When is a turnaround complete? How do you measure renewal success? Companies in search of renewal must manage both real returns and growth over a period of several years to accomplish a true renewal or turnaround. According to management guru Peter Drucker, “Most turnarounds don’t!” Let’s look at the record using the same tools that long-term investors, concerned directors, and CEOs are using to monitor corporate performance and value.

The authors have reviewed long-term performance records of hundreds of companies. In this article we provide a graphic tour of the financial performance history of 15 companies in three major industries. Each of the companies has undertaken some level of renewal activity over the 19-year time span of our graphic tour of success and failure.

Our prescription for renewal and value building for a company is growth while earning a real cash flow return above its cost of capital. As the reader will see, this can be a tall order and requires strategic and operational changes, more dramatic than most companies are willing to make. The two mandates can be difficult to balance in a changing environment, and company management and the board may become frustrated in their attempts to build value.

The complex and changing environment faced by a typical corporation has many variables: economic, legal, political, cultural, structural, and competitive. These external factors combine with internal denial and cultural inertia to make it difficult to attain the level of real cash earnings performance that a company’s leadership might plan. In addition, those who invest in public companies have many investment alternatives and low transaction costs. Thus, the company must not only perform, but it must also outperform other investment alternatives, and present an appealing risk-reward profile to continue to attract capital.

The challenge to management is finding the right balance between return, growth, and risk. The goals are often conflicting. For example, sales growth can be cheaply manufactured by cutting prices or making risky investments, and thus reducing returns. Successful renewal requires making the operational and strategic changes necessary to rebuild a profitable, value-building, and customer-focused business model first, and then invest in the growth needed to produce wealth, relative to the S&P 500 Index. Renewal efforts fail when they don’t produce the dramatic strategic changes needed to bring about the returns and growth demanded by investors.

Our prescription for management of both highly profitable and distressed companies is continuous renewal at the business unit level. Corporate renewal of key business units should be on the agenda of top management and the board at each major decision point and at every board meeting.

We begin the tour by describing the graphic panels that help explain value and renewal success and failure over the 19-year period.
**RENEWAL SUCCESS AND INTRINSIC VALUE IS A FUNCTION OF REAL RETURN AND ASSET GROWTH**

For our graphic tour we have used the CharterMast Value Analysis Framework, one of several cash-flow-return-based frameworks made popular in the investment community. The CharterMast Value Analysis Framework is a proven methodology for explicitly measuring the value created by a business. Based on decades of research by Ativo Research, one of the nation’s top-ranked independent investment research firms, it provides an explicit link between a firm’s operating performance and its actual stock price. Institutional investors use this and similar frameworks to decide which stocks to buy or sell, while corporate executives and boards use this approach to analyze acquisitions, make capital spending decisions, set objectives, and measure corporate and business unit performance for executive compensation.

The graphic “Value Analysis” panels in Exhibit 1 provide a concise summary of a firm’s value creation history. It shows how alternative combinations of real asset growth, real return on investment, and cost of capital combine to produce either superior value creation for shareholders, substandard results, or average performance. This example shows the value creation history of FMC Corporation, a diversified maker of machinery and industrial chemicals over a 19-year period (1987–2005). We chose FMC as our “poster child” for corporate renewal success and failure because of its dramatically changing

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**EXHIBIT 1**

**How to Read the Graphic Panels**

The 19-year graphic panels include 18 years of historic performance data and a 2005 estimate based on interim financial statements and analysts’ estimates. The first panel compares cash return on investment (bars) with the real cost of capital (line). “Real cash flow return” is an internal rate of return measure that incorporates a firm’s total capital investment and the free cash flow before reinvestment. The real cost of capital incorporates long-term investor return requirements, inflation, taxes, and overall market price levels and reflects the expected return that investors require to choose this firm over other firms. FMC has struggled to earn its cost of capital over the last 25 years, even though it has shown accounting profits.

The second panel shows the firm’s annual change in total invested capital (bars) and its annual sales growth rate percentage (line). The horizontal line at zero percent provides a quick way to see whether the firm is growing or shrinking. FMC’s growth rate has been erratic, with assets shrinking in more years than not, during the same 20-year period. Note that periods of positive growth during 1987–1990 and 1994–1996 resulted in sharp declines in relative wealth as FMC tried to grow returns by investing in low return commodity businesses.

The third panel provides a scorecard showing how well an investor fared relative to an indexed investment in the S&P500. This chart shows total return with dividends reinvested. The chart is indexed to a base of 100% in December 2000.

FMC’s wealth, relative to the S&P500 peaked in 1987. It has trended downward or flattened through 1999 as FMC struggled to find profitable growth opportunities. However, since 1999, relative returns have exceeded the S&P Index (but still lagged behind its industry) as its specialty chemical refocusing has taken hold.
fortunes over time. Prior to the dates shown on the chart, FMC undertook its now famous leveraged recapitalization in 1986. The leveraged recap was the culmination of a process by which the company had divested less productive assets, focused resources on high return businesses, and then borrowed to recapitalize the company to pay a one-time large cash dividend to shareholders. FMC created tremendous wealth for shareholders through 1987. After that point (as shown in the lower panel of the chart), it became a renewal failure with a series of management changes and a loss of cash flow performance culture. The discipline was gone and FMC attempted to grow by investing in low return commodity businesses. The downturn in the lower panel of the chart shows the resulting destruction of corporate wealth. A decade later, new renewal efforts paid off. Since 1999 FMC has been a value builder by spinning off its machinery unit to shareholders and focusing more on specialty chemicals.

