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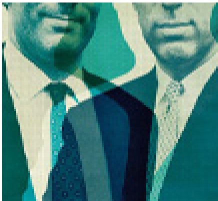
MANAGING

A Dynamo Called Danaher

The Rales brothers' sprawling conglomerate makes everything--especially money



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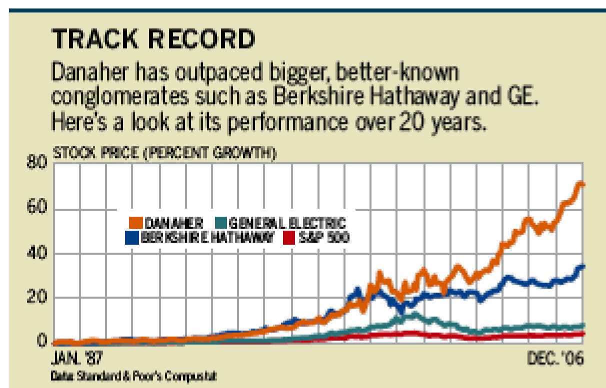
Danaher Corp. (**DHR**) is not nearly as big, famous, or influential as conglomerates such as General Electric (**GE**), Berkshire Hathaway (**BRK**), or 3M (**MMM**). It owns such a mundane and sprawling portfolio of sleepy, underloved industrial businesses--companies that make dental surgery implements, multimeters, drill chucks, servomotors, and wrenches, just to name a few--that it seems deliberately assembled to be as unsexy as possible.

But despite its low profile, Danaher is probably the best-run conglomerate in America. It's clearly the best performing: Over 20 years, it has returned a remarkable 25% to shareholders annually, far better than GE (16%), Berkshire Hathaway (21%), or the Standard & Poor's 500-stock index (12%).



The Washington (D.C.) company is the brainchild of the obsessively private brothers Steven M. and Mitchell P. Rales. The onetime corporate raiders, who have not spoken to the media in more than two decades, have pulled off an unusual corporate metamorphosis. They have turned Danaher from a mere acquisition vehicle into a true-blue, cash-producing, publicly owned industrial manufacturer. In the process, the Rales brothers have become two of the richest people in the U.S., worth more than $2 billion apiece.

Unlike most other '80s-era raiders, Steven, 55, and Mitchell, 50, are so publicity-shy that it's almost impossible to find a photograph of them, alone or together. Many businesspeople have never even heard of them. But among both industrial and private-equity cognoscenti, their reputations are as big as their fortunes. "These guys are really good. There is no luck involved," says Mark D. Ein, a private equity investor at Washington's Venturehouse Group, who has known the Raleses for many years.

Steven and Mitchell Rales, who now serve as chairman of Danaher's board and chairman of its executive committee, respectively, declined comment. But in a rare interview, Danaher Chief Executive H. Lawrence Culp Jr. described the hard-charging business culture that has produced such remarkable results. In 2006, Danaher posted revenues of nearly $10 billion and net profit margins of 16%, truly astounding for a company still in such Old Economy businesses as heavy-truck braking systems and hand tools. Its return on invested capital is 15%, way ahead of its industrial peer group, which is near 9%.

THE ANTI-BUFFETTS

Sitting in Danaher's unassuming headquarters on the top floor of a glass office building (there's no sign announcing the company's presence), six blocks northwest of the White House on Pennsylvania Avenue, Culp sounded like a man who is hard to please. "There are a lot of companies where if you win 10-9, nobody wants to talk about the nine runs [they] just gave up," Culp says. "We'll celebrate the win, but we'll talk about 'How did we give up nine runs? Why didn't we score 12?'"

Think of Danaher as the anti-Berkshire Hathaway. Warren Buffett runs his empire like a benevolent curator. The Rales and their management team are "the polar opposites" of that model, says Ann Duignan, an analyst at Bear, Stearns & Co. (**BSC**). These conglomerateurs have built their portfolio not by buying undervalued companies and holding them but by imposing on them the "Danaher Business System."

DBS, as it's called, is a set of management tools borrowed liberally from the famed Toyota (**TM**) Production System. In essence, it requires every employee, from the janitor to the president, to find ways every day to improve the way work gets done. Such quality-improvement programs and lean manufacturing methods have been *de rigueur* for manufacturers for years. The difference at Danaher: The company started lean in 1987, one of the earliest U.S. companies to do so, and it has maintained a cultish devotion to making it pay off.

