Body of Knowledge

MANAGEMENT
LESSON 6
Basic Requirements for a Successful Turnaround
Successful turnarounds come in a variety of shapes, sizes, industries, and levels of distress. However, when assessing the probability for success and resulting longevity for a business in distress, there are certain issues that must be addressed. They require analysis, judgment, and decisive action in order for a turnaround to succeed.

A turnaround is only possible when:

- There are one or more viable core businesses
- The company has the management and infrastructure resources capable of supporting a turnaround
- Management understands and accepts the underlying causes of the company’s financial difficulty
- Key stakeholders, including lenders, customers, and suppliers, have confidence in management and the recommended turnaround strategies
- There is adequate financing to support a turnaround
- The company has a dedicated person to lead the turnaround

**One or More Viable Core Businesses**

At the heart of every successful turnaround, there must be one or more viable core businesses. Sustainability is measured by the company’s ability to generate ongoing profits and positive cash flow over a long period of time. However, simply because a business or business unit is unprofitable and/or lacks positive cash flow does not necessarily mean it is not viable or can’t become viable. Ultimately, a business must have unique, strategic competitive advantages that ensure ongoing, long-term positive cash flow.

Having a unique, strategic competitive advantage does not necessarily mean the business was the first to invent a particular product or service. Rather, it illustrates the customer’s desire to continue purchasing from a particular company instead of its competition. There are numerous examples of companies that were the first to market with a new product or service that eventually were not long-term viable.

Uniqueness can be derived from a number of areas. For example, analysis of product, price, place, and promotion, can provide insight into a company’s potential competitive strengths:

- Unique product or service
- Lower customer pricing due to a lower cost structure
- Business locations
- Ability to use the internet for purchasing or sales
- Unique approach to the promotion of a product—including advertising, public relations, and sales promotion
Any sustainable and unique, strategic advantage must result in ongoing positive cash flow. Depending upon the business, profitability is important, but accounting profits do not define long-term viability. A business must have ongoing positive cash flow, after debt service and unfinanced capital expenditures, to ensure its success.

Viability may be enhanced or even restored, under the right conditions, provided the necessary action steps are implemented during the time available. Within the context of the turnaround process, viability is a function of three key measurements:

1. Positive cash flow, through analysis of cash receipts and disbursements
2. Liquidity, through analysis of working capital
3. Solvency, through analysis of the income statement and balance sheet

**Business and Personnel Infrastructure**

Assessing the business’s personnel, as well as its organizational structure, is vital to obtaining insight into the potential effectiveness of a proposed turnaround plan. The ability to institute change starts with having a team that is tasked with developing and implementing strategies. Without internal cooperation at all levels of the company, a turnaround plan will be difficult, if not impossible, to implement and complete.

Some of the initial analysis that needs to be completed by the team includes:

- Whether there is alignment between the company’s overall business strategy and its organizational structure and size
- The opportunity to lower costs in its current configuration
- The strategy that will best suit the company, its capabilities, and customers going forward

Cultural alignment is also a key to success, which relates to the current leadership roles, reporting lines, and financial systems and controls. Without a coherent working relationship, a turnaround plan may not be viable. Some considerations include:

- Key leadership and employees should be incentivized in a way that is consistent with short- and long-term goals
- Sales teams need to be compensated on achieving the bottom line, such as goals based on gross margins versus sales volume
- Production or manufacturing teams should be incentivized on cost or efficiency measures, such as less process waste or defects
Analysis

Many, if not most, clients have more than one business activity. Frequently, more than one business activity is combined in the company’s financials. Each of these activities needs to be separated and the contribution margin, break-even, and location of each business analyzed separately. Client companies rarely know where they are making and losing money, primarily because their financial systems do not provide this type of information.

Contribution Margin

Contribution margin analysis is a fundamental building block of a broader break-even analysis. Contribution margin is defined as the difference between revenue and its variable costs, which is useful in determining the amount of margin being contributed to covering fixed costs and the profitability of individual products or services.

To ensure viability, the company must, at a minimum, have a strategically important reason to keep any product or service with a negative contribution margin. For example, a company may need to offer a product with a negative contribution margin in order to offer a full product line.

Even with positive contribution margins in all aspects of its business, a company may still be cash-flow negative due to its fixed-cost structure. Possible immediate responses to negative cash flow are:

- Reducing variable costs to increase the contribution margin
- Reducing fixed costs
- Reducing variable and fixed costs
- Increasing revenue, assuming the business has enough time and resources to implement the strategy

At times, the most successful strategies to combat negative cash flow are those that include changes in each aspect of the business.

