

DYNAMICS OF A SUCCESSFUL TURN AROUND STRATEGY.

Andres E. Breiter
A.B.C.-Tecniche Avanzate di Gestione S.R.L.
Via Spallanzani 15, 20129 MILANO, ITALY

ABSTRACT

A crisis in a previously successful enterprise occurs when the value generated by the company's activities becomes insufficient to cover the total costs incurred during a certain period. Frequently, in our days, management faced with this problem needs to modify company goals and reduce costs over a short time. The rapid changes of goals and aggressive cost reductions frequently cause unexpected and dangerous secondary effects. These may inhibit company growth for a long time after the costs are brought into line.

Simple qualitative models of typical situations encountered during company restructuring are presented. Their understanding allows management to avoid the most common fatal pitfalls. Managers facing critical situations such as those encountered in the early stages of turn around are very receptive to tools allowing systematic analysis of their problems. Thus system dynamics based way of thinking becomes a key weapon for managers at the very moment they enter the decisive battle for their career.

THE DYNAMICS OF COMPANY CRISIS AND TURN AROUND.

The most successful strategy for a company turn around is to avoid the need for it. Unfortunately many companies get themselves into crisis with all the dire consequences for their owners, managers, creditors, employees, customers, suppliers and their community.

This paper briefly describes why companies get into crisis, how their critical conditions are perceived as such and the dynamics involved in the turn around process. It is based on several direct successful experiences and on examination of many failures.

The author hopes to help avoid common problems and thus contribute toward improving the rate of success in company rescue operations. The turn around efforts fail for the following reasons:

- Action to redress a crisis is started too late or is too slow,
- Management fatally damages its credibility through too optimistic promises to shareholders, creditors and other key stakeholders in terms of results and timing ,
- The communication strategies with one or more groups of stakeholders is inadequate,
- The rescue strategies are erroneous.

Why do companies get themselves into critical situations?

Most companies use elaborate planning tools to ensure continuing profitable operations. They develop long-term strategic plans, annual budgets and action programs designed to maintain them on course to success yet at some time they face an unexpected crisis. Why? Are the tools inadequate for predicting problems? Are they being poorly used? Is management unwilling or unable to act in time to overcome future problems?

In our experience the answers to all three questions are affirmative.

The planning tools are frequently complex, costly and cumbersome but tend to be inadequate to detect early weak signals premonitory of future catastrophes. Current planning tools and processes aim mainly

at anticipating the evolution of markets and of the likely actions by competitors. They often use precise methods for estimating financial results based on rough and frequently incomplete appraisals of future market volumes, revenues, customer preferences and costs. Many elements that will have crucial impact on future company results frequently either are ignored or are poorly evaluated.

Currently companies are considered in critical conditions only when three facts have been perceived. Substantial losses occur for some time, debt becomes critical and the risk of collapse is clearly visible. Financial statements record history therefore when they show danger it is frequently late for an orderly, painless and successful correction of the course being followed. Acting on financial data is like searching under the bright street lamp on a cold, snow storm night for a small key to the cosy warm home right next door. The only problem is that the key was lost elsewhere and it is quite dark there. The system dynamics approach would help spot danger well in advance but it is not yet widely used. It allows timely perception of signals anticipating crisis, however, the knowledge required for construction system dynamic models is not yet widely diffused.

System dynamics models provide much more convenient tools for planning and for charting progress toward objectives but currently they are used only under exceptional circumstances. They offer the potential for better evaluating the timing of events and the joint effects of such variables as:

- markets evolution based on changes in the economy, in the demography, in social behavior, in psychological preferences and in technology,
- competitive actions likely to be stimulated by market reorganization, technology and information technology in particular as well as by competitors' managers' preferences,
- social, political and legal pressures in response to evolving attitudes, availability of information and evolving social structures
- company's speed of response based on culture, availability of information and organization structure.

Managers, especially if successful, tend to restrict their field of vision to elements that have been important to their past success. They tend to avoid considering variables that may eventually upset their success stories in the future. It is much easier to refer to proven experience than it is to elaborate models of new relationships between variables based on weakly perceived signals. Thus, they prepare strategic plans to fight past wars based on obsolete weapons and ideas. Even with current planning tools many critical situations are avoidable but for this narrowing of the field of vision. This tendency to stick to experience allows managers to settle into comfortable mental patterns. Current planning tools do not force exploration for growing influence of new variables or for new relations between those variables. This explains many current situations where crisis unexpectedly presented its ugly face to self-confident managers.

