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Dedicated to my wonderful sons, Justin and Jered, for their encouragement, their senses of humor, and for teaching me what's important in life
Employees at Rhodes Plastics in Linden, New Jersey, trudged through another dreary March day. The plant received its raw materials and supplies at one end of the building, converted them into sterile packaging for the food and drug industry, and shipped them out the other end. The office workers were the first to register shock and confusion when armed sheriff deputies stormed in and ordered everyone out of the building.

“You will take nothing, not even the family pictures on your desks!” one officer shouted. “Not until the bank figures out who owns what.”

While locksmiths arrived to change all the locks, the plant workers were ordered out and told to leave even their own tools behind. Unbeknownst to everyone there, the company’s top officers had failed to convince the company’s lenders that they could turn the company around. Unpaid suppliers and customers with unfilled orders would soon share in the employees’ shock.

Although your problems may not be as dramatic, chances are, at some point in your career, you will participate in a turnaround. No matter how profitable you have made your business, or how recession-proof you consider your industry, you will find yourself dealing with a troubled company. Perhaps your own company will need to reinvent itself to deal with new competitive realities, or perhaps a valued customer will begin paying you later and later due to its own internal distress. You may even serve on the board of a nonprofit organization that requires its own strategic, operational, and financial initiatives to remain viable. Whatever the case may be, you will—with near 100 percent certainty—be party to a turnaround at some point in your professional career.

Introduction: Conditions and Causes of Distress
A turnaround is any effort to revitalize and make a clear change in the direction of a struggling business of any size. It also applies to improving a business that has simply underperformed its competition. Understandably, many executives are reluctant to admit that their firm needs a turnaround, so I began using the term corporate renewal almost a decade ago; they seem to find it a bit less threatening. These terms can apply to an entire company, a subsidiary, or just a division.

The turnaround field relates to companies and nonprofits with clear problems, but also to those who should question whether their employers, customers, or suppliers are on the wrong track. Years ago, I met with the CEO of Siemens Corp., a $100 billion company based in Munich, Germany. The CEO has 700 internal consultants, but still pays out tens of millions of Euros per year on outside consultants, none of whom could prevent the fact that at any given time, at least one of his business units would invariably be performing poorly. He asked me very frankly what “turnaround consultants” do differently than the big consulting firms. This book will answer that question.

Bob Johnson, the highly successful entrepreneur and founder of BET (Black Entertainment Television), asked me to speak to his executives. Although I usually meet with companies in trouble, I met with his staff while they piloted one of the most successful and profitable companies in the country. BET wasn’t in trouble—but Johnson was smart enough to want to know why so many similarly successful companies got into trouble, and he wanted his entire senior staff to recognize the warning signs and avoid similar pitfalls. The saddest cases are those that fail to heed the many early warning signals that they are in trouble, or that a customer or supplier is in trouble, until the damage is irreparable.

I have told my students at Northwestern University’s Kellogg School of Management as much for the better part of the last decade in my “Managing Turnarounds” class. The course draws on my three decades of experience helping salvage troubled companies and returning them to profitability, and this book codifies the lessons I have learned in that time and applies them to a broader audience that will surely need them in volatile economic times. I also teach “New Venture Formation” at Kellogg, a pairing
that strikes some executives and students as unusual. However, as I explain in the very first class of Managing Turnarounds, turn-around situations often resemble startups in the demands they place upon management. Effective turnaround managers must often become much more entrepreneurial in their approach to any turnaround, and entrepreneurs also should heed the lessons here.

**Turnarounds as Entrepreneurship**

As already mentioned, one need not work in the field of turnarounds and restructuring to apply the lessons of this book. Turnaround CEOs face many of the same challenges faced by entrepreneurs. In fact, the following ten conditions most frequently encountered by turnaround professionals are also characteristic of entrepreneurial startup situations.

**Lack of Cash**

Most entrepreneurial ventures fail due to undercapitalization, which prevents a company from gaining sufficient working capital to fund its operations until it can create positive cash flow. Even rapid growth can exacerbate this problem, for as Figure I.1 demonstrates, the gap between cash outlay for salaries and supplies that occurs later in a company’s life (G2) typically exceeds that same gap earlier (G1).