**THE RETAIL LANDSCAPE CLEARLY DEMONSTRATES RENEWAL SUCCESS AND FAILURE**

We’ve all come to accept the volatility of retailing. Store figures in the last few weeks of the calendar year generally tell the difference between success and failure for the whole year. Changing consumer tastes force a continuous re-evaluation of merchandising methods, private label mix, store format and location. New technology, modern logistics, and better product tracking forced changes in distribution and buying patterns. These factors combined with continuous demographic changes and competition for the consumer dollar play havoc with the financial performance of retailers and their ability to grow and earn a cash return greater than their cost of capital.

Major retailers live and die off their ability to provide what the consumer wants at the right place and right price at the right time. Customer preferences shift from mall, to strip mall, to standalone stores and back again, demonstrating the importance of real estate in the retail mix. Balancing the cost of flexibility and store investment in suburban, urban or rural locations distorts many retailers’ balance sheets. Differences in lease accounting, inventory accounting, and real estate strategies often make comparisons between retailers difficult. Our real cash flow return graphics makes such comparisons more insightful.

Exhibit 2 (top) graphically portrays how Target Corp. has continually renewed itself. From 1995, Target’s customer intimate culture outperformed the S&P500 Index, distancing itself from Kmart and other slow-to-change retailers that fell into bankruptcy. Target is a prime example of successful retail renewal. Once known as Dayton Hudson department stores, Target has shed its department store culture by morphing into Target’s standalone retail store chain, while shedding its traditional department store foundation. Performance—as measured by real cash flow returns—in all years after 1995 exceeded its real cost of capital by at least two percentage points. Target creates excitement for its customers by a unique product design approach to differentiate everyday products and stores from those of competitors.

Dayton Hudson became Target in January 2000. To maintain its higher returns and significant store and sales growth, Target sold both Mervyn’s and Marshall Field’s department stores in 2004. Target demonstrates the importance of successful and dramatic cultural change as well as attention to differences in business unit profitability and growth prospects. Target’s evolution is unusual. It emerged from a traditional slow-growth, mall-based department store culture. From there it pursued a successful retail concept: freestanding one-floor design-oriented and customer appealing stores.

Our approach is to examine corporate renewal efforts from a unique perspective. Company profiles are set in an analytical framework that neutralizes many common accounting distortions. There is a common scale for real cash flow returns, real growth rates, and relative value creation against the S&P500 Index and the industry. For both individuals with inside knowledge of a firm and those who have had little contact with each company, the graphic panels provide new insights in each company’s history of relative success and failure in pursuing its renewal efforts.

Quarterly accounting profits alone can lead to false confidence in renewal and turnaround efforts. Management and the board must monitor business unit performance against relevant costs of capital and industry benchmarks to help management make changes dramatic enough to outperform alternative investments like the S&P500 Index. To rise above the market, companies must construct goals that balance customer value and real growth, with real cash flow returns above their cost of capital. Once balance has been achieved, real growth will reward investors compared to an index fund.

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EXHIBIT 2

TARGET CORP VALUE ANALYSIS

WAL-MART STORES VALUE ANALYSIS

FEDERATED DEPT STORES VALUE ANALYSIS

PENNEY (j C) CO VALUE ANALYSIS

Shareholder Wealth Index (Relative to S&P)

(Index Year 2000 = 100x)

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth

Company Real Growth Rates

Asset Growth

Sales Growth
Exhibit 2 (top) describes Wal-Mart’s growth and performance over the last 19 years. To maintain this type of growth Wal-Mart had to continuously renew and refine its business models. Speed bumps along the way include current challenges by labor, and Wal-Mart’s problems with its early attempts to grow its Sam’s Club discount store chain before it had improved the basic business model profitability. As a result, in the years 1991–1996 Wal-Mart destroyed shareholder wealth, underperforming the S&P500 Index, despite earning 3–5% points above its cost of capital.

For a retail giant, Wal-Mart’s relatively new move into groceries and into international markets demonstrates the dramatic, continuous renewal needed to produce growth. As part of Wal-Mart’s continuous renewal efforts, older Wal-Mart stores in profitable markets continue to be torn down and rebuilt as superstores. Many of these new superstores are open 24 hours a day and are clearly putting stress on the supermarket industry.

Only time will tell if Wal-Mart can perpetuate its continuous renewal efforts and remain the world’s largest retailer. Centralized fact-based information systems and state-of-the-art low-cost distribution, combined with face-to-face communication between store and headquarters are the key ingredients. These factors seem well aligned to enable Wal-Mart’s cost-conscious and customer-focused management culture to be consistently communicated to all, by repetition of “Every day low prices” and “May I Help You.” Clear communication helps satisfy both customers and shareholders.

