Columbia Business School

Graham & Doddsville

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Koch Industries — Creating Value in Society

Dave Robertson

Steve Feilmeier

Koch Industries is an industrial conglomerate headquartered in Wichita, Kansas. It is the second largest private company in the U.S. with $115 billion in sales. Its businesses range from petroleum refineries and fertilizers to chemicals and fibers, as well as Georgia-Pacific, which Koch acquired in 2005 for $21 billion.

Koch's recent investments include a $1.5 billion minority stake in Guardian Industries, an architectural glass manufacturer; an investment in Colfax Corporation, a diversified manufacturing and engineering company; and a $240 million preferred stock investment in American Greetings Corp.

Richard Hunt, *Graham and Doddsville*'s former AVP and a summer business development intern at Koch Industries, sat down with Steve Feilmeier and Dave Robertson at Koch's headquarters. Steve Feilmeier is Koch's executive vice president and chief financial officer and has been with the company since 1997. Steve earned his bachelor's and master's degrees in accounting from Wichita State University. Dave is president and chief operating officer of Koch and started his career with the company in 1984. Dave earned his bachelor's degree in business administration and marketing from Emporia State University.

Graham and Doddsville (G&D): Koch Industries has one of the best long-term compounding records, with mid-teens compound annual growth for over 50 years. Why do you think Koch has been so successful over the years?

Dave Robertson (DR): Our management philosophy, Market-Based Management®, is what allows us to achieve those types of returns over time. When we acquire a new company, Market-Based Management® unleashes the knowledge and ideas that people in that firm have to innovate and to make their product or process better.

Our incentive system is very key to unleashing those pent-up ideas and innovations. The system allows all of our employees to share in a portion of the value that they are creating. It doesn't matter what your role is—if you can find ways to help us better serve our customers so that we profit more, we want you to share in some of that profit. You are rewarded like an entrepreneur is rewarded. If you're successful at that, you'll do better and if you fail, then you won't do as well.

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Dave Robertson

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Steve Feilmeier (SF): It's also the incentive to speak up when you think somebody else's idea has some limitations—what we call our challenge process. Not only do we incentivize people to speak up, but we also expect the recipient of that information not to be defensive so he or she is open to incorporating different viewpoints. We'd much rather limit the mistake rather than invest in it—then you've really got a mess on your hands.

Having an open and honest culture where we trust each other is key. A lot of companies think they do a good job at incentivizing people, then they get in here and say, "Wow, it's night and day."

G&D: A recent article in the Wall Street Journal talked about how Koch Industries wants to be considered alongside Berkshire Hathaway as a buyer who can do big deals quickly. What sets you apart from not only Berkshire Hathaway, but also other financial or strategic buyers when it comes to investing in businesses?

SF: It's our ability to tailor our investment to the very specific needs of our counterparty to solve the problem they're trying to solve. A typical hedge fund or private equity fund is limited in the types of things they can do, types of securities they can invest in, or the duration of the investment because they are beholden to their own investors who may prescribe certain mandates or rules.

We try to listen and will adapt to meet our counterparty's needs. The key is to make sure we're being compensated for the risk that we're taking.

G&D: Koch is in a unique position to allocate capital given its diverse set of businesses and significant capital to invest in new opportunities. Can you explain Koch's overall capital allocation philosophy?

SF: First, you have to be in the right businesses where you have the capability to create real value. Then, don't try to optimize and trade in and out of them like a private equity firm has to do.

As Charles [Koch] likes to say, it's hard enough to find good businesses. Why would you want to sell one once you already own it? That is a very important key to how you compound—get good businesses, and then invest in them for the long run.

Another critical dimension is to stay very rigorous in your discipline. All too often, you'll hear public companies acquiring businesses for "strategic reasons." For us, if we're not earning an appropriate rate of return, it's never strategic. Strategic should mean that you're creating real value in society. If you're not earning an appropriate return on your investment, by definition, you're not creating value.

So we stick to our disciplines and make sure that the returns on risks are appropriate each and every time. Then we look at things not through a filter of "who's going to get how much capital this year." We'll fund any and all projects in each of the businesses we have that meet these criteria.

