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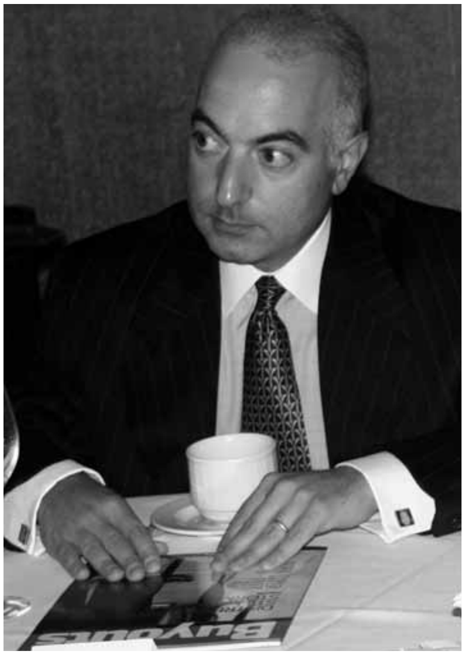
ROUNDTABLE: THE BEARS SPEAK

By Ken MacFadyen

At the end of June, *Buyouts* had the opportunity to sit down with five of the biggest names in the distressed buyouts space. Few would confuse these investors as a glass-is-half-full lot, but with that aside, their pessimism over the M&A market's current sunny environment should not be taken lightly. (It should be noted that those in attendance were indeed optimistic, although only as it relates to their own contrarian styles of investing).



> "It may not last very long, but when the downturn comes it'll be something that hits the economy with great violence, and we're going to invest a lot of money when that happens."
> —*Michael Psaros*

The conversation drifted from the role of the hedge funds to which countries are the easiest (and most difficult) to inculcate change. The banking community found itself in the crosshairs of those at the table, while poor company managements were celebrated as opportunity generators.

So what keeps these pros up at night? It's not the China threat—they're embracing that. Rising health care costs may be the Achilles' heel of the space, as it's the one outlay that can't be cut.

The roundtable took place on June 29 at New York City steakhouse Patroon Restaurant. In attendance were **Gary Talarico** of **Sun Capital**, **Black Eagle Partners**' **Michael Madden**, **KPS Special Situations Funds** Co-founder **Michael Psaros**, **Chrysalis Capital**'s **Paul Halpern** and **Wilbur Ross** of **W.L. Ross & Co**.

Combined, these pros have made major bets in steel, autos, textiles, retail and paper. They've invested in the U.S., throughout Europe, Japan, India and Korea. What follows is a slightly trimmed down version of their discussion over lunch.

On Finding Opportunity

Buyouts: The traditional LBO industry is peaking. Firms are raising and returning record amounts of cash, financing remains strong, and deals keep getting bid up to double digit multiples: How does a contrarian operate in an environment like this?

Wilbur Ross: The default rate is very low, about one percent... but there's always something to do in some sector.

Michael Psaros: There's always going to be bad management. It's the one thing you can count on in good cycles and downturns. Two-thousand and five was the busiest year we've ever had and 2006 has been extremely busy... A lot of companies are making money today, so they see it as a time when they should trim their portfolios even if it means incurring writeoffs. Actually, they're doing it because they're making money, and can offset those writeoffs.

Gary Talarico: I would agree that we're seeing a lot of activity... We had a record year last year. We did 30 deals, around 15 of which were add-ons. Some were not altogether distressed. We came across a lot of corporate divestitures... People are flush with money, and it's a good time for them to take a hit on an underperforming division.

Paul Halpern: It's counter cyclical. Those divestiture opportunities are not balance sheet driven or even distress driven. In fact, the inspiration for becoming a seller in those cases is the success of the parent.

Talarico: Right, but you have to question if they are motivated sellers. That's the thing that always troubles us. Because they say they want to sell, but they have to get to a price that is really a distressed price, and then they get indigestion when it comes time to make a decision.

Michael Madden: The last five or six years have been pretty benign. We've all been able to find some good deals during that period. When conditions become more difficult there's one big condition—liquidity. When that becomes constrained, all of the credits that have been allowed to bump along in the night become focal points for people who ask, 'What's my credit exposure?'... The genesis of that is usually some kind of event, something with financial implications, maybe a credit derivatives scandal, who knows? It is in this context that we'll be able to see much more stuff and upgrade our opportunities.

