Kohlberg Kravis Roberts & Co. and the Leveraged Buyout

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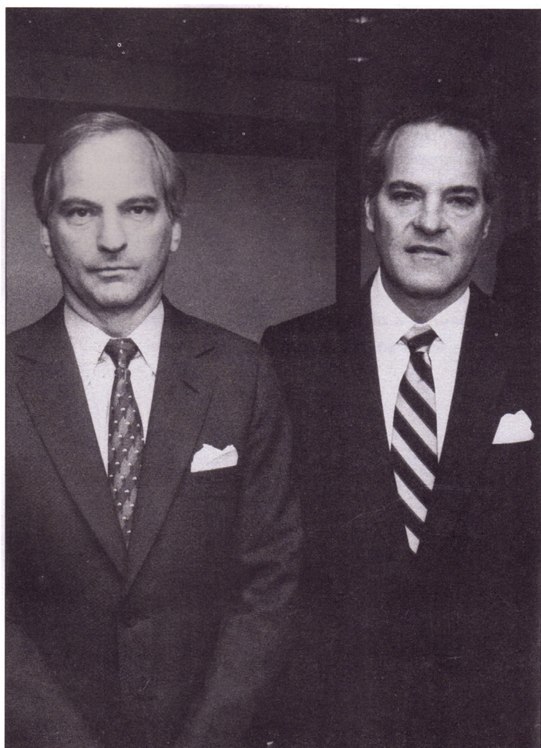

George Roberts and Henry Kravis of KKR in 1988.

For much of the twentieth century, corporate managers regarded debt warily. It was a necessary part of the balance sheet of nearly any healthy company. But the conventional wisdom was that too much debt was dangerous. In the late 1970s and 1980s, however, senior executives began to see debt in a different way. A company could be awash in debt and still prosper; senior executives could prosper, too.

Debt became "leverage"—a means to move or control a larger object, in this case a company. In the financial strategy popularized by the founding partners of Kohlberg Kravis Roberts & Co., whom the journalist George Anders aptly dubbed "Merchants of Debt," leverage made it possible to acquire large and successful companies with little money down.

KKR, as the firm is known, based its business on a high-stakes transaction called a "leveraged buyout." In a typical LBO, a group of upper level managers, investors, and financial specialists buys back stock from a corporation's shareholders, usually at a price substantially above market value. To raise the cash for this transaction, the buyers borrow from institutions or sell high-yield bonds against future revenue streams from the acquired company.

Jerome Kohlberg, Henry Kravis and George Roberts, three specialists in corporate finance, formed KKR in 1976 with $120,000. At first, KKR focused on small companies. Later, the partners made cold calls on likely take-over targets and hoped to entice senior executives into cooperating on a leveraged buyout (LBO). In its third year, the firm acquired three corporations and spent over $407 million. KKR became known for working their deals in cooperation with management. Eventually, KKR's success gave it the strength to choose its own targets and execute buy-outs independent of a target company's wishes. As the three financiers completed increasingly impressive deals, others followed the KKR formula and used LBOs to build empires overnight. The founding partners of KKR had introduced a significant innovation to corporate finance, a sort of mortgage mentality that allowed businesses to live with massive debt as easily as homeowners did. As the field became crowded and access to cash became more crucial, KKR found a powerful new partner in Michael R. Milken, of Drexel Burnham Lambert Inc. Milken's prowess in raising huge sums through the sale of high-yield "junk" bonds gave KKR an extraordinary instrument of debt to work with, one that offered immense financial power under the right circumstances.

The 1980s were very good to KKR. By 1989, it was the general partner in the ownership groups holding such well-known American companies as RJR Nabisco Inc., Safeway Stores Inc., OwensIllinois Inc., and Duracell International Inc. Yet KKR ran its huge portfolio with a staff of only a few dozen people. While the firm,

with various investors, owned controlling interests in these companies, it was not interested in running day-to-day operations. KKR was content to let those on the scene mind the store. It used an inclusive management-style, usually allowing (even insisting) that the top managers of its acquisitions participate in ownership. As a result, to use one of Jerome Kohlberg's favorite expressions, they were "all on the same side of the table."

KKR's partners became near-billionaires by applying their initial insight: that debt enforces a unique kind of discipline on managers and owners. The KKR philosophy of using high-level debt to enhance value has since been adopted by the managers of hundreds of publicly held firms.

