Round #59: Drexel Burnham Lambert: Godfather of Private Credit

The Rise and Fall of Drexel Burnham Lambert

DEBT SERIOUS
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In Round #59:

1. Thank you!
2. History of Drexel
3. Bulletin Board

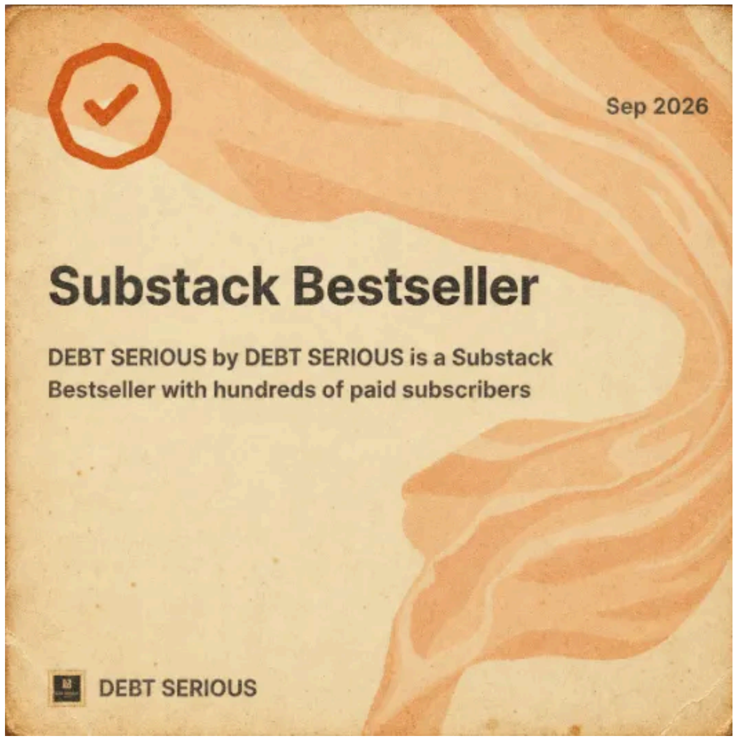
Disclaimer: *there are 4,600+ of us here discussing private credit and leveraged loans, which is not a big world. At some point, I will probably throw punches a your company. I am blunt and sarcastic and, as friends like to remind me, too mouthy to live to an old age, so my take likely won't please you. But don't worr next week it will be someone else in the spotlight and you will quietly nod alo in satisfaction.*

Also, none of this is investment advice.

1. Pop the Champagne

So, last week I received an email from Substack notifying me that DEBT SERI had become a bestseller by reaching 100 paid subscribers.

What I find fascinating about this is that the newsletter is free, yet somehow 1 of you still decided to enter your credit card information. Now, even if we assu that half of those are my Mom's fake accounts, created to boost her beloved so ego, that still leaves 50 of you lunatics doing me a solid.



Jokes aside, I am really (really) grateful. I can now finally show my wife proof that I'm not just locking myself in my office to watch movies all day instead o spending time with the family.

2. Drexel Burnham Lambert: Godfather of Private Credit

This week's letter is a bit different, as I've primarily focused on one piece that wanted to write for many months. It all started when I came across the graph below on social media, which traces the roots of many of today's leading priva credit firms back to Drexel Burnham Lambert.

It is pretty stunning how significant Drexel's legacy is, and this list is far from complete. Just off the top of my head, I know that Mitch Julis and Josh Friedn founded Canyon Capital after leaving Drexel, while Drexel's alumni also incluc David Solomon (CEO of Goldman Sachs), Rich Handler (CEO of Jefferies), and K Moelis (founder of Moelis & Co). I'm sure some of you will add other notable names in the comments that will blow my mind.

Most people, myself included, know Drexel mainly for Michael Milken and jur bonds. And also that Drexel collapsed, proving those bonds really were junk. E as debtageeks, we need to know more than that, so we'll get into the company origins in the early 19th century, its growth and evolution, and, of course, Milken's role in its failure in the 20th century. It's a long read, so plan accordingly.

THE BEGINNING

Drexel, Francis Martin

It all starts with **Francis Martin Drexel**, who, according to Wikipedia, was bor in Austria in 1792 into the family of a successful merchant. He studied langua later became a painter, but had to leave the country to avoid mandatory conscription. He eventually moved to Philadelphia, and in 1837 founded a ban because, I guess, that's the typical career progression for painters, right?

Fortunately, Drexel's son later founded Drexel University, which eventually ha bunch of people dig into the founder's family history, giving us a much more detailed biography of Francis. So, let's fill in the blanks.

The languages and the painting parts initially read like Francis was studying liberal arts college. In reality, when Francis was 11 years old, his father sent hi to Italy to study French and Italian, preparing him for a future career in the family mercantile business. But two years later, Napoleon invaded Austria, annexing the Drexel family's home state of Tyrol, which led to an economic collapse that ruined the Drexels' business. The family could no longer afford Francis' education, so he returned home.

With the family business gone, Francis obviously no longer had any expectati of following his father into the mercantile business, leaving him free to pursu his passion for painting. For the following several years, he worked as an apprentice to a local painter.

When Francis was 17, the state of Tyrol rebelled against Napoleon's rule, and t French emperor returned to fight the resistance. Given Francis' age, he was eligible for conscription into Napoleon's army to fight against the Austrian resistance, so he escaped to Europe and spent the next five years moving arou the continent, making money as a painter. Was he a good painter? Well, below his self-portrait, and with my finance degree, I can tell you he knew what he v doing.

Francis briefly returned home after the fall of Napoleon, but soon departed aga working his way around Austria and Switzerland, until he ultimately decided try his luck in America.

In 1817, the 25-year-old Francis arrived in Philadelphia. He continued earning money as a painter, but also started holding exhibitions and teaching art at a seminary. Over the next decade, he married and had three children: a daughte Mary, and two sons, Francis Anthony and Anthony Joseph (he later had a thir son, Joseph William, and if you write the names one after another, you'll notic the algorithm behind how he came up with them).