Halpern: What we're seeing now is the beginning of a process that starts in small cap and works its way up. Our range is $50 million to $500 million revenue companies, and in the $50 million to $200 million range is where we're getting all of our activity this year. Certainly, the last liquidity crunch was much harder on smaller companies than it was on larger companies. This does move up.

Talarico: One comment I'd make is that our opportunities are not driven just by bad management, it's also just bad luck. There've been some big changes occurring in the world economy. Sometimes it's that management didn't move quickly enough, but I've got to tell you, it's hard to say that if we were sitting in that same spot that we'd move quickly enough either. China is a big factor. A lot of companies prided themselves on being the biggest manufacturer of this or that in the U.S. and that was their problem. They should've moved faster than they did. You can look at that today and say that they should've moved offshore, but it all happened in about a year and a half. You basically had about a six-month window to make that decision, and if you didn't, you got caught short.

Ross: The textile industry had a 10 year notice that the quotas would be coming off on December 31, 2005. Virtually none of them did anything. In 10 years you'd think that somewhere along the line they'd do something.

Psaros: I'd argue they even had more than ten years because the quotas were never going to survive.

Ross: They're still fighting it today. Vietnam is up for the WTO. Rather than go there and open a plant, they'd rather lobby in Washington. It's an amazing phenomenon.

Halpern: It's a much shorter flight to Washington.

Ross: Although the language differences can be just the same. (laughter)

On Hedge Funds

Buyouts: There's a lot of talk about the hedge funds, and their role in the debt markets. What are you guys seeing?

Ross: They're doing a lot of that second lien paper. They've helped out a lot of people, at least temporarily. I don't see it, though. If a company is going cash negative and you're only putting more cash in and not materially fixing the business, you're just building a bigger time bomb for the unsecureds later on.

Talarico: They're not bringing any value to the table, just money. That's why we created a fund for minority investments. We're seeing opportunities where we didn't want to mix control and non-control for return reasons. We're starting to put that money to work, but the hedge funds are so cheap relative to what we would do, that we're not finding it that easy. We are finding club deals to do and taking some positions in stock not necessarily as activist investors, but as constructive partners with management. This is the first time we've done this… But the money's too cheap. At some point it's all about liquidity. There's a little too much liquidity, and as a result, people are propped up with money that on a risk-adjusted basis is just way too cheap.

Psaros: But we're very grateful for their presence on the financing side…We create these companies. We buy assets out of bankruptcy cheaply, and take EBITDA negative companies and turn them into growing profitable concerns. Between 10 and 14 months later we're able to execute a recap. We can return capital, plus find profit for our investors. It's been a wonderful thing. On the buyside, though, the hedge funds have been very problematic in the control market. And I don't understand it. I believe the markets are efficient and eventually the excess will be weeded out of the system.

Madden: I think its creating some inventory for us down the line.

Halpern: I think their participation on the financing side has a macro economic impact as well, because the hedge funds as lenders are not only aggressive but are basically unregulated. That means when the controller of the currency decides the banks are overextended—the way it happened after the Russian debt crisis—this time around there will be a significant pool of liquidity that does not have to report. That, I think will have a significant mitigating effect in the next crisis. It will slow it down… I think that makes them a really constructive player in the markets.

Ross: Do you really think so, or do you think that they're going to start getting redeemed out if something goes bad?

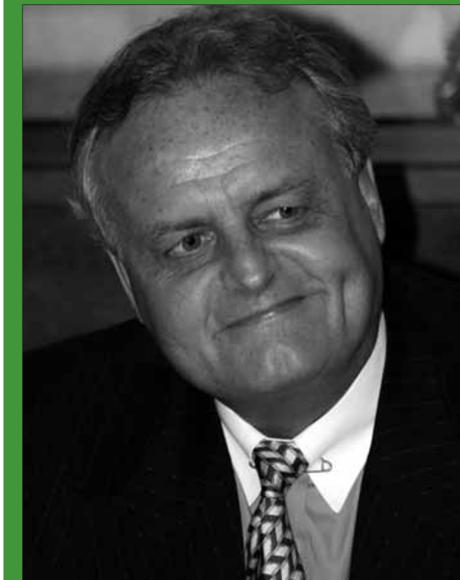
Halpern: I think the SEC just helped them all put two-year lockups in. I don't know what percentage of hedge fund money actually has got a two-year lockup as opposed to the way it used to be, but I still think that will have a significant effect.

