The ECONOMY

Bill Haney was once considered a lucky man. The Muskogee, Oklahoma, native worked for Safeway Stores, known as one of the best employers in the state. For 13 years he was the friendly dairy man, managing the perishable section and helping to close the store. Haney earned $10.68 an hour from his reliable union job, some $20,000 a year.

In Muskogee that was pretty good money. At 55, Haney had every intention of keeping that job for the rest of his working life. He had previously worked for Carnation for 22 years as a route salesman, but then the company pulled the plug on its Oklahoma dairy operations. Safeway was more reliable: it offered good health benefits, a three-week vacation, and cordial worker relations. He found the company lived up to its pledge to its employees: "Safeway Offers Security."

In the summer of 1987 Haney's world fell apart.

SOLD SHORT

By JONATHAN GREENBERG

When Wall Street feasted on the country's largest food chain, you weren't the only one to pick up the tab.

He knows very little about big-city financiers and their volatile takeover industry, but he knows that's why his supermarket was closed down and he lost his job. Six weeks later Haney was offered a job at another Safeway in town, working with high school kids carrying groceries to customers' cars for $3.50 an hour. He refused.

"To go back for three and a half and carry out groceries with all your old customers' seeing you—I couldn't take it," Haney says. "I was planning on the retirement but I just got left out completely. I've applied for other jobs in the area—I'd take anything —but I'm at the age where no one wants to hire me. So now I set here, 55 years old, in my own prison, looking at four walls when I'm used to working. Takeovers are ruining the country. It's a raw deal."

Safeway Stores, headquartered in northern California, was founded in 1926 and for decades was managed as somewhat of a family fiefdom. One of the organizers was Merrill Lynch cofounder Charles Merrill; Merrill's daughter married Robert Magowan, who took over in 1955. By the end of his reign, in 1971, Magowan had built what was by 1972 the world's largest grocery chain. But in the late 1970s competition heated up, and Safeway stagnated: it was slow to switch to optical checkout scanners and the large "superstore" format with lucrative specialty departments that were drawing shoppers to other stores. Profit margins dwindled and Safeway stock drifted toward the bottom of industry listings for "return on equity" performance.

In 1980 Safeway directors passed over a host of more senior executives to name Magowan's 37-year-old son, Peter, as chairman. Peter Magowan was determined to restore Safeway's financial health. "[He is] obsessed with leaving a mark. He wants to be the Lee Iacocca of the grocery business," says a former associate. The new boss worked to squeeze higher profits out of the company without sacrificing its reputation for service. He closed a few of the least profitable divisions and upgraded existing operations. A healthy balance sheet carried moderate debt and plenty of capital for expansion. In 1985, the company earned $231 million on revenue of $20 billion. Annual dividends came to $98 million, giving stockholders a yield of about 5 percent.

Within five years the stock price doubled. Yet the speculative boom pushed the price of other giant food retailers even higher. Many competitors weren't unionized, so their costs were lower and their profit margins higher. To a lot of investors, Safeway as an ongoing business lacked pizzazz. Yet to Wall Street wolves, it was an underpriced "asset play." Beneath its 2,365 expensively equipped stores the company owned or leased valuable land. Safeway also had the industry's highest wage structure. By selling assets and pressing for large payroll concessions, a tenacious raider—a raider such as Robert Haft—could make a lot of money.

The downfall of Safeway began with Haft, then 33, the smooth-talking president of an outfit one-sixtieth the size of Safeway. Like many other recent graduates of the Harvard Business School, Robert Haft thinks of corporate raiding as the country's greatest get-very-rich-very-quick industry. On May 15, 1986, armed with a borrowed bankroll and his own secret analysis that said Safeway's assets were worth 50 percent more than the overall value of its stock, Haft ordered brokers in New York to buy up 3 million shares (4.9 percent) of Safeway stock at the publicly traded price of $37 a share.

As with all his major corporate decisions, Haft had the go-ahead from his father, Herbert, to make a run on Safeway; the family team runs the Dart Group Corporation, based in Landover, Maryland, which owns two large cut-rate chains, Crown Books and Trak Auto.

