IN 1999 JOHN CASTLE TOYED WITH INVESTing $25 million of his clients' money to take a railroad-construction outfit private. The company boasted solid earnings growth and a "strong buy" rating from Deutsche Bank, but was short of capital for more acquisitions. After spending months (and a few hundred grand in accounting fees) poring over 30 of the firm's contracts, Castle begged off. The business, he concluded, wasn't as strong as the figures in public filings suggested. That was a

# The LBO Method

JUSTIN STEELE FOR FORBES

**Buyout firms get rich owning mundane businesses. Can you do the same on a smaller scale? Here's what John Castle can teach you about value stocks.**

**BY BRETT NELSON**

wise move: The company filed for Chapter 11 a year later.

Castle, 63, is a leveraged buyout guy, one of the best around. His Manhattan firm, Castle Harlan, has, over the past 17 years, ponied up $7 billion for 60 firms. A third of these have worked out well enough to be sold or taken public; for these, Castle claims a weighted average return of 28%. To be sure, one must be wary of weighted averages or any kind of statistic that by its nature favors inclusion of winners. Still, Thomson Venture Economics estimates that Castle Harlan is well ahead of competing LBO firms in average returns.

Even if you are not willing or able to be a Castle Harlan investor (typical ante: $5 million) and just want to buy a few shares of a public company, there's plenty you can learn from Castle's due diligence. True, his bloodhounds can dig deeper into a prospective takeover target's financials than the average investor can. (Usually, their deals are friendly and they get to see every last operating detail in exchange for signing a confidentiality agreement.) Nevertheless, Castle Harlan's methods are universally applicable.

First Castle looks for industries making unsexy, overlooked products like diamond-studded drill-bit inserts, airplane toilets and class rings. Volatile sectors like technology, fashion and real estate are verboten, as are commodity businesses with large fixed costs (think airlines). Within his select industries, he finds companies that are cheaper than the peer average and sport better sales growth and return on invested capital. Some prospects are classic value plays, appearing on the surface to be in trouble. Then they surprise everybody. While Castle won't pick public stocks, we've applied his methods to some of his favored sectors (*see table, following page*).

**The company was forecasting 15% growth. Its customers were saying that number was too low.**

An example from our table is chemicals maker International Flavors & Fragrances. This company has managed to boost sales 9% annually over the last three years, four times the industry average, while keeping expenses in check with layoffs and debt refinancing. The company has been dogged by lawsuits, however. That's one reason the stock has been stuck in a narrow trading range the past two years. Factory workers in a popcorn plant claimed lung damage from inhaling fumes given off by a butter-flavored chemical sold by IFF. (The company says the popcornmaker didn't follow published safety instructions.) In May IFF settled the second of 30 suits for around $5 million. The news encouraged J.P. Morgan analysts to peg the total payouts at a maximum $165 million, down from an initial estimate of $200 million to $300 million.

A lumbering, soft-spoken fellow with a knowing smile and degrees from MIT and Harvard, Castle has vast investing experience. In 1987, after 21 years at investment bank Donaldson Lufkin & Jenrette (2 of those as chief executive), Castle and fellow DLJ alum Leonard Harlan founded their LBO outfit. As a takeover artist, Castle gets to both buy and run companies, which he prefers to being a passive stockholder. "I like to be the master of my fate," he says.

Given his strong record, he had little difficulty raising $1.2 billion for his fourth, and largest, fund. This was at a time, between May 2002 and September 2003, when many LBO types were starved for capital. "Some of the economic incentives [in private equity] are out of whack," admits Gary Hiatt, partner at Pantheon Ventures, a fund of funds that invests in Castle on behalf of its institutional clients. "After fees, Castle's still worth it."

Certainly, LBOs are back in vogue. While marquee LBO shops Kohlberg Kravis & Roberts, Clayton Dubilier and Blackstone still hunt for big game—witness such recent deals as Qwest's Yellow Pages unit ($7.1 billion) and TRW ($4.7 billion)—more capital is chasing targets in the sub-$100 million realm where Castle is a king. Today nearly 1,000 LBO funds, with average capital under management of $800 million, are in business, quadruple the total 15 years ago, according to Thomson.

Tips from an old hand:

**Find out if bad news is overblown.** Like IFF recently, Truck Components looked like a risky investment. The company owned 40% of the market for brake drums in heavy-duty trucks when Castle first eyed it in 1994. The problem was a potential $500 million liability for dumping hazardous waste at 15 Superfund sites in Illinois and Wisconsin. The risk was enough to repel a previous large buyer after six months of negotiations.

Smelling a "willing seller," as he calls them, Castle spent $2 million on environmental consultants and attorneys to measure Truck's exposure and liability at every site. Turned out a bunch of other companies had the same problem, so that $500 million would be carved up among them all. Four months and a 30-column spreadsheet later, Castle's team concluded Truck's risk was more like $16 million. They also "did enough homework to know that the truck cycle had enough years to run so they could get in and get out," says Thomas Cook, Truck's former chief executive who now serves on the board of two Castle Harlan companies.

