LBOs are best known as financial plays. As practiced by Clayton, Dubilier & Rice, they can also promote corporate renewal.

Rehabilitating the Leveraged Buyout

by W. Carl Kester and Timothy A. Luehrman

Once the rage of Western capitalism, leveraged buyouts have lost their glamour and much of their respectability. Suggest an LBO today as a healthy way to create value, and polite company outside of Wall Street will assume you are just trying to stimulate lively conversation. Propose it as a means of improving operating performance by restoring strong, constructive relationships among owners, managers, and other corporate stakeholders, and you may be viewed as a refugee of the 1980s, dined by the decade of greed.

It's easy to see why LBOs have developed such a negative image. Even when they were booming, critics complained about "paper entrepreneurs." And when the boom faded, a wave of bankruptcies ensued. Since 1987, scores of companies that had been acquired in highly leveraged transactions and that managed more than $65 billion in assets have filed for bankruptcy. The spectacular fall of Drexel

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Burnham Lambert and junk-bond pioneer Michael Milken added to the perception that the LBO wave had been whipped up and sustained by unscrupulous financiers who enriched themselves at the expense of others. Harrumphing members of Congress held hearings. Soon, a chorus of I-told-you-sos from LBO critics and finger-pointing in the savings-and-loan and banking industries turned leverage into a dirty word. Even the LBOs that “worked” were dismissed as good luck or, more often, the result of deep and painful cuts in employment, investment, and R&D spending. Indeed, it seems as if almost every sales or purchasing manager has a story to tell about a good customer or supplier who was “ruined” by an LBO.

Although some leveraged buyouts may have deserved the criticism they have received, we believe that the overall public perception about them has been distorted. Right now, it is premature to dismiss LBOs as artifacts of the 1980s and to discuss their impact entirely in the past tense. Leveraged deals are still coming together, including some under corporate ownership. Furthermore, the companies they managed ultimately thrived. CD&R’s experience over more than a decade provides insights into what constitutes best practice in the ownership and governance of corporate enterprises. Contrary to what many people think, temporary ownership by an LBO firm can provide an important bridge to better long-term management and performance. Moreover, this form of ownership is adaptable to a much wider universe of businesses than commonly assumed—excluding not only the underperforming low-tech companies that have long been associated with LBOs but also neglected divisions and other pieces of corporations with potential for growth and an appetite for investment.

**Challenging Old Assumptions**

In 1987, CD&R (which was called Clayton & Dubilier until 1992) executed an LBO that transformed Borg-Warner’s Industrial Products Division—a producer of industrial pumps, seals, and fluid-control equipment with revenues of $245 million—into a stand-alone company called BW/IP International. The division’s parent, Borg-Warner Corporation, had shifted its strategic priorities away from industrial machinery businesses like BW/IP’s; in response, the division’s president, Peter Valli, and a team of executives joined forces with the LBO firm to buy the business for $235 million. More than 90% of the purchase price was financed with debt. Equity worth $20 million was owned by management (20%), Clayton & Dubilier (70%), and subordinated lenders (10%).

At first, BW/IP’s managers were alarmed by both the price tag and the debt burden. When they were running a subsidiary of a large, diversified parent, they had had little need to concern themselves with liability management. But once they were on their own, their instincts told them to begin conserving cash and repaying the debt as quickly as possible. Indeed, that was what they had assumed LBOs were all about: tightening cash management; putting a clamp on new investment and development expenditures; selling assets as needed and using available cash to reduce leverage; and then selling the business at the first suitable opportunity. To their surprise, however, the advice they got from Martin Dubilier, a founding partner of Clayton & Dubilier and the firm’s lead representative on BW/IP’s board of directors, clashed with those assumptions. Instead of pressuring managers to

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large ones. More important, LBOs are evolving in ways that we think will establish them as a permanent feature of the corporate financial landscape. Under certain circumstances, they offer a useful format for effective governance of corporations. Under the right conditions, LBOs are not merely deals. They represent an alternative model of corporate ownership and control just as public ownership, venture capital ownership, and franchise arrangements do.

