A Turnaround Strategy Framework

BY KATHRYN RUDIE HARRIGAN

ABSTRACT
This note outlines the most common reasons that firms fail and presents a practical model of the key strategic, organizational, and financial ingredients that must be the basis for any successful turnaround plan.

CONTENTS
Introduction ........................................1
Critical Ingredients for Successful Turnaround ........................................2
Observable Indicators of Turnaround Progress ............................................7
Summary of Performance Indicators 9
Introduction

Firms fail because they are mismanaged. Whether competitors are stealing market share from an oblivious, distressed company or operations have been expanded faster than the troubled firm’s cash flows can support, managerial errors have been made in a distressed firm and are being compounded by failing to take corrective actions fast enough.

The symptoms of a distressed company are clear. Insolvency is a heartbeat away because cash outflows exceed inflows. Suppliers are losing patience over being paid. Customers are alienated because of quality defects and servicing problems. Creditors are worried because of covenant violations and coupons not being paid on time. Employees are despondent because they fear for permanently losing their jobs. Sometimes the operating situation has deteriorated beyond the point of no return; in other cases, the patient can still be revived.

In facing each distressed company challenge, the turnaround team must decide whether the firm in difficulty shows enough potential to justify the effort of restructuring. They must decide whether the distressed company in question should be liquidated, sold off, or whether it is worth the pain and suffering associated with turning around the company’s operations. The turnaround framework (see Figure 1) suggests how to identify the firms that are worth saving.

FIGURE 1: BASIC TURNAROUND MODEL

When approaching a turnaround situation, the objective is triage—to conserve energies and resources for saving that part of a distressed firm that merits survival, while allowing the other parts to be liquidated (or restructured under bankruptcy protection, if the situation is dire enough). A realistic turnaround depends on having a business plan that can be implemented effectively. The likelihood of developing a credible, post-restructuring business plan depends upon the ability of the management team to match the firm’s strategic posture with a realistic, competitive outlook concerning the markets it serves and to persuade the firm’s organization to implement the turnaround plan quickly enough for management to negotiate a feasible capital structure—one that can be serviced by the
cash flows generated from the firm’s operations. The new business plan must be credible and the firm’s employees must be determined to do whatever is needed to save their company by making the necessary operating improvements. For that reason, the framework for undertaking turnarounds is based on three ingredients that must be available in order to save distressed firms—a feasible corporate strategy, appropriate organizational arrangements, and acceptance in the capital markets. Briefly, a successful turnaround plan depends on satisfied customers, enthusiastic people (to carry out the plan), and adequate access to cash.

**Critical Ingredients for Successful Turnaround**

The turnaround framework suggests that three factors must interact in a compatible fashion to give hope that a sustainable turnaround can be achieved: (1) the feasible corporate strategy generates an attainable forecast of cash flows that will be generated to repay new debt (because it is based on satisfied customers); (2) the changes required in how the distressed firm’s organization will operate must be feasible to implement and carried out by enthusiastic employees (because details of the firm’s organizational structures, systems and processes have been modified appropriately to reward successful execution); and (3) the capital markets must be willing to refinance distressed debt at a reasonable cost of capital (to ensure that the firm’s employees have adequate access to the cash needed to execute the turnaround plan).

**FEASIBLE CORPORATE STRATEGY**

A firm’s strategy proceeds from its assessment of customer demand. A realistic sales forecast is the cornerstone of positive valuations—even if the distressed firm must cope with slowly growing or slowly declining demand.¹ As long as the firm delivers products and services that customers are willing to purchase at offered prices, there is hope that an operating turnaround may be accomplished. This hope is reflected in the cash flow forecast which translates strategic intent into revenues, costs, and profits.

The *pro forma* cash flow forecasts used to project the firm’s value as an ongoing concern should capture the effects of industry-wide demand traits as well as the cost of recovering lost customers and making other achievable operating improvements.² A thoughtful turnaround strategy acknowledges customer demand traits by re-focusing resources from troubled lines of business into more-profitable ones.³ Briefly, businesses that operate in crowded, competitive arenas that reduce profitability should

---


² The narrative explaining the underlying assumptions used to prepare such forecasts provides an important indicator of the likelihood of whether plans will be attainable (see progress indicators).

