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King Henry

How the master of leveraged buyout deals got his way in Washington

By Max Holland and Viveca Novak

If the narcotic of choice for investment bankers is doing deals, then Henry Kravis is Wall Street's biggest junkie.

Kravis lives and breathes for the big deal, the one that sucks that air out of competitors and detractors. Time stops for a moment when a big deal is consummated, the corporate landscape is forever changed, and fortunes are made. In less than a decade, the forty-five-year-old Kravis has parlayed a financing technique known as the leveraged buyout (LBO) into a holding-company empire that surpasses General Electric in size. He also ostentatiously presides over a personal fortune estimated (conservatively) at $330 million. That beats the rush from any non-prescription drug.

The story of Henry Kravis is a quintessential tale from an era whose central theme, we don't need media sociologists to tell us, is greed. It's about insatiable avarice on Wall Street, worker concessions and lost jobs, businesses dismantled or sold off to foreign buyers, and, finally, how great financial interests ward off Washington. For after he used leverage to conquer Wall Street, Kravis successfully applied the same principle to Washington – except this time, the return on his investment did not yield controlling interest in a corporation, but privileged access for his views, and immunity from close scrutiny of his acts. Kravis procured political inaction.

Even as Kravis tries to keep America safe for deals, though, deep fissures have appeared in his empire, raising the specter of a huge bill coming due in the nineties. Months of disarray in the "junk" bond market, underscored by February's collapse of Drexel, Burnham, Lambert Group, Inc., the premier marketer of high-yield debt, have knocked out one big assumption upon which his empire of leverage was engineered. The market for new deals is nearly dormant. Still, because of old deals, U.S. industry as a whole is diverting more cash to debt relief than at any time since World War II. This means over-leveraged companies, at a minimum, will make corresponding cuts in the investments that yield profits, products, and jobs over the long term. And if the economy slides into a recession, all bets are off. A new, corporate debt crisis could take its place alongside the Third World and savings-and-loan debacles, bringing incalculable losses for the banks, insurance companies, and pension funds that invested in Henry Kravis's buyouts.

Henry Kravis's Wall Street lacks any sense of obligation to society, and its motto is "get as much as you can." There are only two kinds of people: players and schmucks. Telling the difference is easy. Players, like Kravis himself, are not bound by the rules. Schmucks are.

Kravis first learned this critical distinction from his father, Raymond, a successful petroleum geologist in Tulsa, Oklahoma. The elder Kravis was a shrewd speculator and sometime partner of Kennedy-clan patriarch Joseph Kennedy. He sent young Henry to prep school and college, then off to New York in 1967 to begin Columbia University's MBA program. Attending one of the most radical campuses during the height of the anti-war movement scarcely affected the single-minded Kravis. "I left it to my liberal friends to do things like getting arrested," Kravis would later recall. "I had my mind on business."

Since he was Jewish, Kravis lacked the proper pedigree for a job after graduation with one of the blue-chip, WASP investment-banking firms. Instead, through his father's connections, he latched on at the less prestigious Bear, Stearns & Co. It was there that Kravis and his first cousin and colleague George Roberts met taciturn corporate financier Jerome Kohlberg, Jr.; together, these men would eventually turn wood-paneled Wall Street upside down.

The three shared a passion for a then-obscure corporate finance technique known as a leverage buyout. In a typical corporate LBO, a small group of investors buys up all the stock of a publicly traded corporation. They put about 10 percent down, and the rest of the purchase price is raised through high-interest loans from banks, insurance companies, and pension funds. As with a home mortgage, the interest on this debt is wholly deductible. So a leveraged company will often pay virtually no corporate income taxes immediately after a buyout, a margin that is critical to servicing its debt. In fact, some buyouts in the past have received tax *refunds*, courtesy of the U.S. treasury.