Such a cash crunch also rears its ugly head during turnarounds, for it is precisely the lack of working capital that brings a company into crisis. In both cases, turnaround managers and entrepreneurs must carefully scrutinize any expenditure requiring a cash outlay. Both types of managers must quickly and accurately determine which expenditures are absolutely critical to the company’s ongoing operations (payment to key suppliers or payroll taxes) and which can be delayed (a new machine or holiday party). Both types of managers must also find short-term projects that generate cash, such as the sale of nonproductive assets. The successful execution of such projects not only frees up incremental liquidity but also restores credibility with suppliers, customers, and employees. Cash is an issue for large as well as
small companies. One of my students, a young entrepreneur who developed a new energy-bar business, found himself running out of cash despite a truly phenomenal growth in new orders. He wound up on the ABC television show *Shark Tank* to raise money from a rather nasty panel of financiers of ventures. He succeeded in procuring financing for his small business, but most do not. At the other end of the spectrum, it was a critical cash shortage that caused Flying J—an $18 billion company—to come to a screeching halt. Best known for its truck stops, they missed payroll only days before Christmas, forcing them to file bankruptcy on short notice. They failed to monitor true cash availability, relying instead on “book” earnings, a subject discussed in more detail later.

**Analytical Needs**

In a crisis, a turnaround manager often must focus on near-term problems with near-term solutions, typically those related to the cash issues discussed previously. Similarly, entrepreneurs make investment decisions based heavily on the timing of cash outflows...
to ensure that the fledgling enterprise can remain viable long enough to turn profitable. As a result, entrepreneurs and turnaround executives both have little use for widely used Generally Accepted Accounting Principles (GAAP), as the accrual methods of accounting that they prescribe are irrelevant if a company cannot continue as a going concern. One subtle difference is that turnaround managers frequently must “shock” accountants or chief financial officers out of their historical reliance on GAAP accounting methods, whereas an entrepreneur rarely encounters such problems, if only because of the realization that every dollar is their life blood to survival.

Aside from its manipulability, GAAP provides little value to these managers because it provides an incredibly detailed account of the company’s historical performance at a time when the only thing that matters is the accurate forecasting of each of the next thirteen weeks. Both types of executives require up-to-date information about how various strategic decisions—increasing a startup’s advertising reach, perhaps, or selling a division of a troubled company—will affect the company’s cash balance. The accrual accounting methods of GAAP often mask the cash effects of such decisions, and its assumption of “smoothed” and “matching” of collections and disbursements can project a break-even financial quarter when in fact the company’s cash balance will turn negative in a matter of weeks. As such, managers in startups and turnarounds alike have no use for the historical analysis tools provided by GAAP—they must take more of a pragmatic forecasting approach to financial analysis. This concept is discussed in depth in Chapter Four.

The J.A. Jones Construction Company was a highly successful contractor based in Charlotte, North Carolina, with billions of dollars of massive construction projects under way around the world. Jones appeared profitable, because income and expenses were booked according to GAAP. Their projects, including eight new U.S. embassies, hotels, airports, hospitals, and office buildings throughout the world, all came to a halt when the company ran out of cash and declared bankruptcy.

One should not confuse executives’ manipulation of earnings reports allowed under GAAP with fraud. When CEO Garth Dabinski changed the depreciation and other schedules at
Cineplex Odeon to make earnings look deceptively strong, those moves were technically permissible under GAAP. While the accounting changes allowed him to show a $40 million profit, in reality the movie theater chain bled over $50 million in cash that year, because he focused on financial engineering instead of on the turnaround tripod discussed in Chapter Three. Dabinski later fraudulently changed accounting records at LiveEnt Company, for which he is now serving a seven-year sentence.

