When They Forgot the Nuts and Bolts, Everybody Got Screwed

How one American company was killed by greed, incompetence, and Henry Kravis

by Mark Reutter

Fred Burg was an enlightened tinkerer, an inventor, who built his company from nothing into the largest maker of machine tools west of the Mississippi.

Gerald Saltarelli was an auto bumper mogul who folded firms into his conglomerate, confident that he could improve any enterprise. In 1965 he bought Fred Burg's company.

Henry Kravis was a young investment banker who peddled an obscure financial device—the leveraged buyout (LBO). In 1978, a decade before he splashed onto the pages of *BusinessWeek* and *Time* as "King Henry" for his record $24.88 billion takeover of RJR Nabisco (and earned ink for his opulent lifestyle with his designer wife, Carolyne Roehm), Kravis and his associates took Saltarelli's publicly held firm and turned it private. It was the largest LBO to date. Staggering under the load of debt piled on by the financiers, the firm spun out of control after the 1982 recession. Fred Burg's company was a victim of the floundering LBO: drained of its cash—and reputation—it was shut down and its equipment auctioned off.

At the time of Burg's collapse in 1985, the shrinking of America's manufacturing base was seen as inevitable. According to conventional wisdom, machine tools, steel, textiles, and rubber could not compete with more modern foreign mills. American companies were too inefficient, too old, or paid union wages that were too high to make it in the global marketplace.

That was the sad-but-true school. The not-so-sad school said that, while shutting down plants was tough on some companies and workers, it was good for the country. The United States should phase out heavy industry, it was argued, let other nations do the dirty work, and move into high tech and services.

Max Holland's important new book* adds to the growing research that calls into question the view that America's manufacturing woes were the inevitable consequence of progress, or in the words of the famous economist Joseph Schumpeter, "creative destruction." Instead, focusing on the growth and self-destruction of a single machine foundry, Holland draws out in convincing detail how cupidity, short-sightedness, and managerial hubris led to the rusting away of a superior organization.

Today the Japanese—ironically using the blueprints sold to them by Burg and others—dominate the market for the most advanced machine tools. Why is this important? Reliance on foreign know-how is costly. America's trade deficit in machine-related goods is more than $20 billion. More importantly, machine tools are the lynchpin of a nation's industrial base. Without these machines-that-build-other-machines, we can only fall further behind.

The "Hey, Joe" School

For those who believe that steel-based goods belong to the industrial scrap heap, the story of Fred Burg will come as a surprise. A machinist and garage tinkerer, he developed a unique turret drill that reliably combined several steps. His drill permitted other manufacturers to make their products cheaper, quicker, and better.

Borrowing $5,000 from his sister, he went into business in the late 1940s. By 1954, his annual sales were $500,000; six years later they had jumped to more than $4 million. Holland celebrates Fred Burg as an exemplar of the American inventor—a loner "who takes previously disparate elements and fuses them together in a classical and enduring combination." While sounding a bit corny, his characterization rings true. Burg was an unhappy man on the days he couldn't get his hands dirty. His enthusiasm and intimate knowledge of the trade soon attracted

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* *When the Machine Stopped: A Cautionary Tale from Industrial America.* Max Holland. *Harvard Business School Press, $22.95.*

employees—including Holland's own father—who became intensely loyal to the suburban Los Angeles company, even though it paid less than competing firms. Burg was an autocrat all right, thinking nothing of giving a machinist a rush job that needed hours to complete, then coming back in 15 minutes and, peering over his shoulder, asking, "How is it going?" His "style" of management wasn't slick; it was to get the job done right.

With Fred Burg setting the tone at the top, pride flowed naturally through the ranks. "When we designed new machines, he would bring in everyone he thought could contribute," remembers designer Bob French. "I would sit there with colored pencils, thinking, and he would be asking for ideas from everyone who worked on machines."

"We were entrepreneurs," agreed machinist Ed Merk.

When the workers voted to be represented by the United Steelworkers, the old man was furious. But the arrival of the union was of less consequence than might be imagined. Because trust had been forged between the front office and labor, wage negotiations were amiable and the management-employee Christmas party continued to be the high point of the year.

A similar optimism pervaded the industry. U.S. machine toolmakers thrived in the early 1960s. Unrivaled in the world, they had introduced a radical new tool called numerical control, or NC. It used coded instructions (such as punched tapes) to direct drill press operations without human oversight. In 1957, Burg's company had been one of the first to introduce NC machines. Financing expansion, though, became a headache. In the past, Burg and his business partners, his son Joe and his son-in-law Norm Ginsburg, had dipped into retained earnings or taken out bank loans, pledging their personal assets as collateral. But that didn't seem feasible when Burgmaster (named after its famous turret drill) was surging forward by 20 percent or more a year.

