The Science of Operational Restructuring

By Neil Minihane, CTP, Principal, Turn Works LLC

When restructuring small to mid-sized companies (those with revenues up to $500 million) the traditional investment banker approach of selling divisions and off-loading plants as going concerns often is not an option.

Operators must look at the blocking and tackling aspects of the production and process functions to determine which have the largest potential for improvement. In this arena, the distressed company cannot afford another big mistake, so it is helpful to have a repeatable process that reduces probabilities for errors and quickly focuses on the root issues.

Having a repeatable process reduces operational restructuring to a science, one that follows integrated and repeatable steps that rely on cold, hard, unshakeable facts, not gut or intuition. There are situations in which, due to lack of reliable data, cash concerns, and timing, gut calls are necessary and must be made, but these should be the exception rather than the rule.

While all businesses are different in some way, there are commonalities. The universal commonality, management, is charged with generating increasing amounts of cash flow for the owners now and in the future (**Figure 1**).

The remaining commonalities lend themselves to a structured restructuring process. On a macro level, turnaround efforts can be broken down into five basic phases and then each one of these phases can be and should be subdivided into smaller actionable items. The five generally accepted stages of an operational restructuring are:

1. **Evaluation**
2. **Management Change**
3. **Emergency Action/Execution**
4. **Stabilization**
5. **Return to Normal/Return to Growth**

While these five stages are observed either formally or informally in every restructuring, the uniqueness among businesses shows up in how the different stages are emphasized: order, time, focus, energy, etc.

A structured process allows the turnaround specialist to drill down quickly and determine the various underlying problems. It also provides a foundation for the incumbent management, many of whom have never been in a distressed situation before, to grasp.

