CORPORATE TAXES: BEYOND THE OBAMA PLAN

BusinessWeek

PRIVATE EQUITY

TESTING THE WATERS

HOW A $1 TRILLION WAR CHEST COULD REVIVE THE ECONOMY

PLUS

THE PERILS OF GLOBAL BANKING

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How can you plan ahead when you can hardly see ahead?
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GLOBAL BANK TRAP

Investors worldwide have been burned twice—by Lehman's toxic bonds and by weak global regulations and remedies

|BW| PAGE 038

Maria Bartiromo is on vacation

(COVER) ILLUSTRATION BY TIM O'BRIEN; (ABOVE) BRYAN CHRISTIE

002 THE BUSINESS WEEK

EDITED BY HARRY MAURER & CRISTINA LINDBLAD

Obama called for new rules on how companies with global operations are taxed

A LOOMING CORPORATE TAX BRAWL

On May 4, **President Barack Obama** hauled out the heavy artillery to blaze away at the U.S. tax code, specifically the parts that allow companies and individuals to avoid paying up by investing or stashing money overseas. "It's a tax code," argued the President, "that says you should pay lower taxes if you create a job in Bangalore, India, than if you create one in Buffalo, New York." Obama proposed changes that he said would net nearly $200 billion over 10 years, mostly by altering the rules governing how companies pay U.S. taxes on income earned abroad and by limiting their ability to lower levies by shifting funds between subsidiaries. Business immediately fired back, saying such changes would hamstring American companies abroad. A memorable brawl is certain when Congress takes up the plan, probably late this year.

| BW | PAGE 018 "The Overseas Tax Squeeze" PAGE 020 "Here's an Idea: Cut Corporate Taxes"

(OBAMA) JIM WATSON/AFP/GETTY IMAGES; (BUILDER) CHRIS RANK/BLOOMBERG NEWS

UPBEAT ON THE STREET

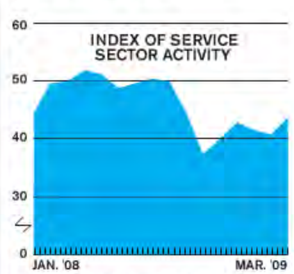
As U.S. investors dared to hope that the economy had hit bottom, stocks continued their remarkable bounce. On May 4 the **S&P 500** index fought back into positive territory for 2009, having risen 34% from its Mar. 9 bottom. Among the signs and portents inspiring the bulls: The **Pending Home Sales** index, which measures purchase contracts, rose 3.2% in March from a month earlier and 1.1% year-over-year. Crude oil prices hit $56 a barrel on May 6, a $22 jump from mid-December. Construction outlays inched up 0.3% in March, the best showing since September. And the **Institute for Supply Management's** services index rose more than economists expected, indicating that the sector, which constitutes almost 90% of the economy, is shrinking more slowly.

Homebuilding: Construction outlays were up 0.3% in March

STRESS TEST RELIEF?

At press time, on the eve of the **Treasury Dept.'s** release of "stress test" results, the fearsome threat the tests once seemed to pose to the financial markets had largely evaporated. True, *The Wall Street Journal* reported on May 5 and 6 that about 10 of the 19 big banks being evaluated, including **Bank of America, Citigroup,** and **Wells Fargo,** will have to raise tens of billions in capital—$34 billion in BofA's case. Other reports said Citi would try to land $10 billion from private sources rather than give Uncle Sam further control. But the leaks from Treasury suggested that the overall tenor of the test results would be reassuring, and investors acted accordingly, bidding up the financials as part of the broader market upswing. Regulators also appeared set to tell banks that they can't return TARP money unless they can raise capital without an **FDIC** guarantee.

SLOWING SHRINKAGE



Note: Reading below 50 indicates contraction

Data: Institute for Supply Management

TALF: SIGNS OF LIFE

The third month may prove the charm for the **Fed's** bid to awaken consumer debt markets. On May 5 investors sought $10.6 billion in subsidized loans to buy securitized consumer debt, a nice jump from $4.7 billion in March and $1.7 billion in April. More than half would purchase credit-card debt, while most of the rest would be split between student loans and auto loans. Analysts said the rise could be a sign of investors warming to the **TALF** program. Some had feared making money on it would draw after-the-fact congressional meddling.

GE'S Rx FOR GROWTH

At **General Electric,** the doctor is in. Taking a page from its successful "eco" effort, the conglomerate was scheduled to announce a $6 billion health-care strategy on May 7. The goal is to shift its health-care business toward global markets and priorities championed by the White House, such as digitizing medical records. GE will channel $3 billion into R&D for new products aimed at cutting the cost of providing health care and broadening access to it. Several GE businesses will spend $1 billion setting up partnerships and creating health-oriented content and services, while

004 NEWS YOU NEED TO KNOW

its finance arm will offer $2 billion in funding, mostly for health-care IT.

CHRYSLER FOR SALE

So far the Chrysler bankruptcy hasn't hit any major potholes: On May 6 the judge overseeing the proceedings ruled that the company could start rolling toward a sale of most of its assets to **Fiat.** In doing so, he overruled recalcitrant bondholders who object to the sale and the debt haircut the White House tried to force on them before the filing. The process is widely viewed as a template for a likely Chapter 11 filing by **General Motors.** Meantime, Fiat stepped up its drive to buy GM's European division, **Opel,** winning a pledge of help from the German government. The combined acquisitions would push Fiat from 1.5 million annual vehicle sales to 5.5 million. **Renault-Nissan CEO Carlos Ghosn** on May 6 smacked down published reports that his companies were interested in acquiring GM's **Saturn** or Opel brands.

Fiat's Marchionne may buy Chrysler and is stepping up his pursuit of GM's Opel

STRANGE BOARDFELLOWS

Have **Apple** and **Google** become too cozy for trustbusters' comfort? *The New York Times* revealed on May 4 that the **FTC** is examining ties between the tech superpowers. **Genentech CEO Arthur Levinson** sits on both boards, and **Google CEO Eric Schmidt** joined Apple's board in 2006. A few weeks afterward, the search giant bought **YouTube,** which competes with Apple's **iTunes** store. Later it introduced a Web browser that vies with Apple's **Safari.** Now phonemakers in search of an answer to the **iPhone** are making devices that run on Google's **Android** operating system. The **Clayton Antitrust Act** bars a person from serving on the boards of rival companies when that would restrain their competition.

STORIES WITH LEGS

Two problems first spotlighted by *BusinessWeek* were back in the news this week. **Senator Christopher Bond (R-Mo.)** on May 4 called the **Federal Housing Administration** home mortgage guarantee program a "powder keg that could explode," leaving taxpayers with an enormous bill. The FHA's woes were exposed in *BusinessWeek*'s Dec. 1 Cover Story, "The Subprime Wolves are Back." And on May 5 a 21-year-old Swede, **Philip Pettersson,** was charged with illegally hacking into computer systems at **NASA** and **Cisco.** *BusinessWeek* revealed the NASA attacks in another Dec. 1 article, "The Taking of NASA's Secrets."

The Dec. 1 cover story alerted readers to the FHA's mortgage guarantee woes

THE McCAFE BLITZ

It's the most lavish launch in Mickey D's history, and this is a company not exactly shy about mass marketing. The campaign for the company's McCafé coffee lineup—cappuccinos, lattes, mochas, and the like—is expected to cost $100 million and to press into service virtually every medium imaginable, including TV, print, radio, billboards, the Web, giveaways with top prizes of $50,000, and, of course, **Twitter.** Why spend so much dough on an upscale brand shift during a severe downturn? Because **McDonald's** figures McCafé eventually could add $1 billion annually to its bottom line. Take note, **Starbucks:**

(MARCHIONNE) FABIO FRUSTACI/EIDON/WPN

006 NEWS YOU NEED TO KNOW

Buffett at his shindig: He stayed mum on succession

Analysts estimate the McCafé gambit could cost the ur-coffee chain 5% of its revenues.
Advertising Age

CHINA'S DOLLAR DILEMMA

The People's Republic's growing aversion to dollar-denominated assets will likely rebalance the world economy, argues scholar **Wenran Jiang.** But the nation's economic mandarins know well that any sudden move to shrink the mountain of T-bills would wreak havoc on financial markets. So Beijing is slowly and methodically moving to ease itself out of what some call its dollar trap. One technique involves boosting use of its domestic currency in trade transactions. Since mid-2008, China has arranged more than $120 billion in currency swaps with its trading partners. And it's helping its national champions fund acquisitions abroad—with emphasis on energy and mining assets.
YaleGlobal

BUFFETT'S WISDOM

It was the time of year when disciples from Bangkok to Baltimore make their annual pilgrimage to Omaha to hear the sage speak—even if **Warren Buffett's** clairvoyant credentials seem a tad tarnished, given **Berkshire Hathaway's** 36% stock drop since its peak last year. On May 2 the 78-year-old zillionaire told shareholders that he remains outraged by CEO pay in the U.S. He said **Wells Fargo,** of which he owns a big chunk, is a solidly capitalized bank, and that derivatives aren't inherently "evil." But on one matter of intense concern to his acolytes, the question of succession, Buffett resembled the Oracle of Delphi—and shed zero light.

THE KINDLE IS GROWING

Amazon's popular e-book reader just got a brother, but this one, unlike most newborns, is bigger than its siblings. On May 6 the company unveiled the **Kindle DX,** whose more generous proportions make it newspaper- and magazine-friendly. Although the price is steep, at $489, Amazon is partnering with papers such as *The New York Times* to lower the sticker shock by giving discounts on long-term subscriptions. Textbook publishers such as **Pearson** are also keen on the DX: They're hooking up with six universities to get Kindle coursework into the hands of students this Fall. **CEO Jeff Bezos** says Kindle books account for 35% of a title's Amazon sales when it's available in the format.
"Amazon's New Kindle: Winners and Losers"
businessweek.com/magazine

BUCK-BREAKERS CHARGED

Like father, like son—at least in the eyes of the **SEC.** The agency filed securities fraud charges against the founder of **Reserve Management, Bruce Bent,** and his son **Bruce II** on May 5. The civil suit alleges that the Bents misled investors about the safety of Reserve's flagship money market fund. On the day **Lehman Brothers** filed for bankruptcy last September, the $62 billion fund held $785 million in Lehman securities. The fund "broke the buck" despite the Bents' pledges to maintain a $1-per-share value, the SEC alleges. In a statement, the elder Bent said he would fight the complaint.

Bezos with the Kindle DX: Another hit?

(BUFFETT) ANDREW HARRER/BLOOMBERG NEWS; (BEZOS) ERIC THAYER/REUTERS


WHEN YOU COVER
ONE IN THREE
AMERICANS YOU
DON'T JUST KNOW
HEALTHCARE, YOU KNOW
QUALITY CARE
Serving more than 100 million members and collaborating with 80% of doctors and 90% of hospitals nationwide gives Blue Cross and Blue Shield companies the experience to identify issues, the knowledge to create solutions and the scale to implement them. We are leading the way with Blue Distinction®, a designation that recognizes higher-quality care, and Blue Health Intelligence®, which shares evidence and insights with those working toward better healthcare nationwide. Find out more at bcbs.com
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REAL RECOVERY WILL HINGE ON CAPITAL SPENDING

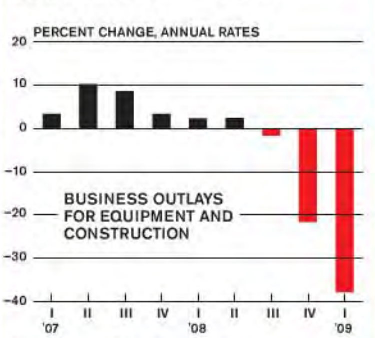
Companies are reluctant to make new investments without seeing concrete gains in demand and profits. Until they're ready to expand, overall growth will drag

Amid signs that housing and consumer spending are stabilizing, cautious optimism on the economy is spreading. Investors are showing it, and some economists are even boosting their growth forecasts. However, don't look for U.S. businesses to jump on the recovery train just yet. Companies are still chopping costs aggressively in an effort to limit the recession's hit to their profits, and there's no indication they are ready to put away their axes. Capital spending, a crucial part of the economy's growth engine, remains especially vulnerable.

Companies have few incentives to expand their operations. They face meager expectations for growth and profits, costlier and scarcer credit, and a glut of production capacity and commercial buildings created by the recession. Even if the economy stabilizes this summer, as is generally expected, capital spending will most likely be a major drag on growth for the rest of the year. And longer term, some economists worry that future U.S. growth and competitiveness could suffer from a dearth of new investment.

Falling outlays for everything from computers to forklifts to office space accounted for 4.7 percentage points of the 6.1% decline in first-quarter real gross domestic product. In fact, the 16.8% drop in capital spending since the third quarter of last year is the largest since the 1930s.

THE WORST CAPITAL SPENDING BUST SINCE THE 1930s



Data: Bureau of Economic Analysis, IHS Global Insight

The declines have been both deep and broad. Expenditures for industrial machinery fell at a 47% annual rate last quarter. Purchases of transportation equipment are only 39% of their year-ago level. Outlays for information processing gear have already fallen more than they did during the tech bust in 2001. And business construction, off a stunning 44% last quarter, will continue to suffer from past overexpansion, rising vacancy rates, and tight credit.

The major weight on capital spending right now is the recession. Businesses don't make decisions to shell out money based on cautious optimism. They have to see actual improvement in demand and profits. That's why capital spending in recessions doesn't turn up until after the economy hits bottom. Prospects are unlikely to look bright enough to encourage new outlays anytime soon.

Profits, a key driver of business investment, continue to get hammered. With about two-thirds of the Standard & Poor's 500 companies having reported, first-quarter earnings are on track to fall about 35% from a year ago, according to Thomson Reuters. Pressure on profits will remain intense, as pricing power is sure to stay weak for the rest of the year. At the same time, productivity has stalled, providing less offset to labor costs, thus adding to the squeeze on profit margins.

If internally generated funds for expansion projects are limited, external financing is even scarcer. In the credit markets, borrowing rates for any company less than investment grade are in double digits, and those for many higher-quality borrowers are still more than 8%. These rates remain extremely high in relation to both inflation and riskless Treasury notes.

At banks, senior loan officers said they continued to tighten lending standards in April for all types of business loans, although the pace did slow compared with January. Their reasons: an unfavorable economic outlook, less tolerance for risk, and a worsening of problems in some key industries.

Perhaps the biggest factor working against a capital spending recovery is that U.S. businesses have a growing glut of production capacity—they can go a long time before needing to expand. Capacity utilization in manufacturing fell to a record low 65.8% in March, 14 percentage points below its long-run average. Also, office vacancy rates began rising rapidly last year, after business construction surged 14% per year in 2006 and 2007.

Amid the current rush of hope for the economic outlook, it's important to remember that robust recoveries always require solid gains in capital spending. Until businesses begin to expand again, any upturn in the economy will be a pretty tepid affair. | BW |

BRAD TRENT; CHART BY DAVID FOSTER

NUMBERS

AMID A DECLINING ECONOMY, SIGNS OF A BOTTOM?

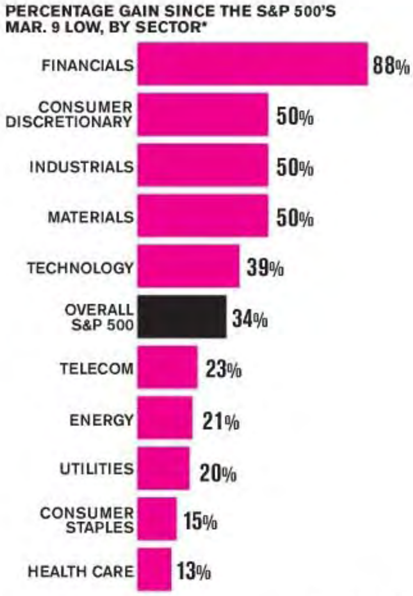
By Tara Kalwarski/Charts by Laurel Daunis-Allen

The first quarter's estimated 6.1% drop in gross domestic product was bigger than expected, but there are some signs of economic improvement. Equities have seen double-digit gains, home-price declines slowed in February, and consumer confidence jumped in April.

Stocks: Four major market indexes have rebounded smartly since their lows in early March.

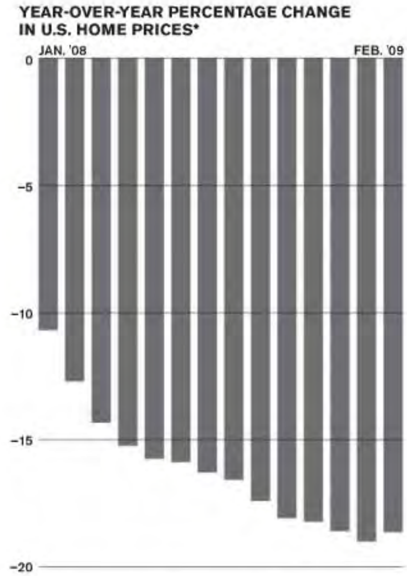
Data: Bloomberg

Sectors: Financials, up 88% in less than two months, have led the rally.



Data: Bloomberg *As of Apr. 30

Real estate: The decline in home prices moderated in February.



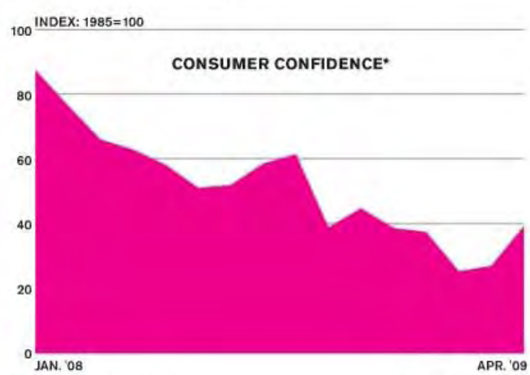
*Based on a composite index of 20 major metro areas
Data: Standard & Poor's, Case-Shiller, Bloomberg

66%

Share of the 326 S&P 500 companies reporting first-quarter earnings that exceeded expectations. A quarter of the companies came in below analysts' expectations, and 9% matched.

Data: Thomson Reuters

Sentiment: An index of consumer confidence climbed sharply in April.



Data: Conference Board *Seasonally adjusted

THE NEXT BUSINESS WEEK

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The financial crisis may have taken some luster off the Golden Years, but there are still steps you can take to preserve—and replenish—your retirement savings. In our Special Report "Investing in Retirement" we focus on strategies for investors at different stages, whether you're just starting out, reaching your peak income years, or nearing the finish line. We also show you how your 401(k) stacks up against other companies' offerings, and provide data on the best and worst corporate plans. Go to **businessweek.com/go/09/retire** for this plus insights on health insurance and what the latest moves in Washington could mean for your retirement portfolio. |BW|

CHEAP COMPUTING

At a time when companies need to slash costs, our Special Report "CEO Guide to the Desktop of the Future" takes a look at alternatives to the pricey PC, including netbooks, handhelds, and machines that get their software and files from another location. Go to **businessweek.com/go/09/desktop** for new computing options.

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Business Exchange

HOT TOPIC: U.S. AUTOMAKERS

BusinessWeek's Business Exchange welcomes our readers to collaborate and share knowledge on business topics and connect with other users. Join *BusinessWeek*'s Tara Kalwarski and others in our Business Exchange topic on the U.S. automakers at **http://bx.businessweek.com/us-automakers/** or dig into any of our other 1,400-plus subjects.

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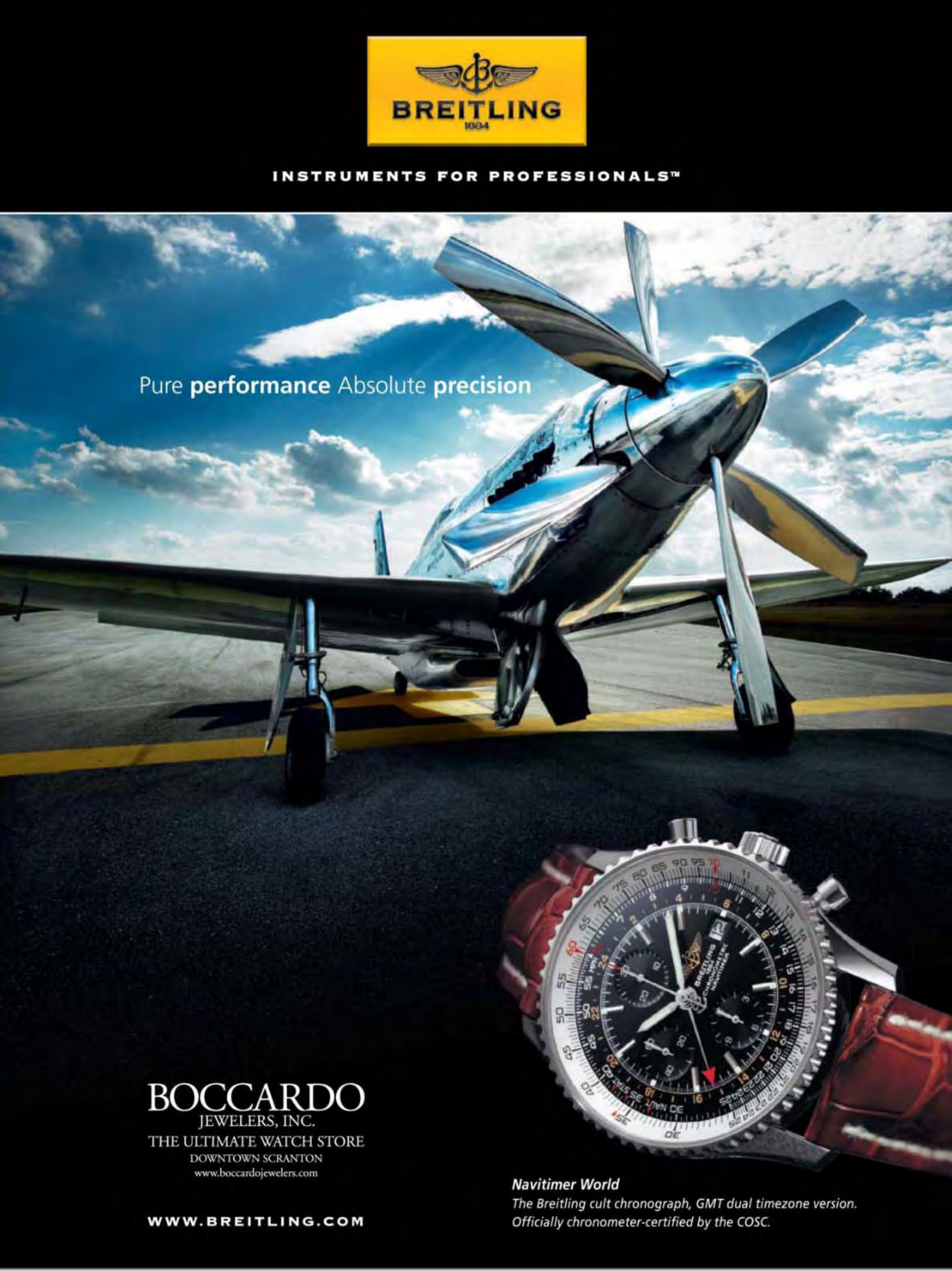
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SELLING THE FUTURE

"We're building a new car company." That's the headline on the full-page ad Chrysler ran just days after its May 1 Chapter 11 filing. Pictured in the ad are autos planned for 2011 and beyond, including two electric cars. The message: Chrysler has a future.