³ Harrigan and Porter, “Endgame Strategies.” Resource redeployment is typical of the “Niche” or “Shrink Selectively” endgame strategy.
be starved—in favor of lines of business serving markets where adequate cash flows are more likely to be earned. Operating costs may be reduced by hollowing out operations if the brand equity of the firm’s products is strong enough to support a marketing-only strategy. The pro forma forecast of operating improvements must reflect these and other attainable cost reductions in order to argue persuasively that the firm can be saved.

If a distressed firm offers goods and services that its customers value, price increases may be possible (to recognize the unexploited, competitive superiority of its products), and such price increases could improve the firm’s cash flows. If instead the firm has abused its customers in the past (through its indifferent product quality, lackadaisical service, or inferior value propositions), revenue enhancements will be more difficult to achieve. Without customer loyalty, cash flow forecasts will not be believable.

**APPROPRIATE ORGANIZATIONAL ARRANGEMENTS**

Turnarounds are a re-contracting of the understanding implicit between the firm and its employees. When assets are sold, employees are laid off (or terminated), and benefit plans are altered during the turnaround process, management is hoping to change employee expectations and behaviors. Many employees will be shocked to discover that their firm is failing and that they must help implement a turnaround—especially if the company’s culture does not encourage employees to suggest operating improvements. The managers leading such turnarounds may be battling an entitlement mentality as well as scrambling to find ways to make operating improvements.

The organizational arrangements that affect the firm’s emotional state and employees’ belief systems are the second critical ingredient needed for a successful turnaround. Briefly, employees must be motivated to work smarter to lower operating costs and make cash flow faster. Somehow employees must become willing to sell more of the firm’s products and services, dun the firm’s slow-paying

---

4 In a distressed situation, the claims of creditors assume primacy over those of shareholders—with the consequence that turnaround plans which generate cash (but cut into the muscle of the firm’s former strategy) will be more acceptable to creditors than those that try to preserve assets and strategic position. In particular, a turnaround plan that unravels unjustified diversification (by selling off attractive lines of business for cash while liquidating unattractive assets) shows a greater sensitivity to the needs of creditors than one that proposes to take a bundle of businesses through the bankruptcy process intact and unravel what may be a flawed corporate strategy later. Creditors will typically require sweeter terms in distressed situations where strategic concessions are not being made during restructuring. Lenders do not give sweetened credit terms for conceptually-flawed strategies; their scrutiny of a firm’s corporate family often reveals how bustable that firm’s corporate strategy really is.

5 Harrigan and Porter, “Endgame Strategies.” Price increases are typical of the “Leadership” or “Increase Investment” endgame strategy.

6 Short of acquiring a competitor’s customers through an acquisition or merger, there is no way to add market share quickly (and profitably) if the distressed firm has not satisfied its customers in the past. Without buying market share, cash flow improvements must be made through operating improvements.

7 The challenge of motivating a distressed firm’s workforce will be especially high for outsiders who have no past, implicit understanding with employees to form the basis for trust in their employment contract. Workers will be suspicious of the outsider’s motives and intent until they find a basis for cooperating with him.
customers, collect receivables faster, accelerate materials flows—from the receiving dock through operations to finished goods—reduce waste, improve productivity, and keep inventories at appropriate levels.

The changes expected of employees may shake the organization’s emotional state. Sometimes the prospect of keeping their jobs provides adequate motivation for employees to make the needed operating changes. But simultaneously—in the course of cutting overhead costs—employees may also be asked to take on greater personal responsibility for their health care, retirement plans, transportation, lunches, and other perquisites that the firm previously provided. The managers of some distressed companies may even truncate employees’ work weeks, pay wages less frequently, and reduce headcounts because they do not know of better ways to conserve cash outflows. At some point in the cost-cutting process, employees will balk.

