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CORPORATE RENEWAL AND TURNAROUND OF TROUBLED BUSINESSES: THE PRIVATE EQUITY ADVANTAGE[§]

Kathryn Rudie Harrigan*
Henry R. Kravis Professor of Business Leadership
Columbia Business School
701 Uris Hall
New York, NY 10027
(212) 854-3494
krh1@gsb.columbia.edu

* Corresponding author

Brian M. Wing
Cerberus Operations and Advisory Company, LLP
875 3rd Avenue
New York, NY 10022
(248) 705-9081
brian.michael.wing@gmail.com

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ABSTRACT

Turning around distressed operations is an alternative response to underperformance—as contrasted with using transactions such as divestitures or resource redeployment to deal with troublesome assets during corporate renewal. Taking the perspective of private-equity owners whose interests are primarily financial, we explain how their approach to turnarounds of troubled companies may differ from that of managers within publicly-traded firms who may envision the realization of longer-term sources of operating synergy among their firms' lines of business. Financial owners can revitalize firms' performance more effectively because they use turnarounds differently. Observations have implications for consulting engagements involving organizational decline, for corporate directors who must respond to outside pressures for performance improvements from shareholder activists, as well as for managers who are faced with corporate renewal challenges inside their companies. Managers within publicly-traded firms are not maximizing value for their firm's investors if they cannot turn around troubled operations effectively.

(126 words)

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CORPORATE RENEWAL AND TURNAROUND OF TROUBLED BUSINESSES: THE PRIVATE EQUITY ADVANTAGE

by
Kathryn Rudie Harrigan and Brian Wing
Columbia Business School

Operating turnarounds are an important means of corporate renewal that has received little research attention to date. They are a means of revitalizing business operations. If managers within publicly-traded companies have devoted resources and time to repairing troubled operations and changing scope arrangements within their underperforming, multi-business firms, their decision to do so would suggest that the expected value of fixing problems within their firm is greater than the proceeds that could be garnered via divestiture of associated assets. It would be logical for the firm's managers to turn around its underperforming operations to maximize investor value.

Unfortunately, investors in distressed firms are often so impatient for performance improvements that they sell off their shareholdings at fire sale prices—signaling a lack of confidence in management's competency to fix the firm's problems. Abrupt declines in a firm's share prices frequently shrink its access to the cash that would be needed to execute a full-fledged turnaround process. If creditors charge a high price for money and demand stringent loan covenants, that situation further increases the difficulty of renewing the distressed corporation's viability successfully.

Financial owners, *e.g.,* private-equity owners, sometimes exploit investors' impatience for performance improvements in order to acquire a portion (or all) of a distressed company's equity and perform their own turnaround upon it. Private-equity owners have several advantages over publicly-traded firms when turning around their distressed divisions. As this essay will explain, turnarounds led by financial owners have salient differences from turnarounds implemented by the managers of publicly-traded firms because private-equity owners can think differently about diversification strategy and perform the corporate renewal task without regard for relatedness considerations among the troubled firm's lines of business. Financial owners can view each piece of a firm for its intrinsic value-creating potential, respectively, and need not cross-subsidize lines of business temporarily—unless doing so will maximize the net cash flows that are ultimately generated via operations.

FINANCIAL OWNERS AND VALUE CREATION VIA TURNAROUNDS

Although the managers employed by publicly-traded firms should be able to take the longer-term approach to corporate renewal of financial owners, they are, in fact, more likely to use divestitures, carve-outs, spin-offs and other methods of resource redeployment that do not recover value for owners as fully as simple disciplined management of operations would do. Managerial incentives, expectations regarding attainment of stretch goals, and the structural relationship of managers to the firm's owners prevent effective turnarounds from occurring within many publicly-traded enterprises.

Contrasting Financial Owners with Publicly-Traded Firms

Figure 1 summarizes how financial owners approach the turnaround process. Private-equity owners make temporary investments in companies whose viability can be renewed by investing in resources to foster growth opportunities as well as repair past managerial errors. Because they raise funding from their passive partners in advance of acquiring target companies, private-equity owners have abundant capital to invest—which they will provide prudently, as warranted. By contrast, publicly-traded firms are constrained in the amount of capital that their managers can devote to turnarounds because their borrowing costs increase when capital markets lose faith in their abilities to resolve performance problems. Typically, the managers of publicly-traded firms are reluctant to become overly-leveraged—lest all lines of business be pulled into a court-supervised restructuring when one division cannot service its debt.

Unlike the private-equity, corporate raiders of an earlier era that created value by breaking up poorly-diversified conglomerate firms, the financial owners that acquire troubled firms to pursue operating turnarounds typically lock in the improvements that they create in acquired firms by monetizing their investments after revitalizing them. Since they are *private* owners of the assets undergoing turnaround, outside observers usually have no information about the firm's financial condition until it is offered for sale at the end of the turnaround process. By contrast, the press reports on every false start within a publicly-traded firm when its management undertakes a turnaround process. The quarterly reports filed with financial agencies reveal to investors and future employers the gritty details of management's lack of progress in revitalizing the firm's resources.

Financial owners know that most troubled businesses fail because they have been mismanaged in the past. Products under-perform because their previous managers have not been supporting them properly within their respective marketplaces. Although private-equity owners are in the business of turning around companies to release unrealized value through continued operations, their principals and key managers are rewarded most highly when turnarounds are ultimately monetized. Their highly-sophisticated investors understand that cash generation takes precedence and successful track records are rewarded. Thus, agency costs are lower for financial owners than they would be within publicly-traded firms that require short-term monitoring to evaluate stock prices that are based upon future expectations.

While publicly-traded firms tend to rely upon their existing stable of managers to fix operating problems, private-equity owners typically employ turnaround experts and functional specialists to intervene when taking action in order to optimize potential performance on every operating dimension (Klier, Welge, and Harrigan, 2009). Although the checklist of potential problem areas to remedy is well-known in operations (Grinyer, Mayes, and McKiernan, 1990), publicly-traded firms do not have a complete stable of specialist talent on hand. Their managers must reach beyond readily-available talent if they hope to remedy mediocre performance by attacking areas where aggressive changes will have the greatest impact. Their managers are not accustomed to pressing as pointedly for performance improvements as financial owners do—thereby creating the self-fulfilling expectation that performance problems cannot be improved.

