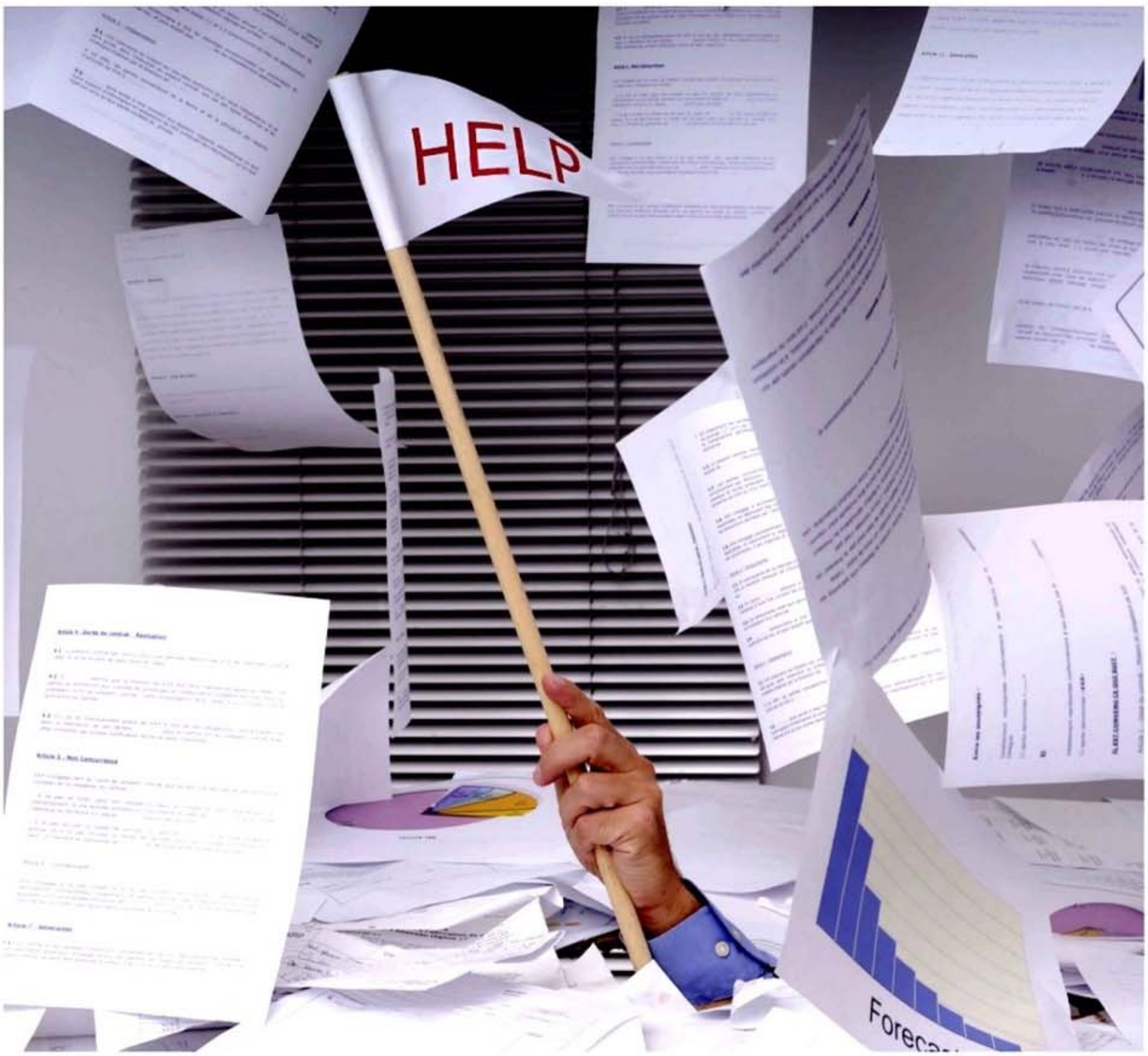
Managing Turnarounds Requires Clear Thinking, Quick Action, and a Plan

• • The process for turning around troubled companies is easy to understand and challenging to implement.



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By John M. Collard

THERE IS PLENTY of trouble in today's economy, and few industries have been spared hardship. Turnaround opportunities abound for those who have the knowledge and fortitude to go through the process. The rewards can be plentiful and the failures catastrophic.