**Hiring Difficulties**

Entrepreneurs and turnaround managers also constantly face the problem of recruiting and retaining quality employees. Employees naturally gravitate toward stability, something neither a startup nor a distressed company can offer. The entrepreneur must recruit new employees without any guarantee that the company will thrive sufficiently to pay their salaries, while the turnaround manager often finds a staff whose most qualified members have already departed, leaving only those employees unable to find employment elsewhere, often an indication of their productivity. In both cases, the use of equity incentives proves very useful in overcoming this incentivization problem, as employees can typically receive restricted stock or stock options at a low valuation, indicating significant financial upside if the new venture takes off or the distressed company returns to profitability and increased equity value.

In addition to the difficulty of attracting full-time staff, entrepreneurs and turnaround managers also have trouble paying for legal, information technology, marketing, and advertising services. Just when such services can prove immensely valuable, managers in both situations can least afford them. As a result, turnaround executives and entrepreneurs often have no choice but to perform those crucial tasks either themselves or with minimal support.

**Disbelieving Customers**

Customers also crave stability, not wanting to jeopardize their company or their career if a supplier fails to deliver an order on
time, reliably, and of the promised quality. Without a track record, entrepreneurs struggle to convince potential customers that they can deliver, whereas a turnaround manager must overcome a recent negative track record caused by the distressed company’s failure to meet customer expectations. One venture capitalist has opined that a successful high-growth startup must offer a tenfold improvement in quality or other important product features over existing alternatives to convince prospective customers to risk relying on an unproven venture. A troubled firm’s competitors’ salespeople often try to add to potential customers’ fears with implicit threats to purchasing executives along the lines of “we’ll only supply those who buy from us now” and “you’ll look foolish when they don’t deliver.”

As a result, both entrepreneurs and turnaround professionals find that they can only earn business from less creditworthy customers and those who shop exclusively based on price, thus exacerbating the company’s problems with low- or no-margin buyers. Less price-sensitive, more creditworthy buyers can simply wait until the struggling company stabilizes itself by using the advice found in this book. Chrysler faced such problems in 1980 and again in 2009, when consumers and large fleet buyers postponed Chrysler purchases until they could feel comfortable that the company would survive long enough to honor its warranty obligations.

Time Sensitivity

Both startups and troubled companies face a rapidly shrinking time span during which a new opportunity can be exploited or disaster can be averted. With employees working long hours, managers must run meetings focused on specific, detailed “to do” lists rather than as a chance to discuss the company’s problems in general. Lacking the luxury of time to conduct detailed analyses, managers must make decisions quickly, often relying on a “Ready—Fire—Aim!” decision-making philosophy. This frenzied pace forces managers to walk a delicate tightrope; they must at once create the sense of urgency necessary to spur an often complacent workforce into rapid, aggressive action, but they must do so in a manner that assuages employee anxiety rather than
exacerbates it. Such a balancing act requires a unique blend of charisma, competence, and credibility on the part of the entrepreneur and the turnaround practitioner, shown primarily through how one makes and implements those timely decisions. This concept is discussed in greater detail in Chapter Three.

Steve Miller, author of *The Turnaround Kid* and professional turnaround CEO of six companies, uses this approach. He warns his employees of “paralysis by analysis,” whereby they keep studying an issue rather than making much-needed decisions.

**Centralized Decision Making**

Startups lack organizational structure, thus making it difficult for the entrepreneur to turn to resources inside the company for consultation or delegation. Conversely, such organizational structures may be in place for the turnaround manager, but those same structures’ complicity in causing the company’s distress makes them an unattractive source of such support. As a result, both situations require a strong, centralized leadership structure rather than a democratic process of decision making until the organization is on an upward course. One need not go to the extreme of “Chainsaw” Al Dunlap, who belittled everyone around him when he took charge of Scott Paper, or “Queen of Mean” Leona Helmsley. Helmsley frequently shouted obscenities at employees just before firing them, and made them beg on their knees for their jobs even for the slightest mistakes, while Dunlap told long-term Scott employees that they were “stupid” for staying so long; both approaches are foolish and short-sighted. Strong management requires at least a short-term focus on centralization which eases as the organization changes course, but leaders must boost morale in the process. Better role models include Jamie Dimon at Bank One, Selim Bassoul at Middleby, or Michael Jordan at EDS, each of whom is discussed elsewhere in this book.

