


MERGERS & ACQUISITIONS

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A close-up portrait of Michael Psaros, a middle-aged man with short, graying hair, wearing a dark suit, white shirt, and a patterned tie. He is looking slightly to the right of the camera with a neutral expression.

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WORDS, KPS CAPITAL'S
MICHAEL PSAROS
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OF THE MARKET.
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WANT TO LOOK AWAY.

BRASS TACKS

A man in a dark suit and tie stands on a modern staircase with glass railings. The background shows a multi-story building interior with large windows and a staircase with a glass railing. The man is looking directly at the camera with a neutral expression.

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By Ken MacFadyen

BRASS TACKS

Few deal pros wanted to see the bubble that was emerging as far back as 2006. KPS Capital Partners' Michael Psaros, meanwhile, may have been motivated to see it. He is, after all, a distressed investor. Perhaps that is the reason so many people dismissed his public pronouncements at the time that the economy was headed for a major crash.

In trade publications, in correspondence with limited partners, and in conversation, Psaros would make a case as to why the deal market and the economy in general were being set up for an incredible fall. It was a convincing argument in 2006; today it resonates like gospel.

Psaros, who co-founded KPS alongside David Shapiro and serves as a managing partner at the fund, remains pessimistic about what lies ahead for both the US economy and the M&A market in general. He does, however, like the opportunity set emerging in the distressed arena, although even there, he is taking a cautious stance.

In a candid conversation with *Mergers & Acquisitions*, Psaros offers a view on how he sees the market shaping up and describes, in detail, how the distressed market will develop. Some deal pros may want to read this sitting down.

Mergers & Acquisitions: *To start off, I'd like to take you back to a forecast you made in early 2006. At the time, in the middle of what was a tremendous bubble, we were discussing the possibility of a soft landing for the economy. Your response was that when the downturn comes "it will be something that hits the economy with great violence."*

This was quite a different take than what most pundits and deal pros were saying at the time and for the next 24 months that followed. As it turns out, and despite widely held opposition to this sentiment, you hit the mark. What were you seeing then that allowed you to be so far ahead of the curve?

Psaros: There were a number of factors. Basically, the world forgot that there is this concept of risk, and risk metrics were not being applied anywhere, up and down the economy, especially in the credit system.

We were looking at the deal economy, in particular, and in the M&A markets pedestrian companies were being acquired at absurd multiples of cash flow. These companies were being levered at levels we had never seen before in our careers. That leverage was being supplied by hedge funds who were more interested in clocking phantom carried interest for a particular calendar year than ever recovering their capital back. So we perceived this mania, primarily in New York and other financial capitals, in which people had basically lost their minds.

This was coupled with the fact that a wide gulf was being created, separating the very few who could be considered wealthy and the preponderance of people who would be considered the "have nots." We could tell that it wouldn't take much for the consumer to stop spending. In Amer-



ica, when that happens, we end up in the quasi depression that you're seeing today.

Mergers & Acquisitions: *I noticed you used the word "depression."*

Psaros: I don't know what else to call it. We're not in a recession. It's not necessarily the Great Depression; that would be melodramatic. But this is going to be worse than the last two recessions and it will be worse than what we saw from 1980 to 1982. I don't know what the word is for a "super recession."

Mergers & Acquisitions: *Are you at all surprised about the current depths of the downturn? You correctly forecast the distress, but I can't imagine that anyone would have expected Lehman Brothers' demise, the automaker bailout or the carnage throughout the rest of Wall Street.*

Psaros: Up until September 15, 2008, everything had unfolded exactly in the manner that we expected. Having said that, the decision by Treasury Secretary Henry Paulson to

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blow up Lehman Brothers was the dumbest decision made by the US government in my lifetime. I'm 41 years old, and I have never seen a dumber move, and Paulson owns it.

Within 48 hours, the world had changed irrevocably. That's not something that can even be argued. There's no nuance to it; there's no subjectivity; it's black and white. The world that we knew ceased to exist within 48 hours of Lehman going under. Before that, nobody could ever envision a world in which the literal plumbing of the credit system worldwide was fractured, and that's exactly what has happened.

