

advantages

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Introduction

2011 is already showing signs of economic recovery and the fear of double dip recession is quickly receding. The absence of a housing market recovery, the high unemployment rate, and rising food and fuel prices, however, seem to be frustrating any form of rapid, consistent recovery, while technology continues to drive shifts in the way we do business. So, if we were to make a single prediction about 2011 – even if a somewhat obvious one – we anticipate that a high degree of unpredictability will persist. In turn, success will go to the businesses which remain nimble and can adjust quickly to dramatic changes in the economic landscape.

To put it mildly, the last three years have been challenging for American business. A number of the survivors should be applauded for cutting costs or extending their lifeline through amend-and-extend and high yield bonds for debt exchange tactics. In many cases, however, those approaches were superficial measures designed to buy time until revenues could recover. They did not address the underlying causes of the problems. For some industries, revenue will continue to decline (newspaper publishing and book retailing come quickly to mind), and the companies that have missed the opportunity to adapt to the new environment will remain vulnerable.

“In times of rapid change, experience could be your worst enemy.” – J. Paul Getty

In this issue, Craig Dean and Shiwali Varshney take a look at the common question: When a business is under pressure and questions its raison d'être, what type of leader is more effective, an industry expert or an outsider? While both certainly need to bring the requisite management skills to the table, when extreme change is called for, we believe an outsider has the best chance of success. Interestingly, AEG has delivered some of our most compelling results when we did not utilize an industry expert as part of our team. As an outsider, we often find it much easier to approach turnaround assignments with an unbiased view and focus on the basics of success: a business should make a profit, should be sufficiently agile to change course quickly, and its capital structure should provide adequate cushion to miss even the most well-thought-out plan.

Recent AEG Engagements

<p>Telecom Equipment</p> <p>Telecommunications Equipment Distributor</p> <p>Business plan assessment and financial forecasting</p> <p>Financial Advisor to the Company</p>	<p>Franchisor</p> <p>Home Business Provider</p> <p>Business plan development and implementation support, financial forecasting and liquidity management</p> <p>Chief Restructuring Officer</p>	<p>Silicon Wafer Recycler</p> <p>Silicon Wafer Reclamation Company</p> <p>Business evaluation, negotiation support for secured lender exit</p> <p>Financial Advisor to Secured Lenders</p>
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Your Next Turnaround Leader: Industry Expert or Outsider?

By Craig Dean, Principal, and Shiwali Varshney, Senior Associate

“You cannot solve a problem from the same consciousness that created it. You must learn to see the world anew.”

- Albert Einstein

Change is difficult, painful and requires a lot of work. Picking a change leader is even a more daunting task. Tomes have been written on the characteristics of a good change leader, with a fair amount of agreement on what those characteristics should be: inquisitive, objective, methodical, careful, a strong communicator, and so on. There is one aspect that has still puzzled most business leaders – should the change leader be an **Industry Expert** or an **Outsider**?

When AEG is approached to advise a company on a restructuring or to become Chief Restructuring Officer, invariably the first question is, “What is your experience in the left-handed widget industry?” It is not an illogical question, and it’s usually just a short-hand method of discerning an individual’s or firm’s expertise.

But almost just as often, we find the problems at companies under stress have little to do with industry issues, and everything to do with fundamental management mistakes: shifting focus and resources away from the core business, poorly conceived and executed go-to-market strategies, lack of understanding of the internal cost structures, improperly priced product and the like.

Based on our direct experience leading change within organizations, we believe an Outsider has clear and important advantages over an Industry Expert. Why? Because the Outsider can start with a clean slate, see beyond the accepted norms of the industry and focus on the elements necessary to lead a business back to health. Recently we have seen a greater willingness of boards to bring in Outsiders as CEOs – hiring knowledge and competence rather than industry expertise – and meeting with success. Examples include Alan Mulally at Ford, Ed Whitaker at GM and Keith Wandell at Harley Davidson.

The Outsider Advantage:

No Sacred Cows

The most common reason for corporate decline is failing to identify practices, products/services and strategies that have become obsolete or unnecessary with time. Therefore, when an organization is in need of dramatic change, we find it is critical to evaluate each and every aspect of a business objectively and make a determination whether it should continue to be part of the business going forward.

For Industry Experts, their experience is two sided. On the one hand, they bring an understanding of common practices and industry players and how they function. On the other hand, those same factors cannot help but color how they look at issues and influence their decision making. Industry norms, prior strategies and sacred cows often drive a resistance to change strategy or a reluctance to exit businesses that are draining important resources.

Let’s look at perhaps the most high profile example, the American auto industry. Why did the Big 3 automakers in Detroit not launch a competitive product when consumers were screaming for smaller and more fuel efficient cars? American car companies were the pioneers of large-scale automated car manufacturing and had long standing practices that were at least intermittently successful (and intermittent success can be very addicting, just think of gambling). Over time, though, Japanese car companies learned to make cars from their American counterparts, but further refined the process. Later, when American manufacturers saw the Japanese producing small, high quality cars, the thought of copying something that was pioneered by the Japanese just didn’t compute. It would have meant admitting the student had surpassed the teacher. This resistance and the resulting disconnect with consumers started a slow, steady decline and the inevitable march toward bankruptcy for GM and Chrysler (as well as a highly vulnerable financial position for Ford). It’s very telling that Ford avoided a bankruptcy with an outsider at the helm, and GM seems to be headed for its best performance in years with an outsider in the CEO slot.