Will consumers buy it? The company's sales are already down 46% so far this year, compared with 38% for the industry. Now comes bankruptcy, a word that has a negative impact on the buying decisions of 21% of consumers, a recent Cars.com poll found.

"There needs to be a powerful message about a new beginning—a message of trust like the one Iacocca conveyed," says consultant Leo-Arthur Kelmenson, the architect of the ads featuring CEO Lee Iacocca that ran following the company's bailout almost 30 years ago.

Crisis management counselor Eric Dezenhall says Chrysler's recent ad may be a good start. "The advertising should paint a picture of the Chrysler of tomorrow—and how a new generation of consumers might benefit from it," he says. Other auto marketing experts agree. No campaigns featuring old Jeeps or vintage Dodges, they warn. The nostalgic approach some other marketers are using in the recession doesn't apply. "Chrysler's history is irrelevant during a bankruptcy," says Cameron McNaughton of TreeFarm Partners, who has run campaigns for Audi and Mercedes-Benz. The company "needs to make a promise to its employees and the American people and then keep it." For leading auto shopping site Edmunds.com, the answer lies less in promises and more in promotions. "Chrysler's best bet is the old standby of bigger incentives," says Edmunds CEO Jeremy Anwyl. Chrysler vehicles already sell for an average 18% below sticker, vs. an industry average of around 16%, according to the site.

One way to boost sales while in bankruptcy, says Edmunds.com: bigger incentives

CHRIS MCGRATH/GETTY IMAGES

So far, the bankruptcy seems to have piqued the interest of the loyal and the frugal. Chrysler Vice-Chairman James Press says there was a surge in showroom traffic after the May 1 filing, with shoppers saying they "wanted to be part of this." Edmunds reports a 15% rise in searches for Chryslers, but says some of its participating Chrysler dealers say customers are making "outrageously low offers." *–David Kiley*

THE DALAI LAMA ON THE ECONOMIC CRISIS

*When you think of the people you'd expect to be doling out advice in the wake of the global economic meltdown, the Dalai Lama may not come to mind. But the exiled spiritual leader of Tibet, who has written about ethics and on-the-job stress (*The Art of Happiness at Work*, with Howard C. Cutler, 2003), has strong opinions about the crisis and its causes.* BusinessWeek *senior writer Steve Hamm met with the Dalai Lama in New York on May 5. Here are some excerpts from that conversation.*

On what caused the collapse:
I'm telling people, including some businessmen who are my friends, what this global economic crisis was caused by: One, too much greed. Second, speculation. Third, not being transparent. That's my view. These are the moral and ethics issues.

On the importance of transparency:
When things become difficult, make it clear to the public. If right from the beginning the true picture is made clear, the public may be less shocked. So be transparent and honest right from the beginning.

On the obsession with money:
There are those people who are only concerned with money: It's just money, money, money, money. With such people, since the crisis happened, there are much disturbances. Of course, money is important. Without money you can't survive. However, it is not the only measure of value. We have other values: the happy family, compassionate family, the family full of affection, and the compassionate community. Those people have much less disturbance due to this money crisis. Therefore, this crisis reminds us you should find some other values. Money value alone is a limitation.

On how people who lost jobs or savings should deal with their anger:
The tragedy has already happened. Instead of more frustration and anger, think about alternatives. Make an effort. That's better. There's a Tibetan saying: Nine times failure, nine times effort, without discouraging oneself.

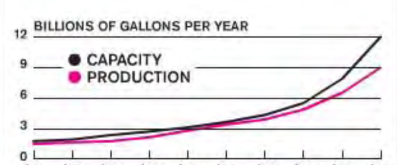
On the Buddhist approach to dealing with economic calamity:
According to Buddhism, these things happen due to their own causes and conditions. Through years or through decades this present crisis developed. All the causes and conditions were fully ripe. No force could stop it. It's the natural law. So you accept it.

LOBBYING FOR A BETTER BLEND

The ethanol industry is about to hit a wall—the "blend wall." U.S. biofuel factories now have the capacity to make about 12 billion gallons of ethanol a year, and the U.S. market can't use much more than that. That's because annual U.S. gasoline consumption is about 137 billion gallons, and gas isn't allowed to contain more than 10% ethanol, a blend called E10. If every drop of gas actually met that limit, the ethanol market would be 13.7 billion gallons. But for logistical reasons, a portion of the gas sold will never contain any ethanol.

The looming blend wall is making it harder to get new ethanol plants financed, so corn growers and ethanol producers are lobbying to increase the blend to allow up to 15% ethanol (E15). Opposing them: a coalition of oil producers, food companies, and green groups, which complained to the Environmental Protection Agency that raising the quotient may lead to higher food prices and other woes. In April, the EPA agreed to review the issue.
–John Carey

ETHANOL OVERFLOW?



Data: Renewable Fuels Assn.

PHOTOGRAPH BY MANAN VATSYAYANA/AFP/GETTY IMAGES


WANT TO GET A GRIP ON DATA ENTRY?
TRY USING TWO HANDS.
Introducing the Sharp® MX-Series with Full-size Keyboard.
These stylish MFPs make data entry easier than ever. That's because they're the only MFPs with a standard full-size retractable keyboard*, to simplify repetitive scanning tasks and e-mail entries. Not to mention a big, colorful 8.5" LCD touch screen, to help manage document workflow and navigate stored files. Plus, Sharp OSA® technology delivers seamless access to anything on your network right from the control panel. What's more, the MX-Series comes with Sharp's award-winning security suite for superior protection. So why are you still using a mini-screen keyboard, when you can step up to the real thing? To learn more, visit sharpusa.com/documents
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*Keyboard not available on all models

THE OVERSEAS TAX SQUEEZE

Obama's plan to bring home more revenue from multinationals is more complex than meets the eye

By Jane Sasseen

The verbal slugfest between the Obama Administration and American business leaders over new proposals that would raise taxes on profits earned abroad has framed a complex issue in simplistic ways. The Administration, resorting to starkly populist language, has all but labeled some global companies as tax evaders. Meanwhile, R. Bruce Josten, the top lobbyist for the U.S. Chamber of Commerce, accuses the President of hammering "companies struggling to compete in global markets."

Policy rumbles over taxes are never pretty, and this one threatens to increase costs by nearly $200 billion for U.S. corporations operating overseas. The Administration is proposing tougher rules for when profits generated abroad should be taxable in the U.S. It's also taking sharp aim at the common practice of shifting profits from foreign subsidiaries in countries with high tax rates to offshore tax havens (table). Another focus: tighter limits on the credits companies receive for the foreign taxes they pay, which offset what they owe on U.S. income. Obama's team thinks these new rules will curb incentives for companies to shift jobs overseas. Business lobbyists see the changes differently. "The bottom line is, they have proposed a tax increase of $190 billion on the overseas activities of U.S. multinationals," says Kenneth J. Kies, who has represented General Electric, Microsoft, and others on tax issues.

Beware of spin-doctoring by both sides in this debate. For instance, in a May 4 speech announcing his tax plan, Obama chastised U.S. corporations for paying little more than 2% on foreign revenue to Uncle Sam. That works out to just $16 billion in taxes on the $700 billion they took in overseas in 2004. However, the White House neglects to mention the $120 billion American companies paid in foreign taxes that year.

There is no denying some huge distortions in the tax code. James W. Owens, chairman and CEO of construction-equipment maker Caterpillar, argues that the proposed changes will damage the ability of U.S. companies to compete overseas. "Do we want to have U.S.-based multinational companies that are leaders in the world?" he asks.

TRACKING DOWN TAX REVENUE OFFSHORE

The Obama Administration has proposed more stringent tax regulations governing foreign subsidiaries of U.S. companies. Here are the key ones:

DEFERRAL OF U.S. TAXES

A new rule would end the ability of American companies to deduct expenses on foreign investments immediately while indefinitely deferring U.S. tax payments on overseas profits.

REVENUE: *$60.1 billion

INCOME SHIFTING

U.S. companies would find it harder to shift foreign profits from one offshore subsidiary to another in order to take advantage of foreign tax havens and avoid U.S. tax payments.

REVENUE: *$8.6 billion

FOREIGN TAX CREDITS

The U.S. would crack down on breaks that allow companies to maximize the reported amount of taxes paid overseas, thereby increasing a credit against income taxable in the States.

REVENUE: *$43 billion

Data: *BW* and the White House

*Projected revenues from 2011 through 2019

JIM WATSON/AFP/GETTY IMAGES

Yet that's a different issue from whether U.S. companies are accurately reporting where they generate profits overseas. According to a Brookings Institution study, some 30% of the profits earned by U.S. companies abroad come from the Netherlands, Ireland, and Bermuda—all low-tax regimes. However, none of those three nations is among the top 10 locations for U.S. multinational jobs. "In the end, this bill is aimed at getting rid of the aberrations in the way the tax code works," says Michael Ettlinger, the head of economic policy at the Center for American Progress, a liberal think tank.

Most of the corporate fury so far has focused on Obama's plan to limit the benefits companies get when they defer paying taxes on money earned abroad. Under current law, companies don't pay the 35% U.S. corporate rate unless they bring those profits home. As long as they keep the money abroad, they pay the lower rates in effect overseas. American companies say that break is critical, since their foreign rivals pay the lower local taxes.

But a senior Administration official says the tax deferrals wouldn't end altogether, as many had feared. Instead, the goal is to better align when a company can write off the expenses it incurs abroad with when it actually pays U.S. taxes on the profits it earns. Today, a U.S. multinational can immediately deduct those expenses, even if it indefinitely puts off U.S. taxes on the earnings. Under the President's plan, a company wouldn't get the deduction until the year it brought the money home and paid U.S. taxes. "They can't have it both ways," says the official.

Sounds reasonable. But it's a distinction without much meaning to many executives, since the result would be a higher tax bill on foreign profits kept abroad. Avoiding such a financial hit is one reason disk-drive maker Seagate Technology incorporated in the Cayman Islands a few years ago, says former CEO William D. Watkins. He predicts many other Silicon Valley firms will follow Seagate's lead if the Administration continues its push. "Trust me, plenty of companies will do what we did," he says.

Such arguments have won some sympathy on Capitol Hill where Republicans are already planning to resist the Obama plan. But business may have a tougher time pushing back against the President's proposal to eliminate rules in effect since 1996 that allow companies to reduce their U.S. tax exposure through complex financing deals between subsidiaries in countries with high and low tax rates.

Obama's plan to overhaul how foreign income is taxed has caused an uproar

Say a company invests $10 million in a plant in Germany, a high-tax country. At the same time, it sets up a subsidiary in the tax haven Cayman Islands, which lends the $10 million at a 10% interest rate to the German unit. Now, the cost of that loan ($1 million in interest in this case) becomes a deductible expense in high-rate Germany. At the same time, the subsidiary that lent the money gets its $1 million in interest income taxed at a lower rate in the Caymans.

Normally, the interest received by the Cayman unit would be taxable in the U.S. But since the mid-1990s rule change, the income simply disappeared for U.S. tax purposes. Not surprisingly, such lending subsidiaries in tax havens have flourished—from a few hundred in late 1996 to nearly 8,000 as of 2000. Altering these tax rules could potentially have an even bigger impact on corporate bottom lines than deferral, allowing the U.S. government to recoup $86.5 billion in tax revenues between 2011 and 2019.

Similarly, Obama has proposed trimming companies' use of foreign tax credits to reduce their U.S. tax liabilities. Here, the Administration is targeting multinationals' ability to maximize the credits they get for foreign taxes paid by attributing all the overseas income they bring home to high-tax countries. If Obama's tax proposals become law, a company would have to average out the tax rates paid in the various overseas countries it operates in.

To win business support, the Administration has offered to use some $75 billion of the funds raised to make permanent a popular research and development tax credit. But many executives argue that any changes in overseas tax treatment should be part of an overall reform bill that would lower the 35% statutory rate. Though Obama has said he'd consider such a move, for now it's not on the table. That is a future battle with far bigger stakes. |BW|

Business Exchange

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How to Tax Multinationals

The current system of taxing U.S.-based multinational firms by assigning income and expenses to specific countries is complex and encourages tax evasion. In a 2007 Brookings Institution paper, two tax specialists suggested an alternative: Calculate the taxable income for such companies based on a portion of the firm's worldwide income rather than allocate income to specific countries overseas.

To read more about this tax reform proposal, go to **bx.businessweek.com/tax-reform/**

HERE'S AN IDEA: CUT CORPORATE TAXES

Obama could reduce red tape and boost job creation in the U.S. by trimming income tax rates for multinationals

MANDEL ON ECONOMICS

As the saying goes, the road to hell is paved with good intentions. For decades, Washington politicians have tinkered with corporate income tax rules, with the laudable goal of getting U.S.-based multinationals to pay their "fair" share of taxes on growing overseas operations. The result has been a disaster: a corporate tax system that no one understands, that requires vast resources to comply with, and that altogether contributes only 10% of federal revenue, on average. And, oh, yes—the current rules seem to encourage U.S-based multinationals to move jobs overseas.

Unfortunately, President Barack Obama's latest proposal to get U.S.-based multinationals to pay higher taxes on their foreign profits does nothing to fix these problems. The tax system will become even more complex, an unintentional stimulus package for tax lawyers and accountants. And U.S.-based multinationals will find themselves at a bigger tax disadvantage compared with competitors headquartered outside the U.S., which operate under a different set of tax rules. The end result could well be fewer good jobs in the U.S.

Instead of adding more rules, President Obama should take a stand for simplicity and job creation by reducing the corporate income tax rate from its current 35% to 25%. This move has been advocated previously by many economists and politicians, notably Senator John McCain (R-Ariz.) during last year's campaign. But just as the diehard Republican Richard Nixon could take the political risk of opening relations with China, it may be that a Democratic President with strong liberal support is the right person to reduce corporate tax rates. Indeed, in a meeting with the Business Roundtable in early March, the President indicated interest in the idea. A senior Administration official leaves open the possibility of lowering corporate tax rates in the future if the tax base is broadened at the same time.

What are the advantages of lowering the corporate income tax now? First,

ILLUSTRATION BY CHRISTOPH NIEMANN; PHOTO BY BRAD TRENT

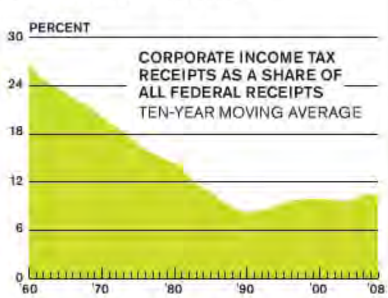
lower rates would help U.S-based multinationals compete against foreign-based multinationals—a good thing, since companies based in the U.S. are more likely to locate their high-end research, planning, and marketing jobs at home. Such a drop will also give corporations less incentive to base their global investment decisions on tax avoidance. In particular, opening up new operations in the U.S. would become more attractive.

Reducing corporate taxes will help get the U.S. out of a game it cannot win. In a global economy, chasing profits across national borders is hopeless. When a product is designed in one country, manufactured in another, and sold in a third, it's hard to figure out where the profits are really being made.

What quid pro quo should Obama extract in exchange for lowering the corporate tax rate? One possibility: getting solid business support for other initiatives such as health-care reform. Cutting corporate taxes may mean some lost revenue, but the long-term budget benefit of getting a grip on health-care costs is far more important. A more far-fetched trade-off would require companies to make their income tax returns public, at least in summary form. Companies now keep two different sets of books, one for investors and one for the tax authorities. Being able to see both sets would give us a better sense of what is going on in the global economy.

The bottom line: At a time when jobs are disappearing by the millions, raising taxes on U.S.-based multinationals is not the right way to go. |BW|

A SMALL CONTRIBUTION



Data: Bureau of Economic Analysis

Mexico City: Can digital simulations keep flu in check?

REAL DISEASE, VIRTUAL HELP

U.S. health officials are using digital tools to respond more quickly to swine flu and other potential epidemics

By Arik Hesseldahl

A day after news reports about an outbreak of swine flu in Mexico, health officials in Allegheny County, Pa., huddled to discuss contingency plans. How should they respond if the virus came to their part of the world? By closing schools? With widespread vaccinations? To test different courses of action, they turned to computer scientists who had built a working model of the county. "It helps come up with recommendations of when and how to intervene," says Dr. Ron Voorhees, chief of epidemiology and biostatistics at the Allegheny County Health Dept.

This is the first time Voorhees has had such technological support. A team at the University of Pittsburgh had built a virtual world, similar to Second Life or SimCity, with the county's 1.3 million residents represented by digital characters. It ran through 15 scenarios, with a variety of government reactions. Ultimately, the county avoided a serious outbreak, but Voorhees says it was well prepared.

In recent years public-health officials have turned to computer scientists for aid in fighting a variety of infectious diseases. Techies help harness the growing amount of data people create each day, through Google searches, cell-phone calls, and the like, so officials can detect potential problems faster than before. Google, for example, tracks the number of searches for "flu" and related terms and reports the results to the government. IBM donated to researchers and governments, including Mexico, a program it created that can simulate the outbreak of a pandemic flu in more than 100 cities.

At the University of Pittsburgh, Dr. Bruce Y. Lee, an assistant professor of medicine, works on the effort with virtual worlds. His team plugs in real data—infections and deaths in different regions, say—and then crafts simulations. It uses Census Bureau data to create a digital representative of each person in the U.S., with details down to a person's age, location, and job. Lee works under the auspices of a National Institutes of Health project called Midas, short for Models of Infectious Disease Agent Study.

The biggest decision for health officials, says Lee, is when to close schools and offices because that causes "a significant economic burden." In any case, when virtual workplaces and schools are closed, digital citizens don't necessarily stay home. Some still go for walks or to the mall, where they might catch or pass on a virus, just like in the real world. "Not even [virtual people] will all do what they're told," says Lee. |BW|

GREGORY BULL/AP PHOTO; CHART BY DAVID FOSTER

A SECRET WISH FOR HEALTH REFORM

Some CEOs are so fed up with the status quo that federal intervention is sounding O.K.

ROBERT NEUBECKER

By Catherine Arnst

Congressional leaders say they'll have a health-care bill in June that will deal with the uninsured. Fine, says business, as long as the existing employer-based insurance system is maintained. That seems counterintuitive, given that health care is the fastest-growing cost for U.S. companies. "I've worked in the employer-based market for 35 years, and it's bizarre that CEOs continue to support this system," says Robert Laszewski, president of consultants Health Policy & Strategy Associates.

But perhaps they really don't. Health reform experts say many CEOs would secretly love the federal government to take on the burden—and some don't bother to hide it. "There are employers that don't want the responsibility, and we are in that category," says Carl T. Camden, CEO of Kelly Services. Managing insurance for his vast, geographically dispersed workforce of temporary workers is horrendously expensive, he complains: "My health-care costs total more than my profits."

Insurance premiums charged to employers have soared 119% over the past decade, four times faster than wage increases. Based on a survey of 428 companies, Mercer, the consulting division of Marsh & McLennan, estimates that 46% of employers plan to shift more health costs to employees in 2010.

Neverthless, CEOs tend to insist they want to keep offering benefits for two reasons. They're a valuable employee perk, as the Business Roundtable and other corporate groups point out. Further, top executives figure they would pay for health care anyway if the government took control, through higher taxes or fees, while losing the ability to hold down costs.

But in private, "CEOs overwhelmingly want out of this business," says Benjamin Sasse, an Assistant Secretary of Health & Human Services under President George W. Bush who's now an assistant professor at the University of Texas at Austin. "They just do not want to be seen as more willing to dump [benefits] than their competitors are." Sasse says many CEOs he has talked with would even pay a new tax if it got them out of the insurance business.

"STATEROOM ON THE *TITANIC*"

Companies first started offering health benefits during World War II's tight job market. Wage controls were in effect, so health coverage took the place of raises as a recruitment and retention tool. Sixty years later, that benefit has become entrenched.

Plenty of CEOs continue to support the status quo, of course, despite the drawbacks. "A lot of businesses take the approach that 'this is a lousy system, but we're good at it,' " says Joseph J. Minarik, research director for the Committee for Economic Development, a Washington think tank. "I interpret this as, 'I've got the best stateroom on the *Titanic*, and I'm not moving.' "

Democratic senators are calling for a new, federally funded insurer that would expand coverage by competing with private health insurers. Although insurance companies hate the idea, opposition from other businesses has been muted, even though this "public option" is characterized by Republican lawmakers as the first step toward a government-run system. "CEOs are focused on the bottom line," says Len Nichols, director of health policy at the New America Foundation, another think tank. "They know high health-care costs put U.S. companies at a competitive disadvantage."

James Hagedorn, CEO of Scotts Miracle-Gro, describes himself as a conservative. Nevertheless, he sees much to like in the national health systems of Europe. "If someone said to me, 'you can pay the same amount [for health care] and we will redeploy to a national system,' I'm fine," he says. "Why would I argue with that?" BW

SWELLING COSTS

Cumulative U.S. growth rates since 1999

34%	CONSUMER PRICES
29%	WAGES
119%	HEALTH INSURANCE PREMIUMS*

*Figures are for employer-based plans
Data: Kaiser Family Foundation

One of many infrastructure jobs: an electric railway linking east and central China

NI SHUBIN/XINHUA/LANDOV

CHINA'S STIMULUS GOES TO WORK

Funds from Beijing are pouring into projects all over the country. Will that slow economic reforms?

By Dexter Roberts

TIANJIN, CHINA

For a glimpse of China's economic stimulus plan at work, stroll the factory grounds of Tianjin Baocheng Group. Sales of its giant cylindrical boilers for commercial buildings and small power plants are on track to grow 40% this year, to more than $25 million, as government funds fuel a construction boom. With demand soaring, Baocheng is building a huge new factory that will more than double annual production. "The Chinese economy has hit bottom," says Chai Baocheng, a former soldier who founded the company 25 years ago. Thanks to the stimulus, he says, "from now on, it will only keep going up."