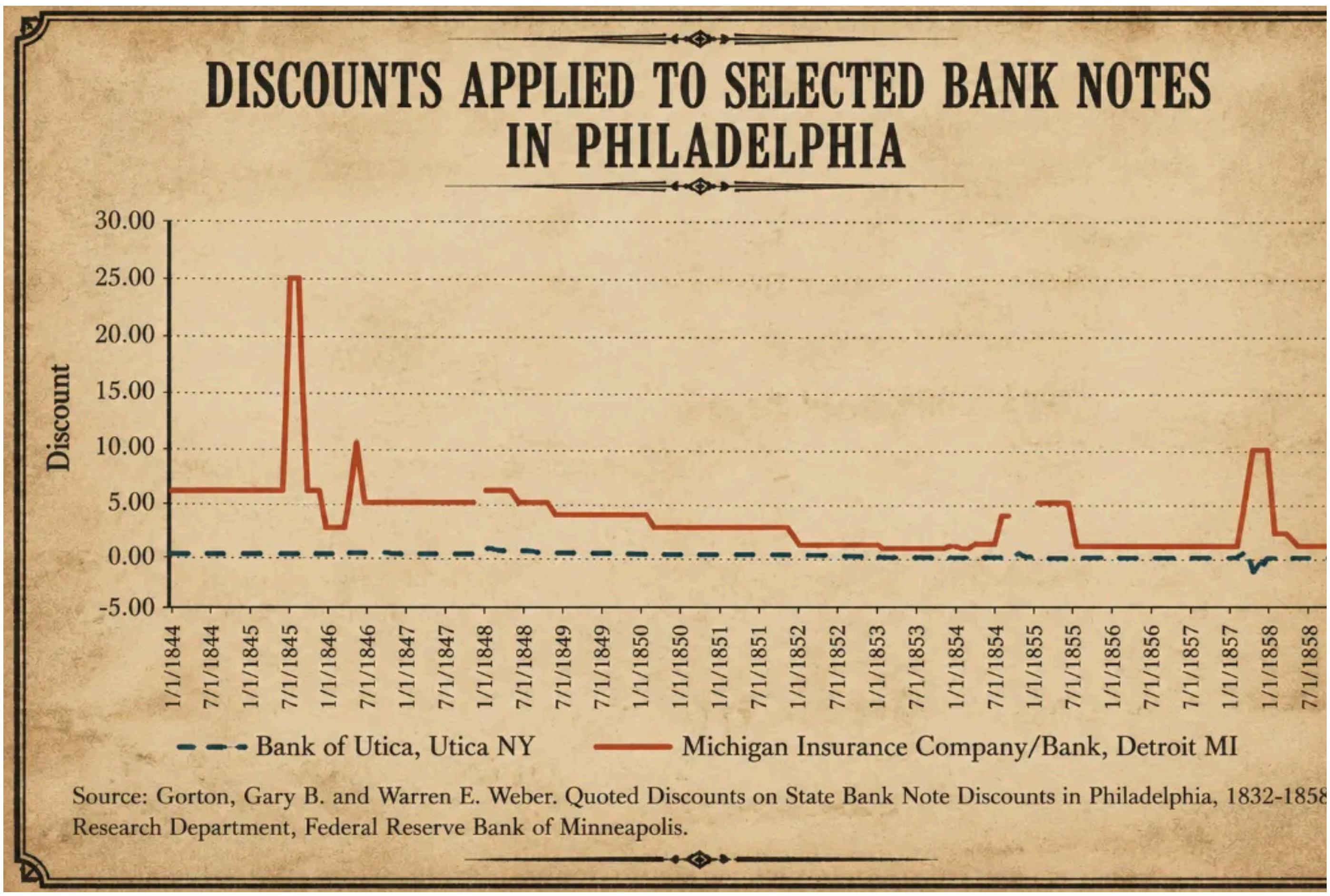
Right before Anthony Joseph (remember this guy) was born in 1826, Francis moved to Latin America for painting work, while his family remained in America. If by now you're thinking Francis was a broke painter wandering around the world in search of himself, don't. He was actually quite entrepreneurial, constantly coming up with new ventures, including an antiqu shop and a brewery. Neither worked out exactly as planned, but they showed t he had some business instincts beyond painting. Even on his trips to Latin America, he managed to secure commissions to paint the luminaries of the countries he visited, including Simón Bolívar (the "Liberator" of South Americ and Bernardo O'Higgins ("founding father" of Chile). More importantly for wha comes later, his travels around the world made Francis very comfortable deali with foreign currencies.

In 1837, at 45 years old, Francis returned from another trip to South America a made a permanent career change. He moved his family to Louisville, Kentuck where he founded a currency brokerage (exchange), leveraging his knowledge foreign languages and both foreign and national currencies. Things just got re

Louisville grew rapidly as a transportation hub in the 1830s after the Louisvill and Portland Canal opened. By letting boats bypass the dangerous Falls of the Ohio River, the canal created a single, uninterrupted water route connecting Pennsylvania, Ohio, and Louisiana. With boats now able to travel freely, trade the city boomed.

Even more significant, the period in the US from 1837 to 1863 is known as the "Free Banking" era. There was significant growth in state-chartered banks ba on simplified regulation. Each bank was allowed to issue its own currency, a bank note, which, of course, was the bank's obligation and had to be backed b collateral. These bank notes were redeemable at face value for gold or silver u being presented to the issuing or correspondent bank they contracted with.

However, because there was a significant number of banks with their own currencies and different financial health and regulatory regimes, exchanging one bank note for another was problematic. In the absence of the issuing or corresponding bank in close proximity, these bank notes could only be redeem by a third party at a discount to their face value (similar to modern-day factoring), and discounts varied widely. Look at the chart below, which compa the discounts on Bank of Utica (barely any) and Michigan Insurance Company/Bank (up to 25%).

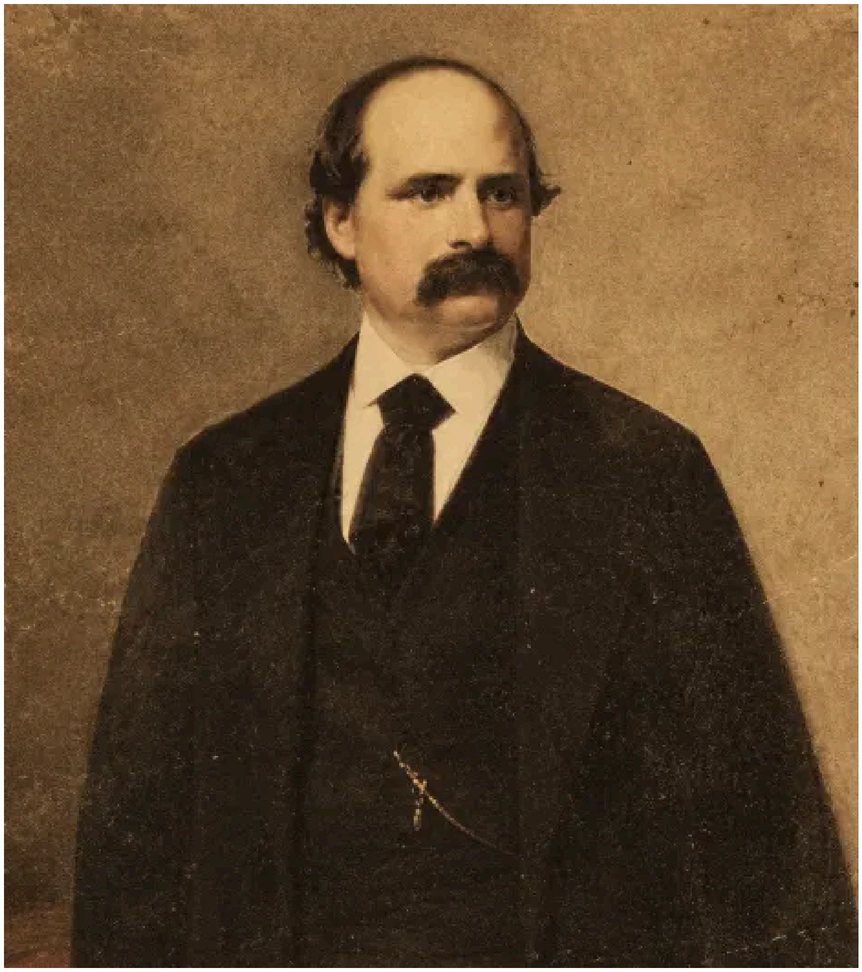


So, besides traditional foreign currency exchange, Francis' firm was engaged i these factoring-like transactions. Within a year, the business started prosperi and Francis moved the family back to Philadelphia. Then he started his signature enterprise, his bank, Drexel & Co.