In situations where businesses have been so neglected, a turnaround process is needed and new leadership is typically required since the managers who put the company into a hole are rarely a suitable choice for climbing out of the hole that they have dug. Since the financial owner seeks financial returns primarily through improved business operations, the private-equity investor's team performs turnaround analyses to pinpoint problems, starts the change processes, and recruits professional personnel who can follow through on pursuing the necessary processes in order to shepherd troubled companies to monetization. Sometimes it takes time to find the best maintenance manager for distressed business units. Therefore the private-equity owner's team of professionals sometimes phones in plays to the flailing management team in the interim or seconds a partner from their firm to serve as interim CEO until a replacement can be found. Either way, expectations for sharp improvement are created when financial owners take charge.

Varying Turnaround Urgency

Private-equity owners can invest in both *early-stage* and *late-stage* turnaround processes; these contexts vary by the degree of urgency required to rescue the firms that they have invested in. Within *early-stage* turnaround processes, a company's performance may be mediocre, but there is tremendous value to be captured through operational improvements. Knowing this when they invest in currently-healthy companies, the cash infusions of financial owners are typically accompanied with legal covenants that will allow them to bring in their teams of turnaround managers when company performance flags or other pre-negotiated constraints are triggered (Curry and Talmor, 2007). When healthy firms stray off the path to financial success, the private-equity investor's covenants are invoked and its team of professionals starts their turnaround process to optimize each functional aspect of operations.

Late-stage turnarounds are typically performed on firms that have violated their financing covenants and face their last chance at survival. Late-stage turnarounds are typically undertaken by private-equity owners via out-of-court restructuring activities. Within late-stage processes, a distressed firm typically cannot service its debt and requires more drastic measures in order to survive. The late-stage, distressed company may be co-owned with a group of lenders who look to the private-equity partner for expertise concerning how to renew the value of the firm's assets—including potential replacement of senior management. The creditors may have accepted equity in exchange for cancelling the debt that they once held in late-stage turnaround situations. In such cases, the company's original shareholders have typically been flushed following restructuring and the new firm's owners, the firm's former creditors, are funding the costs of the turnaround process in partnership with private-equity owners who contribute their operational approach to managing adversity.

Turnaround professionals from the private-equity owner's stable of talent transform the troubled company's operations in order to realize maximum recovery for the partnership of new financial owners. Private-equity turnarounds go beyond traditional banking workout processes when working with such deathbed candidates because of their emphasis on changing workers' behaviors as they rectify day-to-day operating mistakes. Theirs is a discipline that could be extended broadly to all firms with stagnating performance in order to keep them out of the weeds and position them towards corporate renewal as well. Doing so requires changing internal aspirations and rewarding corporate heroics, not complacency.

Some late-stage turnarounds do involve divestitures or spin-offs of businesses in order to generate enough cash to pay down creditor obligations. Late-stage restructurings that involve court–supervised restructuring processes may also require professional management in order to accomplish a turnaround that leads the firm out of court supervision, but the process of leading a company out of bankruptcy is beyond the scope of this paper (Harrigan, 2012; Sheppard, J.P., 1994; Tenkasi and Kamel, 2016; Xia, Dawley, Jiang, *et al*. 2016.).

DECLINING PERFORMANCE IS LINKED TO DIVESTITURE

Remedying declining performance has long been a concern of strategy scholars (Gopinath, 1991; Harrigan, 1980a; 1988; McKinley, 1993; McKinley, Latham, and Braun, 2014; Koh, Durand, Dai, *et al*., 2015.). Declining performance has been driven by both exogenous (Harker, 1996; Harrigan and Porter, 1983; Ndofor, Vanevenhoven, and Barker, 2013; Pant, 1991) and endogenous forces, including managerial neglect in the face of declining demand (Purves, Niblock, and Sloan, 2016; Trahms, Ndofor, and Sirmon, 2013). When ill-considered managerial decisions drive companies into the *zone of insolvency*—the point where corporate directors' fiduciary obligations increase to include creditors' interests as well as those of shareholders—managerial action is required to preserve shareholder value and renew the worth of resources that have been invested in a corporation (Furrer, Pandian, and Thomas, 2007; Pretorius, 2017).

Declining performance is also of interest to finance scholars who study highly leveraged firms that may require court supervision to restructure. Debt typically enables firms to undertake projects to foster their transformation and growth (Doidge, Kahle, Karolyi, *et al*., 2018), but the priority of creditors over equity holders is invoked when a firm stumbles. Because the interests of creditors precede those of equity holders in a turnaround situation, carrying high debt loads actually *encourages* creditors to act as stewards of shareholder wealth. Thus creditors become an additional check against the likelihood of managers funding projects that may offer inadequate returns or of hoarding large cash balances unjustifiably—by virtue of their financing covenants (since the servicing of debt pressures managers to slash unsound investment programs, shrink overhead, and dispose of assets that would be more valuable outside the company).

Financial owners frequently use debt to discipline the managers of their portfolio companies to perform turnarounds or other forms of corporate renewal. Since financial owners are not constrained by access to capital, they are sometimes the superior corporate parent for firms that require corporate renewal processes (Jensen, 1989)—particularly since they can take the time to recover full asset value.

Retrenchment

Declining performance has long been associated with divestiture as a quick response to adversity. In the management literature that has addressed turnarounds, declining performance is usually addressed using a combination of *retrenchment* and *recovery* activities (Robbins and Pearce, 1992). *Retrenchment* is the turnaround approach first used by diversified corporations to reduce the complexity and overall size of the operations of the company. Retrenchment is most frequently associated with cost cutting measures, reducing the scope of operations through divestiture, or otherwise removing resources from the distressed portions of a firm. Robbins and Pearce (1992) have advocated that retrenchment *precede* recovery activities during corporate renewal processes (but the order of those activities is typically reversed when financial owners take charge, as is explained herein).