Government money is coursing through this sprawling industrial city of 12 million. A historic port 80 miles east of Beijing, the Tianjin area is currently China's fastest-growing region. Not far from century-old banks built by the French and British, a cavernous new station serves as the terminus for a bullet train that takes just 30 minutes to reach Beijing. Stimulus money will help pay for an even bigger station and an extension of the high-speed line to Shanghai by 2012. There's also a new port and a second runway at the airport, plus wastewater-treatment plants and hospitals—all helped by funding from Beijing. "Government companies, private firms, and foreign enterprises are all benefiting from the stimulus," says Yang Weidong, vice-chairman of the Tianjin Chamber of Commerce & Industry.

$676 billion

New bank lending in China in the first quarter

Data: People's Bank of China

It's a similar story across China. Despite three decades of quasi-capitalism, the biggest companies and banks remain under state control, making it relatively easy for Beijing to dump money into the economy. The building binge drove a

29% surge in fixed-asset investment in the first quarter, compared with 25% last year. And even though exports are off by 20%, manufacturing expanded in April for the first time in nine months. Economists now think China will hit its 8% target for gross domestic product growth this year, despite a decade-low GDP of 6.1% in the first quarter. "China's rapid reaction in rolling out the stimulus package has resolved some prominent problems in the economy, strengthened market confidence, and stabilized people's expectations," Premier Wen Jiabao said in April.

ECONOMIC CURE-ALL?

While the $586 billion package made headlines in November for its size, actual investment is already far higher. In the first quarter, new bank lending soared to $676 billion, close to Beijing's full-year target and more than total lending in 2007. While some of those loans are also counted as part of the stimulus, it still amounts to a big boost for fresh infrastructure initiatives not included in the official plan. "Thousands of [additional] projects are being undertaken by local governments, and that's stimulus too," says Stephen Green, head of China research at Standard Chartered Bank. Boiler manufacturer Baocheng, for instance, got a hefty loan from the Agricultural Bank of China to fund its expansion.

Some observers are queasy over the speed at which China has unleashed spending. They fear money will be dumped into questionable pet projects of local governments or even used for speculation in stocks and real estate. More critically, economists say the initial success with stimulus may convince officials that government largesse is an economic cure-all. That could slow reforms such as opening the state-dominated services sector to more competition. "As long as the government is allocating resources, there is going to be waste and corruption," says economist Xu Xiaonian at the China Europe International Business School in Shanghai. "What we need is a further opening of the economy, not more government spending." BW

ILLUSTRATION BY JAMES STEINBERG

A CASH INFUSION FOR MUNICIPALITIES

Investors are buying up Build America Bonds—popular new issues from state and local governments

By Ben Levisohn

Last year, Joseph G. Zegers, the finance director of De Pere, Wis., learned the true cost of the credit crisis. To raise money, the suburban community of 22,000 sold municipal bonds with an interest rate of 5.6%, up from 4.15% in 2006. Facing a higher debt bill, Zegers figured he would have to postpone plans to upgrade roads, sewers, and buildings, hurting local construction. Now, thanks to a new federal program, De Pere is selling munis at 3.3%, saving the city around $200,000. "Without the bonds some projects might not be done," says Zegers. "There would be less employment."

Cash-strapped states and municipalities may have a fix for some of their financial problems: Build America Bonds, a new type of municipal debt that's the financial crisis equivalent of war bonds. Interest rates on the taxable debt, created as part of the $787 billion stimulus package, are higher than typical munis. But Washington foots part of the bill, which in the end makes them cheaper for municipalities.

By some estimates this market could swell by $50 billion this year and another $100 billion in 2010. The funds are good news for states and local governments, whose economies account for 13% of the gross domestic product. Local officials can use the proceeds to build bridges, fix roads, and spruce up schools—the sort of infrastructure projects the Obama Administration is counting on to rev up the U.S. economy and job growth.

Pension funds, university endowments, insurers, and other big investors can't get enough of the debt, which hit the market in late April. The New Jersey Turnpike Authority, the agency that oversees the 148-mile highway, planned to offer roughly $250 million of Build America Bonds. But investor appetite was so great that the agency actually sold $1.4 billion, and it plans to plow that money into road work. The New York Metropolitan Transit Authority, which runs the city's subway system, issued $250 million more in bonds than expected.

California officials, who have just sold $5 billion of the new debt, estimate that the bond deal will translate into 90,000 jobs. Says Tom Dresslar, a spokesman for the California State Treasurer's Office: "The sale of these bonds creates or preserves jobs, pumps millions in revenues into companies that depend on the projects, and bolsters the state coffers." BW

El Comandante wants to revisit deals with foreign contractors

CHAVEZ TARGETS THE DRILLERS

As lower crude prices bite, Venezuela is making foreign oil services companies feel some of the pain

By Peter Wilson

CARACAS

In his never-ending search for scapegoats, Venezuelan President Hugo Chávez is quick to point the finger overseas. Now *El Comandante* has found a new bunch of foreigners to blame: Instead of Big Oil, this time he's hounding oil services companies, which do drilling, exploration, and other important work for state-owned Petróleos de Venezuela (PDVSA). "We will not pay contractors that have tried to speculate and don't care about our company," PDVSA President Rafael Ramírez warned in an Apr. 24 video address to employees. "We have to renegotiate the rates [we pay them]."

PDVSA already owes contractors and suppliers some $3 billion. Tulsa-based natural gas processor Williams Cos. has written off $241 million to cover late Venezuelan payments, and the company is threatening to stop all work in Venezuela unless it gets the money. Offshore drilling contractor Ensco International in January stopped work in the country after Venezuela confiscated a drilling rig in a dispute over payments, though the two sides agreed to a new contract on May 6.

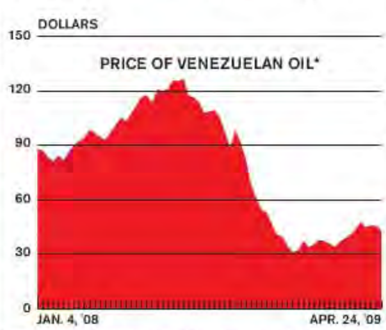
And drilling contractor Helmerich & Payne is waiting on $116 million from PDVSA. While CEO Hans Helmerich expresses some optimism that he will ultimately get paid, he says he will no longer book revenue from Venezuela until the money is in the bank. The Tulsa company is idling seven of its 11 drilling rigs in the country while it negotiates payment. "It's been a difficult period, and frustrating," Helmerich said in an Apr. 30 conference call to analysts.

Things could get even more frustrating for foreigners. On May 5 the National Assembly gave preliminary approval to a bill that would allow PDVSA to take over services such as water injection into oil wells and compressing natural gas. This work is currently done by private companies; the bill says they would be compensated. The measure still faces a few hurdles before it becomes law. But the atmosphere in Caracas is already having a chilling effect on private investment in the oil sector, which last year fell to $500 million from twice that level in 2007, according to the Venezuelan Hydrocarbon Assn., a trade group of foreign companies involved in the oil business. If this keeps up, says Roger Tissot, an independent oil analyst, "PDVSA will find it difficult to find new service companies willing to do business."

Last time Chávez picked a fight with foreign oil companies, prices for Venezuela's heavy crudes were heading for record highs. In 2007, Chávez nationalized four oil joint ventures, spurring ExxonMobil and ConocoPhillips to leave the country. Now, even though oil prices are plunging, Chávez still wants to extract more money from foreigners.

That's because PDVSA, which provides about half the government's revenue, is in trouble. The company last year clocked more than $120 billion in revenues, but this year it's likely to see only about $50 billion. In April, PDVSA cut salaries for managers by 20% and imposed a wage freeze for rank-and-file employees—a move that could poison upcoming contract negotiations with its unions. And the company has slashed investment by $10 billion, delaying three new refineries in Venezuela and two abroad. "PDVSA has to invest in the business," says James L. Williams, heads of oil consultancy WTRG Economics. "You have to feed a cow if you expect it to give milk." BW

CRUDE AWAKENING



*Basket of 70% crude and 30% other oil and gas products
Data: Bloomberg

DAVID ROCHKIND/RAPPORT; CHART BY LAUREL DAUNIS-ALLEN/BW

HOW PRIVATE EQUITY COULD REVIVE THE ECONOMY

By Peter Carbonara
and Jessica Silver-Greenberg
Photograph by Bill Wadman

Armed with $1 trillion, the firms are cranking up their dealmaking. That will pump capital into the markets

Donald B. Marron, founder of the $3 billion private equity firm Lightyear Capital, has been eyeing financial wreckage for more than a year. In early 2008 Marron, the former chairman and chief executive of brokerage PaineWebber, sent teams of analysts to scout out more than 200 struggling U.S. financial firms. So far Marron has made only one deal, buying a stake in student lender Higher One last summer. But the 74-year-old art aficionado, whose starkly modern New York office brims with abstract paintings, says dealmaking will soon pick up dramatically. "We expect this trend to continue," he says.

While some attention has been paid to the vultures now circling the troubled banking sector, private equity is beginning to venture out across the economy in search of deals big and small. Glen T. Matsumoto, a partner in Swedish buyout shop EQT Partners, is looking for more ways to spend the $1.5 billion his firm has amassed for infrastructure and energy plays, having picked up Michigan energy company Midland Cogeneration Venture in March. Brian A. Rich of Catalyst Partners, an upstart buyout shop with $300 million in assets, recently plowed $5.6 million into Mindbody, a California software company. He's hoping to invest in more cash-starved technology and media outfits. "We think it's a great time to put capital out," says 48-year-old Rich, who ran Toronto Dominion's U.S. merchant banking arm before starting Catalyst in 2000.

It's been a rough two years for private equity firms, those freewheeling and much-vilified financiers who buy companies only to sell them later for a profit. The buyout boom that ended in 2007 wasn't pretty; many of the deals made at the height of the frenzy have been disasters. Bankruptcy courts are littered with private equity blunders, including household names Chrysler, Tribune, and Linens 'n Things. Such high-profile blowups heightened private equity's reputation as a group of fast-buck artists who are better at destroying companies than running them.

But a strange thing has happened. While the experts were proclaiming—and maybe even celebrating—their death, private equity firms were quietly bulking up their war chests and readying themselves for a new wave of deals. By some measures they're stronger than ever: Firms are sitting on a record $1 trillion with which to make new purchases, according to research firm Preqin. "They are showing up at the party with a wheelbarrow full of cash," says Donna Hitscherich, a professor at Columbia Business School.

EQT's Matsumoto picked up Midland Cogeneration in March for $650 million

Slowly and deliberately, firms are mobilizing their forces to exploit huge opportunities being created by the recession. Some big buyout firms, filling the void created by the financial crisis, are acting like traditional investment banks, providing loans to troubled companies and even advising executives on mergers. Some firms are aggressively hiring and firing buyout specialists, turning the cold eye they usually train on companies onto themselves. Other firms are prowling bankruptcy courts in search of cheap assets or are capitalizing on government stimulus spending. "There is every reason to believe that private equity will have tremendous opportunity once we hit bottom," says Colin Blaydon, director of the Center for Private Equity & Entrepreneurship at Dartmouth's Tuck School of Business.

When private equity starts cranking up its dealmaking machine—and it will, eventually—the $1 trillion it has amassed could help revive the economy by pumping crucial capital into the markets. "Private equity will be an integral part of this country's economic recovery," says Gregg Slager, a senior partner at accounting firm Ernst & Young. Noted Stephen A. Schwarzman, founder of Blackstone Group, in the private equity firm's March annual report: "Getting the world economy moving again will take more than government intervention."

STILL ATTRACTING INVESTORS

Private equity's surprising resurgence is a study in managing through a downturn. With markets and businesses blowing up all around them, buyout firms calmly made their case to big investors that they were still worthy stewards of capital. In 2008 they attracted $554 billion from pension funds, university endowments, and other big investors, down only modestly from the record $625 billion the previous year. Even this year's seemingly small tally thus far of $49 billion still puts private equity on track to match 2004's total of $206 billion, the sixth-highest ever.

Partly that's because returns haven't been as awful as feared. Private equity funds lost an estimated 20% in 2008. That was on a par with hedge funds and handily beat U.S. stocks (-37%), real estate (-38%), and commodities (-47%). Big investors think private equity will perform better in the future, too. U.S. corporate pensions are assuming their private equity holdings will return 10.1% a year over the next five years, compared with an estimated 7.8% for hedge funds, according to research firm Greenwich Associates.

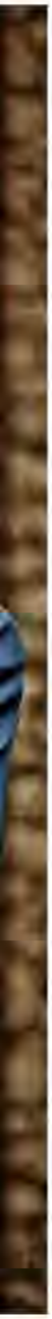
To Carlyle's Sarkozy, "the time is ripe" to buy into banks, both in the U.S. and abroad

BILL WADMAN

The nation's largest pension fund, California Public Employees' Retirement System, even boosted its target for private equity holdings in its portfolio by four percentage points last year. "We're strongly committed to private equity, which helps diversify the portfolios of long-term investors," says CalPERS' spokesman Clark McKinley. Robert Hunkeler, who manages the $13.1 billion in International Paper's pension funds, says he's keeping his stake in private equity at 5% despite recent losses.

The next few years will be dismal for many firms, no question. Buyout shops may be sitting on piles of cash for new purchases, but their portfolios also are stuffed with companies at risk of folding unless they can refinance their debt. Boston Consulting Group estimates that 20% to 40% of private equity firms will disappear altogether in the next few years.

But the wiliest players have inoculated themselves from the worst of the pain. During the boom years, firms used a number of slick tricks to extract money from companies right away and ease potential losses. First they loaded the companies they bought with debt and kept the proceeds for themselves. Then they collected ongoing management fees from those same companies.



Often they did both. Kohlberg Kravis Roberts, founded in 1976 by Henry R. Kravis and George R. Roberts, pulled off the biggest buyout ever in October 2007 when it joined with another big firm, TPG, to buy Texas utility TXU for $45 billion. (KKR also pulled off the largest transaction during the last buyout boom with its $31 billion bid for RJR Nabisco in 1989, the controversial deal immortalized in the book *Barbarians at the Gate*.) After picking up TXU, KKR and its private equity partners immediately collected $300 million from TXU for "certain services" associated with the deal, according to filings with the Securities & Exchange Commission. Plus, the firms are "entitled to receive an aggregate annual management fee of $35 million," which "will increase 2% annually." TPG and KKR declined to comment.

Private equity firms also exploited the remarkably easy lending environment during the boom, negotiating financing terms with unprecedented flexibility. Firms often had to put up minimal capital to close a deal. The maneuvers are paying off now.

Consider the tale of Chrysler. Cerberus Capital Management—named after the mythical three-headed dog that guards the gate of Hades—bought the troubled carmaker in May 2007 for $7.4 billion. Founder Stephen A. Feinberg, a secretive financier with blue-collar roots, has, with hard-nosed dealmaking, transformed Cerberus over the years from a scrappy vulture into a private equity stalwart. In the case of Chrysler, Cerberus contributed only $1.2 billion in cash. And even though Chrysler has filed for Chapter 11, Cerberus isn't likely to lose all of that money; it may be able to offset some of its losses with Chrysler Financial, the carmaker's lending arm, which isn't part of the bankruptcy. Cerberus could merge the lender with another Cerberus investment, GMAC Financial. "It is a big hit," says one Cerberus executive of the bankruptcy. "But it won't break the company."

To be sure, the days of larger-than-life dealmaking are over. Banks are no longer providing the loans that fuel the biggest buyouts. Small purchases will replace megabuyouts, and firms will likely focus their energies on sprucing up operations rather than extracting fees and engineering financial gains. "It's back to the future," says William E. Ford, chief executive of General Atlantic, a private equity firm with $13 billion in assets.

Some firms have even begun to deemphasize buyouts, quietly transforming themselves into diversified financial players that provide a wide array of money management, trading, and advisory services. Schwarzman, the 62-year-old head of Blackstone Group, is aggressively filling the void left by the Lehmans of the world. Schwarzman's ambitions are as grand as his New York City apartment, a 35-room triplex once owned by John D. Rockefeller. At the firm's start in 1985, Schwarzman and co-founder Peter G. Peterson shared a secretary and oversaw a grubstake of just $400,000. Today Schwarzman, infamous for a lavish birthday party he threw himself in 2007, sits atop more than $90 billion in assets and employs more than 1,340 people. Blackstone collected $410 million last year—not from its bread-and-butter buyout business but from advising other companies on mergers, acquisitions, and restructurings. Said Schwarzman in the firm's annual report: "Our financial advisory group delivered record fees last year by meeting the demand for a trusted, independent adviser."

PROFITING FROM THE PAIN

Blackstone's advisory clients range from troubled insurer AIG to the Ukrainian government. In December Tim Coleman, who co-heads Blackstone's reorganization and restructuring group, flew to Detroit to meet with Ford Motor's CEO, Alan Mullaly, and other top executives. Coleman's recommendation: Rework the debt. After that initial meeting, Mullaly hired Blackstone and Goldman Sachs to dispense advice. The three companies spent the next few months brainstorming and hashing out strategies at Ford's headquarters. "We worked 'round the clock," says Coleman. "There wasn't room for anyone's ego to get involved." They brought their plan to bondholders in April, offering to exchange $1.8 billion in debt for $1.3 billion in equity. The investors agreed.

Like all tough-minded investors, private equity firms are busy looking for ways to profit from rivals' pain—and even

CHART BY RAY VELLA/BW

their own. College friends Rodger R. Krouse and Marc J. Leder are among the most aggressive. The two left Lehman Brothers in 1995 to forge their own firm, Sun Capital Partners, in Boca Raton, Fla. They had a tough time muscling into the clubby world of private equity, but since 2002 Sun Capital has bought more than 200 small and midsize companies and earned 20% a year. Among its holdings: restaurant chain Friendly Ice Cream and bagel chain Bruegger's Enterprises. More than 10 of Sun Capital's companies have filed for Chapter 11, including retailer Big 10 Tires, auto parts supplier Fluid Routing Solutions, and department store Mervyns. But Krouse and Leder, both 47, are capitalizing on the trouble by doling out high-interest, short-term loans to some of its bankruptcy victims. Sun Capital declined to comment.

Few private equity portfolios are as troubled as that of New York's Apollo Management—but even its list of losers is presenting opportunities. The $45 billion Apollo owns bankrupt retailer Linens 'n Things, along with struggling casino chain Harrah's Entertainment and real estate firm Realogy. But Apollo recently raised $15 billion for new investments and plans to use a quarter of that stash to buy distressed debt, including the debt of some of its own holdings.

Junk bonds are familiar territory for Apollo founder Leon Black. The 57-year-old started Apollo in 1990 after leaving Drexel Burnham Lambert, the notorious investment bank that collapsed that year. Black's interest in his own distressed debt is partly defensive and partly speculative. By buying back bonds aggressively, Black can try to prevent other vultures from picking up the debt and wresting control of his investments. He's also likely betting that the bond prices will rise in value and that he'll be able to sell them at a profit later. Apollo declined to comment.

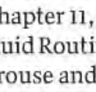
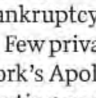
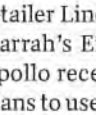
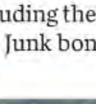
FRENCH CONNECTION

Many private equity firms are taking a sharp pencil to their own books as well. Even as the giants are laying off staff and closing offices, they're recruiting specialists in fields where they see opportunities. Apollo, for example, added former Morgan Stanley banker Neil Shear to its new commodities group. In a burst of recent hiring, Blackstone picked up infrastructure specialists Trent Vichie and Michael Dorrell from the New York branch of Australia's Macquarie, among other recruits.

Carlyle Group, one of the largest and most secretive private equity firms, started preparing for a flood of bank deals last year. The 22-year-old firm, whose ranks have included such

MASTERS OF THIS UNIVERSE

The largest private equity firms are bulking up their war chests and readying themselves to make deals

	COMPANY NAME POSITION/FOUNDER	ASSETS (BILLIONS)	STRENGTHS	WEAKNESSES
	**Blackstone Group** Chairman: Stephen Schwarzman	$91	The diversified financial firm invests in companies, real estate, mortgages, and debt. Blackstone made $410 million last year advising companies on mergers, acquisitions, and restructurings.	Shares are down 35% since the company's 2007 IPO. One holding, Hilton Hotels, has been battered by a drop in tourism.
	**Carlyle Group** Founders: David Rubenstein (left), Daniel D'Aniello, William Conway Jr.	$85.5	Carlyle uses its political clout to land deals. Former President George H.W. Bush and former Secretary of State James Baker III are among those who have worked for the firm.	New York Attorney General Andrew Cuomo is investigating whether Carlyle influenced pension fund managers to snag more business.
	**Bain Capital** Founders: Mitt Romney and seven partners	$60	Turnaround artists known for their strong management skills, the firm bought a 93% stake in Domino's Pizza in 1998 and sold it to the public six years later, returning 400% to investors.	Bain's portfolio is filled with troubled retailers, including craft chain Michaels and Guitar Center.
	**Kohlberg, Kravis, & Roberts** Founders: Henry Kravis (left) & George Roberts	$55	The firm—whose 1989 takeover of RJR Nabisco inspired the book *Barbarians at the Gate*—is poised to capitalize on infrastructure spending. It also is eyeing a South Korean brewer.	One KKR unit's shares plummeted after suffering a $40 million loss on bad mortgage investments.
	**TPG** Chairman: David Bonderman	$50	A specialist in reviving floundering businesses, TPG could scoop up assets in Chapter 11. The firm is skilled at collecting fees from its portfolio companies up front.	TPG lost $1.7 billion on its investment in Washington Mutual, which was seized by regulators and sold to JPMorgan Chase.
	**Apollo Management** Chairman: Leon Black	$45.1	With hundreds of names in its portfolio, Apollo can weather the downturn. One holding, big-box grocery store Smart & Final, is surging as consumers look for discounts.	Apollo has plenty of clunkers among its companies, including Harrah's and Realogy.

(TOP TO BOTTOM) PHOTOGRAPHS BY JAMES LEYNSE/CORBIS; STEPHANIE KUYKENDAL/BLOOMBERG NEWS; JIM COLE/AP PHOTO; DANIEL BARRY/BLOOMBERG NEWS; ANDY SHAW/BLOOMBERG NEWS; ADAM BERRY/BLOOMBERG NEWS

Rich of Catalyst Partners is hunting small tech and media companies

BILL WADMAN

well-connected advisers as former President George H.W. Bush and former British Prime Minister John Major, has been expanding aggressively into real estate, venture capital, and other alternative assets—and has bagged some high-profile talent. Last year, Carlyle lured UBS investment banker P. Olivier Sarkozy, half brother of the French President. Sarkozy has advised on a number of bank deals, including ABN Amro's sale of LaSalle Bank to Bank of America for $21 billion, part of a breakup of the Dutch bank.

