No-Holds-Barred Assessment — The Foundation of Corporate Turnarounds

BY JIM FLEET AND BOB GOWENS

Accepting the reality of a corporate crisis can be significantly painful. However, as Phoenix Management's Jim Fleet and Bob Gowens point out, options for help are available — and if a distressed company is willing to face the *real* truth behind its underperformance, it can reverse the downward spiral and return to strength.

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In business as in life, the truth can hurt. Management teams are reluctant to admit failure, investors fear the impact of possible fundamental change and bankers cringe at a request to restructure loans. Yet, an accurate picture of reality is absolutely essential for a company that is either underperforming or facing crisis.

In many cases, the challenges for underperforming companies are exacerbated by management inefficiencies or inadequate communication. A management team in crisis may feel overwhelmed in choosing priorities for dealing with all types of tasks — a certain indication of lack of control for addressing the tasks that require immediate attention.

Not facing the truth, however, is just one component of a much larger problem that can impact efforts to complete a successful turnaround. Others are politically-based hidden agendas and sacred cows, which may be unquestioned but are equally problematic. Existence of these issues creates a classic environment in which decision-making is deeply flawed.

The Trouble With Corporate Truths

Business truths, or perhaps the perception of them, fall into different categories, but most surface during a crisis. For instance, a historically successful company often turns a blind eye to underlying problems involving processes, products, escalating costs and employee performance when business is booming. A management team confident in its strategy may see no reason to create a Plan B or might be incapable of addressing a crisis in the first place. Yet, when a crisis strikes and a company lacks essential underlying systems and/or the management team is unfamiliar with product contribution margins, true costs and other key financial metrics, valuable time is wasted, delaying the initiation of a possible survival turnaround.

Management may be placing itself in a difficult and possibly unsustainable position by failing to acknowledge an evolving environment within the industry. Think of the iPhone versus the Blackberry. Reaction from the various constituencies is fairly predictable. Contention erupts between management, senior lenders, equity investors and other stakeholders over the permanency of the situation. This only compounds the chaos and further hampers the turnaround process.

Sacred Cows and Hidden Agendas

Typically, sacred cows and hidden agendas surface during a crisis and are equally counterproductive in a turnaround process. One example of the former comes from a family business in which less-than-qualified family members remain in management positions to the detriment of the organization. Another is the classic "roll–up" strategy where the sacred cows often involve local loyalties. A management team refuses to close a location, even though the footprint reduction is necessary and part of the original strategy. As a result, the new synergistic and planned organizational structure fails to materialize.

Sacred cows often appear as upper management pet projects, such as questionable construction of new offices or headquarters or continuation of non-essential engineering projects. In a crisis situation, both are likely to negatively affect the bottom line or cash-flow. Sacred cows may also have historical significance, such as when management refuses to cut ties with a long-time customer or vendor despite analytics showing a declining return on investment with the relationship.

Just as toxic to the turnaround process are hidden agendas. There is no shortage of business case studies in which companies were guilty of gross mismanagement or lying to investors. In fact, failure to report activities of questionable legality will prove fatal to any turnaround plan efforts. The same can be said for the discovery of financial manipulation that casts suspicion over the actual state of the corporation. Additionally,

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any situation where only select management is aware of any hidden disturbing fact or approaching negative event can result in disaster if other stakeholders are not given adequate warning.

With misrepresentations such as these often so lethal to companies in trouble, why aren't they addressed before they become problematic? In part, this is because the misrepresentations are presumed to be factual.

Management and The Real Truth

Perhaps upper management is unaware of the *real* truth of its situation. Usually the root cause of such ignorance is a breakdown in communication either by accident or choice. In the case of the latter, middle management may feel the need to protect either its actual position or perceived authority. So the truth is filtered to present only what the middle managers believe upper management wants to hear or to steer decisions that may suit middle management's interests with little regard to the wellbeing of the enterprise.

Upper management, however, has its share of the blame, particularly by setting low communication standards. For instance, CEOs, CFOs or COOs may tend to isolate themselves from regular communications with those on the firing line who work directly with products — a major mistake. The production floor core team is in the best position to spot product quality issues. So are front line production schedulers and materials managers who are often the first to uncover flaws in manufacturing, materials management and the supply chain. Similarly, who knows better than the sales team which products are falling short of meeting customer needs, which ones sell better and which fail when compared to the competition? All of this is valuable information that could help mitigate the crisis is filtered due to self-serving middle management agendas.

