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# Bloomberg Markets

## "Always worry about what you might lose on the downside"

**Henry Kravis** on 40 years of creating—and re-creating—KKR

# *Henry Kravis:*

**The Markets Q&A**

# *“Always worry about what you might lose on the downside”*

By JASON KELLY

**PRIVATE EQUITY HOLDS** trillions of dollars in assets, controls brand-name companies, and invests on behalf of pensions, endowments, and government funds around the world. Back in 1976, it barely existed. That’s when Henry Kravis, his cousin George Roberts, and their boss Jerome Kohlberg Jr. quit Bear Stearns and started their eponymous investment company, KKR, which is celebrating its 40th anniversary. ¶ Kravis and Roberts, co-chief executive officers, have transformed not only how companies are bought and sold, but also how they’re run. They’ve also expanded the firm far beyond leveraged buyouts, diversifying into real estate and hedge funds as well as a few businesses once dominated by big banks. Today, through ownership stakes in more than 100 companies with a combined annual revenue of $200 billion, KKR indirectly employs almost a million people. ¶ In this interview, Kravis, 72, ruminates on becoming a CEO of CEOs, being a steward of other people’s money, his unique partnership with Roberts, and the evolution of the firm. Competition in private equity will only increase, Kravis predicts—as will the appetites and ambitions of his investors and competitors. “There’s money everywhere today,” he says. ►

**JASON KELLY:** Let's start with some numbers. KKR began with $120,000 in 1976. Forty years later, you have more than $120 billion. What's the biggest lesson between all those zeros?

**HENRY KRAVIS:** Jerry Kohlberg, George Roberts, and I started with a specific culture in mind, which is one of the reasons we all left Bear Stearns. Bear was very much an eat-what-you-kill culture, and that's exactly what we didn't want. We were big believers in working together. We wanted everyone to share in everything we did, whether you worked on a deal or not. We got as far away from eat-what-you-kill as we could and went to the idea of what's the right thing for the firm. Get the best out of everybody and the best out of the firm. So we started with that 40 years ago, and today our culture remains identical.

**JK:** What's changed in those 40 years?

**HK:** There's money everywhere today. There's almost no institution in the world—whether it's a sovereign fund, a foundation, an insurance company, banks, pensions funds—that doesn't do something in the private equity sector. Information today is better than ever before. Markets are pretty darn good. There's so much more transparency. Which also means our business has much more competition. I sort of liked it when it was just us.

**JK:** Buy-slash-and-sell is the typical perception of the private equity industry. How do you think of yourselves at KKR?

**HK:** We like to think of ourselves as industrialists. I'm using industrialists in a broad sense. We buy a company and look at what we can do to make it better. How can we improve operations? Maybe it's fixing the pricing or the supply chain, or putting the proper metrics in place so we can better measure what the company is doing. Maybe we have to change some of the company's management. And understand that we are long-term investors for the most part. Our average holding is seven years. To me, there's so much more to investing than buying low and selling high.

**JK:** There was a lot more to invest in and fix 10, 20, 30 years ago. What's been the impact of private equity on the corporate world?

**HK:** The biggest area where we've influenced companies is governance. You don't read much about a company blowing up because it wasn't governed properly. Governance plays such an important role. We hold management accountable. But at the same time, we're a partner with management, and we really want them to understand we're in this together.

**JK:** What's the difference between private equity in the U.S. and elsewhere?

**HK:** I go to China a fair amount. I was on a trip there a couple of years ago, meeting with the head of their CSRC, which is like the SEC. I asked him, "How many private equity companies in China do you have? And he said, "We are well in excess of 500—probably more, but that's not a bad number." I almost fell off my chair.

What they do, so many of them, is they focus on buying stock before an offering and then dumping it once it goes up. So the CSRC asked me to speak to their top 75 people about what you do with a company once you buy it, which was exactly the message they wanted to get out to people in China's private equity industry. They wanted to get away from buy-and-flip because that wasn't helping companies at all. They said, "You are actually helping companies, and that's what we'd like to have in China."

**JK:** So you have 500-plus competitors in China alone, not to mention the U.S. and Europe. What differentiates you from the competition?