At Carlyle, Sarkozy spends much of his day poring over balance sheets and scouring troubled mortgage portfolios. He has been traversing the U.S. for the past few months, visiting local banks in tiny towns and regional players in urban areas. Now Sarkozy, along with Blackstone, Centerbridge, and W.L. Ross, are in discussions with management at BankUnited, a struggling lender in South Florida. "Private equity will be a prime catalyst in the necessary recapitalization of banks, both here and globally," says Sarkozy, 39. "The time is ripe."

BARGAINS IN THE 'CANDY STORE'

Perhaps the most combative arena for private equity these days is the bankruptcy courts. Buyout firms are swarming, making bids on busted businesses and in some cases entering into bidding wars. Lynn Tilton, the pugnacious founder of Patriarch Partners, spends much of her time in court fighting over cheap assets. The 49-year-old Tilton, known for her flamboyance in stiletto heels, recently lost a contentious 16-day auction for instant photography pioneer Polaroid to rivals Hilco Consumer Capital and Gordon Brothers Brands. She's appealing the decision. On Apr. 20 Tilton bought Stila Cosmetics, filling out a portfolio of troubled brand names that include mapmaker Rand McNally. Stila had fallen behind on its debt payments, and lenders took control of the makeup manufacturer. They called Tilton on a Friday night to make a deal. She talked with management on Sunday and by the following weekend owned the company. "I haven't seen anything like this in 35 years," Tilton says of the opportunities before her. "This is like a candy store for us."

The value in Patriarch's distressed plays isn't always obvious. Last summer Tilton bought a paper mill in Maine, since renamed Old Town Fuel & Fiber. But she didn't buy it just to make pulp. A main attraction for Tilton is the mill's $30 million grant from the Energy Dept. for a research program studying how to make biofuels from wood chips. Tilton wants to produce a biofuel called butanol at the plant, which can be used as aircraft fuel. That would create another potential opportunity, because Patriarch also owns a helicopter maker and an aircraft parts manufacturer.

Few investments look as appealing as those blessed by government dollars. As part of the $787 billion federal stimulus package signed into law in February, the government has earmarked $29 billion to patch crumbling roads, bridges, and schools. Thanks to Uncle Sam, the infrastructure investing trend is picking up. The states' cash crisis is also sparking interest. "With states facing real economic trouble, you will see further pressure on them to hand over infrastructure to private firms," says Ben Heap, co-head of infrastructure in UBS's private equity group. There were 127 infrastructure funds in 2008, up from 91 in 2006, according to research firm Probitas Partners.

When Sadek Wahba, investment chief at Morgan Stanley's $4 billion infrastructure fund, goes shopping for deals, he follows two main principles. First, invest only in public necessities. Second, make sure the concerns of local citizens are heard—to minimize political problems later. In December, Morgan Stanley and a group of investors paid $1.15 billion for 36,000 parking meters in Chicago. Wahba is converting the old coin-operated devices to electronic pay machines. "These assets are a good hedge against inflation, because you are providing a basic service," says 43-year-old Wahba.

But the best example of private equity's shrewdness in the downturn may be its ability to spiff up its sullied image. In Pittsburgh, Robert B. Fay and his brother Pat feared selling their 62-year-old construction business, Joseph B. Fay Co., to private equity, worried that a buyer would dismember the company and lay off staff. The family's lawyer called New York's FdG Associates after reading that the $300 million buyout firm had experience working with family-run businesses. In all, the Fay brothers met with six private equity firms. FdG's team wore casual khakis to its meeting to underscore its anti-Wall Street image, while rivals sent representatives in designer suits. The Fays identified with the FdG team instantly and agreed to sell to the firm in February. Says Bob Fay: "These guys came to us as partners, not vultures." |BW|

—With Tara Kalwarski in New York and David Welch in Detroit

Business Exchange

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Old Stakes, New Value

Amid the ongoing cash crunch, some university endowments, insurers, and other big investors are looking to sell their investments in private equity funds. An Apr. 13 piece on Deal.com reports that Goldman Sachs recently launched a $5.5 billion fund to buy up those stakes on what's known as the secondary market. "Things may be tougher than usual in the world of private equity ... but it just means more opportunities for Goldman," the author writes.

To read the full article, go to **http://bx.businessweek.com/private-equity/reference**

ISRAEL'S NEW PIONEERS CASH IN ON CLEANTECH

They're pros at getting the most out of limited natural resources. The world is taking notice—especially U.S. venture capitalists

By Roben Farzad
Photography by Eilon Paz

Yavne, a hazy industrial corridor in central Israel, seems at first glance an improbable haven for geothermal technology. Its largely barren environs offer no geysers or volcanoes, the essential raw materials for geothermal energy. Yet this small city of 32,000 is home to Ormat Technologies, a $2 billion multinational listed on the New York Stock Exchange that builds geothermal power plants around the world, from Colorado to Kenya.

At a kibbutz, or farming collective, 70 miles to the south in Israel's Negev Desert, entrepreneur Amit Ziv recycles runoff water from a nearby spa to raise sea bass and barramundi, a white fish in demand at high-end restaurants. He then channels the water from his desert fish farm to grow olives, which he exports to, of all places, Spain. "Seagulls and pelicans must be thinking, 'What the hell?'" remarks Shai Ben-Tal, one of the kibbutzniks.

One can't help but think the same.

Anyone visiting Israel will quickly realize that its resourcefulness is a matter of necessity. The New Jersey-size nation of 7 million has no choice but to conserve: Marked by long stretches of desert and a dwindling freshwater supply, it is both bereft of natural bounty and flanked by neighbors bent on its annihilation. Simmering hostilities often rise to full-fledged military actions, most recently in December, when Israel responded to Palestinian rockets by invading the Gaza Strip.

Levy and Schwaber of Cleantech: The green energy industry hums "despite politics"

Israel's siege mentality is driving its six-decade quest to coax more from the soil, water, air, and sunlight than do most other nations on earth. In the throes of a three-year drought, for example, Israel leads the world by recycling 70% of its wastewater, three times the figure for No. 2 Spain. Now many of Israel's so-called cleantech companies, including drip irrigation pioneer Netafim and solar power outfit BrightSource Industries, are exporting their wares around the world. They're even setting up shop inside that other hotbed of innovation, the U.S. "The world is now realizing it has to deal with things that Israel has had to tackle for 50 years," says Jacques Benkoski, a venture capitalist with Silicon Valley-based U.S. Venture Partners. "Doing more with less is becoming the standard."

Venture capitalists seem eager to get in on the action, especially at a time when most other investment prospects are bleak. Just about every major VC firm in Silicon Valley, from Kleiner Perkins Caufield & Byers to Sequoia Capital, is prospecting across Israel for cleantech investments. All told, at least 80 venture funds, many of them American, manage more than $10 billion here, with an increasing share devoted to cleantech companies.

Google co-founder Sergey Brin and several U.S. politicians have paid visits to Israel recently to learn about water- and energy-conservation technologies. "We can't rely on others for our safety and security," says Phoenix Mayor Phil Gordon, who is looking to import Israeli solar expertise.

One might assume that the Israeli government is driving the audacious efforts to raise fish amid the sand dunes. But officials seem too preoccupied with national defense and political scandals to take notice.

Israel is a nation of contradictions, socialist in many ways but laissez-faire when it comes to the economy. The national equivalent of a startup, it was founded by people willing to make a go of it in a swath of land dominated by desert. The core element of that plan was the kibbutz, wherein people eat together, tend to communal crops and livestock, and even dispatch their two-year-olds to a dormitory. Kibbutzes are still common: There are at least 200 throughout Israel. That sense of shared purpose has always translated to national defense, which politicians consider paramount. Israel spends vast sums on its military and requires at least two years of active service for 18-year-olds and continuing service for adults.

HOW TO PLAY IT 058

But government leaders agree on little else, apart from military imperatives. Prime Minister Ehud Olmert recently resigned amid corruption charges and ongoing public resentment over Israel's 2006 invasion of Lebanon. As usual, rival factions on the secular left and religious right, instead of studying long-term policy goals, are plotting to shift the short-term balance of power. In Israel's 60-year history, only two prime ministers have served out their full terms.

The paralysis helps explain why business and the economy are mostly left to their own devices, with few companies outside the defense sector reaping the benefits of government investment—or even attention. "The cleantech economy here hums independently, on market forces and innovation, despite the political situation," complains Glen I.A. Schwaber, 39, a founding partner at $75 million Israel Cleantech Ventures, a VC firm that he runs with Harvard classmate Jack S. Levy. Just imagine, says R. James Woolsey Jr., a former director of the CIA, if an Israeli politician were to rise to national prominence by championing, say, government investment in crude-oil alternatives. "They couldn't do anything better for their own security," he says. "And ours."

No essential commodity is scarcer in Israel than water. Sure, wastewater is recycled, but there's precious little freshwater for drinking. "The government has been promising more freshwater since I was a kid," says a waiter at a café in Tel Aviv. "But they will spend it on the next war instead. We'll all die of thirst first." With government officials focusing on other matters, business is stepping in to solve the water problem just as it always has: with high-tech ingenuity.

The late Simcha Blass, a Polish-born veteran of World War I, saw world-changing possibilities where others saw only sand. In the decade before Israel won statehood, Blass had a Ben Franklin-style lightning-bolt moment in the Negev Desert. Captivated by an abnormally large tree he spotted in a grove, he shoveled underneath it and discovered a cracked drainpipe feeding steady droplets directly to the tree's roots—just enough water to allow the tree to flourish. In 1965, after years of iterations, Blass patented and sold his vision of "drip irrigation" to Hatzerim, a kibbutz in the Negev. Hatzerim had great faith in drip irrigation's central promise, the measured release of the perfect amount of water to sustain agriculture. It sounds simple, but getting it right takes an enormous amount of technological prowess.

Today Hatzerim and two affiliated kibbutzes remain majority owners of the company that has grown into Netafim, a $500 million high-tech drip-irrigation giant employing 2,600 people in 110 countries. Besides making drip pipes, Netafim sells greenhouses and advises governments on how to tease cash crops from stingy tracts. Netafim keeps its finances intensely private, except to note that it has produced a 17% compound annual growth rate since 2003.

WATER SECRETS

In 2005, a pair of private equity funds, Los Angeles-based Markstone Capital Group and Tel Aviv-based Tenne, took a combined 20% stake in Netafim, placing their chips on what is expected to be a $540 billion global water market in two years. "We bought into decades of collective agronomic experience and all the trial and error it took to master drip irrigation," says Elliott Broidy, chairman of Markstone, which owns 13% of Netafim. Drip irrigation's appeal seems undeniable: Just 0.3% of the world's water can be used for drinking or farming. At the same time, the world will have to achieve far greater crop yields to sustain a population expected to grow from 6.3 billion today to 8.1 billion by 2030.

Netafim's lush corporate and residential campus is dotted with palm and date trees, but it has the secretive feel of a semiconductor foundry. Ofer Bloch, Netafim's 49-year-old chief executive officer, isn't keen on letting photographers snap pictures of the place, so precious are the secrets of his technology. Inside, machines custom-carve "labyrinths" on millions of microchips that are then installed behind tiny drip holes inside plastic pipes. The chips measure, time, and distribute the perfect drop of water to be channeled to the roots of every plant in the field. Netafim lays out nearly 3 billion meters of drip lines a year and monitors every bit of water that courses through.

Solar utility BrightSource is exporting its technology to the U.S.

Having conquered the tiny Israeli market, Netafim has set its sights abroad, where it earns 95% of its revenues. In Peru, a provincial government retained Netafim to assess what kind of crops could be sustained in a dry, mountainous region. After engineers computer-modeled the terrain, the verdict came in: asparagus. Citrus and almond growers in California, meanwhile, use Netafim pipes to irrigate thousands of inland acres that otherwise would lie fallow.

Couldn't the government channel such technological expertise to solve its drinking-water problem? Even public officials complain of the lack of progress in desalinization, or removing salt from seawater. "What we've done in terms of drip irrigation we desperately need to do for desalination," says a highly placed government adviser. "Drinking water is immediately urgent. Everyone in Israel, rich or poor, knows it's a crisis. But government just keeps delaying, especially because it will require billions of dollars and years of focus that Israeli leaders won't commit to. So they blame the lack of rain."

Energy is just as vexing to some Israelis. Most of Israel's terrain is well suited for solar panels, yet the nation still derives almost all of its electricity from coal and other nonrenewable fuels. Arnold J. Goldman, chairman of solar utility BrightSource Energy, complains about the situation during a two-hour ride from Jerusalem to the company's testing complex in the Negev. "All that light, all that heat," he says, pointing at the hot sand, "is practically begging you to use it." So far,

BrightSource has raised more than $160 million from investors including U.S.-based VantagePoint Venture Partners, Google, BP's investing arm, Morgan Stanley, and JPMorgan Chase.

Goldman, an avuncular engineer with a chin-strap beard, made a killing during the 1970s by founding Lexitron, the first word-processing software maker in the U.S. After selling the company in 1977, he says, he dove headlong into alternative energy, building nine solar power facilities in the Western U.S. That startup, Luz International, folded in 1991, a victim, alleges Goldman, of collusion by utilities, the gas-and-coal lobby, and their friends in high office. BrightSource Industries, launched in 2004, is Goldman's revenge.

BrightSource's technology seems right out of science fiction. As the van traverses the final mile to a test center in Dimona, what looks like a burning oil rig looms in the distance. Inside the maximum-security complex, passengers present their passports and don protective boots to guard their feet from the scorching sands. A semicircular array of 1,641 mechanized coffee-table-size mirrors pivot to reflect the desert sun's rays onto the boiler atop the rig, which BrightSource calls a "power tower." The company's power towers produce superheated steam for turbines. They "offer the maximum level of efficiency," says Alan E. Salzman, managing partner of Silicon Valley's VantagePoint, BrightSource's largest investor. Salzman says the towers convert steam back into water and return it to the boiler, where it is reused again and again.

SOLAR BOUNTY

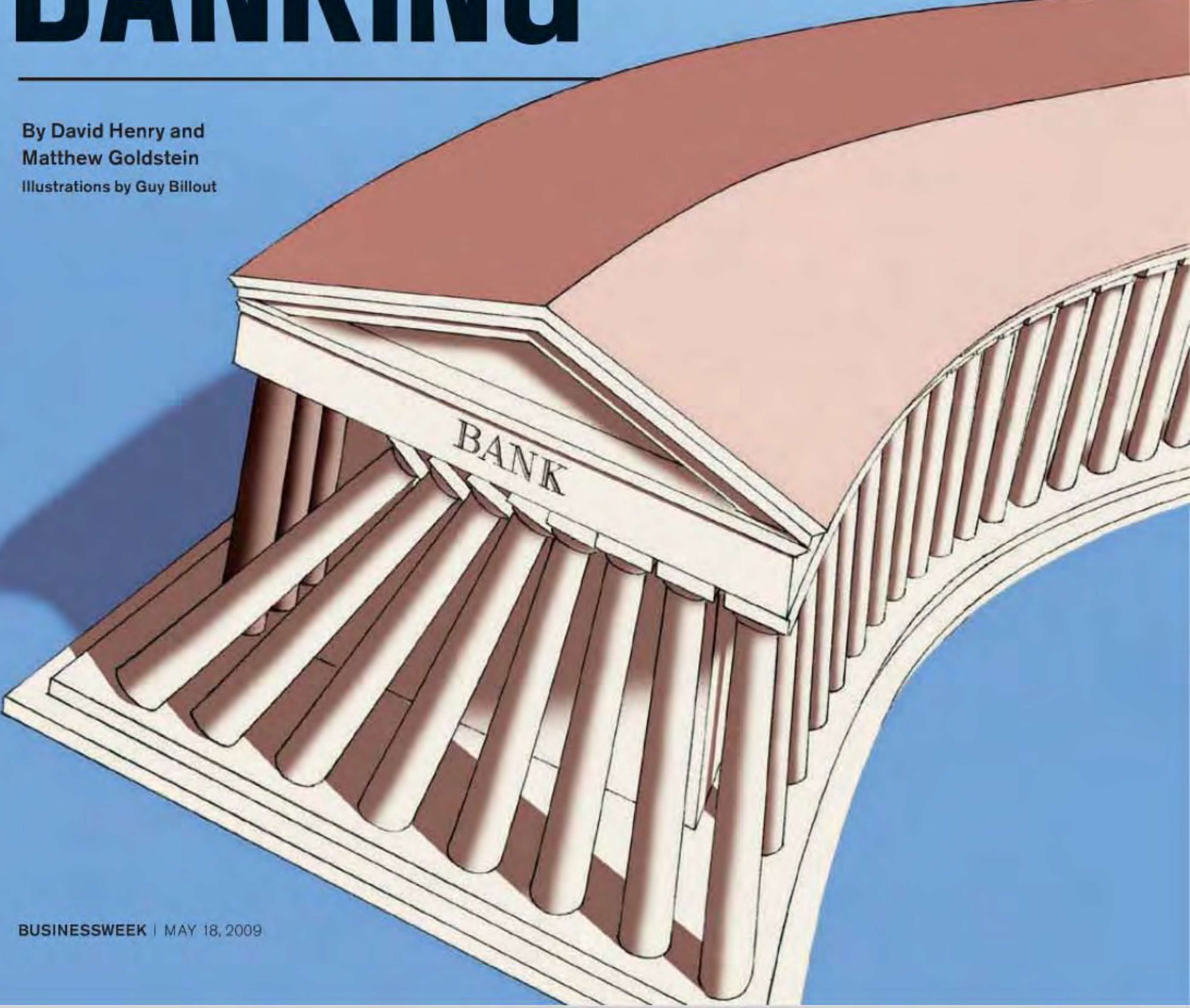
The technology, claims Goldman, could help reshape some countries' population centers. Parched stretches of California and Nevada, Saharan Africa, Saudi Arabia, and Australia are especially suited for solar thermal power plants, he says. Last March, BrightSource inked a deal with California's Pacific Gas & Electric to provide up to 900 megawatts of solar thermal electricity in the Mojave Desert as early as 2011. (In February, BrightSource signed an even bigger deal with Southern California Edison. At 1,300 megawatts it's the world's largest solar-power purchase agreement.) "We see solar making a big impact in the Southwest and California," says Jack Keenan, PG&E's chief operating officer. "Partnering with BrightSource will enable us to increase the growing amount of renewable energy demanded by our 15 million customers." Goldman says that if he were able to plaster the southwestern U.S. with solar mirrors, he could meet 69% of the nation's electricity needs.

David Faiman, director of Ben-Gurion University's National Solar Energy Center Dept., says Israel needs to stage a national research and development push to bring down the cost of solar electricity. "It's only natural to ask why a country with all this sunlight and no fossil fuels never moved on that vision," he says. "And yet you also come to learn that our political disarray doesn't lend itself to long-term planning."

What if Israel could find the will to harness the power of its drip pipes, power towers, and desert fish farms? "Israel has such a geopolitical vested interest to steer this innovation," says Jonathan Shapira, a corporate attorney in Boston who organizes and blogs about Israeli cleantech. "Innovating around scarcity is increasingly the world's story." | BW |

THE PERILS OF GLOBAL BANKING

By David Henry and
Matthew Goldstein
Illustrations by Guy Billout



Selling through a web of subsidiaries, banks have left investors across the globe holding potentially toxic bonds. Now governments are moving to restrain foreign financial firms

JA Solar Holdings, a once-thriving Chinese manufacturer of solar-power cells, is getting a rude introduction to the dangers of global finance. So is Peter Howard, a retired British tax official. And so are Cedric Ruber, a Belgian school inspector, and his father, Rene, a retired employee of the U.S. Army. ¶ Each is trying to recoup money from Lehman Brothers, whose bankruptcy in September paralyzed the world economy. They're just a few of the tens of thousands of burned investors around the world complaining loudly that they were sold toxic bonds that were supposed to be safe. In street demonstrations from Hong Kong to Hamburg, protesters are demanding that their governments do something to get their money back. ¶ Now there's a growing fear among economists, policymakers, and business groups that in the name of protecting their citizens from global financial institutions, governments could slow the flow of capital between countries—at a time when

the world economy is already contracting. "We're looking at a period of, at best, a pause of globalization, and more likely a period of 'de-globalization,'" Mohamed El-Erian, chief executive officer of bond giant PIMCO, said at a conference on Apr. 27. Governments are already moving to impose new hurdles on foreign firms. Regulators in Britain have started asking U.S. banks selling bonds there to provide hundreds of pages of proof that the mighty U.S. government, which is backing the bonds, could actually repay them.

A revelation from Lehman's bankruptcy illustrates why public confidence has been so shaken. It turns out that during the credit boom, a little-known Amsterdam unit called Lehman Brothers Treasury churned out $35 billion worth of dubious bonds, fully a quarter of the parent company's total bond debt when it went bust. Many of those bonds, baroque in their complexity, were sold to small investors in Europe and Asia—high finance for the masses. In the U.K., at least 6,000 retirees bought in. Brokers in Asia plied small investors, a few of them mentally ill, with free digital cameras and flat-screen televisions. As Lehman fought for its life in its last six months, it pushed harder to sell the bonds, most of which were "guaranteed" by the parent company in New York.

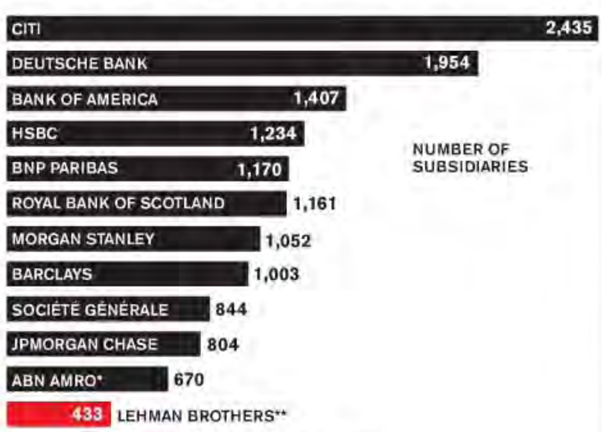
Or so the investors thought. When Lehman Brothers Holdings collapsed in September, the bonds lost virtually all their value. JA Solar ate $100 million. Howard lost $74,000 of his retirement savings. Rene and Cedric Ruber are out some $200,000.

