transformed itself. Fueled in part by profits from its defense-related deals, Carlyle has gone mainstream. Today, just 15 percent of its $15.8 billion under management is invested in defense and aerospace. And with a new chairman—former IBM CEO Louis Gerstner replaced the shadowy former CIA hand and Defense Secretary Frank Carlucci last January—and a portfolio of everything from real estate to high-yield bonds, Carlyle is starting to resemble a regular old money-management firm.

Carlyle got its start in the late 1980s, when David Rubenstein, a former Carter White House aide, and Stephen Norris, a former Marriott executive, figured out a way to profit by peddling tax losses generated by Alaskan Eskimo businesses to other U.S. companies. For several years, Carlyle tried—and failed—to complete leveraged buyouts. The small firm, whose principals lacked significant Wall Street backgrounds, simply couldn't raise money in big chunks from institutional investors or close deals.

Carlyle founds its legs after former Reagan and Bush administration officials with close ties to the national security bureaucracies came aboard, among them longtime Republican apparatchik Fred Malek, Carlucci, and Bush I Secretary of State James Baker. (Amazingly, Richard Perle did not work for Carlyle.) Throughout the '90s, the firm concentrated mostly on purchasing companies that relied primarily upon Pentagon or government patronage for business. In doing so, Carlyle didn't face much competition from private equity firms like Kohlberg Kravis Roberts, or Thomas H. Lee, because defense is a realm where financial expertise is a distant second to contacts.

Carlyle's desire to play in the incestuous world of politics, national security, and lobbying led to several embarrassments. Soon after it bought airline services company Caterair, and placed George W. Bush on the board, that company cratered. One Carlyle-owned firm—Vinnell—employed former special-operations troops to train the Saudi military.

After executing a few successful defense-related leveraged buyouts, Carlyle got its hands on more cash in the early- and mid-1990s. This gusher helped lay the groundwork for Carlyle's transformation. The niche in which Carlyle had a competitive advantage—defense and aerospace—wasn't big enough for Carlyle to put all its new funds to work. And in the pre-9/11 world—where defense spending seemed destined to fall rather than rise—diversification took on a greater logic.

The biggest change at Carlyle in recent years has been in personnel. The firm now employs some real, live businessmen, people whose careers can be easily described rather than explained with a grimace. In January, Gerstner, who led IBM's storied turnaround in the '90s and who has never held a government post, replaced Carlucci as chairman. (Gerstner spends 20 percent of his time with Carlyle.) In February, Daniel Akerson, the former head of XO Communications, joined as a managing director. And the ex-government officials Carlyle has brought in recently—former Securities and Exchange Commission Arthur Levitt Jr. and former Federal Communications Commission Chairman William Kennard—possess useful industry knowledge.

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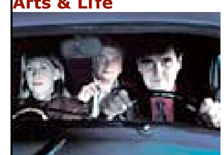
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Carlyle, which historically shunned publicity, also has a new attitude. The company is rolling out a new Web site and hired its first in-house publicist: the earnest and highly effective Chris Ullman, who was Levitt's flack at the SEC. "We're bringing glasnost to the Carlyle Group," he says.

Most significantly, however, Carlyle has a new business model. No longer just a merchant bank that brokers deals and spends its own cash, Carlyle is turning into a more stable—and more respectable—asset-management company. With 500 employees in offices around the globe, Carlyle now runs some 23 funds, focusing on everything from Asian venture capital to high-yield debt. It has opened up certain funds to investors willing to plunk down as little as $250,000, and it counts as investors the sort of do-gooder institutional firms that supply the life-blood of private equity: the California Public Employees Retirement Systems and the Communications Workers of America, to name two.

Carlyle now has the personnel, the track record, and the critical mass to chase all kinds of deals, not merely access gigs. And so, with the exception of a recently announced agreement to purchase Fiat's aerospace division, Carlyle's recent transactions closely resemble those of your garden-variety private equity shop. In March, for example, Carlyle agreed to acquire Breed Technologies, which makes auto parts, and a portfolio of Italian real-estate properties sold in a public auction. Last January, it teamed up with other investors to buy Casema, the largest cable TV operator in the Netherlands, for about $700 million. In 2002, it banded together with Welsh, Carson, Anderson & Stowe, to purchase Qwest Communications' Yellow Page directories business for $7.05 billion—the second-largest buyout in U.S. history.

The past occasionally intrudes on Carlyle's present. After 9/11, it came out that the Bin Laden family had invested in Carlyle funds. And Carlyle certainly benefits from the fact that it keeps George H.W. Bush on its payroll and that many of its principals have close ties to the Bush administration. The difference is that, today, trading on favors and relationships is a part of Carlyle's business, not the whole thing.

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