How to Fix the Rotating CEO Dilemma: *Best Practices of Turnaround Management Professionals*

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A company under your watch is struggling. Projections have been missed; sales are flat, or maybe even worse; the bottom line is starting to more closely resemble a downhill ski slope than the upward-trending bar graph management eyed at the last board of directors meeting. What once seemed like a sound business opportunity will soon be an ill-fated gamble unless something is done to rectify the situation. So what are your options?

This dilemma provides a glimpse into an enormous challenge facing equity partners and corporate leaders today: how to best fix underperforming organizations, especially small and mid-cap companies, that have been beleaguered by the multitude of new challenges.

In many cases, a change of leadership via a new chief executive officer is the decided-upon solution. When a company struggles, the urge to assign blame is strong. Chief executives bear the brunt of the finger pointing, as they are often viewed as the key driver of corporate performance. As statistics indicate, an unprecedented number of companies are parting ways with their CEO. Many struggling organizations are bringing in new leaders, in hopes that a fresh face with new ideas will restore the bottom line and return the business to profitability. Unfortunately, a large percentage of these companies later find themselves in the same, or in many cases worse, situation than that which existed prior to the dismissal of the original CEO. These companies are finding out the hard way that replacement CEOs frequently are not the savior they are hired on to be.

This article will examine the "knee-jerk" tendency to replace CEOs of distressed or underperforming companies with new leaders that, in many cases, are no more capable of fixing the underlying problems causing the distress than their predecessors. It will present a new methodology for equity groups to consider prior to replacing incumbent CEOs of struggling companies in their portfolios. This methodology is driven by the benefits gained by hiring a turnaround management professional to serve as interim CEO or, in the case of public companies, interim COO or CRO.

A PERFECT CORPORATE STORM

Global macroeconomic forces have been fiercely working against equity groups and CEOs alike since the economy began its decline in the late nineties, leading to what has now become the largest economic downturn in recent history. Since March 2000, $7 to $8 trillion of value has evaporated from the capital markets. In addition, over 35,000 companies have filed for bankruptcy protection in each of the last three years, according to the American Bankruptcy Institute. With so much at stake, investors today are constantly watching, assessing, and judging the performance of CEOs. The result is a quicker-than-normal trigger finger when leaders fail to meet expectations.

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On top of today's economic hurdles and heightened investor angst, an equally powerful factor driving CEO scrutiny has surfaced recently in the form of corporate governance mandates and increased government regulations. The recent wave of accounting fraud and inaccurate financial reporting has not only led to a severe lack of confidence in senior management, but inspired a new age of government regulations, led by Sarbanes-Oxley, with significant effects on both corporations and those who lead them. CEOs are now required to certify financial statements under Sarbanes-Oxley, and their own personal financial dealings are viewed under an increasingly fine microscope. Smaller and mid-market companies are especially vulnerable to the complexities and high costs related to the new regulations, which can cost a public company an additional $300,000-$500,000 annually.

All of these factors are combining to form a perfect corporate storm, resulting in more CEO firings than ever before. With the average tenure of current CEOs dropping recently to a mere 2.75 years, according to global human resource consultants Drake Beam Morin, CEO chairs today are looking more like rotating hot seats than the stalwart, veritable thrones they once were.

Statistics on the record turnover rate of CEOs have been well documented, with a significant increase in involuntary turnover. Involuntary successions in 2002 increased by more than 70% over 2001, according to a recent study conducted by Booz Allen Hamilton, with 39% of 2002's global CEO departures being forced, performance-based changes. Numerous high-profile Fortune 500 CEOs have been dismissed over the past few years: AOL Time Warner, Deutsche Telekom, Honeywell, Merrill Lynch, AT&T, and several others have all parted with their leaders.

There are many traditional reasons why an organization may choose to dismiss its CEO. The inability to meet projections is, logically, among the most frequently cited grounds for dismissal. The inability to deal effectively with the board of directors and the inability to control surprises, although less frequently cited, are common deficiencies that send CEOs out of a company's favor and head office. Other common reasons include the failure to motivate employees and subordinates, as well as poor customer interaction.

These deficiencies are often used individually or in various combinations by boards of directors and private equity partners as the rationale to explain why they chose to dismiss a CEO. In some cases, these reasons are well founded. Serious deficiencies of a CEO can significantly contribute to the company's distress. But are CEOs today less able to overcome these challenges than their predecessors? Surely, this is not the case. Instead, it is today's extraordinary business climate that is causing this situation to occur.

