Chapter 1

Find the Money

Oregon to Abu Dhabi

From Steve Schwarzman's corner office 44 stories above Park Avenue, the northern landscape of New York City unfurls before you, Manhattan melting into the Bronx. It calls to mind the old cartoon, "The New Yorker's View of the World," where the details of the city quickly give way to everything else beyond. On a clear day, Schwarzman can see both the George Washington and Tappan Zee bridges as the Hudson River snakes northward. Looking west, he can peer deep into New Jersey. In both views he can also pick out a couple of his fiercest competitors and sometime collaborators. Henry Kravis's office is perched on the 42nd floor of a building on 57th Street, a 10-minute walk from Schwarzman. A five-minute stroll to the west is the Carlyle Group's New York office, its biggest outpost despite its Washington headquarters. When Carlyle co-founder David Rubenstein is in town, he sits on the 41st floor. A couple more avenues toward the Hudson, TPG's David

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Bonderman and Jim Coulter decamp 37 stories up when they're visiting from San Francisco.

This dozen square blocks in the middle of Manhattan is the undisputed home of the private-equity industry. Walk into just about any skyscraper along Park Avenue and the building's directory is bound to feature a handful of firms practicing leveraged buyouts or some variation thereof. This is where the moneymen ply their trade. At first glance, they are indistinguishable from the rest of the always-in-a-hurry New Yorkers of a certain stature, ferried about in black sedans, catching up and cutting deals over expense-account lunches at restaurants tucked into the towers.

The story of how the money flows really begins on the opposite side of the country, along U.S. Interstate 5. Dotted along the country's westernmost north-south highway, the only road to touch both Canada and Mexico, sits a handful of nondescript offices that have played a crucial role in the formation and the history of private equity. It's there where the journey begins, and what happens from there has profound consequences on the global economy and our individual livelihoods.

Any serious exploration of private equity has to start with the simple question: Where does the money come from? Money doesn't magically appear in private equity funds. Someone has to give it to them, and what buyout managers discovered over the past 30 to 40 years is that there are a lot of someones—pensions needing to pay their retirees, universities looking to grow their endowments, rich people looking to get richer, and foreign governments looking to diversify their state-run funds—willing to listen to their promise to turn money into more money. Lots more than they could get simply by plunking it in stocks or bonds. These are the so-called limited partners in private equity.

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Tigard, Oregon, is a suburb of Portland, about a 20-minute drive from downtown. The low-slung building that houses the offices of the state pension fund's investment division sits a couple of blocks from a sandwich shop called Big Town Hero, a local chain.

It was in a small conference room at the Oregon Treasurer's office in suite 190 that Hamilton "Tony" James, the president of the Blackstone

Group, found himself in July 2010 with a group of Oregonians seated in a semicircle around him, peppering him with questions about his funds' performance, the types of fees he was charging, and the state of his current investments.

James arrived confident that he could win a commitment, which would be the state fund's first investment with Blackstone after decades of trying. Oregon's staff had already vetted Blackstone's proposal and met or talked with fund-raisers who worked for James numerous times. The investment board, wary about the damage the global financial crisis had inflicted on their investments across the board, wanted to ask James several questions to his face.

For an hour, he fielded mostly friendly, but occasionally pointed, questions. "That all sounds really great, and you probably raised money at the right time so you could go out and get deals," board member Katherine Durant said to James during the meeting. "That said, why does Fund V look so bad?" James said the firm's fifth buyout fund was valued at a loss of 2 percent, compared with a 7 percent loss in the Standard & Poor's 500 Index during a specific period.[1] Another board member pressed James to promise that they wouldn't throw fancy investor meetings that the pension would have to pay to attend. James smoothly assured him that instead of a resort, they held their meetings in New York, at the Waldorf-Astoria hotel, which had the benefit of being Blackstone-owned through its control of the Hilton hotel chain.

James eventually emerged victorious, with a $200 million commitment for Blackstone Capital Partners VI, a fund that eventually would total in excess of $16 billion when James and his colleagues finished collecting commitments the following year. To secure Oregon's money, Blackstone agreed to reduce some fees, a deal it then extended to all of its investors. The firm already had told potential investors it would lower the management fee to 1 percent a year, from 1.5 percent, for those who committed $1 billion or more.

