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Matthew McClearn

Knitting and crocheting enthusiasts will tell you that making sweaters and scarves is a great way to relieve stress. The same has sometimes also been said of income trusts: ideally, they¹re supposed to pay investors a predictable stream of income from a stable business. And calm is the defining characteristic of a small rural community like Listowel, Ont., with its 5,900 souls and surrounding farmland. Yet somehow, these three ingredients combined to create a nightmare for investors who bought into the Spinrite Income Fund.

Spinrite, a yarn manufacturer, has for decades been one of Listowel¹s largest employers, rivalled only by a Campbell¹s food plant. The town¹s tallest buildings are churches, and Mennonites move about in black horse-drawn buggies. That income trusts made it here is testament to just how pervasive they¹ve become. It¹s a world apart from the Byzantine wheeling and dealing of Wall Street and Bay Street, which paid the town several visits in recent years. Listowel may seem an unlikely destination for investment bankers, institutional investors and analysts‹but much is possible when stock markets and hobby fads converge.

Though the official line places Spinrite¹s founding in 1952, a trip to the Stratford-Perth Archives reveals that the company¹s roots stretch back to just before the First World War. According to local history and folklore, German immigrant Max Becker was on his way to set up a wool-spinning and dyeing shop on the shores of Lake Huron. But a fateful encounter with six Listowel businessmen, each of whom offered him $1,000 to set up in their town instead, convinced him to found Perfect Knit Mills on the banks of the Maitland River. He was just in time to capitalize on massive wartime demand for wool to manufacture soldiers¹s uniforms. That made Becker rich. As a local newspaper noted decades later: ³Mr. Becker was a man whose timing was good.²

Becker sold out in 1933, and the new owner renamed the company Maitland Mills. It again enjoyed strong demand during the Second World War, but subsequently suffered three unprofitable years and eventually folded. A member of a prominent local family, David Hay, came to the rescue. He cobbled together new investors, bought Maitland¹s assets and founded Spinrite Yarn and Dyers Ltd., in 1952.

Through a combination of workaholism and constant investment in new technology, Hay built Spinrite into one of North America¹s largest yarn manufacturers. Hay explained to a local newspaper in his later years: ³We have taken out machines only four or five years old and replaced them with better, more efficient models.² But toward the end of his life, he despaired as his

customers in the Canadian textile business faltered. They couldn¹t keep up with American competitors, let alone those in developing countries.

Upon Hay¹s death in 1985, his two sons, Robert and Douglas Hay, took over. The latter presided over Spinrite¹s declining commercial yarn business, which dried up during the 1990s as clothing manufacturers moved offshore to reduce labour costs. Robert Hay, meanwhile, rescued the company yet again by diversifying into craft yarn‹basically the balls of yarn you see at craft and department stores. He bought up or licensed brands such as Phentex, Patons, Bernat and Lily during the 1990s.

In 2002, the company consolidated its dispersed warehouses in a new manufacturing and distribution centre. Henceforth, it concentrated on craft yarns, pitting itself against U.S. competitors such as Caron International, Coats & Clark and Lion Brand Yarn Co. (Commercial yarn operations ended in 2003, by which time Douglas Hay had left‹leaving his brother as the lone shareholder.) Spinrite became Canada¹s yarn leader by buying out competitors, and grew its U.S. market share to nearly one-fifth.

By early 2004, Robert Hay wanted out. His two adult children showed no interest in running the business, and he hoped to retire. So that January, he sold Spinrite for about $81 million to a partnership led by New York based private equity firm Sentinel Capital Partners. (Sentinel invested US$19 million.) Hay said at the time: We are confident that by working together with Sentinel we will be able to further develop our business. As to how exactly the business would be developed, however, little was said.

Private equity firms make some people nervous. For decades, detractors have accused them of hijacking weak companies, boosting their short-term cash flow, piling on debt and then flipping them to unwary public investors. But academic studies consistently found evidence that reverse leveraged buyouts (a popular private-equity maneuver, and one Spinrite was about to experience) actually performed as well as‹or better than‹other types of transactions. This year, a study by Harvard University professor Josh Lerner and Boston College¹s Jerry Cao argued private equity firms get a bad rap, but offered one caveat: firms held by private equity for less than a year before being spun out performed far worse than average thereafter.

Sentinel certainly saddled Spinrite with debt. Whereas Spinrite had just $4.8 million of it in January 2004, the leveraged buyout increased that more than eightfold. Scotiabank provided most of the credit; Norwest Mezzanine Partners, a Minneapolis-based debt provider, contributed $10 million.

Short-term cash flow also surged, thanks to Sentinel¹s timing‹which was as uncanny as Becker¹s had been nine decades earlier. It so happened that the purchase coincided with a knitting and crocheting craze across North America.

