The Board's Role in Corporate Renewal

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In today's competitive business world characterized by global competition, technological change, and demographic upheaval, all organizations need to find an effective way to continuously renew their strategies and business models. However, when execution fails to produce desired results, management must begin a renewal process. It's easy to know that execution has failed when your business runs out of cash, but by then it may be too late to explore a full range of options. The key to effective renewal is to start when the warning signs first appear or practice continuous renewal.

Most businesses fail because of internal reasons. In a recent survey of investment bankers, venture capitalists, work-out professionals, and Fortune 1000 CEOs, 87% of more than 1,900 respondents believed that businesses fail because of management's inability to change, excess of levels of debt, and ineffective planning. In the past 20 years, over one million businesses have failed despite the economic expansion of the '80s and '90s.[1]

> ***Definition: Corporate Renewal***
> *Corporate renewal is a process of adjusting the business model and making the dramatic changes needed to meet the expectations of investors and other stakeholders, and to position the business for survival. As such, it may require a change in management and a change in business strategy. Earning more than your cost of capital is a critical benchmark and goal for corporate performance and renewal efforts. Business units that cannot earn their cost of capital must be renewed through downsizing or sale. In addition to ongoing changes in the business model and the strategies of the business units, continuous corporate renewal requires ongoing succession planning and constantly upgrading organization skills.*

While there will always be organizations that fail, due in part to Adams Smith's "invisible hand" of free markets, corporate failure rates can be reduced through a proactive corporate renewal process. Based on a six-year study of more than 55 corporate failures, where failure was defined as a major loss of value rather than bankruptcy, four prescriptions to reduce corporate failures emerged.[2] They were:

1. Change the mindset of corporate leaders to better reflect reality of competition and the marketplace.
2. Challenge management assumptions and solutions that keep people from accepting reality.
3. Develop and manage insightful and relevant information more effectively.
4. Change dysfunctional and unsuccessful leadership habits.

These four factors can be summarized as creating organizations that continually renew themselves by overcoming denial and learning from their failures.

Even good companies have a crisis now and then. Dell Computer, which is known as one of the most successful companies in the past 50 years, needed to recall an entire line of notebook computers in 1993 because of design flaws. An execution error like that could have put a lesser company into bankruptcy. Dell learned from its mistakes and went on to expand into servers and now consumer electronic items. Despite several rounds of layoffs, Dell continually renews itself by focusing not only on shareholder value, but by developing a culture that fosters speed, integrity, and ability to use the supply chain more effectively than anybody else.

Studies show that early warning signs are frequently ignored:

- Quality problems
- Autocratic management
- Politically motivated decision making
- Declining growth rates
- Low employee morale
- High employee turnover
- Declining productivity
- Growth of new competitors
- Customer loss
- Declines in gross margin and market share

Unfortunately, it usually takes significant financial distress before senior management and the board become engaged in the problems of the business and recognize the need to renew. It doesn't have to be that way.

An alert board begins questioning management when the early warning signs appear. An effective management team engages the board and takes action to adapt to changes in the environment before crisis occurs. The quality of the management team itself is maintained by an ongoing succession planning process as part of the planning calendar. The alert management team overcomes denial by facing the brutal facts and taking action early.

In order for the board to exercise its oversight role and act promptly, it must receive unbiased, unfiltered, and realistic information from the organization. It must quickly receive non-financial information on the drivers of business performance for key business units. Precious time can be wasted while awaiting quarterly financial statements, a covenant violation, or a bond rating decline to set off the alarm. If the renewal effort is not continual, more time is required to plan an effective turnaround, once the need is recognized.

McDonald's is the world's largest food service organization, but it too needs to continually renew. When profits dropped, McDonald's had to shift focus away from adding new units to improving the quality and profitability of its existing units. The renewal effort at McDonald's may not have been possible without senior management sharing detailed operational performance statistics with the board.

BOARDS WAIT TOO LONG BEFORE RENEWING TROUBLED BUSINESSES

Because boards are constantly reminded not to micromanage, they typically give management the benefit of the doubt when it comes to improving performance and execution of a plan. However, when a plan is not producing desired results, the board must become engaged and more proactive. Without early action and the right actions by management, valuable options can be lost forever.