**HK:** At KKR, our best asset is our people. George and I have encouraged everyone to think as creatively as they possibly can—not to wait by the phone and think that JPMorgan or Goldman Sachs are going to call them with an idea. Sure, you get that too, but go out and create ideas. Everyone at KKR is paid on how well the firm does. By doing that, we can get you the best solution you need.

No. 2, it's our long-term approach, the fact that we focus on stakeholders. We used to pay more attention to the stockholder: How well did you do on this investment? Today we worry about the environment, the community, the employees—they're all top of the mind. George and I are also cousins, so when we talk to family companies, we can relate to them. They say, "You're like us."

Lastly, we have a very large balance sheet. That gives us an opportunity to invest side-by-side with our investors and put much more of our own capital into any transaction we might do.

**JK:** What's the most surprising thing you're doing as an investor?

**HK:** We did only private equity until 2004. We'd go see a company and by about the third sentence somebody on our team would ask, "Is your company for sale?" And the CEO would say, "We have no interest in selling." And our team wouldn't have much more to say after that.

Today KKR is in three broad buckets: private markets, public markets, and capital markets. Private equity is probably 40 percent of what we do, and the rest is these newer businesses, which are all growing very well.

We didn't start off thinking we would be in the credit business, or real estate, or hedge funds. This is an evolution. We didn't do any of this overnight. It took a long time. In the process we became much more of a solutions-provider that can invest up and down the capital structure as opposed to a pure private equity investor. So we never have a conversation that begins and ends with, "The company's not for sale." Now we start off with, "What do you need today that you're not getting?"

**JK:** Did you miss deals because of that?

**HK:** In 2002, I remember going to see an energy company called Williams, in Oklahoma. I'd grown up with the Williams family in Tulsa, and they were having some financial difficulty and needed to restructure their balance sheet. We said, "Why don't we buy the company, take it private, and as part of that we'll restructure the balance sheet?" They thought about it and decided they didn't want to go private. So we said, "All right, let us provide you with a structure that can fix your balance sheet." They thought about what we gave them and said, "That's a great structure, but we have no money for this." They ended up taking the exact structure we gave them and calling Warren Buffett. After about five minutes, Buffett said, "This is a no-brainer," and he did the deal. We decided right then that KKR needed to get into the credit business.

**JK:** You interact with executives so much. What was your first experience on that front?

**HK:** The summer before graduate school I worked for the Madison Fund. Ed Merkle, who ran it, used to call me Kid. He'd say, "Kid, I want you to go out and see Tri-State Motor Transit." And I'd say, "Who's going with me?" And he said, "No one." It's the first company I'd ever called on, and I'm going to see the CEO. A few weeks later, he said, "Kid, I want you to go out and see Disney." I said, "Who am I going to see?" He said, "Roy Disney." I said, "Who's going with me?" He said, "No one." Well, that scared the heck out of me. Later, working with Jerry and seeing how he treated people and dealt with executives, that certainly gave George and me awfully good training, too.

**JK:** Take me back to 1976. How did the whole KKR experiment begin?

**HK:** We started with $120,000. George and I each put up $10,000—that was all we had—and Jerry put up $100,000, because he was 20 years older. And then we went out to raise our first fund, a $25 million private equity fund. There was no such thing then, but the first people we talked with—mostly insurance companies we'd worked with at Bear—all liked what they heard. But the catch was they wanted to be the investment committee. Well, we'd just done that and had left Bear for a reason: to make our own mistakes and our own right decisions.

**JK:** So no $25 million fund. What did you do?

**HK:** George and I went to Joe and Rose Restaurant—there's a picture of it right over there—and said, "Why don't we go to eight individuals and ask them to put up $50,000 each for 5 years?" That would give us $400,000 a year. Then, if you've given us $50,000, in return you get the ability to come into any of our deals. But if you do invest, we want 20 percent of the profits.