The process of turning around a troubled entity is complex and made more difficult by the multiple constituencies involved, all having different agendas. Lenders want their invested capital returned, preferably with interest. Creditors want to get paid for goods and services. Original investors want and hope for recovery of their capital, while distressed investors want to buy in at 20 cents on the dollar and then turn a profit, some by trading the credit and others by turning the business positive and then selling. Owners want to avoid guarantees and recoup some of their equity. Employees want to retain their jobs and benefits. Directors want to avoid risk and litigation. Other stakeholders want their interests protected. These varied desires often can be at odds with one another and hamper the turnaround effort.

Let's address the turnaround process as if all constituents favor proceeding through to the end, when a restructured entity emerges, although clearly other scenarios can be envisioned.

The High Cost of Mismanagement

Many causes contribute to business failure. According to a study conducted by the Association of Insolvency and Restructuring Advisors, only 9% of failures are due to influences beyond management's control and to sheer bad luck. The remaining 91% of failures are related to influences that management could control, and 52% are rooted in internally generated problems that management didn't control.

Businesses fail because of mismanagement. Sometimes it is denial, sometimes negligence, but it always results in loss. Mismanagement is most often seen in more than one of multiple areas:

- Autocratic management and overextension.
- Ineffective, non-existent communications.
- High turnover and neglect of human resources.
- Inefficient compensation and incentive programs.
- Company goals not achieved or understood.
- Deteriorating business and lack of new customers.
- Inadequate analysis of markets and strategies.
- Lack of timely, accurate financial information.
- History of failed expansion plans.
- Uncontrolled or mismanaged growth.

Will Rogers said, "If you find yourself in a hole, stop digging." It's good advice for directors and managers with responsibility for leading a company and very good advice for lenders and investors contemplating investing more capital into a troubled entity. This is an opportunity for distressed investors having the "dry powder" to invest at bargain rates, the stable of leaders to affect a turnaround, and the knowledge and chutzpah to take on these challenges.

The Role of Turnaround Specialists

To engineer a successful turnaround, a company needs someone with clear thinking to quickly assess opportunities, to determine what is wrong, to develop strategies that no one has tried before, and to implement plans to restructure the company. The problems are rarely what management indicates they are, but rather are usually two or three underlying, systemic ills that often can be fixed. You can't focus on the symptoms; you must find the real causes. Management has allowed these problems to exist and bring the company to its depressed state. Therefore, management is not equipped to manage the turnaround.

When these circumstances are present, turnaround specialists are often an excellent choice. They bring a new set of eyes trained in managing and advising in troubled situations. These experts are either practitioners or consultants. Turnaround practitioners take management and decision-making control as chief executive officer or chief restructuring officer. As an alternative, turnaround consultants can advise management, perhaps the same management that failed before.

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The key to turnarounds is building enterprises in which future buyers want to invest. Investors and buyers look for businesses that:

- Create value and exhibit consistency from period to period.
- Have a high probability of future cash flows or have a history of performance and improvement or the promise of cash.
- Possess a market-oriented management team with a focus on producing revenue.
- Are able to sell and compete; to develop, produce, and distribute products; and to thrive and grow as indicated by a track record or demonstrated changes in the right direction.
- Exhibit a fair entry valuation and realistic return potential.
- Have exit options (a high return on investment, or ROI, realized at time of resale).

There is a process of recovery and investment in a turnaround. It is based on the fundamental premise that management is lacking when companies are in trouble. Turnaround specialists must conduct fact-finding to assess the situation and then prepare a plan to fix the problems. They must implement the planned courses of action by funding the process and building a team to carry it out, then monitor progress and make changes where necessary.

Stages in the Turnaround Process

The turnaround process has five stages:

- Management change.
- Situation analysis.
- Emergency action.
- Business restructuring.
- Return to normal.

Let's look at each stage individually to understand the objectives and what should be done by each function within the company. The timing is important to coordinate what's happening between functions. Stages can overlap, and some tasks may impact more than one stage.

The process is designed to first stabilize a situation, which is done by addressing management issues, assessing situation, and implementing emergency actions. The restructuring process begins with preparations during the emergency action phase. Positioning for growth starts with restructuring and grows when the normal stage is reached.

Management Change

It is very important to select a CEO who can successfully lead the turnaround. This individual must have a proven track record and the ability to assemble a management team that can implement the strategies to turn the company around. The best candidate most often comes from outside the company and brings a special set of skills to deal with crisis and change. His or her job will be to stabilize the situation, implement plans to transform the company, and then hire a replacement.