Cyclical businesses pose a unique problem for the board. Since many industries have a two- to five-year business cycle, management is given the opportunity to execute its plans through at least one business cycle. In these cases, the board faces a difficult challenge in predicting or evaluating the success or failure of management during the cycle.

> ***Zone of Insolvency***
> *If the board waits too long, the corporation may become insolvent. Many board members who have little experience with distressed situations are not aware that their fiduciary responsibilities specifically shift once their company enters "the zone of insolvency." No longer acting solely as the agent of the shareholders, the board must focus all of its decisions on maximizing the value of the estate of the company for the benefit of all creditors. When this occurs, there are sometimes dramatic differences in the character of board discussions.*

Eventually, it becomes clear that one business or another does not fit the corporate portfolio. Throughout the 1960s Wilson was the premier brand in sporting goods. It was acquired by PepsiCo, a premier marketing company, on the belief that aggressive marketing could grow the brand at a higher rate. PepsiCo upgraded Wilson's marketing and sales talent with imports from other PepsiCo divisions. Wilson focused on the "pro" segment of the market, yet in the '80s and '90s, Wilson lost its reputation in both racquet sports and golf as innovative com-

A Note on High-Tech Metrics

When the high-tech boom was in full swing, basic metrics and key performance indicators were often ignored by both management and the board as unimportant relative to the growth of the organization. The discipline of evaluating performance on more than one metric—growth—was lost. As a result, a great deal of shareholder wealth was eroded as high-tech companies over-invested in unproven business models that never materialized. Directors and management need to remember basics like the fact that improving margins typically produce greater value than small increases in market share.

petitors introduced new products that took the general market by storm. By the late 1970s, it became apparent that Wilson could not meet PepsiCo's target return and growth goals. In racquet sports, there was a disruptive shift from wood to larger-sized and composite tennis rackets. In golf, a variety of young competitors like Nike, Calloway, and TaylorMade introduced composite and titanium drivers of larger sizes. PepsiCo sold Wilson from its corporate portfolio in 1985 as these new competitors chipped away at the Wilson brand and the value of the business. Its new parent, Finland-based Amer Group, continues to search for a magic formula to bring the Wilson brand back to life.

To determine the prospects of a business and the need to renew, the board must know more about the environment and the changes that the business faces. Here are some questions about the environment the board can ask to help determine the viability, risk, and future of the core business.

1. If the market is declining, how long will the downtrend continue?
2. If there are quality problems, what will it cost to overcome them?
3. If market share is declining, can it be reversed?
4. If productivity is declining, what will it cost and how long will it take to improve?
5. If the customer perceives low value added, what can be done to increase it?
6. If investment intensity is high, what can be done to reduce it?
7. If unions are present, will they make concessions necessary to produce a reasonable economic return on investment?
8. If industry prices are declining, is overcapacity the issue?
9. If employee morale is low or the management is in denial, will a leadership change make a difference?

SUCCESSFUL ORGANIZATIONS FIND WAYS TO RENEW THEMSELVES CONTINUALLY

Different industries have different patterns and characteristics that have been observed and documented. For example:

- Specialty retailers must keep their stores in tune with the pace of the market.
- Manufacturers of clothing must be attuned to changing tastes and styles of their target market segment.
- Specialty restaurants that do not cater to changing tastes come and go because there is little barrier to entry.
- High technology companies must constantly drive home the goal of innovation with faster, cheaper, and better functionality.
- Manufacturers must stay aware of global manufacturing trends and costs.

Each industry, because of different characteristics such as growth rate, investment intensity, barriers to competition, and degree of technological change, faces the need to renew in a different way. For portfolio companies with multiple business units, directors must assure that there is a process in place to encourage business unit managers to stay at the forefront of their industry in terms of value creation.

In the past, some simple rules have been used as shortcuts to building value. General Electric's Jack Welch kept pressure on his managers with his mantra: "You must be number one or number two in your industry or you will not be part of General Electric." Jack's rule was driven by the fact that industry leaders are usually more profitable than industry followers because of their size and ability to use economies of scale to their advantage.