**JK:** How did you come up with 20 percent, which became the industry standard?

**HK:** George's father and my father were in the oil-and-gas business, and in those days there was something called "a third for a quarter." If I had a lease and wanted to drill a well, I would go to the money person and say, "I'll put up 25 percent of the cost, you put up 75 percent, and you're going to get a two-thirds interest and I'm going to get a one-third interest for my 25 percent." We thought 20 is close enough to 25. I'm often asked, "Why didn't you pick 25 percent because that would have stuck and carried interest?" We were just trying to get started, so that was literally what we started from.

**JK:** You've mentioned Jerry Kohlberg a few times. He left the firm in 1987 after 11 years and passed away last year, but he's one of the K's in KKR. What contribution did he make beyond that initial $100,000 investment?

**HK:** Jerry had a big contribution here. Don't forget, he was 20 years older than George and myself. We learned a lot from Jerry. The very first private equity deal—Stern Metals in 1965—that was Jerry. One of the things that worked really well was that he let us run. I've always had that opportunity. My parents also gave me enormous leeway and said, "Go make your own mistakes."

Jerry gave us that leeway and provided a little gray hair, which, at 32, neither George nor I had. Together we all discovered the culture and values we thought were important. Jerry's had a lasting legacy in that regard.

**JK:** You and George have one of the most unique partnerships in business and have been co-CEOs of KKR for the past three decades. Why has it worked so well?

**HK:** I think it starts with our DNA. We're first cousins and have known each other since age 2. We grew up together, went to college together, roomed together in New York during the summers.

When you share common values and common goals, you can go a long way. I only want the best for George, and he only wants the best for me. I love him. Next to my wife and my children, he's the closest person in my life.

But if we talk about things, we're not going to agree on everything. And that's good. I can finish George's sentences, and he can finish mine. I know what is going to be an issue for him, and we talk about it.

**JK:** What are those conversations like?

**HK:** The last major disagreement we had was when we were 7. He wanted to ride my new bike. Obviously I wanted to ride it first. I was getting chased around the house for not being gracious, ran into a corner, cracked my head open, and needed 26 stitches. So I made a decision that there's no point to argue with him.

**JK:** What was your toughest moment together?

## "There's so much more to investing than buying low and selling high"

**HK:** Somewhere in the 1990s the firm was struggling a little bit. Our returns were suffering. George and I sat down in this room and said, "We're making mistakes." It wasn't other people making mistakes. You're running a firm, your name is on the door, the responsibility is yours. That's when we set up a new investment-committee approach. We set up 100-day plans for new companies we buy. We go through every division, look at personnel, and put metrics in place.

But it was George and I looking at each other. It wasn't, "You made that mistake" or "I made that mistake." We made that mistake together, so let's figure out what we're going to do. Everything we've ever done has been split right down the middle. It always has been, and it always will be.

**JK:** Looking to the future, how do you replicate the relationship you and George have here?

**HK:** I don't think you do. We don't have anybody here who's known each other since age 2. I remember getting into an interesting discussion with a professor from Yale who said, "There's no co-CEOs who ever work."

**JK:** Right, that's true!

**HK:** Well, that's not true. Goldman Sachs had them for years—I mean, Weinberg and Whitehead, a famous partnership. And it worked until it didn't, but it did work.

**JK:** But not like this.

**HK:** I'm guessing there are probably some other companies where people started something together and kept going. Who are those guys who have the ice cream? Ben and Jerry? I think they did pretty well.

**JK:** What are you doing to ensure KKR can endure?

**HK:** The one thing we do want is for KKR to outlive us, like a Goldman Sachs. We talk about culture and values—that's our foundation and the reason this firm can last many more years. Will it go on exactly as it has been? Probably not. It'll be different.

**JK:** KKR is such a well-known brand. Is that ever a burden?

**HK:** I don't look at it as a burden, I look at it as a responsibility. Every day I worry about the hundreds of thousands of employees we have at all our various companies. I worry about the millions of pension beneficiaries who are counting on us. I'm also worried about growing. So yeah, I worry about that. And to me, that is the responsibility a brand—a good, strong brand—brings.

One of the things that always sort of surprised me is the kind of brand we've been able to build. George and I, every day, try to get better—we try to make ourselves better and try to make this firm better. You build your reputation a brick at a time. But we're going to make mistakes. Believe me, we've made a lot of mistakes.

