The Three Major Causes of Troubled Companies

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a) Deficient management practices

b) Ineffective or outdated business model

c) Inadequate capital structure.

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Introduction

There are many reasons why companies get into trouble or eventual fail; certainly a heck of a lot more that three reasons. You could just as easily be reading an article about 'the 300 major reasons companies fail. However, having been involved with troubled businesses, turnarounds and restructurings for nearly 25 years, I have found over whelming evidence that most companies that find themselves on the brink, or over the brink in some cases, have common evolutions. The three most prevalent precursors of underperforming or distressed companies are: a) deficient management practices b) ineffective or outdated business model and c) inadequate capital structure.

Many companies with critical flaws in any of these broad areas have become underperformers, financially distressed and become insolvent. Likewise, well-run companies, with strong performance records, often demonstrate significant strength in each of these areas. The following is a look at what I have found to be the 3 most common traits in troubled companies. Distilled from nearly 25 years in the trenches, the key factors that weaken and ultimately destroy many companies and how these traits can be redirected to turnaround a distressed company to recover and eventually grow.

Understanding Cause and Effect

One can list many reasons why companies fail, how they lose course and drift afloat. Yet, many of these 'reasons' are not the cause the company's downfall, they are merely effects of some other underlying problem. Good examples are excess inventory, diminishing margins or poor liquidity. These are often sited when trying to explain financial distress within a company. However, upon closer examination, these examples merely demonstrate or reflect the fact that the company is in financial distress; they don't actually explain it. We need to dig a little deeper: why is there excess inventory? Why are margins decreasing? Why does the company have poor liquidity?

Answering these questions, and several iterations of them, will show the real reasons for the company's troubles. To understand the genesis of a company's operating and financial troubles, one must first discern between cause and effect. More often than not, what executives site as 'causes' of trouble are actually the 'effects' of some other underlying problem. The first step in turning around a company is to understand this distinction and then to start focusing on the actual root cause.

Root Cause

The best technique for diagnosing an underperforming or distressed company is to ask one question: 'Why?" If a manufacturing process is inefficient or below QC standards – ask Why. If a company is choking on excess inventory – ask Why. If a company is losing customers – ask Why. If product or service margins are deteriorating – ask Why. Don't just ask those in charge of the function, ask the rank and file employees as well. Ask the frontline employees, those who interface daily with customers. Ask the contractors, the vendors, the customers, service providers and any other person that may be related to the company. However, this is the most import part of asking: ask at least 5 times! That is the secret.

For example, ask a person why we recently lost a key customer account; they will provide an answer. Then, ask again, “Why?” They will provide a deeper answer. Then, ask again, “Why?” They will provide yet a deeper answer. Keep doing this until there is simply no further, more detailed, more revealing answer. Don’t worry, you’ll know when you’re there. Based on my experience, it usually takes about 4-6 “Whys.” Be focused and diligent on this technique, no mater how annoying others may find it to be. The fact is, it works and will help you accurately piece together the real underlying causes of the company’s problems. It will enable you to see and understand the actual root causes that need to be addressed.

Through the many years of managing turnarounds, I have used this simple, yet effective technique in many different circumstances, in all kinds of industries and found that the root causes tend to revolve around three principal areas: management, business model and capital structure.

Management

Management, as used in this discussion, relates to the relatively small group of individuals that occupy the positions within the highest hierarchy of a company, commonly called *senior management*. It does not relate to middle management or supervisors. While middle [1]managers and supervisors play a critical role in any organization, it is very rare that such people are in any way responsible for a company’s failure or financial decline. It is even rarer that rank-and-file or front line employees are responsible for a company’s decline.

It is the role of senior management to develop and implement the strategic direction of a company. They have the fiduciary responsibility to shareholders and officers to make such decisions based upon their collective experience and adequate and appropriate due diligence. It is the responsibility of middle management and supervisors to execute the directives of the senior management team.

The practice of management involves the development, implementation and maintenance of the policies and procedures that directs the people within an organization to do the work that is necessary to accomplish the goals and objectives of the company. Without proper management, there would be no focus, organizational structure or resources to run the company.