Just as the corporate office can get off the value creation track, business unit managers can also become overconfident, insular, and myopic. It's not unusual for managers of low return businesses to continually ask for more investment dollars despite the risk that the new investment may not boost the returns above the cost of capital. A positive attitude toward growth is always easier

War Story: The Steel and Airline Industries in Crisis

Investment intensive businesses such as steel companies and airlines are concerned with keeping equipment operating at or near capacity. When employees (unions) demand benefits or strike, management may solve the short-term crisis (strike) at the expense of long-term values. Both steel companies and airlines destroyed value by providing concessions to employees that they could not afford over the long term. Management conceded to union work rule demands. These onerous work rules prevented renewal efforts until it was too late to save the companies from bankruptcy. Company after company in these industries has either been liquidated or reorganized under Chapter 11.

New business models, represented by mini mills and low frills nonunion airlines came to dominate these industries. They gradually took away customers that the "majors" never expected to lose.

to sell than retrenchment. Yet in low return businesses, growth is very dangerous and is likely to produce a decline in corporate value. The board and individual directors must assure that business unit managers are value creation and renewal focused. Business unit managers must be reminded that in the long run all costs are variable. The mantra for portfolio companies should be: "Continually renew your business to earn above the cost of capital, or we will sell your business unit the highest bidder."

Different organizations approach the continual renewal process in different ways. Success depends upon a variety of factors that are often difficult to predict. Experience shows that fact-based experimentation and cutting losses early should be encouraged.

Innovation is considered by some as the guiding principle for continual renewal, yet there are no guarantees of success even with a single-minded focus on innovation. Just as the "right people" are critical to renewal, so is the "right innovation."

Customer focused companies continually renew themselves by listening to the customer better than their competitors. Innovations do not have to be technology based. They can be serviced based. Howard Schultz, founder and former CEO of Starbucks, saw an opportunity to add value to the basic product of coffee that nobody else saw. He created a business model with the simple idea of a premium product combined with high service in a friendly environment that has achieved tremendous success. Despite how simple the Starbucks concept sounds, others have found it difficult to duplicate. Starbucks does not rely on patents to produce what many companies consider almost monopoly profits and growth. It relies on soft and intangible attributes like "friendly people" and a premium brand image to create value. Renewal is an ongoing effort to find ways to create value in the minds of your customers better than the competition.

ESCAPING THE CIRCLE OF DOOM: FOUR CRITICAL FACTORS FOR BUSINESS TURNAROUND[3]

We believe that there is no one-size-fits-all renewal plan. Each company is unique, and the boards must fashion individualized solutions for providing oversight of the strategic processes of the business. Jim Kilts, Gillette's first outside CEO in 70 years and a corporate turnaround expert in the field of consumer products, might agree. In May 2001, he provided some wisdom at the Annual Management Conference of the University Chicago Graduate School of Business. His experience in turnarounds of consumer products companies has taken him from General Foods to Kraft Foods and then Nabisco. Recently, he brought together Gillette and P&G in what Warren Buffett said could be the merger of the decade.

What we term "failure to renew," Kilts refers to as the "circle of doom." He described it in six phases:

1. Management promises unrealistic improvements in results.
2. Management throws money after the problem (typically taking on high levels of debt).
3. Management raises prices to improve profits.
4. Sales decline and marketing budgets are cut.
5. Bad business practices like creative accounting and quarter-end loading are used in desperation.
6. Earnings disappoint and management's credibility is lost.

The circle of doom continues and often deepens, sometimes over 10 to 20 quarters. To break the circle of doom, Jim Kilts says that management must develop four key attributes:[4]

- First, management must have *the integrity to see the world as it really is*. Directors can certainly help here to ensure that current management has the integrity to share the brutal facts.

E X H I B I T 1

Environmental Framework for Renewal

Environment	Action	Result
If customer needs are changing,	Innovate new services better than competition.	Maintain higher margin and grow new product sales.
If global competition offers similar products at lower prices,	Reduce cost and provide better service.	Maintain margins; reduce loss of sales.
If new technology improves performance,	Adopt new technology better than competition.	Maintain margins and sales.