Changes in the “employment contract” like the aforementioned items suggest the need for corresponding, appropriate changes in organizational arrangements—specifically those that reward the greater employee accountability implied by successfully implementing the firm’s turnaround plan. Why else would employees carry the additional workloads of laid-off comrades? Gain-sharing incentives may be appropriate rewards for the employees who accept the necessary changes in how they perform their duties to save their distressed company. The re-contracting relationship also calls for a better sharing of financial information with employees (to encourage them to act in profit-oriented ways in the future). Replacing salaries and hourly wages with bottom-line oriented compensation plans will direct employees’ attentions to fixing activities that must be improved in order for the distressed firm to survive.

Moving to a flat organizational structure is helpful during turnarounds because it eliminates the cost of supervisory levels of management that may become redundant when the cost-saving creativity of hourly employees is unleashed. In addition to saving the cash formerly paid in salaries, reducing a distressed firm’s organizational layers can accelerate the discovery and communication of problems encountered during the implementation process that could stymie turnaround success.

The speed and decisiveness of turnaround actions will influence the pricing and terms offered by creditors for financing the turnaround process. Although the bargaining power of each firm undergoing the turnaround process will differ, the price and terms of capital available for restructuring should improve where the firm’s managers and employees have demonstrated their willingness to bite the bullet in making the hard decisions regarding product lines, facilities, and personnel in order to make the firm’s turnaround sustainable.

ACCEPTANCE BY CAPITAL MARKETS
A favorable appetite for investing in turnarounds is the third ingredient needed to save distressed companies. The appetite for the risks associated with turnarounds waxes and wanes over time and that appetite for risk affects the pricing, terms and availability of bridge loans, balloon-term coupons, DIP financing, and other forms of capital infusions that will be needed to refinance distressed
companies. Because capital providers will judge poor financial performance harshly by punishing it with higher-priced money (offered with less attractive covenants and repayment terms), the turnaround process should show early cash-flow improvement victories in order to qualify for more favorable, future financing rates.

Many small companies abuse their banking relationships when credit is plentiful—only to discover that they have been pruned from their former bank’s customer list when they want to renew their line of credit or get funding for expansion. As the banking industry consolidates via acquisition, customer triage is an inevitable part of the integration process for acquired banks. A credit freeze exacerbates the tendency of banks to drop those marginal customers who invoke grace periods when they make repayments and violate lending covenants. Meanwhile after years of being dropped by local banks of diminishing quality, a distressed company is facing a spiral of higher-cost credit and restrictive covenants that will lower managerial autonomy when it seeks financing.

The availability of capital for distressed companies will be determined by the sophistication of the turnaround plan presented to potential investors, the amount of time required to make cash flows turn positive, the alternative opportunities for earning higher returns with other turnaround situations, and the overall availability of capital to fund any new debt instruments that the firm may issue as it refinances.

It is useful to remember that the “capital markets” are not monolithic in their preferences concerning the disposition of distressed companies who are their debtors; while the management team is struggling to keep their troubled firm out of bankruptcy court, value investors may be opposing their requests for help by purchasing their debt off the balance sheets of original lenders. These opportunistic, “vulture” investors who have been buying up the loans of distressed companies for small fractions of their face value (often from frustrated institutional lenders) typically want the firm’s operating turnaround plan to fail. A buoyant market for the debt of distressed companies gives management a better chance to pay off old debt obligations with new junk bonds (thereby defeating the “vultures” that could become the firm’s new owners). A credit freeze hurts owners and shareholders while it helps “vultures” to gain control of a distressed firm’s undervalued assets and dispose of them accordingly.

---

8 Financial infrastructure companies (analysts, ratings firms, banks, etc.) can influence the cost of capital that distressed firms must pay during their turnaround process. They base their evaluations of distressed firms’ creditworthiness on their track records (as well as on the track records of new managers who have been recruited to take firms through the turnaround process). Investors in distressed securities can increase the range of financing alternatives by providing DIP financing, bridge loans, or other forms of financial assistance that supplement the offerings of traditional capital markets.

