

Cultivating Companies: Growing Value Using Turnaround Management Techniques

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As a veteran turnaround manager, one who has spent her life in the returns department, I envy the private equity owner of companies his great opportunity to grow company value under protected conditions. By the time I arrive, options are few, and often much value has been lost. The private equity owner, though, has a wonderful chance to craft new value, with the great luxury in today's world of a reasonably clear investment horizon, stable funding, and the opportunity to work in a private setting to grow a garden of companies toward abundant harvest.

And yet, from the perspective of the turnaround manager who admittedly sees only the bad news cases, many private equity investors do not capture nearly as much value as they could from these wonderful circumstances, and in fact are often surprised by negative news in their companies, which can spiral out of control very fast.

This article focuses on lessons from turnaround management practices that private equity owners can use to help their management teams and all employees realize their dreams, which after all is the basic reason most people get up in the morning to go to work. In the parlance currently in vogue, the aim is to help owners be sure that all elements of an organization's infrastructure are tightly integrated and working in concert to maximize growth and profit. In other

words, to avoid having to face the need for a turnaround manager, be your own, and most important, do this regardless of whether there is an apparent problem. When things look too good they often are, and early recognition of possible trouble is the most important component involved in fixing it.

THE FIRST FOCUS: CASH

In almost 30 years of working with troubled companies, I have never yet seen a company that has a good understanding of its cash. That is not an overstatement or a misprint. It seems that executive time is spent on important bank and capital market relationships, and on financial reporting. Cash management is typically a clerical function that is not part of regular management scrutiny. There are many reasons for this, but they are not important. What is important is that the private equity owner, not burdened with the daily distraction of actually running the business, can assist on this, and through this continuing process can help the company better understand its business dynamics. Greater understanding of the critical drivers of cash through the business leads to greater confidence in the value created by the business and thence to improved results at sale.

How to do this? The first thing a turnaround manager does on arrival in a new situation is to figure out as fast as possible

how much cash there is, where it is, and who has what claims on it, typically working from the general ledger and actual receipts and disbursements. A rolling cash flow forecast is typically created, covering for example 16 weeks forward, and including receipts, disbursements, use of working capital, and taking into account major debt and capital expenditure payments.

Understanding the flow of cash allows the turnaround team to estimate how much time there is to identify and address sources of difficulty, and how broad the range of possible options might be. In one recent subprime mortgage originator situation, I arrived at a company that had \$600 million in cash on its books and an owner comfortable he had the resources to withstand the storm. On a quick look, all but \$15 million of that cash was encumbered, payroll was in jeopardy, and an immediate filing was inevitable. A company can appear to have more than adequate resources when looked at on a financial reporting basis, but GAAP interpretation can often disguise the availability of cold hard cash.

The next thing the turnaround manager does is work on creating an integrated financial model, tying the cash flow to profit and loss and to the balance sheet. Typically, financial and management reports are periodic snapshots and do not focus on constant improvement of understanding key drivers and their integration. Generally, the private equity owner has built something like this as part of the initial investment analysis, but often discontinues work on it once the purchase is made.

The key is to continue actively to work on constantly improving the model against the actual numbers that the company generates. This can lead to tremendous insight and a very good early warning system that will allow both owners and management to focus attention on key measures quickly, with confidence. By comparing the model to budget and actual results each month, the model not only improves in accuracy each month, but the variance analysis provides critical insight into the underlying drivers of the business and allows early identification of trends. In some instances, it may not be the model that needs to change but the process of creating the budget in the first place.

Sticking relentlessly at the owner level to iterative improvements each month to the integrated model helps deepen understanding of the business drivers that determine earnings quality and profitability. This knowledge leads to greater confidence at the time of possible harvest and thus the very real chance to realize high valuations.

On the downside, it keeps visible such critical issues as compliance with key ratios and covenants and the dynamics of working capital usage. If a two-year rolling projection is employed, for example, it will help to identify possible crunch periods—tight covenant compliance or possible cash shortfalls—so they can be planned for well in advance. A final benefit of doing this work at the owner level allows shared ownership of the information itself and a reduction of risk from employee turnover, causing a loss of critical knowledge.

SECOND: GO BEYOND THE NUMBERS TO QUALITATIVE ANALYSIS

The fresh thinking that may have guided the company's prior success can easily ossify into rigidity that rejects experimentation and punishes mistakes. Often the initial strategic focus and framework get set in stone, and a well-intentioned management team forces all data into the existing framework. Oddly, the more successful the management team has been in the past, the more likely it seems they are to be vulnerable to this. The owner can play the role of the curious outsider, by walking around and listening. Are customers leaving? New ones arriving? Why? Where does execution fall short of expectations, and where does it exceed? Collect your own impressions and find ways to cut across the silos through which information typically moves.

