Value Creation Logic – Not Budget Logic – Is Key to Successful Turnarounds

Profits come from the gap between revenues and costs. So it is not surprising that when a downturn hits (typically in the form of lower demand and revenues), the typical emergency response is to develop plans to (a) increase revenues, and (b) decrease costs. How this is done, however, explains the difference between successful turnaround strategies and incremental, cosmetic responses.

A common problem in managing in downturns is the tendency to pursue actions to grow revenues and reduce cost, but with little coordination across those actions. If uncoordinated, these actions may be ineffective and even counterproductive. During the last three years, I have seen organizations trying to weather the crisis by mandating budget cuts across all business units or department, so that all budgets are reduced by a similar amount across the board. At the same time, aggressive revenue growth targets are set, even as units are facing budget cuts. Not surprisingly, the results of such policies tend to be marginal and unlikely to create a lasting impact. Cost reductions are more likely to involve postponement of costs or investments (reducing maintenance cost, reducing marketing or training cost), rather than true and sustainable cost efficiencies. Because units have fewer resources, revenue growth tends to come from incremental extensions. While these additional revenues may help at moments of low capacity utilization, the profitability of those incremental revenues is typically weaker than in the core activities. As a result, these new sources of revenues are unlikely to be sustained when demand returns to core activities and capacity is at a premium. At best, this approach leads to reducing losses during a downturn, but does little to improve long-term competitiveness.

Most strategy research has focused on understanding the sources of superior performance, but a small literature has sought to understand the determinants of successful turnarounds (e.g., Pearce and Robbins, 1993, 2008; Barker and Duhaime, 1997). Rather than focusing on incremental revenue growth and cost reductions, successful turnarounds focus on value creation (focusing on products or services with the greatest gap between the customers' willingness-to-pay and the opportunity cost of resources). The principle of value creation requires an integration of the revenue and cost sides, and therefore avoids the incrementalism of the budget logic. Of course, such integration is more difficult for companies that are organized around functional structures, where marketing looks after revenues, and operations looks after costs. Not surprisingly, an effective recipe in turnaround management is to deploy cross-functional teams (popularized by Lee Iacocca's turnaround of Chrysler), which are able to cut through the silo mentality and align marketing and operational activities around the principle of value creation.

Research also suggests that successful turnarounds often involve more radical, rather than incremental, strategic changes. Typically, those successful turnarounds would involve a period of strategic retrenchment (focusing on those core markets, activities and capabilities where the company still retains strong advantages, and abandoning others which may no longer fit), followed by a period of transformation or renewal (developing a new scope based on these sources of strengths). Lou Gerstner's turnaround of IBM, transforming the organization from product to service focused, is a textbook example of retrenchment and transformation.

It is true than in some cyclical downturns, it may not be necessary to perform a full-blown strategic turnaround. In those contexts, the focus might be on surviving and conserving resources, in preparation for a rebound. But for many organizations, a downturn is also an opportunity to realign strategy at a time when there is a strong sense of urgency. For those companies, as economist Paul Romer (and Rahm Emanuel) said, "a crisis is a terrible thing to waste".

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