One essential element, however, makes LBOs risky business. After a corporation is leveraged, there is no independent source of income – like, say, a new homeowner's wage earnings – to pay off the mortgage; instead, the earnings of the "new" corporate entity itself are used to make the payments. This puts a heavily leveraged company on a razor's edge until its debt is paid down. Competition in the marketplace, a slowdown in the economy, or anything else that disturbs earnings, can push the entire corporation into bankruptcy, or force it to sell off valuable assets to meet debt payments. But if a leveraged corporation survives the three to five years it take to pay down its high-interest (or "junk") debt, investors who put only 10 percent down own the entire corporation and can put it back on the stock market, at as much as twenty or thirty times their original investment.

In 1976, Kohlberg, Kravis, and Roberts ventured forth on their own to show the world what an LBO could do. With missionary zeal, a Garbo-like penchant for secrecy, just $120,000 in capital, and the barest-of-bare-bones offices, the new "boutique" firm of Kohlberg, Kravis, Roberts & Co. opened inauspiciously. Kohlberg's good name, and almost legendary caution and reserve, gave ballast and credibility to the new firm. For his part, Kravis, short, intense, and volatile, was the consummate and well-tailored salesman; he had a knack for striding into a meeting with staid money managers and striking the perfect note of urbanity, briskness, and confidence. Consequently, he often got the "doggiest" sales job, that is, making the rounds of the pension funds, banks, and insurance companies, trying to persuade them to invest funds in KKR. It was a hard sell, for most of corporate America still considered LBOs to be immoral, and investors knew it.

In 1979, though, KKR engineered a deal that "broke the sound barrier," as one investment banker later put it. The partners, using an intricate network that included two newly-created holding companies and a staggering array of banks, insurance companies, and state pension funds, captured control of Houdaille Industries, a conglomerate worth almost $400 million, while contributing just over $1 million of their own funds. "The public documents on that deal were grabbed up by every firm on Wall Street," said one investment banker. "[KKR] showed everybody what could really be done. We all said, 'Holy mackerel, look at this!'"

KKR mounted the Securities and Exchange Commission registration statements from the Houdaille buyout in a Lucite frame. It was the corporate equivalent of big-game hunting, and there would be many more stuffed trophies during the 1980s. KKR's own creativity was soon augmented by other imaginative outsiders, notably Michael Milken, master of the high-interest junk bond, and Ivan Boesky, whose speculative buying put corporations "into play" overnight. (Several KKR buyouts, in fact, would become the object of Boesky-related insider-trading investigations by the SEC.) Together with haphazard deregulation, all these elements spawned the *laissez-faire* Reagan era, as rampant speculation replaced enterprise.

The price of speculation was paid most often by the most vulnerable variable in the equation – labor. At Houdaille, KKR forecast a whopping 44 percent increase in net income within a year of the buyout. To make economic forecasts pan out, slash-and-burn management decisions inexorably followed. In 1980, the KKR-owned conglomerate decided to close down a modern production facility in Canada and notified the two-hundred-plus work force that it would not meet its originally contracted pension, severance, or medical-benefits obligations. It took a two-week sit-in by workers, the first strike at the plant since 1948, and government mediation before Houdaille agreed to fulfill contractual obligations.

This same pattern held in other KKR buyouts. In 1984, KKR leveraged Amstar, the nation's largest manufacturer of sweeteners. Three thousand workers were laid off within six to nine months. Through it all, KKR exhibited an uncanny knack for making worker concessions and asset sales highly profitable for its investors, which, in a bitter irony, began to include many workers' pension funds. The Oregon Public Employees Retirement System, for example, invested $4 million in the Amstar LBO and was paid back $18.3 million three years later. Such returns have made LBOs "the best-performing asset class we have," according to Oregon's investment manager James George. But

George professed ignorance about the cost to labor of the Amstar buyout. “I don’t know about those [allegations], and don’t know why anyone in Oregon would,” George said.

During the early to middle eighties, KKR alone was responsible for engineering more than two dozen buyouts worth just under $14 billion, including one deal of truly mammoth proportions: In 1986, with an unprecedented dose of junk bonds and scarcely any equity, the Beatrice food conglomerate went private for $8.2 billion. KKR’s fee for just arranging that deal came to $45 million, then the largest single transaction fee ever. “I don’t think the fees were excessive given the new ground we were breaking,” observed Kravis.