**JK:** What's been the biggest mistake?

**HK:** I don't know if there's any one biggest mistake. We've had financial mistakes. We've had companies that didn't work out, such as TXU and Samson, or Regal Cinemas a long time ago. But you learn from those mistakes. You hope you never do them again; shame on us if we do. And we want everyone at KKR to understand what the mistake was. One of the things we do not do at the firm is say, "You made that mistake, you caused us to lose money." Hey, the buck stops with George and me. We could have stopped any investment. We're on the investment committee, we hear all the opportunities. So that's our responsibility. It's also our responsibility to make sure that everyone here understands and lives by the values. Those values are what create the brand.

Also, George and I believe you have to be as transparent as you possibly can with your investors. They've given you money, and you've lost it.

**JK:** When you think about how deals are done today compared with back in the day, how are things different?

**HK:** Well, we used to be able to put up a dollar of equity and borrow $20 or $30 to buy a company. When we bought Safeway in 1986, it was about $5.3 billion, and we put up about $123 million of equity. When we bought RJR Nabisco, originally we put up $1.3 billion of equity against $30 billion of total purchase price. But today, that's all changed. You put up a dollar of equity and borrow a dollar of debt, maybe two, depending on your total earnings. So the capital structures have changed entirely.

**JK:** How does that change you as an investor?

**HK:** When you buy a company, obviously you've got to look at the price you're paying. One thing that's different from the 1970s and the 1980s is that the valuation of companies has changed significantly. So we look at where the industry is going, and we look at the downside.

**JK:** Where did you learn that?

**HK:** When I was in my early 30s at Bear Stearns, I'd have drinks after work with a friend of my father's who was an entrepreneur and owned a bunch of companies. "Never worry about what you might earn on the upside," he'd say. "Always worry about what you might lose on the downside." And it was a great lesson for me, because I was young. All I worried about was trying to get a deal done, for my investors and hopefully for myself. But you know, when you're young, oftentimes you don't worry about something going wrong. I guess as you get older you worry about that, because you've had a lot of things go wrong.

**JK:** That must inform how you talk to companies you're interested in buying.

**HK:** One of the questions I always like to ask a CEO when I'm thinking of us making an investment is, "You're here today, where do you want to be five years from now?" Then I want to know 10 years. And the body language is great. Most of the time they're thinking about what's going to happen next quarter. But we really do think in those long-term increments.

**JK:** Any big ideas you've come across in recent meetings with CEOs?

**HK:** We thrive on innovation. George and I really try to stay on the cutting edge. I love it. I learn a lot from meeting with startups. There's a terrific company in San Francisco called AppDirect, started by Nicolas Desmarais and a partner. They focus on the enterprise area with apps, and it's growing like crazy right now. I'm amazed at the number of entrepreneurs I meet with who are starting these companies. I ask them, "How do you hire? What's your strategy?"

I compare their responses to the dot-com period around 2000. Back then I'd ask, "What's your strategy?" and people would tell me, "Go public." I'd say, "That's not a strategy—that's a way to raise money." "It's all eyeballs," they'd say. "OK, eyeballs," I'd say. "You're looking at your screen: How are you going to turn those eyeballs into money?" And of course all of those people went away. The arrogance during that time was staggering. I can't tell you how many people told George and me, "You don't get it, we're probably going to put you out of business."

**JK:** But this time is different?

**HK:** These are real businesses that are going to be around for a long time. I don't know if the valuations are too high or too low, but the companies will stay, and they will grow. There will be shakeouts yet—you can't have four competitors in the same category that are valued more or less the same, because only one or maybe two are going to survive. But what these companies are doing right now and how they're thinking about disruption is phenomenal.

**JK:** How does that affect your investing decisions?

**HK:** We focus a lot on disrupters: What they're doing, what they could do. When we're making an investment in a nonstartup-type company, we ask ourselves, "Who's going to disrupt this company or industry?" Then, "Let's really think about it, so we don't make the wrong investment."

**JK:** Because you and George are really CEOs of CEOs, you probably have better access to C-suites than anybody else. What insights are you gleaning?