DR: A lot of firms have a budget mentality where they say "we'll give this business this much capital," and we're not doing that. We have shareholders who historically have reinvested 90% of the earnings back in the company. So we're looking at any and all opportunities and then trying to pick the ones that provide the best return on the risk that we're taking.

It's a little bit of first-come, first-served in that when we see good opportunities that present an attractive return on the risk, then we go after them.

SF: We've never been in a situation where our internal funding hasn't generated enough capital where we've been constrained. So we're not constrained by the fact that we're private. We're typically constrained by

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whether or not the markets are offering an appropriate return or whether or not we've got the capabilities to manage the investment. When we have more ideas or good opportunities than capital, we could always use debt capital but this is rare. Our goal is to finance everything with equity.

DR: Our transaction excellence capability is the discipline that Steve's talking about. We can evaluate each of these opportunities, whether it's a project to add on to an existing facility, an acquisition, or an equity investment. We're putting each of those through the same rigor and analysis to determine the expected risk-adjusted return.

G&D: You have said in the past that Koch is not bounded by any industry—instead, it's bounded by its capabilities. Could you describe Koch's capabilities? And given how fast the world changes, how do you think about developing new capabilities?

SF: Most of our businesses have more in common than might meet the eye. We take some form of commodity and we'll process it through a very, very large plant that requires sophisticated technology and analysis to ensure that we have a competitive advantage and a capability to go to market in scale. Then we'll optimize around that processing or manufacturing process because there is raw material risk, commodity risk, and counterparty risk.

We also have the capability to be very efficient and effective from a cost perspective and the capability to constantly innovate because the technology changes in these big plants. We must be adaptable to ensure that we don't fall from the first quartile to the second, third, or fourth quartile in cost advantage.

"As Charles [Koch] likes to say, it's hard enough to find good businesses. Why would you want to sell one once you already own it? That is a very important key to how you compound: get good businesses, and then invest in them for the long run."

Our other core capabilities besides innovation and operations excellence are Market-Based Management®; trading; transaction excellence; and public sector, which encompasses legal, communication, community relations, and government relations.

So, whether it's crude oil going into refined products, natural gas going into fertilizer, naphtha going into chemicals, trees going into pulp, metals going into our manufacturing businesses—each of these businesses fit the capabilities described above.

Certain businesses simply do not benefit from these capabilities. We're not a big, multi-unit retailer. The capabilities of the largest retailers are being very, very sophisticated at information technology management and logistics. They make their money by being excellent at getting product to the store and having the right inventory at the right place at the right time. And they have the scale to do so at low cost, too.

We don't have that capability. So there are certain things that we couldn't envision—that doesn't mean that we

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Steve Feilmeier

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wouldn't build the capability. We would consider building capabilities whenever it's evident that society is not effectively allocating capital to an industry. That requires looking forward and trying to understand the trends that might really matter, for example, energy and agriculture products should continue to be in high demand. The world is going to need more of the products from these industries in the future.

G&D: How would you define a great business? What are some examples of great businesses that you admire?

DR: A great business is one where you have a significant competitive advantage with offshoots that allow that business to grow. That advantage could come from a raw material advantage, technology advantage, or a number of other sources.

Take our Pine Bend, MN refinery. It's a great business. We buy advantaged feedstocks, convert those into very high-value end products, and sell them in one of the best marketplaces in the country. That has propelled us into other businesses, like our petroleum coke business in Koch Minerals.

SF: When we say "competitive advantage," that does not mean an advantage over our customer where we can profit at their expense. It means that we have created something that creates a great advantage over the way things used to be done or over the way our competition does it today. As a consequence of that, we're using fewer resources to produce goods or services that somebody will value. And that's good for society. Everybody wins. Our customers win because they'll participate in that value creation.

"A great business is one where you have a significant competitive advantage with offshoots that allow that business to grow. That advantage could come from a raw material advantage, technology advantage, or a number of other sources."

We stress this idea to all of our employees that we're not seeking the type of advantage where you win and someone loses. Not every business thinks of it this way. We think of this as subsidization or cronyism which distorts markets and is not good for society.