Wall Street Engineers

Jerome Kohlberg arrived on Wall Street in 1955 after graduating from Harvard Law School. He joined the firm of Bear Stearns, then known as a trading powerhouse. With a contemplative manner more typical of a university professor than a Wall Street dealmaker, Kohlberg stayed away from the frenetic trading pits, instead choosing to work in the corporate finance department. He advised clients and arranged financing for corporations that were merging, expanding, refinancing, or selling stock.

Business was steady in the corporate finance department. In the 1960s, impelled by the riches of a long-running bull market, many companies sold shares to the public. Still others were acquired by larger firms that were developing into conglomerates. In either case, company managers were losing autonomy in the firms they worked so hard to manage. In response to this problem, Kohlberg began to sell owners of companies on a strategy whereby they would cash in on the equity they had created without ceding control. He reasoned that groups of investors led by top management could obtain control of their firms with a small amount of equity and a great deal of debt. This would concentrate ownership in the hands of a few investors, including management. Over the years, the new owners could pay down the debt through earnings from operations.

Kohlberg found a willing client in H. J. Stern, the septuagenarian proprietor of a gold-refining firm called Stern Metals. Stern wanted to realize a profit from the firm he had built up, without selling control. "I suggested that he could have his cake and eat it too," Kohlberg later said.

In the summer of 1965, Kohlberg organized an investor group, which bought the firm with borrowed funds, leaving the management of Stern Metals and a considerable amount of company stock to the Sterns. The financier rounded up about $1.5 million in cash from the Stern family, from Bear Stearns, and from individual investors. Kohlberg also borrowed $8 million from banks. The beauty of the deal to the family was that it had received millions for their company without relinquishing its leadership. The beauty of the deal to Kohlberg was that the very presence of the debt compelled all those interested in the deal, both the outside investors and the Stern family, to operate the company efficiently. And the fruit of the deal for all concerned was a high rate of return: within four years, the value of the shares had gone up by eight times.

As Kohlberg continued to pursue LBOs, he was assisted by two younger men, George Roberts and Henry Kravis, who were cousins. Roberts grew up in Houston, and Kravis was raised in Oklahoma, the son of an oil man with many connections on Wall Street. The cousins spent a great deal of time together as children, and both attended Claremont College in California. Roberts went on to law school, and Kravis received an MBA from Columbia University, where he was singularly unaffected by the campus turmoil of the 1960s. "I left it to my liberal friends to get arrested. I had my mind on business," he later said. Roberts was the first to start at Bear Stearns; after working there during summers, he was hired by Kohlberg full-time in 1969. But Roberts, more reserved than his extroverted cousin, didn't like the hustle of New York. When Kohlberg agreed to let him work out of Bear Stearns' San Francisco office in 1970, Roberts recommended that his cousin, Henry, become his replacement in New York. Within a decade, these three men would both transform the way companies thought about debt and reconfigure the relationship between ownership and management.

To drum up business, Kravis and Roberts analyzed thousands of company reports, made cold calls to managers, and went on extensive trips to meet chief executives. Positioning themselves as friends to management, they looked for companies or executives that would actually benefit from the type of takeover in which they specialized. In general, the two were met with skepticism, though the rebuffs did give them a chance to polish their pitch to a high gloss.

Most managers instinctively viewed deep debt of the type described by the young dealmakers from Bear Stearns as a danger that could run a company into total bankruptcy in a downturn. Kravis and Roberts assured executives that Bear Stearns did its homework and would not recommend an LBO for a company without strong qualifications for it. In essence, Kravis and Roberts asked managers to regard themselves as if they were homeowners. After all, people didn't flinch at borrowing up to 90 percent of the purchase price paid for their homes. In fact, the tax code encouraged mortgage debt by allowing people to deduct interest paid on home mortgages from taxable income. Likewise, the government permitted corporations to deduct interest paid on debt from their taxable income. The corporate tax break was intended to encourage companies to invest in new plants, machinery, equipment, and research: the usual uses for borrowed money. Kohlberg and his colleagues saw an additional benefit from this tax break. Highly leveraged companies could deduct the interest payments on their debt, reducing their taxes substantially. Still, the company, like the family with a very big mortgage, would have to change its way of life and make some hard sacrifices in order to find the cash every month to make its payment.

