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Factory Job

How Financiers Pursue Profit At Skidding Auto-Parts Maker

Private Equity Faces Union At Jernberg Industries; Tough Talks With Detroit

'From Irrational to Rational'

By JEFFREY MCCRACKEN

CHICAGO—In a South Side neighborhood dotted with junked cars, crumbling houses and shuttered factories, a New York private-equity firm is betting it can make big money in a battered business: manufacturing wheel hubs and engine parts for cars and trucks using union labor.

KPS Special Situations Funds has put more than $23 million into Jernberg Industries since 2005. It aims to at least double its money in three years or so. Jernberg, which supplies parts to Detroit's Big Three auto makers, tumbled into bankruptcy court in 2005, joining a raft of other auto-parts makers there.

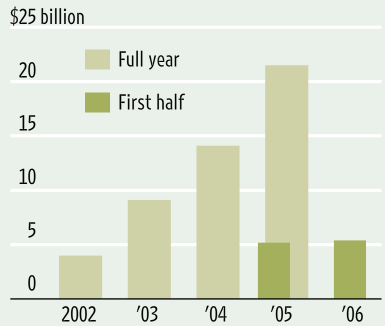
For KPS and other private-equity firms circling the auto-parts industry, these are some of the most daunting turnarounds in all of business. For starters, the new owners often have to hammer out agreements with unions to rein in labor costs. They must also contend with a challenge unique to the auto-parts industry: Much of its revenue depends on the shaky health of three customers, Ford Motor Co., General Motors Corp. and DaimlerChrysler Corp.

But these turnaround experts think the payday could be big. Some auto-parts plants are antiquated and inefficient. Many existing contracts with labor and with big customers are unfavorable. In bankruptcy court, these investors figure, they can jettison the bad deals, close unneeded plants and start more or less from scratch. And beleaguered workers, fearful of losing their jobs, are likely to play ball.

Over the past decade, the U.S. auto-parts industry has been squeezed by rising costs for raw materials, production cuts by embattled auto makers and low-cost competition from overseas. North American parts sales total about $225 billion a year, automotive-research firm CSM Worldwide estimates, holding steady due to the growth of Asian and European suppliers' operations in the U.S.

Revving Up

Amount spent by private-equity firms on global automotive mergers and acquisitions, including suppliers, manufacturers and dealers:



Sources: PricewaterhouseCoopers; Thomson Financial

By some estimates, auto-parts businesses with about $50 billion of annual sales are currently for sale. The nation's biggest auto supplier, Delphi Corp., is currently in bankruptcy court, and a battle for control of Delphi could be shaping up between rival investor groups. Lear Corp., another big parts supplier, recently negotiated a complex deal to transfer its auto-interiors business to investor Wilbur Ross, who has been investing heavily in the sector.

Private-equity funds and hedge funds see parallels between auto parts and steel, a formerly troubled industry that also drew turnaround specialists. In auto parts, as in steel, there is substantial demand for the product, but high labor costs and overcapacity have destroyed profitability. Investors such as Mr. Ross picked up steel companies on the cheap, restructured them and sometimes merged them, then reaped substantial profits.

But unlike steel producers, auto-parts makers rely on a mere handful of big customers. For the past decade, the U.S. car makers that buy auto parts, struggling to compete with Japan, have pressed hard for price concessions. Recently, when prices for steel and plastic rose, parts makers were unable in most cases to pass along the increases to customers. Parts makers sometimes even agreed to money-losing contracts with car makers. They figured they'd make such contracts profitable eventually, or at least wouldn't have to bear the added costs of shutting down plants.

"There had been a lot of irrational actions among suppliers, people acting without any discipline," says David Shapiro, co-founder of KPS. "Eventually, it will get rational. Our thesis is there is money to be made as it goes from irrational to rational."

KPS, which has $600 million under management, has been investing in distressed manufacturing and transportation businesses since 1991. Its three founders have a long track record hammering out deals with unions. One of them, Eugene Keilen, was a restructuring banker at Lazard Ltd., where he advised steel companies and union airline pilots at UAL Corp.