Ford: Ford presents the most dramatic turnaround of the group. When Alan Mulally joined Ford, it was a mish mash of brands – Ford, Jaguar, Land Rover, Aston Martin, and Mercury. “Detroit Big 3” was ignoring the consumer demand for smaller, fuel efficient and high quality cars. Mulally quickly identified the disconnect between customer needs and Ford’s product offerings emanating from Ford’s complex “House of Brands.” He built his strategy behind “One Ford,” focused efforts towards developing smaller fuel efficient cars and divested the luxury car brands that were no longer relevant. Industry insiders viewed this strategy as a sign of weakness, and it likely would have been impossible for an Industry Expert to execute.

Mulally was recently heard calling Ford “the app of choice for car buyers” when launching Focus Electric at the 2011 Consumer Electronics Show – a dramatic change from Henry Ford’s approach of offering a car in any color as long as it was black. To leaders and observers of corporate change, Ford’s approach marked a much needed shift of focus from the assembly line manufacturing mentality to the needs and wants of the customer. A simple and perhaps now obvious concept, but it took an Outsider to make it happen.

Questioning the Status Quo

Over and over again we have seen organizations develop their own belief systems or rules, such as: “The customer will never accept a price increase,” or “We must have plenty of inventory on hand so we can fulfill 100% of customer orders.” Such myths may mislead an organization into pursuing tactics that are harmful to the business, may blind an organization to strategic and tactical options which could enhance performance, and can make an organization feel that it has little control over its destiny.

For an Industry Expert, these “rules” or “myths” are not only difficult to challenge, but often difficult to identify, because he is already a part of this belief system. An Outsider, on the other hand, either through experience or as part of a learning process, brings a natural skepticism to challenge the way things have long been done.

Southwest Airlines: It took two outsiders, Herb Kelleher (a lawyer) and Rollin W. King (Herb Kelleher’s client), to figure out a way to make money in the long-ailing airline industry. They questioned the status quo and broke a host of sacred rules of the airline industry:

- Flew point-to-point instead of following a hub-and-spoke strategy;
- Reduced training and maintenance costs by using only one type of aircraft - the Boeing 737;
- Reduced labor costs by cross-training and cross-utilizing their employee base;
- Pioneered electronic ticket booking and reduced the cost from \$6-\$8 to \$1 per ticket; and
- Developed a process to turnaround an aircraft at the gate in 10 minutes, keeping the airplanes in the air longer and generating more revenues per plane.

As a result, Southwest remains the only company in the airline industry that has consistently delivered a profit over that last decade, while some estimates indicate that the other leading airlines have lost a combined total of \$55 billion during the same period.

The Industry Experts at the other airlines still seem puzzled how to make lasting and fundamental changes to drive consistent profitability. Many continue to generate losses even after going through multiple bankruptcies, which were intended to cleanse them from past sins.

What has industry got to do with it?

True, industry characteristics determine the profitability potential of a company, and that in turn drives an optimal cost structure. While it’s counter-intuitive, though, industry sometimes has little impact on business performance. Managers often tend to confuse the status quo with Industry knowledge, in essence surrendering to inertia or to misplaced optimism that eventually leads to a corporate decline.

US Mint: Take for example the US Mint. It is a state-owned monopoly and has high demand for its product. There certainly is no industry reason for poor performance. Yet in the early 1990s it was struggling: profitability was declining and customer service was dismal.

In 1994, President Clinton appointed Philip Diehl, an Outsider, as director of the US Mint. Diehl applied the most basic of business concepts – connect with the consumers, develop products that meet the customer needs, measure and improve performance, and make a profit. He started changing the expectations of customers, the government, and employees. He

opened the organization to the needs of its consumers. As a result, by year 2000 the US Mint was shipping 95% of its orders within 2 weeks (up from 50% of orders in 8 weeks), launched new products such as the 50 state quarter program, and made the Fort Knox guard unit into a revenue-generating operation. During Diehl's reign, the US Mint's profitability increased from \$727 million to \$2.6 billion.

Conclusion

Einstein's comment that you must learn to see the world anew sums up our experience and belief about leading change. A clean break from the past is a necessary ingredient. A change leader above all should be objective, able to see through unfounded myths and should have a good grasp of business fundamentals. Industry knowledge often is secondary and may be a detriment to objective and breakthrough thinking. Of course, there are Insiders who have been able to maintain the detachment from the past with great success. Robert Iger of Disney and Steve Jobs of Apple have done so. Those examples are few and far between for a reason.

AEG NEWS AND EVENTS

AEG Partners partnered with Neal Gerber Eisenberg and organized and presented a seminar on "Human Factor - and its Effects on Corporate Success in Uncertain Times." **Craig Dean** and **Shiwali Varshney** discussed symptoms and **diagnoses of ineffective corporate leadership**, focused on **non-traditional methods to assess a company's ability to weather economic uncertainty**. Nick Miller and Bill Tarnow from Neal Gerber Eisenberg highlighted the challenges and approaches to reorganizing management to increase leadership effectiveness.

Principal **Craig Dean** was quoted in an article by Tom Hals from Reuters regarding Hal's findings at the Turnaround Management Association January Distressed Debt Conference. "...Craig Dean of AEG Partners in Chicago pointed to the trade show business. After nine straight quarters of decline because of shorter conferences and falling attendance, the business is drowning in too much capacity and falling prices. He sees similar problems in consumer products companies and retailers such as Borders Group Inc. Borders, the No. 2 U.S. bookstore chain, said Thursday that it got a new financing commitment, but was also exploring options including a possible 'in-court restructuring.' 'Borders is a poster boy for that,' Dean said."

Shiwali Varshney has been named a **Certified Turnaround Professional – Designate** by the Turnaround Management Association. The designation signifies successful completion of the educational and professional endorsement requirements of certification, and is a major step toward full certification as a Certified Turnaround Professional.