Drexel, Anthony Joseph

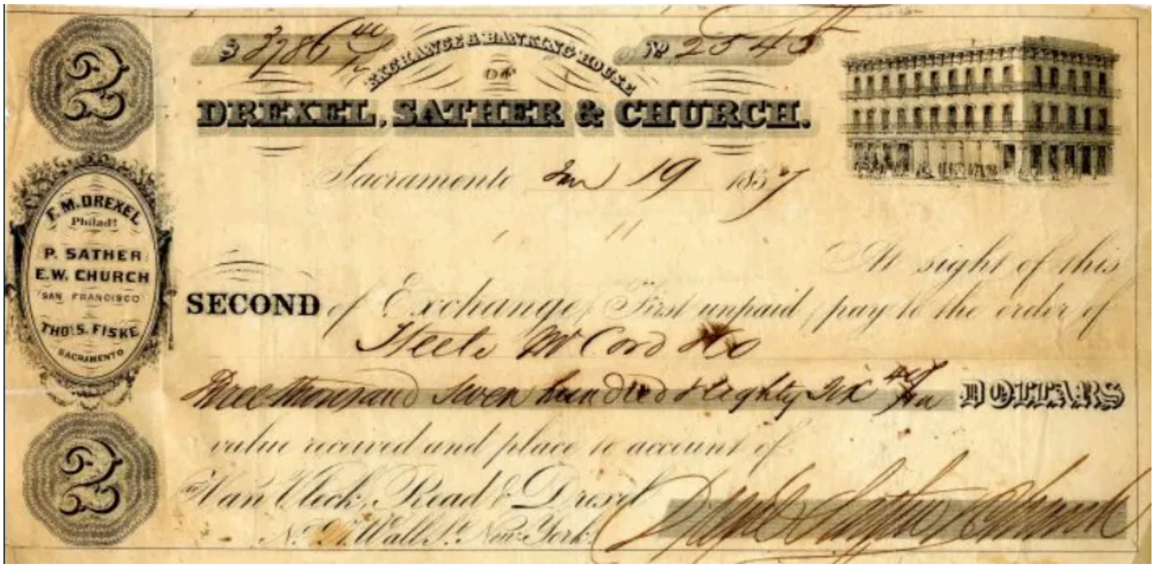
Before I continue, you are about to meet possibly the most powerful and consequential financier the U.S. has ever seen, yet whose extreme privacy ke him largely unknown to the public (certainly to me… I discovered him two da ago). By complete coincidence, this post will go live almost exactly 200 years after his birth on September 13, 1826.

In 1839, when Francis's sons, Francis ("Frank") Anthony and Anthony Joseph, turned 15 and 13, respectively, they joined their father's bank as clerks. Althou both boys had received an excellent education up to that point, studying at French and English boarding schools, Francis pulled them out of school to ass with the bank, where he taught them how to trade currencies, deal in securitie and, importantly, finance the gigantic projects that would come Drexel's way i the not-too-distant future. Although the brothers were still boys, they worked l adults and received no special treatment: they came in early and stayed late, a cold dinners at the counter, and often slept underneath it, serving as night watchmen.



Nine years later, Frank and Anthony became partners at the firm, following a spectacular period of growth that transformed it into a well-known private ba that financed everything from railroads to the Mexican-American War of 1847 when it sold $49m of Treasury bonds to raise money for the country. Going fro a currency exchange to a government financing bank within 10 years was, by any measure, an impressive achievement, and the brothers played an importa role in making it happen.

Although Anthony was the younger of the two, in Francis's absence, he would assume leadership of the bank. So, when Francis went to San Francisco to expand the firm's business during the Gold Rush, launching the Drexel, Sather Church partnership, Anthony became the de facto head of Drexel & Co.



During the American Civil War, Anthony played a major role in financing the Union army by partnering with financier Jay Cooke. Together, they came up w a creative approach for the time: buying government debt and selling it to ordinary citizens, instead of financing it through foreign governments and wealthy individuals. Anthony eventually became a lifelong friend and advisor Ulysses S. Grant, who offered him the position of Secretary of the Treasury, bu Anthony declined.

After his father's tragic death in a railroad accident in 1863, Anthony continue expand the bank's reach. In 1868, he founded Drexel, Harjes & Co. in Paris, whi helped create a financial link between Europe and the U.S. and allowed Europ investors to invest in America. Just three years later, the firm played an important role during the Franco-Prussian War, helping the French governme both diplomatically and financially in the aftermath of the war.

Perhaps, I was a bit hyperbolic when I called Anthony the most powerful and consequential financier in U.S. history. That title is probably better reserved fo John Pierpont (J.P.) Morgan, who was so influential that he was credited with helping save the country during the financial panic of 1896 and went on to dominate American corporate finance throughout the Gilded Age and Progressive Era. But without Anthony Drexel, there would be no J.P. Morgan a the world knows him. In fact, J.P. Morgan ruled American finance during the Gilded Age from the offices of Drexel, Morgan & Co., where he was a junior partner and Anthony Drexel's protégé. Below is an excerpt describing how the partnership came together (emphasis mine).

> Pierpont had first met "Mr. Drexel" just two years before. Anthony (Tony) Drexel, then 44, had built his father's Philadelphia-based currency brokerag Drexel & Co., into an influential private bank with branches in New York an Paris.
>
> Pierpont Morgan, then 33, was both sickly – suffering from headaches, fati insomnia and fainting spells – and heartily sick of his New York banking partnership, which seemed about to fold anyway. Junius Morgan [Pierpont' father] had written to Tony to suggest he take Pierpont on as a partner in Drexel's New York office, thus establishing an alliance between the Drexel f and his own based in London. He then wrote to Pierpont asking him to mee with Drexel.
>
> Drexel was as impressed with Pierpont as Junius hoped he would be. Drexe not only offered Pierpont a partnership, he offered to re-organize the New Y office as Drexel, Morgan & Co. with the Drexel family putting up almost all t money. **Pierpont told Drexel that he'd been considering retiring to the life o gentleman farmer (money being no obstacle) and, at the very least, felt he needed a year off. Drexel said that if Pierpont accepted his offer, he could have his long vacation and a bright future on Wall Street, too**.
>
> And so it was.
>
> For more than 20 years, Tony Drexel visited Pierpont Morgan in New York weekly, usually on Monday, to make recommendations and suggest guidelines. And when Drexel died in 1893, Morgan, then age 56, wrote to a

> friend: “I am at a complete loss to know how I am going to get along withou him.”

Drexel, Morgan & Co. opened its doors in 1871 and eventually moved into an iconic building at 23 Wall St. (below), across from Broad St., where the House c Morgan stands today.

Anthony was an extremely private person who never gave interviews or speeches (even deliberately destroyed his personal papers), so J.P. Morgan became the public face of the partnership, which helped propel him to prominence.

Beyond building his father's bank into a global powerhouse, Anthony left seve other legacies. The most famous was Drexel University. Perhaps the most unexpected was his role in raising and mentoring his niece, *Katharine Drexel*, the daughter of his older brother, Frank. Katharine's mother died shortly after was born, and for the next two years, until Frank remarried, Anthony and his wife cared for her. Anthony remained a mentor and influence in her life as sh grew older and eventually devoted herself to apostolic work. She founded the Sisters of the Blessed Sacrament and spent her fortune supporting people in need. In 2000, Pope John Paul II canonized her, making her the second saint b in the United States.

Drexel Without Drexels

In 1895, after Anthony's death, Pierpont changed Drexel, Morgan & Co's name t J.P. Morgan & Co. and the Paris office from Drexel, Harjes & Co to Morgan, Harj Co. The Philadelphia-based Drexel & Co retained the name, but was operated a an affiliate of J.P. Morgan.

There was nothing notable about the company for the next 40 years, but when the Glass-Steagall Act was passed, requiring commercial and investment banking to separate, J.P. Morgan & Co. became a commercial bank. Not related our story much, but during that Glass-Steagall saga, 17 partners from J.P. Morg and Drexel & Co. resigned, including W. Ewing, H. Stanley, and H. Morgan, and started an investment bank… drum-roll… Morgan Stanley.