Finally management actions in response to crisis are frequently delayed by two causes:

- Managers just as anybody tend to resist innovation in their own behavior, even when they happily push for innovative behavior of their subordinates. New problems may require managers to act in totally new ways perhaps contrary to established culture - tradition, value systems - and to managers' views of their own role.
- Managers frequently find it difficult to push unpopular actions based on weak signals that point to a distant danger. It is likely that they would act sooner if those signals were stronger. Better planning tools could help here too.

The timely replacement of managers in companies facing crisis is generally an unresolved problem. Shareholders usually do not have access to relevant information other than financial results. Board members sometimes do but they frequently tend to delay action until crisis is evident and time for

corrective action limited. Creditors generally can push for change of management only when the debtor is in desperate need of help.

When a company is in critical conditions, this affects shareholders, management, employees, bankers, suppliers, customers and sometimes the entire community. All these groups are stakeholders in the company and the dynamics of relationships among some of these groups are very important.

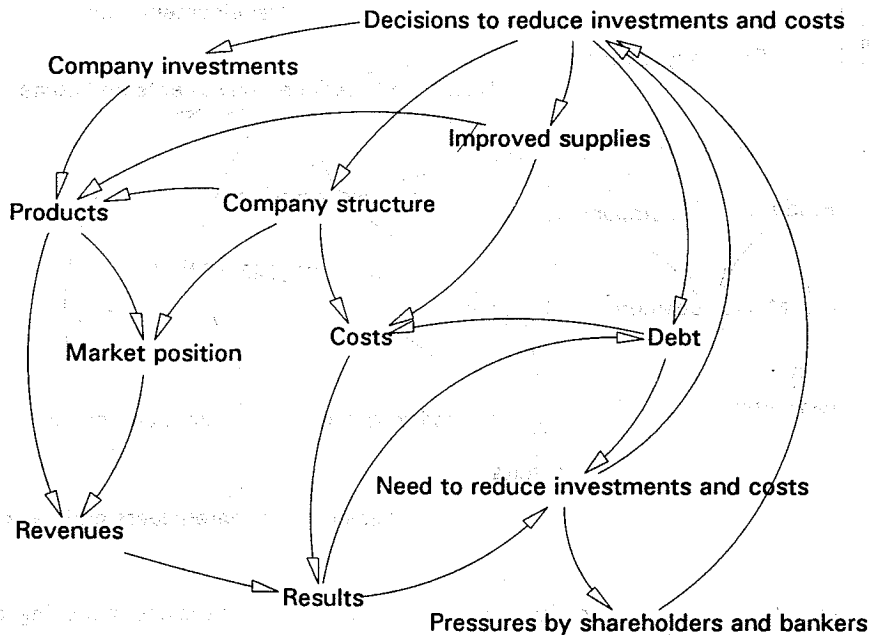
The crucial Importance of Dynamics in Crisis Recognition and in consequent Events.

Successful turn around strategies usually are aimed at the following three objectives:

- reduction of costs to be enacted over a time horizon that varies between a few months and two or three years,
- reduction of debt through sale of disposable assets,
- enacting early well-designed growth strategy.

It is crucial to avoid risks for the growth prospects through badly targeted or poorly executed cost cutting or divestment. Yet the proximity of disaster, pressure by creditors and by shareholders and management preferences frequently cause hasty and erroneous decisions regarding cost pruning and disposal of assets.

Fig. 1.- FREQUENTLY THE POSSIBILITY OF IMMEDIATE COMPANY COLLAPSE, THE PRESSURES BY SHAREHOLDERS AND BANKERS OR MANAGEMENT'S TENDENCY TO SIMPLIFY ARE THE CAUSES OF ERRONEOUS DECISIONS FOR COST AND INVESTMENT REDUCTIONS.



