How to manage a turnaround and seize long-term opportunities

Applied Value Knowledge
Turnaround Management

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Applied Value's Framework for Turnaround Management

This report is part of a series of initiatives that demonstrates Applied Value's recommended strategic and operational best practices during economic uncertainties. The series highlight how companies can seize and sustain the strategic and operational opportunities arising from a sudden downturn.

How to manage a turnaround and seize long-term opportunities

Revenue	› How to ensure Lean Growth when responding to an economic crisis › The urgent need to prioritize customers and products in times of economic uncertainty › How to maintain a healthy pricing strategy
Cost	› Value-driven SG&A organization › Commodity strategies in times of uncertainties › Proactively manage supply base risk in economic downturns
Capital	› Proven methodologies to aggressively improve working capital › Efficiently use limited capital to future-proof your business › Opportunistic M&A in times of crisis

Figure 1 Series of value papers by Applied Value on operational best practices during economic downturns

Applied Value has led clients through several successful turnarounds. This Value Paper demonstrates a selection of key concepts for managing a transformation program. Our approach is both offensive and defensive and aims to help companies overcome strategic, operational, and financial challenges during both the current downturn and future downturns.

Leveraging Applied Value's Sustainable Lean Growth Methodology

Since our inception in 1997, Applied Value has built our own and our clients' successes by leveraging a Lean Growth methodology. Lean must always come before growth!

Figure 2 Sustainable Lean Growth framework: From Cost to Innovation

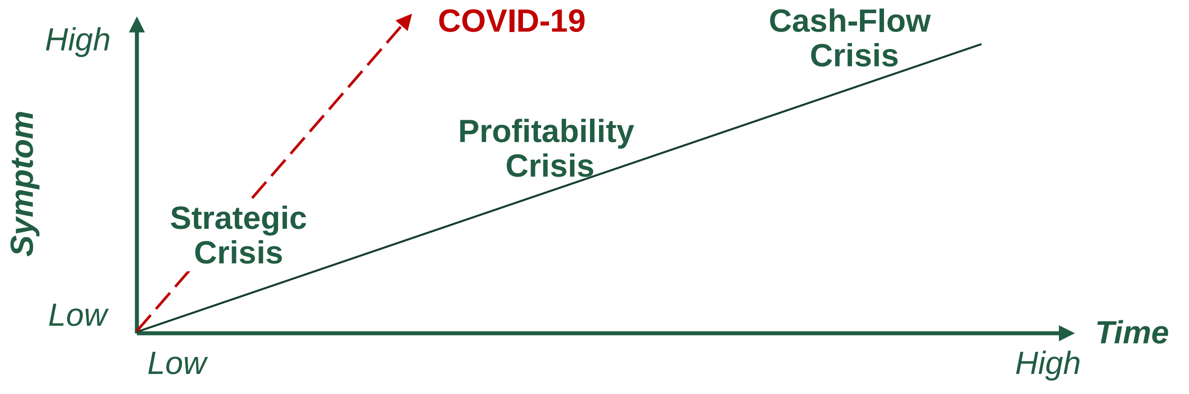
Protecting revenue and key customers is equally as important as cutting costs. Only in very few cases can companies grow out of a crisis without fundamentally addressing structural levers. Our Lean Growth framework helps companies radically take out costs while sustainably strengthening their competitive advantage by becoming increasingly focused, less complex, and faster.

Evolution of Crises: COVID's immediate impact on Cash-Flow

The challenges from the COVID-19 pandemic are affecting companies in all industries. Stagnating revenues, furloughs, and organizational uncertainties pave the way for a challenging future. A new baseline is forcing businesses to swiftly review both their current strategic focus and operational structure to adapt to an unstable economy and a changing market environment.

Our experience is that management teams who fail to recognize and address a strategic crisis early will typically overreact in their response (e.g. cut more costs than necessary or focus on the wrong areas), ultimately having a longer and costlier recovery.

Generally, companies face three types of operational crises: Strategic Crisis, Profitability Crisis, and Cash-flow Crisis.