**SOFT-GOODS RETAILING MEANS CONSTANT REFOCUSING ON CONSUMER PREFERENCES**

Let’s now turn to profiles of two well-known department store turnarounds. Exhibit 2 (bottom) profiles the classic successful turnaround and renewal at Federated Department Stores. Federated owns Bloomingdales and Macy’s. Over time it acquired Rich’s and Bullock’s and now Dayton’s and Marshall Field’s, all being rebranded as Macy’s. Burdened by excessive debt, due to the 1988 takeover by mall operator Robert Campeau, Federated Department Stores declared bankruptcy in January 1990.

Federated’s “Merchant Prince” department store culture had been reluctant to change, until Allen Questrom returned to Federated as chairman and CEO in 1990. Questrom is noted as a fact-based decision maker and highly skilled customer-focused private label brand merchant that required department managers to know their customers, merchandise, and competition intimately. After emerging from bankruptcy in 1992, Questrom led Federated’s acquisition of Macy’s out of bankruptcy in 1994, and acquired financially distressed California retailer Broadway Stores, Inc. in 1995. A critical part of Questrom’s turnaround strategy in all of his successful renewal experiences was internal culture change and a renewed focus on the needs of the consumer, breaking with past practices.

Questrom was selected for Federated’s top job because of his previous well-documented turnaround leadership within Federated at Atlanta-based Rich’s and outside Federated in the 1989 turnaround of Dallas-based Neiman-Marcus. Under his leadership, Rich’s went from Federated’s worst division to its most profitable division in 4 years. Unlike Target, Federated did not abandon the department store concept, despite shrinking department store revenues. Federated has continued to earn its cost of capital since Questrom’s departure in 1997, but it has not found the growth formula characteristic of the renewal successes at Target and Wal-Mart. It is now seen as a department store industry consolidator making dramatic changes to rebrand famous chain store names like Dayton’s and Marshall Field as Macy’s. Will Federated’s dramatic rebranding strategy work? Only time will tell.

While J.C. Penney had moved from Manhattan to Dallas in the early 1980s, in part to change the culture, its profitable years had reinforced a culture of privilege and inability to respond to rapid change. Penney’s first big renewal effort was in its break-away from the pack of “all-things” department stores to specialize in soft goods. This was no easy task in the early 1980s, having been a clone of Sears. However, breaking away from an imbedded strategy can be accomplished when management is truly committed to the strategy and does not backslide. A decade later, the challenge was the successful proliferation and growth of well-merchandised specialty apparel and soft-goods retailers. Penney’s foray into a different market, through its 1997 acquisition of the Eckerd drug store chain, was a further digression from the main strategy. New management forced a redirection and better focus as the foundation of a successful renewal effort, and Penney’s sold off Eckerd in 2004. Despite the difficulty in duplicating the success of the specialty retailers, Penney’s strategy called for positioning itself as a customer-focused, value-providing, and trendy retailer.

In 2000, at age 60, Allen Questrom took on the even larger task of turning around J.C. Penney. After a
two-year stint turning around Barneys New York, Questrom was selected for this even bigger challenge. J.C. Penney, like many department stores, struggled for years to find a survival and growth formula. Most readers will be surprised to know that J.C. Penney was a value creator from 1986 through 1993, while Federated reorganized in bankruptcy court, and the U.S. economy went through two recessions. However, after posting cash flow returns well above its cost of capital from 1992 through 1995, Penney’s stock plunged from over $50 per share to around $10 in 2000. J.C. Penney, posted a loss in 2000 and began a retrenchment program that has again produced returns above its cost of capital in 2002 and 2004. The renewal efforts are still in progress, but J.C. Penney appears to be on the right path to value creation. Key factors cited by Allen Questrom in the J.C. Penney 2000–2005 turnaround plan include familiar items: culture change, a refocus on higher margin store brands, effective central-ized merchandising systems, and closing unprofitable stores. Penney’s relative wealth performance has been dramatic, plummeting in the years up to 2000, and then dramatically recovering thereafter.7

Before presenting his 2000–2005 turnaround plan, Questrom spent several months in two-way communication with frontline employees, while intensely studying Penney stores and the competition. This approach is characteristic of the grass roots level communication that forms the basis of many successful turnarounds.8

As part of J.C. Penney’s turnaround and refocusing, Questrom spun off the Eckerd drugstore chain and undertook a major share buyback. The slow-growth mall-based department store industry continues to face challenges as most established mall-based retailers struggle to find profitable opportunities for growth while newer free-standing formats like Kohl’s continue to grow. Share buybacks have become a common financial maneuver to reduce the number of shareholders, and raise the widely reported earnings per share metric. While this may appear to be a means of rewarding shareholders of these department stores, it does not increase the value of the underlying business. In some cases, companies that pursue this approach are left with high debt burdens.9

**AUTOMOBILE INDUSTRY STRUGGLES WITH OVER-CAPACITY AND SHARE WARS**

For decades the Big 3 U.S. auto manufacturers, General Motors, Ford, and Daimler Benz (Chrysler), have continued to fight to retain their individual North American market shares. They appear to have been fighting a losing battle. As the auto industry went global, the Big 3 diversified their manufacturing and marketing and invested in offshore operations. As they expanded overseas, Japanese and German manufacturers built plants in the United States leading to global overcapacity and a price war battle for market share.10

Chrysler’s decline was arrested by a U.S. government bailout in 1979. The company’s renewal and subsequent stability was based mostly on the acceptance of the minivan, where it maintained its advantage for over a decade. In November 1998, Chrysler was merged into Daimler Benz.