**Scarcity of Knowledge and Risk**

Both startups and troubled companies operate in an environment of bounded rationality, with limited information and a great deal of uncertainty. Startups lack an organizational history to guide them, while troubled companies are typically troubled precisely
because the lessons of their own histories have limited value (see under the heading “Causes of Distress”). Both types of companies lack the institutional knowledge necessary to deal with the problem appropriately, thus making planning and forecasting difficult while increasing the risk of failure. Relying on poor institutional knowledge has caused the downfall of many executives, such as Rick Wagner, the CEO of General Motors, who relied on GM’s “If we build it they will buy it” mentality, even in the face of plummeting market share. It wasn’t until the U.S. government forced him out that the board faced up to the fact that change was needed. It didn’t help much when a longtime GM executive, Fritz Henderson, was named as the replacement, but he only lasted eight months on the job.

At a company that made appliance parts, the CEO finally agreed to a detailed list of steps to return the company to profitability. Months later, when the board of directors confronted him as to why he had not yet implemented any of the steps, he responded that he had split the list in two. They assumed he had created short- and long-term goals, but he took a more practical view of the two lists, declaring that the lists were “those things I don’t know how to do and those that I can’t bring myself to do.” He chose early retirement, and his replacement turned the company cash flow positive once again.

Supplier Problems

Competitors’ sales and marketing personnel will invariably extol the weaknesses of a new venture or distressed company, telling potential or existing suppliers that they would be “foolish” to supply such firms given the likelihood that they will not survive long enough to pay for the goods or services provided. Suppliers often feel disinclined to alienate their established customers by selling to the startup or distressed company, requiring an entrepreneur or turnaround manager to exercise almost mystical forces of persuasion to overcome their objections without leverage in terms of price, delivery, or quality. In particular, both the entrepreneur and turnaround practitioner must try to avoid the dreaded “cash in advance” demand from suppliers.

This is a particular problem when there are critical, key suppliers. Fannie May Candies faced this when Bloomers Chocolate
Company demanded cash in advance on all orders. Only Bloomers could produce the exact chocolate mix Fannie May needed to make its well-known Mint Melt-a-Way’s™. Unable to pay Bloomers in advance, Fannie May had no choice but to declare bankruptcy when it couldn’t come up with the cash.

Lack of Credibility with Lenders

Lenders generally will not extend credit to startups, for they lack the assets necessary to collateralize a revolving or term loan. Similarly, distressed companies have already stretched their lenders to the limit, going so far as to exceed their loan advance rates on accounts receivable, inventory, and other collateral, thereby forcing lenders to enter into an “over-advance.” Such a situation allows the debtor access to working capital in excess of the company’s collateral in order to finance its turnaround, but it implies that a lender has taken on equity-like risk without equity-like returns, for it stands to lose the entire uncollateralized portion of its advance. Eventually, a lender will require a forbearance agreement or waiver of its foreclosure rights, which typically imposes new restrictions on the company, increases the debtor’s effective interest rate, and may even mandate the hiring of turn-around professionals to rectify the over-advance situation.

One company that leased railroad boxcars, coal cars, and containers received multiple waivers on debt defaults from its lenders. When cash flow problems persisted, the lenders, suppliers, and lawyers met to reach an agreement. The meeting started poorly when an argument between the lawyers for the two largest lenders escalated into a full-on fist fight, as both began grappling on the floor over who got to talk first. Each wanted to show everyone how tough they planned to negotiate with each other and with the borrower. It became clear that the company executives probably wouldn’t get any additional relief from their creditors.

Great Chance for Equity Gains

When companies start up, it’s clear that the equity values are very low, with great opportunity for capital gains. The risk of failure is high, but so are the potential rewards.
Similarly, the stock of troubled companies is valued very cheaply. The difference, of course, is that the stock of a poorly performing company is low because the company is in financial and operating distress. A successful turnaround can thus bring substantial rewards to those who acquire equity even when risk is high.

