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RESTRUCTURING SERVICES

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A fresh look at company turnaround

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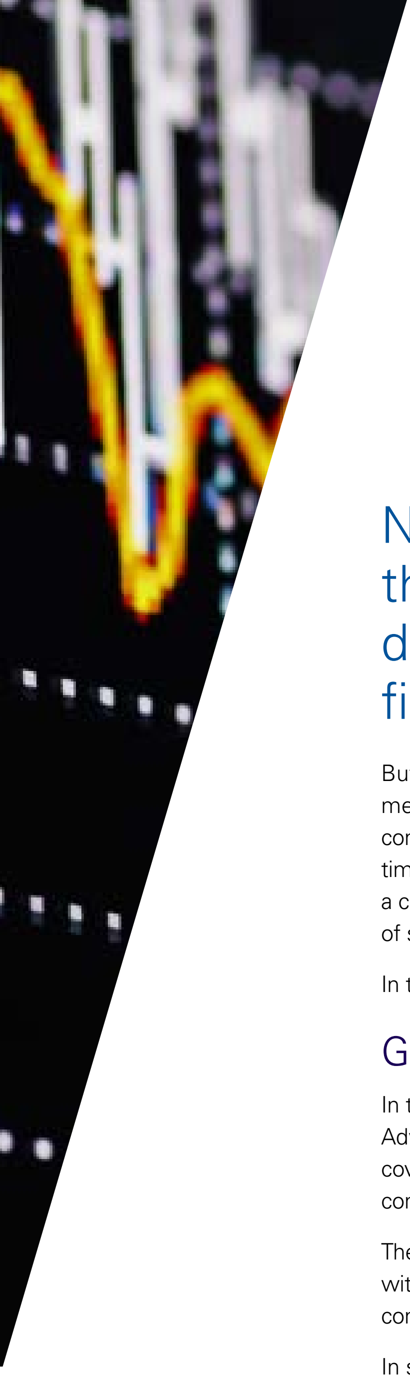


No matter what stage in the economic cycle, there will always be organisations suffering distress that manifests in the form of a company financial crisis.

But there is usually no training for a board in how it should respond to a financial crisis, and often board members do not have active experience in spotting the warning signs and dealing with such events. Most companies do not respond soon enough and as a result find themselves poorly prepared, with less flexibility and time to drive the changes required. The impact can be significant on companies and their subsidiaries, and often a company doesn't start formulating a recovery plan until it is already underperforming and losing the confidence of stakeholders.

In this paper we take a fresh look at company turnaround and comment on some lessons learned.