Ross: I think there's a lot of it without a lot of lock up.

Talarico: Well, it would delay the day of reckoning. At some point a fund will melt down. If it melts down, that can't be avoided, but the run on the bank won't be as immediate as it has in past crises… We're starting to see just the beginning of trouble situations coming out of the hedge funds and it's really interesting. They clearly don't want to operate these companies unless they've got private equity bents, which some of them increasingly do. What's interesting is how little they understand about how far under water they are. Somehow you just assume that the hedge funds have smarter guys. You assume that they're maybe a little sharper, a little more detailed than the banks. When something goes to [a bank's] workout group getting the right guy is impossible. At least in a slim hedge fund, you'd think that you can get a decision maker and talk reason with them, but that's not always the case. They just don't get it.

Ross: They don't get it or don't want to get it?

Talarico: I think they're in denial. And we've seen both. We had one situation



Michael Madden
Founder
BlackEagle Partners

Before BlackEagle, Madden served as a general partner at Questor Management, and also spent time as the vice chairman of PaineWebber and as co-head of worldwide investment banking at Lehman Brothers.

B.A.: LeMoyne College

M.B.A.: Wharton School at U. Penn

Lunch: Shrimp Cocktail, Grilled Rib Eye

Wilbur Ross, Jr.
CEO and Chairman
WL Ross & Co.

Before WL Ross & Co., Ross led the bankruptcy and restructuring advisory practice of Rothschild.

B. A.: Yale University

M.B.A.: Harvard University

Last investment: Common shares of Montpelier Re Holdings (a publicly held provider of property and casualty reinsurance)

Lunch: Chopped Salad, Grilled Skirt Steak

where the hedge fund came to us and said, "We're under water and we know we're under water. Give us this price for 50% of the debt, and let's own this together." We did the deal in a 363 and it's going to work out great for both of us… [With another hedge] we gave them a bid, said it's the best we could do, but they ended up hiring an advisor. It's now two months later and the advisor is coming to us telling us they'd do the deal. But guess what, we're not there anymore. The company is worse off today and there's no deal to do. It's going to liquidate.

Madden: They tend to exacerbate their problems by buying to own.

Talarico: It's just one of those situations where four months ago, we could've gotten the deal done and made it work, but by the time they approached us, it just collapsed.

Halpern: The annual cycle is so critical to all of these distressed companies. People riding that train for the first time don't really understand how it's going to work out.

Buyouts: From what I've heard, even the veterans are wondering how things will work out considering how complex capital structures have become. Do you have any thoughts?

Ross: The unsecured recoveries are going to keep getting worse. I think there's been a long-term trend of unsecured recoveries going down and down, and that's only going to get worse with [the arrival of] second lien loans.

Talarico: What'll be interesting is the interplay between the second and first lien providers.

Madden: Nobody knows how that will turn out.

Talarico: Nobody knows, and the documents aren't uniform. Everybody's all over the place with these things. They haven't been tested yet.

Psaros: They haven't been litigated, and every jurisdiction is different.

Talarico: It could make it harder for us to do deals.

Halpern: The loan could be owned by a securitization pool that doesn't have an interested party.

Ross: It's unknowable. We haven't had the court history. The real issue with these things is how're the courts going to treat it.

On Sector Focus

Buyouts: It was said earlier that there's always something to do in some sector. What areas do you like today? I know three of you are active in auto parts.

Halpern: I hate the auto parts space.

Ross: Good. Why do you hate it? (laughter)

Halpern: I can't figure out how you make money with such a concentrated customer base. That's it in a nutshell. It is obvious folks have made money, but there seems to be a secret sauce and that scares me away.

Ross: It's a tough industry, we agree with that. But on the other hand it's huge, it's global and it's not going away. Whoever's the nameplate, whether it's GM, Toyota, Hyundai, they need the parts… The problem is that the industry is too fragmented and there is too much overcapacity. The plastics side has about 40% global underutilization of capacity. How do you make money in manufacturing when you're operating at 60% capacity? That's tough.

