

Private Equity – A 35 Year Perspective

Keynote Speech Delivered by Henry R. Kravis at *The Private Equity Analyst* Conference in New York City on September 22, 2004

I'd like to begin by thanking *The Private Equity Analyst* for inviting me to speak at its 10th anniversary conference. I know from my experience with print media companies that it's a tribute to any publication to not only survive for 10 years, but also to thrive. More importantly, the popularity of this publication and its conferences, as can be seen here today, demonstrates the contribution of its editors and other managers to the private equity industry. Little did I know in the 1960s, when George Roberts and I bought our first companies, then known as "bootstrap" investments, that I would ever use the term industry when talking about what I do. Thank you *Private Equity Analyst* for being so supportive to all of us here today.

I would like to share with you a discussion I had in one of our fund raising meetings several years ago. In many ways, it frames the subject I would like to talk about today. KKR was in the process of raising its Millennium Fund and I was meeting with a very large pension plan. This was the third or fourth time I was meeting with the pension fund's staff. After about an hour of discussion, a young staff member looked at me and said, "Mr. Kravis, you just don't know how to do the private equity business."

After thinking about his statement for a few seconds, my curiosity overcame my shock and I asked him to tell me how he thought the business should be done. "It's very simple," he said. "You make an investment in year one and get to know the company, you add value in year two, and you sell the company at a profit in year three."

Oh! If it was only that simple! I would love to be in that business! Unfortunately, at no time in my experience has the private equity business been that easy or that formulaic. It took a lot of time and hard work 35 years ago and it takes even more time and hard work now.

Today, I'd like to talk about how the private equity industry has evolved over the past three decades, and the difficulties we, in the industry, have faced and overcome. I suggest to you that the challenges we face today as an industry are the direct result of our past success. I'd like to offer my thoughts on how we can overcome today's challenges to secure our futures and specifically focus on the notion of adding value in year two.

When George and I first started doing deals at Bear Stearns in the late 60s, "bootstrap" transactions, were in their infancy. The private equity industry as we know it was not yet born. In the early days, there was very little understanding about what we were proposing among corporations, or among the debt providers we needed to support our buyouts, or among institutional investors. There was limited debt capability and no high yield markets. There were only a handful of "bootstrap" investors. Most people don't realize that we started with no fund -- and we were supported by only five individuals as investors and one bank investor.

The hardest work in the early days was finding capital from investors, financing the transactions, and educating corporations about leveraged buyouts and the meaning of maximizing shareholder value. I remember visiting Boren Clay Products in 1973 trying to explain to the CEO what a management buyout was.... how a transaction would work... the benefits of leverage...and how we could unlock shareholder value by providing management real economic incentive through ownership to drive improved operating performance. He looked at me like I was from another planet, unable to grasp what we were trying to accomplish. Contrast that with today. You can't graduate from a business school without understanding how to build an LBO model. You can't work in an investment bank without going through training which includes understanding the private equity industry. You can't work in a corporate law department in any firm in the country without understanding the laws relating to "going private" transactions and shareholders' rights.

Today, there's plenty of understanding about leveraged buyouts and lots of capital available. What a long way we've come. And everyone in the room and their institutions deserve a portion of the credit for what our industry has accomplished.

But we certainly haven't done it alone. Institutional investors have played a critical role in building our industry. The buyout business began as an offshoot to venture capital with individual investors supporting the earliest deals. Then came some innovative banks such as First Chicago, Continental Illinois Bank, and Security Pacific, all names of the past.

They were followed by insurance companies such as Prudential, Teachers, Mass Mutual, Met Life, and the Equitable. The real breakthrough came when non-financial institutions began to invest in private equity because the returns were attractive.

Endowments, foundations, and corporate pension funds led the way on the venture capital side of the business. Then in the early 1980s a few state pension funds launched their private equity programs and became the major supplier of capital to the buyout industry. These funds truly showed great insight into our kind of investing and led the way for others to follow. I will always be grateful for the support and foresight we received from Washington, Oregon, and Michigan at the beginning in the early 80s, important investors who are still investing with us 24 years later.

We should all remember that without our investors, no general partner could have achieved the success we all have.

Let me ask you, has the faith our investors placed in us been justified? Well, the returns in our industry have been excellent and the fact that our industry has flourished reflects that. But it's how we generate our returns that I think is the interesting story to talk about today.

There was a time in the early days of our industry when it was easier to generate returns for our investors. If we empowered management, provided them with ownership incentives, and if the transaction was consummated, we would make money.

Often we found subsidiaries that were neglected. Duracell and American Re-Insurance are two examples of companies we bought and sold successfully that were owned by much larger companies. If we freed up the managements to focus on their businesses, gave them the support with capital and quick decisions, value creation inevitably followed.

