THE SUCCESS TRAP: HOW GROWTH CAN MASK SIGNS OF A DETERIORATING BUSINESS

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An emerging growth company is in its fourth year of life. Revenues are increasing by 20 percent or more year-over-year. The management team—frequently the founder and a few close confidants who signed on early—is excited, and its enthusiasm flows down through every level of the company, particularly as the entire team regularly pitches in at the warehouse to get products out the door. Everything looks rosy, and visions of a lucrative exit strategy are starting to enter into conversations throughout the company.

Amid all this excitement, the warning signs of pending difficulties are going unnoticed because management lacks the time and/or training to notice them. A few of the danger signals that might be flashing are:

- **Aging Accounts Receivable.** As the team celebrates sales, collections are lagging. Some accounts may not deserve terms, but credit checks are perfunctory in the rush to bring on new customers and increase revenue. Other customers take advantage of lax collection efforts to improve their own working capital positions.

- **Inventory Imbalances.** As high-demand products are backordered, slow movers begin to stack up. Although inventory turns might appear healthy on the surface, there is a cancer growing in the body.

- **Quality Control.** Supply chain errors are multiplying as vendors are pushed to meet demand, and receiving controls are lagging or are overridden to drive shipping. Shipping errors are growing, resulting in increasing numbers of returns and customer allowances.

- **Aging Accounts Payable.** Earlier unnoticed warning signs culminate in cash shortfalls and vendor payment demands. The most vocal vendors are paid, while those that are patient and supportive bear the brunt of the lack of cash.

- **Controls.** The failure to file key documents in a timely manner is a clear indicator of a critical lack of controls. Late tax filings and state registrations and the failure to maintain good-standing certificates should ring alarm bells for management.

The apparent success the company is enjoying today is a trap, and this emerging growth company is on the verge of crashing due to the lack of discipline, analytics, and controls. The story is not unusual.

One turnaround client, for example, was a small, family-owned manufacturing business with two major product lines: a stock product with a limited number of SKUs and a highly engineered product line customized to each customer's unique needs. Although revenues were increasing, cash resources were stretched, and management submitted a borrowing base report to its asset-based lender that accelerated the recognition of accounts receivable. Management acknowledged this misstatement and corrected the borrowing base within 24 hours, but the lender requested that the company retain a consultant to address mounting losses and diminishing cash.

Customer and product line contribution analyses demonstrated to management that their stock product line was highly profitable and had a favorable working capital profile. In contrast, the highly engineered product line, although providing a favorable gross margin, had a negative contribution margin after below-the-line expenses were allocated through detailed analyses. Moreover, the inventory stocking requirements for raw materials necessary to meet the turnaround times for customers of this customized product line were driving working capital shortfalls.

Based on these analyses and recognition that prices could not increase enough to generate an acceptable contribution, the client abandoned the highly engineered product line and pared the underlying fixed costs associated with it. The consultant used its product line contribution analyses to develop pro forma historical financials and forecast financials, and secured a new lender for the company.

Although the client didn't realize it at the time, its lender's insistence that the company retain a consultant was the best thing that could have happened to the company. Before the consultant arrived, the company did not have the resources or inclination to do the deep dive that was critical to restoring it to financial health.

Avoiding Trouble

How does today's emerging growth company avoid becoming the turnaround of tomorrow? The following are a few key steps that will help it avoid that fate:

- **People.** The skills that brought the company to the dance are unlikely to be those it needs to prosper at the next level. A retailer that grew from a single store to more than 40 scattered across the country transferred one member of the management team into three different roles, hoping to repay his loyalty. He failed at all three. After the man floundered in his first role, it was evident to all but the company's founder that he would suffer a similar fate in the other two positions he was assigned.

  Loyalty is an admirable trait, but a company must weigh rewarding someone's loyalty against his or her prospects for future success or failure. An outside resource or an advisory board can help assess management team members and their roles going forward. In particular, it is important to ensure that the company's financial talent is top-notch, whether that is achieved by staffing an internal position, hiring a consultant, or adopting some combination of the two.

- **Systems.** All companies have failures in product lines and services. Businesses that thrive are those with

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the tools to assess quickly to identify products, services, and customers that are not meeting expectations and take quick corrective actions.

While it may appear to be overkill, the company should establish from the start the mechanisms to track its business by customer and customer type, product, and product line. The more granular the data, the more management can glean from a deep dive. For example, if the company serves both big box and small retailers, can management assess the *contribution* margin of each—including inventory carrying costs, markdown money, promotional funds, and other costs? The results may be surprising.

- **Analytics.** Combining the right people and the right systems provides robust analytics—the ability to slice and dice data to discern patterns of profitability and purchasing behavior. These tools don't just identify problems; opportunities also emerge.

  For example, an apparel manufacturer, with assistance from a database expert, analyzed cross-purchasing behavior across product lines and assigned behaviors to key customer groups. Promotional activities based on this work led to increased customer penetration and greater revenues from a high-margin accessory line.

  While it may be too early in a company's life cycle to have a full-time employee driving these analyses, there are many highly qualified resources available on a consulting basis.

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- **Working Capital Management.** These are basic blocking and tackling skills and disciplines that are often neglected in the rush to manage day-to-day business and keep the customer satisfied. These practices should include:

- Monitoring accounts receivable closely. Credit lines should be extended judiciously, and a company shouldn't be afraid to place an account on credit hold; customers that are poor credit risks can be like quicksand and drag the company down with them. One technique used with an overextended account in the past involved collecting the full amount on any new shipment plus some reasonable percentage of that shipment's invoice amount (*e.g.,* 10 percent) to be applied to past due invoices before release of the new shipment.

- Micromanaging inventory and moving quickly to sell through slow-moving SKUs. As a former colleague was fond of saying, "Inventory is not like fine wine; it does not improve or increase in value with age." Product life cycles dictate how aggressive a company should be with its disposition plan. Products that tend to be usurped by new introductions (*e.g.,* consumer electronics or fashion apparel) require rapid and regular action, while inventory excesses of basics frequently can be addressed through supply chain management.

- Developing strong vendor relationships. Accounts payable should be managed with care, balancing the positive effect on working capital of stretching payables with the value of strong and positive vendor relationships. Vendors that are treated as business partners are frequently willing to work with a company when presented with a reasonable request, such as allowing for extended terms as inventory is built for seasonal requirements.

- Remembering that cash is king! A rolling 13-week cash forecast should be used and continuously refined to anticipate working capital requirements. If a company needs to work with its lender to address temporary cash shortfalls, this level of diligence can go a long way toward convincing the lender that a seasonal or temporary overadvance will be repaid.

Some readers will remember an old advertisement for Fram oil filters that featured the tag line, "You can pay me now or pay me later." The clear message was that the cost to fix a problem later would be considerably higher than the cost of preventive maintenance today. Similarly, investing in the skills and resources that focus management on these critical factors will pay dividends in the future as growth is disciplined and profitable. J

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