**HK:** Smaller and midsize companies are telling us, "I don't have the banks covering me anymore." The banks today are pulling away from a lot of these companies, because the capital charges are so high. There's not enough margin in it for them. They've let a lot of people go and ceded quite a bit of that business. We got into a lot of these businesses because we saw a need.

**JK:** How much of that was opportunistic in the wake of the credit crisis and the heavier regulation that came for some of the traditional providers?

**HK:** We saw the opportunity to build out this solution-provider approach. Today, because of regulation in the banking industry, many of these banks used to carry inventory and make markets, and that's no longer the case. You had much faster pricing, you had more transparency. A lot of that is gone now.

**JK:** Doesn't that worry you?

**HK:** What worries me is, if there's ever a major run on credit funds—high-yield funds, let's say—who's going to buy this debt? The banks used to be the ones that made the markets and had very big inventories, and they could take it on. Today, if they're even still in the business, they're down to a third of what they were. And that worries me, because I think we have put certain things at risk when we didn't need to. In the U.S., I think regulation may have swung too far now. We needed it, no question about it. But I think there also is a need to step back and ask, "Do we really need everything that Dodd-Frank or the Volcker Rule has created? Are we hurting mainstream corporate America because they can't get credit or capital as easily as they could before?" Sure, if you're a big company, no problem, you can get all the capital you want. But if you're a small or midsize company, it is much more difficult today, because the inventory and capital charges are just so high.

**JK:** Do you think regulators are too heavy-handed?

**HK:** Some regulation is really important. I don't know what the exact right amount of regulation is. Don't forget, until the financial crisis, which certainly was not created by the private equity industry, there was no oversight of us at all. Zero. Today, all of us in the private equity industry, whether you're publicly traded, private, or an alternatives firm, you come under the regulation of the SEC. And that's fine, I think it's made us all better. To be able to say to you this regulation is important and this one's not, I don't want to go down that road. But I do think everyone, in every industry, should have accountability. We have accountability to our shareholders, to the institutions and high-net-worth people who give us money, to our employees, to the communities in which we serve, and to all the employees of the companies we buy. I have no problem with that at all. I just think in certain areas maybe that pendulum has swung too far.

**JK:** You mentioned information earlier. What's a source you're able to use to your advantage?

**HK:** One company I like to look at is First Data, which we own and gives us enormous up-to-date information on the consumer—and this is extremely important because the consumer is about 70 percent of GDP in the U.S. First Data puts out something called SpendTrend reports based on the credit- and debit-card usage during that month. And since we process well over 40 percent of all transactions in the U.S., we get enormous information. Are customers using credit cards, or are they using debit cards? That tells you their state of mind. If they're using debit cards, they're worried about building up debt. If they go back to using credit cards, they're feeling better about themselves. What's the transaction size? That reveals if they're buying necessities or something more.

**JK:** What's something that jumped out at you?

**HK:** Our most recent SpendTrend reports have shown that consumers' largest expenditure, by far, has been on health

## “People who are curious are going to be better investors and better stewards of others’ money”

care. It’s funny, you had a big dividend for the consumer with the advent of lower gasoline prices. You would think they’d go out and spend on things, go shopping at Macy’s or whatever. But they have not spent on things, except on essentials. A lot of people are saying, I want to spend my money on experiences. And we can pick that up. We have a dashboard of all our companies that shows what their revenues are, what they’re earning, whether or not they’re hiring, and we break it out by Asia, Europe, and the U.S.

I don’t know if we picked the right companies, but what they’re showing, interestingly, is mid- to high-single-digit revenue growth and double-digit earnings growth. Part of that is management. They’re really operating the companies much better than when we bought them.

**JK:** What other data points interest you?

**HK:** Our focus used to be much more on the micro, which meant we focused on the company and didn’t look at the macro enough—and that’s something you have to take into account if you want to be a good investor. Certain times we got into trouble and made mistakes; I think there were macro issues that were really out of management’s control. But having said that, shame on us. We should have known that this would happen or would be an issue. We didn’t focus on it enough. And about five years ago we set up a macro asset and allocation group, which has been invaluable and made a huge difference in how we think.