The Amsterdam debacle offers a rare glimpse into Wall Street's relentless drive to exploit foreign markets. Overseas locales provide banks great opportunities for "regulatory arbitrage," the practice of searching high and low for the most beneficial legal environments for particular lines of business. Lehman chose Amsterdam because of the tax benefits there. In recent years Wall Street firms have set up thousands of overseas subsidiaries for various purposes. Among other things, the entities have sold trillions of dollars worth of risky "derivatives" like the ones bought by Howard and the others. Lehman had 433 subsidiaries when it blew up—and it was relatively small. Citigroup has more than 2,400 (chart).

That global tangle of bank subsidiaries is creating bigger problems than anyone realized. The Lehman case shows how hard it can be for burned investors to get their money back in the event of disaster. Its bankruptcy alone has spawned more than 75 insolvency proceedings in 15 countries, each with differing rules. Without coordinated efforts, countries could find themselves pitted against one another. Even Belgium and the Netherlands, two close friends, clashed after the multinational Fortis Bank began to collapse in September. The bankruptcy proceeding quickly devolved into each country looking out for its own citizens.

A GLOBAL WEB

Many financial firms were more complicated than Lehman, whose collapse brought on a worldwide crisis



*Acquired by consortium of RBS, Fortis, and Santander
**Bankrupt; most assets acquired by Barclays and Nomura
Data: Richard J. Herring, Wharton School, 2008

TAX HAVEN

Equally worrisome, Wall Street's embrace of foreign markets makes it nearly impossible for national regulators to keep watch over what's being sold abroad and to whom. Even now, in the thick of the credit crisis, the biggest firms on Wall Street, Goldman Sachs among them, are setting up deals to sell potentially risky investments through foreign subsidiaries. This is one reason why the current financial debacle is unlike any that policymakers have had to confront. "I wouldn't want to be a regulator today," says Fried Frank partner Thomas P. Vartanian, who served as general counsel to the Federal Home Loan Bank Board at the start of the savings and loan crisis of the 1980s. "Some of the buttons on the control panel simply don't work." Prominent regulators concede the point. "A lot of these institutions [that got into trouble] were already regulated," Sheila C. Bair, head of the Federal Deposit Insurance Corp., said at an Apr. 23 industry conference in Washington.

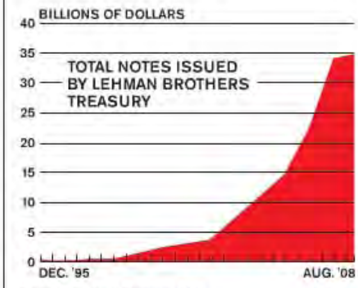
It's no wonder that Lehman's Amsterdam operation is fueling outrage. The operation was created in 1995 to sell "structured notes," a type of derivative that's like a bond except that the payments are tied to the performance of other investments. The subsidiary had an Amsterdam address but was run out of London by Lehman Brothers International (Europe), itself a subsidiary of Lehman Brothers Holdings in New York.

Bankers call such enterprises "special purpose entities," but a more direct term might be "shell company." The Amsterdam unit had no independent staff and was overseen, nominally, by a board of five directors. Two worked for Equity Trust, a Dutch company that provides administrative services for companies and investors—everything from setting up trusts to serving as directors on boards. Equity Trust counted Lehman as a client. What's more, the Amsterdam subsidiary used Equity Trust's mailing address as its own. In the past, the address was used by a unit of Enron. Equity Trust declined to comment.

The Netherlands has emerged as a haven for companies

In Belgium: The Rubers lost $200,000 invested in Lehman notes

THE DUTCH CONNECTION



Data: Houthoff Buruma N.V.

that want to avoid certain taxes on profits. A 2006 report by SOMO, a research group that focuses on multinational companies, found that some 20,000 "mailbox companies" had set up shop in Amsterdam for this purpose alone. That's one reason the Obama Administration is proposing a crackdown on offshore corporate tax havens.

Jeremy Isaacs, head of Lehman Brothers International (Europe), oversaw the Amsterdam unit. He had been something of a wunderkind, embarking on his career in finance at age 18, with a back-office job at a U.K. brokerage. In 1989 he got a job as a derivatives trader at Goldman in London. Isaacs joined Lehman in 1996, at age 31, and within four years had taken the helm of Lehman's entire European operation.

ULTRA-CUSTOMIZED NOTES

From 1995 through 2002 the Amsterdam subsidiary was a bit player in the Lehman empire. But as the global credit boom began, Isaacs turned the operation into a virtual factory, issuing $30 billion in structured notes from 2003 through August 2008. At industry conferences during those years, Lehman executives, including CEO Richard S. Fuld Jr., said the Amsterdam notes were an important source of revenue. Isaacs left Lehman two days before it collapsed.

Lehman's Amsterdam notes were bafflingly complex. In all, the unit issued some 4,000 variations, and the documentation for each type often ran to 600 pages. Lehman tailored the notes in an amazing array of styles to cater to just about any investing need. Would someone like a bond that would pay on the "outperformance" of Japanese stocks vs. U.S. stocks? Lehman created them, along with a "rocket tracker" on the Dow Jones Euro Stoxx 50 index. How about a bond for a thrifty soul who wanted to guard against inflation in Italy? Lehman had notes tied to consumer price indexes there, and in Spain and Mexico, too. It shipped the proceeds from selling the bonds back to New York.

JA Solar bought $100 million worth last summer, at the urging of its Lehman bankers. It says the bankers pitched the notes (which paid a little interest each quarter if a certain commodity index registered a gain) as no riskier than a money market fund. JA Solar says it was told that at worst the investment would come out flat. "We did not anticipate [the notes'] coming even close to risky," says Anthea Chung, JA Solar's chief financial officer.

Now the company is reeling. It has written off the entire $100 million on its books. Its stock, which is traded in New York, is down 66% since Lehman filed for bankruptcy. JA is becoming one of the pioneers of de-globalization, preferring to keep its financial deals closer to home. "For the near future, we are quite comfortable with Chinese banks," says Chung. "They are backed by the Chinese government."

Lehman also tapped retail banks, including Citigroup and UBS, to hawk the Amsterdam notes, which were part of an enormous market. All told, Wall Street has sold more than $640 billion of structured notes to small investors around the world, according to StructuredRetailProducts.com—most of them from overseas units. That's about the size of the market for subprime collateralized debt obligations (CDOs), which brought on the global crisis. "[Lehman's notes] were sold directly by the banks to their retail customers," says Erik Bomans, a partner at Deminor, an advisory firm specializing in investor protection. Deminor, based in Brussels, is working with attorneys representing buyers of Lehman notes sold in Belgium, Italy, and the Netherlands. To date, the firm says, it has been

BURNED LEHMAN INVESTOR JA SOLAR ILLUSTRATES WHAT MAY BE A DE-GLOBALIZATION TREND: NOW THE CHINESE COMPANY IS STICKING WITH CHINESE BANKS

ED ALCOCK

contacted by 1,600 investors. "You can't even call them investors—they were savings bank customers," says Bomans.

The Rubers are among those who claim they were misled. Rene Ruber says a banker at a Citigroup office in Belgium sold him and his son about $200,000 of Lehman notes, promising an annual return of up to 6%. He says the notes were presented as a risk-free savings tool. "In plain English, we were screwed," says Rene. "I was lied to. They are not honest bankers." His son Cedric says some of his lost money had been earmarked for a new home, and some for college savings for his two children.

UBS says it "properly sold these investments to its clients. The offering materials clearly identified Lehman as the issuer and discussed all the relevant risks." A Citi spokesman in Belgium says the bank "is committed to helping affected customers retrieve as much of their original investment as possible through Lehman's bankruptcy proceedings in the U.S. and the Netherlands."

In Britain it's a somewhat different story. Most of the notes sold there were marketed under the names of various London-based brokerages. Investors say they never knew that Lehman originated the bonds or guaranteed them. "If people knew it was Lehman, many wouldn't have bought them," says Howard, the retired British schoolteacher, who purchased notes in February 2008. "Many [American banks] were having a sticky time back then."

Howard, 58, is trying to organize U.K. investors to recoup their money. Working from his home in Wantage, in Oxfordshire, he has spoken with about 100 people so far, he says. "The average age is 65," says Howard. "Most of them took some of their pension money and invested in these notes." He says he has been talking to members of Parliament to get them to pressure brokerages to reimburse investors. In the next few weeks, his grassroots group, SPIRIT—short for Structured Products Investors Recovery & Information Team—plans to launch a Web site to draw more attention.

Similar stories abound in Asia, where investors have taken to the streets in Hong Kong several times since Lehman collapsed. The government says the Hong Kong Monetary Authority received more than 20,800 complaints about the notes, called minibonds there. Government officials on Apr. 28 alleged that some banks sold minibonds to mentally ill investors, although more details couldn't be obtained.

The minibonds were similar to the Amsterdam notes except that they weren't "principal protected." Instead, a marketing leaflet said the minibonds were "credit-linked to a basket of well-known international financial institutions," such as JPMorgan Chase. In fact, they were tied to a CDO. The leaflet said the minibonds were safe and that returns "may reach 48.4%." But they were no more secure than Lehman's ability to pay back the cash. That risk was buried in the fine print, below icons for gifts—digital cameras, LCD TVs, even grocery coupons.

GORDIAN KNOT

Now investors are trying to get their money back. "We feel totally cheated," says Alex Chow, 51, who lost about $130,000 and is organizing more protests. "The bank stole

BATTLING 'TOO BIG TO FAIL'

How the U.S. could avoid future giant bailouts

By Theo Francis and David Henry

When Lehman Brothers collapsed, Washington learned that some firms are too tangled up in the global financial system to fail. But unless the White House figures out a way to shrink the global giants, U.S. taxpayers will likely have to bail out more big firms in the future.

To combat this problem, the Obama Administration is asking Congress to broaden regulators' powers to seize failing banks. It wants the feds to be able to take over such diverse financial giants as insurance-based conglomerate American International Group, as well as big holding companies, such as Citigroup, that own both traditional banks and securities-trading units.

But that wouldn't address one key problem laid bare by Lehman: the byzantine profusion of rules different nations have for handling failed financial firms. Without more coordination, countries could find themselves pitted against our money," he says. Two firms that distributed Lehman minibonds have agreed with regulators to repay investors. About 6,000 investor claims are being settled, says the Hong Kong government.

Meanwhile, in Amsterdam, the untangling of Lehman Brothers Treasury is just beginning. Rutger Schimmelpenninck, a partner with law firm Houthoff Buruma who is serving as the bankruptcy trustee, is daunted by the task. His exasperation came through in an Apr. 16 report in which he complained that "almost all the notes are governed by English law, while the validation of debt...is under Dutch bankruptcy law. ... Obligations under the notes are governed by New York State law [and claims] have to be calculated and filed in accordance with the bankruptcy law of the United States." There's no clean way to slice through the Gordian knot of contracts, he tells *BusinessWeek*: "The legal practices for resolving disputes in bankruptcy situations around notes with embedded derivative elements have not yet developed."

Regulators have worried about that sort of problem for years. "Insolvency proceedings from one country to another are completely different," says Michael H. Krimminger, special adviser for policy to FDIC Chairman Bair.

Despite the mess in Amsterdam, new deals are hatching in Europe. On Feb. 11 Goldman registered a plan in Ireland to sell notes that seem similar in structure to the ones sold by Lehman in Amsterdam. The notes will be issued by an Irish unit called Goldman Sachs Financial Products Europe, according to the prospectus. Like Lehman's notes, some of Goldman's will be backed by the parent company in New York. Goldman declined to comment.

Ireland, like Amsterdam, has become a favorite place for global banks to set up subsidiaries to sell financial instruments. A recent Government Accountability Office report listed Ireland among more than 30 nations where U.S. companies have established units to take advantage of easier regulation.

Goldman's operation is similar to Lehman's in another way. Two of the subsidiary's directors are executives with Deutsche International Corporate Services, a unit of Germany's Deutsche Bank that provides trustee and securities services to scores of investment vehicles set up by Goldman and others. The mailing address for Goldman's Ireland subsidiary? It's the one used by the Deutsche operation.

If more structured notes go sour or if bank bailout burdens grow, the biggest loser could be globalization itself. Josef Ackermann, chairman of Deutsche Bank, warned of the consequences of financial protectionism in a recent speech at the London School of Economics. "Market integration, for goods and services and for capital, is the bedrock of our prosperity," he said. But by selling risky instruments to unwitting investors around the world, Wall Street is placing that prosperity in jeopardy. **BW**

–With Theo Francis in Washington and Bruce Einhorn in Hong Kong

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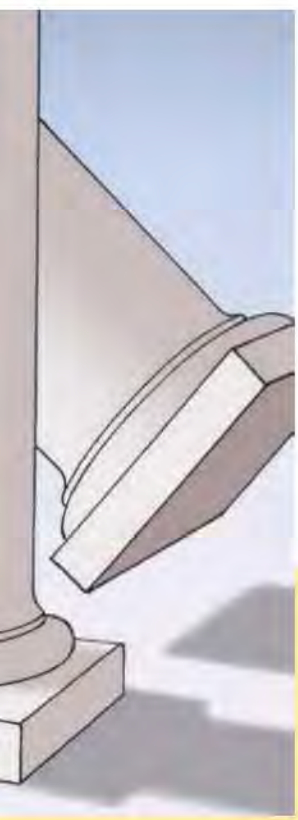
End Life Support for Troubled Banks

Propping up failed banks isn't working, says Thomas M. Hoenig, president of the Federal Reserve Bank of Kansas City. Despite billions spent, markets haven't recovered, he wrote on May 4 in the *Financial Times*. Hoenig has argued for the forced liquidation of assets of failing banks.

To read Hoenig's column, go to **http://bx.businessweek.com/banking-industry/reference/**



one another. "There's a lot of work to do," says Sheila C. Bair, chairman of the Federal Deposit Insurance Corp.

Another option would be old-fashioned trustbusting. Regulators could break off chunks of firms until those entities fit neatly inside national borders. "Banks that are too big to fail must now be considered too big to exist," says Simon Johnson, a former International Monetary Fund chief economist.

One step would be to revive the Glass-Steagall Act, the Depression-era law that barred commercial banks from owning investment banks and other firms. The 1999 repeal of the law permitted huge amounts of risk to be concentrated in a handful of giant banks. "The original Glass-Steagall wasn't just a banking law; it was also a very good form of antitrust law," says Charles Geisst, a finance professor at Manhattan College and Wall Street historian.

But even a new Glass-Steagall might not solve the risk problem. Many small firms that rely on the volatile capital markets for money could fail just as Lehman did.

One approach gaining favor is akin to a living will and would require big firms to plan for their own demise much as many terminally ill people do. The banks would prepare to unwind derivatives, move assets to healthy firms, and settle up their estates. If regulators knew such plans were in place, they could better judge the risk of a failure and then, perhaps, let some firms fall. Says Richard J. Herring, professor at the Wharton School: "You've got to make global companies think about how they can gracefully leave the scene."

–With Matthew Goldstein

INFO TECH

Attack of the Google Wannabes

Challengers aim to offer a better search engine to steal away lucrative traffic

ILLUSTRATION BY DAVID POHL

By Robert D. Hof

Google dominates Internet search, but a growing number of companies are trying to come up with something better. On May 15, British mathematician Stephen Wolfram plans to launch an online service intended to provide more useful answers to search queries than the standard list of Web pages. IBM just took the wraps off a computer program designed to field questions well enough that it can compete on *Jeopardy!* with the game show's best human contestants. And Microsoft is planning to relaunch its own search service this spring, though the details are top secret.

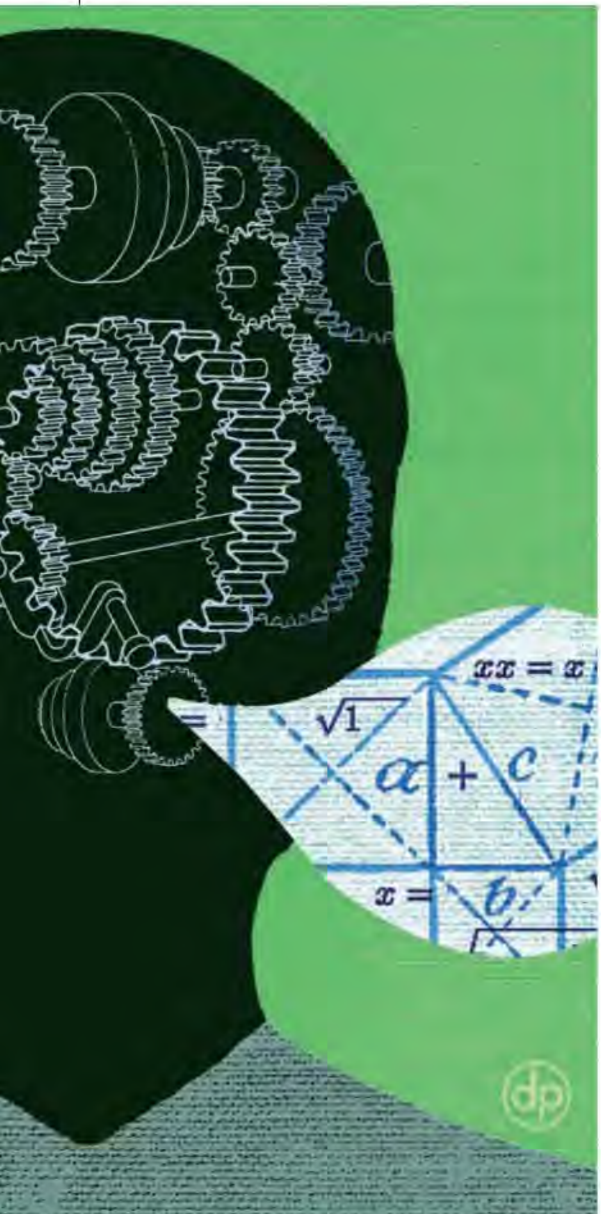
Wolfram hopes to provide "expert-level knowledge" in search results

Why challenge a company that has crushed every contender to date? Certainly, rivals want a slice of Google's $20 billion in search-related revenue. But they also see that search has loads of room for improvement. Too often, search engines return a list of Web sites people must comb through for information, and that's if they get the right sites at all. The Google challengers, as well as Google itself, aim to divine the essence of what people are searching for and to provide answers that come closer to what they actually want than the standard list of blue Web site links.

These services have been hyped as "Google killers," but they're really no such thing. Google remains essential to most Internet users, and the new services are often more complementary than competitive. For its part, Google has been relentlessly tweaking its own search engine, trying to prevent others from getting a toehold. "It's a huge challenge for anyone to break the Google habit," says Danny Sullivan, editor-in-chief of the Web site Search Engine Land. "But there are a lot of things Google doesn't do that are necessary, so there is a need for alternatives."

The most ambitious is Wolfram-Alpha, which takes a new approach to collecting information and presenting it. Its staff of 250 culls government and other public databases and crunches the data so they can be presented quickly as useful facts and figures. The idea is to "give everyone expert-level knowledge of everything," says Wolfram.

For instance, a search on "New York Tokyo" gives you the populations of both cities, a map of their locations, and the estimated flying time between them. Search on "$100,000 at 5% ARM," and you'll see tables on mortgage payments and principal bal-



ances over time for several interest-rate scenarios. "When you're doing [traditional] search, you're being told: 'Here are some places where you might look,'" says Wolfram. "We're trying to compute answers for questions that people have." It is hardly an all-purpose search tool, though. For many everyday queries, say, "Chicago restaurants," WolframAlpha produces few helpful results or nothing at all.

Other startups are staking out new territories of data that Google hasn't yet conquered. Twitter, which lets people post short public messages about what they're doing or thinking, has just added a way to search all posts. Twitter has quickly become the go-to place to find out what's happening in real time—from airplane crashes to the latest Apple rumors. Because it takes hours or days for Google to index most Web pages, the search giant's results generally don't offer the same immediacy.

USING FRIENDS

Perhaps the most promising new search enhancement is bringing people and their knowledge and contacts more overtly into the search results. The startup Aardvark, for instance, whose staff includes five former Google employees, lets people send questions by instant message or e-mail to friends whose social networking profiles show they're knowledgeable about particular subjects. Ask Aardvark what's the best off-road bicycle to buy, and a friend who's a cyclist might answer with a model and a good local store. Another startup, Mahalo.com, uses a staff of people instead of computer algorithms to organize search results for the most popular search terms. That helps eliminate unhelpful sites and save time.

Then there's Microsoft, which has tried unsuccessfully for five years to slow Google. When the software giant relaunches its search engine later this spring, it's likely to focus on giving people all the tools and sites they need to accomplish a given task, such as booking a hotel room in the city they're flying to. "[Users are] looking for insight and knowledge rather than just links that navigate you to a Web site," says Yusuf Mehdi, senior vice-president of Microsoft's Online Audience Business Group.

Google isn't standing still. Already, its searches usually return not just text links to Web sites but also photos, maps, and other information. On Mar. 24, Google unveiled a technology that helps it understand the meaning of words and their associations with similar words. For instance, if you search "Star Trek," you get videos, news on the new movie, and a list of related searches at the bottom of the page, such as "spock star trek." "You should expect to see great new things in the next few years," says Udi Manber, Google's vice-president of engineering for core search. "We should just solve your problem."

But the main reason the new services face steep odds is that they're not yet businesses—or not lucrative ones. Google's huge impact was not so much in search technology but in perfecting a way to make a lot of money by matching relevant ads to search results. Wolfram says his company can profit in several ways, including by posting advertising alongside search results and by licensing WolframAlpha technology to companies to help them crunch internal data. He says he may yet turn to an established Internet company, such as Google or Yahoo!, to develop the advertising business. "There are certainly discussions along those lines," Wolfram says. "We're open to all sorts of partnerships." | BW |

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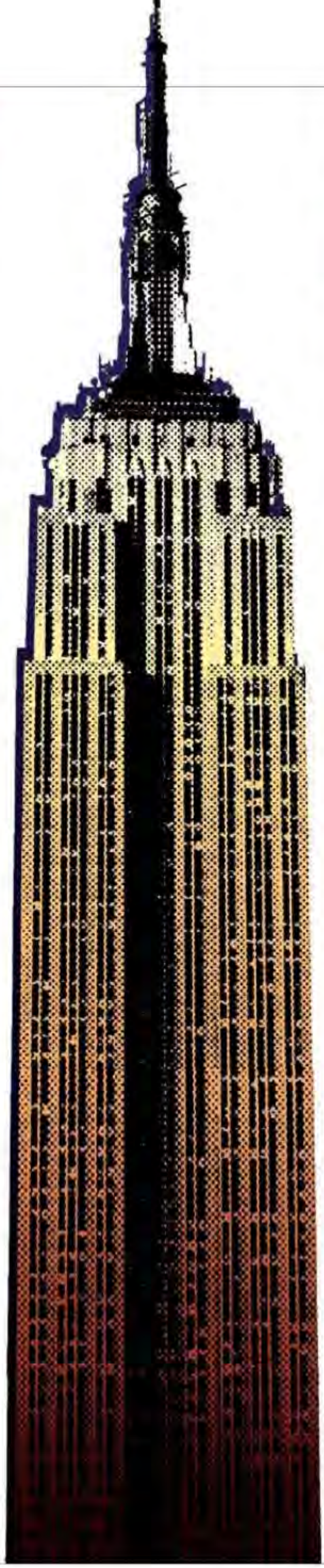
Search Engine Face-Off

How does the new Wolfram-Alpha compare with Google? *Technology Review* put the two search engines through several tests and gave results side by side. One search was for "Microsoft Apple" and another for "Sydney New York." The comparison underscores that Google and WolframAlpha try to deliver very different information for users.