9 In contrast to small and local bankers that could afford to offer lenient credit terms to lodge brothers who ran local businesses, the managers of acquired banks impose large-company credit criteria on all small-business financings in an effort to trade upward to serving clients who are better credit risks.

10 The actions undertaken to improve the performance of a distressed company before issuing junk bonds or other debt will influence the willingness of capital providers to invest in a particular turnaround situation (see progress indicators below) as well as of creditors to provide future cash to finance operations.
SUMMARY OF CRITICAL INGREDIENTS
Several variables must be favorable in order to justify the effort of turning around a sick company. First, there must be adequate demand for the firm’s products and services to make its operating forecasts feasible to attain. Some distressed companies lack sufficient demand to justify the efforts of the turnaround process. Second, the firm’s organizational arrangements reward those who implement the operating changes necessary to turn around a troubled situation. Some shaky companies cannot be saved because they ask employees to make heroic sacrifices that are not adequately rewarded. Third, the turnaround plan presented is credible enough to merit financing at reasonable rates and terms. Some firms cannot be saved because the prevailing cost of credit that they face (and demands of operating covenants that would be imposed) is too high for the troubled company’s expected cash flows to service adequately (and managers are hamstrung by the operating restrictions imposed by potential providers of cash).

Those distressed companies that can revitalize their customers’ demand for their products by improving the customer’s experience with them have the best probability of being turned around successfully—provided that the operating changes required in their turnaround plan are feasible and lenders are willing to provide favorable credit terms to finance the process. If there are enough satisfied customers to base a turnaround plan on, employees must be determined enough to make reasonable sacrifices to change how the distressed firm operates—even if implementation requires layoffs, plant closings or sales of assets. In the turnaround process, it may be necessary to divest a portion of an ongoing company in order to finance operational improvements needed by the remaining lines of business.11 Divisions of multi-business firms may be hived off into saleable pieces in order to preserve the valuable corporate core. If the distressed company’s assets are fundamentally strong and customers continue to purchase its products, the US legal system provides a way for the downsized firm to survive. If the capital markets will not provide favorable terms to finance a salvageable company as an ongoing concern, restructuring under protection of the bankruptcy courts will enable an ultimate-successor company to endure the intermediate steps of restructuring as are needed to turn such companies around successfully. Significant shareholder value is destroyed during the bankruptcy restructuring process and should be avoided if possible.

11 Alternatively, the troubled parts of a distressed, diversified firm could be hived off as a corporate cleansing event to entrepreneurs who specialize in turning around distressed operations (provided that there is adequate financing to support such divestitures). As the experience of General Motors suggests vis-à-vis its divestiture of Delphi Automotive LLP, however, sometimes corporate-provided financing is the only way to implement such a strategy (and the subsequent default of their divested subsidiary could pull the parent company downward into a whirlpool of bankruptcy).
Observable Indicators of Turnaround Progress

Troubled companies attract many interested parties who are observing the implementation of the turnaround plan; these observers crave information. Current and potential creditors, investors, employees, and other stakeholders look at key indicators of how a turnaround is progressing in order to evaluate whether to support management’s restructuring efforts. Three indicators (shown as Figure 2) are useful as observable tests of a turnaround’s progress: (1) evidence of a feasible program of divestitures, downsizings, facility closings, employee layoffs, and product re-marketing campaigns (non-financial progress indicators); (2) evidence of incremental victories that demonstrate the feasibility of the turnaround plan (financial performance improvements); and (3) evidence of ownership changes that reflect revisions in corporate control (restructuring of equity ownership).

FIGURE 2: OBSERVABLE INDICATORS OF TURNAROUND PROGRESS

NON-FINANCIAL PROGRESS INDICATORS
Operational turnarounds are preferable to bankruptcy filings because they destroy less shareholder value. Many of the changes that must be undertaken during restructuring under court supervision could have been done earlier by management at less cost to the firm’s original shareholders if they had been willing to make big changes in management practices. All stakeholders expect management to make changes in the firm’s scope of operations when it is in trouble. The plan proposed for turning around a distressed organization should include a feasible program of discontinued products, divestitures, downsizings, plant closings, work force reductions, and repositioned product lines that are intended to generate cash inflows (or reduce cash outflows). Investors expect troubled companies to bite the bullet in making hard decisions and will penalize distressed companies that try to maintain a bad status quo strategy. At a minimum, distressed companies should show evidence of product, customer, and geographic triage; unprofitable activities should be eliminated by applying the 80%–20% rule.

