



# Turning the Turnaround on its Head



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In a turnaround situation, too many businesses rush to apply short-term fixes rather than diagnosing the real problem. There is only one cure: identifying the competitive advantage and transforming the corporate culture, while keeping a laser-sharp focus on the end-game.

To paraphrase the opening line from Tolstoy's *Anna Karenina*, all healthy companies resemble one another; every unhealthy company is unhealthy in its own way.

Indeed, there are many reasons why companies end up in poor health: flawed business models, strategic gaffes, poor execution, emerging competitors and weak management, to name a few. When it comes to turning around an unhealthy company, however, there is a single formula that works. The field of turnaround management has attracted a wide range of practitioners and philosophies over the years. We believe that some approaches are not only ineffective, but actually serve to stifle recovery. This article will describe a proven framework for operational turnaround management that can help to ensure sustainable long-term profitability and market leadership.

## The Balance Sheet is Not the Place to Start

Thousands of companies are in the midst of financial distress every day, even in the best of economic climates. But restructuring and operational turnarounds tend to attract the most attention during periods of economic contraction. Underlying problems in core business models are exacerbated

during these periods, and bankruptcies surge, as recent experience has demonstrated. Moreover, projections of corporate debt maturities and defaults over the next few years (see *Debt Maturity: The Next Wave* on page 8) suggest that we may see a record number of restructurings before this cycle ends.

The effects of the recent global credit crisis notwithstanding, the majority of distressed companies historically have faced challenges well beyond the balance sheet. The problem is that so many management teams in turnaround mode focus primarily on access to capital. This finance-first approach is short-sighted at best, fatal at worst. Recapitalization is helpful for shoring up finances quickly, but it does little to guarantee long-term cash flows and operational sustainability.

We have seen the failure of this

approach most notably in the retail sector, where there are repeated declarations of bankruptcy – known as ‘Chapter 22’ and ‘Chapter 33’ scenarios. Many retailers are prone to multiple bankruptcies because their turnarounds are often little more than feats of short-term financial re-engineering. From an operational standpoint, most distressed retailers overly focus on a ‘four wall’ cash flow analysis. The allure of such an analysis is its simplicity: keep stores that contribute positive cash to overhead and close cash-flow-negative stores. The result is often a slimmed-down operation and a smaller footprint that’s still riddled with shortcomings. Unless management addresses competitive advantages (or the lack thereof), the smaller chain continues to see declining operational performance. It’s akin to treating symptoms.

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# Employees don't have to like your decisions, but they need to understand them.

## Sustainable Turnarounds Focus on the Income Statement

Most failing companies have a fundamental problem in their core business, which is why the only way to execute a successful operational turnaround is to focus on the core, not, as we call it, the *clouds*. The first instinct of many managers when commencing a turnaround strategy is to cut costs. Costs should and will be scrutinized and there will always be areas of inefficiency and waste. However, from a long-term perspective, a company *cannot* cut its way to an operational turnaround. While cost-cutting can help to achieve a cash-neutral or cash-positive position in the short term, it won't solve deeper structural problems facing the core business.

A more dangerous instinct is for managers to try to supplement the core business by launching new products and/or entering new markets. The theory is that the revenue and cash flow from successful new businesses will help to fund the turnaround of the core. This is illogical. Growth on top of a flawed business simply produces a larger flaw. For a struggling ice cream chain, introducing a new flavor will never repair the underlying business problem. Instead, managers must identify and capitalize on the company's distinct competitive advantage. This advantage, if one exists, will serve as a life raft to strengthen core operations over time.

The initial phase of a turnaround is day-to-day implementation toward defining the end-game. It involves a combination of short-term and long-term decision-making, which must be executed quickly and communicated clearly. We've found that maximum interaction with staff

during this phase leads to maximum performance outcomes. Ride along on repair calls. Have lunch with the admin pool. Go on sales calls. Such interactions help the turnaround team to frame the discussion about the competitive advantages.

Like many turnaround advisors, I learned my most important lesson early on in my career: many companies cannot be turned around. Despite natural optimism and good intentions, management teams cannot *will* an operational turnaround to happen. The most brilliant turnaround team cannot turn a market laggard into a market leader. The company's assets and advantages must be evaluated with brutal candor; only then can management determine with confidence whether a turnaround is feasible or if the company's best course of action is liquidation. If there is no clear competitive advantage on which to build a realistic plan, then an operational turnaround is not feasible. And if a turnaround is not feasible, recognizing this fact quickly is the most important strategic decision for preventing further losses.

If a competitive advantage does exist, then it must quickly become management's platform for future profitability. The most effective way to harness this advantage is to make it the core of the end-game, which is management's vision of the company's future state once it has achieved sustainable long-term health. The end-game must be driven by the market opportunity inherent in the company's competitive advantage. An end-game must be as specific as possible and must be driven by markets, not finances. A return to profitability is not an end-game; it is a tool required to achieve the end-game.

