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How to Kill a Company: Anatomy of a Leveraged Buyout

By Max Holland

Phil O'Reilly recognized that his company, Houdaille Industries, was taking a gamble when it underwent a leveraged buyout in 1979. A bad year or two could suck the Florida-based conglomerate into a whirlpool of debt. Ultimately, it might have to sell off its most attractive assets to satisfy creditors and buyout investors.

But if nothing untoward happened, if Houdaille managed to service its debt, then O'Reilly knew that by 1984 a "pot of gold" awaited him and other equity investors. This is the moment when a private, leveraged company, having whittled its debt-to-equity ratio down to acceptable proportions, returns to the stock market. Equity investors then reap a huge reward, as much as 10 or 20 times their original investment.

A buyout is a Faustian deal because it flouts a cardinal rule of management: Don't bet the business. Houdaille's executives did, and lost. Today Houdaille (pronounced WHO-dye) doesn't exist anymore as an industrial manufacturer.

The debate over the business wisdom of LBOs cannot be decided by the fate of one company. Buyout artists point out, and rightly so, that there are lots of "bad" deals to go along with the "good" ones. But interestingly, the investment bankers who engineered the Houdaille deal, Kohlberg, Kravis, Roberts & Co., tout it as a success despite the conglomerate's demise.

More disinterested observers might consider it an object lesson in what's wrong with leveraged buyouts.

Houdaille Industries, took its name from Maurice Houdaille, the Frenchman who invented recoilless artillery during World War I. After the war, a U.S. corporation bought the name and the rights to the rotary shock absorber Houdaille patented. By the 1930s, Houdaille Industries was one of the largest auto-parts subcontractors in Detroit and the premier U.S. manufacturer of shock absorbers. It was not unusual for a car owner to walk into a garage and ask for a new set of "Houdailles."

When national security warranted, Houdaille also manufactured more sophisticated products. During World War II, it participated in the Manhattan Project to develop the atomic bomb. But the modern era for Houdaille began in the mid-1950s, when it found itself being squeezed out as the number of automakers shrank and the survivors moved parts production in-house. To survive, Houdaille was forced to diversify. By the late 1960s, it had become a high-flying conglomerate, with interests in construction materials, industrial products, pumps and machine tools. In fact, its stable of machine tool companies made it one of the top U.S. builders of the “mother” machines which make all machines.

In the winter of 1978, Houdaille common stock was selling for around $ 14.50 a share, well below the conglomerate’s book value. A depressed stock price was a familiar problem for Houdaille -- as for many other industrial conglomerates in the stagflation-prone ’70s. Houdaille had a more immediate problem as well: The conglomerate’s long-time CEO, Jerry Saltarelli, wanted to retire. But passing the baton, while keeping Houdaille independent, was not going to be easy. Speculators noticed that Houdaille was simultaneously debt-free and cash-rich, making it a likely takeover candidate. Funny things -- and heavy trading -- began to occur in Houdaille stock. The prospect of an unfriendly takeover worried Saltarelli. For his energetic lieutenant, Phil O’Reilly, it posed an even greater threat. Taking a leaf from his days as a star football lineman at Purdue, O’Reilly had worked long and hard to overcome every obstacle in the way of his becoming CEO. But now, on the verge of success, Houdaille stood to lose its independence.

Just when there seemed to be no good solution, Houdaille’s financial advisers passed along a message from a then-obscure trio of bankers named Jerome Kohlberg, Henry Kravis and George Roberts. Kohlberg, Kravis, Roberts & Co. suggested that Houdaille could have its cake and eat it too. Saltarelli could liquidate his stake in Houdaille and keep it intact for his chosen successor. There would also be frosting on the cake for holdover management -- an opportunity to reap large profits in just a few years. All Houdaille had to do was undergo a leveraged buyout.

At a meeting in Florida, KKR explained the deal. A small group of investors, primarily KKR and holdover Houdaille management, would acquire all the conglomerate’s public shares. The cash necessary for the buyout would be borrowed primarily from institutional investors, which would lend the money based on Houdaille’s assets. Saltarelli and O’Reilly were mystified by one thing. Where was Houdaille going to get all the cash to pay off the high-interest, or junk-bond, debt incurred as a result of the buyout? At this juncture KKR introduced the Houdaille executives to their silent but consenting partner in the deal: Uncle Sam.