The Management Team: The Truth for Bankers and Investors

For bankers and investors, the view of the management team is often at odds and thus the truth comes from different perspectives. Bankers, understandably concerned about the status of the loan repayment, may support a turnaround plan and/or restructuring, but often with a change of management and leadership, including the insertion of a chief restructuring officer. Investors, on the other hand, may be more concerned about retaining the relationship they have with the company's management. Generally, they see the greatest opportunity is to maximize enterprise value with the lowest risk and gain the best ROI for their investment. Therefore, investors are likely to look less favorably on radical change to management teams until all options have been exhausted. As a result, both bankers and investors tend to give a company more time to get back on its feet.

Unfortunately, providing the management team with this grace period often causes a deepening crisis as the most valuable resources — cash, time and credibility — evaporate. Without meaningful change, the company continues the downward spiral.

Turning Elsewhere for Help

Surviving a crisis and completing a successful turnaround are uphill battles for many companies, especially for those unwilling to look at the truths and realities that are creating their untenable situation. When it gets to that point, the major constituents — the lenders and investors — will no doubt demand the company seek outside help.

Independent turnaround professionals are an invaluable resource for providing a struggling company with a new perspective. Their job is to create a team environment that allows the company to take advantage of opportunities for early wins during the crisis management period. Their responsibility is to help management set clear, tactical and strategic goals. While companies seeking the help of turnaround experts will conduct due diligence before making their selection, there are some standards that they should require from any outside consultant:

- *Knowledge of and assistance to management in creating a culture that relies on regular and truthful communication across the greater employee base.* Effective communication keeps all internal and external constituents informed, which boosts company morale. Without adequate communication, most human beings gravitate to the worst possible interpretation, resulting in the best and the brightest leaving the company.
- *Providing significant guidance to or assuming control of cash management during times of liquidity crisis.* Often this involves changing and improving the company's credit and cash management processes. For instance, a company may face liquidity challenges due to customers demanding unreasonable payment terms, taking exorbitant discounts for early payments or being allowed to build up large A/R balances that require deft collection negotiations. Likewise, vendors may be imposing unreasonable credit terms because they sense the company's vulnerability.

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- *Ability to identify hidden market opportunities to broaden the customer base.* The existing management team may have a limited perspective for a number of reasons that have resulted in lost opportunities. The turnaround advisor should be able to explain how to produce additional revenue streams through solutions such as bundling existing products, introducing new products and services or creating new applications.
- *Creation of detailed financial and operational analytics of cost and margin data to identify product contribution margins.* In underperforming companies, product line profitability reporting and systems are often missing or inadequate. The turnaround expert should be able to explain how to efficiently manage existing products, focus on those that maximize variable margins and identify products that offer minimal returns.
- *Competency in addressing and making the hard decisions regardless of the industry.* These might include how and when to change the management team or how to identify which operations, portfolios and/or customer or vendor relationships are draining the company's margins. The expert should also be prepared to address the identification of redundant facilities, size of the workforce and the need for consolidation and better ways to utilize human resources, such as placing individuals where they can be more successful. Overall, the turnaround professional should be skilled at distilling multiple variables down to a few that focus the company's efforts and best ensure its survival.
- *Understanding of the capital markets and lender cultures and policies.* This is essential because a successful turnaround is often contingent on communicating and gaining the support and cooperation of the company's capital partners.
- *Leadership in developing metrics and reporting processes that more clearly identify and track performance over all critical functions.* Too often this essential component is not only inadequate but missing. Establishing follow-through processes is critical for a turnaround to be successful.
- *Development of a litmus test to separate tasks into urgent, important and not-so-urgent categories.* Essential during a crisis, this business strategy also ensures "corporate hygiene" in the future.

Accepting the reality of the situation can be significantly painful, especially in a crisis, but there is no other option. Unlike fine wine and single malt Scotch, corporate problems do not age well. A plethora of challenges from ill-conceived policies to sacred cows to hidden agendas are among the root causes that jeopardize the company's chances of survival. However, options for help are available. The company's willingness to take advantage of them can reverse the downward spiral and return it to strength and the growth opportunities that accompany it. abfj

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