Our research at one particular LBO firm, Clayton, Dubilier & Rice (CD&R), in New York City, reveals an approach to ownership and governance that challenges the dominant public view about leveraged buyouts and their effect on corporate performance. Instead of finding impersonal transactions in which the buyers put a lid on investment, growth, and managerial autonomy, we found the opposite. In fact, chief executives with a capacity for strong leadership and sound, independent decision making say they had more freedom to exercise discretion under LBO ownership than they had had under corporate ownership. Furthermore, the companies they managed ultimately thrived.
squeeze more cash out of the company and reduce the debt as quickly as possible, Dubilier advised them to search for good new investment opportunities in their industry. Without growth, he argued, the business could survive, but it would not prosper and the returns would not be worth the effort.

Dubilier's convictions were put to the test a year after the buyout when Valli called him to discuss an opportunity to acquire a small manufacturer of centrifugal pumps. The proposed $18.5 million acquisition would double BW/IP's installed base of certain types of pumps and strengthen its position in aftermarket parts and services, the fastest-growing segment of its business. But it also would require additional borrowing and getting the banks to waive some covenants on BW/IP's substantial debt.

At Borg-Warner, such a request would have had to undergo a lengthy bureaucratic process beginning with a written proposal analyzing the pump maker's past performance and strategic fit, and forecasting its future performance. Once headquarters had reviewed the proposal, corporate staffers would visit the division and hear a presentation. If they liked what they heard, the proposal would be turned over to Borg-Warner's Corporate Planning Committee, which met monthly. The committee would review the proposal, hear another presentation, and probably ask for further study and analysis. At best, it would take the committee several months to come to a decision. Valli and his team had run that gauntlet several times, only to be rebuffed or lose opportunities because of delays.

In the environment created by Clayton & Dubilier, things were different. The firm's financial and strategic analyses were every bit as thorough as Borg-Warner's, but the approval process was far more streamlined. Thanks to the relationship that had developed between Dubilier and Valli in their first year of working together, Valli got the firm's approval to make the acquisition in the course of a single telephone conversation. As it turned out, nobody had any regrets: Both the LBO and the acquisition were great successes. By the time BW/IP went public, in 1991, the value of its common stock had grown from $20 million to $352 million, reflecting a compounded return on equity in excess of 100% per year. The company's revitalized core businesses had improved along almost every dimension: higher market shares, higher operating margins, and better working capital management and asset utilization.

What explains CD&R's success? We learned the most about how this LBO firm succeeds by looking at situations in which something went wrong unexpectedly and had to be corrected. According to one partner, "What's different about us is that we can fix our mistakes." The manner in which the "fixing" takes place is integrally tied to the firm's approach to ownership and governance, which re-
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volves around a few basic principles: direct lines of communication between owners and top management; considerable managerial autonomy under normal circumstances and a willingness by owners to step in and direct operations to correct chronic problems; and trust-based relationships among owners, managers, and key creditors. The principles are interdependent. However, although each one may sound simple, practicing them all at once is difficult. What enables CD&R to accomplish this is its operating capability.

How CD&R’s Approach Evolved

The principles by which CD&R conducts business stem in part from the partners’ personal beliefs and experiences. But they also have been shaped over the years in response to problems and opportunities. The firm undertook its first buyout, of Kux Manufacturing Company (maker of commercial decals), in large part because “we wanted to be in the deal business, so we had to do a deal,” says partner Joe Rice. Before acquiring Kux in 1979, Clayton & Dubilier had specialized in turnarounds, not buyouts, and all three of its founding partners—Gene Clayton, Martin Dubilier, and Bill Welsh—were skilled in operations. When Rice joined Clayton & Dubilier in 1978, he brought his expertise in finance and law to guide the firm into leveraged management buyouts.

Kux seemed like a good deal: a small, simple business, a clean company, and a good price. But the partners’ relationship with the company’s managers turned out to be rocky. Although the deal was profitable, the partners concluded that they had to find a better way of monitoring and assisting company executives.

In the next deal, the buyout of Stanley Interiors Corporation (maker of furniture and fabrics) later that year, Dubilier took a more active role, one he initially thought of as that of chairman of the board but which has since become known within the firm as lead representative. At the same time, Clayton & Dubilier began formalizing aspects of its relationships with portfolio companies to clarify roles, responsibilities, and expectations. By the time the firm had completed the buyout of WGM Safety Corporation (a maker of personal safety equipment) in 1981, the partners had recognized the need to intervene in some situations. They fired an underperforming CEO and replaced him not with an outsider but with one of the partners. Soon thereafter, the firm drew on its growing experience as an active owner to buy Harris Graphics Corporation, which was triple the size of the firm’s three previous acquisitions put together.