Enter Jerry Saltarelli, the chairman and CEO of Houdaille Industries (pronounced WHO-dye and named after a French engineer). Saltarelli was playing the hottest game then on Wall Street—conglomeration. In the early 1960s, antitrust laws had erected strong barriers against concentration of ownership in a single industry. But there were no restrictions against buying up unrelated, existing companies. A conglomerate got around reviews by the Justice Department. Another incentive was the tax code. Mergers or acquisitions made through stock swaps were tax-free.

Buoyed by the go-go stock market of the sixties, Saltarelli had diversified Houdaille into construction materials, engineering services, chemical feeders, lubricating machinery, hand tools, and punch presses. He got the Burgs' attention by offering them aid in the matter of expansion. He proposed a new consolidated factory and sent out Houdaille engineers to help with the planning, "no strings attached." Saltarelli began talking about the "synergism" between Burg and Houdaille, synergism being a much-touted selling point for conglomeration. In October 1965 Burg stock was exchanged for Houdaille stock in a friendly takeover.

The new management was different. Houdaille executives who visited the factory were shocked by the Burgs' loose management structure. Most astounding to Saltarelli's circle was the absence of college degrees among top Burg veterans. Modern, professional management could not tolerate such relics of the "Hey, Joe" school of production; henceforth, a supervisor without a high school diploma was blocked from advancement no matter how good he was on the job. Houdaille acted as though "we didn't know how to do anything," a supervisor complained to the author.

Under the new regime, management's focus turned to monthly forecasts and budgets. Prior to the takeover, quotas and budgets, insofar as they existed, were flexible. Out went intuition. In came procedures and paperwork. Fred Burg and his son Joe were eased out. (The old man, still alert and vigorous, consoled himself by inventing a new line of special clocks; he also became an ardent environmentalist.)

By the late 1960s "distrust permeated the atmosphere at Burgmaster," Holland reports, with upper management and shop-floor labor more adversaries than partners. What's striking about Holland's account is how deliberate management was in disrupting the cooperative atmosphere of the Burg years. The new style was a curious mixture, it seems, of condescension and ignorance. Even something as innocuous as the traditional Christmas dinner was discontinued. Since no other Houdaille division invited blue-collar workers to such an affair, managers ruled it should be disbanded at Burg. Workers were to be given a separate buffet luncheon on the last workday before Christmas.

The end of the Christmas party was symbolic of a corporate mindset that wanted nothing from its workforce except obedience. Because workmen were thought to have no advice to offer headquarters, headquarters never knew, for instance, that $50,000 was wasted on unneeded tools for a single machine. The operator of the machine would have told them, but he was never asked.

The conglomerate that once talked synergism became afraid to take risks. Houdaille bypassed its own proven design department to buy its way into the latest line of computer-controlled machines. Thus began the disastrous "Dualcenter" project. The author describes how millions of dollars were lost on a machine that was not only overdesigned but elicited a patent suit from a competitor. In 1975, the glitch-ridden machine was introduced. By that time, though, the division had slid from preeminence to mediocrity.

Of Kemp and Kravis

In 1978 Saltarelli and Vice President Phillip O'Reilly were approached by the two-year-old banking firm of Kohlberg Kravis Roberts & Co. Henry Kravis and Jerome Kohlberg, the principals, made a startling proposal: they wanted to buy Houdaille for $40 a share, or about $10 above the market price, in an LBO. Saltarelli was stunned. He thought he "knew it all," but he had never heard of an LBO.

He recovered sufficiently to hear what LBOs were all about. Investors headed by Kohlberg Kravis would put up a small percent of the bid price in cash and then, borrowing against the company's assets, would raise the rest from banks and from bonds sold to pension funds and insurance companies. The group would take the company private by purchasing all of the outstanding shares of stock. The new owners then would draw down the debt as quickly as possible by slashing costs and seizing upon the majesty of the U.S. tax code.

The tax code was central to the LBO. As Holland writes, "If a leveraged Houdaille remained sufficiently profitable, the annual value of the depreciation allowance, together with the tax write-off for interest payments, would effectively shield Houdaille from the 48 percent corporate tax rate for years. By the time a tax liability was unavoidable, it would be time to make Houdaille a publicly traded corporation once again. Much of the cash Houdaille would need to service its massive debt would be generated courtesy of a silent but consenting partner, Uncle Sam."

In essence, Kravis and Kohlberg proposed to break up the very organization that Saltarelli had pieced together just a decade before. The surviving company, they told him, would be taken public only as a smaller, leaner company, or, if the numbers worked out better, cut up and sold off in chunks. So much for the conglomerate sixties. Saltarelli consented in part because he wanted to retire. The LBO enabled him to walk away with $5 million in stock profits. (Saltarelli was scarcely underpaid as it was—he got $945,600 in salary and benefits in 1978 alone.)

So it came to pass that in May 1979 Houdaille Industries went private in a $355 million deal. As arranged, Kravis, Kohlberg, and George Roberts were assigned three of the five seats on the new board of directors, including that of chairman. In addition to the standard 1 percent fee for putting together the deal, KKR would receive large yearly fees for acting as management consultant and investment adviser to the reconstituted company.

