Buyouts

The newsletter for management buyouts, leveraged acquisitions and special situations

PUBLISHED BY VENTURE ECONOMICS, A THOMSON FINANCIAL COMPANY VOL. 17, NO. 3 • FEBRUARY 2, 2004

Interest In Turnarounds Remains Strong

by Nat Worden

Every time you turn around, it seems there's another turnaround private equity investor on the scene.

With competition for deals fiercer than ever, and scores of companies still depressed after the past economic slowdown, a growing number of private equity firms are retooling themselves as turnaround shops, talking up their operational expertise. Not surprisingly, turnaround veterans aren't hiding their skepticism.

"Five years ago, a lot of these guys were buying Internet companies, and now all of a sudden they've turned into turnaround experts," says **Michael Psaros**, a managing principal with **KPS Special Situation Funds**.

To be sure, some of this shift was inevitable given the economy's slide in 2001-2002. The number of good buying opportunities had been dramatically reduced, as most companies were depressed and sellers were still kidding themselves by requesting pre-slowdown multiples. Faced with a stingy exit market, institutional investors stopped obsessing about their fund's next IPO and started focusing on portfolio repair.

The good news for investors like KPS is that LPs haven't lost interest in turnaround situations just because the economy has improved. KPS, which Psaros says deals with "hard-core, operating turnarounds," is expecting to close its second fund at more than $325 million by the end of this month. Other turnaround funds that raised money in 2003 include Ares Corporate Opportunities Fund, which has a target of $750 million and has closed on $110 million, Arsenal Capital Partners, which has closed on $230 million and is just looking to raise $20 million more. GSC Recovery IIA has closed on $407 million and is expected to close with more than $700 million, while Silver Point Capital Fund is looking to raise $1.3 billion and has closed on $402 million.

True Turnarounds

According to Psaros, many of the new players claiming to specialize in these kinds of deals are really only capable of "vanilla financial restructurings."

"If all you do is take debt in a company that has failed and turn it into equity in a reorganized, broken company, you haven't really done anything at all," he says. "It is destined to fail again. The capital markets have caught on to this, and investors are demanding real cash flows and real profits."

So what does it take to pull off a real turnaround?

The process begins with knowing where and how to find a good opportunity that fits your strengths, and also determining what areas to avoid. **Angus Littlejohn**, the chairman and chief executive of **Littlejohn and Co.**, says his firm won't consider deals in the fashion and high-tech industries because trends in those spaces are so unpredictable. "Investments in high technology usually require so much investment in research, and development, and some of these companies are so complex that by the time we figure out what we're looking at, their business is obsolete," says Littlejohn. The firm also avoids retail due to its low profit margins with respect to the investment that is usually required to make it work.

Likewise, KPS will not consider deals in media, Internet, biotech or telecom because value in those industries can be so transient.

"Unfortunately, there are hundreds, if not thousands of companies that deserve to die because they are effectively horse and buggy whip manufacturers," says Psaros. "These companies do not make for a good turnaround."

Instead, KPS and Littlejohn focus on manufacturing, distribution and unique service companies whose business models are easy to understand. Once KPS finds the right company, the first step in turning it around is identifying a set of concrete solutions to its problems at an operational level and instituting them through a new management team. "Companies don't get into trouble by accident," says Psaros. "They're almost always managed into a ditch."

Executive Help

Executives often play a role in both finding deals and completing the operational turnarounds. One reason **Questor Management Co**. sprung for the acquisition of two coal mines from U.S. Steel Corp. in July was because **Benjamin Statler**, a veteran mining executive, brought Questor the opportunity and remained a part of the team.

"It's a remarkable turnaround that he has been able to accomplish in a short amount of time there," says **Michael**

Madden, a principal with Questor, about Statler, who is now the president and chief executive of the holding company they formed called **PinnOak Resources**. "Management is obviously the most important ingredient in this business, and Statler is the ideal guy to invest behind."

