Turnaround Issues – Does Management Have What It Takes?
By Howard Gross

Recent debt markets have seen unprecedented levels of liquidity and increased competition among traditional and alternative lenders coupled with mounting pressures to grow portfolios, all of which has led to some aggressive deal structures. A potential by-product of this frenzy is a due diligence process that may not be as thorough as it was in the past. One area that may not be given sufficient attention is the assessment of management. Whether it is signs of a downturn in a business or concern that economic storm clouds are gathering on the horizon, sponsors and lenders need to start thinking about the following:

Does management have what it takes to weather the storm?

An effective management team is critical to the success of any company. At no time is it more important to identify and retain the key members of management - and to remove those that are weak - than in a turnaround situation.

Experienced turnaround consultants often combine intuition and analytical procedures to assess the quality of management. Although many considerations are involved in this process, the analysis typically includes the following attributes: **Integrity, Relevant Experience, Leadership Skills/Style, Motivation, along with other factors.** We will review several of these items worthy of consideration when assessing a management team, which should help you determine whether you have the right leadership in place for any challenges ahead.

1. Integrity

In looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if you don't have the first, the other two will kill you." - Warren Buffet.

Management integrity is the foundation upon which stakeholders rely in supporting a business. Some of the key factors which can be used in the assessment of senior management integrity include, **background investigations, changes in personal circumstances and lifestyle, level of control over subordinates, senior staff turnover, compensation drivers, willingness to share information, unusual delays in delivery of financial information, overly complex corporate structure in the circumstances**, among many others.

Consider, as an example, the CEO, COO and CFO, typically the most important drivers of any company's success and the likely leaders of a turnaround. They should also play an integral role between all key parties, including the greater management team, employees, lenders, and suppliers. It is critical that they set the right message within an organization regarding financial reporting, accountability, full disclosure, and ethics, while maintaining open lines of communications.

Vagueness in responses, excessive defensiveness, or unwarranted delays to basic requests, may be danger signs that should not be ignored. We have also found in certain situations that excessive control over the dissemination of information and fear among staff (along with high turnover in finance/accounting) deserves serious attention. Further consideration should be given to Senior

Managements' level of dependency upon achieving unrealistic EBITDA thresholds to reach compensation packages.

2. Relevant Experience

"The only source of knowledge is experience" - Albert Einstein

Simply being hard working, energetic and enthusiastic will not suffice when a business suffers a serious downturn and is in need of a restructuring. Senior management must demonstrate that they have intimate knowledge of the business, its operating systems and capabilities, and an in-depth understanding of the industry in which it operates, in order to formulate the right turnaround plan. The nature of management's previous experience may no longer be appropriate due to company growth or reduction, acquisitions, product diversification, or changing industry conditions. Depending on the elements of a restructuring, Equity Sponsors and Lenders should also consider whether senior management has had previous exposure to divestitures and operating experience in a downturn and the associated stress factors and demands.

With the shift from traditional lending to a more diverse set of alternative lenders, future restructurings may be more fast-paced than ever. Management must demonstrate the ability to rapidly assemble information needed to formulate quick action plans in the midst of uncertainty and rapidly changing conditions.

3. Leadership Skills / Style

"Charisma becomes the undoing of leaders. It makes them inflexible, convinced of their own infallibility, unable to change." - Peter F. Drucker.

Restructuring a business can be an unpleasant experience. Senior management must be willing to admit that there is a problem and that certain decisions they have made (or not reacted to) contributed to the company's weakened position. They also need to be creative and willing to be a change agent. These skills are fundamental for re-engineering, cost-cutting, divestitures, and downsizing. Complacency can be a death sentence. If Senior Management is unable to recognize the issues and is unwilling or unable to recognize that aggressive action must be taken, then they may not fit into the Company's ongoing plans. This tends to be a more serious problem with long-standing companies which were once market leaders and have lived off the past for much too long.

A successful turnaround requires hands-on management. The leaders must be on-site and actively involved. However, leaders in a turnaround situation need to do even more; they need to be out of their offices and on the front lines with employees. They need to energize employees and instill confidence in them. Having these types of leaders meet regularly with staff in finance, administration, or manufacturing is important to keeping staff invigorated and confident. Organizational motivation is critical to a turnaround effort. Leaders whose style can be categorized as solely big picture or dictatorial will not provide the necessary inspiration to the workforce.