It is essential to eliminate obstructionists who may hamper the process. This move could require replacing some or all of top management, depending on the deal. It will undoubtedly also mean replacing some of the board members who did not keep a watchful eye.

Management must address issues related to the major stakeholder groups: executives, function managers, employees, lenders, vendors, customers, and others. To accomplish a turnaround, a company must make a concerted effort to change how it operates. Most turnaround companies have a lack-of-sales problem that necessitates a change to jump-start sales and drive revenue. There must be information that all can rely on for decision making. Production management must support and make what the market wants to purchase at competitive prices. Management must nurture the critical human capital resources that are left within the company, while at the same time holding them accountable for results.

Changing management is synonymous with changing the philosophy of how a company is run to achieve results. Communication with all stakeholders is paramount throughout all stages of the process. Set goals that achieve stakeholder objectives, then apply incentive-based management to motivate the proper results. Tie everyone to the same broad set of goals and emphasize how functions can complement the performance of related departments.

Situation Analysis

The objective at this stage is to determine the severity of the situation and whether it can be turned around. Questions to ask include:

- Is the business viable?
- Can it survive?
- Should it be saved?
- Are there sufficient cash resources to fuel the turnaround?

This analysis should culminate in a preliminary action plan stating what is wrong, how to fix it, and which key strategies can turn the entity in a positive direction. There should also be a cash flow forecast (at least 13 weeks) to understand cash usage.

Identify effective turnaround strategies. Operational strategies include increasing revenue, reducing costs, selling and redeploying assets, and establishing competitive repositioning. Strategic initiatives include adopting sound corporate and business strategies and tactics and setting specific goals and objectives that align with ultimate stakeholder goals. Too often, goals are misaligned with the ultimate direction and lead to confusion, wasted time, false starts, and employees sent in the wrong direction. Understand that many of the good employees have already left the company. Managements have to work with the "second string" in the interest of time and build as they go.

Understand the life cycle of the business and how it relates to the chosen turnaround strategy. Document key issues so that all parties will understand what you are trying to accomplish and will pull in the same direction. Identify which product and business segments are most profitable, particularly at the gross margin level, and eliminate weak performers and nonperformers. Make certain that all functional areas are working to support the goals of their counterparts. Selling work with flexible delivery times can fill valleys in production cycles, which reduces costs per unit. Producing only what sales staff can sell to meet customer demand will increase sales and gross margin.

Turnaround strategies often are affected by local government policy considerations and regulations. In the United States, the Worker Adjustment and Retraining Notification (WARN) Act requires 60-day notice of massive layoffs, which certainly impacts cash flow. In many countries in Europe and the Far East, stringent rules govern payment of wages after layoffs, as well as dealings with local authorities; some regulations even prioritize which workers can be laid off. When government policy favors labor and employment is not "at will," there will be complications.

Emergency Action

At this stage, the objective is to gain control of the situation, particularly the cash, and establish breakeven. Centralize the cash management function to ensure control. If you stop the cash bleed, you enable the entity to survive. Time is your enemy. Protect asset value by demonstrating that the business is viable and in transition.

You must raise cash immediately. Review the balance sheet for internal sources of cash, such as collecting accounts receivable and renegotiating payments against accounts payable. Sell unprofitable business units, real estate, and unutilized assets. Secure asset-based loans if needed. Restructure debt to balance the amount of interest payments with the level the company can afford.

Lay off employees quickly and fairly. It is much better to cut deep all at once than to make small cuts repeatedly. Remaining employees are more likely to focus if they believe their jobs are secure.

Rightsizing the company means much more than laying off employees. Correct underpricing of products, prune product lines to only those that are profitable and meet demand, and weed out weak and problem customers. Sometimes too much overhead is applied to support customers that aren't paying their fair share of that service. Emphasize selling more product at profitable rates. Reward those who change the situation; sanction or release those who don't.

Business Restructuring

In this stage, the objective is to create profitability through remaining operations. Stress product-line pricing and profitability. Restructure the business for increased profitability and return on assets and investments. This is the point at which the focus should change from cash flow crisis to profitability. Fix the capital structure and renegotiate the long- and short-term debt.

Ensure reporting systems put in place are operationalized to show profitability at each revenue center, cost center, profit center, cash center, incentive center. If employees can't see it, they can't manage it.

Incentive-based management drives employees to get involved smartly and manage to the goals all ascribe to. Create teams of employees to identify and rework inefficiencies and promote profitability.

There are only two ways to increase sales: 1) sell existing product to new customers, and 2) sell new products to existing customers. If you want growth, do both.

