# Strategy and Leadership: at the Root of Business Distress

*by Randy Markey, with contribution from Dr. Ronald G. Fountain*

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At a recent seminar panel discussion on insolvencies and liquidations, a member of the audience asked the panel to discuss the key drivers of bankruptcy. The answer, from a partner in a leading advisory services firm, astounded me – "Typically, we find that the drivers are predictable: receivables getting out of hand, inventories are bloated, relationships with vendors not being strong, a lack of controls on cash expenditures, etc. K-Mart is a great example. The bankruptcy at K-Mart is a direct result of poor relationships with vendors."

Are these symptoms or drivers? Our experience would prompt us to look into the fundamental shift in the structure of the big-box, discount retail market as a result of innovations and adaptations in logistics and merchandising technology as causes. What about the impact of the best-in-class practices of competitors Wal-Mart and Target on industry margins? What about the inability of KMart to define and articulate a resonant value proposition to its customers in the wake of shifts in consumer needs, wants, and desires? What about K-Mart's inability to align the critical activities required to deliver product to the shelf on-time, accurately and for the lowest possible cost? Did the inability of K-Mart to (a) choose a strategic position in the market and (b) define and execute a strategy to deliver on that position play any role in its current situation?

In our collective experience as advisors to hundreds of companies in the middle-market, we invariably find that receivables management, cash controls and inventory accuracy are simply symptoms of the larger strategic and leadership issues that truly drive the outcomes that call for our assistance as advisors on sustainable value creation. Alternatively, we have also found those companies that address their strategic and leadership issues early and quickly tend to avoid distress and crisis. While these more proactive companies may run into tough times, they typically manage to weather the storm while remaining cash flow positive and at least at breakeven in terms of profitability.

Over the years, we have found four primary strategic issues that result in underperformance. These are: 1) a lack of response to shifts in market structure; 2) application of the "wrong" strategy in the face of the current market structure; 3) a misalignment of activities (lack of "fit") that inhibits the ability of the organization to deliver economic value; and 4) pursuit of growth for the sake of growth.

## SHIFTS IN MARKET STRUCTURE

In many cases companies can find themselves in a downward performance spiral as a result of their inability, or unwillingness, to respond to shifts in market structure. Changes in the fundamentals of the competitive environment such as new technologies, alternative materials, consolidation of suppliers, a glut of production capacity, etc., can have a significant impact on competition in any market. Firms that have the ability to identify these changes, and more importantly, have the foresight to adjust their strategic focus in the face of such change, can leverage the opportunity to gain competitive advantage. Those firms that cannot or do not make this adjustment, often find themselves facing market share slides and erosion in margins that lead to distress.

In a recent engagement with a $100 million distributor of heavy construction machinery, we found that the driver of the client's woes was its unwillingness to recognize that the economics of the industry had changed as a result of shifts in the market. For years this company had relied upon the sale of heavy equipment units to drive profits.

Service and parts were offered primarily in support of the sales of equipment but were not the primary focus of management. Over time the market had changed. As the technology in the machine business became ubiquitous, and quality became a simple cost of entry (rather than a differentiator), gross margins on machine sales industry-wide began to shrink. As machines became "commoditized," parts, service and rental became drivers of value-added revenues and earnings. At the time we were engaged by this company management had not yet recognized that the problem was traceable to a strategic shift in the industry. While they hung their hats on their ability to populate the market with their machines, they had only a 20% share of the total available parts and service business for the brands they sold in their geography. On this basis, selling their way out of this situation was highly unlikely to deliver the outcomes necessary to provide the client with sustainable performance. A shift in strategic emphasis was required to reposition the company in its market. Not only must management focus on populating the market with as many machines as possible, it must also shift its primary efforts on servicing those machines better than anyone else in order to capture the high margin parts and service business. Failure to make this shift would surely result in extinction.

APPLICATION OF THE "WRONG" STRATEGY

Just as shifts in market structure can obsolete an existing strategy, many times we find that firms are pursuing strategies that are ill-suited to the existing market structure. Firms that fail to evaluate the competitive context in which they operate have a high propensity for developing and pursuing strategies that are destined to deliver mediocre financial results, or fail completely.

Firms that perform the rigorous task of continuously analyzing the drivers of competitive rivalry and anticipate their evolution over a three to five year time horizon have an advantage in positioning themselves for competitive advantage. Those firms which short-cut this process, or simply fail to examine it will likely experience sub-optimal market outcomes.

