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GP PROFILE: KPS CAPITAL NOT WORRIED ABOUT BIG WAR CHEST

By Bernard Vaughan

Executives at **KPS Capital Partners LP** sold a slew of companies at the top of the market, closed a new fund while investors still had cash, and avoided catching falling knives in 2008 even as many firms got burned after diving into the turnaround market too early. Now that knack for timing is going to get a serious test, with KPS Capital sitting on more dry powder than ever before despite an ostensibly improving economy and a rebound in the credit markets.

Limited partners give the New York-based turnaround shop the benefit of the doubt, in part because of its previous foresight. KPS Capital took advantage of what turned out to be a bubble in valuations, selling eight of 11 portfolio companies by August 2007. "We are selling everything that isn't nailed to the floor at prices that are between stunning and inconceivable," **Michael Psaros**, a managing partner at the firm, told *The Wall Street Journal* in May 2007. Partly as a result, the firm's vintage 2003 $404 million KPS Special Situations Fund II LP has generated a more than respectable 1.9x investment multiple as of March 31 for the **California Public Employees' Retirement System**.

Indeed, KPS Capital's limited partner meeting in November 2007 marked a heady time for the firm and its investors. The firm had just raised, in less than four months, $1.2 billion for its third fund, which has since been upsized by an additional $800 million. The economy was sliding into a recession, and the firm's investors were giddy with deal prospects for the firm. But what they then heard from Psaros wasn't at all what they expected: KPS Capital didn't expect to do a single deal in 2008, believing that the weakest companies would be the ones to fail first.

"Had they put money to work before the bottom fell out, they'd probably be licking their wounds... I think being cautious early in the recession makes sense," said **Barry Gonder**, general partner at **Grove Street Advisors**, a longtime investor in KPS Capital funds.

Firm: KPS Capital Partners LP

Senior Executives: Michael Psaros, managing partner; David Shapiro, managing partner; Jay Bernstein, partner; Stephen Hoey, partner and CFO; Raquel Palmer, partner.

Strategy: Invests in turnarounds of underperforming or distressed businesses, financial restructurings and businesses in bankruptcy.

Investment Professionals: 20

Headquarters: New York

Despite having invested between $200 million and $300 million of Fund III's $2 billion, KPS Capital has its work cut out for it when it comes to deploying the rest of the fund over the remaining four years of its investment period. To do so, KPS Capital would have to invest roughly the amount it raised for its entire 2003 fund every year.

Perhaps the firm's biggest competition is the rebound in the capital markets. The ability of companies to amend and extend loan maturities, secure loan-to-own deals and attract private investments in public equities, or PIPEs, has let them avoid limping into bankruptcy and, potentially, into the arms of KPS Capital. Earlier this year, the firm lost a deal in which it would have purchased a company pursuant to a structured bankruptcy; instead, a buyout shop did a PIPE that converted into a 20 percent stake in the company at a value that exceeded what KPS Capital executives thought the entire company was worth. "I don't understand how a limited partner can make an investment in a fund that does PIPEs," Psaros said. "If I want to I can call my broker at JPMorgan and buy stock on the public market without paying someone 20 percent carried interest."

Many market analysts say the default rate won't be as expansive as once believed. Standard & Poor's, for example, recently slashed its September 2010 high-yield default forecast for U.S. issuers to 6.9 percent from 13.0 percent.

Three KPS Capital limited partners interviewed by *Buyouts* expressed cautious optimism over the firm's ability to invest the capital effectively. "Whenever a GP has a dramatic jump in fund size it's certainly a risk factor—it's worked for some GPs, it's been a catastrophe for others," said **Charlie Huebner**, a managing principal at **RCP Advisors**, an investor in the firm's second and third funds. "We're hopeful that because of the strategy they have and the fact that they've been getting better and better, and given the environment we're in, they'll see enough opportunities to deploy that and see the same types of returns they saw in smaller funds."

The KPS Capital Method

Not many firms go where KPS Capital does. The firm wades into turnaround situations that are so thorny—from troubled auto-part manufacturers to makers of adult diapers—that most firms wouldn't even consider them viable deals.

KPS Capital's method of turning a company around starts with buying assets at or below liquidation value, often through bankruptcy processes; dramatically reducing the debt and liabilities;

GP PROFILE:

hiring a new management team; cutting jobs while increasing productivity; and executing a turnaround plan that often takes KPS Capital executives as long as 12 months to formulate. "They're one of the only managers that can show improvement and value creation almost from day-one," Huebner said.

In one of its latest deals, for example, the firm was able to reduce liabilities at WWRD Holdings Limited (the business created out of the assets of the famed Irish crystal company Waterford Wedgewood plc) to $50 million from $1 billion by April 1, 2009, the day the new company started business. Psaros said that the company, under the leadership of **Pierre de Villemejane**, an executive who previously headed another KPS Capital portfolio company, also achieved "very material" savings by outsourcing its crystal manufacturing to European suppliers. He added that after six months under KPS Capital, WWRD Holdings, which had burned through $90 million of EBITDA from March 2008 to March 2009, is profitable. And as of Dec. 31, the company is expected to design, manufacture, distribute and sell more products with approximately 3,000 employees than it did with the 6,300 employees it had before KPS Capital.