Less than a year later, the same group of Oregonians entertained a visit from KKR co-founder and co-CEO George Roberts and committed $525 million to KKR's latest fund.[2] While that was smaller than previous investments (Oregon invested $1.3 billion in KKR's 2006 fund), the new pool was targeted at $8 billion, about half the size of the previous fund. Roberts may have edged out James in the fund sweepstakes by dint of familiarity. He was making a pitch to a group he had sold on KKR for the first time three decades previous.

Roberts made his first meaningful contacts with Oregon's pension fund in the early 1980s, a series of meetings that helped create the modern private equity, industry. Oregon is widely credited with being among the first U.S. pension funds to commit meaningful sums to private-equity funds and then keep re-upping. Oregon was quickly followed by the state pension up the road in Washington State. By 1990, the California Public Employees' Retirement System, known as CalPERS, would create a program for so-called alternative investments like private equity that would become the nation's biggest such effort.

Soon pensions across the country got into the act and, in addition to going to the likes of Tigard and Olympia, private-equity managers trekked to Austin, Texas, and Harrisburg, Pennsylvania, to make their case.

The motivation for the pensions was simple: investment returns that weren't available anywhere else, money they needed to pay their retirees what they'd promised. KKR, and later its competitors, proved they could take a small slice of a pension and double it, or better. Oregon's early investments in KKR funds yielded more than three times what the pension gave Roberts and co-founder Henry Kravis, an annual average return in some cases of close to 40 percent a year.

University endowments also are influential LPs, and schools like Yale and Harvard have benefited from long associations with some of the most successful buyout managers. Endowments are attractive to private-equity managers in part because schools tend to be comfortable locking some of their money up for long periods of time, a key element of private equity's business model. Funds tend to have lifespans of 10 years, giving the managers the ability to spend the first handful of years investing the money, and the latter part of the fund selling those investments to reap profits for themselves and for their backers. Unlike hedge funds, where the best managers can reap profits in seconds or minutes, private-equity managers' pitch involves buying companies that will take in most cases years to fix, expand, or grow but will eventually generate huge gains when they're sold. Pensions are arguably the most interesting way to explore the limited partner world because they ultimately invest money for hundreds of thousands of retirees. They also have seen fit to release some of their data to the public, making it easier to analyze their strategies and those of the managers they choose.

Without these institutions, without the people sitting in that conference room in Oregon and their counterparts in state and national capitals around the country and around the world, Tony James wouldn't have his job.

And so that day in Oregon, James cut the sort of deal that makes it all possible. Oregon agreed to give Blackstone the responsibility for $200 million for the next 10 years. The pension agreed to pay the firm $3 million each year (1.5 percent of the total commitment) as a management fee, a levy meant to help Blackstone pay for salaries and rent. Blackstone would spend roughly five years using Oregon's money to buy companies and roughly the next five selling what it bought, hopefully at a profit.

Blackstone agreed that as those profits came back, 80 percent of them would go back to Oregon, with 20 percent staying at Blackstone. This is the fundamental partnership that defines private equity, between the investors (referred to as limited partners, "limiteds," or simply "LPs") and the managers (known as general partners, or "GPs").

James, Schwarzman, and a handful of other Blackstone executives would replicate this process dozens of times during a two-year period, piecing together promises of money like Oregon's until they were satisfied they had an ample war chest. In mid-2011, they would "close" the fund, shutting it off from new commitments. At about $16 billion, it was the biggest pool for leveraged buyouts raised since the end of the global credit crisis. While less than Blackstone's record-setting $21.7 billion fund that closed in 2007, here was proof that money was still available despite the still-visible scars of the financial crisis.

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The terms, though, had changed. Big investors, especially those outside the U.S. public pension system, have long weighed how to recapture some of the fees they pay to managers like Blackstone, KKR, and Carlyle. The most aggressive in this regard have been, interestingly, a handful of Canadian pension plans that have built large in-house investment teams to effectively work around the big private-equity firms.