Return to Normal

The goal at this final stage is to institutionalize the changes in corporate culture to emphasize profitability, ROI, and return on assets employed. Seek opportunities for profitable growth. Build on competitive strengths. Improve customer service and relationships. Build continuous management and employee training and development programs to raise the caliber of your human capital.

This could be time to restructure long-term financing at more reasonable rates now that the company is stable and on a path to growth.

The odds of a successful turnaround increase dramatically if a turnaround phases-and-actions plan is implemented and followed (table). This plan can certainly be adapted to unique situations when required.❖

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Turnaround Phases and Actions

Stage	Management Change (Leadership)	Situation Analysis (Viability)	Emergency Action (Crisis Control)	Business Restructuring (Change)	Return to Normal (Going Concern)
Objectives	• Put top management team in place. • Select turnaround specialist. • Replace some/all top management. • Eliminate impediments.	• Can the company survive? • Should it be saved? • Is the business viable? • Are cash resources available to fuel turnaround? • Develop preliminary action plan and nature of turnaround.	• Go into survival mode. • Get control. • Establish breakeven. • Turn cash flow positive. • Raise cash to support turnaround. • Protect resources. • Protect asset value.	• Create profitability through operations. • Restructure business for increased return on assets and investment.	• Seek profitable growth. • Emphasize profits and returns. • Build competitive strengths.
Sales and Marketing	• Jump-start sales. • Drive revenue. • Volume in = revenue.	• Analyze products and services distribution, sales and marketing strategies and systems.	• Correct underpricing. • Prune product lines. • Weed out weak customers and distributors. • Bring sales and marketing costs within industry average. • Sell, sell, sell more.	• Reassess competitive and product line pricing. • Exploit existing products. • Develop new products. • Improve customer and distribution mix. • Improve sales and marketing effectiveness.	• Explore new markets and customer segments. • Examine industry restructuring opportunities. • Pursue value-added chain restructuring. • Consider synergistic diversification.
Financial	• Track cash. • Develop trusted reporting and analysis.	• Analyze cash flow, breakeven, profitability, cost reduction, balance sheet, and reporting gross margin by product.	• Restructure debt. • Improve work/capital. • Sell nonproducing assets. • Reduce cost/ increase revenue. • Eliminate creative accounting practices.	• Improve liquidity. • Clean up balance sheet. • Fix capital structure. • Develop control systems. • Create managerial accounting system.	• Develop strategic accounting. • Restructure long-term financing. • Develop stock valuation and buyback system.
Manufacturing and Production Operations	• Produce to meet sales levels only. • Balance peaks and valleys. • Volume out = throughput.	• Analyze facilities, equipment, systems and procedures, and suppliers.	• Shut down operations. • Reduce work force. • Reduce inventories. • Control purchases. • Increase productivity.	• Develop productivity improvement programs. • Reevaluate overhead. • Establish ongoing profit improvement programs.	• Restructure operations for competitive advantage. • Consider strategic alliances with world-class firms.
Engineering, Research and Development	• Develop new products and services to support sales.	• Analyze new product development, improvements in product, process, and productivity.	• Accelerate high-potential projects. • Shut down tangential projects. • Unbundle product offerings.	• Make new product development market- and customer–oriented. • Build an economic value-added orientation into process engineering.	• Establish advanced technology monitoring systems. • Seek competitive advantage, strategic leverage in all R&D activities.
Organization	• Organize for change. • Rightsize the company.	Analyze systems: • Does organizational structure make sense? • Accounting/Control. • Incentive/performance measurement and compensation.	• Structure turnaround team. • Review individual accountability and teamwork. • Reward those who change the situation; release those who don't.	• Restructure for competitive effectiveness. • Develop rewards that reinforce turnaround. • Demonstrate with action the seriousness of the situation.	• Restructure to reflect changing strategies. • Organize to succeed, then fill positions with talented people. Don't compromise.
Personnel and Human Resources	• Hold employees accountable. • Nurture critical human capital resources. • Slow the turnover rate. • Institute incentive-based management.	• Analyze management team; sales, finance, and ops personnel; recruiting, selection, training, starting, and promotional systems.	• Get peoples' attention. • Establish who's in charge. • Create a professional, business-like atmosphere. • Sanction nonperformers.	• Improve people mix. • Institute incentive-based management. • Bolster people to believe in consistent reward system. • Get people to think profit, ROI, and cash flow.	• Institutionalize continuous management and employee training and development programs. • Grow human assets.