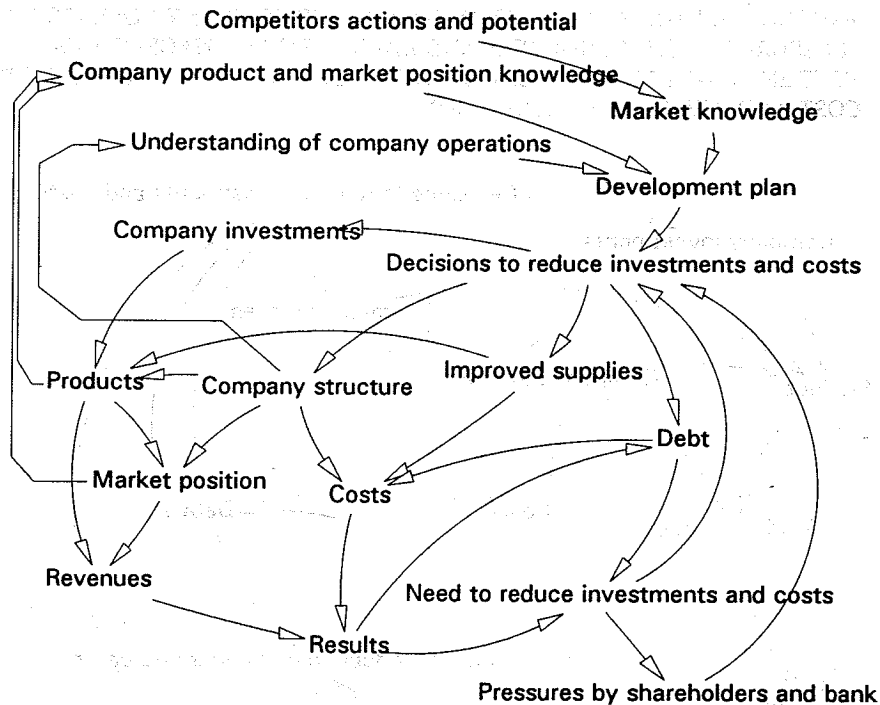
Usually management of a company in critical conditions needs to produce savings and frequently this must be done quickly. Only rarely nowadays management may achieve satisfactory results through increased revenues alone. Frequently the first to go are discretionary costs for R&D, market research

and publicity. Savings in costs of purchasing, production, logistics and sales tend to take longer to achieve and those involving information processing and overhead probably take the longest.

During this cost cutting process personnel reductions takes place. The climate is one of anguish caused by insecurity about the future of many more people than those that need to be eliminated from the payroll.

The above cost reductions promise to improve the current balance sheet but executed without due precautions they cause negative secondary effects. These may result in loss of needed skills and assets and in severance of key external relations. The final consequence may be a greater reduction of company activities than needed under carefully studied and managed conditions. Cost cutting results may leave the company prone to total collapse or at least strongly crippled by the time the financial conditions are ready again for the growth. On the other hand, a carefully crafted approach based on cost reductions executed with an eye on a well thought out growth strategy, is very likely to prepare the company for a much faster rebound.

Fig. 2.- KEY MANAGEMENT DECISIONS TO REDUCE COSTS AND INVESTMENTS MUST BE TAKEN CONSIDERING ALSO PLANS FOR THE FUTURE.



Management will be well advised when facing a critical situation to take decisions on pruning company structure and investments only after:

- evaluating the immediate need for reducing costs and debt,
- learning about company's key markets and their likely evolution,

- fully understanding what makes it possible for the company to sell its products or services, and what is likely to be needed in future,
- understanding how the company structure operates, what the competitors are doing and what opportunities there are for improvement,
- preparing a development plan for the future having decided the markets to serve, the technologies to hone and the kind of products or services to offer.

Only then management can take informed decisions regarding cost and investment reductions. In this way structural costs will be reduced bearing in mind what elements need to be preserved and perhaps strengthened to ensure future development of products, services or markets. Management should also act on assets with similar objectives in mind.

Obviously management requires time to prepare a plan based on thorough understanding of company operations, of market conditions, of relevant technology and of all other relevant elements. Management needs much less time for starting cost cutting and divestment of assets just to carry on current activities in the most penny pinching ways. This second approach may however put the company's future at stake yet many shareholders and creditors expect just such a show of activity. To buy itself the needed time, if company conditions allow and immediate collapse is not likely, management must enact an adequate communication strategy with shareholders, board members and creditors. To proceed with cost cutting and divestment without undesirable reactions from employees, customers and suppliers management must design and execute an appropriate communication strategy aimed at these groups.