In the process of leveraging corporate America, the KKR partners became extraordinarily wealthy. In 1985, Kravis moved into a $5.5 million, sixteen-room, two-fireplace, Park Avenue apartment in a building that was once the home of John D. Rockefeller, Jr. Around the same time, he divorced his first wife and married a former Young Republican named Carolyne Roehm, an ectomorphic thirty-four-year-old designer who fashioned dresses averaging $6,000 each. Kravis and Roehm became the quintessential *Bonfire of the Vanities* couple: King Henry, master of the universe, and Carolyn, a person, according to some who know her, who defines the word vapid. The couple became mainstays of Manhattan society columns: Kravis personally donated $10 million to help the Metropolitan Museum of Art complete its master expansion plan, attaining what passes for immortality in social Manhattan: the new addition was to be named the Henry R. Kravis Wing.

Inside KKR, the story was altogether different. Intractable tensions were growing between the elder statesman Kohlberg and his protégés. Kravis’s pretentious life-style bothered the relatively austere Kohlberg (who merely owned an estate in Westchester County and played a lot of tennis). More importantly, the three men were increasingly at odds over the burgeoning size of LBOs, the competitive bidding that marked the deals now being done, and the increasingly baroque forms of junk financing that were needed to do a deal. Back in 1979, KKR more or less had the buyout field to itself. But by 1983, everyone on Wall Street wanted to do LBOs and mint money. Inexorably, this competition forced KKR to innovate and consider deals that would have once been dismissed out of hand. And the serendipitous, but not coincidental, rise of Drexel’s junk bond factory, headed by Michael Milken, made virtually any financial engineering possible.

In 1984, Kohlberg underwent brain surgery, and for months afterward his hours and duties were strictly limited. Kravis and Roberts had a chance to stretch their wings, and they weren’t about to be re-caged. Kravis and Roberts also felt that Kohlberg no longer pulled his weight in a business starkly transformed. After a particularly divisive struggle over the buyout of Owens-Illinois, the trio decided that their differences over operating philosophy, money, and power were too great. Kohlberg announced his resignation to a select audience of KKR’s investors, using the occasion, in May 1987, to decry the decline of Wall Street ethics and the “overpowering greed that pervades our business life.” Without a resurgence of values, Kohlberg warned, “We will kill the golden goose.” He intended to continue doing deals in a new partnership with his son James. But "I'll stick with deals where reason still prevails," said Kohlberg.

Five months after Kohlberg's farewell address, Black Monday made him look like a prophet. October 19, 1987, saw the biggest one-day plunge in stock market history; most experts predicted that the junk bond market would shrink significantly, dampening the takeover and buyout frenzy. Kravis, however, was more concerned with the effect of the crash on the Hill than on the Street. He knew that as long as deregulation reigned, the stock exchange would right itself over the next few months. But if the crash became a big issue during the upcoming presidential campaign, it could help elect a Democrat, who would presumably threaten the *laissez-faire* environment for buyouts.

For Kravis, another kind of big investment was in order – an investment in politics. He had regularly given substantial sums to key politicians and especially the Republican party: from 1979 to 1986, Kravis's political contributions totaled nearly $100,000, sufficient to put him on a first-name basis with some senators. But what Kravis envisioned now was a role of an altogether different magnitude. He signed on as finance co-chairman of the New York Bush-for-President campaign and began raising millions for his favorite cause: the unfettered market for corporate control.

Just six weeks after the market plunge, Kravis was the key organizer of a Manhattan fund-raiser for George Bush. The luncheon at Wall Street's Vista Hotel netted the fledgling campaign $550,00 with the promise of much more to come. In addition, Kravis funneled $12,000 directly to Bush and $152,000 to an assortment of Republican campaign committees, while Carolyne Roehm chipped in $17,000. The message was clear. Although public-opinion polls revealed widespread skepticism about Wall Street's financial engineering, Bush, whenever pressed, uttered the code words that Wall Street was listening for. There would be no "turning back the clock to the malaise days" and government regulation, Bush told a Manhattan audience during the campaign. He favored a "free-market" approach to takeovers and buyouts.