Oftentimes, the corporate renewal process involves some form of divestiture (Berry, 2010; 2013; Feldman, and McGrath, 2016.). Typically retrenchment may involve downsizing—which includes withdrawing from certain markets or discontinuing sale of particular products (or services) in order to make a beneficial turnaround (Dewitt, 1993; O'Brien and Folta, 2009.). The retrenchment approach is often used to cut expenses with the goal of becoming a more financially stable company (Chakrabarti, Vidal, and Mitchell, 2011), which is a logical course of action if access to capital carries fulsome costs and terms. Sometimes asset divestiture is used to reduce the range of a company's diversification as well as to obtain cash from monetizing assets that are not considered to be "core" to the company's strategy (Barker and Mone, 1994; Pearce and Robbins, 1994), as in the example of Elan Pharmaceuticals where performing internal triage to monetize its assets helped to focus organizational attentions upon those businesses that would become Elan's basis for future corporate renewal (Shein, 2010).

Pruning redundant or excessive product lines and dropping unprofitable customers is good practice. But managers who divest their firms' assets too aggressively at fire-sale valuations may be leaving money on the table; diverting corporate resources to other uses elsewhere prematurely could limit the future returns that could be realized through a "Last Iceman" type of strategy (Harrigan, 1980b). Demand often declines slowly enough for a few firms to thrive within seemingly-adverse environments—especially where remaining customers are relatively price-insensitive—but some managers are too impatient to perform the analysis needed to find good alternatives to selling off assets.

Greater commitment to funding deteriorating businesses has paid off well in the past because declining performance can frequently be improved by pursuing new initiatives and facing down competitors instead of cutting costs to the bone or selling off valuable resources at distress prices (Hambrick and Schecter, 1983; O'Neill, 1986; Taylor, 1982). Indeed, if every troublesome business unit were divested to release the resources invested therein, firms would eventually be liquidated instead of being renewed because every line of business has its rough patches of performance (Vidal and Mitchell, 2018).

Therefore, although retrenchment has been touted as an appropriate first response to declining performance (Robbins and Pearce, 1992), some concerns have been voiced about the wisdom of selling off lines of business that did not have to be monetized in order to pay down debt (Castrogiovanni, and Bruton, 2000; Lim, Celly, Morse, *et al*., 2013; Morrow, Johnson, and Busenitz, 2004). For example, General Electric's plans for divesting its healthcare business may have the unintended result of unravelling extant operating synergies by eliminating beneficial relationships between lines of business that had previously shared salient resources, transferred related technologies or absorbed expenses from centrally-provided overhead services that cannot be easily reduced when lines are business are eliminated (Girod and Karim, 2017; Harrigan, 2018a; Karim and Kaul, 2015; Weigelt and Miller, 2013).

Recovery Operations

Unlike the managers of publicly-traded firms, financial owners do *not* start their turnarounds with retrenchment activities. Because of their differing perspective on value creation, private-equity owners can renew the viability of acquired firms by taking aggressive, early actions that are intended to bring immediate cash flow benefits to the operating company in the form of higher revenues (*e.g.,* price increases, offering complementary products or otherwise revitalizing firms' market presence) instead of contemplating fire-sale divestitures (Kaul, Nary, and Singh, 2018). Financial owners can invest in this offensive because they invest in building considerable industry expertise within their dedicated turnaround teams. They hire professionals from banking, consulting, and industry backgrounds across a variety of needed functions to find and enhance value creation when they choose to intervene in operations. They are astute at executing processes that increase cash flows.

When taking charge, the turnaround teams of financial owners typically focus their attentions *first* on tasks that are associated with the highest monetary returns in order to accelerate cash inflows. Early turnaround efforts for financial owners are often campaigns to offer services and complementary products in order to enhance customer satisfaction and retain their patronage. If divestitures of ill-fitting resources or non-core lines of business later do prove to be warranted, they are done *without haste* in order to generate the highest-possible selling prices for unwanted assets. Corporate renewal for the turnaround teams of financial owners involves maximizing the value of all of the resources that their team will bring to their ultimate exit event. Greater effort is devoted to exploring opportunities to grow market positions within complementary or related assets than is typically seen within the turnaround processes of publicly-traded firms whose managers first cut back resources or monetize assets to expedite their solution to poor performance.

The types of activities that managers from financial owners prioritize may be considered to be *recovery* activities, as defined per Robbins and Pearce (1992). It is noteworthy that when turnaround processes are led by private-equity owners, recovery activities typically *precede* the radical surgery aspect that has been described as being typical for the retrenchment phase within publicly-traded firms. During the private-equity owner's turnaround process, retrenchment and recovery may occur *simultaneously*. For them, revenue generation must dominate pursuit of cost cutting activities and other early retrenchment actions that may be intended to remove costs quickly (*e.g.,* reductions in head count, elimination of redundancy, outsourcing of non-core activities like cafeteria services, *et cetera*). Instead of cutting back on the company's domain via divestiture to generate cash—an activity that might be especially appropriate when companies struggle to survive during a late-stage restructuring—their response to organizational decline is oftentimes answered by executing *recovery* activities first to increase growth opportunities, especially when an early-stage turnaround is being pursued (Barker and Duhaime, 1997; Schmitt and Raisch, 2013). This approach to corporate renewal develops the earnings potential of the distressed company's entire portfolio of assets since private-equity owners do not need to sell corporate assets prematurely. Thus private-equity owners can provide a form of patient capital where turnarounds are concerned and their managers do not pre-judge lines of business as being failures without verification via customer audits and other forms of performance analysis.

The private-equity emphasis upon improving revenue generation *first* is logical since the additional funding that they put into a turnaround situation is typically intended to make transformational improvements that would not be otherwise funded by publicly-traded firms. To reach those transformational events within publicly-traded firms, turnaround teams must first rehabilitate operations by making them self-funding. By contrast, revenue enhancement is often the first objective of private-equity firms while deeper diligence is proceeding simultaneously.