In many companies, particularly mature companies, the processes, policies and procedures have been in place, relatively unchanged, for a long period of time. People tend to get complacent and merely go along, doing what they have always have done in the past. The big mistake here is that the world is not static. Likewise, industries and markets are not static either; in fact, they are often constantly changing and, at times, highly volatile.

When a company’s processes, policies and procedures remain static while the markets around them are changing, disaster often follows. Management practices must be flexible and adaptable to the changes that surround a company. It is the role of the senior management team to have a pulse on the market, industry, customers, competitors and all other external factors. It is their role to change and adjust the company’s processes, policies and procedures to adequately meet the ever-changing demands of the external forces that are constantly acting on a company. When these senior managers fail to do this, the company can fail.

Neapolitan Bonaparte once said, "A commander has the right to be defeated but never to be surprised." While he was referring to warfare, a similar mind set is applicable to good management – never be surprised. It is irresponsible for a senior management to explain the decline of a company on external factors, such as the economy, new competitors, declining customer base, rising supplier costs, inflation, loss of a major customer, new technology or new foreign competitors.

While any or all of these factors (and other similar factors) may be responsible for the company's decline, the role of senior management is to predict these events, before they are real threats, and develop and implement the necessary management practices to defend against these threats. Senior management needs to be driving the car by looking through the front windshield, not the rearview mirror. They need to constantly look forward, try to predict future events, evaluate their probability of occurrence and take the necessary actions to primarily protect the company and, secondarily, to create new policies and procedure to help the company grow in the changing times.

Senior management can help prevent the financial decline of a company by adopting good management practices. While there are many, a short list, culled from 25 years of turning around companies, follows:

1. ***Evolutionary management practices***. Don't assume what works today will work tomorrow. Always look for opportunities to improve every process in the company, no matter how small. In fact, regular small improvements are better that one gigantic change in process or procedure. A senior management team needs to challenge every assumption, every process and every policy and ask, "How can this be improved to better address the changes that are occurring in the industry, markets, suppliers and customers." A company's processes, policies and procedures need to be dynamic and adaptable to the never-ending changes that are constantly occurring all around us. Always reinvent operating practices and how you do what you do. Never be satisfied with the status quo; companies and management practices need to continually evolve and improve.

2. ***Never stop learning***. Be state-of-the-art. A manager, like any other professionals, should constantly be learning about cutting edge practices that are on the horizon of their particular function. This may include regularly attending seminars, reading professional journals, reading trade journals, giving speeches and presentations or teaching at a local college. This doesn't mean you need to be like Albert Einstein trying to develop the unified field theory. However, you need to be an authority on what you do. The world is moving far too fast to sit still and rest on your laurels. Everyday should represent an opportunity to learn something new about your industry or profession.

3. ***Customer focus***. Senior managers often become provider-focused. This is likely due to spending most of their attention to the internal affairs of their company. This is a big mistake. As the saying goes, "if you don't take care of your customer, someone else will." Be customer-focused, not provider-focused. The sustainability of any company and, therefore, the effectiveness of a senior management team, is directly correlated to attaining new customers, keeping existing customers, getting all customers to use more of what you sell and to do it profitably. This is nearly impossible, if senior management is focused on itself; it must be customer-focused.

4. ***Keep an eye on competitors.*** Most companies have 1 or 2 direct competitors, the other companies that provide the same products and services to the same customers as your company. Surprisingly, many companies don't appear to make understanding what there competition is doing a priority. They tend to act as, "We'll just do what we do and let the customer decide." Such a mindset is, indeed, noble and decent but this isn't a couple of Girl Scout troops competing to see who sells the most cookies. This is the big leagues – winner takes all. Coming in 3rd or 4th place could mean being out of business.

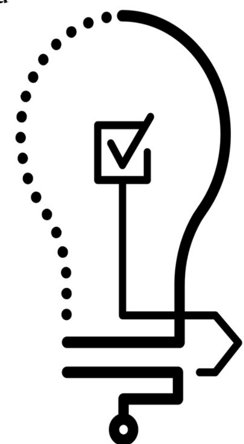
   I'm not suggesting a company should hire ex-CIA agents to spy on their competitors but senior management should pursue all the legal and ethical venues available to learn what their key competitors are thinking, what they're doing and what they intend to do next. By the way, your competitors may be doing the same thing to you and your company right now, so get with the program.

