When Is a Turnaround Not Really a Turnaround?

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When a company faces a distressed operating environment, it is essential to create and execute a permanent turnaround. Yet, too often businesses implement processes that focus solely on increasing cash flow, ignoring the underlying issues that created the financial problems in the first place.

As a result, the financial crisis resurfaces in the future. This article focuses on what constitutes a true turnaround and how to accomplish that goal.

Running a business is rarely a walk in the park. High risk, often compounded by rising costs, financial mismanagement, and changing markets can rapidly force a company into a distressed operating environment. As a result of being unexpectedly cash-poor and facing pressure from constituencies, the company initiates a turnaround plan that appears to work. Yet, once the turnaround process is "completed", the money soon runs out again and the company faces another financial crisis. So, was the process really a turnaround? Or was it merely a temporary bandage?

The distinction lies in the permanence of the results, which more often than not relates directly back to the depth of the process. For although increasing cash flow can be an essential tool in turning a company around, a true turnaround requires more than just statistical improvements on a spreadsheet. It starts by assessing the underlying problem(s) responsible for the crisis, followed by developing and implementing an integrated strategy designed to achieve the company's collective turnaround goals. Only then can a company achieve genuine, sustainable change—creating an environment conducive to continuation of operations, reinvestment and growth.

Why turnarounds are often necessary

With numerous variables influencing the success of a business, companies frequently struggle to achieve their goals and generate liquidity. Sometimes internal issues, such as poor operating decisions by an underperforming management team, are to blame. Outside influences also take their toll, such as changing markets and/or a dying industry sector. Is it any surprise the buggy whip industry took a nosedive following the rise of modern transportation?

In the same respect, ignoring fundamental industry trends can negatively impact a business. For example, with today's massive technological changes, even the most efficiently-operating printing company will fail to experience a true turnaround if it doesn't address the fundamental shifts in the market and plan accordingly.

Incomplete or false turnarounds

Although companies react in numerous fashions when facing a financial crisis, many look for a quick fix. For this reason, management teams may attempt to solve their problems with asset dispositions. Though this action can be an essential turnaround tool, it is rarely successful as a stand-alone solution. For instance, a strawberry farm may sell its trucking division. In taking this action, it converts hard assets into cash and avoids a financial meltdown. But unless the farm's only problem is a poorly performing transportation division, this is not a long-term solution. In addition, by concentrating solely on the company's short-term cash flow, the management team fails to uncover and solve the underlying problem(s) that created the crisis in the first place. As a result, the financial issues will more than likely resurface in the future and, additionally, the company will have fewer assets available to fund a real turnaround at that time.

Another turnaround myth involves companies with seasonal or cyclical business models. An example comes from a company that supplies seasonal items to retailers where the lag time between product delivery and payment received can be months. Although the seasonal nature of the company itself temporarily solves or creates liquidity, yo-yoing between being cash-poor and in the black is far from ideal—especially if the company fails to allocate the liquidity generated from the peak sales season throughout the tighter liquidity periods. Basically, the victory celebrated as the company goes into the high season becomes unsustainable. In the same respect, industries that experience multiple-year cyclicality too often base their turnarounds on unrepeatable revenue. For instance, a commercial printer or a radio station may experience surging income as a result of massive political spending during an election year. But, unless these excess funds are invested in changes that create permanent improvement to the underlying operations, this revenue is unsustainable from one year to the next.

Inconsistent revenue trends can also lead to an unsustainable turnaround in industries that rely on large projects, such as software development companies or companies involved in large construction projects, such as bridge building. Though these projects produce a substantial revenue surge, they additionally create large overhead expenses that may be difficult to ratchet back. So, the apparent turnaround will be unsustainable unless a sales pipeline can replace the surging revenue and cover the increased costs. Alternatively, a company with "lumpy" revenue streams needs to strive to match these peaks in revenue with proportional increases in variable expenses, thereby enabling them to reduce costs when the large projects are completed.

Once again, these examples of revenue opportunities can be important contributors to a turnaround; but, without a precise plan for creating a sustainable business model, a company in this situation will eventually face financial difficulties in the future.

Another example of a turnaround declared too soon involves the common use of Pro Forma financial statements and forecasts that inaccurately reflect future costs. For instance, management might reclassify expenses as one-time costs, part of their restructuring costs, or even leave certain losses out of their financial statements year after year. As a result, the company appears to be moving forward following a successful turnaround. But this accounting practice provides little more than an inaccurate near-term liquidity picture and a false sense of future financial security.