So, Drexel as a standalone entity ceased to exist, but in 1940, a couple of forme Drexel partners and associates formed an investment bank and acquired the rights to the Drexel name from J.P. Morgan. The firm, although profitable, grew very slowly during its first 15 years and never quite made it to investment banking's first tier. Yet, it maintained close ties to many of the nation's biggest securities issuers and was only one notch below the leading firms on Wall Str

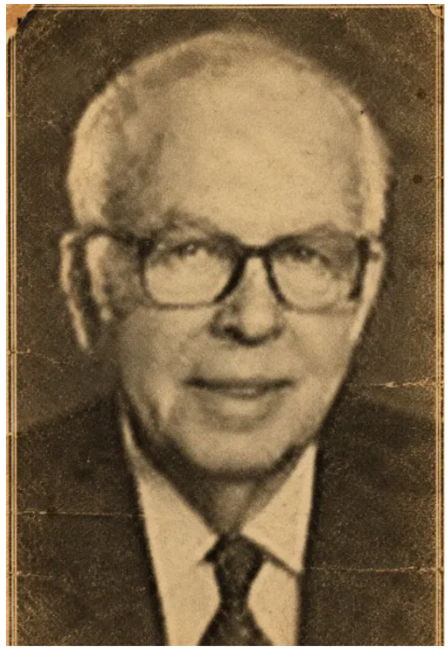
In 1965, Philly-based Drexel merged with another investment bank, NYC-based Harriman, Ripley & Co., which itself was a product of Glass-Steagall, having be carved out of Brown Brothers Harriman. On paper, it looked like a perfect matc with very complementary businesses. Drexel was strong in research and mon management and was focused on smaller and mid-sized clients. Harriman Ripley was focused on larger clients and the products that came with them, lik sophisticated capital raising. The merger was also supposed to give Drexel a stronger New York presence and a broader investment-banking platform.

In practice, though, the merger wasn't properly executed, due in part to differe cultures. As a result, some partners left, taking clients and capital with them.

Drexel Harriman Ripley carried on for a few years, but when it needed liquidit in 1970, the tire company Firestone acquired a 25% stake in the firm (yeah, go figure). The firm changed its name to Drexel Firestone, and that's where we'll leave Drexel.

Burnham

Isaac Wolf Burnham II, better known in the finance world as I.W. "Tubby" Burnham, was born in Baltimore in 1909. His father was a doctor, while his grandfather founded I.W. Harper, a Kentucky distillery that produced a premiu whiskey brand (now owned by Diageo). During Prohibition, I.W. Harper was or of just 10 distilleries permitted to remain in operation after receiving a license produce bourbon for medicinal purposes.



Tubby didn't establish a university, and as such, there is less information abou him. Still, there is enough available to get a sense of who he was. At 15, Tubby contracted typhoid fever and was advised by a doctor to gain 50 pounds to hel him recover. He eventually recovered and lost the excess weight, but the nickname stuck.

When the market crashed in 1929, Tubby was a student at Wharton. After graduating two years later, he joined his uncle's finance firm on Wall Street. Fc years later, he used $4k of his savings and a $96k loan from his grandfather (which he later repaid) to launch Burnham & Co. The investment bank grew substantially over the following decades and developed a reputation as a successful and profitable firm. But its main disadvantage was that it lacked th prestigious "white shoe" image associated with Wall Street's established firms

Lambert

I'm not going to go all the way back to the 1800s, when Samuel Lambert worke as a banker at Rothschild's Brussels branch. Suffice it to say that he eventuall founded the influential Banque Lambert in Belgium.

Two centuries later, in the 1950s, Samuel's great-grandson, Baron *Leon Lambe* (Baron being his title, not his first name), inherited the family business. He we on to become a serial acquirer of financial firms, eventually transforming the boutique bank into Belgium's second-largest bank.

In the 1970s, he began expanding into the U.S., taking a stake in William D. Witter, Inc., which was eventually renamed Lambert Brussels Witter.

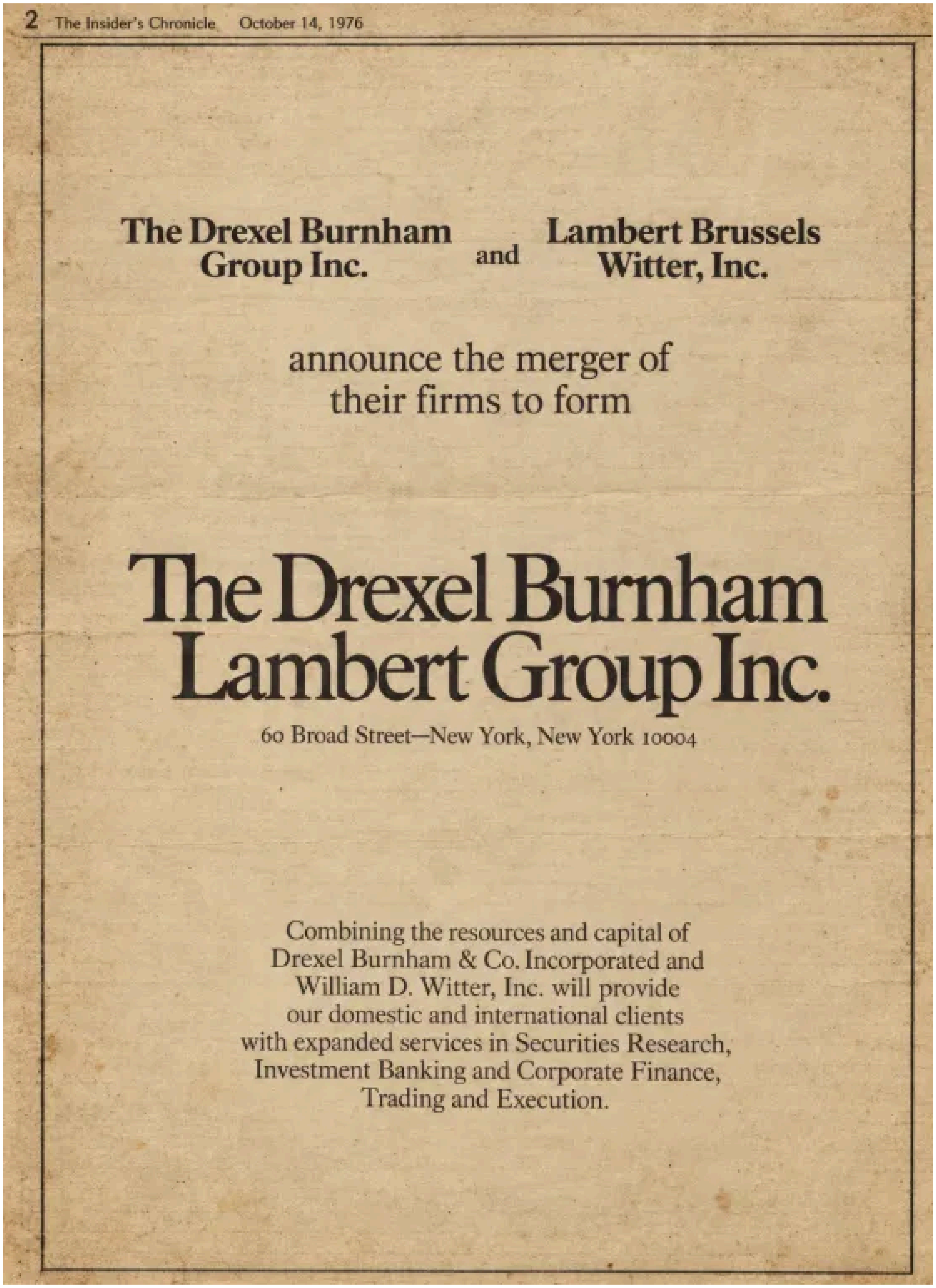
I'm not giving Leon the attention he deserves here, as his remarkable career ar tragic end are themselves worthy of a standalone piece.