Not all of Bear Stearns' LBOs succeeded. In 1971, Kohlberg and his colleagues orchestrated the approximately $20-million buyout of Cobblers Inc. Unfortunately, the shoe manufacturer was not strong enough to withstand the pressure of doing business in the shadow of a high debt load. Soon after the deal, the company's president committed suicide, and Cobblers went bust. When such a leveraged company went bankrupt, the equity investors lost their entire investment, and creditors lined up to retrieve what they could.

Undaunted by the Cobblers debacle, Kohlberg's section at Bear Stearns continued to develop its specialty in reorganizing the financial structure, and so the power structure, of small or midsized companies. They had to hustle, ever on the lookout for LBO candidates and sources of capital.

The leveraged buyout required two different types of financing. The first was the loan, or loans, that made up the bulk of the purchase price. The trio of budding LBO artists found that insurance companies were looking for the high returns featured in an LBO, and made contacts at John Hancock, Met Life, and Prudential, among others. The second type of financing necessary in the LBO was the cash up-front or downpayment. Those who supplied it became not creditors, but owners. These equity participants typically included Bear Stearns itself, private and institutional investors, and the management of the targeted company. Increasingly, the men saw opportunity in pursuing pieces of conglomerates. In 1972 Kohlberg financed a deal—$4.4 million in Bear Stearns' cash and $33.5 million in debt—to acquire Vapor Corp., a division of Singer Co. that made valves, pumps, and components for mass transit sySterns. The managers of the division felt that they could make more progress with Vapor if it were independent of the big company, and so they became partners with Bear Stearns and bought their freedom from Singer.

The deals offered the lure of extraordinary returns, but the equity positions came with considerable suspense. "You have to think at least six to seven times your money over a five-to-ten-year period, because the good ones have to make up for the bad ones," Kohlberg said. Investors in the Vapor deal didn't cash out fully until 1978, when Brunswick Corp. paid $33 a share for the company. Since the original investors had paid just $2.80 per share, the return was 1,178 percent!

Patience was necessary, because management needed time to improve the companies' operations. So long as the company performed well, KKR was content to watch from the sidelines. "We're not operating people. We offer management an opportunity to buy in at the same price as everyone else, and that includes us and the institutions. … This way we're all on the same side of the table, and we're all working towards the same things," Kohlberg said.

Kohlberg, Kravis, and Roberts Strike Out on Their Own

By the mid-seventies, Kohlberg and his team could see that the leveraged buyout really worked, in the short and long term. Despite the success of their deals, though, conflicts arose between Kohlberg and his colleagues at Bear Stearns. Kohlberg wanted to set up an internal unit to focus exclusively on leveraged buyouts. But the firm, suffering along with much of the securities industry in the tough years of the mid-1970s, was reluctant to fund and compensate buyout specialists. Kohlberg decided to leave, and he took Kravis and Roberts with him. *Forbes* noted: "As the business boomed, the three asked themselves a logical question: Who needs Bear Stearns?"

In 1976, they formed Kohlberg Kravis Roberts & Co. Kohlberg contributed $100,000 and the others put in $10,000 each. The total was not used to fund any deals, it was spent largely on travel for Kravis and Roberts, so that they could track down deals. This $120,000 would prove the basis of billions of dollars in acquisitions over the next twenty years.

From makeshift, modest offices on Fifth Avenue, Kohlberg Kravis Roberts sought to work closely with the management of candidate companies, never forcing deals on them. In the ways by which it would make money in each deal, the new firm was both an investment bank and a merchant bank. As an investment bank, it received a fee from the company that it advised. But then, KKR also advised the investor group that purchased the company; for that, it received 20 percent of any profits accrued on behalf of the group and a management fee of 1 percent to 1½ percent on the cash invested. Finally, as a merchant bank, KKR also made a cash investment and took shares of the companies it acquired through a buyout. "We had no idea whether it was going to work or not," Kravis later told a magazine.

During their first year, many companies heard the KKR pitch, but very few considered the LBO a prudent idea. The partners continued to analyze prospects. At first, they looked almost exclusively at small conglomerates or manufacturing companies in unregulated industries, with stable cash flows and low debt-loads. Though buyouts were fundamentally bold, they had to be structured conservatively. As Kohlberg told *Forbes* in 1978, "We look at a company and ask ourselves in our financing, 'What happens if the earnings go flat; or if they drop back to where they were three years before we bought the company? Is the financing substantial enough to hold the company over a bad period?' If not, then the financing is wrong."

