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KPS
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KPS Capital Partners…
Making Things Happen in Turnaround Investing

BY STUART P. PAPAVASSILIOU

From its strict use of asset-based lending structures to its strong relations with labor unions, very little about KPS Capital Partners resembles a run of the mill private equity fund. In the following profile, Michael Psaros, co-founder and managing partner, explains this team's approach to investing in turnaround situations … and a lot more.

MICHAEL PSAROS
Co-Founder & Managing Partner,
KPS Capital Partners, LP

Michael Psaros and his team at KPS Capital Partners are people who make things happen with companies that make things. And while the financial world relates to KPS Capital as a private equity firm investing in distressed manufacturing companies, Psaros sees it differently. "We view ourselves as manufacturers and industrialists that happen to have a $2 billion private equity fund attached to our business," Psaros explains. "And 100% of the value creation by KPS comes by taking businesses that are EBITDA negative or break even and transforming them into viable, profitable going-concerns."

Whichever way one looks at it, it's an undeniable fact that Psaros and three other partners — David Shapiro, Raquel Palmer and Jay Bernstein — have done well for their investors. And with its proven track record, KPS was able to upsize its Fund III by $800 million in September 2009, having raised $1.3 billion for the upsizing in an almost unheard of 14 calendar days.

Finding Value 'In the Ditch'

"If you look at businesses we've owned, they have been premier companies with very dominant market shares in their respective industries," Psaros says. One need not look back all that far to prove that point. In 2007, the New York-based firm acquired the assets of the metal producing businesses of conglomerate Olin Corporation to form Global Brass and Copper, Inc. And in early 2009, KPS Capital announced the formation of WWRD Holdings Limited resulting from the acquisition of select assets from Waterford Wedgwood (WW), the producers of fine crystal and china whose origins trace back to the eighteenth century. Setting market shares aside, Psaros and the KPS team seek investments that share another common feature. "We look for great companies that have been managed … or better said, mismanaged, into the ditch. And it's important to understand that this is a key differentiator of KPS. There's a common perception out there that just because a company has underperformed or ended up in bankruptcy, that it's a bad company. And that couldn't be farther from the truth."

In fact, roughly two-thirds of the deals KPS has completed have involved the creation of new companies to buy underperforming assets of Fortune 500 companies. The other third has resulted in newly formed companies from assets bought pursuant to §363 sales. He explains, "Essentially, we start over with a blank slate and there are few funds that do what we do for as long as we've done it, nor as successfully. And that's because what we do is hard … it's just hard."

In a strategy he describes as "defense first, offense second," Psaros says that KPS won't invest its capital unless the firm has a clear plan to transform the company's cost structure. The first step, he says, is to buy the assets at or near liquidation value. Psaros explains, "We aren't a leveraged buyout, nor are we a financial engineering fund and we don't trade in securities. We approach each investment by creating a *de novo* company to buy assets free and clear of any liabilities."

At the point of investment, he notes that KPS will bring in, without exception, a new management team. "We would never invest our capital behind a management team

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that has caused a train wreck," he says without a twinge of misgiving. "If we have a company with a new management team armed with an efficient and competitive cost structure, we are able to grow the business, either organically or through acquisition."

This growth and return to viability is achieved through a multi-faceted approach. "We accomplish this by improving capacity utilization or capacity rationalization, and by dramatically improving white and blue collar labor productivity. We also tackle supply chain and working capital management and generally speaking, we'll re-engineer the company's manufacturing operations on the shop floor. We'll get there by actually understanding where our companies are making money in terms of the products they are selling and the customers they are selling to."

As obvious the last point may seem to be, Psaros says it's a point that seems to elude almost every management team KPS replaces. "It never ceases to amaze me that in almost every case, we ask the simple question: 'Which products and customer relationships are profitable and which aren't?' And the answer winds up being: 'We don't know.' I'm left to wonder, how can you run a company and not know this information?

"Another significant disconnect is a management team's inability to grasp the difference between profit and cash flow. Again, I'm amazed how they will chase an order that's going to generate *x* million dollars of incremental EBITDA, but don't think they will have to expend *y* million of capital investment to get the order."

