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Assessing Business Viability and Beginning a Turnaround Process

In larger companies, a business turnaround almost always begins with a management change. Poor management is the major cause of business failure, and outsiders are usually brought in to provide a critical perspective, new ideas, and relevant turnaround experience.

Smaller businesses that are entrepreneur-owned generally do not believe that an outsider can understand the business as well as they do, and the owners are usually not willing to put themselves out of work. Unless the owner gains confidence in a turnaround consultant and is willing to manage his business in radically different ways, the likelihood of a successful turnaround is small.

Stabilize cash flow
The first step in a successful turnaround is to stabilize the cash flow and stop the bleeding. Get control over all activities that involve working capital by determining the major reasons for poor cash flows and then seriously managing them. The most common causes of poor cash flow are:

- not collecting accounts receivable quickly enough,
- buying and maintaining excessive inventory, and
- inadequate management of accounts payable.

The critical step here is to forecast cash flow in the smallest unit of time (days or weeks) that is appropriate based on the company's operations, and then make all efforts humanly possible to balance inflows with outflows.

Very often in a negative cash flow situation, the creditors have lost confidence in management due to continual (intentional or unintentional) misinformation. Reestablishing confidence in the company is critical, because creditors that trust you will let you pay more slowly, and customers that respect you will pay faster. Do not wait for suppliers to call you when you expect your payments will be delinquent, and do not think that you can keep your problems a secret. The best way to reestablish confidence with your stakeholders is by talking to them and making a series of promises that you can keep. Sharing and meeting accurate forecasts gets everybody back on the same side and turns potential enemies into partners.

Analyze long-term viability
The next step that a consultant should perform is a situational analysis to assess the longer-term viability of the business. The factors to consider are:

- What stage of decline is the company in? (See my previous article "Which Debtor Companies Will Emerge from Bankruptcy,")

- What parts of the business have potential for profitable operations?
- Will there be financing available during the turnaround period?
- Does the organization have adequate organizational resources to realize its potential?

The key elements to look at in each of the above categories include the industry that the company operates in and the company's position in the industry, the abilities of the company's management, the company's cost structure, and the company's capital structure. Management in a small company will often have very different perspectives on these elements than an outside consultant will, and it is important for the consultant to get management's trust before going any further with the analysis.

Management abilities & structure
In smaller companies, the management structure is often the most critical element to a successful turnaround. Is management willing to admit the seriousness of the problem? Can the entrepreneurs stop focusing on growth and indications of wealth-building long enough to focus on cash flow? Are strong-willed and domineering entrepreneurs willing to admit that they have made mistakes and be open to radically new ideas? Does management have the ability to draft a clearly defined action plan with timetables and performance measurements, and then stick to it? Can the owners focus on the less sexy but critical aspects of running a business, such as administration, information reporting, and communicating both internally and externally?

Cost structure
The company's cost structure is important to understand because cost reduction efforts usually produce more immediate results than trying to increase sales or liquidate assets. Cost reduction strategies include the elimination of all activities that do not add to profitability, and the generation of efficiency improvements.

To an outsider, there is often significant "low hanging fruit" that can generate immediate cost savings, such as discontinuing unprofitable products or services, closing or relocating unprofitable locations, headcount reductions, etc. Unfortunately, these are often the elements of the business that are nearest and dearest to the owner's heart, and the decision becomes a tug of war between the emotional and the financial.

Unprofitable or inefficient activities utilize a disproportionate amount of resources (time, money, attention, etc.), but often do so because they are what the owner most enjoys doing. Some owners are reluctant to lay people off, even when keeping them on the payroll seriously threatens the company's continued existence.

Industry position
The company's position in the industry is determined by its market, customers, competition, suppliers, the capital market, substitute products or services, and the economy. Analyzing these factors requires both historical data and forecasting.

Smaller firms often rely on a small number of major customers and or major vendors. In an economic downturn, companies that are too reliant on a small number of critical partners are often the first to get squeezed. Customers with excessive market power will slow down purchases or payments, while vendors with excessive market power will remain inflexible with prices and payment terms. A strong industry analysis can help determine the feasibility of revenue-increasing strategies (price reductions, increased promotions, etc.) or the need for asset-reduction strategies.

Capital structure

Analysis of the capital structure of the business will determine what financing options are available to keep the company alive while it heals. Typical options include asset sales, secured financing, employee stock ownership plans, debt restructuring, equity infusions, bankruptcy, or in extreme cases for small businesses, simply walking away from the company.

Restructuring

Subsequent steps in the turnaround include financial and organizational restructuring to fix the causes of the problems. In almost every case, the problem is a matter of management trying to do too much with not enough resources. Management needs to fully understand what the value drivers are in the business, and focus only on those activities that add value.

Value is determined by cash flow (sales, margins, fixed assets, working capital) and cost of capital (cost of debt, cost of equity, capital structure). Anything that improves cash flow, including administrative activities such as planning and reporting, adds value. Anything that causes continued cash drains detract from value. If the activities that add value are not the ones that management most wants to be involved in, than an exit strategy is needed.

Sidebar:

Internal Causes of Failure

Despite what most management would like to think, most causes of failure are internal. The most common internal causes of business failure are:

- Ineffective management
- Undercapitalization or excessive leverage – trying to do too much with too little
- Lack of planning and budgeting
- Lack of timely internal reporting and information systems
- Over-dependence on key individuals
- Owners concentrate exclusively on technical issues
- High concentration of customers

Second Sidebar:

Checklist for Situational Analysis:

- Accounts Receivable
  - What is the quality and aging of the receivables?
  - Are there substantial charge-backs?
  - Are there offsets against amounts owed?
  - Are there heavy concentrations?
- Inventory
  - How fast is it turning?
  - What is the mix of finished goods, work in process, and raw material?
  - What is the mix compared to usage forecasts?
  - Are there pockets of inventory gathering dust somewhere?
- Accounts Payable
  - Has the company dishonored commitments or bounced checks?
  - Is the company issuing postdated checks?
  - Are vendors shipping? On what terms?
  - What promises have been made?
  - Have vendors been prioritized based on immediate needs of the business?
- Information
  - Does sufficient information exist to accurately forecast cash flows?

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