The primary measure of an attractive company became cash flow, or the amount of money the business generated above and beyond its operating expenses, since this would dictate the amount of debt the firm could realistically service.

KKR found its first deal in California, through connections made there by George Roberts. The company was A.J. Industries, a conglomerate that hovered on the edge of the defense and aeronautical industries, making metal fuel tanks and brake drums. Noting that its stock had fallen sharply in recent years, KKR approached the company's board and offered to acquire the firm for $5 a share in April 1977, or $26 million, including just $1.7 million in equity. It was a good deal: when the investor group cashed out eight years later, its capital had increased at a rate of 58 percent per year.

LBOs required intensive due diligence, foresight and patience. "When you go into a deal there's a lot of time and monitoring, a lot of work, creativity, and heartbreak," Kohlberg said. The KKR partners spent long hours courting executives, going over financial tables, and developing a network of support: friends in the right places. Kravis and Roberts would often do the preliminary legwork, while Kohlberg would preside as a sort of cool-headed elder statesman when discussions entered a more serious stage.

The funds that fueled the equity positions in early deals came largely from individual investors, and were raised as needed. By 1978, with three successful buyouts to point to, KKR raised a fund organized as a limited partnership, in which KKR was the general partner and made the investment decisions. The 1978 fund totaled $30 million.

In the same year, the partners identified a Florida conglomerate called Houdaille Industries as a potential acquisition target. It was very big fish for KKR to go after: one of the nation's five hundred largest companies and a New York Stock Exchange-listed firm, They contacted the chief executive officer, Gerald Saltarelli, a very conservative businessman who was reluctant to consider a buyout that would place so much debt on his company.

Houdaille was a perfect example of a company that was worth more apart than together. Working with senior managers at Houdaille, KKR responded to Saltarelli's conservatism by planning a way to pay the buyout debt quickly, just by divesting subsidiaries. On that basis, KKR's investor group, which included the senior managers, was able to make an attractive offer to the board of directors, and the parties agreed on a price of $355 million. "When we announced the transaction was going to be done, no one on Wall Street believed we could get the financing put together," Kravis said in 1983.

KKR raised $48.1 million in equity and $306.5 million in debt, much of it in the form of loans from Continental Illinois Bank and insurance companies like Prudential and Teachers. In exchange, KKR and its investment group received 25 percent of Houdaille's total common shares for $46 million, while management and Houdaille employees received 8 percent of them, worth $2.1 million. The size of the deal and its friendly acceptance on all sides attracted attention; KKR would never again be an obscure "boutique" firm. The Houdaille deal showed that Kohlberg's strategy could work on a large scale; even better for KKR, the truly stratospheric deals still lay ahead.

KKR Enlists Public Pension Plans to Raise Larger LBO Funds

KKR needed a larger pool of capital, because the initial practice of raising funds from individuals was no longer adequate. The Houdaille deal, for example, required fifteen times more equity than KKR needed for A. J. Industries. Repositories of cash such as insurance companies had strict requirements on investment, which hindered KKR's growth. Fortunately, the partners found a new set of allies. In San Francisco, George Roberts had made the acquaintance of Roger Meier, chairman of the Oregon Investment Council, which supervised the Oregon Public Employees Retirement SyStern (OPERS). OPERS, like other public pension funds, managed the money the state government had set aside for the retirement pensions of its employees. Though managed conservatively, public pension funds had been allowed to invest more and more of their funds in somewhat riskier stocks than previously.

KKR first tapped into this large pool of capital in 1981. Jerry Kohlberg, who had clerked for a judge in Portland, Oregon, learned about Fred Meyer, a chain of 120 grocery stores based in Portland. With the death of the founder, the company had lost its identity and its ownership was falling into disarray, making it ripe for a hostile takeover. Instead, Kohlberg himself led KKR's effort to buy it out.

The shares traded at $18.50, but KKR agreed to a $55 a share price, or $420 million. Of the purchase price of $420 million, OPERS came up with $178 million in a loan to the company. KKR's solid management appealed to pension-fund managers, who were more than willing to be silent partners in an investment group. After this deal, pension managers from Montana, Wisconsin, Washington, and other states also entrusted small portions of their employees' nest eggs to KKR. "The big state funds, that's really where the money in this country is," George Roberts said. "And it's certainly where the money in this country in the future is going to be."

