

Reinventing KKR

The big private equity firm has put its days as a one-trick pony behind it by rapidly diversifying into new businesses. It's not alone

By DAVID CAREY and VIPAL MONGA

Art by Murray Kimber

IN 1998 BLACKSTONE GROUP LP'S BRASSY and outspoken co-founder, Stephen Schwarzman, in a *Businessweek* story, branded Kohlberg Kravis Roberts & Co. LP a "one-trick pony." The putdown back then rang true. Blackstone, a decade younger than KKR, had recently pulled even in size with its better-known leveraged buyout industry archrival. Schwarzman pinpointed what set Blackstone apart from KKR and the rest of the private equity herd: diversification. Since it opened in 1985, Blackstone had padded its dossier with a bevy of services and products: M&A advice, fixed-income funds, hedge funds and real estate. KKR, notwithstanding its storied past as a pioneering private equity power, stuck with its stock in trade: LBOs.

Today the doyen of the industry is incubating new investment vehicles with the pluck of a Silicon Valley startup. KKR has spawned more than eight new businesses since 2004, three just in the last year, as it sheds old constraints and embraces a freer, more assertive business style. Though the recent moves resemble those of other marquee private equity players, the change at KKR, led by Henry Kravis and George Roberts, who are 67-year-old first cousins, is happening at warp speed. More than a cosmetic makeover, it's a campaign of reinvention.

Instigating the overhaul is a tectonic shift in private equity's competitive landscape and the rules of the game. Today KKR, once the uncontested lord of the field, whose victory in the \$31 billion takeover battle for RJR Nabisco two decades ago in-



**Kravis (left)
and Roberts**
*new turf, new
conquests*

spired the rip-roaring bestseller “Barbarians at the Gate,” is scrambling to keep up with larger, fleet-footed rivals in the race to become bigger and broader. KKR’s \$5.7 billion in-house war chest gives it an edge over most competitors. But there’s no guarantee KKR’s business model will pan out or that it can stay potent in an era when multidimensionality has become the currency of the industry’s elite.

KKR is hardly alone. In recent years, and especially since the onset of the financial crisis, the biggest buyout firms have beefed up their product menus with hedge fund, credit and real estate offerings. Blackstone, the earliest to diversify, has branched out, notably with a 2008 purchase of debt fund manager GSO Capital Partners LP, whose asset base has swelled to \$31 billion from \$10 billion since Blackstone bought it.

EARLIER THIS YEAR Carlyle Group, another top firm, agreed to make a comparably high-profile purchase of AlpInvest Partners NV, a Dutch fund-of-private-equity-funds manager. When that deal closes, Carlyle will leapfrog Blackstone to become the world’s largest independent alternative investment house, with \$150 billion in managed assets, compared with Blackstone’s \$128.1 billion.

The expansion and diversification drive within the upper tier—most midsized and small players remain pure LBO shops—has transformed leading firms like KKR, Blackstone, Carlyle, Apollo Global Management LLC and TPG Capital into

global investment emporia catering to the expanding tastes of pension funds, college endowments, tech billionaires and oil sheiks for the high-return, high-risk investments known as alternatives, of which private equity is a subset.

Not even a worldwide slump that socked the firms with huge mark-to-market losses has slowed the change. If anything, it turbocharged it.

Indeed, various forces have stoked the push, which mostly has taken the form of internally hatched operations, not acquisitions of existing managers. In the early to mid-2000s, pension funds and other institutions sought new outlets to cycle some of the staggering gains they reaped during the LBO boom. The buyout firms, awash in profits, fresh talent and ideas, were disposed to think outside the box. Ferociously competitive and fearful of falling behind, they seized on one another’s conceptions. In 2004 when Apollo, for instance, was first out the door with a \$930 million publicly traded mezzanine debt vehicle, its rivals quickly readied similar funds. (Only Apollo’s, which soaked up much of the market demand, got off the ground.)

Then in 2007 came the credit crisis, and by 2008 the buyout titans’ investments plunged in value and LBO financing froze up. Even Blackstone, whose troubled-company advisory arm did brisk trade and whose hedge fund unit continued to grow, was battered. Laying bare the firms’ vulnerabilities to the vicissitudes of the LBO market, the havoc led them to amp up their diversification efforts.