Some companies create a turnaround illusion based upon driving a business primarily on cost cuts and deferred investments. For instance, a restaurant owner may defer maintenance to create liquidity. But this logic is short-sighted. Without reinvesting, such as updating the decor, hiring enough servers, and repaving the parking lot, the customer base ultimately declines and revenue drops. Or, a trucking company defers vehicle maintenance and/or foregoes scheduled truck purchases to stimulate short-term cash flow. However, trucks wear out and lose their worth, maintenance costs escalate, and the company fails to generate the necessary or expected income. Over time, the trucks break down altogether, forcing the company to increase capital expense spending. In both examples, whatever short-term liquidity gain is created is often followed by the beginning of a downward spiral as revenue continues to decline further and, ultimately, there is no funding for future reinvestment.

Replacing a management team is yet another turnaround technique that rarely solves anything on its own. Although fresh eyes bring heightened energy and creative perspectives, a new team often faces left-over problems from their predecessors, such as long-term obligations that negate forward movement. Additionally, new team members can be a problem in itself. New hires may have excellent organization skills in their area of expertise, but lack the skill set required for this new challenge. For instance, a small IT company that hires a former IBM executive may have high expectations. Although skilled in operating systems, however, the new hire is inefficient managing small business cash flow because a treasury team handled this aspect in her previous position. As a result, the turnaround is put on hold to get the new team member up to speed and the financial crisis remains unresolved.

Components Of A True Turnaround

Truly turning a company around is far more than a statistical improvement. It is a successful business event that provides a sustainable operational performance. Additionally, it achieves the borrower's original goal by solving underlying problems. Ultimately, it produces sufficient liquidity to create a return on capital, so the company can invest in itself and avoid revisiting the same crisis in the future.

Equally important, a true turnaround produces new capital with a return consistent with the risk taken. For instance, a company with a net liquidation value of $10 million that requires $3 million in turnaround costs will need to produce a return based upon the sum total of $13 million, not just the $3 million. In essence, with a true turnaround, the return on capital takes into account the total cost of the process, which, in this case, includes the return on capital for the liquidation value of the assets.

Strategies For Implementing A Successful Turnaround

Successfully turning a company around is a process. It begins by identifying underlying operational issues, determining the required changes to these challenges, and ascertaining essential resources to achieve sustainable change. Here are some specific strategies to achieve a successful turnaround.

- Get the right team in place. Enormous effort on everyone's part is required to turn a company around. Removing deadwood employees accelerates the process.
- Get the entire company onboard from the beginning: Along with management, the board of directors, the lenders and attorneys, the turnaround professionals, and especially the rank and file. A successful turnaround begins by creating a sense of "we are in this together".
- Change the collective mindset. Eliminate the "this is how it was always done" legacy that likely contributed to company's current plight. Educate everyone in regards to how all metrics collectively drive the business. This can also promote morale as "ear-to-the-ground" employees feel valued

when encouraged to offer helpful suggestions for business changes and/or cost reductions.

- Determine core competencies. Identify what products or services the company can generate with positive operating margins for the foreseeable future. Furthermore, decide which divisions or departments can be handled more efficiently by outside experts.
- Identify underlying drivers of the business. Business drivers are industry-and/or company-specific. A full understanding is necessary to implement fundamental change.
- Make sure the metrics accurately address the business at hand. Once the drivers are determined and the goals are set, acquire or develop ways to measure the results. Adherence to a common set of business metrics will often drive results due to the aggregated focus on these key drivers.
- Scorecard the plan consistently and review often. Instruct key management to examine the scorecard every morning or at least once a week to faithfully measure and monitor performance.
- Track the performance through the cycle. For non-seasonal or cyclical businesses, track performance to recent and year-ago periods. For seasonal or cyclical businesses, track the performance against recent periods and similar periods in the past season or cycle. In either case, track for at least 12 months to observe week-to-week changes and seasonal variances.
- Accentuate positive end-results. Faithfully sharing results and progress with all employees benefits the company and accelerates the turnaround process. For instance, employees in the trenches who haven't received raises for a while develop a greater sense of company ownership. This, in turn, encourages increased individual contribution.
- Instruct turnaround managers to review historical problems while also anticipating changes in the marketplace. A forward-thinking mindset and the ability to recognize and deal with future challenges are critical to completing a true turnaround.
- Execute the plan and then stick to it. However, be flexible. A successful turnaround is not a quick fix, but a long-term process, and changes may be necessary as new challenges arise.
- Know when to get out. Sometimes, the best business strategy is an exit strategy.

The business world is ripe with pitfalls. As a result, companies often struggle just to stay afloat. Though there are numerous reasons turnarounds are executed to provide relief, typically, the relief is short-lived. By focusing solely on increasing cash flow or addressing only the short-term solutions, businesses ignore the underlying issues that created the problem in the first place. Only by utilizing a more comprehensive turnaround approach, which identifies, scorecards, and tracks success can a company permanently escape a financial quagmire. TSL

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