5. ***Always look forward***. With the possible exception of H.G.Wells, the world moves in one direction – forward. Likewise, so should your company. Senior managers must be constantly looking forward. While an annual retrospective look at performance may have some merit, looking backwards is largely a waste of valuable time. Whether a company prospers or collapses depend entirely on what happens tomorrow and every day after. Senior managers must be vigilant on keeping their attention forward and they must disseminate this philosophy to every rank-and-file employee. As discussed, when a crisis occurs, it is irresponsible for a senior manager to claim they never saw it coming. Don't' be surprised, always look forward.

The breakdown or flaws within senior management is often the root cause of the failure or underperformance of a company. It is senior management's role to predict future events, understand their probability of occurrence and take the necessary actions to protect the company and, if possible, use these events to find new business opportunities. It is, in fact, the primary role of senior management to prevent business fail. When a business fails, invariably, senior management has failed.

Business Model

The term business model is used often. For the purposes of this article, business model simply means: what and how we do that which we do. It describes how we run our business, develop our products and services, work with our suppliers and satisfy our customers. Financially distressed and underperforming companies are often the victims of outdated, unfocused, inadequately funded or otherwise ill-conceived business models.



One of the key flaws in many business models is that they are overly rigid and static. They are not designed to be effective when things don't go as planned, when customer buying patterns change or when new competitive forces enter the market. A business model must be dynamic; it must be designed to be effective when the unexpected happens.

There is no magic bullet here, it simply means that senior management has to promote the directive to all employees, particular the front-line employees who interface with customers, to continually review the operations, promotion, selling and finance of the company. Feedback must be encouraged and senior management must commit to evaluating all aspects of the value change and initiate the changes necessary of optimal performance.

To accomplish this, flexibility needs to be built into the business model. Managers and supervises should be required to submit operating reviews and make suggestions for improvement, where required. The managers, supervisors and rank employees should be empowered to provide feedback, make tactical decisions and improvise where appropriate. This doesn't mean line employees can do whatever they want. On the contrary, senior management must set the tone, draw the clear lines of authority and apportion the resources according to their strategic objectives.

To compare and contracts a rigid business model with a dynamic one, consider a $400 million designer fashion company. This company has success in designing, merchandising and selling middle-priced womens fashion apparel to top department stores. They has excellent market share and the business model was successful. However, their model was very rigid. Designers created the new lines, handed off to the product development department, who handed off to the production department and finally handed off to the selling department to present to retailers. It was strictly enforced and departments were autonomous, headed by strong-minded managers. This worked well and produced strong profits.

Suddenly, the market changed. Women buying habits shifted, from outfits to items and from suits to sportswear. This seemingly innocent change in the market produced several effects: a) product and brand fragmentation b) decrease in net selling price for certain items but not for others c) demand by retailers for mid-season product changes d) extension of time for retailers to commit to final orders.

The company was unable to address these changes in the short time period in which they occurred (less than 2 years). The company continued to operate as it always did, with little changes in how they developed their products and dealt with their customers. The mangers saw the changes in the market but due to the autonomous and rigid structure in their value change, no one was able to adequately make the changes necessary to keep up with this new market dynamic. The company ended up in serious financial distress and collapsed under the weight of massive retailer liabilities.

One of the key turnaround initiatives was to discard the old business model and replace it with a dynamic model, one that was disciplined and focused yet flexible and adaptable to market changes. First, all departmental walls, virtual and physical, were removed. Next, three cross-functional teams were organized and hand-offs were effectively eliminated. Each team remained responsible for each aspect of the product line, from inception to the showroom.

The designing process was augmented with actual store visits, in several geographic markets; these visits include not just the designer, but people in product development, production and sales. The merchandising process was changed to quickly adapt changes and edits from any team or external input. The product development and production processed were redesigned with a greater utilization of technology to significantly reduce cycle-time to effectively make mid-season changes as they occurred.

Each employee owned the entire process, was responsible to sharing customer and market feedback and information and was encouraged to provide recommendations for process changes to be implemented in the very next season. This new, dynamic business model was built to be market and customer sensitive and evolve as the market evolves, on a real-time basis. Within 18 months, the implementation of the new business model led to a 40% increase in productivity, 17% improvement in product margins and an increase in net income by $35 million.