Celebrities such as Cameron Diaz and Sarah Jessica Parker came out as knitters, providing much-needed publicity. Young women across North America did, too. They were partly attracted by so-called fancy yarns‹jazzier products featuring unique colours and unusual textures like feather and bouclé‹that even novices could use. We had so many people making these very easy scarf projects as Christmas gifts, says Mary Colucci, executive director of the Craft Yarn Council of America, an industry trade association. It drove sales tremendously. Retailers rejoiced; for example, Michaels Stores Inc., based in Irving, Texas, enjoyed a surge in same-store sales of yarn during 2004.

Fancy yarns generated higher margins, so Spinrite enjoyed a remarkable recovery through 2004. Our focus went to just being able to ship product, says CFO Ryan Newell. We ran a lot of overtime at the facility trying to keep up with demand. All told, Spinrite earned record revenue of $105 million that year.

Hay¹s replacement as CEO was Dario Margve. A graduate of the United States Military Academy at West Point, N.Y., Margve built his career with various management positions at Nestle S.A. in the 1980s. During the 1990s, he worked with a private equity firm to develop the business of J. B. Williams Co., a purveyor of personal products including fading brands like Aqua Velva and Brylcreem. Brands play an important role in the craft-yarns business, says Margve. My entire background is in consumer products, primarily in sales and marketing, so I thought I could bring some expertise in that regard. He started at Spinrite in August 2004 with a base salary of $500,000.

By then, Sentinel already had a plan for Spinrite. It had been in discussions with underwriters about spinning off the company as an income trust. Sentinel had held some investments for more than seven years, but not this one. Was this the dreaded ³buy and flip² that investment bankers warn their children about?

The conventional wisdom is that mature businesses with stable cash flows and little need for capital expenditures are ideal candidates to become income trusts. Highly cyclical or seasonal businesses‹or ones requiring extensive capital expenditures‹need not apply. Spinrite's prospectus emphasized the yarn industry¹s even-footedness, and observed that there hadn¹t been a downturn in 10 years. Indeed, between 2000 and 2003, its craft yarn sales consistently ranged between $55 million to $56 million. The brands had been around a long time, says Margve. The competitive base was limited‹the same players had been there for years. Barriers to entry were high. And unlike the commercial yarn equipment David Hay had upgraded often, Newell says craft yarn machinery hasn¹t changed much in 20 years. Capital expenditures would be small, they believed.

Had everyone followed the above logic, things mightn't have turned out so badly. But Spinrite also predicted its unprecedented surge in revenues would continue. Why? For one thing, North America¹s population was aging. That meant more

knitters, management reasoned, because ³the average knitter is female and over 50 years old. Meanwhile, young women‹including college students‹flocked to the craft thanks to the sudden popularity of fancy yarns. And due to deteriorating global security, North Americans claimed to be spending more time with family and friends. This cocooning trend, the prospectus posited, meant that individuals are also spending more time on crafting activities such as hand knitting and crocheting.

A great deal rode on these assertions. Income trusts pay their distributions out of a vaguely defined concept called distributable cash. This generally refers to the cash generated by the underlying business minus typical expenses like operating costs, taxes and capital expenditures, though there¹s no standard method of calculating it. Management claimed Spinrite could generate more than $25 million a year in distributable cash. That assumption helped drive Spinrite¹s enterprise value to about $301 million, almost four times what Sentinel paid a year earlier.

But in arriving at that calculation, Spinrite plugged in the 2004 sales of $105 million, which were unprecedented in the company's history. Most of the metrics or financial aspects of the IPO were negotiated between [Sentinel] and the underwriters, says CFO Ryan Newell. But I can say that it was normal for an income trust being marketed at the time to take the most recent 12-month activity and reflect that in the prospectus as the basis for valuation. Some critics, however, condemn that approach as unduly aggressive. They set the distribution too high, says Diane Urquhart, an independent analyst.

Urquhart (who once worked for Spinrite¹s lead underwriter, Scotia Capital Inc., and is now one of its most vocal critics) says the underwriters shouldn¹t have allowed it. In my years in the business, if a company produced a hockey stick forecast, you didn¹t price it on the hockey-stick high, she says. If a company sets an aggressive distribution and then has to cut it, it's going to suffer damages to the stock Spinrite is symptomatic of a very serious structural problem with income trusts, and the high risks in that structure.

Robin Schwill, a lawyer with the Toronto firm Osler, Hoskin & Harcourt, says such decisions ultimately must lie with management, not the underwriters. Who's best to know? It's going to be management of the enterprise, he says. As long as they're putting forward prospectuses that comply with securities legislation and make full, true and plain disclosure of the circumstances, I don't think there's any requirement for‹nor would the market want‹somebody to step in as an intermediary.