Pension managers were lured not only by the professional charm of Kohlberg, Kravis, and Roberts, but by the promise of substantial returns. By 1983, KKR claimed an average annual return of 62.7 percent on its investments. In comparison, stock market investments at the time averaged about a 9 percent return per year, and safe government bonds returned about 12 percent. In 1982, with eager state pension funds standing in line, KKR raised a $316-million fund, some ten times the size of the 1978 fund.

By the early eighties, KKR had almost single-handedly turned the leveraged buyout from a small-time operation into a potent industry. Others sought to imitate KKR's approach—and its success. The number of leveraged buyouts rose from 75, worth $1.3 billion, in 1979 to 175, worth $16.6 billion, in 1983. The acknowledged master in the field, however, was KKR. In 1984 it completed its first $1 billion deal: the purchase of Wometco Enterprises, a broadcasting and cable company.

While the amounts of money involved grew rapidly, KKR itself grew more slowly. The firm moved its offices to a prestigious address, 9 West Fifty-Seventh Street, a graceful office building just off Fifth Avenue, around the corner from Tiffany & Co. The firm presented itself well: the offices occupied a lavishly appointed suite on a high floor with a stunning view of Central Park, and the walls were decorated with original art. Kohlberg Kravis Roberts signed a small number of partners, but, remarkably, it did not require a large staff. In the KKR formula, operating decisions were best left with the managers of the respective companies.

Those managers had meaningful incentives to do a good job for the partnership. In a typical deal, top executives would invest money with KKR's investor group and receive a substantial equity stake. LBOs represented a rare opportunity for a senior executive. CEOs at major public companies might own sizable blocks of stock, but did not generally have a controlling interest. The prevailing mentality on the issue of ownership and governance Sternmed in part from the differentiation between ownership and management first pioneered by John D. Rockefeller, and the democratization of stockholding, championed by Charles Merrill. Under the KKR syStern, the high-ranking executive tied his or her own financial future to the success of the company by paying off debt and increasing shareholder value. The KKR buyout also represented a reconstruction of a company's ownership and governance, such that a senior executive was part of the group that actually owned the controlling interest in the company. KKR made the person occupying the executive suite his or her own landlord, responsible for making the debt payments on the mortgage and making sure the property remained valuable.

Since the investor group's equity stake stood to be wiped out entirely if the company went bust, KKR acted quickly when their highly leveraged companies faltered. In 1981, KKR used an LBO to spin LilyTulip Inc., a paper-cup maker, out of Owens-Illinois. When the existing management fared poorly through 1983, KKR pushed out the management and brought in Albert Dunlap, a former executive at Manville Corp. An expert at corporate turnarounds, Dunlap moved quickly to sell off the firm's real estate assets, slashed costs across the board, and boosted operating profit by 91 percent in 1983 and 31 percent in 1984.

Junk Bonds Allow for Larger and Faster Deals

As the number and magnitude of LBOs escalated, a new financial instrument arrived on the financial scene—"junk bonds." These were low-rated or unrated bonds that offered high interest rates to entice investors. The leading underwriter of junk bonds was Drexel Burnham Lambert Inc. Their champion and mastermind was a Drexel executive, Michael Milken.

In the late seventies, when the equity markets were low, Milken showed companies how to issue debt in the public markets via junk bonds. He created an entirely new industry, as issuance of junk bonds rose from $5 billion in 1981 to $40 billion in 1986. Milken's reputation was made in 1984, when he was able to raise, almost overnight, $1.5 billion for T. Boone Pickens' attempt at a hostile takeover of Gulf.

As a means of raising enormous quantities of cash through debt, junk bonds were tailor-made for buyouts. The high interest payment could be written off against taxes, and selling them in large chunks let dealmakers operate without relying totally on banks. By the mid-eighties, KKR was targeting enormous corporations; it needed to tap that reservoir of cash for which Michael Milken seemed to control the faucet. By issuing junk bonds, in addition to borrowing from banks, KKR could do bigger deals. "Lots of firms can do smaller deals, but over $1 billion, we don't have any competition," George Roberts said in 1985, as more and more takeover specialists were entering the field.