One of the most noticeable changes was not in any one particular process. While there were many changes in how business was conducted, the most profound change was in the culture of the company. The old culture was every employees responsibility was to do their job, do was they were told and never make (or admit to) a mistake. The new culture was make great product, know what's going on in the market and with the customers, share what you know with co-workers and if you make a mistake, tell people so we can all learn from it.

The change in culture is not by accident. As with nearly all change and turnaround initiatives, it is only as good as the people executing them. Some employees will embrace the change and new ways of doing things. It can actually be an exciting endeavor and people who were once bored and unenthused about work will love the experience and look forward coming to work. Of course, there will also be those who resist change and fight desperately to hold on to the old work processes.

While I completely understand the fear of stepping out of one's comfort zone, these people will impede change, even if it means watching the company disintegrate. I guess it's a combination of fear and denial. People in the company, particularly their peers, need to coach these people and get them to enthusiastically embrace the new way of doing things. If that doesn't work, they need to go. If they don't go voluntarily (and a surprising number of these types leave on their own), then they must be removed. Get rid of any troublemakers quickly as possible. I realize this does not sound nice and perhaps is cold but business is tough and good managers must make tough decisions. Being nice may go well with unicorns and fairytales but it's irrelevant in business.

A dynamic business model that is sensitive to the market and customer needs and changes, will offer superior results and, at the same time, protect the company from financial distress and business failure. A rigid, inflexible business model, which assumes the world and your customers needs experience little change, is an invitation to disaster.

Capital Structure

As it relates to a distressed company and turnaround management, capital structure refers to the debt and equity, and all of their variants, which support the assets of a company. In my experience, many CEOs and senior managers don't focus as much on capital structure as one might think; this is particularly true in a distressed or turnaround situation.

This is surprising to me because capital structure is often the critical determinant whether or not a company can be saved and, if it can, what a new revived company may look like. Additionally, of the three major causes of troubled companies, a deficient capital structure is easier to diagnose and quicker to fix than either bad management or an ineffective business model. Yet, many CEOs seem to focus primarily on fixing the business model and trying to fix symptoms of other problems (increasing sales, cutting costs, lowering inventories, etc).

The fact is, if the capital structure can't be fixed, then it is likely a waste of time focusing on improving the operations or performance of the company. Evaluating and fixing the capital structure should be the very first priority when trying to turnaround a troubled company. This is common knowledge among turnaround and restructuring professionals but most business managers tend to overlook its importance.

It's important to note that restructuring or even significantly changing the capital structure of a company should not be attempted by company executives. This is obvious in large public companies but many middle market companies make the mistake of trying to undertake this process internally. That is a bad idea. To evaluate and address and necessary changes to capital structure, a company should retain an independent financial advisor or investment banker. If a restructuring of the capital structure is necessary, they are well advised to retain a restructuring officer, as well.

Even a brief discussion of capital structure warrants a full chapter in a college-level finance textbook. My goal here is to merely point out the impact of an inappropriate capital structure as it relates to causing a company to fail. This largely boils down to debt. Debt or leverage, is using in nearly every company; it enables the shareholders to use the value of the company's assets to increase the cash available for the normal operations of the business. Debt is a good thing when used properly and in the right proportion to the equity of a company.

Companies often get into trouble with debt in one of two ways, a) they intentionally obtain a high level of debt or, b) the company performs below expectation over a period of time and the equity of the company is systematically depleted. The first instance, intentional high debt levels, often occurs during an acquisition. Investors will use a relatively large amount of debt, couple with minimal cash, to pay for an acquisition. This can be very beneficial for the investors, provided that the business can gradually accumulate equity from the net profits of the company.

Using high levels of debt in an acquisition can lead to substantially return on investment for the investors. The downside of high-leverage buyouts is they also carry an unusually high level of enterprise risk. These companies are not positioned to sustain even a short period of lower-than-expected profit performance, unexpected capital expenses or unplanned changes in financing costs, such as interest rates. These types of companies typically have little to no assets or resources available to fund growth initiatives, which is an additional handicap.