A further spur was a run of firms going public. Starting in

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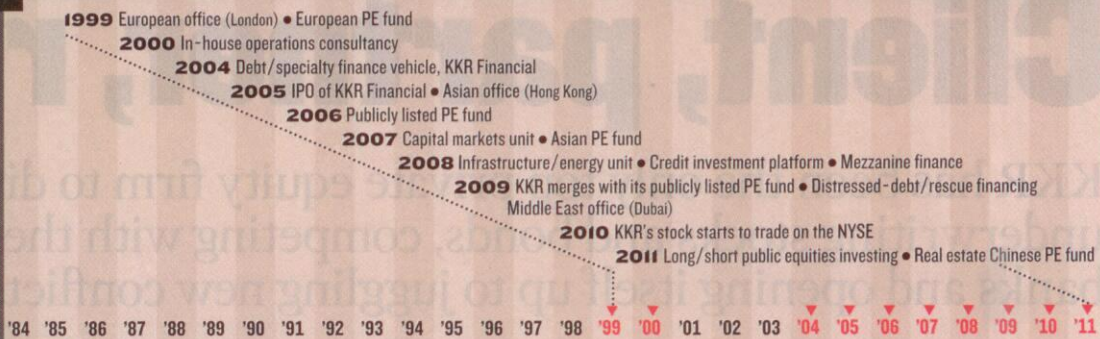
HOW BIG BUYOUT FIRMS DIVERSIFIED

KKR

Founded 1976

Assets under management:

\$61.0B



APOLLO

Founded 1990

Assets under management:

\$67.6B



The Blackstone Group®

Founded 1985

Assets under management:

\$128.1B

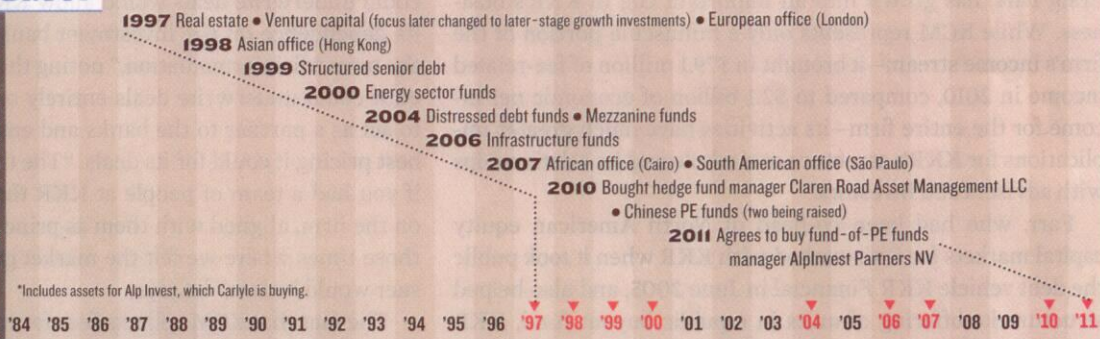


THE CARLYLE GROUP

Founded 1987

Assets under management:

\$150.0B*



*Includes assets for Alp Invest, which Carlyle is buying.

TPG

Founded 1992

Assets under management:

\$48.0B



*Includes assets for AlpInvest, which Carlyle is buying.

Graphic by Steve Hart

2007 with Fortress Investment Group LLC, followed by Blackstone, KKR and, just last month, Apollo, some leading players tapped the public markets in part to bankroll growth. The IPO parade has had a push-pull effect: While the push came from the impulse to build, the fact of being public has intensified the pull to evolve. That's because public-market investors prize diversity and subtract points for relying too heavily on LBOs.

That calculus helps explain the gap between KKR's stock valuation and Blackstone's. KKR, about 70% of whose revenue in 2010 came from its buyout funds, trades at 6.7 times analysts' estimates of after-tax economic net income, a profit yardstick used by private equity firms. Blackstone, just 26% dependent on corporate buyouts, trades at close to 12.

Still, the divide has narrowed as KKR's moves have given it a patina of growth. In the past 18 months, its stock has jumped 89%, compared to just 34% for Blackstone's. "The gap, both in terms of valuation and in terms of moving toward a more diversified portfolio of businesses, is closing," says Sandler O'Neill + Partners LP analyst Michael Kim.