One of the most powerful investors in Toronto, Canada's financial capital, sits not along Bay Street in the downtown banking district but in a squat suburban office building a 20-minute subway ride away.

The Ontario Teachers' Pension Plan during the past two decades has helped raise some existential questions about the private equity industry and pressed some of the most important economic issues around the business. Teachers' has effectively voted with its feet, limiting its traditional third-party investments to a small group of managers, building an in-house staff to make direct deals, most of the time skirting the private-equity barons altogether.

The strategy was born largely of necessity. In the early 1990s, Teachers' saw what most every pension that was paying attention did—that leveraged buyout firms were delivering amazing returns to their small clutch of existing investors, far outstripping what those investors could get from public equities and fixed income. With a bias toward domestic managers, they looked around Canada for private-equity funds and found not very many. So they started their own effort.

It barely survived its infancy because the first deal was a disaster. In 1991, Teachers' paid $15.75 million for White Rose Crafts & Nursery Sales, a company that promptly went bankrupt within a year. The wipeout stands as a testament to the Canadians' fortitude and a reminder of how deals can fail—it's engraved right alongside the fund's best deals in the Teachers' boardroom at headquarters, dubbed the "Wall of Fame and Shame."

Teachers' has gone on to invest in the likes of vitamin seller GNC, which it bought with Ares and later took public, as well as Canada's Yellow Pages Group and luggage maker Samsonite. The fund also at one point owned several local sports franchises, including the Toronto Maple Leafs hockey club, the Raptors pro basketball team, and the city's professional soccer outfit; it agreed to sell the company that controlled those teams in 2011. Its total assets under management were C$117.1 billion ($115 billion) at the end of that year.

During the LBO boom and bust, Teachers' arguably became most famous for a deal it ended up not doing. The fund was part of a consortium that had won a fierce auction to buy BCE, Canada's biggest phone company. The $42.3 billion purchase price would have made it the second-biggest leveraged buyout ever announced, just behind KKR and TPG's $43.2 billion TXU deal, according to data compiled by Bloomberg.

When the credit markets seized in mid-2007, almost everyone involved in the deal got nervous, especially the banks who'd agreed to finance the deal, including Citigroup, Deutsche Bank, and Toronto-Dominion. Were the deal to happen, the banks would be stuck with billions of dollars worth of debt tied to BCE on their balance sheets. The debt would be valued at less than face value and no one would want to buy it, and estimates at the time pegged the immediate losses to the banks if the deal went through at C$10 billion.[3]

Teachers', along with Providence Equity and Madison Dearborn and the buyout arm of Merrill Lynch, were similarly worried. The deal had been conceived in an economic environment defined by confident consumers and heady growth prospects. Now the would-be owners were staring at owning a huge corporation going into a nasty recession. All the parties scrambled through 2008 to recut the deal or get out of it. In December of that year, they got a much needed reprieve—an auditor judged that the company would be insolvent if the deal went forward, which allowed the buyers to walk away, and the banks to breathe a huge sigh of relief. A year after the deal collapsed, Teachers' Chief Executive Officer Jim Leech was understated, saying, "It was the product of a euphoric time."[4]

The BCE near-miss didn't dissuade Leech from his strategy, which blends direct investing and commitments to firms like Ares and Providence, where Leech and his team have determined the firm has a specific expertise they can't easily replicate.

Leech has become a strong and vocal advocate for the pension players in the equation, publicly questioning fee structures that he sees as unfair to the limited partners. "Private-equity firms are first and foremost in business for themselves," Leech told me when I called to talk to him about the state of the business in late 2011. "They are perfectly misaligned on the fee side. I believe that's because a lot of investment bankers got into the business and perverted the model."

It's harder to stray, Leech said, when your investors are stopping by your office all the time. Most days, a handful of retired teachers show up at Teachers' to deal with some sort of question. "The reason we can keep focused is we know who we work for," he said. "In many asset management firms, the people who make the investments never even see their clients."