Break-Even Analysis

Break-even is the point where the revenue a business generates begins to produce a profit based on its variable and fixed cost structure. Once break-even has been reached, each incremental unit sold increases profit by the amount of its contribution margin, assuming the additional volume does not increase the fixed costs.

A break-even analysis is only as good as the financial information used. The analysis of the financial records and observations of the company allow an understanding of the labor and overhead resources used by each business activity.

The key issues addressed by the break-even analysis are:

- Which business activities produce a positive variable cost contribution margin
- The number of fixed costs covered by the contribution margin
• The number of fixed costs that need to be reduced to reach break-even
• The activities with a negative contribution margin

The formula to determine the break-even point is:

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\text{Break-Even Unit Volume} = \frac{\text{Fixed Costs}}{(\text{Per Unit Selling Price} - \text{Per Unit Variable Costs})}
\]

\[
\text{Break-Even Sales Dollars} = \text{Break-Even Per Unit Volume} \times \text{Per Unit Selling Price}
\]

A simple example is a company that has:
• Selling price of $1,000 per unit
• Variable costs of $800 per unit
• Fixed costs of $10,000

The break-even point is 50 units or $50,000 in sales, which means sales must exceed these volumes for the company to be profitable.

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\text{Break-Even Unit Volume} = \frac{10,000}{(1,000 - 800)} = 50 \text{ units}
\]

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\text{Break-Even Sales Dollars} = 50 \text{ units} \times 1,000 = 50,000
\]

Managers can use a break-even analysis to assist in pricing as well as determine profitability. Using the above example, where the break-even point is 50 units, if the price is decreased to $900 per unit, then 100 units must be sold to achieve break-even. Conversely, if the price is increased to $1,050, then company only needs to sell only 40 units to break even.

Limitations to Contribution Margin and Break-Even Analysis
While the contribution margin and break-even analysis are powerful tools, there are some limitations, which are based on the information and assumptions used in the analysis, such as when:

• The designation between fixed and variable costs is not clearly defined, which can lead to either variable or fixed costs being overstated or understated
• The allocation of shared costs between different areas of a company or different products can lead to different results
• Different selling prices for the same product can present challenges in determining the impact of a price increase or decrease.
• Seasonal or unpredictable sales volumes can skew the analysis
• The company has a significant fixed-cost structure, a contribution analysis has limited value, although a break-even analysis is still important.
**Four-Wall Analysis**

A four-wall analysis is critical if the client has multiple locations that conduct similar business activities. Multiple retail sites are the prime example, but this analysis is also useful with many consulting and service providers. The four-wall analysis determines the contribution margin of the activities that occur within each location. Therefore, corporate overhead allocations are removed from the location’s cost when conducting this analysis.

A four-wall analysis is conducted to determine which locations produce a positive contribution margin. The analysis can also model the combined contribution margin that would be available if the money-losing operations were closed and determine if this revised margin is capable of supporting the company’s fixed costs. If not, then the analysis shows the amount of fixed cost reduction that is needed based on the contribution margin available.

**Adequate Financing**

Bridge financing can provide the cash necessary to meet the business’s requirements until sustainable profitability is achieved. When possible, securing sufficient bridge financing early is recommended, as a later round of financing is often more onerous and difficult to obtain. There are multiple sources of bridge financing, and any of them can be equally effective, depending upon the circumstances.

Bridge financing may be available from availability on borrowing-based and cash flow loans. Because incumbent lenders generally do not want their position related to collateral value to worsen, the company will need to demonstrate that the lender’s position is improved, or at least no worse, than its current position, and there are clear benefits to the lender by allowing the company to use its collateral for at least an agreed-upon period of time.

A new third-party lender can provide financing, although it is generally more expensive than financing from the existing lender in terms of the interest rate and related fees. Additionally, this type of facility may contain warrants and/or convertible debt provisions. Collateral for third-party bridge loans could come from unpledged assets, if any exist, or from a second position on already-pledged assets. If the bridge loan has a second position, it will be subordinated to the existing loan agreement and will require the existing lender’s consent.

Bridge financing can also come from the collection of cash from unusual sources, such as selling scrape, obsolete inventory, or underutilized assets.

In addition, there are techniques that can be used to enhance cash and liquidity in the short and long term. Relationships with certain customers that are unprofitable and/or tie up excess working capital can be changed or terminated. Likewise, product lines and processes that do not generate cash flow or that require excess resources can often be re-engineered or eliminated.
The key to success is to consider every realistic opportunity to obtain the cash required to finance the turnaround plan.

**Experienced Dedicated Person to Lead**

A final requirement is to have an experienced, dedicated person to lead the entire process, whether the ultimate outcome is a successful turnaround, sale of the company, bankruptcy proceeding, or a complete liquidation of the assets.