INVESTMENT BANKING

TOO CLOSE FOR COMFORT

Investors are finally starting to ask awkward questions about the cozy world of partnerships

ENRON & BEYOND

In 1999, Merrill Lynch & Co. landed the job of raising nearly $400 million from wealthy individuals and institutions for LJM2, one of Enron Corp.'s 3,000 special-purpose entities and partnerships. As a display of its faith in the deal, Merrill put in $5 million of its own cash, and about 100 of its executives plowed in another $16 million of personal money.

Conflict of interest? No way, says Merrill. Just business as usual on Wall Street. And indeed it is—or was. For years, investment banks have created off-balance-sheet partnerships containing trillions in debt and assets for thousands of respected U.S. companies. Banks and their execs also routinely invest in them.

That's no problem from the bankers' point of view. Everyone has a crack at making big bucks, they say. Pension funds should feel better about the investments when bankers put their money where their mouths are. And the companies remember who their true friends are when they next hand out lucrative work.

Indeed, the practice is considered so routine that Merrill's $5 million investment in LJM2 was too small to merit scrutiny by the bank's entire executive committee, according to Merrill. And the beauty of it all is that the details of the deals can pretty much remain between friends, since private equity escapes all of the rules requiring public disclosure.

Enron is just one example of this enormously profitable but extremely secretive business. Since 1999, Wall Street has raised $34.9 billion for private partnerships, estimates Thomson Financial. Investment banks have helped companies ranging from Vivendi Universal to General Motors Corp., which disclosed on Feb. 25 that it has $136 billion in assets tied up in special-purpose entities. Lehman Brothers Inc. accounting analyst Robert Willens estimates that 400 of the companies in the Standard & Poor's 500-stock index use private partnerships, and that banks have invested in those of about 40 companies. In and of itself, the practice isn't illegal or a violation of accounting rules.

The partnership business allows investment bankers to make money several ways. First, they earn a fee if they create the partnership. When they sell stakes to investors, they earn commissions of 1% to 2% of what they raise. And if they themselves invest, they get the prospective positive return on the investment.

Now, though, the cozy environment that keeps the partnership machine humming has suddenly gotten chilly. Enron's maneuverings in its maze of partnerships are being blamed for destroying the company—and public shareholders' investments, including billions in retirement savings. Even institutional shareholders in Enron's private partnerships are now skeptical that the banks were investing simply to get good returns. "You can't help but wonder if Merrill agreed to handle Enron's private-placement issue to get more underwriting business," says one institutional shareholder. Merrill says it just wanted to win the private placement assignment.

That suspicion is likely to make partnerships a much tougher sell. "We will scrutinize private equity investments a lot more closely in the future," warns Bill A. Shirron, executive director of the State of Arkansas Teacher Retirement System that committed $30 million to LJM2.

Now, Washington is probing the partnership business. Enron executives have told Congress that four banks invested in its partnerships to get an inside line on future financing jobs. On Mar. 6, the House Energy & Commerce Committee sent letters to 10 major investment banks—Merrill Lynch, J.P. Morgan Chase, Credit Suisse First Boston, Citigroup, Morgan Stanley, and Goldman Sachs, among others—demanding documents related to Enron's partnerships.

So far, it's unclear what will happen with the partnerships. Whatever the outcome, the banks are in a bind. LJM1 and LJM2—the partnerships banks mainly invested in—could be consolidated into bankrupt Enron because Chief Financial Officer Andrew Fastow was the general partner of both. In that case, the bankruptcy court judge could force LJM2 investors to return earnings from transactions

THE PARTNERSHIP MACHINE

- Since 1999, investment banks have raised **$35 billion** for private partnerships. They do not disclose such deals, but insiders say they invest in 10% to 50% of the partnerships they sell to pension funds and foundations.
- Experts estimate that **400 S&P 500 companies** have used limited partnerships, or special purpose entities, to move debt off their balance sheets.
- **Investment banks** are extensive users of limited partnerships to move trades and investments off their own balance sheets, say insiders.

PROFITABLE LINKS

Wall Street firms that invested in Enron partnerships snared plenty of its banking business

	LJM Investments Total Amounts MILLIONS	Percentage of Enron M&A advisory assignments since 1999	Value of Enron stocks and bonds underwriting since 1999 BILLIONS
CSFB	$22.5	44.9%	$1.0
CITIGROUP	15	0	2.2
JPM CHASE	15	11.7	0
MERRILL	22	1.5	0.9

Data: Thomson Financial, company reports

worth as much as $100 million. LJM1 would suffer minimal damage since it has been closed.

But if the bankruptcy court leaves them alone, the banks could face a worse public relations problem because some of the partnerships could ultimately make money for wealthy bankers. Portland (Ore.)-based energy consultant Robert McCullough of McCullough Research has closely examined the assets tied up in Enron's partnerships. He argues that in the best case scenario, LJM1, which held 3.7 million Enron shares, would post a 1,719% return—or some $291 million—on an investment of $15 million for the two banks involved: CSFB and NatWest, now the Royal Bank of Scotland. That assumes LJM1 sold its shares at the stock's all-time high of $88 in September, 2000. In the worst case, he says the banks still made an 86% return of $29.8 million because filings imply that LJM1 cashed in more than enough Enron shares to pay off $100 million in investments and debt commitments.

So far, LJM2 limited partners, who say they were led to believe they could expect returns of 25% to 30%, have gotten back 85% of their capital. And many expect the partnership's assets will barely pay off LJM2's $70 million in debt and other claims. But McCullough thinks investors could get at least a 4.9% return on the roughly $244 million they actually invested. He concedes that LJM2 may have to write off equity stakes it holds in several other partnerships. But he believes valuable assets such as a telecom joint venture will more than offset those losses. "This is enormously better than any situation anyone would expect," he says.