In our experience the communication strategies aimed at the various groups represent a key element for the successful turn around of companies in critical conditions. Management must have a clear understanding of the dynamics involved in the relationships with key stakeholders. During the salvaging process usually the key relationships are between:

- shareholders, board members and management,
- bankers and management,
- management, employees and customers
- management and suppliers.

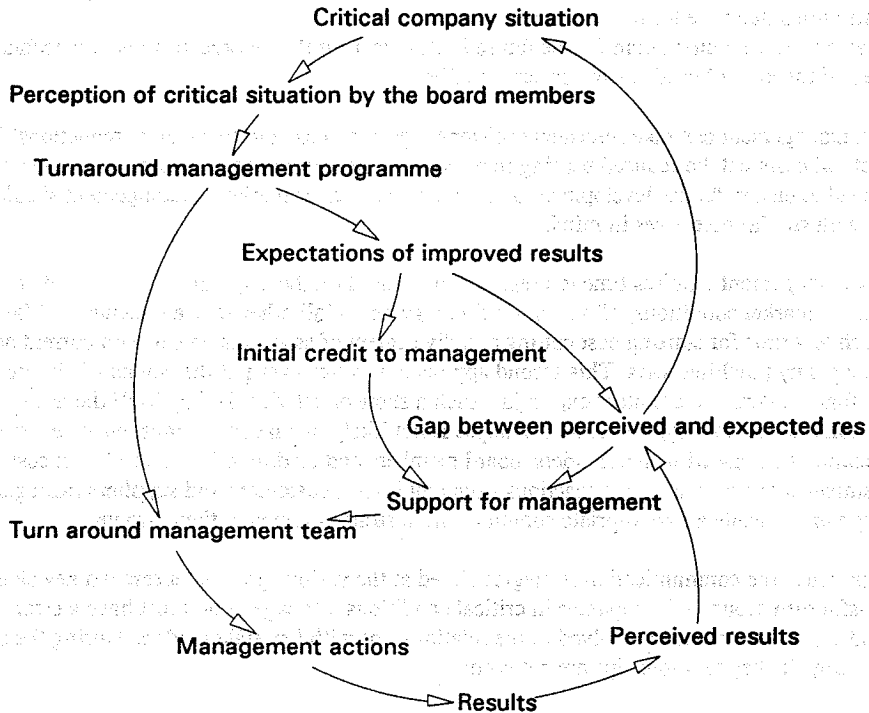
The dynamics of these relationships are described below.

Description of the relationships between shareholders, board members and management and of the dynamics involved follows. Fig. 3. - illustrates the relevant schematic model.

Shareholders generally perceive that their previously successful company is in critical conditions only after financial statements have recorded substantial losses over a sustained period. They rarely have access to other sources of information and even if they do they tend to be uncertain about its effects on company results.

The members of the board who nominally represent the shareholders may or may not have access to information about variables that will determine future financial results. The actual situation varies according to the mechanism of board members selection. When top management selects board members they tend to be fed only such information as top management sees fit to give them. This generally is limited to financial statements and documents produced by the company's planning process. Board members selected by shareholders and by key creditors on the other hand tend to insist on access to broader information. Thus they may perceive advance warning signals of possible problems with future financial results or even identify opportunities for the company to act upon.

Fig. 3.- CAUSES AND EFFECTS CRUCIAL TO THE RELATIONSHIPS BETWEEN SHAREHOLDERS AND MANAGEMENT.



Board members perceiving their company in critical conditions are stimulated to act decisively toward company management stimulated by:

- the risk of personal responsibilities stemming from a possible collapse of the company,
- overt or implied requests for action from the shareholders,
- pressures from public opinion expressed by specialized press and social pressures that manifest themselves through remarks by peers at various social and professional occasions.

The board members decided to act usually confront management requesting programs for redressing the situation. When management submits its proposals, the board may act approving or rejecting them as inadequate. In the first case it will evaluate management against milestones promised in the program, in the second case a new program is eventually prepared. Only rarely management is substituted because it fails to prepare an adequate turn around program.

Frequently if management gets substituted it is because it fails to deliver promised results on time. It is the persisting gap between expected and actual results at preestablished time and the worsening of company's conditions that usually forces the board to substitute management.