Common symptoms		
Strategic Crisis	Profitability Crises	Cash Flow Crises
› Poor strategic planning	› Increasing COGS cost as % of Revenue	› Negative Free Cash Flow
› Inability launch new innovative products	› Increasing SG&A cost as % of Revenue	› Poor credit rating
› Declining orders booked and revenue	› Declining profitability over several periods	› Heading towards a state of insolvency

Figure 3 Crisis Evolution Phases: Strategic Crisis, Profitability Crisis and Cash-Flow Crisis

Typically, organizations can recognize symptoms of a crisis and initiate corrective actions in a timely manner. The COVID-19 pandemic caught many companies off guard and triggered cash-flow crises with unprecedented speed. Now, companies are not only facing cash-flow constraints but will also have to take a step back and rethink business strategies and structural levers simultaneously (addressing Strategic and Profitability crises). In order to achieve a successful recovery, organizational speed has never been more important.

Challenges managing your business through times of crisis

Inaction is the riskiest response in times of uncertainty; however, lack of insight and rushed decisions can be equally as damaging. Companies that demonstrate decisiveness and adaptability to new conditions will be able to stabilize short term and win in the long term. Common pitfalls Applied Value has seen in the past include:

1. Failure to foresee and understand the business impact from crises
2. Management and employees lack a sense of urgency
3. Decision-makers have limited visibility into revenue, cost & resource drivers
4. Fear of reducing cost too aggressively result in limited or no impact
5. Uncoordinated efforts between management & line organizations
6. Missing support tools and clearly defined processes
7. Lack of accountability

Protect your core business and understand your exposure

Companies in challenging business environments should quickly and systematically assess their vulnerabilities, both at group level and by business unit. To understand the risk exposure, companies should develop scenarios, and quantify how each would affect the business. Consider which scenario is more likely to unfold and assess the impact on the business in terms of sales volume, prices, and variable cost. Another consideration should be how customers / consumers would react to news about the rapid deterioration of the business.

A sensitivity analysis helps companies to understand the current state. Plotting expected revenue against assumed gross margin will enable the management team to understand the OPEX-level required to support that business. This along with a comprehensive financial benchmark versus relevant peers will help management to understand the magnitude of the restructuring assignment.

Change in OPEX level required to meet restructuring target

Revenue ($)					
10000	-350	-150	+50	+250	+450
9000	-400	-200	0	+200	+400
8000	-450	-250	-50	+150	+350
7000	-500	-300	-100	+100	+300
6000	-550	-350	-150	+50	+250
5000	-600	-400	-200	0	+200
4000	-650	-450	-250	-50	+150
3000	-700	-500	-300	-100	+100
2000	-750	-550	-350	-150	+50
1000	-800	-600	-400	-200	0
	20	**30**	**40**	**50**	**60**

Gross Margin (%)

Profitable Fixable Unprofitable

Figure 4 Example: Sensitivity Analysis Volume / GM% / OPEX, given 10% EBIT target

With an understanding of the financial exposure, management must agree on common operating assumptions such as; what markets to serve, product and service portfolio, and key technology platforms etc. Without a clear and common vision for the future, it will be impossible to agree on activities and understand magnitude of change required meet the set targets.

Critical measures: Strengthen your Financial Position by focusing on bottom-line performance and cash flow

Protecting the company's liquidity should be the company's top priority during a cash flow crisis. Having enough cash-flow, and access to capital are critical to avoid a state of insolvency. Maintaining a buffer for future investments to avoid losing ground to competitors is of equal importance.

Companies should solve shortages and ensure cash flow improvements by addressing levers related to Revenue, COGS, SG&A, R&D, Inventory, Receivables, Payables, CAPEX investments and company financing. All should be addressed in a mutually exclusive and collectively exhaustive (MECE) manner.

1 **Revenue:** Pricing should be adjusted to the new demand vs. supply situation and efforts should be focused on the most profitable Markets, Customers, Partners, Products, and Services. All low gross margin areas should be reviewed and de-prioritized or exited. Addressing low profitability areas that typically require a disproportionate amount of resources is an enabler to reduce organizational complexity and improve the bottom-line.