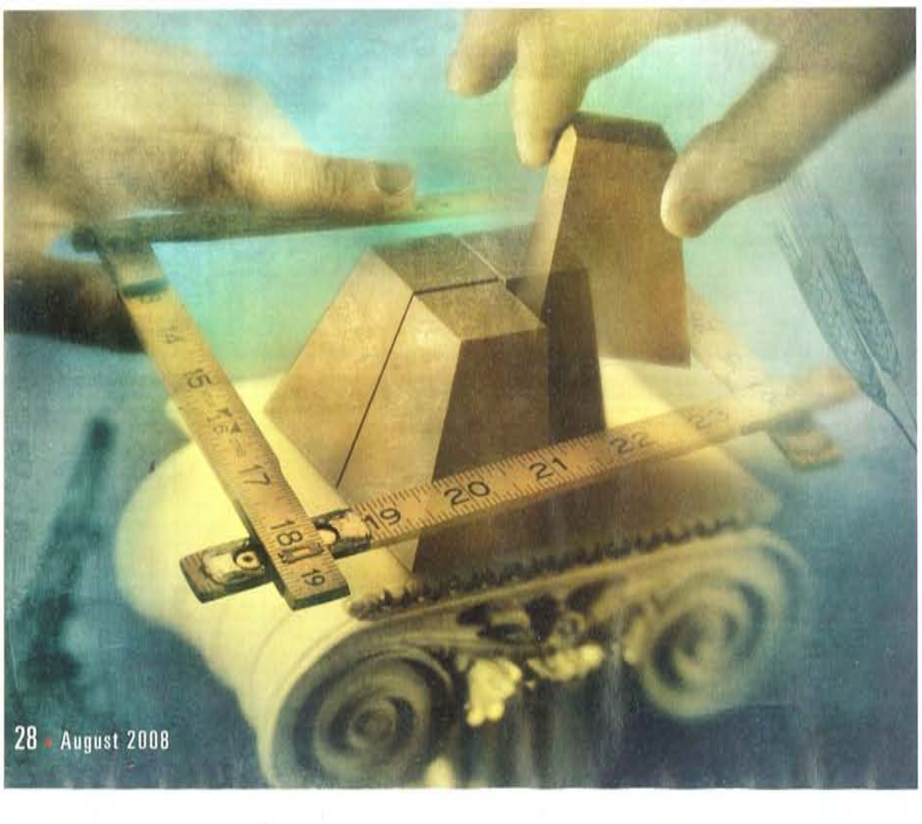

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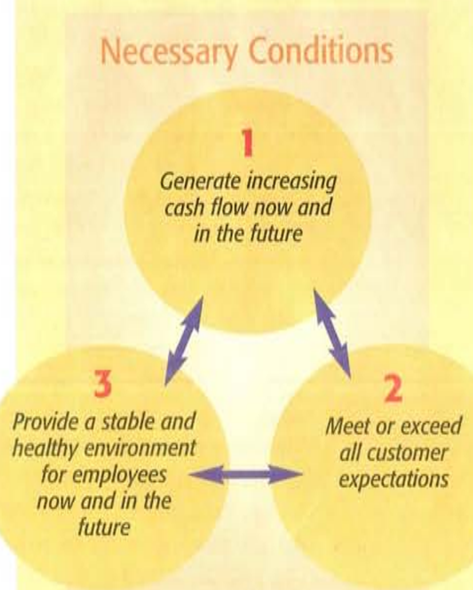
Figure 1: Management's Charter



When a company meets all three "Necessary Conditions" it will be successful and the cycle will perpetuate. If the cycle is broken, the company will stutter and eventually fail. The business environment is constantly in flux and so, too, must the position and focus of the company.

#1: Management must focus sharply on costs and product position.

#2: When management and operating procedures are strictly enforced and maintained, the proper products, correctly priced, on time and with great and consistent quality will follow — hence customers expectations are met or exceeded.

#3: A good strategic vision will balance a company's demand load — avoiding layoffs — helping to create a healthy environment. Layoffs are often a result of management's inability to implement change and are an 'easy-out' for top management (i.e. management makes a bad decision and the employees pay the price). In cyclical/seasonal businesses management must plan for the downturns by diversifying products/services with different cycles or structure the company and workforces around this reality. Do not misunderstand, if management has made bad calls then layoffs are absolutely required. But the issue that has to be addressed is why the layoff was required.

Employees look to the turnaround specialist for leadership to help stabilize the atmosphere and to provide a roadmap out of the current situation. It is the employees who do most of the heavy lifting. Ensuring that they know the thought process, rationale, direction of the company, and how it is going to get there provides them with much needed insight and the opportunity for participation and buy-in.

The management especially needs clear objectives that, preferably, focus on cash. Invariably, incumbent management wants to grow its way out of the losses. This is a flawed approach. In many ways a company does not control its top line. The economy, customers, competitors, and the specific market all exert forces that determine if the company wins new business and at what price. Revenue growth, in the short term, is more often out of management's control.

Thus the initial turnaround focus is typically on the cost structure (even "fixed" costs are variable over time). So companies do well to forget about growth for a while, fix the cost structure, stabilize the business, and return to profitability. Then, growth opportunities can be explored.

New ideas may emerge with a right-sized footprint and the core assets of tomorrow firmly in place. Management must remember that cash is king. One cannot dismiss the importance of depreciation, but emphasizing earnings before interest, taxes, depreciation, and amortization (EBITDA) could lead to an inefficient conclusion and a poor investment choice. A cash return on an investment is the only return that counts.

Meet 'DAN'

Why does a company get into trouble? There are various reasons, but one constant is management's friend, DAN[1], an acronym for:

- **DENIAL** of the problem, despite broken bank covenants, cash flow problems, poor financial performance, or other issues.
- **ARROGANCE** that allows management to believe it has been through this situation before and knows how to solve it without outside help. Management is blinded by an "everything will be fine" attitude. "This is not a big issue. Just sit tight and ride it out," it believes.
- **NOSTALGIA,** or longing for the good old days of three martini lunches and fat profit margins. "The company never had this problem when ... (fill in the blank)."

One or any combination of these three DAN components occupies management's time and energy and fills space in the problem-solving gap. When DAN is coupled with the fact that many troubled companies do not know their real costs, the components of those costs, and how to adjust the cost structure, it becomes clear why a company is struggling.