- Second, management must have *the enthusiasm that inspires people* within and outside the organization to believe that change is possible and goals are attainable.
- Third, everyone in the organization must have *a strong bias for action*, which is needed to overcome inertia.
- Fourth, and the key step, is *understanding the consumer fully and clearly*. Understanding customer needs versus perceived value is critical.

Creating value for Jim Kilts at Gillette was more than a numbers exercise. His vision for Gillette was to create total brand value. Total brand value was defined at Gillette as "*Everyone working to satisfy our customers and consumers better, faster and more completely than our competition.*"[5] He apparently felt that a merger with Procter and Gamble would help Gillette enhance this value. Because commodity products are everywhere, differentiation is a key to success. However, differentiation has no value unless it makes sense to the customer. A growing number of companies have renewed their business model by shifting from selling products and services to developing more value-added solutions.

Understanding what the customer values relative to competition is much more important than a customer satisfaction rating of "good." A customer satisfaction survey is not enough of a basis to decide on a renewal plan or plot business trajectory. Directors need to be sure that management understands competition and the changing values of customers.

Shaking up the organization and pruning out dead wood is a difficult topic for any executive or board. Some organizations restructure in an effort to put greater emphasis on customers. Cross-functional customer-focused teams are gaining popularity as organizations try to drive home the importance of customer service that exceeds expectations and competition.

A renewal plan must look at the business from a holistic perspective. The environmental framework depicted in Exhibit 1 illustrates the elements of environmental change, actions, and results that should be considered in a systematic way when developing a renewal plan.

RENEWAL REQUIRES MORE THAN A TOKEN 15% EXPENSE OR HEADCOUNT REDUCTION

Organizations that produce losses typically go through several rounds of 10%-15% headcount and expense reductions over a period of years. A good renewal process requires a blend of many things. It requires disciplined thinking and an understanding of the reality of the marketplace. It requires disciplined people who are motivated to change and provide exceptional service to the customer. It requires disciplined action and the ability to carry out plans, and yet to be flexible enough to adjust to changing market conditions. It often requires dramatic pruning of unproductive people and assets, unprofitable products, and unnecessary overhead. Pruning is a very difficult decision, even in the face of crisis. For example: United Airlines finally decided, after many months in bankruptcy, to exit some of its regional and unprofitable routes and to focus on its more profitable domestic and international routes.

The questions for management and the board then remain:

- Is there a viable core business that can earn at or above its cost of capital in the near future?
- Is there a viable customer base?

If the answer is "no" to either question, the board and management must take action to either sell the business to the highest bidder or liquidate the business in an orderly fashion. In far too many cases, senior management and the board remain in denial of the facts, hoping for the turnaround that never comes.

War Story: The Domestic Apparel Business

The apparel business has been one of the training grounds for bankruptcy practitioners since the original bankruptcy code was changed by the Bankruptcy Reform Act of 1978 to allow a "debtor in possession" to continue to run the business. Because fashions change, many apparel companies typically bet a year's profit on a given design or product line. If the design or product line was not well received, they frequently went bankrupt. Assets and people moved around with great frequency and lenders learned how to protect their investments by attaching all assets and getting personal guarantees from the owners. For many years, the apparel industries survived and thrived in the United States until a variety of both low- and high-volume manufacturers started using offshore sources. First cut-and-sew materials were sent from the mainland in "kits." As offshore experience and skills improved, they were able to complete the entire garment. Third World economies grew the apparel industry into one that could help them both domestically and internationally. Apparel manufacturers have sourced the globe for low-cost labor and set up sewing operations and textile operations in a variety of Third World countries. Trade increased and Third World countries prospered via exports to the United States.

