Team-Based Incentive Compensation is Vital to Successful Operating Turnarounds

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In recent months, greedy executives have given pay-based bonuses a bad rap. That's unfortunate, because incentive compensation is a vital, essential, and frequently overlooked tool when it comes to turning around a poorly performing company. This is especially true when the focus is on employee incentive compensation. If substantial improvement is to be made to a struggling company's EBITDA, a seismic change in the entire corporate culture must take place, starting at the grassroots (or factory, or office) levels where employees work.

A turnaround plan that incorporates team-based performance and results-based incentive bonuses for managers and employees can create amazing results in a financially challenged company. It must, however, be designed so that managers and employees are given ownership over their portion of the P&L to support a specific customer segment.

WHAT'S WRONG WITH THIS COMPANY?

Typically, employees within a company in serious decline feel little or no ability to alter outcomes or improve the overall performance of the enterprise. And that's a monumental problem, especially since all of a company's work is done by its employees. Unless employee attitudes are improved, there's little chance the company will turn around. The dilemma is that most business owners, equity sponsors, and shareholders are blind to the true nature of this daunting predicament. It's the elephant in the boardroom that owners and investors neither see nor understand. Employees don't bring it up because, well, why bother? If they've raised the issue in the past, they were very likely ignored, or worse, punished in some way for their candor.

This problem, however real, doesn't show up as a line-item on the P&L statement, nor does it emerge as a discrete category in even the most thorough EBITDA calculation. That's because it's a product of something much more ephemeral and harder to quantify: the corporate culture.

Infusion of new capital and energy from an investment group rarely improves an ailing corporate culture. If anything, the purchase of a distressed company by new owners usually has the reverse effect, worsening what was already dangerously low employee morale. Employees today are very well-informed and highly sensitive to even the slightest changes in the company. So, when truly dramatic rearrangements such as a change in ownership occur, most employees are quite aware that within a few years, the new investors will either flip the company or dismantle it and sell off the pieces. The outlook, from the average employee's point of view, is dismal.

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Unless systemic, positive, and enduring changes are made to the corporate culture—and quickly—the company's decline will continue.

ANALYSIS OF THE PROBLEM

How can private-equity investors determine whether (and where) such a problem exists? The first step requires a willingness to take a more active role in the initial due diligence process. Outside professional help will often be needed, as well.

The first order of business for a newly engaged CTP (Certified Turnaround Professional) is to get out and meet with and talk to the employees, from hourly laborers to administrative assistants and junior managers. When asked, most employees will gladly discuss what they see as wrong with the company—granted, of course, that they have no fears of reprimand or retaliation. Once an employee's trust and confidence are earned, it becomes quickly apparent that their assessments of what's amiss are usually right on target. The top two items on the list are often:

- Employees are not listened to and sense that they have little or no say in the day-to-day, essential decision-making that affects their work-life, even though employees are the "brain-trusts" when business challenges exist.
- The feeling of having no power to control the company's productivity and its profitability, and for all intents and purposes their own fate, is profoundly demoralizing. Knowing what employees know and seeing those issues ignored by management, the Board, or new equity sponsors is disconcerting. Moreover, demoralized companies do not, as a rule, demonstrate robust EBITDA.

Most employees have a wealth of valuable and very credible ideas about how to improve things. Even more to the point: they earnestly want to be part of the solution and to have a say in important decisions. Shockingly few investors, owners, and executives understand or utilize the fundamental truth that employees have their company's best interest at heart and want to see it succeed. That's where the rub is, because the energy, expertise, and corporate wisdom of a corporation's employees is precisely what must be engaged and harnessed to move an under-performing company in a new, more profitable direction.

Most equity sponsors introduce company-wide incentive compensation programs based on improvement to the company's EBITDA. While senior executive incentive compensation programs make this an excellent performance metric, most employees believe they have very little direct control over EBITDA. Far too many of these programs end up de-motivating the rank-and-file employees.

A team-based employee incentive compensation program, with individual performances tied to the company's direct contribution margin (DCM), featuring quarterly cash bonuses, is an outstanding method of winning crucial buy-in and fostering a sense of committed ownership among employees. Critical in the design of DCM team-based incentive compensation plans is establishing business-segment, product-line, or geographic customer-centric DCMs. And because DCM is a component of the company's EBITDA, it is a good proxy to measure and reward performance while creating increased enterprise value for the equity sponsors (see exhibit).

From a strict cash flow point of view, such programs, when successful, are like a goose that lays golden eggs—they're self-funding and self-reinforcing; success builds upon success, which in turn attracts higher levels of employee enthusiasm and buy-in. Moreover, as word gets out on the street, it will begin to attract new, similarly enthusiastic and high-caliber employees looking for a vibrant, meaningful, and rewarding place to work. To be effective, such a program must work in concert with other substantive changes in the corporate culture.

Many companies, having heard about the benefits of employee recognition, incentive, and reward programs, often give them a try. Many do it for all the right reasons. Without question, employees should share in their company's increased value (after all, that value is due largely to their efforts). Far too many companies that implement incentive programs, however, hold out unreasonable hope in their transformative power. The market is glutted with professional employee benefit service firms and systems that may, admittedly, get the bonus numbers calculated correctly, but remain tone-deaf to something much more important: the human element. These programs essentially boil down to one-way, top-to-bottom financial gestures made by

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EXHIBIT
Direct Contribution Margin

Basis for Team-Based Incentive Compensation ($000)

	2009 Plan	2008 Actual
Gross Revenues/Sales	$10,000	$8,500
Less Sales Returns and Allowances	(500)	(450)
Net Revenues/Sales	9,500	8,050
Cost of Sales:		
Beginning Inventory	3,000	4,000
Purchases & Product Acquisition Costs	5,500	4,650
Less Ending Inventory	(2,500)	(3,000)
Cost of Sales	6,000	5,650
Gross Profit	3,500 (35%)	2,400 (28%)
Less:		
Sales Salaries and Commissions	700	600
Bad Debts	150	300
Direct Warehousing	250	225
Direct Shipping/Transportation	100	75
Subtotal	1,200	1,200
Direct Contribution Margin	***$2,300 (23%)***	***$1,200 (14%)***

Note: Include only those revenues/sales, costs, and expenses within the team's control and a financial reporting system that can regularly report actual performance.

the company's leaders. They fail to address the true nature of the company's productivity and profitability problems; improvement, if any, will be incremental and probably not long-lasting. As for inspiring substantive change—the kind needed to actually pull a sinking company back from the precipice and set it on a more profitable trajectory—they're rarely sufficient.

To build a company's value in a meaningful way, a team-based incentive program cannot work in a vacuum. But for the true power of such a program to be unleashed, employees must be granted greater ownership of a company's DCM. There must be a direct link, a feedback loop, between their efforts and the quarterly bonuses they receive from their incentive program. The missing link in this particular loop is *influence* (there's that word again). It is important for employees to have a sense that they have skin in the game, along with a substantive control over and investment in the company's fundamental, on-the-ground decision-making processes.

THE CHANGE PROCESS

Follow this four-step process to see quantifiable and qualitative changes.

Step One: Understand the Capability of the Company's Financial Reporting System

This is an important part of the turnaround professional's initial assessment of the business. Ideally, accounting systems that track monthly performance of a customer type, product line, geographic area, or business segment are best suited to the task of implementing direct contribution margin (DCM) incentive programs. *Caution*: allocation of costs in deriving DCM will create de-motivators for employees because they will be viewed as "non-controllable" costs.

The objective should be to measure customer, product line, geographic area, or business segment DCM for all related revenues and direct costs and align employee

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