So far in 2009, KPS Capital has closed five deals, including the complex acquisitions of Waterford Wedgewood and the formation of beer and malt beverage platform North American Breweries Inc., which acquired Labatt USA from Anheuser Busch InBev and High Falls Brewing Co. LLC.

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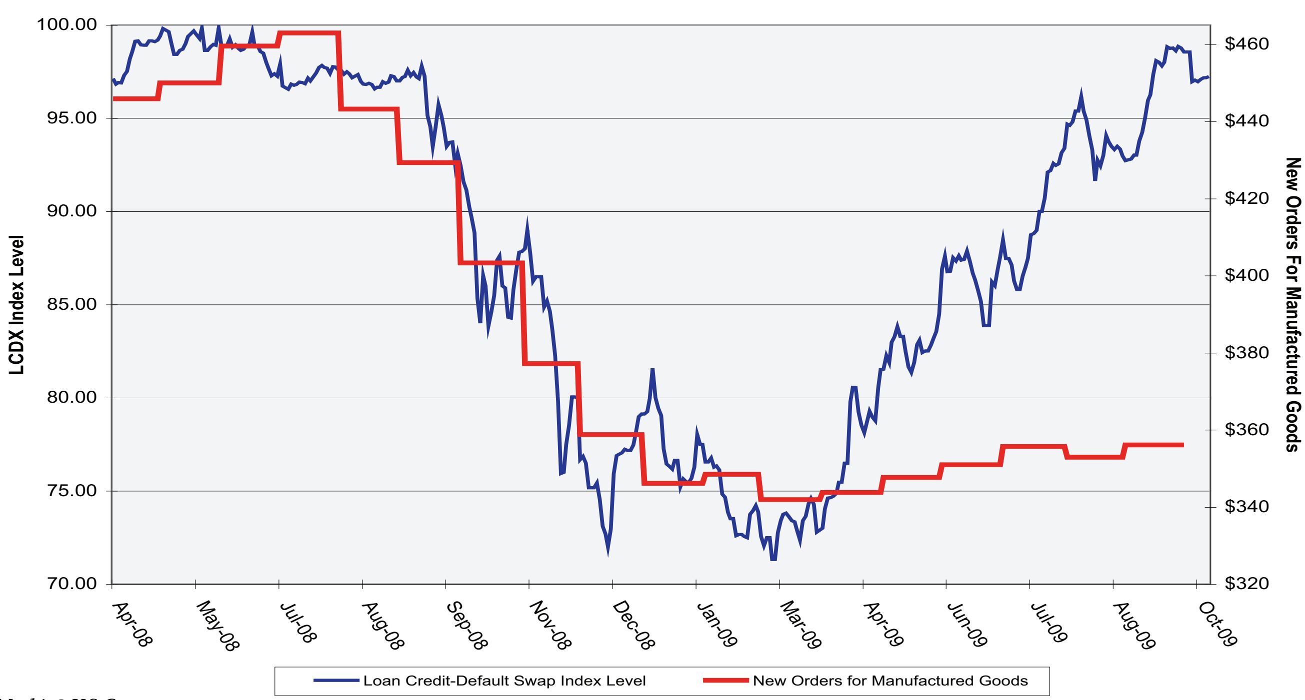
>
> *–Michael Psaros*
> *co-founder and managing partner,*
> *KPS Capital Partners LP*

Unlike previous downturns, when KPS Capital pounced on certain downtrodden industries—such as the paper industry in the late 1990s and the metals industry in the early part of this decade—today the firm's executives see opportunities across the economic spectrum. "I got to tell you, there isn't a single industry that hasn't been impacted by the great recession," Psaros said. "You look at us today—Waterford Wedgwood, North American Breweries, adult diapers—I mean, it doesn't get anymore diverse than that."

Psaros said that the rebound in the credit markets, for one thing, is misleading. He noted that high-yield bonds that were trading at extreme discounts earlier this year are now trading back near par, while new orders for manufactured goods, or what he calls "the real economy," are lagging far behind (see accompanying graph). In other words, he believes investors are trading up securities under the false assumption that the economy is improving. This disconnect is essentially a mini-bubble that he believes will be corrected. "It's 2006-2007 again," Psaros said. "Once again, we're seeing companies that are structurally broken with little to no cash flow being able to finance themselves in the high-yield market."

Looking ahead Psaros said he expects deal opportunities to increase in 2010 and reach a "crescendo" in 2011 and 2012 as companies eventually succumb to poor management and risky capital structures. "For a lot of these companies the inevitable has been delayed by 12 or 24 months," Psaros said. "But the inevitable is the inevitable: too much debt is too much debt, period." ❖

Loan Credit Default Swap Index Level Versus Total Manufacturing New Orders



Source: Markit & U.S. Census