To see the *Technology Review* comparison, go to **bx.businessweek.com/search-engines/reference.**



GREEN BIZ

Why Should Landlords Save the Earth?

Commercial building owners may get in the way of cities' eco-friendly ambitions

By Adam Aston

On Earth Day last month, Mayor Michael Bloomberg announced the latest step in New York's ambitious campaign to green the Big Apple. The proposal, likely to become law, calls for 22,000 of the city's biggest buildings—from iconic office towers to humble apartment blocks—to undergo detailed energy audits. Guided by the findings, building owners will then be obliged to invest in upgrades such as insulated windows or more efficient boilers.

To soften the burden on landlords, they'd only be forced to bankroll changes that would pay for themselves over five years through reductions in energy use. The mayor says the plan will deliver $750 million in annual savings on utility bills, add thousands of new green jobs, and cut the city's greenhouse gas output by 5%.

One tricky problem: The financial benefits of these retrofits flow mainly to tenants in the form of lower electric, water, and gas bills, not to the building owners who are expected to cover the costs. This leaves the owners facing a regulatory stick but no carrot. Without a better reward on the table, the landlords will drag their feet, predicts Jennifer Henry, real estate sector manager at the Natural Resources Defense Council, a nonprofit green advocacy group.

The obstacle is slowing eco-upgrades beyond New York, just when the nation needs them most. A McKinsey & Co. study suggests energy efficiency upgrades in buildings and appliances are the most cost-effective green strategy for the U.S., where buildings consume about 35% of all the energy used each year. That's why President Barack Obama has made retrofits a priority, setting aside $2.8 billion in the federal stimulus package to promote them. "You have to fix existing structures," says Marc Heisterkamp, director of commercial real estate at the U.S. Green Building Council, a standard-setting trade group.

CHILLY RECEPTION

In New York, Bloomberg is trying to jump-start the process, but he got a chilly reception from big property owners, the group he expects to pay for the upgrades. It's not for lack of interest in energy savings. Rather, the current situation and the mayor's proposal offer too few financial rewards.

The snag with paying for retrofits mainly affects major upgrades in large leased properties, especially multitenant buildings, which make up the bulk of the 5 million commercial properties in the U.S. In these buildings, widely varying rental terms—depending on the amount of leased space, market conditions, and lease duration—can make the financing of ambitious retrofits "seem almost byzantine," says NRDC's Henry.

Consider a routine upgrade to common-area lighting systems. Occupancy sensors that turn out lights when no one is around can pay for themselves in a few years. But landlords generally pass on operating expenses such as electricity, including for shared areas. So their costs wouldn't fall because of the upgrade, and they have little pecuniary incentive to pay for improvements. "If

PHOTO-ILLUSTRATION BY SHAKENA THORNTON/BW; FROM A PHOTOGRAPH BY ERIC VAN DEN BRULLE/GETTY IMAGES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a building's systems are inefficient but still fully functional, the owner won't bother [with a green upgrade]," says Sean Patrick Neill, principal of Cycle-7, a New York consultancy that focuses on green-building financing.

BALKING BY BANKS

Such barriers lead to a second problem: Without a clear way to make money from energy savings, "banks have found it difficult to finance big retrofits," says Mike Pedersen, group head of corporate operations at TD Bank Financial Group. Up front, there's the catch-22 that banks want to see "track records of proven savings resulting from the retrofits," he adds. That's tough to provide if the projects can't get financing. Banks are also uncomfortable with fuzzy arrangements, such as lending to an owner backed by hypothetical savings drawn from multiple tenants.

A determined landlord can find novel financing models. New York's Empire State Building is trying to cut energy use by 38% as part of a $500 million planned rehab. Carrying little debt, its owners can use the building, rather than energy savings, to back the loan. In Chicago, Vornado Realty Trusts' Merchandise Mart, the world's largest commercial building, has paid for eco-improvements from its own ongoing operating budgets, eking out incremental savings by updating mechanical systems, windows, and maintenance routines.

And in Toronto, TD Bank works with owners, tenants, and other banks to identify and finance retrofits. With the right market-based solution, "tenants will see energy cost savings, and owners can monetize a share of those savings to finance investment," says David Pecaut, a senior partner at Boston Consulting Group and co-chair of the Greening Greater Toronto initiative. "Then green retrofits will take off." BW

GREEN UPGRADES

In big buildings, energy-saving renovations bring paybacks over time:

LIGHTING	Payback 1 to 3 years	Sensors that turn off lights in empty rooms can cut power bills by up to 30%. Simply swapping in more efficient bulbs can pay for itself in one year.
ELECTRIC MOTORS	Payback 1 year	It takes a lot of energy to pump water and circulate air to high floors. Switching to motors that automatically vary their speed saves electricity.
WINDOWS	Payback 2.5 years	Caulking gaps around old window frames keeps heated (or chilled) air from leaking. Bigger savings come from replacing single-pane windows with multipane designs.

Data: Investment Property Forum (U.K.); New York State Energy Research & Development Authority; *BusinessWeek*

STRATEGIES

Russia's Factories Shift Gears

At some plants, the economic crisis has spurred retooling to boost efficiency and productivity

By Jason Bush

CHELYABINSK, RUSSIA

At first glance, the Chelyabinsk Forge-and-Press Plant looks like a relic. A notice near the factory gate proudly relates how, in the grim winter of 1941, hundreds of men and women evacuated from Moscow built the facility from scratch. Inside the vast production halls, murals of Lenin and stern-jawed proletarians still gaze down on toiling workers. Overhead, a red banner proclaims: "Glory to the Working Class!"

These days, though, the plant serves more as a showcase of management smarts than as a model of socialist industry. Sure, sales of the factory's auto parts and other forged-metal products are off by half since last summer, and the workforce has been cut from 4,400 to 3,500. But Andrey Gartung, the 26-year-old CEO, believes the global economic crisis offers an opportunity to boost productivity. This year he is adding new product lines, ordering every department to trim costs by 15%, and asking workers to ferret out waste wherever they find it—with prizes of up to $300 for the best ideas. "The companies that will survive are the ones that are efficient," Gartung says.

Despite Russia's 7%-plus economic growth recently, much of its industry is little changed from Soviet times. Factory productivity is just 16% of the U.S. level, according to Strategy Partners, a Moscow management consultancy. Over the years, a buoyant domestic market, high oil prices, and monopolies inherited from Soviet days let dinosaurs stay in business. But now some companies are changing.

Chelyabinsk: On the streamlined factory floor, productivity is up

Take Chelyabinsk Forge-and-Press: It remains Russia's only producer of the huge wheels used on the Ural truck. And for years after the collapse of the Soviet Union, the plant had few other customers. But in 2005, owner Valery Gartung, a former engineer at the factory and now a member of Parliament, put his 21-year-old son, Andrey, in charge. "Everybody was shocked," says the junior Gartung, who holds a management degree from South Ural State University in Chelyabinsk but had little practical experience.

One of Gartung's first decisions was to reduce the factory's dependence on the Ural. He sought out untapped markets and added new products such as components for railways and the oil industry—just in time, it turns out, as Ural sales hit the skids late last year. Early attempts to interest foreigners in his wares didn't go well: In 2006, Gartung says, a delegation from Daimler told him he'd be better off leveling the factory and starting over. But he persevered. This year exports will likely represent 8% of sales, up from 2% last year. By 2011 he's aiming for 50%.

On the shop floor today you wouldn't know the world is suffering an economic crisis. Workers proudly show off metal links produced for Koch, a German manufacturer of conveyor belts. In April the factory signed up ZF, a German company that builds transmissions and other parts for the likes of BMW and Mercedes-Benz. The Russians will make transmission gears for trucks. "The most important thing is that we now make far, far more kinds of parts," says Alexander Gorkushka, a section head in the forge.

Gartung: Sought out untapped markets

HOLISTIC VIEW

Much of the progress is due to Gartung's decision to engage a consultancy called the Kaizen Institute. The firm, which evangelizes Toyota Motor's production methods and counts Ford and Lockheed-Martin as clients, found plenty of inefficiencies at Chelyabinsk Forge-and-Press. Brian Saylor, a Kaizen senior consultant from Texas who started advising the plant in 2007, says the first thing he noticed was piles of unfinished products lying around. The factory was organized "to make as many pieces as they could at each operation, but not to work as a whole," Saylor says. He recommended factorywide goals rather than production targets for individual employees.

The plant's layout also forced workers to constantly step off the line to fetch parts. Simply by reorganizing production, Gartung managed to boost productivity 50% on some lines. He is trying similar changes in accounting, sales, and other white-collar departments, where countless hours are wasted on unnecessary paperwork.

That's typical in Russia. "There's an assumption that the more reports people make, the more the situation is under control," says Konstantin Akimov, deputy managing director of Basic Element, a sprawling conglomerate. "In Japan, only the problems get reported to the top." Akimov, a 37-year-old with an MBA from the University of Chicago, earned a reputation as a management whiz after turning around Poliar, the country's largest maker of commercial refrigerators. There he doubled revenues by identifying production bottlenecks and figuring out which products were most profitable. "The biggest problem in Russia is that everybody's busy, yet it may only be one section that needs to work harder," Akimov says. Now he is attempting to use the same strategy at Basic Element.

For many Russian factories, it may be too late to change. Back in Chelyabinsk, Andrey Gartung gleefully predicts bankruptcy for his less nimble competitors. "Some companies are chronically incapable of making quality products," he says. "Sooner or later, they'll exit the market."

Such a shakeout could be just what Russia needs to rid itself of its inherited industrial weaknesses and give dynamic companies the chance to grow. "The crisis has given a very positive push toward increasing efficiency," says Alexander Idrisov, managing partner at consultancy Strategy Partners. "If you want to survive and emerge stronger from the crisis, you have no alternative." BW

—With Jack Ewing in Frankfurt

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Rebooting Russia
To meet their goal of doubling GDP per capita by 2020, Russia's leaders will have to find ways to boost productivity by some 6% a year, says a new report by McKinsey Global Institute. The study, titled *Lean Russia*, is packed with policy recommendations.

To view the report, go to **bx.businessweek.com/russian-business/reference/**

Sysco Hustles to Keep Restaurants Cooking

With fewer people dining out, the food supplier offers clients profitable tips and guidance

By Christopher Palmeri

On a recent Monday morning, Everett Sanderson paced in the kitchen of a Houston warehouse owned by food distribution giant Sysco. The owner of Sanderson's Restaurant & Bar in Nederland, Tex., was there to get cooking tips from Neil Doherty, one of nearly 200 chefs Sysco employs across the country. "Here, taste this," Doherty said, as he plopped two bowls of chili con queso on the counter. One was made with Land O'Lakes cheese; the other with a Sysco private-label brand called Casa Solana, which Doherty contended has more cheese taste and would save $60 a week. "You can thin it with milk or water and get an even higher volume," Doherty added. Sanderson, a taco chip in his mouth, nodded his approval.

Every dollar counts in the restaurant industry these days. And few feel the big squeeze more than Sysco, the country's largest distributor of food and other restaurant supplies. Last year the Houston company earned a record $1.1 billion on sales of $37 billion. But Sysco is now facing its first down year since its founding in 1969. Vice-Chairman Kenneth F. Spitler predicts that 15,000 restaurants could shut down during the recession.

But the company has a weapon it hopes will save customers and lead to greater market share during the slump: a free consulting service called the Business Review. Along with selling cases of napkins and three-gallon containers of ketchup, Sysco is using employees such as Doherty to help clients design menus, train waitstaff, and market their businesses. The company has turned its warehouse kitchens into schools for its customers. "We felt if we could improve their business, that would improve our business with them," Spitler says.

INTO THE FRYING PAN

Sysco began using its warehouses to teach customers in 2000, but lately interest from clients has surged, with some sites performing five consultations a day. Sanderson spent more than two hours at the Houston warehouse sampling such dishes as bow-tie pasta with Cajun chicken (suggested retail price $9.95; food cost $2.86) and tilapia Veracruz. The restaurateur told Doherty he had a "salmon problem"—one out of four fillets his cooks prepare gets stuck to the grill and has to be thrown out. Fry it up in a pan, the chef suggested. He recommended cooking the salmon in a 90% vegetable oil and 10% olive oil mix that's half the cost of pure olive oil or margarine.

Onora Miller, a graphic artist at Sysco, helped Sanderson design a menu that put the most profitable items where they were most likely to catch a customer's eye. That meant moving the $14.95 seafood platter into the menu's upper-right-hand corner. The print size for prices was shrunk. A $14.50 Angus rib eye is now highlighted on the menu, while $7 burgers are buried in the middle.

Kelly Walker, a part-time actress who works in customer support, coached Sanderson's waitstaff on basic skills. Approach customers about dessert before they lean back from the

WHAT'S ON SYSCO'S MENU

America's largest distributor of restaurant supplies is offering more than napkins and 30-pound drums of mayonnaise. The company consults for free on ways to improve restaurant operations, betting clients will give Sysco more business in return.

TIMELY TIPS

A monthly newsletter offers business-building tips such as: Contact local sports groups to arrange parties for them or provide them with takeout meals. A new online tool lists top-selling menu items and their average prices across the country.

COST CONTROLS

Through its Business Review process, Sysco chefs analyze client menus for ways to cut costs and boost profits. Operation consultants train waitstaff and reorganize pantries. Graphic artists redesign menus to catch the customer's eye.

SWEET DEALS

Sysco has teamed up with two dozen other companies to offer services to restaurants at discounted rates. These include businesses that provide specialized insurance, e-mail marketing, and even background music.

ROBERT SEALE

Sysco's Doherty shows Sanderson some flashy moves with a skillet

table, she suggests, and encourage them to save room for chocolate cake.

Such techniques are critical in an industry where serving hot food cold can mean losing a customer forever. Sanderson says his sales were up 15%, to $2 million, in 2008—his first year with Sysco. He recently had some of his best weeks ever.

Having chefs whip up recipes and pitch new products has long been part of the $230 billion-a-year restaurant food supply industry, in which Sysco has a roughly 16% share. Spitler declined to reveal the cost or returns of the Business Review program, but he says customers who have been through it are far less likely to abandon Sysco for another distributor. "What's unique about what they did is they sort of formalized it," says Michael Roach, president of the food division at Sysco competitor Ben E. Keith Co.

Staffing the company with chefs, graphic artists, and other consultants is expensive, especially when looking to trim costs. Spitler says he spends less these days on such client perks as football tickets. The company also has teamed up with partners who discount services, from payroll processing to background music, for Sysco clients. Says Brent Berkowitz, director of operations at Innovative Dining Group in Los Angeles: "It's like having a car dealer tell you how to save money on your car." |BW|

Putting Home Depot's House in Order

Executive Marvin Ellison is battling to repair its damaged customer-service reputation

MARK ANDERSON

By Jena McGregor

Sarah Larsen used to avoid Home Depot, having dealt for years with surly, hard-to-find employees and indifferent store managers. But about six months ago, faced with a major renovation project, the Naperville (Ill.) communications consultant gave the store another try. She immediately noticed the difference: Sales associates were friendly, helpful, and in large supply. Now, Larsen says, "it has become my go-to store."

One reason for Larsen's newfound bond with Home Depot is a man behind the scenes: Marvin R. Ellison. Eight months ago, Chief Executive Francis S. Blake promoted Ellison, 44, from a regional post to be the \$71 billion-a-year retailer's executive vice-president of U.S. stores. Ellison's mission: to recreate his success running Home Depot's northern division, where he cut through a conflicting array of messages from headquarters and gave store managers just three goals—cleaner warehouses, stocked shelves, and top customer service. "You could go blindfolded into two stores and know when you were in Marvin's store," Blake says.

MORALE BUILDERS

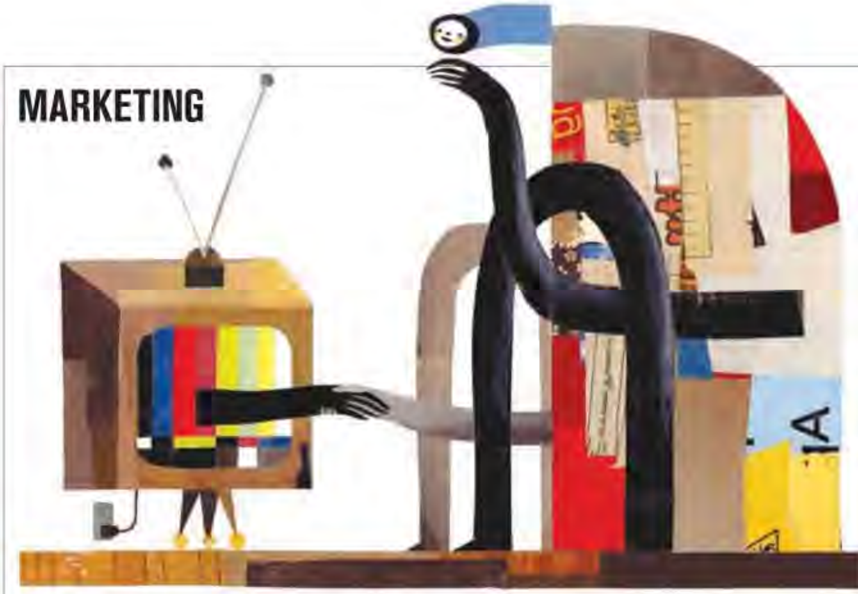
But Ellison faces an uphill battle repairing Home Depot's damaged reputation. Once renowned for customer service, the chain has been among the worst-performing retailers over the past several years in the University of Michigan's American Customer Satisfaction Index. Despite an improved score, it still ranks last among its peers. Insiders say former CEO Robert L. Nardelli, who stepped down in early 2007 after a six-year stint, alienated staff with a command-and-control style that focused on cutting costs over encouraging employees. "When you're an hourly associate and you're trying to cover 3,000 square feet by yourself on a Saturday, that's going to damage morale," says one former executive.

Ellison is also trying to win back customers at a time when many don't want to spend much at Home Depot's 2,238 stores. The company reported a loss of \$54 million in the fourth quarter, and same-store sales dropped 8.7% last year. With resources squeezed, Ellison is trying to keep things simple. He has slashed the number of reports, tasks, and messages handed down from the corporate office. Store managers who were flooded with some 200 company e-mails and reports on any given Monday now typically get one: The rest are available online. And he severely restricted messages from headquarters to the stores during the rest of the week.

More important, Ellison is enforcing a practice called "power hours"—weekdays from 10 a.m. to 2 p.m. and all day on Saturdays and Sundays—when employees are supposed to do nothing but serve customers. They can stock shelves, unload boxes, and survey inventory at other times. "We could not address customer service needs because we were too busy doing other things," says Ellison, who began his own career as an hourly worker at Target in 1987.

As a division president, Ellison led his stores to No. 1 in sales and profits

To make the strategy stick, he has just changed performance reviews so store employees are evaluated almost entirely on customer service. It helps that Blake has expanded financial incentives for staffers who deliver great service. While customers report improvements, Home Depot still has far to go. San Diego welding contractor Seth Collins says that when he recently entered a local store, "five or six people said 'Welcome to Home Depot.' But then I wandered around trying to find someone in the paint aisle to help." BW



Paying for Viewers Who Pay Attention

Engagement scores are helping TV advertisers target ideal audiences—those who are really interested

By David Kiley

When ad agency Crispin Porter + Bogusky wanted to put a 1964 Beetle in ads for the 2009 Jetta sedan and Tiguan crossover SUV, Volkswagen's U.S. marketing chief Tim Ellis knew executives in Germany would be skeptical. And yes, they were put off by a 45-year-old Beetle named Max that talked like a German-accented Herbie the Love Bug in an ad touting sophisticated new vehicles. But Ellis figured he could placate his bosses with new data that purport to measure how engaged viewers are with a given show or commercial. The Germans relented when he told them that viewers were up to 75% more likely to pay attention to the ads with Max than without him. "The skeptics," says Ellis, "were silenced."

Marketing executives have long sought better information about how closely people watch TV programs and commercials. Engagement ratings, they believe, give them a better sense of whether ads are working and are matched with the right show. Not everyone thinks engagement ratings are ready for prime time. But industry executives say that at least half of the top 100 TV advertisers in the U.S. this year will demand that the networks use engagement ratings to help determine how much advertising time should cost. "It's almost like we're getting price guarantees on how well our ad is doing," says Ford Motor's marketing chief, James Farley. "And that's close to the holy grail for me."

Viewers most absorbed by the show *Dirty Jobs* turned out to be men 18 to 49 who buy trucks—a ripe audience for Ford

For years, advertisers have relied on Nielsen ratings, which measure if the TV is switched on but not whether people are sleeping, snacking in the kitchen, or surfing the Web. IAG, a research firm, began asking viewers in 2004 how well they recalled programs and ads. The more viewers can recall and say what they liked, the higher the rating. In 2005 and 2006, a few advertisers—such as Toyota, which had been using the data simply to figure out which programs to advertise on—began cutting the first deals with networks to tie ad prices to how well their programs scored. Last year, Nielsen, seeing the trend, bought IAG for $225 million.

NOT HARD CURRENCY—YET

Like many companies, Ford has slashed its TV advertising budget. Marketing chief Farley is keen to make every ad dollar resonate with potential buyers and has been striking more deals tied to a program's engagement ratings. On the face of it, Ford had little reason to advertise with the Discovery Channel's *Dirty Jobs* series, starring Mike Rowe. The show delivers puny Nielsen ratings. But when engagement metrics were applied to the program, the viewers most deeply absorbed in the show turned out to be truck-buying men aged 18 to 49, a ripe demographic for Ford. That prompted Ford to advertise heavily and hire Rowe to appear in Web videos demonstrating the durability of the F-Series pickup.

If advertisers love engagement ratings, network executives haven't entirely embraced them. They say they need more testing and fine tuning. "Engagement ratings are proving very useful [for advertisers]," says Alan Wurtzel, president for research and media development at NBC Universal. "But they aren't to the point where we can replace traditional Nielsen ratings as the hard currency for pricing deals."