Another client, a mid-sized, niche product manufacturing and marketing company, was facing serious pressure from its lenders and its board to make major changes in management. The perception at the board level was that the current management team had a problem with executing its plans. Therefore, the board sought our evaluation of management and recommendations for change. During our assessment we found that execution was the least of their worries – in fact, if there was one thing this company was good at, it was "plan" execution. However, what we frequently witnessed was the execution of an inappropriate strategy. The client had developed more than 80% of the technologies that existed in its product markets; had more than 30% market share in the "new installation" market for the products it produced; had successfully transferred production to a new, lower cost facility; and consistently developed and commercialized new technologies with growth rates that outperformed the competition. But the company was losing money hand-over-fist. At the core of its dilemma was the company's inability to capture the lifetime value of its highly consumable innovations. Therefore, the company could not achieve a reasonable return on its investment in innovation because of its chosen position in the context of the current market structure. A change in strategic emphasis was the prescription for cure, not a wholesale change in management!

For this client, the basis of competition in the high margin, consumable – or annuity – business of replacement products was distribution share. As a niche manufacturer – only producing products in one of many categories of trade within its market – this company lacked the market power to compete against the industry's three major players. The industry's "big three" could keep them off the shelf at the distribution level by leveraging the breadth of their own product offerings. In addition, those major players had the distinct advantage of being able to sit on the sidelines and observe the degree of success that our client had in any new product introduction. This role might persist for two years (the operating life of each product installed) before they had to decide whether or not to enter the market with a "knock-off" product.

These large players could then capture the vast majority of the replacement product business into perpetuity while having to suffer little of the development costs. By shifting to a strategy of "Market Judo" – leveraging the strength of the other channel players to their advantage through strategic alliances rather than trying to fight head on – this company now has the opportunity to capture a larger share of the replacement market.

By shifting the emphasis from "brand share" to "manufacturing share," the company can capture a larger slice of the value in the product lifecycle, and increase total returns on assets. Firms which fail to recognize the importance of competitive context run the risk of developing strategies that deliver sub-optimal economic outcomes. A rigorous focus on strategic analysis, applied at least annually, can mitigate the threat that the wrong strategy is being pursued.

LACK OF "FIT"

Strategy is often simply defined as the coordination of activities designed to deliver outcomes that customers will find desirable. Performed well, these activities should also produce economic returns that are superior to those of one's competitors. If a firm seeks a competitive position as the low-cost producer of "value" products, then it must develop activities that are focused on delivering on that proposition. The degree to which each activity contributes to the strategic position, or the degree to which it "fits" within the context of that position, determines the degree of value it adds or detracts from the final outcome.

Unfortunately, as firms evolve over time and infrastructures grow, we often find that this coordination, or "fit," has deteriorated. The unwillingness to make choices and trade-offs in the name of market positioning,
or the inability to coordinate activities around the delivery of the specific value that customers desire, can have significant impact on an organization's performance. Conversely, firms who relentlessly pursue the coordination and continuous improvement of activities, increase their probability of success significantly.

We recently worked with a distributor of highly commoditized industrial components. The client positioned itself in all of its sales literature, and in every customer communication as the premier value-added supplier of premium products and components to the market. As such, this firm viewed itself as worthy of commanding a premium price for its products in specialty applications.

Activities designed to deliver on this proposition included the acquisition of distribution rights to the highest quality products; superior technical support; highly trained custom fabrication and design capabilities; a best-in-class service and remanufacturing facility and staff; and a well compensated, highly technical sales staff.

However, some critical activities required to truly perform at the premium end of the market were lacking. This contributed to an inability to deliver superior financial outcomes for the firm and its shareholders. Contributing to high rates of customer defection and poor operating results were a lack of focus on procurement, poor inventory management and controls, inadequate training for line employees, ineffective internal processes in order entry, invoicing and other critical practices. Product availability and lead times were outside of customers' demand parameters, order accuracy was below 85%, and the quality of customer service and invoicing was reported by customers as disappointing and challenging. The results were predictable – bloated inventories, high rates of returns and credits, significant delays in receivables, high levels of invoice disputes, and extremely high operating costs experienced to support the "reworking" of numerous orders. Cash flow became negative and earnings disappeared.