Stripped of all the complicating factors, KKR could offer an unheard-of $ 40 per share for Houdaille stock, leverage the company to the hilt and then cash in four or five years down the line -- all because of Uncle Sam’s largesse when it came to the redepreciation of capital assets and interest write-offs. In effect, a leveraged Houdaille would have to pay little, if any, corporate income tax for the life of the buyout. Thus, the same stream of corporate income would suddenly provide an extra 30-40 percent in cash, enabling Houdaille to service its massive debt -- courtesy of Uncle Sam. As Treasury Secretary Nicholas Brady observed some years later, “The substitution of [deductible] interest charges for [taxable] income is the mill in which the grist of takeover premiums is ground.” Or as buyout artists like to put it, the process “unlocks hidden value.”

KKR hastened to add that managing for cash flow, rather than quarterly profits, would not be easy. But other managers had proved that it could be done. And if Houdaille executives could do it too, they would enjoy a financial windfall when the firm went back to the stock market in four or five years -- not to mention immediate profits from the $ 40 buyout and the hefty raises promised if the LBO was consummated. Phil O'Reilly, for one, was promised a raise from $ 110,000 to $ 200,000, exclusive of bonuses. Little wonder that wags on Wall Street soon took to calling LBOs the "kiss which turns the frog into a handsome prince." In May 1979, Houdaille became the first large industrial corporation to undergo a leveraged buyout. The deal was a milestone. No corporation worth more than $ 100 million had ever been leveraged, and the Houdaille deal was worth $ 390 million. Wall Street immediately recognized that the financial rules were no longer the same. "The public documents on that deal were grabbed up by every firm on Wall Street," one buyout artist, Frank Richardson, recalled several years later. "We all said, 'Holy mackerel, look at this!'"

On the day that he finally assumed the top spot at Houdaille, Phil O'Reilly, a new millionaire, told *The New York Times*, "We're looking forward to working with KKR. Their experience in finance coupled with our experience in manufacturing and marketing will make a very complementary group." He indicated that Houdaille retained its appetite for growth through acquisition, but for the time being that aim had to take a back seat to a more pressing concern. "We're highly leveraged right now, so our first goal is to pay off some of the debt."

A large chunk of Houdaille's savings, $ 35 million, was immediately used to retire some debt. In addition, the new, privately-owned Houdaille liquidated the balance of its interests in construction materials, which had not been profitable since 1973. Another product line also underwent abrupt changes as automakers' demand for chrome-plated bumpers -- which as recently as 1976 had accounted for more than half of Houdaille's profits -- evaporated in 1980 as Detroit turned toward plastic bumpers.

But the acquisition of John Crane in 1981, a company two-thirds the size of Houdaille, more than compensated for these divestitures. John Crane was an Illinois-based maker of mechanical seals used to prevent leaks around rotating parts and enjoyed more than 40 percent of the domestic market and 30 percent of the global market for seals. By any measure, the $ 204 million acquisition (via debt financing) was a business coup, putting the conglomerate exclusively in the business of manufacturing high value-added goods. Some two years after the buyout, Phil O'Reilly had every reason to be ecstatic. Houdaille had been able to restructure, and the pot of gold was within sight. But then the unexpected happened, or perhaps more accurately, the expected. For surely what makes running a business or corporation so invigorating is the almost constant need to cope with challenges, be they economic or technological. Normally, however, a corporation the size of Houdaille has a comfortable cushion -- its own equity -- to fall back on. It can suspend dividend payments if need be, or borrow against its equity if new investment is needed. But a leveraged company has only one option: service the debt, even if it means breaking up the company.

The unexpected came in the form of a recession and foreign competition. Nothing like the deep 1981-1982 recession had been forecast when Houdaille underwent its LBO in 1979. As if that wasn't enough, seemingly overnight Houdaille was also facing the specter of fierce competition in a business segment that was supposed to be a safe niche: machine tools. The Japanese were making startling inroads into the American market, long the almost exclusive preserve of U.S. builders like Houdaille.

Two years after the buyout, Houdaille was caught in a triple bind of debt, recession and competition. The first was a given, and the second Houdaille could do nothing about. But O'Reilly believed that the last problem, foreign competition, might be amenable to a Washington cure. He hired a savvy lawyer, Richard Copaken, to press Houdaille's case for import protection in Washington. But Copaken's case did not adequately support Houdaille's thesis: that Japan's Ministry of International Trade and Industry had commanded a machine-tool cartel bent on carving up the U.S. market.