2,3 **COGS:** Scrutinize, challenge, and reduce all non-business critical sourcing spend. Challenge demand and product specifications based on "need to have versus nice to have". In the new reality, suppliers are fighting for volume, giving buyers a very favorable position in re-negotiations. Raw material prices typically come down.

4,5 **SG&A:** SG&A is not directly linked to revenue making it highly ambition driven. A company can decide on the size of the SG&A cost bucket. Make a risk assessment and evaluate with a "what can we afford" mentality. Applied Value has helped clients secure SG&A cost reductions by up to 50-60% during a given year, with no or limited revenue impact.

6 **R&D:** Despite the fact that R&D is the heart of the business, companies must quickly revise the strategy and adapt based on the new reality. The R&D roadmap should be re-prioritized accordingly. Focus on your core business, peripheral projects with unclear NPV should be scrapped or put on hold. Review possibilities to change your R&D footprint to optimize cost (i.e. site locations, in-house vs. outsourcing)

7 **Working Capital:** Many companies neglect to systematically monitor and manage working capital including inventory, payables, and receivables. Applied Value has seen that optimizing working capital can significantly improve efficiency, releasing cash equivalent of 10% of their annual revenue.

8 **CAPEX:** A company should ensure that they maximize the ROI from all existing CAPEX investments. For example, evaluate the production footprint to ensure that you maximize the utilization of all plants and equipment. Limit all non-business critical CAPEX investments until cash-flow levels have been restored.

Applied Value has listed several areas covering all discussed levers, which typically yield significant strategic and financial improvement.

	Example Checklist of Activities that Needs to be Considered
Revenue	Focus on the most profitable markets, customers, partners, offerings
	Address customers/partners with high financial risk and low strategic value
	Re-direct marketing efforts and focus on core prospects
	Identify new potential business models and revenue streams
	Review and adjust pricing, minimize discounts
	Optimize the product / service portfolio
COGS	Target COGS reductions incl. direct material sourcing
	Focus efforts to secure efficiencies and reduce production lead times
	Re-negotiate key raw material contracts when market prices are down
	Rationalize complex and costly offerings
	Scrutinize, challenge and consolidate the existing supplier base
SG&A	Address quick wins in indirect spend incl. travel, IT, rent relief, recruiting
	Identify opportunities to shift cost positions from fixed to variable
	Assess outsourcing opportunities for HR, Payroll, IT, Finance
	Remove all non-business critical spend and address behavior (policies)
	Reduce ambition and service level in support functions & administration
	Halt non-essential sales activates e.g. trade shows, tail accounts etc.
	Remove time spent on non-value adding activities
	Reduce the # of organizational layers and increase span of control
	Standardize processes and ways of working – increase speed
	Streamline and standardize roles and responsibilities
	Perform competence assessment to understand org. capabilities
	Review and set up new KPIs focusing on bottom-line performance
R&D	Scale back & re-prioritize the R&D roadmap, review footprint
	Assess outsourcing opportunities for R&D, engineering and production
Working Capital	Right-sizing inventory levels – do not stock up on slow-moving items
	Reevaluate safety stock requirements to fit new demand levels
	Re-negotiate Accounts Payable and Receivable with Customers and Suppliers
	Use government stimulus / incentives on a country-by-country basis
	Ensure that invoicing processes are understood to secure cash collection
CAPEX	Limit all non-essential / non-business critical CAPEX investments
	Optimize use of all existing CAPEX investments
	Review the manufacturing footprint to realize synergies were possible
	Reduce, spin off, or sell under-utilized manufacturing facilities

Figure 5 List of recommended improvement initiatives

Plan and Prioritize short, medium and long-term initiatives

All identified improvement hypotheses/initiatives should always be prioritized based on bottom-line impact and time-to-money. Perform risk assessments and determine whether initiatives support your core business or not.

