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Corporate Finance Practice

Ten tips for leading companies out of crisis

Even good managers can miss the early signs of distress, says McKinsey's Doug Yakola, who's been running recovery programs for 20 years. The first step is to acknowledge there's a problem.

"I've seen my share of boiled frogs," says Doug Yakola, comparing companies in crisis with the metaphorical frog that doesn't notice the water it's in is warming up until it's too late. As the chief restructuring officer or CFO of more than a dozen turnaround situations over nearly two decades, Yakola has witnessed firsthand how managers back right into a crisis without recognizing that their situation is worsening. "They're not bad managers, but they're often working under a set of paradigms that no longer apply and letting the power of inertia carry them along." And if they don't realize they're facing a crisis, they won't know that they need to undertake a turn-around, either.

He's also heard the regrets: sometimes managers underestimated how critical their situation was—or they were looking at the wrong data. Others took advantage of easy access to cheap capital to stay the course in spite of poor performance, believing they could push through it. Still others got so caught up in the pressure for short-term returns that they neglected to ensure their company's long-term health—or even willfully sacrificed it.

Rare among them is the executive who stepped back to review his or her own plans objectively, asking "Is this what I thought would happen when I first started going down this road?" That's a problem, Yakola says, because acknowledging that your plan isn't working is a necessary first step.

Yakola joined McKinsey's Recovery & Transformation Services as a senior partner in 2011. Here, he offers ten ways ailing companies can get started on the turnaround work they need.

1. Throw away your perceptions of a company in distress

It's next to impossible to come up with one working definition of a company in distress—and dangerous to think that you have one for your own company. Depending on the situation, there are probably 25 different signs of potential distress (exhibit). The problem is seldom made up of just one or two of these things, however. Rather, it is the result of a greater number of them interacting together and with other external factors.

2. Force yourself to criticize your own plan

The biggest thing you can do to avoid distress is periodically review your business plans. When

Exhibit

There are numerous signs of distress—and a distressed company is typically dealing with multiple signs.

Signs of distress

Working capital/liquidity
- Declining or negative free cash flow
- Large contingent liabilities
- Unresolved near-term debt maturities
- Revolver drawdowns
- Contracting vendor terms
- Increase in accounts-receivable aging
- Increase in outstanding accounts payable

Financial
- Declining stock price
- Declining bank or bond price
- Inability to meet debt covenants
- Resignations of key finance staff
- Diminishing liquidity
- Repeated bank amendments
- Downgrades in debt ratings
- Accounting restatements
- Inability to file financial statements

Profitability and industry outlook
- Shrinking EBITDA[1] margin
- Reduced capital-investment programs
- Going-concern opinion
- Deteriorating industry fundamentals
- Adverse regulatory environment
- Regulatory inquiries

Employees
- Large or unplanned reductions in workforce
- Management turnover
- Disruption in unionized workforce

[1]Earnings before interest, taxes, depreciation, and amortization.

you're creating them, whether at the beginning of the year or the start of a three-year cycle, build in some trigger points. A simple explicit reminder can be enough: "If we don't have this type of performance by this date or we haven't gotten the following 12 things done by this date, we'll step back and decide if we're going down the right path, given what's happened since our last review."

Such trigger points should be oriented both to operational and market performance as well as to basic financial metrics and cash flow. Look at where you are as a company using basic financial and cash milestones, and then look at where you are with respect to your industry and competitors. If you're not moving with the rest of the industry (or not outpacing it, if the industry is struggling), then your plan may be obsolete. And don't forget to look back at your performance over past cycles to identify any trends. If you keep missing performance targets, ask why.