The term "management change" can refer to replacing incumbent management or simply working with the management team to change perspective and approach. If a company's management is open to change and is looking for guidance, it is often best to retain them. They know the company, customers, suppliers, and the market and, with buy-in, they can facilitate change quickly.

Even simpler than the five stages of a turnaround effort is the three-stage model that describes the problem, the solution, and the improvement process, and is detailed in **Figure 2**.

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Figure 2: Operating Improvement Process

1. The Problem:
- Costs too high [Revenue – Costs = Profit (Loss)]
- Productivity too low (Units per labor hour)
- Too much indirect labor
- Sales and general administration expenses too high

2. The Solution
- Fix management by making clear, definitive decisions backed by hard numbers and logical thought processes
- Fix standard costs bill of material (BOM)/routing
- Reduce all costs
- Monitor productivity daily
- Monitor product sales revenue versus product costs (loaded and unloaded)
    a. Report and monitor key indicators daily/weekly/monthly

3. The Improvement Process
- Know what the costs are and should be (both internally and externally)
- Use financial statements and develop detailed financial reports itemized by product
- Determine product actual and standard costs, broken down by variable and fixed costs.
- Verify BOM and product routing.

Focus on reducing fixed and variable costs
- Use scientific management, in which floor managers make improvements based on data from their stop watches
- Watch overhead costs closely
- Increase productivity through careful tracking, worker incentives, and improved processes
- Weed out losing products

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The problem often involves market dynamics that are beyond the company's control. The market no longer values the company's offerings at the price it charges. The reason could involve any of Harvard's Michael E. Porter's elegantly detailed "Five Forces," such as a substitute product offering or lower cost option, changing customer tastes, or a disappearing market. No company, regardless of effort, can reverse or change these dynamics, and the company must embrace them. Again, DAN comes into play.

How is the company losing money, or where is the company making and losing money? Depending on the company and industry, this can be compartmentalized by geographic region, product line, market segment, facility, or individual product. By viewing the company from a variety of perspectives, one can determine what is generating cash and what is draining it.

This type of detailed analysis occurs in each of the five stages. However, a turnaround specialist must be cautious not to get too tied up in the minutiae. If this happens the pace of change grinds to a halt.

A good plan is not perfect. One should pick the low-hanging fruit and return for another pass once the company is stabilized. A turnaround professional should follow the Keep It Simple, Stupid (KISS), approach and break every function down to simple steps. Simple measurements are easy to manage and troubleshoot.

Using a stopwatch is helpful in solving the tug-a-war over function rates. Each step in the process should be carefully isolated and timed. Along the way, methods to improve the system by rearranging the shop floor, modifying tools, or eliminating a movement should be identified. Supplying instruction cards so that the employees do not need to think about what to do can be helpful. The company must understand how each position and function adds value. The key is to blend a strict standard operating procedure (SOP) culture with floor management that continually learns from employees and updates instructions/procedures accordingly.

A Structured Approach

In the manufacturing and process-oriented arena, low-cost production is necessary to win. Exceptions, such as Caterpillar Equipment Corporation, do exist. CAT equipment is among the most expensive on the market, but intangible benefits, such as 24-hour service and access to supplies anywhere in the world, have allowed the company to charge a premium.

Even with this distinct advantage, however, the Caterpillars of the world must consider the low-cost/value producer equation carefully. Management of these companies must watch the costs and the market while constantly updating procedures and offerings. A strict operating discipline, along with a tight financial reporting model, are key factors in cost control, product quality, timeliness, and customer satisfaction—hence financial success.

When a company's deliverables and the market's values do not align, the business underperforms. A turnaround specialist must be an analytical third party with a cold eye for facts, someone who can review operations, enumerate issues, and then develop solutions for each—one at a time, in a prioritized and methodical manner. A structured approach to this process is valuable, and the five stages of a turnaround provide guidelines. •

[1] 'DAN' was introduced to the author through a personal friend who learned of the acronym at an industry conference in San Jose, California, during an executive's presentation. The executive attributed DAN to an unnamed consultant who once worked for his firm.

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