Not yet. As advertisers push for the kind of accountability they have become used to on the Web, TV engagement ratings eventually will transform the negotiating game between networks and advertisers. Already Ford and other companies are demanding discounts if shows miss promised engagement scores. | BW |

GORDON WIEBE

PERSONAL BUSINESS

MONEY REPORT

COAL GETS HOTTER

Coal companies have taken their lumps since President Barack Obama took office, with investors fearful the Administration's proposed "cap and trade" emissions plan could force one of the industry's biggest customers—owners of coal-fed power plants—to raise prices by as much as 50%, hurting demand. But some analysts are becoming more bullish, in part because they expect greater demand from China. Coal producers themselves think valuations are attractive: Mechel OAO, a Russian mining and metals company, agreed in late April to pay $436 million for West Virginia coal producer Bluestone Industries. ¶ Stronger-than-expected earnings from James River Coal and Consol Energy also provided evidence that supply and demand are getting back into balance. Goldman Sachs analyst Brian Singer upgraded the sector to "attractive" from "neutral," figuring prices will benefit from a second-half rebound in steel production, as well as stronger demand from China. He also upgraded Massey Energy to a buy. –*Dean Foust*

BONDS

TREASURIES ON THE RISE

Since Mar. 18, when the Federal Reserve announced it would buy up to $300 billion in U.S. debt, investors had assumed that a 3% rate on the 10-year Treasury bond was the central bank's "line in the sand." If yields went above that, the thinking went, the Fed would try to talk prices up, and thus yields down, or would buy bonds to get the same effect. But on Apr. 29, as the Federal Open Market Committee met, the yield topped 3%—and the Fed did nothing. The 10-year bond closed at 3.16%.

The Fed wants rates low to help the economy. But the U.S. has huge debts to fund, and investors have been favoring riskier assets over lower-yielding Treasuries. The Fed has little choice but to let rates rise. Over three to six months, expect the 10-year bond's yield to move in a range from 2.8% to 3.5% before it goes higher, says Peter Greig, co-manager of fixed income for AFBA Mutual Funds. He prefers corporate bonds, but if he had to own Treasuries, he'd buy one- to three-year bonds. –*Ben Levisohn*

3.5%

Yield the 10-year Treasury could reach in three to six months

Data: AFBA Mutual Funds

STOCKS

INSIDE STORY

Insiders at Microsoft, Gap, and Google dumped thousands of company shares in late April. Should investors follow their lead? Trading based on what insiders do is a poor strategy in the best of times, says James Stack, president of InvesTech Research, and even less advisable during highly volatile periods. Insiders were buying through the last half of the 1973-74 bear

market and selling in 1982, just as the Dow Jones industrial average broke 1000 on its way to 2700. Insiders tend to place trades that are driven by the size of a movement in a stock's price, says Stack. If shares fall 30%, they're likely to buy; if they rise 30% or more, they are likely to sell. Since the trades are not usually based on a change in the company's fundamentals, investors shouldn't read much into the transactions. Says Stack: "Historically speaking, these guys make very poor investors." –*B.L.*

PHOTOGRAPH BY LES STONE/POLARIS

ISRAEL'S NEW PIONEERS CASH IN ON CLEANTECH

(FROM PAGE 034)

By Aaron Pressman

Clean energy may be the wave of the future, but shares of alternative energy suppliers have taken investors on a wild ride. After getting hit hard by the credit crunch last year, the sector has rallied recently as stimulus plans from the Obama Administration and other governments promise substantial sums for renewable energy projects. The Market Vectors Global Alternative Energy ETF, which tracks 30 companies around the world, lost 61% last year but has risen 22% over the past three months.

Much of the money will likely go to the industry's biggest and best-known companies, like Denmark's wind farm developer Vestas Wind Systems or solar-panel maker First Solar of Tempe, Ariz. There will also be opportunities for smaller players. But "this can be a hairy sector for investing in early-stage companies," says Edward Guinness, co-manager of the Guinness Atkinson Alternative Energy Fund.

While solar and wind projects are now commonplace, geothermal power is less developed. Geothermal systems typically use heat found deep underground to make steam and generate electricity. WaterFurnace Renewable Energy in Fort Wayne, Ind., builds heat pump systems that don't require deep drilling for homes and businesses. The technology takes advantage of modest but consistent temperatures of about 55 degrees found a few feet underground. Air pumped underground is heated or cooled, which reduces the load on traditional heating and cooling systems and cuts energy bills by about two-thirds. Over time, that offsets installation costs. Revenue is growing 50% a year, and installations haven't been hurt by the credit crunch, says Jack Robinson, lead manager of the Winslow Green Growth Fund. Guinness' fund owns Energy Development Corp., a Philippine utility that oversees a dozen geothermal plants and consults on projects for others.

Stocks in the biofuels area have been crushed, not just by difficulty obtaining financing but by overbuilding and rising prices for key ingredients. It isn't clear which players will survive. Still, the sector could one day generate big profits so it pays to stay up to date, says Guinness. He thinks Maple Energy, a Peruvian oil and gas producer, could become a leading ethanol supplier. Even so, Guinness sold the stock last year after a runup. "When they get their plant up and running, they'll be the world's lowest-cost ethanol producer," he predicts. But he's waiting to see how the project progresses.

President Barack Obama's plan to reduce air pollution with a system of tradable pollution rights, known as "cap and trade," could lead to the development of trading exchanges rivaling those for stocks, bonds, and derivatives. U.K.-based Climate Exchange, a publicly traded company, is the leading player in European pollution-rights trading, but Guinness says it's too pricey at more than five times expected 2009 revenue (it has yet to show a profit). Unless a national cap-and-trade system becomes a reality in the U.S., the stock is too speculative, he says.

Another player, World Energy Solutions of Worcester, Mass., trails Climate Exchange in revenue. But new Environmental Protection Agency chief Lisa Jackson is familiar with the type of system World Energy has developed, which could bode well for the technology, says Winslow's Robinson. "They're a small player but are just becoming profitable and growing at a 50% rate," Robinson says. Investing in it now, he adds, is like being a venture capitalist. | BW |

CLEAN ENERGY PLAYS

COMPANY/TICKER	PRICE	COMMENT
Climate Exchange/ CLE*	698 pence	European pollution-rights trading platform. Owns Chicago Climate Exchange
Energy Development/ EDC**	n/a	Geothermal power utility leader
Maple Energy/MEYPF	$3.90	Peruvian energy producer building low-cost ethanol plant
WaterFurnace Renewable Energy/WFIFF	$19.93	Homebuilding slump hasn't slowed the geothermal developer
World Energy Solutions/ XWES	$6.60	Runs pollution trading system for 10 eastern states

*Trades on London Stock Exchange **Trades on Philippine Stock Exchange Data: Google Finance, as of May 4

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BUDGETS

A PENNY SAVED...

By David Kiley

Stock market declines have laid waste to many people's retirement plans, including my own. Since my wife and I don't expect the market to retrace its highs anytime soon, we are trying to replenish our nest egg another way—by attacking our budget. We're on a mission to make up the losses and add to our principal so we're ready to pounce on opportunities when the market turns. A couple in our mid-40s with a child, we are using this crisis to rid ourselves of bad habits and to impart some valuable lessons to our son.

The first move we made was to fire the wealth-management firm we'd signed on with 16 months ago. They were charging 1.15% on the assets in our portfolio, and had advised us to go 65% in equities shortly before the market tanked. Luckily, I didn't take their advice. (Our advisers didn't even try to stop us from leaving.) Now we are steadily funneling money into a bond index fund, a municipal bond fund, and a stock index fund at Vanguard; 25% will remain split between cash, money market funds, and certificates of deposit. Estimated savings from not using our adviser: $7,000 a year.

$212

Monthly amount saved by refinancing our mortgage from 6% to 5.12%

The next part of the Kiley Family Recovery & Reinvestment Act of 2009 involved our mortgage. We pay monthly, like most people. To knock down the principal, we are going to make smaller payments twice a month, which will add the equivalent of one extra monthly payment a year. That will reduce the 27 years we have left on our mortgage to a little more than 22 years, saving us $77,000 in interest. And we're refinancing from a 6% rate to 5.12%, with no fees and no closing costs—that's $212 less a month.

With household expenses, some economies we and other budget-minded consumers can make may seem like piddling savings. But it all adds up. And we're finding chasing savings can get addictive. Here are a few of our cuts:

Our plan is to save money to build up our battered portfolio. The first step was to fire our financial adviser. Savings: $7,000

HEALTH CARE I was seeing a chiropractor twice a week at $35 per visit. Cancelled; I think I can get the same relief by working out more on my underused Total Gym. Also, my wife was seeing an out-of-network specialist, which could have cost $2,000 this year. She is now seeing an in-network specialist, which requires a 90-minute round trip. With gas at $2.00 a gallon, the added fuel cost doesn't bother me.

VACATIONS We've piggybacked family trips onto two business trips this year, to New York and Florida, to save some airfare and hotel expenses. That will whittle about $3,000 off what we would have spent taking those trips on our own. We're also dining out twice a month now, rather than weekly.

CREDIT CARDS When my wife and I left our advisers, we sold our actively managed mutual funds and I paid off a $6,000 credit-card balance, saving the 13.9% I'd been paying in interest on the debt. We also got out of the American Express Rewards program. For 10 years, I'd paid a $40 annual fee to get one rewards point for each dollar spent. Each 10,000 points buys a $50 traveler's check; the 70,000 points I'd earned got me only $350 in traveler's checks—not worth the cost.

Where does all this get us? If we add what we would have spent on an adviser to the cash saved from fewer dinners out, cheaper vacations, lower debt payments, and a host of smaller cuts, we can boost principal by about $15,000 per year. If the markets bounce back sooner than we think, we hope our new habits will die harder than our old ones. | BW |

SOPHIE CASSON

FINANCIAL ADVICE

WHAT'S WORTH PAYING FOR

By Lauren Young

How valuable is your financial adviser? After seeing even carefully crafted portfolios devastated by the market turmoil, many investors are wrestling with that question. Yes, good advisers will hand-hold during rocky periods and can help you stick to a smart asset-allocation plan. But what kind of entrée, or break on fees, can you get from an adviser that you can't get on your own? Here are some answers:

MUTUAL FUNDS

Fund families put a lot of effort into building relationships with financial advisers because their clients' money is more "sticky" and usually more substantial than the average retail account. Advisers are rewarded by being able to give clients access to funds at the same low fees charged to institutional investors, says Stephen Wetzel, a certified financial planner at Prometheus Capital Management in Yardley, Pa.

The biggest leverage advisers have is that they can pool client assets to get those institutional share classes of funds, which can otherwise have a $5 million minimum. Expenses are typically one-quarter to one-third of a percentage point below that of retail shares, says Ronald Deutsch, an adviser at Sage Capital Management in New York. He likes the PIMCO Total Return bond fund, which has a five-year annualized return of 5.7%. Expenses for its institutional shares are nearly half those for its retail shares.

Some fund families primarily cater to financial advisers, so it can be difficult to buy their funds on your own. Austin-based Dimensional Fund Advisors (DFA) sets a high hurdle for advisers who want to sell its index funds, which rely on quantitative modeling. "They want people to understand the science of their funds ... and they want people who are going to be intelligent users of what they have to offer," says David Yeske, a certified financial planner at Yeske Buie in San Francisco. He sat through a two-day seminar at a Santa Monica (Calif.) hotel and, after additional vetting to make sure he had a buy-and-hold philosophy, got approval to distribute DFA funds to his clients. The lure for Yeske is DFA's microcap and international small-company value funds, which have below-average expenses and above-average performance.

One of the most popular fund families with independent as well as broker-affiliated advisers is Los Angeles-based American Funds, whose funds are only sold through advisers. It is now the nation's largest mutual fund company. The firm spends a lot of time educating advisers about its team-managed funds, which have deep investment expertise, low costs, and excellent long-term track records, says Russel Kinnel, director of mutual fund research at Morningstar, the Chicago-based fund tracker. "They have been good long-term stewards who have not burned investors the way a lot of the other broker-sold fund families have in recent years," Kinnel says.

SEPARATE ACCOUNTS

Separately managed accounts, at first glance, resemble mutual funds. At the core of the accounts, offered by asset management firms like Neuberger Berman and AllianceBernstein, are portfolio models representing a wide range of investment styles. But unlike a mutual fund, investors own the actual stocks and can remove those they don't want. The funds also give investors the ability to take gains or losses in ways that can minimize taxes. A client of Jonathan Bergman, chief investment officer at Palisades Hudson Asset Management in Scarsdale, N.Y.,

COMSTOCK/JUPITERIMAGES

WHAT YOU GET

The key differences between advisers who are independent and those at brokerages

FEES

Brokers, who may call themselves financial consultants, used to rely on commissions. It's more common now to charge 1.5% on the amount of assets under management. That goes for most independents, too. Typically, the rate gets lower as assets increase. Brokers may get commissions or rebates from fund families or insurance firms; independents can't accept such payments.

PRODUCTS

Advisers affiliated with brokerage firms offer financial products from a set menu of investments that are manufactured or pre-approved by their firms. Independent advisers have more freedom to choose from an array of third-party investment products supplied by financial firms that do not pay them commissions.

STANDARDS

At a brokerage firm, advisers are supposed to make "suitable" recommendations for clients. For example, it wouldn't be suitable to put an 80-year-old person entirely in stocks, or a 30-year-old primarily in bonds. To reduce conflicts of interest, independent advisers pledge to put a client's interests first, and, as fiduciaries, are bound to this promise by law.

had 70% of his $100 million portfolio tied up in the household-products industry. Since it didn't make tax sense to liquidate holdings immediately, Bergman worked with an asset manager to build a personalized separate account. It features a Standard & Poor's 500-stock index portfolio that excludes household-product companies. Bergman has winnowed his client's stake in the sector to 6% by offsetting gains on those stocks with losses in other holdings and reinvesting in other sectors. When compared with fees on institutional shares of mutual funds, those for separate accounts are higher, with expenses ranging from 1% to 1.25% of assets.

HEDGE FUNDS

Sage Capital's Deutsch works with a group of smaller hedge funds that he has screened by meeting with management, auditors, and lawyers. The price of admission is usually $1 million or $5 million, but in some cases Sage has been able to negotiate minimums of $250,000 for clients. (Clients still have to be "accredited" – meaning they'll need $1.5 million in assets.)

Merrill Lynch clients may even get access to high-profile hedge fund managers. In February Merrill offered 400 clients a conference call with hedge fund giant John Paulson, of Paulson & Co., who predicted the meltdown in the mortgage market. Paulson "really got it right over the past few years," says John Olson, a wealth management adviser with Merrill in New York. Paulson fielded questions from current and prospective investors on the call. Olson notes that a big firm has full-time staffers performing due diligence on managers.

PRIVATE EQUITY

Investors typically need $5 million to get into a private equity fund, but advisers can pool accounts to get clients lower minimums. Due diligence is "enormously labor-intensive," says Bergman. His firm invests in one out of every 10 private equity deals it reviews. "It's not terribly difficult to access private equity, it's just not easy to access good private equity," he says.

MANAGED FUTURES

Managed futures funds buy and sell currency, commodity, and equity futures as well as other derivatives within a limited partnership structure that affords tax protection. They try to capitalize on volatility using computer models to identify trends that may last a few days or months. Costs are typically 2% of assets, and an adviser doesn't have much leverage to negotiate lower fees among the 100 or so funds available.

After fees, some of the better-managed, medium-risk futures funds have returns in the lower teens, says Louis Stanasolovich, president of Legend Financial Advisors in Pittsburgh. He likes the fact that investors can trade in and out of managed futures once a month. He thinks that gives managed futures funds an edge over hedge funds, which may let investors withdraw money only a few times a year.

STRUCTURED NOTES

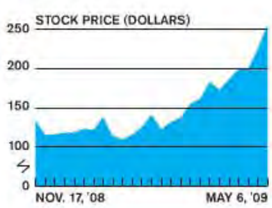
Structured notes are derivatives for retail investors. While structures vary, these hybrid securities combine some type of underlying bond with an options contract. The option bets on the direction of stocks, currencies, or other asset classes and can allow investors to benefit from up markets while receiving some downside protection. The notes are created and often backed by financial institutions such as JPMorgan Chase.

In a low-rate environment, such notes are popular with advisers because they offer yields as high as 8% and the potential to minimize losses. Costs for bank-sold versions range from 2% to 3%, though independent advisers such as Stanasolovich will combine client assets to get commissions as low as 0.5%. But sometimes an adviser's value is his advice about what not to buy. "We've evaluated hundreds of notes and only used three," Stanasolovich says. "Most notes we see, we don't like. There's not enough return, given the risk you are taking." | BW |

BAIDU.COM: IT'S NO GOOGLE

Shares of Beijing's Baidu.com (BIDU), the No. 1 provider of Chinese-language Internet search services, are on fire, climbing to 255.67 on May 6 from a 52-week low of 100 on Dec. 10. One big reason behind the runup: Many investors equate it with Google and see it as a promising bet on the vigorous Chinese stock market.

WAS BAIDU'S RISE TOO SWIFT?



Data: Bloomberg

"The conventional view that Baidu is China's Google is wrong," says Tian Hou of Pali Capital. The two are "very different in their business fundamentals." Also bearish is Standard & Poor's Scott Kessler, who rates Baidu a sell, with a 12-month target of 205. After its sharp rise since January, Baidu is now "overvalued," he adds.

Kessler and Hou say Google clearly separates nonpaid search results from paid "auctioned" search, while Baidu mixes them on a single list. So users click more to complete a search, says Hou, thus inflating revenues. Baidu disagrees, saying it clearly marks the paid from nonpaid search results even if they are on one list. In addition, Baidu has started using a system called Phoenix Nest aimed at producing more accurate results. It also better distinguishes paid from nonpaid search results. But Hou says until Phoenix is totally in place, "it's too early to buy the stock." She also expects China to regulate Web ads—"a negative for Baidu," she says.

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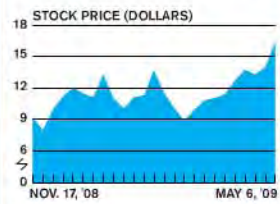
COMMERCIAL METALS' PROGRESS



Data: Bloomberg

A Steel Giant Shows Its Mettle

Worries about the economy are overshadowing the long-term values in steel stocks, some of which are starting to rise. One mover is Commercial Metals (CMC), a big recycler of scrap metal and a maker of structural steel, now at 16.39, up from 6.25 on Nov. 20. But it's still down from 40 in June. "It has yet to reflect CMC's strong recovery potential," says Jared Levin of investment firm A.R. Schmeidler, which owns shares.

As a major steel producer, CMC will gain from global government stimulus outlays, including those for massive road, bridge, and other infrastructure projects, says Levin. He puts CMC's value at 25, based on its earnings power, solid balance sheet, and dividend yield of 3.4%.

Researcher New Constructs says CMC's high-quality earnings and 16% return on investment capital make it attractive and offset the stock's downside risk.

BLUEPHOENIX HAS ROOM TO RUN

Data: Bloomberg

Saving IT Outlays With BluePhoenix

Mounting pressure on the companies' info tech units to slash costs has been a boon to BluePhoenix Solutions (BPHX). It specializes in helping companies shift to lower-cost software systems and standardized hardware. BluePhoenix customers often save 50% to 90% on their annual maintenance costs, says Jeff Van Rhee of Craig-Hallum Capital Group, who rates BluePhoenix a buy. Although few investors are aware of this Israeli outfit, its growing order backlog and rising margins give it "significant room for appreciation," says Van Rhee. He sees the stock, now at 2.20 a share, rising to 5 in a year. (Craig-Hallum has done business with BluePhoenix.)

Daniel Meron of RBC Capital Markets rates BluePhoenix outperform, and sees earnings of 45¢ a share on sales of $93.7 million in 2009, vs. 35¢ on $91.8 million in 2008. | BW |

BRAD TRENT; CHARTS BY DAVID FOSTER

BusinessWeek
EVENTS

中国 • 天津
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The Path to Future Global Economic Revival

Global Green Business Summit

Global Green Business Summit

8 June 2009
Tianjin, China

Green economics is the latest buzz phrase that you need to understand. It's all about how environmental issues must be considered in business plans or you will find yourself behind the curve. In Europe, mandatory carbon reduction emissions efforts are already the norm. In the U.S., President Barack Obama has put environmental issues on the top of his agenda with clean energy infrastructure development plans. World leaders are hopeful that he will endorse legislation that will lead to the U.S. being part of a post-Kyoto agreement expected to be reached in Copenhagen this December. In China, the government is also focusing on sustainable development as a path to continued growth and economic restructuring. It is already home to one-fourth of the world's Clean Development Mechanism projects.

How promising is the force of green economics to help drive the global economy out of the current doldrums? What should governments do to accelerate their green transformation? As for the corporate community, how can executives efficiently steer their businesses towards sustainable development? Where are the opportunities?

BusinessWeek's inaugural "Greener China Business Awards" special report to be published in May will seek to provide insights to these questions. To coincide with the report, BusinessWeek will launch a Global Green Business Summit to gather high-level international business leaders to discuss how a global transformation to a more green outlook can help catalyze the future global economic revival. By participating, you are demonstrating your commitment to sustainable development.

Confirmed speakers to date include:

- *Zhang Lijun Vice Minister, The Ministry of Environmental Protection of PRC*
- *Wan Gang, Minister, Ministry of Science & Technology*
- *Zhang Guobao, Vice-Chairman of National Development and Reform Commission and Director-General of National Energy Administration*
- *Frank O'Brien-Bernin, Chief Sustainability Officer, Owens Corning*
- *Victor Kwong, Corporate Health, Safety and Environment Manager for Towngas (Hong Kong & China Gas Co Ltd)*
- *Lorraine Hahn, Moderator, former CNN anchorwoman*
- *Wu Changhua, Director for Greater China, Climate Group*
- *Robert Wu, Chairman & CEO, US-China Green Energy Council*
- *Matthias Gelber, Board Member, Maleki GmbH, voted "Greenest Person" on Earth*
- *Dr Andrew Thompson, CEO, BEC*

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OPINION

TECH & YOU | STEPHEN H. WILDSTROM

Bigger, Better, Budget Ultrathins

HP's dv2 is the first of a new class of notebooks aimed at netbook-weary road warriors

HP's Pavilion dv2: Heavier and fatter than Dell's sleek Latitude, but about $1,250 cheaper

Netbooks—really cheap, really small notebooks—have taken the PC business by storm. Yet I suspect a lot of buyers will wind up disappointed with the tiny screens, cramped keyboards, and limited processing power they provide. Spotting an opportunity, computer makers are rolling out yet another class of very thin notebooks for less than $1,000 with many of the features of models that cost twice as much. Having spent time with the first of this new breed, the Hewlett-Packard Pavilion dv2, I think the category could be a winner.