With a renewed focus on operating excellence, and the support of three of the company's largest suppliers, "fit" is now understood to be a critical driver of success. Alignment of activities directed to delivering value to a targeted set of customers is a critical practice. A careful assessment of an enterprise's activities can reveal opportunities to enhance both competitive position and operating results before underperformance becomes distress or even crisis.

PURSUIT OF GROWTH FOR GROWTH'S SAKE

The pressure to deliver year-over-year growth in both sales and earnings has become overwhelming yet common in the past decade. As companies pursue growth opportunities, they often convince themselves and their investors of the efficacy of rationales such as "synergies," "complementary product offerings to the same core customers," "translation of core competencies," etc. It is frequent that these rationales are legitimate, and with skilled management, great success can be achieved. Just as often, if not more so however, such rationales are generated without the appropriate level of due diligence. Whether through acquisition or internal, organic growth, firms who pursue growth opportunities without the appropriate level of strategic analysis often find themselves overextended and struggling to produce satisfactory results.

We recently worked with a large distributor of HVAC and plumbing products. Over time, the second generation CEO of this family-owned business felt a need to grow the business. Three strategies were played out to achieve the growth objective. These included acquisition of a telecom equipment distribution company; acquisition of a plumbing supply firm in an adjoining state; and expansion into the "building products" category to support the contractors who purchased their core plumbing and HVAC products for kitchen and bathroom additions and renovations.

The results were predictable. The telecom distribution company, while profitable, served as a distraction for the senior leadership of the firm, diverting attention from the core business. The acquisition of the plumbing supply firm in an adjoining state was accomplished without sufficient due diligence. This resulted in acquiring underperforming assets that provided significantly less synergy than originally anticipated. The expansion into a support category evolved into a cash and profit drain – "building products" as originally defined included only those items that supported the plumbing category, such as kitchen counters, cabinets, and appliances. All of these products were high margin, low inventory (custom) items that truly supported the company's position with contractors. The term "building products," however, soon grew to include items such as roofing shingles, vinyl siding, windows, etc. None of these was related to the core business of supporting the renovation of kitchens and bathrooms! In addition, all of them required large outlays of cash for substantial inventory requirements and provided low margins. The result was material negative impact on the firm's ability to deliver value to its customers in its core HVAC and plumbing businesses. This occurred as resources were diverted away from the activities required to support them. By the time we were retained, customers were defecting at alarming rates; the client was losing $2 million a year, and was burning through cash at an unsustainable rate. All of this was driven by the lack of a focused growth plan.

Businesses that pursue growth for the sake of growth alone run the risk of pulling value away from the core business and undermining the fundamentals of their business models. A well designed growth strategy, whether for external or organic growth, includes a rigorous process of analysis and due diligence. When that strategy is planned and executed correctly, value will be enhanced.

TRULY AVOIDABLE

While we consistently find these four strategic issues at the core of distressed businesses, we also have had frequent opportunity to encounter organizations which address these issues early and
with speed, and manage to avoid distress.

We were recently engaged by a firm, at the suggestion of its bank, in the value-added rubber processing industry. The market for the client's products and services had been hit hard by the downturn in the economy. One of their largest customers was suffering the results of some serious interruptions to its business due to product failures and the impending liability issues associated with those failures. Due in large part to the strong focus that this company has on its core position in the market and its customer service orientation, in combination with a rapid response to the warning signs of the broad economic downturn, the company was experiencing difficulty but was not in crisis. It had shut down ancillary product lines, consolidated shifts, and focused on maintaining and improving its performance with core customers. While cash flows and earnings were negative for a period of time (the source of its lender's concern), the fundamentals of the business were sound. The enterprise had lost no customers to lower-cost providers. Its scrap rates and thru-put were improving due to a focus on continuous improvement in the plant. Its quote activity had increased almost three-fold over a two year period, and new customers were signing on for significant projects as competitors failed to meet demands.

By the time we were engaged, the company had achieved three consecutive months of cash-flow positive results, and had one month of positive (albeit small) earnings. Management projected improved earnings in the current month. What a pleasure it was for us to report to the lending bank that management of the client was ahead of the curve in implementing a thoughtful business plan in a decisive and positive fashion!

With a focus on its core business, combined with swift and decisive action in the face of adverse economic conditions, this business has weathered the economic storm with minimal damage. It has also been able to improve its competitive position as rivals struggled to survive. The foundation for this result was built not during the recent period of difficulty, but over the preceding years. This occurred thanks to a strong leader with a solid strategic orientation and a deeply engrained process for evaluating the competitive context.

