

# Is Your Leadership Team Recession-Ready?

## CHALLENGING TIMES OR LEADERSHIP OPPORTUNITY?

Fortunes have been made by those who found opportunities in the face of adversity. And many of those have been CEOs who generated reputations for bringing value to stakeholders in the most difficult circumstances. The current economic environment may well be setting the stage for a new round of stand-out CEOs.

Speculation about recession dominates the business press these days. Turmoil in the capital markets, concern over consumer spending and layoffs fill the headlines. Wall Street Journal economists, Goldman Sachs and the Tatum Survey of Business Conditions are all predicting recession. Even optimists have noted that continuing talk of recession can become a self-fulfilling prophecy.

## TAKE A CRITICAL LOOK AT YOUR FINANCIAL HEALTH IN TERMS OF THE DOWNTURN

In the current environment the daily pressures of managing are exacerbated by the uncertainties evidenced daily on the national news. Companies that were in marginal condition a year ago may benefit from some degree of restructuring this year as a course-correction driven by the economy. Many in the C-suite think the approach of a turnaround situation is obvious. For example, if a company is experiencing successive quarters of losses and is having difficulty paying its vendors in a timely manner, there is clearly need for assistance. But it is important to understand that rarely does a company's financial health deteriorate to that extent overnight.

Many businesses in the early stages of potential difficulty may not be showing the outward earnings or cash flow signs of distress. There are almost always more subtle indicators which, either singly or together, can give management a "heads-up" that there may be some rough waters ahead. These leading indicators may vary in importance across various industries, but they generally are the same few.

Now is the time to consider the early indicators, because erosion of financial performance is like a cancer – by the time the signs are obvious the disease has become harder to remedy. Performing a financial diagnostic during a volatile economic climate is a sensible preventative measure not unlike a basic health screening that enables you to take action before a situation becomes dire.

So how can the C-Suite tell if a changed approach is warranted? Many of today's finance executives have come of age during a strong economic period and may never have experienced recession while in a leadership role. Happily, there are lessons that any business leader can learn from the world of Turnaround Management. Executives who specialize in turnarounds see again and again situations that could have been more positive if the management team had recognized issues at an earlier stage.

## LEADING WARNING INDICATORS

**Declining Gross Margin and/or Operating Margins.** In an environment of steady revenues and prices, declining margins is likely a sign that there is a breakdown in control of production costs. Declining margins could be a signal that raw material costs are rising faster than prices. This can especially be an issue when sales are tied to long-term pricing contracts and there is a spike in energy driven production costs or in raw commodity prices. The mismatch of selling prices to the cost of production can have a substantial negative impact on a company's health in the current volatile business climate. Adjustments to your pricing strategy or a renegotiation of client and supplier contracts may be possible to reverse the trend.

**Inability to Meet Forecasts.** It is not unusual that actual financial and operating results for a given month or quarter might vary from the original annual budget. Prudent management should be constantly updating its forecasts for changing conditions, and advising stakeholders of the revised projected information.

But missing a forecast can also be a sign of more serious problems. It could be a sign that one of the most critical

management tools, the forecasting model, is inadequate. Many companies don't have the systems in place to assemble meaningful predictive models and forecasting may be simply a compilation of the best guesses of sales and operations. Or it could be an indication that there are a wide range of issues from ineffective management to inadequate systems and controls. As top management is all too aware, when there is a pattern of missing these updated forecasts, the credibility of management becomes the first the casualty.

**Increasing Debt.** Cash, whether on hand or as the result of borrowing, is most always an indicator of the health of a company. Lack of available cash coupled with the need to incur debt for capital expenditures or for an acquisition can be positive reasons to incur debt. However, increases in short term debt which can also indicate insufficient working capital.

Sometimes a need for additional working capital that could signal a looming liquidity issue. For example, it is not uncommon for working capital needs to increase in periods of rising sales and production. However, in a period of steady sales and production, rising short term debt could indicate a poor collection of accounts receivable or the lack of production efficiency. This trend can have substantial negative impact on lending agreement covenants. Management should consider having an objective analysis of sources and uses of cash prepared along with a rolling 13 week cash projection. With that information, management can be provided the appropriate advice regarding the alternatives available.

**High Turnover among Employees and/or Management.** Even in today's highly automated world, corporate results are still the product of the efforts of management and employees. When there is corporate health there tends to be stability in the workforce. A high rate of management or employee turnover can be an indicator of deeper issues. It is generally assumed that management would be the first to notice underlying problems and therefore management turnover would be the best indicator.

However, it is equally valid to monitor turnover in the employee ranks, for they are the individuals who "touch" the business and many times see what management fails to see. Understanding the drivers of turnover is important, especially if you see trends in key departments such as sales that may indicate an organizational issue that will eventually impact financial results.

**Declining Market Share.** Market share can be the most difficult and contested business metric that exists, especially if your industry has a substantial number of closely held private companies. However difficult it may be, you need to monitor how well you are doing versus your key competitors by monitoring won versus lost contracts and understand why a customer decided for the competitor.

Loss of market share is a potential indicator that a competitor's product is perceived to have higher value. It can also be the result of ineffective marketing or improper pricing. Also as technology causes rapid changes in products, the failure to keep products current can cause a loss of market share. Recognizing declining market share and the root causes enables the management team to address both immediate and long-term issues before the trend is irreversible.

#### EARLY CORRECTIVE ACTION DENOTES STRONG LEADERSHIP

Taking early action when warning signs first appear is where reputations can be built. All companies face some difficult issues during their life cycle, and CEOs and CFOs who take decisive action are recognized for their keen awareness of their business metrics and the resulting steadiness during business cycles.

An experienced outsider can help assess issues and recommend actions to make a course-correction to a more profitable future. This objective perspective will vastly enhance the speed of insight, given the officers are typically already stretched thin. Remember, when the economy changes drastically the techniques that have worked before may not be effective. There is always a certain loneliness at the top, but this generation's stand-out CEOs would do well to consider how the techniques of Turnaround Management could bolster results. Many pitfalls can be avoided with wise counsel, protecting or even building the reputations of the leadership team who stays ahead of the curve.

*Tatum, LLC is the largest executive services firm in the U.S. With nearly 1,000 executive and consulting professionals in 37 offices around the country, Tatum provides strategic and operating leadership to assist in transitions such as restructurings and leadership vacancies.*