Of course, we had to provide oversight and strategic insights at the board level. And we were proactive directors reviewing budgets, and emphasizing the creation of shareholder value. But the nature of our involvement was more limited. The managers largely did the job.

This is no longer the case. The businesses we invest in today are better managed companies than those we invested in 10, 20, or 30 years ago. And there is more transparency in business, so it is extremely hard to find a hidden jewel. None of us make money at the time of the acquisition. We only make money because we improve the operations of the newly acquired company, and, subsequently, if capital markets are strong, utilize this capital to our advantage. As a result, we've had to get more skilled at building businesses. And it is no small irony that our need to work harder today to increase the value of our companies is the fault of our own collective success. Let me explain what I mean by that.

It is no longer as easy as it once was to increase the value of our companies, in part because we, as investors and general partners in this industry, have institutionalized some enduring business values in the United States and in many other parts of the world that have made businesses more efficient and better run and, as a result, more valuable.

Contrary to formulaic notions of how a buyout is done, we can't wait until year two to start adding value. We need to start adding value the day after we complete the transaction and keep working at it until the day we exit. Thirty years ago, the hardest work occurred before we made the investment. Today, we work hard before we make the investment, but we work harder after we make the investment.

Let me share with you what I believe we, as an industry, have contributed to corporate business and how these contributions have forced us to manage our own firms differently.

The first enduring value of private equity that our industry institutionalized is Management Ownership. Running the business as an owner inevitably unlocks value. Significant ownership by management was not typical in the 60s and 70s. I remember an early board meeting at one of our investments in the 80s, Union Texas Petroleum. This company was involved in the oil and gas business. Management once recommended a \$100 million oil exploration budget. Our reaction was that management must be quite optimistic about their prospects for finding oil to risk that much of the shareholders capital. We pointed out to them, that as shareholders who owned 10% of the company, they were putting \$10 million of their own capital at risk. All of a sudden the lights went on and management decided to reconsider the budget. One month later, the exploration

budget had been cut in half and I can assure you they were far more focused on the results of each and every drilling site.

Today, most companies have ownership plans of some sort and the top managers typically must own stock. So while instituting management ownership programs used to be a way we could pretty easily impact the profits of a business, that lever has probably already been pulled before we get involved in the company. As a result of our success in making management ownership the norm, our industry has had to become more skilled and creative in building successful companies.

The second enduring value is our mantra of Maximizing Shareholder Value. As significant owners of the businesses in which we invest, most of us in the industry have always held seats on our portfolio companies' boards of directors. But we generally aren't board members who show up once a month and whose primary source of revenue is elsewhere. Most of us in the industry live with these businesses on a day-to-day basis as shareholders and as guardians of our limited partners' capital. We perform extensive due diligence and analysis, not only of the businesses in which we invest, but also of their competitors and the overall industry dynamics. We at KKR, as I sure many others in our industry, are very granular in our approach to monitoring a business.

As a result, we know these businesses as well, if not better, than the management teams. We have a laser focus on the bottom line. Board meetings are interactive discussions, not reports to passive friendly directors. All decisions are made with a clear intent to create shareholder value. And while each private equity firm has its particular strengths, I believe that, as an industry, we have always strived for transparency to protect the shareholders.

If you examine all the major corporate scandals of the last 25 years, none of them occurred where a private equity firm was involved. Businesses have failed under our ownership and that happens. But to my knowledge there has been no systematic fraud or management abuse in our industry. Why? Because I believe that as general partners we are vigilant in our role as owners and we protect shareholder value. The private equity industry should be proud of this record.

After the recent corporate scandals, the Government stepped up to protect the shareholders from Enron situations by introducing Sarbanes Oxley. I believe that Sarbanes Oxley is a positive development for shareholders. Today, directors are taking their responsibilities to shareholders more seriously and this is good. One consequence, however, is that they are also being more conservative and risk averse. An enormous time is spent on legal process by the board, rather than pushing innovative ideas. Sometimes this is to the long-term detriment of the business. It is easier to say "no" to risk and play it safe than it is to examine the risk closely to determine if it is the right decision for the business. To the extent that Sarbanes Oxley causes public companies to be less competitive, there is an opportunity for the private equity industry in taking these businesses private and putting some energy back into growing them.

Today, in spite of Sarbanes Oxley, increasing shareholder value still permeates boardrooms throughout the corporate world. So the result of our success in bringing the shareholder to the forefront is that companies are run better. Again, the success of our industry has forced us to become more skilled at building successful companies.