Whether competitors have stolen market share from an oblivious, distressed company or a firm's operations were expanded faster than the troubled company's cash flows could support, managerial errors were made within underperforming companies. Mismanagement has typically been compounded by failing to take corrective actions fast enough when problems are detected. Failing to respond fast enough (or responding incorrectly) is often a problem among publicly-traded firms whose product portfolios have become too complex to manage effectively. Unraveling real or imagined sources of synergy across lines of business creates strategic exit barriers that slow down the speed with which implementation may proceed (Porter, 1976).

Choosing Appropriate Turnaround Candidates

It is easy to argue that private-equity investors thrive when executing turnarounds because they are more cautious when becoming owners of troubled firms. Financial owners perform stringent due diligence in order to avoid taking on situations with low potential returns. They are especially sensitive to the risks created by past warrantees. For example, some companies, like Jarvis, an industrial maintenance and renewal contractor for the British railway industry who was responsible for several train crashes, required extensive changes that were not cost-justified (Wild and Lockett, 2016). Although private-equity owners understand how to thrive within endgame situations, some firms face declining demand that will not revive, such as Kodak in photographic film or Cumulus Media in commercial broadcast radio. These firms would be examples of poor candidates for future investment (Harrigan, 2017) and private-equity owners make the extra effort that is needed to know what returns they can realize, given their unique context. For example, Johns Manville appeared to be so tarnished by past events that some potential owners could not raise funding to acquire the firm (Harrigan, 2016), while the firm that ultimately bought it enjoyed substantial cash flow benefits. Therefore the private-equity owner's turnaround process begins when their due-diligence team finds a company that is not too toxic to renew successfully which operates within markets where demand is likely to revive.

While they execute short-term policies to collect receivables and increase working capital, the turnaround evaluation team must dive deeply into the longer-term drivers of profitable business operations in order to renew the viability of the firm's resources, especially focusing upon the external market's demand for the company's products. It is not unusual for the turnaround team's professionals to uncover many misconceptions that the troubled company has relied upon as they dive into the drivers of the distressed business operations—since competitive conditions may have changed, but extant managers may not have adapted to these changes. Bringing in an outside set of eyes is especially useful for challenging legacy wisdom about customers and drilling down on financial analysis that will guide subsequent action plans that the turnaround team pursues. The analysis undertaken during the private-equity team's evaluation phase can uncover missed opportunities, legacy misconceptions and other operating problems that can renew the corporation effectively if they can be remedied. The following section describes salient traits of effective turnaround processes and speculates about why managers within publicly-traded firms approach underperformance problems so differently than private-equity managers do.

SUCCESSFUL TURNAROUNDS MANAGE DETAILS CLOSELY

Too many companies find themselves in a turnaround situation because they have lost track of the finer details. When a company is in distress, its condition offers evidence that—somewhere in its past—top management stopped worrying about those little things that drive profitability. Day-to-day management is detail-oriented and unmanaged details can accumulate in ways that may eventually require a turnaround process.

Turnarounds are a grind to manage and a typical turnaround process moves slowly to repair the many details that have been ignored in the past. The work is demanding and successful turnaround managers must keep a mind-numbing focus on operational details. The need to address so many areas with equal urgency explains why effective turnaround managers typically get very little sleep during the early phases of the process. In particular, attention must be paid to every dollar of revenue that can be collected and every check that is paid out to vendors. The way in which the turnaround team proceeds includes urgent actions that may be at variance to what the academic literature reports about managing turnaround processes, as Figure 2 suggests. The contrast between the approaches shown in Figure 2 is illustrated by discussing the details of salient turnaround principles.

Strong Controls

Successful managers should always have a tight grasp on the patterns of their company's cash flows (Whitney, 1987b). Sundar Pichai (CEO of Google) need not review every expense above a thousand-dollar threshold, but proper controls should be in place within his firm to ensure that spending does not spiral unjustifiably. Recall the pushback that Google's parent, Alphabet, encountered in 2015 when Ruth Porat (CFO of Alphabet) first requested budgets and plans from the various businesses comprising its "Other Bets" Division. Some "Other Bets" entrepreneurs defected from taking Alphabet's $4 billion of largesse rather than endure such minor attempts at corporate governance as the straightforward budgeting exercise that was requested at that time (Alcacer, Sadun, Hull, *et al.,* 2016). In a similar manner, private-equity turnaround managers exert strong controls over working capital changes as well as capital expenditures by insisting upon strict accountability when authorizing expenditures. This requirement can cause friction between ownership, extant executives, and functional or division managers, but it is a crucial component of cash management and is often required to stabilize cash flows within a distressed organization.

There is a misperception that the turnaround process pertains primarily to cost-cutting and efforts to "trim the fat" to make cash flow positive. The renewal process within private-equity turnarounds starts with analysis of sales and customers. When financial owners take charge of troubled companies, revenue enhancement is an equally important means to stop the bleeding and move towards renewing asset viability. To make a sustainable turnaround, there needs to be an appropriate balance between taking short-term kamikaze actions during the crisis period, and making prudent investments in growth when it is time for the company to progress from its intensive-care status to steady-state operations.

In turnaround situations that are managed by financial owners, a temporary evaluation team assesses the situation, uncovers the garbage, and drills down to find the drivers of company profitability. From the evaluation team's recommendations, a turnaround team is assembled to address the distressed company's operating problems—bringing expert management talent into whichever function needs fixing to ensure that all valuable assets can returned to viability.

In order to know where to focus attentions during their turnaround, the evaluation team probes for the root causes of problems. Typically they build a profit tree to identify the true drivers of revenues and costs. As a result of their drilling down, the evaluation team discovers which factors require greater prioritization from management than they were previously receiving. Further drilling down may dissect declining profitability into hundreds of different drivers with varying impact. Each of these many profit drivers must be managed with varying prioritization as the turnaround action plan is formulated and internal policies may be changed, particularly with regard to pricing services associated with serving customers.