Talarico: We're very interested in U.S. manufacturers who're behind the trend in moving to China.

Ross: That's 92% of them.

Psaros: Some of these companies used to be able to deliver a part or an engine, but now they can't. If they want to keep that business, they need to have a broader solution.

Ross: That creates scale.

Psaros: That has been the theme with our three [auto parts] platforms…We believe that you have to be a design and engineering company today. You can't just be a shoot and ship company. Then you need to be either sole sourced or the critical vendor, and that makes you feel a lot better.

Madden: How do you deal with a customer base that comes back to you every year and asks you for a five percent concession?

Psaros: You say no…What's interesting, if you look at Toyota, Nissan, Hyundai or BMW, if you want to do business with them, then you need to build a plant right here. That's why I hate all this talk about moving a lot of parts work to China, and take it with a grain of salt. Look at all the new domestic companies in the system. They want you to be right here… Generally speaking, everyone's very in tune about what's going on in China and the threats coming from there, but I think in auto parts it's been very much overblown.

Ross: I don't agree with that, because they're going to start making more cars in China. It isn't that the parts are going to be shipped out [individually], they're going to get shipped out as whole cars.

Talarico: We're not particularly sector driven. More company driven, really, but in the auto sector, one of the things we try to do is find something that is safety critical. One, it's hard to change suppliers; two, they really don't want to; and three, the [auto makers] typically want more than one supplier, at least two and typically three. We did a pedals deal. It's still got a way to go, but from what we've found, it's got to be good and the engineering has to be hand in glove with their engineers. So it's not easy to just stop. We had meetings with the automakers and everyone, except for GM, were really good. They all said they really wanted this company to survive.

Buyouts: With the domestic OEMs struggling, could there ever be a buyout of GM or Ford, and if so, how would you go about fixing the business?

Madden: That sounds like a Wilbur deal.

Talarico: No, he'd probably have to buy all three.

Madden: Anything is possible. I think that they could do something like that, but in order for that to happen, the situation would have to resemble the steel industry or other businesses where there's no alternative other than to restructure the entire cost base.

Ross: I don't think we're there yet…It may be possible, but the real question is if they will ever build cars that people want. Steel is more or less steel. If you're the low-cost producer you can do alright. With cars, cost is one thing, but you have to make cars that people will want to buy.

Psaros: I remember when Nissan was in trouble and Carlos Ghosn had just taken over… I got to know Ghosn a little bit because our kids played soccer together. I asked him what were the positive surprises he found when he took over and he said that the biggest surprise was that the engineering talent was phenomenal. Once they understood the direction, the speed was amazing. It took time to convince people and get them to understand what they needed to do, but once they got it, they were off to the races.

On Foreign Investment

Ross: It's hard to inculcate change in Japan. The whole society is resistant to change. That's the bad part and the good part. The bad part is the culture is very resistant, but the good part is that if you can get somebody that is willing make change, it can create big improvement very quickly. We bought a failed bank from the government, and in one year it was making 18% on equity…We turned it into a real retail bank that didn't try to lend to broken down companies. It didn't take very long.

Talarico: In the good years, the best Japanese banks were making 4% to 5% on equity.

Buyouts: How do you encourage change across different cultures?

Ross: You need local people who get it. It's a rare commodity. We're in Japan still and we're in India now. It's a whole new industry there. On one hand we have a first-mover advantage, but on the other hand the local people don't have any technical skills, so it's tricky. You have to try to migrate the skills over by parachuting people in and out from the States.

Michael Psaros
Managing Principal
KPS Special Situations Funds

Before KPS, Psaros worked at Keilin & Co., an investment banking firm specializing in financial restructuring and bankruptcy transactions.

B.A.: Georgetown University

Masters: Sofia University (Tokyo, Japan)

Last investment: Cloyes Gear & Products Inc. (auto parts manufacturer)

Lunch: Chicken Vegetable Salad

Paul Halpern
Partner and General Counsel
Chrysalis Capital Partners,

Before Chrysalis, Halpern worked at Levene & Eisenberg, a bankruptcy and insolvency law firm.

