CEO SPOTLIGHT

Henry Kravis and George Roberts: All in the Family

The first cousins built KKR, one of the world's biggest private-equity firms.

By DYAN MACHAN
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Henry Kravis and George Roberts hit the highway in 1965, driving from Tulsa, Okla., to New York to work as summer interns on Wall Street—Kravis at Goldman Sachs and Roberts at Bear Stearns. As the hours passed and the miles flew by, the cousins' conversation ranged widely. In addition to the usual topics—cars, sports, and girls—they traded notes about price/earnings ratios and dividend yields. More than a decade before forming Kohlberg Kravis Roberts, their now-legendary private-equity firm, Kravis and Roberts already were looking for an edge.

Almost everything on Wall Street has changed since that summer—everything except their edge. KKR (ticker: KKR), the company they founded in 1976 with Bear Stearns colleague Jerome Kohlberg, now has 21 offices in 15 countries and manages $102 billion. It has generated private-equity returns of 19% to 20% a year, annualized, over its 38-year history, compared with an annualized gain of 12% in the Standard & Poor's 500. Kravis and Roberts, both 70, serve as co-chairmen and co-chief executives. Kohlberg left the firm in 1987.

KKR IS BASED IN Manhattan but has a global reach. In a recent two-week period, it invested in companies in Korea, Brazil, Japan, France, and Germany. Its biggest competitive edge, say Kravis and Roberts, is its balance sheet, whose book value increased to $10 billion in the first quarter with the acquisition of KKR Financial, its finance subsidiary. A bigger capital base, they expect, will facilitate growth and lead to higher distributable earnings.

KKR currently has 93 companies in its private-

Over 38 years, Kravis and Roberts, first cousins, have generated private-equity returns far exceeding the performance of the S&P 500. *Gary Spector for Barron's*

equity portfolio, representing a broad range of industries. Even so, private equity has become a smaller part of its business through the years, accounting for just over half of last year's $3.4 billion of revenue. Its public-markets unit offers investments in leveraged loans and other credit, equity, and hedge fund strategies, while the capital-markets division arranges debt and equity financing for transactions, underwrites securities offerings, and provides advice.

KKR HAS INVESTED IN hundredsof successful private-equity deals, including the purchase of First Data, Dollar General, Duracell International, Safeway, and Oriental Brewery. Private-equity investors typically realize returns by selling portfolio companies in whole or part to other companies, other private-equity firms, or the public market.

Ironically, the firm might be best known for one of its biggest disappointments—the $25 billion leveraged buyout of RJR Nabisco in 1988, which saddled an ailing tobacco company with enormous debt. RJR eventually was dismantled, and KKR investors lost almost $1 billion on the deal.

More recently, KKR took a hit to its reputation and wallet when Energy Future Holdings, which it helped take private in 2007 for a record $48 billion, filed for bankruptcy protection. An operator of coal-fired power plants, the company, formerly known as Texas Utilities, was hurt as natural-gas prices plummeted. KKR, Goldman Sachs, and TPG, another private-equity firm, will lose their $8 billion investment.

"Believe me, George and I have thought a lot about what we could have done differently," Kravis says of the fiasco. "We just misread the macro view."

With increased competition from buyers, higher prices, and a greater flow of information, the private-equity business in general has grown tougher in recent years. Buyers today are paying an average of 1.8 times revenue, up from 1.5 times in 2012, according to S&P Capital IQ. As an asset class, private equity underperformed the public markets over one year, matched it over three years, and outperformed by 10 percentage points in the past decade, notes Preqin, a research firm.

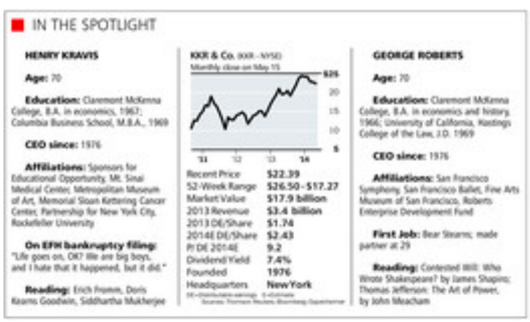
KKR's founders blame lower returns, in part, on excess liquidity created by the world's central bankers. "The world is awash in cash," says Kravis. "The money has to go somewhere, and it is looking for yield. More money flowing to certain places drives returns down."