Which brings me to the third enduring value institutionalized by the private equity industry... Using The Balance Sheet to Drive Value. Of course, I'm primarily talking about the use of debt in companies. Commentators often refer pejoratively to some of the techniques we use in buyouts as financial engineering. I do not believe anyone should apologize for the efficient use of capital and capital markets. Since our industry began, the capital markets have exploded with growth. We saw the birth of the high-yield market. Debt became available to good businesspeople with good ideas. We have seen companies in the United States grow because of the availability of all types of capital -- debt, preferred stock, common equity, and various derivatives of those securities.

Today, capital is a commodity. For all intents and purposes, it is widely available. Our debt markets are extremely deep and liquid. The banking industry is healthy and well capitalized. This has not always been the case.

One of our earliest transactions was Houdaille Industries, in 1979. It took us almost one year to raise \$355 million. The availability of financing was our biggest challenge. Literally we had to add up the potential capital sources at that time, which consisted of several banks and insurance companies, and one-by-one go out and raise the money, and then create a capital structure based on availability of funds.

I know a lot of people in the room think that the past few years have been tough, and they have been. But think about an environment where inflation is running north of 10%, the prime rate is 21%, and the Chairman of the Federal Reserve has effectively frozen all corporate lending for non-essential purposes, such as M&A -- AND you've just raised the biggest pool of capital in private equity history, a whopping \$135 million. That was KKR's situation in 1980.

Having lived through five cycles since then, it's my view that the current economic environment is fairly benign. Interest rates have just bounced off historic lows, inflation is low, and capital is readily available. There is no question that the economic strength in the US derives in part from the ability of our companies, large and small, new and old, services, media, and manufacturing, to access capital to grow their businesses. This is also something of which the private equity industry should be proud.

Unfortunately, there is a flip side to having access to plentiful capital. It means that too many people without experience in building businesses have too much money. For example, last month, KKR along with Blackstone, TPG and Hellman and Friedman, announced an investment in Texas Genco, which owns various energy assets. The other bidder in this case was a consortium of hedge funds. This investment is a multi-billion dollar buyout with over \$1 billion of equity. And if the hedge fund consortium had won, the company would have been owned by investors who had never previously managed a

company. Hedge funds know how to pick stocks and make lots of money, particularly with stocks which they can trade “at will”, unburdened by inside information or other constraints. But, that is not the same thing as creating value through ownership of an asset over the long-term in a hands-on way. Perhaps this consortium would have done a wonderful job -- but someone’s equity capital would have been at risk if they didn’t.

So here’s where private equity stands after three decades: First, management ownership has become institutionalized, eliminating for us a relatively simple method of increasing value in our companies. Second, an emphasis on creating shareholder value has become an important driver in powering a dynamic and prosperous U.S. economy, increasing the valuations of our potential investee companies. And finally, as if making money wasn’t hard enough, our success in building businesses by leveraging our flourishing capital markets has led to increased competition from traditional private equity investors as well as from outside the industry. In short, everything we have accomplished in driving corporate excellence makes it harder for us to achieve the returns that our investors expect from us.

But, while today companies are happy to show you their well-run subsidiaries and sell them to you for high prices, I still believe that private equity can deliver returns way above the public market indices. How do we solve this conundrum? It’s a bit more involved than waving a wand and saying, “Add value in year two.” Here’s my view which breaks down into several different areas many of which are under our control.

First, you can’t wait until year two to add value. Our job of creating value begins on the first day of the first year. As investors we must bring a sense of urgency to the business. In dealing with this sense of urgency in our businesses, we have learned that any delay in implementing business decisions can be costly. We have implemented in all our new portfolio companies what we call “100-day plans.” That means that we hit the ground running from the day a transaction closes. For example, if a sales force is inefficiently run and its compensation structure is poorly designed in a company that we are acquiring, not only should we understand that as part of our due diligence, but within the first 100 days of ownership implementation of corrective measures should already be well underway.

Establishing operating metrics at the outset of a transaction is part of our approach because it provides us with indications of businesses in decline before the financial data would reveal such results. We bring focus to efficiently operate the businesses we own. We institute the best business practices. We bring business judgment and experience to the decisions made in a boardroom; such as the purchase or sale of a business, capital expenditure requests, research budgets, and compensation structures. We also understand who is a good manager and who is not. We move quickly and decisively in changing management when deemed necessary.

The hard reality is that value creation takes as long as it takes. We must constantly ask ourselves how can we create additional value? Are we continuing to add value? When a private equity firm has completed its job, in the first year or after 5 years, it’s then time to

move on. Knowing when to sell and managing that sale wisely comes down to the judgment of experienced professionals.

