Hedge Funds Grab for Cash In Attempt To Stop Blowout

by Paul Gallagher and Rainer Apel

The global leveraged takeover bubble of hedge funds and private equity funds may begin to explode this month in your living room, especially if you live in Manhattan or in Dresden. Two large private-equity takeover schemes speculating on the price of housing—one based in New York, the other in Germany—are threatening to blow up, one on the markets for junk bonds, the other in an IPO on the New York and Frankfurt stock markets. Both schemes, in addition to the prospect that they could fall apart and start a default chain in the huge global bubble of takeover debt, also represent the worst operations of the hedge and private equity funds as financial predators—"locusts" as they are often called in Germany.

The big IPO (initial public offering, or sale of stock on the exchange) of Fortress Investment Group LLC is occurring on Feb. 8 on the Wall Street and Frankfurt stock exchanges. This IPO, a means to get stock investors to put something like $650 million in new capital into Fortress, is based on that hedge fund's large-scale holdings of apartments in German cities, which it has bought up from city governments or, in some cases, from real estate firms. Fortress owns 110,000 apartments in Berlin, 47,000 in Dresden, 165,000 in Germany as a whole. Other hedge funds like Cerberus, and private equity firms like Terra Firma, have been doing the same thing since 2004. All in all, some 600,000 apartments have been privatized, while 3.3 million (the residences of about 10 million Germans) remain owned by city and state governments and other public groups and entities.

The Fortress Investment Group LLC, with $30 billion assets in its latest public claim (its declarations have been marked by sudden and mysterious changes in its statements of those assets) is run almost entirely by former bankers of the Lehman Brothers and Goldman Sachs Wall Street investment banks. Three of the top five of those executives have previously been principals of Black Rock Partners, the private equity firm behind the takeover of middle-class housing in Manhattan. And several of them have working links to UBS AG, the Swiss-based bank that lends to predatory takeovers worldwide, including those of the well-known "vulture capitalist" Wilbur Ross. They're quite a group. But a very large amount of Fortress's investments has been put into it by pension funds.

The underwriter on the Fortress IPO is Goldman Sachs, and the co-managers are Lehman Brothers, Bank of America, Citigroup, and Deutsche Bank. Fortress's prospectus tells investors that its German subsidiary, GAGFAH, owns $4.9 billion of assets, primarily German commercial real estate leased to high-credit quality tenants. We focus on assets that are underpinned by stable, long-term cash flows with an upside potential, they claim.

But the truth? Fortress is a notorious "locust" hedge fund in Germany. The impoverished eastern German city of Dresden sold it all the 48,000 apartments the city owned for $1.2 billion, despite a petition against the sale by 45,000 tenants! Fortress had to sign agreements restricting rent increases and evictions, even for the apartments below market rent rates. Real estate conditions are more than bleak in Dresden, which has a 15% official unemployment rate and 40,000 vacant housing units. Many residents are paying no rent, because they have no significant income. Fortress cannot dump or resell three-quarters of the apartments in Dresden, without breaking a contract which also bars turning them into condos.

None of these facts are disclosed in Fortress's IPO prospectus.

The outrageous thing about the Fortress IPO, is that for it, the "value" or market price of the apartments Fortress owns in Germany is calculated as 17.4 times the gross annual rent

that tenants pay for the apartments. This is an almost unheard-of rent multiple. By contrast, apartments in New York City have a price-to-annual-rent multiple of 8-9 up to 12 at the highest.

Given that Fortress is, in fact, unlikely to get out of these and the whole 165,000 apartments in Germany without losses, its hoped-for $650 million IPO looks like a plan to bring in new investors to pay the debt charges of the previous investors' capital: the basic Ponzi-type scheme.

There is a pattern of these hedge funds, after a massive 2006 binge of leveraged buyouts and takeovers, which have created $3-4 bank debt for every dollar they invested, to want to issue stock. Previously supposed to be exclusively for wealthy and sophisticated capital investors, they are now "going downmarket," to get new cash from millions of smaller investors and, of course, more pension funds.

Superdeal To Become a Super Train Wreck

In a huge real-estate leveraged takeover in New York City, more than 12,000 apartments of Peter Cooper Village and Stuyvesant Town, the only remaining middle-class housing in Manhattan's hyperpriced real estate market, were bought up in October 2006 by Tischman Speyer Realty and the private equity fund Black Rock Partners, which manages over $1 trillion in speculative capital. Black Rock was the real estate speculating unit of the private equity fund giant Blackstone, started by the former Lehman Brothers chairman and protégé of George Shultz, Peter Peterson. Black Rock has since merged with a Merrill Lynch unit and with PNC bank. These Manhattan apartment communities had been famous for more than 60 years for both quality and controlled rents, until the MetLife insurance firm sold them to Tischman Speyer and Black Rock, without consulting the New York City government which had financed their construction, in partnership with MetLife, in the 1940s, for returning GIs and their families.

