After years of toil in the turnaround trenches, KPS Special Situations Funds is throwing itself a profit-taking party.

The festivities kicked off Feb. 27, when KPS, a New York private equity shop that buys ailing enterprises, clinched its first-ever outright sale of a portfolio company. It was a doozy. The firm reaped more than 7 times the $27.7 million it invested in busmaker New Flyer Industries Ltd. two years ago.

That was a much-needed antidote for a $42 million hit KPS took last summer, when a fluke explosion in a blast furnace owned by another portfolio company, Republic Engineered Products LLC, sent the steel bar maker into Chapter 11.

The New Flyer exit also meant that, at a single stroke, KPS, which began 12 years ago as a restructuring consultant, has earned back almost all the $210 million it raised for its first investment pool in 1998.

KPS, too, scored gains on partial exits from two more holdings, Curtis Papers Inc. and Blue Heron Paper Co. Now, with the economy on the mend and asset valuations on the rise, KPS contends the fun has only just begun.

“In the course of the next 18 months, we could have three to five additional realizations,” reckons partner David Shapiro, the “S” in KPS. Says the “P,” Michael Psaros: “We're hoping that, at the end of the day, relative to our peer group, which is 1998 or 1999 vintage funds, we're going to do exceedingly well.”

No idle boast, that. At a time when private equity returns have slumped and most buyout funds raised in 1998 have recouped only a fraction of invested capital, KPS' performance stands out.

“Among funds that invest in operating turnarounds, KPS' results have been pretty terrific,” says Erik Hirsch, chief investment officer at Hamilton Lane Advisers LLC, a pension fund consultant and investment firm.

Indeed, the surest sign of KPS' rising stature in private equity circles is the fact that it recently fattened its purse. The same day New Flyer was sold, KPS wrapped up another closing—of the $404 million KPS Special Situations Fund II LP, the firm's second investment pool. The fund, which had begun making investments last year, attracted more than 30 institutional investors, nearly triple the number that backed KPS's first vehicle. Hamilton Lane and its clients, according to Hirsch, kicked in about $50 million of the total.

KPS' secret? In a recent interview at KPS' offices on the top floor of the Met Life Building, which looms over Grand Central Terminal, Shapiro, 42, Psaros, 36, and their 61-year-old partner, Eugene Keilin, sketched out a modus operandi to which they adhere consistently deal to deal.

For starters, KPS tends to swoop in to capture businesses in the wake of failed auctions. The targets, often as not, are ignored or overlooked by corporate and other financial bidders alike. Size is partly the reason: Most other private equity firms that specialize in turnarounds, such as Questor Management Co. and Sun Capital Partners Inc., gravitate to larger-cap deals.

“It’s a very inefficient market we operate in,” observes Keilin. “There are few, if any, other lookers and almost never any other serious buyer. We’re the buyer of last resort.”

That, of course, speaks volumes about the nature of its targets. Most are corporate detritus—cyclical businesses that have touched bottom, cursed with runaway costs. Often they're hemorrhaging cash. They are, in other words, heavy-duty turnaround cases that can't be fixed simply by deleveraging their balance sheets and tweaking things operationally.

As a result, while the lack of rival bidders usually allows KPS to buy on the cheap, its acquisitions tend to require more sweeping remedies than many distressed investors care to bother with.

Another attribute that sets KPS apart is its warm ties to labor unions. Keilin, in particular, brought a history of friendly union dealings from his stint at Lazard in the 1980s as a restructuring adviser. Aware that KPS bends over backwards to accommodate labor, union leaders regularly give the firm the heads-up on prospective deals.

“I don't have a relationship like this with any other equity funds out there,” says Dave Foster, a district leader for the Midwest and northwestern United States at United Steelworkers of America, who helped KPS source its latest investment, in AmeriCast Technologies Inc., which makes steel and iron sand castings. “With KPS, we can deal with issues in a way that doesn’t threaten the majority of our members' jobs.”
Those ties play a vital role in KPS deals, enabling it to win pay and benefits concessions from labor while rewarding workers with a piece of the upside in the form of equity or future profits.

Labor concessions go to the heart of KPS’ investment strategy: The cornerstone of any KPS deal is to rein in operating costs. Before it bets a dollar on a company, KPS usually spends months hammering out a strategy with management, deciding which factories to shut down, reworking labor contracts and reconfiguring the balance sheet with creditors. The idea is to cure a company’s ills before KPS infuses capital—which it invariably does at the time a reorganization or restructuring takes effect.

Of KPS’s 11 deals to date, starting with the May 1999 purchase of coated-paper producer Blue Ridge Paper Products Inc., six were of bankrupt businesses; three were assets bought from corporations; and two were of enterprises restructured out of court. Regardless of the particulars, each KPS deal has combined a retangling of the balance sheet with a retrenchment of operations and a rethinking of the business.

How has KPS’ approach panned out? With New Flyer Industries, a Winnipeg, Manitoba-based maker of city buses, including accordionlike articulated buses used in cities such as New York and San Francisco, it did so to perfection.

Before KPS took over New Flyer, bus sales were shrinking, and New Flyer’s costs were bloated, recalls Shapiro. “It was run by an entrepreneur [Jan den Oudsten] who was a fantastic bus designer but, by his own admission, not a great manager,” he says. “It had grown too quickly, from one plant to three.” As it jacked up debt to fund the growth, New Flyer failed to meld the facilities’ operations.

