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2

Executive Summary

Most sick businesses were once healthy. As you might expect, financial executives of healthy businesses want to help keep them that way. Know what can kill you, because otherwise it will—is the operative message.

This is not always as simple as it seems in hindsight. One reason for this study is to identify the causes of companies' financial woes more precisely than past studies have done. The financial executive of a healthy organization who recognizes the symptoms of trouble early enough to effect a cure is much less likely to end up with a sick company.

To avoid findings relevant to only one industry, we looked at 20 companies in five major industry sectors. We also wanted to identify effective strategies for reversing a troubled situation. That's why we sought to include only companies whose management succeeded in turning them around. In two instances, however, case-study companies encountered a second set of problems that led them to liquidate.

Causes and Remedies

Our study shows that incompetent management was seldom the sole cause of corporate problems. Only in the smallest businesses did we find managers whose abilities were not equal to the task. What we did find was that acquired companies sometimes had weaker management teams than the acquirer anticipated, distracting the purchaser's executives from the company's core business and exacerbating existing problems. Also we found that takeover threats might have encouraged management to take riskier actions in the short run than it normally would—and sometimes the short-term solution metastasized into a serious, long-term problem.

We also found a few instances of financial problems caused by major external shifts, although often some economic event was a contributing factor. For example, style shifts created problems for

Jos. A. Bank, the clothing retailer, and Forstmann, the garment-fabric manufacturer.

In any case, the majority of problems stem from broader strategic misjudgments in three areas, often in combination:

- Ill-advised strategic decisions—too big and too rapid expansion, overdiversification, and the failure to invest profitably and sufficiently
- Marketing failures—lack of customer and product focus, poor product quality, poor matches between sourcing and selling, and ineffective pricing structures
- Inadequate financial management—excessive leverage; lack of proper performance measures; accounting, information, and control systems that don't supply important data quickly and effectively; and poor management of daily cash flows

We found that companies used both short-term and long-term measures to reverse their ailing fortunes.

Short-term remedy

- Move from negative to neutral or positive cash flow

Long-term remedies

- Refocus on core strengths
- Redeploy assets to support this position
- Develop control systems to monitor the progress of the strategy
- Install incentive and compensation systems that reinforce strategic direction

Short-term crisis management is necessary if the business is bleeding to death. Management must staunch the cash outflow immediately and direct available cash flow toward maintaining essential operations. The situation, the responses, and their effects must be explained to the creditors, who usually have forced the crisis by calling a loan or refusing to extend additional credit. The sick company must be stabilized, at

Ch02.qx4 1/24/02 2:41 PM Page 3

least to a cash-neutral position. If possible, management should aim for a cash-positive situation because at this point it can at least make token payments to suppliers. This helps persuade suppliers that the situation is under control and that they will benefit more by supporting management's efforts to revive the business than by attempting to enforce their creditor rights.

Once the emergency is over, long-term remedial action can begin. This phase involves a careful but quick assessment of what caused the problems. In which of the three categories, or, more typically, in which combination of categories, did the trouble originate?

There are many potential responses to this question. All troubled companies, however, should concentrate on their core business or businesses, where they have the greatest competitive strength. They should restructure and deploy their assets to support those strengths. Then they must reinforce that strategy by setting up control systems that will provide sound information, which will accurately measure the company's successes and alert management to problems. Finally, they should design incentive and compensation systems that will motivate employees to achieve the company's goals.

Even if all the remedial actions succeed, management sometimes cannot avoid seeking bankruptcy-court protection. Despite the favorable press this remedy has received, our study suggests this route should be a last resort, to be considered only after efforts to solve the problem by negotiation fail. A Chapter 11 proceeding is expensive and time consuming. It is distracting for management, and, worse, it can be devastating if customers flee because they lack confidence in the company's ability to survive and stand by its product. In the long run, bankruptcy probably means that the common equity will be wiped out. Nevertheless, in some circumstances, we found that bankruptcy may be the only way for the business to restructure for survival.

Summary and Implications for CFOs

Overall, we found strong similarities in both causes and remedies across all industry types and company sizes. This fact may not be comforting to those who have spent their careers in one industry and believe "It can't happen that way in my business." Likewise, turnaround specialists—

Ch02.qx4 1/24/02 2:41 PM Page 4

company doctors—sometimes think the same way if they specialize in a particular industry. The good news here is that we can learn some universal lessons about pulling a company out of a financial nosedive even when we factor in industry and size variations.

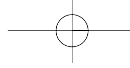
On a more human note, CFOs of troubled companies often face similar personal and professional quandaries. Of the three major causes of fiscal woes—ill-advised strategic decisions, marketing failures, and poor fiscal management—the CFO is directly responsible only for the third. However, he must alert the CEO and other executives to the financial implications of their actions, such as an aggressive credit policy, a change in inventory policy, or a rapid expansion of fixed assets.

Ultimately, however, the CEO makes the final decisions, and his strategic objectives can preempt the CFO's efforts to maintain fiscal responsibility. CEOs who are top-line driven, for example, are often impatient with any actions that would slow sales growth. They may override the CFO's recommendations or neglect to invest in adequate systems or personnel.

A CFO whose concerns have been overruled faces a serious dilemma: to seek a new employer or to remain at the post to maintain some continuity if the situation unravels. Without the CEO's cooperation and support, however, it is impossible for the CFO to function effectively. By the same token, the absence of a competent and supportive CFO will endanger the company, regardless of the CEO's abilities.

If you're the CFO of a company with financial problems, you should consider whether the satisfaction you might gain from contributing to the company's survival is worth the personal stress. This is especially true if the problems developed because management did not heed your advice. Managing a turnaround is not easy, particularly for those who were there as the problems arose. First, there is often friction between existing management and new management. The existing management naturally has an emotional commitment to the failed policies, plus, it is saddled with blame by subordinates and outside stakeholders. By contrast, the new management arrives unconcerned about who did what in the past.

Effecting the turnaround requires painful decisions about marshalling the company's cash, decisions that often result in layoffs or asset sales. Again, those decisions may be emotionally easier for new manage-



ment team members, who lack personal ties with laid-off employees and closed or sold facilities.

In addition, a turnaround requires a completely different managerial focus, at least temporarily. Rather than thinking of customers, products, and production, management must concentrate on cash flow and placating financial sources to keep the necessary resources available. This change in focus is so distracting that troubled companies often choose to have two teams at the top—one to run the business and one to negotiate the turnaround. Otherwise, neither job is done well.

In any case, whether your company is troubled or sound, you can learn a great deal from the cautionary tales that follow. Although these companies all faltered, in some instances more than once, their stories—however varied—demonstrate that strong leadership, a clear focus on the company's core products and markets, and sound fiscal management are still the bedrock of success.