Operational restructuring: an important turnaround strategy

Management often cites operational restructuring as necessary for improving efficiency, controlling costs, and coping with the changing business environment. In reality, how effective are restructurings in improving the operating performance of firms?

There are mixed conclusions. While some restructurings are able to establish firms in a more efficient and competitive position, others may cause organizational disruptions, unsettle a business, and create uncertainty about a firm's future operating earnings and cash flow.

For example, IBM, a world-known computer technology and services company, had approximately 405,000 employees in 1985. In 1992, IBM suffered $5 billion in losses. By 1994, IBM had taken a series of restructuring actions and cut its workforce to 219,207 to "streamline and reduce resource utilized in the business". IBM began emphasizing consulting services with its 2002 purchase of PricewaterhouseCoopers Consulting for $3.2 billion. IBM also began selling off its low-end product divisions in 2005. Over the course of nearly 100 years of doing business in the field of information technology, IBM has evolved in an ever-changing environment, and remained as a pioneer in its industry, using restructuring as one of its important tools.

However, restructurings can sometimes be an indication of incurable operational problems and/or financial troubles. Take Montgomery Ward for example. In the 1980s and 1990s this company was one of the well-run retail chains in the country. But sales margins began to slip in the mid 1990s in the competitive electronics and appliance markets, which traditionally were Ward's strongest lines. Its once revived mail-order business also slowed. In 1997, Montgomery Ward filed for bankruptcy. It had been struggling to compete with other low-cost retailers such as Wal-Mart and Target. After emerging from bankruptcy, it abandoned the specialty store strategy, closed 250 stores in 30 states, and spent millions of dollars renovating its remaining outlets. In December 2000, after lower-than-expected Christmas sales, the company announced it would go out of business, close its remaining 250 stores, and lay off its 37,000 employees.

Needs for operational restructuring

The decision to restructure is driven by a number of considerations. At times, restructuring is in response to significant "sea" changes in the business environment while in other cases it is done to address poor operating/stock performance. Both internal and external economic and financial conditions can drive the decision to restructure. Additionally, votes of no confidence in management will likely lead to corporate restructuring.

Changing business environment

Restructuring often occurs as a response to major changes in the business climate and/or surroundings, such as technological or product innovations, changes in tax laws, deregulations, and/or foreign competition. Changes in market demand and expectations can cause a firm to find that it is offering the wrong products or services or that it has the wrong business model.
Poor operating performance and stock returns

In announcing a restructuring, managers typically cite the need for restructuring to deal with poor performance. Restructurings are often preceded by a decrease in profitability.

Financial distress

Financial distress refers to a condition when a firm incurs more debt than its firm size, profitability, and asset composition can sustain. With declining ability to generate revenue coupled with inadequate cash flow from operations, a financially distressed firm will be trapped into severe liquidity problems, consequently affecting its solvency.

Economic recession

Corporate restructurings tend to be concentrated within times of economic recession. Recessions threaten the survivability of businesses. Data on industry performance shows that over 500,000 companies failed in the 1990 and 2001 recessions in the USA. A weakening economy will cause decline in product demand. This makes credit more difficult or expensive to access, and therefore, presents a greater challenge for financially weak firms to manage through the down cycles.

Corporate disciplinary events

Corporate disciplinary events such as management turnover, changes in the management compensation plan, or shareholder activism frequently precede corporate restructuring programmes, such as refocusing and divestures. This suggests that restructurings are sometimes initiated to reduce conflicts between shareholders and top management teams and to correct past inefficient expansion, diversification, or operational missteps.

Typical activities of operational restructuring

For a firm that incurs losses, cost control is often the first step to return to profitability. Slashing labour costs, production costs, R&D expenditures, and financing costs are common measures of corporate restructurings. Downsizing and employee layoffs are the restructuring actions that are typically taken to cope with poor operating performance, especially within contracting economies.

Corporate restructuring also often involves refocusing or eliminating non-core businesses. A firm might curtail diversification in order to concentrate on its core businesses. Moreover, a firm may find its needs in shifting its product or service focus to stay competitive in the market. In this case, a change in firm skills may be necessary. In addition, a firm might decide it has too much capacity or has capacity in the wrong locations – for example, high-cost locations or far from target markets. Accordingly, some adjustment activities in response to these issues will be considered by management.