Scotia spokesman Frank Switzer agrees. People looked at the industry and the solid history of this company, looked at who its customers were, and made decisions based on that, he adds. Everybody has to remember that income

funds are still equity investments subject to a company¹s performance. It's not like a bond.

Prospectuses are often dismissed by investors, partly because prospectuses read a lot like technical manuals. But investors ignore them at their peril. In addition to the usual boilerplate warnings about unforeseeable events, Spinrite's revealed specific concerns. One was that nearly two-thirds of Spinrite¹s recent revenue gains came from two customers. If either of them fell on hard times, Spinrite's growth spurt could end in a hurry.

Spinrite¹s prospectus also mentioned that most of the growth came from fancy yarns. But it pointed out that consumer tastes and fashion trends are fickle. An employee of one Toronto yarn shop (who requested anonymity) explained that manufacturers risk their products falling out of favour. It's all about fads, he said. Knitting will become a fad, and then it will go into crochet, and this year felting is very popular. Either you get lucky and it¹s still in, or you¹re very unlucky and you¹re stuck with warehouses full of stuff.²

Perhaps the biggest risk was that the IPO saw Spinrite pile on even more debt. It intended to pay off its outstanding loans and enter into a new credit agreement with a syndicate that included Scotiabank, CIBC and the Bank of Montreal. Total debt would rise to $67.7 million‹the highest on public record. Of course, that money came with strings attached. One debt covenant proved particularly significant: Spinrite promised to maintain its ratio of debt to earnings before interest, taxes, depreciation and amortization (EBITDA) below 2.5:1. (This ratio theoretically shows how many years of operational earnings are needed to pay off company debt.) We were leveraged very similarly to other income trusts that went to market around the same time we did, which was 1.5 times EBITDA, says Newell. In other words, at the time of the IPO, Spinrite was well under the 2.5:1 limit. As long as the business is operating the way it's supposed to, that¹s an acceptable ratio. If the business encounters difficulties, there's not a lot of leeway there.

If these risks kept investors awake at night, it didn't show. On Feb. 8 2005, the oversubscribed offering raised $202.9 million, $181 million of which was used to buy 80% of the operating company, Spinrite Inc. Sentinel retained a 13% interest.

This transaction was highly lucrative for its backers. Sentinel made a killing: it received US$109 million in cash, a 474% return on its original investment, making this, by far, the most lucrative of the five deals it had executed the preceding year.

Transaction costs totalled nearly $14.7 million. Much of that went to the underwriting syndicate (along with Scotia Capital, the other members included CIBC World Markets, BMO Nesbitt Burns, RBC Dominion Securities and TD

Securities). Riches flowed into management's pockets, too. Margve received nearly $2 million in cash‹plus another $1.5-million worth of subordinated units‹from Sentinel. The justification was his performance, but he¹d been on the job just six months. And he was promised $3.1 million more in cash, and more subordinated units, during the following three years if he stayed on as CEO. Other executives received lesser amounts.

That left investors. They received trust units at $10 a pop, and the prospect of receiving $1 of income per unit each year derived from Spinrite¹s future yarn sales. Though a significant number were retail investors, institutional investors also jumped on board. Bloom Investment Counsel, once described by investment guru Gordon Pape as one of Canada¹s leading experts on income trusts, bought significant amounts for funds it managed, such as the Citadel Diversified Investment Trust. Manulife Financial Corp. bought several of its Elliott & Page mutual funds. The Globe and Mail dubbed it the strangest offering of 2005. It only remained to be seen whether Spinrite could deliver on its promises.

Just after the February 2005 offering, American domesticity maven Martha Stewart walked out of a federal prison camp in Alderson, W.Va. wearing a poncho knitted by a fellow inmate. Spinrite and Lion Brand both speculated publicly that the inmate had used their yarns. She actually used Lion¹s product, but Spinrite declared ³Martha Poncho Madness Month and produced a pattern so that customers could make a similar item using its Bernat Galaxy yarn.

It was indeed a time of madness. Spinrite¹s sales continued at a frenetic pace during the first nine months of 2005, as retailers stocked up on yarns in preparation for a blockbuster Christmas. Spinrite had to fly in raw materials and outsource some production to other manufacturers. Investors drove its units to a high of nearly $14 that summer. Scotia Capital equity analyst Chris Blake was gung-ho, issuing reports that consistently forecast increases in the value of Spinrite¹s units. In September 2005, Margve increased distributions by 6%, to $1.06 a year. Everything seemed to be going as planned.

But they were all mistaken.