Using Dart as their chief investment vehicle, the Hafts have become among the nation's most successful corporate raiders; the family is worth an estimated $675 million. They inspire takeover panics by purchasing sizable chunks of stock in publicly owned companies and threatening hostile buyouts. Speculators drive prices up, and by the time the Hafts accept a deal to withdraw, the value of their holdings has soared.

In the takeover game, risk-loving arbitrage traders, who stake out multimillion-dollar positions in companies targeted for hostile takeovers, are the wildest players. The "arbs" marked Safeway "in play" and pounced on its stock, expecting that eventually Safeway's management or a raider would make a "tender offer" to buy the shares back at a premium. This drove the price higher, and Magowan couldn't stem the tide. Nor would he relinquish control without a fight. His

Meanwhile, back at the IRS...

In all likelihood, the Safeway buyout cost U.S. taxpayers more than $100 million in 1987; eventually the tax burden may amount to more than $500 million. In 1985, the last year Safeway was publicly traded, the company paid $28 million in federal taxes on net income of $231 million. In the first nine months of 1987 the new Safeway Stores, despite more than $300 million in operating profits, reported a loss of $103 million. Under U.S. tax law, a company can deduct interest payments from profits before it pays taxes, and with $4.3 billion in additional debt, Safeway has plenty of interest to pay off. It will probably be ten years before Safeway pays taxes again.

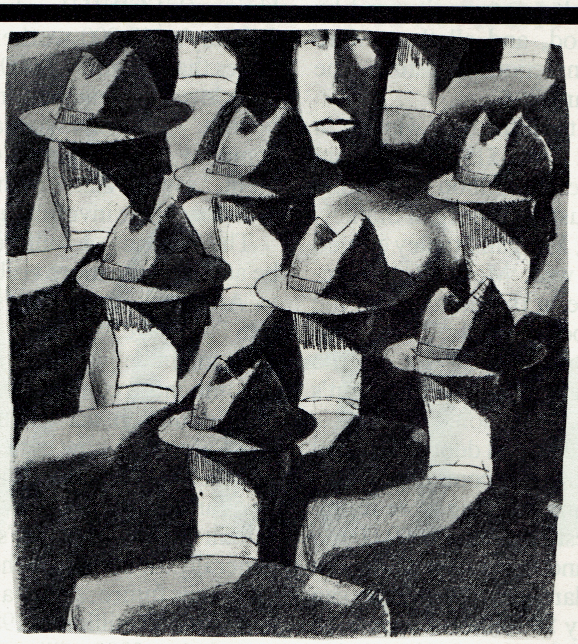
It will also have a wealth of excess tax credits to use up. The company's excess "income tax benefit," estimated at over $70 million for 1987, more than offset the taxes it owed the government on the sale of hundreds of stores. Safeway's new owners will therefore receive enormous tax advantages for transforming thousands of productive people from taxpayers to tax liabilities as they turn to unemployment and welfare.

Arguably, those who receive Safeway's interest payments—who hold its debt—will eventually have to pay taxes on *their* income, but the typical creditor is generally a financial institution such as a bank or pension fund, which either pays no taxes or has its own tax loopholes, so it's unlikely that this will ever amount to much. And Safeway no longer pays cash dividends to shareholders; in 1985 the company paid out $98 million, most of it taxable. —*J.G.*

father had died only five months earlier; to lose the company at that point would have been a profound humiliation.

Magowan did not fight alone. He responded with the strongest allies money could buy. Attorneys from the country's best-known corporate defenders—Wachtell, Lipton, Rosen & Katz—were imported from New York for top-level meetings in Safeway's Oakland offices. Those lawyers eventually were joined by financial advisers from Merrill Lynch, Morgan Stanley and Company, and Bankers Trust Company.

The experts came up with several choices: the company could try to force its stock price above what a raider would want to pay, by "recapitalizing"—buying back millions of its own shares on the open market. It could plan a "leveraged buyout," borrowing the billions necessary to purchase all of Safeway's stock and go private. It could impede a prospective buyer with technicalities its experts had worked into the corporate bylaws, or find a friendlier buyer (a "white knight").



