Operational Turnaround Precursors

Description

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Every turnaround is unique not only by its different issues, but also by the time pressure and the actions of stakeholders around a company or not-for-profit. Turnarounds are often a startling experience—and for most people, the crisis appears to come from nowhere or happens on a rapid timeline. “How did you go bankrupt? Two ways. Gradually and then suddenly.” – Ernest Hemingway, The Sun Also Rises. The sudden part makes the headline, but it’s that slow part that is more bothersome. It’s like an Alfred Hitchcock movie, where the problems are evident before fate befalls the hapless actor. But for many, that ends up being more of a Monday morning quarterback moment. However, a little bit of science can help peer into this slow burn and provide context for where all that smoke is coming from. This article will explore some examples—the targets of the discussion will remain nameless to maintain anonymity. To get started, a framework must be established around the issue.

First, the company will be discussed in terms of its external and internal activities. In these situations, the smoke may come from a single spark, but it was not in isolation or spontaneous. The company will be examined from 10 different frames, discussing how all of these interact. But to put weight to the point that if a business had 10 different attributes and each of those attributes had 10 different conditions of existence, by the simple math of combinations, there are approximately 110 trillion different combinations of states of existence for a business. That is a lot, so the goal is to keep it relatively simple. Nobody can keep that many variations in their head, much less function in a system trying to keep tabs on all those conditions. It makes a trip to Las Vegas look like a safe bet. Establishing there are lots of ways to manage or wreck a company, scale also needs examination. Companies grow and decline and, for many, constantly shift their existence in markets. So not only is a CEO of a company trying to manage a near impossible combination of state of existence, the mechanisms are constantly rebalancing themselves. All in all, that’s daunting. To avoid creating a laundry list of issues that is too long to count, focus can be placed on the smoke from a couple different potential hot spots. First,

nothing exists in a vacuum—not even a monopoly—so what is going on around a company? To do this, look at four of the 10 attributes. There is competition, the immediate environment, global trends, and, last but not least, the company's own strategy.

Putting some of this into context, competition is a good place to start. Smoke from competition comes from several things, but the number of competitors a company has is a straightforward metric. It only takes seven or more to create an air of commoditization. For some, like retail, competition is just down the street. For companies that make things that ship, they will face any number of larger geographies. If the competitors have subsidies or advantages, slow profit leaks can be justified by management, saying it has to hold this ground, even when margins are unsustainable. Competition in and of itself is not automatically a smoke generator, but it can seep into an organization and create friction and smoke. Moving further into the analysis, customers, vendors, and lenders can all be points of friction. Customers have choices, always. Relationships start to tilt to transactional as options increase. A company may not be modifying its offering, but if the competition is, that makes smoke. Vendors are always an interesting topic. In much of the world, vendors are taken for granted. If one vendor cannot read minds or meet demands, a company will just find another one—perhaps something cheaper from overseas. Grinding vendors is the same as abdicating. Let the vendors set the table and, yes, lower cost will win. But has the company invested in those vendors? Or does it allow its supply chain to be the commodity train? The absence of value lowers a company's options, which causes friction when change comes knocking and cannot pivot, creating smoke. Lenders would seem to be an easy one. Money is fungible, but capabilities and temperament mean more than the interest rate and fees. Put into context, a borrower that constantly grinds on the cost, without looking at liquidity's integration into a plan, is just creating smoke from that pressure without it being applied to the mechanism of a business. Is treasury management requiring employees to work harder or do more tasks? Is the capital deployed really letting a company grow or is it just a safety net, not deployed, but there as baggage, just in case? That absence of thought will create smoke as markets move and the wrong capital is deployed to either protect or pivot a business. Not every business needs to rethink their capital deployments, so this isn't an area of smoke for a lot of businesses, but it will come up at the most inopportune times.

Sticking with outside influences, the outside world cannot be ignored—smoke can come from changes. In today's rapidly changing environment, this area is ripe with smoke alarms. First, channels of distribution are changing—logistics are more critical, and the impact of choosing incorrectly is friction in a big working capital way. Technology adoption curves have sped up. How this impacts various industries is still being weighed, but the impact on companies in the professional services industry cannot be missed, just for starters. Not seeing the opportunity for most levels of professional services will create friction and smoke. The foundations of society that seem to be changing are important considerations. Advocacy, political administration, and even global influence are continually shifting. Some will be impacted sooner than others, but change is real. For instance, if a restaurant in Iowa sees input costs go up, customers have to make decisions about where to spend money because farmers just down the road are grappling with societal changes as their products are shunned by more and more international trading partners. Just as regulation benefits certain groups, the move to deregulation will have unintended consequences. Consumers with more currency choice disrupt financial institutions, but deregulation brings out the fraudsters, shaking trust in long-established safe harbors. Not seeing the shifts will bring smoke.