To their credit Ford and GM undertook periodic attempts at corporate renewal, often dramatic. While these efforts did not lead to dramatic success, the payoff was in the ability of each company to remain independent and apparently profitable. However, it was some of the foreign units of GM and Ford, unburdened by the inflexible legacy and ongoing costs of existing union contracts that helped these companies post overall profits in some years. Over the last decade the North American operations of these two giants weakened and again spent red ink.

While both Ford and GM attempted to streamline operations and reduce employment by “lean” techniques, automation, job buyouts, and spinning off their parts operations, they did not act dramatically enough. For example, GM spun off its parts supply operations into the newly formed Delphi Corp in 1998 and Ford did the same with its parts operation and formed Visteon in 2000. But the underlying problem could not be completely spun off. For example, GM had to retain the liability for unfunded pension and medical costs for employees who were transferred to Delphi. After the bankruptcy filings of Delphi and other major parts suppliers that have occurred since 2001, critics have occasionally suggested that bankruptcy for both Ford and GM is the only way to rationalize their medical, labor cost, and benefit agreements for both current and retired workers. This issue may stand in the way of a successful industry renewal, much in the same way as these issues finally led to multiple bankruptcies in the steel and airline industries in the United States.

Ford and GM continue to deny the rumors of potential bankruptcy. However, as their performance declined, the bonds of both were downgraded to junk status. The junk status of their bonds limits GM and Ford in their ability to finance a current turnaround and invest in longer term renewal efforts at a reasonable cost. Turnaround and renewal efforts at GM and Ford must now be financed out
of cash flow and/or asset sales. GM is known to be considering a partial sale of its GMAC finance unit that finances much more than cars. Ford seems focused on different alternatives. As recently as January 2006, Ford executives were being quoted, saying that the company has no plans to spin off Ford Motor Credit.

The normal formula for renewal in an industry with overcapacity is to shrink to a profitable core. However, in the American auto industry, the process of shrinking is painfully slow and generates high severance costs. Over the years, the industry has automated and agreed to high severance costs to hold down labor contract increases. This has increased fixed costs, pushing up the sales level that is required for breakeven operations. Thus, in the United States shrinking to fit a declining market share cannot “work” without tremendous concessions from the unions. But the unions have been unwilling to accept the major “game changing” concessions and job reductions that would be necessary. Therefore, GM and Ford management have used a variety of price incentives in a futile attempt to hold market share, so that they can operate at acceptable capacity utilization levels. Unfortunately, even with price incentives, the American consumer has not had to assume the responsibility to pay billions in severance costs, or face the impact of a Delphi strike.

Exhibit 3 (top) compares recent renewal efforts at Ford and GM. The charts are adjusted for typical accounting distortions and they allow us to draw conclusions at the consolidated level of each business. The companies themselves could benefit from further analysis of this type, by breaking out North American operations from Europe, SUV and truck results from cars, and even separating the various car divisions themselves. The aggregate global numbers can hide deeper troubles. The decline and losses in North American operations over many years is covered up by profitable product lines such as financing, SUVs, trucks, and operations outside North America. (Note: Although the cash flow returns for Daimler Chrysler are not shown, they appear even worse than those profiled for General Motors.) GM's real cash flow returns, shown in Exhibit 4 (top), demonstrate a clear cyclical pattern with recessions causing real cash flow returns to drop below GM's cost of capital. GM's declining trend in real cash flow returns began again in 1998 and has continued to trend down since then. Sales growth at GM has been erratic as GM has lost market share, despite significant price incentives.

GM's problems have been in the making for much longer. For the last two decades, GM struggled with aggressive competitors, stubborn unions, and governance problems. The fact that it has survived at all amid all of the internal and external turmoil is amazing. The painful legacy of the wasted renewal efforts of the 1980s and 1990s is that GM entered the new millennium burdened with high costs, offering too much similarity among its models, and generally out of touch with its customer base. Except for the SUV and truck segments, GM models were unexciting and not highly valued or demanded by the end consumer sufficient to operate plants at profitable levels.

It is interesting to note that GM's Alfred P. Sloan, Jr., in his book *My Years with General Motors* extolled the organization to manage each business unit to “develop statistics correctly reflecting the relation between the net return and invested capital of each operating division—the true measure of efficiency—irrespective of the number of other divisions.”

A generation later, current management of GM has been unable to absorb this metric into its culture and to successfully execute to achieve this basic, but difficult, goal.