Even before a deal is done, the DBS team, made up of managers throughout the company steeped in training, works with the acquisition target to inject a heavy dose of Danaher DNA. For employees at the newly acquired companies, it can be a jarring experience. It wouldn't be at all unusual for a Danaher manager clutching a clipboard, a tape measure, and a stopwatch, in a search for wasted motion, to tick off how many steps a data analyst has to take to get to the copier. Danaher also isn't afraid to swing the ax; it has, at times, bought certain product lines and shuttered the rest of a company. "Those guys have a very well-defined model of how to do M&A," says Jim McTaggart, founder of strategy consulting firm Marakon Associates, now part of Trinsum Group. "They do the strategy well, they price [deals] in a disciplined manner, and they integrate these things superbly."

Danaher's portfolio--with more than 600 subsidiary companies--reflects a move away from its hand-tool legacy to more technologically advanced products. The newest of its four units, accounting for 23% of sales, specializes in medical technologies. It includes Sybron, a dental-equipment maker, and Leica Microsystems (**DHR**), which makes high-end microscopes for pathology labs. Its most profitable division, professional instrumentation, includes Fluke (**DHR**), known to engineers for products such as multimeters. The company's industrial-tools division, though it only accounts for about 14% of sales, houses Danaher's most well-known brand, Craftsman hand tools. The rest of Danaher's business comes from industrial technologies, including machinery components and product-id devices, such as Accu-Sort package scanners.

The Raleses didn't set out to build an empire. In the early 1980s they took a former real estate investment trust, turned it into a leveraged-buyout vehicle, and swashbuckled through the next few years, tacking assets on to their shell company through hostile bids, greenmail, and junk-bond financing, with Michael R. Milken's Drexel Burnham Lambert and First Boston as their bankers. They even crossed swords with Buffett, who swooped in as the white knight buyer of ailing consumer-products company Scott Fetzer Co. after Danaher tried to snatch it.

GOOD COP/BAD COP

Although they were never flamboyant, their brash dealmaking rubbed some people the wrong way. A 1985 Forbes article headlined "Raiders in Short Pants" suggested the Raleses were "callow youths," "more like

real estate speculators than industrialists," and "cocky to the point of foolishness." Neither Mitchell nor Steven has spoken to the media since.

Around 1988, with the leveraged buyout market tanking and their fledgling company struggling under a heavy debt load, the brothers changed course. After a group of managers in one of their divisions, Jacobs Vehicle Systems, found early success by mimicking Toyota Motor Corp.'s (**TM**) lean manufacturing, the brothers decided to implement the Toyota system companywide.

Within a year, Danaher was reborn as a bona fide operating company. Soon after, in 1990, the Raleses ceded daily control to a chief executive, George M. Sherman, whom they hired away from Black & Decker Corp. (**BDK**). Danaher, then and now, makes plenty of acquisitions, but it barely uses any debt to do so, even as the LBO market has swung back into favor. It's not that the company is debt-averse all of a sudden. It's the luxury of $1.4 billion in free cash flow.

Although they have long worked in tandem, Steven and Mitchell have distinct managerial personalities. "Steve is more strategy-oriented," says Friedman, Billings, Ramsey Group Inc. (**FBR**) analyst Ned Armstrong. "Mitch is more operations-oriented." In practical terms, says ex-Danaher executive John A. Cosentino Jr., that meant "Steve was sort of the good cop and Mitch was the bad cop. If someone needed a course correction, Mitch might do that talking."

Despite their lack of industrial background, the Raleses had a near-instinctive affinity for lean manufacturing, say ex-managers. The process breaks from the traditional "batch-and-queue" manufacturing system, in which big lots of product are assembled in discrete steps. In a lean environment, a company moves a smaller flow of items through production. Wasteful steps are easier to spot. And if a mistake creeps into the process, it won't affect a huge amount of inventory and can be fixed quickly.

In a typical Danaher factory, floors are covered with strips of tape indicating where everything should be, from the biggest machine to the humblest trash can. Managers determine the most efficient place for everything, so a worker won't have to walk an extra few yards to pick up a tool, for instance. The lean attitude permeates the culture at Danaher--only 40 people work in the Washington corporate headquarters, at a company of 40,000.