DR: It's a great point because win/lose is not sustainable over time. You can't do what Koch has done over 50 years by us winning and our customers losing. Competitive advantage assumes that we can provide goods and services to our customers and be their best alternative. The spread in that equation is profit, and we believe profit really is the measure of how much value we are adding in society.

The only reason a business exists is to make people's lives better. We use resources more efficiently to produce goods and services that people want to buy. If we do that effectively, then we are creating value in society. It's an important backdrop to this discussion.

G&D: Dave, you've said that Koch often has more than 100 companies on its investment watch list. How does Koch go about generating these investment ideas?

DR: We have business

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development (BD) personnel in all of our different businesses. So for example, Georgia-Pacific has a BD Team and Flint Hills has a BD team. Within Steve's group at a corporate level, we also have a business development team. Those teams' daily activity is to find actionable opportunities that would fit our capabilities. We have well over 100 business development personnel across all the companies.

SF: We must be able to do something with a business that the incumbent owners cannot, or else we're not creating any value—they're a better owner than we are otherwise. It doesn't make sense for us to own anything unless we add value to it.

I'll give you two examples out of our fertilizer business. Agrotain, which produces a specialty molecule that, when combined with straight-run commodity fertilizer, makes a much better product for the farmer. With Agrotain applied, the amount of fertilizer that actually reaches the plant goes way up, and that creates value for everybody. J&H Bunn in the UK is good at fertilizer distribution, blending, and warehousing and dealing directly with the customer.

Koch Fertilizer's core competency before acquiring these two businesses was having a global breadth and depth of manufacturing commodity fertilizers, and then getting them to market through our terminal system and marketing capability. The Agrotain and Bunn business lacked the capability that we have to reach global markets.
These businesses came together synergistically where we could take Agrotain, use J&H Bunn's knowledge of blending, storing, distribution, and customer service, and do that globally.

"We must be able to do something with a business that the incumbent owners cannot, or else we're not creating any value—they're a better owner than we are otherwise. It doesn't make sense for us to own anything unless we add value to it."

That's what we brought to both of these businesses and why transactions made sense for all three businesses.

DR: We can't just dream up or manufacture these opportunities amongst business development people. They have to have contacts and relationships in the industry to have the opportunities shown to us. So it requires a lot of different interactions to be able to size up, screen, and think about where the opportunities might be.

G&D: How do you judge whether or not the culture of a potential acquisition will be a good fit for Koch? How do you prevent mistakes?

DR: It's very difficult to do, and it depends on the type of deal. If it's a public company deal, you get very little due diligence. You're not going to get a full picture of the culture, other than the feel you get from the handful of leaders that you meet.

If you're doing an asset-based deal or carve-out, you may get a lot more time to work with the counterparty to find out what their culture is like. But it is very easy to make a mistake. We know that our culture is unique—we talk about that a lot. So we're not going to find someone whose culture fits exactly.

We try to make sure that

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their culture isn't so antithetical to ours that we wouldn't be able to, over time, meld it or blend it into our culture. But it's something that we haven't really been great at. We're trying to get better by spending more time and energy assessing it and understanding how different they are, what those differences are, and what we need to do to bring them into our culture.

SF: Culture is many different things. For us, it starts with our ten principles. They are each important because they work together, but there is one in particular that I pay attention to when we're looking at another company, and that is humility.

Being open to challenge is really important. The way people treat each other is also really important. I was with a company yesterday where the CEO knew every single person's name that he passed by. It tells you a lot!

Understanding culture before we acquire a business could be the most important thing we do. And it's been the one of the hardest to do. You have to talk to the employees, customers, and suppliers. You learn a lot about how the company treats them.

DR: If we thought a company's culture was one that lacked integrity and compliance, we'd back away. We wouldn't do the deal; it's not worth it. And that has happened more than once.

G&D: Given that gasoline consumption in the U.S. is in structural decline from increases in fuel efficiency and the shift toward hybrid and electric vehicles, is the refinery business still a good business?