Result: Castle bought Truck for $170 million, or $3.16 per share, in May 1994. Three months later Truck went public at $10, and the next year it was sold to Johnstown American Industries for $16.

**Go for niches too small to bring serious competition.** US Synthetic was another winner in disguise. It had a tidy business in early 1997 selling coin-size diamond-embedded inserts that fit into larger drill bits used to dig oil and gas wells. Synthetic diamonds, made by compressing diamond shards under

## Due Diligence

Castle won't pick equities, so we applied his LBO-like criteria to root out good public stocks. The method: Find an overlooked industry, then look for a company with a low earnings multiple plus a peer-beating sales-growth rate and return on capital.

| Company/business | Recent price | P/E | | ANNUAL SALES GROWTH[1] | | RETURN ON CAPITAL | |
|---|---|---|---|---|---|---|---|
| | | company | industry | company | industry | company | industry |
| **Applebee's International**/family restaurants | $37.28 | 21 | 25 | 13% | 12% | 20% | 11% |
| **Ducommun**/aerospace | 18.91 | 13 | 20 | 14 | 11 | 10 | 7 |
| **International Flavors & Fragrances**/food processing | 35.49 | 17 | 21 | 9 | 2 | 11 | 6 |
| **Key Technology**/automation systems | 13.90 | 12 | 24 | 7 | 3 | 17 | 10 |
| **Superior Energy Services**/oilfield services | 8.98 | 25 | 46 | 25 | 13 | 4 | 3 |

[1]Three-year annualized.
*Source: Reuters Fundamentals via FactSet Research Systems.*

high temperature and pressure, are less brittle and wear more evenly than natural diamonds. The key to this deal was drilling down on a paltry yet profitable $75 million market too small to get rivals De Beers and General Electric all that excited.

With crude fetching $26 a barrel (a lot at the time), producers were drilling with abandon. US Synthetic was their largest supplier, with 36% market share. The most important question was growth. The company was forecasting a 15% annual rise in sales for the next few years. Yet a survey of both the drill-bit manufacturers, which were Synthetic's immediate customers, and the drilling companies hinted that those projections were light.

Back then diamond inserts cut just 12% of total feet drilled worldwide; manufacturers expected the number would soon hit 50%. And even though diamond inserts cost roughly ten times as much as carbide inserts, they didn't need to be replaced nearly as often, thus lowering overall drilling costs, especially at offshore rigs.

Sure enough, as producers kept drilling, US Synthetic's operating income (earnings before interest, taxes and nonrecurring items) jumped from $12 million to $22 million in just 15 months. Castle bought the firm in February 1997; he paid $85 million. He sold it 15 months later for $165 million to Bain Capital, another LBO fund.

**Find the forgotten sure thing.** The class-ring business, with its huge installed customer base and dependable demand, caught Castle's eye in 1996. But how to make it pay? Answer: consolidation. First Castle looked for targets that relied on different distribution channels; then he estimated savings from combining their factories. Five months later he formed American Achievement Corp. by acquiring two companies: ArtCarved made high-quality rings sold through jewelry stores; Balfour had savvy door-to-door sales reps working the schools.

**No tech, fashion or real estate here. Castle likes diamond drill-cutters, airplane toilets and class rings.**

Castle folded production into ArtCarved's lower-cost plant in Austin that can crank out 650,000 designs. Later he looked for cross-selling opportunities, buying publishers of yearbooks and "Who's Who" lists. Once you have it down, "it's a relatively sticky customer base," says Justin Wender, a Castle managing director; schools tend to stick with the same supplier year after year.

In March Castle sold American Achievement to Fenway Partners, a New York private equity firm, for $431 million—7.5 times operating income and 1.7 times its original investment.

**Diversify. Despite your best efforts, you can get blind-sided.** Diligence, of course, is never foolproof. Knowing that you're going to invest in some clunkers helps prepare you for the inevitable pain.

In 1994 Castle shelled out $40 million (including debt) for Strawberries, the record chain once owned by Jose Menendez, murdered by his two sons in 1989. The industry looked healthy: Publicly traded rivals Musicland and Trans World Entertainment were adding stores at a healthy clip. But while the others built in big cities and malls, Strawberries opted for saturating small New England towns.

That might have been fine if giant Best Buy hadn't started horning in on its turf by selling ultracheap tapes and compact discs as a loss leader for higher-margin appliances, computers and stereos. Circuit City followed suit. Slumping overall demand exacerbated the price war, pushing Strawberries into Chapter 11. Castle's $10 million in equity went to zero in two years. (Trans World now owns the assets.)

The LBO due diligence is more than typical investors can mount. "We have the benefit of eliminating a lot of bad answers," Castle says. Still, he maintains the same techniques are relevant to making stock selections based on public information. F