The strategy of a company is moving a little closer to home—but still looking outward. This is where the entrepreneurial intent to help people runs into the challenge of customers' changing taste and options—essentially, how one goes to market and how deliverables can change. Smartphones have altered vast landscapes of delivery versus the 1990s—and AI will change the status quo. Office workers, for example, need something for lunch, but how they find that something, how it is delivered, and how they pay for it have changed and will continue to. All that gear shifting gets the mechanism of strategy turning. Just consider the expansion of available options compared to 2019 (pre-COVID). All the while, new options continue to arrive. Smoke is coming out of some CEOs' ears trying to keep up.

Most people looking for smoke and early problems might not dissect all the externalities of a business. After all, it is a lot of stuff to consider, and for every loser, there is a winner. It gets harder to identify the issue at hand in a business that is not yet distressed. That is OK, because much of the smoke from early warning signs manifests itself inside a business. And for that, smoke detection in these areas can be helpful: sales and marketing, operations, accounting, infrastructure, human resources, and legal. One could divide the pie differently, but these categories help locate smoke at small and large businesses through a similar lens. And in these areas, focus is placed on their internal workings—how does it all fit together?

Jumping from strategy to sales and marketing, a lot can be said about current events. AI has completely flipped marketing strategies on their heads. For the moment, everyone is in the same boat—but innovators are going to figure out the new playbook faster than others, causing otherwise stable offerings to disappear. In the commercial sales world, marketing does not carry as much weight as in consumer spending, but sales is not immune to AI. How prospecting is done, and proposals are written are all changing. If a team cannot adopt, the cost of customer acquisition will go up and close rates will decline, creating just the right friction to create smoke. A management team that is not proactively addressing this now is allowing the smoke to spread. Leveraging technology is becoming as important as having a customer relationship management tool. Sadly, it is not a focus for everyone and that will create damage. Sales professionals do not like systems as a general rule, but ignoring the process is a sign of early problems for any company.

Operations—getting things done—is the core of every company. It gets focus, attention, and is measured a good bit, even if it can look more like Kentucky windage at times. But two of the most compelling things about today's world in operations are logistics and waste management. Logistics tie back to the discussion about market changes, but internally, it makes for issues where systems must be integrated. Guesses create working capital and scheduling problems that make smoke. This is hard to see, unless someone's looking for inventory bubbles, shortages (that can happen at the same time), and either delivery date misses, which might become present in accounts receivables where items might age out, or discounts may grow due to customer complaints. On the second topic of waste management, instead of exploring important green initiatives, this is more akin to lean processes. What is hard to see, but makes smoke all the same, are optimized processes that should not exist. Eventually this will impact margins, but that is too late for smoke detection. Process waste is going to produce

smoke as technology ages out without replacement from new generations. Farmers are admirable in their incredible knack for repairing and maintaining machinery well past its expiration date, but if they cannot keep up with harvesting technology that might even alter or remove the need for that equipment, there's not much use to keep up the fight. An outsider might observe that capex is not keeping up with industry norms. The friction of maintaining old equipment or, better yet, deferring maintenance creates valuable smoke signals.

Moving to accounting, it is easy to see financial information pointing to issues, but from a smoke standpoint, that is too late. Once financial metrics start pointing south, fires are raging inside a business. Accounting smoke looks more like late financials, revised financials, or audited or reviewed financials that alter the picture from those that are produced internally. Those surprises are fires smoldering, just waiting for enough problems to burst. However, keeping the accounting picture simple, the lack of information from accounting should raise the most concerns. Contractors who have their outside accountant do WIP reports once a quarter rather than internally from project management monthly shows smoke. On a larger scale, due diligence requests—that should represent management's ideas that they want to turn into actions but are delayed as management puts that analysis together—show a lack of clear upfront analysis of the situation. Cue the smoke rising from the executive suite.

Infrastructure was covered in the earlier discussion about systems keeping up with changes like AI and not making investments in evolving process needs, but that other investment in human capital is so complicated these days. Staffing and labor people will say the economy is in a strange state of stagnation. Jobs are not lost en masse, but new openings are not showing up in significant quantities. Political policies are impacting labor as well, but a lot is changing in labor with border and immigration issues, aging populations, birth rates, and evolving needs for technological skills. Stats look good on the surface, but if a company is not actively addressing these forces, they are likely experiencing skill gaps either in missing workers or competition that has loaded workers with tools to move faster and better. Smoke here will be hard to see, so finding it might require asking around. If management shrugs its shoulders at any questions, that company has smoke.

Finally, the turnaround and restructuring world appears to be becoming one that is less civil and more litigious. Steps in the negotiation process seem to have broken down and going to arms appears to be more common. It feels like entitlement, but whatever it is, it generates smoke. Though if a company is racking up legal bills, that is fire and not smoke. The culture of an organization can help determine if it is self-aware or if it arrogantly strides forward into the fires. Smoke is there to see for those who stop to ask questions—and companies give off signals every day. Listening provides the fire suppression system that keeps a company in a fast moving and gyrating economy from suddenly going out of business.

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