Once management is in place, Psaros says the most important area for improving a company's operations is its cost structure. "I cannot underscore the importance of cost," says Psaros. "Never assume growth. You can't grow your way out of a problem. We will not proceed unless we can go in and remove a large magnitude of operating cash costs out of the company, such that in a reasonable amount of time after closing, the company is cash-flow positive and profitable."

KPS purchased 70% of New Flyer, a bus manufacturing company, in March 2002, investing $28 million in an out-of-court restructuring, and it quickly signed on a new chief executive named **John Marinucci** to implement strict cost control. Almost two years later, little has changed at the company's top line, but its operating margins have more than doubled, increasing profits dramatically. Now, the firm plans to sell the unit to **Harvest Partners** and **Lightyear Capital** for more than $300 million within a month or two, and it will likely make more than 10 times its original equity stake in the deal and an IRR of well over 100 percent.

> **"If all you do is take debt in a company that has failed and turn it into equity in a reorganized, broken company, you haven't really done anything at all."**
>
> *—Michael Psaros*

Bankruptcy Buys

After a plan for an operational fix is put in place, a buyout firm is faced with the task of creating a new capital structure for the company that will relieve the burden of debt and provide the necessary cash flow to run the business. While some firms use the bankruptcy process, Littlejohn tends to avoid it except when it is adding on to an existing platform.

"It's a very inefficient process as a buyer," says Littlejohn. "You are dealing with many professionals—it's a very expensive process—and because it's such an open auction, it tends to result in a lower yield."

In contrast, KPS finds bankruptcy court to be a fertile ground for opportunity. "The bankruptcy process allows one to shed large magnitudes of debt, leases and other obligations to get a fresh start," Psaros says.

The firm put that strategy to work at the end of last year with its purchase of Atchison Casting Corp., a bankrupt manufacturer of steel and iron castings and components. Smelling an opportunity for a cost-driven turnaround, KPS set the stage by creating a new company called Americast that purchased Atchison's remaining business and assets out of bankruptcy, leaving its liabilities behind.

"In bankruptcy, there are many parties involved and the deals can be very complex," says Psaros. Turnaround deals tend to be complex in general. In the New Flyer deal, Psaros remembers negotiating with big industrial unions in Canada and the U.S., customers, trade vendors, government authorities in two countries, banks, bonding agencies and a new management team. "We had to create a winning situation for everyone."

However, when everything goes right in a turnaround, they often yield higher returns than other buyout deals due to the high level of risk involved. For Questor's Michael Madden, a successful turnaround offers an intellectual challenge that can be very satisfying when things go right.

Things went right for Questor after it purchased Lep International, a British freight forwarder that became GeoLogistics, in 2001. That year, the company had lost $23 million in EBITDA. In 2002, it began to break even. Then, in 2003, it made $17 million, and this year, it is running at a rate of $30 million for 2004.

One way Questor finds an edge in an operational turnaround is by tapping into its bench of over 300 consulting professionals at its sister company, AlixPartners, a turnaround and performance improvement firm (both firms share the same founder—Jay Alix). Consultants from AlixPartners have been involved in many high-profile turnarounds, like those of Worldcom and Kmart, and this network helps Questor find deals and execute them with expertise in almost every industry.

Despite a hard fundraising environment and a lingering uncertainty in the overall health of the economy, Psaros is optimistic about the wealth of turnaround opportunities.

"We have never seen the quantity and the quality of opportunities in the turnaround market as we do today," he says. "If a company was able to survive until 2003 or 2004, that means that it's one of the strongest companies in its industry," he says. "It has staying power and a strong franchise. These players will sometimes make for good opportunities."

Psaros also says that secured creditors have significant power these days, and pressure is ratcheting up on banks to force troubled companies into the bankruptcy process. "Debtors are being denied the opportunity to reorganize," he says, "and banks are insisting on sales. That makes for a broader spectrum of opportunities for us."

KPS completed three acquisitions and one exit in the last six months, and the firm is predicting more activity in the future. "We're waiting for a boom in the economy to start selling some portfolio companies from our first fund," says Psaros.