Now, if the name Witter sounds familiar, it should. Dean Witter was the brokerage that later merged with Morgan Stanley, and William D. Witter was t son of its founder, Dean Witter. William had worked at his father's firm before striking out on his own. Yes, the number of interconnections in this piece mak me dizzy.

Drexel Burnham Lambert

As I mentioned above, Burnham & Co. was doing very well financially, but it didn't have that "white shoe" image. Drexel Firestone, on the other hand, had t opposite problem: even though it was not a tier-one investment bank, the Drex name was prestigious and had a rich history, while the firm had literally taken money from a tire company to stay in business. So, I.W. Burnham approached Drexel about the merger, and in 1973, the Drexel Burnham Group was formed.

Then, three years later, Drexel Burnham merged with Lambert Brussels Witter and the thesis behind that deal is shown in the announcement below.



And with that, Drexel Burnham Lambert was born.

DREXEL & JUNK BONDS

Michael Milken

Michael Milken was born into a middle-class family in Encino, California. His father was an accountant and a lawyer, while his mother was a homemaker. Milken later joked that anyone whose family owns an accounting firm starts working on balance sheets and taxes at eight years old, and he was no excepti It is therefore not surprising that he became interested in math and science at early age. After reading every comic book he could get his hands on, 11-year-o Milken wrote a letter to President Dwight D. Eisenhower saying he was ready lead the United States into space. He never received a response.

His interest in STEM ultimately led him to UC Berkeley in 1964, where he studied... well, physics and math. However, he later switched his major to business. Milken said the reason for the switch was that he witnessed the Wa riots in Los Angeles in 1965, which made him realize that opportunities were spread equally across the country and led him to develop a mission of making financial markets accessible to more people.

At UC Berkeley, Milken came across a widely overlooked book, W. Braddock Hickman's *Corporate Bond Quality and Investor Experience*, which contradict the common perception that markets adjust yields based on risk. Hickman's survey of yields and defaults from 1900 to 1943 concluded that investors usual overestimated the risk of higher-yielding bonds.

After graduating from UC Berkeley in 1968, Milken went straight to Wharton f his MBA, where his interest in high-yield bonds became an obsession. He eventually became convinced that careful research and diversification could make a portfolio of high-yield bonds attractive, with the higher interest payments more than compensating for the additional risk. Milken focused on factors that rating agencies overlooked, placing greater emphasis on a compa future prospects than on its historical performance.

At the recommendation of a Wharton professor, Milken began working part-ti at Drexel Harriman Ripley. His first initiative was to organize overnight delive of securities, which saved the company $500k a year. Showing that he could a value, he was invited to join the firm full time, which he did after completing h MBA the following year. By then, as you'll recall from above, Drexel Harriman had become Drexel Firestone.

Theory to Practice

At Drexel Firestone, Milken joined the firm's high-yield bond research department and quickly became its director of research, largely because few people were interested in that line of business. His mandate extended beyond high-yield bonds, however, and would today be better described as distressed and opportunistic credit, with the flexibility to invest in convertibles, preferred

REITs, and other securities. Milken was a workaholic who commuted from Philadelphia to New York every morning by bus, spending the trip reading bor prospectuses. Apparently, he avoided the train because colleagues and other industry professionals took it, meaning he would be distracted from his work.

Although he was generating profits for the company, his approach was viewec too speculative for the old-fashioned firm, which preferred dealing in securitie issued by blue-chip companies. His focus on deep research rather than pure sa also created friction with the sales force. As these tensions grew and the firm's financial position worsened, Milken began considering leaving the firm to tea at Wharton.

However, at the time, I.W. Burnham was moving to acquire Drexel. Burnham visited the firm, where he had the following conversation with young but very promising Milken:

> Burnham: Why do you want to quit?
>
> Milken: Because I think Drexel is going broke; they're not even going to pay me.
>
> Burnham: It's not going broke; we're taking them over. We're going to pay yc

Burnham later commented about Milken:

> The first year he made $2 million on $2 million I gave him. The next year, I gave him $4 million and he made $4 million on that.

By the time Burnham retired from the firm in 1984, Milken was trading $800m bonds a day. So, fair to say, he had earned their trust. That was still a decade away, so let's go back to the early years of Milken's career.

So, I.W. Burnham established a semi-autonomous sales and trading unit for Milken to lead, with its own P&L and the department keeping 30-35% of its profits. The department was essentially one of the few, if not the only, shops operating in high-yield bonds. But that wasn't the only thing that differentiate the group. It also began establishing relationships with mutual funds and insurance companies, neither of which had historically shown much interest high-yield bonds. Milken's sales pitch, which essentially boiled down to "you c generate greater risk-adjusted returns," was the same idea that had brought hi to the space in the first place, and it worked like magic.

That magic was reinforced in 1974, when the Fed doubled interest rates to batt inflation, crushing the stock market and helping trigger a recession. Meanwhi high-yield bonds performed significantly better than anyone expected, just as Milken had predicted

New Era

Popularizing this high-yield asset class among institutional investors was onl half of Milken's genius. The other half was even more impressive. Until that ti Milken was essentially trading the existing supply of high-yield bonds, which were known as "fallen angels." These were essentially former investment-gra bonds whose issuers had gotten into trouble, causing the bonds to be downgraded to "junk."

With demand for high-yield bonds growing but the supply limited to fallen angels, Milken proposed raising bonds for non-rated companies, essentially creating high-yield bonds from the outset. Historically, these companies had relied on bank financing to meet their capital needs, but banks' extreme avers to risk left such companies starved for capital. Lehman Brothers was among t first banks to provide this type of financing to troubled clients, but these deals carried little prestige, so the firm pursued them reluctantly. Drexel, by contrast saw an opportunity and was prepared to make this business a core focus.

In 1977, Drexel underwrote its first $30m high-yield bond for oil and gas produ Texas International. In addition to successfully raising capital for the compan expansion, Drexel earned a 3% underwriting fee, 3x the fee typically charged f investment-grade bonds. By the end of the following year, Drexel had become largest underwriter of junk bonds, a position it would retain for the rest of its existence.

The biggest intangible behind Drexel's success in junk bond underwriting wa the client base Milken had built as a bond trader. Insurance companies and mutual funds trusted his judgment when it came to assessing borrowers, so th were ready to snap up new bond issues as soon as they came to market. This made Drexel the underwriter of choice for companies looking to raise capital, since borrowers knew their bonds could be sold and the money raised essentially within a day.

In 1978, Milken moved the entire high-yield operation from New York to Bever Hills because he wanted to be closer to his father, who was battling cancer. By then, he was Drexel's main revenue generator, so there was little resistance to move, despite the fact that it would mean less oversight of his department.

The following year, Drexel pulled off a transaction that perhaps best illustrate just how powerful a tool high-yield bonds could become in Milken's hands. A year-old Steve Wynn was a successful but relatively small operator of the Gol Nugget casino in Las Vegas, with approximately $10m in assets and $3m in earnings. Atlantic City had just legalized gambling, and Wynn wanted to expa the Golden Nugget there by building a hotel and casino, a project that would require $100m in financing.

Banks obviously couldn't finance such a transaction, not only because of the financial profile of Wynn's operations, but also because no one wanted to touch the gaming industry. Wynn was introduced to Milken, who later raised $125m junk bonds for the project based largely on Wynn's vision. It was a demonstration of how Milken and Drexel could raise capital for businesses an projects that traditional banks were unwilling or unable to finance.