KKR has been playing catch-up with its peers since it first ranged beyond LBOs in 2004. Apollo had made a big splash in distressed debt years earlier. Carlyle back then was involved in real estate, venture capital and structured debt. TPG, a turnaround specialist, had a venture arm and a renewable-energy fund, in addition to being the first U.S. buyout group to plant a flag in Asia. There too was Blackstone, an avatar of diversity. KKR was a glorified buyout shop, pure and simple.

Partner Scott Nuttall says the tipping point came in 2002. Williams Cos., a pipeline operator and Enron-style energy trader that had been talking with KKR about a deal, suddenly had to round up \$900 million to avert bankruptcy. It dangled an offer to KKR to invest that sum in debt at a lofty interest rate, sweetening the offer with warrants.

But betting on debt was off limits to KKR's buyout funds. Williams then reached out to Warren Buffett and

Lehman Brothers Holdings Inc., which scored a nifty profit on the deal. "That was a painful thing" to have to turn down, Nuttall recalls. "We did not have the ability to pivot and take advantage of the opportunity. We said, 'This is nuts! We've got to figure out a way to go to where the opportunity is.'"

In addition to affording greater financing options for the corporate set, KKR wanted to offer a buffet of products to investors in its LBO funds. It has striven to bolster its investor base, which is smaller than Blackstone's and Carlyle's.

KKR'S FIRST DETOUR from LBOs was with the 2004 start-up of KKR Financial Holdings LLC, a corporate debt and specialty finance vehicle that went public in 2005. It's now a part of KKR Asset Management LLC, a \$14.8 billion-in-managed-assets platform KKR formed in 2008 that pumps money into everything from leveraged loans to junk bonds to structured debt.

The Williams incident "is really what led to us starting to build what is now" KKR Asset Management, says Nuttall. "That gives us the ability to go up and down the capital structure."

Since 2007 KKR has started new businesses with great regularity. Besides KKR Asset Management, known as KAM, it has launched a capital markets stock and bond underwriting unit (see story, page 34); an infrastructure and energy investing group (2008); a mezzanine debt business within KAM (2008); and a distressed-debt/special-situations unit, also part of KAM (2009).

This year it began drumming up money for a public-stock investing fund group, led by ex-Goldman, Sachs & Co. trader Bob Howard, whom KKR recruited in October, and started a real estate unit headed by another Goldman alumnus, Ralph Rosenberg. On the private equity side, KKR wrapped up a \$1 billion fund to invest in fast-growing Chinese companies.

The startups have begun to pay off. In 2010 KAM and KKR Capital Markets each brought in 14% of KKR's \$735 million in fee revenue.

KKR boasts a vast cache of in-house assets smaller only than Blackstone's. Most of these arrived on KKR's balance sheet as a result of the unorthodox way KKR went public. After the credit crisis derailed its plan to go public in a conventional fashion, KKR did so by merging in late 2009 with a publicly traded buyout fund it had raised three years earlier. The fund's investors took a 30% stake in KKR, while KKR gobbled up its assets, worth \$3.5 billion at the time. KKR's stash since has grown to \$5.7 billion as the markets have rebounded. Much of that is tied up in stakes in the firm's LBO funds and in recent deals. But as those stakes are unwound, it will unleash rivers of cash that KKR can use to seed new businesses, add muscle to current operations or back new deals.

Though giving KKR loads of firepower, the stockpile isn't an unalloyed blessing, for it magnifies KKR's near-term exposure to LBOs. "If the [buyout] markets are going well and lots of returns are being generated, people are going to love

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it," says a partner at another big private equity firm. "But if the markets are going the other way, it's like double leverage, and it'll work against them from a [stock] valuation standpoint."

Analyst Kim offers a different spin: "It does create a bit of earnings volatility on a quarterly basis, just because they're marking to market these investments every quarter," he says. "But [overall] I think it's a positive for the stock. It's a very significant pool of permanent capital they can continue to leverage to expand and diversify."

It took awhile to kick into high gear, but KKR is quickly changing its ways. Many initiatives have yet to deliver profits and meet the test of time. Still, the old pony is learning heaps of new tricks. ■