In the fall, craft retailers soon discovered that sales during the crucial Christmas season weren't nearly as buoyant as anticipated. For example, A.C. Moore Arts & Crafts Inc., based in Berlin, N.J., saw yarn sales plummet by 30% in the second half of 2005. Jo-Ann Stores Inc., based in Hudson, Ohio, also noticed unsold yarn piling up. They responded by slashing orders‹and dumping the stuff at liquidation prices.

One of Spinrite¹s smaller customers, Lewiscraft Corp., based in Brampton, Ont., couldn¹t handle it. The 90-store chain applied for court protection from creditors at the beginning of this year. Of Lewiscraft's nearly 150 suppliers, it owed Spinrite the most‹some $600,000. Meanwhile, turmoil at Spinrite¹s other customers

continued. In the three months ended April 29, Michaels' yarn sales were down 38% from the same period a year earlier. Jo-Ann lamented a significant deterioration in yarn and quickly replaced top executives.

Manufacturers felt the sting immediately. Spinrite's sales for the final quarter of 2005 plummeted by more than a quarter compared to the previous year. Margve ushered in 2006 by cutting 51 jobs and trimming production. Scotia's Blake, however, remained upbeat. And another analyst, Duff Kovacs of Clarus Securities, commenced coverage in January. Spinrite's units then traded at $6.90, but Kovacs thought they would return to $10. He called it a speculative buy. Bloom Investment Counsel was apparently in a speculative mood: during the first three months of 2006, it acquired more Spinrite units for its Citadel HYTES Fund, even as its existing holdings dwindled in value. Nobody saw what was coming. I guess we shouldn¹t have been surprised says Colucci at the Craft Yarn Council. But our industry had never experienced this before.

Finally, horror set in. When Spinrite revealed its first-quarter results that spring, sales were just more than half what they had been a year earlier. There was no way its cash flow could cover the generous monthly distributions, so those were cut in half. The unit price imploded, and the analysts slashed their price targets.

Remember the debt? Spinrite quickly ran afoul of its covenants, forcing management to renegotiate them with bankers. In May, they reached an agreement that included a reduced credit limit, relaxed debt-to-EBITDA covenants and a one-year extension to repay borrowed money. Spinrite sold all of its foreign exchange hedge contracts for $5.1 million and used the proceeds to reduce debt. Management figured this would provide enough breathing room.

But it wasn¹t enough. In June, Spinrite eliminated distributions entirely. By September, its units traded at an all-time low of 80¢. Since its units had lost most of their value, Spinrite¹s market capitalization was grossly out of whack with the enterprise value on the company¹s books. Spinrite decided to revise in August, writing down its assets by $160 million. Simultaneously, management revealed that Spinrite was again in danger of violating its debt covenants. During a conference call, Kovacs asked whether management would seek protection from creditors under the Companies¹ Creditors Arrangement Act. Newell denied that. 'We feel it can generate enough cash flow to service the debt and be able to offer a proposal to the banks to get our debt down to what they believe is an acceptable level,' he said. But with unit prices around $1, Kovacs wasn¹t alone in wondering about Spinrite's future. In an August report, Scotia's Blake fretted about how little cash Spinrite had left. The most encouraging thing he could say was that the company is worth more as a going concern than broken up and liquidated. At press time, negotiations continued.

In a Lewiscraft store in a drab subterranean mall in downtown Toronto, a wall of brightly coloured Patons and Bernat yarns sells at half price. Lewiscraft is no

more; a receiver liquidated it this summer and 595 employees lost their jobs. Now in the hands of an agent, its few remaining stores are just one venue where knitting and crocheting enthusiasts can pick up yarn dirt cheap. Colucci says members of the Craft Yarn Council expect sluggish sales to continue until next fall.

Spinrite's ownership structure changed in recent months. Bloom Investment Counsel bailed out, while Royal Capital Management Corp. (not affiliated with RBC Royal Bank) began purchasing units in July. By the end of September, RoyCap had acquired a 16.75% stake, making it Spinrite's largest shareholder. It claims this is for investment purposes only, and that it hasn't reached any agreement with management. A RoyCap spokesman declined to comment on the company's intentions. Notably, however, on its website, RoyCap calls itself an expert in financial reengineering for companies in crisis.

What the hell happened? Looking back, Margve believes one contributing factor was that the yarn business failed to convince newcomers to stick to their knitting. For whatever reason, they didn¹t continue to the next level, he says. They didn't make sweaters and afghans. They got bored, and they left. He doesn¹t think his team was to blame. But having experienced both the knitting craze and its implosion, Margve and Newell agree the income trust structure proved inappropriate for Spinrite. In hindsight, should a business experiencing that kind of fluctuation be an income trust? Newell says. No. That's a given.