The Teachers' hybrid model has been adopted selectively elsewhere. The Canada Pension Plan Investment Board, its Toronto neighbor, hired Mark Wiseman, Leech's former lieutenant at Teachers', in part to pursue a direct strategy. CPP has emerged as a significant direct investor and frequent co-investor in deals like Dollar General, Nielsen, and Univision. CPP has a larger number of investments than Teachers' into traditional private-equity funds, with commitments to Blackstone, KKR, and TPG.

Like Teachers', Wiseman's group is an active investor and engages heartily with the managers it backs. While limited partners in general are asking for more information, CPP is among the few who will actually show up at a manager's office for more information, and to soak up the knowledge and expertise of the GP.

Public pensions in the United States quietly grumble that even if they wanted to pursue a Teachers' or CPP-like strategy of direct investment, they couldn't. U.S. pensions have neither the government permission, the political will to seek it, or the staff to execute a strategy like Leech's or Wiseman's. Part of the secret sauce for the Canadians is an ability to pay something closer to market rate for their staff, or at least far in excess of what a comparable staffer at a U.S. plan would make.

Leech earned C$4.38 million ($4.39 million) total compensation in 2010 and Teacher's head of investments, Neil Petroff, earned C$3.5 million, according to Teachers' annual report that year. That's almost six times more than Joseph Dear, the chief investment officer at CalPERS, who earned $552,052 in 2010, the most recent data available.[5] While Leech may not be bidding against tycoons like Steve Schwarzman and Henry Kravis for a house, the paychecks far outstrip his U.S. peers.

Where the Americans and Canadians have found the most fertile common ground is an effort that also has its roots in Toronto. The Institutional Limited Partners Association began as an informal supper club in Canada in the early 1990s, around the time Teachers' was beginning its grand experiment. In the wake of the financial crisis, it's become a much-needed megaphone for the institutional investor community to voice their concerns about the excesses embedded in the private equity industry.

To get a private-equity manager's attention in 2010 and 2011, especially if you had a pot of money to invest, you just had to utter the word "ILPA" (most people pronounce it as "ILL-puh"). That's because, in 2009, ILPA released a set of investing "principles" that rattled the world of private equity for a simple reason: The industry's biggest backers had never gotten together before and spoken with anything resembling a common voice.

The story of the ILPA Private Equity Principles, as they're officially called, goes back to the financial crisis, when the biggest pensions were scratching their heads about what had just happened to them and their portfolios. The question was more than academic—all of their investments had been crushed in the crisis as stocks plunged. Even the best hedge funds posted losses (though less than the broader indices), and private equity for its part was essentially frozen. The global meltdown had another real impact on pensions especially—they realized their own underfunding woes had become a full-blown crisis. Public pensions in the United States as of 2010 were facing $3.6 trillion in unfunded liabilities, according to a study by Joshua Rauh of Northwestern University and Robert Novy-Marx of the University of Rochester.[6]

That left pensions in a pickle with private equity. Clearly, they needed the returns that buyout managers had delivered over the years. In a time of effectively zero interest rates, the siren song of double-digit annual returns was more than compelling. And yet the pension managers ranged from befuddled to furious at the behavior they'd witnessed over the previous decade, especially the high fees they'd paid in return for what was feeling like middling performance.

Having poured money into funds raised during the first years of the new century, they watched as deals crept in size to never-before-seen heights in 2006 and 2007. Private-equity firms outmaneuvered each other on some deals, then pooled money with other firms—a practice known as "clubbing"—to buy bigger companies. The net effect was extraordinary exposure to giant deals, especially for big investors with commitments to multiple managers. Take Freescale, the semiconductor firm taken private in 2006 by Blackstone, TPG, Carlyle, and Permira. CalPERS had commitments to every one of the firms involved in the deal, according to data posted on its website, a bet made all the more painful as that deal ran into a buzz saw of a bad economy and the failure of its biggest customer.

Private equity had long been touted as uncorrelated to the broader markets, its illiquidity—a technical way of saying you couldn't get your money out anytime you wanted—seen as a safe haven of sorts. When the financial markets cratered around the world in 2008, private equity was far from immune. While they weren't forced to sell what they owned, the companies they owned were struggling. And the buyout firms' investors were worried. And mad.