Some apparel companies were quick to get on board with offshore sourcing while others lagged behind, hoping that quality, product innovation, or their brand would allow them to compete with lower-priced imports. While the transition to offshore sources occurred over the last 30 to 40 years, some domestic manufacturers like Levi Strauss tried unsuccessfully to compete. Levi's closed its last domestic plant in 2001. While Levi's strong brand name allowed it to survive the onslaught of apparel imports, hundreds of apparel and textile firms literally went out of business as their people and equipment could no longer compete with Third World countries and lower labor costs. Tariffs and duties designed to protect domestic jobs were ineffective in the long run. Those companies that survived recognized—before it was too late—that they had to change their business model from one of manufacturing to one of product design, marketing, distribution, and sourcing from the best source. Other industries such as consumer electronics, small appliances, machine tools, fasteners, computers, and even high technology are following the trend of the apparel industry. If only some of the directors had acted sooner, billions of dollars of shareholder wealth and meaningful jobs could have been saved by early action.

What Is the Liquidation Value?

When a business is nearing or in a financial crisis, one of the first analyses performed by turnaround professionals is a liquidation analysis. Liquidation analysis provides a benchmark valuation of the organization that can be used as a basis to evaluate a variety of other alternatives.

It's a fact that hundreds of small businesses fail every day. Owners at the end of their rope just close up shop and go away, hoping to leave creditors far behind. In very small businesses, personal bankruptcy is frequently the result. Yet bankruptcy statistics do not reflect the actual failure rate of smaller businesses. Many simply fade away and do not go through bankruptcy court and are lost in the statistics.

Directors and managers take note: the best way to avoid liquidation is to identify the need to renew the business model long before cash flow turns negative and losses erode shareholder equity.

THE BOARD MUST ULTIMATELY DETERMINE WHEN AND HOW TO UPGRADE ITS RENEWAL PROCESS

Because the board is the guardian of the business for the shareholder, directors bear the ultimate responsibility on when to upgrade its renewal process. It's a tough decision for any board, and it may cause conflict as the board may need to take action despite the resistance of current management. It may require the board to engage an outside adviser on how best to restructure the company and its obligations. It may require hiring bankruptcy counsel. In any event, the decision to renew carries new responsibilities for the board and the need for dramatic change among the management team.

A variety of advisers will recommend that the board consider the techniques of "turnaround management" in everyday business:

- Recognize problems early
- Act quickly and decisively when difficulties arise
- Evaluate options on whether to stabilize or liquidate
- Continually renew and restructure the organization for effectiveness
- Resume growth only when healthy earnings are likely to meet or exceed your cost of capital.[6]

Every board can rate the effectiveness of the organization's corporate renewal processes by asking a variety

EXHIBIT 2

Questions for Boards to Evaluate the Effectiveness of the Renewal Process

Rate your company on each of the following questions using the following scale: 0 = never; 5 = sometimes; 10 = always.

1. Does management recognize "reality" and warning signs early? ____
2. Is action taken when returns drop below the cost of capital in any given strategic business unit? ____
3. Are the actions taken sufficient to make a difference? ____
4. Are there detailed written turnaround plans with specific actions, due dates, and persons responsible? ____
5. Are the board, management, and key employees on the same page when it comes to understanding the priorities of what needs to get done? ____
6. Does management identify and sell, liquidate, or divest weak operating units that are unlikely to earn their cost of capital? ____
7. Is a cash flow forecast prepared and is cash flow managed carefully? ____
8. Are accounting and financial systems and data continually improved to provide the information needed for decision making? ____
9. Are strategic solutions identified and implemented on a regular basis as part of the strategic planning process? ____
10. Are changes in demand, market size, and market share evaluated periodically? ____
11. Is management concerned with improving liquidity and cleaning-up problems, or with overstatements on the balance sheet? ____
12. Is productivity continually improved with new processes? ____
13. Are mixed messages avoided by clear and frequent communications at all levels? ____
14. Is succession planning effectively used to renew the skills of the organization? ____
15. Are all elements of the strategy mutually supportive and internally consistent? ____
16. Is the strategy compatible with the culture, mission, and life cycle of the company? ____

of questions of management. These questions are also included as a rating form as in Exhibit 2 and can be customized for any company.

OVERSIGHT PRINCIPLES CAN HELP

Following are 12 principles for board oversight of the three critical strategy processes: strategic planning, risk assessment, and renewal. After developing a full understanding of these principles, directors and management will be able to provide better oversight of continual corporate renewal.