In the case of the railcar leasing company mentioned above, all the employees who helped with the turnaround received shares valued at fifty cents each. Four years later, the company was sold for fourteen dollars a share: not bad, but there are many stories of investors in troubled companies doing even better, which are discussed in more detail in Chapter Nine. It is interesting to note that one of the lenders represented by the battling lawyers became more cooperative, and was paid in full plus a premium, while the other remained contentious and had his client sell its loan for ten cents on the dollar after months of fighting, thinking he had outsmarted everyone.

In summary, both turnaround managers and entrepreneurs face crisis situations that require the skillful management of multiple, often conflicting constituencies. This requires incredible persuasion and salesmanship in order to overcome their objections and get all of the company’s stakeholders working toward a common goal. Ultimately, the two primary challenges are the same: conserving and raising cash, and establishing trust both inside and outside of the organization. Doing so requires a very different skill set than that required of a traditional manager, for mere competence and confidence will not suffice. Startups and turnaround crises demand a certain charismatic zeal in the face of overwhelming adversity to inspire the confidence necessary to invigorate cautious employees and build the trust necessary to assuage nervous suppliers. Therefore, this book is every bit as much about entrepreneurship and innovation as it is about reorganization and corporate recovery.

**Causes of Distress**

It is important to diagnose the causes of organizational distress, both to help avoid it as well as to repair it. Companies may find
themselves in distress from a variety of sources, which can be broken down into the two main categories—internal and external causes.

External Causes

As the name suggests, external causes represent exogenous shocks to all or a significant part of the company, sending management into a tailspin. Here are some common external causes of companies’ declines:

**Economic Downturns**

Economic downturns such as the one recently plaguing world markets can undermine even the soundest businesses. For example, Saks Fifth Avenue’s pristine brand equity and strong retail presence in critical markets has historically afforded it significant bargaining power against vendors. Combined with its effective use of technology to streamline its inventory management, this put Saks in an enviable competitive position against other high-end luxury retailers. But even Saks began to struggle in the face of a nationwide collapse in discretionary consumer spending following the macroeconomic crisis of 2008; it watched its gross margin fall an unprecedented sixteen percentage points from the fourth quarter of 2007 to the same period in late 2008.

Such downturns could also come in the form of troughs following waves of financial liquidity. That same macroeconomic crisis of 2008 came on the heels of a tightening in credit markets that kept even healthy companies from financing that could have carried them through. Companies with sufficient foresight, luck, or both to raise funding while credit markets remained loose could ride out the storm, while companies who came too late to the party found themselves unable to close financing.

When Flying J failed to make payroll, they could not raise additional capital on short notice in the face of falling oil prices and frozen credit markets. Similarly, when Circuit City could at last borrow no more to cover the problems it never fixed, it too filed for bankruptcy.

Not all downturns are as far-reaching as the crisis of 2008 and 2009, but regional, or even local, downturns can have a negative
impact on businesses. For example, the closing of the Fore River Shipyard in Quincy, Massachusetts, represented a devastating external cause of distress for the nearby restaurants and bars that catered to the shipyard’s employees coming off shift from building submarines and tankers.

**Industrywide Issues**

Industrywide issues, particularly structural ones rather than cyclical ones, may affect not an entire national or regional economy, but instead focus on one industry or vertical. Such changes could come in the form of industry consolidation—such as how the explosive growth of Wal-Mart gave it disproportionate bargaining power against its vendors of clothing, cosmetics, and children’s toys, thus crippling supplier margins—or the emergence of new competitive products, such as the eventual devastating effects margarine had on butter producers, or the growing competition steel producers faced from plastic in products ranging from containers to automobiles. Weather can represent another industry issue, as it did when a severe drought devastated coffee manufacturers throughout Brazil in 1999, wiping out some 40 percent of the crop. Changes in commodity prices can also affect entire industries on both the top and bottom lines. For example, sugar processors such as Imperial Sugar faltered in the wake of increased sugar prices in the 2001–2002 timeframe, as they struggled to pass along such cost increases to customers. Similarly, tumbling oil prices in late 2008 slashed revenues at major oil companies, which subsequently rippled through the drilling and exploration industry because it had become less profitable to drill for new reserves. Finally, litigation—particularly class action toxic tort litigation such as that which prompted dozens of bankruptcies among manufacturers with asbestos in their products from the 1980s through today—can represent a widespread external cause of distress to an entire industry.