This leads us to one final but essential observation.

THE ROLE OF MANAGEMENT/LEADERSHIP

In our practice, the situations described above are more common than one might imagine. What makes our work interesting is identifying and helping to correct the root cause of those situations.

It is rare that we encounter a complete absence of technical skill or knowledge in the organizations to which we provide advisory services. In almost all of the cases where we are engaged, the underlying source of the problems is an absence of constructive leadership or management. It is worth noting that we rarely are confronted with a lack of knowledge about how to do what needs to be done. That is not our usual experience. More frequently we see the cause of a business failure or decline being rooted in an unwillingness or inability on the part of management to make the changes required for survival and ultimate success.

This is not to imply that those managers always take an actively resistant role to change. More often the approach we experience is one of mangers passively resisting the requirement to change and the advice regarding that change. But passive resistance can be effective and deadly. This is particularly true in situations of significant business under-performance.

Often we hear the comment, “Everyone wants progress but no one wants to change.” In our experience that is all too often the case. However, it is worth exploring why it is true. What is it about change that makes it so threatening and what is the role of management/ leadership in achieving necessary change?

Change in organizations can be an extremely emotional event. Frequently it can be more emotionally challenging for managers than their subordinates who actually have to alter their patterns of decision-making and behavior. For a manager the acknowledgement of the need to alter his or her organization’s path might be seen by the manager as an indication of the failure in championing that path. However, the failure to acknowledge the valid need to change, and act on it can be one of the most dangerous blind spots a manager can experience. It is dangerous not only for the manager but also for the organization she is leading.

One of the aspects of change that makes it so challenging is its ability to act as an organizational status equalizer. When change occurs there is a very real threat that others in the organization might be equally or even more skillful at operating in the new manner than their manager is in that mode. While great managers embrace this challenge and respond to it enthusiastically and constructively, many others fail to do so. Being only experientially equal or even inferior in possessing newly required knowledge is something that many managers have not encountered before. When that occurs, an escalation of commitment to existing patterns of behavior is often the response, and at just the wrong time. Such actions can, and frequently do, result in an organization being deprived of critically important resources and therefore being irreparably harmed. Unfortunately, time is one of the most important and most commonly wasted resources in these circumstances and time is irreplaceable. On the other hand, when a manager sees her responsibility as leading the organization to a defined outcome success is more likely to occur. To do this requires that the manager commit to the needed change, regardless of her concern for her position after change occurs in the enterprise.

Another aspect of change that can make it threatening to some is more about what is not known than what is predictable about the outcomes of change. The threat of uncertainty can be powerful! All too often we encounter managers who would rather remain embedded in their comfortable patterns of practice or even increase their commitment to those practices than to confront the uncertainty of taking a new and unfamiliar path. This can even occur when managers know that remaining fixed on the existing path is not operationally sound.

In businesses that succeed the most common role of management is as an enabler of change. When managers, and for that matter all members, of an organization are focused on achieving a shared vision of a legitimate outcome, the ability to make changes in processes comes easier. The competitive pressures between disciplines or practices give way to the excitement of the possibility of achieving the shared outcome. This occurs because there is no requirement to give up on the certainty of where the organization is attempting to go. The commitment to the outcome remains, regardless of the process employed or the strategic competence being featured at the time. Instead the emphasis now is on how we get there not on where we will finally land.

In most cases where we are engaged we find that the rank and file employees are quite prepared to make at least some of the changes that need to occur in order for the enterprise to achieve its vision. They frequently know, and have known for some time what actions are necessary for improvement and sometimes even for success.

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Having managers who will grant them the opportunity to put some of those actions into practice is a factor that most look forward to expectantly. More often than not, the barrier to moving in this direction is the resistance of managers who see the threat of change more challenging than the rewards that might come from change.

In closing it is useful to note that to achieve business success, it is essential that an organization make decisions and take actions that fit their strategic context. Recommitting to old patterns of practice that have been proven to produce sub optimal results, only because of management's comfort with those practices is a roadmap to failure. However, solid and constructive management and leadership in these situations is the key to business success.

Fear of the unknown can lead to paralysis; giving in to that fear may lead to death. In our practice we prefer the role of healer to that of undertaker. Our experience tells us that most businesses can be healed. More often than not it is the willingness of management to recognize the need for, and to embrace change that makes the difference.

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