## Cultural Change is the Ultimate Factor in Turnaround Success

Achieving the end-game will often take years and will depend on the wisdom of hundreds of decisions along the way. After nearly three decades in this field, I've learned that one element in the turnaround process is more important than any other: employee behavior. In fact, we've developed a Golden Rule of operational turnarounds (see below).

Culture is all-powerful in turnaround situations, and what fuels culture are the incentives for staff to behave in a certain way. What's more, culture has little to do with the balance sheet, but has everything to do with the income statement. The key is to focus employee behavior – through proper incentives – on the activities that will most rapidly enhance the income statement, which of course will depend on the nature of your business problem. If done properly, these new behaviors can reduce or eliminate negative cash flow, which is a necessary precursor to long-term health.

Every unhealthy company struggles with counter-productive internal behaviors, even if these same behaviors at one time enabled the company's growth. As shown in Figure 1, negative behaviors do not appear overnight. They typically become entrenched in the culture of the organization

## GOLDEN RULE

$$I (F+NF) = B$$

$$B \times T = C$$

Boiled down to its essence, this Golden Rule is simple: incentives produce culture. Specifically, **Incentives (Financial and Non-Financial)** produce **Behavior and Behavior over Time** produces **Culture**.

over many years. And when they are exacerbating the core business problem, the first job of the turnaround specialist is to identify them.

A real-world example will help to illustrate our recommended approach to operational turnarounds. In 2000, I was CEO of a leading company in the time-share market, with 89 resort properties in eight countries and \$500 million in annual revenue. A key growth driver for the company was its mortgage origination business, which loaned customers 90% of the \$10,000 unit purchase price. A majority of these subprime mortgages were securitized and sold to Wall Street, thus removing significant risk from the balance sheet. However, some of the mortgages remained on its books. When defaults on the mortgages held by the company accelerated, its ability to tap the secondary market dried up and this sudden lack of liquidity forced it into bankruptcy. When I became CEO of the company, I worked with management through four key stages of the turnaround process, forcing honest reflections and tough decisions. This process generally doesn't make a lot of friends, but sticking to these phases will invariably optimize any company's outcome.

### Assess Existing Behaviors

Nobody likes working for a weakened company. But it's the entrenched behaviors of these same employees, often starting with the CEO, which usually have weakened the company in the first place. And they usually know it. That's why employees often open up to the turnaround team, offering their own diagnoses and sometimes already knowing the solution. As implied in Figure 1, the turnaround team's first priority is to understand the existing behaviors and their impact on performance decline. Then they must take a step back and evaluate the incentives that are in place to motivate and reward these behaviors. Is the culture driven too much by the sales function? Too little? Are employees rewarded for retaining or expanding customer relationships? Are they given the tools to do so? How are collaboration and cross-selling rewarded? How are acquisitions integrated culturally? Has management communicated a vision

and strategy for the future? How does the company reward employees for helping to achieve that strategy?

At the time-share company, the corporate culture was driven entirely by sales. Built by acquisitions, these acquisitions were poorly integrated. Customer experience and retention were not a priority. An exclusive behavioral focus was on revenue growth. Sales representatives, who were paid entirely on commission, earned 20% of each \$10,000 sale. At the same time, the time-share company provided most customers with mortgages for 90% of the purchase price, or \$9,000. With no credit standards in place, these subprime mortgages came home to roost as high defaults (in the same way as we have seen over the past two years in the U.S. housing market). Without the ability to securitize the loan, even before taking into account overhead and marketing expenses, every sale immediately ate into the company's cash flow, setting it up for a death spiral toward liquidation.

### Define the Competitive Advantage

A turnaround lives or dies on the basis of a company's ability to define its competitive advantage, which necessarily forms the core of the turnaround strategy. So, what is a competitive advantage exactly?

Above all else, this stage is an exercise in market assessment. What distinct advantage or niche does the company own in the market? Why do customers choose the company over its peers? Most importantly, the results of the competitive advantage must be clearly reflected on the income statement; if historical sales patterns and/or cash flows can't demonstrate that the advantage is real, then it isn't.

Examples of competitive advantage may include:

- A presence in more lucrative geographies than any competitor
- A reputation for customer service and support unmatched in the industry
- Exclusive licensing deals with important partners or distributors
- An unrivaled R&D capability and reputation for innovation
- A respected brand that generates greater customer loyalty than that of competitors

Once the competitive advantage is defined, it will become the foundation of the company's turnaround strategy. The competitive advantage will quickly come to define the company's success, both today and in the future. This means that management's end-game must be defined in competitive terms and then communicated aggressively both internally and externally.