Second, the successful private equity firms have to raise the bar in finding the best opportunities. This requires the utmost in selectivity and due diligence. Experience matters. Understanding the industry in which you are making an investment is key. At KKR, we expect our executives to know the industries in which we invest as well as the executives who run our companies. This allows us to recognize the potential in a business before we invest, and make plans for how we can improve or expand its operations after we make the investment. To this end, at KKR we have had dedicated industry groups for several years now, each focused on a specific area of interest such as insurance, utilities, retail, media, and healthcare.

In particular, success in highly regulated industries such as insurance and utilities requires years of study before putting limited partners' capital at risk. In other industries such as retail, media, consumer products, and manufacturing, we have been students of these businesses for almost three decades. Since the days of buying a company on the cheap are pretty much over, and the key driver for success in our business is what you can do with the company after you own it, then intimate knowledge of industries and companies is imperative.

Third, many private equity firms, including ourselves, have had to develop a more disciplined approach to how we manage our internal operations. In the old days, George and I were able to make all the decisions and stay on top of all the details of our portfolio companies. As entrepreneurs, we were comfortable with an informal but highly engaged route. But as our portfolio has grown and as the challenges of value creation have increased, we have had to take a more structured approach. As a result, we have created an investment committee which meets frequently to vet potential new investments and a portfolio management committee which supplements our work as Board members by continuously reviewing the performance of each company based on rigorous criteria.

Fourth, success in creating value today is more than ever a function of the talented people you surround yourself with and the experience, creativity, hard work, and integrity of these people.

Every one of those characteristics is important. Talent is fundamental. But, simply being brilliant does not make you a good investor. As we all know, Nobel Laureates have lost a lot of money. When our young, bright analysts and associates come to our Investment Committee, a review of the numbers and returns is not sufficient. We expect an analysis of the business, why we want to own it, what are the value creating opportunities, how does it compete in its industry, why should it succeed in a downturn, and other arguments for its attractiveness as an investment. The computer model is the last thing we look at.

Which leads me to suggest that one of the best ways to insure the success of the private equity industry is to train and guide our young professionals. While there is no substitute

for firsthand experience, we should constantly look for opportunities to pass on our decades of experience to a new generation.

Our industry is populated with incredibly talented people who in turn hire as their CEOs, CFOs, and other executives for their portfolio company investments, very talented managers. That's why I'm optimistic about the future of private equity. We have unlimited opportunities and the talent and experience to find those that will provide the return criteria suitable to our investors.

Finally, I believe that we can be successful because the flow of potential investments is greater than ever before. One of my great joys in this business is that CEOs are now very receptive to meeting with us. Even better, they call us. Managers are listening and willing to do the right thing for their businesses and their shareholders. It's fascinating to me to visit top managements at large companies in the U.S. and abroad and discuss possible ways to create value. This is perhaps one of the most exciting times in my 35 years in the industry.

It is particularly exciting to see the opportunities sprout up around the world. If you told me 20 years ago, KKR would have an office in London and make over a dozen European investments, including eight investments in Germany alone, I would have been highly skeptical. Ten years ago CEOs in Germany rarely embraced the concept that private equity firms could be helpful. Now, German managements are actively contemplating private equity transactions.

Germany is not unique. Private equity firms are finding investment opportunities around the globe. These investments can take many forms: businesses in emerging markets, turnaround situations in more mature markets such as Japan, or the purchase of subsidiaries from larger multinational companies in Europe or the Far East.

In addition to the geographic spread of the opportunities, private equity investors have found ways to structure investments in a wide range of industries. Deregulation has played a big role. In 1985, if anyone had told me that KKR would be investing in banks, I would never have believed them. But five years later we had two bank investments. In 1990, if anyone had told me that we would be investing in insurance companies, I would never have believed them. But we have made five investments in insurance companies. In 1995, if anyone had told me we would be investing in utilities, I would never have believed them. Already we have announced four transactions in the utility field. I now believe an investment in any industry, in any part of the world is possible. And that's why I enjoy going to work every day: to see what we can do next.

There is no one successful approach to add value to our businesses. As investors we need to develop our own individual approaches that are effective consistently in increasing the value of our companies. This business also requires us to evolve our firms as the environment changes. When we manage our own businesses more effectively, we have a better chance to compete globally and achieve attractive returns. We can never rest on our past successes. We are never done with our job of improving our firms.

The story I told about the young staff member at the large pension plan is really true. It made me realize that we as an industry need to do a better job of explaining to our most important constituents what we actually do on their behalf, day in and day out. To me, it was a call for greater dialogue. Many of the limited partners in the audience may not believe that the general partners hear you. Certainly the good ones do hear you. We are listening. KKR would not be successful if it did business as it was done in the 70s. All of us in the private equity world need to continue to listen to each other, to improve, to evolve. I hope these remarks have been one step towards that goal. If so, I anticipate even greater successes for everyone are yet to come.

Thank you.