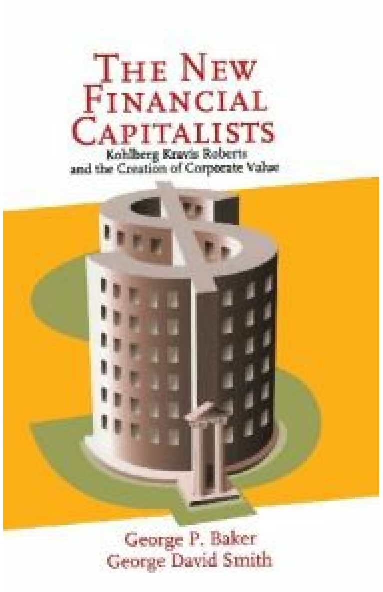

Book The New Financial Capitalists

Kohlberg, Kravis, Roberts and the Creation of Corporate Value

George P. Baker and George David Smith
Cambridge UP, 1998

Recommendation

This revealing book covers a highly charged and controversial period of American investment history. George P. Baker and George David Smith study the emergence of the investment house Kohlberg, Kravis, Roberts (KKR) and follow it during the decade KKR ruled the world of leveraged buyouts. The authors begin with the early days when the partners worked together at Bear Stearns. They track the men as they build their own firm and create their own success. In clear, straightforward language, the book presents KKR's intentions and the economics of leveraged buyouts (LBOs). It discusses KKR's role in structuring and managing the deals. *BooksInShort* recommends this book as a must read for anyone interested in LBOs or the history of KKR. Executives at all levels will find the KKR saga interesting and useful.

Take-Aways

- A leveraged buyout (LBO) is like buying a house; the purchaser expects a good return on the investment.
- The partners in Kohlberg, Kravis, Roberts (KKR) modernized the European concept of merchant banking to establish the LBO industry.
- Requiring managers to become equity investors in the leveraged company is critical to the venture's success.
- LBOs fail in the face of unforeseen circumstances or incorrect valuation.
- The twentieth century's four merger and acquisition waves involved financial capital, management capital, conglomerates, and LBOs.
- KKR did large sophisticated LBOs. One year, when the company did just a single deal, it still constituted twenty percent of the year's total LBO investment.
- Junk bonds provided access to the unsecured capital that fueled the dramatic growth of LBOs in the late 1980s.
- Despite its propensity for large deals, KKR remained a relatively small investment house where the three partners controlled the business.
- KKR viewed its purpose as long-term value creation.
- When KKR opened its doors in 1976, the average American businessman managed his business to limit the total amount of

debt even if it lowered the value of the company.

Summary

KKR and LBOs

In the realm of corporate mergers and acquisitions, the actions of Kohlberg, Kravis Roberts (KKR) were very innovative. The firm's introduction, development, and use of leveraged buyouts (LBOs) altered the way corporate ownership changed hands, particularly as regards under-performing or poorly managed companies. In the realm of mergers and acquisitions, KKR took some very disturbing steps. The power to resolve a distressed company's performance problems shifted from corporate management to KKR. While experts disagree about whether or not the use of LBOs is good for society, they agree that KKR is the most well known and notorious LBO player.

The Four Waves of Merger and Acquisition Activity

Four waves of merger and acquisition are landmarks in the United State's economic history. The use of LBOs is the fourth wave, which started in the late 1970s. The three earlier waves of merger and acquisition activities were financial capitalism, managerial capitalism, and conglomerate formation. Financial capitalism refers to the period from the late 1890s to the 1910s, when the large capital requirements of infrastructure industries led companies to make public equity offerings. The signature consolidation of this era was the formation, in 1901, of U.S. Steel from eight separate steel companies. A syndicate led by investment banker J.P. Morgan financed the consolidation. Morgan's new company was 61 percent leveraged and he placed his partners on the board of directors.

> "When the deal is done the work begins."

During the peak of the financial capitalism period, from 1897-1904, "some 4,277 American companies consolidated into 257 companies." Most of these consolidations were similar to the U.S. Steel consolidation, in that the consolidated companies were in the same business. The Sherman Antitrust Act, which passed in 1890, may have encouraged this wave of consolidation because it prohibited cooperation between companies, but not combination. The underlying reason for consolidation, however, was efficiency, not monopolization. In addition to horizontal consolidation, the first wave was also marked by the push for vertical mergers. Vertical mergers were "the combination of entities engaged in sourcing, production and distribution." Companies pursuing vertical mergers - for example, public utilities - generally wanted to expand from regional to national operations.

> "In leveraged buyouts, the probability of distress was greater, if only because it would happen sooner in the course of a company's decline."

