

# Lone Star's Splash

**Firm Is Flush and Ready to Shop**

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Lone Star Funds' \$6.7 billion dive into mortgage-backed assets dumped by **Merrill Lynch & Co.** shows how ready some investors are to move into this market when the pickings are right.

Last week, Lone Star closed its last wave of fund raising on two pools totaling \$10 billion -- finishing with \$7.5 billion in Lone Star Fund VI, the Dallas private-equity firm's biggest to date, and \$2.5 billion in the Lone Star Real Estate Fund, which will co-invest with the other new fund.

Within days, the firm was poised to seal its biggest deal yet.

The investment firm, run by 52-year-old John Grayken, a former associate of Texas billionaire Robert Bass, agreed to pay 22 cents on the dollar for a portfolio of collateralized debt obligations, complex debt products that originally were valued at \$30.6 billion. Lone Star's equity in the deal is \$1.675 billion.

## **Merrill Finances 75%**

Merrill is financing 75% of the transaction, leaving Lone Star with at least \$8 billion to go shopping. With similar financing, Lone Star could end up buying debt now valued at about \$32 billion and with a face value of more than \$145 billion.

What's more, Lone Star has a big appetite to jump at more deals like this one, according to a person familiar with the firm's plans.

Investors appear keen on trusting the investment firm's instincts. Originally, Lone Star hoped to raise a total of \$6.5 billion for its two youngest funds. The funds target a return of 25% a year, according to reports from investors.

The Merrill investment will be made out of Lone Star Fund VI, according to a person familiar with the transaction. The CDOs that Merrill is unloading are backed primarily by super-senior high-grade bonds. Merrill already had already written down their value to \$11.1 billion as of the end of the second quarter.

The securities firm has been beset by more than \$46 billion in write-downs since June 2007. Merrill also said Monday that it will sell \$8.5 billion in new common stock.

Lone Star, which has \$23 billion total in all of its funds, is showing that it is willing to tread where others won't. It has made other bets on assets affected by the housing slump and credit crunch. The firm has offices in New York, Tokyo and London, in addition to Dallas, and more than 900 employees.

The Texas firm recently acquired **CIT Group** Inc.'s mortgage business for \$1.5 billion, also assuming \$4.4 billion of debt in that deal. Lone Star also bought Bear Stearns's residential-mortgage business and paid \$295 million for Accredited Home Lenders Holding Co.

Lone Star CEO John Grayken (right) started out by buying chunks of companies facing financial stress, rehabilitating them and then selling them to other investors or listing them on stock exchanges. One of its first big deals was the purchase of the Shoney's restaurant chain. Recent acquisitions:



- \$6.7 billion of mortgage-backed assets from Merrill Lynch
- \$1.5 billion (\$4.4 billion of debt) CIT Group Inc.'s mortgage business
- \$295 million for Accredited Home Lenders Holding Co.
- Bear Stearns's residential-mortgage business

Lone Star has investors' money locked up and can take time to let risky assets mature. That means it can turn a tidy profit if even only a portion perform as originally expected.

"If there's anyone who has the risk appetite in this kind of environment, it is going to be the alternative-investment community," said Philippa Allen, a director at ComplianceAsia, which provides consulting services to the financial industry.

A Lone Star spokesman said Mr. Grayken wasn't available for comment.

Lone Star was founded in 1995, after Mr. Grayken developed his investment strategy while resolving bad debt during the savings-and-loan crisis in the 1980s. The fund has made a name for itself by buying chunks of companies facing financial stress, rehabilitating them and then selling them to other investors or listing them on stock exchanges.

Mr. Grayken grew up in Cohasset, Mass., a Boston suburb. He graduated from the University of Pennsylvania before earning an M.B.A. at Harvard Business School in 1982. He worked at Morgan Stanley before joining Mr. Bass.

One of Lone Star's first big deals was the purchase of Shoney's Inc., the restaurant chain that once operated the Big Boy franchise. Lone Star sold the restaurants after about five years. More recently the firm took over Lone Star Steakhouse & Saloon. It also owns Bi-Lo, a supermarket chain.

### Overseas Treks

Lone Star also has dabbled overseas. In 2001, it bought a small nationalized lender from the Japanese government for around \$400 million. It sold about a third of the bank, which it had renamed Tokyo Star Bank, to the public in 2005, raising almost twice what it paid. It then sold another portion to a hedge fund as part of a deal that was valued at more than \$2 billion.

It also bought hotels and golf courses in Japan as the country's prolonged real-estate recession presented opportunities in property-related businesses.

In South Korea, Lone Star made a splash by buying most of Korea Exchange Bank for about \$1.3 billion in 2003. Later, though, South Korean authorities questioned whether Lone Star executives had manipulated the stock prices of a credit-card company KEB bought after it was owned by the fund.

Lone Star is now negotiating a sale of its KEB stake to London-based **HSBC Holdings PLC** that could bring it a profit of as much as \$5 billion. The two sides have a self-imposed deadline of Thursday to reach a deal.