The stars aligned in 2009 to rally investors. That January, a group of roughly a dozen U.S. and Canadian pension managers—together they represented more than $1 trillion—met in a conference room at the Denver airport with the express purpose of talking about private-equity managers and whether they could grab control of the discussion around the industry's economics. What became informally known as "the Denver Group" decided while snacking on peanuts to come up with a wish list they could bring to private-equity managers.

The meeting was the brainchild of a Texan named Steven LeBlanc, a senior managing director at the Teacher Retirement System of Texas, a $110 billion pension fund run from Austin that has 1.3 million members. LeBlanc had responsibility for about $35 billion, the slug that's been designated for private capital, which encompasses private equity and real estate.

LeBlanc, whose mother was a teacher's aide, took the Texas Teachers job after a career spent on the other side of the table, raising money for, and investing, real estate funds. His last job in the private sector was as the CEO of Summit Properties, a real estate investment trust (REIT), where he earned shareholders a 144 percent return during his tenure. He took a job teaching real estate at the University of Texas, a formalized way to do the mentoring he'd always enjoyed while he plotted his next move. Then Britt Harris called.

Harris was the chief investment officer of Texas Teachers and worked to convince LeBlanc to join the pension. LeBlanc pressed back—the teachers at the time were organized to treat private equity and real estate separately and he wanted them both. Harris put them together and LeBlanc took the job in 2008, at a 75 percent pay cut from his last corporate gig.

LeBlanc relished the fox-in-the-henhouse situation he'd created for himself and immediately started asking questions inside and outside the organization. As the broader economic situation worsened and he watched scores of private equity and real estate funds stumble through the post-crisis world, his voice only got louder. He found like-minded LPs who wanted to take action, which is how he found himself in Denver that January.

The small clutch in Denver wasn't the only group talking about pulling private-equity back into alignment. That March, in Atlanta, ILPA held an annual meeting where the group's executive director, Kathy Jeramaz-Larson, held a working session with attendees about the same issues of transparency (what exactly are you doing with my money), and fees (what am I paying you, when and why). During the subsequent months, the Denver group and ILPA initiatives melded and refined the principles.

The first version, released in September 2009, was strident in terms of public statements by pensions. Citing the complexity and length of agreements between private-equity managers and their investors, the principles read in part that "it has become increasingly difficult to focus on what aligns the interests of the limited partner with the general partner."[7] What it boiled down to was pretty simple: Tell us exactly what you're doing and make tons of money only when we do. Private equity's biggest investors were for the first time singing from the same songbook, and most buyout managers didn't like the tune. ILPA's intent was to get both sides of the equation—LPs and GPs—to publicly endorse the principles. Most private-equity firms balked. Despite ILPA's explanation to the contrary, buyout firms viewed the principles as an all-or-nothing proposition and were worried they'd be blessing a set of rules they couldn't, or wouldn't, ultimately comply with.

LeBlanc didn't like that. He and his staff sent out a detailed survey to Texas Teachers' own limited partners to drill down into the document and find out what individual firms did and didn't like in the principles. He and a handful of other ILPA board members spent much of 2010 working the managers personally, figuring out how to revise the principles to get a larger number on board. In early 2011, more than a year after the initial volley, version 2.0 of the principles was released.

The language was less aggressive ("This release retains the key tenets of the first Principles release while increasing their focus, clarity, and practicality"[8]) and ILPA made it clear that this was not an all-or-nothing document. Within weeks, KKR, arguably the best-known brand name in private equity, publicly endorsed the new version. Blackstone, Carlyle, and TPG followed.

The ILPA principles are seen as a boon, especially to institutions with smaller staffs who don't have the time or resources for extensive due diligence on a manager. The principles can serve as a cheat sheet, or at least a starting point for every fund-raising discussion. Understaffed pensions feel emboldened to press for better terms, knowing that their brethren were making similar demands. "It's a game-changer," said Joncarlo Mark, a former senior portfolio manager at CalPERS who served as chairman of ILPA from 2007 to 2010.[9]

LeBlanc has another set of principles specifically for his pension, a PowerPoint manifesto of sorts called The Texas Way that takes the principles a step further, his way of hitting the reset button with the private-equity firms.