DR: Yes, depending on the asset. We look at these businesses on a supply stack from who we think is most competitive to who we think is least competitive. As volume shrinks in a market, you move closer to the more competitive players to be able to meet the demand in the marketplace. As long as you're far left in the supply stack, then it can be a very attractive business. If you're far right—if you're a high-cost producer—and the market is shrinking, then it's a bad place to be because you're going to be less profitable, or unprofitable.

We feel good about our position in the refining business, but for those with marginal assets, it's probably not a good place to be.

SF: Having the correct vision for the business is key. For example, Flint Hills used to view themselves as strictly a crude-oil-based refined products business. Now they view themselves as a transportation fuels business. These visions are very different. When you make that shift in how you think about the world, suddenly you will look at ethanol, biodiesel, and hybrid vehicles differently. It's changed the way we invest in those assets. Time will tell how good the vision is, but we'll adapt it again as we need to.

G&D: How do you think about investing in areas boosted by big government subsidies such as ethanol, especially given Charles Koch's free-market views?

DR: We're not in favor of any subsidies or mandates where the government picks winners and losers. We're opposed to all of that, even if it's detrimental to us. The ethanol industry is not subsidized anymore today, but it is mandated. It's great that the subsidy went away, and we'd like to see the mandate go away and let ethanol compete on its own merits.

If you look at the energy content in ethanol, it's not as good as gasoline or diesel fuel. But ethanol is a very cost-effective way to get octane. To meet the miles per gallon requirements, engine manufacturers are making smaller engines with higher compression. Those engines need higher octane.

A blend of gasoline with ethanol to increase the octane level makes sense to feed those engines. So ethanol has a place in the transportation fuel industry

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today, even without subsidies or mandates.

SF: Here are some numbers to put with that. You can buy 87, 89, or 91 octane gasoline. That is regular unleaded, mid-grade, or premium. One way to achieve 89 or 91 is by blending a higher-octane component with regular gasoline.

Ethanol has a high octane value of about 99 or 100. When you blend it with carbon-based motor gasoline it has the equivalent of 120 octane value because of the chemistry. So as the engine manufacturers increase their compression ratios to get higher fuel efficiency, we're going to need more octane in the future.

People often look at us and say, "You guys are hypocrites because you're investing in an industry that has a subsidy or a mandate." That's not why we're invested. We're invested because it will be an important fuel of the future. The industry survives just fine without subsidies or mandates and we advocate for such policies.

G&D: Given your diverse set of businesses, it seems like you'd have a lot of insights into the current state of the U.S. economy and where it's headed. Are there any unique or interesting data points you look at to get a read on the health of the economy or to help you make investment decisions? For example, Warren Buffett often mentions railcar loadings as a good indicator of the health and direction of the economy.

"We don't spend a lot of energy trying to predict the future. That goes back to getting into businesses where you have competitive advantages, where you can build out a platform, and where you have optionality in what you do. Then you can adjust as things change in the economy. We're much more effective at doing that than spending time trying to predict the future."

SF: We look at our business over the next 20 years. We do not worry too much about short-term data points that might help explain our quarterly earnings. We worry about the long run and I will give you two examples.

First, many policies coming out of Washington are going to distort the economy in a big way. For example, the very artificially low interest rates that are being pushed on us by the government and the Federal Reserve are causing artificially higher asset values.

It's interesting to me that they're doing it as a response to a problem that they created in the first place with the exact same low interest rate policy that was there throughout the beginning of this decade. We now know that much of the investment following these low rates was unproductive and unprofitable. The Fed is making the same mistake over again.

We are very wary of assets with sky-high valuations. We are not tempted to invest in them because it's going to end badly.
Second, from a policy perspective, the EPA is promulgating policies through regulation that they can't get done through legislation, in my opinion. It makes it very difficult to meet the immediate demands of consumers

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when this happens. So, we look at the implications of those policies. Do we want to be an industry like that? If we can't get a permit to evolve our assets in a productive manner, it's a hard industry to be involved with.

Those are the macroeconomic things we look at. Short-term measures like rail loadings might help us manage working capital levels or something of that sort, but long term fundamentals are what matter most.

DR: Many companies embark on those things to try to predict the future, but we think the future is unknown and unknowable. So we don't spend a lot of energy trying to predict the future.