KPS has bought four auto-industry suppliers besides Jernberg. In September 2005, it purchased Blue Water Plastics of Marysville, Mich., which makes plastic parts such as ashtrays. This May, it bought Arkansas-based Cloyes Gear & Products Inc., which makes timing systems for engines. KPS has merged the five companies into three. Together, they employ about 3,800 and have combined sales of about $650 million.

Jernberg, founded in 1937 to forge steel into machine parts, was bought and sold several times over the years. During the 1990s, it won six consecutive supplier-of-the-year awards from GM, which used its transmission parts. But by early 2005, rising steel prices, money-losing contracts and inefficient practices had brought red ink. In the five months before its June 2005 Chapter 11 filing, Jernberg, a closely held company, lost $3.4 million on sales of about $60 million.

When KPS bought Jernberg's assets out of federal bankruptcy court in 2005, it got right to the point with the parts maker's roughly 700 workers. In a four-hour meeting that July with local union leaders, KPS co-founder Michael Psaros told them he needed to reduce labor costs by 20%. His plan, he said, was to eliminate jobs, freeze wages, cut overtime pay, raise health-care premiums and eliminate pensions.

(over please)

Tom "Smoke" Robinson, a 45-year-old factory worker with three teenage daughters, including one in college, says Jernberg's workers faced a stark choice: "fight about not getting paid more" or risk having no job at all.

Mr. Robinson, who like many of his factory-floor colleagues makes between $40,000 and $50,000 a year, says the plant was in poor shape and machines would go months without repair. "This place was a dinosaur," he says. Steven Towbin, a Chicago lawyer who represents the previous owners, says his clients decline to comment on the company's failure or on KPS's takeover.

KPS bought Jernberg's assets for $54.5 million, $23.5 million of it in cash. The bankruptcy proceeding, from which the company emerged that month, wiped out about $45 million of other debts, including pension and health-care obligations to about 100 retirees, their spouses and their dependents.

Mr. Psaros, who is 39, took charge of turning the company around. KPS, as it typically does, swept out top management. "We will not back the guys who caused the train wreck in the first place," says Mr. Psaros. To run the company day-to-day, KPS hired George Thanopoulos, a Michigan native who had worked in the parts industry for two decades.


Michael Psaros

KPS needed concessions from everyone from union leaders to car makers to lenders. It wanted to be seen by each group as a last resort.

Even before the purchase was complete, Messrs. Psaros and Thanopoulos began negotiating a new collective-bargaining agreement with 650 members of the United Steelworkers. They made it clear up front that KPS would walk away from the purchase plan without a new labor pact.

Negotiations took just one week. The new five-year contract gave Jernberg the right to eliminate about 125 of 700 jobs, to shorten work weeks during slow periods and to shift workers from job to job. It eliminated pensions in favor of 401(k) plans and required workers to pay far more for health care. Workers agreed to build more parts per hour in exchange for bonuses if they meet certain targets. Wages were frozen for two years.

"Plenty of people didn't like it," recalls Dennis Woodard, a union steward and 22-year veteran of Jernberg. "There was lots of grumbling. But what are you going to do? It's about trying to keep a job."

Mr. Thanopoulos says the agreement will "just about" produce the 20% labor savings that KPS was seeking. "I think the union thought we were going to push for worse cuts," he says. "And, quite frankly, we were saving their jobs."

The concessions will cost Mr. Robinson thousands of dollars a year in overtime pay. And after 22 years of paying little or nothing for health care, he will have to pay an extra $100 to $150 a month. "No one is happy you have to give up money," he says. "But I'd rather have a job than fight about not getting paid more."

With the new labor deal in hand, KPS invested about $17 million in the plant, installing new machinery, repairing long-damaged equipment and fixing up workers' locker rooms and other facilities. "The only thing I'm mad about," says Mr. Robinson, "is they didn't get here five years ago, before it got so bad."

Mr. Thanopoulos brought in Mike Keslar, 40, as vice president and general manager. "We are trying to take this plant from 1955 to 2005 as fast as we can," says Mr. Keslar about Jernberg's main plant.

