




TURNAROUND SOLUTIONS



Beyond mere survival: the
transformational turnaround

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Beyond mere survival: the transformational turnaround

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Businesses suffer financial distress for many reasons – lack of focus, resulting in declining competitiveness and margins; being blindsided by frame-breaking technological change from unexpected external directions; failure to see or address other fundamental industry changes in time for anything but defensive and temporary responses; mediocre talent across key functions; misbegotten strategic decisions gone awry; weak operating fundamentals and/or controls, and external events that perhaps really have been out of management's control. Whatever the reasons for financial decline, managements all-too-often fall prey to the 3D's (denial, distractions and delay), guaranteeing further deterioration, narrowing the range of viable, corrective options as further time passes.

Turnaround professionals, when finally asked to craft and implement action plans find themselves limited to what often seem to be just variations on a single theme: how to sell or otherwise wind the business down, recovering as much as possible for the assets. Specific details might include how to be creative and/or aggressive in the application of a bankruptcy strategy (or threat thereof), or which alternative wind-down strategy might be better than an actual filing; or, at best, the typical downsize, consolidate, 'tighten-up' plan to survive, hoping the negative cycle doesn't repeat itself for awhile. More often than not, outcomes of such approaches might be judged as successful 'turnarounds' if the money-losing, value-dissipating performance is stopped, with positive cash generated for at least

some stakeholders, while allowing the business to be sold at some price above what it would have attracted earlier.

A different solution?

Transformation (transfer-maysh'n), noun. A complete change, usually into something with an improved appearance or usefulness.

There can be a fine line between a business that has suffered irreversible damage with, at best, realistic expectations of achieving a fragile stability from another that deep down contains the makings of a once-again-vibrant business, capable of going beyond a successful reversal to being repositioned and/or reinvigorated so as to launch a new, prosperous future from which can emerge lasting new value for shareholders.

Statistics suggest that only a minority of turnaround situations are viable candidates for a transformation. These can be difficult to spot if one is neither looking carefully nor thinking boldly. And, transformation always involves a more holistic thought model than the typical financial workout process driven by competencies in finance, controls, operations and law. But, while execution of the transformation can be more difficult and risky, the rewards can be substantial.

A third generation family distribution business

Lack of management depth, a weak sales culture, and antiquated technology and business processes had paralysed the organisational development of a third-generation family business (a leading distributor of supplies and materials for certain construc-

tion and HVAC markets). Pretax profitability had been oscillating around the breakeven point for years, with the 30 percent of branches losing money wiping out more than two-thirds of the EBIT of the other 70 percent in a typical year. Sales growth was non-existent. Operating staff in the field had been plagued with unacceptable defections of middle-management. The board of directors, which included several independent members, had been considering offers to sell the company in a consolidating industry. But, convinced that the value was too depressed for that strategy, they took the bolder step to reposition the company so it could achieve a new era of growth, thus generating new value.

Unprofitable market locations deemed non-strategic were eliminated. The management team was streamlined, realigned and then enhanced with some new talent, including marketing, sales and IT. A company-wide team of veterans and the new people designed and implemented a program to bring information systems into the modern era, a goal achieved ahead of schedule.

A new hands-on CEO (non-family) led a cultural transformation focusing on creative customer and market segmentation; redefined value propositions based on customer classification; new vendors, products and innovative programs; sales training and targeted incentive plans. Sales began growing, with EBIT growing faster. With a transformation well-entrenched and shareholder value increasing, instead of selling, the company began expanding into new regions. ►►

Shareholder turmoil in longstanding retailer/franchisor

A large family-controlled retailer/franchisor was struggling amid an industry consolidation. An abrupt transition to an unprepared third generation resulted in a dysfunctional senior management team, unqualified family members in executive positions, non-working family members at the financial trough, and litigation distractions coming from several directions at once, all contributed to the company's having become the senior lender's largest problem loan. Estimated enterprise value was less than the debt. Covenant defaults had put the company into the lender's Special Assets group, while minority shareholders behind the scenes were plotting litigation of their own.