In three months, by January, rents in about 2,000 of these apartments had been raised by up to 33%. Why? Because so much debt, known as "leverage," was taken on in the $5.4 billion buyup of Stuyvesant Town and Cooper Village, that the deal assumed big rent increases to pay that debt. It was generally recognized in the real estate sector, that "the deal would be a train wreck" without significantly higher rents. The deal violated a 1992 New York State law which prohibited owners from removing apartments from under rent control without municipal approval. Now, lawsuits in the State Supreme Court may undo the buyout entirely; more likely, if they block the wave of rent increases which Black Rock and Tischman planned, this real estate "megadeal" will blow up in a leveraged debt default.

Hedge Funds Threaten Global System

These are only two among most recent excesses that make the case for a ban of such fund activities. Sparked by weeks-long political campaigning of the LaRouche Youth Movement in Germany, during the first months of 2005, the urgency of "action against hedge and equity funds" has been at the center of heated public debates, especially after Franz Müntefering, then-chairman of the Social Democratic Party, attacked the funds as "locusts": Ever since, the funds have been called that, in the debate. Another prominent Social Democrat, past Chancellor Helmut Schmidt, called for "control of the new speculators" in a widely read essay, published by the weekly *Die Zeit* on Feb. 1. Characterizing the funds, especially because of their aggressive market conduct and their hyper-leveraged borrowings, as a threat to the global financial system, Schmidt urged legislation for a total ban on loans to such funds.

The German government has, just recently, invested more energy into its July 2005, initiative (first launched by then-Chancellor Gerhard Schröder) at the Group of Eight, for increased "transparency" of the funds. Schröder's initiative was instantly blocked by British Prime Minister Tony Blair and U.S. President George W. Bush, and when Germany's present Chancellor, Angela Merkel, took office in November 2005, the initiative was slowed down for almost a year. Several spectacular defaults of locust funds towards the end of 2006 (MAN Group, Amaranth, and others) did spark, however, a rapid return to the hedge fund control initiative.

In an interview summarized by the German business daily *Handelsblatt,* on Feb. 6 (three days before a meeting of the G-8 finance ministers in Essen, Germany), Thomas Mirow, Assistant Finance Minister, said that it was urgent to get a realistic assessment of the risks posed by locust funds for the global financial system. The excessive multi-leveraged indebtedness of funds is reason for concern about the stability of the global financial system, Mirow said, elaborating that the government's initiative, to be presented at the June 6-8 summit of the G-8 in Heiligendamm, Germany, focusses on two main steps: 1) Getting an overview of which big banks and funds have lent money to hedge funds, and how much. This is important, to know which banks could be hit first, by defaults of hedge funds; and 2) Getting an overview of the scope of hedge fund investments in industrial firms, to know

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which firms could be affected by hedge fund crises. The overview, as well as the one mentioned earlier, is to be arranged with the central banks, maybe in cooperation with a special agency, but on a voluntary basis for the time being.

Insiders to the funds sector have welcomed that initiative as a first step, but have also pointed out that it is "too timid" to have any effect on the multi-leveraged debt structures that the funds have created. A spokesman for a Frankfurt-based, traditional equity fund that stays out of the leveraged loan branch, told *EIR* on Feb. 5 that the market situation has been so distorted by locust funds, that in case one of them defaulted, its own managers and the bankers that provided them with loans, might not even know what the gravity of the default was. Banks might find themselves pulled down by the default of a fund they were not even aware of as a borrower of their money.

LaRouche: 'What You Have Is Madness'

Economist Lyndon H. LaRouche, renowned for his precise assessments, commented on the issue on Feb. 6, saying, "What you have, is game-players outside the banks themselves, who are using bank money for these kinds of operations, and once the banks turn loose this credit, you have another group of players who are orchestrating the whole damn thing, and they're the ones who may know, or may not—if they're playing so recklessly, they may really not know; they may have fragmented the thing so that they have their own people bidding against each other. So therefore, they really do not have effective centralized control. What you have is madness, a madness of a bubble, like a John Law bubble,* in spades. And no one really knows. If they tell you they know, they're either stupid or lying to you."

And that is why simple "transparency" of the kind which the German government wants to achieve, will not work with the insane funds. There is, as LaRouche has pointed out again and again, no remedy to this madness within a system that is mad as a whole. A new approach, entirely new principles of issuing credits not for speculation, but for production, is required, and that starts with putting the volatile banks and funds into an orderly bankruptcy reorganization. Restoring control of the global finances, implies nothing less than a New Bretton Woods financial reorganization, of the kind which LaRouche has proposed.

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*John Law (1671-1729) was a Scottish financier and speculator who was named by French regent Philippe d'Orléans as France's Controller of General Finances in 1717. From this post, he introduced to France the use of paper money. Law had bought up the Mississipppi Company, to help support France's colony in Louisiana, selling shares to the company at extravagant prices. The company went through various mergers, including with the Royal Bank, emerging eventually as the Compagnie Perpetuelle des Indes, with a monopoly on maritime commerce. An explosion of speculation in the company's shares broke out in 1719, but the bubble crashed in 1720, losing 97% of its value by 1721. Law was fired from his job, fled France in disgrace, and died in poverty.