Everything was going smoothly – Bush was flying high in the polls, and the market was inching its way back up – until mid-October 1988. Then F. Ross Johnson, CEO of the RJR Nabisco corporation, dropped a bombshell. In concert with senior management, he proposed taking the nineteenth largest corporation in the country private, via a $17 billion leveraged buyout. Kravis was taken aback. Almost a year earlier, he had invited Johnson to an intimate dinner at his apartment to discuss a buyout of RJR. But now, Johnson was locking Kravis out of the deal of deals. Vowing to protect KKR's "franchise," Kravis decided to submit a competing bid. The unseemly battle that followed uncorked a flood of public criticism – so much, in fact, that even before winning the bidding with $25 billion offer, Kravis tried to put a friendly public face on the secretive KKR. "Greed really turns me off," he would tell *Fortune* in a carefully scripted interview. "To me, money means security."

In spite of this sudden attempt at spin control, a few prominent administration policymakers-to-be, including WASPish Treasury Secretary Nicholas Brady, an old Wall

Street hand himself, looked askance at the explosion in corporate indebtedness. Still, the new president was not likely to bite the hand that had passed along so many checks. Little more than a week after Bush's inauguration, Brady disclosed the administration's position on LBOs: Treasury would monitor the situation. The substitution of corporate debt for equity left Brady with a "gnawing feeling." Said the treasury secretary: "You don't see convulsions of restructuring in West Germany, Japan, Taiwan, Korea, and our other major competitors. They are putting their assets to work." Still, the Bush administration's basic philosophy was to let market forces work their will.

The lack of decisive presidential leadership may have struck a fatal blow to any prospects for immediate reform, but the Democratic-controlled Congress remained problematic for Kravis's kingdom. By the end of 1988, no fewer than nine separate House and Senate committees had announced hearings into leveraged buyouts, specifically including Kravis's RJR deal. The committees ranged from such powerhouse panels as the House Energy and Commerce Committee, chaired by Congressman John Dingell (D-Michigan), to the relatively obscure Senate Banking Subcommittee on Securities, led by Senator Chris Dodd (D-Connecticut).

The last thing Kravis wanted to do, though, was explain in a public forum how Houdaille Industries was dismembered in 1987 to pay off its debt, or how Marley Company, a respected Kansas manufacturer, was forced to slash its work force in half after a 1982 LBO. Rather, he wanted private audiences and legislators' undivided attention, so he could personally show why buyouts were an elixir for corporate America.

Kravis invited several Congress members and staffers for meals in his palatial offices. While a phalanx of waiters attended to his guests, he held forth on corporate America's flabbiness. According to a guest who asked not to be named, Kravis's standard refrain was the same as that of his public speeches: "gridlocked [corporations] are dragging the U.S. economy down the drain," and LBOs "free U.S. business from the paralyzing clutches of hidebound corporate bureaucracies." The biggest obstacle in his selfless but lucrative quest to make America more competitive, Kravis asserted, was labor. "Most of the problems buyouts have are with unions," he candidly said.

Throughout the winter of 1988, Kravis courted committee members as patiently, assiduously, and successfully as he once cultivated pension-fund managers with millions to invest. He visited nearly every member of the Senate Finance and Banking panels, and a score of members in the House. "He doesn't come off as a robber baron," said Representative Charles Schumer (D-New York), a key House opinion leader on corporate issues, after meeting Kravis. "He comes off as a nice, courtly gentleman."

Kravis hired five separate law and lobbying firms to help him curry congressional favor. Perhaps the most valuable was Wunder & Diefenderfer. William Diefenderfer – who left his firm last year to become deputy director of the Office of Management and Budget – was the former staff director of the all-important Senate Finance Committee in the mid-1980s. And, most significantly, he had magnificent access to one senator in particular, his former boss, Republican Bob Packwood.