Of course, pension funds, which owned 22% of LJM2, would also do well. All the same, some of them are on the warpath. Their complaint: Wall Street knew Enron's partnerships were endangering the company, kept silent about it, and continued to allow their equity analysts to issue strong buy recommendations on Enron stock. They charge that the banks abetted Enron because it was such a lucrative source of business, hiding behind their Chinese wall, which forbids investment banks from sharing inside information on clients with equity analysts. Some legal experts like Professor John C. Coffee at Columbia Law School argue that investment banks should be required to withdraw their research analysts' buy recommendations if they become aware of information that is strongly inconsistent. Otherwise, the retail investor will always end up the sucker.

One reason investment banks are so comfortable with the partnership game is that they're big users of limited partnerships themselves, according to industry insiders. Although brokerages are legally required to disclose the off-balance-sheet vehicles they use to securitize credit-card receivables and mortgages, they are mum on private partnerships. And that is frustrating analysts and rating agencies. "What's important is not just off-balance-sheet assets but the on-balance-sheet credit risk they may create," says Amy S. Butte, securities industry analyst at Bear, Stearns Cos. "Incremental disclosure would help the process."

Some investment banks are already reconsidering the way they operate. One major firm, which asked not to be named for competitive reasons, has stopped investing in the private partnerships of companies it advises to avoid conflicts of interest. The bank, says an executive, sees the risk to its reputation as more of a problem than the potential loss of fees. "If firms are serious about regaining faith, they have to take steps themselves before regulations force them," says a senior banker at another firm.

For now, Wall Street may be prepared to indulge in some soul-searching about partnerships. But it's money, not necessarily good intentions, that makes Wall Street go round. The real test of its sincerity will come during the next boom. Once the money comes back and investors stop agonizing over their losses, the deal rooms may again be filled with the purring of the partnership machine.

By Emily Thornton in New York, with Wendy Zellner in Dallas

DID CalPERS BEND ITS OWN STANDARDS?

For years, the California Public Employees' Retirement System (CalPERS)has staked out the moral high ground by calling companies to task for cronyism, conflicts of interest, and rubber-stamp boards.

But lately, CalPERS own image has been challenged. It was a big investor in Enron Corp.'s off-balance-sheet partnerships. CalPERS has said that "a core of Enron executives deceived everyone—from the individual investor to many sophisticated investors." On Feb. 21, CalPERS called for such reforms as a commission on financial conflict of interests. Yet, documents *BusinessWeek* obtained by a state open-records request show CalPERS had its own conflicts of interest with Enron.

The documents show the role that Pacific Corporate Group (PCG), a La Jolla (Calif.) investment adviser, played in steering the fund to commit more than $750 million to Enron partnerships. PCG provided what would have been independent advice on investments for CalPERS, yet it effectively earned commissions when some deals closed. Some of the money came from Enron—by agreement of all three parties. CalPERS says the arrangement, which was legal, was a way to get more from consultants but was abandoned in 2000. "There are no perfect fee structures," says Michael Flaherman, chairman of CalPERS' investment committee. "We've changed [them] multiple times since that deal was done." PCG officials wouldn't comment, citing client confidentiality.

Still, the documents shed light on the relationships between large U.S. pension funds and their lightly regulated advisers. These 200-odd gate-keepers are supposed to give impartial advice on investments and managers but often play conflicting roles.

In 1989, PCG, a well-regarded 35-person firm run by Christopher Bower, an accountant by training, started picking investment managers for CalPERS—for $295,000 a year. PCG brought its first Enron deal in 1993: a $500 million natural gas partnership called Joint Energy Development Investments (JEDI I). CalPERS took 50%. PCG got $375,000 when the deal closed and $375,000 per year for monitoring it, all paid by CalPERS. It also stood to get a multimillion-dollar payout if the investment hit its benchmark, which it didn't.

The fund's advisers got fees from an Enron partnership for recommending the deal

CalPERS' SACRAMENTO HQ

In 1997, CalPERS asked PCG to look at Enron Energy Services, a retail energy unit, and the $1 billion JEDI II fund. PCG stood to gain $750,000 if either deal went through and $375,000 if neither did. But this time, the Enron affiliates, not CalPERS, paid the fees. CalPERS pledged $500 million for JEDI II but invested only $175 million.

Other fund managers and consultants say such a fee structure was highly unusual. Flaherman says the idea was to motivate PCG to find new investment ideas. "One would want to give them an incentive to beat the bushes," which a flat advisory fee didn't do, Flaherman says. "Otherwise, we'd end up paying them to sit in their bathrobes." But for the past two years, the fund has used a pool of firms and has kept the initial investment review and the continuing work separate.

PCG did flag a big problem with LJM3, a partnership to be run by Enron Chief Financial Officer Andrew Fastow. It got paid only for assessing LJM3, which never got off the ground. It noted that CalPERS risked a PR disaster by buying into a partnership headed by a public company executive that bought its assets from that company. "As a champion of activist corporate governance," reads the PCG assessment, "CalPERS should be prepared to address its participation in a fund that utilizes such fiduciary duality." But it did recommend the investment.

What did CalPERS earn on PCG's three Enron deals? It made $132 million on the first, broke even on the second, and lost $37 million on the third. Net gain: $91 million. But CalPERS lost $105 million on Enron stocks and bonds. PCG also led the fund to a $500 million gain in a partnership with Comcast Corp. PCG now manages a $500 million fund for CalPERS that invests directly in private deals.

Ultimately, CalPERS' relationship with PCG might have been profitable. But as the fund urges the financial world to root out conflict of interests, it would be helpful if it would share its own experiences wrestling with this devil.

By Christopher Palmeri and Ronald Grover in Los Angeles