By 1984, Clayton & Dubilier’s track record and the investment climate were good enough to attract investors to a $46 million limited-partnership fund organized to invest in the equity of the firm’s buyouts. In the meantime, the firm was also expanding its pool of talent. Three new partners arrived with mostly financial skills, and a fourth was an operating manager who had served successfully as chief executive officer of Stanley Interiors. The new funds and a balanced team of finance and operations professionals positioned Clayton & Dubilier for the wave of buyouts that would run through the end of the decade.

Uniroyal, the tire and chemical company, was the firm’s first buyout of a public company and also its first billion-dollar deal. That acquisition, completed in 1985, enhanced Clayton & Dubilier’s stature and reputation on Wall Street: It was big, relatively complicated, and, some thought, unusually risky. The Uniroyal transaction and the subsequent buyout of the Uniroyal Goodrich Tire Company, in 1988, were both successful financially. But the deals convinced the partners that the firm’s skills and operating style were less suited to acquiring entire public companies than to acquiring divisions of public companies. As Rice explains, “With a public deal, you can’t negotiate much besides price. I make a living negotiating good acquisition agreements. We have a good team with strong capabilities—we don’t make many mistakes—and there’s a lot I want to talk about besides price. Also, when you buy a public company, you buy management—

The balance between operating and financial partners is crucial to the way CD&R operates.

all of it—all sitting in the same spots with the same mind-set, the same organizational problems, and so on. In a private deal, there are many possibilities to change things quickly.” The firm has maintained that preference ever since.

Uniroyal and Uniroyal Goodrich were milestones in another respect: They triggered substantial growth within Clayton & Dubilier itself. Between 1987 and 1992, the firm added nine new partners, nearly tripling its ranks at the partner level. In keeping with the firm’s tradition, five of the part-
ners had experience as CEOs of manufacturing companies, and four were financial experts. The balance between so-called operating and financial partners in both numbers and influence is crucial to the way CD&R operates. It is further reinforced by the firm’s compensation policies: All partners participate financially in every deal, and all partners—financial and operating—at a given level (there are only two) receive the same compensation.

Financial partners are the firm’s primary link with the larger community of deal makers, lenders, and investors. They locate prospective acquisition candidates and process transactions from start to finish: analyzing projections, negotiating prices and other terms, performing due diligence, arranging financing, and attending to tax and accounting matters. They also take the lead in postdeal financial matters, including relationships with lenders, restructurings, refinancings, the sale of portfolio companies’ assets, and the eventual liquidation of CD&R’s interests.

Operating partners, too, play a significant role from a transaction’s inception. A prospective candidate receives serious consideration only after an operating partner endorses the viability of the enterprise. To the question, Would you be willing, if necessary, to step in and run this business yourself? at least one operating partner must answer affirmatively before CD&R invests much time or money in a deal. Not surprisingly, operating partners also play a large role in the due diligence process and in formulating operating objectives and performance goals.

Once CD&R purchases a business, operating partners remain active—as board members, consultants, advisers, owners, and sometimes CEOs—for as long as CD&R owns the company. This involvement stands in sharp contrast to more financially oriented LBO firms, which generally seek operating expertise from outsiders on a fee-for-service basis and often only when a crisis develops.

The active role that Martin Dubilier first played in the Stanley Interiors buyout became a standard part of every transaction by the mid-1980s. The lead representative, usually an operating partner, sits on the board of an acquired company and has chief oversight responsibility for CD&R. The lead representative also determines what the firm can reasonably expect of the company’s CEO and management team.

CD&R’s organization and its relationships with portfolio companies are structured to make the best possible use of the lead representative. In contrast to the complex hierarchies and elaborate approval processes typical of large corporations, CD&R emphasizes the relationships between the senior managers of portfolio companies and the lead representatives. CD&R’s in-house corporate policy manual carefully describes the firm’s and the lead representative’s monitoring and support activities on the one hand, and the CEO’s authority and obligations on the other. CD&R provides this information to CEOs even before the buyout is completed.