Mergers & Acquisitions: *Given everything, where do you see the market, M&A in particular, going from here?*

Psaros: We're in a dynamic environment. Who could have ever imagined that the Federal Reserve would cut interest rates to zero? But let's forget about macroeconomics for just a second. There is still a group of people out there who will tell you that we didn't have a recession in the early 90s. We invest in manufacturing and industrial companies, and I can assure you that those sectors went through a depression during that period, so I'm not going to weigh in on the macroeconomic statistics that "define" a recession.

This economy is going to suffer for at least another 18 months or maybe as long as another 24 months. It will be a long time before the consumer starts spending again, and this economy is not going to recover until that happens. For the first time our lives, consumers will start accumulating capital instead of liabilities. Unfortunately — or fortunately, depending how you look at it — that will continue to have a negative affect on the economy.

As for the credit markets, after all that has happened I am stunned people are still out saying they expect financing will reappear anytime soon. I don't believe that we'll see any true leverage for years.

We're all human. The men and women who sit on the credit committees of the bank and non-bank lending institutions are staring into the abyss, and it is going to be a long time before they're financing cash flow at four, five or six times. The "L" in LBO is dead. But now we get to see how good people are at generating returns through fixing and growing businesses.

Mergers & Acquisitions: *Do you anticipate that the traditional private equity firms will be able to work their way through this? In the past few years, a lot of groups have made a point of bolstering their operational focus and we've seen a lot of corporate executives flood into the asset class. Will that make a difference?*

Psaros: We don't have any operating partners at KPS. That stuff is pure marketing shtick for limited partners. If we wanted to, we could put 50 former GE or Allied Signal executives on retainer. If a private equity firm has historically been able to improve businesses, they'll continue to be able to do so.

Mergers & Acquisitions: *Tell me about the distressed world. Not to dance on anyone's grave, but I have to imagine that this is, or will be, a great time to be a distressed buyer. How would you characterize the market thus far?*

Psaros: You said "will be," and I think that's an important distinction. We just raised \$1.2 billion for our latest fund, and we told our limiteds that for the first 12 to 18 months of a downturn our job is to duck. It's the weakest companies who are the first to get sick, whereas the strongest are always the last to capitulate.

In the first 12 to 18 months, we'll always see a large quantity of dealflow but the quality is extremely poor. And we were actually taken aback by some of the investment opportunities that were funded in the turnaround space throughout the spring and summer of 2008. I was astonished that some of those deals got funded.

To go back to the original question, though, we made an affirmative decision to duck in 2008. We completed just two deals and let the rest of the stuff just pass us by. With that said, looking out over the next two to three years, we're expecting to see the buying opportunity of a lifetime.

In terms of dealflow, we're at an inflection point today. There has been a steady supply of under-performing or distressed divisions owned by global Fortune 500 companies. We were seeing these opportunities up until September of 2008. Now we're starting to see the return of the stand-alone bankruptcy deal, and these are the kinds of investments that we haven't seen much of since 2002 or 2003. I believe the pace of these opportunities is going to expand dramatically through the next two years.

Mergers & Acquisitions: *Considering there hasn't been a whole lot of activity involving Chapter 11 since the new bankruptcy laws went into effect in 2005, what kind of impact will that have on dealmaking?*

Psaros: It's a mildly positive event for control private equity firms like KPS since the new bankruptcy laws will result in more sales and quicker disposals of assets. The time that a company has to complete a reorganization has been truncated. Therefore, on or about the time a company files, it will have to decide whether to initiate a sales process or pursue a stand-alone transaction.

I think you will also see a huge uptick in pre-arranged bankruptcy transactions. The agreements between the creditors and the debtor will be arranged prior to filing so when the company goes into bankruptcy a pre-cut deal will already be in place.

Complicating things today is the fact there is basically no DIP [debtor in possession] financing available. It would not surprise me over the next two to three years if we end up providing the DIP loan to a lot of the companies we intend to acquire. We're not in the DIP business, per se, but we will extend credit to companies we would like to acquire.

Mergers & Acquisitions: *What are the problems that you're seeing as you scan the market for new investments? Is it performance, too much leverage, mismanagement, fraud, or a combination of all of these factors that are contributing to corporate distress?*

Psaros: The whole reason we're in business and the reason we were able to invest our second fund into the teeth of a booming economy is because there is an inexhaustible supply of bad management. The level of mismanagement we see everyday still staggers me.

