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KPS Wades Into Auto Space

Six months ago, **KPS Special Situations**' **Michael Psaros** went on record with *Buyouts* to discuss the opportunity he sees in the auto parts industry. A contrarian by nature, Psaros is obviously looking for distressed areas within the market, and he couldn't have picked a better candidate than auto parts, a sector he described in February as going through a "convulsion."

The struggles of General Motors and Ford have been well documented, but the weakness of the customer base is only part of the problem for the auto-parts players. The other factor, and perhaps more significant, is the increase in metal and raw material costs. These expenses, particularly in steel and resin, have escalated alongside commodity and energy prices, which are struggling to meet an intemperate demand coming from Asia.

To most in private equity, auto parts have become the bête noire of the industry, especially considering a number of firms, such as **Heartland Industrial Partners**, have already been burned by the sector. As of the end of August, more than 15 auto-parts makers had filed for bankruptcy, according to reports, and anecdotally many more are just barely hanging on. Collins & Aikman and Tower Automotive are two of the more notable businesses to file Chapter 11, while Delphi Corp., another big name, recently warned its creditors that it could be the next in line. Even the auto parts companies are trying to mitigate their exposure to auto parts, as evidenced by Johnson Control's purchase of HVAC outfit York International Corp.

So amid this "convulsion," why would anyone want to make a bet on an automotive axle maker?

"We believe that in chaos is opportunity," says Psaros.

KPS recently made its first move in the auto parts space last month, when it agreed to acquire **Jernberg Inc**. out of bankruptcy for roughly $60 million. KPS will invest $23 million of equity in the manufacturer of forged parts, which will be renamed **Hephaestus Holdings Inc**. (HHI) at the conclusion of the deal. The equity infusion will go toward the company's turnaround plan and working capital, and KPS will provide another $8 million of interim financing dedicated to the purchase of new manufacturing equipment. Through the bankruptcy process, Hephaestus was able to wipe clean over $40 million of liabilities from its books.

For KPS, this isn't just a case of buying low while everyone else evacuates. The firm believes Hephaestus has staying power, and has brought in former Metaldyne executive **George Thanopoulos** to direct it going forward.

"We see this as an opportune time to make targeted investments in the *right* areas of the automotive parts industry. The company is the third largest competitor in the North American forged parts industry and we intend to further build HHI organically and through acquisition," Psaros said. "Between buying it right and having a plan in place to fix it, that's what gives us confidence."

Part of the plan Psaros referred to was to rework the company's many legacy contracts. KPS renegotiated 30 separate agreements with the HHI vendors, customers, lenders and unions, and because of this, Psaros expects the company to be cash flow positive right out of the gate.

Additionally, the firm will "aggressively" seek to reduce costs through capital investment in the company's equipment as well as find savings through the implementation of leaner manufacturing methods.

In terms of what drew KPS to the forged parts space, Psaros cited that the size and complexity of the parts it provides helps insulate the industry from offshore competition. The shipping costs would severely limit any offshore discount.

While the rest of the auto parts sector is sinking around it, KPS anticipates that HHI will be able to distinguish itself by its stronger capital position. "The new company is going to be well capitalized with low leverage and low legacy costs," Psaros noted. "Its balance sheet alone will distinguish it from most other auto parts suppliers today."—*K.M.*