3. Expect more from your board

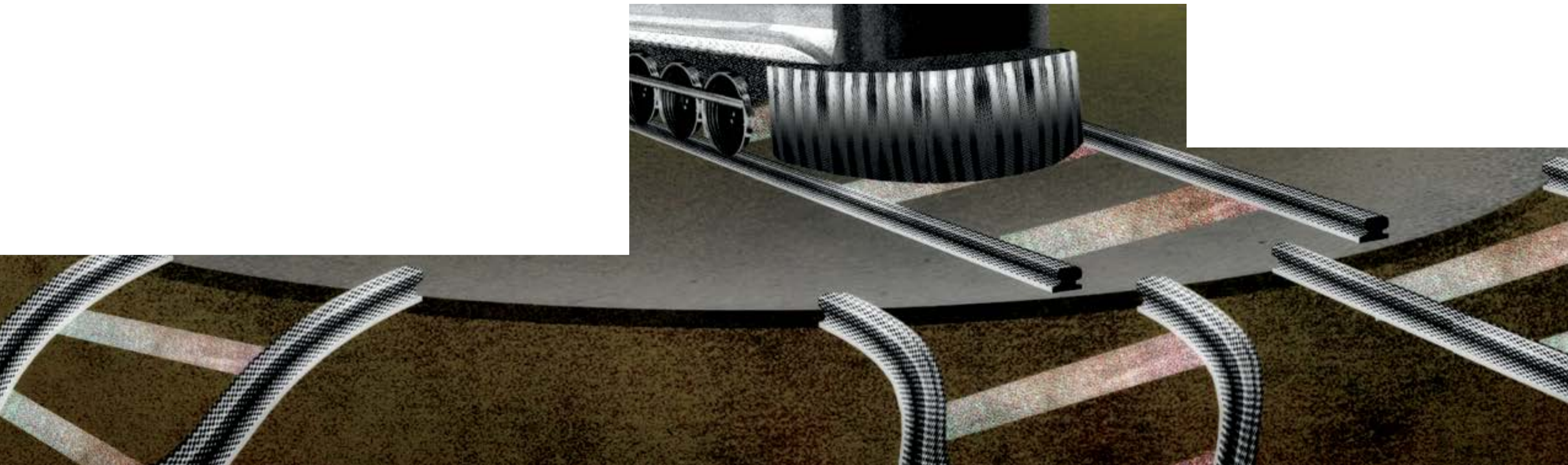
The beauty of a board is that it has enough distance from the company to see the forest for the trees. Managers often treat their board as a necessary evil to placate so they can get on with their business, but that undermines the board's role as an early-warning system when a company is heading for distress.

It's also the board's responsibility to look the CEO, the CFO, and the chief operating officer (COO) in the eye and say, "OK, we like your plan. Now let's talk about what it would take to cut costs not just by 3 percent but by 20. Let's talk about all the things that can go wrong—the risks to the business." Sometimes significant events happen that no one could have foreseen, of course. But in a typical distress situation, a company has usually just had 18 to 24 months of poor performance, and the board hasn't been aware or hasn't asked the right questions. Independent board members—truly independent ones—can have a big impact here.

The senior team at one company maintains a list of risks to the business, employees, and the plan. They review those risks with the board on a quarterly basis to ensure that they're staying top of mind. It's an excellent way to have conversations that you wouldn't normally otherwise have in a business operation.

4. Focus on cash

A successful turnaround really comes down to one thing, which is a focus on cash and cash returns. That means bringing a business back to its basic element of success. Is it generating cash or burning it? And, even more specifically, which investments in the business are generating or burning cash?



Nasty surprises await when no one is focused on cash—and keeping track of cash isn't just about watching your bank balance.

I like to think about this in the same way one would if running a local hardware store. By that, I mean asking fundamental questions, such as whether there is enough cash in the register to pay the utility bill, for example, or to pay for the pallet of house paint that will arrive next week, or how much more cash I can make by investing in a new delivery truck. When you bring a business back to those basic elements, the actions you need to take to get back on track become pretty clear. In many of the cases I have seen, the management team and board are focused on complex metrics related to earnings before interest and taxes (EBIT) and return on investment that exclude major uses of cash. For example, variations on EBIT commonly exclude depreciation and amortization but also exclude things like rents or fuel. These are all fine metrics, but nasty surprises await when no one is focused on cash.

Keeping track of cash isn't just about watching your bank balance. To avoid surprises, companies also need a good forecast that keeps a midterm and longer view. For example, failing to pay attention to the cash component of capital investments routinely gets companies in trouble. Project net present values can look the same whether the return begins gradually at year two or jumps up dramatically at year five. But if you're not focusing on the cash that goes out the door while you're waiting for that year-five infusion, you can suddenly find yourself with very little cash left to run the business, sending you into a spiral you may not recover from.

5. Create a great change story

Companies in distress don't focus enough on creating a change story that everyone understands—and that creates some sense of urgency. Here's an example. I recently did a turnaround as chief restructuring officer of a mining company. It was profitable, returned a decent margin, and was cash positive. But the commodity price was dropping, and the board was worried about generating enough free cash flow to drive the capital needs of the business. The change story we created said, "Yes, we are profitable. But the whole point of profitability is to generate enough cash to expand, grow, and maintain operations. If we can't do that, then we're headed for a long, slow decline where equipment breaks down and lower production becomes the new reality."