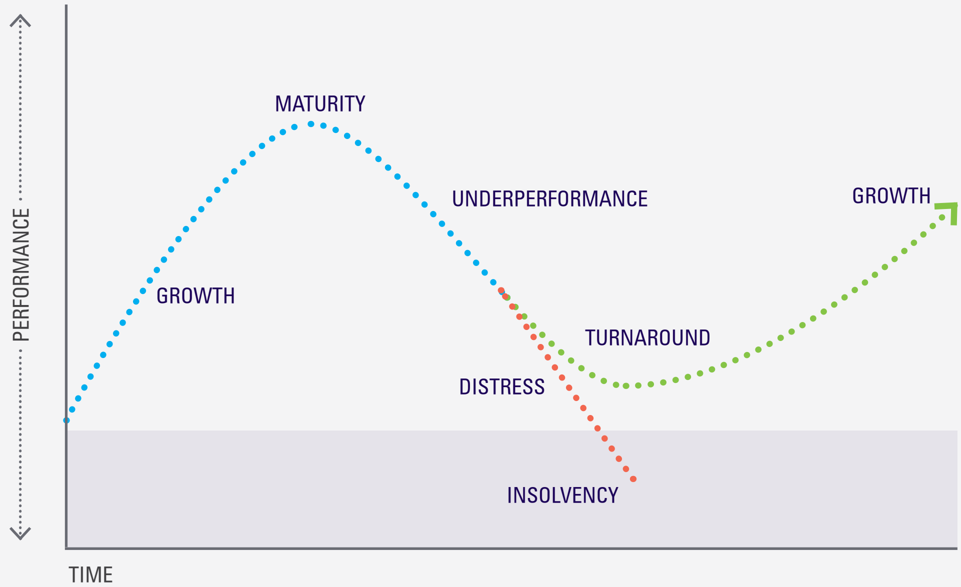
Growth Maturity Decline lifecycle

In the context of a company's theoretical Growth Maturity Decline (GMD) lifecycle (see Table 1), the Turnaround Adviser (TA) is often called upon after the second or third round of restructuring activity, or after multiple covenant resets or a bank covenant breach, often after an investigative accountant has been appointed by the company's lenders.

The TA is typically called upon to assist a company develop a turnaround plan that makes meaningful change within the first 60 to 90 days in a way that helps restore control into the hands of the company, increases the confidence of stakeholders and provides a roadmap for management to deliver against.

In such a relatively short period, the response has to be quite tactical in nature although the outcome will often be quite strategic in its application.

TABLE 1: GROWTH MATURITY DECLINE LIFECYCLE



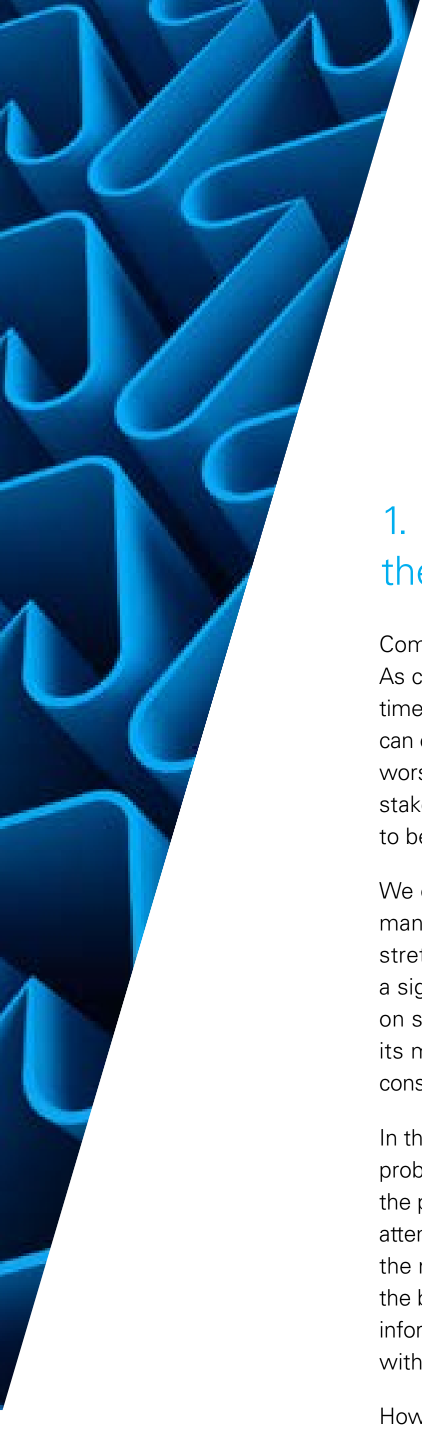
Where a company finds itself on the GMD curve dictates both the nature and severity of its response, as well as the breadth of options available. An experienced TA often seeks to quickly diagnose the nature of the crisis to determine the way a company might respond. For example, if the organisation is suffering from mere underperformance, the response might be less severe. If an unfunded wages liability is due in the next 24 hours, the nature of the organisation's response would be more dramatic.

There is no standard off-the-shelf approach in a turnaround. No prescriptive 10-point plan that can be deployed across all circumstances – in fact, each company's circumstances will be unique. In our experience, however, some common principles prevail which can be usefully deployed in a turnaround no matter where a company sits on the curve. In our opinion, the top three principles are as follows:

1. **Managing stakeholder expectations remains the key challenge for companies in turnaround.** Realigning expectations among stakeholders is the biggest challenge for corporate restructuring.