The board of a portfolio company is usually made up of CD&R’s lead representative, two other CD&R partners, the company’s CEO, and three outside directors who are selected by the CEO and approved by CD&R. More so than the other directors, the lead representative serves as the CEO’s sounding board on both day-to-day operations and long-term decisions. In addition to contributing an understanding of what’s involved in running a company, this individual is expected to listen, ask questions, react to ideas, and suggest alternative ways to address problems and opportunities.

Although primarily an adviser, the lead representative is often actively involved. The Allison Engine Company, a producer of aircraft and industrial engines, was a division of General Motors before CD&R bought it for $340 million in 1993. Allison executives had never had to manage cash and working capital, because those and other treasury functions had been handled by GM. At the time of the buyout, Allison was turning over its inventory of $400 million less than twice a year. CD&R’s lead representative stepped in to help Allison’s managers improve their working capital management. Touring a 3-million-square-foot company facility, he examined samples of work in process, deciphered date codes, and determined that a lot of inventory had been sitting idle in the shop for months. With the lead representative’s help, Allison executives established a process for reducing working capital. It eventually involved more than 100 employees, who were offered cash incentives.
Within ten months, working capital had been reduced by $75 million.

Lead representatives generally have discretion for selecting auditors and insurance agents and for approving employees’ benefits and pension plans. CD&R also assumes primary responsibility for maintaining relationships with banks and subordinated lenders, and it helps obtain additional capital as needed for strategic investments. The firm will often assist in selling or restructuring noncore parts of a portfolio company’s business. But the lead representative does not otherwise make decisions or give instructions. Rather, it is up to the CEO to gather input from staff and other advisers, weigh alternatives, and make decisions.

Core Management Principles

While CD&R brings a high level of operating capability to each new deal, that capability is enhanced by the way in which the firm interacts with portfolio companies and managers. The firm’s involvement is characterized by the principles it has come to embrace.

Direct Lines of Communication. To improve its monitoring of portfolio companies, CD&R retains the right to talk to anybody in the company, subject to two constraints: It must inform the CEO, and it cannot tell anyone in the company what to do. Normally, of course, CEOs are expected to keep CD&R’s lead representative abreast of the important strategic and operating issues as they develop. Communication at this level is direct, fast, and usually informal. One CEO estimates that in the course of six years under CD&R’s ownership, he received fewer than 20 pages of memos from the firm.

Within CD&R, communication among partners is also direct and informal—a reflection of the firm’s flat structure and egalitarian culture. In addition to sharing the workload of meetings, negotiations, analyses, and due diligence, the partners have an obligation to contribute by communicating. They share ideas, expertise, opinions, and criticisms—including criticisms of themselves, the firm, and one another. CD&R relies heavily on an open exchange of views as a way to tap the expertise of a very small group (13 professionals, 8 of whom are partners). Whenever we asked a partner about problems at specific companies, the response usually began with, “Well, I’ll tell you the mistake I made” or “So-and-so [another partner] was wrong about...” Everyone in the firm has made mistakes, and, in CD&R’s open culture, people are accustomed to hearing critiques from their colleagues.

Selective Intervention. CD&R’s operating capability and close contact with portfolio companies enhance its ability to know when to intervene and how to be constructive if it does. A case in point is the Kendall Company (now Kendall International), a maker of disposable medical products that Clayton & Dubilier acquired in 1988 for $960 million and that became the firm’s first big acquisition to develop major problems. Everyone involved in the transaction now agrees that, among other mistakes, the firm paid too much for the business. More than one partner attributes part of the problem to hubris. A Kendall executive agrees: “They thought they were magic.”

Things began going wrong almost from the start. As Kendall’s performance slid, employees became obsessed with the debt, key salespeople and managers departed, and lenders pressed for repayment. Clayton & Dubilier developed plans to restructure operations and sell assets but pulled back in the face of an unreceptive market. The CEO’s job turned over twice—the second time just before a crucial bondholders’ meeting. The firm’s operating partners convinced their colleagues that Kendall, though weakened, had a valuable core and could be turned around. Dubilier himself stepped in as the interim chief executive before recruiting an outsider to lead the recovery.