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We will go into companies and find that they don't have any idea which customers or products are profitable; they'll have no handle on their cost structure; and they'll be completely focused on their reported income statement irrespective of how much capital is required to support those earnings.

Mergers & Acquisitions: *What about the leverage you're seeing? Is this a product of mismanagement?*

Psaros: You can have great management that has been put in charge of an over-leveraged company. But that presents another kind of opportunity. If you're a company today that has a leveraged capital structure with maturities due in 2009 or 2010, I don't know what you can do unless the owner is prepared to inject a significant amount of capital into the business. Those companies are going to have to file for bankruptcy or be restructured out of court.

The amount of leverage employed between 2005 and 2007 is in many cases just beyond comprehension. As an example, my partners and I visited a company recently that had \$300 million of funded debt and break-even Ebitda. We went to see another company with \$110 million of funded debt with \$2 million of Ebitda. There are a lot of examples like this, and these are going to be your bankruptcies over the next 12 to 36 months.

Mergers & Acquisitions: *If you had a preference, what's more appealing, balance-sheet opportunities or dealing with companies that require a true operational fix?*

Psaros: I haven't seen a good company with a bad balance sheet since the late 1980s or early nineties. I think in this cycle, we'll start to see some great companies with bad balance sheets, and I hope we can take advantage.

Having said that, those situations, requiring just a simple balance-sheet fix, is not what we're actively looking for. We are a hard-core, operations-driven turnaround firm. The situations we're attracted to are companies that have a history of recurring losses, including losses at the Ebitda level. We are seeking companies that don't have a management team or a strategy, or businesses with a material cost problem. We're attracted to the complexity of the operational turnaround.

But we are opportunists. There are so many companies dealing with these balance sheet issues, so it would be nice to get few layoffs that don't necessarily involve the typical turnaround process.

Mergers & Acquisitions: *Could you flesh out the balance-sheet opportunities you're seeing?*

Psaros: Companies that were over-leveraged during the last cycle, who are now seeing their earnings plummet, are obviously that much more over-levered. I think, according to [Standard & Poor's] data, that the average leverage multiple in the last cycle peaked at as much as eight times trailing Ebitda. That's "trailing" Ebitda in what was a booming economy. If your Ebitda is off by 20% or 30% today, you're essentially leveraged that much more. And if you don't have access to capital and maturities are coming due, then you have a major problem. This is why there is going to be carnage in private equity portfolios. Nobody likes to talk about it, but we're see-

ing it already.

What's going on in the macroeconomy is obviously going to hurt earnings, so folks are not going to have the cash flow to even service their interest payments. We're going to see a lot more payment defaults.

Mergers & Acquisitions: *Switching gears a bit, it seems like so many different industries are facing true transformational distress, including the automakers, retail, print media, energy, financial services; I'm sure I'm missing a few. What are your thoughts about the expansive nature of this radical disruption in what are core sectors to the US economy?*

Psaros: The list of industries is actually longer. Generally speaking, the only area that appears to be weathering the storm is healthcare, although nobody really knows how the new presidential regime will affect profits there. We're also seeing a severe downturn in industries that are involved in or dependent upon manufacturing. We just had the worst quarter in manufacturing since 1980. Aerospace companies are hurting, capital equipment manufacturers are hurting, chemical companies are hurting. The list could go on.

In the almost 20 years that we've been together as a firm, we have never been in a period in which there is no visibility into the next year on the top line. Company after company is trying to look into the future, but basically cannot put together a forecast or even guess on a range in terms of what their actual revenues will be in 2009.

If you look at the industries today that are in extreme situations — autos for one; building product companies would be another — I can't tell you how many businesses have just seen the top line evaporate; literally. We just looked at a company in the recreational vehicle space, and their order book went from having hundreds of units in their backlog to having just two or three units in the fourth quarter [of 2008] and nothing lined up for 2009. Building product companies in particular and companies directed toward the consumer are effectively seeing their demand fall off of a cliff.

Mergers & Acquisitions: *KPS has always been active in the industrials and manufacturing arena. Will you look to be opportunistic in some of these other areas as companies become available?*

Psaros: There's no style drift with us. We invest in companies that make things. Even our investment in Attends Healthcare; outwardly, it's a healthcare company, but we saw it as a manufacturing business with a gold plated brand name. We will continue to invest in companies that either make or distribute products, so that means no high tech, telecom, entertainment or real estate. We also made the decision as investors to stay away from restaurants and retail.