To understand the net effect of all this CEO activity on business today, it is helpful to examine the process by which the vast majority of companies dismiss chief executives and then hire a replacement leader. Typically, the replacement process is initiated when a company's board of directors and/or managing private equity group begin to get suspicious of underperformance. Underperformance is a broad term with many flavors, but is often driven by the common criteria associated with stock valuation, sales, and net financial results.

Once a problem is suspected—or if it becomes obvious at a later stage—the board and/or equity partners will alert the CEO to their concerns and prod him or her to present a solution for rectifying the situation. Inevitably, meetings will be scheduled; presentations will be made; a solution will be quickly sought. But most importantly, precious time will be lost. Most boards of directors and investment groups do not have an extensive depth of understanding into operational issues and associated problems inherent to distressed businesses, nor sufficient time to devote toward fixing the underlying problem(s) themselves. Instead, the CEO is relied on to provide answers.

But as the statistics documenting the current rate at which they are being forced to leave indicate, these exchanges between CEOs and dissatisfied board members rarely end in the CEO's favor. The board of directors, frustrated with the incumbent, arrives at the conclusion that new leadership is the best course of action. The incumbent is dismissed and, unless an obvious replacement is available to step in—which typically is not the case—an executive search firm will be retained to find a replacement. Once the search firm is hired, it is not unusual for another six to nine months to pass before the replacement is brought on board. It is then likely to take the new leader a minimum of two to five months to get fully engaged and up to speed on the situation at hand. Under this timeline, it is not unusual for 10 months to a year to pass before any real action is taken by the new CEO. This process, although typical, does not frequently work for distressed organizations.

A study conducted by the University of California indicates that bringing in a new CEO is not a panacea to be relied upon in times of trouble. The study, conducted by Margarethe Wiersema, examined all instances of CEO turnover in the 500 largest public companies in the United States during 1997 and 1998.

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Writing about her study in the December 1, 2002, issue of the *Harvard Business Review,* Wiersema states, "Most companies perform no better—in terms of earnings or stock-price performance—after they dismiss their CEOs than they did in the years leading up to the dismissals. Worse, the organizational disruption created by rushed firings—particularly the bypassing of normal succession processes—can leave companies with deep and lasting scars. Far from being a silver bullet, the replacement of a CEO often amounts to little more than a self-inflicted wound."

As Wiersema's research indicates, the hiring of a new, replacement leader is not the surefire remedy it is hoped to be. Replacement chief executives often fare no better or, in many cases, worse than their predecessors. Why is this so?

To answer this question, one must consider the background and skill sets possessed by most CEOs today, and the driving forces that have led up to the current CEO demographic. While there is not a single, all-encompassing profile that can be used to universally blanket CEOs, there is a set of common "CEO traits" that can be identified. CEOs are, by and large, seasoned leaders with domain experience in the industry. Alternatively, if the new CEO is an "outsider," or an individual coming from a different industry, the person will at the very least possess a wealth of solid business experience and a proven track record for delivering consistent growth. A firm understanding of market dynamics is a standard prerequisite, as are the abilities to communicate well and build solid relationships with customers, employees, and suppliers. The ability to examine strategic mergers and acquisitions, build market share and top-line revenues—while both desirable and advantageous—are perceived as common, required skills for CEOs.

Enter the boom years of the nineties. The rhetoric, and unprecedented wealth, associated with the "new economy" and Internet age, greatly skewed the expectations curve for CEOs. When the economy was booming and markets were skyrocketing, the potential for growth seemed infinite. Triple-digit compound annual growth figures were commonplace in many industries. Expectations for CEOs to deliver constant, rapid growth year-over-year mirrored this environment. Business fundamentals, however, were not a key priority for many companies. Equity groups and corporate boards sought CEOs capable of harnessing "the next big thing" that would deliver rapid results and propel their organizations into the upper stratosphere of high returns and limitless growth that was seemingly being enjoyed by so many other success stories. This environment helped breed what we'll refer to as the "growth-oriented" CEO.

Now fast-forward to today's business climate, where even the most modest growth margins are hailed as great successes. The ability to maintain a cash flow neutral position, or even stay in business, has emerged as the key priority for countless companies that have fallen on difficult times. The new, unpredictable business environment is placing new demands on corporate leaders. Chief executives are not only being relied on to grow revenues and profits, but actually repair businesses that are badly broken. But just as emergency heart surgery is a much different proposition than a stress test or other physical exam, so too is fixing a distressed business. Different tools and a different approach are required.