After reporting a bigger than expected loss in 2005 of over $8.6 billion, GM now plans to eliminate approximately 30,000 jobs and close 12 plants by 2008, in a dramatic move to rationalize its North American capacity. Current union contracts prevent GM and Ford from downsizing a workforce that, according to one report, earns an average (with benefits) of approximately $130,000 per year. As a result of the Delphi bankruptcy, GM has also had to assume the responsibility to pay billions in benefit costs, or face the impact of a Delphi strike.

Hindsight indicates that both Ford and GM had mainstream quality and consumer acceptance problems in North America that were masked by years of successful profitable truck and SUV sales. It was no surprise that Ford and GM sales demand suffered, as U.S. gas prices rose well above $2 per gallon and foreign competition began to compete more aggressively in the light truck segment. Consumer preference shifted from SUV to more fuel-efficient, cross-over vehicles. Sales of GM and Ford's most profitable vehicles declined, as consumers who once preferred “Made in America” autos and trucks switched to foreign car nameplates that offered higher quality, innovative styling, and better value. Further confusing “Made in America,” many foreign auto producers continue to...
open U.S. plants. Toyota will open a truck assembly plant in San Antonio, Texas, in 2006. Its sixth assembly plant in North America will produce 150,000 Tundra full-size pick-up trucks per year.\textsuperscript{13}

It appears that earlier renewal efforts at Ford were significantly more successful than those at GM. As shown in Exhibit 3 (top), Ford (consolidated) earned a real cash flow return of approximately 7% or about 2% points above its real cost capital in the 7 years, 1994 through 2000. Apparently, investors anticipated the deterioration taking place in Ford’s base business, as Ford’s share price dropped from a high of over $60 in 1999 to a single digit. Ford’s profitable European operations masked the problem in the U.S. market for many years and the Taurus, which was recognized as the best-selling U.S. car in the United States since 1992, took a back seat to the Toyota Camry, which replaced Taurus as the best-selling car in the United States in 1997.

Ford’s earnings release for 2005 showed a $1.6 billion loss in North American operations, but over $2.0 billion in worldwide earnings. Chairman Bill Ford announced a substantial multiyear restructuring plan that sounds very similar to that executed 5 years earlier at Nissan. Ford’s 2006 renewal plan follows on the heels of the Ford’s less aggressive 2002 renewal plan, which was also designed to strengthen Ford’s market share and financial position. Ford’s 2006 plan recognizes UAW contract limitations but calls for a painful 26% reduction in unit capacity by closing seven plants in 2008 and reducing its 122,000 person work force by 30,000 by 2012.\textsuperscript{14}

Toyota is our award winner for continuous renewal. Toyota pioneered the Toyota production system that helped to accelerate the “lean thinking” revolution that is finally sweeping all manufacturing operations today. Since the 1980s Toyota has set the standard for quality and cycle time in developing new models. Its concern for the customer, speed to market, combined with its commitment to lean thinking, has enabled Toyota to continuously gain market share. Its advantage is in being in the market first with the new features that the consumer wants. Thus, they have been leaders with both popular priced cars such as the Camry and premium brands such as the Lexus. Based on its success, Toyota recently raised its long-range global market share goal (for 2008–2010) from 20% to 25%, an indication of its confidence in its product innovation understanding of its market.

However, Toyota’s current success did not come without a price, as shown in Exhibit 3 (bottom). One might assume that Toyota has always been profitable by the success of its market share growth and popular models. However, Toyota has had its period of retrenchment and renewal just like every other successful company and requires continuous innovation, operational improvement, and renewal to stay at the top of its industry. From 1993 through 1997, Toyota’s real cash flow returns of 3% or less were significantly below those at GM and Ford. Toyota’s market share declined in Japan, dropping below 40% in 1995. At the time, some analysts estimated that Toyota was losing money on every car sold in Japan, in an effort to maintain market share there.

After a period of retrenchment and reinvestment to adjust to the recession in Japan, Toyota’s new leadership continued to renew by

- breaking down Toyota’s “glacial decision making process” that caused missed opportunities
- pushing speed, flexibility, and manufacturing excellence
- focusing on identifying problems and solving them (not ignoring them)
- pouring cash into new models and technology that take share from competitors.

Toyota’s returns again approached its cost of capital, and its growth rate increased to almost 15% in the years 2002–2004. Toyota is now the world class leader in speed and flexibility (some of its 30 plants can build 8 different models simultaneously on the same line).

Toyota continually invests for the future. A recent Booz Allen report indicates that 4% of the Toyota sales dollar was invested in R&D in 2004: “The innovation effectiveness at Toyota...is a benchmark for competitors, yet Toyota is only the third-highest spender in the auto industry.”\textsuperscript{15} Thus, Toyota has found ways to stretch the R&D expenditures across fewer models. For example, Toyota’s Lexus was designed totally for U.S. consumers, from dealership to accessories, and is not sold in Japan.