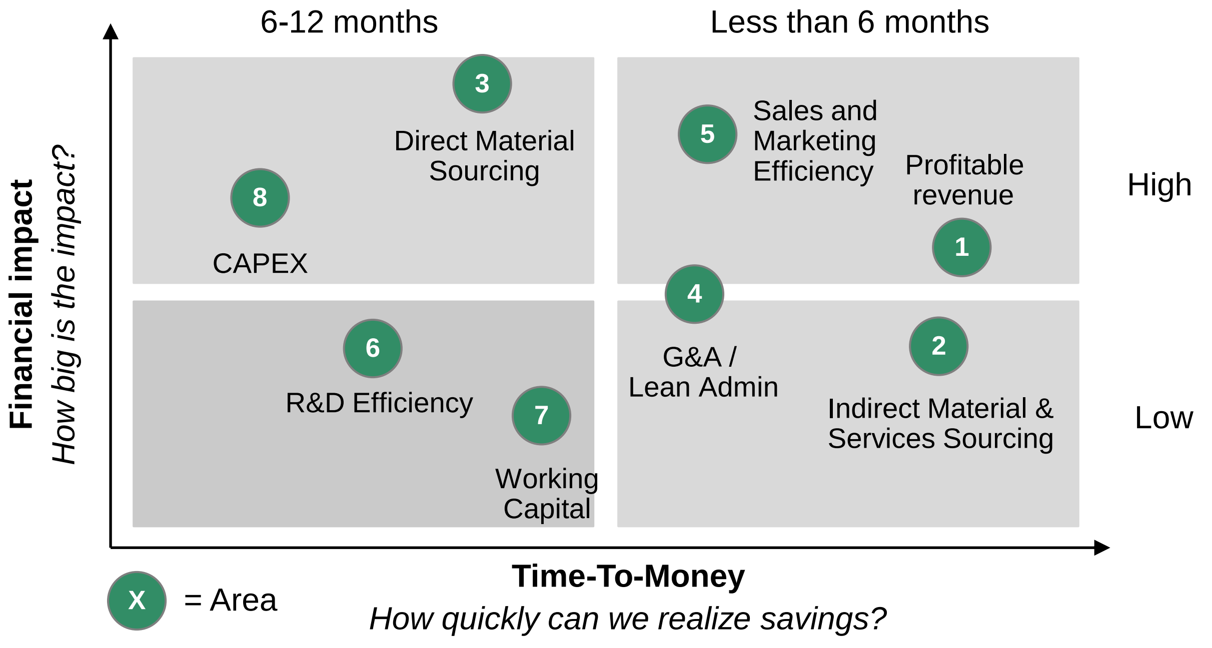


Figure 6 Improvement initiative prioritization framework, financial impact vs. Time-to-Money

In addition to prioritizing all initiatives based on Financial Impact and Time-to-Money it is also critical to consider several qualitative factors before finalizing the implementation plan:

	Qualitative Implementation Considerations - Checklist
1	What are the potential barriers and roadblocks?
2	What are the potential risks by initiative i.e. loss of revenue?
3	What are the identified key success factors / dependencies?
4	What capabilities and resources do we need to leverage?
5	What will the total one-off/restructuring cost be? Severance impact?
6	How will our key customers and partners react to the restructuring?

Figure 7 Improvement initiative prioritization framework, financial impact vs. Time-to-Money

Successful implementation is determined by *structure, discipline, and dedication* throughout the execution, Therefore a detailed implementation plan, governance, and monitoring of the change success must be put in place.

Lead the Change and Secure Successful Execution

Decisive leadership and rapid implementation are key success factors in any turnaround. Time is an asset that should be valued higher than money. You can get the money back, but never lost time. Establishing a sense of urgency within the organization is important since transformation programs require close cooperation between many individuals and functions. Without drive and commitment from the entire organization, it will be impossible to implement necessary changes. Research shows that over 50% of troubled companies fail when it comes to establishing a sense of urgency. A common reason for failure is that executives tend to overestimate how successful they have been in achieving a sense of urgency.