The other most common cause for a company being over-leveraged is the deterioration of equity over a period of time. In this situation, the company has the same relative level of debt as it has in previous years. However, due to recent years of losses, the equity base is reduced; the debt-to-equity ratio increases and the debt service costs become a greater portion of the operating cash flow. While the debt has not increased, the accumulation of losses have caused the company to be over-leveraged and on the road to insolvency.

It's tempting to conclude that the actual cause of the distressed state of the company is accumulated losses and not the capital structure. While tempting, it is often not true. The capital structure of a company is the result of sound corporate financial planning or the lack of it. If a company becomes over-leveraged and on the road to insolvency as the result of a few years of accumulated losses, then the company had too much to begin with.

A disciplined corporate financial plan must provide an adequate cushion in the debt-equity relationship to prevent a financial crisis. In addition, good financial planning includes an on-going, real-time evaluation of capital structure. Before a company becomes over leveraged, it should protect itself with a professionally driven restructuring initiative, which may include an equity call, debt-equity swap, asset sale or debt refinancing.

Many companies simply do not put enough managerial and professional resources behind adopting fiscally sound corporate financial planning. The apply debt based on their working capital or cash needs, not on the long-term stability afforded by a strong debt-to-equity ratio. Retaining good corporate finance professionals and long-term financial planning are the keys to a strong capital structure.

The over-leverage imposed by an acquisition is more of an investment strategy that a lack of financial planning. While this strategy is usually employed by professional invest who are experts at what they are doing, care should be taken in the financial forecast and due diligence because as Jay Alix, one of the greatest turnaround experts, once said, "The distance between healthy and underperforming companies can be as thin as a dime."

Putting It Together: A Prescription for a Turnaround

Companies get into trouble and become financially distressed for many reasons. Likewise, there is single set of actions a business leader or turnaround professional should take to get the company back on track. However, with sufficient experience in turnarounds and restructurings, a few major reasons for a company's failure tend to emerge. The preceding illustrates some the most significant and prevalent underlying problems present in many distressed and underperforming company. A collective summary of these observations can form a blueprint of how to approach many distressed situations.

1. ***Understand cause and effect***. Don't be fooled by assuming the visible problems confronting a company are where you should be focusing your resources and efforts.

2. ***Identify the root cause of the major problems.*** Invest your resources in working on the root causes of the company's problems. Dig deep, ask a lot of questions and keep asking 'why. Fix the company at its core.

3. ***Three major causes of troubled companies***. Among the many reasons why companies fail, there are at least three that are common in most distressed and underperforming companies:
   a. Ineffective or incompetent senior management.
   b. Unfocused, outdated or obsolete business model.
   c. Deficient or weak capital structure.

4. ***Improve senior management***
   a. Develop evolutionary management practices.
   b. Keep learn – become an authority.
   c. Be customer focused.
   d. Carefully watch competitors.
   e. Look forward, move forward, manage forward.

5. ***New business model***
   a. Develop a dynamic and flexible business model that is adaptive to ever-changing markets and customers.
   b. Senior management needs to establish the strategic direction and set the organizational tone.
   c. Frontline employees need to be empowered to make the decisions necessary to execute the strategies.
   d. To change the company, change the culture.

6. ***Strengthen capital structure***
   a. Over-leverage, not poor operating performance, is a common root cause for many distressed companies.
   b. Fix the capital structure first, then focus on operational improvements (not vice versa).
   c. Rely on professionals to evaluate and make any necessary changes to capital structure.
   d. Good corporate finance and long-term planning are the keys to strong capital structure.

Summary

There are many reasons and circumstances that can be the cause for a healthy company to fall into distress and there are many reasons that can result in a company underperforming relative to its competition or its potential. With a quarter of a century experience with distressed and underperforming companies, of many sizes, in many industries and in both domestic and international, I have witnessed that three such causes are common and pervasive.

The three most prevalent precursors of underperforming or distressed companies are: a) deficient management practices b) ineffective or outdated business model and c) inadequate capital structure. Neglect these and you will most assuredly increase the risk of financial trouble or even insolvency. Focus and optimize these and you will reduce the financial risk to your company, strengthen its operating performance and create a platform of growth and long-term sustainability. These three fundamental business principles can be useful tools in nearly any turnaround situation or help you grow a healthy company.

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