

## RESTRUCTURING CHALLENGES & SOLUTIONS

### The best in worst of times: the winning turnaround

BY WILLIAM JACKSON AND JUSTIN PETTIT

Easy money conditions in recent years fuelled a surge in deals ranging from acquisitions and LBOs, to leveraged recapitalisations. The use of increasingly forgiving, and complex, capital structures, including the growth of second lien and PIK toggle note financings, was not only a sign of an overheated market, but will also have an impact on recovery prospects in the reorganisation process. And easy access to cheap credit allowed many faltering companies to delay their day of reckoning. But now the credit tap has turned and business conditions have worsened, creating both supply and demand side impetus for turnarounds.

For example, US Oncology issued \$425m in PIK-toggle notes to fund a sponsor dividend, increasing financial leverage to more than a lofty 6x debt to EBITDA. A subsequent 40 percent decay in earnings pushed leverage to nearly 8x debt to EBITDA. A once sound business saddled with the doubly difficult problem of worsening operating conditions and too much debt.

But turnaround efforts offer no guarantees of success. Only about one-third of companies in turnaround situations manage to achieve a turnaround. And only about one-half of these sustain their turnarounds longer term.

Many reasons exist for these failures, including superficial understanding of the competitive position and poor pricing failure of management to fully realise the magnitude of the problems, and a disconnect between management and boards. That said, the situation is far from hopeless. Successful and sustainable turnarounds do occur. In fact, we see four common themes behind winning turnarounds.

#### Good bones

At its heart, the new company needs a promising core business. The recovery effort begins

by identifying and emphasising this core. Over time, every attractive business tends to attract and accumulate more and more baggage. The initial step is to identify the viable parts of the business – the customers, products, markets and operating assets that contribute most to the businesses value. Positive cash flow is essential, but ultimately, there should be enough to cover period costs, plus the opportunity cost of any investment.

The difficulty is often not in identifying the attractive parts, so much as having the discipline to focus – the discipline to just say no. The turnaround team looks at ways to shrink the business down to those segments that contribute sufficient cash flow. The second challenge here is gaining comfort with a smaller business. Smaller can be better.

Unrecoverable product or market positions are weeded out. The turnaround team reviews 'standard cost' and introduces economic concepts like throughput accounting and cash flow, to rationalise stock-keeping units and customers based on a Pareto analysis of their underlying economics.

Once the baseline has been identified, the turnaround team focuses all of its efforts on restructuring this part of the business. The surviving business entity becomes the target of restructuring techniques that enhance its operational and financial efficiency. Cash flow is at the top of the list. The turnaround team also develops strategies for the longer term – fundamental changes that reposition the cost structure, such as centralised purchasing, offshoring IT, back office and accounting, and consolidating the operating footprint to fit the new baseline of business.

#### Strategic leadership

Turnarounds are as much about execution as concept. Both are required for success. Strong

senior leadership is perhaps the most critical aspect of a successful turnaround. One of the main reasons why companies spiral into trouble is a series of poor decisions made with limited comprehension of the competitive or true financial position of the business.

From wherever the source, the leadership team must possess quite specific skills: the ability to think strategically, test the business concepts and hear the customer, execute and communicate. They will also have broad business experience, strong analytics, organisational skills, decisiveness, and negotiation skills. Finally, the leadership will have the ability to instill trust and confidence in their workforce. If they don't possess these skills or most of these skills, the board has to replace them and build a new leadership team.

Most important, a winning leadership team holds a vision for the company that is realistic and practical, focused on exactly what must be accomplished for the company to survive. The CEO, in particular, has the ability to motivate the organisation and instill the need for change. In a practical sense, this is done by creating financial targets that, if met, enable the company to achieve its aspirations. It also includes visible rewards for employees who support the vision and quick action for those who do not.

Turnaround leaders adopt a hands-on style and immerse themselves in their companies' operations in order to understand how they really work and where opportunities exist. When organisations are in distress, turnaround leaders introduce tight controls. They are often the face to the customer, listening, sensing and testing.

