NAC **Executive Insights**

Perspectives on a Turnaround – A Case History

Key Points

- Turnarounds are a real element of the engineering and construction industry.
- Many of the actions taken during a turnaround are in reality long overdue.
- The responsibility of boards is brought into sharp focus during a turnaround.
- The lessons learned from this turnaround are broadly applicable.

Introduction

In March 2016, a new board was formed for an Australian Stock Exchange (ASX) listed company. The firm operated primarily in the planning and environmental sector across multiple markets. Its prime interests were in Australia and the U.S. Additionally, it had some secondary business enterprises: an engineering operations business, a software business, a materials testing business, and a struggling international development business.

The new board was brought on following investment by patient private equity, which remains invested in the company to date. The public nature of the firm demanded an independent board despite effective 50 percent ownership by private equity.

The new board was immediately confronted with the reality that this was a firm on the verge of bankruptcy. Due diligence had missed a number of key items, including a consent decree with the U.S. Department of Justice; outrageous retention and change of control agreements put in place with the CEO and a handful of managers during the due diligence process; and grossly overstated carrying values for most assets related to goodwill. Cash flow was an immediate challenge and time was of the essence. Immediate action was required.

The new board had no choice but to undertake a rapid and broad turnaround and, to a high degree, begin micromanaging the firm's operations. This turnaround touched every aspect of the business in a very short period of time. When a mistake was made, a quick adjustment to the board's overall approach was required.

By the end of 2016 the software business was sold for $49 million. The net proceeds of the sale were used to strengthen the company's capital structure and to further reduce net debt. The company also sold its U.S. mining business for just under $1 million.

An operation for a U.S. testing business that had been discontinued in 2015 was restated ($23.4 million) by an adjustment to the impairment loss. This together with other similar adjustments resulted in a significant prior-year adjustment to goodwill carrying values. The extent of the adjustments was such that the new board contemplated suing the prior board. Because that would have resulted in incurring the cost of the prior board's defense, the lawsuit was never brought forth.

Capital still was needed, both for the turnaround as well as to reduce debt. The board therefore undertook two separate capital raises on the public markets during 2016, tripling the number of shares outstanding. As a result of the capital raise and restructuring:

- There was a non-cash impairment charge of $154.3 million, reflecting performance issues and the impacts from the sale of the U.S. testing business and specialty engineering operations in the U.S.
- Net debt was reduced from $311 million to $49 million as a result of the two capital raisings, the sale of the software business, and cash generation in the business.
- Intangible assets decreased from $548 million to $346 million due to the write down in goodwill, primarily in the Americas.
- Trade and other receivables plus inventories less trade payables decreased from $271 million to $183 million through a strong focus on working capital management and the sale of the software business.
- Net tangible assets increased significantly from $22 million to $231 million over the year due to the pay down of debt.

All of the above actions happened in the new board's first nine months. The board's goal going into 2017 was to undo many of the poor decisions taken by the previous senior management and board in the previous three years.

From an operations perspective, the new board focused on shifting decision making from the head office to geographic managers and empowering those managers to drive change and execute.

Entering 2017, the new board continued its complete balance sheet review, moving past the major 2016 items that had now been dealt with. A review of the balance sheet both from a leverage perspective as well as a general review of the carrying value of assets was needed. Also, a number of business and office consolidations were required.

The board continued to push decision making to divisional management (the capability of managers was a challenge as was a resistance from the center), to rebuild the trust of its staff, and to invest in business development.

The company moved to a position of effectively no (net) debt, appropriate provisioning on outstanding contracts (as a result of risk and contingency reviews), and debtors and assets that reflected what the board believed was realizable value.

Business review and restructure costs ($56 million) were incurred in the year, including costs ($9 million) associated with redundancy and restructure, costs ($10.7 million) associated with closing or

consolidation of 32 offices, provision ($23.3 million) related to business reviews including the closure of a number of loss-making divisions, and realizable value of assets on the balance sheet, costs associated with debtor provisions ($11.5 million), and indirect tax ($1.5 million).

The board was able to achieve a significant decrease in aged debtors and work in progress (WIP). The value of greater-than-60-day debtors decreased by one-third over the 12-month period and WIP decreased 15 percent through faster billing cycles.

Operationally the new board grew the company's Americas earnings before interest, taxes, depreciation, and amortization (EBITDA) margin through revenue growth and pricing discipline, not by further operating cost cuts.

Early in 2017, a review of the corporate head office was completed, which narrowed the role and size of the head office and eliminated the regional management layer. The new board put in place clear delegations of authority to ensure that divisional management and operational staff had clear decision-making ability and accountability for their cost structures.

At the same time, immediate and decisive actions were taken to invest in people, implement consistent employee contracts (an Australian practice) for senior managers, and put in place realistic and achievable short- and long-term incentive goals and bonus structures. These bonuses were based on what the staff were able to influence and on outcomes created at a local level. In addition, the refocus on accountability and local decision making resulted in a marked improvement in staff engagement. This translated in a much lower staff turnover compared to prior years.