The casino story sounds too speculative and may look like one of the excesses the Milken junk bond era, but many early-stage businesses in telecom, homebuilding, and biotech that lacked access to traditional financing succeed only because of Milken's vision, and that part of the story shouldn't be lost on you.

High Point

Although already a dominant force in high-yield, Drexel was about to take the business to another level. In the early 1980s, Drexel started raising junk bonds finance management buyouts and leveraged buyouts (MBOs and LBOs). The structure of these transactions is familiar: a sponsor or management team put up a portion of the equity and finances the remainder with debt. And if Milken could raise $100m for a casino project, raising debt against an existing compa cash flows, with an equity cushion underneath it, was almost a no-brainer. Importantly, approximately 18% of such transactions in the 1980s were "take private" deals, illustrating just how colossal the scale of these capital raises became.

KKR's acquisition of food conglomerate Beatrice for $6.5B was a good example how these transactions worked. The deal was financed with $400m of equity, $800m of preferred stock, $3.5B of bank debt, and $2.8B of junk bonds raised by Drexel. Drexel earned $84m on the transaction alone. KKR subsequently sold Beatrice off piece by piece, generating $1.8B on its original $400m equity investment. Drexel became KKR's preferred financier (no wonder), and Henry Kravis explains why in one of his pieces:

> After presenting the acquisition plan to Milken and his team at Drexel Burnham's Beverly Hills headquarters, "all members of the team reacted positively." Milken then suggested that the KKR team go out for lunch. Upon our return, Milken had already assembled a group of investors from savings and loans institutions and other organizations. We repeated the presentatio and when Milken asked, "What do you guys think? They need $100 million, the investors nodded in agreement.
>
> Just like that, KKR secured the $100 million needed for the company to complete the acquisition.

Drexel, though, didn't stop at LBOs, which typically involved consensual takeovers. In 1983, it began financing hostile takeovers for corporate raiders su as Carl Icahn, T. Boone Pickens, and Ron Perelman. Historically, hostile takeov were largely limited to well-capitalized companies with strong balance sheets that could fund the acquisition themselves. Now, these smaller raiders, armed with borrowed capital, could take on much larger conglomerates.

Drexel didn't even have to raise the debt upfront. Milken began giving these raiders what became known as a "highly confident" letter, essentially saying, I pretty sure I can raise the capital for you. The letter had no legal force, but bein written on Drexel's letterhead and signed by Milken was enough to send corporate boardrooms into panic. Executives knew that if Milken backed a rai the financing would be there. The practice made Milken deeply unpopular in corporate circles. He warned his boss and future CEO, Fred Joseph, that it coul eventually damage Drexel's reputation, but the potential profits might have outweighed those concerns.

Most of these takeover plays followed a fairly simple formula: buy a conglomerate whose weaker businesses were dragging down its valuation, se off those businesses, and focus on the core operation. Many of these conglomerates existed largely because of the CEO's ego anyway. Shareholders benefited when the conglomerate was sold, or when the threat of a takeover forced the CEO to change strategy in their interest.

Ron Perelman's takeover of Revlon in 1985 was the classic transaction of that

High-Stakes Drama at Revlo

Giant Was Sitting Duck

By ROBERT J. COLE

One of the pivotal corporate battles of modern times opened quietly last March when a little-known businessman riffled through a stack of papers from Wall Street investment bankers looking for ideas about companies to take over.

One page that caught his eye was about Revlon Inc., the cosmetics and health care giant. Ten days ago, in a $2.7 billion takeover, the businessman won control of Revlon.

How Ronald O. Perelman accomplished this feat demonstrates that, in this era of the corporate raider, virtually no company is safe from takeover — regardless of the array of legal and financial roadblocks that it may erect.

Stock was Cheap

Revlon, like hundreds of other publicly owned companies these days, was a sitting duck because its stock was cheap in comparison with the company's earning power or its worth if broken up and resold. With that kind of vulnerability, all that an enterprising financier or corporate prowler needs is access to a pool of funds that will enable him to make shareholders an offer they will find hard to refuse.

What makes the takeover of this bilion-dollar giant even more remarkable and frightening to other major corporations, though, is that Mr. Perelman could raise all the money he needed even though the supermarket chain he headed, Pantry Pride Inc., is much smaller than Revlon.

The 42-year-old executive was able to become a threat because a new breed of bond investors are willing to take on greater risk. They back aggressive corporate executives such as Mr. Perelman by buying high-yield securities, known as "junk bonds," a controversial financing tool that has become increasingly common in hostile takeovers. At the same time, Wall Street investment bankers, enc aged by higher and higher fees, fueling the takeover game by sle ing for possible candidates and ranging financing. The take for try Pride's investment bankers or Revlon deal, more than $70 mil appears to have set a new high-w mark.

Acting as a supporting cast in high-stakes dramas are Wall Str professional arbitragers, who billions of dollars at their dispos invest in potential takeover si tions. Once they catch a whiff of a

The New York

Judge Simon H. Rifkind, left, a member of the Revlon board, lamented "t demise of this enterprise, as we knew it." Arthur L. Liman is a partner Paul, Weiss, Rifkind, Wharton & Garrison, Revlon's outside counsel

Continued on Page D12

King of Junk Bonds

In 1977, when Drexel underwrote its first high-yield bond for Texas Internatio
the entire high-yield bond market was $9B. By 1989, it grew to $190B, an astonishing 21x increase in size. Underwriting high-yield bonds came with a 3
4% fee and monitoring with an additional 1-2%, so it is not a surprise that investment banks jumped into the business soon after Drexel.

High-yield bonds gave middle-market companies access to growth capital th
had never been available to them; provided private equity funds with debt to complete acquisitions, and gave corporate raiders the financing to take over companies they never could have even considered as targets before. It is not a surprise that high-yield bonds quickly became a popular fundraising mechanism.

During that period, the average yield on junk bonds was 14.5% and the default rate was just 2.2%, a combination that resulted in 13.7% returns (after recoveri
It is not a surprise that asset managers were gobbling them up.

Everyone was winning from the high-yield bonanza, but especially Drexel an
Milken. Drexel controlled nearly half of the issuance of this gigantic industry, and Michael Milken became known as the King of Junk Bonds. He wasn't just
dominant force in the market; he often was the market. His former colleague s
that the market was in Milken's head because he knew who owned bonds, wh
wanted to sell, and who would be buying them. He knew how to raise large amounts of capital within a day. And the market knew that Milken was the person you needed to be close to if you wanted access to capital.

As with any such bonanza, the aggressive growth of high-yield bonds led to loosening standards: investment banks underwrote bonds they shouldn't hav
borrowers took on more money than they could handle, and investors bought

bonds whose risks they couldn't handle (particularly insurance companies an savings & loan institutions).

But it wasn't the loosening of credit standards that ultimately took down the market and Drexel with it...

THE FALL

Insider Trading

In May 1986, the SEC filed a complaint charging Drexel's M&A banker, Dennis Levine, with 54 violations of federal securities laws related to insider trading, making it the largest insider-trading case at the time. Levine allegedly amass $12.6m in illicit profits over the previous 5.5 years while working at Drexel, Lehman, and Smith Barney (he had worked at Drexel for a little over a year at time).

Levine was forced to plead guilty to securities fraud and agreed to cooperate w the government's investigation, helping expose other members of his network He directly implicated the highly successful financier Ivan Boesky, who ran what we'd call today a hedge fund focused on M&A arbitrage. Apparently, Boesky's successful bets on various takeovers were the result of insider information he received from bankers directly involved in those transactions. That may not sound surprising to us today, but it was still a relatively novel concept in the mid-1980s.