I first met LeBlanc in October 2011, as he was finishing a dinner at Brasserie 8½, a French restaurant that sits just below 57th Street in midtown Manhattan. The name of the place is a nod to the famous-in-finance address of the building, 9 West 57th Street, known colloquially in private-equity and investment circles simply as "9 West." It's the longtime home of KKR, and fans of the book *Barbarians at the Gate* will recall many scenes set there. The building also houses private-equity firms Apollo, Providence, and Silver Lake.

He was finishing dinner with Scott Nuttall of KKR. As the firm's global head of capital and one of Roberts's and Kravis's chief lieutenants, Nuttall has broad responsibility within the firm, including fund-raising and investor relations. During the past several years, he's overseen a rapid expansion of those efforts at KKR, growing the staff from about half a dozen to more than 40 employees around the world. The biggest investors like LeBlanc get a lot of special attention.

How big and how special LeBlanc was would become publicly apparent several weeks later. The next morning, LeBlanc was back at 9 West for a separate meeting with Apollo's top executives. At the two meetings, he was wrapping up a deal to commit a total of

$6 billion to KKR and Apollo. The sweeping mandate of $3 billion to each firm was an unprecedented agreement in its scope.

Because of the size of the commitment, KKR and Apollo agreed to lower management fees than they'd usually charge, a major victory for LeBlanc, who had pushed, through the ILPA principles and The Texas Way, to lower those levies and put the bulk of the economic benefit for the private-equity firms on the back end. In other words, don't let them get rich getting the money; let them get rich when they make money for the investors.

KKR and Apollo got their respective money on different terms, too. Instead of committing money to a single discrete strategy, Teachers told KKR and Apollo to use the money across a variety of investments, from traditional buyouts to energy to debt. In addition, the agreement had a "recycle" provision that gave each firm the ability to plow some of the pension's profits right back into investments instead of returning the cash and going through the time-consuming and costly process of asking for it again.The biggest investors, like Texas Teachers, CalPERS, and sovereign wealth funds, are hamstrung to some extent by their size and the need to put large amounts of money to work in big slugs. The theory is that with fewer firms to oversee, pensions can do a better job with that oversight. They're more likely to see a manager straying from his stated investment strategy if their attention is focused. LeBlanc's desire to put more money with fewer managers is a key tenet of The Texas Way.

His particular approach is to create a "Premier List," an intense screening process to assess managers up front and then actively manage them once they do win a commitment. The best performers get more and more money, the worst get thrown out of the program, either through attrition (not re-upping on the next fund) or by being sold on the secondary market, where a handful of specialty funds shop for unwanted stakes in private-equity funds.

What's interesting is the confidence, and at times ferocity, with which pensions and other investors in private equity are evaluating their managers. The new approach is being driven largely by pension executives like LeBlanc, who've been in the room all along, just in a different seat. They know all the tricks of the trade and are blending their experience with the leverage provided by efforts like ILPA. (LeBlanc ultimately decided to leave that seat, after fulfilling what he and Harris described as a five-year plan. He stepped down to rejoin the private sector in mid-2012).

Other former private-equity executives have taken on top roles at pensions. In New York City, Lawrence Schloss in 2011 undertook an ambitious plan to coordinate the investments of the numerous employee plans for city workers.

Schloss also set about cutting the number of managers the city worked with, aiming to reduce it to 70 from more than 100 when he arrived at the start of 2010. The reason wasn't just the large number of relationships, but poor performance. For the 12 years before he arrived, the average annual rate of return was 6.8 percent, which he characterized as "not very good," especially in light of the pension's desired 8 percent a year return for its entire portfolio. Yet the good managers stood to get more money under Schloss. He said in 2011 he was raising the percentage of the fund allocated for private equity to 6.5 percent from 4 percent.[10]