The new management is given an initial credit that buys it time for learning the situation and for preparing a new turn around strategy. The first results that new management usually is expected to deliver generally are a new action program and actions on some visible problems that previous

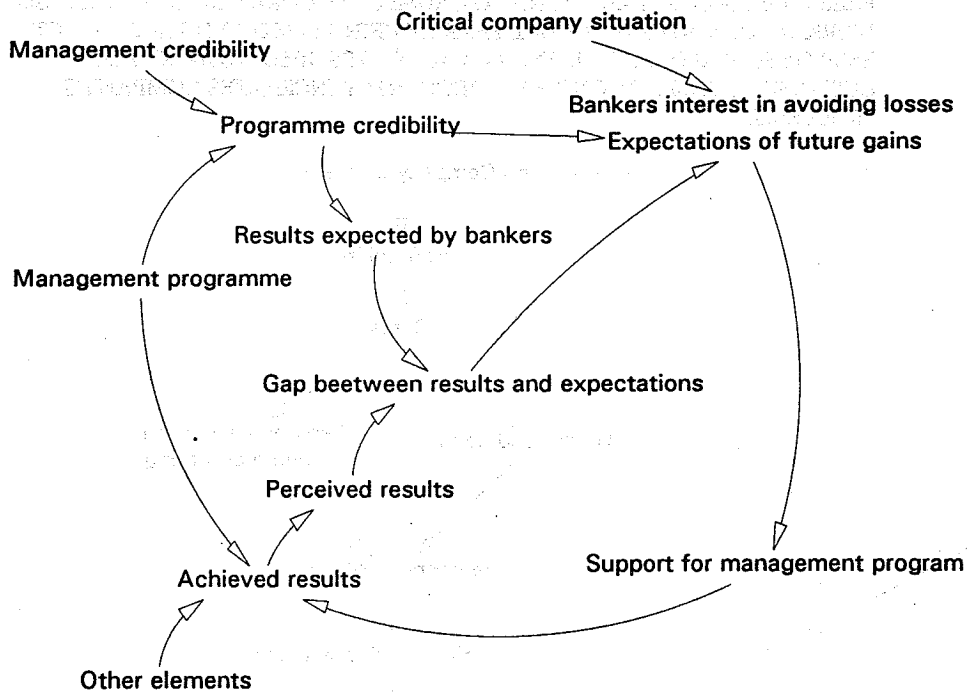
management has failed to confront. After this grace period, however, results closely in line with expectations must follow to ensure continued shareholders' and board members' support.

This suggests that management should present programs fulfilling two conditions: avoid company collapse and raise expectations of results that will be achieved in the anticipated time.

Management should accomplish the promised results on time. In addition it would be wise to activate the necessary communications to ensure that the results once obtained, will be perceived as in line with those promised. Misunderstandings in this area are frequent and may prove fatal. On occasions a delayed or incorrect perception of results achieved has resulted in frustration of shareholders and board members with management. Communications to board members regarding certain important actions and their results may reinforce management's credibility and prepare the climate for the formal results review sessions.

Description of the relationships between bankers and management and their dynamics follows. Fig. 4.- illustrates schematically the reference model.

Fig. 4.- COMPANY SITUATION AND RELATIONS BETWEEN BANKERS AND MANAGEMENT.



It is essential to ensure creditors' support for management's program during the turn around phase. Management should motivate creditors to avoid pressures for immediate repayment of debt. They usually will also be asked for financial resources needed for the support of the turn around program.

When deciding whether to support such a program bankers usually evaluate:

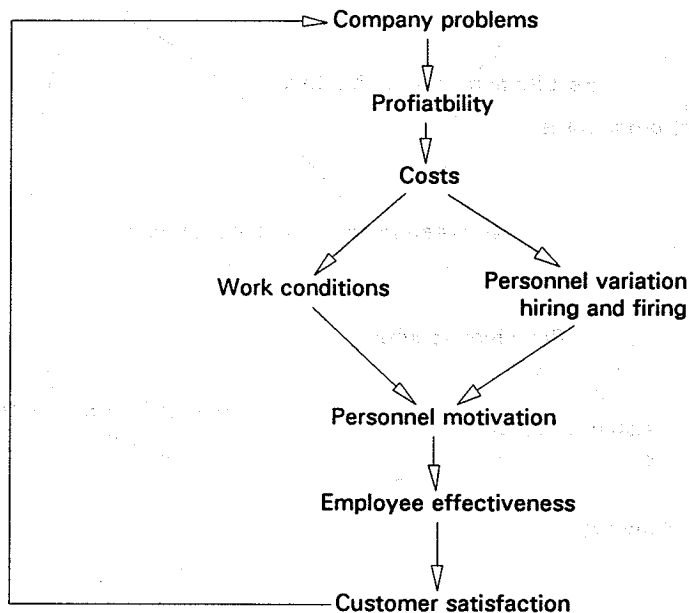
- the risk of losses on outstanding debt if they do not support the program,
- the risk of losses on currently outstanding debt and of additional credits required for the program should it fail,

- the prospects of future gains through financing the turn around,
- management's credibility and the quality of the program.

Therefore management must be very careful to raise only such expectations as may be met over the anticipated time. Since management's credibility is an essential element in bankers' decisions the strategy management adopts for communication with bankers is crucial. Management should avoid disclosures of worse than expected results. If they happen the disclosure must be made when the differences are known. Management should present results truthfully and fully explain any gaps between expectations and reality. Simultaneously it should propose corrective actions designed to bring results in line with expectations. Interim information relayed to bankers may reinforce management's credibility. It is frequently essential to ensure that the information bankers themselves gather is in line with the results presented by management. Bankers may collect information on company's operations based cash inflow, amounts of payroll, investments, other cash inflows and any other information that they may obtain through company's banking transactions.

Description of the relationship between management, employees and customers and of the relevant dynamics follows. Figures 5.- and 6.- present the schematic models.

Fig. 5.- CRITICAL COMPANY PROBLEMS REDUCE PROFITABILITY, GENERATE PRESSURE ON COSTS AND TEND TO CAUSE DETERIORATION OF PERCEIVED WORKING CONDITIONS, INDUCE FEAR OF BEING FIRED AND THUS AFFECT EMPLOYEE PERFORMANCE AND LOYALTY. THIS RESULTS IN LOWER CUSTOMER SATISFACTION THAT FREQUENTLY INCREASES COMPANY'S PROBLEMS.



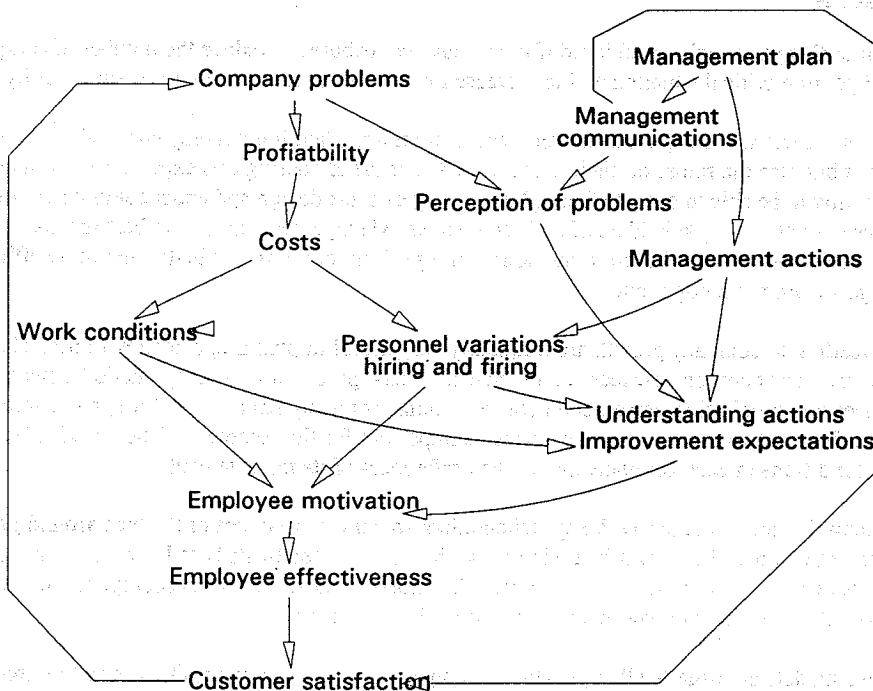
Frequently aggressive management actions aimed at reducing costs hurt relations with employees. Especially when employees do not feel identified with the company they perceive problems facing the company as "their" (the management's and shareholders') problems. Pain caused by firing and by any savings originating the slightest inconvenience to the employees is the result of "their" ineptitude and "their" lack of consideration for employees.