Additionally, executives often lack patience and want to start execution before a firm strategy has been defined. Without a sensible vision and a sound strategy, a transformation program can easily dissolve into a wide range of incomprehensive and disconnected activities that will either lead the company in the wrong direction or nowhere at all.

Thus, the most difficult part during a turnaround is the execution, and the necessary continuous improvements that come thereafter. A structured governance model including a steering committee, executive program sponsor, and dedicated transformation management team (restructuring office) is essential to ensure accurate and timely delivery.

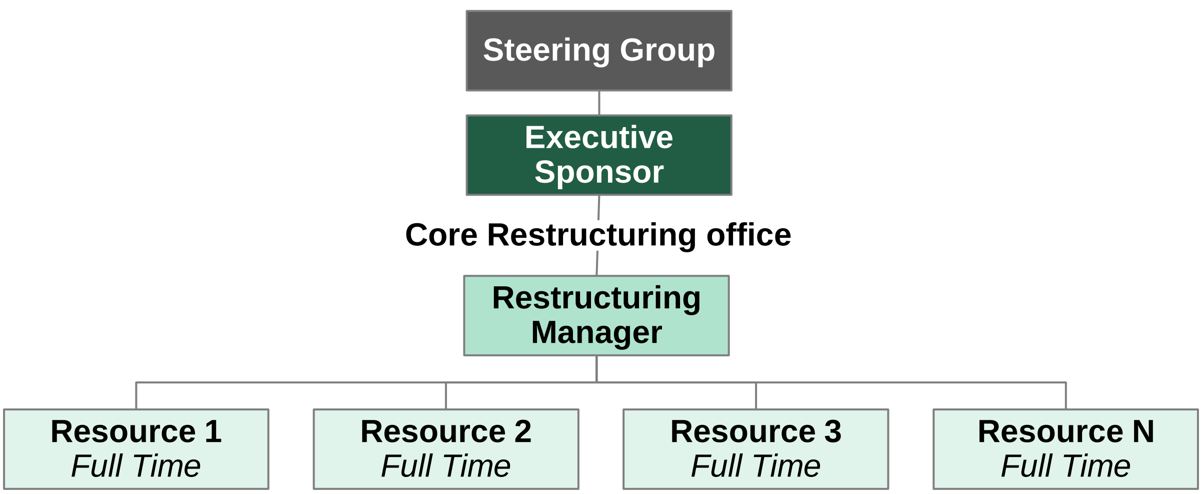


Figure 8 Example restructuring office set up

Although it may seem counter intuitive to involve external parties, who sometimes limited visibility into specific challenges, it allows the company to operate outside its normal boundaries, which is necessary during a state of transformation.

Applied Value recommends the company's management team to considers seven criteria when deciding on resources (internal vs. external) for the restructuring team.

	Considerations when putting together a restructuring team - Checklist
1	**Scale of project** – Can we dedicate resources that can cover the full project scope i.e. Markets, Functions, Business Units, Product Areas.
2	**Resource commitment** – Do we have enough bandwidth to dedicate key personnel and divert their time and efforts from other activities
3	**Management experience** – Do internal candidates have adequate experience?
4	**Decision-Making** – Will the resources be able to implement the required activities without being biased?
5	**Mandate** – Will the resources have the required mandate and adequate access to all stakeholders?
6	**Authority** – Does the project require the individual to challenge company executives / board / owners?
7	**External Perspective** – Do we have clear visibility into specific company challenges and understand best-practice from peers and other industries

Figure 9 Restructuring team considerations

The restructuring team will be responsible for monitoring the progress of all initiatives and making sure that all objectives are re-evaluated to account for changes within the company or in the marketplace.

Failure to understand the business impact from a crisis, as well as having an uncoordinated plan are a few common mistakes that companies make before initiating a transformation program. One of the key success factors to prevent unsuccessful efforts is to develop a detailed turnaround plan, covering all areas that require improvements incl. Revenue, COGS, SG&A, R&D, CAPEX, etc. The plan should be fact-based and data-driven, and typically takes between 30-60 days to formulate. A solid plan should start to yield bottom-line results within 60 days.