Targeting KKR's market, major investment banks like First Boston, Prudential Bache, Merrill Lynch, Morgan Stanley, and American Express' Shearson Lehman Brothers formed leveraged buyout units. The rules of the game began to change. Financiers, sighting a target, launched hostile takeover bids. Rather than include management as a partner in the LBO, as KKR had generally done, buyers in hostile takeovers dislodged the existing management. Sometimes boards and managers interested in keeping their jobs would ask KKR to step into the negotiations as a "white knight," to forge a deal that would keep existing management in place.

KKR's acquisition of Safeway in August 1986 embodied many of the emerging principles in the LBO arena. The grocery chain had been assembled by Charles Merrill in the 1920s and 1930s and now was run by his grandson, Peter Magowan, who owned a small sliver of stock and ran the business rather loosely. KKR became involved after an investor group, the Haft family, started acquiring shares in preparation for a takeover bid. In conjunction with Safeway's management, KKR assembled a $4.2 billion bid that included about $2 billion in junk bonds and $130 million in equity. Afterward, Magowan began behaving like an entirely different CEO. With the aid of a consultant brought in by KKR, he reduced drastically the staff at the corporate headquarters. When Safeway realized that a small percentage of the outlets were accounting for large chunk of the profits, it began to sell off the less profitable units. These divestitures raised $2.4 billion, and enabled the company to pay off debt rapidly. Safeway's value had appreciated eightfold by the time it went public in April 1990.

Competition for Deals Leads to a Near Disaster

By 1987, according to Bryan Burrough and John Helyar, the authors of *Barbarians at the Gate,* "If it were ranked as an industrial company, the businesses Kohlberg Kravis controlled, from Duracell batteries to Safeway supermarkets, would place it among the top ten U.S. corporations."

In the mid-eighties, the firm went through a major change. Jerry Kohlberg fell ill and, after a major operation, needed over a year to recuperate. On his return, he was dismayed to see the way that KKR was quietly abandoning the precepts on which it had been founded. For example, the firm's April, 1986 buyout of Beatrice Co. was not a friendly partnership with management; it was a forced takeover. In 1987, Kohlberg left the firm, with $300 million and options to participate in future investment groups. He later started another acquisitions firm.

As the 1980s wore on, more and more buyout funds entered the field. And the increased competition artificially boosted the cost of doing deals. "As prices rose and people became increasingly eager to do deals, standards were lowered steadily," Forbes noted in 1989. LBO activity rose from $1.3 billion in 1979 to $77 billion in 1988. "Today, the money is out looking for the deals, rather than the other way around," *Forbes* reported in late 1988.

This competition and escalation almost resulted in KKR's undoing. RJR Nabisco, the massive tobacco and consumer products company, with brands ranging from Camel cigarettes to Oreo cookies, was put into play in 1988, when the flamboyant CEO F. Ross Johnson started an LBO bid at $75 per share. KKR scrambled to join the bidding with a $90 per share offer. The RJR Nabisco deal assumed almost epic proportions, as a host of would-be deal-makers, including management, other veteran buyout firms, and Wall Street companies seeking to make a name for themselves, entered the fray, pushing the price to higher and higher. KKR ultimately won, offering a staggering $109 a share for a company that had been trading at a mere $60 only months before.

The $30 billion deal was the largest LBO ever done. The financing included more than $12 billion debt in bank and short-term debt and $11 billion in junk bonds, and an amazing $1.5 billion in equity—more equity than in any of KKR's previous deals. KKR received nearly $75 million in fees for its participation in the deal. To many observers, however, the RJR Nabisco deal represented speculative hysteria.

In 1989 the junk-bond market crashed, which encouraged the flow of money into other bonds or equities, and led to a series of defaults on major junk-bond issues. In 1989, Milken pleaded guilty to six felony

The Junk Dealer

Michael Milken became intrigued with the hidden strength of the so-called "junk-bond" when he was a graduate student at the Wharton School of the University of Pennsylvania in the late sixties. His MBA thesis argued that debt should be managed within a corporation not merely as a source of capital, but as a hedge against current market conditions. At the right time in a market, junk bonds outperformed higher rated securities, even though they defaulted more often, on average. After graduation, Milken aggressively put his theory into practice. As *Forbes* put it in 1992, "With penetrating insights, 15-hour workdays, and almost unbelievable powers of concentration, he built a medium-size brokerage firm—which became Drexel Burnham Lambert—into the terror of Wall Street."

