Looking Beyond Short-Term Fixes
Fundamental Change Needed for the Long Term

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In any turnaround of a distressed business there is a strong emphasis on short-term fixes. This concentration is natural because quick and decisive action is almost always necessary to save distressed businesses from bankruptcy or liquidation. The turnaround program, which usually occurs over a six- to 12-month period, invariably centers on certain key programs: short-term cash-flow management, asset restructuring, financial restructuring, and the creation of a plan for the future.

The successful completion of such a program typically results in a business in which:

- Cash-flow hemorrhaging has been controlled.
- Peripheral non-core businesses and assets have been sold or shut down, leaving a smaller company that is focused on its core business
- The balance sheet has been fixed, with some — and sometimes most or all — of the prior debt eliminated.
- New financing is in place.
- A business plan for moving forward and a management team to execute the plan are in place.

However, there is increasing evidence that the successful completion of such a turnaround program does not guarantee ultimate success. Studies indicate that as many as one-third of companies emerging from Chapter 11 are forced to file again under Chapter 22 within five years. *[1]*Moreover, a high percentage of business plans of companies emerging from Chapter 11 don't come close to being met. In one study, actual profits underperformed projections by a median of 80 percent. *[2]* Indeed, the record is such that some question whether the current process itself is the culprit. *[3]* How can turnaround efforts be improved?

One answer may lie in recognizing a number of realities:

- If a turnaround is feasible, a business almost always requires strategic, operational, and organizational restructuring, as well as financial and asset restructuring. Fixing the balance sheet is rarely enough.
- Turning around a business remains a significant challenge after the initial restructuring period. A company emerging from Chapter 11 or another restructuring process starts in a deep hole. Even though non-core businesses and assets have been sold, the remaining core business is not necessarily healthy. In fact, it is likely to be uncompetitive, have poor customer relationships, possess a tired or outdated business model, suffer from underinvestment in key value and growth drivers, and have a demoralized staff. Although short-term fixes are necessary to save a distressed company initially, the turnaround job has, in many ways, just begun when a restructuring plan has been agreed upon.
- There are situations in which a distressed business cannot be turned around and an "intelligent" sale — a sale of the business while it is still operating — is the best option.

The common thread running through these realities is the critical importance of a strategic restructuring and the execution of a business plan, particularly during the period immediately following the agreement of the restructuring plan.

Strategic Restructuring

It is difficult to underestimate the importance of a strategic restructuring. A company's past and current strategies led it into distress; if these are not changed, odds are the company will get into trouble again.

There is a perception that the problems of distressed companies derive from carrying too much debt on the balance sheet and that once a financial and asset restructuring is complete, the major problem is solved. The reasoning is that with its debts greatly reduced or eliminated and extraneous assets and businesses disposed of, a company's costs are reduced significantly.

However, fixing the balance sheet solves only one part of the problem. In fact, excess debt is invariably a symptom of more fundamental issues. These boil down to how the company derives value, profit, and cash flow from its business, which are functions of strategies and competitive positioning, operational effectiveness and efficiency, and organizational capabilities. Too often these fundamental issues are given only cursory attention in the rush to complete the restructuring process and emerge from Chapter 11.

Air Canada provides an example of this problem. After its restructuring is complete, Air Canada will have renegotiated labor and aircraft lease agreements, eliminated most of its debts, sold off certain assets, reduced capacity, and have a plan in place to deal with its pension plan deficit. However, these actions alone will not return the company to profitability, and it will still have a significant cost disadvantage versus its domestic competitors. Air Canada will still need to make fundamental changes to its business model and strategy to have a chance of succeeding.

Another often-heard misconception is that the time, energy, and resources needed to save a business leave little time to consider and plan for the future. The reality is that the business plan of a company attempting to emerge from Chapter 11 results from negotiations among many stakeholders, including management, turnaround professionals, lenders, investors, and the courts. Creating the business plan becomes a process of reconciling the varied interests of these stakeholders, gaining approval from the court, and securing new financing.

Unfortunately this creates pressures on the management and turnaround team to be overly optimistic about what can be achieved and to implore judges to approve their plans and enable companies to emerge from Chapter 11. However, while time may be short and the team may experience diverse pressures, appropriate planning nevertheless must still be done.

Despite these perceptions, the need for distressed companies to change their strategic positioning is increasingly being acknowledged. What is less understood is the degree to which the strategy needs to change — in almost all cases, fundamental change is required. In most industries the 80/20 rule applies; 80 percent of the value created in the industry is captured by only 20 percent of the companies.

