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George P. Baker and George David Smith
Frontmatter
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The New Financial Capitalists

"... an insider's view of the major deals for which KKR is known, including the $31 billion buyout of RJR Nabisco, much of which had not been written about so thoroughly before."

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The New Financial Capitalists

Kohlberg Kravis Roberts and the Creation of Corporate Value

GEORGE P. BAKER

GEORGE DAVID SMITH

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For Lauren and Susan

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Preface

GOOD ORGANIZATIONS HAVE STRONG memories. In the spring of 1994, George Roberts engaged the authors as consultants to help his firm, Kohlberg Kravis Roberts & Co., document the histories of its investments in systematic fashion. After some eighteen years in business, KKR was no longer just a small association of investors with a shared body of experience. It was important for the firm's senior partners to transmit both the details and the patterns of nearly two decades of experience to its younger generation of professionals and its widening circle of investors. For us – an economist (George Baker) and an historian (George Smith) – it was an exciting prospect. Though the project was strictly proprietary and intended for internal use, it gave us privileged access to the records and people of one of the modern era's most innovative and influential financial firms. We stood to learn a great deal about the private equity markets, and in particular the leveraged management buyout, a phenomenon that remained largely a mystery outside the rarefied precincts of high finance.

The project involved not just documenting the financial and structural parameters of each transaction KKR had done, but recording the post-transaction operating decisions, management and strategy changes, and operating performances of each of the forty-odd companies KKR acquired between 1976 and 1992. We combined extensive archival research (offering memoranda, SEC filings, internal budgets and memos, annual reports, and the like) with interviews of KKR principals and company executives. What concerned us were not only questions that could be answered by quantitative measures of leverage and operating performance, but also questions of business judgment, behavioral incentives, and the nuances of personal and professional relationships. Since much of the information we sought was qualitative and unrecorded, we relied heavily on the interviews to flesh out the history of each KKR investment.

As the record accumulated, we became aware of a rich history of financial innovation and organizational evolution. Much of what we learned in our research struck us as news. We learned a lot about what happened to corporate managers after they had undergone LBOs, how managerial behavior and operating performance changed as a consequence of leverage, management ownership, and active governance – not just in one or two firms, but in dozens of them. We were exposed to the thought processes of investors and managers as buyouts transformed the dynamics of owner-manager relationships. With the detail we had accumulated on how KKR's principals functioned as investment bankers, general partners, and board directors, we began to form in our minds a deeper, more textured understanding of the so-called LBO firm – its nature as an institution, its role in the economy – than had been possible for the most sophisticated financial economists to glean from the public record.

In the fall of 1995, we discussed with KKR's senior partners, Henry Kravis and George Roberts, the possibility that we might write a more complete history for public consumption. After some discussion, they concluded that some greater good might come from allowing more light to shine on KKR's history. They thus agreed to let us interpret and publish our findings, but only if *we* agreed to make any book that came out of the effort a serious study in financial history and policy. KKR had already been the subject of a body of popular business literature, which, with few exceptions, offered little insight into the historical and financial implications of the firm's business. Histories of the firm tended to be replete with trivial gossip and financially naïve. It was time, Kravis and Roberts agreed, for more serious consideration of the buyout as a financial technique and incentive system, for some assessment of its larger implications for corporate control and governance. These sentiments suited our interests perfectly.

Thus our engagement continued, but now with a public purpose. We developed an outline for a book that would be historical, insofar as we would attempt to understand KKR's story as a developing process, and to place it in its wider and longer-term social and economic contexts. We also wanted the book to be explicitly policy-oriented; we would present an argument for the leveraged buyout as an example of economically productive financial engineering. We wanted to explain what we had learned about the strengths and weaknesses of leverage, the need for more rigorous corporate governance, and the way in which KKR, in particular, had developed what we and other scholars believed to be a novel form of business organization. We wanted to assess what implications the management buyout had for the organization and management of corporations during a watershed era in the restructuring of the American business economy.

Under rules of engagement that have become accepted practice among scholars writing histories of firms, we requested that KKR give us complete access to its files and personnel. All choices of subject matter, themes, and interpretations were to be left to us alone. To ensure that a serious academic publisher would accept our work, there could be no censorship. We asked, and received, KKR's permission to publish any financial information that the firm shared with its limited partners. KKR released to us the rights in the manuscript in exchange for the following: We agreed that KKR would be able to review the text and have the opportunity to offer corrections of factual errors. We agreed to keep confidential proprietary information such as current competitive secrets or investment information. We agreed that interviewees could go off the record on sensitive issues so that we might at least benefit from important "background" information.