This fast-paced transformation was accompanied by operational changes, including a number of significant hires in business development in Australia and in the U.S. For example, in Australia a dedicated major projects team received significant investment. Also, a chief risk officer was recruited. The internal audit function, previously discontinued by the outgoing board, was reinstated.

In order to close out small or loss-making operations, the new board sold an African operation serving the energy market, closed a loss-making drone operation in the Americas, and sold a small coal consulting operation and a non-core software division. Even as these non-strategic businesses were being eliminated, the board completed two bolt-on acquisitions.

The dividend program was halted by the new board. Instead, it opted to move to a share buy-back program. This was believed to be a better use of capital at that time.

In 2017, its first full year of engagement, the new board:

- Improved revenue per client by focusing on cross-selling of all the company's services.
- Continued a focus on operational efficiencies and conservative fiscal and balance sheet management.
- Added small, carefully considered bolt-on acquisitions to supplement existing divisional business.

- Dismissed the CEO, who could not deal with the pace of change effectively, and appointed one of its own board members as an interim CEO.
- Subsequently, a CEO was recruited and replaced the interim CEO.

Lessons Learned

The perspectives presented here focus on the turnaround aspects of a board working in a role as a non-executive director. There are other aspects to this particular board role that are noteworthy: addressing strongly similar but different cultures in Australia and the U.S.; addressing ineffective integration of a multitude of prior acquisitions; and importantly, engaging with effective venture capital ownership and control.

The particular lessons learned from this turnaround perspective include the following:

1. **Do the due diligence** – in this instance it included venture capital's initial investment.
2. **Prohibit certain changes after an initial acquisition/investment approach** – changes to the prior board's and senior officers' employment agreements were not in the best interest of the company and directly affected the initial pace of the turnaround.
3. **Rigorous project and business reviews are required** – effective monthly project reviews are needed as are effective monthly business reviews. These were initially hampered from the lack of effective integration of prior acquisitions. There needs to be consistent business language and metrics. Here, there was a professional services and supporting services element that led to differences in detail. Balance sheet, income, and cash flow metrics require consistency. The same could be said for safety, employee satisfaction, and how risk is assessed.
4. **Time is not a friend** – in turnaround situations, the banker will be paying close attention to its investment. Problems get exponentially worse if left to fester. Act, assess, and adjust.
5. **There are three financial statements** – balance sheet, income statements, and cash flow must be worked all of the time. The intimacy of the relationships between these three takes on greater urgency in a turnaround. Various bank covenants and regulatory requirements make the challenges even more daunting when a business is under stress.
6. **Goodwill is neither tangible nor cash** – goodwill write-offs are not desirable. Cleaning up the balance sheet and putting the focus on cash and income are. Goodwill and its potential impairment need closer examination since the rising risk of impairment highlights the challenges being brought to the underlying segment of the business.
7. **Make bankers partners** – Bankers do not want a venture to fail, putting their investment at risk. Renegotiate covenants and terms.
8. **Leadership matters** – the true character and capabilities of leadership become apparent under stress.
9. **Look for non-value adding elements of the organization** – this should be a regular exercise in any company, but the laser like focus a board can bring does make a difference. A board facing a prospect of a covenant breach cannot afford to leave anything critically unexamined.

10. **Put responsibility and accountability where it makes a difference** – the old centralization/decentralization debate will never be resolved. When one must make decisions and take actions quickly across the organization, it is best if line managers are empowered. That does not mean operating in a vacuum, but rather enabling, helping, and observing results.
11. **Incentivize performance** – those who are making a real difference are essential and should be rewarded. Even when faced with financial pressures, one must take care of stellar employees and those who demonstrate an ability to deliver the results that are absolutely required. This applies during both normal and tough times.
12. **Growth cures many problems** – two adages are worth stating: (1) Grow or die. (2) Nothing good happens until a sale is made.
13. **Strengthen differentiation** – in a turnaround, it is essential that a company put forward its competitive advantages and strengthens them. Even in the face of financial challenge, a business must be willing to invest for success.
14. **Sharpen brand focus** – the organization and importantly its people are challenged and stressed during any turnaround situation. They need identity, shared beliefs, and purpose. In this particular turnaround, that need was further challenged by the failure to integrate myriad prior acquisitions.
15. **The board is responsible to the shareholders** – the obligation to shareholders resides with the board, not with the CEO, although this latter version is often the belief. In this particular turnaround and given the difficulty the CEO had in acting in a timely manner, the board micromanaged the company. This is not desirable for any company or in any situation.

About the Author

Bob Prieto was elected to the National Academy of Construction in 2011. He is a senior executive who is effective in shaping and executing business strategy and a recognized leader within the infrastructure, engineering, and construction industries.

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