A guide to choosing genuine opportunities for turnarounds

Robert M. Shaughnessy and Kathryn Rudie Harrigan

Robert M. Shaughnessy is President of the consultancy R. M. Shaughnessy, LLC, Dallas (rmshaughnessy@yahoo.com).
Kathryn Rudie Harrigan, Henry R. Kravis Professor of Business Leadership at Columbia University, teaches turnaround management and corporate strategy (krh1@columbia.edu).

With the credit freeze of 2009, the on-going recession and well-documented increases in the number of bankruptcies, the US economy seems a worrisome arena for investment. But for corporations seeking to boost market share or gain valuable assets, turnaround managers and private-equity investors, compelling turnaround opportunities seem to abound.

As markets reacted to news of mismanagement in the banking sector, panic-stricken investors and arbitrageurs dumped stocks so brusquely that many companies' equity values were driven downward to levels far below their intrinsic values. Such times look like bargain sales to value investors. Yet experienced turnaround specialists know that most of the troubled companies that could be acquired are not good buys. With so many distressed companies in need of turnaround talent and money, investors would be well advised to reflect on the lessons learned over the years by experienced specialists before they leap into a thorny acquisition.

The good, the bad and the ugly

Distressed companies fall into three categories: (1) hopeless situations that no amount of time, money or effort can save; (2) obvious winners that will revive as the current credit freeze thaws; and (3) problematical situations that require a careful due diligence process to sort the lackluster survivors from those businesses that will best respond to skilled turnaround management. Only the last category offers compelling high returns that justify the resources committed.

Situations to avoid. The ugliest candidates for failure can be easily identified and discarded from further consideration. Many of them are publicly-traded corporations facing pressure from investors to show fast quarterly performance improvements. Many of these firms face crippling legacy costs and have worn-out equipment or infrastructure and lack sufficient company resources to do needed repairs, updating, and employee retraining. The firms that are already over-leveraged, with no additional debt capacity to tap to fund problem solving, are referred to as ''zombies'' by turnaround specialists.

Situations that attract a lot of investor interest. Sound companies that were caught temporarily in the credit freeze will attract eager attention from investors. Competition to turn around these solid firms snagged and left adrift by the downturn will be quite intense. They will likely attract many bids because they are relatively easy to fix. The companies that have superior business models and are operating within industries that will easily recover with time can be easily identified. Fundamentally-attractive companies that have a temporary cash-flow crisis will be among the first ones to receive credit on favorable terms when their restructuring is completed. Sophisticated investors, however, avoid spending a great deal of

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analytical time on them because they will likely attract many bids, and as a result their acquisition cost tends to become inflated. Because of this high price, winning bidders are likely to suffer ''buyers remorse'' when they realize that their profits from the turnover are likely to be modest at best.

Situations that require intense investigation. There's another group of troubled companies that are some what better off than the ''zombie'' businesses, but their troubles aren't likely to be solved just by a line of credit that keeps them afloat until the recession ends. Experienced turnaround analysts apply a triage approach to assess struggling companies in this middle group in order to concentrate on genuine opportunities.

The companies to avoid are the ones we call ''lackluster survivors'' because they only seem to be dramatically undervalued. Although they have problems that can be remedied, the question experienced investors and turnaround specialists ask is, ''What is their upside potential?' By focusing on the answer to this question first, experienced analysts don't waste time and talent considering turnarounds that will likely produce low returns.

But within the middle group of stumbling companies are some genuine turnaround opportunities, despite the fact that they have been beaten down by the market and have performance problems that don't have obvious solutions. Experts know that some of these struggling companies – because of potentially valuable attributes such as intellectual property, market position or special competencies – offer the greatest chance for yielding the extraordinary gains that will come from a recovery in better market conditions and after an effective management turnaround program.

The problem is that traditional due diligence, with its concentration upon legal and financial analyses, is necessary but not sufficient to ferret out the promising opportunities in this middle group. In today's world, careful diligence should include: overall industry economic outlook; competitive environment; operations' strengths and weaknesses; distribution strengths; weaknesses and reputation; end user and customer insight into reputation; quality controls; product viability; and insights into each situation's idiosyncrasies.

Separating losers from winners

Should you invest in or undertake a particular turnaround? In spite of assurances that thorough due diligence has been done and the pitfalls are identified, most situations are likely to be much worse than they are represented to be. This is often the case because potential investors receive their information from the failing management within the failing company. With so many firms to save and marginal returns available on many of them being so low, how do experts distinguish between the situations that can be salvaged, but offer only modest returns, and those that are truly worth the effort?

Sustainable turnarounds

Your objective is to create a sustainable business enterprise where customers value what the firm sells and all activities undertaken to serve them are cost justified. Most companies have several constituents that depend on a turnaround's success. These include: shareholders, suppliers, employees, distributors, creditors and ultimate customers. You are seeking

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evidence of their commitment to making difficult changes to help the distressed firm survive. Without their buy-in, there is no point in starting the process.

Committed shareholders. At the top of every turnaround wish list is advantageous financing. Most turnaround efforts need additional funding to convert a mess of archaic activities into a taut operating wonder. If stakeholders will not provide for adequate capitalization – or if most or all of your time will be spent attempting to raise cash – get professional fundraising help. There are many types of lenders available to provide financing for the right price; competent operating managers, however, are scarce.