ABL: One Constant in a Non-Linear World

For Psaros, asset-based lenders and ABL structures provide an important constant. For the more than 18 years of KPS Capital's existence, every investment the firm has made has been financed in the ABL market. He says, "Every single one of our deals has a formulaic revolver for inventory and receivables and some of our deals have had term loans against fixed assets … every single one.

"Then we keep the asset-based loan in place and eventually drop in either a second lien loan or some other leveraged piece. We upstream the proceeds to our limited partnerships and we run the companies for however long we think we're creating value. And then, we sell them."

From the standpoint of timing, a deal from start to finish can range anywhere from 60 days to 11½ months. But on average, Psaros says, KPS will take three months to formulate an actionable and concrete turnaround plan for implementation at closing.

While many of KPS' deals are broadly syndicated, he lists his agents or "go-to" firms as Bank of America Business Capital, including the former LaSalle Business Credit; GE Capital; and Wells Fargo Capital Finance, which also includes the heritage practice from Wachovia Capital Finance. "Many of our companies have more than one ABL financing and, in fact, we've built an extraordinary automotive acquisition platform called HHI."

The fund, Hephaestus Holdings I (HHI), is aptly named for the Greek god of fire and forging, and as Psaros explains, it is "really what private equity is about." HHI has absorbed the assets of several manufacturers into its three divisions: parts forging, wheel bearing production and timing systems supply. He explains, "Bank of America has four different capital structures in HHI and every time we acquire a business, we drop in a new ABL under that one umbrella. Wachovia agented, with GE Capital as co-agent, the biggest ABL we've ever done with the $575 million facility for Global Brass and Copper. We really couldn't do what we do without the ABL market."

Psaros emphasizes that turnaround investing is non-linear in nature and as such, he views covenants as loathsome in the beginning phases. And his asset-based lenders, all of whom he deems as partners, comply. "As long as we maintain availability above a certain level, we have no covenants," he says. "And that," he continues, "is perhaps more than anything else, very important to us. It gives us the ability to go in and affect material change to these companies without having to worry about a bank agreement."

He turns to Waterford Wedgwood to illustrate his point. "WW was burning $8 million of EBITDA per month and it had $60 million of interest costs per annum on top of that … so through the capital structure, WW was burning $13 million a month. We would not have wanted to be encumbered by any covenant given the nature and the magnitude of the turnaround we successfully implemented."

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Psaros also notes the firm's relationship with its asset-based lenders can take on a different form. "To the extent an ABL has an underperforming loan or a credit they aren't happy with that's in our red zone from an industry perspective, we will buy a piece of the senior debt as long as we believe that the debt is in a fulcrum position to cause either a bankruptcy event or a change of control," he says.

'An Opportunity of a Lifetime'

In an interview in early 2009, Psaros went on record saying he expected the ensuing period to offer "an opportunity of a lifetime" in terms of attractive investments. Has he reassessed this viewpoint?

"Well, I can say this much — we're in it with both feet. But keep in mind, we really don't need a bad economy to be successful because there is always an inexhaustible supply of bad management. Having said that, I think we're in for a very interesting run for the next two to three years. There's been a lot of 'extend and pretend' and 'delay and pray' in the market. But I can tell you that companies are not going to have cash flows return to the 2006/2007 levels. Many of these deals were at irresponsible levels of leverage. So, you can pray as hard as you want, but the debt is still going to be there," he cautions.

Looking out to the future, Psaros explains that he and the KPS Capital team — comprised of some 20 professionals — have four years left in its investment campaign to make an additional ten good decisions in Fund III. Given KPS' philosophy in turnaround investing, those decisions will require critical analysis.

Psaros says frankly, "We believe that a high number of investments is anathema to professional turnaround investing, and I can't imaging anything more irresponsible from a fiduciary standpoint than stating an objective of doing 20 to 30 deals a year. I don't care how many people we have on staff, at the end of the day the buck stops with four partners." abfj

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