Still, the pair do see opportunities, particularly in health care, technology, retailing, and energy. KKR also raised money recently for funds focused on oil and gas, real estate, distressed debt, and direct lending, the last aimed at filling a gap created by the lending constrictions of troubled European banks. "There is always opportunity somewhere in the world if you are creative, flexible, and smart enough," Roberts says.

Yet, if he were starting an investment firm today, Roberts says he would focus on smaller real-estate deals, not private equity. The big banks don't bother with small deals, and smaller developers are shut out of the market. "In certain areas there are shortages of capital," he says. "That's why direct lending has become attractive."

BOTH PARTNERS THINK THE stock market is just about fairly valued. Investors could see a 7% return on average in the years ahead, they say, with 2% to 3% coming from dividends. Roberts maintains that sluggish economic growth in the U.S. is tied to the policy logjam in Washington. He argues the government needs an industrial policy—not one that picks winners and losers, but one that sets a framework for long-term growth and allows businesses to create jobs.

The right policy, he says, would support areas in which the U.S. has a superior competitive advantage, such as energy. To that end, Washington ought to fast-track permits for drilling on government land to open vast energy reserves in the continental U.S., and promote the export of liquefied natural gas. "We would need pipelines, railroads, terminals, and engineers," which would create well-paying jobs, he says.



Kravis' recipe for faster growth calls for "an entire redo of a tax code that isn't efficient anymore." That gets into tricky territory, however, given growing calls to tax hedge-fund and private-equity partners' profit as compensation, not return on investment. The former is taxed at ordinary rates; the latter, at the preferential 20% capital-gains rate.

Kravis argues that focusing solely on partnership profit, or carried interest, misses the larger point—that the current tax system retards American competitiveness in the world. Moreover, the government tends to make poor use of the people's money. "If anyone could prove that raising taxes is efficient—and it has never been proved—and that the money would be well spent, I'm all for it," he says.

KRAVIS AND ROBERTS ARE first cousins; Kravis' mother and Roberts' father were siblings. Both learned the energy business from their fathers. Roberts' father was an oil broker in Houston who took his son to business meetings; Kravis' father was a petroleum engineer in Tulsa. The Kravis and Roberts families spent summers and holidays together, and the future lions of Wall Street swear they haven't had an argument since they were 8 years old. The last one involved who would get to ride Kravis' new bicycle first.

Kravis left home for Eaglebrook, a pre-prep school in Deerfield, Mass., and then attended

Loomis-Chaffee, a boarding school in Connecticut. At Eaglebrook he befriended Michael Douglas, the future actor, who recalls a well-dressed 14-year-old with "gracious manners that belied a tough-as-steel interior," which revealed itself on the football field.

"I was in awe of his courage," says Douglas. "One of the reasons we got along well is that we came to enjoy each other's successes."

Roberts also attended boarding school, at the Culver Military Academy in Culver, Ind., where he endured a grim, regimented existence. During his first year he was forced to shovel snow at 4 a.m. But the discipline instilled at military school later served him well. "He was feisty and focused, with his eye on the future," says Bernard Armbruster, a former Culver classmate.

Roberts says the "sink-or-swim environment" bolstered his confidence, and he swam hard, excelling academically and in sports.

The cousins attended Claremont McKenna College, near Los Angeles. Kravis then went to business school, while Roberts studied law. Both men gravitated to Bear Stearns, where they were mentored by Kohlberg, 20 years their senior. The trio didn't invent leveraged buyouts, but perfected the takeover strategy at Bear Stearns, to the consternation of the firm's then managing partner, Salim "Cy" Lewis. After failing to persuade Lewis of the merits of buying companies with unsecured debt and exploiting the advantages of leverage, the three parted ways with Bear Stearns.