The second wave, managerial capitalism was driven by the separation of corporate ownership from management control. Managers under this wave did not have ownership stakes or family ties to the businesses they managed. Rather, they had strategic talents, and technical and organizational expertise. The growth of General Motors under the leadership of Alfred Sloan was an example of successful managerial capitalism. Over time however, the strength of managerial capitalism became its weakness. The personal interests of the managers became increasingly removed from the interests of the shareholders. The ability of managers to control boards and to get long-term employment contracts, permitted managers to build personal empires that did not directly enhance shareholder value. This wave peaked during the rapid expansion of the U.S. economy following World War II.

> "As general partner and corporate directorate, KKR performed its most important economic function: long-term value creation."

The third wave of mergers and acquisitions, conglomerates, grew out of the power of corporate managers, a change in antitrust policy against anti-competitive mergers, and a surplus of investment cash. During this third wave, corporations of all types purchased businesses that did not necessarily relate to their core business. For example, in 1969, during the height of the consolidation wave, 6,107 transactions were announced. Most companies, however, failed to manage the vast conglomerates created through consolidation. In one case, ITT acquired 350 companies between 1959 and 1970, and yet failed to develop a cohesive management strategy. The company took a substantial loss when it sold most of its acquired entities during the 1970s.

> “Good organizations have strong memories.”

The fourth merger and acquisition wave was marked by the financial strategies of hostile takeovers and leveraged buyouts. Several factors contributed to the emergence of the fourth wave. These factors included changes in the markets and in technology that made former assets obsolete and made personnel redundant. The conglomerate boom "saddled corporations with unwieldy, inefficient or under-managed operations." Deregulation of the airlines, telecommunications, and the trucking industry revealed their excess capacity. The United States had a general feeling that its largest companies "were suffering from low productivity and a widely perceived loss of managerial confidence."

> “Flexibility in financing and adaptability to unforeseen events are crucial determinants of success.”

KKR’s success during this wave was a result of its ability to use LBOs to extract value from under-performing assets. Although KKR did not execute the largest number of LBOs during the 1980s, it was responsible for some of the biggest and most visible successes and failures. For example, at this time, KKR financed the leveraged buyouts of Houdaille, Beatrice, RJR Nabisco, and Borden. The RJR Nabisco LBO was particularly visible because it required $31 billion dollars of financing.

KKR and the Role of Debt

People in the U.S. have a paradoxical perspective about debt. While people feel a strong historical aversion to being in debt, high leverage (that is, a high level of indebtedness) is a key tool for amassing wealth. Beginning in the early 1960s, the societal aversion to carrying debt began to change. Leveraged buyouts in the form of bootstrap acquisitions started to multiply. "All bootstraps were financed by using a company’s own assets or cash flow to secure high levels of debt financing." KKR’s Jerome Kohlberg is credited with modernizing the bootstrap process by "adding the role for management as owners."

> “Expansive empires and local tribal cultures alike have tried to curb entrepreneurial behavior with political restraints and social taboos, lest it upset the status quo.”

Additionally, KKR also took on the role of merchant banker in financing acquisitions by becoming a principle investor. At the start of KKR in 1976, the company still used the term merchant banking to refer to its own financing of projects that required a lot of debt. Over time, however, as the projects became larger, "LBO" replaced the term merchant banking. KKR’s pro forma plan for a LBO was ten to twenty percent equity and eighty to ninety percent debt. A typical plan would have a company "repaying the acquisition debt within five to seven years."

> “The essential populism of American culture is uncomfortable with financial schemes, which have so often been associated with venal fraud and scandal, or worse, unfruitful labor.”

In 1978, KKR acquired Houdaille, in the firm’s first breakthrough use of a LBO to acquire a mid-sized public company. They succeeded even though the company’s investment banker, Goldman Sachs, believed such a buyout strategy was impossible. The Houdaille buyout set the stage for the rapid growth of the LBO tool in the 1980s. Financial analysis of the deal established the basic operating premise of LBOs: "Value creation does not necessarily come from growth" of the acquired business.

> “Still, debt remained in Revolutionary America what it had been throughout the history of Western civilization: a moral problem. For many, to take on debt may be necessary, but it was not a good thing to be in debt.”

Following its success with Houdaille, KKR scaled up its ability to do larger deals by evolving its relationships with debt and equity investors. The growth of pension fund investment was particularly important, as was the use of junk bonds from Drexel Burnham Lambert and Michael Milken. The availability of large amounts of unsecured junk bond debt permitted rapid decision-making since Milken could issue assurances letters. Although these letters were non-binding, the marketplace viewed them as certainties. That enabled KKR to use them to acquire several companies including: Motel 6, Storer Communications, Owens-Illinois, Beatrice, and RJR Nabisco.