Often there is a great divide between management and owner, in which management generates numbers and reports, owner reviews and questions, and they meet again in a month or a quarter. Going back to the turnaround management protocol, the next thing the turnaround manager does in a problem situation is work on a diagnosis: Where is this problem really coming from? Problems may manifest as body parts of the elephant—what on earth does the elephant really look like? What makes him tick? What business are we in and how do we fit? What are the company's key strengths and how are they being deployed? What customer need do we really fill?

Once again, this analysis is typically done by the prospective private equity purchaser at the outset of a purchase process but often is left behind in a file cabinet somewhere. And often that initial investment thesis is not refined by dint of the reality that may be better understood once the company is acquired. This continued probing and questioning can provide huge benefits to

a management team blessed by an owner who actively understands the business and shares responsibility for its success, and, in the alternative, its failure. Avoid the idea that this is micromanagement and focus instead on defining an environment that includes owner, management, and employees in the same equation.

In a typical turnaround engagement, the initial assessment is done by the turnaround manager as an unbiased outsider collecting data and asking questions, holding interviews with the management team and with function heads and if possible with members of the rank and file. This simple device often yields untold riches as the detached outsider asks basic questions, the answers to which are often assumed to be obvious; day-to-day behavior and habits build up assumptions about company activities that may be untrue, untested, or out of date. Stories and myths that have grown up can be challenged by the outsider, whether turnaround manager or owner, in a way that employees, often blinded by context, cannot achieve. How many times have I heard about the company being the low-cost provider as an end in itself? Or the most modern, or the best located. Now tell me why that matters to the future health of the corporation?

As they mature, companies often seem to divide into two very different worlds: the world of execution, and the world of management or policy. In many cases if not most, only a handful of people cross the line between one world and the other. Often CFOs have not been in the stores in decades, or the head of HR has never set foot in the plant. These divisions create communications barriers that can be invisible when times are good but impenetrable when times are harder—management retreats from talking as they feel they are supposed to know the answer, and the operators responsible for execution, often feeling blamed and impotent, throw up their hands in disgust and stop trying to be heard.

At a home-improvement-products retailer I was involved with, I asked a store manager to tell me what his biggest problem was in 10 seconds or less, and he immediately said that the distribution center had no tracking of orders so he routinely ordered carpet and got glue or spray paint. No matter how much money the new owners poured into advertising, sales were not going to move if inventory in the stores could not be managed.

Stories like these are easy to find, and hard to believe. What is a private equity owner to do to address

them? The first and easy response is to say that these issues are failures of management, and the CEO is not doing his job. Changing the CEO may, however, not have any impact on these absurdities, which are often completely invisible unless someone is actually walking around looking for them. Following the normal-course standard operating procedure is often what creates these glitches; the SOP has not changed to match new realities, but unless someone is empowered to look, ask, and see, communication about the problems they cause often goes unheard.

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In an unusual response to the glitches at the home improvement retailer, the new owner of the company asked me—the incumbent and at his invitation continuing chairman of the board—if I would serve as an ombudsman, a blind drop box to whom employees or vendors, or customers for that matter, could address their concerns without regard for hierarchy or political ramifications. Once confidence in my goodwill and discretion was established, this actually worked pretty well as I learned how to field issues and where to go to get the causes identified and the fixes put in. It became a badge of honor to have brought me something that could be and was fixed. The sourcing and fixing of silly problems became fun, as all of us were focused not on blame but on improvement and forward motion, and as we collected them we got much better at seeing trends and fixing underlying issues as we focused the whole

company on acknowledging problems, fixing them, and moving constantly toward continued improvement.

So own the numbers but look beyond them, cut across the categories as defined, harness the tremendous value that the owner or his representative can play in walking around as the curious and detached outsider. Focus on fixing, not blaming, and on constant improvement. Foster a world in which early failure is embraced as an opportunity to learn.

These steps, however, are anecdotal, and rely on individual perception and filtering of information collected in what can be a bit of a random pattern. What other tools can the owner use truly to understand the company he controls—preferably while enhancing the vision of his management team, not disrupting the regular functioning of the company, and not undermining the existing fabric of relationships with employees, customers, and vendors? In current buzzwords, how can the owner enhance the alignment of the effort of all with the corporate purpose?

To supplement the anecdotal information gleaned by walking around, we now use as turnaround managers a new online tool that rapidly and accurately helps identify the causes of difficulty and the possible solutions to strategic or operational issues. Using the results of our anecdotal process, we create and analyze specific diagnostic questionnaires tailored to address the concerns of various constituencies: employees, managers, customers, vendors. The respondent universe is defined by the originator, the questions are customized, and the answers can be provided anonymously in just a few minutes. Questions can be both highly structured and open ended. Most importantly, the analysis is rapid and allows the creation of a consistent view not dependent on anecdote and individual perception.

The analysis is performed in real time, gives a good cross check to the interview results, and allows us to play with any “what if” questions instantly and follow a path of inquiry with ease. Focus shifts easily to the meaning of findings and not to questioning the judgment of the author of the report; business cases are immediately made far more compelling and easier to communicate than the results of interviews; and the transition to action is much more rapid. Millions of data bits about the opinions of many, both positive and negative, are quickly sorted by importance and performance, and displayed graphically and interactively, within seconds.