Boesky also pleaded guilty and agreed to cooperate, later implicating Michael Milken as a co-conspirator. The investigation led the government to indict Milken, his brother Lowell (who worked at Drexel), and former Drexel trader Bruce Newberg on 98 counts of racketeering, securities fraud, insider trading, and other offenses. Milken publicly proclaimed his innocence and planned to fight the charges in court. However, he eventually pleaded guilty to six felony charges, none of which involved insider trading. He also agreed to pay $600m fines and penalties and was sentenced to 10 years in prison (he ultimately ser about two years).

The most serious of all the charges was racketeering under the RICO Act, whic would be used for the first time against a major Wall Street firm. The RICO Act short for the Racketeer Influenced and Corrupt Organizations Act of 1970, was originally passed to target organized criminal enterprises, in other words, the "Mafia." Fighting RICO charges in court was an extremely risky proposition, which likely contributed to Milken deciding not to take his chances at trial. Instead, he pleaded guilty to lesser charges, including tax evasion, conspiracy (with Boesky), mail fraud (sending confirmation slips that omitted informatio and others.

Drexel also settled. After a two-year investigation, the government gave the company an ultimatum: settle or face a RICO indictment. An indictment under RICO allowed the government to freeze a company's assets immediately, which for a financial firm meant instant death. Drexel therefore pleaded guilty to six felony counts and agreed to pay $650m in fines and penalties.

Rudy

Defenders of Drexel and Milken have argued that the case against the Junk Bo King was politically motivated. That is a fairly standard defense for people try to protect their reputations, and we have seen it plenty of times before, so it is worth digging into the argument a little further.

The lead prosecutor in the Drexel/Milken case was Rudolph Giuliani, who became U.S. attorney for the Southern District of New York in 1983. He had previously been associate U.S. attorney general, but took what was technically demotion because he wanted to personally litigate cases. The Southern Distric of New York was considered the highest-profile U.S. attorney's office in the country, and the job was often held by people who had their eyes on a future ir politics.

The Drexel case brought Giuliani a lot of attention, and his push to take on wha he portrayed as Wall Street greed was extremely popular. His use of RICO to pu pressure on white-collar defendants to plead guilty rather than fight the charg in court was one of the tools that made him so effective.

Drexel/Milken, though, wasn't his first major case; that was the Mafia Commission Trial, where he indicted 11 Mafia members, including senior figur from New York's "Five Families" (Gambino, Colombo, etc.), and then hit them with… the RICO Act. Three bosses received 100-year sentences. One was murdered on the streets of New York before the trial was over, while another v initially released but was sentenced to 12 years the following year and died shortly afterward (the initial release was because the Donnie Brasco infiltratic of that family had kept him out of the Commission indictment… this informati is for the nerds).

In 1989, before the Milken and Drexel cases had fully wrapped up, Giuliani left U.S. attorney's office and… launched his campaign for mayor of New York.

(One important caveat: saying the case was politically motivated doesn't mea Drexel or Milken were viewed as innocent, only that the punishment was disproportionate to the crime)

End of Era

Whether or not the case was politically motivated, it was the beginning of the end for Drexel. Besides the legal challenges, the firm was also facing a turbule high-yield market, which was itself partly a result of the legal troubles facing market's dominant player.

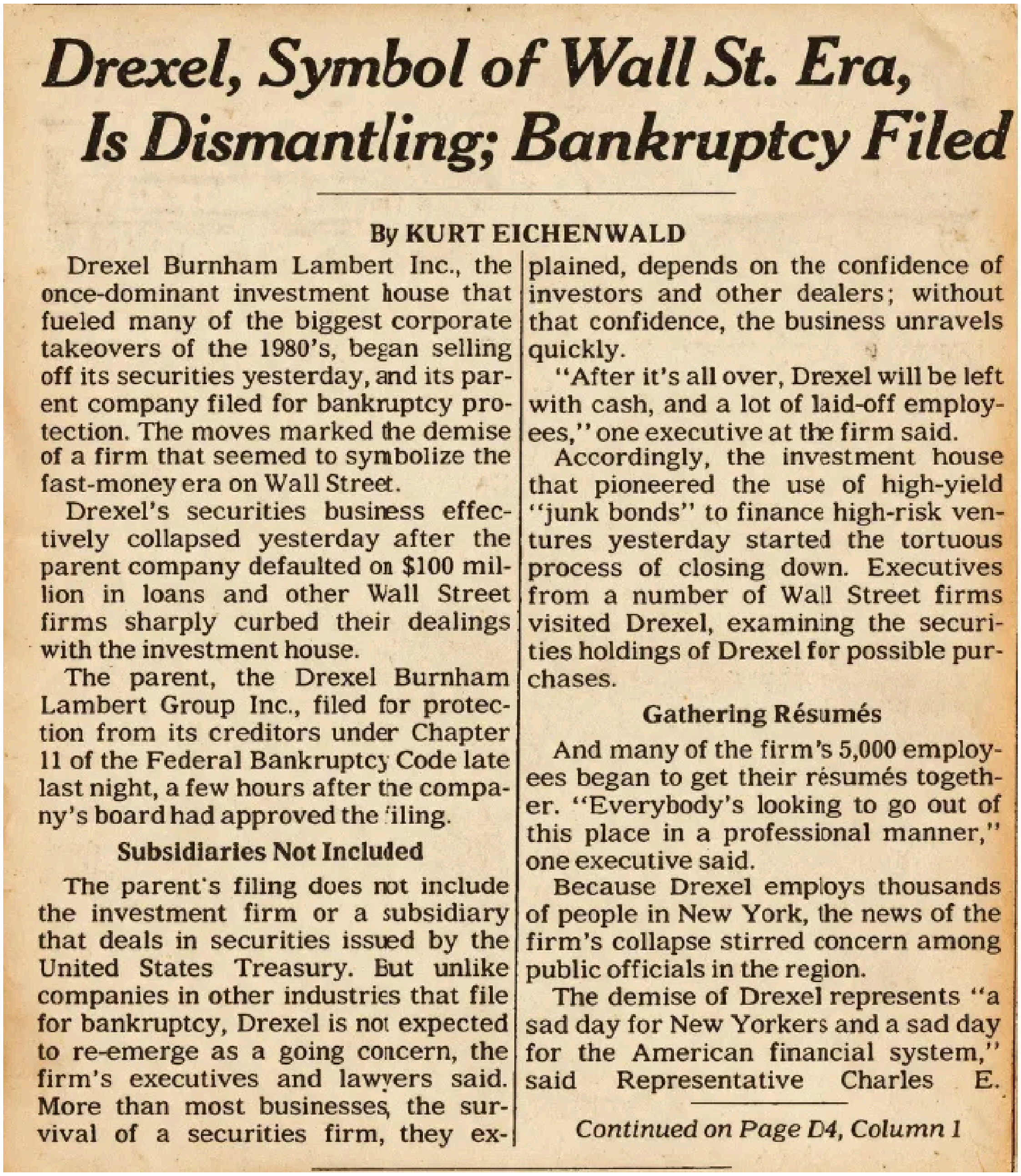
Since the early 1980s, the country had been dealing with the S&L crisis, as thri that were originally created to help homeowners with mortgages expanded in riskier investments, including junk bonds (the S&L crisis is a long story on its own, so I'll skip most of the details). In 1989, the government passed the Finan Institutions Reform, Recovery, and Enforcement (FIRREA) Act, which forced S to clean up their balance sheets and dispose of many risky assets, including below-investment-grade bonds. The result was a wave of junk bonds hitting t market at a time when demand was already weakening. With not enough buy to absorb the supply, bond prices collapsed.