B.A.: Reed College

J.D.: Stanford University

Last investment: Republic Storage Systems (maker of lockers)

Lunch: Stuffed Medjol Dates, Roasted Monkfish

Talarico: We opened a London office a year and a half ago, and have made five investments. It's a completely different operating environment. You must find local operating executives. It's not always the top people in a company. Most often it's the next layer down. Each environment is different. The U.K.'s the best in terms of getting changes through. Germany, I don't know if it's necessarily the next best or not, but it's a lot like Japan in my mind in that once everybody is on board, change can move pretty quickly. France is France—probably one of the more difficult operating environments for creating change.

Ross: Italy is another that's very difficult.

Madden: We did a deal in Italy, Teksid, and what an ugly mess that was… They'd "yes" you all day long and if you're not riding them and you're not right there, you'll have no hope in figuring it out. You really have to get your people in there and make your presence felt… It was like trying to penetrate Fort Knox. It's mostly fixed now, but it has taken three years.

Buyouts: Where's the next hot spot to invest?

Ross: India. To me, China got built on the arbitrage of blue-collar salaries there versus here. India, I think, will get built on the arbitrage of engineering salaries. There are a lot of people designing products there right now. And if you're designing, you're in a growing market, and it's cheap, pretty soon companies will start making the products there.

On Entry Points

Buyouts: Is there a preferred point at which to begin pursuing a company?

Ross: The bottom.

Halpern: Can't beat that.

Madden: That's it. Next question. (laughter)

Psaros: You really want to get in when a company has capitulated and it knows it's time to restructure. But you also want to get in as early as possible from a process standpoint. If you can get in on a pre-arranged basis that's always a preference. If not, then you always want to be a stalking horse, where in most instances you can drive the process. But the company has to be at the bottom and everyone has to recognize that it requires a restructuring in or out of court.

Halpern: The fact is as a turnaround person, you want to get there sooner rather than later. As an investor, at the front end you have all these stakeholders with a lagging view of value. If you start at a high enough point the company can keep marching down and down. The inverse is true as well—after the turn—especially if it was turned out of court. They have a lagging view of value, so there are certainly pricing opportunities very late in a turnaround process.

Madden: We prefer not to do stuff in bankruptcy if we can help it.

Ross: You really do?

Madden: Unless we can do a deal where we find somebody with a fulcrum security and can affect control ahead of time, but the transparency and value-leakage potential of waiting around the rim, for us that's a toughie. We'd rather get in before the value leakage and the customers have fled. And we can do it with someone who's got a stakeholder position and help them revalue the position on the upside.

Psaros: Maybe we're masochistic, but we really like buying in bankruptcy.

Ross: You can really clean it up. You can deal with the contracts and really paint with a different brush. That's the good part about it.

Talarico: We don't mind bankruptcy. What we don't like is the process necessarily. We used to do a lot of 363s in a lot of smaller companies, but last year we had a bad experience…We were negotiating with the counsel representing the banks trying to do a pre-packaged deal. We thought we were having exclusive discussions. Everything was all mapped out ready to go and then we heard they had opened up discussions with other people. We walked and decided that from then on, unless we can get a break up fee, that we're done. We stopped small bankruptcies completely because of that.

Madden: A couple of other bad things in the bankruptcy process that we've experienced is that you've got bad lawyers advising the company that there's always a better deal out there. The other problem is with a weak banking group. The two go together usually. You'll have a weak bank group that's too scared to make a decision being advised by a bad lawyer looking to extend their fee structure and be a hero.

Psaros: That's where the new bankruptcy laws help us all out. I think it's great to the extent that the bankruptcy period is going to be truncated, and will compel more sales.

Ross: It's not so much that [the lawyers] are bad, but their motivations are different. A lot of these guys got all the technical skills in the world, but that's part of the problem. They can delay and delay and delay. It's so hard to make things go fast.

On Health Care

Buyouts: What's the next shoe to drop? Everyone refers to the China threat, but what are some problems closer to home, such as health care?

Ross: I don't see too much enthusiasm for changing it right now. Everyone talks about it, but I don't see anything really getting done.

Psaros: When we meet with limited partners, their favorite question to ask is, "What keeps us up at night?" The expectation is that it's China or India, but what keeps me up at night is health-care and health care costs. I don't know what the solution may be. It's not my thing. But if you ask me what is my number one cost problem, it is health care. Our management teams get up every day and take costs out of the business. But year after year those savings go through the chimney in the form of health care premiums.