A distressed company is unlikely to be in a position to compete head-to-head with industry leaders or even against average performers. The only way to overcome what might seem to be insurmountable disadvantages is to change the nature of how the company competes. This can only be done by redefining the business — what it does to create value for targeted customers and what role it plays in delivering that value.

The trouble is that many companies and investors are not comfortable with fundamental strategic change. Company executives, including the go-forward team, are typically chosen partly on the basis of their industry experience. In many cases they are recruited out of a leading company in the industry. Their natural inclination and training is to link fundamental change — "radical" change, from their perspective — to risk and opt for a more conservative approach.

Furthermore, a company's investors are comprised, in part, of previous lenders whose primary interest is in getting their money back and who see fundamental change as a potential threat to that goal. New investors, as part of their evaluation, will have completed industry comparables and believe that if the company can simply perform at the industry average, they will reach their return targets.

These attitudes inevitably result in strategies and plans that make insufficient changes and companies that fail to reach their targets. The paradox is that for a newly restructured company, fundamentally changing its strategic positioning is less risky than pursuing a more conservative tack. The turnaround industry has a role to play in this regard, both in educating investors and company executives on the greater risk of conservatism and by playing a role in devising and executing more appropriate strategies.

Operational and organizational restructuring naturally follows from strategic restructuring and, in fact, must be driven by it. All too often, companies focus on operational and organizational initiatives and targets that ultimately bear little relation to creating value for customers and, in turn, for the organization. They are rooted in a poor understanding of the basis of competition (usually cost) and result in processes and capabilities that are indistinctive and ultimately don't meet the needs of the restructured company.

Executing the Business Plan

Whether within or outside Chapter 11 or an equivalent process, enormous effort is required to reach agreement on a restructuring, gain approval for a business plan, and secure new financing. After considerable time has been spent on these initiatives — often a year or longer — it is easy to assume that moving back into a "normal" operating environment will be a lesser challenge. The turnaround team is usually disbanded, and the management team takes complete charge. The business has been saved; all that is left is to execute on the plan.

This assumption, however, is misguided. The ability to execute strategic and operating plans is an issue even for the best of companies. An entire body of management literature has recently been devoted to the execution gap, the difference between an organization's strategic goals and the results it actually achieves. In addition, the challenges in executing the business plan faced by companies emerging from Chapter 11 are arguably greater than those encountered by relatively healthy companies.

The line between the creation of a business plan and its early execution is, in many ways, an artificial construct. An organization's ability to execute should be a fundamental aspect of any business plan. Furthermore, the process of executing creates information and learning which, in turn, impact a company's plans. This is particularly true in fast-changing industries and in companies attempting to carve out new or different positions and to establish a growth trajectory, the situation often facing companies emerging from Chapter 11.

Begin Early

Starting early with a strategic review is imperative, despite the pressures that abound early in a turnaround engagement. Short-term fixes naturally take up the majority of time early in the process. But once triage is complete, thought must be given to how a business should be repositioned. Indeed, this consideration must occur before a determination is made that at least part of the business can be turned around.

Plans for repositioning the business must be pushed further during the creation of the business plan. Even if investors and the court are ultimately only interested in results, the turnaround team should be under no illusion as to what changes are needed to achieve the promised results.

In addition, the leadership of the turnaround and go-forward executive team is critical. These people devise and ultimately execute the strategic restructuring and must be able to persuade investors of its necessity. If this team is comprised of long-standing industry veterans or the same management team that existed prior to the restructuring, its members will have difficulty taking the required steps toward fundamental change.

Finally, the turnaround industry can build awareness of the critical nature that strategic, operational, and organizational restructuring — and execution during the early period of the plan — play in the overall turnaround process. As the turnaround industry matures, meeting this need will be a natural service to provide beyond the short-term fixes.

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[1] "Second Acts," Alix Nyberg, *CFO Magazine,* July 23, 2003.

[2] "Postbankruptcy Performance and Management Turnover," Edith Shwalb Hotchkiss, *The Journal of Finance,*Vol L, No. 1, March 1995.

[3] The argument that the current process attempts to save companies that should be allowed to fail is taken further by those who believe that the current process actually does wider economic damage. This view was recently expressed by David N. James ("The Trouble I've Seen," *Harvard Business Review*, March 2002), who argues that a company emerging from Chapter 11 with its debts wiped out is able to lower prices and steal customers from competitors who are obliged to continue to pay their debts. Thus, the profitability of the whole industry declines. However, James' view that companies emerging from Chapter 11 have a competitive advantage is troublesome; if this were the case one would expect more of them to succeed when, in reality, most fail.

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