**Shifts in Consumer Demand**

Shifts in consumer demand can unexpectedly erode a company’s revenue growth. For example, the explosion in popularity of low-carbohydrate diets such as the Atkins, South Beach, and Zone diets weakened many fast-food restaurant chains, notably donut
maker Krispy Kreme, which cited the diets’ popularity in explaining its expected lower profits to Wall Street in 2004. Similarly, Chapter Nine will demonstrate how Schwinn’s failure to recognize the growing popularity of lighter, more agile mountain bikes over its traditionally heavier cruising bicycles presaged its dwindling sales and eventual bankruptcy filing.

Changes in Technology

Changes in technology have disrupted many industries, from the iconic business school example of the buggy whip industry falling in the face of the automobile to significantly more subtle, complicated technological shifts in computing architectures. Today’s information technology products and networks have grown so interdependent between software and hardware products and the standards that govern them that a company need not even manufacture the changing technology in order to falter, as did Wang Computer in its failed attempt to hang onto the “midframe” computer market in the 1980s.

For example, Electronic Data Systems found itself lagging significantly behind more nimble competitors like Razorfish, Scient, and even IBM Global Services in the late 1990s, as its historical expertise in legacy mainframe systems created a strategic mismatch with the rapid adoption of the client/server model. The wide-scale introduction of personal computers into the workplace drove adoption of the client/server architecture, leaving EDS with increasingly obsolete mainframe expertise. Though EDS only provided outsourced IT services, its expertise in the disappearing mainframe model (and corresponding inexperience with the client/server model) made it no less a victim of technological change than the manufacturers of such mainframe products. (See Chapter One for more information on the challenges faced by EDS.)

Kodak and Xerox came close to collapse with their belated realization that customers preferred digital cameras and copiers over analog devices. Similarly, it was the Internet as a technical pipeline of information that affected newspapers at the turn of this century, even more than the technical advance in television advertising did in the 1950s.
**Government Regulation**

Government regulation can send shocks to an otherwise stable industry, most often through deregulation such as that brought about by the Telecom Act of 1996, which sent telecommunications providers scrambling to adjust to the new economic realities of increased competition in the form of competitive local exchange carriers, or CLECs. Bans or restrictions can also shrink market sizes (such as the increase in the legal drinking age to twenty-one from eighteen in many states in 1984) or cut off marketing channels (such as the ban on advertising cigarettes on television and radio enacted by the Public Health Cigarette Smoking Act in 1970). However, regulation need not be so dramatic or sweeping to affect an industry. For example, the push to produce more environmentally friendly fuel prompted the 2007 passage of the Energy Independence and Security Act, which specified levels of ethanol production well above current market demand. This artificially increased demand for the corn used to make ethanol, in turn increasing the price of corn and compressing margins across the livestock and dairy industries, which rely on corn as a primary component of cattle feed. Furthermore, local minimum wage increases can significantly increase operating costs for labor-intensive industries such as retail, as San Francisco’s 26 percent minimum wage increase in 2004 drove many Bay Area restaurants out of business.

**Changing Interest Rates**

Changing interest rates can change the cost of a company’s debt, thereby leading to fluctuations in cash outflows. Although the most common example is an unexpected spike in interest rates for a company that has issued floating-rate debt, many financial institutions ranging from investment banks such as Goldman Sachs to credit card issuers such as GE Commercial Finance have complicated balance sheets full of interest rate derivatives, with profitability often predicated on a steady “spread” between floating- and fixed-rate debt. Such institutions can suffer merely from increases in interest rate volatility, even in the absence of a sustained directional move in interest rates. Even nonfinancial companies seemingly without interest rate exposure can suddenly
find themselves hamstrung by interest rate spikes when customers or suppliers with floating-rate debt find themselves cash-constrained, and begin stretching out payables or demanding stricter cash collection policies, respectively.