Separately, several highly leveraged LBOs financed with junk bonds started running into trouble, adding to the anxiety around the market.

In Q4 1989, Drexel reported an $86m loss, which helped trigger downgrades of commercial paper by the rating agencies. That made it nearly impossible to ro the paper over, forcing Drexel to repay maturing debt instead of refinancing it. There were also rumors that banks planned to cut the firm's credit lines. For t full year, Drexel posted a $54m loss, its first annual loss in more than 50 years. Without a liquidity provider, the company began discussing a potential sale, b those talks collapsed at the end of the year because of potential liabilities from the lawsuits.

There was also talk of a government bailout, but that ran into a problem. Years earlier, Drexel had financed T. Boone Pickens' raid on Unocal, which was represented by investment bank Dillon, Read. Dillon, Read chairman Nicholas Brady was now Secretary of the Treasury, and reportedly had not forgotten Drexel's role in the deal. He was not willing to entertain a bailout.

Out of options, on February 13, 1990, Drexel Burnham Lambert filed for Chapter making it the first major Wall Street firm since the Great Depression to be forc into bankruptcy.



Drexel, Symbol of Wall St. Era, Is Dismantling; Bankruptcy Filed

By KURT EICHENWALD

Drexel Burnham Lambert Inc., the once-dominant investment house that fueled many of the biggest corporate takeovers of the 1980's, began selling off its securities yesterday, and its parent company filed for bankruptcy protection. The moves marked the demise of a firm that seemed to symbolize the fast-money era on Wall Street.

Drexel's securities business effectively collapsed yesterday after the parent company defaulted on $100 million in loans and other Wall Street firms sharply curbed their dealings with the investment house.

The parent, the Drexel Burnham Lambert Group Inc., filed for protection from its creditors under Chapter 11 of the Federal Bankruptcy Code late last night, a few hours after the company's board had approved the filing.

Subsidiaries Not Included

The parent's filing does not include the investment firm or a subsidiary that deals in securities issued by the United States Treasury. But unlike companies in other industries that file for bankruptcy, Drexel is not expected to re-emerge as a going concern, the firm's executives and lawyers said. More than most businesses, the survival of a securities firm, they explained, depends on the confidence of investors and other dealers; without that confidence, the business unravels quickly.

"After it's all over, Drexel will be left with cash, and a lot of laid-off employees," one executive at the firm said.

Accordingly, the investment house that pioneered the use of high-yield "junk bonds" to finance high-risk ventures yesterday started the tortuous process of closing down. Executives from a number of Wall Street firms visited Drexel, examining the securities holdings of Drexel for possible purchases.

Gathering Résumés

And many of the firm's 5,000 employees began to get their résumés together. "Everybody's looking to go out of this place in a professional manner," one executive said.

Because Drexel employs thousands of people in New York, the news of the firm's collapse stirred concern among public officials in the region.

The demise of Drexel represents "a sad day for New Yorkers and a sad day for the American financial system," said Representative Charles E.

Continued on Page D4, Column 1

Milken

A year later, in March 1991, Michael Milken entered federal prison. He served 2 months of a 10-year sentence and was released early in response to his cooperation with prosecutors and good behavior.

In 2020, President Donald Trump granted Milken a full presidential pardon, meaning his federal criminal convictions were completely wiped clean. While pardon doesn't erase the past reality of prison time, it carries major legal (restoration of certain rights) and symbolic implications.

One symbolic implication that received less attention was the list of 33 prominent individuals who had provided "widespread and longstanding supp for Milken's clemency. Among Wall Street figures like David Rubenstein (Carly and John Paulson (Paulson & Co.), there was one name that looked a little off: *Rudy Giuliani.*

AFTERMATH

Milken Cubs

The introduction to this piece showed how Drexel alumni went on to build sor of the leading firms in private credit. In some ways, private credit is a second cousin to junk bonds, so it makes sense that people who cut their teeth lendin below-investment-grade companies would eventually find their way back to some variation of the same business. But I wanted to take a closer look at two those firms because there is a more direct connection to Drexel: both were founded by Drexel alumni, and both built their early businesses around major deals involving assets originally underwritten by Drexel.

Apollo Global Management

When Drexel went under, its head of M&A and Michael Milken's loyal lieutena Leon Black, founded Apollo with Marc Rowan, a younger colleague from Drexe M&A group. Josh Harris, another former Drexel M&A colleague, joined Apollo shortly afterward from Blackstone. Today, all three are considered co-founder the firm, but that wasn't exactly a Larry Page and Sergey Brin-type founding story.

One of Apollo's first investments was a bond portfolio it acquired from Executi Life, a life insurer that collapsed in the aftermath of the junk bond bust. Executive Life's CEO, Fred Carr, was a close friend of Michael Milken, and the insurer participated in 90% of the bonds Drexel originated. The irony was that Leon Black, who had been at Drexel when Executive Life was receiving allocations of junk bonds, later bought the insurer's entire bond portfolio for $3 or roughly 50 cents on the dollar.

Within two years, as the market recovered, Apollo sold the bonds for $5B, turn one of its earliest investments into a major success. Apollo itself now describe the Executive Life transaction as one of its "earliest and most successful deals crediting it with helping establish the firm's credit business.

Crescent Capital Group

After Drexel was forced into bankruptcy, former bankers Mark Attanasio, Bob Beyer, and Jean-Marc Chapus stayed behind to manage the bankruptcy estate which included $2B of high-yield bonds, the largest distressed portfolio in the country at the time.

Having successfully navigated the estate, in 1991 the trio launched Crescent Capital, initially investing in high-yield bonds before raising a mezzanine fun within a year to finance LBOs.

Crescent was sold to TCW in 1995, spun off in 2010, and in 2021 sold a 51% stak Canadian-based Sun Life Financial.

P.S. I wanted to finish this piece with one anecdote about Francis Martin Drex the original founder of Drexel & Co. After leaving Austria to avoid the draft, he briefly returned home in 1812 to visit his family. However, he quickly departed again because Napoleon was conducting a mandatory draft for his campaign against Russia. The draft was done by lottery, based on the numbers drawn. Francis' father drew number 41, and everyone who drew through 43 was draft Because Francis did not appear, his father was jailed and fined.

Most of those drafted never returned from Russia, while others died shortly af returning from their injuries.

This got me thinking: if Francis had stayed, he would have been drafted, and likely wouldn't have returned. Meaning there wouldn't have been Drexel & Co.. and Drexel Burnham Lambert… so Milken wouldn't have worked for the ambitious second-tier bank that would unleash him… so junk bonds wouldn't have taken off as they did and subsequently wouldn't have blown up… and the wouldn't be alumni of Drexel who went on to build famous private credit firms so there wouldn't be this private credit noise we are hearing about.

All of that happened because Austria couldn't keep all 43 people who drew the numbers within its borders. If something happens to private credit, the U.S. m sanction Austria!

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Khan at **sadaf@theloanedge.com** and let her know you are from the DEBT SERIOUS community

As a reminder, I don't personally benefit from either of these offers. I am just saving you money.

Lastly, our community is over **4,600** strong and includes a broad cross-section mid- to senior-level professionals across private credit, private equity, LPs, anc debt advisory. Please use the Bulletin Board at the end of each weekly letter to share events, discounts, or deals that benefit the community. I will continue to feature these opportunities and personally connect interested parties at no co:

That's the bell — round over. See you in the next.

Aznaur

Aznaur.Midov@KierLior.com

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Drexel Burnham and Lambert, aka Dewey Cheatem and Howe.

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Wow! Thank you for the Drexel history, this was most enjoyable and worthy of sharing with frien
Well done.

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