Toyota’s renewal effort in the 1990s, entitled “Global 21,” identified how Toyota would position itself globally in the 21st century. This effort led to the successful development of the revolutionary hybrid Prius. Its latest renewal program, Construction of Cost Competitiveness for the 21st century (CCC21), where no detail is too small, has an even deeper focus on dramatic and continuous improvement in operations and speed to market.

The onset of higher gasoline prices, the decline of the SUV, and a credit downgrade finally brought a wakeup call, in the form of crisis knocking at the doors of GM
and Ford. First Ford and then GM announced dramatic programs similar to the one executed by Nissan’s Carlos Ghosn over 5 years ago. Nissan’s turnaround is widely credited as a classic success. The formula seems simple enough but execution in a unionized North American environment has proven difficult:

- Change the culture
- Institute fact-based decisions and transparency across all operations
- Communicate and commit to change through the use of cross-functional teams
- Implement significant headcount reductions through benchmarking and cost controls
- Introduce exciting new products and process innovations.

At Nissan, Ghosn put together his 3-year turnaround plan after 3 months of intense diagnostic study. Despite the fact that Nissan had lost money in 7 of the 8 previous years, Ghosn committed to return the company to profitability in 3–4 years. He communicated the commitment clearly and provided clear incentives for the turnaround. Ghosn promised workers that he and his entire executive team would resign if the turnaround was not achieved, and that incentive worked!

GLOBAL MANUFACTURERS MUST DO ALMOST EVERYTHING RIGHT: SOURCING, CUSTOMERS, AND THINKING LEAN

With all the failed attempts at renewal exhibited by the U.S. auto manufacturers, are there any other U.S. manufacturing companies that have successful renewal records? If so, what are their best practices?

Diversified manufacturers Danaher and Illinois Tool Works (ITW) demonstrate that it is possible to create wealth in the manufacturing sector in the United States. Although there is no single magic formula, consumer electronics companies like Apple and Koss Corporation show that success requires the correct strategy and almost flawless execution. Management must pay disciplined attention to facts, customer needs, all the details of the business, and production of cash flow to create wealth.

The Shareholder Wealth Index of Exhibit 4 (top) shows that Danaher outperformed the S&P and its industry peers in all years except 1995, 1999, and 2005. Danaher has accomplished this marvelous record by applying its own lean thinking culture, known as the Danaher Business System (DBS), to a variety of both large and small acquisitions. Like Coca-Cola and its secret formula, Danaher has remained relatively quiet on its formula for success. Danaher adopted lean thinking techniques in the mid-1980s as a survival mechanism. It became an entrenched part of the Danaher culture and is now Danaher’s prime driver of continuous renewal. Danaher continues to acquire smaller companies with good products, improve their business models using the DBS lean techniques, and then grow the business units using Danaher’s broader distribution power. Those operations that do not fit the culture or meet the profitability hurdle rates are sold off.

The results of the DBS are apparent in the cash flow return charts and real growth charts. Danaher has earned almost double its cost of capital in over half of the last 18 years. Danaher has grown sales in all years except the 2 years associated with the 1992 and 2001 recessions.

Danaher is now a diversified $8 billion company that plans to produce 5–7% organic growth every year. Because of its heavy manufacturing content, Danaher is establishing operations in China and hopes to be a supplier to Chinese consumers as well as to serve the global market from a lower-cost Asian manufacturing base.

Best practices in renewal at Danaher include

- strong focus on end customer needs
- cultural focus on lean manufacturing and continuous improvement
- “business unit” focus on accountability.

Exhibit 4 (top) shows that over 19 years, Midwest-based ITW has consistently outperformed the S&P500 Index in all but 2 years (1999 and 2004), by keeping its real cash flow returns well above 9% and growing. In almost all years both sales and assets grew. ITW maintains its discipline through a focus on the 20% of its customers and products that generate 80% of the profits. ITW operates as an acquiring and consolidating machine. ITW pursues its own form of continuous self-renewal through several steps: acquiring manufacturing businesses, renewing their business model with its 80/20 rule, pruning unprofitable units, and holding management accountable. ITW has proven that it can manage over 600 independent business units and produce high returns, while maintaining its decentralized management philosophy.

Through product line simplification, and by focusing on the 20% that represents its most critical customers and products, ITW typically doubles the operating margin of the acquired businesses within 5 years of acquisition. It
renews those businesses that cannot renew themselves and produces high returns for ITW shareholders while doing so. ITW is one of the few companies that have managed to produce value as well as sales growth through acquisition. Numerous studies show that over 50% of acquisitions fail to create value for the acquirer, but not at ITW or Danaher. The difference is that renewal at ITW and Danaher is part of the culture, a disciplined system of acquiring and transforming smaller manufacturing businesses into more profitable ones.

Exhibit 4 (bottom) profiles Apple Computer. Due to Apple’s high real cash flow returns through 1992 and 4 years of losses between 1996 and 2000, long-term Apple shareholders have been on a wild ride. Over time, Apple’s relative wealth performance has swung wildly out of scale.

Apple Computer has created value and renewed itself through periodic dramatic innovations and CEO change. This has led to volatile performance for stockholders, as strategic missteps and internal strife have been part of the ongoing process.