A group of distinguished turnaround experts assembled to assess the situation and offer a solution. To a person, each focused on issues of whether or not to file bankruptcy, which stores to close, leases and contracts to reject, whether an out-of-court restructuring was better, whether creditors would have to take haircuts and of what magnitude, and the like. There was almost no mention among the experts as to whether or not beneath the mess there might be an inherently good business, reasonably capable of being transformed. That is, except for several directors, whose judgements eventually carried the day. With the help of a new CFO, the board discovered that two of the company's three most significant business units were unprofitable and assessed what it would take to fix them. A unified board then established an action plan to save the company, avoiding a nasty and public shareholder fight in the process.

Strengthened corporate governance made possible the development of a new business model. The company's backward integration initiative was eliminated, and a new outside CEO recruited, who in turn rebuilt the company's marketing staff. The product line was revamped, customer service was enhanced, a new advertising and branding strategy unfolded and battered relationships with angry franchisees were repaired, in part by naming one of their own to a new VP/Sales post.

Debt was successfully refinanced, with the existing senior lender taken out in full. No company stores were closed; the outstanding litigation was resolved. The company returned to profitability, and within a relatively short time, started growing again. While this success was unfolding, a number of larger competitors failed.

Opportunities and overalls

Thomas Edison once remarked that "the reason many people miss opportunity is that when it appears it is dressed in overalls and looks too much like work." This is surely the case with those candidates for real transformation, such as the two situations just recounted. It's also the type of work that can be daunting, especially for turnaround practitioners whose experiences are primarily in finance, lender negotiations and law.

Creating shareholder value through strategy

In his classic 1986 book, *Creating Shareholder Value: A Guide for Managers and Investor* (recently revised and updated), Alfred Rappaport showed that increase in shareholder value resulting from strategy is maximised overtime by (i) strong, sustainable sales growth at an incremental profit margin above a minimum threshold, while (ii) the business's rate of return consistently exceeds the expected hurdle rate over a specific time period (see Figure 1).

A key to value generation is p^*_{\min} , the minimum threshold incremental profit margin ($\Delta EBIT/\Delta Sales$) below which business performance actually dissipates value rather than creating it. At a given hurdle rate, this minimum threshold margin is driven down by improving asset productivity rates for both fixed and working capital (see Figure 2).

Figure 2 $[(f+w) = \frac{\Delta \text{ net capital employed}]}{\Delta \text{ Sales}}]$

A common 'turnaround' strategy, focusing on accounting, cost and other controls and often downsizing, can create value as the threshold margin declines, and there are even instances where value can be created as sales drop (EBIT goes up while sales decline). But substantial and sustainable value (i.e., that which has to come over time after an initial downsizing) must be the result of sales growth at a margin above the minimum needed to create economic value.

Conclusion

A turnaround becomes a transformation when the business's competencies are enhanced so it can grow sales with better margins over a period of years. What that requires is: (i) products or services perceived as superior by a definable and defensible group of customers; (ii) an ability to articulate a company's value proposition in terms of real customer needs; (iii) the technical skills to consistently improve existing offerings and successfully develop new ones; and (iv) the ability to execute through marketing, product development, quality assurance, and sales so that creativity and new ideas actually can be turned into successful innovations in the marketplace. As the theme of this year's annual conference of the Turnaround Management Association suggests, these are skills and experiences becoming more critical to the turnaround – make that transformation – profession. This may have been what Mr. Edison was talking about a century ago. ■

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Figure 1

Key

- k = hurdle (or discount) rate
- ΔS = sales increase in period t
- T = corporate tax rate
- ΔE_t = increase in shareholder value in period t

$$\Delta E_t = \frac{\Delta S (p - p^*_{\min})(1-T)}{k(1+k)^{t-1}}$$

$$p^*_{\min} = \frac{(f+w)k}{(1-T)(1+k)}$$

$$\text{where } p = \frac{\Delta EBIT}{\Delta Sales}$$

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ROAD AHEAD,
ASK THOSE
COMING BACK.

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