Tolerant suppliers. Once burned, suppliers will be reluctant to extend credit to a deadbeat firm. Vendors may demand cash on delivery or before delivery instead of carrying the distressed firm’s accounts as receivables. For example, when one large retail chain emerged from bankruptcy restructuring, its telephone company refused to provide service without a hefty prepayment for each line. The turnaround CEO had to mortgage his house to raise enough cash to prepay service for the chain’s hundreds of telephone lines to finance the firm through those critical first months of post-bankruptcy operations.

Motivated employees. During the due diligence process, it is important to obtain a reading regarding employee morale, housekeeping, safety, and any other employee satisfiers or grievances that indicate whether the distressed firm’s personnel can carry off the necessary changes. Make an assessment of whether the workers are capable of making a turnaround from the standpoint of their own dedication and resourcefulness. The changes you must introduce may stress the workers to their limits before cash flows become positive. They must be willing to follow your lead.

Enthusiastic distribution channels. The distressed firm’s distribution channels should be carefully analyzed and interviewed during the diligence process because they could represent one of the firm’s most valuable resources. This is true whether the target company sells to dealers, distributors, directly to end users through independent sales representatives, or some combination of distribution methods (and after-sale servicing). Important insights include the distribution organization’s assessment of the company’s viability and hopes for future success.

Loyal customers. Customers should be interviewed in detail, asking many of the same questions that would be asked of the experienced managers in the distressed firm’s distribution channels. If lost customers cannot be recovered and the remaining customer base is not loyal then a turnaround is all but impossible.

Sharing information with those who need it

The importance of doing a thorough due diligence of operations before accepting a turnaround assignment cannot be over emphasized. Although such inquiries are costly and time-consuming to perform, careful advance scrutiny of the activities undertaken within each function can yield insights about whether better managed operations will merely break even or pay off big.

Restoring communications. Sometimes different groups in the company are not communicating adequately with each other. Miscommunication may be promulgated by

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political infighting that persists even when a distressed company is going under. For example, one distressed firm routinely revised product specifications – adding and deleting various options – but never made the spare parts division aware of these changes.

Stop making dumb and costly mistakes. Fixing dumb mistakes and finding easy opportunities to cut costs may be sufficient to start to move a company from a loss to a profit position. Fixing such mistakes creates the organizational momentum needed to sustain employees while the more difficult turnaround problems are tackled. Sometimes a distressed organization clings to costly and stupid policies that can be easily eliminated by sharing information. Since this type of victory typically can be done quickly, it tends to win the confidence of the various constituents and build enthusiasm for the turnaround. Share financial information with everybody in the distressed firm to make them believers in the turnaround campaign.

> Case: A firm that earned sizable margins in selling replacement parts to industrial customers commanded a 10 percent pricing freight surcharge when parts were delivered overnight. Since the service organization did not realize that the cost of shipping involved was $600, they provided superb customer service when $120 of parts were needed overnight. The revocation of this policy contributed a $3.7 million improvement to the company's bottom line. Its elimination provided a graphic illustration among employees of the need to exchange information that previously was hoarded or never requested.

Supply products and services that customers will pay for. Distressed organizations must remove products that are high-cost and low demand from the product portfolio – unless their best customers will pay an adequate premium to continue buying them. Distressed companies often overlook untapped market opportunities. For example, they often ignore aftermarket support for products requiring periodic parts and service. Because they have cash flow problems, they overlook the opportunities available to provide customer financing or software upgrades. Sometimes the troubled firm's organization is simply too worn down to think about the problem with fresh eyes.

Overcoming battle fatigue. The counterproductive activities we've cited are typical of the problems employees within distressed companies face. Briefly, the workers have given up hope that their firm is a viable competitor and are simply marking time until the end comes. The performance of workers suffering from such battle fatigue has likely been failing for an extended period of time. In such cases, morale must be boosted before sustainable performance improvements can be made. Accountability must be increased, as well.

These are the best of times

For experienced turnaround managers, these are truly the best of times. Many entire industries have been priced as though they were actually obsolete. Demand in some industries may shrink, but most of them will still offer exceptional opportunities for good cash flows. But don't be seduced into trying to save a company that will limp along for years on life support systems or provide only negligible returns. Be brutally realistic about what the future could look like for a struggling firm and only put your energy into potential winners and not into lackluster survivors (Exhibit 1).

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Exhibit 1 Turnaround pitfalls and ways to cope with them

Pitfall	*Avoidance/solution*
Company data are misleading or incomplete	Identify correct metrics and develop data during diligence
Melding two IT platforms that are unable to communicate with each other	Select the better platform. Operate both platforms until transition is proven
Business plan is not integrated – a series of calculations and assumptions that are not tied together	Break the plan down and rebuild it using appropriate assumptions and causal relationships
Bias for action. Abundant capital and investors demanding immediate returns often result in decisions to acquire or undertake inappropriate turnarounds	Must be very selective. Accept that you may have to look at 100 deals to find one good one
Direct or labor/hourly workforce is not up to the turnaround task	Interview key workers during diligence and certainly before accepting the assignment. Assess whether new workers must be recruited
In a privately held company, co-mingling of private and corporate finances	Extensive sampling of transactions directly involving shareholders
Worn out assets such as tooling, rolling stock, facilities	Physically visit all locations and inspect assets for suitability. If worn out, ensure there is adequate capital to restore or replace the assets
Market is saturated and probably permanently shrunken	Interview distributors and end users Develop a market share growth plan
Legal content requirements (e.g., Buy America provisions)	Investigate sources of content and related costs

Corresponding author

Robert M. Shaughnessy can be contacted at: rmshaughnessy@yahoo.com