An Examination of the Darker Aspects of Leveraged Buyouts

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E VERYTHING Henry Kravis touches does not turn to gold. In fact, Kohlberg Kravis Roberts & Co.'s first big buyout, the $348 million purchase of Houalille Industries in 1979, was close to a disaster.

That's why any banker making leveraged buyout loans should carefully read "When the Machine Stopped" by Max Holland, just issued by Harvard Business School Press.

Proponents argue that buyouts free management from worrying about satisfying the stock market with quarterly growth of net profit. Instead, managers are able to focus on running the company efficiently. Their incentive is high leverage, which will either make them very rich or destroy the company.

As you can surmise from the book's subtitle, "A Cautionary Tale from Industrial America," high leverage did not lead to a pot of gold for Houalille. According to Mr. Holland, operating to maximize cash flow was precisely what ruined Houalille. A conglomerate built up in the 1960s.

Mr. Holland focuses on one of Houalille's companies, Burgmaster Corp., the machine tool company where his father worked for 29 years.

Company founder Joe Burg was the archetypal tinkerer and entrepreneur. He started Burg Tool at age 49 in 1945 based on an innovation that made it easier for machinists to change tool bits.

The Burg Tool grew quickly, fueled by the innovations of Mr. Burg and others who joined his company.

By 1954, the company, which had taken the name of its biggest selling product, was strong enough to go public. Burgmaster went from profits of $35,903 in sales of $573,000 that year to profits of $547,030 in sales of $7.4 million in 1964.

By then, the company's growth was pushing up against the limits of the Burg's financial resources. To aid further growth, the family, which had resisted previous offers, finally agreed to a buyout from Houalille.

Burgmaster went from entrepreneurial management to professional management, and the result was not good.

Houalille's chairman, Gerald Saltelli, was not a manufacturing man, though he was running a group of manufacturing companies. He stressed numbers. His subordinates did well if their performance met their projections. So the emphasis at operations like Burgmaster became matching the numbers, not serving the customers.

That got even worse after the leveraged buyout in 1979. Financial reporting became so extensive that it interfered with operations, according to the division's president at the time.

Meanwhile, the company was being destroyed maximizing cash flow in order to service the buyout debt. To increase sales, management sent out machines that weren't working to be fixed in the field. Salesmen were encouraged to promise anything to customers to get the sale. Too often, the company wasn't able to deliver, or if it did, the machine cost more than the agreed price.

Burgmaster received preferential treatment from suppliers because it always paid on time. Now, it ruined that relationship by first delaying payments, and then trying to unilaterally impose a price cut. And the company alienated dealers by selling parts directly to customers, abrogating contracts with dealers.

By 1985, crushed under the weight of its debt, Houalille restructured. Burgmaster, destroyed by the policies imposed by that debt burden, was closed and liquidated.

Bad management was not the only cause of Burgmaster's demise. The whole machine tool industry was decimated by an onslaught of Japanese competition and problems in the U.S. economy.

At one point, Houalille turned to Washington for relief for its machine tool operations. The company claimed that the Japanese had set up and subsidized a machine tool cartel. Mr. Hol-

When the Machine Stopped: A Cautionary Tale From Industrial America
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