After spending $ 1.5 million on the trade petition, O'Reilly was naturally bitter about losing. The stakes could not have been higher. The hemorrhaging of Houdaille's machine-tool group, which typically accounted for about 25 percent of Houdaille's revenues and profits, subverted the entire buyout because it pushed the pot of gold out of sight. Instead of shrinking as planned, Houdaille's debt was actually increasing: from 107 percent of total capitalization in 1983 to nearly 113 percent in 1984, the year by which equity investors had been promised the pot of gold.

In the always-revealing vernacular of Wall Street, the Houdaille buyout had become a "dog." Yet Phil O'Reilly was still publicly praising leveraged buyouts. Among the joys cited by O'Reilly was that as CEO of a private company, answerable only to select institutional investors, he could "look out at a longer horizon." After vigorous but vain attempts to find a buyer for its machine-tool group, Houdaille announced a "business restructuring program" in late 1985, thereby "reducing its interest expense and enhancing its future." The divestiture was a complicated one. All told, seven divisions were split off from the conglomerate, including its entire machine-tool group. Phil O'Reilly blamed the Japanese, and then the Reagan administration, for the 2,200 highly-skilled, high-paying jobs that were lost as a result. But the real significance of Houdaille's demise as a major machine-tool builder was that the Japanese were handed a still greater share of the U.S. and world markets in an industry that remains central to the health of any industrial economy.

The restructuring greatly reduced Houdaille's junk-bond debt, but investors clamored for more. Consequently, one year later Houdaille underwent another leveraged buyout, or what might be more accurately called a recapitalization. Its main purpose was to cash out those equity investors who wanted out of the deal after seven years. These investors, who paid $2.52 per share for their stock in 1979, received $11 per share.

But "quieting the natives" came at a very high cost. Whereas the 1979 deal had been constructed with a pot of gold in mind, the recapitalization piled debt upon debt and put Houdaille on a precipice from which there was no escape, save dismemberment. Debt leverage soared from 103 percent to 152 percent of capitalization. Houdaille's newlyissued junk bonds were rated CCC (a D rating means bankruptcy), and the conglomerate was forced to pay junk bondholders 13.875 percent interest at a time when interest rates were less than 10 percent. “Cash interest coverage and debt service coverage are very thin,” noted a Standard & Poor’s analyst in a report analyzing Houdaille’s new junk bonds. Little wonder that Houdaille’s rate of capital investment, as a percentage of revenues, was now less than half of the rate prior to the buyout.

Less than a year after the recapitalization, Houdaille announced that Phil O’Reilly was retiring from active management, effective immediately. His abrupt departure caught industry observers by surprise. Few CEOs were more vigorous than O’Reilly, and at age 61 he was well short of normal retirement. No explanation was given out by Houdaille, but three weeks later, the shoe dropped. A British conglomerate, Tube Investments Group, announced that it was taking Houdaille over. TI intended to keep only one Houdaille division -- John Crane -- and dispose of the rest.

Houdaille had passed into oblivion as an industrial manufacturer, a classic example of the consequences when debt is more profitable than equity, speculation more lucrative than enterprise. Ten years after the Houdaille LBO, the elaborate financial engineering pioneered in that deal has become commonplace, and LBOs are fundamentally restructuring corporate America. In the wake of KKR’s unprecedented $ 25-billion RJR Nabisco deal, Congress decided it was finally time to take a closer look at what Wall Street was up to.

KKR promptly commissioned the accounting firm of Deloitte Haskins & Sells to prepare a study on LBOs. The 32-page report, naturally, extols the virtues of LBOs, or at least some of those engineered by KKR. More to the point, the last two pages describe the Houdaille success story. “All of the Houdaille ’constituents’ . . . fared well in the LBO,” says the report. Houdaille never fell behind on its debt service. And far from weakening the conglomerate, the LBO “improved management’s flexibility in dealing with the severe, rapid and adverse changes in the company’s operating environment.” As the result, “not only were all creditors paid in full . . . but superior returns were realized [emphasis in the original] by investors.”

Postscript: Eighteen years later, leveraged buyout artists have redubbed themselves private equity investors, but they are still financial engineers who engage in flipping companies like so many hamburgers.

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