Cost-Justified Pricing Policies

Pricing policies typically include hidden costs that firms have absorbed to retain their customers. In a turnaround situation, the company must pass along its materials cost increases to customers and charge a premium price for providing accelerated services. Rebate policies need to be frequently revisited, lest outdated conditions eat into current profit margins. The firm's value proposition must be reviewed and re-justified as the turnaround progresses. Assessing customers' willingness to pay is an important step in assessing which resources remain valuable.

In one turnaround engagement, the organization had incentivized its sales force to increase sales from their repeat customers. But analysis revealed that two-thirds of the company's orders were short-run productions of off-standard items that were made as a courtesy for its repeat customers. Any additional margins that were charged for the required off-standard setups were more than offset by the costly operational inefficiencies incurred when changing over the manufacturing layout or making other process changes to accommodate these presumably-valuable customers. Moreover, the firm was expediting delivery for these off-standard items to retain customers. Price increases for off-standard production runs were immediately instituted, but the firm inevitably suffered a decline in revenues when it stopped subsidizing its customers since their value as a vendor could not be renewed in dealing with some former clients. Analysis revealed that only one-third of the company's sales were to new customers and these were, in fact, driving its profitability—which is consistent with Bibeault's (1981) 80%-20% rule.

In another instance, a distressed company wished to differentiate itself to its Silicon Valley customers by giving them a speedy response when producing custom components. Their quick-turn strategy had been incredibly successful during the first fifteen years of demand run-up. Its high service level as an OEM allowed the firm's customers to differentiate their branded cell phones and computers through quick delivery. The specialized component OEM thrived when the popularity of its customers' products gave the troubled company high production volumes for fifteen years. But later, as their clients' products became legacy items (with declining volumes and profitability), customers still expected to receive quick-turnaround service on their orders because the precedent for doing so had been set during the earlier periods of higher demand. Instead customers' order volumes had fallen markedly and did not justify quick-turnaround services.

In an attempt to gain back some margin on customers' quick-turn manufacturing requests, the company's new owners raised prices by 30%. Some orders were lost by doing so since those customers were unwilling to pay for services that were once provided without charge, but many of its customers realized that they had to pay such a quick-turn premium to compensate for their own poor inventory planning. Ultimately, only those customers that were willing to pay the required premium received the faster service, while the others went elsewhere or adjusted to normal order turnover speeds at a lower price. Profitability at the distressed company improved, sales volumes increased, and operations planning was easier thereafter. During re-negotiations with customers wanting quick turns, the turnaround team learned which of their firm's various customer relationships remained valuable (or not) and adjusted the firm's product mix accordingly.

Effective turnaround managers can ferret out where necessary information is being hoarded (or was never requested) that should have been shared across the entire organization to improve operations. In one company that once earned sizable margins when selling replacement parts to industrial customers, a freight surcharge equal to 10 percent of the order price had been imposed when parts were delivered overnight. The firm's service organization did not realize that the cost of overnight shipping involved on a $120 order was $600, so they failed to quote the actual cost of shipping when invoicing the customer. The service group had provided superb customer service when $120 of parts were needed overnight because nobody told them to deviate from their standard surcharge shipping policy. Sharing information about actual shipping costs with the service organization resulted in the revocation of this policy, which soon contributed a $3.7 million improvement to the company's bottom line. Forthright sharing of other seemingly mundane information among affected personnel identified other low-hanging fruit for the organization to eliminate as managers persevered in assessing which activities that they performed still created value.

Revitalizing the Work Force

From the perspective of a private-equity owner, "turnaround" is a term that puts a sexy label on the type of work that nobody wants to face. Employees within distressed companies are typically demoralized and observers expect the firm to fail in its quest to revitalize its operations. Sometimes the troubled company's people are too worn down to think about offering additional revenue-generating services (such as updated software or financing) to existing customers. Dispirited sales managers may have ignored the potential to sell aftermarket parts or cross sell their other products to existing customers. Employees may have given up hope that their company could become a viable competitor and are simply marking time until the end comes. Such organizations would seem to be poor candidates for corporate renewal since their culture suggests that failure is imminent, but private-equity owners know how to extract heroics from operating details.

If underperforming companies have lost their discipline for managing salient details, the turnaround team strives to change the firm's culture by reestablishing the importance of these activities as they evaluate the existing executive team and test their operating plans. Turnaround managers must combat battle fatigue by introducing activities to improve revenues and revitalize organizational enthusiasm since it is important to give the distressed firm ample time to resolve its problems. By creating greater breathing space on the sales side and engaging employees to operate efficiently, the turnaround team has more time to work on taking out the garbage that impairs profitability within operations by solving root-cause problems (Shaughnessy and Harrigan, 2009).

Since turnarounds are a re-contracting of the understandings that have been implicit in the relationships between the company and its employees, suspicion will be rampant among insiders when bringing in outsiders who have no history with the company's operations and may not have the tribal knowledge of why things were done in a particular way (Whitney, 1987a; 1996). The private-equity team may initially be functioning as the Chief Restructuring Office (CRO) if they work in parallel with existing managers because entire management teams can rarely be replaced immediately (Daily and Dalton, 1995). That is frequently why there may not be as much attrition among the upper-echelon management team as might be expected while the turnaround commences. The financial owner presses for big performance improvements by working with extant personnel to find a way to change for the better.

RETAINING THE EXECUTIVE TEAM (OR REPLACING THEM)

As a part of the turnaround process, replacement managers are often needed. Oftentimes tired incumbent leaders are focusing their attentions upon a limited array of big-ticket activities that allegedly will have the potential to "save the business" because they cannot see other potential solutions. Incumbents may support these pricy campaigns because they have no other valid ideas for getting their troubled company out of the ditch. For example, one Chief Financial Officer (CFO) pushed operating executives to shut down excess facilities to save costs (Purtill and Caggiano, 1986). Although such dramatic actions may have reduced operating costs temporarily, their impact on revenues would have been devastating if closing the wrong facilities had disrupted customer service levels.