MORE ***was spent on takeovers in 1987 than the total profits of America's top 500 companies.***

By June 6 the stock price was $47, up from $37 a few weeks earlier. And the Hafts kept on buying. By mid-June they owned 5.9 percent of Safeway, and by law they had to disclose their identity. Backed by Drexel Burnham Lambert, they were ready. Drexel had found fame in touting "junk bonds," the high-risk, high-yield instruments of corporate debt that have fueled the spread of takeovers. The firm was willing to raise $3.5 billion to enable Dart to purchase all of Safeway's stock.

"The Most Feared Family in Retailing," as the Hafts were dubbed by *Fortune* magazine, had a reputation for sacking top management and milking corporate assets when taking control of a company. With time running out, Magowan, whose salary, bonus, and perks came to $925,000 in 1986, was advised that a more friendly acquirer could be persuaded to move in and keep the top brass in place. The knight who would save a Safeway in distress—the New York–based Kohlberg Kravis Roberts & Co. (KKR)—was a specialist in such rescues, and the firm agreed to a leveraged buyout. KKR would simply outbid the Hafts, borrowing billions to buy up all the publicly held shares. Magowan and dozens of his top executives would be assured of their jobs and would receive a free option to buy 10 percent of the new company for just $2 a share.

KKR thrives on such action. The partnership of Jerome Kohlberg, 62, Henry Kravis, 44, and George Roberts, 44, was formed in 1976, and since then the trio has engineered nearly 30 buyouts. Each partner has accumulated at least an estimated $500 million. Despite last October's stock market crash, their $5.6 billion corporate takeover fund, the nation's largest, has not dwindled. When the Hafts heard that KKR was in the wings, they raised their bid to $64 a share, the highest offer they could justify. On July 24, KKR produced a counteroffer roughly equivalent to $69 a share.

The company's fate was in the hands of Safeway's 13 prestigious outside directors, among them the presidents of BankAmerica, Shell Oil, and Apple Computer. The directors could have spurned both offers, but in the final analysis they had to sell the company to one of the two. "It's a dollars and cents investment figure," says Mary Gardiner Jones, a member of the board who had served on the Federal Trade Commission and then set up a consumers' research group in Washington. "You don't have much discretion to think about whether it's a good idea, whether it's going to be good for the community or the country in the long run."

With his job and those of 172,351 workers at stake, Peter Magowan chaired several long, tense meetings. The Hafts declined an invitation to go higher, and on July 25 the board accepted KKR's bid. The Hafts did not go away empty-handed, though. In exchange for withdrawing, they got a special option that eventually brought their profits to $140 million on a three-month, $149.5 million investment.

Few miracles of modern financing can surpass KKR's leveraged buyout of Safeway. It came up with just $130 million in equity, most of it from its investors' $5.6 billion buyout fund, to acquire a $4.3 billion company. KKR's partners own a share of Safeway and have already pocketed far more than they personally invested. That's because KKR received $60 million in fees from Safeway, plus expenses, for engineering the buyout. It

Illustration by Whitney Sherman

also receives $500,000 a year in consulting fees. And KKR will get 20 percent of the profits its investors make, which in itself may someday net the partners more than $200 million. (The Safeway coup was just one of three major leveraged buyouts engineered by KKR within a 12-month period, and all three were among the five largest such transactions in history. The Safeway deal was the second-largest.)

KKR was the big winner, but not the only winner, in this "rescue." Drexel received some $15 million from the Hafts, plus a portion of the $51 million in banking fees it shared with Bankers Trust and Morgan Stanley. As KKR's investment bankers, Morgan Stanley earned a $10 million advisory fee as well. Merrill Lynch received $14.8 million for its role in the drama, and the lawyers and accountants reaped a cool $25 million. Tacking on $2.7 million in printing bills for all the documents, the total price tag for the white knight's shining armor came to nearly $200 million.