Founder Steven Jobs was pushed out of his management roles in 1985 as returns dropped and the board of directors felt he was no longer capable of managing an operation of Apple’s size and complexity. John Scully was at the helm until 1993 when he was ousted by the board, at a time when the company’s financial performance was faltering.

Further turmoil ensued through the tenure of two more CEOs. In 1997, Jobs was brought back into the Apple family as interim CEO, when Apple bought NeXT Computer, which Jobs had founded upon his earlier departure from Apple. Jobs blended NeXT’s technology with that of Apple and developed the successful iMac, and later the iPod.

Jobs assumed the full CEO title once again in 2000 with a salary of $1 per year, plus millions in stock options. His renewal plan helped return Apple to profitability and high growth through product innovations.

Apple’s core competency is innovation. Its manufacturing is outsourced to various highly competent manufacturing specialists. Steve Jobs has been a constant innovator, both inside and outside of Apple. After leaving Apple in 1985, he purchased the computer graphics division of Lucasfilm for $10 million and turned it into Pixar, creating another multibillion dollar company that Disney recently agreed to acquire for over $7 billion, a move that will make Steve Jobs Disney’s largest shareholder.

While Danaher and ITW create value through acquisitions, others may stumble. An acquisition and diversification strategy put stereo headphone inventor and innovator Koss Corporation into bankruptcy in the mid-1980s. Koss changed management, survived a Chapter 11 bankruptcy, and today continues to be a supplier to big box retailers, while earning real cash flow returns on its investment that exceed its cost of capital. Although its growth rates have been somewhat erratic as shown in Exhibit 3, its cash returns have strongly exceed its cost of capital in every year beginning in 1993. Koss has dramatically outperformed other consumer electronics peers as well as the S&P500 Index since 2000. Koss provides an insightful example of continuous renewal and helps prove that a small company can remain profitable in a world of global competitors and big box retailers. It too focuses on innovation and marketing while outsourcing most of its manufacturing to Asian sources. Michael Koss, son of founder John Koss, summarized its turnaround and continuously renewal strategies with these four basic principles.

1. Make money every month. Don’t be fooled by seasonal trends. Find a way to be flexible and staff correctly.
2. Promote from the inside. With a narrow product focus and company culture, company veterans can provide most of the necessary resources for growth.
3. Don’t manage by accounting profit and loss statements. Product managers are often confused by accounting statements. It is cash every month and every day that matters.
4. Be disciplined about cash. Cash discipline is a carryover from the turnaround.

Mike Koss continues to sign all checks personally to keep track of operations. If Koss can learn to renew and survive in a highly competitive global consumer electronics industry, many other manufacturing companies can also renew and survive. Those that can’t are destined to be acquired by consolidators such as Danaher and ITW, or eventually fall into bankruptcy—a one-way trip for many companies.

EVEN HIGH RETURN COMPANIES NEED RENEWAL

Proctor & Gamble’s performance is summarized in Exhibit 5. In the late 1990s P&G failed to meet investor expectations for growth. Its share price tumbled as investors lost confidence in the management of this marketing powerhouse.
Even great companies need a change to improve, and it frequently begins with a new CEO: “At Procter & Gamble, for example, chief executive A.G. Lafley has brought new rigor and creativity to the company since 2000. In the past two years alone, P&G has raised its new product hit rate—the percentage of new products that deliver a return above the cost of capital—from 70 to 90 percent. And that’s in an industry where half of all new products fail within 12 months of launch.”

Exhibit 5, the Shareholder Wealth Index for Gillette shows the tremendous wealth creation and destruction that occurred in the mid-1990s as Gillette first outperformed and then underperformed the S&P Index. Management frequently missed quarterly earnings targets. It failed to live up to investor expectations for growth, as both asset growth and sales growth declined from 1997 to 2000. Turnaround CEO Jim Kilts was hired to change the culture and renew the organization. Kilts’s strategy for breaking Gillette’s circle of doom was repeated frequently and communicated thoroughly within the company: “Everyone working to satisfy customers and consumers better, faster and more completely than the competition.”

This requires four basic steps:

1. Management must have the integrity to see the world as it really is.
2. Management must inspire enthusiasm to build confidence inside and out.
3. Everyone must have a strong bias for action to overcome inertia.
4. Everyone must understand the consumer fully and completely.

Highly profitable Gillette was sold to P&G in 2005 in an effort to realize Gillette’s true higher growth potential and increase Gillette’s market power. The Gillette case proves that continuous renewal is needed in even the most profitable companies. Continuous renewal requires management to help the organization balance the conflicting needs of investors, customers, and employees.

**SUMMARY OF KEY POINTS**

Successful renewal and turnaround efforts are complex and typically require dramatic changes. Management usually needs to change financial targets, metrics, customer focus, levels of productivity, culture, and internal
processes to sufficiently improve profitability. The goal is to provide cash returns acceptable to investors over the long term. All too often, a turnaround falters when growth is resumed before a profitable business model is firmly in place. Profitable products or divisions may give leaders false security and divert attention from the drag of unprofitable units. Changes must be dramatic enough to make a difference in the business unit model and move the real cash flow return “needle” for all key business units above the cost of capital.