Instead of accepting the CFO's familiar plant-closing suggestion, the turnaround team investigated which profit-tree factors impacted the distressed operations most significantly. When the private-equity turnaround team drilled deeply into the firm's operating problems, they found many inefficiencies—from high levels of excess scrap to steep labor costs—that would not scale downward when excess facilities were closed. Also they discovered that the one-time process of closing a plant incurred unforeseen termination expenses that wiped out some of the promised cost-saving benefits of downsizing, although other indirect costs were unaffected. The turnaround team sought other ways to improve cash flows, including ways to fill excess plants by redeploying them to serve related lines of business (Folta, Helfat, and Karim, 2016; Sakhartov and Folta, 2014).

Expediency Trumps Idealism

It is important to remember that the extant top managers in a company needing a turnaround are the stewards who put the organization into distress. In order to avoid being swayed by the agendas of such executives (or their efforts to justify past decisions), the turnaround team often finds that it is wise to spend time with the second and third layers of leadership—without including their bosses in the discussions. Such candid discussions are helpful when making personnel decisions, such as who goes and who will be retained. Such interviews often lead to a no-holds-barred view of flaws in business operations that could be rectified. One-on-one sessions with middle-level managers are also most critical for forming the team that will ultimately be needed to implement the turnaround plan—once it has been articulated—since middle managers' skills must frequently be supplemented with outside talents where gaps exist. Candid one-on-one discussions are helpful for assessing where functional gaps in talent exist and must be supplemented.

It takes a substantial amount of time to find an appropriate replacement CEO who (a) has the necessary skills and experience to support the turnaround process and (b) is willing to step into a distressed situation, albeit temporarily. Although financial owners may wish to "clean house" and build a new executive team to lead the turnaround, reality suggests that the right leaders may not be available when needed. Since timing is urgent, the turnaround process often starts by paying hefty retention bonuses to the very managers who should have been pink-slipped instead. Thus seemingly-incompetent managers may benefit from lucrative incentive programs when they implement the turnaround process that the private-equity team initiates (Barker, Patterson, and Mueller, 2001; Santana, Valle, and Galan, 2017). Not surprisingly, they can rise to the challenge that is demanded of them.

In summary, sometimes the extant management team is not immediately replaced. Managers may be retained if the CEO is the company's founder, for example and cannot easily be removed (Abebe, and Tangpong, 2018) or the right managers cannot be hired immediately. The latter situation occurs most frequently when no suitable executive alternatives are readily available—making the fact that whomsoever may be on the scene in the moment of crisis becomes especially valuable in an urgent turnaround situation. In summary, failure to replace incompetent leaders could reflect organizational barriers to exit (Porter, 1976), but it may simply reflect expediency since time is scarce and action is required. Turnaround teams move with great urgency to stop the bleeding in operations so that they can gain enough breathing space to refine the management team's composition after cash flows have been stabilized. They can give orders to lame duck leaders in order to get the job done.

Taking Charge

If the culpable top management team works temporarily in parallel with the private-equity owner's Chief Restructuring Office, a replacement CEO and other key managers must ultimately be recruited after the turnaround process gains traction and performance improves (Haleblian, and Rajagopalan, 2006). Post-turnaround CEOs must remain highly engaged with the processes that have been set in motion when responding to the crisis. The new CEO must understand what was done during the crisis, articulate a clear direction for future operations, and stick with the plan to bring the rehabilitated firm to monetization (Bonvillian, 2013).

A great crisis manager makes tough decisions about headcount and compensation. That CEO is often a great communicator and serves as the face of the turnaround process to rally personnel during the difficult times (Brandts, Cooper and Weber, 2015). The successor CEO that follows the Chief Restructuring Office's team (when replacement managers are finally recruited) must be the type of healer who acknowledges that cultural change starts at the top of the company via the leader's actions, but can resonate that message throughout all of the rungs of the organization. As a great communicator who can sell the new strategy to outside stakeholders, the successor CEO bridges the company's functional gaps in building a cohesive top management team.

The ideal candidate for protecting such hard-won gains is one who is willing to get their hands dirty in maintaining the details that were established during the turnaround process and will work to install a process-driven culture of accountability within the troubled firm so that additional appropriate decisions can happen at an appropriate level in the organization in order to bring products to market faster (and cull products that are not so profitable). As Flynn and Staw (2004) note, appointing the right CEO can give a distressed company greater breathing space by creating temporary enthusiasm for the potential turnaround. Examples include Jack Welch at

General Electric, Lou Gerstner at IBM, Carlos Ghosn at Nissan Motors, Larry Bossidy at Honeywell and AlliedSignal, Jamie Dimon at JPMorgan Chase, and James Gorman at Morgan Stanley. When the Chief Executive Officer (CEO) and top-management team must be replaced, the new leaders' compensation is often substantial. But enthusiasm for their reputations as change masters may explain why outsider CEOs command higher salaries (that are often held in escrow for payment even if their turnaround efforts are not successful) and generate organizational optimism concerning their abilities to implement effective renewal processes (Chen, 2015).

Successful turnaround managers are great communicators across all levels of the distressed organization, as well as with outside stakeholders (*e.g.,* shareholders, lenders, customers, suppliers, and others). A great turnaround manager keeps outside stakeholders apprised of the situation as operating improvements are made internally, while also communicating a shared vision throughout the organization. The enormity of leading the turnaround task of renewing the value of corporate resources and leading firms to monetization suggests that most turnaround CEOs are worth their exorbitant price tags (Harrigan, 2018b).

It is important when taking firms out of the turnaround phase to unite their organization in seeing the single commercial purpose that is their company's reason for existing—*i.e.,* what their business stands for. For example, turnaround executives at school-bus manufacturer, Blue Bird, were able to articulate the firm's commercial purpose and, as a result, galvanize the entire workforce—from executives to line operators—by their shared quest to "Build a better bus." Their slogan was catchy and it resonated throughout the organization. The dilemma of how the embattled bus manufacturer was to survive in the marketplace was shared across each and every employee. Their campaign to "Build a better bus" led the organization to improve the quality of bus manufacturing and enhance product content. The value of their corporate resources increased and Blue Bird's market share grew from 18% to 33%, while large competitors saw little growth. Although the turnaround managers received credit for Blue Bird's new success, company insiders know that it was their own ability to engage the entire workforce in the turnaround process that saved their bus manufacturer from oblivion.