By 2001, when KPS first looked at New Flyer, it was “in something of a death spiral,” Shapiro says. New Flyer’s wretched credit rating barred it from bidding on most municipal contracts because cities and transit districts demand that their contractors be insured by a bonding agency.

“The banks were squeezing it, and it had effectively lost access to its markets,” says Shapiro.

To get New Flyer back on its feet, KPS orchestrated an out-of-court restructuring. It negotiated easier terms with lenders, got the unions to accept layoffs and less-rigid work rules, wrangled a capital infusion from the province of Manitoba, persuaded a bonding agency to back New Flyer’s bids, and worked out deferred payments to trade creditors. It also recruited a new CEO, John Marinucci, to run the business.

“John executed the hell out of the business plan,” says Shapiro. “Because of the lost bonding, the backlog was at an all-time low—a couple of hundred million dollars. Over the next 20 months, it rose to over a billion.”

Shapiro won’t give out the numbers but says that Ebitda more than tripled. The turnaround, he says, enabled New Flyer to hire back many of the workers it had laid off.

Last summer Goldman, Sachs & Co. was hired to auction New Flyer. In February two private equity firms, Harvest Partners Inc. and Lightyear Fund LP, paid more than $300 million for New Flyer, netting KPS more than a better-than-sixfold gain.

“We felt we’d achieved what we could do,” Shapiro says. “We’re a turnaround fund, and the turnaround was in place.”

KPS’ touch isn’t fail-safe. On Aug. 14 it fell victim to the East Coast power blackout. The power failure caused a 30-story-tall blast furnace at a Republic Engineered Products plant in Ohio to explode. No one was killed or injured, but production shut down for weeks and Republic’s banks forced the company into Chapter 11. KPS, which had bought Republic out of bankruptcy in August 2002, lost its $42 million investment.

Before the blast, KPS had succeeded in

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**About turn**  **KPS Special Situations investments to date**

<table>
<thead>
<tr>
<th>Company / Business</th>
<th>Date of investment</th>
<th>Amount invested ($mll.)</th>
<th>Realized?</th>
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<tr>
<td><strong>FUND I DEALS</strong></td>
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<tr>
<td>Republic Engineered Products LLC</td>
<td>Aug ‘02</td>
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<td>Filed Chapter 11 Oct. 2003</td>
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<td>New Flyer Industries Ltd.</td>
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<td>Curtis Papers Inc.</td>
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<td>10.0</td>
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<tr>
<td>United Road Services Inc.</td>
<td>July ‘00</td>
<td>25.0</td>
<td>Unrealized</td>
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<tr>
<td>DeVlieg-Bullard Inc.</td>
<td>June ‘01</td>
<td>10.0</td>
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<tr>
<td>Blue Heron Paper Co.</td>
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<td>Blue Ridge Paper Products Inc.</td>
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<td>AmeriCast Technologies Inc.</td>
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<td>$15–$20**</td>
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<td>Speedline Technologies Inc.</td>
<td>Nov ‘03</td>
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<td>Wire Rope Corp. of America Inc.</td>
<td>June ‘03</td>
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<td><strong>$45–$50</strong></td>
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*All partial realizations have recouped original equity investments and produced some profit, according to KPS.
**Also supplied $55 million of bridge financing, most of which will be refinanced. Source: KPS Special Situations: The Deal
slashing costs, shutting down nine of Republic’s 15 plants and shrinking the work force from 4,000 to 2,300 employees, Psaros says.

Another KPS purchase, United Road Services Inc., apparently has soured for more prosaic reasons. In July 2000, KPS sank $25 million into a financial bailout of the vehicle-towing company, whose aggressive rollup strategy had led to runaway costs.

But KPS was unable to cut costs far enough, and in December 2002 United Road Services was threatened with technical default on its loan covenants. United’s shares, which trade over the counter, now sell for pennies.

Several others holding, the partners say, have weathered a slump in manufacturing and are on the rebound.

Blue Ridge Paper Products, KPS’ first deal, fits that description. KPS formed Blue Ridge to buy units of Champion International Corp. that make uncoated paper for envelopes along with coated stock for milk and juice cartons. Even though Blue Ridge has been hurt by dismal demand and tumbling paper prices, it has cut costs more than $25 million a year.

“At Blue Ridge, we’ve accomplished a lot,” says Psaros. “We’ve reinvested more than $100 million of cash flow back in the company to modernize it. We’ve paid down a lot of debt, all in the face of this recession. Now that the paper markets are recovering, we’re looking forward to reaping the benefits of the operating leverage we’ve created.”

In coming months, as KPS angles to cash out of Blue Ridge and other holdings, it also must deploy its fresh capital. Despite the improved health of manufacturing, the partners believe there is an abundant stock of alluringly priced, down-on-their-luck enterprises to choose from.

Indeed, KPS recently has sprung for three: Wire Rope Corp. of America Inc., purchased in June; Speedline Technologies Inc., a maker of equipment used to assemble printed circuit boards, acquired in November; and AmeriCast Technologies, which KPS bought in December.

In particular, Psaros says the buyout market’s impulse to test the outer bounds of leverage will yield a bumper crop of distressed plays down the road.

“People are drinking the Kool-Aid again,” said Psaros. “As a matter of historical record, every single time the high-yield window has opened up, it’s been followed by an echo boom of bankruptcies within 24 to 36 months. So a lot of opportunities are being manufactured for us today by the capital markets.”

“We’re grateful for that,” he adds wryly.