The firm’s financial partners also played a critical role: working with banks to arrange a financial restructuring that would provide time for the operating changes to come to fruition. In mid-1992, Kendall filed for Chapter 11 with a prepackaged bankruptcy. Among the provisions of the complex reorganization was the injection of new equity capital from one of CD&R’s funds—an investment that was unanimously approved by that fund’s investors. To bolster Kendall’s position further, CD&R waived its management fees and gave up its...
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Longtime turnaround specialist who has been a CD&R operating partner since 1990. "You try to figure out what to do. You talk to the managers, set very specific hurdles, and see what happens. It's an experiment. Then, based on what happens, you try another experiment. It takes time. You're always trying to strengthen a weak person rather than replace him."

As important as it is to know when to get involved, knowing when to not intervene is just as important. Excessive intervention hurts management's morale and undermines managers' sense of initiative and willingness to take risks. The BW/IP deal was one situation in which intervention was never necessary. As Peter Valli, BW/IP's chief executive, describes the relationship, "The partners wouldn't hesitate to push you to do something, but you could push back. Each side respected the other's judgment."

We asked CD&R's partners how different managing a crisis would have been had they not had the firm's operating capability to call upon. One partner said, "Financial buyers with no operating capability would eventually see the numbers going bad. So they'd talk to the CEO and probably hear excuses. Then the bad results continue, so maybe they'd replace the guy. But then what? How do you know the new guy is any good? Whom do you get? Maybe an industry guy, maybe a workout guy - it can go on and on. It's an awful position to be in. That's why some buyers walk."

Despite Kendall's disappointing early performance and the financial restructuring it necessitated, the experience highlights important aspects of CD&R's view of ownership and governance. In the rescue operation, both operating and financial partners played major roles, and the strength of the firm's commitment to a company was tested and confirmed. CD&R might well have been better off financially had it put Kendall into bankruptcy two years earlier, one partner observes. "But we never seriously considered it. We felt that it was our problem and we were going to fix it." CD&R's partners take considerable satisfaction in Kendall's current strength and in the fact that the lenders didn't lose any money and the company's operations didn't have to be gutted to repay the debt.

Deciding when to intervene can be difficult, even for someone with extensive operating experience, because often the cause of a company's problems can be determined only over time, through patient interaction with the chief executive and other managers. "You agonize a lot," notes Bard Howe, a CD&R's operating partners are accustomed to such relationships. All of them have held senior operating management positions in large corporations. In addition, many have had successful careers as management consultants.

One executive who has run a company under both CD&R and another, financially oriented LBO firm notes some of the differences between the two approaches: "The finance-only LBO firms are actually more likely to get in your hair because they worry about operations but know they don't understand them. Financial LBO firms ask you for much more information - data, reports, everything - and they don't understand any of it. The CD&R operating guys ask for what they need, and you know they understand it. It's easier for a CEO and the CD&R liaison to trust each other because they're both operating guys. They can talk."

**Trustworthiness.** We asked the CEOs of portfolio companies to tell us how managing a CD&R company differs from managing a division of a large corporation. Second only to the pressures of managing with lots of debt, the CEOs cited their ability to trust CD&R's partners. They said that with CD&R they could discuss problems and opportunities openly, act more independently, and generally focus on business, rather than feeling compelled to "game" the corporate control system or to protect themselves from it.

CD&R's partners understand the importance of trust and work hard to foster and maintain it. Trust was indispensable in the creation of Lexmark International, a business formed from IBM's printer, typewriter, and keyboard business in 1991. Accord-
ing to one CD&R partner who was heavily involved in negotiations with IBM, “Both sides agreed early on that they were going to have to trust each other. More than one IBMer said to me, in effect, We know you guys won’t embarrass us.” The trust that was established in the Lexmark negotiations carried over into positive relationships between the firm and Lexmark’s managers (most of whom were former IBM employees) and between Lexmark and its employees and suppliers.

Trust between CD&R and the CEOs sometimes develops early through good personal chemistry. More often, it has to be cultivated. As Alberto Cribiore, a financial partner who has helped put many deals together, observes, “We’re typically not in love with these guys [the prospective senior managers] prior to the deal, and vice versa.” Instead, trust is built over time in a variety of ways, including the alignment of interests through equity ownership and incentive compensation. Setting realistic expectations, sorting out responsibilities and authority, and then respecting those decisions are also important. The trust that develops between a lead representative and a CEO often fans out into both organizations, and it gets tested over time. Eventually, a reputation for trustworthiness becomes self-reinforcing: People who anticipate trustworthy behavior from their counterparts are more likely to interact informally and see their expectations confirmed.