Another thing that’s been phenomenally helpful is ESG [environmental, social, and corporate governance]. We partnered with the Environmental Defense Fund, for example, to see what 26 of our companies could do with $CO_2$ emissions, recycling, water, and waste. And it was a story of doing well by doing good. Not only did we cut down the emissions and were able to recycle and save on waste and water usage, but we also saved an enormous amount of money on cost.

**JK:** So you’re thinking more broadly. What have you been reading lately?

**HK:** It runs the full gamut. I just finished Walter Isaacson’s *Einstein: His Life and Universe*, Charles Murray’s *Coming Apart*, and Greg McKeown’s *Essentialism*. I also recently read *ISIS: The State of Terror* and *The Emperor of All Maladies*. So everything from how you run your life, to what we’re all worried about today, to what’s happening in our communities, where I wish we all had more tolerance than we do.

**JK:** You’re a longtime backer of Republican candidates. What are your thoughts on the political landscape this election year?

**HK:** That leadership matters, OK? But I’m not going to comment on who’s my candidate or go down the road of who would do a better job.

**JK:** So when you think about the future of private equity, what happens next? You’ve witnessed the first 40 years. What does the next 40 look like?

**HK:** Certainly more competitive than the last 40, there’s no question about that. It’s an asset class that almost every institution today says, “We have to be in this because we cannot meet our obligation unless we put more and more capital into this.”

So I imagine there will be many more private equity firms than there are today. It’s very hard to kill a private equity firm. You can kill a hedge fund overnight; people pull their money out as fast as they put it in. You can’t pull your money out of a private equity firm as easily. If a firm is bad, all that can really happen is that it won’t be able to raise another fund. Eventually it’ll go out of business. But that can take years.

There are some firms—I call them the I-I-I firm, meaning it’s all about me—where once that one person retires or passes away, the firm will disappear. But the firms that have really focused on building a long-term, institutional approach to investing will, I think, be here for a long time.

**JK:** If you could talk to Henry and George at Joe and Rose’s 40 years ago, what advice would you give them as they figured out their next move?

**HK:** When you’re 32 years old and starting a company, you don’t know what you don’t know. Young entrepreneurs don’t have any fear. They don’t have any belief that they can fail. So here’s the advice I give young people: Believe in yourself, build an incredibly strong team, and focus on your company’s culture.

Also, if I can take one thing other than integrity and instill that in people, I’d want it to be curiosity. Because to me, people who are curious are going to be better investors and better stewards of others’ money. If there’s no curiosity, you’re basically doing something that’s already been done by someone else.

Kelly is Bloomberg’s New York bureau chief.

***The attached article: Henry Kravis Q&A: 'Worry About What You Might Lose on the Downside',[1] is provided for informational purposes only and should not be construed as investment, tax or legal advice of any kind, nor does it contain a recommendation to buy or sell any specific securities.***

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Private equity investing presents both the opportunity for profit, as well as potential risks of loss. The nature of private equity can result in a lack of transparency due to limited information, and the risk of loss is increased due to speculative strategies employed by private equity investment managers, including investing assets in early-stage venture investments which may not perform as expected. More importantly, interests in private equity funds are typically not listed on any national securities exchanges and are subject to restrictions on transferability, thereby making them generally illiquid. Other risks may include, but are not limited to, overall market risks, and in some cases concentration and diversification risks. Private equity investments may also be leveraged, which can create the potential for greater volatility than exists with investments that do not utilize leverage in its various forms. Private equity investments also may impose higher fees and additional layers of expenses as compared to more traditional investments, such as mutual funds or direct equity or debt investments.

Private equity funds may also invest in companies around the globe, resulting in additional geographical, geopolitical and currency fluctuation risks. Private equity fund managers operate in highly regulated environments across the globe, and they and the funds they manage are subject to the potential adverse effects and increased risks of loss due to changes in business and tax laws and shifting political and regulatory environments in the markets in which they operate.

***Past performance is not indicative of future results and there is no guarantee that any investment will achieve its objective, generate profits, or avoid losses. Private equity involves substantial financial risks and should be considered speculative. An investor should consider the risks, objectives, and expenses before investing in any product or strategy.***

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[1] Bloomberg Markets, June 13, 2016 (by Jason Kelly).