Implications for practice

The following are primary factors that differentiate survivors from losers, and the associated key restructuring strategies to managing through the difficult times.

The timing

The decision to restructure can be driven by many factors, and is often a tough decision to make. Ideally, managers should anticipate a crisis and act pre-emptively, before being overtaken by the event.

Greater value can be created when a restructuring is done pre-emptively rather than under the threat of financial distress or hostile takeover.

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However, it is often difficult to persuade corporate stakeholders to restructure without the presence of an imminent crisis.

The negative effect of a restructuring change on the firm’s income can also affect the timing of the decision. Managers may choose not to restructure, as they can be reluctant to admit past mistakes. Labour laws and unions may make it costly for firms to lay off employees. Finally, organizational restructuring might be hard to implement if employees resist the change. These barriers show that a rational decision-making process is needed to determine the optimal timing for implementing a restructuring plan.

**Cost retrenchment and downsizing**

In a time of economic recession and performance decline, retrenchment is indispensable to conserve cash flow. Cost retrenchment (e.g. reducing labour, production and R&D) is found to be an effective strategy to achieve turnaround. It is also a necessary strategy to survive a recession. There are a variety of cost retrenchment methods. Examples of cost reduction include divestures, liquidating out-dated inventory, consolidating functions, product elimination, outsourcing and headcount cuts.

Although the strategies above can be beneficial to business in some ways, managers should be aware of the possible negative impact. For example, outsourcing can result in false economies. Many companies underestimate the time, money and people it takes to manage distant operations effectively, and overestimate the overall cost savings outsourcing can bring.

**Refocusing**

Greater focus is associated with both operating-performance increases and higher stock returns, especially when firms exit businesses that are underperforming or unrelated to their core businesses.

Selling a division that is losing money is a common strategy. For example, Qualcomm sold its cell phone manufacturing business to Kyocera, a Japanese handset maker in 1999. Analysts said Qualcomm was losing money by selling handsets and could be more profitable by focusing on its semiconductor and CDMA licensing business.

Unrelated businesses can distract attention and capital from a firm’s core businesses. Home Depot sold its “HD Supply” division to private investors for $10 billion. The division sells infrastructure and maintenance products to builders, municipalities, and other businesses. The division was launched in 1997 and expanded via expensive acquisitions, most at the height of the home-building boom. The former CEO, Robert Nardelli, initially saw the supply business as a defensive counter to dips in the cyclical housing market, but in fact the supply division sold to home builders as well. Critics complained that the supply business was “a distraction, gobbling up funds needed to improve staffing, renovations and computer systems at its stores”.

**Maintaining liquidity and solvency**

For a financially troubled firm coping with economic recession, liquidity and solvency present the two greatest challenges. Liquidity deals with a firm’s ability to meet short-term obligations when come due. Solvency measures a firm’s ability to pay its long-term debts and meet its long-term fixed expenses. In order to determine the optimal capital structure, a firm should weigh the advantages of debt – such as shielding tax and reducing agency costs – against the likelihood of incurring debt-related financial distress. For firms that are loaded with large debt, keeping up with the payment schedule is especially difficult in bad times and endangers its solvency.

To cut debt, firms can use proceeds from the liquidation of inventories, receivables, property plant and equipment, or a division to extinguish their obligations. For instance, in 2003, British industrial controls and automation firm Invensys sold software division Baan
for $135 million as part of its strategy to spur growth and reduce debt (Invensys acquired Baan for $708 million at the height of the tech boom in 2000).

**An important turnaround strategy**

Operational restructuring has been considered as one important turnaround strategy for a firm in a bad situation, especially during an economic recession. However, the delisting risk of restructuring firms increases when firms undertake repetitive restructurings, massive workforce reduction, and large-scale asset downsizing. Moreover, firms with high levels of debt and failure to cut costs and/or narrowing its focus on core competencies are also more likely to delist.

In terms of quantitative analysis, although the logistic regression is a commonly used method when analysts attempt to identify the relationship between variables and output, it is not without limitation. For example, the logistic regression may only focus on the static relationship between delisting and factors at the time of restructuring, and ignore events occurring in between. It is suggested that more sophisticated methods be considered, such as the Cox survival model and event-history analysis, using longitudinal data to take time into consideration in the evolving process of restructuring.

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