Trust also helps managers innovate and take risks. The pressure of substantial debt can paralyze managers and discourage them from taking additional risks even when it is to the company’s advantage to do so. To have the confidence to take “good” risks, managers must be able to trust that the individuals evaluating their performance can make discriminating, informed judgments. CD&R’s operating capability helps instill such confidence.

CD&R also stresses trustworthiness in its relationships with LBO lenders. To protect their financial position, lenders require formal contracts with explicit terms and covenants. But sometimes the restrictions need to be relaxed to permit the portfolio companies to take advantage of strategic opportunities or to allow managers to take corrective steps. Ordinarily, lenders will agree to waive covenants or to suspend certain payments temporarily when doing so is in their best interest. When the lenders are confident that their flexibility will not be abused by the equity owners, there is usually less haggling. CD&R’s willingness to inject more equity capital into Kendall and to give up its own share of the company’s operating cash flow rather than cut its losses exemplifies the kind of trustworthy behavior that the firm tries to exhibit.

Parties that trust each other can interact on the basis of informal, implicit agreements. Such agreements are valuable to both sides because they are inexpensive and because they permit rapid and highly refined adjustments to a changing environment. When people expect frank discussions of all material facts, many of the cumbersome control systems typical of large hierarchical organizations can be dispensed with.

Why LBOs Make Sense

Despite the unfavorable public perception of LBOs, they are alive and well. Judging from the experience of CD&R, that is not an accident: As a model for ownership and governance, the LBO firm has considerable advantages. Our look at CD&R also indicates that the American LBO is still evolving and that, within the universe of LBO firms, CD&R represents a distinctive variant—one that might be labeled an operating (as opposed to a predominantly financial) LBO firm. The strength of CD&R’s operating capabilities seems unusual. However, we can envision smaller, more narrowly focused firms pursuing a similar approach by concentrating on one or two related industries in which their partners have extensive hands-on operating experience. The combination of operating capability, direct lines of communication, a capacity for selective intervention, and an emphasis on trustworthiness greatly expands the range of businesses that can be successfully acquired and managed as LBOs.

The Lexmark deal illustrates how the range of potential buyout candidates is expanding to companies that look nothing like the stereotypical LBO candidate. To begin with, Lexmark’s computer-printer business is relatively high-technology, high-growth, and high-risk, and it demands substantial ongoing investment. Before Clayton & Dubilier...
purchased it for about $1.6 billion, it had not been structured as a freestanding division, so the firm had to pull it together from various parts of IBM. Organizing the company required cooperation and expertise from many quarters: operating and financial partners at Clayton & Dubilier, executives at IBM, suppliers and customers, and many outside advisers. The deal required some 70 different contracts, mostly between Clayton & Dubilier and IBM; it used more equity than typical buyouts do (with IBM itself becoming an equity investor); its senior debt came from a small number of banks that held on to the debt without syndicating it; the subordinated debt came from a single institutional investor; and two other institutions purchased all the preferred stock (thus eliminating any need to sell public securities). The Lexmark transaction is a ringing endorsement of the firm's approach to LBOs by sophisticated investors.

CD&R completed five more acquisitions totaling $2 billion from 1993 through February 1995—the firm's most active period since 1987 and 1988, when it closed five deals totaling more than $2 billion. Those five companies are growing rapidly and require considerable ongoing investment or have substantial operating risks stemming from the need to bring about a turnaround. Whereas other LBO firms normally avoid such companies, CD&R, confident in its operating capabilities, seeks them out.

CD&R acquired its newest businesses from Xerox, General Motors, DuPont, Westinghouse, and Philip Morris. The businesses (all of which were valued at $300 million or more at the time of purchase) no longer fit their former parent's strategic interests, and each had suffered from some form of neglect: overspending, lack of controls, or under-investment. The recent acquisitions were not small- to medium-sized low-tech businesses whose stagnation or decline was the reason they were good LBO candidates. Rather, they were parts of mainstream corporate America that had been suboptimally governed: businesses with valuable market positions and opportunities that required liquidity and access to capital in order to thrive. Today there is no shortage of such acquisition candidates.