In his heavily guarded, contemporary-art-filled office in midtown Manhattan, Kravis displays a small, framed photo of New York's Joe & Rose steakhouse, taken in 1976. Over dinner at Joe & Rose, Kohlberg, Kravis, and Roberts, having failed to find institutional backers for their new endeavor, decided to tap eight family members and friends for a total of $400,000 (equivalent to $1.6 million in today's dollars). Help of another sort came a few years later, when Michael Milken, a banker at Drexel Burnham Lambert, demonstrated the benefits of raising debt quickly in the public market via the issuance of high-yield, or junk, bonds. Junk bonds shortly became the jet fuel of the 1980s' LBO boom, in which KKR was an active participant.

KKR FIRST FILED TO GO public in 2007 but shelved its offering as turmoil swept the markets. It finally listed shares on the New York Stock Exchange in 2010, after engineering a reverse takeover of a listed affiliate. The deal gave the company a greater ability to raise capital in the public market. It also enabled the partners to spread the wealth to all employees, including administrative assistants. Having come out of Bear Stearns' cutthroat "you eat what you kill" environment, they were seeking a different model. "Henry and I have tried to build KKR so that it will last," Roberts says.

Kravis and Roberts did not sell any shares. They each own 12.5% of the company.

KKR was trading late last week at $22.39, just past the midpoint of its 52-week range of $26 to $17. Like the shares of other alternative-asset managers, including Blackstone Group (BX), Apollo Global Management (APO), and Carlyle Group (CG), the stock has fallen amid concern that recent volatility in the market could hamper exit strategies such as initial public offerings for portfolio companies.

KKR and its peers typically are valued on a multiple of pretax distributable earnings rather than economic net income, partly because market moves can skew each quarter's results. The stock trades for nine times this year's expected distributable earnings, compared with a peer range of 11 to 13 times, according to Michael Kim, an analyst at Sandler O'Neill. He considers KKR undervalued, especially given its newly muscular balance sheet.

Kravis, noting the recent increase in corporate mergers and acquisitions, as well as a pickup in deals done between private-equity firms, sees a bright future for the business. "We're back to a pretty active corporate M&A market," he says.

BOTH KRAVIS AND ROBERTS have applied their business acumen and deep pockets to an array of charitable interests. During KKR's annual meeting last winter in California, employees were expected to spend a day in Los Angeles working with Roberts' foundation, the Roberts Enterprise Development Fund, known by the acronym REDF. It seeks to give people with major personal challenges, including parolees and addicts, the chance to work in start-up businesses it has created. The foundation has helped 8,700 people get jobs.

Kravis disdains the concept of giving back, saying, "I didn't take anything from society." He calls it simply giving, and says he learned about generosity from his father, who helped others even when he didn't have much money of his own. Kravis will soon announce a major gift in the health-care field that he is excited about.

Likewise, he's proud of chairing a recent event for one of his newest causes, Sponsors for Educational Opportunity. He calls the 51-year-old organization, which gives low-income students extra education on Saturdays and during summers, and supports them in college, New York's "best-kept secret." It won't be for long, as Kravis aims to double the number of participants to 250.

Kravis also has given lavishly to programs seeking to end drug abuse and support military veterans. He is a major benefactor of the arts and New York City, having learned years ago from the philanthropist David Rockefeller that while it is easy to write a check, true giving also means donating brain power and time.

Kravis doesn't shy away from the current focus on wealth inequality, which French economist Thomas Piketty, author of the best-selling *Capital in the 21st Century,* believes poses a threat to the future of capitalism itself. "There is inequality, maybe a lot of inequality," Kravis says.

But academics, he adds, assume the high-wage class contains a static number of people. "Constantly, people are moving into and out of this 1%," he says. "I believe in bringing everyone up, not bringing everyone down to a lower common denominator."

IN THE LATE 1970s, Kravis was asked to join the board of New York's Mt. Sinai Hospital, which he considered a tremendous honor. At a breakfast meeting, one of the hospital board members asked Kravis, whose firm had yet to make a profit, to pledge $1 million.

"I choked on my eggs," he recalls. "I didn't have a million dollars."

But he thought about it and asked if he could give the money over five years. Even though the pledge caused him some sleepless nights, he says, "I had enough confidence that George and I were going to figure out how to make some money here."

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