Fear of losing the job may for a short time cause improved visible performance by employees. After a while frustration prevails causing decreased performance. This frequently has negative effects on customers as quality of products or of service deteriorates. Fear of losing the job is likely to scare the most valuable employees into searching for new positions outside the company further depressing company performance and results. Unions may sometimes present problems responding to employees' anger. Customers frustrated with company's performance or fearing lack of continuity in supplies may choose alternate suppliers thus causing long term damage to company's market position.

Management conscious of these problems will be careful to avoid them as Fig. 6 illustrates. It will design a communication strategy aimed at persuading employees that company problems are also "our" (the employees') problems. Thus, the employees need to fully participate in overcoming the critical situation. Management will present its program for turn around explaining why any deterioration in working conditions and any layoffs or early retirement are essential to safeguarding the remaining jobs. Management will allay fears of essential employees early to ensure their full cooperation and remove their motivation for seeking other employment. Management will inform the unions about the situation and its plans for turning the company around and will request their cooperation. Generally unions will provide support for reasonable programs to avoid total collapse of a company. Problems however may be hard to resolve on local levels if entire units need to be closed in order for the company to survive. Management will be wise to design careful communication strategies toward the customers, both actual and potential, to reduce the risks of losing them to competitors.

Generally it will be wise to discuss progress toward the turn around goals with all those concerned.

Fig. 6.- A CAREFULLY DESIGNED INFORMATION STRATEGY WILL REDUCE OR AVOID DANGEROUS PITFALLS IN RELATIONS WITH EMPLOYEES, UNIONS AND CUSTOMERS.



Management must also be aware that employees will continuously scrutinize it to understand whether it knows what it is doing and whether it is worthy of their trust; their well being is at stake. Higher level managers and technical experts will try to derive answers from personal interactions with top level managers. At lower levels people will look at changes in the ways how things are done and in the company's culture. Initial opposition to change is frequent but once people become convinced of its need they support it.

There is of course a risk that management will exhaust the initial credit accorded it before employees will recognize the changes it pushes through as necessary. Consequently management must act promptly, monitor how employees perceive its actions and use communications wisely.

The dynamics of relations with suppliers need to be evaluated case by case.

Monopolistic suppliers with diversified customers will probably try to impose their own conditions. These conditions may be the harder the more difficult appears the company's future. Suppliers with whom relations are based on long term cooperation need to be dealt with following similar approach to the one followed with bankers. They may be requested to extend credit terms or to decide investments for new components to be built into planned company products.

Suppliers easy to substitute may be pressed for better conditions. That will result in greater value for the company at lower costs. Even here it may be very helpful to make these suppliers aware that their current sacrifice may result in long term profitable relationship.

Management should avoid pushing valuable exclusive suppliers away so that they will not become competitors' competitive weapon.

Conclusions.

The goal of this paper will be achieved if it will have contributed to reduce the number of companies that will get into critical situation and to increase the number of those that will be successfully rescued.

If more managers will design and execute rescue programs planning not only cost and investment reductions but also the future of their companies, the effort of sharing this experience will have payed off. Naturally to be able to execute these plans managers must design and enact communication strategies with all key stakeholders of their companies. Management can obtain best results implementing cost and investment reductions resulting from doing things better and more efficiently and not just from not doing them.

Models leading to company growth are frequently very useful in planning company future. They may simulate relations between new technology, new products, production capacity, markets, customer preferences and purchasing power, competitors' actions, company structure, culture, and commercial practices, financial variables and other variables important for the company. They need to be tailored to specific conditions of each company and to the preferences of its management.

The communication strategies with key stakeholders are an essential part of the turn around game. Management can win the market battle but loose the war defeated by its board, company creditors and even by its own employees. Success will crown the efforts of those who will accomplish the interests of the various stakeholders and will get them to appreciate this early.

The above models are usually all applicable in companies faced with crisis. Occasionally it may be necessary to consider also other relationships not described above, for example with the government authorities or with the community.