To pay off Safeway's new $4.3 billion debt, KKR and Magowan had to sell off part of their company. In the search for immediate profits, an operating store represents a valuable piece of real estate, about $200,000 to $500,000 worth of inventory, and more than $1 million worth of equipment. A standard-size open store can earn nowhere near the roughly $2 million it would be worth to the company, or a buyer, closed. Since being bought out, Safeway has sold or closed more than 1,100 of the 2,400 stores it owned when it was a public company. As Peter Magowan said, "There's so much debt in a leveraged buyout that you have to look at your assets in a cold and calculating way."

THE HAFTS' RAID ON SAFEWAY WAS PART OF A WAVE OF corporate takeovers and buyouts that started in 1974. Years of high inflation had increased the value of most corporations' assets beyond the value of their stocks, making it cheaper for growth-hungry companies to buy than to build. Fueled by Reagan's anti-antitrust policies, the enthusiasm reached new heights in the '80s. In 1982, *Forbes* magazine's original list of the 400 wealthiest Americans included 19 who had made their $100 million–plus bundles in "finance"; by 1987, the number was 69. For *New York* magazine, these "economic engineers" were the "rock stars of this decade."

In 1987 at least $165 billion was spent on takeovers, more than the combined profits of the nation's 500 most profitable companies. During the last five calendar years, at least $700 billion went into takeovers, producing staggering debts and virtually no new jobs, new plants, or new products. In the words of Arthur Taylor, dean of Fordham University's Graduate School of Business, "Where companies exist to produce [takeover] fees rather than to produce things, it is a distortion of the system." Companies take on crippling debt by acquiring other companies just to avoid being swallowed up.

Corporate restructuring and takeovers have put an estimated 500,000 people out of work during the past three years alone, and unemployment is only one consequence. Millions of American workers have had to accept lower wages—and shattered expectations. The United Food and Commercial Workers International Union (UFCWIU), which represents 90 percent of Safeway's 110,000 workers in the United States, estimates that roughly 37,000 Americans will have substantially lower-paying jobs or no jobs at all as a result of the buyout. "The employees also have an investment in the company, an investment of time, energy, and commitment," says Al Zack, of the UFCWIU. "They deserve a return on their investment as well."

The burdens of welfare and unemployment have to be added to the more visible cost of the Safeway buyout to American taxpayers (see "Meanwhile, Back at the IRS . . ." page 38). Some losses in revenue, and even of jobs, might be justifiable if takeovers helped companies become more competitive. Yet a close look at Safeway casts doubt on that claim. Peter Magowan maintains that Safeway is now better able to position itself for the future. "As a private company," he told the local press, "we can concentrate on what is good . . . long term." Yet a look at the company's capital expenditure budget, generally thought to be the best barometer of a retailer's faith in its future, shows a plummet from $550 million in 1986 to $300 million in 1987, and this year it is expected to go below $200 million.

Senior management at Safeway is assiduously upbeat. After telling *Mother Jones* that sales and profits are up in those stores Safeway has not sold, Safeway senior vice president Robert Bradford said, "We have every confidence that we will be successful in the future, and that anyone who shares that belief by investing in Safeway will be handsomely rewarded."

Magowan has indicated that eventually KKR plans to sell a portion of Safeway to the public again. Selling stock would raise much-needed cash to offset some of the corporate debt. It would also mean that the managers of Safeway's buyout, and Magowan himself, would make a tidy bundle. Last year, the chairman and 35 other Safeway executives began to exercise their option to buy 10 percent of the company at only $2 a share, and Magowan now owns nearly 2 million shares. When the company goes public again, this stock will be worth tens of millions of dollars—more than the total severance pay for the 10,000 workers Safeway fired in 1987.

Still, this will seem like small change when compared with the value to Kohlberg Kravis of its low-cost, highly leveraged buyout. KKR's 65 million shares of stock in the company, once it goes public, are likely to be worth well over $1 billion. Beneath the rhetoric of the Reaganites' "anything goes" brand of capitalism, this will be the true bottom line of the Safeway buyout—and hundreds of corporate takeovers like it.

Jonathan Greenberg, formerly a Forbes *reporter and* Manhattan, Inc. *contributing editor, specializes in business journalism.*