Such a CAT scan of the company creates the ability to see inside the corporate body to understand what is creating health, wealth, or disease. Every company has its own unwritten set of rules or culture, yet it is often invisible to executives. People talk to each other about what it’s like to be in the culture, yet it’s often anecdotal, not quantitative. This assessment process allows ownership and management alike to access powerful, laser-like insight into their organization, helping leaders align teams and build organizational focus around the most important and vital issues required to sustain competitive advantage.

THIRD: FOCUS ON GROWING THE PEOPLE

One of the greatest pleasures of working as a turnaround manager in often-desperate situations is to find out how very much people are capable of doing, and what remarkable achievements can occur when all are urgently pulling toward the dream of renewing the company’s fortunes. If owners could avoid complacency and access that energy and passion all the time, the value realization would be incredible.

Having seen people develop hugely when under the gun in dozens of situations, I realize it is because in turnaround situations people feel they matter hugely. Difficult circumstances cause people to look inside themselves and determine who they are and what they stand for. Blinders come off, and the perceived cost of a mistake seems low compared to the agony of inactivity. Passions to lead and risk and try harder come out in unexpected places as the purpose is urgent, initiative is often rewarded rather than stunted, and daily regimentation is reduced. Turnarounds allow people to be themselves, and often to be appreciated for being themselves in ways that they have never experienced before. When people feel they are being their best, most authentic selves and being appreciated and recognized for that, they can and often do achieve unbelievable things.

How can management be helped to inspire and engage employees every day to feel valuable and appreciated for who they are? In what may seem an ironic twist, emulate the best aspects of the turnaround environment: Foster growth by bringing company resources together around shared information and a shared context, a shared set of values and goals, and then encouraging them to try, to innovate, to fail, to grow, and to lead. Work actively to build an organization where people are rewarded for

initiative, not punished because they're the ones who know the most about the work. Empower people to develop themselves.

The reality today is that the people doing the work know a lot more about their jobs than their bosses ever will. It is not up to the boss to tell them how to do it, and often they have options to work somewhere else. Play to their need for purpose and meaning in work, not to their pocketbooks alone. Help people to understand the significance of what they're doing and value the meaning for which they come to work every day. And help them understand that the owner, likely far richer and more privileged than they will ever be, values what they do.

Private equity firms today are sometimes reviled as the home of smart people interested only in money, who confuse power with leadership and money with success. By bringing companies into their greenhouses, carefully cultivating their growth under protected conditions, successful private equity companies instead shift from a pure focus on money and numbers to understanding that the biological model drives growth. Their actions reflect the knowledge that sustained success requires tending to a living, constantly changing organism that is to a great extent the creation of a collective imagination. They know that the company in their care is not a tangible fixed thing called ABC Corp. but an organism in which the owner plays the role of farmer, dedicated to creating a rich medium for growth. It is a collaborative environment where owner, manager, and employee work together to craft value through embracing change, welcoming problems as opportunities to learn, grow, and realize dreams.

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Scenarios Help Private Equity Evaluate Price

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We need to look at more scenarios. Yes, it's comforting that we have excess cash in these uncertain times. But let's run the numbers again. What is the impact on the value of each of our key business units if oil prices increase or decrease 35% over the next three years? I am not sure that we have an adequate cushion to withstand dramatic changes like that. Our gross margin, earnings, and cash could be at risk.

"With all these uncertainties, I'm reluctant to ask the board to consider a share repurchase in either case. What will the value look like if we are unable to negotiate that new labor contract? What will happen if we take a strike? Can we still generate a 15% return per year in years two, three, and four of our plan? Should we sell those less-profitable divisions and buy back some stock?"

A few days later the chairman received a call from a private equity firm. "Are you available for dinner? We ran some numbers and would like to discuss taking your company private."

At the meeting the private equity player said: "We like your company and the businesses in which you operate. We would like to acquire your company for cash. We are prepared to pay a 15% premium over the average price traded over the last 30 days. Please give us your response in three days."

After the meeting, the chairman murmured to himself: "Who do they think we are?"

Will they break us up? We can't possibly reply to their offer in three days. We have several alternatives to evaluate!"

Not many people would build or buy a new home without looking at several alternatives. New visualization technology allows an architect or broker to give you a virtual tour of the inside and outside of a variety of different home designs. Yet, most business plans examine only one course of action. Despite the future uncertainties, many companies do a poor job of examining alternative scenarios. Successful private equity players¹ have long-term plans to create value and constantly consider scenarios that might build more value. Running scenarios provides insights on whether to buy or to sell a business or a business unit.

Effective strategies come from a full but never perfect knowledge of how the company will interact with its customers, supply chain, and competitors. By building scenarios, management can explore how the company will fare in varying states of its environment. Inputs on macroeconomics, the industry, and competition can dramatically alter business value. Prepared management teams are those who have tested their business model under a full range of inputs. Successful private equity players run scenarios to determine if they can extract value.