Mergers & Acquisitions: *As it relates to a particular business, what might be considered too distressed for KPS?*

Psaros: We've already discussed the top line at length. If we can't have complete confidence in a company's revenues we will walk. The second red flag is insignificant market share. If a company only controls three to ten percent of its respective market then the industry is telling you that the company doesn't matter.

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A third thing we try to avoid is the necessity to invest a large amount of capital in order to generate cash flow and profits. We'll see a lot of companies that generate minimal Ebitda. You can get these businesses up to \$40 million or \$50 million in Ebitda, but you have to invest \$150 million, so the economics don't make sense.

Ultimately, though, you have to ask if the company has a reason to exist. If you're the fourth or fifth biggest competitor in a sector, this is a question that should apply.

Mergers & Acquisitions: *This downturn, perhaps unlike any other, is truly global in scale. What are your thoughts on what might happen to the globalization theme that has been so important during the past few years?*

Pсарos: I could talk on this subject for hours. The first point I'd make is that the reason a US company goes to China or India today is to service those particular markets. The whole transfer of North American manufacturing capacity happened 10 years ago and it's done; we're not going back.

For our second fund, which was made up of North American industrial companies, China was the greatest thing that ever happened. The giant boom in consumption there raised the prices for manufactured goods and the intermediate goods that feed into those products.

Mergers & Acquisitions: *KPS has invested a few times overseas: Ebro and Ashcroft come to mind. Do you like the opportunity set for global deals or is it more difficult to get your arms around foreign investments?*

Pсарos: We're seeing an incredible amount of dealflow emanating from Europe. We have had successes there, so we're excited about the opportunity, and a significant portion of Fund III will be invested in companies that are domiciled in Western Europe. But you will not see us making a platform investment in Asia or Japan.

In terms of restructuring, I think Europe is where the US was between 1985 and 1990. We're seeing a lot of companies that are run in the same manner of a US company about 15 or 20 years ago, so that presents an opportunity.

There are three primary obstacles, though. With the exception of the UK, very little asset-based financing is available in Europe. That's usually how we finance our deals. In the US, all of our capital structures have a plain-vanilla revolver with a term loan against the assets. The law in various jurisdictions over there blocks asset-based financing, so you have to get creative, whether it's through factoring or just adding more equity.

Also, it's very difficult to pursue a bankruptcy transaction in Europe, given all of the different jurisdictions; there's no commonality to the law. So, to date, we have yet to buy anything out of bankruptcy in Europe.

The third obstacle is that it's difficult to do the same things that we can do here. It's a fallacy that you can't reduce headcount in France or Germany. The difference is that you just have to pay to do it, so you have to factor those costs into the purchase price.

Mergers & Acquisitions: *What does the domestic distressed market look like these days? It seems like many of the same faces who were the players in 2002 — such as KPS, WL Ross & Co., and MatlinPatterson to name a few — are the same*



firms who will be active in 2009. And considering the travails of Cerberus, Sun Capital and Apollo Management, who have all been burned recently, not to mention the contraction among the hedge funds, it's almost as if there will be fewer firms active in the distressed space?

Pсарos: There are probably fewer control-oriented turnaround funds out there today than any other time that my partner Dave [Shapiro] and I have been doing this. That's because what we do is really hard, and it is even more difficult to demonstrate success over an extended period of time.

I think we're privileged to be in the company of those groups that you mentioned. We have seen a few new entrants; basically smaller firms whose marketing shtick is that they'll do micro-cap or small-cap turnarounds. Generally speaking, though, we wouldn't go after any of those deals.

The hedge funds are nowhere to be found. In our space, 2005 was really the year of the hedge fund. Billions of dollars effectively moved from bond trading into control private equity, and for the most part they went on to lose an astonishing amount of capital doing really silly and stupid things. It's been a long time since we've run into a hedge fund, though. A lot of these fund managers, on an IQ basis, are very smart people, and they have probably made their investors very attractive returns around their core trading strategies. But companies are not securities or mere pieces of paper. They're living, breathing entities. You can't sit behind a Bloomberg terminal and try to turnaround a brass mill. It just doesn't work like that.