In the spring of 1997, we presented an outline to Cambridge University Press along with some drafts of a text for blind reading among academic experts. The three reports solicited by Cambridge were positive and critically useful. The readers were especially encouraged by our plan to explore KKR's more problematic and failed investments as well as its successful ones. One report, in particular, urged us to write for the intelligent lay reader, not just the specialist. To that end we have striven to eliminate unnecessary jargon and to be as clear as we can, without sacrificing rigor, in explaining the nature and transactions of the firm.

The product of our efforts is this volume, organized into half a dozen chapters covering KKR's activities from its founding in 1976 through the merger and acquisition boom of the 1980s. Each chapter is designed to be a more or less self-contained essay with its own thematic and interpretive structure, so that a reader may enter the book at any point depending on his or her interests. At the same time, we have designed the book so that it presents an integrated and overlapping set of themes regarding how financial structure relates to managerial performance in the pursuit of long-term value.

The first chapter is an overview of the leveraged buyout in its long-term historical and historiographical contexts. The second focuses on the highly leveraged transaction as both financing technique and incentive structure for realizing value (improving operating performance) in "undervalued" companies. The third takes up the issue of post-acquisition governance and management, with some in-depth case detail on the varied processes by which bought-out firms attempt to increase asset values. The fourth is a discussion of distressed buyout investments – the various causes and consequences of failure and how the buyout firm attempts to minimize and resolve serious problems. The fifth is a discussion of KKR as an institutional phenomenon. Here readers will encounter a firm that we believe to be an exception among small professional organizations, both in its formal management systems and in its style and culture. We also offer some hopefully useful correctives to the literature on the "LBO association," which we argue is a new and distinct form for organizing and monitoring corporations through critical phases of reform. Finally, in Chapter 6, we bring KKR's history up to date and summarize what we believe to be the larger implications of its financings for the governance and management of corporations.

We expect that the quantitative and narrative detail we provide in this volume will be useful to students of financial economics and history, to public policy makers, and to legal and financial practitioners. We hope that the insights we derive from our study of KKR's history will repay any nonspecialized reader's time and effort as well. The lessons readers will encounter are manifold, but four deserve highlighting. *Financial structure matters to corporate value creation.* In contrast with much of the theory of modern capital structure, we demonstrate that the way a company is financed affects not just the distribution of its cash flows, but also the way it is managed. *Value creation is, in turn, a long-term pursuit that requires hard work and constant vigilance.* Far from the conventional images that come to mind with the term "financial engineering," we find that the processes by which management and KKR create value following a buyout are far from short-term, formulaic, or guaranteed. *Aligning managerial and ownership interests leads to good results.* Some will find this the most obvious point in the book, but few will fail to appreciate the dramatic effects of turning managers into financial risk-bearing owners. *Flexibility in financing and adaptability to unforeseen events are* *crucial determinants of success*. Probably the greatest difference between a financial firm that completes many successful buyouts and one that founders in these treacherous waters is the former's consistent ability to structure transactions that can survive any number of unforeseen contingencies. Many parties – including investors, employees, and indeed society as a whole – suffer when financiers and managers ignore these basic lessons.

Many people have assisted us in the preparation of this work. A few deserve special acknowledgment. Davis Dyer of the Winthrop Group, Inc., provided substantial intellectual and writing assistance in the early phase of our documentation efforts. Elizabeth Neiva, Daniel Gross, Elizabeth Johnson, and Mark Samber were tireless and skillful research assistants.

Among our professional peers, each of us owes much to past colleagues, coauthors, and friends from whom we have learned and on whose wisdom we draw in this book. George Baker would like to thank Cynthia Montgomery and the Coordination, Control and the Management of Organizations teaching group at the Harvard Business School, including Carliss Baldwin, Kevin Murphy, Malcolm Salter, and especially Karen Wruck and Michael Jensen for years of conversation, joint thinking, and insights on these and related issues. (To Mike, in particular, I owe an incalculable debt.) George Smith would like to acknowledge the years of valuable collaboration with his consulting partners at The Winthrop Group, Inc., where he has learned to appreciate both the utility and the limits of economic and organizational theory. Countless hours of conversation with colleagues in the economics department at the Stern School of Business and with investment professionals Gene Dattel and Betty Sheets have deepened his knowledge of contemporary financial institutions. Most of all, thanks go to Richard Sylla, with whom he is writing a history of capital markets. (Dick, more than anyone, has nurtured my late-blooming interest in financial history.) We both also thank Lauren Jennings and Susan Gray, who, in addition to their criticisms and provocative questions about our work, have blessed us with their warm personal support.

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