Finding an Appropriate Balance

Some outside turnaround appointments do not work out as expected (Chen and Hambrick, 2012; Kick, Nehring, and Schertler, 2017). Chrysler and Home Depot both experienced drastic cost-out programs, and there have been concerns that cutting too deeply to solve operating problems too quickly may have adversely affected these companies' ultimate abilities to produce high-quality products and service customer needs effectively (Tang and Crossan, 2017). There are no shortcuts to managing a troubled company out of danger; there is no silver bullet to solve all problems. When the emergency team hands over the reins to the successor management team, the next captain must keep the ship out of potential weeds and stay the course towards improved profitability. The maintenance CEO's job requires attention to detail and patience in making progress to move away from insolvency and towards steady cash flows while retaining the viability of corporate resources.

Turnaround managers will always be responsible for making difficult decisions. Some job losses may be inevitable, but necessary, so that a larger group of jobs can be preserved. Facilities may need to be shuttered and compensation programs may have to be altered so that troubled business operations can survive. When managing a carve-out from a distressed situation, it is important to recall that there will be some collateral damage that could affect a population of people who had nothing to do with getting the company into a distressed situation in the first place. What is termed a "redundant role" may, in fact, be a breadwinner working on a production line in South Carolina. The euphemism, "workforce optimization," must consider the human impact of downsizing and seek humane solutions while maximizing financial gains for owners—regardless of who owns the firm.

Wise leaders have invested aggressively in improving their firms' condition by redistributing assets, adjusting internal controls, and optimizing coordinating mechanisms between businesses pre-emptively—at times when competitors cannot afford to do so, *e.g.,* during recessionary times—instead of cutting back on resources and management systems too dramatically during crisis periods when demand becomes uncertain, competitive positions are endangered, and turnarounds must be undertaken (Barbero, Di Pietro, and Chiang, 2017; Lieberman, Lee, and Folta, 2017; Mann and Byun, 2017; Tangpong, Abebe, and Li, 2015). It is better to avoid the human pain and suffering of doing a turnaround process by managing the hard details of operations daily instead of allowing complacency to develop.

SUMMARY AND ASSUMPTIONS

This essay has demonstrated that, in contrast to the traditional emphasis upon retrenchment followed by recovery (Pearce and Robbins, 1994), the private-equity approach to turnarounds emphasizes activities to increase revenues and accelerate cash flows *before* undertaking retrenchment. Attention to mundane details permeates their turnarounds; their Chief Restructuring Office team often trains the troubled organization to stop them from doing stupid things and concentrate on working smarter.

Businesses fail because they have been mismanaged and the financial markets recognize such errors retroactively. Managerial errors have been made in the distressed company, and the impact of those problems has been compounded by failing to take corrective actions fast enough. On a spectrum that ranges from ignorance to incompetence, procrastination can be remedied with varying degrees of success, depending upon how long performance has lagged and how dire are the consequences of managerial neglect. Change is driven by necessity and retarded by fear. Turnaround managers take a proactive stance in correcting mistakes, renewing the company's value, and making predictable decisions that others have resisted undertaking for too long.

Many companies could benefit from confronting the marketplace realities that a private-equity owner's demanding turnaround process necessitates. Too many companies are lagging in performance and their owners are restive about seeing successive quarters of reported losses. Operating cash is becoming scarce for them and financing options are becoming limited because management cannot deliver anything more than breakeven financial results.

Why can't the managers of publicly-traded firms exert the types of controls that private-equity owners instill during their turnaround processes? The shortfall in how managers within publicly traded firms respond to performance crises may be a lack of appropriate talent, but it is more likely that managers have not been sufficiently challenged to perform as well private-equity turnarounds do. Managers within publicly-traded firms may be promoted because they are generalists that have never been challenged to apply the analytical training needed to see the same operating flaws that a specialist retained on a private-equity owner's turnaround evaluation team can identify. The complacency problem may lie in staffing critical functions with inadequate managers since better ones were not available at the wages offered. Perhaps because some managers have never confronted the issues of operating within mature or declining demand environments, they lack experience with generating appropriate responses for managing in the face of adversity. Most certainly the pressures of quarterly reporting to investors will dissuade some managers from taking the temporary financial hits that implementing turnarounds will entail.

Whether a company is in distress or is currently riding the wave of an exuberant market within a young industry setting, effective managers will apply the special competences required in a turnaround process to their firm's day-to-day operations in a timely fashion in order to minimize human pain and suffering. By taking pre-emptive actions, managers may avoid the need for workforce optimization and carve-outs that will leave behind large stub of unrelated operations behind that no buyer wants, *e.g.,* the toxic assets of General Motors. If a turnaround process is successful, the distressed company will be transformed into a cash generating engine that can service its debt and create value for its customers (Pearce and Robbins, 2008).

This essay has also noted that, although a fresh broom may be desirable to sweep out the uncovered garbage, reality sometimes rewards the very same managers who drove the troubled company into distress because appropriate replacements are not available at the time that they are needed and the incompetent managers can follow instructions from private-equity owners. When the ship is finally out of the weeds, a maintenance manager will be recruited to prepare for monetization, but in the interim sometimes compromises must be made in the interest of expediency. When private-equity owners run the turnaround process, their emergency team strives to instill accountability and discipline within troubled organizations during their rehabilitation processes. Managers within publicly-traded firms could apply turnaround methods similar to those used by financial owners' teams to renew their firms' corporate viability. Unfortunately the requirement for publicly-traded firms to post quarterly performance improvements makes it difficult for them to find the slack needed to subsidize turnaround activities. Most firms' resource allocations do not reserve funds for the process of executing a corporate renewal (since such reserve reversals are prohibited by accounting standards). Therefore it is easier to divest the underperforming business (and make it somebody else's problem) than it is to execute a turnaround even though net returns may be higher by operating the problem business instead of walking away from it.