Across the Hudson River in New Jersey, Robert Grady is the chairman of the New Jersey Investment Council. He's a former managing director at Carlyle who at one time was responsible for the firm's venture capital activities. He left Carlyle in 2009 and joined a small private-equity company in Wyoming called Cheyenne Capital. Grady's pursuing a similar strategy of more money to fewer managers. At the New Jersey Division of Investment's monthly meeting in December 2011, Grady unveiled a deal with Blackstone that was similar in scope and tone to the tie-up between KKR, Apollo, and the Texas teachers. New Jersey approved a plan to give Blackstone $1.8 billion, $1.5 billion of which would be divided into so-called separate accounts, pools that contain only New Jersey money instead of commingling with other investors' commitments. Those allow Blackstone and New Jersey to invest together on individual investments, in this case a pool each for traditional buyouts, credit investments, and energy deals. New Jersey committed another $300 million into funds that included other Blackstone clients designed for natural resources, credit, and the firm's flagship buyout fund.

With the deal, Blackstone brought its total New Jersey commitments pledged in a 12-month period to $2.5 billion, the most it had attracted from a single investor during one year in its history. What did

New Jersey get? In addition to the promise of future profits, Blackstone agreed to cut its fees to the tune of $122 million over the life of the agreement, according to New Jersey's calculations.[11] Blackstone cut a similar deal in May 2012 with CalPERS, agreeing to manage $500 million in a separate account for the giant pension.The clear message to Tony James and his cohorts was that the money is there, in some cases more than was available even at the height of the private-equity frenzy in 2006 and 2007. But from Oregon to New Jersey, the money's a lot harder to get and you've got to assure your backers that they'll get paid before you do. The relationships are different once you get on a plane bound for points overseas.

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The Abu Dhabi Investment Authority occupies a soaring tower along the Corniche, the beachside road in the capital of the United Arab Emirates. Abu Dhabi is lesser known than its fellow emirate Dubai, about an hour's drive through the desert, the long stretches broken only by what appear to be gates to Gulf-front palaces. Dubai gained international prominence in the first decade of this century for its unbelievable growth and shows of wealth, and the real estate crash that followed in 2009. It still boasts the tallest building in the world, the Burj Al Khalifa, its name an honorific to the president of the UAE and ruler of Abu Dhabi.

Abu Dhabi, which sits on a massive oil reserve, bailed out its ultimately poorer, and oil-bereft, cousin Dubai after the collapse, leaving clusters of see-through buildings and sprawling half-finished developments like Dubai World. ADIA remains one of the most influential investors in the world, by virtue of its size and tentacles into money managers around the world. The government won't disclose how big ADIA actually is, but studies have pegged ADIA's assets at around $750 billion and have called it the largest sovereign wealth fund.[12] With ADIA and its brethren funds in the Gulf Cooperation Council enjoying a rise in oil prices through the early 2000s, the region became an increasingly important subsector of potential limited partners. While Dubai favors glitz and spectacle and made a name for itself by pushing for superlatives, I found Abu Dhabi to be much more understated, the opulence less prominent. And yet it's clear that money is abundant, much more so than at the public pension funds back in the United States. After showing ID and saying who I was there to visit, I was escorted to a small table and offered a menu with various coffee and tea beverages served by a waiter. Once upstairs, I took in panoramic views of the emirate, which sits on the Arabian Gulf. It felt much more KKR than CalPERS.

ADIA was among the investors who went a step further than investing in funds, seeking a tighter relationship with some private-equity managers. The Abu Dhabi fund bought a stake in Apollo itself, paying to own a slice of the manager, not just participating in the funds. Carlyle cut a similar deal with Abu Dhabi-based Mubadala Development Company, another arm of the government whose specific charge was buying stakes in and backing companies that could benefit the emirate directly.

The Middle East was an alluring and seemingly untapped part of the world for the private-equity barons, both as a proven source of capital and potentially as a source of deals. After a speed bump around the financial crisis, when a number of funds in that region made bad bets on U.S. and European financial institutions, the latter theory about a source of capital has continued to be true. However, the notion that the Middle East could be a lucrative emerging market for deals has thus far not played out.