Successful renewal efforts result in a new business model that can earn cash flows at or above the company’s cost of capital and then resume growth to build value. Alert managers and board members will install board-level early warning systems to ensure that all business units are pulling their weight.

Value-building turnaround and renewal efforts for underperforming units are usually a combination of dramatic change, executed through refocusing business unit models, to align

- the right leadership and people
- the right strategy
- communication and execution
- the right products and services
- focus on the right markets
- effective processes
- the right incentives
- both a long- and short-term view.

Successful renewal involves this long list of executing almost everything right. Miss one or more factor and failure may be assured. Choosing the right, growing, profitable markets generally requires a disciplined customer focus rather than a product- or asset-based focus.

Maintaining the proper balance between growth and profitability in a changing world is clearly critical to survival and renewal, regardless of industry. Making dramatic strategic decisions, such as deciding to spin off non-core assets to focus on a niche or core capability, is the key in some of these examples. Maintaining this balance and outperforming the S&P 500 Index over 10 or more years is very difficult for even the best and most profitable companies.

It is emphasized time and again that growth at the wrong time is the wrong strategy and can destroy value and renewal efforts. Retaining or building market share has proven costly for more than one company searching for renewal. Surgically shrinking, knowing how and when to refocus on a more profitable business model may make the difference between success and failure. On a corporate level, undisciplined growth may lead to complexity beyond the management’s ability.

The graphic tour has shown the pathways that managers and boards have taken to turnaround and renewal success and failure. We hope this graphic review of relative performance sheds light on plotting your corporate future.

ENDNOTES

1See William J. Hass and Shepherd Pryor IV, Building Value Through Strategy, Risk Assessment and Renewal, CCH Incorporated, Chicago, 2006. Hass, Pryor, and Broders consult to boards and CEOs providing value-based insights, under the auspices of CharterMast Partners LLC, which specializes in monitoring and managing corporate and business unit value creation. The authors also gratefully acknowledge contributions from Dennis Aust, managing director of CharterMast Partners LLC., and Scott Tober, retail consultant.

2Cash flow return frameworks are based on the practice of transforming accounting information to cash flow and making a series of adjustments to GAAP financial statements to put all companies on a level playing field. This approach is used by institutions such as Fidelity, Merrill Lynch, UBS, CSFB, Oppenheimer, and Bank of America. The approach was originally developed at Callard, Madden & Associates, Inc., during the 1970s. See Bart Madden, “CFROI Valuation,” for a complete description. See also links to www.CharterMast.com and www.AtivoResearch.com.


4Unlike more traditional performance measures such as EPS and ROE, the framework for real cash flow returns is backed by extensive empirical research that verifies a high correlation with actual market prices. Major institutional investors use similar frameworks to decide which stocks to buy or sell. Corporate executives and boards use this approach to analyze acquisitions, make capital spending decisions, and set objective and measure performance for executive compensation and business units.

5Target attempted to sell its Mervyn’s stores for several years without success. In 2004 Mervyn’s was finally acquired by a group of distressed equity investors including Sun Capital Partners, Inc., Cerberus Capital Management, L.P., and Lubert-Adler and Klaff Partners, L.P.

6CFO Magazine, December 1, 2004, “A Penny Saved.” A deft turnaround buys time, but what’s in store long term for the venerable retailer?

7Note: if viewed on a larger scale, the story of Penney’s renewal becomes clearer. Penney’s shareholders lost 90% of relative wealth on their investment in the years 1993–2000. There-
A graphic tour of success and failure in corporate renewal

After, new investors were rewarded, as investments made in Penney’s stock in 2000 have appreciated sixfold relative to the S&P500 Index.

8Ibid.
9For additional profiles on other retailers including Nordstrom’s, Sears, and Kmart, and specialty retailers such as Home Depot, Lowes, and Crate and Barrel, see Building Value Through Strategy, Risk Assessment and Renewal by Hass and Pryor, 2006, CCH Incorporated, Chicago, 2006. Additional information is available on the web at http://onlinestore.cch.com/default.asp?SessionID=2474808&ProductID=3643&WBID={633817B7-864D-4CCC-80C4-BFFC3032B9}

10A peek at market share statistics shows how Asian producers have advanced against the Big 3 U.S. manufacturers:

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(Source: Board Resources graphic, Standard & Poor’s data from WardsAutolink.)

12Chicago Tribune, January 27, sec. 3, p. 4.
13http://www.toyota.com/about/careers/tmmtx/index.html
17If viewed on a full scale, the dramatic story of Apple’s renewal comes into high relief. Apple shareholders lost 85% of relative wealth on their investment from 1987 to 2000. Thereafter, new investors would have been rewarded, as investments made in Apple stock in 2000 have appreciated tenfold relative to the S&P500 Index.
18An expanded scale on the “real cash flow return” chart was necessary to allow room to show P&G’s recent success in renewal.
20Jim Kilts, presentation on May 18, 2001 at the University of Chicago GSB Management Conference.

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