Articulate, intelligent, and liberal on social issues, Packwood is the Republicans' heavy hitter on the Senate Finance Committee. His official position on LBOs, according to his staff, was that "we're not sure there is a problem, or if so, how to fix it." But this seemingly open-minded stance was belied by Packwood's comments and questions throughout three days of hearings in January 1989. He noted how well Oregon pension funds had fared with KKR, and introduced into the record a virtual advertisement for KKR's buyout of Fred Meyer, a retail-store chain in Oregon. It was as if one LBO (and an unrepresentative one at that) justified the buyout binge.

Packwood packaged his viewpoint as if it had been solely informed by his state's lucrative experience with KKR, and his staff claimed that "labor didn't have anything to back up what they were saying." In truth, his stance reflected an equally keen appreciation of Kravis's role in financing the Republican party and senatorial campaigns. As one former Senate investigator noted at a hearing, "it's tough to take their money and then cut off their balls the next day."

Republicans were not the only linchpins for Kravis. At the very least, he had to neutralize the Democratic side of the aisle, especially in the House, where anti-buyout sentiment ran strongest. Here again, he would turn to Wunder & Diefenderfer, whose ties to liberal Democrats easily rivaled its links to Republicans. Ken Levine, a former Carter administration appointee; Michael Forscey, a onetime member of Senator Edward Kennedy's staff; and Tom Ryan, former chief counsel for Representative John Dingell, all worked at the firm. Forscey and Levine, moreover, have been involved with Independent Action, one of the largest Washington-based PACs dedicated to supporting progressive Democrats.

Through these hired channels, Kravis contacted Democrats like Representative Tom Downey (D-New York), one of the most thoughtful and energetic Democrats on the House Ways and Means Committee. Downey had met Kravis several times, and Kravis knew that the congressman persistently criticized the existing, often lethargic corporate structure. Kravis presented himself as a plausible antidote to corpocracy, and Downey gave Kravis some lobbying advice. "I did not walk him around and introduce him,"recalled Downey, but "I gave him a list of people on Ways and Means who are effective and intelligent, [and] told him he should contact them if he wanted to make his case." Downey even called some colleagues, like buyout critic Representative Byron Dorgan (D-South Dakota), to ask them to hear Kravis out. Kravis, Roberts, and a third KKR partner subsequently contributed $1,500 to Downey's campaign treasury.

What made Kravis's lobbying especially effective was a study that KKR itself commissioned. It showed uniformly positive results from the LBOs engineered by the firm, and claimed increases in employment, profits, and taxes paid to the federal government. The study didn't always work. When Kravis went in to see Senator Max Baucus (D-Montana) and urged him to read the KKR study, Baucus pointedly refused. Since KKR paid for it, the senator was heard to remark, "I already know what it says." But many other members, and staffers, were snookered. The report's claims, numbers, and methodology seemed reasonable. And Kravis and KKR so effectively presented the report that, virtually overnight, congressional sentiment shifted from “LBOs have gotten out of hand” to “Let’s not make the cure worse than the disease, if there is one.”

It was five months before KKR’s presentation was impeached. A former Federal Trade Commission economist, William Long, in testimony before Congressman Ed Markey’s (D-Massachusetts) subcommittee on finance, showed in painstaking detail how KKR had cooked the books to shed the most flattering light on its buyouts. Long showed that KKR’s conclusions were premature, if not suspect. Many of the claims, it turned out, had been based on projections rather than the actual figures. But this was May. By that time, King Henry’s study had taken the Hill.

Of course, other elements defined the debate over LBOs, not the least of which were Congress’ notoriously short attention span and particular fear of complex financial issues. Nevertheless, Kravis’s calculated moves affected debate at a pivotal moment. In the wake of the massive criticism over the RJR deal, the KKR study showed that at least some on Wall Street would not bend to popular outrage; it also cowed Democrats afraid to be blamed for another market meltdown. The only reforms that passed in 1989 – reforms vigorously opposed by Kravis – were two changes to the tax laws that affect the deductibility of some of the junkiest forms of corporate debt.