Danaher takes great pains to instill its values in new employees. New managers are often sent to Japan, where they soak up the attitude of *kaizen*, or continuous improvement. In fact, Culp himself, fresh from Harvard Business School, started his tenure in 1990 at Danaher's Veeder-Root Co. (**DHR**) unit by spending a week in Japan building air conditioners in a lean manufacturing plant.

Despite the company's early success at mimicking Toyota's operational acuity, the Raleses didn't seek distinctions like the Shingo Prize for Excellence in Manufacturing or the Baldrige Quality Award. "There was an active strategy of keeping it under the radar," says former Jacobs Vehicle president George Koenigsaecker, who now runs a private-equity firm, Lean Investment, in Muscatine, Iowa. They had two good reasons. First, according to former managers, the Raleses worried others would notice their results and copy the strategy. Second, they didn't want to be raided for talent.

Former Danaher executives credit the Rales brothers for having the smarts and self-confidence to cede daily company responsibility. Still, the two have influence over Danaher's direction and hold about 20% of the shares. Culp and his directors talk about strategy regularly, although the Raleses don't come into the office often. Nor do they sweat the day-to-day minutiae.

Steven and Mitchell have turned to other pursuits. In addition to Danaher, the brothers also control Colfax Corp., a smaller, privately held conglomerate that hasn't shied away from using debt to pursue growth. Equity Group Holdings, the Raleses' private equity arm, shares space with Danaher on Pennsylvania Avenue. Both brothers are art enthusiasts and philanthropists. Mitchell, who was named a top 10 collector by *ArtNews* in 2003, recently turned his Potomac (Md.) estate, which housed a number of animals, including alpacas, into Glenstone Museum, a private art sanctuary. Steven has recently begun financing movies.

OPENING UMBRELLAS

Danaher has reached a crucial point in its short history. As revenue creeps toward $10 billion, its market cap has moved past $20 billion. The outfit's goal, set by Culp in the 2002 annual report, is to hit $25 billion in sales by 2012. At current growth rates, it's on track. But of Danaher's average annual 20% sales growth in the past five years, about 14% has come through acquisitions. As M&A gets more expensive, Danaher must either increase the pace of its deals or swallow bigger fish. And it may be more difficult to convert bigger companies with established traditions, entrenched cultures, and larger workforces to its fervent brand of lean manufacturing.

Danaher is a prolific acquirer, averaging about a deal per month. Most are small to midsize and supplement existing businesses. Danaher considers bigger deals, but only if they create new umbrellas under which more deals will fall. Fluke, for one, was a $625 million foray into more tech-intensive instruments.

Some analysts have raised eyebrows at the sizable goodwill on Danaher's balance sheet--$6 billion worth. But there haven't been any writedowns that would call into question the price paid for an acquisition. Part of the reason, perhaps, is the company's exacting, unsentimental M&A process. Before a deal, Danaher executives tour plants and search for ways to improve performance. They estimate how wide an acquisition target's profit margins could get, given the Danaher treatment. "That allowed us sometimes to bid more on an acquisition because we knew we'd get that value back," says Mark C. DeLuzio, president of Lean Horizons Consulting, who used to spearhead Danaher's DBS team.

When it bought Fluke in 1998, margins were 8%, much too thin for Danaher. As part of the team that managed the acquisition, Culp sought to boost that number to 20%. Many employees at Fluke, which had an engineer-centric culture where most good ideas got funding, said that couldn't be done without hurting quality and innovation. But under Culp, Fluke narrowed its product focus, sped up inventory turns, and reduced floor space. Now, margins in that segment are 21.5%.

In recent years, Culp has tried, with limited success, to stress organic growth to investors. Internal, as opposed to acquired, growth has been chugging along at a respectable 6% a year or so for the past few years. But that's not why the company has such a high price-earnings ratio: 23 times trailing earnings, vs. 18 for ge and 17 for 3M. One of the few Danaher bears, Prudential Equity Group (**PRU**) analyst Nicholas Heymann, cites concerns over organic growth as a reason for his "underweight" rating. As Duignan of Bear Stearns puts it: "I think the biggest risk is that the acquisition pace slows because of competition."

So far, that hasn't happened. The company's pipeline is well-stocked; Danaher walks away from more deals than it consummates. Its managers are determined not to lose their reputation for price discipline and rigorous execution. Of course, a continued ascent into the rarefied air of large conglomerates carries one big risk: It makes publicity-shy Danaher and the Raleses all the more conspicuous for their success.