Figure 1: Correcting Entrenched Behaviors Key to Effective Turnaround

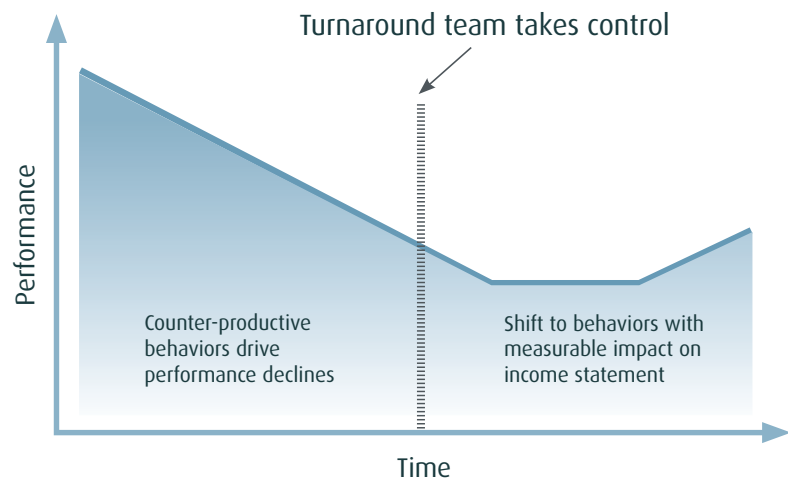


Figure 2: Matching Talent Orientation to Turnaround Needs

	HUNTERS	HERDERS
Personal motivation	Customer acquisition	Customer retention
Operational goal	Top-line revenue growth	Profitability and efficiency
Scenarios when needed	Weak sales, new market entry, heightened competition	Weak profits, consolidation, strong brand equity, high existing market share

Every decision throughout the turnaround process will be measured against its effect on the end-game, which is why it must be as specific and realistic as possible. Years ago, I asked a client to describe his end-game, to which he replied, ‘To get bigger.’ Such a response is not entirely uncommon. Unfortunately, such a vague notion is not only reckless, but can be extremely damaging to the turnaround process. On the contrary, end-games must be market-driven and specific, such as *to become the number one or number two player in market A*, or *to be the largest provider to vertical market B*, or *to have physical presence in our 10 most important geographical markets*. Such objectives are not only realistic and measurable, they are infinitely more inspiring to employees who know the company’s competitive position better than anyone.

In the case of the time-share company, rudimentary market analysis revealed that the company’s international footprint of properties was its key differentiator and unique advantage in the marketplace; not a single U.S.-based competitor offered customers such a breadth of international options. Moreover, the European operation was the only profitable part of the business at the time. Yet these were the assets that management was planning to sell to raise cash to continue funding the non-profitable part of the business. Such a transaction, which was ultimately canceled, would

have all but guaranteed the infeasibility of a turnaround and the liquidation of all of the company’s remaining assets.

### Define the Required Behaviors

The next stage can cause a turnaround specialist to become extremely unpopular, as it’s during this period that changes are made and sacrifices are required. Compliant with our Golden Rule mentioned earlier, new standards and incentives are introduced to change human behavior – a daunting exercise even in the best of circumstances. The first priority is to fix the cash-negative problem through short-term strategies, which may include:

- Centralizing operations to maximize cost efficiencies
- Decentralizing operations to promote greater revenue growth
- Closing certain business segments that are beyond repair

- Securing new contract terms with customers and vendors
  - Introducing new metrics for staff productivity and performance
- Since these short-term fixes will change incentives and require new behaviors, there is likely to be an onset of employee fallout. Embrace these departures! They are a sign that the message and end-game are clear. Headcount reduction is usually inevitable during a restructuring process and the most successful form is natural attrition. As behavioral standards suddenly change, certain staff will come to realize that they will no longer thrive in the new environment. And this is good.

From our experience, sales talent falls into one of two orientations – and skill sets – within an organization. We call these *hunters* and *herders*. As shown in Figure 2, hunters are oriented toward customer acquisition and see their mission as helping the company maximize revenue growth, while herders are oriented toward customer retention and see their mission as helping the company maximize efficiency and profitability.

These categories apply not only to the sales team. Typically, one orientation is more likely to leave the company based on the end goal. It is management’s job to change the incentives in a way that ensures the wrong type of talent is departing and that the talent required is staying.

In the time-share company’s situation, its short-term survival required a dramatic shift in behavior from revenue-at-any-cost to profitability-at-any-cost. The first step was to centralize control of the sales and mortgage origination processes,

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## DON'T RUN BEFORE YOU CAN TALK: A COMMUNICATIONS PERSPECTIVE



Giles Sanderson  
Managing Director

Realizing that you have a problem and need specialist turnaround help is the first step in seeking to re-establish your business. However, don't overlook the impact that communications can have, both positively and negatively, on that process.