Throughout the program, the restructuring team should facilitate a regular cadence with all the stakeholders who are accountable for executing the initiatives. Applied Value recommends that initiatives be continuously evaluated individually and collectively to avoid potential overlap, and to ensure that all initiatives are fulfilling its part of the overall restructuring plan. It is imperative to have Finance and HR involved in the process to validate financial and operational impact of the activities.

Key Take-Away: Factors for a Successful Turnaround

- **Create a well-defined plan:** The success of a turnaround program is dependent on a well-defined strategy and plan. A prerequisite is a clear understanding of the key operating assumptions and cost drivers that impact the business. A flawed plan is more likely to obstruct an initiative than recover it.
- **Communicate the plan:** Without organizational buy-in it is impossible to execute a cohesive restructuring plan for the company. Establishing and maintaining commitment and accountability across the organization are necessities for executing a restructuring program.
- **Establish a sense of urgency:** Managers must be challenged and pushed beyond their comfort zone to stretch operational goals. By establishing a sense of urgency managers and the organization becomes engaged and motivated.
- **Drive the change:** The restructuring office facilitates the target setting, monitors the progress of on-going restructuring initiatives, and quickly identifies roadblocks and key decisions; it drives and leads the change through experience.
- **Prioritize and re-evaluate:** All on-going initiatives across functions should always be prioritized based on bottom-line impact, Time-to-Money, and whether they support the core business or not. The reduction targets driving the initiatives should be revisited several times to maintain relevance and alignment with shareholder expectations.
- **Go after quick-wins first:** Even with limited impact, get quick wins to show that you are making progress with the cost reduction program. Use increased credibility from early wins to change systems, structures, and policies.
- **Invest in the future:** A downturn may also be a good opportunity to invest – in R&D, human capital, and M&A. Investments are important to ensure long-term competitiveness and organizational growth. It is a good opportunity to elevate high performers to new roles
- **Encourage innovation:** Downturns provide an opportunity to rethink products and services and innovate their business models to profit from business opportunities. Open the organization to promote the flow of ideas from all layers.
- **Adopt new ways of working:** Although the restructuring program itself may be temporary, improvements made should have a long-term impact. Make sure people do not fall back into old habits after the restructuring.

Recent examples of Applied Value turnaround engagements

1 Supported client from an 80% sales decline to profitable growth

Project Approach

Define Strategy and Ambition → Productivity Assessment → Detailed Execution Blueprint → Org. Transformation

Outcome / Result:

- Reduced operating costs and achieved savings to a value of $3 billon
- Implemented new pricing strategy and cost reductions leading to a 2% GM increase
- Identified and dismantled direct product expenses by $73 million

2 Supported client suffering from heavy operating losses

Project Approach

Productivity Assessment → Planning and Anchoring → Org. Transformation

Outcome / Result:

- Identified and eliminated redundant costs resulting in a 27% total cost reduction
- Improved capital efficiency and increased ROIC by 10%
- Clients stock price increased by 360% during Applied Value's engagement

3 Supported client in reducing SG&A cost by 46%

Project Approach

Define Baseline and Benchmark → Org. Productivity Assessment → Org. Design Analysis → Org. Transformation

Outcome / Result:

- Created productivity evaluation model to test different scenarios
- Developed leaner support functions resulting in savings $25M
- New organizational structure supporting a 39% reduction in headcount

4 Supported client in recovering after $1B operational loss

Project Approach

Org. Productivity Assessment → Org. Transformation → Governance & Support

Outcome / Result:

- Turnaround engagement led to $5B OPEX reductions
- Achieved headcount reduction of 48%
- Implemented initiatives for increasing decision-making speed

Applied Value can help respond to this development with precision and speed, whilst keeping internal stakeholders focusing on the core business

For more information, please do not hesitate to reach out to:

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Applied Value Group is a premier boutique management consulting, investment, and social impact firm with a global presence. We focus heavily on ROI and tangible bottom-line results for our clients. We service both global conglomerates as well as small and medium-size companies on improving their cost and capital productivity from our offices in New York, Stockholm, and Shanghai.