**Changes in Business Model**

Changes in business model can also hamper historically sound businesses. Newspapers are currently facing a drastic shift from their old monopoly-based business models in response to the popularity of reading news on the Internet and their strategic misstep in giving away content for free online. In order to survive, they will have to adapt to these new realities while preserving their historical mission: discovering and presenting the news. As discussed later, they need to rely on their core competencies as “trusted infomediaries.”

**Internal Causes**

Though managers are naturally eager to point to external causes so as to deflect blame, a study suggested that causes of distress coming from within the company are six times more likely to cause a firm’s failure. Although there are many examples of such internal causes, the most common—and most deadly—is unquestionably ineffective management, which plagues everything from small, family-led concerns to multinational conglomerates.

Just as Roman writer Publilius Syrus wrote that “anyone can hold the helm when the sea is calm,” many management teams can coast along smoothly during periods of stability and economic prosperity. However, executives often fail in the face of adversity simply because they lack the skills to deal with the challenges posed by any of the external causes of distress just discussed. Steven Rogers at the Kellogg School of Management extends this naval metaphor, comparing the revelation of management teams’ weakness in times of crisis to a boat that has cruised through a passageway time and again at high tide. When the water level falls, though, dangerous rocks appear suddenly, making navigation unexpectedly treacherous. Always present, the rocks—or management incompetence and organizational problems—lurked innocently below the surface until falling tides or plunging economies
reveal the danger that had been there all along. While ineffective management is by far the most common internal cause of distress for faltering companies, it is not the only one. But even when there is another internal problem, like those listed next, management failure usually plays a role, making a bad situation worse.

**Blind Pursuit of Growth**

Blind pursuit of growth can cause an organization to lose sight of what made it successful in the first place. CEO John H. Bryan took Sara Lee through a reckless strategy of acquisitions for most of the 1980s and 1990s, as the company purchased more than 200 companies, many well outside of Sara Lee’s core foods business. This overly aggressive acquisition binge increased revenues from just over $2 billion when Bryan took the helm in 1975 to nearly $20 billion in 2004, a massive growth that hid several underlying problems in the company’s management, who fundamentally failed to understand their core customers. Sara Lee had become a complex, decentralized organization with inefficient cost controls, causing Sara Lee to have the highest sales and administrative expenses among its competitors (see Figure I.2)\(^8\) and poor customer relationships.\(^9\)

Blind devotion to “the deal” had many side effects common to poorly managed companies. First, the overriding inclination to buy competitors rather than innovate from within led to insufficient investment in research and development, thus frequently leaving Sara Lee a step behind other competitors and forcing it to play catch-up with “me-too” offerings. Like many companies who overexpand during times of prosperity, Sara Lee’s unrelenting pursuit of growth led to inadequate postmerger integration efforts, with management seemingly uninterested in ensuring that new pieces fit together before becoming distracted by the prospect of the next big deal. For example, Sara Lee soon owned nine meat companies, each with a different sales team approaching large grocery chains, an approach that annoyed those chains’ buyers who preferred to deal with only one contact. As they so often do, these distractions prevented management from seeing coming changes in the industry, with disastrous results. A host of problems, including slowed growth following the 2001 recession, rising input costs, and pricing pressure from consolidated retail
customers, led to the replacement of CEO Steven McMillan in 2004, just four years after he had succeeded Bryan.

Organizations that grow too fast often demonstrate a second example of ineffective management that frequently leads companies further into decline: an excessive reliance on cost-cutting, to the exclusion of more effective alternatives. In the absence of a comprehensive turnaround strategy that pairs a genuine strategic change with downsizing to create a leaner, more focused organization, simply reducing costs by cutting headcount or selling off divisions will invariably fail. In their efforts to turn Sara Lee around, McMillan and his successor, Brenda Barnes, relied heavily on cost-cutting and downsizing. After five years of trying, Barnes still hadn’t fully turned Sara Lee around. Sara Lee’s turnaround efforts have faltered at least in part due to its reticence in reaching out for help, either from turnaround specialists or from newer, more talented hires lower in the organizational structure. Despite

Figure I.2. Cost Inefficiency at Sara Lee in 2007

- Canagra: 15.9%
- General Mills: 19.2%
- Kraft: 21.0%
- Heinz: 21.6%
- Campbell Soup: 24.5%
- Procter & Gamble: 31.8%
- Sara Lee: 32.8%
a decade of underperformance, change at the top came slowly, typified by McMillan’s moving to the chairmanship from CEO and staying there throughout several failed turnarounds.