Tangible progress should be made in implementing the proposed retrenchment program. Because observers know how much time restructuring activities typically require, the organizational exit
barriers that impede a firm’s timely change should be overcome quickly to make scope and operational changes within a reasonable time frame. Engage professional assistance to sell assets, facilities, and lines of business that must be jettisoned. Negotiate severance packages to terminate those employees whose salaries or wages can no longer be paid. Offer discontinued merchandise at fire sale prices to generate cash while reducing the cost of carrying excessive inventories. Above all, communicate the nature of the changes being made within the organization to avoid expenditures that may be contrary to the restructuring plan.

**FINANCIAL PERFORMANCE IMPROVEMENTS**
To manage investors’ expectations, it will be necessary to set realistic expectations regarding the speed of turnaround. In particular, management should suggest when tangible evidence of improvement will be seen. All obvious improvements to cash management should be in force as soon as the turnaround program begins, and tangible gains in performance should be communicated as soon as they are made.

Because the distressed firm’s financials must resemble those of a “normal” firm in order to be eligible for a “normal” cost of capital, making improvements to those operating ratios that have been industry outliers is especially crucial. Although performance comparisons will be made with the distressed firm’s current competitors, it may be prudent to push for internal comparison of the firm’s operating ratios with those of firms that operate in especially difficult arenas because competitive conditions are more likely to deteriorate over time instead of improve.

In spite of research findings that suggest that the greatest improvements in productivity occurred within firms that were completely shut down and re-built using updated capital and practices, the turnaround management team that makes large changes in ongoing operations can improve a distressed firm’s output incrementally without making it rise from its ashes like a phoenix. In successfully capturing the hearts and minds of workers, management can accelerate the speed with which improvements to ongoing operations can be shown—if it chooses its spots for showing early victories with care.

**RESTRUCTURING OF CORPORATE GOVERNANCE AND EQUITY OWNERSHIP**
Changes in corporate governance reflect changes in the audience consuming information concerning the firm’s performance indicators. As creditors’ rights grow in importance (due to the distressed firm’s impending need for court-supervised restructuring), it would not be surprising to see changes in board independence, creditor representation on the board, replacement of the top management team, appointment of a chief restructuring officer or a court-appointed receiver/trustee who operates the firm to recover its economic value for creditors. Governance changes are often precipitated by execution of debt for equity swaps (which convert creditors into owners) and reflected in

12 “Vulture capitalists” thrive best when the distressed company defaults on its debt and is forced into bankruptcy court for restructuring; bankruptcy court is where the “vultures” turn their debt holdings into equity holdings in order to get access to the distressed firm’s assets.
management’s greater efforts to manage the firm’s balance sheet, coverage ratios, and remaining covenants imposed by creditors to avoid further dilutions to shareholder value.

Summary of Performance Indicators

This note has assumed that court-supervised restructuring under a bankruptcy filing is the alternative of last resort because the Chapter 11 process risks destruction of shareholder value. Accordingly, this note favors turnarounds based on operating improvements. It argues that turnaround success depends on managers who can triage effectively; they save those firms that merit survival. They must match their businesses’ competitive outlooks with a capital structure that can be serviced with firms’ cash flows. They must present investors with a realistic business model detailing the turnaround’s implementation in order to qualify for financing. They must find a solution that minimizes human pain and suffering while preserving shareholder value.

The willingness of professional managers to undertake turnaround assignments (and of investors in distressed companies to offer supplemental financing alternatives) depends on the relative autonomy they are given by the board of directors to change a distressed firm’s strategy, dispose of its assets, re-contract with its labor force, or make other changes they deem necessary to save the company.