The management team also needs to communicate to the workforce the problems facing the business, the plans to address the situation, and the urgency of the situation. Often management doesn't want to "spook" the troops, but this will only make matters worse, as they learn about the company from the "street". Direct and clear communication provided on a regular basis helps employees feel they are an integral part of the turnaround process and shows employees how their contribution will benefit them and their company in the long-term.

4. Motivation

"Motivation is the art of getting people to do what you want them to do because they want to do it." – Dwight D. Eisenhower.

The motivation of the management team who can lead a restructuring is invaluable. Factors which should be considered in assessing their motivation level include their compensation structure, relationships among fellow management, prior undertakings by equity and associated expectations, as well as the stage of their career path.

Understanding the conditions upon which senior management was retained and the evolution of their position is vital to ensuring they are adequately motivated to undertake the arduous task of a turnaround. For example, we have seen CEOs hired months before a lender default being relatively disinterested, as they were previously provided with unreliable forecasts and EBITDA targets. They had not signed up for a restructure and were expecting large “guaranteed” performance bonuses.

We have also been faced with management teams that have intimate knowledge of the business but were relatively close to retirement and unwilling to make the required sacrifices to see the company through a crisis. Unfortunately, many of these de-motivated management teams are not identified early enough in the cycle to allow for the hiring of those better positioned to execute the actions necessary to rehabilitate the company.

5. Other Factors

Equity Sponsor – While Equity Sponsors often play a pivotal role in supporting a company, it is imperative to assess whether they have inadvertently stepped into the shoes of certain management positions (more often the CFO position) rather than hiring strong replacements for the company. While it may serve as a short term solution, the sponsor representative may not have significant restructuring experience and will typically not be there for the long term. In addition, the company may become sponsor dependant for key decisions resulting in the emasculation of the management team.

Middle Management – While the emphasis is usually on senior management, attention should also be paid to middle management. What are their skill sets? Can they replace certain senior management positions should the need arise? What is the depth chart? Much of the critical information and analysis which will form the basis of a turnaround plan will emanate from middle management, so it is important to evaluate their competency, experience, and control over information systems.

Compensation – Management and senior employees deserve to be rewarded for delivering results. In the case of a turnaround, compensation should be structured to reward them for their efforts and ability to return the Company to pre-established realistic levels of profitability (taking into consideration the appropriate measurement tool such as corporate EBITDA or divisional contribution, etc…).

Stage of Downturn – Some crisis situations happen faster than others. If the situation has turned into a survival situation, quick and drastic actions need to be taken immediately. This often means parachuting a CRO or turnaround specialist into the fray.

When Senior Management Doesn’t Measure Up

In a perfect world, an objective assessment of management takes place at the onset of a customer relationship. However, all too often, as unexpected crises occur, or as a company and industry evolve, equity sponsors and lenders learn the hard way that management is no longer capable of dealing with the tasks at hand.

If Equity Sponsors and lenders are faced with a troubled company and after considering the factors raised in this article find that management does not measure up, then they need to take the necessary actions. This may require a change of the management team or the involvement of a Consultant or CRO. The operational and strategic skills of an objective experienced outside professional are often what are needed to set a company on the path to recovery. Experienced specialists can increase the comfort level by formulating and directing a company’s turnaround strategy while either recommending required management changes or leaving the existing team to oversee the day-to-day business operations.

Being able to address the significant needs of a troubled company situation as it evolves (i.e. enhanced short term cash flow models and controls, revised EBITDA models, formulation and implementation of strategic and operational initiatives, etc…) often goes beyond the skill-set of a typical senior management team. Bringing in experienced motivated management or a turnaround specialist that can provide objectivity and superior analytical skills does not guarantee a perfect ending, but it is often the best opportunity to preserve value in a difficult situation.

Richter Consulting, Inc. has a comprehensive financial advisory practice in the areas of business reorganization, insolvency consulting and transaction advisory. If you have any business reorganization issues, including questions regarding this article, please contact the author, Howard Gross.

The content of this article is intended to provide a general guide to the subject matter. It is for general information and discussion only, and is not a full analysis of the matters presented. Professional advice should be sought regarding your specific circumstances.

Our reputation stands behind every assignment

Richter Consulting
200 South Wacker, 31st Floor
Chicago IL 60606
www.richterconsulting.com

Telephone: (312) 828-0800