The services provided by a proven, qualified turnaround management firm will often provide the best solution for getting underperforming or distressed organizations back on track. There are various scenarios by which a turnaround management firm can assist organizations, with different degrees of engagement required depending on the stage of distress that a company is at when turnaround help is sought. There are steps that management and equity groups should consider when their organization, or a particular company in their portfolio, is struggling. The steps below outline a general process equity groups can first consider when working with underperforming companies, with special focus on how corporate leaders can work with turnaround management professionals to fix an ailing business.

LOOK FOR EARLY WARNING SIGNS

Companies are like humans in one key respect: every company, big or small, public or private, has a life cycle. Within this life cycle, organizations will experience growth, stagnation, and decline at various points. In almost all cases, decline will occur at one point or another, even at the best companies. It is the responsibility of boards and managing investors to recognize when a period of decline is approaching or, if it is later in the decline phase, already occurring. Unfortunately, a strong sense of denial is often experienced during this phase. This could be on the part of the CEO, board members, and/or the private equity group. Regardless of who is at fault, not recognizing that there may be problems early on wastes valuable time and inevitably causes the decline to snowball.

Early warning signs of distress include likely danger

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zones that indicate a company may be in a precarious state. These danger zones include rapid revenue growth, systems conversions, overexpansion or aggressive acquisition strategy, high debt to equity deal structures, low margin distribution channels, or the emergence of family matters in a family-owned business. The presence of any one of these danger zone items by itself may not be a cause for alarm. Any company experiencing two or more danger zones simultaneously or in conjunction with any of the signs of distress warrants close examination. In addition to these danger zones, there are also clear signs of corporate distress which may require immediate action. Inadequate understanding of customer and product line profitability, ineffective management, lack of financial and operating controls, delay in keeping pace with market/ technology changes, or unfavorable Z-score analysis results all indicate action is needed.

When any of these items are first suspected, the best way for companies to determine what the underlying causes are is engage an objective, unbiased third party—a turnaround management firm—to perform an evaluation. Rather than simply firing the CEO and bringing a new leader on-board, a thorough assessment of the business should be performed. Turnaround management firms are able to evaluate businesses in an unbiased manner. Their experience allows for the pragmatic, yet forceful actions necessary for each situation. They are also able to quickly determine whether shortcomings of a CEO are contributing to decline or if there are other contributing factors.

Turnaround management firms will work with CEOs, board members, and equity groups to perform a general situation analysis. The objectives of this analysis are threefold: 1) to verify that the business can be saved; 2) to identify the most appropriate turnaround strategy based on current operating and strategic health; and 3) to develop a preliminary action plan. To achieve these objectives, financial, sales and marketing, operational, engineering, research and development, organizational structure, personnel and business/competitive environments are assessed. It is imperative that all possibilities be examined, including whether or not management has made the tough decisions required to cut its cost structure and solve critical problems.

MANAGEMENT EVALUATION

The second stage is the evaluation and, if necessary, replacement of senior management. The top executive team must be put in place to lead the turnaround effort and to weed out or replace any manager who will impede the turnaround process. From the work performed in the situation analysis phase, boards of directors and equity groups must determine if the current CEO is capable of working through the turnaround process to effect real change. Is the CEO willing, both intellectually and emotionally, to have assistance from outside the organization? If the incumbent CEO is not willing to accept constructive criticism or is going to undermine the turnaround process, then the incumbent must be removed.

Frequently, however, the incumbent CEO will recognize that assistance is required. In these cases, the incumbent CEO may be key to maintaining the growth-oriented aspects of a business, and can continue in that capacity, while the turnaround management firm fixes the underlying problems causing distress. Turnaround management professionals can complement the incumbent CEO in these situations. Because even the most capable CEOs typically do not possess the required abilities to fix a distressed business, especially if it is badly distressed, a qualified turnaround firm will work with the equity group, board of directors, and CEO alike to implement the necessary changes to recover.

In the case of Los Angeles-based BMK, Inc., President and CEO Richard Craig found himself in a situation where his bank requested he engage a turnaround firm to address the causes of defaulted loan covenants. BMK, a $400 million wholesale distributor, had internal reports that indicated the company was solvent following a rapid period of acquisition. Through a roll-up strategy, BMK, Inc. had acquired 14 companies in 30 months. A turnaround firm helped diagnose the company's ills and remedy the situation.

BMK was operating without sufficient financial controls, one of the most obvious signs of corporate distress. BMK, with the guidance of the turnaround firm that had been retained, took decisive action and replaced the CFO and several of the divisional-level operating staff. They then began implementing the turnaround actions necessary. An interim COO and CIO were brought in to ensure the competency and integrity of BMK's operating practices and new financial systems. BMK's bankruptcy may well have been avoided entirely if diagnostic efforts had begun at the first signs of distress, instead of when loans were in real jeopardy, but serves as a good example of turnaround professionals working with the incumbent CEO to identify the underlying issues plaguing the organization.