Ross: It's a real problem… As long as it stays in the private sector, and there's a separation between who pays [employers] and who gets the service [employees], it's hopeless to fix.

Psaros: You've got something like 40% of the population being uninsured, and that means that the 60% of the population that is insured has to pay for the rest of the population. That has to be brought into balance. All of our companies offer health care, so we're basically paying for Wal-Mart's employees to go to the emergency rooms.

Ross: We're the only country in the world where the private sector is the basic funding mechanism for health care. There's nobody else that we compete with that has a similar situation… It's a joke.

On Traditional Buyout Investors

Buyouts: There has been a lot of talk about the LBO boom among traditional firms. Do you think this is a bubble?

Ross: I just came back from Europe. I saw a presentation there that said the average multiple paid for LBOs in Europe last year was about 8.3x EBITDA. To me that is off the chart. In '01 it was about 5 times. That's a lot of movement in multiples.

Halpern: The issue to us is price paid not leverage obtained. From the point of view of a private equity group, the more leverage you can get for a given price, the better your returns are going to be. But as prices have gone up, it's gone beyond my ability to understand.

Ross: What people are saying is that it's alright if I'm paying a higher multiple because financing costs are cheaper. That's great if you're going to resell into that same financing environment… But you have to ask yourself, how are you going to get out? It's been a mistake to let cheap financing costs translate into higher multiples.

Psaros: This isn't our world, we're just observing it. But as prices have gotten pushed up it's apparent people are pricing off of the financing available. That's great for us, considering we've got a bunch of companies for sale today. I hope we do get these multiples but that's not something that we'd do on the buyside.

Ross: There'll be explosions. A lot of these [financing structures] have bullet loans that carry a lot of refinancing risk… If you have a low-coupon bullet loan, you better have your numbers right when it comes up for refinancing.

Gary Talarico
Managing Director
Sun Capital Partners

Before Sun, Talarico served as a managing director and head of Global Corporate Finance for Deutsche Bank Group in Tokyo.

B.A.: Illinois State University

Masters: Paul H. Nitze School of Advanced International Studies, Johns Hopkins University

Last investment: POP Displays (maker of point-of-purchase displays)

Lunch: Stuffed Medjol Dates, Cobb Salad

Madden: [All the lenders] are looking at each other saying this is crazy, but we've got to do it because the next guy will. So the lemmings are providing the leverage on [business models] that are only achievable in a perfect world. It creates a death spiral, because the minute the world turns just a little bit, they'll lose certain synergies and there's no room for error.

On the Future

Buyouts: Any bold predictions as to what we can expect next from the industry?

Ross: I think you'll start seeing more private equity funds go public. Not just the thing that KKR put together in Europe, but entire firms themselves will start to go public. If the investment banks can do it, why not the private equity firms?

Talarico: I'd predict that the middle market will continue to be underserved. I don't expect that to change. If there is going to be an economic or cyclical discontinuity, it will probably come from a default swap in the derivatives market.

Madden: I'd agree with that. We could see a big credit derivatives debacle.

Halpern: The one thing that I'm expecting to occur, although I don't know when it's going to happen, is that the buyout multiples people are paying now will have to drop substantially. It will probably take one or two more drops in the interest rate and some bumps in the road for the economy but everyone's been saying in the next 18 months that something's going to happen, and they've been saying that now for the past 18 months. We have some inflation coming into the economy, and consumers' wallets are starting to get stretched.

Psaros: Already in the press people are talking about a potential soft landing. I don't know when it's going to happen, but because of a confluence of events… I think it will be a step function. I don't see a soft landing. It may not last very long, but when the downturn comes it'll be something that hits the economy with great violence, and we're going to invest a lot of money when that happens.

Madden: The big guys have been enjoying a wonderful period in the sun. With all these club deals, there's been a commingling of concentration and investors have been putting to work huge amounts of money with "me too" strategies. I've got to believe that the returns in this vintage will be pretty damn mediocre. I think there will be some pendulum swinging backwards with people looking again for more specialist strategies or smaller, nimbler funds. ❖