THE BOARD'S ROLE IN A TURNAROUND

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We've discussed in previous articles how productively acknowledging that an organization is struggling financially can be a challenge. How, instead of avoiding this issue, management and board members should have an honest and constructive discussion as soon as possible. Addressing warning signs of financial distress early could be the crucial step to rescuing your company.

When experiencing underperformance or financial distress, companies often implement a mitigation or turnaround plan. Afraid to broach the subject, their plan is frequently developed in a vacuum by management, only casually mentioned at the board level and initially given a non-threatening label, such as rejuvenation plan, task improvement, transformation, profit maximization, etc. These early plans are often tactical in nature and can include laying some people off, initiating a hiring freeze, adjusting the ERP system, or improving the business process.

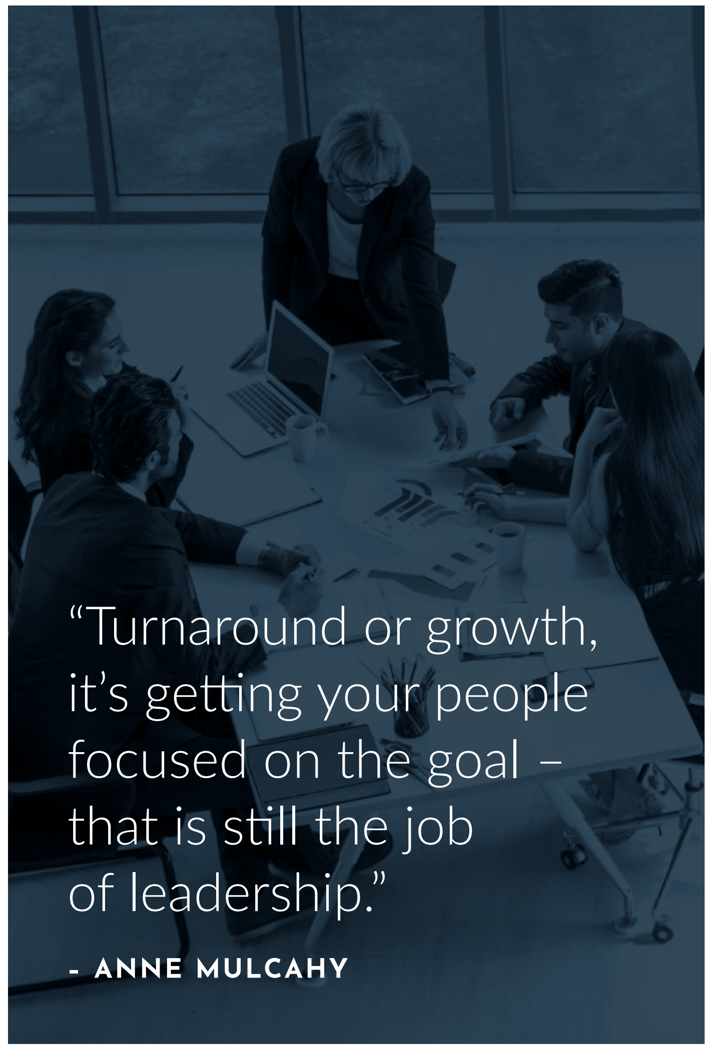
TURNAROUND SLIPPAGE

Later, if not effective, these tactics can drift into more radical actions that may be labeled a turnaround plan and include actions like exiting markets, offshoring production, and deferring capital projects. In both stages, the primary effort is on operations and the left side of the balance sheet.

If more radical actions still don't achieve the desired result, creditor negotiations may be necessary. These activities involve the right side of the balance sheet. I call this erosion of operations in the face of increased mitigation efforts, "turnaround slippage." Performance continues to deteriorate, and more problems appear despite the turnaround actions being increasingly aggressive.

HIGH ALERT

When there is meaningful underperformance and management begins a transformation, turnaround, or similar plan, the board should be on high alert. Understanding what is happening and management's planned responses are only the start of a board's work in these circumstances.



> "Turnaround or growth, it's getting your people focused on the goal – that is still the job of leadership."
>
> **- ANNE MULCAHY**

Monitoring progress and discussing whether the plan is aggressive enough to address the problems are some of the steps in validating the veracity of the plan. In short, being on high alert against turnaround slippage. There should be a board-level dialogue about the cost, resources needed, timing, measurement of progress, risks, and compensation issues of the company's turnaround plan.

"SEEMS-LIKE-THEY'RE-ON-IT" APPROACH

All too often, the board gets a casual update and then becomes "satisfied" that "management is on it." Frequently, this is not the case. Here is a typical management/board dialogue:

CEO: We seem to be encountering some headwinds in our main operations, so the team has put together a plan to reduce costs.

Board member 1: Are we firing people?

CEO: It's a combination of things. We're eliminating some redundancies, cutting back on advertising, and laying a few people off.

Board member 1: How many people?

CEO: About 3% of total employees.