Owner Managed Corporations and Value

As KKR's success in doing deals increased, so did criticism of LBOs and - by association - of KKR. The public perceived that LBO firms such as KKR were robber barons. The public believed that KKR purchased companies, cut spending and staff to the bone, and made great short-term profits. Media accounts of KKR's transaction fees reinforced this perception. These criticisms stung KKR because they believed they provided a way to increase value in their acquired companies. KKR compared their actions to the typical U.S. citizen's purchase of a house saying, "We see a house and we like it, so we pay the owner a premium price. Like every other American we borrow money to do it. The average American puts down maybe ten to twenty percent to buy a house - a highly leveraged transaction. We do the same thing." KKR doesn't let its house rot. Like any homeowner, it improves the building's condition, fixing what needs to be fixed and ripping out old plumbing and windows. And like most people, it plans to sell the house for a profit sometime after buying it.

> "The nature of the relationship between owners and managers in a highly leveraged firm rested on a basic principle: make managers owners by making them invest a significant share of their personal wealth in the enterprises they manage."

To ensure that a transaction creates value in the future, KKR follows a policy of aligning owner and management interests. Managers from the company in the buyout, for instance, are required "to invest a significant share of their personal wealth in the enterprises they manage." Managers, therefore, are converted to owners because that makes them personally liable for the results of their decisions. At the same time, investors in the buyout would only see a return if they remained committed to a long-term relationship with the acquired company. LBOs typically run for five to seven years before debt is paid down, and a high return on the investment is possible. A team from KKR also played an important part in the success plan. KKR was required to give (either internally or externally) expert support services to the newly formed KKR-controlled management board. KKR Board members had to provide ongoing support at a level beyond the scope of board members at non-leveraged companies. For a buyout to be successful, therefore, all the players - from management to investors to KKR directors - had to be aligned to a common plan implemented during a five to seven year timeframe.

> "There is no question that RJR Nabisco was a unique transaction for KKR and in the end it failed its equity partners."

KKR's purchase of Duracell in 1988 is an example of unlocking the unrealized value in a healthy company. KKR bought Duracell from Kraft Foods, where it was too small for the corporate parent to provide the attention it needed to grow. The post acquisition plan for Duracell was "simply to find the best way to increase its business." By 1996, after a successful and aggressive plan to increase international business, and after research and development in conjunction with INTEL produced a smart laptop battery, Duracell was sold to Gillette Corporation for a 39 percent annualized return on its investment of $350 million. The total return was $4.22 billion.

> "In the scramble to build wealth, high leverage was not a good thing."

Not all KKR buyouts were successful. Some investments ran into financial distress due to unforeseen factors or too large a purchase price. KKR ran into financial distress due to unknown factors when it purchased Jim Walter Homes. Jim Walter Homes owned another company called Celotex, which was sold as part of the acquisition by KKR. A year after the sale of Celotex, Jim Walter was named in a class action asbestos suit against Celotex. KKR could not have know this was coming. The asbestos litigation placed pressure on KKR and Walter, which forced the company into bankruptcy. Eventually, Walter settled with the asbestos litigants for $375 million, and KKR and its investors received a poor return on their investment.

> "Since it relied heavily on external sources for finding and minding companies, and since it had to bring investors back to the table time and time again, KKR also encouraged the kinds of personal behavior that would promote trust in the markets for information and capital."

An example of an investment with too large a purchase price was RJR Nabisco. In a bidding frenzy, KKR paid $109 dollars per share or $31 billion dollars for RJR Nabisco. In formulating the bid, KKR overestimated the value of the tobacco business. Legal battles over tobacco-related health concerns and sales competition from Phillip Morris dragged down the company's value. KKR could not make its projection. Several years later, as part of the buyout of Borden, KKR exchanged RJR Nabisco stock and divested itself of RJR Nabisco stock.

KKR and Internal Management

KKR managed LBO value creation through an internal group structure called a "LBO association." This term indicated KKR partnership groups who developed specialized industry knowledge. Internal and external observers found it ironic that this organizational structure was the same conglomerate structure that LBOs dismissed as undervaluing assets. While partly true, academic observers tended to classify the KKR LBO association as more closely resembling a Japanese keiretsu. The keiretsus held equity stakes in multiple entities and monitored their performance. However, KKR was not a holding company, so the analogy does not fit perfectly. Critically, the basis of the LBO investment was limited partnerships, which generally had a life of twelve years. After that, the partnerships were dissolved and the equity returned to the investors. KKR, therefore, had no organization structure in common with the companies it bought and sold.

About the Authors

George P. Baker, a Harvard Business School business administration professor, holds his Ph.D. in business economics and a Harvard MBA. He is an associate editor of the *Journal of Financial Economics*, and a director of Clear Communications, Inc. His many articles cover management incentives, leveraged buyouts, and organizational economics. **George Davis Smith**, clinical professor of Economics and International Business at New York University Stern School of Business, earned his Ph.D. in history from Harvard in 1976. A consultant to major corporations, he has written numerous articles and four books, including *Anatomy of a Business Strategy* and *From Monopoly to Competition*.