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Rebuilding Business Profitability

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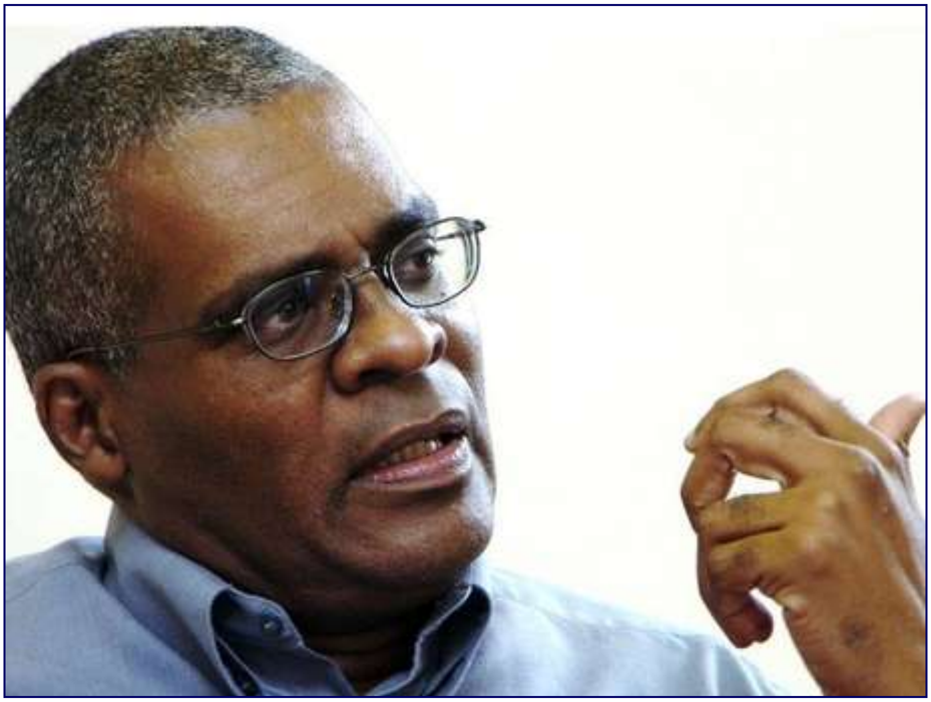

Dr William Lawrence, Guest Writer

There is an urgent need for more information to guide managerial decision-making on how to breathe fresh life into a commercial entity for recovery from profit decline.

During 2010, most of the firms listed on the Jamaica Stock Exchange (JSE) reported profit decline or losses relative to the prior year, 2009.

The Global Entrepreneurship Monitor Jamaica Report 2008 revealed that less than two per cent of small business owners believed that their ventures would grow and create jobs over the next five years.

Many business executives and entrepreneurs blamed economic recession for the misfortunes of their firms.

The recent global financial crisis, regarded by some economists as the worst since the Great Depression of the 1930s, created liquidity shortfalls in banking systems around the world, triggering substantial contractions in credit and international trade.

A changed environment, called 'the new normal', has emerged with features such as more volatile consumer demand, heightened competition and greater propensity for business failure.

However, analysis done by Mona School of Business at the University of the West Indies showed that real growth of gross domestic product (GDP) explained only 18 per cent of the variability in losses reported by firms on the JSE.

Therefore, company leaders need to be alert to not only economic recession but also other possible causes of decline.

RECOGNISING DECLINE

The early signs of decline can be subtle but if managers delay in admitting the problem, there is further erosion of resources to weaken the firm.

Later stages of decline appear as working capital deficiency and negative net worth. Profit turnaround is only worthwhile attempting if the going-concern value of the firm is greater than its liquidation value (Hofer 1980).

FINANCIAL RESTRUCTURING

When the firm is unable to pay its bills as they become due, managers must urgently retrench assets and restructure debt to defer or shrink the burden to an affordable level. The degree of success depends on support from creditors and ease of coordinating the effort.

Profit turnaround is impossible if the balance sheet remains weak. Forced sale of assets often yields only a fraction of the proceeds possible under normal market conditions but may be necessary to stop cash erosion. Sale and lease back of assets can raise money while retaining use.

Strategies for debt restructuring, such as rescheduling, sale of equity and refinancing, help to improve cash flow. However, some firms need temporary protection from adverse creditor reactions in order to restore financial health. An appropriate bankruptcy code can provide this vital breathing space.

PROFIT RECOVERY

A change of strategy is not always required for profit turnaround. However, when the source of decline is external, the firm needs to adjust its corporate or business strategy for better alignment between firm behaviour and the external environment.

Expansion is beneficial when there is unmet consumer demand for which the firm has resources and can realise competitive advantage. Contraction is useful when the firm has underperforming assets and cash crisis. Restructuring is required if the firm has low competitiveness but core business strength. Stability is a strategy to combat low productivity if the firm has competitive advantage and resources.

Increased operating efficiency is necessary for profit turnaround. This may be achieved by expanding the scope and scale of outputs or reducing cost and waste. Some firms also improve technology while others boost supply-chain throughput.

A ROADMAP

For any firm, the correct way to rebuild profitability depends on the answers to three questions asked in sequence. Is the company in cash crisis? If so, financial restructuring is necessary. Is the source of decline external to the company? A change of strategy is required if the answer is affirmative.

Is performance recovery taking place? If not, the process must be repeated, and perhaps through a different route.

Firms should strive for turnaround on the first attempt because each failed effort consumes resources to further weaken the company. Moreover, there must be congruence not only across the different levels of strategy but also among strategies and tactics or initiatives.

To rebuild business profitability, the firm must focus on both economic value and organisational culture - the psychology, attitudes, experiences, beliefs and values emanating from the totality of people, systems and structures in place to implement strategies and tactics.

Managers need to lead by example, assure transparency and open lines of communication, motivate teamwork, reward performance and deliver on promises.

Finally, to sustain profit turnaround, firms need to have a cushion of resources, called organisational slack, to absorb environmental jolts and fund strategy execution.

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