**Corporate Governance and the Quest for Best Practice**

The recognition that parts of mainstream corporate America are suboptimally governed is by no means new. Corporate governance has been a prominent topic of study and debate since the early 1990s, when academics and practitioners alike began hypothesizing that good governance contributes to competitiveness. What followed was an international effort to formulate, or at least describe, a model of best practice for corporate governance.

**Debt and equity are not merely different types of financial claims. They are alternative approaches to governance.**

A 1992 report by Great Britain's "Cadbury Committee" attempted to set forth principles of best practice in British corporate governance. In the United States, leveraged buyouts, venture capital firms, and relational investing (as practiced, for example, by Warren Buffett) have all been studied as possible models for best practice. In a similar vein, observers have also touted the organizational advantages of the industrial groups of Japan, Germany, and Scandinavia.

Is there a best-practice model for governing business enterprises that can be applied across the board? If LBO firms such as CD&R can acquire large divisions of mainstream corporations and increase value through better governance, then why can't the corporations do it themselves by adopting similar operating approaches, avoiding the transaction fees, and letting their shareholders keep the profits the LBO investors would make? Unfortunately, it's not that simple. Senior managers are seldom able to impose the necessary operating disciplines on themselves. Nevertheless, they can learn some valuable lessons from CD&R's experience.

The first lesson may be obvious, but it bears repeating: How a company is governed matters. There is ample evidence other than CD&R's portfolio to support this assertion, although the firm's results bear it out. Among the firm's 15 acquisitions before 1990 (it is too soon to tell about five of the six more recent deals), only one company failed to double its earnings before income and taxes. Those gains did not come from laying off employees: Head count rose at some companies and fell at others; on average, it rose modestly (less than 4%). Nor did they "just happen" as the result of new incentive compensation schemes or managers owning equity; in fact, operating problems usually arose that required active intervention. To put the lesson an-
other way, governance affects how important decisions get made and therefore how efficiently a company's resources, including capital, are utilized. Poor governance can be very costly.

Because LBOs tend to be viewed primarily as financial transactions, their effects on governance are often overlooked. Finance and governance are commonly seen as distinct and separate spheres of activity. In fact, the two are closely related. As Cri briore observes, "With equity, [corporate governance] is a matter of constant negotiation. With debt, it's a matter of reality - did you hit your covenants or not?" His comment underscores the fact that debt and equity are not merely different types of financial claims. They are, in addition, alternative approaches to monitoring corporate performance and directing management - in other words, to governance.

By its very nature, debt constitutes a fairly rigid, rules-based approach to governance. Borrowers contract with lenders to make regular cash payments of interest and principal, and they agree to restrict the payment of dividends and the sale of assets, and to maintain minimum levels of working capital. Failure to abide by the rules can lead to further constraints or, ultimately, seizure and liquidation of the company's assets. Although covenants can be waived and terms renegotiated, such steps are costly and are not undertaken lightly.

Equity, by its nature, is more flexible and forgiving. Individual shareholders may come and go, stock prices may rise or fall, but equity as a class is "patient." Equity investors can and should intervene selectively and administratively to correct performance shortfalls, rather than relying on financial triggers to bring other safeguards into play automatically. In effect, pure debt and pure equity occupy opposite ends of a continuum of potential governance regimes. The imperatives of debt make for a rigid but fundamentally simple and low-cost regime, while equity's flexibility makes it more adaptive but inherently more complex and costly.

The ideal form of governance for a business at a particular stage depends on the nature of the assets being managed, the transaction stream those assets support, and the number of attractive growth opportunities within the company's reach. In general, a business that has easily redeployable assets (multiuse facilities, conventional rolling stock, low-technology manufacturing equipment, and so forth) and that faces relatively few good growth opportunities will be better governed by the simple, low-cost, rules-based regime provided by debt. Such businesses do not require much cash, and their assets are readily transferable to other management teams in the event of default. In the early days, LBO firms sought to acquire companies with just this profile: ordinary businesses with stable cash flows and readily salable assets.