Mergers & Acquisitions: *Do you anticipate that the traditional private equity funds will make a run into distress?*

Pсарos: It's bound to happen. It has happened in the last three cycles, where we've seen firms that historically pursued true leveraged buyouts come in and try to take on an opportunistic turnaround. What happens is that they apply traditional LBO metrics to an Ebitda negative company. I fully expect to run into these groups who will overpay for an opportunity because they don't understand the risks involved. It will cost us a few opportunities.

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Mergers & Acquisitions: *What about the strategic buyers? Are they competitive in this market or does the whole bankruptcy process tend to scare them away?*

Psaros: For almost two decades, we went about our business and never ran into an industrial strategic buyer in a restructuring or bankruptcy process. Then, this past May, when we acquired [the wheel bearings business] out of the Delphi Corp. bankruptcy, our only competitor was an industrial company based in China. This was the first time in 20 years we had seen a strategic. They were there and they were serious. We just knew how to do bankruptcy better.

Generally speaking, strategics are looking for a well-run, profitable company without any major problems. We'll sell a lot of businesses to strategics. They would rather pay up for a shiny new apple than buy one that's at the bottom of the barrel.

Mergers & Acquisitions: *Earlier you alluded to the decision by KPS to "duck" in 2008. Yet, we've seen quite a bit of activity involving distressed assets, and a lot of investors who got burned. Was this at all predictable?*

Psaros: Look at the deals that were done in 2008. There were very few transactions that we saw that didn't run the risk of catching a very sharp falling knife.

Mergers & Acquisitions: *The investment in Washington Mutual might be one example and the investment in Steve & Barry's would be another high-profile failure. As an investor in the space, how do you avoid this?*

Psaros: It's a matter of doing thorough due diligence on the revenue line. It starts with the industry, moves to the company and then goes to the customers. We have to believe that the top line has either stabilized or is facing only minimal further erosion. Then we figure out if we can re-engineer a company's cost structure on that diminished revenue. But it's really about thorough due diligence and just being careful.

Mergers & Acquisitions: *What's the typical ratio of companies you will look at versus the number of investments you actually make?*

Psaros: It changes with the market but it's at least 50 to one. In 2008, it was probably 100 to one, but we won't waste our time. We'll only go through a due diligence process with a select few of the companies we see.

Mergers & Acquisitions: *Given that creditors are seeking to move the restructuring process along, does that add some pressure on the buyers?*

Psaros: Absolutely. A lot of creditor constituencies are pushing companies to do something expeditiously, in or out of court. You're going to have to run faster in today's market place. Traditionally, our due diligence has taken between five weeks and 13 months, although we can move as fast as necessary.

Mergers & Acquisitions: *What if anything might signal a market bottom?*

Psaros: The bottom is going to occur when banks and other financial institutions start lending money. That's when credit becomes available to the consumer and companies again.

The second thing we're watching is capital spending. Corporate America has dramatically pulled back on expenditures. When businesses have the con-



fidence to stop hoarding cash and start spending money again that will be another signal. Until those things happen, though, I wouldn't call it a bottom.

Mergers & Acquisitions: *Where will the credit come from? We've seen so much consolidation on Wall Street, and many of the traditional players in the middle market have pulled back.*

Psaros: The only constant on Wall Street is change. We live in the world's most efficient capitalist economy. Over time there will be institutions, which either already exist or will emerge, that will provide capital. You have some giant institutions in existence today that were not even around 20 years ago. I don't know who will fill the void but this country doesn't operate without access to credit — somebody is going to be around to provide it.

Mergers & Acquisitions: *Time for predictions. Is it possible that the worst isn't behind us and there will be a second shoe to drop?*

Psaros: I hate to discuss this, but it was a topic that was brought up during the Presidential election. I think that President Obama will be tested at some point with international events. There will be a global or domestic crisis that will test the President. The last thing we need at this point is any further erosion in consumer confidence. That's the biggest potential "other shoe."

Mergers & Acquisitions: *What about the optimistic scenario?*

Psaros: I believe that President Obama's fiscal stimulus package is going to be larger than what anyone expects. And if that's the case, it would have a profoundly positive effect on the economy.

Overall, the economy is a super tanker, so it's going to take a while for any stimulus to work its way through the system. I don't anticipate there will be any return to macro economic growth until at least the second half of 2010, and I believe it will be years before we see the credit markets functioning properly again. **MA**