Carlos Ghosn who assumed the head position at Nissan during their turnaround years, is an example of a winning turnaround leader. Ghosn remained undeterred despite being ►►

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considered an outsider. He put his own job on the line by pledging to resign if any turnaround objectives were not accomplished successfully and on time. One of his first decisions was to unwind more than \$4bn in keiretsu investments to fund operations and growth. Ghosn also moved the company from a tenure-based promotion system to a meritocracy. While initially skeptical, the organisation began to appreciate Ghosn's changes as Nissan's position improved.

### Financial restructuring

Financial restructuring focuses on maximising near term liquidity from two principal sources: operating cash flow and liability management. Operating cash flow includes both immediate profitability improvement, as well as one-time sources and quick hits that provide immediate sources of cash, such as selling idle or underutilised assets, even at a book loss, to raise cash. They also include 'process discipline' to reduce the consumption of cash, like deferring capital expenditures, and making operational changes that reduce the need for capital, such as abandoning weekly bucket scheduling in favour of daily bucket scheduling for materials management. A host of other tactics directed at working capital management can add up to a significant source of liquidity, by tightening terms, extending payables and improving inventory management.

Meanwhile, liability management builds liquidity by establishing back-up lines and refinancing to extend duration and avoid maturity towers in the liability ladder. Beyond enhanced liquidity, the turnaround will include a comprehensive plan to re-equitise the balance sheet through debt-equity exchanges, eliminating dividends and buybacks, and potentially issuing hybrid capital instruments.

### Employee engagement

The turnaround engine is the employees who will drive it forward. The importance of dealing with employee uncertainty through careful and structured communication cannot be overstated.

The 'burning platform' of a turnaround helps to create a sense of urgency and a common understanding of the change agenda – a shared purpose. The turnaround team leads the development and communication of a vision and aspirations for the business with a clear agenda for change. The agenda itself will not be complete until it is grounded in how the business will compete, achieve advantage and defend its position. This is an ongoing process of analytics, financials and market discovery. Furthermore, the agenda must be actionable, containing details of the approach, the timeline, deliverables and responsibilities. This includes detailed business cases and work plans that will be handed to the line organisation, and a roadmap for execution that includes the basis for individual performance measurement and incentives.

We often see the promotion of less experienced managers who are excited by the challenges of a turnaround. Early on, leaders can motivate by finding tangible successes and honestly communicating them to employees. Managers sketch out a roadmap of tasks that need to be accomplished to restore profitability, breaking down the larger task into monthly goals that are reasonable. The key is providing specific expectations and goals for the workforce, establishing reporting guidelines and maintaining consistent communication as the company moves down the restructuring path. Once the organisation is truly focused on results, leaders begin to coach employees to develop personal improvement plans, providing the necessary space and autonomy for

people to succeed. As individuals succeed, managers seize those opportunities to recognise and reward, promoting individual and team accountability. Tracking and monitoring are, of course, critical to determining how well the workforce is performing.

A good plan requires appropriate measures for tracking and monitoring its implementation. At the highest level, the turnaround teams are held accountable for developing workable solutions. Tracking is the most effective vehicle for measuring the accomplishment of long term projects as well as day-to-day operations of the company. Monitoring progress in these areas allows for reallocation of resources or refinement of the plan when necessary.

If turnaround leaders can successfully maintain this cycle of tight communication, measurable goals and highly visible recognition, employee engagement will flourish. Without it, the turnaround will fail.

Turnaround plans that encompass these four elements help struggling companies return to winning in the marketplace. Change is never easy, but through strong leadership, a focus on the core, financial strength, and support of employees, the results are rewarding. It is not a simple process. However, it can and does work for many. ■

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## Essential Advantage

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In a period when business conditions have worsened, once sound businesses are saddled with tough operating conditions and too much debt.

Driving a recovery from aspiration to realization requires adept steering through an array of tasks—honing the core, executing strategic leadership, engaging employees, and restructuring the finances—and is critical to turnaround success.

Booz & Company works closely with our clients to overcome uncertainties and to create essential advantage throughout the restructuring.

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