2. **No one is the owner of all the good ideas.** The burden to identify a turnaround plan should not just rest with the C-suite.

3. **Cost reduction continues to be a prime focus to improve earnings, but few corporates achieve their savings targets.** Companies also fail to implement turnaround plans – it is one thing to develop a plan, it is another to successfully action it.



1. Managing stakeholder expectations remains the key challenge for companies in turnaround

Companies in distress are under pressure. As circumstances deteriorate, the quality and timeliness of the communication to stakeholders can often deteriorate as the news varies or gets worse. That goes for both internal and external stakeholders. The agendas of stakeholders have to be reconciled and confidence re-built.

We often experience situations where management feel under pressure to present stretch or optimistic forecasts. This can have a significant, and at times terminal impact on stakeholders' trust in the company and its management. Transparent, realistic and consistent communication is vital.

In the context of a public company, the inherent problems during a turnaround are often under the public spotlight and boards rightly direct their attention to meeting their ASX obligations to keep the markets informed. The investors 'price-in' the bad news and make decisions based on the information provided by the company in keeping with its continuous disclosure obligations.

However, the level and extent of disclosure required in managing a company's interaction with its lenders, customers and staff is often underestimated and yet these stakeholders often have the biggest role to play in assisting with the turnaround of the company.

Often the involvement of a TA can provide an additional level of comfort and confidence to stakeholders that the company is taking proactive steps to engage with specialists to drive change within the business. A TA can also assist with the messaging and engagement with the range of stakeholders involved, and have an understanding of the conflicting objectives of each of them.

A key to achieving a successful turnaround is to decide what to communicate and:

1. adopt a rigorous governance process around messaging
2. communicate early and often to build commitment and support. (Taking care with what, to whom and when)
3. acknowledge the circumstances and to the extent possible seek the involvement of stakeholders in the preparation of a plan
4. plan for the downside, target the upside with risk based initiatives. Don't rely on hope as a plan
5. the CEO in most instances should be seen to articulate the imperative but all management should be seen accountable for delivering outcomes.

2. No one is the owner of all the good ideas

Usually in a turnaround companies focus on a capital solution (e.g. distressed M&A; increased debt/equity), despite the possibility that finding one additional dollar of earnings could mean a company is able to service an additional 3 dollars of debt (assuming a 3x leverage ratio). It follows, therefore, that improving a company's earnings is likely to have a high impact in any turnaround strategy. The ideas to improve earnings are often in hindsight relatively simple in application, but in practice are not always obvious to identify. Such solutions are beyond a basic 'sell more with less' strategy.

Typically the board looks to the CEO/CFO for ways to improve earnings. However, the challenge is that they may not have all the ideas to identify and then implement the solution(s). Indeed they may have exhausted all ideas!

While some circumstances require the appointment of an externally sourced CEO/CFO or Chief Restructuring Officer (CRO), in our experience, the people employed in the company across management layers will often be the ones best able to originate ideas to improve earnings and determine the path a company should take. The premise that only the CEO/CFO or externally appointed CRO can own the ideas in a turnaround is flawed, given the best ideas will often flow from the intellectual capability residing in management.

Furthermore often a fresh set of eyes from either within the organisation (e.g. 'shop floor') or from external advisors (e.g. TA) can help identify options. We often see the best ideas with the lowest risk originate from second and third tier management when they are given the opportunity to participate in deriving a solution. For example:

We ran a process for one client where such a circumstance occurred. In the context of a depressed construction manufacturing sector and downward pressure on prices – our options appeared limited other than to cut costs.

One of the best and simplest ideas, came from one of the logistics managers, who proposed raising prices, which in the current environment the sales team said was very problematic. We challenged the manager to develop the concept more and it became apparent from our data analysis that a number of SKU's were sole source and had recently been in high demand. As a trial, prices on selected SKU's were raised with little impact on demand. The company established for itself that it was a price leader in a whole category and soon raised prices across the board. Its competitors also raised their prices.