He did this by developing a market for a high-yield, low-rated bonds. Others called them junk, but not Milken. "It grates me to call them that," he told Forbes. "They are a debt instrument that trades more on the underlying credit risk of the company or the industry than on movements in the interest rates. They have the legal characteristics of debt, but if things go bad, you're generally the first creditor to take on the rights of an equity owner." He was so successful at finding customers, that he then turned his attention to finding more bonds to sell, underwriting junk bond issues for large companies and small ones. Encroaching on the role of banks as sources of debt-financing, junk bonds became the instrument most associated with LBOs and more notoriously, with hostile take-overs.

When Milken started work in 1970, junk-bonds were a $6 billion market; by the time he left, after pleading guilty to violations of the securities laws, in 1989, they were a $210 billion market, and they had effectively restructured American finance. But according to Milken's own theory, junk-bonds made for good investments only some of the time, under certain prevailing conditions—not all of the time. In the late 1980s he advised his clients to substitute equity for debt but few paid attention.

The junk-bond market continued to overheat and was oversubscribed until 1988, when it was rocked by a handful of unsupported defaults. At the same time, Drexers credibility was breeched both by its failure to rescue a defaulting issue it had underwritten, and by charges filed by the Securities Exchange Commission. Other branches of government also closed in on the junk-bond trade. Prosecutors won convictions or guilty pleas in cases against Milken and other traders. And finally, Congress stepped in too. Many representatives had nervously disapproved of the take-over mania, financed in large part by junk-bonds, that swept through corporate America in the late eighties. In 1989, Congress passed the Financial Institutions Reform Recovery and Enforcement Act (FIRREA), forcing savings banks to divest themselves of all but a fraction of their junk-bond holdings. With that, the market collapsed. Savings & Loan institutions took the brunt, and many of them folded.

Junk-bonds didn't go away in the aftermath of the fall. They rebounded eventually and have remained both a viable investment and a respectable form of financing. As Milken said, speaking of his start in the field in the early seventies, investing in the debt of American business was the best investment, not the worst."

counts for violations of securities law. He had made in excess of $100 million per year from 1984 to 1986, and in 1987 he'd earned $700 million, dealing in "junk." Drexel Burnham Lambert went bankrupt in February 1990.

KKR was nursing RJR Nabisco, and its monumental debt, through crises within the company and without. Profits for the cigarette business were handcuffed by a tobacco price war. Meanwhile, the bubble that burst in the junk-bond market made RJR bondholders fearful of default. True to form, KKR and its investor group had at least as much to lose as anyone else, and stood to get wiped out in the case of a Chapter 11 filing on a buyout the size of RJR. In order to stave off any such default on RJR Nabisco's bonds, KKR and its investment partners ultimately agreed to inject an additional $1.7 billion in new cash into the company—even more than it had initially invested. In 1991, it brought the company public, selling shares on the New York Stock Exchange, in order to reduce its debt.

Adjusting to the New Economic Realities of the 1990s

Between 1980 and 1989, attitudes in American business across the board had been changed by 2,385 leveraged buyouts worth a total of $245 billion. Kohlberg Kravis Roberts had chalked up twenty-eight LBO transactions worth over $63 billion. These deals helped revolutionize corporate finance, create new incentives for efficient management, and inspire risk-taking on a grand scale.

However, the RJR Nabisco deal with all its fiscal excess marked the end of an excessive era, for KKR at least. The company, which had started in the seventies in partnerships with the management of the companies it bought out, became more independent and more aggressive when opportunities thinned in the eighties. In the early nineties, it was more active as a stockseller, bringing its companies public, than as a buyout specialist. Even so, the climate was changing. "The problem is, there aren't that many good opportunities out there," George Roberts said in 1990.

Having seen what KKR did through the power of debt, corporate managers began to rethink financial structure, in both its offensive and defensive aspects. Financial officers began to leverage their companies before they were taken over. They increased debt loads to raise capital and tap off the cash flow that made a company attractive to a raider. Executive officers at conglomerates reevaluated themselves and their separate divisions, acting to carve out the fat before an unwelcome raider could come in and do the same thing. The financial world had internalized much of KKR's message, that well-managed debt, however large, did not compromise ownership.