That goes back to getting into businesses where you have competitive advantages, where you can build out a platform, and where you have optionality in what you do. Then you can adjust as things change in the economy. We're much more effective at doing that than spending time trying to predict the future.

G&D: Going back to your comment on the Fed. Steve, how do you see the unprecedented Fed intervention ending, and what do you do as CFO of Koch Industries to prepare Koch for that eventuality?

SF: There are lots of ways to manage risk. One way to manage risk is simply not to take the risk. Here's an example. If you invest in an asset, you need to look at what the source of return is from that asset. If you're investing in a 10-year treasury, your source of return is almost 100% attributable to the duration of that security and very little attributable to credit risk. If you believe there's much more downside than upside because of all the manipulation, don't try to time it—just don't do it because you can't time it.

"We take some form of commodity and we'll process it through a very, very large plant that requires sophisticated technology and analysis to ensure that we have a competitive advantage."

We would rather invest where the source of the return comes from the capability or the innovation of a project or business. If that means taking on more illiquidity or duration risk, those risks are much more palatable in this environment than taking on interest rate risk. That's how we look at it. That's how we're trying to do it anyway (laughs).

What we're doing with the American Greetings investment ties into this idea. Although it is an interest-rate-sensitive security, the valuation of the investment will not move around very much because the primary source of return comes from the capability of the equity investors that we're supporting and the capabilities within their industry.

G&D: What is the thesis behind the American Greetings investment?

SF: Even though the industry demand trends are flat, they still create tremendous value for their customers. They have very strong relationships with their retail partners and long-term contracts with them. It is the most profitable single item that a grocery store sells on a per-square-foot-of-retail-space-required basis.

That's why the greeting card section still has massive

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amounts of square foot allocated to it, and it is prominently featured so you're likely to walk by it before you leave the grocery store.

A reporter commented to me on the day the deal was announced, "I still don't get it. The internet is taking over this whole space." And I said, "Not really, I don't think you're right. The facts don't bear that out. Let me ask you a question. Are you married?" And the reporter said, "Yeah, but what does that have to do with this interview?" I said, "Everything. Try sending your wife a text on her next birthday. Tell me how that works out for you!" And he said, " I kind of get it now!" (laughs)

When we see the value that's being created for their customers and the capability of the company to continue to create value through innovation, we're very comfortable supporting that investment and earning a return that's not 100% tied to the discount rate, but more tied to the capabilities that they have.

G&D: Can you share some of the biggest investing mistakes Koch has made and what you've learned from them?

SF: Well, this is going to use the rest of the time! (Laughs.)

I think our single biggest mistake was the polyester business that we acquired from Hoechst, a German company. We probably got back about 80% or 90% of the capital we put in the business. That's definitely a mistake when you don't get your capital back. In this case, we did not understand how significantly the Chinese economy had invested in polyester.

"The number one thing that appeals to the companies we talk to is our focus on the next twenty years, not on the next ninety days."

When the treaties between the United States and the other WTO countries were put in place, a lot of polyester started coming over to the United States. We had no idea how sophisticated these Chinese producers were and how much volume would actually land on our shores. It displaced a lot of capacity that existed here that we had just purchased.
We also didn't understand that the rate of learning within the industry had substantially accelerated. For example, a plant that once cost $500 million to build fell to $250 million within three years.

A couple key lessons came out of that acquisition: one was that we must have global knowledge systems, not just regional knowledge systems, and have a much greater awareness of how globally fungible our products are. Second, we must talk to customers, suppliers, and vendors before we do an acquisition so we can be attuned to the speed of the technological change within the industry.

DR: Another thing we've learned the hard way is how much debt we are willing to put on a deal. Too much leverage not only stresses a deal, but the associated debt covenants also limit your ability to invest for the long term. During downturns, you start to bump up against those covenants, and then you become very restricted in making good long-term decisions.

So you start making short-term decisions just to make it through the next quarter to meet those debt covenant metrics. We've learned that it's just inconsistent with our long-term philosophy, so we're

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going to be relatively conservative in how much debt we're willing to put on a deal. We don't want to be handcuffed in our ability to invest and do the right things for the long-term benefit of the business.

