Everything Must Go

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September 14, 2009

Late last year, when activist investor **Kirk Kerkorian** saw that his 6% stake in **Ford Motor Co.** was headed due south, he decided that he had had enough. From October to December 2008, the chief executive of **Tracinda Corp.** sold off all of his shares in the troubled automaker.

Fast forward to the third quarter of 2009: With Ford's market share valued at more than three times its year-end valuation, Kerkorian's early exit from the automaker now looks like one of the worst-timed investment departures in recent history. As PE investors watch the auto parts sector, one can't help but wonder if some bets in the sector are headed toward a similar trajectory. Dealmakers would certainly be wise to beware an early trigger.

Patience, however, comes at its own price, and the sector's data isn't encouraging. Automakers have historically produced between 14 to 17 million vehicles per year, and this year's projections, at 8 million, are unable to support a massively decreased supply chain. As auto manufacturers cut their production to about 40% capacity, few companies will prove well-capitalized enough to weather the decrease in production.

Already, there have been quite a few casualties of the slowdown in auto sales. In late May, **Visteon Corp.**, the 2000 spinoff from Ford, and auto supplier **Metaldyne Inc.** filed for Chapter 11 bankruptcy protection. In August, yet another parts maker, **Cooper Standard** filed for bankruptcy and **Delphi**, after operating in bankruptcy for nearly four years, went to a lender group, which used its credit to outbid PE investor **Platinum Equity Partners**.

Despite the cheerless news, several investors anticipate even more bankruptcies and the shuttering of plants. Even throughout the massive production downturn, there has been relatively little consolidation of the parts supply chain. Some observers see the highly-fragmented industry as largely propped up by larger automakers.

Stephen Presser, a **Monomoy Capital Partners** principal said automakers will eventually have to decide which parts makers will continue to exist, and which will be allowed to go out

of business. These strategic decisions are not without significant short-term costs, as it is prohibitively expensive to consolidate multiple tiers of production, or to move the manufacturing capabilities of a particular component from one plant to another. “There is much more dislocation to come than is behind us,” Presser said.

Many of the restructuring efforts that have taken place are what pros like Presser consider to be balance sheet restructurings, but fail to involve more thorough operational restructuring changes.
To boot, when **Lear Corp.** arranged its bankruptcy, the supplier arranged a $500 million financing, and exited a commitment to a syndicate led by **JPMorgan Chase & Co.** and **Citigroup Inc.** This seems to have been the pastern with recent restructuring arrangements. When **JL French** filed for bankruptcy, the auto part manufacturer also removed several levels of debt through a renegotiation of with lenders, but did not make significant capacity reductions.

Daniel Tredwell, managing partner at **CoveView Advisors**, a Stamford, Connecticut-based restructuring firm that was launched in July, begs to differ. He said he has seen dramatic restructurings on the supply end. “Virtually everything that is even close to a marginal plant has been shut down,” he said.

Of course, this doesn’t mean that suppliers have seen the worst of the dislocation. As competition between the Detroit Three and “the new domestics” grows more fierce, suppliers will face even greater troubles ahead if new domestics continue to gain share.

Despite this continuing spate of troubles, there are bound to be at least a handful of winners among the carnage. **Daniel Collin**, a partner at Monomoy, expects auto component companies that manufacture more advanced, highly engineered parts will be in high demand. Amidst the wreckage, he has been eyeing companies manufacture “mission-critical components that are complicated to manufacture.” In March, his firm made an bolt-on acquisition to its **Compass Automotive Group** platform, acquired the aluminum die casting and machining operations of **Citation Corp.**, a lightweight safety components manufacturer.

A riskier strategy that some firms show interest in has been the strategy of buy devalued parts suppliers at below assets price, then raising prices by holding the threat of closing operations if higher margins aren’t achieved. As Delphi made it clear that the Troy, Michigan-based supplier considered its auction process over – despite Platinum Equity’s claims to the contrary – it became apparent that such a strategy might have been Platinum’s goal in attempting to purchase Delphi. A similar strategy may have also been KPS Capital Partners’ intent in its bid to acquire Metaldyne Corporation’s power-train division.

Many would-be buyers, are essentially practicing a “wait it out” strategy. In light of all of the tremendous dislocation facing the sector, the draw of heavy returns is not enough to draw many investors to the space yet. The fear factor prevalent among most investors will benefit the handful of pro that overcome their reluctance and pursue the sectors’ exciting opportunities. However, as Presser commented, “exciting” is relative. “I’ve probably

broadened my view in light of developments," he said.

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