The confluence of capital-raising and deal-making came into the open in 2007, when the well-regarded Super Return conference series decided to put on a regional version in Dubai. This was the time when Dubai had burst onto the international financial scene, with gleaming skyscrapers, an archipelago of manmade islands meant to mimic a world atlas with "countries" for sale to be developed as private getaways, and a nightlife whose thinly veiled excesses evoked Las Vegas.

The collective private equity industry was salivating (mostly over the investment opportunities). Here was a dream combination—resident capital that appeared to lack the infrastructure and experience found in New York and London but wanted it; local companies eager to grow to meet the crushing demand of a fast-growing regional economy; and a market that was bending traditional financial and business rules tied to Islamic mores in order to accommodate outside investment to help fuel the growth.

Carlyle co-founder Rubenstein and TPG co-founder Bonderman, two of the industry's best-known and successful practitioners, headlined

Super Return Middle East, each man using it as an excuse to make his pitch publicly and then meet with existing and would-be investors around the GCC. Ten months later, and only weeks after Lehman Brothers filed for bankruptcy, throwing the U.S. and global markets into turmoil, Blackstone's Schwarzman showed up at the second-annual event, along with Kravis. Schwarzman—wrongly—declared the end of the credit crisis that had taken deep root with the collapse of Bear Stearns earlier in the year, praising U.S. regulators for their swift action. And at that moment, Dubai and its neighbors in the Gulf were at least removed from the troubles back in the U.S., and potentially a safe haven of real growth as the West stumbled.

Carlyle, given its penchant for covering the world through a combination of Rubenstein visits and local executives, in 2007 opened an outpost in the Dubai International Financial Centre, becoming the first large U.S. firm to set up an office there. The DIFC, built around a signature squared arch known as The Gate, became an expat banker hub, where French-cuffed Europeans and Americans mixed with Emiratis and other Arabs in dishdasha, the traditional dress. In the food court below the Gate still stands an outlet that's an emblem to U.S./Gulf private-equity cooperation. Caribou Coffee, a Starbucks rival started in Minnesota, was eventually bought by Arcapita, a private-equity firm in Bahrain funded by Arab investors whose North American offices are located in Atlanta.* KKR eventually followed Carlyle to Dubai with a small office, as did Blackstone. All of them heralded the region as a fast-growing land of opportunity, with potential deals aplenty. They conceded that it wouldn't be like the United States or Europe, with traditional leveraged buyouts, take-privates, and transactions that gave the U.S. GPs controlling stakes in their targets. Instead, they would more likely be partners with local investors, or buy minority stakes in high-growth companies.

The opportunity, of course, turned out to be a mirage, at least immediately, and especially in and around Dubai. By late 2009, the emirate was enveloped in a real estate and credit crisis of its own, requiring the bailout from Abu Dhabi. It became a symbol of excess in its own right, shorthand for bubble.

*Arcapita filed for Chapter 11 bankruptcy protection in 2012.

Yet Dubai's troubles and the so-far missed, or elusive, opportunities in terms of investments can't overshadow the enormous role the sovereign wealth funds continue to play in the world of private equity. By most accounts, they will become the biggest source of capital for private-equity funds within the next decade, a shift that stands to have profound implications on the form and strategy of the industry. The sovereign wealth landscape is increasingly influenced by Asia, and especially China. As in many other aspects of the global economy, China has emerged as both an ally and potential threat to private equity. China Investment Corp., a sovereign wealth fund, bought a stake in Blackstone around the time of its IPO in 2007. Schwarzman and his biggest competitors have pursued deals in China. At the same time, China has feverishly developed its own private equity industry to rival their U.S. counterparts. All of this serves to add another element of competition to the mix.

Carlyle's Rubenstein believes that the big investors will continue to press for lower fees and in some cases ask for co-investment vehicles that give them more discretion over where their money goes. Meanwhile some SWFs will follow the Ontario Teachers' model and nurture staffs that can invest money directly and avoid third-party managers for at least some of their private-equity strategy. "The economic model is evolving a little bit," Rubenstein said.

He maintains that ultimately people like him—professional private-equity investors—will win the lion's share of money to be invested in leveraged buyouts and related businesses. It's an admittedly self-interested opinion. But the tens of billions he raised across the world during the past two decades give his take a little more credence.