By contrast, businesses with highly attractive growth opportunities or a need for functionally specific assets (dedicated to a particular customer or supplier, locationally fixed, or dependent on specific human capital, for example) will be better governed by a regime dominated by equity. Such businesses typically require substantial managerial discretion and administrative flexibility. Not surprisingly, businesses with mixed characteristics are best suited to hybrids of the pure rules-based and discretion-based extremes. Some of the hybridized adaptations we observe in the real world (Japanese industrial groups, for example) are quite sophisticated and highly evolved.

Businesses change over time and so, too, should the type of governance they employ. Some changes are discontinuous and driven by phenomena external to the business; others occur gradually and may result from internal factors or from a company- or industry-specific life cycle. Regardless of what is driving the change, it is unreasonable to expect one form of governance to remain optimal in all circumstances. Managers should abandon the idea of a single dominant model of best practice to which all well-managed companies should conform. Instead, well-managed companies will pass through several forms of ownership and control - some of them perhaps more than once. This is a natural and desirable consequence of continual corporate renewal.

A leveraged buyout is one form of governance through which a relatively wide cross-section of businesses may pass. CD&R's system of combining operating and financial expertise with direct communication, selective intervention, and an emphasis on trust helps overcome some of the rigidities of high leverage. For some businesses, a traditional pure-finance LBO might be a mistake, but an "operating" LBO might make sense as an efficient way to accomplish a transition from one phase of

Though ownership by an LBO firm may be transitory, the improvements can endure.
LEVERAGED BUYOUTS

the business's life cycle and one form of governance to the next. Though ownership by an operating LBO firm may be transitory, the evidence from CD&R suggests that a company's improvements in operations can be enduring.

The continuing evolution of the operating LBO could bring substantial benefits to U.S. business and to the overall economy. Currently, CD&R by itself has the capacity to undertake about two high-impact transactions per year. In contrast to the 1980s, when the firm's prospects came from investment bankers who presented the deals to several firms, today's opportunities are more along the lines of Lexmark, in which the selling company offers the deal to the buyer directly.

CD&R has held its companies an average of four and a half years. As the pool of potentially attractive LBO candidates expands and the transactions themselves become more complex, we can expect to see LBO firms holding on to portfolio companies longer. Nevertheless, CD&R has no plans to become a relational investor in the mold of Warren Buffett's Berkshire Hathaway. To motivate and retain the best deal makers and to keep their skills sharp, the firm must initiate new deals. To remain small and focused and to reward partners, investors, and managers, it needs to divest its holdings in companies that are ready for a transition to some other form of governance. Doing so makes room for new investments.

One can imagine circumstances in which the ability of CD&R and other LBO firms to put deals together could be seriously impaired. So far, however, the firms that stress operations have shown staying power. CD&R, for its part, has survived the death of Duhilier and the retirements of two founding partners and several others. Moreover, it has been able to continue assembling the necessary financing despite the disfavor shown to LBOs by many lenders and financial regulators.

If, as we expect, more firms begin to adopt elements of CD&R's approach and the operating LBO becomes more prevalent, the impact on U.S. business will be substantial. It will facilitate efficient changes in the governance of assets worth billions of dollars, culled from some of the world's largest corporations. Most of those companies will see their operations improve and investments increase before they return to public ownership directly through stock offerings or indirectly through sales to other public companies. The firms that facilitate this process should be able to survive the ups and downs of Wall Street well into the future.

Respectability and Rewards

Not so many decades ago, capitalism itself was held in low esteem by many as a means of organizing economic activity. Intellectual skepticism about its merits, hostility toward its mechanisms, and unease with some of its apparent side effects all contributed to its poor image. Today the image of capitalism is much improved, but not because today's critics are more insightful than yesterday's. Rather, capitalism has proved its usefulness by succeeding in extended, real-world competition against alternative systems.

Today's skepticism about leveraged buyouts is likely to undergo a similar transformation. LBOs represent a young and still evolving organizational form under the umbrella of capitalism. Like other complex forms of ownership and control, including the modern public corporation, LBOs may always be imperfect. Even so, they are well suited to certain important tasks. Over time, as they compete in the real world, LBOs will establish a record of operating successes that should cause the skepticism to give way to qualified respect. In the meantime, substantial rewards await the pioneers who perfect the form and demonstrate its capabilities.

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