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Which way forward for underperforming companies?

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Although companies facing temporary problems can usually improve investor perception within a short period of time, an underperforming company steeped in negative sentiment must usually embark on a focused transformation that forces significant changes to the way it approaches its business. While the interests of diverse stakeholders—equity shareholders, lenders, vendors, customers and employees—influence the development of an underperforming company's transformation strategy, the equity markets seek convincing signs that a company is undertaking necessary change.

Faced with uncertain outcomes and reduced financial resources, a company that effectively communicates with shareholders and other equity market participants can increase the probability of successful turnaround. Value investors not only focus on how well a company's CEO and CFO handle the turbulence that arises from drastic change but also assess the frankness and consistency of their communications.

In fact, we do not often agree with the market's collective reaction to a company's problems but instead look for specific financial, structural and competitive characteristics to decide if a meaningful transformation can be accomplished within an 18- to 24-month period. Understanding the causes of a company's performance problems, specifically the internal and external factors that contributed to the company's current state, not only allow us to determine if those problems are temporary, they help us judge which corrective course is likely to improve the company's prospects and provide insight into management's ability to effect needed change.

Our verdict on management begins with an analysis of the impact of internal and external factors on the company's competitive position, cash flow and overall financial strength. We undertake an extensive analysis of a company's competitive position to determine if its leading revenue-producing products have moved from a growth phase toward maturity—a phase marked by sales volume peaks and proliferation of competitive products. How a company's strategic planning process anticipates, plans for and implements change during both favorable and unfavorable periods is the most crucial test of management's skill.

We recognize that even management teams focused on creating long-term shareholder value face considerable pressure to provide consistent growth and strong quarterly results. As investors, we are willing to look past underperformance due to management's mistaken reading of external elements if we believe the company's internal controls, fiscal discipline and proposed corrective measures are aligned with shareholders' long-term interests. Since most external elements, such as an economic downturn, changing market dynamics or new regulatory constraints, are likely to affect all companies in a particular industry, we want to understand how certain companies reduce the negative impact of external factors to maintain solid financial results.

Our analysis has consistently highlighted several internal factors that separate strong performers from their underperforming counterparts: senior management that has a clear understanding of its industry combined with realistic performance expectations, disciplined financial management and effective operating controls; a sturdy balance sheet and ability to generate free cash flow; and, most importantly, a management team that has adequately planned for the challenges of an unfavorable environment.

Regardless of a company's size, we examine all internal factors that may have contributed to poor performance and assign specific priorities to factors that need to be sufficiently addressed in the company's transformation strategy. Our first priority is to determine whether the CEO and CFO have demonstrated a history of clear, candid communication with shareholders. We review several years of shareholder communications—annual reports, news releases, presentations and public filings—to judge the viability of the company's strategy and verify that management has engaged in frank discussions of the company's progress and failings.

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Are accounting policies and disclosure practices conservative or creative? Is all relevant information to assess both risk and reward properly disclosed? Are shareholder letters consistent and do they measure current performance against previously stated objectives? Does management deal with reasonable, company-specific performance metrics or is it overly promotional by paying too much attention to the current stock price?

Senior management that acknowledges the company's problems, employs conservative disclosure practices and articulates a clear understanding of the competitive environment and appropriate transformation strategy is the starting point for separating viable investment situations from classic value traps.

Our next priority is to determine whether management understands the importance of financial strength—cash flow, working capital controls and the strengthening or declining health of the balance sheet. Many CEOs and CFOs state that cash flow and a solid balance sheet are top priorities but engage in strategies that contradict their stated resolve. In such situations we are less concerned with what management is saying and more concerned with what management is actually doing. Our analysis of shareholder communications, particularly recent annual reports and press releases, must provide satisfactory answers to the following questions.

Do the financial statements reflect a commitment to transparency or has the company used accounting smokescreens to misrepresent economic reality? Are key decisions based on long-term objectives or meeting quarterly earnings estimates? Are free cash flow and reported earnings comparable? Are management incentives aligned with shareholder interests and is management collectively a material owner of the company's stock?

Managements that adopt harmful short-term strategies or continue to leverage their balance sheets not only reduce the company's maneuverability when faced with an economic downturn, they also deprive the company of other viable options such as share repurchases, payment of sustainable dividends and meaningful strategic acquisitions.

The third internal factor is the quality of the company's proposed turnaround strategy. Most successful transformations require a significant strategic repositioning, a redefining of business boundaries, and new business unit strategies that respond to customer needs. In many cases the current CEO and senior management team fail to grasp the significance of the changes needed to stem the decline and reverse the company's fortunes. We frequently encounter management teams that cannot admit to a failed initiative or acknowledge their inability to keep pace with market trends. Compounding this management weakness is constant pressure from Wall Street to maintain and grow revenues even if the unrelenting pursuit of growth proves to be a profitless course of action. We applaud a corporate leader who thoughtfully analyzes the situation, understands the company's strengths and weaknesses and takes the time to craft a viable strategy that addresses the company's most pressing problems.

Since many aspects of management and corporate leadership are intangible and difficult to measure, management's communications to shareholders and potential investors provide a valuable key to judging management's effectiveness. As value investors who seek out companies trading at a significant discount to our determination of their private market value, we spend a great deal of time poring over financial statements to understand the story the numbers tell us. If management's public communications contradict our understanding of the company's strategy, results and future prospects, our analysis focuses on whether current management is suited to the task at hand. Management teams often blame factors beyond their control—unforeseen economic conditions, fluctuations in capital markets, shifts in buyer behavior, unexpected competition or rapid technological changes—for periods of poor performance. Yet an examination of several years' worth of company financial statements almost always points to internal factors as the principal causes of a company's problems. Experience has taught us that a management team that fails to acknowledge shifts in its competitive environment or has repeatedly failed to address internal signs of decline cannot lead a transformation that closes the valuation gap between the company's stock price and its private market value. **F**W

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