G&D: Corporate profits in the United States as a percentage of GDP are currently around 11%, which is at all-time high and well above the average over the last 20 years of about 7%. Do you guys expect a reversion to the mean, and how do you think about investing in an environment when asset values probably reflect these record-high profits?

SF: In this part of the business cycle, labor normally starts getting a bigger piece of the overall GDP via expansion of employment and wage rates.

There are a couple things happening that are different than in previous cycles, which have caused profits to be higher. First, U.S. companies aren't just competing with U.S. companies anymore; they're competing with global companies. Even though U.S. workers are much more productive, there is still a cap on our ability to pay more to stay competitive globally and to expand employment.

A second reason is the uncertainty caused by public policy coming out of Washington. If you don't know what the Affordable Care Act is going to do to your healthcare costs, for example, then it's hard to make the investments in new capacity that would get supply and demand back in balance. This puts upward pressure on prices in a supply constrained industry.

So ironically, the very policies that the federal government is promoting are causing the opposite of their intended effect on employment and wages. And, when supply and demand stay imbalanced, you're going to have higher profits by definition.

So that's why we're where we are as a country and corporate America. Will that change? Well, we hope so. We want less non-value-added bureaucratic regulation. We want the ability to take care of our customers.

This doesn't mean that all regulations are bad. But when you layer on regulation after regulation after regulation, it becomes extremely counterproductive. We have a lot of that right now.

Higher profits will reverse over time as new economies emerge and compete. Exchange rates will also eventually adjust and our prosperity will be challenged without change.

DR: Uncertainty is one of the biggest factors as to why you see these profit levels. For example, if you want to get a permit to build a greenfield facility or to expand capacity, you may be in the permitting process for five, six, or seven years.

To start committing capital to something which may not start for seven or eight years from now is a very, very high-risk bet because you don't know what the environment's going to be. You don't know what the supply and demand balance is going to be. You don't even know whether the product is going to be needed that far in the future.

So that dampens additional investment, which keeps capacity low and margins high. If only the U.S. does that, then all the manufacturing and production will eventually go to other countries that are more advantaged, and we'll be an importer.

SF: Look what happened to Wal-Mart just recently in Washington, D.C. where the city council tried to impose upon them a $12 minimum wage. So what happened? When that kind of regulation came in, Wal-Mart said, "We're not building."

Is that good for the consumers? The rest of the retailers have less competition, and prices will be higher. So profits are higher and labor is constrained. Those kinds of

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regulations are causing these high profits.

DR: It hurts the poor. The consumers are the ones who suffer the most because the goods they need just for necessities are more expensive.

SF: Any form of a price control causes this imbalance. In Venezuela, the former Chavez administration stipulated that, "The price of milk cannot exceed X." Guess what happens? There's no incentive for people to create milk. And there's no milk. It leads to scarcity. When you have scarcity, you have very high profits for the people that are left in the business, and that's happening on a much larger, more discrete scale here.

G&D: Is there anything else you'd like to add about Koch Industries' strategy in acquiring businesses?

SF: The number one thing that appeals to the companies we talk to is our focus on the next twenty years, not on the next ninety days. That unleashes companies to make different decisions that they don't get to make when they're a public company under the scrutiny of an investor base that's trading, not investing, in their shares.

We're talking to a company right now that is in the trough. Their industry is being significantly constrained because there was overbuilding and demand is weak. As a result of this temporary condition, this company is being forced to let go very highly skilled, great-culture-fit engineers within their company—people that in the long run would create much more value staying employed with the company than not. Yet they're letting them go because their investors are putting so much pressure on the management team that they have to reduce their costs to meet short term objectives.

So they're making poor decisions for the long run. Look at how disruptive that is. It's disruptive to the company because it is getting rid of capability that it needs. It's disruptive to the family of that employee that is being let go. We don't need to think that way here. We look at an investment in that kind of an employee as an investment in the long run. Let's find something that he or she can be working on until the market comes back. That is the number one thing that I talk to people about, and it's pretty compelling to them.

G&D: Dave and Steve, thank you for your time.

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