1. ***Corporate renewal, strategic planning, and risk assessment need to be done at the business unit level.*** The board of directors with management must decide if it wants to just oversee the results of the business unit analysis and decisions or actually participate in the processes at the business unit level. Boards of larger corporations must oversee the performance and plans of a portfolio of businesses.
2. ***The board needs to be sure that the people accountable for implementing the renewal efforts are those who developed and presented and believe in the plan.*** Motivated people who believe in the plans are the key output of any successful planning process. The renewal, strategic planning, and risk assessment processes need to be blended to meet the unique needs and capabilities of the organization.
3. ***The output of the corporate renewal, strategic planning, and risk assessment process must identify key performance metrics and be easy to communicate.***

Planning is primarily a communication tool needed in all organizations. The right performance metrics, such as minimum rates of return, actually improve communication.

4. ***Senior management working with the board of directors must adapt the planning process to the skills and capabilities of the management group and the board.*** A planning effort can be too advanced or too basic for the capabilities of any organization or for the challenges it confronts.
5. ***Directors and management need to have open debate on the renewal efforts and plans and how they reflect the realities of the internal and external environment. At some point leaders need to stop debating and start doing.*** Knowing when is based on experience. Organizations in deep distress or potential financial need to have a strong leader with a cash flow focused plan.
6. ***Directors need to encourage management to install a process to quantify the magnitude and likelihood of alternative strategies and risks.*** Asking "what if . . ." is a tool for encouraging management to run alternative scenarios. Scenarios are like exercise: they help strengthen the organization's ability to prepare the renewal strategies needed to create the future.
7. ***Renewal plans that cannot be executed are meaningless.*** Execution is where the rubber meets the road. Directors cannot allow a strong leader to take the organization down the wrong path. All too often a strong CEO, chairman, or lead director with the wrong vision or strategy can destroy the organization.
8. ***When execution fails to earn an acceptable return on capital, directors need to encourage management to dig below the surface and renew the organization and strategies.*** Renewal may 1) require numerous special board meetings to investigate and discuss the issues or, 2) hiring a consultant or chief restructuring officer (CRO) to evaluate alternative strategies and business models. The key to continual renewal is understanding alternatives and starting early, not after three years of losses, and having succession plans that provide needed management bench strength.
9. ***In order for strategies to be effective they must be communicated up and down the organization.*** Strategies that are held secret from shareholders will not add to the shareholders' future value expectations. Strategies that are kept secret from most employees are unlikely to motivate employees. Disclosure of strategies, risks, and renewal efforts should be appropriate for the situation.
10. ***For-profit businesses such as family-owned and non-public corporations (not listed on any stock exchange) require different approaches to renewal, strategic planning, and risk assessment.*** Understanding and incorporating the risk and return goals of the ownership group into the planning process is critical. The size, degree of success or distress, and ownership structure do matter, but are secondary to the goals of the owners. This principle applies in both family enterprises seeking to employ family members and in private equity companies seeking to "go public."
11. ***Not-for-profit and governmental organizations, such as hospitals, commissions, and boards of trustees, should use different approaches to organizational renewal, strategic planning, and risk assessment.*** While these organizations must have a balanced budget, they are focused on serving a non-financial mission. Directors are typically heavily involved in renewal efforts, strategy development, and the planning process but need to reflect the mandates of those they represent.
12. ***Directors must continually monitor progress against plan and support efforts for continual improvement and renewal.*** Directors must remember that management cannot manage what they do not measure. Measuring the fundamental attributes of the key strategies and results must be an ongoing process for the board. Management must be held accountable and responsible for appropriate and timely reporting of the value drivers and early warning signals.

ENDNOTES

[1]Buccino & Associates, 2003 Business Failure Study, Seton Hall University.

[2]Sidney Finkelstein, *Why Smart Executives Fail*, Portfolio Books, 2003.

[3]James M. Kilts, speech before University Chicago Graduate School of Business, Business Management Conference, May 18, 2001.

[4]Ibid.

[5]Ibid.

[6]John O. Whitney, "Turnaround Management Every Day," *Harvard Business Review*, September/October 1987. pp. 49-55.