If you can tell that story in a paragraph or less, in a way that means something to the average guy on the front line, then people will get on board. In this case, employees wanted to have their children and their grandchildren work for this company in the same remote mining location, and the change story spurred them to action. The key was a simple message, not fancy metrics.

6. Treat every turnaround like a crisis

Without a crisis mind-set, you get a stable company's response to change: risk is to be avoided, and incrementalism takes over. Your workers are asked to do a little more (or the same) with less. More aggressive ideas will be analyzed ad nauseam, and the implementation will be slow and methodical.

In contrast, a crisis demands significant action, now, which is what a distressed company needs. Managers need to use words like crisis and urgency from the first moment they recognize the need for a turnaround. A company that's in true crisis will be willing to try some things that it normally wouldn't consider, and it's those bold actions that change the trajectory of the company. Crisis drives people to action and opens managers up to consider a full range of options.

7. Build traction for change with quick wins

The tendency of most managers is to put all of their focus and resources into three or four big bets to turn a company around. That can be a high-risk approach. Even if big bets are sometimes necessary, they take a lot of time and effort—and they don't always pay off. For example, say you decide to change suppliers of raw materials so you can source from a low-cost country, expecting 30 percent lower direct costs. If you realize six months later that the material specifications don't meet your needs, you'll have spent time you don't have, perhaps interrupted your whole production schedule, and probably burned a bunch of cash on something that didn't pay off.

In addition to going after big bets, managers should focus on getting a series of quick wins to gain traction within the organization. Such quick wins can be cost focused, cutting off demand for some external service they don't need. Or it could be policy focused, such as introducing a more stringent policy on travel expense.

Not only do such moves improve the bottom line, they also generate support among employees. In any given company, you're likely to find that a fifth of employees across the organization are almost always supportive. They work hard. And they will change what they're doing if you just ask them. These are the people you'll want to spend most of your time with, and they're the ones you'll promote—but you'll probably spend too much time with the bottom fifth of employees. These are the underachieving ones who actively resist change, look for ways to avoid it, or are simply high maintenance.

What often gets ignored is the remaining 60 percent of the organization. These are the fence-sitters, and they are tuned into action, not just talk. They see the changes going on, and if you proactively work with them, then 80 percent of the organization will be behind you. But if you don't give them a reason to stand up and be positive about the company, they'll go negative. That's the importance of quick wins. When you quickly take real action, and when those actions affect the management team as well, you send a powerful message.

8. Throw out your old incentive plans

Management incentives are often the most overlooked tool in a turnaround. In stable companies, short-term incentive plans can be a complex assortment of goals related to safety, financial and operational performance, and personal development. Many are so complex that when you ask managers what they need to do to earn their bonus, many just shrug their shoulders and say, "Someone will tell me at the end of the year."

In a turnaround, take a lesson from the private-equity industry and throw out your old plans. Instead, offer managers incentives tied specifically to what you want them to do. Do you need $10 million of improvement from pricing? Then make it a big part of your sales staff's incentive plan. Need $150 million from procurement? Give your chief purchasing officer a meet-or-beat target. Be willing to forgo bonus payments for those that don't achieve 100 percent of their target—and to pay out handsomely for those whose results are beyond expectations.

9. Replace a top-team member—or two

Experience tells me that most successful turnarounds involve changing out one or two top-team members. This isn't about "bad" managers. In my 20 years of doing this, I've only seen a small handful of managers I thought were truly incompetent. But it's a practical reality that there are managers who must own the decline. And more often than not, they are incapable of the shift in mind-set needed to make fundamental changes to the operating philosophy they've believed in for years. Whether they realize it or not, they block that change because they're bent on defending what they believe to be true. Although it's difficult, removing those people sends another signal to your stakeholders that there will be changes and you're not afraid to make tough moves.

10. Find and retain talented people

Beyond the leadership team, there are two types of people I look for immediately. First are those that have the institutional knowledge. They may not be your top performers, but they know all the ins and outs of the company—and are vital to understanding the impact of potential changes on the business. Many times they are the disgruntled ones, unhappy with the company's performance. But you need people who are willing to point out the uncomfortable truths.

A turnaround is also a real opportunity to find the next level of talent in an organization. I've been through multiple crises where the people who added the most value and impact weren't the ones sitting around the table at the beginning. I have often found great leaders two and three levels down who are just waiting for an opportunity—and the fact that they can be part of something bigger than themselves, saving a company, is often enough to attract and retain them.

For both groups, it's important to realize that retention isn't always about money and bonuses. It's also about figuring out the individual's needs. Good turnaround managers actively look for those people and find a way to get them involved. o

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