Congress didn’t even carry through on its vow to get to the bottom of the deal of deals, the RJR buyout. Congressman John Dingell’s usually tough investigators mounted the probe amid great fanfare in December 1988, in part because the money that was made seemed so “out-goddamned-rageous,” said chief counsel Michael Barrett. All the major players in the RJR deal were questioned for hours on end, including Kravis. His performance was so effective that Reid Stuntz, the staffer charged with drafting the initial report, took to quoting Kravis approvingly on the deal. Kravis’s claim – that RJR wasn’t a good case study – became the conventional wisdom, and the committee’s investigation soon ran out of steam because, said Barrett, “we just couldn’t get a real good handle on [the deal].” In reality, the probe was far too narrowly conceived, and the educative role of hearings all but ignored. The issue wasn’t simply whether board chairman Ross Johnson tried to steal RJR away by “low-balling.” The ingenious funny money Kravis devised was of at least equal importance, as was the $8 billion of tax breaks that the RJR deal hinged upon.

The very skill that made Henry Kravis, though, may eventually undo him. He scaled the heights of finance capitalism through his highly aggressive entrepreneurship, spurning prudence and the normal rules of financial conduct. Now, with the junk market “in shambles,” to use his own characterization, and amid a slowing economy, Kravis may reap a taste of what he has sown. SCI Television and Seaman Furniture recently had to reschedule their debt after missing payments, and last December, the former Jim Walter Corporation filed for bankruptcy, KKR’s first. Everything pales though, next to the looming mountain of debt incurred from the RJR buyout. Some of the unsecured debt has plummeted in value, even though RJR bonds were initially considered next to sacrosanct by junk bond investors. And in February, RJR had to postpone a new $1.25 billion debt offering because of turmoil in the market. If interest rates remain high or rise, the company faces a “bust-up” far beyond anything contemplated when the deal was consummated. The safety net once provided by Drexel is gone, and new junk debt cannot be piled upon bad debt any longer.

There are even signs, albeit faint, that Democrats may awaken from their slumber. In focus-group interviews privately conducted for the Democratic National Committee early this year, disaffected Democratic voters singled out leveraged buyouts as an abuse that needs curbing and chastised the party for doing nothing. Subsequently, House Speaker Tom Foley pointedly criticized buyout mania as “a waste of resources” in his rebuttal to Bush’s state of the union address. Still, it’s not clear whether this new resolve goes beyond mere words, or whether it’s sufficient to overcome the dependence of some influential members, like Senator Bill Bradley (D-New Jersey), on Wall Street’s largess. During the last election cycle, Bradley received $96,00 from individuals linked to LBOs, and he wasn’t even running for anything. The Democrats’ inclination still has a decidedly facile and Republican tinge to it: let the market discipline what have admittedly been excesses.

Kravis has responded to the gathering clouds by lashing out at the media for its sensationalism, and by criticizing investment managers who divested junk bonds from their portfolios. At a February gathering organized in lieu of Drexel’s notorious “predator’s ball” conference, Kravis accused the money managers of following a “herd mentality” rather than acting as his long-term “partners.” It was a rare misstep for the consummate salesman of debt. Many there resented the implication that they were cowards, swept mindlessly along by a media-induced panic. “That speech may come back to haunt him,” one senior portfolio manager told *The New York Time*s.

All these developments are being followed in exquisite detail on Wall Street and Fifth Avenue. What Germans call *Schadenfreude* (taking malicious joy in a neighbor’s misfortune) is manifest in Manhattan’s gossip columns. If King Henry loses his preferred vocation, “there’s always Carolyne’s rag business,” goes one jibe. Tom Daly, a KKR spokesman, refers to this as the “banker and banana peel” phenomenon. People delight in seeing “a successful banker slip,” he says.

Henry Kravis works without a net, and has never fallen. His mistake may be in thinking that it can go on like that forever.

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