Board member 1: OK good, that's not too many.

Board member 2: Right. Seems like they're on it.

CEO: We'll check in later in the year and report our progress. Next agenda item …

The board feels satisfied and management didn't have to give many details or have their plan tested. People are happy … and then there is turnaround slippage.

ENGAGED GOVERNANCE IN A TURNAROUND

While much of the day-to-day execution for a turnaround plan falls to management, meaningful engagement by the board can provide a solid foundation for success. This means management should carefully coordinate with the board, and the board should be prepared to oversee the implementation and progress of the plan. Ideally, the board has members with turnaround experience who can probe the turnaround plan and contribute towards getting the company back on track.

Engaged governance is when the board is deeply involved and focused on problem solving, not merely getting reports from management and providing some encouraging words. Engaged governance partners the board with management's turnaround plan and the related progress. Management and the board are "both" in it together.

While this approach may not be necessary in every turnaround situation, it is an effective strategy to guard against turnaround slippage.

Below are some tasks for a board in a serious turnaround situation using an engaged governance approach.

1. **Understand the nature of the problem.** A few examples of problems include:
   - A competitor's new product is taking market share.
   - Inflation is increasing the cost of goods sold.
   - The company is "over-leveraged" or experiencing unaffordable interest expenses.
   - The company has debt that is maturing soon.
2. **Understand how the problem impacts enterprise value and debt capacity.** A few examples of this are:
   - EBITDA is a primary value driver and is declining.
   - Revenue growth is slower than the market expects, resulting in stock declines.
   - Receivables are not being collected and are limiting access to financing.
   - Underperformance may result in violating a loan covenant.
3. **Understand the situation as completely as possible, including possible pain points and other problems that may arise:**
   - Know your loan documents. At what point might underperformance result in a covenant default, going concern audit opinion, or limit access to additional funds?
   - Understand cash flows: Use a detailed 13-week cash flow forecast to understand the company's cash-conversion cycle, liquidity needs, and ability to potentially stretch payments.
   - Communicate what is expected of management, including the timing and format of progress updates.
   - Gather competitor intelligence for context on other turnaround strategies in use.
   - Consider the impact of the plan on other stakeholders, including employees, customers, and suppliers.

4. **Managing communications with the market and understanding perspective.** It's not right to expect the stock price to increase if you don't understand what the market wants to see or is expecting in terms of performance. Also, understanding what investors are seeing or expecting in other situations (e.g., with competitors) can be valuable.

5. **Work with management to develop a detailed strategy to address the problem.** The strategy should also include the necessary tasks, milestones for achievement, accountability to various managers, and expectations for measured improvement.

6. **Develop and monitor key performance indicators (KPIs) to track the progress of the turnaround and have these reported frequently to the board.** Having milestones and dates for expected progress can be valuable indicators for the validity of a turnaround plan.

7. **Align compensation to the desired actions.** If you want something done, it needs to be measured and aligned with compensation. While compensation is usually set on an annual basis, starting earlier may create strong incentives to avert a crisis.

8. **Designate a responsible person to be accountable for implementation and reporting of the turnaround plan.** This person, sometimes the CEO, is tasked with getting the organization to take the necessary steps to address problems and report progress to the board of directors.

9. **Watch for secondary effects of distress.** Problems can create other problems. Being aware of the secondary effects of distress in a turnaround situation can help provide early warning signs of other problems. For example, reducing customer service as part of a cost-saving measure could result in lost sales.

10. **If the expected progress doesn't occur, consider pivoting to an alternate or more radical plan.** Not every set of actions will result in success but learning from what is and isn't working provides vital information to turnaround a business. Plans not cutting deeply enough early on is a frequent problem where board interaction can help.

11. **Consider bringing in outside help to affect the turnaround.** This decision is often viewed purely as a matter of cost, but effectiveness should also be considered. For example, does the company have the resources necessary to achieve a turnaround organically or does that stretch the team too far?

12. **Be prepared to take radical action if management isn't up to the task.** Yes, that can include replacing key C-suite executives. A board's role isn't just determining compensation of the company's management team, but also determining if the company has the right team to succeed. Some team members will flourish in a turnaround environment, some will benefit from coaching or working collaboratively with turnaround professionals ... and a few may be top-grading candidates.

CONCLUSION

Engaged governance might seem too intrusive for many boards and management teams, and they may not be used to such close collaboration. However, by not working together closely during serious situations, they risk failing to implement a successful turnaround plan, which can result in worsening financial problems, loss of investor confidence, and even bankruptcy. When management and boards are engaged and open-minded, they can achieve better outcomes.

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Investment banker and restructuring advisor with more than 30 years of experience in advising companies, creditors and other stakeholders in distressed, bankruptcy and special situations. Advised clients in more than 150 transactions with total aggregate debt well in excess of $100 billion and testified as an expert witness in more than a dozen matters. Experienced board member at public and private companies.

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