The new devices, with a 12-inch to 13-inch display and weighing less than 4 lb., look a lot like ultralights such as Dell's sleek Latitude E4200. But until now such systems were aimed at executives and mobile professionals and carried price tags well north of $1,500. Like the Latitude, which starts at around $2,000, HP's dv2 fits easily in a briefcase or on an airplane tray table. It has a 12.1-in. screen, weighs 3.8 lb., and is 1.3 in. thick—a bit heavier and fatter than the Latitude. On the other hand, you can take it home for just $750. In coming months, other laptop makers will have their own models for $700 to $1,000.

Of course, hitting that price does require compromises. The Pavilion dv2 uses an old-fashioned hard drive

(TOP) BRAD TRENT

THREE CLASSES OF LIGHTWEIGHTS

	EXECUTIVE ULTRALIGHT	NETBOOK	THINBOOK
Display	12.1 in.-13.3 in.	9 in.-12 in.	12.1 in.
Processor	Intel Core 2 Duo, ultralow-voltage	Intel Atom	AMD Athlon Neo
Storage	Solid-state drive to 128 GB	Flash memory to 16 GB; hard drives to 160 GB	320 GB hard drive
Weight	3 lb.–4 lb.	2 lb.–3 lb.	3.8 lb.
Price	$1,500+	$300–$500	$750
Examples	Dell Latitude E4200, Lenovo ThinkPad X301, Apple MacBook Air	Dell Inspiron Mini, Asus Eee PC, Hewlett-Packard Mini 1000	Hewlett-Packard Pavilion dv2

instead of a fancy solid-state drive that stores data on flash memory chips. Hard drives are slower and heavier than chips, but in return, the dv2 packs 320 gigabytes of storage instead of the 128 GB on solid-state drives.

Where HP really saved money is on the processor. And in doing so, it opened a new chapter in the long rivalry between giant Intel and its dogged challenger AMD. The Dell Latitude sports Intel's ultralow-voltage Core 2 Duo chip, which costs $284 in quantities of 1,000. The dv2 is powered by AMD's Athlon Neo chip, which is believed to go for well under $100 (AMD doesn't disclose its pricing).

Because the AMD chip is a single processor, it provides less punch than Intel's two-core variety. But a computer's overall performance depends on both the main processor and the graphics processor. Intel integrates these functions in the microprocessor, while AMD compensates by adding extra graphics technology from its subsidiary, ATI. In the dv2, this combination delivers Blu-ray high-definition movies, something the laptop could not do if it relied on the processor alone.

Where HP cut costs is on the processor. That has ignited a new battle in the long war between chipmakers Intel and AMD

The downside is that the processor and graphics adapter of the dv2 draw significantly more power than an Intel system, taking a toll on battery life. The dv2 got less than three hours on a charge—a mediocre showing. And unlike low-voltage Intel systems that I have used recently, the dv2 got a bit hot during extended use.

Despite these drawbacks, the dv2 is still a lot of laptop for the price. For most people, I think it represents greater value than any netbook. And whatever you call this new class of laptop—suggestions include "thinbook" and "affordable ultralight"—there are going to be more of them.

This fall, AMD will offer a dual-processor version of its Neo chip with more efficient graphics, thus slashing power consumption and heat.

AMD has always been good at slipping into any seam Intel leaves exposed, but the chip giant is ready to strike back. It is already shipping cheaper Celeron low-voltage chips in Japan. And this summer, in time for the back-to-school season, it will offer a new line of Consumer Ultra Low Voltage processors targeted specifically at sub-$1,000 thin-and-light notebooks.

Then Intel will have to contend with other challenges, including graphics chips from Nvidia. In a recent conversation, Nvidia CEO Jen-Hsun Huang declared: "The $1,000-plus notebook is over." The company is jazzing up netbooks with its Ion platform, which pairs Intel's bare-bones $40 Atom processor chip with a robust Nvidia graphics adapter. My prediction is that the Ion platform will prove Huang's point, leading to even more powerful executive-class notebooks with racy graphics, an inexpensive microprocessor, and a sub-$1,000 price tag.

The bottom line for mobility-minded buyers is that the need to choose between expensive executive ultralights and cheap but underpowered netbooks is nearly over. And what looks like the beginning of heated competition among chipmakers guarantees that the new breed of notebooks will get better and cost less—a happy outcome for fans of lightweight laptops. | BW |

Business Exchange

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Netbooks from 1 to 10

Gadgets blog Crave, from CNET UK, surveyed the expanding universe of netbooks and picked 10 favorites. Asus nabbed the top three spots with its N10 and Eee PCs, praised for keyboards, battery life, and style. Samsung's NC10 picked up fourth place for strengths in many areas.

To peruse Crave's picks and other stories, go to **http://bx.businessweek.com/netbooks/reference/**

OUTSIDE SHOT | JEFFREY F. RAYPORT

OurSpace: The Shift to a Social Web

Soon we'll take our social networks with us whenever we surf the Internet

When we talk about "gateways" to the Web, most of us tick off the names of four Internet companies: Google, Yahoo!, Microsoft's MSN, and Time Warner's AOL. Collectively (with Google in the lead) they account for or broker 90% of the gross dollars advertisers spend online. And they get huge amounts of traffic, in part because millions of users choose one of these four as their home page. Each of the sites continues to draw well over 100 million monthly unique visitors.

But a shift is under way—one that is ushering in the next stage in the battle for influence on the Web. Other players are becoming gateways, too, in a kind of evolutionary advance that will change the way we use the Internet—and alter advertisers' behavior.

The change is taking place on social networking sites, where new applications and cross-site partnerships are turning the likes of Facebook and MySpace into one-stop shops for hundreds of millions of users—platforms from which all the Web's offerings can be reached.

More important, in the next wave of development for such sites, new tools will allow members to take their social-media identities with them when they go to other Web sites. Once wedded to a single networking platform, a member's "social graph"—password, profile, list of friends—is becoming portable. In other words, as they surf the Web, users increasingly will be able to define themselves by their social network of origin.

That's big. It signals that Web companies are no longer in a race to build "destination sites" that attract vast numbers of users. Instead, social networking players are racing to extend their influence over the entire Web by exporting their social features to all sites.

Content, communications, commerce, and search have already ceased to be the unique province of the Big Four. Until recently, only "portals" offered free Web mail. Now MySpace, with its 300 million users, is gearing up to offer e-mail. It also has introduced a toolbar that lets members see "feeds" from friends—accounts of what they're seeing or buying on other Web sites. As for Facebook, having recently surpassed 200 million active users, it offers e-mail, instant messaging, photo posting, and video sharing. Members can also shop online without leaving the site and in some cases (with amazon.com, for instance) communicate with "friends" from their social network about what they're buying. Consider it a social variation on the news feeds provided by Google, Yahoo, and MSN. According to technology blog TechCrunch, such features enabled Facebook to add 40 million users in February alone. It now has 276 million unique monthly visitors—double the traffic of any of the Big Four portals, including Google.

> **Forget "destination sites." Instead, social networking players are racing to extend their reach across the entire Web**

As usage shifts to these networks, a social overlay is spreading across the Web. To varying degrees, Facebook Connect and MySpaceID both allow members to explore the Web using their social-network passwords and, in some cases, to chat with "friends" they find on nonsocial sites. Portals are doing their best to catch up. Google has Friend Connect, and Microsoft has a similar feature in its new Windows Live package of online services. Even ailing AOL is trying to get into the game, with portable "lifestreaming" (real-time updates from friends) and chat.

All these technologies make a user's social context portable to all sites. And this promises to transform the Web experience. Users are already asking questions about the privacy and ownership of their social-media profiles. That debate is likely to heat up. Advertisers, meanwhile, may eventually stop buying specific ad space on the Web and go after users, wherever they pop up, based on their social profiles and networks. And Internet companies? As this social Web emerges, the players that own and harness social applications will be positioned to reshape the Web in ways we can only imagine today. Google's oft-cited mission has been "to organize the world's information." The new goal is to organize the world's people. BW

Jeffrey F. Rayport is founder and chairman of Marketspace LLC, a digital and customer experience strategy group. He was formerly a faculty member at Harvard Business School.

ILLUSTRATION BY MATT DORFMAN

Put Some Fight Back in CNN

Here's a cure for the post-election ratings slump: Bring noisy debate to prime time

TO: CNN Management
FROM: Loudmouth Media Consultancy
RE: Pugilism

Bravo for '08, eh? The U.S. elections brought a rare twofer. Intense viewer interest in news—better ratings, which translate into more ad dollars—and increased ad demand, thanks to well-heeled campaigns buying every second of airtime they could grab. Now, almost halfway into '09, the election's as gone as last night's thunderstorm. Well, that's not quite right. There's no half-life to a weather story. There is a half-life to an election, especially one in which power is handed to a new President intent on using it in manifold new ways.

But CNN's evening Nielsen ratings among a key audience—adults aged 25 to 54—have fallen from their pre-election peaks. Yes, the same fate has befallen your competition, Fox News Channel and MSNBC. But if MSNBC's ratings between 7 p.m. and 11 p.m. now best yours—they did, among those adults in February and March—then your falloff is worse. Your executives make the point that CNN's overall all-day audience is growing. But that does you little good if the other guys outdo you in the most precious part of the day. (And it looks dreadful if flagship CNN ever trails CNN Headline News among adults 25 to 54 in prime time. It has in some recent months.)

In prime time it's not enough to lean on CNN's advantages: your bigger reporting staff and middle-course sensibilities. Those help when viewers hunger for continuous coverage of big breaking events or for ongoing stories like last year's election. They don't help much right now. Changing realities require changing tactics. Your opponents have staked their evening programs—successfully—on pugilism, not punctiliousness.

It's time to embrace a new prime-time ethos for CNN, which encompasses the bona fides of the brand CNN and the fact that, like it or not, on-screen combat is good TV. No, CNN should not suddenly solely air food fights, though a little food fight never hurt anyone. No, CNN should not dive madly toward some new and overt point of view. No, don't bring back *Crossfire*. (*Pace* blogger Mickey Kaus, who has suggested that.) Rather: Remake *Crossfire*. Make prime-time CNN the place for vigorous debate. (You can add the word "respectful" to the description if you feel the need.) The venue for intellectual combat. Two, or more, viewpoints enter an arena; one comes out the victor.

I know: CNN was healthy enough last year to throw off around $500 million in profit, and you guys take pride in being the financially strongest news joint around. I know much institutional ego is wrapped up in CNN laying claim to a sober take on the news. (Here's where I mention Lou Dobbs' loud opinions; here's where CNN execs shift uncomfortably.) *The Wall Street Journal* and *The New York Times* show that capital-J journalistic outlets can sling some serious smack-talk—on their op-ed pages, at least.

Klein's CNN has seen a big ratings drop among 25- to 54-year-olds

The election may have come and gone, but the issues haven't. One new-style debate show—or more—can capitalize on the national conversation regarding the government's new roles in the economy and business. You can do this and subtly elevate your brand above all else: CNN is the place for debate, not the place for argument. (You can claim in on-air promos, if you feel you need to drape gravitas around this new idea, that CNN is honoring a robust American tradition going back to Lincoln-Douglas. Or something like that.) And a healthy on-air argument spawns online clips, which, while not especially monetizable yet, bolster a brand and show it off to those who don't tune in.

This will require a remake of the political shoutfest, which has been pretty much the same for decades. A new talent stable may be required to ensure that, as CNN President Jon Klein puts it, these shows' participants don't fall into "Punch-and-Judy roles, and spit out talking points." Great. So CNN can reinvent this form and make it its own. If it doesn't, maybe the 2010 election cycle will be a barn-burner, or perhaps a bunch of really bad rainstorms this summer will rescue the ratings. Would you rather depend on your programming skills or the weather? | BW |

BUSINESSWEEK.COM |

For Jon Fine's blog on media and advertising, go to businessweek.com/innovate/FineOnMedia.

(FROM TOP) BRAD TRENT; DAVID S. HOLLOWAY/GETTY IMAGES FOR TURNER

An Idea that Sideswiped Wall Street

A *Financial Times* writer examines JPMorgan's role in the spread of collateralized debt obligations

The setting was Florida's fabled Boca Raton Hotel on a summer weekend in 1994. The characters at the JPMorgan off-site were mostly twentysomething bankers from New York, London, and Tokyo. The upshot: "the banking equivalent of space travel." Despite many hang-overs—and one broken nose—this brash group hatched a revolution in high finance, even though the purpose of their corporate retreat was merely to bolster the bank's burgeoning derivatives business.

That's the catchy riff with which Gillian Tett kicks off *Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe*. Tett is a respected business journalist at the *Financial Times* with years of credit-market reporting under her belt. She was also schooled in social anthropology at Cambridge University, although regrettably she avoids a cultural analysis of the risk managers and risk seekers who were central to the events leading up to the mess we're in now.

The bright idea that came out of Boca was derivative investment vehicles based on commercial loans, which offered two benefits to banks: They could off-load the risk of the loans on their balance sheets to investors. That, in turn, freed up capital to make more loans. JPMorgan also was an innovator in negotiating AAA ratings with credit agencies and eliciting the blessings of regulators—both turning points in modern financial history. And Tett successfully pieces together the colorful backstory of the bank's work to win acceptance in the market for its brainchild, turning credit derivatives "from a cottage industry into a mass-production business." With the benefit of hindsight, we know that while these inventions were intended to control risk, they amplified it instead. This novel idea turned noxious when applied broadly to residential mortgages, a game that the rest of Wall Street later entered into with gusto.

Its chockablock title aside, Tett's book is mostly about what JPMorgan's crack derivatives team did not do, namely abuse their own invention. At times it veers down alleys that have little to do with the construction, dissemination, or explosion of the financial weapons of mass destruction (as Warren Buffett refers to derivatives) that the bank brought to the world. Readers get a rehash of Chief Executive Jamie Dimon's well-documented spat with mentor Sandy Weill at Citigroup, as well as digressions into Enron, the Internet bubble, and a series of other woes at JPMorgan as it struggled under two of Dimon's predecessors.

When the book returns to its main thrust—the mechanics of the crisis—the promise of an insider's take in the early chapters is replaced by technical particulars. We learn in deep detail about not only how collateralized debt obligations are assembled but also their many iterations. For those seeking a primer, Tett delivers.

Tett praises JPMorgan, breathlessly at times, for its deft risk management. Others on Wall Street didn't fare so well

She gives Dimon and his team ample credit for deft risk management. And recent events appear to back Tett up: JPMorgan beat earnings forecasts in April and showed market share gains in investment banking, in part because of Dimon's strategic acquisition of Bear Stearns last year. But her praise is often breathless, making her subjects come off as oddly naive or highly excitable. Nearly every sentence attributed to Dimon is punctuated with exclamation points. ("Love it!" "Get to the point!" "The business cycle will turn!") As the crisis unfolded, JPMorgan folks were alternately "shocked," "stunned," and "astounded" to find that rivals' derivatives traders "might simply ignore all the risk controls JPMorgan had adhered to."

***Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe* by Gillian Tett; Free Press; 293 pp.; $26**

Perhaps it's noteworthy that Tett's book begins when JPMorgan had the face-value equivalent of $1.7 trillion in derivatives on its books. Today that number has jumped to a mind-boggling $87 trillion. Part of that portfolio includes almost $8.4 trillion in credit derivatives, more than Bank of America's, Citi's, and Goldman Sachs' holdings combined. Clearly, the final chapter on Dimon and his team has yet to be written. (BW)

BUSINESSWEEK.COM | Meet the author: For a video interview of Gillian Tett by banking and finance editor Mara Der Hovanesian, go to businessweek.com/go/09/gold

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HEALTH REFORM
BRINGING MEDICINE ONLINE

"The Dubious Promise of Digital Medicine" (In Depth, May 4) focused on the companies scrambling for some $20 billion in stimulus funds aimed at computerizing health records—and the serious shortcomings of some of this pricey software. Readers had some challenging questions. What about health-care staffs who are resistant to change? Or shortsighted bureaucrats? Others emphasized the benefits many expect to see if medicine goes paperless. *–Chad Terhune*

The media has mindlessly promoted health IT without looking critically at how difficult it is to build systems that are safe, secure, and private. Many vendors, slow to address problems, contractually require purchasers/users not to air complaints or problems in public, risking patients' lives. Some vendors "own" or can use and sell sensitive personal records without informed consent or even notice.

Dr. Deborah Peel
Founder
Patient Privacy Rights
AUSTIN, TEX.

While the issues and risks described are real, we at Seattle Children's Hospital have made strides in patient safety that would not have been possible without our electronic health records. These include reductions in mortality, in bloodstream infections, in time elapsed from order to medication administration, and in pharmacy-ordering errors. We've also made much greater use of evidence-based treatments, decreasing the use of unwarranted therapies in specific populations. None of these changes were attainable with our old paper-based record system.

Dr. Mark Del Beccaro
Chief Medical Information Officer
Seattle Children's Hospital

For tech vendors, health-care staffs are the most difficult to work with. They are the most backward in terms of computer literacy and they keep changing system requirements just before implementation.

Some blame lies with vendors who don't accurately portray how their systems fall short of a health institution's requirements, [leading to] costly customizations.

Screen name: jonathan

TOBACCO
WHERE THERE'S SMOKE, THERE'S PHILIP MORRIS

Regarding "Philip Morris Unbound" (In Depth, May 4): What's the difference between a street pusher and Philip Morris International CEO Louis Camilleri, who is "racing" to get overseas kids hooked on Marlboros? Camilleri's assertion that he's not wooing new smokers, "just encouraging existing ones to switch to higher-quality cigarettes," is transparently false, especially given PMI's Indonesian marketing campaign, aimed at teens.

Jack Blanton
LEXINGTON, KY.

AUTOS
WHAT BOB NARDELLI DID RIGHT

Although "Bob Nardelli's Wrong Turns" (News, May 4) doesn't mention a single accomplishment, Nardelli has achieved much in 21 months at the helm of Chrysler.

He and his talented team have improved quality, created a more competitive cost structure, strengthened dealer relations, and reduced capacity and inventories to maximize the company's assets.

Chrysler has also continued to develop products for the future, including an impressive lineup of electric vehicles. Bob Nardelli has been a true professional in the most difficult of circumstances.

Roger Penske
Penske Corporation
DETROIT

Penske Racing, which has a Nascar contract with Chrysler, won the 2008 Daytona 500 with a Dodge stock car.

THE ECONOMIC CRISIS
A PRESCRIPTION FROM THE AUSTRIAN SCHOOL

Regarding "What Good Are Economists Anyway?" (Cover Story, Apr. 27): A significant body of economists did predict the current crisis: Austrian School economists. We saw this coming for a long time. And we have the answer, too: abolishing the Fed, instituting a sound-money (gold standard) policy, and limiting the government's role.

Patrick Barron
WEST CHESTER, PA.

COMPANY INDEX

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names.
Companies listed only in tables are not included.

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A Week of Blows to Business

Why a recent series of events bodes ill for American competitiveness

You know how sometimes you have a week where Monday starts out on the mediocre side, Tuesday's pretty lousy, Wednesday's worse, and it goes downhill from there? You know how sometimes you have a week so foreboding that you wonder if you're starting to see a trend that you wish you didn't?

There's just been one of those weeks—that is, if you support business. Because if you do, three recent events should make you worry. Each suggests a rising tide of union influence and the concomitant lowering of American competitiveness, just when our country can least afford it.

Are you thinking: "Here they go again, bashing organized labor because of its higher wage rates?" Not so fast, please. For the record (and to repeat), we are very much in favor of healthy wages and employee voice, from the shop floor up, in winning companies. But we object to union work rules, which tend to be rigid and adversarial, and almost always inject needless, gummy bureaucracy into organizations.

Work rules kill productivity. We've seen it in industry after industry. Which brings us back to the three events in recent days that concern us.

The first is Senator Arlen Specter's defection to the Democratic Party. Of course, with all his politicking over the decades, Specter was never a staunch Republican. In 2003, he co-sponsored the Employee Free Choice Act, legislation that, by eliminating the secret ballot and installing "card check," would facilitate unionization efforts, to put it mildly. The Act died in 2007, but its revival this year was going strong.

However, just a few weeks ago, in the midst of Pennsylvania's Republican primary, Specter reversed his support of the bill, dealing what appeared to be a deathblow to its 2009-2010 passage.

Who knows what Specter will do next? But with him on board and an Al Franken win likely in Minnesota soon, Senate Democrats could have the filibuster-proof 60 votes they need to push the Employee Free Choice Act into law. Given his support of the legislation on the campaign trail, President Obama can be expected to sign it.


Specter's switch may be a boon to the unions

Hello, then, to unionization efforts everywhere, and not just in blue-collar places but in banks, insurance companies, and every corner of the service sector. Hello all over again to the possibility of the slow-moving, workers-vs.-management America that existed before globalization. Except that global competition now exists, and it's fierce.

The second worrisome event occurred in North Carolina on Apr. 29, when Bank of America shareholders, galvanized in part by strong union advocacy, voted CEO Ken Lewis out of his post as chairman. What's so bad about that, you wonder? Nothing—in terms of shareholder voice. We're all for that. But ultimately, we don't support the splitting of the two top executive roles because it can encourage dysfunctional, productivity-sapping "decision shopping," wherein managers go to the leader who's most likely to support their initiatives. The split roles also tend to cut into something companies desperately need today: clarity. When there are two bosses, you can often get two messages, and that's too bad.

We're not against healthy wage rates. But we object to the hit to productivity from typically rigid and adversarial union work rules

And then there's the car industry, which the government basically proposed to hand over to the UAW last week. How ironic. The unions, which had a hand in killing Chrysler, now own half its equity, and GM looks to be going in the same direction. As one of us (Jack) put it on Twitter: "Even France wouldn't do this."

Look, we don't know how the Washington-Detroit negotiations played out. But the ease with which the large bank lenders appeared to cave to a pennies-on-the-dollar deal might suggest that TARP was involved; the government was wielding a big stick, and it wielded it in favor of the unions over the conventions of bankruptcy law. Is such a radical upending of the economic system good for business confidence and capital formation? It's hard to imagine how.

And so, we are beginning to feel afraid—very afraid. We believe America needs to be more competitive than ever to get out of this recession.

It looks like not everyone agrees. BW

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Jack and Suzy look forward to your questions. You can e-mail them and view their new Web site at welchway.com. For their PODCAST, go to businessweek.com/search/podcasting.htm

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