In the early 1980s, Frank Lorenzo grew Continental Airlines through the acquisition of four airlines, following a standard protocol of ruthlessly cutting costs at each subsequent target in order to help fund the next deal. Passengers on Continental flights saw a mismatched assortment of seats: some red, some grey, some tall, some short, based on whatever had become available from different planes being stripped for parts. Duct tape secured ancient overhead bins, and on-time performance plummeted. Gordon Bethune, the CEO later credited with the turnaround at Continental, compared this cost-cutting strategy to saving money by taking toppings off a pizza to cut costs; sooner or later, no one will buy it at any price. The key elements to Bethune’s successful turnaround are chronicled in Chapter Five.

As noted earlier, Krispy Kreme management blamed the low-carb diet craze for the company’s plummeting profits. In reality, many of their problems resulted from excessive growth. As the company first expanded across the country from its home in the southeastern United States, a mystique surrounded their hard-to-find hot donuts, a real treat for many. Soon, however, they appeared in thousands of gas stations and retail outlets, a situation that made them a ubiquitous commodity. The resultant turnaround involved closing some outlets and retrenching, as discussed in Chapter Five.

**Overextension of Credit**

Overextension of credit in overly indulgent credit markets can sink companies who become too optimistic about their own growth prospects. In boom times, firms often finance acquisitions with debt, naively using “best case” scenarios as base cases for the purposes of financial forecasting. Excessive liquidity can hide severe underlying critical problems at a company the way a fresh coat of paint may conceal dry rot in a building’s timbers. Management grows complacent, knowing that they can find an accommodating lender who will let them simply throw money at the problem instead of attacking it head-on. In the face of a downturn, these companies find themselves swamped with debt.
Just one or two bad quarters can lead to depressed profitability and result in tripped covenants, thus forcing these companies to negotiate often expensive forbearance and waiver agreements with their lenders. See Box 1 for examples of frequent covenants that can require such forbearance agreements.

Box 1: Typical Covenants Tripped by Downturns

Although the frothy capital markets of 2004–2007 led to the prevalence of so-called “covenant-lite” loans featuring very few, very lax restrictive covenants, bank loans have historically contained features requiring certain levels of financial performance in order to protect lenders with warning signals. If a company fails to meet one of the covenants at an agreed upon date—typically the end of each financial quarter—the lenders may enforce certain rights, such as a higher interest rate, an additional equity contribution, the divestiture of a subsidiary, the retention of a turnaround professional, or even seizure of the assets. The following covenants have returned to popularity in the wake of the 2007 credit crisis, and are likely to remain so for the foreseeable future.

**Fixed Charge Coverage Ratio (FCCR) = Cash Flow / Fixed Charges**

The fixed charge coverage ratio measures a company’s ability to pay its fixed expenses, typically comprising interest expense, the current portion of long-term debt, capitalized leases, and rents. Lenders often insist on a minimum FCCR of, for example, 2.0x, indicating that cash flow divided by agreed-upon fixed charges must equal or exceed 2.0, with cash flow measured quarterly on a rolling four-quarter basis and adjusted for any unusual or one-time items. The rolling calculation means that one down quarter could throw a company previously above the 2.0x threshold below it. The company below, for example, remains healthily above the threshold before a sudden downturn brings it into violation in Q1 2007.

**Funded Debt to EBITDA = Funded Debt / EBITDA**

Like many such measures, this ratio uses earnings before interest, taxes, depreciation, and amortization (EBITDA) as a proxy for cash