Managers within public-traded companies are constantly under scrutiny by firms' owners who are, increasingly, financial institutions and retirement funds who delegate day-to-day operating decisions to the firm's managers but monitor performance with a short-term bias. The viability of publicly-traded firms' corporate strategies are always being evaluated by shareholder activists who seek to arbitrage some aspect of firms' business mixes or other scope decisions for their profit. Divestiture is an example of one of the event-driven outcomes that activists seek in order to reap their rewards (Chen and Feldman, 2018).

Our essay has reviewed the alternative of turning around distressed operations, typically using outside professionals temporarily for leadership during the transformation to profitability. Taking the perspective of the private-equity investor whose preliminary due diligence has indicated that the troubled company can be revitalized, as well as examples from archival data and inventories of experience, we have provided insights concerning the implementation process and other challenges encountered when performing turnarounds in order to supplement the literature of turnaround management. The process of turning around distressed operations described herein should be of interest to scholars as well as practitioners and corporate directors since it represents the alternative case where the market for corporate control has shifted to favor private-equity organizations that use their own professionals and hired experts to guide the underperforming organization's renewal process to profitability.

Observations contained herein have implications for consulting engagements involving organizational decline as well as for corporate directors as overseers of firm value. Corporate renewal is an ongoing management responsibility. Mismanagement of it cannot be tolerated if divestitures, carve-outs, spin-offs and other resource deployments do not recover value as well as simple disciplined management of operations would do. Our essay should be a considered to be a call to arms for management professors to focus upon managing resources astutely instead of encouraging the incurrence of transaction costs by disposing of resources that have become troublesome to fix. It is time for managers to earn their salaries and become worthy of their titles.

IMPLICATIONS FOR FUTURE RESEARCH

How will managers within publicly-traded firms change their responses to underperformance when a turnaround must be undertaken? Allowing for data availability, scholars will wish to contrast how the performance gap has narrowed over time between private-equity and publicly-traded firms—especially as studies of corporate renewal increasingly highlight what performance disparities exist between different forms of ownership.

As management's performance is benchmarked to document salient differences under alternative forms of ownership, it would be reasonable to expect that investors' expectations of the managers that they employ will increase as investors in publicly-traded firms aspire to earn the types of returns that private-equity owners enjoy. If investor expectations converge, how will managerial autonomy change within publicly-traded companies when managers' turnaround performance is compared with that enjoyed by financial owners?

How will formerly-passive investors become more involved in second-guessing the managers that they employ? Which managerial decisions will be scrutinized most severely under performance benchmarking and what types of shareholder resolutions are likely to be proposed to curtail unwarranted diversification and other types of managerial decisions that may increase firms' operating risk excessively? How will managers' expectations of their incentives and compensation change if shareholder activists (and the investors that they serve) demand that managers within publicly-traded firms change their stewardship approach regarding turnarounds to remedy underperformance in ways that parallel private-equity practices? Will managers of publicly-traded firms demand a share of carried interest for improving their firms' performance?

Armed with greater knowledge of how managers within private-equity firms have approached the challenges of remedying underperformance, how will turnaround practices change within publicly-traded firms? If investors' performance expectations converge, can managerial practices regarding turnarounds similarly converge (or are there too many other expectations that managers of publicly-traded firms will be compelled to satisfy)?

Finance scholars are already benchmarking performance disparities between private-equity and publicly-traded firms in light of diverse exogenous conditions. Soon they will also be benchmarking performance differences in light of comparable internal crises. Strategy scholars will want to develop theory regarding the effective role of turnaround management to guide future policy-making debates.

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Figure 1

How Financial Owners Approach Turnarounds

Are in the business of turning around companies to release unrealized value through continued operations

Are privately owned and do not report financial results quarterly

Raise tranches of capital to fund transformative investments in firms needing turnaround processes before they locate target turnaround candidates

Perform extensive due diligence upon potential turnaround targets to avoid exposure to risks created by past mis-management

Question every assumption about every aspect of operations and mis-understandings regarding the basis of customer acceptance of products

Do not pre-judge the earnings potential of assets that require renewal; do not sell such assets prematurely without making careful efforts to improve the cash flows that such assets may generate if operated

Hire experienced functional specialists to deploy to fix troubled operational areas and train their successors before moving on to their next turnaround assignment

Principals are sometimes seconded to serve as CEOs of portfolio companies to oversee the turnaround process if appropriate leadership is not available and cannot be recruited immediately

Pay attention to small details of cash flows as well as capital expenditures to attain strict accountability when managing turnaround process

Prioritize operating issues differently than managers within publicly-traded firms do

Prices products and services at full cost—charging for accelerated delivery or special services that were formerly absorbed by over-eager sales force

Increases information sharing among affected operational personnel

Revitalizes company culture by reminding employees of the values justifying firm's existence

Why can't the managers employed by publicly-traded firms take the same approach to corporate renewal?

FIGURE 2

Summary of Differences in Turnaround Processes

Publicly-Traded Firms	**Private-Equity Owners**
Retrenchment activities first, including transactions, *e.g.,* divestitures, spin-offs, oftentimes at fire-sale prices	Revenue-generating activities first *(Recovery),* doing divestitures when higher purchase prices are offered
Firm faces fulsome cost of capital and terms because capital markets have lost faith in management's competency	Financial owners invest funding to turn around distressed firms
Redeploys cash to other activities within corporate family	Funds for projects needed to transform company's potential that were not forthcoming within corporate portfolio
Emphasis on cost-cutting activities	Emphasis on raising prices, selling complements and services to self-fund due diligence phase
Lower levels of debt	High leverage as discipline, removing potential slack that could be mis-used
Inadequate managers are replaced	Inadequate managers may be retained during turnaround process, but professional management team is recruited to lead firm to monetization
Successful managers stay with rehabilitated business unit (or are promoted internally)	Professional managers may depart after monetization is accomplished
Successfully-rehabilitated businesses remain in corporate family	Successfully-rehabilitated companies are monetized