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MANAGEMENT CONSULTING FOR CORPORATE RENEWAL

The Turnaround; Elements of Success

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The purpose of this article is to give the reader some practical insight into the key elements necessary for a successful turnaround.

Corporate transformation or turnaround happens when a company with major problems has adequate time and resources to find solutions and implement them. Crisis management however happens when a troubled company is irreversibly near the end of its existence.

One definition of a successful turnaround can be found in **"The Turnaround Experience by Frederick Zimmerman"** as follows;

> *" The method used for determining whether the turnaround was successful centered around three necessary conditions; a return to profitability, a substantial improvement in profitability, and overall improvement in market position all lasting several years and resulting in a measurably better situation for the company with respect to these criteria. More specifically, a turnaround was classed as successful if the following were achieved;*
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> - *Profitability improved from the levels of the period of crisis for a period of at least several years.*
> - *Profitability was positive.*
> - *Market position was significantly strengthened either by increasing market share.   or by successfully concentrating on an important subset of the market."*

Another definition can be found in **"Corporate Turnaround by Donald Bibeault"**

> *"I think that the turnaround becomes a turnaround at that point in time when your financial partners begin to treat it as such. In most large businesses, the turnarounds are involved in partnerships of the company and its banks, and obviously the attitude of the banks in relation to the type of loan agreements and the type of stranglehold they have on the company is very direct measurement of when they have accepted the fact that a turnaround exists. When your financial partners begin to treat the company as a customer again, rather than the bank feeling like it is the customer, that's the point in which the turnaround has been affected."*

If we consider both of these definitions a turnaround obviously involves lasting, substantial and fundamental change to a company and how it operates.

In order for this change to be made there are certain key elements that are required, their presence does not automatically guarantee success but their absence guarantees a very high risk situation in terms of a turnaround.

These elements are;

- A management change. Either new and competent management or a complete change in the attitudes of existing management. Management must have authority to act and usually act quickly.
- A core operation, that is viable from an economic point of view and is competitive.
- Sufficient financial resources to implement the turnaround.

Let's look at each of these elements in turn. Certainly of all of these elements the change in management is crucial. It is also perhaps the most difficult to achieve, to quote Niccolo Machievelli;

> *"It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new system. For the initiator has the enmity of all who would profit by the preservation of the old institutions and merely lukewarm defenders in those who would gain by the new ones. The hesitation of the latter arises in part from the fear of their adversaries, who have the laws on their side, and in part from the general skepticism of mankind which does not really believe in an innovation until experience proves its value. "*

It is difficult to achieve management change in large corporations; sometimes it is impossible in family owned and operated companies. Recently we served in a family operated company. It had been performing dismally for years. The CEO who was a family member had just lost over a million dollars in one year, sufficient to cause a financial crisis and severely impair the company. We were staggered to learn that he did not even understand the implications of this loss on working capital, but the family dynamic ensured he would remain.

Notwithstanding the difficulties with respect to management change it is crucial to the process of corporate renewal. It is very difficult for a custodial manager, even a good one, to act as change manager for the company he has steered for many years. There are hard choices to be made and emotions cannot be considered. If a company is in serious difficulty resources of time and expertise are limited and there is likely a credibility problem with lenders, creditors and suppliers. Lastly turnaround and crisis management is a specialized skill distinct from custodial management.

The next key element then is a viable core operation. To turn a company without a platform that provides positive cash flow is very difficult, some turnarounds succeed in this manner but they are few and far between.

In identifying a viable core there are factors to examine;

- The core will have a positive cash flow defined as cash after costs but not after depreciation or the balance of probability suggests that it will in say six months.
- The core will have sufficient sales to support the firm during the time its problems are identified and solutions implemented.
- The core will have machinery, equipment and data handling systems that are competitive. This usually means they are relatively new.
- The core will have a competitive location.

Sometimes just what the core is comprised of can be surprising.

A few years ago we served as crisis managers for a yacht company. We found that gross margins on yachts were negative. This abysmal situation was due to pricing and production issues and was nearly impossible to correct. In our assessment we noted that the use of composite materials in yacht making had many other commercial applications. The company had explored the commercial market and successfully completed some projects including contracts for the United States military.

Indeed the size of the commercial market was substantial and the company had superior skills in composite work. Most importantly gross margins were over 30%. Clearly the core competency for this company was not yachts but the commercial application of its skill in composite work. For irrational reasons management had ignored this fact and allocated massive resources to yachts resulting in substantive operating losses. Unfortunately additional resources were not available and we could not explore what should have been the core business.

This example serves to reinforce the fact that once identified, the core must be protected. This often means different policies for the core with respect to customers, payables, clients, etc. It also means that non essential resources (not belonging to the core) should be sacrificed as needed.

Strategically it is important to stay close to the market niche during stabilization and to use marketing resources on an opportunistic basis. Rapid expansion without thought to the competitive market niche would be the final disaster at this time.

The tactics used to solidify the cores market position involve what we would call cutting the fat. Product lines which are considered to be core are; protected, enhanced and exploited.

Any line not deemed to be core is quickly and ruthlessly eliminated. Excessive or unnecessary diversification is also eliminated. Lastly any business segment or product that cannot compete because of the sheer market power of larger competitors is eliminated.

The last key element is sufficient financing to implement the changes necessary to bring the company back to health. Obviously the best strategy with the best management and motivated employees will fail without adequate resources.

Financing which is available can be from external or internal sources. The external sources will include both secured and unsecured creditors. Internal sources include such things as the divestiture of assets, reduction in employee compensation etc.

In both cases there are two important factors in raising capital, the operating performance of the company, and the level to which assets are encumbered.

These two parameters impact the ability of the company to raise capital from either an internal or external source. If all assets are pledged to secured lenders and leveraged to their maximum it will be very difficult to raise cash by selling assets or through the issue of new debt. Similarly if operating performance is truly abysmal, it will negatively influence debt or equity holders.

Recently we served as advisors to a small family owned company that had been poorly managed and had been losing money for years. Essential to any turnaround effort would have been capital to reduce the overall debt level. This was only possible via an equity injection which would have to come from the family. We reviewed this with them and they declined any further injection. Our decision was simple and quick, we filed for bankruptcy.

It is critical that the turnaround manager look at cash needs and sources with a cold eye before attempting the reorganization of a company. This includes looking at the company's balance sheet through the eyes of a pawn broker for it is that perspective that will give an estimate of value of assets held by a company in distress.

In summary the purpose of this article was to identify three key elements in the success of a turnaround; management change, core business, and financial resources.

Turnaround managers, even very good ones, are not magicians and without these elements a true turnaround is unlikely.

These elements will more likely be present when custodial management identifies problems sooner than later and acts quickly.

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