The solution is to adopt a multistakeholder approach to communications, with a different plan for each audience. This includes not just the media but all internal, commercial, financial, political and regulatory audiences. Failure to identify and address the communications issues on a multistakeholder basis can potentially cause immense damage to a business. Competitors and the media may wish to create drama, driving customers to take their orders elsewhere, suppliers to change their terms of business and nervous investors to dump their shares.

Whatever the exact situation, it is crucial to maintain confidence and trust in a business throughout the turnaround process. The challenge is for the communications strategy, working hand-in-hand with the turnaround work of the restructuring professionals, to negate the risks that arise from a corporate crisis – the communications agenda needs to be set, control demonstrated and change managed.

Early planning ahead of an anticipated problem helps significantly, although this is often not possible as the restructuring process may have already started. While all businesses need to understand the importance of effective communication in helping companies maintain 'business as usual,' the

process differs slightly based on a company's market status.

Publicly-listed companies have to comply with the relevant rules of their respective stock exchanges regarding the disclosure of material information to the market. While there is usually little discretion over the timing and level of disclosure, it is necessary to consider the impact of public announcements on each stakeholder group and examine whether there is a particular need to reach out to each audience to provide additional clarity or stability. Examples might include calling a company's significant trade creditors to explain the impact of the turnaround or presenting the challenges facing the business to the staff and giving them an opportunity to have their questions addressed by the company's management.

In the case of private companies undergoing a restructuring, there is more flexibility to determine the exact level of disclosure and timings with each stakeholder. Even when a decision is made not to disclose an event or milestone, there is a still a need to prepare a contingency plan which will give the business a clear course of action should there be a leak.

Remember that in a vacuum people will draw their own conclusions. So companies in turnaround situations should strive to manage the messages and communicate where possible.

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This will help to avoid the panic that often accompanies uncertainty and, in particular, will tackle the appetite of the media for conflict and crisis. If an organization can demonstrate clarity and control though its communications as it undergoes change, then it stands a much better chance of preserving confidence in the business and, ultimately, protecting its value.

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RISKS	NEEDS
Uncertainty and anxiety	Set the agenda
Destabilized business	Stabilize the business
Loss of performance	Demonstrate control
Increased scrutiny	Manage change
Erosion of confidence/trust	Resolve disputes
Destruction of value	Maintain confidence

control for which previously was scattered across a variety of managers and locations. All contracts would require central approval. Credit standards would be dramatically tightened. The historical 10% down payment requirement was scrapped and we reset the goal of down payments to an average of 30%. These new standards proved highly disruptive to the company's sales-driven culture, but were essential to guarantee at least a cash-neutral position in the immediate future. Using our formula, we changed sales compensation from being based on total contract value, to being based on total amount of the down payment. We achieved our target of 30% down payments and were cash neutral in just over a month.

### Implementation

Consistent communication is critical throughout the turnaround. Management must make sure all decisions – even the ugly ones – are designed to leverage the company's competitive advantage and achieve the end-game. A world-class communication infrastructure is essential here. The management team, particularly the CEO, should always be accessible for questions. (See sidebar on page 23.) Employees don't have to like management's decisions, but they need to understand them. During turnarounds, lack of information is always worse than having negative information. This is why management must be quick in disclosing bad news as well as good news. And if management doesn't have the answer to a question, it shouldn't be afraid to say so.

So when is the turnaround complete? There's no magic formula for deciding when the company is on a path to long-term growth, but in our experience, the board and management team will know it when they see it. The results of improved performance will be evident on the income statement. Staff turnover will have subsided. New behaviors



will have been institutionalized. And sustainability and growth will be the new words of the day.

At the time-share company, management made the long-term decision to kill bad revenue; in other words, it needed to reduce sales volume and revenue in favor of sustainable profitability. And that's exactly what happened. Within two years, revenue fell from \$500 million to \$280 million, but the company was profitable again. Overhead expenses were shaved, but many costs – sales and marketing, for example – were appropriately right-sized for a leaner, smaller organization. In 2007, seven years after its brush with total

liquidation, the time-share company was sold to its new owners for \$700 million, a 35% premium to its stock price. In announcing the deal, the new owner cited the time-share company's international properties as a strategic complement to its own U.S.-focused portfolio.

### Conclusion

Successful turnarounds have many elements. Financial engineering is often hailed as a cure-all, but in our experience, even the best-capitalized company will ultimately fail if its core business model is flawed and its internal culture and behaviors continue to support that model. The four phases of turnaround management described here represent a proven framework for any management team struggling to repair fundamental problems in its core business. Turning around any company is often difficult, disruptive and sometimes unpleasant. However, through proper strategic planning and consistent decision-making, even the sickest of companies can hope for a recovery and a long, prosperous life. ■

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