"Something akin to what happened to Burgmaster when it was taken over by Houdaille would now happen to Houdaille," Holland states. Finance took over from management as the driving force of the organization. The new philosophy was to generate enough cash flow to take maximum advantage of tax depreciation allowances. Burg's machines were no longer an end but only a means to pay off the usurious debt.

Aside from tax writeoffs, the LBO strategy hinged on managing firms with an established share of the market and minimal competition. Despite its lagging technology, the Burg division had steady markets—customers who had stuck around since the family days. Yet the division was not prepared for the grueling competition of Japanese imports. In 1976, Japan's share of the high-end machine tool market was under 5 percent. By 1982, three years after the buyout, the Japanese share had rocketed to 60 percent.

The Asian challenge was nothing if not filled with irony. In 1970 Saltarelli had signed an agreement with Yamazaki Machinery to transfer some of the most advanced machine designs of the Burg division to Japan. A man who couldn't hatch new technology in his own company proved skilled at selling it abroad. If he gave any thought to where the selling of secrets might lead, he did his best to banish it from his mind, expressing delight to his colleagues that Japanese royalties would add to Houdaille's bottom line. It was another example of profits without production.

Fast forward to the 1980s. The very same company, Yamazaki, invades the American market with machines that improved on the Burg version at lower cost. Did Houdaille stand up and fight? Yes, in the hallways of Congress. O'Reilly hired Richard Copaken of Covington & Burling to represent the company in a trade petition.

An extraordinary sideshow followed, which Holland traces in minute detail. The Houdaille trade petition was, from first to last, a political petition, premeditated to spark a firestorm of abuse against Japan. Copaken alleged in documents that a cartel masterminded by the Japanese Ministry of International Trade and Industry had decided to destroy Houdaille through unscrupulous subsidies and dumping. The lawyer constructed his "yellow-peril" case with utmost media savvy, putting together a video tape for special showings to reporters and congressmen.

Holland presents a portrait of Washington where trade policy is made only in reaction to partisan complaints, not according to any rational plan. Here we have Jack Kemp, the free-enterprise guru, lobbying the White House shamelessly on behalf of

Houdaille. The company's Strippit division was located in his district and his association with the firm went back to the Saltarelli period. At the bottom of one letter to the Reagan trade representative, Kemp scribbled, "This is very important to me."

The trade flap obscured the crucial role of the moneymen in the deteriorating performance of the company. Kohlberg Kravis—and the young "whiz kids" they installed as managers at Burg—had no more concept of renewal than did the Washington establishment. Writes Holland, "Burgmaster was not being managed for the long term and not even for the short term. Rather, Burgmaster existed primarily to pay off a gamble."

Burg's reputation for quality was destroyed under the cash-hoarding policies of the KKR regime. Soon its machines left the factory packed with two-page lists of problems "to be fixed by field service." The division stopped paying its bills on time, often delaying payment for months. Employment was slashed mercilessly, and the machinists who remained called themselves "the mushrooms" because they were always kept in the dark.

The division's position was desperate by 1984. The company had lost the trade petition and, worse, was losing money. So in a final zigzag, Houdaille entered into talks with the same Japanese manufacturers it had publicly castigated in Washington. President O'Reilly thought he had reached an agreement to sell Burg to Okuma Machinery. But he was wrong; the Japanese didn't want a basket case.

On October 1, 1985 George Delaney, the plant manager, announced that the factory was shutting down. Symbolically, white- and blue-collar workers were told of the company's demise in separate meetings. A year later Houdaille Industries passed out of existence. Several of the divisions were sold to TI Group, a British conglomerate, and other pieces were "releveraged" in a company called IDEX corporation.

In telling the Burgmaster story, Max Holland helps to clarify the ongoing story of American deindustrialization. In particular he blows away the proposition, entertained seriously during the Reagan years, that Wall Street was about to share its profits with the people by revitalizing underperforming industries and generating the capital needed for balanced economic expansion.

At the center of this tale is another lesson—that skilled management is just that, management based on a thorough knowledge and understanding of the engineering, manufacture, and marketing of a particular commodity. The kind of nuts-and-bolts mastery Fred Burg possessed is not something that can be bought or sold by financiers, and, in the wrong hands, it can easily slip away. ☐

Let Them Eat Sushi

Forget Japan. The way to make America great again is to be more like us.

by Tom Peters

In two issues of the *Harvard Business Review* last year, George Gilder, the supply-side maven, and Charles Ferguson, an MIT policy analyst, squared off over America's future. Gilder foresaw a new golden age if only our entrepreneurial spirit could be unfettered. Ferguson begged the powers that be to rein in the entrepreneurs via a higher capital gains tax and to provide incentives for sizeable Japanese-like consortia in vital markets.

At the same time, Paul Kennedy's *The Rise and Fall of the Great Powers* was at the top of the best-seller lists, predicting American decline unless we turn inward and trim our obligations to others. And

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