In instances where it is determined that the incum-

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bent CEO is not the right leader to help drive the turnaround, whether due to deficiencies in his or her skill set, a negative attitude toward the turnaround, or other factors, the CEO will inevitably have to be dismissed. If it is a private company (or a public company facing bankruptcy), an interim CEO specializing in fixing distraught businesses under tense circumstances will often be the best option for the organization. A turnaround management professional serving as interim CEO has the benefit of being completely unbiased, with no existing relationships with anyone in the organization. As a result, the interim CEO is able to see things much more clearly—a critical requirement for identifying red flags and profit and cash flow drivers, as well as implementing necessary reporting systems to drive organizational efficiencies. The stage of decline, as assessed in the first phase of turnaround, will determine the necessary actions that the interim CEO will implement.

When the distressed organization is a public company, implementing an interim CEO is typically only the best option if it is facing bankruptcy. In cases of lesser severity, equity groups should consider implementing a chief restructuring officer (CRO) or, in some cases, an interim COO, to drive the turnaround process. Turnaround professionals serving in these capacities can fix the internal mechanics of the business, while the CEO continues to serve as the outward facing leader to the public, thereby not causing a severe lack of investor confidence or shakeup that could catch the media's attention.

TAKE ACTION

After the ideal management team has been identified and implemented in the previous phase, whatever actions are necessary to enable the organization to survive must now be implemented. These actions are intended to get the organization to a cash flow positive position from operations as soon as possible, to raise sufficient capital to implement the chosen turnaround strategy, and to protect and/or develop the resources (human and financial) that will be needed for future growth and profitability. The turnaround strategies developed in the initial assessment process should be applied in a surgical fashion, as opposed to a "slash and burn" methodology.

The company must establish control over cash and cash flow, restructure debt, make working capital improvements, implement cost reductions, perform expanded profitability analysis, sell non-productive assets, and eliminate creative accounting and budgeting practices. Sales and marketing actions include correcting serious underpricing problems, pruning of product lines and products as needed, weeding out weak customers and providers, and the reduction of sales and marketing costs to industry averages. Marginal facilities must be shut down and, in many cases, the work force must also be reduced.

BUSINESS RESTRUCTURING PHASE

Once all required actions have been taken to ensure the sustainability of the business, it is then time to restructure the business for increased profitability, return on equity, and return on assets. The financial focus is shifted from immediate cash flow enhancement and debt liquidation to profitability, while cost cutting activities are migrated to balance sheet enhancement and clean-up as well as liquidity improvement. Sales and marketing activities likewise shift to mirror the actions taken in the previous phase, whereby product lines and competitive pricing practices are reassessed, while existing products are exploited and new product lines are developed. Productivity improvement programs are developed, as are ongoing profit improvement programs. In addition, the organization should be restructured for competitive effectiveness and people should be rewarded for delivering ROI and contributing to profits.

After these initial four phases are successfully completed, the company goes into a new phase with the overarching goal of returning to a state of normalcy. At this point, management must institutionalize an emphasis on profitability, ROE, and enhancement of economic value added.

Every company and individual situation is somewhat unique, and thus the basic five-stage process must always be tailored to some degree. However, it is a process-specific, non-company-specific course of action that should be undertaken. The precise application of the process will change from company to company, but the steps remain the same. The key to a successful turnaround is early intervention. Catching a potentially deadly disease early on increases a victim's chance for survival, with the rates of recovery often directly proportional to the stage at which the disease is first discovered. Businesses function in a very similar fashion. Early detection provides organizations with the ability to choose from a variety of options for recovery, with additional time to make the right choice for any given situation—a luxury that is not offered to businesses that wait too long.

It is not enough to merely identify the signs of dis-

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tress, but the sources of trouble must be sought out and appropriate action must be swift and thorough. Do not fall victim to the traps of denial, thinking that things will somehow correct themselves. When it is determined that a company is experiencing multiple danger zones at once or signs of distress are apparent, early action and the organization's willingness to adapt can avert a significant restructuring or worse.

Acting swiftly does not mean automatic dismissal of the CEO. The lack of proper due diligence in this regard has not only contributed to the highest dismissal rate of CEOs to date, but a number of CEO firings that were unnecessary and harmful to the business. Turnaround management firms are experts in fixing businesses and then handing the reins back over to management. They can offer urgent, dispassionate approach to due diligence and the process of managing businesses, creating and increasing value for stakeholders. For more information on turnaround management professionals, please go to www.actp.org.

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