A simple but seemingly 'radical' solution that the sales team rejected initially dropped millions to the bottom line. Whilst cost cutting is often inevitable, on that initiative, no staff lost their jobs and no sites were closed. It was managed in a way that was low risk and was able to be implemented very quickly.

In 'the moment' even the most seemingly obvious or simple solutions can appear obscure or radical. But investing time in harnessing the intellectual capital of a company's people can be one of the best ways to originate ideas to find a way through a turnaround.

3. Cost reduction continues to be a prime focus to improve earnings, but few corporates achieve their savings targets

KPMG commissioned the Economist Intelligence Unit to undertake a survey of 427 companies across the globe, regarding cost reduction program execution, effectiveness and sustainability.[1]

Detailed interviews were conducted with executives across all of the global regions, and a number of sectors, including Consumer, Financial Services, Manufacturing and Mining with over 60 respondents having revenues over $10 billion down to those generating under $500 million a year.

The results were remarkably consistent across the organisations reviewed:

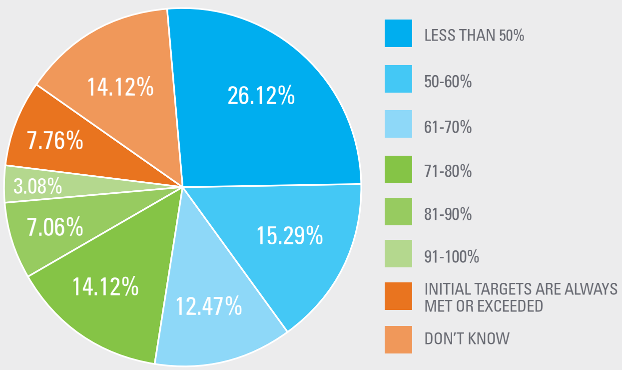
Cost reduction programs are failing to achieve their targets

Make no mistake – implementing cost reduction is hard. Doing so in a way that does not destroy the earning capacity of the organisation is even harder. Doing so in a way that is sustainable is harder still.

Our research indicated that only 8 percent of organisations always achieved their savings targets. Further, on average these companies only achieved 60 percent of targeted levels, which suggests that 40 percent of potential savings are being unrealised.

We asked: **"When your organisation decides to implement cost saving ideas, on average, what proportion of planned savings does your company typically achieve in practice?"**

TABLE 2:



The findings from this survey point to the fact that:

1. Cost strategies are not planned well.
2. Cost ownership is unclear and too narrowly defined.
3. Cost strategies are often too cautious.

In our experience, rarely are there circumstances where in hindsight management have said "we cut too deep". The results of this survey suggest that a turnaround plan premised entirely on cost savings will achieve on average only 60 percent of the target savings.

Experience tells us that one way of gaining comfort around cost targets is to ensure ownership is clearly assigned and each target is assessed on a low, medium or high basis in respect of its execution and business risk. Any target, risk rated medium or above, is likely to be a stretch target and therefore should not form the basis of a turnaround budget but form part of a stretch budget.

[1]Rethinking Cost Structures Survey, KPMG International, 2007. https://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/sustainable-cost-structure-O-0702.pdf

Conclusion

Where a company sits on the GMD curve will dictate the way it responds to a crisis and each company's circumstances are unique. That said, there are some common principles that can be usefully deployed across all turnarounds that can help a board to regain control of the organisation, stabilise the business and effect a turnaround plan. Central to this are the principles of managing stakeholder expectations, seeking and generating ideas from across all levels within the organisation, and a sharp focus on accountability and implementation of any cost reduction plan.

An experienced TA can also play a key role in supporting boards, to increase the confidence of stakeholders, bring new perspectives and experience and help with the facilitation and management of the process. Successful planning and execution of a plan can help boards regain control, restore enterprise value and reposition an organisation for further growth.

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