KPS set about getting rid of the kind of jobs that had been automated by auto makers decades ago. It spent $150,000 on metal-trimming robots. This year, automation has eliminated 20 jobs, including pressmen who use heavy metal tongs to feed cherry-red-hot steel into hulking forging machines. These were grimy, difficult and dangerous jobs that required hard hats, heavy gloves, earplugs, breathing filters and safety glasses.

KPS aims to cut another 30 or 40 jobs in 2007. Machines will replace the "chargers" who load pieces of steel shaped like hockey pucks into 2,200-degree furnaces. Management also plans to cut the number of forklift drivers who ferry parts and materials around the noisy 284,000-square-foot plant, which shakes from the impact of 3,500-ton forging presses.

For years, there was a one-hour gap between plant workers' shifts, and employees were often paid overtime to keep working. By reworking the schedule to eliminate that gap, KPS trimmed Jernberg's annual overtime bill by about $3 million—and cut several thousand dollars from the annual pay of most workers.

Workers say Jernberg's previous owners were loath to take big chances, citing tradition or cost. KPS managers, they say, seem willing to listen to their suggestions. For example, workers figured out that by changing the layout of plant machinery, Jernberg could save 10,000 trips a month by the forklifts.

Driving a forklift at Jernberg used to be a bone-rattling ordeal. Antone Drain, a union steward for the Steelworkers local, says he and his fellow drivers appreciated that KPS spent thousands of dollars ripping out old train tracks in the plant's cement floor and repairing potholes. "Driving over those tracks wasn't fun," says Mr. Drain, 47. "I might make it to retirement now."

KPS has negotiated other deals with the United Steelworkers that have saved jobs at other failing manufacturers. "They seem to want to keep some manufacturing jobs in the U.S.A., which we like," says Fred Redmond, vice president of human affairs with the Steelworkers in Pittsburgh, which has urged KPS to look at other troubled auto-parts makers.

When Jernberg filed for bankruptcy protection, its previous owners moved under federal bankruptcy laws to reject all existing contracts with customers. With some of those contracts, Jernberg lost money on every part it built. KPS needed more favorable new ones from its 12 customers, which include Detroit's Big Three, Toyota Motor Corp. and Harley-Davidson Inc.

In the summer of 2005, Messrs. Psaros and Thanopoulos began pushing for better terms during face-to-face meetings with customers in Detroit. Once again, the fact that KPS hadn't yet completed its purchase gave it leverage. So did the importance of its parts to certain customers. GM, for example, needed two transmission parts from Jernberg to launch its next generation of full-size sport-utility vehicles, such as the Chevy Suburban, which GM was banking on to improve its profit picture.

Ford and GM pushed back hard on paying more for each part. "We didn't get all we wanted," says Mr. Psaros. The new contracts provide Jernberg with better pricing on some parts, faster payment terms, and protections if costs for raw materials like steel rise again. Mr. Psaros declines to quantify the price increases, but says that every new contract is profitable. Spokesmen for Ford and GM declined to comment.


George Thanopoulos

"It helped that everyone was giving up something, and we showed each group how much everyone was giving up," says Mr. Psaros. "The union, the customers, the lessors, everyone. We were herding cats."

In July, KPS acquired another forging company, Impact Forge Inc., for an undisclosed amount. Jernberg, which has sales of about $200 million a year, is turning a profit, Mr. Psaros says, but he declines to provide details about its finances. Workers have collected some bonuses for meeting production targets. In July, KPS distributed a $20 million cash dividend to its investors, which include pension funds and banks, in connection with the Jernberg deal. In September, it sold a minority stake in its two forging businesses to Mitsubishi Corp.

Mr. Psaros says KPS expects to own Jernberg for "several years." He declines to discuss its plans for cashing out or the profit it expects. Typically, KPS sells its portfolio companies outright to other companies in the same industry or to other investment funds.

Mr. Thanopoulos, Jernberg's chief executive, expects 2007 to be difficult because GM and Ford are poised to slash production. He says the industry downturn will allow KPS to pick up more parts-forging companies on the cheap, a line of thinking he shares with other auto- parts prospectors such as Mr. Ross. KPS has looked at 15 more troubled suppliers.

"We hope the pain being afflicted on the forging business will be good for us," says Mr. Thanopoulos.